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A worsening US office market might erode the credit quality of the US CRE sector and banks

by Wang Chenye

- **NUS-CRI Agg PD for the US office developers and REITs increases as property values decline and concerns over credit accessibility grow**
- **NUS-CRI Forward PD for the US commercial real estate sector and US banks also increases given the latter's exposure to distressed office loans and possible spill-over effects**

The United States commercial real estate (CRE) market, one of the world's largest CRE markets, has experienced notable defaults and losses since 2023. These challenges have primarily stemmed from increased borrowing costs and refinancing hurdles faced by the industry, as highlighted by NUS-CRI's weekly credit brief in Feb-2023. Particularly hard-hit by this credit crunch are office property owners, constituting the largest sub-sector within the commercial real estate market in the US. To provide a comprehensive view of this multi-tiered CRE market, we have expanded our analysis to include Real Estate Investment Trusts (REITs). REITs, functioning as active and substantial commercial property owners[1], play a pivotal role in infusing liquidity into the real estate market and facilitating price discovery, thus their NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) serves as a potential reflection of the overall credit health of the wider US commercial real estate market.

The Agg PD for US office developers and REITs has been increasing since Jan-2022 closer to the BBB+ upper bound when referenced to PDiR2.0 bounds[2] during the banking crisis, mainly due to the growing concerns regarding the CRE industry's access to credit from the banks amidst the market downturn. Meanwhile, US banks, being the main lender to the CRE industry, are faced with declining collateral values and worsening asset quality, with their Agg PD surging after SVB's collapse and then hovering around the BBB+ upper bound. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[3]) in Figure 1b shows the deteriorating trends for both the US office developers & REITs' and US banks' credit quality, suggesting that a persistently tight monetary environment, in conjunction with the slowdown in the commercial real estate market, is likely to further pressure the credit risk profile of both industries.

[1] The REITs in the sample shown in Figure 1 are property owners (equity REITs), which means the mortgage REITs that only invest in real estate mortgages or related securities but do not own the properties themselves are not included in the sample.
[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates
[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

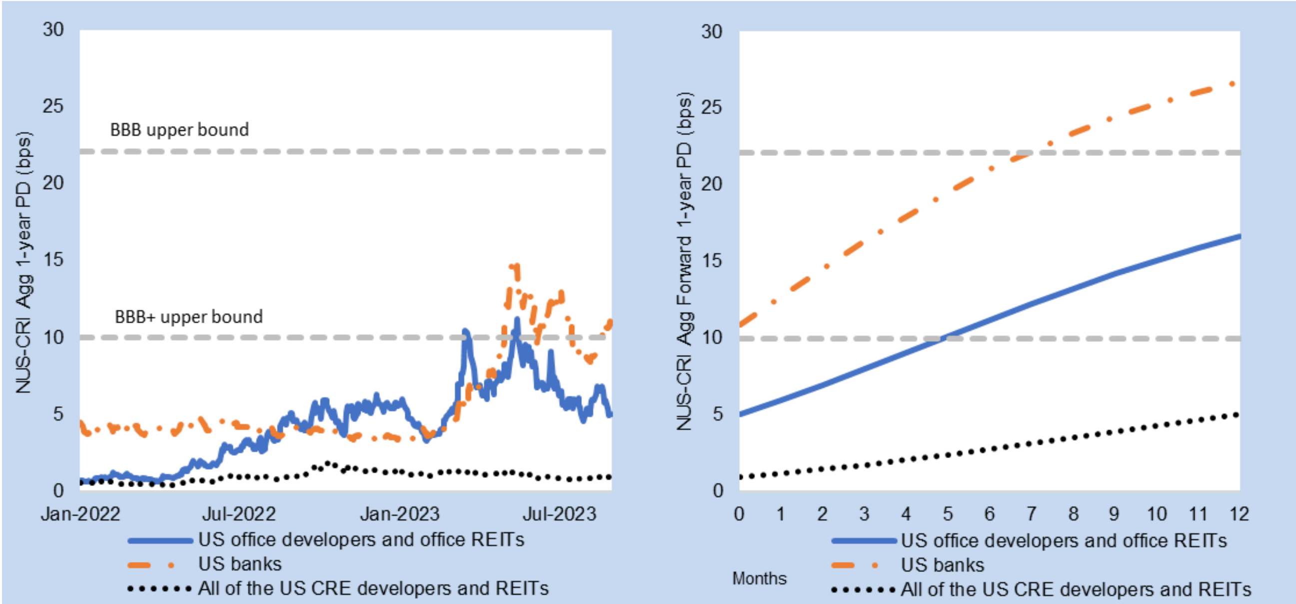

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for US office developers and office Commercial Real Estate Investment Trusts (REITs), all of the US commercial real estate developers and REITs, and US banks with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for US office developers and office REITs, all of the US commercial real estate developers and REITs, and US banks with reference to PDiR2.0 bounds. *Source: NUS-CRI*

In addition to the worsening credit conditions, the significant structural demand contraction following the pandemic has emerged as a primary catalyst for the decline in office property values and the subsequent increase in CRE security defaults. The office REITs index continues to decrease in tandem with the Fed's rate hike cycle, hitting a 14-year-low in Apr-2023. As shown in Figure 2a, both the office REITs index and the mortgage REITs index fell during the Fed's rate hike cycle; however, the office REITs index is much more susceptible to the rising interest rate due to the significant value declines of the underlying assets and refinancing pressures, along with a structural shift in working patterns post the COVID-19 pandemic. Conversely, mortgage REITs stand to potentially benefit from the increasing interest rates as they may expand their interest margin. Moreover, they tend to be less affected by the depreciation of underlying asset (not only office properties) values since they do not possess direct ownership of these properties. Additionally, other sub-sectors of the US CRE industry, however, may have a different story. Industrial properties including warehouses and logistics facilities experienced strong rent growth, while data center demand also thrived. As a result, office property owners are among the hardest hit of all commercial real estate players as they are contending with oversupply, high levels of debt and leverage, and a heightened sensitivity to interest rates. The divergence in the Agg PD between US office owners and the broader US CRE sector, as shown in Figure 1a, serves as a clear reflection of these challenges.

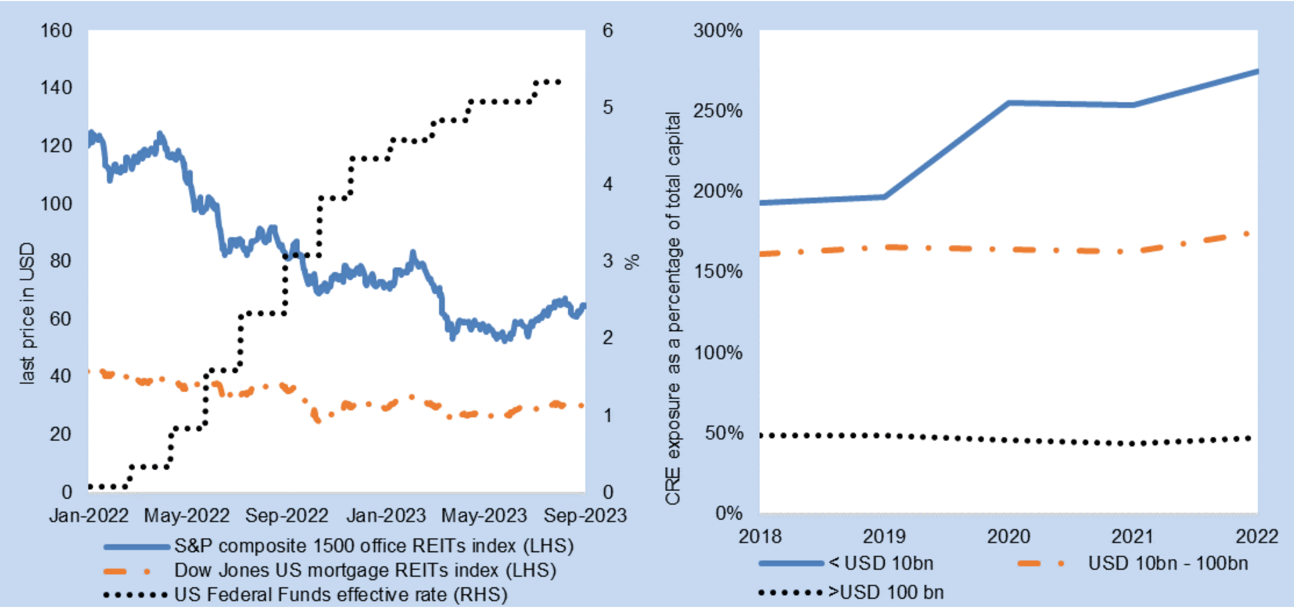

Figure 2a (LHS): S&P composite 1500 office REITs index, Dow Jones US mortgage REITs index and the US Federal Funds effective rate. Figure 2b (RHS): CRE exposure as a percentage of the total capital for banks with total assets less than USD 10bn, between USD 10bn - 100bn and more than USD 100bn, from 2018 to 2022. *Source: NUS-CRI, Fitch Ratings*

Bank types	Holding percent of total CRE loans outstanding (%)	Holding volume of CRE (in tn USD)	Holdings of office and downtown retail CRE (in tn USD)	Total assets held (in tn USD)
Category I banks (U.S. G-SIBs)	8	0.28	0.1	14.3
Category II-IV banks	9	0.34	0.11	6.8
Other	43	1.55	0.51	7.4
Total	61	2.17	0.72	28.5

Table 1: US banks' exposure to the CRE market as of the end of 2022. *Source: Federal Reserve*

The latest financial stability report released by the Federal Reserve reveals that US banks have a substantial total exposure to CRE exceeding USD 2tn, which accounts for 61% of the total outstanding CRE loans in the market (see Table 1). Notably, office loans make up a significant portion of the banks' CRE investments, comprising around 30% and more than USD 300bn of them are at-risk debt. The delinquency rate for office loans experienced an increase of 124bps over the previous quarter, reaching 4.47%, with USD 1.63bn of newly defaulted office loans in Q2-2023. Within the banking system, the CRE exposure varies according to the size of the bank. The US-domiciled Globally Systemically Important Banks (G-SIBs) only held 8% of the total CRE loans at the end of 2022, which makes these large banks' CRE exposure as a percentage of their total capital much smaller than that of other banks over the past 5 years (see Figure 2b), thus suggesting greater resilience, compared to their smaller counterparts, to weakening asset quality stemming from their CRE exposure. The relatively smaller US regional banks are also faced with tighter regulatory requirements after the banking crisis and might be forced to sell the troubled office loans at a steep discount, potentially resulting in higher losses.

The office property market's downturn is poised to persist, marked by an escalating vacancy rate and declining property values. With more than USD 300 bn in at-risk loans set to mature by the end of 2025, office property owners are grappling with substantial refinancing pressures. This situation, in turn, heightens the default risk for their primary lenders, the US banks. While the spillover effects of the distressed office property sector may currently be contained, the scenario might change if credit conditions continue to tighten given that nearly half of the CRE loans are floating-rate loans. This may result in added pressure on the credit profiles of not only the entire US real estate sector but also US banks, as indicated by the Forward PD in Figure 1b.

Credit News

US borrowers seek to ease pain of higher yields with secured debt

Aug 31. Amidst elevated borrowing expenses in the US junk bond market, borrowers are increasingly opting for secured debt to facilitate transactions. In 2023, nearly 66% of the total junk bonds issued, amounting to USD 70bn, have been backed by collateral. This marks the highest proportion on record, as per Pitchbook LCD data spanning 18 years, with the previous highest share in 2019 standing at just over a third. This shift highlights companies' innovative financing approaches amid challenging market conditions and rising borrowing costs, driven by the Federal Reserve's efforts to combat inflation through interest rate hikes. (FT)

Country Garden gets approval to extend yuan bond repayment

Sep 02. Chinese property developer Country Garden has received approval from creditors to extend the maturity of a maturing CNY-denominated bond worth CNY 3.9bn (USD 537mn) until 2026. This approval helps Country Garden avoid its first-ever default, amid China's ongoing liquidity crisis in the property sector. The company recently posted an unprecedented net loss of CNY 48.9bn for H1 2023 and warned of possible default. Country Garden still faces significant debt obligations totalling up to USD 2.9bn later this year. Its struggles highlight the broader challenges faced by China's private-sector developers as they grapple with the ongoing property debt crisis and government measures to curb speculation. (Bloomberg)

Europe’s retail bond rush shows household savers’ clout

Sep 03. In recent bond sales, European governments are increasingly turning to households as a means of navigating a high-interest-rate environment. Countries like Belgium aim to strike a balance by offering attractive interest rates to their citizens while reducing sovereign borrowing expenses. Such bond sales also incentivize banks to provide higher interest rates on deposits, which is particularly significant in the UK. A bond with a yield significantly above the prevailing market rate was recently sold in the UK, intensifying competition and prompting banks to better align with recent central bank rate hikes. This shift signifies that Europeans are eager to move away from zero or even negative interest rates, and it underscores ordinary citizens' appetite for higher-yield investment options. (Bloomberg)

Chinese lenders extend billions of dollars to Russian banks after western sanctions

Sep 04. Amid Western institutions pulling back their operations in Russia due to international sanctions and political pressures, four of China's largest banks significantly increased their exposure to Russia's banking sector. The Industrial and Commercial Bank of China (ICBC), Bank of China, China Construction Bank, and Agricultural Bank of China raised their combined exposure to Russia from USD 2.2bn to USD 9.7bn between January 2021 and March 2022. This shift highlights China's efforts to promote the renminbi as an alternative global currency to the US dollar. Concurrently, Austria's Raiffeisen Bank, the foreign bank with the largest exposure to Russia, increased its assets in the country by more than 40%, from USD 20.5bn to USD 29.2bn, despite the bank pledging to reduce its exposure in the country due to the sanctions it faces. (FT)

China tries to defuse local debt risk with USD 200bn refinancing tool

Sep 02. China is introducing a new bond issuance scheme that allows certain local governments to refinance the debts of struggling infrastructure developers. This move aims to address the risks associated with off-balance-sheet debt held by local governments. Much of this concealed debt originates from entities known as local government financing vehicles (LGFVs), which were established to finance infrastructure projects like roads. The special refinancing bond program is expected to have a scale of USD 206 bn. (Nikkei)

South Korea kicks off historic samurai bond sale in Japan (Bloomberg)

Regional banks ready a wave of bond issuance (Bloomberg)

Country Garden has wired ringgit bond coupon (Bloomberg)

Regulatory Updates

Swiss regulator needs more powers to deal with bank crises, experts warn

Sep 01. A government-appointed panel of financial experts has concluded that Switzerland's market regulator, Finma, lacks the power needed to adequately handle banking crises. The report, delivered to the Swiss finance ministry, states that Finma's authority is weak compared to international peers, making it challenging to enforce its will on the banking sector. It suggests that the Swiss government should explore changes to the law to grant Finma greater powers, including the ability to issue fines and publicly name and shame banks and individuals subject to enforcement proceedings. The report comes after the near-collapse of Credit Suisse earlier this year. (FT)

Russia central bank head not ruling out rate hike, against tighter currency controls

Sep 01. Russian central bank chief, Elvira Nabiullina, has indicated the possibility of further interest rate hikes as a measure to counter persistent inflationary risks. She emphasized that adjusting interest rates is more likely to support the Russian. The central bank had recently increased its key interest rate by 3.5 percentage points to 12% during an emergency meeting on August 15. This move aimed to mitigate the sharp depreciation of the Ruble, which had been adversely affected by Western sanctions impacting Russia's trade balance and a surge in defense expenditure. The central bank's decision to raise rates was prompted by an average annual inflation rate of 7.6% over the previous three months, well above its 4% target, and it acknowledged the ongoing upward pressure on inflation. (Reuters)

China central bank to cut FX reserves ratio (WSJ)

Gary Gensler unleashes biggest SEC regulatory blitz since financial crisis (FT)

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