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Banking Trends

Why Don't Philly Banks Make More Local CRE Loans?

Nationally, local banks do a large share of commercial real estate lending, but this isn't true in Philadelphia. We take a trip through the geography, history, and data of this unusual banking market.

BY JAMES DISALVO

Between 2011 and 2017, the Philadelphia area experienced a commercial real estate (CRE) boom. New construction, rehabbing, and sales of existing properties were all at high levels. Where did the funding for all of these projects come from?

Throughout the nation, banks are by far the largest CRE lenders, and small banks capture a large share of this lending. Relative to large banks, small banks excel in local knowledge and local relationships, giving them a comparative advantage in making these loans.

However, using data from Real Capital Analytics, I found that local banks originate a surprisingly small share of CRE loans in the Philadelphia market. To find out why, I examined the types of banks making these loans.

Small Banks Are Strong Competitors in CRE Lending Nationwide

Along with small-business loans, CRE loans are the bread and butter of small banks. Nationwide, small banks (those with less than $10 billion in assets) are the largest holders of CRE loans. They hold over 40 percent of CRE loans made by banks, even though they hold less than 15 percent of total assets (Figure 1).[1] CRE loans are one of the few remaining areas in which small banks enjoy a competitive advantage over medium-sized and large banks, according to banking analysts.

There are several reasons why small banks have an advantage in CRE lending. First, small banks draw the vast majority of their customers from the area around their headquarters. That means they are likely very knowledgeable about market conditions, including areas with under- or overvalued properties, areas likely to have neighborhood opposition to a project, and the best and worst developers.

Their proximity to the market may be important in other ways as well. Local lenders can better monitor a project by visiting the site, and they can schedule meetings with the developer to discuss problems that might arise. They may also be better connected to relevant local parties, including developers, investors, contractors, labor leaders, and politicians. For example, members of Philadelphia's City Council can use their prerogative to hold up projects in their own elective districts.[2] Understandably, developers and lenders benefit from cultivating relationships with these local politicians.

Bank balance sheets provide direct evidence of small banks' comparative advantage in CRE lending. Nationally, CRE loans represent just over 30 percent of their total assets in aggregate (Figure 2). This compares with about 5 percent for the largest banks. In Philadelphia, CRE loans represent only a slightly smaller share of assets—a little over 27 percent. And yet, local banks are only minor players in the Philadelphia CRE lending market.

Who Does CRE Lending in Philadelphia?

As in most of the nation, banks and other depository institutions are by far the largest CRE lenders in the Philadelphia market.[3] Between 2011 and 2017, they made about 81 percent of the number of loans and about 72 percent of the dollar value of loans (Figure 3).[4]

Depository institutions dominated not just overall lending but also every category of CRE lending. Banks' closest competition came from nonbank financial firms, but only for loans secured by apartment buildings and possibly office buildings. All of the other operators—insurance companies, government and quasi-government agencies, and private lenders—are at best fringe competitors.

Because banks have such a dominant market share, and because I have accurate data on the locations of their headquarters and branches as well as their size, I limit my analysis to the activities of banks and other depository institutions, which I refer to as banks.

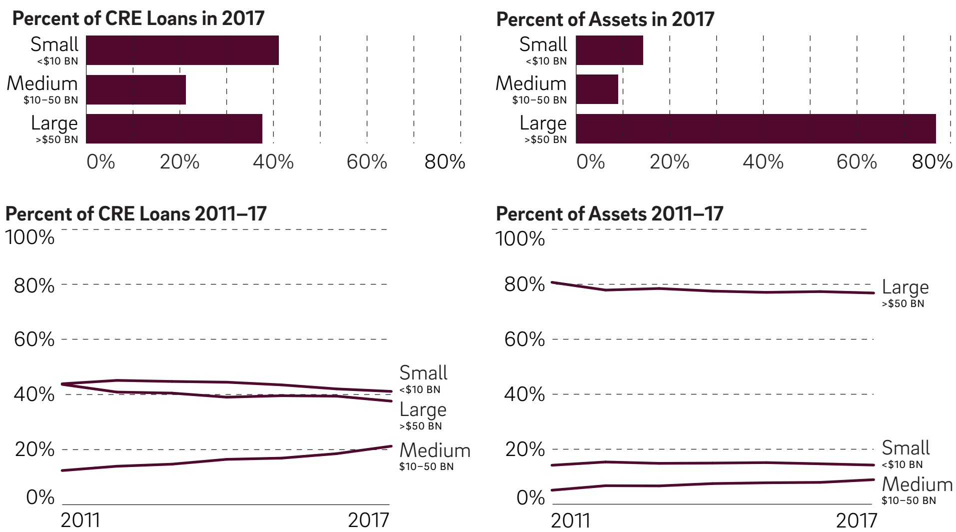
Local banks (that is, banks headquartered in the Philadelphia market) capture only a small share of Philadelphia CRE loans (Figure 4). The data show that Philadelphia-area banks originate about 22 percent of the number and about 10 percent of the dollar value of loans in this

FIGURE 1

Nationally, Small Banks Are Largest Holders of CRE Loans

They hold a competitive advantage when it comes to these loans.

Percent of all CRE loans nationwide; percent of all CRE assets nationwide; bars, 2017; lines, 2011–2017



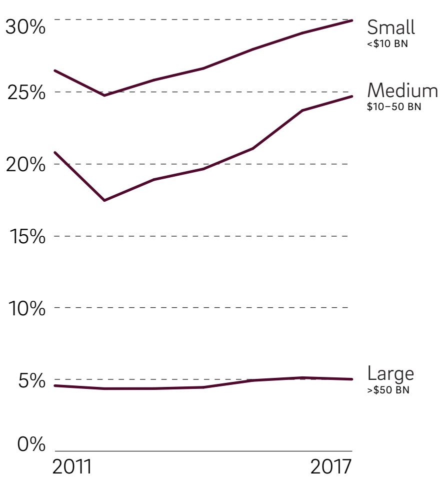
Source: FFIEC Call Reports and Federal Reserve FRY-9Cs.

FIGURE 2

Bank Balance Sheets Show Small Banks' Competitive Advantage

By 2017, CRE loans represented over 30 percent of their total assets.

Percent of total assets nationwide, 2011–2017



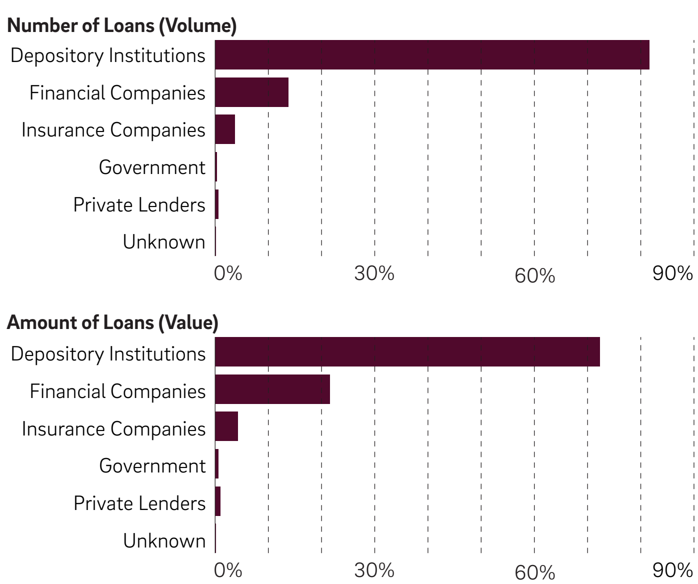
Source: FFIEC Call Reports and Federal Reserve FRY-9Cs.

FIGURE 3

Depository Institutions Are Largest CRE Lenders in Philadelphia Market

They dominate in both volume and value of CRE loans.

Number of and value of CRE loans by category of lender, Philadelphia lending market, 2011–2017



Source: Real Capital Analytics, Inc. https://www.rcanalytics.com/.

Note: Philadelphia lending market comprises Burlington, Camden, Cumberland, Gloucester, Mercer, and Salem counties in New Jersey, and Bucks, Chester, Delaware, Montgomery, and Philadelphia counties in Pennsylvania.

market. In part, this finding probably reflects data limitations; most notably, the data cover only transactions where the sale price was over $1 million. Local banks likely have a larger share of smaller CRE loans. Regardless, the question remains: Who is making these larger loans? And why don't standard theories about local lenders' comparative advantage apply in Philadelphia?[5]

See *A Note on the Data*

Philadelphia-Market Banks Are Small

Local Philadelphia banks are quite small compared with banks nationally.[6] As of year-end 2017, banking organizations headquartered in the Philadelphia area had average total assets of $915.4 million. The mean size for banking organizations in the nation was $3.8 billion. The largest bank in the Philadelphia area had $5.8 billion in total assets, and the last large bank to be headquartered here, CoreStates Financial, was acquired by First Union Corporation (a North Carolina bank, now part of Wells Fargo) in 1998.[7] Maybe local banks are just too small to originate many large loans.

Some evidence suggests that, even among nonlocal lenders, bank size plays a significant role in local CRE lending. In Philadelphia, large banks supply about 49 percent of the number and about 72 percent of the dollar value of loans made by nonlocal lenders (Figure 5, top two bars).[8] Furthermore, putting loan size into quartiles shows that large banks have a commanding share of both the number and the value of the largest quartile (Figure 6). So the lack of many large local banks in Philadelphia partly explains why so many CRE loans are made by nonlocal banks.

But bank size is not the whole story. These same data indicate that, although large, nonlocal banks do make the largest loans, many nonlocal lenders in the Philadelphia market are not large. As Figure 5 shows, in Philadelphia only a little less than half of the loans (by number) are made by large nonlocal banks.

Conversely, large nonlocal banks do compete successfully against local banks even for smaller loans. About one-third of both the number and the value of the lowest quartile of loans—presumably loans that could have been made by local banks—are made by large organizations (Figure 6).

Although structural issues such as bank size are important, something more than size explains why local banks have such a small share of the local market.

The Philadelphia Banking Market Is Close to Other Large Banking Markets

One unique feature of Philadelphia is its proximity to active banking markets in New York, northern New Jersey, and Delaware.[9] Lenders from these areas account for about 56 percent of the number and 57 percent of the dollar value of loans made by nonlocal lenders in the Philadelphia market (Figure 5, middle two bars).

Unlike urban areas in most of the rest of the country, Philadelphia's neighboring cities are close and easily accessible in either direction. New York City is about a 90-minute drive from Philadelphia, and there are numerous links by train and bus. Northern New Jersey has the same train and bus links, and it is even closer by car. Wilmington, Delaware, is about a 40-minute drive from central Philadelphia, and it is accessible by both Amtrak and local public transportation.

These distances may be longer than the typical distance between a small bank borrower and a lender, but they are close enough for a loan officer to schedule a morning site visit or meeting with the property developer and be back in their office by early afternoon.[10] Also, these distances may be even shorter than they appear because a substantial share of the loans are made by banks with a branch presence in the Philadelphia market.

A Local Branch May Substitute for a Local Headquarters

Many nonlocal banks maintain branches in the Philadelphia market. Having a local branch may be a good substitute for being headquartered in the area. Branch employees, such as the branch manager and lending staff, can cultivate relationships and develop specialized local knowledge, much like locally headquartered banks.

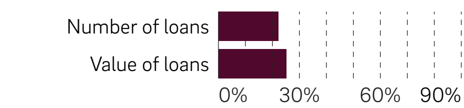
In addition, many local branches were acquired as a result of mergers; in those cases, the relationship was already in place,

FIGURE 4

Local Banks Capture Small Share of Philadelphia CRE Loans

Banks headquartered outside the Philadelphia market dominate the local market by both number and dollar volume.

Number and value of CRE loans made by local banks, Philadelphia market, 2017

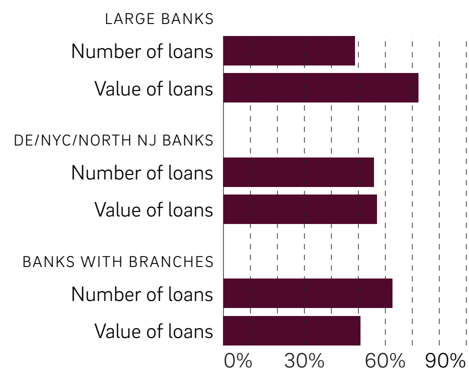


Source: Real Capital Analytics, Inc. https://www.rcanalytics.com/.

FIGURE 5

Size and Location Help Nonlocal Banks Compete

Value and number of loans by category of lender, as percentage of all nonlocal Philly CRE loans, 2017

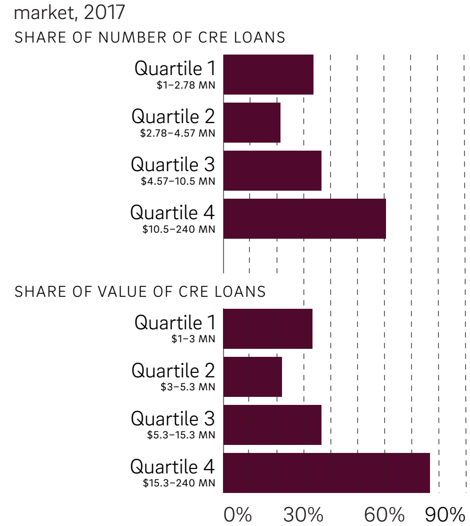


Source: Real Capital Analytics, Inc. https://www.rcanalytics.com/.

FIGURE 6

Large Nonlocal Banks Take a Bigger Share of the Larger Loans

Large nonlocal lenders' share of number and share of value of CRE loans, quartiles, Philadelphia lending market, 2017



Source: Real Capital Analytics, Inc. https://www.rcanalytics.com/.

A Note on the Data

Most of the data used in this paper were supplied by Real Capital Analytics. RCA collects data on commercial real estate transactions where the amount lent is at least $1 million. To identify lenders, I used my local knowledge of the Philadelphia banking market to get an accurate measure of the loans originated by locally headquartered banks in the data set. Some transactions involved multiple loans on multiple properties; some even involved multiple lenders. If the deal involved multiple lenders, I dropped it from the data because I was unable to determine the lead lender.[11] I counted as one loan those deals involving the same lender but multiple loans. I analyzed only property sales.

Although this data give an accurate picture of the CRE lending market in Philadelphia, RCA's data set excludes loans smaller than $1 million, which may still be too high for some small banks. I suspect that local banks have a stronger presence in the market for small CRE loans.

How much of the CRE lending in the market is accounted for by RCA? I got a rough estimate of the data coverage, at least among local lenders. I took the local lenders that appear in the RCA data set in any year and looked at their CRE loans outstanding, taken from the Reports of Condition. I then compared those outstanding loans to total CRE loans for all banks headquartered in the market. There is no simple mapping of loan originations to outstanding loans on bank balance sheets, but this exercise provides some evidence about the share of bank CRE lending that is captured by RCA.

I found that I captured about 71 percent of local CRE loans on bank balance sheets between 2012 and 2016. I then compared the banks included in the RCA sample with those excluded from the sample. There was a difference between their average sizes—$1.9 billion and $342.6 million in assets, respectively, as of year-end 2017. There was also a substantial difference in the percent of their assets in CRE loans. In-sample banks had on average 36.8 percent of their assets as CRE loans, compared with 18.2 percent for out-of-sample banks, including a number of banks with no CRE lending at all. RCA is capturing loans made by local banks that are more active in the CRE market.

requiring only that it be maintained. For example, WSFS Financial of Wilmington, Delaware, recently acquired Beneficial Savings Bank of Philadelphia. WSFS already had several branches in the suburbs, but Beneficial's roots in the area went back to the mid-19th century, and it had a substantial branch network in both the city and the suburbs.

Consistent with the view that a local branch may substitute for local headquarters, of the loans not made by local banks, more than 62 percent of the number and 51 percent of the dollar value of the loans were made by banks with branches in the Philadelphia market (Figure 5, bottom two bars). Indeed, it appears that a local presence is important even for banks in the neighboring region. A loan made in Philadelphia by a bank from New York/North Jersey/Delaware is even more likely to have been made by a bank with a local branch than for nonlocal banks located farther away.

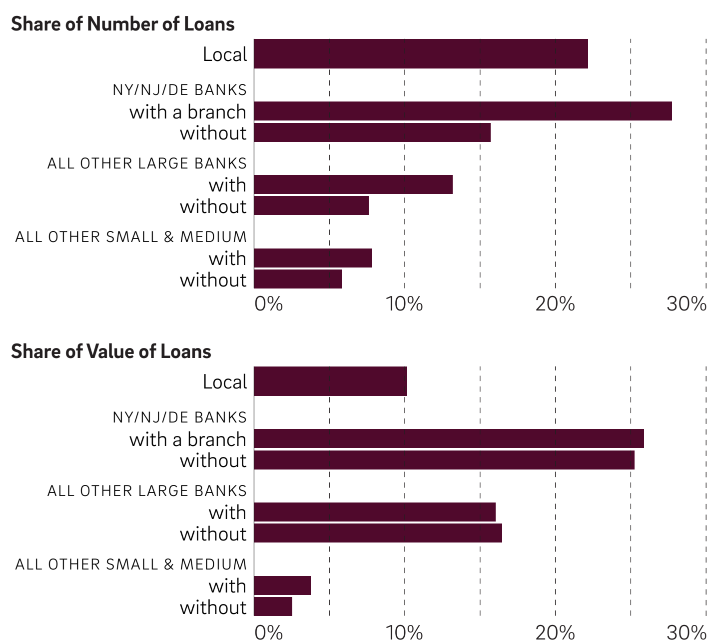
Note that nonlocal banks with branches in Philadelphia have a smaller dollar share of loans than their share of the number of loans. This suggests that a local presence is less important for larger real estate deals—that is, the market for large commercial real estate deals is larger and less localized. For larger loans, the originator's capacity to organize a lending syndicate or to securitize the loan may be more important than local knowledge or local ties.

Although local knowledge and local connections may give a local branch a competitive advantage in the Philadelphia market, there is an alternative explanation consistent with the data. Maintaining a local branch may indicate a nonlocal bank's commitment to the local market without actually facilitating the building of lending relationships. Regardless, the numbers

FIGURE 7

A Local Branch or a Location in a Nearby State Helps Nonlocal Banks Compete

Number and value of CRE loans in Philadelphia lending market, by lender category, 2017



Source: Real Capital Analytics, Inc. https://www.rcanalytics.com/.

suggest that a nonlocal branch may be a substitute for having a local headquarters.

If we view all banks in nearby regions or with local branches as having a Philly presence, we account for 83 percent of the volume and 79 percent of the dollar value of all loans not made by local banks. One reason for the large shares of both adjacent-area banks and banks with local branches is that the states in the area were early adopters of liberal branching and interstate banking laws.

See *Intrastate and Interstate Banking in and Near Philadelphia*

What Does All of This Tell Us About CRE Lending in Philadelphia?

Figure 7 summarizes the structure of CRE lending in Philadelphia.

First, locally headquartered institutions play a relatively minor role in the market.

Second, one important reason for this is that these institutions are relatively small: Large nonlocal banks account for 73 percent of the total value of loans not made by local banks, and they dominate the market for larger loans.

Third, having a branch in the Philadelphia market appears to be an acceptable substitute for having a local headquarters, and institutions that have branches here account for the bulk of nonlocal lending.

Fourth, proximity to the market is also important, with or without a local branch. Institutions from Delaware, northern New Jersey, and New York City and its environs account for a substantial part of the rest of the market.

A history of relatively liberal intrastate and interstate banking laws is a strong contributing factor to both the small size of Philadelphia banks and the strength in the local CRE market of banks from outside the Philadelphia market.

Finally, loans made by banks without local branches tend to be much larger. For these loans, the relationship benefits of proximity may be less important than other competitive advantages—for example, the ability to line up a syndicate of lenders to finance shares of the loan or the capacity to securitize the loan.

Intrastate and Interstate Banking in and Near Philadelphia

In 1994 Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act (IBBEA), allowing banks to merge and branch across state lines. The law went into effect in 1997. However, even before the IBBEA, many states were already permitting some form of interstate banking, most commonly through reciprocity agreements, whereby two states would agree to allow their banks to merge across state lines. These agreements were usually regional, focusing, for example, on New England or the Southeast.

In much of the nation, and until the 1980s, states imposed restrictions on banks' ability to compete in markets within the state but outside their local market—so-called intrastate banking restrictions. All of the states in the tristate region have a history of relatively liberal intrastate and interstate banking laws.

Delaware, with only three counties, adopted statewide branching in 1921 and never limited multibank holding companies. It was also an early adopter of interstate banking, albeit in an unusual way. In 1981 Delaware allowed out-of-state bank holding companies (BHCs) to set up de novo, limited-purpose banking subsidiaries. However, these subsidiaries were prohibited from competing with Delaware banks. In practice, three kinds of institutions were established: credit card banks (which offered only credit card loans and large certificates of deposit), wholesale banks (which catered only to large corporate customers), and back office operations (which operated usually in tandem with a credit card or wholesale operation). In 1988 Delaware allowed BHCs headquartered in the District of Columbia, Maryland, New Jersey, Ohio, and Pennsylvania to acquire existing Delaware banks on a reciprocal basis. In 1990 this law was expanded to include the entire country. Then in 1995 the reciprocity requirement was dropped.

New Jersey gradually adopted statewide branching throughout the 1970s, removing the last restrictions in 1983. By then it was moot, as multibank holding companies were permitted beginning in 1968.

New Jersey went the reciprocity route with interstate banking. In 1986 New Jersey allowed reciprocal acquisitions with Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, Missouri, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia, Wisconsin, and the District of Columbia. In 1988 it instituted national reciprocity, which was dropped after the IBBEA was passed.

New York has had the most liberal laws. It gradually adopted full statewide branching between 1961 and 1976. It also removed all restrictions on multibank holding companies in 1976. It adopted national reciprocal interstate banking in 1982, national reciprocal interstate branching in 1993, and full national interstate banking in 1995.

Pennsylvania was the most restrictive of the three states, although it was still fairly liberal relative to many states. Until 1982, branching and merging were restricted to banks in contiguous counties. In 1982 this was changed to bicontiguous counties, that is, two counties away from a bank's headquarters county. Not until 1990 was this changed to full statewide branching. Likewise, multibank holding companies were prohibited until 1982, after which BHCs were allowed to own up to four banks. This was expanded to eight banks in 1986, and the limit was dropped in 1990.

On interstate banking, Pennsylvania adopted a reciprocal law in 1986 allowing acquisitions with banks in Delaware, Kentucky, Maryland, New Jersey, Ohio, Virginia, West Virginia, and the District of Columbia. This was changed to national reciprocity in 1990, and then full nationwide banking in 1995.[12]

Notes

1 Here, small banks are organizations (either stand-alone banks or bank financial holding companies [FHCs]) with less than $10 billion in assets in 2010 dollars; medium-sized banks are those with total assets between $10 and $50 billion; and large organizations are those with total assets greater than $50 billion, plus several large foreign-based banks whose U.S. presence may be relatively small.

2 See DiSalvo and Johnston (2016).

3 My study's local market is similar to the banking market as defined by regulators for antitrust purposes. We both define the local banking market largely by commuting patterns. In my study, the Philadelphia market comprises Burlington, Camden, Cumberland, Gloucester, Mercer, and Salem counties in New Jersey plus Bucks, Chester, Delaware, Montgomery, and Philadelphia counties in Pennsylvania. Regulators, by contrast, include only parts of Burlington and Mercer counties. I include whole counties both for simplicity's sake and because the banking market includes the majority of the population and the entire urbanized area of both counties. For further explanation, see DiSalvo (2014).

4 Our primary data come from Real Capital Analytics. Its definition of banks encompasses any depository institution, including commercial banks, savings banks, savings and loan associations, and credit unions.

5 It is possible (but not likely) that local banks' low share of local CRE originations is a more general phenomenon; that is, it is possible that the market for CRE loans is significantly larger than our standard measures of the local banking market. Carrying out this exercise for the Philadelphia market required hand-matching of the majority of deals, using local knowledge of the banks operating in the local banking market, as described in A Note on the Data. Without local knowledge of other banking markets, this type of hand match would be infeasible.

6 See DiSalvo and Johnston (2015).

7 Even at its largest, CoreStates was only the 21st-largest bank in the country.

8 A large bank is the same as defined above. The others in Figure 5 are small and medium-sized nonlocal banks.

9 The Federal Reserve Bank of New York defines the Metro New York/North Jersey banking market as Fairfield, Litchfield, and New Haven counties in Connecticut; Bergen, Essex, Hudson, Hunterdon, Middlesex, Monmouth, Morris, Ocean, Passaic, Somerset, Sussex, and Union counties in New Jersey; Bronx, Columbia, Dutchess, Greene, Kings, Nassau, New York, Orange, Putnam, Queens, Richmond, Rockland, Suffolk, Sullivan, Ulster, and Westchester counties in New York; and Monroe, Pike, and Wayne counties in Pennsylvania. As in the Philadelphia market, we used whole counties even though the New York Fed includes only parts of some of these counties. As noted above, we assigned to the Philadelphia market counties that are shared between New York and Philadelphia. Delaware banks are defined as any bank or parent BHC/FHC headquartered in the State of Delaware.

10 Although there are no estimates for the distance between CRE borrowers and banks, there is a substantial literature measuring the distance between small-business borrowers and their banks. For example, Kenneth Brevoort and Timothy Hannan found that small businesses in nine metro areas were located between 2 and 5 miles from one of their lender's branches. Other studies have found that the median distance from small-business borrowers to their lenders is less than 10 miles.

11 There were only three such deals, so it is unlikely that dropping these deals creates a selection bias.

12 For further information on state branching and interstate banking laws, see Amel (1993) and Jayaratne and Strahan (1997).

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