Five Ways To Shore Up CRE Lending Right Now

lending business customers CRE

Summary: It’s not clear if or when the CRE market will return to pre-pandemic levels, but experts say there are steps that banks with significant exposure to the space can take to help mitigate losses. We suggest five ways to navigate the slump.

With more and more people working from home or adapting to hybrid work schedules, one would think that workplace shows would go down in popularity. The opposite has happened: during the COVID-19 pandemic, “The Office” was the most-streamed show of 2020. There has been no shortage of workplace comedies and dramas recently, and some psychologists and television critics believe it’s due to a nostalgia for the social systems and relationships that in-office work can sometimes provide.

In reality, however, commercial real estate (CRE) is feeling the effects of our new ways of working. It’s not an easy time to be an in-office business. Commercial mortgage interest rates have nearly doubled in the last year, from between 4% and 5% to between 7% and 8%. That’s a significant additional burden for the $20B in CRE office mortgages that matured in 2023.

Demand for commercial real estate is down because hybrid and remote work have changed the ways that companies use office space, with few firms requiring the same square footage as before the COVID-19 pandemic. The national office vacancy rate was 18.2% at the end of November 2023, up 190bp YOY. That number was much higher in some local markets. In San Francisco, for instance, 24.2% of office space stood vacant. Rents were up nationally by 30bp, but the increase wasn’t enough to make up for a profound lack of demand.

Big Banks Look for the Exit

Some large financial institutions, including behemoths such as Goldman Sachs, JPMorgan Chase, Capital One, and M&T Bank, have tried to sell debt backed by offices, hotels, and apartments. Mostly, they’ve struggled to offload the CRE exposure.

“Even if most of these loans are performing loans today, they’re trying to reduce their exposure by selling loans at a discount as they head into a refinance cycle,” says Gregory Hagood, president of SOLIC Capital. “A lot of these banks will say, ‘I’d rather take the hit [on price] than take the hit on a foreclosure and have to deal with the asset after.’”

Five Ways To Ride Out the Storm

If large financial institutions are hurting, community financial institutions (CFIs) as a group may be in yet more pain. CFIs hold 68% of all CRE loans, and they often don’t have the same resources that larger financial institutions might use to sell the debt. Fortunately, CFIs can take steps to help both borrowers and themselves.

1. Talk to your CRE borrowers.

As with any business lending relationship, regular conversations with the borrower about how their business is faring can give both a preview of what to expect from loan performance and an opportunity to help a struggling borrower by giving proactive business advice.

Talk to your CRE borrowers about their tenants, as well. Are the tenants likely to renew their leases? Will they want smaller amounts of space, or might they leave for another building or ask workers to go 100% remote?

If the borrower anticipates that a tenant might not renew a lease, how will the landlord position the property to attract a new tenant? A new office tenant might be the first choice, but using those spaces for other things may also make sense. The spaces could be repurposed to take advantage of other high-demand CRE industries, such as mixed-use properties, hotels, apartments, and shared workspaces.

David Schiff, head of retail and consumer banking at consulting firm West Monroe, emphasizes the value of talking early and often with CRE borrowers. “Banks who take a true relational approach to partnering with clients will experience substantially lower losses than those whose relationships are really just transactional.”

2. Implement risk mitigation strategies.

Develop and execute risk mitigation strategies to safeguard against potential challenges in CRE lending. This may include diversifying the portfolio, stress testing loan portfolios, and staying informed about market trends to adapt new, responsive lending strategies.

3. Consider concessions.

Do your borrowers have the liquidity they need to make timely payments? If they do, they can minimize the effect that higher interest rates will have on the repayment structure.

But don’t offer concessions automatically to every CRE borrower. Consider them for valuable clients and situations in which a concession can meaningfully improve debt performance. Addressing a borrower’s near-term needs when doing so can bring long-term profit.

4. Look at the places where your local market is thriving.

Yes, the national office space market is down, but that doesn’t necessarily translate to your local economic conditions. You may find islands where office demand is strong. Remember, too, that industrial and warehouse properties, retail space, and hotel/motel facilities have all performed well in recent months, giving many CFIs a way to diversify their CRE lending.

5. Leverage technology for data-driven decision-making.

Utilize advanced data analytics tools to gain insights into market trends, borrower behavior, and potential risks. Adopting a data-driven approach can enhance decision-making and allow for more accurate risk assessments. Having data on hand can also help you take a more proactive approach to mitigating any challenges.

We don’t yet know if CRE lending will have a recovery, given the massive shift in the way we work. Proactive communication, strategic concessions, and a diversified lending program can all help CFIs maintain strong relationships with their current CRE borrowers as well as weather the downturn in office space CRE lending.

LOOKING TO GROW YOUR LOAN PORTFOLIO?

ECONOMY & RATES

Rates As Of: 02/27/2024 05:38AM (GMT-0800)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.47	0.05	0.07
6M	5.34	0.16	0.08
1Y	5.00	0.30	0.24
2Y	4.68	0.47	0.43
5Y	4.29	0.45	0.44
10Y	4.27	0.36	0.39
30Y	4.40	0.23	0.37

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