

Industry Outlook: The Worst May Still Be Yet To Come For U.S. Commercial Real Estate Loans

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Standard & Poor's Ratings Services believes that U.S. banks' real estate exposures may trigger substantial losses on the financial system during the current economic cycle. Each real estate cycle is different, and this one is likely to be different from the one during 1990-1993. In our view, however, that does not mean that this cycle should be any less severe. Although the causes of this cycle, and the players, are different, the sector nevertheless is likely to suffer the same degree of supply and demand imbalances and price declines that historically devalued the collateral backing real estate loans, resulting in severe losses for lenders. The severity of commercial real estate (CRE) cycles has always caused us to view CRE lending as one of the riskiest loan categories for banks. Therefore our risk-adjusted capital (RAC) methodology assigns a higher risk weighting for these loans than for most other asset classes. As a result, banks with high CRE exposure were generally rated lower than banks without this exposure.

In addition, elevated CRE exposure has driven many bank downgrades in the past two years, particularly of regional banks or finance companies with outsize exposures. Even though most highly exposed banks with weaker balance sheets are already rated below investment grade, more downgrades are possible; indeed, approximately 75% of the rated banks with the largest exposure to CRE carry negative outlooks. On a more positive note from a ratings perspective, even though many of the rated banks could suffer heavy losses, we believe that their capital is in most instances sufficient for them to pull through, as long as the losses are realized over a few years rather than taken at once, and as long as liquidity can be maintained. CRE exposure generally tends to represent a higher proportion of smaller, largely unrated community banks' exposures. Therefore, there is a greater proportion of risks in the unrated banking sector.

Sliding Fundamentals Portend Bank Losses

Banks lose money on their CRE exposures when the collateral values and cash flows on properties fall below a level that can support the debt. Put simply, this happens when the supply and demand fundamentals go out of balance. Whether this happens because of overbuilding or because demand for space decreases, it does not make a difference. The impact on vacancies, values, and rents can be the same. Another reason for prices to fall is that risk appetite is reined in, which causes the required return on investment to increase. We see both of these factors at work in the current CRE markets, with vacancies at very high levels, rents expected to decline further, and required returns, or cap rates, climbing back to historic levels after having fallen during the boom years. Thus, we expect fundamentals to be similar to those prevalent in the real estate cycle of 1990-1993, and we therefore expect the impact on collateral values likely to be as severe as it was during that period.

As we look at the fundamentals across the various sectors of CRE, we see that the homebuilding sectors were hit the earliest and the hardest. About 40% of rated banks' CRE loans are made for construction, acquisition, and development purposes, of which 22% (or 8% of total CRE loans) are for residential construction, a sector that has been particularly hard hit by a severe (79% from the peak) plunge in homebuilding that began in late 2007. As a result, builders have defaulted with greater frequency and undeveloped land has fallen in value, causing nonperforming loans in the homebuilding sector to rise to 18% as of Sept. 30, 2009. Homebuilder-related net

charge-offs rose steeply to an annualized run rate of 4.8% for third-quarter 2009. More recently, commercial construction loans have gone sour as the fundamentals in those markets deteriorated.

Supply and demand imbalances are visible in all segments of mortgage lending as well. National vacancy rates in the office, retail, multifamily and hotel sectors are now in the neighborhood of 1991 levels. For example, office vacancies reached 17.3% as of third-quarter 2009, and C.B. Richard Ellis (CBRE) estimates they will go to 19.5% in 2010, higher than the peak of 18.9% in 1991. Likewise, retail vacancies, currently at 12.3%, are headed to 12.9% per CBRE estimates, versus 11.3% in 1991. Multifamily vacancies are at 7.4%, versus 7.0% in 1991. Nationally, rents for offices are down substantially more than in 1991--by 15.7% versus 9.4%. This time around, a particular trouble spot is the hotel sector, especially the casino hotel sector, where overbuilding has been a factor. The occupancy rate for this asset class is a low 60.9%, a level last seen after Sept. 11, 2001. Nationally, rents for offices are down substantially more than in 1991--by 15.7% versus 9.4%. RevPAR (revenue per room) for hotels nationally is down 20%. Real estate cycles generally lag the economic cycle, so vacancies could deteriorate further even as the economy recovers. This is due to the buildup of "shadow" vacancies of empty space still under lease but unutilized by strong companies able to make lease payments.

The causes of the high vacancy rates are different this time than last--less the result of overbuilding than of the economic recession and overfinancing. In the previous cycle, tax law changes spurred a building boom. This time, annual completions of offices, industrial properties, and multifamily residences were much lower. However, absorption rates turned sharply negative due to the recession, as retail sales and office employment declined. The previous CRE cycle began in 1989-1990, prior to and probably causing the mild recession that hit a year later. This time the recession began before the CRE cycle, and was more severe, with a higher impact on employment and other factors that drive demand. Arguably, underwriting standards were also different. We can take some comfort from the notion that banks in this cycle are more likely to have required personal guarantees and lower loan-to-value (LTV) ratios in the initial underwriting of their CRE loans. However, this was somewhat offset by liberal pricing and unsustainable cap rates.

With the supply and demand fundamentals so far out of balance, it is not surprising that prices for commercial buildings have fallen. While transaction activity is very thin and estimates of price declines vary as a result, MIT Center For Real Estate estimates that prices across all sectors have fallen about 30% from their peak, down to 2004-2005 levels depending on the sector. That compares to about 50% declines in the 1990-93 period (CBRE). We believe that much of the current problem is the effect of an unsustainable inflation in prices of about 90% during the past decade, to a point where the cap rates had fallen to 5%, down from 7% in more normal periods. Cap rates have climbed back somewhat but prices would need to fall further to return them to historic rates. CBRE estimates are for a 40% decline in office prices.

The decline in collateral values poses a difficulty for loans that need to be refinanced. If the types of loans that make up commercial mortgage-backed securities (CMBS) pools are representative of bank loans, refinancing needs will be somewhat elevated in 2011 and 2012, although the bulk of them will not come until 2015. Bank policies often require that the LTV of CRE loans be lower than 80%. A simple calculus suggests that if prices are already down 30%, with a potential to fall further, refinancing will be difficult unless the borrowers can contribute additional equity capital.

How the refinancing plays out could depend on cash-flow performance of the properties. For mortgages on more stable, largely leased-up properties, the impact of CRE market conditions has been somewhat softened by good cash

flows. Lower interest rates for the substantial proportion of loans that were made at floating rates have offset the decline in rents and occupancy. As long as cash flows can cover interest payments, banks are likely to continue to extend the loans, hoping for a collateral value rebound. We believe that this tactic is unlikely to do more than delay the problem recognition because until the market clearing prices are reached, partly through forced liquidations, liquidity will not return to the marketplace and the refinancing overhang will remain. Reliance on cash-flow coverage is in any case likely to prove untenable when interest rates rise and rents fall further, constraining cash flows. At the point when neither the cash flows nor the collateral values support extensions or refinancing of loans, banks will face difficult choices about whether to foreclose, restructure, or otherwise attempt to minimize the losses they must record. Accelerating foreclosures and write-downs could weigh on the market further and breed more loss recognition. That would make refinancing even good loans more difficult.

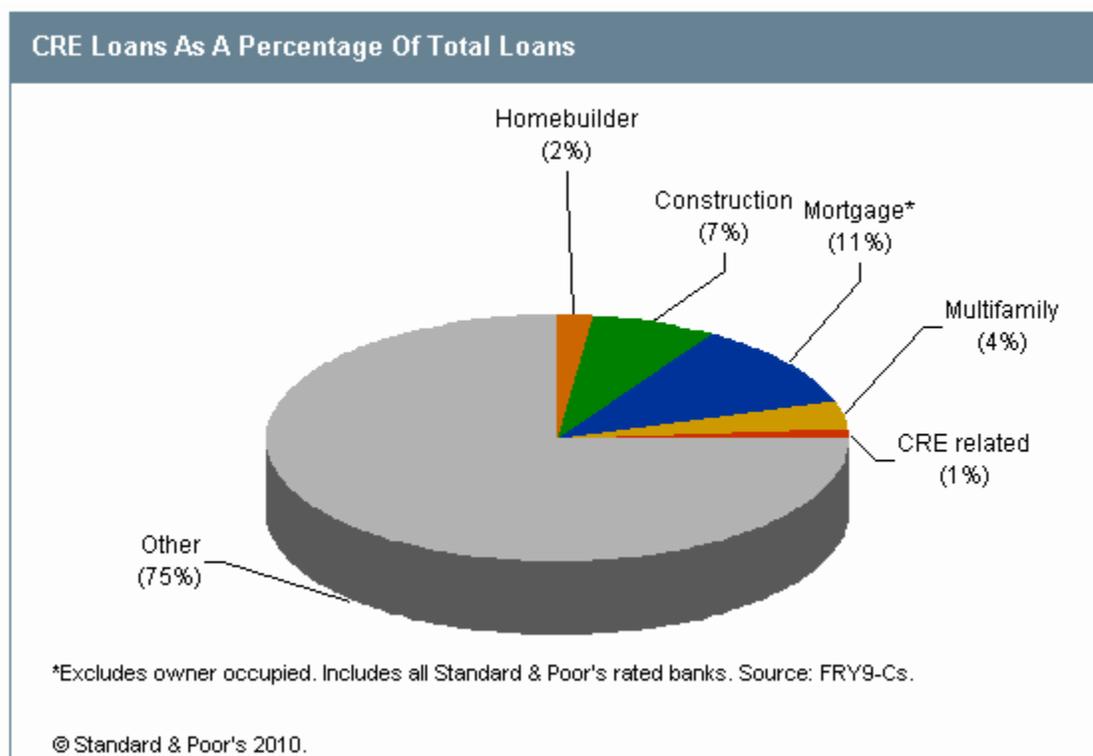
Not All Banks Would Suffer Equally

During the CRE cycle of 1990-1993, large commercial banks experienced losses of about 16% on their CRE loans, counting charge-offs plus write-downs on their foreclosed properties that were taken through expenses rather than reserves (using company disclosures in 10-K and other reports). We use this historical data to arrive at estimates of our base-case stress losses for this cycle. The highest loss levels were on construction loans. Thus, we believe that in general banks could experience cumulative losses over the CRE cycle of 24% on their construction exposure. Mortgage loan losses were smaller at about 12% and multifamily losses were about 10%. For our stress tests we assume that two-thirds of the losses occur during the next two years.

How heavy such losses will prove for the banks depends on their exposure as well as on their capital and earnings capacity to absorb those losses. Our stress tests demonstrate the impact of such losses on earnings and on capital during a two-year period. We believe that banks that can maintain at least a 4% tangible equity-to-risk-weighted assets (RWA) ratio after the projected losses from their holdings have sufficient capital to weather the correction.

The average, rated bank makes 25% of its loans for CRE, which we define as homebuilder loans, other construction loans, mortgage loans on investment commercial properties (which exclude owner-occupied buildings), multifamily mortgages, and loans to CRE-related enterprises that are not collateralized by real estate. CRE portfolios tend to be about 36% construction related and 60% for income-producing properties like offices, retail, hotel, or industrial.

Chart 1



That is not to say that we would assume the same levels of losses for all rated banks. Not all banks have equally risky portfolios in each of these three asset classes.

Geographic mix matters even though weakness is visible across almost all major markets in the U.S.

Table 1

Geographic Breakdown For Selected Regional Banks	
(%)	
Florida	6.24
Arizona	4.66
Nevada	1.60
Texas	5.90
California	6.76
Midwest	22.76
Mid-Atlantic	9.44
Northeast	0.00
Other south	33.39
Other west	3.36
Not specified	5.89
Total	100.00

Interestingly, the weakest CRE markets coincide with the weakest residential mortgage markets: California, Nevada, and Florida, where price declines were greatest and vacancies are higher. This is particularly true for real estate

properties that are correlated with the housing sector (i.e. retail, tract financing, office tenants concentrated in finance, and the housing sector). Texas, on the other hand, has held up better than many other markets.

Table 2

Product Breakdown Of Selected Regional Banks	
(%)	
Construction (homebuilder and other)	33.10
Land	8.50
Income-producing properties	57.20
Office	10.50
Retail	11.70
Industrial	6.00
Hotel	4.20
Multifamily	10.70
Other	4.70
Other CRE	1.10
Total	100.00

The nature of the loans is also important. The highest losses should be on the raw land components of the construction portfolios. The mortgage loans on income-producing properties vary widely as well. To pick one major characteristic, banks have made loans with quite different LTV requirements. Some, like Zions Bancorporation, have portfolios whose average LTVs at origination were in the mid-50% area, whereas others aimed for 80%. Part of the differences also stem from the nature of the relationships the banks have with the borrowers. Some of the mortgage loans are shorter term (three-to-seven years) with an ability to alter terms during the course of the loan. They may have recourse to other resources of the real estate investor, or the bank may provide other services and have a greater knowledge of the overall cash flows of the borrower's business. Other shorter-term loans are the so-called "mini-perms," or construction loans that are rolled over into mortgage loans to allow further leasing activity and stabilization of the property. Other banks make 10-15 year permanent financings, like insurance companies do. We evaluate the conservatism of the lending practices within each type of lending and adjust our base stress assumptions for each bank accordingly.

Ratings Impact Of CRE Exposures

The banks with the highest, riskiest exposures in this cycle are the regional banks as opposed to the large complex banks, which were the most exposed in the past cycle. In general, rated banks have less concentration in CRE, averaging of 25% of their loan portfolios, than the smaller unrated banks.

However, we rate 26 independent banking organizations whose CRE loans represent more than 25% of total loans (i.e., Synovus Financial Corp., Banco Popular de Puerto Rico).

Table 3

Rated Banks With Highest Concentrations In CRE		
	% CRE/loans	Rating (bank level)
New York Community Bancorp Inc.	94.83	BBB
Carolina First Bank	48.68	B+

Table 3

Rated Banks With Highest Concentrations In CRE (cont.)		
Synovus Financial Corp.	48.57	BB+
S&T Bancorp Inc.	47.29	BBB+
First Midwest Bancorp Inc.	47.05	BBB
Wilmington Trust Corp.	38.06	BBB
Zions Bancorporation	38.03	BBB
Susquehanna Bancshares Inc.	34.98	BBB-*
Whitney Holding Corp.	34.87	BBB-
M & T Bank	34.41	A
BancorpSouth Inc.	34.27	A-
Marshall & Ilsley Corp.	33.31	BBB
Valley National Bancorp	30.05	A
Cullen/Frost Bankers Inc.	29.34	A
Associated Banc Corp.	29.08	BB+
Huntington Bancshares Inc.	28.82	BBB-
First BanCorp	28.57	B
Citizens Republic Bancorp Inc.	28.1	B+
Regions Financial Corp.	26.87	BBB+
BOK Financial Corp.	26.83	A-
Trustmark Corp.	26.72	A-
FirstMerit Corp.	26.62	A-
First National of Nebraska Inc.	26.27	BBB-
BB&T Corp.	26.23	A+
Banco Popular de Puerto Rico	25.31	B+

*Holding company rating.

We have lowered our ratings on these banks an average of two notches in the past two years, with some, like Synovus or Popular, downgraded six or seven notches, respectively. Moreover, the majority of these companies carry negative outlooks. Those in the investment-grade range pass our base stress case with more than 4% tangible common equity-to-RWA ratio after two years of capital-eroding losses, thanks to currently high capital ratios. Those that do not pass are in the noninvestment-grade range.

Even for the most heavily exposed banks, underwriting varies. For example, New York Community Bancorp Inc. focuses on rent-controlled New York City apartment houses, which produce steady cash flow and do not experience significant vacancies, and where nonperforming CRE loans were only 2% of CRE loans at Sept. 30, 2009. Synovus, on the other hand, with a high proportion of construction loans, has 10% nonperforming assets (NPAs). Despite its exposure, Valley National Bancorp has only 87 basis points of NPAs. In addition to underwriting differences, companies are tied to the economies of the markets in which they operate: Whitney Holding Corp. and Carolina First Bank are suffering to some extent from their exposure to the Florida and, more generally, Southeastern markets, which have experienced a steep downturn after several years of outsize appreciation in residential and other property values. In contrast, BancorpSouth Inc. operates largely in more stable markets, so loans were written without the expectation of steep price appreciation, so that we believe deterioration will remain in the context of a normal cyclical downturn.

Not all CRE exposure is in the form of loans. The larger banks tend to have some of their exposure in the form of CMBS.

Table 4

CMBS Exposure (At Fair Value)				
(Mil. \$)	Held to maturity	Available for sale	Trading acct	Total
Wells Fargo & Co.	N.A.	11,264	329	11,593
Bank of America Corp.	N.A.	7,727	3,759	11,486
JPMorgan Chase & Co.	N.A.	5,820	2,941	8,761
PNC Financial Services Group	2,170	4,873	38	7,081
Morgan Stanley	N.A.	N.A.	5,465	5,465
Citigroup	879	809	2,458	4,146
State Street Corp.	3,658	291	N.A.	3,949
Bank of New York Mellon Corp.	13	2,913	N.A.	2,926
Citizens Financial Group Inc.	N.A.	2,300	N.A.	2,300
The Goldman Sachs Group Inc.	N.A.	110	1,590	1,700
Susquehanna Bancshares Inc.	N.A.	192	N.A.	192
U.S. Bancorp	N.A.	174	N.A.	174
Fifth Third Bancorp	N.A.	140	N.A.	140
Webster Financial Corp.	N.A.	104	N.A.	104
Aggregate Exposure Rated Banks	6,731	37,135	17,482	61,347

Data as of Sept. 30, 2009. N.A.-Not available. Source: FRY9-C

The exposures tend to be in the form of the most senior tranches of the CMBS transactions, about which we have fewer concerns about ultimate losses. However, valuations on the securities, currently at about 83% of par according to the CMBX index, have been very volatile. Valuation changes could affect income for the banks that carry the exposures as trading assets, where they are marked to market. Even available for sale securities are subject to temporary impairment charges and affect the other comprehensive income component of equity. On the other hand, for banks like Wells Fargo, which acquired much of its exposure from Wachovia, the assets have been marked to fair value through purchase accounting, limiting any further potential losses.

Some banks also have equity interests in real estate. These exposures are particularly risky in a declining value environment.

Table 5

Equity Interest In CRE	
(Mil. \$)	
Bank of America Corp.	7,276
KeyCorp	991
Fifth Third Bancorp	749
Citigroup Inc.	592
Huntington Bancshares Inc.	196
M&T Bank Corp.	193
BancWest Corp.	148
Citizens Financial Group Inc.	142
Wells Fargo & Co.	62

Table 5

Equity Interest In CRE (cont.)	
Associated Banc Corp.	38
Zions Bancorporation	23
S&T Bancorp Inc.	15
Susquehanna Bancshares Inc.	6
Wilmington Trust Corp.	5
Citizens Republic Bancorp Inc.	5

Data as of Sept. 30, 2009. Source: FRY9-C reports.

Taken all in--the loans, the CMBS and the equity investments--the banks' exposures as a multiple of their tangible common equity are shown in table 6.

Table 6

CRE Loans, CMBS, And Equity Investments As A Multiple Of Tangible Total Equity	
(x)	
New York Comm Bancorp	10.94
South Financial Group Inc.	7.08
Synovus Financial Corp.	6.10
S & T Bancorp	5.89
First Bancorp , PR	5.85
Susquehanna Bancshares	5.17
M & T Bank	5.01
Marshall & Ilsley	4.70
Zions BanCorp	4.63
First Midwest Bancorp	4.61
Wilmington Trust	4.47
Whitney Holding	4.08
BancWest Corp.	3.35
BancorpSouth Inc.	3.31
Valley National Bancorp	3.17
Popular Inc.	3.16
Huntington Bancshares	3.09
Associated Banc-Corp	3.05
Regions Financial	2.90
BB&T Corp	2.84
Citizens Republic Bancorp	2.83
TCF Financial Corp.	2.76
Trustmark Corp	2.58
Webster Financial Corp	2.55
PNC Financial Services Group	2.44
Keycorp	2.37
Cullen/Frost Bankers	2.11
City National Corp.	2.08
FirstMerit Corp.	2.00

Table 6

CRE Loans, CMBS, And Equity Investments As A Multiple Of Tangible Total Equity (cont.)	
Fifth Third Bancorp	1.99
Wells Fargo & Co.	1.89
Comerica Inc.	1.82
U.S. Bancorp	1.77
BOK Financial	1.68
SunTrust Banks Inc.	1.50
Capital One Financial	1.47
First Citizens Bancshares	1.44
UnionBanCal Corp.	1.40
First Horizon National Corp.	1.08
Old National Bancorp	1.03
Bank of America	1.00
J.P. Morgan Chase & Co.	0.77
Northern Trust Corp.	0.53
Bank of New York Mellon	0.49
State Street Corp	0.46
Oriental Financial Group	0.34
Citigroup	0.30
UMB Financial Corp.	0.25
SVB Financial Group	0.17

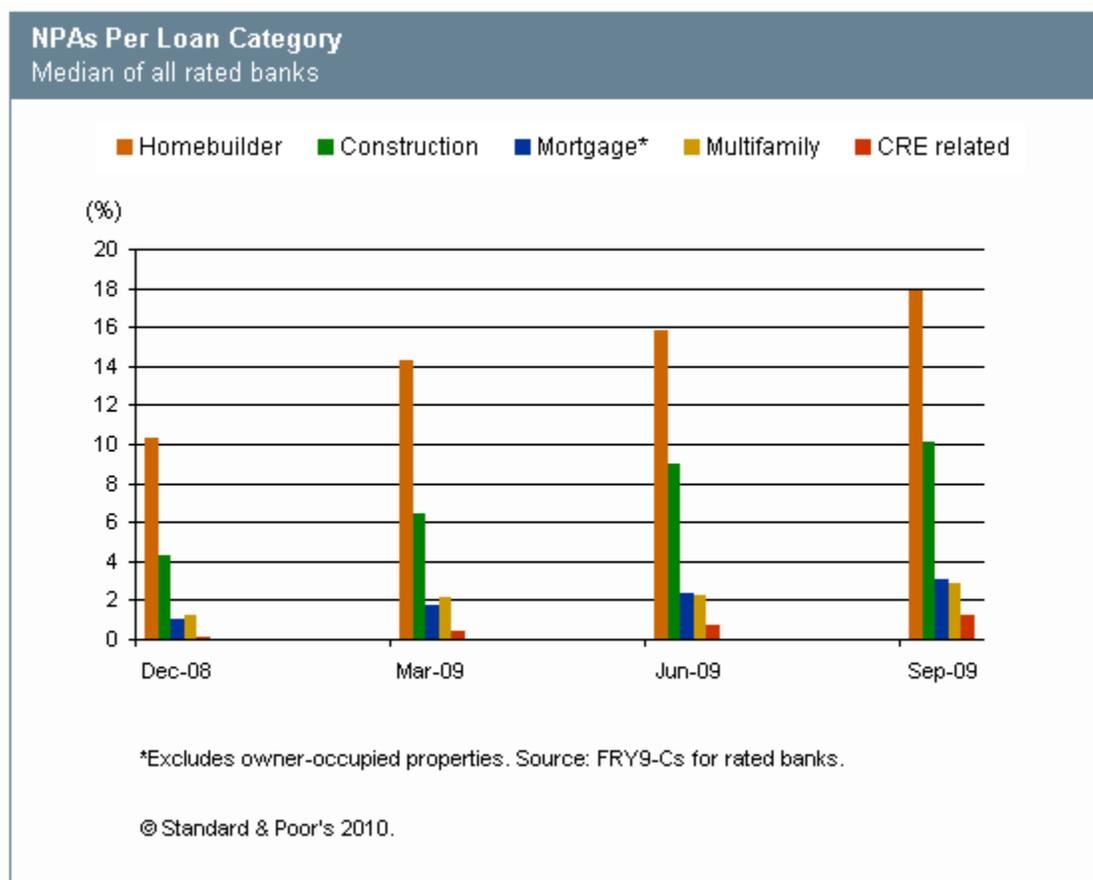
Data as of Sept. 30, 2009. Source: FRY9-C reports.

Once again, the banks with the larger exposures are the regional banks rather than the large complex banks, even when we include the real estate exposure the larger banks hold in the form of CMBS or equity interests.

Still In The Early Innings Of The Problem

Problem recognition to date is not very advanced. Even in the homebuilder sector, where nonperforming loans (NPLs) are at 18%, losses for the seven quarters through third-quarter 2009 totaled only 5.5% (median). Commercial construction losses have been 3.9%, with NPLs at 10%. This implies substantial additional losses during the next few years to attain our estimate of 24% cumulative losses for these categories. Cumulative losses in mortgages and multifamily lending have been only 0.80% and 0.92%, respectively, and even NPLs are not yet very high; we expect them to rise sharply in 2010 and eventually achieve the stress loss assumptions, though maybe not until 2012.

Chart 2



There is substantial variation in the experience of individual banks on both nonperformers and net charge-offs in each of these categories. Again, this reflects the differences in geography, underwriting, and loan types--as well as perhaps problem recognition.

Conclusion

The fallout from CRE exposures for banks has yet to run its course, in our opinion. Although many of the problems are already evident in the homebuilding sector, and are well underway in commercial construction, these are the smaller sectors. We believe the problems in the larger mortgage and multifamily sectors are yet to be felt because for now low interest rates and still-adequate cash flows make debt servicing possible. As rates rise and rent rolls decline further, we believe that delinquencies will rise in this sector as well, and prices will fall further, complicating the refinancing of these portfolios.

We see no reason to believe the impact of this credit cycle in CRE will be less severe in terms of losses banks incur than that of the 1990s. However, this time the smaller banks have the heavier concentrations in CRE. They also have healthier capital cushions that could help them weather the painful cycle. Our stress tests show that most rated banks are able to absorb the associated losses without eroding capital below 4% of tangible common to RWA, as long as the losses are spread over a few years. We believe that downward pressure on the ratings will continue,

however, as the banks that appeared to be better positioned in terms of their portfolios or capital cushions prove to be more vulnerable, or fail to maintain their business-generating power.

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