



Here's The Domino That Could Kickstart Another Banking Crisis

Will Kessler

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- Smaller banks hold a disproportionate amount of commercial real estate loans compared to all other loans, according to data from the Federal Reserve.
- Higher vacancy rates for commercial properties following the COVID-19 pandemic have stifled demand in the sector, while high interest rates have raised costs, leading the developers to run a higher risk of default, according to experts who spoke to the Daily Caller News Foundation.
- “My view is that the commercial property market is a slow-moving train wreck that is going to have a major adverse effect on the regional banks,” Desmond Lachman, a senior fellow at the American Enterprise Institute, told the DCNF. “That, in turn, could derail the economic recovery and force the Federal Reserve to cut interest rates in a big way.”

Small and mid-sized banks could face another crisis due to their outsized investment in the commercial real estate sector, which is struggling under the weight of a lack of demand and high interest rates, experts told the Daily Caller News Foundation.

Small banks, defined as those outside the top 25 in assets, hold only 36% of all loans but own around 70% of commercial real estate loans, according to Federal Reserve data reviewed by the DCNF. Smaller banks' exposure to the struggling commercial real estate sector poses a significant risk in terms of triggering another banking crisis, as those banks rely on returns from indebted developers that they might not be able to payout, experts told the DCNF. (RELATED: China's Real Estate Collapse Infecting Troubled American Sectors)

“My view is that the commercial property market is a slow-moving train wreck that is going to have a major adverse effect on the regional banks,” Desmond Lachman, a senior fellow at the American Enterprise Institute, told the DCNF. “That, in turn, could derail the economic recovery and force the Federal Reserve to cut interest rates in a big way. The basic problem for the commercial property market is the record high vacancy rates that have resulted from the increased post-COVID trend for people to work at least part of the week at home rather than at the office.”

Around \$2.81 trillion in commercial real estate loans are set to come due through 2028, when firms will have to decide whether to pay off the loan in its entirety or refinance at a higher

interest rate. A total of \$544.3 billion in commercial real estate loans came due in 2023, the largest amount ever, which led many developers to refinance under the current costly credit conditions.

Interest rates for commercial real estate loans are being swollen by hikes to the federal funds rate by the Federal Reserve, which is currently sitting in a range of 5.25% and 5.50%. Developers could soon see some relief with the Fed projecting that the federal funds rate will be cut to around 4.6% this year.

Vacancy rates for commercial real estate have spiked due to a drop in demand as a result of inertia from COVID-19 work-from-home pushes as well as online shopping. Office vacancies have seen the biggest increase, rising from around 13% in 2019 to 20% in the third quarter of 2023.

“It is now expected that property prices will decline by around 40 percent,” Lachman told the DCNF. “That means that a \$3 trillion market will see some \$1.2 trillion in value evaporate. This, together with high interest rates, will make it difficult for the property developers to roll over the \$500 billion a year in property loans that fall due over the next two years. That will pave the way for a wave of property loan defaults. While the banking system as a whole will take a big hit, it will be the regional banks that will be the ones that are most damaged.”

Commercial mortgage-backed security delinquencies are projected to rise from 2.25% in November 2023 to 4.5% in 2024 and 2.9% in 2025, according to Fitch Ratings.

More banks could follow the path of the now-defunct Silicon Valley Bank (SVB), which kicked off a string of bank failures in early 2023 after depositors panicked and triggered a bank run, resulting in the bank’s collapse and an acquisition by the Federal Deposit Insurance Corporation (FDIC). First Republic and Signature banks followed SVB, as fleeing depositors also triggered a collapse.

“We just saw the near-death of New York Community Bank, which appears to have been saved by deposit transfers from other banks,” Peter St. Onge, research fellow in economics at the Heritage Foundation, told the DCNF about the possibility of more bank failures. “But, absolutely, there are roughly \$300 billion of [commercial real estate] loans at regionals, making up about 30% of their balance sheets. Many have lost half or more of their value. So, absolutely, it’s a live risk.”

New York Community Bank (NYCB) acquired Signature following its collapse but recently unveiled a dismal earnings report showing losses related to the bank’s huge exposure to commercial real estate, according to The New York Times. As a result, the bank’s stock declined by nearly two-thirds as investors deemed the bank a risky bet.

Some economists are more optimistic about the health of the banking system, with Norbert Michel, vice president and director of the Cato Institute’s Center for Monetary and Financial Alternatives, telling the DCNF that the trouble in the banking sector is an exaggeration.

“There’s no particular reason to think that the banking system is not well capitalized,” Michel told the DCNF. “That said, there’s just no way to know for certain whether some sector of the economy might suffer a shock. There’s also no special reason to focus on real estate right now — real estate shocks have caused problems in the banking sector for more than a century. The good news is that pundits have predicted ten of the last two bank failures that were caused by real estate problems.”

The number of depositors at NYCB remained roughly steady following the announcement, avoiding a panic and a possible bank run, according to the NYT. Many depositors may have fled following the news, but money from other lenders may have shored up the bank’s books.