

Impairments and Opportunities

The Current State of Commercial Mortgage Loans

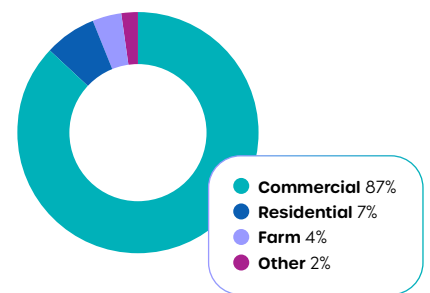
In the ever-changing landscape of the real estate industry, commercial mortgage loans (CMLs) hold a significant position, providing crucial financing options for various property types including retail, office, industrial, and apartments. As the market conditions, regulatory factors, and sector-specific challenges continue to evolve, it becomes imperative to explore the current state of CMLs. In this comprehensive analysis, we will delve into the key trends, opportunities, and potential concerns surrounding these loans. We will close with how technology is easing the accounting and reporting burden.

Investment Landscape: Who are the Key Players?

According to the Mortgage Bankers Association, over \$800 billion in commercial real estate loans were closed last year.¹ The biggest commercial lenders include banks such as Wells Fargo, JPMorgan, and Key Bank, and life insurance companies like Northwestern Mutual, MetLife, and TIAA. Stable long-term cash flows and historically low loss ratios make commercial loans attractive to life insurers, who have 13% of general account assets invested in mortgages of some type. Property/casualty, health, and title companies hold less than 2% of assets in mortgage loans. Not surprisingly, the overwhelming majority (87%) of mortgage loans held by insurers are commercial loans, with lesser amounts in residential (7%), farm (4%) and other (2%).²

13%

**Life Insurance Assets
Invested in Mortgages**



**U.S. Insurer's Mortgage Loan
Exposure (by Loan Type)**

Source: NAIC Capital Market Bureau 2021 BACV

Total U.S. Insurance Industry Cash & Invested Assets (by Asset Class & Insurer Type)

Asset Class	Year-End 2022 (BACV\$ in Millions)					% of Total
	Life	P/C	Health	Title	Total	
Bonds	3,630,254	1,248,301	189,308	6,127	5,073,991	62.3%
Common Stock	210,618	817,493	43,830	2,847	1,074,789	13.2%
Mortgages	695,160	29,372	514	12	725,059	8.9%
Schedule BA & Other Assets	324,657	188,258	21,552	384	534,851	6.6%
Cash & Short-Term Investments	143,957	158,127	70,160	2,176	374,420	4.6%
Contract Loans	131,852	2	1	-	131,855	1.6%
Derivatives	95,430	2,350	6	-	97,787	1.2%
Real Estate	22,611	13,147	6,174	206	42,138	0.5%
Other Receivables	31,799	5,093	752	14	37,658	0.5%
Preferred Stocks	17,195	16,526	988	177	34,886	0.4%
Securities Lending (Reinvested Collateral)	14,329	6,196	2,641	-	23,165	0.3%
Total	5,317,863	2,484,864	335,927	11,943	8,150,598	100%
% of Total	65.2%	30.5%	4.1%	0.1%	100%	

Note: Numbers in the table have been rounded. | Source: NAIC Capital Markets Bureau

¹ MBA. 2023. "MBA Releases 2022 Rankings of Commercial/Multifamily Mortgage Firms' Origination Volumes." <https://newslink.mba.org/mba-newslinks/2023/march/mba-newslink-thursday-mar-23-2023/mba-releases-2022-rankings-of-commercial-multifamily-mortgage-firms-origination-volumes/>

² NAIC Capital Market Bureau. 2023. "Capital Markets Special Report." <https://content.naic.org/sites/default/files/capital-markets-special-reports-asset-mix-ye2022.pdf>

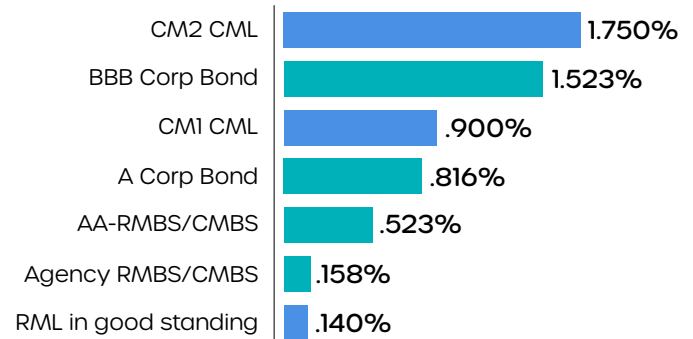
Market Outlook and Opportunities: Navigating Uncertainties

Historically, CMLs have provided excess yield over comparably rated bonds of at least 25–50 basis points, with lower loss ratios. The NAIC rewards this lower risk profile with favorable risk-based capital charges. Mortgage loans have the advantage of collateral to cushion the blow of default. This lack of “cliff risk” in recovery value makes mortgage loans much more attractive in a volatile economy. While they may certainly suffer defaults in an economic downturn or high inflation environment, losses will typically be less than unsecured corporate bonds or non-AAA tranches of structured securities. Still, higher yields and better downside protection have failed to lure investors back into the CML market in 2023.

Granted, the current outlook for CMLs is clouded with uncertainties, ranging from low transaction volume (and thus price discovery) to higher loan-to-value. Higher interest rates imposed by the Federal Reserve have increased borrowing costs and lowered real estate values. Clearwater has seen clients impair CMLs. Nevertheless, amid these increasing challenges, our recent interview with Gregg Michaud of Voya Asset Management identified several opportunities to astute investors in the market.³

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NAIC RBC (Life) Private vs. Public Loans



RETAIL: The retail sector experienced losses even before the Covid pandemic as malls fell from favor and several big-box retailers failed. When the pandemic hit, additional brick-and-mortar retail loans were impaired as consumers made purchases online. According to Voya, this shakeout in retail has been good for the *future* of retail commercial loans (although not so great for those holding the bag on current mall loans). Some underperforming and out-of-date retail concepts have been replaced by retail/entertainment venues, and stronger tenants now occupy properties. Recent rent growth is rising low-single digits and consumer spending is strong. Therefore, retail CMLs should provide investment opportunities.³

OFFICE: Office loans are a different story which require more due diligence on the part of the lender. The pandemic hit downtown office space hard, and work-from-home is not only a result of the pandemic, but a shift in demographics.⁴ The office sector, particularly in super-commute areas such as San Francisco, New York, and DC, has faced considerable challenges. There may be no “return to normal” for office properties. Lenders are seeing properties being given back by major investors.⁵ Typically, lenders to real estate are not interested in holding real estate equity, choosing instead to sell at fire sale prices. Not only are bondholders left holding the bag, they also need to write down values to reflect the market. According to Voya, it is early enough in the downturn that lenders are wise to tread with care on new office investments.³

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³ Clearwater Analytics. 2023. “Commercial Real Estate Investing: Panic or Patience?” <https://clearwateranalytics.com/resources/on-demand-webinars/commercial-real-estate-investing-panic-or-patience/>

⁴ Wall Street Journal. 2023. “Industries Reliant on Thriving Downtowns Suffer From Remote Work.” <https://www.wsj.com/articles/woe-in-office-market-from-remote-work-spreads-to-multibillion-dollar-ecosystem-d195809e?page=1>

⁵ Commercial Observer. 2023. “A Flood of Defaults Swamps Big Names and Big Properties, Especially Offices.” <https://commercialobserver.com/2023/03/default-floor-brookfield-blackstone-columbia-property-trust/>

Property Sector Summary

Multifamily
Preferred asset,
limited transactions

Industrial
Strong outlook
despite supply

Retail
All time low
vacancy with little
new supply

Office
Liquidity
& valuation a
challenge in 2023

Spreads and Relative Value*

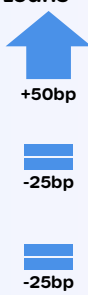
Core Loans

- Coupons
5.50 – 5.75+%
- Spreads
+175 – 215+
- Relative Value
+90 – 125+



Transitional Bridge Loans

- Coupons
8.25 – 8.75+%
- Spreads
+325 – 375+
- Relative Value
+250 – 300+



*Represents change from 4Q 2022 to 1Q 2023. Core spreads are estimates of fixed-rate, 7-10 year maturities rated A-/BBB+ on Voya's proprietary rating model. Transitional Loan spreads are estimates of floating-rate, 3 year maturities rated BBB/BBB-. Relative Value compares commercial mortgage loan spreads to public corporate bonds with similar rating and maturity.

Lending Risk Scale

Collateral & Locations

- Keeping at Medium, but remains higher up the spectrum
- Cap rates likely still rising in all locations and property types

Underwriting

- Keeping at Low
- Lenders holding underwriting standards



Early Warnings

- Keeping at Medium, but moving higher up
- Bid/Ask gap continues, limiting transaction volume
- DSCRs on floaters causing some stress

Loan Structures

- Moving closer to Medium given some lender friendly structures already starting to be waived
- Appropriate reserves and caps

INDUSTRIAL: The industrial sector, fueled by the rise of e-commerce and logistics, presents a promising opportunity for investors seeking stable returns. Warehouses are cheap and fast to build, meaning they are less likely to be overbuilt or overvalued. Warehouses rarely sit idle without rental income. This stalwart commercial mortgage sector does not provide the highest return, but it continues to serve well as a stable investment.

MULTIFAMILY/APARTMENT: Multifamily real estate is holding up better than expected given the fast pace of development.⁶ Vacancies are increasing, but mostly in high-end, big-city properties where workers are having trouble covering steep rents. Class B apartments (think 25+ years old with minor updates) are occupied and provide enough cash flow to cover debt service. A typical Class B apartment tenant works in the trades, where employment remains strong.³ There is still a lack of single-family homes, which also helps apartment values. One factor that could hurt the multifamily sector is higher unemployment.

TAKING ADVANTAGE OF TECHNICALS:

- Now is the time to demand more liquidity premium, according to industry participants. There is a small secondary market for CMLs, but it dries up during times of stress. Lenders should be paid more for the (small but) increasing probability of default and potential unintended management of the property.
- An investor may be able to take advantage of forced selling of mortgage loans by banks. Banks have been increasing liquidity and asset-liability matching at the behest of regulators.
- Insurance companies, other than the largest few, have room to add CMLs. The large life insurers with built-in origination departments have excess capacity. They are happy to source and manage loans on others' behalf. The low marginal cost to the large originators means small and medium insurers can outsource CML management for a low cost.

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Lessening the Burden of Accounting for CMLs with Technology

One of the biggest needs we hear from investors in CMLs is the need for automation to support accounting and reporting. Clearwater has made a significant investment in streamlining accounting for CMLs including:

- Direct data feeds with loan servicers and CML managers to reduce errors and increase timeliness of data
- Supporting look-through visibility of underlying loans in a pool
- Combining data from CMLs with all other investments, allowing portfolio-wide calculation of duration, sector exposure, book yield, etc.
- Projecting CML designations based on loan amount and property valuation
- Greatly increasing the ability to determine credit exposure. Notably, exposures can be aggregated with other asset classes. Amazon stock exposure can be combined with the Amazon credit tenant loan on Schedule D and the Whole Foods tenant in the retail strip mall CML
- Improved compliance testing on the *entire* portfolio, including CMLs
- Ability to look-through loan pools and receive favorable risk-based capital treatment. While the pool may be shown on Schedule BA, the RBC charge for life insurance companies is the same as if loans were individually placed on Schedule B
- Ability to tag loans pledged to the FHLB and track spread-investing portfolios
- Consistent, polished, timely reports

Clearwater believes that a company's accounting processes should not limit their ability to invest. Our product continues to evolve with the market, and we welcome client input.

Want to learn more about Clearwater for CMLs?

Speak to an Expert ·>

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