Opinion: A ‘perfect storm’ from higher interest rates and lower values threatens commercial real estate, construction and jobs

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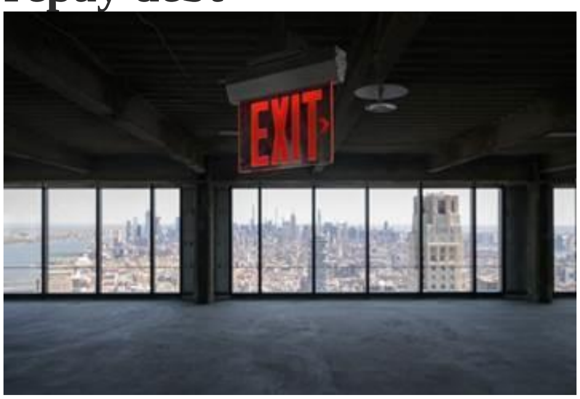
With $1.5 trillion in loans maturing in the next two years, developers and landlords need more time to restructure and repay debt



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Tight lending conditions and loans refinanced at higher, unsustainable rates could potentially stifle construction and development.

As the U.S. emerges from the COVID-19 pandemic, much attention has been given to rising inflation and the interest-rate hikes to combat it. But there is another looming threat with equally impactful and widespread implications for consumers and the economy: commercial real estate. About $1.5 trillion worth of commercial real estate loans are due to mature over the next two years, at a steep increase.

The combination of the tightening of lending conditions and loans refinanced at higher, unsustainable rates could potentially stifle construction and development in major cities struggling to bounce back from the pandemic.

To avoid inflicting more far-reaching economic uncertainty, the Federal Reserve and the financial services regulatory agencies should grant more time for borrowers — including corporate real estate developers — to restructure commercial real estate loans.

This strategy has a proven track record of success. During the 2008-09 financial crisis and again in the COVID-19 pandemic, similar programs provided financial institutions flexibility to work constructively with borrowers. In the summer of 2022, the Board of Governors at the Fed proposed a comparable policy. Granting borrowers more time to adjust the economic climate makes more sense than pushing loans that could result in more foreclosures and bankruptcies.

Failure to act will hurt more than just those holding these loans. The perfect storm brewing from higher interest rates, lower real estate values and an illiquid market will burden consumers, businesses, stall affordable housing expansion and further imperil the health of our major metropolitan areas.

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Consider that the bulk of commercial real estate loans were financed when base rates were near zero — far below today's rates closer to 5%. Not only are the rates higher, but the real estate values are much lower, especially in cities afflicted with high vacancy rates from ongoing work-from-home policies. Prior to the pandemic, 95% of U.S. offices were occupied. Today, that number is closer to 47%. The drop wiped out $453 billion of commercial real-estate value, according to the U.S. National Bureau of Economic Research (NBER).

Additional time will provide several benefits as inflation and interest rates moderate. It will allow businesses to further emerge from the pandemic, pressure-test how many workers will permanently work remotely, and allow the price of materials and labor to further recede from their post-pandemic highs. By comparison, office occupancy rates in Europe and the Middle East have already returned to 70% or higher. Without intervention, developers will be forced to halt or delay construction in cities, including projects to revitalize vacated downtowns.

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More than 70% of municipal taxes come from property taxes. Without a healthy market, developers will be forced to seek tax-abatement, resulting in lower collections for city budgets, and less resources for public schools, law enforcement, public transportation and other municipal services. A sustained lack of activity in U.S. cities will further diminish the vibrancy of businesses that rely on foot traffic from offices and residents — ranging from restaurants, retail stores and more.

Inaction from Washington will cost jobs. By creating a downward spiral, construction projects are likely to freeze, risking jobs of those in an industry that already experienced the largest-ever monthly decline in employment openings over a two-decade period.

Fortunately, leaders at the local and state level are taking incremental steps in recognition of the looming crisis. For example, New York Governor Kathy Hochul is pushing for policies allowing conversion of vacant office space to housing. New York City Mayor Eric Adams has called on Wall Street to force workers back to the office. Washington D.C. Mayor Muriel Bowser has pushed a similar theme for federal government workers in her city, where the government and its 200,000 jobs occupy one-third of all office space.

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This is not a call for a bailout, but for recognition that the monetary and fiscal policy imposed by the federal government during the pandemic created this dilemma. The federal government strongly encouraged workers to stay home during the pandemic, which led to a decrease in demand for office space. Plus, a decade of zero interest-rates and cheap money ended with $6.5 trillion of federal spending and nine consecutive interest-rate hikes in a 12-month period. This has been an unprecedented, rapid series of events no one could have predicted.

Now the federal government must play a role to avoid further damage. Defaults on commercial real estate loans hit a 14-year high in February. Allowing additional time for markets to stabilize has worked in the past and can again. Time will allow borrowers to emerge from the pandemic and work through these challenges so the public doesn't end up bearing the cost.

John F. Fish is chairman & CEO of Suffolk and chair of The Real Estate Roundtable's Board of Directors.

https://www.marketwatch.com/story/commercial-property-owners-face-a-perfect-storm-from-higher-interest-rates-and-lower-values-and-loans-are-coming-due-82aa0d1f?siteid=nf-rss