TARP Panel: Small Banks Are Facing Loan Woes

Nearly 3,000 small U.S. banks could be forced to dramatically curtail their lending because of losses on commercial real-estate loans, a congressional inquiry concluded.

The findings, set to be released Thursday by the Congressional Oversight Panel as part of its scrutiny of the Troubled Asset Relief Program, point to yet another obstacle for the slow-moving economic recovery. The small banks being threatened by loans they made for shopping centers, offices, hotels and apartments represent a major cog in the U.S. credit system, especially to entrepreneurs.

"The banks that are on the front lines of small-business lending are about to get hit by a tidal wave of commercial-loan failures," said Elizabeth Warren, a law professor at Harvard University who heads the TARP oversight panel.

Concern about banks' exposure to commercial real estate has been building for months. Job losses, corporate retrenchments and curtailed spending by many Americans are squeezing banks that financed commercial properties. Some troubled lenders were previously battered by residential mortgages that soured when the housing bubble burst, leaving banks with less capital to cushion them from commercial-real-estate woes.

Of the roughly 8,100 U.S. banks, some 2,988 small institutions have problematic exposure to commercial real-estate loans, according to the report. That means their level of commercial real-estate loans is at least 300% of total capital or their construction and land loans exceed 100% of total capital.

In the 183-page report, the panel said it is "deeply concerned" loan losses could jeopardize the stability of many banks. Since January 2008, 181 banks and savings institutions have been seized by regulators, including 16 so far this year. The panel based its analysis on guidance issued by the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corp. on risk-management practices for commercial-property lending.

To be sure, the report's prediction of gloom could end up being overstated if the economy and market rebound. A decrease

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in unemployment and more availability of credit for developers could stanch losses. That would ease the pressure on real-estate developers, retailers, restaurants and other businesses that have been struggling to keep up with their payments.

Representatives for the Federal Reserve, Treasury Department and OCC either weren't available for comment Wednesday or said they were waiting to read the report before expressing an opinion on it.

It isn't clear how much loan volume could disappear if banks rein in their already reduced appetites for extending credit as commercial real-estate losses mount. But banks that failed since the beginning of last year had combined about $73.8 billion in loans and leases at the end of the quarter before they were seized, according to an analysis by The Wall Street Journal of data submitted to federal regulators by the banks. The total includes loan-loss allowances, or money set aside to cover loans that aren't repaid.

Few experts are predicting a resurgence in commercial real estate anytime soon. Commercial real-estate debt in the U.S. totals about $3.4 trillion. Of that amount, banks hold $1.5 trillion, or 45%. Bondholders who own pools of real-estate debt hold $708 billion, or 21%.

Over the past decade, many banks increasingly relied on property loans for profits. According to the oversight panel, as of 2003, banks with $100 million to $1 billion in assets had commercial real-estate portfolios equal to 156% of their total risk-based capital. By the third quarter of 2006, that ratio had risen to 318%. The concentrations have been especially worrisome in the western and southeastern U.S., the panel's report said.

Commercial real-estate loans typically come due in three to 10 years, and monthly mortgage payments usually aren't enough to cover the loan in that period. At the end of the loan term, the panel's report said, the borrower needs to take out a new loan to maintain ownership.

Given the turbulent environment, lenders are facing several risks. The first is that a borrower won't be able to cover the interest and principal payment that comes due. The second is that a borrower won't be able to refinance the loan because of tougher bank underwriting standards or decreases in the value of the property.

From 2010 to 2014, some $1.4 trillion in commercial real-estate loans is coming due. But for nearly half of those loans, the borrower's debt is more than the property value, the panel said.

Ms. Warren, one of the panel's five members, said a related problem is that federal bank regulators should have better information on specifically which banks are most troubled. Ms. Warren said she believes regulators should undertake stress tests of small U.S. banks in the same way they scrutinized the 19 largest U.S. banks in 2009 to examine their ability to withstand future losses.

In September at a congressional hearing, Treasury Secretary Timothy Geithner said it hadn't been feasible to stress-test thousands of banks. Bank supervisors, he said, were working to stay on top of loan risks at smaller banks.

The Obama administration is trying to offset the loss of potential lending by devoting $30 billion in Wall Street bailout funds to small-business lending through community banks. Still, that amount only represents 4.3% of the $700 billion in small-business loans held by U.S. banks and savings institutions, according to the Treasury Department. Gene Sperling, a counselor to Mr. Geithner, said the plan "has the potential to leverage a far higher amount of actual new small-business lending."