CMBS Uncertainty Threatens Lenders

The securitized-loan market is coping with a dearth of much-needed predictability

By Ann Hambly

The commercial mortgage-backed securities (CMBS) business is a numbers game. CMBS conduit lenders generate profits by selling commercial loans into the secondary market, where they are packaged into pools, securitized and the resulting bonds sold to institutional investors. The lender's premium on such deals is driven by the yields investors receive from their bond investments.

A key to success for conduit lenders is the predictability of the bond spread — which is the difference between yields for two bonds with differing credit ratings. Another major factor is the assurance that there will not be an extensive period of time between origination and sale of the bonds. Without predictability, the game is a gamble, and a high risk one at that.

The length of time a conduit lender has an originated loan on its balance sheet before securitization is called the "warehouse period." The shorter the warehouse period, the less the risk is to the originator. The longer the warehouse period, the higher the risk, because bond spreads can move in the wrong direction.

Bond-spread uncertainty

There are probably more reasons for instability now than ever before in the history of CMBS lending, but a few stand out:

■ **Oil-price volatility:** Many CMBS loans were originated in 2013 and 2014, when oil was at its peak, and secured by properties that were heavily, if not solely, dependent on the oil boom. Once oil prices dropped sharply, the values of many of these properties dropped almost as drastically and, in some cases, the properties had very little or no income to support the debt. Oil-price fluctuation will ultimately determine the fate of these properties, so the market is taking a wait-and-see approach.

■ **Interest-rate hikes:** Almost everyone is prepared for small, gradual increases in interest rates from the Federal Reserve. But a sharp increase and/or a sustained spike would create even more CMBS volatility.

■ **Capital constraints:** New capital regulations, Wall Street reform measures, consumer-protection mandates and rules promulgated by federal banking agencies are requiring lenders to maintain higher capital levels for commercial real estate. This has impacted lender profitability and investment strategies, especially with respect to loans originated for the purpose of selling — regardless of whether the sale is to Wall Street bond buyers or other investors. This is causing many lenders to pull back from CMBS conduit-loan originations.

■ **Risk-retention regulations:** The risk-retention rules that will take effect in the fourth quarter of this year are a big driver of instability. The rules, mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act and written by several federal regulatory agencies, require the issuer of a securitization to retain 5 percent ownership in the bond structure. If a third-party buyer purchases the 5 percent bond piece, that investor will be required to hold the bonds for five years. This could reduce the overall profitability of a CMBS structure and will likely increase the cost of borrowing overall. The effect of the regulations could be significant for conduit lenders, who have never before been required to retain ownership in the bond structure after securitization.

There are plenty of other factors that can affect the market, including the global economy and the outcome of the presidential election.

Lenders leave market

The net effect of all this is a significant reduction in the number of conduit lenders, as well as a possible reduction in overall CMBS origination volumes. There already have been announcements this year of some key conduit lenders exiting the market. Smaller conduit shops have pulled back from the market temporarily, and the big lenders are hesitant to price loans, given the uncertainty of the warehouse risk in a volatile bond-spread environment.

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Scotsman Guide

Reprinted from *Scotsman Guide* Commercial Edition and **ScotsmanGuide.com**, June 2016

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Conduit origination activity in 2007 skyrocketed to well over $200 billion. In the three years between 2005 and 2007, conduit origination totaled more than $550 billion, which, of course, led to the overall CMBS maturity bubble. After the market crash of 2008, through 2012, conduit origination was minimal. In 2015, the total volume was close to $100 billion, or less than half of what was originated in 2007.

All of this instability could not happen at a worse time in the CMBS industry. More than $200 billion of CMBS loans will mature in 2016 and 2017. According to many industry sources, 35 to 40 percent of those coming due this year will likely not be in a position to pay off at maturity. In 2017, the number is expected to be even higher, with almost half of the loans not expected to pay off at maturity.

A key assumption in many CMBS forecasts has been that the conduit-lending market would remain alive and well. In many cases, new conduit financing or highly creative loan structures will be required to provide the funding necessary to pay off the maturing, highly leveraged CMBS loans. Without the conduit-lending market, the maturity-payoff numbers will likely get worse.

Uncertain future

The current market has eliminated the predictability that is a key ingredient to the success of CMBS conduit lenders. The conduit originator needs to be able to predict when the loan will be sold and for how much, which is dictated by the bond buyers.

Accomplished forecasters in the origination business might accurately predict one area of uncertainty, such as oil-price swings, the affect of new banking regulations, or the winner of the presidential election. But the chances of accuracy dwindle if you are expected to predict all of those variables correctly, as well as the many others that will dictate the future of the conduit market. ■

Reprinted from *Scotsman Guide* Commercial Edition and **ScotsmanGuide.com**, June 2016