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Could Today's CRE Loans Prove Risky at Maturity?

Market players largely agree that lending standards have not deteriorated despite the sustained economic cycle and positive real estate fundamentals. Bucking the history of past cycles, lenders generally have avoided the temptation to lard properties with high levels of debt while times are good.

That's not, however, the same thing as saying risk has been eliminated. While it is true that leverage has remained relatively constant in recent years, some measures of aggressive lending have grown as lenders battle to win assignments. One example is the increasing number of loans with interest-only components, which means that fewer loans require borrowers to pay down principal. Also, loan coupons have declined to historical lows as lenders offer tight loan spreads on top of low Treasury yields.

The upshot is that today's healthy lending environment could be planting the seeds for a problematic refinancing environment when loans mature. Even though loans written today have conservative debt-service and leverage levels, some combination of rising interest rates, higher expenses and weak growth in property income due to a recession could lead to a deteriorating credit environment and eventually produce a sharp uptick in defaults.