Fed Still Worried CRE Poses Risk to Bank System

And interest rates cuts aren't coming until the central bank has 'greater confidence' that inflation is moving toward 2%.

By Erik Sherman

The Federal Reserve's Monetary Policy Report to Congress comes out twice a year. The first one for 2024 suggests a number of things. Two of note for the commercial real estate industry: CRE remains a factor in continued risk to the banking system and interest rates aren't coming down until the Fed has "greater confidence" that inflation is moving toward 2%.

Too bad that CRE hasn't hit bottom and while things came in as expected for the Fed's favorite metric for core inflation, the report still suggests everyone will be waiting for rate cuts. At least one former Fed economist, Claudia Sahm, has noted that July 31, 2024 is likely the earliest possible date for a rate cut. FOMC [Federal Open Markets Committee, which sets rates] votes on July 31, giving it six months of CPI, core PCE, and employment for 2024, he writes. "Six months is a nice, responsible-sounding number."

And it is, except that at the January 31 press conference after that FOMC meeting, Chair Jerome Powell seemed to indicate something longer than six months. Maybe 9 to 12 of "good" economic data. While the Fed didn't mention CRE as an explicit factor in inflation, shelter — multifamily rents and the rent equivalent for homeowners — has been a major force in inflation calculations. Supposedly a lagging metric, it has yet to begin a big drop in government figures. That is still likely to happen as rent growth has slowed and even moved in a negative direction in many metro areas.

Then there is the impact of CRE on the banking system. ""Vulnerabilities in the financial sector remain notable, as losses in the fair value of long-dated bank assets remain significant," they wrote. Risk-based capital ratios are "well above regulatory minimums, driven both by robust bank profitability and by a decrease in shareholder payouts at the largest banks."

However, while "credit quality at banks remained strong," the "quality of CRE loans backed by office, retail, and multifamily buildings continued its decline." The Fed says that is a result of the shift toward telework lowering demand for downtown real estate, but it also notes that there is more going on than a desire not to commute to central business district offices.

"Commercial real estate (CRE) prices continued to decline, especially in the office, retail, and multifamily sectors, and low levels of transactions in the office sector likely indicated that prices had not yet fully reflected the sector's weaker fundamentals," they wrote. "Some smaller regional and community banks with high concentrations of CRE loans are also highly reliant on uninsured deposits, potentially compounding vulnerabilities."

Translation: portfolios of loans are based on properties with falling valuations, which reduces the values of the loans, opens the potential for an inability to refinance, and further pushes on the how long banks can carry loans at full original value on their balance sheets.