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Black Swans and Commercial Real Estate

Radley & Associates Ltd

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Since the publication of The Black Swan by Nassim Taleb, the term has entered the media as a way of expressing the unpredictability of financial crises such as occurred in 2007. No more so than in commercial real estate where a belief has grown that the events leading up to 2007 were so unusual and unpredictable that they can be compared to the arrival of a novel new bird that has never been seen before and could not be guessed existed: a Black Swan. This summary is somewhat unfair to Taleb but authors have no control over how their analogies enter the realm of public discourse.

In the popular imagination a Black Swan is a truly unexpected event, in the rather unfortunately articulated phrase of Donald Rumsfeld "an unknowable unknown", and the view has developed that the 2007 financial crisis came out of the blue and was unpredictable with normal economic or risk models. There are two fundamental problems with this view. The first is what do we mean by predictable, and second, was there really a lack of information that would have enabled an estimate to be made of increasing risk in the system?

What do we mean by predictable? To say something may happen in the future is not the same as saying it will happen. No one (even with perfect information) sitting in 2005 could say with certainty there would be a crisis in 2007 – no more than anyone could say Chelsea would win the FA Cup in 2007 – although it is possible to say they had a higher probability of winning than say Hinckley United FC. Or to put it another way if Hinckley United did win the FA cup it would be highly unusual but within the bounds of predictability and indeed bookies would give odds for that prediction (what might also be described as a 'tail event').

These sorts of events or risks are, to once again quote the belligerent Mr Rumsfeld, "knowable unknowns" and thus not Black Swan events. Can we say the 2007 crash was so unpredictable or that it is so difficult to assess the data that we may as well think of the crash in commercial real estate values and loans as a Black Swan event? This is the view of many regulators including Dr Andrew Bailey, Managing Director of the Bank of England with responsibility for Prudential Regulation: *'transactions in the (Commercial Real Estate loan) sector were so large and so idiosyncratic it was all but impossible to build models to determine whether an individual loan would default and what the losses might be.'*

In 2005 there was ample evidence that the risk of a crash in the near term was rising and a distinct possibility: property prices were well above long-term trends, the volume of lending had increased substantially, lending margins were at historically low levels, loan-to-value ratios were rising and property yields were very compressed. Any one of these indicators raised the risk of a future fall in values and an increase in loan defaults. There was writing on the wall for those who wished to read but even then these indicators do not enable one to state unequivocally when and if there would be a crash or an individual loan would default: only that it is more likely. It was clearly a "knowable unknown" and it was entirely possible to place a probability that there would be a market crash or that an individual loan would be under water.

Appealing to the idea that financial markets in general and commercial real estate in particular are so unpredictable and complex that it is beyond the wit of man to estimate risk is as absurd as believing all swans are white – just because you have not actually seen a black one yourself. But perhaps those responsible for regulating markets before the crash are motivated to blame events on unforeseen circumstances rather than a lack of insight or oversight.

What caused the 2007 crash and subsequent meltdown was not a flock of black swans suddenly appearing over the horizon but that no one was monitoring the gauges and drawing the right conclusions that there was a rising trend in potential but predictable losses if the worst happened (knowable unknowns) – and the worst did happen.

There were no Black Swans in 2007 other than those swimming in Regents Park boating lake.

Radley & Associates is an independent firm dedicated to the development of advanced simulation based analytics for the Commercial Real Estate industry. Our clients include leading banks, fund managers and REITS. We have deep expertise in property, simulation modelling, econometric analysis and risk.

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