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INSIGHT

Bank Exposure to Commercial Real Estate

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The economic turmoil resulting from the pandemic negatively affected commercial real estate (CRE), particularly by leading to a sharp, albeit temporary, increase in delinquencies among commercial mortgage-backed securities. As the economy recovers from the pandemic, some CRE owners with mortgages outstanding are continuing to face pressure from a decline in lease payments. Missed payments potentially jeopardize owners' ability to repay their lenders, many of which are banks. According to the Federal Deposit Insurance Corporation (FDIC), "more than 98 percent of banks engage in CRE lending and CRE loans are the largest loan portfolio type for nearly half of all banks." This Insight examines the extent to which banks are exposed to CRE risk and explores issues Congress may find relevant.

Overview of CRE Market Stress

The CRE market is large and complex. Most of the properties are owned or leased by private companies, so valuing the market is difficult. Banks are the largest lender of CRE mortgages and hold around $3 trillion in CRE debt on their balance sheets. Nonbank financial institutions also play a significant role. CRE comprises many subsectors, including office and industrial space, retail storefronts, apartments, hotels, health care facilities, and other specialty properties such as sports venues, storage units, and data centers, but stress is concentrated in office and retail space.

CRE mortgages are financed on shorter terms than residential mortgages, often with balloon payments due at maturity, often two to five years. Trepp, an industry analysis firm, estimates that $448 billion in CRE loans are maturing in 2023, with about $270 billion of that coming from bank loans. In the retail subsector, leases on many retail spaces tend to last between three and five years. This means that many of the tenants of properties with mortgages coming due are deciding whether or not to renew their leases. In the office subsector, due to the convergence of work-from-home policies and other economic pressures, many companies that rent space from CRE owners are not renewing their leases, and some are breaking their leases or trying to renegotiate terms. This is evidenced by higher office vacancy rates, which hit all-time highs earlier this year.

A loss of rental income will lead to higher default rates among CRE owners. This is compounded by the coinciding maturities of many CRE mortgages, which will accelerate defaults if rental income cannot sufficiently offset the balloon payment obligations or if alternative financing cannot be procured.

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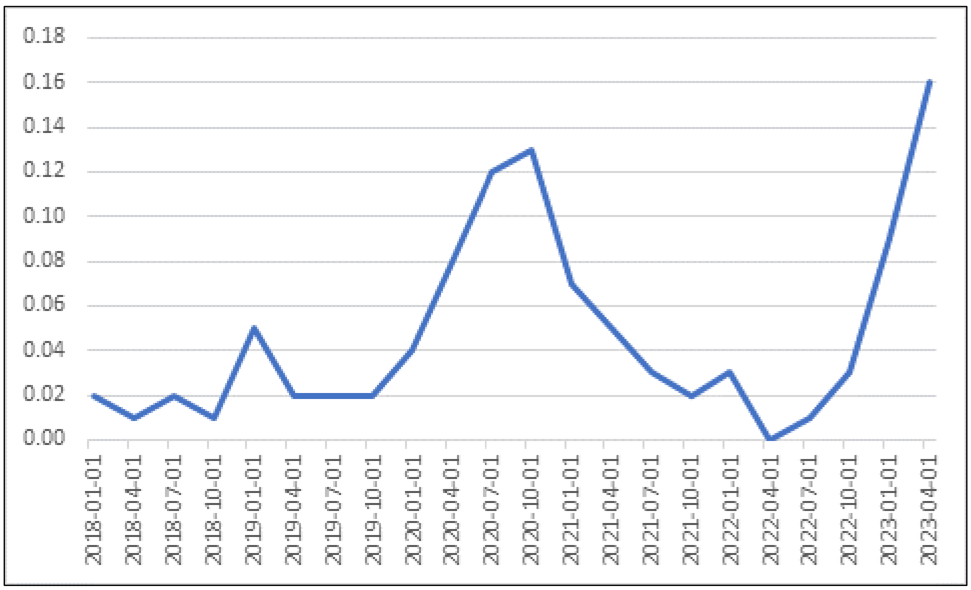
Bank Exposure to CRE

Banks are exposed to CRE in a few ways. The most direct way is by issuing and holding CRE loans on their books. These loans can be issued to commercial property owners or to developers. A more indirect way banks are exposed is through holding commercial mortgage-backed securities on their books as investments. (This is not the focus of this Insight but is an important source of liquidity in mortgage markets.) Banks hold $1.8 trillion of non-farm, non-residential CRE loans on their books. Delinquency rates on CRE loans peaked at 9% in 2010 in the aftermath of the financial crisis and fell to a recent low of 0.58% in 2018 before spiking briefly during the pandemic. While delinquency rates have risen again, they are still lower than pandemic levels. However, charge-off rates have already begun to exceed pandemic levels, suggesting that banks are writing down the values of their CRE portfolios (see **Figure 1**).

Figure 1. Charge-Off Rates on CRE Loans

All Commercial Banks



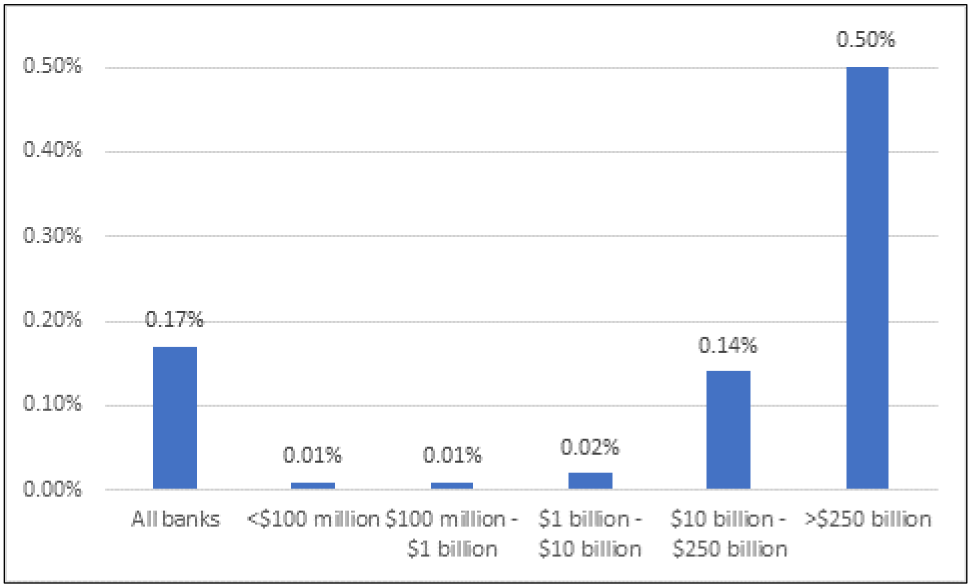
Source: Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/CORCREXFACBS.

Note: Seasonally adjusted data.

According to FDIC data, charge-offs are highest among the largest banks (see **Figure 2**). Because the largest banks generally tend to make larger loans, this could mean that vacancies among large office and retail spaces are driving this trend. Alternatively, it could mean the large banks have just been quicker to write down their CRE loans.

Figure 2. Charge-Off Rates on CRE Loans

By Asset Size of Bank



Source: FDIC Quarterly Banking Profile, Q2 2023, https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2023jun/qbp.pdf#page=11.

Bank Supervision and Regulation of CRE Risk

Congress has shown considerable interest in bank supervision in the wake of three large bank failures in 2023. One area of focus of recent oversight has been on banks' ability to manage unrealized losses and hold appropriate amounts of capital to offset the associated risks of assets held in their portfolios. To that end, capital rules assess risk weights to CRE exposures. Other bank regulatory considerations related to CRE include the following:

- In June 2023, the federal banking agencies issued guidance on "Prudent Commercial Real Estate Loan Accommodations and Workouts," in which they issued a formal policy statement to provide a framework for how banks should accommodate loans that are not being repaid.
- In accordance with 2007 regulatory guidance, supervisors place enhanced scrutiny on banks that hold more than one of the following measures: "construction loans surpassing 100% of risk-based capital" or total "CRE loans above 300% of risk-based capital" and "50% growth in CRE over the last 36 months." CRS calculated that as of June 2023, 483 banks held construction loans exceeding 100% of Tier 1 capital. These banks represent relatively small institutions comprising $631 billion in assets. However, 1,020 banks held CRE loans exceeding 300% of Tier 1 while reporting growth exceeding 50% over the past three years, representing $2 trillion in banking assets, including 35 banks between $10 billion and $100 billion in assets.
- In July 2023, the banking agencies announced a proposal to modify capital rules for the largest banks—those exceeding $100 billion in assets. These banks hold about $1.5 trillion in CRE exposure, and none meets either of the above supervisory thresholds. According to the proposed rule, "the agencies estimate that the proposal would slightly decrease marginal risk-weighted assets attributable to retail and commercial real estate

- exposures." In other words, if the rule were finalized, large banks would hold less capital against CRE exposures.

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