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Credit markets: Risks, stimulus and the search for financing

May 07, 2008 - Financial Digest

For a significant period of time, the only concern with respect to financing in the commercial real estate sector involved the quality and strength of property cash flows. In fact, before the credit crisis, discussions addressed whether then current spreads on financings adequately priced risk. Everyone was lending and spreads tightened. Now the reverse is true. Debt is hard to secure and frequently expensive when obtained. Once again the debt markets are having issues with pricing risk, but not out of leniency. Financial institutions appear to be overleveraged and risk averse.

The credit crisis at its heart is a risk management crisis. The structures and institutions designed to mitigate and spread risk did not operate in the intended manner. Risk spreading yielded to interlocking of risk. Institutions that were assumed to be built on strong capitalization were instead subject to significant leverage. Previously uncorrelated markets became correlated, increasing the spreads at which issuances across a plethora of asset classes and types traded. Municipal bond markets exemplify this. As monoline insurers expanded beyond municipal bond markets into subprime securitizations, it imperiled insurance coverage for municipal bond issuances. As a result, spreads for municipal bond issuances have risen dramatically.

Credit availability is affecting the ability and cost to enter into new and permanent financings. Sponsors of recently completed construction projects may prefer extending their bridge financing rather than locking in permanent financing. Negotiated extensions, even with penalties, might be cheaper than an exorbitant permanent loan. In fact, they might be the only practical alternative for long-term financial viability of the project.

Also, the first third of 2008 was a poor time to have a loan with a bullet maturity. Credit availability looms as a larger issue than project cash flow performance. Put another way, the majority of defaults appear to be maturity defaults. The cost of refinancing a balloon at maturity is high under existing market conditions. Accordingly, borrowers are resorting to costly extension arrangements with existing lenders to buy time in anticipation of a credit market turn around.

In its April 30, 2008 statement, the Federal Reserve cut the federal funds rate to 2%, omitting references to downside risk to economic growth and potentially signaling a pause to further rate cuts. This appears to reflect inflation concerns as much as the potential for an accelerating economy. The March 18, 2008 minutes of the Federal Reserve's Federal Open Market Committee illustrate that debt markets are subject to competing influences. Various forms of economic stimulus have been injected into the economy. They are expected to positively affect GDP during the remaining period of 2009. On the other side, consumer and business spending were down, affected both by sentiment and the credit crunch. While the trade deficit narrowed, bolstered by the weaker dollar, the minutes express concern over the ability of foreign markets to sustain United States exports growth.

This much is clear: Funds are being formed in order to remove excess housing loans and assets from the books of financial institution, mirroring the process of non-performing loan inventory reduction that occurred in the late 80's and 90's with banks, savings and loans and the Resolution Trust Corporation. Foreign investors are bulwarking the balance sheets of investment banks and financial institutions. Under legislation adopted by the Senate (and a reversal in position by the IRS), financial institutions holding defaulted loans (including Fannie Mae and Freddie Mac) would be permitted to receive net operating loss, as opposed to capital loss, treatment with respect to defaulted loans. This alone can provide meaningful relief by not compounding asset write-downs with tax liability.

The news in the financial markets reflects this confusion. Predictions range from "the worst economic slowdown since World War II" to "the worst is behind us." And when all is said, perhaps the most important question will not be when will the markets turn around, but what lessons we have learned -- perhaps not many. Our system never operates in perfect equilibrium. The only certainty is that when the market is weak, there is room for growth, and when the market is up, beware of the fall.

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