# Outlook for Commercial & Residential Mortgage Finance

WGA

Whalen Global Advisors

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# Mortgage Sector Trends

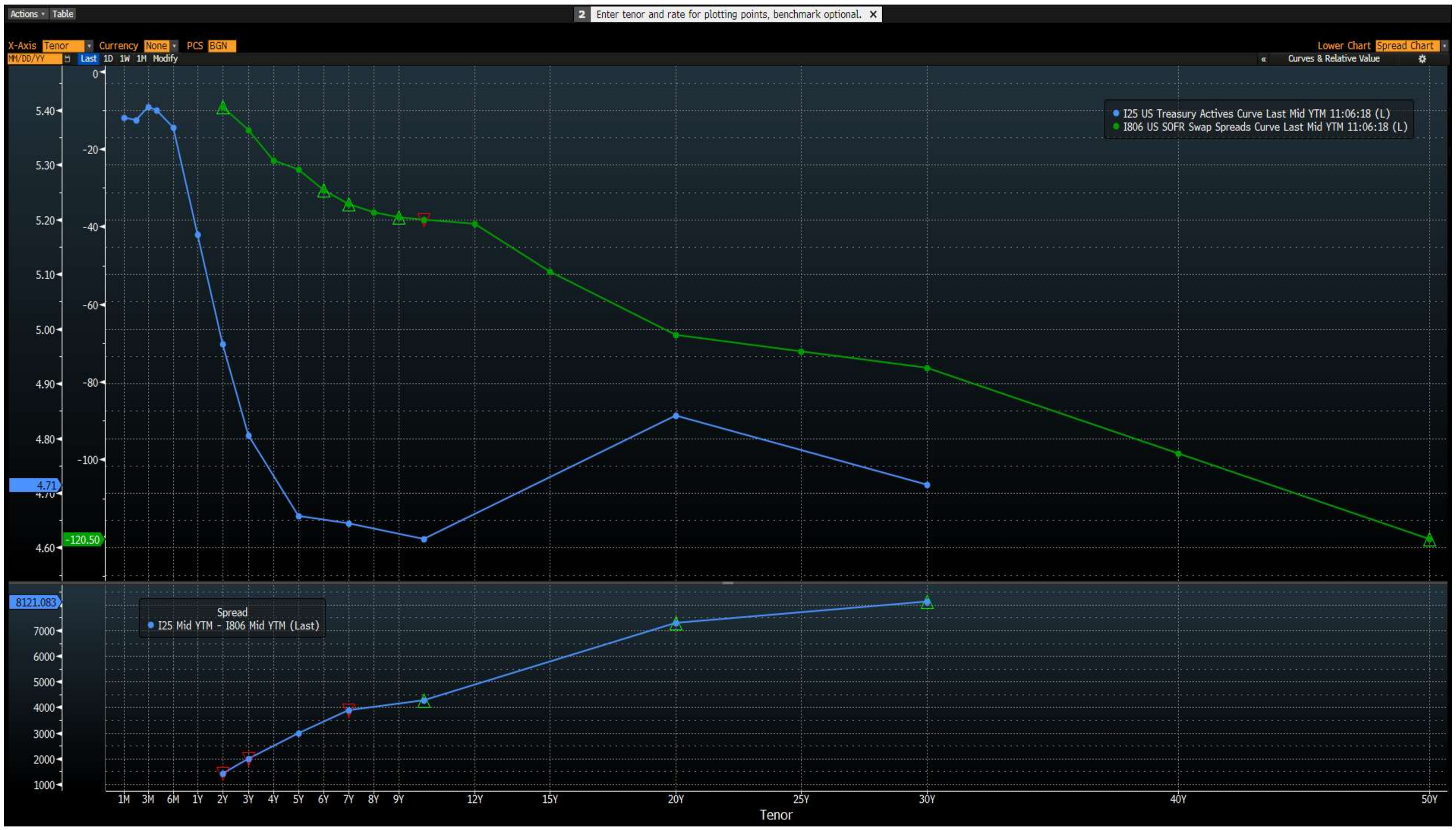
- The $20 trillion US commercial real estate (CRE) market, includes office buildings, retail space, commercial properties and multifamily housing assets. CRE is undergoing long-term deflation in asset values. *The change in direction of CRE valuations is a massive deflationary reversal*.
- Declining CRE valuations are driven primarily by higher interest rates, but specific factors also contribute. Changes in behavior of businesses and consumers, and socialist policies in a number of blue cities and states, negatively impact asset values.
- Even as many commercial assets come under pressure due to credit defaults and a general trend toward reducing office space, the $13 trillion residential sector remains relatively quiet. Default rates are subdued due to the Fed's aggressive actions in 2019-2022, but a residential home price reset is likely later in the decade.

# Commercial Mortgage Finance

# Commercial Real Estate (CRE)

- The MBA reports that > 90% of respondents have a "very negative" attitude regarding the $20 trillion CRE market. Significantly, office market fundamentals are seen as bigger negative than interest rates.
- Multifamily assets are fairing better than office CRE generally, but states with aggressive consumer laws (NY, CA) see valuations negatively impacted. Astute investors assume high rate of tenant turnover in all office due-diligence investigations.
- Falling valuations and rent rolls cause lenders to be cautious about underwriting new CRE exposures and negative on retaining impaired loans. Many NYC rent stabilized assets are unfinanceable by banks and now face a cash investor market.

# Higher Rates, Lower Valuations

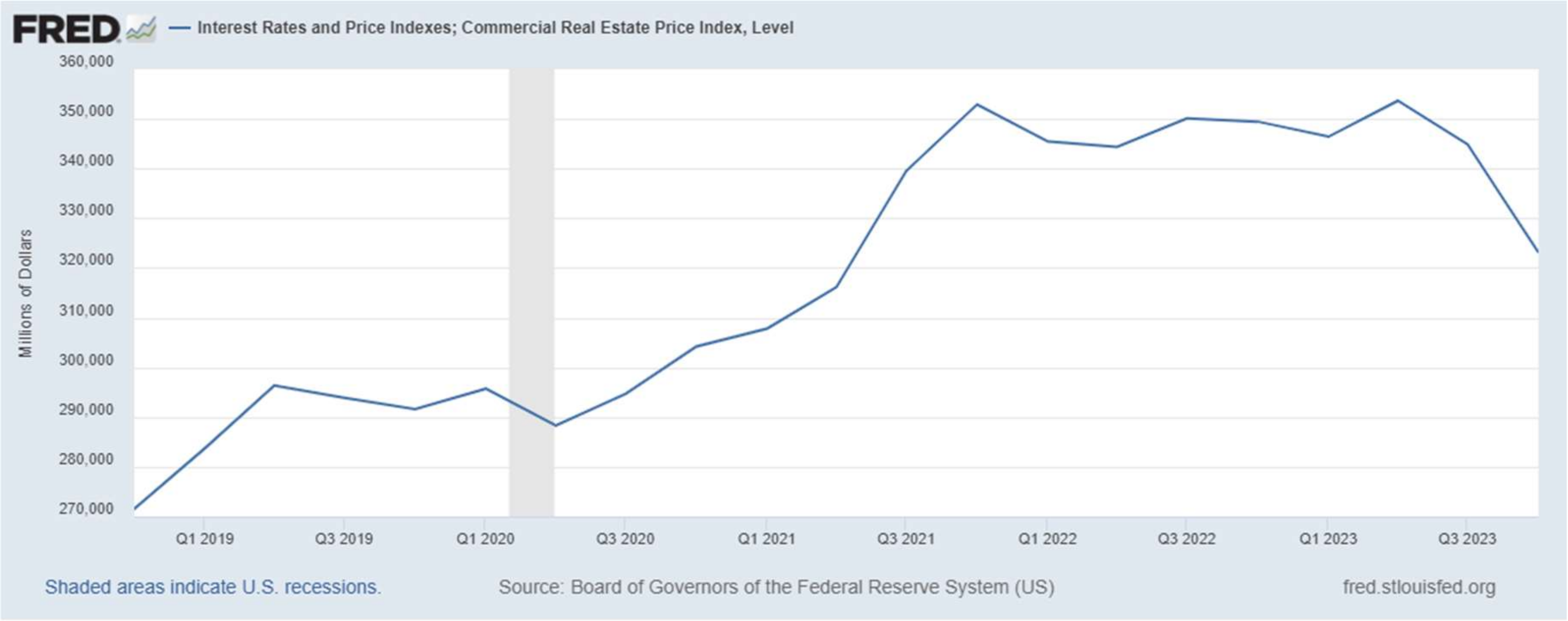



Source: Bloomberg

Treasury yield curve remains inverted (blue line) but dollar swaps (green line) reflect continued demand for dollar assets by global investors. The 10-year Treasury note Is the lowest yielding part of the cash curve, four points below swaps.

"The risk of a squeeze in US funding markets is increasing as the yield curve bear steepens, i.e. longer-term yields rise more than short-term ones," notes *Bloomberg*.

# CRE Bubble is Deflating

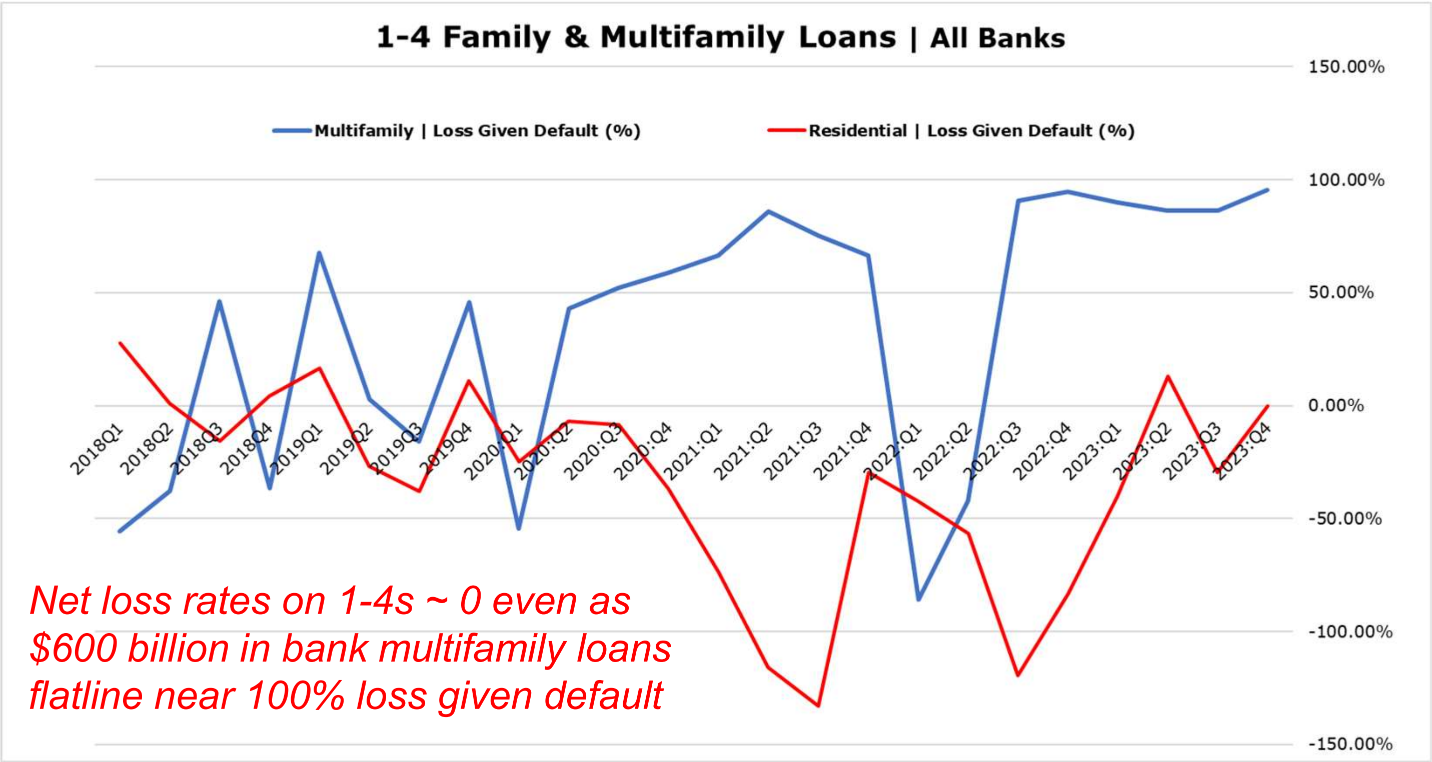



*It is dangerous to generalize about CRE, but individual transactions suggests that a significant price correction is underway. The period of QE from 2019 through 2022 saw an extreme upward surge in CRE prices, creating a global bubble.*

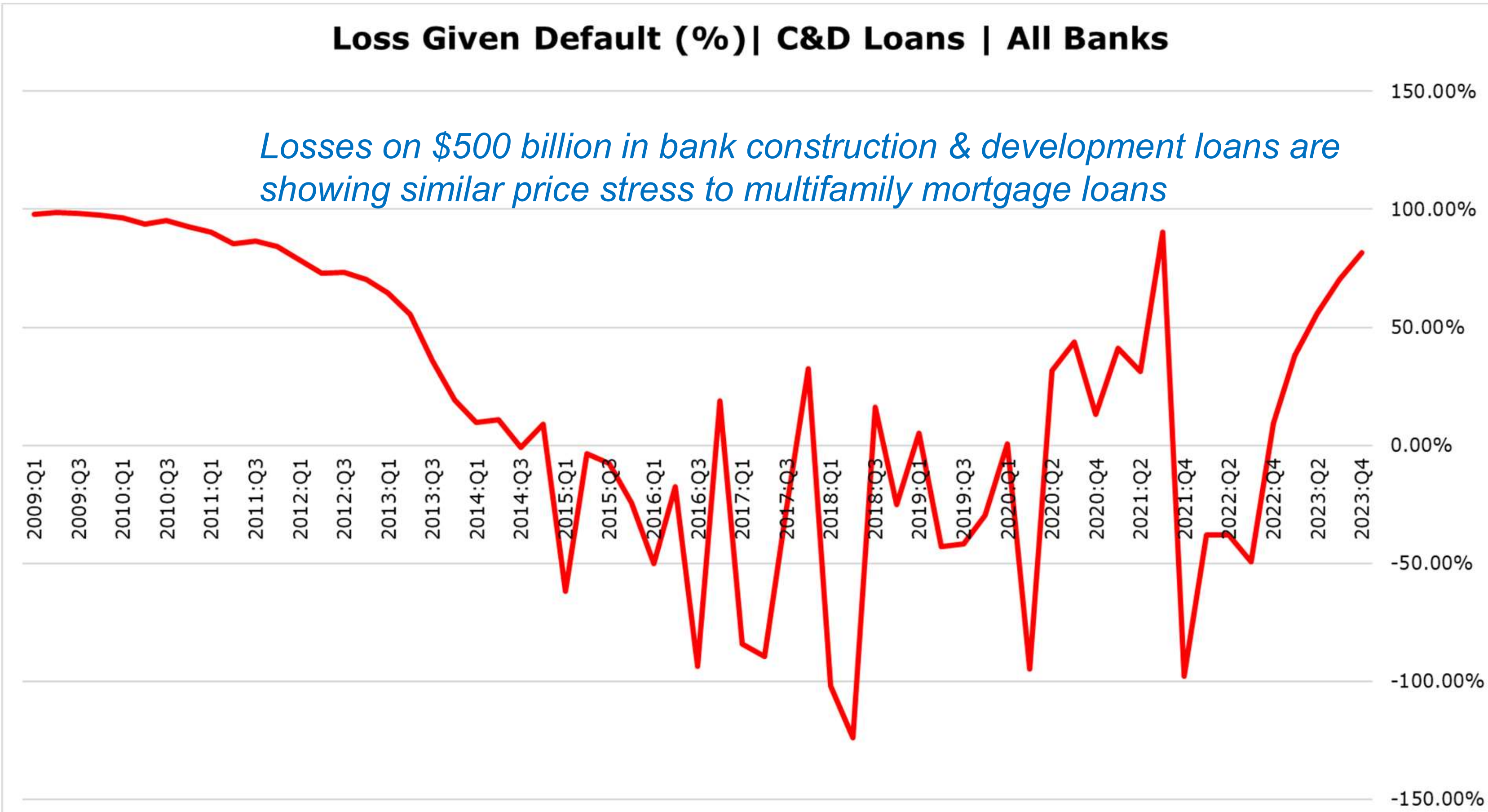
# Credit: Residential vs Commercial

- After a decade of increases, residential home prices around the nation are starting to see signs of fatigue from high interest rates and a resulting dearth of rate sensitive buyers. The flow of cash out refinance transactions continues, however, as home owners monetize record equity vs 20% plus credit card rates. Incredibly, net loss rates on 1-4s remain near zero in Q1 2024.
- In CRE, on the other hand, some rent stabilized and even market rate multifamily assets continue to struggle. Ultra-low financing rates of the 2008-2022 period are now a distant memory. New commercial mortgages are being priced based upon cap rates north of 6-8x net operating income vs 2-4x in 2020-2022 period.

# Credit: Residential vs Commercial




*Source: FDIC/WGA LLC*




*Source: FDIC/WGA LLC*

# Capitalization Rate Deflation

- Capitalization rates are the accepted way to assess the potential value of a CRE property and the profitability of a commercial asset. The cap rate is calculated by dividing a property's net operating income (NOI) by its market value:

Cap Rate = NOI / Current Market Value or Purchase Price

- Until COVID, bank CRE valuations generally had risen for 100 years in the US. Interest-only balloon financing became common in the CRE industry because asset prices only ever went up. Now asset prices *are falling along with NOI*, creating a CRE credit meltdown.

# Cap Rate Math is Deflationary

- In 2020, your NYC apartment building had $1 million in net operating income (NOI) and a cap rate of 4%, resulting in a value of $25 million. Owner has $14 million mortgage.

$1 million NOI / 4% = $25 million

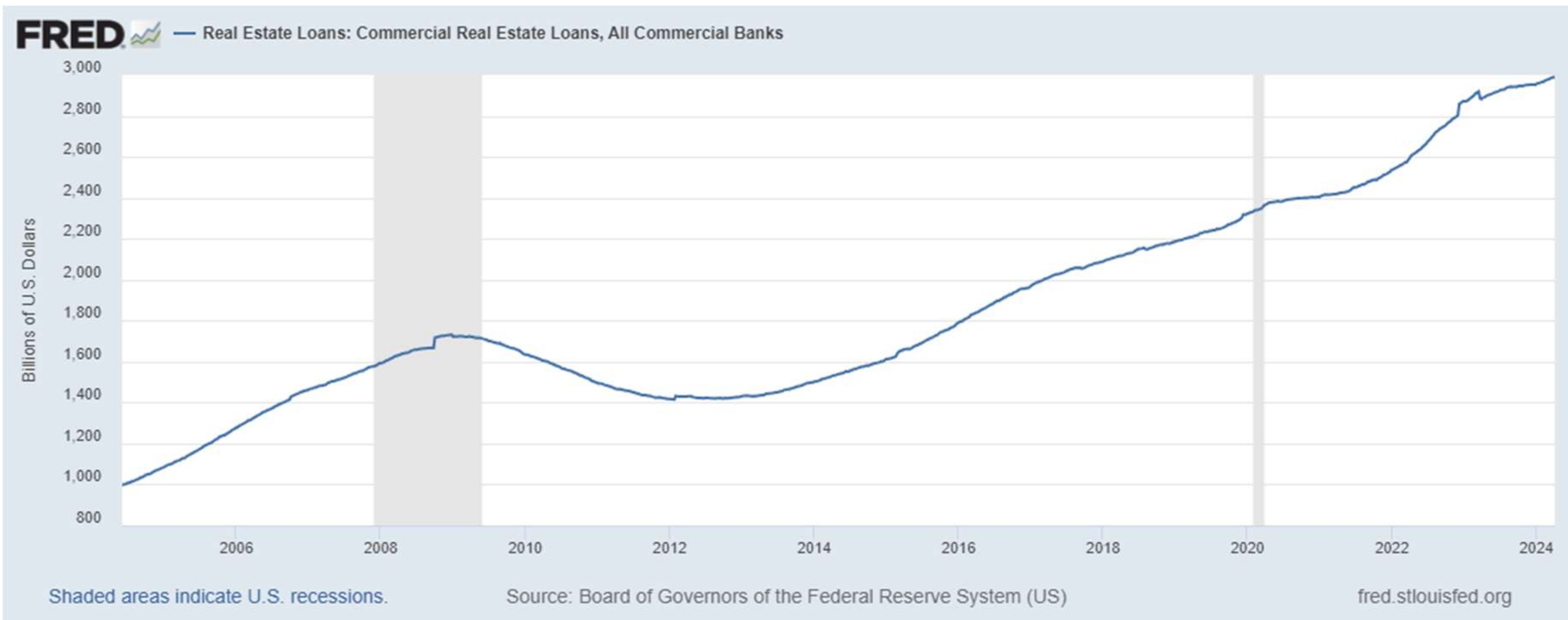
- In 2022, the NOI of the building falls to $500,000 after two years of COVID rent moratoria for tenants. The value of the building is cut in half to $12.5 million but still at a 4% cap rate. Bank mortgage originally 60 LTV is underwater with LTV over 100%. Bank extends loan on existing terms.

$500,000 NOI / 4% = $12.5 million

- In 2023, interest rates rise and so do investor expectations. You try to sell. At an 8% cap rate, the value of the building with $500,000 NOI falls to just $6.25 million. Lender wants significant new cash to get back to 50 LTV. Owner walks away. Bank forecloses. Loss given default ~ $9 million.

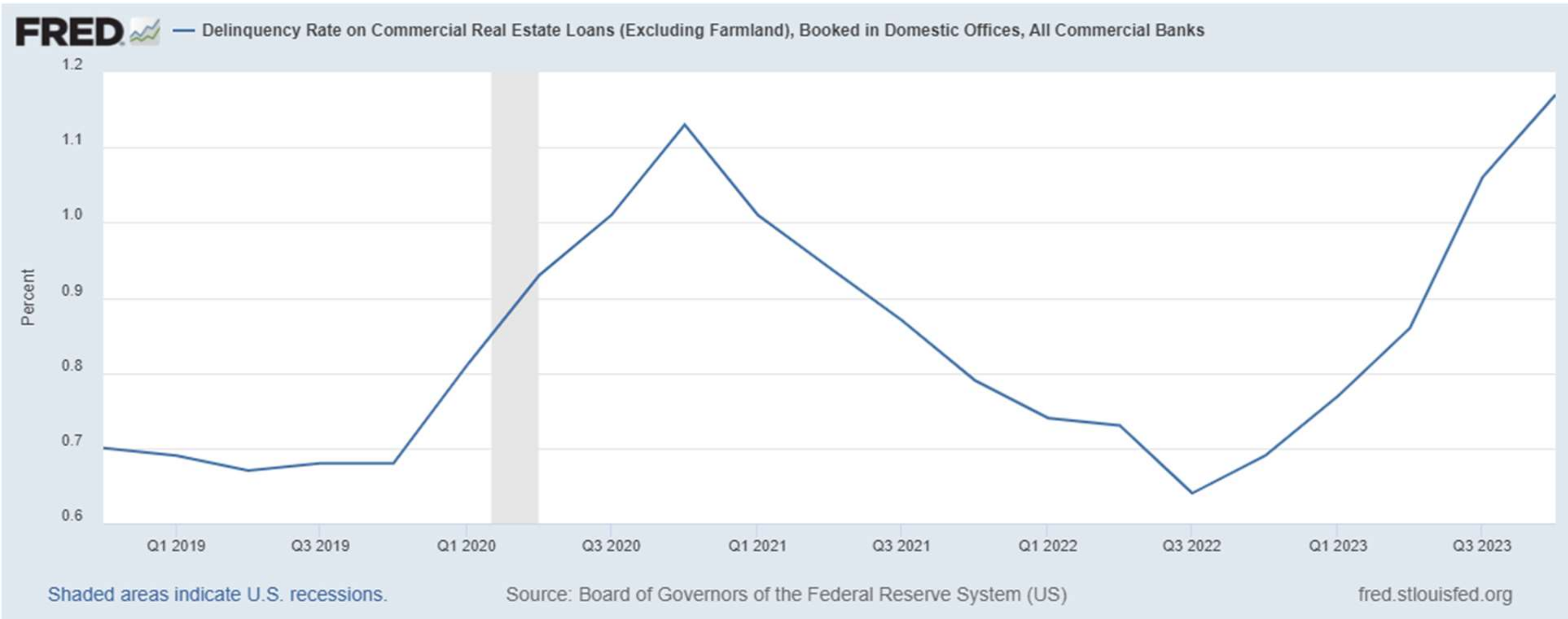
$500,000 NOI / 8% = $6.25 million

# CRE Valuations Reflect Inflation



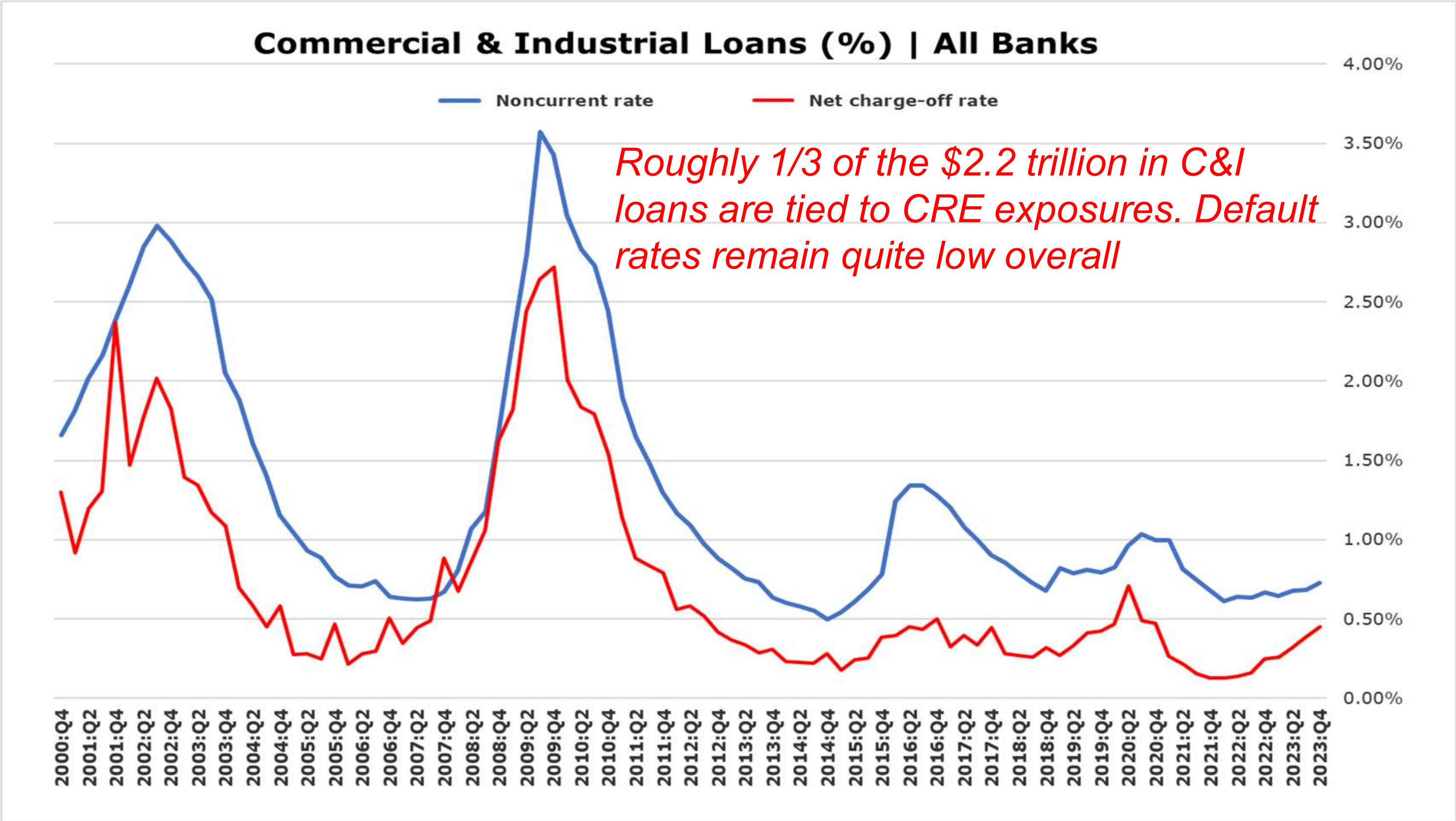

*Commercial real estate prices have been inflated since the GFC, partly because of global investor Preference away from resi and partly because of low interest rates. Higher interest rates also imply higher cap rates, and lower LTVs, and thus lower valuations – even if net operating income remains stable.*

# CRE Delinquency Rates Rising



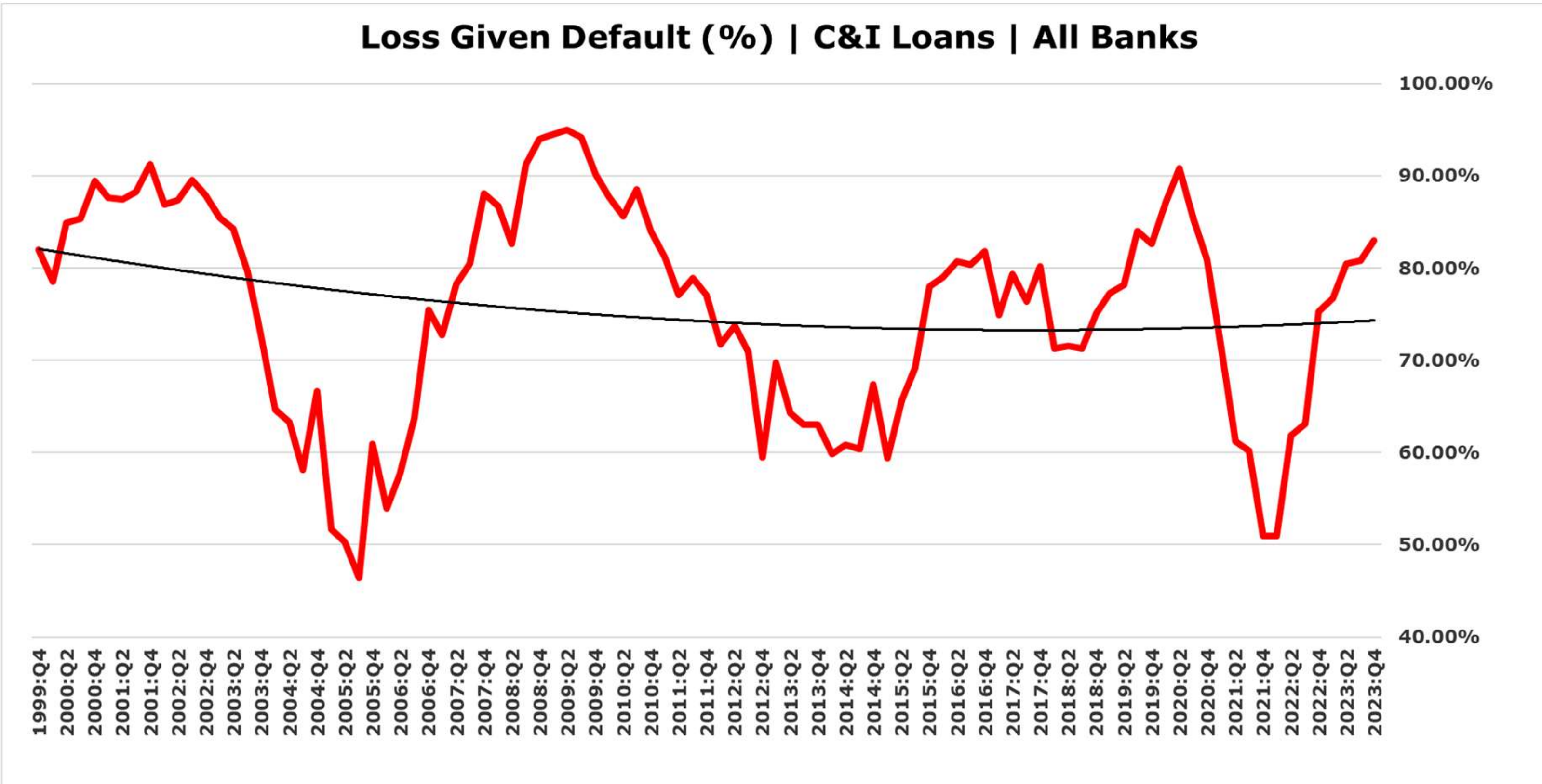

*The US commercial property market has been on a roller coaster since COVID, again driven by interest rates and The aspirational desires of global investors, and very low financing rates. But we are still at miniscule levels of delinquency overall compared with the loss rates experienced in 2008.*

# Commercial Loss Rates Low




*Source: FDIC*

# C&I Net Loss > 85% of Loan Balance




*Source: FDIC/ WGA LLC*

# CRE Deflation Has Many Losers

- Owners of impaired CRE assets face possible double-digit losses. When the equity is wiped out, the secured lender often ends up as the involuntary “owner” of an impaired asset. Cities will not allow banks to abandon moribund urban properties.
- Signature Bank multifamily loans were partly sold at a 40% discount. FDIC retains majority stakes of remaining impaired Signature Bank assets inside the Bank Insurance Fund. Valuation of other rent-stabilized assets also in question, affecting NYC tax revenues.
- More than $1 trillion in commercial real estate loans are set to mature by the end of next year, according to Trepp. A good starting estimate of loss on urban office assets ~ 25%. Big issue for cities is whether regulated multifamily assets can be financed.

# Does CRE Require a Public Solution?

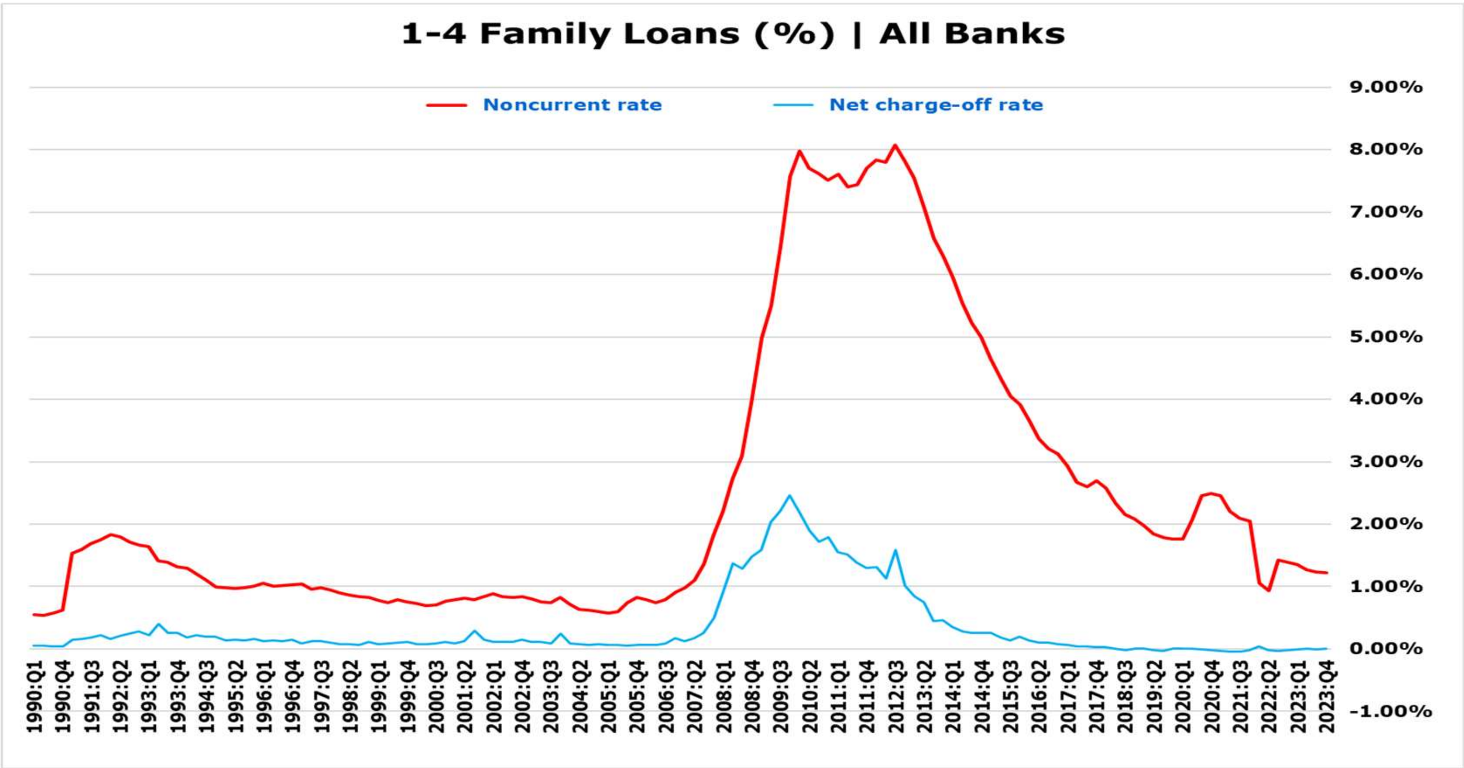
- The scale of the financial loss and economic dislocation occurring in cities is massive. This is not just a blue state problem. The growing insolvency of commercial buildings in major cities hurts economic activity and job creation, not to mention the fiscal stability of major urban centers.
- Falling valuations for CRE is not only a problem for the US. The global economy faces stiff deflation due to 1) COVID and 2) massive property speculation in Asia, the EU and the US fueled by low interest rates and massive deployment of capital by pensions, sovereign wealth funds and traditional investors.

# Residential Mortgage Finance

# Residential Mortgages (RESI)

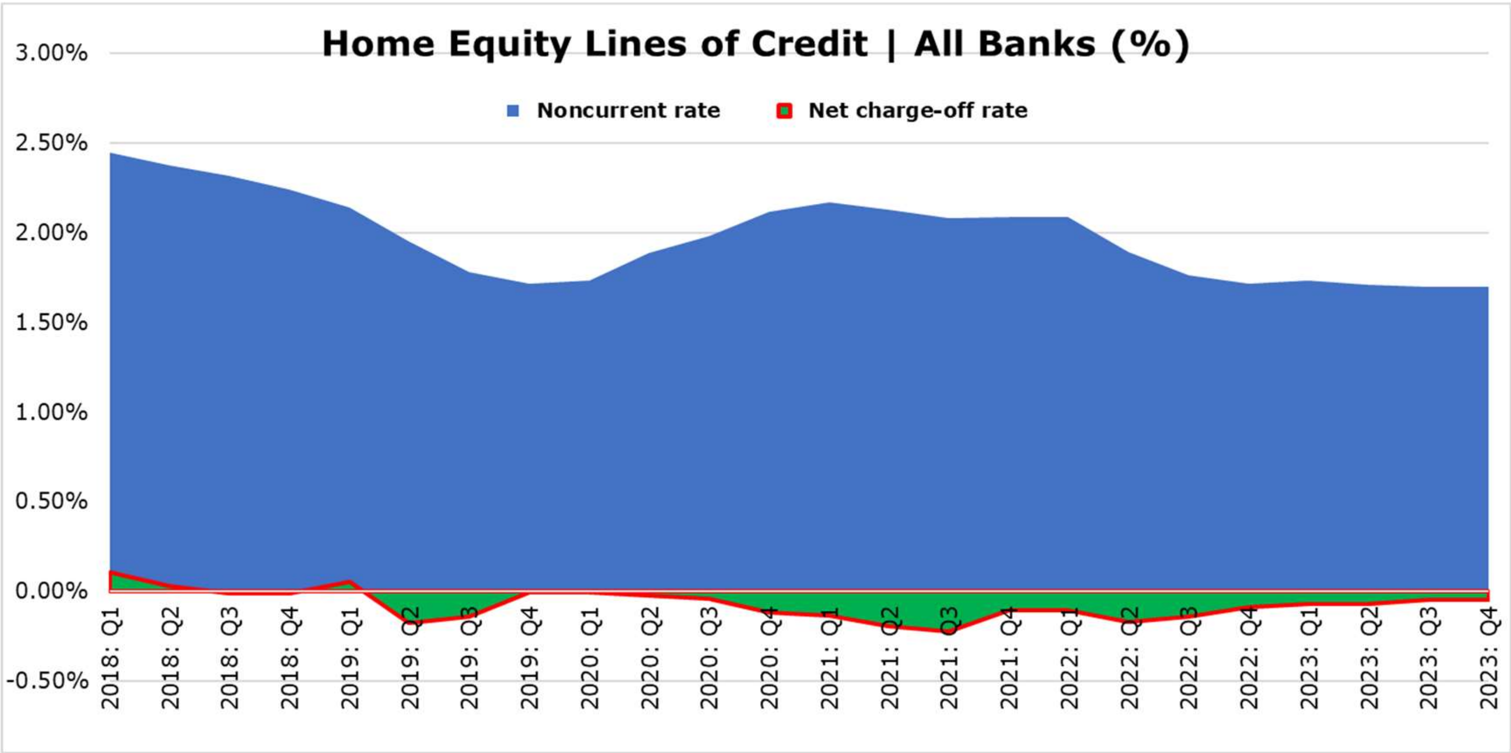
- Compared with CRE, the world of residential mortgage finance remains relatively subdued, but the stability is deceptive. Defaults on the bottom quarter of FHA borrowers based upon FICO score are elevated, but large prime conventional and jumbo loans have very low delinquency rates.
- The apparent calm in residential exposures, however, is a function of low interest rates and the adoption of COVID-era policies regarding loss mitigation which conceal the true rate of delinquency. We expect to see higher default rates in 2025 and beyond, leading to an eventual home price correction.

# Residential Defaults at 40-Year Low



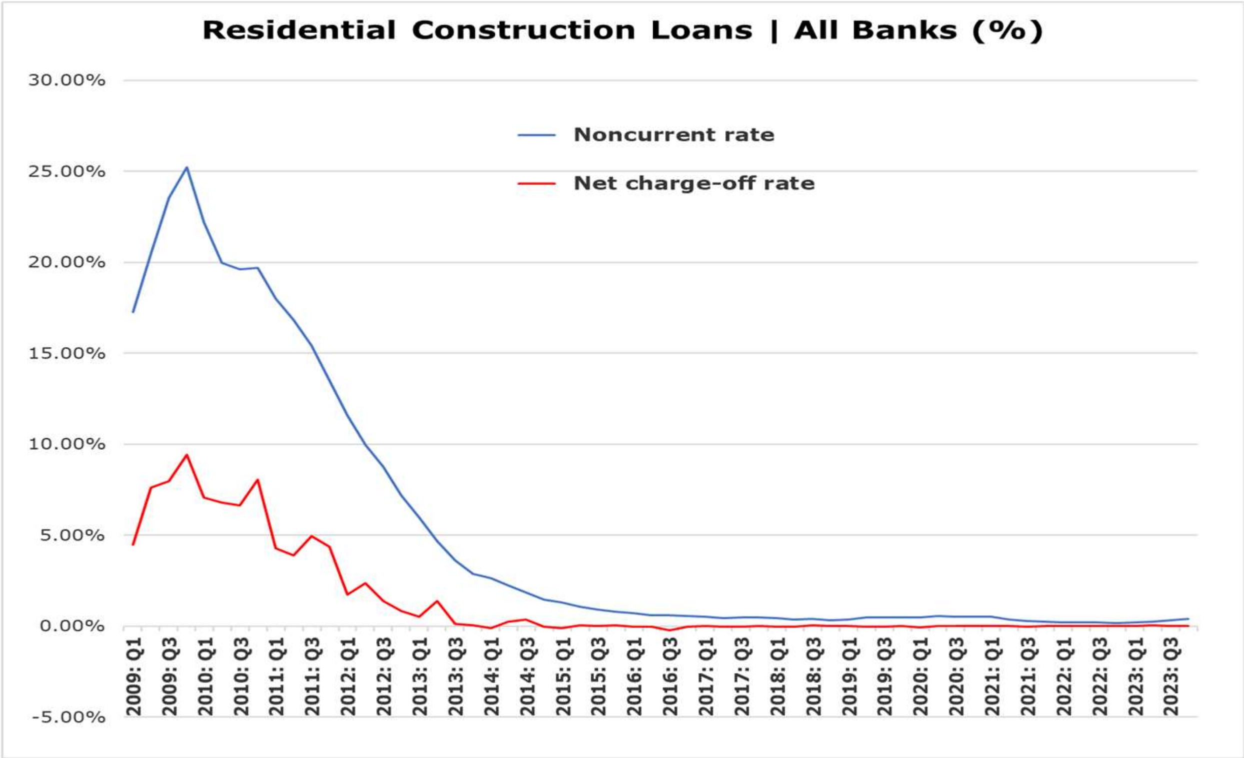

*Source: FDIC*

# Bank HELOC Defaults Negative




*Source: FDIC*

# RESI C&D Loan Defaults ~ 0

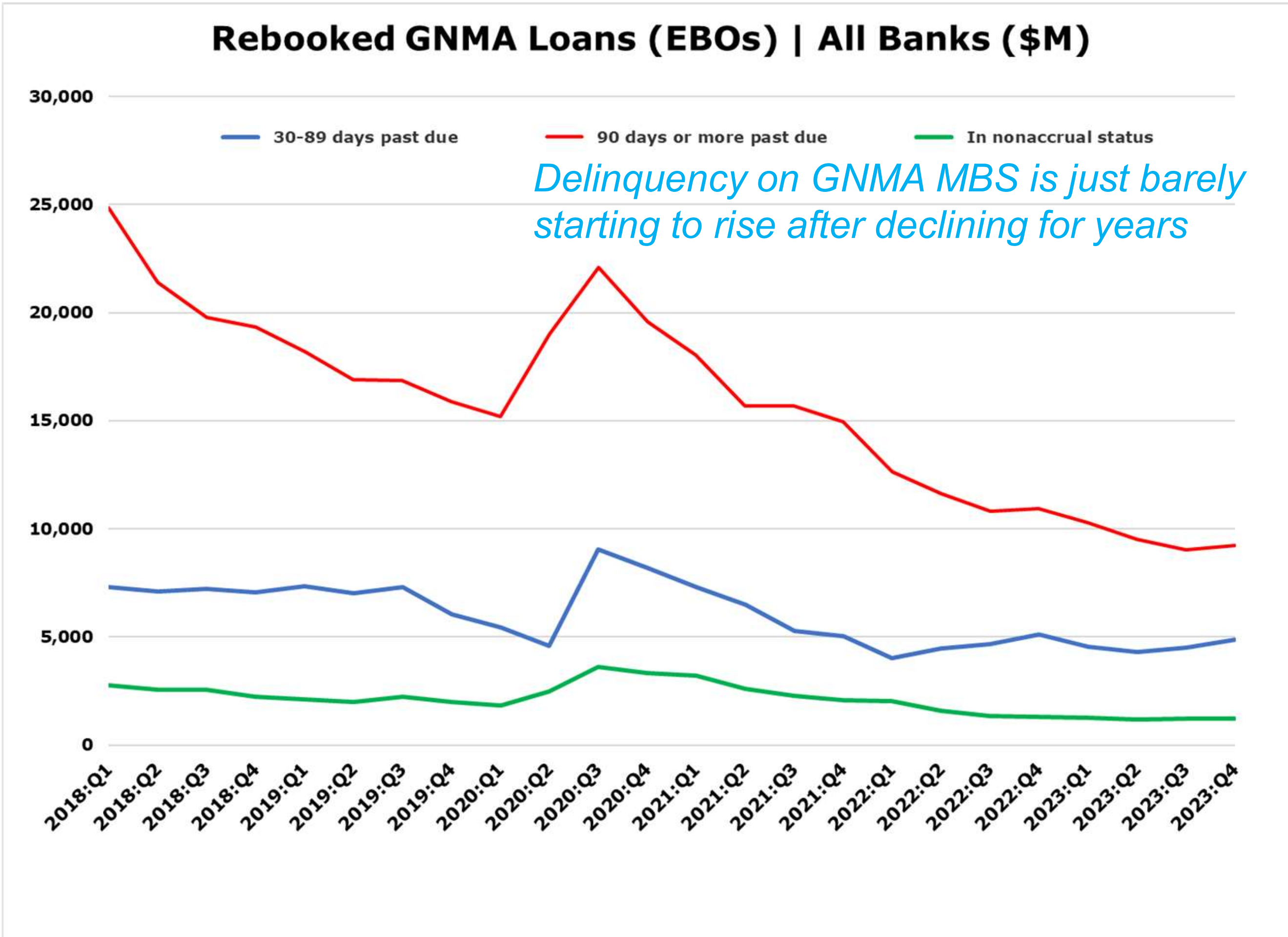



*Source: FDIC*

# Delinquency Rates 1-4 Family Assets

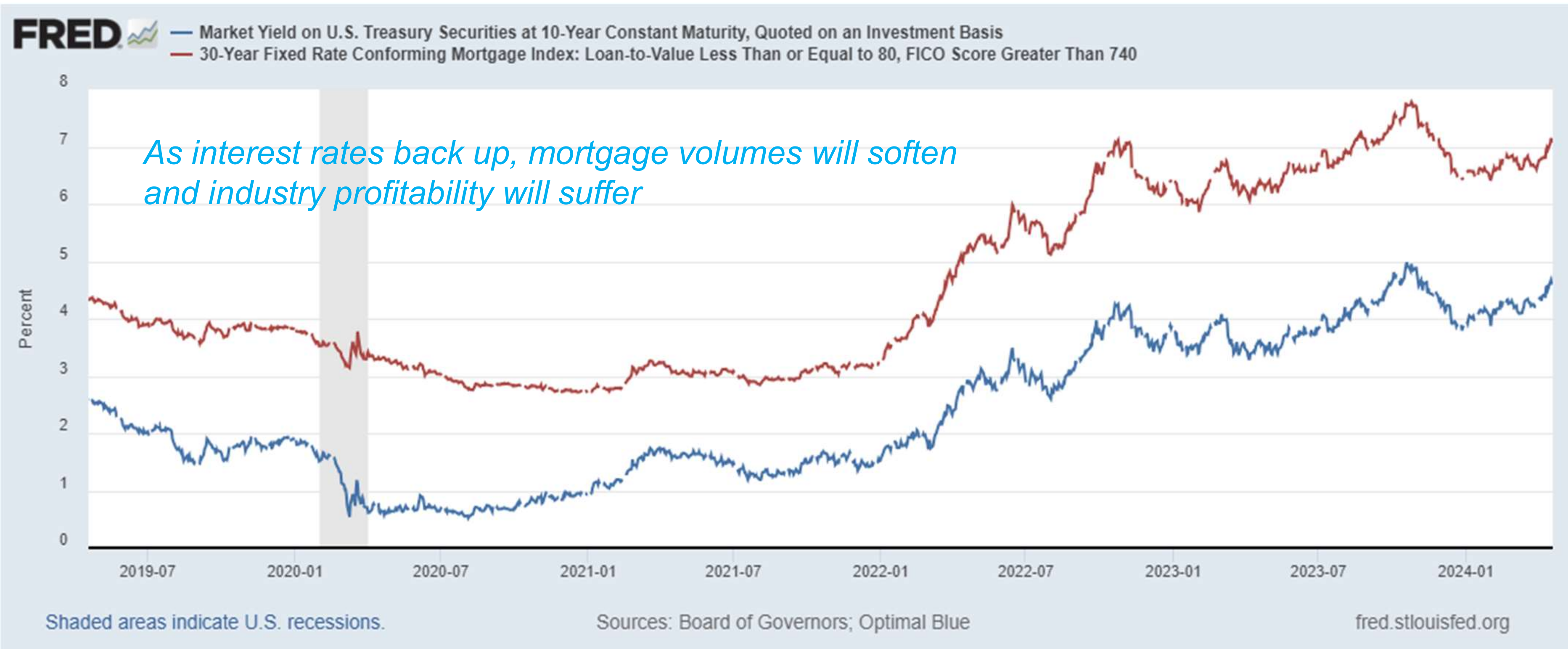
| Delinquency Rates \| 1-4s | Total Loans | Conventional | FHA | VA | Bank Owned |
|---|---|---|---|---|---|
| **2023 Q4** | *3.88%* | *2.61%* | *10.81%* | *4.07%* | *1.17%* |
| **2023 Q3** | *3.62%* | *2.50%* | *9.50%* | *3.76%* | *1.23%* |
| **2023 Q2** | *3.37%* | *2.29%* | *8.95%* | *3.70%* | *1.27%* |
| **2023 Q1** | *3.54%* | *2.44%* | *9.27%* | *3.98%* | *1.35%* |
| **2022 Q4** | *3.96%* | *2.78%* | *10.61%* | *4.16%* | *1.39%* |
| **2021 Q4** | *4.65%* | *3.58%* | *10.76%* | *5.24%* | *2.04%* |
| **2020 Q4** | *6.73%* | *5.09%* | *14.65%* | *7.29%* | *2.50%* |
| **2019 Q4** | *3.77%* | *2.82%* | *8.38%* | *3.64%* | *1.76%* |
| **2018 Q4** | *4.06%* | *3.19%* | *8.65%* | *3.71%* | *2.05%* |
| **2009 Q4** | *9.47%* | *6.73%* | *13.57%* | *7.41%* | *7.75%* |

*Source: MBA, FDIC*

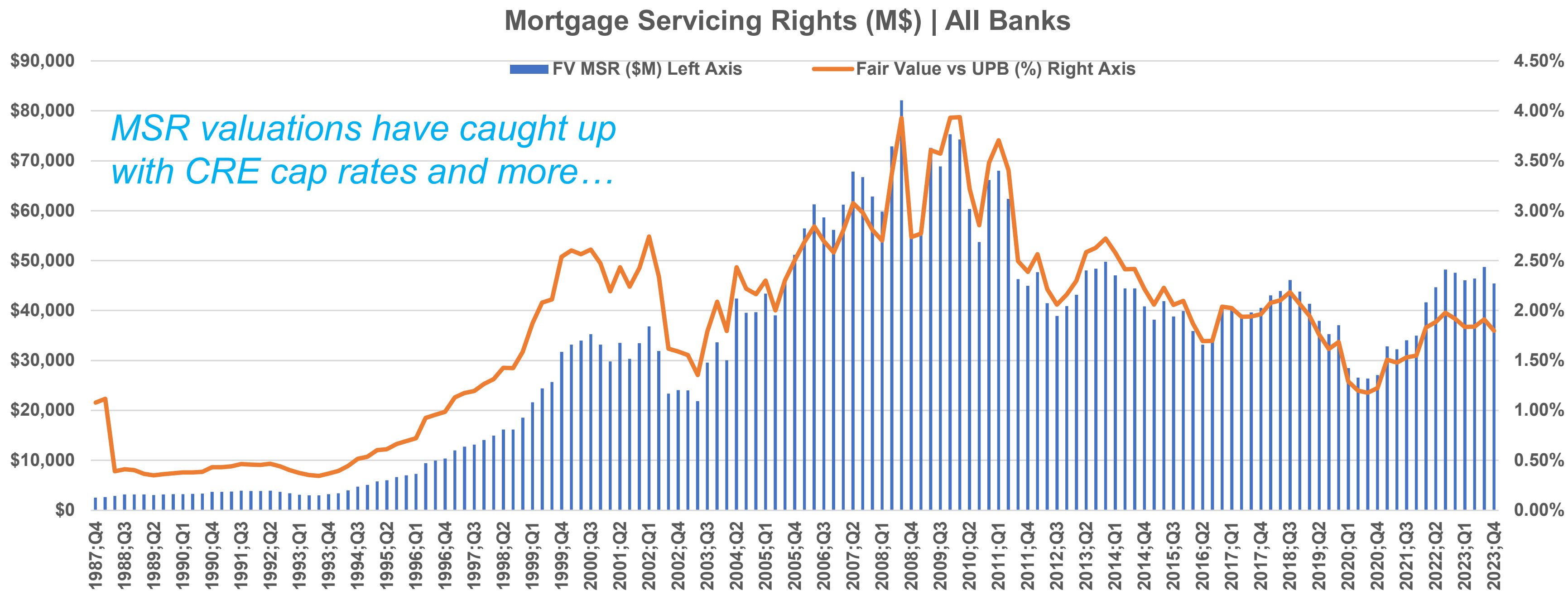

Rebooked GNMA Loans (EBOs) | All Banks ($M)
30,000
25,000
20,000
15,000
10,000
5,000
0
30-89 days past due
90 days or more past due
In nonaccrual status
Delinquency on GNMA MBS is just barely starting to rise after declining for years
2018:Q1
2018:Q2
2018:Q3
2018:Q4
2019:Q1
2019:Q2
2019:Q3
2019:Q4
2020:Q1
2020:Q2
2020:Q3
2020:Q4
2021:Q1
2021:Q2
2021:Q3
2021:Q4
2022:Q1
2022:Q2
2022:Q3
2022:Q4
2023:Q1
2023:Q2
2023:Q3
2023:Q4

*Source: FDIC*

# Rising Rates Hurt Volumes

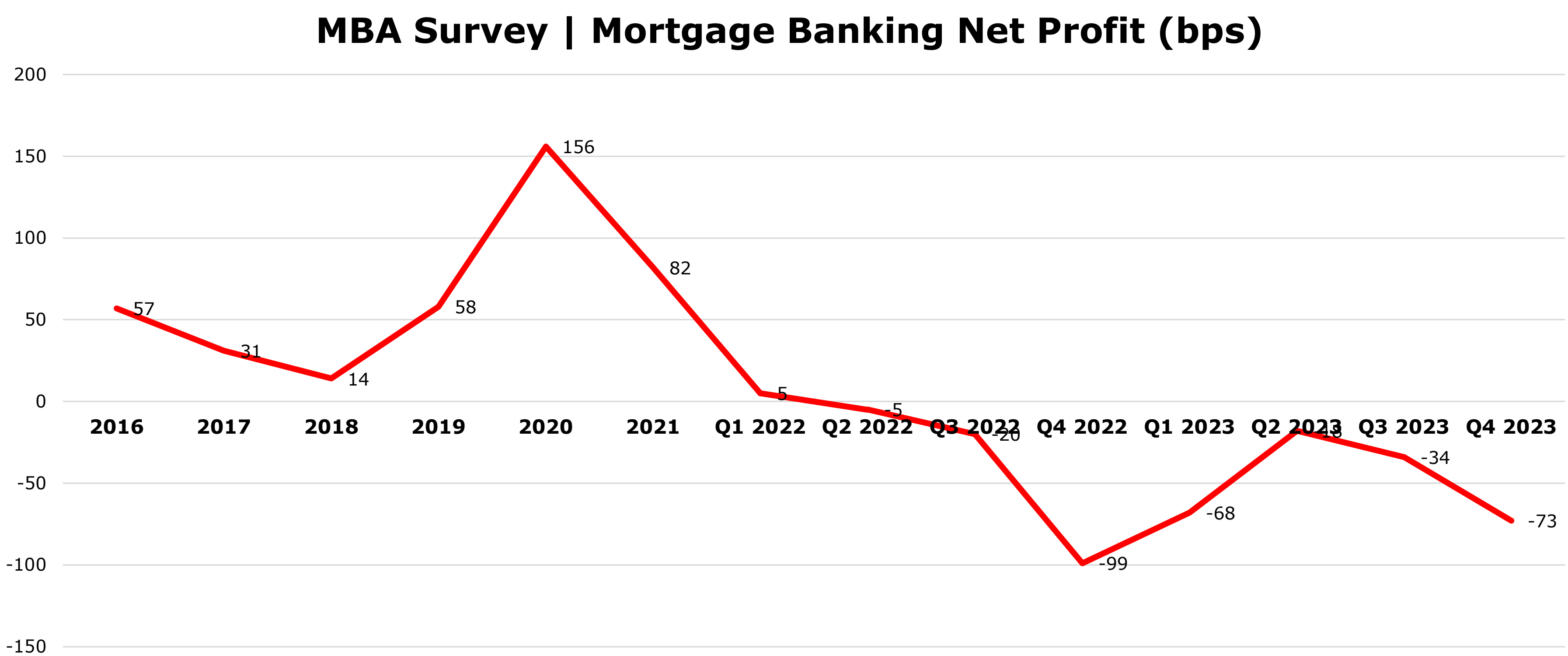


# MSR Valuations ~ 6-8x Cap Rates



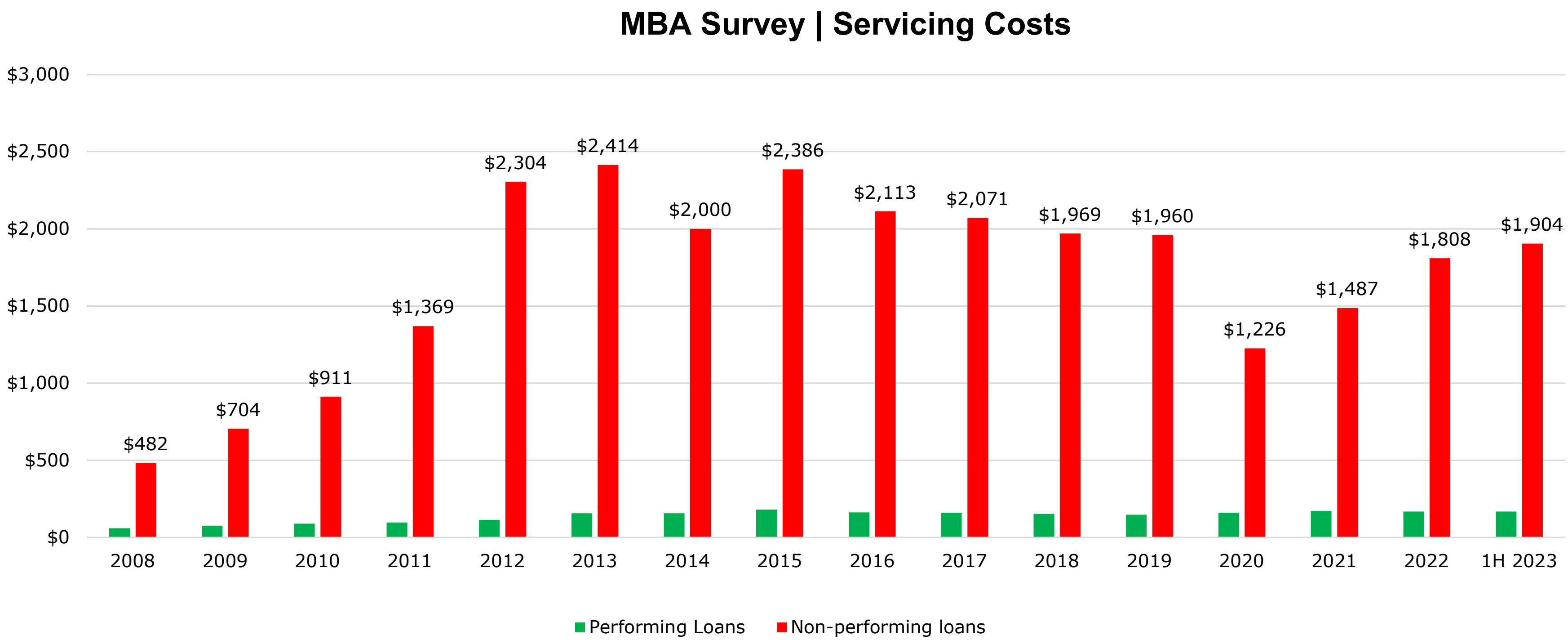

*Source: FDIC/ WGA LLC*

# Higher Rates Kill Lender Profits




*Source: MBA Quarterly Performance Report; www.mba.org/performancereport*

# Default Servicing Costs Rising




*Source: MBA Quarterly Performance Report; www.mba.org/performancereporth*

# Savings & Higher Interest Rates

- The US and other industrial nations are moving from a glut of savings and resulting low interest rates to a savings drought, implying much higher costs for capital in the future. Federal budget deficits add to the upward pressure on interest rates and inflation.
- CRE assets must navigate changing use cases and rising funding costs to find a new balance between valuations and investor expectations for returns. Large institutional buyers of CRE may temper future risk appetites given higher equity return hurdles.
- Higher interest rates are dampening demand for residential housing, but so far only enough to affect home prices above the national averages and the conforming limit. Home price inflation due to COVID and QE may remain until we see a macro price reset.

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