Commercial Real Estate Will Collapse

Stuart Saft 11.19.09, 4:00 PM ET

The commercial real estate market is on its last legs and unless drastic actions are taken, the effects on the broader economy will be catastrophic. The obvious problem is the excessive amount of debt placed on the properties and the amount of debt that has to be refinanced during a relatively short period of time.

Between now and 2013, at least $1.3 trillion of financing comes due, of which $160 billion was the result of securitizations. Unfortunately, as a result of the virtual disappearance of the secondary market, the weakened condition of the banks, and the amount of debt already held by insurance companies and pension funds, even under the best of circumstances, less than half of the outstanding debt can be refinanced. This is compounded by the collapse of the commercial rental market in the last 18 months as a result of the Great Recession. For example, office rents in prime areas of Manhattan that were in the $100-$120 a square foot range in 2007 are now trading (with rent concessions and work letters) at half that amount.

After two years of one financial crisis after another, the Fed has fewer cards to play, and the foreign investors who bailed out commercial real estate investors in the past are sitting on the sidelines waiting for the prices to collapse. This problem is exacerbated by the lingering effects of the recession: absence of credit; growing job losses as a result of falling prices, consumer demand and credit; the insolvency or near insolvency of so many institutions; and the loss of confidence in the U.S. economy by our trading partners.

In the last few weeks there have been a series of court decisions that will have repercussions in the credit markets for years to come making an already cautious lending community absolutely paranoid, and restricting credit even if available.

In Syracuse, N.Y., a state court refused to allowCitigroup to foreclose a mortgage on what was to be the second largest mall in the country even though it had no tenants. In a recent decision in the General Growth Properties bankruptcy, the court held that the special purpose entities structure was not bankruptcy-proof. The court also ignored the fact that General Properties fired the independent directors of the special purpose entities and appointed new ones without telling anyone, including the fired directors, for seven weeks. Finally, last week in the Tousa bankruptcy in Florida, the bankruptcy court set aside the subsidiary's obligations and grants of security and ignored the savings clause in the loan documents to reverse a legitimate transaction meant to save the company.

The recent court decisions demonstrate how courts can override the words and intent of loan documents and lenders' remedies notwithstanding the widespread concern about the fiscal health of our lending institutions and the need for them to recover to unfreeze the credit markets and permit economic growth to resume. The media regularly contains stories about home owners who have been able to avoid foreclosure and have their debt canceled because of administrative or technical errors by the lenders. One would think that the courts believe that the money people borrowed to buy homes magically appeared and did not come from other people’s savings, investments and retirement accounts. Has any court considered that, when they preclude a bank from foreclosing a mortgage, the home owner, who actually borrowed the money and is refusing to repay, is actually stealing the savings of their neighbors? So far, the courts seem to believe that they are playing the role of Robin Hood and ignoring creditors' rights. This behavior is also causing lenders to think twice before making loans.

As far as commercial loans are concerned, lenders have been hoping that something will happen to avoid their being required to either foreclose or declare a default. Both would have an immediate adverse impact on the lenders’ financial condition and could result in a need to raise more regulatory capital to avoid being taken over or merged into another institution or reporting another mess to their shareholders. However, delaying the recognition of the problem will not cause it to disappear.

In order to avoid a collapse that will result in a significant erosion of capital and the likely freezing of credit again with consequences worse than a year ago, the following steps should be taken immediately:

The Federal Reserve should provide a credit facility to commercial real estate owners as a lender of last resort with the government obtaining an equity interest (but not control) over the real estate in order to avoid the real estate from being dumped on the market, thereby further depressing values, which will also provide lenders with a way to liquidate their loans.

Lenders should not be required to appraise real estate that they own, are part of special assets or the subject of workouts using a mark-to-market standard but, recognizing the current aberration in the market place, using a "fair value" approach that recognizes the need to sell in an orderly transaction. What helped to destroy the S&L industry in the late 1980s and bring on the last real estate recession was the need of solvent banks to mark the real estate assets to market.

The City of New York (and the taxing authority in other jurisdictions) should reduce the real estate tax assessments on commercial properties to reflect the loss in value rather than making owners pay real property taxes based on assessments that are no longer relevant and then wait years to obtain a refund to help offset lost revenues.

Courts must begin to take cognizance of the fact that ignoring the terms of loan documents is not in the best interest of anyone except the owners of assets that no longer have value in excess of debt. Until the lenders begin to provide credit again, the economy is not going to grow and unemployment will increase.

Until the commercial market corrects itself, municipalities and states should suspend unfunded mandates that require large capital outlays by building owners that are not safety related (e.g., this is not the time to demand that buildings comply with new "green" standards) unless the municipality provides an economic benefit (i.e., tax abatements) to the property owner.

The Internal Revenue Code should be modified to suspend the passive activity rules and reduce the depreciation period for real estate acquired between 2010 and 2013 in order to make the acquisition of commercial real estate more attractive for domestic investors and offset the loss of value in the current market, which actions are just an income tax deferral and not a loss in revenue.

The Internal Revenue Code should also be modified to reduce the negative tax implications for foreign investors in purchasing and holding US real estate.

Finally, the federal government needs to focus on policies that will produce jobs and an environment that will spur job creation.

In all probability the subprime collapse and the damage done to the broader economy could have been averted by faster government intervention. In the current environment, there are just a few weeks left before phase two of the Great Recession commences due to the hundreds of billions of dollars in credit that will be lost from commercial defaults. Fixing the problem afterward will be far more expensive and damaging to the nascent economic recovery.

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