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Bank failures put spotlight on concentration risk for CRE cash management

One lesson learned from the global financial crisis was that there needs to be a strict chain of control over cash management accounts.

Samantha Rowan - 05/02/2023

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The March failure of Signature Bank, a major provider of cash management accounts for US commercial mortgages, revealed an unanticipated risk around the ability of lenders and servicers to understand and control the income stream from the assets underlying these loans.

Cash management accounts are a critical component of managing commercial real estate portfolios, providing a way for lenders and servicers to track cash coming in from tenant receipts and make sure it is allocated according to the agreement of the underlying loan documents.

But because these accounts are not a major revenue generator for banks, there are only a handful of banks which provide them, including Wells Fargo, Truist Bank, and PNC Bank. And market participants who spoke with *Real Estate Capital USA* highlighted the risks around having a limited number of banks providing this function.

“It is critical for the market to have options they feel are safe,” said Ted Wright, an executive managing director at Atlanta-based servicer Trimont. “As a servicer, our job is in the risk management business and we need to be able to help our clients manage the risk related to cash collateral.”

Cash management accounts became an important part of the commercial mortgage business with the advent of the commercial mortgage-backed securities market in the mid-1990s. These accounts tend to work in a similar way, with all tenant receipts initially flowing into a lender-controlled account.

"Cash management began to gain momentum with CMBS because there was an understanding that it was important to control and monitor that cash," Wright added.

Cash that flows into this lender-controlled account, called a deposit account control agreement, can then move into either locked or springing cash management accounts, Wright said.

A locked account, or a hard lock box, is typically controlled by the lender, which will apply the cash coming in based on requirements from the underlying loan documents. "There will be a priority of payment, including putting money aside for reserves, taxes or insurance and there could a provision for the borrower's operating expenses," Wright said. "There could also be situations in which cash goes into an excess cash reserve, depending on the deal."

The situation is different for springing lock boxes, where tenant receipts come into the deposit account and then, if everything is performing, the cash gets swept back into the borrower's operating account.

"If there is a trigger event and the lender needs to trap the cash, the lender can send one letter to the bank that controls the deposit account and the bank redirects the funds to the cash management account," Wright said. "Springing cash management situations will turn into hard lockboxes upon a trigger event."

Cash management accounts also let lenders and servicers keep tabs on a property's month-to-month performance. "The pieces come together to track what kind of income you're getting, determine how dependable and sustainable it is and what it will take to improve that income stream," Wright said. "We're also looking at what could possibly erode that income stream."

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Stricter controls post-GFC

One lesson learned from the global financial crisis was that there needs to be a strict chain of control over cash management accounts. "There were situations during the GFC where no one seemed to know where the DACA accounts were or

discovered a borrower had closed an account, both of which were problems for servicers who needed to intervene and trap cash in distressed situations," Wright said. "The market tracks those accounts very closely today."

The due diligence around cash management goes a step further today and is part of the surveillance process. "When we review monthly and quarterly financial statements, we also want copies of the bank accounts for all of the DACAs so we can perform a quick reasonable test on the amount of cash coming in to make sure it matches the rent roll and is being used the way it is intended," Wright added.

As distress rises, the role of cash management accounts will be one of the pieces of the puzzle for servicers to figure out next steps for a troubled asset.

While distress has so far been muted, there have been signs of trouble in the commercial mortgage-backed securities market as the special servicing and delinquency rates creep up. According to data from New York-based data provider Trepp, the special servicing rate rose 37 basis points in March to 5.55 percent. This represents the largest month-over-month increase since August 2020.

While the special servicing rate was actually higher one year ago, at 5.66 percent, Trepp believes the increase in March was significant for a number of reasons.

"The volume of loans to transfer was higher, as nine loans with an outstanding balance of at least $100 million were transferred," the report stated. "Also, three of the five major property types saw significant increases in the special servicing rate." Trepp tracked at 84 basis point increase in the retail rate, with multifamily and office each rising by 34 basis points.

As distress rises and more loans enter special servicing, cash management will be a critical piece of putting together a larger picture, Wright said.

"We need to protect that income stream which is how money is lent – it is based on the ability to repay, which is from the property. Preserving the cash is critical," Wright said. "And as the market shifts, the inability of tenants to pay will affect

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the income stream and if we can’t control the cash, it doesn’t matter how strong the income stream is.”

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