# And the Momentum is going Which Way?

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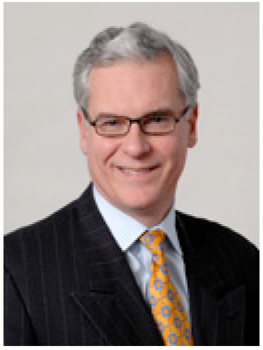

My team and I have spent the better part of the past eight weeks dealing with Irish loans and other portfolios of…stuff. While the conduit market was imploding, pipelines were being aggressively repriced and loan production was shifting into a very low gear, there has been a full scale feeding frenzy for portfolios of seasoned loans. While new loan originations were being dragged through the knot hole of torturous and ultimately paralytic analysis, millions of dollars were spent in high speed car chases for billions of dollars of seasoned loans in awkward, brief and brutal auctions.

Cognitive dissonance anyone? These are alternate universes. In the Ordinary Course Loan Origination Universe, every proposal suffers the death of a thousand cuts: “OK, maybe it’s a pretty good loan but I need to really understand what happens if the anchor tenant leaves, the president of the management company gets arrested and an asteroid hits Ohio. What exactly happens in the cash flow?” In the Alternate "Bid ‘Em Up Universe", crappy reps, document defects and weird deal features? Fine! Win the bid!

In the meantime, back in Alternate Universe A, getting a loan approved and closed still seems to be just plain tough. Spreads are volatile, hedging simply isn’t doable, and for the human beings involved in the trade, risk and reward is highly asymmetrical: an attaboy on the upside and a pink slip on the down.

Alternate universes make terrific grist for sci-fi potboilers, but are somewhat more disturbing in real life. And since it is, in fact, our real life, this bears musing about some.

A couple of things flow from this phenomenon. First, and this may fall into the no-duh category, the sale by sovereign or near sovereign banks of U.S. commercial loan portfolios is not going to be a one-month wonder. It is dead nuts certain that more portfolios of commercial mortgage loans will come to market here in the United States. The success of the Irish banks in August is certainly going to encourage the weak and the lame, particularly throughout Europe, to monetize their U.S. commercial mortgage loan portfolios to re-patriot funds and burnish liquidity. Just yesterday, one of the major French banks announced a $45 billion de-risking initiative. Wanna bet that some of that risk will be US CRE? Will there be auction fatigue on the institutional buy side? I sort of think not. For every institution that spends a zillion dollars and comes up empty, another will still see opportunity. In light of the realities of the Ordinary Course Loan Origination Universe, the siren song of get long fast by being able to put a billion dollars of seasoned loans on the books in one fell swoop will be compelling. Hey, and since the team is not building the book by onesies and twosies, we've got the resources to swing for the fence.

The other trend that I think we can tease out of the recent portfolio auction frenzy is that it will continue to support the rapid growth of the shadow banking market. With all the uncertainties in the formal banking market place brought to us by Dodd-Frank, Basel III, the braying of the attorneys-general community, an increasing taste for private litigation in the financial markets and the general populist anti-Wall Street narratives coming out of the Administration (egged on by a swath of the chattering class), the appetite of the major money center banks for these auctions may have a natural limit. These transactions are public circuses and highly visible. They will attract a high level of attention from the regulatory communities. How long until the regulators and the political class begin to test out the populist screed (loudly) that buying other people's loans does not contribute to jobs?

So as deal fatigue wearies first movers (the major banks), and political exposure and regulatory attention begins to increase around bank to bank portfolio sales, the door will open for more of the fund-based shadow banking community to play a significant role in dis-intermediating the sovereign and near sovereign banks from their U.S. real estate portfolios. We've already seen many of the major players take a run at these portfolios this August and it's likely to continue as competition from the banking sector flags. Moreover, where a bank might buy and hold and reap the benefits of banking economics from adding to its loan count, the non-bank market buys these assets with dynamic plans in hand. Plans to do something with these assets to earn an outsize return on its investment. Seasoned loans will be restructured, re-bundled and re-securitized. Seasoned loans will be aggressively reduced to REO for re-positioning, re-development, re-sale and re-finance. The process, net net, will transform sedate pools of portfolio assets into highly dynamic portfolios of financial assets subjected to the tender mercies of the non-bank community. It should be fun.

We'll have to learn to live with this cognitive dissonance for a while. Eventually, though, that dissonance will become unsustainable and the two worlds will re-integrate. Will it be where institutional lenders, both banks and shadow banks, are risk-on and are aggressively growing portfolios, or a world in which risk-off is the watchword and the flow of capital will be reduced to a trickle?

I'm betting on the former because the latter is simply too depressing to contemplate. One requires growth, the other retrenchment. I've done retrenchment and it's just not fun. Sometime in the next few months we'll see whether the risk is on or the risk is off. Stay tuned.