RBC Global Asset Management

Commercial Real Estate

The bigger the bank, the smaller the problem

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John Guarnera
Senior Corporate Analyst, Financials

Tim Leary
BlueBay Senior Portfolio Manager at RBC GAM

BlueBay Fixed Income Team

Commercial Real Estate (CRE) fears and US regional banks' exposure to the space has come back into focus following 4Q earnings from New York Community Bank (NYCB) where the bank reported a quarterly loss due CRE related asset quality issues. This has led to questions about the extent of NYCB's exposure and how this compares to the broader US Regional bank space.

Thus far, the biggest focus within CRE has been on office properties and tenants' needs for space in a post-pandemic world. While the number of corporations offering full time work from home arrangements is declining, hybrid arrangements remain popular. In fact, as of 2023, according to Forbes Advisor, 28.2% of employees are offered a hybrid work from home option[1]. Work from home arrangements vary by vocation and geographic location, but even the transition to hybrid arrangements has challenged corporations to rethink their workspace needs. Although headlines would suggest that office real estate is doomed, the reality is much more nuanced. The challenges within the office space are impossible to generalize by geographic region, city or even by neighborhood. Instead, the difference between in-demand and out-of-demand office space often comes down to specific location, floor plan, and amenities that a particular office offers.

Within our REIT coverage universe, we have several examples of property owners seeing net absorption of their vacant space suggesting that there is demand for well-appointed office space. Additional trends that we have seen include an increase in the volume of floor tours from prospective tenants, positive rent rate growth for new and renewed leases, smaller tenants looking to upgrade their current space needs, and extended lease terms compared to prior years. These are offset by several headwinds including larger corporate clients downsizing their space requirements, less demand for space with fewer amenities, and a reluctance of potential tenants to look at leasing space in buildings where there is a pending maturity on financing for the building. This creates an outcome where not all office space can be viewed through the same lens and that certain properties remain in demand while others have languished. As such it is impossible to paint a picture that accurately describes the situation for all office buildings with the more accurate characterization being determined on a property-by-property basis.

[1] Remote Work Statistics & Trends In (2024) – Forbes Advisor.

A natural extension of these concerns around office real estate is to question who provides the financing for these buildings. Similar to our assertion that not all office properties can be characterized in the same way, the same goes for banks' exposure to the broader office sector and real estate in general. Recent actions from NYCB to boost their loan loss reserves held against their office portfolio has thrust regional banks back into the spotlight given their role as a capital provider to the sector.

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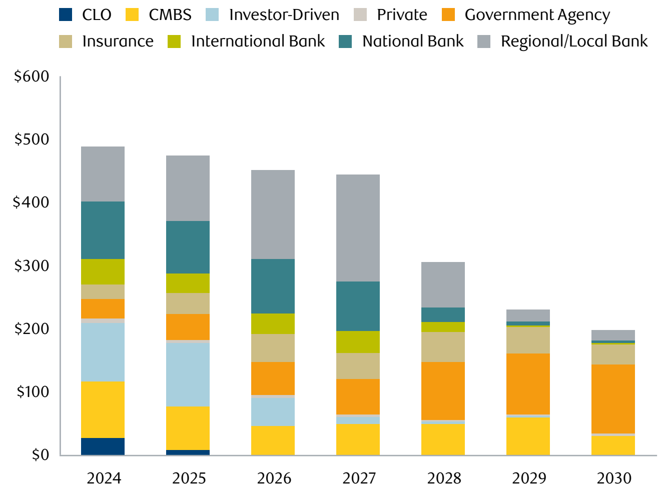
According to the Federal Reserve, US banks had approximately $2.9 trillion of commercial real estate loans on their books. Commercial real estate loans encompass an array of underlying property types including multi-family, office, industrial, retail, and lodging properties. Each of these presents their own unique risk profile and the level of loan exposure to each subsector varies by bank. Of the $2.9 trillion of CRE exposure in the US banking system, roughly $2 trillion (69%) is held on the balance sheets of small banks while large banks hold $0.9 trillion (31%). For large banks this is equal to about 6% of their assets while for small banks this amounts to 30% of their assets. The definition of large and small bank is important here as it helps to clarify the issue.

- **Overall, there are approximately 4,200 FDIC insured banks in the US. The Federal Reserve defines "Large Banks" as the top 25 insured institutions with total asset sizes ranging from $3.386 trillion (JPMorgan) to $152.9 bln (Regions Financial).**

Anything smaller than $152.9 bln is included in the "Small Bank" definition. NYCB stands at the upper end of the small bank classification ($111 bln in assets as of Sept 30) and currently only has a single bond larger than $250 mln. Due to their size, the vast majority of these banks are too small to issue bonds that would be eligible to enter most investment grade corporate bond indices. **As such we have never invested in these smaller regional banks**. It's important to note that while Banking comprises 18% of the Investment Grade ICE BofA US Corporate Index, the top 10 largest US bank issuers are 8% of the index and 10% are actually large foreign banks who have issued in USD[2]. Suffice it to say that there is actually very little exposure to smaller US banks in the US Investment Grade Index and less than 1% in the US High Yield Index[3].

Exhibit 1: Commercial Real Estate Debt Maturities by Lender Type ($B)[4]



Source: MSCI Real Capital Analytics. Data as of September 26, 2023.

Of the Large Banks, these all have multiple tranches of unsecured debt and represent issuers where we could potentially invest. Included within this Large Bank categorization are the Regional Banks that have been subject to increased scrutiny following the failure of SVB. On the other hand, except for just a handful of names, **the remaining 4,000+ banks included in the Small Bank definition do not issue public debt**. Subsequently, the banks that hold the largest amount of CRE loans, both nominally and as a percentage of their total loan portfolios, are those that do not come on our radar as they are not public debt issuers. Even then, of the few Small Banks that do have public debt outstanding, the exposure to the office space is limited, with any of those that screen as having high levels of office loans not being a focus of our investment process. This suggests that the office real estate challenges are more broadly spread across the industry with the bulk of the exposure in small community banks, structured products and private capital providers.

Early on, most large banks were quick to address the deterioration in the office sector with collateral revaluations, moving troubled loans to criticized status, and establishing loss reserves where appropriate. For now, the trend is that a large majority of criticized office loans are still current on payment, which has not made them delinquent nor forced banks to charge these off. Some of this reflects the staggered maturities across the space which makes this an issue that banks will have to deal with over the next several years rather than being faced with a wall of maturities in a coming quarter.

[2] Face amount of index eligible bonds as of December 31, 2023.
[3] ICE BofA US High Yield Index.
[4] Wells Fargo Equity Research 2 February 2024 *"CRE—The Recaps Are Coming!—Part 2 (Our Comprehensive Guide)"*.

We believe the NYCB situation to be unique due a combination of its recent growth trends and the composition of its loan portfolio. Following several years of strong growth, mostly through acquisitions, NYCB recently crossed the regulatory threshold of having more than $100 bln in assets. This led to the bank being classified as a Category IV bank which implies that it is deemed to be systemically more important bank than those with less than $100 bln in assets. This categorization led regulators to demand more robust risk management, liquidity, and capitalization, as they sought to move NYCB closer in line with its Category IV regional peers.

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To put specific numbers around this, NYCB's office real estate exposure was equal to 4% of loans which is at the high end of the regional bank universe. Prior to 4Q, NYCB had only established loan loss reserves that were equal to 2% of their office loans while regional bank peers were reserved at 4-11% of office loans depending on the characteristics of their portfolio. As part of loss provisioning actions taken during 4Q, NYCB's office specific reserves are now at 8% which puts them close to peers. In terms of liquidity, NYCB had cash and securities equal to just 18% of assets versus the peer median of 25% hence the regulators' demand for them to boost their balance sheet liquidity levels. As for capital, NYCB has a CET1 ratio of 9.10% compared to a regional peer average of 10.55%. Therefore, the quarterly loss we saw for NYCB and the improvement in reserves, liquidity, and capitalization seem unique to the bank and the need to bring its metrics closer inline to peers. The company provided a liquidity update on February 7th where they noted increased deposits from 4Q levels and enough liquidity to cover 163% of uninsured deposits. These metrics all suggest a stabilized liquidity situation although confidence in the bank is fragile and liquidity is susceptible to changes in market sentiment.

Across the broader regional bank space, the situation away from NYCB has stabilized since the failure of Silicon Valley Bank. While deposit pricing has increased due to higher rates, deposit flows have stabilized with all of the regional banks we follow seeing normalized trends. Away from commercial real estate, banks' asset quality has been good. Office CRE exposures are generally limited to 1-2% of loans with two exceptions, MTB and CFG at 3.7% and 4.1% respectively, both of which have long histories underwriting office loans in their respective footprints and are adequately reserved against this exposure. The move in rates since 3Q has benefitted almost all banks as the level of mark to market losses within their securities portfolio has improved which has led to less questions about regional banks' overall capital levels. As of 4Q earnings, regional bank capital ratios remain robust with CET1 ratios in excess of 9.7%. In addition, all of these banks have capital structures that include several billion of investible bonds providing opportunities for a potential investment.

The challenges in office real estate are likely to exist for several years. This represents a positive factor for the large banks we follow as it allows them and extended period to generate earnings and capital to offset any potential losses. Additionally, the extended duration of this issue also allows banks and the underlying properties to benefit from any cuts in interest rates that the FOMC may enact. Decreasing interest rates would help alleviate some of the stress for borrowers that are being challenged by diminished debt service capacity. In the meantime, we believe the large US banks, including Regional Banks, are well prepared to deal with these challenges due to limited office exposure, prudent underwriting, well established loss reserves, and ample capital positions.

RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **rbcgam.com**