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Real Estate Industry Seeks Softening of CMBS Risk Retention Rules

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The CMBS market was supposed to be white-hot this year, and instead it has been ice cold for much of the year to date. Some of the main reasons involve volatility in global capital markets and the ripple effect of low oil prices, but another significant factor is CMBS investors' concerns about loosening underwriting standards. And investors aren't alone in worrying about risk: The federal government has weighed in, with a warning to lenders by several agencies and new risk retention rules imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The question today is whether CMBS supply can keep up with borrower demand over the next two years if CMBS sponsors and bank lenders adopt more restrictive underwriting terms.

Banks were put on notice in December, when the Banking Agencies—the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve—issued a Prudent Risk Statement to the effect that banks are concentrating too much on commercial real estate loans. The statement pointed to increasing lender risk via the "easing of CRE underwriting standards, including less-restrictive loan covenants, extended maturities, longer interest-only payment periods, and limited guarantor requirements." The Banking Agencies recommended a set of safeguards to ensure appropriate underwriting as market conditions change, and stated that they would focus investigations in 2016 on institutions that continue to aggressively grow their CRE portfolios.

Of course, a lot of the loans that banks originate are intended for CMBS rather than their own balance sheets. But volatility in the CMBS market has caused underwriters to lose money on some loans in recent months, and some conduit loans are now getting kicked out of pools by issuers or B-piece buyers worried about underwriting quality. Moreover, CMBS players are bracing for implementation of the Dodd-Frank risk retention rules that go into effect this December.

Under Dodd-Frank, CMBS issuers and other sponsors of asset-backed securities will be required to hold at least 5 percent of the fair market value of transactions for five years without refinancing or reselling. Alternatively, a sponsor can find one

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Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

or two B-piece buyers willing to hold the investment for five years. The rule is designed to ensure that the holders of the first-loss position perform the proper due diligence and refuse loans with questionable underwriting.

Total issuance in the first quarter of 2016 was one-third lower than in the same period in 2015 as investor yields on top-rated CMBS rose from 125 basis points to 175 basis points. Risk retention is not the sole cause of the volatility or the drop in volume, but many view the new rule as a contributing factor to the market's hiccup.

Domestic, Private-Label CMBS Issuance					
Q1 2016			Q1 2015		
Deal Type	# of Deals	Vol ($mln)	# of Deals	Vol ($mln)	% Change
Conduit	13	11,409.40	12	13,138.55	-13.2
Single-borrower	8	5,801.50	18	12,477.80	-53.5
Floater	NA	NA	2	1,154.80	-100
NPL	NA	NA	1	341.82	-100
TOTAL	21	17,210.90	32	26,274.15	-34.5

Source: *Commercial Real Estate Direct*

The timing couldn't be worse: With about $190 billion in 10-year CMBS loans set to mature in 2016 and 2017, owners need low-cost debt to refinance properties that in many cases are worth less today than they were the last time around. If investor demand remains weak, many borrowers will need to go to life companies, banks and mezzanine lenders at less-favorable terms than they've been getting with conduit deals. But the new rule could also help stabilize the lending market and assuage fears of a more serious downturn.

Debt markets get overheated when lenders focus too much on yield and ignore risk factors. Underwriting gets lax, bad loans get made, and eventually the market implodes. In the early days of CMBS, when investors weren't sure about the asset class, the first-loss position was typically held by the loan servicer, creating an alignment between due diligence and risk. As CMBS became more widely accepted as an investment, some of the safeguards were removed. Underwriters motivated by origination fees rather than coupon yields started cutting corners, fueling market volatility.

The new rule re-establishes alignment, but creates new challenges. A five-year hold period doesn't work for a lot of current B-piece buyers, such as hedge funds, which usually seek a quicker exit strategy. Thus, the illiquidity of B-piece investment shrinks the pool of investors, and those who remain expect significantly higher yields to go with the additional risk.

The concern of many in real estate is that the constraints go too far—the industry runs on capital availability, and over-regulation could lead to a credit crunch that would damage the market. Accordingly, organizations like the U.S. Chamber of Commerce, National Association of Realtors, International Council of Shopping Centers and the Appraisal Institute are supporting the Preserving Access to CRE Capital Act of 2016, legislation introduced this year that would ease the requirements just enough to encourage market liquidity.

The act would exempt single-asset and single-borrower deals from the risk retention rule and allow for pooled CMBS issuers to identify third-party B-piece buyers willing to shoulder the risk. Some real estate organizations suggest that the proposed act establishes the risk retention rule as Congress intended it, before the regulatory agencies made it more stringent.

After the underwriting excesses of a decade ago, it's a good idea to re-establish accountability to CMBS sponsors in order to create market stability. It would be ironic, and unspeakably tragic, if the safeguards against a market failure were to cause the downturn they were designed to avoid. The good news is that such a scenario is unlikely, as all the players involved—investors, underwriters, government agencies—are aiming for market stability.

For more information,
contact Jack Mullen
Founder and Managing Director
203.293.4844
www.summerstreetre.com