Office of the
Comptroller of the Currency

ON POINT
ECONOMIC AND POLICY INSIGHT FROM THE OCC

Office Loans in Urban Areas Hold Most Credit Risk

At the start of the pandemic, businesses embraced remote work and office buildings emptied—and remained largely empty through 2021 as new COVID-19 variants emerged. Since this occurred in most cities across the country, geographic differences have been less pronounced than in prior recessions. Instead, differences in office property stress in this cycle have been more evident across different submarket types, where submarkets with high office building density have fared the worst. Specifically, office properties located in urban business districts have had greater increases in vacancy rates, and deeper declines in asking rents, than office properties located in suburban submarkets. This difference in stress appears to have caused a similar divergence in large bank commercial real estate (CRE) loan credit quality. Loans made by large banks and secured by office properties located in urban business districts have a higher share of loan commitments[1] rated classified than do loans secured by suburban office properties.

Remote Work Adds Medium-Term Downward Pressure on Demand

Post-pandemic, the transition to new remote and hybrid office-work models will likely emerge slowly, cushioning the effect on office demand. Historically, demand for office rental space is largely determined by employment growth, with more space needed as firms add office-based employees. The expansion of remote and hybrid work, however, has eroded this traditional relationship between office-using job growth and rental space demand. But not completely. For example, employees’ time in the office under a hybrid model is expected to shift to more team activities onsite while independent work is conducted at remote locations. As a result, firms will likely reorganize their current office footprint to include more collaborative space. In addition, some tenants may decrease office density to improve workplace health and safety, further increasing overall square footage demand. Nonetheless, most analysts expect a moderate *net* decline in demand over the medium term as firms balance these pressures and implement their plans. And this process may take several years, since companies are waiting until workers return to the office and their office leases expire before deciding their office space needs.

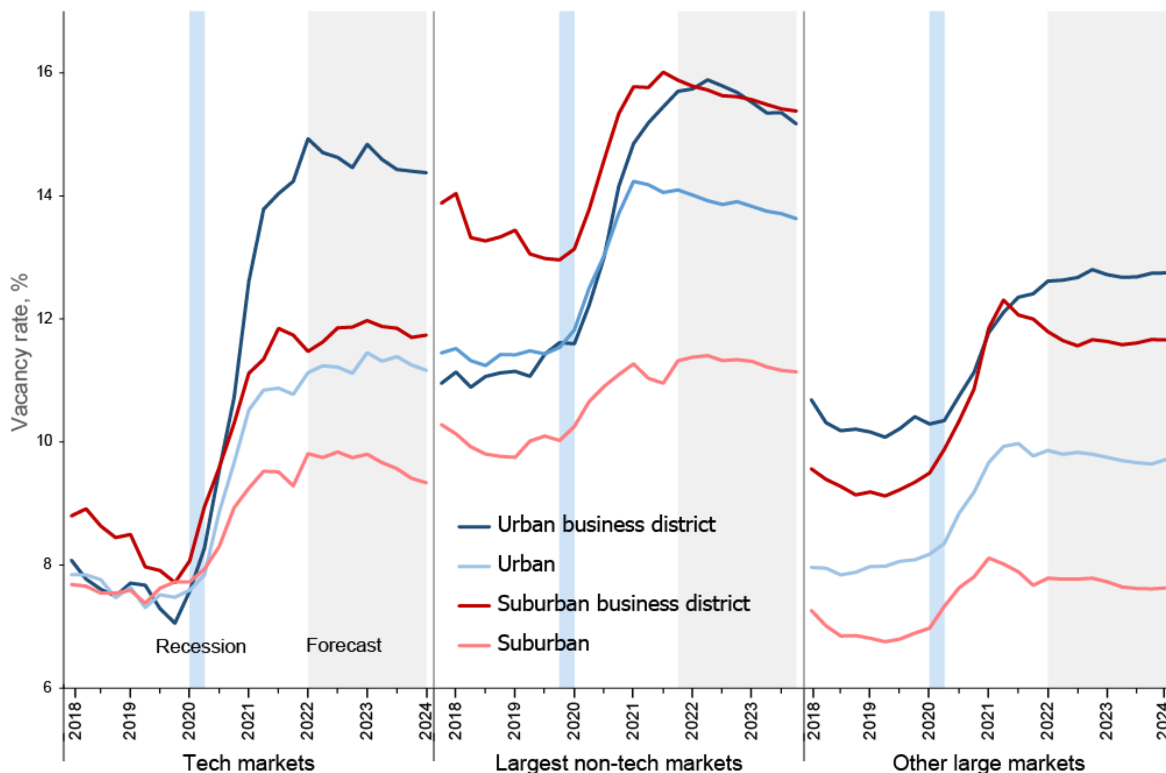
[1] Loan commitments are the maximum amount that can be drawn on a loan.

Vacancies & Rents Deteriorated the Most in Urban Business Districts

While demand for office rental space fell in most markets in 2020, two factors influenced which markets recorded the deepest declines: reliance on employment in technology industries and population size. Thus, looking at the largest 54 markets by technology employment and size produces three groups: markets with an above-average share of workforce in technology industries (tech markets), the largest non-technology markets (largest non-tech markets), and the remaining markets (other large markets).[2] Additional insights can be obtained by examining how vacancies and asking rent changed during the pandemic *within* each of these three market types.[3]

What we find is that vacancies rose the most for properties located in urban business districts within the tech market group, rising by 7.2 percentage points from the fourth quarter of 2019 to the fourth quarter of 2021. The largest non-tech market group recorded an increase of 4.0 percentage points in urban business district office vacancies, while the group for other large markets had an increase of only 2.0 percentage points. The forecast is for office vacancies to remain elevated across the three market groups in 2022, with urban business district vacancies generally remaining the highest among submarket types (figure 1).

Figure 1: Vacancy Rates in Urban Business Districts Increased the Most



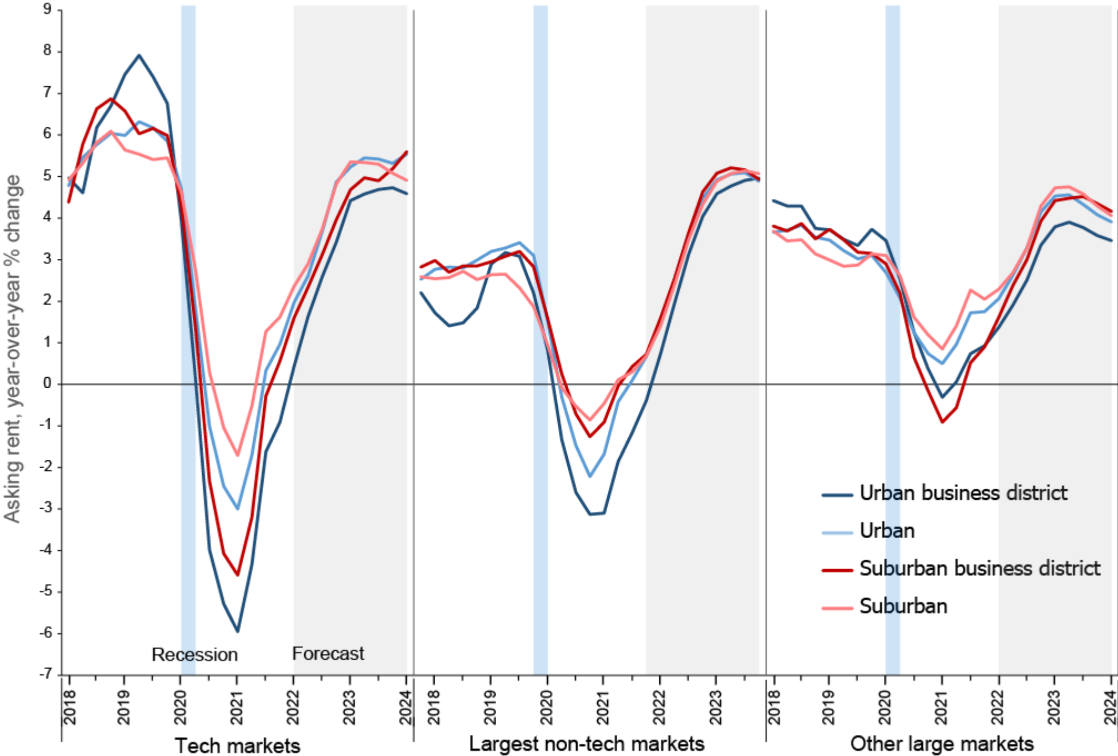
Source: CoStar Portfolio Strategy (data through the fourth quarter of 2021)

[2] Tech markets: San Francisco, San Jose, East Bay, Seattle, Portland, Ore., Salt Lake City, Austin, Denver, and Boston. Largest non-tech markets: New York City, Northern New Jersey, Philadelphia, Washington, D.C., Chicago, Atlanta, Houston, Dallas/Fort Worth, and Los Angeles. Other large markets: remaining 36 markets among the largest 54 markets covered by CoStar.

[3] CoStar divides all 54 large markets into mutually exclusive submarkets based on office space density and overall population density. Office space density is used to define urban and suburban business district submarkets, while population density is used to define urban and suburban submarkets.

Growth in office property asking rent followed a pattern similar to vacancies, with urban business districts performing the worst. With the onset of the pandemic, year-over-year rent growth slowed sharply in early 2020 in all market groups. Tech markets fared the worst, with rents in urban business districts contracting in the second half of 2020 and recording a year-over-year decline of 6.0 percent in the first quarter of 2021. The largest non-tech markets reported the next worst performance, with rents in the first quarter of 2021 contracting by an average 3.1 percent on a year-over-year basis. The “other large market” group had the smallest decline in asking rents, with a year-over-year decline of 0.3 percent in the first quarter of 2021 (figure 2). Office rents in urban business districts are expected to resume growth by the second quarter of 2022 for the tech and largest non-tech market groups, while the other large market group had weak, but positive, rent growth since the second quarter of 2021. Looking ahead, asking rent growth is forecast to strengthen in 2022 and plateau in 2023. Among submarkets, urban business district rent growth is expected to be the weakest in all three market groups through 2023.

Figure 2: Asking Rents in Urban Business Districts Fell the Most

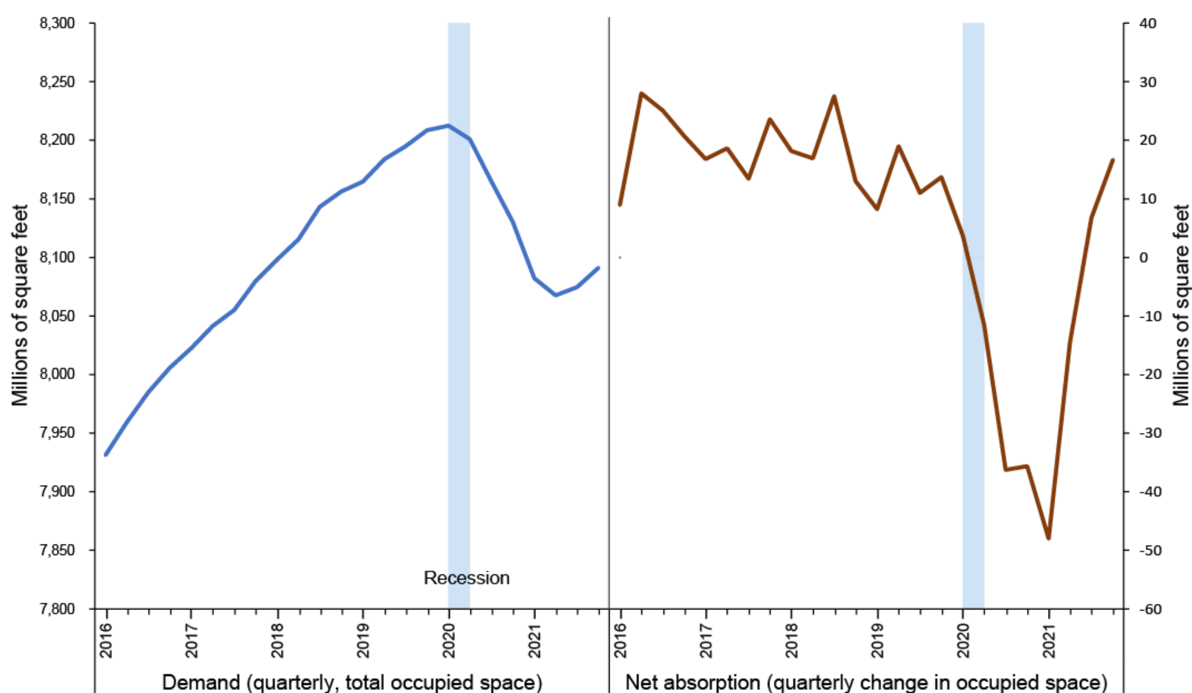


Source: CoStar Portfolio Strategy (data through the fourth quarter of 2021)

Credit Risk Has Increased for Loans Secured by Office Properties

While businesses grappled with deciding how much office rental space is needed over the next several years, demand for office rental space stabilized in the second half of 2021. Net absorption, which measures the quarterly change in occupied space, turned positive in the third quarter of 2021 for the largest 54 markets covered by CRE market data provider CoStar Portfolio Strategy (CoStar). Despite this return to quarterly gains, total occupied space remained well below its pre-pandemic peak (figure 3).

Figure 3: Demand for Office Rental Space Is Below its Pre-Pandemic Peak, but Began to Increase in 2021



Source: CoStar Portfolio Strategy (data through the fourth quarter of 2021)

Note: Data are for the largest 54 markets covered by CoStar

What do these developments in net absorption, vacancies, and asking rents mean for loan performance? Specifically, are there differences in performance between loans secured by properties located in urban business districts and loans secured by properties in other submarket types?

These questions can be analyzed using the Federal Reserve's nonpublic quarterly Capital Assessments and Stress Testing Data Collection, Commercial Real Estate Schedule H.2 (FR Y-14Q),[4] which collects data from bank holding companies with consolidated assets greater than $100 billion on loans above $1 million secured by CRE properties. FR Y-14Q data include CRE loans secured by office properties and bank-assigned internal risk ratings for these loans.[5] These ratings are used to identify classified assets.[6] Thus, it is possible to track the financial

[4] Supplemented with the OCC's large bank CRE data from the fourth quarter of 2010 through the third quarter of 2012. One caveat with the FR Y-14Q's data is that, because it is only reported by large bank holding companies, the loans in the FR Y-14Q dataset may not be representative of the types of loans made by community banks.

[5] The FR Y-14Q Schedule H.2 data used for this analysis only cover loans secured by CRE properties (office properties), where the primary source of repayment is derived from third-party, nonaffiliated rental income associated with the property (i.e., any such rental income is less than 50 percent of the source of repayment) or the proceeds of the sale, refinancing, or permanent financing of the property. Banks may have other exposure to CRE such as loans to finance CRE that are not secured by real estate, unsecured lending to real estate investment trusts (REITs) as well as loans secured by owner-occupied non-farm, non-residential properties that are part of the FR Y14-Q Schedule H.1 data on corporate loans. Data for other types of CRE exposures do not include information about the specific property type being financed or the location of the underlying property type and are excluded from this analysis.

[6] Classified loans are those rated as substandard, doubtful, or loss.

performance of loans secured by office properties before those loans enter nonperforming[7] status.

Loans secured by single office properties in the FR Y-14Q data were mapped to CoStar's submarket designations using the collateral property's zip code reported by the bank and the zip codes contained in CoStar's submarket designations. The classified loan ratio[8] for each submarket type was then calculated by dividing total classified office loan commitments by total commitments secured by offices.

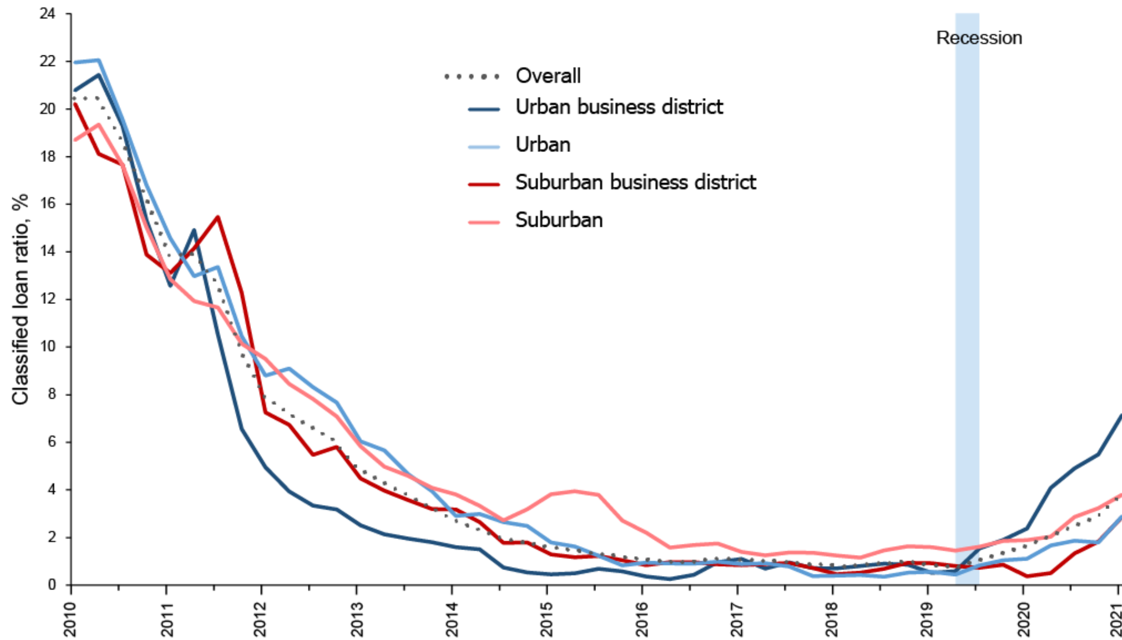
The overall classified loan ratio for loans secured by office properties remained moderate at 3.7 percent in the fourth quarter of 2021. This compares with an overall classified ratio of slightly over 20 percent at the beginning of 2011, after the 2008-09 recession. But this ratio is on an upward trend, increasing by 3.0 percentage points between the fourth quarter of 2019 and the fourth quarter of 2021. The classified loan ratio for urban business districts is the highest, at 7.1 percent, followed by a classified ratio of 3.8 percent in suburban submarkets, with urban submarket and suburban business district submarket sharing the lowest classified ratio of 2.9 percent each in the fourth quarter of 2021 (figure 4).

These findings are generally in line with the market analysis, which indicated that properties located in urban business districts have suffered the most stress in terms of demand, vacancy, and rent growth. Given that the two-year forecast is for elevated vacancy rates and moderate rent growth, it is possible that classified loan rates could continue rising over a similar time frame.

[7] Nonperforming loans are defined as loans 90 or more days delinquent or on nonaccrual.

[8] The classified loan ratio calculation is based on loans collateralized with single-location, single-property type collateral (office properties) and do not include construction loans. To calculate classified loan amounts across banks, internal loan ratings are mapped to a common regulatory scale for substandard, doubtful, or loss classifications.

Figure 4: Credit Risk of Loans Held by the Largest OCC Banks and Secured by Office Properties in Urban Business Districts Increased the Most



Source: Federal Reserve FR Y-14Q Schedule H.2 data for commercial real estate (OCC-supervised institutions, data through 4Q:2021)

Note: Loans secured by multiple properties are excluded from our analysis, since the property types and locations of collateral underlying these loans is not fully known. While the number and commitment value of loans secured by multiple properties is not immaterial, our analysis showed that assigning these loans to the property type and location based on the predominant property underlying them does not materially alter the classified loan ratios of loans on specific property types secured by single properties.

The Point?

The pandemic-related disruption to office space demand produced a moderate increase in credit risk for underlying loans over the past two years, but especially for loans secured by office properties located in urban business districts.