Loss Characteristics of Commercial Mortgage Foreclosures

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This study examines the loss characteristics of a large sample of foreclosed commercial mortgages which were originated by 14 life insurance companies during the period 1964 through 1995, and terminated through foreclosure over the period 1986 through 1995. Data for the study were compiled from annual statements as filed with state regulatory agencies, and include a series of reported items which allow for the estimation of mortgage loss recovery, total foreclosure costs, and an estimate of accrued interest associated with the commercial mortgage foreclosure process. Gross loss recovery, defined as the relationship between outstanding loan balance at the onset of foreclosure and the estimate of the underlying real estate collateral value at completion of foreclosure, is found to average approximately 82% over the entire study period. This suggests that mortgage borrowers behave in a manner consistent with commercial mortgage pricing theory. Net loss recovery, which includes all costs associated with foreclosure as well as an estimate of accrued interest, is found to average approximately 69%, a figure slightly lower than found in a previous study of commercial mortgage foreclosure. Roughly 40% of total mortgage loss is found to be comprised of foreclosure costs and accrued interest, while 60% results from diminution in property value. Accrued interest is found to comprise the major component of total foreclosure cost, while evidence is presented that rental income, security deposits, and escrow accounts significantly lower the cost associated with commercial mortgage foreclosure.

On average, small mortgages are found to exhibit higher loss recovery than large loans, yet after controlling for year of foreclosure and foreclosure method, this relationship is found to be only marginally significant. While the Southwest region of the country is found to have experienced the highest average net loss recovery on foreclosed mortgages, this region also exhibits a significantly higher frequency of default over the study period, illustrating the importance of both loss frequency and loss severity in understanding the impact of mortgage foreclosure for purposes of pricing these debt contracts. Loss recovery is also found to vary by region, although the inter-relationship between foreclosure year, the method of foreclosure, and region in which the loan is originated warrants further examination.

Results also suggest that the method by which the mortgage is foreclosed has a strong statistical relationship to all forms of mortgage loss recovery as well as the cost associated with foreclosure. On average, loans foreclosed non-judicially are found to have experienced greater loss recoveries relative to their judicial counterparts. The year in which the mortgage is foreclosed is found to have a strong statistical relationship to loss recovery, with average net recovery levels ranging from a high of slightly greater than 80% for loans foreclosed in 1986 and 1987, to a low of 61.8% in 1993. Mortgages originated just prior to or during a recession appear to experience greater losses, while mild evidence is found to support the fact that those originated immediately after a recession may result in slightly lower losses. Finally, statistical evidence suggests that seasoned loans experience higher gross loss recovery, but this relationship diminishes when examined across net recovery level.

The results of this study suggest that even over a period which may arguably represent one of the worst real estate recessions in memory, loss recoveries on foreclosed commercial mortgages are on average found to be significantly higher than those used by many rating agencies in the stress-testing of whole loans during the underwriting and analysis of commercial mortgage-backed securities. To the extent the results of this study are representative of actual mortgage loss recovery over the long run, subordinate security issues backed by loans such as those examined in the present study may prove to be slightly under-priced, depending upon assumptions employed in the underwriting of the issue. While there may admittedly be an upward bias associated with the self-reporting of property values at mortgage foreclosure, values are found to be generally consistent with those as reported in the Russell/NCREIF Index. The finding of significant differences in loss recovery and foreclosure costs by jurisdictional foreclosure law, suggests that both originators and holders of commercial mortgages may wish to further examine the role of this variable in the underwriting and ongoing management of mortgage debt.

Future research on the loss characteristics associated with commercial mortgage foreclosure will continue to be limited until such time as mortgage-specific data become more readily available. The present study is limited in the level of analysis which may be conducted, as loan-specific underwriting characteristics which would allow for precise estimation of foreclosure time period, estimates of accrued interest, and most importantly, the overall yield impact of mortgage foreclosure are not available. Yet, given the recent improvement in real property markets, and the increased level of interest in both the origination and securitization of commercial mortgages, a need clearly exists for continued research on the credit-related performance of these assets.