Smaller Banks' Exposure To Commercial Real Estate - Banking Sector Update

The commercial real estate market, over the past three years, has struggled with a critical factor that is vastly changing the security it previously held. Following the pandemic, there has been a massive change in the way people work, live, shop, and navigate their surroundings. This issue has been furthered by rising interest rates, which have increased the risks of defaults on mortgage loans and may structurally change the market.

Remote work has drastically changed how corporations view the importance of office space, and with more companies shifting toward a permanently remote form of work, office vacancies are expected to rise significantly. With $2.6 trillion of commercial mortgages expected to mature in the next four years, landlords who previously benefitted from long-term leases may begin to find it more difficult to replace their previous tenants.

As mortgages mature, the U.S. office vacancy rate is expected to rise, which some analysts expect to result in a downturn for commercial property. Additionally, since the rise of remote work appears to be cementing itself as a structural change rather than a temporary choice for employers, building values may not rebound as they have in previous downturns. This coupled with the fact that small banks greatly outpace large banks in commercial real estate lending creates a more fragile market. Small banks, which are more susceptible to interest rate changes in today's bond market, historically are more likely to default on mortgage loans than larger banks.

Sources: Wall Street Journal, Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System.