SPECIAL REPORT

Banking and CRE Distress

APRIL 2023

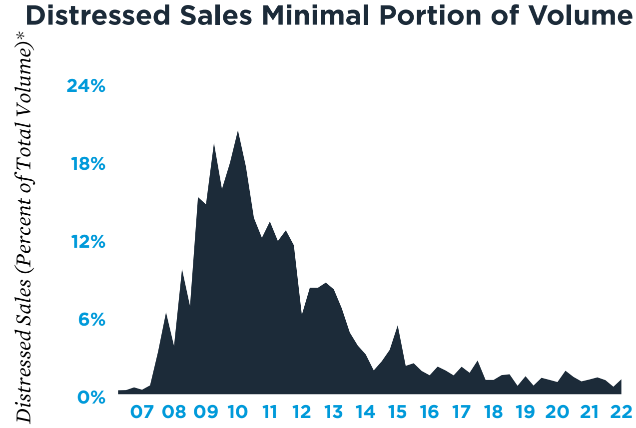
Risk of Banking Sector Disruption From Commercial Real Estate Defaults is Low

Commercial real estate distress remains low. Following the failures of Silicon Valley Bank and Signature Bank, concerns surrounding high concentrations of commercial real estate portfolios held by local and regional banks has captured headlines. Outside of a few challenged segments, however, commercial assets have generally performed well. Current CRE distress levels remain low in comparison to historical periods of disruption. During the fourth quarter of 2022, nearly three years after the onset of the pandemic, distressed CRE assets comprised only 1.2 percent of nationwide sales volume. Twelve quarters after the global financial crisis began, distressed sales accounted for 20.3 percent of deal flow. The situation remains fluid, however, and will evolve as loans continue to mature in the new higher interest rate climate.

Volume of CRE debt maturating is not a systemic risk. The volume commercial real estate debt maturing in 2023 ranges between $400 billion as estimated by MSCI, and the Mortgage Bankers Association's estimate of $728 billion. During a time of elevated capital costs and fewer active lenders, apprehension has mounted around borrowers' ability to refinance assets and the associated risk of loan defaults. A significant consideration is that loan underwriting has been more stringent since the global financial crisis and the average loan-to-value has been in the relatively conservative 65 percent range. In addition, robust rent growth over the term of the loans has provided the owners of most types of CRE with sufficient equity to mitigate default risk. The majority of the impending loan maturities were originated five to seven years ago, and over the last five years CRE property revenues have increased by about 25 percent on average across the sector.

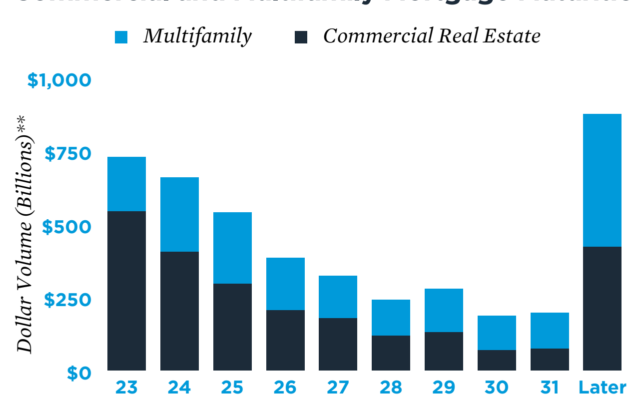
Risk prevalence varies by property type. Revenue gains over the past five years have been particularly pronounced in the industrial and multifamily sectors, which comprise about 35 percent of the CRE debt due this year. Office properties, which comprise about 26 percent of the loans set to mature this year, face the highest risk profile because rent growth over the last five years has been nominal on average and vacancy rates have been on the rise. Office properties likely comprise the greatest portion of the distress risk.

Distressed Sales Minimal Portion of Volume



Some struggling properties may hit the distress threshold. Not all sectors are seeing robust fundamentals. In February, data analytics provider Trepp noted more CMBS loans fell into special servicing, representing 5.2 percent of total CMBS CRE debt. Properties currently experiencing cash flow challenges, such as downtown offices, may be predisposed to a distressed sale. The same is true for borrowers with variable rate debt who did not hedge against interest rate increases with a rate cap. Over the past three years, between 42 percent and 65 percent of loans issued each quarter had floating rates. Borrowers without interest rate caps may be subject to interest payments greater than the revenue capabilities of the asset, with little prospect of a recovery. Those properties may reach default. Investors with fixed rate debt have been more insulated from rate increases, but properties that have not experienced steady rent gains during the term of the loan may face a challenging refinance outlook requiring a significant cash infusion.

Commercial and Multifamily Mortgage Maturities



* *Sales $2.5 million and greater* ** *Loans outstanding as of 2022*
Sources: IPA Research Services; MBA; Moody's Analytics; MSCI, Inc.

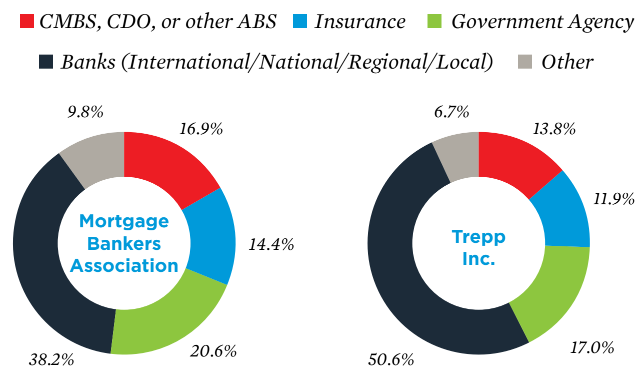
Default Risks Unlikely to Be Systemic; CRE Dynamics Unrelated to Bank Failures

CRE is unlikely to prompt systemic bank closures. While banks hold more than half of the commercial real estate debt set to mature this year, as estimated by MBA, substantial distress in commercial properties has not materialized, limiting risks posed to depository institutions. Concern primarily surrounds regional or local banks that might have a more real estate-concentrated portfolio; however, much of the outstanding debt originated by smaller banks is not set to mature this year. When possible, bank lenders will also likely defer action on maturing commercial real estate debt that comes due. Given the option, many banks may choose to extend loans or offer other creative alternatives to foreclosure. Small and regional banks have little incentive to realize losses by foreclosing on property and marking those assets to market at this time. If they can, many could follow the model established following the global financial crisis, using loan workouts, extensions, and other means, at least over the short-term.

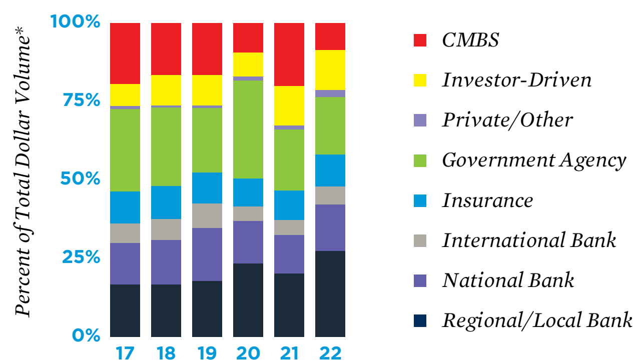
Case-specific bank failures not applicable to CRE. Experts, including Federal Reserve Chairman Powell, agree the situations faced by Silicon Valley Bank and Signature Bank are not comparable to most small banks with more commercial real estate-centric portfolios. The two high-profile bank failures were caused by situations specific to those institutions. In the case of SVB, the bank was highly concentrated in the venture tech space and did not appropriately diversify its portfolio. When tech-related headwinds and the rapidly shifting interest rate climate prompted elevated withdraws, SVB attempted to raise cash through bond and stock sales amid high rates on short term treasuries, igniting depositor concern and inciting a run on the bank. The SVB failure prompted scrutiny of Signature Bank — a primary lender to the beleaguered cyprocurrency sector — leading regulators to find irregularities in their practices.

CRE benefits from varied, largely positive outlooks. The commercial real estate sector spans a wide array of segments, geographies and demand drivers. This allows banks that are heavily concentrated in the market to hedge against risk by diversifying portfolios using factors like property type, location and borrowers' profiles. Some properties purchased between 2020 and the first half 2022 with more aggressive underwriting and adjustable rate mortgages may face near-term complications from the Federal Reserve rate hikes, but the majority of debt held by banks either has significant equity or years before maturity, making them unlikely to face distress.

Estimates of Total Outstanding CRE Debt



Lender Composition by Year



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Sources: IPA Research Services; MBA; MSCI, Inc.; Trepp

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Sources: IPA Research Services; Bureau of Labor Statistics; Capital Economics; CoStar Group, Inc.; Federal Reserve; Mortgage Bankers Association; Moody's Analytics; MSCI, Inc.; Trepp; RealPage, Inc.; U.S. Census Bureau