



Economic Bulletin

Banks' Commercial Real Estate Risks Are Uneven

by: Jordan Pandolfo and W. Blake Marsh

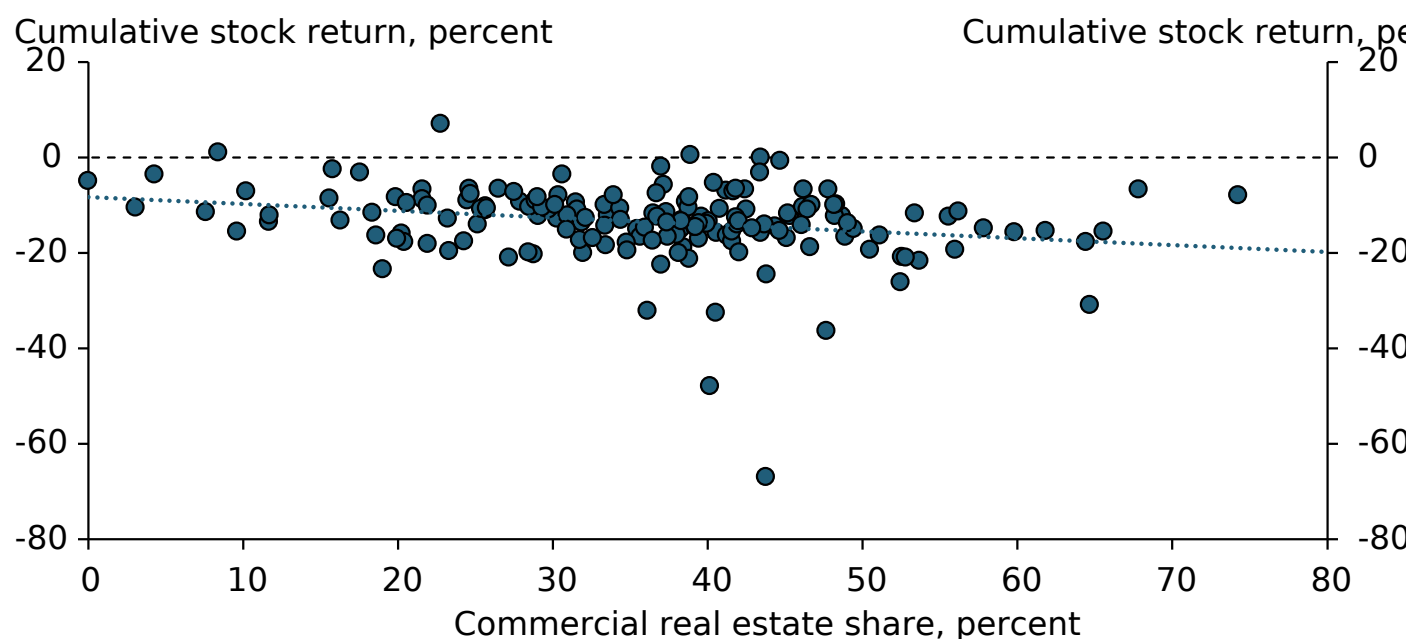
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Investors have been acutely attuned to commercial real estate (CRE) risks recently due to higher interest rates and changes in how Americans work. On the surface, these risks may seem particularly concerning for small and regional banks, which tend to hold large concentrations of loans backed by commercial properties. However, we show that CRE risks can vary substantially across property types and geographic locations, suggesting that aggregate CRE exposure may be a poor measure of risk.

Both higher interest rates and a decline in office attendance have prompted concerns about bank exposure to commercial real estate (CRE) risk. Banks are major lenders in the CRE market, providing nearly \$3 trillion in financing to the sector. Moreover, CRE lending can make up a significant share of a bank's total loan portfolio, particularly at small and regional banks. Thus, any downturn in the performance of loans backed by CRE properties could pose challenges to the long-term viability of exposed banks (Marsh and Sengupta 2017).

Indeed, in recent months, investors appear to have become more cautious about banks' CRE concentrations. Chart 1 shows that cumulative excess returns on bank stocks were negatively correlated with the share of assets held as CRE loans during February 2024, a period that coincided with rising concerns about CRE risks for regional banks (Pascus 2024). In particular, a 40 percent increase in CRE concentration corresponded to a 5 percent lower cumulative abnormal return during the month.^[1] Thus, while almost all banks experienced negative returns during this time period, excess losses were most pronounced for banks with high CRE exposure.

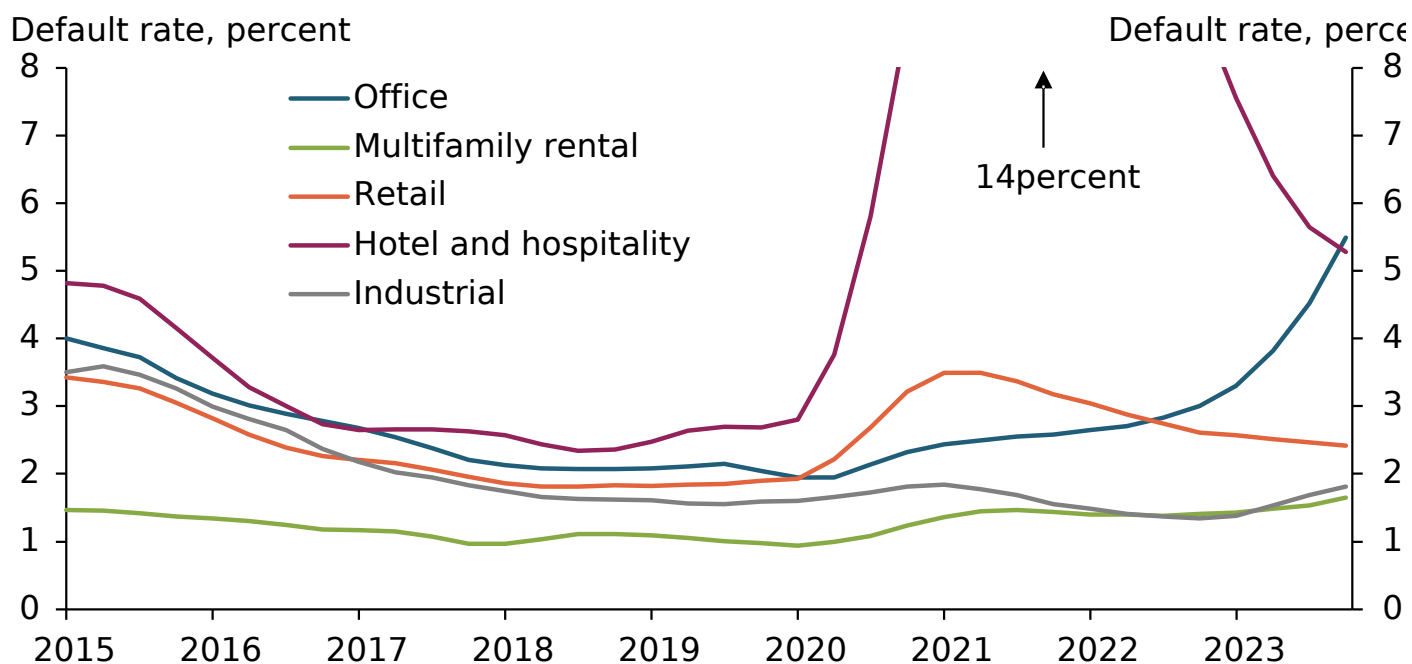
Chart 1: Higher CRE loan concentrations are associated with lower bank stock returns



Notes: Each dot represents a bank's abnormal stock return between January 31 and February 23, 2024. See endnote 1 for a description of the abnormal return calculation.
Sources: Federal Financial Institutions Examination Council (FFIEC), Bloomberg, and Federal Reserve Bank of St. Louis (FRED).

However, banks' exposure to CRE risk depends on more than just loan concentration. Other key factors include the stringency of the bank's underwriting, its willingness and ability to monitor existing borrowers, and the capital and loan loss provisions it holds against potential losses. The characteristics and location of the underlying properties matter, too. CRE properties include office buildings, apartment dwellings, warehouses, and hotels—each with a different set of default risks based on business use and local economic conditions. For example, based on available data from large banks, Chart 2 shows a surge in expected defaults on loans to hotel and hospitality properties (purple line) and retail properties (orange line) during the pandemic, when consumer activity fell sharply.^[2] More recently, rising interest rates and an increase in remote work have weighed on office property valuations and elicited concerns about their future profitability. As a result, expected defaults on office properties are currently at decade highs.

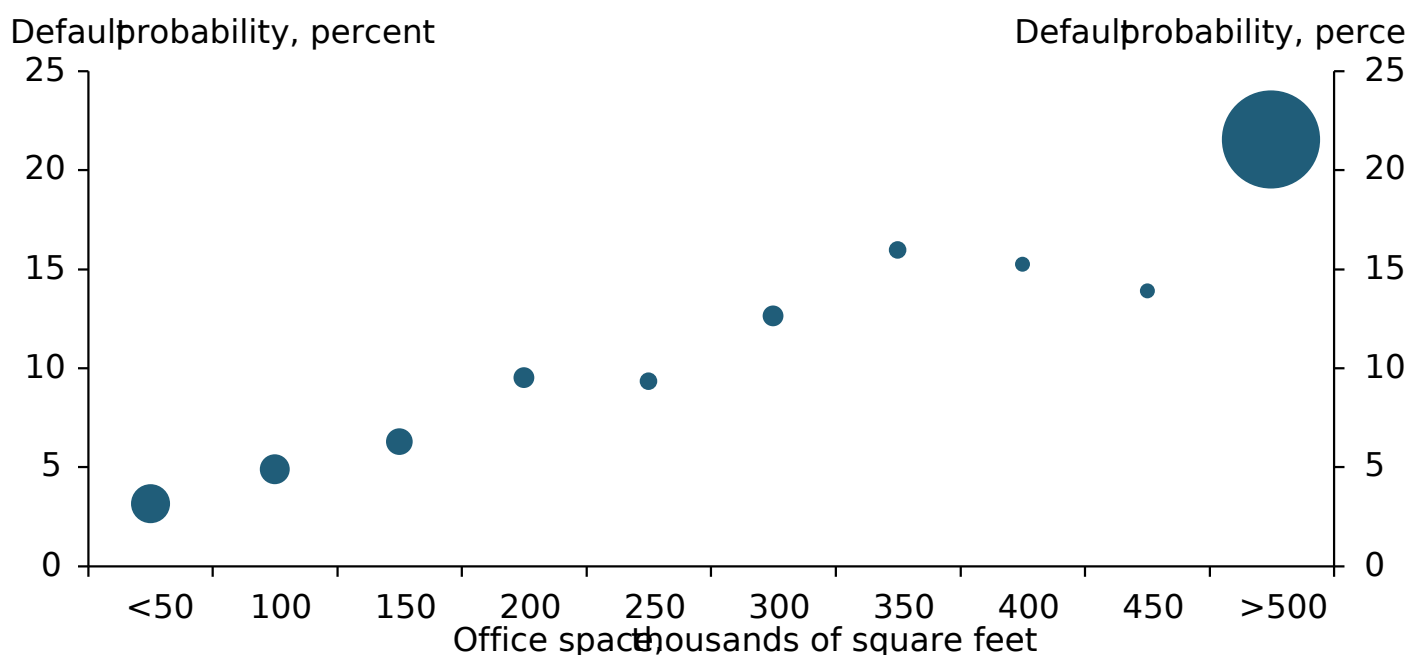
Chart 2: Expected default rates have increased on office properties



Note: Default forecasts are reported by banks at the loan level.
Source: Board of Governors of the Federal Reserve System.

CRE risks can also vary within a particular class of commercial properties by size. Chart 3 shows that in a sample of loans from 2023:Q4, expected default rates on office properties are correlated with the size of the office building. Indeed, expected default probabilities are nearly 25 percent for the largest office properties (those with more than 500,000 square feet). In contrast, smaller properties tend to have substantially lower expected default rates.

Chart 3: Expected default rates on office properties increased with property size



Note: Dot size represents share of outstanding loans.
Source: Board of Governors of the Federal Reserve System.

Importantly, characteristics such as property type or size are likely correlated with geographic location. For example, hotels are likely to concentrate in areas that serve as vacation destinations. Similarly, larger office buildings are more likely to be concentrated in large metro areas. In this way, specific localities—and the banks that serve those localities—may be disproportionately exposed to CRE risks.

Despite a relatively strong economic outlook, investors continue to closely assess the risks that commercial properties pose to banks, particularly those with sizable loan concentrations. Under closer examination, though, CRE risks are diverse and depend strongly on property type, property characteristics, and geographic location. In addition, underwriting standards and loss absorption measures can differ substantially across banks. Thus, broad bank risk measures may not provide a complete picture of the risks CRE loans pose to individual banks.

Endnotes

- [1] Abnormal returns are generated from a model that regresses each bank's daily stock return on the daily return of the S&P 500 between July 2023 and January 2024. These model estimates are then used to predict the stock's return between January 31 and February 23, 2023. The daily abnormal return is the forecast error, which is cumulated over the February event period.
- [2] Loan level data on defaults are drawn from the Federal Reserve's FR Y14Q report. These data are collected quarterly from bank holding companies with total consolidated assets of \$100 billion or more as part of the stress-testing program. The CRE schedule collects loans secured by commercial properties with committed balances of \$1 million or more that are outstanding as of the report date.

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