MSCI

RESEARCH INSIGHT

Not Every Bank Is at Risk from CRE Lending

March 2024

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Introduction

Commercial-property prices are falling, and lenders, investors and especially regulators are fearful of the impact on the broader financial system. The risks in the system today are not the same as those seen during other crisis events, however. Making the assumption that all banks will face the same challenges as in other downturns will lead one down a path to bad decisions.

- Each commercial-property type has unique characteristics and unique forces driving demand, so painting a broad picture of gloom based on the troubles in the office market would be a mistake.
- Office properties in central business districts (CBD) of the U.S. have experienced the largest price declines in the current downturn, and particularly those in the six major metros.
- Banks are not the only lenders in the CBD-office markets, with other sources such as investor-driven lenders representing a substantial but volatile share of financing.

Commercial real estate (CRE) is not well regarded in some regulatory circles. Regulators give the sector side-eye as long memories put CRE risks dead center for the financial shocks from the savings-and-loan crisis, Asian financial crisis and other calamities. The memory of what these shocks did decades ago to the banking sector survives with the regulators, even as the investment world can sometimes be more concerned with the next quarterly earnings statement. Long memories can be harmful if one draws the wrong lessons from history.

If one simply focuses on the fact that property prices are falling, one is likely to paint too broad a picture of doom around CRE and the banking industry. If instead one asks why prices are declining, the answers vary by property type, with underlying performance characteristics that are different from those seen in previous downturns. Understanding those drivers can help one see patterns of where lending problems exist and which banks may and may not face challenges in the current environment.

Challenges are not the same for all U.S. property types

Yes, commercial-property prices are declining. After hitting a peak in July of 2022, the RCA CPPI US National All-Property Index fell a cumulative 12% through to January of 2024. As interest rates rose, so too did financing costs, and potential buyers of property pulled back due to less optimistic underwriting. As potential buyers retreated, prices fell. Such a decline in prices is obviously not a sign of market health, but the drop has not hit every property type equally.

Each property type has unique forces driving tenant demand for space, and those forces are moving in different directions today. Demand for industrial property, for instance, is driven by the need to manage the flow and storage of goods from point of production to the point of consumption. Investors have been optimistic around ongoing tenant demand for industrial space; and with that optimism, asset pricing rose 1% from July of 2022 to January of 2024, despite the shock to financing costs.

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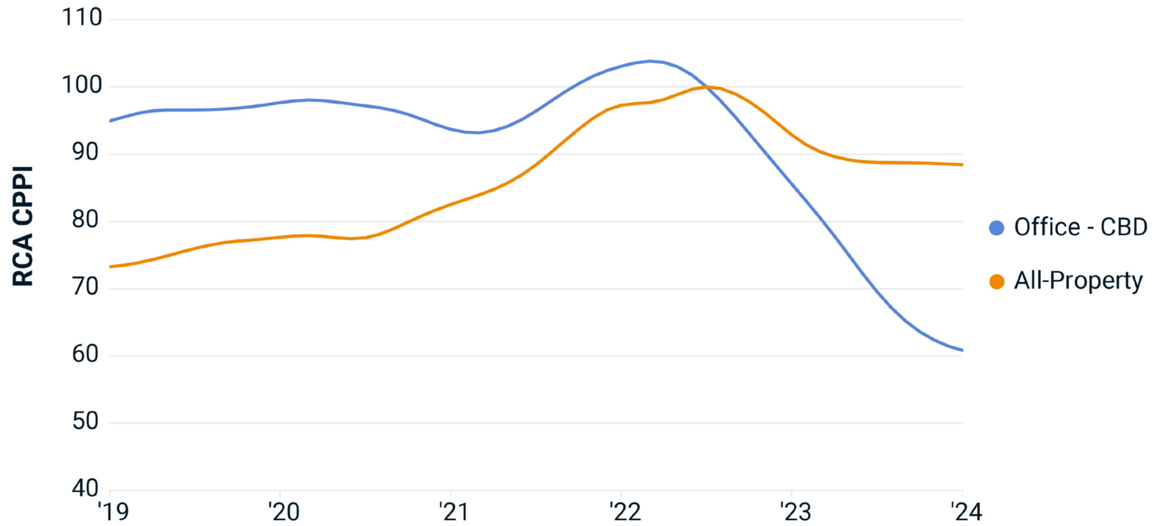
Exhibit 1: CBD-office pricing more challenged than the U.S. market overall



Index level July 2022 = 100. Source: January 2024 data release of the RCA CPPI

Exhibit 2: Other major property types have been more resilient than office

	Price change to January 2024	
Property type	**From January 2023**	**From July 2022**
Apartment	-7.9%	-16.3%
Industrial	1.4%	1.0%
Retail	-3.6%	-8.4%
Office	-15.1%	-20.2%
Office - CBD	-28.9%	-39.2%
Office - Suburban	-11.9%	-16.7%
Hotel	-0.7%	1.9%
All-Property Index	-4.7%	-11.6%

Source: January 2024 data release of the RCA CPPI

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Demand for retail assets is driven by those retailers and service providers who would occupy space as a way to engage with consumers. There is less investor optimism about this process of matching with consumers, and for this reason and the financing shocks, retail property prices fell 8% from July 2022 to January 2024. That scale of decline can hurt for the owner of an asset, but with conservative loan underwriting the lender could survive such a decline.

The office market is facing more fundamental challenges than either industrial or retail. Office vacancy has risen as remote work reduces tenant demand and long-dated leases expire. With less income and uncertainty around future income growth, the financing shock that hit commercial property in 2022 was a double whammy for the office market. Office prices fell 20% from the peak in July 2022 to January 2024, but it is offices in central business districts (CBD) that are more problematic: The index for CBD offices fell 39% from July 2022.

The pain felt in the CBD-office market is not seen in other commercial-property markets. And yet this market is being perceived as symptomatic of all commercial property. Part of this perception is likely because CBD-office investment was, in the not-so-distant past, the largest component of institutional-investor portfolios and always grabbing headlines in the business press (usually for more positive reasons).

Not all banks exposed to CBD-office loans

Just as every commercial-property asset is not feeling the pricing pressure of CBD-office assets, so too every bank is not facing problems from this segment of the market. CRE-lending markets are opaque. One can easily go to the call sheets of the Federal Deposit Insurance Corp (FDIC) and look up the CRE exposure of every bank in the U.S., but only the total exposure. Thanks in part to the Paperwork Reduction Act, regulators themselves cannot see the relative exposure to, say, the industrial market versus the office market.

The FDIC call sheets do provide a broad picture of CRE loan exposure for each bank, but we supplement this information by determining the lenders behind the sales in the MSCI Real Capital Analytics database. Between that data and our data team collecting information on refinancings, we can produce insights on each lender at the property-type level.

CBD-office lending was more a story of the big banks historically. Looking at all loan originations since 2012 when we started tracking this activity comprehensively, it was international banks whose lending was more exposed to this segment than any other type of bank. Over the 12 years from 2012 to 2023,[1] these globally headquartered banks had 26% of all their loan originations focused on the CBD-office market, making it the largest segment of CRE financing for these entities.

We define national banks as large, U.S.-headquartered banks with a national presence, and chartered and supervised by the federal government.[2] These national banks were exposed to the office

[1] 2023 through Q3 2023. Data through Q4 2023 will be released in the March 2024 edition of MSCI's US Capital Trends report.

[2] In the MSCI Real Capital Analytics database, most but not all of the U.S. banks participating in the Federal Reserve's stress tests (and prior to that, subject to Comprehensive Capital Analysis and Review regulations) would be classified as national banks. For

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market — 30% of their originations since 2012 were tied up in the segment. CBD offices constituted only 11% of their book of business, however. The industrial market, apartments and retail were more important for these lenders.

After international and national lenders, the regional/local banks are then all remaining banks. Typically, these are smaller banks in dispersed areas of the U.S. These lenders put 4% of their originations since 2012 into CBD offices. Part of the issue here is scale and availability. A small bank headquartered in, say, Topeka, Kansas, cannot originate loans in the hundreds of millions or even billions of dollars. These banks also tend to stay in their lanes supporting the industry in their local communities. There are simply far fewer CBD-office buildings in places like Topeka.

The most problematic loans, however, are going to be those originated in 2021 and 2022 when CBD-office prices reached the high-water mark. The underlying value loss for the collateral will be sharper from that peak level and make these loans more caustic for a lender's balance sheet.

Exhibit 3: Bank story on office lending not as bad as some fear

Property-type composition of loan originations across bank scales 2012-23			
	International banks	National Banks	Regional/Local Banks
Apartment	23%	28%	30%
Hotel	12%	8%	11%
Industrial	13%	17%	18%
Office	37%	30%	20%
Office - CBD	26%	11%	4%
Office – Suburban	12%	19%	16%
Retail	13%	13%	18%
Seniors Housing & Care	2%	4%	4%
Total	100%	100%	100%

2023 data through Q3 only. Data as of Feb. 26, 2024. Source: MSCI Mortgage Debt Intelligence

In those peak years for pricing, bank lenders of all scales reduced their originations of loans tied to CBD-office assets as a share of their total book of business. What had been a 26% share of all lending by the international banks became a 14% share over 2021 and 2022. These large globally

instance, given its broad range of financial service offerings outside of banking, we classify State Street Corporation, Inc. as an investor-driven lender. We do not use the list of national banks from the Office of the Comptroller of the Currency.

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headquartered banks were more focused on the apartment and industrial markets than CBD offices just like many of their large global equity-investment clients.

The national banks pulled back on CBD-office lending to the extent that new loan originations were just a little bit ahead of their business for hotels and seniors housing and care. The regional/local banks had the smallest portion of their originations focused on CBD offices.

Banks of all scale did pull back on CBD-office lending as a share of their total book of business in the peak years, though it does raise a question about who actually was providing financing for these assets.

Banks are not the only source of CRE finance

Anybody can make a loan on a CRE asset. One does not need to be a bank to become an investor in CRE debt. In fact, the financing for the sector is far broader, with a variety of lender types competing for opportunities.

Looking at the composition of all CBD-office lending since 2012, the originators of commercial-mortgage-backed securities (CMBS) have provided more financing than any other group. These lenders were behind 27% of all financings on average over this 12-year period. International banks were the next-largest group, with an average 17% share of the market.

The insurance lenders have been an important part of the financing solution for CBD offices since 2012, but their exposure has been shrinking. Originations by these lenders averaged 16% of the market for CBD-office loans over the whole history, but what was a 20% share from 2012 to 2016 slipped to a 12% share from 2020 to 2023.

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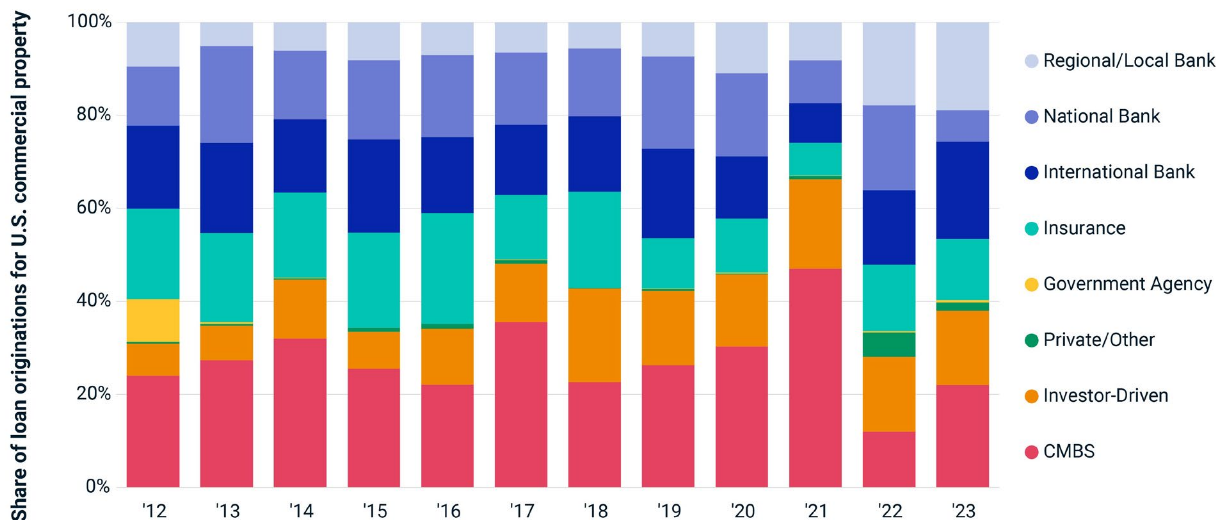
Exhibit 4: Multiple sources of CBD-office financing are active



2023 data through Q3 only. Data as of Feb. 26, 2024. Source: MSCI Mortgage Debt Intelligence

The investor-driven lenders, however, have been a growing source of financing for the CBD-office market over this 12-year period. This category includes debt funds, mortgage REITs and old-line hard-money lenders, though most of the growth in originations in this period came from the debt funds. What was an average 9% share of all CBD-office originations from 2012 to 2016 grew to an average 16% share from 2020 to 2023, surpassing the activity of the insurance companies, which are more conservative lenders.

There was more volatility around these shares in the period from 2021 through to 2023 than over the previous nine years. Except for the investor-driven lenders steadily gaining market share over that previous period due to more aggressive lending by the debt funds, most lenders stayed in their lane over that time frame and stuck to the same type of assets and locations where they had existing relationships.

Our preliminary data for 2023 through to the third quarter does suggest that banks of all scale were more important for CBD-office financing in 2022 and 2023 than in 2021, when the CMBS and investor-driven lenders dominated the market. Some of this exposure is a market effect, with improving CBD-office activity in smaller cities.

The problem in CBD-office markets is concentrated

One should not read this analysis and flee from all city centers as if there is a zombie apocalypse underway. The decline in CBD-office prices is particularly severe in the six major metro areas of the

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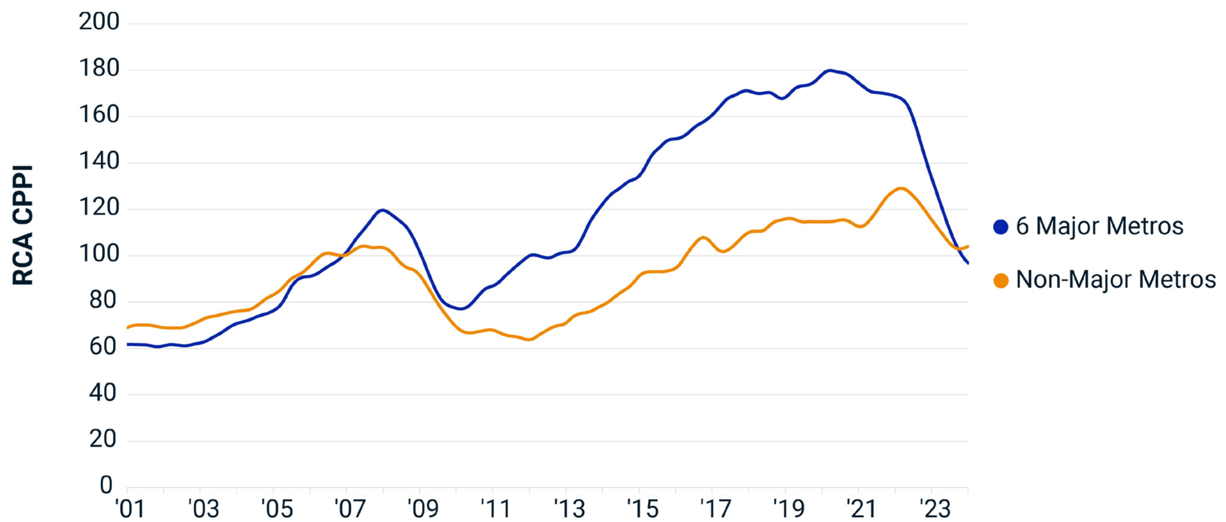
U.S.[3] Cumulative price declines to January of 2024 from the peak for CBD offices in smaller areas of the U.S. were 60% of that seen in the dense urban markets of the country.

Office prices in the six major metros hit a peak in April of 2020 just as lockdowns got going. Prices have not been improving since then, with a cumulative 46% decline in the RCA CPPI for CBD offices in these locales. These six metro areas — Boston, New York, Washington, D.C., Chicago, San Francisco and Los Angeles — represent a sizable portion of the U.S. economy. Still, they are not the entirety of CBD offices nationally.

If one is exposed to CBD offices in cities like Charlotte, Dallas, Atlanta or other locations with more-dispersed urban footprints, the price declines have not been as intense. CBD-office prices fell at a 2% year-over-year pace in early 2021 in these smaller markets before spiking up in 2022 amid cheap financing and investor hunger for yielding assets. Many of these areas did not experience the same pain around lockdowns as that seen in the dense urban environments, leading to less of a work-from-home culture and providing more certainty around asset income.

Exhibit 5: CBD-office prices falling from greater heights in the six major U.S. metros



Index level December 2006 = 100. Source: January 2024 data release of the RCA CPPI

[3] The MSCI Real Capital Analytics database classifies the U.S. in two geographical tiers: six major metros and non-major metros. Non-major metros refers to all secondary and tertiary markets.

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The RCA CPPI figures are subject to revision, but on a monthly basis, CBD-office prices have been improving since late in 2023.[4] The trends in December 2023 and January 2024 suggest an annualized 6% pace of price growth for CBD offices in these smaller cities. This sort of growth is great news when set against the ongoing double-digit declines for CBD-office prices in the six major metros. It is not as if CBD offices in these smaller markets are getting a free pass from the problems seen in the depths of the COVID-19 era, however. Price levels in January of 2024 were still 9% lower than the average level of 2018 and 2019.

The picture is more complicated than the headline figures

CRE is a dirty word in some regulatory circles. Current fears around banks because of commercial property's price declines are potentially misplaced. The sector faces a stigma effect from lingering memories of problems faced in previous downturns. One can only get the true picture on the scope of the risks by digging into the details of each property type and the exposures faced by each lender group, not just banks as a whole.

The most severe price declines in the current cycle are for CBD offices in the six major metros of the U.S. Price changes for other property types and in other cities are far less severe, with some showing signs of improvement late in 2023 into 2024. Making a conclusion that banks everywhere are in trouble because of high-profile price declines in big media markets is overstating the challenges faced today.

Banks themselves were not the only lenders in these markets. CMBS originators have provided much of the debt to this market and the debt funds have been particularly aggressive over the last 12 years. Yes, the globally headquartered banks were some of the biggest lenders for the most challenged CBD-office space, but smaller banks face far fewer risks there. Assuming that just because a bank has CRE exposure on their books ignores the reality of the relationship-driven nature of the banking business and the differences in urban scale across U.S. cities.

Humans often set their expectations for bad events by looking at the experiences from similar events in the past. This behavior served us well when we were hunter-gatherers tying to figure out which plants and animals would kill us. Figuring out financial events today requires more than just memory of bad events, it requires a deep analysis of the forces driving market challenges.

[4] The RCA CPPI, published monthly, is based on repeat-sales transactions. The RCA CPPI incorporates new data received subsequent to publishing and allows for backward revisions.

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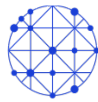

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