

Commercial Real Estate and the Banking Sector

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Relatively high interest rates and increased telework opportunities have had significant effects on the commercial real estate (CRE) sector, specifically office buildings. High inflation in the years following the onset of the COVID-19 pandemic resulted in the Federal Reserve (Fed) increasing interest rates in 2022 and 2023. The pandemic itself resulted in a structural shift in where employees work, with significant increases in telework.

Higher interest rates are likely to affect industries that rely heavily on borrowing, such as CRE. CRE contributes notably to U.S. economic activity, and banks are major lenders, providing nearly \$3 trillion in financing to the sector. Further, tighter credit conditions can affect the ability of builders to obtain financing for new construction, which can in turn reduce CRE growth and, all else equal, increase rents for occupants. Due to the convergence of this new labor market landscape and other economic pressures, including higher interest rates, many companies that would typically rent space from the office subsector of CRE owners are not renewing their leases. This is evidenced by higher office vacancy rates, which continued to rise throughout 2023 and 2024. According to the Fed, banks are reporting weaker demand and tighter loan conditions for all CRE categories.

If these trends continue, individuals and institutions that finance CRE face greater risk exposure to losses resulting from loan delinquencies and defaults. Much of this exposure lies within the banking sector. CRE lending often comprises a substantial share of banks' loan portfolios, especially among small and medium-size banks. Furthermore, the majority of the loss-absorbing capital held by many small banks is apportioned for losses generated by their CRE portfolios. Therefore, regional downturns in subsectors of CRE markets risks local or regional banking stress. Other banks have exposure to potential CRE losses through commercial mortgage-backed security holdings, which may materialize losses if borrowers default or if banks have to sell their holdings at a discount due to higher interest rate environments (in the event of a liquidity shortage).

Bank regulators have identified CRE as a key risk to financial stability, particularly within the office subsector. Further, CRS, using proxies for bank supervisory metrics, calculated that nearly a third of banks have significant exposures to CRE lending portfolios. The banking agencies have issued guidance in recent years to the banking industry about supervisory expectations pertaining to CRE exposures. Further, the Fed included CRE loss scenarios in its most recent stress test and found that significant stress could lead to around \$80 billion in losses for the banking industry. While this type of stress alone is unlikely to drive a widespread financial crisis, it could lead to solvency or liquidity issues among smaller, regional banks. Regulators have also begun to consider whether and how the existing capital framework can or should address additional risk in the CRE market.

Congress has held numerous hearings on the health of the banking system and on oversight of bank supervision, particularly in the wake of the regional banking crisis of 2023. There has been considerable legislative debate about how and whether to adjust the way banking agencies are adjudicating risk in the banking system, capital requirements, and incentives among bank executives for taking on certain exposures. While these debates are generally applicable to any risk a bank may take, CRE is a possible area of risk that has potential to materialize losses in the next year, and so it may be a suitable test case for the ongoing policy discussions around risk management.

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Introduction

Commercial real estate (CRE) activity is a contributor to overall economic activity and plays a significant role in local economies.¹ There are several types of CRE properties such as office, multifamily residential, retail, and industrial.² Each type is its own market with unique supply and demand conditions. CRE markets also differ across locations. Local regulations and market conditions can differ significantly, meaning that CRE in general, or particular types, can perform significantly better in some locations than in others. For this reason, many policy considerations in this space take place at the local level.

The availability and cost of CRE space can affect both local residential and business markets, and taxes from the properties themselves and the residents and businesses that occupy them can contribute revenue to local governments. Relatively high interest rates and inflation in recent years have negatively impacted certain sectors of CRE, and the office sector may be facing stress from increased remote work. Given the stress in office space specifically, it is possible that certain local economies may be disproportionately affected compared to the national economy. For example, some observers are concerned about a so-called *urban doom loop* in which stress in office real estate leads to economic declines in downtown centers.³ In the long term, the disparity between supply and demand in the office sector could be resolved in many ways, including with or without government intervention. One such solution that has been posed is the conversion of empty office space to residential or other types of in-demand real estate.⁴ This report does not cover such longer-term considerations and focuses on the policy issues arising from the acute situation in the office sector.

It is not clear that a collapse in CRE markets alone would cause a recession, although CRE affects other parts of the economy—notably the banking sector. Banks are a primary lending source for CRE loans, and the banking industry is estimated to hold \$2.7 trillion in outstanding loans backed by CRE.⁵ Further, many tenants, particularly in the office subsector of CRE, are not renewing leases, leaving borrowers with less income to make payments on their loans, which exposes lenders to default risks. Banking regulators have provided guidance to banks on prudent CRE activity. Congress may be interested in the impacts of a potential CRE downturn on the banking system in addition to oversight of ongoing regulatory activities.

While larger banks hold larger overall size exposures to CRE, smaller institutions tend to have higher concentrations of their portfolios exposed to CRE borrowers. While a banking crisis may

¹ According to CRS calculations, investment in CRE comprised nearly 3% of total economic activity in 2022, based on Bureau of Economic Analysis (BEA) data on private fixed investment in nonresidential structures and multifamily residential structures. For data, see BEA, National Income and Product Accounts, Tables 1.1.6 and 5.4.6, <https://www.bea.gov/itable/national-gdp-and-personal-income>.

² One estimate suggests that the market shares as of Q4 2023 were 31.6% for multifamily, 23.9% for industrial, 17.3% for office, and 15% for retail, with the remainder taken up by other types. See CBRE, “Investment Volume Continued to Fall in Q4,” 2024, p. 3, <https://mktgdocs.cbre.com/2299/180a6212-1edf-4e8e-81a8-5989a95e22ba-1772932242.pdf>.

³ Rachel Siegel, “How the ‘Urban Doom Loop’ Could Pose the Next Economic Threat,” *Washington Post*, August 28, 2023, <https://www.washingtonpost.com/business/2023/08/28/commercial-real-estate-economy-urban-doom-loop/>.

⁴ While conversions have potential benefits, there are also several constraints to realizing them, such as zoning issues and the logistical and financial burdens of retrofits. Conversions are regulated primarily at the local level, although there may be a secondary role for the federal government. For more information, see CRS Insight IN12257, *Converting Office Space to Residential Housing*, by Lida R. Weinstock.

⁵ For an overview of CRE financing, see CRS Report R46572, *COVID-19 and the Future of Commercial Real Estate Finance*, by Andrew P. Scott.

not be imminent, CRE stress could result in local and regional loan performance issues and even some bank failures.

Congress is generally concerned about the health of the banking system, particularly with respect to systemic risk and the potential exposure to public sector support. Congress may also be concerned about the impact CRE markets have on constituents, businesses, and banks in their districts.

This report highlights how CRE sector stress may spill over into the financial sector and potentially weaken overall macroeconomic performance. First, it discusses the impact of recent economic conditions on CRE markets. Second, given the banking system's role in financing CRE, this report analyzes bank exposure to CRE and discusses regulatory action regarding this exposure. Finally, it raises several issues for Congress including the federal role in local CRE markets, regulatory standards for banks, and labor market regulation.

CRE Market Conditions

Recent Economic Conditions

One of the main ways in which the economy impacts CRE is via interest rates. Higher interest rates in both the short term and the long term are likely to affect industries that rely on credit, such as CRE.⁶ Tighter credit conditions can affect the ability of builders to obtain financing for new construction. Higher borrowing costs can in turn reduce CRE growth or increase rents for CRE occupants. If CRE owners ultimately cannot make payments on higher cost loans, this could result in losses for those individuals and institutions that finance CRE.

In recent years, interest rates rose significantly, one of several fundamental shifts in the economic environment. Prior to the pandemic, inflation was low and stable despite over a decade of historically low interest rates and accommodative monetary policy.⁷ This led to low borrowing costs. However, inflation began rising in 2021, reaching highs not seen since the 1980s, and interest rates have also risen significantly.

In response to inflation, the Federal Reserve (Fed) raised the federal funds rate (FFR) over five percentage points between March 2022 and July 2023.⁸ Other interest rates in the economy responded to the Fed's actions, resulting in a higher interest rate environment and higher borrowing costs. The Fed has yet to begin lowering rates but is expected to begin lowering rates in late 2024. The Fed projects that the appropriate monetary policy path will result in an FFR of 2.8% in the longer run—relatively low in historical terms but higher than most of the period since the 2007-2009 financial crisis and recession.⁹

⁶ Peter Grant, "The Money Has Stopped Flowing in Commercial Real Estate," *Wall Street Journal*, October 31, 2023, <https://www.wsj.com/real-estate/commercial/the-money-has-stopped-flowing-in-commercial-real-estate-43c003d3>.

⁷ *Accommodative monetary policy* refers to policy that is intended to stimulate the economy, such as maintaining a low target for the federal funds rate.

⁸ The FFR is an interest rate that the Fed influences through monetary policy. The Fed does not determine other interest rates in the economy, but rates are affected by movements in the FFR (as well as changes in economic and financial markets), with shorter-term rates affected more so and longer-term rates less so. A long-run FFR higher than what it was for much of the 15 years up to 2022 would likely translate to higher interest rates in general. See CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*, by Marc Labonte.

⁹ Federal Reserve Board of Governors, "Summary of Economic Projections," June 12, 2024, <https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20240612.htm>.

CRE is also likely to be affected by other economic conditions, including demand and investment behavior. Despite the Fed's efforts to reduce demand through interest rate hikes, the economy has remained unexpectedly robust in the face of monetary tightening particularly with respect to metrics that could affect CRE, such as consumer spending and labor market conditions. While monetary tightening has weighed somewhat on investment, including residential investment (which includes multifamily CRE properties), consumer spending has been strong, which could help retail CRE properties. Overall, the labor market closed out 2023 relatively strong with unemployment at 3.7%, and economic growth largely beat expectations in 2023 at 2.5% for the year.¹⁰ While the first quarter of 2024 did show an increase in the unemployment rate, higher-than-anticipated inflation, and slower growth, the economy remains in relatively good condition, with growth at a strong 3.0% in the second quarter. A continued strong economic performance could help buoy CRE markets despite higher borrowing costs.

Economic Outlook for CRE

Since the Fed began raising rates in response to high inflation in March 2022, it has been trying to achieve a *soft landing*—a return to low inflation while maintaining moderate economic growth and full employment.¹¹ Achieving a soft landing after sustained monetary policy tightening is notoriously difficult. Historically, most periods of sustained tightening have been followed by *hard landings*, meaning recessions. Nonetheless, the recent period of monetary policy tightening has so far resulted in falling inflation without a significant decline in employment or economic activity.

A soft landing would be advantageous to CRE, as it would be to all sectors of the economy. All else equal, low and stable inflation, moderate growth, and a strong labor market would lead to robust and sustainable demand, including consumer spending and business investment. A hard landing would lead to lower demand and likely lower CRE growth.

In terms of CRE, the path of interest rates may be of particular policy interest given the role they play in CRE. In the projected scenario of a soft landing, interest rates are likely to decrease beginning this year. As of June 2024, the Fed's Federal Open Market Committee projected that one rate decrease in the second half of 2024 would be appropriate, with the median projected appropriate policy path resulting in an FFR of 5.1% at the end of 2024, 4.1% at the end of 2025, and 3.1% at the end of 2026.¹² In August 2024, Fed Chair Jerome Powell stated that "the time has come for policy to adjust," indicating likely rate cuts beginning in September 2024.¹³ However, changes in the FFR are unlikely to affect longer-term interest rates by the same magnitude. For example, an Organisation for Economic Co-operation and Development model for long-term interest rates forecasts that the rate on a 10-year government security will be 3.9% in the third quarter of 2025.¹⁴ The yield on a 10-year Treasury as of July 2, 2024, was 4.43%.¹⁵ Easing credit

¹⁰ For unemployment rate data, see <https://data.bls.gov/timeseries/LNS14000000>. For GDP data, see <https://www.bea.gov/data/gdp/gross-domestic-product>.

¹¹ See CRS Insight IN11963, *Where Is the U.S. Economy Headed: Soft Landing, Hard Landing, or Stagflation?*, by Marc Labonte and Lida R. Weinstock.

¹² Federal Reserve Board of Governors, "Summary of Economic Projections."

¹³ Federal Reserve Chair Jerome H. Powell, "Review and Outlook," speech at "Reassessing the Effectiveness and Transmission of Monetary Policy," an economic symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, WY, August 23, 2024, <https://www.federalreserve.gov/newsevents/speech/powell20240823a.htm>.

¹⁴ For data see Organisation for Economic Co-operation and Development, "Long-Term Interest Rates Forecast," <https://www.oecd.org/en/data/indicators/long-term-interest-rates-forecast.html>.

¹⁵ For data see Federal Reserve Bank of St. Louis, "Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis," <https://fred.stlouisfed.org/series/DGS10>.

conditions could boost construction and CRE growth generally, although there is a high degree of uncertainty about how much interest rates will ultimately fall.

While most economists are not predicting an imminent recession, it is possible that one could occur nonetheless. For example, the recent increases in the unemployment rate have some concerned that the economy is weakening.¹⁶ In this scenario, the Fed may opt to lower the FFR either more quickly or by a larger magnitude than it may otherwise have done. Such an economic contraction would likely hurt CRE growth, but the monetary response would help it to recover, all else equal.

Structural Changes Affecting CRE Properties

While certain broad economic conditions may be expected to affect CRE broadly, the impacts can look quite different based on type. For example, COVID-19 was a shock to all CRE segments as well as the broader economy. However, based on the nature of the pandemic, demand for office or retail space took relatively big hits, as restrictions on in-person contact made spending in brick-and-mortar stores difficult and resulted in increased telework.¹⁷

While the performance of CRE sectors has largely been mixed, the office sector in particular is continuing to show signs of stress and has the highest potential to cause stress in the banking sector. For example, while vacancy rates are up since pre-pandemic for multifamily and retail, they are elevated to a lesser degree than in the office sector, which shows record-level vacancy rates. In the industrial sector, vacancy rates have fallen since the beginning of the pandemic. Other metrics, such as rents, tell a less consistent story across sectors over this period. Nonetheless, as of the second quarter of 2024, quarterly effective rent growth was positive in all sectors apart from office.¹⁸

The Office Sector

The pandemic resulted in a structural shift away from in-office work, resulting in high vacancy rates for this segment of CRE that persist today. With the rise in telework, many companies renting space from the office subsector of CRE owners are not renewing their leases. This is evidenced by higher office vacancy rates (see **Figure 1**), which continue to rise, hitting a record 20.1% in the second quarter of 2024, according to Moody's Analytics, a credit rating agency.¹⁹ Consequently, the number of office property rental leases has declined, generating lower revenues and potentially imperiling the ability of the property owners to pay back financing costs. According to Moody's, effective rents have been negative or largely unchanged for the four

¹⁶ For example, see CRS Insight IN12410, *The Sahm Rule Trigger: Is the United States in a Recession?*, by Lida R. Weinstock and Marc Labonte.

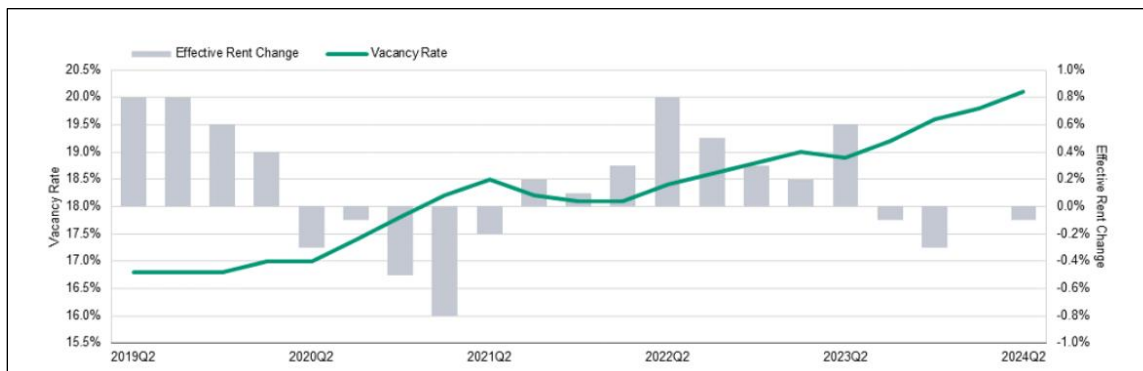
¹⁷ Bank of America, "Brick-and-Mortar Retail: Weaker Foundation," June 29, 2023, <https://institute.bankofamerica.com/content/dam/bank-of-america-institute/economic-insights/brick-and-mortar-retail-weaker-foundations.pdf>.

¹⁸ Moody's Analytics, "Q2 2024 Preliminary Trend Announcement," <https://cre.moodyanalytics.com/insights/cre-trends/q2-2024-preliminary-trend-announcement/>; and Moody's Analytics, "Q1 2024 Preliminary Trend Announcement," <https://cre.moodyanalytics.com/insights/cre-trends/q1-2024-preliminary-trend-announcement/>. Of note, there are many different sources of CRE data, each with its own methodology and analysis. Data across sources are not necessarily comparable.

¹⁹ Thomas LaSalvia et al., "Q2 2024 Preliminary Trend Announcement," Moody's Analytics, July 2, 2024, <https://cre.moodyanalytics.com/insights/cre-trends/q2-2024-preliminary-trend-announcement/>.

quarters ending in Q2 2024 (see **Figure 1**).²⁰ To minimize losses, some CRE owners have been willing to break leases and renegotiate terms with tenants.²¹

Figure 1. Office Sector Vacancy Rates and Effective Rent
Q2 2019-Q2 2024



Source: Thomas LaSalvia et al., “Q2 2024 Preliminary Trend Announcement,” Moody’s Analytics, July 2, 2024, <https://cre.moodyanalytics.com/insights/cre-trends/q2-2024-preliminary-trend-announcement/>.

Note: Data differs across sources and methodologies.

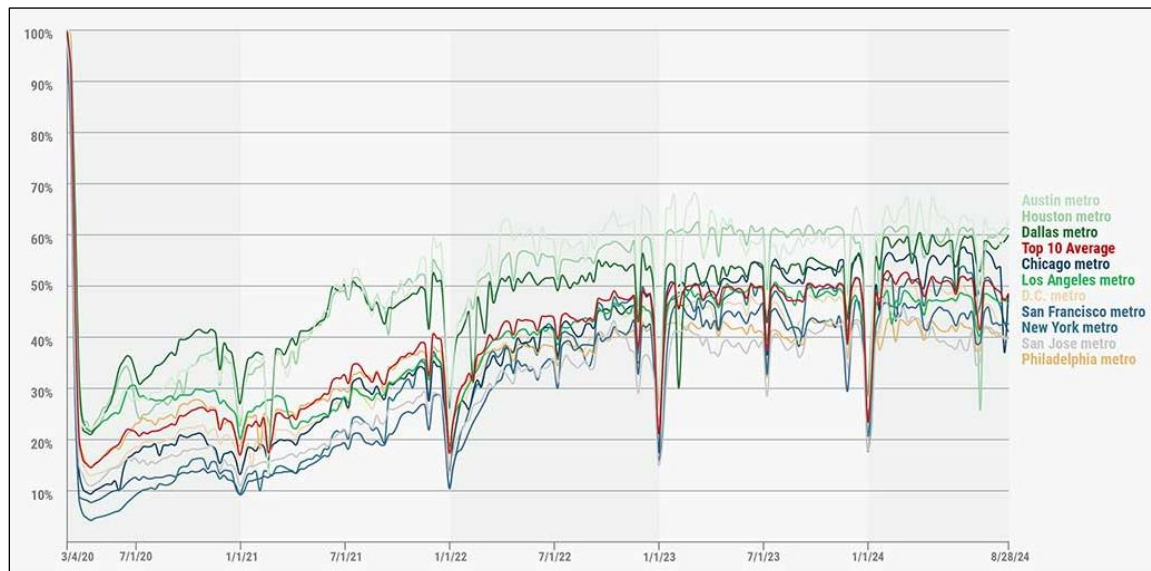
Further, while norms surrounding remote and hybrid work have shifted in the past few years owing to the COVID-19 pandemic, the extent to which remote work will shift the CRE landscape is uncertain. While rates of office utilization are lower than prior to the pandemic (i.e., February 2020), according to some estimates, they have, on average, trended upward in selected major cities after the initial onset (i.e., March 2020) of the pandemic (see **Figure 2**).²²

²⁰ LaSalvia et al., “Q2 2024 Preliminary Trend Announcement.”

²¹ Brian Pietsch, “WeWork to Renegotiate Most of Its Leases Amid Financial Trouble,” *Washington Post*, September 7, 2023, <https://www.washingtonpost.com/business/2023/09/07/wework-lease-renegotiate/>.

²² Kastle, “Kastle Back to Work Barometer,” July 2024, <https://www.kastle.com/safety-wellness/getting-america-back-to-work/>. Kastle is a company that provides security system services to businesses. The data it tracks comes from its clients and, therefore, is likely not a nationally representative sample. Other measures of in-person worker attendance may differ. The use of this Kastle data is meant only to be illustrative of the larger point of increased office vacancy rates, for which there are other corroborating data sources.

Figure 2. Office Worker On-Site Attendance (Samples in 10 Metro Areas)
 Among Office Buildings and Businesses with Kastle Access Control Systems; Not a National Statistical Sample
 March 4, 2020, to August 28, 2024



Source: Kastle, “Kastle Back to Work Barometer,” July 2024, <https://www.kastle.com/safety-wellness/getting-america-back-to-work/>.

Notes: Kastle Systems’ measure of average weekly office attendance (measured by badge swipes in office buildings and businesses served by Kastle Access Control Systems in 10 metro areas) compared to a pre-pandemic baseline (100%). For more information on the methodology, see Kastle, “Occupancy Barometer: Methodology and FAQ,” <https://info.security.kastle.com/occupancy-barometer-faq>.

Trends in workers’ bargaining power may also play a role here, with tighter labor markets—ones in which workers are scarce relative to the demand for them—potentially resulting in more telework. For the past couple of years, the overall labor market has been characterized by fewer unemployed workers than available jobs, likely giving workers a greater ability to demand flexibilities such as telework. The labor market remains tight—the ratio of unemployed persons to job openings was 0.8 as of April 2024.²³ However, the labor market is cooling. Labor force participation increased in 2023, the unemployment rate is up from lows earlier in 2023, and the rate of job growth is moderating.²⁴ If and how this will affect the amount of telework moving forward is uncertain. However, if (1) labor supply and demand fully rebalance or shift more in the favor of employers and (2) employers on average desire more in-office work, then the amount of telework could decrease as employees lose bargaining power.²⁵ Some companies have mandated in-office attendance five days a week, and many others have mandated more in-office work relative to pandemic lows.²⁶ Nonetheless, there is still a higher rate of telework than prior to the pandemic. This could indicate that workers currently still hold an advantageous bargaining

²³ For data see Bureau of Labor Statistics (BLS), “Job Openings and Labor Turnover Survey,” <https://www.bls.gov/jlt/>.

²⁴ For data see BLS, “Labor Force Statistics from the Current Population Survey,” <https://www.bls.gov/cps/>; and BLS, “Current Employment Statistics—CES (National),” <https://www.bls.gov/ces/>.

²⁵ Telework opportunities are driven by more than labor market tightness and bargaining power. Other factors such as housing costs and mobility rates likely drive some amount of telework.

²⁶ Cheryl Winokur Munk, “The CEO ‘Return to Office or Else’ Is Having Limited Success in 2024,” *CNBC*, February 5, 2024, <https://www.cnbc.com/2024/02/04/the-ceo-return-to-office-or-else-is-having-limited-success-this-year.html>.

position or that employers do not necessarily share a widespread, strong preference for in-office work, possibly due in part to cost savings from reduced office usage.

Labor market trends and the future of telework significantly influence the performance, outlook, and viability of the office sector. Empty or partially empty office buildings mean lower rental income for landlords, imperiling their ability to pay back loans, which could, in turn, result in stress for those who hold the loans, including banks. Banking exposure to CRE is discussed in the next section. Empty or partially empty office buildings could also have significant local impacts, as discussed earlier. Fewer workers in downtown centers means fewer patrons of the businesses in those areas, which could put stress on the retail sector as well as office sector. Transitioning commercial properties (e.g., converting and rezoning properties for other purposes) may resolve or ameliorate these stresses over time. However, as stated earlier, this report focuses on current market conditions and the potential stresses they create and thus does not discuss the possibility or challenges associated with such redevelopment.

Banking Exposure to CRE

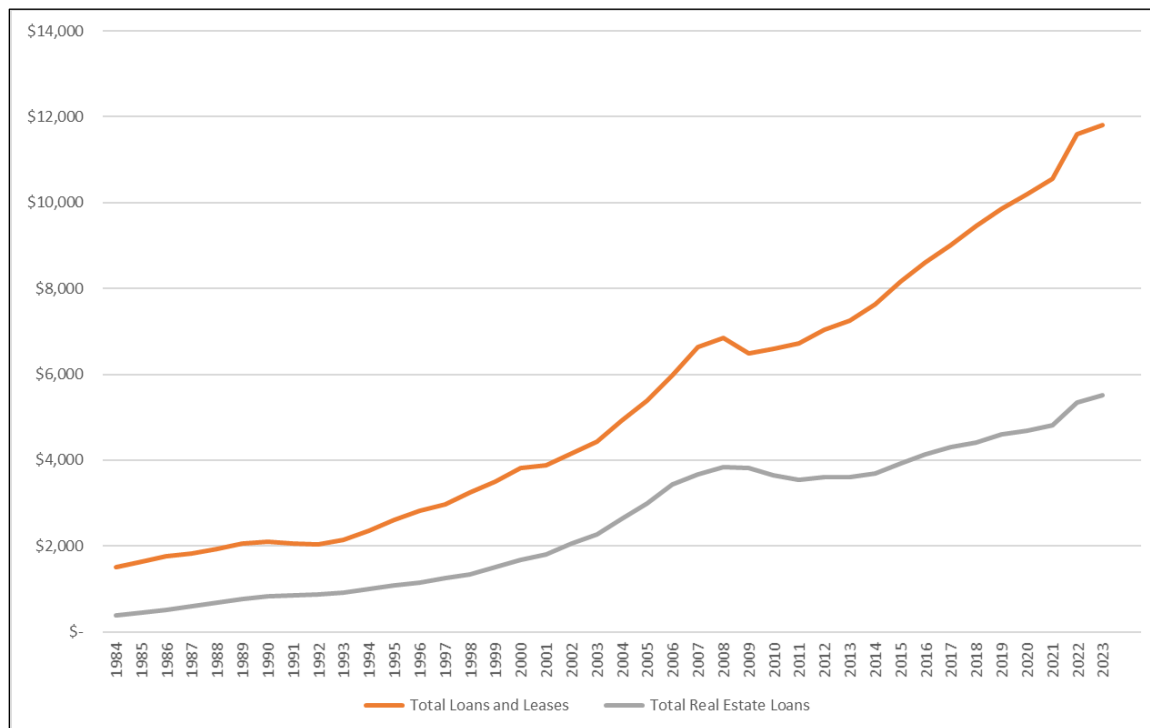
Congress may be interested in the impacts of a potential CRE downturn. One reason is that banks hold a significant amount of exposure to CRE loan portfolios. Both the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee have held several hearings and passed legislation recently pertaining to the health of the banking system. While stress seems likely to be a local or regional phenomenon, Congress is generally concerned about systemic risk and the potential exposure of public money to a bailout or public sector support. Congress may also be concerned about constituencies that are impacted directly by CRE stress. How many banks are exposed to CRE and how exposed they are determines how resilient the banking sector as a whole may be if CRE borrowers default at higher rates. This section analyzes data related to bank exposure to CRE.

Overview

As of year-end 2023, the banking system had roughly \$23 trillion in assets, and real estate loans comprised nearly a quarter of banking assets and nearly half of total loans. Each bank has a different business model, but in general, banks play a significant role in real estate markets and specifically CRE lending. (See **Figure 3**.)

Figure 3. Bank Real Estate Lending Portfolio

Loans in Millions of Dollars, 1984-2023



Source: FDIC historical data, 1984-2023. Data accessed at <https://banks.data.fdic.gov/bankfind-suite/historical?displayFields=BANKS%2CDEP%2CEQNM%2CNETINC%2CLNLSGR%2CLNRECONS%2CLNRERES%2CLNREMULT%2CLNEAG%2CLNRENRES%2CLNREDOM%2CLNREFOR%2CLNRE&endDate=2023&pageNumber=1&resultLimit=25&searchPanelExpand=true&selectedReport=CBF&selectedStates=0&sortField=YEAR&sortOrder=DESC&startDate=1934>.

Notes: The blue line represents the total loan portfolio for the banking system, and the orange line represents the total real estate loan portfolio for the banking system. Data were pulled from 1984-2023. Note that there were 14,496 banks in 1984 and 4,036 banks in 2023.

The total loan portfolios and the real estate loan portfolios of commercial banks have both grown considerably over time.

Although exposure to CRE can be defined in various ways, one measure to is to look at a bank's loans to CRE borrowers. Typically, CRE loan portfolios are defined as the sum of nonfarm, nonresidential loans; construction and development loans; and multifamily loans. CRE loans comprise a significant portion of banks' real estate loan portfolios. Industry data show that CRE loan assets are around \$2.7 trillion.²⁷

One of the unique features of bank CRE lending is that banks tend to keep CRE loans "on their books" (i.e., hold them as assets on their balance sheets). This differs from residential loans, where banks often sell mortgages to one of the government-sponsored enterprises (GSEs), such as Fannie Mae or Freddie Mac, in the secondary market.²⁸ Because banks hold many CRE loans to

²⁷ KPMG, "Commercial Real Estate (CRE): Expanded Regulatory Focus," 2024, <https://kpmg.com/us/en/articles/2024/commercial-real-estate-expanded-regulatory-focus-reg-alert.html>.

²⁸ For more on housing finance and GSEs, see CRS Report R42995, *An Overview of the Housing Finance System in the United States*, by Katie Jones, Darryl E. Getter, and Andrew P. Scott.

maturity, the risks of default often do not transfer to private investors or GSEs in the secondary market. Thus, bank regulators tend to have specific supervisory interest in the risk exposure caused by bank CRE portfolios.

Bank regulators have issued guidance and rules to banks on CRE exposures in the past and even have certain regulatory data thresholds they use to gauge concentration in CRE lending. In the past 10 years, regulators have issued guidance and rulemakings for appraisals, loan modifications, and managing various CRE risks.

Loan Concentration

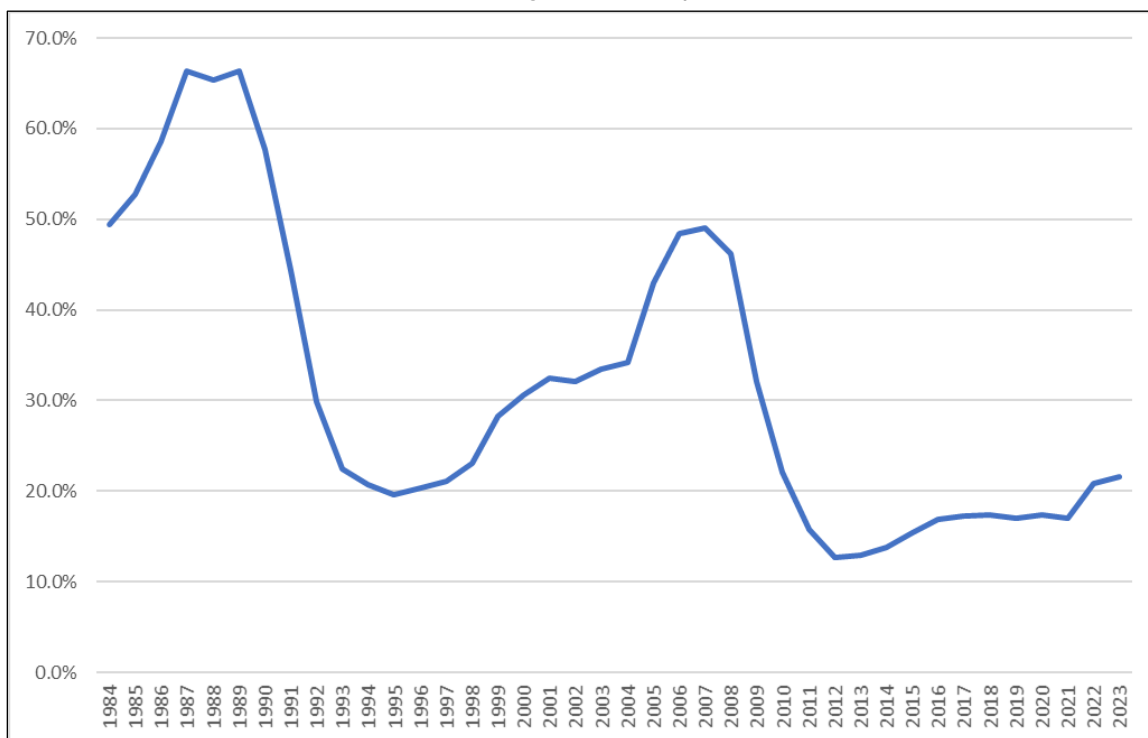
In some of these guidance documents and policy statements, the regulators have stated that there is cause for enhanced regulatory scrutiny if a bank has a concentration in CRE lending. *Loan concentration* for CRE is generally defined in guidance.²⁹

Figure 4 below shows that current banking system CRE exposure levels, as a percentage of total bank capital, are relatively low by historical standards. However, industry exposure has been generally rising over the past decade. The banking industry exposure is, as a whole, well below 100% of bank capital³⁰—an indicator of concentration that typically signals supervisory scrutiny—but a large number of banks may nevertheless be highly exposed on an individual basis.

²⁹ According to the interagency guidance from 2006 entitled, “Concentration in Commercial Real Estate Lending, Sound Risk Management Practices,” there are two key supervisory criteria for higher levels of supervisory scrutiny: The first is when total reported loans for construction, land development, and other land represent at least 100% of total capital. The second is when total CRE loans comprise at least 300% of total capital and the balance of the bank’s CRE loan portfolio has increased 50% in the prior 36 months. Total CRE loans are a larger subset of loans than the loans for construction, land development, and other land that is used in the prior metric. The guidance can be found at <https://www.fdic.gov/resources/regulations/federal-register-publications/2006/06notice1212.html>.

³⁰ Capital is a form of funding that banks use to absorb losses on their balance sheets. It protects banks from insolvency but is a relatively expensive funding source when compared to deposits and debt. For more, see CRS Report R47447, *Bank Capital Requirements: A Primer and Policy Issues*, by Andrew P. Scott and Marc Labonte.

Figure 4. CRE Concentration Estimates
Percentage of Total Capital

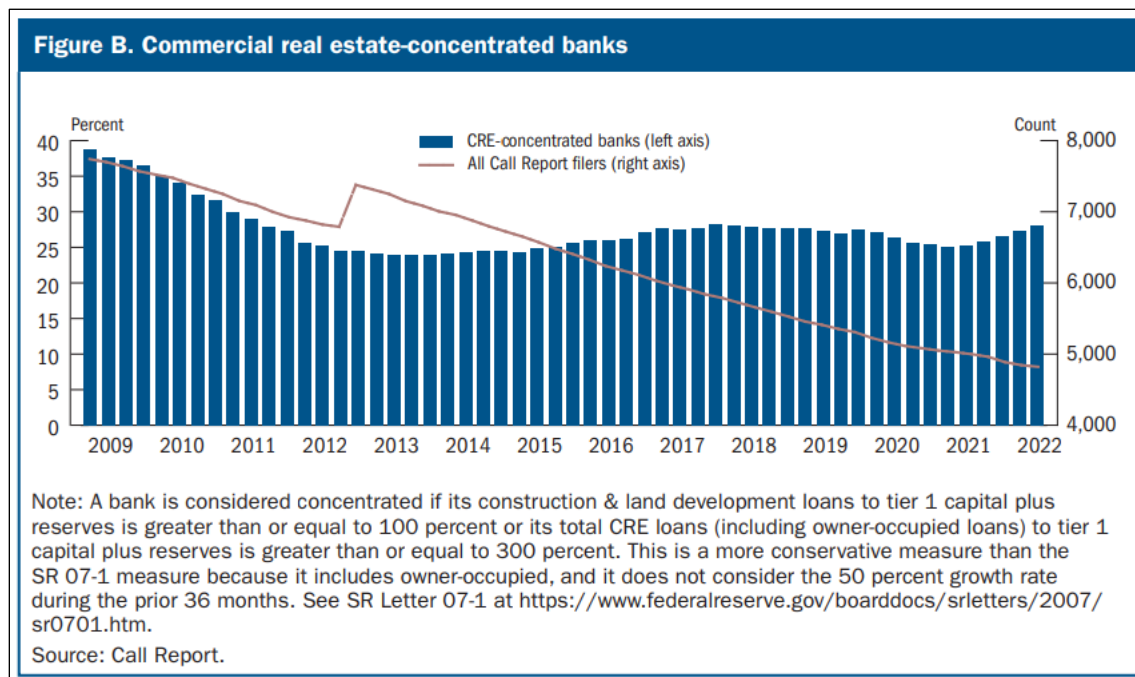


Source: FDIC historical data, 1984-2023. Data accessed at <https://banks.data.fdic.gov/bankfind-suite/historical?displayFields=BANKS%2CDEP%2CEQNM%2CNETINC%2CLNLSGR%2CLNRECONS%2CLNRERES%2CLNREMULT%2CLNREAG%2CLNRENRES%2CLNREDOM%2CLNREFOR%2CLNRE&endDate=2023&pageNumber=1&resultLimit=25&searchPanelExpand=true&selectedReport=CBF&selectedStates=0&sortField=YEAR&sortOrder=DESC&startDate=1934>

Note: The blue line represents the proportion of total loans for construction, land development, and other land to total capital.

CRS analyzed the year-end 2023 call report data to assess how many banks might be crossing the threshold for supervisory concern. Of the 4,641 reporting banks with 2023 data, 2,956 reported all the data necessary to calculate this threshold. CRS estimates that 10%-33% of banks would meet regulatory criteria for additional scrutiny over their CRE concentrations. Almost all of these institutions are smaller banks. Several of these banks had more than \$10 billion in assets.

For context, according to the Fed's November 2022 *Supervision and Regulation Report*, around 28% of banks met the Fed's measure for CRE concentration, and the Fed reported the figure to have risen steadily since 2021 (see **Figure 5**).

Figure 5. Fed Estimates of CRE Concentration in the Banking System, 2022

Source: Federal Reserve, *Supervision and Regulation Report*, November 2022, p. 30, <https://www.federalreserve.gov/publications/files/202211-supervision-and-regulation-report.pdf>.

CRS analysis of the most recent industry data suggests that the trend of increasing concentration has continued. Given that capital levels have generally gone up in the past few years, this would also suggest that banks are increasing their CRE lending portfolios compared to other market exposures: The current 34.5% level of concentration is much closer to 2009 levels than at any other point since the 2007-2009 financial crisis.

Loan Performance

The Fed's November 2023 *Supervision and Regulation Report* noted that delinquency rates among CRE loans to hotels, retail space, and office space jumped during the pandemic and remain elevated today. Office loan delinquencies have further increased since the pandemic. The Fed's May 2024 *Supervision and Regulation Report* notes that CRE loan delinquencies have hit a five-year high.³¹ According to CRS's analysis of call report data, 73 banks reported delinquencies in loans to financial CRE, construction, and land development portfolios. This is normal, as not all loans perform well. Most banks have zero loans reported as 30-89 days past due. However, among the 45 banks that reported some nonzero value for 30-89 day past due CRE loans, the rate was much higher at around 1.4%. This list includes some of the largest banks in the country. CRS further aggregated all loans past due or in nonaccrual status to evaluate the total nonperforming CRE loan basis. There were 32 community banks that reported positive loan delinquencies, averaging 3.4% of construction, land development, and other land loans. There were 41 banks with assets over \$10 billion and positive delinquencies, with average loan delinquencies of 0.3%.

Further, the Fed's Capital Assessments and Stress Testing information collection shows that "the delinquency rate for the office segment was over 1.8 percent in the fourth quarter of 2022, well

³¹ Federal Reserve, *Supervision and Regulation Report*, May 2024, <https://www.federalreserve.gov/publications/files/202405-supervision-and-regulation-report.pdf>.

above its 10-year average of 0.7 percent.... The office segment represented 22% of total income-producing CRE loan commitments as of fourth quarter of 2022.”³² Further, some banks have made allowances for their CRE investments. Allowances are an indicator of a bank’s expectation of loss in the future. According to the 2023 year-end call report, just over 900 banks reported CRE investments and allowances for loss on those investments. Among the banks with the largest ratios of loss allowances for their CRE investments are some of the largest financial institutions in the country. The Fed’s 2024 *Supervision and Regulation Report* suggests that large banks indicate that their allowances will be sufficient to cover potential future losses, including office CRE loans.³³

Commercial Mortgage-Backed Securities (CMBS) Exposure³⁴

While banks generally make loans to CRE borrowers, they can also be exposed to CRE through holdings of CMBS—securities that make payments to the owner from the cash flow of repayments on an underlying pool of loans. A rudimentary measure of exposure to loss is the difference between the fair value (a proxy for what the bank could sell it for today) and amortized cost (a proxy for what the bank paid for it) of a bank’s CMBS portfolio. Banks typically classify their portfolios of CMBS as “held to maturity” (HTM) or “available for sale” (AFS), depending on the intention of their investments. Each of these portfolios is valued at fair value and amortized cost.

One concern for policymakers is the “unrealized loss”—the difference in value between the fair value and amortized costs—of each CMBS portfolio. For example, a bank makes allowances to plan for losses and, should a loan default, realizes a loss by writing down the value of the asset. By realizing losses immediately, a bank and its regulator can estimate the value of the existing risk. However, with respect to securities holdings, fair value may drop due to changes in interest rates or market sentiment. As this gap grows, the bank could be sitting on larger unrealized losses, and while such losses may never be realized (i.e., the bank holds the assets until the gap shrinks), the bank may be forced to realize those losses during a period of stress.

As is evident, the largest unrealized losses are typically on the books of the some of the largest banks. However, because the supervisory concern over losses is largely tied to the Tier 1 capital a bank holds, a better measure of risk may be the proportion of unrealized loss to Tier 1 capital.

Presumably, regulators would have concern over the concentration of potential losses as it relates to the Tier 1 holdings of these mainly smaller institutions. In any case, CRS calculated that over 1,800 banks had unrealized losses in their AFS CMBS portfolios, and the average value of a bank’s unrealized loss in its AFS CMBS portfolio was nearly \$5 million. Looking at the HTM portfolios, the same pattern is observed.

These calculations, used for illustrative purposes, provide insight into a circumstance when banks become stressed. If banks were forced to sell their CMBS portfolios today, many would experience losses. CRS further added the HTM and AFS portfolios and found that 16 institutions have more than \$500 million unrealized losses on their books (seven with over \$1 billion), and 88 institutions have unrealized losses that exceed 10% of Tier 1 capital.

³² Federal Reserve, “Federal Reserve Supervision and Regulation Report,” May 2023, <https://www.federalreserve.gov/publications/2023-may-supervision-and-regulation-report-banking-system-conditions.htm>.

³³ Federal Reserve, *Supervision and Regulation Report*, May 2024.

³⁴ For an explanation of CMBS markets, see CRS Report R46572, *COVID-19 and the Future of Commercial Real Estate Finance*, by Andrew P. Scott.

2023 Bank Failures and CRE Exposure

In 2023, three large banks—Silicon Valley Bank (SVB), Signature Bank, and First Republic Bank—failed.³⁵ While the nature of these failures was largely tied to their exposures to markets outside of CRE, they also had sizeable CRE exposures.³⁶ For example, SVB reportedly held around \$13 billion in real estate exposure and about \$2.6 billion in CRE loans, about a third of which were backed by multifamily properties and a fifth of which were backed by offices.³⁷ In SVB's February 2023 annual report, it noted that its CRE portfolio³⁸

may involve a higher risk of default compared to our other types loans as a result of several factors, including prevailing economic conditions and volatility in real estate markets, occupancy, rental collections, interest rates and collateral value. Additionally, the continued adverse impacts of the COVID-19 pandemic and long-term work-from-home arrangements on the commercial real estate sector, including retail stores, hotels and office buildings, creates greater risk exposure for our CRE loan portfolio.

In March 2023, First-Citizens Bank and Trust Company assumed all deposits and loans from the bridge bank set up by the Federal Deposit Insurance Corporation (FDIC) to receive SVB's portfolio.³⁹

In September 2023, the FDIC began to market the \$33 billion CRE loan portfolio from Signature Bank.⁴⁰ This portfolio comprised roughly half of Signature's loan portfolio held in receivership by the FDIC at the time of its failure.⁴¹ The majority of this loan portfolio was backed by multifamily properties, and about \$15 billion of those CRE loans were backed by multifamily residences that were rent controlled. (Loans used to finance rent-controlled units are not attractive to lenders or when lenders need collateral because such caps limit the potential profitability of the exposures.)⁴² Most of the assets and liabilities of Signature were assumed by Flagstar Bank, a subsidiary of New York Community Bancorp, in March 2023.⁴³ However, according to the purchase and assumption agreement between Flagstar and the FDIC, it did not purchase "loans secured by non owner-occupied

³⁵ First Citizens Bank purchased most of SVB's loans and assumed a majority of deposits. Flagstar Bank purchased certain loan portfolios and assumed substantially all deposits from Signature. JPMorgan Chase acquired all deposit accounts and assets of First Republic.

³⁶ For more information on the failures, see CRS Insight IN12125, *Silicon Valley Bank and Signature Bank Failures*, by Andrew P. Scott and Marc Labonte.

³⁷ Isabella Farr and Pawan Naidu, "Sizing Up Silicon Valley Bank's Real Estate Exposure," *The Real Deal*, March 10, 2023, <https://therealdeal.com/sanfrancisco/2023/03/10/sizing-up-silicon-valley-banks-real-estate-exposure/>.

³⁸ Silicon Valley Bank, "Annual Report," February 2023, <https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/f36fc4d7-9459-41d7-9e3d-2c468971b386.pdf>.

³⁹ FDIC, "First-Citizens Bank and Trust Company, Raleigh, NC, to Assume All Deposits and Loans of Silicon Valley Bridge Bank, N.A., from the FDIC," press release, March 26, 2023, <https://www.fdic.gov/news/press-releases/2023/pr23023.html>.

⁴⁰ FDIC, "FDIC Announces Start of Marketing Process for \$33 Billion Commercial Real Estate Loan Portfolio of Former Signature Bank, New York," press release, September 5, 2023, <https://www.fdic.gov/news/press-releases/2023/pr23071.html>.

⁴¹ Martin J. Gruenberg, "Remarks by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation on 'Oversight of Prudential Regulators,' before the Committee on Financial Services, U.S. House of Representatives," May 15, 2024, <https://www.fdic.gov/news/speeches/remarks-martin-j-gruenberg-chairman-federal-deposit-insurance-corporation-oversight>.

⁴² In December, the FDIC completed a sale of a 20% equity stake in SIG CRE 2023 Venture LLC, an entity the FDIC created as a receiver to market "approximately \$16.8 billion in CRE loans collateralized by office, retail and market-rate multifamily properties." The venture does not hold any loans collateralized by rent-stabilized or rent-controlled multifamily properties. Morgan Stanley has reportedly acquired around \$700 million of those loans as of May 15, 2024. See FDIC, "FDIC Signature Bridge Bank Receivership Sells 20 Percent Equity Interest in Entity Holding \$16.8 Billion of Commercial Real Estate Loans," press release, December 14, 2023, <https://www.fdic.gov/news/press-releases/2023/pr23105.html>; and Reuters, "Morgan Stanley to Buy \$700 Mln Property Loans Tied to Signature Bank, Bloomberg Reports," May 15, 2024, <https://www.reuters.com/business/finance/morgan-stanley-buy-700-mln-property-loans-tied-failed-signature-bank-bloomberg-2024-05-15>.

⁴³ FDIC, "Subsidiary of New York Community Bancorp, Inc., to Assume Deposits of Signature Bridge Bank, N.A., From the FDIC," press release, March 19, 2023, <https://www.fdic.gov/news/press-releases/2023/pr23021.html>.

commercial real estate, specifically including multifamily and one-to-four-family residential development and construction loans.”⁴⁴

Industry analysis also suggested that First Republic held significant CRE loans, with CRE accounting for about 19% of its \$173 billion loans portfolio (about \$33 billion).⁴⁵

Future Concern over Banks and CRE Exposure

In the Fed’s 2024 *Financial Stability Report*, it reported concerns over asset valuations in CRE markets and leverage exposure to CRE stress in the banking system.⁴⁶ As stated earlier, CRE loans held by banks are valued at around \$2.7 trillion, making up “around a quarter of an average bank’s assets.”⁴⁷ According to the Mortgage Bankers Association, “Twenty percent (\$929 billion) of the \$4.7 trillion of outstanding commercial mortgages held by lenders and investors will mature in 2024, a 28 percent increase from the \$729 billion that matured in 2023.”⁴⁸ Of the \$929 billion coming due in 2024, roughly half is held by banks, and a quarter is in CMBS and other CRE-related securities. A quarter of the debt coming due is backed by office properties, and nearly 40% is backed by lodging properties.

This increase is in part due to older loans that were supposed to mature (and thus be paid off) instead being modified and extended into 2024. Lenders are incentivized to extend and work out repayment terms both by market dynamics⁴⁹ and by regulators, but this is not intended to be a long-term arrangement.⁵⁰ Generally, CRE exposures are most vulnerable among office buildings, where loan maturities are close to expiration and leases may not be renewed. Moody’s estimates that more than three-quarters of maturing CMBS office loans are likely to have issues with timely payoff in 2024.⁵¹

Table 1 below shows CRE lending as a share of assets by bank size.

⁴⁴ FDIC, “Purchase and Assumption Agreement,” March 20, 2023, p. 22, <https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/signature-ny-p-and-a.pdf>.

⁴⁵ Randy Plavajka, “JPMorgan Set to Buy First Republic, Assume CRE Assets and Loan Book,” May 1, 2023, <https://www.recapitalusa.com/jpmorgan-set-to-buy-first-republic-assume-cre-assets-and-loan-book/>.

⁴⁶ Federal Reserve, *Financial Stability Report*, April 19, 2024, <https://www.federalreserve.gov/publications/files/financial-stability-report-20240419.pdf>.

⁴⁷ Amit Seru, “Yes, You Should Be Worried About a Potential Bank Crisis. Here’s Why,” *New York Times*, May 4, 2023, <https://www.nytimes.com/2023/05/04/opinion/silicon-valley-bank-first-republic-financial-crisis.html>.

⁴⁸ Mortgage Bankers Association, “20 Percent of Commercial and Multifamily Mortgage Balances Mature in 2024,” February 12, 2024, <https://www.mba.org/news-and-research/newsroom/news/2024/02/12/20-percent-of-commercial-and-multifamily-mortgage-balances-mature-in-2024>.

⁴⁹ For example, if a company holds a lease that is expiring this year and chooses not to renew, the landlord will not generate revenue on that property to pay back its debt obligations unless it finds a new tenant. If the landlord cannot find the money to repay, the lender can cut the landlord out of the property but then must find a new landlord or manage the property itself.

⁵⁰ For example, the banking regulators issued a policy statement in 2023 that called for financial institutions to “prudently and constructively” work with creditworthy borrowers during times of financial stress.

⁵¹ Kevin Fagan, “NYCB Announcement Foreshadows Trouble to Come in 2024, but CRE-Related Downside Has Limits,” Moody’s Analytics, February 8, 2024, <https://cre.moodyanalytics.com/insights/cre-news/nycb-announcement-foreshadows-trouble-to-come-in-2024-but-downside-has-clear-limits/>.

Table I. CRE Lending/Bank Assets

Bank Asset Size Category	Multifamily	Commercial CRE	Construction	Total Direct Exposure
>\$160 Billion	1.4%	2.1%	0.8%	4.4%
\$10B-\$160B	4.8%	8.9%	4.0%	17.8%
\$1B-\$10B	6.0%	14.0%	5.8%	25.7%
\$100 Million-\$1B	3.1%	10.3%	5.3%	18.7%
<\$100M	0.9%	3.9%	2.5%	7.3%

Source: Moody's analysis of FDIC data. See Kevin Fagan, "NYCB Announcement Foreshadows Trouble to Come in 2024, but CRE-Related Downside Has Limits," Moody's Analytics, February 8, 2024, <https://cre.moodyanalytics.com/insights/cre-news/nycb-announcement-foreshadows-trouble-to-come-in-2024-but-downside-has-clear-limits/>.

As is shown above, smaller and mid-size banks tend to have higher concentrations of CRE exposure on their books. Most larger banks generally have limited exposure to CRE. However, the Fed included CRE in its 2024 stress tests for large banks and found that a 40% decline in CRE prices would result in a loss rate of around 9%, or around \$80 billion. This is roughly 3% of banking assets. Further, the stress test results found that increases in losses to the CRE office subsector were generally offset by a decline in projected losses on other CRE subsectors.

In addition, the 2023 banking crisis fueled concern of CRE exposure at a few larger regional banks. For example, one large regional bank reportedly faced financial pressure in early 2024 over its CRE exposures, cut its dividend payout to preserve capital, and had its credit subsequently downgraded by Moody's. And in June, another large regional bank sold nearly \$2.8 billion in multifamily CRE loans to Bank of America in the largest non-FDIC-assisted CRE loan sale in history.⁵² According to reports, the sale was strategic and intended to generate liquidity and to reduce overall CRE exposure.

CRE exposure is also impacting some merger deals. For example, a recent merger agreement between FirstSun Capital Bancorp and HomeStreet was amended to include more capital and also to change the chartering status of FirstSun's subsidiary bank from a national bank—overseen by the Office of the Comptroller of the Currency (OCC)—to a state-chartered bank. Reports suggest that this decision occurred after the "OCC made it clear that there would be hurdles to approval due to the companies' commercial real estate (CRE) exposure."⁵³

Regulatory Anticipation

Exposure to CRE (and any other market) can raise concern if banks are not properly managing it. An effective supervisory regime can require banks to properly manage risk and use enforcement authorities to compel banks to meet those requirements. In its oversight capacity, Congress may consider whether banks and supervisors are adequately managing risk.

According to reports from S&P Capital IQ, regulators are "upping the ante in exams and acting much faster to downgrade banks' regulatory ratings and hand out both confidential and public orders" and "trying to get ahead of potential capital and commercial real estate (CRE) stress after

⁵² Zacks Equity Research, "WaFd (WAFD) Completes Sale of CRE Loans, Enhances Liquidity," Nasdaq, June 24, 2024, <https://www.nasdaq.com/articles/wafd-wafd-completes-sale-cre-loans-enhances-liquidity>.

⁵³ Zoe Sagalow, "CRE Concern, Higher-for-Longer Outlook Drive FirstSun-HomeStreet Deal Amendment," S&P Global Market Intelligence, May 8, 2024, <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/cre-concern-higher-for-longer-outlook-drive-firstsun-homestreet-deal-amendment-81555452>.

feeling like they dropped the ball on being proactive about the factors that led to Silicon Valley and Signature Bank's demise."⁵⁴ According to the report, regulators are asking banks to hold more capital and increase reserves against CRE. Further, the Fed is "encouraging banks to implement risk management strategies as it monitors potential vulnerabilities in the financial system," including CRE, according to Fed Governor Lisa Cook in May 2024.⁵⁵

Issues for Congress

How the economy, the CRE sector, and the banking sector may perform throughout the remainder of 2024 and beyond is uncertain. If interest rates remain high and labor market conditions do not loosen sufficiently to change the current state of telework, the office CRE sector is likely to experience further losses. In that scenario, the banking system is likely to be affected given that a significant portion of CRE loans is held by banks. Certain banks may fail as a result, and this could lead to regional stress in the banking system. As far as systemic risk goes, the effects of these failures on the broader banking and financial system remain uncertain and could depend on the performance of other sectors of CRE markets, which could hedge or exacerbate office CRE losses.

One broad set of policy questions Congress may consider are related to federal regulation of the banking system. Congress has held numerous hearings on the health of the banking system and on oversight of bank supervision, particularly in the wake of the regional banking crisis of 2023. There has been considerable legislative debate about how and whether to adjust the way banking agencies are adjudicating risk in the banking system, capital requirements, and incentives among bank executives for taking on certain exposures. For example, Congress held several hearings on the supervisory processes that preceded the 2023 failures of SVB and Signature Bank and debated whether those processes should be more transparent, particularly with respect to supervisory findings during exams. Bank exams are confidential to protect institutions from bank runs and speculative behavior. At the same time, it is possible that a bank examiner may find that a bank today is over exposed to certain CRE subsectors, and the public would not know this, as the publicly available information is offered only quarterly and on an aggregated basis that does not separate different types of CRE loans.

Further, regulators have proposed a rulemaking to update the regulatory framework for capital requirements, and policymakers have debated whether this update is appropriately addressing new risks in the banking system.⁵⁶ While this rulemaking would apply only to larger banks, it would affect the way unrealized losses and market risk are accounted for, which in turn would have an impact on the provision of credit to CRE markets. While these debates are generally applicable to any risk a bank may take, CRE is a potential area of risk that has potential to materialize losses in the next year, and so it may be a suitable test case for the ongoing policy discussions around risk management.

⁵⁴ Lauren Seay, "Capital, Commercial Real Estate at Center of Bank Regulators' Scrutiny," S&P Global Market Intelligence, May 28, 2024, <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/capital-commercial-real-estate-at-center-of-bank-regulators-scrutiny-81832498>.

⁵⁵ Alex Graf, "Fed Urging Banks to Increase Loan Loss Provisions, Test Discount Window," S&P Global Market Intelligence, May 9, 2024, <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/fed-urging-banks-to-increase-loan-loss-provisions-test-discount-window-81583109>.

⁵⁶ For more on the proposed capital regulation, see CRS Report R47855, *Bank Capital Requirements: Basel III Endgame*, by Marc Labonte and Andrew P. Scott.

In addition, current and future stress in CRE raises other policy questions that may be of interest to Congress:

- Many actors are involved in CRE, including tenants, landlords, and various lenders, including banks. Further, CRE impacts both local and national financial markets and economies differently. Should Congress prioritize legislative efforts for any one type of impact or actor more so than others?
- The impacts of any CRE defaults are likely to be realized disproportionately at the local level. How much of any policy response to CRE defaults and local bank failures should be happen at the state and local levels versus at the federal level?
- In addition to the shorter-term implications of CRE stress, should Congress consider some of the longer-term financial and economic consequences of structural increases in telework—for example, through federal telework policy or options for federal involvement in CRE conversions?

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