Securitized Products Special Topics

CRE CLO Mods: Rising Volume Not Necessarily Telegraphing Distress

Structural Features Facilitate Mod Flexibility on CRE CLOs

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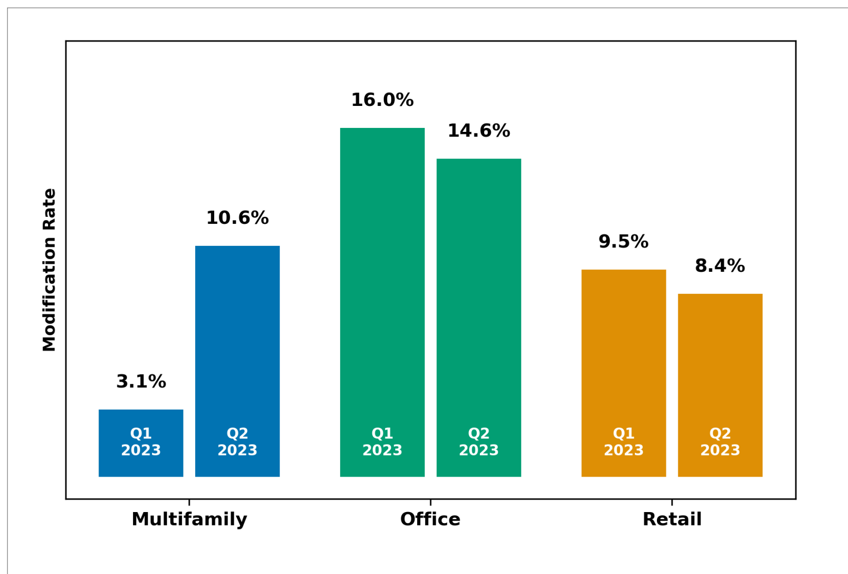
The rising volume of CRE CLO loan modifications spotlights the unique features of mods on transitional properties, and structural differences compared to CMBS mods. Notably, CRE CLO collateral managers can execute mods on performing loans, subject to various restrictions such as a cap on the number of such mods (so-called "criteria-based modifications"). In contrast, in CMBS because of REMIC rules it is nearly impossible to modify performing loans without triggering severe adverse consequences. The higher mod flexibility in CRE CLO aims to allow managers to better handle transitional, "high touch" loans. Still, if investors can't easily distinguish between criteria-based mods and full-fledged mods on troubled properties, CRE CLO modification levels can overstate distress.

The CRE CLO overall loan modification rate rose to 11.81% as of Q2 2023, a marked 532-bp increase QoQ, according to Morningstar DBRS. Mods on multifamily properties drove the quarterly increase, lifting the property type mod rate to 10.58% from 3.10%, the rating agency noted (Figure 1). In contrast, and perhaps somewhat counter-intuitively, the mod rates on office and retail properties declined QoQ.

Figure 1. CRE CLO Modification Rates by Property Type



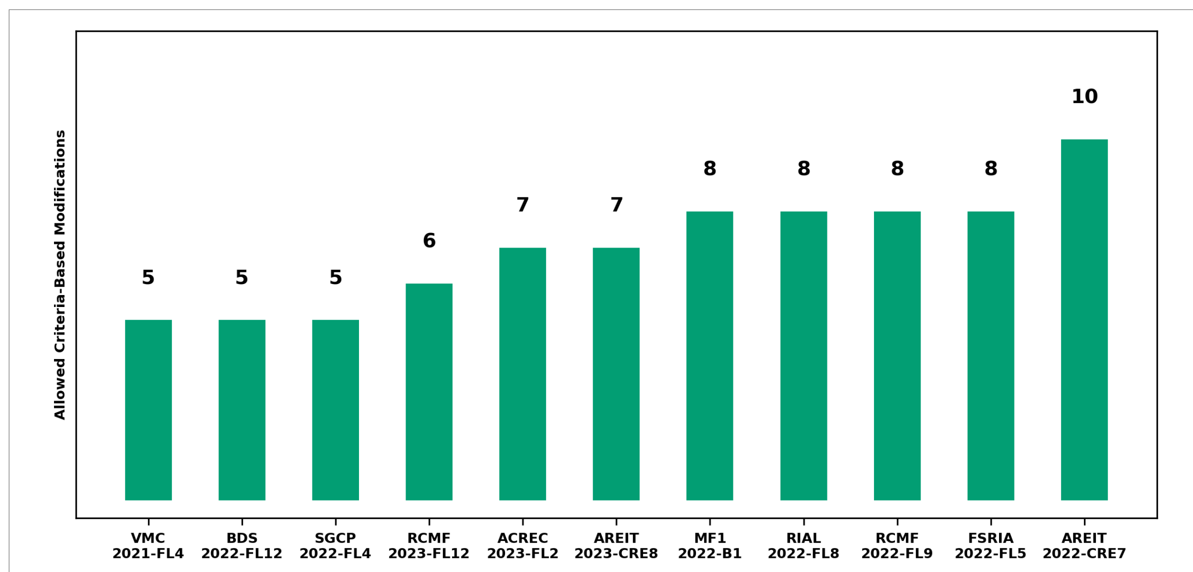
Source: Morningstar DBRS and Academy Securities

The recent mod trends sharpen the need to understand the nature and driver of CRE CLO mods. For example, the past quarter saw a complex modification on the Falchi Building ($201.7 million, BXMT 2021-FL4, BXMT 2020-FL2, and FL3), an urban office property in Long Island City, NY, that has faced some challenges as the sponsor executes a comprehensive, value-add capex plan to attract new TAMI tenants. The loan is now considered a “modified loan”, indicating the servicer executed it amid loan performance issues. In turn, the Huntley Apartments ($20.8 million, AREIT 2021-CRE5), a garden-style multifamily property in Pelham, AL, was also marked as modified over the summer. Unlike Falchi, deal documents do not suggest significant stress at Huntley. The loan was never delinquent. The modification extended the loan’s maturity date by one year, according to deal documents.

Caps on Criteria-Based Modifications

We find that the number of allowed criteria-based modifications, or the timing managers can execute them vary across CRE CLO deals. Quite a few deals allow up to eight such mods over the course of the transaction, or after the reinvestment period. Some deals diverge from this common number, allowing up to ten mods, or as few as five (Figure 2). In other deals, the cap may be more complex. Deals such as BSPRT 2022-FL9 allow mods of up to 10% of the collateral balance after the reinvestment period. We also found cases of deals that allow criteria-based mods only during the reinvestment period, with ARCREN 2022-FL2 one example. In contrast, other deals allow an unlimited number of criteria-based mods during the reinvestment period.

Figure 2. Allowed Criteria-Based Modifications



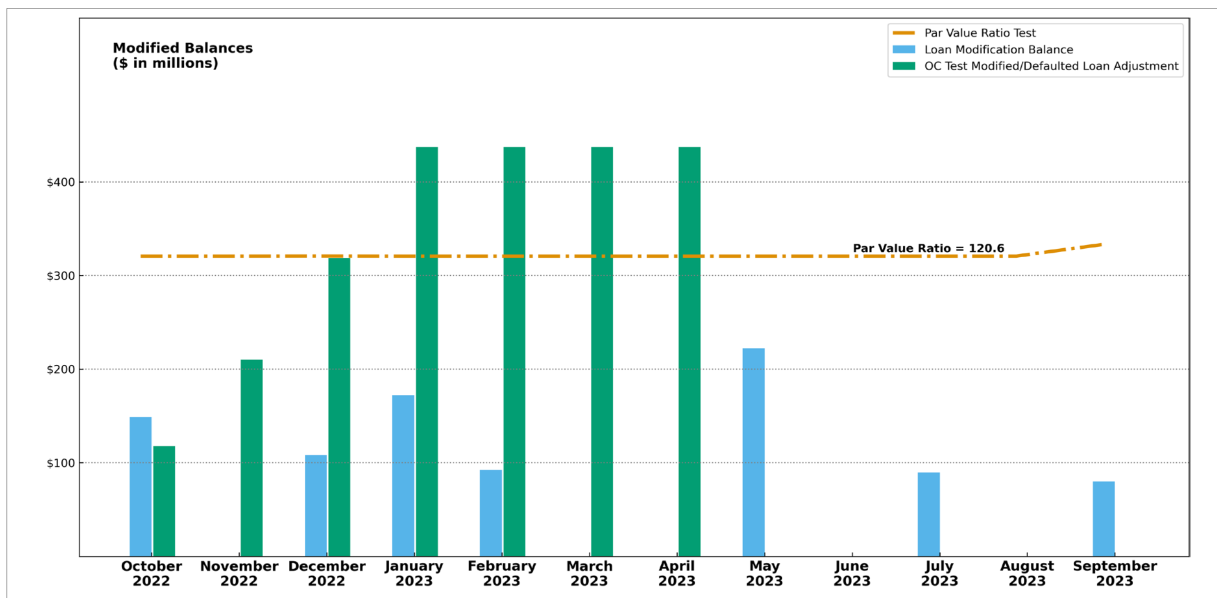
Source: Deal Documents and Academy Securities

Note Protection Tests Intact

The elevated CRE CLO mod volume apparently has not negatively impacted note protection tests so far. The par value, or overcollateralization (OC) test, could be particularly sensitive to any modified loans in a deal. The test, which calculates the ratio of the principal balance of the collateral to the principal balance of the offered notes, triggers cash diversion to the senior notes if the ratio falls below a certain threshold, say 110%. Notably, the collateral principal balance – the numerator of the OC test – could see a haircut if there are modified or defaulted loans. The haircut is aimed to reflect the pool's deteriorating credit quality, and trigger cash diversions sooner rather than later. Modified loan haircuts would reflect any appraisal reduction amounts.

Anecdotally, we find limited correlation between pool modification balances and adjustments to the OC test calculations. For example, in BXMT 2020-FL3, which saw quite a few modifications in recent months, including the Falchi Building one, the impact on the OC test appears very tenuous (Figure 3). The deal continues to feature healthy OC levels, hovering around 123%, compared to the deal's OC test threshold of 112.2%. We suspect one reason modified loans are not immediately impacting OC ratios is that few if any loans have recorded appraisal reduction amounts (ARA) so far. Of course, if and when deals report ARAs, and OC tests breach their thresholds, senior bondholders should benefit from cash diversions.

Figure 3. BXMT 2020-FL3 Modifications and Par Value Tests, October 2022 - September 2023



Source: Deal Documents and Academy Securities

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