News: National

February 01, 2012

Written by Mark Heschmeyer (mheschmeyer@costar.com)

No More Fear and Loathing of CRE Lending for Banks

Five Years After the Onset of the Great Recession, Banks Are Ready To Venture Back in to Commercial Real Estate; Yes, Not Even Las Vegas is Off Limits Anymore

As economic headwinds subside, the commercial real estate lending business for U.S. banks has hit an inflection point. For the first time in five years, a majority of banks are finally talking about their ability to grow their loan portfolios.

While the sentiment among banks is neither unanimous, nor the projected lending growth strong, bank executives in analyst earnings calls over the past couple of weeks were clearly signaling they believe they are on the other side of writedowns and are ready to return to CRE lending.

As bankers see it, they have worked through most of the troubles tied to real estate over the last few years, and now view that segment as one that represents a great amount of potential for earning's growth.

"We're beginning to see opportunity in the marketplace in select markets, and in particular asset classes," said William H. Rogers, Jr., president and CEO SunTrust Banks Inc. "We transitioned this business back into production mode, and we believe there is good future potential here. As with our other non-housing related exposures, our commercial-oriented real estate businesses have also performed relatively well through the cycle."

The question of how much growth there is in commercial real estate is one Regions Financial Corp. executives said they revisit each month.

"Things are getting better, quite frankly, in that space [investor real estate]. But I think part of it is, perhaps the survivor bias. Those that have lasted this long are able to last a little bit longer, and they are hanging on to better days," said Barb Godin, executive vice president and chief credit officer of Regions Financial Corp. "I think, we saw the early (sell-down), and that has been a lot of what we have seen in the last couple of years, in terms of our charge-offs, or things moving to criticize classified. But again, we are seeing just an overall improvement in that sector right now."

Up until the fourth quarter of 2011, non-performing commercial mortgage and construction loans were still increasing notably. And indeed, for many banks, they are still going up, but at moderating rates. So there is still a note of caution from bankers.

"Because the financial condition of many of our borrowers has suffered over the last several years, we expect to continue to see downgrades within the portfolio into an extended recovery as a play," said Daryl D. Moore, executive vice president and chief credit officer of Old National Bancorp. "This will be especially true in the commercial real estate portfolio where capital and liquidity continued to be an issue for many of our clients."

Fed Survey Confirms Anecdotal Evidence, though Caution Remains the Watchword

Some banks are still being aggressive in charging off some loans, particularly construction loans, and are trying to sell off their foreclosed real estate inventory and nonperforming loans as best as they can.

However, in the Federal Reserve Board's latest Senior Loan Officer Opinion Survey issued this week confirmed the anecdotal evidence from the quarterly earnings calls. U.S. bank loan officers reported that demand for CRE loans had strengthened, on net, over the past three months. In addition, during the past 12 months, on net, domestic banks reportedly eased maximum CRE loan sizes and many domestic banks trimmed loan rate spreads.

Generally though, bank executives will proceed much like Claude Davis, president and CEO of First Financial Bancorp, who is tiptoeing back in to CRE lending.

"Through 2011 obviously we've all been very cautious in that sector due to some of the challenges that have been experienced," Davis said. "Where we've seen our new opportunities are really with those investors who have weathered the storm well, had the liquidity and the cash and the capacity to kind of grow and expand if you will, kind of win assets at a cheaper level. And so we've actually seen the quality be very good from our perspective in that book."

"Obviously, [we're] staying away from the high risk areas you know like residential development or some of the kind of the higher risk areas that you would expect that are more speculative," Davis added. "So we've actually seen some really nice quality credits come our way in that area in 2011."

First Financial Bancorp's commercial real estate balance increased 10.2% on an annualized basis in 2011, Davis said.

Russell Goldsmith, president and CEO of City National Corp. said, "If you looked at it year-over-year, from where we were a year ago, the pipeline looks better than it did in January of 2011. We started to do some lending in real estate a year ago. And that's kind of picked up. Mainly in finished properties and starting to look at and do a little for kind of top rate infill multifamily where things have been very strong and you are seeing some quality development."

"In terms of where our clients are in terms of rising optimism, willingness to spend, willingness to borrow, I think it's too early to declare a big trend," Goldsmith added. "But I think we are seeing some small positive signs as people. We are seeing greater appetite to invest in real estate, to do some hiring to build some inventory. But it's still I think tentative."

Philip Flynn, president and CEO of Associated Banc-Corp., said, "We continue to see opportunities for growth and expansion in CRE lending because of the retrenchment of other competitors and other sources of capital. The capital markets aren't there like they used to be for refined commercial real estate and a lot of our competitors have exited that space."

But Flynn added, "We are building a portfolio in a much more disciplined way than we did in the past. I mean, as we talked about before, one time this bank allowed real estate construction loans to grow to 11% of the total loan portfolio. You will not ever see that again here at Associated Bank."

Here's What CRE Lending Will Look Like in 2012

While it is apparent that the growth in commercial real estate lending will be limited and cautious, the timing for an improved lending environment couldn't be better for some investors who financed at the peak of the market five years ago. As mortgage production ramps up, investors will see banks being more competitive on pricing.

The bad news is that, initially, it will be the well heeled who stand to benefit first and financing terms are likely to be fairly tight. Banks will also use the opportunity to restructure the makeup of their portfolios - weeding out the less creditworthy.

"We would expect [CRE] to trough in 2012 and we have a large core group of relationships that as they become more active, or we open the spigot to allow further credit extensions, that certainly will help with amortization and other prepayments," said Donald R. Kimble, senior executive vice president and CFO of Huntington Bancshares Inc. "Frankly, that's the profitable side of the equation where we're looking to, to build it back as we deplete the non-core side of real estate. We are looking at becoming a bit more active in the REIT space as well. So, it's principally core customers, maybe a little supplementation with some

REIT activity -- that would be publicly traded REITs."

"I think there is no question that the marketplace that we principally do our business in is very, very strong. And we are seeing a great deal of opportunity," said Joseph Ficalora, president and CEO of New York Community Bancorp. "We don't do every loan that we were asked to do. And sometimes, we bid on loans and we bid more conservatively than others in the marketplace and therefore we don't get every loan."

"Also the LTVs [loan-to-values] are very, very low," Ficalora said. "People are putting a lot of money into these properties. There is a lot of money from the world that's investing in real estate. So, the ability for us to do these commercial loans at low LTVs is very attractive."

Mitchell Feiger, president and CEO of MB Financial Corp., said "more remixing remains for our commercial real estate portfolio, and if this excitement grows, it will grow slowly and only because we are able to find very high and very profitable new credits."

"There are a lot of loans that were originated with 5-year terms that have not matured yet, that we may or may not want to continue to be in or maybe priced inappropriately. So it's just a continuing process, not anything different than we've done before. It's looking at each loan based on what we know now, which is influenced a lot by what we learned in the last credit cycle and decide is that the kind of business that we should invest our capital in. Our credit standards have tightened. Our return expectations are we enforce more rigorously, and so each loan that comes due or each loan that matures, we look at it and say, is this something we should do or shouldn't do."

At CVB Financial Corp., Christopher D. Myers, its president and CEO, said most of the deals his bank is doing are pricing in the 4.5% to 5.25% range -- unless the bank does an interest rate swap. Then typically the bank is pricing CRE loans somewhere around 3% on a variable rate.

"There is no question that we're having a lot of discussions with customers about refinancing their existing loans with us on the commercial real estate, we're lowering their rates," Myers said. "The good news is, is that we have prepayment penalties embedded in the vast majority of these loans, so we're able to harvest some of these prepayment penalties and use that as leverage when we do refinancing."

The retooling also extends to borrowers who still have ample time to maturity but want to refinance at today's lower rates, Myers said.

"We might have a deal where we have a commercial real estate loan that we took over and the guys having problem paying us and maybe have a maturity that goes beyond the five years expiration of the loss sharing. Well, our choices are, do we foreclose on that property? Do we work with the borrower," Myers said. "Well, if we're going to work with that borrower, we would be inclined to try to shorten that maturity to before the 5-year period of time so that at least if there was a problem going forward, we would have a matured loan prior to the five-year expiration of our loss sharing."

"If we have a problem loan that may expire in 2020 and we want to work with them, we want to give them some time to get back on track and lease the property up, or whatever the issue is. We want to make sure that we try to shorten that maturity before the 5-year expiration, so that we're at the table with them before that date determining whether we really want that loan to be on our books and we really want to extend it going forward. Hopefully then if we shorten that to, say, October 2013, we have a year to make sure that this is a loan that we want to keep, and if not, then we still have enough time to foreclosing the property if they can't pay us," Myers said.

Loan Growth Will Be Selective by Market, Asset Type

In general, bank executives said they would be targeting the strongest growth in particular assets and markets. Multifamily was most frequently mentioned as a targeted asset category as were some select middle-market industry segments such as, restaurants, health care and energy.

"Multifamily in the right location, location, location is stabilized, but everything else is still struggling to some extent and probably we'll see a bit of decline even in 2012," said John M. Killian, executive vice president and chief credit officer of Comerica Inc.

Harris H. Simmons, chairman, president and CEO of Zion Bancorporation, said the words 'major' and "growth" would not be words he'd use in the same sentence. However, he did add that "we are seeing some and anecdotal - a little bit even in single-family in top areas of Southern California, and we're seeing some apartments in Texas and in California, but there's no major rush to jump into real estate before seeing the demand side."

By market area, Bank of the Ozarks Inc.'s George Gleason, chairman and CEO, said, "I think the largest part of [our] growth is going to come from our Texas offices. The second largest part of that growth I would expect to come from our metro Little Rock, [AR], area offices and the third largest part of growth I would expect to come from our metro Charlotte [NC] office."

In the last quarter Bank of the Ozark's Texas office had accounted for 41.8% of its total loan portfolio.

"We are primarily a construction development CRE and a multifamily lender within that context and I would expect to see the vast majority of the growth occur in the construction and development commercial real estate book consistent with where it has always come from us," Gleason said.

Independent Bank Corp.'s president and CEO, Christopher Oddleifson, said he was big on his home market.

"Locally, the Massachusetts economy continues to perform better than the nation as a whole. Massachusetts employment has dropped to below 7%, its lowest level since December of '08, and the best of the Boston metro area unemployment rate has dropped to just about 6%," Oddleifson said. "The Boston area continues to see a pickup in the real estate construction projects, especially in multifamily-used properties."

And finally here's the kicker to our headline. While other banks said the desert states of Arizona and Nevada continued to be a challenge, Western Alliance Bancorporation, said for that reason, it was targeting those markets.

"We are kind of filling the void and picking up some of those relationships… rather quickly," said Robert G. Sarver, chairman and CEO of Western Alliance. "If you took a look at the competitive set of Arizona, San Diego, and Nevada banks, you would see that we really kind of stand out as pretty much the only local alternative at this point. So that's helping us get a lot of the market share."

While Nevada real estate values are still declining, Sarver said he is seeing fundamentals there getting better.

"Three months ago, they had the biggest traffic month at [Las Vegas' McCarran International Airport] in history. Convention business is up. Room rates are up 10% year-over-year," Sarver said. "So we are starting to see stabilization and a beginning of a recovery of consumer spending money, and primarily of businesses spending money."

"Arizona is probably the biggest story for us and where we have the most upside, because it's a big market," Sarver added. "It's the 16th largest state in the country at this point and growing, and its recovery is in place, and it's beginning to strengthen."