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IS THERE AN EMERGING CREDIT CRUNCH?

They said it was idiosyncratic.

JOSEPH NATARELLI AND ANIRBAN BASU

When Silicon Valley Bank (SVB) faltered in March, many pundits raced to express that the financial institution was different and did not reflect broader underlying conditions characterizing the U.S. banking sector. After all, by banking some of the most innovative and wealthiest in the United States, the bank had a lumpy deposit base. It had quickly expanded to become the 16th largest bank in the United States as of year-end 2022.[1]

As concerns regarding balance sheet losses mounted, those large deposits began to disappear. On March 9, panicked customers withdrew $42 billion from the bank based on concerns that uninsured deposits were at risk.[2] Regulators shuttered the bank the next day, rendering SVB the largest bank failure since the Great Recession of 2008. Federal Reserve officials have indicated that had they not acted on March 10 to close the bank, a total of $100 billion "was scheduled to go out the door that day."[3]

But again, many suggested that this was simply a one-time phenomenon. Other banks were better managed and did not suffer as many uninsured depositors. Two days later, Signature Bank faltered. An April 2023 report by the Federal Deposit Insurance Corporation (FDIC) indicates that Signature Bank's failure, which was the third largest in U.S. history (SVB was second), was attributable to mismanagement.[4] At 2022's conclusion, S&P Global listed Signature Bank as the 19th largest bank in the United States.[5]

As was the case with SVB, talking heads raced to declare Signature's failure idiosyncratic. In 2018, the New York–based bank ventured into digital banking, subsequently introducing its blockchain payments platform in 2019.[6] As indicated by Investopedia, by 2021, Signature Bank was added to the S&P 500 Index. Its shareholder returns ranked highest among all financial institutions in the Index.[7]

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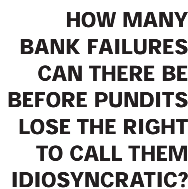
For a few days, it appeared as if the banking crisis would prove to be short-lived. While there was some lingering concern regarding other regional banks, financial markets stabilized, and life in the post-pandemic era went on as usual. Several analysts pointed out how correct they had been to assert that SVB and Signature were simply different and therefore lacked generalizability.

Then came the saga of First Republic Bank, another financial institution rooted in California. The bank initiated operations in 1985 and was best known for serving the needs of wealthy clients in coastal states. At the year's onset, First Republic had more than two-thirds of its deposits in accounts over the $250k FDIC coverage limit.[8] At last year's conclusion, it was the nation's 14th largest bank, according to the Federal Reserve. Attempts by certain larger banks to supply $30 billion in liquidity proved insufficient. That lifeline helped the bank to sustain itself for several weeks — but then came a quarterly financial report that disclosed massive deposit withdrawals by the end of March.



HOW MANY BANK FAILURES CAN THERE BE BEFORE PUNDITS LOSE THE RIGHT TO CALL THEM IDIOSYNCRATIC?

Once again, certain stakeholders were able to shrug off another major bank failure. In early May, JPMorgan Chase announced that it had acquired "the substantial majority of assets" while assuming the deposits of First Republic from the FDIC.[9] Taxpayers are among those at risk. Under the deal, the FDIC will cover 80 percent of any losses incurred on First Republic's portfolio of single-family residential mortgage and commercial loans over the next five to seven years.[10] JPMorgan Chase will not assume First Republic's corporate debt and will receive $50 billion in financing from the FDIC to complete the deal.[11] First Republic now has the distinction of being the second largest bank failure in U.S. history.

After deal completion, JPMorgan Chase CEO Jamie Dimon asserted: "This part of the crisis is over."[12] He also indicated: "There are only so many banks that were offsides this way."[13] In other words, the notion that there is no contagion continued to be propagated. Perhaps that is right, but less than a week later, investors turned their collective attention toward emerging issues at PacWest and Western Alliance. On a recent Tuesday, shares of the two banks each fell more than 25 percent.[14] Perhaps this part of the crisis is not over. To state it differently: How many bank failures can there be before pundits lose the right to call them idiosyncratic?

Credit tightens

Recent data indicate that credit conditions have been tightening in the context of serial bank failures. In its recent periodic compilation of business survey responses, otherwise known as the Beige Book, the Federal Reserve indicated: "Lending volumes and loan demand generally declined across consumer and business loan types ... Several Districts noted that banks tightened lending standards amid increased uncertainty and concerns about liquidity."[15]

For construction firm leaders, this represents an approaching dark cloud. For now, many contractors remain busy, reporting a healthy backlog and substantial pricing power. Many construction firms remain in growth mode. A recent Associated Builders and Contractors survey indicates that the typical contractor expects sales, employment, and even profit margins to expand over the next six months.[16]

But growing uncertainty regarding bank health and stability indicates that private project financing stands to become more difficult going forward. There is already a growing set of anecdotes suggesting that project owners have been unable to line up sufficient capital to keep projects going, with projects shutting down midstream.

The volume of project starts is likely to be stunted going forward. While banking issues are less likely to impact demand for public construction/infrastructure, developer-driven construction stands to be hamstrung by tightening credit conditions. According to the Beige Book, accessing credit has become substantially more challenging in the Federal Reserve's San Francisco district, where SVB was headquartered.[17]

Data indicate similar dynamics infiltrating the economy's consumer sector. The New York Federal Reserve's most recent Survey of Consumer Expectations indicates that the share of respondents suggesting it is more difficult to access credit from a year

earlier climbed to its loftiest level since at least 2013.[18]

There's more: A survey conducted by the International Association of Credit Portfolio Managers (IACPM) found that 81 percent of fund managers predict the number of corporate defaults to rise over the next year.[19] IACPM's executive director said, "Our members have expected to see the impact of rising interest rates for some time and we're beginning to see more credit stress and defaults in corporate borrowers now."[20]

While all of this is ominous, a common rejoinder might be that the economy nonetheless remains strong. As of March, the nation's unemployment rate stood at just 3.5 percent.[21] Recent data indicate that there are still 9.6 million available, unfilled jobs, including well more than 300,000 in construction.[22]

There has even been some good news in the world of commercial real estate. In February — admittedly before the recent spate of bank failures — Colliers International released its 2023 Commercial Real Estate Outlook report, which predicted that the nation's commercial real estate market will stabilize during the latter half of this year and be in a good position when the economy picks up again in 2024.[23] The report pointed out: "The oversupply of retail inventory is stabilizing, since more than 80 million square feet of existing retail space has been demolished in the U.S. since 2019 as properties are repurposed. The lack of quality retail supply will compress the availability rate and slow store openings, and starts of new projects have fallen to their lowest levels in decades."[24]

What's more, after its most recent interest rate increase on May 3, 2023, Federal Reserve officials altered their policy language to suggest that further rate increases are unlikely.[25] Given ongoing economic momentum and the possibility of an easier monetary policy, perhaps concerns regarding a handful of banks are overblown. Those working now or prospectively on megaprojects in the manufacturing sector (for example, chip manufacturing factories in Ohio, New York, Arizona, Texas, etc.) or public works projects (across the country) also have reason to remain upbeat. It would appear that there is ample reason for optimism.

But it's not that simple — certain segments stand to face especially harsh financing conditions going forward, and commercial real estate is one of them. Some of the issues facing commercial real estate are obvious. Perhaps the most embattled segment is the office market, where workers continue to wage a battle against in-person appearances and have expressed strong preferences for remote employment. While Wall Street banks seem relatively insistent that their people return to the office, many other firms, which tend to pay far less than Wall Street, have been more willing to allow workers greater flexibility in exchange for a dollop of loyalty.

None of that is particularly good for the office market. Last year, the U.S. economy expanded by 2.1 percent and added hundreds of thousands of white-collar jobs.[26] Nonetheless, office vacancy rose, and that stands to persist as more leases expire and employers choose to limit their use of real estate.[27] Shifts in behavior have also resulted in higher shopping mall vacancy rates (ecommerce) and lower hotel occupancy rates (business meetings via Microsoft Teams, Webex, or Zoom).

In other words, even without financing challenges, certain segments of commercial real estate were poised to generate fewer opportunities for contractors. Even segments that have been strong, including the construction of fulfillment and data centers, stand to weaken as the economy continues to downshift. There are now more vacant fulfillment centers as ecommerce growth softens. The shifting fortunes of the U.S. tech sector also have resulted in many large technology companies engaging in cost-cutting methods, including the announcements of large-scale layoffs and taking on fewer real estate–related obligations.

WHILE ALL OF THIS IS OMINOUS, A COMMON REJOINDER MIGHT BE THAT THE ECONOMY NONETHELESS REMAINS STRONG.

A wall of debt

As recently reported by Bloomberg, nearly $1.5 trillion of U.S. commercial real estate debt comes due for repayment before 2025's end.[28] The question is obvious: Who will lend to commercial real estate under current and emerging circumstances?

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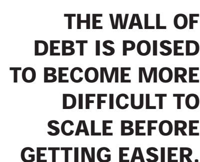
Analysts seem to agree that refinancing risks are front and center for owners of properties ranging from office buildings to shops to warehouses. Morgan Stanley analysts estimate that office and retail property valuations could decline by as much as 40 percent from peak to trough, which expands the risk of defaults.[29] None of this is good news for contractors, as the implication is that demand for construction services associated with these and other similarly situated segments is set to fall off a cliff.

It really is a confluence of several problematic factors. The small and regional banks that have heretofore been implicated by the deposit outflow situation are precisely the financial institutions that represent the largest source of credit to the industry.[30] The wall of debt is poised to become more difficult to scale before getting easier. The level of maturing debt will expand for the next four years, peaking at $550 billion in 2027, according to Morgan Stanley.[31] Banks own more than half of the agency commercial mortgage–backed securities — bonds supported by loans to property issued by U.S. government-sponsored entities like Fannie Mae. That expands bank exposure to commercial real estate, with many bankers seeking to trim that exposure.[32]



THE WALL OF DEBT IS POISED TO BECOME MORE DIFFICULT TO SCALE BEFORE GETTING EASIER.

There is good news: The overall sentiment regarding multifamily housing remains much more positive as rent prices rise. Still, once one excludes apartment blocks, the scale of the issues facing banks becomes starker. According to Bloomberg, as much as 70 percent of the other commercial real estate loans that mature over the next five years will be held by banks.[33] Knowing that financial conditions are tightening, commercial real estate owners are responding.

As indicated by Bloomberg Intelligence analyst Tolu Alamutu, "We are definitely seeing real estate companies do all they can to deliver — scaling back investment programs..."[34] The upshot is that development is going to slow substantially during the months ahead, with some contractors finding that much of their existing backlog will have dissipated by next year or the following year.

Looking ahead

Credit conditions are set to worsen during the months ahead as regulatory and other forms of scrutiny intensify at U.S. banks. This is likely to be especially impactful on commercial real estate, which is threatened by sharp losses in valuation and declining demand for newly constructed space. ■

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