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The government bailout and its affect on commercial real estate lending market

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The Troubled Asset Relief Program (TARP) lies at the heart of the Emergency Economic Stabilization Act of 2008, which has authorized the United States secretary of the treasury to spend up to $700 billion to purchase distressed assets from the nation's banks. TARP is arguably the federal government's most significant economic intervention in the financial system since the Great Depression. This program allows the treasury to purchase residential and commercial mortgage loans as well as mortgage-backed securities and other related obligations that were issued by financial institutions on or before March 14.

While all of the details about TARP are unknown as I write this article, I believe the program will have a positive impact on the commercial mortgage market. While the treasury will most likely give preference to acquiring residential mortgages over commercial mortgages, anything that improves the sentiment of the housing market and lender's balance sheets will be a net positive for the commercial mortgage market.

TARP is certainly a constructive first step toward shoring up the balance sheets of financial institutions, but the key issue is whether or not the strengthened financial institutions will increase their allocation of capital to commercial real estate. Until property values stabilize and the housing market bottoms out, lenders will most likely sit on their capital and hold off on allocations to commercial real estate.

Statistics from the Federal Reserve and the Mortgage Bankers Association support a significant slowdown in loan originations. Overall commercial mortgage originations have fallen 63% in the second quarter of 2008 compared to the second quarter 2007. The Commercial Mortgage Backed Securities Market (CMBS) has fared even worse with year-to-date originations totaling $12.1 billion compared to last year's total of $196.9 . The story is the same for insurance companies who have seen originations fall 36 percent in the past year.

The only groups of lenders that have actually seen originations increase are Fannie Mae and Freddie Mac. While both Fannie Mae and Freddie Mac were put into conservatorship by the federal government, they experienced a 66 percent jump in originations throughout the second quarter.

Not all news is bad, however. Unlike residential mortgages, commercial mortgage delinquency rates have remained stable across the different lender types. As of the end of the second quarter: insurance companies-0.03%, Freddie Mac-0.03%, Fannie Mae-0.11%, CMBS-0.53% and Banks & Thrifts-1.18%.

To put these numbers in context, of the 35,276 commercial/multifamily loans in life company portfolios, only 23 loans with an aggregate unpaid principal balance of less than $69 million were 60+ days delinquent at the end of the second quarter. Of the $1.2 trillion of commercial/multifamily mortgages at FDIC insured banks and thrifts, only $15 billion was 90+ days delinquent.

As the above facts above indicate, the commercial mortgage market is still performing relatively well. Delinquency rates will certainly increase as the weakening economy takes its toll on the commercial mortgage sector, but lenders are entering this next stage in a strong position. While many institutions have marked down their commercial mortgages, this is a result of market pricing issues rather than the actual performance of the underlying mortgages.

Origination volume from all lenders will continue to decrease as capital preservation becomes the main priority for lenders in the near future. While commercial mortgage delinquencies are low, lending will be constrained and conservative until lenders have a better view of what the economy is doing and where property values are going to stabilize. Many smaller banks are in good shape because of limited exposure to sub-prime mortgages and have continued to lend. These lenders, who are looking to limit their exposure to any one property, are most comfortable with loans under $20 million. Borrowers will have a much easier time getting these sized loans funded.

Unfortunately, borrowers with maturing loans over the next six months will have to deal with the current market. These borrowers must prepare themselves for first mortgages in the 55% to 60% leverage range with DSCR greater than 1.30X. Mezzanine money is available to bridge the gap between the maturing loan amount and proceeds from the new first mortgage, but borrowers should be prepared to pay in the mid-teen percent range for that money. This new, strict lending environment will become the norm and borrowers need to adjust their expectations accordingly.

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