Leap Into Alternative Lending

Nontraditional lenders are emerging as important players in the evolving commercial mortgage market

By Gary Bechtel

Illustration by Dennis Wunsch

As banking regulations have tightened, banks have grown reluctant to fund as many loans as they used to, leaving commercial mortgage brokers and borrowers feeling the pinch. Alternative lending sources are more than happy to fill the void.

Alternative lenders can be more nimble than traditional lenders, are less burdened by regulations and benefit from emerging technologies that make it easier than ever for borrowers to find the loans they need. Brokers who recognize the changing landscape should have no trouble diving into the brave new world.

U.S. bank holding companies have substantially increased their capital since the devastating bank failures of 2009, and most as of year-end 2016 had met or come close to meeting regulatory expectations. That's the conclusion of the Federal Reserve Comprehensive Capital Analysis and Review 2016, which included only mild warnings over perceived weaknesses among some bank holding companies. The Fed report, however, did little to reveal or analyze the impacts these institutions — and the new rules they follow — are having on the markets they serve.

There may be more cash available to fund commercial real estate loans, according to the Fed, but that doesn't mean the market is rich with opportunity. Many commercial mortgage brokers and borrowers are finding themselves squeezed out — not only by the regulatory restrictions placed on banks, but also by the growing reluctance of some traditional lending institutions to fund loans because of risk-retention rules. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires these lenders to put some skin in the game by retaining at least a 5 percent of the risk in loan pools they securitize.

The intent of the law was to make lenders more accountable, but it also has made them more skittish in committing to deals. That

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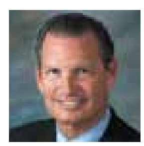

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hurts commercial mortgage borrowers who are acting in good faith only to have their lenders get cold feet and pull out unexpectedly at the eleventh hour after months of work.

Need for capital

According to real estate services company CBRE, loan maturities in the commercial mortgage-backed securities (CMBS) market in 2016 and 2017 are expected to exceed $400 billion annually, which is nearly 33 percent more than in 2015. The same report projects that 29 percent of CMBS loans that mature in 2017 will have trouble refinancing, partially due to increased regulations.

Many lenders are still grappling with the risk-retention rules and are determining the best structures for the loans they are originating. At the same time, B-piece buyers are still getting used to the new structures for the unrated investment tranches.

These factors create an increased need for capital. They also raise questions about how that capital will be brought to market.

The funding gap

This funding gap leaves an opportunity for nontraditional lenders — such as nonbank and online marketplace lenders, investment funds and private lenders backed by hedge funds — to collectively take a lead in providing increased capital to the marketplace and to create streamlined nationwide lending programs. It is imperative that the solution include a mix of alternative lenders, as many of these industries are in their nascent stages.

Marketplace lending will be a critical component in helping to provide liquidity to the industry because it offers a single source of financing that makes available a variety of financial products. It also provides access to previously untapped sources of capital via accredited or institutional investors. Marketplace lenders raise capital via their online platforms and then match borrowers with investors who fund or purchase interests in the loans. The marketplace lender sources, underwrites, funds and services the loans, while marketing the loan online to investors.

Greater liquidity also may be offered by the emergence of new funds available through nontraditional lenders. Similar to what has played out in the unsecured-debt space, there will likely be an increase in the number of funds acquiring interest in loans backed by commercial real estate — bringing new and previously untapped sources of capital to the marketplace.

Additionally, to specifically address the large number of CMBS loans coming due in the near future, funds may be formed to provide gap equity to borrowers who have CMBS loans maturing, but cannot generate enough proceeds to cover a full refinance. These funds will likely have the backing of a variety of capital providers, including hedge funds, opportunity funds, Wall Street and mortgage real estate investment trusts.

It is imperative that alternative-lending sources make up a larger portion of the market in order to provide much-needed liquidity. In fact, this trend has already begun to take hold. According to the Mortgage Bankers Association's Commercial/Multifamily Annual Volume Origination Summation for 2015, alternative lenders originated 68 percent more loans in 2015 than they did the year prior. Compared to the 35 percent increase that commercial banks and savings institutions saw during the same period, it is clear that alternative lenders are picking up steam and filling a void in the marketplace.

Factors to consider

When evaluating opportunities in the alternative-lending market, there are several important considerations that brokers and borrowers must keep in mind to ensure that both the lender and final transaction meet their needs. One major factor to consider is whether the chosen platform is a direct lender.

Direct lenders eliminate the middle man, allowing brokers and borrowers to work directly with the lender to facilitate the deal. In an industry where getting the deal done on time and within its original parameters is of the utmost importance, direct lenders can help provide a necessary level of certainty that a transaction will be completed.

In many cases, alternative lenders, especially those that are direct lenders, may be more nimble than traditional institutions. Because alternative lenders are not subject to some of the same operational and regulatory constraints as traditional lenders like banks, they can often cut down on costly regulatory processes and provide more flexibility when structuring and closing transactions. As a result, brokers may be able to work with the lender to create custom deals tailored to the specific needs of both the property and borrower.

Another factor to consider is whether and how the lender utilizes technology in its deal process. Many lenders have opted to incorporate technology into their lending practices to create a streamlined, faster and more-efficient process. One of the greatest benefits of progressive technology solutions is a higher caliber of customer experience.

Technology-based platforms can offer one-stop shopping for various lending products — ranging from preferred equity to mezzanine to bridge to permanent — resulting in a convenient experience for borrowers looking for a variety of lending opportunities. Additionally, because many of these technology-heavy platforms are web-based, they often provide online deal trackers or managers, keeping brokers and borrowers in the loop on each step of the process.

Appropriate use of technology also can result in a dramatic reduction in the funding-cycle timeline. As a result, the marketplace will likely see a shift in the origination of loans away from regional lenders to nationwide marketplace-lending platforms, but not to the extent of replacing those regional players.

Finally, while technology is an integral component of marketplace lending for commercial real estate, the business itself still relies on industry proficiency and experience. It is essential that a marketplace lender's platform is backed by a solid team of finance professionals who possess years of experience in underwriting commercial real estate loans. That will create an environment for success for both investors and borrowers. ■

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