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Recent bank failures should lead to a more resilient banking system and help transform functionally obsolescent real estate - by Michael Zysman

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The recent failure of some large regional banks has created ripple effects throughout the commercial real estate capital markets. Signature Bank, Silicon Valley Bank, and First Republic Bank were the major casualties of the most recent banking crisis. These banks focused on providing premium lending products to borrowers that had substantial deposits with the banks. Utilizing this business model created a situation where there was a high percentage of deposits not eligible for FDIC insurance. If depositors feel the institution they have uninsured deposits with is weak, it can lead to swift bank runs for those institutions. In addition, large depositors tend to be more interest-rate sensitive and are more inclined to move their deposits from lower yield bank products to treasury securities as their rates increase. Unfortunately, these banks suffered failures due to deposits quickly leaving the banks for these reasons and others. To protect depositors and limit future bank runs during this crisis, the government swiftly stepped in to help by insuring all bank deposits and allowing banks to borrow against their assets at par, even if the market value of the underlying collateral was below par.

Early in this crisis as large depositors moved money from the banks that ultimately failed, the banks needed to come up with additional liquidity to cover redemptions. Historically, banks were able to use the Federal Reserve's emergency window if they were not able to raise sufficient short-term liquidity to cover a large number of redemptions. The Federal Reserve window is not a par vehicle and can only be used to borrow against bank assets at a discount to the pledged collateral's market value. Due to the recent increase in interest rates, many of these banks were holding long-term loans at interest rates well below current interest rates which decreased their loans' current market values. Ultimately, the rate of deposit withdrawal was so great that these banks then became insolvent. Subsequently, the FDIC put the failed banks into receivership so their balance sheets could liquidate appropriately to limit the FDIC's ultimate cost of covering deposit losses. Larger banks ultimately acquired the failed banks and are actively managing their underlying assets and their customers' deposits.

The FDIC made the decision to sell Signature Bank's assets on the open market vs. selling them to a bank at a discount. This creates a great opportunity for Signature Bank's borrowers to potentially buy their property's underlying debt at a discount and also help create price discovery. This will also help stimulate additional investment sales and capital markets transactions due to these new market comps. Also banks that hold functionally obsolescent real estate will be better able to understand the value of those assets once these loans are sold which will help them manage their balance sheets accordingly.

As a result of these failures many local and regional banks have pulled back on lending for commercial real estate as they further assess their balance sheets. This creates an opportunity for private credit to step in and lend on assets that previously would have obtained bank financing. Once regional and local banks get a better grasp of the value of the underlying assets and shore up their balance sheets, they should become active lenders again. In the interim period, buyers of real estate should expect to pay higher rates which will lead to a short-term value decline that will dissipate once more attractive long- term financing options emerge. In addition, government backed lenders should become more active as well for assets and borrowers that normally would have obtained loans from regional and local bank loans.

We are living through an interesting transitional period for commercial real estate capital markets. Hopefully this period will be less severe than previous downturns and the main causalities will be limited to functionally obsolescent real estate owners and their underlying loans. As lenders of these obsolete assets begin to take losses on their loans, it will allow for these assets to be purchased at prices that should be suitable for their redevelopment. The end result will most likely be the transformation of cities. In addition, it will hopefully lead to a strong and more resilient banking system as well, since regulators will be able to learn from the mistakes that occurred in this current banking crisis.

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