Managing CRE Risk: Growing Liquidity for Commercial Real Estate Loans Helps Financial Institutions Diversify and Lower Risk

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In the past year, the Office of the Comptroller of the Currency has issued a series of warnings to commercial banks about growing concentrations of commercial real estate (CRE) loans.

Concerned about the CRE problems of the 1980s, Comptroller John C. Dugan said that "nearly all" of the national mid-sized and community banks today have CRE loans that exceed 300% of total capital. Two decades ago, when a sharp downturn in the CRE market contributed to a wave of banking failures, these same banks had CRE loans consisting of *175%* of capital.

Despite the warning, it's unlikely another market meltdown will occur in this economic cycle for several key reasons.

First, underwriting and risk management practices have improved markedly since the last CRE slump and continue to improve as new portfolio evaluation tools are brought to market. Second, a new liquid market for CRE loans has given institutions a powerful new vehicle to improve the management of their CRE loan portfolios.

Bringing Liquidity to an Illiquid Market

Over the past five years, technology has helped create two groundbreaking solutions that have enabled previously illiquid assets to become a global, multi-billion dollar market for CRE. Working in tandem, electronic trading of CRE debt and third-party valuations of CRE portfolio based on actual trade data have fundamentally transformed the way institutions buy and sell CRE loans.

Online trading has enabled CRE debt to be traded at a fraction of the cost and time compared to the traditional, offline environment. As it has done for many other financial products, electronic trading has effectively eliminated much of the friction in the loan sale process that had existed for decades. The fixed transaction costs that suppressed CRE liquidity have largely gone away.

The speed, transparency and efficiency of an electronic market have had a profound impact in a relatively short period of time. Finance professionals trained to originate and hold CRE loans for the life of the credit are now selling or buying loans easily and cost effectively.

Trading loans via an electronic exchange, rather than holding them, has delivered compelling benefits. Institutions can improve diversification and credit quality, reduce risk, and lower the type of portfolio concentration that worries the OCC and other regulators. Selling loans online has also proven to be a less distracting and less expensive alternative than managing non-performing loans with teams of workout specialists.

A Better Way

Electronic trading has created an efficient execution platform, but technology alone does not account for the liquidity in the CRE market. In fact, the liquidity in the CRE market is the result of marrying human expertise and experience with technology. The art of the loan sale still exists, but with a distinctly twenty-first century flavor.

Human judgment plays an especially important role setting the initial pricing at the front end of the process. Traditionally, loan sale professionals used an informal "friends" network to help set the offering price. Today, a repository of transaction data from thousands of trades has minimized the guesswork and has injected a measure of transparency into the process. A central database can be shared by a community of buyers, bringing more science to the art of pricing.

In an electronic environment, marketing and due diligence are especially efficient. Communicating with an international pool of buyers can be done quickly and cost effectively. Meanwhile, because the loan sale process has largely become digitized, buyers can perform due diligence online, which is far faster and cheaper.

In years past, prospective investors would have to make onsite visits to search boxes of loan documents, collateral appraisals, operating statements, court proceedings, or other underwriting documents. If investors decided against making an offer, or another bid was accepted, travel expenses and management time went unrecovered.

Using electronic platforms, investors can now view thousands of pages of loan documents online. There is no need to travel. Reams of documents can be easily searched, and sophisticated financial modeling is built right into the platform. From the comfort of their own office, investors can view and analyze a dozen or more deals in the time it takes to jump on a plane and fly to someone's office.

The Virtues of Dynamic Pricing

Perhaps even more beneficial is that electronic trading offers dynamic pricing and allows small pieces of debt to be purchased more efficiently. With online bidding, offers can be made in real time. Investors can adjust their bid as they see fit, rather than being locked into a single offer, which is typically the case in an offline, sealed-bid process. By driving down the fixed costs of the loan sale, investors can now purchase loans as small as $1 million. Investors can buy exactly what they want—and no more. In the past, investors often wound up with loans they didn't want, but were forced to buy because they were bundled and couldn't be sold separately.

Standardized legal documents for buyers and sellers have truncated the closing process and eliminated exorbitant legal fees. Sales that took 120 days or more can now be fully executed in 45 days.

Sellers have benefited handsomely from the market efficiency in the form of superior trade execution. In sharp contrast to the traditional process, in which investment bankers shopped loans to a handful of their friends, electronic platforms have opened up the bidding process to far more investors. More buyers have meant more bids per transaction and ultimately higher prices. That's been very motivating for lenders.

Independent Portfolio Valuations: A New Option

The same electronic trading platforms that have delivered liquidity to the marketplace have also produced better information on which to develop accurate portfolio valuations.

Because there has never been a single repository of trade data, most CRE valuations have had to rely on internal valuations and anecdotal market data. By default, institutions have been forced to make decisions using dated or biased information.

Electronic trading platforms easily aggregate data in a timely manner and provide the silver bullet the market has always wanted: market-based data for objective third-party valuations. Objective valuations bring new credibility to the evaluation process, while significantly improving risk assessment and enhancing portfolio diversification. With an objective analysis using market data, it becomes abundantly clear whether buy, sell or hold is the best course of action.

No one can predict the future with any certainty, particularly the CRE market. However, institutions have new options that are making a difficult task easier. With those tools at their disposal, shareholders and regulators can rest a little easier in this economic cycle. ❑

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