What Commercial Lenders Can Learn from Residential Mortgage Lenders

By Brian Shaw

Lesson #1: Understand the underlying causes of trends.

The health of commercial lending is based on several variables, including basic supply and demand as well as proper risk mitigation. Economists and politicians continue to banter about who is to blame for the current financial climate. Nevertheless, some very basic truths, if studied and applied, may keep the commercial real estate industry from a collapse of the same magnitude as the residential mortgage industry. Learning these lessons now and changing certain behaviors may not fully preclude impending pain in commercial lending, but it may help our industry and economy avoid similar mistakes in the future.

It appears that our society loves the euphoric feel of the simulated champagne bubbles. The question is, do we want to continue cleaning up messes?

Turn off the Bubble Machine

Some may have heard the line "Turn off the bubble machine …" from The Lawrence Welk Show many decades ago. This visual effect was used to provide a champagne-like, bubbly feel to the music, but band director Welk tried to encourage containment as the bubbles increased. It appears that our society loves the euphoric feel of the simulated champagne bubbles. The question is, do we want to continue cleaning up messes?

The last few bubbles had three forces in common: greed, excess wealth and increased funds available for investment. First, greed is a powerful driver. We could debate whether greed is a natural human trait or it is learned; regardless, the desire to have more or protect what one possesses can, in some cases, overcome rational thought.

Second, excess wealth across the industrialized world has been increasing. For my argument here, I will define excess wealth as that which is above meeting basic physical needs at a reasonable standard. For example, transportation is typically required to get to and from work, a necessity; however, the number of cars per capita with air-conditioning, power windows, power locks, leather seats, onboard computerized navigation and gas-guzzling engines has tremendously increased over the last 100 years. Necessity or nicety? Would a car with fewer options, better fuel economy and a good paper map do just as well?

This excess wealth created the third force: the increasing amount of investment funds available. As funds available increases, the pool of solid investment choices must increase, or problems are likely to result. This final factor is very important when combined with greed, as it drives new innovations created to soak up investment dollars that may claim low or similar risks compared to well-established investments but are unproven or not well vetted.

Keeping in mind theses three forces—greed, excess wealth, more funds chasing investment opportunities—let's look at how the current state of affairs with lending started.

Brian Shaw is CEO of Custom Credit Systems, Richardson, Texas. Contact him at bshaw@customcreditsystems.com.

Causes of the Consumer Mortgage Crisis

In the early to mid-2000s, a euphoric feeling enveloped the residential real estate market, which helped exacerbate the consumer mortgage crisis.

One primary cause was the U.S. government's many initiatives to increase home ownership. The Federal National Mortgage Association (FNMA, Fannie Mae), created during the Great Depression, became a government-sponsored enterprise (GSE) in the late 1960s. The GSE Federal Home Loan Mortgage Corporation (Freddie Mac) helped mortgages expand onto the secondary market through mortgage-backed securities (MBS) and securitization. During both the Clinton and Bush administrations, programs were implemented to extend home ownership to as many people as possible. For example, a paper titled *The National Homeownership Strategy: Partners in the American Dream*, posted to the Department of Housing and Urban Development's Web site, indicated "creativity" was needed to achieve higher levels of personal home ownership. In addition, laws such as the Community Reinvestment Act were enacted to ensure that Federal Deposit Insurance Corporation–(FDIC) insured institutions provided access to credit equally across all groups and geographies. One main purpose was to eradicate so-called redlining of low- to moderate-income segments.

Another cause was excessive optimism. Proven metrics for prudent debt levels (debt-to-income ratios, down payments, loan to value, *etc.*) gave way to lending "creativity" as investors and lenders were taking risks based on inflated or inflating prices, and home owners were buying and moving into houses that they could barely afford when the market prospered. This overzealous market led to the creation of exotic loan products (no-doc loans, no-income no-assets [Ninja] loans, 100 percent or zero-down mortgages, *etc.*) designed for consumers who may not be as sophisticated with monetary concepts. And let's face it, given the opportunity, most consumers are driven to consume and most lenders relaxed their underwriting standards. (Some consumers and mortgage professionals saw the market climate as the right time to commit fraud, but that is an entirely different subject.)

Real estate investments seemed to be the commodity that would never lose value. Residential developers saw the wave and began a building frenzy that led to an oversupply as financing dried up and new consumers could not be found. Residential defaults rose so high and so quickly that the federal government had to bail out many of the financial institutions that had contributed to the financial collapse.

What has proven true over the years was proved once again: Uncreditworthy people are uncreditworthy. Real estate marketing firms conducted studies about the potential growth of popular geographic areas. Based on the public studies, developers would move into the area and start building elaborate office complexes or shopping centers. Instead of constructing the one or two million square feet of office buildings that the study might have indicated was supportable, multiple investors added three-four-five million square feet. The supply ultimately exceeded the demand, which in turn drove down the cost and adversely affected the entire geographic area. All around our country, luxury office space is completely or nearly empty because companies cannot afford the rent.

> *As funds available increases, the pool of solid investment choices must increase, or problems are likely to result.*

Despite some overbuilding, most commercial developers did not create the tremendous oversupply of space seen in the consumer market. For the most part, commercial lenders are and were more educated about evaluating investment decisions. This knowledge proved beneficial because lenders did not for the most part invent outlandish new products that allowed marginally creditworthy entities or individuals to borrow for commercial development. This is not to say that commercial lending will be immune to the difficulties or foreclosures faced in the residential lending arena. The downdraft on the consumer side is unlike any other we have seen since the Great Depression, and it is having a profound impact on all aspects of the global economy.

Lessons from the Residential Mortgage Industry

Funding of commercial properties has historically been based on investment theory rather than on consumption demand. Unfortunately, many commercial property investors and lenders were caught up in the same euphoria of the moment as their residential counterparts. Yes, they brokered deals that they might not otherwise have done in normal times. The market was good, and they wanted on the bandwagon.

With an estimated $204 billion in commercial mortgages coming due this year, lenders are sure to face many troubled accounts, such as the St. Regis Monarch Beach Resort, which was foreclosed by Citigroup after missing three payments on its $70 million loan. Similarly, the Wall Street Journal reported on December 17, 2009, that lenders are likely to take back the Miami condominium/hotel complex Icon Brickell. The three-tower complex was financed by a group of lenders, including Bank of America Corp. and HSBC Holdings PLC, who provided approximately $700 million in loans. These loans make jumbo residential mortgages look like rounding errors.

> *The downdraft on the consumer side is unlike any other we have seen since the Great Depression, and it is having a profound impact on all aspects of the global economy.*

Commercial lenders can take many lessons from the residential mortgage lenders, including the following:

- Be sure you understand the underlying causes of trends.
- Fundamentals do not change quickly or frequently.
- Avoid secondary market dependence.

Underlying Causes of Trends

The first lesson we can learn from residential mortgage lenders is that long-term trends exist for many reasons. What we witnessed in the residential mortgage industry was oversupply and overvaluations driven by demand artificially created by easier credit. The mitigating factor, many thought, was that homes were going to appreciate at that increased pace forever.

Importance of Fundamentals

The second lesson is that fundamentals do not change quickly. Lenders should look at historical trends and then answer the questions, "Have fundamentals truly changed? And if so, what is the real, likely impact on the long-term trend line?" Take, for example, the value of property. Fundamentally, residential property in some markets was escalating at 20, 25 or 30 percent or more each year. This was predicated on the increased demand driven by new would-be home owners. In addition, the second or vacation home market mushroomed as second homes became affordable via eased underwriting criteria. This was coupled by investors looking for places to put funds that produce higher returns than Treasury bills or certificates of deposit.

Property pricing is set by real demand that is based on needs and disposable income. This, in turn, is based on gross domestic product (GDP) growth, efficiency improvements and other macroeconomic demand variables. If these fundamentals were not changing dramatically, what made lenders think that demand would drive real estate value appreciation above its long-term average, which in many markets was between five and 10 percent?

Lenders have a long history of showing what an individual can spend for the various categories of basic living at the differing income levels. Basically, we are going to consume what we need or can pay for even if a teaser rate allows us initial entry to things we otherwise could not afford. The invention of new loan products doesn't mean that "credit-worthless" people will pay you back.

Secondary Markets

The third lesson is to avoid secondary market dependence. According to Gary Shaivitz, senior consultant of CCG Catalyst, commercial lenders should always underwrite their loans as if they will hold them until maturity. "A large part of the problem with the residential mortgage meltdown was the originating lender's reliance on the secondary market," he explained. "Because with little or no skin in the game, there was minimal incentive to apply traditional credit standards to loan requests."[1]

Commercial Lenders Can Make a Difference in the Near Term

It may be too late to learn from these lessons this time around. Unfortunately, today's financial market is reaping the results of the poor decisions previously made in the commercial industries. Substantial challenges will continue for the next several years as a large portion of debt comes due amid very weak consumer demand. This will translate into additional stress on smaller or regional financial institutions, where a single very large loan default can be overwhelming. It would more than likely lead to that particular bank failing, affecting the already weak residential industry. There would be a devastating effect simply because commercial loans carry significantly larger loan balances.

Commercial lenders have the opportunity to learn from the residential market and use the knowledge to make a difference near term as lenders address commercial mortgage issues. Jeff Reibel, CEO and founder of Conexxus, offers the following suggestions:[2]

- Do not underestimate the speed at which large volumes of defaults can happen. At the beginning of the residential collapse, there was a general thought that banks could manage; that quickly proved to be false.
- High levels of professional skepticism regarding distressed loans are important to get out in front of the issue. You cannot be overprepared for a loan to go south; the more the industry does to understand the underlying distressed asset the better.
- Take immediate action based only on high levels of data, information and documents. Making decisions quickly without an understanding of the whole picture can lead to unexpected problems and high costs.

In addition, lenders should be conscientious and creative with resolutions. Consider the following suggestions for making sure the commercial industry fares better than the residential mortgage industry:

- Lenders should not hang on to empty buildings too long. Real estate owned (REO) has dragged many residential lenders and servicers into unfamiliar territory. In addition to keeping properties properly maintained for possible sale, some lenders and servicers have become landlords to garner some return from a property that would otherwise be an empty liability. The Wall Street Journal article about Icon Brickell noted that maintenance and tax costs for the properties are running at $21 million per year. Banks are in the business of lending and taking in money, not managing properties. Don't go into the business of leasing office space unless you absolutely must.
- Make sure to value-price properties so they will sell quickly. Price should be based on the fact that some income on a nonperforming property is better than none. Looking at the long-term trend line might help set a real price for a property.
- Consider putting empty and foreclosed properties into an alternate investment vehicle such as a real estate investment trust (REIT) and then selling it to corporate or private equity investors. Bundling similar properties could be the best way to remove those properties from a lender's list of liabilities.
- Be creative about the use of empty buildings. A lender could move some of its internal operations from leased space to the foreclosed space.
- Help interested, but qualified, purchasers acquire the vacant space. For instance, a rent-to-own program might be offered with the lender reviewing the deal every year to find the correct timing to convert the arrangement to a more traditional loan.
- Contact existing borrowers frequently. While this is typically very low on the fun meter for many bankers, understanding the health of the borrower and detecting early signs of trouble can provide the greatest opportunity to avoid catastrophe. This technique has been used successfully in subprime lending to ensure payments are made.
- Implement technology tools that quickly provide information on even minor shifts in a portfolio and tools that are supported by drill-down capabilities

to pinpoint trends. Predictive analysis tools that provide what-if simulations are even better, as they can help lenders prepare multiple strategies in advance. If financial institutions had a better view of what their lending departments were facing five years ago, we might have avoided the recession we are experiencing today. (A true portfolio management tool must work across all silos of lending, providing one cohesive report. Commercial, commercial and industrial, real estate, indirect and all other loans should be consolidated, common-sized and analyzed as a whole. Otherwise, trends may not be detected until it is too late.)

Lenders Must Stick to Underwriting Principles

On the positive side, if the small signs of economic recovery we are starting to see continue (for example, GDP growth as predicted for the third quarter of 2009, slowing unemployment rate), we may be able to avoid a catastrophic event for the commercial lending industry.

Both residential and commercial industries will recover from the current financial climate. It is still a good time for originations. Solid, viable opportunities remain for banks. For example, more individuals are seeking small-business loans as they decide to become entrepreneurs. The important lesson for lenders is to stick to their underwriting principles and leave some deals on the table—not all deals, but those that do not meet proven credit standards. If lenders take an honest look at their standards and their portfolios and do not let the pendulum swing too far to the risk-avoidance side, they will make the right decisions and do what they went into banking to do—lend money.

Endnotes

1 Paul Schaus, president of CCG Catalyst, in e-mail, Dec. 11, 2009.

2 Jeff Reibel, CEO and founder of Conexxus, in e-mail, Dec. 10, 2009.