



**Current developments in the commercial real estate  
structured finance market - by Michael Zysman**

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Currently, the commercial real estate structured finance market is finding its footing. This is primarily due to the increase in interest rates, pull back of bank financing, and Federal bank policy. Much of the real estate financing that occurred between 2020 and 2022 assumed a low U.S. interest rate policy for the long-term, high availability of credit and continued strength in the economy. When using those assumptions, it justified low historic cap rates and reasonable rent growth. After the recent bank failures and distress, those assumptions have quickly come into question. Many real estate investors and lenders are making the decision not to act until there is more certainty in the government's long-term credit availability and interest rate policy.

As short-term risk-free interest rates began to exceed rates banks could pay customers for deposits, many large customers moved their bank deposits to short-term treasury securities or money market accounts which created stress on many bank's balance sheets. As the deposits were moved, banks needed to raise liquidity to comply with Federal regulations. Due to decreasing asset values of long-term debt investments, banks would need to sell those assets at a loss which could create additional bank failures. To help bail out banks, the Federal Reserve created the Bank Term Funding Program in March of 2023 which allowed banks to borrow money at par against U.S. Treasuries, agency debt and mortgage-backed securities, and other qualifying assets held on their books at a new index called the Bank Term Funding Rate + 10 basis points for a period of one year. Advances from this facility can be drawn until March 11, 2024 and the rate for program as of November 16, 2023 is 5.31%. If long-term and short-term interest rates remain high, banks that borrowed from this facility may have a hard time paying it back as it comes due if the Federal Reserve is unwilling to give an extension and/or the banks are unable to attract replacement bank deposits. This dynamic is further putting stress on new bank loan originations.

Stabilized properties that are performing well from an operations perspective but have loans coming due that originated in a low interest rate environment may have difficulty refinancing their debt. If NOI is similar to where it was when the loan was originated and interest rates increased, a borrower will likely have to do a cash in refinance or sell into a changing market. Due to programs like the Bank Term Funding program and others, banks are in a position to extend loans they many not have been able to. If the Bank Term Funding Program ends and there is no replacement, banks may have to force borrowers who cannot cash into their properties to sell.

In June 2023 the board of governors of the Federal Reserve System, the Federal Deposit Insurance Corp., the National Credit Union Administration, and the Office of the Comptroller of the Currency made a joint statement that financial institutions should work "prudently and constructively" with good borrowers during times of financial stress. Most lenders have been following that guidance, except in cases where borrowers are bad actors and/or not capable of managing the underlying assets from a financial and/or professional standpoint during times of distress.

Another area of potential distress is the commercial real estate CLO market. According to a KBRA report from October 2023, 72.9% of 2021 and 2022 vintage CLO debt would fail to meet 2023 stabilized CRE fixed-rate lenders' debt yield expectations, even if it was assumed that originally

projected stabilized net cash flows were achieved on every property. Since CLO loans generally have two-three year initial terms, that represents a good portion of the outstanding commercial real estate CLO debt. In addition, many of these loans have interest rate caps that are set to expire soon. Loans with expired caps may go into payment default if the underlying properties are not able to cover the increased interest rates and the owners are not covering the shortfall. Many CLO lenders have been extending or forbearing loans to good borrowers.

Lenders may have to change their asset management approaches soon if it is anticipated that federal policy will allow for higher interest rates and lower availability of credit in the short term, and federal emergency bank programs are not renewed. If the market's perception is that rates will be higher over the long term, borrowers with high leverage loans that are not able to cover their debt service may lose incentive to adequately maintain their properties since they will be "out of the money" for an extended period of time. Lenders will need to make sure the underlying collateral of their loans are maintained to preserve value and limit potential loan losses. Paying attention to federal monetary policy is now more important than ever for participants in the commercial real estate industry.

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