CRE: The cracked glass slipper?

CRE exposure and delinquencies are on the rise for Ninth District banks, but the full fallout is difficult to gauge

By RONALD A. WIRTZ
Editor

It's a common assumption that commercial real estate represents the proverbial "other shoe" for the banking industry, and that CRE portfolios are poised to reclobber banks after many had only begun to recover from a deep recession and meltdown in housing markets.

For a number of reasons, it's hard to say how closely the health of the banking sector is tied to the commercial real estate market. Without doubt, the banking sector will experience—and is already seeing—fallout from the CRE slump. A notable number of banks have portfolios that exceed regulator guidelines for CRE concentration, particularly for construction and land development loans. In tandem with that trend, delinquency rates for all types of CRE loans are rising.

But it's difficult to gauge or predict bank health based on the current and expected performance of the broader CRE market. For starters, the CRE boom was financed by a number of different sources. The banking industry (including savings institutions) is the single largest holder of outstanding commercial mortgage debt, with about $1.4 trillion of the $2.5 trillion owed nationwide, according to December flow of funds data from the Federal Reserve Board.

A little less than one-quarter of outstanding debt is held in so-called commercial mortgage-backed securities (though virtually no new CMBS debt has been generated since 2007). Life insurance firms have about 10 percent of commercial mortgage debt, and the remaining amount is held by a hodgepodge of sources, including the federal government, real estate investment trusts, finance companies and pension funds.

Unfortunately, no similar estimates exist for CRE financing in the Ninth District, so it's difficult to say how large the CRE pickle jar is for district banks or what submarkets are most exposed. That's not a small matter, given the fact that the annual value of retail CRE transactions in the Twin Cities rose almost 20-fold just from 2001 to 2006, to more than $3 billion, while office CRE transactions rose eightfold during the same period, to $2 billion, according to data from Real Capital Analytics.

While CRE borrowers may experience deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work constructively together.

Sibling rivalry?

Within a range of other banking metrics, the scope and nature of the CRE problem is both better and worse than its residential housing predecessor. The district's large banks—those with more than $10 billion in assets—have comparatively low CRE exposure, according to third-quarter Call Report data from the Federal Deposit Insurance Corporation.

But potential problems from CRE are much more widespread among smaller community and regional banks that predominate in the Ninth District. For example, total outstanding CRE debt held by banks with less than $10 billion in assets has more than doubled in real terms since 2000, to $33 billion. Residential loans (traditional mortgages and home equity loans) among this group have also risen, but more slowly, and total about $18 billion (see Chart 1).

Exposure at some banks has crossed certain thresholds that regulators consider prudent; about one in seven banks in the Ninth District have loan concentrations in this sector that exceed bank regulator guidelines.

For example, regulators (including the Federal Reserve) deem a bank's portfolio concentrated if it includes CRE loans in excess of 300 percent of the bank's total risk-based capital. Such concentration can be potentially dangerous because the lack of loan diversification puts a bank in harm's way should an economic shock hit the sector. A total of 39 banks in the district exceeded this 300 percent threshold at the end of September, with the highest percentage in Montana and Minnesota (see Chart 2). Exceeding this threshold does not imply imminent demise for a bank. But it is an indicator of enhanced risk, evident by the fact that regulators require more sophisticated and enhanced management practices from these banks.

This CRE loan concentration also is more prevalent among smaller banks. Whereas the housing debacle slammed the nation's largest banks—with assets in the hundreds of billions—no district bank that exceeded the 300 percent ratio had assets exceeding $1 billion in assets, and the large majority were much smaller than even this level.

These concentration figures also do not include so-called owner-occupied nonfarm-nonresidential property—in essence, commercial mortgages to firms that own their office or manufacturing plant, rather than leasing space from a property owner. The rationale for this exclusion is that repayment for such loans does not depend on the swings in supply and demand for commercial buildings themselves; rather, repayment depends on the performance of the company and the broader economy.

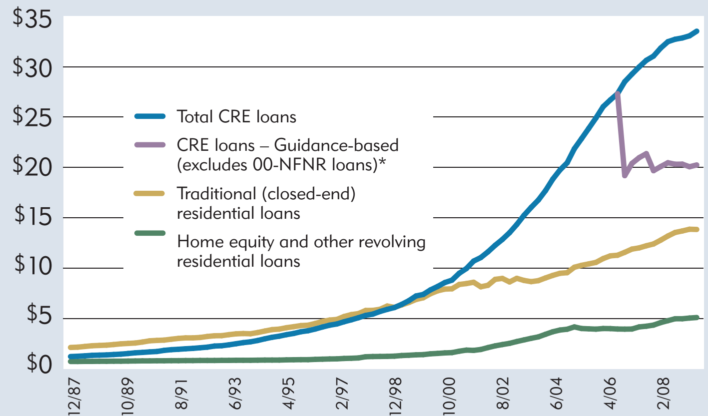
This bit of methodological minutia offers both good and bad news. First, this owner-occupied segment of commercial mortgages is big, making up 30 percent of the outstanding CRE debt held by district banks (see Chart 3). That means a large share of CRE lending is, technically speaking, of less concern to regulators in terms of concentrated risk in this sector.

At the same time, loan performance among owner-occupied borrowers nonetheless has some influence on supply and demand in the broader CRE market and has been worsening; the delinquency rate for owner-occupied commercial loans is currently higher than for nonowner-occupied property loans and is on a steeper trajectory (see Chart 4).

Another indicator of heightened risk is concentrated lending in construction and land development (CLD). Regulators become concerned when such loans amount to 100 percent or more of a bank's total risk-based capital. The lower guidance ratio for this measure is due to the fact that these loans usually don't generate income until completed, so they can be particularly risky if real estate markets sour. And even more district banks—86, in all—had crossed this guidance threshold as of the end of September, with Montana and Minnesota banks again seeing the largest share. Also notable is the fact that delinquency rates for CLD

Chart 1: **District CRE loans growing faster than housing**

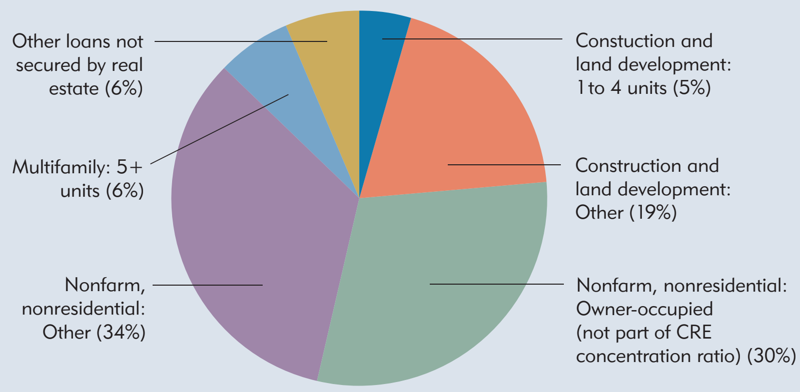
Merger-adjusted, billions of 2009 dollars
Banks with less than $10 billion in assets



*2006 regulator guidance on CRE loan concentration excludes loans for owner-occupied, nonfarm nonresidential real estate, which is why that segment is split off separately starting in the first quarter of 2007.
Source: Reports of Condition and Income (Call Reports), FDIC

Chart 3 **Outstanding loans by CRE sector**

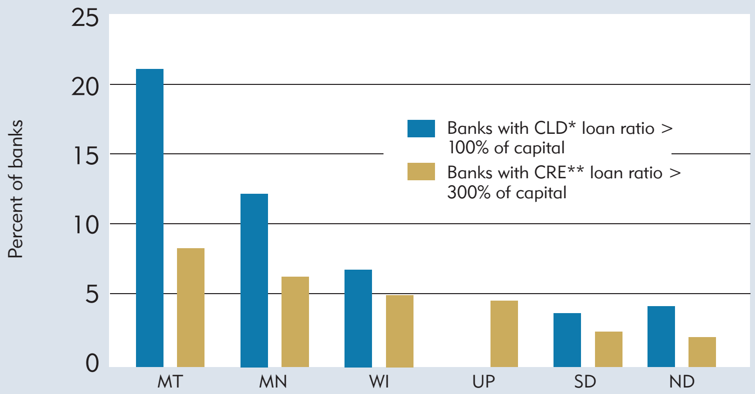
Ninth District banks, as of Sept. 30, 2009



Source: Reports of Condition and Income (Call Reports), FDIC

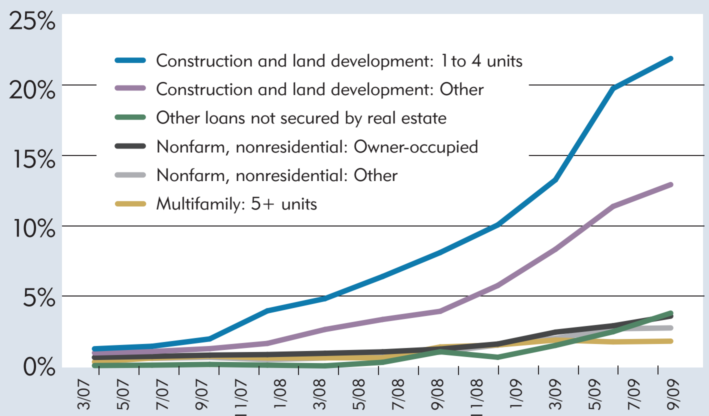
Chart 2 **CRE & CLD concentration highest in Montana and Minnesota**

CRE loan ratios compared with 2006 regulator guidance



*Construction and land development; the 100 percent concentration ratio includes residential and nonresidential loans.
**Commercial real estate; the 300 percent concentration ratio includes all CRE loan categories except nonfarm, nonresidential owner-occupied loans.
Source: Reports of Condition and Income (Call Reports), FDIC

Chart 4 **District bank CRE delinquency rates rising**



Source: Reports of Condition and Income (Call Reports), FDIC

loans have risen much faster compared with other CRE loans.

Combined, 101 of the 713 commercial banks in the district exceeded at least one of these guidelines; a total of 13 banks violated both guidance measures, with almost half (six) of them in Montana.

With rising delinquency rates as well as a looming threat of maturity default for some loans (discussed in the cover article), lenders and borrowers alike received some helpful guidance from regulators last fall. First, the IRS approved a rule change that allows CRE borrowers to begin negotiating loan modifications before the loans themselves go bad. Previously, such modifications carried tax penalties, typically delaying such negotiations until default was imminent.

Then in late October, bank regulatory agencies (including the Federal Reserve) jointly announced guidelines to help banks "prudently" renew and restructure troubled CRE loans without intensifying the underlying risk to bank capital. The hope is that this change will better align the desire of both regulators and bankers to lift the banking sector to safer ground while loosening credit to the CRE market.

In a joint statement, regulators said new guidelines for loan workouts "recognize that financial institutions face significant challenges when working with commercial real estate borrowers. ... While CRE borrowers may experience deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work constructively together." f

Associate Economist Daniel Rozycki and Economist Mark Lueck contributed data and analysis to this article.