Banks With Bulging Commercial Property Loans Face Extra Regulatory Attention

Analysts Expect Institutions With High Levels of Business Real Estate Lending To Be Examined

Banks with a high concentration of commercial property loans such as ConnectOne Bank can expect extra regulatory scrutiny this year, analysts say. (James Leynse/CoStar)

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Federal regulators told all U.S. banks this summer they would be keeping a close eye on commercial real estate loan portfolios through the end of 2022. But some financial institutions can expect to be in the crosshairs of some regulators more than others, analysts say.

Banks with the highest concentrations of commercial property loans should expect examiners to dig deep when inspecting their upcoming quarterly reports. Examiners plan to focus on newly issued commercial real estate loans and those in the riskiest categories such as office, retail and hospitality, as well as loans with payments vulnerable to rising rates, according to a report from Janney Montgomery Scott, a Philadelphia-based investment bank.

Banks with loans in cities with relatively distressed office markets, such as Houston, Dallas and San Francisco, should also expect more attention from examiners, Tim Coffey, an analyst at Janney Montgomery Scott, told CoStar News. The vacancy rate in Houston's office market is 19%, according to CoStar data. Dallas-Fort Worth's vacancy rate is 17.3% and San Francisco's rate is 15.7%. All are higher than their pre-COVID vacancy rates.

Banks that are publicly traded will start reporting third-quarter earnings later this month as all 4,000-plus banks in the United States, whether public or privately held, begin filing their quarterly reports with regulators. Some of the largest U.S. banks by assets are first up to report, with JPMorgan Chase and Wells Fargo scheduled to issue third-quarter earnings on Friday.

Regulators with the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency and the Federal Reserve will closely scrutinize banks' financial statements in the next round of examinations in an attempt to keep a lid on commercial real estate loan delinquencies. The FDIC specifically warned that rising inflation, higher interest rates and concerns about the viability of office buildings necessitated the move.

Banks are a major source of loans for commercial real estate properties, as business property loans are the largest lending category at about half of all U.S. banks, according to Janney Montgomery Scott. The total amount of commercial real estate loans outstanding at U.S. banks recently reached an all-time high of $2.7 trillion.

Executives at banks with some of the highest commercial property loan concentrations were careful to emphasize earlier this year that they've got things under control.

“We're going to be disciplined and cautious and not just throw darts at anything, but do what we've always done here,” Frank Sorrentino, chairman and CEO of ConnectOne Bancorp, said during a July conference call discussing second-quarter earnings.

Dime Community Bank, which operates this branch in Bellmore, New York, is one of dozens of banks with a high concentration of commercial real estate loans that can expect more scrutiny from regulators. (Jeffrey Siegel/CoStar)

Lending Level Watched

At Englewood Cliffs, New Jersey-based ConnectOne, total commercial real estate loans as a percentage of risk-based capital was 525% as of June 30, according to Janney Montgomery Scott. Any bank with a commercial real estate concentration above 500% is likely to get extra attention from regulators, said Coffey with Janney Montgomery Scott.

A ConnectOne spokesperson said Sorrentino was not available to comment.

Kevin O’Connor, CEO of Dime Community Bancshares in Hauppauge, New York, said his bank is largely avoiding two of the riskiest segments of commercial real estate lending: office and hospitality.

“We are not really involved with retail and office space,” O’Connor said during a July 29 conference call. “We're really staying away from that. So, from a credit standpoint, we're very careful.”

It makes sense that bank executives are wary of commercial real estate loans to the office sector, Anthony Paolone, an equities analyst at JPMorgan Chase who covers the financial services industry, wrote in a report last month.

"Looking ahead, we are not in the 'office is dead' camp, but we think cash flow growth will be challenged in the office sector," Paolone said in the report. "If a building is not in the right location, lease economics may suffer for some time to come."

Dime’s commercial real estate loan portfolio represented 603% of its risk-based capital as of June 30, according to Janney Montgomery Scott. Dime did not respond to a request to comment from CoStar News.

Loans for Offices

Other bank executives said they are still making loans for offices.

“Property types are important, especially in" commercial real estate, Christopher Maher, chairman and CEO at OceanFirst Financial, said during a July conference call. “So office, I think everybody is looking at a little harder at office because no one knows what's going to go on at lease expirations in a few years” and questions remain about whether remote work is here to stay.

At OceanFirst, based in Red Bank, New Jersey, commercial real estate loans were 508% of risk-based capital at the end of the second quarter. Maher declined to make additional comments.

Rising interest rates may have slowed growth in commercial real estate lending during the third quarter, as investors wait to pull the trigger on deals until rates fall again. But many banks active in business property lending said they are still seeing plenty of loan demand from their clients.

“Candidly, most real estate investors, they’re in the game,” Patrick Ryan, CEO at First Bank in Hamilton, New Jersey, said during a conference call at the end of July. FirstBank did not respond to a request to comment from CoStar News.

“You may not like the rates that are out there, but as long as you’re buying assets at the right prices,” that will result in more commercial real estate loan activity at First Bank, Ryan said.