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# Liquid Market for Loans Helps Financial Institutions Diversify

**By Kingsley Greenland**

Since April 2006, the Office of the Comptroller of the Currency has issued a series of warnings to commercial banks about growing concentrations of commercial real estate loans.

Alarmed about a repeat of 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 percent 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 percent of capital.

Clearly, bankers and regulators have something to worry about. However, the good news is that another 1980s-style market meltdown seems improbable in this economic cycle for two important reasons.

First, the underwriting and risk management practices at most financial institutions have clearly improved since the last CRE slump. Second, and perhaps more importantly, a new liquid market for CRE loans has given institutions a powerful new weapon to improve the management of their CRE loan portfolios.

## A New Day for CRE

Over the past five years, technology has helped create a global, multi-billion dollar online market for CRE debt. Electronic trading has ushered in a new era of liquidity that has dramatically transformed the way institutions buy and sell CRE loans.

Today, CRE debt can be traded at a fraction of the cost and time compared to the traditional, offline environment. Electronic trading has effectively eliminated much of the friction in the loan sale process that has 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 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 expensive alternative than managing non-performing loans with teams of workout specialists.

**A new liquid market for commercial real estate loans has given institutions a powerful new weapon to improve the management of their CRE loan portfolios.**

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 21st century flavor.

Human judgment plays an especially important role at the front end of the process: Initial pricing. 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 hundreds or even 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

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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.

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.

No one can predict the future with any certainty, particularly the CRE market. However, one thing is certain: Institutions now have a liquid market at their disposal that, if used strategically, can go a long way to reducing the factors that lead to the problems 20 years ago. ■