Big Banks Distance Themselves From CRE Debt While Pouring Billions Into Reserves

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While the country’s biggest banks reported boosts in profits during the rockiest quarter for financial institutions in more than a decade, they also took steps to guard against future losses, adding billions of dollars to their reserves in anticipation of loan nonpayment and credit crunches.

These are nervous times for banks. But the nation's largest banks, while exposed to some bad CRE debt, might be able to wiggle out of it, assuming the current nervousness doesn't morph into a full-blown Great Financial Crisis 2.0, experts say.

Wells Fargo, JP Morgan, PNC and Citigroup all ratcheted up their reserves compared to last year, while assuring depositors and investors not to worry and emphasizing the relatively small portion of loans they hold related to commercial real estate, especially office.

“Given the recent focus on commercial real estate, let me remind you that our office sector exposure is less than 10% of our portfolio and is focused in urban dense markets, and nearly two-thirds of our loans are multifamily, primarily in supply-constrained markets,” JP Morgan Chase Chief Financial Officer Jeremy Barnum said during the company's earnings call in mid-April.

“There are obviously specific things here and there to pay attention to, but in the scheme of things, for us, [exposure to office] is not a big issue,” Barnum said.

Overall in Q1 2023, the New York-based bank posted a profit of $12.6B, up from $8.3B a year earlier, on revenue of $38.3B. JP Morgan also nearly doubled its credit loss provision, to $2.3B from $1.5B one year ago, according to its first-quarter financial report. It’s unclear how much of that is set aside for dealing with problem real estate loans.

“My sense is that it might not have the impact on banks that some people are trying to scare-monger,” MSCI Research Executive Director Jim Costello said, pointing out that even when smaller banks are considered, the banking industry has provided only about 27% of CRE loans.

“There have been a lot of people quoting the figure that 70% of commercial real estate lending is from banks,” Costello said. “That's totally bogus. It's a case of innumeracy on the part of the reporters, and you can quote me on that.”

Varying figures tallying banks’ exposure to commercial real estate have come out in recent months, including those estimating that 70% to 80% of CRE loans are held by regional banks. Larger banks, with huge coffers and service lines that include credit cards, private equity and wealth management, are less exposed as a percentage of their overall business.

Still, some CRE-related losses are likely.

Commercial loans set to expire in 2023 total around $400B, with office assets serving as collateral for roughly one-quarter of those loans, according to MSCI. At the end of 2022, nearly $40B of office properties had a high probability of distress, more than any other asset class.

Wells Fargo, in reporting its Q1 2023 earnings, said it added $643M during the quarter to its reserves to cover potential loan losses, with a portion of that total included specifically for commercial real estate loans associated with office assets.

“The office market continues to show signs of weakness due to lower demand, higher financing costs in challenging capital market conditions,” Wells Fargo Chief Financial Officer Mike Santomassimo said during his company's earnings call.

“While we haven't seen this translate to meaningful loss content yet, we expect to see more stress over time,” Santomassimo said. “We have been derisking the office portfolio, which resulted in commitments declining 5% from a year ago, and we continue to work with borrowers to manage our exposure, including structural enhancements and paydowns as warranted.”

Wells Fargo also reported a jump in profits, bringing in $5B for the first quarter, up 32% from a year ago, on income of $20.7B, up from $17.7B a year ago.

At PNC, nonperforming loans declined 13% from last year, according to its financial results. Even still, the company boosted its reserves by $235M after removing $208M in the same quarter of 2022.

“While credit quality is strong across the majority of our CRE book, office as a segment is receiving a lot of attention in this environment,” PNC CFO Robert Reilly said during the company's earnings call.

At the end of the first quarter, PNC had $8.9B or 2.7% of its total loans in its office portfolio, Reilly said.

“Reserves against these loans which we have built over several quarters now totals 7.1%, a level that we believe adequately covers expected losses,” he said.

Pittsburgh-based PNC reported a profit of about $1.7B for the first quarter on revenue of $5.6B, up from $1.4B a year ago, when revenue came in at $4.7B.

First-quarter reporting for the nation's largest banks is mostly done. Over the next two weeks, regional and community banks will report, letting the market know whether or not they, too, will be able to cope with CRE losses.

And while banks gird for choppy waters, others await the deals that are likely to come for troubled properties.

“Credit losses for commercial real estate loans at banks have been fairly muted to date, despite some of the headlines surrounding SVB and Signature,” Morning Calm Management CEO Mukang Cho said.

As banks look to shore up liquidity in an environment in which prudence means deleveraging and raising cash, Cho said, they will turn away from weaker commercial real estate assets. Morning Calm is planning to take advantage of the trend, recently launching a $500M venture to finance office assets, either through origination or secondary purchases.

“For many legacy lenders, including banks, this will also mean that they will dispose of portions of their book, often at meaningful discounts,” Cho said. “We expect the appetite for banks to rebalance their portfolios away from office assets will be fairly high.”

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