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Knee-jerk collateralizing due to economy rather than the deal

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Typically in financing a deal, lenders underwrite a loan relying on the project's cash flow; they use financial covenants, such as a debt service coverage ratio as a testing mechanism; insert a reserve requirement; manipulate amortization periods; peg rates to the treasury market, LIBOR, or the FHLB; utilize a loan to value ratio that relies on appraised value; and ultimately underpin the pricing of the deal to the credit quality of the borrower. Collateralizing a loan against the property itself, with recourse to the borrower usually suffices to secure the financing. In some circumstances, other valuable consideration, at the lender's discretion, may be pledged by the borrower, but, traditionally, these terms are based upon the deal fundamentals themselves, and not on the state of the marketplace.

Recently, however, I closed a transaction for a client where the lender secured the loan with substantial and various forms of collateral, seemingly unwarranted by the deal itself. There was a solid appraisal, robust cash flow, and a strong borrower. I couldn't help but wonder whether this was a kneejerk collateralization response by the lender; an over-collateralization based upon the declining economy and battered investor confidence rather than the deal itself? The result of such policies may serve as a self-fulfilling prophecy in that encumbering additional collateral may affect future cash-out refinancings, and carry with it an opportunity cost which could result in a larger overhang on the market than the underlying conditions themselves may have created.

We are currently seeing a credit crunch that is just as attributable to consumers curtailing their spending, lenders tightening their credit standards, and investors shying away from certain products, than it is attributable to the effects of the underlying mortgage crisis itself. These market conditions cause our legislators to overreact, and unwittingly intensify the original problem.

We have seen responses like this before.
In the early part of the decade, when the public equity markets were faced with large scale corporate implosions, such as those of MCI and Enron, investor confidence was shaken, and legislators pounced into action, enacting the Sarbanes-Oxley Act (SOX). In hindsight, SOX was a heavy-handed response intended to cleanse the equities markets and restore investor confidence. There were those who warned that we may have been over-regulating the markets; creating a disincentive for new public offerings or even for the continued public listing of existing issuers, particularly smaller cap companies and foreign issuers. In early 2000, there was a great deal of interest, and substantial multinational business opportunities created by companies across the globe wanting to list their shares on U.S. equity markets. The concern was that SOX could change that business climate, and it did. The law created a complex reporting structure and potential liability for

signators of annual and quarterly reports. SOX enriched auditors and securities lawyers, but drove issuers away from the equities markets. Understandably, an argument can be made that the recent private equity boom may have had its underpinnings in the SOX marketplace, as it created a climate at that time that painted privately-held companies as a more lucrative and high octane option than the expensive, over regulated, and "on-balance sheet" world of public companies. Similarly, the lightly regulated hedge fund marketplace became a lot sexier. Was this capitalism at its finest; the creation of new business opportunities, or was it only benefiting a select economic strata of society, a consequence that would have little effect on the broader marketplace.

Well, considering that we now have a staggering trade imbalance between our imports and exports, a mind-numbing deficit, a weak dollar, and a global economy less focused on the U.S. marketplace than at any time this decade, perhaps the latter.

Today's deterioration in the financial markets may have had its origins in the housing market, but the resultant dent in consumer and investor confidence has deflated the capital markets. So far, there has been legislation tailor-made to assist struggling homeowners, but presently the legislators have leveled no particular focus on the commercial real estate market. Let's keep it that way. Bankers will acknowledge that delinquencies on commercial transactions have inched upward, but are still at tolerable levels. Over-regulation, whether by statute, or action by market participants, just like an over-reaction in a personal situation, generally exacerbates, rather than remedies the core problems. Underwriting and collateralizing a deal on its own fundamentals sits better with me, as it is rational and market-oriented.

Food for thought - it's a marathon not a sprint.