CMBS Credit Focus

Interest Adjustments: Track Shortfalls Repayment and Priority



BOLT and 1440 Broadway Show the Impact of Coupon-Reduction Mods

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Coupon reductions on recently modified loans are driving significant interest shortfalls across entire capital structures. It is not clear if, or when, investors should expect to see reimbursement of such shortfalls. This is the case even when the rate reduction is temporary, and the modification states the time the borrower should repay the deferred interest. The $232.5 million Aspiria Office Campus loan (JPMCC 2021-BOLT) is a case in point. A recent mod cut the interest rate to 2.5% from SOFR+4.61% (Figure 1). The rate reduction has led to $16.2 million total shortfalls so far, affecting all deal classes. The reduced interest is payable at the loan's modified maturity, in August 2025. If the loan fails to refinance, as happened before on modified loans, shortfalls may keep accumulating.

Figure 1. Aspiria Office Campus Loan and Property Parameters

Asset	Aspiria Office Campus
Deal	JPMCC 2021-BOLT
Loan Balance ($ per sq. ft.)	$232,500,000 ($63 per sq. ft.)
Maturity	August 2025
Coupon	TSFR1M + 4.6145% (2.5% pay rate and balance accrues)
Amortization	Interest-only
Loan Status	Performing
Property Size / Occupancy	3,721,308 sq. ft. / 67% occupancy (Sept 2024)
Property Type / Location	Office / Overland Park, KS
Appraisal History	$367 million (June 2021), $183 million (July 2023), $176 million (July 2024)
Total Cash Reserves	$3,452,000 (December 2024)

Lease Expiration Schedule

Tenant	Sq. Ft.	Expiration
T-Mobile	1,018,159	Jul-2029
Hill's Pet	104,211	May-2039
Black & Veatch	85,759	Jan-2025
Support Center	77,595	Dec-2030
Amenity CC	76,642	Dec-2030
Total	**1,362,366**	

Source: Morningstar Credit and Academy Securities

Interest Adjustment Shortfall Recovery May Prioritize Principal Payments

There is also ambiguity over the priority of coupon reduction-driven shortfalls at liquidation. We believe the reimbursement of such shortfalls on subordinate classes could prioritize principal payments to senior classes. This could surprise some investors as modified loans with coupon reductions begin liquidating. Such liquidations could see favorable treatment of subordinate bonds, similar to what happened at 1740 Broadway.[1] Coupon-reduction shortfalls will be paid first, similar to non-recoverable shortfalls, and unlike ASER shortfalls.

1 "Recovering Shortfalls: Credit IO Value in Distressed Office," Securitized Products Special Topics, Academy Securities, May 21, 2024

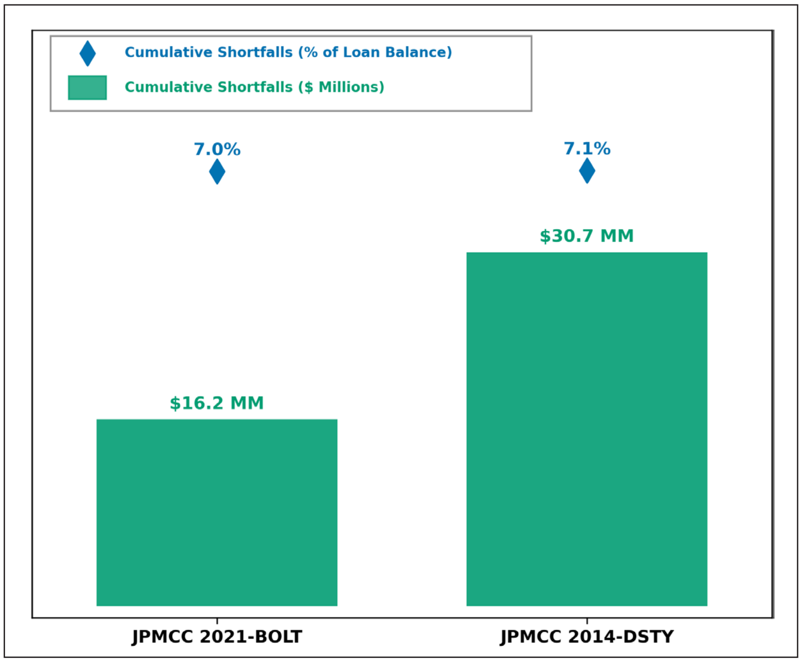
The market has very limited experience with liquidations of modified loans with coupon reductions. Searching through realized loss reports, we find only a handful of examples of liquidations that included reimbursement of accrued interest that is not due to ASER or non-recoverability determinations. Such reimbursements are categorized in liquidation waterfalls as “other unpaid interest”, part of “accrued Interest – current period and prior interest shortfalls” (item 3(d) of IRP fields L117/D76).

Previous liquidations did reimburse unpaid interest before principal payments. But because such liquidations were legacy loans, we cannot determinate with certainty that CMBS 2.0 loan liquidations follow the same path and prioritize unpaid interest reimbursements over principal payments. Still, we believe only ASER shortfalls were de-prioritized at liquidation in CMBS 2.0.

Varying Reporting of Coupon Reduction Situations

Mod-driven coupon reductions, temporary or permanent, can show up in different places in deal reporting. This makes it a bit challenging consistently tracking the impact of coupon reduction situations. For example, the deferred interest in JPMCC 2021-BOLT is reported in the “interest adjustments” field of the deal’s interest shortfalls table. The interest collection reconciliation also shows the monthly interest adjustments resulting from the mod. The adjustment stood at $1.2 million in the latest remittance report. Interestingly, we do not see many loans across the CMBS universe that currently accumulate interest adjustments. Destiny USA Phase I ($300 million, JPMCC 2014-DSTY) is another notable example of a large loan with outstanding interest adjustments (Figure 2).

Figure 2. CMBS Loans with Accumulating Interest Adjustments



Source: Bloomberg and Academy Securities

In turn, JPMCC 2021-1440 is reporting its coupon reduction-driven shortfalls in the "modified interest reduction" field. The mod on the deal's $399 million 1440 Broadway loan features interest reduction to S+2.26% from S+4.225%. The deal's interest collection reconciliation does not show any interest adjustments.

IRP reporting guidelines may explain the different ways investors need to track rate reduction shortfalls. In situations where interest is being deferred following rate reduction, the servicer can choose to report either (1) the original rate with a corresponding interest adjustment, or (2) the modified rate with no interest adjustment. In turn, modifications with permanent note reductions can result in either (1) a reduction to the loan interest or (2) a reduction to the principal collections with a corresponding realized loss. There isn't consensus across master servicers on this determination, according to CREFC's guidelines. As such, servicers use one of two possible reporting methods. One simply reports interest amounts based on the modified rate. The second involves a few more reporting fields, including adjustments to principal and realized loss, and interest adjustments.

All told, in addition to distinguishing between permanent and temporary rate reductions, investors need to track various fields that contribute to accumulating shortfalls. We find that some of the relevant IRP fields, such as "other interest adjustments" (L102) and "deferred interest – cumulative" (L125), are not readily available on some cashflow systems.

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