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Use caution when selecting a nonconventional lender

Before getting into the secrets of nonconforming lending, it is important to explain nonconforming lending. Nonconforming lending also is referred to as hard-money lending and private lending. It is any loan that is unable to go to a conventional lender (i.e., bank, Wall Street, life company, etc.). In essence, a nonconforming loan is a loan that is a little outside the box for a traditional lender.

What are the key reasons a loan falls outside of traditional lending parameters? As everyone is aware, banks' lending standards have tightened exponentially during the recent financial crisis. More and more loans do not fit the box of conventional lenders. If a deal is not plain-vanilla traditional lending, sources are unable/unwilling to lend on the property. The reasons vary wildly but they can be associated with how quickly a transaction must close, the borrower's credit, a current loan coming due, the current cash flow on the property, borrower's income, or a multitude of other reasons.

How is a hard-money lender able to close a transaction that a bank cannot? Most hard-money lenders are funded privately (as is my firm) or via a fund. Hard-money lenders are not regulated by the Federal Deposit Insurance Corp. and therefore have flexibility to do loans that make sense. Hard-money lenders typically loan up to a maximum of about 60 percent loan to value off the quick sale value of the property. This LTV allows lenders to get comfortable on loans that a conventional lender cannot. Along with the correct LTV, the deal must make sense both for the borrower and lender.

The increased risk of a loan that does not fit traditional underwriting guidelines comes at a price. Hard-money lenders' rates are typically 5 percent to 10 percent higher than a



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bank. A hard-money lender typically structures the loan for anywhere from one to five years to allow the borrower time to transition into a more conventional lending product or, alternatively, sell the property.

What is an example of recent hard-money transaction? We recently closed a transaction with a borrower who had excellent credit and income. His existing lender was taken over by another bank and the loan was nearing maturity. The bank offered the borrower a substantial discount if the loan was paid off early. We were able to close the loan in under two weeks and the borrower received a 40 percent discount on the outstanding loan amount.

What should a borrower know before utilizing a hard-money loan? As mentioned above, hard-money lending is not regulated like other traditional lenders. Not only does this allow lenders to be flexible but also it opens the door for unscrupulous lenders/brokers. With the lack of regulation, it is imperative that the borrowers fully understand the transaction and do their homework on the lender/broker before signing anything or sending money for various due diligence fees.

As with any financial transaction, if the deal sounds too good to be true, it likely is. Borrowers need to utilize common sense when pursuing a hard-money transaction. For example, if a lender states that it can provide a prime rate on a hard-money transaction, one should highly

question the lender. Hard-money lenders' cost of funds is higher than traditional lenders' costs, which makes it unlikely that their rates would be comparable with a conventional lender.

Borrowers need to do their homework on the broker/lender. A simple step is to do a couple of quick searches online to help vet the broker/lender. First, look at the lender/broker's Web site. If the site is very thin (not a lot of content), that is a red flag. Next, use Google to search for the lender/broker and see what comes up. Are there people who have had issues with the lender/broker in the past? Next, use Google to search the broker/lender with the word "lawsuit." There are many lenders that have been sued for various reasons from borrowers. Along with searching Google for the lender/broker, check with the Better Business Bureau. Finally ask around in the banking community if anyone knows of the lender. For example, in Denver there are likely four or five predominant players in the hard-money arena. It is advisable to stick with the well-known local players since they will be able to best understand your transaction.

Not only do borrowers need to do their homework on the broker/lender, but also they need to be careful that they are not trying to chase a "golden rainbow." Many times, borrowers are so deep into the transaction that they end up making poor decisions. For example, I commonly receive calls regarding transactions that likely never will be closed by any lender at any level. For example, I received a call from a borrower who had a property he thought was worth \$1 million. The borrower stated he had a loan that was in default with a lender for \$1.1 million and wanted a lender to loan him \$1.2 million. It is highly unlikely that anyone would even consider closing this transaction since it makes no

sense for any lender. Unfortunately, these borrowers typically are the prime targets of unscrupulous lenders/brokers.

Next, due to the unregulated nature of the industry, many lenders/brokers come and go frequently. There are a number of unscrupulous players in the industry. Some lenders (including my firm) do all underwriting in-house and therefore do not charge fees prior to closing. Many lenders get reasonable fees up front for third-party reports (appraisals, etc.). A borrower needs to make sure he fully understands these fees and that they typically are nonrefundable if the transaction does not close. Borrowers need to be careful if sending money prior to closing since there is a broad sector of lenders/brokers that charge exorbitant "due diligence" fees. For example, the lender/broker requests \$30,000 to review a \$1 million loan package. A borrower should avoid lenders/brokers that request fees that are out of line. As soon as these fees are sent, the borrower typically gets strung along for a while and ultimately told that the transaction is unable to close for some reason. The fees typically are not refunded from the unscrupulous lender/broker. I get multiple calls a week from borrowers who have lost substantial money as a result of exorbitant due diligence fees.

Although the borrower needs to be extremely careful when engaging a hard-money lender, there is a time and place for this type of transaction. As mentioned above, on one of our recent closings the borrower received a substantial discount on its note by being able to close the transaction quickly. There are thousands of other transactions where the borrowers received substantial benefit from utilizing hard money. Hard money can be a great tool for borrowers when utilized properly.▲