News & Analysis

Outlook: Market sees securitization solution should banking woes rise

Should the CMBS market be used to resolve potential problems at regional banks, there are questions about how this could play out, however.

Samantha Rowan - 8 hours ago

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There is a tried-and-true strategy that could come into play should the loan books of regional US banks become a more serious concern: the commercial mortgage-backed securities market.

While markets seem to be more stable in the wake of a trio of failures in early March, it would be naïve to state that there are no problems in the market, said Richard Hill, a senior vice-president and head of real estate strategy and research at New York-based Cohen & Steers.

Hill, who outlined the potential problems facing both banks and commercial real estate in a paper published earlier this month, noted that in the period after the Savings & Loan Crisis, the Federal Deposit Insurance Corporation created the Resolution Trust Company to spearhead what became the first mortgage securitizations.

"The FDIC created the CMBS market to help small banks get loans off their balance sheets. There was a lot of lot of technological innovation, including the start of the CMBS market and the dawn of the modern REIT era, which helped the market to recover from the S&L crisis," Hill said. "It is even more interesting that the FDIC used the same technology in the aftermath of the Global Financial Crisis."

He continued: "I see a very real scenario in which CMBS issuance could boom in the aftermath of what is going on today, if in fact, the risk to small banks is more than what we are currently anticipating," he said. "I could see the FDIC using CMBS as a means to help get loans off of bank balance sheets, not dissimilar to

what they did in the aftermath of the S&L crisis or the GFC." A key question, however, is who buys the AAAs as banks are typically a key investor.

Quantifying potential problems

The thesis of Hill's report was that commercial real estate mortgages are unlikely to pose a systemic risk for the US banking sector due to the diversity of capital sources and more stringent underwriting that has emerged since the end of the global financial crisis.

The report underscored that the problems in the market today do not mean the market is poised for another residential subprime situation. "Debt service coverage ratios indicate loan default risk is low and underwritten loan values are low, especially after considering the rise in property values over the past 10 years. In fact, we believe commercial mortgages as a group are underleveraged," Hill said.

Hill also noted the risk of loss to commercial real estate lenders is likely less than is expected, with Hill estimating a 20-25 percent drop in values. Moreover, lending standards are much more conservative than they were prior to the global financial crisis.

Compressed recovery cycles

Justin Curlow, global head of research and strategy at Paris-based AXA IM Alts, believes the evolution of the markets has meant the distress period of this cycle will be shorter than during previous downturns.

The commercial real estate market has been through enough downturns that it has matured significantly since the 1980s. This is evidenced in part by the greater institutional capital that is holding and lending on these assets, he explained.

"I feel like the market is taking its medicine with regard to valuations more swiftly than we did in the past, and that valuations are correcting more swiftly," Curlow said. "Post GFC, it took about 12 months for this to happen in the UK but in the late 1980s, it took approximately 26 months. Hopefully this compressed time

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frame will allow us to rebound more swiftly than what happened during previous cycles."

Structuring it out

Should the CMBS market be used to resolve potential problems at regional banks, there are questions about how this could play out, however.

"The biggest question mark is who will buy the triple-A bonds? Banks are usually the biggest buyers of triple-A CMBS and while I think the junior bonds will be priced at a level that can incentivize money managers and hedge funds, this might not be the case for the triple-A bonds, which make up the majority of deals," Hill said.

There are ways to price the triple-A portion of the bonds to incentivize buyers to come in. "But I am less concerned about how the bonds are priced and more interested that the technology exists already and has been used before in the past on this exact issue," he said. "The beauty of the CMBS market is that they are bonds and bonds clear. You have to find the right level, but they clear."

Hill, like many of his peers, believes the market is facing a liquidity problem rather than a credit problem. "I think the market is massively underestimating the role CMBS could play in helping resolve this issue if it becomes bigger than what we are currently anticipating," he said.

Private and public

Karen Stager, a senior director at Los Angeles-based manager Tauro Capital Advisors, believes that in the current banking crisis, the effectiveness of the CMBS market will rely on finding the right balance between private market initiatives and government support as well as considering the overall market environment and investor risk appetite.

The role of the RTC was to pool non-performing and sub-performing commercial real estate loans into securitizations which allowed real estate assets to enter the investment market after a prolonged period of distress. "This model was utilized in

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the private sector by a few lenders during the years following the 2009 financial crisis," Stager added.

A case in point is Rialto Capital's 2012-LT1, a $132 million securitization made up of mostly non-performing loans pooled from hotel, office, and retail portfolios within the Rialto portfolio. According to Trepp, approximately $12 million was resolved in the first month of issuance. "Given the potential magnitude and heightened scrutiny on lending standards, targeted government intervention may be crucial to facilitate the securitization of troubled loans in the near term," Stager added.

Still, Felix Gutinov, principal and head of originations at Thorofare Capital Management, said he believes it will be hard for the CMBS market to have a significant impact due to the current uncertain climate with securitized lending. This is true for fixed-rate permanent loans or floating-rate, short-term loans issued in collateralized loan obligations.

"This is especially [the case] with any troubled loans, since both CMBS and CLO lenders target performing assets with an emphasis on multifamily for the latter," Gutinov said. "To appeal to rating agencies' metrics and to attract relatively low-cost capital from bond buyers, the properties making it through securitization in today's market environment will have to underwrite well and most of the troubled loans we've seen coming out of regional banks' balance sheets have rarely been multifamily properties."

There is a logical buyer, however. "Distressed debt vehicles and opportunistic private capital will be circling upcoming bank loan sale offerings," Gutinov added.

Looking ahead

There is a consensus that in the coming months, there will be substantial distress. And this dislocation presents opportunity, Hill said.

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"The equity and bond markets do a really good job of embracing the concept of buy low and sell high, but the real estate market does a really poor job of that. Everyone wants to buy everything when it feels good and sell when it feels bad," Hill said.

He added: "As an investor, I think this is going to present one of the best and most interesting markets that I've seen in my career. The very best vintage returns historically for commercial real estate come in the aftermath of events like this and there are opportunities where smart patient money can come in and generate returns that typically aren't seen over an investment horizon."

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