PCCP MARKET COMMENTARY

Fourth Quarter 2020

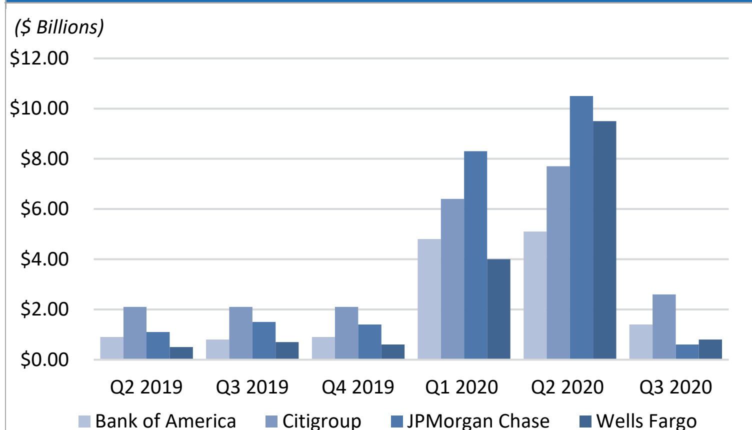
Intersection of Reporting Standards and Commercial Real Estate

The banking system is integral to the health of the commercial real estate community, as banks hold a significant percentage of all mortgage debt – 51% as of 4Q19[1]. Early in the pandemic the Federal Reserve infused much needed liquidity into the financial system. This early action helped to avoid a capital freeze in the banking system, reduced systemic distress, and served as a backstop for auto loans, commercial and industrial lending, and commercial real estate. As a result, despite record unemployment levels seen at the beginning of the pandemic, we have seen communities start to return to work and unemployment rates fall, slowly moving the economy toward a sense of normalcy. Another significant impact to the banking system this year has been the adoption of a new financial reporting standard that modified how banks are required to account for potential loan losses. This new standard, referred to as CECL (Current Expected Credit Loss), along with the economic effects of the pandemic, may result in a 2020 cumulative write-down of nearly $320 billion of all the major US banks[2], recording the largest loan loss reserves in history. The enactment of this new accounting standard, born out of the Global Financial Crisis (the "GFC") over ten years ago, may not be widely known, but is beginning to produce significant impacts on the banking system, with a large ripple effect on the commercial real estate markets.

In order to provide an accurate picture of a bank's financial condition, reporting standards require that banks provide for a loan loss reserve, or a provisional loss for bad debt that may occur in the future. Prior to, and during the GFC, banks did not adequately reserve for bad loans on their balance sheets, and too little was reserved too late. Inadequate banking reserves and a bottoming out economy exacerbated the liquidity freeze in 2009-2010. In the wake of the downturn, Congress and federal regulators began to enact new legislative protections to provide for additional oversight of the lending system, and to prevent a future freeze on liquidity. One of these new standards, enacted by the Financial Accounting Standards Board (FASB) in 2016 and implemented for large public institutions at the beginning of this year, was Accounting Standards Update (ASU) 2016-13, Financial Instruments—Credit Losses (Topic 326), or as it is commonly known, CECL.

Before CECL was enacted, banks were required to reserve for any probable and reasonably estimable loss. CECL requires companies to forecast their expected losses over the life of each loan held on the balance sheet. The new standard forces banks to prescribe a forward-looking model when preparing loan reserves, instead of a historical model. As expected, particularly given the backdrop of the pandemic, loan loss reserves increased substantially in the first two quarters of 2020.

Loss Provisions for the Four Major Banks



Source: Trepp, Company Filings

During the earning season for the second quarter of 2020, the largest 34 banks in the United States, all of which are subject to the Federal Reserve's annual stress testing, recorded nearly the largest reserves in history trailing the GFC[2] due to both the economic shutdown and the implementation of CECL. Typically, loan reserves are not a material issue, averaging less than 1% to cover potential credit losses[3], and remaining relatively consistent at that level. However, in the last year, big banks' loan reserves

[1] Federal Reserve Mortgage Debt Outstanding, December 2019. Data compiled by CoStar Advisory Services

[2] "US Loan Loss Reserves approach Great Financial Crisis Levels" S&P Global Market Intelligence, September 2020

[3] "Coronavirus Credit Crisis" Accenture, July 2020

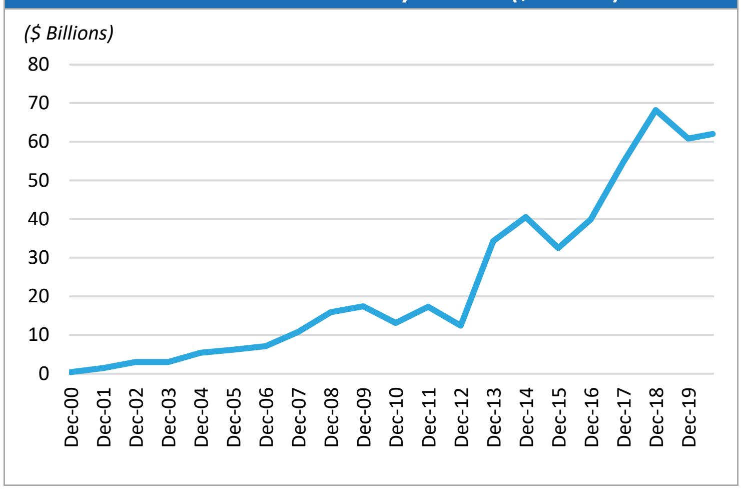
jumped to 2.4%[3], meaningfully decreasing their lending liquidity. Third quarter results, published in early October, show reserve additions more in line with pre-COVID numbers.

Our economy has been fueled through the current business cycle by historically cheap credit that has been widely available in the markets. The significant increase in loan reserves caused by CECL implementation initially forced banks to slow down their lending activity. In addition, the CECL requires banks to record losses at origination, providing a disincentive to banks to provide loans to borrowers with riskier profiles as reserves begin to grow. Finally, the CECL does not define standards for the assumptions which dictate the expected losses, requiring only that they be "reasonable and supportable," a definition open to interpretation. These factors could result in only the best borrowers having access to credit, while non-traditional or riskier borrowers are denied, forcing non-traditional borrowers to look for new avenues to seek credit. Fortunately, current reserve levels are projected to be the height of provisional loss reserves, as most banks are currently reserving for worse than the base case scenario. As with all new regulations and accounting standards, as the banking industry refines their reporting, we expect further clarity to develop around CECL requirements.

As banks have limited their focus to the top tier borrowers, we have seen a more limited slowdown in financing sources available for assets with uncertain cash flows that remove them from consideration by the traditional bank lenders (although financial distress still exists in most of the hospitality and retail assets). Compared to the GFC, capital from non-bank lenders is nearly six times higher, with $62 billion of current dry powder (available capital) in the system. In PCCP's debt business, competition remains fierce, but lenders with less experience managing prior downturns are still reserving capital to manage the most troubled of their hospitality and retail positions. With low rates and ample liquidity in the market, CECL has had the most meaningful effects on the financing of those assets straddling the line between bank financing and non-bank financing options.

What does all of this mean? We have seen a slight uptick in bank lending in Q3 compared to Q2, corresponding with lower reserves posted by the banks for Q3. It feels like a spring thaw. We don't know when spring will actually arrive for the economy. There is still lots of stormy weather. In a scenario with limited activity from banks, it will be a lender's market. However, it will also be critical to keep our eye on credit, cash flow, and borrower and real estate quality. The real estate debt fund dry powder is competing vigorously for the few underwritable opportunities in the market. On balance, it feels like quality projects are being financed at rates and spreads accretive to all parties. Time will tell whether the reserves already posted by the banks are sufficient. We're making sure we have plenty of dry powder to make quality investments when the pendulum is fully in the lender's court.

Real Estate Debt Fund Dry Powder ($Billions)



Source: Preqin

Our thanks to PCCP's Herman Ahuja in drafting this quarterly newsletter.

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