

Expert View

Banks Failing To Fess Up To Commercial Property Losses

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Big risks not always well-disclosed in financials.



Over the next four years about \$1.4 trillion in commercial real estate loans will come due, with nearly half the properties expected to be "underwater"--meaning they're worth less than the amount owed. That's according to "Commercial Real Estate Losses and the Risk to Financial Stability," a report released last month by the Congressional Oversight Panel for the Treasury Asset Relief Program.

Real Capital Analytics states that as of last December \$203 billion worth of U.S. commercial mortgage assets were "troubled" (defined as properties that are still operating normally but facing financial distress, in the process of being restructured or modified, already real estate owned or in "resolved" status).

The risk that these commercial real estate assets pose to the financial sector is very real. Commercial real estate loans are typically larger than other loans and are generally viewed as posing greater [default risk](#). Audit Integrity examined financial institutions with at least \$10 billion in assets that trade on a North American exchange and bear our Accounting and Governance Risk (AGR) rating of Very Aggressive. The 20 banks on our list (an abbreviated version of which appears below) exhibit the following alarming levels of risk:

- Commercial real estate loans comprising a median 26% of total loans
 - Commercial real estate loans equal to a median of 170% of [Tier 1 capital](#) (defined as equity capital and undisclosed reserves)
 - A median increase of 100% in commercial real estate non-accrual loans in the nine months through September 2009
 - Commercial real estate non-accrual loans comprising a median 53% of total non-accrual loans
- In addition to the standard commercial real estate loans on the balance sheet consisting of construction and mortgage loans, additional risk exists from the following sources:
- Additional real estate obtained primarily through foreclosures
 - Agreements to extend customer financing and other commitments and contingent liabilities
 - Off-balance sheet assets securitized in special purpose entities
 - [Operating expenses](#) that include collection efforts and carrying costs for nonperforming assets

Given the weak economy and depressed real estate market, it is more critical than ever that banks report their financial status in a clear and transparent manner. Risk factors outlined in financial reporting include warnings such as "further deterioration in economic conditions may cause increases in delinquencies, problem assets, charge-offs and provisions for credit losses" or "allowance for loan losses may prove to be insufficient to absorb losses that may occur in the loan portfolio."

Despite the ongoing risks, the actual data that banks report in their financial statements do not necessarily err on the side of conservatism. What's more, management enjoys a high degree of latitude regarding estimates and assumptions that are integral to assessing creditworthiness and the adequacy of loss provisions. Among the 20 banks we studied we discovered the following:

- Total nonperforming assets grew at a median rate of 85% in the nine months through September 2009
- Net charge-offs grew at a median rate of only 1.16 percentage points year over year
- The median allowance for loan and lease losses was only 80% of the total value of nonperforming loans

With Very Aggressive AGR ratings, these banks are also waving a high number of accounting and governance red flags. These indicators suggest the banks studied are engaging in stretch-the-limits accounting though practices like carrying a large amount of goodwill on their balance sheets. Governance practices, like allowing a lone officer to serve as chief executive and chairman, raise further concerns. Our advice: Investors beware.

James Kaplan is co-founder and chairman of Audit Integrity, a financial research firm based in [Los Angeles](#).

Banking on a Commercial Property Rebound			
Bank/Ticker	Recent Price \$	Tangible Book Value Per Share*	Bum Commercial Real Estate Loans as a Percentage of Capital**
Synovus Financial/SNV	2.71	3.88	41.1
Wilmington Trust/WL	14.01	8.41	22.1
Zions Bancorporation/ZION	18.37	20.35	21.1
Huntington Bancshares/HBAN	4.80	4.07	20.7
Wintrust Financial/WTFC	33.91	23.22	18.3
New York Community Bancorp/NYB	15.44	6.52	17.7
Fifth Third Bancorp/FITB	12.46	8.38	13.5
Regions Financial Corp./RF	6.61	6.68	12.6
M&T Bank Corp./MTB	76.54	28.03	11.6
Wells Fargo/WFC	28.16	9.35	10.5

Source: Audit Integrity, Thomson Reuters Fundamentals via FactSet Research Systems.

*As of 12/31/2009

**Tier 1 capital is a measure of a bank's cushion against losses. It includes [shareholders' equity](#) (common and preferred) and excludes many intangibles.