

LAST WORD

Why liquidity should help you sleep better

A vibrant secondary market for commercial real estate loans emerges. **By Kingsley Greenland**

As the good times continue to roll in commercial real estate, a liquidity squeeze may be the furthest thing from anyone's mind. But could it happen again? Probably not, but the reason may surprise you.

Conventional wisdom suggests the CMBS market has eliminated the possibility of a lending contraction. In today's market, memories of financial gridlock that paralyzed Texas in the mid-1980s or New England in the 1990s have largely faded. Back then, banks simply stopped making commercial real estate loans because the market overheated and non-performing loans rose sharply.

After a decade of extraordinary gains, a sudden drop in lofty commercial real estate valuations is not implausible and could cause today's robust CMBS market to head south abruptly. Terrorist attacks, double-digit interest rates, a huge spike in the price of oil per barrel, or an incident like the massive Russian bond default of 1998 could also dislocate the CMBS market.

However, there is good news for both borrowers and lenders. Greater liquidity in the secondary market for commercial real estate loans would likely buoy the primary credit markets and mitigate the fallout of a CMBS downturn. If a credit crunch occurred, lenders could forego securitization and go straight to the secondary market, comprised of an ever-expanding pool of global investors. This secondary market has the proven capacity to handle both large pools, as well as individual loans.

The importance of technology

For borrowers, the liquid secondary market for commercial real estate loans is a positive development because it can maintain equilibrium in the debt markets

and head off a lending squeeze. It acts as an efficient conduit through which money flows from other capital markets, making the primary market more liquid and helping borrowers achieve their top priority: continued access to credit.

To understand why the secondary market would help keep new capital flowing to commercial real estate in a downturn, it's critical to understand the profound impact technology has had in streamlining the loan sale process.

Over the past five years, online trading has inspired a total re-engineering of the loan sale process and has lowered transaction costs dramatically. Today, a loan sale can be completed for as little as \$1,000

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compared with the minimum transaction costs of \$25,000 or even \$50,000 common several years ago.

Most importantly, electronic trading empowers institutional investors to buy individual loans with specific loan characteristics, a concept that was impossible in the past. The ability to purchase loans in smaller increments brings more institutions, particularly regional and community banks, into the marketplace as both buyers and sellers. The result is a self-perpetuating cycle of increased liquidity.

Surprisingly for borrowers, a loan sale in the secondary market can also

prove to be highly beneficial. In a workout situation, for example, a loan sale can actually result in a better outcome for the borrower. When the original lender is taken out, the dynamics of the relationship improve tremendously. Instead of the lender focusing on losses, the acquiring investor thinks only about how much can be made.

How lenders benefit

The secondary market benefits lenders by enabling them to avoid overexposure to any particular loan type or industry segment by adjusting their portfolios dynamically. Lenders can conduct quick and targeted loan sales, much like a stock portfolio manager would buy or sell equities in response to changing market conditions.

Rather than originating their way out of portfolio imbalances or simply curtailing lending — the strategy that precipitated the liquidity crises of the 1980s and 1990s — lenders can leverage the secondary market to make mid-course portfolio corrections without throwing the credit markets into turmoil.

If a loan does start to perform poorly, the availability of loan pricing data based on routine secondary market loan sales helps rationalize the workout process. Valuations based on actual sales minimize reliance on subjective, internal valuation models that lack objective benchmarks and transparency.

There is no crystal ball that can predict the next lending squeeze, or if one will even occur. What is certain however, is that greater liquidity in the secondary market for commercial real estate loans is an important safety valve for the entire industry. Perhaps most significantly, the secondary market today is delivering benefits to enhance the profitability of both borrowers and lenders. ■



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