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Non-conforming does not mean sub-prime

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We are all acutely aware of the results of the sub-prime fallout on the financial and residential markets. Unfortunately, real estate does not exist in a vacuum. The uncertainty present in the residential world has begun a slow creep into the commercial area as well. For the past few years there has been tremendous growth in what is referred to as "small balance" commercial lending. As bank consolidation grew over the last decade there have been fewer choices for applicants in the $100,000 to $500,000 loan pool. The traditional lender in this market segment has been the hometown "community-based" financial institution. These banks provide vital services to local entrepreneurs, investors, developers, and the self-employed commercial borrower. Such loans are often tied to relationship banking with business checking and other service components. The history of community banking remains strong in New England and in Connecticut with newly-formed institutions arriving at a steady pace even as the economy contracts nationally.

Community banks are, however, limited in the scope of their lending. Individual institutions may set policies defining lending territories, loan amounts, loan-to-value ratios, relationship history, property type, debt service coverage ratio or asset verification. A void has been filled by the emergence of nationally-based, non-depository commercial lenders. These companies act primarily as wholesale lenders through a network of independent commercial loan brokers. These conduits typically fund or purchase loans originated by brokers, bundle them into Commercial Mortgage Backed Securities (CMBS) and sell them based upon their ratings to Wall Street investors. It is at this point that the fallout from the sub-prime residential debacle has influenced this market. Many large firms with clean portfolios have seen their bond ratings slip. The result of these downgrades has been a tightening of credit.

While no market can claim to be totally free of abuse, many of the excesses seen in residential originations are absent from the commercial segment. Here is where the distinction must be made between "sub-prime" and "non-conforming." Very few of the small balance commercial loans originated by third-party brokers would fit the criteria of "sub-prime" with its negative correlations regarding fraud or predatory lending.

A "non-conforming" commercial loan simply is a loan that may not fit within the typical guidelines of a local financial institution. Typical financing scenarios may include properties with environmental issues like gas stations, lube shops, dry cleaners or sites with "brownfield areas." A simple premium environmental policy in lieu of an expensive Phase II Study may allow a loan to close. Applicants with less than 20% equity or down payment may obtain financing subject to FICO analysis, DSCR and in-depth appraisal analysis. As nationally-based lenders there is no geographic lending limitation. An out-of-state investor looking to purchase in Connecticut can be serviced as easily as a Putnam-based retailer looking to expand into the Waterbury market. A significant portion of the

"small balance" market is targeted toward the self-employed and owner-occupied borrower. These borrowers may be new to this country and have limited business histories. Additionally, these borrowers may be unable or unwilling to completely document all their financial transactions. While this segment has the potential for abuse, cautious underwriting mitigates some of this risk.
Typically these loan programs have strict appraisal policies to insure the value of the collateral, given that the cash flows are not fully identifiable. Appraisals are typically completed by locally designated firms and reviewed by regional offices. The review procedure is intense. Typical requirements include sale and rental photographs, maps and adjustment grids with market-derived overall rate analysis. The underwriting is further strengthened by the lowering of LTV ratios on programs where the property may be considered "special purpose" and the cash flows are not easily verified. Loans for non-flag motels, SRO and self-storage facilities typically fall within this property tier.

Recently we have seen issues migrate from the residential to the commercial sectors. The first quarter of 2008 has seen a tightening of credit within the small balance commercial markets. The Connecticut market has remained strong and commercial values can be considered somewhat stable. Nationally there have been areas where investor markets have collapsed and fraud has been uncovered. Large commercial conduits typically do not have localized lending policies when loans are pooled. The oversupply of Class B/C apartments in Las Vegas will affect the availability of credit in New Haven, which remains a strong market.
The changes have been subtle but nonetheless impactful. As bond ratings lower, lending rates become higher and less affordable. Loan-to-value ratios have tightened a bit and more property types have been reclassified Tier I to Tier II collateral assets. The appraisal review function, however, remains strong. The primary difference has been a decrease in turn time due to lowering volume levels. Real estate markets cannot function without the availability of adequate, affordable credit. There is a constant demand for funding to allow the acquisition of a small multi-unit apartment, mixed-use corner deli, used car or auto repair facility. Hopefully the impact upon the commercial segment will be limited in duration and scope and we can return to business as usual in the near future.

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