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Big Changes in Commercial Mortgages July 12, 2007



David Barnett

There have been big changes happening in the mortgage market. Have you noticed the headlines talking about the “sub-prime” mortgage lending? The term “sub-prime” refers to the borrowers. They are below the threshold of what traditional lenders consider their “prime” market.

One of the reasons lenders in this market are able to make loans that other lenders won't is because of where they get their money. These mortgages are packaged and sold as mortgage-backed securities. Because they tend to be at higher interest rates, the investors can get a better return. This ensures a market for the bonds and, in return, more money becomes available for mortgages. These lenders are sometimes called conduit lenders. The term comes from the fact that the lender is just funneling money from the investors to the borrower.

This type of funding is starting to play a greater role in commercial mortgages here in the Maritimes. Conduit lender products can be recognized by some of these advantages for borrowers: ease of application, relatively high Loan to Value ratios, relatively quick funding procedures, and no requirements for annual reviews. These advantages come with a price. Typically, these mortgages are priced at higher interest rates, feature “locked in” periods where you can't pay out the mortgage, or include floating rate periods where the rates can quite quickly move upward from fairly attractive “introductory rates.”

Some of the advantages of these mortgages are that they allow people to borrow who have traditionally had a hard time getting money from banks. Businesses such as hotels, restaurants, auto service businesses can now

borrow with relative ease whereas before they were considered risky by lenders. Also, borrowers that are considered to have good credit quality are now able to borrow to a greater extent. One conduit lender operating here in the Maritimes offers up to 90% financing on apartment buildings to people with good credit with no requirement for CMHC insurance. A traditional lending institution would be hard pressed to go beyond a loan to value of 75% in the same deal.

Obviously, these mortgages will be available to the extent that investors are willing to purchase the securities that fund them. So far, this has not been a problem. Because of this focus on the investor (they're the source of the money) these mortgages can come with conditions that a borrower should take some time to understand. One conduit lender operating in the Maritimes requires a two year blackout period. This means no prepayment of the mortgage. Why? They make a commitment to the investors that they will receive their return on investment for at least two years. Why does this matter to a borrower? By entering into this agreement, you effectively lose the ability to sell your property for two years. This can constrain your options as a business person.

Conduit lenders are helping business people succeed by making capital available that has traditionally been hard for some entrepreneurs to access. In this respect, they're doing a great service and are filling a niche increasingly left underserved by the traditional lenders. Just make sure that before you sign on for this kind of financing that you're ready to live with the conditions that come with it.

David Barnett is a Business Finance Consultant with Advantage Liquidity Partners Ltd. in Moncton. ALP Ltd can be found at www.alpatlantic.com or by calling (506) 387-4881.

Phone (506) 387-4881
Toll-Free..... 1-877-387-4881
Facsimile (506) 387-4797
E-mail: info@alpatlantic.com

Advantage Liquidity Partners Ltd.
Visit us online at
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