Now, Commercial Real Estate Collapse Is On

by John Hoefle

Oct. 2—The panic spreading across the world about the perilous state of the U.S. commercial real estate sector is not about buildings, but about debt—the vast quantities of debt represented by commercial mortgages and the derivatives piled atop them.

As the economy collapses, so do the values of the office buildings, shopping centers, and commercially owned residential properties. While a few of these properties are owned outright, most of them have huge mortgages and other debts attached.

According to the FDIC, $4.7 trillion of the $7.6 trillion in loans outstanding at U.S. banks and thrifts in the second quarter were secured by real estate. Having 60% of their loans secured by real estate when values are plunging, is more than enough to make the bankers nervous. The banks also hold $1.4 trillion in mortgage-backed securities.

The commercial real estate sector, while smaller than the residential real estate sector, is a $3.5 trillion market. And while values have fallen by some 40% since their peak in 2007, the debts remain due. That presents a major problem for property holders, most of whom are leveraged to the hilt. Many bought their properties in the anticipation that real estate values would continue to rise, and that their debts could be refinanced when they came due. Guess what? They were wrong.

Derivatives, Again

The commercial real estate market, in its current form, is an outgrowth of the global derivatives market, and in particular, that subset of the market known as securitization.

By now, many of us are familiar with the role of mortgage-backed securities, collateralized debt obligations, and the myriad other securities tied to the residential real estate markets. By issuing securities nominally tied to the income streams from mortgage payments, and the repackaging of those securities into different instruments, speculators were able to create derivatives whose "values" were greater than the values of the underlying mortgages. The proceeds from these securities sales were then used to make more mortgage loans, to allow the creation of more securities, and so on, in a toxic spiral. It was this game that drove home prices to dizzying—and unsustainable—heights, creating a mortgage bubble that burst with horrific consequences. It was called a "subprime" crisis, but in reality it was a derivatives crisis.

The same game was played in commercial real estate, and that game has broken down, too. The result is that many of the mortgage-holders are unable to pay their mortgages, and many of the securities issuers are unable to cover their debts. Just as with residential mortgages, the losses are skyrocketting for all involved.

Many of these commercial mortgages are relatively short-term debt, intended to be rolled over when they come due. In the past, with securitization in full swing, that process was relatively automatic. Lots of money was available, and both the borrowers and lenders had a vested interest in keeping the game going, and keeping property values rising. Not any more. With property values off more than 50% on some buildings, the owners are unable to refinance loans as they come due, and defaults are growing.

At the same time, the market for the commercial mortgage-backed securities (CMBS) and their derivatives, has dried up. The only thing keeping the market from complete collapse is the Federal bailout scheme, which is financing a trickle of activity.

The bailout program is not nearly enough to deal with the demand. Some $1.4 trillion of commercial real estate mortgages will come due in the next five years, and about half of that will come due in the next three, according to analysts. Nearly all of those loans will need to be refinanced, but the prospects for doing so are nil.

Ron Sandler, an analyst with Crosswinds Capital, recently estimated that commercial banks and thrifts have $1.8 trillion in exposure to commercial real estate, plus another $300 billion for life insurers, $190 billion for Fannie Mae and Freddie Mac, and $350 billion for private lenders and others. In addition, he estimated another $900 billion in exposure to issuers of CMBS. That's a $3.5 trillion hole in the system, without counting all the knock-on effects.

Holding the Bag

By a significant amount, the bank with the largest exposure to commercial real estate loans is Wells Fargo,

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It's not the vacant office buildings, such as this one in Leesburg, Va., but the trillions of dollars of debt in mortgages and derivatives attached to commercial real estate holdings, that are now causing bankers to panic.

which had $88 billion in such loans as of the first quarter of this year. In second place is Bank of America, with $59 billion, and in third is MetLife, with $33 billion (MetLife is now a bank holding company, the seventh-largest by assets in the U.S., behind Bank of America, JP Morgan Chase, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley). JP Morgan Chase, PNC, U.S. Bancorp, Regions Financial, BB&T, TD Banknorth, and Zions round out the top ten, in commercial real estate exposure; Citigroup is 12th, with $12.9 billion.

While the exposures at the big banks are worrisome, they have so many other losses that they actually are dead already; and regulators are keeping them open by a combination of extraordinary forbearance, phony accounting, and the bailout.

With the big zombies thus "saved," regulators are increasingly turning their attention to small and medium-sized banks, which have even higher concentrations of commercial real estate loans in proportion to their capital.

"Over a third of the nation's community banks have commercial real estate concentrations exceeding 300% of their capital, and almost 30% have construction and development loans exceeding 100% of capital," Comptroller of the Currency John Dugan told a banking conference in January.

A study of 940 small and mid-sized banks by the *Wall Street Journal* in May, projected that these banks could lose $100 billion on their commercial real estate loans by the end of next year, versus losses of $49 billion on their home loans. Total losses at these banks could exceed $200 billion, the paper said, adding that at 923 of the 940 banks, the losses would exceed projected revenue.

The *Journal* study was based upon the rosy "more adverse" scenario used in the cosmetic "stress tests" administered to the top 19 banks this Spring. As with the results of those tests, it dramatically understates the problem.

The problem is more severe, relatively speaking, at the smaller banks, because they do not engage in the derivatives speculation as do the giants; and neither do they get as heavily into residential mortgages. Instead, they have put much of their effort into local commercial real estate, financing the development of small shopping strips and buildings for local businesses. But even though they have not engaged in derivatives speculation, they are caught up in its effects, and are now paying the price. Many of the 98 banks which have failed so far this year, were brought down by commercial real estate. More failures are coming.

Shut It Down

The nation's local and regional banks are being wiped out by a system which should never have been tolerated. Decades of the systematic dismantling of regulatory protections, culminating in the repeal of Glass-Steagall in 1999, allowed our big banks to be turned into giant casinos, and our smaller banks to be turned into local gambling dens. FDR's 1933 Glass-Steagall Act forced a split between commercial banking and investment banking. Further reforms prohibited interstate banking, as a way of protecting real banking from the speculators. We must return to that system, putting the speculators though bankruptcy, and saving our banks from further plundering.

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