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What the Bank Stress Tests Tell Us About Commercial Real Estate

Most Potential Harm Seen Coming From Housing, Consumer Loan Defaults, Not Office, Industrial and Retail Property Loans

If the current economic malaise brings down any of the largest banks in the country, commercial real estate likely WON'T be the culprit. Office, industrial and retail properties specifically are even less likely to bring down the nation's top banks.

The 19 largest U.S. banks, which account for 70% of the bank holdings of this country, were the focus of the U.S. Federal Reserve 'stress tests' results released this past week. Under the worst case scenarios envisioned for the current recession, commercial real estate losses would cost those banks \$53 billion in losses this year and next.

While that is a lot of money, it still pales in comparison with residential loan losses, which still would make up the bulk of the projected losses, \$185.5 billion. In fact, exposure to commercial real estate loans falls way down the line in terms of producing projected losses for banks. Trading and counterparty investments would lose \$99 billion; consumer loans \$83.7 billion; credit card loans \$82.4 billion; business loans, \$60.1 billion; only then comes commercial real estate.

The two-year loss estimates totaled about \$600 billion in the more adverse scenario for the 19 bank holding companies.

Estimated losses on residential mortgages are substantial over the two-year scenario, consistent with the sharp drop in residential house prices in the past two years and their projected continued steep fall in the more adverse scenario. The effects of reduced home prices on household wealth and the indirect effects through reduced economic activity, also push up estimated losses on consumer credit, including losses on credit cards and on other consumer loans. Together, residential mortgages and consumer loans (including credit card and other consumer loans) account for \$322 billion, or 70% of the loan losses projected under the more adverse scenario.

Even in terms of percentages of losses, commercial real estate loans hold up better on the banks' books than its other assets and investments. About 22.5% each of residential real estate loans and credit card loans would go bad but only 8.5% of commercial real estate loans would go bad.

To cover those potential losses, the Federal Reserve has asked the 19 banks to raise \$75 billion in additional common equity by next November.

"This was a carefully designed, credible test," said U.S. Treasury Secretary Tim Geithner. "Banks supervisors applied a historically high set of loss estimates on securities and loans, as well as a conservative view towards potential earnings that could act as a buffer against those losses."

"These are estimate of potential losses and earnings that could occur in the event of a more severe recession. They are not a prediction of where the economy is headed," Geithner added. "The results are less acute than some had expected, in part because concern about the risk of a more severe recession have diminished, market have improved, and banks, in anticipation of the release of the stress test, have acted in the last few months to increased capital."

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The stress test process involved the projection of losses on loans and investment assets, as well as the firms' capacity to absorb losses. To analyze commercial real estate loans, the bank holding companies were asked to submit detailed portfolio information on property type, loan to value (LTV) ratios, debt service coverage ratios (DSCR), geography, and loan maturities.

Loss rates on commercial real estate loans reflected realized and projected substantial declines in real estate values. However, federal supervisors analyzed loans for construction (both residential and construction) and land development, multifamily property, and non-farm non-residential projects separately. And the bulk of the projected losses in the commercial real estate come from the construction and land development loans. Income producing properties fared much better.

The stress tests projected a baseline loss of 9% to 12% for construction loans and a worse case scenario of 15% to 18%; multifamily losses had a projected baseline loss of 3.5% to 6.5% and a worse case loss of 10% to 11%; office, industrial and retail properties had a projected baseline loss of 4% to 5% and worse case loss of 7% to 9%.

The results of the stress tests "were good news and were generally received as such, although it is important not to take excessive comfort from what remains essentially a highly educated guess as to the future of the banks in a very uncertain environment," concluded Douglas J. Elliott, a fellow in economic studies at The Brookings Institution. "The test appears to be somewhat tougher than the base case of the International Monetary Fund, but not nearly as harsh as the most pessimistic analyses."

"This implies that while we may well have turned the corner, we can be far from certain that the solvency crisis in banking is over," Elliott wrote in a paper this week. "Even if it is, the stubborn credit crunch will last for considerably longer. The banks will be in a better position to lend more freely as a result of the modest influx of new capital and the greater benefit of the confidence boost from passing the tests. However, the depth of this recession and the shattering of the securitization market will keep credit tight for some time."

One unintended side effect of the results of the stress test, Elliott said is that they will work against the government's plan to encourage investors to buy toxic assets from the banks.

"The government's reassurance that these banks have, or will soon have, the capital to handle even the stress scenario without selling their toxic assets makes it harder for the regulators to pressure the banks to actually sell," Elliott concluded. "This matters because the banks generally believe that even with government incentives the private investors are looking to pay unreasonably low prices for these assets."

The banks would generally prefer to hold onto the assets until they can get a better price, Elliott reasoned.

Generally across the board, the 19 bank holding companies put to the stress tests, said they believe the stress test assumptions were unreasonably conservative and actual losses will be far less than projected.

Regions Financial Corp. in Birmingham, AL, questioned whether it should be required to raise additional capital now to provide for a two-year adverse economic scenario, particularly in view of the fact that Federal Reserve Chairman Ben Bernanke this past week said that he expects the economy to begin recovering during 2009.

Regions said it believes that the stress test results do not accurately reflect the loan losses that Regions is likely to experience even in the "more adverse" economic scenario. In particular, the anticipated two-year cumulative loss ratio of 13.7% projected on its commercial real estate is sharply higher than Regions' actual annualized loss ratio on its portfolio in the first quarter and sharply higher than that projected for the other banking companies.

Bank of America Corp. in Charlotte, NC, was projected to have a 2-year loss rate on its commercial real estate loans of 7.4%, or 3.7% per year. Bank of America said its actual first quarter annualized loss rate on the equivalent portfolio was 1.68%. So, loss rates would have to more than double to 3.9% and

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remain there for the remaining seven quarters to reach the FRB's projections.

Additionally, the FRB's loss rate is well above the combined commercial and commercial real estate peak loss rate experienced by Bank of America in either the 1991 recession or the 2002 recession.

Individual CRE Stress Test Results

Company	Est. Worse-Case CRE Loss	As a % of Loans	Bank of
America	\$9.4 billion	9.1%	Wells Fargo & Co.
5.9%	Regions Financial	\$4.9 billion	13.7%
billion	12.6%	PNC Financial Services Group	\$4.5 billion
JPMorgan Chase & Co.	\$3.7 billion	5.5%	U.S. Bancorp
10.2%	Fifth Third Bancorp	\$2.9 billion	13.9%
\$2.8 billion	10.6%	Citigroup	\$2.7 billion
rp	\$2.3 billion	12.5%	Capital One Financial
MetLife Inc.	\$800 million	2.1%	Morgan Stanley
45.2%	GMAC	\$600 million	33.3%
35.5%	Bank of New York Mellon	\$200 million	9.9%
Express	not applicable	not applicable	Goldman Sachs Group
applicable	not applicable		not

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