Trepp®

T-ALLR Research

April 2022

CRE Loan Performance at Banks: Originations Up Sharply in Q4 2021, Concerns Over Higher Interest Rates & Future of Office Market

Originations of commercial real estate (CRE) mortgages rebounded again to end the year, while delinquencies continued to trend down after a moderate rise in 2020. Industrial and multifamily are leading the way for loan originations, reflecting the investment shift toward these two sectors. We are seeing some mixed signals for the office sector – originations are up, but delinquency rates have edged higher and banks in large urban areas have not yet ratcheted down risk ratings on office loans. Similarly, origination volume has picked up, even in the hardest-hit retail and lodging sectors, but delinquencies have not yet recovered.

The Analysis

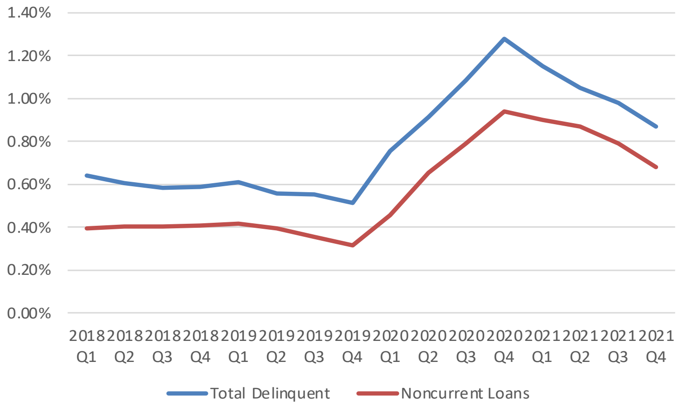
The analysis here is mainly built on the examination of trends in Trepp's Anonymized Loan-Level Repository (T-ALLR) data set. The T-ALLR data is comprised of bank balance sheet loan data, a diverse set of loans totaling over $160 billion sourced from multiple banks.

Delinquency Rates – Improving Overall, But Still Elevated in Lodging and Uptick in Office

CRE mortgage delinquency rates (or the rate at which a loan is behind on payment) hit a recent peak of 1.3% in Q4 2020, as the pandemic disrupted economic activity across a broad range of geographies and industries. Since year-end 2020, the economic recovery that began in the second half of last year has helped bring mortgage delinquency rates down, with modest improvements in the first three quarters of 2021. As of Q4 2021, the overall CRE delinquency rate stood at 0.9%, while the noncurrent (more serious delinquencies) rate stood at 0.7%, both still above their pre-pandemic levels.

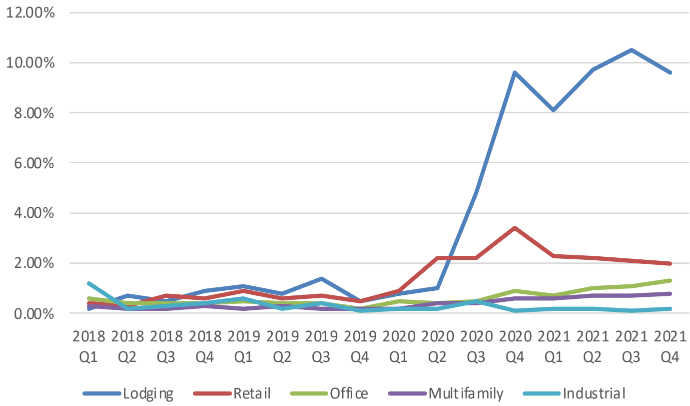
The highest delinquency rates are in the lodging and retail property types, although the delinquency rate for retail has been improving since Q4 2020 and the lodging delinquency rate declined in Q4 2021. These were the two sectors within

FIGURE 1: BANK CRE LOAN PERFORMANCE DELINQUENCY RATES PEAKED IN LATE 2020



Source: Trepp Bank Navigator

FIGURE 2: DELINQUENCY RATE BY PROPERTY TYPE CONTINUED STRESS IN HOTELS, IMPROVEMENT IN RETAIL



Source: Trepp T-ALLR

commercial real estate that were hardest hit by the impacts of the pandemic.

The office delinquency rate has been rising for the last several quarters, representing a delayed reaction to low office occupancy rates during the pandemic. The office delinquency rate edged up to 1.3% in Q4, up from 1.1% in Q3, and 1.0% in Q2. This sector will bear a closer watch through 2022 and beyond, as leases roll in the coming months and loans come up for refinancing.

Delinquency rates for the other major property types are below 1%. The multifamily delinquency rate has risen to 0.8%, from 0.2% before COVID hit in early 2020. The industrial delinquency rate is a very low 0.2%, reflecting the strength of the sector through both the recession and recovery.

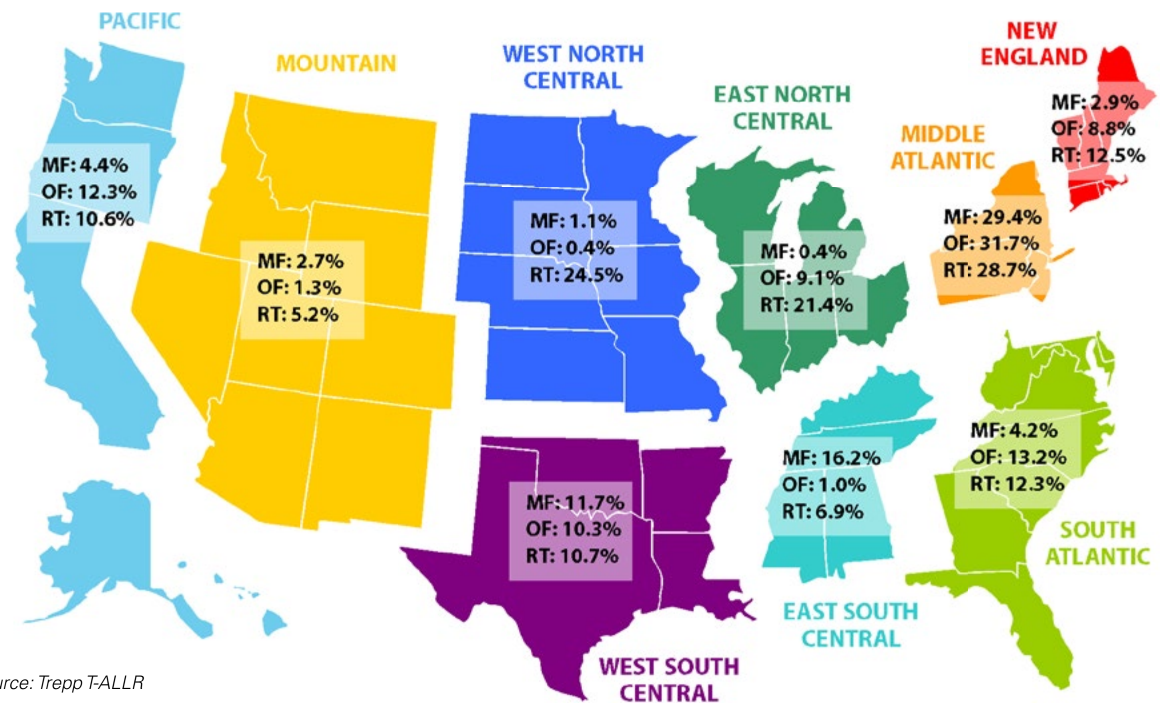
Risk Ratings – Broad Concerns About Retail, Regional Differences in Office and Multifamily

Criticized loan rates show significant variation across geographies and property types. When the pandemic hit in the first quarter of 2020, lenders were allowed to offer forbearance to COVID-impacted borrowers. If a borrower received forbearance, the loan would not be marked as delinquent. However, the lender was expected to update its risk rating on the loan, to reflect the lender's expectations for ultimate re-payment of the loan. So, while delinquency rates have shown a more muted response to the economic disruption of 2020, risk ratings started to adjust immediately.

- Lenders in the Mid-Atlantic have elevated concerns about risk across all three of the largest loan types. More than 30% of office loans – by loan balance – carry risk ratings of six or higher. The proportions for multifamily (29.4%) and retail (28.7%) are slightly lower. Pandemic-related concerns are still evident in the higher risk ratings.

- Risk ratings for office loans have increased, especially in the largest markets, as the long-term prospects for the sector have become less certain. The large and commute-dependent New York office market is the source of the Mid-Atlantic's high 31.7% proportion of

FIGURE 3: CRITICIZED LOANS BY REGION MULTIFAMILY, OFFICE AND RETAIL – Q4 2021



Source: Trepp T-ALLR

criticized loans. The other large metro areas with large central business district office markets – such as Boston and Chicago – are also driving double-digit proportions of criticized loans in the New England and East North Central areas.

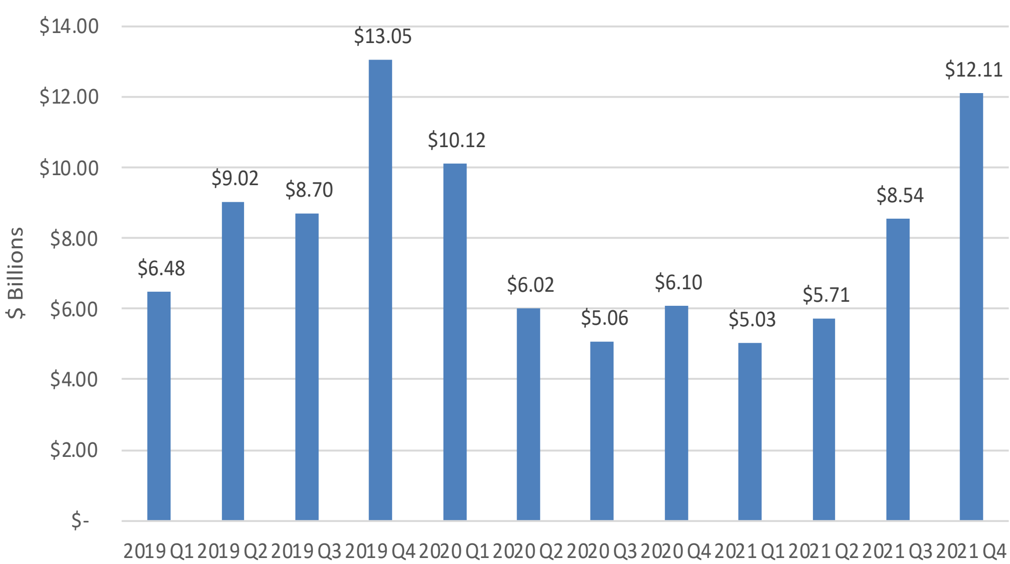
- Multifamily generally has a low proportion of criticized loans. However, lenders in several areas – from the West South-Central area, through the East South Central and up to the Mid-Atlantic area – were keeping a closer eye on multifamily. Many areas have recovered from the economic disruption of the pandemic, but lenders are still maintaining a higher level of vigilance.
- Retail loans are widely perceived to be at higher risk, with double-digit proportions of loans in the Criticized category. The areas with the lowest proportions of Criticized loans are the Mountain and East South-Central regions.

Origination Volume – Recovery Being Led by Industrial and Multifamily

New CRE loan originations increased substantially in Q4 2021 to about 30% higher than the pace in 2019. With economic growth, still-low interest rates, and the prospect of higher rates ahead, there is plenty of capacity for more borrowing.

- Industrial volumes more than doubled when compared to pre-pandemic levels, as lenders and investors have driven investment activity to record levels. The shift to online shopping and delivery has given a boost to a sector that was already growing rapidly. Concerns about supply chain susceptibility to disruption will likely lead to increased production of industrial space.
- Multifamily originations have caught up and surpassed the average pace in 2019. Despite increased concerns about the risk levels of some existing loans, multifamily is still seen as a safe sector and loan performance has been strong throughout the pandemic. Banks are competing with other lenders – especially the government-sponsored enterprises (GSEs), i.e., Fannie Mae, Freddie Mac – so liquidity within the multifamily sector is high.
- Office origination volumes have increased and are now on-par with pre-pandemic levels. Despite concerns about

FIGURE 4: COMMERCIAL MORTGAGE ORIGINATION VOLUME GETTING BACK ON TRACK



	Q4'21 AS % OF 2019 AVERAGE
Multifamily	152%
Office	103%
Retail	96%
Lodging	87%
Industrial	215%
Total	130%

Source: Trepp T-ALLR

the longer-term outlook for office, lenders and investors are still finding deals they can get comfortable with.

- After a drop in Q3, retail loan originations rose in Q4 and are nearly even with 2019 levels. As one of the hardest-hit real estate sectors in the 2020 downturn, lenders have been treading cautiously.
- Lodging recovered substantially in Q4, only slightly behind the pace pre-pandemic in 2019. Lending in the sector had been slow, so there is still capacity left to catch up with pre-pandemic volumes.

Looking Ahead – Inflation and Higher Interest Rates, Return to Office

The Federal Reserve now recognizes inflation as more sustained than it had previously thought, and interest rates are on the rise. Market expectations are currently for rate increases of approximately 300 basis points over the next two years. Higher interest rates could diminish demand and reduce real estate values (through higher borrowing costs). But in the longer-term, inflation should lead to higher rents and higher real estate valuations. With higher income and values, existing loans will see debt service coverage ratios (DSCRs) increase, and loan to value ratios (LTVs) decrease, which will make today's loan portfolios look less risky in the future.

Refinancing risk will remain a concern though, especially since the market has enjoyed the benefits of very cheap financing for several years. More companies and workers are returning to offices, though questions remain about the pace and breadth of the return. These questions could remain only partially answered for some time, as tenants and landlords try to establish what the new normal will be.

Meanwhile, Trepp estimates that more than $300 billion worth of office loans will come due in the next two years, so there could be some volatility ahead for both borrowers and lenders.

Disclaimer: Figures may have shifted somewhat from previous quarters due to the inclusion of new data rolling in

For more information about Trepp's commercial real estate data, contact info@trepp.com.
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About Trepp

Trepp, founded in 1979, is the leading provider of data, insights and technology solutions to the structured finance, commercial real estate and banking markets. Trepp provides primary and secondary market participants with the solutions and analytics they need to increase their operational efficiencies, information transparency, and investment performance. From its offices in New York and London, Trepp serves its clients with products and services to support trading, research, risk management, surveillance and portfolio management. Trepp subsidiary, Commercial Real Estate Direct, is a daily news source covering the commercial real estate capital markets. Trepp is wholly-owned by Daily Mail and General Trust (DMGT).

About T-ALLR

Trepp's Anonymized Loan Level Repository (T-ALLR) houses CRE and C&I data from large and mid-sized commercial banks. The T-ALLR Data Feed contains anonymized loan level and period level attribute and performance information on each loan. With 9+ years of history and new quarterly originations typically exceeding $7 billion for CRE and $9 billion for C&I, T-ALLR provides the breadth and depth necessary to gain insights into market activity, identify trends, and spot emerging pockets of risk and opportunity.