

Small Banks and the Recovery Advantage in Commercial Real Estate

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Introduction

Small banks play a large role in commercial real estate (CRE) lending. For example, while banks with under \$5B in assets comprise less than 12% of the industry's assets, they hold close to 30% of CRE loans held by banks. Furthermore, their market share of CRE loans is higher than their share in all other major loan sectors, like single-family residential real estate, or commercial and industrial loans. In this research project, I explore the comparative advantage of small CRE-focused banks.

Research question

What is the nature of the comparative advantage of small in CRE lending?

Main Findings

Small banks that specialize in CRE lending have an advantage in recovering funds from distressed loans

1. Small CRE-focused banks obtain higher loan recovery rates conditional on foreclosure

- Not due to screening based on the collateral's potential to minimize losses given default
- Difference in recovery rates is robust to geographical distance and the lender's relationship with prospective buyers of the foreclosed properties

2. Early loan defaults of small CRE-focused banks are less likely to become permanent losses. Compared to larger CRE-specialized institutions, small CRE banks have

- A larger share of CRE loans delinquent between 30-89 days
- A lower share of CRE loans delinquent over 90 days or no longer accruing
- A lower charge-off rate for CRE loans

Data

- Loan originations and CRE transactions from Real Capital Analytics (LTV, loan date, lender name, property type)
- Regulatory bank data on FDIC-insured commercial banks
 - Financial statements (Call Reports)
 - Branch-level deposits (Summary of Deposits)

Differences in recovery rates

Using data on foreclosed CRE properties sold by banks, I regress loan recovery rates on a set of property, loan, and lender characteristics.

- **Dependent variable:** Ratio of sale price to original loan amount
- **Main regressors:** Bank size, CRE loan holdings, interaction
- **Controls:** Property type, state F.E., year F.E., type of borrower, type of buyer, LTV ratio, bank liquidity, T1 capital ratio, REO

	(1)	(2)	(3)	(4)
<i>crebank</i>	0.3871** (0.1804)	0.3774** (0.1782)	0.3732** (0.1783)	0.3613* (0.1824)
<i>Size_{it}</i>	0.0647 (0.1306)	-0.0757 (0.1305)	0.0595 (0.1306)	0.0952 (0.1371)
<i>crebank : Size_{it}</i>	-0.5407*** (0.1977)	-0.5260*** (0.1945)	-0.5298*** (0.1957)	-0.5926** (0.1970)
<i>crebank : acqlen</i>		-0.6270* (0.3578)		
<i>crebank : Size_{it} : acqlen</i>		0.7325 (0.4562)		
<i>network</i>			0.1922*** (0.0550)	
<i>branchsale</i>				-0.0614 (0.0553)
<i>crebank : branchsale</i>				0.1885** (0.0817)
Controls	Yes	Yes	Yes	Yes
Standard Errors	Bank+qtr	Bank+qtr	Bank+qtr	Bank+qtr
Num. obs.	3089	3284	3089	3089

*** $p < 0.01$; ** $p < 0.05$; * $p < 0.1$

Results

1. Small CRE specialists obtain high recovery rates

- 38 pp higher than small non-specialists
 - Difference between small and large CRE banks is approximately ½ their difference in size ranking
- ### 2. Ex ante screening does not explain the difference in recovery rates
- I explore bank acquisitions as cases in which the seller of the property is different from the loan originator
 - Loans originated by small CRE banks had lower recovery rates when sold by a different bank

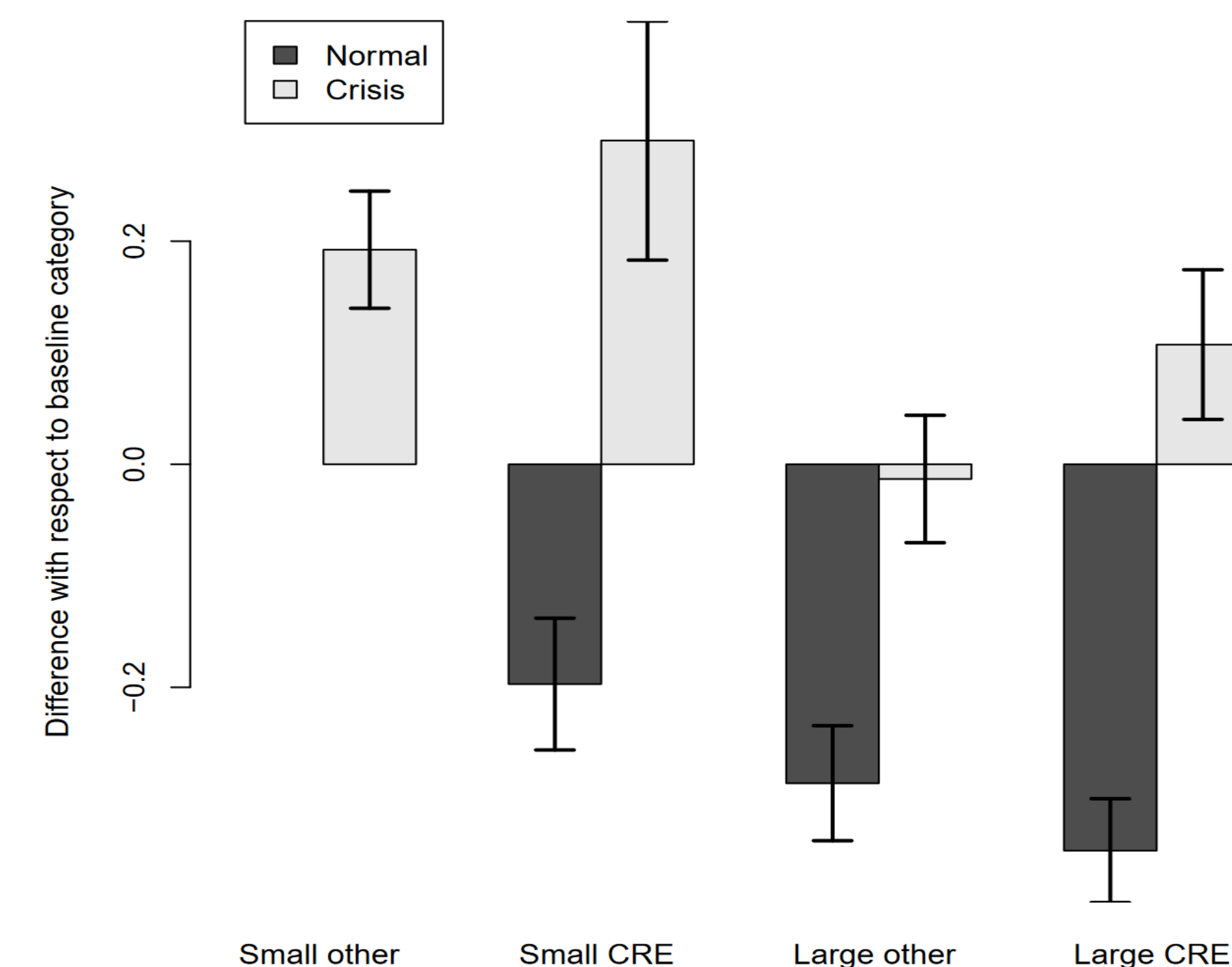
3. Selling to former clients is positively correlated with loan recovery rates, but does not explain the difference between small and large CRE specialists

4. Having a branch close to the property is associated with higher recovery rates for CRE specialists, but the difference between small and large CRE banks remains large and significant after controlling for geographic proximity

Differences in CRE loan performance

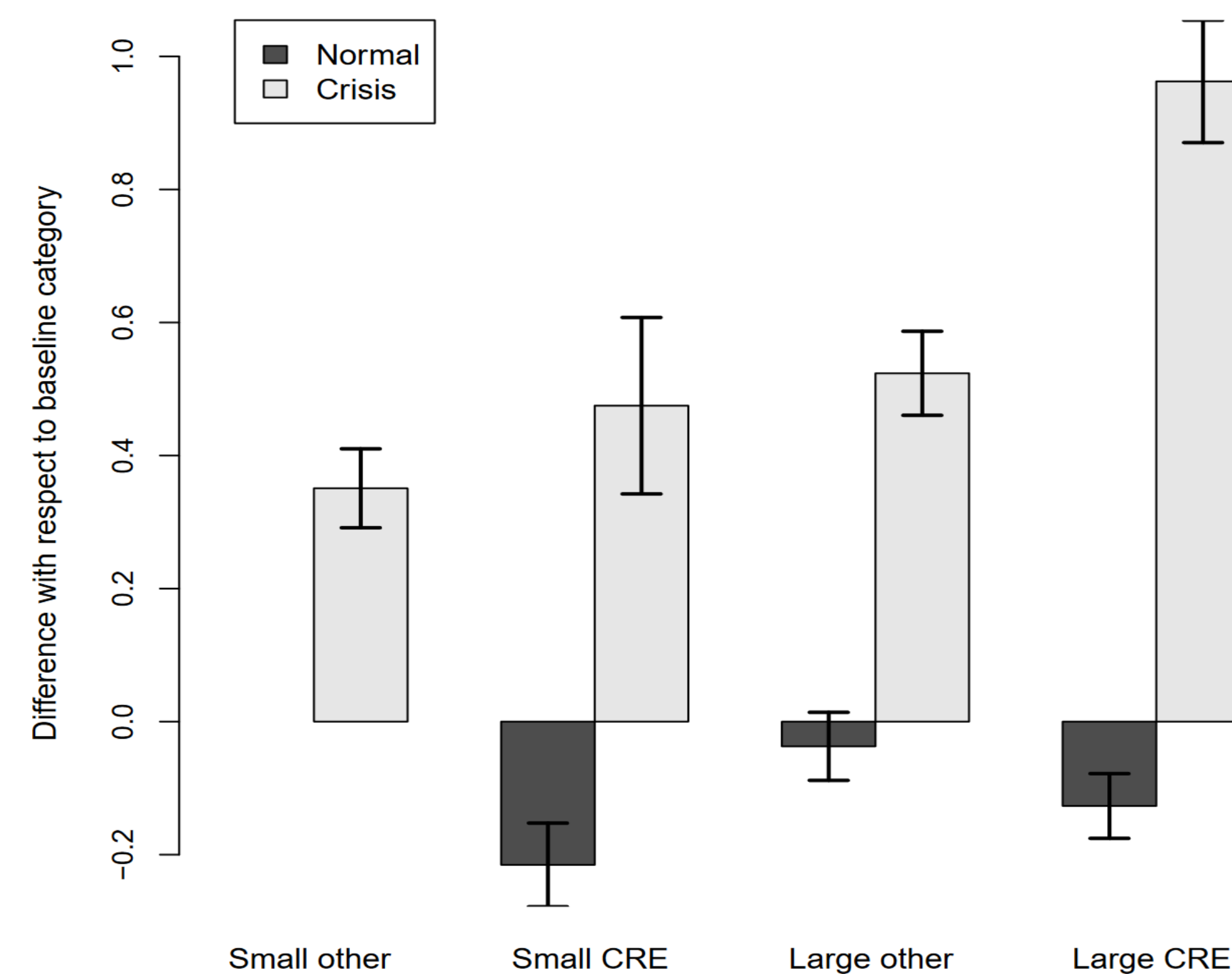
Loans held by small CRE specialists default more often than those held by large CRE banks...

Early CRE loan delinquency rate (30-89 days delinquent)



But they are less likely to remain delinquent or become permanent losses:

CRE loan delinquency rate (>90 days or not accruing)



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