



A Bright Future

THE SECONDARY MARKET FOR commercial real estate mortgages has grown an amazing 35 percent annually over the past five years, and if current trends are any indication, it's not about to let up anytime soon.

The reason: Growing liquidity in the secondary market is enabling mortgage lenders, banks, credit unions, pension funds and others to sell loans at higher prices to meet the growing demand from institutional buyers seeking quality assets that were previously a scarce commodity.

For mortgage lenders and institutional investors, higher proceeds from loan sales are leading to improved profitability and are also having strategic implications for how lenders manage their balance sheets going forward.

More liquidity, more profitability

The continued rapid growth of the secondary market for individual loans means that mortgage lenders will have far more flexibility in deciding which loans to sell and which to keep—an option that has been available traditionally only to large securitizers of real estate loans.

A liquid secondary market allows lenders to look at each loan—regardless of size—to determine whether it fits with their diversification and risk strategies. This includes an opportunity to sell performing loans in addition to nonperforming loans, which have dominated secondary market loan sales in the past.

A vibrant secondary market leads to enhanced profitability by providing lenders more strategic options. Leveraging the liquidity in the marketplace today, lenders can sell loans quickly to respond to changing market conditions where they couldn't before. Likewise, the secondary market can help lenders originate more loans for sale to boost fee income. Equally important, the secondary market can be used to free up room on the balance sheet to pursue growth opportunities.

This discipline of assessing and selling loans regularly, known as active portfolio management, is the emerging paradigm inside many leading institutions for the simple reason that it has proven so successful in a relatively short period of time.

While it's dangerous to forecast that any market will continue expanding 35 percent per year, that kind of growth is

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not without precedent in the recent history of the debt market. In the 1990s, the corporate debt market benefited from a similarly rapid increase in liquidity. That experience may be a useful comparison when looking at the future of the secondary market.

A market transformed—with plenty of room to grow

The growth of the secondary market will continue to be fueled by an unstoppable tide of innovation via the Internet, which fundamentally changed the dynamics of the game over the past few years.

Prior to the Internet, the secondary market for individual loans or pools of loans—those not part of a syndication involving many institutions—was thin and inefficient. Transactions were typically executed by loan sale advisers with

no real ability to scale. Pre-Internet, loan sellers invited buyers to their offices to conduct due diligence and to inspect loan documentation. If the investor declined to bid, the travel costs and precious executive time were lost.

Marketing the loans was also done in an antiquated way. Sellers rounded up the usual buyers or those lucky enough to show interest from a campaign of phone calls. The bidding usually came down to two or three buyers, but often fewer. The closing process took weeks or even months, as attorneys hammered out individually negotiated purchase agreements.

The Internet changed that by doing what it does best: aggregating buyers and facilitating information sharing. Online exchanges such as Boston-based DebtX have created a ready market of thousands of online buyers, where there once were only a few handpicked favorites of the loan sale adviser. Due diligence is done online, thus eliminating unnecessary trips to distant locales and enabling buyers to look at far more assets in the same period of time. This reduces dead-deal costs, and in and of itself creates liquidity by enabling buyers to submit more bids. The closing process is far faster because all parties agree to use standardized legal documents upfront. Bottom line: A loan sale can now close in 45 days, compared with 120 days before electronic-trade execution changed the market dynamics.

Small is beautiful

The efficiency of the Internet has served to unleash a potent source of liquidity in smaller institutions, which have previously been frozen out of the market.

In the past, smaller institutions could not engage a loan sale adviser, who typically wouldn't touch a pool of loans aggregating less than \$50 million because it wasn't worthwhile to the adviser. Today's technology allows institutions and loan sale advisers to sell

individual loans as small as \$1 million. To put it another way, it's now almost as profitable to sell a small number of small loans as it is to sell a large number of large loans. The playing field has been leveled, and smaller institutions are now among the winners.

It's likely that these smaller institutions—community banks, business banks and mid-tier mortgage companies—will show more than a passing interest. Local institutions, with their intimate knowledge of their communities, often have a measurable advantage over larger institutions, which can't compete with a local institution's understanding of an area's economics and politics.

Moreover, smaller institutions are quickly realizing that even a limited number of loan sales or purchases can have a positive impact on their balance sheet and profitability. As smaller banks and mortgage lenders institutionalize the practice of selling loans, they will be a powerful driver of future liquidity.

It's important to note that the collective impact of more secondary market participants has had a multiplier effect that translates into a greater number of

bids per transaction.

Several years ago, selling institutions would typically get two or three interested buyers that were mostly larger institutions. Today, it's not uncommon for sellers to get 10 or more interested parties. That has led directly to higher loan sale prices, which tend to have a snowball effect that deepens and broadens the market. There is every reason to believe that the law of supply and demand will power the secondary market in the short- and midterm.

Active portfolio management is here to stay

The success of loan sales in the secondary market has triggered a quiet revolution in loan portfolio management, and it's unlikely that lenders will turn back the clock.

Many institutions now recognize that active portfolio management is an outstanding way to increase productivity and minimize headaches. Instead of holding on to nonperformers or investing time in complicated workouts, lenders that embrace active portfolio management can simply sell the assets

on the secondary market. It's then much easier to apply the 80-20 rule of spending most of your time on your most profitable endeavors. And just because a loan is performing doesn't mean it isn't demanding an inordinate amount of

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time and effort to keep it that way. Institutions are selling performing loans, often at a profit, dropping dollars to the bottom line and increasing productivity all in one step.

A corollary benefit is that the secondary market offers a safety valve that simply didn't exist before. With sufficient liquidity, institutions can now re-examine lending decisions on an ongoing basis rather than waiting until they become critical and potentially visible issues. Many institutions are now regularly selling loans simply as a confirmation of their internal pricing and proof of liquidity value.

Taking the longer view of the secondary market, it's important not to overlook an immutable law governing the behavior of mortgage lenders: Once they are successful doing something, they tend to do it again and again. One of the most promising trends in the secondary market is the steadily growing number of repeat customers. More and more lenders are leveraging the secondary market because it advances their strategic objectives. This fact alone bodes very well for the future of the secondary market.

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