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U.S. Banks Are Increasing Their Commercial Real Estate Lending--But At What Risk?

Primary Credit Analyst:
Rian M Pressman, CFA, New York (1) 212-438-2574; rian.pressman@spglobal.com

Secondary Contact:
Jeffrey Feit, New York 212-438-0300; jeffrey.feit@spglobal.com

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U.S. Banks Are Increasing Their Commercial Real Estate Lending--But At What Risk?

For the first time since the Great Recession, U.S. bank commercial real estate lending (CRE) has surpassed its 2008 peak. After a sharp decline in construction lending and an overall reduction in CRE loans outstanding between 2008 and 2012, S&P Global Ratings has seen a resurgence in lending for this asset class over the past four years--specifically by banks--across CRE loan types. This increase may not last long, however, given the overall frothiness of CRE markets and increased scrutiny by regulators, among other factors.

S&P Global Ratings has been monitoring these trends, and we are updating our previous report, "U.S. Banks With Higher Concentration In Commercial Real Estate Lending Could See Risk Rise," published May 23, 2016, with the most recent data. Multifamily, construction and development (C&D), and non-owner-occupied lending have grown on average at 13.2%, 11.5%, and 8.0%, respectively, per year at depository institutions from year-end 2012 to year-end 2016, according to the Federal Deposit Insurance Corp. (FDIC). Average CRE loans on banks' balance sheets reached $1.63 trillion at year-end 2016, surpassing the previous peak level of $1.52 trillion in 2008.

Low interest rates coupled with an improving U.S. economy have stimulated CRE markets nationwide, resulting in strong price increases and high valuations. At the same time, the commercial mortgage-backed securities (CMBS) market has not been a huge source of competition for banks. These factors, combined with historically benign asset quality performance, have promoted relatively strong growth for CRE lending, most prominently among regional and community banks. While our assessment of each bank's underwriting practices plays a critical role in our assessment of its CRE lending concentrations, banks with higher concentrations may be at risk of downgrades if the asset quality performance of the sector substantially worsens because of higher interest rates or deteriorating economic conditions.

Overview

- Exposure to CRE remains an important factor in our ratings on banks, and we believe the risk related to CRE has increased, which could have negative ratings implications over time.
- Banks have increased CRE lending since 2012, and total aggregate exposure at year-end 2016 was 12% higher than peak levels in 2008.
- Positively, C&D lending has declined substantially and banks have increased their capital buffers in the aggregate since 2008.
- Regional and community banks continue to have larger CRE exposure on a relative basis than larger money center banks.
- We expect decelerating growth and tighter underwriting standards in 2017, as regulatory scrutiny of the asset class has increased and banks have become more cautious.
- Pressure points for bank CRE portfolios include exposure to energy-dependent geographies, overheated multifamily markets, or CRE subsectors experiencing secular change (retail and suburban office buildings).

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We Look At CRE Lending Concentration When Rating Banks

Concentration in CRE lending continues to be an important factor in our bank ratings. We scrutinize overall concentration levels in CRE in relation to total loans and capital, particularly in riskier subtypes of lending, including C&D and multifamily. Among the banks we rate, smaller regional banks and those that specialize in CRE niches tend to have the highest concentration in the asset class. All else being equal, these banks have lower ratings, reflecting the incremental risk associated with such exposures.

A report by federal bank regulators issued in 2013 found that 23% of banks that exceeded regulatory guidelines regarding CRE concentrations failed within the most recent three-year economic downturn, versus less than 1% that stayed below. This reinforces for us the importance of prudent concentration management, which is a key factor for our ratings. In addition, a growing concentration in CRE may be reflected in the rating outlook.

Positively, CRE origination volumes have decelerated, shrinking more than 4% year over year (at December 2016, according to S&P Global Market Intelligence), reflecting increased regulatory scrutiny and caution on the part of management. In addition, although outstanding total CRE loans at FDIC-insured banks have increased 12% in the aggregate since 2008, C&D loans have declined 47%. Lastly, we believe banks are better positioned to absorb the impact of weakening asset quality in the sector given the more than 44% increase in equity in the aggregate across banks over that period. Nonetheless, banks could see downgrades if they decrease their resilience to CRE concentrations by reducing capital buffers.

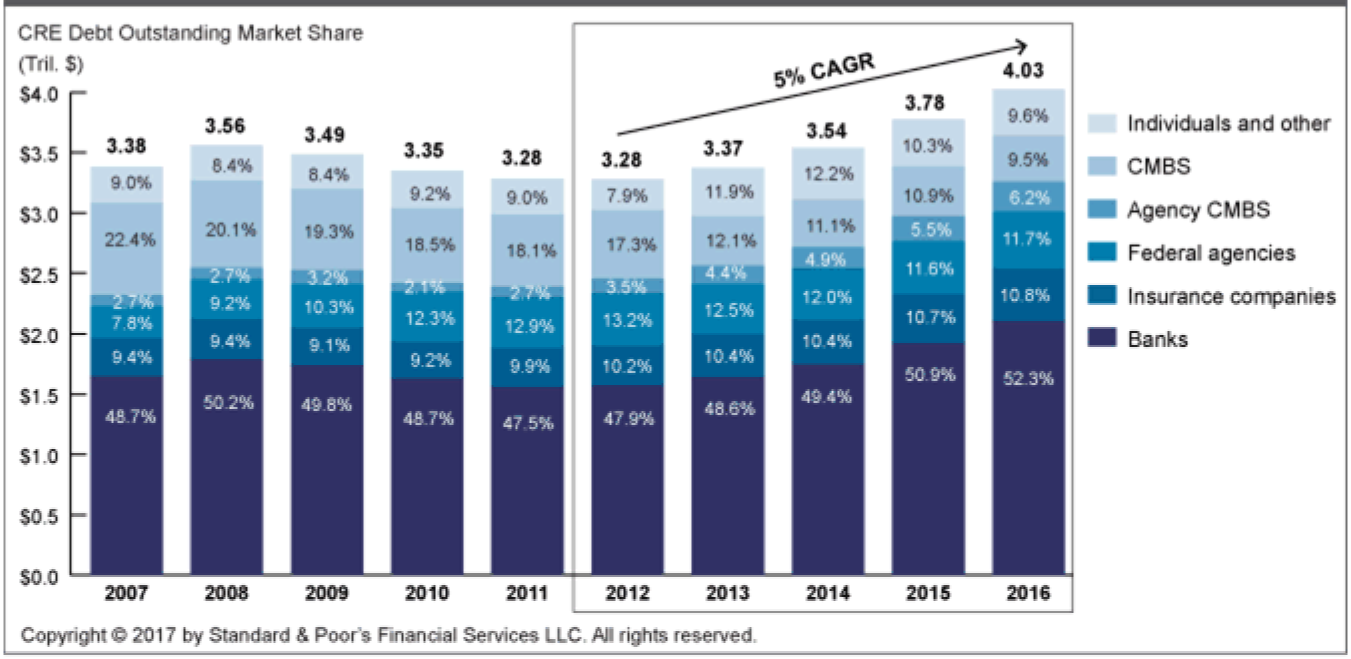
Banks' Role In CRE Lending Markets Continues To Grow

Today, depository institutions represent slightly more than half of outstanding financing for commercial property. Persistently low interest rates, currently pristine asset quality, and heightened competition for other asset classes, including for commercial and industrial loans (C&I), spurred banks to aggressively reenter the CRE lending market. In addition, the favorable environment for CRE (rising property values, low vacancy, high absorption rates) and declining unemployment have increased demand by real estate investors for financing.

Depository institutions contributed 73% of the growth in commercial mortgage loans from the beginning of 2012 to the end of 2016 and held about 52.3% of outstanding commercial mortgage debt as of Dec. 31, 2016, according to Federal Reserve mortgage data (see chart 1). This surpasses the 50.2% share banks had during the crisis and is up from a postcrisis low of 47.5% in 2011.

Chart 1

Participants In The CRE Lending Market



We estimate that total bank CRE loans amounted to approximately $1.71 trillion as of year-end 2016. FDIC data records roughly $811 billion of investor-owned (or non-owner-occupied) nonresidential loans, $383 billion of multifamily loans, $313 billion of C&D loans, and $96 billion of farmland. Furthermore, depository institutions have $105 billion of certain CRE loans not secured by real estate properties. (These are typically loans to companies whose primary business involves CRE, including real estate investment trusts, or REITs.) Those five categories make up our definition of CRE. Banks also held another $513 billion of "owner-occupied" CRE loans, but we exclude these from our CRE statistics because we believe they have a credit profile more similar to C&I loans. (Owner-occupied CRE loans are generally used for general corporate purposes or to finance the purchase of properties used for business purposes, not to finance properties purchased for investment. We also exclude real estate loans held in foreign offices, which are concentrated at a limited number of financial institutions.)

Regional and community banks held proportionately more of the CRE loans in the banking system and generally have greater concentrations in CRE than the largest banks. The three largest domestically focused U.S. bank holding companies (JPMorgan Chase & Co., Bank of America Corp., and Wells Fargo & Co.) accounted for nearly 44% of the assets of all U.S. banks we rate but only 36% of CRE loans as of Dec. 31, 2016. Additionally, CRE loans at smaller banks, in aggregate, represented 20% of total loans, compared with 10% for the three largest domestically focused banks.

Table 1

Top 10 Banks By Total CRE Loans To Total Loans And Tier 1 Capital

	--Total CRE loans--	
	% of total loans	**% of tier 1 capital**
Median	**16.4**	**111.0**
Average	**19.1**	**149.1**
New York Community Bancorp Inc.	88.2	928.9
Valley National Bancorp	45.2	460.1
Astoria Financial Corp.	45.0	298.6
S&T Bancorp Inc.	43.5	419.8
Western Alliance Bancorporation	38.6	304.3
Synovus Financial Corp.	37.3	332.2
People's United Financial Inc.	35.4	324.4
M&T Bank Corp.	31.6	237.9
East West Bancorp Inc.	34.4	295.1
First Midwest Bancorp Inc.	33.7	280.9

Note: Total CRE loans, for the purposes of this study, include C&D, non-owner-occupied, and multifamily. Does not include owner-occupied CRE or real estate loans in foreign offices. Median and average of all S&P Global Ratings rated banks. As of Dec. 31, 2016. Source: S&P Global Market Intelligence.

Outside of the banking system, insurance companies, government-sponsored agencies like Freddie Mac and Fannie Mae, finance companies, asset managers, REITs, and pension funds are also large financers of CRE loans--either directly on their balance sheets or through investments in CMBS. There can also be overlap between sectors. For example, Fannie Mae provides financing to the multifamily market in concert with lenders (including banks) through its Delegated Underwriting and Servicing Program.

Banks, insurance companies, and nonbank financial institutions (represented as "Individuals and other" in chart 1) now hold a higher portion of the $4.03 trillion in U.S. commercial mortgage debt outstanding relative to other financing providers, with about 73% of the total as of Dec. 31, 2016, versus 67% in 2007, according to Federal Reserve data. Conversely, mortgage pools and trusts now hold less, with 16% of the total (down from about 25% in 2007), largely because of declining nonagency CMBS balances.

CMBS Issuance Has Been Declining

The contribution from CMBS financing has declined for numerous reasons. While CMBS issuance increased considerably from its nadir in the wake of the financial crisis, it remains at about one-third of precrisis levels, according to Securities Industry and Financial Markets Association data. Very low interest rates globally and good recent asset quality performance has increased the relative attractiveness of holding CRE on balance sheet from a risk/return perspective. Also, periodic bouts of market instability can significantly widen spreads on CMBS, making it a cost-ineffective form of financing for issuers versus direct borrowing from banks.

The renewed emphasis on traditional portfolio lending in the marketplace also reflects the heightened risk aversion of lenders--including the largest U.S. and U.S.-based subsidiaries of European banks that dominate the CMBS market--to the originate-to-distribute model. This has been largely the result of increased regulatory requirements, including those related to capital, stress testing, and risk retention. For example, beginning on Dec. 24, 2016, issuers have to retain 5% of a CMBS deal's market value and trading will be restricted for five years, with subsequent additional limitations on possible buyers after that. As a consequence, numerous conduit providers have exited the CMBS marketplace.

The risk retention requirement will likely dampen CMBS issuance in 2017, just as 10-year CMBS that was originated in 2007 matures. (S&P Global Ratings forecasts that CMBS issuance will be $65 billion in 2017, a 15% decrease from 2016.) This "wall of maturities"--which we estimate at $92 billion for 2017--was originated a decade ago under precrisis underwriting standards, which we believe were more lenient. Nonetheless, we believe the higher-quality subset of underlying properties that can be underwritten conservatively may be refinanced via the banking or insurance sectors or the CMBS markets. However, defaults will likely increase given the high number of properties that are poor candidates for refinancing. (In April 2017, the CMBS delinquency rate was 5.52%, according to Trepp, up 15 basis points (bps) from March and more than 100 bps from the prior year, largely reflecting loans reaching maturity and being unable to refinance.) Poor candidates for refinancing include properties with high loan-to-value ratios (LTVs), or those in CRE subsectors where there have been secular changes over the past 10 years (such as retail properties or suburban office parks). Nonetheless, continued low interest rates could help ease refinancing since rates were higher in 2007.

CRE Lending Has Surged Since The Financial Crisis

Banks have aggressively increased CRE lending since 2012. CRE loan exposure at FDIC-insured depositories rose at an average annual growth rate of about 10% from year-end 2012 to year-end 2016. Moreover, this growth has accelerated to 12.2% and 10.5% in 2015 and 2016, respectively, from 6.7% in 2013.

Low interest rates have increased loan demand in tandem with strengthening CRE values, and banks are now more willing to participate in CRE lending again as the credit quality problems of 2008-2010 recede from institutional memory. We believe asset-quality metrics are currently as good as they can get across CRE loan types, further fostering a highly competitive market for CRE lending as banks search for yield while interest rates are low. Strong growth can mask asset quality problems by suppressing banks' ratios of nonperforming assets and net charge-offs.

Nevertheless, relative to total loans and capital, banks are somewhat less exposed to the asset class than before the financial crisis (see table 1). For instance, total CRE loans at FDIC-insured banks made up 18% of total loans and 92% of equity as of Dec. 31, 2016, down from 19% and 118%, respectively, in 2008. (The reduced exposure as a percentage of capital is partly because of the significant capital build across the industry since the financial crisis.)

In addition, although outstanding total CRE loans at FDIC-insured banks have increased 12% in the aggregate since 2008, the riskiest subset of CRE lending, C&D, has declined 47%. We believe banks are better positioned to absorb the impact of weakening asset quality in the sector given the more than 44% increase in equity in the aggregate across banks over that period.

Table 2

CRE Loans for all FDIC-Insured Institutions

	2008	2010	2013	2016	% change 2013-2016	% change 2008-2016	2016: % of total loans	2016: % of total equity
C&D loans	591,022	321,102	210,101	313,203	49	(47)	2	3
Other nonfarm nonresidential	592,206	595,848	633,554	810,571	28	37	5	9
Multifamily loans	206,475	212,701	263,025	382,722	46	85	2	4
Farmland	63,700	67,978	78,090	95,771	23	50	1	1
Unsecured CRE loans	69,805	49,567	75,007	105,017	40	50	1	1
Total CRE Loans	1,523,209	1,247,196	1,259,777	1,707,285	36	12	10	18
Average CRE Loans	1,516,295	1,322,239	1,220,334	1,626,171	33	7	-	-
Total banking system equity	1,291,063	1,484,509	1,642,990	1,863,641	13	44	-	-
Total loans and leases	7,873,504	7,375,321	7,892,996	9,305,365	18	18	-	-
Total assets	13,841,149	13,318,923	14,730,802	16,780,224	14	21	-	-

Note: Total CRE Loans do not include owner-occupied CRE or real estate loans in foreign offices. As of Dec. 31, 2016. Source: FDIC.

The increase in CRE exposure has been more meaningful for regional banks than for money center banks. CRE loans accounted for only about 7%-13% of the loans of Bank of America Corp., JPMorgan Chase & Co., and Wells Fargo & Co. at the end of 2016. Conversely, the median exposure for large and small regional banks was 16% and 22% of loans, respectively, with some institutions above 30%. (Money center banks generally have additional exposure to CRE through CMBS held in their securities and trading books; CMBS holdings are typically nominal at regional banks.)

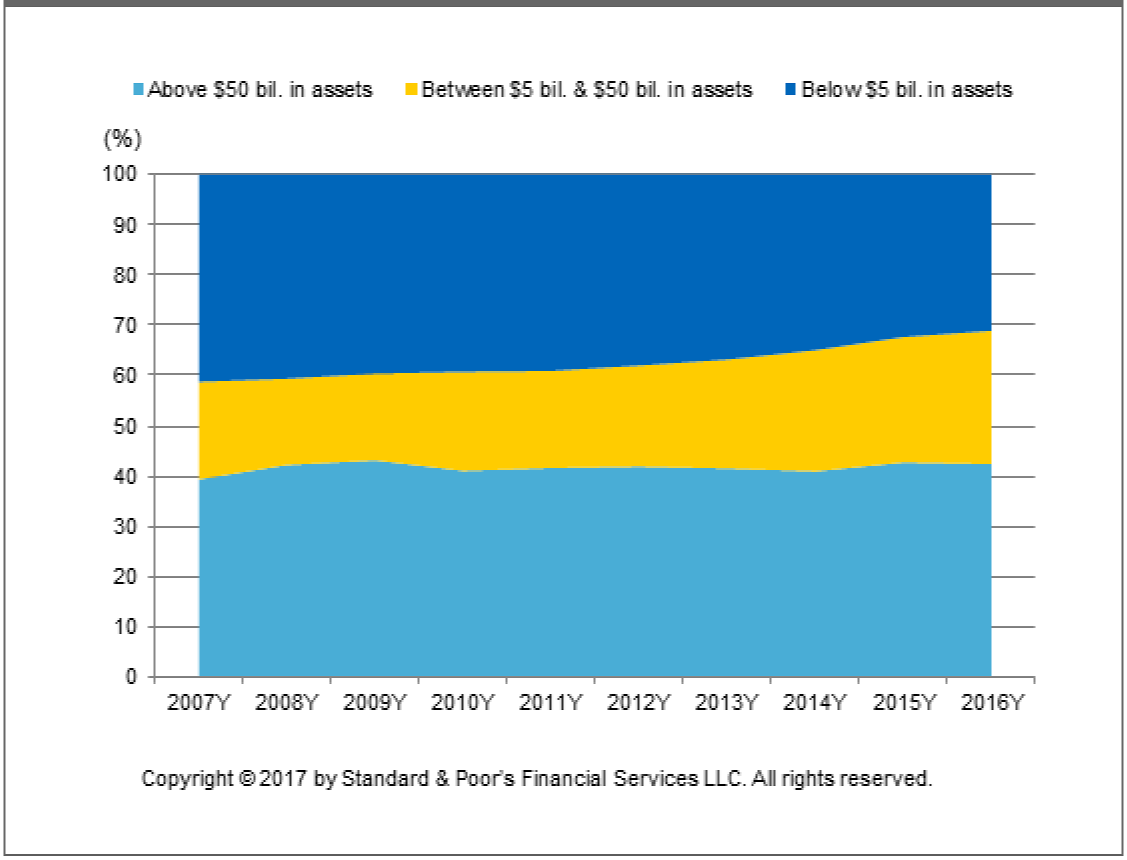
CRE market share has declined at the smallest banks, mostly to the benefit of small-to-midsize regional banks. (This largely reflects the declining number of community banks over time.) The percentage of CRE loans held at banks with less than $5 billion in assets declined to 31% in 2016 from 41% in 2008 (see chart 2). In contrast, banks in between $5 billion and $50 billion in assets grew their market share to 26% in 2016 from 17% in 2008. And although banks with greater than $50 billion in assets retain the most significant market position in CRE, the relative proportion of CRE outstanding at these institutions has remained more or less stable at the lower 40% range from 2008 to 2016. (It was 43% in 2016.)

We expect CRE to remain a core asset class for most U.S. regional and community banks. CRE lending is more of a local business and one of the few loan categories that the larger banks do not dominate. (CRE is one of the few categories of lending where localized expertise gives smaller banks an edge.) Consumer asset classes, such as credit cards, residential mortgages, and auto loans are concentrated at the largest U.S. banks or the asset-backed securities markets, and C&I lending has grown more competitive.

We believe that banks with less than $5 billion in assets--which are generally outside our rated universe--are most concentrated to the CRE asset class. Given the typically large size of CRE loans relative to other asset classes, community banks can more easily reach or exceed regulatory CRE concentration guidelines. The FDIC Community Bank Study (published in December 2012) showed that, over a 26-year time period, community institutions specializing in CRE lending were the most likely among other types of lending specialists to fail, with a failure rate of 2.25 times that of the average community bank.

Chart 2

CRE Market Share (%) By Bank Size



Weaker Asset Quality Is Emerging In Certain Pockets Of CRE

CRE is largely priced for perfection given the recent run-up in asset values. Therefore, an unexpected market shock, caused perhaps by a steeper-than-expected rise in interest rates, could raise borrowing costs for borrowers and slow or reverse price growth. In addition, other situational factors could result in borrower financial stress. For example, emerging pressure points for bank CRE portfolios could include exposure to energy-dependent geographies, overheated multifamily markets, or CRE subsectors experiencing secular change (retail and suburban office buildings).

We remain cautious regarding CRE loan exposure banks may have in markets directly exposed to the oil and gas industry. This includes parts of Texas, North Dakota, Oklahoma, Louisiana, and Pennsylvania. For example, in Houston, Texas, we anticipate office property valuations will remain at risk given the amount of space occupied by upstream and services companies within the oil and gas industry. We believe multifamily, retail, and industrial properties in energy regions may also be similarly affected over time, and we are carefully monitoring the exposures at

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our rated banks.

CRE tied to overheated multifamily markets is another emerging risk to bank asset quality. As noted by the Office of Comptroller of Currency (OCC), multifamily is in a more advanced stage of the vacancy rate cycle than other CRE types. The OCC expects new apartment construction, most of which has been at the luxury end of the market, to outpace demand, propelling vacancy rates up and slowing rent growth. Prices may also soften more in markets where luxury apartments are pushing the bounds of affordability, such as in New York City and San Francisco.

Outside of multifamily, vacancy rates are generally improving across property types, albeit at a decelerating pace, according to the FDIC. However, certain CRE subsectors are troubled because of secular changes in the marketplace. Retailers have come under pressure from evolving consumer preferences for purchasing goods online. This has resulted in rising vacancy rates for brick-and-mortar retail locations nationwide. Shopping centers and strip malls have been particularly hard hit, particularly regional shopping centers (highly sensitive to a loss of an anchor tenant or "big box" store) and lower-to-mid-range malls focused exclusively on retail (versus service providers). Similarly, a secular change in the way people work has reduced demand for suburban office buildings. Corporations have been relocating from suburban locations to city centers to attract millennial-age employees. Such moves also generally encompass a reduction in overall square footage, reflecting the proliferation of telecommuting arrangements.

We believe banks' exposure to retail CRE (including shopping or strip malls) and suburban office parks is relatively limited. However, increased delinquencies in this sector could result in possible contagion effects across other types of CRE. For example, banks are active lenders to REITs, and financial distress in retail or office subsectors of CRE could therefore indirectly hurt banks' asset quality.

Lastly, we view hotels as particularly susceptible to cyclical economic weakness. We analyzed default rates by property type for loans with debt service coverage below 1.0x. At 33%, loans secured by hotels have a higher propensity to fall below 1.0x debt service coverage relative to other property types, despite being originated at a higher going-in debt service coverage. Of the loans secured by hotels whose debt service coverage fell below 1.0x at some time during their loan term, 47% ultimately defaulted (became 60 days or more delinquent), a much higher rate than other property types.

The Mix Of CRE Loans On Banks' Balance Sheets Is Evolving

In addition to an acceleration of CRE lending, we have seen a shift in the types of CRE loans banks are originating. Banks have been largely focused on originating loans collateralized by non-owner-occupied CRE and multifamily properties at the expense of originating riskier C&D loans. (See the Appendix for rated banks with the most sizable concentrations in each CRE subcategory.)

C&D loans

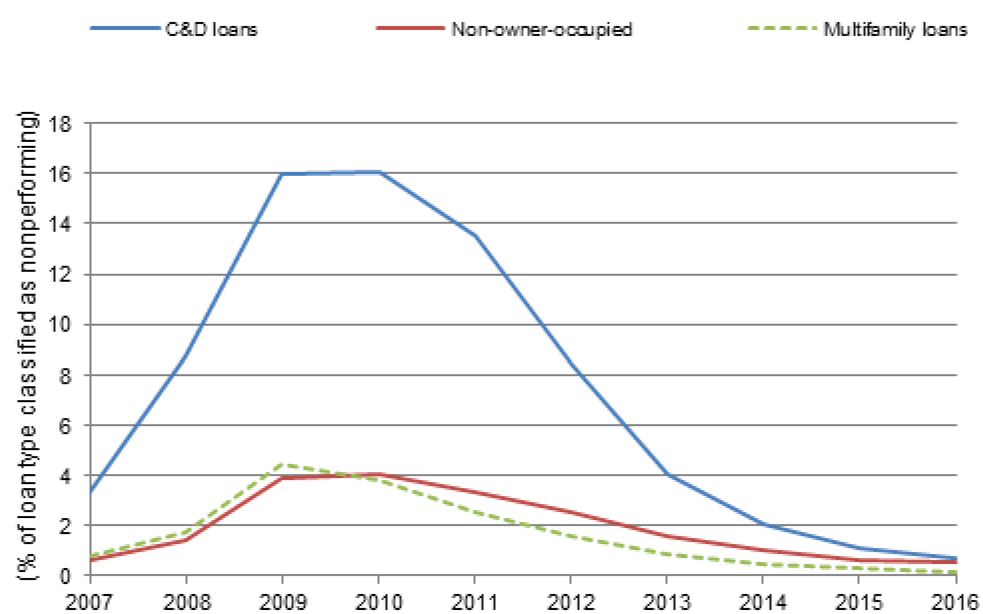
C&D loans expanded by 15% and 14% in 2015 and 2016, respectively--the highest rate of growth of any CRE type. We believe this is indicative of banks' continued appetite for higher-yielding asset classes, although, positively, outstanding balances remain less than half of what they were in 2007.

We view C&D loans as the riskiest subcategory of CRE because they typically are for properties that are not stabilized, varying from undeveloped land (the most speculative asset type) to "transitional" properties (existing structures that require significant construction to prepare them for another use). Losses for banks in the most recent downturn were primarily in this category, with loss rates at almost 6.5% in 2010. In particular, banks that had concentrations of land and vacant lots for residential real estate construction suffered high losses when the housing market collapsed.

Asset quality within the C&D category remains benign (see charts 3 and 4). In 2016, banks experienced net recoveries of 0.03%, and nonperforming loans were 0.73% of total C&D loans, down from a peak of 16% in 2010. We believe asset-quality metrics can only deteriorate from current levels, although there is some anecdotal evidence that banks are proceeding cautiously in underwriting C&D loans and are closely monitoring concentrations.

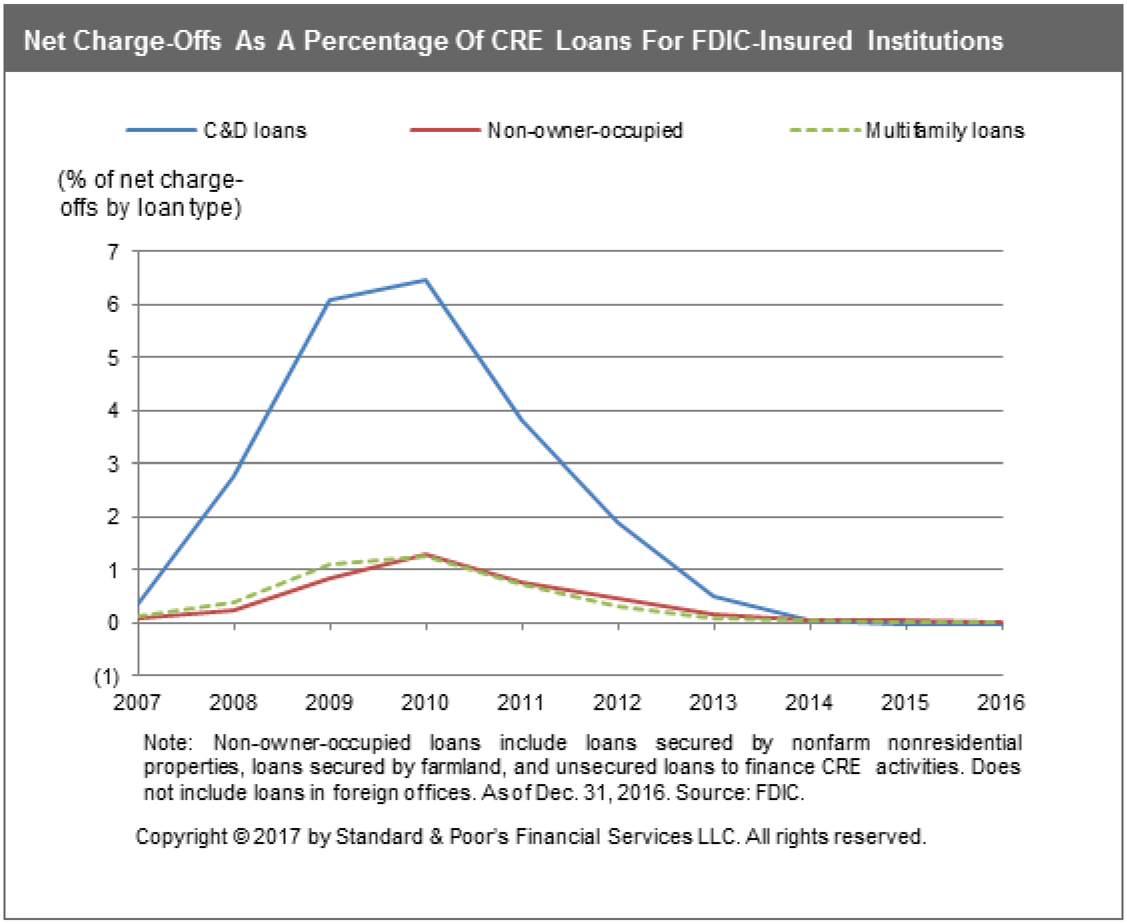
Chart 3

Nonperforming Loans As A Percentage Of CRE Loans For FDIC-Insured Institutions



Note: Non-owner-occupied loans include loans secured by nonfarm nonresidential properties, loans secured by farmland, and unsecured loans to finance CRE activities. Does not include loans in foreign offices. As of Dec. 31, 2016. Source: FDIC.

Chart 4



As of year-end 2016, C&D loans at the median of the banks we rate comprised only 3% of total loans. Many banks are avoiding financing speculative construction projects or undeveloped land. In addition, the higher capital charge associated with CRE categorized as "high volatility commercial real estate" (HVCRE) may further suppress banks' appetite for C&D. For example, under the Basel III capital standards, HVCRE is risk weighted at 150% (versus 100% for loans permanently financing owner-occupied CRE), unless banks strictly underwrite the loans within certain conservative bounds.

HVCRE is a subset of acquisition, development, and construction (AD&C) loans. HVCRE is not all AD&C loans, and sometimes most of a bank's construction book is not classified as HVCRE. Generally speaking, the regulatory definition of HVCRE excludes: 1-4 family residential mortgages, community development loans, and agricultural loans. Most importantly, AD&C loans underwritten at LTVs at or below the applicable FDIC thresholds and where the borrower has contributed capital of at least 15% of the property's appraised (completed) value are also excluded. (The FDIC threshold LTVs are 65% for raw land, 75% for land development, and 80% for construction.)

Investor-owned CRE loans

CRE loans secured by non-owner-occupied properties (or "investor owned" CRE), which make up the largest portion of U.S. banks' CRE portfolios, increased 49% between 2007 and 2016, and more than half of this growth occurred in 2015 and 2016. We view this category as generally less risky than C&D. For example, nonperforming loans and net charge-offs peaked at 4.08% and 1.30%, respectively, in 2010--a much lower level than C&D loans. As of year-end 2016, nonperforming loans were 0.56% of non-owner-occupied loans and losses were minimal.

Currently benign asset quality and bankers' perception that investor CRE is generally a safe asset category if underwritten properly has propelled the expansion of this CRE subtype. (On an absolute dollar basis, investor CRE has grown more robustly than both C&D and multifamily loans.) For investor CRE, banks most often hold three- to five-year floating-rate loans on "stabilized" commercial properties (those with adequate cash flows relative to their debt service requirements and not in need of much additional leasing, sales, or renovation) and may require significant equity and guarantees from borrowers. However, interest rates charged and underwriting standards (including down payment and debt service coverage requirements, maturities, amortization periods, and the inclusion of guarantees/recourse arrangements and prepayment penalties) can differ among lenders, which in our view will eventually cause some dispersion in the ultimate performance of these loans.

While non-owner-occupied CRE, according to our definition, is predominantly comprised of loans secured by nonfarm nonresidential properties, we also include loans secured by farmland (which are nominal across our rated universe) and unsecured loans to finance CRE and construction activities. Based on FDIC data, unsecured CRE loans have more than doubled since 2010 and now represent about 6% of total CRE loans. We believe a primary source of this increase is a boost in borrowing by REITs, which have taken advantage of low interest rates to obtain a relatively cheap financing. REITs--which are required to pay out 90% of its taxable income in the form of dividends to avoid paying corporate taxes--use bank debt as a source of liquidity to finance additional property acquisitions and development activity. REITs therefore could present incremental sources of contingent risk for banks.

Multifamily loans

Multifamily loans (secured by rental apartment buildings and condos) have demonstrated the strongest growth of CRE subtypes, rising consistently since 2007, albeit off a smaller base. Multifamily loans have grown about 90% since 2007 and now comprise 22% of total CRE loans (13% in 2007). Multifamily CRE credit quality has remained excellent, with net charge-offs averaging less than 5 basis points over the past four years. Peak credit losses during the 2007-2008 financial crisis were also relatively low, further bolstering the attractiveness of the asset class to banks. Nonetheless, we remain cautious on the underlying fundamentals of the multifamily market, particularly given recent forecasts of broad-based rent declines in many major cities.

After the financial crisis, the number of renters increased as many potential homebuyers had difficulty qualifying for mortgage financing. A shortage of construction during the financial crisis and increasing demand, particularly from affluent millennials, empty-nesters, and foreign buyers in urban areas, also helped push prices on multifamily properties upward and expanded demand for construction financing. Rental rates have risen as vacancy rates in many U.S. urban areas have been near historical lows, although they have declined somewhat recently, particularly for high-end apartments in the largest urban areas.

According to the U.S. Census Bureau, the vacancy rate for rental housing was 6.9% as of Dec. 31, 2016. Comparatively, the peak vacancy rate between 2007 and 2016 was 11.1% in the third quarter of 2009. However, given rapid multifamily supply growth in some markets, the FDIC has urged banks to monitor demand for units in those markets versus the inventory of rentable units. The FDIC notes that, as demand slows in certain markets, those markets may not be able to absorb the excess supply as quickly as projected, resulting in higher vacancy rates and lower-than-projected cash flows and potential credit quality stress on banks.

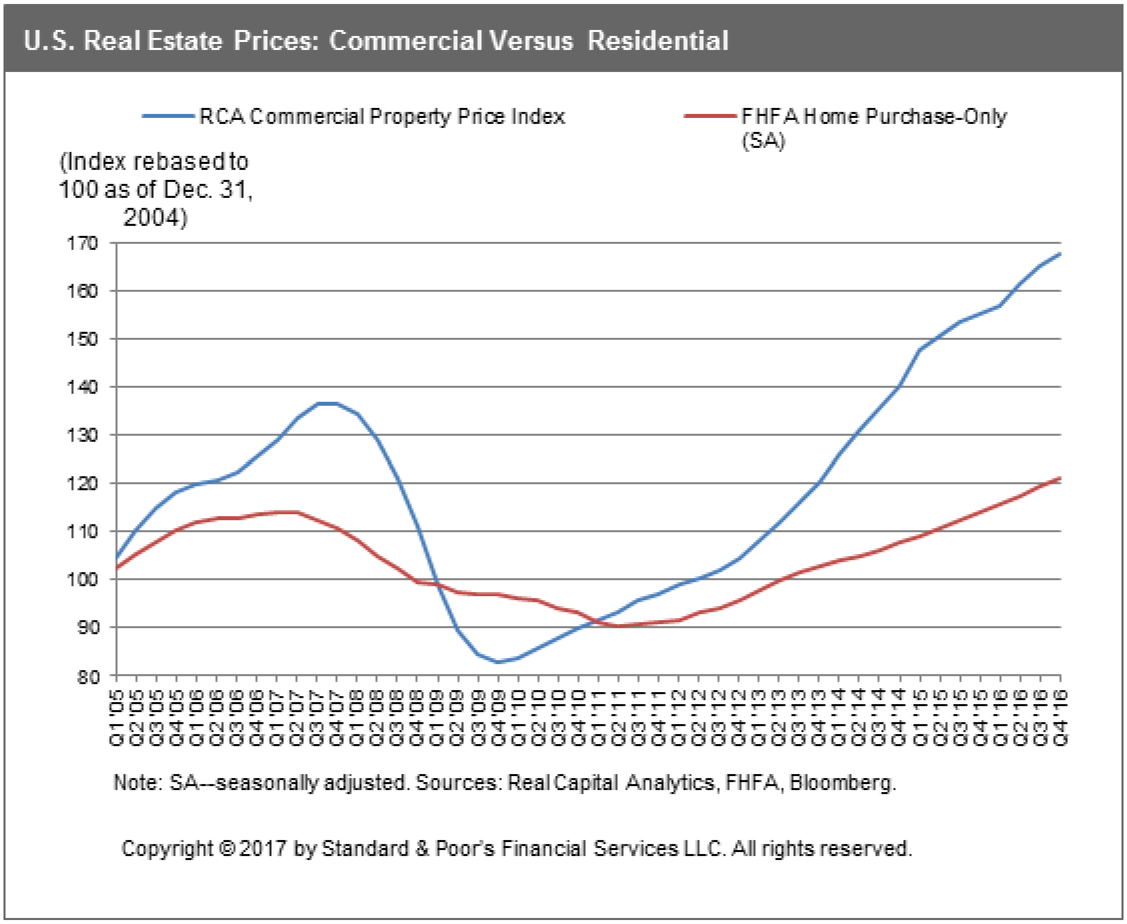
However, although multifamily remains a relatively small portion of all FDIC banks' loans and equity (4% and 21%, respectively), it represents an area of risk given its robust growth. Capitalization (cap) rates--the ratio of net operating income to the price paid for a property--are at historical lows for multifamily properties. Companies can incur risk when lending on properties valued at low cap rates (implying high property valuations) since a rise in cap rates, all else being equal, suggests lower property valuations. On a given loan, this would lead to less collateral and higher LTV ratios. Real Capital Analytics (RCA) calculates that cap rates for transactions in large metropolitan area markets throughout the U.S. were 5.4% for multifamily properties versus an average of 6.6% across all CRE property types (retail, multifamily, office, industrial, and hospitality properties across all markets, as of year-end 2016). Cap rates are primarily influenced by the overall level of market interest rates, which have risen from historical lows, and we expect them to rise in 2017 and beyond. (Factors such as the overall health of the economy and supply-demand dynamics also influence cap rates.)

Decelerating CRE Loan Growth Is Likely For 2017

The CRE lending environment remains highly competitive. Low interest rates and rising commercial property valuations continue to spur loan demand, and banks are competing for opportunities to expand revenue and bolster loan yields. In 2016, this resulted in 10.5% year-over-year growth in total CRE loans outstanding, according to FDIC data, down from 12.2% in 2015. According to S&P Global Market Intelligence, CRE originations shrunk more than 4% for 2016 versus the prior year, although the level of origination activity remains high historically. In 2017, we expect that CRE loans by banks will continue to expand--but at a decelerating rate. The increased caution on the part of bank management teams reflects the overall frothiness of CRE markets--particularly for C&D projects and multifamily properties--and increased scrutiny by regulators, among other factors. Nonetheless, we still consider CRE to be a significant risk for the banks we rate.

CRE property prices have rebounded strongly after the crisis. Federal Reserve data regarding CRE prices for the U.S. shows steadily rising property values, including an average change in CRE prices of more than 10% annually between second-quarter 2010 and year-end 2016 (see chart 5). Yet, RCA reported that U.S. commercial property transaction volume declined by 11% in 2016, despite remaining strong historically (the third strongest year on record). Transaction volume consisted of apartments, followed by office, retail, and industrial properties. According to RCA, the cap rate average across CRE property types is currently the lowest it has been since 2007 (below precrisis troughs at approximately 6.6%, from a peak of more 8% in late 2009). Positively--outside of multifamily--rents and occupancy levels remain generally sound across CRE property types, and construction activity has been more limited. However, a downturn in the economy could put pressure on real estate prices, as could rising interest rates, which could cause available financing and sales activity to diminish.

Chart 5

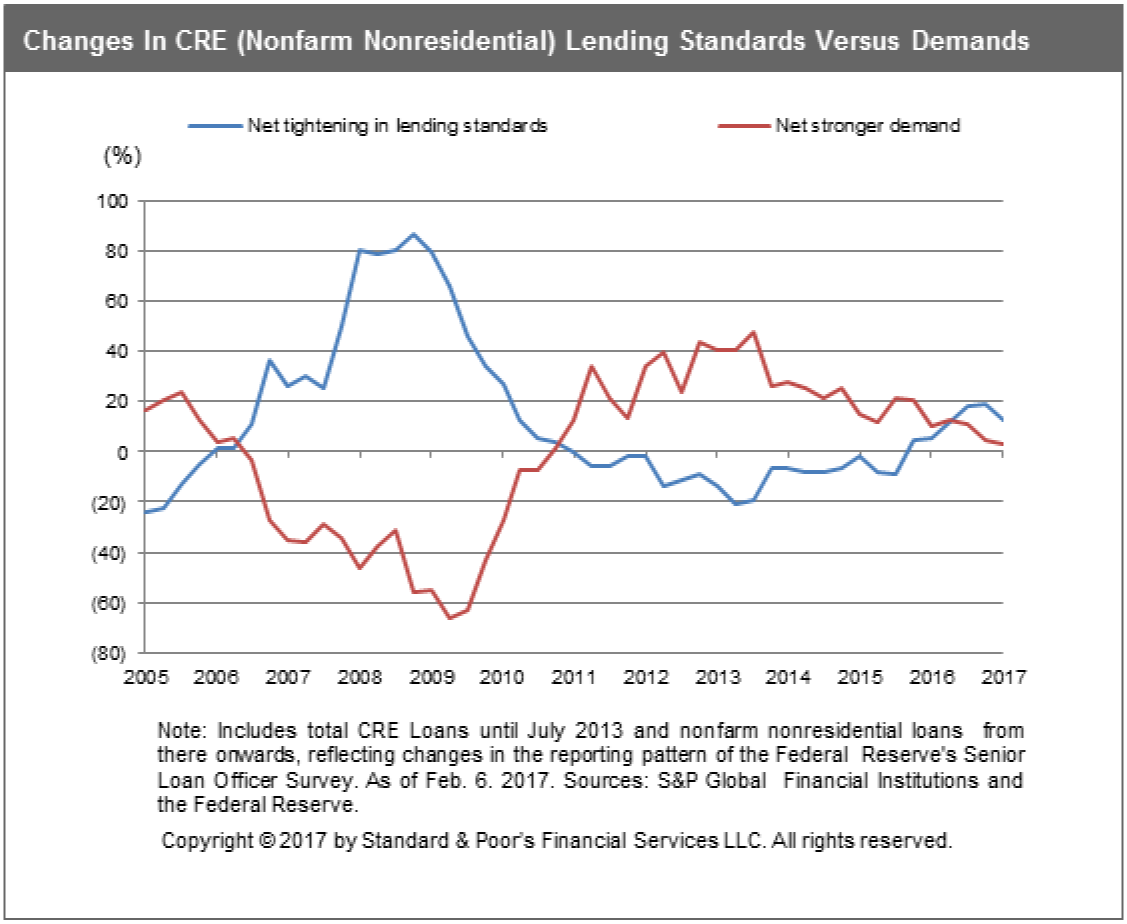


Renewed interest in CRE lending by banks has attracted greater supervisory scrutiny from regulators. On Dec. 18, 2015, federal bank regulators issued a "Statement on Prudent Risk Management for Commercial Real Estate Lending." Regulators noted that, while the CRE market remains strong and asset quality benign, CRE concentrations are rising throughout the industry. The statement is a reminder of regulators' focus on underwriting standards and risk management, particularly at those banks with C&D loans in excess of 100% of total capital, or total CRE loans in excess of 300% of total capital (and the portfolio increased by 50% or more during the prior three years). According to the FDIC, there were 521 FDIC-insured institutions that met one or both of the two criteria set forth in the concentration guidance (or more than 8% of the FDIC-insured almost 50% over the past three years.

Federal regulators' statement on CRE lending also points to an easing universe). Although the number of institutions exceeding the guidance remains well below the level observed precrisis, it has increased of underwriting standards since the financial crisis, including less restrictive loan covenants, extended maturities, longer interest-only payment periods, and limited guarantor requirements.

We believe banks management teams' risk posture toward CRE lending may be becoming more conservative because of the high level of competition and increased regulatory scrutiny, as results from the Federal Reserve's Senior Loan Officer Survey suggest. Although underwriting standards generally remained the same or were eased from 2011 through 2016, banks started tightening standards across CRE loan types in the third quarter of 2015, especially for multifamily. For the fourth quarter of 2016 (as reflected in the January survey), banks reported continued tightening, particularly for C&D and multifamily, in conjunction with weakening demand (see chart 5). In addition, survey respondents expect to further tighten standards on CRE lending in 2017.

Chart 6



Notwithstanding the current regulatory stance on CRE, we think that regulatory relief--particularly for community banks--is possible in the future. The administration of President Donald Trump has articulated a philosophy that espouses a "lighter touch" with regard to regulation. This may cause banking regulators to pull back from areas of risk that are currently highly scrutinized, including CRE. In addition, other initiatives are currently underway that may make CRE lending easier. On March 21, 2017, Federal regulatory agencies issued a joint report to Congress on their efforts to reduce regulatory burden. Proposals that are being considered include amendments for community banks that would replace the existing HVCRE framework with "a more straightforward treatment" of acquisition, development, or construction loans. In addition, regulators are developing a proposal to increase the loan size threshold for which banks have to obtain an appraisal of CRE to $400,000 from $250,000. Regulators are also developing a process whereby, under certain conditions, appraisal requirements for properties located in rural areas can be waived, even if the loan size is over $400,000.

For the remainder of 2017, we expect to see the most tightening for C&D and multifamily and some tightening for investor CRE loans. (This would be largely accomplished through preventative loan covenants, shorter maturities or interest-only payment periods, and additional guarantor requirements.) We also expect continued moderate slowdown in demand for credit across CRE loan types, indicating that CRE market activity may be slowing, albeit from elevated levels.

Appendix

Table 3

Top 10 Banks By C&D Loans To Total Loans And Tier 1 Capital

	--C&D--	
	% of total loans	**% of tier 1 capital**
Median	**3.0**	**22.6**
Average	**3.5**	**27.5**
Texas Capital Bancshares Inc.	11.7	102.4
Cullen/Frost Bankers Inc.	11.5	57.7
Western Alliance Bancorporation	11.2	88.2
BancorpSouth Inc.	10.5	78.1
Trustmark Corp.	10.3	67.1
M&T Bank Corp.	8.8	66.5
Synovus Financial Corp.	8.8	78.3
S&T Bancorp Inc.	8.2	79.4
Associated Banc Corp.	7.1	65.4
UMB Financial Corp.	7.0	41.5

Note: Median and average of all S&P Global Ratings rated banks. Does not include loans in foreign offices. As of Dec. 31, 2016. Source: S&P Global Market Intelligence.

Table 4

Top 10 Banks By High Volatility CRE Loans To Total Loans And Tier 1 Capital

	--HVCRE loans--	
	% of total loans	**% of tier 1 capital**
Median	**0.9**	**6.9**
Average	**1.2**	**9.6**
M&T Bank Corp.	5.6	42.3
Commerce Bancshares Inc.	4.9	27.8
Comerica Inc.	4.7	30.7
Regions Financial Corp.	4.6	30.2
First Midwest Bancorp Inc.	3.7	31.1
Cullen/Frost Bankers Inc.	3.5	17.5
PNC Financial Services Group Inc.	3.2	18.8
S&T Bancorp Inc.	3.1	29.6
BancorpSouth Inc.	2.7	20.3

Table 4

Top 10 Banks By High Volatility CRE Loans To Total Loans And Tier 1 Capital (cont.)

	--HVCRE loans--	
	% of total loans	**% of tier 1 capital**
Median	**0.9**	**6.9**
Average	**1.2**	**9.6**
BMO Financial Corp.	2.7	15.3

Note: Median and average of all S&P Global Ratings rated banks. Does not include loans in foreign offices. As of Dec. 31, 2016. Source: S&P Global Market Intelligence.

Table 5

Top 10 Banks By Non-Owner-Occupied CRE Loans To Total Loans And Tier 1 Capital

	--Non-owner-occupied--	
	% of total loans	**% of tier 1 capital**
Median	**9.8**	**71.8**
Average	**11.1**	**81.8**
S&T Bancorp Inc.	28.2	271.9
Western Alliance Bancorporation	25.9	203.9
East West Bancorp Inc.	25.4	218.3
Synovus Financial Corp.	24.6	218.9
Valley National Bancorp	22.2	225.6
People's United Financial Inc.	21.5	197.1
First Midwest Bancorp Inc.	20.8	173.3
BancorpSouth Inc.	20.2	150.2
BOK Financial Corp.	20.0	122.8
Cullen/Frost Bankers Inc.	19.0	95.4

Note: Non-owner-occupied loans include loans secured by nonfarm nonresidential properties, loans secured by farmland, and unsecured loans to finance CRE activities; Median and average of all S&P Global Ratings rated banks. Does not include loans in foreign offices. As of Dec. 31, 2016. Source: S&P Global Market Intelligence.

Table 6

Top 10 Banks By Unsecured CRE Loans To Total Loans And Tier 1 Capital

	--Unsecured CRE--	
	% of total loans	**% of tier 1 capital**
Median	**0.9**	**2.7**
Average	**1.2**	**7.0**
Regions Financial Corp.	6.2	40.8
U.S. Bancorp	4.6	32.3
MUFG Americas Holdings Corp.	4.5	24.0
PNC Financial Services Group Inc.	4.5	26.5
KeyCorp	3.9	26.3
M&T Bank Corp.	3.5	26.1
Comerica Inc.	3.1	20.1

Table 6

Top 10 Banks By Unsecured CRE Loans To Total Loans And Tier 1 Capital (cont.)

	--Unsecured CRE--	
	% of total loans	**% of tier 1 capital**
Median	**0.9**	**2.7**
Average	**1.2**	**7.0**
Associated Banc Corp.	2.7	25.2
BBVA Compass Bancshares Inc.	2.6	20.2
BMO Financial Corp.	2.3	13.1

Note: Median and average of all S&P Global Ratings rated banks. Does not include loans in foreign offices. As of Dec. 31, 2016. Source: S&P Global Market Intelligence.

Table 7

Top 10 Banks By Multifamily Loans To Total Loans And Tier 1 Capital

	--Multifamily--	
	% of total loans	**% of tier 1 capital**
Median	**1.8**	**12.1**
Average	**4.5**	**39.8**
New York Community Bancorp Inc.	68.3	719.3
Astoria Financial Corp.	38.8	257.4
Valley National Bancorp	18.3	185.9
First Republic Bank	12.7	100.5
People's United Financial Inc.	11.0	101.3
Santander Holdings USA Inc.	9.8	51.4
First Midwest Bancorp Inc.	8.2	68.1
JPMorgan Chase & Co.	7.3	32.0
S&T Bancorp Inc.	7.1	68.5
East West Bancorp Inc.	6.3	54.3

Note: Median and average of all S&P Global Ratings rated banks. Does not include loans in foreign offices. As of Dec. 31, 2016. Source: S&P Global Market Intelligence.