Back to the future?

US CMBS origination is back in full swing, with as much as US$50bn of new issuance estimated to launch before year end. But, as conservative parameters are compromised and underwriting standards begin to slip, **Anna Carlisle** asks whether CMBS 2.0 is a true departure from pre-crisis issuance and what the future holds for the asset class

Since the first post-crisis transactions emerged in late 2009, a steady flow of market participants has returned to US CMBS – a market that was all but written off in 2008. The new breed of multi-borrower conduit CMBS, dubbed CMBS 2.0, is popular: the simple, conservatively-underwritten, transparent structures are snapped up in the primary market and competitively bid in the secondary market.

But, as confidence in conduit CMBS increases and investors once again become more focused on the hunt for yield, is the sector in danger of slipping into its old habits? Warning flags are being raised.

Ann Hambly, ceo and president of 1st Service Solutions, says that although CMBS 2.0's origination standards started out looking like the 1997 model with conservative reserves, lender protection and amortising loans, the sector is rapidly beginning to look more like the 2007 model. "The environment is becoming increasingly competitive and certain requirements on deals are being waived already," she says. "There is nothing happening in the CMBS 2.0 regulatory changes – in my personal opinion – that is going to prevent 2007 happening all over again."

Hambly continues: "As long as you have borrowers who will take the money and a lender who will loan the money and make a profit on it, and investors that will buy the bonds, you will have a CMBS market. The only way to prevent this slide is for the bond pricing to speak for the quality of the loans, or there really does have to be some long-term skin-in-the game enforced on the people making the loans."

She points to how serious the situation is. "We have a tremendous meltdown of loans originated in 2007 in the industry and there will be tremendous losses. It's estimated that close to 100% of all loans originated in 2007 will eventually be in default. If we get back there in a year or two – and personally I don't think it's going to take much more than a year to get back to those standards – we're going to have a whole new cycle of problems."

Research shows that – in comparison to early 2.0 CMBS transactions – deals that have priced from 2Q10 onwards have experienced rising stressed LTVs, more aggressive assumptions in appraisals, rising concentration risk and non-primary loans referenced in deals' top-10 loans *(see Figure 1)*. Meanwhile, debt service cover ratios (DSCRs) are on a downward trend, mezzanine debt is creeping back into transactions and the concentration of interest-only loans in conduit pools is on the rise.

Stressed LTVs have gone up by about 10% on an absolute basis from 2010 to 2011, according to Jim Manzi, senior director on the global structured finance research team at S&P. He notes, however, that those levels are still well below anything seen at the peak of the market.

"Overall, the risk profile of 2010 and 2011 deals is a lot better than it was in 2005, 2006 and particularly 2007. But there are some things that we're seeing that we think investors should be aware of," Manzi says.

He adds: "For example, we are alerting investors to the assumptions made in appraisals. We believe that in some recent deals there have been some fairly aggressive appraisals in certain office loans in primary markets."

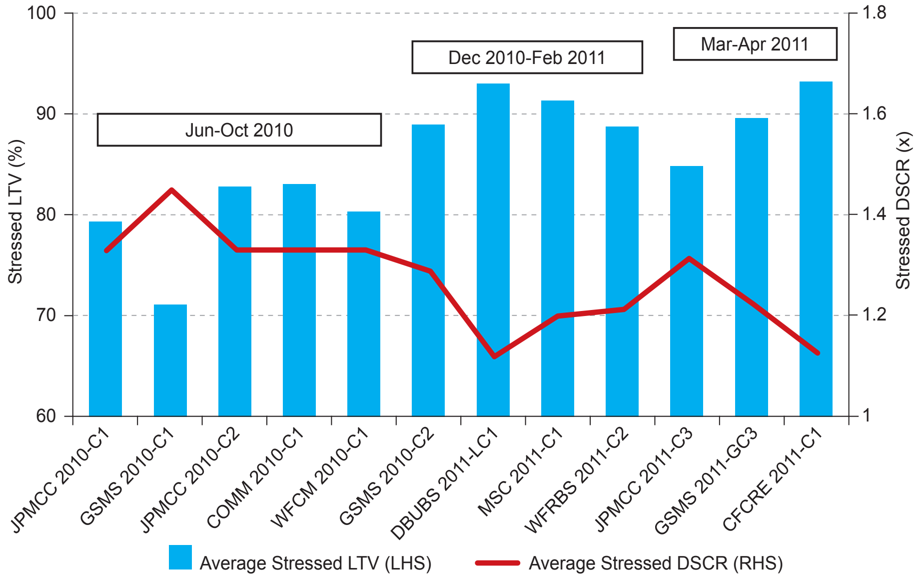
The part that S&P believes should be most alarming to investors is that the appraisals appear to be building in upside in rents and occupancy to arrive at a value for the properties in question instead of using in-place rents and tenancy at the time of closing. Manzi also points out that many loans in a deal's top-10 loans are not located in the primary market and that new deals seem to be more concentrated compared to older deals.

Ann Hambly, 1st Service Solutions

For example, one metric is the percentage

Figure 1

Rating Agency Stressed LTVs and DSCRs



Source: Standard & Poor's

of the deal made up of the top-10 loans. "Recently it has been around 60%. Even at the peak in 2007, this figure was in the high 30s or low 40s, so there's some concentration risk there," he says.

A concentration of interest-only loans in conduit pools (both period and full term) is generally considered to be one of the first signs of credit deterioration. Even though IO concentration in CMBS.2.0 is still nowhere close to where it used to be in the 2005-2007 vintage (at 27%), CMBS analysts at Barclays Capital note that it is increasing rapidly.

"For the entire CMBS.2 issuance, life interest-only loans account for about 3.8%, while period IO loans (with initial interest-only period followed by amortisation) stand at about 16.3%," says Julia Tcherkassova, CMBS analyst at Barclays Capital. "However, concentration of IO loans started to increase significantly with the last 2010 deal (GSMS 2010-C2) and forward. Using one of the more recent examples, JPMCC 2011-C3 had a 41.5% concentration in IO loans, including 39.3% in period IOs."

Jim Manzi, S&P

Tcherkassova also points out that the instances of 'schedule' loans – loans that do not follow the amortisation, but rather have an individual schedule with varying monthly debt service that usually steps up, one or multiple times during the loan life – in CMBS 2.0 have increased. Some of these loans are more seasoned; however, others were originated relatively recently. An example of a schedule loan is the 180 North LaSalle Street securitised in GSMS 2010-C1 *(see Figure 2)*.

"We've been asked if we're already back to 2007 standards and the answer is no – not by a long shot," says S&P's Manzi. "I think things have certainly slipped a bit since the market revival in 2009, but LTVs from a rating agency stress point are around 90%, whereas in 2007 the average was around 110%. If we continued along this trajectory, however, then obviously we'd be close in a couple of years. But that's an aggressive assumption."

On a more granular loan-level basis, Keith Mullen, co-chair of the Financial Services Industry Group at Winstead, also confirms that CMBS 2.0 loans are markedly different to CMBS 1.0. "The documentation is much more conservative and much broader in scope. These documents are tougher than most life insurance company mortgage loan documents – that's an incredible change to where we were in 2003 to 2007. You could have a US$50m CMBS loan or a US$5m CMBS loan and each would have the same 130 page loan agreement," he says.

He continues: "CMBS 2.0 is a true departure from 1.0: there are no complicated capital structures and you don't see the subordinate or mezzanine debt that was abundant in structures in 2003-2007. Yes – we're going to see this sort of stuff creep back in and it will be interesting to see how the market reacts when it does because investors have a much better understanding of the CMBS structure. They are also pounding the table for risk retention and want loan-level disclosure."

A return of B-piece buyers also demonstrates renewed confidence in the CMBS market. One of the major concerns regarding the return of the sector was a lack of B-piece investors, as traditional players in this space from 2005 to 2007 were either out of business or tied up with legacy portfolios, meaning they would have no capacity or funding to take part in the new market. New participants have solved that problem, with a steady stream of investors entering the fray.

Excess spread

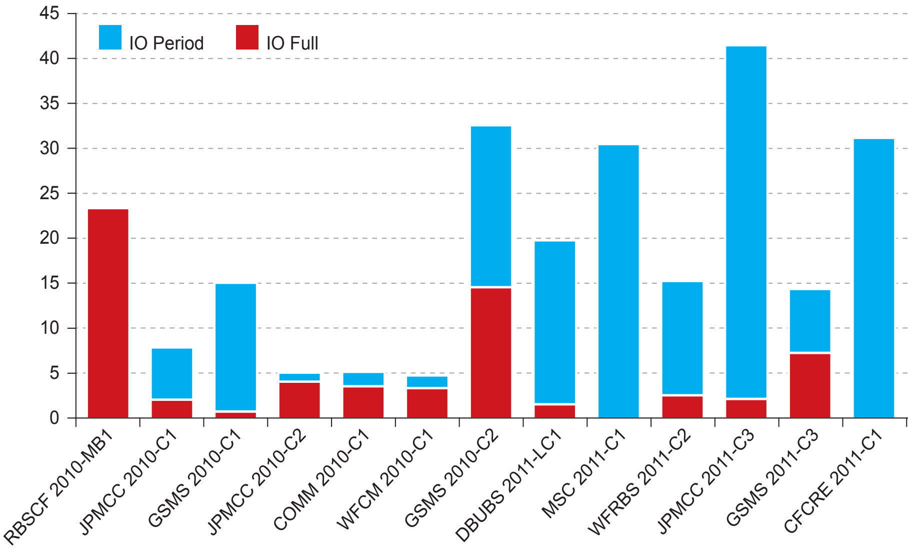
Other members of the CMBS community also remain upbeat about the new breed of CMBS transactions. Tom Zatko, md, capital markets at Cornerstone Real Estate Advisors, suggests that there aren't enough data points to say conclusively that underwriting standards are slipping already.

He notes that it is worth bearing in mind that when the market restarted it was under incredibly conservative parameters.

"We've been asked if we're already back to 2007 standards and the answer is no – not by a long shot"

Figure 2

IO Loan Concentration in CMBS 2.0



Source: Barclays Capital

"Deals may appear more aggressive when you compare them to that very conservative base, but it's not an outlandish level of aggressiveness," he says.

Meanwhile, Manus Clancy, md at Trepp, suggests that in many ways CMBS 2.0 looks a lot like CMBS 1.0 was before 2005. "The loans are focused not on future events, but what is in place, and the LTVs are far below what was in place at the height of the market. Deals are beginning to see rising LTVs and some mezz debt, but I'd say deals now look like they did in 2004 – the conservative phase."

However, Clancy also points out that investors have returned to the mindset of 2006-2007, where their predominant concern was capturing excess spread. "Buyers are generally happy that we're seeing CMBS 2.0, and keeping an eye on underwriting standards, but it seems like their predominant concern is capturing excess spread wherever they can," he says. "Investors have very quickly returned to the point where they were in 2006/2007, where capturing yield was very important. A lot of the problems with CDOs were driven by the fact that in 2006 and 2007 everyone was looking to get an extra quarter a percent in yield, and that took investors further and further off the beaten path of traditional securities into things like CDOs: that's what we're seeing right now."

Indeed, since August 2010 investor appetite has steadily moved from the triple-A category down into the AM, AJ, double-A and single-A levels. From August to March, desire for some of the dicier credits increased to the point where paper that was bid at 30c on the dollar three years ago and 75c on the dollar a year ago is now trading at around par.

"2.0 deals have been well received and well bid," says Clancy. "But investors now face the choice of whether they put their money in CMBS 2.0 and get a spread of 100bp above swaps or go into 2007 triple-A paper with the potential to generate an extra 20bp-30bp yield."

Unintended consequences

While Dodd-Frank reforms are unlikely to come into effect in the CMBS market for at least two years, a lack of clarity over the implementation of new regulations is causing concern for many industry participants. The rules over risk retention and the premium capture reserve account are deemed vague, partly because they are meant to address securitisations in general – not just CMBS – and there are fears that regulations intended to safeguard the sector could actually deter issuers from selling CMBS all together.

The FDIC, Fed, OCC, SEC, FHFA and HUD have agreed that ABS issuers should retain at least 5% of credit risk in underlying securities, although US government-guaranteed ABS and certain RMBS backed by 'qualified residential mortgages' will be exempt. The 5% retention piece can be a vertical slice, a horizontal first-loss piece, an L-shaped slice, a cash reserve or a representative sample. According to the regulators, the sponsor can allocate risk to the originator, provided that the originator supplied at least 20% of the pool and will retain 20% of the risk.

"The proposed risk retention regulations are a cause for concern for many parties," confirms John Lonski, vp, capital markets at Cornerstone Real Estate Advisors. "There are also issues surrounding consolidation. All that needs to be understood before the market comes back properly."

He continues: "For CMBS, implementation is not expected until 2013, so the market will come back at some sort of natural level. But before the market can come back at full speed, that regulatory environment will have to be understood – particularly around the concept of risk retention."

Barclays Capital's Tcherkassova notes that the risk-retention requirements put forward by the FDIC in late March pose a significant risk. If the proposals are adopted as they stand, any excess proceeds on execution of the deal would be kept in a premium capture reserve account and act as the first loss piece. But requiring an issuer to put excess spread from premium securities or IOs into the reserve account could be problematic as it would not necessarily be easy for the issuer to monetise this at the time of bond issuance, thus reducing the incentive to issue.

"However, there are some preliminary indications that this proposal would be amended in the final rules," she adds.

On the other hand, the 5% risk-retention requirement itself remains less of a limiting factor, as the proposal allows it to be transferred to the B-piece buyer. Tcherkassova observes: "To be sure, these are only preliminary proposals that will likely be modified before the final rules are drafted. As such,

Tom Zatko, Cornerstone Real Estate Advisors

Operating advisors: a permanent feature?

The control structure in CMBS 2.0 differs to that of pre-crisis transactions due in part to the addition of an operating advisor (OA) in certain transactions. Whether or not these advisors will become a permanent feature is unclear, however.

The OA's role is primarily to consult with a transaction's special servicer on major decisions on behalf of all bondholders. Previously, only certain classes of bondholders – usually the junior bondholders – had this right.

Not all deals that have been issued under CMBS 2.0 have contained the feature, however. Four multi-borrower transactions in 2010 featured OAs, while three did not. Consistency is also lacking: the MSC 2011-C1, WFRBS 2011-C2 and JPMCC 2011-C3 deals contained a 'trust advisor', while the DBUBS 2011-LC1 transaction, for example, did not.

"Investors – especially investment grade investors – have been clamouring for more control and more transparency," explains Tom Zatko, md, capital markets at Cornerstone Real Estate Advisors. "But there has not been a clear pattern regarding some of the new senior bondholder protection features of transactions, particularly regarding the operating advisor.

"Consistency will hopefully come in the next few months," says John Lonski, vp, capital markets at Cornerstone Real Estate Advisors. "The main inconsistency revolves around the operating advisor concept: we've seen some deals with operating advisors, some without. For some transactions, the operating advisor has limited involvement; for others, the operating advisor is engaged in a more proactive role. These are all viewed slightly differently to the last deal."

He adds: "A bit more consistency going forward would be appreciated, because each new deal feels like a one-off transaction."

It remains to be seen whether this feature will become part of the standard CMBS 2.0 deal. Some market participants suggest the feature will continue to evolve alongside CMBS 2.0, while others think it will disappear completely as confidence in new issues increases. Others doubt that compensation incentives will be sufficient to entice potential OAs to become involved with transactions.

Julia Tcherkassova, CMBS analyst at Barclays Capital, expects the OA language to continue in future CMBS.2 issuance. "The recently released FDIC rules dealing with risk-retention requirements also contained language that would mandate an operating advisor on deals where the B-piece buyer holds the first loss piece and has control rights," she concludes. "The new proposals also give the OA more teeth: if accepted, any special servicer removal recommendations by the OA would be binding, unless a majority of certificate holders voted against it."

CMBS issuers still have two years to comply with these regulations once the rules are finalised."

Increasing supply

In the absence of Dodd-Frank issues, the CMBS market is expected to see continued expansion of volume. Zatko notes that at present there tends to be a lot more combined deals to try and get enough volume to create a CMBS pool.

"In the past there were some companies that worked together, but by and large they would have used their own shelf," he says. "Now we're seeing a combination of contributors, several shelves or several companies or issuers getting together to bring some velocity into the market. That will certainly be a trend that we expect to continue. As time passes, I'd imagine that the natural progression would be for larger pools and more loans."

Clancy, meanwhile, estimates that there will be US$50bn of CMBS issuance in 2011. "I also think there will be European issuance in 2011 and some CDOs in 2011. Next year there could be as much as US$80bn in issuance, which would be outstanding to see that sort of growth given where we've come from," he says.

Increased supply will, however, require a change in the investor base or a change in the type of transaction issued. At present, most transactions have been issued under 144a guidelines, thus limiting the number of buyers. Zatko suggests that this situation will have to be resolved on either side: either the buyers will have to change their mandates to allow for 144a issues, or the issuers will have to switch to public offerings.

"I think we'll see the more creative financing structures returning before the end of the year for sure," adds Winstead's Mullen. "But I also know that investors are wiser. I don't think the market can expect to see issuance levels reach US$80bn or US$100bn without some sort of risk retention," he concludes. SCI

Overview of 2010 and 2011 Multiborrower Transactions

Deal Name	Month/Year	Size ($m)	No. of Loans	No. of Bond Classes (+10s)
JPMCC 2010-C1	June 2010	716.3	39	11 (+2)
GSMS 2010-C1	August 2010	788.5	23	8 (+1)
JPMCC 2010-C2	October 2010	1,101.3	30	11 (+2)
COMM 2010-C1	October 2010	856.6	42	10 (+4)
WFCM 2010-C1	October 2010	735.9	37	8 (+2)
GSMS 2010-C2	December 2010	876.5	43	8 (+2)
DBUBS 2011-LC1	February 2011	2,176.1	47	10 (+2)
MSC 2011-C1	February 2011	1,548.4	37	12 (+2)
WFRBS 2011-C2	February 2011	1,299.3	50	8 (+2)
JPMCC 2011-C3	March 2011	1,492.9	45	13 (+2)
GSMS 2011-GC3	March 2011	1,400.6	57	10 (+1)
CFCRE 2011-C1	April 2011	634.5	38	11 (+2)
2010 Average		**845.9**	**36**	**9 (+2)**
2011 Average		**1,425.3**	**46**	**11 (+2)**

Source: Standard & Poor's