

Domestic Credit by Steve Parsons

Commercial mortgage debacle looms

A severe commercial mortgage liquidity crunch portends big problems for banks and insurance companies.

According to data compiled by major investment banks and reported in the Arthur Andersen *Real Estate Perspectives* newsletter, annual commercial mortgage flows decreased in 1991 for the first time in postwar history. These flows, which denote the net change from one period to another in mortgages outstanding, were a negative \$6.9 billion in 1991, based on annualized data through the end of the second quarter.

This contrasts sharply to 1987, when a net \$121.5 billion poured into commercial mortgages. Commercial mortgage lending by banks did increase slightly last year by \$9.8 billion, but this was only 20% of the 1986 peak of \$49.6 billion net increase. Far worse was the huge contraction by the battered thrift industry and insurance companies. Outstanding mortgages from thrifts fell nearly \$35 billion in 1991, while insurance companies had a net swing of \$37 billion—from a positive \$22.5 billion in 1990 to a negative \$14.8 billion last year.

Bad as these figures are, the net decrease in commercial mortgages would have been a negative \$37.5 billion last year had the U.S. government not shoveled in more than \$30 billion, in part from its ownership of mortgages assumed from the takeover of S&Ls. In contrast to the disinvestment by the private sector, the U.S. government put 50% more money into commercial real estate mortgages than it did in 1990—the net flow jumped from \$19.6 billion in 1990 to \$30.6 billion last year—meaning that in the last two years, the government has dumped more than \$50

billion down this sinkhole.

The newsletter reports that only 42.5% of commercial mortgages were repaid from June 1990 to June 1991, with an even grimmer outlook for the July 1991 to July 1992 period. “Of the \$75 billion which came due from June 1990 to June 1991, 42% was repaid, 45% was extended, and 13% was foreclosed.” That means that the majority of mortgage loans—58%—was either rolled over or foreclosed.

But the situation is even worse. First, much of the 42% that was counted as “repaid” was actually rollovers financed by lenders other than the original ones. Second, many lenders, who either cannot afford or justify the refinancing of many non-performing loans, are exchanging debt for equity, i.e., becoming part-owners of the worthless property without officially foreclosing, in the chimerical hope that property prices will go up.

According to the National Realty Committee, there is an even greater \$82 billion coming due from July 1991 to July 1992. So far, only 6.8% stands to be repaid or refinanced by other lenders, and only 12.7% is slated for loan extension. That leaves over 80%—\$66 billion—coming due with no deal in place either for rollovers or repayments.

On top of this, the newsletter notes that “insurance companies have an additional \$75 billion of construction and miniperm (short-term) loans coming due over the next two years.” Small wonder then that one of the pacesetters in the desperate debt-for-equity tactic is insurance giant Aetna, which is

faced with a confluence of bad loans and heavy annuity contract payouts.

Underlying the mortgage debacle is a 26% drop in the value of office properties during 1986-91. This has contributed to a 50% drop in office net operating income in real dollar terms from 1981, and has made refinancing of current mortgages exceptionally difficult, while all but shutting down lending for new projects. Most lenders, except the government, are demanding far more equity or cash from borrowers: anywhere from 25-50% now, versus only 0-20% in 1989.

Banks now hold \$385 billion of commercial real estate loans. This is 170% of their equity capital, and represents “values” that in general have not been written down to market value for fear of torpedoing even more banks. Many insurance company mortgage portfolios are in equally bad shape, though lax reporting requirements obfuscate the true dimensions. Admitted bad mortgage loans are running at a 5.4% rate for insurers, double that of 1989, but the situation is far worse, especially considering that so many of the short-term loans advanced in the mid-1980s are now coming due.

The Andersen newsletter hints at one so-called solution: If the banks and insurance companies can't roll over commercial mortgages, maybe pension funds can be suckered to pick up the tab. The reasoning goes like this: Since pension funds have only 5-7% of their assets in real estate, and since their earnings on safe government securities and other such investments are inadequate because of low interest rates, then higher-interest “debt financing” of real estate is a natural, even if everybody else is getting out. Pension funds should “turn increasingly to real estate as a portfolio diversifier and longer-term inflation hedge” to “become a significant factor in meeting refinancing needs.”