Credit Benchmark®

Financials Credit Risk Could Grow if Real Estate Woes Infect Wall St

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The winners and losers in the virus crisis are becoming clearer. China reports a strong economic rebound while Western economies continue to struggle. Hotels and airlines fight for their survival while online fulfilment and delivery logistics firms cannot hire staff quickly enough. And real estate is seeing a "race for space" in residential markets, but serious viability issues in some commercial lines – Bloomberg report that Land Securities will sell a quarter of their total portfolio, mainly lightening up on retail and leisure.

And real estate is a critical link between Wall St and Main St, which have so far shown rather different responses to the crisis. Figure 1 shows that, in credit terms, global Financials have so far held up better than global Corporates.

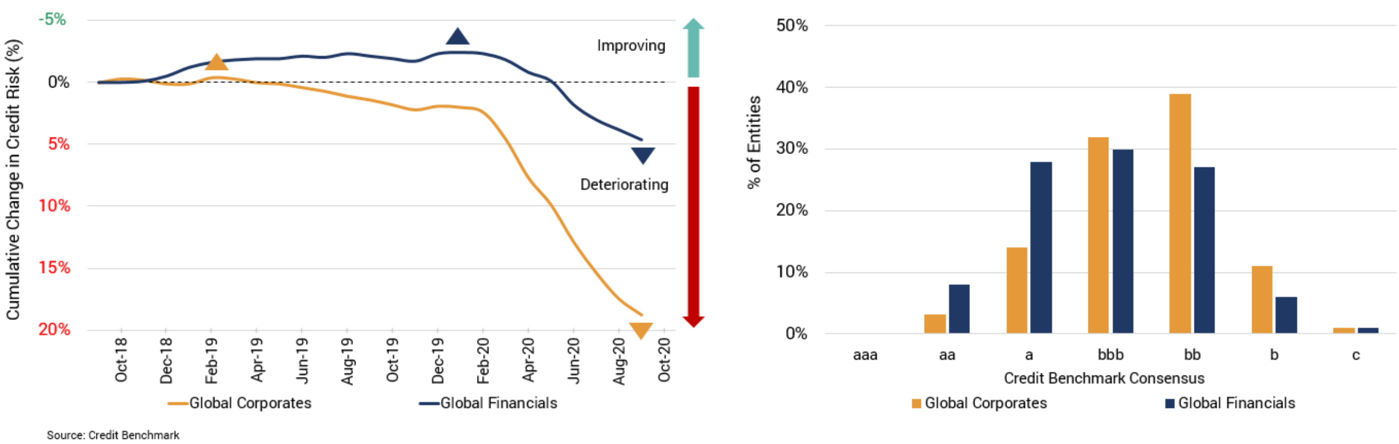
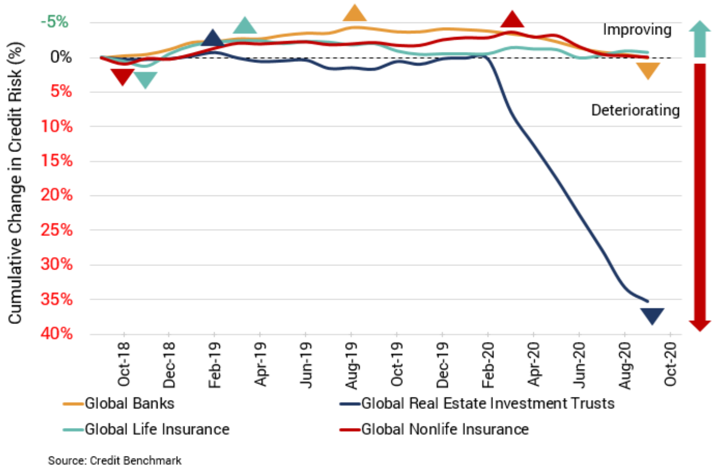


Figure 1: Global Corporates vs Global Financials - Credit Trend & Distribution

Corporate credit risk has increased by more than 15% since early 2020, while Financial credit risk is up by less than half of that. The **bb** credit category dominates the Corporate universe, whereas Financials are more evenly spread; with nearly 30% in the **a** category. The Corporate deterioration has been steep and relentless; Financials barely moved in the early stages of the crisis and the recent drop in credit quality has been modestly paced.

Does this reflect a genuine robustness in the face of the economic damage from the virus, or are financials waking up to some problems of their own?

Within Financials, there is another split. Figure 2 (following page) shows Banks, Insurance (Life and Non-Life) and Real Estate Investment Trusts (as a proxy for all Real Estate) as separate series.



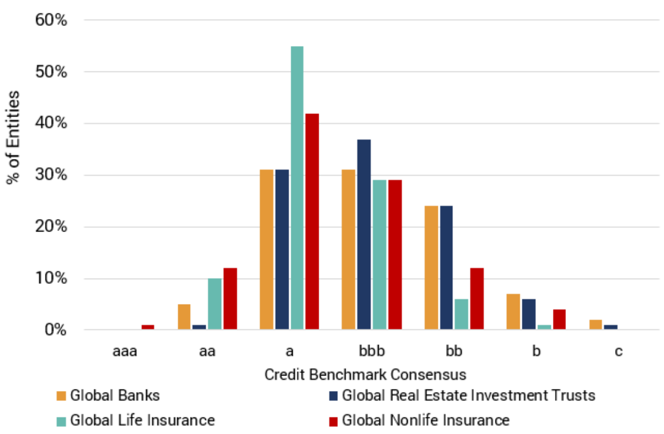


Figure 2: Global Banks vs Global Real Estate Investment Trusts vs Global Life Insurance vs Global Nonlife Insurance - Credit Trend & Distribution

The Global Financial credit risk changes shown in Figure 1 are entirely due to the 35% deterioration in REITs – Banks and Insurance companies show no change over the period. Banks and REITS still have very similar credit profiles (banks have more in **aa**, REITS in **bbb**) – but if these trends continue the two will start to show marked divergences.

However, what seems like a Real Estate-specific problem today tends to become everyone else's problem tomorrow. The Wall St Journal has just highlighted the potential impact of NYC commercial property woes on the broader financial sector.

The Journal reports that prices for loans collateralized by hotels have been particularly hard hit. The Credit Benchmark aggregate for US Hotel risk shows a staggering 230% increase since February – the equivalent of nearly 6 notches in the 21-category scale. Some iconic properties (e.g. The Royalton Hotel) have been sold at significant discounts to previous purchase prices.

B-rated CMBS are trading at less than half of their face value. While it is the higher rated CMBS that are widely held by asset managers and insurance companies, they are unlikely to be immune to problems afflicting retail, hospitality and office spaces simultaneously.

Banks will suffer from drying up deal flow, and some of them have direct exposures to potential write downs.

So Financials may be heading for more credit strain as the Real Estate sector transmits problems on Main Street into problems for Wall Street.

About Credit Benchmark

Credit Benchmark brings together internal credit risk views from 40+ of the world's leading financial institutions. The contributions are anonymized, aggregated, and published in the form of entity-level consensus ratings and aggregate analytics to provide an independent, real-world perspective of risk. Consensus ratings are available for 50,000+ financials, corporate, funds, and sovereign entities globally across emerging and developed markets, and 75% of the entities covered are otherwise unrated.

CB USA
12 East 49th Street, 9th Floor
New York, NY, 10017
Telephone: +1 646 661 3383

CB UK
131 Finsbury Pavement, 5th Floor
London, EC2A 1NT
Telephone: +44 (0)207 099 4322

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