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Banks, non-bank lenders team up on new originations

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Sondra Campanelli 1 March, 2017

Banks and their non-bank counterparts are working together more frequently on commercial real estate loan originations, with banks increasingly buying A-notes of new loans from non-bank lenders. The trend stems from regulations that include Basel III, Dodd-Frank, and the Federal Reserve's stress testing, which makes it more difficult for banks to hold certain kinds of loans on their balance sheets.

"Banks today want significant recourse for things like construction [loans] and may want relatively high rates. They're only willing to lend on a low leverage basis to their best borrowers," said **Richard Mack**, ceo and co-founder of **Mack Real Estate Group** and head of

Mack Real Estate Credit Strategies. This philosophy has opened the door for non-bank lenders to originate loans on a riskier project, bifurcate the loan into A- and B-notes, and sell the A-notes off to banks while retaining the remainder, market players told *REFI*.

Here's how it works. "If a borrower is paying 6% interest, a NBL may sell $50m [of a $100m loan] to a bank in an A-note at 4%. The NBL is still getting paid 6%, so [they add that additional interest on to their B-note] and now they're getting 8-9% on their piece," said **Mark Edelstein**, chair of **Morrison & Foerster**'s real estate group. This strategy also eliminates some of the overhead costs of originating a loan. "Given their higher cost of capital for risker loans, owning less risky A-notes is a nice business for [banks]," Mack added. "They can often make more money owning A-notes than they do in originating a whole loan at a higher spread and risk level."

Regulations have encouraged banks to move away from certain types of loans that hurt them in CCAR or portfolio management, said **Mark Cagley**, chief credit officer at **Starwood Property Trust**. "These dynamics have created an opportunity for platforms like Starwood Property Trust, as our global footprint, scale and real estate underwriting skills enable us to source complex real estate finance transactions that banks and other alternative lenders might shy away from. As a result, we play a critical role in meeting the total debt capital needs of our borrowers," he added. Warehouse financing, where banks hold loans as collateral in exchange for providing a line of credit, offer banks a chance to get exposure to real estate in an indirect way, with lower capital charges, better spreads, and a better return.

While regulations are a part of the shift, there's another story that's factoring in – the real estate market may be late in the cycle, which is also making banks more conservative. "The net effect is that [bank] lenders today generally want to lend less proceeds on a given project than they did a year ago," said Edelstein. "On a $100m project, if they used to lend $60m, for example, now they want to lend $50m. When they do make the loans, the developers have to fill in the gap with something." One alternative lender agreed, noting, "[Banks] are flat on real estate or down," he added. "That's just as big of a factor in banks being less aggressive in the lending space as is the regulatory environment."

Smaller lenders could face risks, however, as competition increases among firms that don't have broad access to the syndication outfits. "They're out there competing to put loans in a small handful of banks that take A-note participations," said **David Blatt**, ceo at **CapStack Partners**. "If a bank doesn't have an appetite for it anymore or just doesn't want that loan, that lender is in a tough spot." Lenders can face a hard choice – get a reputation for not

being able to close a loan quickly or face the risk of having to hold a loan that only generates single digit returns. “It’s [essentially] a syndication kickout,” he added. “With more people coming in, there just won’t be [places for everyone] to put A-notes.”

The **Trump** administration has also made broad promises to roll back regulations on banks, which could allow them to jump back into the lending market. However, non-bank lenders have a solid reputation for flexibility and ease-of-use, which has many borrowers bullish on their staying power. “I think banks will get back in [to the business if regulations are rolled back], but I also think that non-bank lenders tend to understand risk better,” said **Mitchell Hochberg**, president and chief operating officer of **Lightstone Group**. “They understand the borrower better, are easier to work with in structuring complex loans, and have a better grasp of balancing risks and how to accommodate borrower’s needs.”

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