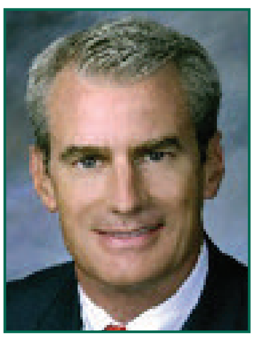
“Deleveraging” – a Cure for the Subprime and Credit Market Meltdown

By Stan Mullin, SIOR, CCIM, CRE, FRICS,



Stan Mullin, SIOR, CCIM, CRE, FRICS, and 2006-2007 SIOR President has been with the Grubb & Ellis Company in Newport Beach, California for 26 years. He specializes in industrial leasing and sales. He served as 2007 President for the Los Angeles based AIR Commercial Real Estate Association and has taught for Grubb & Ellis, AIR, BOMA, CAR, and SIOR.

“A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain.”
Mark Twain (1835-1910)

The most powerful economic force in the world right now is what bankers call “deleveraging.” Essentially, this is when lenders ask for their loans back, in particular from borrowers perceived as high risk. The March 17th *Weekly Bulletin* of BCA Research’s *U.S. Bond Strategy* began it’s issue with “The Deleveraging Cycle Has Accelerated.” Margin calls are going unmet, investors are demanding their money back, and multiple bond funds face windup or shut down.”

The United States is on the receiving end of a massive margin call. Across the financial markets, lenders are demanding more collateral, capital, and debt reduction. Standard & Poor’s Ratings Services predicted last March that large financial institutions will ultimately need to write down $285 billion in subprime-related securities (Bill Gross of Pimco, thinks the mortgage-related amount could be closer to $500 billion, *which in perspective…is still just above two percent of the overall value of the stock market*). That is a troubling prospect for a savings-short, debt-heavy economy that relies on $2 billion a day from abroad to finance investment. Keep in mind that delinquencies in the subprime mortgage market are not even necessarily the primary problem. Subprime was the “trigger” that both uncovered and exacerbated other weaknesses in the global financial system (Rappaport and Lahart in the

Wall Street Journal, see reference list at the end of this article).

Bob Eisenbeis a former Executive Vice President of the Federal Reserve Bank of Atlanta, and now the Chief Monetary Economist with Cumberland Advisors, said, "It is time to step back and recognize that the current situation isn't a liquidity issue and hasn't been for some time now. Rather, there is an uncertainty about the underlying quality of the assets—which is a solvency issue, driven by a breakdown in highly leveraged positions" (Rappaport and Lahart).

The past decade witnessed the greatest expansion in U.S. private-sector leverage in the post WWII period.

Breakdown of Leveraged Positions

Banks in general are highly leveraged institutions. Invest $1, borrow $9, buy something for $10. If its value rises $2, you have tripled your investment. This is great in a bull market and brutal in a bear market. If roughly half of the mortgage losses are borne by banks, say around $200 billion, then they will have to shrink their balance sheets by about $2 trillion by lending less (likely $900 billion less in loans) and selling assets. The current banking requirement of "mark-to-market" rules add to the despair because now banks have incentives to buy more when prices are high and are forced to sell when they are low—the opposite of the stabilizing effect that our economy needs (Wessell, *Wall Street Journal*).

The past decade witnessed the greatest expansion in U.S. private-sector leverage in the post WWII period. The unwinding of a debt-fueled speculative asset boom always inflicts severe financial pain on both borrowers and lenders, and this current cycle is no different. However, one primary difference between our current economic trouble and the late 1980s and early 1990s is that 10 years ago, government debt was a primary factor, whereas today's meltdown is driven by private debt. We also know that the Fed has made it clear to the financial markets (through the Bear Sterns bailout) that no major financial institution will be allowed to fail and liquidity will be made available to those in need (to the extent the Fed has the capacity). This has removed a huge downside risk to the financial markets (Barnes, *The Bank Credit Analyst*).

We are still left with a prolonged period of balance sheet rebuilding for borrowers and lenders, which will likely keep interest rates low and result in the forced sale of real and non-real property assets (Barnes).

Combined consumer and business debt jumped by almost 50 percent of GDP between the fourth quarters of 1997 and 2007 (63 percent of which was residential mortgage debt). That is almost double the rise of the debt-to-GDP ratio that occurred in the recession of the late 1980s (Barnes).

American household debt has more than doubled in the last decade from $6.4 trillion in 1999 to $13.8 trillion at the end of 2007, the vast majority of it in mortgages and home equity lines of credit. The catch is that the value of a typical U.S. household's largest asset—their home—is now falling (Rappaport). In the fall of 2007, Lehman Brothers forecast the value would to ultimately drop 20 percent.

Even though the "originate-to-distribute" banking model moved most of the originated loans off banking balance sheets, it still resulted in a growth in the stock of loans held by banks, and today banks are far more exposed in real estate than they were in the cycle of the late 1980s (Barnes).

What distinguishes the most recent decade of banking is the growth of securitization and complex structured products. This led to the leveraging of leverage. The outstanding value of pooled securities overtook that of bank loans in 2001, meaning that banks faced losses on their loans and greater losses on the securitized products that they held on (and off) their balance sheets (Barnes).

We know that, before our capital and real estate markets can stabilize, a "floor" to the housing market must be reached. Credit spreads must decrease and the mountains of debt in the mortgage-backed securities market must be priced and written down (taking the loss) reducing balance sheet debt. Since the beginning of the year, financial institutions have written off more than $400 billion in assets and the IMP predicted last April that losses may reach $945 billion worldwide (Duhigg).

The pain that the commercial real estate (and financial) markets will have to endure is the "deleveraging" of our industry. On the bright side, corporate profit margins have been high, balance sheets are liquid, and debt-servicing burdens are relatively low. Corporations were cautious about leverage after the tech-bust, and interest payments as a percentage of corporate cash flow in the second quarter of 2008 fell to the lowest level in 40 years (Barnes). So the commercial real estate markets should weather the current crisis in the capital markets better than most industries. On the flip side, owners of commercial and, in particular, residential real estate, will have to reduce the amount of debt they carry.

Most economist and bond managers believe that loan default rates will be slow to decline.

When credit was easy, homeowners, commercial users of real estate, developers, hedge funds, and other borrowers loaded up on debt. In many cases, the borrowers bought assets they otherwise could not afford. In many cases, hedge funds used huge amounts of debt to reach for returns as the profit margins on their transactions compressed (Patterson, *The Wall Street Journal*).

"..prediction is very difficult, especially when it's about the future..."
Niels Bohr, Nobel Laureate

The Margin Spiral

We know the days of easy credit and money are history. Today, banks want home equity lines of credit ("HELOCs") paid off before they will issue replacement credit, and they want more equity (typically 35 percent) to secure conventional commercial real estate loans. Banks are making margin calls on loans secured by assets declining in value (homes, commercial buildings, and investment vehicles) and they are much quicker to demand loan repayment when deals sour. As this demand for equity increases, it forces asset sales into a declining market, which then leads to reduced values and...more margin calls. Economists call this a "margin spiral." Mohamed El-Erian, co-CIO and co-CEO of Pimco in Newport Beach, California, says, "It's like sucking oxygen out of a room" (Patterson).

When mortgage-backed securities are written down, it reduces the equity cushions in the shadow banking sector holding those obligations (Wall Street), and increases their leverage at the least desirable time. Efforts to sell the assets to increase balance sheet strength, typically results in even lower prices for the assets, which adds to the selling pressure (Greenlaw).

Even with the recent tightening of lending standards, loans *as a percentage of assets* have continued to rise. On a more personal level, most households face a period of debt consolidation and reduction in contrast to the credit-financed spending of the last 10 years (Barnes). To quote the title of a March 6, 2008 Op Ed piece in the *Wall Street Journal* written by Terry Couto, a partner in Newbold Advisors, "Some mortgages should fail."

This deleveraging process has been growing in intensity and scope since the summer of 2007. To ensure that banks have enough cash on hand, the Fed can lower short-term interest rates and use other monetary policy tools, but in the end, many investors will be forced to sell their assets to meet the upcoming lender equity demands. That will push cap rates up and reduce commercial real estate prices. I'd prefer to say that this deleveraging will bring assets closer to their true value (Patterson).

I think Kevin Duffy, principal with Bearing Asset Management, put it in context with the larger economy when he said "The Fed is attempting to thwart a deflating credit bubble with inflation, which to date has only lit a fuse under food and fuel prices. The best the Fed can do is to allow the inevitable deleveraging process to proceed without meddling" (Duffy).

Deleveraging and the Commercial Developer

What is the practical application to commercial developers? Along with the obvious requirement for a greater equity contribution and the requirement for better credit, developers will be facing the return of recourse: the dreaded personal guarantee (Wei in the *Wall Street Journal*). Historically, if a developer had several successful projects, his or her lender would eventually accede to lending without recourse. The competition for that kind of borrower was fierce, and the bank knew that other banks would not require guarantees. Now with a 90 percent drop in sales of commercial mortgage-backed securities (CMBS), banks have all but stopped originating loans aimed at the bond markets. Instead, they are returning to the traditional model of holding on to—as opposed to selling—the loans. "We're not closing loans for securitization. We're closing loans for balance sheet," said Brett Smith, Managing Director of Wachovia Corp.'s real estate group.

Today, when commercial loans come due, lenders that are willing *and able* to offer the same loan amount are requiring borrowers to guarantee anywhere from 25 to 100 percent of the loan amount. Roughly $16 billion in loans that were packaged into CMBS—which are nonrecourse—are expected to come due in 2008, followed by about $19 billion in 2009 (Wei).

One of the strongest warning signs that the worst is yet to come was after a Lehman Brothers report said accounting rule changes could force Fannie Mae and Freddie Mac to raise as much as $75 billion in new capital. Shares in these firms, the nation's largest buyers of home mortgages, plunged 18 percent and 16 percent respectively on July 7th (at one point, Freddie was down 30 percent). Their role is crucial to retain liquidity in the mortgage market at a time when other secondary market buyers have vanished. If these giants stop buying mortgages, absent the U.S. government taking control *(which would render their investor shares worthless, and their bondholders protected*), the debt market in the U.S. will essentially come to a standstill. This would be the ultimate in forced deleveraging.

In 2007 alone, Fannie's and Freddie's shares lost 76 percent and 80 percent of their value, respectively (Freddie Mac's stock price has dropped by 56 percent since May 14th alone). According to Paul Miller of the Freidman, Billings, Ramsey Group in Arlington, Virginia, "If Fannie and Freddie are vulnerable; it means no one is absolutely safe" (Duhigg).

The impact of deleveraging on risk assets such as commercial real estate is not clear. Most economists and bond managers believe that loan default rates will be slow to decline. Imagine what's in store for the U.S. economy if every person and business had to eliminate 15-20 percent of its debt. That may be what is in our future. On the other hand, the likely period of lower-than-normal interest rates will be positive for the commercial real estate industry by forcing investors out of low-risk assets and into real property and other similar investments (Barnes).

"The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Means" by George Soros is a good source of further reading and www.Implode-O-Meter is a good source of data for failing lending institutions.

References Cited

Barnes, M. 2008. "The Implications of Deleveraging." *The Bank Credit Analyst.* June.

Couto, Terry 2008. "OpEd." *Wall Street Journal*. March 6

Duffy, K. 2008. "They Said What? – Inflation and Rate Hikes." *Barron's*. June 16:.

Duhigg, C. 2008. "Mortgage Fears Depress Shares at Two Agencies." *New York Times*. July 8:

Greenlaw, D. 2008. "Leveraged Losses: Lessons from the Mortgage Market Meltdown.". www.brandeis.edu/global/rosenberg_institute/usmpf_2008.pdf, February 29

Patterson, S., and M. Gongloff. 2008, "Deleveraging's Vicious Spiral Picks Up Speed." *Wall Street Journal* March 6: C1.

Rappaport, L. and J. Lahart. 2008. "Debt Reckoning: U.S. Receives a Margin Call." *Wall Street Journal*, March 15: A1

Wei, L. 2008. "Guarantee Gamble: Developers Dread Return of Recourse." *Wall Street Journal.* June 18: C1.

Wessel, D. 2008. "Magnifying the Credit Fallout," *Wall Street Journal.* March 6: A2