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For Commercial Real Estate Executives

November 24, 2009

THE CHANGING LOAN LANDSCAPE


Gavin Campbell

Did you ever play kick the can when you were a kid? If you didn't, don't worry; real estate bankers and commercial real estate owners have a chance to play it once again. However, if you are an investor in commercial real estate looking to make a killing in the $1.4 trillion of real estate debt coming due through 2012, this is going to be a very painful game to watch.

The FDIC quietly issued a ruling recently that essentially enables banks to classify real estate loans that have spotty debt service coverage or whose property values have fallen below the loan balance as "performing." With commercial real estate values down in some places as much as 40 percent, this is a true leap of faith on the part of the federal government. The government is hoping that by keeping these loans in the performing column, banks can "kick the can" farther down the road until private real estate values re-inflate. The FDIC is quietly trying to avoid a replay of the early 1990s, when the creation of the Resolution Trust Corporation resulted in deep-discount pricing of real estate loans and assets.

As a result, banks are "pretending and extending," keeping the loans on their books in their held to maturity accounts; as such, they are not required to mark them or bring them to market and sell them. If they did, the banks would look insolvent, and nobody, especially the government, wants this to happen. The banks are moving some very small loans and selling them at deep discounts, and as we have seen from recent investments, these can be bought attractively and quickly. The larger troubled loans, however, are just being held. Meanwhile, with most bad loans focused in regional banks, the FDIC has already implemented a playbook for keeping the increasing number of bank failures from impacting the economy by having them taken over by larger banks. However, with only 22 percnet of commercial loan defaults coming from bank loans there is more to the story.

Today, nearly 54 percent of all current commercial real estate loan defaults are in the CMBS sector — not loans held at banks, but rather loans that were made by other financial institutions and securitized. Is this the path to successful vulture investing? Unfortunately, there is can kicking here, too. As the loans mature or go into default, there is no clear picture of how things are going to play out, except that there will be a lot of delays before these loans are sold at market due to their structure.

Once a CBMS deal fails to pay off, the deal administration is transferred from the master servicer to the special servicers, and three problems pop up. First, under the agreements that governs the loan, the special servicers have very limited powers to adjust the loan, forgive it, or sell it; they can only do things that don't negatively impact the loan. Second, most of these players also have a B piece of the deal, which means they are in the first loss position; even if the deal matures and they are not paid off, it's in their benefit to extend (without the extension, they lose their position entirely). Finally, most of the agreements give the special servicers a number of years to resolve the issues. Meanwhile, the investors in the senior bonds, which are the most protected from a value and cash flow perspective, would love to foreclose. They can often go to war with the special servicers.

More and more of these will deals mature in the coming years, so this mess will only get worse. Special servicers and borrowers will attempt to postpone this as long as possible, hoping that the economy will recover enough to minimize the damage. The bottom line is that eventually these deals will get written down and sold. Asset types that are most exposed to the markets — like hotels — will go first. Property types with longer lease terms will go later.

Have patience, and watch the game. There may be a few cans to pick up yet.

— *Gavin Campbell is the managing principal with Steelbridge Capital.*