

Commercial Real Estate Wreck Looms For Regional Banks

The commercial real estate beast has begun to expose its claws in earnings, posing the single greatest threat to the banking industry's recovery through the rest of the year.

As bank earnings begin to pour in, a recurring theme has established itself: More diversified institutions like **Goldman Sachs** and **JPMorgan Chase** are showing stronger resiliency, while others, particularly at the regional and local level with little ability to offset commercial real estate losses, are going to suffer.



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"The larger banks that have multiple revenue streams, some of those streams are doing very well," said David Twibell, president of wealth management at Colorado Capital Bank in Denver. "For the smaller banks, the primary revenue generator is going to be the lending side of the business. That's still a real mess out there. Particularly relating to commercial real estate, it's getting worse, not better."

The contagion from commercial real estate has spread throughout the industry, striking institutions of all sizes. Consider some

examples just from earnings released Wednesday:

- **Morgan Stanley** lost \$700 million in commercial real estate for the quarter. Though the number actually was lower than the \$1 billion reported last quarter, CFO Colm Kelleher said "we haven't seen signs of bottoming" in the commercial market.
- **Wells Fargo** reported a 69 percent increase in commercial loans where borrowers were not making payments, also known as nonperforming assets. Fitch Ratings said commercial loans would "exhibit significant deterioration over the near to intermediate term" for Wells, though it said the company has mitigation safeguards in place that will help.
- **US Bancorp** also reported rising commercial delinquencies and said it expects the trend to continue for the next year.
- **Key Corp**, a Cleveland-based regional bank, missed analyst estimates due to large commercial loan writeoffs. It said nonperforming assets in the category increased to 3.09 percent of its total portfolio, a 30 percent jump from the previous quarter.

- **HMN Financial**, a regional bank based in Rochester, Minn., said it saw a \$12.2 million increase in loan-loss provisions for commercial and commercial real estate loans for the quarter.

"Banks are writing off commercial real estate loans now at a bigger rate than in the last 20 years," said Kathy Boyle, president of Chapin Hill Advisors in New York. "It's a double-whammy. Banks have another shoe to drop on their balance sheets, and regional banks tend to have a much bigger exposure."

The larger money center banks like Goldman and JPMorgan either have active trading desks or diversified enough interests that they won't be saddled as badly as some of their smaller brethren.

Some analysts had been growing more bullish on the sector as a whole as the contagion from the subprime mortgage collapse seemed to fade.

But second-quarter earnings are showing that the industry now must wrestle with deterioration in the commercial markets, as well as continued consumer weakness likely to be reflected in credit card defaults.

Analysts say they'll be watching regional bank earnings as they accelerate in the coming days. The current poster child for commercial loan troubles, **CIT Group**, is scheduled to report earnings Thursday.

"There are still significant problems in the commercial real estate market," Twibell said. "We're probably in the third or fourth inning of that, whereas in the residential side we're in the seventh or eighth inning. There are so many problems, it's tough for me to get excited about banks despite the move higher."

Indeed, banks as a whole have participated in the rally of the past 10 trading days that has seen the major averages jump about 9 percent. The sector turned around in afternoon trading Wednesday after opening sharply lower, and the **SPDR Financial Select ETF** is up a shade under 10 percent since its July 10 closing.

Some analysts remain positive on the group despite the commercial obstacles ahead.

"We have a 'buy' rating on the stocks, and we're aggressively pounding the table," said Dave Lutz, managing director of trading at Stifel Nicolaus in Baltimore. "As soon as banks start taking loan-loss reserves down, that's when" the sector will take off.

- **Cashin: 30 Percent Chance of 'Sudden Reversal'**

Others are taking heart from a general feeling during earnings season that an economic turnaround is coming. The banking sector, in particular, surged after noted industry analyst Meredith Whitney sang Goldman's praises on CNBC and said the industry's higher-end stocks look fairly good, at least for the moment.

"More and more companies are sticking their necks out and saying there is light at the end of the tunnel," said Peter Cardillo, chief market economist at Avalon Partners in New York. "We haven't heard that for a while."