A publication of CRE Finance Council

# CRE FINANCE WORLD®

The Voice of Commercial Real Estate Finance

Autumn 2013
Volume 15 No. 3



HIGHLIGHTS:



*complete contents on page 2*

# Showcase Your Company Here

Reach thousands of commercial real estate finance industry leaders with your ad in CRE Finance World.

CRE Finance World's 2014 Advertising Program is now available!

With printed distribution at CREFC's two major Annual Conferences and our After-Work Seminar series and an enhanced digital edition circulated to more than 6,000 Members and additional subscribers, CRE Finance World reaches the industry's most influential participants.

The 2014 Advertising Program provides our advertisers with more benefits and visibility than ever before. Sponsor for a full year (3 issues) and receive a 10% discount!

To secure your ad in CRE Finance World, contact Stephanie Heliker, CRE Finance Council, at (646) 884-7578 or sheliker@crefc.org.


CRE FINANCE WORLD

The Voice of Commercial Real Estate Finance

*A publication of* CRE Finance Council®

*The Voice of Commercial Real Estate Finance*

A publication of CRE Finance Council

*Autumn 2013*
*Volume 15 No. 3*

# CRE FINANCE WORLD®

The Voice of Commercial Real Estate Finance



Previous issues of CRE Finance World are available in digital format on our website.

CRE Finance World is published by

CRE Finance Council®
The Voice of Commercial Real Estate Finance

CRE Finance Council
900 7th Street NW, Suite 820
Washington, DC 20001
202.448.0850

www.crefc.org

THE VOICE OF CRE FINANCE AS CELEBRATING 20 YEARS 1994 2014

Autumn Issue 2013 is Sponsored by

talmage

# Contents




CRE FINANCE WORLD®
The Voice of Commercial Real Estate Finance

Publisher: Joseph Philip Forte, Esq.

Editor-in-Chief: Brian P. Lancaster

Co-Managing Editors: Paul Fiorilla & Nicoletta Kostiansas

Associate Editor: Stephanie Heliker

Design: Bruce Zahor
Production: Kristin Searing





Volume 15, Number 3, Autumn 2013

CRE Finance World® is published by the Commercial Real Estate Finance Council (CREFC®), 900 7th Street NW, Suite 820, Washington, DC 20001
email: info@crefc.org, website: www.crefc.org.

# Letter from the Editor

**Nicoletta Kotsianas**
*Associate Director*
Kroll Bond Rating Agency, Inc.

Welcome to the Autumn 2013 edition of *CRE Finance World.* As I write this letter, the Federal Reserve announced it would continue buying bonds at a pace of $85 billion a month, sparking enthusiasm in the market— for this week. The Fed may still be gun shy given the fear already priced into rates and the agita of the stock market. Those of us that call the debt markets home are playing a game of long ball. After a summer spent watching rate gyrations, the market has settled into a holding pattern of sorts. Loans are still being quoted and closing, deals are being packaged and bought, but all activity is punctuated by the looming question of when — no longer if — tapering will occur.

Our online issue tackles the heart of the rate debate with a roundtable focused on the impact of these macro issues on business plans. Our respected panelists offer their predictions on directionality as well as observations on how rates are shaping deal structure, tenor and underwriting standards. Other issues discussed by our experts include the robustness of the rating agency process, concerns over multifamily assets, and the perennial favorite — risk retention.

Although new issuance and forward looking concerns have recently taken center stage, legacy trends are never far behind. Ed Shugrue at Talmage posits the anatomy of severe CMBS loss severities, pointing out some dubious distinction loans along the way. Continuing on the theme of workouts, check out pieces on the evolution of special servicer behaviors as well as bad boy guarantees in practice versus theory.

Other highlights in this issue include a hard sell for Canadian CMBS by Charles Gamm and Christopher Kane of Institutional Mortgage Capital Canada. The pair make the case for the bonds from the North on a relative value basis. David Nabwangu of DBRS explores the hot topic of single-family rental securitizations, begging the question of whether the fledgling asset class has staying power if the housing market recovers.

We hope you enjoy this issue and as always, please pass along any suggestions to the Editorial board. Also be on the lookout for our CREFC survey in the near future. We look forward to publishing your responses in our January issue in Miami.

**Nicoletta Kotsianas**
Co-Managing Editor/KBRA

# Letter from Stephen M. Renna, President & CEO

**Stephen M. Renna**
*President & CEO*
CRE Finance Council

CRE Finance Council is pleased to present to you the October 2013 edition of *CRE Finance World* magazine.

This edition contains articles on a wide range of important topics such as regulatory reform, the global recovery and much more. We also feature our signature roundtable discussion comprised of industry leaders sharing commentary on the current state of the markets.

Each of these articles is expertly written and they collectively provide insight and perspective on some of the most relevant issues in many sectors of commercial real estate finance.

We are deeply appreciative to the authors of the articles contributed and to the *CRE Finance World* magazine Editorial board and staff. The quality of work product and production is of the highest caliber and reflects the exemplary professionalism of our industry. I'm confident you will find *CRE Finance World* magazine to be a valuable and timely source of industry information.

With all this improvement and growth, sponsorship and advertising opportunities in *CRE Finance World* magazine are 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 and the progress we have made in getting it there. We'd like to see you become a part of it.

**Stephen M. Renna**
President & Chief Executive Officer
CRE Finance Council

# Economic Recovery Faces Q4 Political Headwinds; Robust Policy Agenda Ahead

## Risk Retention Rule Reborn, TRIA Gets Hill Attention, Lease Accounting Again in Spotlight

**Martin Schuh**
*Vice President, Legislative and Regulatory Policy*
CRE Finacne Council

The work of funding the government for the next fiscal year – commenced October 1st – which includes the debt limit ceiling and spending authorization, will be the focal points for Congress in the coming months. Included among their fiscal duties will be the approval of a new Federal Reserve Committee chair to replace Chairman Bernanke, whose term expires in January 2014. We'll examine below some of the challenges facing the macro environment as Washington continues its acrimony and gridlock.

The conservative wing of the House GOP caucus is flexing its muscle on any measures related to spending, giving Speaker John Boehner headaches as he tries to move spending legislation through the House. It's been proven many times in the past session that not even routine votes can be taken for granted, even when endorsed by leadership. A prime target and recurring theme of conservatives is defunding ObamaCare and that permeates all spending related discussions. Senate Democrats and the White House are looking to thwart any attempts by Republicans to implement their spending agenda via the mandatory legislation to raise the debt ceiling or continue to fund the government. Regardless of whether Democrats or Republicans are "right" on fiscal policy, one thing isn't debatable: there remains a host of unfinished fiscal business for the remainder of 2013.

Aside from foreign policy, two must-pass items will dominate the Congressional agenda this month and next. By the time you read this, the House will likely have already passed the first hurdle in the budget showdown (or have caused a shutdown) by passing a Continuing Resolution (a "CR") that will keep the government functioning until a full-year funding bill can be passed. Speaking of hurdles, the second must-pass item is the perennial battle over the borrowing authority of the U.S. Treasury. Secretary Jack Lew says the U.S. will run out of credit sometime in October.

Regardless of the actual credit exhaustion date, Congress must pass another debt limit extension to accommodate the yearly operating deficit and leave enough room for continued access to credit markets. How much headroom they will leave is the big question. On this matter, Obama made his case directly to the American public recently, reiterating his stance that he will not negotiate over a debt limit bill. This means that the so-called "Boehner Rule" (i.e. for each dollar of additional borrowing authority, a dollar of savings must pass) will likely be off the table.

If this whole scenario sounds familiar, it should. This has become a seasonal occurrence now in D.C., and one that unfortunately distracts Congress from its oversight responsibility of demanding accountability of the Agencies under their purse strings. Now that appropriations have been largely on autopilot (via the stop-gap CRs passed), the regulators are no longer subject to effective oversight from their respective appropriations Cardinal who could easily make life difficult for them by cutting off necessary funding. We spend time on this subject because it does have a direct and indirect impact on our issues. The less time Congress has to conduct oversight and the less leverage they have over the Administration and regulators, the harder it is for us to lobby them to affect change.

The two Houses are still miles away from the finish line on FY 2014 — the House has passed only four of the 12 appropriations bills and the Senate has yet to pass any bills. We expect some sort of compromise among the appropriations committees and a large, unruly omnibus is almost compulsory at this point. Until we have a "Grand Bargain" to reset this pattern of stop-gap funding — along with continued Congressional marginalization on oversight — this is the new normal.

While the initial, temporary Continuing Resolution may be inevitable, the ultimate spending levels are less certain. The likely outcome is to freeze spending at post-sequestration fiscal 2013 levels to satisfy the budget hawks committed to continued austerity. Yet this will leave a significant drag on the economy as federal spending remains well below the levels at which the economy had grown accustomed.

### Risk Retention Response Underway

In late August, the White House released a re-proposed risk retention rule that includes significant revisions to their 2011 proposal on risk retention. As many readers already know, the re-proposal was largely in line with our expectations. Specifically the elements of 5% retention of "fair value" (versus par value), B-piece transferability restrictions for the first 5 years, revamped qualified mortgage rules and modifications to the operating advisor sections were largely expected.

For our response to the regulators, the Forum Chairs and vice-chairs have concluded the forum deliberations, and they will soon deliberate those recommendations in the Policy Committee which, under the leadership of Committee Chairman Bob Foley and CREFC Immediate Past Chairman Paul Vanderslice, will synthesize and harmonize the views of the CREFC membership constituencies to the greatest extent possible. The Policy Committee is charged with overseeing the drafting of CREFC's comment letter and the Executive Committee must approve that letter before it can be filed with the regulators. The deadline for comment submission is October 30th.

During the initial Forum discussions, it became clear that there is broad agreement that some of the revised portions of the re-proposed rule — including the flexibility the rule allows in allocating the retention obligation between issuer and B-piece buyer — are very positive developments. The significant issues that were discussed that many believe could be most impactful to CMBS and that may warrant comment included: Operating Advisors, B-piece pari passu requirements, qualified commercial mortgages, and high quality, single borrower/single asset transactions subject to retention.

We expect the rules to be finalized sometime around year-end or early first quarter. CMBS issuers will have two years from that date to be in compliance with the new rules.

### TRIA Reauthorization Hearings Begin, More to Come

Capitol Hill appears ready to take up the issue of reauthorizing the essential insurance program that expires next year. The Terrorism Risk Insurance Act (or "TRIA") has been hotly debated recently in Congress, with many supporters pitted against a vocal minority (who oppose federal intervention in any form in the insurance markets). As we go to press, both the House Financial Services Committee and the Senate Banking Committees have announced or commenced hearings on the subject.

Regular CREFC Friday bulletin readers will recall that Representative Michael Grimm (R-NY), introduced his reauthorization legislation to extend TRIA by 5 years. His bill now boasts nearly 80 co-sponsors in a thoughtful, bipartisan fashion. Because of the proliferation of co-sponsors, we believe the issue will begin to garner more attention at the committee level. Readers will also recall that the panel's Chairman Jeb Hensarling (R-TX) is opposed to a reauthorization of the bill in current form and is soliciting input on potential changes. While we expect a reauthorization bill to eventually be reported out of the House Committee, we cannot at this time foresee what modifications Hensarling or Insurance Subcommittee Chair Neugebauer (R-TX) will be able to command.

Further hearings from both sides of Congress are being scheduled at the subcommittee level for later this congressional session.

*An Ongoing Effort:* CREFC is an original steering committee member in an industry coalition called CIAT (the Coalition to Insure Against Terrorism) and, in this role, we remain in active engagement with members of Congress and the Administration to lobby for a smooth and swift reauthorization to minimize market disruption. We estimate that over 60% of the Congress has no experience with the issue and helping to fill this education gap should facilitate greater Congressional involvement and support for the issue.

### Member Involvement

As always, this is a member-driven organization. We strive to be on the cutting edge of industry trends and data. We encourage input from our members and rely heavily upon those exchanges that have proven so valuable in policy circles. Please call your government affairs team for more granularity on any policy or political issue facing the industry. We would welcome the opportunity and would be happy to brief you by telephone or in person if logistically feasible. Please contact Christina Zausner or Marty Schuh.

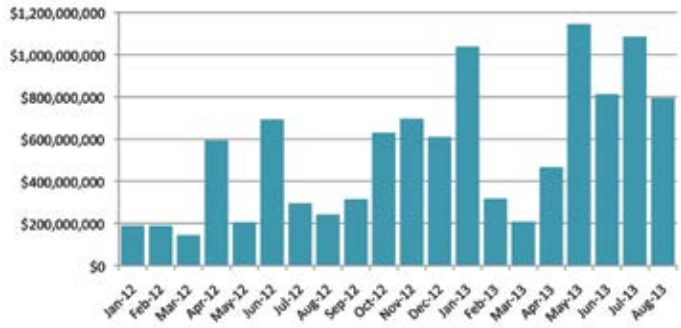
# Rate Moves Move the Dial on Defeasance

**Christina Zausner**
*VP, Industry and Policy Analysis*
CRE Finance Council

Defeasance activity has accelerated to $5.8 billion through August. Volumes are up by 131% over the same period the year prior and 26% in 2013 year-to-date versus the full year 2012.

If a loan is a part of a CMBS pool, it oftentimes will include a requirement that only allows prepayment in the event that the borrower pledges high quality securities in place of the loan. Defeasance in the CMBS sector generally requires that the borrower offer zero-coupon Treasury bonds in the amount necessary to cover future payments to maturity.

*Chart 1*
**Defeasance Activity Jan 2012–Aug 2013**




Source: Trepp

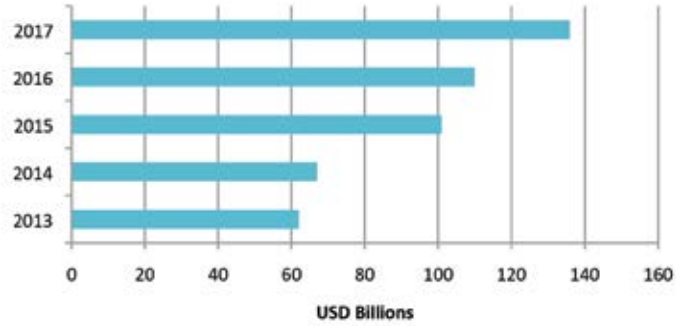
A couple of factors drive a borrower's decision to resort to defeasance: interest rates and property values. Both come together to create the incentives and the conditions under which an owner will consider the high up-front costs of defeasance.

In 2013, the tapering discussion and other issues started to influence interest rates, and to convince the industry that borrowing costs could break out of the lower range going forward. Paul Vanderslice, Citigroup Co-Head of the US CMBS Group, says: "Many borrowers are concerned about rates dropping and their defeasance costs rising. As counterintuitive as this may sound, a borrower cannot release equity in a property without refinancing existing debt with a new loan."

Property values continued to recover this year, especially for premium buildings in tier 1 markets. Lisa Pendergast, Co-Head of CMBS Strategy and Risk at Jefferies LLC, suggests that borrowers may have found current conditions to be something of a sweet spot. At some point, jobs and GDP growth will need to support incremental increases in values and to justify the cap rates that will make refinancing attractive. If the borrower cannot take equity out, the economic benefits of defeasance generally disappear.

In addition to rate volatility and property values firming, the "wall of maturities" continues to advance, pressing the question of selling and refinancing.

*Chart 2*
**CMBS Maturities**




Source: Trepp

Richard Hill, Head of CMBS & CRE Debt Research at Morgan Stanley, puts the recent uptick in volume into perspective. "Defeasance was a bigger strategy prior to the collapse. As financings increasingly become available and markets continue to normalize, you would expect to see more defeasance, especially as loans mature in greater numbers."

# CRE Finance World Roundtable: Macro Issues Facing CRE Finance

Moderator:

**Lisa Pendergast**
*Managing Director*
Jefferies LLC

Participants:

**Larry Brown**
*President*
Starwood Capital Group

**Sam Chandan PhD FRICS**
*President & Chief Economist*
Chandan Economics
*Professor in the Associated Faculty of Real Estate*
The Wharton School

**Samir Lakhani**
*Director, Senior CMBS Trader and Portfolio Manager*
BlackRock

**Greg Michaud**
*Senior Vice President &*
*Head of Real Estate Finance*
ING Investment Management

**Mitchell Resnick**
*Vice President, Multifamily Loan Pricing & Securitization*
Freddie Mac

Roundtable conducted September 16, 2013

**Lisa Pendergast: Thank you all for joining our panel discussion on the macro issues facing commercial real estate finance. The macro-economic and geopolitical issues faced by the market today affect our industry more than ever before. For example, clarity on a likely appointee as Chair of the Federal Reserve and the Fed's decision not to begin tapering in September triggered a 'risk-on' mentality in all financial markets, with CMBS being no exception. Whether one is originating commercial or multifamily mortgages, buying commercial real estate-related bonds, or investing in hard assets, the outlook for the direction of rates going forward is vital. Given today's historically low rates and the understanding the Fed's quantitative easing will eventually come to an end, the question isn't will rates rise, but how fast will it happen and how aggressive will the increase be?**

**Sam, I would like to make you the central point in the beginning of this discussion. Then, everyone weigh in.**

**Sam, where do rates go from here now that they've already backed up 100 basis points? Do we see another 100 basis point gain before the year is out? Or will the Fed hold steady to see what the economy does? And, what are your thoughts if they do begin to taper, what will that mean for rates?**

**Sam Chandan:** The initial adjustment in rates that we saw earlier this summer was certainly abrupt. It speaks to the Fed's limited influence over the long end of the yield curve. It also caught many commercial real estate investors and lenders by surprise. Not in as much as they did not understand or anticipate that there would be an adjustment in rates at some point; I think the suddenness of it was unexpected for participants in the market that incorrectly perceived the Fed as setting long-term rates when it only influences them. That is clearly the most immediate issue for participants in the market today and with good reason. Very low costs of capital, very low interest rates, and very low borrowing costs have been among the defining features of the commercial real estate recovery. It has impacted capital flows into a variety of assets. It has also been defining in terms of how balance sheet lenders and CMBS market participants have dealt with distress and challenging maturities. After an initial disruption, the first shift in the rate environment has been largely absorbed into lending and cap rate spreads. We risk overconfidence in drawing conclusions from that. The next 100 basis points will not be so easy.

**"As long as there aren't those sticker shock moments, where you wake up one day and rates are way different from yesterday and you're getting significantly less proceeds or more expensive proceeds – commerce will take place."**

The initial adjustment on the order of about 100 basis points, in absolute terms may not be terribly large, but in relative terms it certainly has been. We saw that rates bottomed out on the 10-year around 1.4 to 1.5%. Since then, the risk-free yield underlying borrowing costs has nearly doubled as rates have come up closer to 3%. The outlook for the economy did not change materially during that period; it's naïve to assume that every increase in Treasuries will be offset by a commensurate adjustment in the economic forecast.

Looking forward to what the rest of the year might hold, there are a couple of things going on. It's not that the underlying economy or capital market conditions are sufficiently strong that we will see rates trend toward their long-term averages at this point. Whether it is the Federal Reserve or other institutional market participants, there are still some forces working to keep long-term rates low. We have the potential for a more significant upward adjustment but it won't necessarily come from any specific moves that would be made by the Fed, or any specific commentary that would come from the chairman of the Federal Reserve. When we look back at research that has been done, their own estimate of how directly impactful something like quantitative easing has been or can be on Treasury rates, the direct impact is fairly modest. What the Fed has a significant role in doing is shaping the expectations of other participants in the market with regard to where it will set its inflation targets, and how aggressive it will be in supporting its current monetary policy bias. And then it's the flow of capital from all sorts of other sources that ends up being what determines where we sit with the yield curve.

There is an acknowledgement within the Fed that adjustment in their language has generated observable responses in the financial markets. At this point, I think they are being cautious in their choice of words even more so than they usually are. Although they might be in agreement that rates have to trend higher in the long run, exaggerated volatility in the rate market makes it difficult to invest, lend, and anticipate what investment flows will look like. That will make their assessment of the economy harder to read. Expectations are that some of the downside risks to economic growth have abated. Although they may not have a more sanguine view of what growth will be in 2013, they see fewer downside risks. That's even after accounting for fiscal drags and dysfunction in Congress. They're not seeing as many of the stress scenarios being as severe. That certainly helps. But they're not expecting runaway growth.

The wildcard in some of this is the pending nomination of the next chairperson of the Federal Reserve. At this point in September and certainly following the announcement by Larry Summers that he would not pursue the nomination, the odds weigh heavily toward Janet Yellen. The markets are taking that potential very well. Janet Yellen is perceived as being in close alignment with Chairman Bernanke, in terms of her views of appropriate monetary policy and how accommodative the Federal Reserve should be. Compared to some other candidates where we might anticipate a more abrupt tightening of policy over the course of the next 6 to 12 months, with the appointment of Janet Yellen to that role, we would really see the Federal Reserve stay the current course if she can rally the other voting members.

**Lisa Pendergast: All financial markets knew the Fed would begin to 'taper' and eventually cease altogether its $85 billion in monthly Treasury and mortgage purchases. In fact, many believe it has gone on too long already. The question I have is that even when the Fed begins to taper, Chairman Bernanke has said that the Fed Funds rate would remain at or close to zero for some time to come. Shouldn't that be enough to prevent a sharp gap higher in rates?**

**Sam Chandan:** On the short end of the yield-curve, the Fed exercises a far greater degree of control. Based on the information they have available to themselves at this point, their expectation is that they will keep those targets at or near zero for the next couple of years. If the economy were to suddenly start growing quickly, if job growth were to pick up, if inflationary pressures came to bear in a more significant way, they're not ruling out the possibility that they would adjust those short-term targets. The more immediate concern for investors in our industry is the long-term rate, where the Fed is influential but not omnipotent. What do higher rates mean for property valuation and for financing costs? In the data that we're collecting, with regard to borrowing costs, there is preliminary evidence that during the third quarter, for properties of comparable risk, duration, and loan structure, rates have increased. Did they go up by 100 basis points? No, they didn't. Some of the increase has been absorbed into the spreads. But the relationship is not fixed. That's where it becomes a real issue. When you look around the various commercial real estate markets, for example in some of the markets where fundamentals have lagged, where investors are more concerned about illiquidity, where the capacity to absorb rate increases into spreads is more limited, whether it be the cap rate or the borrowing cost, managing investors' demands for higher yields is more challenging. It's there that we see a greater degree of responsiveness in borrowing costs and cap rates. It doesn't play out in the same way in every market.

**Lisa Pendergast: Thank you Sam. I'm going to turn now to the lenders on the call. To me, the recovery in commercial real estate has been uneven, but it has been there. The significant difference between commercial and multifamily real estate markets and the single-family residential market is that we've**

**enjoyed a much quicker return of liquidity. Nowhere else was that more evident than in the multifamily sector, with the GSEs providing liquidity to that market very early on during the crisis. The result was that multifamily led our industry out of the crisis, with the commercial real estate markets following suit. Portfolio lenders, particularly the life companies, were quick to provide both debt and equity capital to the sector, and by 2010 CMBS conduits were on the mend providing another source of capital for property owners. With that as backdrop, does the recent backup in rates slow that progress going forward? What does it do to origination volumes and the re-financability of legacy loans?**

**Mitch Resnick:** One thing I want to note as far as liquidity is concerned is the time frame we are considering. Sam rightfully pointed out before, that the speed at which rates move will have an impact. It definitely had a big impact on securitized lenders. We saw 10-year Treasury rates bounce up 100 basis points in a period of two months; it had a dramatic impact on the overall liquidity of the loan market. Typically, you see spread product and interest rates have a slightly negative correlation. What we experienced in May and June was a rare positive correlation; as rates went up, and spreads widened. That was a function of investors being uncertain about what the Fed was going to do next. You saw "buy the rumor, sell the fact" as the market overreacted to the initial taper talk. There was a major reaction as to what was coming out of the Fed at that time and it was a concern. As liquidity started to dry up, spread product went wider, therefore loan liquidity from securitized lenders started to dry up. However, that wasn't a long-term thing. It was relatively short-term in the grand scheme of things, but it's important to note.

I wonder if we had seen the same rate increase take place over a period of three to four months and for it to be a steady, gradual thing, if we would have seen that pocket of illiquidity that we experienced.

**Larry Brown:** I think you said that beautifully, Mitch. That was my answer as well, which is, if rates rise gradually, it's okay. Lucky us, we're not selling luxury goods; we're selling and trying to originate mortgages. Unless you're Warren Buffet, if you're buying a property, you need to borrow money; if your 10-year balloon is coming due, you need to borrow money. As long as there aren't those sticker shock moments, where you wake up one day and rates are way different from yesterday and you're getting significantly less proceeds or more expensive proceeds — commerce will take place. So inasmuch as rates are historically low, if rates rise gradually, then I think we can all do business. It's those sticker shock moments that make everyone pause.

**Greg Michaud:** From a life insurance company perspective, we're still much keyed on coupon. While spread is important, coupon really drives the life company. It creates more liquidity at least from a life company perspective, (as much as life companies can create liquidity in the market for the $50 billion or so they do a year) because the absolute coupons are going up, especially on the short end of the curve. This actually enables us to lend more money on 3- and 5-year term deals because even though the spreads haven't changed much, and in some cases we are absorbing the increase in spread a bit, the absolute coupon is up compared to what it was when it was a 160 basis points over the 10-year Treasury. On that basis, we can now get a coupon in the mid-3% area whereas that coupon six or seven months ago was 2.5%. We're having conversations internally regarding where rates are going; portfolio management is interested in allocating more money to CRE because it, as well as private placements, has been a good relative-value play. So the rate movement actually creates a little more liquidity, at least for life companies, because the coupon is that much more attractive.

**"The rate movement actually creates a little more liquidity, at least for life companies, because the coupon is that much more attractive."**

**Lisa Pendergast: From an investor's perspective, what is your view on the impact of rising rates on credit quality? Do you worry about legacy refinancing?**

**Samir Lakhani:** We experienced a "risk-off, rates-off" dynamic over the summer months. What was really interesting to note out of that was yield-oriented capital could purchase further up the capital structure in CMBS, as a combination of higher rates and higher spreads satisfied yield requirements. We hadn't really seen much of that before. Credit curves are naturally going to steepen when you have volatility, but if you look at these new issue transactions you see the lingering effect; senior classes have retraced more of their summer wide levels and subordinate classes have lagged.

As for credit, the rate back-up clearly puts pressure on certain loan metrics and that may hinder some of the refinancing of legacy CMBS loans. For example, the coverage ratio is something we are all focused on now. However, it also seems to me that there has been a lot of capital raised to fill down the capital structure. So it really comes down to location and property type. There were a lot of trophy assets securitized in legacy product that may attract capital upon refinancing.

With respect to new-issue product, to the extent we are locking in higher coupons today and closing the gap to where expected rates

are down the road, some of the pressure can be alleviated. The key is keeping the lending based on sustainable cash flow and really recognizing that the growth trajectory that we are in, alongside a rising rate environment, is softer than prior post-recessionary periods.

**Lisa Pendergast: One development that's puzzling me in the current round of new CMBS deals in the market is the increased size of 5-year triple-A tranches. This indicates to me that conduit lenders are originating a lot more 5-year loans than was the case earlier in the year. Why would borrowers not want to lock in today's still low long-term rates? Is it because the higher rates on 10-year loans lead to much lower debt service coverage ratios that don't meet lender underwriting criteria?**

**Greg Michaud:** From our perspective, we're receiving numerous calls on 20 to 25-year loans; we're seeing a lot of appetite for these longer-dated loans from borrowers who are going to sit on the property forever. We are still not getting a lot of requests on the short paper, though we will as rates move higher. We will get more active on the short end of the curve right now as those rates become more attractive, and that's really from pension funds that desire shorter loans. They borrow low leverage so you don't have to really worry about refinance issues. We have seen some borrowers who originally requested 10-year deals now looking for 5-year loans because the coupon works better. We have a stringent refinance test and we are shying away from those deals because we don't think the loans will refinance in 5 years if 10 year yields increase to over 5%.

**Mitch Resnick:** From where I sit, we are starting to see a little bit of pick-up in interest down the curve, meaning five years and seven years. It really is a function of the steepening that we have witnessed in the past few months. Borrowers feel they can get more proceeds but if they can't, at least get a lower coupon for their loan. One other thing I think you may be experiencing as far as the creation of five-year classes in securitization, is that with rates at such historical lows that when you run a 30-year am-schedule, the amount of amortization that you get in the first ten years at these prevailing rates is almost double the amount that you would have seen five or six years ago. Since most of the five-year classes are just absorbing the amortization, you're going to see growth in those classes compared to the types of deals you saw pre-crisis.

**Samir Lakhani:** I would say shifting some loans to the five-year class certainly seems to have eased the burden of placing some of the larger ten-year classes that we saw earlier in the year. Five-year bonds also have the benefit of being exposed to less duration, an obvious concern this year. However, I would also point out, that at that part of the curve, there is a considerable amount of legacy product from '06 and '07, with a similar weighted average life, competing for that capital. And if you look outside of CMBS, in the securitized product set as a whole, there is a lot of product at that part of the curve as well. So while ratings may be more uniform on new-issue product, I think flexible capital has more options to choose from when you are looking at the five-year part of the curve.

**Lisa Pendergast: When I think about legacy dupers that are now in that five-year area, the first thing that comes to mind is negative convexity — that worry just doesn't exist on the new-issue side. In a way it makes the universe for those bonds very concentrated and comprised mainly of credit-focused investors who are willing and able to conduct the diligence.**

**Samir Lakhani:** I think you are right. The legacy universe as we move closer to maturity is becoming more idiosyncratic. It's easier to say that for the junior securities but it's also becoming the case for senior securities as well, as many are trading at significant premium dollar prices. If we have an easy policy back drop on the front end of the curve, and we will get more information to that effect from the Fed this week, the premium price impact will continue and so doing your work on the underlying loans to estimate timing of cash flow will be critical.

**Lisa Pendergast: One thing that does concern me going forward is that a further backup in rates comes not because the economy is showing improvement or is on the verge of becoming inflationary, but because the Fed has determined it's time to take the punchbowl away and allow the markets to walk or crawl on their own. We're not really seeing the economic growth that one would normally see in such a backup. So the concern might be that even though rates are rising, the commercial and multifamily markets are not enjoying the meaningful pickup in demand, occupancies, and rents that normally would accompany such a move. We've had a pretty easy go of it, all things considered, in terms of the refinance-ability of legacy loans; the hit ratio for refinancing some of these loans would not be as high as it is if rates were higher. I'm worried that this could change going forward — and the difficulties may not just be in legacy CMBS loans, portfolio lenders may run into difficulties as well.**

**Sam Chandan:** I just want to jump in on one point there. We should be careful to avoid assuming that the increase in rates necessarily implies improvements in economic activity. That's true a lot of the time; it was not the case earlier this summer, when the immediate trigger was an expected shift in monetary policy. There is this

**"The securitization machine is not nearly as geared as it was pre-crisis. Pre-crisis, whether it was a cell-tower, casino, or restaurant transaction, we saw a lot of corporate transactions dressed up in CMBS clothing. We are not there yet."**

widespread belief that rates are going up and that it's got to be attributable lock step to an improving economic outlook and improving job market trends. The disconnect is that the rates we've observed over the last couple of years are not consistent with the level of growth that we're experiencing. The rates we're observing in the market are substantially lower than what we would normally see for the current level of growth. And that has been a reflection of significant intervention on the part of monetary policy makers. So we have this initial increase in rates that we might normally attribute to a better set of underlying fundamental drivers, but that might not actually be the case at all. It's why the unqualified argument about wide spreads is flawed.

**Lisa Pendergast: That's a very good point. Growth has certainly been sub-par, but it's been there. It's not the 3%+ that everyone wants to see, but it has been sufficient, especially combined with Fed-inspired historically low rates, to enhance the refinance-ability of once marginal legacy loans. Mitch or Larry, any thoughts?**

**Larry Brown:** I'll throw out an observation: you can see we're in a different environment because for the last two and a half years, everything has been LTV constrained. For the last 60 to 90 days you're actually hearing the words uttered, 'debt service coverage constraint.' It's new and different, but it does show that the landscape has changed just a little bit. You have to keep your eye on it, and what it does to the finance-ability of assets. It means there is a new benchmark now that there is the DSC constrain — not for all deals, but it is out there now.

**Lisa Pendergast: Samir, maybe you can talk a little bit about what you think the market is going to do. What are your views on current underwriting? Do you anticipate further deterioration? Do you stay in the sector, and if you do, do you reallocate to something you feel more comfortable with?**

**Samir Lakhani:** Underwriting is certainly trending in a direction of higher total debt leverage and looser standards. It might not always come through in outright metrics but we are certainly seeing more loans with weaker structures like partial or full IO terms, or concentrated roll near maturity. This can exacerbate negative loan outcomes in what is already expected to be a more difficult refinancing environment. That being said, one point to highlight is that currently, the securitization machine is not nearly as geared as it was pre-crisis. Pre-crisis, whether it was a cell-tower, casino, or restaurant transaction, we saw a lot of corporate transactions dressed up in CMBS clothing. We are not there yet. Yes total leverage is creeping up, which is worth paying attention to, but right now it feels more balanced across markets and product types.

**Lisa Pendergast: What does a higher-rate environment do to the very large pool of outstanding legacy CMBS? Do investors continue to focus on legacy knowing of the so-called 'wall of maturities' that lies ahead and the impact the inability to refinance some of these loans will have on bond values? Or do you re-focus your attention squarely on the new issue market with improved underwriting and asset-level upside in most cases?**

**Samir Lakhani:** Because they are at two different parts of the curve, you could end up with a mix of both. Legacy product, as it shortens in maturity will become less of a beta-trade and likely more reactive to news headlines on individual loans. That's where you are going to have to cull through you portfolio and keep those stories you like. With any fixed income portfolio, there is some element of replacing product being refinanced with new-issue product, but because they are at very different parts of the curve, there is room to own both.

**Lisa Pendergast: And I think you hit on something interesting. If you look forward to when 2005 through 2008 legacy loans secured by well sought-after trophy assets began to mature, the new loans that result will make for very attractive collateral for new CMBS deals, assuming underwriting standards remain reasonable.**

**Samir Lakhani:** Agree, and I think just this year we saw close to one-third of the issuance in single-borrower, single-asset product. I think it's easy to argue that many of these loans are higher quality than many of the loans going into conduits and you will have a natural supply of that a few years forward as these trophy assets come back to market in single-borrower form or as a portion of future conduit transactions.

**Lisa Pendergast: Let me change gears and talk about the lending environment, as competition certainly has grown. What are you finding today? Has the increased competition caused a degradation in underwriting standards? Already, most market participants agree CMBS underwriting has slipped since the early stages of the recovery but still remains considerably more conservative compared to the peak in the market in 2007.**

**Greg Michaud:** Well one of the reasons why we are out competing heavily on longer-term loans like 15-, 20- or 25-year loans is that there is little or no competition from the GSEs or conduits in this space. So that's where we're most competitive. As we go shorter, and get around 10-year loan request, life companies will be competing with the conduits and GSEs who are really competing on loan proceeds. As loan requests get shorter than 10 years, we

are competing with the banks, and they are very hard to compete with on five-year and shorter deals. They are doing deals that are LIBOR +140 or +150 basis points with no floors. So it's very competitive on the short end. Our greatest competition is with other life insurance companies all of whom are searching for the best low leverage business. But when you have a sharp rise in rates and because we are willing to rate lock fast, a more volatile the market benefits life companies. So with the volatility, we've definitely seen a pickup in our deal volume.

The other pickup that we are seeing is in the multifamily space. As borrowers get worried about what happens with Freddie or Fannie they are seeking out life company relationships. We are doing several deals now with borrowers who has never borrowed from anyone other than an agency. So we are starting to see a fair amount of that business come our way because of the uncertainty in the market of the GSEs. Primary competition is definitely other life companies, and when things aren't as volatile, competition with CMBS does pick up.

**Lisa Pendergast: Greg, the insurance companies certainly held sway over the commercial real estate lending markets coming out of the recession. I believe insurance company commercial-mortgage origination volume hit a high of over $60 billion post crisis, does that sound right? Do you see the life companies getting to that level again anytime soon? I'm thinking the business must look very attractive at this point given the higher coupons and yields.**

**Greg Michaud:** Yes, high water mark production for life companies are in that $55 to $60 billion range. I think you could go over a little in 2013. Obviously it's not going to go much above that. I think that's about as high as it will ever get. Could it reach those levels again if rates stay up? I think yes. But what might happen is if you start seeing deals that don't hit refinance tests, or coverage gets tighter, you'll probably see the life companies back out. They love the relative value of the rate, but they're not going to love the underwriting if property incomes do not keep pace with rate increases. Obviously, the relative value and available conservative underwriting a couple years ago was a perfect storm for life companies. So, I'm not sure whether that happens now, probably not. They love the coupons, but you'll get to a point where, I think as Larry said, coverages are going to be getting tight. Actually you're paying attention to debt coverage ratios, where as you didn't pay attention to that much until recently. Now, we are paying attention to it, and we are starting to see deals not work because of low coverage.

**Lisa Pendergast: Mitch, Greg just hit on something I was going to ask you. How much business do you believe you are not seeing because of concerns about regulatory issues that relates to the GSEs? Has that changed the way in which you look at your businesses in terms of either areas of the curve or the types of loans, or any kind of main shift in the way you think about this?**

**Mitch Resnick:** It's a good question, a difficult one to try to prove the negative. I'm sure there is business we are not seeing due to concerns about the future. However, as long as we're around I know folks are going to want to talk to us because I do feel we provide an excellent product for them. There are some borrowers out there, not many, that think the relationship is over once the loan is funded. We try not to think of it that way. So any future uncertainty doesn't really matter because it is short term for them.

We do see a lot of competition. As everyone knows, we have a mandate as to the amount of production we have to do this year. So we have seen more competition this year from insurance companies, from conduits, from banks, not just from our sister Fannie Mae. Greg said it pretty well, as you get further out beyond 10 years, it starts to become a significantly different marketplace as far as the competition is concerned. Ten years and in is really the area where we focus. We will gladly quote out to 15 years but at this point 90%+ of what we are originating is scheduled to be securitized. So we may not be as competitive.

**"What might happen is if you start seeing deals that don't hit refinance tests, or coverage gets tighter, you'll probably see the life companies back out. They love the relative value of the rate, but they're not going to love the underwriting."**

I suspect that competition is going to remain fierce. Going back to what I was mentioning earlier, at times of illiquidity in the marketplace, we do have an advantage there and we are also mandated to calm markets and maintain liquidity, so we may see more activity in times of uncertainty than a typical conduit or bank. But again, that is a major part of our purpose for being here.

**Lisa Pendergast: The volume of multifamily loans in conduit CMBS has increased substantially thus far in 2013. Many of these loans are to borrowers who succumbed to the recession and/or the lack of liquidity in the lending markets and were forced to give back assets or file for bankruptcy protection. What are your thoughts on doing business with these types of borrowers? What I'm asking is what role does character play in non-recourse lending? Can you structure sufficiently to put a solid multifamily asset in a deal with a borrower who has run into some trouble and possibly behaved badly?**

**Larry Brown:** My two cents is that we are very big into sponsor behavior in bankruptcy. I work for a subsidiary of LNR, the world's largest special servicer, and so we get a pretty good window into things. So we ask ourselves whether the borrower is simply "guilty" of being in a tough economic environment but was otherwise a wonderful operator and it was just wrong place wrong time, or was he using bankruptcy as a weapon against his lender and how did he behave during that period, and things like that. So that's a big deal for us. We feel like we can't have it both ways where we whine, and say, 'Oh this guy is a newbie, he hasn't been in the business long enough, we don't feel good about him as a sponsor,' but then you want a nice experienced sponsor, who may have been through some cycles — he may have had a bankruptcy or two — so then you look into why he went into bankruptcy. Poor/reckless/dishonest management or a tough economy? And how did he behave once the market crash hit.

**Greg Michaud:** I'm there with Larry. We experience the same thing. Bankruptcy typically knocks you out, but why did they go bankrupt? Did they go bankrupt because the bank got taken over by the FDIC or a new bank and they said all of the loans here are going to get called and the guy just got stuck in a bad market? That's one story. The other is the guy with little or no equity who filed bankruptcy to fight the lender and keep the lender away from the property. We are not going to touch that guy. For the most part, it's non-recourse lending, so we're really looking more at the property but we do try to avoid the litigious borrower. We want guys that are going to act honorably.

**Mitch Resnick:** I know this sounds cliché, but something I learned very early on in my lending career is there is no such thing as a good loan to a bad borrower. I think that is what we are getting at here. You really get to see the character of a borrower when the tide goes out. Do they use bankruptcy as a weapon? It really is a very important factor in evaluating a potential borrower.

**Lisa Pendergast: Samir, the Dodd-Frank re-proposed risk retention rules do not exempt issuers of single-borrower or single-asset CMBS from the risk retention requirement. Do you think the rules have the potential to sharply reduce the issuance of these deals and bring back conduit/fusion CMBS with large loans split pari passu across a number of transactions?**

**Samir Lakhani:** I think that is possible. The way the rules are written right now, it can increase cost on single-asset, single-borrower execution and that may push some loans in the direction of being cut and sprinkled into conduits if that execution is better. Our hope is that the rules evolve to a place where these loans can remain as single borrower transactions, as aside from higher quality, these tend to be 144A transactions where investors get detailed information and have the ability to do a deep study on one asset or one property.

**Lisa Pendergast: At the last conference, Jack Cohen hosted a roundtable discussion at which a conduit lender made the comment that, in times of heightened volatility, conduit lenders tend to become far more conservative. And yet, over the last several months, we've seen a good amount of volatility and I think underwriting has become less conservative. I still think underwriting remains based on in-place cash flow and the amount of disclosure as to underwritten cash flow is as good as it has ever been, and those are all positive factors. But it's clear that proceeds are on the rise, and reserve levels are not what they used to be just a year or so ago. How do you see this unfolding over the next year? Does commercial and multifamily mortgage lending grow even more competitive? Who are the new lenders?**

**Larry Brown:** The first thing I'll say is guilty as charged, and what I mean by that is, as you alluded to earlier, there is no way anyone can look you in the eye and say, 'You know, 2013 is as conservatively underwritten as 2011 deals, let alone 2012 deals.' It's just not the case. What I'll say is this, which may not be much of a feel good moment, but – with the CMBS business now being somewhat mature 20 years later – I think one can feel when it's getting frothy. With the deals I'm losing now, 90% or more aren't like in the mid-2000s when you started losing deals to really poor underwriting, and you're saying, 'sold to my competitor if they want no reserves and things like that.' At present, when I lose a deal it's due more to spread, which sometimes leads to a head-scratching moment during times of volatility—but I don't think it speaks to irresponsible underwriting. It seems like some shops are a little bit "risk-on" that I wouldn't have necessarily expected. Starwood Mortgage Capital may be more conservative on occasion when others may not be, but it's not at that stage now where I'm shaking my head because people are doing stupid things from an underwriting standpoint. And by the way, I don't mind adding the word 'yet.' What you're hearing from me is, I think we're in the fourth inning of that nine inning game –I do think we may eventually get to the point where things get overly aggressive, you'll hear the dreaded word 'CDO' and things like that – I think we could get there. But I don't think it's an imminent 2014 or 2015 event. But it's fair to ask, 'if you can see it coming down the pathway, what can we do about it?' Then it goes back to the last question you asked me about new entrants. So yeah, with the wall of maturities that are coming due, I think there is pressure on folks to do high volume, and when there is pressure to do high volume, that means some will say 'yes' to stuff that they otherwise wouldn't say yes to. So you have some new entrants, but 'new' doesn't equal 'bad' by the way. So my bottom

**"It seems like there are some shops that are a little bit "risk-on" that I wouldn't have necessarily have expected... but it's not at that stage now where I'm shaking my head because people are doing stupid things from an underwriting standpoint."**

line is that, in the fourth quarter 2013, it doesn't feel like a free-for-all YET to me, and it doesn't feel like we're hurtling toward a free-for-all. It feels like it was more aggressive than it was a year ago, but not unhealthily so… YET. And you notice I keep saying the word "yet", because it's on all of us — the entire CMBS community — to keep things on track and learn from the mistakes of the mid-2000s and be grateful as heck that we still have a thriving industry to be stewards of.

**Mitch Resnick:** One thing I want to add is, looking from 2009 to 2012, the pendulum has swung pretty far. Early on, it was pretty conservative to the point where credit was squeezed too tight. So you kind of only had one direction to go. But, how much further does it go from here. I do see us losing on credit underwriting issues occasionally, although not all NOIs are created equal. I do think that future regulation could cause people to play with the NOI numbers. That is a possibility. But it's important to acknowledge that aggressive underwriting is something that can be an issue but if folks are incentivized to go that way, if there is no check on the system, then that's the way it's going to go. Right now, when we lose, I lose on pricing sometimes, but we lose more on credit and loan structure than anything else — items like interest only, leverage, borrower structure and lockout provisions.

**Lisa Pendergast: Samir, from an investor perspective, what do you think about new lenders? Do they help or hinder the overall quality of the end product? In many cases, the new lenders are just the old conduit lenders under a new name, but there are definitely brand new lenders on the scene. Is that a good thing?**

**Samir Lakhani:** You certainly get more of a selection with that. But I think by definition, when you have an increased number of originators and an increased number of B-buyers, more collateral can get through, and with competitive pressure that can include weaker loans. That means investors have to be more selective as to which deals they are participating in. Frankly, I think that touches on another point, which is that I don't think there has been all that much differentiation across a lot of these new issue deals. Within any particular vintage there is room for more pricing differentiation, especially if underwriting standards loosen and leverage points continue to increase.

**Lisa Pendergast: I may sound like Pollyanna here, but I'm going to say it anyway. I have some confidence that this time around will be better. The rating agencies have been put under such a microscope and I'm hopeful they'll be guided by that and not by the fact that increased competition within the rating agency universe means there is less to go around. To the good, credit enhancement has increased along with the percentage of IO loans and deterioration in stressed rating-agency LTVs and DSCRs in 2013. I'm not sure that is going to prevent us from getting to Larry's ninth inning, but I think it will slow that process. And, while there may be something to hate in the risk retention rules for everyone, they too will slow the market's natural inclination to race to the cliff.**

**Samir, I think the rating agencies have stepped up their game in the 2.0/3.0 CMBS environment. Yet, there have been almost no structural changes in the way in which the agencies operate. Does that concern you as an investor? Are you comfortable with what you see from them thus far?**

**Samir Lakhani:** We have seen some of the enhancement numbers go up in light of the higher LTVs, and that's a positive. But, for us, it really comes down to collateral underwriting. Ratings are important for capacity and liquidity in the overall financial system as there are still a number of ratings-constrained buyers. But, if you look at the legacy market as an example of deals moving through time, there is a wide variance in ratings on any one security. Some securities have an investment-grade rating from one agency and a below investment-grade from another agency. So it's another set of views on the collateral that we take into account, but we predominantly rely on our own credit work.

**Lisa Pendergast: What can a lender do with a loan structurally to protect against bad-borrower behavior?**

**Mitch Resnick:** You can try to structure around it as much as you want but there will still be risk. There are mechanisms you can use to try and set at-risk borrowers off to the side, springing recourse is one method we saw pre-crisis and I think what happened during the crisis proved that mechanism doesn't necessarily work. While it sounds great on the surface, it's kind of like the nuclear option; you never think you're going to have to use it. It hasn't prevented folks from filing for that bankruptcy to try to protect themselves. Like I said, you can try to wall them off as much as you can but it's never going to be 100%.

**Lisa Pendergast: Sam, in terms of the property market themselves, where are we in the cycle?**

**Sam Chandan:** In terms of the underlying fundamentals for the properties, the trends have been in line with what we have been observing in the broader economy. There are certainly some sub-types and geographies that have done better or worse in terms of recovering their fundamentals. With the exception of the

apartment market, however, it's very difficult for us to make broad statements about meaningful improvements in fundamentals that are consistent with what we've seen happening with prices. When we are thinking about where these different sectors are in the cycle, that's the most significant concern that I have right now. When the fundamentals are lagging, when their hasn't been an appreciable change in the outlook for the economics, then we know that in some of these market segments, capital costs and capital flows are playing a larger role in the determination of market-clearing prices.

Debt markets matter here. There are markets where there has been an undue share of appreciation over the last couple of years that we can attribute to very low cost mortgages, and it's going to be in those kinds of markets where the adjustment is going to be most difficult. Looking at this from the perspective of some of the maturing debt, that broad, slow improvement in the economy certainly helps to create some stability in the financial and capital markets and helps improve the fundamentals. But there are also the retail neighborhood and community shopping centers on the periphery of your secondary market, where in spite of improvements in economic conditions refinancing will be a challenge without new equity. I think we're still going to have to deal with those issues whether or not capital is available. People are looking at the CMBS market, looking at the wave of maturities, but when we actually dig a little bit deeper, a lot of those properties are going to be mismatches with underwriting standards and lenders' desired risk profiles. That's going to be an issue.

The apartment market is actually one where there is greater sensitivity in our analysis to changes in the interest rate environment, in part because of the structural relationships between apartment

borrowers, the GSEs and the government. In as much as there was a strong benefit to this segment of the market as rates declined, there's also some sensitivity as rates go up. Combine that with some limited rebalancing of housing tenure. We can argue about how far that rebalancing will take us but at least on the margins, it does impact the rate at which we observe continued growth in demand for apartments. You've got that happening at the same time as you have a new supply coming online in some markets. Supply is generally in check, but there are certainly places where it's not. We also face the potential for structural change in housing finance reform. That is impossible for anyone in our industry to make a determinative call on, even if we think a particular path is rational and the other irrational. On balance, there are some apartment loans we see being made today by smaller regional and community banks that are struggling to find their niche in commercial real estate. We are going to face challenges in refinancing some of those loans in a couple years' time.

**Lisa Pendergast: Sam, the single-family housing sector has responded swiftly and harshly to the backup in rates, with home sales and refinance activity plunging. While I am concerned longer-term over the potential for overbuilding in multifamily, I take solace in the fact that a significant shift has taken place in the U.S. away from homeownership. Americans have a very different view about homeownership than they did 20 years ago. Add to that an aging baby boomer population and immigration trends, and the outlook for multifamily looks positive. Do you agree?**

**Sam Chandan:** I'd have to agree. I don't think there is any chance that we're going to return to the kind of housing market outcomes that we've observed historically. We are not going to see that level of policy intervention. We will inevitably see a change in how people think about housing and home-ownership as prices start to go up again, but we've got secular changes at work, as well. If we are getting married and having children later; that plays a role in driving when it is that we choose to become homeowners. We also have the potential for big changes in housing finance reform. As compared to what we've known, the balance between multifamily and single-family home ownership is different going forward. But what I would suggest that on the margins, not at the median, we do have some apartment loans that are being underwritten in a way that implies continued gains in fundamentals that look like what we had in the worst days of the housing crisis, when everything was working in apartments' favor. There is a real challenge there, particularly in segments of the market where a smaller bank lender might be constrained and competing with a GSE partner. In many of those cases, the basic math is being ignored. Are we going to be able to grow income enough over the next five years? When we may have one or two years of interest up front? Can we refinance this loan when we know that the exit environment will be quite different?

**Lisa Pendergast: What about other asset classes? Which loans will be the most challenging to refinance in the years ahead?**

**Greg Michaud:** For us, we always worry about office, especially suburban office. We worry about office because of the capital-intensive nature. So as rates are rising, we are going to be very cautious with office going forward. Not so much with multifamily or industrial, maybe a little bit with retail.

**Larry Brown:** We are pretty much right with Greg there. If multi and retail are the two most persona-grata asset classes, office is the bronze medalist and in final place is hotels. Obviously there is a lot that we don't even think about in capital markets like golf courses and casinos and healthcare. So I would say hotels is the collateral class that we are doing now and have the most concern about due to obvious reasons, like you have to rent them out every night kind of thing, to being the most volatile in a volatile economy compared to some of the other asset classes.

**Lisa Pendergast: Finally, on the regulatory front, what are your thoughts on the re-proposed risk retention rules? My view is that, while not perfect, they do help align interests far better than pre-crisis. And, even when finalized, hopefully early next year, the market still has another two years before the rules are implemented to figure it out. Feel free to weigh in on other regulatory issues that pertain specifically to your businesses.**

**Greg Michaud:** Well life companies are the most regulated group out there, so my comment is, jump on in, the water is warm. We are heavily regulated by the states and are watched over by the rating agencies. The close watch stems from the previous blow up in the late-80s, early-90s. As far as a buyer of bonds, as we buy CMBS bonds, we hope that what is coming out with risk retention is the best of all worlds. We like to see a little bit of risk retention but not so much that it drives people out of the business. We think that there might be a decent balance struck, in so much as they are making sure someone is at home and they are not re-REMICing the B-pieces. If we can make sure that doesn't go on but still ensure that sufficient liquidity is provided to B-piece buyers, we should have a healthy and robust CMBS issuance market.

**Lisa Pendergast: Larry, are there enough B-piece investors to deal with risk retention?**

**Larry Brown:** My belief is yes. There are probably seven legitimate contenders and maybe five or six more "pretenders" who are looking at these deals from the B-piece perspective. So I do think there is a healthy B-piece market. Like you alluded to Lisa, I do think there are a couple of head-scratchers left in what is being proposed regarding risk retention. All credit to CREFC for making it so it is at least bearable and perhaps over the next three years, we can work out those last two or three items. So it's a net positive for our industry, if you think of it as a long term game, and we are not just doing it for 2013, and it is workable and will hopefully become even more workable.

**Lisa Pendergast: It has to be difficult to operate in an environment where the sands are shifting. Mitch, how do you operate in this environment and is there a way forward for the GSEs in the multifamily space that makes some sense?**

**Mitch Resnick:** You said it very well, the sands are shifting. But how do you operate in this environment? You can't run the business on what-ifs really. We don't know what the future is going to hold, and it doesn't seem like we are getting there anytime fast, either. For example, if folks were operating their business based upon a conjecture of what the regulations are going to be, starting three years ago, then they wouldn't have done any business for the last three years. We don't have the final say on what the regulations are going to be, I know that there are some folks in the industry who are saying, 'just tell us what the rules are so we can move on.' Uncertainty is never a friend to the marketplace as far as stability is concerned. Uncertainty does not beget liquidity. It works quite the opposite way. So having some vision and clarity as to what the rules and regulations will be regarding the marketplace will be helpful in its own right. Now, how those rules and regulations play out is a different story. We need to be sure that the regulations are not too harsh so that it doesn't do opposite of what they are intending to do. You don't want regulations that choke off the market too much. That is the fine line to walk right now. The regulators basically have a thankless task in front of them; it's not an easy thing to figure out.

**Lisa Pendergast: You have all been very giving of your time and energies and I want to thank you. Our discussion has been captivating, funny, and at times even profane (don't worry, it's been edited out). On behalf of the CRE Finance Council and *CRE Finance World*, I want to thank everyone for their participation and insights.**

**Panelist Bios:**

**Lisa Pendergast**
*Managing Director*
Jefferies LLC

Lisa Pendergast joined Jefferies LLC, a subsidiary of Jefferies Group LLC. (NYSE: JEF), in July 2009 as a Managing Director and Head of CMBS Strategy and Risk in the Fixed Income Division's MBS/ABS/CMBS Group. Ms. Pendergast has more than 20 years of industry experience in the structured-finance markets. Prior to joining Jefferies, Ms. Pendergast was a Managing Director in the Fixed-Income Strategies Group at the Royal Bank of Scotland, where she worked for eight years. Ms. Pendergast provides analysis and commentary on commercial real estate credit fundamentals and relative value within the CMBS and structured-product markets. From 1987 through 1995 and prior to her focus on commercial real estate and CMBS, Ms. Pendergast focused on the residential MBS marketplace as a research analyst at Prudential Securities, co-authoring reports on various securitization structures and mortgage-related bond analyses.

Ms. Pendergast has been a top-ranked research analyst in the highly competitive Institutional Investor All-American Fixed-Income Research Team survey in the CMBS category for a number of years. She was the 2010/2011 President of the Commercial Real Estate Finance Council (CREFC) and currently sits on its Executive Committee as Immediate Past President. Pendergast has published several articles and reports on various aspects of the CMBS markets that have appeared in industry handbooks and academic journals, as is often quoted in the financial press on commercial real estate debt-related issues. Ms. Pendergast holds a BA from Fordham University at Marymount College.

**Larry Brown**
*President*
Starwood Capital Group

Mr. Brown is the President of SMC, overseeing all of the lending and subsequent securitization activities of the firm. Prior to forming SMC, Mr. Brown was a co-founder, Managing Director and Chief Operating Officer of AllBridge Investments, an investor in the commercial real estate capital markets. Before co-founding AllBridge, Mr. Brown started Deutsche Bank Mortgage Capital, L.L.C., a wholly owned subsidiary of Deutsche Bank, in May 1999 and served as President and Chief Executive Officer through April of 2005. While at DBMC, he oversaw more than $23 billion in public and private securitized transactions as well as the origination of over 750 loans totaling approximately $9 billion.

Prior to the formation of DBMC, Mr. Brown served as President of WMF Capital Corp., where he oversaw all commercial real estate finance and capital markets activities of the company. Before joining WMF CC, he was the Managing Director of Commercial Real Estate Finance at First Union National Bank (now known as Wells Fargo), co-founding the Real Estate Capital Markets Group and overseeing the origination and subsequent distribution of commercial mortgage-backed securities including over

$6.5 billion in public/private securitized transactions. Prior to joining FUNB, he was a Senior Vice President in the Real Estate Finance Group at Donaldson, Lufkin & Jenrette, supervising the negotiation, documentation, and closing of more than $1.5 billion of securitized commercial mortgage transactions. Before joining DLJ, Mr. Brown was an Associate at the law firms of Baker & McKenzie and Mudge, Rose, Guthrie, Alexander & Ferdon, where he specialized in real estate banking and real estate finance law.

Mr. Brown graduated Magna Cum Laude from Tufts University and earned his law degree from Georgetown University School of Law.

**Sam Chandan PhD FRICS**
*President & Chief Economist*
Chandan Economics

Dr. Sam Chandan is President and Chief Economist of Chandan Economics and Professor in the Associated Faculty of Real Estate at the Wharton School of the University of Pennsylvania. He is the National Economist for the Real Estate Lenders Association and an active participant in the policy dialogue on financial market structures. His eponymous firm supports commercial real estate lenders and investors with quantitative risk analytics and supporting data, backed by the industry's broadest database of mortgages originated by banks, life companies, and other balance sheet sources of financing.

Dr. Chandan received the PhD in Applied Economics from the Wharton School and was a doctoral scholar at Princeton University. In addition to his current teaching in the fields of Real Estate Finance, Public Policy, and Business Economics at Wharton, he has served as a visiting professor in the Economics Department at Dartmouth College. Prior to establishing Chandan Economics, Dr. Chandan was Chief Economist at Reis and Global Chief Economist at Real Capital Analytics.

**Samir Lakhani**
*Director, Senior CMBS Trader and Portfolio Manager*
BlackRock

Samir Lakhani, Director, is a member of the Securitized Assets Investment Team within BlackRock Fundamental Fixed Income. Mr. Lakhani is a Senior CMBS trader and Portfolio Manager. Mr. Lakhani is also responsible for investing in structured finance opportunities for a number of BlackRock managed funds.

Prior to joining BlackRock in 2009, Mr. Lakhani was a Vice President at R3 Capital Partners, where he invested in securitized assets including ABS, CMBS, CLO's and Specialty Finance. Mr. Lakhani held similar roles at Lehman Brothers in their Global Principal Strategies group. Mr. Lakhani joined Lehman Brothers in 2006 initially in Structured Credit Products. Previously, Mr. Lakhani held positions at JP Morgan Partners, in their Private Equity and Mezzanine Debt group, from 2001 to 2004.

Mr. Lakhani currently serves on the Board of Governors for CREFC. Mr. Lakhani earned a BS in economics and a BS in engineering from the University of Pennsylvania and an MBA from Harvard Business School.

**Greg Michaud**
*Senior Vice President & Head of Real Estate Finance*
ING Investment Management

Gregory Michaud is Senior Vice President and Head of Real Estate Finance for ING U.S. Investment Management, responsible for the oversight and management of sourcing and underwriting all commercial real estate loans. Additionally, he serves on the Executive Leadership Team for proprietary assets, the U.S. Credit Committee and chairs the CMBS Steering Committee. Prior to joining ING in 1995, Greg was a real estate appraiser focused on commercial properties and eminent domain cases in the Southeastern United States. Greg is an active member of several distinguished real estate industry groups, including the Urban Land Institute, Commercial Real Estate Finance Council, Mortgage Bankers Association and the National Association of Real Estate Investment Managers. Greg received his B.S. in real estate from the Florida State University, an M.B.A. in finance from Kennesaw State University and an Executive M.B.A. from University of Georgia.

**Mitchell Resnick**
*Vice President, Multifamily Loan Pricing & Securitization*
Freddie Mac

Mitchell Resnick joined Freddie Mac as a Vice President in the Multifamily Division in November 2011. In this role he heads pricing for all multifamily loan purchases, capital deployment and marketing for all securitizations including the K-deal program. In addition, Resnick manages the relationships with securities investors and the broker/dealer community.

Prior to joining Freddie Mac, Resnick was a Vice President in the Real Estate Finance Group at Goldman, Sachs & Co in New York. In this role he was the co-head of the Capital Markets area where he was responsible for the pricing and distribution of commercial real estate loans. During his 15 year career at Goldman, Resnick also ran the Structured Products Syndicate Desk in London as well as the secondary CMBS trading book in New York. Earlier in his career, he gained experience as an underwriter and analyst for commercial real estate loans.

Resnick holds a Bachelor of Science in Economics from the Wharton School at the University of Pennsylvania.

Freddie Mac was established by Congress in 1970 to provide liquidity, stability and affordability to the nation's residential mortgage markets. Freddie Mac supports communities across the nation by providing mortgage capital to lenders. Over the years, Freddie Mac has made home possible for one in six homebuyers and more than five million renters.

# Canadian CMBS: "Low Hanging Fruit" For U.S. Fixed Income Investors


**Charles Gamm**
*Vice President*
Institutional Mortgage Capital Canada

**Chris Kane**
*Managing Director, Principal*
Institutional Mortgage Capital Canada

**Doug Klaassen**
*Partner*
Stikeman Elliott LLP


Canadian CMBS investors are a very happy group. And no wonder — it can't really get much better. Canadian CMBS has a pristine credit record, with only 0.087% of *cumulative* losses from market inception (1998), and a current delinquency rate (0.27%) that is lost in rounding. It pays on time — 98.1% (by dollar value) of all Canadian CMBS loans have repaid at or within 120 days of scheduled maturity. Furthermore, Canadian CMBS has been "stress tested" — Canadian CMBS investment grade bonds proved to be far more resilient to the 2008–2009 financial crisis, and recovered their value much more quickly than U.S. CMBS bonds and many other credit products. On top of everything else, the new issue Canadian AAA and A CMBS are currently trading at a *discount* to U.S. CMBS bonds (with up to an 18 to 34 bp pickup in spread to investors). For fixed income investors, Canadian CMBS is an attractive risk-adjusted investment.

Unfortunately, in the past most U.S. investors missed this opportunity. The primary culprit was Canadian withholding tax which, for many years, made investment by U.S. investors in Canadian CMBS investment grade bonds highly uneconomic. While many U.S. investors wanted to buy these bonds, this tax was simply too punitive.

However, today things have changed. First, this withholding tax was eliminated as of January 1, 2008 with the passage of the *Budget and Economic Interpretation Act, 2007 (Canada)*. As a result, U.S. investors can now participate in the Canadian CMBS market without any tax disincentive. Second, after three years of hiatus (2008-2010), new Canadian CMBS issues are coming back into the market, with four new deals (including three since July, 2012) and more on the way. Our review of the key CMBS credit metrics of these new Canadian issues indicates that they are as good as, or better than, the legacy Canadian deals that have performed so well. For U.S. investors, or frankly any non-Canadian investor, who wishes to diversify their portfolios, new issue investment grade Canadian CMBS is truly the "low hanging fruit" in this market.

### Current Universe of Canadian CMBS

To date, there have been a total of 67 Canadian CMBS issues since market inception in 1998, for a total issuance of $24.87 billion involving 3,706 (Canadian only) commercial mortgage loans. Historically, Canadian CMBS originators and issuers have included Merrill Lynch, TD Bank, RBC, CIBC, Column, GE, GMAC, Laurentian Bank, BNS and First National Financial (as direct participants or sponsors). Of all issuers, Merrill Lynch led the overall market with a 42% market share.

Since the re-opening of the Canadian CMBS market in 2011, Institutional Mortgage Capital Canada (IMC) is the current market leader. IMC has an active CMBS origination platform with over $900 million of new loan originations since 2011, and has sponsored three new CMBS transactions for a total of approximately $700 million. Two other participants have established CMBS origination platforms with one (CMLS Financial) bringing its initial $249 million CMBS issue to market in 2012.

As of August 1, 2013, the current outstanding balance of all Canadian CMBS deals (both legacy and new vintages) is approximately $10.85 billion, with 25 of the legacy CMBS transactions having been repaid and retired.

### Exceptional Credit Performance

The overall credit performance of Canadian CMBS has been exceptional:

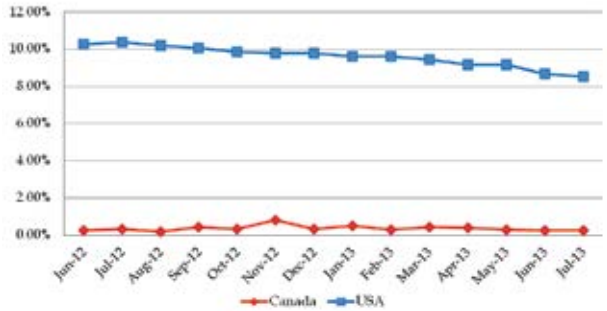
- *Cumulative* losses for all Canadian CMBS transactions since 1998 have been less than 0.087% ($21.5 million) based on the total issuance of $24.87 billion. *No Canadian CMBS investment grade bond has suffered a loss — ever!* By any measure, this loss experience is truly remarkable. To date, U.S. CMBS has experienced *cumulative* losses of more than $27 billion or 2.87%, *a loss rate more than 30 times the Canadian loss rate*.

- 2,190 Canadian CMBS loans have matured since market inception and 99.95% of these loans (by dollar value) have been repaid in full; only 2 CMBS loans have matured and not been repaid as of this writing; 98.1% (by dollar value) of all Canadian CMBS loans repaid at loan maturity or within 1–4 months thereafter.

- Of the 386 investment grade principal bond classes in the universe of the 67 Canadian CMBS conduit transactions, only two classes (the BBB and BBB- bonds in the MLFAI 2001-Canada 5 deal) have ever been downgraded by all agencies rating the bonds and both of those classes repaid on time and with no loss to those investors. Of the remainder, there has been only a handful of downgrades and, in each case, by only one of the agencies which rated the transactions; primarily due to a change in rating methodology by one agency.

- As of August 1, 2013, there were only three Canadian CMBS loans in special servicing across all outstanding Canadian CMBS deals. The current delinquency rate for all deals is 0.27% according to the July 2013 DBRS Monthly North American CMBS Market Overview. By comparison, this report reveals the current U.S. CMBS delinquency rate is 8.55% — *again over 30 times the current Canadian delinquency rate*. Table 1, which follows, provides a comparison of Canadian and U.S. CMBS delinquency rates over the past year.

*Table 1*
**Canadian v. U.S. CMBS Delinquency Rates 2012–2013**



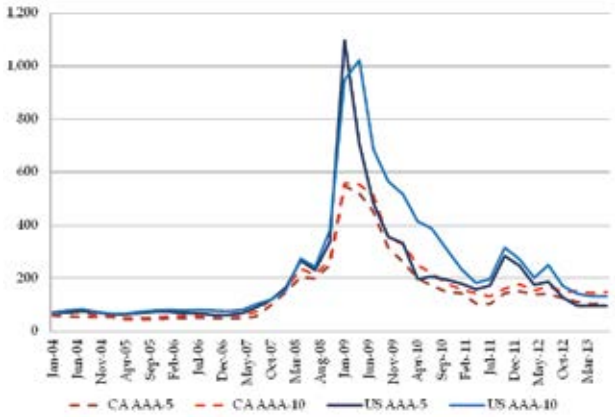

Source: DBRS

There are multiple reasons for the exceptional credit performance of Canadian CMBS, including strong (non proforma) loan underwriting, a conservative Canadian credit culture, smaller CMBS pools that are more manageable and transparent to investors, a high level of recourse loans in Canadian CMBS pools and lender-favourable Canadian bankruptcy and foreclosure rules. While a review of these factors is beyond the scope of this article, as discussed below the loan pools in the new Canadian CMBS deals compare very favorably to these legacy Canadian CMBS deals.

## Strong Relative Value and Lower Pricing Volatility

Given its stellar credit performance, one would expect Canadian CMBS investment grade bonds to trade at spread levels that are very close to or even better than comparable U.S. CMBS spreads. As shown in Tables 2 and 3, this was true prior to the 2008–2009 financial crisis, however, the new recent vintage Canadian CMBS as shown on Table 4 have AAA and A bonds which have traded *at a discount* to U.S., i.e. giving investors not only stronger credit metrics but also a potential yield/spread pick-up.

*Table 2*
**Canadian and U.S. CMBS AAA Spreads for Legacy Bonds**




Source: TD Securities; Trepp LLC

As shown in Table 2:

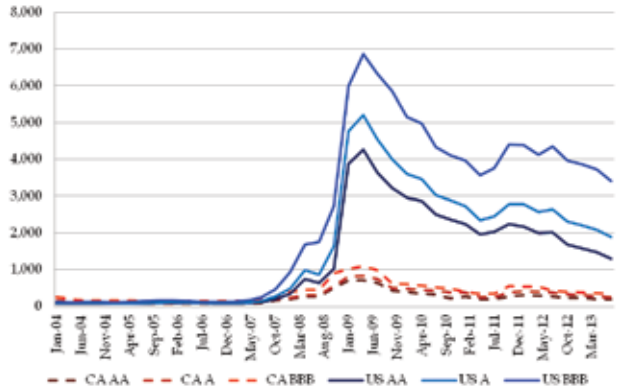
- Before the 2008–2009 financial crisis, Canadian CMBS AAA spreads generally traded at or slightly inside comparable U.S. AAA spreads, on a spread to government bond basis, of up to 15 bps for 5 year AAA's and 19 bps for 10 year AAA's. During the 2008–2009 financial crisis, U.S. CMBS bond spreads widened to levels significantly higher than Canadian CMBS spreads. However, in the past year Canadian AAA spreads have traded on par with or at a slight discount to comparable U.S. spreads.

- When "stress tested" by the 2008–2009 financial crisis, Canadian CMBS AAA bond spreads were far less volatile (and held their value better) than U.S. AAA bond spreads — U.S. AAA spreads widened to over 1,000 basis points between January and April, 2009 while the increase in Canadian AAA spreads was only half of U.S. levels.

- Canadian CMBS AAA bond spreads recovered far more quickly from the financial crisis than U.S. AAA spreads, normalizing almost 15 months earlier than U.S. CMBS spreads.

A comparison of Canadian and U.S. AA, A and BBB CMBS bond spreads is even more dramatic:

*Table 3*
**Canadian and U.S. CMBS AA, A and BBB Spreads for Legacy Bonds**




Source: TD Securities; Trepp LLC

Not only did U.S. CMBS bond spreads in these investment grade classes increase to unprecedented levels during the financial crisis (U.S. BBB spreads topped out at 6,860 basis points in April 2009), the values of these U.S. investment grade bond classes have not recovered (and likely never will). By comparison, the widening of Canadian CMBS AA, A and BBB spreads was significantly less (on both an absolute and relative basis) and Canadian spreads have now largely recovered to normalized levels.

Compared to U.S. CMBS, Canadian CMBS investment grade bonds have clearly demonstrated that they are significantly less volatile (and hold their value better) in a severe market disruption and recessionary environment. Part of this stronger performance might be attributed to a larger number of "buy and hold" investors due to the positive credit metrics of Canadian CMBS, resulting in fewer day to day traders and lower volatility. The longer term market perspective of Canadian CMBS investors, combined with these positive credit metrics of Canadian CMBS likely helped limit the market dislocation during the 2008-2009 financial crisis.

*Table 4*
**Canadian and U.S. New Issue CMBS Spreads**

| | AAA | | AA | A | BBB |
|---|---|---|---|---|---|
| | 5yr | 10 yr | 10 yr | 10 yr | 10 yr |
| US "New Deal" Spread to US Treasuries | 92 | 119 | 204 | 236 | 349 |
| Canadian "New Deal" Spread to GOCs | 110 | 145 | 205 | 270 | 350 |
| Canada CMBS Premium (bps) | 18 | 26 | 1 | 34 | 1 |

Similar to the legacy CMBS bond spread comparison in Tables 2 and 3 (measured as the cost of risk over the government risk free rate), Table 4 shows that recent Canadian AAA new issue CMBS bonds are at a premium to U.S. AAA CMBS spreads of 18-26 bps recently. Furthermore, recent Canadian A rated new issue spreads were a 34 bp premium to the U.S. A rated bond spreads. AA and BBB bond spreads were generally flat with comparable current U.S. levels. Considering that the lion's share of investment grade CMBS buyers invest in AAA CMBS, one would believe the credit metrics and potential of a spread pick up on Canadian AAA CMBS, particularly the 10 year bonds, to be compelling to investors.

## Key Credit Metrics of New Canadian CMBS Loan Pools

As shown in Table 5, the new CMBS Canadian loan pools compare favorably to the legacy Canadian pools in key CMBS credit metrics:

*Table 5*
**Comparison of Key Credit Metrics: New Canadian Issues v. Legacy Deals**

| Canadian Deals | Cut-Off LTV | Maturity Date LTV | DSCR (NCF) | Recourse | Amort. |
|---|---|---|---|---|---|
| Older Legacy - CMBS loans to 2005 | 66.36% | 52.25% | 1.53 | 60.53% | 282 |
| Newer Legacy - CMBS loans 2006 & 2007 | 67.99% | 55.18% | 1.45 | 62.30% | 324 |
| New Canadian multi borrower CMBS[1] | 62.50% | 52.86% | 1.52 | 85.42% | 311 |

1. Includes IMSCI 2012–2, IMSCI 2013–3 and CCMOT 1 2012–1.

Based on these credit metrics, the underwriting of these new Canadian CMBS loan pools appears across the board to be *more conservative* than the most recent legacy Canadian CMBS loan pools (the 2006-2007 vintage "Newer Legacy" deals) that have performed so well and on par with the "Older Legacy" Canadian CMBS loans (1997-2005 vintage). The new issue Canadian CMBS loan pools have significantly lower Cut-Off and Maturity Date LTVs, higher NCF DSCR and shorter amortization than the Newer Legacy CMBS. When compared with the Older Legacy CMBS, new Canadian CMBS deals fare well with significantly higher recourse, comparable NCF DSCRs and, while amortization is a bit longer, Maturity Date LTVs are comparable to Older Legacy CMBS due to the lower initial Cut-Off Date LTVs in New CMBS.

Finally, we note IO loans *have never been* an established feature of Canadian CMBS and *are not expected* to be going forward. In the new Canadian CMBS deals there were only 2 interest only loans, both in the CCMOT 1 2012-1 pool, and both of which were made to a single investment grade-rated Canadian REIT with

**"No Canadian CMBS investment grade bond has suffered a loss – ever!"**

recourse. While past performance is never an assurance of future performance, the expectations for the new Canadian CMBS vintage are understandably high.

### The Canadian Economy and Real Estate Markets

An in-depth review of the Canadian economy and real estate markets is beyond the scope of this article. However, despite the strong performance of the Canadian economy since the 2008–2009 financial crisis, certain observers have expressed concerns about the current level of Canadian household debt and a possible correction in Canadian residential real estate markets, and particularly the condo markets in Toronto and Vancouver. Based on what we see happening, these concerns appear to be vastly overblown. Here are a few of our own observations:

- Commercial real estate markets are currently performing very well across Canada. Canada's major downtown office markets have a collective vacancy rate of 6.2% (Source: CBRE Canada, Canada Office Occupier Overview, Q1 2013), compared to the U.S. downtown office vacancy rate of 12.5%. For industrial properties, Canada has a 5.8% vacancy rate (Source: CBRE Canada Industrial MarketView, Q2 2013) compared to 12.0% in the U.S. Multifamily vacancy in Canada is 2.3% (Source: CMHC) compared with 5.3% in the U.S. Retail space in the U.S. averages 23.8 sq. ft. per capita, but in Canada (Source: Colliers Canada, The Retail Report, Spring 2013) retail space averages only 14.6 sq. ft. per capita (38.6% less). Potential areas of market concern in Canada are largely limited to residential condominium markets in Toronto and Vancouver, an asset class which is not (and never will be) included in Canadian CMBS transactions.

- The Canadian economy has always performed in a manner that mirrors the U.S. economy — usually with a 6–12 month delay. While Canada generally follows the U.S. economic cycle, it does not experience either the extremes at the top or at the bottom of any cycle. The U.S. is Canada's biggest customer, so good news for the U.S. economy is ultimately good news for Canada. If one believes that the U.S. economy is in the early stages of recovery, it is very difficult to make a compelling argument for any kind of prolonged Canadian economic downturn.

- Some observers point to the current level of Canadian household debt-to-income as a possible indicator of future economic stress. However, in response, many economists and other market commentators have pointed out that, after making appropriate adjustments for items such as health care and other costs, the average Canadian household debt-to-income ratio today appears to be roughly equivalent to current U.S. levels (and significantly lower that U.S. pre-recession levels). Further, at the end of 2012, Canadian households had a higher average net worth than their American counterparts ($400,151 in Canada v. $381,086 in the U.S.).

- The Canadian government has made proactive efforts to avoid a housing bubble introducing changes to mortgage rules in 2012 which (a) reduced maximum amortization to 25 years (March 2011 it reduced this from 35 to 30 years), (b) limited maximum refinancing amount to 80% LTV (March 2011 it reduced this from 90% to 85%), and (c) reduced maximum total debt service (total debt + house related expenses) from 45% to 44% (significant coupled with the amortization reduction in "a").

- As to concerns relating to the flux of new condo units in Toronto in recent years rental demand for such units has been able to keep pace with listings, driving average rents up by 4.1% from last year. The growth in condo rental activity reflects a greater movement of younger households into the downtown Toronto core and a lack of growth in traditional multifamily rental supply. Due to changes in tax structure and the subsequent introduction of residential rent control in Ontario in 1975, development of new multifamily rental construction dwindled to a trickle from the mid-1970's onward. The lack of new purpose-built multifamily rental construction has ultimately led to a net decrease in the traditional supply of this rental stock through the 1990's and 2000's. The development of condo stock and subsequent rental of these units over the past 20 years has served to fill the undersupply due to the dramatic decline in rental housing construction over the past 30 years.

- Canadian and U.S. unemployment rates today are very similar (7.1% in Canada v. 7.3% in the U.S.). Historically, the unemployment rate in Canada has always been higher (by 1% +/-) than in the U.S. Since the financial crisis, these rates have inverted as the Canadian unemployment rate dropped significantly below U.S. levels. These rates appear to be converging again as the U.S. economy improves. However, despite recent fluctuations in the Canadian rate, unemployment in Canada is virtually unchanged from a year ago and total employment is up 1.4%. This addition of 246,000 jobs over the past twelve months is expected to translate into increased demand for all forms of commercial real estate.

- Canadian residential mortgages are not tax deductible and are full recourse to the homeowner. For this reason and others (see Canadian homeowner equity below), Canadian residential mortgage markets are performing very well. *Canadian residential mortgage loan arrears are currently at their lowest level since November 2008* — Canada Mortgage and Housing Corporation (CMHC) reports 0.35% of residential loan arrears across Canada and the Canadian Bankers Association reports 0.31% as of May, 2013. U.S. residential delinquencies at the end of Q2/2013 were 6.96% (its lowest level since mid-2008, *but still over 20 times higher than in Canada*).

    - CMHC is Canada's national housing agency and largest public mortgage insurer. In many respects CMHC is similar to the U.S. GSEs (Fannie Mae and Freddie Mac), however, it is a Crown Corporation whose insurance bears the full faith and credit of the Government of Canada.

- Canada does not have (and never has had) a sizeable sub-prime residential mortgage market. For the most part, Canadian lenders have avoided "no equity" loans, "teaser rates" and other embedded time bombs that have created significant default rates on U.S. residential loans.

- Finally, homeowner's equity currently is (and has always been) significantly higher in Canada than in the U.S. Canadian households average approximately 68% equity in their homes. Not surprisingly, "negative equity" is virtually non-existent in Canada. In the U.S., pre-recession homeowner equity never exceeded 60% and is approximately 47% today.

## Conclusion

Canadian CMBS has been around for 15 years. During that time, it has survived three global market disruptions — the 1998 Russian currency crisis, the 2000–2001 "tech bubble" and the 2008–2009 financial crisis, and their related economic downturns, three Canadian Prime Ministers and three U.S. Presidents. It has maintained a pristine credit record and a virtually non-existent delinquency and loss rate. Canadian CMBS credit spreads have been far less volatile, normalized more quickly than the U.S., and new issuance currently provides a discount to comparable U.S. CMBS bonds in the AAA and A tranches. Canadian CMBS has thrived in all markets by providing investors with strong risk-adjusted returns based on exceptional credit performance and its market premium over U.S. CMBS bonds.

Looking forward, we expect that the investment grade tranches of new Canadian CMBS deals will be actively marketed and placed cross border with U.S. and other non-Canadian investors who understand the relative value of this product. For these investors, Canadian CMBS is one of the best opportunities to diversify their portfolios with real "low hanging fruit".

About the Authors

Mr. Gamm is a Vice President with IMC responsible for CMBS and real estate debt credit, and formerly responsible for business development with Fitch Ratings-Canada, previously headed Moody's Canada structured finance rating program after similar credit analysis/review positions with Moody's-London (UK) office.

Mr. Kane has been a Principal of IMC since its formation in 2009, and a former senior executive with the Merrill Lynch-Canada CMBS program founded in 1998, and is experienced in real estate finance and capital markets structured finance.

Mr. Klaassen is a partner in Stikeman Elliott LLP's and co-head of its Structured Finance and Financial Products Group in Toronto and has been involved in real estate finance since 1987 and structured finance since 1998.

# Losing More than Your Loan

## Understanding Extreme CMBS Loss Severities

**Edward L. Shugrue III**
*Chief Executive Officer*
Talmage, LLC

**"You effed up. You trusted us." *–Otter, 'Animal House' 1978***

With CMBS loss severities increasing and the largest CMBS loan origination vintages of 2005–2007 approaching their maturity windows, this paper examines extreme CMBS losses, including: what characteristics they share, what could have been done to avoid these losses and what lessons can be learned. The 2005-2007 vintage is considered by many to reflect the most aggressive underwriting standards in CMBS history and some of the trends noted herein are alarming and have led to predictions of CMBS cumulative losses as high as 14% in certain vintages which could create losses to "AJ" classes of bonds originally rated AAA at issuance.

Despite a gradually improving economy, the unevenness of the recovery has left many assets in secondary and tertiary markets without viable business strategies. Stronger and better capitalized competitors have taken tenants from these weaker assets, thereby accelerating their demise. For those assets in rapid decline, time has been a critical factor in determining asset survival or extinction, often with material consequence to the CMBS trust.

### Background

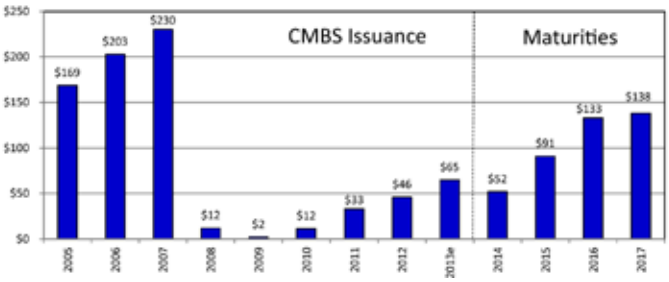
As illustrated below, while CMBS delinquency rates have declined modestly from their peak of 10.4% in July 2012, these rates remain stubbornly high from an historical perspective at nearly 9%. Of perhaps greater concern is the increase in loss severities for liquidated loans, particularly in the 2005–2008 vintages.

*Table 1*
**CMBS Delinquencies and Loss Severity**


Source: Citi group, Moody's Investor's Service
*Excludes losses <2% (share of balance at resolution)

Further, when considering historical issuance, particularly for the peak origination vintages of 2005–2007, and the more than $400 billion of CMBS debt that contractually matures between 2014–2017 (see below), the rate and volume of delinquent loans and attendant losses has the possibility of significantly exceeding historical standards.

*Table 2*
**CMBS Issuance and Estimated Maturities ($billions)**




Source: Bloomberg Commercial Mortgage Alert

*Table 3*
**Selected Historical Loss Severity by Property Type ($billions)**

| Property Type | Loss Amount | Severity |
|---|---|---|
| Retail | $7.6 | 48.6% |
| Hotel | 2.6 | 45.9% |
| Industrial | 1.3 | 37.9% |
| Office | 6.4 | 37.5% |
| Multi family | 5.2 | 37.3% |
| All Properties | $24.6 | 41.5% |

Source: Moody's Investor's Service and Trepp, LLC

Having analyzed the largest dollar losses within the CMBS universe as well as realized loss severities in excess of 100% of original face, we have developed a "top five" watch list of considerations for what can go wrong in a CMBS transaction and how to potentially avoid or mitigate these kinds of losses going forward.

### #1 — Beware of Specialty Assets

As noted in the chart below, specialty assets, particularly retail and hotel, account for the largest realized loss severities of all asset classes. This is not terribly surprising as these assets are more closely related to operating businesses with more volatile earnings than traditional real estate. Further, the myriad of co-tenancy clauses at many retail properties, coupled with the economic success of the in-line stores being closely tied to the health of the property's anchor tenants, can rapidly accelerate the demise of a retail property when it loses a key anchor tenant to bankruptcy, often setting off a negative chain reaction.

*Table 4*
**CMBS Origination and Loss Statistics by Vintage ($billions)**

| | CMBS Origination | Loss Amount | Loss Severity | Cumulative Realized Losses |
|---|---|---|---|---|
| 2004 | $93 | $1.4 | 39.8% | 1.8% |
| 2005 | 169 | 3.8 | 39.4% | 2.6% |
| 2006 | 203 | 6.0 | 50.3% | 3.5% |
| 2007 | 230 | 5.8 | 41.7% | 2.8% |
| 2008 | 12 | 0.4 | 46.9% | 4.2% |

Source: Commercial Mortgage Alert, Moody's Investor's Service and Trepp, LLC

Additionally, other highly specialized assets (or special use assets), such as casinos and land, while unusual in CMBS transactions, have not typically fared well in times of economic distress. Two floating rate loans come to mind from the CSMC 2007 TF2A securitization: Resorts Atlantic City (a resort casino loan in the amount of $175 million) and Biscayne Landing (a Florida land loan in the amount of $72 million).


Resorts Atlantic City


Biscayne Landing

Resorts Atlantic City was a hotel/casino that was devastated by the financial crisis and has never recovered its footing. After going into default, the loan was deemed unrecoverable in 2010 and sold for $29 million. After repayment of servicer advances of $31 million (primarily for taxes), the CMBS trust experienced a realized loss of $177 million or 101% of the loan's original balance.

Biscayne Landing was the largest parcel of undeveloped urban land in South Florida. It was a public-private venture in cooperation with the City of North Miami with an intended eight-year development program. Following the financial crisis and the lack of demand for high-end development in the region, the borrower defaulted under its ground lease payments to the City of North Miami, its ground lease was terminated and the loan was liquidated, net of advances, for a 101% loss severity of original face.

Clearly, not all assets are created equal, but cash flow remains the best driver of value and survival. All of these assets had highly volatile cash flows, or none at all. In a downturn, they were the first assets to default and suffer disproportionate losses.

### #2 – A Good Sponsor Does Not Always Equal a Good Loan

Harkening back to the "Five Cs of Credit" (Character, Capacity, Capital, Collateral, Conditions), "Character" is often cited as one of the most important lending considerations. However, even the best sponsors are not immune from making bad investments and have a fiduciary duty to their partners (not the CMBS trust) to "walk away" from a loan if that is the most prudent financial course of action. Too many times, we have heard, "Oh, this is 'XYZ Sponsor', it has to be good." Not true, especially in CMBS lending where nearly all loans are non-recourse to the borrower.

Take for instance the Highland Mall ($61 million – JPMCC 2002-CIB4). Highland was a million square-foot enclosed regional mall in Austin, Texas sponsored by The Rouse Company and Simon Property Group and anchored by Dillards and JC Penney, among others. After losing its anchor tenants, the property became REO, ultimately being converted to a community college. Net of servicer advances, the loan ultimately experienced an eye-popping 120% loss severity, collapsing the classes "F" through "K" of the related CMBS trust. The sponsor (GGP as successor to Rouse/Simon) behaved in a financially rational way by not supporting the property and is thriving today.

Similarly, the Oviedo Marketplace loan ($49 million – MSC 2005-HQ6) in Florida was ultimately selected by its sponsor (GGP) to be returned to its lender via a deed-in-lieu of foreclosure when the company emerged from bankruptcy. Again, GGP acted in a prudent fiduciary manner to its investors by abandoning this sub-performing asset, ultimately saddling the CMBS trust with a 108% loss severity, including advances.

While sponsorship is critical to an asset's success, without recourse and without restrictive transfer provisions (assuring that the sponsor you underwrote will be there tomorrow), it is foolhardy to expect a thoughtful sponsor to throw "good money after bad" and support a failed transaction. For CMBS underwriting, Collateral and Conditions trump Character.

### #3 – Beware of Servicer Advances

As illustrated above, it is not just about the recoverable value of the asset, but also the servicing advances to get you there. Often, these costs and expenses (including advances, servicing fees, legal, etc.) are not factored into asset recovery calculations and can have a profound impact on loss severity. In an adverse or distressed transaction, 10% or more of the face amount of the loan may be required to be spent to generate any recovery.

Two transactions come to mind in this regard: The City View Portfolio in Houston, Texas ($72 million – JPMCC 2006-CB16 – 101% loss severity) and the Washington Mutual Buildings just outside of Los Angeles, California ($39 million – GECMC 2005-C1 – 117% loss severity).

City View Portfolio

Washington Mutual Portfolio

In City View, a portfolio of eight Class B multifamily properties totaling 2,700 units, the portfolio performance deteriorated following the economic downturn and then suffered significant damage from Hurricane Ike in 2008. In 2010, the loan went into special servicing due to imminent default and became REO in 2011. Despite being sold for $27 million (nearly 20% above its appraised value), significant unpaid principal and interest, servicer advances, transaction expenses and servicing fees exceeded the sales price and the CMBS trust experienced a 101% loss severity.

For the Washington Mutual Portfolio, after Washington Mutual, who occupied 100% of the buildings, was seized by regulators in 2008, the buildings were vacated and the loan was foreclosed upon by the servicer in 2009 and liquidated in 2012. A previous ruling obtained by the special servicer that the sponsor was liable under a recourse guaranty was overturned by the California Court of Appeals and the CMBS trust was required to refund in excess of $50 million to the sponsor resulting in a loss to the CMBS trust of nearly $46 million or 117% severity.

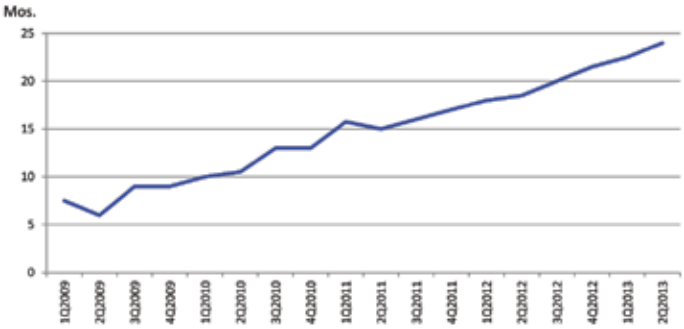
Despite valuable assets, the cost of realization exceeded the sales proceeds in the above two examples resulting in losses in excess of the loan amounts contributed to the CMBS trust. Even if a CMBS investor had underwritten 100% losses for these assets, the incremental loss severity (in excess of the loan amount) would contribute to losses above and beyond those underwritten for the CMBS trust. While difficult to imagine, "losing more than your loan," as demonstrated above, can happen. It is therefore imperative for special servicers to regularly recalculate their advances versus recoverable values to determine if their expenditures can indeed create recoveries. Just as borrowers abandon financially worthless assets, servicers too, from time-to-time, may determine abandonment to be the most responsible course of action. In all cases, all advances should be carefully considered.

### #4 – Beware of Time – Not Always a Friend

In a rapidly declining market or asset, time is often a critical element. As noted in the chart below, the amount of time that a loan spends in special servicing, as reported by Fitch, has been alarmingly on the rise and has nearly quadrupled to 24 months since 2009. This trend does not bode well for recoveries for two primary reasons: 1) generally, the better transactions get into and out of special servicing faster (meaning the more challenged assets remain), and 2) loans that are in special servicing for two or more years are generally headed to foreclosure, are often harmed by a lack of aligned and motivated ownership/management, and are also burdened by greater servicing fees and expenses.

*Table 5*

**Average Months in Special Servicing (2009–2013)**




Source: Fitch Ratings

Further, given the lengthy lead times required for new appraisals that determine controlling holders who appoint special servicers, assets that are rapidly declining in value are often being directed by a controlling holder who may be out of the money on a "spot" basis. In these instances, the controlling holder's interests are not necessarily aligned with the CMBS trust and the controlling holder may be more willing to pursue a longer-term strategy in the hopes of generating a recovery; by the time that there has been a shift in controlling holder status to the next senior most class, the damage may have already been done.

Generally, we observe that well-leased cash flowing assets will benefit from additional time and that assets with diminishing cash flows, or cash flows that are highly volatile and subject to diminution (such as retail and hospitality), benefit from swift resolutions that "staunch the bleeding." Notable cash flowing assets that have benefitted bondholders from gaining additional time to stabilize include: Stuyvesant Town (despite the controversy of the strategy at the time), Equity Office Properties, and Hilton Hotels, among others.

### #5 — Unintended Consequences

Adverse loan resolutions can have unintended consequences for CMBS trusts. Not only do the realized losses invade the credit enhancement for senior bondholders, but loss severities in excess of 100%, as noted herein, divert cash flow from bondholders (through interest shortfalls) to recoup non-recoverable servicer advances. In particular, larger loan assets can have materially harmful impacts on senior CMBS bondholders when things go wrong.

In the case of the Tri-County Mall Portfolio ($135 million — CSFB 2005-C2 – 91% loss severity), that represented 9.3% of the CMBS trust, the related losses extinguished the classes "B" through "G" of its trust. Similarly, in the Macon & Burlington Mall Portfolio ($131 million – WBCMT 2005-C20 – 97% loss severity), that represented nearly 4% of its CMBS trust, the related losses extinguished seven classes ("J" through "P") and impacted the "H" class of its trust.

Likewise, reimbursement of non-recoverable advances can create interest shortfalls, cutting off "money good" securities until the underlying loans amortize and the interest shortfalls are reimbursed out of principal cash flows (converting interest shortfalls into principal realized losses).

### Conclusion

Despite a generally improving economy, CMBS delinquencies remain stubbornly high and loss severities are on the rise. Additionally, the most aggressively underwritten CMBS vintages of 2005–2007 are entering their maturity windows and more than $400 billion of CMBS loans contractually mature over the next four years. CMBS investors will need to carefully consider the characteristics of the underlying collateral for these vintage transactions to determine if extreme loss conditions exist that can invade trust classes previously thought impenetrable. Specifically, we note the following themes from our analysis of CMBS losses:

- **Cash Flow is King.** Assets with cash flow dramatically outperform those without it. More important than in-place or underwritten cash flow, is the quality and volatility of the asset's cash flow. As demonstrated by actual realized losses, assets with higher cash flow volatility experience greater loss severity.

- **Underwrite the Collateral and Conditions vs. Character.** Since the majority of CMBS loans are non-recourse, ultimately, the trust's recovery is limited to the asset quality of the collateral and the conditions of its marketplace. The expectation that a borrower, even a high-quality and highly-capitalized borrower, will throw good money after bad to support a non-performing loan, has proven to be false. Not surprisingly, among liquidated loans, higher quality assets in desirable markets suffered the lowest loss severities.

- **Not All Advances are Recoverable.** Servicers need to be more vigilant in advancing funds to determine that such advances are not just recoverable but accretive to the asset recovery. As noted herein, extreme loss severities (beyond 100% of the loan amount), create unintended consequences for bondholders who become subject to interest shortfalls, or losses, to recoup otherwise non-recoverable servicer advances. In certain instances, like a borrower, it may be better for the trust to "walk away" from the asset rather than to support it.

- **Time Is Not Always an Ally.** When loans go bad, they can go bad very quickly. Swift action, in hindsight, could have generated materially greater recoveries for the respective CMBS trusts, particularly for those assets that were not self-supporting, in the above examples. "Waiting and seeing" or "extending and pretending" can work, but often just preserves hope for a junior controlling holder who may no longer retain an economic interest on a spot basis.

- **The "Trickle Down" Effect.** Extreme CMBS losses do not just impact "B-piece" buyers and junior certificate holders. As discussed, extreme losses, particularly for larger trust assets, can quickly and significantly impact even AAA holders through interest shortfalls and/or principal losses.

The damaging effects of the financial crisis on the economy and on CMBS in particular, have opened up investors' eyes to the breadth and width of what can go wrong in CMBS from an asset, servicing and structural perspective. Applying lessons learned from extreme CMBS losses will help eliminate unpleasant surprises when underwriting legacy transactions and also mitigate potential losses in future CMBS "3.0" transactions. As always, caveat emptor.

Edward L. Shugrue III is the CEO of Talmage, LLC ("Talmage"). Talmage 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 and acted as the Special Servicer or advisor on over $40 billion of successful CMBS resolutions. Talmage is headquartered in New York City. www.talmagellc.com

# CMBS Global Recovery Continues to Be Slow and Uneven


**Larry Kay**
*Director (United States)*
Standard & Poor's Rating Services

**Arnaud Checconi**
*Director (Europe)*
Standard & Poor's Rating Services

**Narelle Coneybeare**
*Director, (Australia and Singapore)*
Standard & Poor's Rating Services

**Yuji Hashimoto**
*Director (Japan)*
Standard & Poor's Rating Services

**Maria Rabiasz**
*Senior Director (Canada)*
Standard & Poor's Rating Services


With new issuance already topping the full-year 2012 total, the U.S. CMBS market has rebounded in 2013, in part due to an improving economy. But the same can't be said for CMBS in other corners of the globe, even countries with expanding economies. For example, Japan, Canada, Australia and Singapore have had either no or limited issuance so far in 2013. Meanwhile, like the U.S., Europe is above its 2012 levels, although volume remains low.

The result is that the U.S. is accounting for 90% of global CMBS issuance in 2013 (year-to-date through June). That's much higher than the 72% U.S. market share in 2006, a year that we consider to be a comparable period of time for issuance among all regions.

Standard & Poor's Ratings Services believes that the U.S. CMBS market has benefited from low interest rates and the recovery in property prices, which has helped borrowers to refinance maturing loans. While most regions are rebounding from trough issuance levels, a nascent recovery across the CMBS globe still persists (see Charts 1 and 2).

*Chart 1*
**Global CMBS Issuance – Year to Date Through June 2013**

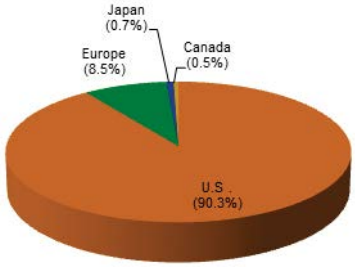
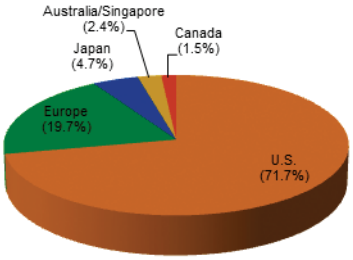



*Chart 2*
**Global CMBS Issuance – 2006**

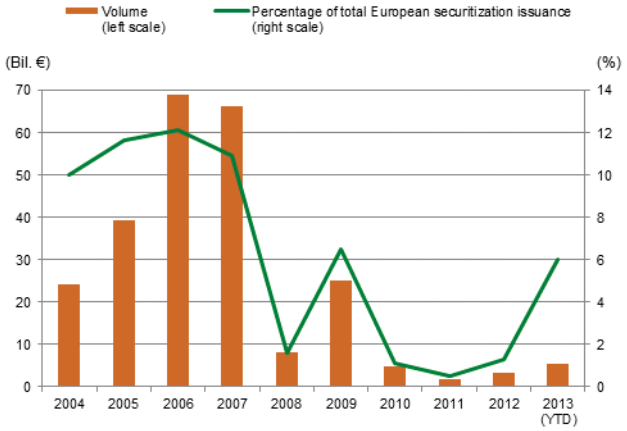



## EUROPE

### New Issuance Is Focused On Stable, Performing Assets

Cautious optimism prevails in the European CMBS primary market. European CMBS issuance through the first half of 2013 was €5.4 billion, which was already about two-thirds higher than full-year 2012's €3.2 billion. Total CMBS issuance and CMBS as a percentage of total securitized product (about 6%) are at their highest since 2009. Peak issuance occurred in 2006, when volume was approximately €69.0 billion and accounted for 12.1% of total securitized issuance (see Chart 3).

*Chart 3*
**Global CMBS Issuance**




Source: JP Morgan

The primary focus of CMBS new issuance has been on loans that have demonstrated stable performance and strong fundamentals. These newly issued transactions have mainly concentrated on loans that have low leverage, strong underlying assets, and granular cash flows.

German multifamily has dominated recent issuance and appears to appeal to investors. Legacy multifamily CMBS has lent itself to CMBS refinancing, as the asset class has generally exhibited stable cash flow performance and reasonable leverage levels.

In 2013, already two large CMBS multifamily portfolios were refinanced: German Residential Funding and Taurus 2013 (GMF 1). Both were issued at the tight end of pricing guidance and widely oversubscribed.

Although German multifamily refinancings have been strong, only about a fifth of our rated CMBS universe fits the profile of recently securitized loans. As such, we expect that the vast majority of legacy loans are unlikely to be refinanced through the CMBS market. Maturing legacy loans will continue to face long-term refinancing and repayment issues and borrowers will likely continue to look to traditional bank financing to refinance, in our view.

The absence of a normalized commercial real estate lending market could also constrain potential CMBS volumes in the near to medium term. As a result, we expect limited issuance for the rest of the year, with an estimate of €6.5 billion, just slightly above current levels.

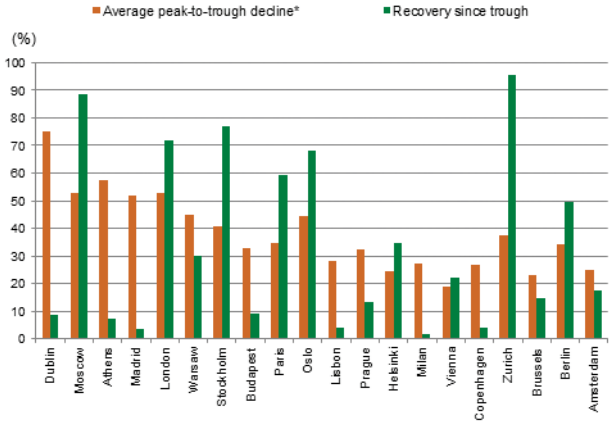
### CRE Capital Values Are Still at a Significant Discount from Their Peak

The European CRE market is fragmented — both by nation and even regionally within the countries with the largest markets. In addition, differences in terms of demand, occupancy rates, capital value volatility, and access to financing delineate a polarization between prime and non-prime properties.

Local, regional, or even global supply and demand shape each market and could affect the property assets performance as well as their funding. For instance, a city such as London has characteristics appealing to a potential global base of investors and is less sensitive to local factors.

While it would be misleading to assume that all individual European CRE markets move in perfect sync, the latter were all severely affected by the adverse macroeconomic conditions prevailing during the great recession; this trend still holds true in peripheral countries. The economic integration and interdependency among European countries as well as the mobility of capital and banks' cross-border activities increased the correlation between their CRE markets' behaviors. All major CRE markets saw a sharp fall in capital values during 2007/2008 followed by a rebound that occurred mostly in the primary markets. Soft conditions continue in the non-core markets (see Chart 4).

*Chart 4*
**Capital Values Between Q1 2007 and Q1 2013**




•Arithmetic average of industrial, retail (high street), retail (shopping centers), and offices.
Source: CBRE

Since late 2009, a few markets have seen a notable bottoming-out in capital values and an associated fall in yields. This occurred mainly in prime segments of core European markets such as Germany, France, the U.K., Switzerland, and Scandinavia. German real estate values have been particularly strong, and in core markets such as Paris and London, values have stabilized.

However, values are still declining in markets considered peripheral and for non-prime properties. Capital values in weaker markets — such as Ireland, Spain, and Greece — are either stagnating or recording a sluggish growth. The combination of an ongoing severe recession, banking sector difficulties and, in some cases, sovereign problems has put further downward pressure on capital values.

The U.K. is by far the largest European CRE market with an invested stock in excess of €600 billion. According to CBRE data, the Central London office capital values fell 67% from the mid-2007 peak to third-quarter 2009 then rose by 71% until third-quarter 2012 but have since slipped 1.5%; they remain 45% below the

2007 peak. Furthermore, these data are somewhat biased toward investment property in primary locations. There appears to have been little or no recovery in U.K. secondary and tertiary property values, which likely remain at least 40% below their 2007 peak. Outside of Germany, we do not expect prices to improve in the short term.

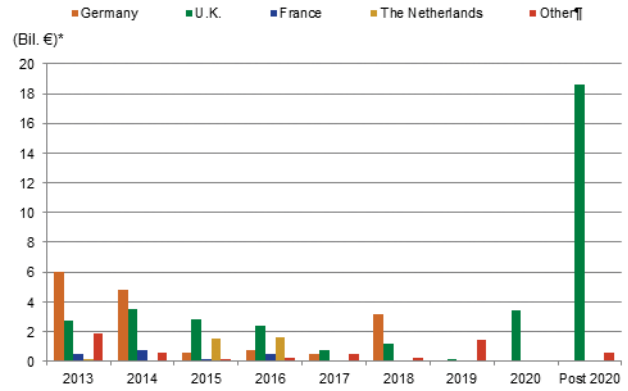
### CMBS Loan Refinancing Remains Challenging

Two of the heaviest vintage maturity years, particularly in Germany and the U.K., are 2013 and 2014. By contrast, the U.S. has its CMBS loan maturity profile skewed during the 2015-2017 period, as U.S. CRE loans tend to have longer maturities (about 10 years) than their European counterparts (five to seven years). By asset class, office has the largest amount of loans maturing over the next couple of years, followed by retail and multifamily.

In the first half of 2013, 105 loans were scheduled to mature in the European CMBS transactions that we rate. Only 41 (39%) repaid in full, 32 (31%) defaulted/repaid at a loss, and 12 were extended (11%). The remaining 20 (19%) are either in standstill (five), were restructured (one), or we are awaiting information on their status (14). We anticipate that the loans in standstill will be further extended or will default, depending on servicers' decisions.

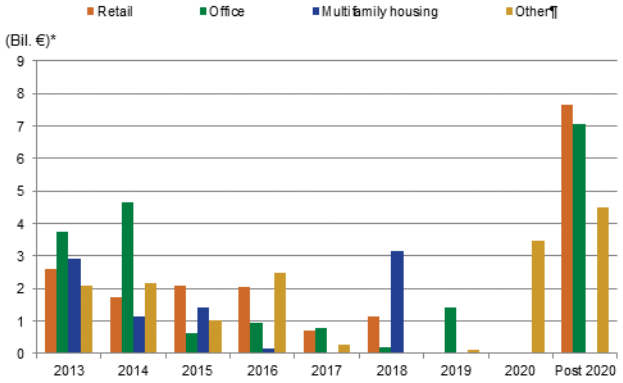
European CMBS loan maturities refinancing will remain challenging in the short term, as funding remains scarce due to stricter underwriting standards and reflecting the large number (€9.7 billion) of maturing loans in 2014 (see Charts 5 and 6). As a result, we expect loan performance to continue to come under pressure in the second half of the year, as loans near their maturity dates and interruptions to cash flow and margin mismatches become more pronounced.

*Chart 5*
**Jurisdiction Breakdown of European CMBS Loan Maturities**




Excludes the loans in small loan transactions, nonperforming loan transactions, and commercial real estate collateralized debt obligations.
*Includes loans denominated in British pound sterling, which are converted into euro.
¶Includes Belgium, Bulgaria, Czech Republic, Finland, Ireland, Italy, Poland, Spain, Sweden, and Switzerland.

*Chart 6*
**Sector Breakdown of European CMBS Loan Maturities**



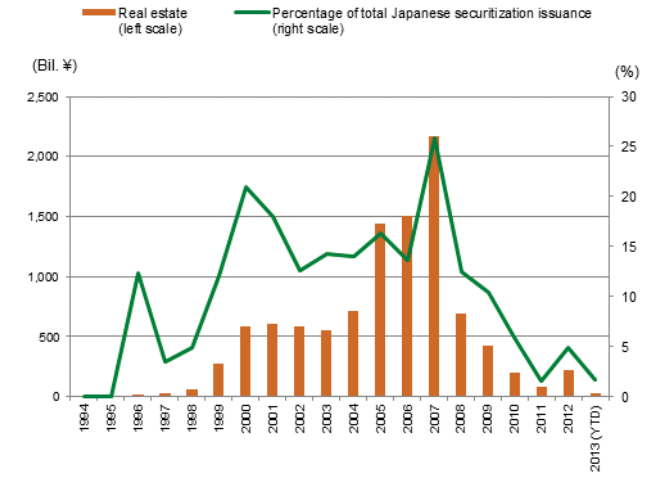

Excludes the loans in small loan transactions, nonperforming loan transactions, and commercial real estate collateralized debt obligations.
*Includes loans denominated in British pound sterling, which are converted into euro.
¶Includes industrial, mixed use, bank branch, distribution warehouse, DIY, hotel, leisure, and nursing home sectors.

## JAPAN

### CMBS Market Slows, Bank Lending Busy

Japan's CMBS market saw a high level of new issuance from 2005 to 2007, peaking in 2007 with ¥2.17 trillion in new CMBS issuance out of total securitizations of ¥8.42 trillion (25% of new structured finance issuance). New issuance of Japanese CMBS has been subdued since 2009, following the onset of the global financial crisis, and has yet to show signs of a recovery. For the six months ending June 30, Japanese CMBS new issuance was ¥31.4 billion, which was a little less than 2% of total Japanese securitizations for the first half of 2013 (see Chart 7).

*Chart 7*
**Japanese CMBS Issuance**




Source: Deutsche Securities

Issuers of Japanese CMBS have been mainly international investment banks. Borrowers have been primarily opportunistic/value-add CRE funds — both international and domestic — that tended to hold assets for shorter terms (about three years). As a result, the tenor of the loans they borrowed were also shorter (three to five years) with prepayment options.

Although the CMBS new issuance market is very slow, Japanese banks are quite aggressive in making new loans. As major banks in Japan are utilizing the Internal Rating Based (IRB) method under Basel II (which allows banks to rate loans themselves and calculate risk weight based on their internal ratings), they do not need ratings from the rating agencies. Because implementing an IRB process is relatively difficult for smaller banks, such banks need ratings for the purpose of calculating asset risk.

Therefore, there are cases in Japan where borrowers get financing from banks while senior loans are extended by major banks without external ratings. Because the size of mezzanine loans tends to be small, they usually require one rating, typically from a local agency.

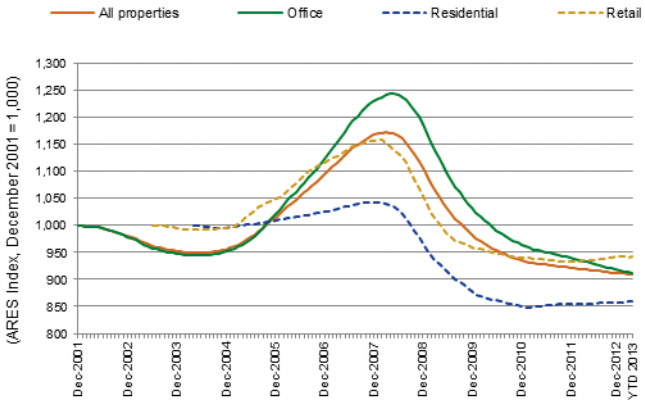
## CRE Prices Have Bottomed

The historical pattern of new issuance in Japanese CMBS has followed a similar trajectory as CRE prices in Japan. The ARES Japan Property Index (AJPI) — an index of appraised values for CRE included in the portfolios of listed Japanese REITs (J-REITs) and unlisted core funds — peaked in 2008. Since then, the total property index has had consecutive quarterly declines, and through first quarter 2013 was 22% lower than peak levels. All major property types are still below peak levels, with office lower by 27%, retail by 19%, and residential by 18% (see Chart 8).

In Standard & Poor's view, CRE prices in Japan have bottomed out, and the risk of a further decline in value for the remainder of 2013 is limited. In fact, the total acquisition amount of J-REITs increased by about 45% in 2012, according to the Association for Real Estate Securitization (ARES). Tokyo's office market took in a large supply in 2012, which caused vacancy rates to rise above 9% compared with 2.5% in 2007 and led to a decrease in rents. Given that the supply is being absorbed, rents for class A Tokyo office properties grew by 2% in the first quarter 2013, according to Colliers International.

The Japanese CRE market has been recovering in part due to the Bank of Japan's monetary easing policies. However, Japan, which has jumped from recession to one of the fastest growing economies, could see its rate of economic growth slow. The International Monetary Fund in its July 2013 World Economic Outlook lowered its economic growth forecast by 0.3 points in 2014 to 1.2%, which could temper demand for tenant space.

*Chart 8*
**ARES Japan Property Index**

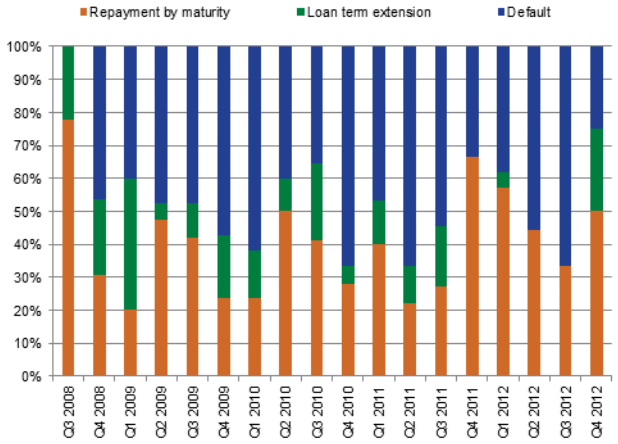



Source: ARES

Due to their short note term, CMBS loan maturities peaked in 2009-2011, with 2010 seeing the highest peak in maturities of about ¥1.2 trillion. As the typical loan term in Japanese CMBS is three to five years, almost all of the loans have matured. In the first half of 2013, two loans matured. Currently, there are only five loans with future scheduled maturity dates, with two scheduled to come due in the second half of this year. All of the other loans have already matured and either fully paid or defaulted.

From the third quarter of 2008, when the first Japanese CMBS transaction loan defaulted, through the end of 2012, the maturing loan default rate averaged about 47%. Compared with 2011, when 53% of the maturing loans defaulted, 2012 experienced improving conditions, as 43% defaulted, 52% repaid by their due date, and 5% extended (see Chart 9).

*Chart 9*
**Japanese Breakdown of Loan Repayments/Nonrepayments by Number of Loans**




By the end of 2012, servicers had completed the recovery process for 82% of the defaulted loans. Of these, servicers fully recovered 55% of the securitized principal amounts, and the remaining 45% incurred principal losses that averaged 23% of the securitized principal amount.

Despite the stabilizing CRE market, we do not expect Japan's CMBS new issuance market to recover in the near term for several reasons:

- The volume of asset trading remains low, limiting a borrower's need for new financing.
- Domestic banks have ample liquidity and are actively looking for opportunities to lend. As a result, the average spread on bank lending has tightened significantly, thus making securitization not economically viable for issuers.
- Investors in Japanese CMBS are predominantly banks, which are expected to perform the same level of due diligence when they purchase CMBS as when they extend a loan directly. Thus, banks do not have an incentive to choose CMBS over lending.

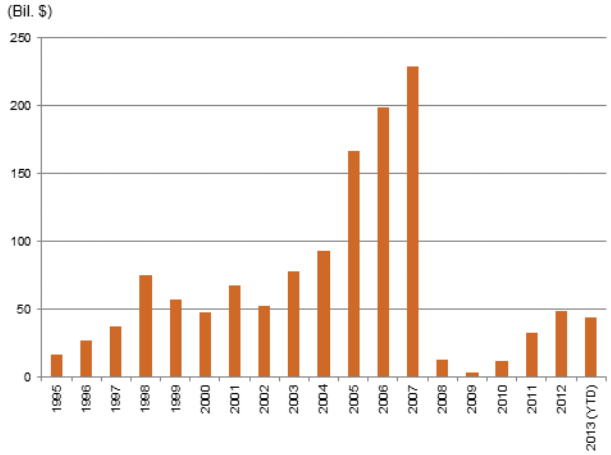
## NORTH AMERICA

### U.S.

### As Clouds Appear, CMBS Issuance Pauses

The overarching message that the U.S. central bank still expects to start scaling back its massive bond purchase program (depending on economic circumstances) will likely continue to scare the market. We expect that following the summer slowdown, new issuance will show renewed life in the fall — but at a cautious pace. We are forecasting that CMBS private-label new issuance could end 2013 totaling approximately $70 billion. According to Commercial Mortgage Alert (CMA) releases, this would be one-third higher than the 2012 full-year total ($48.4 billion) and about where the market was in 2001 when pulling out of the recession (see Chart 10).

*Chart 10*
**U.S. CMBS Issuance**



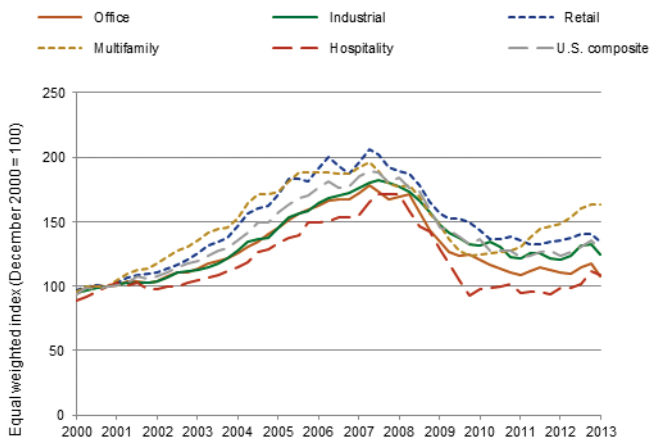

Source: Commercial Mortgage Alert

### Real Estate Investment Migrates to Secondary Markets

Despite a slower-than-normal real estate recovery, property fundamentals and prices continue to improve. Overall demand is increasing, reflecting job growth and confidence that the economic picture is brightening. Completions have been low, and we believe that supply should remain constrained — at least in the near term. The major exception has been the multifamily sector, where construction has ramped up in various markets amid strong demand for rental housing.

CRE prices are recovering from their recessionary lows. Based on sales activity data from CoStar Group, overall prices are still off by about one-third from peak levels, but they are 5% above their trough. This varies by property type, with office still searching for a bottom and multifamily about 33% higher than its year-end 2009 low (see Chart 11).

*Chart 11*
**U.S. Property Type Indices**




Source: CoStar Group

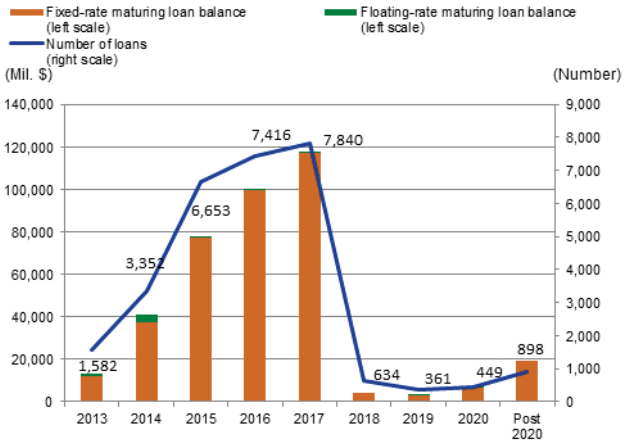
With strong competition in core primary markets, capital has moved to the secondary markets for yield and investment opportunities. Following capital flows, CMBS liquidation activity in secondary and tertiary markets picked up in the second quarter. This investment activity should continue to benefit CMBS collateral, which is more dominant in the non-primary markets.

Continuing job growth should sustain the real estate recovery. And unless the economy strengthens significantly, interest rates might not rise much further in the near term. As a result, CRE should continue to benefit from rates that remain low by historical standards.

### For Future Loan Maturities, Interest Rates Might Not Be As Forgiving

Through the first half of 2013, maturity loan payoffs have been strong at 87.65%. We expect this positive trend to continue into 2014, though the recent rise in interest rates could complicate the refinancing of marginally performing loans. However, looking beyond 2014, as the next major wave of maturities comes due in 2015 and continues through 2017 (77% of remaining maturities, $295 billion), the prospects might not be as bright (see Chart 12). As these vintages were characterized by highly leveraged loans and underwritten close to or at peak rent levels, market dynamics might not be as forgiving. By 2015, we expect that most likely there will be less liquidity because of the drawdown of the Federal Reserve's quantitative easing. Unfavorable loan characteristics — coupled with less liquidity and expected higher interest rates (which typically cause a compression in capitalization rates) — could outweigh any value enhancement from improving property cash flows, thereby limiting refinancing prospects.

*Chart 12*
**U.S. CMBS Fixed- and Floating-Rate Final Maturities as of July 1, 2013**




Source: Standard & Poor's

## CANADA

### Strong Property Markets and Collateral Performance

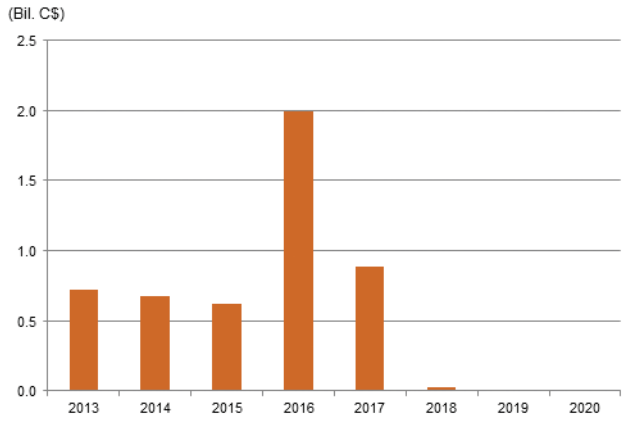
Canada, which has been hampered by sluggish global growth and reduced demand for resource production, has nonetheless experienced strong property fundamentals and collateral performance. Both office and industrial sector fundamentals are among the strongest globally, and these sectors are enjoying relatively low vacancy rates. Multifamily has remained strong, reflecting both favorable demographics and investment demand, while retail has posted strong sales per square foot levels that have attracted foreign retailers.

The Canadian CMBS delinquency rate as of June 30, 2013, was 0.47%, which pales compared with the U.S CMBS delinquency rate of 8.89%. We believe that the strong property markets — coupled with Canadian mortgage loan financing, which usually provides the lender with recourse to a guarantor with tangible assets — support collateral performance. It is our view that this provides a strong incentive for borrowers to avoid loan defaults.

Yet even with this strong performance, Canadian CMBS issuance has been very slow. Volume peaked in 2006 at C$4.7 billion then fell to C$3.5 billion in 2007. Since then, there has been very little issuance, with only two transactions totalling C$0.5 billion issued in 2012. Year-to-date through June 30, 2013, C$250.4 million of CMBS has been securitized in one transaction. Mortgage loan collateral has been primarily from secondary and tertiary markets, originated by non-bank sponsors. While conduit spreads have been tightening, they still remain above pre-crisis levels.

As of June 30, 2013, Standard & Poor's had ratings outstanding on 23 Canadian CMBS transactions with an aggregate loan balance of approximately C$4.9 billion. More than 80% of that amount will come due by the end of 2016, with one-half of it maturing in 2016, reflecting a large issuance year and 10-year term maturities (see Chart 13).

*Chart 13*
**Canadian CMBS Loan Maturities**




We expect that CMBS Canadian issuance could reach C$1.0 billion in 2013 but don't see significant activity returning to this sector in the near future. In the office and industrial sectors, there could be some pressure in both demand (due to economic developments) and supply (reflecting increased development). Multifamily is expected to remain healthy, though increasing home ownership is an obstacle. Retail will continue to be affected by online sales and will be tested by Target's entrance into the Canadian market with the scheduled opening of more than 100 stores.

## SINGAPORE AND AUSTRALIA

### Stable Market Conditions, but No New Issuance

CMBS issuance in Australia peaked in 2006 with just over A$5 billion. Prior to that, it had averaged about A$2 billion a year. Issuance dropped off significantly after 2006. We do not expect significant new issuance of CMBS in Australia or Singapore, with any activity in the medium term most likely to come from the refinancing of existing programs.

In Australia and Singapore, single-borrower deals are the predominant securitized transaction type. CMBS collateral in Australia and Singapore currently consists mostly of retail and industrial properties.

CMBS collateral principal balance in Australia and Singapore has decreased over the past four years. At present, three publicly rated CMBS transactions remain in each market. They are performing within expectations, against a backdrop of stable macroeconomic conditions and improving real estate markets. There have been no defaults on rated notes in the sector in these markets. Refinance risk has eased in line with improvements in lending to the sector and general trading conditions. However, it remains the key risk for the remaining transactions.

The retail property sector remains flat in Australia. Subdued consumer sentiment is the key challenge in the medium term. Office markets are generally stable, with moderate supply pipelines. Office markets dependent on mining and the resources sector currently face the greatest risk. The industrial and logistics property sector continues to be characterized by stable demand and supply.

In Singapore, the retail property market remains tightly held. Office markets are generally stable, with moderate supply pipelines. Demand and supply in the industrial and logistics property market remain stable.

The effects of a potentially worse-than-expected global economic outlook and uncertainty in the financial sector — including slower-than-expected economic growth in China and further deterioration in the eurozone (European Economic and Monetary Union) — are the key threats to our stable macroeconomic outlook.

# JOBS Act Private Offering Regulatory Reforms to Benefit Commercial Real Estate Mortgage Industry: Creates Opportunities for Sourcing Private Capital through Innovative Methods

**Michael L. Zuppone**
*Partner*
Paul Hastings LLP

On September 23, 2013, historic improvements to the Securities and Exchange Commission's private capital market regulations will take legal effect. Many observers expect these long overdue regulatory reforms, which were mandated by Congress in the Jumpstart Our Business Startups Act (JOBS Act), to usher in a new era for private capital formation in the United States. In substance, the regulatory reforms amend the SEC's principal private offering exemption to remove a regulatory straightjacket that has unnecessarily constrained private capital formation by corporate, private investment fund and other securities issuers. Stated simply, the SEC has removed the prohibition against general solicitation and advertising in securities offerings conducted pursuant to the new Regulation D rule, a step that will enable innovators to develop new alternatives for soliciting investment from "accredited investors" through private offerings conducted with general solicitation or advertising.

While much of the impetus for the JOBS Act centered on reducing barriers to capital formation as a means of fostering job creation by emerging growth companies, the SEC's regulatory reforms are clearly available to commercial real estate mortgage industry participants. This has not been lost on forward-thinking firms with plans to intermediate capital in innovative ways and expand the pool of capital available to the industry. As one contemplates this JOB Act development and what it means for the commercial real estate mortgage industry, it is important to note that there is an expansive pool of investment capital that will be more become accessible as a result of the regulatory reform.

Individuals with an annual income over $200,000 (or $300,000 for a married couple) or a net worth over $1 million, excluding a primary residence, and entities with $5 million in assets qualify as accredited investors. The SEC estimates that there are approximately 7.6 million U.S. households (6.55%) that qualify as accredited investors[1]. The potential pool of capital available for investment by accredited investors is vast. If each of the 7.6 million households invested just $10,000, that would represent $76 billion in invested assets.

Owners and operators of commercial real estate, like other enterprises operating in industrial, technology and service industries, require debt and equity capital to develop, improve and operate their properties. For those industry participants that for strategic and other reasons seek to monetize their properties in value maximizing transactions, their counterparties' access to debt and equity capital is equally important. With the exception of investment capital ultimately sourced from public investors by publicly-traded real estate investment trusts, much of the capital required by commercial real estate mortgage industry participants historically has been obtained from the private capital markets as regulated by the SEC.

The commercial real estate mortgage market has evolved so that today conduit and balance sheet originators can source capital for their lending operations through loan participations and securitization offerings directed to institutional investors. Private equity fund managers focused on commercial real estate mortgages have been able to amass equity capital from institutional investors, such as governmental pension plans, endowments and family offices, for investment in mortgages and mortgage related instruments consistent with their investment strategies. However, in many cases, the pool of capital available to originators and private equity fund managers has been unnecessarily restricted because in the face of the prohibition on general solicitation and advertising they have been unable to publicize their private offerings at all, let alone through modern mass communication technologies. Many believe that the vast pool of capital available from eligible individual and institutional accredited investors can be accessed in cost-effective and efficient ways as a result of the lifting of the ban on general solicitation and advertising. Other provisions of the JOBS Act raise the holder of record threshold that triggers SEC public company reporting requirements to 2,000 if the holders are all accredited investors. These provisions allow up to 2,000 publicly solicited accredited investors to invest in an issuer's securities without incurring public company compliance costs.

**"There is a vast pool of capital available from eligible individual and institutional accredited investors that many believe can be accessed in cost-effective and efficient ways as a result of the lifting of the ban on general solicitation and advertising."**

Now that the SEC has acted to remove the prohibition on general solicitation and advertising, commercial real estate mortgage industry participants and their broker-dealer intermediaries will be able to expand the universe of investors to whom they can offer their securities beyond the inherently limited group of investors with whom they already have a prior substantive relationship. Industry participants can revisit their corporate websites and promote their businesses and publicize their successes without regard to whether the content would be considered general solicitation or advertising with respect to any ongoing securities offerings. They will even be able to conduct online offerings though publicly accessible internet websites and other mass communication media.

Indeed, many market observers expect securities market innovators to use emerging social networking technologies and crowdfunding strategies to organize communities of alternative investment-oriented investors to more efficiently deploy this important source of private capital. There is every reason to believe that market participants will design new investment products that provide for direct investment in commercial real estate mortgages and mortgage participations. One can envision structures that provide investors with an interest in a single mortgage or in multiple mortgages. We can also expect that private equity fund managers will create private fund structures that will enable individual and small institutional investors to invest in their commercial real estate mortgage investment programs.

### How the New Rules Work

Regulation D is a non-exclusive safe harbor pursuant to which compliant offerings are treated as non-public offerings exempt from the Securities Act's registration requirements. This regulation is frequently relied upon by market participants to conduct private offerings to accredited investors because the regulation does not require any mandated disclosure be provided to investors and state Blue Sky offering qualification regulations are preempted. Thus, market participants are free to develop disclosures relating to the investment opportunity that are suitable for their transactions and are not subject to review by the SEC or any state Blue Sky regulator.

The SEC added new Rule 506(c) thereof which expressly permits general solicitation or advertising in connection with offerings made under the rule, provided that, the issuer takes "reasonable steps to verify" that all purchasers of the securities are accredited investors. Either all purchasers of the securities must be accredited investors, or the issuer must reasonably believe that all purchasers are accredited investors at the time of the sale of the securities. The SEC was measured in its implementation and resisted the call for the imposition of onerous verification requirements advocated by certain commentators. Instead, the SEC adopted a flexible principles-based approach to verification and even added a non-exclusive list of acceptable verification methods for use in determining the accredited investor status of natural persons. The SEC explained that whether the steps taken are reasonable is an objective determination, based on the particular facts and circumstances of each transaction. The agency noted that issuers should consider a number of factors when determining the reasonableness of the steps to verify that a purchaser is an accredited investor and highlighted the following:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information about the purchaser; and
- the nature and terms of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

With respect to natural persons, as long as the issuer reviews the prescribed documentation relating to the investor's personal income and net worth set forth in the rule, such action will be deemed to constitute reasonable steps to verify as required by the rule. In addition, the issuer may satisfy the requirement by obtaining written confirmation from a registered broker-dealer, a registered investment adviser, a licensed attorney or a certified public accountant confirming that such person or entity has undertaken the requisite verification within the prior three months and has determined that the investor is an accredited investor.

The SEC specifically noted that under the right circumstances, issuers can outsource verification to third-party verification service providers. A number of market participants have announced plans to provide verification services (presumably priced with economies of scale in mind), and issuers will be entitled to rely on them as long as the service provider undertakes the requisite verification and the issuer has a reasonable basis to rely on such verification.

### Conclusion

While not the intended beneficiary of the regulatory reform, it is clear that the commercial real estate mortgage industry can benefit from the ability to conduct what are essentially public offerings marketed to accredited investors. Ultimately, time will tell as to whether the industry will embrace the reforms to innovate and develop new alternatives for raising capital that take full advantage of the reforms. It is worth noting that many accredited investors do not have access to opportunities for investment in commercial real estate mortgages that may offer a better return/risk profile than is available from other investments offered in the market place. The intermediary that can develop innovative products that satisfy the investor demand and deploy the capital raised efficiently will distinguish itself as a forward-thinking market participant.

1 Net Worth Standard for Accredited Investors, SEC Release No. 33-9177 (January 25, 2011), available at: http://www.sec.gov/rules/proposed/2011/33-9177.pdf; Net Worth Standard for Accredited Investors, SEC Release No. 33–9287 (December 21, 2011), available at: http://www.sec.gov/rules/final/2011/33-9287.pdf

# More Money, Fewer Problems? U.S. CMBS Servicers Position for Continued Growth In Commercial Real Estate Lending


**Andrew Foster**
*Associate*
Standard & Poor's
Rating Services

**Brian Snow, CFA**
*Director*
Standard & Poor's
Rating Services


As U.S. commercial real estate fundamentals have improved significantly during the past couple of years, commercial mortgage loan servicers have begun shifting gears to prepare for continued growth in lending. Special servicing (mainly the working out of defaulted loans) was a key focus during the market downturn, when distressed assets were the primary source of deal flow for buyers and service providers alike. More recently, the focus has shifted to commercial mortgage-backed security (CMBS) originations, which have rebounded, along with refinancings and investment sales. Partially in recognition of this activity, and perhaps in anticipation of accelerating U.S. CMBS issuance, the commercial mortgage servicing industry has seen a number of mergers and acquisitions.

These acquisitions, with other transactions, give Standard & Poor's Ratings Services some insight into how commercial mortgage servicers are reacting to trends in the industry.

**Overview:**

- Commercial real estate trends are broadly benefitting commercial mortgage borrowers and lenders, partly because of Federal Reserve policy.
- Projections for commercial mortgage lending are robust. Therefore, some servicers' business strategies are once again predicated on growth as opposed to taking advantage of market distress.
- As the volume of defaulted loans decreases, more servicers are seeking growth through CMBS investments, servicing opportunities, and loan origination.

## The Near Term Outlook Is Brighter for U.S. Commercial Mortgage Servicers

*Underwriting standards ease*

Increasing U.S. CMBS issuance has accompanied greater investor demand, a widening of the B-piece buyer pool (the investors in the most subordinate CMBS bond classes), and clear loosening of underwriting standards. Coinciding with these trends, real estate capital markets have become more liquid, which has generated a positive feedback loop: higher values, fewer loans in special servicing, and lower loss severities on specially serviced loans. Meanwhile, borrowers have increased leverage, and riskier interest-only loans have become more prevalent (see published June 10, 2013, on RatingsDirect). These trends coincide with the Federal Reserve's quantitative easing (QE) program, during which the Fed has lowered interest rates by acquiring long-duration Treasuries and U.S. residential mortgage securities. By doing so, the central bank has increased market liquidity and decreased the cost of capital for borrowers.

The additional money pumped into the system and lower rates have strongly benefited markets in the short term. However, we are less certain as to the possible long-term costs. In the near term, market participants are eagerly anticipating the Fed's next move with respect to tapering their monthly purchases. Last week's decision to not taper immediately surprised many market participants and will have only modest effects on structured finance, in our estimate. Weak economic growth and fiscal policy uncertainties, reasons for the delay, have negative implications for credit.

*Resolution trends are favorable*

After two years (2009 to 2010) of defaulted loans getting stuck in extended workouts, special servicers are speeding up the resolution process. The *Commercial Mortgage Alert* reported as of August 2013, the total balance of specially serviced loans declined to $54.6 billion from just over $67 billion in February 2013, and the pace of new defaults in U.S. CMBS continues to slow.

In the meantime, the issue of transfers of special servicing rights has taken center stage. Specifically, the liquidation of specially serviced loans has triggered "change in control" provisions, governed by the U.S. CMBS transaction documents. "First loss" investors have gotten wiped out, and the market has welcomed a new crop of controlling parties that were previously senior to the original (or subsequent) B-piece buyers (see published Aug. 8, 2012). This inevitability has led many securities holders to bid for "second loss" positions and the accompanying right to appoint the special servicer if they become the most junior class outstanding.

Although these servicer appointment rights continue to have substantial value and that value will likely remain a source of conflict among servicers and securities holders, in our opinion, their relative importance will decrease as the number of specially serviced loans decrease and the markets refocus on originations.

*Lending is trending*

According to the *Commercial Mortgage Alert*, new U.S. CMBS issuance totaled $56.4 billion through September 2013, up from $24.9 billion for the same period in 2012. The recent spike in interest rates dampened issuance forecasts across the board

for second half 2013, but nonetheless, we believe fundamentals remain solid as interest rates remain near record lows. We also expect market volatility will keep new issuance from reaching the frothy peaks of 2004-2007. In our opinion, these are positive trends that should keep the U.S. CMBS delinquency rate and pace of transfers to special servicing on a decline through the end of 2013.

*B-piece buyers line up*

Three B-piece buyers, C-III Capital Partners, CWCapital, and LNR Partners, traditionally dominated the market and also served as special servicers for their transactions. Consequently, they maintain the majority market share (approximately 82%) for legacy CMBS transaction special servicing assignments, according to the Commercial Real Estate Direct.

From 2010 to 2012, a similarly small pool of B-piece buyers dominated the CMBS market's recovery. Originators and issuers have generally relied on the B-piece buyer's active participation in order to successfully execute a CMBS transaction. As a result of the lower number of active bidders, these early "CMBS 2.0" transactions had credit characteristics and prices that were highly favorable to the B-piece buyers' investment objectives. More recently, however, new issue B-pieces are selling for higher prices (lower yields), despite what we view as a decline in credit quality of recent CMBS transactions.

The number of B-piece buyers grew tremendously in 2013 and is currently at approximately 15, helping to keep conditions ripe for new issuance, but also adding potential risk. Some observers have noted that B-piece buyers, given their opportunity to underwrite loans and the inherent credit risk of their position in the capital stack, serve as "governor" for the credit characteristics of U.S. CMBS transactions. While this could arguably be true once risk retention provisions are implemented, in our opinion, a large supply of B-piece buyers may make it more difficult to maintain underwriting standards and collateral quality in U.S. CMBS transactions. In our view, more buyers may translate into less market discipline, because issuers may have fewer concerns of potential "kick-outs" of troublesome loans. With only three B-piece buyers, originators had fewer options for loan sales and had to maintain credit and underwriting standards that would meet the requirements of at least one of the three. With an expanded pool of potential B-piece buyers, originators may have additional underwriting flexibility.

We will continued to monitor how shifts in the number of B-piece buyers affects pricing and underwriting, particularly as new risk retention rules come into play.

## Recent Notable Mergers and Acquisitions

*LNR Property LLC*

In April 2013, Starwood Property Trust and an investment fund managed by Starwood Capital Group closed on the acquisition of LNR Property LLC. This transaction is noteworthy given the focus of the strategy. In addition to taking advantage of growth in special servicing fees and ancillary opportunities created by a distressed environment (see published March 9, 2012 on RatingsDirect), Starwood Property Trust also projects growth by originating loans.

*The Wall Street Journal* notes, "Since the crisis, the firm has originated loans and taken part in new commercial mortgage debt, businesses cited as key attractions to Starwood Property in its acquisition." This acquisition strategy presumes that the volume of distressed assets will continue to decrease. This also represents

the first sale of a large special servicer by a private equity owner that acquired the company after the U.S. CMBS market ground to a halt. While the strategy focuses on loan growth, according to Standard & Poor's analyst E. Robert Hansen, "We think LNR's special servicing business could benefit somewhat in the event of an industry downturn and will add some diversification to Starwood's total revenues" (see published April 19, 2013, on RatingsDirect).

*CT Investment Management LLC (CTIMCO)*

In December 2012, an affiliate of The Blackstone Group LP (Blackstone) acquired CTIMCO, an investment management business operated through a subsidiary. Blackstone subsequently renamed that business Capital Trust Blackstone Mortgage REIT, however, the special servicing business line continues to operate as CTIMCO. In April 2013, shortly after the acquisition, *The Wall Street Journal* reported the company planned to raise $100 million in equity. We believe this acquisition and the subsequent equity infusion is another example of a new business plan that is predicated on continued growth in the credit markets as opposed to focusing mainly on distress.

*Ares Commercial Real Estate Corp.*

In May 2013, Ares (ticker symbol: ACRE) agreed to buy multifamily lender Alliant Capital LLC, which originates loans and provides asset management and servicing primarily through Fannie Mae's delegated underwriting and servicing program. We believe this acquisition enables Ares, a specialty finance company, to deliver a more diverse set of loan products, in particular adding a permanent financing option for customers. In our opinion, the theme of growth through lending continues.

*Orix Capital Markets LLC*

Orix put approximately $1.5 billion in distressed loans and real estate owned (REO) properties up for sale in May 2013, with advisers Mission Capital and CB Richard Ellis. According to Commercial Real Estate Direct, Orix offered the portfolio sale to "take advantage of strong investor demand for distressed and otherwise high-yielding assets." Assuming the portfolio sale successfully maximizes recovery and investor demand remains healthy, we would anticipate other special servicers to follow suit. However, we believe many servicers are already pursuing the bulk sale strategy, albeit not with their entire portfolios.

### Special Servicers Are Likely To Continue To Refocus As The Economy Stabilizes and Real Estate Lending Recovers

Given the recent downturn's length and depth, some commercial mortgage special servicers have had to restructure and resolve a significant amount of defaulted commercial mortgages. As in past cycles, this process of working through distressed mortgages is likely to end with the special servicing industry shrinking because fewer personnel are required once there are fewer defaulted loans to restructure and resolve. More servicers, particularly special servicers, appear to be positioning for growth in lending. While fewer personnel will be needed to work out loans, growth in lending should create new opportunities for those with workout experience. As in previous upturns, we believe many of these loan workout professionals will prove invaluable to as new business models are developed.

### Related Research:

- published April 19, 2013, on RatingsDirect.
- published Aug. 8, 2012, on RatingsDirect.
- published March 9, 2012, on RatingsDirect.
- published June 10, 2013, on RatingsDirect.

### External Sources:

- Commercial Mortgage Alert, published Sept. 6, 2013.
- "Special Servicing Volume Falls to Lowest Level In 4 Years," Commercial Real Estate Direct, published Aug. 7, 2013.
- "LNR Captains Resign As Starwood Charts Its Own Course," The Wall Street Journal, published May 1, 2013.
- "Orix Puts $1.5Bln of Distressed Loans, REO on Sales Block," Commercial Real Estate Direct, published April 30, 2013.

# Single-Family Rental Securitization

**David Nabwangu**
*Senior Vice President, CMBS*
DBRS Inc.

**Rich Carlson**
*Senior Vice President, Operational Risk*
DBRS Inc.

**Erin Stafford**
*Managing Director*
DBRS Inc.

In many ways the securitization of single-family rental (SFR) real estate makes good sense: it is similar to established property types of CMBS in its operations, it contributes to the stability of a sector that was in crisis, and it is simple to identify and understand its revenue and expense drivers. However, given the newness of the sector, it may be difficult to quantify the sector's potential size. Since the publication of a Request for Information (RFI) on rating bonds backed by single-family rental, DBRS has received input from a number of potential lenders, issuers, owners and operators, data providers, consultants and other interested parties. The responses have yielded many answers to the concerns that were listed in our original RFI, and also raised additional questions that need to be addressed. Particularly, it is possible that the securitization of single-family rental pools will not be sustainable in the future because they are reliant upon the massive market dislocation that unfolded in the late 2000s. Whether recent market conditions are such that there is an opportunity to securitize portfolios of SFR is one question. Whether portfolios of SFR can be securitized on an on-going basis is another. Will the same economics that make institutional SFR plausible today persist as the housing market recovers? Can the economies of scale that are gleaned from centralizing and professionalizing SFR operations, create enough benefit for the product to survive in the long run? The answers to these questions will be seen in the coming years.

This report discusses the current state of the SFR market and the pros and cons associated with securitizing this product type.

## Overview

The Single-Family Rental Space has experienced an elevated public profile with a flurry of activity in the past 12 months as a few large operators have issued public debt through IPOs and several others have been exploring the viability of securitizing single-family rental pools. Meanwhile, market participants continue to learn about the product and accumulate performance data. Since the first tenant renewals from institutionally owned properties purchased in the past two years are just starting to happen, we are just beginning to see statistics with regard to length of stay and the ability to pass through rental rate increases to SFR tenants.

In 2011 there were an estimated 91 million year-round single family housing units in the United States, 14.8 million (17%) of which are considered to be rental real estate[1]. The vacancy rate in the space in 2011 was 15%[2].

History has proven that renters of single-family homes are more likely to be families, therefore neighborhood and schools do matter. Many institutional players have leasing velocity that is strong and has improved quite dramatically in the past year. They use a variety of approaches to reach their target renters and screen them for credit. Some demand is generated from individuals that are recovering from the recession and may have otherwise been homeowners, but lack the required minimum down payment or credit score. There is also pent up demand from low housing starts and the constrained multifamily market which is just now starting to experience additional supply after a period of more than three years of elevated rental increases coupled with low vacancy.

Continued demand for single-family rental homes is difficult for DBRS to predict for a number of reasons. First, new family formation (a significant component of the target market for single-family rentals) remains low. Second, given the housing recovery experienced over the last few years, baby boomers may begin to put their houses on the market and downsize or may also become landlords themselves if they are looking for a supplemental source of monthly income. If they have owned their homes for years, they are likely to have a very low basis risk in their properties and therefore could undercut or cap the rents. As a result, renters may decide to accept a tradeoff for lack of efficient service from the "mom & pop" landlord for a reduced rental rate. Third, renters may start to repair their credit and prefer to purchase homes, ultimately creating higher than expected turnover and/or causing the landlords to lower their standards on the credit worthiness of renters.

These concerns contribute to the wider question of whether the securitization of single-family rental real estate is viable in the long term.

## The Value of Institutional SFR

Historically, the single-family rental market has been a fractured "mom & pop" business, which operated in an unsophisticated setting. Recently, substantial declines in value and capital markets dislocation in many markets has allowed large institutional players to purchase homes out of foreclosure for less than the replacement costs. These institutional players have access to two very important things that the "mom & pop's" lack: cash liquidity and an ability to exploit economies of scale. However, the primary question that remains open is if the institutional investor will stick around once one takes away or levers the home appreciation.

The value that institutional players provide the SFR market are 24/7 responsiveness to the needs of renters, purchasing power on materials for repairs and capital expenditures, and an established brand as a good neighbor within home owners' associations. This level of service provides tenants with the comfort and familiarity of an established brand manager. DBRS research shows that this level of responsiveness and service is something the "mom & pop" or individual entrepreneurs would be challenged to compete with. Therefore, the institutional SFR has the ability to add real value to the economy. Consumers (Renters) could expect consistent and prompt responsiveness from professional property managers (with a mandate that is pro-tenant), that show up at the door in uniform.

As with traditional multifamily, operators of a certain size can leverage their "buying power" for appliances, paint, HVAC equipment, and management services. Therefore, centralization of purchasing and contracting will help to keep expenses in check. Having standard appliances or finishes across all properties helps to reduce the disadvantage of properties not being in one location.

## The Case for Rating SFR

DBRS issued a request for information in May 2012 looking for additional information on the single-family rental market in order to mark the beginnings of methodology exploration. The asset class can neatly borrow from both CMBS and RMBS rating approaches: CMBS has cash flow producing assets and the SFR assets, when rented, are income producing. RMBS relies on market value declines and the houses as the tangible saleable asset should the cash flows prove to be insufficient to cover the debt service payments. Both CMBS and RMBS rely on servicers to manage the payments and in this asset class it would also heavily rely upon the property manager and the leasing agents whose jobs resemble that of an apartment manager.

In CMBS, cash flow is considered to be the key driver of credit risk. The element of the single-family rental market that would make it different from an RMBS or a liquidating trust is the ability to recognize the cash flow of the underlying assets. Factors that influence the rental cash flow of the asset include the assessment of the viability of each rental market, the appropriate credit loss or vacancy factor, the lease structures, the assessment of property quality and the expenses associated with the upkeep and operation of the assets at a property and portfolio level.

## Concerns and Mitigating Factors

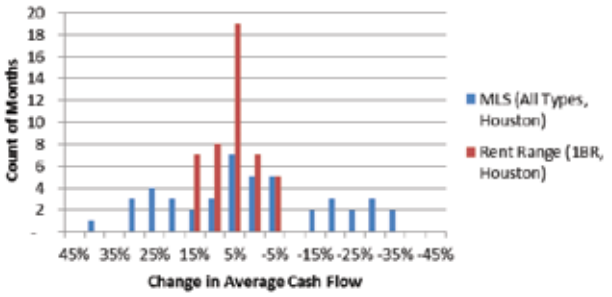
*Market vacancy & market rents*

There are many sources of market vacancy and rents, including a potential issuer's own holdings and the national housing surveys which look at rental vacancies nationally. The challenge for SFR is that market dynamics (in terms of vacancy and rental rates) contain block by block and neighborhood considerations. Many times rental rates can change drastically if you are on the wrong side of the street (and, potentially, in a different school district). This issue is being addressed by players who are now seeking to more closely monitor the SF rental space and have the knowledge to gather, scrub and analyze the data.

Corelogic is amalgamating public rental listing data to track rental rates, which is helpful. The multiple listing service (MLS) data can provide insight into how the asset class behaves, on average. However, drilling down into each neighborhood or block is problematic using MLS data for a variety of reasons. Many times the listings are simply not granular enough, lack data on concessions, or rely on data from properties that are not adequately comparable to each other. For this reason, market participants that are gathering, storing, cleaning and controlling raw data are adding clarity to the cash flow volatility of this property type. For example, Rentrange.com is using public, proprietary, and MLS data to track rental prices in these markets. The construction of appropriate comparable sets can yield substantially different results in terms of implied cash flow volatility, as seen in the chart below which compares raw listing data to cleaned Rent Range data.

*Chart 1*

**Change in Average Cash Flow (Houston, Q1 2009–Q2 2013)**



DBRS believes it is still too early to form an opinion on the resilience of rents and ongoing demand of the tenants. The data has only begun to be gathered on a systematic integrated basis in the recent past as institutional interest in SFR increased. It is therefore difficult to find clean data that predates 2009.

### Assessment of the Property Condition

Rented single-family homes allow more limited access for site visits than commercial properties, which may pose challenges for servicers or issuers that need to visit and assess the collateral. This concern could be mitigated somewhat by sampling both vacant and occupied homes to gain a qualitative sense of the markets and neighborhoods where the properties are located. Sampling the pool for inspection would be made easier by the fact that homes in SFR pools are often clustered locally in order to take advantage of leasing & maintenance practicalities and market research conducted by the issuer/borrower at the time of acquisition.

With multifamily, CMBS market participants get comfortable that there are third-party reports including an environmental and engineering report that will assess the condition of the asset — combined with annual servicer site visits and often a site visit by the investors. In the case of a portfolio of hundreds or thousands of homes, it is difficult and more often legally prohibited to gain access to a rented home without prior notice to the tenant and may not be practical for a third-party to perform additional independent verification of all of the assets in a timely fashion.

This concern can be mitigated if the issuing entity or servicing entity 'touches' each asset on a periodic basis. Visits to the property can be justified in order to perform regular maintenance such as changing the batteries in fire alarms, replacing the furnace filter, or other on-going maintenance tasks which permit an inspector to walk through and take stock of nearly every room in the house. DBRS believes that this could form the basis for the service site visit that the market has grown accustom to in CMBS to ensure that the quality of the assets are being maintained.

### Expenses

There have been strong and positive developments made toward making the management side of the equation efficient with call center technology and the outsourcing of maintenance and leasing agents.

Most of the homes require a level of renovation prior to being made available for rent. This is true not only for institutional players, but the "mom & pop" scenarios as well. Certain things are expected to be in the capital expenditure budget much like multifamily, such as new paint, repairs of deferred maintenance and replacement of damaged appliances. Unlike multifamily, SFR leases are structured such that renters are required or otherwise encouraged or incentivized to do some basic upkeep of the home like: mowing the lawn, shoveling the sidewalks and performing certain routine maintenance items. DBRS finds the "treat it like you own it" philosophy to be a very delicate balance for these landlords and believes it is more successful when renters are incentivized through rental concessions or through a cap placed on the rent which offsets the maintenance. In theory, by eliminating some common maintenance items typical in multifamily, this should help to keep the expense ratio lower than the multifamily equivalent.

In addition, bulk operators of SFR will have the advantage of vastly improved purchasing power with the major national home improvement chains that are amenable to providing discount pricing and integrated information technology and purchasing software. The economies of scale of centralized buying are significant.

But, in other ways SFR pools do not benefit from scale: SFR pools will have more HVAC units with limited useful lives, more washers & dryers (if provided), more roofs, more garages, etc. Those things will be more costly to replace because they are one per house as opposed to a multifamily property where some of those expenses can be spread across multiple units. Estimates for the cost of these items are untested. Many of the recent pools being contemplated for securitization have undergone significant recent renovation and refurbishment. They likely have new furnaces, refrigerators, ovens, washing machines, dishwashers, AC units, and other major appliances. The expense ratio experienced in the first 2 years of operation of a newly rehabbed SFR pool will certainly be different as the assets season and the end of the useful life of those appliances approaches. This concern can be overcome if operators have, or are partnered with, players who have deep experience, and who can provide a detailed maintenance budget that considers the depreciation of the major appliances and capital items — and includes these in underwriting.

With multifamily properties, as expenses rise rents will often follow suit, keeping an expense ratio of 45% on average. It has been untested as to whether or not rents can be as easily raised without effecting occupancy in the single-family rental space. It would appear to be a better value for a family to rent a single-family house than an apartment because of the price per square foot, but the real expense ratio of these properties is not something that has been historically tracked against institutional standards.

Of additional concern is the fact that expense ratios in single-family rentals are closely tied to the quality of the tenants. Tenants can create costly expenses without being aware that they are "trashing the place", just by virtue of being inconsiderate of the costs of home ownership and the savings of preventative maintenance. This concern is not unique to single-family rentals but, today, the quality of the SFR tenants has never been better and will arguably only deteriorate from here. Homeownership has reduced from historically high levels (70% in 2005) and is expected by John Burns consulting to trend downwards to 62.1% by 2015[3]. After which, a reversion to higher homeownership is expected as people who want to own a home but are forced to rent now, re-build their credit and save the necessary down payment. As the SFR space begins to lose its best tenants to homeownership, DBRS questions whether the expense ratio will increase as the quality of the renter decreases.

Other potential sources of expense ratio volatility (or stability) would include:

Real Estate Taxes: Probably the most influential expense to be considered due to its relative weight and also its fluctuation from asset to asset. Good neighborhoods and good school districts — one of the purported incentives of SFR, also experience high property tax rates that are likely to escalate each year. The benefit of course is that the taxes are a known, discoverable quantity and potential increases can be accounted for by careful underwriting practices.

Insurance: For large institutional players, insurance would likely be provided using a blanket policy assessment of the portfolio value. Again, a known quantity, that may also benefit from the economies of scale that pools of assets provide.

Utilities: Typically utilities are paid by the renter.

Management Fees: Can run as high as 10% in an inefficient market. Most of the institutional players assume management fees of 7-8% would attract a good replacement manager. Additional compensation in the form of leasing commissions could also be available. A survey of knowledgeable market participants suggests that the quality of the manager plays a critical role in managing other expense line items. Managers must have knowledge of the local market, by-laws, HOA restrictions, eviction procedures and other local administrative needs. SFR pools therefor need to balance the cost of having localized property managers with centralized reporting and control. Local managers must be properly incentivized to operate in the best interest of the securitized pool for the end benefit of investors.

As a result of the expense items noted above, DBRS would not be comfortable with expense ratios lower than the multifamily counterpart which averages 45% but could be as high as 55% on SFR pools.

### Operational Risk

As the securitization market for single-family rentals is untested, assessing operational risk is more important than it is with established product types. Rating analysts and investors need to be comfortable with the deal from an origination perspective as well as an ongoing administrative perspective.

In the case of single-family rentals, "origination" should more properly be called "investment", as asset aggregation is the process with the most operational risk if not done correctly from the on-set. Investment characteristics to consider when evaluating a single-family rental portfolio include the following:

- Asset sourcing methods and personnel
- Market and demographic analysis
- Property renovations and maintenance

### Asset Sourcing

Single-family rental product can be sourced in a number of ways. Banks, financial institutions and RMBS special servicers often have a large inventory of defaulted homes to dispose. Many times, the homes are listed with a realtor and sold individually. Occasionally, however, dispositions are accomplished through bulk sales, or the sales of multiple assets. In either case, it is important to consider the amount of due diligence the buyer can perform prior to sale. Individual purchases generally allow the buyer full access to the property. However, if the asset is being sold by auction, the buyer likely is allowed only limited access to the property, and may not fully understand its condition.

Bulk sales can provide the investor with multiple properties at once. If the seller is a servicer or a financial institution that is disposing of foreclosed properties, the homes could be in poor shape and require more renovations. An additional issue with bulk sales is that a buyer may be forced to "take the good with the bad" and purchase some less desirable properties in order to win the bid.

Ultimately, the experience of the SFR investor and its employees is a key consideration. Companies with established track records that hire staff with significant real estate experience over a long period of time are preferred. However, due to the relative newness of this market, even experienced companies are likely to only have

a few years of operating history. Therefore, the ability to respond locally and have the knowledge to make wise decisions would yield a number of questions for a potential issuer: Does the sponsor concentrate on certain markets? What demographic characteristics are considered? Is there a critical mass of properties to make the local operation cost effective?

Management of the army of contractors and sub-contractors required to get the properties in rent ready condition, with an acceptable level of quality, is also a challenge. Strong central management information systems integrated to local teams with remote technologies such as an IPad, can effectively mitigate the risks associated with quality control, by allowing managers to know what type of work is being performed, when and by whom. Furthermore, attention must be paid to the qualifications of the contractors and the experience of the manager who is overseeing them.

Ever since the construction industry imploded in the late 2000s the SFR issuers have had their pick of the best contractors the local markets had to offer. They have also enjoyed substantial bargaining power in negotiating the work that needed to be done in specific time budgets. With the return of the construction industry, the quality of available contractors is expected to decline, and the time budgets should extend.

### Post-closing Administration

The administration of SFR portfolios has many operational challenges. Operators need to strike a balance between local presence and centralized control. Local staff is necessary for the operator to ensure that properties are being properly maintained by the tenant. Also, local staff is necessary to handle the various maintenance issues that need attention, such as plumbing, HVAC, or broken appliances in a timely manner. Multifamily properties often have on-site maintenance staff to handle many of these types of issues. However, an operator of an SFR portfolio has to be able to provide maintenance and management services to a disparate group of properties throughout a city or region. As a result, staffing in this kind of model is challenging.

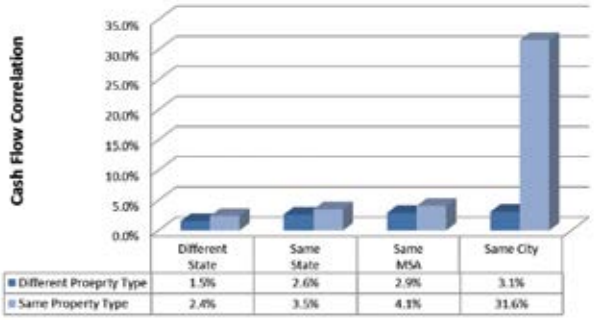
Large multifamily properties often have on-site management offices staffed with employees responsible for showing vacant apartments, screening potential tenants and reviewing rental applications and collecting rents. For SFR properties, this set up is not possible. SFR operators, therefore, must decide whether to maintain an in-house leasing staff or to hire outside brokers. While maintaining an in-house staff could lead to better operational controls, depending on the operator's local presence, it also may be more expensive.

### Losses and Workouts

Modeling loss severity in the event of delinquency would likely emulate the RMBS market which projects potential market value declines and has elements of distressed sales built into those declines. However, there are a number of important differences associated with the sector.

First, the pools are likely to be situated in the most distressed markets in the U.S. where the potential demand for home rentals would be the most significant and the credit of the renters the most damaged. Arizona, Florida, and California, for example, have significant concentrations of SFR. This concentration helps in terms of making operations more efficient, but it would hurt if there was a shock to a particular housing market. In addition, while it is almost impossible for issuers (purchasing thousands of homes) to adversely impact the national SFR market through their operations, it is possible for competing issuers to influence local markets by purchasing homes in specific areas, driving up the costs of renovation, management, and the homes themselves. Indeed many of the early entrants have stopped purchasing homes in the most common SFR markets, due to this saturation. Properties of a similar type that are clustered in different neighborhoods will likely display a high correlation in performance, increasing the risk to the bondholders within a securitized structure. Such movements can be observed in empirical CMBS data by examining correlation of cash flows across similar property types and geographic locations. For example, CMBS properties of a similar property type in the same city exhibit multiple times more correlation in annual cash flow (and ultimately value) than their peers. This same level of analysis for cash flow and asset level correlations at a granular level beyond the MSA must be completed for the residential housing market.

*Chart 2*
**CMBS Property Level Cash Flow Correlations**



Second, securitized SFR has a distinct first mover disadvantage as discussed below.

### The Exit

There is currently no long-term established private or public lender market that would provide a means by which a SFR loan could refinance through securitization. This may create a situation in which issuers look to pay down of the bonds through other means such as a REIT offering, portfolio sale or individual sale of the assets. Since, there is no precedent through which rating agencies would be able to quantify refinance probability of default for securitized SFR loans, this concern would need to be addressed in the structure of the securitized pool.

It is possible that a securitization could have structure in place that may rely on a transfer of the assets to a special servicer who would perform an orderly liquidation of the portfolio at maturity. However, a distressed sale of SFR assets would be tricky as there is a real risk of flooding particular markets with supply. As such, DBRS would expect value recovery results to be less than that of residential NPL collateral.

Alternatively the portfolio may also be structured in a way that it does not need to experience a forced sale of the assets upon maturity but instead maintains them as performing assets with a replacement operator and fast-pay amortization. This type of structure would need to rely on finding a replacement operator who could swiftly take over the operation of the assets, collect rents, and perform leasing and all of the required maintenance.

Given the sophistication of the management information systems necessary, the network of knowledgeable local operators required, the specialized central control needed to take advantage of the economies of scale, and the sensitivity of property level performance to management expertise; DBRS believes it would be problematic to switch operators. At the present time, there may not be enough third-party managers in the business to swiftly take on thousands of nationally diversified homes in a timely manner that would ensure no missed payments to bondholders. As such, the success of an SFR securitization may be as much tied to the quality of the operator as the real estate itself.

### Conclusion

Many companies have made a business out of buying REO homes unlevered, fixing them up and renting them. This has helped to reduce the inventory of properties that were flooding the market and allowed certain communities to avoid urban blight. Furthermore, investors have been able to make a profit by renting the house or, if that was not a viable option, selling the property at an attractive yield. Often, if the basis in the properties is low enough, one could say that a failed rental is still attractive with less downside because you could just sell it. However, as prices rise the opportunity for new acquisitions should wane because, with leverage, rents will likely not support the cash returns that the sector is expecting and the asset appreciation may not be as dramatic in the future.

Until now, this space has not been able to support the expense that comes with securitization, the cost of issuance and cost of debt. That may be for good reason. DBRS cannot be sure that securitization opportunities that are being contemplated today will be a viable option in the future for this asset class if they face a balloon refinance payment, or other traditional lenders emerge in this space. Portfolios that would need to rely on value appreciation in order to be economical, depend on a public offering, or future re-securitization in order to be profitable, would have risks that are challenging to quantify. Having said that, the proposed SFR securitizations are (in a broad sense) likely to be more stable than a typical Residential Non-Performing Loan transaction. Additionally, with the upfront cash investment in the properties, buyers can safely assume that the deferred maintenance that was present from the purchase has been remedied. However, there are still some concerns that the properties may be located in markets that are highly susceptible to NPL activity and therefore there may be additional value impacts when calculating subordination levels in a securitization. As a result, DBRS expects the first few SFR transactions to be viewed conservatively by the market and, if ultimately rated, that the ratings will reflect the lack of imperial data and the products uncertainties discussed in this report.

1 General Housing Data – All Housing Units (NATIONAL) more information 2011 American Housing Survey

2 General Housing Data – All Housing Units (NATIONAL) more information 2011 American Housing Survey

3 http://www.realestateconsulting.com/blog/wayne-yamano/homeownership-fall-8

# Bad Boy Guarantees Strictly Construed

**Michael Viscount, Esq.**
*Partner*
Fox Rothschild LLP

Real estate finance transactions typically involve non-recourse mortgage loans to single asset special purpose entities (SPEs). In these situations, the lender's recourse is limited to the mortgage property, rents, deposit accounts and other assets affixed to or derived from the operation of the property upon non-payment of the loan. Recent court decisions addressing the scope and extent of the liability limitations indicate that parties signing bad boy guarantees need to be very clear and detailed in the documents supporting the agreement so as not to be caught off guard by the exposure they will undertake.

The owners of the SPE/borrower are not personally liable for the non-recourse loan, unless the lender required the execution of a non-recourse carve-out guaranty, commonly referred to as a "bad boy" guaranty. The owners who sign these guarantees agree to repayment obligations in the event of specified acts or violations of the loan documents. Courts in recent decisions out of various states have strictly construe bad boy guarantees to impose liability for the entire loan balance irrespective of the nature of the damages to the lender arising from the breach.

The case of *Princeton Park Corporate Center v. SB Rental I,* 410 N.J. Super 114 (App. Div. 2009) is illustrative. Here, the mortgage loan documents executed in 2001 prohibited secondary financing without approval by the mortgage lender. A subordinate loan was obtained in 2004 without the lender's knowledge or approval, and it was paid off in just seven months. Nonetheless, when the first mortgage loan went into default in 2006, the lender foreclosed and immediately thereafter sued the signers of the bad boy guaranty for the full deficiency of $5 million.

The lender won at both the trial court and on appeal. The appeals court held that even though the lender was not actually damaged by the second lien loan (that had been paid off before the default), the absence of direct damages was not relevant.

In this regard, the court stated, "[h]aving freely and knowingly negotiated for the benefit of avoiding recourse liability generally, and agreeing to the burden of full recourse liability in certain specific circumstances, defendants may not now escape the benefit of their bargain."

The obligors in the Princeton Park case did not contest the foreclosure action, but in the separate suit to enforce the carve-out guaranty they did defend with the argument that the lender was not harmed at all by the subordinate loan that was repaid in full before the default. The defendants asserted that the carve-out clause was a liquidated damages provision and that to allow the lender to recover under such circumstances would effect a penalty that should be unenforceable as a matter of law. The New Jersey courts, at both the trial and appellate levels disagreed. At the appellate level, the Court observed that the clause at issue was "not a liquidated damages provision," that it operated "principally to define the terms and conditions of personal liability, and not to affix probable damages," and that it did not matter that the obligors "eventually cured the breach … and that no harm accrued to the plaintiff as a result thereof." Id., 410 N.J. Super at 121-123. What did matter to the New Jersey courts was that the carve-out was sought by the lender to afford some special protection in the otherwise non-recourse context, and that the carve-out provision was "freely and knowingly" agreed to by the obligors in return for the benefit of avoiding recourse liability generally. Id at 124.

Another example — this one from Michigan — is *Wells Fargo Bank v. Cherryland Mall, 812 N.W. 2d 799* (Mich.Ct.App. 2011), where both the trial and appellate courts found the non-recourse carve-out guarantor liable for the full deficiency after the SPE/borrower became insolvent in violation of the loan covenant requiring that the SPE remain able at all times to pay its debts and liabilities from its assets as the same became due. The Court of Appeals in Michigan characterized the solvency covenant as one of the "Separateness Covenants" customarily included within the recourse triggers under typical CMBS non-recourse transactions involving an SPE as this one was. The operative covenant of the Note read as follows:

> Notwithstanding anything to the contrary in this Note or any of the Loan Documents, … the Debt shall be fully recourse to Borrower in the event that … Borrower fails to maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of the Mortgage….

*Id.,* 812 N.W. at 806. The operative covenant of the Mortgage read as follows:

> Mortgagor is and will remain solvent and Mortgagor will pay its debts and liabilities including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due.

*Id.* at 808.

As was the case in New Jersey, the Michigan courts in Cherryland strictly applied what they found to be unambiguous provisions of the loan documents even where the obligated party argued against enforcement on equitable grounds to avoid a windfall or the imposition of a penalty. In so doing, the appeals court in Michigan observed:

> the documents at issue appear to be fairly standardized nationwide, and defendants elected to take that risk — as did many other businesses in Michigan and nationwide. It is not the job of this Court to save litigants from their bad bargains or their failure to read and understand the terms of a contract. (citation omitted).

*Id.*

**"Courts will strictly construe unambiguous text, making for a potentially unexpected and unsettling result for the non-recourse carve-out guarantor."**

The lesson here is that parties signing bad boy guarantees need to be very clear about the extent of the exposure they will undertake. If the intent is to limit the lender's recovery to the extent of damages actually realized, or to place other limits on enforceability of the carve-out provisions, the documents need to be specific in that regard. In New Jersey, Michigan and elsewhere, the courts will strictly construe unambiguous text, making for a potentially unexpected and unsettling result for the non-recourse carve-out guarantor.

# U.S. Conduit CMBS Update: Credit Metrics Were Stable in Third-Quarter 2013, but Transactions Remain Riskier Year-Over-Year


**James M. Manzi, CFA**
*Senior Director–SF Global Research*
Standard & Poor's Ratings Services

**James C. Digney**
*Senior Director–CMBS*
Standard & Poor's Ratings Services

**Kurt C. Pollem, CFA**
*Senior Director–CMBS*
Standard & Poor's Ratings Services


While average credit metrics such as leverage, deal diversity, and percentage of IO loans were generally stable thus far in third-quarter 2013 conduit deals on a quarter-over-quarter basis, we believe both Q2 and Q3 2013 transactions are riskier than last year's. Further, we believe slipping loan standards in 2013 will translate to higher eventual loss rates versus 2012 and other recent vintages. Overall, risks appear contained versus peak issuance years, but in our view certain recent conduit transactions include some loans with characteristics prevalent in the 2006-2007 vintages.

Third-quarter 2013 trends thus far include increasing residential assets as a percentage of pool balance and a growing number of B-piece buyers. The limited return of pro forma underwriting (a common practice in peak issuance years) has continued, although it has mostly been constrained to single borrower transactions thus far. In addition, cash management provisions have continued to gradually weaken, and loosened recourse provisions combined with large cash-out refinancings are a risk for CMBS investors that we believe bears watching.

### Borrower Leverage Remained Stable, While IO Loans Decreased Slightly

Borrower leverage was mostly unchanged versus the second quarter, but increased several percentage points compared with 2012 levels. The percentage of IO loans actually fell slightly in the third quarter on a quarter-over-quarter basis, but still represent about half of the deal pools by balance, versus one-third last year. While average concentrations by loan size (as measured by the Herfindahl-Hirschmann Index) are basically unchanged versus last quarter and 2012, third-quarter transactions contain modestly higher deal-by-deal variance in the number of effective loans (see table 1).

*Table 1*
**Conduit CMBS Transactions Third-Quarter 2013**

| Deal | S&P expected LTV (%) | Moody's stressed LTV (%) | Fitch stressed LTV (%) | 'AAA' C/E (%) | 'BBB-' C/E (%)^ | IO full/partial (%) | Effective loan count/Herf Index |
|---|---|---|---|---|---|---|---|
| GSMS 2013-GCJ14 | NA | 102.5 | NA | 22 | 6.75 | 19-Dec | 25 |
| WFRBS 2013-C15 | NA | 97.6 | 96.6 | 22.75 | 6.5 | 13/40 | 23 |
| JPMBB 2013-C14 | NA | 103.3 | 99.8 | 23 | 7.75 | 23-Nov | 21 |
| MSBAM 2013-C11 | NA | 101.7 | 101.8 | 24.25 | 7.5 | 0/46 | 16 |
| COMM 2013-CCRE10 | NA | 97.5 | NA | 20.125 | 6.625 | 16/23 | 29 |
| GSMS 2013-GC13 | NA | NA | 101.8 | 22.625 | 6.5 | 26/25 | 19 |
| WFCM 2013-LC12 | NA | 101.8 | 103.6 | 21.75 | 6.75 | 14/47 | 27 |
| COMM 2013-CCRE9* | 82.5 | NA | 97.9 | 20.125 | 6.5 | 18/37 | 35 |

*Several recent deals had rating splits at the 'BBB' rating category. §Rated by Standard & Poor's. Sources: Standard & Poor's, Trepp, and the presale reports from the respective rating agencies. LTV—Loan-to-value. C/E—Credit enhancement. IO—Interest only. Herf Index—Herfindahl-Hirschmann Index. N/A—Not applicable.

### Property Mix: Residential and Industrial Assets Are on the Rise, While Lodging and Retail Have Stayed Steady

*Residential assets increased in the third quarter*

Residential assets, such as apartments and manufactured housing, have climbed to nearly 20% of third-quarter pools, up from 14% in the second quarter and 10% last year. Manufactured housing alone increased to 8% so far this quarter, versus 3% last year. We expect that multifamily compositions will remain elevated if Freddie Mac and Fannie Mae's participation rate in the sector continues to decrease, which should increase competition among conduit lenders attempting to gain market share as they try to fill the financing gap (see table 2).

*Table 2*
**Changing Property Type Mix**

| Deal | Retail (%) | Office (%) | Lodging (%) | Multifamily (%) | Manufactured Housing (%) | Industrial (%) |
|---|---|---|---|---|---|---|
| GSMS 2013-GCJ14 | 21 | 24 | 19 | 16 | 10 | 0 |
| WFRBS 2013-C15 | 38 | 16 | 18 | 15 | 3 | 0 |
| JPMBB 2013-C14 | 43 | 12 | 15 | 2 | 3 | 11 |
| MSBAM 2013-C11 | 32 | 13 | 25 | 7 | 8 | 5 |
| COMM 2013-CCRE10 | 18 | 28 | 14 | 12 | 13 | 6 |
| GSMS 2013-GC13 | 28 | 35 | 8 | 16 | 3 | 2 |
| WFCM 2013-LC12 | 40 | 22 | 12 | 6 | 13 | 0 |
| COMM 2013-CCRE9* | 37 | 6 | 10 | 13 | 10 | 13 |
| | | | | | | |
| **3Q 2013 Average** | 32 | 20 | 15 | 11 | 8 | 5 |
| **2Q 2013 Average** | 31 | 22 | 15 | 9 | 5 | 3 |
| **2012 Average** | 36 | 26 | 13 | 7 | 3 | 5 |

*Rated by Standard & Poor's. Source: Trepp.

Nationally, apartment performance has improved since the downturn, though rental growth has begun to slow somewhat; CB Richard Ellis Econometric Advisors projected 2.2% rent inflation in 2013 (as of the first quarter), versus a 4.2% gain in 2012 and nearly 5% growth in 2011. At the same time, apartment properties in most markets are trading at all-time-low market capitalization rates and at a wider margin versus rating agency capitalization rates. This creates the potential for a repeat performance for those properties securitized during the last credit cycle (at the end of second-quarter 2013, Standard & Poor's multifamily CMBS delinquency rate was the highest of the five main property types at 11.25%). In addition, certain recent conduit transactions include some loans with higher rating agency LTVs made to apartment owners who over the past several years either defaulted on loans, filed for bankruptcy, or both.

*Lodging exposures remained elevated*

At 15%, lodging collateral exposure thus far in 2013 is higher than the 9% concentration in all outstanding conduit deals. But despite relatively strong performance in the lodging sector, we consider hotel properties to be a riskier property type due to nightly room re-pricing as opposed to the long-term leases that characterize office, retail, and industrial assets.

National revenue per available room (RevPAR) continues to rise, but has slowed in recent months. According to Smith Travel Research, national RevPAR in first-half 2013 advanced 5.6%, although May (+5%), June (+3%), and the first 28 days of July (+4%) displayed modestly weaker growth compared with earlier this year. Weak consumer spending is a potential headwind for the sector, while low supply is a positive. Hotel construction remains constrained in most markets, although one exception is New York City.

Looking through credit cycles, our analysis considers whether the general trend in lodging performance to date through 2013 is sustainable. A drop in RevPAR can quickly stress a lodging property's net cash flow and ability to cover debt service when it's also burdened by relatively high fixed expenses. Consequently, to the extent that RevPAR appears to be outpacing historic growth rates and prior peak levels, we may use a RevPAR number that is lower than the most recent performance in our analysis.

*Retail assets are still the most popular*

Although retail concentration fell slightly versus 2012 vintage deals, it still remains the most popular asset class in conduit CMBS this year (32% of pools by balance). It is a positive sign that retail sales have increased over the past four months, although many large retailers have reduced their full year sales growth forecasts based on weak consumer spending. Top malls in primary locations continue to outperform secondary locations and smaller properties.

E-Commerce growth is a medium- to long-term challenge for traditional brick-and-mortar retail--the U.S. Census Department reported that online sales grew 18% year-over-year during second-quarter 2013, more than four times the rate of non-auto overall retail sales, albeit from a smaller base. The debate also continues as to consumers' preference for the ease and convenience of online shopping, versus visiting "destination" or "needs-based"

retail locations. The traditional mall model appears to be changing in favor of a more all-encompassing shopping and entertainment experience that includes more sit-down dining options as well as traditional grocery stores and even fitness clubs. Some older malls have seen vacated anchor spaces filled by Targets, Wal-Marts, and Costcos.

*Industrial demand has been buoyed by e-commerce*

E-Commerce has been a boon to industrial space demand, as retailers require fulfillment centers in key locations to ensure speedy delivery to their customers. Prologis, the world's largest industrial property landlord, recently reported via the Financial Times that average warehouse rents climbed 4% year-over-year in second-quarter 2013, marking the second consecutive quarter of growth. One potential risk though is speculative development in certain locations. According to a recent analysis by Cushman & Wakefield, 70% of warehouses currently under construction in Southern California's Inland Empire do not yet have tenants.

*B-piece buyers went up to 11*

The total estimated par size of 2013 B-pieces is now about $2.4 billion, compared with $2.2 billion last year and $6 billion in 2007, according to Commercial Mortgage Alert data aggregated by Standard & Poor's. Cerberus Capital Management recently became the 11th B-piece buyer this year, nearly matching the dozen buyers during the peak years and surpassing last year's eight. Eightfold Real Estate Capital, Rialto Capital Management, and LNR Partners remain the most active buyers, accounting for about 65% of purchases by deal count, although their combined share has fallen from earlier in the year, reflecting a more diverse buyer base (see chart 1).

*Chart 1*
**Top Three B-Piece Buyers' Market Share***

| | Top 3 Market Share |
|---|---|
| Jan | 100% |
| Feb | 86% |
| Mar | 78% |
| Apr | 79% |
| May | 76% |
| Jun | 76% |
| Jul | 71% |
| Aug | 64% |

Sources: Commercial Mortgage Alert, S&P. Data points are based on month-end figures.

Market participants generally associate a higher number of B-piece buyers with higher credit risk, as more competition lowers buyers' ability to kick-out potentially weaker assets from a pool. In addition, all else being equal, the more B-piece buyers in the sector, the higher the total issuance capacity, and we've found that higher annual issuance is positively correlated to a higher vintage loss rate. That said, annual issuance is still just a fraction of 2007's $230 billion, and the marginal credit impact from each additional new B-piece buyer is likely small at the current levels. Another important aspect of today's B-piece market is that participants appear genuinely focused on the potential credit risks they are exposed to for the entire life of the bonds they hold. This contrasts to the last credit cycle when B-piece buyers were offloading much of that risk by bundling securities and selling them in collateralized debt obligations. Lack of investor appetite, scrutiny from credit rating agencies, and new risk-retention rules are likely to limit a repeat of this strategy.

## Other Trends We're Watching

*Lease rollover assumptions and partial IOs highlight limited pro forma underwriting*

The practice of including upside potential in property-level cash flows and values remains limited, but does still occur, albeit mostly in single borrower deals. In some recent examples, tenants who currently pay below market rents are assumed to re-sign at market levels (or give way to a tenant who will pay market levels) at future lease rollover dates, leading to a higher cash flow assumption. We believe in-place cash flows and sustainable vacancy assumptions are more appropriate for commercial real estate analysis, especially for debt investors, who typically don't participate directly in property-level upside. Pro forma analysis leaves CMBS investors more vulnerable to adverse performance.

Another loan structuring practice associated with pro forma analysis also appears to be making a comeback: the partial IO term. Anticipating rent growth, borrowers and lenders are agreeing to IO periods lasting up to half the loan term. The initial DSC might be moderate, but by the time amortization kicks in, the idea is that the property's net cash flow will increase to support the higher debt service burden. However, there are many cases of loans with partial IO periods securitized between 2005 and 2007 where the upside rent assumptions didn't occur (rents and occupancy dropped), leading to defaults.

*Borrowers and lenders have adjusted to rising interest rates so far*

Since reaching a low of 1.63% on May 2, the yield on the 10-year U.S. Treasury is up over 100 basis points. Rising interest rates may lead to higher capitalization rates, depending on the prevailing risk-premium (the yield spread between commercial real estate investments and the "risk-free" Treasury yield), potentially decreasing property valuations. A potential offset occurs when gradually rising interest rates result from stronger economic growth, causing increased demand for commercial real estate, which in turn leads to higher rental rates and property values. A rapid increase in rates can lead to lower CMBS loan origination volume, as we saw earlier this summer, as the uncertainty causes lenders to pull back (until rates show signs of stabilizing) and CMBS buyers to demand wider spreads. Borrowers and lenders appear to have adjusted fairly quickly this time, however, as market observers expect a number of conduit transactions to price in September.

*Cash-out refinancing combined with limited borrower recourse increases risk*

In our June update, we highlighted several cases where non-recourse carve-outs for certain "bad-boy" acts (such as fraud and voluntary bankruptcy filing) had decreased. However, in these cases (Irvine Core Office Trust 2013-IRV and Wells Fargo Commercial Mortgage Trust 2013-120B, both Standard & Poor's-rated), there were mitigating factors: the borrowers generally owned and managed the properties for a long period of time, and the first mortgage debt exhibited a low LTV with limitations on additional debt, leaving significant remaining equity tied up in the asset values.

Though long-term institutional ownership and low loan leverage might be considered to mitigate softer non-recourse carve-out guarantor provisions, we believe this growing trend should be scrutinized. For example, in some recent transactions, large private equity funds are taking a significant amount of cash equity out of a property as part of a refinancing and also limiting borrower recourse provisions. We believe these situations merit closer examination from investors and rating agencies.

*Loan cash management provisions have gradually weakened*

Loan cash management provisions continue to weaken as compared to 2011 and 2012 transactions. Ongoing reserves for real estate taxes, insurance, and capital expenditure items are becoming less common in favor of DSC or debt yield-based reserve trap triggers. Moreover, some of these performance-based cash flow trigger thresholds may not necessarily be capturing all additional property net cash flow, which can prove to be a powerful incentive for borrowers to cooperate during a loan workout situation. Cash trap trigger thresholds also appear to be trending lower relative to a property's in-place net cash flow, and sometimes don't apply until DSC drops below 1.0x.

*Pari passu structures are likely here to stay*

To increase deal diversity, certain larger loans may continue to be divided among several deals using pari passu structures. A recent example is 11 West 42nd Street, an office building in midtown Manhattan, which was securitized in GSMS 2013-GC13 and GSMS 2013-GCJ14. In our opinion, pari passu loan structures may lead to more complex workouts in the event of default. The reemergence of pari passu structures for larger loans of at least $100 million has likely been driven by less investor demand for stand-alone transactions, but also general market acceptance of those loans being sliced up and included in multiple conduit/fusion pools. Moreover, market values and rating agency LTVs have been increasing for some large assets, 11 West 42nd Street being such a case. Higher rating agency leverage typically makes these loans more ideal for conduit/fusion execution. Market liquidity and consistent deal flow have probably also eased issuers' concern with holding pari passu pieces on their balance sheets longer than they would like.

## Overall Risks Are Lower Relative to Peak Years, but Some Loans Are Trending Down a Similar Path

We believe conduit credit risk stabilized versus Q2 2013, but remains higher than in 2012. At this point, we are not seeing the same levels of overall risk in underwriting and borrower behavior that were prevalent in 2006-2007. Nevertheless, we believe some recent conduit transactions include some loans with characteristics prevalent in the 2006-2007 vintages. Therefore, we will continue to monitor the deals we rate for these continuing signs of declining loan and pool quality that could eventually lead to higher defaults and losses.

## Related Criteria and Research

- Risks Increase In 2013 Vintage U.S. Conduit CMBS, June 10, 2013


CRE FINANCE COUNCIL JANUARY 13–15, 2014
2014
JANUARY CONFERENCE
FONTAINEBLEAU HOTEL, MIAMI BEACH, FLORIDA
REGISTRATION NOW OPEN
WWW.CREFC.ORG
CRE Finance Council®
The Voice of Commercial Real Estate Finance
CELEBRATING 20 YEARS AS THE VOICE OF CRE FINANCE
20
1994
2014

# Forum Spotlight: High Yield and Distressed Realty Assets Forum (HYDRA)

**Kevin Donahue**
C-III Capital Partners
*Forum Chair*

At the June 2013 CREFC Annual Conference the forum previously known as High Yield Debt and Investment Forum was renamed "High Yield and Distressed Realty Assets Forum" or HYDRA (a nod to the "dark side" of Greek mythology that seemed appropriate). Bill O'Connor of Thompson & Knight and the outgoing chair then announced that the forum would be split into two sub-forums:

**High Yield:**

Chair – Greta Guggenheim, Ladder Capital Finance
Chair Elect – Nik Chillar, Union Bank

**Distressed Realty Assets:**

Chair – Kevin Donahue, C-III Capital Partners
Chair Elect – John D'Amico, Trimont Real Estate Advisors

The forum met during the June Annual Conference and had a very spirited and interactive discussion amongst its membership, led by Bill O'Connor. Topics included: performance of modified loans, special servicing resolutions continuing to exceed new asset transfers, aggressiveness of new issue underwriting, where are the distressed debt buying opportunities (supply and pricing), FDIC loss sharing, trends in the mezzanine and B-note market, the insatiable pursuit of yield and other related topics.

The most hotly debated topics centered on the belief that the next bubble may already be in its formative stages as well as the "elephant in the room," which is rising interest rates. In the month prior to the Conference the benchmark 10-year treasury rate had increased by 56-basis points and since that time has climbed another 78 basis points to almost 3% or an 80% increase from the low water mark achieved in May 2013. The rising interest rate environment will have a dramatic impact on legacy CMBS assets approaching maturity, new issuance, asset valuation and cap rates.

HYDRA will continue in 2013/14 to focus on relevant topics for our constituency and will reach out to other CREFC forums to interact on topics of mutual interest and concern. We are working closely with the broader CREFC organization and focusing on the new risk retention rules being debated, issues around greater transparency and disclosure, regulatory constraints (FASB, SEC, CFPB, etc.), PSA changes, underwriting standards and others areas of mutual concern. HYDRA is also committed to providing venues to our members that will facilitate discussion around topics of interest and do so in a more geographically diverse way so that more of our constituent base is served. Some of these upcoming events include:

- HYDRA Reception in Conjunction with the Trigild Lenders Conference in San Diego
- Forum Meeting and Panel discussion at CREF Investors Conference in January 2014. Location, time and topics TBA
- Roundtable discussion in San Francisco in early 2014 with date TBD
- HYDRA Summit East: March 12-13, 2014 at the New York Athletic Club in NYC
- HYDRA Summit West: May 13-14, 2014 at the Fairmont Miramar in Santa Monica CA

The leadership of HYDRA is committed to presenting interesting venues, topics and events in order to broaden the reach of the Forum and provide a platform to share information and foster enhanced understanding and cooperation among our members. We will reach out to you as more events are announced as well as to seek your input and guidance on topics of concern or relevance. If anyone wishes to participate, propose events or suggest topics feel free to contact any of the respective chairs or chair-elects of the two sub-forums. As you know, HYDRA was a multi-headed mythological beast so more voices are always needed.

# Forum Spotlight: Investment Grade Bondholders Sub-Forum

**Adam Hayden**
New York Life Real Estate Investors
*Sub-Forum Chair*

Over the course of the past year, the Investment Grade Bondholders Sub-Forum partnered with CRE Finance Council to oversee the creation and adoption of a set of transparency reporting templates used by special servicers to document the actions and results of modifying or liquidating delinquent loans. These templates provide an amount of transparency heretofore unavailable with regard to special servicing practices. The data and information revealed in them has found a welcome reception among investors and research analysts alike. In addition, these templates are useful and easy to find on third-party websites.

In the second half of 2013, the sub-forum has focused on providing feedback to the Dodd-Frank Risk Retention Re-Proposal released in September 2013. The broad measures in the re-proposal were generally well-received. However, members of the sub-forum look forward to suggesting improvements to the several subject areas within the re-proposed regulations including the proposed features of the B-buyer, the role of the Operating Advisor, change of control thresholds and the impact of risk retention on single asset/single borrower transactions.

Over the remainder of 2013, the sub-forum aims to complete a suggested "Best Practice" term sheet for conduit transactions. The goal of which is to identify elements of an idealized term sheet that issuers can draw from. The sub-forum will highlight certain term sheet features that are most popular while suggesting improvements that will strive to maximize the utility of this important marketing document. It is imperative that investors unite and ask for this necessary enhancement. Better information that provides increased transparency will be critically important to an enduring recovery of the CMBS market.

The Investment Grade Bondholders Sub-Forum contains more than 100 members from firms across the investment management community. Investment grade bondholders represent over 90% of the capital structure of a typical conduit transaction. The forum hosts semi-annual roundtable meetings at the CREFC conferences as well as semi-annual After-Work Seminars. The sub-forum seeks to change detrimental market practices and encourage beneficial market practices that promote the long term health and vibrancy of the CRE capital markets from the perspective of investment grade investors.

# Forum Spotlight: Portfolio Lenders Forum and the Insurance Company and Bank Sub-Forum

**Greg Michaud**
ING Investment Management ,
*Chair of Portfolio Lenders Forum, Insurance Company Sub-Forum*

**Greg Murphy**
Natixis Real Estate Capital
*Chair of the Portfolio Lenders Forum, Bank Sub-Forum*

The mission of the Insurance Company and Bank Portfolio Lender Sub-Forum(s) has been to add value to its constituent through representation on regulatory matters, assistance in managing perceptions of the rating agencies, promotion of best lending and portfolio management practices and to provide an open environment for lenders to share thoughts and ideas. The forum's overriding goal is to provide support and access to best practices for its member. Finally, as there is continued change in the market with various regulations be implemented or soon to be implemented, this forum is one of the few industry groups focused on bank and insurance company issues.

The leadership team of the sub-forum(s) continues to seek increased involvement of portfolio lenders, both insurance companies and banks, in order to provide a broad perspective across the entire commercial real estate finance industry. With banks and insurance companies holding nearly 50% of the outstanding debt on commercial real estate in the United States, CREFC is significantly underweight in these categories relative to the role that they play in the industry.

The sub-forum(s) have been active on all fronts in 2013 with the following schedule of events.

### After-Work Seminar

The forum will be hosting two after work seminars the last quarter, one in Atlanta and one in New York City. The first seminar is scheduled for October 22nd in Atlanta. This seminar will include a capital markets discussion from a leading research who will discuss the commercial real estate capital markets. Following this presentation there will be two panel discussions, one comprised of life insurance companies and the second comprised of banks. The individual panels will each articulate their "sweet" spot and how to get a deal done with them. Each panel will represent banks and life insurance companies of various size and loan appetites.

The second after work seminar will be held in November (exact date to be determined) in New York City. There will be a panel discussion focused on loan syndication and club lending. Several banks and a life insurance company will discuss current topics involving the aforementioned topics. Both should prove to be very topical. Borrowers and brokers will get insight to both life companies and bank lending while lenders will get an insight to current best practices.

### Forum Membership Report

Membership in the Portfolio Lenders Forum (Insurance Company and Bank Sub-Forums) stands at over 120 individuals representing over 50 companies and we hope to continue advances in these numbers throughout the remainder of 2013.

talmage

COMMERCIAL REAL ESTATE INVESTMENTS SPECIAL SERVICING ADVISORY

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 and acted as the Special Servicer/Advisor on over $40 billion of transactions. Put our market reach, research and investment and advisory teams to work for you.

**Investment Management:**

- Closed-End Accounts
- Customized Separate Accounts
- Open-Ended Accounts
- CDO Management

**Large Loan Special Servicing**

**Special Situation Advisory**

Talmage. Let our experience work for you.

Talmage, LLC 430 Park Avenue New York, New York 10022 212.209.1388 talmagellc.com