Extend-and-Pretend Drives Record Loan Modifications

Loan modifications surged to $35.5 billion amid rising defaults.

By Erik Sherman | January 29, 2025 at 06:58 AM

Long-standing predictions that many CRE loans would eventually get into trouble might be right. CRED iQ looked at data over the last three years across CMBS, SBLL, CRE CLO, and Freddie Mac loans.

There was "steep growth in modifications" over this period, with 2,778 loans at a total balance of $35.5 billion that were modified through a "lumpy pattern but consistent overall growth," according to the findings. Filings varied from 52 properties in January 2022 at $584.1 billion in balances to only five properties ($157.5 million) in January 2023. December 2024 saw a higher number of loan modifications, comprising 347 loans and $1.1 billion in value. The highest loan value was in April 2024.

There are some examples of the current dynamics. Energy Centre is a 757,275-square-foot office property in the French Quarter of New Orleans. Backing a $53.3 million loan, there's also an additional $8.7 million in mezzanine financing. Fast-approaching monetary default set off a transfer to a special servicer in September 2023. The extension of the loan supposedly closed in October 2024, but there is no new updated maturity. The valuation grew from $83.6 million at origination to $92.6 million last January. As of December 2023, DSCR was 1.75, and occupancy at the end of 2024 was 86%. Those numbers would seem to support the ability to pay debt service, but would it qualify for refinancing?

Then there is RFR's 17 State Street. The CMBS loan was due in August 2024 and the firm hadn't found new financing. And then, RFR announced refinancing for the 42-story, 571,000-square-foot tower on January 22, 2025. "RFR's commitment to holding our prized properties has never wavered," said Aby Rosen, co-founder and principal of RFR, in prepared remarks.

According to Fitch Ratings, loan modifications are likely to continue. It said that those increased loan modifications along with improved CRE loan refinancing and strong new issuance volume will help temper an ongoing rise in overall delinquencies through this year. The higher levels of maturity defaults, which will be particularly present in Class B and C offices, as well as lower-tier malls, will happen because of still-elevated interest rates, deteriorating operational fundamentals, tight lending, and an eventual reduction in times allowed for workouts and fewer special servicing options.

The lingering question is how long the modifications will be offered. All along, the hope in the industry has been that lenders could justify modifications, putting off taking actions like foreclosure and defaults because eventually interest rates would return to where they had been and the circular pattern of refinance under interest only, come to maturity, and refinance again would restore balance.

There are two problems with that scenario. One is that the Federal Reserve looks like it plans to hold rates steady for a potentially long period. If there were a sharp increase in unemployment or if the economy faced a recession, it would have a reason to drop rates. But as things are, it may be that the so-called neutral interest rate, which neither encourages nor discourages economic growth, may have shifted and might be higher, as has been true in the past. The effect of the Fed not lowering rates primarily affects bridge and construction lending, which are tied to shorter-term rates.

The second problem is the bond market. Yields for the 10-year Treasury have been volatile while staying well above the 4% mark. There is strong concern among investors that inflation combined with higher national debt will keep yields up or drive them even higher. That means the risk-free portion of interest rates stays higher, and so longer-term lending will likely stay more expensive.

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