COMMERCIAL REAL ESTATE: RESILIENCE, RECOVERY, AND RISKS AHEAD

Overview

Commercial real estate (CRE) lending is important to the banking industry.[1] FDIC-insured institutions collectively hold $2.7 trillion in CRE loans, more than 50 percent of the broader financial industry's CRE loans. FDIC-insured institutions' CRE loan portfolios have experienced the ups and downs of economic cycles, including significant credit quality stress during the Great Recession and challenges posed by the COVID-19 pandemic.

The pandemic initially strained several types of CRE properties. Hotels sat empty as travel came to a near standstill. Foot traffic at retail properties all but ceased. Many office employees transitioned to remote work, and office occupancy dropped significantly. In contrast, the multifamily sector largely held up, as the degree to which tenants paid rent on time declined only slightly as the pandemic took hold. More positively, as delivery of goods from online shopping increased, industrial property demand strengthened.

While CRE market conditions improved with economic recovery in 2021, some parts of the CRE industry may experience lasting changes. The retail sector already had been facing long-term growth in online shopping, suggesting less need for brick-and-mortar retail, and the pandemic hastened this trend. In the office sector, the pandemic spurred businesses to re-evaluate use of office space as they explored remote work capabilities. Reflecting this dynamic, forecasts suggest office vacancy rates will rise and rent growth will be weak in 2022. Meanwhile businesses' use of technology to manage properties, or PropTech, is expected to increasingly become part of the office landscape.

The issues facing CRE after the pandemic will be important considerations for a large share of the banking industry. Almost all FDIC-insured institutions are involved in CRE lending and many have large CRE loan portfolios. Banks have increased CRE loan exposure over the past decade, and while construction lending has grown only modestly, many banks have increased multifamily lending. The pandemic initially looked like it would significantly challenge banks' CRE loan quality, but loan delinquency rates remained low through third quarter 2021 against the backdrop of economic rebound, stimulus support, and loan forbearance.

This paper is organized into two sections. The first section analyzes the five major CRE property types—multifamily, industrial, lodging, retail, and office—and the conditions evident in each since the onset of the pandemic. We identify those property types that have emerged in relatively good shape (multifamily and industrial), those that are still challenged in one or more subcategories (lodging and retail), and the one whose future may be most uncertain (office). In the second section, we discuss FDIC-insured institution exposure to CRE loans, credit quality, and potential challenges ahead.

I. CRE Market Conditions

The Multifamily and Industrial Property Sectors Have Weathered the Pandemic Relatively Well

Despite initial concerns about the prognosis for CRE, the multifamily and industrial sectors have recovered from the initial shock of the pandemic. By some measures, these sectors have exceeded pre-pandemic performance.

Multifamily

Heading into the pandemic, the multifamily sector's balance of supply and demand was healthy, despite a large amount of new construction in recent years. In the six years leading up to the pandemic, the multifamily construction industry built a record amount of properties. From 2014 to 2019, almost 2 million multifamily units were built in the United States, more than double that of 2008 to 2013.[2] The number of units built, referred to as completions, also was high when measured against the size of the existing U.S. multifamily

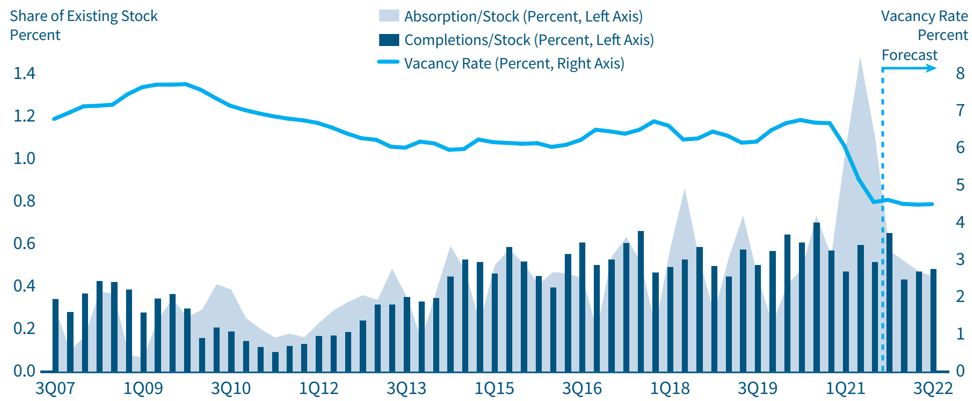
[1] The term "banking industry" refers to FDIC-insured institutions.

[2] CoStar, third quarter 2021 data.

market; the number of completions averaged 0.51 percent of total stock from 2014 to 2019, compared with only 0.25 percent in the previous six years. High levels of construction can lead to a rise in vacancy rates, but increased demand for multifamily-type living in the mid-2010s absorbed the large amount of construction. As a result, the U.S. multifamily vacancy rate was low and flat—it hovered near 6 percent from 2014 to 2019 (Chart 1).

Chart 1

Strong Demand Kept Multifamily Vacancy Rates Low for Much of the Past Decade



Source: CoStar.
Note: Data are quarterly figures with forecast data as of third quarter 2021.

When the pandemic hit, some stress emerged in the multifamily sector, but little stress has lasted. The multifamily vacancy rate increased slightly early in the pandemic but since has declined to 4.5 percent as of third quarter 2021, the lowest rate in more than 20 years. Demand for multifamily rental units improved significantly in 2021—the ratio of absorption of multifamily units to the amount of total stock has almost tripled from the pandemic low in 2020. Rent growth dropped from 2.4 percent in fourth quarter 2019 to 0.2 percent in third quarter 2020, its low during the pandemic. But by third quarter 2021, multifamily property rent growth had surpassed its average pre-pandemic level and was the highest among the major property types. Finally, renters' payment performance weakened only modestly during the pandemic, despite labor market weakness. According to the Multifamily Housing Council, the share of rent payments due that were ultimately paid in a given month slipped only 1 percentage point nationally to 95 percent on average between March 2020 and September 2021.[3]

The multifamily sector's resilience likely reflects several factors. First, the health risk of living in close quarters may have driven people who shared houses and apartments to seek independent living. Second, prices of single-family homes have risen dramatically in 2021, which may have led home seekers to rent instead of buy a home. Finally, stimulus payments and aid for renters may have mitigated weakening in rental payment performance; several studies found that about 30 percent of renters reported reliance on government support to pay rent at some point during the pandemic.[4]

While the multifamily property sector has been resilient, pressure may be ahead for part of the sector. Some properties' cash flows could be strained by delayed rent payments as relief programs and forbearance efforts wane. And, as the pace of construction is expected to remain brisk, demand will need to be strong to keep vacancy rates stable.

[3] National Multifamily Housing Council Rent Payment Tracker, October 2021.

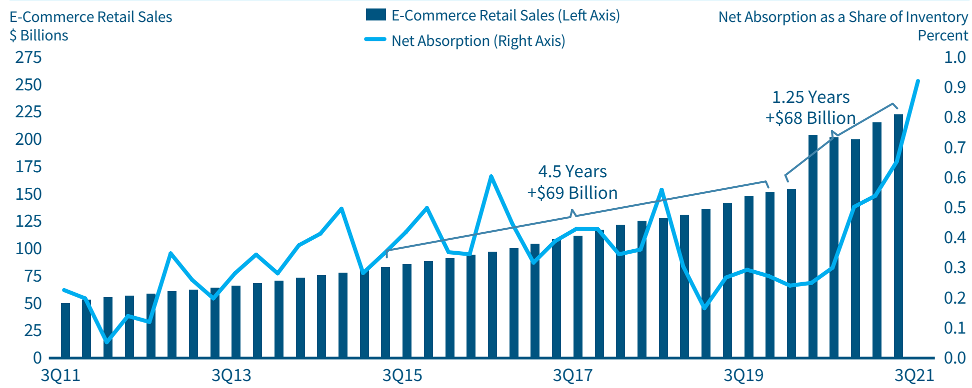
[4] Whitney Airgood-Obrycki, Ben Demers, Solomon Greene, Chris Herbert, Alexander Hermann, David Luberoff, and Sophia Wedeen, "Renters' Responses to Financial Stress During the Pandemic," Joint Center for Housing Studies of Harvard University, April 2021, https://www.jchs.harvard.edu/sites/default/files/research/files/harvard_jchs_renter_responses_covid_airgood-obrycki_etal_2021.pdf.

Industrial

Demand for industrial space increased significantly during the pandemic. In the almost two years from first quarter 2020 through third quarter 2021, 582 million square feet of industrial space was rented (absorbed). This amount is well above the 366 million square feet rented in the almost two years leading up to the pandemic. As a percentage of the total amount of industrial space in the United States, the amount of space absorbed increased from 0.2 percent in first quarter 2020 to 0.9 percent in third quarter 2021, the highest percentage on record.[5] The rise in demand reflected, in part, an increase in e-commerce since the start of the pandemic. E-commerce sales grew by $68 billion from the start of the pandemic in first quarter 2020 through second quarter 2021. This growth is equal to the increase in e-commerce sales in the four and a half years leading up to the pandemic (Chart 2).[6]

Chart 2

Demand for Industrial Properties Increased Amid a Rise in E-Commerce Sales



Sources: U.S. Census Bureau (Federal Reserve Bank of St. Louis), CoStar.
Note: E-commerce retail sales are seasonally adjusted quarterly figures through second quarter 2021. Net absorption are quarterly figures through third quarter 2021.

This increase in e-commerce boosted demand for industrial space because e-commerce is logistics-intensive and requires warehouse space at transportation hubs and close to "last-mile" population centers.[7] Users of industrial space include not just e-commerce providers but also manufacturers, brick-and-mortar retailers, and third-party logistics firms. Tenants nationwide have leased a record amount of industrial space to meet customer demand. Amazon remains the most active tenant, both in the number of leases and in total space, but third-party logistics firms like DHL and FedEx have been active as well. Traditional food and beverage manufacturers and retailers round out the broad sample of industrial tenants that contributed to the record leasing pace in early 2021.[8]

The rise in e-commerce and increased need for industrial space helped absorb a large amount of construction that has occurred in the industrial sector for much of the past decade. Prompted by increased demand shortly after the Great Recession, construction of industrial properties has been rising since 2014. From first quarter 2014 to first quarter 2020, deliveries of new industrial space as a share of total space increased more than fivefold. Demand has been strong in 2021, but the large amount of industrial property supply in recent years bears watching.

[5] Data available from first quarter 2001.

[6] U.S. Census Bureau (Federal Reserve Bank of St. Louis).

[7] Transportation management firm Cerasis defines last-mile logistics as the final step of the delivery process from a distribution center or facility to the end user.

[8] CoStar, Industrial National Report, July 1, 2021.

Lodging and Retail Sectors Have Improved, but Some Subsectors Still Face Headwinds

The pandemic immediately and severely affected the lodging and retail sectors. Hotel visits dropped as travel all but ceased. Retail stores were empty as shoppers stayed home. These two sectors have since recovered but continue to face headwinds in important subsectors.

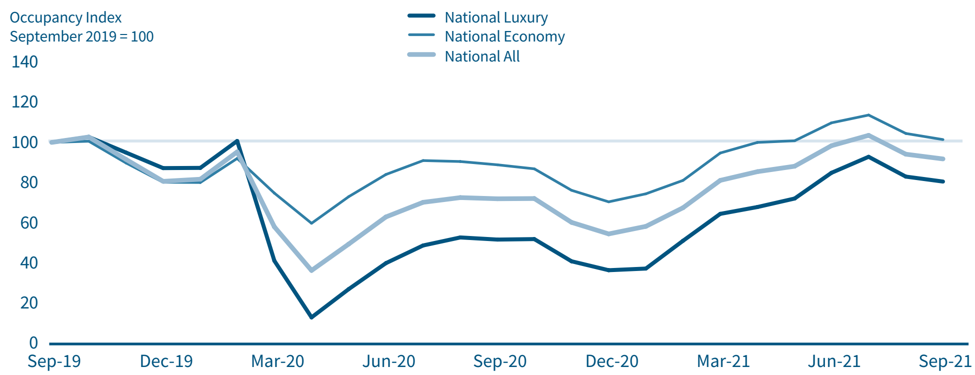
Lodging

The lodging sector was among the most severely affected sectors early in the pandemic. The U.S. hotel occupancy rate dropped sharply from more than 60 percent pre-pandemic to less than 25 percent in April 2020.[9] In luxury hotels, the occupancy rate dropped to single digits. The severe decline in hotel occupancy sharply reduced hotel revenues. Hotel revenues fell by 80 percent in April 2020 compared with the previous year. As travel began to increase in late 2020, overall occupancy rates rebounded from 2020 lows and returned to pre-pandemic levels by mid-2021. Hotel revenues have partially recovered, but through third quarter 2021 have yet to stabilize at pre-pandemic levels.

Differentiation in the lodging sector is driving performance. The luxury hotel sector was hit hardest, and while it has largely recovered, occupancy remains below its pre-pandemic level (Chart 3).[10] The luxury hotel sector continues to suffer from the slower return of corporate travel. According to CoStar, mid-week occupancy, a measure of corporate travel activity, was low as of mid-2021 at approximately 50 percent.[11] The resumption of corporate travel to pre-pandemic levels is uncertain, as companies reevaluate their travel needs in the context of widely available teleconferencing technology.

Chart 3

After Falling Early in the Pandemic, U.S. Hotel Occupancy Nears Pre-Pandemic Levels, While Luxury Occupancy Lags



Source: CoStar.
Note: Data are monthly figures.

In contrast, the economy hotel sector recovered more quickly, which reflected the return of leisure travel. Increased vaccinations and pent-up savings and vacation time supported a rise in leisure travel demand. The weekend occupancy rate, which reflects leisure travel, rebounded by mid-2021 to consistently above 70 percent.[12]

While leisure travel is important, accounting for the largest share of the hotel industry's room nights, group and corporate travel account for roughly two-thirds of hotel revenues.[13] Therefore, the return of corporate travel is important for a more complete recovery of the lodging sector.

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[9] CoStar.

[10] Ibid.

[11] CoStar, Hospitality National Report, July 2, 2021.

[12] Ibid.

[13] Bank of America, Lodging Primer, September 11, 2018.

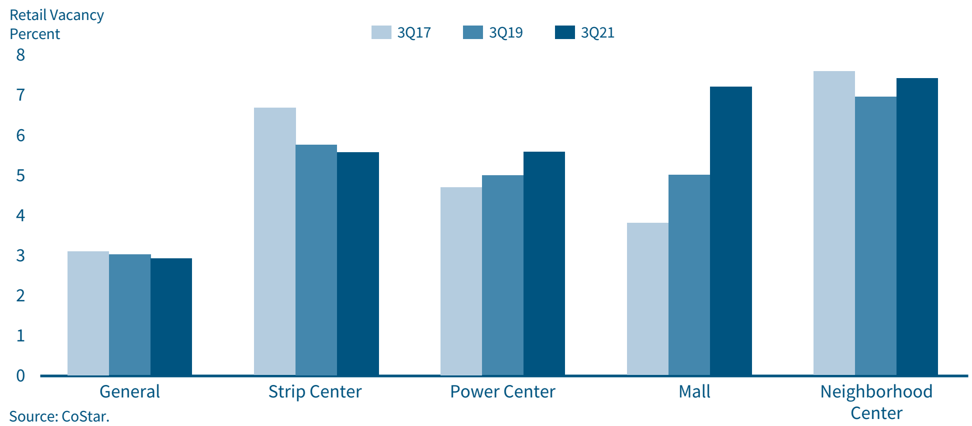
Retail

Trends in the retail segment reflect changes under way in the sector before the pandemic. The sector had already been struggling with elevated store closures and competition from online shopping.

The retail sector comprises several subtypes such as malls, strip centers, and general retail.[14] Mall space has suffered the quickest rise in vacancy since the onset of the pandemic. Many mall anchor tenants, such as traditional department stores, were struggling before the pandemic, and the complete closure of malls for several months dealt a blow to struggling inline stores as well.[15] Elimination of all foot traffic at the nation's malls contributed to a doubling of the vacancy rate from a near cycle low of 3.8 percent in third quarter 2017 to 7.2 percent in third quarter 2021 (Chart 4). Much of that increase occurred since the onset of the pandemic.

Chart 4

Vacancy at U.S. Malls Increased More Than Other Types of Retail



Source: CoStar.
Note: Data are quarterly figures.

Rising vacancy in some malls may indicate the degree to which property valuations may contract. Between February 2020 and September 2021, mall property valuations dropped 18 percent.[16] And a recent report showed that at least 49 U.S. malls have re-appraised at values 65 percent lower than pre-pandemic levels.[17] Landlords are experimenting with new uses for unproductive mall space, including various forms of experiential retail such as fitness centers, movie theaters, and climbing gyms. More dramatic transformations include medical office, education, industrial, and even multifamily use. Despite the rapid increase in vacancy, malls were not the most-vacant retail subtype as of third quarter 2021.

Another common suburban and rural retail subtype known as a "neighborhood center" ended third quarter 2021 with an average vacancy rate of 7.4 percent, the highest among subtypes.[18] Neighborhood centers typically are anchored by a grocery store and have several smaller stores. While grocery stores held up relatively well through the pandemic, smaller ancillary stores were hard-hit by competition from e-commerce and the sharp

[14] According to CoStar, there are five major subtypes of retail properties: general, strip center, power center, mall, and neighborhood center.

[15] Commercial real estate consulting company VTS describes inline stores as what most people would consider smaller stores that fill in the space between the larger stores in malls and open-air centers. These stores compensate for the discounted rents provided to anchors and typically pay more per square foot. Inline stores range between 1,500 and 5,000 square feet.

[16] Green Street Advisors Commercial Property Price Index.

[17] Bank of America Securities, "CMBS Commentary: Appraising the Situation," November 1, 2021.

[18] Neighborhood centers have 30,000 to 100,000 square feet of space and are typically anchored by grocery stores. Inline stores surrounding the grocer may include apparel, sporting goods, electronics, and other personal goods and service stores.

drop in foot traffic as the pandemic took hold. Taken together, malls and neighborhood centers account for a third of all retail space.

General retail, which typically includes freestanding and independent, nonchain retailers, accounts for the largest amount of retail space in the United States. It also is the fastest growing retail subtype; most of the retail space added in the United States over the past five years has been general retail. Despite adding more space than other types of retail, demand for general retail has kept pace with supply. As a result, the general retail vacancy rate has been approximately 3 percent for the past five years, less than all other types of retail space.

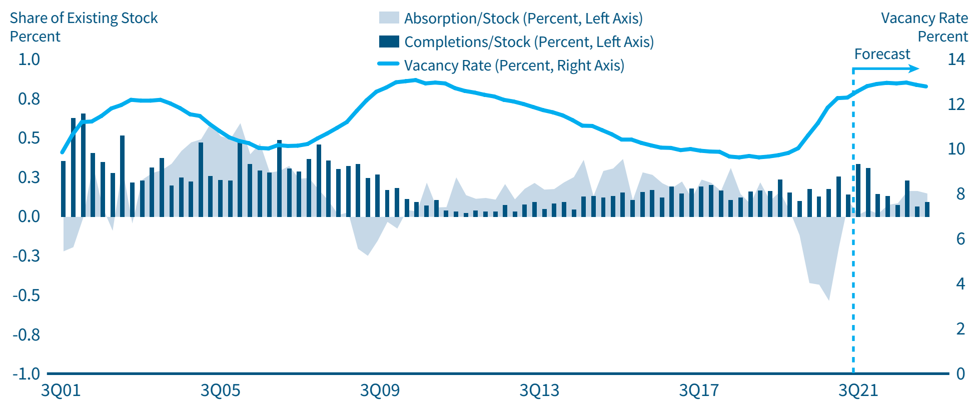
Since the U.S. economy is consumption-centered, retail will continue to occupy an important place in the CRE industry. Different types of retail will continue to adjust to evolving consumer preferences, and vacancy rates, demand, and rent growth likely will reflect those preferences.

The Office Sector May Face the Most Significant Challenges

The pandemic has reduced demand for office space, possibly for the long run. Net office absorption in second quarter 2020 was negative for the first time in a decade; this means that the amount of commercial office space that was vacated or supplied by new construction exceeded that which was leased, or absorbed, by commercial tenants. At its worst during the pandemic, negative net absorption reached 0.5 percent of total inventory, twice the worst percentage recorded during the Great Recession.[19] The drop in demand for office space as the pandemic emerged contributed to a significant increase in office vacancy. The office vacancy rate increased in almost two-thirds of U.S. office markets, and in each of the nation's ten largest markets, since the start of the pandemic. As a result, the U.S. office vacancy rate increased from 9.7 percent in fourth quarter 2019 to 12.3 percent in third quarter 2021, an eight-year high (Chart 5).

Chart 5

Demand for Office Space Dropped Significantly at the Onset of the COVID-19 Pandemic



Source: CoStar.
Note: Data are quarterly figures through third quarter 2023 with forecasted data as of third quarter 2021.

Large Office Markets

The nation's large office markets have suffered more than smaller markets since the pandemic began. The average vacancy rate in the nation's gateway markets (large, typically coastal markets that attract significant foreign investment) increased from 9.4 percent in fourth quarter 2019 to 13.0 percent in third quarter 2021.[20] In contrast, the average vacancy

[19] CoStar, third quarter 2021 data.

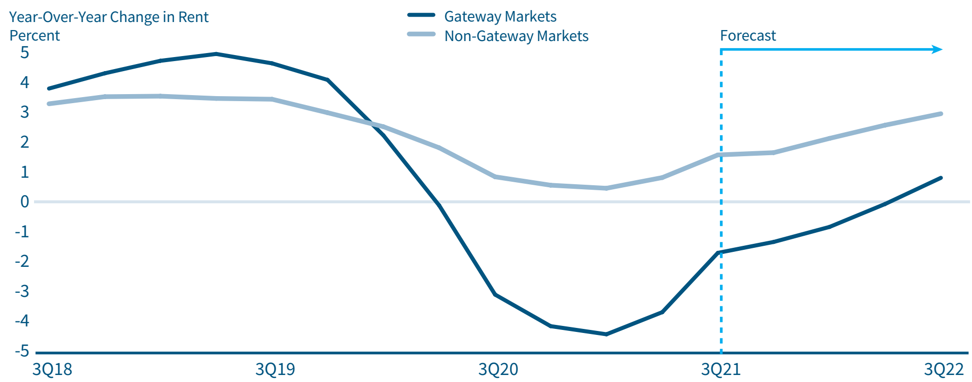
[20] CoStar. FDIC calculations of vacancy rates for gateway and non-gateway markets are simple averages and will not tie to the aggregate national vacancy rates cited above.

rate in the rest of U.S. markets increased only modestly from 5.6 percent to 6.3 percent over the same period.

Gateway office markets also suffered an outsized decline in rental rates. Rent growth in the nation's gateway markets had exceeded or at least equaled the U.S. average in the two years leading up to the pandemic. But as the pandemic took hold in 2020, office rent growth decelerated across the nation, and rents dropped in the gateway markets, reflecting avoidance of densely populated cities (Chart 6). Rent growth is expected to be low across U.S. markets and remain negative in gateway markets into 2022.

Chart 6

Rents in Gateway Office Markets Dropped More Than Others in the COVID-19 Pandemic



Source: CoStar.
Note: Data are quarterly figures with forecast data as of third quarter 2021. Gateway markets include New York, Washington, DC, Boston, Chicago, Los Angeles, and San Francisco.

The drop in demand also has led to an increase in sublease availability across many markets. Sublease availability occurs when tenants offer excess space for lease to a third party, typically at a discount. During the pandemic, space available through sublease increased, especially in large, densely populated markets such as San Francisco (Chart 7). Offering space for sublease became more common as the pandemic progressed into early 2021, reflecting in part tenants' uncertainty about returning to the office. The amount of space offered for sublease began to ease in second quarter 2021 but remains above pre-pandemic levels in some cities, which suggests vacancy issues in some office markets will continue.

Chart 7

The Amount of Office Space Available for Sublease in Several Large Cities Increased as the COVID-19 Pandemic Took Hold

Source: CoStar.
Note: Data are quarterly figures.

Remote Work, Return-to-Office, and Changing Office Layouts

Many companies re-evaluated their office space needs and expanded remote work during the pandemic. Office usage dropped significantly, and the number of employees that regularly occupied office buildings declined. According to one company that monitors office building access in several large markets, less than 15 percent of the workforce was going into the office in April 2020, with some markets dropping below 5 percent.[21] Foot traffic in office buildings has since improved with more than one-third of workers returning to offices as of October 2021, but uncertainty around new variants of the virus has many companies delaying their return-to-office plans to 2022.[22]

Several surveys and reports reveal that a large share of companies have or plan to adopt a hybrid return-to-office model—a mix of office and remote work—rather than a full return to the office. According to PwC, more than two-thirds of company executives surveyed plan to implement a hybrid model.[23] As companies execute new work plans, an increase in remote work may eventually translate into less demand for office space.

Companies also are planning to change how they use office space. Some companies are redesigning space to account for fewer employees working in the office each day. Changes include more shared workstations, fewer permanent desks and offices, and more flexible space. This redesign could further dampen demand for office space, but could be partially offset by the need to implement social distancing among workers. Additionally, increased interest in flexible space also could boost demand for space provided by co-working companies, which struggled at the onset of the pandemic.[24]

Flexibility and changes in the sector also include how various forms of PropTech will be implemented in CRE. PropTech is a term used to define technologically innovative products and business models for the CRE market (Inset Box).

What Is PropTech?

PropTech, short for property technology, is a term used to define technologically innovative products and business models for the CRE market, similar to the way FinTech describes the use of technology in finance. PropTech is the use of digital innovation to address the needs of the property industry. Below are a few examples of PropTech.

Technology	Description
“Smart” Buildings	Equipping buildings with internet-enabled technology and sensors that can connect and exchange data with each other via an internet connection. Internet-enabled devices can gather maintenance data, power usage statistics, and information about the movement of people in a building. The information can be studied using building management software to improve building efficiency.
Construction Technology	Improving the speed, environmental efficiency, cost savings, and safety of building construction through modeling, planning, and automation.
Appraisal	Completing appraisals faster using property valuation technology based on multiple data sources.
Virtual Experiences	Increasing the number of potential buyers by providing virtual visualizations to tour available space. This technology was implemented quickly by many brokers at the onset of the pandemic.
Power Efficiency	Building and retrofitting buildings with upgrades that reduce energy use or change the types of energy used in construction and operation.

Note: PropTech examples are sourced from multiple analyst reports and articles. This is not an exhaustive list of technologies nor endorsement of specific products or technology.

[21] Kastle Systems LLC, Back to Work Barometer, October 2021.

[22] Morgan Stanley Research, WFH Tracker, October 2021.

[23] PwC, US Pulse Survey, August 2021. The US Pulse Survey is conducted periodically to track the sentiments and priorities of business executives. PwC surveyed 752 U.S. company executives in August 2021 about company workforce location plans.

[24] Co-working companies sign long-term office leases and sublease that space at a premium over current market rates. Co-working tenants are attracted to the flexibility of short-term obligations and the ability to avoid costs to build out office space. Popular co-working companies include WeWork and Regus.

While there have been encouraging signs, such as an increase in office lease activity since mid-2021, hybrid return-to-office policies and reconfigured office space likely will contribute to changes in the office sector. Technological innovations helped make the transition to remote work possible, and the transition has landlords and tenants considering a new equilibrium level of demand for office space. Some degree of remote work likely will become a permanent part of the office culture.

The Decline in CRE Property Values During the Pandemic Has Been Modest Compared With the Great Recession

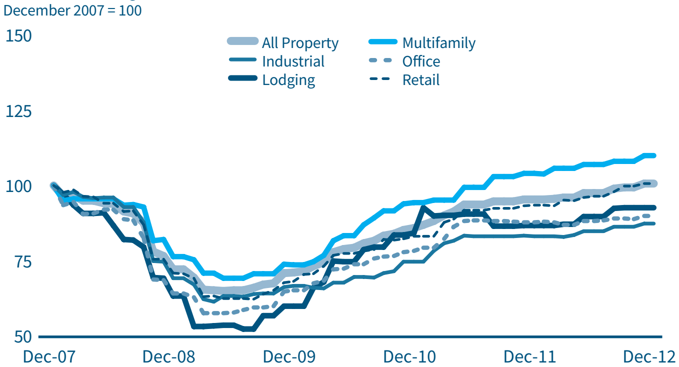
Economic stress hurt CRE values in the Great Recession and the pandemic, but price performance in each of the two recessions was different. A more modest drop in CRE prices in the pandemic compared with the Great Recession reflects the different natures of each crisis. The Great Recession followed a global crisis in financial intermediation and manifested in a boom and bust cycle in real estate conditions in much of the United States. The pandemic recession was caused by a global health crisis and manifested in economic shutdown and contraction, with more significant stress felt in some industries and CRE property types than in others.

During the Great Recession, CRE prices dropped significantly. According to Green Street Advisors, prices for a compilation of all CRE property types, otherwise known as the all-property index, dropped 28 percent within one year of the start of the recession and 35 percent within two years.[25] The ultimate fall in prices ranged from 31 percent in multifamily to 48 percent in lodging (Chart 8). The decline in CRE values accompanied significant financial market dislocation and credit quality stress in the banking industry, and took five years to recover.

Chart 8

Price Declines in the Great Recession Were Steep...

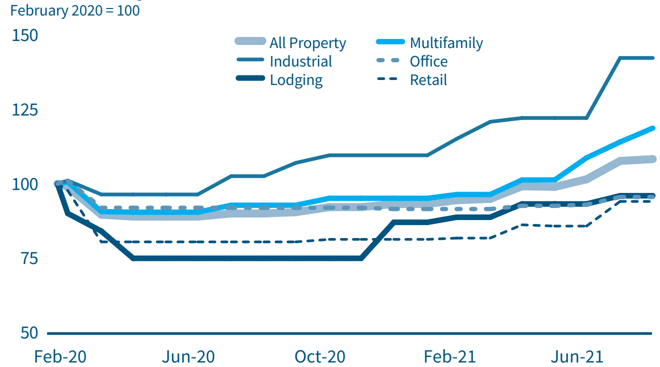
Indexed Price Change From the Onset of the Great Recession
December 2007 = 100



Source: Green Street Advisors.
Note: Data are monthly figures through December 2012.

...But Were Less Dramatic During the COVID-19 Pandemic

Indexed Price Change From the Onset of the Pandemic
February 2020 = 100



Source: Green Street Advisors.
Note: Data are monthly figures through September 2021.

In the pandemic, CRE prices initially dropped by approximately 10 percent. However, there was no second leg down and many prices were flat for several months as transactions declined sharply. CRE prices have since recovered with prices for some property types now well above pre-pandemic levels. Industrial and multifamily property prices, after falling during the pandemic, have rebounded, with industrial property prices 42 percent above the pre-pandemic level and multifamily posting an 18 percent increase. Property prices in the retail, office, and lodging sectors have recovered more modestly. Property prices are still 6 percent below pre-pandemic levels in retail, 5 percent in office, and 4 percent in lodging.

[25] Green Street Commercial Property Price Index.

CRE prices have recovered with improvement in COVID-19 cases, business re-openings, and economic recovery. Investors have begun to show willingness to pay higher prices for some of these properties as fundamentals are stronger than expected and borrowing costs are relatively low. Financial market dislocation and credit quality stress have been much more muted than in the Great Recession, but rapid price appreciation in some CRE property sectors warrants monitoring.

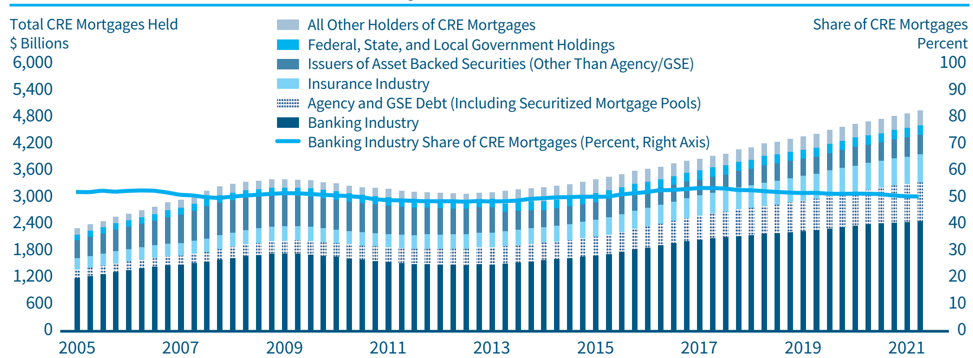
II. CRE Lending and Credit Conditions

Banks Remain a Leading Source of CRE Lending

As important providers of CRE financing, FDIC-insured institutions are among those lenders interested in CRE market dynamics in the years ahead. Banks are the largest participant in the commercial mortgage lending market, holding more than half of the nearly $5 trillion in commercial mortgages outstanding as of second quarter 2021.[26] Entities such as insurance companies, government-sponsored enterprises (GSE), and other issuers of commercial mortgage-backed securities (CMBS) also are active in CRE financing. However, FDIC-insured institutions' market share has remained significant at near 50 percent for more than a decade (Chart 9).

Chart 9

Banks Hold More CRE Loans Than All Other Market Participants Combined and Their Market Share Has Held Steady for More Than a Decade



Source: Federal Reserve Board, Financial Accounts of the United States, Levels of Financial Assets and Liabilities, by Sector and by Financial Instrument, Multifamily Residential Mortgages and Commercial Mortgages, September 23, 2021 release.
Note: Data are quarterly figures through second quarter 2021.

While the ten largest FDIC-insured institutions hold nearly one-quarter of the banking industry's CRE loans, participation in CRE lending is widespread among banks. More than 98 percent of FDIC-insured institutions hold CRE loans, and CRE is the largest loan category at more than 40 percent of insured institutions.

CRE lending is particularly prevalent among community banks. As noted in the FDIC's December 2020 Community Banking Study, community banks play an outsized role in CRE lending relative to their overall market share.[27] As of third quarter 2021, community banks held less than 12 percent of the banking industry's assets but accounted for 29 percent of CRE loans.

Besides exposure through loans, the banking industry is exposed to CRE via holdings of CMBS. As of third quarter 2021, banks held more than $550 billion in CMBS, most of which was U.S. government agency-issued or GSE-issued CMBS. Although not as prevalent as CRE loan exposure, more than 40 percent of banks hold some level of CMBS.

[26] Federal Reserve Board, Financial Accounts of the United States, Levels of Financial Assets and Liabilities, by Sector and by Financial Instrument, Multifamily Residential Mortgages and Commercial Mortgages, September 23, 2021, https://www.federalreserve.gov/apps/fof/FOFTables.aspx.

[27] FDIC, *Community Banking Study*, December 2020, https://www.fdic.gov/resources/community-banking/report/2020/2020-cbi-study-full.pdf.

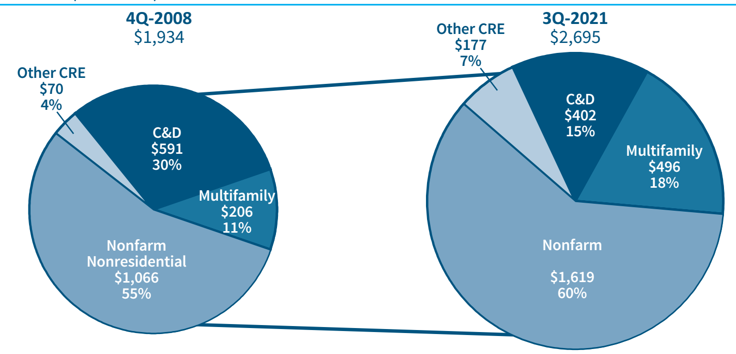
The Composition of CRE Loan Portfolios Has Shifted Since the Previous Real Estate Cycle

The mix of CRE loans held by the banking industry as the Great Recession took hold in the United States in 2008 differed from that heading into the pandemic. In 2008, construction and development (C&D) loans were a large part of the mix reflecting, in part, significant bank involvement in residential construction projects. C&D lending was particularly active in the Pacific, Mountain, and South Atlantic U.S. Census Divisions of the nation amid rapid residential construction activity.[28] At that time, the volume of multifamily property loans was modest. But following more than a decade of growth amid rising interest in multifamily living, the dollar volume of multifamily property loans outstanding more than doubled, and multifamily loans as a share of total CRE loans increased (Chart 10).

Chart 10

Since the Previous Cycle's Peak Reached in 2008, Bank CRE Lending Focus Has Shifted Away From C&D and Into Other Categories

Composition of CRE ($ Billions)



Source: CoStar.
Note: Other CRE includes loans to finance commercial real estate that are not secured by real estate. Due to rounding, the loan dollar balances do not add up to total CRE loans.

Despite Substantial Loan Growth, CRE Concentrations Remain Below Levels Reached in the Previous Cycle

Although the total amount of CRE loans has grown, individual banks' holdings of CRE loans relative to their capital levels, referred to as concentrations of CRE loans, have remained below the peaks reached in the Great Recession.[29] High concentrations of CRE loans are often a subject of interest to analysts, regulators, and economists, reflecting the significant stress experienced by highly concentrated banks during the Great Recession and other economic cycles.[30]

CRE loan concentrations rose steadily from 2013 to 2018, consistent with a recovering economy, rising CRE prices, and increasing demand for multifamily property loans. However, concentrations have eased in recent years because growth in capital and reserves has outpaced CRE loan growth. The median ratio of CRE loans to capital and allowances of 181 percent in third quarter 2021 is well below the peak of 214 percent reached in fourth quarter 2008. Further, the share of banks with elevated levels of CRE loan exposure has declined. Less than one-quarter of banks hold elevated CRE concentrations as of third quarter 2021, compared with 35 percent of banks at year-end 2008.[31]

[28] U.S. Census Bureau, "Census Regions and Divisions of the United States," www2.census.gov/geo/pdfs/maps-data/maps/reference/us_regdiv.pdf.

[29] "CRE concentration" in this article is shorthand for the volume of a bank's CRE loans expressed as a percentage of its tier 1 capital and allowances. It is an analytical measurement and is not intended to denote examination concerns.

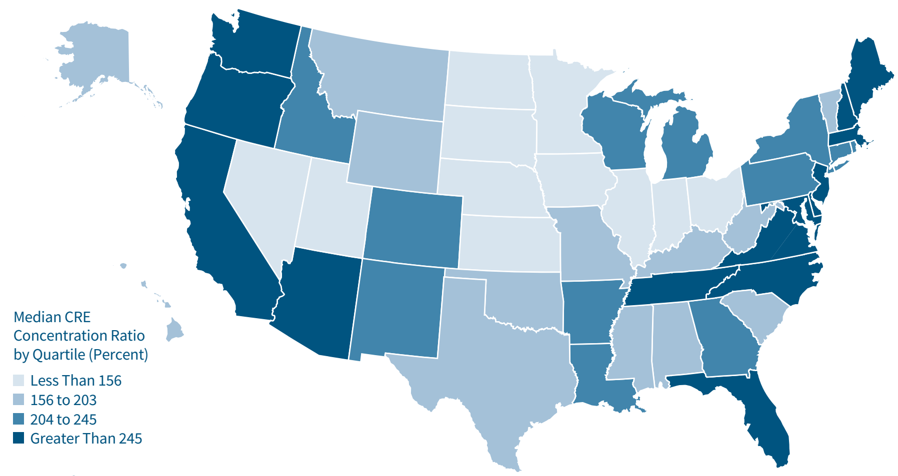
[30] FDIC, *Crisis and Response: An FDIC History, 2008-2013*, https://www.fdic.gov/bank/historical/crisis/crisis-complete.pdf.

[31] For this analysis, a bank is considered to have an elevated CRE concentration if its ratio of CRE loans to tier 1 capital and allowances is above 300 percent. This terminology is used only as means of identifying banks with a significant CRE lending focus rather than to denote examination concerns.

Nevertheless, pockets of high exposure exist, most notably in the Pacific, Middle Atlantic, and South Atlantic U.S. Census Bureau Divisions of the nation (map).[32] The states with the highest median CRE loan concentration levels include California, Arizona, Washington, New Jersey, and Florida.

Map

CRE Concentrations Are Highest Along the Coasts



Source: FDIC.
Note: The CRE concentration ratio measures banks' CRE loans as a percentage of tier 1 capital and allowances. Data as of September 30, 2021.

CRE concentrations reflect many factors, including local loan demand, bank-specific lending expertise, and board-approved risk appetites. Another key factor is the geographic proximity to commercial properties. So it is understandable that CRE lending is most prevalent among banks headquartered in metro areas, where large amounts of CRE properties are located.

Multifamily lending has become a driver for CRE loan growth among many banks, particularly in the Pacific, New England, and Middle Atlantic U.S. Census Bureau Divisions of the nation.[33] For example, median multifamily loan concentrations have more than doubled in the past decade among banks headquartered in California, Massachusetts, New Jersey, and New York. Multifamily loan concentrations in these states are among the highest in the nation, reflecting, in part, the above-average prevalence of multifamily living in these states.[34] Increasing concentrations of multifamily loans could influence loan portfolio performance going forward as multifamily loans have historically experienced lower delinquency and loss rates than C&D loans.

CRE Credit Quality Was Resilient in the Pandemic, Reflecting Stimulus, Forbearance, and Economic Recovery

CRE credit conditions remained relatively stable despite a sharp downturn in the U.S. economy in 2020. The total dollar amount of delinquent CRE loans held by FDIC-insured institutions increased in 2020 but has steadily improved since then. The CRE delinquency rate among banks increased from 0.64 percent in fourth quarter 2019 to a pandemic peak of 1.11 percent in December 2020, and has since improved to 0.87 percent in third quarter 2021

[32] U.S. Census Bureau, "Census Regions and Divisions of the United States," www2.census.gov/geo/pdfs/maps-data/maps/reference/us_regdiv.pdf.

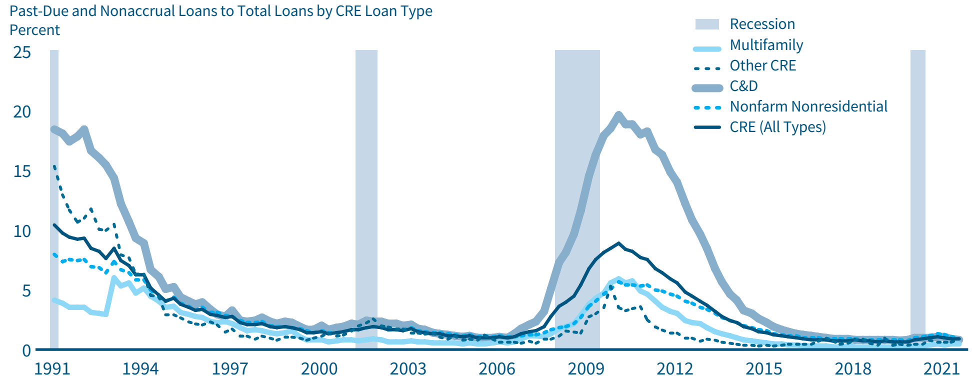
[33] Ibid.

[34] 2018 American Community Survey, One-Year Estimates, U.S. Census Bureau, https://www.census.gov/programs-surveys/acs/technical-documentation/table-and-geography-changes/2018/1-year.html. The four states mentioned in the text have a higher percentage of total housing with five or more housing units than the national percentage.

(Chart 11). Additionally, net loan loss rates have been negligible among CRE loans and are comparable to pre-pandemic levels.

Chart 11

CRE Delinquency Rates Remain Historically Low



Source: FDIC.
Note: Data are quarterly figures through third quarter 2021. Other CRE loans include loans to finance commercial properties that are not secured by real estate.

The resilience of CRE credit quality among FDIC-insured institutions reflects several factors. First, government stimulus, including economic relief programs, grants, and tax breaks, helped borrowers maintain loan payments.[35] For example, increased unemployment benefits helped apartment tenants pay rent. And, funds allocated under the Restaurant Revitalization Fund and the Small Business Administration's Paycheck Protection Program were specifically designed to help businesses affected by the pandemic to pay operational expenses, including rent.

Second, banks offered forbearance plans to borrowers to provide temporary relief in certain instances. Bank-offered forbearance plans included short-term loan modifications such as payment deferrals, fee waivers, extension of repayment terms, or other delays in payment to borrowers hurt by the pandemic.[36]

Finally, broader economic circumstances lessened the pandemic's effect on CRE. For instance, historically low interest rates played a role in limiting property value declines and kept interest payments on loans down. Also, the speed of economic rebound helped job growth and consumer spending return, which helped businesses recover. Other factors helped parts of CRE as well—the sharp rise in home prices may have spurred some would-be buyers to rent apartments, and the boom in e-commerce drove demand for industrial space.

But there have been signs of credit stress in CRE outside of bank-reported delinquencies. CMBS delinquency rates among hotel and retail properties hit double digits in 2020, surpassing peak delinquency rates in the previous cycle. CMBS delinquency rates have improved in 2021 but remain above pre-pandemic levels. CMBS backed by industrial, multifamily, and office properties had only limited increases in delinquency rates, which helped moderate the effect on overall CMBS performance.

[35] Relief programs for individuals include Economic Impact Payments, federal unemployment compensation, and emergency rental assistance. Tax breaks for individuals include the Child Tax Credit. Relief programs for businesses include the Emergency Capital Investment Program, the Paycheck Protection Program, the Small Business Lending Fund, the Community Development Financial Institutions Fund, and others. Tax breaks for business include Payroll Tax Deferral, the Employee Retention Credit, and the Paid Leave Credit. The Restaurant Revitalization Fund and the Shuttered Venues Grant are other examples of funds or grants provided to businesses affected by the pandemic. More information on economic relief is available at https://home.treasury.gov/policy-issues/coronavirus.

[36] FDIC, "Revised Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working With Customers Affected by the Coronavirus," Financial Institution Letter 36-2020, April 7, 2020, https://www.fdic.gov/news/financial-institution-letters/2020/fil20036.html.

Challenges Facing the CRE Industry and the Lending Landscape

CRE has been resilient amid the pandemic, but challenges remain. First, loan performance could weaken as stimulus benefits sunset and loan modifications wind down. Stimulus programs such as the Paycheck Protection Program and supplemental unemployment benefits have ended, and many loans have exited loan modification agreements or will soon.

Second, banks are facing low loan yields. Loan yields have declined in recent years amid the drop in interest rates and reached a record low in third quarter 2021.[37] Low loan yields contribute to margin compression and may complicate risk/reward lending decisions, as banks seek to deploy the record levels of deposits that flowed into banks since the start of the pandemic.

Third, lending decisions likely will need to navigate uncertain CRE conditions for some time. Rising office vacancy rates and elevated sublease activity indicate waning demand, but the full effects of changing dynamics in the sector are still developing. Office property demand may take time to stabilize as tenants navigate remote work decisions and adjust how much space they need. A slow return to densely populated urban office centers could reduce the desirability of nearby multifamily and retail space that caters to those office employees. Similarly, the extent to which business travel returns could have lasting effects on certain hotel properties.

Last, pandemic-related stress continues to hamper economic conditions. Labor market weakness and inflation concerns may continue to pressure borrowers' ability to repay loans. The threat of new COVID variants and the pressure of combating a pandemic may continue for some time. These and other potential threats remain, but CRE so far has weathered some of the most severe economic conditions in recent history and has been resilient.

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[37] Loan interest income is aggregated among all nonresidential real estate loans, so yields calculated include agricultural real estate loans.