Don't Wander Back to Old CMBS Habits

Remember the lessons learned by players in the commercial mortgage-backed securities market after the 2008 crisis

By Ann Hambly, founder and co-CEO, 1st Service Solutions | bio

Commercial mortgage professionals and their clients have been eagerly anticipating being able to reap the benefits of a less-restrictive credit market this year. A late-2013 survey by PricewaterhouseCoopers (PwC) and the Urban Land Institute indicated that commercial lenders expected to loosen the restrictions on lending that they imposed after the 2008 credit crisis.

The survey indicated that some of the credit-quality worries lenders had have faded with time, and in the minds of many in the real estate and financial industries, the headwinds have changed to tailwinds, according to a report from Bloomberg.

To determine if the mortgage and lending industries have worked through and solved all of the systemic problems sufficiently to ensure that they don't enter into another credit crisis like the one in 2008, it is important to look more closely at what caused the crisis to begin with. It is also critical to compare it to today's practices to ensure that changes have been made to avoid the mistakes of the past and prevent a similar financial crash from happening.

Background

What caused the crisis to begin with? Although it wasn't the sole culprit, commercial mortgage-based securities (CMBS) played a major role.

The attitude toward CMBS in the industry before the crash can be summed up by the answer to the hypothetical question, "How long will you play a game with me where for every dollar you give me, I give you two dollars back?" For many people in the industry, the answer was easy: forever. And conventional wisdom back in those days was that CMBS worked because of that answer. There is some truth to that. That's because of the structure of the CMBS model.

To fully understand the structure, it is helpful to know why the CMBS market was developed in the first place. It was created as a way to deal with hundreds of billions of dollars of commercial mortgages and other assets that the Resolution Trust Corp. (RTC) inherited when it liquidated the failed savings and loans in the late 1980s.

The RTC needed to sell these assets but found a financial gridlock had created almost total illiquidity for commercial real estate mortgages. To liquidate this huge portfolio, the RTC had to find new investors, so it turned to the eager capital markets which, at the time, had little or no commercial mortgage exposure.

As the prospective buyers of this immense portfolio, capital markets — banks, life companies, etc. — were the entities that could best absorb this kind of debt, and the capacity to do so was virtually unlimited contingent on the industry finding a way to rate the credit risk. That is in essence how today's CMBS model was born.

The boom

What eventually emerged was a CMBS model of “originate to distribute,” meaning the company that originated the loan and ultimately securitized it was not the one that would suffer the loss if the loan failed. This is where the analogy of getting two dollars back for every dollar you give came from.

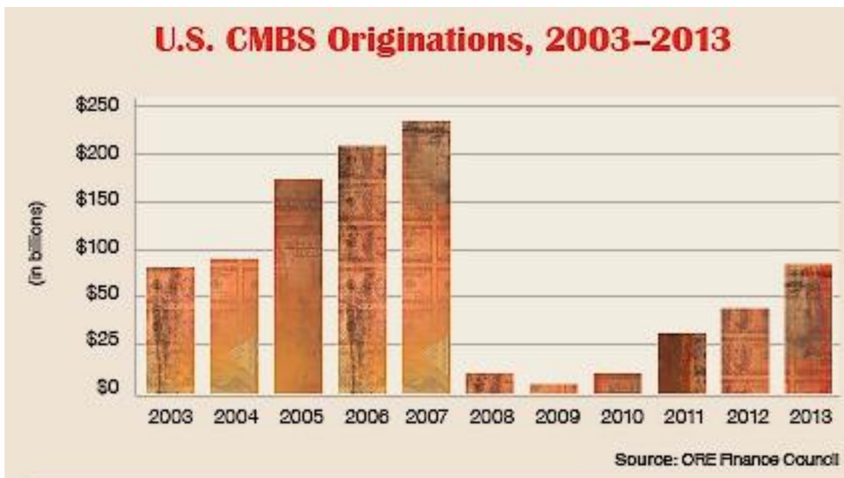
A review of U.S. origination-volume statistics from the CRE Finance Council shows that the CMBS market heated up in the early part of the past decade and got especially competitive from ’05 to ’07, reaching a high of $230 billion in originations in ’07 before plunging to $12 billion in ’08.

As a result of the intense competition that emerged when the booming CMBS market took off, there was a clear difference between the underwriting quality of the loans originated when the CMBS model first emerged and that of the ones originated in the heydays between ’05 and ’07. The change was not for the better, ultimately.

At that time, investor demand increased and competition grew swifter, leading to the following significant differences in the underwriting standards from pre-2005 to the heady CMBS market of ’05 through ’07:

- **Loan-to-value ratio (LTV):** Before 2005, LTV ratios were between 65 percent and 75 percent. From ’05 to ’07, LTV ratios increased to 80 percent.
- **Amortization:** Until 2005, there was no interest-only amortization; from ’05 to ’07, amortization was mostly interest-only.
- **Reserves:** Before 2005, reserves were required. In the boom period, reserves were often waived.
- **AAA bonds:** These were issued for 70 percent of loans before 2005. Through 2007, the rate increased to 90 percent.

The crash



Combine the extremely competitive CMBS market and the significantly less stringent underwriting standards that became predominant from ’05 to ’07 with the major decline in real estate values that occurred in ’08, and it adds up to a crisis. The impact of the CMBS boom from ’05 through ’07 resulted in an abundance of situations where commercial property was worth less after ’08 than it was when the loan was made in, say, ’07.

Typically, the principal balance had not been paid down because the loan was interest-only, the property had been cash-strapped because there were no reserves and the borrower likely had to use all available money to keep the loan current, and the property may have had tenants who were paying lower rent than they had previously. Overall, it was — and still is — a recipe for disaster.

Reforms

After the market crash of ’08, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in ’10. The act focused on making changes to the securitization model so the lending organizations that create and securitize loans have skin in the game in the long term, which they did not in the previous CMBS model. The end product of these changes, in theory, would alter behavior in the underwriting of the loans and avoid a replay of 2008’s crash.

The question is: Did they? Going back to the PwC survey from this past year, the conclusion could be drawn that many professionals in the financial and real estate industries believe that the problems that led to the crash have been fixed and their worries are behind them — that it’s all tailwinds going forward.

Lessons learned?

To determine if facts support the conclusion that the system has been fixed, take a look at the current year.

By this year, the majority of the Dodd-Frank regulations that were proposed in ’10 have been implemented. And as is inevitable with most regulations, clever professionals in the mortgage and financial industries may be finding ways around them.

Many mortgage originators and bankers experienced firsthand the hard-won lesson that it is not a good idea to make CMBS loans with the characteristics of those originated in the period from ’05 through ’07. Imagine going back to the practices of that time and doing a deal with, for example, no reserves for tenant improvements or leasing commissions on an office loan with a big tenant that will roll over a few years after origination. Many mortgage professionals know not to do something like that now, don’t they?

Stop for a moment and think of any negative event that had a major impact in your life. At the time, you probably thought that you would never forget how horrible that day was and how it changed your life. Yet, it’s easy to forget those bad events if you don’t stop to think about them.

In much the same way, if everyone isn’t careful, it will be too easy for the industry to collectively move forward and forget the lessons of the market crash of ’08. This is especially true when people think they’re once again playing the game where they get two dollars back for every one dollar they give.

Concerns

Unfortunately, recent trends identified by market observers point to signs that the commercial real estate and financial industries are starting to forget the unsustainable practices of the past that led to the financial crisis of 2008.

- **Loan-quality decline.** There was a dip in CMBS loan quality for the loans originated over the past year, according to a report from Kroll BondRatings released late this past year. Gradual deterioration in underwriting standards was detected based on the Kroll BondRatings’ sampling methods and analysis of the top-20 loans in the pools it rates.
- **Higher CMBS loss rates.** The credit quality of new-issue CMBS is expected to deteriorate this year as the result of increased competition among lenders and higher tolerances from B-Piece buyers, the highest-risk bond holders at securitization, according to a statement from Standard & Poor’s (S&P) this past December. Deals completed this past year were already riskier than deals done in ’12, and the slipping loan standards will translate into higher loss rates for CMBS deals issued in this past year than those issued in ’12, according to S&P.
- **Underwriting deterioration.** Wall Street banks that securitize CMBS deals are foregoing rankings from Moody’s Investors Service on the higher-risk aspects of the deals, according to a report from Bloomberg this past October. Because of declining underwriting standards, Moody’s isn’t willing to label low-ranking debts as investment-grade. In the same report, JPMorgan Chase & Co. analysts said that CMBS underwriting had “steadily deteriorated” this past year.
- **Pressure to compete.** This past December, Fitch Ratings noted the declining CMBS credit quality in a report that indicated small and new CMBS originators were being forced to make less-desirable loans and were allowing their underwriting quality standards to slip because of pressure to stay competitive with bigger, more established lenders.

• • •

How quickly the market forgets. Signs point to the lessons that should have been learned from the market crash being forgotten by many commercial real estate professionals and financial institutions when it comes to CMBS, although no one in the industry wants to see, or can afford, a repeat of what happened in 2008. For mortgage brokers and bankers, it’s not too late to heed the wisdom of the old saying, “Those who forget the past are doomed to repeat it.”

Ann Hambly is the founder and co-CEO of 1st Service Solutions, the first company to serve as a borrower advocate and the first company to be officially rated as an operating adviser. To date, 1st Service Solutions has resolved $11 billion in commercial mortgage-backed securities loans on behalf of borrowers and has more than $4 billion in process. For other articles and webinars, visit 1stsss.com. Reach Hambly at (817) 756-7227 or ahambly@1stsss.com.