

COMMERCIAL MORTGAGE SECURITIZATION— AN OVERVIEW

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The securitization of residential mortgages during the late 1970s and 1980s has been very successful and lucrative for the entire industry. Securitization allowed lenders to maximize loan activity by effectively and quickly recycling funds available to loan. Collateralized residential mortgages became one of Wall Street's shining stars of the 1980s and continue to be an important vehicle in the 1990s. Now, it appears the era has begun for commercial mortgage securitization.

Although the general concepts between residential and commercial mortgage securitization are somewhat similar, there are several key structural differences that have caused commercial securitization to stumble for over a decade, while residential securitization has been incredibly successful.

Residential vs. Commercial Securitization

Table 1 highlights the differences between commercial and residential securitization. First, the U.S. government established programs to promote and encourage home ownership through guarantees and special loan programs. Guaranteed repayment of principal and interest by governmental and quasi-governmental agencies like Fannie Mae, Freddie Mac and Ginnie Mae is a very attractive attribute of residential mortgages in the secondary mortgage market. There is no equivalent for commercial mortgages.

Second, most residential mortgages are written using standard underwriting and documentation. This facilitates packaging into securitized structures and also eases the ability to forecast performance based on past performance of similar assets. Similarly, home mortgages tend to be in a relatively small dollar range, \$25,000 to \$500,000, while commercial mortgages can range from under \$100,000 for a small commercial building to several hundred million dollars for a major office building. It is obvious why standardization of commercial mortgages would be difficult given these parameters and why development of generally accepted rating models also has been difficult. The rating models in place during the 1980s imposed a very strict and unwieldy process that was unworkable given the rapid financing changes prevalent in the mid-1980s commercial real estate boom. During the 1980s, there was no reason to struggle with commercial securitization since so many other capital sources were readily available. These other sources were

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relatively easy and cheap alternatives that effectively crowded out commercial mortgage securitization.

TABLE 1

Commercial vs. Residential

<u>Residential</u>	<u>Commercial</u>
<ul style="list-style-type: none"> • Guaranteed by US Government (FNMA, FHLMC, GNMA) • Standardization of underwriting & documentation • Wealth of long-term performance data to assist statistical analysis • Existence of generally accepted rating models 	<ul style="list-style-type: none"> • Not generally guaranteed • No established standards • Dearth of dependable, long-term performance data • First rating models introduced in November 1984 with limited applications.
<ul style="list-style-type: none"> • Easy money readily available in 1980s 	<ul style="list-style-type: none"> • "Hard money" ignored in favor of more readily available funding in 1980s.
<ul style="list-style-type: none"> • Advent of credit crunch in 1989 brought drastic change in real estate capital markets. 	<ul style="list-style-type: none"> • Advent of credit crunch in 1989 has brought drastic change in real estate capital markets.

The glory days of commercial real estate have been over for quite some time. The savings and loan crisis, an overbuilt market and new government regulation (specifically FIRREA) brought a drastic change in lending policy, drying up the credit which was readily available only a few years earlier. Lenders became focused on cleaning up existing messes rather than extending credit. The recovery of traditional lending activity will continue to be extremely slow. Because of this, a window has opened to commercial securitization.

Securitization Structures

Securitization is the process of dividing or segmenting the cash flow associated with a group of discrete assets into new cash flow streams or classes of particular interests to certain investors. Securitization can be accomplished through single class or multiclass structures (See Table 2).

In a single class instrument, all investors are treated identically. This is a very simple structure. In a multiple class instrument, investors are able to choose one of several classes, which are given different preferences. Instruments anywhere between 2-8 classes and larger are possible. Typically, all classes are paid interest currently while all principal goes to the first class until repaid in full. Obviously,

the first classes will have an investment of considerably shorter duration than subsequent classes. This is an important feature of the multi-class structure since some investors need an investment with a relatively short maturity while others look for a longer term investment.

TABLE 2

Securitization Structures

- Whole loans
- Participation certificates
- Single-class securities
- Fast pay/slow pay multi-class structure
- Senior/subordinated multi-class structure
- Zero coupon security (class)
- Participating security (class)
- Hybrid

Senior/subordinated multi-class structures

One specific example of a multi-class investment is the senior/subordinated multi-class structure. In this structure, the senior class has first priority for repayment of interest. If done properly, this structure should allow the senior class to be rated as a suitable investment vehicle by the rating agencies. The subordinate class boosts the overall collateralization of the structure, which strengthens the senior class instrument. The subordinated class, because it is second in line, is usually not investment grade, but can be attractive to big investors seeking a higher interest rate and willing to accept greater risk.

Another example of a multi-class structure involves strips of investments. This is a modified multi-class structure. Each class receives a designated portion of the underlying cash flow. For example, Class A might receive 60%, Class B 30% and Class C 10% of principal received until the class is paid off. Assuming that the classes have relatively equal original balances, Class A will pay off much faster than the other classes, which offers several options for the investor. One specific strip structure commonly used is the interest only/principal only (IO/PO) strip. This is a two class structure where, as the name implies, all interest received flows to one class while all principal received flows to the other class. Clearly, the principal class would be much larger than the interest class. As one might guess, the structural possibilities are numerous, limited to the creativity of the deal structure and what the market finds attractive.

Typically, all classes in a multi-class structure are paid interest currently. However, one variation is

TABLE 2.1

RTC Mortgage Trust 1993-N1

Loans	# Of Loans	Book Balance	% Of Total Pool DIV Balance	DIV Balance	% Of Total Pool DIV Balance
>\$300,000	310	\$575,648,000	93.16%	\$282,388,000	93.16%
<\$300,000	427	\$ 42,242,000	6.84%	\$ 20,721,000	6.84%
Total	737	\$617,890,000		\$303,109,000	

to defer the payment of interest on a particular class or on the instrument as a whole. The name normally associated with instruments or classes that defer interest is zero coupon, Class Z or accrual bonds. These structures are paid neither principal nor interest until all prior classes are paid in full. Once again, although the risks may be higher, the return is also higher. There are many investors in Class Z residential CMOs from the mid-1980s with bonds accruing interest at 11% and more, a tremendous return for government guaranteed bonds in today's market.

Financial structure

The following example, a transaction known as the RTC Mortgage Trust 1993-NI with Salomon Brothers as investment advisor, demonstrates the financial and organizational structures needed for success in securitization of a pool of non-performing loans with a multi-class structure.

The securitization consisted of 737 loans with a total book balance of \$617,890,000. DIV calculations were performed on all loans with a principal balance of \$300,000 higher, which came out to be 310 loans. These 310 loans had a total book balance of \$575,648,000 and the Derived Investment Value (DIV) balance for these loans was \$282,388,000. The DIV balance for the remaining loans was extrapolated based on the ratio of DIV to book balance of the >\$300,000 loans. These 427 <\$300,000 loans had a DIV balance of \$20,721,000. Table 2.1 provides a brief synopsis of the DIV calculations and the book balances of the loans.

The securitization involved four separate bond classes. The transaction was assumed to have a disposition rate of 7%, meaning that 7% of the assets were to be disposed of quarterly. The disposition factor was 100%, which meant that each asset was assumed to be disposed of at 100% of DIV value. Table 2.2 summarizes the transaction structure.

The total face value of the bonds issued for this securitization is \$225,000,000, which is approximately 74% of the DIV value and 36% of the book balance. The coupon rate is segregated into two separate rates. The initial rate is the beginning rate of the class. The highest rate represents increases in interest based on the failure of the pool to meet performance objectives regarding the disposition of assets. Should these performance hurdles not be met, the coupon rate triggers higher, increasing up to the maximum rate established as the highest.

Based on the face value of the bonds and the total book balance of the loans, the total gross receipts (not including transaction costs) as a percentage of book value are calculated in Table 2.3.

Total gross proceeds from the securitization were 35.41% of the total book balance of the loan pool and 72.165% of the DIV value of the loan pool. The risk increases the higher the bond class. With this added risk comes an increased incentive for investment in the form of higher interest rates. The yield of each bond class is increased from the coupon rate if the price is less than 100% and decreased

TABLE 2.2

Transaction Summary

Class	Bond Amount	Coupon Rate		Fixed/ Variable	Price	WAL*	Yield**	Rating	
		Initial	Highest					S & P	Fitch
1	\$114,000,000	4.75%	12.00%	V	100.00%	0.89	L + 152 BP	AA	AA +
2	\$ 43,000,000	6.50%	9.50%	F	96.56%	1.68	9.00%	BBB +	A +
3	\$ 48,000,000	9.00%	12.00%	F	94.69%	2.16	12.00%	BB	BB +
4	\$ 20,000,000	9.00%	12.00%	F	89.13%	2.50	14.50%	B -	BB +

*WAL indicates weighted average life of the assets used to payoff the respective class.

**Variable rate is LIBOR + 152 basis points.

from the coupon rate if the price is greater than 100%. In the case of the RTC Mortgage Trust 1993-N1, the discount (the difference between the face amount of the bonds and the purchase price, represented as a % by price) increases as the class gets higher. Thus, it can be said that the coupon rate of the Class 4 bonds is not justified according to the rating, and the market makes an adjustment to price to bring the yield in line with the risk.

TABLE 2.3

Bond Receipts As A % Of Book Balance

Class	Bond Amount	Price	Gross Receipts
1	\$114,000,000	100.0000%	\$114,000,000
2	\$ 43,000,000	96.5625%	\$ 41,521,875
3	\$ 48,000,000	94.6875%	\$ 45,450,000
4	\$ 20,000,000	89.1250%	\$ 17,825,000
Total	\$225,000,000		\$218,796,875
Gross Receipts as a % of Bond Amount	97.243%		
Bond Amount as a % of Book Balance	36.414%		
Bond Amount as a % of DIV	74.231%		
Gross Receipts as a % of Book Balance	35.410%		
Gross Receipts as a % of DIV	72.165%		

Investor Structure

The organizational structure of a typical RTC securitization includes large financial investors and a servicer. In the RTC Mortgage Trust 1993-N2 transaction, the Wilmington Trust Company was the owner trustee, and the bond trustee was the Bank of America National Trust and Savings Association.

The Investors Limited Partnership held a 49% Class A share, while the RTC held a 51% Class B share. The Class A share is broken down further between limited partners and general partners. In this example, the investors as limited partners held a 98% stake in the non-RTC share with the general partnership holding the remaining 2%. This general partnership is comprised of equal ownership among Aldrich, Eastman & Waltch, L.P., J.E. Roberts Company, and Secured Capital Corp. and a 1% ownership stake held by a management corporation which is equally owned by the three. These groups handle the servicing of the trust, including servicing fees, disposition fees and distributions under a servicing agreement between the owner trustee, the investors limited partnership and the management limited partnership.

Securitization Process

Regardless of the structure employed, certain fundamentals of the securitization process will apply.

There are many ways to illustrate the actual process of securitization. The most basic elements to begin the securitization process are the borrower, the investor, collateral and an intermediary. The borrower is the developer or financial institution that is looking to collateralize the mortgages and raise capital or restructure a portfolio. The investor is the party that will ultimately provide the funds to the borrower, acting as the lender. The collateral consists of mortgages or properties. A successful securitization would require seasoned and/or stabilized products. Securitization of properties or new mortgages on properties is referred to as primary securitization, while a transaction involving existing mortgages is referred to as secondary securitization. An investment banker is typically used to bring all the parties together, coordinating the efforts of the underwriting and documentation processes, developing a proper structure, closing the transaction and marketing and distributing the product.

From the issuer's perspective, the first and probably most important step is preliminary planning. At this stage there are three key steps: establish objectives, identify collateral and inventory the type and quality of data. It is critical for the issuer to know **why** it wants to pursue securitization. Like any business endeavor, without clearly defined objectives the project is likely to drift aimlessly, which is inefficient and quite expensive. By establishing objectives, all the necessary people, from top management down, will be focused in the same direction.

Second, the issuer needs to tentatively identify the collateral to be securitized. Certain collateral characteristics may lend themselves to a particular structure, pricing strategy or marketing approach. If the collateral has not been identified, drifting is likely once again. The third step in the preliminary planning stage is assessing the data. Are the files complete and well organized? Are they readily accessible? Are the necessary personnel available to get through the due diligence and documentation processes? Most issuers are not honest with themselves. The quality and availability of data is clearly important to the securitization process. The most obvious impact is on the timing of the project. The underwriting will take longer if the files are poor and time means money. Someone will have to gather all the information and gain a certain comfort level with the information. The costs of having employees finish this task is acceptable if they have the time and ability. However, if the condition of the files is overestimated, attorneys and accountants may be spending the time to gather missing information and reconstructing poorly organized information at significant billing rates. Regardless of the

actual condition of the data, it is important to complete a frank assessment and structure the timing accordingly in the preliminary planning phase.

The next step in the process is to evaluate alternatives. The structure of the deal should follow the economics of the deal. Careful consideration should be given to several structural possibilities which best fit the economics. After tentatively selecting an alternative, a first cut evaluation of the economic, accounting and tax consequences should be completed. Will the deal work based on the assumptions and projections? Some reconsideration of other alternatives may be necessary if the first cut results are unacceptable. Several iterations may ultimately be necessary.

At the same time that evaluations are being done, the due diligence should begin. The data should be assembled and organized for the due diligence team. The due diligence team will want to see all documentation relating to the deal, so it knows the deal structure reflects the reality. The due diligence should begin at this point even though the deal has not been finalized. Due to the amount of work to be completed in the due diligence phase, it is usually worth the risk to begin early so this task is completed on time.

Finally, the due diligence is completed and a final structure selected. At this point, the issuer must set the final timing and pricing of the project, considering the effects of market and interest rate changes. This is the point of no return for the issuer as the ultimate go/no go decision must now be made. The instruments then are distributed and sold to the investors.

Subsequent to the issuance of an instrument, there is ongoing administration and support required. This is important, but fairly mundane, consisting of collecting principal and interest from the underlying borrowers, distributing funds to the investors and complying with reporting requirements.

Credit Enhancement

Given the current condition of the real estate markets and economy as a whole, one of the key current topics in the securitization process is credit enhancement. Simply put, many mortgage pools are not strong enough to support a securitized instrument on their own. Credit enhancement techniques add to the strength of the instrument (see Table 3). The most common example is over-collateralization, meaning that the amount of collateral exceeds the amount of the bonds. This offers protection against defaults of the underlying mortgages. Another technique is that the borrower may be required to submit a line of credit or hold cash in reserve to cover cash shortfalls. A surety bond may be purchased from an independent party to cover

all or part of the amounts to be paid that may be defaulted. Mortgage insurance is similar in that an insurance premium insures against defaulted payment.

TABLE 3

Credit Enhancement

- **Overcollateralization**
- **Cash reserves**
- **Letter of credit**
- **Surety bonds**
- **Mortgage insurance**
- **Guarantees**
- **Loan substitution/repurchase**
- **Subordinated position**

Guarantees offer similar enhancement. Loan substitution and repurchase are less common situations. When this happens a bad loan is removed from the portfolio and replaced by another. Finally, certain classes may be subordinated, which strengthens the more senior classes. All these techniques bolster the credit worthiness of the instrument and make the instrument more appealing to the investment community.

Problems And Pitfalls

Certain problems and pitfalls have been encountered in the securitization process that can turn a potentially strong transaction into a costly failure (see Table 4).

TABLE 4

Problems & Pitfalls

- **Unrealistic expectations**
- **Poorly defined objectives**
- **Structure myopia**
- **Lack of issuer control / weak organizational commitment**

First, many issuers have unrealistic expectations: securitization is not a cure-all. Second, poorly defined objectives probably will cause the securitization process to fail. Many issuers do not know why they are pursuing securitization or what results to expect. It is difficult to find the destination when you don't know where you are going. Many issuers also suffer from structural myopia. There is a tendency to fixate on one alternative without sufficiently analyzing key attributes and other possible

alternatives. Finally, many issuers lose control over the process or fail to give the project adequate organizational commitment. Simply put, the securitization process requires a major commitment of time, human resources and financial resources. Without the commitment from key members of the organization, the effort will be terribly inefficient at best and a disaster at worst.

Potential Of Commercial Securitization

The biggest spark to the commercial securitization has been the RTC. In an effort to divest itself of the mortgages and properties acquired from failed savings and loans, the RTC has made a big entrance into the securitized commercial mortgage market. The RTC has demonstrated that this process can be a successful tool.

The potential for commercial securitization is tremendous and yet remains largely untapped. During the real estate boom of the 1980s, thousands of commercial properties were constructed and financed. These projects are the opportunities of the 1990s. As Table 5 illustrates, there are enormous dollar amounts of commercial mortgages out there waiting for the market to catch up. Given the credit crunch from more traditional financing sources, savvy investors, financial conglomerates and institutions have warmed to commercial mortgage securitization.

TABLE 5

Potential of Commercial Securitization

- Estimated \$800 billion of commercial mortgages available for securitization
 - RTC securities have paved the way for the commercial securitization market
 - Increased regulation forcing lenders to move mortgages
 - Emerging roles of industrial - financial conglomerates (i.e. General Electric)
 - Stabilization of real estate market through long-term capital over short-term high leverage financing
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Conclusion

There are numerous opportunities for all sorts of players. First and foremost, commercial securitization is an important new financing source. It can be used for new financing, which is quite scarce at this time, or as a means of restructuring and refinancing existing portfolios. Experts will be needed to structure and manage the deals from commercial securitization. This is a ground floor opportunity for lenders, investors, investment bankers, accountants, lawyers and consultants.