

## Addressing Concerns about the Potential Impact of Commercial-Real-Estate-Debt Maturities on Real Estate Portfolios

Between 2010 and 2020, \$2.4 trillion of commercial-real-estate debt is scheduled to mature.<sup>1</sup> Because the market for commercial-real-estate debt has been troubled since late 2007, when delinquency rates started to increase, institutional investors are concerned about the impact that the large volume of commercial-real-estate debt maturities may have on the value of their real estate portfolios if delinquencies and defaults continue to rise.

This *Research Note* puts current delinquency and default rates for commercial-real-estate debt in historical perspective, and highlights that the worst news for investors in real estate may be in the past. It also makes the case that the economic impact of the debt maturing in the coming decade could be partially mitigated by several recent initiatives. In light of this information, investors may want to start contemplating whether making a new investment in real estate is appropriate in the context of their investment guidelines.

### Delinquency and Default Rates

Current delinquency rates for commercial-real-estate debt are mixed, with commercial mortgage-backed securities (CMBS) delinquency rates at an all-time high, while delinquency rates on bank and life insurance company-originated commercial-real-estate debt are lower than historical peaks. The graph below shows the delinquency rates for commercial-real-estate debt since 1991.

Comparatively, the foreclosure rate for CMBS and real estate owned (REO)<sup>2</sup> was 1.33 percent as of January 31, 2010, which is close to the historical high reached at the end of September 2009. The bank

charge-off rate<sup>3</sup> was 3.05 percent as of December 31, 2009, the highest rate on record (data goes back to 1991), and the life insurance foreclosure rate was 0.03 percent as of September 30, 2009, which is well below the high of 3.50 percent set on June 30, 1992.

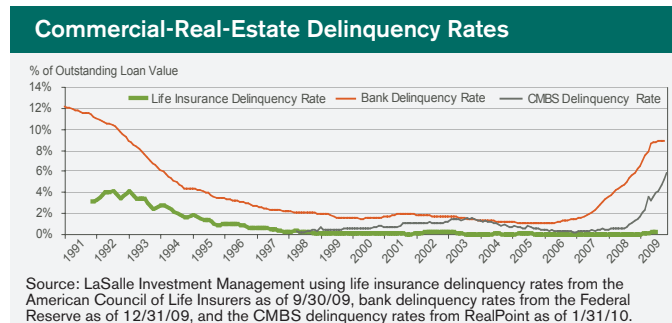
The perception among investors is that the delinquency and default rates will continue to tick higher as borrowers realize that the value of recently acquired investments are worth less than the in-place debt. However, due to the amount of the real estate debt outstanding, if CMBS, banks and insurance companies foreclosed, they would have to hold or sell the assets. Holding the assets could be onerous because most debt issuers are not equipped to manage the real estate, and selling the assets would flood the market with a significant amount of distressed sales, which could drive prices lower and would cause the three major lenders to realize significant losses.

### Initiatives Aimed at Reducing the Impact of Commercial-Real-Estate-Debt Maturities

The federal government and the Financial Accounting Standards Board (FASB) have focused on introducing initiatives that may soften the impact of commercial-real-estate-debt maturities. The bulk of the maturities are comprised of bank loans and CMBS, which represent 45 percent and 30 percent, respectively.<sup>4</sup> The government and FASB initiatives are described briefly below:

➤ **Expansion of the Troubled Asset-Backed Securities Loan Facility (TALF) to CMBS** The TALF, which the Federal Reserve launched in March 2009 to jumpstart the newly issued AAA asset-backed securities market, was

expanded in May 2009 to include the new issuance and recently issued AAA-rated CMBS. As of January 20, 2010 (last loan settlement date), the total amount of loans provided by TALF to finance the acquisition of newly issued CMBS and legacy CMBS was \$72 million and \$10 billion, respectively.<sup>5</sup> In the fourth quarter of 2009, three new



<sup>1</sup> This is according to an analysis by Foresight Analytics, *Commercial Mortgage Outlook: Growing Pains in Mortgage Maturities*, which can be ordered from the following page on Foresight Analytics Web site: [http://foresightanalytics.com/stu\\_mtgmtat.php](http://foresightanalytics.com/stu_mtgmtat.php) The maturities will peak in 2012 and will drop dramatically by 2018.

<sup>2</sup> REO means that the property in question has been foreclosed on and has been taken back by the mortgage lender or trustee. REOs and foreclosures are not the same thing, however an REO is only produced as a result of an unsuccessful foreclosure, in which a buyer for the property cannot be found, and so the mortgage lender repossesses the property to sell separately.

<sup>3</sup> Charge-offs are the value of loans and leases removed from the books and charged against loss reserves. They are calculated as the flow of a bank's net charge-offs (gross charge-offs minus recoveries) during a quarter divided by the average level of its loans outstanding over that quarter.

<sup>4</sup> This data is from the Foresight Analytics report cited in footnote 1.

<sup>5</sup> This information is from the Federal Reserve Bank of New York: [http://www.newyorkfed.org/markets/CMBS\\_recent\\_operations.html](http://www.newyorkfed.org/markets/CMBS_recent_operations.html)

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CMBS issues came to market, including a \$400 million TALF-eligible issue and two non-TALF-eligible issues comprising \$960 million.<sup>6</sup>

➤ **Creation of a Public-Private Investment Program (PPIP)**

The Treasury Department launched this program in March 2009 to provide an avenue to acquire legacy residential mortgage-backed securities (RMBS) and CMBS. As of December 31, 2009, PPIP managers had acquired \$440 million in legacy CMBS securities.<sup>7</sup>

➤ **New Accounting Guidance on Marking Assets to Market**

In April 2009, FASB issued guidance on the relaxation of FASB 157 giving lenders latitude on how assets could be marked to market.<sup>8</sup> The main objective was how to determine fair values when there was no active market or where the price inputs being used really represent distressed sales. The guidance has allowed lenders time to renegotiate or temporarily extend loan maturities.

➤ **New Internal Revenue Service (IRS) Guidance Allowing Mortgage Holders to Negotiate with Lenders Prior to Default**

On September 15, 2009, the IRS issued Revenue Procedure 2009-45 in an attempt to address concerns about the tax code-based restrictions on the ability of mortgage borrowers, whose loans have been securitized, to negotiate with servicers in advance of a default or imminent default. This has allowed CMBS servicers a greater ability to determine when a “reasonably foreseeable” default exists, which, in turn, provides time to modify the affected mortgage loans.

➤ **U.S. Treasury Department Removes Caps on Aid to Fannie Mae and Freddie Mac**

On December 25, 2009, the Treasury Department announced it will remove the caps on aid to Fannie Mae and Freddie Mac for the next three years.<sup>9</sup> The two companies are the largest

source of mortgage financing in the U.S., are under government conservatorship and have been guaranteed \$200 billion each in last-resort capital from the Treasury Department. Under the new agreement, these limits can rise as needed to cover net worth losses through 2012, and both are required to keep the value of their portfolios below a maximum limit of \$900 billion, that will go down by 10 percent a year. This move equates to approximately \$100 billion in potential lending from each organization.

These initiatives have started to entice some investors to invest in CMBS and RMBS. The initiatives have also provided time for lenders to repair their balance sheets and to restructure existing loans. They may have provided the impetus for lenders to start to lend. Another benefit of the initiatives is that they have helped the securitization market to begin to re-emerge as a source for commercial-real-estate debt.

Outlook

Although investors have felt the pain of the quickest and most drastic real estate downturn since data has been kept, as noted in the January 2010 *Research Note*,<sup>10</sup> core real estate values are nearing a turning point. Transaction activity may increase as distressed owners exit investments, assets are repossessed by lenders, and the significant amount of capital raised between 2006 and 2009 begins to be put to work.

Consequently, now may not be the best time to liquidate real estate investments. Rather, sponsors of plans that are below their target allocation to real estate may want to consider re-balancing. In addition, this may present an opportunity for plan sponsors that do not currently invest in real estate to consider an allocation, provided that the asset class fits into the plan’s return objectives and risk tolerance. Real estate investments can improve diversification, protect against periods of high inflation and help produce a higher expected long-term return when combined with a portfolio of equities and bonds.



*If you have questions about this Research Note or you would like to discuss the role of real estate in your plan’s investment portfolio, contact your Segal Advisors consultant or Justin Mallis at 212.251.5241 or [jmallis@segaladvisors.com](mailto:jmallis@segaladvisors.com).*

<sup>6</sup> This information is from the online financial reporting service CreditLime: <http://www.creditlime.com/2010/01/25/new-commercial-mortgage-backed-securities-cmbs-ready-to-make-a-comeback-in-2010>

<sup>7</sup> This January 29, 2010 Legacy Securities PPIP update report is available on the following page of the federal government’s Financial Stability Plan Web site: <http://www.financialstability.gov/docs/External%20Report%20-%2012-09%20FINAL.pdf>

<sup>8</sup> See FASB Staff Position No. FAS 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly” (April 9, 2009): <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818748755&blobheader=application%2Fpdf>

<sup>9</sup> For more information, see the following article on Bloomberg.com: <http://www.bloomberg.com/apps/news?pid=20601087&sid=abTVU5p9zbAY>

<sup>10</sup> That issue is available on the following page of Segal Advisors’ Web site: <http://www.segaladvisors.com/publications/jan2010.pdf>

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