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Bankers Say Deal Flow, Interest Rates to Blame for CRE Drop-Off

Fed Survey Shows Lending Standards Tightened Nation-Wide

By James Sanna | Banker & Tradesman Staff | Nov 19, 2023

Bankers say the Federal Reserve's high interest rates are continuing to drag down commercial real estate lending as different market players are unwilling to lower their expectations of rates of return or prices of existing assets. iStock illustration

The fundamentals remain strong for most local property types, but commercial real estate lending still doesn't appear to have picked up even after fears of a bank failure-caused economic crisis dissipated this summer.

A quarterly report released by the Mortgage Bankers Association earlier this month shows that, nationwide, commercial real estate loan originations were down 49 percent by volume year-over-year across the country during the late summer and fall.

And a quarterly Federal Reserve survey of loan officers at 57 U.S. banks, released the same week, showed that two-thirds had tightened their construction loan credit standards either "somewhat" or "considerably" in the third quarter. A similar share reported doing the same for loans secured by multifamily properties, with smaller banks reporting significantly more tightening in both cases.

Some Massachusetts bankers say, unlike some of their colleagues in other states, they're still quite willing to lend – and it's not any change in their lending standards that are to blame for a drop-off in construction and purchase mortgages.

"It's not because banks are afraid," said James Rizzo, chief commercial banking officer at Hanover's Rockland Trust.

Strong Demand, Tough Ratios

Aside from the state's troubled office sector, most real estate investment classes are in good shape, said Bob Fraser, CEO of North Adams-based MountainOne Bank, which lends in both the Berkshires and Greater Boston. Multifamily developments, in particular, appear to be safe bets.

"The demand is still relatively strong given the shortage of housing. While absorption may be a little bit slower than the market's heyday [in 2021] it's at a pretty good clip," he said.

Greater Boston's diversified economy, in particular, is a buoy for bankers' sentiment, said South Shore Bank chief commercial banking officer Steve DiPrete. And plenty of developers still want loans to buy an existing building or build a new one.

The catch: Despite the Federal Reserve's recent pause in its interest rate-hike campaign the rates on many commercial real estate loans are upwards of 500 basis points higher than they were 18 months ago.

That's put developers in a tough position, Rizzo said, where they have to lower the size of a loan either putting significantly more money from investors or their own pocketbooks into a deal than they've had to in recent years or find ways to reduce the cost of a development. Alternatively, they can find ways to make an asset generate more revenue, he said.

"There are certain aspects of commercial real estate that just have to pencil out. You have net operating income [from a development] that can only service so much debt," Rizzo said.

But with construction costs not showing signs of falling and many renters seemingly nearing their upper limit on how much they can pay for housing and consumer credit card debt the highest it's ever been, Rizzo said, developers aren't left with many options when planning a new building unless they own their development's land or have some other edge.

Fewer Deals Need Funds

A similar problem afflicts developers looking to buy an apartment building or other existing asset.

"It certainly has almost stymied the acquisition market," DiPrete said. "As far as properties trading, you have very few because the cost of capital is higher than the [capitalization] rate. You have this inversion in what your expected return is."

And with the need to bring more money to the table to get a loan, investors and developers both have so far not shown much more willingness to accept a lower return on capital invested in a deal than they showed this spring, when the realities of the current interest rate environment began to hit home.

"What we've experienced is a rate shock" thanks to the Federal Reserve, Fraser said. "As it takes time for our balance sheets to adjust to that rate shock, it takes time for [a borrower's] business model to adjust to rate shock – and isn't that the intent of the Federal reserve, to slow things down?"

It's also hard for investors to find sellers willing to drop their prices in line with these new market realities thanks in part to what brokerage CBRE recently deemed one of the smallest multifamily construction pipelines

in the nation, said Helge Capital CEO Oleg Uritsky, and absent an economic crisis, few if any building owners are desperate to sell. It's helped notably reduce the number of deals advancing far enough to need financing.

"If new developments aren't coming out on the market next year and the year after, existing properties will be in demand, so there will be more pressure on the sale of existing multifamilies," he said. "That's another reason why sellers are saying 'Ok, if I can't get my price today and I don't have to sell, I'm just going to hold on and rents are going to go up.'"

Higher for Longer

Around the edges, though, some caution may be creeping into a few local bankers' thinking thanks to persistent uncertainty about the national economy's direction.

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"I would say [MountainOne is exercising] a higher level of prudence and looking at borrower liquidity so that they have the resources to manage a project if it lasts longer than originally anticipated, whether for higher labor costs, supply pipeline disruption or maybe a slower absorption rate" in the event of an economic slowdown, Fraser said.

Today's economic uncertainty, he said was "probably more than I've seen in my 40 years of banking."

One thing appears to be clear to local bankers, though: The current interest rate environment will likely last for some time, unless something tips the country into a recession and pushes the Federal Reserve to cut its benchmark interest rate.

"Do we see that changing in the foreseeable future, not really. Not in the next 18 to 24 months and beyond that it's not a crystal ball we have," Rockland Trust's Rizzo said. "We're expecting more of the same and preparing for that."

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