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The Imperative Need for Enhanced Oversight of Commercial Real Estate Loan Portfolios

In the wake of the Great Financial Crisis of 2008 (GFC), the landscape of banking and financial servicing underwent significant transformation. One area that saw notable changes was the management of real estate loan portfolios at state and federal banks. Historically, banks maintained specialized units known as Special Assets Groups (SAG Divisions) to handle loss mitigation, workout, and restructures for any of their borrowers, commercial or residential. However, post-GFC, many banks opted to dismantle these divisions, outsourcing the stress in their residential books to third parties. While the major banks have maintained skeleton SAG Divisions, these departments are considered an option of last resort for portfolio managers and executives inside the bank. As interest rates rise and regulatory scrutiny intensifies, there is a pressing need for better oversight of commercial real estate loan portfolios. This document explores the necessity for reinstating robust portfolio oversight, the potential role of third-party advisors in providing objective analysis and more efficient execution, as well as the increasing importance of loan-by-loan evaluation for optimal portfolio performance.

The Evolution of Oversight in Commercial Banking

Before delving into the current landscape, it's essential to understand the historical context. Prior to the GFC, banks relied heavily on internal SAG Divisions to manage distressed loans and mitigate losses. These specialized units possessed the expertise to navigate complex loan restructurings and negotiate with borrowers to achieve favorable outcomes.

The aftermath of the GFC brought about a paradigm shift in banking practices. Faced with increased regulatory scrutiny, capital constraints, and a heightened focus on headline risk management, many banks made the strategic decision to dismantle their SAG Divisions. Instead, they sought to streamline operations, reduce costs, and enhance efficiency by integrating loan management functions into broader departments and outsourcing most borrower interface and REO management to third parties.

While all eyes were on residential real estate, most commercial loan distress was easily managed by bankers able to offer extend-and-pretend measures and lower rate bailout loans available during a declining interest rate environment. The elimination of SAG Divisions at banks also seems logical from a banker's perspective since assets assigned to that department require the bank to cover those potential capital losses. The Troubled Debt Restructure (TDR) is a new loophole created post-Covid that allows for banks to restructure loans and consider them as accruing even when the terms may change significantly.

A Need for Enhanced Oversight in the face of Rising Regulatory Scrutiny

Fast forward to the present day, and the banking landscape is once again undergoing significant changes. With interest rates on the rise and memories of the GFC fresh for older bankers but non-existent for the new generation, regulatory agencies such as the Office of Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) are tightening their oversight of banks. This increased scrutiny stems from a desire to ensure financial stability, mitigate systemic risks, and protect the interests of depositors and investors. It also derives from a known fact that when interest rates rise, some sponsors will not handle it well and many deals will no longer pencil. Commercial office buildings in major metropolitan cities face a double whammy because of the paradigm shift created by COVID. Banks historically have chosen to portfolio these office loans, once considered to be the most stable.

We are seeing a huge increase in TDR levels of CRE loans at $30B+ banks. Video CLICK HERE.

The absence of specialized units dedicated to managing distressed assets becomes a glaring deficiency. Without the expertise and focus of dedicated teams, banks will struggle to effectively identify and address emerging risks within their existing loan portfolios. A lack of action can leave a bank vulnerable to maturity mismatches, loan losses, sharp increases in defaults, eroding investor confidence, and could further undermine the stability of our financial system, if this problem becomes systemic.

The Role of Third-Party Entities in Providing Objective Analysis

Recognizing the need for enhanced oversight, banks must explore alternative approaches to managing their commercial loan portfolios beyond the role of the special servicer. One promising solution lies in engaging third-party entities such as trustees, consultants, private firms, or other banks to provide independent analysis and oversight. By outsourcing these functions to external specialists, a bank can benefit from objective evaluations, specialized expertise, and access to best practices unvarnished by internal motivations or politics. An external perspective can help banks to identify blind spots, challenge existing assumptions, and make more informed decisions.

LLM Loan Loss Mit An MWOB joint venture between LCR Management and First Lien Capital. Founders Erick Gonzalez, his wife Linh Ho, and First Lien CEO Bill Bymel created Loan Loss Mitigation LLC (LLM) specifically to serve banks facing dislocation in their whole loan mortgage portfolios. LLM currently manages over $80 million of equity capital on behalf of First Lien, a mix of residential performing and non-performing loans as well as vacant HECM REO properties purchased from HUD. The HECM fix-n-flip strategy is one that LLM specializes in, and LLM has several third-party clients in this strategy.

In November 2023, LLM became an approved Asset Manager by the FDIC as part of First Lien's approval to bid the Signature Bank Commercial Loan Sale. LLM has existing relationships with most mid- and top-tier loan servicers. LLM provides expertise in all major metropolitan markets including New York, Los Angeles, Chicago, Miami, Palm Beach, Las Vegas, Detroit, and Washington DC. The Founders have worked together through multiple organizations over twelve years and have combined in the direct acquisition, management, and profitable resolution of over $500 million of invested equity together.

LLM conducts comprehensive assessments of an investor's balance sheet and deep dive into loan and real estate portfolios, identifying potential areas of weakness, assessing credit risk, deciphering true value, recommending appropriate strategies for risk mitigation, and most importantly, implementing the appropriate mitigation path in a proactive and cost-effective manner.

The Importance of Loan-by-Loan Evaluation for Optimal Performance

The reason to outsource loan portfolio oversight stems from the importance of conducting thorough, loan-by-loan and property-by-property evaluations of the commercial and residential loan portfolios. A holistic, borrower-first approach that considers each loan and property on its own merits is essential for optimizing portfolio performance and minimizing losses. This also ensures good customer service and the potential to retain that distressed borrower, by providing a single point of contact outside the bank that can act as an objective intermediary, not a debt collector. Using LLM as an intermediary enables borrowers to address concerns outside legal foreclosure. This allows for a confidential, non-binding environment to negotiate payoff or settlement terms and explore potential workouts or restructures. This personalized approach not only fosters stronger relationships between banks and borrowers but is also critical to achieving the most mutually beneficial or win-win outcomes.

Current Headwinds in Commercial Real Estate

Several factors are creating instability and uncertainty in the commercial real estate market with the sharp rise of interest rates from zero to normal being only one factor. The rise of tensions with foreign trading partners, political instability at home, extreme weather events and its effect on insurance rates, and the COVID-influenced shift from city centers to suburban or live-work models, all could cause dislocation in sectors of commercial real estate:

1. Interest Rates: Many loan officers, asset managers, and bankers are too young to know what a normal interest rate environment feels like and how to navigate that cost of capital.
2. Climate Change: Rising insurance costs are already having an adverse effect on commercial property prices in high-risk zones prone to hurricane, fire, flood, and tornado. Banks need to reassess seasoned mortgage portfolios to lessen liability by reducing exposure in these areas.
3. CBD Metro Office: Once considered the darling loan asset for bank portfolios due to their safety and security, downtown office sponsors now face huge vacancies, and many will default.
4. NYC Rent Control: In 2019, a new law stripped speculators' ability to convert rent-controlled and rent-stabilized buildings in New York City and further limited existing operators' ability to increase revenue. Faced with rising costs and greater HPD expectations, many will default.
5. Multi-Family Dislocation: The fallacy that low-rise apartment complexes in middle America will price at sub 5% CAP is quickly disappearing and as maturities happen, MFR sponsors will default.
6. Geopolitical Events: The rise of tensions in the Middle East and Eastern Europe combined with concerns over a direct conflict with China, should be hedged. Chinese banks own the largest concentration of commercial and residential mortgage loans outside the United States.
7. US Political Unrest: A rise in political unrest as well as continual mass casualty events is causing a shift in retail demographics as well as adversely affecting downtown metros, especially in cities where less enforcement exists, and crime is rising. Banks can address these risks now.

The Time is Now – Our Win-Win Revolution

The need for better oversight of commercial real estate loan portfolios at major and regional banks has never been more urgent. As interest rates rise and regulatory scrutiny intensifies, banks must evaluate their approach to managing any potential rise in defaults and mitigate risk now before it becomes a stain on balance sheets or risk to the health of the bank. By adopting a proactive and comprehensive approach to oversight, including the use of outside advisors like LLM (a *Special Assets Group for hire*), banks can position themselves for long-term success and safeguard the interests of all stakeholders. Banks currently find themselves ill-equipped to effectively navigate the complexities of commercial loan portfolios, particularly in an environment characterized by evolving borrower needs.

LLM and First Lien are partnering with serious players to support this mission.

We may rebrand this venture LoanDR™. Doctor in da house to assess the health of your portfolio.