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 oans 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.

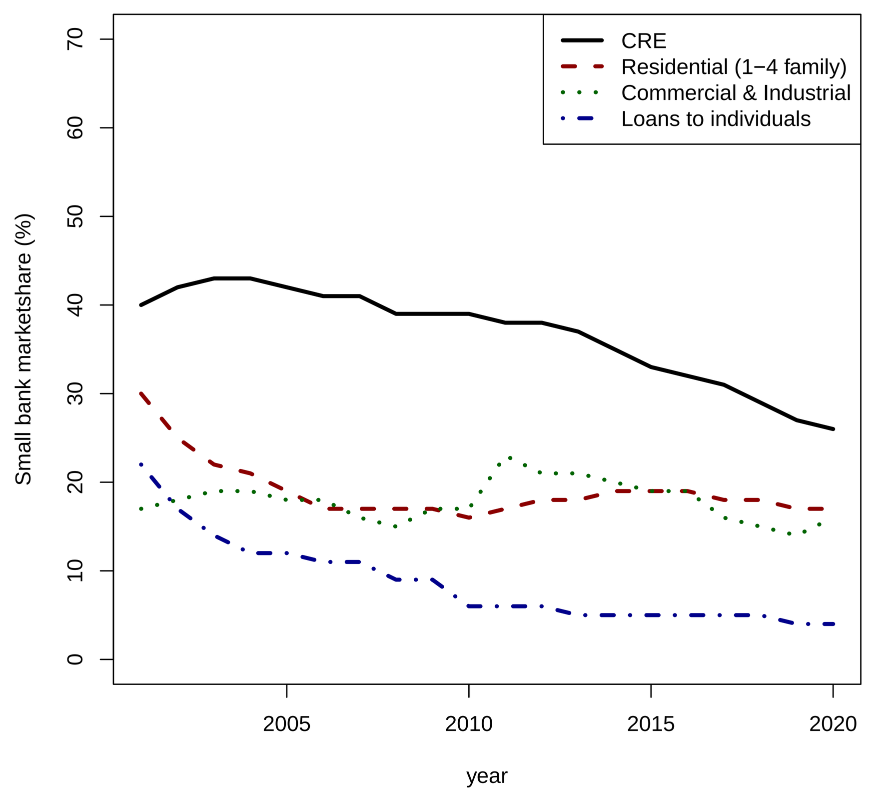

Figure 1:Market share of small banks (<$5B) by loan type

Research Question

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

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)

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
2. Early loan defaults of small CRE-focused banks are less likely to become permanent losses

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)
crebank	0.3871**	0.3774**	0.3732**	0.3613*
	(0.1804)	(0.1782)	(0.1783)	(0.1824)
$Size_r$	0.0647	−0.0757	0.0595	0.0952
	(0.1306)	(0.1305)	(0.1306)	(0.1371)
crebank : $Size_r$	−0.5407***	−0.5260***	−0.5298***	−0.5926**
	(0.1977)	(0.1945)	(0.1957)	(0.1970)
crebank : *acqlen*		−0.6270*		
		(0.3578)		
crebank : $Size_r$: *acqlen*		0.7325		
		(0.4562)		
network			0.1922***	
			(0.0550)	
branchsale				−0.0614
				(0.0553)
crebank : *branchsale*				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

$^{***}p < 0.01$; $^{**}p < 0.05$; $^{*}p < 0.1$

Figure 2:Regression results - Loan recovery rates

Results

- Small CRE specialists obtain high recovery rates (Fig. 2, Column 1)
  - 38 pp higher than small non-specialists
  - Difference between small and large CRE banks is approximately half their difference in size ranking
  - Interpretation: on average, a bank in the first quartile of the size distribution recovers 25 pp more than a bank in the third quartile

Differences in Performance

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

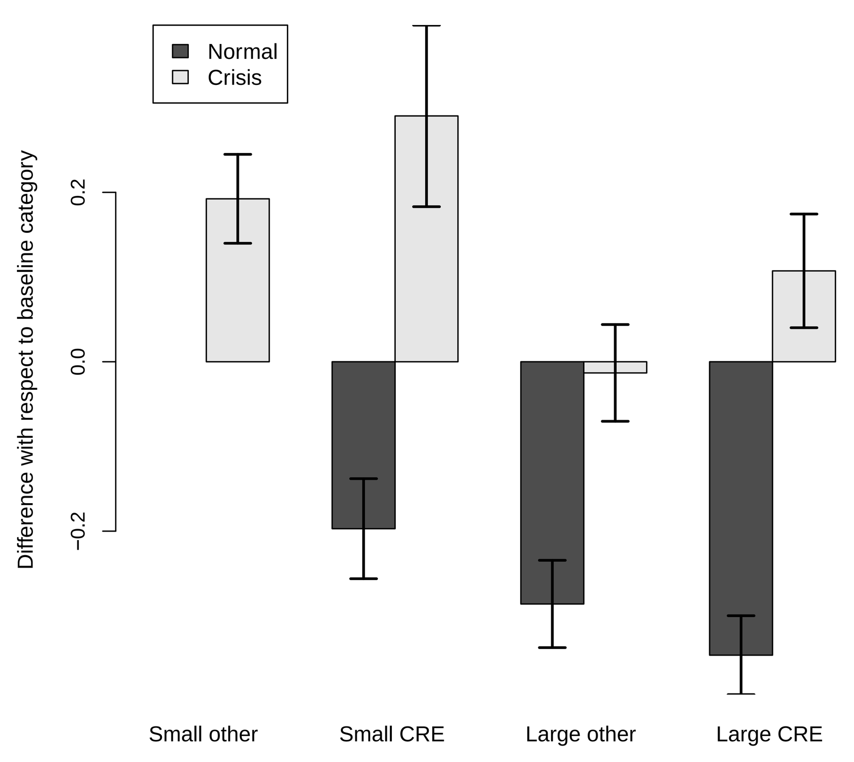

Figure 3:Differences in CRE delinquency rates (30-89 days)

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

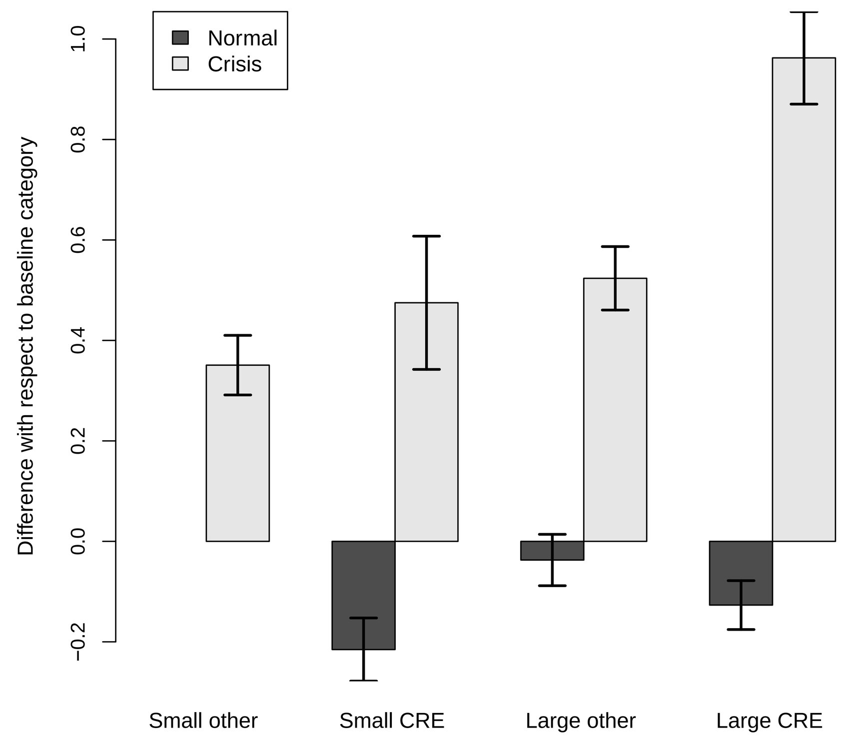

Figure 4:Differences in CRE delinquency rates

Potential Mechanisms

- Ex ante screening does not explain the difference in recovery rates (Fig. 2, Column 2)
  - Evidence from bank acquisitions: loans originated by small CRE had lower recovery rates when sold by a different bank
- Selling to former clients is positively correlated with loan recovery rates, but does not explain the gap between small and large CRE specialists (Fig. 2, Column 3)
- Having a branch close to the property is associated with high recovery rates, but the gap between small and large CRE banks persists after controlling for geographic proximity (Fig. 2, Column 4)
- Alternative explanations: Organizational structure, bank personnel

Conclusion

Small banks with a CRE focus have riskier loan commercial mortgage portfolios. However, this is compensated by their comparative advantage in handling distressed loans, both before and after foreclosure. This has implications for regulators: curtailing the exposure of small specialized banks to CRE could reduce their competitive advantage and impact their ability to remain in business.

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