Hedging Can Strengthen CRE Lending

hedging BLP Borrower's Loan Protection lending CRE

Summary: CRE developers and lenders are seeing a stressed landscape for their business, as predictions of workers returning to offices haven't been fully realized. A forward rate lock hedge can help both sides of the lending transaction by fixing a rate on future loans.

There's no place like home, according to the character of Dorothy in "The Wizard of Oz." Millions of office workers agree with her. Working from home lets people get things done while also refunding the time they would otherwise have spent commuting.

Many businesses in the US and indeed the global economy had a forced experiment with letting employees work from home during the COVID-19 pandemic. When the pandemic was better controlled, business owners figured, office workers would come back to their offices.

That hasn't entirely taken place. American office occupancy is between 40% and 60% of pre-pandemic levels, depending on when and where you look. With a 3.4% unemployment rate, the labor market is tight enough that workers can use their leverage to insist on working from home at least some of the time. A survey of 2.3K workers done by Owl Labs and Global Workplace Analytics found that 39% of workers say they would quit if they could no longer work from home, and nearly half say that they'd stop working as hard if their employers made them return full-time to the office.

Pressure on Commercial Real Estate (CRE) Loans

With fewer employees in the office on any given day, businesses have less need for office space. That's showing in how CRE investors are handling their debt. This spring alone, a real estate investment fund defaulted on mortgages worth $750MM for two skyscrapers in Los Angeles, a private equity fund reduced its investment in Chicago's Willis Tower by nearly a third, and a large New York landlord began negotiating to extend its deadline for paying down a mortgage on a Park Avenue office tower.

CFIs Holding Substantial CRE Debt

Community and regional financial institutions hold more than $2T in CRE debt; $270B of commercial mortgages held by banks is scheduled to mature in 2023. Lenders' exposure to this part of the credit market will likely draw regulator attention and should be part of community financial institutions' (CFIs') own consideration of their fiscal health.

Hedging Benefits for Both CRE Borrowers and Lenders

CFIs don't want to write more CRE loans if those loans will be of questionable quality. Likewise, CRE borrowers don't want loans they won't be able to repay. Hedging with a forward rate lock (FRL) can make CRE borrowing more palatable for both parties in the transaction.

In an FRL, a CFI and a borrower set a fixed rate for future financing. For the borrower, an FRL eliminates the risk that the loan's rate will change before financing begins. The hedge component of the agreement, a forward rate swap, also assures the CFI of its loan-pricing spread.

FRLs are useful for permanent, post-construction financing and to set future rates on existing, resettable loans. They're especially handy when the yield curve is inverted or interest rates are rising, two situations that are either happening now (the inverted yield curve) or have only recently begun to slow down (rising interest rates).

An FRL is also useful in addressing net interest margin compression. CFIs have needed to raise the rates they pay on deposits to keep those deposits as interest rates have risen. That substantially higher cost of funds has squeezed CFI margins. A forward rate lock lets a financial institution convert a loan from one that reprices every 5Ys to one that resets every month, allowing loan rates to go up in step with deposit rates. The hedge can also generate fee income to augment current earnings.

Some CFIs may be wary of the complexities of hedging, like managing derivatives. PCBB's unique tool, Borrower's Loan Protection® (BLP), relieves that pressure for your institution, and makes the hedging process much simpler on your end. PCBB shoulders the operational responsibilities, such as derivatives and regulatory requirements, so you and your customers can reap the benefits of a hedged loan and rest assured that a trusted partner is handling the technicalities behind the scenes.

HOW DO INTEREST RATE SWAPS BENEFIT MY INSTITUTION?

Business clients are expecting long-term, fixed rates from their financial institutions. See how you can meet both your needs and your borrower's needs with an interest rate swap using Borrower's Loan Protection® (BLP).

ECONOMY & RATES

Rates As Of: 08/08/2023 05:34AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.56	0.01	1.14
6M	5.53	0.00	0.77
1Y	5.28	-0.08	0.58
2Y	4.73	-0.15	0.31
5Y	4.09	-0.09	0.08
10Y	3.99	0.03	0.11
30Y	4.16	0.15	0.19

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.30	8.50	5.32