November 2023 Live Event-AICA Fall Roundtable CEF Track Panel #2; "Tax Free & Investment Grade Exposure: Managing for Recessionary Risk"

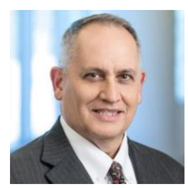
Wednesday, November 15, 2023

Patrick Thomson, Trader with Virtu, moderates the second panel of the AICA November 15th, 2023 live event; "ax Free & Investment Grade Exposure: Managing for Recessionary Risk". Read the transcript below to hear the discussion among Mr. Thomson and panelists Jonathan Mondillo, Head of US Fixed Income with abrdn, Cheryl Pate, Senior Portfolio Manager with Angel Oak Capital Advisors, and Michael S. Davern, Senior Market Strategist with Nuveen.


Patrick Thomson


Jonathan Mondillo


Cheryl Pate


Michael Davern

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Patrick Thomson: Hello, hello. I'm Patrick Thomson, Virtu, ETFs trader, I'm here backing up one of my colleagues. I trade equity ETFs and I've been trading for the last 20 years. The last panel was really interesting to me because I usually do ETF arb, and seeing how active managers and the difference between active and passive managers is kind of eye opening. In that for the last 15-20 years I've looked at high-yield funds as just being passive, and we're doing this index arb, and then the in-depth in which the panelists talk really means that I need to look at the way I look at ETFs in a different way and look at active managers as being very fundamental and important to the infrastructure. That's just me coming from an ETF side. But I'd like to introduce my panelists, and let them introduce themselves and their backgrounds.

Jonathan Mondillo: Jonathan Mondillo, I'm head of US fixed income for abrdn. We manage roughly $22 billion in fixed-income assets out of the region, we also manage roughly $2 billion in municipal assets, both taxable as well as tax exempt, open-end and closed-end funds. Our recent closed-end fund vehicle, which we started managing, ticker VFL, Abrdn National Municipal Income Strategy.

Cheryl Pate: Good morning, everyone. I'm Cheryl Pate, I'm a senior portfolio manager at Angel Oak Capital. We manage assets largely split between structured credit and corporate credit. I'm part of the financials team, we manage about a billion and a half of financial services-focused assets across a multitude of liquidity buckets from open-end mutual funds, closed-end funds, private credit strategies, and SMAs looking at securitization of bank debt.

Michael Davern: Good morning, I'm Mike Davern, I'm a former portfolio manager of open and closed-end municipal bond funds, been at Nuveen investments for 32 years. Nuveen is part of TIAA, so a trillion dollar money manager. Most of my career was either in credit or managing bond portfolios, but the last 10 years I pivoted. They took all my money away from me and they put me on the road, so I've been talking to clients and their advisors about how to position municipal bonds in their portfolios. So kind of interesting to be on both sides, actually managing portfolios and now talking to clients as to how these portfolios fit into their overall asset allocation strategy. So, glad to be here.

Patrick Thomson: So we decided to break up the panel into two sections, first investment grade with Cheryl, and we'll move on to municipals and tax-free debt to begin. So Cheryl, why do closed-end funds that hold investment-grade bank debt make sense in this current yield environment?

Cheryl Pate: Yeah, so not sure if anyone's aware, we had some volatility in the banking sector this year. When we look at the bank debt market, what you have is a market that's priced for a crisis that never fully occurred. As such, there's a lot of value in bonds that we look at in the community bank debt space, and also we like a barbell approach in this type of environment on the large cap space.

So I think the regional banks are still an area where the risk-reward is not as attractively priced, we feel as the small end and the big end of the spectrum. But what we're seeing is a sector that has gone through quite a lot of scrubbing by a lot of the credit rating agencies. We have internal proprietary models that scores every bank in the country as well, and a lot of granularity and disclosure over the three earning cycles that have happened since the regional bank failures in March. So pretty comfortable with the assets, the balance sheets, and frankly the coming increase in regulation as fixed-income investors.

On the flipside, you have a very dislocated market in terms of pricing, where these bonds are yielding low double digits to maturity and mid-teens to call for investment-grade credit trading above high-yield levels. So that's where we see a fairly large disconnect, we'll get into the structure of these types of bonds I think in a minute, but you're seeing opportunities where yields to worst are double digits for investment-grade credit.

Patrick Thomson: Can you tell me about subordinated debt and how has it been providing extra yield within the financials?

Cheryl Pate: I think that's one of the key points to consider here. What we're looking at when we say bank debt, it's called subordinated debt, which is a little bit of a misnomer but what this is is a regulatory capital tool. It qualifies for tier two regulatory capital for the banks, which can be up to 25% of their capital structure. So it's a growing market given that it is a capital tool, it's not a financing tool, we all know banks can fund themselves much cheaper with deposits, hence a lot of the debate that's happened over the last six months. So it is structured as a 10 no-call, 5 fixed to flip, and banks are highly incentivized to call it at the five year mark because capital treatment starts to decline ratably the last five years it's outstanding. And that's why I reference yield to maturity versus yield to call, these are typically yield-to-call type products because there is such a high incentive to call and refinance at that point.

The market that we're in today is a little bit different in that rates have moved up as dramatically as they have, and there's a line of sight to potentially starting to see rates come back down. I don't think that's necessarily a '24 event, but if someone's coming into their call period in the next year, might they hold that for one more year at 80% capital treatment and then look to refi at a lower rate? That's what we think will happen. So you'll have a little bit longer duration on some of these, but you're getting paid to wait because they move from their fixed-rate period to their floating-rate period, and in some cases are repricing up 400 to 500 basis points. So fairly short duration in terms of what you're looking for a call date, but a very nice coupon in the meantime, sort of paid to wait, and then you get that pull to par because they're trading in the high 80s to mid-90s today.

Patrick Thomson: And what's your outlook for the banking sector following the regional bank failures in March?

Cheryl Pate: Yeah, so I think a few things, when we think about the fundamental outlook for the banking sector for the next year, and a lot of pieces have sort of clicked into place to provide I think a pretty attractive fundamental look for bank debt, which I think is important to highlight is different than our view on bank equities. But contagion risk has largely faded, there are a couple banks that are on watch lists, but by and large there's 4,700 banks in the United States and most of them are doing just fine.

We are at/near the end of the Fed hike cycle, regulations are going to increase. That's particularly good as bank debt investors, we want more capital, we want more focus on liquidity, we want more focus on balance sheet de-risking, and I think that's the other thing that we have been seeing. As I said, we went through three different earnings cycles since then, and what I think we're seeing is a focus on increasing capital. Not through common equity raises but by managing the denominator in that sort of de-risking the balance sheet, looking to sell non-core assets, you're seeing sale leasebacks come back, so it's sort of managing down your risk-weighted assets and your total assets to help boost up capital ratios.

We're starting to see normal course debt issuance again in the space. The large banks, the regional banks, the super regionals have all been issuing, community banks do tend to lag, it's a sort of less sophisticated management team and they tend to be a little bit later in the cycle, so that sets up for a good issuance year for 2024. Typically we see eight to $10 billion in issuance in what we would characterize as community banks, that's $50 billion and below. Clearly the large banks issue substantial amounts post-earnings pretty regularly four times a year, so we're starting to see normality resume in the system. And then the final point is M&A has resumed as well, and I think that is something that will be a good theme for 2024 as well.

Jonathan Mondillo: If I could just add something too, I know this isn't my section but to your first point on active versus passive too, from my standpoint, from the portfolio managers that manage our bank debt, there's probably been no sector that has contributed more to alpha this year when you look at the delta from those bank defaults in March and April. And certainly speaks to the ability to get in and out of banks that we view positively despite the credit spread widening and contributing to that alpha generation this year. So there's a tendency always to throw the baby out with the bathwater, but certainly tremendous opportunity as a result of that as well, some of the points that she just mentioned.

Patrick Thomson: Awesome. We'll move on to the tax-exempt and municipal bond debt. For investors focused on tax-exempt income, how should they be thinking about their municipal bond allocation Jon?

Jonathan Mondillo: Yeah, sure, and feel free to interject if you'd like, I went into your space. So when we look at the tax-exempt municipal bond market, we probably look at three things when we're looking at relative attractiveness of the asset class. The first just being all-in yield and relative yield compared to both treasuries as well as corporate bonds. The second being fundamentals, what fundamentals look like. And then the third probably, on a go-forward basis, what tax policy looks like currently and what tax policy's going to look on a go-forward basis.

As we step back and we look at municipal debt performance, tax-exempt municipal debt performance over the last two years, it's been pretty poor along with many of the other fixed-income asset classes. But certainly to your retail investors which represent roughly two thirds of the tax exempt bond market, they're not used to seeing red, and they were off over 8% in 2022, up until three weeks ago municipal bond market was in the red as well.

But again, getting back to those three points on when we think is the right time to buy tax-exempt munis, when we look at the tax-exempt municipal bond market and on a taxable equivalent basis, you now are looking at yields north of 7%, pretty difficult not to find yields north of 7% taxable equivalent. State-specific, triple tax-exempt from the City of New York for example, you're pushing closer to 9% taxable equivalent yields. So long-term equity-like returns with very low risk, we think presents certainly maybe not once in a lifetime opportunity, but one of about the best opportunities to invest in tax-exempt munis in probably about 20 years.

To the second point that I said, fundamentals, extremely strong, and I think we could probably get into that later into the discussion, what's driving that, but municipal fundamentals, 20 plus years strong right now.

And then the third, tax policy. Tax policy, right? So over the next two years we've got the Tax Cuts and Jobs Act that's rolling off, so the top marginal tax bracket's going to go from 36% back to 39.6%, taxes are going up. We just saw ballot measures for certain things like mansion taxes and millionaire taxes in states like New York, California, Massachusetts, some of which passed, some of which didn't. Fiscal deficits, certainly the federal level and projected deficits on a go-forward basis at the municipal level. So my point being that taxes in our view are going nowhere but up, so all those three factors I think contribute to what we view as a historic buying opportunity for the asset class.

Michael S. Davern: I'll just add one comment. I thought in the last two years you kind of needed a view on duration, you needed a view on asset allocation and how munis play a role to dampen volatility, et cetera. And now you don't need a view, you just buy the yield, it's as simple as that. You have to remember that most of our investors are retail, and while retail investors are running to the short end then buying CDs in money markets, the idea is that if we can show them those kind of yields for five, 10, 15 years, it's an attractive entry point.

Very difficult to get clients out of money markets right now. Yes. And it's nice to get paid out money, but we have yield, and we haven't had yield in a long time. And now is a time to be banging the table with your retail investors to move out of the short end where you're going to see yields collapse, assuming the Fed eventually starts to cut rates, and they're going to miss the opportunity to grab yield now.

Jonathan Mondillo: Yeah, it's just been so easy talking with investors, for them anyway, to park money into T-bills. You've got yields north of 5%, it's a risk-free asset, why don't I just put all my investors' money into T-bills? To your point, it's been a difficult discussion, even though on a taxable equivalent basis, whether you're at the short end in an ultrashort tax-exempt municipal strategy which significantly out yields T-bills and Treasury money market funds. Whether it's trying to push investors out the curve as we look to get to peak rate cycle, and they're going to be missing out on the total return opportunities. It's been a very difficult discussion.

One of the things that we spend a lot of time doing is projecting out just what investors are missing out on by putting and parking their money into money market funds or into T-bills. And what we found is, is that during previous three hike cycles, when we got to this pause environment which I think we're in right now, long-dated municipal debt strategies out performed T-bills by 500 basis points, outperformed the S&P 500 over those time periods by 300 basis points, and outperformed investment-grade corporate bonds by over 300 basis points. And this was from a timeframe where all-in yields were much lower, so we actually think that the total return that they'll be missing out on by not investing into the asset class is going to be heightened in this environment.

Patrick Thomson: Let's say a recession is coming next year, how will that impact credit in the municipal bond space?

Michael S. Davern: I'll start. Municipals, it's a strange asset class because you're going to pay your property tax, people will get ill and they'll go to hospitals, kids will go to school, a lot doesn't change. Where you'll mostly see change would be on the income side, that'll be the biggest change in a recession, so that impacts the states more than cities and other local municipalities. So the bigger impact at the state level, but the state has a lot of leverage that they could pull.

What we're seeing in today's environment is increasing sales tax collection, increasing property tax collection, we'll see income taxes come down as bonuses come down, but tax revenue's still coming, and so there's a lot of strength in the municipal bond market. And also there's a good story in the marketplace, and stories drive investor behavior. If there's a story in the marketplace about one particular credit, and it's a credit you don't own, that credit is still the reason why your account is down. I've seen it over and over again, like say Illinois is in the news because of our many, many numerous problems, and you're a portfolio in Tennessee or Kentucky but Illinois' the reason why your portfolio's down, you don't even own it.

In this market there isn't that story out there, so I have some hope that the municipal investor will be able to ride through this recession without a sense of panic. But what happens is we get caught up in the story of the flow, and so we're going to have to watch that story because revenues will come down from what has happened in the last two years because we don't have the stimulus coming in again. That's not going to be happening here.

So that'll be picked up in the news and it'll be pointed to as revenues are down because there were higher revenues in the past, less now, and that could scare investors. But for the most part we have a strong story going into this recession; massive reserves, way more than we saw in the financial crisis, cities that were scared by Covid and actually did something to improve their liquidity position, and now we're going to go into this recession, hopefully a mild one, with a much better credit profile.

Jonathan Mondillo: Yeah, and I think if you listened to the last panelists too, some of the things that's driving top-line revenue growth on the corporate side has significantly benefited municipalities as well when you talk about inflation. Obviously on the expense side it costs more to pave a road, it costs more to pay a teacher if you were looking to hire. But on the revenue side, you look at the strength of the consumer, and when we talk about the top three revenue drivers of municipalities, you're talking sales tax revenues, you're talking income tax revenues, and you're talking about real estate tax revenues.

Two out of those three have been uniquely beneficial for municipalities, the strength of the consumer sales tax revenue collections have been through the roof. Wage pressures, while it makes headlines to the negative, directly contributes to income tax revenues at the state level. And then while I hope your property taxes, for those of you who own homes or apartments have not been up north of 30% over the last two years, your valuations certainly have and that directly speaks to the fundamental strength of certainly local governments as well.

To Mike's point, headed into any economic slowdown, any recessionary environment, when you've got states, two thirds of which are setting on record rainy day balances, city, local governments that have benefited from those increased revenues, we actually love the asset class right now relative to other fixed income asset classes that we like but don't love.

Patrick Thomson: What makes high yield munis different? And how have you allocated within your portfolios? This is for both of you.

Michael S. Davern: I'll start on the high yield side, for me it's a separate asset class that happens also be tax free, but the retail investor hears the talking points of the last panel and they hear the talk about high yield and default rates and it freaks them out. And it's often the media talking about high yield this, high yield that, the investor in a high-yield muni asset class thinks they're talking about them and they're not, they're talking about high yield corporates and the impacts there, for good and bad.

On the muni side, the high-yield muni market isn't cities, counties, and states, for the most part. Occasionally a city, occasionally a state will become a higher yielding bond, but that's not the average high-yield muni credit. What is in high yield muni is infrastructure, real estate, corporate-like bonds, and education and healthcare. These are things that are going to happen recession or no, so it's the risk of the project rather than the general economy that impacts credit.

And it's a very misunderstood asset class, and it's our fault because we call it high-yield muni, which doesn't really mean anything except maybe risky cities, high yield being risk, and muni being a city. And so the investor thinks this is a portfolio of risky cities, where really we should have renamed the asset class tax-free infrastructure or tax-free corporates, along those lines. Of course Congress would then have realized there is something called a tax-free corporate and they would have gone and taxed it, so perhaps it's okay that we haven't named it that way. And it still may happen, who knows, down the road.

In the meantime, there is a great story going into this recession on munis, on high-quality munis, but that is translated over into the high yield space, investors thinking that cities and states are doing well so there's not an issue here in high-yield munis. And again, this is the story that I keep focusing on, this is a good story to have in this market. Defaults are very rare, we talk about half of one percent, in our experience has been less than that. In a really bad recession it might double to 1%, but any defaults in high-yield muni freaks investors out. We also are not rated, we're mostly a non-rated market, because investors don't want to see ratings is the only reason I could figure. They just don't want to know.

And many advisors often, even yesterday tell me, "O*h, yeah, these are small issues that didn't go pay to get a rating." Some wholesaler told some salesperson that a long time ago and it's gone everywhere. Non-rated bonds are typically BB, BB+ to BB-, occasionally there is a city that doesn't go pay for a rating, but it's rare because the rating helps the liquidity, helps reduce the cost of borrowing, and cost of the rating isn't that much considering the size of the deals that are normally coming. So some differences, I'm sure I skipped some as well.

Jonathan Mondillo: Yeah. No, if we're going to change names, I'd put high-income in the hat as well if we're going to change the high-yield name to anything. But yeah, it's a difficult conversation with investors that typically buy munis for safety and for security, they hear the high-yield name and I think it scares a lot of investors off. I think it's a bit irrational, to your point, when you look at historical default rates.

We can look at high yield munis, which have default rates less than six times what a single B-rated corporate bond would, and then we can look at again that 0.1 in terms of relative value when we're looking at and assessing the asset class relative to other fixed income. When we look at yields and high yield muni bonds relative to single B-rated corporates, again lower defaults, you're picking up 90 basis points in additional income with a significantly lower risk asset class.

And then also to Mike's point, some of the names that you're talking about that are quote/unquote "high yield" are names in higher education, hospitals, which we view as an essential service, as well as charter schools, which have certainly made headlines over the last five to 10 years. We see that asset class, broadly speaking, as almost an investment-grade asset class. Revenues distributed quite similarly to what the public schools would be, but then on the expenditure side is controlled, so a lot of opportunity there. And I think for investors that are willing to look into that high-income asset class and not get scared away by the high-yield name, certainly can contribute to their portfolios.

Michael S. Davern: Also another difference is we're mostly secured. If you do have a city or a county or a state in there, in the high-yield space, it would be unsecured as typically with high quality. But in the typical high-yield municipal bond, you're a secured lender backed by taxes, and if the entity doesn't pay its taxes it loses control of the project and the project can be sold for back taxes, we still get paid.

We also have a debt service reserve fund, we force the borrower to borrow enough money to cover maximum annual debt service for at least one year. But that debt service reserve fund can cover a project for two or three years or more. Depending on if there's revenues coming in but maybe not sufficient to cover all expenses, you can tap into the debt service reserve fund. Not something we want to happen, but again it gives the credit time to stand on its feet and get back into a paying asset class. Two very strong differences.

And then the final one is we don't have refinance risk, we typically amortize down like a mortgage. So you don't have the wall of debt I always hear about on the corporate side, we don't have that. It isn't something that's a feature in high yield munis, although occasionally it is something that you see in the high-quality space where a municipality will roll over its debt. But not something that you see, it's very rare in high-yield munis.

Patrick Thomson: Where are the opportunities in the muni space and where should investors be cautious over the next 24 months?

Jonathan Mondillo: I think we might have touched a little bit on this.

Patrick Thomson: Yeah, but on the cautious side.

Jonathan Mondillo: Yeah, yeah, I think on the cautious side, probably with the consumer strength waning, we're probably veering away from your sales tax backed bonds. I think you're going to start to see revenues, and we've started to see that too, revenue growth dissipate at the state level too, so we sort of like local general obligation bonds versus state general obligation bonds, obviously based on the strength of real estate valuations.

I think on the high-yield front, it's a bit contrarian but you see a lot of headlines in and around the risk within higher education, education broadly speaking, as well as hospital systems. And that's not a lie but when we look at hospital systems, there's 6,000 hospitals in the united States, what percentage of those are going to go under? When we're looking at fundamental credit, we look at it on an individual basis, but there's been a tendency to, and I'll use the phrase again, throw the baby out with the bath water. And when we look at relative value in hospital systems, when we look at relative value in higher education, when we look at relative value in charter schools, there's a lot of spread to be had and a lot of interesting opportunities there as well.

Michael S. Davern: So let's talk about the wrapper, because this is a closed-end fund conference. So interesting in the wrapper, we get to keep these portfolios stable as the shareholder buys the shares up and down, and so as an opportunity, we're able to buy these funds today at a low share price and at a significant discount. There's still double digit discounts there, although less so than two weeks ago as the market has made a good move. So I like the closed-end wrapper, with high quality and high yield, and then we have the mix. We have 13 national closed-end funds that do munis, and so we have high quality, high yield, and then the mix of the two.

Yields drive the performance of the share price, and what we're doing today is massively increasing the yields inside the funds. If you walk around the bond desk and you say, "What are we doing? What are you doing today?" "I'm booking yield, that's what I'm doing." I'm looking for generally in the new issue market you're going to get the maximum amount of yield for the dollars that you're putting at work because you're investing in today's real yields, and then we have the headwind. The biggest headwind in the closed-end space is leverage, leverage costs. It's been a tremendous headwind and it's the reason why the discounts have opened up so wide and the share prices have come down.

But now we potentially are shifting to a period in the future where you might see Fed cuts, Fed cuts are bringing down our funding costs, and the yield stays in the fund, so now what's a headwind today becomes a tailwind. Of course the market will be sniffing this out well in advance, perhaps it's even starting to do that now, and you see these discounts start getting narrowed.

Over a long period of time in your asset allocation, I view this as my pay me not to work type fund, where I'm going to be able to live off some of this income that I've been generating and reinvesting for all these years. And even in my mom's account, my mom and dad, now just my mom, they retired at the top of the market in '07-'08, 100% closed-end funds. They would never have lasted if I didn't turn off their ability to look at the account, because they would focus, like every other investor, at the value of the investment, which I didn't care about, I wanted that income for them. And they've been able to live, and now my mom's been able to live off that income now for 15-18 years without ever touching the principal. It's not intended to be 100% allocation, it's just the way it worked out for us in her family, but there's a roll for income in a diversified portfolio for an investor heading into retirement or in retirement.

Patrick Thomson: Any closing notes by you three before we go to questions in the audience? Audience, anyone? Go ahead, thank you.

Audience Question: Hi, Cheryl, how do small banks operate [inaudible]? I don't know anything about small banks but that sounds like a really high [inaudible].

Cheryl Pate: Their cost of funding is not that high in fact actually. I think one thing that the small banks really benefit from, and here when we're talking about community banks, in a lot of cases they may be the only bank in a rural town, a suburban footprint, they're not competing in major markets against J.P. Morgan. So the benefit that they have is really they tend to have a very high-quality deposit base, very sticky customer relationships tied to lending relationships.

So if we look at, for example, we can look back to the bank failures of Silicon Valley for example, they had very high levels of uninsured deposits tied to relationships. Very different model for the community banks, the average deposit size is smaller, uninsured deposits is a much smaller piece of their funding but it's not unusual to see 30-40% of their funding based on zero-cost deposit operating accounts.

And so when you look at the overall cost of funding, all banks are paying out more for CDs, for money market accounts, that's just a sliver of the funding. And then the debt that we're investing in is a very small piece of the liability structure, it tends to be the only debt outstanding, so we have common equity, a small slice of debt, and the deposits are the main funding mechanism. So they've typically been able to generate higher margins than their larger counterparts for that reason.

Audience Question: [inaudible] as a rule they have a large concentration of community property in their portfolios, [inaudible], that might be in the larger space. How do you think about the risk of that portfolio in the context of changes in business models and [inaudible] this sort of question mark over [inaudible]?

Cheryl Pate: Yeah. No, definitely when we look at the year ahead, we expect that credit will continue to normalize upwards, and more on the commercial side this cycle than the consumer side that we saw in '08-'09. But then I think it's important to dissect the commercial loan portfolio, and clearly we're most concerned about office, CRE, and most notably office CRE in Class A offices in major metropolitan areas. That's not what a community bank is lending against. Number one, the size just is not comparable. But when we look at total commercial real estate outstanding, about a quarter of that is in the banking system, a good chunk is in CMBS, life insurance companies, so I think the press sort of over inflates the amount that is on bank balance sheets.

But when we look at the smaller banks, what they're really in, in their commercial real estate portfolio, number one they tend to be collateral lenders, so it may be a small business loan but they want a personal guarantee, and if you have real estate they'll secure against that as well, while the call report is a collateral based report and that's going to show up as a commercial real estate loan despite that not really being the purpose. So there's a little bit of that that goes on, but I would say by and large we've gotten a lot more granularity in commercial real estate portfolios.

You'd be hard pressed to find a bank, any bank, that has more than 5% of their loan portfolio in office CRE, and generally much less than that. But the small banks specifically tend to have a lot of strip center lending, tend to have a lot of medical and dental office, things that we think are relatively more recession proof and still have a need for physical space. So we feel better about the types of loans that are in the portfolio. But I think the final thing that we think about, and likening back to the Financial Crisis, commercial real estate is not a point in time cycle, consumer is a much faster cycle.

Commercial real estate plays over a multi-year period, not all loans are coming due at the same time, there will be workouts, there will be troubled debt restructurings probably come back in a little bit. But if we look at cumulative losses in commercial real estate historically, mid-single digits and you earn through it over a couple of years. Provisions are moving up fairly rapidly now to get ahead of that, and that typically is covered through general earnings versus dipping into capital, so a lot of nuance in the portfolio clearly matters a lot but that's how we get comfortable with it.

Patrick Thomson: Go ahead.

Audience Question: Maybe if I could just piggyback off the CRE piece, looking at it from the [inaudible]. Mike, when you talked about the three fundamentals that kind of support the [inaudible], and one of them being property taxes. So the [inaudible] have gone up quite a bit since the start of Covid, but on the flip side, Cheryl, you talked about the [inaudible] with the CRE piece. How do you think about it over time, where do CRE property values go and the pressure that puts on property taxes or revenue [inaudible]?

Jonathan Mondillo: Yeah, sure. There's no doubt that it's going to be a headwind to real estate taxes when it comes to office. But I think you could take the City of New York as a perfect example, as a percentage of overall revenues, let's say it represents 10% of overall revenues, if valuations drop by 50% it's only a 5% hit on revenues.

What historically municipalities have been able to do is they've been able to raise revenues from other sources, and I think in addition to that many municipalities have a lag effect on that. So City of New York will have a five-year lag to those real estate taxes, where valuations on the open market may come down but the actual assessed value of the property will take five years to come down, thus won't be as large of a hit to those real estate taxes. Yeah, I don't know, Mike, if you wanted to?

Michael S. Davern: Yeah, you could raise the millage, the city can get the money from other sources, not only other taxed sources but even within the real estate side. You might have assessed valuations come down but you can theoretically raise the millage, it depends on the market and how expensive taxes are, et cetera. And so what you look at when you look at a city or a county, you're looking at the mix of the downtown versus the surrounding area, is it a city that's all downtown or is it a city that has a lot of mix?

Residential is rapidly have been rising, the city might come down, and so the collection of taxes could even be flat or even up even though the city center's coming down. Depends on the city and the type of property it has outside of the city center, and we look at that closely when we look at lending, this is mostly in the very high-quality space. You're talking about the general obligation bond from the city county, the state would be less important here, it'd be the city or county.

Jonathan Mondillo: Just one more point too. The time that they have in order to move the pieces around and change the millage, thus keeping revenues relatively stable, municipality also has the ability to change from commercial to residential. Which you're seeing that right now too in cities like Boston, New York obviously has been entertaining that as well. It takes time, we saw this post-9/11 in downtown Manhattan where we saw a lot of conversions as well. It's expensive, so they're going to need to incentivize that, but again I think a municipality, a city, a county has a little bit more levers to pull as a result.

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