Tightening the Screws

Federal Proposal May Increase Commercial Real Estate Lending Scrutiny

By Paul Rosta

Availability of capital has become a cliche in today's robust lending and development environment. Yet a proposed federal regulation in the pipeline raises concerns about how much real estate lending commercial banks will be doing in the future. Critics charge that the rules are unnecessary and overreaching and could restrict the volume of capital and slow development, especially for smaller banks and projects.

A battery of federal agencies is proposing to establish thresholds that banks can use to determine whether the proportion of real estate loan concentrations in their portfolios is too high to be prudent. Giant real estate lenders—such as Bank of America Corp., Wachovia Corp. and KeyBank Real Estate Capital—will be largely unaffected, bank executives said, because they typically do not have high concentrations of real estate lending relative to their other loans.

However, the rule will certainly affect smaller commercial lenders, potentially forcing customers to look elsewhere. "Inevitably, there will be some dampening of enthusiasm for commercial real estate loans from smaller banks," said E.J. Burke, executive vice president & head of KeyBank.

Not surprisingly, the proposals have raised a red flag for those smaller institutions. "We believe knocking these guys out will be damaging to the community and damaging to the bankers," argued Janet Frank, director of mortgage finance with America's Community Bankers, a national trade organization representing commercial banks with a typical capitalization in the $300 million range.

Yet other observers downplayed the impact of the proposed guidelines and suggested that the regulators are right to respond to concerns raised by the vast volume and easy terms of capital. During the past year, executives have expressed increasing concern that competition and aggressive lending have prompted many banks to provide loan structures in which the borrower puts little or no skin in the game. Moreover, rising cap rates in some sectors and markets suggest that a market slowdown may reduce yields.

The bone of contention is the proposed guidance being considered by four federal agencies whose oversight includes commercial banks: The Treasury Department's Office of the Comptroller of the Currency and the Office of Thrift Supervision, the Federal Deposit Insurance Corp. and the Federal Reserve System's board of governors. Spokespeople for several of the agencies declined to comment on the reasons for the concerns or on the status of the proposed regulations. But a document published jointly by the four agencies earlier this year spells out their concerns in detail. Specifically, high and increasing concentrations of commercial real estate loans on bank balance sheets raised alarm bells that market cycles may put those banks at risk of failure. The agencies stated they are particularly concerned about commercial real estate exposures in which repayment hinges on the rental income or the asset's sale, refinancing or permanent financing.

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The federal regulators' unease with the high proportion of real estate lending in some smaller banks' portfolios stems from the recent memory of the rash of bank failures in the late 1980s. "In today's world, people are very mindful of concentrations of risk," Burke said. "We learned very painful lessons in the '80s and '90s."

The guidance document cites several asset types it considers to pose particular risk: undeveloped land, development, multi-family property and non-farm residential property, as well as four-unit and smaller residential developments. Also included are loans to REITs and unsecured loans to developers that fall into those categories.

The proposal asserts that risk management practices and capital levels are falling behind what would be considered appropriate for banks with increasing real estate lending concentrations. "In some cases, the agencies have observed that institutions have rapidly expanded their (commercial real estate) lending operations into new markets without establishing adequate control and reporting processes, including the preparation of market analyses," the proposed guidance document stated.

Another issue is that many banks with high real estate loan concentrations also have worrisomely low capital levels that approach regulatory minimums. That, the agencies contend, leave banks without sufficient reserves to withstand losses.

Crossing the Threshold

As a result, federal regulators want to establish two thresholds that would trigger increased scrutiny of such institutions:

- Reported loans for construction, land development and other land that represent 100 percent or more of the institution's total capital.
- Total reported loans secured by multi-family and non-farm residential properties and loans for construction, land development and other land that represent 300 percent or more of the institution's total capital.

Either of those milestones would trigger a review of risk-management practices. For banks reaching the 300 percent threshold, further analysis of the loans is recommended.

According to an analysis released in January by Credit Suisse Group, 18 of the 74 U.S. commercial banks with market capitalizations of at least $1 billion would fall under the first category. Seventeen of the 74 banks exceeded the 300 percent concentration. A broader survey released in April by A.M. Best Co. determined that 22 percent of FDIC-insured banks have construction loan-to-capital ratios exceeding the 100 percent threshold. Leading the list of states with banks exceeding that threshold are Georgia, with 56.7 percent, and Florida, with 51 percent.

The document goes on to stress that the guidelines reinforce previous ones for sound lending practices, such as the responsibility of the board of directors for providing guidance to the bank's management for commercial real estate risk.

Bankers are raising varying degrees of concern about the implications of the proposed regulations. Although the guidelines are advisory in nature, America's Community Bankers is concerned that they will carry the weight of regulation with bank examiners. "We don't think the thresholds should be applied at all because they are arbitrary," said Frank. Moreover, she said, they fail to take the nature of the assets into consideration.

While representing a different constituency, the Mortgage Bankers Association also weighed in against the regulations. "Our concern is, we want the regulatory agencies to take a look at the individual circumstances of each bank rather than taking a prescriptive view," said George Green, director in the commercial multi-family group. For example, the 300 percent threshold need not indicate that the bank requires increased capital or additional risk analysis, he agreed. The MBA also urged the regulators to consider an array of factors when determining a bank's risk-management program, such as the experience of lender and borrower, the bank's size and the geographic dispersion of real estate loans.

Despite the concerns of leading industry organizations, some experts contend that the guidance may allow more flexibility than meets the eye. The guidelines do not prohibit banks from exceeding the guidelines, but do require the company's board to sign off on the policy. An analysis published this year by Credit Suisse also offers a less drastic scenario. Federal regulators stipulate that the banks should have risk management measures in place but not that financial institutions should necessarily reduce their levels of commercial real estate loans or increase their capital. ■