Extend, Forbear, or Foreclose? Lenders Consider Options as $929 Billion in Commercial Mortgages Set to Mature in 2024

With high interest rates and declining commercial property values, borrowers are facing a challenging situation as their mortgage loans reach maturity. In recent years, there has been a focus on loan workouts as both lenders and borrowers strive to navigate the current market conditions. However, loan extensions or short forbearance agreements cannot extend the due date of the debt indefinitely, and the amount of debt coming due in 2024 surpasses that of 2023. Consequently, even though lenders would rather not own underperforming properties, some may be compelled to take ownership by utilizing the ultimate remedy of foreclosure following an uptick in foreclosures after a slowdown during the pandemic.

Encouraging Loan Modifications

Loan modifications and extensions and forbearance agreements have been prevalent in recent years as lenders acknowledge the state of the market and are willing to work with borrowers facing circumstances often beyond their control. Last summer, lenders received additional guidance on best practices for loan workouts when the FDIC, along with the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and National Credit Union Administration, issued a new Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts. This 2023 policy statement replaced a 2009 statement and continues to highlight the importance of constructive negotiations between lenders and borrowers experiencing financial difficulties. The 2023 policy statement also introduced a new section on short-term loan accommodations, which encourages lenders to proactively work with borrowers and consider short-term solutions that can mitigate long-term effects.

Congressional Efforts to Encourage Loan Modifications

Congress has also been exploring ways to incentivize loan modifications, particularly through tax incentives. H.R. 5580 proposes excluding certain income generated by the discharge of commercial or retail indebtedness secured by specified real property for income tax purposes. The bill applies to indebtedness incurred before March 1, 2022, and discharged between December 31, 2022, and January 1, 2027. However, the bill has not made significant progress since its introduction in the House in September 2023.

Increasing Debt and Foreclosure Rates

At some point, lenders may find themselves exhausting other options, leading to foreclosure as the best course of action. Data from ATTOM reveals that commercial foreclosure levels, which reached a low point in 2020, have been steadily rising since the beginning of the pandemic. While a mere 141 commercial foreclosures were reported in May 2020, January 2024 witnessed a significant increase to 635. As more debt comes due, more lenders are likely to consider foreclosure as an option. Partly due to recent lender flexibility and short-term extension options, there has been a 28% increase in outstanding commercial mortgages maturing from 2023 to 2024. This year, $929 billion of the total $4.7 trillion outstanding commercial mortgages will reach maturity, with 25% of loans backed by office properties being affected. Office buildings pose a particular challenge, as significant office vacancy rates have given rise to the problem of "zombie office buildings." Marcus and Millichap's Senior Vice President and National Director of Research and Advisory Services, John Chang, predicts that older urban office buildings will pose the greatest risk of foreclosure.

Future Outlook

As the commercial real estate market gradually recovers from the impact of the pandemic, lenders may find ways to collaborate with borrowers and successfully circumvent loan defaults through loan extensions or forbearance agreements. However, for certain loans, especially those secured by distressed properties, lenders may reach a point where they can no longer delay the inevitable and opt for foreclosure.

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