Testimony of Richard Parkus
Commercial Real Estate: Do Rising Defaults Pose a Systemic Threat?
Before the Joint Economic Committee, U.S. Congress
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Chair Maloney, Vice Chairman Schumer, Ranking Members Brownback and Brady, and other distinguished members of the Committee:

My name is Richard Parkus. I am a research analyst working for Deutsche Bank Securities Inc. in New York. I have been employed by Deutsche Bank since 1998 to provide research coverage of the securitization markets, with a focus on the commercial mortgage backed securities (CMBS) market. It is a privilege for me to testify at this important hearing to explore the current state of commercial and industrial lending, and to discuss the effectiveness of government efforts to restart credit markets.

My testimony today will focus on three research reports that I recently published. The first report, published on April 23 of this year, titled "The Future Refinancing Crisis in Commercial Real Estate," addresses what I believe will be widespread refinancing problems for commercial mortgages over the coming decade. The other two reports, both published in May of this year, provide my views on the likely efficacy of the TALF programs, both for legacy CMBS and for new issue CMBS. All three of these reports have been provided to the Panel as my written submission. With the Chair's permission, I would also like to submit as part of the written record a forthcoming report to be issued this month, focusing on the potential impact of commercial real estate loan defaults on banks.

Before addressing my research, I must note that the views I express today are my own and do not necessarily represent those of Deutsche Bank or any of its staff members.

The commercial real estate sector is currently under greater stress than at any time since the crash of the early 1990s. In fact, I believe that the severity of the current downturn is likely to exceed, possibly by a large magnitude, that of the early 1990s. The problems are two-fold. First, the extraordinarily severe economic recession has resulted in vacancy increases and rent declines that are already of a similar magnitude to what occurred in the previous episode. This has pushed default rates to levels approaching those of the 1990s. The second problem, one that is potentially even more serious, is that for those loans that do make it to maturity, a very large percentage, perhaps in excess of 65%, may not qualify for refinancing under the dramatically tighter new underwriting standards, particularly in view of the fact that commercial real estate prices on stabilized properties have declined by 35-45% or more from their peak in 2007, and almost surely have further to go.

On the whole, I expect that total losses in CMBS will be approximately 9-12% of the outstanding CMBS loan universe, or about $65-$90 billion. For the 2005-2007 vintage loans, my estimate of total losses is somewhat higher, about 12-15%. For the 2007 vintage alone, I expect in excess of 20% losses. This compares with approximately 10% total losses for the worst performing vintage -- the 1986 vintage -- in the early 1990s.

In order to manage through this extremely stressful process, it is critical that commercial real estate financing markets begin functioning again with some degree of normalcy. By this I mean that loans which qualify for refinancing must be able to obtain financing. At the moment, this is not the case. Commercial real estate financing markets are effectively closed, at least for loans in excess of $25-$35MM. Smaller loans on properties that are performing well have continued to have some degree of success refinancing, mainly with regional banks. However, we believe that this source will continue to deteriorate as problem loans mount in bank portfolios.

Within the larger commercial real estate finance sector CMBS has roughly a 25-30% market share, while banks have about 50% market share, life insurance companies about 10% and pension funds about 10%. One common misconception, in my view, is that commercial real estate problems started in CMBS and somehow migrated to banks and other sectors. In fact, I believe that banks will, once again, prove to be the epicenter of commercial real estate loan problems.

When looking at "commercial real estate" exposure in banks, one must distinguish between three categories of loans: construction and land development loans, core commercial real estate loans, and multifamily loans. In aggregate, banks have exposure to about $550 billion in construction loans, $1.1 trillion of core commercial real estate loans and $150 billion of multifamily loans. By far the most problematic of these are the construction loans, which contain high proportions of both loans to home builders and condo construction loans. Moreover, exposure to construction loans rises rapidly as one moves from large money center banks to smaller regional and local banks—the four largest US banks have an average exposure of less than 2% of total assets, while the 31-100 largest banks have an average exposure of about 12%. Given that prices are down 40-45% on stabilized commercial properties, they must be down vastly more than this on newly completed or only partially completed properties. I expect that loss severities on defaulted construction loans could approach 80-90% in many cases. 90+ day delinquency rates are currently in the 12% range for construction loans in bank portfolios, but are somewhat higher for construction loans in regional bank portfolios. In fact, I am perplexed by the fact that construction loan delinquency rates are only 12% at this point. However, I believe that this can be explained by the fact that they are typically structured with interest reserves which are sufficient to cover interest payments until the expected completion of the project. Thus, construction loan delinquency rates are currently artificially low due to interest reserves, but will likely rise dramatically within the coming 6-12 months. In my view, losses on construction loans are likely to be in excess of 25%, possibly well in excess, which would imply losses of at least $140 billion. This, of course, would be disproportionately borne by regional and local banks.

In terms of core commercial real estate, the story is much the same, at least qualitatively. Again exposures are much higher for regional and local banks than for the largest money center banks. The four largest banks have an average exposure of 3-4% to commercial real estate loans, while smaller regional banks have an average exposure of 15-20%. I also believe that core commercial real estate loans in bank portfolios are likely to be riskier than those in fixed rate CMBS. There are two main reasons for this view: First, bank loans tend to have fairly short terms, typically 3-5 years, while fixed-rate CMBS loans have much longer terms, typically 7-10 years. As a result, a much higher percentage of bank loans will have been made at the peak of the market and will come up for refinancing at the bottom of the market, the 2010-2012 period, when they are least likely to qualify. Second, bank loans tend to be used to finance transitional properties, while fixed-rate CMBS loans typically finance stabilized properties. Loans on transitional properties are generally riskier than loans on stabilized properties, particularly in a economic downturn.

The view that core commercial real estate loans in bank portfolios are likely to underperform those in CMBS is supported by the fact that delinquency rates for bank loans have for many years far exceeded those of CMBS loans. As of the end of Q1 2009, the delinquency rate on bank commercial real estate loans was approximately two and a half times that on CMBS loans.

In terms of specific loss estimates, it is reasonable to assume that loss rates on core commercial real estate loans in bank portfolios will be at least as large as those of the 2005-2007 vintage CMBS loans—which I expect will be in the 12-15% range. This would imply losses of at least $120-$150 billion on banks' core commercial real estate loan portfolios.

The problems facing commercial real estate are severe and will likely take many years to resolve. There are no easy solutions. However, there are measures that can be taken that will help mitigate the pain and disruption of this process. By far the most important of these are steps that promote the recovery of commercial real estate financing markets. In my view, these should focus on reviving the public securitization market. I expect that over the coming decade the amount of capital from traditional sources (e.g., banks, insurance companies, pension funds) committed to financing commercial real estate will decline significantly. It is absolutely critical that a revitalized CMBS market be able to step in and fill the void. The CMBS market worked effectively and efficiently for well over a decade and, with the right changes, is capable of playing a vital role again in the future.

I thank you for your time and am happy to answer any questions you may have.