

UNDERSTANDING THE COMMERCIAL REAL ESTATE DEBT CRISIS

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The popular, if simplistic, understanding of the most recent economic crisis is that it was triggered by the bursting of an unprecedented residential real estate bubble. In this narrative, the bubble was caused by interrelated factors—the irrational beliefs of homeowners that property values would continue to rise and the aggressive lending practices, which focused on maximizing the size and volume of loan originations at the expense of prudent underwriting. Although we see signs of a slow recovery,¹ the bubble’s collapse continues to have a destabilizing effect on every corner of our economy and society, from financial institutions struggling with “toxic assets” on their balance sheets, to community disruption caused by residential foreclosures.

Although the total amount of outstanding commercial real estate debt is less than a third of the amount of outstanding residential debt,² there is increasing concern that a commercial real estate debt crisis is on the horizon. The Congressional Oversight Panel, chaired by Elizabeth Warren, issued a report in February 2010 that warned that a commercial real estate debt crisis could cause a “second wave of property-based stress on the financial system.”³ Given the potential threat to our fragile recovery, we should act quickly to understand the scope and causes of the looming collapse of commercial real estate so that we can

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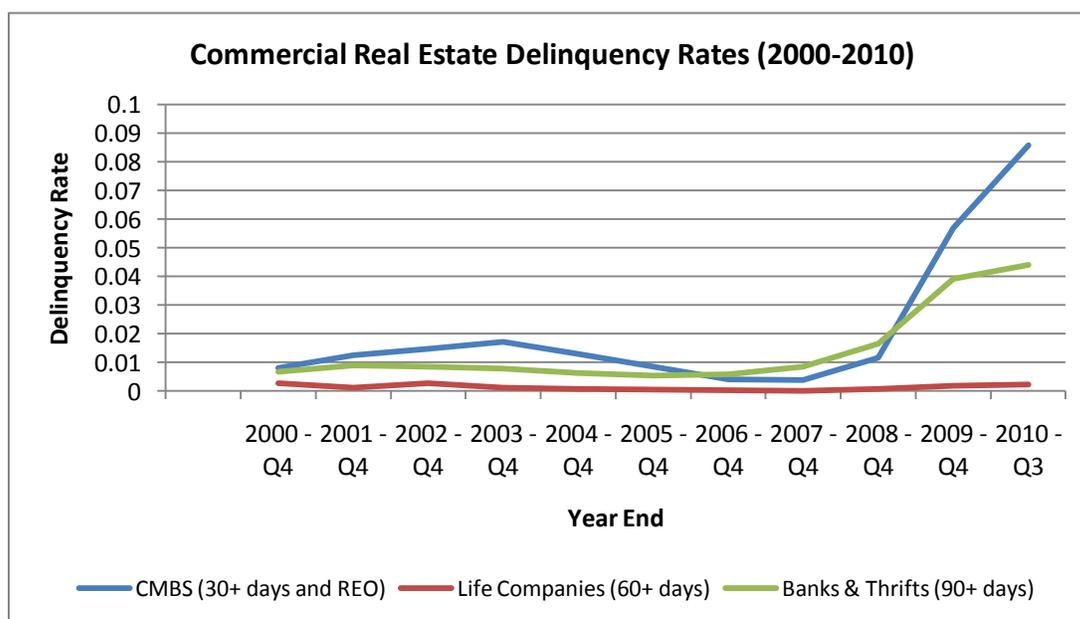
¹ See Sudeep Reedy, *Jobs Setback Clouds Recovery*, WALL ST. J., Dec. 4, 2010.

² Total outstanding commercial real estate debt is currently \$3.2 trillion compared to \$10.6 trillion in outstanding residential real estate debt. *Flow of Funds Accounts of the United States: Flows and Outstandings Third Quarter 2010*, FED. RES. STAT. RELEASE (Bd. Of Governors of the Fed. Reserve Sys., Wash., D.C.), Dec. 9, 2010, available at <http://www.federalreserve.gov/RELEASES/z1/Current>.

³ See, e.g., Cong. Oversight Panel, February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability 6 (2010), available at <http://cop.senate.gov/reports/library/report-021110-cop.cfm> [hereinafter COP Report]; *CRE Complications Infecting Small Banks, May Cause Double Dip, Says Hill Roundtable*, 3 REAL ESTATE L. & INDUS. REP. 840 (BNA) (Nov.18, 2010) (quoting Rep. Walter Minnick as stating that “the losses are coming, and if the CRE credit markets are not stabilized, the losses could . . . trigger both an avalanche of bank failures and the much talked-about second dip of the recession”).

craft appropriate policies to mitigate losses and prevent future problems. As we analyze the issues, however, we need to be careful not to summarily adopt the prevailing narrative of the residential crisis—that irresponsible borrowers and aggressive lenders are to blame.

Increasing Delinquency Rates. In comparison to residential foreclosure statistics,⁴ the commercial real estate debt problems currently appear to be mild.⁵ Over 50% of outstanding commercial real estate debt is held by banks, which reported that as of September 30, 2010, only 4.41% of such mortgages were more than 90 days delinquent.⁶ However, as the table below shows, the delinquency rates for commercial real estate mortgages have shown steady and marked increases since the beginning of 2007.⁷ If these trends do not reverse themselves soon, commercial real estate defaults will become a significant issue, particularly for our nation's banks.



Source: MBA Report, *supra* note 6.

⁴ In the third quarter of 2010, nearly 14% of residential mortgage loans were in foreclosure or at least one payment past due. Although the overall delinquency rate is improving, the percentage of loans that are 90 days or more past due remains almost four times the average percentage over the past twenty years. *See* Press Release, Mortg. Bankers Ass'n, Delinquencies and Loans in Foreclosure Decrease, but Foreclosure Starts Rise in Latest MBA National Delinquency Survey (Nov. 18, 2010), <http://www.mortgagebankers.org/NewsandMedia/PressCenter/74733.htm>.

⁵ In the third quarter of 2010, 8.58% of mortgages held in commercial mortgage backed securities, which represent 25% of outstanding commercial real estate debt, were at least one payment past due or in foreclosure. *Commercial/Multifamily Mortgage Delinquency Rates for Major Investor Groups, Third Quarter 2010, SURV.* (Mortg. Bankers Ass'n), Dec. 2010, available at www.mortgagebankers.org/files/Research/CommercialNDR/3Q10CommercialNDR.pdf.

⁶ *Id.*

⁷ *Id.*

Comparing Residential and Commercial Real Estate Debt. There are important differences between residential and commercial real estate debt that make it difficult to analogize causation factors. The most common residential default is failure to make monthly loan payments because the borrower has suffered an economic setback, such as unemployment, or because the loan was structured so that payments dramatically increased at some point during the term. In some cases, particularly if a property has suffered increased vacancy, commercial borrowers also default due to a failure to make monthly payments. But the increasingly common commercial defaults are “maturity defaults” in which the borrower is unable to borrow a large enough sum to pay off an expiring loan.⁸ The difference between the balloon payment owed on the maturing loan and the amount that can be borrowed today is the “equity gap.” The equity gap is caused by two factors: falling valuations of commercial real estate and lack of liquidity.

All lenders use written and informal guidelines to analyze potential loans to residential and commercial borrowers.⁹ These “underwriting standards” are a product of market conditions, guidance from federal banking supervisors, and internal decisions about risk tolerance. Underwriting standards include pricing decisions (fees and interest rates), loan-to-value ratios, creditworthiness of the borrower or guarantor, and loan covenants. The extent to which a lender conducts due diligence on property, borrower, and guarantor is also determined by underwriting standards.

A residential real estate loan is underwritten by evaluating both the market value of the property and the creditworthiness of the borrower. The value of residential real estate is primarily determined by analyzing the sales prices of comparable properties, and therefore values can fluctuate widely over time. Regardless of the value of a home, the borrower’s financial stability and ability to repay the loan are critical components of residential underwriting. Relaxed underwriting standards clearly contributed to problems in residential real estate because: (1) Many homes were over-valued during the 2000s; and (2) many borrowers qualified for loans that they were unlikely to repay even in the most optimistic circumstances.¹⁰

In commercial lending, the collateral and the borrower are both evaluated, but the emphasis is on the ability of income-producing real estate to continue to generate income in an amount sufficient to cover operating expenses and debt

⁸ *The Impact Of Economic Recovery Efforts On Corporate and Commercial Real Estate Lending: Hearing Before the S. Cong. Oversight Panel*, 111th Cong. 33 (May 28, 2009) (Statement of Richard Parkus, Head of CMBS and ABS Synthetics Research, Deutsche Bank Securities, Inc.) [hereinafter COP Transcript].

⁹ Real Estate Lending Standards, 57 Fed. Reg. 62,900 (Dec. 31, 1992) (codified at 12 C.F.R. pt. 365.2).

¹⁰ COP Transcript, *supra* note 8, at 34.

service.¹¹ Most commercial real estate is owned in a single-asset limited liability company or limited partnership, which serves to segregate exposure to contract and tort liability. This ownership structure is significant in the debt context because most permanent commercial real estate loans are non-recourse or limited-recourse to the parent company or individuals behind the single-asset entity. Therefore, the creditworthiness of that parent is not a significant factor in underwriting because it is unlikely that they will be called upon to satisfy a deficiency. The experience and ability of the owner to operate the collateral to obtain maximum return, however, is highly relevant.

It has been estimated that commercial real estate has dropped in value 35-45% since the height of the market in 2007.¹² That decline is the result of two factors: (1) Downward pressure on rent and increasing vacancy rates; and (2) increasing capitalization rates. The value of commercial real estate is generally estimated by dividing the net operating income of a property by a capitalization rate. The capitalization rate is essentially the market's attempt to quantify the risk in collecting a particular income stream in the future. Capitalization rates are impacted by macroeconomic phenomena like liquidity and tax policy, and microeconomic factors like local unemployment rates and supply and demand of the type of asset. A lower capitalization rate results in a higher property value and a higher capitalization rate results in a lower property value. Capitalization rates are problematic where a market is stalled, as ours is, by limited liquidity and decreased demand.¹³ Capitalization rates have increased significantly since 2007, which has in turn devastated appraisal values of commercial real estate. As a result, many borrowers who have no problem making monthly mortgage payments find themselves in technical default because of low appraisals that fail to satisfy required loan-to-value ratios.

The more significant problem is that borrowers of performing assets are finding themselves in maturity defaults, unable to refinance expiring debt. Unlike residential loans, which normally fully amortize over a 30-year term, permanent commercial loans normally partially amortize over a 10-year term. As a result, every ten years the borrower must refinance a balloon payment. Over \$1.4 trillion in commercial debt will mature before 2013.¹⁴ Combining the dramatic increase in capitalization rates with the sluggish capital markets, borrowers and lenders are

¹¹ Fed. Fin. Insts. Examination Council, Policy Statement on Prudent Commercial Real Estate Loan Workouts (2009), *available at* <http://www.occ.gov/news-issuances/news-releases/2009/nr-ia-2009-128a.pdf> [hereinafter FFIEC Report].

¹² COP Transcript, *supra* note 8, at 34.

¹³ FFIEC Report, *supra* note 3, at 31-32.

¹⁴ Deutsche Bank, CMBS Research: The Future Refinancing Crisis in Commercial Real Estate 7 (2009), *available at* <http://cop.senate.gov/documents/report-042309-parkus.pdf>.

faced with an equity gap that some analysts have estimated will exceed \$800 billion.¹⁵

Understanding What Went Wrong. A few governmental agencies have begun to review the issues surrounding commercial real estate debt, particularly in the contexts of small business lending and the stability of banks and thrifts.¹⁶ The February 2010 report by the Congressional Oversight Panel (COP) is the most thorough attempt by policymakers to describe the challenges posed by commercial real estate debt. But one weakness of the COP report is that it adopted the narrative borrowed from the residential crisis—that aggressive underwriting by lenders is largely to blame.¹⁷ The COP primarily relies upon surveys of senior loan officers¹⁸ to summarily conclude that “faulty”¹⁹ and “dramatically weakened”²⁰ underwriting standards resulted in “riskier” commercial real estate loans during the mid-2000s.²¹ The COP assumes too much when it relies on broad survey information that underwriting standards were “relaxed.”²² For example, lowering the interest rate on a commercial real estate loan, or providing a ten-year rather than five-year term would constitute weakened underwriting standards but would not make the loan inherently riskier. Empirical work should be done to evaluate changes over time in debt service coverage ratios, reserves, and loan covenants before we can conclude that the reported “easing” of underwriting standards during the 2000s resulted in riskier loans.²³

¹⁵ COP Transcript, *supra* note 8, at 34.

¹⁶ See, e.g., *Managing Commercial Real Estate Concentrations in a Challenging Environment*, FIN. INST. LETTERS (Fed. Deposit Ins. Corp., Arlington, Va.), March 17, 2008, available at www.fdic.gov/news/news/financial/2008/fil08022.html; *The Condition of Small Business and Commercial Real Estate Lending in Local Markets before the H. Fin. Services Comm. on Small Bus.*, 111th Cong. 4–8 (February 26, 2010) (Testimony of Stephen G. Andrews on behalf of the Independent Community Bankers of America) [hereinafter *HFS Hearing*].

¹⁷ The Executive Summary to the COP Report states that “[t]he loans most likely to fail were made at the height of the real estate bubble when commercial real estate values had been driven above sustainable levels and loans; many were made carelessly in a rush for profit.” COP Report, *supra* note 3, at 2.

¹⁸ See Release, Bd. of Governors of the Fed. Reserve Sys., The October 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices 33 (Nov. 9, 2009), available at <http://www.federalreserve.gov/boarddocs/SnloanSurvey/200911/>; see also Office of the Comptroller of the Currency, Survey of Credit Underwriting Practices 2006, at 25–27 (2006), available at <http://www.occ.treas.gov/publications/publications-by-type/survey-credit-underwriting/pub-survey-cred-under-2006.pdf>.

¹⁹ COP Report, *supra* note 3, at 28.

²⁰ *Id.* at 27.

²¹ *Id.* at 20.

²² The surveys may also be challenged by other data as not all senior loan officers agree that underwriting standards were relaxed during the 2000s. Wells Fargo Chairman Richard Kovacevich has stated that at his institution, commercial real estate underwriting was actually “more disciplined” during that decade compared to previous periods. See Ari Levy & Daniel Taub, *Defaulting Commercial Properties Hit Banks on Vacancy-Rate Rise*, BLOOMBERG, Mar. 22, 2009.

²³ In another example, the COP stated that “lax underwriting” is apparent in CMBS loans made from 2005–07, relying on data which shows that the number of interest-only and partial-interest-only loans contained in CMBS portfolios during those years increased significantly. Again, however, the COP summarily concluded that the partial- or non-amortization of a commercial real estate loan necessarily leads to the conclusion that such loan was “risky.”

In the absence of empirical evidence, it is important to challenge the COP's connection between weakened underwriting standards and increased risk because of the strong moral dimension in political responses to the broader financial crisis. It is human nature to balk at helping those that we believe created their own problems. Understanding the root causes of the commercial real estate debt crisis, and determining whether "blame" can be appropriately assigned to "reckless" borrowers or to "aggressive" lenders may have a significant impact on our policy responses.

Conclusion. Determining how that equity gap will be satisfied, and by whom, will be a major challenge over the next few years. If borrowers cannot raise the funds, then lending institutions, particularly local and regional banks and thrifts, will be confronted with severe losses.²⁴ Government action will then likely be needed to prevent commercial real estate debt from derailing our fragile economic recovery. Given the potential political and economic impact, it is important that empirical work be done to fully investigate the factors that have contributed to a commercial real estate debt crisis.

COP Report, *supra* note 3, at 22.

²⁴ HFS Hearing, *supra* note 16, at 5.