



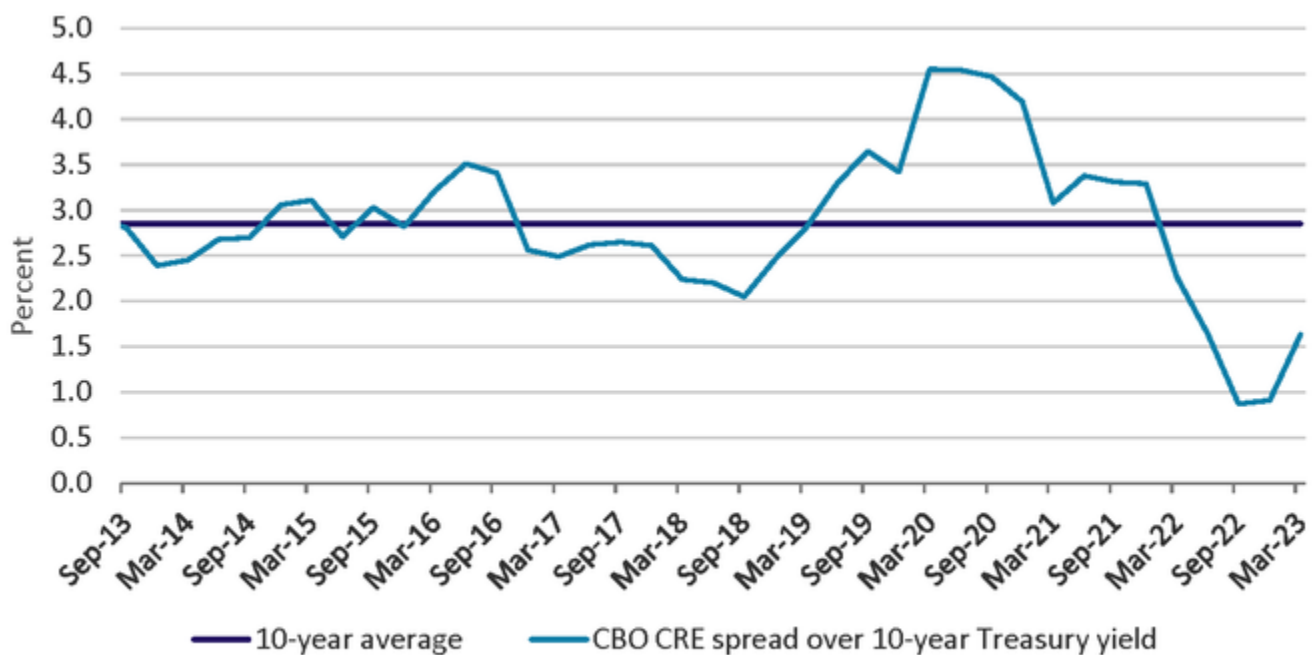
## Community Banking Bulletin

### Highlight: Risk premium for CRE lending has declined

June 01, 2023

As the federal funds rate and broader market interest rates have risen over the past year, lags in repricing have resulted in a dramatically narrowing risk premium for commercial real estate loans.

#### Commercial Real Estate Loan Rate Spread\*



Sources: Reports of Condition and Income; Haver

\*Includes interest and fee income on loans secured by real estate, excluding 1-4 family residential properties, as reported in Schedule RC-C, part I, items 1.a, 1.b, 1.d, and 1.e.

- From year-end 2021 to March 31, 2023, the federal funds rate and the yield on the 10-year Treasury note increased by 476 basis points and 196 basis points, respectively, while the median rate on commercial real estate (CRE) loans at community banking organizations (CBOs)<sup>[1]</sup> increased by only 30 basis points. As a result, the spread between the median CBO CRE loan rate and the yield on the 10-year Treasury rate declined significantly, falling from a peak of 455 basis points in March 2020 to 87 basis points in September 2022.

- The narrowing spread between loan rates and broader market rates is to be expected given lags in loan repricing and extended loan terms; however, the current compression indicates declining relative compensation for CRE lending risk.
- Further, the lag in CRE loan repricing suggests that the impact of rising interest rates has likely not yet been fully reflected in CRE credit performance. With only minimal increase in bank CRE rates since the current tightening cycle began, borrowers' debt service requirements have likely not increased materially. Given the lagging nature of loan repricing, further rate increases are likely; while this would benefit bank interest income, it may add pressure to credit performance.

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## Endnotes

<sup>[1]</sup> Community banking organizations are defined as having less than \$10 billion in total assets.

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