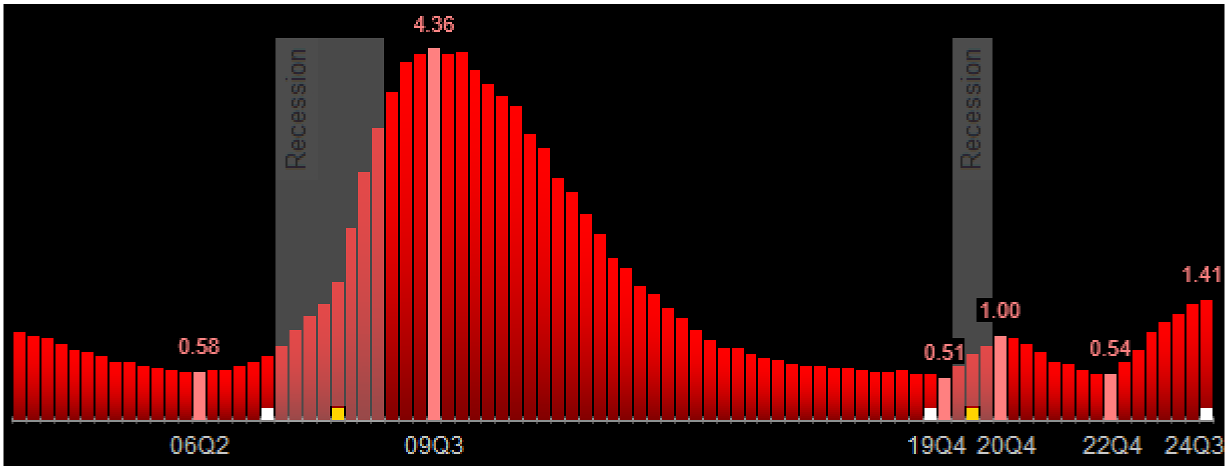
This week [BankRegData] provides an update on bank industry CRE delinquency trends that we discussed in an earlier June 9, 2024 [article].

First up, the following chart tracks industry Commercial Real Estate Nonperforming Loans (NPL %). The data includes both Non Owner Occupied and Owner Occupied CRE.

Commercial Real Estate NPL %: All US Banks

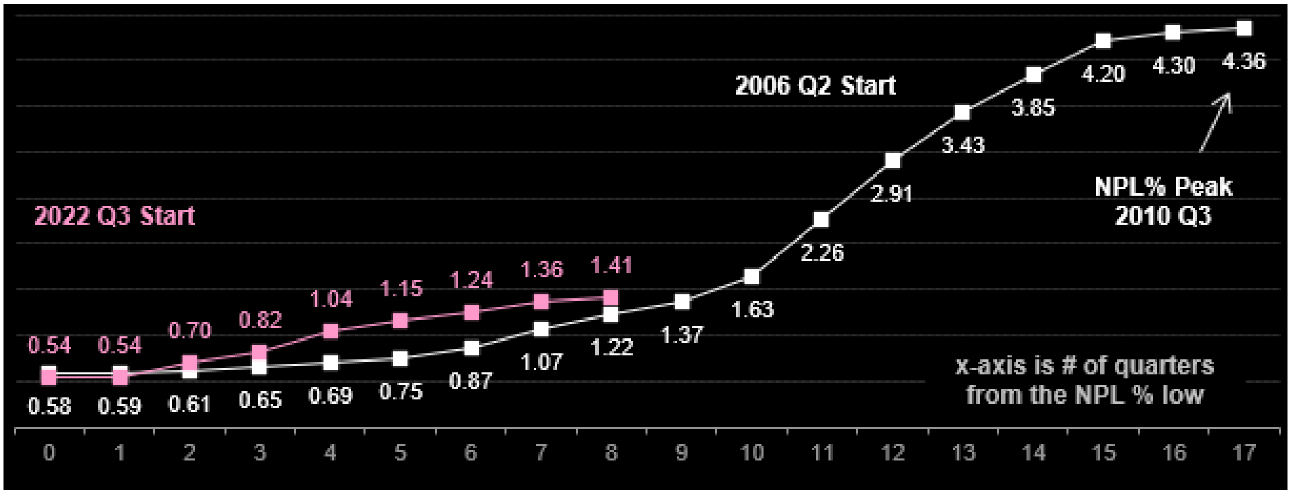


Pink represents the cycle low and high for each of three periods. The grey shading is the overlaid Recessions as per [FRED]. The white dots represent the quarter of the first Fed Cut while the gold dots represent the drop to [cycle low].

Observations:
1) Note how rising delinquencies overlap and presage recessions.
2) The current period is sharper and faster than 2006 Q2 starting period.
3) First Fed cut (white dots) starts near the inversion of CRE NPLs.
4) Dropping to 1% and 0% (gold dots) does not stop the pain.
5) We had a first rate cut in 2024 Q3.
6) If you look close on the right it almost looks like we might be peaking.

The question is when do we know when we've topped delinquencies and are starting to roll over into an improving environment? Part of the answer is when we see a slowing in the rate of increase quarter over quarter. The next chart overlays the GFC cycle (white) with the current cycle (pink) and makes it a bit simpler to see the slowing in the current cycle.

CRE NPL % Cycle Comparison: All US Banks



The pink line starts in 2022 Q3 at 0.54% NPL% and the current 1.41% reflects the 8 quarter out period which is 2024 Q3. We've earlier commented about how this cycle NPLs climb earlier and are worse than the GFC CRE issues, but it certainly looks like the 1.36% to 1.41% may reflect a slowing in the rate of deterioration.

While the 1.41% is still higher than the corresponding 1.22% in 2008 Q2 one might think that 2024 Q4 may be near or lower than the 1.41%. Maybe this CRE correction cycle is sharper and faster, but tops sooner than prior cycles?

I don't think this is the case - I think we're actually nearer to a change in the slope up rather than a topping and future lower NPL levels. The reasons are threefold:

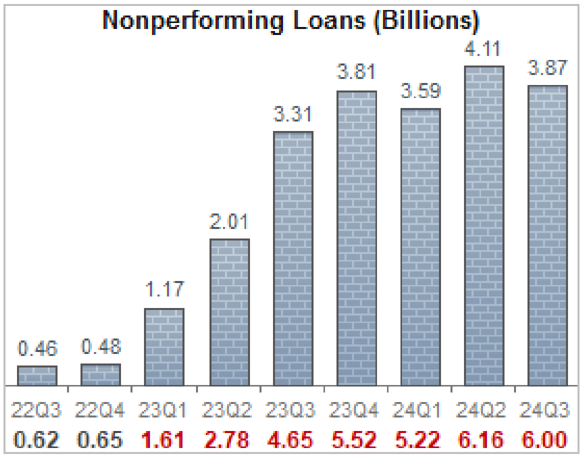
1) The denominator for the largest banks (CRE loans outstanding) continues to shrink and Unused CRE Commitments continues to drop.

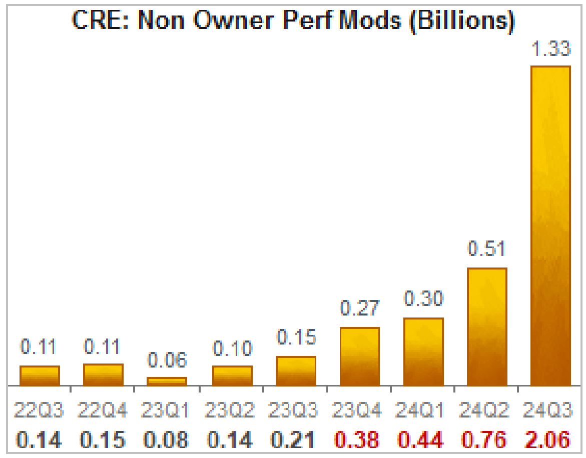
2) The largest banks are the worst performers and they are going all in on Loan Modifications (aka extend and pretend).

3) Aggregate CRE is composed of Non Owner and Owner Occupied. Owner Occupied has lately been at historic lows and that has recently inverted. The lower Owner Occupied NPLs have provided a weighting effect of keeping aggregate CRE levels lower and I suspect that tailwind will turn into a headwind.

The largest Non Owner CRE lenders are Wells Fargo ($64.52B), Bank of America ($36.67B) and JPMorgan Chase ($35.79B). All three have elevated Non Owner NPL levels and all three are pivoting to historic loan modification levels (i.e. lowering payments so that borrowers can avoid delinquency).

Wells Fargo: Non Owner Occupied NPLs and TDR





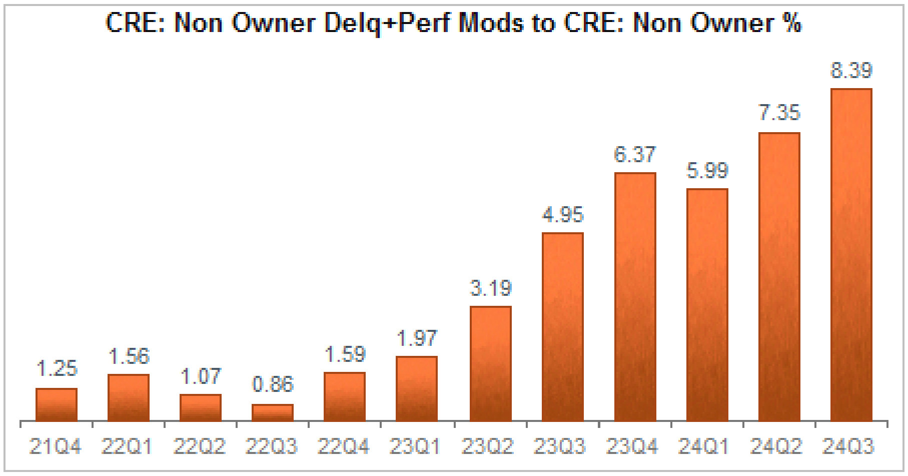
The left hand chart (blue brick) reflects the Non Owner NPLs and shows a shocking increase from $480 Million to $3.81 Billion in 2023 Q4. Since then, we see a reasonably stable level. The numbers below the chart axis are the quarterly NPL % and we see it climb from 0.65% to 6.00% in in 2024 Q3. The higher % is due to Wells outstanding Non Owner portfolio continuing to shrink.

Frightening numbers, but perhaps the high is in? Well, no. The gold chart on the right details the NOO CRE loan modifications where the payment has been lowered and the TDR has been left on accrual. They do this so that it avoids the NPL designation since NPLs are loans 90+ Days Due accruing Fee/Interest Income PLUS loans on Nonaccrual.

Note how Wells has gone from 0.08% in 2023 Q1 (the new rule start date) to 2.06% in 2024 Q3. Over 2% of WFC's NOO portfolio has been modified so that the borrower can stay out of delinquency. If we combine total NOO delinquencies plus Performing TDR we see that Wells' NOO Portfolio Stress is 8.39%.

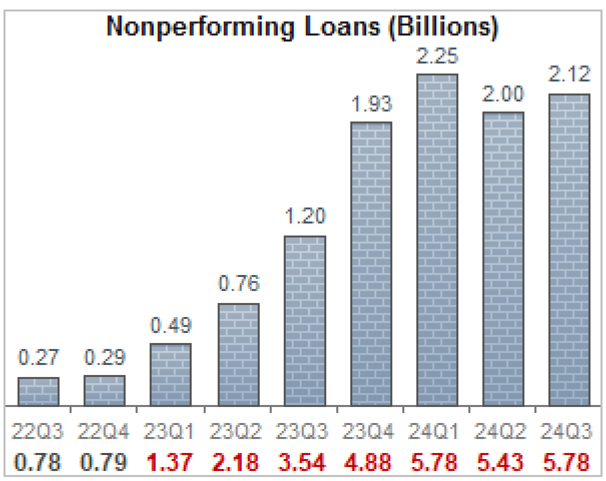
Wells Fargo: Non Owner Portfolio Stress

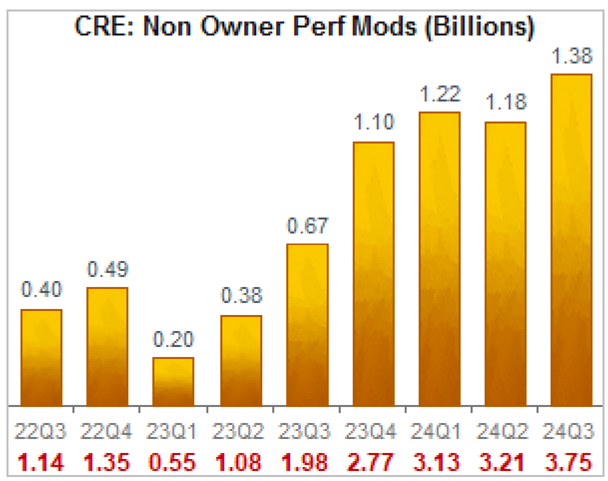
Qtr	Delq+Perf Mods
20Q4	913,000,000
20Q1	1,150,000,000
20Q2	781,000,000
20Q3	638,000,000
20Q4	1,168,000,000
20Q1	1,434,000,000
20Q2	2,295,000,000
20Q3	3,521,000,000
20Q4	4,394,000,000
20Q1	4,120,000,000
20Q2	4,906,000,000
20Q3	5,416,000,000



They can report NPL % as topping, but in reality they are modifying loans at a dizzying pace. We see the same trends with Bank of America and JPMorgan Chase (curious that all three happen to do the same thing at the same time).

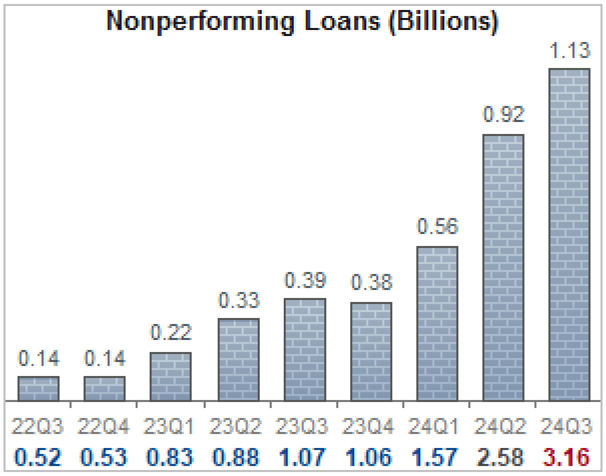
Bank of America: Non Owner Occupied NPLs and TDR

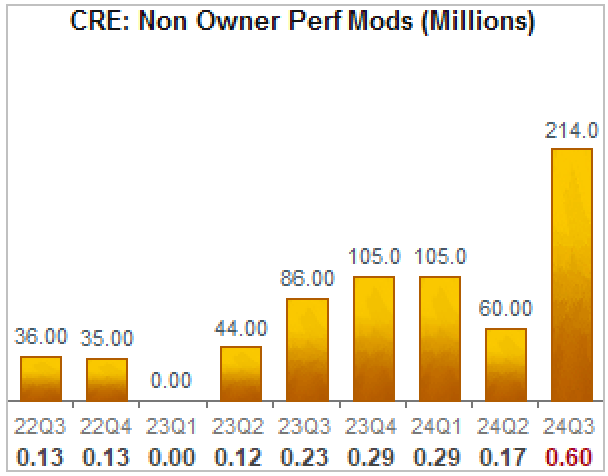




NPLs skyrocket, appear to be topping at 5.78%, 5.43% and 5.78%, but we see performing TDR levels go from 0.55% with the new rules to 3.75% in 2024 Q3. BAC has modified 3.75% of their NOO portfolio and left them off Nonaccrual. The [Portfolio Stress ratio is at 10.19%].

JPMorgan Chase: **Non Owner Occupied NPLs and TDR**



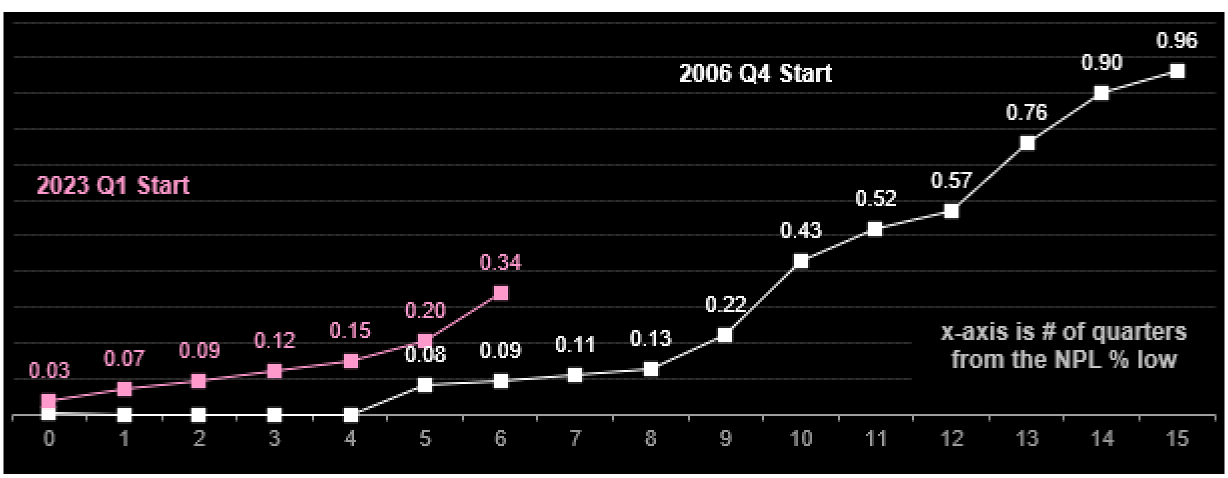


JPM sees the same trends although their NPLs are still increasing at the same time they have moved aggressively with loan mods left off nonaccrual.

Is the massive increase in loan mods the same pattern we see every cycle?
Alas, I do not have the portfolio level loan mods going back prior to 2011 Q1 so I cannot see CRE mods for each of these banks.

That said, I do have the aggregate Performing TDR levels since that component is part of the Texas Ratio. And yes, another reason why the larger banks with lots of loan mods would lobby FASB to change the Performing TDR rules.

Wells Fargo: **Performing TDR % Cycle Comparison**

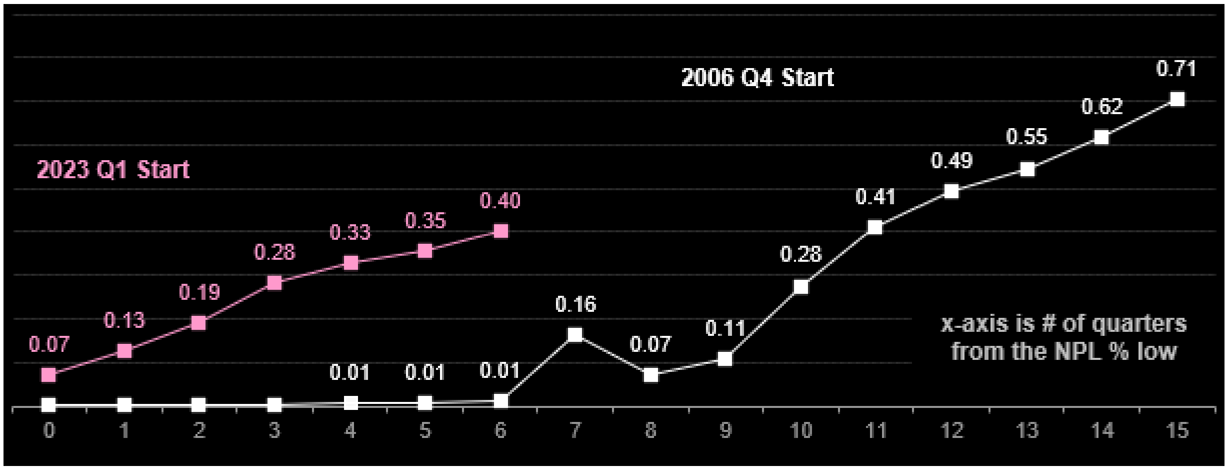


I'm using the same White/Pink cycles as before, however, I've slid the starting time period two quarters to avoid the 2022 Q4 to 2023 Q1 artificial lowering of TDR levels. This is frankly a generous way of reporting Wells Fargo's performing TDR since they went from $3.93B (0.42%) in 2022 Q4 to just $313M (0.03%) in 2023 Q1 with the new rule. **Wells' TDR levels are higher we just don't know about it.**

What we see is that Wells had 0% Performing TDRs in 2006 Q4 (white) through 2007 Q4 when they started ramping up loan mods (left off nonaccrual). This time around they are going full on with loan mods much earlier in the delinquency cycle.

We see the exact same behavior with Bank of America.

Bank of America: Performing TDR % Cycle Comparison

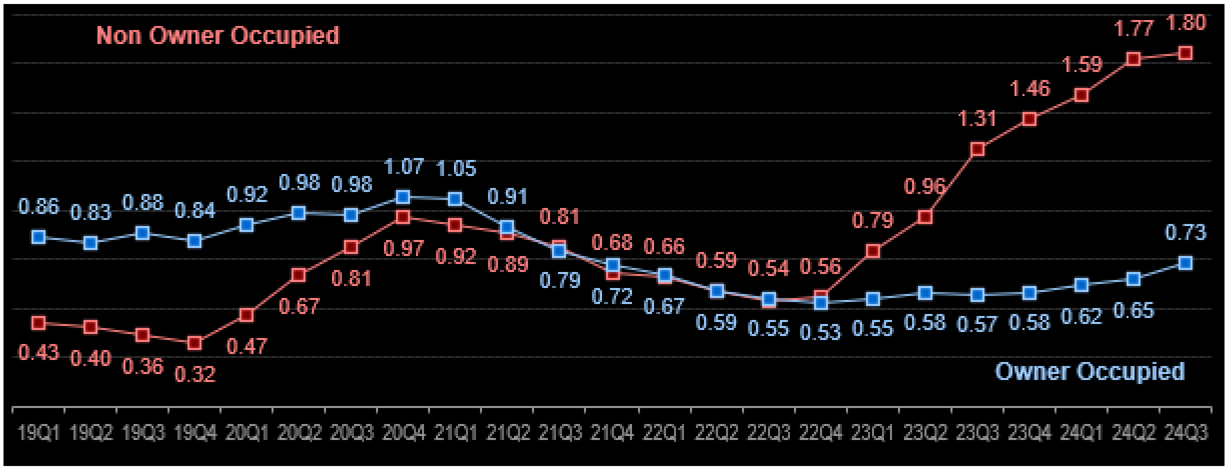


As the largest banks aggressively ramp up loan mods to lower payments to avoid delinquencies it can give the illusion that NPLs are moderating. If we expect a shallow recession then perhaps this works. If we're in for a longer credit cycle (we are) then this creates a series of 'second wave' delinquencies as these borrowers drop back into delinquency and have to be put on Nonaccrual.

PNC is a perfect example of where their NPLs skyrocketed, they pivoted to loan mods left off nonaccrual and then we see a second jump in loan mods on nonaccrual a few quarters later.

The following chart is an update of the September 7th [Grab Bag]() mailing that details the massive increase in Non Owner NPLs (pink) and the much lower Owner Occupied NPLs in blue.

CRE NPL % by Portfolio: All US Banks



I earlier addressed the slowing in the Non Owner NPL % due to a shift of the big banks to large loan modifications left off nonaccrual. What I wanted to address next was the fundamental risk shift in 2021/22 where Owner Occupied went from being the traditionally riskier CRE type to being considerably safer than Non Owner (payment from rent).

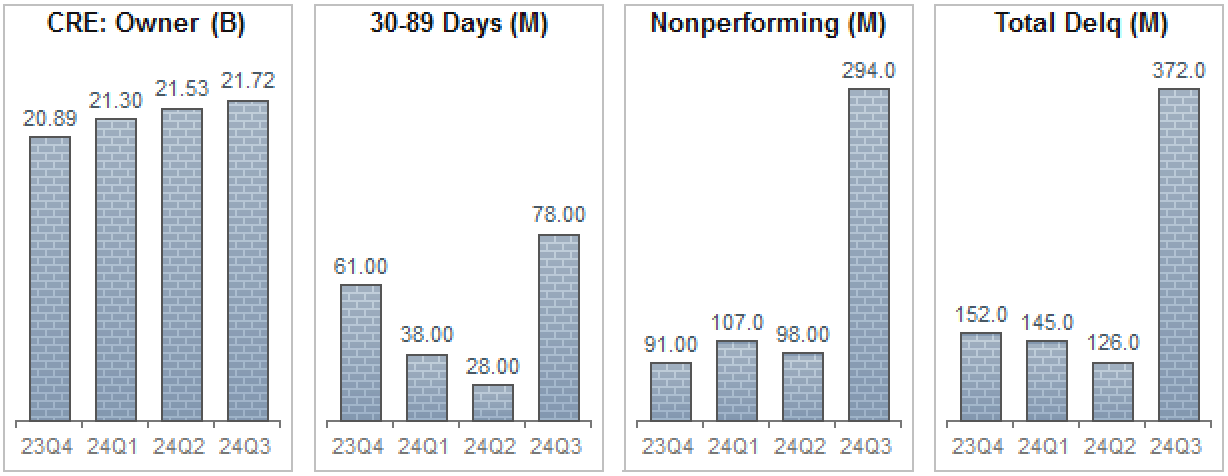
Several bank executives commented that they believe the phenomena was a result of owner operators disproportionately benefitting from government aid/programs (e.g. PPP, RRF, ERTC...) relative to rental driven Non Owner Occupied.

This makes a ton of sense and the follow on question then is whether this is a transitory situation or whether it's permanent. The feedback I received was not unanimous, but the majority of bank execs felt it was transitory as those borrowers worked through the excess funds. Owner Occupied NPLs will revert to a higher level.

So, are we beginning to see this reversion with the 0.65% to 0.73% jump in 2024 Q3?

The largest Owner Occupied lender is Bank of America and they saw large jumps in both Early Stage Delinquencies and NPLs.

Bank of America: Owner Occupied Portfolio

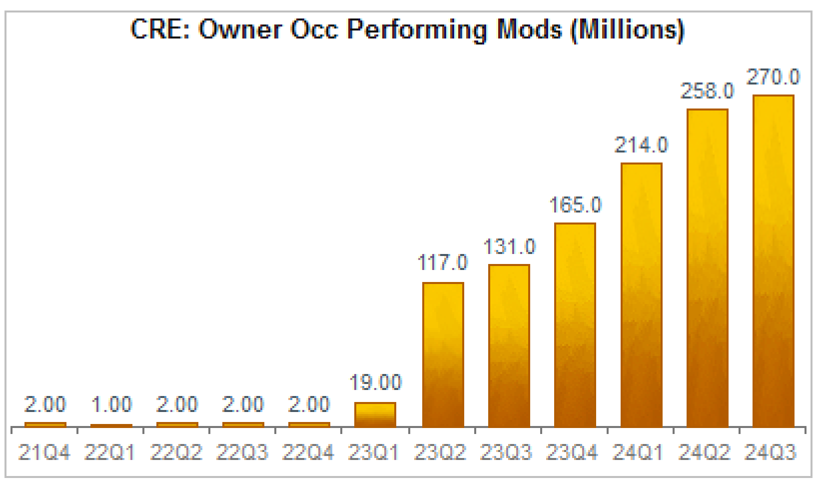


Bank of America jumped from 0.59% Owner Occupied delinquency rate to [1.71%]() in 2024 Q3. About a third of the industry increase is from Bank of America so while impactful it does not solely explain the industry increase.

The second largest Owner Occupied lender is Truist and while they continue to have low NPLs they are [modifying]() a fairly large amount of Owner Occupied loans and leaving them off Nonaccrual.

Truist Bank: Owner Occupied Performing Mods

Qtr	Perf Loan Mods	Perc
21Q4	2,000,000	0.01
22Q1	1,000,000	0.00
22Q2	2,000,000	0.01
22Q3	2,000,000	0.01
22Q4	2,000,000	0.01
23Q1	19,000,000	0.11
23Q2	117,000,000	0.61
23Q3	131,000,000	0.66
23Q4	165,000,000	0.82
24Q1	214,000,000	1.06
24Q2	258,000,000	1.31
24Q3	270,000,000	1.39



From 0.11% of portfolio in 2023 Q1 to 1.39% in 2024 Q3. Easy to avoid NPLs in the short term if you just proactively lower troubled borrowers' payments.

Error Mea Culpa: *Lastly, I need to apologize for a rather stupid error in my last email. I erroneously stated that Other Expenses Accrued and Unpaid were being managed to* *impact PGC's Pre-Tax Net Operating Income. The element tracks unpaid expenses, however, they are already taken against earnings. Possibly a cash management issue, but not an income manipulation tool.*

I appreciate the handful of bank executives who kindly caught the error. I was able to replace a different 'Ugly' in the analysis, however, you were one of the 20% of our distribution that saw me face-plant on the subject. Not my best moment and I'll endeavor to better.

If you have any questions or suggestions feel free to contact me.

Regards,
Bill Moreland
469-605-8106
