Analyst AGENDA

PROFESSIONAL PRACTICE

The Future of the CMBS Model

With the right adjustments, could the CMBS market come back bigger than ever?

BY CHRISTOPHER WRIGHT

The commercial mortgage-backed securities (CMBS) model is down but not out. The securitization of commercial real estate (CRE) loans is reviving, if three small deals at the end of 2009, the first since 2008, are any indication. Brian Lancaster, head of MBS, CMBS and ABS strategy for RBS Global Banking & Markets–Americas expects US$15–20 billion in new CMBS issuance this year, and others predict that new CMBS will return in significant amounts in 2011.

CMBS has a long way to go before it encompasses the estimated 30 percent of all new CRE loans that it did at the height of the CMBS boom in 2006–2007. New issuance in the United States totaled approximately US$230 billion in 2007 before collapsing the next year.

If the CMBS market doesn't come back, consequences could be dire for most of the real estate industry. Hundreds of billions of dollars annually for the next several years will be needed to meet CRE refinancing needs. The refinancing problem is expected to peak in 2012, according to Brad Case, vice president of research and industry information for the National Association of Real Estate Investment Trusts (NAREIT) in Washington, DC. Defaults on previous CMBS loans are rising, and the highly leveraged loans made at the peak of the 2006–07 market will still be causing problems through the middle of this decade. Banks are currently looking to reduce their CRE exposure. Already, refinancing activity has begun to crowd out loans for new projects.

Getting Back on Track

The CMBS model in use at the peak of the market has been thoroughly discredited. Issuers, credit rating agencies, and investors all wildly underestimated the risks in CMBS. Investors mistakenly thought that CMBS were based on adequately diversified loan pools and were easy to evaluate and rate. The new iteration of the CMBS model needs to address these concerns, and further changes are in order.

Conservative Underwriting. Tighter lending standards characterized the loans in at least two of the three CMBS deals made at the end of 2009. The deals were smaller (US$500 million or less), were based on single-borrower transactions, and had lower loan-to-value (LTV) ratios (estimates vary from 50 percent to 70 percent) than was common at the market peak. Secondary debt at the borrower level was disallowed or capped. In contrast, deals a few years back were larger (e.g., US$2 billion–US$3 billion), featured multiple borrowers, were based on projected rents, had lax debt coverage ratios, and had LTVs approaching 90 percent or more, with few constraints on secondary debt. Tighter underwriting should reduce default probabilities for the post-boom CMBS market.

Fewer Tranches. CMBS structures will be simpler and flatter. "Investor appetite for very complicated structures has waned," says David Jacob, an executive managing director at Standard & Poor's. That means fewer tranches and fewer interest-only strips. The norm will be four or five classes, as opposed to the couple dozen typical during the boom. At the peak, "the subordinate tranches were quite thin," says Eric Thompson, S&P's analytical manager for U.S. CMBS surveillance. This situation resulted in a top-heavy structure. Highly rated tranches at the top were not sufficiently supported by lower-rated, first-loss junior tranches at the bottom. Moreover, junior bondholders risked falling off a cliff. Small differences in realized losses could make the difference between a junior tranche living or dying. Investors now find such "cliff risk" unacceptable, making it unlikely that CMBS will be structured this way for the foreseeable future.

Skin in the Game. During the go-go years, loan originators commonly did not retain the risky piece or other ownership interest in CMBS deals. Because they were not in the deal for the long haul and had no skin in the game, they had no incentive to ensure careful underwriting, the argument goes. Lenders just slapped together loans, and securitizers bundled them at a furious pace and palmed entire packages off on unsuspecting investors as soon as possible. Despite numerous calls for more skin in the game, however, what will change, if anything, is unclear.

The three deals at the end of 2009 got done at investment grade without lender equity, CMBS pioneer Ethan Penner points out. Now president of CBRE Capital Partners in Los Angeles, Penner believes the marketplace has spoken and has shown itself not to require skin in the game at low LTVs. In his view, low leverage is tantamount to high property owner equity. The fact that the property

KEY POINTS

- The post-boom CMBS model features more conservative underwriting, fewer tranches, more transparent legal structures, and more accurate credit ratings than before.
- Standard & Poor's has increased the degree of subordination required to earn a AAA rating on CMBS instruments.
- Analysts may be looking at smaller, simpler deals but need to perform more of their own due diligence.

owner has skin in the game mitigates the need for lender equity in investors' eyes, but whether investors will demand lender equity at higher leverage levels remains to be seen.

Although legislators and others are pushing the idea of skin in the game, Lancaster warns that it's not a panacea. According to his research, more than 1,500 U.S. banks hold commercial real estate assets greater than 300 percent of tier-one capital, an undue concentration of risk. Bank charge-offs from bad real estate loans are now approaching the same peak levels as when the Resolution Trust Corporation was mopping up after the S&L scandal in the early 1990s. Banks are overexposed to real estate, not underexposed, and hundreds will go under despite having plenty of skin in the game, Lancaster predicts. Moreover, "you can transform your risk profile with derivatives even if you do have skin in the game," he points out. The exposure can effectively be negated through the use of credit default swaps, and some banks routinely purchase credit protection on their exposures.

Legal Structures. Boom-era CMBS were typically attached to idiosyncratic 400-page legal documents that hid a number of uncertainties, thus increasing complexity, confounding investors, and reducing transparency. Future iterations of CMBS will be more standardized and feature more transparent legal structures. In distress situations, CMBS legal structures devised during the boom could surprise investors who had not studied them sufficiently. For example, when default rates passed certain thresholds, the waterfall, or "pour over," from junior to senior tranches in some of these instruments would stop and property cash flows would begin to be distributed on a pro rata basis. Some investors neglected the nuances of these one-off deals and got blown up as a result.

Class Warfare. A major structural flaw in CMBS was the inordinate number of tranches. The complexity and competing interests between junior and senior tranches to this day makes it difficult for special servicers to work out loans in distress situations. Special servicers are typically given a lot of discretion whether to sell the property now, extend the loan, or modify it with a "hope note" (interest-only balloon) that changes the cash flow in the deal. Special servicers are often instructed to realize the highest net present value recovery, but there is always a lingering uncertainty as to how that will play out in any given deal. Thus, first-loss bondholders may jockey to protect their own interests, frustrate consensus, and look for malfeasance among the other parties to make themselves whole.

Flatter structures with fewer tranches will mitigate the problem to some degree. Also, future pooling and servicing agreements (PSAs) are likely to curtail special servicer discretion somewhat by spelling out more precisely what the servicer will do in a distress situation. Finally, an industry group may step up and forge standardized solutions. Ethan Penner calls the current situation "idiotic": "Every deal should work the same. We don't have an industry like that right now and that's one of the great failings of the past cycle. It didn't create a consistent, predictable relationship between the different classes of interests."

Bankruptcy. Before the General Growth Properties debacle, investors perceived that deal cash flows were insulated from bankruptcy of the borrower. As long as cash flows from the property continued as expected and the borrower had put in equity, analysts were satisfied. When GGP made it clear that bankruptcy courts could put all the borrower's assets on the table, the reality sunk in that the assets underlying CMBS instruments were only "bankruptcy remote," not "bankruptcy proof." As a result, investors will now demand CMBS legal structures that reduce or eliminate the possibility that underlying properties will get tied up in bankruptcy.

Joint Venture Liability. Suppose a borrower sues a lender for making an abusive and predatory loan. Ordinarily, the securitizer would be off the hook because it ostensibly had nothing to do with originating the loan. Not so fast. Arguably, the loan would not have been made but for the fact that it would be bundled for securitization later. Because the loan was made solely for the purpose of creating asset-backed securities and because the securitizer may have been orchestrating the activities of the lender to some degree, the securitizer may face legal liability as a joint-venture partner of the lender. The argument has been made in the residential context (RMBS), but undoubtedly, some attorney will advance it in the commercial arena soon. Wall Street firms will move to shield themselves from joint-venture liability in future CMBS deals.

The Role of the Rating Agencies

Investor confidence in credit ratings eroded after the financial crisis, although criticism specifically directed toward CMBS ratings is not easily found. Standard & Poor's made significant changes to its CMBS rating methodology in June 2009. The changes apply only to conduit/fusion pools (aggregations of small loans and combinations of small and large loans), which account for about 85 percent of all outstanding CMBS. Single-borrower deals are exempt.

The goal is comparability—a AAA rating should denote the same credit worthiness regardless of asset class (structured finance, corporates, municipals, sovereigns). Comparability is defined not by specific default probabilities but by the relative performance of each particular rating (AAA, BB–, etc.) within each asset class.

S&P starts with a 1929 Great Depression scenario: A CMBS tranche deserves a AAA rating only if cash flow can withstand the projected effects of 25 percent unemployment, a 40–50 percent drop in property values nationwide, a 70 percent decline in the stock market, and several quarters of a shrinking economy. S&P wants a AAA rating to

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remain stable. "It doesn't mean it will never be downgraded, but it will take a lot to get there," says S&P's Eric Thompson.

Credit Enhancement. The principal guarantor of the credit quality underpinning each CMBS rating is the degree of subordination in the instrument. Ten years ago, a AAA rated CMBS tranche had on the order of 30 percent subordination underneath to support it. Standards slipped to 10–12 percent of the principal balance, which, in combination with lax underwriting, meant that boom-era AAA rated CMBS were not as safe as their earlier counterparts. S&P's new criteria call for 30 percent subordination for AAA super-senior CMBS tranches and 19 percent for AAA rated senior CMBS tranches (a "major recalibration," according to S&P). The required percentages will increase if the quality of the "archetypal loan pool" deteriorates—i.e., if LTVs start ratcheting up industry-wide. Also, S&P is employing new tests—e.g., geographic concentration, potential for litigation in the loan pool—to supplement its Monte Carlo default-simulation model.

With only three small deals done since S&P announced its new criteria, it's too soon to tell what, if any, effect they will have on ratings efficacy or investor confidence. But NAREIT's Brad Case believes that CMBS can be properly rated and the credibility of the rating agencies restored.

The Job of the Analyst

The job of the analyst becomes easier and harder at the same time. On the one hand, smaller deals with fewer loans and fewer tranches will be easier to analyze. On the other hand, past experience should lead analysts to rely less on rating agencies and to perform more of their own due diligence.

The days of investors simply looking at the rating, the yield, and the top five loans are gone for good. Analysts will have to consider the vintage year, perform more bottom-up analysis, and understand what the special servicer is likely to do in a distress situation and how that will affect the various tranches in the waterfall. And analysts will need to arrive at their own conclusions regarding property fundamentals and appropriate leverage levels.

Ratings can be used to benchmark across asset classes and help determine whether an instrument with a higher yield is in fact a better relative value than a security in another asset class with the same rating. When gauging comparability, however, analysts need to understand that rating agencies use different yardsticks to assess credit risk. S&P works off a 1929 depression scenario as described above while another ratings firm might start with a 1981 recession scenario. "It's very important for the analyst to understand what those yardsticks are," Jacob says.

Here To Stay

Many things must happen before CMBS issuance can find a new normal—a better economy, the stabilization of property fundamentals, the resolution of nonperforming loans, and last but not least, a new iteration of the CMBS model.

The conduit factory model of CMBS may be dead (rapid-fire origination and securitization), but the CMBS model in some form is here to stay and even has a number of advantages. It increases the number of sources of capital for commercial real estate beyond banks and insurance companies, reduces the cost of borrowing by forcing those sources to compete, distributes capital efficiently, and reduces the risk that all capital sources will decide to withdraw from the market simultaneously.

"Fundamentally, bundling a bunch of debt exposures and either selling them as a package to an investor or carving them up into tranches and selling the tranches is a very good idea," Case says. "There are very few innovations in financial management that don't provide significant advantages and, therefore, very few that we can expect to see disappear. CMBS is a perfect example of that."

Lancaster of RBS, who serves on the board of governors of the newly renamed CRE Finance Council, agrees that securitization remains a valuable means of distributing capital, despite previous failings. The key is avoiding extremes. But he believes the pendulum has swung too far and people are currently taking *too little* risk. In his view, risk parameters need to be loosened to more normal levels.

REITs raised capital in big numbers in 2009, as they did in the early 1990s when they turned to the public capital markets after S&Ls (a major piece of CRE financing infrastructure at the time) collapsed. While REITs may be able to function without new CMBS issuance, others with CRE refinancing needs are having a much harder time of it. New CMBS issuance is essential, Lancaster says, to getting financing flowing to the other 95 percent of the commercial real estate market.

It's hard to tell what the new normal of CMBS issuance will be. Right now, investors understand the risks better and don't seem to want them to the same degree as before. But Case believes that with structural changes to the CMBS model and better risk evaluation and management techniques, investor confidence could build over time and CMBS could be bigger than ever.

Christopher Wright, an award-winning writer in Arlington, Virginia, publishes his own investment newsletter and country risk reports.

RECOMMENDED RESOURCES

"Asset-Backed Securities: Where Have We Been and Where Are We Going?"
CFA Institute Take 15 Series
(www.cfawebcasts.org)

"Asset-Backed Securities beyond the Cash Flows: Advantages and Challenges of Investing in ABS and CDOs"
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