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Regional/Local Banks Eat More of the Commercial Mortgage Pie: When is Enough?

- Commercial banks are lending at a healthy clip. Since 2012, commercial and multifamily mortgage holdings of the nation's 5,300 banks have grown by 37.3% to $1.8 trillion.

- Growth is a function of banks searching for higher-yielding investments, the stellar performance of the sector, strong borrower demand and weak volume in other lending products.

- Regional and local banks are the fastest-growing segment of the commercial bank sector. In recent years, the largest growth in commercial mortgage portfolios on both an absolute and percentage change basis has come from banks with total assets of less than $100 billion. The largest banks are also increasing commercial mortgage holdings, but more incrementally.

- While leverage levels remain firm, banks are winning deals through aggressive pricing, and are increasingly being laxer on terms such as recourse and debt-service covenants. Although commercial mortgages are rapidly growing as a share of the economy, lending standards have not deteriorated as much as during the cycle that led to the financial crisis.

- Banks with less than $100 billion in assets—which encompass more than 97% of the sector—on average devote a much larger percentage of their assets and total loan books to commercial real estate than larger banks.

- Risks include the lack of diversity in mortgage portfolios, rising interest rates, the mismatch in financing long-term assets with short-term funds and a potential downturn in real estate performance. Although regional/local banks don't rise to the level of "systemically important," a downturn could have a broad impact on the market.

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Rapid Growth in Bank Lending

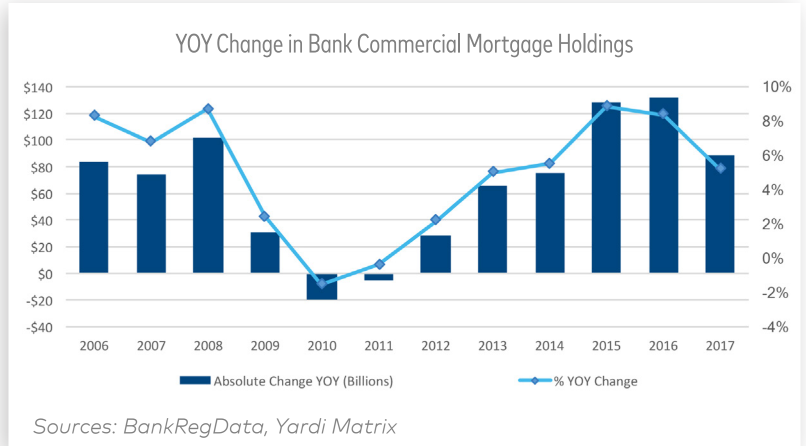
The post-financial crisis expansion has been a heady time for banks in commercial real estate. As of year-end 2017, banks held $1.8 trillion of commercial and multifamily mortgages, up nearly $500 billion (37.4%) since the recovery began in earnest in 2012 and 50% more than the $1.2 trillion banks held 10 years ago, at the height of the last lending boom. Growth was highest in 2015 and 2016, when commercial mortgage holdings grew a combined $258 billion, or more than 8 percent each year.

Commercial mortgages are also rising as a share of banks' overall business. Commercial and multifamily loans represented 10.3% of bank assets as of year-end 2017, up from 9.0% in 2012. They represented 18.5% of total bank loan books in 2017, up from 17.0% in 2012.

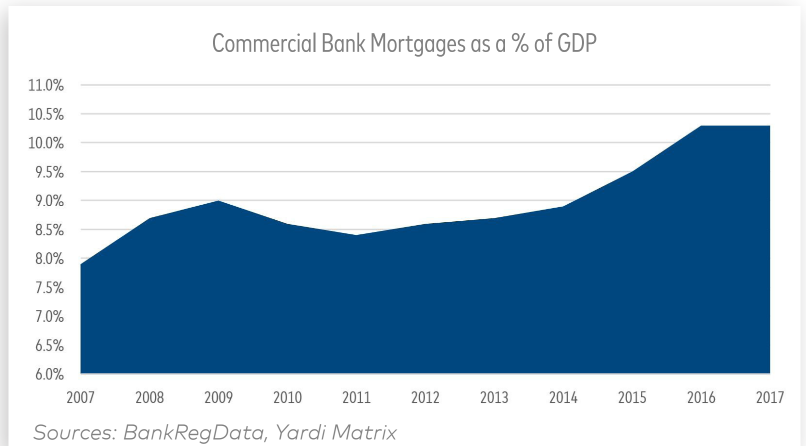
Because property values are rising much faster than the economy—values are more than 50% above the 2007 peak, per various indexes—bank mortgage holdings are growing as a share of GDP. As of fourth quarter 2017, commercial and multifamily loans represented 10.3% of U.S. GDP, up from 8.4% in 2011 and 7.9% in 2007. The growth reflects the extent to which commercial property values have risen, in large part due to strong capital markets forces.

Whether the growth in commercial mortgages indicates a bubble is an open question. Certainly, growth of the last few years is unsustainable, and there was a similar rise in outstanding balances before the global financial crisis. However, there are few signs that banks are engaging in the highly leveraged lending practices that led to the bubble a decade ago.

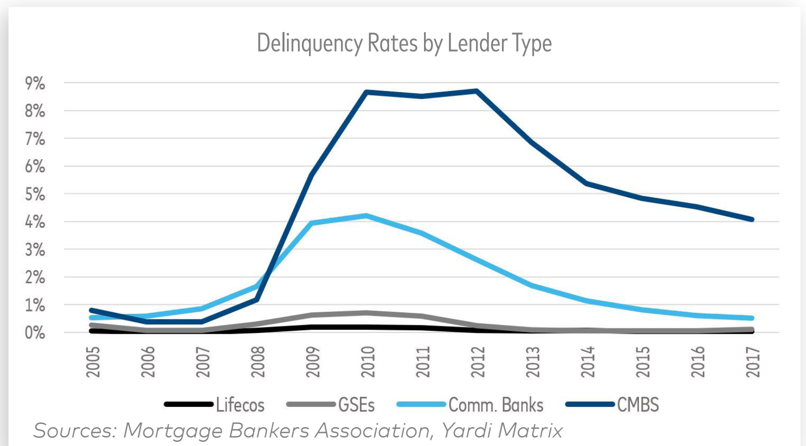
Growth in mortgage lending reflects commercial real estate's position as a favored asset class among investors, both equity and debt, during the



Sources: BankRegData, Yardi Matrix



Sources: BankRegData, Yardi Matrix



Sources: Mortgage Bankers Association, Yardi Matrix

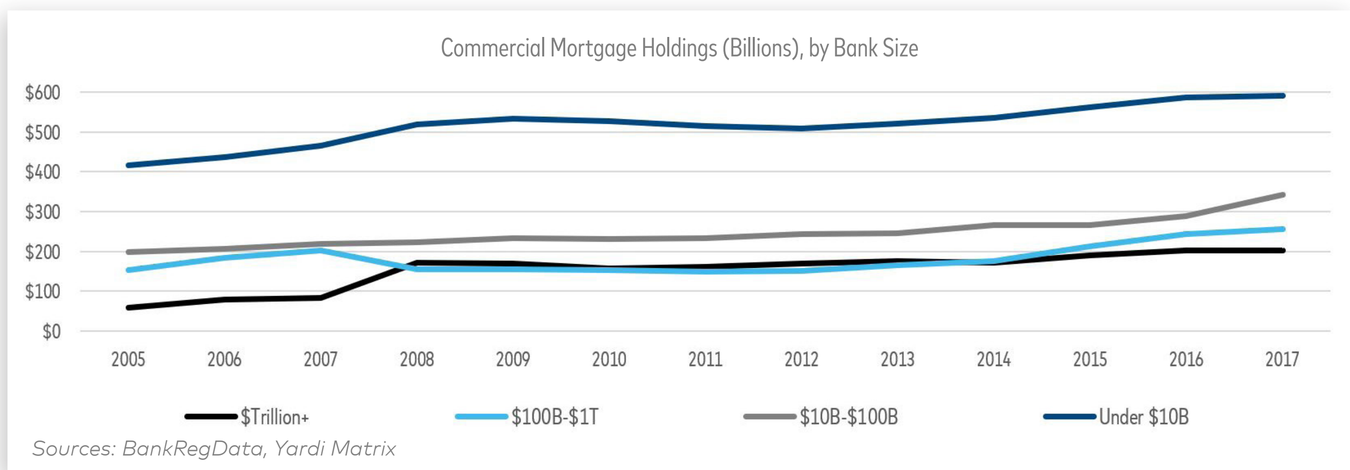
current economic cycle. Strong demand for space in most segments has led to increasing property income, while attractive returns have brought a great deal of institutional capital into the sector. So far this cycle, that faith has been rewarded, as mortgages are providing attractive yields with low risk. Delinquencies on bank loans have gradually subsided to 0.5% as of fourth quarter 2017, down from the cycle peak of 4.2% in 2010.

Regional/Local Banks Lead in Growth

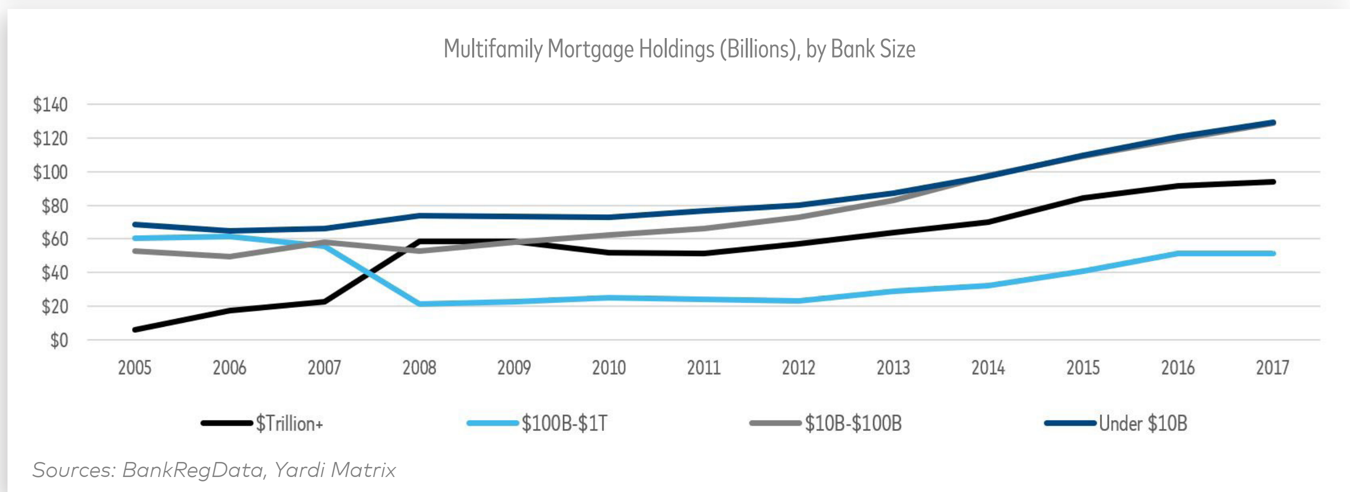
To understand how growth differed by type of bank institution, Yardi Matrix broke down bank lending statistics into four categories based on asset size: banks with $1 trillion or more (of which there currently are four), banks with $100 billion to $999 billion (there are 24), banks with $10 billion to $99.9 billion (there are 78) and banks with assets of less than $10 billion (there are 5,187). Bank lending statistics in this report come from BankRegData.

While all categories of banks have increased lending, data shows that the amount of growth varies. The portfolios of regional and local banks are increasing at a faster rate than the relatively few national and money-center banks. That holds true both for the most recent year and over the course of the recovery.

In 2017, bank commercial and multifamily mortgage portfolios rose by $88.2 billion, and $63.8 billion—almost three-quarters—came from banks in the $10 billion to $99.9 billion category. Year-over-year banks in that category increased mort-



Sources: BankRegData, Yardi Matrix



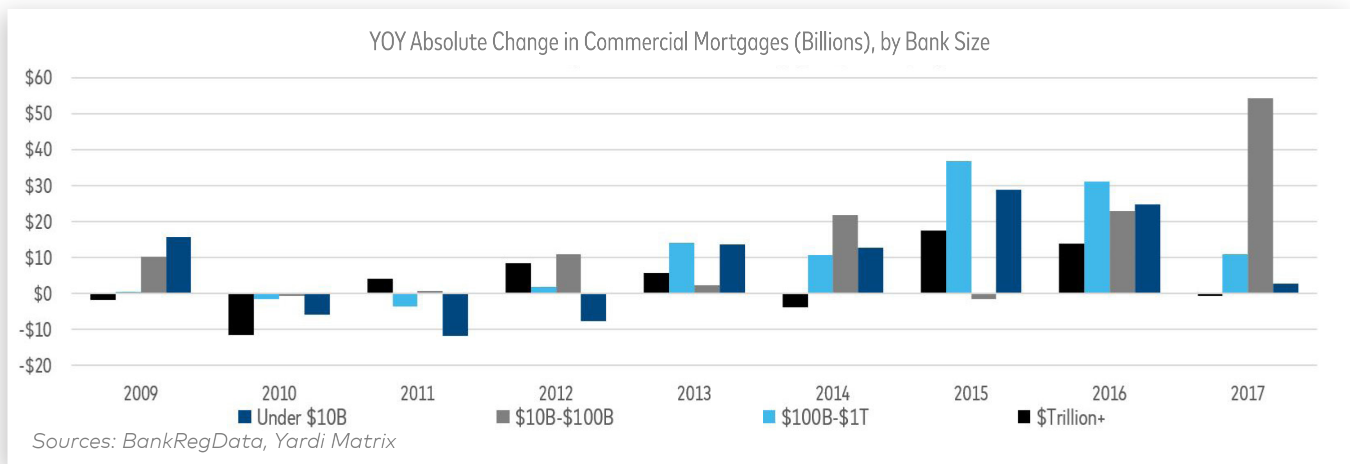
Sources: BankRegData, Yardi Matrix

gage holdings by 15.7%, compared to 0.6% for the $1 trillion banks, 3.8% for the $100 billion to $999 billion category, and 1.6% for the under $10 billion category.

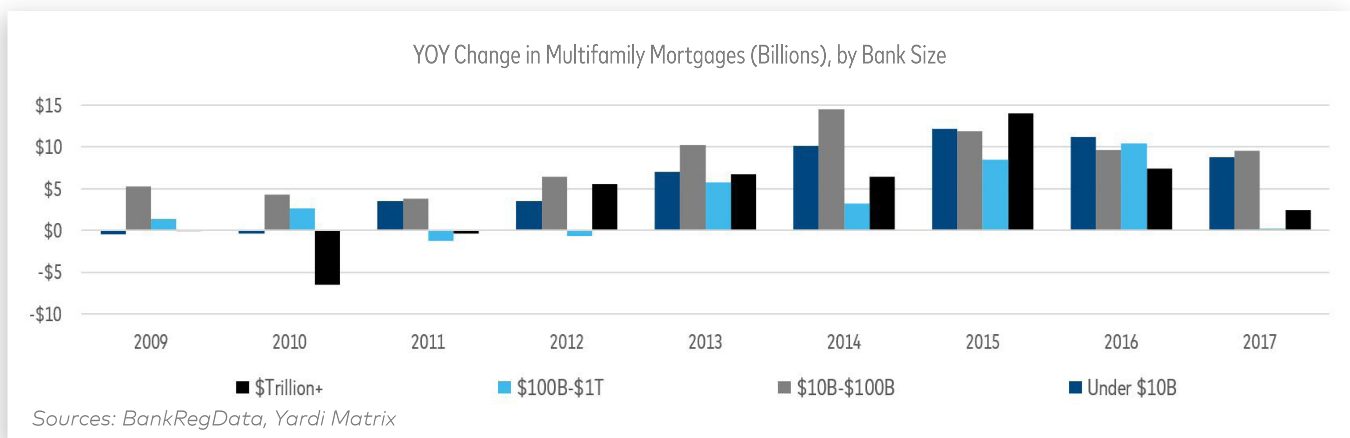
While last year was an extreme example, the outsize growth in regional/local bank lending started in 2012, after bank commercial mortgage holdings shrunk for two years in the wake of the recession. Since 2012, banks in the $10 billion to $99.9 billion category increased commercial mortgage holdings by $172.6 billion, compared to $132.8 billion for the $100 billion to $999 billion category, $127.6 billion for banks under $10 billion, and $83.3 billion for the $1 trillion institutions.

As a percentage of total assets, commercial mortgage holdings of $10 billion to $99 billion banks rose to 18.2% at year-end 2017, up from 12.2% in 2012. Again, that was more growth than other categories of banks. During that time, holdings of $1 trillion banks rose to 4.1% from 3.6%, while holdings remained flat at 6.4% for banks in the $100 billion to $999 billion category, and rose to 25.3% from 21.5% in the under $10 billion category. (It should be noted that as banks merge or change in asset size, they might change categories during the study.)

This growth in commercial mortgage lending increased not only regional banks' share of the overall bank market but their share of all commercial mortgage lending. Small and regional banks comprised 18% of all commercial mortgage lending in 2017, double their share in 2011, when total originations were much smaller, according to Real Capital Analytics. National banks' share of the to-



Sources: BankRegData, Yardi Matrix



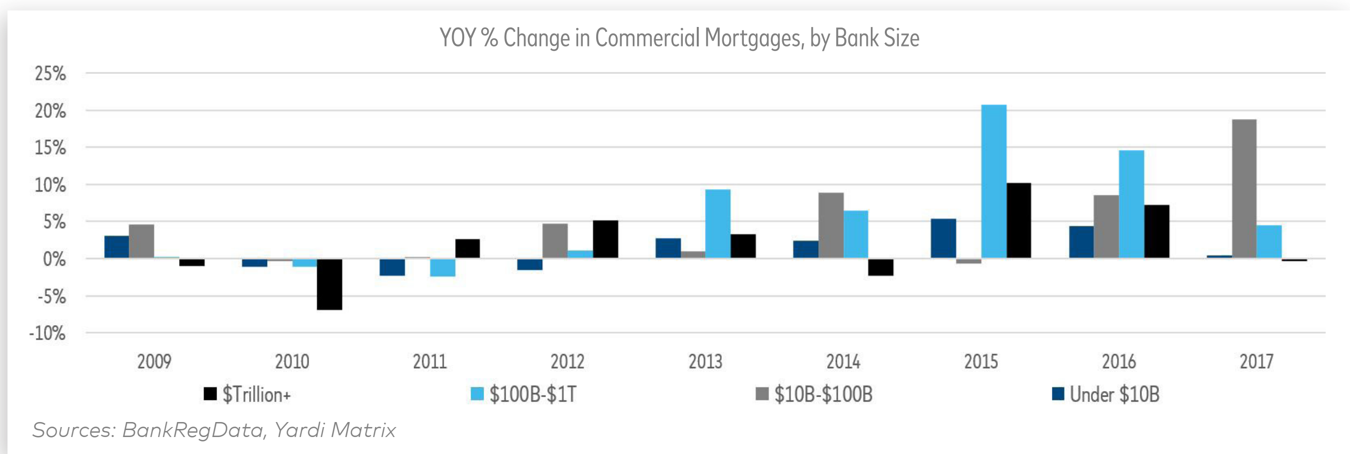
Sources: BankRegData, Yardi Matrix

tal mortgage market is more consistent, ranging between 13% and 18% during that time.

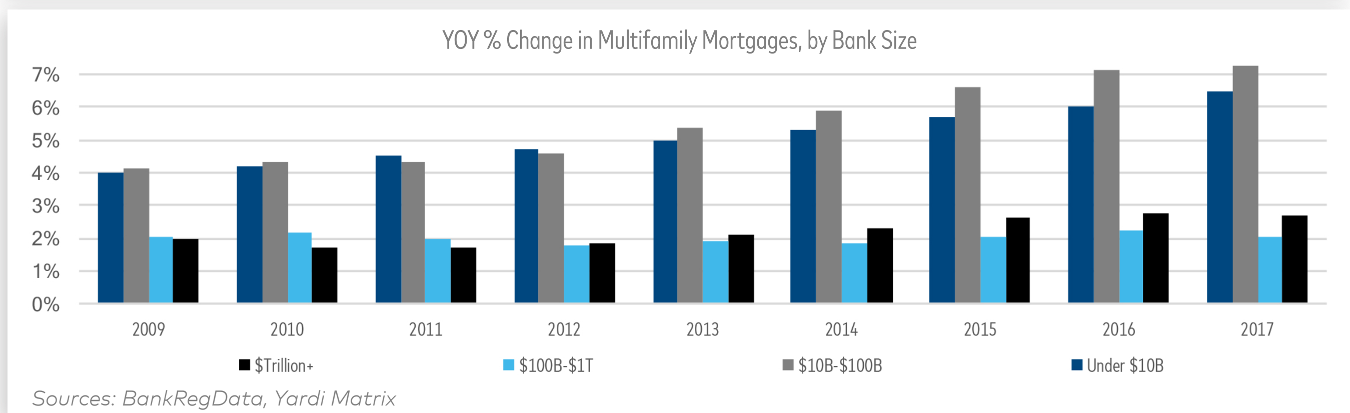
CMBS has been impacted the most by growth in small bank lending, because it is regional banks' most natural competitor. Although CMBS volume is up year-to-date in 2018, the growth in volume is in single-borrower and single-asset deals. CMBS "conduit" lending—or smaller loans that are pooled in $1 billion transactions—has declined in part because regional/local banks are often outbidding securitization programs for small- and medium-size properties in secondary and tertiary markets.

What's driving the growth in commercial mortgage activity of regional and local banks? The product fills a need and it is expedient. Commercial mortgages provide more yield than other investment products, even with coupons in the 4% range. The yield looks even better on a risk-adjusted basis, since loan defaults are less than 1%. Another factor is geographic: Many local banks operate in rural areas, so their increase in lending comes later in the economic cycle and increases as the economy begins a decline.

Maybe the biggest reason for growth in small bank lending, though, is the availability of the business. Large banks have many more revenue sources, such as investment banking and wealth management. For small banks, commercial mortgages are more readily available than consumer and industrial (C&I) business loans, which are usually awarded to banks at which the borrower has deposits and relationships. Property owners routinely put mortgage assignments up for bid, and banks can control volume based on how aggressively they bid. Plus, commercial mortgages usually come in larger chunks than other types of loans, an important factor to banks looking for growth.



Sources: BankRegData, Yardi Matrix



Sources: BankRegData, Yardi Matrix

Risks of Overheating?

Banks' lending freely makes for a liquid and healthy market—if loan underwriting remains disciplined. Although data on the quality metrics of bank loans is thin, anecdotes report a mixed bag. Lenders have generally held the line on loan-to-value ratios, while growing more aggressive on loan spreads and increasingly giving borrowers more flexible terms, such as waiving recourse and debt-service covenants and extending maturity periods. On a broader level, some of the risks involved with the growth in lending of regional and local banks include:

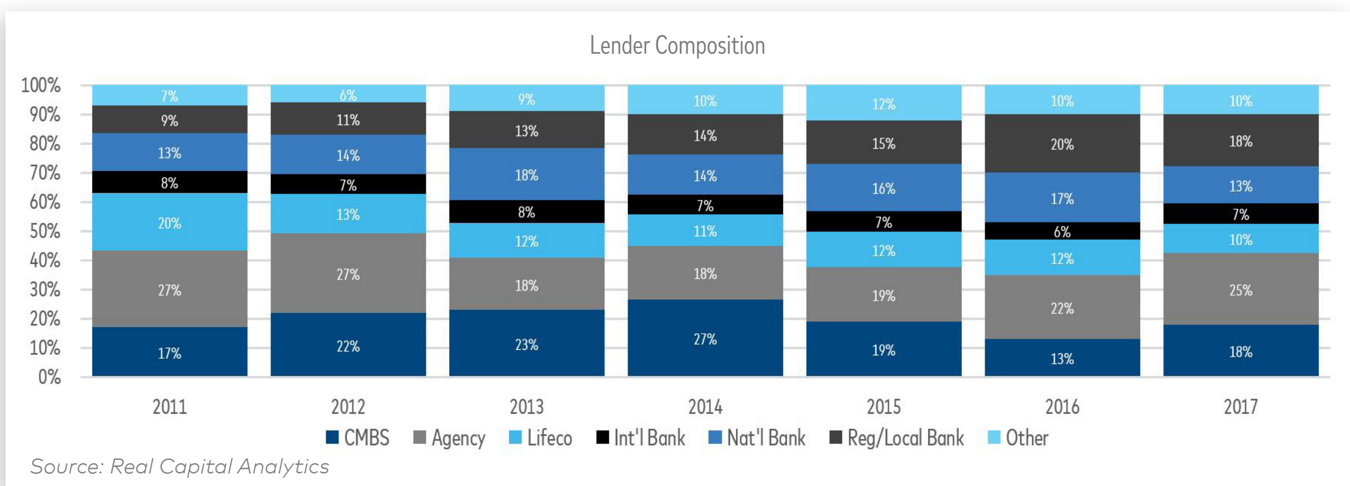
- **Concentration risk**. Generally, the smaller the bank, the larger the concentration of commercial mortgages. Banks with $10 billion to $99 billion in assets have 26.6% of loan portfolios in commercial mortgages and 18.2% of total assets. For banks smaller than $10 billion in assets, the concentration is 36.2% of loan portfolios and 26.3% of total assets. For money-center banks, commercial mortgages represent only 8.6% of loan books and 4.1% of assets. Few small banks undertake the type of sophisticated cross-product allocation models that large institutions use to make sure they are not overexposed to a sector.

  What that means is that a downturn in commercial real estate performance would have a significantly larger impact on regional and local banks than on large institutions. Smaller banks don't rise to the level of "too big to fail," but a downturn could create havoc in the banking industry that could affect the real estate market.

  A related concern for regional/local banks is that they typically focus on the area in which they are based, which means their portfolios can easily get concentrated on a geographic level. A Texas bank that lends mostly around Houston, for example, is exposed to risk of the fluctuations in oil prices.

- **Interest-rate risk**. Virtually all commercial mortgage holdings in banks' portfolios were originated during a time of historically low interest rates, with fixed-rate loan coupons in the 4% range. If the Federal Reserve keeps increasing the federal funds rate and interest rates increase as many expect, the gap between the banks' cost of capital and yield on their investments—the net interest margin—will shrink or disappear entirely. That would sharply reduce bank profits, which is a big reason they have invested so heavily in the segment.

- **Maturity risk**. During this cycle, banks have shown an unusual willingness to originate fixed-rate loans and loans with maturities between five and 10 years—and sometimes even longer. Consequently, banks are increasingly investing

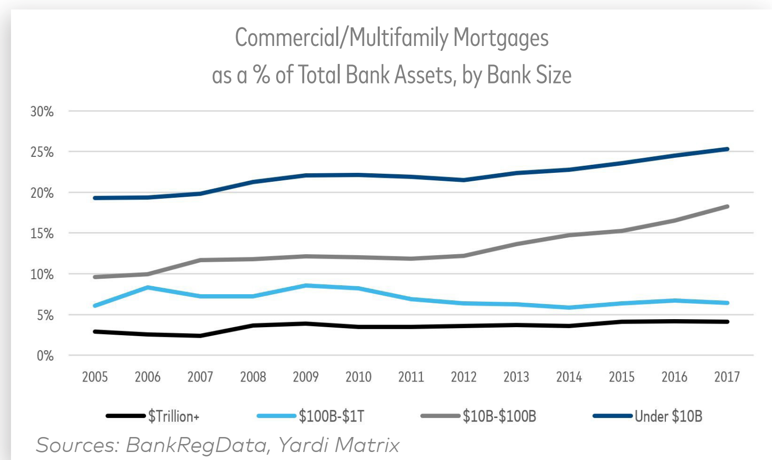


Source: Real Capital Analytics

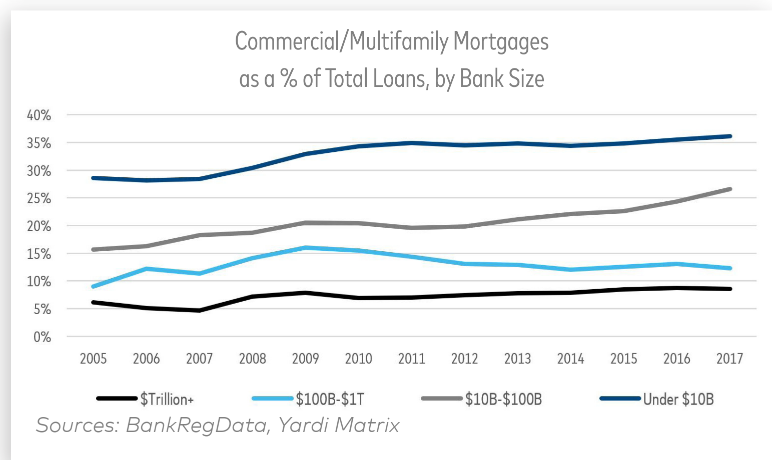
short-term depository capital in a long-term product. More simply, they are borrowing short and lending long.

If the market continues to perform well, with growing property income and defaults kept to a minimum, such a strategy could pay off. But borrowing short and lending long has a history of failure in real estate downturns. It's why portfolio lenders that hold long-term loans on books typically lend more conservatively. CMBS, which came into being in the wake of the S&L crisis, is structured as a way for lenders to get match financing for mortgages.

None of this is to predict another crisis, or to say that loans originated today will default at an unusually high rate. That said, history has shown that smaller banks tend to be less sophisticated at designing portfolios to mitigate risk, hedging and working out loans, so a crisis could hit the regional/local bank segment disproportionately hard.



Sources: BankRegData, Yardi Matrix



Sources: BankRegData, Yardi Matrix

Can Banks Maintain Discipline?

That regional and local banks are so active in the commercial mortgage market is generally a positive development for the industry, particularly in the middle market and secondary and tertiary markets that are not well served by larger institutions. At the same time, though, banks must tread carefully and avoid mistakes of the past, which include being too willing to negotiate away lender protections and pushing mortgage holdings beyond what is prudent.

Bank commercial mortgage holdings rose as a share of the overall economy in the run-up to the last financial crisis. That doesn't necessarily mean the market is on the verge of another downturn. Leverage levels remain conservative by historical standards—which means property owners have more skin in the game—and small banks don't seem to have enough market share to create systemic risk. That said, historically small banks have played a major role in some of the market's biggest busts, so lenders should exercise caution in writing loans this late in the cycle.

—**Paul Fiorilla,** *Director of Research*

Top 10 Banks Per Category—YOY Change in Mortgage Holdings

Institution	2017 CRE/MF Mortgage Holdings	2016 CRE/MF Mortgage Holdings	YOY Change
$1 Trillion+			
Citigroup	$13,662,000,000	$11,263,000,000	21%
JPMorgan Chase & Co.	$106,483,000,000	$100,869,000,000	6%
Bank of America Corporation	$62,682,000,000	$62,998,000,000	-1%
Wells Fargo & Company	$114,089,652,000	$119,964,652,000	-5%
$100 Billion-$1 Trillion			
Goldman Sachs Bank USA	$5,080,000,000	$3,447,000,000	47%
Morgan Stanley	$15,006,000,000	$11,930,000,000	26%
Ally Bank	$3,600,000,000	$3,277,182,000	10%
Citizens Financial Group	$11,557,723,000	$10,560,916,000	9%
BNP Paribas	$16,602,343,000	$15,502,898,000	7%
Bank of Montreal	$7,564,465,000	$7,079,083,000	7%
SunTrust Bank	$14,069,267,000	$13,580,758,000	4%
Toronto-Dominion Bank	$24,608,295,000	$23,961,762,000	3%
Bank of New York Mellon	$2,718,297,000	$2,656,859,000	2%
PNC Bank	$29,068,967,000	$29,344,532,000	-1%
$10 Billion-$100 Billion*			
Sterling National Bank	$9,000,260,000	$4,086,335,000	120%
Pinnacle Bank	$6,693,118,000	$3,216,083,000	108%
Simmons First National	$4,556,401,000	$2,213,268,000	106%
First Tennessee Bank	$6,359,356,000	$3,414,283,000	86%
South State Bank	$3,824,159,000	$2,155,448,000	77%
First Interstate Bank	$2,731,920,000	$1,640,796,000	66%
Community Bank	$1,385,225,000	$856,906,000	62%
First National Bank of Pennsylvania	$6,984,999,000	$4,427,284,000	58%
Old National Bank	$3,429,967,000	$2,340,195,000	47%
Centennial Bank	$5,041,422,000	$3,494,047,000	44%
>$10 Billion**			
Hoyne Savings Bank	$26,187,000	$897,000	2819%
Home Savings Bank	$497,631,000	$91,359,000	445%
Old Dominion National Bank	$46,843,000	$9,487,000	394%
Rigler Investment Company	$69,158,000	$15,958,000	333%
Waseca Bancshares	$140,347,000	$43,160,000	225%
Virginia Commonwealth Bank	$226,696,000	$77,168,000	194%
Standard Bank	$206,519,000	$72,549,000	185%
Veritex Community Bank	$1,019,352,000	$385,379,000	165%
NexBank	$984,690,000	$383,677,000	157%
Riverview Bank	$456,032,000	$179,208,000	154%

*Source: BankRegData, Yardi Matrix; *Minimum $1 billion mortgages; **Minimum $10 million of mortgages.*

Top 10 Banks Per Category—Mortgages as a Percentage of Total Assets

Institution	Total Assets	2017 CRE/MF Mortgage Holdings	CRE/MF Mortgages as % of Assets
$1 Trillion+			
Wells Fargo & Company	$1,768,282,851,000	$114,089,652,000	6.5%
JPMorgan Chase & Co.	$2,284,640,406,000	$106,483,000,000	4.7%
Bank of America Corporation	$1,771,328,000,000	$62,682,000,000	3.5%
Citigroup	$1,385,030,547,000	$13,662,000,000	1.0%
$100 Billion-$1 Trillion			
M&T Bank Corporation	$123,032,697,000	$25,059,992,000	20.4%
BNP Paribas	$110,317,892,000	$16,602,343,000	15.0%
Branch Banking and Trust Company	$216,077,000,000	$30,358,000,000	14.0%
MUFG Union Bank	$118,537,345,000	$14,406,876,000	12.2%
KeyBank	$135,758,439,000	$14,845,638,000	10.9%
The Huntington National Bank	$104,052,030,000	$9,071,161,000	8.7%
Regions Bank	$123,325,220,000	$10,498,334,000	8.5%
Toronto-Dominion Bank	$311,657,974,000	$24,608,295,000	7.9%
PNC Bank	$370,002,264,000	$29,068,967,000	7.9%
Morgan Stanley	$194,834,000,000	$15,006,000,000	7.7%
$10 Billion-$100 Billion*			
New York Community Bancorp	$49,109,550,000	$35,416,945,000	72.1%
Bank of Hope	$14,201,986,000	$8,112,424,000	57.1%
Signature Bank	$43,119,702,000	$24,346,369,000	56.5%
Investors Bank	$25,142,360,000	$13,122,164,000	52.2%
Valley National Bank	$23,965,254,000	$9,490,759,000	39.6%
Cathay Bank	$15,619,791,000	$5,676,787,000	36.3%
Centennial Bank	$14,440,346,000	$5,041,422,000	34.9%
Umpqua Bank	$25,711,323,000	$8,672,859,000	33.7%
Synovus Bank	$31,106,198,000	$10,131,655,000	32.6%
United Bank	$19,041,801,000	$5,794,959,000	30.4%
>$10 Billion**			
First Federal Savings and Loan of San Rafael	$193,726,000	$179,620,000	92.7%
Dime Community Bank	$6,392,762,000	$5,392,221,000	84.3%
Oritani Bank	$4,121,727,000	$3,330,345,000	80.8%
Malaga Bank	$1,040,273,000	$816,094,000	78.4%
Americas United Bank	$235,231,000	$181,608,000	77.2%
Eastern International Bank	$111,700,000	$84,957,000	76.1%
National Bank of New York City	$229,332,000	$171,575,000	74.8%
First Bank of Owasso	$338,823,000	$249,531,000	73.6%
Universal Bank	$374,752,000	$272,539,000	72.7%
Noah Bank	$380,906,000	$269,327,000	70.7%

*Source: BankRegData, Yardi Matrix; *Minimum $1 billion mortgages; **Minimum $10 million of mortgages.*

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