

The Case for the Return of CMBS

BY THOMAS A. FINK, CRE

OVERVIEW

THE UNITED STATES AND GLOBAL COMMERCIAL MORTGAGE-backed securities (CMBS) markets experienced sharp declines in issuance tied to the 2007–2008 financial crisis and have been slow to recover. As near-term uncertainties have continued to keep current issuance muted, it is prudent to examine the long-term health and prospects for CMBS. The author's view is that, after 18 months of continued turbulence, the market is highly likely to recover. The U.S. CMBS market should reset itself to a base outstanding balance of \$550–\$600 billion before resuming its growth, with new issuance recovering to approximately \$100 billion per year. See Figure 1.

Commercial real estate is a long-term investment that is best funded with fixed-rate debt of similar duration. CMBS is a viable and financially sound source of such debt for the commercial real estate industry. The outlook for issuance levels for 2013 through 2017 is driven by a number of factors:

COMMERCIAL REAL ESTATE ENVIRONMENT

- Improved property performance will lead to more real estate transactions, increasing the demand for capital;¹
- Up to \$2 trillion of debt is scheduled to mature over the next five years;²
- Commercial real estate property sales activity has been recovering.³

The improvements tracked to date, and the forecasts of continued improvement, are closely tied to continued recovery in the overall economy. A downturn in economic recovery leading to another recession could significantly reduce the level of investment property sales. The amount of commercial real estate debt sched-

uled to mature must be restructured or refinanced. The balance coming due exceeds the combined multi-family and commercial real estate mortgages financed during the peak of the last real estate cycle, from 2003–2007, when CMBS issuance accounted for almost one-third of the capital.⁴

About the Author



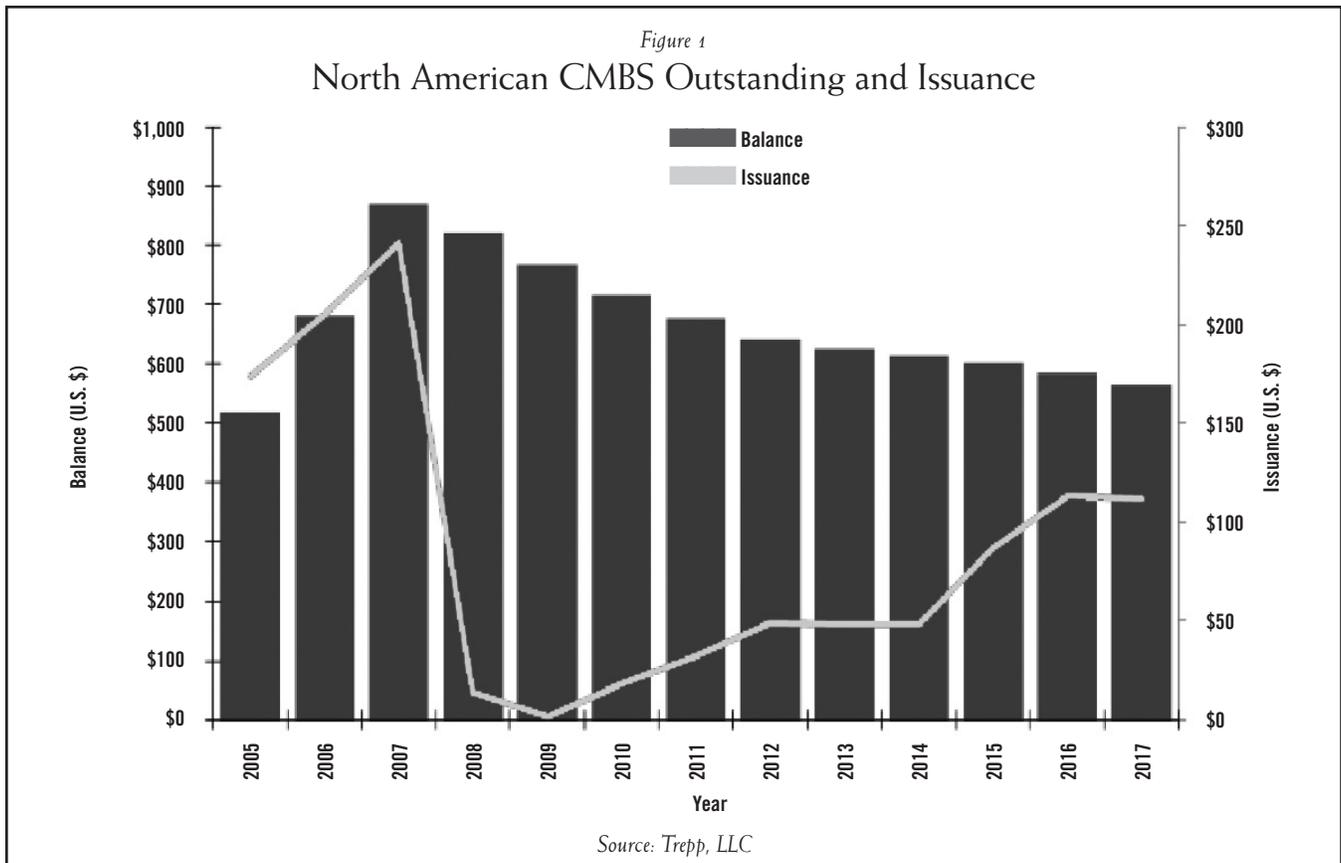
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At Trepp, Fink is responsible for business development, which includes identifying and building strategic relationships with third parties. He works with Trepp's major clients including investors, issuers, rating agencies and regulators. Fink has more than 35 years' experience in the financial markets, in diverse areas such as CMBS, leasing, economic development and tax-exempt securities. Prior to joining Trepp, he served as the CFO of the North American Development Bank. He also was a senior banker at several securities firms, including Blyth Eastman Dillon, Bear Stearns and Chemical Securities.

Fink has served on The Mortgage Industry Standards Maintenance Organization Board of Directors since 2009. He also serves on various committees for the Commercial Real Estate Finance Council, including the Global Initiatives Committee and the High Yield Debt and Investment Forum. He is a regular participant and speaker at industry conferences, particularly addressing the needs of reporting and transparency in the capital markets.

Fink earned a bachelor's degree in foreign service from the Edmund A. Walsh School of Foreign Service at Georgetown University, and a juris doctor degree from Seton Hall University.

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**LENDING ENVIRONMENT**

Traditional portfolio lenders, primarily banks and insurance companies, cannot meet the entire needs of the market:

- Portfolio lenders can finance about \$1 trillion of the \$2 trillion maturing;⁵
- Large commercial banks prefer short-term, floating rate loans. CMBS provides fixed-rate, long-term loans;⁶
- Community banks are under pressure to maintain higher capital levels;⁷
- Insurance companies want Class A properties in Class A markets with low loan-to-value ratios (LTVs);⁸
- Government sponsored enterprises (GSEs, e.g., Fannie Mae, Freddie Mac) must use capital markets to finance loans or reduce their activity; either outcome increases issuance of CMBS.

INVESTOR BEHAVIOR

- Insurance companies want AAA CMBS because of the long average life and higher yield;
- Money managers will use CMBS to capture yields higher than similarly rated corporate bonds;
- Hedge funds buy CMBS for higher yields (10 percent-

plus) and additional return;

- Exchange-traded funds (ETFs) referencing CMBS opens the market to new categories of investors.

Notwithstanding current short-term impediments, a strong case exists for long-term issuance to return to sustainable levels similar to those from the 2004–2005 time frame.⁹ This article will expand on the above factors expected to drive this growth.

INTRODUCTION

Commercial mortgage-backed securities (CMBS) are bonds whose payments stem from a loan or a pool of loans on commercial real estate. Commercial mortgage-backed securitization is the process by which a loan, or more commonly a group or pool of loans, is packaged into a deal structure, and CMBS are created and issued. These bonds are “tranching,” or split into different risk levels, thereby enabling investors to buy varying levels of risk. CMBS are an important source of capital for commercial real estate, and complement other sources such as portfolio (balance sheet) loans from insurance companies and banks, and mortgage-backed securities issued by government agencies.

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The onset of the global financial crisis in July 2007 led to an immediate and sharp decline in the level of CMBS issuance in both the U.S. and global markets. Recovery outside of North America continues to be extremely slow, with only two deals sold to the market in Europe since 2009.

As shown in Figure 1, in the U.S. non-agency CMBS vanished from the market for a period of almost 18 months. Issuance restarted at a trickle in 2009, and returned to a level of \$30 billion in 2011. Near-term impediments have continued to keep current issuance muted, but as of the end of September 2012, issuance was at \$25 billion, or 80 percent of the 2011 level.¹⁰

While there remains debate as to whether CMBS issuance will ever return to its historical high (\$200 billion-plus per year) levels, the market will indeed return to strong levels of issuance over the next five years. As noted in the Overview above, commercial real estate is a long-term investment that is best funded with long-term fixed-rate debt. CMBS are a viable and financially sound source of such debt, and represent a necessary part of the overall landscape of capital sources, even in the view of competing balance sheet lenders.¹¹

Figure 2
CMBS Volume Predictions for 2012

	U.S. (\$Bil.)	Non-U.S. (\$Bil.)	Total (\$Bil.)
Manus Clancy, Trepp	\$25	\$2	\$27
Alan Todd, Bank of America	28	2	30
Sally Gordon, BlackRock	31	3	34
Darrell Wheeler, Amherst Securities	33	2	35
Jeffrey Berenbaum, Citigroup	33	3	36
Brian Lancaster, RBS	35	2	37
Larry Brown, Archetype Mortgage	34	4	38
Tim Gallagher, Morgan Stanley	36	2	38
P. Sheridan Schechner, Barclays	40	4	44
Lisa Pendergast, Jefferies & Co.	40	2	42
Daniel Bennett, Goldman Sachs	40	5	45
Anthony Orso, Cantor Fitzgerald	65	7	72
John Beaman, AREA Property	60	15	75
Average Prediction for 2012	38	4	42
Actual 2011 Volume	33	3	36

Source: *Commercial Mortgage Alert*, Jan. 6, 2012

At the beginning of 2012, *Commercial Mortgage Alert* surveyed the CMBS industry, and estimates for 2012 global issuance ranged from \$27–\$75 billion. See Figure 2. As stated above, through the end of the third quarter, issuance was at \$25 billion, and many in the industry are

forecasting increased activity in the second half of the year with total issuance passing \$40 billion. Further, in testimony before the U.S. Congress on July 10, 2012, Paul Vanderslice, president of the Commercial Real Estate Finance Council (CREFC), stated “the annual level of CMBS issuance required to provide healthy liquidity levels to the commercial real estate marketplace would be \$50–\$100 billion.”¹²

The author used the industry forecast and estimates of the timing of future refinancing to prepare an issuance forecast for 2013–2017. The forecast is driven by a variety of factors:

- the commercial real estate environment;
- the lending environment;
- investor behavior; and
- conduit issuer behavior.

COMMERCIAL REAL ESTATE ENVIRONMENT

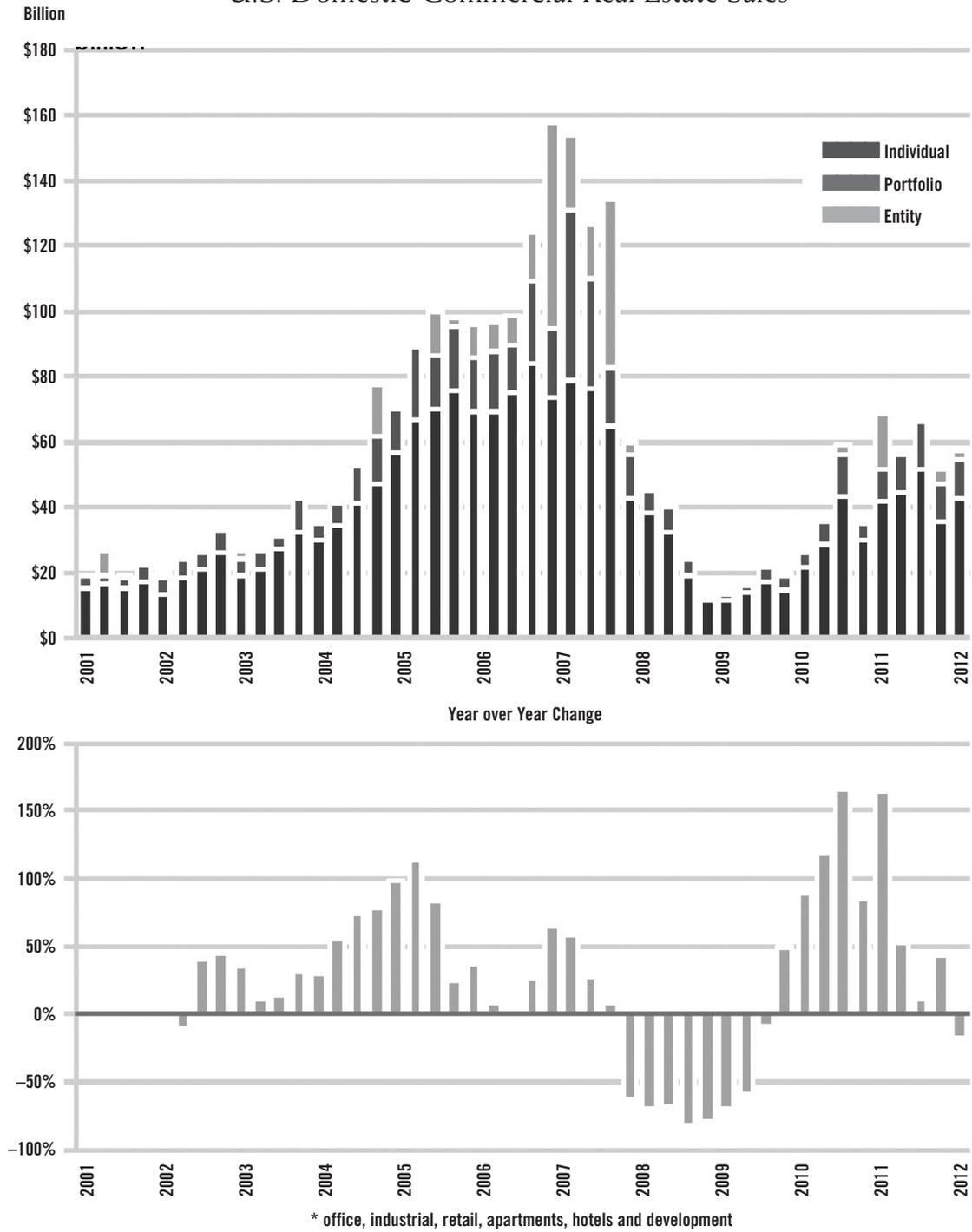
Across the board, industry research is pointing to a higher level of commercial real estate transactions over the next five years. The trend of commercial property sales, as tracked by Real Capital Analytics (RCA), is up significantly from the depths of the market following 2007. See Figure 3.

The Urban Land Institute (ULI) Consensus Forecast for September 2012 is for 2012 property sales to be on a par with 2011, and increase in 2013 and 2014.¹³ The ULI Consensus Forecast is based on a survey of 39 leading real estate economists and analysts from across the U.S. and reflects the median forecast for 26 economic indicators. These include property transaction volumes; issuance of CMBS; property investment returns; and vacancy rates and rents for several property sectors. The ULI forecast concludes that:

- Commercial property transaction volume is expected to increase by nearly 21 percent through 2014;
- Issuance of CMBS is expected to more than double;
- Institutional real estate assets and real estate investment trusts (REITs) are expected to provide returns ranging from 8.5–11 percent annually;
- Vacancy rates are expected to moderately decline for office, retail and industrial properties, and remain stable at low levels for apartments, while hotel occupancy rates are expected to improve;
- Rents are expected to increase for the four major property types in 2013, ranging from 1.2 percent for retail up to 4.8 percent for apartments.

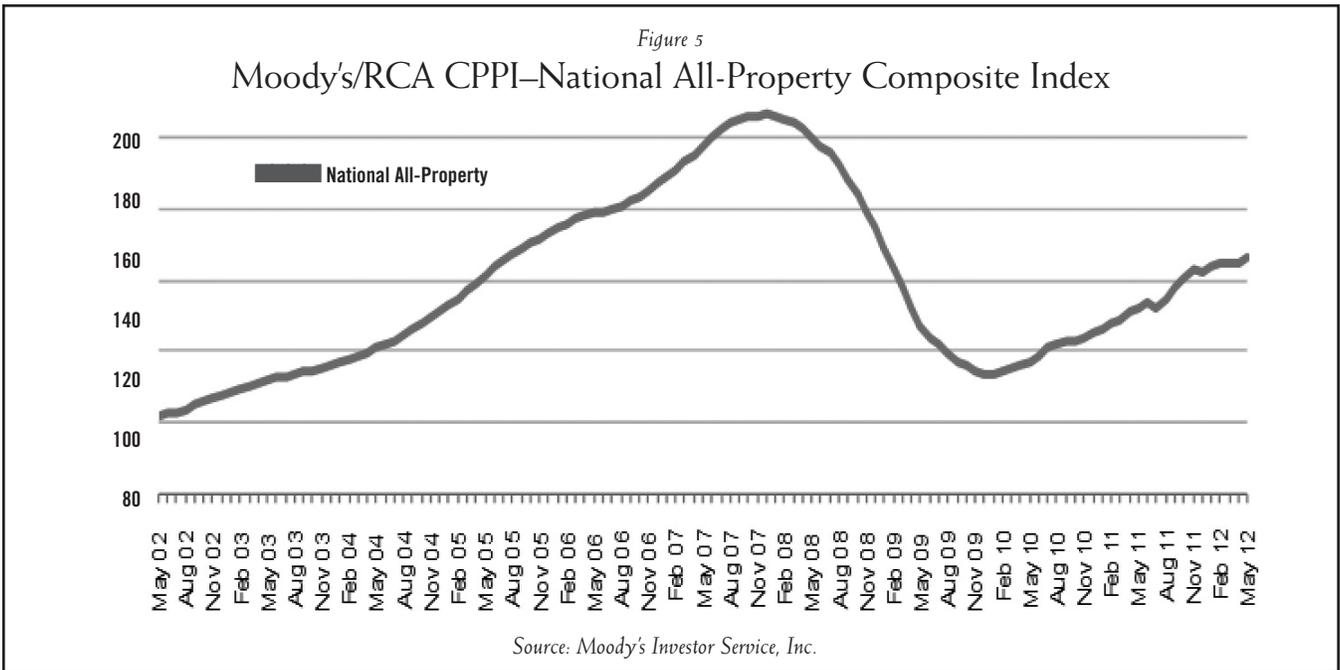
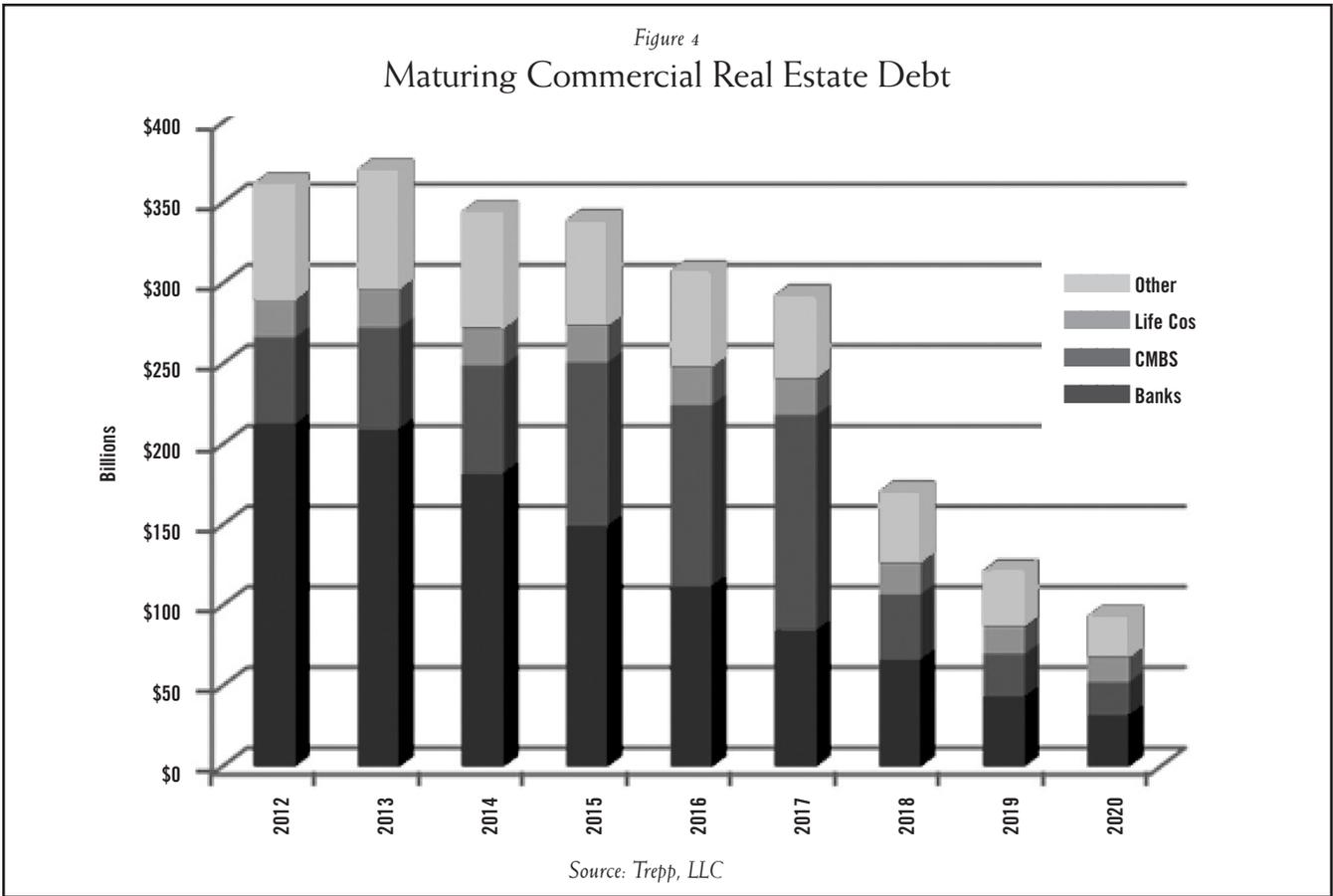
INSIDER'S PERSPECTIVE
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Figure 3
 U.S. Domestic Commercial Real Estate Sales



Source: Real Capital Analytics, July 2012

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The Case for the Return of CMBS

Increasing property sales will contribute to increasing lending and CMBS issuance. At the same time, the commercial real estate market is facing a mountain of debt to refinance over the next five years. See Figure 4. In the CMBS market, refinancing demands are moderate for 2013 and 2014, but begin climbing in 2015, and reach a maximum in 2016 and 2017. Commercial banks have the highest refinancing needs over the next five years, which could spell opportunity for increased activity in the CMBS space. “[T]he portfolio lenders and the GSEs can only fund slightly more than one-half of the burden.”¹⁴

Increasing property sales are also contributing to an increase in overall property values. Moody's calculates a commercial property valuation index based on RCA's property sales database. That index has shown a 26 percent improvement nationwide since the bottom of the market was reached after the 2007 recession. Increasing property values also make it easier for servicers, lenders and investors to realize greater returns on distressed real estate assets. The improved environment for investing has led the real estate industry to begin using CMBS, through non-performing loan transactions, to finance their investments in distressed assets. This has the twofold benefit of increasing CMBS issuance volume today and also speeding up resolutions of distressed assets in existing CMBS transactions. As of Sept. 30, 2012, three such transactions have been completed:

- \$132,000,000 Rialto Capital, Series 2012-LT1;
- \$159,500,000 S2 Hospitality, Series 2012-LV1;
- \$195,000,000 Oaktree Real Estate Investments / Sabal, Series-LV1.

The sale of distressed loans also provides commercial banks with conduit operations an opportunity to clear their books in order to create capacity to hold and aggregate new commercial real estate loans for purposes of securitization.

LENDING ENVIRONMENT

In the U.S., CMBS faces competition for loans on commercial real estate from four principal sources:

- 1) Large commercial banks with national lending platforms;
- 2) Community banks that serve their local markets;
- 3) Insurance companies, particularly the major life insurers; and
- 4) GSEs—primarily Fannie Mae and Freddie Mac (for multi-family properties only).

All four sources are active in today's market, but each faces capital and regulatory constraints that prevent them from displacing CMBS, and that will limit them in the future.

Large commercial banks are back in the business of lending on commercial real estate. However, the appetite for long-term, fixed-rate loans is limited. Because of their capital and funding structures, commercial banks primarily focus on short-term, floating rate products. Within those constraints, the banks are actively lending on transitional assets, to REITs on an unsecured basis, and in the construction fields. It should be noted that a number of the large commercial banks (including Wells Fargo, J.P. Morgan and Citibank) also operate active origination platforms for CMBS loans.¹⁵

Smaller community banks are active competitors for smaller loans in their local markets. These banks are searching for higher yields in a low interest rate environment, and find that real estate can be an effective way to increase returns.¹⁶ However, smaller banks do face considerable pressure to manage their commercial real estate investments judiciously. All of the U.S. banks that failed in 2012 (through July 31) were hurt by heavy concentrations in non-performing commercial real estate loans, including construction loans.¹⁷ Regulators continue to be concerned that banks do not become overly reliant on commercial real estate. Comptroller of the Currency Thomas Curry recently stated “[f]or commercial real estate specifically, current non-performing and loss rates continue to significantly exceed historical averages.”¹⁸ Also, because of their size, community banks often cannot effectively fill demand for mid- to large-size loans.

Life insurance companies continue to be a major source of capital for the commercial real estate market, and many have been reporting strong origination activity, which has continued into 2012. However, insurance company lending is focused on Class A properties in the largest markets, with an emphasis on low LTVs.¹⁹ The companies' preference for high quality, low LTV loans will be reinforced by the proposed changes to their risk-based capital requirements, which could double or triple capital held against loans with LTVs higher than 60 percent.²⁰

As an outcome of the 2007 financial crisis, the two GSEs, Fannie Mae and Freddie Mac, were placed in receivership by their regulator, the Federal Housing Finance Agency (FHFA). As conservator, FHFA has stated that the GSEs should “gradually contract the GSEs' dominant presence

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in the marketplace while simplifying and shrinking their operations.” In the multi-family space, the FHFA wants to encourage the return of private capital to the multi-family lending market.²¹ Over the past two years, Freddie Mac has begun to rely heavily on the capital markets to fund its multi-family lending, and has adopted a CMBS-like approach to its securities (which have totaled \$24 billion in issuance beginning in 2011). Over that same period, Fannie Mae also accessed the CMBS market for \$9 billion of capital. Federal policy should lead to an increase of multi-family assets available to the private market, which will contribute to higher issuance of CMBS.

INVESTOR BEHAVIOR

Borrowers may want to use CMBS loans, and conduits may want to make the loans, but if investors will not buy the securities, there would be no CMBS market. The news in this area reinforces the author's long-term view of the market.

Credit Suisse, in its “2012 Global Outlook,” stated that “[t]he reach for yield, in a low rate environment, and the generally high level of credit enhancement should keep this sector in demand from a variety of investor types.” This was a common sentiment at the beginning of 2012, and subsequent events have not changed that perspective. In its *U.S. Fixed Income Weekly* for June 29, 2012, J.P. Morgan stated that CMBS securities continue to “offer convincing relative value versus comps in corporate credit.”

Trepp, LLC is a provider of data and analytics to many of the participants in the CMBS industry, and is the employer of this author. In the course of business, Trepp employees canvas clients for their opinions and comments about the current state and the direction of the CMBS industry. The comments that follow are based on such discussions. Broker/dealer research opinions are reinforced by conversations with many of Trepp's key clients. One insurance company stated that when it sees a deal it likes, it will buy all of the “subordinate” AAA bonds in the deal. (Note, in a typical CMBS structure, the AAA bonds are split into two tranches—a “super-senior” and a subordinated AAA.) Similarly, other investors view that AAA CMBS, particularly the super-senior class, will continue to be a major investment, particularly because of its return advantages in today's market. Some of the latest CMBS issues have seen insurance company interest in purchasing bonds beyond these AAA levels as well.²²

Bonds below AAA and above the “B-pieces” (i.e., the bonds rated less than BBB/Baa) have been primarily

purchased by hedge funds and private equity funds. Trepp's discussions with the managing director at one of the large CMBS issuers identified the target yield for purchasing these securities as in the range of 10 percent.²³ In the opinion of that managing director, there will be sufficient demand for bonds priced to produce a yield in this range, and there would be little difficulty in selling bonds on new issue.

As a last point about investor interest in CMBS, it is important to note that Blackrock iShares initiated a new exchange-traded fund (ETF) for CMBS. (An ETF is a listed fund that issues shares of stock in the fund in exchange for the deposit of actual securities. ETFs are designed to permit investors access to a wider variety of diverse investment alternatives.) While the full impact of the emergence of a CMBS ETF remains to be seen, such an ETF does open up the CMBS market to new categories of investors who otherwise might not invest directly in the segment, such as active equity or macro traders.

CONDUIT ISSUER BEHAVIOR

The U.S. conduit issuers (such as J.P. Morgan, UBS and Cantor Fitzgerald) continue to rebuild their operations in 2012. “[T]he conduits have ramped up their hiring and their parent companies have started to breathe new life into those that were dormant for years.”²⁴ The number of firms that are making conduit loans is increasing, and the number of lead managers is increasing as well.

MARKET ISSUES / IMPEDIMENTS

The continued return of the CMBS market does have issues that must be resolved in order for CMBS issuance to return to sustainable levels. First among these issues is the impact of the legacy (pre-2008) CMBS transactions. The structure of these “CMBS 1.0” transactions had certain built-in tensions which became conflicts of interest when exposed to the massive increase in delinquencies and defaults that resulted from the 2007 recession. The resolution of these legacy issues, and the modifications made to the structure of new issue CMBS, will be part of the ongoing debate over the next few years. New issues of CMBS since 2008 (“CMBS 2.0”) have included new structural features relating to subordinate investor control rights, special servicer compensation, potential conflicts of interest and affiliate transactions. Many of these changes have been made in response to issues raised by the AAA investors in CMBS 1.0 transactions, but the changes remain to be tested and “unintended consequences” cannot be ruled out.²⁵

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Another brake on the volume of conduit lending is the absence of a reliable hedging instrument for lenders. Hedging can reduce the risk of loss to a conduit lender from interest rate and spread changes between the time a loan is made and the time that loan is securitized. Without a clear hedging strategy, issuers are reluctant to warehouse large volumes of loans, and it is harder to create large, efficient transactions. One response of the market is to structure more transactions where multiple originators contribute collateral to a single deal. For lending beyond 2012, various market participants are already working to develop new swap instruments to support hedging.

Finally, regulatory and legislative uncertainty continues to put a drag on the CMBS market. The law firm Davis Polk reported on July 2, 2012, that the Dodd-Frank rulemaking requirements for asset-backed securities are lagging behind schedule. Only two of the 14 required rules have been finalized, and there is ongoing debate between the regulators and Congress over significant portions of the Dodd-Frank rules, including risk retention.

Proposed changes to bank capital requirements could also require sizeable changes to the structure of CMBS transactions. One example is in the area of servicer compensation.²⁶ With the U.S. presidential election taking place in November 2012, significant progress is not expected in this area until early 2013. Further, the outcome of the November elections could have an impact on the direction of the regulatory framework. Members of both the Senate and the House have begun to express strong opinions about various aspects of the securitization regulations and have been conducting hearings on the impact of such regulations on capital formation.²⁷ If there is a shift in political sentiment away from some of the extensive regulations being proposed, it could increase the pace at which CMBS regains market share.

CONCLUSION

The downturn in CMBS issuance was caused by the collapse of the real estate bubble (primarily in the U.S. single family market) which triggered a global recession and financial crisis.²⁸ The downturn was deep and started a major restructuring of the CMBS industry that continues today.

Market dynamics will produce a continuing resurgence of the CMBS market for a number of reasons:

- Recovering real estate markets will increase the demand for fixed-rate, longer-term loans;
- Active lenders in the current market are facing constraints on the total amount of lending they can do, as well as the types of loans they can fund;
- Investors continue to find value in the CMBS asset class; and
- The market is adapting to the changes and needs that emerged from the recession.

The market should stabilize over the next three to five years, with total CMBS outstanding reaching a plateau of between \$550 billion and \$600 billion. Once stabilized, CMBS should thereafter grow in size to meet the capital demands of the commercial real estate market. ■

ENDNOTES

1. ULI Center for Capital Markets and Real Estate, "ULI Real Estate Consensus Forecast," September 2012, projects a 21 percent increase in real estate transaction volumes. The Forecast also projects improved operating performance for commercial real estate, though these improvements will be modest for non-multi-family property types.
2. Commercial Real Estate Finance Council (CREFC), "Outlook for Bank Portfolio Lending in Commercial Real Estate," presentation of the Bank Portfolio Lenders Sub-Forum, June 28, 2012.
3. Real Capital Analytics report on U.S. real estate transactions through second quarter 2012. See Figure 3 for more detail.
4. Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," March 6, 2008, showed an aggregate total of \$1.4 trillion of multi-family and commercial mortgages.
5. CREFC, *op. cit.*
6. *Ibid.*
7. *Ibid.*
8. *Ibid.*
9. Net mortgages financed by CMBS were \$52 billion in 2004, and \$111 billion in 2005. Board of Governors, *op. cit.*
10. Based on Trepp, LLC's record of CMBS issuance as of Sept. 27, 2012. Trepp has been tracking the CMBS industry since late 1998 and is the author's employer.
11. CREFC, *op.cit.*
12. Testimony of Paul Vanderslice, Managing Director, Citicorp Securities, on behalf of the Commercial Real Estate Finance Council before the United State House of Representatives Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises, July 10, 2012.
13. ULI, *op. cit.*

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14. Vanderslice, op. cit.
15. CREFC, op. cit.
16. Ibid.
17. TreppWire (www.trepp.com), beginning with the "U.S. Bank Failure Report, January 2012" through the "U.S. Bank Failure Report, July 2012."
18. Remarks by Thomas J. Curry, Comptroller of the Currency, before the CRE Finance Council, June 13, 2012.
19. CREFC, op. cit.
20. National Association of Insurance Commissioners, "RBC for Commercial Mortgages, Proposal, Life Insurance Company Risk-Based Capital C-1 for Commercial Mortgages," May 18, 2012.
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23. The apparent contradiction of yields of 10 percent in an interest rate environment where U.S. Treasuries yield two percent to three percent is explained by the fact that such bonds are normally sold for a price less than par (i.e., less than the face amount of the securities). At issuance, the bonds are priced based on the convention that there are no losses, and thus the yield is calculated at 10 percent.
24. Samaad, Michele A., "Lending Competition: New Rivals Woo Small Business," *Credit Union Times*, May 29, 2012.
25. Berger, Stacey, "The New World Order for Special Servicers: Is the Cure Worse than the Disease?" *CRE Finance World*, Summer 2012.
26. Berger, Stacey, "Improve CMBS Servicing Quality? Change the Business Model," *CRE Finance World*, Autumn 2012.
27. Including the United States House of Representatives Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises which held a hearing on July 10, 2012.
28. Reinhart, Carmen M. and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.