GUEST COLUMN

Distressed Commercial Real Estate: The Elephant In The Banking Room

By **Joseph Ori**

The commercial real estate industry is still reeling from the Great Recession, thanks to lack of debt and equity capital for new investment and the amount of distressed assets in the banking system. Many commercial real estate analysts and pundits have been saying lately that the industry is starting to turn the corner and good times are ahead. I don't see this at all.

The commercial real estate industry, which turned down in 2007, has been in a depression for four years with no recovery in sight. The economy is growing very slowly with last quarter's GDP increasing at only 2.6%. There is virtually no job growth (which is the most important metric for the commercial real estate industry), and with the November unemployment rate rising to 9.8%, the consumer is still de-leveraging and not spending. Also, a number of countries in the European Union may default on their debt.

The other issue – and one that's the elephant in the room within the commercial real estate industry – is the amount of distressed assets held by the banking industry and the commercial mortgage-backed security market. The banking industry, made up of 7,760 financial institutions, held as of the third quarter of 2010, $1.7 trillion in commercial real estate loans. The CMBS industry held, as of November 19, 2010 $683 billion of commercial real estate loans. Therefore the total commercial real estate loans at banks and the CMBS industry total $2.4 trillion.

With total loans of $2.4 trillion and assuming that the average loan-to-value ratio of these loans is 75%, then the estimated value of commercial real estate securing these loans is $3.2 trillion ($2.4 trillion divided by 75%).

If it is also assumed the average commercial real estate property across the country has lost 45% of its value since the top of the market in 2007, then the property securing these loans is today worth only $1.7 trillion ($3.2 trillion times 55%).

The difference between the amount of commercial real estate loans of $2.4 trillion and the estimated value of the property securing these loans of $1.7 trillion equals a value deficit of approximately $700 billion, or the amount of distressed commercial real estate in the system. This amount includes loans on apartment properties, shopping centers, warehouse properties, land, office buildings, hotels, resorts and senior housing properties located throughout the country.

The distressed amounts above do not include loans and assets held by the **Federal Deposit Insurance Corp.** and the insurance industry, which could easily add $100 billion more. Until there is action to mark these assets to market and recycle them into the marketplace to new investors with new capital, the commercial real estate industry will not recover. These distressed assets are also prohibiting the banking industry from making new loans.

Loan growth during the last two years at financial institutions has been negative. How can a bank make a new commercial real estate loan if the majority of its current loan book is under water? According to the **Federal Reserve**, there are almost $1.5 trillion in commercial real estate loans coming due between 2011 and 2015. If banks are not making new loans, where will the new funds come from to re-finance these loans?

Why aren't these assets marked down and recycled? Because there is no pressure on the banking and securitization industries to do so. The Federal Reserve and Treasury are concerned that this large amount of distressed commercial real estate may bring down the banking industry if marked to market. The securitization industry is not pressuring the special services to sell their distressed assets for the same fear. There is also no pressure from the **Financial Accounting Standards Board** and accounting industry to apply market-to-market rules to these assets.

Unless these assets are marked down and resold, not only with the industry not recover, but the U.S. economy will continue to sputter. Exact statistics are not available, but many economists estimate that the commercial real estate industry accounts for five percent of the country's GDP.

What is the solution for these distressed assets? I believe that the Federal Reserve, Treasury and securitization industry should encourage banks and servicers to restructure as many loans as possible, foreclose on those that can't be re-structured and liquidate the owned assets over the next 24 months. This is similar to what the **Resolution Trust Corporation** did with distressed real estate assets from the collapsed Savings and Loan industry in the early nineties. Unless this is done, recovery in commercial real estate will not occur for a decade.

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