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Despite Economy, CRE Portfolios Performing Adequately for Banks

Recession is Driving Down Property Values, But Cash Flows Providing Cushion for Loan Values

For all of the dread concerning a widespread crash in the commercial real estate markets that has been put into words in the first quarter of 2009, the nation's largest banks seem relatively unruffled coming out of the quarter.

That's not to say that real estate asset quality has not deteriorated nor that problem loans have not surfaced, but the prevailing attitude from bank executives in their first quarter analyst conference calls was one of composure regarding their commercial real estate loan portfolios. To date real estate delinquencies and losses have been relatively minimal and manageable.

The major and the bulk of the problems discussed continue to center around loans on residential development projects, which banks categorize as commercial real estate lending. Any problems associated with income producing properties such as office, industrial, retail and multifamily properties were deemed secondary and isolated.

"Remember now, we've been talking about contagion for almost a year now and just have not seen it," said Mike Willoughby, chief credit officer of Regions Financial Corp. "We may have seen a couple of apartment projects come through, but nothing really to speak of. So, even though we start to look at what unemployment may do, we have not seen it come through our portfolio yet."

List Underwood, Regions' investor relations officer, added as a follow up: "One of the things we have noticed is that when we have seen a, let's say, a commercial real estate retail project experiencing difficulties, that unlike our experience in the homebuilder business wherein often there is not liquidity and staying power with these credits, [on the retail project] there is cash flow and that allows for workouts."

"That is different from the homebuilder workout approach," Underwood said. "Homebuilders, when they are no longer functioning, you have lots, you have land, you have spec houses, and it's a question of what you can get for that. So the loss on those kinds of credits, once they resolve is materially higher than the loss you are going to find on the retail."

Bill Parker, executive vice president and chief credit officer of U.S. Bancorp, echoed that theme. More than half of U.S. Bancorp's commercial mortgage portfolio is for owner-occupied property, which is all recourse loans, has an income stream and is broadly diversified. That does not mean some of those loans won't be prone to trouble, but they are problems that are showing up on a deal-by-deal basis, Parker said.

Mary Tuuk, chief risk officer for Fifth Third Bancorp, noted that at her bank holding company even though there was a significant increase in nonperforming commercial real estate loans there was a significant gap between owner occupied and non-owner occupied ratios, which were 4.2% and 7% respectively.

Commercial mortgage losses of \$77 million at Fifth Third were driven by the continued weakness in Florida and Michigan, which accounted for about two-thirds of the losses, she said. Commercial mortgage losses in Florida were particularly high, with net charge-off ratio 7.1% for the quarter, compared with 2.5% in Michigan and 1.4% for the remainder of the footprint.

Florida was commonly mentioned as the location where many of the banks' nonperforming loans were

originated.

Parker said U.S. Bancorp saw additional stress in California, the Pacific Northwest, Las Vegas and Phoenix. PNC Financial Services Group Inc. noted increased stress in Maryland. And KeyCorp note problems in Ohio.

Despite the underlying calm tone, it was also clear that recession-related pressures were evident in the banks results. Many took goodwill impairment charges because of downward economic pressure on the fair value of their mortgages and commercial real estate related assets.

Even in this regard though, the nation's largest banks have a built-in cushion. Because of the time frame over which loans were made, the banks will not absorb all of the losses in real estate values.

MetLife Inc., now considered a bank holding company by the U.S. Treasury, laid out its projection of how much of an impact the recession might have on its commercial real estate portfolio going forward.

MetLife did its own stress testing of its portfolio using peak-to-trough valuation declines of 40%, said Steve Kandarian, executive vice president and chief investment officer.

"We took [values] down 40% from the peak," Kandarian explained. "That's really taking a look at 2003 or the beginning of the uptick."

So starting with a value of 100 in 2003 then add in the 40% increase from that time, values went to 140. Then MetLife took that value down 40%, which took the value down to 84. So even if values drop 40%, MetLife would see a value decline of about 16%.

If things are getting to get much worse than that, it's not in the foreseeable future as far as banks are projecting.

"We don't see [the economy] tempering yet," Parker of U.S. Bancorp said. "We don't see it coming to an end. But we also don't see any unexpected outcomes that would cause our trajectories to change in the next two quarters."

"We hear glimmers of hope with respect to economic and credit outlook, and while we know recovery will be forthcoming, we're not looking for things to turn around quickly," said James Wells, CEO of SunTrust Bank Inc. "It is therefore appropriate that we remain sharply focused on maintaining a strong capital position and mitigating near term recession-related risk."

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