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Squeezing Lemons (So Your Lender Won't Have To)

Ensure there is an even flow of information between brokers and lenders

By **Carlos F. Crespo,** principal, NIGMA Capital & Finance LLC

In 1970, economist George Akerlof's seminal paper "The Market for 'Lemons': Quality, Uncertainty and the Market Mechanism" demonstrated that used-car buyers' inability to differentiate between good and poor-quality cars ("lemons") comes from an asymmetry of information between the buyer and the seller.

The seller has more information about the car's quality than the prospective buyer. Unable to value the difference in quality, buyers must price good and poor-quality vehicles equally.

Asymmetry of information, therefore, results in good-quality cars being removed from the marketplace. As a result, the used-car buyer can suffer from purchasing a lemon.

This problem also is common in commercial lending. It affects the valuation of credit risks, loan pricing and the term structure of the loan. Borrowers possess far more information about the project's prospects for success and the project's risk exposure. If the asymmetry of information between the borrower and lender is significant, the lender may not understand the additional risk undertaken after the loan is issued.

Mortgage brokers who recognize the effects of asymmetry of information can help their clients develop a comprehensive assessment of the project's risk profile — and a quality loan proposal for the lender. As with the lemon example, when lenders can't identify the difference in quality between projects, they must deny a loan or allocate a higher risk premium to the term structure.

Carlos F. Crespo is a principal at NIGMA Capital & Finance LLC, a financial consulting and mortgage brokerage firm specializing in risk-management consulting and brokering structured finance solutions for developers. He has more than 25 years' experience developing real estate and structuring creative-financing packages for complex development projects. Crespo has bachelor's and master's degrees from Indiana University and a master's degree in financial management from the University of London. E-mail ccrespo@nigma.com or visit www.nigma.com.

The adverse consequences are clear. On the lender's side, the result is increased underwriting of riskier projects, which may lead to a higher proportion of risky assets in the lender's portfolio than desired. Borrowers with good projects will not be funded or will be forced to pay a higher risk premium than warranted. Mortgage brokers are faced with potential loss of business, unsatisfied clients or both.

A thorough guide for how to document the risk-profile analysis can be found in the "Principles for the Management of Credit Risk," a publication issued by the Basel Committee on Banking Supervision of the Bank of International Settlements.

The committee recommends that brokers consider and document the following factors when assessing the risk of a borrower.

- **The purpose of the loan and the source of repayment funds**: The loan's purpose affects its risk profile. A loan request for improving a property increases the collateral value, thus reducing risk. A cash-out loan, on the other hand, increases the risk of the transaction. Further, established sources of funds for repayment are less risky than pro forma projections.
- **The borrowers' integrity and character:** Lenders must know they are dealing with borrowers and counterparties of sound repute and creditworthiness. In addition to providing résumés and credit ratings in their application, your borrowers should provide letters of references from known parties or lending institutions with whom they have had successful transactions.
- **The risk profile of the borrowers and the project:** This includes sensitivities to economic and market conditions. If the borrowers own other assets or properties with varying risk profiles, these factors will impact their overall portfolio.
- **The borrowers' capacity to repay:** Creating a projection based on historical trends can help measure risk.

In addition, borrowers should demonstrate their ability to repay using forward-looking projections in various scenarios. This provides a more realistic risk projection based on expectations in changing conditions. If your clients can further identify, measure and develop mitigation strategies to manage potential shortcomings, they show they have management expertise. Lenders, therefore, are likely to have more confidence in the project.

- **The legal capacity of the borrowers or counterparties to assume liability**: Providing documentation of the legal rights and capacity of borrowers to assume the liability is integral to the application process. This documentation can include copies of deeds, titles and proof of identity.
- **The borrowers' business expertise, the status of their economic sector and its position within that sector:** Your clients can demonstrate the strength and quality of their background and their project by showing that they have the following — years of industry experience, educational background,

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leadership position in professional associations, special accomplishments, cross-sectional performance in the economic sector and a high-performing project compared to sector statistics.

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By complying with these principles, brokers can demonstrate their clients' commitment and confidence in the higher quality of their project. In addition, they can often negotiate a more favorable term structure, add value to their services and earn the professional appreciation of their clients and lenders.

Principles for the Management of Credit Risk

The Basel Committee on Banking Supervision of the Bank of International Settlement recommends that you consider the following factors when assessing borrowers' risk:

- Purpose of the loan and source of repayment funds
- Borrowers' integrity and character
- Risk profile of the borrowers and project
- Borrower's capacity to repay
- Legal capacity of borrowers or counterparties to assume liability
- Borrowers' business expertise and status of their economic sector