January 14, 2010

Will Commercial Real Estate Bring Down the Bank?

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This is the question asked by CEOs, rating agencies, investors and politicians. Simply, there are three answers: "Yes," "Maybe," and "No." Banks in each of these three groups should take a different strategy.

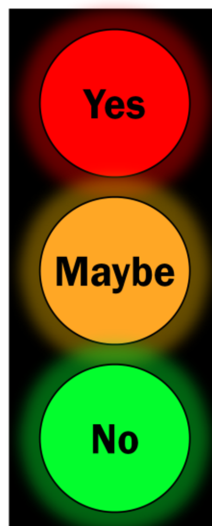
For the banks that know they will be underwater, the game-theoretic optimal course of action from an equity or option holder's point of view is to hide the losses, extend doubtful loans to reduce write-downs, keep the bank running and have enough time for future earnings to cover the losses and one day perhaps start creating dividends.

The strategy is much more complex for the large majority of banks in the middle ground, which may or may not be brought down by their commercial real estate (CRE) portfolios. The first part of their strategy is, of course, to triage the portfolio and identify loans where early action may reduce the losses; for example, triggering covenants to use all cashflows from the property to pay down the loan, get extra cash from the investor or restructure the loan to avoid a foreclosure in the midst of a downturn.

The second part of the strategy is outward looking, with the goal of proving that the bank is not in the category of those who will be brought down by the losses. Investors, regulators and senior executives will force the bank's commercial real estate group out of business unless the group can show that the portfolio is not going to bring down the bank. To be credible, this communication to the rest of the world must be centered around a solid core of timely, accurate data. The data needs to be objective, detailed and not obscured through layers of assumptions. Accuracy and detail in data reporting can save the bank.

Finer Measuring Tools Needed

Knowing this, many portfolio managers are struggling to pull together vast amounts of data that has been held on spreadsheets on or paper. This is especially acute in commercial real estate, where the level of detailed information on leases, and collateral can make a vast difference in the risk profile. This is even more true for construction, where risk is not just determined by simple ratios like loan to cost, but critically determined by construction schedules, sales plans, contract structures and counterparties. There can be thousands of data points to describe a complex deal. Portfolio managers are now struggling to consolidate that data to get a view of the portfolio and credibly communicate that view to the rest of the world.



Hide and hope
Extend and pretend

Proof of strength
Triage restructuring

Be seen in control
Buy low

At the asset level, in restructuring deals to improve their viability, banks need to show they are being economically rational and not playing at "extend and pretend" to mask losses. Traditional blunt instruments like loan-to-value ratios (LTVs) are insufficient, because many loans with poor LTVs will still be servicing their debt. Within those servicing their debt, some will have long stable leases, others will have short remaining leases, and there will be a grey area of long leases with poor tenants. In some cases there may also be good reasons to restructure the debt.

Although no new loans would be originated with an interest-only structure, some existing loans could be restructured to service their debt if they were modified to become interest only, especially if they had the current low, short-term rates. This must be balanced against the risk of increases in future interest rates if the lending is not at a fixed rate. Interest-only structures reduce the short term payment risk but increase the long-term refinancing risk. The question is how to rationally balance all of these factors.

Establishing a Threshold

Risk measurement can help, by taking the complicated set of deal features and alternative financing options, and weighing the interplay of all the factors to get a comparable quantitative measure of the fundamental risk for that deal; for example, the expected loss. The expected loss can then be compared across all deals. A threshold can be set to determine which re-structurings are economically sound, compared with a re-structuring that is "extending and pretending" to mask an underlying problem.

For example, within a commercial mortgage-backed security, this threshold could be used to differentiate between those loans which should be extended versus those that should suffer foreclosure. The threshold could be set at an annualized 1 percent expected loss so that any individual loan with an expected loss of less than 1 percent could be extended without adverse comment by the regulators. Deals with poor loan to value and weak interest service coverage ratios will exceed the threshold and would not be considered fundamentally healthy.

In normal times the threshold might be a lot tighter than 1 percent, but some additional leeway may be sensible to avoid legal fees and forcing sales into a depressed market.

For strong banks that are confident that they are not going to be brought down by commercial real estate loans, there are two parts to the strategy. The first is that the lending group must show investors and the rest of the bank that the portfolio is well controlled. Without this proof, the perception of the CRE business will be shaped by the headlines of losses happening at other banks and consequently no new business will be allowed.

Banks that have passed that barrier are now looking out into the market with fresh eyes and seeing wonderfully low prices with wide yields, and great opportunities to buy distressed deals at their lowest prices. Venturing into this territory, investors will want to be doubly sure that they understand all the dimensions of the deal and how they will come together in a portfolio.

Conclusion

In large part, this current crisis is due to a lack of transparency. Lack of consolidated data obscured the view and allowed banks to over-confidently extend themselves into an overheated market. Now, with confidence shattered, the current instinct is that if a bank shows a lack of transparency, there must be a problem. This instinct can be only be countered with objective, detailed data. It is only when banks can give solid proof of their soundness that they will be able to persuade their managers, regulators and investors that they can get back to the business of new lending.■

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