

The Past, Present, and Future of CMBS

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In the aftermath of the savings and loan crisis, commercial mortgage securitization emerged as the dominant source of new financing by the property market's peak in 2007. Its roost atop the lending hierarchy was short-lived, however, as the next year's financial collapse upended securitization across a broad range of asset classes. Issuance of commercial mortgage-backed securities (CMBS) fell from \$229 billion in 2007 to \$12 billion in 2008, and just \$3 billion in 2009 (Figure 1). For all practical purposes, the CMBS market had ceased to function. Interventions designed to trigger new CMBS activity during this period, including the non-legacy provisions of the Term Asset-Backed Securities Loan Facility (TALF), were largely unsuccessful.

Following three years of dormancy during which the performance of legacy CMBS loans deteriorated sharply, a spate of new issues in the first half of 2011 raised expectations of a revived conduit. In spite of strong demand for these deals, a macro finance environment that exacerbated investor risk aversion and roiled bond markets negated the early momentum. Spread over swaps for AAA-rated CMBS widened from a low of 170 basis points in early 2011 to more than 300 basis points in the fourth quarter, complicating loan pricing. Issuance for the year ultimately reached \$33 billion, prompting some conduit originators to shutter.

The ratcheting back of activity has allowed investors to revisit persistent structural weaknesses in the securitization market, such as potential conflicts in issuers' selection of ratings agencies. Specific events, such as the well-publicized collapse of an August 2011 deal, have resuscitated questions linked to other principal-agent conflicts as well. Balancing these issues against a recalcitrant shortfall in secondary markets' access to financing for new transactions and maturing debt, CMBS activity is projected to resume its recovery during 2012. The long-term outlook is qualified, however, as industry-led and regulatory reforms compete to shape the next generation of securitization.

CMBS Past

Until the savings and loan crisis, traditional sources of financing dominated the commercial real estate industry. The mass failure of thrifts and the broader disengagement in real estate lending saw alternative forms of financing grow in importance. Listed real estate investment trusts (REITs), which had been a peripheral feature of the market during the early 1980s, increased their aggregate market capitalization more than fourteen-fold between 1987 and 1997. During the same period, the establishment of the Resolution Trust Corporation (RTC) through the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) gave rise to the modern CMBS market.

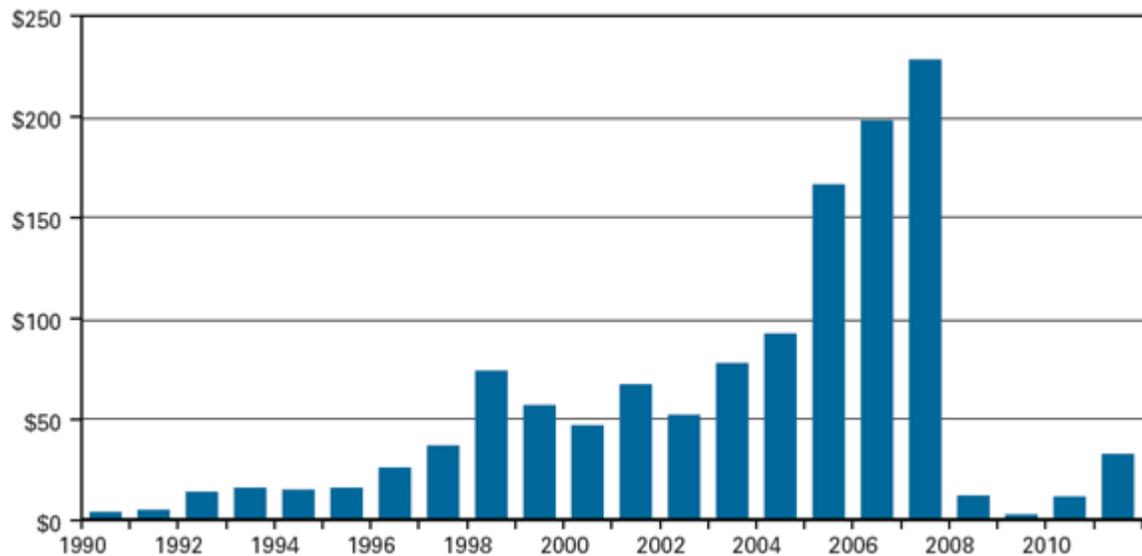
Bonds backed by commercial mortgages were not an entirely new phenomenon. In fact, bonds were a measurable source of financing as early as the 1920s and 1930s. At that time, securitization structures were much simpler, with bonds generally backed by a single loan and property. Returning to the modern era, the first collateralized mortgage obligation (CMO) was issued in 1984 by the Penn Mutual. In spite of beneficial developments, including the introduction of the Real Estate Mortgage Investment Conduit (REMIC) with the Tax Reform Act of 1986, issuance was tepid in the following years, with cumulative CMBS volume only passing \$10 billion in 1991.

Following the establishment of the RTC and its first rated issue in January 1992, CMBS volume swelled. In contrast with the market's early experience with commercial mortgage bonds, the RTC employed the modern CMBS structure

to pool large numbers of mortgages into a single issue. This strategy was necessitated by the sheer volume of commercial mortgages on the balance sheets of the failed thrifts. Demand for RTC CMBS issuance was tepid at first. Measures taken to improve transparency, including the creation of the Performance Portfolio Report (PPR), contributed to market acceptance of twenty-seven deals with an aggregate balance of more than \$17 billion including commercial and multifamily loans. By 1997, the cumulative losses to bond holders amounted to only 3 percent of the original mortgage balances, a fraction of the rating agency credit reserves of 26 percent.

While the RTC incubated CMBS through a period of extreme distress in property markets, the securitization vehicle outlived its initial *raison d'être*. By the late 1990s, the CMBS market had shifted from a tool for managing seasoned loans originated and held on distressed balance sheets to a source of financing for new mortgages originated specifically for securitization. Adding to the attractiveness of securitization, FIRREA imposed new capital rules that required savings institutions to hold risk-based capital equal to 7.2 percent (initially 6.4 percent; 8.0 percent beginning December 31, 1992) of their risk-weighted assets. For some institutions, new commercial mortgage lending was also constrained by discrete concentration limits.

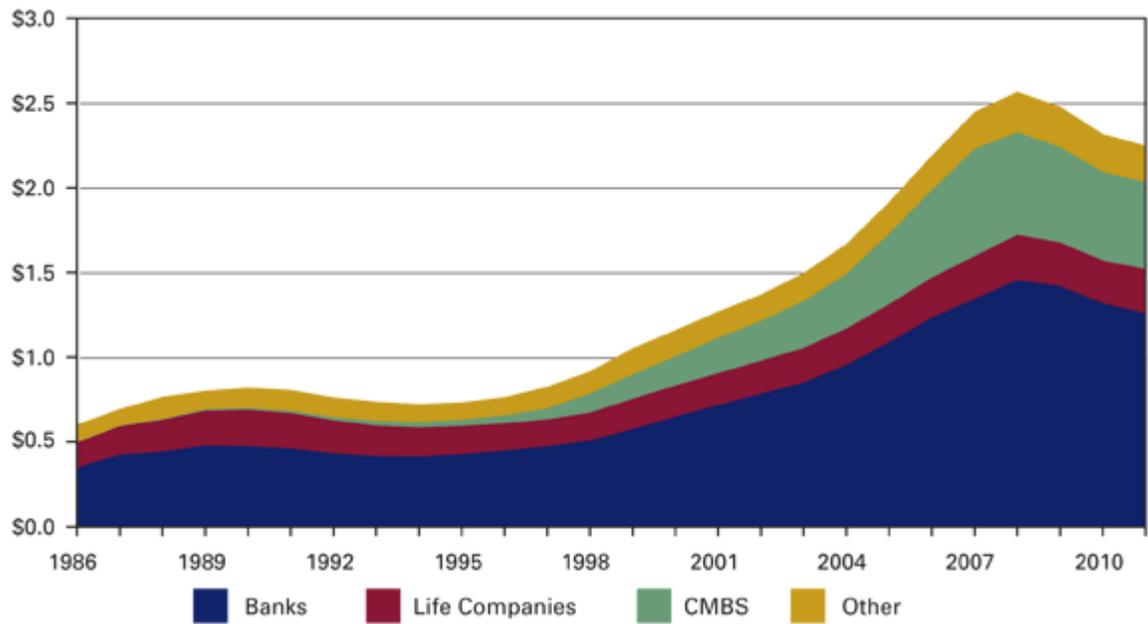
Figure 1: CMBS issuance



Source: Chandan Economics.

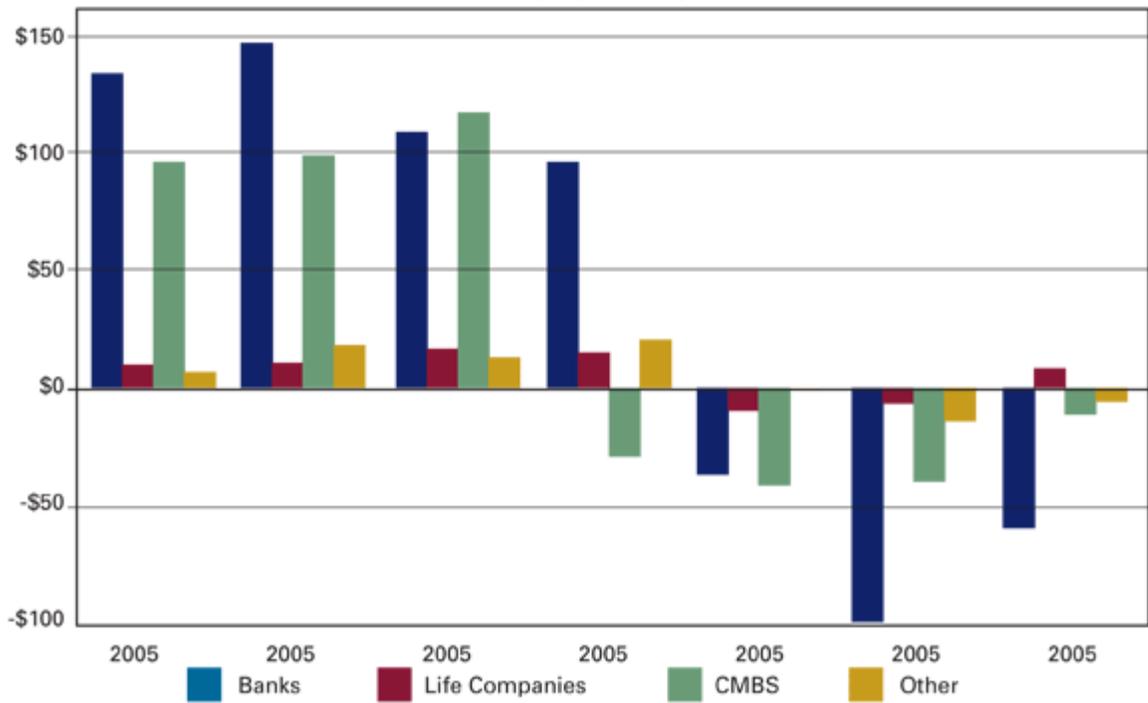
With the costs of portfolio lending rising, the institutional structures of CMBS markets matured. Bond ratings opened investment to a wider range of passive investors and secondary market liquidity increased. By 2001, CMBS displaced life company loans as the second largest pool of commercial mortgages outstanding (Figure 2). During 2007, the net increase in CMBS balances surpassed banks (Figure 3). The latter had been under increasing regulatory and supervisory pressure since at least early 2006, when the major bank regulators formally expressed "that some institutions have high and increasing concentrations of commercial real estate loans on their balance sheets," adding that they "are concerned that these concentrations may make the institutions more vulnerable to cyclical commercial real estate markets."

Figure 2: Commercial mortgages outstanding by lender group, excluding agency multifamily and construction loans (in \$ trillions)



Source: Federal Reserve.

Figure 3: Net change in commercial mortgages outstanding by lender group excluding agency multifamily and construction loans (in \$ trillions).



Source: Federal Reserve.

To the extent that deepening credit markets and low interest rates were amongst the complex set of factors that contributed to rising property values during this period, passive investors' diminished perceptions of risk enhanced the competitive position of CMBS versus balance sheet financing. Investors' required yields fell, reflected in narrower bond spreads that allowed conduit lenders to compete more aggressively with banks (Figure 4). Even as debt yields declined, a larger share of each deal was assigned to the senior or super-senior tranche. For example, AAA credit enhancement generally exceeded 30 percent in 1996 and 1997 but had fallen to an average of just 12.1 percent by 2007 (Figure 5). By way of context, estimates of the losses on the 2007 CMBS vintage have been projected to exceed 20 percent.

Figure 4: CMBS AAA spreads over swaps (basis points).

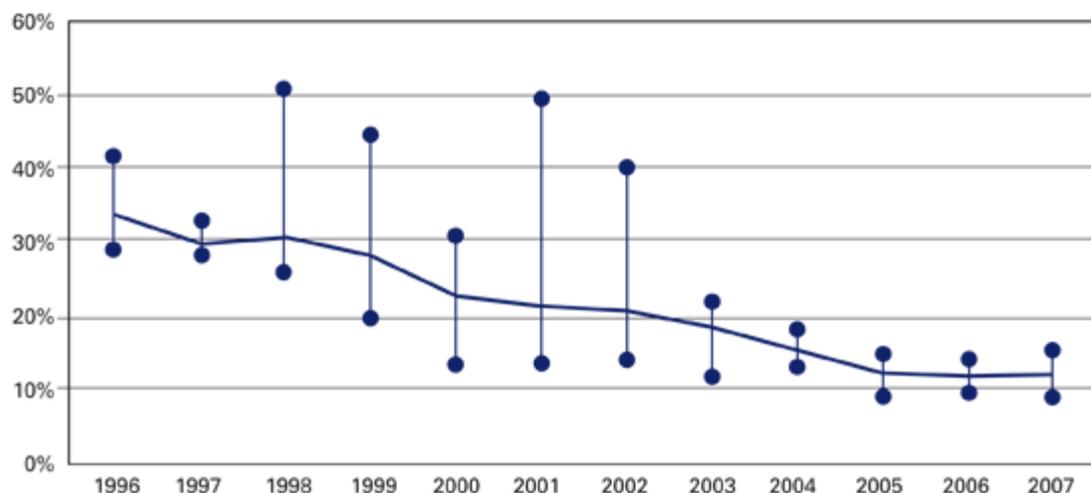


Source: Trepp.

An endogenous relationship between property prices, investor assessments of risk, and declining subordination requirements during this period showed little sensitivity to the cyclical default and loss characteristics of commercial mortgages. A self-reinforcing cycle of low-cost credit, higher leverage, and rising prices limits the potential for self-correction until some unsustainable level is reached, triggering a crisis during which property values fall below their indebtedness.

In the case of the CMBS market, the market structure itself may exacerbate pro-cyclical lending. Ratings shopping, wherein market structures may allow issuers to select the ratings agencies that offer the most favorable credit assessments, contributed to a decline in bond and loan quality as well. In their working paper on CMBS subordination, Richard Stanton and Nancy Wallace of the Haas School of Business attribute changes in subordination to regulatory-capital arbitrage, finding that "the difference between AAA CMBS yields and AAA corporate bond yields fell significantly in the years after 2002, when risk-based capital requirements for highly rated CMBS were lowered greatly. No comparable drop in relative yields occurred for lower-rated bonds."

Figure 5: Average and range of AAA credit enhancement level by vintage.



Source: S&P.

Pre-crisis research attributes some of the incentives for securitization to arbitrage or reputational considerations, finding that loans retained on bank balance sheets experienced higher rates of default than mortgages that were transferred to securitization. In the denouement of the market peak, delinquency and default rates on commercial mortgages increased rapidly. The performance of CMBS mortgages deteriorated further than for other lender groups, which may reflect changes in the conduit origination path and the competitive position of conduit originators and portfolio lenders in the final years of the run-up. Differences in CMBS loan performance across originator types also appear to have been significant determinants of variation in loan performance, reinforcing that incentives and moral hazard are potential and realized features of the prevailing structure of securitization markets.

CMBS Present And Future

Following a protracted period of illiquidity and retarded price discovery, investment, asset prices, and credit conditions began to improve in late 2009. That improvement was circumscribed, however, with gains concentrated among high quality assets and borrowers in a small set of historically very active investment markets. With preferential access to capital, listed REITs became the dominant (net) acquirers of assets in 2010 and 2011. For competing bidders with a greater reliance on secured financing, life companies, foreign bank lenders, and national and large regional banks have been the primary sources of new credit. In 2011, life companies were the only major group to register a net increase in commercial real estate lending. Still, spreads on loans in the office and apartment sectors narrowed for the most coveted assets, falling below historic norms by mid-2011.

As CMBS lending has resumed under a "CMBS 2.0" moniker, its impact has been observable across a much broader geographic area. In primary markets, CMBS in late 2010 and early 2011 accounted for less than 10 percent of loans. Even at its relatively low volume, it accounted for approximately 15 percent and 25 percent of issuance in secondary and tertiary markets, respectively. Reliant on well-diversified collateral, conduit lenders have necessarily grown more active outside of cardinal markets, in locations where the lender landscape is more thinly populated, where lending competition is more subdued, and where higher spreads are more supportable. Retail and industrial properties have been the primary beneficiaries of new CMBS activity (Table I). Multifamily lending, on the other hand, has accounted for a de minimis share of issuance on account of more favorable terms available through agency financing.

Table I: Original balance characteristics of CMBS loans originated and securitized in 2011 (\$ millions)

Property Type	Mean	Median	≤ \$10M
Hospitality			
Full Service	\$40.5	\$24.4	14%
Limited Service	\$16.3	\$12.0	39%
Industrial	\$20.9	\$13.2	44%
Mixed Use	\$25.4	\$15.3	31%
Office	\$36.8	\$21.5	23%
Retail			
Anchored	\$31.7	\$12.8	39%
Unanchored	\$13.8	\$6.6	60%
All Commercial Properties	\$29.5	\$15.0	35%

Excludes single-borrower deals and loans accounting for more than 30 percent of total deal balance.

Source: Chandan Economics.

Constraints on many regional and community banks' capacity to extend credit in support of smaller markets' commercial property sales and refinancing needs are likely to persist for some time. Particularly in cases where the bank lender has significant exposure to legacy construction and development lending and in cases where the management of legacy distress has proven unwieldy, regulatory and supervisory pressure may require a long-term drawdown of exposure to the commercial property sector. Given a paucity of alternative credit sources in these markets, liquidity has been significantly enhanced as conduit lending has increased. The immediate value of CMBS in meeting the market's financing needs will increase as more legacy debt matures over the next several years.

Almost as soon as CMBS issuance resumed, the less conservative geographic and property mix began to raise questions about the quality of assets being bundled into new issues and concentrations in the largest loans. Stressed measures of loan risk have risen. As compared to pre-crisis issuance, new deals are more disciplined. Consensus benchmarks for a target level of discipline are elusive, so the quality debate continues. For market skeptics, the absence of a comprehensive structural overhaul of CMBS means the current bias in favor of conservative underwriting will ultimately give way to greater risk-taking as the market normalizes. While the mix of loans and underwriting standards embedded in forthcoming deals may weed out more risk-averse investors, there are other reasons to be cautious in welcoming a resurgence of CMBS activity. Aside from the record-high volume of loans in special servicing, many of the structural issues that were material contributors to the CMBS market's crisis-period collapse remain unaddressed or poorly understood.

The Commercial Real Estate Finance Council (CREFC) has made progress in addressing investors' desire for a more transparent and well-functioning market. The recently released CMBS 2.0 standards are evidence of that progress. Among the other provisions, new guidelines address lenders' representations and warranties to investors regarding an issue's loans and the due diligence performed on properties and borrowers. The guidelines also provide model remediation language, outline underwriting principles intended to minimize the risk of loan non-performance, and further standardize issues' Annex A files.

Conclusion

The industry's progress in enhancing its capacity for self-regulation is laudable. However, the empirical findings regarding incentives raise serious questions that extend beyond the achievement of CMBS 2.0. In the near- to medium-term, uncertainty related to methodological standardization across ratings agencies, the performance of the legacy market under increased stress from maturing debt, and risk retention requirements specified in Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act have fueled a divergence of expectations about deal flow. Opponents of across-the-board risk-retention requirements for CMBS argue that it will unnecessarily raise costs and inhibit issuance. In May 2011 testimony before the Senate Banking Committee, the CREFC pointed to the initial improvements in CMBS volume and cited the "securitization risk retention framework mandated by Dodd-Frank [as] the biggest threat to sustaining that recovery." There is certainly a danger that some elements of the implementation will have deleterious consequences unanticipated by the Act's framers.

Even if some implementations of risk retention will adversely impact issuance, the motivation properly reflect that CMBS pools have performed poorly during this cycle and that the market structure is partly indictable in this outcome. As noted in a recent Federal Reserve Board of Governors report, "the financial crisis has highlighted several ways in which the incentives of participants in securitization markets may have been misaligned with incentives one would expect to find in a well-functioning market." The elevated rates of CMBS delinquency and default are consistent with structural weaknesses in the securitization market that are not replicated elsewhere to the same degree. The impact of market failure is not contained; the externalities from CMBS losses are felt across the property market.

One example of these spillovers presents a challenge for the nation's banks, where the incentives to project long-term loan performance at origination are different from those for conduit lenders. Rising competition from the conduit can ultimately undermine loan quality among its competitors, including the regulated banks. CMBS may be underwritten more carefully now than a few years ago, but this cyclical focus on risk is not a substitute for measures that will ensure the long-term health and sustainability of the industry. The structural assessment of CMBS that addresses the range of incentive conflicts with practical and implementable remedies is incomplete. In the best case, industry-led efforts will intensify, limiting or precluding inflexible regulatory regimes and encouraging rather than impeding robust securitization activity. In the worst case, inattentiveness to incentive conflicts will allow the current bias in favor of conservative underwriting to cede to undue risk-taking later in the cycle. In the immediate future, demand for new issuance will be evidence of sufficient lessons learned and the cycle will threaten to repeat itself again.

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