Commercial mortgage delinquencies on the rise

Non-residential loans will soon deepen banks' woes

By Beth Braverman

AFTER HOLDING RELATIVELY firm over the past year as residential mortgage delinquencies climbed steadily, default rates on commercial mortgages are starting to head higher as well. That spells more trouble ahead for banks and other lenders, although not on the scale seen in subprime residential mortgage lending.

Although commercial mortgage delinquencies remain near historic lows, the eroding fundamentals in the commercial real estate market and continued weakness in the overall economy mean more commercial mortgage holders will have difficulty meeting their obligations, according to experts. Overly aggressive commercial mortgage underwriting and deteriorating commercial real estate values mean some commercial real estate mortgages may be worth more than their underlying properties, but contracting credit markets and lenders' risk aversion have put an end to easy refinancing. Sound familiar?

An increase in commercial mortgage delinquencies and defaults will create ripple effects throughout the financial world, with commercial banks—the largest providers of commercial real estate loans and big holders of commercial mortgage-backed security debt—taking the biggest hit.

"There are an awful lot of banks out there that are vulnerable [to commercial real estate write-downs] because of loans they put on their books for good customers who expected to be able to refinance their loans in the capital markets or by borrowing from life insurers," said Larry Longua, a professor at New York University's Schack Institute of Real Estate. "But [the borrowers] aren't able to do that right now."

Commercial bank write-downs on commercial real estate, which come on top of write-downs in residential real estate, financial instruments and other troubled investments, have already begun to increase. Banks with more than

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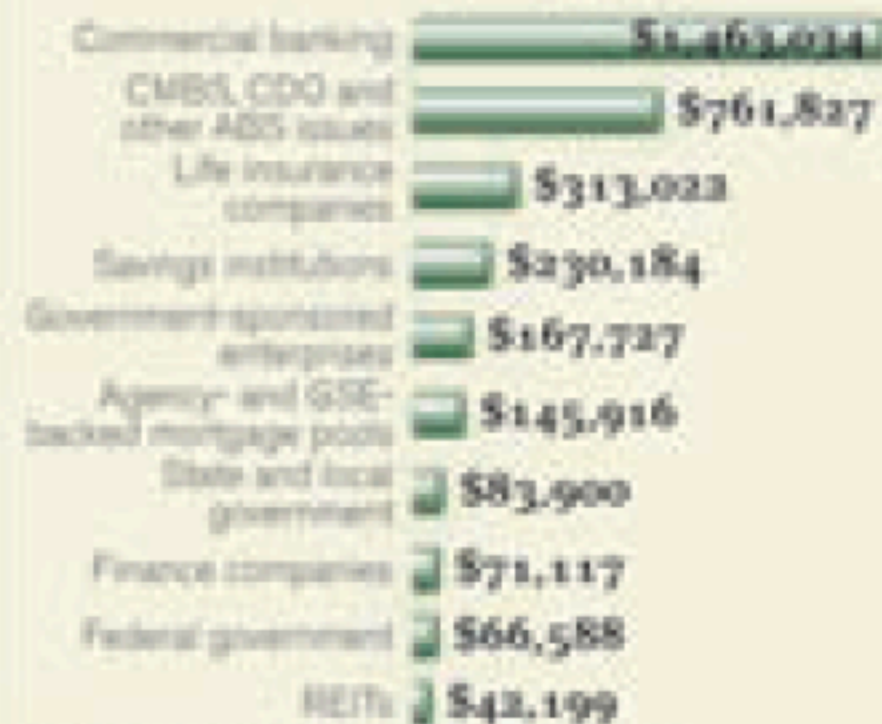
Holders of outstanding commercial and multifamily mortgage debt



Notes: Data as of June 30. In millions.
Source: Federal Reserve flow of funds.

CMBS

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$10 billion in assets charged off 0.2% of non-farm, non-residential loans in the first nine months of 2008, according to the Federal Deposit Insurance Corp. The rate remains low, but is more than three times the rate of charge-offs for the same period in 2007.

"The banks don't know how or when they are going to be repaid," Mr. Longua said. "Even if these loans are performing, they are very likely underwater."

Commercial real estate values have declined progressively this year, a trend expected to continue through 2009. Sixty-eight percent of senior real estate executives surveyed by the Real Estate Roundtable last month said commercial values will be lower next year, while 27% believe prices will be "much lower." An Urban Land Institute report in October said commercial real estate will bottom out in 2009, flounder in 2010 and begin a slow recovery in 2011.

The trend in the CMBS markets highlights rising investor fear of increased delinquencies. The cost of insuring highly rated mortgages stood about 500 basis points above benchmark interest rate swaps on the Markit CMBX index last week, double the spread a month earlier. The spreads spiked in mid-November, after Treasury Secretary Henry Paulson announced that the Troubled Asset Relief Program would not follow through on a plan to buy troubled assets but instead inject capital into banks.

Although investors in CMBX have clearly priced in a spike in defaults, the defaults themselves may not occur until 2010 or 2011, when many of the loans written at the height of the commercial real estate boom in 2006 and 2007 reach maturity. Of the almost $800 billion in outstanding CMBS, only about $41 billion comes due in the next 18 months, according to real estate research firm Reis.

"The big spreads are pricing in a pretty negative scenario," said Michael Van Konynenburg, president of real estate investment banking firm Eastdil Secured. "Whether or not that's realized is dependent on the overall health of the U.S. economy."

He is hopeful, however, since property owners who can hold vacancy rates in check will have the means to continue to service their mortgages—at least until their loans mature.

"While there was a lot of aggressive lending in commercial real estate at the end of the cycle, it wasn't nearly as aggressive as what we saw in the single-family area," Mr. Van Konynenburg said.

Many loans made in 2006 and 2007 carried 75% to 80% loan-to-value ratios and interest rates of 5% or 6%, he said. The underwriters of commercial loans did consider the underlying cash flow of properties, which differentiates them from many subprime and Alt-A loans in the residential sector, where lenders did not consider buyers' ability to service the debt.

But the fundamentals that supported the commercial real estate loans have deteriorated along with the broader economy. Mortgages for sectors like retail and office space, where tenant losses and rent declines have been more pronounced, will perform worse than others, experts said.

"There are going to be losses and defaults, but they're not going to be on the same scale as in residential single-family," Mr. Van Konynenburg said. FW