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Waiting for the other shoe to drop in commercial real estate

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Law Talk

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Anyone who owns a commercial property knows there are cycles in commercial real estate. There are times when the market is hot, and times when the market is oversaturated and is considered soft.

The economy has been in a deeper-than-normal recession. To that end, the commercial real estate market is also experiencing deeper issues than in a typical soft market. In fact, a congressional watchdog panel recently raised new warnings about the condition of the commercial real estate market.

In its monthly report, the Congressional Oversight Panel for Troubled Asset Relief Program believes the failure of these loans could further endanger the banking system and preclude a true economic recovery. The report noted about $1.4 trillion in commercial real estate loans will come due at the end of their terms and about half of those are considered "under water," where the fair market value of the property is less than the mortgage debt outstanding.

The report further stated that potential losses from these loans could amount to $300 billion, which would severely impact small- to mid-sized banks, who have a high concentration of commercial real estate loans in their portfolios. The concern is that if these banks do not have adequate reserves to cover these losses, there could be more bank failures, which will adversely impact any real recovery in the economy.

There were several potential solutions listed in the report, including conducting a "stress test" of individual banks whose portfolios contain a concentration in commercial real estate loans. Due to the sheer volume in number of these small- to mid-sized banks, it may not be feasible to review these banks' records at such a detailed level.

Another suggestion is the federal government could inject additional capital into the small banks, buying their toxic assets or guaranteeing loans. Unfortunately, the federal government is considered by many as spending too much of the taxpayers' money already, so this may not be a feasible approach. Additionally, many believe the federal government may "reuse" paid back TARP funds, causing concern as to whether it is constitutional to do so without additional legislation.

A more practical approach might be to allow the banks to extend the due date for the underwater loans, rather than force a bank to recognize losses at this time. This would allow the economy to recover and, over time, the commercial market place would recover, allowing the fair market values to rebound as well.

It would also allow the owners of the property to find additional tenants, or sell and pay off the outstanding balances of loans for the property. This may allow the banks to recover 80 percent or more of their loans outstanding, as opposed to taking a loss for the entire loan, reselling the property and being able to recover maybe 20 cents on the dollar.

In addition, if the bank forecloses and cannot sell the property because of a dearth of buyers in the current marketplace, the bank will have to pay the maintenance and upkeep for the property, along with insurance costs and real estate taxes, as well as a management fee. These costs, along with legal expenses, may force the bank to take a lower offer than they would have normally accepted in a decent market.

Hopefully, the federal government will enact the necessary regulations permitting banks to extend the due dates of the loans on terms that will allow the borrowers to pay. This may include the accrual of a small interest amount—1 to 2 percent—until three to five years goes by, allowing the cycle to pass.

After all, most of the commercial real estate loans were good loans destroyed by a really bad economy. In other words, the borrowers did not cause the loans to go bad, it was the economy.

Enacting regulations of this nature would make the best of a bad situation for both the borrower and the banker, as well as for the overall economy. If regulations allowing a "lend-extend" type of loan adjustment are absent, the federal government may force the other shoe to drop, which will cause additional bank failures and additional economic problems.

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