BANK PORTFOLIOS: MILES FROM NOWHERE
BY NATHAN MOEDER

There is a formidable $2.3 trillion problem of bad loans facing the financial industry. These institutions, which are the backbone of our economy, ultimately face a long road ahead and will continue to negatively impact the economy.

The CMBS market totals 54,000 loans and $625 billion of paper. But added to this is another load of loans on banks' books totaling $1.7 trillion that is yet to be fully acknowledged or worked out. According to Deutsche Bank, $1 trillion of exposure is classified as "core" commercial properties, $532 billion of construction and land loans, and $150 billion of multifamily (including conversions). Moreover, the $1.7 trillion total exposure in commercial real estate loans represents more than 25% of banks' total assets.

This is a very troubling level of financial exposure. In the era of easy money and loose underwriting, banks found it increasingly difficult to compete with the highly demanded CMBS paper at low interest rates. In their efforts to keep the lending window open, banks identified new real estate and finance sectors which required more aggressive lending practices dependent on "pro forma" cash flow (e.g. projecting impossible high returns each succeeding year) or taking on risky construction land loans.

We've now been witnessing the impact of this exposure: more workouts and creative strategies (at best) by developers to stay in the game. In an ultimate expression of denial, some banks have recently been known to sell their nonperforming notes, then turn around and finance the new acquisition just to avoid a complete loss on the books.

This systemic problem is far from over. In fact, it's just beginning.

Loan Performance

The total delinquency rate for CMBS paper has increased at the rate of 120% in the last three months. According to Deutsche Bank research, the delinquency rate reached 1.8% in March 2009. By June 2009 it had rocketed to 4.1%. This pace already exceeds the corrosion experienced during the 1990s downturn, and total delinquencies are anticipated to reach 6% to 7% by the end of the year. This rate could increase further as more properties do not meet their performance projections.

The CMBS defaults cover all vintages, and include loans originated from 1999 through 2008. The most common reason was maturity defaults which occur when a project cannot refinance due to stricter underwriting standards, even if the property has been generating cash sufficient to cover the existing debt load. Increasingly, however, loans are not even reaching maturity due to weakened cash flow, which is classified as "term defaults." As expected, the losses are much greater for loans that have weak cash flow – nearly 2.5 to 3.0 times greater than loans that simply mature.

Not all lenders are sharing equally in the problem. Based on a portfolio review by Deutsche Bank, construction loans (which represent the greatest exposure) are more common for smaller banks. For the top 19 largest banks, the exposure to construction loans since 2003 was only 0.7% to 2.1%. But for banks ranked 20-50 the exposure was 4% to 6.5%; and for banks ranked 51 to 97 the exposure was 5.2% to over 9%. This isn't surprising and is consistent with the business strategy of smaller banks seeking new sectors to finance and compete.

The more alarming concern is the default rates for loans held by banks. Bank commercial real estate loans have significantly underperformed relative to CMBS. In fact the delinquency rate is two to three times higher than CMBS loans. This gap may close in the next 18 to 24 months, but it is still likely that it will be higher than CMBS due to more aggressive lending practices that were engaged to originate these bank loans. So while we read about a $625 billion CMBS market, we should really be concerned about the $1.7 trillion in commercial real estate loans.

This enormous risk is now coming due. An estimated 65% to 73% of loans that are lucky enough to survive to maturity will not qualify to refinance. This refinancing debacle is due to properties not being valued as high as initial forecasts. As a result, properties cannot take out a loan large enough to retire the existing debt. So owners and lenders are stuck. It’s extremely unlikely that rents and occupancy rates will recover fast or high enough to soothe the problem. Lenders should recognize this now and act diligently to work out, not around, the situations before losses begin to mount.

Fixing the Epicenter

The banking sector is no longer just suffering a refinancing problem. They now have a major cash flow problem. Across all sectors, except for health care, vacancy is up. It’s a tenant’s market. A total of one million square feet of vacant office space has been added to the San Diego inventory in 2009. The industrial market has increased by three million vacant square feet. The current vacancy rates now stand at 15.3% for office and 7.7% for industrial. This is reflected in demand as nationally the unemployment rate has reached a 26-year high of 9.7% (matching the 1983 level).

Fixing the banking problem means fixing the economy. Simple to state, harder to do. To find signs that the financing sector is stabilizing, one must first look for signs that the economy is stabilizing.

The key to recovery is to discover the “next” economic generator that will occupy the space in our industrial and commercial buildings. In the past this included diversification of new sectors such as bio- and high-technology. More recently it was consumer spending, easy money and construction jobs. Today, we are attempting recovery with stimulus, clunkers and green technologies. But we need more than this. We require greater consumer confidence, which will likely return once the monthly job losses stem. When people feel better, they think positively, act positively and begin making acquisitive business decisions.

The solution must be comprehensive and encompass all sectors. It will require the participation of banks to lend money to companies for expansion, hiring, and capital improvements. It’s a long road ahead, and it feels like the banks are miles from nowhere, but over time we can achieve the step by step process to get there.