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Recourse: Risk and rates in the real estate market

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We have all read enough about the credit crisis to understand its ramifications in financial and real estate markets. We also know it is a lot harder to get commercial loans because of it. Most recently, however, I have been seeing articles pop up on new obstacles: that is, personal recourse for these loans. As credit tightens, and more equity is required, it stands to reason that eventually lending would return to personal recourse liability.

Those of us who were around in, and survived, the real estate recession of the late 1980s and early 1990s, remember that personal recourse was substantially the only way to borrow money. Lending was more traditional, and real estate was not quite as "available" an investment as it is today. During those years, there were many foreclosures, and lenders took back property and sued owners for any shortfalls. There were many painful experiences on both sides of these loans.

After the bloodbath, it took a while for people to dive into real estate again, but as the pendulum swings, lenders and buyers crept back into the market. While there still were traditional banks which were lending, many had gone out of business along with developers during those troubled times. Wall St. filled the void by creating and finding new ways to provide funding to real estate. Loans were "securitized," and the risk was spread among many smaller investors. The need for any owner liability or recourse diminished as the risk for each loan was dissipated among many.

Not only were the risks individually reduced through this type of finance, but the desire for real estate grew to a feverous pitch, and loans were flowing freely. Investors and developers were more willing to take higher risks, for lower returns, without the burden of additional collateral.

We had about twelve years of this type of financing leading up to the recent credit crunch. Now with the crunch, the trend may be returning to lenders who keep the loans on their balance sheets, and thus require more collateral than the building itself, in case of failure.

I always wondered back then as to why real estate analysts didn't differentiate more significantly those loans that had recourse from those that did not. Capitalization and discount rates were based on a risk analysis, but it was mostly comprised of the cost of equity and debt. It puzzled me that we could presume that a developer's required equity rate of return was the same under recourse and non-recourse debt.

I now find myself again with the same question. What happens to these low cap rates today, where buyers are willing to accept increasingly lower returns for real estate, if recourse comes back into play? Buyers have purchased at increasingly higher prices, accepting increasingly lower present returns, because they must view real estate as having unlimited upside. If recourse comes back to lending practice, are these same buyers willing to accept 4% and 5% return on real estate, when their personal fortune may also be at stake. I believe some developers may stay out of the market completely. Others will clearly view their investment activities as riskier. In either case, cap rates will begin to increase reflecting both the risk of developing a project and the risk of losing hard won fortunes.

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