# Geopolitical turmoil raises specter of credit freeze

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Samantha Rowan 23 October, 2017

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One of the biggest systemic risks to the U.S. commercial real estate market is a potential military conflict with North Korea, with veteran lenders warning about the possible impact on debt funds using callable repo or warehouse financing provided by major commercial and investment banks. "Some of us have seen this story before but there's an entire generation of commercial real estate professionals who don't remember **Long-Term Capital Management**, the Russian ruble crisis, or what happens in a credit freeze," said **Jay Rollins**, managing principal at **JCR Capital** . "We've warned investors about being exposed to transactions that have callable bank lines."

The North Korean situation has been deteriorating steadily, with increasing rhetoric from U.S. President **Donald Trump** and North Korean President **Kim Jong-un**. "It's not that far-fetched to think that there might be bombs in Seoul or war on the Korean Peninsula and if that occurs, it's very possible banks could stop lending and call lines due, if the documents allow," Rollins said. "A credit freeze is different than a price decline or recession, with the potential to last a month or three months."

Repo lines are widely used in the commercial real estate debt markets, with the caveat that the banks that provide them also have the ability to call a time out in the event of major market or credit events. "I remind our client base that repo-based financing is the easiest, simplest and least painful form of financing in the world – until it becomes your worst nightmare," said **Rick Jones**, a finance and real estate partner at **Dechert**.

Jones noted that during the 1998 Russian debt crisis, most banks had the ability to mark to market portfolios based on perceived valuations. "Banks typically no longer have the ability to call a repo line due to general market conditions, and marks are now generally tied to credit events, but banks still maintain a lot of flexibility to mark assets and withhold funding" Jones said. "Repo lines are vulnerable to market shock, and the conversations I've had with clients around these types of things includes the realization that they're vulnerable but hey, the money is cheap so they're going to throw the dice."

While many debt funds need leverage to achieve their returns, repo lines aren't the only game in town. The long-dormant commercial real estate collateralized loan obligation market has been seeing an uptick this year, in part because the spread between CLOs and repo has tightened. "It's easier and less painful for a borrower to say, 'I'm going to buy insurance to term out my financing through a CRE CLO. It's still more expensive than going to a bank but not as expensive as it's been over the past five years," Jones said.

Another option is selling A-notes or senior interests in loans, according to **David Blatt**, ceo of New York-based investment bank **CapStack Partners**. "The lifeblood of the whole debt fund business is leverage," Blatt said. "With respect to lines being pulled, it's probably a concern that every lender has, regardless of what triggers the pullback. It might force more [debt fund lenders] into seeking out that A-note or senior tranche execution."

Many of CapStack's debt fund clients don't have repo or warehouse lines and look to the firm's syndication desk to sell A-notes. "When you see a space that's growing as quickly as this one is, there are a lot of lenders that create a bigger pool of profiles to sell A-notes to, and that goes beyond money center bank relationships," Blatt said. "We've been very active in that space."

One positive is that there's a cautious tone in the market – and there's been one for quite some time. "Cautious is a good place for the market to be. There was a sense that once the debt funds started to grow, they'd be the cowboys of structured finance. But when we talk to them on a deal level, that sense of caution permeates everything," Blatt said. "A debt fund looks at every deal with the possibility of ownership and that injects a level of scrutiny at the front end that makes for better loans coming out. Being a lender today is being cognizant of the financial and global political landscape and thinking about how to get quality deals done."

At this point in the cycle, the conventional wisdom is that investors may be safer in debt, Rollins said. "But the investor really needs to look through and see how things are being financed. Daily callable repo lines means that a fund is taking on more risk than an investor might think," Rollins said. JCR, on the other hands, uses term debt on an asset by asset basis, he added.

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