Goldman Sachs The Markets

Regional banks back in focus on real estate concerns

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Sam Grobart: It's been nearly a year and regional banks are back in the news again. This is The Markets.

Hi, I'm Sam Grobart. Today I'm joined by Ryan Nash, managing director in the Financials Group within Global Investment Research here at Goldman Sachs. Ryan, thanks so much for joining us today.

Ryan Nash: Thank you for having me.

Sam Grobart: Ryan, I just want to set the stage here. It's been nearly a year since the collapse of some regional banks. And they're back in headlines again with some concerns about their exposure to real estate, both commercial, and now it seems maybe a little bit residential. So, help us understand. Is this a continuation of last year's crisis? Is it a repeat of the crisis? Or is it something entirely

different?

Ryan Nash: It's not a repeat. But it's really a byproduct of what happened last year. And I would say you've got to go back and think about the context of where we were at that point in time, 2023 versus today.

The macro environment was a lot less certain. Now we're talking about a soft landing relative to a hard landing. And really, we were talking a lot about the potential for contagion. And the events of that point in time really led to an onslaught in competition at a time that was already really intense.

Now, if you think about it, the banks that failed shared a couple of characteristics. They had highly illiquid assets that they couldn't sell because they were meaningfully underwater. They had highly sophisticated depositors with almost no uninsured deposits. And they didn't have enough short-term liquidity to be able to outstand deposit outflows.

This time it feels very different. We're talking about one or two idiosyncratic instances of banks that crossed

regulatory thresholds that are now subject to heightened regulation.

Sam Grobart: They just got bigger, is what you're saying.

Ryan Nash: They just got bigger. And they were in very specific markets that regulators had concerns about. So, we don't think this is a repeat. We think it's a byproduct. And we think the industry, at this point, is still in reasonable shape. And we'll see that emerge as we move through 2024.

Sam Grobart: So, let's talk about real estate, both commercial and residential. How is that playing out in regional bank balance sheets? And how widespread of an issue is it?

Ryan Nash: As we went through 2023 and we got to the latter part of the year, the risks of office looked like they were spilling over into multifamily. Now, interestingly enough, residential real estate at this point in time isn't really a huge area of concern. If you think about it, there are lots of loans that have really low interest rates because

lots of consumers refinanced. But those who were not homeowners, you've been forced to rent in markets where rents have really gone up a lot.

Now, I would say the fact that long-term interest rates have come down a lot has been a big help to the overall sector. Now, office has been a challenge. And that's because there have been both cyclical and secular issues. Return to office is still lagging in a lot of parts of the country. And higher interest rates have put pressure on both values and debt service costs.

Now, the good news is lots of banks have high reserves in this area. But we do expect losses to continue for several years.

Multifamily is clearly an area that we are watching. But I think this is much more specific to the markets and the property. This is much more of a cyclical issue. Keep in mind, we still have a shortage of housing, particularly on the low-end part of the market.

Now, even within multifamily, there are sub pockets, right? And rent stabilized, which is clearly a part that has been a

focus in the more recent, I'll say, concern area, values have fallen there given the pressures from inflation and debt service coverage. However, if you look across the broader US, values have risen. We've had good wage growth. And population growth has happened in a lot of these markets where there's been a lot of building.

So, you know, to put it all together, we're clearly watching commercial real estate. We have an eye on multifamily as an area where there could be higher losses. But nothing that we think is going to be widespread at this point.

Sam Grobart: So, that brings me to my next question which, of course, is what everyone else worries about, that one particular corner of the industry can affect the larger banking industry. Is there any real risk of spillover here to larger banks?

Ryan Nash: So, we think the answer to that is no. Now, I think it makes sense to give some context as to why. If you think about it, our main concern from a credit perspective now lies within commercial real estate. Now, if you think about it, commercial real estate is about 20 percent of loans in the banks that we cover. The higher risk stuff is

just below 10, right, if you think about it. 6 percent in multifamily and 3 percent in office.

Now, if you were to bifurcate that across the banks that we look at, roughly 25 percent of the loans for banks below 100 billion are in commercial real estate. And about 13 or 14 percent for banks that are above 100 billion. So, the smaller the bank, the more exposure their risk to commercial real estate. And just for context, over 70 percent of commercial real estate loans in the banking industry sit with banks below $150 billion in assets. In the banks that we saw come under pressure, those exposures were much, much greater.

Also, you've got to think about it in the context of reserving, right? So, the average bank that we look at has a reserve around 7 percent in their office portfolio. And we've estimated about 1.5 to 1.75 percent in multifamily. Banks that have come under stress have been meaningfully below that. So, call it 2 percent in office that went to 8. And 40 basis points in multifamily that was taken up to 80.

So, when I put all that together, we think the larger banks are in very good shape. And while we expect losses to be

higher in 2024 than they were in 2023, we don't expect them to be outsized.

Sam Grobart: It's obviously a continuing story. Ryan, what are you going to be looking at in the days and weeks ahead?

Ryan Nash: I would just say, look, a couple of things that we're really focused on. One thing that has become clearer over the last 18 months is things just move much faster in today's day and age than they did years ago, right? So, social media plays a much greater role--

Sam Grobart: We saw that a year ago.

Ryan Nash: Which is what we saw a year ago when that led to bank runs. So, I think the first thing that we're really looking for is just stabilization in stock prices. If you look, the KRE, which is the regional banking index, is down about 10 percent. We actually came in with a relatively constructive view this year on net interest income bottoming, credit performance being okay, and banks being able to start to grow their top lines as we move throughout the year.

So, the things that we're watching for the near-term - do banks that are facing trouble, do they start to take action? And that will include asset sales, potential for capital raising, or anything to shore up their liquidity positions. I would say the banking industry from a liquidity perspective, BTFP program is still open for another month. And banks have access to the discount window, which in theory should provide them with lots of access to liquidity. So, we shouldn't run into some of the same issues that we ran into last year.

I think the second thing is we're keeping our eyes closely on funding conditions, right? So, last year, we had a step function change in terms of the competitive forces as it pertained to funding. So, banks were expecting to have to increase to one level. It ended up being meaningfully higher.

At this point we haven't seen any change in actuality. We've actually seen it continue to ease a bit. So, that's clearly something that we're going to have our eyes on. But it's really the steps that companies that are feeling stressed are going to take, what is happening in funding markets? But

the reality is we think the banks are in a good position and we're not expecting any major changes here.

Sam Grobart: Ryan, thanks so much. Great to have you on. That does it for another episode of The Markets. Be sure to find us on Apple Podcasts, Spotify, or wherever you get your podcasts.

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