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Commercial Loans Weigh on Banks

The residential real estate market has damaged them. But commercial real estate is now also taking a toll on regional and community banks.

By KENT BERNHARD, Jr.

Small and regional banks have a big problem—commercial real estate and construction.

"Across the board, if you look at the fraction of loans that have stopped paying, you'll see there's a huge spike," said Amiyatosh Purnanandam, finance professor at the University of Michigan's Ross School of Business. Bad loans are running three to four times higher than they were two years ago, he said.

Joshua Siegel, managing principal at New York-based Stone Castle Partners, said construction loans were particularly problematic for regional and community banks. "Diversifying into higher profitability during good times...all of these can be very detrimental when the market turns—and the market always turns."

For the majority of bankers in trouble, the problems are construction loans and failing commercial real estate loans. "A lot of them are full of...commercial real estate, and it is really coming back on them," Jim Gardner, chairman of Commerce Street Capital LLC, said of regional banks facing problems.

The rate of homeowners either behind or in foreclosure has risen to a record 13 percent. The default rate for commercial real estate is also on the rise, but much lower than residential. The default rate for commercial mortgages rose to 2.25 percent from 1.61 percent in the first quarter. It's expected to rise to 4.1 percent by the end of the year.

In addition, the market for commercial real estate sales has been frozen for more than a year, so setting a value for commercial properties is difficult.

Bankers don't want to foreclose on those properties because they're likely to have to sell them at a loss. They're renegotiating loan maturities to give building owners more time to pay off debt or preparing to take over the properties and hold them until they can sell them at a higher price.

All of which is a strain on their already-stressed balance sheets.

The commercial real estate crisis might not be a big problem if small and regional banks could raise capital to offset it. But for regional players, the market for raising money is a tough one.

Kamal Mustafa, former head of Citigroup's Global M&A and corporate finance departments and now chairman of Invictus Consulting Group, expects the recession to take a vicious toll on regional banks—and on some community banks as well.

"They should be looking very closely at their own balance sheets and making sure they can survive the recession," he said. Unemployment will stress personal loans, mortgages, commercial loans, and lines of credit. And commercial real estate loans are going sour as tenants flee strip malls and small offices around the country.

But for all that, there are still optimistic regional and commu-

nity bankers out there.

"Where there's chaos there's opportunity, so we're taking advantage," said Charlie Crawford, CEO of the Private Bank of Buckhead in Georgia. "We're seeing a lot of opportunities and can basically cherry-pick the best ones. And that goes for banking talent too."

It's a matter of timing.

"I'd like to tell you how smart we are, but it helps that we're young," he said. The Private Bank of Buckhead is only three years old. Its loan portfolio doesn't have some of the problems that other, older institutions accumulated in commercial real estate.

Umpqua Bank's CEO Ray Davis, whose bank has 151 branches in Oregon, Northern California, and Washington, is also optimistic. He believes the economy is poised for improvement and that he might be seeing the bottom of the residential market in his region.

But it hasn't been easy for Umpqua, which reported its first-ever quarterly loss in the first quarter of this year. The second quarter, though, showed improvement. Umpqua posted a surprise profit for its second quarter, earning \$7.7 million, or 7 cents a share, when analysts expected the bank to lose 7 cents a share.

Like most other regional and community banks, Umpqua didn't have anything to do with subprime lending or the exotic financial instruments that



Small and regional bankers are coming under pressure from troubled commercial real estate loans.

brought down the Wall Street giants. But what it did do was loan money to residential developers.

Then the housing market collapsed and with it the market for the new housing Umpqua had financed.

"It's been catastrophic," Davis said. In early 2007, as the housing market erosion became apparent, Davis went public with the loan problems his bank expected. After that, Umpqua worked through its loan portfolio, taking the losses when it needed to.

His bank has reached the point where capital is strong. Regulators require risk-based assets of 10 percent. Umpqua's stand at 14.4 percent. The bank has \$2 billion in liquidity. And its non-performing loan ratio is 1.8 percent, better than average peers in the Northwest. And Davis doesn't expect disaster from commercial loans, despite the prognostications of some. "I don't think they're going to be as catastrophic as (residential) real estate." Davis said now is a difficult time to be a banker, but one filled with opportunity.

"What I'm trying to do right now is make sure this company is stronger," Davis of Umpqua said. "We want to come out of this downturn stronger than we went into it."