Preparing Your Bank for Possible Turbulence in Commercial Real Estate

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Reports of potential trouble in commercial real estate lending have steadily increased this year.

Per the Wall Street Journal, a record number of commercial mortgages are expiring in 2023. Prices for commercial mortgage-backed securities, many of which are backed by increasingly empty office buildings, have been in decline. Even Elon Musk has chimed in, echoing concerns that some $2.5 trillion in commercial real estate debt will mature in the next 5 years. “This is by far more than any 5 year period in history. Meanwhile, rates have more than doubled and commercial real estate is only 60-70% occupied. Refinancing these loans is going to be incredibly expensive.”

So what happens next? Borrowers on floating rates have seen their payments jump, while borrowers with maturing fixed rate loans will need to either pay off their loans or refinance at higher rates. These factors raise the risk of default, especially for loans backed by leased buildings with struggling occupancies. Furthermore, nearly 70% of outstanding commercial real estate loans held by small and midsized banks.

While the future is uncertain, here are three things bankers should do now to prepare for the changing landscape:

1. Check in on your current CRE loans.

Look for signs of trouble within your current portfolio. Ask for a current certificate of insurance to make sure hazard and liability insurance is still in place on your real estate collateral. For leased property, confirm that any lease remains in place and has been properly renewed, if applicable. Make sure all property taxes have been paid and familiarize yourself with the current condition of the property.

2. Reacquaint yourself with the Bank’s options upon default.

As defaults occur, lenders must use caution in how they respond; renewing a credit facility or amending the applicable loan documents will act as a waiver of the default. Where applicable, a carefully drafted forbearance agreement can be a versatile and highly customizable tool to preserve a default while working on a favorable resolution and evaluating the bank's options.

3. Bolster your due diligence practices for new real estate loans

The collateral value (and transferability) of commercial real estate may be severely impaired by issues that can be discovered and addressed before closing. Banks should take this opportunity to ensure that new CRE loans and renewals are being handled properly, and with special attention to due diligence. When the bank must take possession or resell commercial property, the Borrower's real estate problems become the Bank's problems.

Skilled review and negotiation of title, survey, environmental, and tenant matters are essential for every CRE loan, regardless of amount. The bank must be secured by a clean piece of property—compliant with zoning and other restrictions and free of encroachments, access limitations, and environmental problems. The lender's title insurance policy must be negotiated for the bank's maximum benefit, including the appropriate coverages and endorsements tailored to the specific transaction. A current ALTA survey should be required for every CRE loan.

While real estate presents many unique complications as collateral, these risks can be mitigated with a little bit of planning. Careful planning now will make the road smoother in the future, wherever it may lead.