Tightening Loan Standards?

What a more conservative lending environment means for real estate projects in 2024

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Several times a year, the Federal Reserve conducts a survey of up to 80 domestic banks and 24 U.S. branches and agencies of foreign banks to gauge opinions on bank lending practices. Its July Senior Loan Officer (SLO) Opinion Survey confirmed market data about the tightening of loan standards and more conservative underwriting standards. The survey confirmed that rising rates have caused banks to place more emphasis on balance sheets, cash flow and income statements.

What does this mean for 2024? Currently, borrowers with strong credit are typically receiving term sheets for commercial real estate lending transactions from banks with typical loan-to-value (LTV) requirements of 70%. This compares to prior year's LTV of 75-80% for similar transactions.

The July 2023 Survey gave insight into expectations for the remainder of 2023, with banks reporting expectations for further tightening of credit standards for all loan categories. Heading into and during 2024, we can expect banks' justifications for tightening underwriting standards to continue to hold based upon the uncertain "economic outlook and expected deterioration in collateral values and the credit quality of loans as reasons for expecting to tighten lending standards further over the remainder of 2023."

SLOs reported supervisory changes and the desire for stronger liquidity due to economic headwinds – factors that lead to a decrease in value or growth of the economy – which may occur. This makes sense. The Federal Reserve imposed individual capital standards for large banks with $100 billion or more in total consolidated assets, effective October 1, 2023.

The Federal Reserve also proposed 1) implementing the final components of the Basel III (Basel III is an internationally agreed set of measures, developed in response to the financial crisis of 2007-09, which aim to strengthen the regulation, supervision and risk management of banks) and 2) further revising capital standards for large banks. This would increase the cost of capital for banks, particularly large banks.

Since the 2008 financial crisis, we have seen the availability of credit from financial institutions being impacted, from time to time, by specific bank concentrations. Because commercial real estate (CRE) lending is a top segment for U.S. commercial banks, concentrations in CRE are monitored heavily by regulators and banks themselves.

Adjusting to banking environment changes

To be sure, banks and private lenders are still lending money. Capital for real estate transactions remains available. Underwriting standards at some institutions have gotten tighter, while others – mainly community and regional banks – have stayed relatively the same. Brouse McDowell's recommendations to clients when seeking borrowing capacity include:

1. Be organized – Have your financial statements, tax and organizational documents ready
2. Enlarge your investigation of available funding
3. Have your elevator pitch ready about what sources of funds are needed and uses of the funds
4. Be strategic in making development decisions that maximize increases in value

5. If equity capital is needed, reach out to counsel to organize capital raises to facilitate your goals

Maintaining deal volume in 2024

Savvy investors are maintaining deal volume and diversification by acting more deliberately in the funding process and investigating or using more funding sources in projects.

Outside equity funding can provide the additional level of equity to keep your deal pipeline flowing, particularly in changing interest rate environments. Benefits of this approach include:

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- Minority investors provide liquidity outside of bank debt
- Deal flow can be maintained with existing capital levels of the majority investor
- Maintenance of diversification in real estate investments
- Calls and puts can be used to allow for buyouts at the issuer or investor request
- Reducing lending requirements may reduce financing costs, particularly in rising rate environments P

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