Commercial Real Estate Lending

National

Economic Pulse

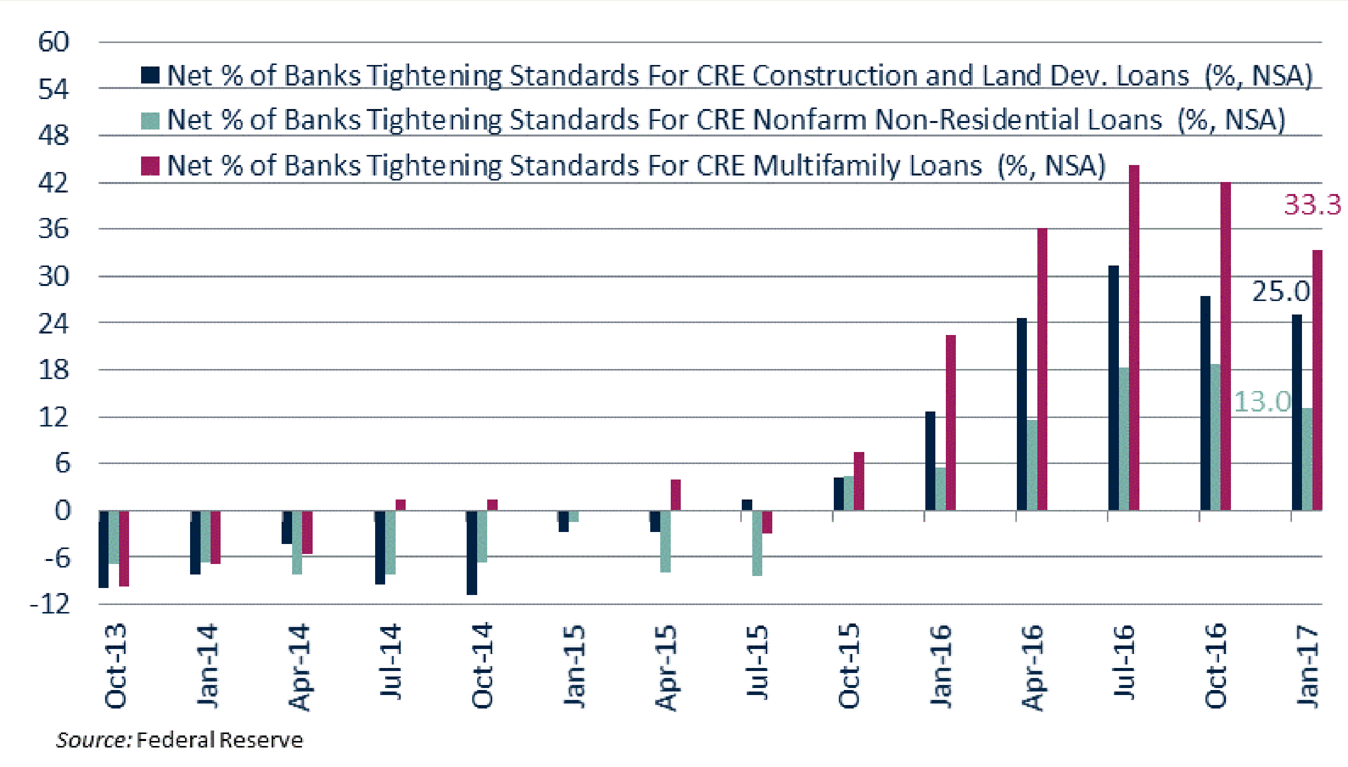
Tightening Standards for Commercial Real Estate Loans

February 14, 2017

The Senior Loan Officer Survey, a quarterly release from the Federal Reserve's Division of Monetary Affairs, discusses the lending environment based upon responses from domestic banks and U.S. branches and agencies of foreign banks. Among other areas, the survey focuses on commercial real estate (CRE) lending, specifically assessing 1) construction and land development loans, 2) loans secured by nonfarm non-residential structures, and 3) loans secured by multifamily residential properties. In general, **while banks left their standards on commercial and industrial (C&I) loans largely unchanged over Q4 2016, banks tightened standards on CRE loans, particularly for construction and land development and multifamily loans.**

Chart 1 shows that in aggregate, bank respondents reported a continued tightening in lending standards for all types of commercial real estate. A special survey question this quarter asked respondents about the prospects for CRE lending standards in 2017; the fraction of banks foreseeing even *more* tightening was similar to the trends observed by asset type in Q4 2016. **44.1% of net respondents envisioned further tightening of lending standards for multifamily residential properties in 2017, whereas only 13.2% saw further tightening ahead for nonfarm non-residential properties (such as office buildings.)**

Chart 1. **Commercial Real Estate Credit Standards (All Domestic Banks)**



Source: Federal Reserve

399 Park Avenue · 11th Floor · New York, NY 10022 · 212.326.1000

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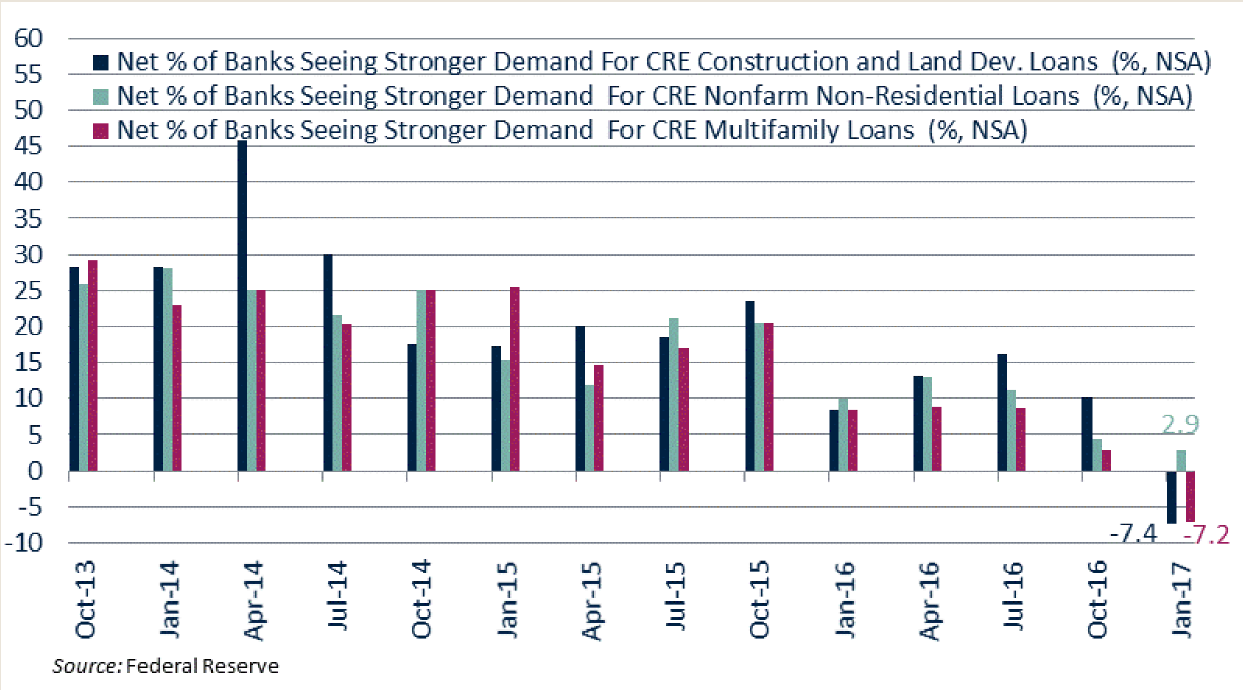
Lending standards have been tightening for many quarters, so perhaps it was surprising that Q4 2016 marked the first time that banks reported weaker, rather than stronger, loan demand (*Chart 2*). And reflecting more caution ahead, **no bank respondents saw the outlook for delinquencies and charge-offs "improving substantially" in the year ahead.** Instead, the percentage of banks who foresee delinquencies for all CRE types (construction and land development loans, loans secured by nonfarm non-residential structures, and loans secured by multifamily residential properties) "deteriorating somewhat" exceeded the percentage who foresee delinquencies "improving somewhat." Given that the percentage of total loans backed by CRE that are 30-89 days delinquent stood at just 0.71% in Q3 2016 according to FDIC data—the lowest level since Q3 2006—the degree of caution suggested by the responses is somewhat unexpected.

***Chart 2.* Commercial Real Estate Loan Demand (All Domestic Banks)**



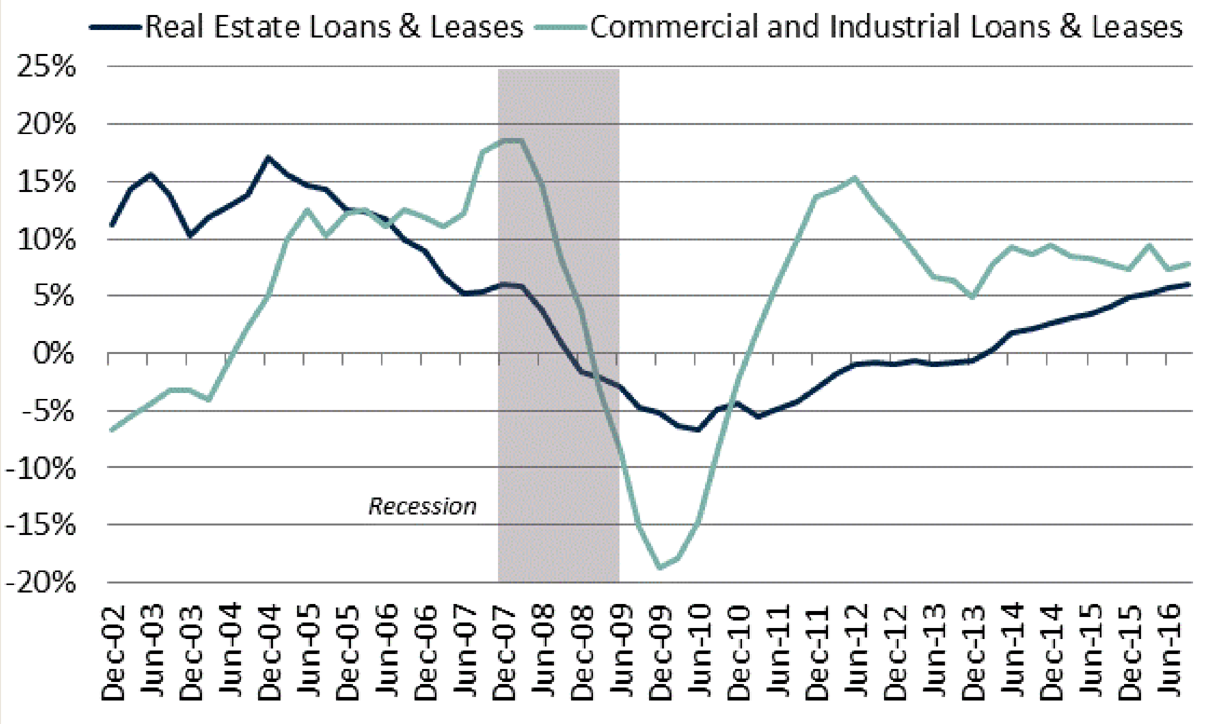
Data from the FDIC (*Chart 3 on the following page*) highlight the relatively slower growth of CRE lending versus C&I lending, with growth on the former hovering just around 5 per cent. (Despite the slower *growth* of CRE loans, however, it is important to note that the total *level* of CRE loans outstanding is almost 2 ½ times the level of C&I lending.) While single family lending remains robust, the fraction of real-estate related lending to nonfarm non-residential projects has risen steadily, and now comprises more than 28% of total real estate loans from commercial banks and savings institutions (*Chart 4 on the following page*.)

Interest rates are likely to continue to rise throughout the balance of this year; in her testimony to Congress just today, Federal Reserve Chair Yellen reminded markets that "waiting too long to remove accommodation would be unwise." Sluggishness in loan demand will not be helped by credit tightening, and while there are few signs of upward pressure on cap rates, the extent to which CRE valuations will continue to rise remains to be seen.

RESEARCH CONTACT

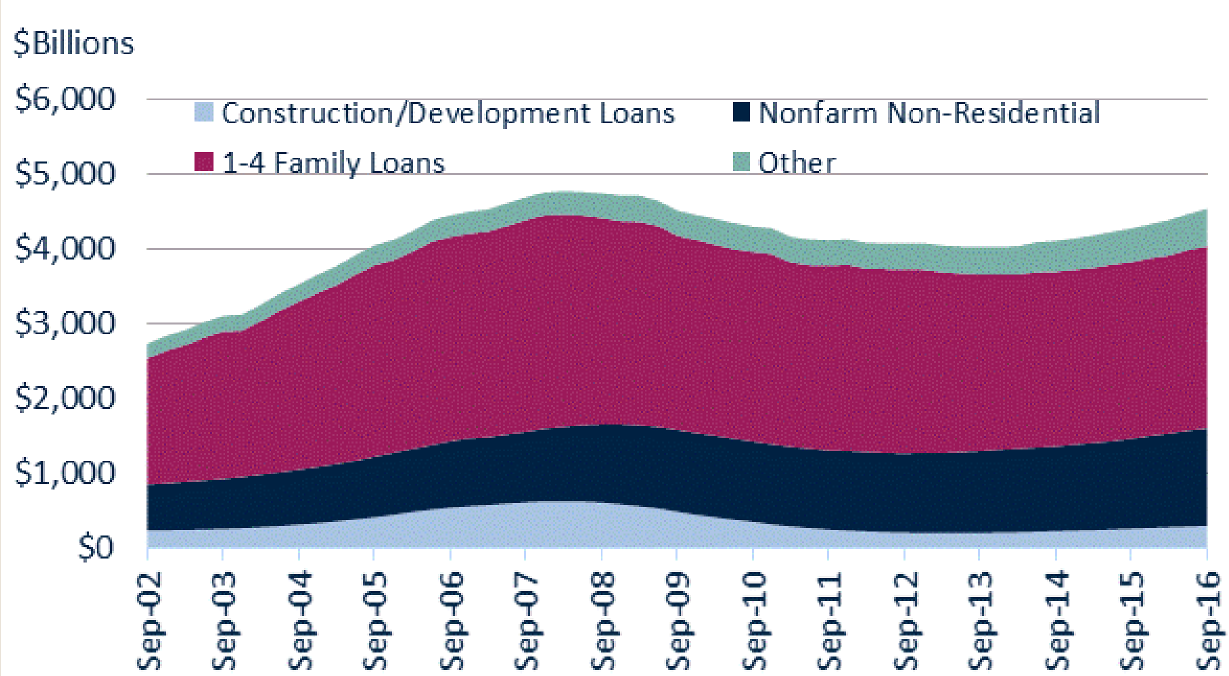
Heidi Learner
Chief Economist
212-326-8648
hlearner@savills-studley.com

Chart 3. **Loans and Leases by Type, All FDIC-Insured Savings Institutions and Commercial Banks, YoY % Growth**



Source: FDIC

Chart 4. **Loans Secured by Real Estate (FDIC-Insured Commercial Banks and Savings Institutions)**



Source: FDIC