MOODY'S ANALYTICS | CRE

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The State of CRE Lending

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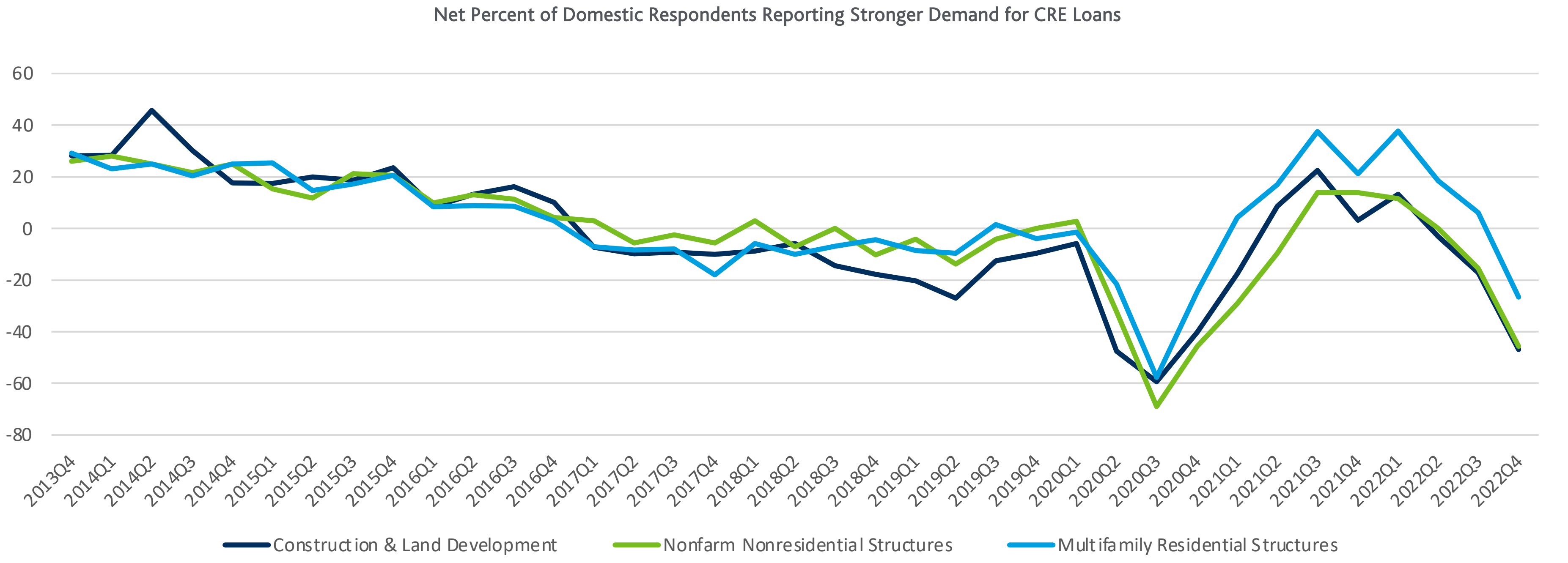
The Lending Environment in 2023: Rapidly Changing Dynamics

2021 was a record-setting year for Commercial Real Estate Lending. The Mortgage Bankers Association forecasted a high single digit growth rate in total CRE originations for 2022, with the spotlight on industrial and multifamily sectors.

Focus for lenders was on speed-to-decision – how to deploy resources quickly and effectively as a competitive advantage in order to capitalize on what was a record-breaking market

In the Spring and Summer of 2022, market dynamics started to change dramatically. A variety of factors have put pressure on loan origination volume – inflation, the Fed's persistence in raising target interest rate, stock market volatility, and pressure on cap rates, to name a few.



Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

The Lending Environment in 2023: Solving for Major Challenges

Two major concerns for the space are cap rates and refinance risk. We've seen a growing disjointedness between the 10-year treasury rate and cap rates. Over time, these two usually correlate together, but cap rates haven't adjusted as dynamically as interest rates, causing concern for some in terms of asset value.

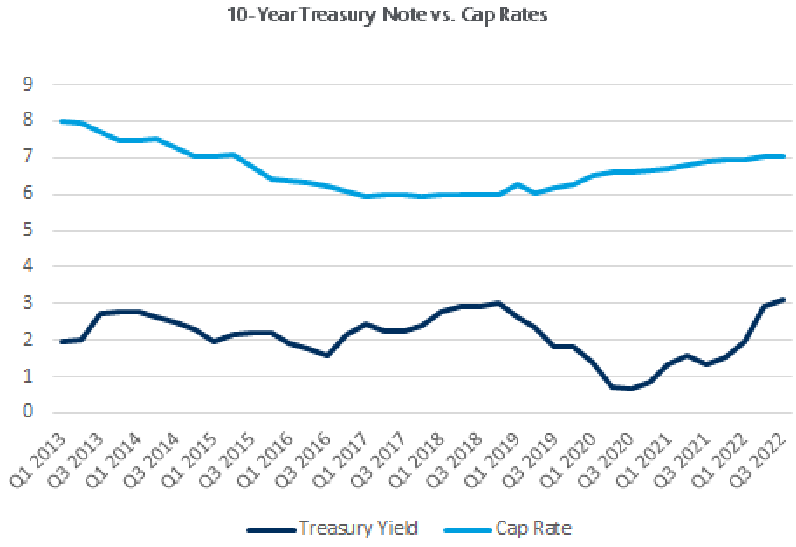
Now, lenders are bracing for what could be a sudden snap increase in cap rates, sending property values and loan security downwards.

This leaves Commercial Real Estate lenders with a great deal of uncertainty: can leases and rentals keep up with the increased cost of loans?

Due to persistently low rates over the past few years, maturity and refinancing risk have been relatively low.

However, massive interest rate hikes mean that lenders need to pay close attention to upcoming maturity loan dates, in order to avoid major hits to cash flow. Many deals were priced aggressively when interest rates were low, and now that rates have increased, the loan needs to be paid off at a much higher rate. Borrowers might struggle with the new terms.

Now lenders are left with a new challenge: determining the "what if" for a variety of interest rate scenarios.



Source: St. Louis Federal Reserve, Moody's Analytics

The Lending Environment in 2023: How to Respond

Lenders have had a range of reactions to the current environment – some have scaled back on CRE loans or pulled out entirely, depending on portfolio diversity and cash flow in other areas. To some, the spread and risk, and shock to the market just aren't worth it so they've moved to the sidelines in some cases. Smaller banks have been gaining a larger share of CRE lending recently. This may be due to a calmer regulatory environment when compared to their larger counterparts, the creation of new relationships with borrowers, and willingness to offer aggressive terms in order to win deals.

Even when working with long-term, trusted clients, lenders need to be careful in this kind of uncertain environment, where there isn't much room for error. Lenders have begun pricing with uncertainty in mind, and the market increasingly believes this uncertainty is here to stay, at least in the short to medium term. This level of caution extends past banks – developers are becoming more gun-shy too.

In some cases, the ability to lend aggressively has diminished as the year has progressed, as competition for deposits has increased. Banks that were flush with cash in January, thanks to pandemic-related savings behavior, are no longer, tightening the competition and highlighting the need for comprehensive risk management.

The focus on quick decision making and increased efficiency underscored the lending environment over the past few years. While these elements remain vital *lenders need to focus on future uncertainty, and risk preparedness.*

Analyzing Risks Earlier – Current Clients

The risk analysis step of the lending workflow can often lose priority to finding and securing new deals as well as renewing existing transactions. As the market tightens, this step has become more vital than ever.

Integrating risk analysis earlier into new and existing transactions can make the difference between a loan that's ready for approval and a loan that's "dead on arrival". The best way to avoid default and subsequent losses is by having a clear understanding of your loan portfolio. Make sure you're asking the right questions to existing clients. Which of your loans has the greatest potential to deteriorate over time? Do you sell the loan? What options do you have? Can you work out a deal with the client, like a principal reduction?

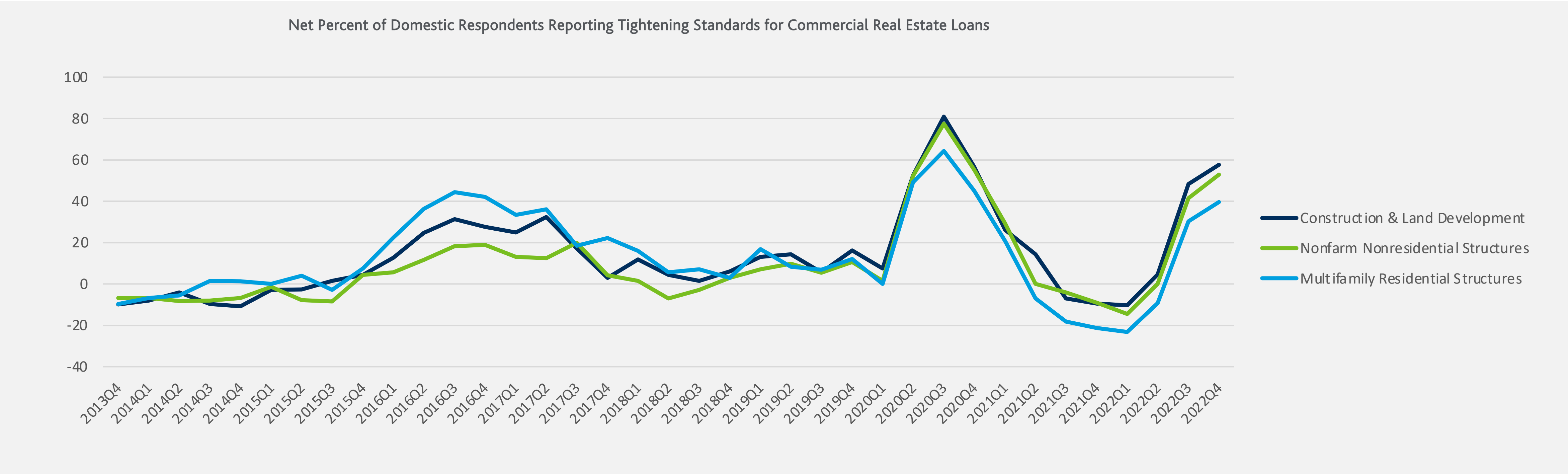
Discussing concerns with clients earlier cement your team as responsible lenders – ones that borrowers will want to continue to work with in the future. A client may surprise you and provide information such as market or asset-specific insights, that will influence your course of action. Having this discussion earlier gives clients more time to prep and leaves them in a better position to meet their obligations.

Incorporating risk analysis earlier will allow your team to do a better job at determining internal risk ratings. Do you need to downgrade loans? Or should you just flag them? Early risk analysis means you can attribute the correct amount of loan loss allowance for downgraded deals.

Analyzing Risk Earlier – Finding New Deals

The need for risk analysis earlier in the process applies to new deals, too. How can your team bring in the best borrowers and projects?

Because of rate hikes, there isn't a lot of proactive refinance activity happening. This can be good for maintaining your existing business, because borrowers aren't shopping around for new terms and deals, but it may be detrimental to securing new business.



General tightening of credit standards is leading to more conservative underwriting and pricing. According to the Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices in October 2022, a "major net share of banks" cited tightened standards for construction and land development loans, and nonfarm nonresidential loans. A significant share of banks reported weaker demand for all CRE loans in the US.

Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Creating an Integrated Lending Workflow

Creating an Integrated Lending Workflow

In times of uncertainty, it's normal to look inward and focus on streamlining your processes. In the CRE Lending industry, that means analyzing every step of your loan process to find room for added efficiencies. Is your portfolio diversified sufficiently? Are you prepared to handle a variety of risks?

Cost Efficiency

- Stay vigilant about operating leverage, as competition continues to compress margins.
- Learn how to do more with fewer resources and deploy the resources you do have efficiently and towards the right activity.

Time Efficiency

- Don't let cycle time slip. The same number of lenders are still in the market. Time to market is as vital as ever in securing deals.
- Reduce the number of disparate tools and applications your team uses, saving time and minimizing mistakes and human error.

Process Efficiency

- Create a workflow that integrates processes – from origination and underwriting to monitoring and management, all in one place.
- Utilize a responsive system that adjusts to changes, creating models and scenarios that update systematically.

Standing out in a Crowded Market

As the industry reacts to these changes, no one solution will fit every firm or bank. Within CRE Lending, each persona faces its own unique challenges:

LENDER NEEDS

- An easy view of the lending process from origination and underwriting to monitoring loans and managing credit strategy
- More data in order to gain more insight into the market and portfolio

UNDERWRITER NEEDS

- A streamlined and integrated underwriting process
- Workflows to enable better, faster decision-making via contextual insights, embedded risk management, and reduced cycle time
- A process for utilizing AI and machine learning tools to automate manual tasks

RISK MANAGER NEEDS

- Facilitated risk analysis with periodic review and alerts
- Integrations that help identify and flag potential areas of distress
- Workflow to analyze loans on the balance sheet coming due over the next few years

CreditLens™ CRE

Standing out in a Crowded Market

It all comes back to the question: how can your team be successful in these dynamic market conditions?

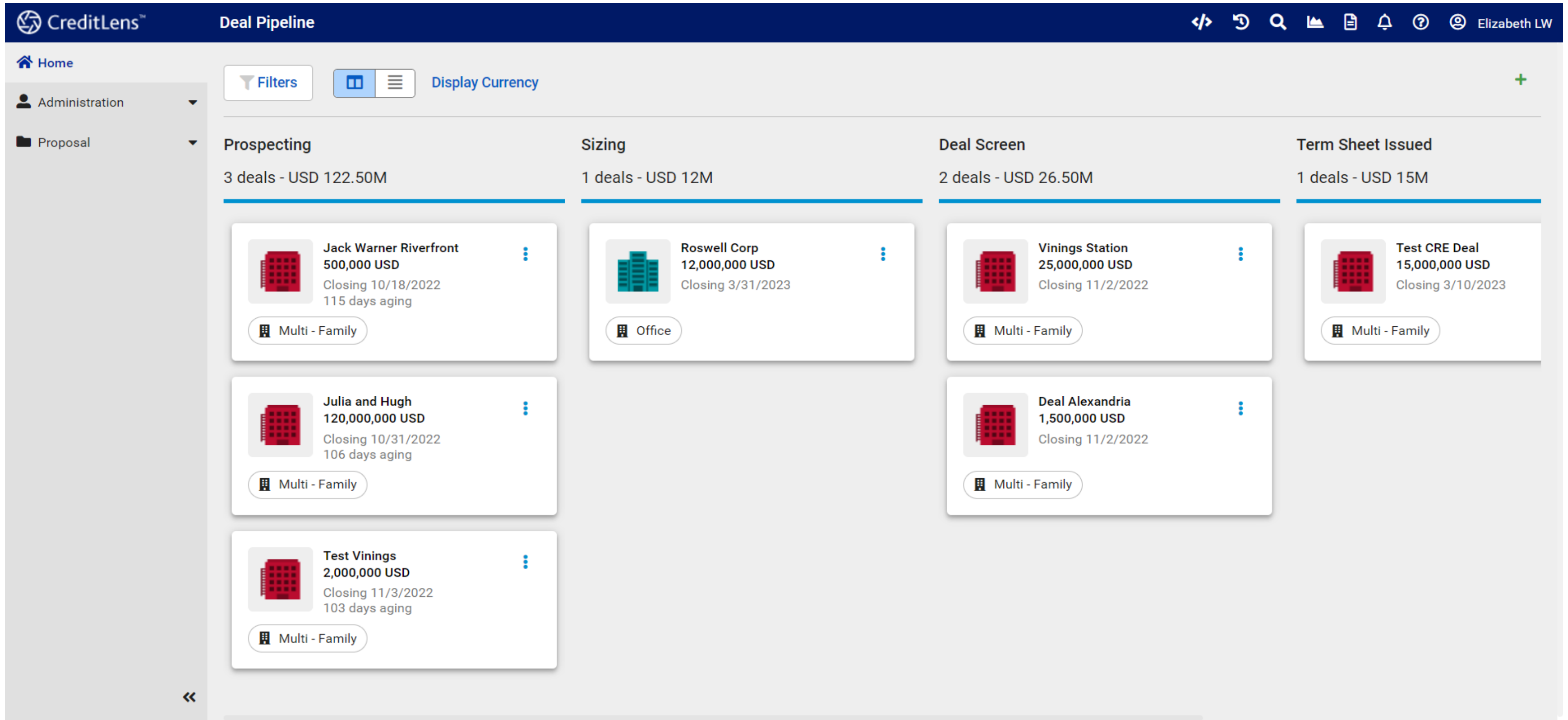
The difference between making competitive, compelling offers to potential borrowers without sacrificing your financial well-being all comes down to your team's technology.

Bringing together every step of your lending workflow can allow your team to be more agile and quicker to respond to changes in the market.

With CreditLens™ CRE, your team can run simultaneous scenarios at once. As you're quoting a deal and thinking about how to structure it, you can compare risk metrics under different assumptions, like term length.

CreditLens CRE forecasts and scenarios are updated much more regularly than other products in the marketplace, thanks to in-house CRE economists. This will mean your team is working off the most up-to-date information.

CreditLens CRE allows your team to be more dynamic and informed. You can understand your rent roll in detail, make assumptions about individual or tenant groups. This informs your cash flow projections, and your NOI in turn. By bringing together all these analyses within the same product, you can look at the upside, base, and downside scenarios simultaneously, and model how changes will affect you before they occur.



When one assumption changes, like an adjustment in the rent roll, CreditLens CRE cascades it down through the whole lending process. A change in rent flows down to NOI, your various scenarios, and allows you to issue a term sheet based on all of this analysis.

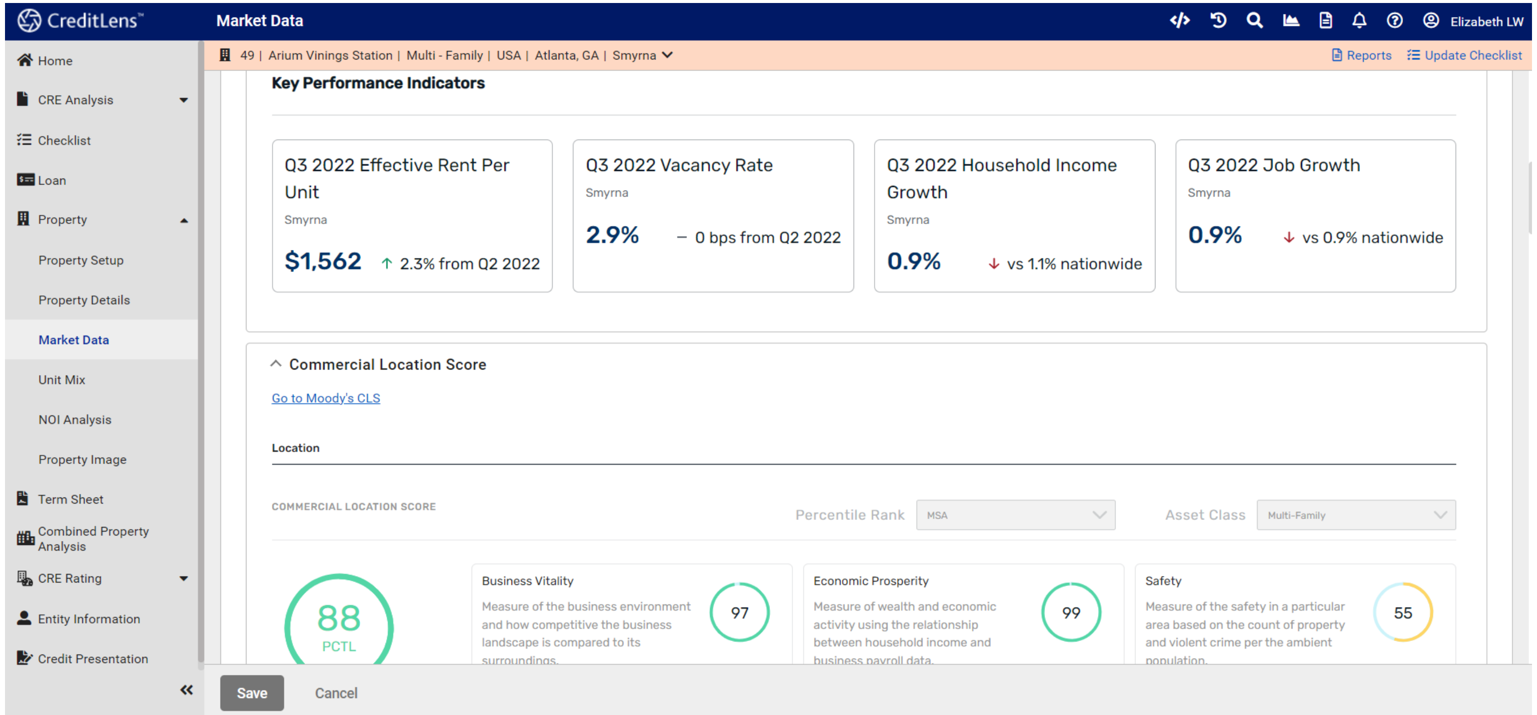
Property Data

CreditLens CRE is the only solution in the market custom-built for CRE, that combines proprietary data, market analytics, and workflows with API and open architecture.

Having property insights built into your lending flow gives your team a high-level view of the market. It allows you to see what's popular and what's oversupplied or undersupplied within a market.

Location and property type have historically been a focus when loan originations are down, and individual asset data can help you see where a property is sitting within the market. Is there a supply due to come online? How has demand been?

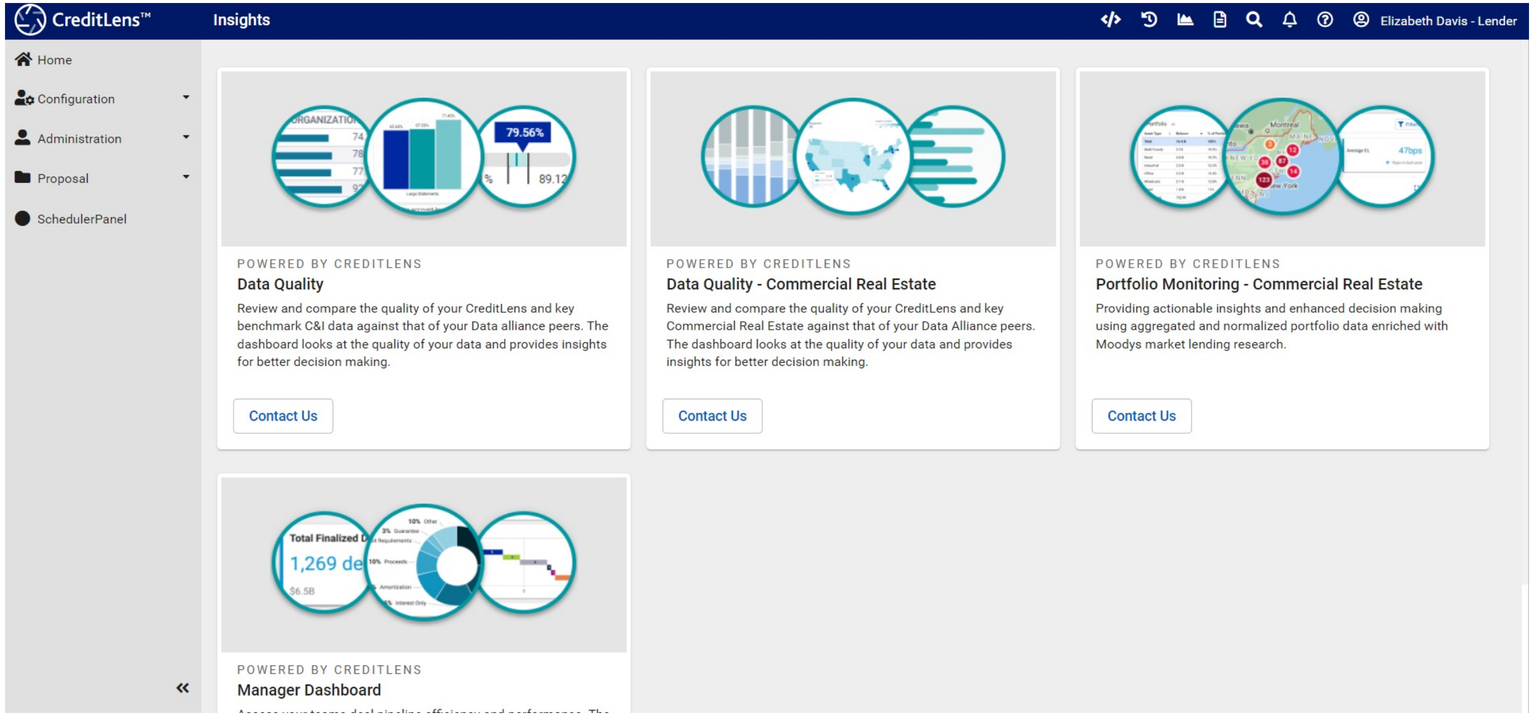
Overlaying this with Moody's Analytics CRE forecasts gives you a reliable, in-depth 3-5 year projection for your portfolio.



Portfolio Insights

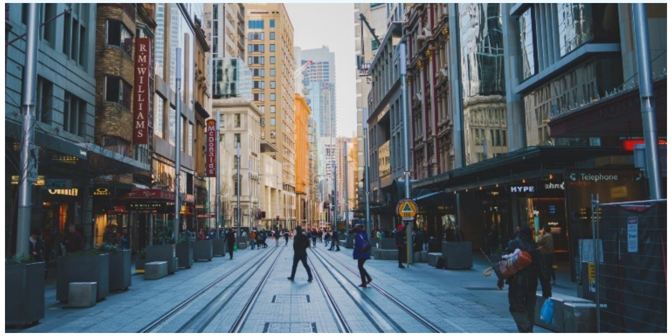
You can keep a close eye on your portfolio with CreditLens CRE thanks to automated alerts from Moody's Analytics Commercial Mortgage Metrics technology. This allows you to identify which deals are coming to maturity, and what that means for the client.

For new builds, you can track if the assumptions you made during construction, like occupancy and rent, are holding true. Viewing property and market data alongside your portfolio allows you to look at the market and know what rent levels you can charge, and if the planned rent is going to cover debt service at higher rates.



Moody's Analytics CL CRE provides customers with insight into their portfolio and market by understanding risk exposure and warning signs, and by integrating processes so all teams are aligned on market conditions and lending strategy.

During heightened economic uncertainty, transparency is key, and granularity is critical when there is no margin for error.

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