Bank CRE Loan Performance: Delinquency Uptick, Office Erosion, Higher Interest Rates, Slower Originations in Q1 2022

The overall commercial real estate (CRE) delinquency rate increased – albeit slightly – with the office sector as the main contributor to the increase. Concerns about the office property type have continued to increase, with banks' risk ratings on office loans in large urban markets going up. High interest rates have been taking a bite. Origination volume fell in the first quarter of 2022, although industrial and multifamily remain as relative bright spots.

The analysis here is mainly built on examination of trends in Trepp's Anonymized Loan-Level Repository (T-ALLR) data set. The T-ALLR data is comprised of bank balance sheet loan data, a diverse set of loans totaling over $160 billion sourced from multiple banks.

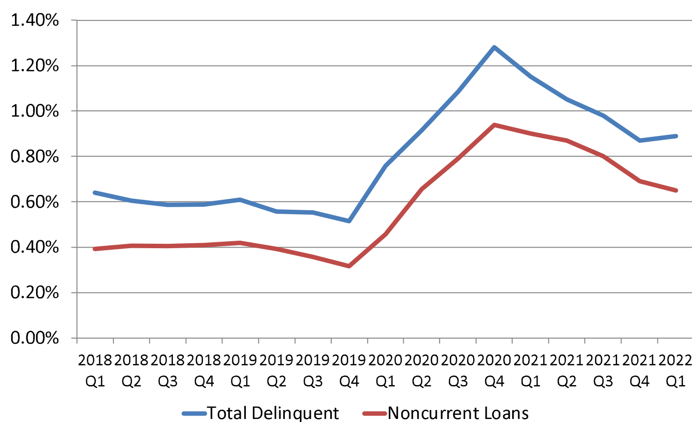
Delinquency Rates – Uptick in Short-term Delinquencies, Continued Improvement in Serious Delinquencies

CRE mortgage delinquencies experienced a slight uptick in the first quarter, after four consecutive quarters of improvement. The increase was driven by short-term delinquencies, with the overall rate rising to 0.89%, from 0.87% in the fourth quarter. While the uptick is slight, it is noticeable after the previous pattern of steady improvement. The serious delinquency rate – the noncurrent loan rate – continued to improve, falling by 4 basis points to 0.65%.

The highest delinquency rates are in the lodging and retail property types, although the delinquency rate for retail has been improving since Q4 2020 and the lodging delinquency rate declined in Q4 2021. These were the two sectors within commercial real estate that were hardest hit by Covid.

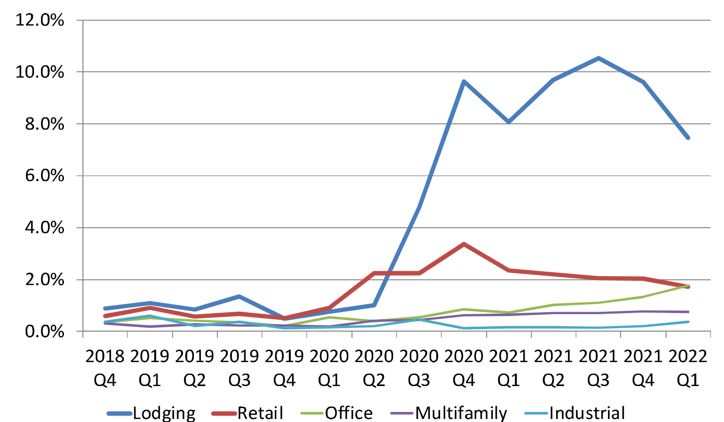
The office delinquency rate has been rising for the last several quarters, representing a delayed reaction to low office occupancy rates during the pandemic. The office delinquency rate rose to 1.8% in Q1, up from 1.3% in Q4. This sector will bear a closer watch through 2022 and beyond, as leases roll in the coming months and loans come up for refinancing.

FIGURE 1: BANK CRE LOAN PERFORMANCE: 1Q UPTICK IN DELINQUENCIES, DEFAULTS FALLING



Source: Trepp Bank Navigator

FIGURE 2: DELINQUENCY RATE BY PROPERTY TYPE: CONTINUED STRESS IN HOTELS, IMPROVEMENT IN RETAIL, OFFICE EROSION



Source: Trepp T-ALLR

Delinquency rates for the other major property types are below 1%. The multifamily delinquency rate was flat at 0.8%. The industrial delinquency rate is a low 0.4% but is up from the 0.2% rate in Q4 2021.

Risk Ratings – Increasing Concerns in Urban Office, Regional Differences for Multifamily

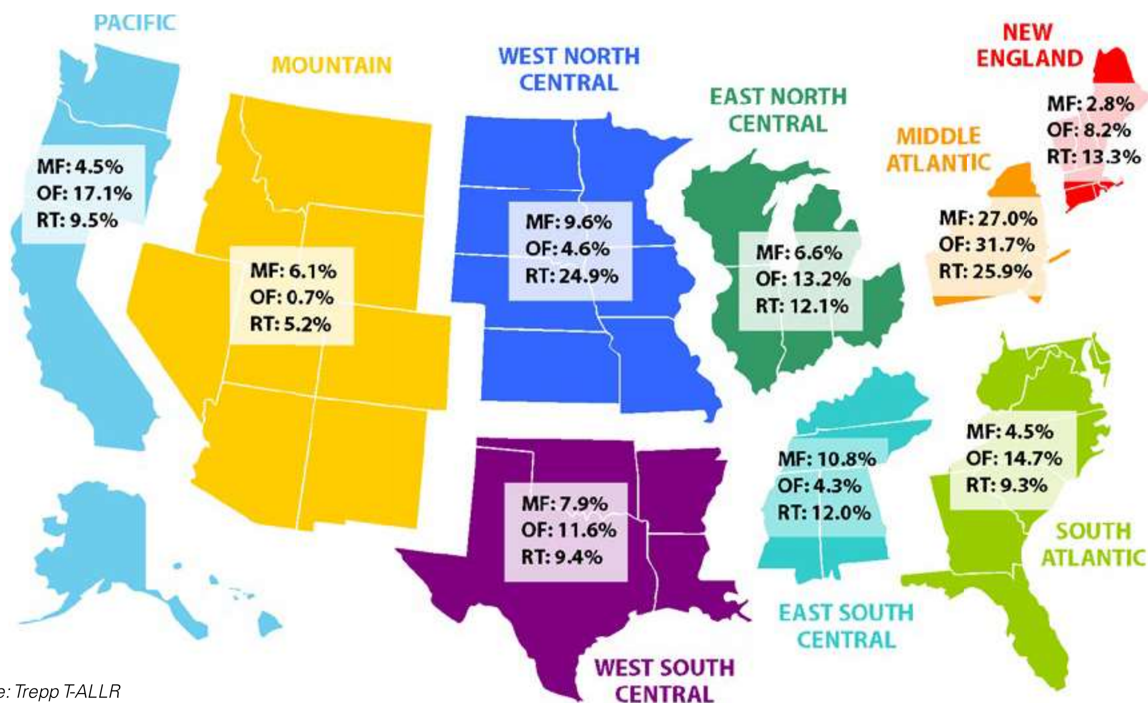
Criticized loan rates[1] show significant variation across geographies and property types. When the pandemic hit in the first quarter of 2020, lenders were allowed to offer forbearance to Covid-impacted borrowers. If a borrower received forbearance, the loan would not be marked as delinquent. However, the lender was expected to update its risk rating on the loan, to reflect the lender's expectations for ultimate re-payment of the loan. So, while delinquency rates have shown a more muted response to the economic disruption of 2020, risk ratings started to adjust immediately.

Lenders in the Mid-Atlantic have elevated concerns about risk across all three of the largest loan types. More than 30% of office loans – by loan balance – carry risk ratings of 6 or higher. The proportions for multifamily (27.0%) and retail (25.9%) are slightly lower. Pandemic-related concerns are still evident in the higher risk ratings.

Risk ratings for office loans have increased, especially in the largest markets, as the long-term prospects for the sector have become less certain. The large and commute-dependent New York office market is the source of the Mid-Atlantic's high 31.7% proportion of criticized loans. The other large metro areas with large CBD office markets – such as Chicago and San Francisco - are also driving double-digit proportions of criticized loans in the East North Central and Pacific areas.

Multifamily generally has a low proportion of criticized loans. However, lenders in several areas – from the West North Central area, through the West and East South-Central areas and up to the Mid-Atlantic area – were keeping a closer eye on multifamily. Many areas have largely recovered from the economic disruption of the pandemic, but clearly lenders are still maintaining a higher level of vigilance.

FIGURE 3: CRITICIZED LOANS BY REGION: MULTIFAMILY, OFFICE AND RETAIL – Q1 2022



Source: Trepp T-ALLR

[1] Criticized loans have a standardized risk rating of 6 or higher. As part of its data collection and anonymization process, Trepp translates contributors' internal risk ratings to a standardized risk rating that ranges from 1 (lowest risk) to 9 (highest risk) for default and loss.

Retail loans are widely perceived to be at higher risk, with double-digit proportions of loans in the Criticized category. The area with the lowest proportion of Criticized loans was the Mountain region, at 5.2% of the outstanding balance.

Origination Volume – Recovery Being Led by Industrial and Multifamily

New CRE loan originations fell in Q1, after a strong showing in Q4. Originations increased substantially in Q4 to about 30% higher than the pace in 2019. With economic growth, still-low interest rates and the prospect for higher rates ahead, there is plenty of capacity for more borrowing.

Industrial volumes were strong – outpacing the average quarterly volume in 2019 by 17%. While investor sentiment has cooled off somewhat, investors and lenders have continued to commit money to the industrial segment. The Covid-led shift to online shopping and delivery gave a boost to a sector that was already growing rapidly. Some concerns of overbuilding/oversupply have emerged recently however.

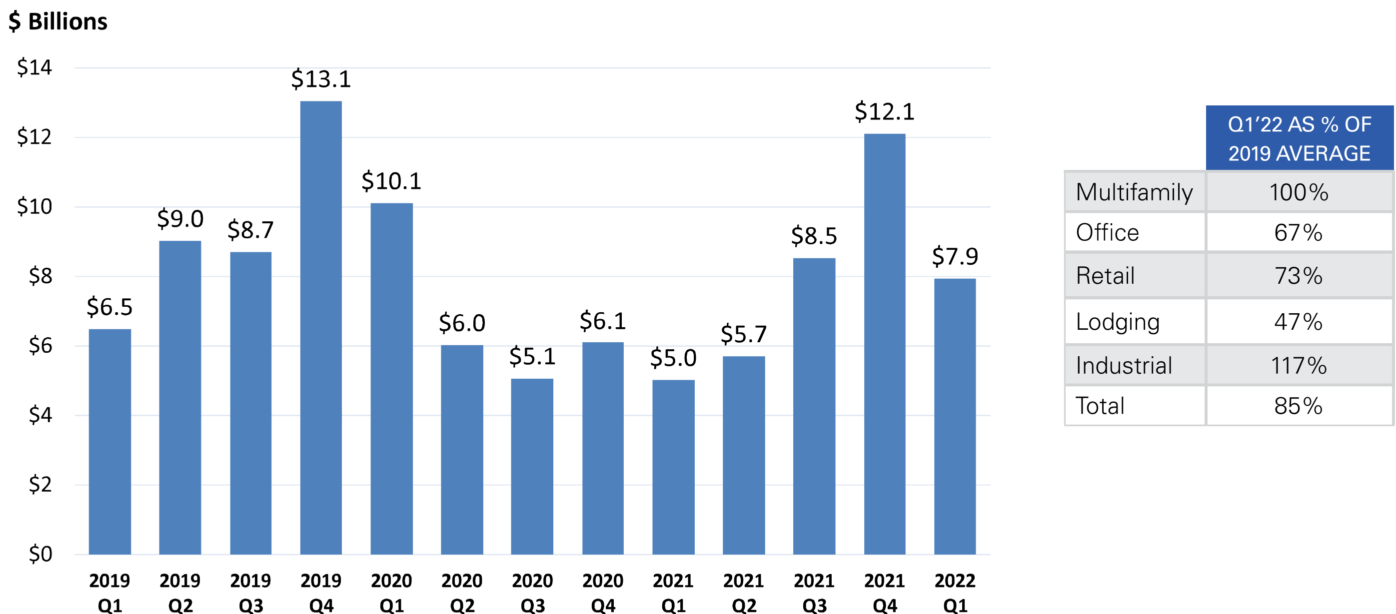
Multifamily originations were also strong – with Q1 volume matching the average pace during 2019. Despite increased concerns about the risk levels of some existing loans, multifamily is still seen as a safe sector and loan performance has been strong throughout the pandemic. Banks are competing with other lenders – especially the GSEs – so liquidity within the multifamily sector is high.

Office origination volume dropped in Q1, running about 1/3 lower than the average volume in 2019. Rising delinquency rates have reinforced lender concerns about the longer-term outlook for office. Despite the relative drop from pre-pandemic activity, the office sector is still the largest non-residential component of CRE lending.

Retail originations in Q1 were at 73% of their levels in 2019. As one of the hardest-hit real estate sectors in the 2020 downturn, lenders have been treading cautiously.

Lodging activity was a little under half the pre-pandemic pace. Lenders are still treating the lodging sector with care and are scrutinizing new deals carefully.

FIGURE 4: COMMERCIAL MORTGAGE ORIGINATION VOLUME: MULTIFAMILY AND INDUSTRIAL SURPASS PRE-COVID PACE



	Q1'22 AS % OF 2019 AVERAGE
Multifamily	100%
Office	67%
Retail	73%
Lodging	47%
Industrial	117%
Total	85%

Source: Trepp T-ALLR

Looking Ahead – Inflation and Higher Interest Rates, Recession Risk

Interest rates have risen significantly since the beginning of the year, driven by the highest inflation in forty years. In an effort to dampen demand and higher prices, the Fed has raised the Fed Funds rate by 150 basis points since March, and more rate increases are expected. The 10-year T-bond yield has responded by jumping 120 basis points since February.

Asset prices have felt the impact of higher rates, with stock market indices falling into bear market territory. Other asset prices have fallen as well, most notably cryptocurrencies which have fallen by 50% or more from their peak values. Commercial real estate prices have shown signs of softening. Cap rates have risen by approximately 50 basis points since the beginning of the year.

With rising rates and falling asset prices, the fears of recession have increased. For now, most economic indicators are positive. Job growth has been strong, and the unemployment rate has fallen to roughly where it was prior to the onset of the Covid pandemic. Both consumer spending and industrial production have been growing. However, large firms have recently shown signs of slowing the pace of hiring and spending on large-ticket items, such as cars and housing may be easing. If the economy does indeed fall into recession, the Fed will probably feel less pressure to raise rates. But then the concerns will probably shift from inflationary pressures to falling demand and credit quality.

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About T-ALLR

Trepp's Anonymized Loan Level Repository (T-ALLR) houses CRE and C&I data from large and mid-sized commercial banks. The T-ALLR Data Feed contains anonymized loan level and period level attribute and performance information on each loan. With 7+ years of history and new quarterly originations typically exceeding $7 billion for CRE and $9 billion for C&I, T-ALLR provides the breadth and depth necessary to gain insights into market activity, identify trends, and spot emerging pockets of risk and opportunity.

The information provided is based on information generally available to the public from sources believed to be reliable.