

FOREIGN-OWNED U.S. BANKS IN
THE U.S. REAL ESTATE LENDING MARKET

by
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Submitted to the School of Urban Studies and Planning
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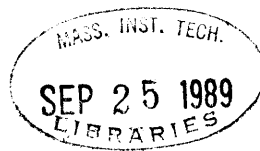


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ABSTRACT

This study identifies the current status and intentions of foreign-owned U.S. banks with respect to real estate lending in the U.S. The study focuses on the construction mortgage lending activities of Canadian and European banks.

As foreign-owned U.S. banks expand their real estate lending operations, they must compete with domestic banks who have previously dominated the market. Because real estate lending relies heavily on market knowledge and long-term relationships, it presents a formidable challenge to foreign-owned U.S. banks who are relatively new to the market. The findings show that foreign-owned U.S. banks involved in real estate lending suffer from dependence on home offices for transaction approvals, lack of market knowledge, and apprehension towards new real estate markets.

This study concludes that foreign-owned U.S. banks wishing to successfully compete with domestic banks in the U.S. real estate lending market must confront these issues.

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CHAPTER ONE

Foreign-owned banks have developed a well-established presence in the U.S. banking industry. Most foreign banks initially came to the United States both to follow the operations of home country clients who were expanding their operations into the U.S., and to participate in U.S. financial markets. As the banks expanded their operations and became a competitive force in the banking industry, they have ventured into lending activities, including real estate lending, previously dominated by domestic banking institutions.

Because real estate lending relies heavily on market knowledge and long-term relationships, it presents a formidable challenge to foreign-owned U.S. banks who are relatively new to the domestic real estate market. While foreign investment in general has attracted a great deal of attention in recent years, little is understood about foreign-owned U.S. banks who participate in, or intend to participate in, U.S. real estate lending.

OBJECTIVE

This study identifies the current status and intentions of several Canadian and European-owned banks operating in the U.S., and analyzes the challenges they face as foreign

lenders involved in the U.S. real estate market. The construction mortgage lending activities of these banks is emphasized.

Canadian and European banks were surveyed for several reasons. First, they provide an interesting contrast. Canada is both economically and geographically intimate with the United States. European countries, on the other hand, are comparatively independent from the U.S. in terms of location and home economy. Secondly, European and Canadian banks account for seventeen of the thirty-eight largest foreign-owned banks in the U.S. Although the largest of these foreign-owned U.S. banks are Japanese, Japanese banks are relatively new to the U.S. banking industry and have only just recently begun to engage in construction mortgage lending.

METHODOLOGY

To understand the objectives of foreign-owned U.S. banks, we must first look at a brief general history of foreign banking operations in the U.S. This material is presented in Chapter One. The chapter explores three themes: the effect changes in the U.S. regulatory environment have had on foreign banks entering the U.S. banking industry, a discussion of the current market share of foreign-owned U.S. banks, and a review of the current

literature regarding future trends of foreign-owned U.S. banks.

Chapter Two contains profiles of three Canadian and four European banks involved in the U.S. construction mortgage lending market. The various banks illustrate different objectives and approaches of foreign-owned U.S. banks in the areas of lending roles, asset criteria and decision-making. This chapter also contrasts the banks' U.S. operations and opportunities with those in the banks' home countries.

The findings of this study are summarized in Chapter Three. Based on this data, an attempt is made to project the future role of foreign-owned U.S. banks as lenders in the U.S. real estate market.

GENERAL HISTORY OF FOREIGN-OWNED U.S. BANKS

The first foreign banking offices in the United States were established by the British, Canadian and Japanese in the 1870's. These banks were established to give the home banks greater access to the New York stock and bond markets, to finance trade, and to facilitate the transfer of funds. U.S. foreign bank activity declined during World War I and the Great Depression, but was revived after World War II when the U.S. dollar became the international medium of

exchange.¹

It wasn't until the 1970's, however, that the U.S. experienced significant increases both in the number of foreign banking offices located in the U.S. and in the total assets of these banks. This growth was encouraged by congressional passage of the International Banking Act of 1978 (IBA). The IBA was written in response to allegations by the U.S. banking industry that foreign-owned banks in the U.S. were not as strictly regulated as domestic banks and therefore enjoyed unfair competitive advantages related to the cost of funds, multistate operations, and involvement in non-banking activities.² Most foreign-owned banks in the U.S., for example, could engage in interstate banking activities although domestic banks could not. In addition, many foreign banks enjoyed cost savings because they were not subject to federal reserve or insurance requirements. The intent of the Act, therefore, was to place domestic and U.S. foreign banks under equal regulatory requirements. It represented the government's policy of promoting nondiscrimination and competitive equality within the U.S. banking industry.³

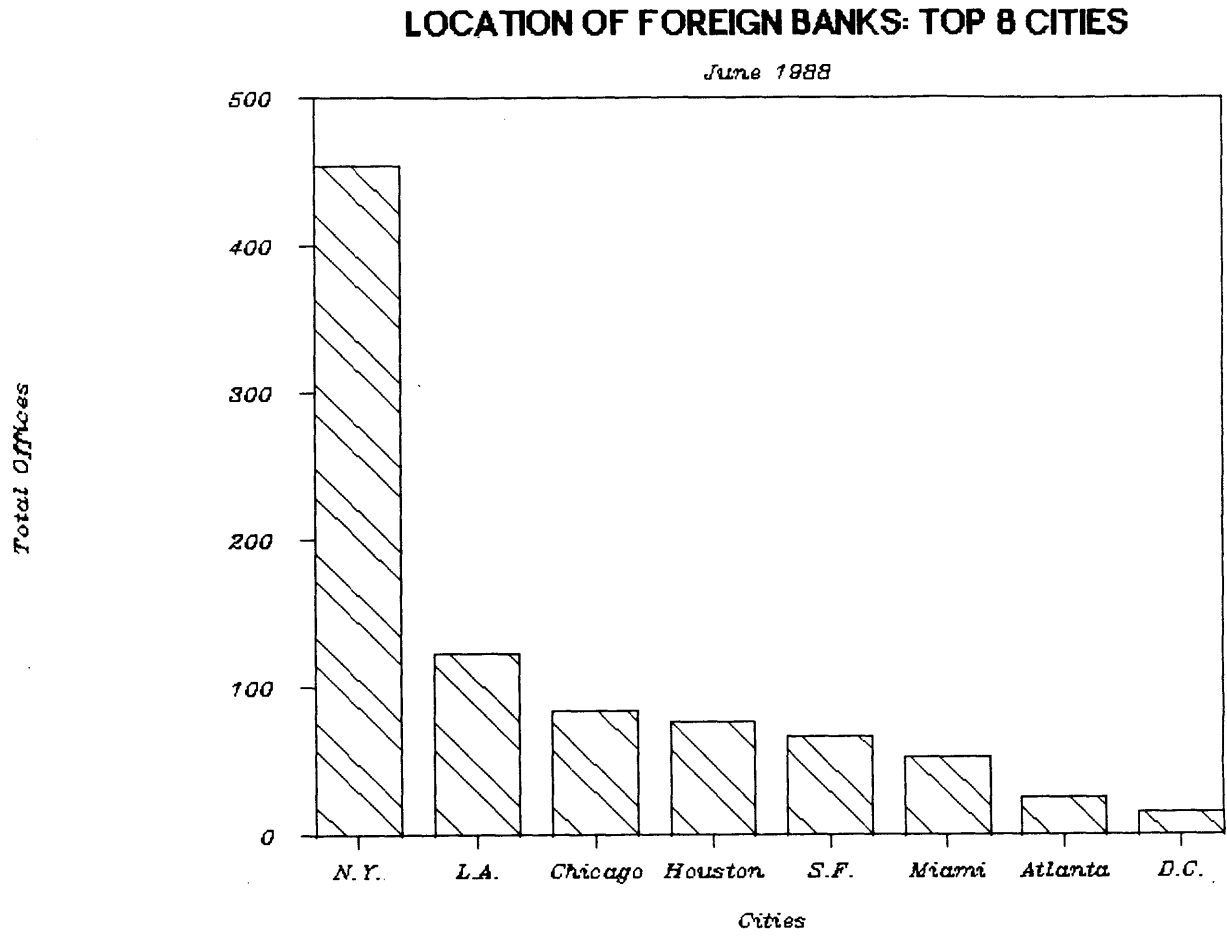
Until the IBA of 1978, foreign banks in the U.S. were licensed and regulated according to state law. Most states discouraged foreign bank branches and, as a result, the

opportunities for foreign banks were limited. In 1961, however, New York state felt financially and politically compelled to open the door to foreign-branch banking. New York wanted to enhance its position as America's leading financial center as well as bring foreign capital and increased employment opportunities into the state. In addition, many New York domestic banks were concerned that their overseas branches would be penalized by foreign governments in response to a lack of reciprocity.⁴ As shown in figure 1, location of foreign banks, almost half of the foreign bank offices in the U.S. today are located in New York City.

FOREIGN BANK OPERATIONS

Many foreign banks currently operating in the U.S. established U.S. agency banks in the 1970's to serve home-country clients who were expanding their operations into the U.S. Because agency banks are not authorized to accept deposits, a cheap source of funds, many of these foreign banks acquired or established branch offices in the U.S. to compete more effectively in the U.S. banking market. Unlike agency banks, branch offices have full banking privileges and are therefore subject to the same restrictions as similar U.S. banks. To establish branch offices, foreign banks must meet U.S. regulatory requirements. European banks incorporated this strategy in the 1970's and were

FIGURE 1



Source: American Banker, March 1989

especially aggressive in establishing branch banks. More recently, Japanese banks have converted agency banks into branches to develop their retail banking business and to access cheaper funds.⁵ The recent expansion of both European and Japanese banks into the U.S. has been promulgated by the appreciation of their respective home currencies. Canadian agency banks previously enjoyed the largest foreign banking presence in the U.S.⁶ However, because until recently N.Y. state banks were prohibited from opening branches in Canada, Canadian banks were limited to agency form under N.Y. state reciprocity law and were therefore unable to compete in size with the larger foreign banks (for a summary of foreign bank organizational forms, see Appendix A).

Most foreign banks have had difficulty entering the retail market because of the high entrance costs and the lack of a visible reputation in the U.S. The majority of deposits in these banks are from the home country government and businesses as well as ethnically related U.S. groups. Foreign banks often act as a financing link for U.S. and home country trade as well as between the U.S. and third party nations. The majority of foreign owned U.S. banks commit over 50% of their loan portfolio to trade finance.⁷

This trend, however, is changing as foreign banks

continue to win over and extend credit to their domestic clients. Foreign banks appeal to these clients for two reasons. The first is financial soundness. In light of recent problems the U.S. banking industry is experiencing, not the least of which is the recent savings and loan debacle, many company treasurers are worried about the financial health of U.S. banks. Secondly, these customers feel that foreign banks offer better value than domestic institutions. In addition to competitive loan pricing, foreign owned U.S. banks can offer their clients international service and innovative international banking methods. Pete Garrison of Greenwich Associates, a Connecticut based market research firm says that

Foreigners have picked up credit business, particularly from U.S. money center banks, which have stopped fighting for low margin business because they no longer want it. Many foreign banks do want that business, partly because their capital structure allows them to make a profit where U.S. banks can't, partly because it enables them to get a foot in the door.⁸

CURRENT MARKET SHARE

From June 1981 to June 1988, the dollar amount of commercial and industrial (C&I) loan transactions by foreign owned U.S. banks rose by 137%. This growth rate was more than double that of domestic banks during the same period. Foreign bank assets during this time increased 144% compared to a 64% increase in domestic bank assets (table 1).

TABLE 1

GROWTH IN C&I LOANS, DEPOSITS, and ASSETS AT U.S. BANKS

Foreign Bank Owned U.S. Banks Compared with U.S. Owned Banks from 6/30/82 to 6/30/88
(Dollar Amounts in Billions)

<u>Year</u>	<u>C&L Loans</u> June 30, 1988			<u>Assets</u> June 30, 1988		
	<u>Foreign</u>	<u>U.S.</u>	<u>Foreign % of total</u>	<u>Foreign</u>	<u>U.S.</u>	<u>Foreign % of total</u>
1981	\$69.2	\$276.3	20%	\$261.6	\$1,474.9	15%
1982	83.0	303.7	22%	285.4	1,569.3	15%
1983	84.9	311.0	21%	321.6	1,681.4	16%
1984	92.9	360.0	21%	380.9	1,734.6	18%
1985	105.7	378.6	22%	423.8	1,883.3	18%
1986	114.2	402.0	22%	461.0	2,050.7	18%
1987	138.5	419.5	25%	571.9	2,158.5	21%
1988	164.3	433.9	28%	638.3	2,289.2	22%

Source: American Banker, March 1989

While the asset and C&I loan growth rates of these foreign banks are greater than the growth rate of the U.S. domestic banks, the absolute dollar amount of foreign bank assets and C&I loans are small when compared to those of the domestic banks. Total foreign-owned U.S. bank assets amount to \$638.3 billion dollars, or 27.9% of the \$2.3 trillion dollars of domestic bank assets. In the C&I lending market, foreign banks currently hold a 27.5% share of the U.S. market. The Japanese lead the foreign banks with a 13.9% market share of the total U.S. lending market. They are followed by United Kingdom and Canadian banks who have market shares of 2.5% and 2.2%, respectively (figure 2).

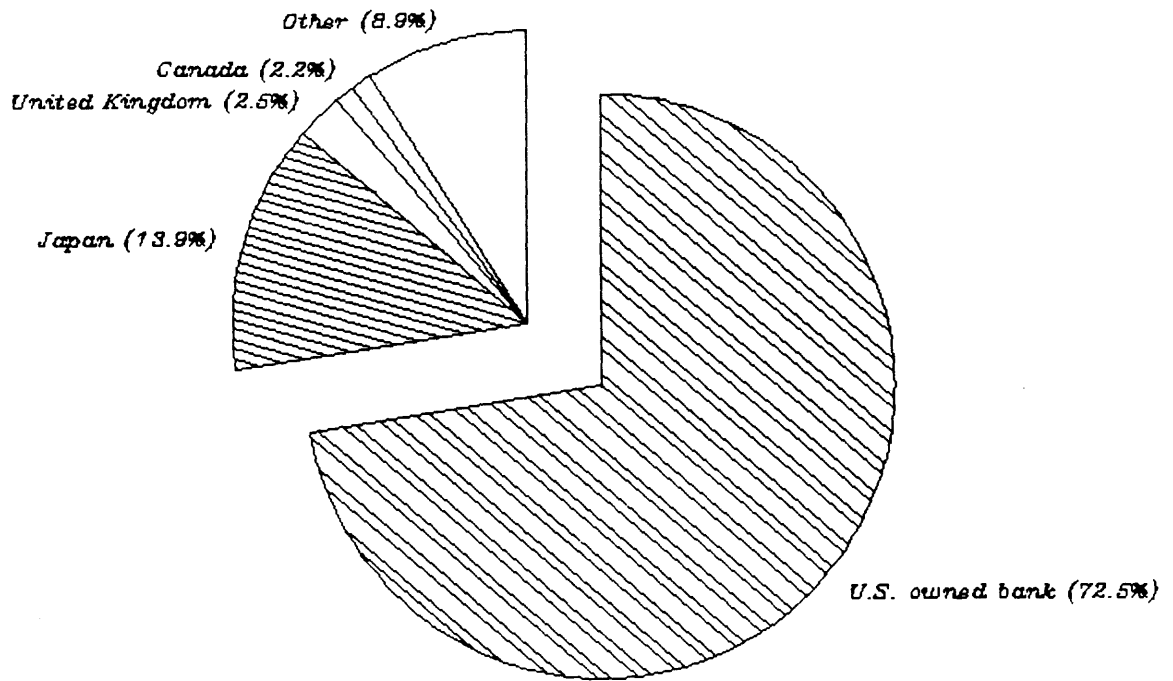
Foreign-owned U.S. banks have a small foothold in the U.S. mortgage market. For the first two quarters of fiscal year 1988 foreign banks in the U.S. lent \$1.98 billion mortgage dollars. This amount is approximately 7% of the \$29.07 billion mortgage dollars that U.S. domestic banks lent during the same period.⁹

CHALLENGES FACING FOREIGN OWNED U.S. BANKS

Foreign banks striving to compete successfully with larger, established domestic institutions in the U.S. real estate lending market face three major issues. First, most foreign banks are centralized, forcing the U.S. office to rely heavily on the home office for investment approvals.

FIGURE 2

FOREIGN BANKS LENDING IN U.S. MARKET
June 30, 1988 C&I loans outstanding



Source: American Banker, March 1989

Many of these banks, as a result, are unable to act quickly enough to take advantage of various opportunities.

Secondly, both the foreign bank and the home office are usually at a disadvantage to their domestic competitors in regard to U.S industry and investment knowledge. Decisions are often made by individuals who are not familiar with the investment or its market. According to Kim and Miller, "this lack of knowledge of U.S. industry and investment opportunities may be one of the most serious problems that foreign banks confront." Finally, many foreign owned U.S. banks are perceived to have little involvement in the communities where they do business.¹⁰

CHAPTER ONE END NOTES

¹ Seung Kim and Stephen Miller, Competitive Structure of the International Banking Industry, Lexington Books, Lexington, MA, 1983, p. 25.

² Staff of the Office of the Comptroller of the Currency, Foreign Acquisition of U.S. Banks, 1981, p. 5.

³ Dana Khambata, The Practice of Multinational Banking, Quorum Books, New York, 1986, p. 41.

⁴ Seung Kim and Stephen Miller, p. 36.

⁵ Ibid, pp. 31-32.

⁶ Ibid, p.33

⁷ Ibid, p.36.

⁸ "More U.S. Firms Using Foreign Banks: Study," American Banker, December 27, 1988.

⁹ Comptroller of the Currency, September 30, 1988.

¹⁰ Seung Kim and Stephen Miller, p. 167.

CHAPTER TWO

The previous chapter presented a general overview of the activities of foreign-owned U.S. banks. Chapter Two focuses on the lending activities of seven foreign-owned U.S. banks, including each bank's lending role, asset criteria and decision-making process. In the interest of confidentiality, the names of the banks surveyed have been changed. The names of the bank representatives interviewed have also been omitted.

CANADIAN BANK ONE¹

Seven years ago the current president of Canadian Bank One moved to the U.S. to head the bank's U.S. operations. He "...made a real commitment that this [Canadian Bank One] was going to be a North American Bank." By 1988, the bank was the fourth largest Canadian Bank in the U.S. in terms of commercial and industrial loans outstanding and had eight offices across the country.

Each office established a corporate banking unit staffed by marketing officers. These officers were primarily U.S. trained bankers who were familiar with the regional market and who could bring their expertise to the bank. Although these offices called on very large U.S. developers and Fortune 500 companies, the emphasis was on

following Canadian developers, such as Cadillac Fairview and Olympia & York, who were entering the U.S. market. In 1985, the bank agented its first deal, a \$325 million ten year acquisition loan, with two other Canadian banks and several domestic groups. The Canadian banks were forced to keep a substantial portion of the loan in their own portfolios because none of them had the contacts to "sell it down" (sell the loan to participating banks - see Appendix B).

In 1986, the bank was an agent for a \$545 million project in Manhattan involving fourteen participating banks and an American developer. Because one of the developer's partners was concerned that Bank One was not a U.S. bank, Manufacturer's Hanover was brought into the deal as co-agent. "Today," remarks the Vice-President of Real Estate, "I would be more adamant about saying 'no, I would like to syndicate on my own.' We have the administrative capabilities to handle it as well as the contacts." The vice-president attributes this confidence to experience and exposure: "...We have a syndications capability that is now more developed and we are more confident [that] ...our name is recognizable because of some of the deals we have agented."

Canadian Bank One's portfolio is evenly split between agent and participant deals. When the bank is the sole

agent of a deal and underwrites the entire loan, 25% of the debt is kept in the bank's own portfolio and the remainder is sold. By selling a portion of the debt, the bank can make money on the skim (if a portion of the loan can be sold at a fixed yield determined by prime to another bank, and prime goes up a quarter, the seller makes a quarter, called the "skim", on the buyer's share). Keeping the asset in the bank's portfolio is not considered by Bank One to be as profitable. There are often situations, however, when the bank has to keep 35% of the loan because the participants want the agent at the table for a large amount of the loan. The banker interviewed remarked that "...It has been European banks that have pressured us more [to keep a large percentage of the loan] than domestic banks."

Canadian One usually does not consider construction loan proposals under \$10 million. The bank does not, however, have a ceiling on the amount it will lend: "...The dollar figure is not a limit like some U.S. [domestic] banks. We have done coagency deals...with four major banks, three of which were Canadian, for \$400 million - \$500 million." The bank's average yield requirement is 100 basis point over LIBOR (London Interbank Offer Rate). Exceptions are made for development proposals with special circumstances or from developers with whom the bank has had a long standing relationship.

The bank is principally interested in preleased commercial office buildings in major urban locations and retail shopping malls in strong locations. Bank One has participated in residential developments, but these have been exceptions. The bank does not lend to industrial and R&D projects because these types of projects are usually too small given the staffing needed for them. The bank avoids lending to speculative office buildings and only works with top-tier developers. The vice-president explained that

The key is being close to developers. Not all [developers] take a lot of risk, [there are] still good deals out there. I'd like to do predevelopment loans where we are very comfortable with the location because this will give us an entre into the construction loan. It is speculative, but you have equity from the developer and a good location so you are lending on the value of land you know is there.

When asked about the bank's approach in analyzing deals, the vice-president offered a comparison to the other Canadian banks interviewed:

Canadian Bank Two believes the most important thing to look at is the market and Canadian Bank Three believes the most important thing to look at is the customer - the market changes, the economics of the deal change, but the customer stays the same. We are somewhere in the middle. We do a fair amount on the market, but the target market is limited to the first tier. So we are not quite as dependent on the [strength of] the borrower as Bank Three or as refined in market analysis as Bank Two who really look at things on a micro level and have people quite knowledgeable on some of the markets. If they get comfortable with a market, Canadian Bank Two might go ahead with the deal where we wouldn't.

The real estate department at Bank One is staffed by two analysts who do the underwriting, supervision of loans and who work with participants. The department is in the process of hiring two more analysts. The bank uses discounted cash flow models and sensitivity analysis to analyze the loan proposals. These figures are compared to an outside appraiser's evaluation of the project. The financial models and accompanying written report are extensive and include details of the construction budget compared to the budgets of similar projects, the state of the market, the project's strengths and weaknesses and a summation of the compensation to the bank.

The loan approval limit for the U.S. office is \$15,000,000. The majority of transactions the bank is involved in are greater than this amount, so a home office signature is usually needed for loan approvals. The project is often approved in the home office within one to two days and the whole approvals process takes approximately two weeks. The process is not as lengthy or involved in Canada for Canadian development deals because it is a close-knit community and the decision makers are probably familiar with the developer and the market. The ability to pass on information verbally, in a centralized office, also helps cut down on written documentation.

Opportunities for the bank lie in the fact that the U.S. economy and real estate market is bigger than Canada's. With many U.S. banks coming into the Canadian market, it made sense for Bank One to enter the U.S. market to increase profits. Another opportunity mentioned by the bank representative interviewed is that the organization is much smaller in the U.S. There is an opportunity, therefore, for the representative to have more access to the senior people in the bank as well as to the U.S. customers. In Canada, the senior member of a bank would be socially connected with the senior officer of a company and the two would deal with each other directly.

A disadvantage the bank feels it must overcome in the U.S. market is that the domestic banks have been close with U.S. developers for years. The domestic banks "appear to be more comfortable with risk than the Canadians. They will therefore do land loan, predevelopment loan and unusual deals for someone they know." Also, most domestic banks are located in the same building and can get approvals in one day. If they are comfortable with the market, they require less analysis of the deal.

The vice-president added that Canadian Bank One should follow the example of domestic banks and become more involved in social and charitable functions. These

activities demonstrate good will and are important for networking reasons. It is "a hard point" to make to the home office.

CANADIAN BANK TWO²

When the vice-president of Canadian Bank Two joined the bank, the bank acted primarily as a participant in deals. In the last three years, however, the bank has become

...large enough and arrogant enough, if you will, that we want to lead our own transactions and really refrain from participating with other banks. We know enough and have good enough contacts and connections that we want to underwrite our own transactions and sell off to other banks. We are now in the stage when some of the New York money center banks buy from us.

Bank Two is currently the most active Canadian Bank in U.S. real estate. It is also among the twenty largest foreign banks in the U.S.

Bank Two originates deals in a variety of ways. The bank has a list of prospects which it actively markets. Because of its reputation in the marketplace, it is often approached by developers and other lending institutions. The bank considers City Bank to be its major competitor for underwriting real estate deals.

The bank typically keeps 20% of the loan it underwrites in its own portfolio. It is the sole underwriter for two-

thirds of the deals in which it is a lender. The bank has a policy of selling down its loans in order to free up lending capacity, to promote risk diversification, and to enhance return on the asset through the "skim."

Canadian Bank Two usually does not consider construction loan proposals for less than \$20,000,000. The average size of the deals it has worked on during the last two years is \$100 million. "Canadian banks," according to the vice-president, "have the reputation of underwriting large projects. As opposed to a \$20 million project they do a \$100 million project and take the whole underwriting risk as opposed to having it syndicated beforehand." The bank's target for return on assets is 100 basis points over LIBOR after tax. Because of the significantly higher risk involved in real estate lending, however, the internal requirement for real estate assets is higher than the banks average.

The bank lends primarily to office projects in central business districts and regional shopping centers. It will also lend to suburban office buildings, neighborhood shopping centers and industrial parks. Ninety percent of the portfolio is in commercial projects and the remaining ten percent is in residential projects. Residential is "...work intensive and we usually don't work with middle

market clients, just the top echelon developers and institutions." Middle market clients are considered to be anyone under \$100 million net worth.

Up to this point, the bank has made a conscious decision not to enter the middle market:

I have fifty accounts, five per officer, and they are able to give a lot of attention to each client. Going into the middle market will create overhead and a higher risk profile.

But, as the top market becomes overbanked, the vice-president believes that the bank will have to find a more downscale market strategy.

Bank Two has a real estate staff of ten comprised of analysts and account officers. The vice-president of the real estate department takes a cursory look at the deals as they come in to see if the deal makes sense and meets bank policy. The deal is then handed to an account officer who researches the project and market area, analyzes the finances, performs sensitivity analysis, and then prepares a written recommendation in conjunction with a team leader. Cost consultants review the construction budget. If it is either an exceptionally large project or a hotel, outside consultants such as Pannell Kerr Forster or Laventhol and Horwith are hired to look at the market. If approved by the vice-president, the application goes to the credit

department for a counter signature. If above a certain dollar limit (not available), the application must go to the head U.S. office in Chicago and be approved by the vice-president of credit. Over the vice-president of credit's limit, the application must go to the home office in Canada.

The time needed for approvals takes from two weeks to two months, depending on the projects size and complexity. The system is one of checks and balances where two signatures of equal authority are needed to keep the project progressing through the pipeline. Consulting the home office for projects which exceed the U.S. office approval limit significantly increases the application processing time. The approval process in Canada for Canadian deals is the same as in the U.S. However, in Canada the deals take less time to process.

What are the opportunities for Canadian Bank Two in the U.S.? The real estate market in the U.S. is much larger than the Canadian real estate market. There is room to gain a competitive edge:

In Canada, you have five big banks covering 85% of the market...so in one way or another, these banks deal with the major developers in Canada. They go much more into the middle market. Down here, competition is not so transparent. Here you can attract people with [by offering] expertise in the marketplace. Up in Canada, everyone has expertise in the marketplace. We can still outshine Japanese banks, they have not yet come to that

kind of expert level, or European banks who are just starting to come in.

In addition to the U.S. providing a larger market, the bank's return on assets is greater in the U.S. than in Canada.

A handicap on the bank's operations in the U.S. is that the bank does not offer a full spectrum of banking services as they do in Canada. In Canada the bank often provides personal loans and mortgages to the president and chairpeople of the companies they work with. Because the U.S. bank offices do not have retail deposits, the bank must rely on more expensive money market deposits for funding.

The future of the bank will be more fee driven than interest rate driven. Because good deals are overbanked and highly competitive, the bank will increasingly shift its relationship with developers to that of an advisor: "Reserve requirements and heavy competition by foreign banks squeeze the margins on cost of funds and what your lending at...You can't meet return on equity anymore by just lending."

CANADIAN BANK THREE³

Canadian Bank Three is one of the largest Canadian banks in the U.S. and among the twenty largest foreign owned bank in the U.S. with eight offices throughout the country.

Until three years ago, it was strictly a participant in deals. Today, the bank is an agent for 85% of its deals. It is the sole underwriter for half of these.

Bank Three prefers to keep at least 50% of the deals it underwrites in its own portfolio. Construction loan proposals usually exceed \$25 million and the bank's target yield on these loans is 175 basis points over LIBOR.

The specific focus of the bank is wholesale banking. Deals are actively marketed in areas that have been researched by the bank. The bank considers only top-tier developers with large projects in healthy markets. A representative of the real estate department explains that

...[our] market is narrow and specific; the cream of the market. It is easier than dealing with the middle market. The market information is easier to obtain, as is the developer's track record and financial statements.

For these reasons, the representative feels it is much safer to avoid the middle-market.

Office buildings make up 65% of the bank's debt portfolio. The remainder of the portfolio includes retail malls (20%), residential developments (10%) and industrial developments (5%). The bank would like to do more smaller deals involving industrial projects, but the small dollar

size of these deals does not fit into the bank's wholesale image. This wholesale image combined with a lack of a branch network also prevents the bank from doing end mortgages as is done in the bank's Canadian offices.

Loan proposals are analyzed in-house by a staff of sixteen which includes team leaders, marketing representatives and account officers. Assuming all the information is available for a team to process the application, approvals usually take ten to fifteen business days. All proposals, accompanied by a formal written presentation, must go to the home office in Toronto. This process is identical to the process in Canada for Canadian real estate deals.

The representative of the bank believes that because Bank Three is a Canadian bank it has an advantage over other foreign banks:

It is different...[we have] been here a long time and we speak the same language. Decision makers are in the same time zone and cultural differences are minor. Our long term opportunity in the U.S. is relationship banking which requires good services and communication...

FIRST EUROPEAN BANK⁴

First European Bank is strictly a participant in U.S. real estate lending. Most of the deals come to the bank

from agent banks with whom it has had established relationships. The agent banks with which First European participates in the majority of its deals are well-known institutions such as Citicorp, Chase Manhattan and Chemical Bank.

The real estate department of the bank is part of its merchant banking section. The department is not a profit center; its main purpose is to objectively analyze deals. In addition to the real estate group's analysis, the credit, portfolio and management departments all prepare small summaries and recommendations. These reports are reviewed by the five members of the Credit Committee in New York. This review process usually takes two to three weeks. If the loan request exceed \$20,000,000, the home office must be consulted. The approvals process in this case may take up to a month. Says one banker, "[First European] would take forever - they need to translate reports at the home office."⁵

The debt decisions at First European are based on the current position of the bank's loan portfolio, the market area of the project, the project's leasing status and on the interest rate. The biggest weight is put on the sponsor's (borrower's) reputation and net worth.

SECOND EUROPEAN BANK⁶

Ten years ago, Second European Bank had offices in only two locations; its home country and New York. At this time, the bank did not do any real estate lending. Today, the bank has offices in several countries, four in the U.S., and is in the process of establishing a real estate department in its New York City office. The bank invests primarily in New York corporations and start up companies from the bank's home country.

Originally, Second European would not get involved in U.S. real estate deals. The vice-president interviewed attributes the bank's wariness to a market crash in the bank's home country during the late 1970's where, in some cases, property values depreciated by as much as 33%. The bank's current activity in U.S. real estate is limited strictly to participatory lending.

The bank's current lending policies are very conservative. Second European will only invest in commercial buildings located in prime areas such as central business districts and preleased office parks. The bank has lent to a few residential projects, but considers these deals to be exceptions. The bank's target yield for real estate is 85 basis point over LIBOR but, according to the bank's representative,

...we want less [return] if we can take it for less risk...we want to know what risks we are taking and build those into our fees. Too many banks know the developer and take risks based on this relationship. They need to look at the project.

Loan proposals originate through one of the bank's lending groups. Most of the deals come from agent banks looking for participants. Because the approval authority limit for the New York office is \$3,000,000, virtually all deals require the approval of the home office in Europe. The New York office is required to prepare short, informal reports for the home office. According to one staff member, the U.S. office must translate all credit reports before they are sent to Europe. Reports, consequently, are "...written on a sixth grade level. [Translating reports] really holds up the process."⁷ The entire approvals process usually takes two weeks.

The bank is currently in the process of setting up a real estate department in its New York office. Explained the bank's representative:

The exposure was not justified up to now...[we have not been] knowledgeable and have been learning about the market, what to invest in...the U.S., however, has a bigger economy and a better return on assets.

THIRD EUROPEAN BANK⁸

Third European Bank has been in the United States for ten years and is a relatively new bank in respect to real estate. Third European's primary focus is lending to large U.S corporations and subsidiaries of the home country and other European companies. The bank underwrites deals originated exclusively through the real estate group in Third European Capital, a capital corporation related to its parent company. It is also involved in a small number of participations with other banks. From the bank's perspective, real estate is less important than the corporate business which is crucial to the institution's global operations:

We look at real estate really as a secondary priority for the branch, and so it is a small section of our portfolio. It will grow because of an increase in transactions in the real estate area, but it will never [hold a significant position. We are a provider of financial services to industrial corporations, and that is how we are structured world-wide.

Third European Capital is a separate legal entity from Third European Bank. Because its focus is on real estate, however, the two are often involved in transactions together. Third European Bank will often provide construction financing and initial short term and medium term financing for deals that the capital corporation originates. Once there is an opportunity to finance the building at a low cost, European Capital will take out the

loan and repay the bank.

As an example, the bank is currently working on a multi-use project which is being underwritten by the capital corporation for \$533 million in the form of a convertible debt issue. The bank is providing approximately \$125 million in short-term and medium-term financing. The capital corporation will then underwrite the term debt and take out Third European's loans.

Third European Capital is primarily interested in deals with leading national and regional developers. The corporation invests in major office building with value in excess of \$100 million dollars and in a limited amount of shopping malls. Ninety-percent of its portfolio is in commercial buildings. It's principle objective is to invest in a building when the building is in the conceptual stage and is 30%-35% preleased with a viable design program. By investing in buildings in the conceptual stage and assuming development risk, the corporation seeks to earn a high return: "[We] don't have a hard and fast number [for return]...we would normally not want to go into something that does not provide a substantial upside potential."

The bank performs a close analysis of construction cost figures to determine the feasibility of a project and hires

a cost consultant to review the figures. The bank then performs a market study and runs a proforma based on estimated lease-up rates. A worst case lease-up scenario is projected to analyze the effect a slow market would have on the ability of the project to repay debt. Third European Bank and the Third European Capital conduct separate analyses. After completing their analyses, they meet and compare their results and assumptions. Most of the loan proposals must be approved by the bank's home office in Europe. This requirement does not significantly increase the amount of time needed for approvals. Analysis, according to the bank's representative, is the most time-consuming factor.

FOURTH EUROPEAN BANK⁹

At the end of 1988, Fourth European Bank was ranked among the thirty largest foreign banks in the United States and among the ten largest European banks in the U.S. in terms of commercial and industrial loans outstanding. There are thirteen Fourth European offices throughout the country.

The bank is a participant in 75% of the deals in which it is a lender. The remaining 25% of the loans in which it acts as an agent bank are kept in the bank's loan portfolio and not sold down. Deals are originated through agent banks, brokers, contacts and existing customers.

Most of the bank's loan portfolio is in residential multi-family properties. The bank also invests in commercial and retail shopping buildings. The deals the bank considers range from \$5 million to \$20 million in size and on average yield 150 basis points over their cost of funds. The New York office is autonomous from the home office; the representative of the bank does not talk to the home office.

CHAPTER TWO END NOTES

¹ Interview with Vice President of Real Estate, Canadian Bank One, New York, June 22, 1989.

² Interview with Vice President of Corporate and Governmental Banking, Canadian Bank Two, New York, June 20, 1989.

³ Interview with Senior Representative of Real Estate Banking, Canadian Bank Three, New York, June 29, 1989.

⁴ Interview with Representative of Real Estate Department, First European Bank, New York, June 12, 1989.

⁵ Interview with Vice President, Second European Bank, New York, June 22, 1989.

⁶ Interview with Vice President, Second European Bank, New York, June 22, 1989.

⁷ Interview with staff member, Second European Bank, New York, June 22, 1989.

⁸ Interview with Senior Vice President, Third European Bank, New York, June 29, 1989.

⁹ Interview with Vice President, Fourth European Bank, New York, June 19, 1989.

CHAPTER THREE

FINDINGS

This study shows that foreign-owned U.S. banks wishing to successfully compete with domestic banks in the U.S. real estate lending market must confront a variety of issues. These issues are: dependence on the home office for transaction approvals, lack of market knowledge, and apprehension towards new real estate markets. These issues are often related and are a function of two factors. The first factor is the amount of experience and confidence a foreign bank has as a lender in the U.S. real estate market. The second factor is the banks' objectives.

Kim and Miller cite an overly centralized decision making process to be a major issue facing foreign-owned U.S. banks:

...[it is] quite common for major decisions of foreign bank branches in the U.S. to be made by home office top management...banking philosophy and policies are influenced greatly by parent banks.¹

The authors also characterize foreign-owned U.S. banks as having insufficient knowledge of U.S. industry and investment. This study shows that both these issues exist for foreign-owned U.S. banks involved in the U.S. real estate lending market. These issues are particularly acute

for foreign lenders because successful lending relies heavily on market knowledge. The combination of these factors often results in a time consuming approvals process. Lengthy project feasibility studies and market reports are often generated to help the foreign bank to become comfortable with lending in an unfamiliar market. This information must often be translated for and analyzed by the home office before a decision is made.

TABLE 2

U.S. OFFICE APPROVAL LIMITS AND PROCESSING TIME

<u>Bank</u>	<u>U.S. office Approval limit</u>	<u>Processing time w/home approval</u>
Canadian Bank One	\$15,000,000	14 days
Canadian Bank Two	not available	14-60 days
Canadian Bank Three	\$0	10-15 days
First European Bank	\$20,000,000	14-30 days
Second European Bank	\$3,000,000	14 days
Third European Bank	\$0	not available
Fourth European Bank	no limit	not applicable

As table 2 illustrates, there seems to be little correlation among the foreign-owned U.S. banks surveyed regarding U.S. office approval limits and the processing time needed when home office approval is required. The banks with a relatively high U.S. office approval limit do not process applications any faster than the other foreign banks. The approval limits for these banks, however, are in most cases very close to or lower than their preferred loan

amounts. When compared to U.S. domestic banks which typically take seven to fourteen business days to approve a construction mortgage loan application, however, the process for foreign banks is more time and resource consuming. This is a competitive disadvantage for the foreign-owned U.S. banks who are unable to offer clients approvals in a short amount of time.

In many domestic banks, an application can be processed in a matter of days because it can be walked through the central office. The real estate approvals process for Canadian Bank Two is considerably shorter for the bank's home office in Canada because the entire approvals process can take place under one roof and the reports can be verbally presented. Two of the European banks interviewed, First European Bank and Second European Bank, are required to translate written reports into the home office's language before the reports are sent to and reviewed by the home office. This requirement lengthens the approvals process:

[First European] would take forever - they need to translate reports at the home office.²

[Reports are] written on a sixth grade level.
[Translating reports] really holds up the process.³

Extensive analysis and lengthy formal reports also lengthen the approvals process and, in addition, are a drain on human resources. These types of reports are often

required by foreign-owned U.S. lenders because they are unfamiliar with the U.S. real estate market. This is particularly true at the home office where the decision to lend is made. Many of the bank representatives interviewed commented that the approvals process at the home office for home country real estate is considerably shorter than that of the U.S. office because decision makers are familiar with the home market.

The predominant lending role a foreign bank plays in the U.S. construction mortgage market, as an agent or as participant, is an indicator of the bank's level of involvement in the market. Because agent banks underwrite debt and assume most of the risks associated with underwriting, they are required to be sophisticated and experienced lenders. For each bank surveyed, table 3 below shows the percentage of the bank's construction mortgage loans in which the bank is an agent and a participant.

TABLE 3

LENDER'S ROLE: AGENT OR PARTICIPANT

<u>Bank</u>	<u>Agent (% of deals)</u>	<u>Participant (% of deals)</u>
Canadian Bank One	50%	50%
Canadian Bank Two	95%	5%
Canadian Bank Three	85%	15%
First European Bank	---	100%
Second European Bank	1%	99%
Third European Bank	not available	not available
Fourth European Bank	25%	75%

As table three illustrates, the Canadian banks surveyed are much more active as agents than are the European banks. All three of the Canadian banks have become primarily agent banks within the last five years. The representatives from Canadian Banks One and Two each mentioned that their bank's transition from participant to agent bank was made once the bank felt it had enough experience in the real estate lending market. The representative from Canadian Bank Two said the following:

We know enough and have good enough contacts and connections that we want to underwrite our own transactions...⁴

Second European Bank waited until it was comfortable with its knowledge of the real estate market before beginning to establish a real estate department:

The exposure was not justified up to now...[we haven't been] knowledgeable and have been learning about the market, what to invest in...⁵

The second factor affecting lending activities is the bank's objectives. Third European Bank concentrates on its role as a provider of financial services to industrial corporations. The bank's real estate activities are virtually limited to transactions with its related capital corporation; it rarely becomes involved with other institutions and does not want to pursue a significant position in real estate.

First and Fourth European Banks are both participant banks. Neither of the banks' representatives would reveal their respective bank's future intentions with regard to participating in or agenting transactions. However, because First European Bank has been a participant in 100% of its real estate deals (table 2), it probably will not focus on agenting transactions in the near future. Fourth European Bank, by contrast, is a relatively large foreign-owned U.S. bank that has agented 25% of its real estate transactions. The bank may have the desire and experience to expand its activities as an agent bank.

All of the foreign banks surveyed, with the exception of Fourth European Bank, specifically mentioned that they lend to only top-tier developers in healthy well-established markets. These types of deals are becoming more scarce, however, and many of the bankers felt that their banks might be forced to venture into the middle market in the future. Many of the banks interviewed were hesitant to enter the middle market because of increased staff overhead and risk. According to Canadian Bank Two's representative:

[Residential is] work intensive and we usually don't work with middle market clients, just the top echelon developers...Going into the middle market will create [staff] overhead and a higher risk profile.⁶

Likewise, the representative of Canadian Bank Three had this

to say:

...[our] market is...the cream of the market. It is easier than dealing with the middle market. The market information is easier to obtain, as is the developer's track record and financial statements.⁷

Because middle market lending is riskier than lending to top-tier projects, it becomes even more important that foreign banks expanding into the middle market have the capacity to make well-informed decisions. By increasing U.S. office approval limits and autonomy from the home office, U.S. office staff could redirect their efforts towards a more efficient approvals process in which decisions are made by U.S. office staff familiar with the particular market and project.

Kim and Miller argue that a third major issue confronting foreign-owned U.S. banks is that the "foreign banks are not perceived as social or civic conscious as U.S. banks within the regions in which they operate." Although substantiating this claim is not within the scope of this paper, the banker interviewed at Canadian Bank One, pointed to this issue as being often overlooked by Bank One and by foreign banks in general. Domestic banks are usually well-versed at projecting a socially conscious image and providing services and contributing funds to community organizations and projects. Perhaps the fact that none of

the other foreign bank representatives interviewed raised this issue is indicative of a lack of awareness by the banks.

What foreign-owned U.S. banks are aware of, however, is that the U.S. real estate market offers opportunity for growth and a relatively high return on assets. Foreign-owned banks operating in the United States which intend to expand their real estate lending activities will learn to respond to the challenges of operating in the domestic market, allowing them to increase their competitive efforts and therefore capture a greater share of the U.S. real estate lending market.

CHAPTER THREE END NOTES

¹ Seung Kim and Stephen Miller, Competitive Structure of the International Banking Industry, Lexington Books, Lexington, MA, 1983, p. 167.

² Interview with Vice-President, Second European Bank, New York, June 22, 1989.

³ Interview with staff member, Second European Bank, New York, June 22, 1989.

⁴ Interview with Vice President of Corporate and Government Banking, Canadian Bank Two, June 20, 1989.

⁵ Interview with Vice-President, Second European Bank, New York, June 22, 1989.

⁶ Interview with Vice President of Corporate and Government Banking, Canadian Bank Two, June 20, 1989.

⁷ Interview with Senior Representative of Real Estate Banking, Canadian Bank Three, June 29, 1989.

APPENDIX A

ORGANIZATIONAL FORMS OF FOREIGN BANKS

The organizational structure of a foreign bank operating in the United States is a function of the type of business the bank is involved in, as well as the regulatory and legal differences among the different forms. There are five organizational forms: representative offices, agencies, branches, subsidiary banks, and investment companies.

REPRESENTATIVE OFFICES

Representative offices are not legally authorized to engage in banking activities such as deposit-taking and financing. These offices are usually set up in the U.S. by the parent bank to perform the groundwork, such as researching a new market or working with the regulatory agencies, necessary for establishing a formal office. Banking transactions are performed through a correspondent bank.

AGENCIES

Agencies are low-overhead entities that engage only in wholesale international commercial banking. They are allowed to extend commercial and industrial loans and to finance international transactions. Agencies are not legally authorized, however, to accept deposits, sell Certificates of Deposits, or to

perform trust functions. Agencies are not subject to regulations dictating maximum loan limits and are therefore able to make larger loans than branches. Most agencies are fiscal agents for their home countries and finance trade for their home office clients.

BRANCHES

Branches enjoy full banking privileges and are subject to restrictions similar to those regulating U.S. domestic banks. Branches are subject to a maximum loan limit based on the parent bank's capital and surplus. Most branches are involved in international financing and wholesale banking. They usually do not compete with domestic banks for retail business. Unlike a subsidiary, the parent bank can control the operations of a branch without establishing a separate board of directors.

SUBSIDIARY BANKS

Subsidiaries are separate legal entities from their parent banks. They operate under the same restrictions as U.S. banks and are able to engage in the full range of banking activities. Most subsidiaries actively solicit domestic deposits and make loans to area businesses and individuals.

Source: Competitive Structure of the International Banking Industry, pp.36-38.

APPENDIX B

A NOTE ON CONSTRUCTION MORTGAGE LENDING

A construction mortgage lender in the U.S. gives out short-term loans to fund the development construction costs. The lender disburses funds as construction advances. These disbursements are often called "advances" or "draws." Draws are usually made by the bank according to a predetermined schedule of items completed or percentage completed. The bank disburses the funds after the bank, or a consultant representing the bank, has made an inspection of the work completed and determined that the developer has satisfactorily met the requirements for the scheduled draw.

The term of the loan usually depends on the amount of time needed for construction and can vary from four months to five years. The interest rate on the loan can be fixed or it can be variable and dependent on a prime rate.

Construction mortgage lending has the highest degree of risk in mortgage lending. The advantages of construction mortgage lending include a higher return than other types of mortgage lending, a shorter term loan and the opportunity for the lender to offer other services.

Construction mortgage loans originate from a wide variety of sources such as developers, real estate and mortgage brokers and attorneys. Another important source of construction mortgage loans is other lenders. In this case, a lead bank, known as the agent bank, will take the initiative of finding a deal and will assume the risks associated with underwriting. The agent bank will then "sell down" a portion of the loan to other banks, called participating banks or participants, to spread the risk.

A construction lender, whether a participant or an agent, must determine the desirability of a loan in relation to the bank's particular criteria. In determining if the bank should proceed with financing, most institutions conduct project feasibility studies which include a market study and financial analysis in one form or another. Other considerations include the reputation and track record of the developer, the loan amount and fees. Very often consultants are hired by the lender to conduct these studies and submit them to the bank or to first compare them with the lender's own research.

Virtually all construction mortgage lenders require the developer to have takeout financing. Takeout financing is a commitment from a lender to provide permanent financing

following the completion of construction. The takeout commitment can be from the construction mortgage lender or from a separate lending institution.

Source: The Banker's Handbook, pp. 703-711.

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