Banks

All eyes back on CRE

Industry Overview

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High Grade Credit
United States
Banks

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NYCB: Idiosyncratic but with nuances

Few concerns were raised about CRE in large bank earnings reports in 4Q, continuing the narrative that CRE issues are likely to be digested over many quarters if not years as was the case in prior cycles (S&L and GFC). On Wed. 1/31, NYCB's (not covered) earnings report renewed concerns, sparking a sell-off in both bank stocks (KRE -8% vs. 1/30) and bonds (+5-20 bp). The two main questions in our view are 1) whether NYCB's situation is idiosyncratic or indicative of small banks' preparedness for CRE issues and 2) does this result in funding and liquidity stresses for the sector broadly as occurred last year? NYCB's situation is largely idiosyncratic, in our view, given its business mix (22% of loans in NYC rent stabilized multifamily), its role in acquiring some of Signature Bank's (SBNY) loans and deposits via the FDIC, implications of becoming a Category IV bank (i.e. application of Reg YY), and credit deterioration in mainly two loans, among others. However, we struggle to rationalize why the accounting for loan reserves should be a function of the size of the lender. While this is only part of the NYCB situation, we believe it to be the portion of the story that warrants read through to smaller banks. We do not expect funding or liquidity stress issues like last year and, as BofA Equity analyst, Ebrahim Poonawala, highlighted on Feb 2nd, "feedback from [NYCB management] indicates that the bank is not seeing any unusual deposit inflow/outflows."

More headlines to come with 4,000+ banks in the U.S.

While most public banks have reported 4Q results (>85% of system assets), there are still thousands of banks (public & private) that have not reported results yet. Weekly Fed H8 data does not show a spike in aggregate loan loss reserves for small banks so there does not appear to be a sector-wide decision to raise reserves materially (a positive). But as skittishness in markets indicated this week, the tolerance of 20, 50, or 100 banks (inclusive of privately held banks) reporting material provisions in 4Q is unknown. We have taken a stab at estimating the reserves for office CRE loans across the spectrum by asset size and find that small banks are likely reserved for about ¼ of the level of large banks. Inclusive of other CRE exposures, small banks have about ½ the reserves of larger banks. It's unclear if the delineation is underwriting-related or relates to banks' collateral value estimates (our view) but our framework is consistent with NYCB's statements of raising office CRE reserves from 2% in 3Q23 to 8% in 4Q23 due to realities of complying with Reg YY. While different regulatory scrutiny was "known" prior to this week, it begs the question why the size of a lender feeds into the level of reserves for a loan (from accounting and economic perspectives) and whether there should be more consistency further down the bank spectrum to smaller banks.

Credit risk manageable for large banks

With office CRE representing a relatively small portion of total loans, even at smaller banks, increases in provisions and reserves should be manageable, especially for larger banks that are better reserved, in our view. Headline risk related to CRE, broadly, is a threat to sentiment but we do not foresee a logical reason for funding stress en masse. We continue to view super regionals as offering better value given their spread discount, less credit sensitivity, earnings diversification, and strong capital generation.

BofA Global Research Reports

Title: Subtitle	Primary Author	Date Published
Banks: Constructive tone on credit continues	Tom Curcuruto, CFA	31 January 2024
New York Community Bancorp: Top questions asked (and answered)	Ebrahim H. Poonawala	02 February 2024
US Banks: Reading the Tea Leaves: Implications: NYCB, FOMC	Ebrahim H. Poonawala	31 January 2024
New York Community Bancorp: Heavy lifting ahead	Ebrahim H. Poonawala	31 January 2024

Taking inventory of what we know about office CRE portfolios

Office CRE disclosures vary widely from bank to bank, such as some banks including medical office properties and others excluding. On average, large banks' office CRE reserve to loans ratios are about 8% and origination LTVs (loan-to-value) of about 55-60%.

Exhibit 1: Large banks Office CRE reserves average ~8%

Office CRE portfolio stats as of 4Q23 for banks that disclose

	Amount $B	% of Loans	Reserves / Loans	LTV %
BAC	18.0	1.7%	-	55%
WFC	31.5	3.4%	7.9%	-
USB	6.9	1.9%	10.0%	-
PNC	8.0	2.5%	8.7%	-
TFC	5.3	1.7%	8.5%	61%
COF	2.3	0.7%	13.2%	-
CFG	3.6	2.5%	10.2%	-
FCNCA	2.9	2.2%	4.8%	-
FITB	1.3	1.1%	-	55-60%
KEY	0.8	0.7%	-	-
MTB	4.7	3.5%	4.4%	-
HBAN	1.8	1.5%	~10%	-
RF	1.5	1.5%	4.3%	66%
NYCB	3.4	4.0%	~8%	61%
ZION	2.0	3.5%	3.8%	53%
CMA	0.8	1.6%	-	-
SNV	1.9	4.4%	-	59%
CFR	1.9	10.3%	-	-
VLY	3.3	6.6%	-	53%
WBS	1.0	2.1%	-	54%
WAL	2.4	4.8%	-	55%
EWBC	2.3	4.4%	2.4%	52%
COLB	2.9	7.7%	-	56%
Median		2.5%	8.0%	56%

Source: Company filings and conference call transcripts. CFR as of 2Q23

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Making sense of reserve levels

As an illustration to validate a range of reserve levels, we estimate reserves as a function of default rates and impact to collateral values via property valuation declines. With the average LTV at origination of about 60% for office CRE loans, material reduction in property values is required to move the needle or reserves. We assume reserves/loans of only 1% on non-defaulted loans and minimum of 5% on defaulted loans to capture costs of loan workouts. Implied reserves/loans are effectively static until property valuations cross 40% (i.e. 1 - origination LTV). This illustrates to us that the major difference in reserves has to do with property valuation estimates (or origination LTV) than with default rate estimates. Both origination LTV and default rates are indicative of underwriting practices, among many other factors, and since most banks disclose LTVs around 60%, we infer most of the variation in reserves has to do with estimates for collateral values in this simplified framework.

BofA CMBS Research has noted office property values declined 15% in 2023 with steeper, 26% decline in central business district properties but also highlighted the risk of further downside as transaction volumes remain low by historical context, indicating market clearing prices have not been reached. The confluence of higher interest rates (higher cap rates), lower occupancy rates/higher vacancy rates, in part caused by post-Covid work-from-home / office attendance trends, and limited re-development opportunities for office floorplans are contribution to driving lower valuations.

For context, cumulative net charge offs in the past two CRE episodes (S&L and GFC crises) were about 5-7% each over 4-year spans, including construction loans. Excluding construction loans, cumulative losses were 3.6-4.4% over each 4-year span.

Exhibit 2: Reserves/loans driven more by property valuation decline than default rate

Illustration of reserve levels as a function of property valuation decline and default rate assumptions

		Property valuation decline					
		20%	30%	40%	50%	60%	70%
Default rate	10%	1.4%	1.4%	1.4%	2.6%	4.2%	5.9%
	20%	1.8%	1.8%	1.8%	4.1%	7.5%	10.8%
	30%	2.2%	2.2%	2.2%	5.7%	10.7%	15.7%
	40%	2.6%	2.6%	2.6%	7.3%	13.9%	20.6%
	50%	3.0%	3.0%	3.0%	8.8%	17.2%	25.5%
	60%	3.4%	3.4%	3.4%	10.4%	20.4%	30.4%
	70%	3.8%	3.8%	3.8%	12.0%	23.6%	35.3%

Source: BofA Global Credit Research estimates. Universal assumptions include 60% LTV at origination, 1% reserve for non-defaulted portion and minimum reserve of 5% for defaults to capture costs of workouts

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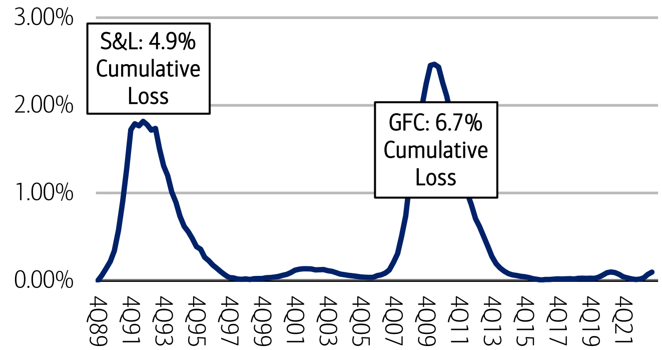
Exhibit 3: Cumulative CRE losses were 5-7% in past two episodes

Net charge off ratio % on CRE loans including construction



Source: FDIC. CRE includes construction loans. S&L (Savings & Loans crisis) = 1991-1994 and GFC (Global Financial Crisis) = 2008-2011

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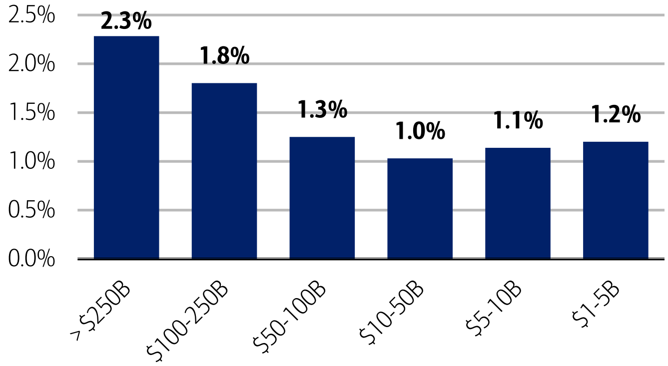
Framework for estimating office CRE reserves across the banking system

Using call report data from a sample of 550 banks with assets greater than $1B covering about 83% of system wide assets, we attempt to estimate office CRE reserves to loans for each group of banks by asset size. Disclosures on office CRE are sporadic even for larger banks as shown earlier. Our methodology starts with call report disclosures for total CRE reserves to loans. We then adjust CRE exposures for the proportion of office CRE relative to 'other' CRE exposure (ex. multifamily and owner occupied) using the average (as proxy) from the banks that disclose this information and for non-office CRE reserves/loans, using ranges for each.

Whereas reserves to loans for large banks (2-3% in aggregate) appears to be about 2x the level smaller banks (1-1.5% in aggregate) for total CRE as of 3Q23, large banks are likely carrying reserves on office loans at 4x the level of small banks. This observation is supported by news of NYCB raising reserves on its office CRE from 2% in 3Q23 to 8% in 4Q23. As illustrated above, we believe that majority of the difference in reserve levels between large banks and small banks is the estimate/assumption for property valuations.

By our estimates, each 1% increase in reserves for office CRE exposures would have a negligible impact on large banks annual earnings by <1% and capital ratios by 1 bp and a manageable, 2-3% of earnings and ~3-4 bps on capital ratios for small banks (< $100B of assets). Even a 600 bp increase in reserves for small banks would erase about 10-20% of annual earnings but only about ~20 bp of capital. The moderate impact reflects office loans representing ~2% of loans for large banks and ~5% of loans, on average for small banks, by our estimates. One risk is that the reserving practices for office CRE loans at small banks persists in other loan categories.

Exhibit 4: Large banks' CRE reserves/loans are ~2x small banks...
CRE Reserves/Loans by Asset size; as of 3Q23



Source: Bank call reports and BofA Global Credit Research estimates. Excludes construction loans
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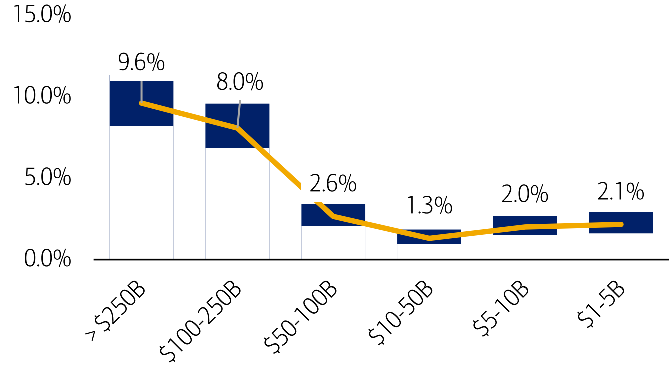
Exhibit 5: ...with ~4x greater reserves on office CRE loans
Estimated office CRE/loans by Asset size as of 3Q23



Source: Bank call reports and BofA Global Credit Research estimates. Bars = range based on different assumptions. Line = mid-point of assumptions
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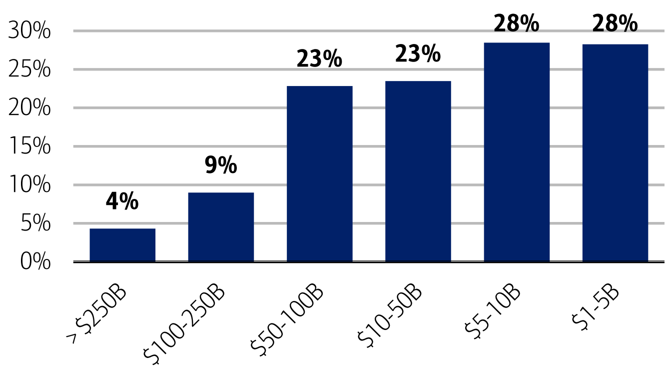
Exhibit 6: Smaller banks have greater exposure to CRE at 20-30% of total assets...
CRE loans including nonfarm nonresidential, owner occupied and multifamily loans as % of total assets by Asset size; as of 3Q23



Source: Bank call reports and BofA Global Credit Research estimates
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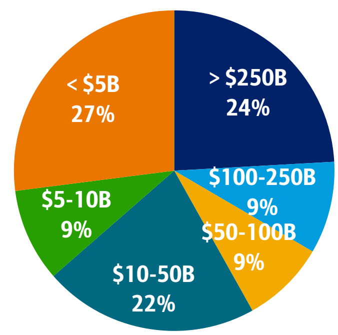
Exhibit 7: ...And about 2/3 of the $2.4T of CRE held by banks
CRE loans including nonfarm nonresidential, owner occupied and multifamily loans by Asset size; as of 3Q23



Source: Bank call reports and BofA Global Credit Research estimates
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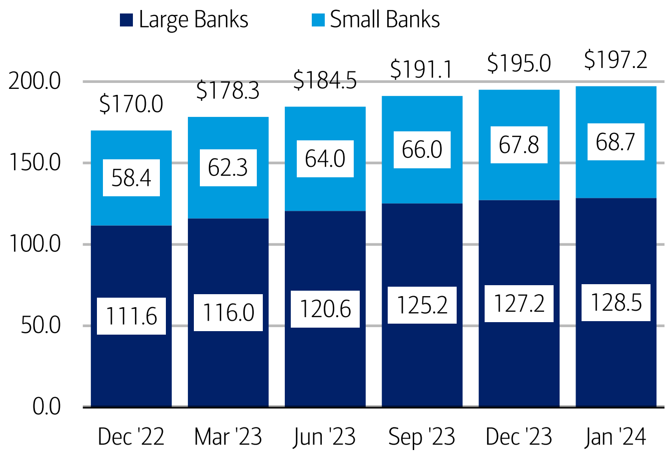
There is no indication that small banks (or large banks) have increased loan loss reserves materially in either 4Q23 for those banks who have not reported, or in January 2024 to date. While we could see more headlines from small banks about pressures on office CRE (or other loan categories) given the 4,000+ banks that exist in the U.S., to date, the aggregate increase in reserves is similar to recent quarters.

Exhibit 8: Bank industry allowance for loan losses increased only $4B in 4Q and $2B in January
Allowance for loan losses, $B



Source: Federal Reserve H8 data

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Glossary

AOCI: accumulated other comprehensive income
AT1: alternative tier 1 capital
B3: Basel III
CET1: common equity tier 1 capital
CRE: commercial real estate
C&I: commercial and industrial
FTE: fully taxable equivalent
GFC: global financial crisis (2007-2009)
GSIB: global systemically important banks
HQLA: high-quality liquid assets
LCR: liquidity coverage ratio
LTD: long-term debt
NCO: net charge-off
NIM: net interest margin
NII: net interest income
NPL: non-performing loans
NSFR: net stable funding ratio
ROTCE: return on tangible common equity
RSA: retailer share agreement
RWA: risk weighted assets
S&L: savings & loan crisis
SLR: statutory liquidity ratio
SRB: super regional banks (USB, PNC, TFC)
TA: tangible assets
TCE: tangible common equity
TLAC: total loss-absorbing capacity
T1: Tier 1 capital

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