



Interest Rate Environment Complicates Commercial Real Estate Maturities

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Rising interest rates over the past two years have led to many challenges in the commercial real estate finance market. Although the Federal Reserve has signaled that rate cuts are likely on the horizon, the current interest rate environment continues to pose a hurdle to many transactions. While parties that can avoid transacting in the current environment may elect to do so, that is not an option on loans that are approaching maturity.

Approximately \$2.75 trillion in commercial mortgage loans will mature between 2023 and 2027 ([Trepp.com](#)), leading to difficult decisions for lenders and borrowers. Below is a discussion of the options available to lenders and borrowers, and the analyses needed to execute on such choices.

Continue reading the article below or watch this short video for key points and takeaways.

Refinance

Many borrowers will look for opportunities to refinance their properties with new loans. However, the rate on a new mortgage loan is likely to be higher than the existing rate, which the property

may or may not support. Determining the financial viability of the property at current rates is an important step in the process. See also [“Interest Rate Woes: A Snapshot of the Lending Landscape in Commercial Real Estate”](#) for more discussion of the comparative rate environment.

Other challenges may exist, such as issues with valuations on commercial properties. The Commercial Property Price Index maintained by advisory firm Green Street estimates that commercial property prices were down 22% at the end of 2023, from peak prices in March 2022—although not uniformly across property types. The result is that many borrowers will be unable to obtain a mortgage loan large enough to fully pay off the existing loan.

As a result of these trends, some owners will find themselves unable to take out their existing loan through a cash-positive or cash-neutral transaction. Instead, they will need to inject additional capital into the property at the closing table. Many owners will be unwilling or unable to make such additional investments and will look for other options.

Sell

Some property owners will consider selling their properties, either because of challenges in the existing market or due to a pre-existing investment strategy. This can be an attractive option for a seller who would be unable to pay off their existing loan by refinancing at a lower loan-to-value ratio, but could pay off the loan with a sale at full market value. However, market values are also affected by the interest rate environment, with higher costs of acquisition capital leading to lower valuations. Ultimately, finding a buyer at an acceptable price may prove difficult for many properties.

We have seen these issues reflected in lower transaction volumes in the commercial real estate market, with sales volumes down as much as 50% based on 2023 sales data (such as this [CoStar Group report](#)), again affecting some property types (e.g., office) more than others (e.g., multi-family and industrial). These lower transaction

volumes are likely to continue until there is tangible relief in the interest rate environment.

Contractual Extension Options

Borrowers will continue looking for other options when refinancing the property is unattractive and selling the property is not feasible. One such option may be to extend the existing loan, as many floating-rate bridge loans include built-in extension options. Borrowers and their counsel should review the existing loan documents closely to evaluate any contractual extension options. The existence of extension options does not guarantee the viability of those extension options, as extension rights will require satisfying substantive and procedural conditions.

One common condition to extend a floating rate loan is a requirement that a borrower extend the existing interest rate cap to the new maturity date, with a strike price that was set based on interest rates at loan origination. See also [“Rapidly Rising Rates Complicate Existing Floating Rate Loans”](#) for further discussion of rate cap requirements.

Such a requirement may prove expensive as a result of increased rates. As an example, a three-year rate cap with a strike rate of 3% on a \$100 million loan would have cost less than \$100,000 in 2019. Today, that rate cap would cost \$3.5 million, according to Chatham Financial’s [interest rate cap calculator](#).

Another common requirement to exercise an extension option is that the loan satisfy financial metrics, commonly tied to debt service coverage ratio and/or debt yield calculations. A common practice is to require those metrics at the time of extension to meet such metrics at the original closing. The same factors that make it difficult to refinance a property will also lead to issues satisfying these metrics. However, many loans provide the ability for borrowers to partially prepay the loan in the amount necessary to satisfy these criteria. An analysis of the loan documents should uncover any such right.

For those borrowers that can satisfy the requisite criteria, exercising an existing extension option in hope of the interest rate market

improving such that a more permanent alternative becomes viable, will be an attractive option.

Non-Contractual Extensions

Where the existing loan documents do not contemplate loan extensions, borrowers may nevertheless approach their lenders to request an extension. Where possible, these conversations should be initiated far enough in advance of the maturity date to permit the parties to work toward a solution. Lenders are aware of the challenges and are often willing to consider an extension, particularly where they are reticent to foreclose.

There are factors that should be considered by borrowers and their legal counsel when considering an extension request. First, many lenders will want to see evidence that borrowers have truly explored the options for refinance or sale. Having engaged a broker to explore refinance and sale options will go some way toward satisfying lenders that borrowers are seeking to avoid a maturity fault in good faith.

Second, an analysis of any recourse provisions will be essential to determine a borrower's leverage in such discussions. A fully guaranteed loan with a well-heeled guarantor is likely to find a tougher path than a non-recourse loan, assuming the borrower has not triggered any recourse carveouts. Fully analyzing any recourse obligations, and confirming no recourse carveouts have been triggered before approaching the lender, is a wise course of action.

There may be strings attached when lenders are willing to offer an extension. Common requirements include extension fees, partial pay downs, deposits into interest reserves and/or the creation of static collateral reserves. These options put the lender in an improved financial position if the loan ultimately goes into default. Borrowers may be able to negotiate that reserve deposits come in the form of a letter of credit rather than cash, reducing the initial cash outlay.

Another common requirement is additional guarantor recourse. Making a loan that is otherwise non-recourse, partial recourse, may be discussed—and on partial recourse loans, the amount of such

recourse may be increased. Lenders often see this additional recourse as incentivizing borrowers to actively pursue all available options to pay off the loan at the extended maturity date.

One last option on fixed-rate loans may be to step up the interest rate. The new rate may still be less than current market rates, but would be a compromise by both parties. In all cases, the requirements listed above are likely to be combined to some degree.

Workout and Foreclosure

In the most extreme cases, where none of the options discussed above are satisfactory, borrowers and lenders may be faced with a workout process. Common workout scenarios include negotiating a discounted payoff, a note restructuring, or another arrangement that does not involve the lender taking possession of the property.

On non-recourse loans, borrowers may elect to work with a lender toward a deed-in-lieu or other friendly foreclosure option. Such an option should not be approached lightly. A borrower and their counsel need to be confident that they have not triggered any recourse carveouts before approaching the lender about handing over the keys to the property; if a recourse carveout has been triggered, the guarantor of the loan may be liable for certain losses to the lender or for the entire amount of the loan, depending on the nature of the carveout.

Similarly, lenders should make the same evaluation before agreeing to take a property in satisfaction of the debt. Absent an agreement, lenders may initiate contested foreclosure proceedings. Industry expectations are that we will see a rise in such activity in the commercial real estate space absent significant interest rate relief.

Conclusion

The interest rate environment will continue to pose challenges for existing property owners and their mortgage lenders for the foreseeable future. Navigating those challenges will require constant evaluation as conditions evolve, as well as a complex interplay between business and legal considerations.

For more inform, contact the author or any attorney with Frost Brown Todd's [Commercial Real Estate](#) and [CMBS](#) teams.

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