U.S. Bank Commercial Real Estate: Delinquencies Rising, Losses to Come

Small Banks More Vulnerable Due to Elevated Concentrations

"Fitch expects that CRE loan losses will play out for the banking sector over an extended period. During the Great Financial Crisis, losses did not peak until almost two years after peak in delinquencies, and problems loans have yet to peak for the sector."

Julie Solar, Group Credit Officer

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Commercial real estate (CRE) has been a credit concern for U.S. banks, driven in large part by structural changes in patterns of office utilization coupled with the rapid increase in interest rates. In Fitch Ratings' view, valuation deterioration driven by the aforementioned changes will lead to difficulties refinancing certain office properties underwritten during the prior extended low rate environment, particularly those in larger central business districts (CBDs). This will ultimately result in increased CRE credit costs for the banking industry.

U.S. Banks are Largest CRE Lenders

There are a number of participants in the U.S. CRE lending market, including non-bank financial institutions, insurance companies and government-sponsored entities. However, the bulk of CRE loans are held in U.S. banks, which hold approximately 50% of outstanding CRE debt.

Within the banking sector, banks with over $100 billion in total assets hold a material portion of CRE loans on a dollar basis, but these loans represent a significantly lower concentration in terms of total loans versus smaller institutions.

To date, CRE credit quality has begun deteriorating at the large banks relative to smaller banks, though asset quality remains generally benign overall for the entire sector. A significant portion of non-accrual loans at the largest banks remain current and are classified due to conservative credit risk management of certain banks. Fitch expects smaller banks to see increases in late-stage delinquencies and non-accruals from currently low levels of problem credits over time.

Additionally, given the elevated level of CRE concentrations in these smaller banks, the ultimate impact is expected to be greater than at the banks with over $100 billion in assets. As credit losses play out over the next several years, under a severe scenario (in which prices decline by approximately 40% on average), losses in CRE portfolios could result in the failure of a moderate number of predominately smaller banks.

Office CRE Highly Vulnerable

In the post-pandemic era, the continuation of hybrid-working has led to valuation concerns for office CRE, especially for properties located in CBDs. As occupancy rates and rents decline, it will become more difficult to refinance loans at lower valuations and debt service coverage ratios due to the higher rate environment, leading to elevated losses

Office portfolios for larger and smaller banks could diverge if CBD office CRE loans, held mostly by the larger banks and tend to be investor properties, perform differently than suburban office in this environment.

Deterioration Expected in CRE

The focus on CRE lending reflects structural questions regarding the future of certain CRE sectors in the U.S. Office is the most notable, particularly older buildings with less amenities, following a sustained increase in hybrid working post-pandemic.

Fitch anticipates an “higher for longer” interest rate environment scenario will pressure borrowers’ ability to refinance loans given deteriorating valuations, as well as reduced debt servicing capacity. Combined with deteriorating fundamentals, including lower occupancy rates and declining rents, this will contribute to elevated loan losses, likely to play out over several years as maturities come due.

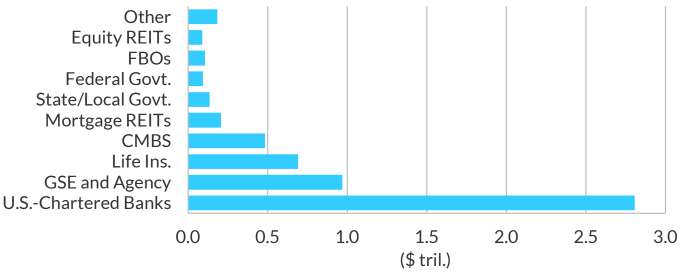
Composition of the CRE Market in the U.S.

While there are numerous participants in the U.S. CRE mortgage market, U.S. banks play an outsized role, holding nearly 50% of approximately $5.8 trillion in outstanding CRE and multifamily loans at June 30, 2023. Banks also hold nearly $380 billion in CMBS on balance sheet; however, agency (Fannie Mae and Freddie Mac) CMBS comprise 84% of these, materially limiting the associated credit risk. U.S. banks also have indirect exposure to the CRE sector through lending to nonbank financial intermediaries, such as REITS or real estate funds.

In dollar volume, a material portion of CRE loans are concentrated in larger banks, with 34% of the roughly $2.8 trillion in bank CRE loans held by banks with more than $100 billion of assets. However, the concentration relative to assets and capital to CRE lending for this cohort is well below that of the smaller banks. Only one bank with more than $100 billion of total assets held CRE loans greater than 200% of equity at June 2023.

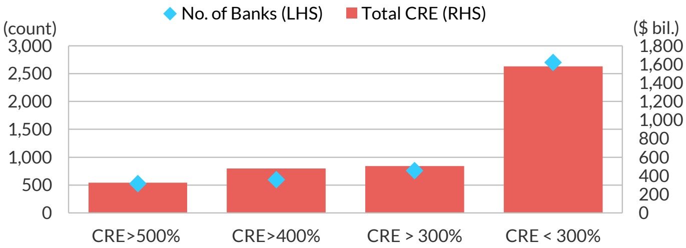
Conversely, more than nearly 1,900 banks with assets less than $100 billion had CRE loans outstanding greater than 300% of equity. This is attributed in part to their more community-based lending model, serving the needs of small businesses in their local communities. Further, as certain lending products, like residential mortgage or credit cards, have moved to scale players, smaller banks are left mainly with commercial & industrial (C&I) and CRE lending as core products.

Holders of U.S. Commercial Real Estate Debt
U.S. banks hold the largest portion



Source: Fitch Ratings, Federal Reserve

Number of Banks with CRE Concentrations
Nearly 1,900 banks with CRE > 300% of Equity with $1.3 tril. in CRE balances



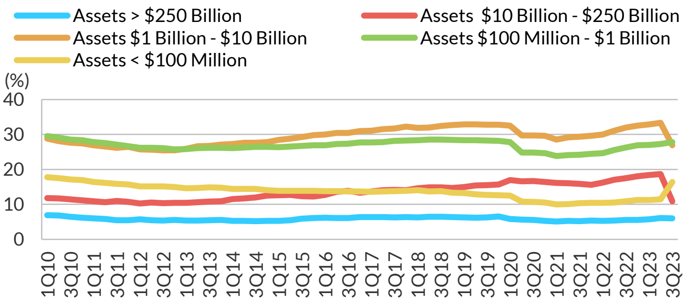
Note: Certain data exclude banks with no CRE exposure at June 30, 2023.
Source: Fitch Ratings, FedFIS

Exposures Differ from GFC

The largest banks' relatively low exposure to CRE lending has been fairly constant through time as a percentage of assets. Conversely, since the Global Financial Crisis (GFC), banks with assets between $1 billion and $250 billion have increased CRE balances, as a percentage of assets, as growth has outpaced other loan categories. While most of the banks saw a material pullback from peak CRE levels following the GFC, banks between $1 billion and $250 billion have seen their concentrations grow to exceed prior peaks.

Since the GFC, there has been a notable decline in construction and land development lending in particular for the industry. At June 30, 2023, U.S. banks had $488 billion in construction and land developments loans outstanding, compared to $631 billion at the peak in 1Q08. Most of this is concentrated in banks with assets between $1 billion and $100 billion, which held nearly 60% of these loans outstanding at June 30, 2023.

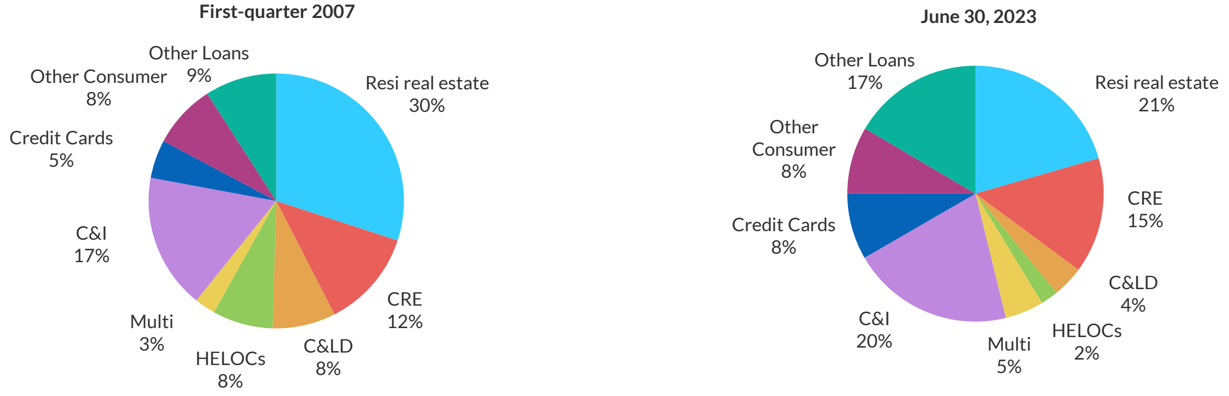
Commercial Real Estate Loans as % of Total Assets
Since the GFC, concentration increasing for banks between $1 bil. and $250 bil.



Source: FDIC

Conversely, multifamily lending has been growing twice as fast as construction lending, with the long-standing housing supply shortage in the U.S. driving strong demand for multifamily loans. As a result, the overall composition of CRE portfolios is significantly different in 2023 compared to those prior to the GFC, when the proportion of construction lending was nearly double.

Industry Loan Composition



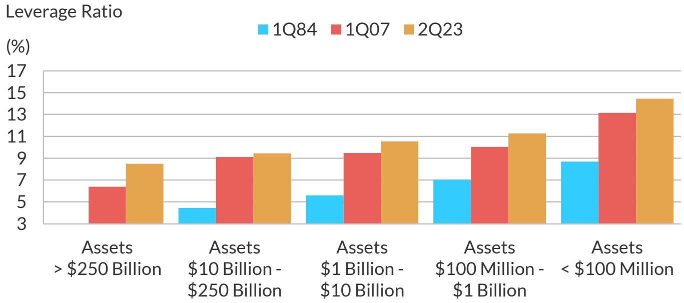
Source: FDIC

This shift reflects U.S. banks' retrenchment from construction and land development lending following steep losses incurred during the GFC, compared to relatively milder credit costs on other CRE segments. Construction loan losses were particularly high, with cumulative losses over 9% from 4Q08 through 4Q10, while multifamily experienced around 3% of cumulative losses over the same timeframe.

Almost all U.S. banks are approaching this challenged environment with materially higher levels of capital and reserves than maintained prior to the GFC, while smaller banks tend to maintain the highest regulatory capital ratios. As such, banks across the size spectrum are coming into the current economic downturn with a higher capacity to absorb losses than in prior cycles.

Capital Levels Highest at Smallest Banks, though Improved for All since GFC

Leverage Ratio



Note: There were no banks with assets greater than $250 billion in 1984.
Source: FDIC

Small Banks Lag Larger Banks on CRE Deterioration

While smaller banks tend to be more exposed to CRE lending as a percentage of capital, presently late stage delinquencies and non-accrual loans are lower for these banks compared to larger peers at June 30, 2023. This is attributed to higher balances of non-owner-occupied (NOO) CRE loans or investor properties at larger banks, which have exhibited worse asset quality performance on average across the industry since the start of the pandemic, compared to multifamily and construction lending. Conversely, Smaller banks typically have higher percentages of owner-occupied (OO) CRE lending, in which they finance bank customers' operating real estate, where the business is often the primary source of repayment and a reduction in occupancy is less of a concern.

Over the past nine quarters, CRE non-performing loans as a percentage of total loans have been increasing for the largest banks or those with total assets greater than $250 billion, but have proven relatively stable to improving for smaller banks.

CRE NPLs by Bank Size over Time

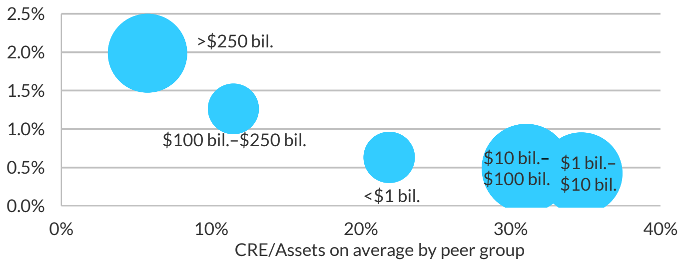
	Jun 2023	Mar 2023	Dec 2022	Sep 2022	Jun 2022	Mar 2022	Dec 2021	Sep 2021	Jun 2021
>$250 bil.	2.05%	1.74%	0.67%	0.64%	0.62%	0.84%	0.87%	0.95%	1.10%
$100 bil. - $250 bil.	1.11%	1.09%	0.89%	0.89%	1.06%	1.11%	1.24%	1.26%	1.32%
$10 bil. - $100 bil.	0.47%	0.44%	0.40%	0.41%	0.45%	0.51%	0.43%	1.06%	1.43%
$1 bil. - $10 bil.	0.55%	0.52%	0.51%	0.55%	0.56%	0.62%	0.69%	0.80%	0.90%
<$1 bil.	0.68%	0.59%	0.61%	0.65%	0.69%	0.74%	0.80%	0.90%	0.97%

Note: Nonperforming loans (NPLs) include nonfarm nonresidential, multifamily and construction and land development loans that are more than 90 days past due or on non-accrual status as a percentage of total CRE loans
Source: FedFis

While a relatively high percentage of loans classified as non-accrual are still paying as agreed at some of the large banks that disclose this figure, it is unclear whether smaller banks will experience a similar pattern of delinquencies at the largest banks and begin to also report deteriorating asset quality metrics.

Largest Banks Less Concentrated, but Worse Credit Quality

% of nonfarm nonresidential loans 90 days past due or non-accrual on average by peer group



Note: Size of each bubble is the total CRE in dollar by bank peer size.
Source: Fitch Ratings, FedFis

Higher levels of loan loss reserves reported by the larger banks help mitigate the risk of higher balances of impaired loans and offset some of the notable increases in delinquencies in this peer group. Additionally, Fitch believes that underwriting and risk management related to CRE has improved relative to the GFC, particularly as Dodd-Frank Stress Tests (DFAST) and current expected credit losses (CECL) methodology have prompted the largest banks to better gauge their downside risks, thus reducing potential loss rates or acute financial impacts as non-performing CRE loans increase.

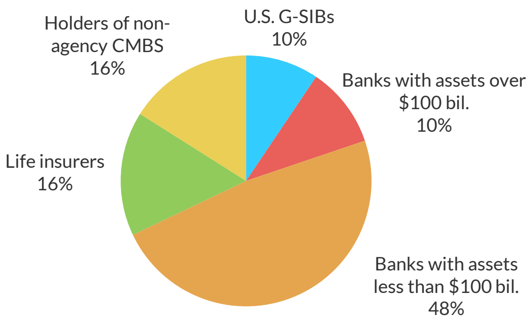
Office CRE Vulnerable to Changing Work Patterns

According to Green Street, prices on office properties have already fallen 31% since their April 2022 peaks, compared to 16% for apartment, hospital, industrial, lodging, and mall, on average, during this period. This decline in valuation has likely not yet filtered into reported loan-to-value (LTV) ratios. As such, these may be understated and will require time for the LTVs calculated at origination to catch up with LTVs based on the current market.

Based on Federal Reserve data, U.S. banks hold nearly 70% of office and downtown retail CRE exposure; moreover, most of the loans are held at banks with less than $100 billion of assets, as shown in the chart below. Given a lack of visibility into the broader industry's loan portfolios, it is challenging to assess the make-up of that office exposure.

Holdings of Office and Downtown Retail CRE

Universe $1.06 trillion



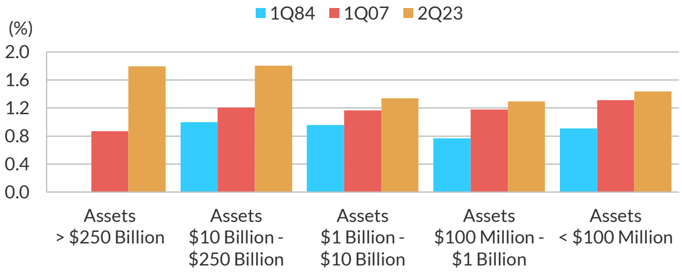
Source: Federal Reserve

Fitch believes that the impact of higher rates on borrowing costs and defaults has not worked its way through the office sector yet. Delinquencies are a lagging indicator, and as such, ultimate losses will be realized over a multi-year period. For example, quarterly CRE loan losses did not peak in dollar terms until 4Q10, seven quarters after the peak in early stage delinquencies.

Over the next several years, inability to refinance due to materially lower valuations and/or an inability to service debt at higher interest rates will lead to increased bank credit costs associated with office CRE.

Loan Loss Reserves Materially Higher than during GFC, Particularly for Largest Banks

ALLL/Total Loans



ALLL – Allowance for loan and lease losses
Note: There were no banks with assets greater than $250 billion in 1984.
Source: FDIC

Some mitigants to this include higher levels of loan loss reserves against office. For example, Citizens Financial Group disclosed that loan loss reserves for office totaled 8% at June 30, 2023, a level generally in line with other large banks that disclose this figure. This level of reserves took into the account the following assumptions: peak-to-trough price declines of approximately 67%, average loss severity of between 45% and 50%, and an estimated default rate of between 16% and 18%.

Expanding DFAST to the Entire Sector

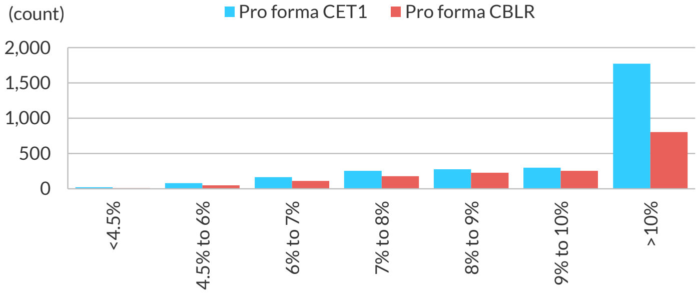
Supervisory stress testing in the U.S. is required of banks with more than $100 billion in assets. During this year's exercise, assumed CRE credit losses under the 2023 Federal Reserve Stress Tests for the nine quarters (1Q23 to 1Q25) averaged 8.8% for the 33 participating banks for a total of $64.9 billion of losses.

This scenario included a nearly 40% decline in CRE prices, resulting in losses for banks ranging from 3.4% to 16%. The price declines will likely vary by property type and geography, with some experiencing much sharper drops in value than others, as evidenced by the wide range in loan losses in the results.

If we apply this level of loss as of June 30, 2023 to the entire industry or an additional approximately 4,400 banks with CRE loans outstanding at quarter-end, total stressed CRE losses would total roughly $250 billion (inclusive of the $64.9 billion DFAST CRE losses). This compares to around $90 billon in CRE losses during the peak loss period for CRE net chargeoffs from 4Q08 to 4Q10 during the GFC.

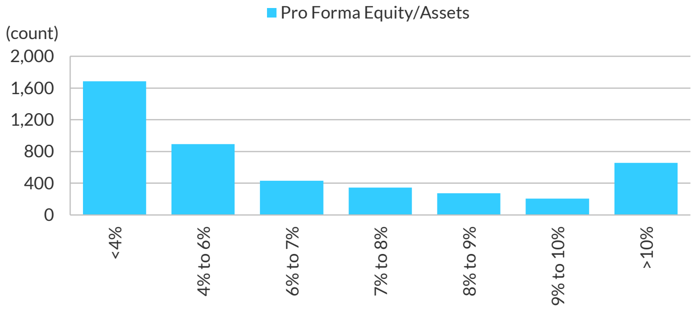
Based on this static shock to bank balance sheets, only 22 banks that report CET1 would breach 4.5%, while only three that report under the community bank leverage ratio (CBLR) would breach 4% and no longer be considered "adequately capitalized" for prompt corrective action (PCA) purposes. This simplified scenario does not factor in the benefit of earnings during this period or account for capital distributions or RWA growth/contraction. Further, this scenario assumes uniform losses across the industry; however, some banks will have materially higher loss rates, while others may realize lower losses.

Estimated Capital Ratios under DFAST CRE-only Loss Scenario



Source: Fitch Ratings

Estimated Leverage Ratio including Unrealized Losses



Source: Fitch Ratings

Assessing just CRE losses under the DFAST scenario also does not account for the loan losses in other categories, which would also deteriorate under the economic backdrop of this stress test.

Given considerable differences between the carrying value and market value of securities and loans on balance sheets as a result of the rapid rise in interest rates, Fitch also assessed the impact of CRE losses to reported equity, inclusive of unrealized losses on available-for-sale securities, which are currently excluded from regulatory capital for all but the largest eight banks.

This was conducted in light of the March 2023 banking turmoil that demonstrated the value of a marked-to-market balance sheet can dramatically impact the outcome of bank's future when under duress. As shown in the chart above right, a significantly higher number of banks fall below "adequately capitalized" under this stress.

While it remains unclear the trajectory of any downturn in CRE over the next several years, the Federal Reserve has concluded large U.S. banks can withstand stress in their loan portfolios; as the Fed stated in its October 2023 Financial Stability Report: "while stress tests suggest the largest banks are well positioned to withstand a severe recession and contraction in CRE markets, other financial institutions with concentrated exposures could be forced to retrench." This second order effect of tightening loan standards and reducing loan balances could compound any downturn in the sector.

Since 2020, nine U.S. banks have failed, including three notable failures of regional banks in the spring 2023, and we expect bank failures to rise moderately over the near- to intermediate-term, particularly as CRE loans mature and are unable to meet debt service from cash flow at higher rates or refinance out of the banks. Bank failures will occur most among smaller banks (under $100 billion in assets), skewed heavily toward the smaller end of this range, most of which are not rated by Fitch. While bank failures among smaller banks are unlikely to pose financial stability risks, this could contribute to credit tightening, which in turn would be a headwind to CRE and economic growth.

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