NASHVILLE NOTES

Commercial Real Estate Can-Kicking Trumps Immediate Loss Recognition

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There is something to be said about getting in front of expected problems.

A friend pointed me to a March 17 letter that the Real Estate Roundtable wrote to federal banking regulatory executives touching on the credit elephant in the room: commercial real estate (CRE). My friend, a capital markets credit professional, also had the spot-on observation that liquidity issues often morph into tomorrow's credit issues.

Real Estate Roundtable (RER) is a trade group that represents the interests of real estate ownership, development, management and financing in setting policy and the like. The letter asked the federal banking regulators to "reestablish immediately a program similar to prior programs in 2009, 2010, 2020 and 2022 that encouraged financial institutions to work prudently with borrowers on commercial real estate troubled debt restructurings (TDRs)."

Some bearish investors have quipped that money-losing private equity-backed companies may face a mass extinction event in 2024 if markets do not reopen soon. The same may apply to CRE borrowers that have to refinance, and construction projects nearing completion that seek permanent financing from insurance companies or the commercial mortgage-backed securities market.

> ***If the plea from RER is to allow banks to kick the CRE can, the question becomes: how far? My bet is as far as possible.***

Lenders and CMBS investors are mostly in a "pencils down" mode presently. The math does not work because of the wrecking ball that high rates has on debt service coverage, and the value of CRE assuming loan-to-value matters to lenders. Plus, many CRE lenders have a funding issue.

The setup looks to be big (huge?) CRE losses over the next several years unless RER's call for regulatory forbearance is granted to banks. Even if it is granted, no relief will be forthcoming for CMBS financed properties given contractual obligations that govern how delinquencies are handled by servicers.

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It is not a perfect analogy, but Mark Twain's observation that history rhymes comes to mind when comparing todays emerging CRE issues with "lesser developed country" (LDC) loans that weighed on banks after then-Federal Reserve chair Paul Volcker pushed short-term interest rates toward 20% in the early 1980s.

During the 1960s and 1970s, newly rich oil-producing nations deposited oil revenues into large banks. The "petrodollars" were loaned to LDCs rather than invested in outsized amounts of government bonds that were then called "certificates of confiscation" due to rising inflation and interest rates that pummeled the value of fixed-rate bonds. To this point, Twain's observation that history rhymes is spot-on when comparing big unrealized losses in bond portfolios then and now.

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According to the Federal Reserve, LDC debt equated to 290% of capital of the nine largest money center banks (i.e., some of today's global systemically important banks) when the crisis erupted. The banks probably were insolvent because they could not mark-to-market the LDC loans through sufficiently large reserve build because they did not have the capital. However, they were liquid and continued to dispense credit to the economy.

Had the large banks immediately recognized the full LDC loss, they would have tested a maxim that I believe is attributed to Walter Wriston, then-CEO of Citigroup Inc. predecessor, Citicorp, that banks do not need capital so much as liquidity. My guess is, had the banks taken massive write-downs, large depositors would have tested his liquidity maxim, just as the large depositors became spooked that Silicon Valley Bank would be forced to realize its massive unrealized loss in its held-to-maturity bond portfolio.

Regulators were pragmatic in the early 1980s because they had to be, and the LDC crisis may have forced Volcker's hand to start cutting rates like Wall Street is banging pots and pans now for Fed Chair Jerome Powell to pivot and cut rates.

Banks used the installment method to deal with the LDC problem through gradually building reserves and capital during the mid-1980s. Then in 1987, John

Reed, who replaced Wriston as CEO of Citicorp, surprised the market when the bank made a $3.3 billion provision to top-off reserves for its LDC exposure. Other banks followed suit, which set the stage for final resolution of the crisis a decade after it first erupted through the issuance of "Brady bonds" as part of a comprehensive debt restructuring.

If the extent of issues facing CRE lenders is like the LDC issues, then it is hard for me to see how a similar policy of can-kicking will not occur as loans are extended and modified, while reserves are gradually built. I do not think most lenders can handle mass foreclosures because price discovery for CRE properties dumped on the market would be brutal in the current rate environment, unless Wall Street gets its wish and the Fed slashes rates sharply.

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