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Hard Money and the Secondary Market

Private lenders offer a rapid solution in difficult lending times

One of the fundamental principles of lending is that a loan's terms are directly related to the security put up by the borrower, which guarantees that the lender's investment will be returned. Mortgage professionals know all too well, however, that the lending market has become considerably tighter in the last decade because of the mortgage crisis and the financial sector's resulting reluctance to lend.

The end result of this restrictive lending climate is that clients often lack the capital that lenders require to approve loans. This puts many buyers interested in flipping commercial properties in a tough position because the loan market isn't as accommodating to them as it used to be.

This dynamic is causing many commercial mortgage professionals and their clients to turn to hard-money lenders to generate the necessary capital to pounce on investment opportunities. Although hard-money interest rates are often higher, the lending process is more streamlined, giving borrowers an advantage in response and closing times over their competitors who go through standard lending channels.

To fully understand the climate in real estate lending, it's important to analyze the nature of lending and how the mortgage crisis may have permanently changed the lending landscape.

Declining market

When a lender issues a real estate loan to a borrower, the lender's intention is not always to hold the loan for its entirety, despite what many people believe. Instead, the loan is often initiated, held for a short period of time and then sold to another, or secondary, entity. The government-sponsored enterprises (GSEs), which include Fannie Mae and Freddie Mac, are well-known examples of secondary lenders. These organizations do not initiate the original loans; they merely purchase them from the original lenders.

How does this relate to hard-money lending? When the secondary market dried up because of the riskiness of real estate loans after the financial crisis, first-tier lenders drastically reduced the number of loans they issued. After all, the original lenders weren't usually planning to keep the loans for the duration of their terms, but with the secondary market for the loans considerably smaller if not gone altogether, lenders were likely to be stuck with them.

Although the market has improved and many conventional lenders have gotten back in the game, they are inclined to be reluctant to offer capital in any situation that carries even a remote amount of risk. The securitization of the loans simply isn't enough for them to make the decision whether or not to lend, leaving many borrowers waiting weeks for a decision before eventually learning that they have been declined.

In other words, the secondary lending market has everything to do with the current climate in real estate finance. Prospective buyers without access to capital have far fewer options to make moves within the industry.

Lending alternatives

Given the change in the fundamental commercial real estate loan market because of the declining secondary market, it isn't difficult to see why hard-money lenders have enjoyed a rapid ascent within the real estate industry. By eliminating much of the red tape that borrowing through traditional lenders entails, hard-money lenders help borrowers to access capital quickly. Anyone who has flipped a property can attest to the importance of timing when it comes to borrowing.

Hard-money lenders, or private lenders, as they are often called, have helped bridge the gap between investors and the current conservative — some might even say stingy — policies found in the finance sector. These loans often carry higher interest rates, but because the capital isn't likely to be tied up for long, especially when the goal is to flip the property, the prospect of a higher interest rate isn't a deterrent.

It is important to remember that risk is the greatest, and often deciding, factor when a lender considers a request for capital. Will the investment pay off? What if the borrower defaults? Will the amount of the loan get recouped? The answers to these questions will determine the outcome of the loan submission.

Securitization

When the traditional lending market is tight, hard-money lenders offer up the capital necessary to acquire a commercial property. Borrowers should expect that the

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appraised property will act as collateral should they default on the loan. Because these lenders provide only an amount of capital that is as much as 70 percent of the property's appraised value, they can be certain that their investment is protected.

Securing loans in a volatile real estate marketplace may scare many standard lenders away from approving loan applications, but this doesn't mean buyers cannot make moves on distressed properties or other commercial real estate opportunities that require fast action. Even as the market continues its gradual recovery and conventional lending becomes less restrictive, hard-money lending is now commonplace, helping to eliminate the gap created by a lack of mortgage purchasing in the secondary marketplace.

Mortgage originators and their clients who take advantage of lending opportunities offered by private lenders can enable themselves to swiftly navigate the volatile commercial real estate marketplace and seize the timely opportunities that often are unavailable when going through conventional lending channels.