

Detect and Protect

A Fresh Take on CRE Collateral Monitoring

**VIGILANCE IS THE TASK AT HAND FOR SMALL-BALANCE LENDERS
THAT SUPPORT THE SMALL BUSINESS ECONOMY.**



BOXWOOD MEANS

Know the value of Main Street®

NO DIRECTION HOME — YET

The pandemic-induced lockdowns and social distancing protocols delivered a heavy blow to small businesses with estimates of up to 100,000 firms having permanently shut down across the U.S. While many segments of the economy are recovering, countless small businesses are still on the brink. Vigilance is the task at hand for small-balance lenders that support the small business economy.

The upheaval of Main Street businesses rippled briskly through small commercial real estate markets. Boxwood previously [detailed](#) how small-cap CRE vacancy rates increased across office, industrial and retail sectors as record negative net absorption wiped out occupancy gains accumulated over the entire previous two years.

While leasing conditions showed marked improvement during Q4 of last year, the pace of economic recovery is still anyone's guess. As the Federal Reserve stated in its semi-annual Monetary Policy [Report](#) to Congress earlier this month, "Insolvency risks at small and medium-sized firms, as well as at some large firms, remain considerable." The report also suggested that current peak-level commercial real estate prices are "susceptible to sharp declines" if the velocity of distressed property transactions picks up speed or the pandemic creates long-term, structural changes in leasing demand.

The verdict is still out on the long-term impact of the work-from-home movement on occupancy levels for office buildings. Overall office space demand is severely depressed, e.g., as of January the national sublet vacancy rate for small-cap office buildings matched the highest recorded level in over 15 years — set in 2009 during the Great Recession.

Additionally, the volume of distressed sales remains unclear largely because loss mitigation and forbearance programs by lenders have kept the lid on higher rates of loan delinquency and default.

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So, while CRE observers may disagree on which way the winds will blow this year, e.g., provoking a storm of distressed asset sales and price deflation, inviting a lukewarm recovery, kickstarting a post-Covid boom, etc., one thing is certain: Complacency about current property market and credit risk is a guaranteed ticket to some unexpected outcomes, or worse, loan losses.

Net-net: Prudent small-balance lenders will keep a sharp eye on the risks to their CRE loan collateral.

FOUNDATIONAL DATA

Gathering local CRE market data in support of loan transactions and monitoring is commonplace and rather straightforward. Via assorted local and national sources, lenders routinely gauge and correlate the likely impact of market-level trends such as supply and demand, sales prices, cap rates, and local economic/demographic developments on the investment risk of loan collateral and the portfolio. Naturally, the pandemic has produced disparate effects on varying asset classes, i.e., pummeling leasing conditions in office and retail sectors while only modestly weakening industrial and multifamily fundamentals.



Such CRE market information offers lenders useful but generalized insights about the locality. But it is the details and facts about the subject properties themselves that are the foundation upon which to monitor loan performance during all phases of the real estate cycle; and these requirements bubble up to the top of the list of priorities during periods of economic disruption or recession.

Lenders that procure rent rolls and operating statements, and obtain updated property valuations on a regular basis, are better equipped to detect problem loans in the portfolio and proactively protect their investments whether by modifying or extending loan terms, lowering rates, and/or deferring debt payments, among other options.

“As the saying goes, ‘Bad news never improves with age.’”

Indeed, early, energetic assessment of CRE collateral risk is a key to capital preservation and loss reduction efforts by bankers. As the saying goes, “Bad news never improves with age.”

(Cont’d)



Granted, collecting financial records from property owners is a burdensome and oftentimes futile exercise for lenders especially when it comes to less sophisticated, resource-challenged, or simply recalcitrant small-balance borrowers. Furthermore, loan officers who are frequently tasked with collecting such client documentation (post origination) typically have marginal interest or incentive to do so.

“...borrower noncompliance is a systemic issue and major pain point for financial institutions...”

As a result, borrower noncompliance is a systemic issue and major pain point for financial institutions that impedes the efforts of several internal constituent groups such as Appraisal, Credit/Underwriting, Loan Review and/or Portfolio Management. Noncompliance also undercuts the achievement of strong risk management practices expected by bank regulators such as quantifying loan risk and setting aside adequate capital reserves. And, lastly, it hinders third-party providers downstream, principally the lenders’ appraisal firms, external loan reviewers, and auditors.

A FRESH APPROACH

Current market uncertainties coupled with recurring institutional lapses in securing collateral updates merit a fresh approach to property data collection that can illuminate asset performance on a more consistent and reliable basis. When armed with more current information on items like contract rents, collections and deferments, physical and economic vacancies, expenses, valuations, etc., bankers across various departments can make more informed assessments of risky collateral on individual loans and collectively across the loan portfolio.

Such a data repository becomes even more valuable and actionable in transaction support and/or portfolio risk management when accessible through a loan monitoring system that can readily produce aggregated trend reporting on key loan and property metrics over time.

“...small-balance lenders can enhance their CRE loan and portfolio risk management capabilities by utilizing technology tools that support robust and timely credit decisions.”

To that end, small-balance lenders can enhance their CRE loan and portfolio risk management capabilities by utilizing technology tools that support robust and timely credit decisions. Such tools can:

- ▶ Capture, convert, and standardize borrowers' property financials and valuations into a centralized database powered by cloud-based, loan monitoring software.
- ▶ Deliver data, risk analytics, and reporting at the loan and portfolio level that can be stratified by variables such as asset type, building use, loan terms, property value, geography and more.

It is difficult times like these that challenge lenders to find new solutions that improve their credit decision-making. The slogan “desperate times require desperate measures” may seem a bit excessive and ill-fitting for today; but then again it may turn out to be the lenders' watchword if loan non-performance and losses begin to mount.

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