Shadow Lenders Are Pushing Into Risky Real Estate Deals

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Seven years after the financial crisis, private funds in the U.S. are extending their push into traditional banking.

So-called shadow lenders -- asset managers that operate outside the banking industry's regulatory oversight -- have been making an increasing number of leveraged loans to midsize businesses. Now their involvement is growing in commercial real estate, a market that scorched traditional lenders when it blew up after the 2008 financial crisis.

Shadow banks are firms that act like lenders but don't have depositors, federal bank regulations or access to the Federal Reserve's discount window, where banks can borrow when money is tight. Their expanding role in the U.S. economy, hailed by some regulators, has been made possible by tighter lending restrictions imposed on banks after the crisis. But it comes with danger: the collapse of nonbanks such as Lehman Brothers Holdings Inc. helped inflame the 2008 meltdown.

"We clearly need to be very vigilant about monitoring risks that are migrating to that system, and certainly in the Federal Reserve we have hugely ramped up our attention to the shadow banking system," Fed Chair Janet Yellen said Wednesday in testimony to Congress. "We are thinking about regulations that might address -- like minimum margin requirements that would apply not only to banking organizations but more broadly that might address some potential risks in the shadow banking system."

Taking Risks

U.S. private funds that target debt investments in commercial real estate raised a record $14.2 billion last year, a 67 percent jump from 2013 and up from just $1.7 billion in 2010, according to data researcher Preqin. Over the next several years, shadow lenders could pick up as much as $118 billion in commercial real estate mortgages and development loans that banks would've handled, taking risks that regulated institutions won't, Goldman Sachs Group Inc. said in a March report.

The migration to nonbanks shows "a structural change that has taken place, and will continue to take place," said Bruce Batkin, co-founder and chief executive officer of New York-based Terra Capital Partners LLC.

Michael Nash, global head of Blackstone Group LP's real estate debt strategies, said it's "good and healthy" for the economy to diversify sources of credit. Bank regulators don't oversee the New York-based asset manager, but the U.S. Securities and Exchange Commission does.

Assets Doubled

Blackstone's publicly traded real estate investment trust, Blackstone Mortgage Trust Inc., almost doubled its assets under management last month to about $10 billion after completing the purchase of $4.8 billion of commercial mortgages from General Electric Co.

Blackstone originates loans for construction “very selectively,” Nash said.

In November, the firm provided a $600 million loan to Howard Hughes Corp. subsidiaries to finance two condominium towers in Honolulu, the 171-unit Waiea and the 311-unit Anaha, according to a regulatory filing.

Nonbanks’ growing slice of the market is still smaller than that of traditional lenders. Banks insured by the Federal Deposit Insurance Corp. had $246 billion in construction and development loans on their books at the end of the first quarter, a 3 percent increase over 2014 year-end balances. At the peak of the credit boom that crashed in 2008, that figure topped $630 billion.

Fastest Growing

Regulated banks have kept a hand in the market by lending to shadow banks. Loans by banks to non-deposit-taking financial companies were one of the fastest-growing categories of bank credit last year, rising 36 percent, or $47.3 billion, according to the U.S. Office of the Comptroller of the Currency.

Terra, which manages $500 million of commercial real estate loans, helped developer Witkoff Group secure land on Sunset Boulevard in West Hollywood, California, last year for Marriott International Inc.’s new boutique hotel brand, Edition. Mexico’s Banco Inbursa SA provided a $25 million senior loan to develop the land while Terra stepped in with $25 million of higher-yielding subordinate financing.

In April, Terra closed a $16 million mezzanine loan to fund the renovation and expansion of the hotel and retail portion of the 67-story Marquis Tower on Biscayne Boulevard in Miami. The hotel will serve as the flagship U.S. location for Melia Hotels International’s ME brand.

“I don’t think that banks could have done this business,” Batkin said. “And if they could do it, it would have been a long, arduous process.”

Higher Hurdles

If banks face higher hurdles, part of the reason is repercussions from the financial crisis. Soured commercial property loans cost them $135 billion in charge-offs from the end of 2007 through 2013, according to the FDIC.

“The banking industry, especially community banks, lost a heck of a lot of money in commercial real estate, and the regulators are very wary of it,” said Karen Shaw Petrou, managing partner at Federal Financial Analytics Inc., a Washington regulatory consulting firm.

Tougher regulations followed the lending bust. Under international standards known as Basel III, banks must set aside more capital for certain loans that finance commercial real estate acquisition, development and construction, making the lending less profitable.

‘Very Healthy’

Given the additional capital and the singed fingers among bank loan officers, regulators aren’t surprised that riskier deals are leaving the banking system, and they don’t seem opposed to it.

“It stands to reason that more activities may migrate outside the perimeter of regulated institutions,” Daniel Tarullo, the Fed governor in charge of bank oversight, said in a June 25 interview at the Council on Foreign Relations. He added that “much of the activity” will be “very healthy.”

Not everyone is as sanguine. Mayra Rodriguez Valladares, managing principal at MRV Associates in New

York, a consultant to both regulators and banks, said she's concerned that lending has been "moving to the shadows" in the U.S., Europe and China, and that regulators lack authority or have largely ignored the growing threat that might pose.

"Regulators need to write rules to regulate the shadows," she said. "The focus has been too much on banks. Bear Stearns and AIG were not banks."