Six Pre-Default Strategies to Pursue Now

lending CRE

Summary: Certain segments of commercial real estate are showing signs of stress, with certain office markets reporting vacancy rates at record highs. CFIs should pay close attention to trends and forecasts while preparing for action in case loan defaults rise. We discuss six strategies to help identify and address CRE loans at risk of default.

In the pre-pandemic tech boom, San Francisco had one of the nation's lowest office vacancy rates, at just 4% vacancy. The pandemic emptied offices, however, and far too few workers have come back, leaving San Francisco's office vacancy rates at 30%, the highest rate in the country.

Community financial institutions (CFIs) that made a 5Y office loan in 2019 might find it difficult to refinance that same office loan when it comes due in 2024. In the first quarter of 2023, the national office vacancy rate stood at 18.6%, a record high and nearly six percentage points above the rate in the final quarter of 2019.

Rising Vacancies Cause Concern

It's not just offices that are still lagging, but segments of retail and hospitality as well. Hedge fund manager Chris Hansen recently said he worries that the ongoing commercial real estate (CRE) problems could spread and cause a much broader economic crisis.

In other words, while the waters may still feel fairly calm at the moment, pressure is likely to show up in the CRE portfolios of lenders over the next 12 months (or so), as loans booked just ahead of the pandemic are coming to maturity. In addition to higher vacancy rates, CRE borrowers are facing a barrage of additional challenges, such as higher interest rates, higher operating expenses (i.e., labor and supplies), and higher cost of capital improvements.

Even top CFI clients with pristine records could find themselves falling behind on loan payments. If the current situation persists, loans can soon go from falling behind on a payment or two to severe default.

Keeping an Eye on Commercial Loan Portfolios

For financial institutions, this is a time to reevaluate commercial loan portfolios and be on the lookout for potential problems. The office vacancy problem, for instance, varies widely across the country and is most acute in major metropolitan areas such as San Francisco, New York City, and Austin. Even in New York, there are differences in vacancy rates between midtown, with a 14.2% change in vacancy rates, and downtown, with a 10.7% change. CFIs should keep a close eye on vacancy rates and other trends in their own markets as well as nationally.

The overall trend line does not look favorable, as some offices and retail spaces are simply becoming obsolete in the wake of changing work habits and consumer demands. Cushman & Wakefield estimates that 330MM square feet of office space could become obsolete by 2030.

Last December, we provided some pre-default advice for CFIs, including how to spot warning signs such as slower loan payments, and how to work with borrowers who might fall behind. The need to look closely for potential problems has only gotten more urgent.

Taking Proactive Measures

The first step is to engage with your loan customers. There may be things that can be done to help you and your borrowers avoid commercial loan default.

Here are **six actions you can take to flag loans that are more likely to default and address them:**

1. **Review loan collateral.** Determine the current value of collateral and whether it is still sufficient.
2. **Review lien priority.** Where do you stand in the event of a default? This can help you better evaluate risk in your portfolio.
3. **Review recovery resources.** Do your clients have sources of recovery in addition to collateral, such as co-borrowers or guarantors?
4. **Maintain detailed documentation.** Make sure you have a clear document trail in case of default. If some of your borrowers go to forbearance, pay close attention to the details and the documents. Check to make sure your borrowers have been represented by legal counsel, which can be important if things go sour.
5. **Assess all options.** Review all options available to you in case a loan defaults, including foreclosure and the sale of loans. Start having discussions with borrowers far ahead of loan maturity.
6. **Check your reserves.** Be sure you have adequate reserves in case defaults rise.

CRE may be experiencing a tough time and there's no sign of when the troubles might ease up, but there are actions your CFI can take to identify and address potential defaults before they occur. CFIs should keep an eye on vacancies in their local market and remain alert in case of a rise in loan defaults in their areas, and be prepared to take appropriate action.

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ECONOMY & RATES

Rates As Of: 08/02/2023 05:32AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.54	-0.01	1.12
6M	5.54	0.01	0.78
1Y	5.35	-0.01	0.65
2Y	4.90	0.02	0.47
5Y	4.23	0.05	0.22
10Y	4.04	0.08	0.17
30Y	4.11	0.10	0.14

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.31	8.50	5.32