2/14/24
CRE Flashpoints

New York Community Bancorp (NYCB) has become the face of our fears around the regional banking industry. Market analysts are linking the stock plummet to macro concerns over overweight commercial real estate (CRE) loan portfolios. The outlook for the CRE sector in 2024 is grim— loans require restructuring in this high interest rate environment and the value of capital-intensive office buildings is set to tumble. What remains to be seen is whether NYCB is symptomatic of a whole sector's instability or an isolated case.

The stock plunge took place following the release of NYCB's Q4 earnings report and a reported $260 million net loss. The loss was driven by a $552 million provision to cover potential credit losses and address exposure in the office and multi-family sectors. NYCB's loan portfolio is composed of 15.8% ($13.4 B) CRE and 44% ($37.3 B) multi-family residential loans.

The good— While a surprise, unexpected loss on the accounting sheet is never encouraging, the move to address credit exposure may be a prudent move going into 2024. The process brought the allowance for credit loss (ACL) into line with peer banks. At the end of Q3, NYCB's ACL was around 0.74% of total loans. The increase in provisioning brought NYCB more into line with industry standards for ACL; NYCB's ACL in their quarterly report increased to 1.17% of total loans. Accepting a short-term loss to shore up credit risk may prove to be a prudent move. Banks who have not moved to build liquidity may find themselves in a worse position in 2024 if loans are refinanced and the value of commercial properties continues to drop. The bank has also displayed a drive to diversify. Corporate and industrial loans have doubled over 2023.

The bad— NYCB provisioning was in part a result of a dramatic increase in net charge-offs: $185 MM for Q4 against $24 MM in Q3. The charge-offs were driven by two loans: a co-op loan that NYCB is trying to sell in 2024 and a non-accruing office loan that had its valuation change. The IMF has reported an 11% percent decrease in value across the CRE sector since the start of monetary tightening in 2022.

The ugly—NYCB's 4Q Report mentions a key fact: NYCB crossed the $100 B regulatory threshold surprisingly early. The move into Category IV status pushed NYCB into more intensive risk management and liquidity requirements. The bank seemed off guard by this change; NYCB had to accelerate its provisioning and assign further capital to credit provisioning. Prior to the increased regulatory pressures, the NYCB had not stress tested their loan portfolio based on current appraisals.

Imagine this scenario. Regional banks who are overexposed in CRE and short on liquidity reserves will struggle when loans come due and are refinanced in 2024. Not all regional banks are built alike—some will fail, others will survive. The result is a large consolidation of the regional banking industry and the catapulting of a few emergent players into the Category IV regulatory scheme. Are the regional banks ready for this consolidation? The compliance will force a more accurate accounting of the value of loan portfolios. The consolidated banks will have to come to terms with the risky lending practices in the regional banking market.

ADDENDUM 03.11.24

Following our initial synopsis of NYCB's fourth quarter surprise loan loss provision and CRE exposure, material news continued to flow surrounding the regional bank. NYCB provided another "shock" when it disclosed goodwill impairments on legacy transactions and the identification of material weaknesses stemming from the internal loan review process. Regional banks were under further scrutiny given the latest unsettling announcements. A few days later the situation stabilized from a creditor's perspective when a group led by Steve Mnuchin's Liberty Strategic Capital agreed to inject $1.0B+ of fresh equity capital, thereby shoring up the bank's balance sheet and liquidity.

We continue to monitor the cracks in the CRE sector and anticipate more negative surprises in the regional banking sector. While recent bank difficulties (SVB, Signature, NYCB) could signal more problems ahead, it seems that these situations are due more to management foot faults as opposed to greater systemic risk in the system. Asset / Liability mismatch, suboptimal commercial loan portfolio diversification, and weak internal controls are problems that appear to be more situational at this point. The progression of CRE default and restructuring activity (frequency and severity) will be a key risk factor to monitor for some time as markets evaluate the potential for recession later in 2024 or next year.

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