

### Loans for office properties – a mild breeze or a true storm?

#### **Current interest rate environment & monetary policies**

Since July 2023, the federal funds rate has been at its peak at 5.25 to 5.5%, and at its March 2024 meeting the US Federal Reserve (Fed) decided to keep the level unchanged for the time being. The main reasons were in particular the strong labour market with a low unemployment rate and core inflation, which at 3.8% in February 2024 was still well above the long-term target of 2.0% and, as expected, is only falling slowly, which is also reflected in the still elevated inflation expectations. According to the Fed there will be two to three interest rate cuts of 0.25% each this year (if the economic development corresponds to the Fed forecasts), with the first interest rate hike likely in mid-June or at the end of July 2024. The inversion of the yield curve, which has persisted since July 2022, is anticipated to remain in place until 2025, and so far the Fed seems to be succeeding surprisingly well in walking the tightrope of cooling the economy without forcing it into a recession, especially because consumption is very robust and the real economic growth expected for 2024 recently was revised upwards (from 1.4% in December 2023 to 2.1% in March 2024).

In contrast, Eurozone gross domestic product expectations for 2024 were recently cut to 0.6%. The situation therefore remains challenging for the European Central Bank (ECB), because at the same time core inflation of 3.1% is still well above the medium-term inflation target of 2.0%, mainly due to strong wage growth while demand is weakening. The depressed economic growth therefore indicates the need for a reduction in the key interest rate, while inflation still speaks against it. We expect that the ECB will give greater weight to economic developments and announce the first interest rate cut in June 2024 (from 4.5% to 4.25%) in order to reverse the last interest rate increase in September 2023. However, it is

questionable whether this will have a significant impact on the economy as the structural problems in the Eurozone cannot be solved with monetary policy alone, and a uniform interest rate for the entire Eurozone does not take into account the different developments in the individual countries. The challenges will therefore continue in the years to come.

In a rather un-Swiss manner, the Swiss National Bank (SNB) rushed forward on 21 March 2024 and reduced interest rates by 0.25% to 1.5%. This step surprised the market and most economists but is consistently in line with the SNB's primary goal to ensure price stability because at 1.1% core inflation was within the price stability range (according to the SNB's definition) in February 2024. The expected increase in apartment rents (due to the recent increase in the reference interest rate) and higher travel costs were partially offset by lower prices for imported goods. The real appreciation of the Swiss franc in recent months reduced inflationary pressure and made it possible to cut interest rates, as expected inflation will remain well below 2.0% in the coming months, according to the SNB's forecast. The fact that Switzerland was able to weather through the last three years of high inflation is due, among other factors, to the large share of administered prices, but primarily to the forward-looking monetary policy and the targeted interventions in the foreign exchange market under the leadership of Thomas Jordan, who steps down as president of the SNB at the end of September 2024 after 12 years in charge. He will likely leave potential further interest rate cuts to his successor if economic developments do not require rapid interventions beforehand.

#### **Loans for office properties**

It is challenging to estimate how inflation and consequently interest rates would have developed if neither the Covid-19 pandemic (with the resulting lockdowns and the extensive government

support programs that continue to have an impact today) nor the Russian invasion of Ukraine (with the severe supply chain disruptions). However, it is clear that the Covid-19 pandemic in particular has permanently changed the way we work. Working from home has accelerated significantly in recent years, especially in the US. According to a recent survey conducted by WFH Research, at the beginning of 2024, approximately 13% of employees in the US were engaged in full-time remote work, while 28.5% adopted a hybrid work model. 28% of working days were carried out from home, compared to 7% before the Covid-19 pandemic. Since most employees value the better work-life balance (especially the younger generation), it is expected that working from home will become more widespread, especially if the labour market remains tight, even if the studies on productivity for remote work are contradictory.

The massive increase in working from home, preferably on Mondays and Fridays, has a significant impact on office occupancy in the US, especially in cities on the East and West Coasts. Compared to March 2020, shortly before the rapid spread of the Covid-19 pandemic, Kastle Systems only reports around 50% of office building access activity, and this number has hardly changed in the last 18 months. It can be assumed that the American vacancy rate for office properties of almost 20% at the end of 2023 (according to Moody's) will continue to rise in the next few years as the mostly long-term rental contracts expire and companies reduce or even give up office space entirely. The mix of lower demand and higher interest rates for refinancing is having a major negative impact on the valuations of office properties. CRED IQ reported valuation reductions of around 50% in distressed commercial mortgage-backed securities (CMBS) for office properties in 2023, and since mid-2022 the number of distressed CMBS increased from 3% to over 10% in January 2024. According to a study by the National Bureau of Economic Research, which paints a bleak picture, 45% of CMBS for office properties had a loan-to-value ratio of over 100% as of the end of December 2023, i.e. the debt capital exceeded the value of the properties.

CMBS represent just one indicator for the level of stress in commercial real estate loans, as they only cover around 12% of the market (including multifamily housing), which had a volume of USD 5.9 trillion at the end of 2023. Over half of the amount was held by banks and thrifts, and according to Trepp, around half of it, almost USD 1.5 trillion, will come due between 2024 and 2028. It is very likely that significantly higher interest rates will be required for the refinancing than for the original loans, and it can be assumed that the loan-to-value ratio will be applied to updated valuations and in some cases even reduced. This will pose major challenges for many borrowers, and not all property owners will be able to raise additional equity capital if necessary or to find a buyer for the property at short notice. Therefore, a certain level of loan defaults seems inevitable.

The large refinancing requirement of around USD 300 billion per year could particularly put pressure on smaller banks with less than 100 billion in total assets because they tend to have a higher concentration of loans in commercial real estate. According to Fitch Ratings, in June 2023 commercial real estate loans exceeded equity by more than five times at 528 banks (i.e. over 10% of American banks by number), primarily regional and municipal banks (commercial real estate loans exceeded equity by more than three times at further 1,358 banks), so they are vulnerable to possible loan defaults or rating downgrades, which in turn would lead to higher refinancing costs for the banks. Experience shows that losses on commercial real estate loans only take effect over several years. During the global financial crisis (2007-08), losses peaked only two years after the peak of defaults. Moody's expects a trough in office properties in the first quarter of 2025, with valuations around 25% below the peak in the third quarter of 2022, while Morgan Stanley expects a decline of as much as 30% from peak to trough. The dark clouds on the horizon only give an idea of the extent of the impending storm.

At the end of September 2023, according to the Federal Deposit Insurance Corporation, American banks had unrealized losses on securities of USD

684 billion compared to total equity of 2,243 billion (i.e. around 30% of equity). Since the unrealized losses are not only limited to securities (which have increasingly been reclassified from “available for sale” to “hold to maturity” in order not to have to report losses), but also affect the loan portfolios of the banks, there are even significantly higher unrealized losses to be expected. A New York University estimate totalled USD 1.7 trillion in unrealized losses at the end of 2022, meaning the interest rate hikes would have wiped out around three-quarters of the equity in the entire American banking system. As long as the losses do not have to be realized, there is hope that they will not occur. However, losses on commercial real estate loans that materialise could turn this hope into wishful thinking in the months ahead.

In Europe, the situation with office properties looks more positive than in the US as office occupancy is significantly higher and has continued to rise slightly in the last few quarters, and vacancies are also stabilizing at around 8%. Together with the lower discount rates, according to Savills, this only resulted in an average overvaluation of 3% in Europe at the end of 2023, although there are strong differences between the cities (e.g. Amsterdam with 17% and Munich with 16% overvaluation, while Copenhagen with 21% and Dublin was undervalued at 19%). The limited need for negative revaluations combined with a typically lower use of leverage than in the US lead to a relatively stable market situation. Nevertheless, the increased interest rates and higher costs for building materials led to a number of insolvency cases in real estate projects (such as the Signa Group), the effects of which can be easily absorbed by the financing banks so far.

A source of concern, however, is the exposure of various European banks to US commercial real estate loans, especially German banks, which are traditionally more active in commercial real estate lending than banks in other countries. With EUR 17 billion (of which approx. 40% in office properties), Deutsche Bank is most exposed to the US commercial real estate sector, and Aareal Bank (EUR 9 billion), Landesbank Baden-Württemberg

(EUR 6 billion) and Deutsche Pfandbriefbank (EUR 5 billion) have larger loan amounts outstanding. The adequacy of the approximately EUR 1 billion in provisions will become clearer in the upcoming quarters. Like Moody’s Ratings, which lowered the outlook for the German banking sector from stable to negative at the beginning of March 2024 (as well as for France and United Kingdom), we are rather sceptical. In addition to the German banks, the Spanish Banco Santander also reported a significant US exposure with a loan volume of USD 18 billion (as of mid-2023), particularly in multifamily housing and construction projects.

The interest rate increases have also negatively affected valuations in the Swiss market for office properties. According to JLL, prime yields have risen by 60 to 80 basis points in the last two years, resulting in double-digit percentage revaluation losses. At least on paper, because the transaction volume in the last two years was significantly lower than in previous years. In Switzerland, too, properties in top locations in the city centres are particularly sought after, while decentralized locations such as Zurich Airport are struggling with high vacancies. Across Switzerland, the vacancy rate remains low at around 5%.

In Switzerland there are two additional local factors that play an important role. On the one hand, the takeover of CS by UBS will free up various office spaces in prominent locations in city centres (particularly in Zurich), and, according to several sources, UBS appears to have decided to reduce its Swiss commercial real estate exposure. On the other hand, Bank Julius Baer and several cantonal banks have granted loans for Signa Group properties that could lead to defaults or at least time-consuming recovery processes. We assume that overall, the appetite of Swiss banks for commercial real estate loans will remain limited. However, since office properties in Switzerland are typically only 30 to 50% financed with debt, we do not expect that the valuation corrections will have a substantial impact on bank loans, except in a few special cases. It can also be assumed that Swiss banks have no significant exposure to the US commercial real estate market.

There is unquestionably a risk of a systemic event like a financial crisis, once again originating from the US, particularly concerning loans for office properties. A small spark could cause the powder keg to explode, but regulators, central banks and governments have learned from the global financial crisis that swift interventions can prevent the spread of contagion, according to the motto “when in doubt, bail out”. This concept has also recently proven itself at the Silicon Valley Bank

and will likely be applied again in the next imminent storm, even if questionable measures such as the generous expansion of deposit protection, forced takeovers and/or extensive government guarantees have to be applied. We are confident that commercial real estate lending will trigger a few global gusts of wind but will not develop into a true storm. Ultimately, everything depends on trust in the perceived stability of the banks, not on their actual stability.

### **About Fincerta**

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