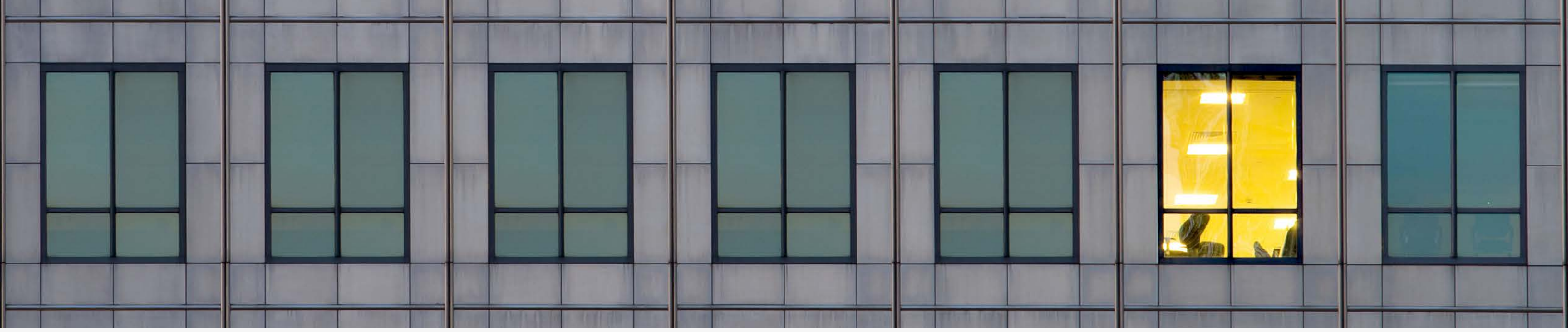
Will credit losses return to office?

Market Insights

May 8, 2023



Will credit losses return to office?

Chadi Richa, Manager, North American Equities Analyst | Wealth Investment Office

As if a liquidity crisis and the prospect of a recession weren't reasons enough to raise concern over the banking sector, another threat has reared its head: commercial real estate (CRE). Given the dramatic interest-rate hikes, the higher interest costs, lower valuations, defaults and further credit tightening, we believe that we could see significant disruption in the real estate market. Currently our Wealth Asset Allocation Committee is maximum underweight in domestic and global real estate.

While CRE is thought of as a singular asset class, there are 15 sub-categories, each with its unique drivers reflecting the economics of the tenants. For instance, what drives medical office buildings is different from what drives data centres, or retail or cellular towers.

Office real estate is the area of real concern today, stoked by two major headwinds: (1) growing downward pressure on net operating income from declining appraisal values and increasing vacancy rates; and (2) higher refinancing costs. Furthermore, while stress in the banking sector from recent events has abated, the active role of small and regional banks as lenders to commercial properties has added to a long list of secular and cyclical challenges for CRE. Regional banks are facing pressure on their balance sheets, competition for deposits (and funding), greater need for liquidity and potentially tougher regulation, all of which are leading to tightening lending standards that could make it more challenging for CRE borrowers to refinance or access funding.

Key Points

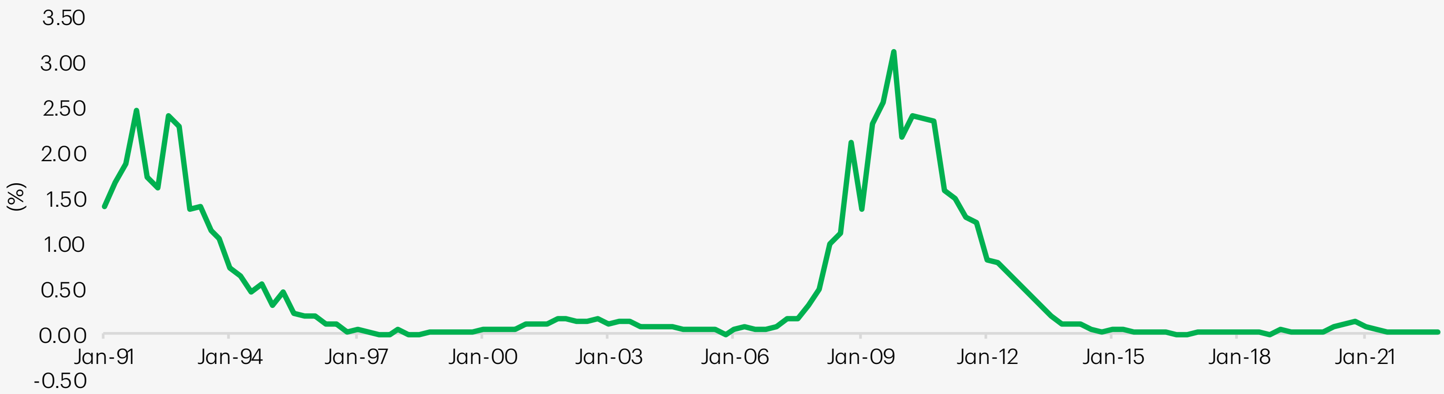
Banks have seen record low defaults for commercial real estate over the past few years. However, given rising stress in the sector, particularly for office, it's likely that credit losses will rise.

Large banks have dramatically improved their risk profiles since the global financial crisis, due to disciplined underwriting, improved risk-management practices and, more importantly, stringent regulation.

Stresses are mounting due to a higher vacancy rate and financing costs. Credit losses will rise, but they will likely be manageable for large banks. Smaller banks, on the other hand, are at a disadvantage.

This isn't the first time this sector has faced this sort of challenge. Federal Reserve data suggests that, in the early 1990s, cumulative losses over three years were 5% and, during the global financial crisis (GFC), cumulative losses over three years were 6%. As Figure 1 shows, CRE charge-offs — the value of loans and leases removed from books and charged against loss reserves — have been at record lows over the past few years, thanks to a benign economic environment and low interest rates. However, given rising stress in the sector, specifically office CRE, it's very likely that CRE credit losses will increase.

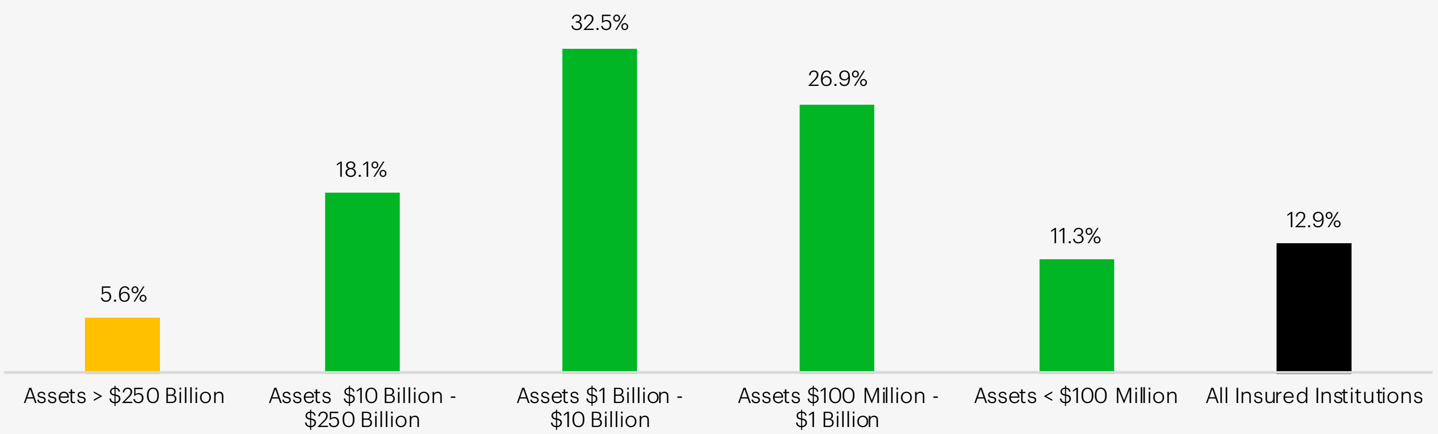
Figure 1: Charge-off rate on U.S. CRE loans (excluding farmland)



Source: Federal Reserve, Wealth Investment Office as of October 1, 2022.

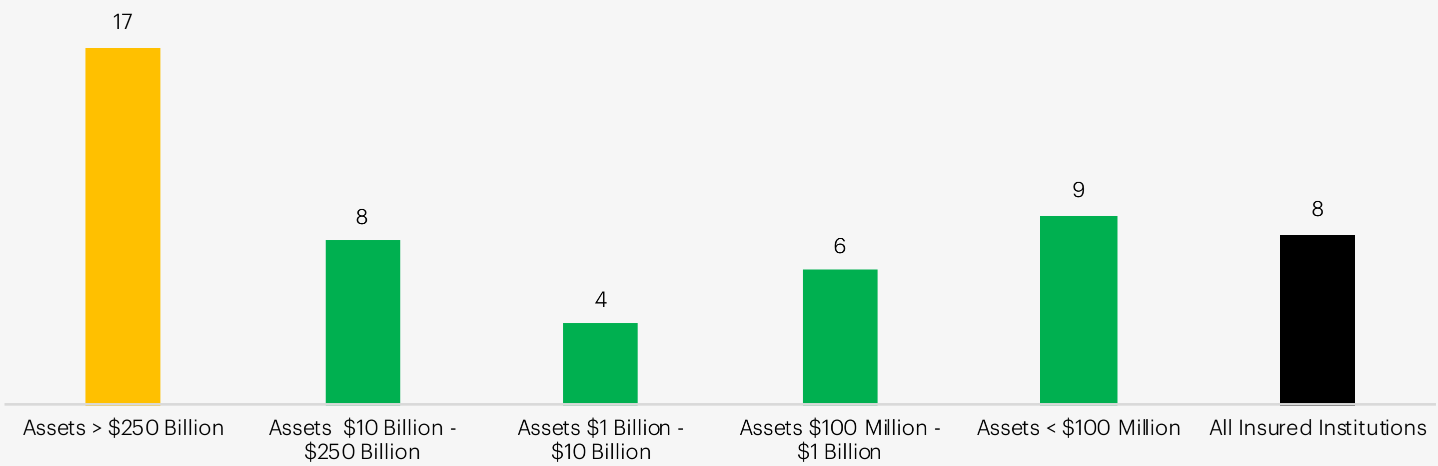
CRE loans were 6% of total assets of large banks, compared to an average of 22% for the small and regional banks (Figure 2). That said, all banks should not be painted with the same brush. Large banks have drastically improved their risk profiles compared to the pre-GFC period. This is mainly due to disciplined underwriting, improved risk-management practices and, more importantly, stringent regulation. As shown in Figures 3 and 4, over the past 16 years, large banks have increased their liquidity and regulatory capital levels much more than smaller banks, which makes them better equipped to deal with headwinds such as rising credit losses and unexpected outflow of deposits.

Figure 2: CRE as a % of assets for small and large banks



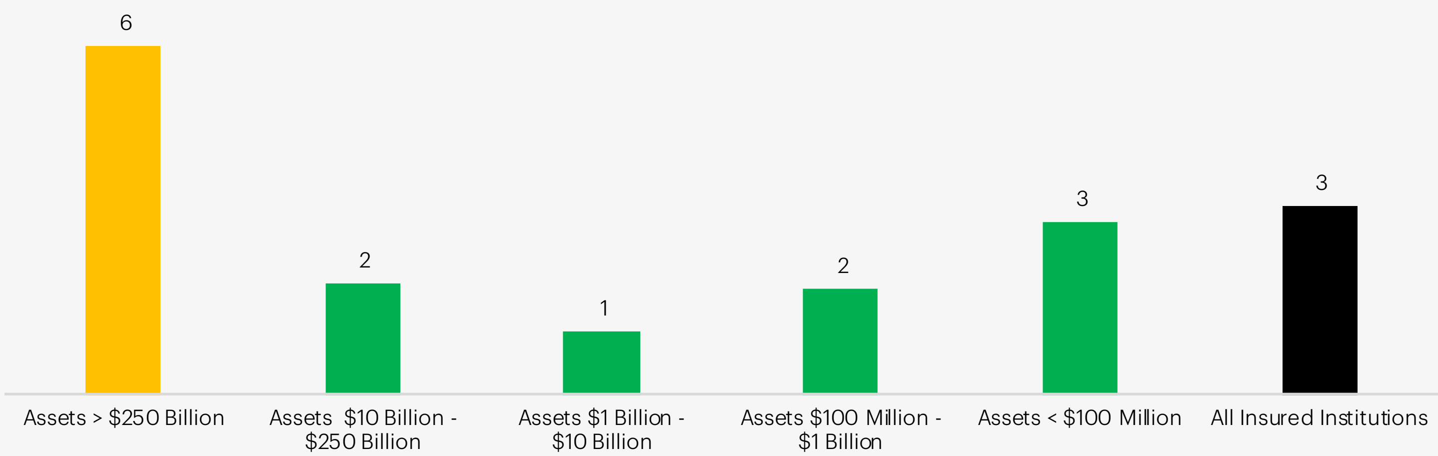
Source: FDIC, Wealth Investment Office as of December 31, 2022.

Figure 3: Change in liquidity ratios since Q4/06 (% points)



Source: FDIC, Wealth Investment Office as of December 31, 2022.

Figure 4: Change in Tier 1 capital ratio (% points) since Q4/06

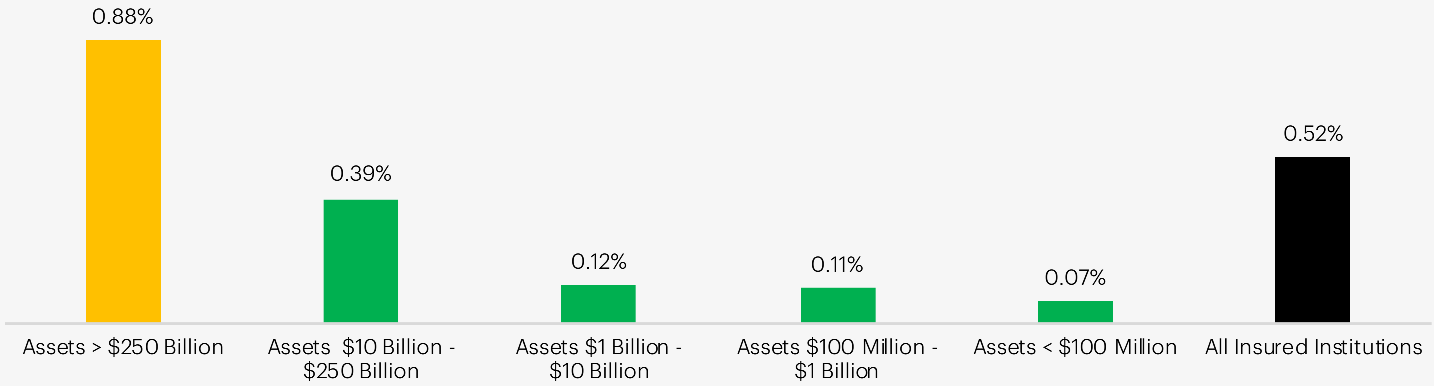


Source: FDIC, Wealth Investment Office as of December 31, 2022.

Large banks also hold more allowances (i.e., provisions for credit losses) as a percentage of loans than smaller banks. The allowance to loan losses as a percentage of loans was 0.88% as of Q4/22 for the large banks, compared to an average of 0.17% for the smaller banks. The coverage ratio for large banks (114%) is also higher than that of smaller banks (72%), which means that large banks hold approximately 60% more allowances against non-performing loans than small banks do.

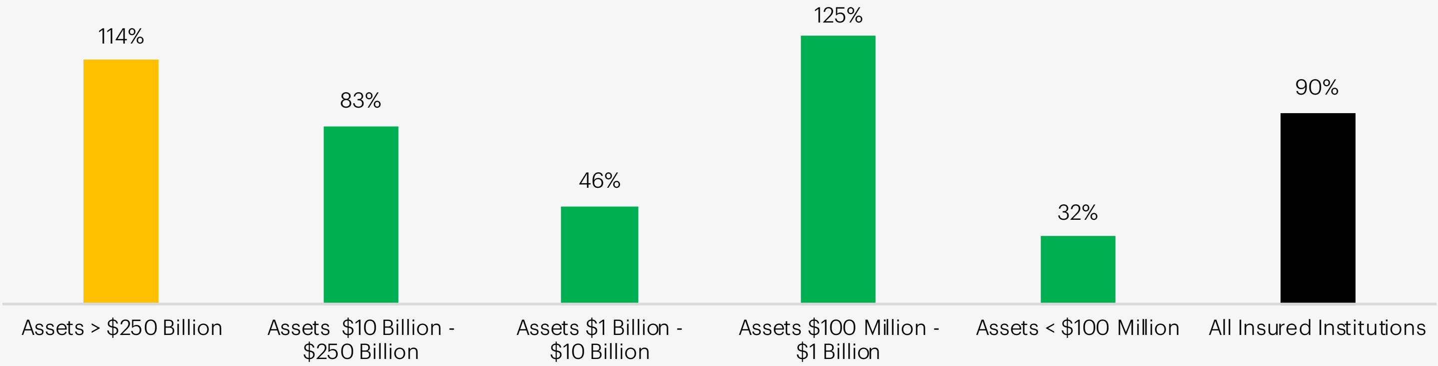
As a result of tougher regulation, adding risk to the balance sheet has become more penalizing for large banks, requiring them to hold more capital and build reserves, which tend to dampen profitability, driving large banks to become more diversified and prudent. CRE exposure has moved in the same direction on average for both large and small banks, but there has been a meaningful uptick for smaller banks in 2022, where exposure as a percentage of total assets increased around 222 bps during the year, compared to an increase of 34 bps for the large banks.

Figure 5: Allowances as a % of loans



Source: FDIC, Wealth Investment Office as of December 31, 2022.

Figure 6: Allowances for non-current loans and leases (coverage ratio)

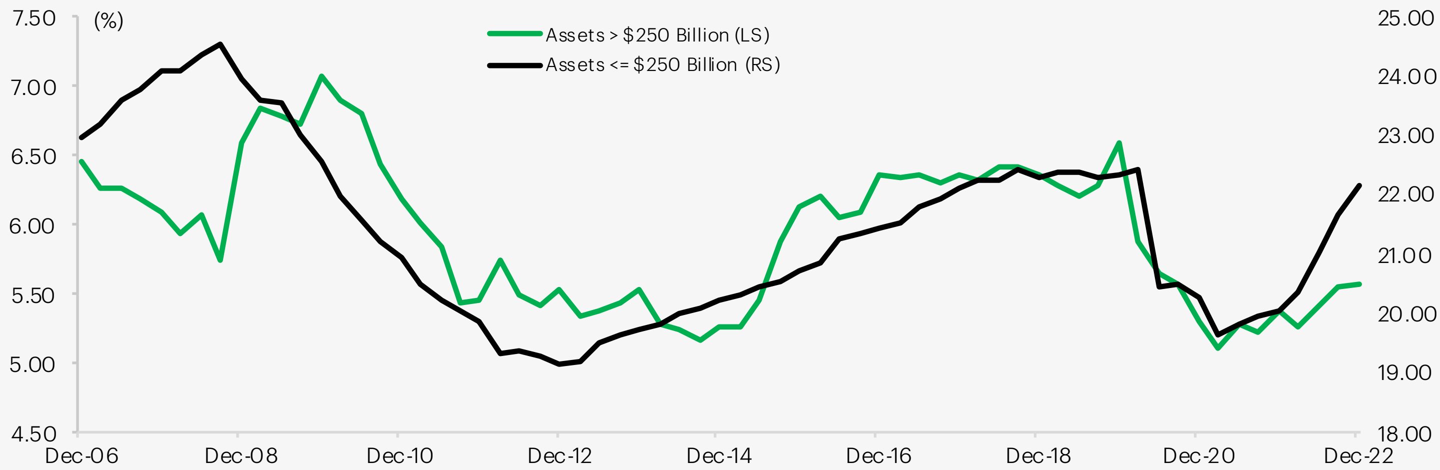


Source: FDIC, Wealth Investment Office as of December 31, 2022.

What does CRE exposure look like at the large banks?

The management teams that have reported so far have acknowledged that dislocations in commercial real estate will need to be monitored, although their own exposures were deemed high-quality and manageable. For the five largest U.S. banks, average CRE exposure as a percentage of total loans was 11% as of Q1/23 and, more importantly, office CRE exposure was around 2%. While pressures are expected to mount over the coming quarters for office CRE, losses will be manageable for the large banks.

Figure 7: CRE as a % of assets



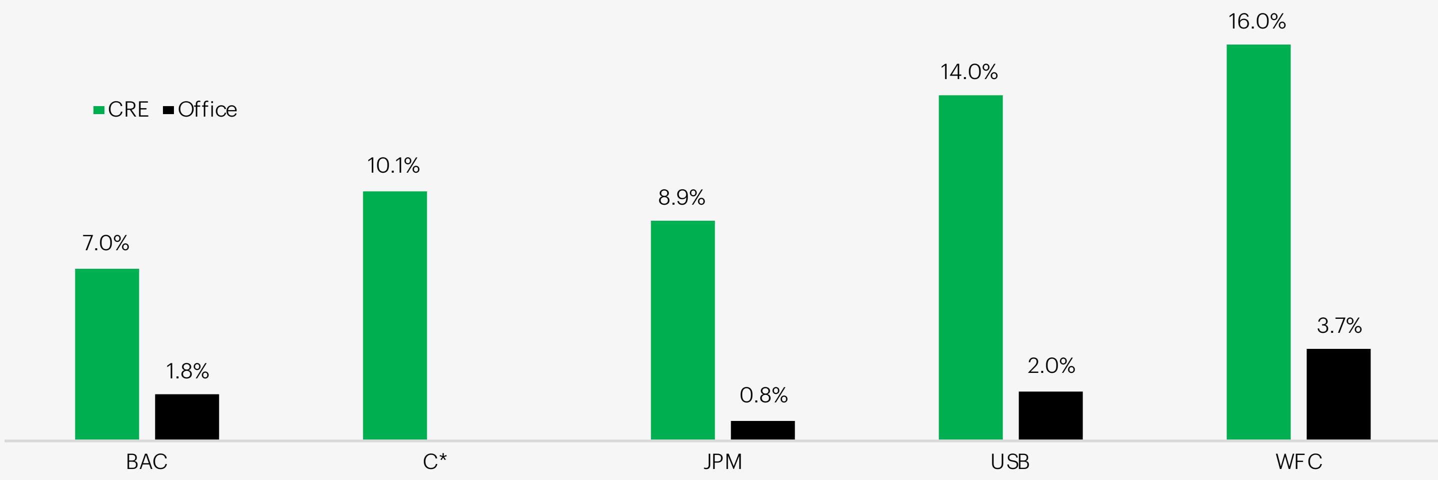
Source: FDIC, Wealth Investment Office as of December 31, 2022.

JPMorgan Chase & Co.: According to management, the majority of its office exposure is backed by class A properties in dense urban areas where the return-to-office trend has been a driver of higher occupancy. With regards to overall CRE exposure, nearly two-thirds are in multi-family loans, primarily in supply-constrained markets, which have performed better than higher-end properties in markets that are not supply-constrained and don't have rent control.

Wells Fargo & Co.: WFC built up a reserve of $603 million as a result of deterioration in CRE. The bank highlighted the quality of its CRE book but noted that CRE office as an asset class is facing mounting stress. The CRE office loan portfolio at WFC amounts to $35.7 billion, or 4% of total loans. Around 12% of the CRE office loan portfolio is owner-occupied and nearly one-third have recourse to a guarantor, typically through a repayment guarantee. Management noted that a significant portion of its CRE office loans is institutional-quality real estate, with approximately 80% in class A properties.

U.S. Bancorp: USB management noted that they expect some pressure in office CRE, but they're in a good position because the bank has been conservative and kept originations limited since the beginning of the pandemic.

Figure 8: CRE and office as a % of loans (large U.S. banks)



*No disclosure from C on office CRE loans exposure. Source: Company reports, Wealth Investment Office as of March 31, 2023.

Similar to their U.S. counterparts, Canadian banks don't have significant exposure to CRE and office real estate, according to reports for fiscal Q1 (ended January 31):

Bank of Montreal: BMO noted on a conference call that their office CRE exposures are high-quality and based on long-term relationships, that two-thirds of their large exposures are investment-grade and that they haven't loosened their lending standards to chase loan growth. BMO also noted that it is stress-testing its loan book frequently.

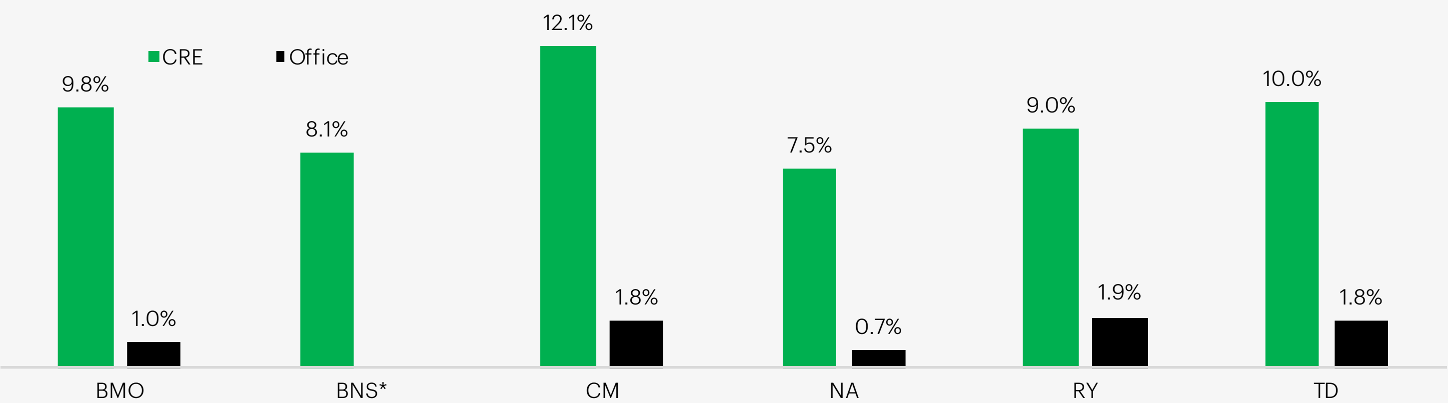
Canadian Imperial Bank of Commerce: CIBC highlighted its low losses in CRE over the past 20 years, and that its loan book is in good shape. CIBC noted that the majority of its book is composed of clients they have been dealing with for a long period of time, and who have been prudent and self-regulating. Regarding office CRE, CIBC noted that sub-lease rates have increased, and that most of their office clients are institutional. Management didn't see any stress in their book yet, but they are watching it closely.

National Bank: Its exposure to office CRE as a percentage of total CRE has declined from 16% in Q1/18 to 9% in Q1/23, and the portfolio has a loan-to-value ratio of 60%.

Royal Bank of Canada: RBC mentioned on its Q1/23 call that it expects to incur some losses in CRE, given that office vacancies are now above pre-pandemic levels and that it has been proactive in provisioning for these expected losses. As a result, RBC's allowance for credit losses on performing CRE loans has increased 40% since Q2/22 and has more than doubled from pre-pandemic levels. The bank noted that its exposure is well diversified and benefits from strong collateral. RBC highlighted the strength of its underwriting standards and that it has guarantees or partial guarantees for 95% of its commercial mortgages.

Toronto-Dominion Bank: On its Q1/23 earnings call, TD noted that its CRE portfolio is well diversified across geographies and segments and that $14.2 billion of its Canadian multi-unit residential segment is insured by CMHC. Similar to other banks, CRE credit losses have been very low, with the five-year average at 1 bp, compared to a loss rate of 10 bps for the broader category of business and government, which includes all commercial loans.

Figure 9: CRE and office as a % of loans (Big Six Canadian)

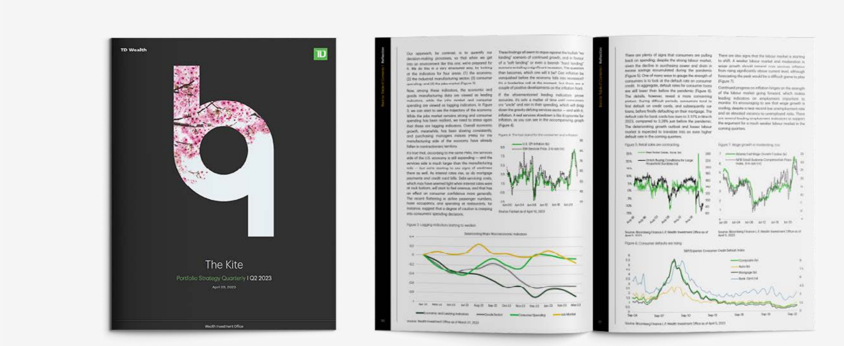


No disclosure from BNS on office CRE loans exposure. Source: Company reports, Wealth Investment Office. As of January 31, 2023.

Conclusion: It really depends

Stresses are mounting in office real estate due to a higher vacancy rate compared to the pre-pandemic period and higher financing costs. While credit losses have been extremely low, it's very likely that this trend will reverse in the near term. The extent of the impact on the entire banking sector is still uncertain and will depend on the future path of interest rates, the vacancy rate and inevitably the macroeconomic outlook. While large U.S. and Canadian banks could incur losses as a result of this headwind, we believe it will be manageable due to their low exposure to the office CRE sector, prudent underwriting standards and strong capital levels. Small and regional banks, on the other hand, are at a disadvantage due to their high exposure to CRE overall and the fact that they are not as strictly regulated as large banks. ☐

To learn more about the environment for commercial real estate, read "Outlook on Real Assets: Difficult times ahead" in our just published *Portflio Strategy Quarterly.*



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