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Small Banks, Big Risks

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America's 8,000 community and midsize commercial banks — which account for the majority of all commercial real estate loan transactions in this country — have bulked up on loans to the point that federal regulators are threatening to increase their oversight. The aim is to prevent another late 1980s-style financial meltdown.

In today's frothy debt market, commercial real estate loans account for as much as eight times these institutions' total risk-based capital, the minimum amount of capital needed to support their business operations. That's a hefty multiple when you consider that regulators look askance at loan concentrations amounting to three times a bank's total capital. And since most of these loans are fueling local construction projects, there are greater inherent risks.

According to the Federal Deposit Insurance Corp. (FDIC), commercial real estate loan volume at community banks, in particular, has skyrocketed over the past decade. Among commercial and savings banks with assets between $100 million and $1 billion, commercial real estate loan levels have doubled from about 156% of total risk-based capital in 1993 to 318% in the third quarter of 2006.

This same trend holds true for commercial and savings banks with assets of $1 billion to $10 billion. Among those midsize institutions, commercial real estate loan levels rose from about 127% in 1993 to about 300% in the third quarter of 2006.

The magnitude of potential commercial real estate loan losses was driven home in the late 1980s. By the height of the last major financial crisis, 206 FDIC-insured banks with $29.2 billion in assets failed in 1989, the most in history.

Now federal regulators are worried that they have seen this combination before — so many loans, along with gradually loosened underwriting standards like shorter credit analyses, higher loan-to-value ratios, and risk of concentration in one property type or geographic area. To head off past mistakes, they issued new guidelines in late 2006, putting community banks on notice that future loans will be more closely scrutinized.

E.J. Burke, executive vice president and group head of Cleveland-based KeyBank Real Estate Capital, agrees that guidelines are in order for smaller institutions, those with total assets under $1 billion. “There's no question that underwriting standards, loan structures and pricing are all pushed to the limit. On a scale of 1 to 10, 1 being a very conservative lending environment and 10 being extremely frothy, we'd be at 9.5,” says Burke.

KeyBank ranked seventh on NREI's most recent survey of direct lenders with $22.2 billion in commercial real estate lending volume in 2005. Burke notes that KeyBank, along with many of his larger banking brethren, filed formal comments supporting the proposed lending oversight, primarily since they've already invested millions in risk management systems to pinpoint potential loan losses.

Overall, aggressive lending has proved to be a boon for mortgage brokers, too. According to the Mortgage Bankers of America's latest origination volume index, loan originations for commercial banks in the third quarter of 2006 rose 30% over the same period a year ago. That is on top of a 65% increase for the same period a year earlier.

For their part, borrowers show no signs of slowing down. NREI's 2007 borrower trends survey reveals that 42% of borrowers expect the total debt in their commercial real estate portfolios to increase this year. Commercial banks are providing a lot of that funding. Four in five respondents indicate that they have used commercial banks as a debt source over the past year.

While times have been good, nothing lasts forever in this cyclical business. “The kind of market we're in, there is not a lot of room for error for either borrowers or lenders,” says Professor Tim Riddiough, who has been tracking major financing trends for the past 15 years and is director of the center for real estate at the University of Wisconsin-Madison.

Loans are holding up, so far

Despite the warnings, commercial real estate loans have been performing well to this point. “Delinquency rates have been extremely low and end up being amongst the lowest rates for the different loans held by banks,” says Jamie Woodwell, MBA's senior director of commercial and multifamily research.

Data from the Federal Reserve seems to support that view. The delinquency rate — loans classified as delinquent after 90 days of nonpayment — across all commercial banks increased only slightly from 1.05% to 1.10% during the 12-month period ending Sept. 30, 2006, and has remained in the same range for several years.

Woodwell argues that the industry is much more transparent today than ever before, largely due to Wall Street's influence and the securitization process. “Between the amount of CMBS activity and the amount of data available, the number of investment banks, rating agencies, life company investors and others looking at the performance, there are a lot of people out there assessing the situation and keeping an eye over the horizon,” observes Woodwell.

Jack Cohen, CEO of Chicago-based Cohen Financial, one of the largest mortgage banking and loan administrators in North America, believes the industry is using that transparency to better identify and assess risk. “Also, remember that there is so much liquidity in the system that even if somebody trips, I don't think we'll ever have the cash crunch of the 1990s,” says Cohen. “Therefore, at a price, a bank will be able to move [the risk] off its balance sheet.”

Community banks are heavily regulated thanks to around 2,000 bank examiners employed by the Office of the Comptroller of the Currency (OCC) and the FDIC to monitor their activities. And for most community bankers, commercial real estate loans are among their primary funding vehicle in the wake of a slowdown in credit card lending and the residential housing bust.

“It's sad to say, but the local banks are the only relationship lenders left,” says Cohen. That explains why many of them now worry that any cutbacks in their commercial real estate loan business could slow their own growth and lead to local economic slowdowns.

Testifying before Congress last year on behalf of the Independent Community Bankers of America (ICBA), James McKillop, president and CEO of Independent Banker's Bank of Florida in Lake Mary, admitted that his commercial real estate loan portfolio equals six times his total risk-based capital. “If a community bank must cut back, it means cutting back on one of its more profitable business lines,” explains McKillop.

The feds get tough

The sheer volume of commercial real estate loans, plus a perceived lack of adequate risk management guidance, has finally moved federal banking regulators to act.

In January 2006, the OCC, which oversees all commercial banks in the U.S. through a system of bank examiners, issued proposed new interagency guidelines for commercial real estate loans at commercial banks.

At the heart of the guidance were proposed thresholds for bank examiners to use in assessing commercial real estate loan concentrations and when risk management practices should be employed.

After a lengthy comment period, the agencies received some 4,400 letters from bankers, economists, civic leaders and trade groups. The predominant message from community bankers was that the industry was already highly regulated and that problems should be tackled on a case-by-case basis.

By December 2006, the OCC backed off from its initial guidance language. Still, it warned: “An institution's lending policies should reflect the level of risk that is acceptable to its board of directors, and should provide clear and measurable underwriting standards that enable the institution's lending staff to evaluate all relevant credit factors.”

There are two telltale signs that a bank is overexposed, warn regulators. First, if total reported loans for construction, land development and other land represent 100% or more of the institution's total capital, then possible loan limits will be imposed. The other trigger is when total commercial real estate loans represent 300% or more of the institution's total capital and the outstanding balance of the commercial real estate loan portfolio has increased 50% or more during the prior 36 months.

“Hopefully these guidelines will serve to raise the sophistication throughout the banks as opposed to curb lending,” says Bob White, president of New York-based Real Capital Analytics. “That was the intention, so hopefully the reality will follow the theory. Some of these smaller banks, quite frankly, haven't been underwriting and managing their risk.”

Slipping standards

Given the unprecedented volume of lending and the heated competition, most industry veterans acknowledge that there has been some slippage in underwriting. “Loan standards have now eased for three consecutive years,” warned John C. Dugan, comptroller of the currency, in a speech to the American Bankers Association in November 2006, citing the OCC's own Survey of Credit Underwriting Practices.

“We don't want to see lending decisions that bankers make today result in excessive foreclosures — and reduced affordable credit — tomorrow. The challenge we face is managing this risk in an effective and timely way and doing it now while credit quality is still good, while loan loss reserves are strong, and while the economy is robust,” remarked Dugan.

While Burke of KeyBank has not observed over-reaching by community banks — such as non-recourse construction loans or 95% loan-to-value levels — he understands regulators' preemptive stance and the need for banks to better monitor their loan portfolios. Some banks don't realize how exposed they are to a market shift, says Burke.

“If you're a community bank and 80% of your loans are only in a six-county area and something happens in that local economy, your capital could get whacked pretty good,” says Burke.

A recent report by front-line FDIC examiners also raises eyebrows. FDIC field examiners reported common deficiencies in commercial real estate monitoring and management information systems to mitigate risk, including failure to consider or establish limits of exposure by type or geographic market, and inadequate or nonexistent interest rate stress testing.

Big banks wade in

LegacyTexas Bank, based in Plano, just north of Dallas, is the prototypical community bank, with a $1.2 billion balance sheet and a commercial real estate loan portfolio of about 50% of its risk-based capital, primarily concentrated in construction lending.

“There is a lot of money out there chasing investments,” says Rick Lafitte, executive vice president at LegacyTexas Bank. But he stresses that he and most of his brethren learned their lessons from the 1980s. “Most banks are requiring the fundamentals to be there, not just lending money because everybody is doing it.”

The bulk of Lafitte's deals are under $10 million, the real sweet spot for most community banks. “If you get a project for under $10 million, the big guys just don't take a look at it — it's under their radar. We can make money on those deals; that's our cup of tea, the $2 million to $8 million loans.”

But on top of the recent federal guidance, local bankers like Lafitte will soon see more big banks playing in their sandbox. “I would think that as liquidity grows, larger banks may think about moving down the chain in size, while community banks may be thinking about moving up the chain,” says David Steinwedell, chief investment officer with Atlanta-based Wells Real Estate Funds, a leading buyer of office properties for the past four years. “So, they may cross over a little more than they have in the past.”

LaSalle Bank is a good example. “I think there is going to be ample lending opportunity for us and other national players, all at the expense of the local banks which have had their hand slapped,” explains Charles Krawitz, national director of small balance originations for Chicago-based LaSalle Bank. “In the past, local banks operated somewhat oblivious to whether the loans they were making were really profitable enterprises.”

In its first foray into the business last year, Krawitz's group originated $1.3 billion in loans in 1,200 deals, yielding an average deal size of about $1.2 million, which is traditional community banking business. His group led three syndications in 2006, and he is planning to generate enough volume in 2007 to lead up to five more syndications.

Why the interest from the big banks? Well, their collective strategy is to crack the code and make money in the huge small-loan market. According to Boxwood Means, a risk management consulting firm based in Stamford, Conn., there are now more than $134 billion in small-balance transactions a year in all property types, with multifamily accounting for an estimated $35 billion worth of transactions a year.

It also is a local and fragmented arena fraught with inefficiencies. “Most national lenders have shied away from getting into the space because there is an art to processing these loans in an efficient manner,” says

Krawitz. “We took the know-how and lessons that we learned with our small balance conduit, LaSalle Select, and capitalized on that in the multifamily lending area.”

Other banks already have explored the sector in a big way, including Washington Mutual. In 2002, the bank began a 10-year, $375 billion Community Commitment program targeting home loans, affordable apartments and manufactured home sites, consumer and small business loans, and community investments and development.

Krawitz predicts that LaSalle will soon start partnering with small banks to help them jettison their commercial real estate loans. “On one hand I want to take their core business. On the other hand, I welcome contact with the more progressive banks with regard to us maybe buying a portfolio or jointly securitizing with them.”

Ultimately, whether the combination of federal guidance and increased competition will be detrimental to community banks or not depends on how banking examiners apply the rules and how community banks react.

“It certainly was a warning and the banks took it as a warning,” says Ann Grochala, director of lending and accounting policy for the Independent Community Bankers of America.

Many small banks also took it as a message to cut back on their commercial real estate lending, but Grochala sees it differently. “In reality, it's a message that you need to be very careful about the lending you do and decide whether this deal is really worth the risk.”

High-end software allows for portfolio ‘stress test’

Community banks traditionally have shunned formal risk management systems, preferring to rely on their experience, intuition and deep community relationships. But in the new era of commercial real estate lending, federal regulators are pressuring even the smallest banks to upgrade their portfolio analysis capabilities to avoid the pitfalls of past downturns.

“In general, we don't like concentration risk,” says Allen Tischler, a senior analyst who follows the commercial banking industry for Moody's Investors Service in New York. Generally speaking, concentrations in any one lending category — commercial real estate loans, for example — are a concern to rating agencies and regulators alike.

Chris Marrison, founder and CEO of **Risk Integrated**, based in Garrison, N.Y., is in the business of helping banks implement risk-modeling software. His company builds a software platform known as the Specialized Finance System. The software enables bankers to quickly analyze and “stress test” all risk aspects of their commercial real estate loan portfolios, including pricing, geographic areas, loan-to-values and terms.

While the software system can flag potential trouble — such as an over-concentration in commercial real estate loans — it's ultimately up to the banker to analyze the data and take any necessary action. Marrison's clients include Hypo Real Estate International in Germany, Anglo Irish Bank, and one of Britain's largest community bank building societies. In the past, he's worked with Morgan Stanley and the Fed to help train their examiners.

“Banks have to go beyond the traditional pie charts showing segmentation by region. They should at least be able to stress test their whole portfolio for changes in interest rates, rental rates and property values,” says Marrison. But for smaller banks, the cost is a major drawback, particularly at a time when commercial real estate loans are performing well. Complete custom-modeling systems can cost millions of dollars.

Marrison says that most bankers cannot easily quantify the volatility of their commercial real estate loan portfolio vs. other types of loans primarily because of the complex analysis required to monitor rents, lease turnover and interest rates. “If you want to have an analyst in the basement who knows that stuff, that's a relatively expensive person,” says Marrison.

In the next five to 10 years, even community banks will be forced to grow their internal capabilities, Marrison believes. “Commercial real estate is difficult, it's quite a tricky business to model and quantify, so it's taking a long time to get there,” he observes. “But if you've got your gut and a model, you're likely to do better than just with your gut.”
— Ben Johnson