Banks Boost Reserves for Commercial Real Estate in Case Recession Hits

Property Lending at Banks Reaches Record As Lenders Put Aside More for Bad Loans

By Andy Peters

Bank loans for commercial real estate hit a record high in the final three months of 2022, but those lenders also set aside more money to cover potential losses from that financing amid recession fears.

For all U.S. banks, fourth-quarter loans for commercial properties grew 1.8% to a record $1.78 trillion compared to the previous quarter, according to figures compiled by Dallas-based BankRegData. Construction loans, recorded separately, rose 4.6% to $467.7 billion.

The sharp rise in commercial real estate lending creates the potential for wider profit margins, but also increases the risk of delinquencies if the economy tanks, Fitch Ratings said in a Jan. 31 report.

“Higher loan loss provisions were driven by strong loan growth and a weaker economic outlook, with many banks now assuming a mild recession in 2023 as their base case,” Fitch said.

In the case of the largest U.S. bank by assets, JPMorgan Chase, the New York-based company recorded a fourth-quarter loan-loss provision of $2.3 billion, a 49% increase from its third-quarter provision of $1.5 billion.

Economic forecasts show the most likely scenario for 2023 is a “mild recession,” JPMorgan Chase chief financial officer Jeremy Barnum said in a Jan. 13 conference call.

“I think we have appropriately conservative assumptions about the outlook embedded in our” loan-loss provisions, Barnum said.

Setting Aside Reserves

Provisions can cover losses from any type of loan including commercial mortgages, as well as credit card loans, auto loans or residential mortgages.

The Financial Accounting Standards Board, an independent organization based in Norwalk, Connecticut, requires banks to set aside reserves for potential loan losses as soon as loans are recorded on their balance sheets. The reserves are designed to improve risk management, but they cut into banks’ profits.

Still, industry analysts said many regional and community banks posted unexpectedly strong lending for commercial real estate in the final three months of 2022.

Moreover, banks with large exposure to the office market have, thus far, appeared to avoid a major rise in delinquencies. EagleBank, based in Bethesda, Maryland, said last month that none of its borrowers for office properties were late on payments.

Loan growth at another Washington, D.C.-area institution, United Bankshares, "surprised us to the upside" in the fourth quarter, because of "sound growth in the construction and non-owner-occupied [commercial real estate] portfolios," Janney Montgomery Scott analyst Daniel Cardenas wrote in a research note.

The holding company for United Bank said fourth-quarter loans for non-owner-occupied commercial real estate increased 4.3% to $6.3 billion from the previous quarter. But with the higher loans came higher reserves. United Bank's fourth-quarter loan-loss provisions more than doubled to $16.4 million on a quarterly basis.

Loan Types

Non-owner-occupied commercial real estate is the largest loan category at United Bank with more than 30% of its total loan book. Non-owner-occupied commercial real estate borrowers are more likely to default than loans for owner-occupied properties.

United Bank's fourth-quarter owner-occupied commercial mortgages dropped 1.3% to $1.7 billion on a quarterly basis.

Janney Montgomery Scott analysts also highlighted strong growth commercial mortgage lending at Camden National Bank in Camden, Maine; First Citizens Community Bank in Mansfield, Pennsylvania; and LCNB National Bank in Lebanon, Ohio.

Some banks reported a drop in demand for commercial real estate loans as higher rates made borrowing more expensive.

"We have seen a slowdown on the commercial real estate side given the rising rate environment," John Connerton, chief financial officer at Evans Bancorp in Buffalo, New York, said in a Feb. 2 conference call.

Construction loans for multifamily projects with a concentration of affordable units was the main driver of commercial mortgage growth at First Interstate BancSystem in Billings, Montana. Its total commercial real estate loan portfolio increased 6.3% to $8.5 billion on a quarterly basis.

"The majority of these projects were multifamily properties," CEO Kevin Riley said in a conference call late last month.