Will Office Space Turmoil Test the Deposit Insurance Fund

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The labor force continues to work from home, leaving the demand for commercial space at levels far lower than pre-pandemic. The recent bankruptcy filing of WeWork provides another reminder of likely continued pressure on the office space market. Metro areas across the country face varying degrees of pressure on this front, with many facing large shares of office leases expiring in 2023 or 2024. Atlanta faces 40 percent of its leases in this position, while New York is at 21 percent, and Minneapolis at 32 percent.[1] With office vacancy rates largely above pre-pandemic levels, landlords will face difficulty in renewing leases or finding new tenants, particularly for older office space.

Difficulties faced by landlords will likely be felt by the holders of this commercial debt, including the banking industry. This note provides some context on the possible exposure of the banking industry to office space turmoil. We also look at the current state of FDIC's insurance fund facing these potential headwinds in the commercial lending market. We then summarize information that bank regulators are reporting on the extent of possible exposure in the banking industry.

Bank Exposure to Office Space Credit Issues

As of the third quarter 2023, Cushman Wakefield reports the national office vacancy rate is 19.4 percent, up 220 basis points year-over-year and 680 basis points higher than at the start of 2020. Vacancy remains below 15 percent in 34 of the markets tracked by Cushman & Wakefield.[2]

Quarterly call reports filed by the banking industry provide aggregate information on the percentage of commercial real estate (CRE) lending, which includes the office space sector. The FDIC's 2023 Risk Review[3] discussed this issue.

- "Banks have substantial exposure to CRE lending as CRE loans comprised a quarter of total loans held by the banking industry as of first quarter 2023. CRE loans as a share of total industry assets have grown and approached their 2009 peak."
- "Longer-term leases, which are prevalent in the office sector, helped to insulate office properties from reduced occupancy earlier in the pandemic, but more office leases are scheduled to expire over the next three years in some large markets."

[1] https://www.fdic.gov/about/advisory-committees/community-banking/2023/2023-10-05-discussion-on-banking-conditions.pdf
[2]https://cw-gbl-gws-prod.azureedge.net/-/media/cw/marketbeat-pdfs/2023/q3/us-reports/office/us_office_marketbeat_q3-2023.pdf?rev=076b773b300747e58c8ced521f320b08
[3] https://www.fdic.gov/analysis/risk-review/2023-risk-review/2023-risk-review-full.pdf

- "…. the share of CMBS loans that are not past due but are in special servicing, meaning loans that are not delinquent but exhibit other potential performance issues, increased particularly among office properties."
- "The increase in CMBS delinquency rates, though small, and the rise in specially serviced CMBS could indicate an inflection point for overall CRE asset quality. Monitoring CMBS delinquency trends also is important as more than 40 percent of banks hold CMBS securities, and CMBS holdings represent at least one-quarter of capital at more than 10 percent of banks.[4]

Bank Capital and the Financial Condition of FDIC's Deposit Insurance Fund

Credit issues related to the office space turmoil are not yet showing up in bank numbers. Bank capital remains stable and the noncurrent loan rate increased slightly from the prior quarter, with the commercial real estate (i.e., nonfarm, nonresidential loan) balances accounting for the quarterly increase, as reported in the most recent Quarterly Banking Profile.[5]

Turning to the Deposit Insurance Fund (DIF), FDIC continues to operate under a DIF restoration plan.[6] The Designated Reserve Ratio (DRR) stood at 1.10 percent, with a balance of $117 billion. The FDIC Board received a DIF Restoration Plan Semiannual Update on November 16, 2023.[7] Based on currently available information about troubled banks, trends in CAMELS ratings, failure rates, and loss rates, FDIC staff project that failures for the five-year period ending in 2027 would cost the DIF approximately $4.4 billion. For comparison, three banks per year failed between 2016 and 2022, on average, at an average annual cost to the fund of about $178 million.

The DIF is now less liquid than the beginning of 2023. This reduced liquidity may cause the FDIC to turn to the Federal Financing Bank or other sources, in the event of significant bank failures. Several items are noteworthy in the most recent FDIC Chief Financial Officer Report to the Board, dated August 30, 2023 which focused on June 30, 2023 data.[8]

- The cost estimate for the sale of First Republic Bank to JP Morgan has been revised upward to $15.6 billion, a 2.6 billion increase from the earlier estimate.
- DIF is carrying a $220 million contingent liability for anticipated failures.

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[4] Defined as CMBS securities held by banks as a share of tier 1 capital plus credit loss reserves for loans and leases.
[5] https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2023jun/qbp.pdf#page=1
[6] The statute requires that the FDIC Board adopt a restoration plan when the DIF reserve ratio falls below the statutory minimum of 1.35 percent, or is expected to within 6 months. Historically unusual insured deposits growth at the outset of the COVID-19 pandemic caused the DIF reserve ratio to decline below the statutory minimum of 1.35 percent as of June 30, 2020. Any restoration plan must show the reserve ratio returning to at least 1.35 percent within eight years.
[7] https://www.fdic.gov/news/board-matters/2023/2023-11-16-notational-mem-e.pdf
[8] https://www.fdic.gov/about/financial-reports/corporate/cfo-report-2ndqtr-23/0623-cfo-report.pdf

- DIF also carries a special assessment receivable of $15.8 billion, reflecting the amount that will be collected over eight quarterly assessments for the systemic risk exception granted on the failures of Silicon Valley Bank and Signature Bank.
- Receivables from resolutions (i.e., the funds DIF expects to recover as assets from bank failures are sold and liabilities are satisfied) stood at $159.5 billion, representing nearly 62 percent of DIF assets.
- As a result of the significant receivable balance related to failure recoveries and the expected special assessment income, the DIF has $78 billion in cash and Treasury securities, or 31 percent of DIF assets.

Federal Reserve Supervision & Regulation Report. November 2023[9]

- “Recent efforts include a horizontal review to address exposures to potential deterioration in CRE markets. Supervisors are centering the review on evaluating credit risk monitoring and measurement, internal loan risk rating accuracy, steps taken to mitigate the risk of losses on CRE loans, and CRE risk reporting to firms’ boards of directors and senior management.”
- “Community banking organizations and regional banking organizations, however, hold a high proportion of the banking sector’s CRE loans. Some CRE market segments have recently been under stress, particularly office.”
- “Several risks that featured prominently in the survey conducted in the spring remained top-of-mind, including the risk of persistent inflationary pressures conducted in the spring remained top-of-mind, including the risk of persistent inflationary pressures leading to a more restrictive monetary policy stance, the potential for large losses on CRE and residential real estate, and the reemergence of banking-sector stress.”
- “CRE valuations are particularly elevated for the office sector, where fundamentals are especially weak for offices in central business districts, with vacancy rates increasing further and rent growth declining since the May report. In the April and July 2023 Senior Loan Officer Opinion Survey (SLOOS), banks reported weaker demand and tighter standards for all CRE loan categories over the first half of 2023.”

Federal Reserve Senior Loan Office Survey[10]

- “Over the third quarter, major net shares of banks reported tightening standards for all types of CRE loans. Such tightening was more widely reported by other banks than by large banks. Major net shares of banks reported weaker demand for all CRE loan categories, which was more widely reported by large banks than by other banks.”

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[9] https://www.federalreserve.gov/publications/files/202311-supervision-and-regulation-report.pdf
[10] https://www.federalreserve.gov/data/documents/sloos-202310-fullreport.pdf

Office of Financial Research Blog[11]

A recent OFR blog focused on the office sector and reviewed five metrics that the OFR is watching to assess the state of the office sector and its implications for the financial system.

- Likelihood of a Recession,
- Size of the Sublease Market,
- Actual Office Space Occupancy (Measured by Card Key Swipes),
- Real Estate Investment Trust (REIT) Performance, and
- Work-from-Home (WFH) Trends.

Regulatory Actions

In June 2023, the Federal financial institution regulatory agencies issued a final policy statement on commercial real estate loan accommodations and workouts.[12] The statement updates and supersedes 2009 guidance on commercial real estate loan workouts. This update includes a new section on short-term loan accommodations

- "The agencies recognize that it may be appropriate for financial institutions to use short-term and less-complex loan accommodations before a loan warrants a longer-term or more-complex workout arrangement. Accordingly, the final Statement identifies short-term loan accommodations as a tool that could be used to mitigate adverse effects on borrowers and encourages financial institutions to work prudently with borrowers who are, or may be, unable to meet their contractual payment obligations during periods of financial stress."

- "The agencies encourage financial institutions to work proactively and prudently with borrowers who are, or may be, unable to meet their contractual payment obligations during periods of financial stress. Such actions may entail loan accommodations that are generally short-term or temporary in nature and occur before a loan reaches a workout scenario."

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[11] https://www.financialresearch.gov/the-ofr-blog/2023/06/01/five-office-sector-metrics-to-watch/
[12] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230629a1.pdf