BY ANNA KOVNER

Banks and the Commercial Real Estate Challenge

Even though years have passed since the major disruptions of the COVID-19 pandemic, it's clear that demand has been hard hit for some types of commercial real estate — especially downtown office buildings. Researchers at the Richmond Fed surveyed employers in March and found that more than a third expect employees to be on site three days a week or fewer. Asset values have adjusted accordingly to this change in demand. One measure of these price declines comes from publicly traded office real estate investment trusts (REITs), where values have fallen by more than 30 percent since early 2022.

Changes in demand for office space are not the only challenge. All types of commercial real estate, or CRE — including multifamily housing, retail, industrial properties, and hotels — have been hurt by the one-two punch of higher operating expenses and higher interest rates. Unlike residential real estate, where most mortgages are fixed rate (thanks in part to federal policies that favor homeownership), commercial real estate mortgages are commonly floating rate, meaning that interest expenses have grown substantially with the increase in interest rates. Higher inflation for building materials and services has also hit the cash flows of most commercial property managers.

To be sure, not everything is going badly for this sector. The U.S. economy has been strong and resilient. This means a strong reservoir of demand for all types of commercial activities, ranging from hotels to rental housing. Properties evolve as demand evolves, with renovations leading to new lives for office and commercial spaces.

The question for monetary policymakers and bank supervisors is this: Will CRE losses ricochet through the U.S. economy? Historically, real estate losses have amplified economic downturns, for example in New England in the 1990s. Declines in asset prices can be amplified beyond real estate when financial institutions such as banks cut back their loan supply in response to losses on bad loans and when foreclosures lead to fire sales of properties. Thus, regulators use capital requirements and supervision to ensure the safety and soundness of banks in the face of losses. This should ensure that banks have enough capital to withstand losses from CRE loans and continue to lend. Moreover, banks themselves have already responded to challenges by reducing the supply of CRE lending. The Fed looked at this in July and found that a significant net share of banks reported tightening lending standards for all types of CRE loans.

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Still, in some particularly levered buildings, it is likely that debt holders, including banks, will also experience losses. Since the average loan-to-value ratio is typically below 60 percent, however, even if office real estate values fall by more than 30 percent, equity owners will likely bear most of these losses. (See "Out of the Office, Into a Financial Crisis?" *Econ Focus*, Second Quarter 2023.)

One way to measure the overall risk in the banking system is through top-down stress testing models, such as the CLASS model. These models stress banks on paper by assuming bad economic scenarios and seeing how much capital banks would have to support lending. Updates of these models that account for losses on long-duration assets from higher interest rates show an increasing number of banks with strained capital under stress.

But all real estate is local, so it's important to consider potential losses and their amplification at the bank level rather than in aggregate. For example, we saw with Silicon Valley Bank that some banks can be outliers in terms of their exposure to risk assets and the vulnerability of their deposits. In this regard, bank size matters: Nonfarm nonresidential CRE mortgages tend to be a small share of total assets held by banks overall but a larger share of total assets of smaller banks. Thus, an important confluence of risks emerges as profit margins at smaller banks are pressured by depositors demanding higher rates just as these same banks are particularly exposed to CRE.

In summary, while the post-COVID-19 economic environment has been throwing some tough punches at CRE, the knockout doesn't seem to be here. As the U.S. economy comes into better balance, risks from CRE are mitigated by strong economic growth. For now, CRE represents one more challenge for bank-dependent borrowers and CRE-lending banks. Yet there are clearly storm clouds on the horizon and supervisors will be carefully monitoring risks in bank portfolios. Careful credit risk analysis has always been key to sound banks and their ability to supply credit. **EF**

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