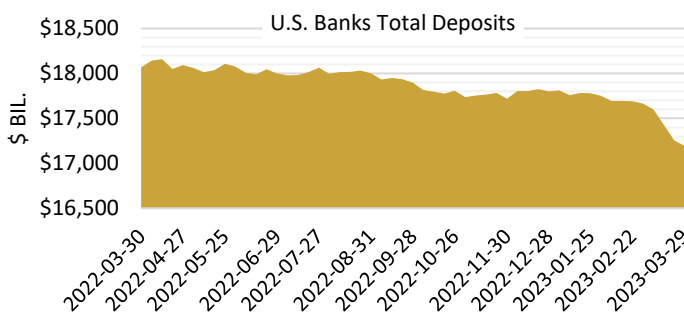


Risk in Commercial Real Estate Takes Center Stage as Stresses in Office Buildings, Healthcare Properties Emerge

As earnings season gets underway banks are signaling a more cautious tone on plans for loan growth. Banks are getting hit from both sides of the balance sheet, as deposit run-off, rising cost of funds, and changing funding mix are squeezing bank margins and raising liquidity concerns, while at the same time rising interest rates may finally be starting to have an effect on some borrowers' ability to service their debt. We note that the Commercial Real Estate (CRE) Office Building nonaccrual ratio (% of outstanding balances) was 1.34% as of March 31st, up 29% quarter over quarter and 436% year over year. The Office Building nonaccrual rate has risen for seven consecutive months (see third chart). Lodging remains high but is trending down, while Healthcare Properties balances on nonaccrual spiked 14% month over month.

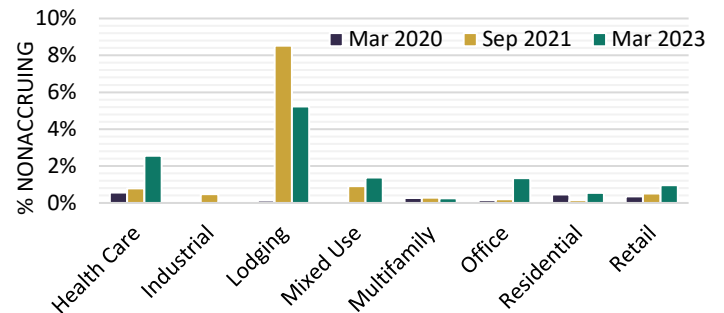
Trend in Deposits for U.S. Banks



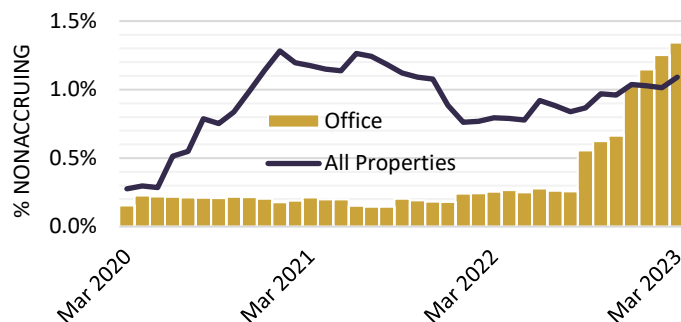
The chart on the left displays the trend in deposits at U.S. commercial banks. Deposits are banks' primary source of funding for lending, so if deposits fall banks may have to recalibrate their plans for loan growth. Deposits fell by \$878 billion year over year (5%), the largest drop in the money supply since the 1930s. Much of the drop was in the last four weeks, as customers were spooked by two bank failures. While safety concerns are largely misplaced, deposits have also dropped because deposit rates are still below money market rates and short-term Treasury yields.

On the chart on the right, we display the trend in nonaccruing loans for each of the eight major property types, starting with March 2020 and going through March 2023. At the beginning of the COVID-related restrictions, loan performance for all property types was relatively benign. Towards the end of that year, we saw dramatic declines in performance for the Lodging sector. As business travel returned to normal, the Lodging nonaccrual rate improved. But now we are seeing problems emerge for Healthcare properties and Office buildings.

CRE Nonaccrual Trend for Major Property Types



CRE Nonaccrual Trend – Office vs. CRE Average



The chart on the left contrasts the performance of Office Property loans with all CRE Property types. As the overall CRE market slipped throughout late 2020 and early 2021, the nonaccrual rate for Offices remained low as firms – despite having many of their employees working from home – honored their leases. Then in late 2022, as a large number of leases began to mature, firms either renewed for less square footage or abandoned their office spaces altogether, leading to an increase in Office Properties on nonaccrual.

Why RMA and AFS?

RMA and AFS are committed to providing relevant, timely, and practical credit risk solutions to banks. Combining the strengths of each to offer information and insight, RMA and AFS are ideally situated for collaborations aimed at identifying and responding to the credit risk needs of financial institutions.

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