CoreLogic®

Tax Defaults on Commercial Real Estate: The Third Shoe to Drop

BY GREG GIAMMARIO

Over the next five years, nearly one half of the $3 trillion stock of commercial real estate (CRE) will need to be refinanced. This year alone, CoreLogic® estimates that $259 billion in mortgages, or 110,000 properties, will come due. Recently, underwriting has significantly tightened and refinancing is no longer an option for many properties. Lenders are facing a Hobson's choice: foreclose and take a big loss first on the specific property and then have to write-down similar assets in their portfolio or "extend-and-pretend" and hope the economy and the market improve.

None of this, of course, is news to most banks and CRE investors. They are actively monitoring the maturity and concentration risks in their portfolios. Many are already working closely with borrowers to come up with interim solutions, such as rolling over current loans and taking an equity position. But there's one other significant risk that may not be on their radar–real estate taxes.

Distressed borrowers, with deeply "underwater" properties, frequently fall behind on their taxes as vacancies rise and cash flows dry up. This behavior occurs so often in the residential market that some forward-looking lenders are now using tax delinquencies as a predictive indicator of future loan defaults. For non-escrow borrowers (roughly 61%* of the loans in the CRE market) tax delinquencies create additional risks for lenders. The most serious is that an aggressive taxing authority may place a tax lien on the property and eventually sell it, leaving the lender with no collateral. A more common problem is that the lenders don't discover delinquent tax issues until well into the foreclosure process and are then forced to make up the payments, often tens or even hundreds of thousands of dollars, to protect their lien positions.

These Problems Are Growing

As one of the nation's largest CRE tax services, CoreLogic, launched from First American, currently monitors more than 600,000 tax parcels nationwide for more than 135 lenders. In the past few years, we have seen a significant jump in tax delinquencies. Between 2007 and 2009, the number of delinquent reporting events on non-escrowed loans more than doubled from 4.6% to 9.3% and the total number topped 50,000.

In some jurisdictions, like California, a tax default has up to five years to cure before a foreclosure begins. However, in states such as Georgia and New Jersey the timeframe can be within one year.

Until recently, many lenders chose not to pay special attention to the tax payment status of loans. Recently, two conditions have shifted the focus toward the risk associated with commercial taxes. These areas include: 1) an increase in the number of late payments, and 2) the increasing trend toward lower property values. In some instances, lenders are receiving notices of pending tax sales. For one large lender, properties have even gone to tax sale. After experiencing a significant dollar loss in this scenario, paying an additional amount in back taxes, interest and penalties can be especially painful.

New Interest in Tax Services

All of which explains why companies, like CoreLogic, have recently seen a surge of new interest in tax services from commercial lenders. Much of the interest has focused on non-escrow accounts. In our portfolio, 61% of the loans under service, representing 300,000 properties, are non-escrow. On these accounts, we perform a tax payment verification for each property (often several parcels may be under one loan) 60-90 days after the delinquency date for each taxing jurisdiction.

Non-escrow reporting includes the status of each property's real estate tax providing both paid and delinquent information.

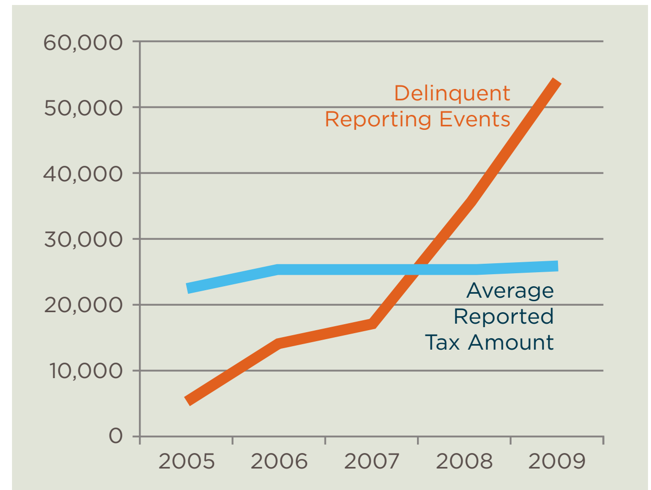
Following a non-escrow reporting event, we can manage the contact and follow up with the borrower on a private label basis, for clients.

We can also provide property- or borrower-specific tax payment verifications to lenders that are not using tax service contracts. Based on client-provided tax identification numbers and tax authority information, we will check the payment status of current and prior year taxes and provide a simple paid/open report.

Our commercial escrow reporting service ensures clients receive a tax-amount report/file for all escrowed properties on average 21 days prior to the economic loss date. To facilitate property tax payments, we make every effort on your behalf to obtain original bills using registration, agency audit and bill request methodologies. When we cannot obtain an original bill, we will provide a memo bill that is acceptable to the taxing jurisdiction. Our web-based commercial tax service platform supports flexible report customization and distribution scheduling, providing clients information in formats that meet their specific needs and schedules.

We can pay taxes on your behalf for any loan/asset under service. Through this service, we assume the burden of processing tax payments, significantly reducing risk of tax penalties and interest. We generate and send clients a file as taxes become due. Once the client identifies the taxes to be paid, we facilitate payments to the appropriate taxing authorities. To accommodate the process, we can establish a clearing account that accepts wire transfers of tax payment advances. In 2009, CoreLogic paid $12.1 billion in CRE taxes for our clients.

Recently, many commercial tax assessments have leveled off. In fact, the average reported tax amount that we track has been remarkably steady at the $25,000 point for the past 4 years. As the chart at right illustrates, the number of delinquent reporting events has increased sharply during the same period.



Reducing Surprises

Over the next four to five years, lenders will be closely monitoring loan payments, markets and individual property conditions to make critical loan-level decisions, such as rolling over loans versus foreclosure. Property-level tax status may be a key predictive element worth building into the decision-making process. Delinquent taxes are frequently an early warning sign that a borrower is in trouble or is on the verge of strategic default. Conversely, a borrower who is current on debt obligations and taxes may be a better candidate for some kind of debt relief or forbearance.

In any event, lenders that decide to extend loans and partner with their borrowers can inexpensively eliminate the additional downside risk of tax liens or additional losses, due to taxes, interest and penalties, in the event of foreclosure. They can do this by requiring modified accounts to escrow taxes or by using non-escrow tax services.

Think of it as protection from falling shoes.

FOR MORE INFORMATION, PLEASE CONTACT KEVIN WALSH
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*Based on analysis of commercial loans under tax service with CoreLogic.

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