Beware of Old CRE Assumptions

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A recent Promontory Interfinancial Network survey of CEOs and CFOs at more than 550 banks confirms that the most worrisome segment of loan portfolios at banks both large and small is Commercial Real Estate. Hotel and retail property loans are understandably the biggest concerns. But the long-term risk of other CRE segments, including some long considered to be among the safest, has increased not because of the pandemic itself, but because of societal and business adjustments to it.

More people than ever are working remotely. Distance learning is suddenly widespread. Virtual meetings of all types and sizes are commonplace. These and other innovative pandemic responses have developed rapidly in the past few months. Their use may decline in a post-pandemic world, but they aren't going away completely. They are already altering some long-standing loan underwriting assumptions, and banks need to take note immediately.

Underwriting improved CRE has always included a fundamental consideration of the property type's inherent risk. In general, those considered to be among the safest were medical office buildings and student housing. Somewhere in the middle was general office space and multifamily, and toward the bottom were unanchored retail strip centers.

Obviously, there are many other layers. Specific property attributes, lease terms, borrower financial condition, property value, etc. have and will continue to receive the bulk of underwriting attention, but that fundamental starting point of higher v. lower inherent risk by property type is changing.

Large scale remote employment will keep large numbers of workers from returning to a centralized corporate office any time soon, if ever. Despite the challenges of managing a remote workforce, many companies are committing to a virtual office, with substantial rent savings being the most common justification. If those savings are large enough, even a COVID-19 vaccine may not be enough to scuttle the remote model. Those recently announcing that most of their staff will be working remotely for at least another year include CNBC, Google, and Forbes. That could all leave a lot of Class A office space dark.

At the community bank level, many small law firms, accounting firms, etc. whose staffs are largely working from home may also cut back on permanent space to save on rent. That will translate to higher vacancy rates and corresponding loan default rates for a large number of smaller office properties.

Medical office has long been considered a low risk collateral type. But the explosion of virtual medicine is now threatening that assumption for many non-surgical, non-dental practices.

Physicians that have reduced or eliminated seeing patients in person have turned to apps like FaceTime to bridge the gap. Those doctors can certainly go back to only seeing patients in-person post pandemic. But why should they? Practitioners find virtual consultations more efficient, patient acceptance is growing, and thus many medical practices could need less leased office space. Some may decide they don't need any. That could leave a lot of medical office properties dark.

Off campus student housing has long been low risk collateral because it was a cash cow with high historic demand, sometimes in spite of less than optimal physical condition. But what if that demand was permanently reduced by distance learning? Harvard, Princeton, and Georgetown announced in July a shift to at least 50% remote instruction for the 2020-2021 academic year. If that results in cost savings for the schools, and it obviously will for parents who pay for the housing, that model could have substantial long-term staying power. That could leave a large amount of off-campus student housing, a segment largely financed by community banks, in the dark.

The highest provision for loan loss expense (either already recognized or soon to be) that many banks have seen in a decade, continued net interest margin shrinkage, and a recent surge in deposit levels have left many banks feeling pressure to grow their loan portfolios. This is especially true for community banks with limited non-interest income.

Those that pursue increased lending against any type of improved CRE should consider significantly expanding their internal underwriting resources, modifying their policies & procedures, and re-thinking basic assumptions that were set in stone for decades but are now being permanently altered by remote working, learning, and living.

Financial institutions have made their own remarkable, difficult, and expensive pandemic adjustments to deal with unprecedented short-term threats. But all of that blood, sweat, and tears will be for nothing if banks, especially community banks, cannot identify and address new and different long-term underwriting risks as they emerge in the wake of the pandemic.

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