Office market woes lessen but JPMorgan, Wells Fargo say banks' troubles far from over

Distressed loans shrank and banks set aside fewer reserves to cover problem mortgages

JPMorgan Chase and Wells Fargo say troubled loans on office buildings will remain a problem into the foreseeable future. (CoStar)

By Andy Peters
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The number of distressed office loans at two of the nation's biggest banks declined in the third quarter, but company executives stressed that the U.S. office market is still troubled and expect its woes to persist.

New York-based JPMorgan Chase, the largest bank in the United States by assets, recorded $156 million in net charge-offs — bad debt that a bank doesn't expect to recover — in its commercial banking division in the third quarter. The decline was "driven by ... downgrade activity primarily in real estate," it said in a statement.

Wells Fargo, based in San Francisco, said net loan charge-offs as a percentage of average loans was 0.24%, an improvement from 0.35% in the second quarter, due to lower charge-off rates from commercial real estate loans, predominantly in its office portfolio.

The results mark the first look at the effect on financial institution earnings from the office market in the third quarter. In that time, office sales nationally continued to close in an indication of demand, though some buildings have sold at prices lower than previously paid.

The office market has struggled since the pandemic as tenants downsized space and businesses cut costs in an era of higher interest rates and reluctance from some employees to return to the office five days per week. A number of older office buildings around the country have high vacancy rates, and owners have defaulted on mortgages.

JPMorgan Chase occupies this office building in Jacksonville, Florida. (CoStar)

“Things aren't getting better and it is kind of more of the same,” Wells CEO Charles Scharf said during a conference call to discuss his bank's results.

JPMorgan and Wells Fargo kicked off the quarterly earnings season for banks on Friday. Bank of America, Citigroup, Goldman Sachs and PNC will report earnings on Tuesday.

Too late

The Federal Reserve’s half-percentage-point rate cut on Sept. 18 came too late in the third quarter to have much impact on banks’ quarterly results. Lower interest rates have a mixed effect on banks’ business.

Lower rates can stimulate lending demand among corporate borrowers. They also allow banks to decrease the rates they pay customers for deposits. But banks will also collect less net-interest income from floating-rate loans when the Fed cuts rates.

“Lower rates was supposed to drive a pickup in loan growth. We just had one cut and it's early, but [are there] any beginning signs of this in terms of the interest in borrowing more?” Matt O’Connor, an analyst at Deutsche Bank, asked JPMorgan Chase during a conference call.

“Generally no,” JPMorgan Chief Financial Officer Jeremy Barnum responded. There was a "tiny bit of pickup" in residential mortgage refinancing, and "there might be some hints of more activity" in the multifamily lending business.

The rate cut essentially had no impact on the office mortgage segment of Wells’ business, Mike Santomassimo, the bank's chief financial officer, said during a conference call.

“We’ve been pretty down on the [office market] space now for a while,” Santomassimo said. “It's playing out kind of largely within that range of what we thought."

Wells charged off $184 million in commercial real estate loans during the third quarter, down from $271 million in the second quarter. The bank's executives expect that charge-offs will remain elevated for an indefinite period of time.

"As I have said over and over, it's going to take a while to play out," Santomassimo said. "This is not something that will take a quarter or two and be over. It will play out over a longer period of time."

Balance sheets

Banks appear to be adequately addressing problem office loans while continuing to maintain a healthy balance sheet in other areas of the company, according to one analyst.

"The proactive measures taken by banks, such as tightening lending standards and increasing loan-loss provisions, should mitigate potential risks and maintain overall financial stability," Laurent Birade, the banking industry practice lead at Moody's Analytics, said in a statement.

Wells has gradually cut its exposure to commercial real estate lending over the past several months. Commercial real estate loans dropped from $148.8 billion in the first quarter to $145.3 billion in the second quarter and to $141.4 billion in the third quarter.

"We are going to continue to work with clients as best we can through it," Santomassimo said.

Santomassimo emphasized that segments of the office market are performing well, specifically that demand is strong for new office buildings in certain U.S. markets.

“New buildings, renovated buildings in good locations are doing fine. It's older office buildings” that are struggling, Santomassimo said during the call.

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