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Lenders' Willingness to Grant Loan Modifications Will Decline After Pandemic

By Kathleen Tarbox Munoz
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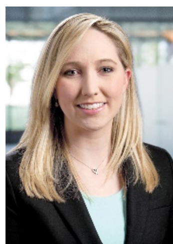

The outbreak of the coronavirus pandemic cultivated an economic downturn that differed significantly from financial crises like the Great Recession or even the Great Depression.

Worldwide stay-at-home orders and mass business closures meant that industries across the board were hit simultaneously, as opposed to experiencing the domino effect reminiscent of past crises. At the onset of the pandemic, the lending industry ground to a halt; few lenders were advancing funds for several months as the world waited to see how long this period would last.

The commercial real estate industry as a whole has suffered as much as any industry, with retail and hospitality being hit fast and hard at the beginning of the pandemic. A future second wave of commercial foreclosures and defaults within these asset classes looms as a near certainty. But the response to these defaults from lenders has followed a unique trajectory — one that is as much a response to the pandemic as shaped by it.

Increased Flexibility

Perhaps the result of empathy born of a shared experience, or perhaps due to the introduction of highly effective vaccines that support the notion of a swift market rebound, lenders have approached looming market deficiencies and defaults of existing deals with a degree of optimism and flexibility not seen in past financial crises. Additionally, given the almost universal downturn in commercial real estate, lenders and borrowers have each become significantly more proactive in getting ahead of defaults to work together to reach the best outcome for all parties.

The onslaught of modification and forbearance requests throughout the pandemic has shown some direct trends as to what to expect from commercial lenders and borrowers moving forward.

Borrowers have been more likely to reach out to lenders prior to defaulting on a loan. This trend partially appears to be an effort to cash in on institutional goodwill, and, through informing lenders early of specific steps taken like applying for PPP loans or seeking statutory relief, to meet their obligations.

Furthermore, lenders have been more likely to take deep dives into getting forward-looking information from borrowers to gauge their operational capacity and future ability to meet loan requirements. These proactive discussions have led to lenders approving swaths of modifications and extensions not originally present in the existing agreement — albeit typically with paydowns required to protect lenders' interests in an attempt to avoid future defaults and to give borrowers an opportunity to right-size the property and the loan.

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And just as suddenly as the pandemic changed our world, big banks have initiated a return to new lending. Meanwhile, smaller institutions largely continue to hold their collective breath in continuing with a very conservative approach to lending — albeit with certain fundamental shifts in their risk analyses.

Post-Pandemic Requirements Examined

Of course, as the pandemic abates, a tightening of lender flexibility with respect to existing deals is inevitable, especially as it becomes clearer that certain sectors of the commercial real estate industry will be unable to rebound. Others — most notably office leasing in certain areas — appear to be trending up. These factors should combine to push lenders towards a return to more typical pre-pandemic lending behaviors and requirements, while simultaneously keeping an eye on markets that continue to struggle.

Additionally, with federal stimulus programs largely devoid of direct relief to the commercial real estate finance industry, lenders are left to work unilaterally to protect their interests. While requiring paydowns in exchange for modifications or extensions will likely continue to some degree, other long-term changes to lenders' requirements may also be left in the virus' wake. The long-term effects of COVID-19 will likely result in lenders imposing more creative requirements on their borrowers.

Even in industries that have thus far survived the COVID crush, we can expect property values to decrease over time as the result of unstable markets and expected struggles to fill office and retail spaces without significant landlord concessions.

As these values drop, loan-to-value ratios will become an increasingly pressing problem for lenders and borrowers to agree upon. Consequently, lenders will likely require increased upfront equity relative to what was traditionally required pre-pandemic, rather than relying on the property's value.

Additionally, we should expect to see an uptick in debt service ratios and interest reserves required by lenders in original loan documents, with additional funding of these reserves required in exchange for modifications or extensions. Prefunded by borrowers, these accounts will serve to protect the value of the loan should things go sideways during the loan term and the borrower is unable to meet debt service obligations.

Lastly, the market should expect equity pledges by borrowers to top a lender's arsenal of protective tools in a post-pandemic market, providing an additional level of security in an unstable market to quickly obtain rights to collateral. Borrowers may also be required to seek alternative debt sources for funding.

With respect to legal terms of new loan documents as society moves toward a post-pandemic world, we expect a number of shifts in thinking as to what will define the market standard. Of course, as the new hot-button issue involves the expectation of "force majeure" clauses and provisions being heavily negotiated in all new loans. Furthermore, we anticipate that borrowers will request more flexibility in operational covenants and provisions governing lease modifications to allow them some ability to pivot based on potential market rebounds and valleys.

As the pandemic recedes and markets begin to rebound, expect lenders to eye a return to business as usual, but with a decidedly post-pandemic approach to managing the risks of a still-recovering commercial real estate market.

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