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BLOG

Banks with elevated CRE exposures in the crosshairs

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The enhanced focus on commercial real estate concentrations is causing pain for some banks.

Regulators' heightened scrutiny over commercial real estate exposures has prompted capital raises by some banks and put pressure on many bank stocks. Analysts are encouraging investors to not paint banks with elevated CRE concentrations with a broad brush, arguing that some institutions have proven they can handle the risk and now are even reporting better loan pricing in their markets.

CRE exposures have come back to the forefront after regulators warned late in 2015 that they would take a harder stance on concentrations, which they define as CRE loans composing at least 300% of total risk-based capital; construction, land development and other land loans composing 100% or more of total risk-based capital; and construction and total CRE growth of 50% or more over the prior 36 months.

Regulators, and in particular the OCC, have asked several institutions exceeding those levels to increase capital or improve risk management practices. Most recently, Carver Bancorp Inc. unit Carver Federal Savings Bank entered into a written agreement with the OCC on May 24 over issues including compliance with the Bank Secrecy Act and CRE concentrations. Carver's CRE loans equated to 481.2% of total risk-based capital at March 31, up from 348.9% a year earlier. The agreement requires, among other things, Carver to develop a risk management program to address CRE concentrations.

Other OCC-regulated banks with CRE loans exceeding 300% of risk-based capital have disclosed plans to build capital, seemingly at the behest of regulators. Suffolk Bancorp said in late April that it expected the OCC to hold it to minimum capital ratios in excess of well-capitalized minimums. The statement came after the regulator expressed concerns about overheated conditions in CRE markets.

Around the same time, First of Long Island Corp. said regulators' increased concern about CRE concentrations was among the challenges it faces. Not long after that, the OCC-regulated bank announced a capital raise, and said the proceeds would be used to support growth.

Some institutions with similar CRE concentrations are also expected to raise capital. For instance, Sussex Bancorp recently attended marketing meetings with FIG Partners analyst David Bishop, who said the company expects to raise capital within 12 months. CRE loans equated to 414.5% of the bank's risk-based capital at March 31, and Bishop believed the capital raise would come in part to improve the ratio and provide capacity for growth.

Institutions like Sussex with higher CRE exposures have increasingly drawn attention from investors, and many of those banks have seen their stock prices come under pressure. There were 170 publicly traded institutions with banking subsidiaries that reported CRE loans exceeding 300% of risk-based capital at March 31, and those institutions have underperformed the banking index in recent months. Over the last three months, the median performance of those institutions' stocks lagged the KBW Nasdaq Bank Index by more 5%, according to SNL data as of June 8.

Some analysts have recently said the selloff in some of those institutions could be overdone. The Raymond James bank analyst team noted in a June 6 report that higher CRE concentrations do not necessarily imply greater risk of increased regulatory oversight. The analysts encouraged investors to consider differentiating factors such as CRE lending experience. With that in mind, the analysts reiterated their "strong buy" ratings of ConnectOne Bancorp Inc. and Bank of the Ozarks Inc., whose stocks have underperformed the bank index notably over the last three months. Those companies' bank subsidiaries reported CRE loans equating to 543.6% and 460.8% of risk-based capital, respectively, at March 31.

The heightened scrutiny on CRE concentrations might not be all bad for some banks, either. Bank of the Ozarks Chairman and CEO George Gleason recently expressed greater optimism about CRE volume and pricing due to the retreat of other market participants, according to Piper Jaffray analyst Peyton Green. The analyst noted in a report that CRE loan pricing has improved recently, increasing 25 to 75 basis points in the last 90 days from levels seen four to six months ago. That increase has come even as long-term rates remain low and short-term rates have only increased modestly.

Banks that have effective risk management procedures in place will be able to capitalize on improving market conditions. Some others, however, could find themselves in the crosshairs of regulators and might look to bolster their balance sheets soon.

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