

Banks Won't Fail This Time, But A Credit Crunch And Debt Distress Still Loom For Real Estate

10 June 2020 | Mike Phillips, Bisnow London 

To understand how real estate lenders are going to act through this crisis, to know how, when and where distress is going to come, you have to understand the complex mechanisms of bank regulation.

The way bank regulations work means distress isn't likely to come through quickly: It may not start to manifest until next year. But those same regulations also mean that borrowers, whose incomes are suffering as tenants withhold rent, can't be given a free ride to miss loan repayments indefinitely. The pressure on all parties affected by the coronavirus will eventually start to put cracks in the system.

Behind a big picture that looks healthier than during the last crisis lies a more nuanced view — the commercial real estate lending sector is still likely to see significant distress, and a credit crunch of sorts is still likely in the coming months and years.



Going into **the coronavirus-induced recession**, commercial real estate lending is in a much better position than it was in 2008. Banks are better capitalised, loan-to-value ratios across the board are lower and there is a much more diverse range of lenders in the sector, from **insurance companies** to **debt funds** to high net worth investors.

“Banks are in much better shape this time: The last crash was only 10 years ago, and is still fresh in the mind of lenders, borrowers and regulators,” Commercial Real Estate Finance Council Europe chief executive Peter Cosmetatos said. “But just because banks don't fail doesn't mean this will be without difficulty.”

That is a given since **the Bank of England is predicting the worst recession in 300 years.**

Although their influence has waned in the past decade, UK-regulated banks are still the largest holders of UK **commercial real estate debt**, according to Cass Business School's annual UK real estate debt report. Their actions determine much of the health of the industry, and some of their decisions over the last few months have been significant departures.

Put simply, normally if a borrower misses an interest payment or a loan covenant is waived, a bank needs to work out the “expected credit loss” on the loan, make a provision for that loss in its accounts, and put some money aside to cover the expected loss. That makes it expensive for banks to hold loans that are distressed, which is deliberate — the rules were made to encourage banks to make less risky loans.

But the coronavirus has changed that. In March, Sam Woods, the chief executive of the **Bank of England**’s Prudential Regulatory Authority, essentially **told the UK’s banks** to grant borrowers who said they were impacted by the pandemic short-term interest payment holidays and not to make provisions in their accounts. The lenience meant banks wouldn’t all of a sudden face big losses if borrowers missed payments or loan covenants were breached.

So far, banks have largely been supporting borrowers, often by waiving some or all interest payments in situations where a borrower’s tenants withheld rent, which affects investors’ cashflow. **RBS** for example **has said it is telling borrowers** they don’t have to make capital repayments for six months and is waiving covenant tests for the immediate term or amending interest to cover covenants. It is not seeking valuations in the short term.



Last week Woods wrote to banks again, telling them that they should continue to grant interest payment holidays and do as much as possible to support borrowers through the crisis. But the guidance was expanded, and subtly changed, when it came to accounting for losses.

Now, banks are told that they should start thinking about whether the payments being missed and potential losses on loans are short term. Which missed payments are likely to be repaid soon since the pandemic has started receding, and which are likely to never be repaid? Will losses likely continue into the medium and long term? It was left up to banks’ own judgement.

If problems are likely to endure, banks need to start thinking about making provisions and taking losses. That is when pressure starts to be exerted on borrowers.

“No lender is going waive interest payments indefinitely,” **Brookland** founder and Partner **Nassar Hussain** said. “Lenders are happy to put in place temporary measures for one or maybe two quarters, but after that they want to know what the plan is for the debt to be properly restructured or for them

to be repaid their money. We are already hearing about some banks being difficult, saying, we are willing to grant a waiver, but what do we get in return?”

Cosmetatos said the financial situation for property borrowers is expected to continue to deteriorate somewhat in the near term, as tenant businesses have been trading for longer with severely reduced income. Even less than the roughly 67% of rent collected in March could be collected in June. The government’s furlough scheme to support employee wages will start to be rolled back in August, which could strike a heavy blow that reverberates all the way up the property line.

“The more interest payments that are missed or the clearer it becomes that borrowers will need forbearance or support longer term, the harder it gets,” Cosmetatos said. “Anything that lasts more than two or three quarters and banks have to start getting to grips with the situation.”

Banks typically put more equity in to deals to cure LTV breaches where values have dropped, to make up for missed interest payments or to build up reserves that can be used in the event that interest payments are missed in future.

“At the moment we are just seeing forbearance from lenders in respect of contractual breaches. However, we anticipate lenders will shortly require equity injections or restructuring plans to address over-leverage capital structures,” RSM partner Damian Webb said. “There are significant losses that lenders are becoming aware of in the property space.”



At that point, the eternal cosmic dance between borrower and lender begins. In some cases, borrowers will be happy to put more equity into loans where the long-term prospects for an asset are good.

But there will be situations where it is marginal, and in these cases, borrowers might prefer to just hand back the keys, or play hardball with lenders. That was already happening in the beleaguered retail sector, where private equity firms including Lone Star, Oaktree and HIG have chosen to hand shopping centres back to lenders rather than throw what they consider to be good money after bad.

And even where borrowers want to put more money into deals, it may not always be possible or economically viable.

“You are going to need a lot of equity for capital expenditure to make properties fit for purpose in the new post-COVID world, and that is before you get on to the expenditure required to meet underlying structural

you get on to the expenditure required to meet underlying structural challenges in sectors like retail or offices,” Cosmetatos said. “Where is that money going to come from?”

There are some obvious areas where distress will be concentrated. Retail is one, but borrowers in this sector may have been handed an unexpected stay of execution by the virus.

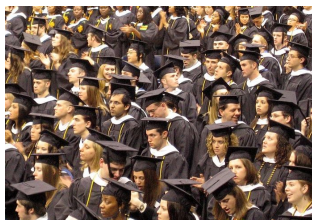
“I don’t think banks will be exerting pressure on secondary retail borrowers to sell,” Hussain said. “There is no liquidity in that market, and they know the buyers in that market will predominantly be cash only due to difficulties in obtaining debt and therefore requiring much higher returns - so what does that do to values?”

Others are less expected.

“Student accommodation has attracted significant investment and has been seen as a robust sector,” Webb said. “However, the social distancing requirements which will negatively impact on the university experience, coupled with the immigration restrictions/obstacles on foreign students, could lead to demand collapsing in September which could take two to three years to work through the system.”

Even traditional offices on long leases, seen thus far as one of the more resilient asset classes, are likely to come under stress in the medium term.

“Take a property like Queensbury House on Old Burlington Street,” Lorenz Consultancy Managing Director Tony Lorenz said. “Rents there were £102 per SF in June 2008, fell to £78 per SF in September and by the end of the year were £68 per SF. There could be an enormous amount of downsizing in the coming months and years, as people work from home due to social distancing. If rents go down 30%, even without yield shift, then the value of a property has gone down 30% and the equity could be in trouble.”



More systemically, debt funds are seen as a potential locus of problems. These funds are not subject to the more stringent regulations placed on other lenders like banks or insurance companies. While that gives them leeway in how they deal with problem loans, it also means some funds are willing to write riskier loans than other types of lenders.

For example, the first loans to go into default this cycle were underwritten by fund manager Federated Hermes for its debt fund, which when it was launched played up its ability to lend to assets banks wouldn’t countenance.

“Some of these funds will also have their own leverage in the form of repo facilities or loan-on-loan finance,” Cosmetatos said. “From what we are hearing the conversations they are having with their own lenders are sensible. But an additional challenge is that their investment strategies often involved taking on more risk than banks or insurance companies.”

There is a second order effect from the situation lenders find themselves in: While they are busy working out where the problems they have lie, and what to do about them, they are less likely to be out undertaking new lending, which could create a credit crunch. In 2009 the amount of debt extended to property fell 69% compared to the year before, according to Cass, as banks spent all of their time dealing with distress. The distress might not be quite the same this time around, but it is likely to hamper new lending, which will in turn put a chill on the investment market.

“Lenders are putting all of their resource to dealing with existing customers, and that means there will be little appetite for new lending,” Cosmetatos said.

This crisis is different from the last, and history never repeats itself exactly. But the way that lenders are structured and regulated means that, even though they are in a much healthier state, they are unlikely to emerge unscathed.

See Also: [As China Puts Hong Kong On Fast-Forward, Investors Look To London](#)

Related Topics: [Finance](#), [commercial real estate finance](#), [Brookland Partners](#), [Cass Business School](#), [RSM UK](#), [UK commercial real estate lending](#), [CREFC Europe](#)