REUTERS

Banks to survive commercial property defaults - Fed

Thu May 28, 2009 5:06pm EDT

By Ilaina Jonas

NEW YORK, May 28 (Reuters) - A Federal Reserve economist said on Thursday the recent stress tests of the largest U.S. banks showed they can weather the impending tidal wave of defaults expected in the commercial real estate market.

"I feel comfortable that the size and portion of commercial real estate exposure was taken into account in the stress test," Til Schuermann, vide president, risk management for the Federal Reserve Bank of New York, told a Congressional Oversight Panel hearing in Manhattan.

Recently federal regulators instituted a stress test of 19 banks to determine the banks' health under extreme economic conditions. The test included two years out but also considered a third year, Schuermann said.

That would include defaults of some of the most aggressive loans to commercial real estate borrowers made during 2004, 2005 and 2006, he added.

Unlike home mortgages, most commercial real estate loan principals don't amortize or amortize little over the life of the loan, which is typically three to 10 years. Instead, borrowers refinance -- they repay the loan with a new loan that is at least as big. If the borrower cannot refinance, default usually follows.

Since last year, the credit crisis has frozen most lending, particularly in the commercial real estate sector.

"This is likely to be a big problem, a very big problem," Richard Parkus, Deutsche Bank Securities head of Commercial Mortgage-Backed Securities (CMBS) and Asset-Backed Securities (ABS) Synthetics Research, told the panel.

The Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) should help grease the gears in the U.S. financial system, Schuermann said, and are a good first step in bringing liquidity back to the financial markets, Parkus said.

But U.S. commercial real estate faces another problem of falling values. Not unlike subprime residential real estate mortgages, many of the commercial real estate loans issued in 2005, 2006 and 2007 covered more than 90 percent of the value of the property and were underwritten using aggressively optimistic rent and occupancy projections.

Many of those loans were securitized CMBS, which account for about 25 percent of the outstanding commercial real estate debt. Banks and thrifts account for 50 percent and insurance companies comprise the remaining 25 percent of the lending, Parkus said.

As many as two-thirds of the CMBS loans, or about $400 billion, which need to be refinanced over the next 10 years may not qualify for refinancing.

Banks issued some of the riskiest loans, often short-term and floating-rate, for properties to be "fixed up" to some degree.

Based on the CMBS data, Parkus said $800 million of the $1.3 trillion in CMBS and bank portfolio loans maturing over next five years have trouble being refinanced.

Still, Kevin Pearson, executive vice president and metro area executive of M&T Bank Corp (MTB.N: Quote, Profile, Research, Stock Buzz), objected to his bank being thrown into the pool of loose lenders.

"I think it's very dangerous to have too broad of a brunch with the banking system," he told the panel. He said M&T learned from the commercial real estate collapse of the 1990s and didn't bend its lending standards during the most recent bubble.

U.S. Congressman Jerrold Nadler said that in addition to the actions so far, the government should take a sizable amount, about $100 million, and create new banks that would attract private investment.

"An alternative, if that's too radical, is to take $50 billion or $100 billion and fund the existing small and regional banks," he said. "These banks then could supply a lot of credit to the system while you figure out what to do with the Bank of Americas (BAC.N: Quote, Profile, Research, Stock Buzz) and the Citigroups (C.N: Quote, Profile, Research, Stock Buzz) and other banks that have these toxic assets on their books."

(Reporting by Ilaina Jonas; Editing by Richard Chang)