



WHITE PAPER

Overcoming Balance Sheet Obstacles for Regional Banks with the Rise of Zombie Office Buildings

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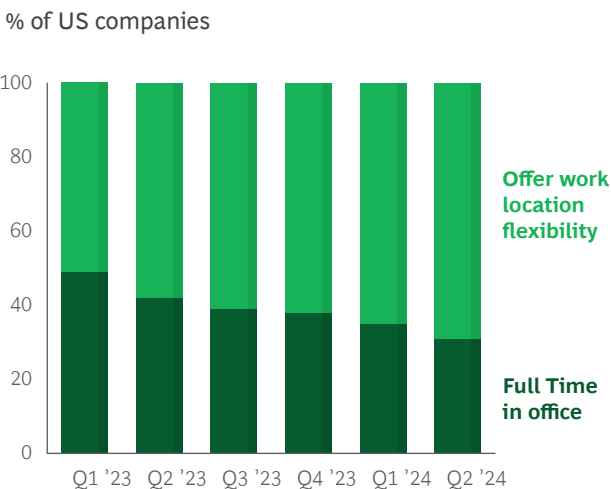
Summary

Employers in America’s busiest metro areas have committed to flexible work from home schedules. With only ~30% of employees required to be in-office every day, the need for permanent large office space has decreased substantially and much higher office vacancy rates have resulted. In last year’s article, “[Regional bank actions against the zombie building threat](#),” we first explored regional banks’ significant exposure to office and commercial real estate. In this piece we evaluate the state of workforce flexibility, examine why regional banks should prepare for defaults in their downtown office space loans, and investigate the condition of bank balance sheets, including value deterioration and acceleration. Finally, we propose five risk mitigation strategies that those banks should adopt today as part of that preparation.

Professional industries have adopted work location flexibility and workers have adapted

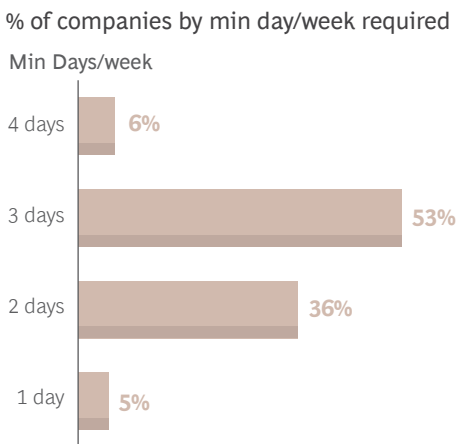
As of Q2 2024, nearly 70% of US companies provide employees with some form of work location flexibility, a proportion that has steadily risen over the past 12 months.¹ Indeed, nearly 90% of firms in some sectors such as technology, financial services, and professional services have taken the flexible route. While some companies with work location flexibility allow fully remote working, the majority of those employers have introduced a hybrid work model that requires in-office attendance for two or three days a week only.

Exhibit 1 - Work location flexibility continues to rise amongst US companies



Source: “[Flex Index](#) (flex.scoopforwork.com), Q2 2024 Flex Report”.

Exhibit 2 - Companies require employees to spend approx. half the week in the office

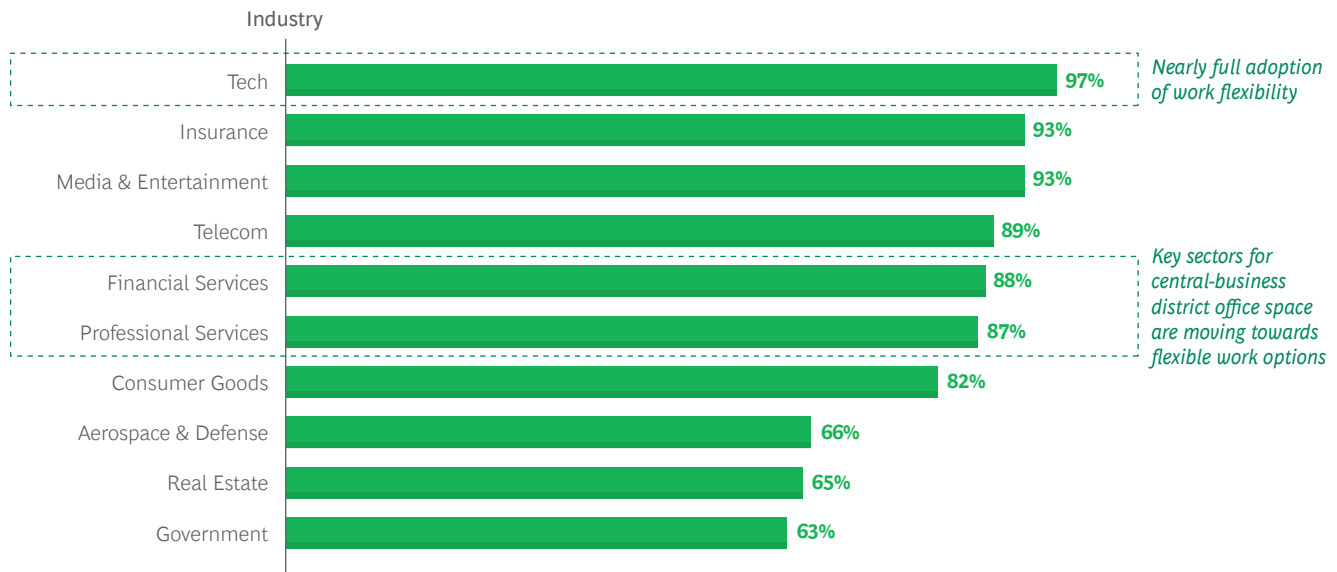


Source: “[Flex Index](#) (flex.scoopforwork.com), Q2 2024 Flex Report”.

1. MSCI RCA.

Exhibit 3 - Flexibility varies by industry

% of companies offering flexibility



Source: “Flex Index (flex.scoopforwork.com), Q2 2024 Flex Report”.

This trend has gone hand in hand with a widespread shift by families moving out of urban areas and into suburban and exurban areas. Exurbia is the region that extends even further from cities than the suburbs – think larger properties, less density, more affordable housing. In Q4 2023, more than half of the 79 primary US metropolitan districts experienced increases in residential and multi-family vacancies, with the largest metro areas bearing the brunt of this shift.³ These locations are among the nation’s fastest growing living areas in 2023 compared to 2019.⁴ While exurbs exist well outside metropolitan business districts, they’re still within the commuter shed of cities, which allows hybrid employees to make the trek when necessary. This movement of the work force bifurcates the exurb/suburban and urban areas – most dramatically affecting city centers of major metros.

2. Cushman & Wakefield.

3. Moody’s - Q4 2023 Preliminary Trend Announcement.

4. US Census Bureau “More People Moved Farther Away from City Centers Since COVID-19”.

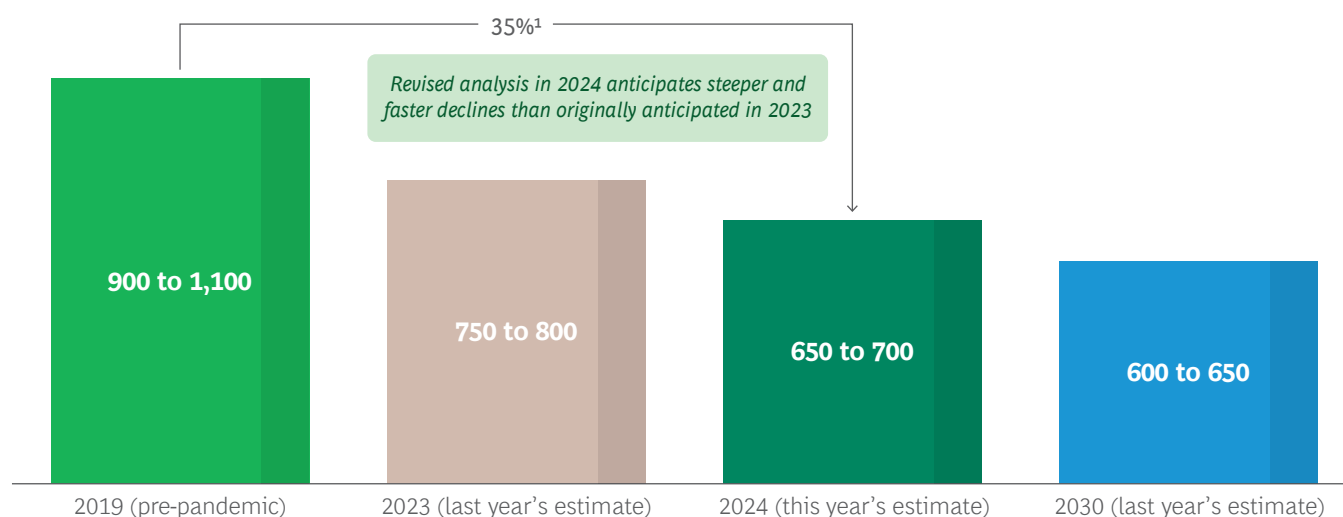
Struggling office assets disproportionately affect regional banks; other commercial real estate assets are stable or rebounding

As the need for office space in city centers decreases, banks with concentrated commercial real estate (CRE) office exposure face significant risk. Research shows that office assets are at higher risk than other CRE assets, and default rates are at the highest levels in 10 years. In Q4 2023, the national vacancy rate skyrocketed to a record high of 19.6%, surpassing pre-pandemic levels by 280 basis points. In 2024 and 2025, leases totaling over 200 million square feet of office space are set to expire.⁶ Looming renewals pose significant risk as many tenants are expected to downsize or not renew at all.⁷

We are already starting to see the effects of exposure to office – illuminated in a refresh of our analysis projecting devaluations in office property values by 2030 versus pre-pandemic levels in 2019. Last year we estimated losses in property values of 45% by 2030, and our revised analysis suggests that 90% of this devaluation will have already taken place by the end of this year. This implies an even worse outlook for office with deeper and faster declines. If this pace continues, office assets will deteriorate well beyond the ~45% total loss estimated last year.

Exhibit 4 - Office assets struggle while other CRE sectors are stable or rebounding

CRE office property values, US (\$B)



Sources: Fitch Ratings, MSCI RCA Commercial Price Property Index, BCG Analysis.

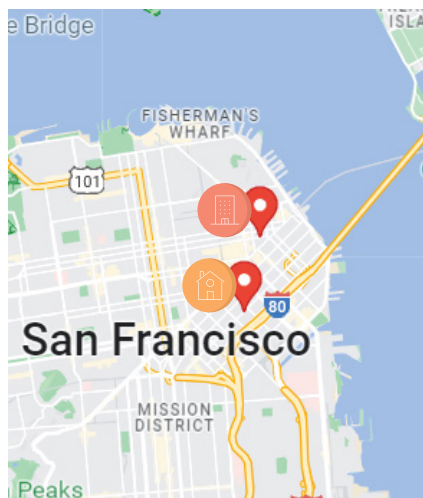
5. Federal Reserve Bank of Kansas City.

6. Commercial Observer.

7. Cred IQ.

Exhibit 5 - Office and Multifamily properties in city centers where the contagion effect may be causing negative impacts

San Francisco – Fisherman's Wharf Neighborhood



Offices selling at discount

Sold at 70% discount



115 Sansome Street, San Francisco

- Vanbarton Group is marketing a half-vacant office property in San Francisco, expected to sell at a 70% discount for what is what traded at in 2016.
- Bids are expected to come in at \$200 PSF and JLL has the listing. Vanbarton paid \$643 PSF for the property in 2016 when it was almost fully leased.
- According to GreenStreet, the expected drop in valuation now reflects the property's drop in occupancy and broader dislocation in the SF office market.

Sellers likely holding out while valuations display possible erosion and concessions are greater than national average

Estimated \$109 M drop in value;
10-week free rent concession



900 Folsom Street, San Francisco

- The Mosso property last sold in 2019 for \$311M to Brookfield Asset Management. At the time of the sale, the property was 92% occupied.
- However, based on local dynamics, peer comps, and previous sales history, Green Street estimates its current value at \$229M.
- According to data from RealPage, as of second quarter 2023, a total of 13.1% of units were offering concessions. The average concession level for all units remains at 4.5% – less than one month's free rent. This property is currently running a 10-week free rent special.

Key takeaway: On a national level, both office and multifamily sectors are displaying a decrease in capital value. The root cause of this decrease is unique to each sector; however, broader urbanization trends such as the donut effect may be influencing local market dynamics, concessions, and property valuations.

Sources: GreenStreet; Fannie Mae; Realpage; BCG Analysis.

Regional banks also face exposure to other CRE assets, such as multifamily properties. The latter experienced a decline in net absorption rates in 2023 – meaning new leases did not fill all the gaps created by vacancies. Higher multifamily vacancy rates may be linked to the declines in office through the contagion effect, where empty buildings (e.g., offices) affect the viability of smaller business in the area, and ultimately drive residents away.

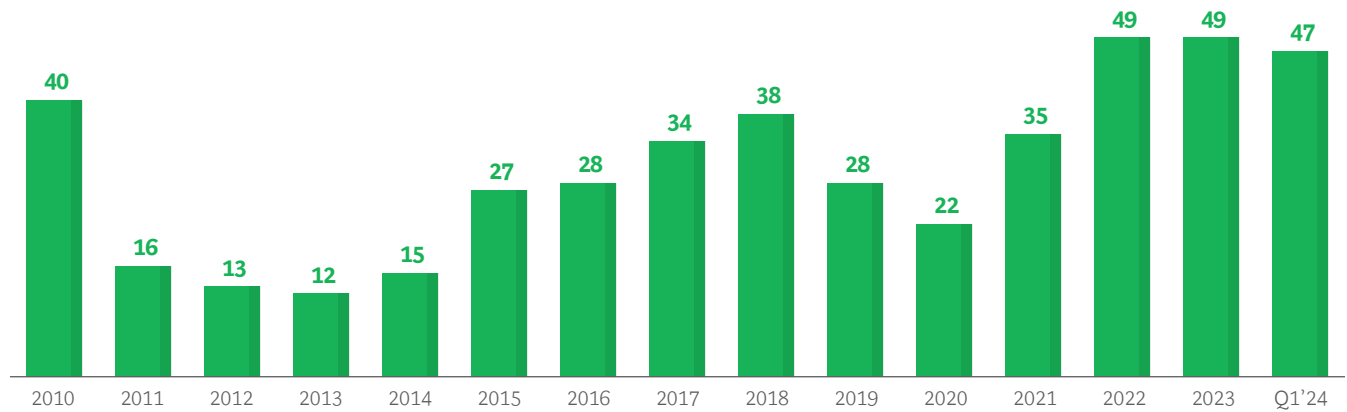
Regional banks with retail and industrial sector risk might be encouraged by a modest rebound from pandemic lows. Industrial capacity grew 6%, and retail capital value remains stable year-over-year. Average rents are expected to increase over the next two years, despite losses in other sectors.¹

What does this mean for regional banks?

Approximately \$2.2 trillion of CRE debt is due to mature by 2027 and regional banks that are overleveraged in office space must implement strategies to help mitigate the effect of expiring leases. As of Q1 2024, 47 of the largest banks by assets in the US remain classified as high-risk for CRE exposure.

Exhibit 6 - 47 of the largest banks by assets in the US remain classified as high-risk for CRE exposure

Banks exceeding regulatory guidance¹ on CRE concentration risk (#)



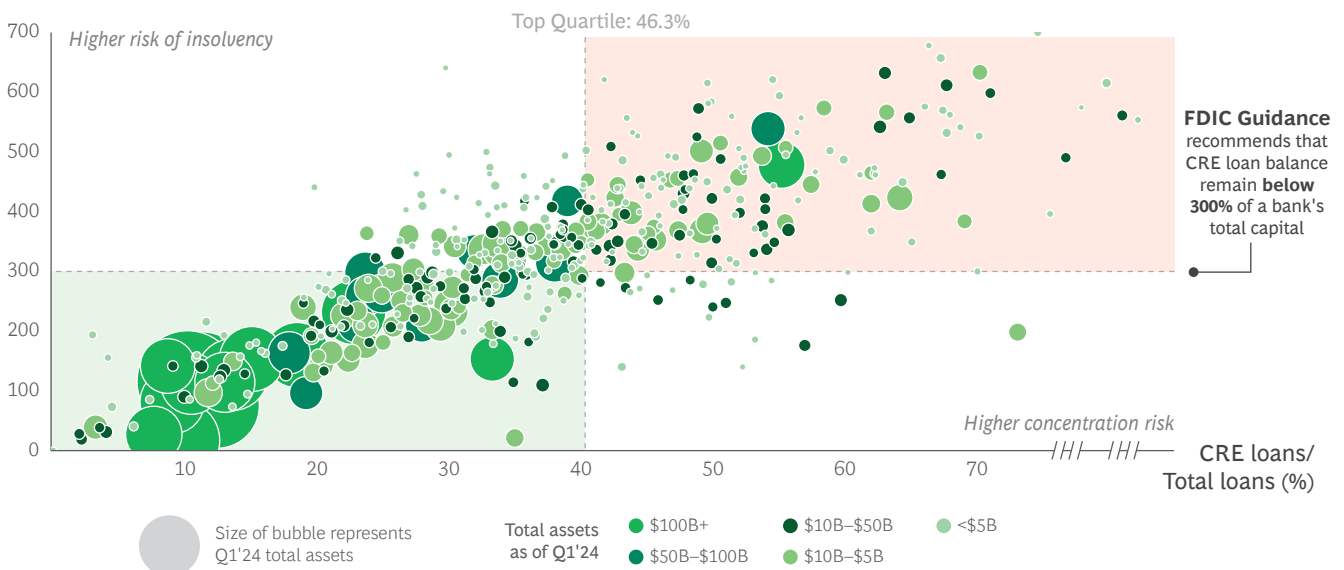
Sources: SNL Data, BCG analysis.

Note: Analysis of largest 500 banks by assets in each year.

¹Regulatory guidance is defined as total CRE loans representing 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months OR total loans reported on the Report of Condition for construction, land development, and other land represent 100 percent or more of the institution's total capital.

Exhibit 7 - Dispersion of banks by capitalization and concentration in CRE

CRE loans/Tier 1 capital & Allowance for loan & lease loss (%)



Sources: SNL Data, BCG analysis.

Note: Includes largest commercial banks by total assets as of Q1'24, excludes universal banks and banks with non-comparable business mixes.

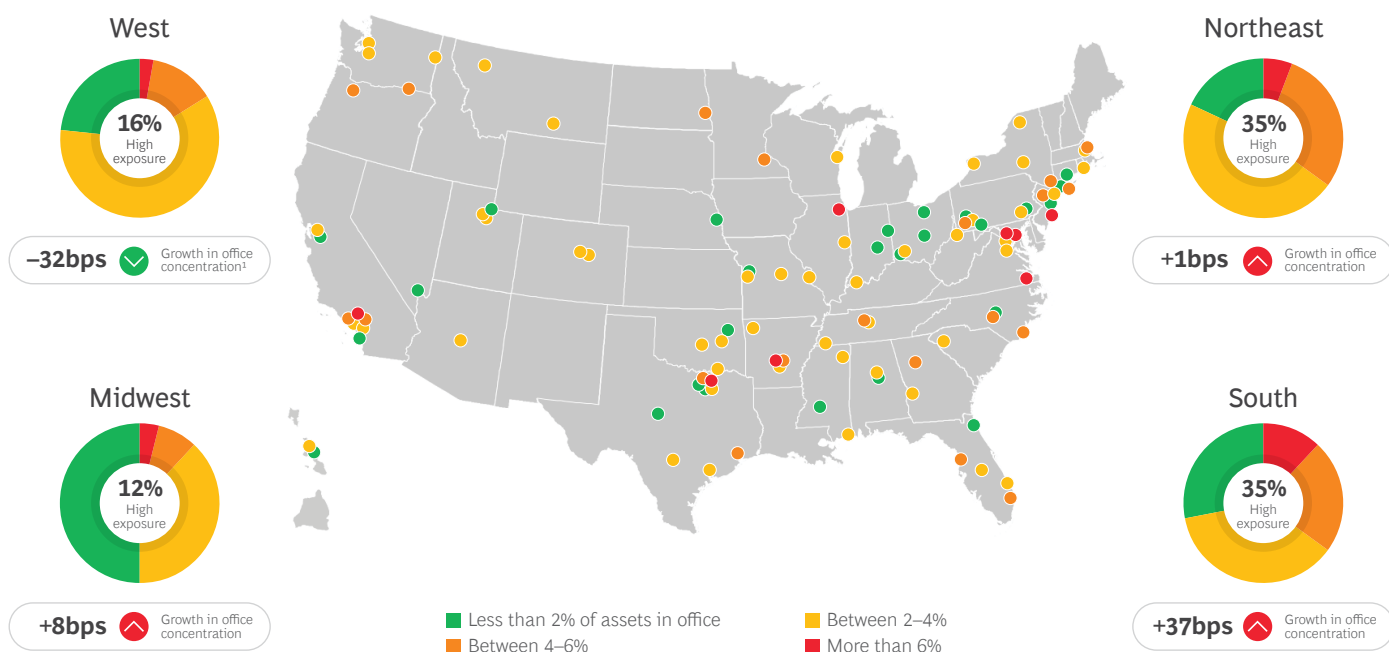
It is not that national banks are immune to office exposure, the problem lies in the relative magnitude that certain downturns can have on regional banks, such as declines in the office sector. Larger national banks not only have greater allowances for lease losses, CRE also represents a smaller proportion of their overall loan portfolio. Smaller regional banks face the prospect that defaults in only a handful of properties could make insolvency a realistic possibility.

We've refreshed an analysis from last year's "Regional bank actions against the zombie building threat" to understand regional differences in exposure to office. Consistent with last year's methodology, we reviewed banks with between \$10 billion and \$250 billion in assets under management, excluded banks with incomparable business mixes, and came to a list of 114 banks to review. Using balance sheet disclosures, we extracted office investment data or used group averages when specifics were unavailable.

Results compared to last year are consistent: regional banks located in the Northeast, South, and West could be at a higher risk given their comparatively higher exposure to office assets. However, a deeper dive into the analysis underscored greater risk and worsening conditions in the Northeast and South:

- Exposure in the Northeast continues to worsen. An estimated 35% of banks are now deemed high risk in this year's study compared to 28% in the Q1 2023 analysis. This is mostly a result of an increase in banks with a 4%–6% office concentration. Moreover, several banking assets have moved east to this region through large acquisitions since last year's analysis.
- In the South, a similar percentage of banks are categorized as high risk (~35%) but the mix of exposure is now worse and there are now more banks in the 6% plus office concentration band. With many of the largest US cities in these regions and central business districts showing the impact of fewer office workers, regional banks need to prepare themselves for smaller leases and non-renewals.

Exhibit 8 - Bank exposure to office sector varies by region



Sources: Investor presentations, BCG analysis.

Note: Analysis includes all banks \$10–\$250B in total assets with comparable business mixes.

¹Calculated as average YoY growth in office share of loan portfolio for banks covered in "Regional bank actions against the zombie building threat" and this analysis.



**Early remedial action
and building reserves
have proven critical in
mitigating risk.**

We've already seen some lenders act

Where possible banks are looking to minimize office CRE loan exposure through strategic sales and strict buying practices. Early remedial action and the building of reserves before charge-offs have proven crucial in mitigating risks. Webster Bank, for example, sold risky assets and offloaded 41% of their subprime loan balance.

Wilmington Savings Fund also adopted a strict approach to its portfolio and office CRE now represents only 5% of its Q4 2023 loan portfolio. Notably, 78% of Wilmington's office loans are weighted towards suburban areas with only 8% in central business districts and this strategy has minimized risk-related loans⁵.

Lenders should implement five strategies to get ahead of looming CRE and office space reduction

1. Implement rigorous risk management: Disciplined and robust risk management practices allow regional banks to identify and address CRE issues. Banks can expand risk monitoring by identifying key risk metrics and implementing processes for monitoring these metrics. By collecting clear and accurate data about key assets such as lease expirations, vacancy and utilization rates, and market comparables, banks can improve effective decision-making.

BCG is helping banks streamline and monitor their portfolios with our CRE tool that provides projection, classification, and decision-making about risk. The tool is comprised by:

- A geoanalytics location intelligence platform and predictive vacancy model, which unlocks CRE investment opportunities and manages distress.
- An interactive and exploratory thematic map with the capacity to select census block groups and view trended data.
- A detailed property attribute information tool including monthly trends and robust filtering capabilities.

Exhibit 9 - With BCG's CRE risk tool, it is possible to...

Be forward looking

Protect and analyze the impact of future vacancies

Incorporate a range of leading indicator data (e.g., footfall, credit card activity, home values)

Evaluate dynamic and flexible scenarios

Easily evaluate a range of possible scenarios with sensitivity testing

E.g., debt to service coverage ratios, different return to office rates, valuations

Be highly traceable

Allow trace-back of factors that leads to risk score or classification changes

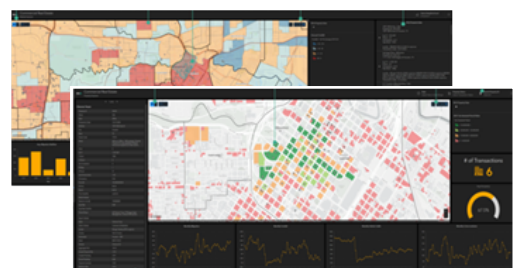
Identify contagion scenarios for future avoidance

Incorporate strategic decisions

Bring together risk scoring with bank strategic needs

E.g., risk appetite, target balance sheet, portfolio strategy

Portfolio dashboard with market overview and heatmap based on key risk indicators



Predictive analytics to project future vacancy levels, leveraging dashboard indicators





**BCG's CRE tool provides
projection, classification,
and decision-making about
CRE risk.**

- 2. Build an office strategy:** A clearly defined approach which differentiates strategic from non-strategic assets alongside disposal plans is required. Banks should decide whether to continue in the office segment or not, and if so, where. Financial institutions can then develop plans for the strategic assets they decide to hold and plan the anticipated holding period. A similar process will need to be conducted for disposing of non-strategic assets, such as mapping out which assets need to be sold in the near-to-medium term and to whom.
- 3. Build internal restructuring capabilities:** Defaults will occur, and borrowers will continue to need assistance. Banks must be prepared to provide proper management through internal restructuring capabilities. A/B loan structures (senior/junior tranches) can be explored to find new sources of capital and reduce exposure as banks sell the senior tranches of their loans.
- 4. Create and utilize a portal marketplace:** A portal for CRE sales can create an outlet for distressed or repossessed properties by providing a marketplace with potential buyers. At a certain price point and under certain conditions, the resale of an asset can be mutually beneficial for a buyer and seller. While the seller can offload troubled parts of the portfolio to manage risk, a seller may be willing to take on risk at a lower cost, strategically enter a market or rezone a building for alternate use.
- 5. Expand the product portfolio:** Owners will look to renovate, repurpose, and redevelop their properties to adapt to the current market and this presents an opportunity for lenders to add to their portfolio. Banks may decide to move on from the office sector, identifying new asset classes and segments in which to invest. Through strict purchasing standards, strategic opportunities can be identified and acted upon.

Prepare today to react appropriately to forthcoming defaults

Banks should not panic but set up a dynamic intervention. By following our workout recommendations, banks can mitigate risk exposure and align the balance sheet for long-term success.

About the Authors

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For Further Contact

If you would like to discuss this report, please contact the authors.

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