Managing CRE Exposure in an Uncertain Market

lending strategic planning CRE

Summary: After two years of post-pandemic recovery in the CRE market, there are signs of a cooling off, driven by rising rates and fears of a recession. This leaves leading financial institutions with high CRE concentrations exposed and subject to greater scrutiny by regulators. We provide four strategies to manage CRE in this current market uncertainty.

There are many curious myths about lemmings (small rodents typically found in tundra climates), the wildest of which includes them spontaneously exploding when they become very angry. A more enduring myth is that herds of these small rodents throw themselves into the sea every few years in an attempt to control their population. In truth, they migrate to different areas when concentration in one area becomes excessive — an eminently sensible strategy. This is a skill that could serve community financial institutions (CFIs) well in the current commercial real estate (CRE) market.

CRE has boomed in the last two years. In 2021, CRE sales totaled a record-breaking $809B and by the end of the year, the value of CRE loans exceeded $2.7T. In its mid-year review of the CRE market, JPMorgan expects a continued positive outlook for the remainder of the year, with forecasts varying depending on the asset class. While strip malls in remote areas and office properties struggle, industrial and multifamily properties are current bright spots in the market.

As we've mentioned previously, CFIs perform very well in CRE loans, thanks to their focus on relationships, flexibility, and local market knowledge. According to Globe St., CFIs held almost $800B in CRE loans in 2021 — roughly 30% of the total CRE market's value, despite having only 12% of the banking industry's total assets. As such, they are especially vulnerable to fluctuations in the CRE market.

Nevertheless, rising inflation, interest rates, construction costs, and fears of a recession — combined with the post-pandemic trend towards hybrid working — is generating uncertainty in the CRE market. Already, there are signs that values are dipping, with the Green Street Commercial Property Price Index declining 4.7% this year. This is leading to concern for CFIs with high CRE loan concentrations.

The FDIC recently announced that it would scrutinize financial institutions with large CRE exposure more closely. One FDIC regulator noted that while most banks with CRE loan concentrations are "*satisfactorily rated,*" those concentrations add "*dimensions of risk that necessitate continued attention from banks and their regulators, especially as the pandemic lingers and uncertainties remain.*" Previously, the Federal Reserve included a 40% downturn in CRE market values in this year's stress testing scenarios, indicating that it, too, is keeping a watchful eye on this area of potential concern.

Here are **four essential strategies for CFIs to manage the current CRE market uncertainty**.

1. **Monitor CRE market data very closely.** CFIs need to be able to gauge the level of activity in the market to stay ahead of any turbulence. Regularly collecting data on demand and price points by property type and geographic location should be an essential part of determining an institution's lending strategy — whether to increase, maintain, or reduce its exposure to a particular market or product.

2. **Actively manage your CRE portfolio.** Maintaining a diversified portfolio with concentration limits for specific products and markets is critical to managing risk. This requires CFIs to develop a comprehensive view of their exposure by geography, property type (pre-sold, speculative, etc.), underwriting characteristics — in particular loan-to-value (LTV) ratios — and portfolio liquidity.
3. **Strengthen risk management strategies.** CFIs should review their risk rating systems and ensure they are appropriate for the size and complexity of the institution. They should also establish reasonable LTV limits for different property types and adhere to those limits. Finally, stress testing to model the impact of a market downturn enables CFIs to take appropriate action to mitigate against significant losses.
4. **Plan for capital adequacy.** All CFIs should develop and maintain a capital plan to ensure they have sufficient reserves to withstand potential turmoil in the CRE market and beyond. We outlined the steps to a sound capital plan in a recent article.

So far, CRE delinquency rates have remained low, and losses have been minimal — partly due to government stimulus and low interest rates. As market conditions toughen, CFIs would do well to deploy sound risk management principles and policies to ensure they are prepared for a potential market downturn.

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ECONOMY & RATES

Rates As Of: 09/20/2022 08:33AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	3.37	0.41	3.31
6M	3.87	0.55	3.68
1Y	4.04	0.53	3.65
2Y	3.97	0.48	3.24
5Y	3.76	0.41	2.50
10Y	3.59	0.39	2.07
30Y	3.60	0.30	1.69

FF Market	FF Disc	IORB
2.33	2.50	2.40
SOFR	**Prime**	**OBFR**
2.27	5.50	2.32