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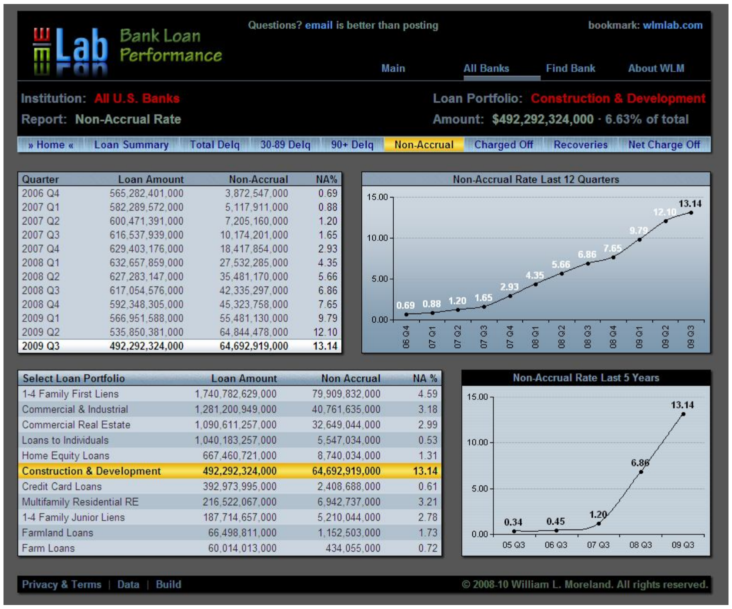
Preparing for the Commercial Downturn

Forecasters for 2010 and 2011 generally agree that the commercial real estate market will experience escalated delinquency, nonaccrual and foreclosure rates, which will lead to more bank closures. Looking back on the residential housing bust and considering the widely accepted commercial projections, we must consider, how can we better prepare for the challenges ahead? What can be learned? How will it be different?

Before we answer those questions, let's put some facts on the table. Loan delinquency and nonaccrual rates are a clear proxy for upcoming foreclosures and are reported quarterly to the FDIC by all U.S. banks. We currently have 3rd quarter of 2009 data. While the data point is from three months ago, the trends and broad based impact on the real estate market as a whole is undeniable. The graphs below are provided with permission from WLMLab.com.

Loan nonaccrual rates for first family liens at September 30, 2009 for all banks nationwide increased nearly 15 percent, or $10 billion, over the second quarter of 2009, while surging $25 billion or nearly 47 percent over the same quarter last year. The upward trend over the past three years is undeniable, which makes sense given the subprime lending issues that have been followed by massive headcount reductions at corporations nationwide, which clearly is impacting the average Joe's ability to earn enough to pay the mortgage.

Loan nonaccrual rates for construction and development at September 30, 2009 are even worse. While the total level remained flat with last quarter at $65 billion, the year over year change surged by $22 billion or nearly 53 percent. This too make sense as buyers of homes focus on gobbling up foreclosure deals, while being reluctant to buy new construction for fear that the development may not be completed or may take many years to build out. Similarly, with lease space reaching record levels, deals can be had by lessors and new commercial construction simply does not make sense in many metropolitan areas.



Quarter	Loan Amount	Non-Accrual	NA%
2006 Q4	565,282,401,000	3,872,547,000	0.69
2007 Q1	582,289,572,000	5,117,911,000	0.88
2007 Q2	600,471,391,000	7,205,160,000	1.20
2007 Q3	616,537,939,000	10,174,201,000	1.65
2007 Q4	629,403,176,000	18,417,854,000	2.93
2008 Q1	632,657,859,000	27,532,285,000	4.35
2008 Q2	627,283,147,000	35,481,170,000	5.66
2008 Q3	617,054,576,000	42,335,297,000	6.86
2008 Q4	592,348,305,000	45,323,758,000	7.65
2009 Q1	566,951,588,000	55,481,130,000	9.79
2009 Q2	535,850,381,000	64,844,478,000	12.10
2009 Q3	492,292,324,000	64,692,919,000	13.14

Select Loan Portfolio	Loan Amount	Non Accrual	NA %
1-4 Family First Liens	1,740,782,629,000	79,909,832,000	4.59
Commercial & Industrial	1,281,200,949,000	40,761,635,000	3.18
Commercial Real Estate	1,090,611,257,000	32,649,044,000	2.99
Loans to Individuals	1,040,183,257,000	5,547,034,000	0.53
Home Equity Loans	667,460,721,000	8,740,034,000	1.31
Construction & Development	492,292,324,000	64,692,919,000	13.14
Credit Card Loans	392,973,995,000	2,408,688,000	0.61
Multifamily Residential RE	216,522,067,000	6,942,737,000	3.21
1-4 Family Junior Liens	187,714,657,000	5,210,044,000	2.78
Farmland Loans	66,498,811,000	1,152,503,000	1.73
Farm Loans	60,014,013,000	434,055,000	0.72

Turning to commercial real estate nonaccrual data, CRE is up nearly $5 billion, or 18 percent, since last quarter and is up an eye popping 155 percent, or $20 billion, year over year. Unemployment rate increases generally lag the economic down as a result of companies reacting to the downturn in revenues. As companies focus on cost reduction through head count, leasehold footprint contraction is a natural outcome. As business locations or storefronts close and businesses fail, more open space is available on the market.

Bank Loan Performance

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Institution: All U.S. Banks

Report: Non-Accrual Rate

Loan Portfolio: Commercial Real Estate

Amount: $1,090,611,257,000 · 14.69% of total

» Home « | Loan Summary | Total Delq | 30-89 Delq | 90+ Delq | Non-Accrual | Charged Off | Recoveries | Net Charge Off

Quarter	Loan Amount	Non-Accrual	NA%
2006 Q4	904,367,917,000	4,868,841,000	0.54
2007 Q1	905,604,499,000	5,278,992,000	0.58
2007 Q2	924,101,310,000	5,546,739,000	0.60
2007 Q3	939,555,957,000	6,058,672,000	0.64
2007 Q4	968,732,298,000	6,937,529,000	0.72
2008 Q1	990,035,481,000	8,760,349,000	0.88
2008 Q2	1,018,987,886,000	10,842,146,000	1.06
2008 Q3	1,043,392,814,000	12,822,353,000	1.23
2008 Q4	1,067,051,407,000	14,911,405,000	1.40
2009 Q1	1,077,426,261,000	21,166,794,000	1.96
2009 Q2	1,087,104,266,000	27,764,510,000	2.55
2009 Q3	1,090,611,257,000	32,649,044,000	2.99

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What We Can Learn from the Residential Bust

Do not underestimate the speed at which large volumes of defaults could happen. At the beginning of the residential collapse, there was a general thought that banks could manage through the crisis without government intervention, but that quickly proved to be false.

A high level of professional skepticism regarding distressed loans is important to get out in front of the issue. Denying or hoping that a distressed loan will improve simply leaves you behind the curve. Valuable information can be garnered before the relationship with the payer becomes strained.

Being proactive about both data and documentation gathering on a troubled asset prior to it being graded a nonaccrual status will expedite both the decision making process for the lender and will directly impact the rate of return on a distressed asset sale. Lenders need to be ready to gather information they do not currently have, nor would they have been expected to have. Experts are available to quickly and more cost effectively gather information for lenders, saving as much as 20 percent across the portfolio.

The data and documents first help the bank better understand the underlying distressed asset, as it has likely changed since loan origination. At a minimum the market around it has changed. Being over prepared for a loan to go south is impossible and the more the bank does to understand the underlying distressed asset quickly the better.

Take quick action based on high levels of data, information and documents. Making decisions quickly without the whole picture can lead to unexpected problems, losses and excruciating internal and external costs.

Employees spend as much as 50 percent of their time just trying to get their arms around a distressed loan. This hits the lender in two places: employee costs and holding costs for the loan or underlying asset itself. Technology solutions that eliminate the administrative burden and shorten cycle times, will both save the bank costs in both areas, but more importantly, free up valuable time to manage the issue proactively rather than battling just to understand. Managing the issue with clear visibility allows the bank to focus on maximizing returns.

Commercial Differences to Heed

While we can glean many procedural improvements from the residential fallout, many commercial and/or construction related issues are simply not going to be the same. Recognizing these key differences may mean the difference between navigating the storm or succumbing to its fury.

Commercial assets have a significantly larger average loan balance and many community banks or mid size lenders may be more deeply exposed to the commercial downturn than they were the housing crisis. Simply put, one or two bad commercial or construction loans will mean a much larger financial hit to the bank than a block of bad home loans. The midsize lenders will have less resources at their fingertips to manage through these issues, as compared to the large residential lenders exposed by the subprime lending issues. Thus, working smarter, using technology and other experts will be a requirement.

Entering the “chain of ownership” for a commercial or construction property may expose the bank to unexpected costs, compliance fines and other upkeep costs which significantly exceeds that for a pool of residential homes. Not to minimize the residential issue, but keeping the grass cut has far less risk than maintaining home owners association requirements, detention pond requirements, environmental regulations, common area maintenance and tenant retention. The regulations or requirements are unique to every area, state and or project and may even expose the lender to compliance fines, which can quickly add up and dramatically increase holding costs.

Buyers of foreclosed homes are the largest pool of possible buyers, the general public or in some cases bulk institutional buyers. The buyers of commercial loans or assets are drastically different and much more finite. Investors in commercial loans are companies, REIT's, hedge funds, etc. with a high level of sophistication, who operate, manage and buy such properties for a living. Lenders do not operate, manage or sell such properties for a living, which puts them at a distinct disadvantage out of the gate. Buyers generally understand the details of the asset far better than the bank and the level of due diligence and documents they require is simply not in the loan file and is not familiar to lenders.

Documentation needed to make decisions and maximize the return on sale of commercial assets far exceeds that of a residential home. Having a clear process of data and document preparation, as a loan enters the delinquent stage, is critical to the lender understanding the underlying asset and how they may be challenged in the ultimate sales process. Buyers of these assets will use the lack of information on the bank side to lower bids and negotiate at closing for a more favorable purchase price. The sharks are out there, seller beware!

Lenders need to deploy technology which can house both the critical distressed asset data **and** the documents in electronic form all in one space. Dealing with boxes and boxes of paper and loads of scanned information or manually checking files is impossible to manage, extremely expensive and greatly limits visibility. The sharing of this critical information throughout the bank is crucial to making the right decisions. Likewise great benefits are garnered when the technology can monitor files automatically, establish security rights and provide audit trails for who is accessing the data. Once decisions are made internally by the bank, such technology needs to be outward facing so that buyers and investor objections are eliminated by presenting them with all the information they need and expect upfront. This serves several purposes, helping the lender to be more knowledgeable or sell direct to buyers, keeping brokers or auctioneers, if any, honest and ultimately limiting risks that investors use to lower their bids.

Investors will pay premiums for “clean” properties and that starts with data and documentation. Internal bank systems and related cannot be opened up for viewing by potential investors. Regulatory restrictions and privacy concerns abound, so new, complimentary technology is required which allow the bank to privately, securely and discreetly assess assets while stacking the deck to maximize returns.

Investors in commercial property will also have clear and defined models for buying assets. As a result, technology can be used to quickly get the right property and then the right information and in front of as many buyer’s eyes, quickly and efficiently. This will help increase bid flow, while also increasing the amount of the bid. Lenders need to establish processes and technology to maximize preparation and cleanliness in appearance and fact. Doing so will directly impact the level of losses and returns the lender experiences.

Lenders not prepared for this process will find themselves inundated with properties that they are struggling to understand and accurately value. A proactive approach is critical. Reactively throwing bodies and consultants at the issue will increase costs dramatically, and prolong decision making and hold times.

While the commercial market presents its unique challenges, the question is not when we will recover, but how long will it take? If lenders are not prepared, none of us may like the answer.