How A Government Bailout Created Today's Commercial Real Estate Catastrophe

John Carney|Nov. 16, 2009, 9:40 AM

By now we all now that “the next shoe to drop” as a result of the bursting of the credit bubble is commercial real estate.

In a pattern familiar from the housing crisis, the value of commercial real estate has been plunging while the volume of distressed commercial real-estate loans is rapidly rising. The problems in commercial real estate could slam financial institutions, especially smaller regional and community banks, with billions of dollars in new losses. That, in turn, could snuff out whatever chances we have of a sustained economic recovery.

In some ways, this shoe has already dropped.

- The MIT Real Estate Center said that commercial property prices has dropped almost 42% over the past 2 years.
- As a result of that drop, about fifty-five percent the $1.4 trillion commercial mortgages that will mature in the next five years are underwater.
- The delinquency rate for commercial mortgages climbed to 5% in October. A year ago the delinquency rate was just 0.77%.
- About half of all commercial mortgages sit on the balance sheets of smaller banks. So the massive number of bank failures this year is significantly attributable to losses from commercial real estate.
- Late last month, one of the largest commercial real estate finance companies in the world filed for bankruptcy.

It’s only natural that you’re asking how the hell we wound up in this mess. Why did a bubble inflate in commercial real estate? Why are smaller banks so disproportionately exposed? What caused this catastrophe?

Fortunately, we figured it out for you.

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