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CUER Research Summary

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Real Estate Development Lending: National vs. Local Banks
by
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Over the next five to ten years Canadian real estate builders and developers are likely to see continued changes in the ranks of financial institutions extending credit for real estate construction loans. Mergers of existing financial institutions, centralization and automation of underwriting within lender firms, easing of barriers to foreign financial institutions, and a greater penetration of construction and development lending by conduit lenders for mortgager backed securities will all affect the type, number, and size of real estate development lenders. To provide an understanding of the potential effects of these changes, the UBC Centre for Urban Economics and Real Estate (CUER) is conducting a programme of research on development lending using a data set of 2,302 senior and junior construction loans made in the Lower Mainland between 1985 and 1997. The first study examines the characteristics of residential construction and development loans by lender type and home office location, and whether conditions in a lender's home market affects their lending decisions in more geographically distant markets. For instance, in the early 1990s did Ontario based lenders evaluate loans in BC based on real estate market conditions in Toronto.

Between 1985 and 1997 the banks dramatically increased their share of construction loans from 24 to 56 percent. This growth came principally at the expense of the trusts, many of which whom were absorbed by the schedule I banks. Figure 1 shows this change over time. Although most bank loans are by national lenders, they also include substantial activity by the Hong Kong Shanghai Bank (HSBC) following its purchase of the Bank of British Columbia. As shown in Figure 2, Ontario lenders increased their shares through 1992. There was a sharp drop in their BC market share in 1992 and 1993, at the same time their home market sunk. At the same time, BC based lenders, especially HSBC and to a lesser extent VanCity, started to increase their loan activity. BC based lender share increased through 1997.

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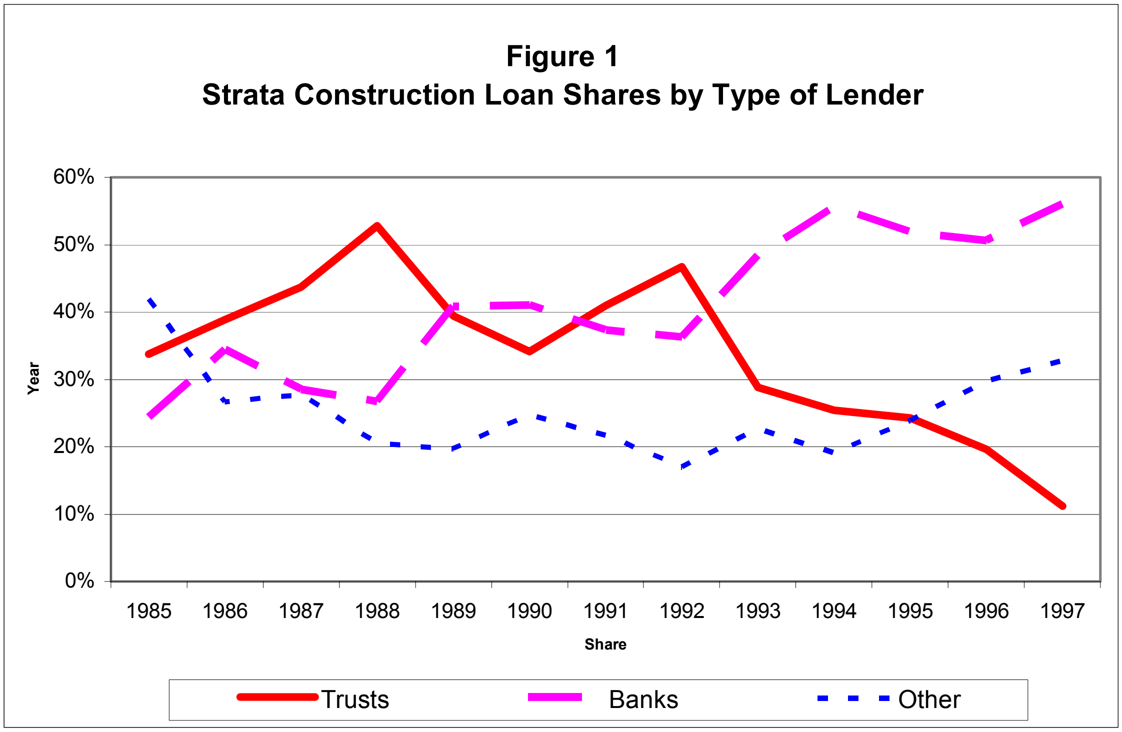

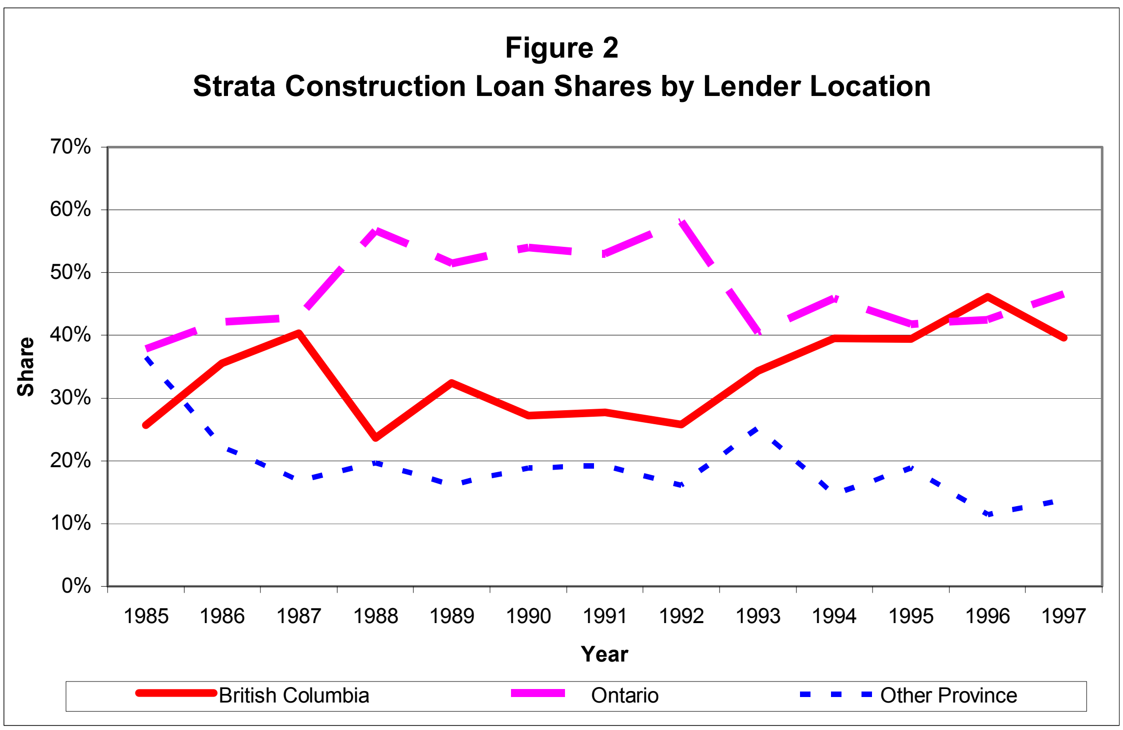

The statistical analysis of mortgage characteristics shows that construction loans from BC lenders are qualitatively different than those from national lenders. First, irrespective of housing market conditions, BC-based lenders are 30 to 50 percent more likely to make junior loans. Second, local BC lenders charge lower spreads, between 38 and 82 basis points lower.

Surprisingly, these spreads are not affected by housing market activity and price growth. In contrast, Schedule I banks charge a premium in the spread over prime for their loans relative to other lenders. In a variety of different tests the results are quite clear that construction loans made by BC lenders differ qualitatively from those made by outside lenders, which for the most part are the large national banks and trusts.

The second question of this research is whether lenders evaluate lending risk in “outside” markets based on conditions in their home housing market. This issue is of particular concern as centralization and automation of underwriting mean that more BC loans made by Ontario and Quebec based lenders are evaluated in the home office rather than a local regional office. Our analysis finds that bank capital flows across the country in response to market conditions. As the BC market improves relative to a lender’s home market, they increase their lending in BC: the number of senior and junior loans made in the Lower Mainland falls as a lender’s home housing market rises relative to the BC market. This analysis takes into account such factors as a lender financial health and other lender characteristics that do not vary with time. These argue that construction lenders do not behave myopically, but that capital flows efficiently within a firm.

The preliminary results of this research program indicates that consolidation of construction lending by non-BC schedule I banks and the centralization of underwriting decisions in home rather than local offices will affect construction lending in BC. The historical evidence suggests that spreads will be higher and smaller borrowers will face more challenges in obtaining financing. However, there is little reason to fear that lending decisions for BC loans will be made based on conditions in the Toronto real estate market.