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Commercial real estate - The next potential crisis

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For the uninitiated, CRE is an acronym for commercial real estate. Those of us who were awake and aware during the last major real estate debacle in the late 1980s and early 1990s can remember the path of destruction left by the Resolution Trust Corporation, also known as RTC. RTC was a government-owned asset management company that was the recipient of mortgages from failed savings and loan associations of the day. During that time, when a commercial property was appraised for RTC, if the appraised value indicated a loan to value ratio (LTV) of greater than 80%, the property owner would be required to invest additional equity in the property to pay down the loan to an 80% LTV even if the owner was making timely mortgage payments. If the owner was unable to make the additional equity payment, RTC took the property and disposed of it, often at a fire sale price. As a result, many properties with performing commercial loans became troubled properties. The owner lost the property, and the tax payer was stuck with the bill.

This time around, financial institutions are behaving much more reasonably than RTC did. Unlike residential mortgages that often have a fixed rate for the entire term of the loan, commercial property loans typically have a five-year balloon. That is, a loan will have a fixed interest rate for a period of five years with a monthly payment amount based on a loan term of 20 years. After five years, the loan is rewritten based on the then current interest rate. If interest rates go down, the monthly loan payment could decrease, and if interest rates go up, the monthly loan payment could increase. This arrangement also gives the property owner the opportunity to take out equity in the property.

In the current economic climate characterized by relatively high unemployment rates as well as business contractions and failures, the demand for commercial real estate has softened. Overall, rents have decreased and vacancies have increased - both events that have a negative impact on commercial property values. Some commercial properties have lost as much as 30% of value based on existing occupancy and rental rates. If the loan on a commercial property has a balloon payment due now and the property does not appraise high enough to meet the 80% LTV, financial institution appear to be willing to work with the borrower to ride out the current crisis if the borrower is making timely mortgage payments.

This program is known as the "pretend and extend" policy. That is, if a commercial loan is performing but the mortgage amount is greater than 80% of the property's value, it makes no practical sense to demand additional equity from the owner, who most likely does not have the assets to meet the demand. In addition, the entities involved recognize that the current economic downturn will not last indefinitely and the situation is anticipated to improve in the not too distant future if not already. Therefore, pretending the equity is in the property and extending the loan is a very viable policy that works for the financial institution and the property owner. This policy provides much needed time to allow economic conditions to rebound and property owners to regain their footing. It is a win-win situation.

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