



CELEBRATING  
63 YEARS

# narej

## **The commercial real estate loan reset catastrophe: Not likely to occur under current federal policy**

October 25, 2012 - Spotlights

I was recently re-reading an old 2009 article forecasting potential commercial real estate defaults, due to a tsunami of short-term financing coming due or re-setting now, and over the next few years. It interested me because I've been wondering what happened to the great reset catastrophe. It seems that, ever since 2007, pundits have forecasted Armageddon with regard to loans coming due.

I decided to research recent articles regarding commercial real estate loan maturity to see what the mantra is now. Right away, I found a September 2012 article on a new "Coming Storm". According to a company providing CMBS analytics, there will be more than \$2 trillion of commercial real estate loans maturing by 2017. They estimated that half are already underwater. They also opined that the trillion of loans underwater will mature in a higher rate environment, without refinancing possibilities, possibly with a decrease in underlying asset value.

Still wondering how the problem in the 2009 articles had been misdiagnosed, I was finding new research indicating another three or four year time horizon with its own fiscal cliff of default at the end! It is true that there is a recent spate of new commercial loans coming due between 2015 and 2017, approximately 100% more than just a few years ago. According to DebtX reporting, impaired and/or defaulting loans have increased about 7% to 10% over the last year. Once again there is credible evidence supporting a doomsday philosophy.

So why didn't the earlier prediction come true, and why wouldn't the newer prediction come true? It's a simple answer on the former: the Federal Reserve has simply kept interest rates low, and all the predictions were wrongly based on reset rates being increased. Cheap money will cause loans not to go into default and prices to potentially increase on the asset. In other words, the Fed is simply not going to allow Armageddon and will continue to push it off until it feels the economy is strong enough to absorb the ramifications of their own artificially low interest rates.

What the Fed does essentially is keep interest rates low by buying treasuries, other bonds, and now mortgaged back securities. In doing this, they hope to stimulate the stock market to higher levels, stimulate companies to grow, try to create the "wealth effect", and avoid further housing deterioration and foreclosure. This last objective has social ramifications as well as economic, because foreclosure is obviously seen as unkind social policy. The commercial real estate market lacks the social impetus for preventing foreclosures and keeping rates low. Thus, the commercial real estate market may be somewhat more vulnerable than the residential real estate market. However, since the beginning of 2000 to the present, the Fed Funds Target rate, U.S. prime rate, and the various month LIBOR rates, have all tracked in lockstep. As a result, activity by the Federal Reserve to help residential has kept commercial rates parallel to residential rates, although at somewhat higher levels. In other words, this is a primary reason why we have not seen the

commercial real estate reset catastrophe in the past, and probably will not see it in the near future. The Fed has publicly stated that it will keep rates low indefinitely, and will only allow them to rise when there is growth in the economy, and/or hints of inflation.

What about the future? Every year, over the last several years, real estate people like ourselves have speculated about what will happen when interest rates inevitably rise. Everybody still believes that they will, and it is just a matter of time. The Fed Funds target rate cannot go any lower and has been flat since January, 2009 at approximately 0%. If recent statements by the Fed hold true, that will not change until 2015, creating a six year time frame without reset catastrophe. However, the \$2 trillion of loans coming due around 2017 and 2018 may potentially be in that very un-sweet spot of needing refinancing at a time when rates will be increasing, consistent with some recent predictions. On the other hand, ironically, if the economy remains stagnant, and chairman of the Federal Reserve Ben Bernanke remains in his position, the rates could stay low for a longer period of time, just as they have and just as nobody believe they could.

Daniel Calano, CRE, is the managing partner and principal of Prospectus, LLC, Cambridge, Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540