Investment Loss Characteristics Associated with **Commercial** Mortgage Foreclosures

Executive Summary

Prepared for the Real Estate Research Institute

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This paper examines the impact of foreclosure and equity ownership on the performance of a sample of commercial mortgages. The sample consists of 308 commercial mortgages, originated by a large life insurance company over the period 1974 through 1990. Each of these loans was foreclosed over the period 1985 through 1995 and transferred to equity. All equities were subsequently sold over the period 1986 through 1996. We construct cash flow histories for each loan over both the debt and equity periods of ownership. For each loan we estimate equity ownership periods as well as a series of recovery measures. We also estimate combined ownership periods for both debt and equity. Combined loss recoveries are also estimated as is the combined impact of performance on yield degradation.

We find that the average equity ownership period for properties in the sample is slightly less than 28 months. Total net cash flows are found to be slightly negative, primarily as a result of significant capital expenditures and tenant improvements associated with the management of these distressed assets. Gross loss recovery during equity ownership is found to average slightly greater than 77% of transfer value, while mean net recovery including interest is reported at 51.5%. Each of these results is found to vary considerably by region of country, property type, and year in which the underlying mortgage is foreclosed.

The combined debt and equity ownership period is found to average slightly greater than 36 months, which is generally consistent with prior research. Gross recovery of the combined debt and equity performance is found to average slightly greater than 65%, while combined net recovery is found to average slightly under 40% of outstanding loan balance as of start of foreclosure. We find yield degradation; the difference between promised and realized return, to average 10.6%. Given the average contractual yield of 10.9% for all loans in the sample, this implies that the combined debt and equity performance results in negative returns on this sample of assets. These findings are significantly lower than reported in earlier studies, and suggest that from purely a financial standpoint it may be in the lenders best interest to foreclose

and sell properties quickly, as property value increases over the cycle are observed to not keep pace with the opportunity cost associated with lost interest. Finally, we note that many of the variables expected to have an impact on the performance of these assets are found to be significant in explaining total holding period, combined net loss recovery, and combined yield degradation.

An interesting avenue for future research would be to examine the performance of distressed mortgages that are not resolved through the foreclosure process, but rather are renegotiated, restructured, or result in some other financial outcome. Another avenue for future research would be to combine the results of the present study with results from frequency studies to create commercial mortgage pricing models. This would be of interest to not only originators of commercial mortgage debt, but those involved in the securitization of these assets, where security structure is based primarily on the expected performance of the underlying assets.