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CRE FINANCE WORLD®

The Voice of Commercial Real Estate Finance

Winter 2013
Volume 15 No. 1

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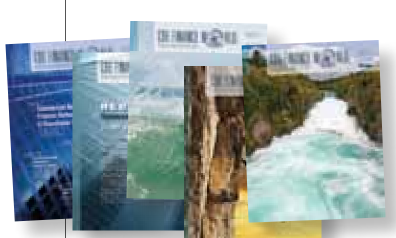

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Letter from the Editor

Brian P. Lancaster
Co-Head of Structured Transactions, Analytics, Risk and Strategy
RBS Global Banking & Markets

Welcome to the Winter 2013 edition of *CRE Finance World.* This issue itself, full color, bursting with great articles, culled from many more and now on a solid financial footing is symbolic of the industry is itself. Yet as I write, House Speaker, John Boehner is in the background on the television rebutting the President's proposal which was a rebuttal of John Boehner's earlier proposal and so forth and so on. While the "fiscal cliff theater" is disconcerting to all of us, I do take some comfort in the fact that the challenge we now face in commercial real estate finance is Washington not "messing up" a market recovery which is underway either through regulatory overreach or fiscal irresponsibility. It was not so long ago that markets were the problem and government, the ham handed solution, certainly a greater challenge.

The task before us now, if we have learned anything from the past, is to not only keep real estate finance profitable for investors, lenders and borrowers, but to make it responsible and sustainable as well. To that end we start this issue, with two articles, our Commercial Real Estate Finance Roundtable Outlook 2013, moderated by myself, and Guideposts for Federal Housing Policy by Douglas Holtz-Eakin, the former Director of the Congressional Budget Office and Former Chief Economic Policy Advisor to U.S. Senator John McCain's 2008 presidential campaign. The Outlook, while optimistically discussing the future of CMBS, of balance sheet lending, and the revival of mezzanine securitizations also highlights ongoing credit quality erosion — a theme picked up again in Ed Shugrue's CMBS — Party Like Its 2007. Douglas Holtz-Eakin lays out his requirements for responsible and sustainable GSE reform, one of which is public and private sector risk sharing, which is complemented by our article on Freddie Mac's K program, a great example of a new program that is already successfully doing just that, growing to a size that nearly rivals the non-agency CMBS market.

If there is any other theme that seemed to dominate the many articles submitted for this issue, it was one of "not so fast". Optimism in the industry is palpable, and for the most part justified, thanks in part to Mr. Bernanke and a generous Federal Reserve, but our authors seem to be telling more subdued and nuanced tales. This theme comes through in the Roundtable discussion where Sam Chandan discusses the improvement in commercial real estate but believes cap rate compression, more than NOI growth, is the driver. Aaron Bryson's "Legacy CMBS Credit Outlook for 2013: Don't Get Caught Swimming Naked" strikes a similar cautionary note as do Eduardo Martinez in, "A Modest Outlook for Commercial Real Estate" and Jack Mullen's "Construction Debt Casts a Long Shadow over Banks' CRE Portfolios."

Perhaps it is the success that commercial real estate finance has enjoyed over the last year and that many expect in 2013 that allows us the luxury of cautionary tales and criticism. But if we are to not repeat the mistakes of the past, we would do well to heed them.

Brian P. Lancaster

Letter from Stephen M. Renna, CEO

Stephen M. Renna
CEO
CRE Finance Council

We are excited to present to you the January edition of *CRE Finance World* magazine. Through the contributions of many, the magazine is improving dramatically in many ways…look, feel and content.

This latest edition is the first print edition to be done entirely in color. Thanks to increasing advertising support and an ever growing readership, we are able to publish in color and enhance your reading experience.

Coinciding with the new and improved look to *CRE Finance World* is a lineup of articles that is broader and more diverse topically than in any prior issue. On the following pages are expertly written articles providing insight and perspective on some of the most relevant issues in many sectors of commercial real estate finance.

We are particularly excited to include in this edition a roundtable discussion featuring several industry leaders sharing commentary on the current state of the markets and the outlook in 2013. Their views and commentary are revealing, provocative and "must know" information.

I'm confident you will find *CRE Finance World* magazine to be a valuable and timely source of industry information.

Helping us achieve our goal is the magazine's editorial board. We are deeply grateful to the board's commitment. This issue of *CRE Finance World* reflects a deeper, more engaged editorial board in many ways ... identifying topics, soliciting articles, review and editing and aiding in advertising. It all adds up to greater take away value for you the reader.

With all this improvement and growth, sponsorship and advertising opportunities, *CRE Finance World* magazine provides a better value than ever. I encourage you to take advantage of *CRE Finance World* as a means to raise the profile of your company among clients, prospects and colleagues in the industry.

We are excited about the direction *CRE Finance World* is heading. We'd like to see you become a part of it.

Stephen M. Renna
Chief Executive Officer
CRE Finance Council

The Year Ahead in DC –
New Faces in Congress, Regulatory Bodies

Michael Flood
Vice President, Legislative & Regulatory Policy
CRE Finance Council

With the status quo election now in the rearview mirror, the focus of the nation as of press time is on the fiscal cliff and debt ceiling impasse. What ultimately happens in those negotiations will likely determine the extent to which the White House and Congress can work together in 2013. And, if they can reach a deal, then the main priority for 2013 will be implementing any agreed upon tax increases and budget cuts.

Regardless of the outcome, the commercial real estate industry will yet again need to concentrate on Congress as it contemplates Dodd-Frank oversight, multifamily finance reform and terrorism risk insurance. At the same time regulators — some of which will come under new leadership — will finally implement a slew of Dodd-Frank regulations important to the future of our industry.

As such, CREFC is focused on the 80 new Members of Congress, the newly installed leaders of Congressional committees and the regulatory agencies likely to receive new leadership. Our primary objective going forward will be to assess the changes and meet with new lawmakers and staff. Our task will be to educate them on the benefits commercial real estate finance provides to their constituents and the economy at large, explain the policies we are seeking to advance or deter and develop productive relationships.

Congress

Down Constitution Avenue to the Capitol, CREFC primarily has two committees of jurisdiction to navigate — the Senate Banking Committee and the House Financial Services Committee. The Financial Services Committee will have two new Members atop the dais for both parties who are polar opposites politically. The ascension of Chairman Jeb Hensarling (R-TX) and Ranking Member Maxine Waters (D-CA) portend big changes both in the way the committee conducts its business and at the staff level. Chairman Hensarling is a staunch advocate for limited government – a position popular in his home district of Dallas. Conversely, Mrs. Waters, a member of the House Progressive Caucus, is an outspoken critic of the financial services industry.

The outspoken Mr. Hensarling is a huge proponent of GSE reform and often attacks Dodd/Frank from behind the dais. We expect the committee agenda to include GSE Reform, qualified mortgage criteria and CFPB oversight, the Volcker Rule and "Too Big to Fail" rule for large financial institutions. For CREFC, we expect Mr. Hensarling, no fan of Dodd-Frank, to maintain rigorous oversight over regulatory implementation of Dodd-Frank and related rulemaking provisions.

Given the majority rules structure of the House, Hensarling will not have to work with Waters to achieve bipartisan consensus if he chooses not to. However, if his intention is to craft legislation that could pass the Senate and be signed by President Obama, he will have to win to some degree the support of Representative Waters.

In the Senate, we are excited to see Senator Mike Crapo (R-ID) ascend to the Ranking Member spot alongside returning Chairman Tim Johnson (D-SD). This is good news for CREFC, as Senator Crapo has been a strong supporter of our markets and constituents throughout his tenure on the Banking Committee.

Senator Crapo was the lead sponsor for the amendment that created the carve out for CMBS risk retention. We enjoy strong staff and member relationships with both offices and we look forward to working with the committee as they pursue their agenda which is likely to see a handful of Administration nominee confirmations, a renewed focus on community banks, oversight of the SEC and the implementation of Dodd/Frank, including Volcker and Basel rules.

Another encouraging sign is the Chairman and Ranking Member's willingness to engage in discreet fixes to Dodd/Frank known in the beltway as "technical corrections". There could be an opening for minor modifications to provisions affecting CRE finance such as risk-retention.

Other CRE Finance Issues Congress Will Likely Consider

Terrorism Risk Insurance (TRIA) Reauthorization. This is the federal program that was established in the wake of the 9/11 attacks that funds property and casualty claims in the event of a terrorist event. It is slated expire in 2014. Some Republicans have taken exception with a government involvement in this program. Democrats need to be convinced this is not a subsidy to the insurance industry, and we expect a somewhat contentious debate as to the government's role going forward.

GSE Reform. With the ascension of incoming Chairman Jeb Hensarling, we expect the debate surrounding GSE reform to reignite. Emboldened by retaining the majority in the House, Hensarling will bring his opposition to government involvement with the two troubled agencies (and, as of recently, FHA) to the fore. CREFC and our coalition partners are already working to ensure that the solution for multifamily is separate and distinct from the prescription for single-family. While we don't expect Congress to reach an agreement next year, we will have a better eye into their intent and the likely supporters. Last congress saw a handful of bills related to both GSE reform and private housing market reforms. We expect similar bills to appear shortly after Congress convenes in January.

Regulation

On the regulatory front the SEC, Treasury and FHFA are expected to see changes in leadership. The departure of Mary Shapiro at the SEC signals a likely agency stalemate for implementing regulations with commissioners now deadlocked at 2-2, until the White House appoints and the Senate approves her replacement. Furthermore, Secretary Geithner has signaled that he plans to leave Treasury after the fiscal cliff negotiations.

Secretary of the Treasury is also the Chair of the Financial Stability Oversight Committee, which acts as an arbiter between regulators on joint rulemakings. Therefore, the President's choice for Treasury Secretary will play a significant role in implementing joint rulemakings such as risk retention. Finally, Ed DeMarco, acting Director of the FHFA, is also assumed to be replaced at some point. Mr. DeMarco has disagreed with the White House on such issues as mortgage write-downs. Whomever the White House appoints will play a significant role in housing finance reform.

That said, the industry should expect to see the following regulations implemented in 2013:

- **Risk Retention** — Regulators have signaled that they plan to release either a re-proposal or final rule in the first quarter. The industry will have two years from the date of any final rule to comply with the standards.

- **Volcker Rule** — While regulators are struggling to reach an agreement on what is considered proprietary trading, they have signaled that they plan to issue a final rule in the first quarter.

- **Regulation AB** — The SEC is highly likely to issue a final rule for disclosures on structured products immediately following a final risk retention rule. Once retention is finalized, the SEC will be able to finalize disclosures necessary to ensure investors have a handle on the nature of the retention.

- **"Franken Amendment"** — The SEC is expected release a study required by Dodd-Frank on implementing the Franken Amendment for initial credit ratings for structured products in the first half of the year, and rumors are circulating that staff has already circulated a draft at the Commissioner lever. As a reminder, the Franken Amendment states that the SEC can move forward with randomly assigning credit rating agencies to perform initial ratings for structured products if it is deemed the best solution to remove conflicts of interest from the current issuer pays model.

- **Basel III Capital Standards** — Regulators have expressed their desire to finalize increased capital standards in 2013. Congress is watching closely, as there is a tension between ensuring the United States keeps up with international capital standards, while rural Members of Congress are greatly concerned about the rules' potential affects on community banks.

As you can see, decisions made in Washington in 2013 will play a large role in the future of our industry.

To stay informed, look for our updates in the CREFC *Weekly Briefing*, sign up for our free monthly government relations update calls, or simply contact myself (mflood@crefc.org) or Marty Schuh (mschuh@crefc.org) and we are more than happy to bring you, our members, up to speed.

CRE Finance Roundtable: Outlook for 2013

Moderator:
Brian P. Lancaster
Co-Head of Structured Transactions, Analytics, Risk and Strategy Markets
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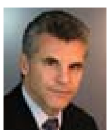
Participants:
Sam Chandan
President & Chief Economist
Chandan Economics



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Managing Partner
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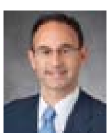

David Nass
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Brian P. Lancaster:

Good afternoon and thank you all for participating in the Commercial Real Estate Finance Council 2013 Outlook Roundtable. The purpose of the Roundtable is to get the views and insights for the year ahead from the leading professionals in commercial real estate finance. With me this year, I have Clay Sublett, SVP of Loan Originations of KeyBank; Nelson Hioe, Managing Partner at Raith Capital Partners; David Nass, Managing Director, Head of Capital Markets Real Estate Finance, UBS; Bill O'Connor, Partner, Thompson & Knight; Francisco Paez, Director, Metropolitan Life; Bruce Cohen, Senior Partner, Ares Management; and last but not least, Sam Chandan, President & Chief Economist of Chandan Economics and a professor at the Wharton School of Business.

Sam let's start with you. Today the Fed just announced that it will continue its significant bond buying program until unemployment falls to 6.5%, or inflation exceeds 2.5%. For the last couple of years now, borrowers have been enjoying record low interest rates. It sounds like 2013 will be no different. How is this impacting commercial real estate, and how is it likely to impact it in 2013? How much of the improvement in capital flows and property values can we attribute to changing fundamentals; how much of it is due to low rates?

Sam Chandan:

Conditions in capital markets and in the monetary policy environment are playing a significant role in driving prices and investment flows into commercial real estate. The way in which we see this playing out differs significantly across markets and across property types. When we look at secondary and tertiary markets and at relatively smaller assets in market segments that by definition are less liquid, markets fundamentals matter more critically to buyers and lenders and the monetary policy distortions are weaker. Because of that we have not seen the kinds of improvements in prices that we observe in the most actively traded primary markets. Now, that is the case even when we observe that some smaller markets have been more stable in their underlying cash flow performance.

Because these markets are traded more thinly and have longer hold periods, we have a buying strategy that is really more dependent on the operating performance of the properties themselves. Given the weak underlying economics at the national level, given the uncertainties that we see in terms of how the recovery will progress, spillovers and improvements in pricing have been relatively modest. There is a discount to illiquidity that is the flipside of the primary market low cap rates and narrowing spreads.

Contrast the secondary market trend to what has been happening in the gateway markets since the early stages of recovery. Prices are up and cap rates have fallen in a way that speaks to continued risk aversion. In part those lower cap rates are supported by an increase in leverage and historically low borrowing costs for qualified borrowers. But there is more to it than that. There is a decoupling of pricing movements from underlying fundamentals that is being driven by capital market conditions.

So we come back to this discussion around interest rates and monetary policy and the Federal Reserve's goals in ensuring that the inflation-adjusted yield on the Treasury is essentially negative. It is not just to keep borrowing costs low; it also ensures that capital must go on a hunt for yield. That has played out significantly in commercial real estate, principally in those gateway markets where there is a lot of liquidity. In some cases the force of that capital, whether it be from the equity or the debt side of the market, has been strong enough that it introduces distortions in asset pricing and return performance.

And that is somewhat troubling. We know that there are significant differences in terms of the performance and attractiveness of different investment and lending opportunities across markets and property types. That is always the case. In many cases those differences and perceptions of risk are exaggerated now.

It is not too different from what we've seen with other asset classes. Because there are subsets of the commercial real estate market where low interest rates are being internalized very aggressively — multifamily, more than office, retail or industrial because of the structural relationship that exists between monetary policy and the cost of financing to the agency — there are distortions in pricing that ultimately allow us to conclude monetary policy is playing a significant role in pricing, even where fundamentals projections may still be rather modest. Lenders should not be myopic in evaluating the risks that accompany these distortions.

Brian P. Lancaster:

Sam, you mentioned the apartment market, and that the GSEs are providing subsidized financing, but that is also one of the few markets where we have seen significant rent growth. There is also a lot of construction coming online. Two questions: are apartment valuations justified by the fundamentals and are you worried about overbuilding and supply?

Sam Chandan:

There is a lot to like about multifamily. It is very attractive as an investment and development opportunity right now, and of course that is in part a function of the complex dynamic that we have with single-family housing. We certainly have improving fundamentals which are well reflected in property prices and investment flows. The challenge for us is not that we are making the same mistake on the lending side that we did during the previous cycle, underwriting to perspective cash flow in evaluating going-in risk metrics. Conditions are a little bit different. We know that fundamentals are improving and there is an expectation that they will continue to improve. But there is also a subset of markets where the combination of a growing construction pipeline and a rebalancing in single-family housing demand means somewhat more modest rent growth as we look forward. The challenge is in how multifamily acquisitions are being financed. Our credit risk models are telling us that in many cases we are planting the seeds of a fairly significant increase in delinquency and default rates in the way that we are structuring new loans, ignoring interest rate and balloon risks.

The challenge is going to manifest — for example — in untenable assumptions about exit financing costs that are being made in this environment of extraordinary low interest rates. Today's newly originated loans will mature and need to be refinanced in an environment where underlying risk-free rates have the potential to be significantly higher than what we see today. That implies upward pressure on cap rates and higher refinancing costs. We can look at deals that have come to market over the course of this year and see increasing leverage, lower debt yields, and an increase in interest-only periods. Amortization has been declining consistently over the last year.

We then have to take the next step and say; some of these properties are in markets where the cash flow growth will offset the increase in interest rates and the upward pressure we will observe on cap rates, such that we can refinance these loans. The strength in NOI growth will allow the loans to perform over the next ten years and also at that point of refinancing.

Where we face a more significant challenge is that there are a large number of loans in these deals, where if you look at the location and the other characteristics of the properties, there is nothing in the historical analysis to suggest that cash flow will grow rapidly enough to offset the downside risks that will result from higher interest rates, even if spreads narrow further.

Brian P. Lancaster:

Talk about the single-family home to rent REO market. That has been an asset class that has been discussed in a number of very well attended conferences. Do you feel that it is the next income producing asset class?

Sam Chandan:

I think it is not. There is a divide in assessments of the viability of the single-family home to rent market. On the multi-family side, we see a generally cautious approach. The potential for us to realize economies of scale is limited. Gains will follow from buying assets at very deep and sometimes artificial discounts, even as compared to where we see the market today. So why do we have this in the first place? Why is this an issue on the table? Over the last five years, so many different policy tools have been brought to bear in trying to put a floor under the housing downturn. One of the suggestions that came out of the Federal Reserve last January was that if there is a strong rental demand out there, then perhaps we can make these homes available for rent out of inventories of foreclosed properties being held by Fannie Mae and Freddie Mac. That would take some of the edge off of the increases in rent growth that are constraining affordability and would also see some of this housing inventory absorbed. The pilot program undertaken by the FHFA and Fannie Mae was not without its bidders. I am skeptical, but a large number of very credible investors are pursuing opportunities in this business, so the jury is still out.

Brian P. Lancaster:

David, Sam mentioned the pilot REO to rental loan securitization. There has also been a lot of discussion in the press and at conferences about financing these types of programs. What is your perspective? Could loans from these programs end up in a CMBS deal or would they have to be done as one-off securitization?

David Nass:

Personally, I think that there is an opportunity to see that product in a potential stand-alone securitization scenario, not as an asset class or property type within a conduit. The demand generators for REO to rental are clear. Sam mentioned the tremendous REO supply, but there will also be further restructurings. The necessity for rentership is there especially given today's tighter lending standards. You can also point to proven success models for rent-to-own product types. The own-to-rent model has worked for cars, DVDs and storage space in the web, so why couldn't it work for the home owner market? As long as the securitization is structured properly, with adequate service agreements, maintenance agreements and leasing agreements in place, it's certainly possible to securitize the revenue stream.

Brian P. Lancaster:

My sense is that, given what the Fed is doing, driving rates down, investors are pursuing a variety of strategies: going down in credit; adding leverage to high-quality assets like the mortgage REITS; or looking out for esoteric assets. We've seen some very interesting off-the-run type deals lately. It seems like investor appetite would be there if you can get the credit enhancements correct and the rating agencies on board.

David Nass:

That's right. Clearly, financial institutions are exploring this. They are providing warehouse lines for sophisticated clients that focus on the REO to rental space. The logical next step, to the extent that it is ratable and structured the right way, is to see a capital market execution as a financing alternative rather than simply a financing on the balance sheet of a bank.

Brian P. Lancaster:

On the topic of different types of securitizations in the market, in the year ahead, what do you see in terms of the CMBS market overall. Where do you see conduit and large loan issuance? Will we see a lot of floaters or mezzanine securitizations?

David Nass:

Hopefully, issuance in 2013 will evolve with more esoteric securitizations both by structure as well as by asset class. I think we will continue to see liquidating trusts, floating rate securitizations, CRE CLOs and some form of CRE CDOs as well. We've seen some of these types of structures issued in 2012 and they have been successful transactions.

Brian P. Lancaster:

How were those deals done? Do you think there will be more of those in the coming months?

David Nass:

UBS issued a mezz securitization three weeks ago. It was over subscribed and extremely successful. With sound structure and reasonable leverage, there are capital markets solutions for traditional balance sheet financings. Capital market solutions provide for efficient financing alternatives and, if properly structured, the product will be absorbed. We saw successful issuance in 2012; my guess is you'll see more of it in 2013.

Brian P. Lancaster:

So you think this will be the year we will see more a fair number of CRE CDO's as well as mezz securitizations?

David Nass:

We went from a fair amount of issuance of CRE CDO's pre-crisis to zero over the last several years. What we observed in our successful issuance in the fourth quarter is that there is appetite for well structured securitization of second liens, and I think that we will see more of that in 2013.

Brian P. Lancaster:

Regarding CRE CDO's, do you think you'll see more CRE CDOs backed by whole loans? What other collateral types might we find in the coming year? Mezzanine loans, B-notes, B-pieces?

David Nass:

I wouldn't say B-pieces. CMBS investors would prefer to see B-pieces purchased and retained by the B-piece buyer. Financing conduit B-piece acquisitions through CRE CDO's is a pre-crisis trade that will likely not be repeated. Let's compare and contrast where we are today versus where we were. Today, securitizations backed by mezzanine loans and/or b-notes are financings. It's not an off balance sheet trade — it's a financing that is taking place in the capital markets. It's not an execution where the equity is only 5%; it's a transaction where the equity owns and retains a considerable amount of risk. These types of executions are used as an alternative to recourse financing on the balance sheets of financial institutions and can be executed assuming reasonable leverage and conservative structures.

Regarding the UBS lead mezz securitization, the equity retained by the issuer was 41%. That's clearly a financing. The distinction is that the issuer retained the risk. They liked the loans they made and they retained the risk at the end of the day. That's wildly different than buying and pooling subordinate conduit B-pieces, issuing highly rated securities while retaining only a small percentage of the equity in the CRE CDO.

Brian P. Lancaster:

Certainly that is an important distinction. Some CMBS investors tend to run for the hills when they hear the word CDO. Nelson and Bruce, do you share similar views with David on the reemergence of this asset class?

Nelson Hioe:

I certainly agree with David on a couple points. CDOs and alternative forms of securitization are coming back, that is for sure. I think the development of new financing structures and products is constructive for the overall market, and generally speaking don't see anything wrong with investors having a broader set of opportunities to place their capital.

The bigger issue is whether the pricing of the bonds reflects the true risk-adjusted return of the underlying collateral. In that regard I think it is incumbent on the investors in any of these products to do the requisite amount of work that enables them to get comfortable with the risk profile. Right now, short term paper that carries any sort of yield is in extremely high demand, and you hope that folks are underwriting the properties and not just a set of strats. Investors have felt burned in the past not necessarily because the products were fundamentally faulty, but because they were mispriced in the marketplace. I think if the goal is to have a well functioning market, it is in all of our collective interest not to have boom and busts with periods of tremendous issuance and then periods of nothing as people are licking their wounds — and that is accomplished by having an investor base that is educated about the risks and rewards.

Bruce Cohen:

The "technology" of CDOs was a valuable addition to the financing toolbox. For those originating or otherwise investing in whole loans, conditioned to retaining the risk and holding to maturity, it provided an attractive means of finance. Interestingly, in those cases, the securitizations actually performed reasonably well from a credit perspective. The problems in the CDO space came largely from the underlying collateral being financed. Poor credit, highly leveraged or speculative loans or mezzanine loans aren't well suited for a securitized financing vehicle.

Taking nothing away from the successful securitization UBS recently completed on mezzanine loans, leveraging already leveraged positions has a meaningfully higher level of risk than that associated with whole loans. Given the challenges associated with resolving defaults in securitized loans, those are exponentially higher when sitting in subordinated positions.

Brian P. Lancaster:

Given Sam's perspective that we are in an incredibly low-rate environment which is driving down cap rates and boosting prices with limited NOI growth, the risk of course is the downward pressure on property valuations or the value of mezz that could ensue when cap rates go up. It's important on how the securitizations are done, and how conservative structures are to deal with that.

Nelson Hioe:

If you are someone who thinks that Libor is going to be 5% two years from now, you should not be playing in any of this. There is a natural weeding out process of who is even participating in this space based on their macro views. It is a self-selected group of investors who have a particular view on rates and fundamentals that allows them, as a gating issue, to be active. Within that, on a deal by deal basis, it's important to understand what one is investing in and make determinations about which transactions offer the best risk-adjusted returns.

Brian P. Lancaster:

Are the mezz loans backing the deals being done more in collaboration, with say, higher LTV refinancing to help get them done, or is it more for acquisition?

Nelson Hioe:

I think Dave can weigh in as well, but I think it's both. We are seeing some mezz being made on loans in 2006–2007 vintage loans, where values have declined somewhat and sponsors are unable to put in significant amounts of new equity. So they are basically trying to top it up in order to make a transaction happen.

David Nass:

I absolutely agree. Across the board, whether it is whole loan financing or mezz financing that's getting done today; we saw a tremendous amount of refinancing in 2012. That said, in the fourth quarter, we saw an increase in acquisition financing. This is another positive sign — an increase in transactional activity with more fresh equity going into deals today.

Brian P. Lancaster:

David, what is your outlook overall for the CMBS issuance, say conduit versus large loans, and floating rate versus fixed in 2013.

David Nass:

I am estimating $65 billion for 2013. Roughly 20-30% of that issuance will be single borrower and single asset securitizations. It looks like we are going to end this year with about $47 billion of new issuance — up about 45% from 2011. Projecting further out, I think that we are ultimately going to reach a sustainable level of issuance at around $100 billion. I could see that happening as early as 2015.

Brian P. Lancaster:

What is driving the growth rate? Are we seeing significant investor demand? Are we seeing new investors coming into the sector? Old investors increasing allocations?

David Nass:

First and foremost, there is general recognition that CMBS is a solid product. The market was possibly too large pre-crisis at $240 billion, but generally speaking, post-crisis the product is recognized as one of the more successful structured products. The CMBS structure was sound even in the height of the crisis. Loans went into special servicing and special servicers either worked-out those loans and returned them to the trust, or the special servicer sold the loans or properties. Generally speaking, when you look at CMBS across other structured products, it is easy to understand why the CMBS industry restarted and was one of the first to come back in 2010. The structure worked even with material changes in property values and cash flows and during one of the most severe corrections in modern day history.

Even though we have had some volatile moments over the past couple years, we continue to see large financial institutions commit capital to originate and securitize loans. The demand is there for a number of reasons, starting with fundamentals. Underlying commercial real estate fundamentals have improved. There is enough liquidity in the financial system to refinance many of the maturing loans. There is also a competitive mezz lending market that provides the required gap financing allowing for the successful refinancings of over-levered legacy CMBS loans. In 2012, CMBS investors and mezz lenders seemed to agree that there was good relative yield in our industry.

Brian P. Lancaster:

Francisco, would you agree as a buyer of CMBS? Do you still find the product attractive?

Francisco Paez:

Absolutely. From a relative-value standpoint, the proposition in CMBS continues to be attractive. Thinking about it in the context of other structured products, the only other product that would be an adequate comparison to CMBS in terms of relative value would be CLOs. There are really not a lot of other alternatives that offer that kind of value. So we do continue to see CMBS as attractive on a relative basis. Now on an absolute basis, that is what is becoming a little more challenging.

Brian P. Lancaster:

What do you mean by "on an absolute basis" becoming more challenging?

Francisco Paez:

From a yield stand point. You have the last transaction right now, the AAA risk was probably 140 basis points of spread for the AS tranche and the super senior was in the low 90s. In a low-interest rate environment, you have a liability benchmark to beat that becomes challenging even if from a relative stand point that's credit attractive.

Brian P. Lancaster:

Do you think it's beginning to approach a point, from someone like yourself at an insurance company, that you have to go down the capital stack to get the yields you need, or you can't participate?

Francisco Paez:

I think investors, particularly life insurance companies, have to prudently try to see how far down the capital stack they feel they can go and still be comfortable with the risk/return. But you can also look at alternative ways of being in the sector. One aspect we see as challenging when we think about going down the capital stack is that you can get tranches that can be thin compared to how chunky some of the underlying assets can be. I think it has gotten better over the last couple of years, but even now tranches down the capital stack we feel are a little bit of a challenge considering the severity of loss that could happen at those tranches. We are constantly thinking of ways to address those concerns, and we've been able to do that in certain instances to the extent that we find those places where we are comfortable from a credit stand point going down the capital stack.

Brian P. Lancaster:

Would you say that generally that has been your observation? That you are finding insurance people are going down the capital stack further than they were a year ago?

Francisco Paez:

I think it depends on the company and it depends on whether they are doing that for their own book or for a third-party book that has benchmarks and sector mandates, and may not be as constrained from an absolute yield perspective. For those that have to purchase assets for their own accounts there is a little bit more of a constraint to continue to participate actively in the super senior space.

Brian P. Lancaster:

Given that you mentioned that you have to be careful when you look for yield, what is your view on 3.0 in terms of the credit quality?

Francisco Paez:

It's a mixed bag. There are two different aspects that we think about when assessing the risk of 3.0, one being the structural characteristics of the deals, and the other being the credit of the collateral. From a structural standpoint, I do think that 3.0 versus 1.0 did address some of the more glaring faults in the structure. However, I do think there are some areas that haven't been addressed. In order for the sector to have the same standing in an investor's mind as it used to have, we need to fully address some of those issues. Just to name a few of those things on the governance front, we still don't feel there are adequate checks and balances in terms of how the structures work as it relates to B-piece buyers and special servicers. There needs to be some mechanism in there to provide those checks and balances. I feel that is a critical point in many investors' minds that needs to be addressed.

From a transparency stand point, I think that the industry has done a comparatively good job. That being said, this is a sector where there is a lot more idiosyncratic risk versus other securitized sectors, and from that perspective we do need more information. In particular, with certain property types that becomes more important. For example, the information we get on retail loans, I think of how much concentration and risk there is at times, it would be beneficial to get additional information that we aren't currently getting.

From the point of view of the credit of the collateral, we are obviously nowhere near the peak of the cycle, but we do see a decline in terms of underwriting standards.

Bill O'Connor:

I would agree with that. We are, in the transactions that we're looking at, seeing a loosening of underwriting standards, particularly as deal buying increases. A lot of the actual blocking and tackling, knocking on the doors, kicking the tires, whatever cliché you want to use is being delegated to third parties. So when you come back to do the review, it's probably not as tight as it would have been when some of these institutions started this cycle of underwriting. It's not as tight as it used to be.

We have to be careful as we go into another increasing round of issuances that we don't make some of the same old mistakes. The B-piece buyer is playing an important role right now in questioning a lot of those underwriting issues, and pushing back a bit, we've seen that in some of the transactions. But, that really should not be their role. They are taking the most risk, so naturally they are going to take the hardest look. I'm just worried as things expand, that you're not going to be able to cover things, and we are going to start repeating some of the old problems at the basis level, which is the collateral level.

Brian P. Lancaster:

Nelson, are you in agreement? As a B-piece buyer, are you seeing credit deterioration or kick-outs increasing? Also, if you could talk about the traditional conflicts of interest and concerns that investment grade buyers had with CMBS 1.0 and how they are being addressed in 3.0?

Nelson Hioe:

In general, I agree with Francisco's comment about 1.0 deals. I would say the underwriting today is materially better than some of the peak underwriting that we saw in '06 and '07. Having been a part of PPIP (Public Private Investment Program, in which funds were raised in conjunction with the US Treasury to acquire legacy RMBS and CMBS securities), and having looked at a lot of the '05-'07 deals, I can say that with a high degree of confidence. With that said, if you go back to when 2.0 deals started in late 2010, there has been a shift since then in terms of where credit has gone. Increasingly we see a more IO loans with a partial or full term. While we do not see pro forma income, leverage has gone up, the quality of the markets has suffered a little bit and structure has started to erode somewhat. I'm not sure investors or rating agencies have explicitly given enough credit to loan structure, which I think is partially why it is one of the first things to go. As a B-piece buyer, I pay a lot of attention to that.

Brian P. Lancaster:

Can you talk more about the structural changes?

Nelson Hioe:

On the structural changes, I would point to things like cash sweeps, where the trigger thresholds have become less lender-friendly. In addition, we have seen that the sizing of reserves to protect against roll risk has become more aggressive; a corollary to this being that the estimated TIs and LCs are smaller than what is actually required in a given market. All of these items that I think could be helpful in better aligning sponsorship with the lender. Structural considerations are generally qualitative in nature; they don't show up in a strat or in an OM, but at the margins can be very powerful in keeping the sponsors engaged in the properties when things get rough, or keeping their feet to the fire, which I believe is a form of value preservation.

So from a credit and structural perspective, I would say things are becoming somewhat more aggressive, in particular post-QE3. It had been drifting over the course of 2012, but I noticed a fairly material difference between pre-QE3 and post-QE3 deals. Between those two times, I think NOI debt yields came in by approximately 100 basis points, and the pools feel a more bar-belled than in the past. So as a B-piece buyer, it makes the investing landscape more treacherous, which is part why there are not a ton of buyers out there. It's a lot of work and it's a high risk proposition.

The counter argument to what I'm saying is that the AAA buyers can still sleep very well at night knowing that they have 30% subordination, which makes it highly unlikely on any deal in 3.0 or 2.0 that these investors would lose principal. But the overall shift in credit, while subtle, can change the risk profile for B-piece bonds, because we are fully exposed to the riskiest loans.

Brian P. Lancaster:

You said one can sleep well at night at the top of the capital structure but the price you pay are low yields, Francisco's issue. You start hitting floors that you just can't live with and then you have to go down in credit.

Nelson Hioe:

The irony of investors piling into AAA bonds, and pricing them extremely tight because it is a form of risk aversion, actually perpetuates the cycle that we are talking about of increasing risk seeking on the part of originators. It leads to better execution for them in the capital markets. To put it another way, if investors are effectively insensitive with respect to relative riskiness between Deal A and Deal B because they are buying AAA bonds, they are in effect rewarding the deal with the riskier loans. There is an interesting feedback loop here that we should all be thinking about.

David Nass:

One thing that I would add that needs to be highlighted is that there isn't a bank in the securitization business today that can afford to make loans meant for securitization and keep them on their balance sheet. If a B-piece buyer removes assets from a deal, that causes a tremendous amount of internal concerns. Many firms have have zero tolerance for loan kick-outs. At UBS, we write loans that are securitizable and we do not have any kick-outs.

That's a significant different business model than the one that was in place pre-crisis. When it comes to making loans, the focus is making loans that are sellable, structured properly, and have the right leverage points. We can talk about the various stages of increased leverage and a slight deterioration of credit metrics over time – however, that is natural and should be expected as the market restarted. We have a market that is functioning again, that is accepting of risk again, that is growing again, but I think everyone would admit that, that we are no where near the leverage points of where we were heading into the crisis. The industry has been hovering around a fairly consistent stress LTV of approximately 100% for the past 6 months or so. And, we continue to see solid structure on loans.

Nelson Hioe:

Dave brings up a great point. One of the material differences between CMBS 3.0 and 1.0 is that banks have a heightened sensitivity to holding loans on their balance sheet. This is definitely also the case with kick-outs, which is another way of saying that their capital is more cautious from a balance-sheet perspective, which is a governor on risk taking on the part of the banks when they originate loans. And that is good thing for investors and for the deals.

Clay Sublett:

I can't speak for other institutions, but if we originate loans with the intention of selling them, we have to classify them from an accounting stand point as held for sale rather than held for maturity. We don't have the luxury of flipping them back and forth based upon kick-outs or what is most convenient. We have accounting firms and auditors who look very closely at whether or not we've originated with the intention securitizing or selling, or whether or not we've originated them for the balance sheet with the intention of holding them for a long time period. You don't get to have it both ways.

Brian P. Lancaster:

Clay, give us KeyBank's perspective. What type of loans are you looking to do? Are you more focused on construction and floating rate loans? That is traditionally where commercial banks have been very active. Or are you now looking at longer term fixed rate loans, recourse, non-recourse. Are you competing with the conduits? How are you making money these days?

Clay Sublett:

It's challenging. It's challenging to make money in the low interest rate environment. But there is a lot more interest on stabilized cash-flowing properties. A lot of focus on acquisitions and repositioning as opposed to ground up construction. That's not to say banks aren't making ground up construction loans, they are, especially in the multifamily space. A lot of the problems that we saw in the last cycle were caused by large holdings in the construction land loans sector. When the music stopped, those were the loans that experienced the greatest stress. We found many borrowers that had numerous projects under construction since we didn't have the cash flow and the portfolio to get them through the crisis. So there is a much heightened sensitivity to overall cash flow of our sponsor, and a focus on effectively managing how much construction lending we are doing. We are closely watched by the regulatory agencies, and supporting the construction loans that we are doing. Like I said earlier, there is a much greater focus on stabilized and or near-stabilized properties.

Brian P. Lancaster:

How far out would you go on a stabilized loan? Are you going out to 10 years, or staying within 5 years?

Clay Sublett:

There is an overlap. Certainly the longer debt, especially on a fixed-rate non-recourse basis has certainly been the territory of life insurance companies in CMBS and the GSEs. On the banking side, 3-year, 5-year, upon occasion a 7-year and a consideration for a 10-year. But there continues to be a focus on staying shorter than other institutions. That's not to say that a bank on a case-by-case basis won't jump out and do a 10-year fixed rate non-recourse loan. That is going on. And there is some overlap and competition between banks, which has been traditionally been shorter term, and life insurance companies which have been traditionally longer term. We are seeing a little bit of confusion of the players in the marketplace, especially in a market where everyone is looking for the best yield. So banks are making more fixed-rate loans than what they have done historically.

Brian P. Lancaster:

It makes sense, everyone has to pick their risk to get yield somehow, either extend duration, go down in credit, add leverage or go into more esoteric products. Speaking of that, how has the regulatory environment affected your CRE exposure and your approach to the business?

Clay Sublett:

Certainly the regulatory environment has an impact. One is the formal regulatory environment with Dodd-Frank, Basel III, the Durbin amendment, and the hard-core regulatory changes. There is also the tenor of the regulatory agencies taking a much more active role in terms of scrutiny. We spend a lot more time answering to the regulatory agencies and loan review and things of that nature. Certainly I don't think KeyBank is alone in that the compliance area of the institutions, which I'm sad to say, has been a growth area as we deal with compliance issues and oversight, such as covered employees, deferral of compensation, of call-backs of compensation. There's just an increasing environment of regulation, both formal regulation and also informal regulation brought upon by closer scrutiny on the loans that we are making, on the practices and things of that nature.

Brian P. Lancaster:

Bruce, in an earlier conversation you mentioned that banks are increasingly migrating to providing financing to projects based on existing cash flow. Do you see the banks competing with CMBS, Life Cos, or the GSEs? What is the impact of the regulatory environment on banks, and the impact of the low interest environment on banks?

Bruce Cohen:

The conventional financing landscape had the life insurance companies, conduits and Government Sponsored Entities generally providing debt on a long term fixed rate basis, matching the long term nature of their funding sources, while short term financing came from the banks and finance companies, with their reliance on shorter term deposits or the commercial paper markets. This positioned the banks as the source of capital for properties either under development or otherwise going through some form of transition. Once the business plan for these properties was executed and the cash flows had stabilized, the property would then be sold or refinanced, typically then becoming subject to long term financing.

With regulators and other constituencies now convinced that cash flow is the only thing lenders can underwrite, it's much harder to find sources of short term, flexible financing for transitional properties. More particularly, this puts the banks competing against the conduits and life companies, leading to tighter pricing and looser covenants, while assets with lower debt yields struggling to find financing. In a market in which developers make their living creating value and when many properties have gone capital starved while values dropped below the outstanding debt, it begs the question as to where the debt comes from to support the industry need.

Brian P. Lancaster:

Bruce, I've known you a long time now. You must have some thoughts. Private equity or debt funds? I think I saw somewhere, PERE maybe, that there are some 200 debt funds raising something on the order of $120+ billion.

Bruce Cohen:

Naturally, only a small portion of those funds will actually be capitalized. That being said, given the migration of banks towards cash flow lending, the market demand is such that it can accommodate a whole industry of emergent players to meet this need. Financing for assets that requires more real estate related underwriting, with a renewed focus on LTC versus debt service coverage, will become the purview of private capital and will fuel the entrepreneurial real estate developer. Moreover, the ability to provide flexibility, in terms of the execution of the business plan, covenants or prepayment, will be something increasingly valued in an uncertain environment.

There will also be niches within the capital structure or market, either for assets that are less conventional or in secondary locations, which will go underserved and create opportunity for investors.

The challenge will be for those funds to truly build out the infrastructure necessary to originate and manage these credits, as they are very different than equity investments.

Brian P. Lancaster:

If you would each give us now your 2013 outlook. How will the coming year play out? What are the potential risks that might change your perspective?

Sam Chandan:

With a focus on credit risk measurement, my big concern is the long-term performance of today's new loans in an environment of higher interest rates and much tighter monetary conditions. With an explicit commitment to low rates, the potential problems are back-ended and are being heavily discounted. That is worrisome. Apart from that, I expect lending conditions will improve over the next year for a wider range of assets. Stability in bond markets is crucial for CMBS issuance. Barring a significant policy shock, conduit lending will improve as global market conditions normalize further. Smaller regional banks are also reengaging. Although the banking system's exposure to commercial real estate declined in the most recent quarter, a majority of individual banks increased their net lending. That is a first during this recovery. It points to a better alignment of credit availability and well-qualified borrowers than we have seen thus far.

David Nass:

My outlook is positive. I think that we will see an increase in issuance in 2013 following a healthy increase in 2012. We will likely see more esoteric types of securitizations, both by structure and property type. We will continue to see conservative structures and reasonable leverage but, at the same time, a healthy increase in volume as there is plenty of product to refinance. And, the continued pick-up in acquisition financing will be another variable driving overall volume levels.

Nelson Hioe:

I'm in the same camp as David on this. I think issuance will be up, and leverage levels will stabilize and be relatively consistent. It would not surprise me if at some point during the year there may be some kind of hiccup. Not to the degree of last year with the European blowup, but something that is disruptive to the steady nature of the capital markets today. It feels like the market is somewhat medicated to many of the world's problems, which have not exactly decreased in size in the last 6 to 9 months. But barring that, it seems like the market is knitting itself together and the investor base is growing larger and more stable.

Francisco Paez:

I have very similar thoughts. In terms of issuance, we do expect to see significant growth next year. There will continue to be strong pressure on spreads, although I would agree there is the potential for some volatility related to macro events. We will have to see what the final rule is on Dodd-Frank and if that causes any kind of effect. In terms of underwriting standards, we are concerned that they may continue to deteriorate and the big question is how rapidly — hopefully not back to '06 and '07 levels. We are particularly concerned about the rate of deterioration of underwriting standards on the multifamily side.

Bruce Cohen:

Paradoxically, heading into the downturn, where there was little room for error, the market had an overwhelming appetite for risk taking. Conversely, today, with rents and the per square foot basis on most properties still close to its nadir, the market remains highly fearful and risk averse. This is particularly ironic when government policy is seemingly designed to induce risk taking. The spreads between the highest quality assets and anything one to two standard deviations away is extremely high. It would not be unreasonable to envision those spreads tightening and those willing to take a bit more risk in this environment being highly rewarded in the coming years.

Brian Lancaster:

Francisco, Bruce mentioned the lending opportunities for less conventional assets or for assets in tertiary locations. Are there any particular areas where you see opportunities in 2013?

Francisco Paez:

In general, look for buying opportunities in moments of volatility. Especially if underwriting standards don't deteriorate dramatically, the middle of the capital stack we feel continues to offer value in moments of volatility so you have to look out for that. Other than that I think continue to look for what the single assets market does and see if there any opportunities on that front as well.

Bill O'Connor:

I agree with what was said about Dodd-Frank. It's like molasses in the winter time the way the regulations come out, and we have to monitor that carefully to make sure it doesn't crimp issuance. Otherwise, I think it will be a positive year for new issuance. One of the things we are seeing is confusion with respect to valuations, particularly issuances that are coming out of institutions that aren't as regulated. In particular, values on middle market assets and properties are a concern. We see this in refinancing where law firms are working with special servicers and sharing certain values for resolution. We are seeing almost across the board, as refinancing occurs, values that are markedly higher than what the special servicer is finding from its third party valuations or appraisals. So I'm a little concerned about that going forward as the market heats up.

Clay Sublett:

Certainly, absent of the stress on the economy by the political environment and the fiscal cliff, assuming we can get past these near term issues, I think 2013 looks promising. There continues to be a lot of capital out in the market place and a lot of it capitalizing on the opportunities as being nimble and deploying it carefully. Hopefully we will see the migration of capital into, what I'll call middle America. It certainly comes from the liquidity of the gateway markets and the marketability of the assets in those markets. We are beginning to see some flow of capital away from those, simply because the prices have been bid up and the cap rates bid down so aggressively in those markets, that people are starting to look at secondary markets as a stable place to deploy capital, and I think the financing is following suit. Where we've got good clients making acquisitions, we will follow those good clients with the financing. In our opinion, the people leading the opportunities are the people who have the cash and the acquisitions that they are going to make in 2013.

Brian P. Lancaster:

Great, thanks a lot. This panel has typically been a harbinger of what to expect at the CREFC January Conference. This year the overall tone seems to be very optimistic. Should I be worried? We look forward to seeing you all there. On behalf of the CRE Finance Council and *CRE Finance World*, I want to thank everyone for their participation and insights today.

Guideposts for Federal Housing Policy

Douglas Holtz-Eakin
President
American Action Forum

The electoral season has ended, the political dust is settling, and the future of federal housing policy is coming into focus. Of course, it is far from crystal clear. Reform of mortgage finance, the future of the government-sponsored enterprises (GSEs, Fannie Mae and Freddie Mac), and incentivizing private sector capital are a colossal undertaking. The problems are complex, a tremendous amount is at stake, and prolonging the status quo is an ever-present temptation. While the top priority of lawmakers on Capitol Hill is and should be putting the federal government on a fiscally sustainable path — something that would benefit mortgage and housing markets — plans must necessarily be made to undertake needed reforms. The reform process will likely take years, but here are four guideposts to the evolution of real estate reforms.

Diminishing Uncertainty

At present, the landscape is littered with uncertainties. There are four primary drivers of this ubiquitous market uncertainty: the macroeconomic environment; the outsized government share of the current market; private market concerns over forthcoming final rulemakings; and the lack of a strategic plan for the wind-down and dissolution of the GSEs.

The macroeconomic environment presents the interrelated issues of an uncertain pace of future growth, the important exit of the Federal Reserve from its extraordinary policy regime, and the reversal of unsustainable federal borrowing. More effective, pro-growth policies can generate the incomes necessary to spur residential and commercial building, firm up the pricing of existing structures, and increase the returns to private investors. When combined with reduced federal borrowing, it will permit the Fed to exit its current policy regime, reducing the financial uncertainty facing market participants. And eliminating the threat of federal debt downgrades and the competition with the private sector for bond market funds will settle the interest rate outlook considerably.

The government's role in real estate must diminish as well. Since the housing and economic crisis began more than five years ago, the government's role in housing has grown tremendously. As private firms pulled back to mitigate risk, the government grew to be the primary player in housing finance, now accounting for 9 out of 10 new mortgages. Stringency in the private sector has shifted mortgage production to the GSEs and FHA, where observed standards have risen as well.

Little effort has since been made to wind down the government's involvement, save some efforts by FHFA, and a tremendous amount is now at stake if Congress drops the ball. The potential costs of failed reform are a paralyzing force in a polarized political landscape. Yet not knowing what will happen to the GSEs also comes at a cost.

Stakeholders do not know what the market will look like in the absence of Fannie Mae and Freddie Mac, nor do they know how competitive or profitable they can be if final rules for QM, QRM, Basel III and others are too narrowly written. The tightness of these rules will certainly have an effect on the economy, and already has. A recent American Action Forum study shows those regulations as proposed may result in up to 20% fewer loans, resulting in 600,000 fewer home sales.[1] In turn, the resulting tightened lending and reduced sales are estimated to cost 1,010,000 fewer housing starts, 3.9 million fewer jobs, and a loss of 1.1 percentage points from GDP growth over the next three years.

Together these regulations will raise the cost of borrowing for millions of homebuyers, and tighten access to credit beyond pre-boom standards. These restrictions on private mortgage origination and housing market activity are a significant cost of the new regulatory regime and an obvious reason why they need to be settled soon and done right. Further uncertainty surrounds other aspects of the financial system including the Volker rule, oversight of credit rating agencies, systemically important designations and more.

With concern over the continued implementation of Dodd Frank and Basel III, and the perils of reducing the government's dominant share of the mortgage market, there has been little to no leadership on this issue apart from efforts at FHFA. In the same way that tax and entitlement reform will require a concerted bipartisan effort with leadership from the President, so too will GSE reform. As housing markets pick up, this uncertainty must end or the system will not function efficiently and taxpayers will continue to bear far greater risk than they realize.

As these uncertainties diminish, it will become far easier to complete the reform agenda and the U.S. will be much closer to a stable system of mortgage finance.

Design a Federal Backstop

In the past few years, commentators have suggested numerous plans for the future of the GSEs. Many of these adopt a "no government guarantee" posture that envisions unwinding the GSEs and leaving private markets to undertake mortgage finance. Advocates argue that these "first-best" solutions eliminate inefficient subsidies and the perils of moral hazard.

However, they also lack political feasibility. With the government currently so deeply entrenched in the housing finance system, it seems unlikely that the government can exit the market easily and that private capital will rush back in. Moreover, in a future crisis the future Congress will intervene. Market participants will recognize this and the resultant moral hazard quite quickly. Progress will have been made when this naïve notion is discarded from the debate.

The realistic solution is to recognize the government involvement is likely, that such involvement should be structured in advance, and should limit the risk to taxpayers. Such a system would have a tiered system that exposes borrowers, originators, securitizers to that risk; followed by a backstop in the form of a government guarantee. It would exploit existing single-family and multifamily technology infrastructure at the GSEs, but eliminate the GSEs as we know them.

Separating the Single-Family and Multifamily Reforms

Housing finance reform cannot be done in a piecemeal fashion; there are too many moving parts that require coordinated reform to ensure an efficiently functioning system. For example, the scope of the GSEs cannot be reduced if volume merely shifts to FHA (as we have seen of late). At the same time, reform does not have to consist of a single gargantuan piece of legislation. Indeed, it will move more quickly if it is reflective of the fundamental differences between the role the GSEs play in the traditional single-family mortgage market and multifamily mortgage market.

Multifamily loans have generally performed quite well with a serious delinquency rate for Fannie Mae and Freddie Mac's portfolios of less than one percent compared to close to 14% rate for private market participants. With more stringent underwriting and risk sharing, the GSEs have played an essential role keeping the multifamily mortgage market liquid without burdening taxpayers. In many ways, the role of the GSEs in the multifamily space stands apart from its role in the single-family space.

As we consider plans for reform, the challenge will be preserving the function of the GSEs in the multifamily space in a new form. The GSEs were profitable when their single-family business sustained huge losses, and the liquidity needs are far more significant.

Hence it makes sense to proceed with multifamily reforms on a separate track, and a sign that reforms are on track will be the recognition of this fact.

Reform FHA in an Integrated Fashion

FHA has become a considerable force within the housing finance system since the bust of the housing bubble. The number of loans insured by the FHA tripled from FY2006 to FY2009 alone. Its market share grew from less than 5% of mortgage originations during the bubble to about one-third of mortgage originations in the past couple years.

Regardless of whether this expansion of the FHA's portfolio was necessary, plans must be made to reduce their market share moving forward and restore the Mutual Mortgage Insurance Fund (MMI Fund) to financial health. With its capital reserve ratio assessed at -1.44% in its most recent actuarial report, the MMI Fund has fallen now well below its 2% capital reserve target.

While the dollar volume of FHA single-family mortgage endorsements in 2012 is slightly below that of 2011, FHA's exit as a primary player in housing finance is not at all assured. In fact, dollar volume estimates increased each quarter this year. The HUD-announced increase in FHA premiums is an important part of restoring the MMI Fund to financial health and necessary to bring back private

"While the top priority of lawmakers on Capitol Hill is and should be putting the federal government on a fiscally sustainable path – something that would benefit mortgage and housing markets – plans must necessarily be made to undertake needed reforms."

mortgage insurers, but may not be enough. Reducing loan limits may also be needed to ensure that FHA's expansion into the broader market is only temporary. With the backing of the federal government, FHA already has a natural advantage in the market that will not shrink dramatically by increasing premiums 10 basis points.

Sustained financial losses on loans made throughout the crisis are expected for years to come. While FHA has come to play an important role not only for minority and first-time homebuyers but now in the broader market, it seems that role will now assuredly come at a cost to taxpayers for the first time in FHA's history. We need to rethink both how government encourages homeownership among lower income families and the role government will play in keeping housing markets afloat during future economic downturns. Our budget and the housing finance system will be better if we can find ways to encourage a robust private market and limit risk to taxpayers.

1 Holtz-Eakin, Douglas, Cameron Smith & Andrew Winkler, "Regulatory Reform and Housing Finance: Putting the "Cost" Back in Benefit-Cost," (October 2012), http://americanactionforum.org/sites/default/files/Regulation_and_Housing.pdf

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Douglas Holtz-Eakin has a distinguished record as an academic, policy adviser, and strategist. Currently he is the President of the American Action Forum and most recently was a Commissioner on the Congressionally-chartered Financial Crisis Inquiry Commission. Since 2001, he has served in a variety of important policy positions. During 2001-2002, he was the Chief Economist of the President's Council of Economic Advisers (where he had also served during 1989-1990 as a Senior Staff Economist). At CEA he helped to formulate policies addressing the 2000–2001 recession and the aftermath of the terrorist attacks of September 11, 2001. From 2003-2005 he was the 6th Director of the non-partisan Congressional Budget Office, which provides budgetary and policy analysis to the U.S. Congress. During his tenure, CBO assisted Congress as they addressed numerous policies — notably the 2003 tax cuts (JGTRRA), the Medicare prescription drug bill (MMA), and Social Security reform. During 2007 and 2008 he was Director of Domestic and Economic Policy for the John McCain presidential campaign. Following the 2008 election Dr. Holtz-Eakin was the President of DHE Consulting, an economic and policy consulting firm providing insight and research to a broad cross-section of clients.

Dr. Holtz-Eakin has held positions in several Washington-based think tanks. He was Senior Fellow at the Peter G. Peterson Institute for International Economics (2007–2008), and the Director of the Maurice R. Greenberg Center for Geoeconomic Studies and the Paul A. Volcker Chair in International Economics at the Council on Foreign Relations (2006). He has also been a visiting Fellow at the American Enterprise Institute, Heritage Foundation, and American Family Business Foundation.

Dr. Holtz-Eakin built an international reputation as a scholar doing research in areas of applied economic policy, econometric methods, and entrepreneurship. He began his career at Columbia University in 1985 and moved to Syracuse University from 1990 to 2001. At Syracuse, he became Trustee Professor of Economics at the Maxwell School, Chairman of the Department of Economics and Associate Director of the Center for Policy Research.

Dr. Holtz-Eakin serves on the Boards of the Tax Foundation, National Economists Club and Committee for a Responsible Federal Budget, and the Research Advisory Board of the Center for Economic Development.

CMBS – Party Like its 2007

How Deteriorating Credit Standards are Bringing Us Back to 2007

Edward L. Shugrue III
Chief Executive Officer
Talmage, LLC

"I was dreaming when I wrote this; forgive me if it goes astray. But when I woke up this morning, could have sworn it was judgment day."

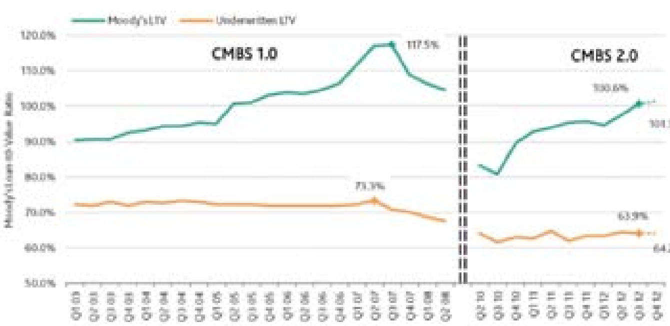
—Prince, 1999

With insatiable demand from investors for yield, CMBS issuers are loosening underwriting standards to win loans in an increasingly competitive origination environment. While the CMBS market is still recovering from the aftereffects of the financial crisis — with delinquency rates hovering around 10% and more than $76 billion of loans in special servicing — underwriting standards for new issue CMBS transactions are sliding into 2007 levels. Granted, the excesses of the top of the market have yet to be met, but the trends are alarming.

Loan-to-Value Creep

Both issuer underwritten loan-to-value ratios (LTVs) and stressed LTV data by Moody's demonstrate that in CMBS 2.0 LTV ratios for conduit transactions have been steadily increasing. While underwritten LTVs appear to have topped at 65%, these self-reported issuer levels have been trending upward, with levels as high as 67%. Perhaps more alarming is that 3Q12 saw the first CMBS 2.0 transaction since the crisis that exceeded 100% of Moody's stressed LTV levels. To be sure, LTVs are still below levels at the market peak, when 16% of deals topped 100% of Moody's stressed LTVs and 9% of issuer underwritten LTVs, but the rate of change is steep as the pressure to originate competitive loans increases.

Exhibit 1
Q3 Conduit Leverage Tops 100% MLTV



Source: Moody's Investors Service Pre-sale Reports

Furthermore, in addition to the CMBS trust debt levels, subordinate debt in the form of B-notes and mezzanine loans is becoming more frequent and increasing the true debt burden of the underlying collateral.

The Reintroduction of Mezzanine Debt

Since the financial crisis, which was substantially driven by high leverage, CMBS 2.0 has sought to address investor concerns with better CMBS structure and less leverage. To bridge the gap and to get transactions closed in an environment with less CMBS debt, mezzanine debt re-emerged in 2012 in a meaningful way. In 4Q12, three mega-transactions were announced with debt structures totaling nearly $7 billion, of which one-third (or $2-plus billion) is comprised of multi-tiered mezzanine debt. While mezzanine debt is held outside of the CMBS trust and is not secured by the real property (but rather by a pledge of the sponsor's equity in the property) and can provide CMBS investors with an extra layer of cushion from a potentially experienced operator, it also poses the following risks:

- **Default Risk.** Additional leverage places greater default risk on the assets and decreases free cash flow. The above noted transactions increased the cumulative underwritten LTV from 50% (CMBS trust) to 73% (CMBS + mezzanine);

- **Tranche Warfare.** The above transactions had multiple layers of credit-tranched mezzanine debt. In the event of a default, this tranching can lead to numerous delays and unintended consequences for the CMBS trust as the mezzanine holders skirmish among themselves; and

- **Intra-Tranche Warfare.** In a broadly syndicated mezzanine tranche (the above transactions had individual mezzanine tranches as large as $500 million), consent to resolve a defaulted transaction may be impossible to obtain due to the diverging interests of the various holders, thereby unnecessarily delaying or hindering a resolution from the CMBS trust's perspective.

Mezzanine debt, in-and-of-itself, is not necessarily a problem and must be considered on a transaction-by-transaction basis. There are many pre-crisis CMBS transactions that in hindsight were over-leveraged with mezzanine debt and were successfully restructured without cash flow interruption to the CMBS trust — even though in some cases the original borrower was replaced by a mezzanine debt holder. Examples of such transactions include: COMM 2006-CNL2 (CNL Hotels), CSMC-2006-TFL2 (Kerzner), and COMM 2007-FL14 (Glenborough). However, the additional debt burden introduced by mezzanine debt unquestionably increases risk for the loan and can create unintended consequences.

The Improving DSCR Fallacy

A mitigant of higher CMBS LTVs that is often cited is improved debt service coverage ratios (DSCRs). Indeed, on first blush, this statement appears to provide comfort. Underwritten DSCRs for CMBS 2.0 conduit transactions have hovered around 1.65x as compared to 2007 levels of approximately 1.25x. Cash flow is, after all, one of the most important determinants of value and stability. However, in our view, this has more to do with historically low interest rates rather than improved underwriting. As a test, we substituted mid-2007 10-year swap rates of 5.0% with current swap rates of 1.7% for the CMBS conduit class of 2012; doing so reduced the weighted average DSCR from 1.65x to below 1.0x.

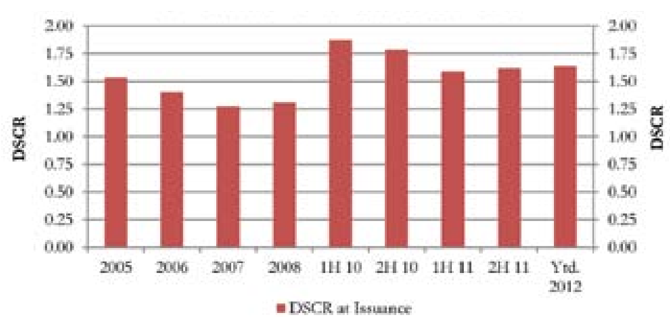
Exhibit 2

Historical 10-Year U.S. Treasury Yields

Source: Bloomberg

Exhibit 3

CMBS 1.0 vs. CMBS 2.0 – Issuer Conduit DSCRs



Source: Barclays Research, Commercial Mortgage Alert

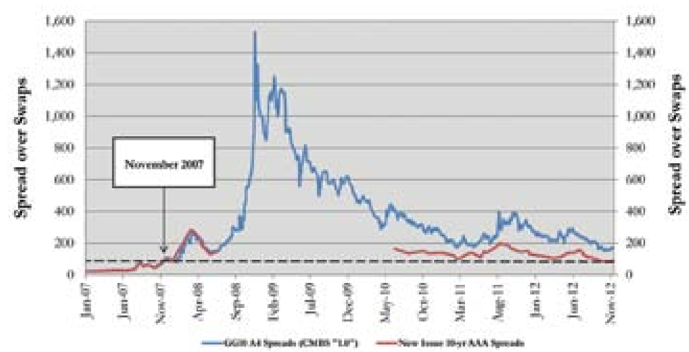
The United States is experiencing the lowest interest rates in recent history. These low rates are allowing property owners to borrow funds for 10 years or more via CMBS at all-in rates often below 4%. As compelling as the credit metrics may be for these loans, given current DSCR ratios and LTVs (driven by capitalization rates that are linked to Treasury rates), investors should ask how these loans will perform at loan maturity (typically, in 10 years) under interest rates and capitalization rates that are closer to historical averages.

2007 Level Credit Spreads Achieved

While CMBS conduit credit spreads have recovered significantly since the financial crisis, generic legacy spreads (as demonstrated by the GG10) remain at historically wide levels, as noted below. More interesting, new-issue credit spreads have rallied significantly and reached new tights in November 2012 in the COMM 2012-CCRE4 transaction where the 10-year AAA priced at swaps+83 bps, a level not seen since November 2007.

Exhibit 4

GG10 A4 Spreads (CMBS "1.0") & New Issue 10-Year AAA Spreads at Issuance



Source: Commercial Mortgage Alert, RBS, Bank of America Merrill Lynch

A governor that may dampen the continued spread rally is the absolute rate of return required by investors. With the 10-year US swap rate at below 1.7%, the total anticipated yield-to-maturity for investors, given current CMBS AAA spreads, is less than 2.6%. Nonetheless, the consensus of market participants seems to be that new-issue AAA credit spreads could continue to tighten to levels as low as swaps+ 60-65 bps in 2013.

Back to the Future? Other Recent and Noteworthy Trends

In addition to the trends noted above, 2012 CMBS transactions have reintroduced a number of unfavorable CMBS structural features and credit underwriting standards not seen since 2007. Again, while none of these items by itself is problematic, the cumulative build-up of these items is worrisome.

- **Pro Forma Underwriting.** Pro forma underwriting is making its way back into CMBS, particularly for non-stabilized assets. For example, it was prominently featured in a recent $1 billion New York City office transaction that was well-received by investors. In this particular transaction, while the leverage attachment points for the loan are sound, in our view, and while there are good reasons for the underwritten cash flows, such as contractual rent step-ups, underwritten cash flow was 56% greater than trailing 12-month cash flow;

- **Interest-Only Loans.** Interest-only loans have been on the increase in securitizations, particularly for larger, stand-alone transactions. While a loan can certainly be sized at origination to compensate for the lack of future amortization, we believe that amortization is a good discipline;

- **Pari Passu Loans.** Like interest-only loans, pari passu loans are on the rise in securitizations. To illustrate this point, there were three such loans in the recently priced GSMSC 2012-GCJ9 securitization. While pari passu loans are a convenient way to reduce loan concentrations, they can introduce complexities in the event of a work-out as various CMBS trusts hold participations in the collateral, as opposed to the whole loan, while control rests only with one holder;

- **Cash-Out Loans.** Increasingly, CMBS new-issue loans are providing cash proceeds to sponsors above and beyond their existing financing, thereby reducing their skin in the game; and

- **CRE CDO Backed by Mezzanine Debt.** The rebirth of the CRE CDO market was established in November 2012 with the successful pricing of the RCMC 2012-CREL1 transaction. Sponsored by a well-regarded investor, the transaction is noteworthy as a first following the financial crisis and as a tool through which an issuer is able to secure funding for its Mezzanine investments.

Issues That CMBS 2.0 Has Overlooked

While CMBS 2.0 has adopted a number of provisions that are helpful to the CMBS investor, primarily on the credit enhancement side, our observation is that credit standards, as noted, are loosening as the market gains stability. We feel that CMBS 2.0 never comprehensively, or consistently, addressed two issues: 1) REMIC (Real Estate Mortgage Investment Conduit) restrictions on modifying the CMBS trust's coupon, and 2) a consistent approach to special servicing.

> **"With insatiable demand from investors for yield, CMBS issuers are loosening underwriting standards to win loans in an increasingly competitive origination environment."**

First, as painfully learned post financial-crisis, CMBS REMIC structures cannot increase their coupon during an extension period or after a modification (unlike a Grantor Trust such as in GSMS 2007 EOP). This challenge can be addressed in the REMIC by building in contractual rate increases post maturity; we have not seen this in CMBS 2.0. Secondly, while concepts such as independent operating advisor are a good start, there is yet to be a comprehensive and consistent approach across CMBS transactions on how best to designate, select, maintain, and pay the special servicer.

Silver Linings

In addition to the developments noted above, there have been positive trends in CMBS following the financial crisis, notably:

- CMBS volume has been up consistently every year and is growing. New issuance creates better liquidity for the market and no one is forecasting the excessive issuance levels seen in 2005-2007;

- Underlying asset quality appears decent and limited to cash-flowing assets (no land, construction or condo loans, yet);

- Delinquency rates appear to have peaked and are declining;

- Property fundamentals are generally improving;

- The floating-rate market has restarted and provides an important source of capital for many borrowers; and

- As noted earlier, credit enhancement levels have found a safe and secure level at the senior AAA level of 30%.

Conclusion

CMBS 2.0 has introduced many new features and improvements, most notably in the more robust credit enhancement levels for the senior AAA securities. Issuers and investors have also been disciplined about overall leverage levels, asset quality and loan structure. As the CMBS market continues to grow and stabilize, along with generally improving real estate fundamentals, we expect to see a continued trend of easing credit standards. While we do not believe that credit standards have fully declined to 2007 levels, we do believe that certain key credit metrics have crossed that bridge. Moderate CMBS volume origination levels should temper excessive easing. However, it will ultimately be up to the investor to police the issuer and their standards by voting with their checkbook.

Despite many of the negative credit trends illustrated, not all bonds are created equal and we are able to selectively find attractive CMBS loans with defensive attachment points and thoughtful structures in the new issue market in which we have invested. Additionally, the CMBS legacy market, even with its many flaws, presents compelling opportunities on a daily basis as loan pools change shape and profile due to repayments, modifications and performance characteristics. As always, caveat emptor.

Edward L. Shugrue III is the CEO of Talmage, LLC ("Talmage"). Talmage, and affiliates, is an independently owned and operated commercial real estate investor, Special Servicer and advisor created in 2003. Since its formation, Talmage has made in excess of $10 billion of real estate debt investments, acted as the Special Servicer or Operating Advisor on over $10 billion of successful CMBS resolutions and has had an advisory role in over $30 billion of such transactions. Talmage is headquartered in New York City. www.talmagellc.com

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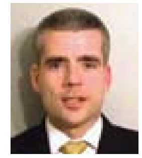
Legacy CMBS Credit Outlook for 2013: Don't Get Caught Swimming Naked



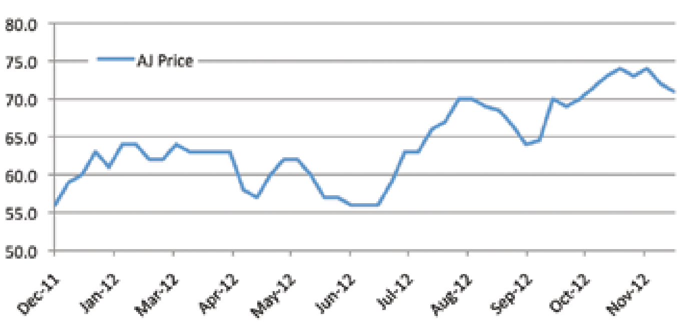
Aaron K. Bryson
CFA, Principal
Spring Hill Capital Partners, LLC

The 2013 year promises to be more challenging for legacy CMBS credit investors, after nearly across-the-board price appreciation in 2012. After a brief review of 2012 performance, we highlight four potential tailwinds to credit performance in 2013. These risks are likely to bring credit analysis and security selection back to the forefront as a driver of return, much more so than in the prior year where exogenous macro issues and a rising tide of liquidity lifted nearly all credit bond prices higher. We expect greater price tiering and dispersion across deals in 2013, providing both potential opportunities and pitfalls for investors. Security selection will be critical; to paraphrase Warren Buffett, don't get caught swimming naked when the tide goes out!

2012 Review

The 2012 year was strong for legacy CMBS credit. For simplicity, we define legacy CMBS credit as 2005+ vintage AJ[1] and below conduit bonds, with a focus on the AJs as an overall barometer. We entered 2012 at depressed valuations, following a late 2011 slide which saw indiscriminate selling pressure and pushed prices to fundamentally cheap levels. Combined with a steady yet unspectacular CRE recovery, global central bank induced liquidity, and a search for yield across fixed income credit products, we saw an impressive rally in 2012 and strong demand technicals. According to JP Morgan, legacy CMBS AJs rallied by $15 points, or 27%, over the YTD period through November. Notably, prices rose by double digits + even across weaker quality AJs; we saw similar moves further down the capital structure.

Figure 1
Legacy AJ Price Rally



Source: JP Morgan, data through November 16, 2012

In addition, there were several factors specific to CMBS that aided the recovery, including:

- A continuation of "kick the can" strategies by most special servicers — leading to reduced liquidations and increasing amount of modifications on larger loans
  - Realized losses remained low/credit support remained high, despite steady increase in delinquency pipelines
- Growing appetite for legacy credit bonds from both investors and dealers, which allowed increased supply to be easily absorbed
  - Two large CRE CDO liquidations saw an additional $3.1 billion of AJ supply floated into the market in 2Q 2012, which paradoxically brought new entrants to the market and enhanced liquidity
- Above consensus rebound in new issue CMBS supply and the beginning of a positive feedback cycle for CRE lending/pricing
  - Improved refinancing results for the large amount of 2012 maturing loans, downward pressure on cap rates, and improved outlook for the wave of 2015–2017 legacy maturities

The price rally in 2012 was in some ways a mirror opposite of the slide in late 2011. We saw almost universal price appreciation in legacy credit in 2012, as increased liquidity and the search for yield led to a rising tide which lifted prices on even weaker credit bonds.

2013 Outlook

As we head into 2013, many of the same macro factors remain firmly in place. The election outcome likely leads to a prolonged period of aggressive monetary stimulus and lower interest rates, forcing fixed income investors to continue to search for yield. Across fixed income credit products, structured products — including select legacy CMBS bonds, continue to offer attractive relative value and structural protection.

By the time of the January 2013 CREFC Conference, hopefully we have a resolution on the fiscal cliff. But, regardless of the outcome, the inevitable consequence is a prolonged period of fiscal austerity that will reduce potential economic growth and place pressure on commercial real estate fundamentals. This fiscal drag will at least partially offset the impact of aggressive monetary policy, unlike in 2012.

Within CMBS, we see potential tailwinds likely to bring fundamental credit work to the forefront and reward effective security selection. We focus on four potential risks:

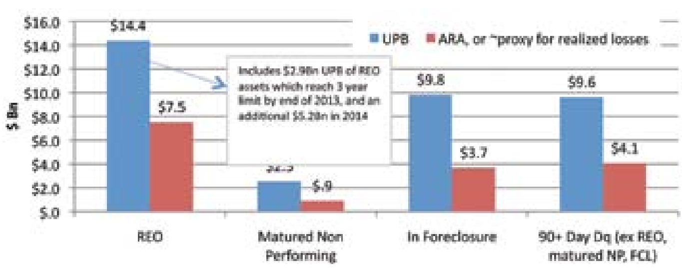
1) A "Kick the Can" Speedbump

First, the "kick the can" strategy employed by most special servicers is bumping up against an obstacle. Loan liquidations and realized losses have remained relatively low in CMBS, certainly below the pace many had expected back in 2009 and 2010 at the depths of the financial crisis. Realized losses for 2005+ vintage CMBS deals stood at only $13.9 billion, or 2.8% of original deal balance, as of November 2012. YTD through October 2012 period, we had seen only $4.6 billion of realized losses across $9.2 billion of liquidated loans by original balance. This is only up slightly from 2011, despite a continued rise in delinquencies. During this period, REO assets increased by $4 billion, to $14.4 billion.

Pickup in REO sales

Time is starting to run out on some of these REO assets. Special servicers are given wide latitude to resolve REO inventory, and generally have 3 years to sell REO assets before facing a REMIC tax issue deadline[2]. The average age of REO assets in 2005+ legacy deals is 14 months; however, this masks a wide distribution across servicers. CWCapital, the special servicer with the largest REO pipeline for 2005+ legacy deals, has an average age of REO assets of 17 months; Helios, a smaller special servicer, has an average age of 18 months. We find that $2.9 billion of REO assets will reach their 3-year hold limit by the end of 2013, and an additional $5.2 billion by the end of 2014.

Figure 2
2005+ Vintage Material Delinquency Profile



Source: Bloomberg. Data as of November 16, 2012

We believe the majority of the assets hitting their 3-year REO limit by the end of 2013 will be liquidated next year, leading to a pickup in realized losses. If we use recent appraisals and appraisal reduction amounts (ARA) as a rough proxy for losses on these loans, this suggests $1.7 billion[3] of realized losses by the end of 2013. We see upside to these loss estimates, as from our experience the longer the asset stays in REO, the greater the chance of a higher than expected loss severity given unexpected advances and expenses.

REO sales are not the only disposition strategies employed by special servicers; they may also pursue note sales, discounted payoffs, principal writedowns/modifications, etc. If we conservatively apply weights to amount of liquidated loans across REO, matured non-performing, foreclosure, and 90+ day delinquent buckets and use ARA's as rough proxy for losses, we estimate over $6.5 billion of realized losses by the end of 2013, or nearly 1.7% of current balance. This would be a sharp rise versus 2012, where we have seen $4.6 billion of loss liquidations through the end of October. These estimates ignore any liquidated loans with small losses (<3%) associated with special servicer fees.

2) There Goes My Credit Support

The rise in liquidations will lead to lower credit support and less "margin of safety" for legacy credit investors. Also, in 2013, investors will not have the same magnitude of benefit from trust deleveraging from maturing loan payoffs as in 2012. At the beginning of 2012, 2005+ conduit loans had over $30bn on loans scheduled to mature; according to Credit Suisse, 68% has paid off through October 2012, exceeding expectations. In 2013, only $7.4 billion of scheduled maturities needs to find refinancing. In 2013, par payoffs on maturing loans will not be able to offset realized losses. Combined, we suspect this will lead to average drops in AJ credit support of ~150bp, with considerable dispersion across deals — from a 0% impact to nearly 12%.

Figure 3
2005+ Vintage Scheduled Maturities

Source: Bloomberg. Data as of November 16, 2012.

"We expect greater price tiering and dispersion across deals in 2013, providing both potential opportunities and pitfalls for investors."

1st AJ to Take Principal Loss?

This drop in credit support will be felt disparately across deals and could lead to some negative technicals. We expect 2013 to be the first year that a legacy AJ takes a principal writedown. There are multiple candidates for this dubious distinction, as 18 2005+ legacy AJs were experiencing interest shortfalls as of mid-November.

Our best guess for the first AJ bond to take a loss is MSC 2007-HQ13, a bond with 8.4% current credit support. Based on the latest appraisal value for the largest loan in the deal, $80.5 million The Pier at Caesar's we expect a small loss to the AJ upon liquidation of this asset. This asset has been REO with the special servicer, C-III, since October 2011, and has been listed for sale on Auction.com on multiple occasions. The servicer has stopped advancing on the asset as future advances have been deemed non-recoverable.

Credit Burnout is Real, But Idiosyncratic Risks Remain

The optimistic view would hold that the exit of weaker loans in the pool and a reduction in the delinquent loans should offset the lack of credit support, and there shouldn't be a negative impact on pricing. This is a variation of the credit burnout phenomenon, commonly used to describe performance in non-agency residential loan pools. As described by Barclays Residential Credit Team[4], credit burnout is described as:

"The mortgage pool goes through a difficult period and worse credit borrowers default out of it, leaving behind better borrowers, who perform better if left to withstand pressures smaller than, or similar to, what they witnessed during the difficult period."

We believe the credit burnout phenomenon is real, but believe the impact is not as significant in CMBS pools as in RMBS. Stable performance history for 5+ years, especially through a severe financial crisis, reduces the future probability of default, especially for amortizing loans where the borrower is slowly deleveraging. However, in CMBS, idiosyncratic shocks still remain, especially around large tenant lease expirations in the office, retail, and industrial property types. Across 2005+ vintage deals, we see over $30.6 billion of loans, or 7.7% of all loans, on servicer watchlists for lease rollover, tenant issues, and vacancy[5]. We remain concerned about loans with large tenant rolls in weaker sub-markets, where demand can be sporadic and the availability of competing space remains high. Often, these loans do not have adequate reserves or much cushion for turnover. The hotel sector, which represents daily lease turnover and is most susceptible to a change in economic conditions, represents nearly 10% of the legacy 2005+ vintage universe. The lumpy nature of CMBS collateral means these risks will be felt disproportionately across deals, unlike in RMBS; security selection will be critical.

One recent example is the $71.2 million Millennium in Midtown loan (2.6% of GSMS 2006-GG6), backed by a 411k sf office building in Atlanta, GA. This loan had a nearly 6-year constant-pay performance history until November 2012, when the loan became 30-days delinquent. Reported financials had been strong, with a YE 2011 DSCR of 1.81X at 97% occupancy. The largest tenant, Price Waterhouse Coopers –which occupied 37% of the building, failed to renew its lease in October 2012. Servicer comments suggest this led to the default; the loan had been on watchlist for the past year.

3) Out of Control?

The pickup in realized losses in 2013 will lead to further shifts in control, causing more special servicer migration and uncertainty around loan workouts. As losses rise above the original B-piece stack and through the lower original investment-rated bonds largely held in CDO's, we will see new controlling class holders with different incentives and motivation[6]. This may have a destabilizing impact on legacy credit performance.

In legacy CMBS deals, control rights work from the bottom up, based on realized losses, not appraisal-based estimates. At origination, the controlling class representative (CCR) is the B-piece buyer, who in many cases was also the special servicer on the deal. Typically the CCR has the right to consult on loan workouts and appoint/replace the special servicer. Despite the rise in delinquencies, the original B-piece buyer is still the CCR on the majority of legacy deals. Across the 192 2005+ CMBS deals, we count 127 deals where losses have not yet reached original investment grade classes and eroded the original B-piece. We expect this number to steadily increase.

Figure 4

2005+ Legacy Conduit Deals, Realized Losses

Source: Bloomberg. Data as of November 16, 2012.

Active versus Passive CCR

As losses rise and control class shifts, credit investors face additional uncertainty. First, it could lead to a change in the CCR with potentially different strategies and/or motivations. From our experience as CCR on 2 legacy CMBS transactions, there is a big difference between an active and passive CCR. An active CCR may be incentivized to expedite loan workouts and resolutions, leading to a quicker pace of liquidations.

Additional uncertainty may occur if the special servicer changes as a result of the CCR. Special servicers can exhibit vastly different workout strategies, with some favoring a longer-term hold of REO assets versus others that tend to liquidate more quickly. A change in the special servicer can be disruptive to investors, as the workout behavior could shift abruptly and alter expected cash flows. Across 2007 vintage CMBS deals, we have already seen at least 14 of 68 deals change special servicers; we expect this trend to continue. This will require additional surveillance by credit investors.

4) More Clarity on Regulation, Status Quo

Finally, we see risks to the new issue CMBS market around risk retention rules. With the outcome of the November elections behind us, we should have more clarity on the path of future regulation. The elections generally preserve the status quo and imply Dodd-Frank risk retention limits and the Volcker rule on bank proprietary trading will likely be here to stay.

Any disruption to the new issue market, which has rebounded above expectations in 2012, will have a negative effect on legacy CMBS, especially as we approach the wave of maturities in the 2015-2017 period. On Dodd-Frank risk retention limits, the rules need to still be clarified. Depending upon the outcome, we see risks that could reduce the number of B-piece buyers and liquidity of the new issue market. Current draft rules require 5% risk retention on all transactions. For CMBS, this can be satisfied by a qualifying B-piece buyer owning the below investment grade bonds, with a string of new conditions. These conditions include limits on any hedging or sale of the position. As a result, a B-piece buyer would have to commit to holding the bonds for 10+ years, without any ability to hedge interest rate risk or sell the position based on a change in view. Additionally, new disclosures will need to be made by the B-piece buyer, including the price paid for the securities and level of experience/diligence.

We applaud efforts around risk retention and increased "skin in the game" but an overshoot of conditions on B-piece buyers could pose a threat to the recent recovery. Any disruption of the positive feedback cycle emerged in the new issue market may have significant implications for the performance of legacy CMBS deals as we approach a large volume of maturing loans.

Summary

Given the broad-based rally in 2012, legacy credit poses less "margin of safety" for investors in 2013. Historically attractive relative value opportunities still exist; however, effective security selection will be crucial to realizing strong returns in 2013 as we expect significant and more pronounced dispersion across deals. A shift in the rising tide of liquidity and/or the CMBS specific factors we highlight could be a catalyst. Until this occurs, legacy credit investors should swim carefully and keep their trunks tied on tight.

1 AJ refers to junior-AAA classes; originally rated AAA with average credit support of 12%, and average detachment point of 20%.

2 REMIC rules required special servicers to sell an REO asset within 3 years of acquiring title; however, the servicer could petition the IRS for an extension but historically this has been infrequent.

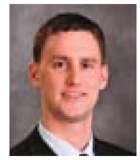
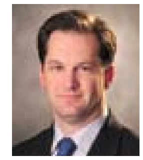
3 This represents the combined appraisal reduction amounts (ARA) on these REO assets. The ARA calculation haircuts the latest appraisal by 10% and factors in advancing/expenses.

4 "Looking for signs of a credit burnout". Barclays Capital Securitization Research, January 22, 2010 on www.barcap.com

5 Servicer watchlist codes 4A–4F.

6 Original B-piece stack refers to the below investment grade and non-rated classes at origination.

The Freddie Mac K Program: Quality, Stability, Liquidity

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Freddie Mac K certificates combine some of the best features of a private label CMBS conduit program with those of agency multifamily deals. Regular issuance, consistent structure, strong prepayment protection, large deal size, diversification, good liquidity and readily available loan level information, are combined with the high credit quality typical of GSE multifamily programs. In addition, a choice of both amortizing and interest only classes with AAA ratings and a Freddie Mac guarantee, as well as higher yielding classes with lower ratings and no guarantee, have led to the market's strong reception of this product and explosive issuance. Indeed in 2012, we expect K-certificate issuance to equal that of the entire non-agency CMBS conduit market.

Historical Context of Freddie Mac Multifamily Lending and the K Program

The Multifamily Division of Freddie Mac finances the purchase and refinancing of multifamily properties (5 or more units), the rehabilitation of older buildings and the construction of new apartments. Freddie Mac purchases loans on mid-rise buildings, high-rise buildings, walk-ups, garden-style apartment complexes and co-op buildings. Freddie Mac has been lending to the multifamily sector both on and off balance sheet since 1993. In 2008, Freddie Mac launched the Freddie Mac K program to facilitate capital markets execution.

Freddie Mac's K program is similar to that of a CMBS conduit. Freddie Mac aggregates and securitizes multifamily loans, which it then regularly issues as Freddie Mac K deals. Freddie Mac buys the loans from a network of approved Program Plus® Seller/Servicers and Targeted Affordable Housing Correspondents[1]. Freddie Mac credit reviews and underwrites these loans to the same standard as those on its own balance sheet.

Freddie Mac K-Deal Structure

Freddie Mac K-deals are typically structured as sequential pay (see Figure 1). As with a CMBS conduit deal, losses are applied first to the lowest rated tranches and then to the higher rated ones. On the other hand, principal is paid down first to the highest rated bonds and then to those lower down in the capital stack. These lower rated, non-guaranteed classes consist of generally longer average life[2] amortizing and interest only classes.

The highest rated bonds on these deals, the A1 and A2 certificates, pay fixed rate coupons and are typically rated AAA by one or two rating agencies by virtue of their senior position in the deal's capital structure. In addition they are also guaranteed by Freddie Mac. These guaranteed, AAA-rated bonds consist of both shorter average life amortizing classes (approximately 5 year and 10 years) as well as an interest only class. The interest only certificates (IO) are stripped off the senior bonds and generally structured as a WAC IO or Variable IO. They are generally priced at 100CPY which assume the underlying loans prepay in full after the prepayment protected periods.

The non-guaranteed subordinate classes receive principal payments in sequential order after the senior bonds and can also have IO classes. In addition to IOs, it is common to see a Principal Only (PO) certificate at the bottom of the capital structure. The mezzanine, subordinate bonds in these K deals have lower ratings given their position further down the capital structure and are not guaranteed by Freddie Mac.

Freddie Mac recently completed its first fully wrapped K-deal, K-P01. The $450 million in K-certificates are guaranteed by Freddie Mac and backed by 28 seasoned multifamily mortgages. Freddie Mac also served as the special servicer for the underlying trust for the first time. The deal was also unique in that it was backed by performing, seasoned loans from Freddie Mac's retained portfolio rather than newly originated loans.

Freddie Mac K-certificates consist of loans with various terms (5 years, 7 years and 10 years), fixed rate, floating rate, new collateral, seasoned collateral, single borrower and multiple borrower conduit deals.

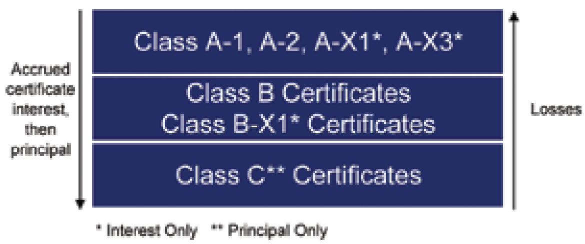
Figure 1
K-Series Types

K-000	Series backed by multifamily mortgages with various terms, but mostly 10-year terms
K-500	Series for loans with five-year terms
K-700	Series for loans with seven-year terms
K-F00	Series for loans with floating rates
K-P00	Series for seasoned loans from the portfolio
K-ABC	Series utilizes letter instead of numbers to designate single loan or single borrower securitizations, such as K-SCT for the financing of Starrett City, a very large multifamily property in New York.

Source: Freddie Mac

At present, yields and spreads on these bonds range from 1.0% or swaps plus 20 bps on the 5 year AAA Freddie Mac guaranteed certificates and 2.1% or swaps plus 42 bps on the 10 year AAA guaranteed certificates to swaps plus 185 bps on the unguaranteed B class and swaps plus 325 on the unguaranteed class C certificates.

Figure 2
Sequential Paydown Structure



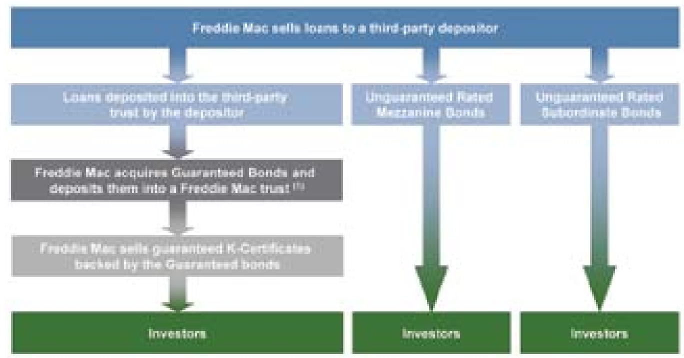
Source: RBS, Freddie Mac

How K-Deals Are Created

To securitize multifamily loans through the K certificate program, Freddie Mac first sells the loans to a third-party depositor who in turn, deposits the loans into a third-party trust. (See Figure 3). The trust then issues private label securities backed by the loans. Freddie Mac then purchases all the senior, guaranteed bonds ("Guaranteed Bonds") issued by the third-party trust and securitizes the senior bonds via a Freddie Mac trust. The resulting Freddie Mac guaranteed structured pass-through certificates ("K-Certificates") are publicly offered via placement agents, typically Wall Street financial firms, of which there are currently 13.

The unguaranteed mezzanine and subordinate bonds are issued by the third-party trust and are privately offered to investors by placement agents.

Figure 3
General Structure



Source: RBS, Freddie Mac
1 Guaranteed Bonds may include senior bonds and/or interest only bonds.

Attractive Features of K-Certificates for Investors: The Freddie Mac Guarantee

The explosive growth in Freddie Mac K certificate issuance is largely attributable to the variety of attractive features these bonds offer investors. The credit quality of the guaranteed AAA certificates is extremely high; the private label securities that back the K-certificates are typically rated AAA without taking into account the Freddie Mac Guarantee. The additional Freddie Mac guarantee provides an extra layer of support and means that they will qualify for preferential capital treatment of a 10% risk weight under the Federal Reserve just as any other Freddie Mac MBS.

Freddie Mac guarantees the timely payment of interest and the ultimate payment of principal when the loan matures on the guaranteed A1 and A2 certificates. It guarantees the timely payment of interest on the guaranteed IO. Payment of the prepayment premium by the borrower to the investor is not guaranteed. For a comparison of the Freddie Mac guarantee of the K-certificates with those of Freddie Mac MBS and FNMA DUS MBS see Figure 4 below. The other classes in a K-deal are typically not guaranteed by Freddie Mac.

Figure 4
K-Deal Guarantee Mechanics and Comparison

Guarantee	Freddie Mac K-Deal Guarantee	Fannie Mae DUS Guarantee	Freddie Mac Gold PC Guarantee
Guarantee of payment, on each distribution date, of monthly interest accrued on the guaranteed certificates	Yes	Yes	Yes
Guarantee of payment, on each distribution date, of underlying borrower's monthly scheduled principal payment due	No	Yes	Yes
If (1) a defaulted loan is liquidated or other final recovery is made with respect to such loan prior to its scheduled maturity date at a loss and if (2) the full amount of such loss is not absorbed by one or more of the junior non-guaranteed certificates, then any loss allocated to the guaranteed certificates will be reimbursed to the guaranteed certificate holders on the distribution date such loss allocation occurs	Yes	Fannie Mae DUS guarantee does not have this feature as the resolution of defaulted loans is intended to be handled outside of the trust following a par purchase	Freddie Mac Gold PC guarantee does not have this feature as the resolution of the defaulted loans is intended to be handled outside of the trust following a par purchase.
Guarantee of payment, on the distribution date immediately following the maturity date of an underlying balloon loan, of the principal on the guaranteed certificates related to such balloon loan	Yes	Yes	Yes
Guarantee of payment in full, on the assumed final distribution date (or equivalent date) for the guaranteed certificates, of any principal balance outstanding on the guaranteed certificates	Yes	Yes	Yes
Guarantee of payment of any prepayment premium payable by the underlying borrower	No	No	No

Source: Freddie Mac

Credit Quality of Underlying Freddie K Mortgage Loans

Given that the K-program is only four years old, it is too early to draw conclusions as to the overall credit quality of the program. That said, the program is off to an excellent start with no bonds having suffered losses and only one delinquent loan out of the almost 1,950 loans in the program in its first four years. As noted above, Freddie Mac retains at least 50% of the X3 IO in each deal. The X3 IO is typically stripped off of the bottom of the deal and so is very sensitive to any credit events.

It is also important to note that Freddie Mac underwrites these loans according to its Capital Markets Execution (CME) guidelines (see Figure 5) which are the same as those used for its on-balance sheet loans, the performance of which has been excellent.

Figure 5
Capital Markets Execution Guidelines

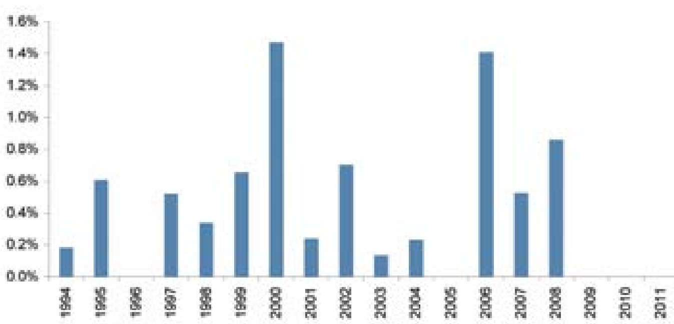
Property Types

Property Types	• Origination requirements are focused on multifamily loans, secured by occupied, stabilized and completed properties. • Limited amount of age-restricted multifamily, student housing, cooperative housing and Section 8 housing assistance payments (HAP) contracts.
Loan Terms	• 5-, 7-, and 10-year loan terms with a maximum amortization of 30 years. • May contain initial interest-only periods of 1-5 years. • Limited exposure to full term interest-only loans. • Full term interest-only loans require higher initial debt service coverage ratio (DSCR). • Fixed or variable rate loans.
Underwriting	• Effective gross income is calculated based on trailing three months actual rent collections or the annualized current rent roll minus a 5% vacancy rate. • Expenses are calculated based on trailing 12 months plus an inflation factor. • Real estate taxes and insurance are based on actual annual expenses. • Property values are based on third-party appraisals and internal value confirmation. • Replacement reserves are required and are generally equal to the higher of an engineer's recommendation or $250 per unit. • Taxes and insurance escrows are generally required. • Other third-party reports are required (e.g., Phase I ESA, property condition, etc.)
LTV & DSCR	• Maximum loan-to-value (LTV) of 80%, minimum DSCR of 1.25x (acquisition loans or refinanced loans with no cash out to the borrower) • Maximum LTV of 75%, minimum DSCR of 1.30x (acquisition loans or refinanced loans with cash out to the borrower)
Borrowers	• Single purpose entity (SPE) is required for almost all loans greater than or equal to $5 million • A non-consolidation opinion is required for almost all loans greater than or equal to $25 million • An independent director may be required for large loans on a case-by-case basis • A warm-body carve-out guarantor is generally required • Established large institutional borrowers with substantial prior experience with Freddie Mac mortgage programs may have more customized documents
Supplemental Financing	• Eligible one year after origination of the first mortgage • Purchased by Freddie Mac from original Seller/Servicer under Freddie Mac's supplemental mortgage product, on a • held-for-investment basis • Lower of 80% LTV or original LTV and minimum DSCR of 1.25x (amortizing) • Re-underwriting required based on current property performance • Subject to a pre-approved intercreditor agreement

Source: Freddie Mac

Figure 6 below shows the percent of on balance sheet defaulted loans by funding year. The Multifamily Loan Performance Database (MLPD) includes multifamily loans funded beginning in 1994, when Freddie Mac actively reentered the multifamily market using a revised underwriting process. Through 4Q11, the 2000 vintage has the highest cumulative default rate at 1.5% followed by 2006 at 1.4%. In total, 0.55% of the reported population has defaulted with a 21% loss severity, resulting in a 0.11% loss. This compares extremely favorably with legacy non agency conduit CMBS. As of October 2012, the total default rate of legacy CMBS multifamily loans was ten times greater at 6.5% with almost double the severity of 40% and a cumulative loss level over twenty times higher at 2.5%!

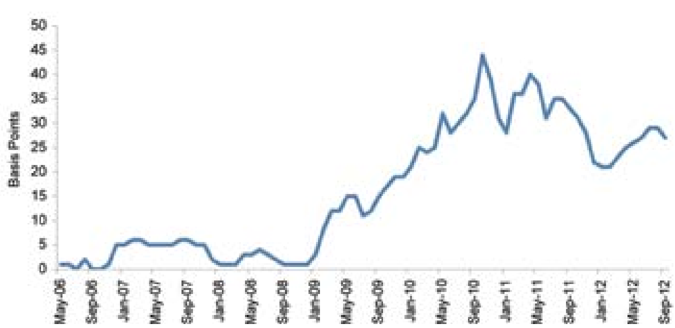
Figure 6
Percent Defaulted by Funding Year



Source: RBS, Freddie Mac

Freddie Mac's serious delinquency rate peaked at 44 bps in October 2010 and has subsequently declined to 27bps as of 3Q2012 (see Figure 7 below).

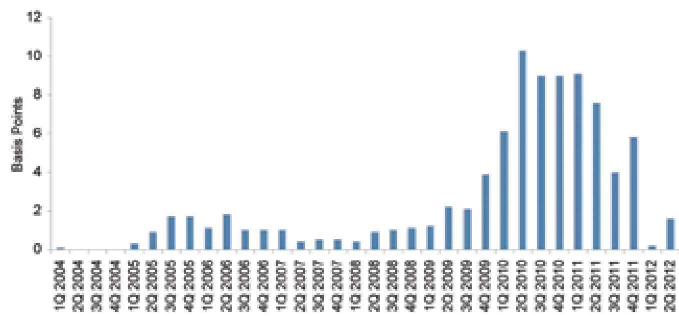
Figure 7
Freddie Mac Serious Delinquency Rates Multifamily



Source: Mortgage Bankers Association

As noted above, the track record of Freddie Mac K collateral to date has been even better than the on-balance sheet performance with only one delinquent loan in the program.

Figure 8
Freddie Mac Multifamily Net Charge-offs (Rolling Through 2Q12)



Source: RBS, Freddie Mac

The inherent quality of the more senior bond certificates and the underlying collateral is also enhanced through diversification. Freddie Mac K deals, on average, are backed by the pooled risk of approximately 68 different multifamily loans with some deals having as many as 91 loans.

U.S. Multifamily Fundamentals

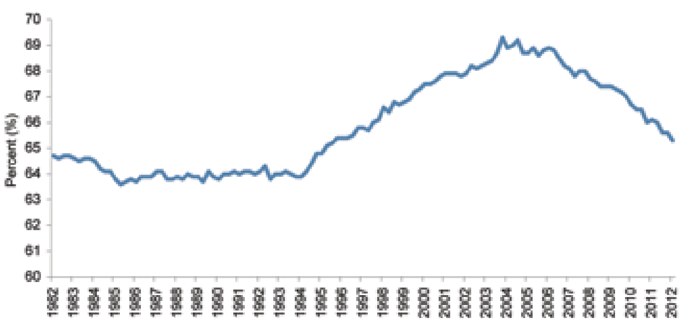
Further supporting the credit quality of the program, the fundamentals of the multifamily housing market in the U.S. are strong. Indeed, the strongest of any U.S. commercial real estate property types at present. The multifamily housing sector is expected to perform well as limited supply and strong demand drive vacancies lower and rents higher. As shown in Figure 9, the vacancy rate is around 6%, the lowest it has been since 2008.

The lack of readily available financing for marginal buyers, job insecurity, continued household formation, concerns that property values could fall or that home ownership is not a good investment have all contributed to increased demand for rental housing. Indeed, the homeownership rate in the U.S. has plummeted to below 66% (see Figure 10), a level last seen in 1996. Property Portfolio Research (PPR), a widely used and respected commercial real estate firm, forecasts multifamily vacancies to fall below 6% by 2016 from a peak of 8.3% in the fourth quarter of 2009 even as net completions pick up.

Figure 9
Multifamily Fundamentals

Source: RBS, PPR Global

Figure 10
Homeownership Rate



Source: RBS, U.S. Census Bureau

Freddie Mac K-Certificates Offer Excellent Prepayment Protection

Nearly all multifamily loans in the Freddie Mac K certificate program are call protected utilizing a combination of lockout and either defeasance or yield maintenance. Most loans backing Freddie Mac K certificates carry defeasance prepayment protection which usually occurs after a 24 month lockout period.

Lockout and defeasance are the strongest forms of call protection. Prepayment lockouts simply prohibit outright the borrower from prepaying their loan. A loan with prepayment protection in the form of defeasance permits a borrower to release the related mortgage property from the lien of the mortgage by delivering substitute collateral. The substitute collateral is typically a Freddie Mac security (although it could also be a Treasury — albeit more expensive for the borrower) designed to eliminate cash flow volatility caused by prepayments. Because of the exact replacement of cash flows by the borrower, loans that have been defeased continue to generate the same anticipated sequence of payments to the investor. Defeasance, when done to a sufficient number of loans in a deal, can also result in ratings upgrades, as the replacement collateral is typically of better credit quality than the commercial real estate loan being replaced.

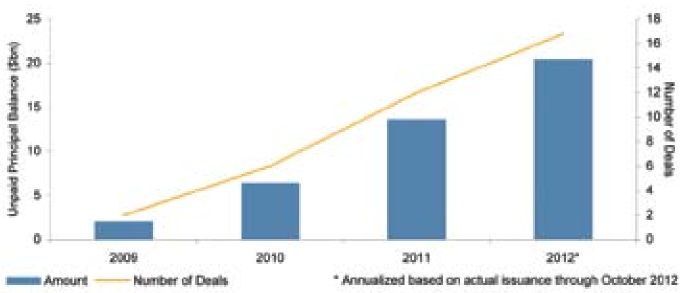
Yield maintenance prepayment protection is designed to compensate the lender for early principal retirement. It is calculated as the present value of future commercial loan cash flows discounted by Treasury yields with the average life equal to the remaining loan term.

When Freddie K deals are being priced the market assumption is 0% CPR. Prepayment protection is in place except for the last three months of the loan. While economic prepayment protection is generally excellent, default induced prepayments could occur. This would arise from the payment to investors of any principal recovered as the result of the liquidation of a loan.

Liquidity and the Investor Base in the Freddie Mac K Program

Since the launch of the program in 2008, the program has been well received by investors resulting in explosive issuance growth. During 2009 two deals worth approximately $2 billion were issued. Deal issuance then tripled to six in the following year totaling just over $6 billion and then more than doubled again with 12 deals worth almost $14 billion in 2011 (see Figure 11 below). So far this year, issuance is on pace to increase 50% to approximately $20 billion on an annualized basis. To put this amount in context, we expect a similar amount of issuance, approximately $25 to $30 billion of total non-agency CMBS 2.0 conduit deals, in 2012. Given the market's acceptance of this product and the general strength of the multifamily sector, we expect K issuance to continue to grow rapidly in 2013 albeit a bit slower than the torrid pace of the last few years.

Figure 11
K-Deal Issuance



Source: Freddie Mac

The investor base in Freddie Mac K deals is well diversified with banks currently accounting for about one third of the investor base, insurance companies and pension funds accounting for just under one third (30%) and money managers for just above a third (35% to 40%). Hedge funds have also participated, most typically in the lower rated, non-guaranteed classes, attracted by a combination of generous yields and a favorable opinion of the credit quality of the deals.

Consistent and Regular Freddie Mac K-Deal Issuance

Since the first K-Deal settled in June 2009, Freddie Mac has continued to consistently issue K-Deals. The characteristics of these K-Deals are comparable across many key features including transaction size, credit characteristics and geographic concentration. A regular issuance schedule of about one deal every three or four weeks contributes to the market's reception of the product.

Figure 12
Freddie Mac K-Deal Snapshot (thru October 2012)[3]

	Col	Col	Col	Col	Col	Col	Col	Col	Col	Col	Col
K-003	984.8	79.9	6/18/2009	62	62	5.85	113	68.8	1.67	GA TX CA CT	Wells Fargo
K-004	994.6	80.6	10/22/2009	46	46	5.56	117	69.2	1.35	TX NY MA VA FL	Deutsche Bank
K-005	1,024.30	83.1	2/3/2010	70	70	5.68	114	67.7	1.45	CA TX	KeyCorp
K-SCT	476	52.9	3/11/2010	1	1	5.77	118	68.7	1.14	NY	Wells Fargo
K-006	1,081.10	150.8	4/6/2010	68	68	5.55	114	70	1.39	CA	KeyCorp Real
K-007	1,012.40	156.3	6/24/2010	85	83	5.63	111	70.1	1.36	CA NY	CWCapital
K-008	1,010.90	147.7	9/23/2010	72	72	5.54	115	69.2	1.35	CA NY TX	CWCapital
K-009	1,089.00	159.1	11/23/2010	70	70	5.26	110	68.3	1.44	CA NY	KeyCorp RECM
K-010	1,009.50	155.9	2/10/2011	81	76	4.89	108	70.6	1.54	CA NY TX	Midland
K-701	861.3	155	3/9/2011	44	44	4.58	79	69.2	1.48	MD TX CA	Wells Fargo
K-011	1,035.10	153	3/31/2011	78	76	4.58	116	70	1.48	CA NY	CWCapital
K-012	1,038.10	172.5	4/27/2011	69	69	4.53	116	68.7	1.39	TX CA	Wells Fargo
K-013	1,097.20	153.7	5/26/2011	81	81	4.84	110	68.4	1.49	TX, NY	Wells Fargo
K-AIV	537.9	134.5	6/9/2011	19	19	5.49	118	64.4	1.31	VA, CA	Wells Fargo
K-702	1,013.20	185.9	6/29/2011	72	72	5.06	80	70.9	1.32	TX, FL, CA, MD	Midland
K-014	1,048.60	143	8/10/2011	90	90	5.3	114	62.7	1.62	NY, CA, TX	KeyCorp RECM
K-703	1,047.40	177.6	9/14/2011	71	71	5.09	84	69.8	1.36	TX, FL	KeyCorp RECM
K-015	1,010.60	154.4	11/9/2011	91	91	5.14	115	66.9	1.4	TX, CA, DC	Wells Fargo
K-704	1,009.00	194	11/29/2011	65	65	4.73	80	70.2	1.33	TX, VA	Wells Fargo
K-016	1,014.50	156.6	12/22/2011	86	85	4.78	116	67.8	1.47	NY, CA	KeyCorp RECM
K-705	1,031.30	191	2/7/2012	70	70	4.36	79	72.3	1.41	MD, NC, TX	KeyCorp RECM
K-706	1,022.80	203.016	2/28/2012	61	61	4.26	80	70.3	1.37	TX, CA, VA, MD, FL	TriMont REA
K-017	1,084.70	187.676	3/20/2012	76	72	4.54	115	67.9	1.45	CA, TX	Wells Fargo
K-501	1,106.10	193.292	4/11/2012	50	50	3.77	52	64.6	1.62	TX, VA, CA, GA, CO	KeyCorp RECM
K-707	1,101.80	211.828	4/26/2012	66	66	4.17	79	71.3	1.38	TX, CA	CWCapital
K-018	1,047.20	165.191	5/22/2012	79	75	4.46	114	71	1.42	TX, CA	Wells Fargo
K-708	1,016.60	197.257	6/7/2012	57	57	4.04	79	72.6	1.39	VA, CA	Midland
K-709	1,036.90	204.905	6/27/2012	54	54	4.02	80	72.9	1.37	TX, CA, FL, NY	KeyCorp RECM
K-710	1,063.30	221.661	7/26/2012	55	55	4	80	70.8	1.3	CA, FL, NY, TX	Midland
K-019	1,078.50	194.058	8/14/2012	83	83	4.28	114	71.3	1.37	NY, TX	Wells Fargo
K-020	1,097.50	201.317	9/25/2012	77	77	4.155	115	72.3	1.39	NY, TX	KeyCorp RECM
K-F01	1,131.16	239.944	10/25/2012	80	80		69	67.2	1.72	TX, CA, GA, CO	Wells Fargo
K-021	1,165.79	205.728	11/8/2012	81	81	4.129	114	70.4	1.5	TX, FL, NY	Wells Fargo

Source: RBS, Commercial Mortgage Alert

CMBS Conduit-Like Transparency and Deal Surveillance

Investors also appreciate the transparency in the Freddie Mac K program which is similar to that of a non-agency CMBS conduit deal. Loan and property level information can be tracked and monitored via Freddie Mac's online Multifamily Securities Investor Access website. This online tool was launched in January of this year and provides investors with information related to Freddie Mac's K-Deal mortgage-backed securities. This central database includes key post-securitization information from the Investor Reporting Packages provided on a monthly basis by the master servicer and trustee for a given security issuance.

The Multifamily Securities Investor Access tool is a good, easily available online source of information for investors. Users of the tool can perform credit analysis and monitor the performance of these investments utilizing the following features of the website:

- Access K-Deal documents such as offering circular supplements and related exhibits
- Download and analyze deal and loan level data
- View and download standard reports
- Create custom reports

The tool is free to anyone who completes a simple online registration form that includes name, phone number, email address and company name. The online tool provides the investor with more readily available information on K deals. Previously, investors and analysts could only find this information on fee-based subscription services or directly from the trustees and master servicers. For access to the website go to: http://www.freddiemac.com/multifamily/investors/reporting.html.

Freddie Mac also provides historical information on its Multifamily whole loan portfolio starting in 1994. It includes information on original loan terms; identifiers for prepaid loans, defaulted loans and delinquencies; property information, and dates of real estate owned (REO) sales.

Master and Special Servicing

Servicing works in a similar fashion as with a regular non-agency CMBS conduit deal. A master servicer collects the principal and interest payments from borrowers and passes them on to investors (see Figure 13 below for a list of master servicers). Wells Fargo and KeyCorp Real Estate Capital account for nearly 70% of all Freddie Mac K program master servicing.

Figure 13
Master Servicer Market Share of Subordinate

	Bal ($mm)	Percent of Total
Wells Fargo	18,469	48%
KeyCorp Real Estate Capital	8,037	21%
Midland	7,172	18%
Bank of America	3,794	10%
KeyBank	1,372	4%
Total	38,843	

Source: RBS, Commercial Mortgage Alert

In addition, a special servicer, as with a private label non agency CMBS conduit, works out any loans that have been transferred to it for credit or other reasons (see Figure 14 below). If a loan is transferred to a special servicer, the master servicer advances only the interest payments to investors. Scheduled principal payments are not paid until the loans are liquidated. Wells Fargo and KeyCorp again account for the bulk of special servicing or about two thirds of the market.

Figure 14
Special Servicer Market Share

	Bal ($mm)	Percent of Total
Wells Fargo	14,612	38%
KeyCorp Real Estate Capital Markets	12,238	32%
Midland Loan Services	4,863	13%
CWCapital Asset Management	4,829	12%
TriMont Real Estate Advisors	1,226	3%
Deutsche Bank	1,075	3%
Total	38,843	

Source: RBS, Commercial Mortgage Alert

Conclusion

Freddie Mac K certificates combine some of the best features of a private label CMBS conduit program with those of agency multifamily deals. Regular issuance, strong prepayment protection, large deal sizes (typically over $1 billion), diversification with an average of 68 loans per deal, good liquidity and transparency of the underlying loans for surveillance, are combined with the general high credit quality associated with GSE multifamily programs. In addition, a choice of both amortizing and interest only class with AAA ratings and a Freddie Mac guarantee, as well as those with lower ratings and no guarantee, have led to strong market reception of this product and the explosive growth in issuance to date. Indeed in 2012 we expect K-certificate issuance "to equal or approach" that of the entire non-agency CMBS conduit market.

Appendix: Freddie Mac Program Plus Sellers/Servicers

Figure A-1
Program Plus Sellers/Servicers

Beech Street Capital, LLC	HSBC Bank USA
Bellwether Enterprise Real Estate Capital, LLC	Jones Lang LaSalle
Berkadia Commercial Mortgage, LLC	KeyCorp Real Estate Capital
Berkeley Point Capital LLC	M&I Institutional Real Estate Group
CBRE Capital Markets	M&T Realty Capital Corporation
Centerline Mortgage Partners	Magna Bank
Columbia National Real Estate Finance, LLC	NorthMarq Capital
Community Preservation Corporation	Oak Grove Capital
CWCapital, LLC	PNC Real Estate - Multifamily
Financial Federal Savings Bank	Prudential Johnson Apartment Capital Express
Grandbridge Real Estate Capital LLC	Walker & Dunlop, LLC
Holliday Fenoglio Fowler, L.P.	Wells Fargo Multifamily Capital

Source: Freddie Mac

1 The originators have over 150 branches nationwide with substantial lending experience and established performance records.

2 Freddie Mac has issued 5, 7 and 10 year deals.

3 The first two K-deals were not backed by Freddie Mac collateral and so are not listed.

Pending Seismic Rating System Will Improve Commercial Property Resilience and Value

Eric Von Berg, CMB
Principal
Newmark Realty Capital, Inc.

Evan Reis, SE
Co-Founder
U.S. Resiliency Council

Hurricane Sandy's impact on the New York metropolitan area is a sobering reminder of the potential destructive force of natural disasters. The need for commercial real estate developers and owners to plan for and mitigate the effects of high winds and flooding was evident by the destruction left in Sandy's wake.

Commercial buildings are also susceptible to another type of disaster — earthquakes. Earthquakes of magnitude 6.5 or greater have occurred in the U.S. in Alaska, California, South Carolina, the Intermountain West, the Central U.S., and New England. Earthquakes as large as magnitude 9 have occurred in the Pacific Northwest. A 2003 Earthquake Engineering Research Institute (EERI) report estimated that a single large earthquake in a major U.S. urban area could result in economic losses between $100 billion and $200 billion.[1]

The creation of the U.S. Resiliency Council comes at a time when the federal government, through FEMA and the DHS is stressing the need for long-term planning for resilient infrastructure, critical facilities and communities. Engineers and government authorities have been working for many years toward the development of better metrics to measurably improve the performance of buildings subject to severe ground shaking.

Building codes largely emphasize life safety, with little consideration given to limiting economic losses. Furthermore, most current seismic evaluation procedures focus on the performance of a building's structural elements. This can lead engineers to design primarily to this one point of measurement, which may not optimize the building's overall performance. For example, as described by Bob McIntire, partner at the construction management firm Nova Partners: "For some of the light-weight steel frame building designs we reviewed for clients, the frame may be quite flexible. After a major quake the frame may perform well, with minor damage, but the occupants and contents will be thrown around violently and the façade, ceilings, walls, and fire sprinkler piping are likely to be damaged to a point that it might take six to twelve months to clear out the soggy mess and rebuild the interior."

The deficiencies with the current state of the PML process have been well documented; significant concerns being that several methods do not use a sound technical basis, or are "gamed" to achieve a PML beneath the required threshold.[2] Thus, the PML process is not considered by many to be a reliable measurement of risk or of resilience, but rather little more than a necessary checkbox to be filled in on a lender's due diligence form.

The consequence of these issues is that a building's probable seismic performance is not reflected in its rents. There are several reasons for this, including lack of awareness by owners and tenants who are not provided with this information, and a perceived lack of importance relative to other value metrics. In downtown San Francisco, there are examples of new high-rise office buildings that although they were built to surpass modern structural code requirements, they are achieving only the same rents as a well-located, well-maintained building from the early 1970s. Building codes have changed considerably since the 1970s, making major leaps in building resilience by incorporating the knowledge learned from recent earthquakes. The new buildings may be equivalent to today's NHFTA five-star rated cars with side impact panels, front and side airbags, crumple zones and back-up video cameras. The 1970s high-rise might remain standing but may take more than a year to be made functional, and may even need to be torn down. This older building is the equivalent to the vilified Corvair or Pinto, but not priced accordingly in rent or cap rate.

"These ratings will likely affect rents and cap rates before the end of the 10-year projected holding period, used to make many commercial property purchase and loan decisions."

Unlike in the U.S., the commercial leasing market in Japan rewards buildings that can promise business continuity after a major earthquake. Basic seismic safety was achieved by the upgrade to the Japanese buildings code in 1981, and validated by the performance of Post-81/82 buildings in Sendai in the 2011 Great Eastern Japan Earthquake. With safety well addressed, the Japanese commercial real estate market is focused on the business-continuity benefits provided by different "anti-seismic" design technologies such as base isolation. Tenants and brokers are aware of the various brands of seismic resilient features that provide performance above code minimums. According to a recent Wall Street Journal article and figures from the real estate brokerage Miki Shoji Co, "Buildings in central Tokyo open for less than one year, which can offer the latest technology in earthquake protection, are now commanding average leasing rates that are 40% above the level for older buildings."[3]

A seismic rating system that covers safety, repair costs and downtime gives the commercial real estate marketplace and lending community the information needed to demand and reward resilient building design. An educated and aware commercial real estate market over time will compensate owners for seismic improvements, which will eventually result in cities and states with better economic resiliency.

The U.S. Resiliency Council® (USRC) was formed in 2011 as a 501(c)3 nonprofit organization to establish a rating and accreditation system for certifying the resiliency of buildings to natural and man-made hazards. The USRC will award Certification of Resilient

"I think that commercial property owners and tenants will become increasingly aware of the importance of assessing seismic risk, and USRC's efforts to create a standard, recognizable, and understandable rating system can be an important step in making this happen."

Engineering (CoRE®) Ratings, much like the US Green Building Council® issues LEED® ratings. The USRC intends that CoRE Ratings become the standard for quantifying the value of improved disaster resilience, and a key metric for due diligence in real estate transactions. Ratings will benefit building owners, lenders, tenants and government jurisdictions by increasing the value of well-designed properties and providing a means to quantify risk. Policy makers will use CoRE ratings to compare and prioritize relative risks and to form a basis for developing long-term resilience policy.

It is important to distinguish resilience from sustainability. New York City has the largest number of LEED® certified buildings in the country, but according to Jonathan Rose, an urban planner, Hurricane Sandy revealed that these buildings "were designed to generate lower environmental impacts, but not to respond to the impacts of the environment."[4] Given the millions of tons of debris generated as a result of Sandy, and the volume of new building materials that will be required to rebuild, one might say that resiliency implies sustainability, but not the reverse.

The USRC will establish an accreditation program for professional engineers who wish to employ the CoRE system. Accreditation will require specific knowledge and training in structural engineering and the performance of buildings under natural and manmade hazards. CoRE Rating certification will also include peer review and validation by the USRC, to ensure that its highest technical standards are maintained.

Initially, CoRE ratings will be offered for earthquake resilient structures. Over time, the USRC expects to adopt CoRE rating systems for other natural and/or manmade perils (e.g. hurricanes, flood, blast).

For the U.S., the proposed seismic rating system will initially be voluntary, and while its use may not be widespread in the short term, these ratings will likely affect rents and cap rates before the end of the 10-year projected holding period, used to make many commercial property purchase and loan decisions. Of course the occurrence of a major earthquake will hasten the market's awareness and adoption of the rating systems. The New Zealand Christchurch earthquakes in 2010/2011 prompted the country to quickly develop a seismic rating system, known as QuakeStar, to communicate measures of building earthquake resilience to the marketplace simply and objectively.

Government regulation of buildings codes is akin to regulation of automobiles. Safety technology evolves and eventually is reflected in government standards for new cars; crumple zones, air bags, side impact panels were all added as requirements over time. However, once a car is sold, it is basically legal forever. The government does not pull unsafe cars off the road and crush them. So too with many older buildings that met building code requirements when they were built, but are now known to be safety hazards or may be demolition candidates after a major earthquake.

The USRC offers a technically sound and replicable methodology for implementing a consistent and measurable rating system. Ratings will build upon existing technical standards. The USRC will provide accreditation, training and peer review. CoRE Ratings will be usable by both the public and private sector, by building owners and occupants, for financial and safety assessments.

Tom Sullivan, Principal with the development firm, Westwood Development Partners, points out: "Seismic risk should be a very significant consideration for commercial tenants and other building occupants, not only in areas like San Francisco that are widely known to be seismically active, but in broad areas of the country, where a lack of recent seismic activity masks the fact that the risks are real and substantial. I think that commercial property owners and tenants will become increasingly aware of the importance of assessing seismic risk, and USRC's efforts to create a standard, recognizable, and understandable rating system can be an important step in making this happen."

CoRE Rating	Safety	Reparability	Functionality
★★★★★	Limit Entrapment	Loss <5%	Occupiable Immediately Functional < 72 hours
★★★★	Limit Injuries	Loss <10%	Occupiable Immediately Functional < 1 month
★★★	Life Safe	Loss <20%	Occupiable < 1 month Functional < 6 months
Certified	Life Safe	Not estimated	Not estimated

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2 Meyer, John D., Seismic Issues that Derail Closings, California Mortgage Bankers Association, Closing Issues Forum, 2004

3 Sposato, William, In Tokyo, Stronger Structures Rise, Wall Street Journal, November 06, 2012

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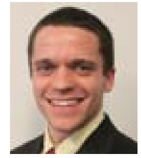
Some Counterintuitive Predictions for Multifamily Properties


Victor Calanog
Head of Economics & Research
Reis, Inc.


Brad Doremus
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Reis, Inc.


Michael Steinberg
Analyst for Economics & Research
Reis, Inc.

Like a snowball rolling down a mountain, certain topics tend to accumulate size and speed the longer they are bandied about. In this article, we examine several recent topics in multifamily that have gained traction in recent months. We offer a more nuanced look at why certain trends, however prevalent they may currently be, do not always point toward a single predictable result. First, we explain why a housing market on the upswing is not a signal for an apartment market that is past its peak. Additionally, we will explain why the upcoming surge in new apartment supply does not spell the end of the sector's robust performance over the last few years.

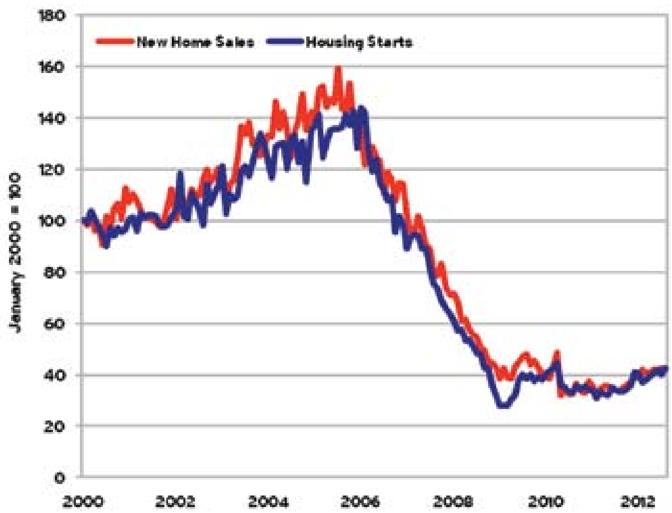
Gauging The Effects of a Housing Market Upswing

Home prices and sales have recently passed what many believe to be their cyclical trough, coinciding with a slowdown in demand for apartments that was visible in third quarter data. The timing of both these occurrences suggests that perhaps an upturn in the housing market may be contributing to slowing improvements in multifamily fundamentals. Could further improvements in the housing market dent the current upswing in the apartment market?

Housing market data releases have been uniformly positive in recent months. Home prices, as represented by the S&P/Case Shiller Composite 20 Index, rose 0.9% from July to August. More importantly, year-over-year price growth turned positive during the summer.

Total housing starts stood at a seasonally adjusted annual rate of 872,000 in September, up 34.8% year-over-year with the single-family portion rising 42.9%. New home sales were at a seasonally adjusted annual rate of 389,000 in September, a 5.7% increase from August and a 27.1% increase from one year ago. Additionally, existing home sales in August totaled 4.75 million units at a seasonally adjusted annual rate, which is 1.7% lower than in August but 11.0% higher than in September 2012.

Figure 1
New Home Sales and Housing Starts



Source: US Census Bureau

While the single-family housing market finally appears to be on the mend, this does not automatically mean less demand for multifamily. Jay Lybik, vice president for market research at Equity Residential, a Chicago-based REIT, tracks move-outs very closely every quarter and has witnessed little to no change in the number of residents leaving to buy a home.

Data from the National Association of Realtors also shows first-time home-buyers percentage of sales flat after spiking due to the Home Buyer Tax Credit, which expired in 2010. Single-family homes that are being purchased by investors for rent cater to different household types than investment-grade multifamily properties. Single-family rentals see households with children as their largest household type compared to investment-grade multifamily properties in which singles dominate, especially in urban locations.

And while all of the recent housing data releases have been quite promising, we must remember that all of these data points are recovering from a very low base. Even though some housing figures are increasing at double-digit year-over-year rates, they are rebounding from historic lows. The housing market is by no means firing on all cylinders. Households are still burdened by underwater mortgages and heightened levels of foreclosures will continue to be for the foreseeable future. Yes, the market is certainly improving as of late. But then again, it doesn't take much to post improvements given that we are emerging out of an historic housing market meltdown.

Another reason for continued optimism for apartments in the face of an improving housing market is the increasing popularity of urban living. The post-war era in America saw a great migration out of cities and into the suburbs. Suburban expansion brought with it an explosion in demand for home ownership. The suburbs provided the parents of the baby-boom generation relatively clean, quiet and crime-free towns to raise their kids. The proliferation of automobiles made suburban living a viable option.

However, recent trends suggest a reverse migration away from the suburbs back to the cities. There are several explanations for why the trend has reversed. Urban areas are no longer the hotbed for crime they once were. The surge in gasoline prices over the past decade has made automobiles a less popular mode of transportation, with many now favoring the public transportation provided in cities.

A greater penchant for urban living is also reinforced by what has been termed the "echo-boom" generation, the children of the baby boomers. The older portion of this generation is now of age to move out, providing a boost to apartment demand. This will continue as more of the echo-boomers enter their early- to mid-20s.

The argument can also be made that this younger generation will be more inclined to rent and live in urban areas for longer than their parents. Life expectancies continue to grow and younger people have responded over time by starting a family later in life, meaning that they may hold off on purchasing a home in the suburbs for longer.

Additionally, it is possible that the appeal of home-ownership has been tarnished by the recent housing market crash. Many of the younger generation may not see owning a home as the ultimate lifetime goal it was once considered. Not to mention that the current high unemployment rate among the young will most likely hinder their employment prospects in the future. Even if they were to dream of owning a home, constrained budgets and poor credit may necessitate being a renter for years to come.

Urban areas also offer higher pay and wage growth, which will appeal to people of all ages. Following a decade or more of stagnant wages, that is a mighty strong incentive for people to move into or closer to cities. While this trend won't push the apartment demand needle much higher in any one quarter, it is a powerful tailwind for the sector that should not be ignored.

There is no reason to discredit the housing market's recovery. Recent improvements have been significant, even if the housing market is experiencing a case of lowered expectations given the relative pain endured in the past five years. However, the housing market poses no imminent threat to the multifamily sector.

In fact, it is notoriously difficult to trace a direct correlation between single-family home prices and demand for multifamily rentals. Fundamentals have more to do with supply and demand trends within each property type than any interaction between them. This is why the forthcoming increase in multifamily supply is the bigger worry for most.

It's Not All About Supply

Much has been written recently about potential risks to overbuilding in multifamily, but analyzing the supply side is not enough. Demand for apartments will remain strong, and will rise further if economic growth quickens.

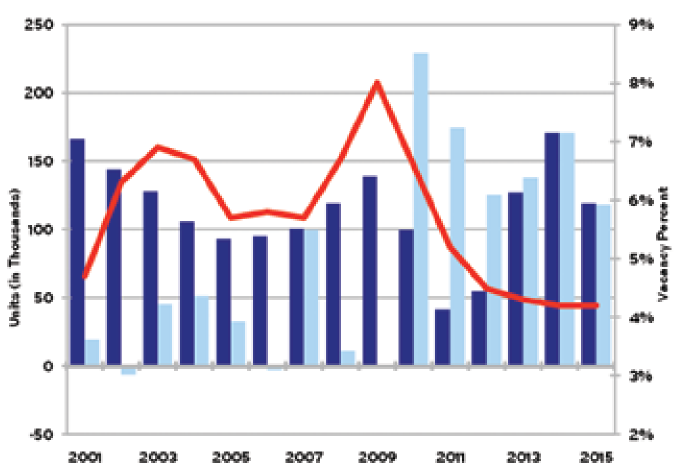
Apartment fundamentals have bounced back robustly since the recession ended in June 2009. Despite middling economic growth, the national vacancy rate dropped sharply from a peak of 8% at the end of 2009 to 4.6% in the third quarter of 2012. Vacancy rates that are this low have not been observed since late 2001.

Asking and effective rents have risen for 11 consecutive quarters and in many areas have surpassed previous peaks achieved in the third quarter of 2008, before the fall of Lehman Brothers. Landlords face little pressure to offer concessions given how tight rental markets are in most places.

Construction also remains tight, with less than 37,000 units coming online over the last three quarters of 2012. An additional 18,000 units are expected to open their doors in the fourth quarter; that adds up to about 55,000 units for the year, a slight increase from 2011 but well below the 125,000 annual average from 2000 to 2009.

Earlier in 2012, there were signs that construction would spike in 2013, in the order of 150,000 to 200,000 units. Developers have since postponed many projects to 2014, so that 2013 figures hover closer to 130,000 units—not far off from the pre-recession 10-year average. The "bubble" now shows up in 2014, but if economic growth ramps up by then (Moody's Economy.com is projecting GDP growth of over 4% in 2014, up significantly from 2% in 2012 and 2.9% in 2013), the additional supply will most likely be absorbed relatively painlessly.

Figure 2
Apartment Fundamentals



Source: Reis, Inc.

This is not to say that certain metros will not be at risk. Washington, D.C. and suburban Maryland, for instance, both face historically high inventory growth prospects over the next couple of years; these metros cannot rely on solid demand drivers like strong employment growth in certain sectors such as tech to push demand for rentals like Austin, Texas or Seattle.

Apartment fundamentals do not face a cliff, given the rise in new completions. Construction activity has been so depressed over the last two years that even new units coming on line only represent a return to recent average inventory growth rates.

However, that does not mean that apartment vacancies will continue to crater more than 100 basis points per year, since current levels are already so tight. Reis projects vacancies to remain in the low 4 percentages through 2015, not much lower than its current 4.6%. Landlords recognize this, and have shifted their focus from improving occupancy to raising rents to meet revenue goals.

There is a limit to how much landlords can raise rents as well, given that household income levels have remained relatively stagnant. But if GDP growth improves and the economic pie starts growing at a faster rate, apartment properties are poised to share in the benefits as well.

As such, apartment investors are likely to do well in the foreseeable future. Certain transactions with going-in cap rates below 3% will encounter significant exit challenges if and when interest rates rise, but market participants with realistic expectations will find it difficult to pick a sector with prospects as sound as multifamily.

Nuance In a World of Swirling with Headlines

In each of the cases above, we offer a nuanced assessment for recent popular topics in multifamily and commercial real estate. We take a more tempered view on these issues than headlines might indicate. The beginnings of a housing market recovery may be welcome news for the economy, but multifamily property owners need not fret of any major slowdown in demand. Demand for apartments will remain strong, even if an influx of new supply will restrain rent growth for specific geographical areas.

Certainty in the Face of Change: Why the Shifting Seniors Housing and Healthcare Market Will Remain a Strong Investment

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Plenty of factors in the global economy can breed uncertainty in commercial real estate markets. One current example is the debate over the "fiscal cliff," which could produce legislation that impacts a broad range of sectors and industries. Other examples: European countries are enduring under the ambiguity of their own ongoing financial crisis, and worldwide there are many regulations and rules being debated that will influence the capital markets.

While healthcare real estate faces similar uncertainties due to upcoming changes — primarily under the recent Affordable Care Act — it is different in that it has unique fundamentals that allow it to overcome such challenges. Other sectors, such as commercial office space, are strongly driven by business cycles and shifting employment trends, but the healthcare sector and subsets such as seniors housing are driven by a foreseeable need and demand. And while the future of the healthcare sector may not yet be decided, one thing is clear — demand will be increasing.

Healthcare and Seniors Housing Increasingly Intertwined

There's no question that healthcare real estate is growing — today three of the 10 largest REITs are focused on healthcare. Of those sectors related to the industry, seniors housing in particular is booming. According to the National Investment Center (NIC) for Seniors Housing & Care Industry, the market value of that sector has now reached $270 billion. As they already share many of the same demographics and fundamentals, it's not only likely that both sectors will continue to grow in the future, but that they will become increasingly intertwined as they do.

One of the primary drivers of this growth is, of course, the aging population. According to U.S. Census Bureau data, in 2010 there were 40 million people age 65 and older living in the United States, accounting for 13% of the population. This segment of the population is expected to grow exponentially by 2030, with Baby Boomers (those born between 1946 and 1964) reaching 72 million, or 20% of the U.S. population. As the life expectancies of this group are also on the rise, this means that a growing number of Americans each year will have increasing and ongoing healthcare needs that must be met by the industry.

Seniors housing facilities are already beginning to evolve to meet these growing needs. While there have always been some medical care elements to seniors housing, today we are seeing a growing number of facilities and campuses that strongly combine the two with, for example, extensive memory care units and long-term care capabilities. Exactly where the line between healthcare and seniors housing stops will depend not on demand, but on how the most recent regulatory changes will end up shaping the healthcare industry and how Americans can pay for these services.

Change Determined by Financing Challenges

As a result of healthcare reform, financing changes both large and small are causing shifts in how the industry is approaching seniors housing and care. Some of these are already taking place — today a total of 44 states offer some form of Medicaid reimbursement for assisted living (AL) facilities, according to the Paying for Senior Care website. The coverage under such waivers varies, as Medicaid options are different state-to-state and are administered at the state's discretion, but this may already be leading to a shift from higher-cost skilled nursing facilities (SNFs) to more affordable AL facilities. While providing such services may not be beneficial for all AL operators, it's clear that many facilities are already taking this change into consideration and are preparing for that trend to grow.

The larger changes to healthcare policy and regulation may be leading to a renewed focus on cost-cutting in the industry. SNFs, already experiencing some pain due to declining Medicaid budgets, are also facing billions of dollars in Medicare reimbursement cuts over the next 10 years and will now also be accountable to the Independent Payment Advisory Board. In order to address such cuts, healthcare facilities will need to trim their dependence on Medicaid revenue, either by shifting tactics on how they bundle such services, or by moving them entirely to lower-cost AL facilities. On a larger scale, we may see more organizations in the future developing affiliations as part of accountable care organizations (ACOs), now that they are eligible to receive Medicare. While none have seen a Medicare-eligible ACO, such as a network of doctors, hospitals and senior-care providers, this could be the new norm for the industry in the future.

"There's no question that healthcare real estate is growing – today three of the 10 largest REITs are focused on healthcare. Of those sectors related to the industry, seniors housing in particular is booming."

Either way, it's expected that the growing demands will lead to increasing development in the seniors housing sector. According to NIC, occupancy rates have been steadily increasing since 2009, with the seniors' population still far from its expected peak. To date, new construction in seniors housing has shown some growth, but has remained somewhat tempered due to difficulties that developers face in securing construction financing. Instead of building brand-new developments from the ground up, the focus for construction in the industry appears to be more on renovating existing communities to shift or expand the types of services offered. For example, several firms in the past years have been working on licensing properties that were previously independent living only, expanding to offer assisted living and memory care services. For other properties, serving today's seniors population may mean remodeling apartments to provide retirees with the more spacious floor plans and layouts that they have become accustomed to having.

Healthcare and Seniors Housing in the Short-Term

While in the long-term there may be significant shifts in seniors housing and care, in the short-term the trends are much as they have been in previous years. It's likely that financing and development will be focused on markets traditionally known for seniors housing: Texas, Phoenix, the Carolinas, Atlanta and South Florida. In addition to those markets, it's also expected that those states with favorable income tax rates for retirees will see increased demand from private pay customers, whose retirement income is often significantly impacted by such laws.

We could also see more consolidation deals like Health Care REIT's acquisition of Sunrise Senior Living earlier this year, as an increasing percentage of healthcare properties are owned by REITs. Because of the tremendous consolidation in the industry and investor money pouring into the public REITs — especially on the seniors housing side — it's expected that more and more healthcare properties will come under REIT ownership in the coming years. While these consolidations are often driven by benefits such as better economies of scale and financing options, many may also be driven by a considerable need for capital for much-needed renovations and improvements. For example, it is well-documented that facilities such as SNFs need substantial updates in order to serve the seniors population in the coming years while meeting the standards set by the new healthcare law.

Strong Investment are Here to Stay

While not completely recession-proof, the healthcare and seniors housing segments have shown themselves to be recession-resistant. While retail and commercial office spaces have struggled somewhat due to economic challenges and shifts in technology and communication, healthcare real estate has pushed forward. According to the Healthcare Financial Management Association (HFMA), Healthcare REITs have outpaced capital raised by real estate investment trusts in other property classifications, such as industrial, office and apartment according to the data. Through July 31, 2012, Healthcare REITs produced current average dividend yields of 4.6% versus 3.5% for industrial investments, and 3.3% for office investments. In 2012 so far, Healthcare REITs have raised 20% of all real estate investment trust capital even though they represent only 13% of the total market value. All of which has taken place without the population and demand boom expected in the coming years.

With such a strong outlook on fundamentals, it's expected that these sectors will continue to produce strong returns for investors for years to come, despite the uncertainties that may surround the industry. Regardless of cost-cutting and regulatory changes, there is simply too great a need for this sector to grow for the demand not to be met.

"Seismic ratings will likely affect rents and cap rates before the end of the 10-year projected holding period, used to make many commercial property purchase and loan decisions."

Office Vacancies and Efficient Space Use

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More efficient use of office space has the potential to keep office vacancies elevated over the long term, which in our view would be a credit negative for commercial mortgage-backed securities (CMBS). A 10% drop in the current space used per worker would raise the office vacancy rate to near 18% by 2017 from 16% currently, according to our estimates, using second-quarter 2012 CBRE Econometric Advisors' (CBRE-EA) forecasts of additions to stock and employment growth. And although we believe it unlikely, if office use per person drops 10% below the long-term average, the vacancy rate could rise as high as 24%, holding all else equal. In addition, higher vacancy rates would likely lead to lower rent growth, which in turn would lower property level net operating income (NOI) and loan debt service coverage ratios (DSCRs).

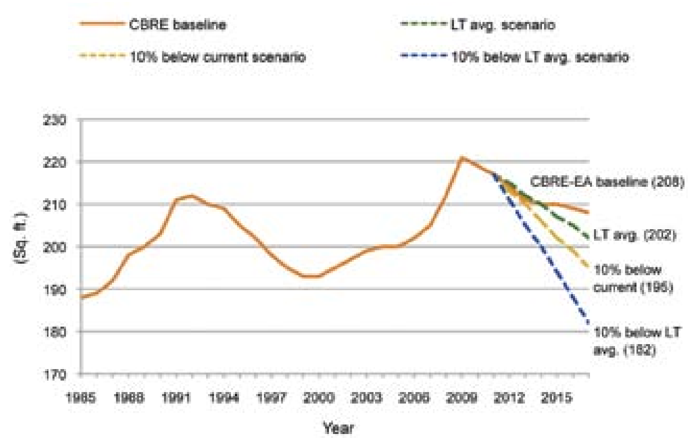
A number of corporations — including some large ones like Alacatel-Lucent, Microsoft, Credit Suisse, Unilever, and Blue Cross — have either recently announced or implemented plans to reduce office space use per person (1, 2). According to a CoreNet Global survey (an association of corporate real estate and workplace professionals), the average office space per worker will be 151 sq. ft. in 2017, well below current levels. New York City's Office of Management and Budget noted in a recent report that although the number of office workers in the city rose by 93,000 over the last two years, the amount of available office space only fell by 9.3 million sq. ft. (or about 100 sq. ft./worker). It attributed the lower square footage per person to a potential shift in company practices toward more efficient utilization of space (3). Some tech firms have already taken this early trend a step further, moving to a so-called officeless work environment as workers use homes as primary workspaces and communicate primarily over the Internet (see "Step Into the Office-Less Company," Wall Street Journal, Sept. 5, 2012).

Space Usage Per Worker Is Near A 25-Year High But Is Trending Down

Despite some early moves to efficiency, in 2011 the average office space per worker was about 220 sq. ft., according to CBRE-EA, above the 1985-2011 average of 200 sq. ft. We attribute some of this increase to the temporary effect of financial and legal sector layoffs and expect a downward adjustment as leases expire. As technology continues to improve, we believe more employees will be able to work remotely. Much like the trend of rising online sales, which has the potential to keep retail vacancies higher than they otherwise would be, we view the more efficient use of space as a structural change that will affect office sector demand over a number of years. The national office sector might not see meaningful NOI growth until 2015, according to Standard & Poor's credit analyst Larry Kay, with office efficiency playing a major role (4).

At the end of 2011, 15.8 million employees occupied 3.4 billion sq. ft. of office space (217 sq. ft. per person) according to CBRE-EA, down from the high of 221 sq. ft./person in 2009. This figure fell gradually from the high of 221 sq. ft./person in 2009. Over the last 25 years, the amount of the total stock occupied by each employee has stayed between approximately 190 sq. ft. and 220 sq. ft., averaging close to 200 sq. ft.

Chart 1
Space Per Office Using Job (1985-2011)*



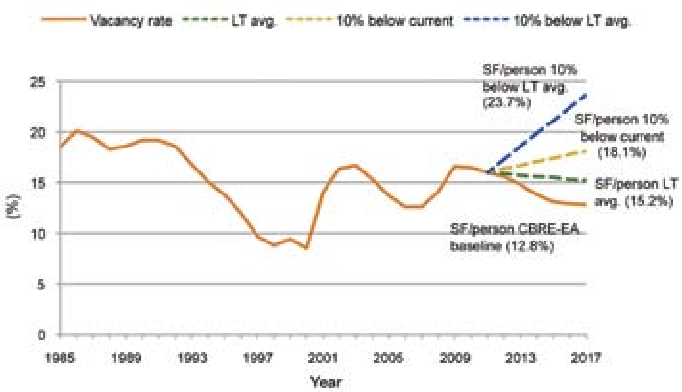
* The Standard & Poor's scenarios displayed in the chart reflect projections for 2017; we interpolated the results for 2012–2016 between the 2011 and 2017 data points.

Sources: CBRE Econometric Advisors and Standard & Poor's. LT — Long-term.

Office Vacancy Rates

The office vacancy rate also reached a near-term high of 16.6% in 2009 and has fallen to 16% as of year-end 2011. Over the 26-year period from 1985–2011, the vacancy rate has averaged about 15%.

Chart 2
Office Vacancy Rate (1985-2011)*



* The Standard & Poor's scenarios displayed in the chart reflect projections for 2017; we interpolated the results for 2012–2016 between the 2011 and 2017 data points.

Sources: CBRE Econometric Advisors and Standard & Poor's. LT — Long-term.

CBRE projects growth in office-using employment and construction over the next five years, but a reduction in office space per person could have a detrimental effect on the vacancy rate. Under the CBRE baseline forecast, the vacancy rate falls to 12.8% by 2017. The baseline results in a decline in space usage per person of 4%, but it remains 3% above the long-term average.

If the average sq. ft. usage per employee returns to the long-term average, the vacancy rate would be 2.4 percentage points higher, all else equal. With more firms looking to increase office use efficiency, the average sq. ft. usage per worker could fall even further, in our estimate. If the average usage drops 10% below the current number — to 195 sq. ft. /worker — the office vacancy rate would be 5.3 percentage points higher than the baseline forecast by 2017. In our most pessimistic scenario for office demand, per worker use falls to 10% below the long-term average, resulting in a vacancy rate of 24%.

Table 1
Future Vacancy Rate Using Selected Scenarios

	Sq. ft. per person	Occupied stock (Bil. sq. ft.)	Total stock (Bil. sq. ft.)	Vacancy rate (%)	Jobs (Mil.)
As of year end 2011	217	3.43	4.08	16.0	15.8
CBRE baseline 2017	208	3.72	4.23	12.8	17.7
Long-term avg. sq. ft. per Person (2017)	202	3.59	4.23	15.2	17.7
10% drop from current (2017)	195	3.46	4.23	18.1	17.7
10% drop from long-term avg. (2017)	182	3.23	4.23	23.7	17.7

Higher Vacancies Could Slow Rent Growth and Weaken DSCRs and NOI

To test the potential effect of higher office vacancies on rents, NOI, and DSCRs, we regressed rents on vacancies using CBRE-EA data from 1985-2011. We found that rents moved in response to vacancies, with a two-year lag. Based on our scenarios, reductions in office space per person may limit 2011-2017 rent growth or even result in a decline (see Table 2). In the scenario of sq. ft. per person usage dropping 10% from the current level, we estimated that rents would fall by 3% instead of rising 13.4% in the CBRE baseline.

Table 2
Rent Growth Using Regression Analysis

Sq. ft. per person scenario	Vacancy rate (2015) (%)	Projected rent index (2011) ($)*	Projected rent index (2017) ($)	Rent index percentage change (2011-2017) (%)
CBRE-EA baseline	13.1	22.31	25.29	13.4
Long-term avg. sq. ft. per person	15.5	22.31	23.24	4.2
10% drop from current	17.4	22.31	21.63	(3.0)
10% drop from long-term avg.	21.1	22.31	18.48	(17.2)

*To calculate the predicted percentage change in the rental index from 2011–2017, we use the 2011 rent index that the regression predicts, not the actual value.

Sources: CBRE-EA and Standard & Poor's. CBRE-EA — CBRE Econometric Advisors.

We believe the effect of higher vacancies and lower rent growth could weaken property-level NOI and loan DSCRs (see Table 3). The weighted average DSCR of 2011 vintage loans on a sample office loan rises from a starting point of 1.20 to 1.41 under the CBRE baseline scenario but falls to 1.13 if office use efficiency rises by 10% from the current level. If sq. ft. office use per person falls 10% below the long-term average, the weighted-average DSCR falls below 1.0 based on our rent regression estimates.

Table 3
NOI/DSCR Results Using Selected Scenarios And A Sample Office Property/Loan

	2011	CBRE-EA baseline	Long-term avg. sq. ft. per person	10% drop from current	10% drop from long-term avg.
Rent index ($)	22.31	25.29	23.24	21.63	18.48
Occupancy (one-vacancy rate) (%)	84.0	87.2	84.8	81.9	76.3
Size (sq. ft.)	100,000	100,000	100,000	100,000	100,000
Revenue ($)	1,874,040	2,205,288	1,970,752	1,771,497	1,410,024
Debt service ($)	1,561,700	1,561,700	1,561,700	1,561,700	1,561,700
Weighted avg. DSCR	1.20	1.41	1.26	1.13	0.90

Sources: CBRE Econometric Advisors and Standard & Poor's. NOI — Net operating income. DSCR — Debt service coverage ratio.

> **"More efficient use of office space has the potential to keep office vacancies elevated over the long term, which in our view would be a credit negative for commercial mortgage-backed securities."**

Elevated Vacancies Could Strain Office CMBS Performance

While a clear, widespread trend toward more efficient use of space has not yet emerged, we believe such a change could be a moderate hazard for CMBS credit. Overall office exposure in conduit CMBS is about 32%, though the 2012 vintage contains only 27% year-to-date. More efficient usage of space could keep the office vacancy rate elevated, which in turn would likely lower rents. Combined, these effects could be detrimental to property-level NOI and DSCR.

Related Criteria And Research

- A Recovering Office Market May Not Move the CMBS Office Credit Needle, Aug. 8, 2012

Notes

1 "Trend: Large Companies and Their Move to Efficiently Use Space," Officesnapshots.com, July 24, 2012

2 "Law Firms Say Good-Bye Office, Hello Cubicle," Wall Street Journal, July 15, 2012

3 "Presidential Politics Delay Manhattan Office Leasing," TheRealDeal.com, Aug. 2, 2012

4 "Step Into the Office-Less Company," Wall Street Journal, Sept. 4, 2012

5 "A Recovering Office Market May Not Move the CMBS Office Credit Needle," Standard & Poor's, Aug. 8, 2012

Construction Debt Casts Long Shadow Over Banks' CRE Portfolios

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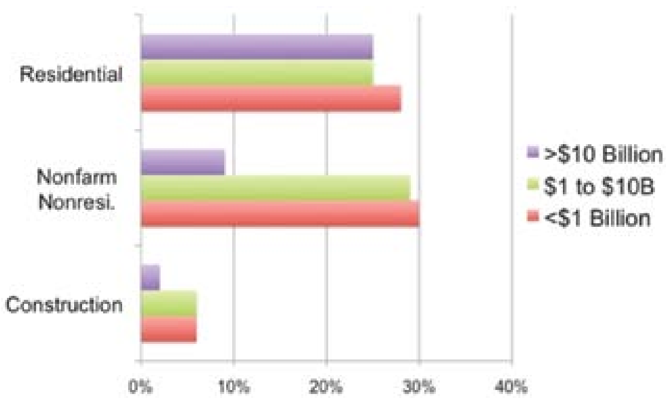
As 2012 comes to a close, the complexity of America's real estate crash in the banking sector continues to unfold. Looking at the big picture, FDIC data for the nation's 7,246 banks and federally chartered thrifts showed commercial real estate (CRE) asset quality indicators continued to improve in the first half of 2012. One important milestone was reached as total delinquent CRE loans and foreclosed properties fell below $100 billion, down almost 28% from a year ago.

Despite slow but positive progress, closer scrutiny on underlying asset classes in banks' loan portfolios reveals the rocky road to recovery continues, particularly for smaller banks. The nation's community banks, defined as having assets less than $1 billion, and mid-sized banks with assets of $1-$10 billion, continue to be vulnerable to disproportionate CRE exposure. While CRE loans comprise 14% of the $700 billion in banks' aggregate portfolios, mid-sized banks have 29% and community banks 30% exposure, compared to 9% for banks with assets over $10 billion.

Even more challenging for the sector is the concentration of construction and development (C&D) loans: $51.9 billion (6%) at mid-sized banks and another $55.1 billion (6%) at community banks. At mid-year, the combined $107 billion in C&D loans is almost equal to the $110.3 billion (2%) on the books of large banks with assets over $10 billion.

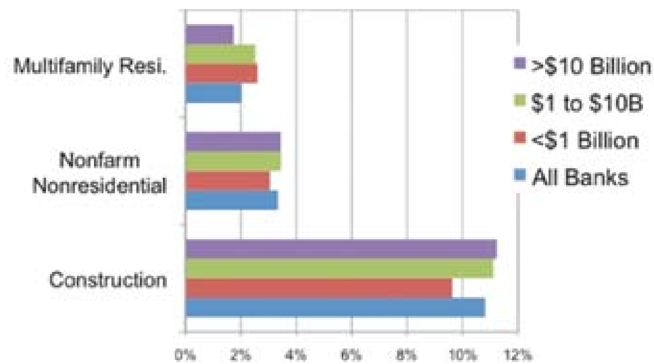
Chart 1
U.S. Banks Loan Portfolio by Asset Size



Construction Loans Produce Shaky Foundation

Across the board, the delinquency rate at the end of June was highest for construction loans. Noncurrent C&D loans exceeded 11% for mid-size and large banks, running 9.6% for community banks.

Chart 2
U.S. Banks % Noncurrent CRE Loans by Asset Size



Mid-year REO statistics also tell a sobering story. The FDIC reported a total $41.8 billion in REO at the end of June, of which $14.3 billion (34.2%) falls in the C&D category. Community and mid-sized banks hold the lion's share, $5.8 billion and $4.7 billion, respectively, $10.5 billion combined – 74% of all construction and development REO.

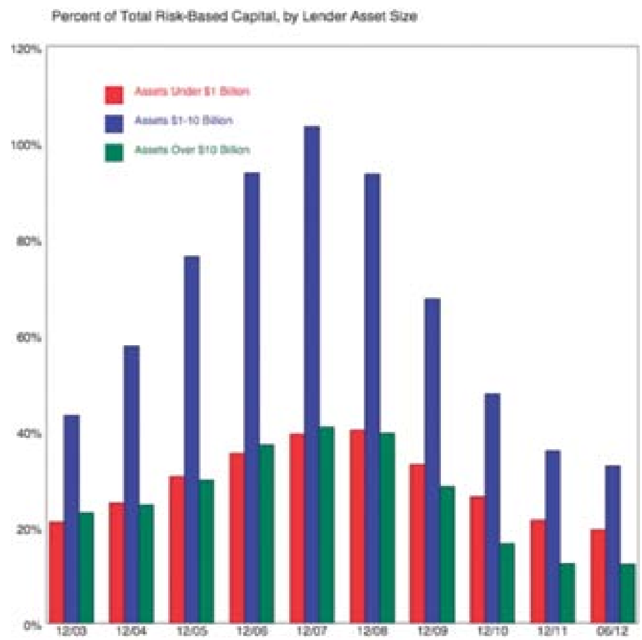
Acquisition, construction and development loans (ADC) can be relatively high-risk, even in a boom economy. Many of the 407 banks that failed since 2007, and those that remain in serious trouble today, did not fully appreciate the concentration risk of construction and land development exposures in a down market.

Portfolios of small and regional banks are more heavily weighted to secondary and tertiary markets, where pricing has been slow to recover. Refinancing in these markets remains difficult, even for properties with stable cash flow.

Even before the sector crash, mid-sized banks had significantly higher concentrations of ADC loans than community banks and large banks. At the end of June 2012, mid-sized banks still held almost 40% of risk-based capital in construction and development loans, more than double the exposure of small and large lenders. This situation highlights the severe risk of CRE losses that many banks still face.

"Looking at the big picture, FDIC data for the nation's 7,246 banks and federally chartered thrifts showed commercial real estate (CRE) asset quality indicators continued to improve in the first half of 2012."

Chart 3
Median Construction and Development Loan Concentrations by Lender Asset Size: 2003–2012



Sobering, But Enlightening, Statistics

It's apparent that banks that hunker down to conduct detailed analyses of their CRE loan transactions may find some surprises.

For instance, if a significant portion of commercial real estate loans are secured by owner-occupied properties, these loans are essentially commercial or business loans and ADC exposure is likely understated, particularly for smaller banks.

Portfolio analyses for banking and CRE investor clients have turned up "misclassified" loans for residential lots, spec homes, built-to-suit industrial space for builders and building companies.

Many times, loans are written where primary or secondary residences of business owner-borrowers serve as additional collateral to CRE loans. Additionally, there are single-tenant office/industrial with little marketable value.

Loan classification distinctions are important for accurate structuring, as well as reporting. A loan backed by an income-producing property relies on the performance of that property for the repayment of the loan. The loan is underwritten based on the ability of future property revenues (in the form of rent and lease payments) to cover both future property expenses and the debt service of the loan. On the other hand, a loan backed by an owner-occupied property is essentially a business loan with additional collateral (the property) pledged as credit support. In this case, the loan is underwritten based on the ability of future business revenues to cover both business expenses and the debt service on the loan.

Five years after the crash, many banks still haven't come to grips with how to deal with distressed construction projects. The reasons banks are having difficulty revolve around three issues: first, there may be no expertise to complete the project, especially if the owner has walked away; second, there's no capital available because the money has run out; third, in many cases, market conditions do not support the real estate as underwritten. All three conditions create a perfect storm for banks stuck with these loans.

Slow-Growth Economic Recovery Extends Banks' Pain

Although fundamental economic health is necessary for real CRE sector recovery, most economic growth measures are only weakly positive. Still, as 2012 closes, traditional drivers of CRE rent growth and demand have begun to track stronger than the broad market (and magnitude of CRE distressed debt) would suggest. Also, corporate balance sheets are showing increased strength.

Another bright spot, home prices continued to rise in the third quarter of 2012. The National Index was up 2.2% over the second quarter of 2012 and 3.6% above the third quarter of 2011, as reported by S&P Case Shiller Index. Improvement in the residential market may also boost commercial property, as a strong housing market helps increase consumer spending.

Once residential prices improve, pricing clarity will provide much more certainty for investors looking to purchase distressed loans, or banks attempting to work them out.

Ultimately, community and mid-sized banks likely will face more difficulty than their large counterparts, as the entire banking system deals with unprecedented pressure.

A Modest Outlook for Commercial Real Estate

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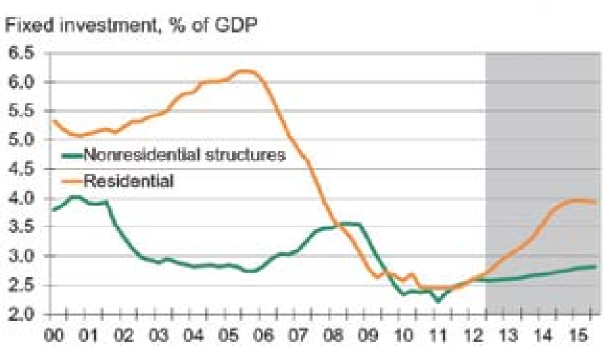
After a sharp downturn during the Great Recession and a slow transition to recovery, commercial real estate can look forward to modest improvement, at best, over the next several years. Setting the stage for the steadily improving outlook is strengthening demand for CRE and stabilizing credit availability for CRE loans. Multifamily residential and office-related CRE have the brightest outlooks because of favorable demographic trends, the lowered homeownership rate, and expansion among technology-related services. Retail faces the weakest outlook because of reduced home equity in the aftermath of the housing crash and expectations of rising saving rates that will limit the outlook for retail sales. CRE's impact on the broader economy will strengthen gradually in the near term and as the economy transitions belatedly into expansion.

Broad CRE outlook

Investment in fixed nonresidential structures as a percentage of GDP has risen modestly since bottoming in 2011 and is now roughly equal with fixed residential investment. Both will increase as a share of GDP, but nonresidential structures investment will trail as pent-up demand for housing fuels new single-family residential construction (see Chart 1). Further reflecting the brightening outlook for housing, investments in apartments will rebound faster than other major components of CRE — office, manufacturing and retail — by the end of the decade. As a share of GDP, fixed investment in multifamily housing will regain approximately a third of its decline of past years, more than double that other components of CRE.

Chart 1
CRE Will Add Modestly to Recovery

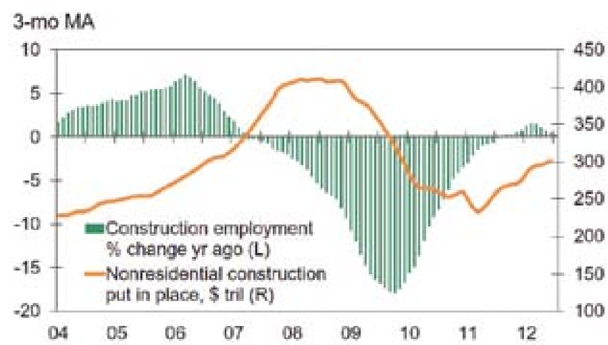


Sources: BEA, Moody's Analytics

Low borrowing costs today offer broad support for CRE investment. Since peaking in 2006 at 5%, yields for five- to 10-year Treasury bonds, to which fixed-rate CRE loans are frequently linked, have fallen below 2%. The low-cost environment, however, will soon begin to gradually dissipate. Treasury yields are projected to begin rising by the first half 2013 amid a deepening recovery. By the end of 2014 yields will reach only those of early 2011, which was the last time when bond yields increased. So while borrowing costs will rise, they will be low in historical terms for the next several years.

CRE will provide a limited lift for construction, the labor market, and the broader macro economy. Construction output and employment have recently leveled off from their long declines (see Chart 2). As the pace of CRE construction and investment accelerates, demand will rise for construction services and labor.

Chart 2
Little Lift for Construction Employment



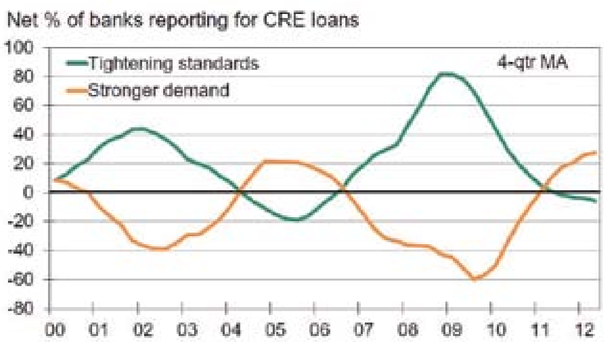
Sources: BLS, Moody's Analytics

Further, CRE markets in the U.S. will strengthen prior to European markets. While the European Central Bank's bank lending survey does not include a breakout for CRE lending standards and loan demand, as is done by the Federal Reserve, the contrast between the environment for business lending in the U.S. and in the EU is stark. Whereas lending standards are easing and demand for loans is increasing in the U.S., European banks are tightening standards on net amid falling demand for business loans.

CRE credit availability and quality

The amount of credit available for CRE is stabilizing. After contracting by 20% from a peak at the end of 2008, commercial banks' assets in the form of CRE loans have been steady in 2012, according to the Federal Reserve. Helping to place a floor on the amount of CRE lending has been an easing of lending standards. The net percentage of senior loan officers reporting loosening lending standards for CRE loans has been increasing since the beginning of 2011 and is now at its highest level since 2006 as reported by the Federal Reserve. The opening of the credit spigot tracks closely with rising demand for CRE loans, which has also been increasing since the start of 2011 (see Chart 3).

Chart 3
CRE Loan Spigot Opens Wider



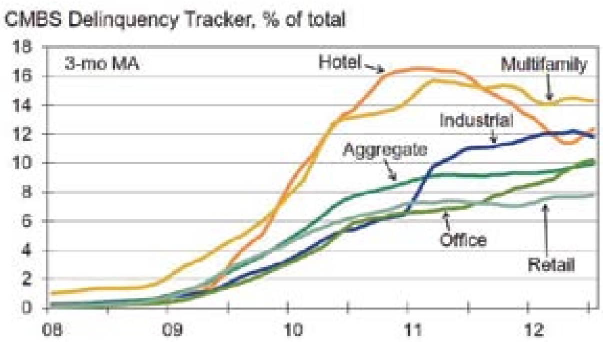
Sources: Federal Reserve, Moody's Analytics

Two key factors are leading to increased CRE lending. First, banks have been able to deleverage a sizable share of their troubled CRE loans in recent years. The delinquency rate for CRE loans issued by the top 100 commercial banks has fallen to below 6% after peaking at almost 9% in 2010, according to the Federal Reserve. Similarly, the charge-off rate for CRE loans has dropped from its peak of almost 3% in 2009 to 1%. Today's delinquency and charge-off rates are still well above their respective 2000 to 2007 averages of 1.5% and 0.1%. Nonetheless, a dwindling amount of troubled loans has cleared space for new CRE loan issuance.

Second, with the federal funds rate and five- and 10-year Treasury yields at historic low levels, the cost of lending has fallen for commercial banks. The net percentage of commercial banks decreasing the spread of their loan rates over the cost of funds has increased since the second half of 2010, according to the Federal Reserve.

In contrast to the general improvements for CRE credit availability and quality, the environment for commercial mortgage-backed securities has yet to turn around. After hovering close to 9% for most of 2011, the percentage of delinquent CMBS has surpassed 10%, according to the Moody's CMBS Delinquency Tracker. The declining portfolio of CMBS and renewing five-year CRE leases — office space in particular — in a much less favorable leasing environment have been responsible for the rising share of delinquent CMBS this year (see Chart 4).

Chart 4
Office Edges Up CMBS Delinquencies



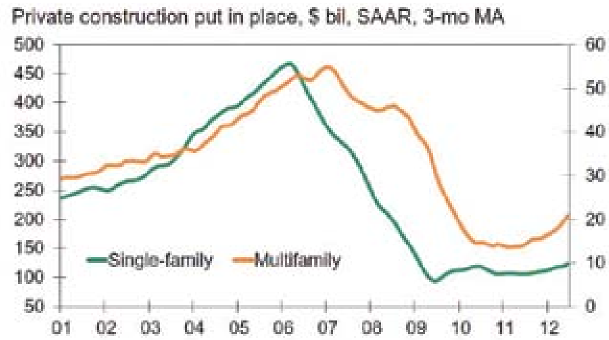
Sources: Moody's Investors Service, Moody's Analytics

Apartments

Apartments have experienced one of the most robust recoveries among the major components of CRE. Multifamily residential construction put in place experienced a 75% peak-to-trough decline between 2007 and 2010, greater than other types of CRE. However, it has already recovered almost 20% of construction put in place lost during the housing crash, second only to manufacturing.

Multifamily housing has benefited from two factors. First, multifamily construction never came close to the excesses that occurred in single-family homebuilding through 2005, leaving it better balanced. The peak-to-trough decline for single-family construction exceeded that of multifamily construction and to date has recovered less than 10% of its decline amid large inventory of distressed single-family houses (see Chart 5). Second, the severe correction in the market for owner-occupied housing has resulted in much stronger demand for rental units. The earlier surge in foreclosures has pushed many former homeowners into the ranks of apartment dwellers. After peaking at 69% at the end of 2004, the homeownership rate has fallen to below 66%, the lowest rate in 15 years. Concurrently, the multifamily residential vacancy rate, which jumped from below 11% in 1999 to above 13.5% at the beginning of 2008, has edged down slightly to 13.3% over the past two years.

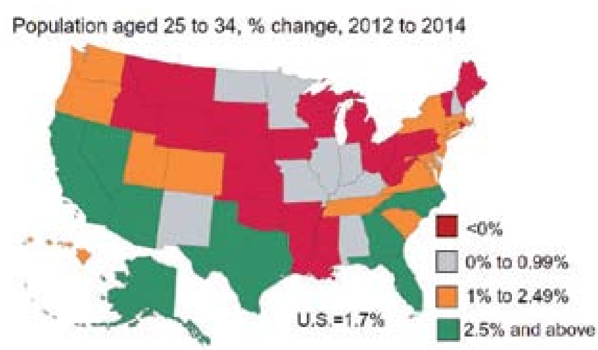
Chart 5
Apartment Construction on the Rise



Sources: Census Bureau, Moody's Analytics

Favorable demographic drivers are also pushing demand for new apartments. The share of the population aged 20 to 34 is rising. This age group is the largest consumer of apartments. The earning power of the so called baby boomer echo has been lessened by the weak labor market over the past four years, limiting the group's ability to purchase homes. As a result, the cohort's pent-up demand for apartments will fuel demand for apartment units as the labor market recovery strengthens. The Sun Belt will experience the greatest growth rate of 25- to 34-year-olds over the next several years (see Chart 6). The major metro areas that will experience the fastest increase of this cohort are Raleigh, Las Vegas, Austin, Phoenix and Charlotte.

Chart 6
Apartment Demand Surges in Sun Belt



Sources: Census Bureau, Moody's Analytics

A strong outlook for overall household formations will also lift apartment demand. After falling to its lowest level on record, the household formation rate is already increasing and is expected to do so through 2014. Apartments will absorb much of this renewed demand for housing. Recent history and the positive outlook for apartment demand can be seen in strong returns for real estate investors. According to the National Council of Real Estate Investment Fiduciaries, apartments have led all other property types in rates of return since the end of 2010.

Manufacturing

Manufacturing has posted the strongest recovery among major CRE components in terms of construction put in place (see Chart 7). Boosting demand for manufacturing CRE was manufacturing's early and outsize recovery in 2009 ahead of the rest of the economy. The falling value of the dollar from 2009 to mid-2011 made U.S.-manufactured goods more competitive worldwide. Further, a strong rebound in business investment spending helped to support domestic demand for manufacturing. Through the middle of 2012, manufacturing construction put in place has recovered 60% of its peak-to-trough loss during the recession.

Chart 7

Manufacturing Leads Non-Res CRE the next few years.

Sources: Census Bureau, Moody's Analytics

The outlook for manufacturing CRE will remain positive for the next few years. Manufacturing output is expected to continue outpacing the rest of the economy, supported by the increasingly favorable international profile of U.S. manufacturing. The weighted average exchange value of the U.S. dollar will help keep U.S. exports competitive. Further, labor costs will remain contained for U.S. manufacturers because of very slow wage growth and little upside pressure resulting from the slack labor market. These factors, combined with higher manufacturing costs in Asia and rising trans-Pacific shipping rates help to improve the comparative advantage of U.S. manufacturers.

The West and the South will experience the largest increase in manufacturing payrolls during this period as a result of tech capabilities and manufacturing-friendly policies such as right to work restrictions on unionization. High-value-added and technology-producing manufacturing output growth will rise further, driven by more capital intensive processes and less labor. Thus there will be rising demand for modern manufacturing space that can accommodate increasingly complex and automated production processes.

Office

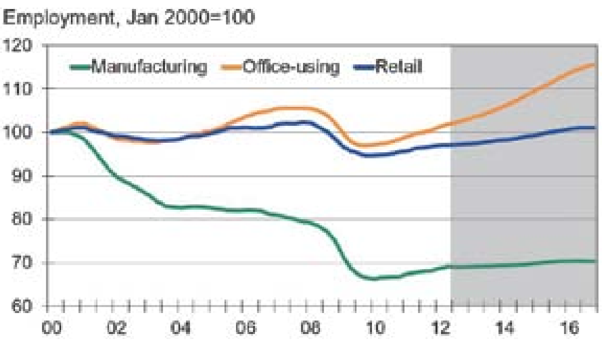
Office space has been the slowest major component of CRE to recover from the Great Recession, particularly as it relates to new construction. Office construction put in place declined more than 60% peak to trough; only retail construction had a greater fall. And its post-trough increase of 9% lags those of all other major CRE components. Slow gains in office-using employment keep office vacancy rates above their prerecession lows in many metro areas. Among the weakest industries are wireless telecommunications, financial services, legal services and government.

Weak office demand is evident in the recent rise of CMBS delinquencies as measured by the Moody's Delinquency Tracker. A rise in CMBS delinquencies was triggered this year by a surge of renewals of five-year office leases that had been signed before the onset of the financial crisis and recession. Renewals are being negotiated in office markets that are much less favorable for lessors of office space than in 2007.

Despite the broad weakness, there are some pockets of strength for office demand. Many tech-oriented office-using industries have already recovered all the jobs lost during the recession, pushing down office vacancies and spurring new office construction in a handful of metro areas with sizable technology clusters, such as San Francisco and San Jose. Physicians and other health practitioners have also recovered their recession peak-to-trough losses reflecting the strength of healthcare in recent years.

Measuring demand for new office-using space by total office-using employment, demand will surpass its prerecession peak by early 2014, ahead of other major CRE related industries (see Chart 8). The industries contributing the most to office-using employment growth from the middle of 2012 through the end of 2014 will be those among the hardest hit during the recession that have registered modest recoveries to date such as temporary employment and financial services. Tech-oriented industries will continue to drive new office space, in particular management, scientific, and technical consulting and computer system design. Regionally, as for manufacturing, the West and the South will outpace the rest of the U.S. in office-using employment on the strength of burgeoning technology-using industries and favorable demographics driving increased demand for finance and other services (see Chart 9).

Chart 8
Office Demand Will Recover First



Sources: BLS, Moody's Analytics

Chart 9
South, West Lead Office Job Creation

Sources: BLS, Moody's Analytics

Retail

The deep business cycle hurt demand for new retail space similar to that for office space. Retail suffered the largest peak-to-trough decline in construction put in place among major CRE components, a decrease of 65%. Several factors triggered the deep decline and weak recovery in retail construction. The sharp drop in house prices eliminated much of the home equity that had fueled consumer spending prior to the housing crash. Plummeting home sales weakened demand for housing-related goods. Finally, the overall weak job market has weakened income growth and consumer confidence.

A tepid rebound in retail construction was led by auto retailers in 2011 as federal support for the automotive industry and pent-up demand spurred sales. Surpassing automotive retail construction since the end of 2011 has been the food/beverage and multi-retail components of retailing. Multi-retail includes general merchandisers, shopping centers and shopping malls. The composition of retail space will likely evolve away from big-box stores toward smaller spaces amid increasing local restrictions on large retailers and more intense competition from internet retailers.

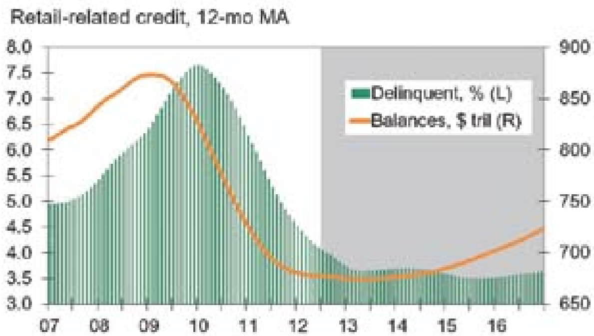
Facing a long time period for the housing market to replace lost equity, as well as a higher personal saving rate, retail will undergo the longest recovery of all major CRE components. The pace of retail sales growth has slowed since the recovery began, and will moderate further in the near term below the levels reached during the housing boom (see Chart 10). The South and Midwest, which avoided the worst of the housing crash and falling home equity, will outpace the rest of the U.S. in retail employment growth through the end of 2014.

Chart 10
Slow Recovery Ahead for Retail

Sources: BLS, The Conference Board, Moody's Analytics

While consumer confidence lags, household deleveraging does provide some optimism for consumer spending and thus demand for retail space. Total retail-related consumer credit balances (bankcard, consumer finance and retail) are on the decline; however, the rate of contraction is moderating. In addition, after peaking toward the end of 2009, delinquencies for all three components of retail-related credit are declining according to Equifax (see Chart 11). Bankcard and retail delinquencies are now below their prerecession troughs, marking a substantial improvement in the quality of consumer credit balances. As a result, lending standards for consumer credit will ease in coming years as consumer spending and demand for credit rise, supporting retail sales and retail CRE demand.

Chart 11
Credit Quality Is Approaching Bottom



Sources: Equifax, Moody's Analytics

Chart 12
Construction Wages Begin to Increase

Sources: Equifax, Moody's Analytics

Construction

The recovery of nonresidential construction, including CRE, has generally been weak since the recession ended. Architectural inquiries for all types of construction have been increasing since the beginning of 2009, according to the American Institute of Architects, but growth of billings for commercial and industrial architectural work has struggled to remain positive, reflecting the difficulty firms are encountering in attempting to transform inquiries into billed work.

Nevertheless there is improvement. Recent construction put in place for the combined major components of CRE — multiresidential, hotel, office, retail and manufacturing — is rising. After declining by more than $155 billion from 2008 through the end of 2009, a fall of more than 60%, total CRE related construction put in place has risen by $43 billion, recovering more than a quarter of the value of construction put in place lost during the recession.

Despite the increase in CRE-related construction, nonresidential construction employment has yet to begin a substantial recovery after shedding more than 20% of workers since 2008. The disconnect between rising nonresidential CRE-related construction put in place and much weaker growth in nonresidential construction employment can be partially explained by contractors using smaller work crews on construction projects amid tighter profit margins than during the earlier construction boom. With residential and nonresidential construction payroll employment still down by more than 2 million since the 2006 peak, construction wage rates have been slow to rise, keeping wage costs low for CRE-related construction firms. However, as the pace of nonresidential construction has picked up, growth of aggregate construction wages has begun to outpace construction employment, implying rising costs for construction firms (see Chart 12).

Conclusion

All major components of commercial real estate have at least reached a bottom for their cycles, and some are now improving. As the economic recovery gains traction later next year, demand for CRE space will accelerate. Increased availability and quality of credit will also drive demand for space and new construction. However, as in single-family residential real estate, the pace of CRE investments over the next several years will be measured relative to previous business cycle.

Multifamily housing, bolstered by favorable demographics and reduced rates of homeownership, has the brightest outlook among the major components of CRE.

Demand for office real estate will improve as financial services and other industries related to real estate that were hurt the most by the housing crash expand once again. Growth of technology-producing industries and other professional services will also add to office space demand.

Demand for manufacturing CRE will undergo the most marked evolution as high value and technology producers create demand for space to house new capital intensive production processes.

Retail faces the most sluggish recovery among the major CRE components amid slow-to-improve consumer confidence and spending.

About Moody's Analytics Economic & Consumer Credit Analytics
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The Timing of CMBS Losses

An update on past industry studies in light of recent CMBS performance and the Great Recession

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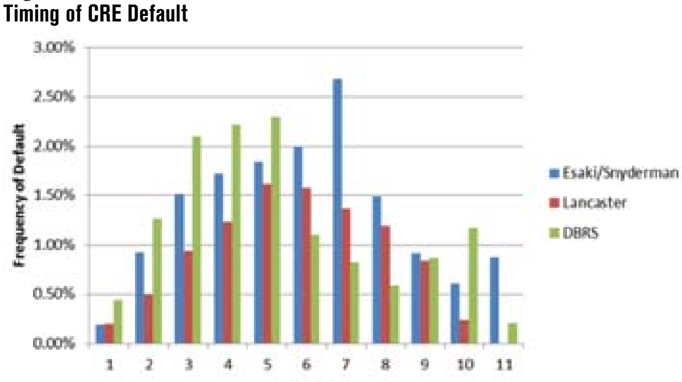
As CMBS losses continue at historically elevated frequency and severity, two important observations emerge in the industry loss data and suggest a break from past experience. The first relates to the effects of loan seasoning on default frequency; in that the bell-shaped pattern observed in past landmark CRE studies is not evident given recent experience and may not hold in the future. The second related point, is that refinance risk is real, and will likely prove to be an influential concern for legacy CMBS through 2017.

Our primary observation is that both the shape of the default frequency curve, as well as the frequency of refinance (versus term) defaults, is mostly driven by the life of a loan relative to an event of recession or other adverse macroeconomic event.

For this article, we define default as all loans with one of the following characteristics: (1) a reported special servicer transfer date, (2) greater than 30 days delinquency or (3) a reported loss to the trust (where no delinquency or special servicing transfer date was available). Refinance (balloon) default is defined as any default that occurs within 180 days of a loan's original scheduled maturity date. Term defaults are defined as all other defaults.

Two landmark studies of CRE proposed that defaults occur in a bell-shaped pattern as loans season. Lancaster, Butler, Mayeux and Frerich, (Wachovia, April 2006) published data comprised of fixed-rate CMBS conduit loans originated between 1995 and 2005, which suggests a bell-shaped relationship between the frequency of loan default and seasoning: "Defaults increase at a steep incline and peak in years five and six, and then steadily decrease over the remaining years in a symmetric bell-shaped, manner."[1] This symmetric bell-shaped curve is also observed in the earlier Snyderman/Esaki studies, which were based on life insurance loans originated from 1972 to 2002.

Figure 1
Timing of CRE Default



Upon first examination of recent CMBS performance statistics, we observed the same bell-shaped pattern in frequency of default with respect to loan seasoning as the aforementioned past studies[2], with two important differences.

First, a significant portion of the defaults seem to be more front-loaded than the past studies, with a greater frequency of loans defaulting in years two to five. The cause of the front-loading of our instances of default is due to the recession that began in 2008 and the larger number of loans issued between 2005 and 2007, which were subject to the environment created by the recession early on in their lifetimes.

Second, while the past studies (especially Lancaster et al.) tended to trail off after year seven, our observations demonstrate a steady increase in default frequency between years eight and ten; caused by the prevalence of refinance defaults in our data set, that occurred during and after the Great Recession.

Indeed, after we controlled our dataset for recession, we found no strong bell-shaped relationship between frequency of default and loan seasoning.

The importance of this finding is evident when we break out timing of loss by vintage and compare it to its relationship with the adverse economic circumstances that began in 2008 with effects that linger today.

The series of charts below indicate the years since origination (the first x-axis) in addition to the actual year of default (the second x-axis) with the stress period of 2008 through 2011 shaded. Nearly all charts show a steep increase in default frequency during this time, irrespective of loan seasoning or the year of origination.

Figure 2
Timing Default by 2007 Vintage

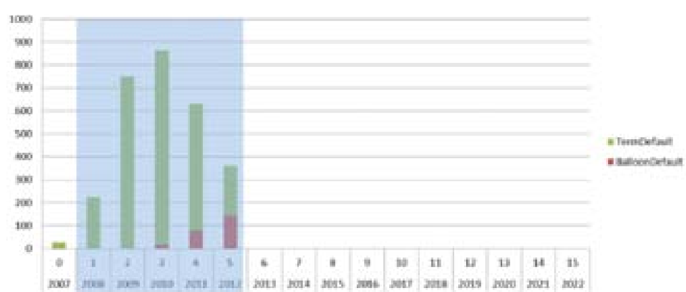


Figure 3
Timing Default by 2006 Vintage

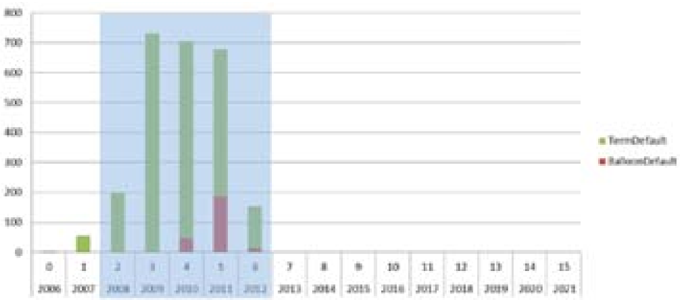


Figure 4
Timing Default by 2005 Vintage

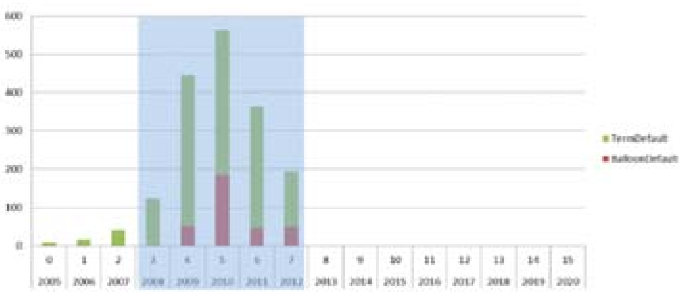


Figure 5
Timing Default by 2004 Vintage

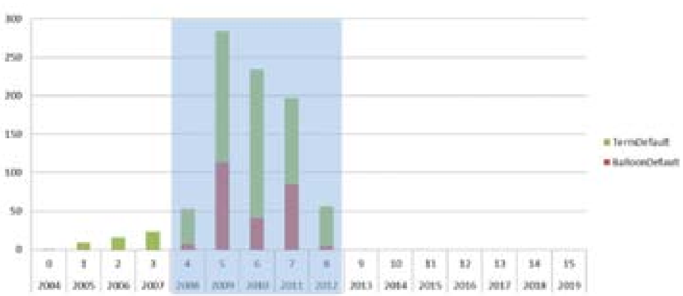


Figure 6
Timing Default by 2003 Vintage

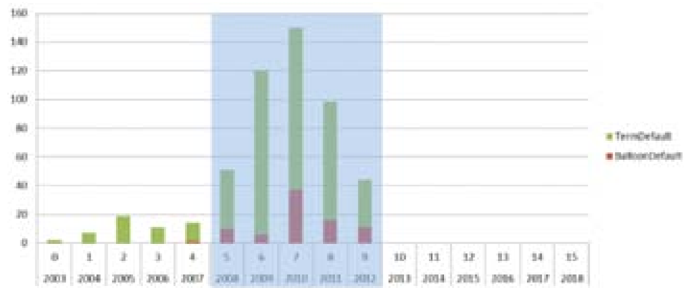


Figure 7
Timing Default by 2002 Vintage

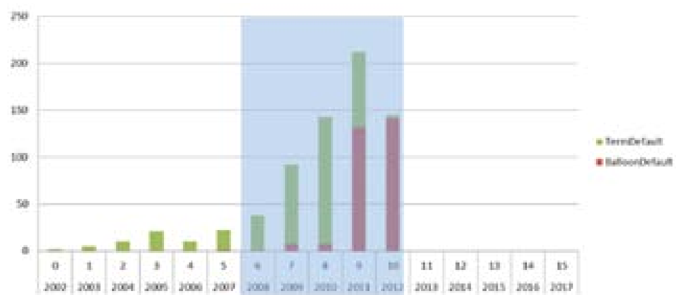


Figure 8
Timing Default by 2001 Vintage

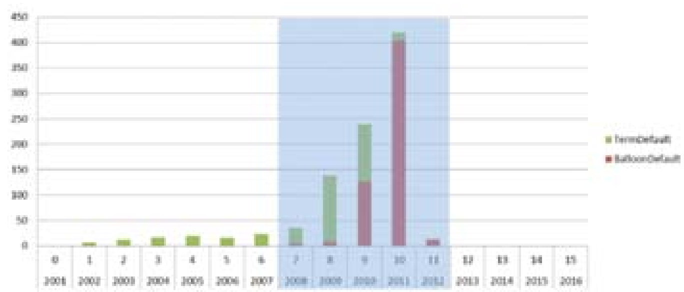


Figure 9
Timing Default by 2000 Vintage

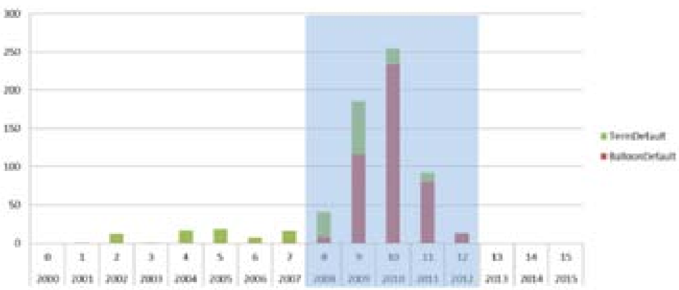


Figure 10
Timing Default by 1999 Vintage

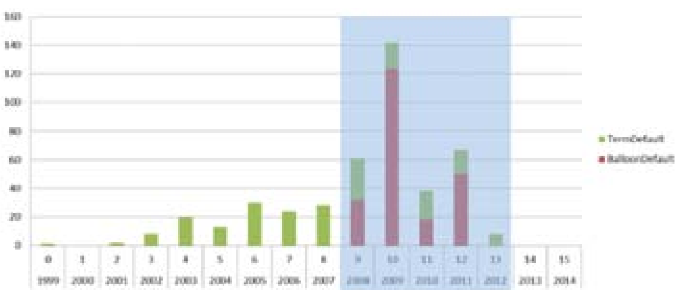
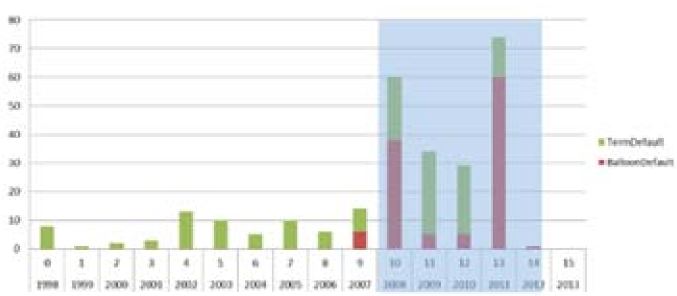


Figure 11
Timing Default by 1998 Vintage

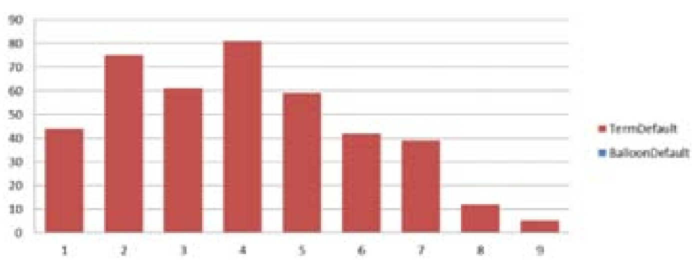


Our data set therefore strongly suggests that the frequency of default depends more on economic conditions and less upon the time elapsed since the loan origination date.

The findings confirm the suspicion of Esaki in his update to the Snyderman study, "The default rate curve… masks individual cohort patterns which vary substantially from the average. Default timing for individual origination cohorts varies depending on the state of the commercial real estate market at the time of origination and the subsequent years."[3] As well as the original thoughts of Snyderman in his first study, "These patterns imply that seasoning has less impact on reducing default risk than one might have expected. Instead, it seems that loan cohorts that have weathered a real estate recession have lower default rates over their remaining lives…."[4]

Stripping away the Great Recession years (and subsequent years of constrained liquidity in CRE)[5] from our data set reveals a curve that is more similar to the original Snyderman studies, which showed a general but uneven trailing off of default rates given loan seasoning.[6]

Figure 12
Timing Defaults by Year Since Origination Exclusive of Recession



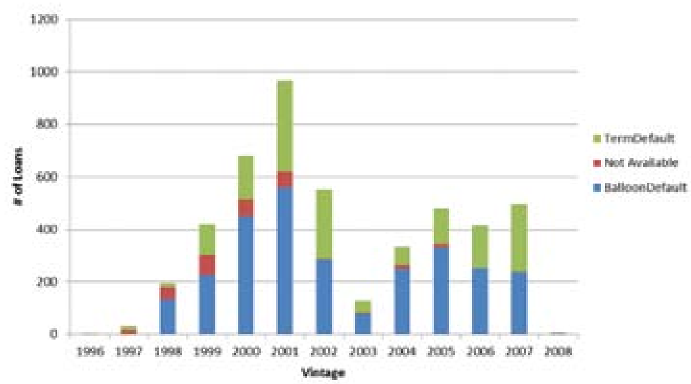
We also note that underwriting standards at the year of origination have a significant impact on the shape of the curve, but the impact is trumped by the recession that took place in that latter part of our sample set.

Refinance Risk

Our findings demonstrate the growing importance of refinance risk, which is finally appearing in CRE loss statistics. Anecdotally, CMBS market participants as a whole seemed to discount this risk in the run-up to the credit crisis, as refinance defaults were largely absent from empirical CMBS data in the run-up to the Great Recession (2008 to 2009). Esaki/Snyderman and Lancaster et al. did not specifically highlight this risk: The Esaki/Snyderman studies focused on loans with strong amortization schedules, and the Lancaster study spanned a time of increasing liquidity in the CMBS market.

The figure below depicts the proportion of term versus refinance defaults by vintage, limiting the dataset only to those loans that have reached their original scheduled maturity date.

Figure 13



Term vs. Refinance Default Counts – Original Maturities Prior to Q3 2012

For these loans refinance risk was more influential than term risk. These results demonstrate how correlated CMBS loans tend to be as vintages are underwritten with the same standards and subject to the same market conditions.

It therefore follows that predicting the proportion of term versus balloon defaults in a specific vintage is in large part an exercise in predicting the probability of economic duress (or lack thereof) at various points in the loans' original scheduled terms.

Conclusion

Loan seasoning in itself likely provides a gradual positive impact on probability of default and severity of loss. But timing of defaults in terms of years since origination is importantly driven by the timing of adverse economic events relative to loan issuance (and maturities). This was true for our data set and we believe that it would likely hold true for past and future data sets.

Likewise, the proportion of refinance defaults relative to term defaults also seems to be heavily influenced by the scheduled maturity date in relation to periods of economic duress. This observation does not negate the need for sound exit strategies in terms of leverage, amortization and loan structure. It is only to say that the probability of refinance default is heavily influenced by the probability of economic duress at the first scheduled maturity date. CMBS refinance risk was (prior to the Great Recession) masked due to the steadily declining interest rate environment and relative absence of acutely adverse economic events occurring in conjunction with a significant concentration of scheduled loan maturities.

Going forward it is hard to predict what the make-up of term versus refinance defaults will be for CMBS, because such estimation would rely on an ability to predict the trajectory of the economic recovery (or lack thereof). This question is especially important due to the fact that many special servicers are extending loans in hopes of more favorable loan workouts. If they are right, we may see refinance defaults comprise less of the total defaulted universe come 2017. If they are wrong, the level of refinance defaults will likely match if not surpass the historical range of roughly 50% to 70% (by vintage) of all defaults.

For this research, we used DBRS' CMBS Advisor research tool, which tracks over 90,000 fixed-rate conduit loans originated from the mid-1990s through to September 2012.

1 Lancaster, Brian P., Anthony G. Butler, Stephen P. Mayeux, Landon C. Frerich. The CMBS Default and Loss Study: 1995–2005. April 17, 2006, Wachovia Securities, Page 3.

2 Our construction of its default timing curve has important differences to the aforementioned past studies. Esaki/Snyderman results spanned a thirty-year time period that allowed for ample measurement of the complete lifecycle of loans. The Lancaster study used modeling techniques to artificially complete the lifecycle of loans thus expanding their dataset. We did not have the luxury of an extended time period, nor did we use modeling techniques to project future loan performance. We therefore expect our curve to evolve as the CMBS loans that we measure complete their lifecycle.

3 Esaki, Howard. Commercial Mortgage Defaults: An Update. February 4, 1999.

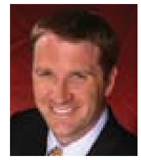
4 Snyderman, Mark P. Commercial Mortgages: Default Occurrence and Estimated Yield Impact.

5 Excludes the years 2008–2012 from the sample set.

6 Snyderman, Mark P. Commercial mortgages: Default occurrence and estimated yield impact. 1991.

Post-Bankruptcy Interest on Oversecured Debt: How Much Can You Get?

The Chapter 11 of Boston's "W" Hotel and Residences Highlights One of the Challenges Lenders Face with Aggressive Borrowers, Even When There is Equity in the Property



Stuart A. Laven, Jr.
Benesch Friedlander
Coplan & Aronoff LLP

As a portfolio lender or special servicer, if you are "blessed" enough to find yourself in a borrower Chapter 11 bankruptcy with a property that isn't painfully under water, you may be confronted with a series of rather technical questions concerning your right to receive post-petition interest on your mortgage. The baseline answer is straightforward enough: oversecured mortgage lenders are allowed to charge and receive post-bankruptcy interest under Bankruptcy Code section 506(b). But the Bankruptcy Code doesn't say anything about the specifics of what the permissible interest rate is, or over what period of time it can accrue. And as was illuminated in an October 2012 decision[1] from the First Circuit's Bankruptcy Appellate Panel (B.A.P.) in the Chapter 11 of Boston's "W" Hotel and Residences project, these grey areas can give aggressive borrowers a window of opportunity to challenge even the most iron-clad default provisions in commercial mortgages.

In the *SW Boston Hotel Venture, LLC Chapter 11*, the debtor-developers of the "W" project challenged senior mortgagee Prudential Insurance Co. on (among other things) the allowable rate of post-petition interest on Prudential's senior mortgage. Prudential originally financed development of the mixed-use property with a $192 million construction loan secured by a first mortgage and backstopped by a $17.3 million letter of credit.

In the course of a lift-stay fight shortly after the April 2010 bankruptcy filing (which Prudential lost), the bankruptcy court valued the property at $168 million. Following Prudential's draw on the letter of credit and some interim debt service, Prudential's outstanding mortgage debt stood at $154 million. With the valuation comfortably exceeding Prudential's claim, Prudential sought bankruptcy court approval to charge interest at the mortgage's stated 14.5% default rate. The debtors opposed the 14.5% rate, and in parallel, sought confirmation of a plan of reorganization that proposed to pay Prudential only 4.5% interest while the debtors sold off their remaining condo inventory and gradually retired the outstanding principal.

Default Interest as a "Penalty" and the General Growth Properties Test

The debtors' opposition to the 14.5% rate was based on an argument that the rate was an inequitable "penalty" under Massachusetts law. The bankruptcy court didn't buy this argument, and, on appeal, neither did the First Circuit B.A.P., who noted a well developed legal presumption in favor of using the contract rate.

But that doesn't mean the debtors were totally out of school. Rather, the "penalty" argument was one of four criteria derived from a checklist developed in the General Growth Properties Chapter 11 for assessing whether the presumption in favor of using the contract default rate should be overcome in the name of "equity." In a 2011 decision in that case, the Southern District of New York considered these factors:[2]

- Whether there has been any "creditor misconduct";
- Whether application of the contract rate would "cause harm to unsecured creditors";
- Whether the contract rate constitutes a "penalty"; and
- Whether application of the contract rate would "impair the debtor's fresh start."

In *SW Boston*, three out of these four factors came off the table quickly because the debtors' plan proposed a 100% distribution to unsecured creditors (i.e., the debtors were flush enough that they really couldn't complain about default interest "impairing their fresh start" or "causing harm" to unsecureds).

But the "penalty" argument had some traction — enough to garner the attention of the B.A.P. in its analysis. Significantly, the B.A.P.'s determination that the contract default rate was not an unfair "penalty" turned on the word of a Prudential loan officer, who testified that the 14.5% rate was consistent with the default rates

Prudential charged on its other, similar loans. That consistency, opined the B.A.P., was enough to overcome any insinuation that the rate amounted to a "penalty" that should be reduced as a matter of equity.

Strategic Considerations: Formulating a Defensible Default Rate

For CRE lenders, anticipating what will happen in a borrower bankruptcy with any precision is extraordinarily difficult. And much of what happens in Chapter 11 cases is either technically or practically beyond the lender's control — a fact of life that's driven largely by the limited "exclusivity" the Bankruptcy Code gives debtors in possession (i.e., the "exclusive" right of the debtor in possession to control its own destiny for a period of time). In *SW Boston*, for example, lender Prudential certainly had no practical way of forecasting, at loan origination, whether default interest would end up having a major negative impact on junior creditor recoveries in a subsequent bankruptcy.

"There are those occasions – primarily loan modifications/ forbearances – when the circumstances of a particular credit inspire a more aggressive demand on the default rate than the lender's internal guidelines will per se tolerate."

But the *SW Boston* decision highlights a potentially important strategic item that can come into play during loan origination or modification: the source of the agreed default rate. Most institutional lenders set their default interest rates (or default/non-default spreads) with a fairly high level of consistency from loan to loan and borrower to borrower—usually as a hybrid matter of internal credit policy and market sensitivity. And rarely will borrowers want to spend much time at origination negotiating the finer points of post-default remedies when there are more pressing matters at hand (like non-default interest).

But there are those occasions — primarily loan modifications/ forbearances — when the circumstances of a particular credit inspire a more aggressive demand on the default rate than the lender's internal guidelines will per se tolerate. In these situations, as *SW Boston* illustrates, there is something of a comparative risk assessment for the lender to make when deciding whether to stay within or go above internal "spec": the risk of leaving a few basis points' worth of default interest on the table versus the risk of the borrower later filing a Chapter 11 and using a "penalty" argument to side-step the default rate altogether.

This risk assessment is not unlike many others in CRE lending, inasmuch as there is a "bird in hand" aspect to it that can't be ignored. With so many loans in some phase of "amend and extend" modifications—loans with covenant defaults but a reliable level of debt service—there is at least a macro-level argument to be made that the risk of borrower bankruptcy is so relatively remote that any opportunity to maximize here-and-now default interest service is one to be seized.

But as the lender in *SW Boston* (perhaps) learned after nearly two years of bankruptcy court litigation, Chapter 11 can create an opportunity for a savvy borrower that, in any other forum, would be foreclosed by the four corners of a carefully drafted loan agreement. In Chapter 11, even something as "boilerplate" as a mortgage's default interest rate can be fodder for challenge, and lenders should remain wary as credit risks are evaluated and material decisions are made.

1 *The Prudential Insurance Company of America v. City of Boston* (In re SW Boston Hotel Venture, LLC), Bankr. Case. No. 10-14535-JNF (B.A.P. 1st Cir. Oct. 1, 2012).

2 In re General Growth Properties, Inc., No. 09-11977, 2011 WL 2974305, *4 (Bankr. S.D.N.Y. July 20, 2011).

Forum Spotlight: CREFC Servicers Forum

Brian Hanson
Managing Director
CWCapital Asset Management LLC

The CREFC Servicers Forum continues in its efforts to represent all of its constituents, which includes not only primary/master/special servicers, but also trustees and third-party service providers. This has been an especially active year for the Forum, dealing with various important initiatives and issues that required our attention and response. I am pleased to note that we had significant input from across the membership, both in meetings at the January and June Conferences, and also through issue-specific working groups. Significant time, energy and thought have been contributed by many people from various organizations, and we give our sincere thanks to everyone for their efforts.

At the top of the list of initiatives this year was transparency (of servicer actions) on CMBS deals, and it remained very topical throughout the year. It was a frequent agenda item on conference panels and in meetings among industry participants. Almost all constituents, from issuers to investors to servicers and service providers, have a vested interest in this issue being resolved prudently and expeditiously. I am happy to report that real progress has been made. To deal with this head-on, CREFC formed the Transparency Working Group, comprised of volunteers from the Servicers Forum, the Investment Grade Bondholders Sub-Forum and Issuer's Counsel.

The Working Group held regular conference calls during the Spring and Summer to outline the various issues surrounding this situation, and some of the natural conflicts between the various parties. For example, investors wanted to see as much information as practical, and with servicers being wary of disclosing more data, especially on specially serviced assets — not to mention the logistics of additional reporting that would be involved. The Working Group reached a consensus on what additional disclosure would be appropriate, and produced draft templates that will provide important information on special servicing resolutions. Three sample reports were produced: a revised Loan Modification Template; a new REO Liquidation Template; and a new Loan Liquidation Template. It was proposed that these reports would be populated by special servicers following the disposition of a specially serviced asset, and would be submitted as part of the standard CREFC Investor Reporting Package (IRP). The templates would then be posted by the Trustees on their websites.

The draft templates have been reviewed by the CREFC Special Servicers Working Group, and have now been distributed to the IRP Committee and CREFC Forums for final review and approval. The goal is that the templates are adopted and implemented on a going forward basis by the end of 2012 or in early 2013. Initial feedback has been positive, especially from Investors, and we look forward to carrying forward this momentum to bring this important next step to completion.

Concurrent with (and in conjunction with) the transparency initiative were the efforts of the IRP Committee to produce an updated version of the reporting package, incorporating the new templates as discussed above, as well as making other important enhancements. New fields have been recommended for addition, unnecessary fields have been recommended for deletion, and certain best practices recommendations have been drafted regarding the reporting of loan modifications and management of the 1099 reporting process. The Loan Modification best practices address the timing, consistency and reporting challenges resulting from the increased disclosure in the Loan Modification Template now in use. The 1099 reporting best practices addresses the challenges servicers are facing with regard to preparation and distribution of 1099 forms in the current economy, including a significant increase in the volume of tax information reporting by servicers with regard to Form 1099-A (Acquisition or Abandonment of Secured Property) and Form 1099-C (Cancellation of Debt).

As time-consuming as all of the transparency and related IRP initiatives have been, the Servicers Forum also found time to work on other important issues. There has been an ongoing effort to simplify and standardize Article 3 of the PSA, with a goal of trying to achieve consistency across CMBS deals on expected servicer duties and performance, and to reduce redundancies and risk caused by inconsistent documents. In the PSA Simplification Project, as it became to be known, master servicers worked with issuers counsel to prepare guidelines with proposed standard language that can be inserted into Pooling and Servicing Agreements without otherwise substantially modifying each Issuer's preferred form of documentation.

Another ongoing effort of the Servicer Forum relates to the CREFC/TreppPort Commercial Mortgage Servicing Rights survey. In collaboration with Trepp and Rockport, CREFC is preparing to issue its second Commercial Mortgage Servicing Rights (CMSRs) survey before year-end. This new survey is the result of an initiative of the CREFC Servicers Forum, and is intended to assist servicers who typically value their CMSR assets on at least a quarterly basis. Trepp and Rockport have been working with companies owning commercial mortgage servicing rights to create a service and product that will establish aggregate retrospective CMSR market valuations of hypothetical servicing pools that represent various CMSR product types. It is CREFC's objective to make this survey an industry standard benchmarking tool.

We look forward to our next meeting of the Servicers Forum at the CREFC January 2013 Conference in South Beach. We will discuss, and hopefully advance, all of these topics and any others that affect servicers and the industry. Please join us — all conference attendees are welcome!

Forum Spotlight: CREFC High Yield Debt and Investment Forum

Bill O'Connor
Partner
Thompson & Knight

The CREFC High Yield Debt and Investment Forum After-Work Seminar in New York on September 5, 2012 was a tremendous success and completely sold out. We wish to thank Kevin Donahue and his panel for providing us with a lively and informative presentation.

The CREFC High Yield Debt and Investment Forum has established cornerstone events which will occur again in 2013.

On March 13-14, 2013, we will host a Distressed Debt Summit in New York at the New York Athletic Club. As previously announced, the High Yield Debt and Investment Forum is teaming with the CREFC B-Piece Buyer Sub-Forum to expand the scope of this popular event and include new topics requested by attendees at previous summits. This Summit will again be hosted by John D'Amico of TriMont Real Estate Advisors and Bill O'Connor of Thompson & Knight.

The West Coast Summit, also hosted by CREFC B-Piece Buyer Sub-Forum, will take place in late Spring, in Santa Monica, Calif. The West Coast Summit will again be chaired by Tim Pine of Assured Lender Services, Inc., who is joined by co-chair Dan Sefcik of Black Rock.

Our Educational Summit, which took place in Dallas in September 2012, will again take place as a one day summit in Dallas in September, 2013, co-chaired by Mark Weibel of Thompson & Knight and Debra Morgan of CIII Asset Management LLC. The Educational Summit is geared specifically to new special asset managers and workout officers from special servicers and balance sheet lenders. Given the fact that this summit was sold out in 2012, we are considering extending it by an additional half day.

We welcome any new ideas from Forum and other CREFC members and encourage others to participate in our programs. We look forward to seeing everyone at the High Yield Debt and Investment Forum meeting at the CREFC Annual Conference in South Beach in January, at which we will discuss the current state of distressed debt markets, including bridge and rescue lending developments.

COMMERCIAL REAL ESTATE INVESTMENTS SPECIAL SERVICING ADVISORY

Talmage thanks our speakers and clients who participated in our 2012 Credit Conference. Your insights, contributions and ideas made the conference a great success. Thanks also to our clients and partners for making 2012 one of our most successful years.

TALMAGE 2012 CREDIT CONFERENCE AGENDA

The Election & The Economy - Perspectives from Kevin Warsh
Distinguished Visiting Fellow at the Hoover Institution and Lecturer at the Graduate School of Business, Stanford University

The Owner's Perspective
Jeffrey Kelter - *CEO, KTR Capital Partners*
David Simon - *Chairman & CEO, Simon Property Group*
Barry Sternlicht - *Chairman & CEO, Starwood Capital Group*

Debt Investing and Lending Strategies Post Financial Crisis
Tobin Cobb - *Co-CEO, LNR Property*
Boyd Fellows - *President, Starwood Property Trust*
James Flaum - *Managing Director, Morgan Stanley*
Michael Nash - *Senior Managing Director, The Blackstone Group*

"Unintended Consequences" - Thoughts on the Economy, Ed Conard
Author of the New York Times best-selling book "Unintended Consequences" and former Bain Capital Partner

The LP Perspective - Opportunities in a New World
Nori Lietz - *CEO, Areté Capital*
Isabelle Scemama - *Head of Commercial Real Estate Finance, AXA Real Estate*
David Sherman - *President & CIO, Metropolitan Real Estate Equity Management*

"The Last Word" - Industry Leaders Share Thoughts on the Market
Michael Ashner - *Chairman & CEO, Winthrop Realty Trust*
Barry Blattman - *Senior Managing Partner, Brookfield Asset Management*
Ron Kravit - *Senior Managing Director, Cerberus Capital Management*

Talmage manages $1.7 billion in commercial real estate debt assets across the country and operates a robust large loan Special Servicing platform. Since 2003, we have made in excess of $10 billion of investments, acted as the Special Servicer on over $10 billion of transactions and advised on over $30 billion of loan restructurings and modifications.