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SMARTER PERSPECTIVE: ENTERPRISE VALUATION

Trouble Brewing for US Banks

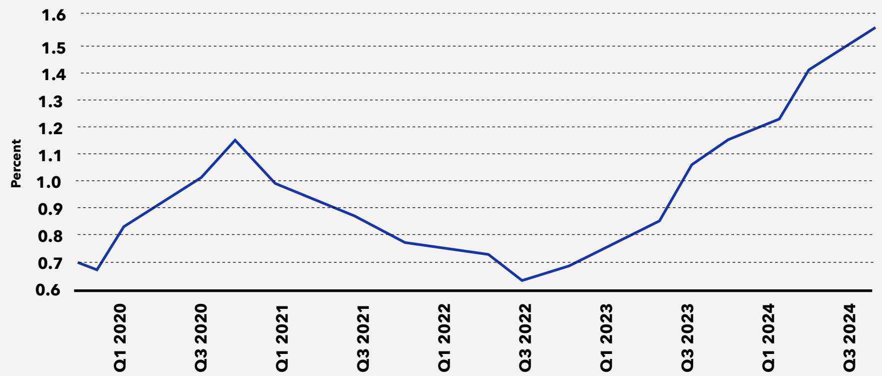
By Joseph Mevorah

March 2025 While the Fed's mission is to keep the economy stable and inflation under check, its current inaction in reducing interest rates in the face of stubborn inflation will likely have an adverse effect on the US banking industry, especially regarding small regional and community banks. Moreover, Chairman Powell is in no hurry to reduce interest rates, particularly in this uncertain business, and economic environment. Given the CPI report released on February 12, 2025, and pending tariffs being proposed by this Administration, it appears increasingly unlikely that the Fed will cut rates anytime soon. While the Chairman needs to keep his options open with regard to the overall economy, minimal or no reduction in interest rates will likely have an adverse effect on the banking industry towards the end of 2025 and for the next couple of years.

According to the Fed's own research, office sector loan delinquencies in the commercial real estate market, which increased steadily in 2024 (see chart below), remain the Fed's "top concern." In December 2024 the delinquency rate for office loans reached 11.01%, surpassing 11% for the first time since 2000, and more than double the delinquency rate from a year earlier. The current workplace environment does not indicate circumstances will change to help the banks avoid those delinquencies either. According to Kastle Systems

Deliquency Rate on Commercial Real Estate Loans

(Excluding Farmland), Booked in Domestic Offices, All Commercial Banks



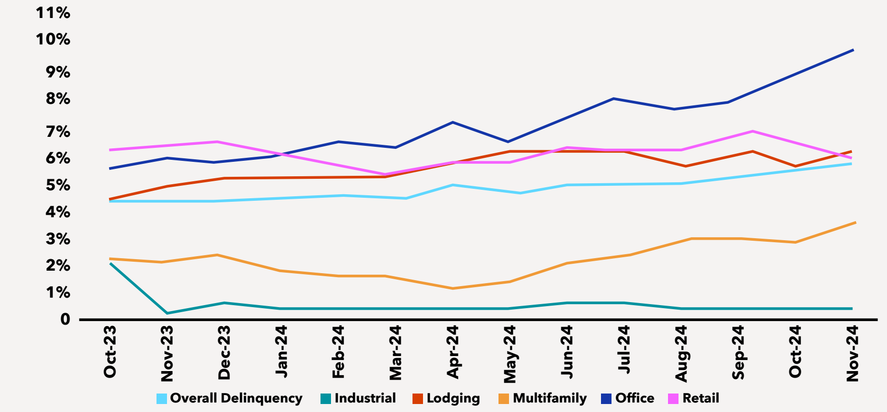
Source: Board of Governors of the Federal Reserve System (US) via FRED

Weekly Occupancy Barometer, even with "back to the office" requirements in many industries, people just are not going back into the office. In Kastle's most recent report, the weekly average occupancy decreased nearly two points from the previous week to 47.7%, according to its 10-city Back to Work Barometer. In any case, occupancy rates of less than 50% do not bode well for the sector.

Other sectors of the real estate market continue to show signs of weakness as well. In its last semi-annual Supervision and Regulation report, the Fed noted that "the multifamily sector had 'come under some stress,' with a material and steady uptick in delinquency rates." Prospects do not look better in the retail sector either. As consumers continue towards online purchases, retailers are closing stores (Macy's confirming closure of sixty-six "non-go-forward" store locations in 2025 as part of its plan to close 150 underproductive stores over the next three years), and traditional urban storefronts and suburban malls continue to become and remain vacant. This puts additional pressure on the financial institutions holding loans on those properties.

The banking industry has been "kicking the can down the road" hoping that, as high-rate commercial real estate loans begin to refinance, interest rates will come down to levels where current cash flows can support lower payments. Simply put, properties are currently not cash flowing sufficiently to support high-interest rate payments on the loans they collateralize, and lenders are hoping to refinance at lower rates. Without significant reductions in interest

CMBS Delinquency Rates by Major Property Type



Source: Board of Governors of the Federal Reserve System (US) via FRED

rates (150bps or more), however, we will continue to see delinquencies rise.

While the largest banks have the capacity and expertise to weather this storm, many regional and community banks do not. Though some of these institutions have begun to address the problem to help stabilize their balance sheets (like Flagstar Financial which, as of January 30, 2025, purged itself of $4.7 billion of CRE loans and 9% of its multi-family loans) most have yet to address these issues. If institutions do not act soon, we believe that there will be an increase in bank mergers and potentially failures later in the year. Ultimately, there will be a need for a regulator to intervene.

Further complicating the situation is the Trump Administration's push to reduce the size of the federal regulatory workforce, and to relax regulation in general. Like many Federal agencies, the FDIC's employees recently received "offers" to participate in the Deferred Resignation Plan ("DRP") under which staff will be paid through September 2025 and then leave their positions. The immediate effect of this will be to speed up merger transactions requiring regulatory approval, because transaction participants will want their deals to be reviewed/approved by staff who no longer have a stake in the outcome. The subsequent effect could be that if bank failures increase later in the year, there will be insufficient FDIC staff to manage/administer those failures leading to a chaotic environment in the banking industry. While it could be argued that the FDIC should be purely an insurer rather than a regulatory body (since the banking industry is regulated by the Treasury (through the OCC) and the Fed), there remains significant public interest in the need for the insurer to be sufficiently prepared to protect depositors' accounts in the event of bank failures.

Over the past few weeks, the FDIC alone has lost as much as 15% of its existing staff. It has also rescinded, or cancelled, openings for 500 new positions. Senior staff members who have now left the regulator are concerned that there is insufficient experienced personnel to not only regulate on an ongoing basis, but to facilitate merger activity and, more importantly, receiverships that may happen later this year and next. Without sufficient, and experienced staff at the regulator, depositor funds could be jeopardized."

Given this uncertainty, it is imperative that regional and community banks get a deep understanding of the current credit quality of their loan portfolios, particularly with regard to CRE, multifamily, and retail properties. While CECL requires institutions mark-to-market their portfolios, it is important for institutions to track the credit migration of existing loan portfolios as well.

Hilco Global is particularly expert in performing this type of portfolio analysis for banks and other financial institutions holding loan portfolios. We gather updated information and analyze quantitative variables including, but not limited to, debt service coverage, debt yield, and current loan to value ("LTV"), as well as other variables including payment history, debt to borrower-net-worth, borrower liquidity, occupancy levels and management expertise. In gathering this information, we work within institutions' risk management and credit policy frameworks to assign a current risk rating, and track both positive and negative risk migration over time. This enables institutions to make informed and timely decisions on how to best position their portfolios to maximize value and mitigate potential losses. Moreover, it provides a solid basis for capital planning and balance sheet management.

Hilco also can assist in all phases of the merger and acquisitions process. From initial due diligence and valuation (including, but not limited to, whole entity, branch network, subsidiary, charter) to loan and securities valuation, process re-engineering, and asset liquidation, Hilco experts have deep industry expertise to assist financial institutions navigate change.

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