How The Commercial Real Estate Slump May Weigh On Banks

By **Atanu Saha and Yong Xu** (August 28, 2023)

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Emerging from the COVID-19 pandemic, the U.S. commercial real estate, or CRE, market has witnessed major changes in demand patterns, property values and investment trends. The office sector, once the epitome of CRE, has struggled and is showing early warning signs of a severe downturn.

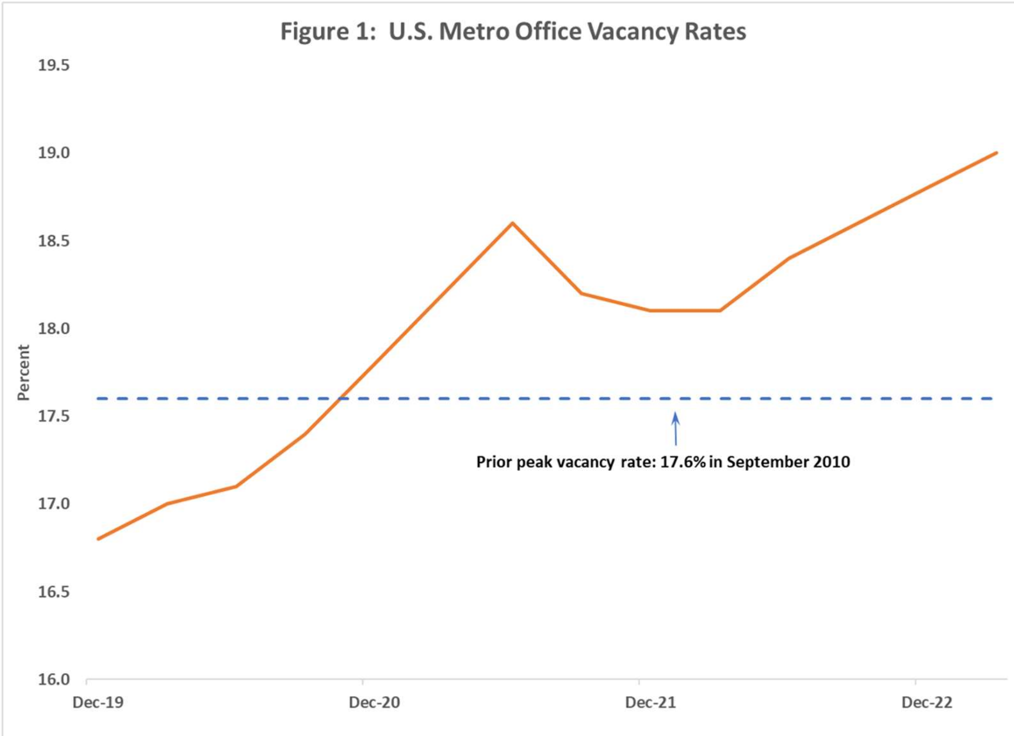
Given its interconnectedness with the banking sector, CRE's underperformance is weighing on regional banks, already stressed as a result of tightening liquidity and portfolio losses. The continuing malaise in the CRE sector has significant implications for the financial performance and disclosure requirements for various banks, especially for the regional ones with large CRE debt exposures.

The What: There Are Early Warning Signs

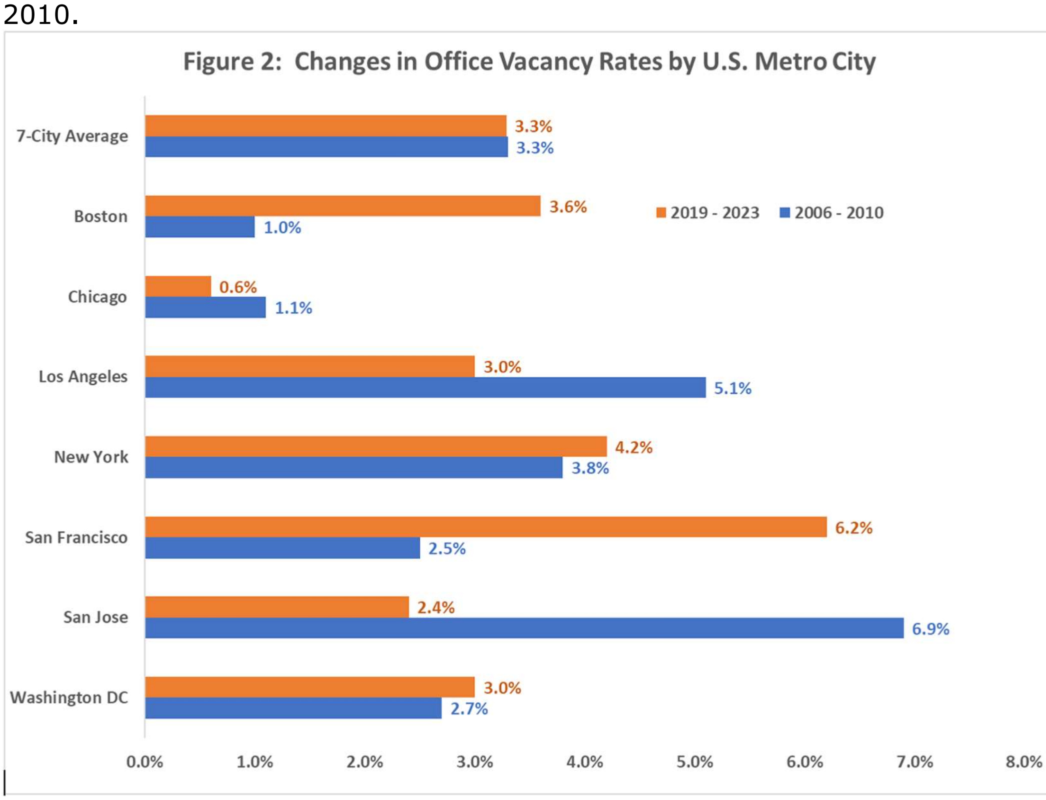
To view transaction volume and prices for office properties in perspective, we compare them with the last CRE crisis, which ensued after the Great Recession. During that time, while the stock market and the economy started experiencing a severe downturn from the fall of 2008, the problems in the CRE sector peaked almost two years later, in September 2010.

Rising Office Vacancy Rates

The latest data from Moody's REIS indicate that the average vacancy rate reached a record high of 19% in U.S. metro office markets in the first quarter of 2023, exceeding the previous peak rate of 18.6% in June 2021. Importantly, the current vacancy rate is higher than the 17.6% rate in September 2010, which was the highest rate during the 2008-2010 CRE crisis, as seen in Figure 1.

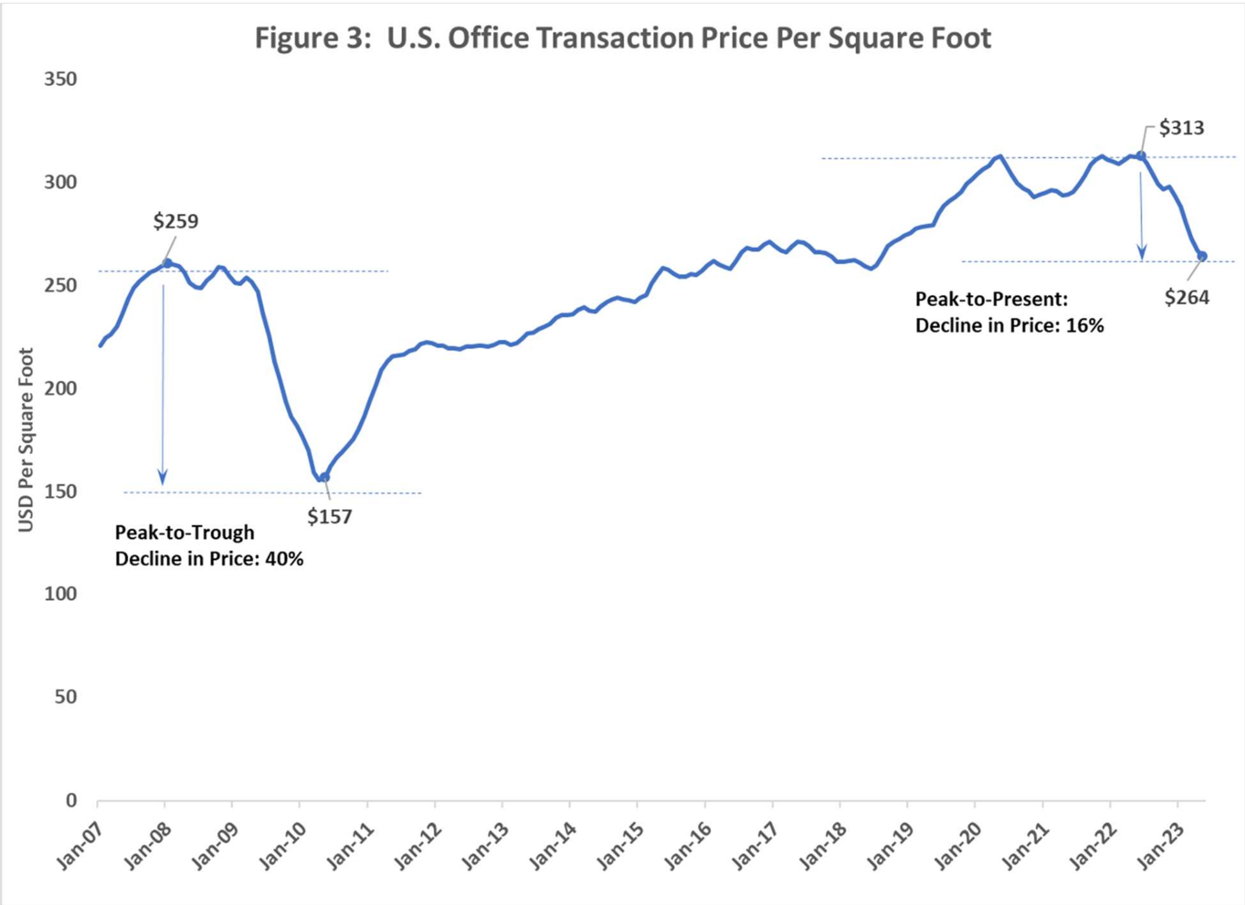


For key metropolitan cities such as Boston, New York, San Francisco and Washington, D.C., the rise in vacancy rates has already exceeded those during the 2008-2010 CRE crisis on a time-matched basis (Figure 2). Across the seven major cities, the average increase in vacancy rates over the period 2019-2023 has reached the average increase during 2006-2010.



__Softening Prices in CRE Office Transactions__

The average U.S. office transaction price has declined 16% from $313 per square foot in June 2022 to $264 per square foot in May 2023 (Figure 3). This decline from the peak is more than a third of the 40% peak-to-trough drop during the 2008-2010 crisis. If the momentum of the current price decline persists, we could see transaction prices plunge to $187 per square foot, close to the lowest level during the prior crisis.

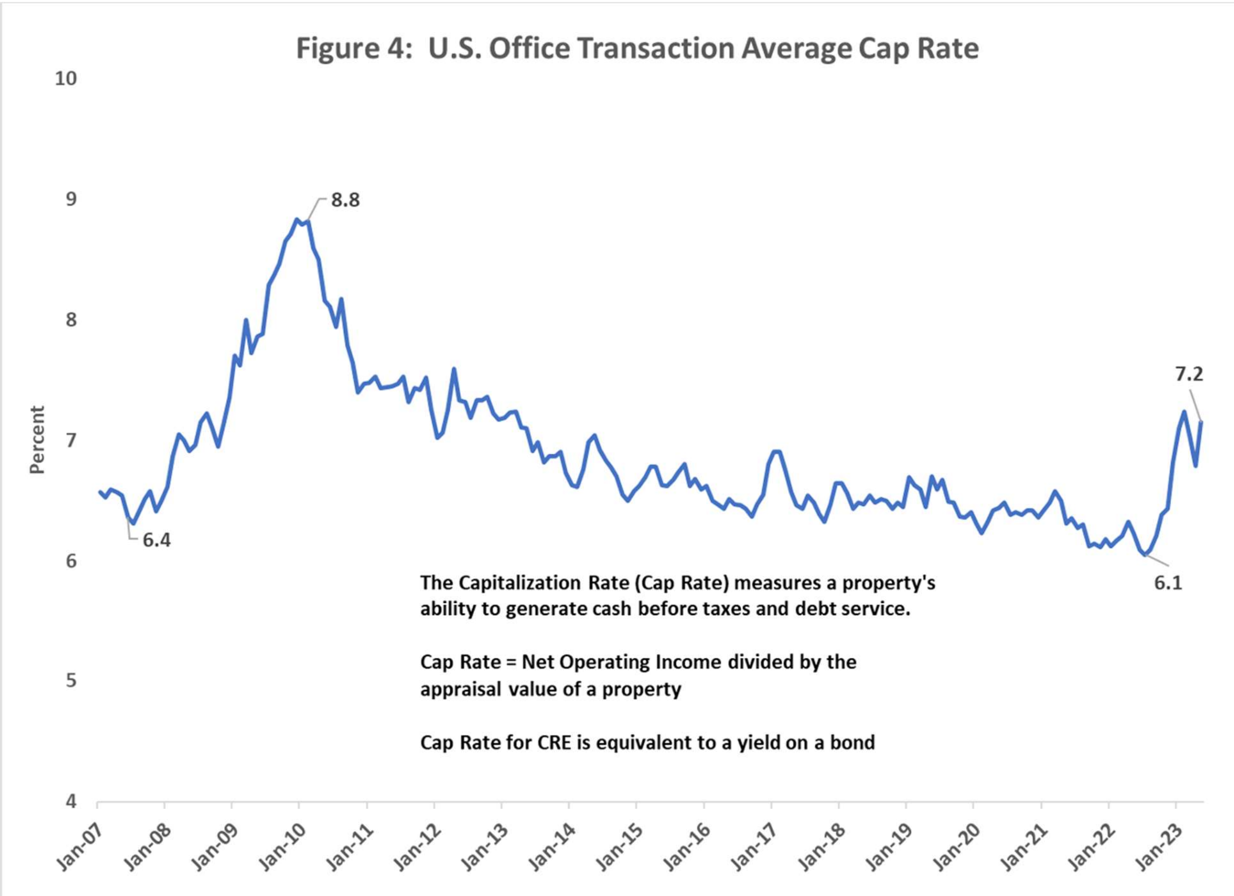


__Rising Capitalization Rates__

As a key performance metric, a capitalization rate measures the net operating income relative to the property value for a CRE asset.

Rising cap rate is analogous to rising bond yields. Just as junk bond investors demand higher yields for holding a riskier asset than an investment-grade bond, higher cap rates reflect higher perceived risks of CRE investments.

The average U.S. office transaction cap rate trended up to 7.2% in May 2023 from the bottom level of 6.1% in July 2022 (Figure 4). If history is an indicator, cap rates will likely continue to rise from their current level.



The Why: The Writing Is on the Wall

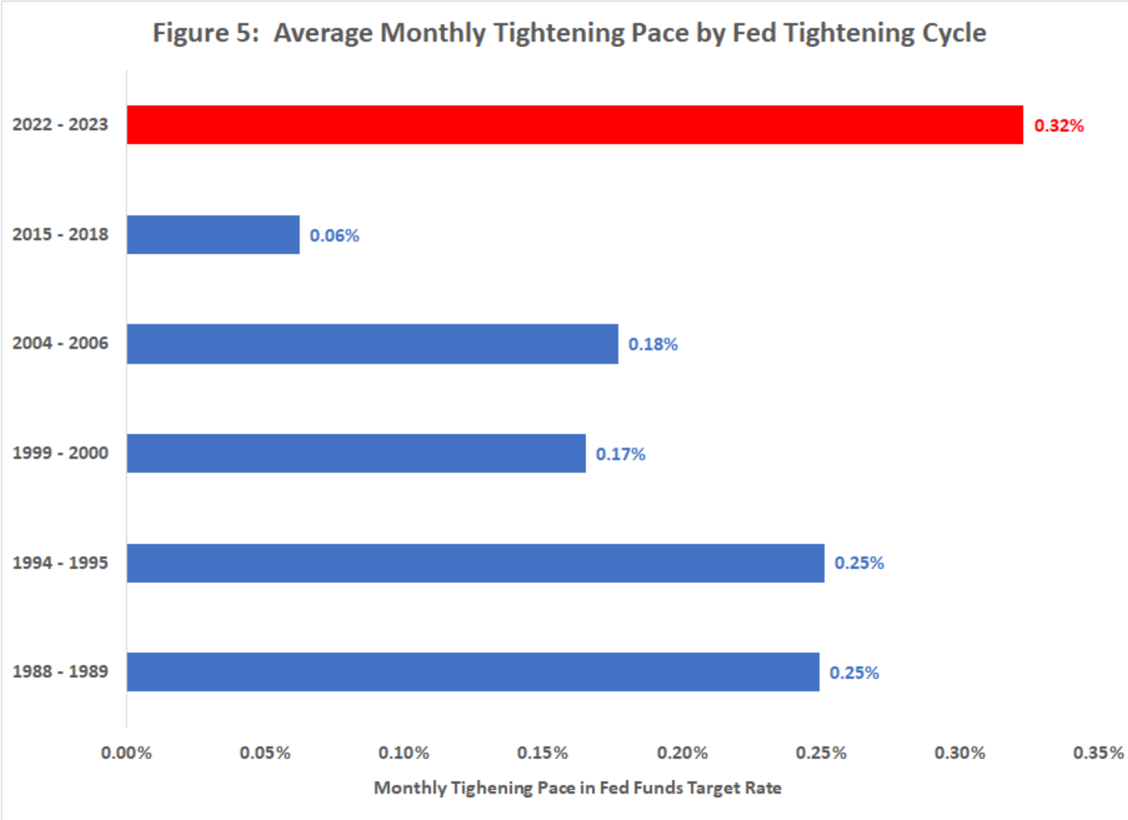
The reasons for the underperformance of the CRE office market, particularly the shift to remote work and layoffs in the technology sector, have been discussed widely in the press. We discuss ones that have received less attention.

Rapidly Rising Interest Rates That Were Unanticipated

During the current Federal Reserve tightening cycle, which started in March 2022, the pace of the Fed's rate hikes has been unprecedented since the 1980s. Compared to the previous five tightening cycles,[1] the Fed has raised interest rates at the highest pace of 32 basis points per month during the current cycle (Figure 5).[2]

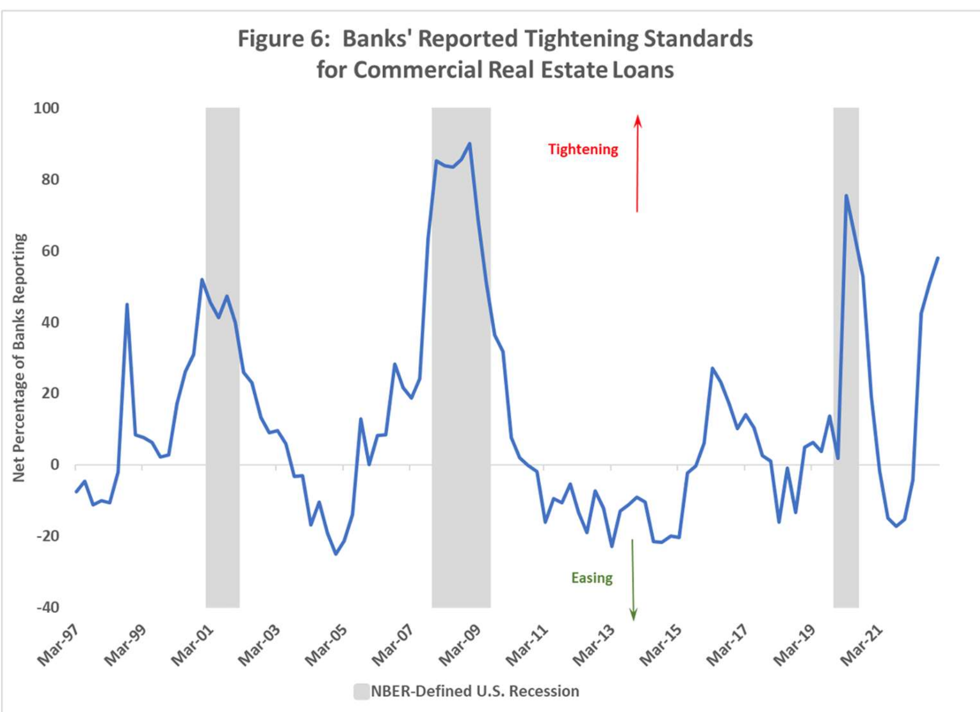
The unanticipated rapid pace of interest rate increases has two key adverse effects on the CRE sector.

First, it increases the cost of borrowing or refinancing for real estate developers and property owners. Second, higher interest rates make CRE investments less attractive to its fixed-income alternatives, such as bonds and money market funds.



Tighter Lending Standards

CRE loan lending conditions tightened this spring to levels not seen since the peak of the pandemic (Figure 6). The tightening CRE lending standards toward the 2008-2010 level implies a more challenging environment for property owners to borrow or refinance their debt.



The Who: Will the Banks Be Left Holding the Bag?

In light of several high-profile bank failures this year, including those involving Silicon Valley Bank, Signature Bank and First Republic Bank, regional banks are under particular scrutiny.

Exposure to CRE Debt Among Regional Banks

For the total outstanding volume of $3.6 trillion in CRE loans, small and regional banks hold more than 40% (Figure 7).[3]

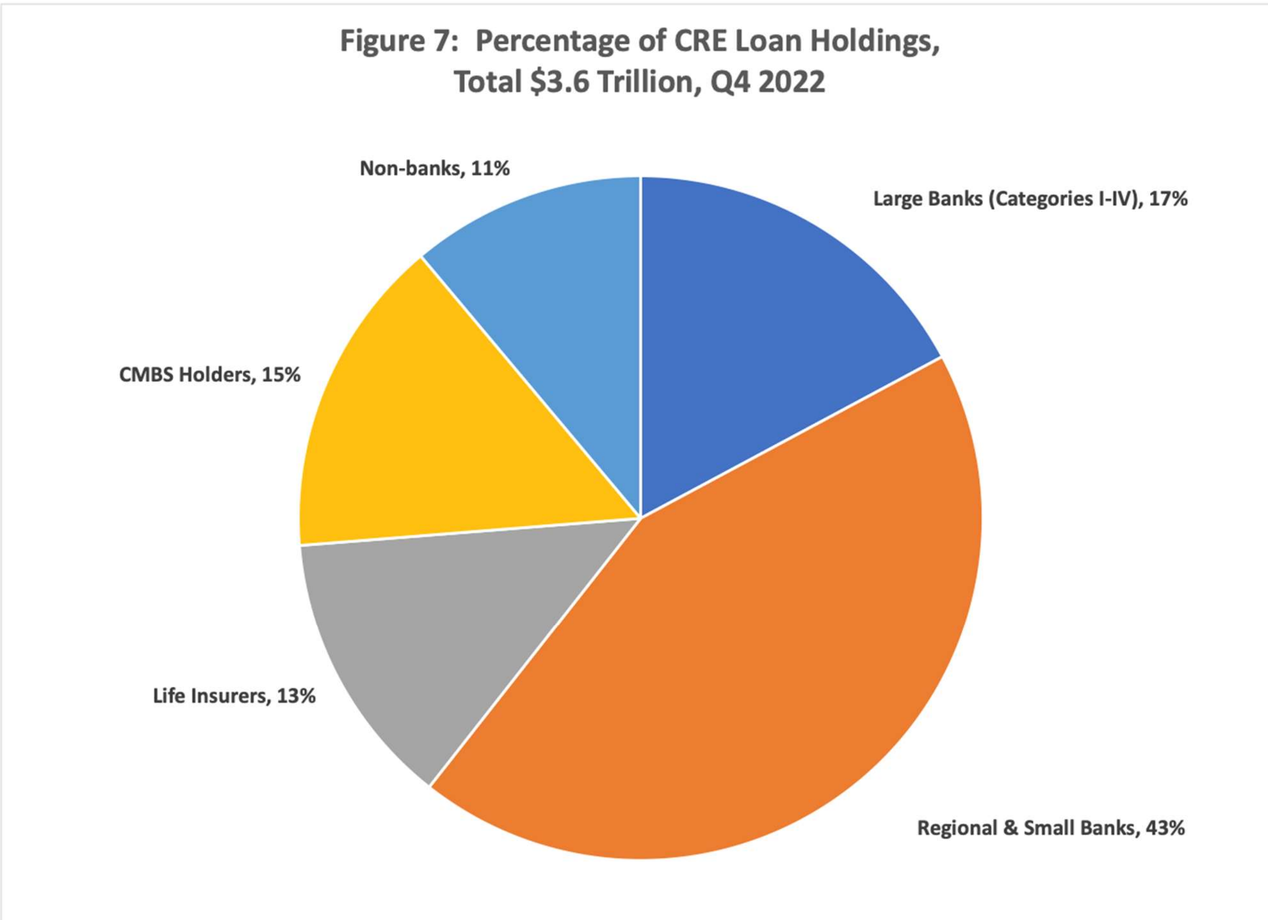
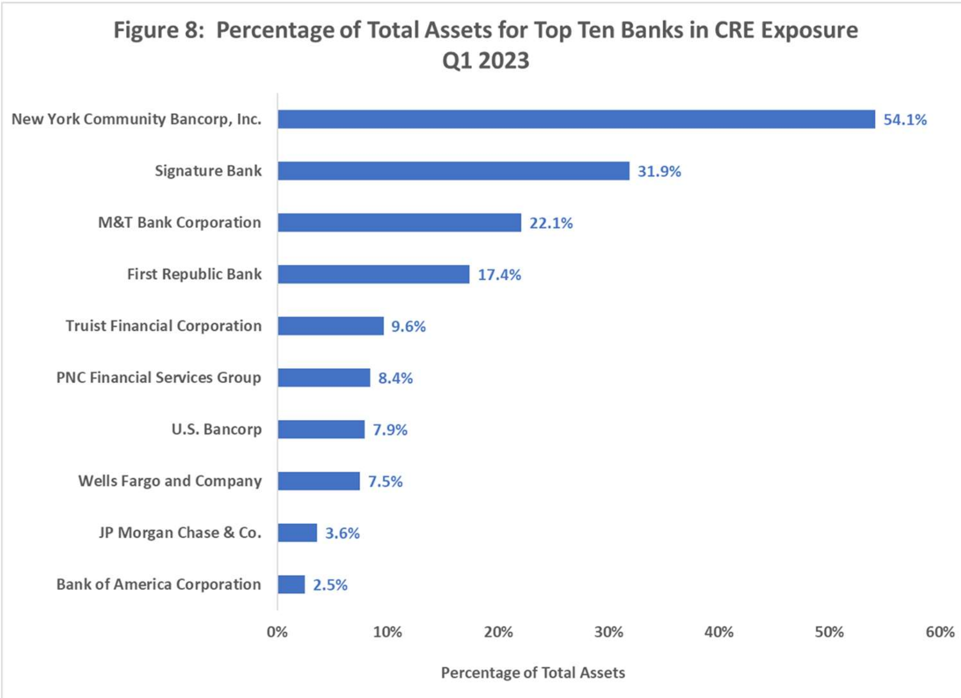


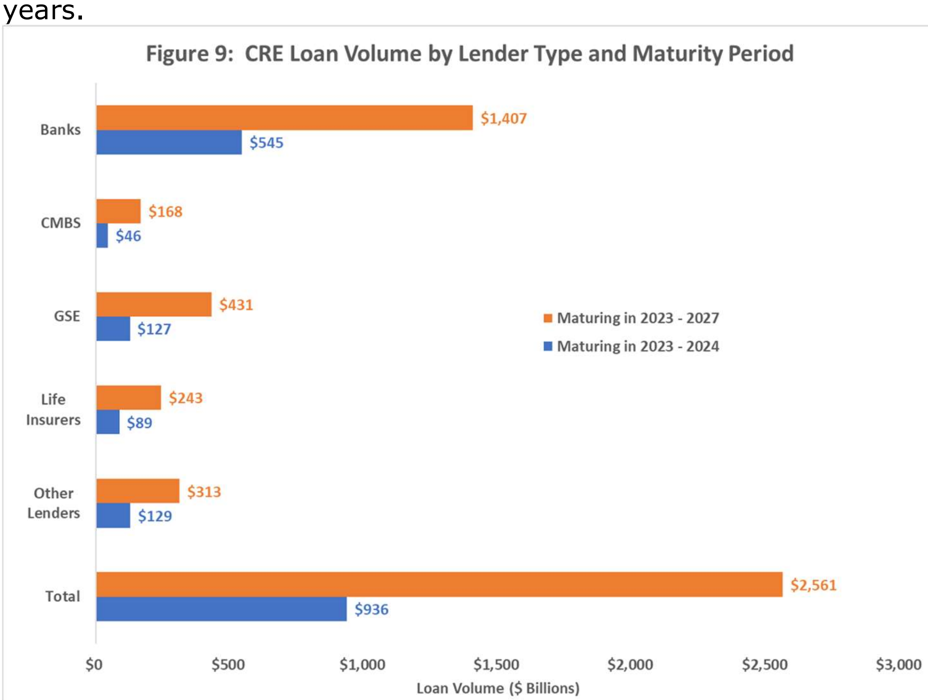
Figure 8 shows the percentage of total assets with CRE loan exposure for the 10 banks with the largest CRE loan holdings. Among these, Signature Bank and First Republic Bank have already collapsed and entered into receivership.



Maturing CRE Loan Volume in the Next Few Years

During the past decade, CRE loan origination volumes have been increasing at a steady pace, reaching $753 billion in 2021 and a record high of $862 billion in 2022.[4]

Over $2 trillion of CRE mortgages are coming due in the next five years, more than one-third of which — $936 billion — will mature this year and in 2024 (Figure 9).[5] Banks, which hold more than half of the CRE debt, will see that debt maturing over the next two years.



Over 80% of commercial mortgage-backed securities, or CMBS, loans since 2019 are interest only, which implies their higher risks to the CMBS holders than amortized loans in a rising rate environment.[6]

Deposit Flight

Regional banks, even large banks,[7] face the double whammy of CRE debt exposures and declining deposits. Banks have seen their deposit base dwindle at a faster pace when the Fed started to raise interest rates (Figure 10).

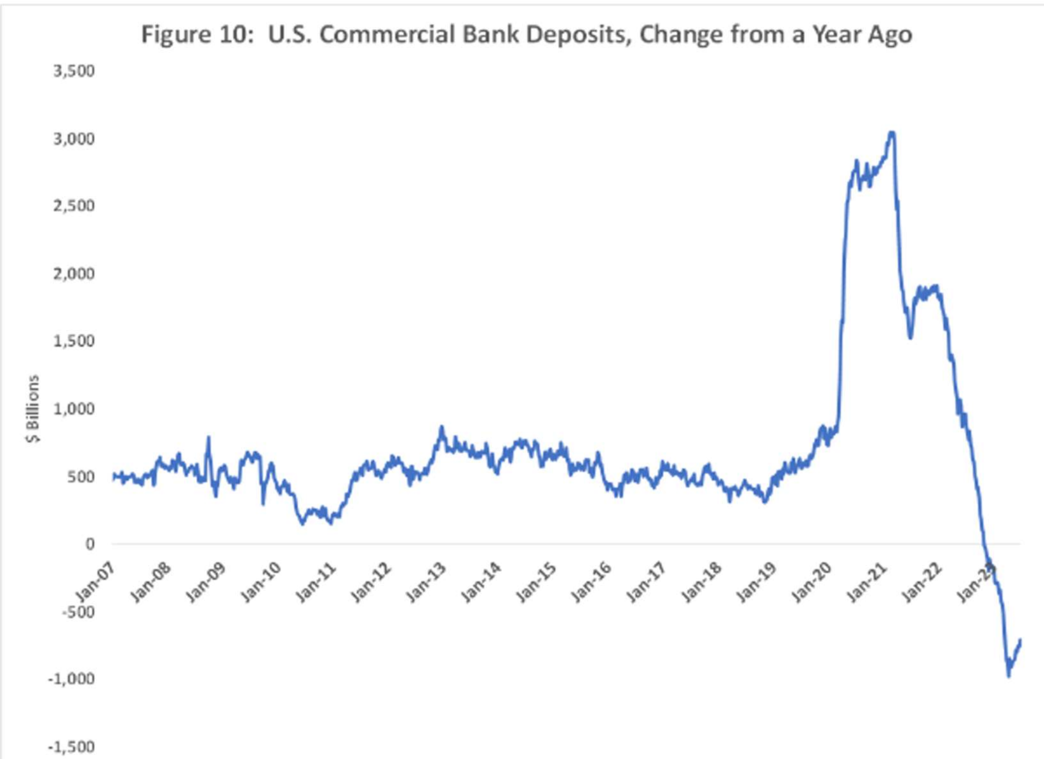


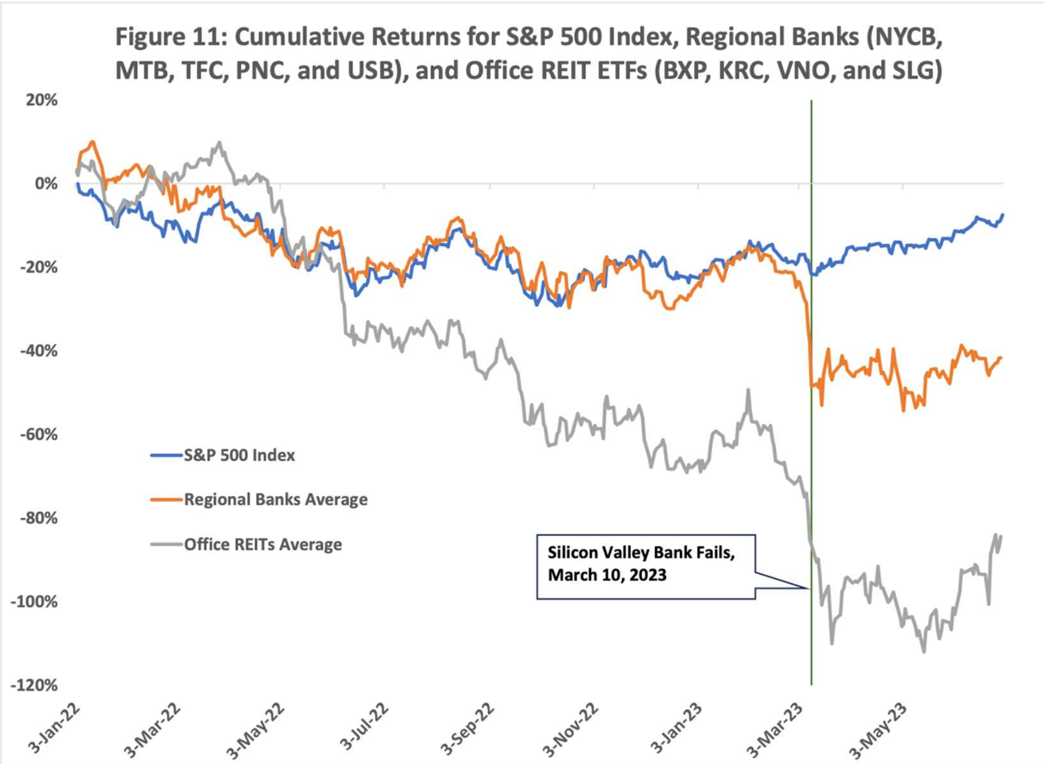
Figure 10: U.S. Commercial Bank Deposits, Change from a Year Ago

After the peak around the height of the pandemic, the increases in commercial bank deposits decelerated dramatically and deposits have started to decrease this year, largely as a result of higher yields of alternative fixed-income assets relative to banks' savings rates.

A March academic study suggests that 186 U.S. banks could fail if half of their depositors suddenly withdrew their funds.[8] The researchers, focusing on banks' CRE loan portfolios, formulated a speculative scenario in which each bank experienced a run and concluded that the Federal Deposit Insurance Corp. would run out of money.

Regional Banks' Market Performance

The impact of CRE sector troubles has already weighed on the stock performance of office real estate investment trusts and regional banks this year (Figure 11).



What if the Darkening Clouds Turn Into a Thunderstorm?

If the CRE sector's troubles mushroom into a full-blown crisis, with the failure of a few more regional banks and the contagion effect dragging down even larger banks, there would no doubt be a slew of lawsuits. The key questions in these lawsuits could be: What disclosures were made by financial institutions and, importantly, were the disclosures adequate?

Prior to its collapse in March 2023, SVB reported in its annual report that the bank held about $2.6 billion in CRE loans, with office and medical properties accounting for 20% of its CRE-backed loans.[9] In this annual report, SVB also disclosed that its CRE loans "may involve a higher risk of default" compared to other types of loans."[10]

Today, with the benefit of hindsight, one might ask whether SVB could have or should have disclosed more. This question is germane not only for SVB, but also for various regional banks and financial institutions with CRE exposure. The answer can be complicated.

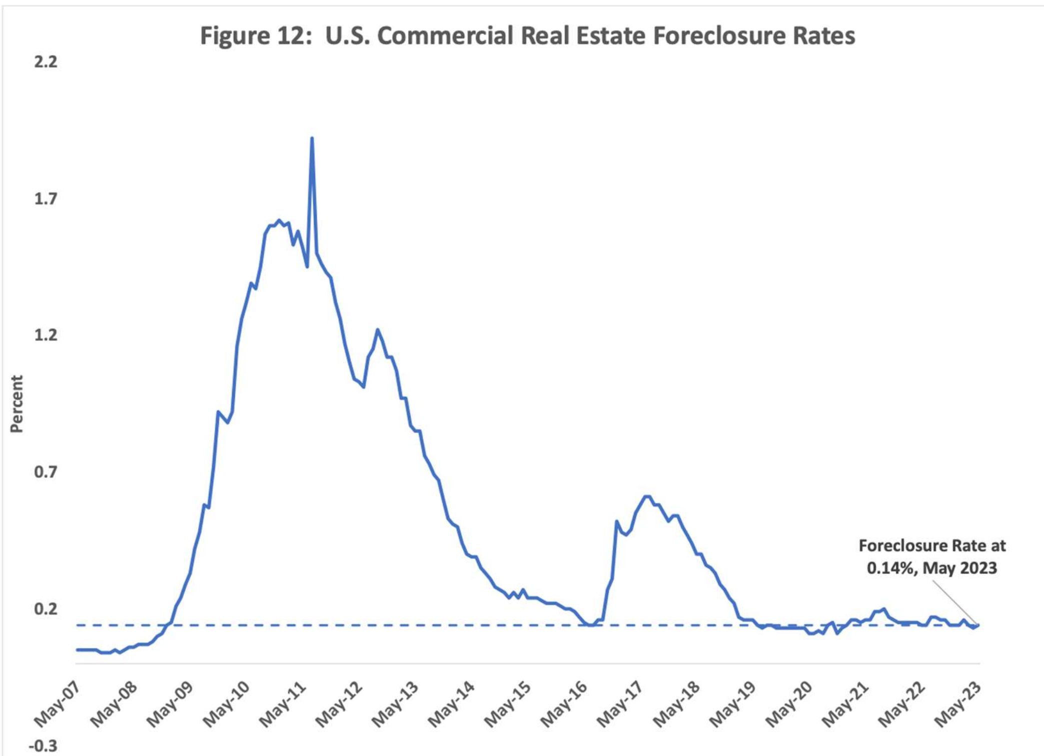
A key issue is predictability, which, in turn, has bearing on the question of the duty to disclose. For example, if a firm knows with certainty an adverse event — for example, a major mining disaster — has happened, and it will impair its future earnings, then clearly it has a duty to disclose the future earnings impact. Thus, the answer regarding the question of the duty to disclose hinges on the foreseeability of the adverse event; in this case, the CRE crisis.

No matter how reliable one's model or research is, anticipating the future path of the CRE market and its impact on a bank's financial statements remains challenging. Despite the many warning signs of a CRE crisis we discussed, CRE loan foreclosure rates remain relatively low at this moment (Figure 12).

As was noted earlier, while the stock market and the economy experienced a severe downturn starting in fall 2008, the CRE foreclosure rates did not peak until fall 2010, suggesting a two-year lag. However, in that crisis, the economy and the stock market had already taken a nosedive by the fall of 2008.

By contrast, the overall economy currently is generally strong, with a 2.4% gross domestic product growth rate in the second quarter of 2023, robust employment figures, fairly healthy consumer spending, and a more than 20% gain for the overall stock market as of the end of July.

It is thus difficult to posit that a full-blown CRE crisis is predictable, let alone inevitable. This raises the question of what disclosure duty financial institutions have regarding the risks of their CRE exposure in regard to the U.S. Securities and Exchange Commission, as well as accounting and regulatory requirements at large.



That said, many financial firms have already voluntarily updated their financial statements to address potential risks and CRE exposures. From a regulatory point of view, how effective or adequate these types of disclosures are remains to be seen. The SEC has already announced it may seek more disclosure from smaller banks in wake of bank failures.[11]

One thing is clear: The regional banks and financial institutions can head off any allegations of disclosure inadequacy by proactively taking measured steps to enhance the transparency of their risk exposures. In securities lawsuits, has anyone heard of plaintiffs suing a firm for too much disclosure?

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[1] Each of the Fed's tightening cycles is defined as the period starting from the month when the Fed raised the fed funds target rate after a pause and a cut to the month when the Fed had the last rate hike before a pause and a cut.

[2] The monthly pace of the Fed's rate tightening is estimated as the difference in the fed funds target rate between the start and the end of the tightening cycle, adjusted by the number of months during the tightening cycle.

[3] Financial Stability Report, Board of Governors of the Federal Reserve System, May 2023.

[4] TREPP CRE Research, CRE Loan Origination Volume Grew 15% in 2022: What This Means in the Face of Bank Failure News and Recessionary Signs. March 2023.

[5] TREPP Quarterly Data Review, Banking Sector Turmoil: Impact on CRE, Spring 2023 Issue.

[6] The Wall Street Journal, Interest-Only Loans Helped Commercial Property Boom. Now They're Coming Due, June 6, 2023.

[7] Bloomberg, "Real Estate Woes Drive Billion-Dollar Hit for Goldman Sachs." July 19, 2023. Large banks are feeling the pain caused by the real estate woes as well during the earnings season for Q2 2023. Not as a largest property lender, Goldman Sachs reported that it has more than $14 billion of real estate investments and had to write down those bets by $1.15 billion for the second quarter of 2023. The CRE office business drove much of JPMorgan Chase & Co.'s $100 million in charge-offs, and the bank built its loss reserves by $389 million largely because of "updates to certain assumptions related to office real estate." At Morgan Stanley, increases in provisions for credit losses were "primarily driven by credit deteriorations in the commercial real estate sector."

[8] Jiang, Erica, G. Matvos, T. Piskorski, and A. Seru. 2023. Monetary Tightening and U.S. Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs? SSRN working paper.

[9] SVB Financial Group Form 10-K, p. 69.

[10] Ibid., p. 20.

[11] The Wall Street Journal, SEC Seeks More Disclosure From Smaller Banks in Wake of Failures, June 22, 2023.