Commercial real estate plunges posing major problems for banks

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The indications by the US Federal Reserve that it is moving towards interest rate cuts may have boosted Wall Street, at least temporarily. However, they have done nothing to alleviate the mounting crisis for banks arising from debts in the commercial property market which have to be refinanced in the coming period.

The Fed move led to a 1 percentage point drop in the interest rate or yield on the benchmark 10-year US Treasury bond. Despite some liquidity being provided to banks in the short-term, it will not halt what has been described as the "slow-burn of the US commercial property slump."

While it may have eased tensions for now, the Fed move has been described as "too little and too late and temporary, to prevent rising bankruptcies."

The worsening situation was laid out in a report published by the National Bureau of Economic Research (NBER) in December, which has been the subject of a number of articles in the financial media. Authored by four economists, it was entitled "Monetary Tightening, Commercial Real Estate Distress, and US Bank Fragility."

Writing in the London-based *Telegraph,* Ambrose Evans-Pritchard cited remarks by Columbia University professor, Tomasz Piskorski, one of the authors of the NBER paper.

"It's not a liquidity problem; it's a solvency problem," he said. "Temporary measures have calmed the market, but half of all US banks are running short of deposits with assets worth less than their liabilities, and we are talking about $9 trillion.

"They are bleeding capital and could not survive if something triggers a sudden loss of confidence. It is a very fragile situation and the Federal Reserve is watching it closely."

Not all banks are immediately affected. The looming crisis is concentrated in smaller and regional banks which are often heavily invested in local commercial property. But the experience of the past year shows that problems that arise in less significant areas of the banking system can rapidly spread.

One need only recall the crisis of March last year when Silicon Valley Bank and two others went under because of a run by depositors. Financial authorities had to intervene to guarantee all uninsured depositors lest the crisis spread throughout the system.

The situation in the commercial property sector and its implications for banks is potentially even more serious. The March crisis was sparked by the fact that due to a rise in interest rates, the market value of the Treasury bonds, which they bought as a safe haven for their cash, had fallen giving rise to significant book losses.

In commercial real estate the problem is refinancing debt at a much higher interest rate. Some $5 trillion taken out in loans in the period when interest rates were at historic lows will come due in a series of tranches.

Evans-Pritchard cited comments by Scott Rechler, chairman of the Long Island developer RXR and a member of board of the New York Fed.

He said lenders were only now beginning to mark down loans. "As an industry, we in the first innings of what's going to be a long game," Rechler said, noting he had defaulted on a $240 million loan for a 31-storey Broadway office tower and handed the keys to a syndicate of banks.

"You can't raise rates this quickly and not expect a financial shock. We're already working on transactions at 50 percent on the dollar; the equity is wiped out and half of the loan is wiped out."

Professor Stijn Van Niewerburgh, a property and finance expert at Colombia University, has described

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the property market as a “train wreck in slow motion.” He recently published a paper which estimated that the “value destruction” of New York office buildings could exceed $650 billion.

The extent of the mounting problems is laid out in the NBER paper. It found that after the adoption of “hybrid working patterns”—the increase in working from home as a result of the pandemic—and higher interest rates, about 14 percent of all loans and 44 percent of office loans appeared to be in “negative equity.”

That is, current property values are less than the outstanding loan balances.

“Additionally,” it continued, “around one-third of all loans and the majority of office loans may encounter substantial cash flow problems and refinancing challenges, reflecting in part a more than doubling of the cost of debt following monetary tightening and substantial increase in credit spreads.”

The effect of the interest rate rises since March 2022 was outlined in the paper. It found that if CRE loan distress had manifested itself in early 2022 when interest rates were low, not a single bank would have failed even under the most pessimistic assumptions.

But because of the interest rate hikes since then and a more than $2 trillion decline in banks’ assets values, as many as 482 banks with aggregate assets of around $1.4 trillion would have the market value of their assets below their liabilities.

According to the research, distress in the CRE sector “could lead to the inclusion of dozens to over three hundred predominantly smaller regional banks within the cohort of institutions vulnerable to insolvency arising from … uninsured depositor runs.”

In other words, the crisis which erupted last March, leading to three of the four largest bank failures in US history, arose from conditions endemic in large parts of the banking system.

It noted that quite apart from spillover effects arising from the direct connections between banks, “the news about commercial real estate defaults and banking losses could be a trigger for a widespread run on the banking system by uninsured depositors, unravelling a fragile banking system,”

Moreover, the analysis suggested that “so long as interest rates remain elevated, the US banking system will face a prolonged period of insolvency risk.”

That conclusion has major implications as regards the very stability of American capitalism. A Fed interest rate of 5 percent or even more is not high by historical standards. But its maintenance today poses the risk of widespread insolvency.

That fact points not to a conjunctural downturn, which can somehow be alleviated, but to a deep-going historical crisis. The rise of American capitalism was powered by its industrial might.

That era has gone forever and today it is the centre of financial parasitism and speculation, financed by the inflow of ultra cheap money such that even the raising of interest rates to levels considered to be entirely “normal” in the past now threatens to bring down the financial system like a house of cards.

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