Banking on Stability: Bank Exposure to Commercial Real Estate—Should We Be Worried?

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As the US commercial real estate (CRE) market cools, banks face heightened scrutiny over their significant lending exposures, raising concerns about financial stability and future lending capacities.

Banks' Role in the CRE Lending Market

In the vast landscape of US commercial and multifamily (CMF) mortgage lending, valued at $4.7 trillion, banks are major players, with about $1.8 trillion (38%) in loans, according to the Mortgage Bankers Association. This figure, however, only scratches the surface of banks' total exposure to CRE because it excludes loans for construction and development, owner-occupied properties, and other indirect real estate exposures, which carry different risk profiles compared with CMF mortgage lending.

Although banks' market share is consistent with history, recent bank failures and a slowdown in US CRE have fueled concerns over the influence between the CRE and the banking sectors. Understanding banks' CRE exposure and the resultant market implications is essential for foreseeing the dynamics of real estate financing.

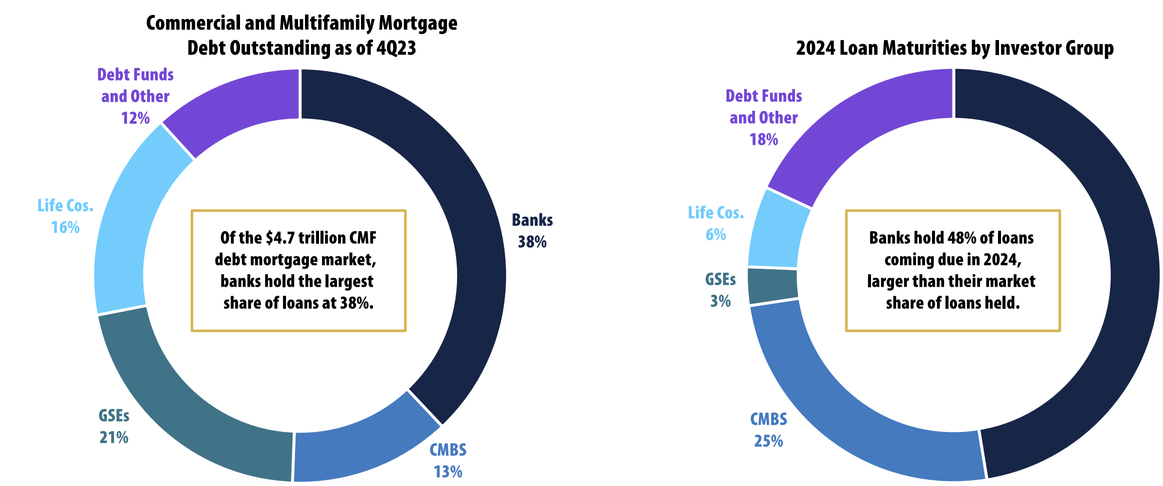
The situation is becoming increasingly precarious because $929 billion worth of CMF mortgages is due for refinancing in 2024, with banks holding nearly half (48%) of these maturing debts (Exhibit 1).[1] The mismatch between the volume of maturing loans and banks' capacity or willingness to refinance them could create a significant financing shortfall, potentially exceeding $150 billion, according to PGIM Real Estate.

Disparate Impact Across Bank Sizes

Regional and large banks, with those possessing assets between $10 billion and $250 billion, hold the largest share, 40.1%, of all CRE loans. Close behind are community banks, with assets up to $10 billion, accounting for 37.2% of CRE loans.[2] This is significant considering that they hold less than 15% of the total banking industry assets (Exhibit 2), as reported by the Federal Deposit Insurance Corporation (FDIC).[3]

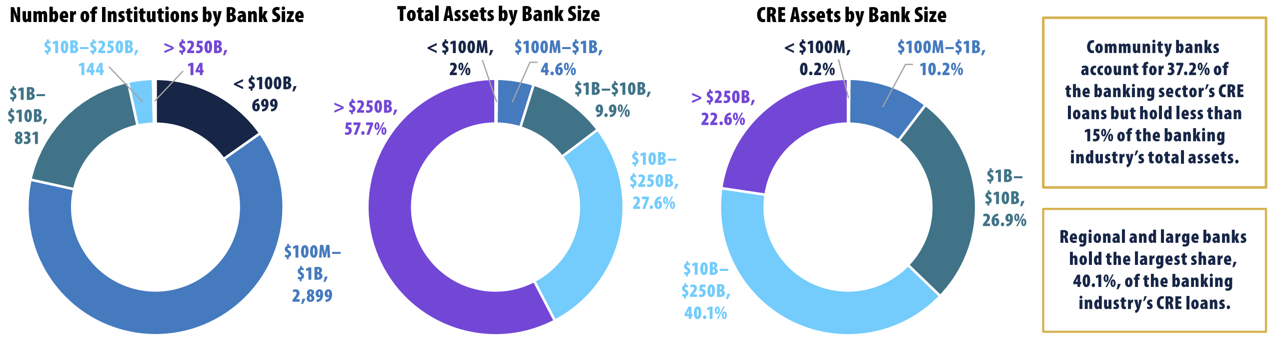
1. "Annual Commercial/Multifamily Loan Maturity Volumes," Mortgage Bankers Association.
2. Community banking organizations are those with less than $10 billion in assets, regional banking organizations are those with total assets between $10 billion and $100 billion, and large financial institutions are firms with assets of $100 billion or more, according to the Board of Governors of the Federal Reserve System.
3. CRE assets in this article refers to commercial real estate exposures in nonfarm nonresidential, construction and development, and multifamily residential real estate, unless specified otherwise. CRE exposures may be higher if indirect CRE exposures are included, such as CRE loans not secured by real estate.

Exhibit 1: Banks Hold an Outsize Volume of Loan Maturities



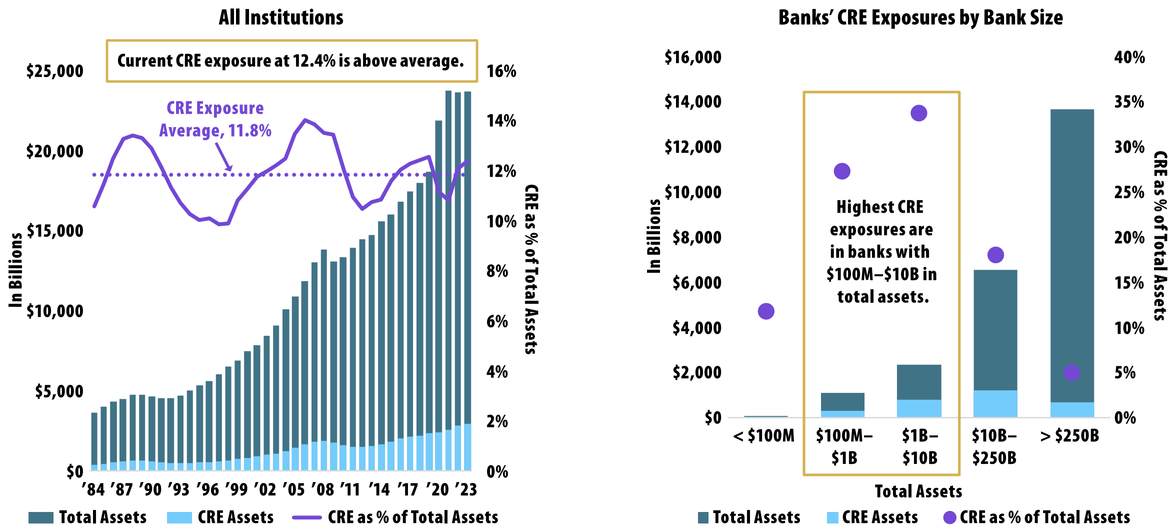
Sources: Mortgage Bankers Association, PGIM Real Estate; as of May 2024

Exhibit 2: Smaller Banks Hold a Higher Share of CRE Loans Than Their Share of Total Assets



Sources: FDIC, PGIM Real Estate; as of May 2024
Notes: Bank size refers to total bank assets. Smaller banks refers to banks with less than $250B in total assets. Regional and large banks refers to banks with total assets between $10B and $250B. Community banks refers to banks with up to $10B in total assets.

Exhibit 3: Banks' CRE Exposures



Sources: FDIC, PGIM Real Estate; as of May 2024
Note: Bank size refers to total bank assets.

Exposure to CRE varies greatly among banks of different sizes, a disparity that could profoundly impact the financial sector. Historically, CRE assets have fluctuated as a percentage of total bank assets, reaching a peak of 14% in 2007 and averaging 11.8% from 1984 to 2023. By the end of 2023, banks' CRE holdings were slightly above average at 12.4%.[4]

Community banks show a particularly high dependence on CRE loans. Smaller community banks have CRE exposures of 27.2%, which rises to 33.7% for larger community banks (Exhibit 3).[5] A subset of banks have exceptionally high CRE concentrations, with levels exceeding 75%, which could jeopardize their stability and safety.

In contrast, the largest banks, those with assets more than $250 billion, have a CRE exposure of only 4.9%. Among this group, some individual banks have CRE exposures exceeding $100 billion, but this represents a small fraction of their total assets. This indicates that while the largest banks hold significant absolute amounts of CRE loans, these loans make up a smaller proportion of their overall asset base compared with community banks.

4. CRE exposure rises to 18% of total bank loans when accounting for additional CRE categories, according to the, "Global Financial Stability Report," International Monetary Fund, April 2024.
5. Small community banks are those with assets between $100 million and $1 billion, and large community banks have total assets of $1 billion to $10 billion.

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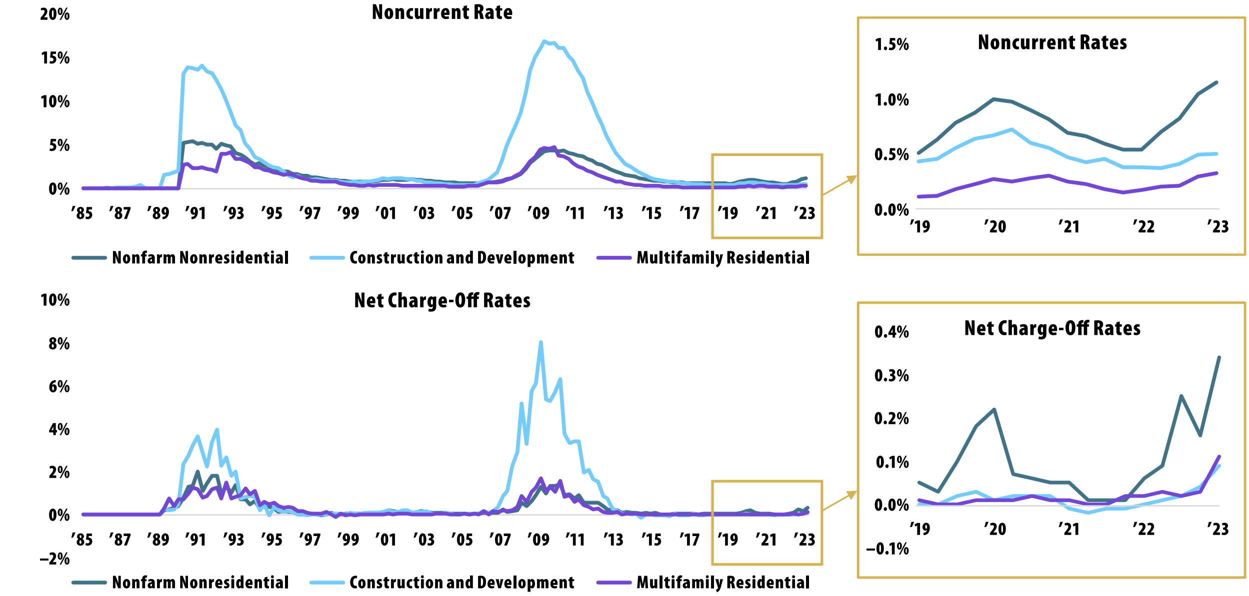
Exhibit 4: Rising Noncurrent and Net Charge-Off Rates Indicate Potential Distress



Sources: FDIC, PGIM Real Estate; as of May 2024

This stratification indicates that smaller banks are more vulnerable to downturns in the real estate market because of their concentrated exposure. Larger banks, although holding significant absolute amounts of CRE loans, benefit from a more diversified asset base.

Emerging Stresses and Financial Stability Concerns

Recent trends in noncurrent and net charge-off rates in banks' CRE portfolios signal potential distress in the banking sector. Although these rates remain below the peaks of past downturns, their upward trajectory is concerning, particularly for nonfarm nonresidential exposures, i.e., loans secured against commercial properties, such as office, retail, logistics, and lodging (Exhibit 4).

The rate of nonperforming CRE loans doubled in the past year, reaching 0.81% at the end of 2023 from 0.4% at the end of 2022, according to the International Monetary Fund (IMF).[6] This rise has forced banks to increase their loan-loss provisions, leading to a decrease in the coverage ratio from 200% to 154%. This decline is more pronounced in globally systemically important banks (G-SIBs).[7] However, these larger banks have relatively smaller CRE exposures, which reduce some risks.

Despite this decline, the coverage ratio remains high, indicating that banks are preparing for potential increases in defaults and charge-offs within their CRE portfolios. Expected credit losses vary depending on the type of CRE property, geographical region, and size of the bank, with the office sector showing higher probabilities of defaults.[8]

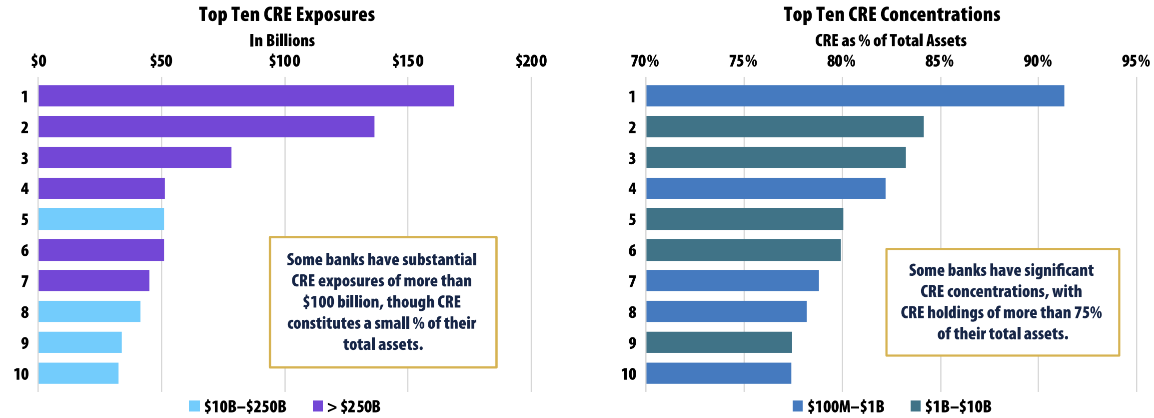
The banking sector also faces additional pressures from recent regulatory costs, including special FDIC assessments to cover losses from notable bank failures, such as Silicon Valley Bank and Signature Bank.[9] These costs are significant, with large banks incurring substantial charges.

Pockets of Concern but Not Widespread Distress

While concerns persist regarding banks' exposure to CRE, especially among small institutions with elevated levels of CRE loans and large institutions with substantial CRE exposures, the banking sector's diversified landscape, improved capitalization, and access to credit from nonbank entities mitigate the risk of a systemic banking crisis.

6. "Global Financial Stability Report," International Monetary Fund, April 2024.
7. A G-SIB is a financial institution with such significant importance that its failure could trigger global financial instability. The Financial Stability Board and the Basel Committee on Banking Supervision identify these banks based on their size, cross-jurisdictional activities, complexity, and interconnectedness. Different regulatory measures are in place to mitigate systemic risk for G-SIBs.
8. "Quarterly Loan Performance Survey," MBA, 1Q2024.
9. "Final Rule on Special Assessment Pursuant to Systemic Risk Determination," FDIC, Nov. 16, 2023.

Exhibit 5: Banks With Large CRE Exposures and High CRE Concentrations Warrant Close Attention



Sources: FDIC, PGIM Real Estate; as of May 2024
Note: Bank size refers to total bank assets.

Although some banks, particularly those heavily invested in CRE, might encounter difficulties, the broader banking system seems robust enough to absorb these shocks. Monitoring remains crucial for institutions with high CRE concentrations, as well as those with large CRE exposures, even if those exposures are only a small fraction of an institution's overall asset base (Exhibit 5).

Trends in noncurrent and net charge-off rates warrant close attention because they indicate deterioration in the credit quality of banks' CRE loan portfolios. The rise in noncurrent rates necessitates larger provisions for loan losses, which would adversely impact bank profitability and capital levels. Meanwhile, escalating net charge-offs, which reflect actual losses, diminish a bank's earnings and deplete its capital reserves, potentially triggering liquidity challenges and heightened regulatory oversight.

Furthermore, the sharp reductions in loan loss provisions suggest insufficient reserves, exposing banks to greater financial risk should loan defaults surpass reserved amounts. However, the observed increases in noncurrent and net charge-off rates also suggest that banks will bolster these provisions in anticipation of higher loan defaults. While higher provisions reduce a bank's net income, they also reflect a prudent approach toward potential losses.

In response to these growing challenges, banks are likely to further constrict their lending capacities, which could slow CRE market recovery and lead to more severe financial difficulties for banks with significant CRE exposures.

Mitigating Factors and Banking Resilience

Although the risks associated with CRE exposure are particularly pronounced among a subset of banks with significant CRE exposure and high CRE concentrations, the wider banking sector is relatively well equipped to manage a potential fallout.

First, the CRE lending market is diverse, with substantial contributions from nonbank lenders that enhance liquidity. Second, today's banks are better capitalized and, third, operate under stricter regulations than in previous downturns, which means that CRE loans originated going into this downturn have lower leverage and have been underwritten more conservatively than in previous downturns. These safeguards suggest that the banking sector could manage these challenges without succumbing to systemic distress. Although vigilance is necessary, the current situation does not resemble the widespread banking contagion of the global financial crisis.

As banks brace for potentially tougher times ahead, the emphasis will stay on managing risk and reinforcing financial stability to navigate ongoing uncertainties. Ultimately, the overall health of the banking sector will hinge on how these institutions manage their CRE exposures and adapt to changing market conditions. ■

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