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Extend and Pretend (and Pray?)

By Jeffrey A. Lenobel

Today's depressed real estate values and tight credit markets have created a perfect storm, preventing commercial property owners from refinancing their debt as it matures. Yet, the mass of foreclosures that many feared has not yet occurred and the so-called "Great Wall of Maturities" has not come crashing down, as many have predicted. The Wall is supported, for the time being, by the lenders' policy of "extend and pretend." Property owners and lenders share the hope that real estate values and credit markets will change, permitting refinancing and preventing the massive transfer of distressed assets.

The Wall of Maturities is staggering; by some estimates $1.1 trillion in commercial real estate loans are set to become due through 2015. The peak year for maturities is expected to be 2013, when $311.8 billion will become due. Maturities will decrease to $286.5 billion in 2014, and continue to subside. Much of that debt was originated at the peak of the past market cycle. It is not surprising that lenders continue to extend and pretend, given the number of troubled loans and how far underwater they are. If lenders chose to foreclose, the losses could significantly erode, and in many cases totally eliminate, lenders' capital—leaving many insolvent.

As vacancy rates increase and rents and property values continue to decline, lenders fear the risk of a default at the loan's maturity and the risk that borrowers will be unable to continue to pay monthly debt service payments. This would end the policy of extend and pretend. Property owners face an equity gap because property values have plummeted and banks have toughened underwriting standards, no longer lending at pre-bubble loan-to-value ratios. Will this result in the borrowers' inability to renew or refinance and result in more commercial loan defaults? Will this trigger a double dip recession?

The Wall of Maturities remains a shaky structure. When institutional investors speak optimistically about the strength of the property markets today, they are referring generally to the biggest coastal cities, which are only a small segment of the market, excluding most assets that are burdened by mortgage balances far exceeding values. Because of the strong markets for class "A" buildings in primary locations, lenders have been flexible about restructuring loans secured by these properties. Owners of properties at the class "B" and "C" levels in secondary and tertiary markets have seen less flexibility from lenders. Owners of lower-tier properties have had fewer options when seeking concessions from lenders on existing debt.

When applied to existing underwater, yet performing, loans, the extend-and-pretend theory has lenders sitting on the sidelines, agreeing to extend loan terms and betting that the economy will rebound in time for the loans to be refinanced at maturity. The policy works for property owners who have sufficient current cash flow, as the maturing loans are being extended rather than foreclosed on, thus postponing the day when the owner loses the property. Of course, lenders also enjoy the policy because they can avoid writing down the loan and recognizing the loss. The lenders' ultimate goal of the extend and pretend policy is to defer the loss recognition until market prices rebound, greatly reducing losses on the outstanding loans, or until the lender is in a financial position to sustain the loss. Is waiting realistic? Will property values increase soon enough to eliminate the inevitable result of foreclosure?

Some commentators suggest that the extend-and-pretend policy is interfering with an economic rebound. They propose that foreclosures could cause an influx of office, industrial and retail space available at lower rents, lowering the cost of business and encouraging business formation. Some also believe that there is a growing investor appetite and substantial money accumulating to purchase the troubled real property at prices that reflect the "new normal."

The foreboding maturity will likely be extended for some time by lenders that are still trying to build up sufficient capital to withstand the losses they would incur if the policy was abandoned. Lenders will continue to avert the feared refinancing crisis and continue to avoid dealing with assets that cannot be sold at favorable prices. As lenders continue to extend and pretend, the over-leveraged, under-valued properties will remain trapped in the status quo. Lenders and borrowers have been in this situation before. What differentiates this financial crisis is the willingness of lenders to extend the terms of troubled loans that are unlikely to return full value. As lenders wait for more propitious opportunities, and continue to pray for an upturn in the economy, the economic forecast remains anything but sunny. The new question becomes: Will the Great Wall of debt come crashing down, creating many opportunities for those with cash ready to be spent, or will lenders be able to continue to extend and pretend until their prayers are answered? In my view, the Great Wall is on the verge of tumbling down.

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