STORMFIELD INSIGHTS

Bank Challenges Create Opportunity for Private Mortgage Lending

NOVEMBER 2023

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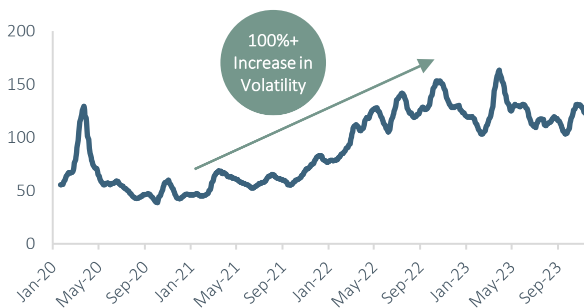
2023 has seen the first large bank failures since the financial crisis, the highest level of interest rate volatility witnessed in over 15 years and, most recently, a raft of newly proposed bank regulations which would significantly raise bank capital requirements, putting further strains on credit availability just as the U.S. faces a record wall of commercial real estate debt maturities. Taken together, these conditions have created a compelling environment for private credit in general and private mortgage bridge lending specifically. Looking at each of these factors, we expect the currently favorable origination environment to persist for some time.

As all are now aware, the Federal Reserve's move to rapidly raise rates in a belated recognition of unacceptable inflationary trends led to a significant surge in interest rate volatility in early 2023. That volatility eclipsed the spike witnessed at the onset of the pandemic in 2020 and is only surpassed by the extraordinary volatility of the global financial crisis. Importantly, unlike the spike of March 2020, the current state of interest rate volatility has endured, causing strain throughout the financial system. Indeed, rapidly rising rates were a driving force behind the deposit flight that felled Signature Bank, First Republic Bank and Silicon Valley Bank.

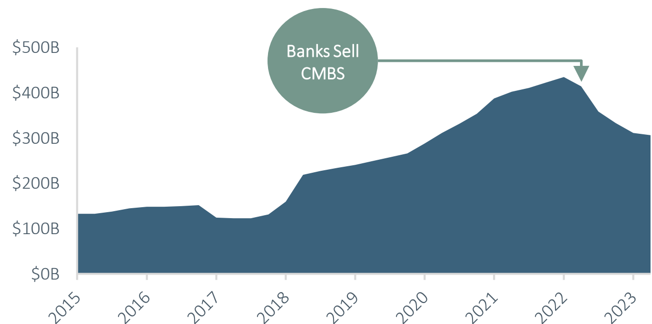
MOVE Index, Jan. 2020 to YTD 2023



Source: Yahoo Finance

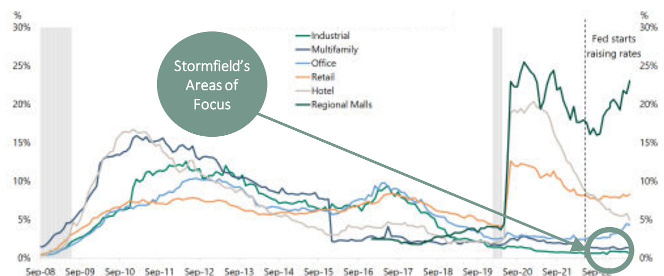
Witnessing the plight of Silicon Valley Bank et al., banks around the country scrambled to both free up liquidity and reduce credit risk. Within commercial real estate debt, whole loans can be costly and difficult to sell. Furthermore, doing so at material losses would expose banks to adverse capital events. As such, banks sold what they could. In the case of real estate debt exposure, this meant dumping CMBS into a market that was less than keen to absorb securities that are heavily exposed to struggling asset classes such as office, hotels and malls.

Banks' Exposure to CMBS, 2015 to Q2 2023



Source: Wall Street Journal analysis of FDIC data, Stormfield Capital

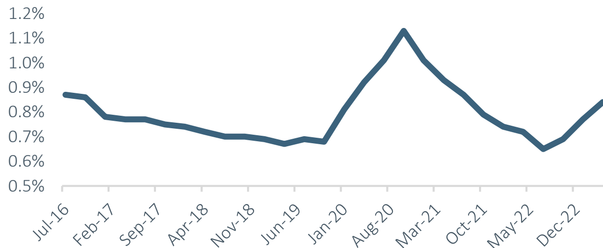
CMBS Loan Delinquency Rate by Property Type



Source: Moody's Analytics, Apollo Chief Economist

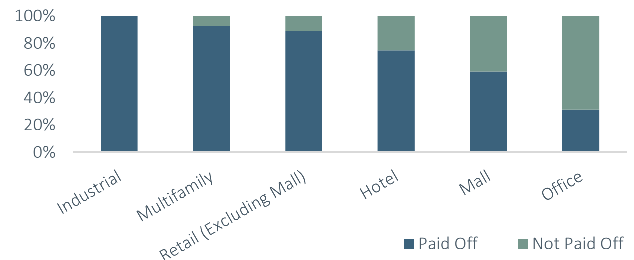
In selling what they could, banks were no doubt aware of troubles brewing within their own commercial real estate debt portfolios and were also likely reacting to foreknowledge that U.S. regulators were soon to announce new capital requirements to bring the U.S. more in line with international bank regulations proscribed under the Basel III bank reform framework.

Delinquency Rate on CRE Loans



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis, Stormfield Capital

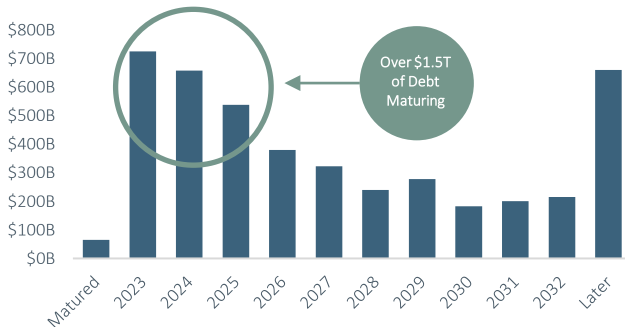
CMBS Loan Payoff Rates By Property Type



Source: Moody's Analytics CRE, Stormfield Capital

A further blow to credit availability came on July 27, 2023, when U.S. federal banking regulators issued proposals that significantly revised the risk-based regulatory capital requirements for midsize and large banks. Somewhat surprisingly, the proposed regulations would not only meet international standards under Basel III but would exceed them by increasing capital requirements by an estimated 19% for the largest U.S. banking organizations.[1] This announcement, when combined with the aforementioned stresses already experienced by banks earlier in 2023 has provided further motivation for banks to reduce lending volumes. This disposition is even more understandable when one looks at the wall of commercial real estate ("CRE") debt maturities coming due in the next two years. Early indications point to certain real estate asset classes experiencing difficulty in successfully rolling or paying down their debt over the next eight to ten quarters.

Estimated Total Commercial Mortgage Maturities



Source: Mortgage Bankers Association, Stormfield Capital

[1]Mid-sized banks would see a smaller increase on a sliding scale down to a 6% estimated capital requirement increase, while U.S. banks controlled by foreign banking organizations would see an estimated increase of 14%.

When taken together, the cause of reduced bank credit availability is clear. It is also likely that this state will persist for some time as the market works through the implications of proposed capital requirements and the significant stress being experienced in office, mall and hotel credits. Importantly, the decline in credit availability from banking institutions benefits Stormfield not only directly (by diverting borrowers who may have previously obtained bank financing to Stormfield) but also indirectly as many small private mortgage lenders rely on bank provided leverage to originate loans which they hope to one day sell into the securitization market. With banks not renewing lines (or dramatically increasing their cost and covenants) and the securitization market operating intermittently, competition for attractive loans from other lenders in Stormfield's target markets has materially declined.

As a result, Stormfield is able to originate short duration, first lien loans secured by liquid, residentially focused real estate at sub-60% loan-to-value ratios while earning gross IRRs in excess of 15%. While we continually assess and reassess the outlook for real estate values in our target 1-4 family, multifamily and mixed-use markets, we believe we are being well compensated for the risk we are taking and are excited for the returns we believe we will be able to earn as we continue to work through the current economic cycle.

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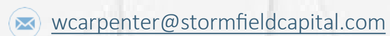
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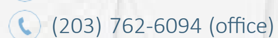
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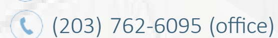
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