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Banks and the wealth of nations: Not all real estate lending opportunities are dangerous

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The role of a financial intermediary is denigrated by those looking to arbitrage lending opportunities.
I try not to take the descriptions of commercial bank lending as stodgy, uninspired or brain-dead personally. I tell younger bankers the reasons for this reputation is most banks use leverage far beyond the risk tolerance of anyone investing their own capital. With equity around 6%, banks borrow 94% from depositors. A 3% loss in principal results in the loss of half a bank's capital.
The safety of a bank's lending is important for its shareholders as well as depositors, bondholders, deposit insurers and regulators. Non-portfolio lenders successfully beat portfolio lenders' pricing and exceeded their risk tolerance by finding buyers to buy securities created from all types of loans. For these lenders, the primary concern is the ability to securitize the loans. Rating agencies do not work for the buyers; the bond sellers pay them. Buyers rarely have the ability to evaluate the risks in the securitized loans and the buyers of the most risky bonds pooled the assets and stratified the loss positions to issue bonds, which were rated by agencies paid by the issuers.
On the other hand, portfolio-lending banks are watched carefully, with internal credit evaluations and then external auditors. Next, multiple regulators evaluate both assets and lending policies. Rating agencies and equity analysts also evaluate the soundness of a bank's lending. Portfolio lenders make mistakes too, but the level of scrutiny, and the pain a rebuke from internal and external reviews, has minimized the defaults in well-run banks. Painful lessons from the early 1990s are still fresh in the banking industry. Banks are far more concerned about making good loans than firms securitizing the loans, as the banks capital is at risk and the securitizing lenders have recovered all their capital once the bonds are sold.
The current debt crisis springs from the sudden realization that the loans backing bonds may fail to perform. Bond sellers, brave with bond buyers' money, are said to look at the diversity and the stratification of risk. Unfortunately, timely payments are predicated on the availability of debt to refinance loans. Now, the underwriting of commercial loans for securitization has been called into question and it seems debt might not be available to refinance. Another issue of concern is the role of trustees for bondholders. Trustees are limited in their ability to work out loans and there are concerns about drawn out fights amongst the various classes of equity, mezzanine and secured debt holders. Credit risk derivatives were added as an inducement for skittish purchasers worried about defaults. Unfortunately, untested credit derivatives are also suspect since counter-party risk or litigation, over the terms of the credit, may not help a bond purchaser recover principal. Pricing of the riskier classes of bond secured by loans, and even the investment grade loans, has widened to a point where the bank lending offers better pricing, proceeds, certainty of closing and flexibility.
Just the hint of difficulty has brought us to the precipice where the lack of financing may hurt asset values and diminish the wealth of both investors in real estate equity and debt. Could this be a

return of a 19th century economic panic?

A panic ends when equity and debt investors recognize concerns are overblown and the opportunities allow for appropriate returns. Unfortunately, losses will be incurred because of both injudicious investments and people unwilling or unable to wait for a recovery.

M&T Bank does not believe all real estate lending opportunities are dangerous. October has been one of M&T's N.Y.C. real estate department's best months, with almost $300 million in commitments. A strategy of lending to strong and experienced clients, based on reasonable expectations of future cash flows, has uncovered a wealth of opportunities. Investment properties still generate cash flow, with the upside evident in the gap between residential and commercial market rents and regulated apartment leases and older commercial leases. Banks cannot support the wealth of a nation alone. Banks need customers to participate in both sides of their balance sheet. If borrowers do not become depositors and users of the banking services provided by lenders, banks will have to redirect investments to other investment opportunities. M&T's customers have responded by utilizing our treasury management and investment management services to help them increase the availability of funds, enhance their returns and invest in real estate and other business opportunities. M&T hopes to help many more real estate investors in the coming months.

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