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Commercial Property Debt Creates More Bank Worries

Large number of office defaults could force banks to mark down value of these and other loans

By Konrad Putzier Follow *and Peter Grant* Follow

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A record amount of commercial mortgages expiring in 2023 is set to test the financial health of small and regional banks already under pressure following the recent failures of Silicon Valley Bank and Signature Bank.

Smaller banks hold around $2.3 trillion in commercial real estate debt, including rental-apartment mortgages, according to an analysis from data firm Trepp Inc. That is almost 80% of commercial mortgages held by all banks.

With the banking industry in turmoil, regulators and analysts are growing increasingly concerned about commercial real estate debt, particularly loans backed by office buildings, according to industry participants. Many skyscrapers, business parks and other office properties have lost value during the pandemic era as their business tenants have adopted new remote and hybrid workplace strategies.

High interest rates also have wreaked havoc with commercial property valuations. Many owners with floating-rate mortgages have to pay much more monthly debt service, cutting into their cash flows. Owners with fixed-rate mortgages will feel the pain of higher rates when they have to refinance.

This year will be critical because about $270 billion in commercial mortgages held by banks are set to expire, according to Trepp—the highest figure on record. Most of these loans are held by banks with less than $250 billion in assets.

If those loans pay off, it would reassure markets. But a large number of defaults could force banks to mark down the value of these and other loans, analysts say, reinforcing fears over the financial health of the U.S. banking system.

Many of these borrowers will have a hard time paying off their loans, said Tomasz Piskorski, the Edward S. Gordon professor of real estate at Columbia Business School. “The destruction of value is quite big,” he said.

While a number of banks have seen drops in the value of their bondholdings—a key factor in Silicon Valley Bank’s collapse—figuring out by how much the value of their mortgages has dropped is trickier because they aren’t publicly traded and every building is different.

In a recent paper, a group of economists including Mr. Piskorski estimated that the value of loans and securities held by banks is around $2.2 trillion lower than the book value on their balance sheets.

That drop in value puts 186 banks at risk of failure if half their uninsured depositors decide to pull their money, the economists estimate. Real-estate loans account for more than a quarter of the shortfall, said Mr. Piskorski.

At the median U.S. bank, commercial real-estate loans account for 38% of loan holdings, according to an analysis by KBW Research.

The good news is that banks lent more conservatively in recent years compared with the period before the 2008 financial crisis. Many buildings might still be worth more than their mortgages even if they suffer a loss in value.

"The saving grace here is that you do have a decent-sized cushion," said Frank Schiraldi, a stock analyst at Piper Sandler.

Also, government regulators have given banks ways to avoid taking losses even when loans are in trouble and are restructured to give borrowers more time and more flexibility to pay what they owe. Much of the guidance the Federal Reserve and other regulators are following was enacted during the global financial crisis to shore up the economy.

For example, in 2009 regulators issued a policy statement that allowed banks to keep loans on their books at full value in many situations even if the property backing the loan was worth less than the loan balance. While banks had a reasonable expectation of being repaid, critics warned at the time that this guidance would hurt the economy in the long run because the pain was only being deferred.

But the strategy was successful. Commercial property values rose steadily in the years after the crisis thanks in large part to low interest rates.

Eventually, many borrowers were able to pay off the loans that were modified and extended during the tough years. Regulators "turned out to be correct," said Tyler Wiggers, a senior staff member at the Fed in the aftermath of the fiscal crisis who is now an adjunct instructor at the University of Cincinnati's department of finance.

The Federal Reserve in September said it planned to revisit its financial-crisis-era guidance regarding commercial property restructurings but noted that new policy would "build on existing guidance." The new policy "is timely in the postpandemic era, as trends such as increased remote working may shift historic patterns of demand…in ways that adversely affect the financial condition and repayment capacity" of commercial property landlords, the Fed said.

Still, a flexible approach to real estate workouts among regulators has limitations. Banks are still typically required to cut the value of the debt on their books if a borrower defaults. Already the number of defaults is growing, partly because of high interest rates, work from home and tech layoffs. Landlords that have defaulted include Pimco and Brookfield Asset Management.

Trepp reported earlier this month that the delinquency rate for commercial mortgage-backed securities increased 0.18 percentage point in February to 3.12%, the second-largest increase since June 2020.

Moreover, if interest rates stay at current high levels, low rates won't come to the rescue of banks' commercial property portfolios as they did in the years following the financial crisis. Indeed, a rise in interest rates would further erode the values of these portfolios.

The Fed recently said it would accept bonds and other assets at face value as collateral from banks, making bank runs less likely. Still, small and regional banks could run into trouble quickly if they have to sell commercial property loans to raise capital, said Richard Jones, a partner with law firm Dechert LLP.