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The NYCB stumble

Lone episode or prelude to wider banking stress?

On January 31, 2024, the New York Community Bancorp (NYCB) shocked market participants with a loss of $252 million in the fourth quarter of 2023 after booking huge provisions on its commercial real estate (CRE) portfolio, particularly multifamily and office, which was accompanied by a sharp dividend cut.

The troubles for the stressed bank, however, deepened when nearly after a month of its quarterly earnings release, it disclosed a huge goodwill impairment charge of $2.4 billion, which resulted in a tenfold increase in its fourth-quarter earnings loss to $2.7 billion. The turmoil exacerbated with the bank flagging noticeable gaps in its internal loan review controls (stalling submission of its regulatory filings) and the abrupt departure of its CEO, Thomas Cangemi, after 27 years of service.

Both Moody's and Fitch have downgraded the bank twice in the past month. Fitch lowered the long-term issuer default rating to junk status i.e. 'BB+'/Negative on March 1, 2024, after taking it down to 'BBB-/Negative' on February 2, 2024, while Moody's cut the bank's long-term debt ratings deeper into junk territory at B3 (outlook under review) on March 1, 2024, after taking the bank two notches lower to 'Ba2' a month back.

The challenges aggravated when on March 6, 2024, the bank's already pressured shares plunged below $2 — down more than 80% year to date — amid reports of a stock sale, resulting in a trading halt. To regain investor confidence, the bank announced a $1 billion plus equity investment anchored by former US Treasury Secretary Steven Mnuchin's Liberty Strategic Capital, Hudson Bay, and Reverence Capital (completed on March 11, 2024), which led to a rebound in shares.

As part of the financing arrangement, a slate of new Board members (including Steven Mnuchin) as well as a new CEO (the second change in one week) i.e., Joseph Otting, former Comptroller of the Currency, was also announced. Furthermore, the bank disclosed a ~5% decline in deposits year to date (as on March 5, 2024) and slashed its quarterly dividend for the second time since January.

While the challenges are largely centred on NYCB, the rout has sparked jitters in the banking industry, raising alarms particularly around the state of the teetering CRE sector and prompting for increased regulatory oversight.

What drove NYCB's troubles?

1. Heightened regulatory scrutiny following transition to a Category IV bank

NYCB's acquisition of Flagstar and some assets and liabilities of Signature Bank pushed its assets beyond $100 billion, making it a Category IV bank. This triggered greater regulatory oversight and tighter financial standards. Consequently, ahead of its first capital plan submission in April 2024, the management 'pivoted quickly' and to align themselves with similar-sized peers undertook actions that partly drove the share price rout.

- **Sharp dividend cut to preserve capital:** After a consistent quarterly payout of $0.17 per share since 2016, NYCB slashed its dividend twice by a whopping overall ~94% to build capital buffers, which at end 2023 trailed Category IV peers. Dividend cut, RWA optimization as well as capital injection, will aid the management to achieve a common equity tier 1 (CET1) ratio of above 10% by end 2024.

Chart 1: CET1 ratio dipped materially at 4Q23

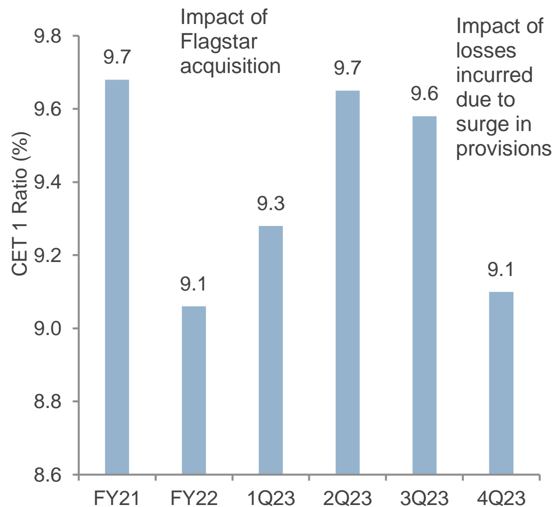
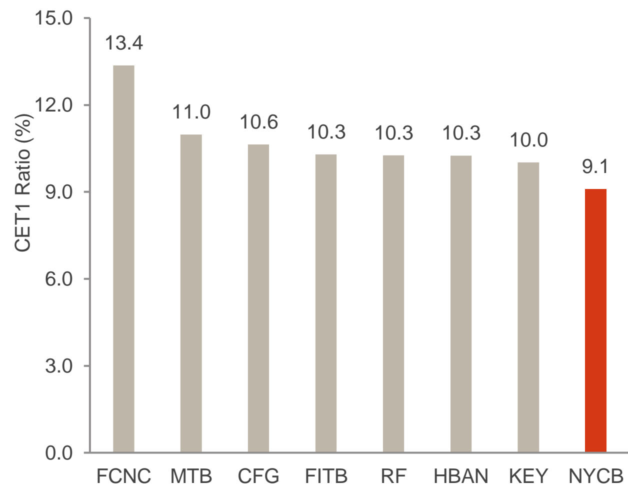


Chart 2: NYCB 's CET1 Ratio trailed peers at end-FY23



Source: S&P CapIQ Pro

- **Ramping up of loan loss reserves:** In the fourth quarter of 2023, NYCB booked ~$552 million in loan loss provisions (LLP; 4.4x on-year) with most of the reserve build being recorded in the office space (*see below for details*) amid souring operating conditions. Despite setting aside huge provisions, NYCB remains materially under-reserved compared with peers and is expected to continue heavy provisioning given its CRE-heavy loan book.

Chart 3: Spike in provisions in 4Q23 to build reserves

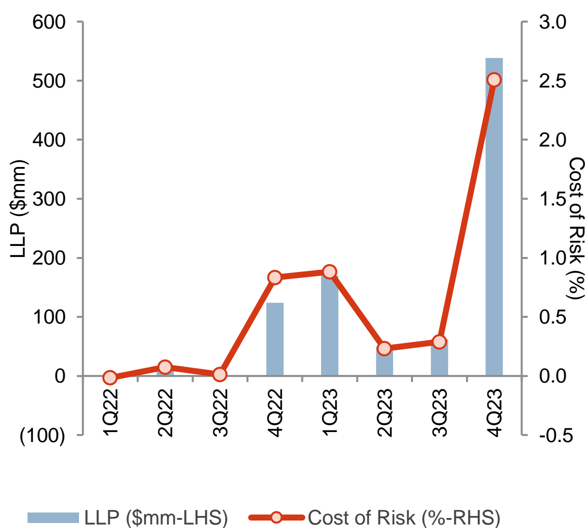
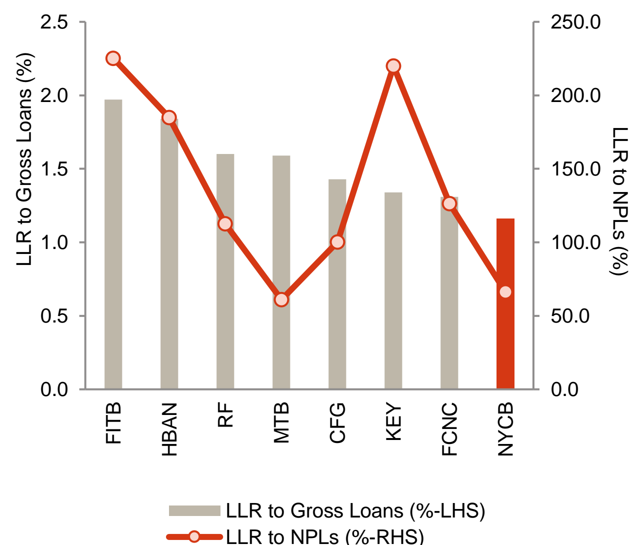


Chart 4: NYCB remains under-reserved vs peers at end-FY23



Source: S&P CapIQ Pro

- **Boosting liquidity to comply with Regulation YY has constrained net interest margins (NIMs):** As a newly minted Category IV bank, NYCB began adding on-balance sheet liquidity in the fourth quarter of 2023 to comply with Regulation YY, thus resulting in its cash and securities portfolio growing to ~18% of assets at the end of the year (vs ~11% at the end of 2022). However, liquidity rightsizing has crimped the bank's NIMs to 2.8% in the fourth quarter (vs peer average of 3.1%), down ~50 basis points (bps) on-quarter and ~20 bps compared with guidance. The bank aims to bring the share of its cash and securities portfolio closer to peers by the first half of 2024 (peer average: 28.2%), which is likely to weigh on margins in the short-term. For 2024, NYCB targets NIM in the range of 2.4%-2.5% after incorporating the impact of actions taken for Regulation YY compliance.

Chart 5: NYCB aims to align with peers in terms of liquidity

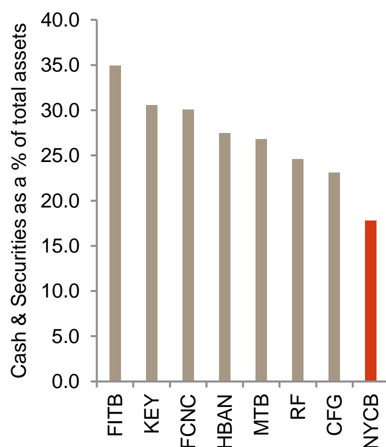


Chart 6: Liquidity buildup in 4Q23 weighed on NIMs

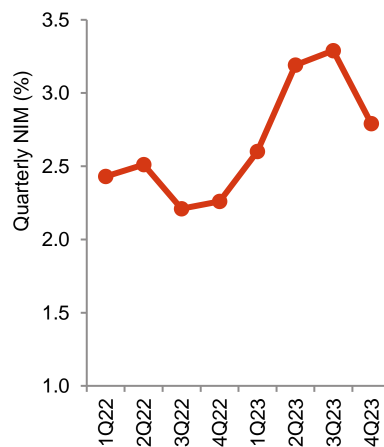
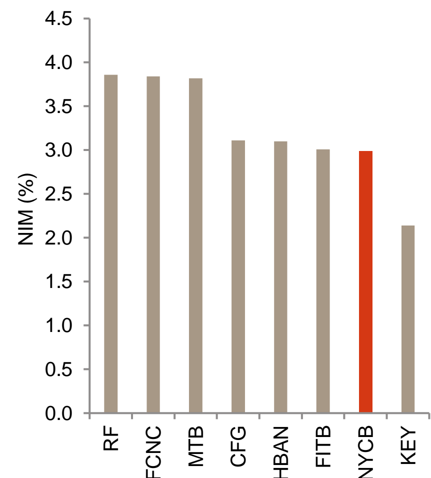


Chart 7: NYCB trails most peers in terms of NIM – FY23



Source: S&P CapIQ Pro

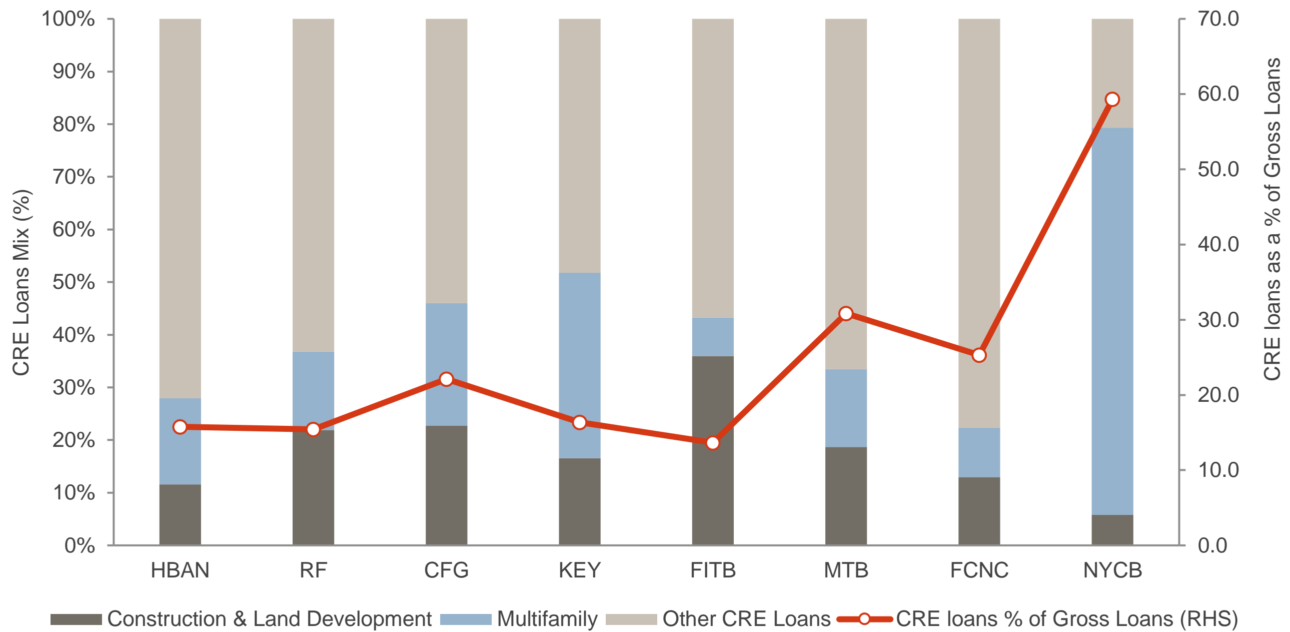
2. High concentration in risky rent-regulated multifamily and office real estate

Additional woes for NYCB stem from its outsized exposure towards stressed CRE sector (much higher versus other Category IV banks) that, in turn, is heavily weighted towards challenging multi-family loans (~44% of total loan book at the end of 2023), particularly New York rent regulated loans[1].

Loans to office sector (though forms a modest at 4% share of the loan book) is another area of concern for the bank (with ~38% of such loans being classified as criticized loans in the fourth quarter of 2023), which has prompted a large increase in loan loss provisions – NYCB raised the reserve coverage for office loans to ~8% in the fourth quarter of 2023 from ~2% in the third quarter.

[1] New York State rent regulated multi-family loans constituted ~49% of the total multi-family portfolio and ~22% of the total loan book at end-FY23

Chart 8: NYCB's much higher concentration in CRE loan book



Source: S&P CapIQ Pro

The historically well-performing rent regulated multi-family properties, has now become an Achilles heel for the bank as borrowers face elevated risks from costlier refinancing (amid elevated interest rates), and higher maintenance costs (due to inflationary pressures), the burden of which cannot be passed onto the tenants due to the 2019 New York rent regulations. This raises the likelihood of increased loan delinquencies, particularly given that at end 2023, ~14% of such loans at NYCB were at risk of default. The losses could exponentially increase if NYCB is forced to sell such loans at heavy discounts. For perspective, in December 2023, the Federal Deposit Insurance Corporation sold ~$15 billion in loans backed by rent New York rent-stabilized apartments at a 40% discount.

3. Gaps identified in the bank's internal controls

An assessment of NYCB's internal controls uncovered noticeable gaps related to its internal loan review process, stemming from ineffective oversight, risk assessment and monitoring activities. To address the shortcomings, the bank has developed a remediation plan (details for the same shall be provided in the bank's 10-K filing). The lapse in internal controls has prompted a reevaluation of NYCB's controls relating to provisioning adequacy, which could result in additional CRE-related reserve building. However, the management asserts that no further reserve buildup is anticipated. Nonetheless, as the assessment is still ongoing, there are lingering concerns regarding the potential revelation of additional weaknesses.

4. Governance/reputational concerns

The surprise departures of the bank's Chief Risk Officer, Nicholas Munson and Chief Audit Executive Meagan Belfinger, just ahead of the fourth-quarter 2023 loss report had drawn concerns around the bank's governance and leadership of its second and third lines of defense. However, in March, the bank appointed financial services veteran George Buchanan as its Chief Risk Officer and Collen McCullum as its Chief Audit Executive. Investor confidence was also rattled by the abrupt departure of NYCB's long-time CEO, Thomas Cangemi, who was first replaced by executive chairman Alessandro DiNello and then again by former Comptroller of the Currency Joseph Otton following the equity investment.

NYCB is also a defendant in a proposed class action lawsuit for allegedly concealing deterioration in its loan portfolio by failing to disclose it plans to set aside more money for credit losses as well as to cut its dividend sharply to preserve capital.

Renewed CRE worries…

The sudden loss and consequent stock rout caused by NYCB has reignited fears over instability of small US regional banks which hold sizeable CRE concentration in their loan book. Almost one-half of US banks hold CRE as the largest loan exposure, while one-quarter of US banks have large CRE loans relative to their capital levels[2].

Table 1: Commercial real estate lending as a share of bank loans

Bank category (as per asset size)	Construction and land development loans	Multi-family loans	Other CRE loans	Total CRE exposure
Over $250 billion	1.7%	3.3%	6.4%	11.4%
$10-250 billion	5.0%	5.8%	17.3%	28.1%
$1-10 billion	8.3%	8.5%	31.0%	47.8%
$100 million to $1 billion	8.1%	4.7%	28.5%	41.2%
Less than $100 million	4.4%	1.6%	14.1%	20.2%

Source: FDIC

The CRE markets are troubled with rising vacancy rates and diminishing value of office properties in lieu of pandemic induced remote work culture, which alongside elevated interest rates, heightened CRE loan maturities (leading to rollover risks) and inflation in property maintenance costs have raised concerns over increased CRE loan delinquencies.

Up till now, it was the Collateralized Loan Obligations (CLO) and Commercial Mortgage-Backed Securities (CMBS) which faced the major brunt of weakness in the CRE markets (delinquency rates for office mortgages that had been securitized into CMBS inched up to 6.6% as of February 2024 — almost tripled from 2.4% a year ago[3]).

[2] *Source: Financial Stability Oversight council*
[3] *Source: Trepp*

On the other hand, CRE loan delinquencies across US commercial banks have increased at a much slower pace, standing at a manageable 1.2% as of fourth quarter 2023 (vs. 0.6% as of third quarter 2022)[4] — benefitting from banks securitizing their pressured CRE loans.

…prompting stringent regulatory supervision and the need to strengthen credit risk management framework

Though the manageable CRE loan delinquencies in the US banking sector have rendered some comfort, NYCB's fallout, along with large losses for certain foreign banks with sizeable US property loan exposure (Japan's Aozora bank) have reignited concerns, prompting stricter regulatory scrutiny. US regulators have stepped up oversight over regional and community banks since the mishap last year. They are working behind the scenes with several small and mid-sized banks with high CRE concentration, ensuring adequate build-up of loan loss reserves as well as capital and liquidity buffers to handle the emerging strain on their balance sheet, while also enhancing supervision for regional banks that have demonstrated aggressive growth or are nearing the $100 billion threshold. SEC has also reached out to multiple community and regional banks with heavy CRE concentration for additional disclosures on their CRE exposure, such as break down of the CRE portfolio by borrower type, geographic concentrations as well as separately presenting owner-occupied and nonowner-occupied properties in their future disclosures.

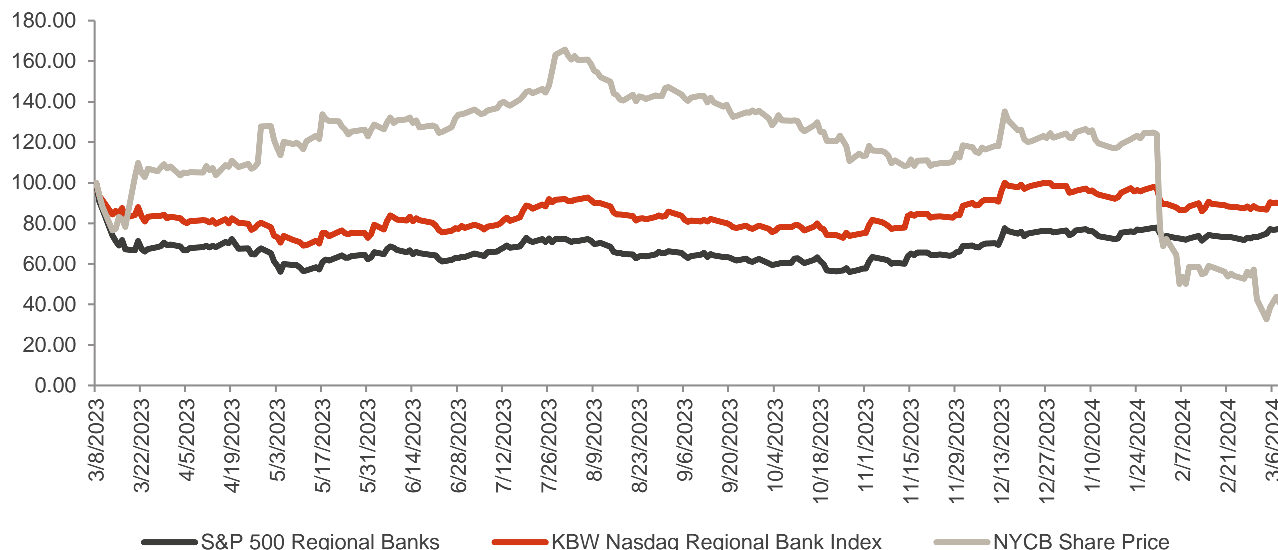
The NYCB setback also underscores the pressing need for banks to reinforce their credit risk management framework, particularly in CRE portfolios given the escalating issues within the sector. With increased regulatory scrutiny, it has become pertinent for banks to proactively fortify their internal controls with respect to loan review process - ensuring vigilant monitoring (both at individual and portfolio level) and early risk identification to mitigate any potential vulnerabilities and prevent new NPL formation. Employment of forward-looking exercises like stress testing and scenario analysis (incorporating both economic and broader uncertainties) enable banks to be well prepared for any adverse scenario. Additionally, given the dynamic operating environment, it has become essential for banks to regularly review their risk management framework - revisiting risk appetite, assessing the effectiveness of risk mitigation mechanisms and identification of potential gaps in internal controls - to minimize potential credit losses.

However, overall risks remain contained

NYCB's woes have spun a reverse halo effect, similar to last year's crisis, with S&P 500 Regional Bank Index and KBW Nasdaq Regional Bank Index showcasing volatility, signaling fears of a wider banking sector stress. US regional bank bonds have also suffered from widening spreads, reflecting market perception of them being risky assets.

[4] *Source: Federal Reserve Economic Data*

Chart 9: NYCB's share performance versus major regional bank indices (rebased to 100)



However, a much sharper dip in NYCB share prices (vis-à-vis the index) implies that issues are idiosyncratic and do not contain a large systemic risk. Nevertheless, we cautiously view a small subset of US regional banks which may have material vulnerabilities arising from their CRE exposure while regulators assert that larger banks are well-positioned to handle the CRE stress. Further, low interconnectedness of these banks limits contagion risk to the broader financial system.

Closing thoughts

The NYCB upheaval does not signal any systemic risk, but is largely a consequence of isolated events, unique to the bank. We acknowledge that the bank's recent troubling announcements and further rating downgrades have led to deposit outflows (deposits contracted ~5% year to date as on March 5, 2024), however, concerns of a heavy deposit run are partly tempered by the bank's low levels of uninsured deposits (vs. regional banks that failed last year[5]), availability of ample resources to tap if uninsured deposits exited the bank as well as the recent capital infusion.

The new leadership is expected to address the structural problems of the bank and drive its recovery. That said, escalating CRE stress continues to remain a pain point for the overall US banking sector, with risks stemming from loans tied to multifamily rent-stabilized properties becoming evident in the wake of NYCB's stumble and prompting for heightened regulatory scrutiny and stringent underwriting standards.

Further, the end of the Bank Term Funding Program as on March 11, 2024, raises escalated concerns as small banks are likely to face liquidity pressures from intensifying CRE strain on the balance sheets.

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[5] *NYCB's uninsured deposits formed ~20% of total deposits as of March 5, 2024, much lesser compared to Silicon Valley Bank and Signature Bank, which had close to 90% of their deposits as uninsured deposits as of December 31, 2022*

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