Principal Asset Management℠

PRINCIPAL REAL ESTATE

U.S. regional banks: Crisis averted but commercial real estate likely to face more scrutiny

The recent crisis in regional banks in the U.S. threatened to metastasize into a full-blown contagion before the FDIC, the Federal Reserve, and a group of large banks worked together to bring some stability into the sector. Many issues still need to be resolved and the coming days may yet see more consolidation in the U.S. banking sector and perhaps globally, as seen in the recent event over the weekend with the merger of Swiss banks UBS and Credit Suisse.

While systemic risk for the U.S. appears to be a small likelihood, the closure of two large regional lenders and further potential consolidation opens questions around broader debt exposure in banks, particularly to commercial real estate at a time when values are deteriorating, especially in the office sector.

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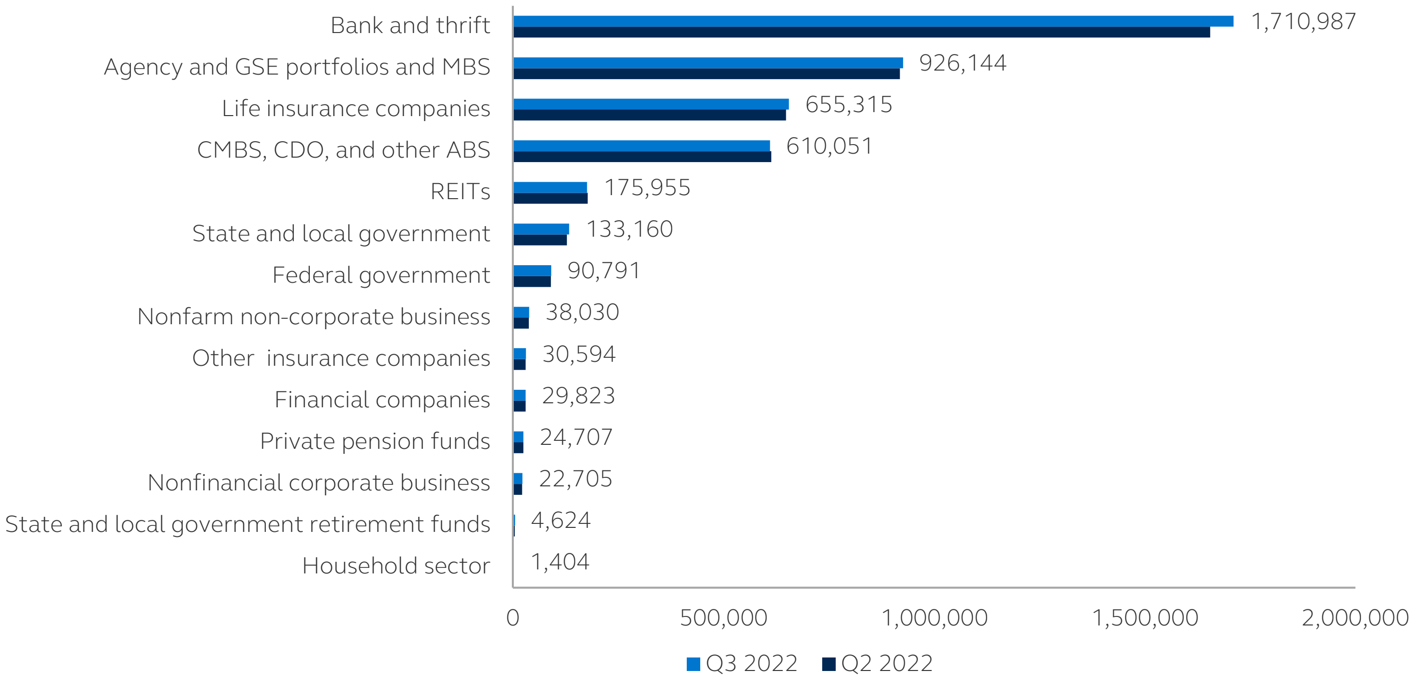
How important are banks to commercial real estate?

The short answer is, very. In the latest data reported by the Mortgage Bankers Association (MBA), commercial banks held 39% of commercial and multifamily mortgage debt outstanding as of 3Q 2022 (Exhibit 1 overleaf). Of that broader lending portfolio, loans to commercial real estate were 64% of the total, with residential mortgages accounting for the remainder (36%). Banks provide critical debt market functions across the risk spectrum and, thus, any stress to their balance sheets or tightening in financial conditions will filter into the commercial real estate markets.

EXHIBIT 1: Total Commercial and Multifamily Mortgage Debt Outstanding, by Sector ($ millions)



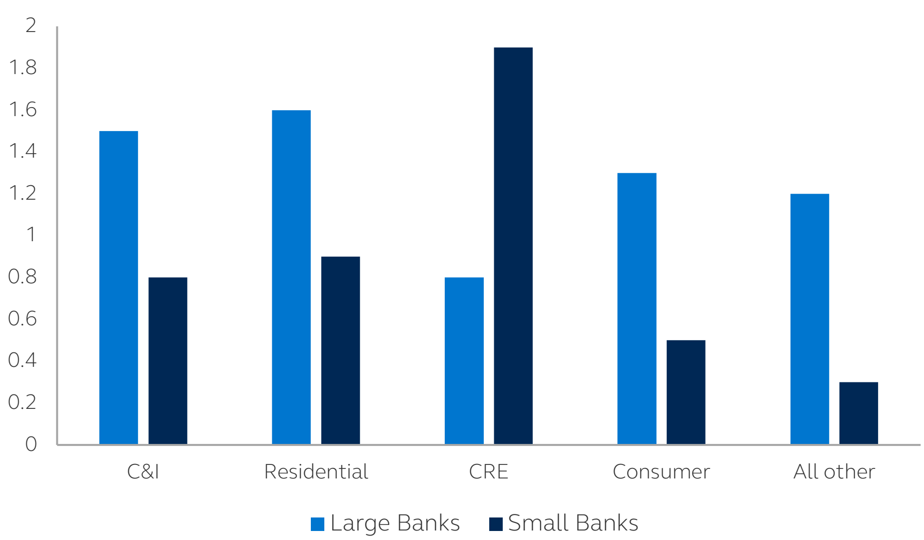
Source: MBA, Federal Reserve Board of Governors, Wells Fargo Securities, LLC, Intex Solutions, Inc., FDIC, Principal Real Estate, Q3 2022

Smaller/regional banks have been more active in commercial real estate

Of particular importance to the current situation in the U.S. banking system is the role of small/regional banks versus large banks. Data from the Fed on "small" versus "large" banks show that smaller banks (including regionals) have been more active in commercial real estate lending as a proportion of their loan book (Exhibit 2). Smaller banks have also been deeply involved in local real estate transactions often providing debt solutions to transactions that are too small/of less interest to larger banks. On an absolute basis, however, smaller banks, have less exposure to residential real estate relative to larger banks.

EXHIBIT 2: Loan types from U.S. commercial banks

$ trillions, December 2022 - March 2023 average



Source: Federal Reserve, JPMorgan, Principal Real Estate, March 2023

Implications for commercial real estate debt markets

Strong action by the Fed and the FDIC and coordinated action by global central banks over the weekend to boost liquidity in the U.S. Dollar swap market should help contain any fears of contagion across the banking sector. Smaller banks in the U.S. should clearly benefit but their lending profiles will likely receive closer attention. Their exposure to commercial real estate may get scrutiny at a time when real estate values are under pressure. The fluidity of the current environment notwithstanding, we place a high degree of probability on the following:

- A continuation of the slowdown in lending to commercial real estate. Loan officer survey reflects a slowdown underway well before the current banking issues and we expect additional risk management efforts to put pressure on lending for the foreseeable future (Exhibit 3).

EXHIBIT 3: U.S. bank responses regarding commercial real estate loans

Net % of banks

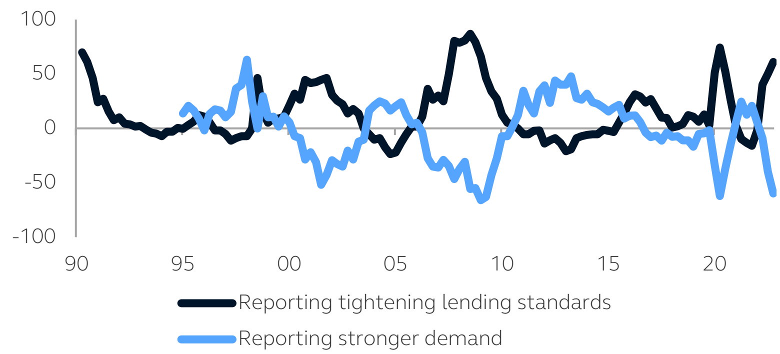


Chart source: Federal Reserve (the Loan Officer Opinion Survey), January 2023

- A potential reduction in lending appetite within small/regional banks. Larger banks may de facto become larger players but are unlikely to pick up the slack entirely given the more stringent risk-based capital requirements they face. As a result, loan origination volumes may remain muted.
- More scarce and expensive debt that is likely to pressure transaction volumes but also accelerate price discovery, particularly in property sectors where valuations are under stress. Office assets may be most vulnerable to the shifts in the lending market given uncertainty around valuations.
- Reduced appetite for commercial real estate loans among commercial banks would increase the cost of capital but also open the opportunity set to non-bank lenders to expand their footprint. While an increase in non-bank lending would be helpful to real estate, it would not be enough to bridge the gap if there is a material decline in loan activity by commercial banks.

The banking system should remain resilient but more emphasis on risk management is likely

We are confident that the issue with small/regional banks or even global banks is unlikely to lead to systemic contagion issues given the swift steps taken by regulators and central banks. However, we do expect a greater focus on risk management going forward including increased scrutiny of existing debt and future underwriting tied to commercial real estate. Since real estate has been a material part of bank lending portfolios, we do expect some pullback and greater selectivity on loan profiles which is likely to accelerate the process of price discovery in stressed assets, particularly in the office sector.

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