

Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit [www.djreprints.com](http://www.djreprints.com)

See a sample reprint in PDF format.

Order a reprint of this article now

**THE WALL STREET JOURNAL**

WSJ.com

THE OUTLOOK | AUGUST 31, 2009

## Commercial Real Estate Lurks as Next Potential Mortgage Crisis

By LINGLING WEI and PETER GRANT

Federal Reserve and Treasury officials are scrambling to prevent the commercial-real-estate sector from delivering a roundhouse punch to the U.S. economy just as it struggles to get up off the mat.

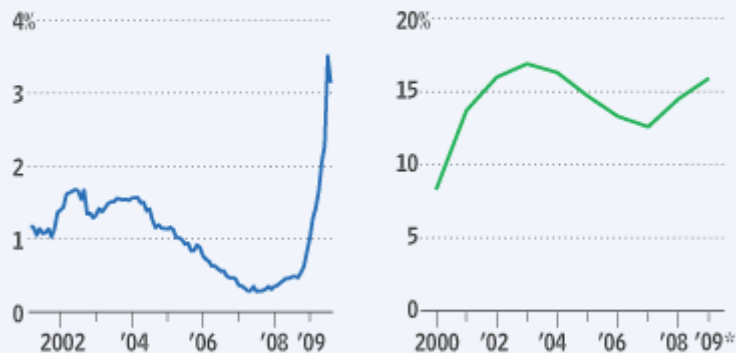
Their efforts could be undermined by a surge in foreclosures of commercial property carrying mortgages that were packaged and sold by Wall Street as bonds. Similar mortgage-backed securities created out of home loans played a big role in undoing that sector and triggering the global economic recession. Now the \$700 billion of commercial-mortgage-backed securities outstanding are being tested for the first time by a massive downturn, and the outcome so far hasn't been pretty.

### Commercial-Property Blues

Defaults on commercial-mortgage-backed securities have risen sharply as vacancy rates have mounted.

CMBS' delinquency rates

Office-vacancy rates



\*As of June 30

Sources: Realpoint LLC (CMBS rates); Reis (vacancy rates)

The CMBS sector is suffering two kinds of pain, which, according to credit rater Realpoint LLC, sent its delinquency rate to 3.14% in July, more than six times the level a year earlier. One is simply the result of bad underwriting. In the era of looser credit, Wall Street's CMBS machine lent owners money on the assumption that occupancy and rents of their office buildings, hotels, stores or other commercial property would keep rising. In fact, the opposite has happened. The result is that a growing number of properties aren't generating enough cash to make principal and interest payments.

The other kind of hurt is coming from the inability of property owners to refinance loans bundled into CMBS when these loans mature. By the end of 2012, some \$153 billion in loans that make up CMBS are coming due, and close to \$100 billion of that will face difficulty getting refinanced, according to Deutsche Bank. Even though the cash flows of these properties are enough to pay interest and principal on the debt, their values have fallen so far that borrowers won't be able to extend existing mortgages or replace

them with new debt. That means losses not only to the property owners but also to those who bought CMBS -- including hedge funds, pension funds, mutual funds and other financial institutions -- thus exacerbating the economic downturn.

A typical CMBS is stuffed with mortgages on a diverse group of properties, often fewer than 100, with loans ranging from a couple of million dollars to more than \$100 million. A CMBS servicer, usually a big financial institution like Wachovia and Wells Fargo, collects monthly payments from the borrowers and passes the money on to the institutional investors that buy the securities.

CMBS, of course, aren't the only kind of commercial-real-estate debt suffering higher defaults. Banks hold \$1.7 trillion of commercial mortgages and construction loans, and delinquencies on this debt already have played a role in the increase in bank failures this year.

But banks' losses from commercial mortgages have the potential to mount sharply, and the high foreclosure rate in the CMBS market could play a role in this. Until now, banks have been able to keep a lid on commercial-real-estate losses by extending debt when it has matured as long as the underlying properties are generating enough cash to pay debt service. Banks have had a strong incentive to refinance because relaxed accounting standards have enabled them to avoid marking the value of the loans down.

"There is no incentive for banks to realize losses" on their commercial-real-estate loans, says Jack Foster, head of real estate at Franklin Templeton Real Estate Advisors.

CMBS are held by scores of investors, and the servicers of CMBS loans have limited flexibility to extend or restructure troubled loans like banks do. Earlier this month, it was no coincidence that CMBS mortgages accounted for the debt on six of the seven Southern California office buildings that Maguire Properties Inc. said it was giving up. "During most of the evolution [of CMBS] no one ever thought all these loans would go into default," says Nelson Rising, Maguire's chief executive.

Indeed, many property developers and investors complain there is no way to identify the investors that hold their debt and that it is difficult to negotiate with CMBS servicers. In light of the complaints, the Treasury is considering guidance that would allow servicers to start talking about ways to avoid defaults and foreclosures sooner, according to people familiar with the matter. But investors in CMBS bonds argue that the servicers are ultimately bound contractually to the bondholders.

So Maguire will soon have a lot of company. In a study for The Wall Street Journal, Realpoint found that 281 CMBS loans valued at \$6.3 billion weren't able to refinance when they matured in the past three month, even though 173 such loans worth \$5.1 billion were throwing off more than enough cash to service their debt.

Mounting foreclosures in the CMBS sector would likely depress values even further as property is dumped on the market. And this would put pressure on banks to write down loans. "What's going on in the CMBS world is a precursor for what might be seen in banks' books," predicts Frank Innaurato, managing director at Realpoint.

The commercial-real-estate market could yet be salvaged by an improving economy and bailout programs coming out of Washington. In addition, capital markets are starting to ease for publicly traded real-estate investment trusts. Since March, more than two dozen REITs have managed to raise more than \$13 billion by selling shares.

Still, most of the \$6.7 trillion in commercial real estate is privately owned. Also, it is unlikely commercial real estate will benefit much from an early stage of an economic recovery. What landlords need is occupancy and rents to rise, and that means employers have to start hiring and consumers need to shop more. So far, there are few signs this is happening.

**Write to** Lingling Wei at [lingling.wei@dowjones.com](mailto:lingling.wei@dowjones.com) and Peter Grant at [peter.grant@wsj.com](mailto:peter.grant@wsj.com)

Printed in The Wall Street Journal, page A2

Copyright 2009 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit [www.djreprints.com](http://www.djreprints.com)