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There's more pain in store for commercial real estate lending, but a full-blown replay of the residential lending crisis isn't likely.

Commercial Realty Lending: Gloom but not Doom

BY DAVE KAYTES

Predictions of a commercial real estate crisis have circulated for better than a year. While a downturn is likely, it won't be as bad as doomsayers are predicting. Unlike the residential crash, the downturn will be concentrated in small, community financial institutions rather than regional or national banks.

The fear of a commercial real estate crisis is an outgrowth of the recession caused by the crash in the residential market. While the similarities are compelling, there are some important differences between the two.

The residential lending market was as much a trading and investment crisis as a loan crisis. Mortgages were deconstructed and synthesized as high quality investments, where they were resold to large and small banks.

When the default rates exposed the sub-prime quality of these instruments, bank capital fell in large and small banks together. Fannie Mae and Freddie Mac became wards of the state, and the big mortgage banks – WAMU, NatCity, Countrywide, Wachovia – were driven into shotgun weddings with stronger institutions. Only banks with diversified businesses thrived.

Commercial real estate by contrast is significantly more concentrated in smaller banks, with less repackaging of loans. And the risk of these loans is likely to be worse for small banks.

The biggest problem in the residential mortgage crisis was the excess valuation of housing. The residential appraisal business is partially to blame. It is a cottage industry, poorly regulated and subject to fraud and abuse.

Banks went along with valuations, assuming that they were safe as long as people cared about their homes, and housing prices kept rising. Then everyone started inflating property values, leading to faulty assumptions about repayment rates. Ultimately we relearned that when the value of a property is less than the amount of the outstanding loan, the borrower acts rationally and walks away.

By contrast, commercial real estate appraisal is generally more sophisticated. And the major banks

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are more skilled at evaluating commercial real estate value than small banks. Simply put, there are more, better trained, more highly skilled commercial lenders at bigger banks who pay them, train them and manage them better.

And while every bank no doubt makes some poor lending decisions, large regional banks have less concentration of commercial real estate than small banks. As a result, the few mistakes have less dire impact for larger banks.

Our research shows that banks with $10 billion or less in assets have about 45 percent of their assets in commercial real estate, construction, and multi-family loans. By contrast, banks with more than $10 billion in assets, including regional banks and larger national banks have only 30 percent in these asset classes.

Additionally, the commercial risk assessment of community banks is generally less sophisticated. Indeed, many small banks take pride in their belief that structured risk management techniques are unnecessary, and they can lend better because they personally know, and can assess the borrower's "character." As we have learned, character often isn't enough to overcome a market downturn.

Real estate downturns are highly localized, and community banks are highly concentrated in relatively small geographic regions. When a community suffers economic misfortune, the large regional banks have enough commercial business elsewhere to offset the losses, while the local community bank has few such alternatives.

A commercial loan default will have much more impact on a smaller bank because there's simply not enough other business to offset it. Some of these small banks made questionable commercial loans for projects that only thrive in bubble markets, like strip malls in underdeveloped areas, or speculative multifamily housing developments. As a result, some of these community banks will face fatal default rates in 2010 and likely fail or be merged into other banks.

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This will lead to some interesting opportunities for the stronger, more diversified regional banks. They can step in and make profitable loans. They're in a very good position to expand their market area while the price of entry is low.

There's been a lot of fear in investing in these banks. They were overvalued for a few years, and then they were absurdly undervalued. Their business has begun to stabilize, but regional banks are probably still undervalued right now.

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