Commercial Real Estate in a Low-Growth World: Exclusive Interview with Tom Flexner

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Paul Fiorilla: Welcome Tom. We at CRE Finance World are thrilled to hear your thoughts about the global economy and commercial real estate. You travel internationally and experience the economies and central banking policies in countries around the world — what is your view of major global economies and the generally accommodative monetary policies central bankers are employing?

Tom Flexner: We're in a world of 2 to 3 percent GDP growth globally – with many factors ranging from demographics to commodity prices to excessive leverage levels to regulatory drags to geopolitics to a pervading sense of uncertainty and ambiguity — all conspiring to tamp down economic activity. The demand side of the world is just not responding, at necessary levels, to the concerted efforts of many Central Banks to stimulate job growth and capital investment.

Policy tools like quantitative easing (QE) and low interest rates are just not translating into stimulating the real economy. Even the China engine of the past 20 years is trending at its lowest GDP growth rate since its economy modernized.

These accommodative monetary policies have served to elevate financial asset values — balance sheet inflation, if you will, but have largely failed to create fundamental demand in the world's real economies where new jobs are produced and wages are determined.

And I'm not sure the central banks have much left in their tool kits at this point. Who knows the effect of sustained negative interest rates? Fortunately the U.S. was the first to address these issues during the financial crisis and is, on a relative basis, ahead of its counterparts in Europe and elsewhere. But even here we continue to experience subpar growth. 2% annual long term is not enough to lift all boats.

Paul Fiorilla: So what is the way out of this weak economic growth cycle that we've been in for some time?

Tom Flexner: Paul, that is the big question confronting most world leaders. And there are no obvious answers which are pain-free or even politically feasible. It just feels to me that we're in the midst of adjusting to some sort of overarching longer-term secular change marked by continued tepid growth, low interest rates, low oil prices, forced deleveraging by foreign sovereigns and so on. If so the adjustment may be to bring down return expectations to reflect the lower productivity of capital in this new world. Right?

So we have a whole bunch of things working against us, and frankly it's hard to identify a single reason to be terribly optimistic about the world's growth trajectory. Other than somehow it always seems to work out at the end. But, you know, up until the financial crisis we had a global economy supported by huge credit expansion — consumers, governments, companies. It lifted growth beyond what would have happened had credit not expanded at such a vigorous pace. Today, we still have a significant amount of leverage, particularly at the sovereign level, but also in the banking systems in China, Japan and Europe; plus regulatory initiatives which will serve to constrain credit creation going forward. And this kind of countervailing pressure — deleveraging — will possibly hinder growth, as credit creation will not be the tailwind it once was.

And demographically, here and through most of the developed world, we have headwinds in terms of aging populations, the percentage of people that are going to be productively engaged in the workplace versus the growing number that have to be supported by those in the workplace.

And so I think the twin impacts of globalization and technology are showing they also have downsides. Technological advances used to amplify human muscle or human capital if you will. That was a fundamental precept during the first two industrial revolutions — you created machines that increased human productivity in a way that allowed everyone to participate in the benefits of enormously increased output. People were able to become much more productive and people harvested a portion of those gains for themselves.

But today, it seems that technology is as often substituting for or replacing human capital as it is amplifying human capital. Think robotics and automation. And that puts a lot of downward pressure on job growth and wage growth in the traditional sectors. And with globalization we have an entire world competing against each other for a finite number of jobs. That's why there's so much noise about unfair trade, currency manipulation and so on. The leaders of every country, if they want to stay in power, have to win on the jobs front, and globalization puts everyone in competition with everyone else.

What else? We have a lot of uncertainty and ambiguity, whether it's the fractious noise around the presidential election, whether its migrant pressure in Europe, a nuclearized North Korea, terrorist attacks, climate change, a non-isolated Iran, or low commodity prices which create difficulties for the emerging market countries having to deal with dollar-denominated external debt.

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I'm beginning to get depressed listening to myself. So all of these things combine, you know, to suggest it will be a long hard climb out of the low-growth world we're in right now. And, of course, on top of all that and near and dear to CREFC and others is the impact of regulatory changes affecting bank capital, bank liquidity, trading rules, risk appetite, all of which are interrelated and which potentially serve to restrain credit and liquidity and which, in my opinion, could make it harder for the financial system to help avert or soften the impact of a future recession or liquidity disruption.

And of course all this affects decision-making in the C-Suite. How do you know where you want to invest and build and develop and produce when you don't know what the tax code is going to look like, you don't fully understand the evolving regulatory environment, you don't know whether free trade agreements are going to be torn up, you don't know which currencies will be manipulated — all of this works, again, to create more caution and hesitation on the part of business.

Paul Fiorilla: We'll get into some of those things a little bit later. However I wanted to follow up because you seem to feel that the global economy is exhausted and things are going to get worse. Do you think that the Fed has been pursuing the wrong strategy — what should they have been doing? And what could they do?

Tom Flexner: I don't think the Fed has been pursuing the wrong strategy, I think what I'm saying is the Fed pursued the only strategy it could. And it's easy for people to second guess the Fed on the heels of their multiple rounds of QE and so forth, but the fact of the matter is the Fed was staring at a true black swan financial crisis almost 8 years ago. Think back to the fall of '08 and what was happening. So today, I think even though we're not feeling all that great about our economy and our country — and the election primaries are raising all the fundamental issues we should be concerned about — we're in better shape than most. My personal opinion is the Fed did what it should have done and could have done, but by itself it was not enough.

I think gridlock in Washington, in terms of budget reforms and stimulus spending etc., meant there was no real fiscal policy corollary that would have reinforced the Fed's actions. Instead, there was just partisan divisiveness over spending bills, tax reform, entitlement reform and so forth over the past 6 years. So you can't put the entire weight of an economic recovery on a Central Bank because they only have one tool and that's monetary policy. And it takes more than one tool.

Paul Fiorilla: Do you get the sense that they're going to continue to be dovish about raising rates going forward, which seems to be the consensus right now?

Tom Flexner: You know Paul, I hope they continue to be dovish because I don't think we've seen enough domestic progress on growth, wages or inflation, and the world economy is pretty fragile and we are not decoupled from that. What is the primary fear of ballooning up the money supply? The primary fear is that inflation expectations and then inflation itself will get out of control, right? And the dollar will crash, correct? Well we haven't seen either meaningful inflation or a weakened dollar. We're finally seeing a little wage growth which is very good, but the fearfulness, you know, around a Fed balance sheet which has grown by $3 trillion over the past several years is completely misplaced. In fact, the flip side of the Fed's balance sheet expansion has been a dramatic increase in excess reserves deposited at the Fed by member banks. And you better get used to it. A $4 trillion Fed balance sheet is the new normal in my opinion. Why? Because the new bank regulatory liquidity requirements are most efficiently met through holding excess reserves, which I believe will stay at quasi-permanently elevated levels which by definition requires a much larger Fed balance sheet. And by the way, will also mean that the targeting of the Fed funds rate will be much less relevant in the future.

Now you can argue that what it has done has created balance sheet inflation in the sense that financial asset classes of all types — both risk off and risk on — have risen in value and probably become a bit disconnected with underlying fundamentals. So maybe you have a correction. But I think that a small price to pay for pursuing a policy that is trying to avoid the U.S. slipping back into a recession and/or seeing a possible re-spiking of unemployment.

So, in my mind it's almost an asymmetric options value approach the Fed is taking. They're basically saying, "We're willing to run the risk of overshooting our inflation target and then correcting, in order to avoid the risk of suddenly pushing our country back into recession, and then having to correct for that."

And it's complicated because everything is interconnected across the globe. The Fed, you know, is not just dealing with a closed economy. It is dealing with trade partners, cross-border financial flows and relative currency movements. And if the Fed starts tightening while everyone else is in easing mode, as we've seen already, even the expectation of tightening caused the dollar to materially strengthen over the past 18 months. Now, it has given some of it back as the Fed is viewed as being more dovish again. But all of these things are interconnected and have to be considered.

Paul Fiorilla: I agree. One of the interesting things about real estate is that the technical or capital market side led it out of the recession ahead of the fundamentals, but now we seem to be seeing that the capital markets are slowing down while fundamentals are still not bad.

Tom Flexner: Yes, I personally think, looking at the fundamentals, we've got more runway in front of us. Sixth inning maybe? Extra innings? It doesn't feel so bad looking at the space markets, rents, vacancies etc. That's been because with few exceptions — like New York hotels and ultra-luxury condos — we haven't had significant new development. And over the course of my career, the majority of real estate cycles ended when there was a supply shock, not a demand shock.

2008, on the other hand, was a demand shock that affected everything everywhere, not just real estate. Although real estate's beta was front and center for a while then. But historically, most of the imbalances in real estate were driven by supply shocks — ample easy capital, or tax shelter demand, or improvident demand forecasting — leading to excess development.

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I think today, due in large part to regulatory constraints and an embedded lower risk tolerance, we are not going to see the profligate sort of lending we saw leading up to the crisis. And while underwriting standards did loosen a bit over the past several years, lenders are pretty disciplined compared to pre-'07. And the B-piece buyers are lot smarter these days, so the market will to some degree regulate itself. And that will help put a cap on the supply side.

Paul Fiorilla: There's a lot of discussion at real estate events about whether we've gotten overheated. Property sales have gotten almost back to 2007 levels, cap rates are at the all-time lows and prices are at all-time highs. Total debt outstanding is once again setting records every quarter, and a lot of people say, well, 'it's been seven years since the last recession, so we're about due for another one.' But on the other hand, cap rate premiums are still above historical averages and well below where they were in 2007 and leverage as you just said is not nearly as aggressive across the board. Plus, the economy is continuing to chug along and create jobs, workforce participation and wages are going up, stuff like that. So where do you think that will lead?

Tom Flexner: It's a worthy debate, Paul. The backdrop on fundamentals is OK, but nothing to write home about. Values have not been supported by rosy forecasts this time around, but rather by historically low interest rates and reasonably tight risk premia. But I think, you know, there is a general sense that for the first time in seven years we're beginning to see a plateauing of commercial real estate prices.

We've seen certain credible major investors say that they think the market has leveled off, and we've seen some Wall Street research saying that we've actually suffered a slight decline since the beginning of 2016.

And it does feel that way. If you're an intermediary brokering real estate deals, a year ago you might have gotten 20 bids, five final round bidders and a fierce bidding war by the final two. Today you might get six bids, two make it to the final round, and the winner then tries to re-trade. Different dynamic and one that points to a less exuberant market.

And I would add that all of the regulations that you're familiar with — Dodd Frank in terms of risk retention and market-making liquidity; Basel III rules around total loss absorbing capital; Tier 1 common equity, risk weightings, liquidity requirements; the Formal Review of the Trading Book risk capital treatments which are punitive for securitization — these will serve to further constrain the extension of capital to not just real estate but other asset classes. They're certainly not going to act to increase credit overall.

My view is the regulatory envelope will impose a level of discipline on the market that many players will not like. And many of the fine details of the regulations I don't necessarily agree with, and they may in fact increase certain types of risk in an unintended way. But overall, the financial system is far stronger with greater regulatory oversight than it's ever been historically, and I think this is a good thing long term.

But, having said all that, on a global basis including the US, I think real estate will outperform other asset classes over time. In this world we've been talking about — low rates, low growth, high volatility — real estate offers yield, stability and predictability, all characteristics which are attractive in such an environment. The world is starving for yield. So call real estate the least worst investment alternative, if you will.

Paul Fiorilla: What's your outlook on CMBS volume? A lot of the analysts have downgraded the volume expectations since the beginning of the year from $100 billion or more to $60 billion to $70 billion.

Tom Flexner: I guess don't have a good view on that. Volume forecasts have certainly degraded as you point out, although the pace of issuance has begun to pick up. And we have a wall of maturities this year and next, approaching $200 billion, of which maybe only 15% have been addressed so far. So you have at least a picture of the demand side. But forecasting is tough because world volatility levels remain very elevated — back and forth risk on, lurching from new datapoint to new datapoint — which is why I think it's hard to have a prediction forecast, especially in an election year like this one.

Also, remember CMBS issuance faded toward the end of 2015, we thought the year would end at $110-115 billion but it ended just shy of $100 billion. And then we had material spread widening through January in and February, hedging strategies failed, and it was clear that CMBS was not insulated from the broader credit markets. You had record corporate bond issuance and near record high yield issuance 2015. And then we saw, starting in mid-summer last year the massive knock-on effects of China's currency devaluation and stock market collapse, and continued pressure on oil prices — we saw credit spreads gap out across both the high yield and investment corporate bond markets. And it wasn't just limited to energy companies, whose P&L's were getting crushed because of oil prices.

No. It was a broad sell-off. Liquidity was drying up. The High-Yield index gapped out 200 to 300 basis points. And CMBS was not immune because your typical portfolio manager is going to say: "Where am I going to get value on a risk-adjusted basis?" And he's looking at CMBS, he's looking at high yield, and he's looking at investment grade corporate. And the latter two just got a lot cheaper, making CMBS less interesting unless the price drops. That's why I think it's hard to predict. And it's the supply side that's less predictable.

I'd love to see a $100 billion CMBS market this year, to address the upcoming maturities and new financings. At this point I don't think we'll get much help from the life companies because they started the year with $60 billion allocated and I think they've been using it up pretty fast.

And banks aren't certainly being prodded by the Fed and their other regulators to go all in on commercial real estate. And we have risk retention to look forward to also.

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Paul Fiorilla: Right, I think that probably the big effect in terms of the lending markets right now is the cost is going to go up a little bit for borrowers. I guess you could debate whether that's such a terrible thing, given how low rates have been, but it seems to me that's probably going to be the biggest impact in the second half.

Tom Flexner: I agree with that.

Paul Fiorilla: Let's talk about liquidity. One of the causes of the recent spread widening is a reduction in liquidity as market makers leave the secondary markets due to regulatory restrictions and Volcker rules. Is there any way you think liquidity can be brought back into the market?

Tom Flexner: You know, "liquidity" is an interesting word because on the one hand you can count up all the hedge funds and credit funds that have dry powder, all the private equity firms that have dry powder, all the pension funds and endowments that have increased their real estate allocations but not yet fulfilled them, the sovereign wealth funds. There is, I think, on one level, a lot of liquidity, right?

And real estate to some degree is competing for that liquidity along with other asset classes. That is one form of liquidity. Let's call it investor liquidity. Then there is, say, the dealer or intermediary liquidity which embraces the market making activities you just referred to – the lubricant which historically functioned to narrow bid/ask spreads, to allow buyers and sellers to execute trades quickly and efficiently, and to reduce overall market volatility.

This market-making liquidity has in many cases been materially reduced because of the Volcker Rules, because the definition of what is treated as a customer-driven trade versus a proprietary trade is not clearly and crisply distinguished. And Basel III makes it more expensive to maintain market-making functions because you've got to allocate more regulatory capital to supporting those functions than you did before Basel III.

And you have the FRTB right? The formal review of the trading book which intends to impose extra capital costs on assets that are in securitizable form or will be securitized.

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And then you have the liquidity requirements that compel banks to hold a significantly higher percentage of their total footings in the form of liquid instruments like Treasury bills and other cash equivalents or readily marketable securities.

Paul, these all serve to constrain not just overall bank lending but also market-making liquidity. Now maybe, I think, we will see more shadow banks step up, and maybe the whole way origination and securitization occurs will change. Risk retention especially may change the types of players and their roles in this business.

Paul Fiorilla: If the industry is not successful in changing regulations that you just described, does that mean that there will be sort of a wholesale change going forward in terms of how banks approach the market-making functions and everyone is just going to have to adjust? Or do you think that eventually people will get comfortable with the regulations and basically get back to doing what they were doing before?

Tom Flexner: Well I don't think you can just go back to the good old days because these rules will literally change the cost of lending when fully implemented. It's both a pricing and availability of credit issue. And while borrowers will inevitably bear most, if not all, of the surcharges, that only works up to a point — proceeds are affected, positive leverage at some point possibly disappears. Lots of unknown unknowns.

Paul Fiorilla: Is that going to change the way CMBS is originated or securitized?

Tom Flexner: Well, when you look at the FRTB rules, they apply to all securitizations, not just CMBS, but RMBS, student loans, car loans, etc. And I think that the regulators, in their sincere efforts to de-risk the system — and they've done a lot to accomplish that goal already — could find that in some unintentional ways the result is to elevate certain systemic risks. Not at the individual bank level but at the broad market-functioning level.

I think historically, when there was an event that caused people to run for the exit, the intermediaries have always been the ones to step in and try to restore some order out of the chaos. Primarily through their market making. But these regulations make that less likely to happen in the future. So in some ways I think the de-risking of the financial markets could actually increase the risk to the underlying economy, by causing deeper adjustments that would have historically been somewhat muted by the market-making.

Paul Fiorilla: I guess it's a tradeoff — I know there are a lot of negative impacts in our industry, but regulation has reduced leverage in the banking system, which is one of the things that was intended.

Tom Flexner: Yes. And I think the number one benefit of this regulatory scrutiny and regulatory change over the last seven years is to de-lever the banks and encourage them to have more liquidity. And it's not just a function of deleveraging but it's also changing the composition of their leverage, terming it out, less reliance on repo, better match funding, so that we don't have the same short-fund contagion risk that dramatically broadened and magnified the impact of the financial crisis.

Now do I think in some cases they may have gone too far? Personally, yes. But I think on balance what they've done directionally has strengthened the financial system and I applaud them for that. Again, the devil is in the details, and we may even find over time that as certain unintended consequences become apparent, the regulators will proactively respond to fix them.

These regulations are not cast in stone for the rest of eternity. I think if it is determined that they are doing more harm than good at the margin, they'll be tweaked. But we may have to go through some pain to get to the tweak.

Paul Fiorilla: Right now I think the biggest regulatory initiative in the CMBS industry is risk retention and there's a lot to talk about how the required capital will be raised from whom at what price. How do you think the industry is going to handle risk retention? Has your firm developed a strategy?

Tom Flexner: Clearly everyone is looking at a number of strategies. And I do think we'll see a number of the sub-scale originators exit the business for multiple reasons. But the committed players are thinking about how best to execute in this new environment. For instance maybe someone who originates today will rent somebody else's balance sheet, use someone else's shelf, act solely as a distribution agent for the securities, or create a minority-controlled subsidiary to meet the risk retention requirement. Who knows?

But at some point, at the margin, the pricing will adjust. If the B-piece buyer retains the risk, the pricing will adjust to reflect the fact that the 5% market value requirement will include BBB's which don't currently meet the return requirements of the B-piece buyer. If the bank retains the risk, as a vertical strip for example, the price will adjust to reflect the bank's cost of regulatory capital supporting that risk retention. And by price, I mean interest coupon to the end borrower.

And of course there are other CMBS issues to be considered. B-piece transferability, AB II, qualified mortgage definitions etc.

Paul Fiorilla: So do you think this will impact issuance volume going forward or the willingness to lend?

Tom Flexner: I think at some point it has to. I mean, these regulations are not neutral. And they're not supportive of increased issuance.

Paul Fiorilla: Do you think there is going to be a problem finding B-piece buyers? That's one of the major concerns, to have a normal B-piece market the way it functioned in the past.

Tom Flexner: No I don't. We have I think eight active B-piece buyers out there today – with most of the volume being done by the top three or four. But the reality is I do think pricing will ultimately self-adjust as I mentioned before.

Paul Fiorilla: OK, to switch topics again, foreign investment in the U.S. grew from $47 billion in 2014 to $90 billion in 2015. Much of the increase is attributable to the commodities-based economies in the Middle East and Asia. Can we expect this trend to continue with commodity prices weakening? Will FIRPTA reform be a difference maker?

Tom Flexner: That is a question on everyone's minds. A healthy portion of the $90 billion was sovereign, but certainly not the majority. And while the oil-dependent sovereigns are under pressure right now, we haven't seen any pullback, at least not yet. In fact, Norges, the largest one – although not technically a sovereign wealth fund – just increased its allocation to real estate. The question is if we continue to have sustainable lower oil and commodity prices, consistent with the longer-term lower GDP growth possibly we discussed earlier, will that ultimately put pressure on the sovereigns to reduce their real estate appetite? And my definitive and highly confident answer is: maybe.

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And that's the best answer I can give you because, you have to ask yourself, what would the sovereigns actually sell first if their sponsoring countries needed to monetize assets to fund deficits in their own national budgets?

And if it gets to that, everything is up for grabs – stocks, bonds, real estate, private equity, etc. My suspicion is the first things to go are liquid securities and hedge fund redemptions for example. But honestly, I just don't think it will get down to that in a meaningful way.

With respect to your FIRPTA question, the recent changes were helpful but I don't think they are a huge needle mover. First, on the private investment side they only benefit foreign pension funds, not necessarily your average SWF. And the definition of who is and who isn't a foreign pension plan is still up for debate. On the public side FIRPTA increases foreign limits on REIT ownership from 5% to 10%. Again, helpful at the margin – maybe $20 billion in potential flows over time – but I don't think a true needle mover will happen until there's comprehensive tax reform which would include a much broader revamping of FIRPTA or even its complete elimination. But I'm not holding my breath.

Paul Fiorilla: Alternative investors expect to raise $67 billion this year compared to $52 billion last year. The regulation of the banks we talked about is providing debt funds with the opportunity and means to come into the market. Do you see a big increase in specialty lenders and debt funds increasing their market share?

Tom Flexner: I'd like to see more alternative non-bank debt funds raise capital and make it available to our industry. As long as they're prudently structured and competently managed.

I think there are components of the credit markets today where banks don't really want to play or have an inefficient cost of capital. Mezz debt for example. We can't, it's too expensive to hold. Or preferred equity, with a dollar for dollar risk capital allocation.

So I think these alternative credit funds are actually going to complement the large bank lending programs because the banks would rather focus on the senior tranches of debt, those that are mortgage secured and investment grade, whether for securitization or balance sheet hold.

But in many cases a typical borrower's need for leverage goes through the investment grade inflection point – in either acquisition financing or refinancing. So to the extent these credit funds are out there and can take down the piece the banks can't afford to hold, it provides the banks with greater assurance of circling the whole facility, knowing that the bank's got a home upfront for the lower-rated tranches that the bank doesn't want to keep. So yes, I like the idea they're there.

Paul Fiorilla: We are out of time, but on behalf of CREFC I'd like to thank you, Tom, for sitting down with us and sharing your thoughts on the industry. I learned a lot, and I'm sure our readers will as well. ■