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Fed Frets About Commercial Real Estate

With Banks Slow to Take Losses, Fears of a Residential-Bust Repeat; 'More Pain Likely Lies Ahead'

By LINGLING WEI and MAURICE TAMMAN

Banks in the U.S. "are slow" to take losses on their commercial real-estate loans being battered by slumping property values and rental payments, according to a Federal Reserve presentation to banking regulators last month.

The remarks suggest that banking regulators are girding for a rerun of the housing-related losses now slamming thousands of banks that failed to set aside enough capital during the boom to cushion themselves when the bubble burst. "Banks will be slow to recognize the severity of the loss -- just as they were in residential," according to the Fed presentation, which was reviewed by The Wall Street Journal.

A Fed official confirmed the authenticity of the document, prepared by an Atlanta Fed real-estate expert who is part of the central bank's Rapid Response program to spread information about emerging problem areas to federal and state banking examiners throughout the U.S.

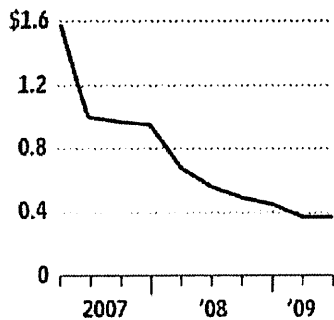
While the Sept. 29 presentation by K.C. Conway doesn't represent the central bank's formal opinion, worries about the banking industry's commercial real-estate exposure have been building inside the Fed for months. "More pain likely lies ahead for this sector and for those banks with heavy commercial real estate exposures," New York Fed President Bill Dudley said in a speech Monday.

In another sign that many U.S. financial institutions are inadequately protected against potential losses on commercial real-estate loans, banks with heavy exposure to such loans set aside just 38 cents in reserves during the second quarter for every \$1 in bad loans, according to an analysis of regulatory filings by The Wall Street Journal. That is a sharp decline from \$1.58 in reserves for every \$1 in bad loans from the beginning of 2007.

The Journal's analysis includes more than 800 banks that reported having more half of their loans tied up in commercial real-estate, ranging from apartments to office buildings to warehouses.

Rainy-Day Funds Get Swamped

Amount set aside by commercial real-estate banks¹ for every dollar in souring loans



¹Banks with more than 50% of assets in commercial real estate

Source: FDIC

Loan-loss reserves typically rise and fall during any credit cycle, being drawn down as losses mount. Some analysts and investors say the recession combined with inadequate loan-loss provisions when times were good have left banks dangerously vulnerable to the deteriorating commercial real-estate market.

Mr. Conway's presentation painted a bleak picture of the sliding real-estate values and enormous debt that will need to be refinanced in the next few years. Vacancy rates in the apartment, retail and warehouse sectors already have exceeded those seen during the real-estate collapse of the early 1990s, Mr. Conway noted. His report also predicted that commercial real-estate losses would reach roughly 45% next year. Valuing real estate has always been tricky for banks, and the problem is particularly acute now because sales activity is practically nonexistent.

Some of the banks with especially low levels of loan-loss reserves are teetering. Capmark Bank, based in Midvale, Utah, and owned by commercial real-estate finance firm Capmark Financial Group Inc., had 11 cents in reserves for every \$1 in bad loans it reported in the quarter ended June 30, the Journal analysis shows.

A Capmark spokeswoman said in a statement that the amount of loans written off by the bank, totaling \$357 million as of June 30, "should be taken into account when evaluating possible future losses."

Capmark's parent company, owned by investors led by private-equity firm Kohlberg Kravis Roberts & Co., warned last month that a bankruptcy filing could be imminent and said regulators intend to order Capmark Bank to raise capital and improve its liquidity. Capmark Bank got a \$600 million capital infusion from its parent company in late September.

These days, many U.S. banks have adopted a policy of extending loans when they come due even if they wouldn't make those loans now. In some cases, values of the underlying property have fallen below the amount of the loan.

"There's been an extend-and-pretend philosophy by banks to forestall hits to their balance sheets that might occur," says Patrick Phillips, new chief executive of the Urban Land Institute, a real-estate industry group.

Matthew Anderson, a partner at research firm Foresight Analytics, adds: "It's like taping paper over a hole in the wall."

Last month's Fed presentation supports criticisms that banks have been slow to take losses on bad commercial real-estate loans. The value of commercial real-estate loans as recorded by banks has declined at a much slower rate than property values since 2005. But banks have been slow to absorb losses on their loans partly due to "capital preservation" concerns, the report states.

Bank examiners are stepping up their scrutiny of commercial real-estate portfolios at U.S. banks. Michael Stevens, senior vice president of regulatory affairs at the Conference of State Bank Supervisors, said regulators are reviewing greater volumes of commercial real-estate loans than they did before the financial crisis erupted.

Commercial real-estate loans are the second-largest loan type after home mortgages. More than half of the \$3.4 trillion in outstanding commercial real-estate debt is held by banks.

The Fed presentation states that the most "toxic" loans on bank books are so-called interest-only loans, which require borrowers to repay interest but no principal. Those loans "get no benefit from amortization," the report states.

"Today, most of the borrowers are paying because interest rates are so low, but the question is whether the loans will get paid off when they come due," said Michael Straneva, global head of Ernst & Young's transaction real-estate practice.

Regulators are zeroing in on banks that use interest reserves to mask bad construction loans. When such loans are made, banks typically calculate interest that would be paid and set that money aside, basically paying themselves until the loan becomes due or the property generates cash flow.

Regulators want to make sure banks don't have a false sense of security only because the interest reserve is paying the loan. Banks need to look at "the sources of repayment" to determine whether the loan will get repaid, says Darryle Rude, supervisor of industrial banks at the Utah Department of Financial Institutions.

According to Foresight Analytics, more than 40 U.S. banks have been hit so far this year with enforcement actions by regulators that include alleged misuse of interest reserves.

Some banks with unusually low levels of loan-loss reserves based on the Journal analysis said those figures reflect their decision to aggressively write off hopeless loans. "We've tried to both build up our charge-offs and reserves," says David Shearrow, chief risk officer of United Community Banks Inc. About 80% of the Blairsville, Ga., bank's problem loans have been charged down to a level where the bank thinks it can sell them.

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