Taking Chances: Managing Risk in the Commercial Mortgage-Backed Securities Market

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Bill Chalker: *Welcome to the Federal Reserve Bank of Atlanta's* Perspectives on Real Estate *podcast series. I'm Bill Chalker with the Federal Reserve Bank of Atlanta.*

Today, we're talking with Sally Gordon, managing director at BlackRock Inc., the world's largest asset management company. At BlackRock, Sally has primary responsibility for managing commercial real estate risk across a variety of debt and equity investment vehicles. We've invited Sally to discuss some of the issues and changes in the commercial mortgage-backed securities market that resulted from the recent crisis and what we should expect going forward.

Sally, thank you for joining me today.

Sally Gordon: Well, thanks for inviting me. I'm pleased to be here.

Chalker*: Sally, before we get into some of the really specific issues, could you tell us, what is a commercial mortgage-backed security and...;how does it work?*

Gordon: Well, to start with sort of [a] short definition, a CMBS, or commercial mortgage-backed security, is a bond-like investment security that's backed by commercial mortgage loans that are secured by income-producing commercial real estate, such as apartments and office buildings. Institutional investors—such as money managers, pension funds, banks, and mutual funds—are the major buyers. They like CMBS because they can usually get a return that is a bit higher than other, similarly rated securities.

From the borrower's point of view, there are both advantages and disadvantages. The major advantage for the borrower is that, at least historically, a CMBS loan would be cheaper. The disadvantage for the borrower is that a CMBS loan, or a capital markets loan, typically has somewhat less flexibility than one from a bank or life company. The two sides of this—[that it's] cheaper but [has] less flexible capital—echo the fact that CMBS has to serve both commercial real estate borrowers and investors.

Chalker: *What were the effects of the financial crisis on CMBS?*

Gordon: Well, in 2008, CMBS spreads widened enormously, which means that the prices of the bonds fell a lot, as did all other asset classes. To provide some scale, in early 2008, triple-A CMBS spreads were at 100 basis points over swap spreads, but they'd widened dramatically in September of that year to 1,350 basis points, a huge run-up. It's fair to remember that a particularly crippling aspect of the financial crisis wasn't just prices falling, it was also illiquidity, and liquidity is virtually the lifeblood of a modern economy.

The result of this illiquidity was that the CMBS new-issue market virtually seized up. We have gone from issuing volume on the order of $230 billion in 2007 to less than $3 billion in 2009, and only $9 billion in 2010. People are expecting $35 to $50 billion this year, but that's still a far cry from the solid days.

As the market is starting to come back to life, albeit in a slightly different form, the new and improved version of CMBS is commonly referred to as CMBS 2.0, after technology releases. While there are many aspects of the underwriting of the loans and the arrangements for the bonds that are more conservative than in the precrisis CMBS, we are already seeing some erosion of standards from the most conservative days. In other words, risk is already creeping back into the system, but we're not seeing the kind of runaway risk that prevailed in 2007.

Chalker: *We've been hearing a lot about the large volume of maturities of the CRE loans underlying the CMBS. What is that all about and how's the market handling this large amount?*

Gordon: Well, many properties are worth less than they were a few years ago, or more importantly, less than when a previous loan was taken out on a particular property. More to the point, the properties are worth less than the loans that have to be refinanced, whether those loans are from a bank or a CMBS deal. For those maturing loans that are underwater, the funding gap has to be addressed somehow for the loan to be refinanced. For one thing, the borrower can just take a loss and pony up more equity, refinancing a smaller loan than the one that might have to have been rolled over, and it's fair to remember that this risk of loss in value belongs to equity, not debt.

A lot of maturing CMBS loans in the last year or so have been simply extended on the same or similar terms as the origination, but with some $500 billion maturing between now and 2017, that can't realistically continue. Not all borrowers will be willing or able to add more equity and

will therefore relinquish their properties to their lenders. As a result, I can't see how some banks aren't going to suffer more losses as they write down these loans.

However, in the funding gap department, as in many areas, one person's loss or challenge is another person's opportunity. For example, this funding gap creates openings for a flow of mezzanine capital, even if on what's casually called a "loan-to-own" basis. That's the phrase that some mezz-debt investors use when they wouldn't mind if the loan defaulted, or even hope that the loan will default, because they want to own the asset. They figure that they win either way— they get a premium loan coupon because they're providing a riskier form of debt, or they get an asset that they had already decided they would be happy to own.

Chalker: *Let's turn for a minute to financial reform. Is there anything in the new legislation that's coming out that causes you any concern?*

Gordon: Well, with regard to the recently proposed particulars for risk retention, in my view, most of these proposals are unlikely to sink the market, although some in the industry feel differently. Instead, I think it's rather more likely that the market will adjust to a different environment, assuming that the financial regulations are approximately as proposed so far.

You've probably all seen the movie *Jurassic Park*, and perhaps recall the mathematician. He was very, very skeptical of the experiment of genetically reengineering dinosaurs, all of whom were supposedly of the same gender. He kept shaking his head, saying, "Nature will find a way. Nature will find a way." Well, so, too, the financial markets will find a way. After all, CMBS was invented to solve another, similar problem: how to allocate capital efficiently following the collapse of the savings and loan industry, which had provided capital to more garden variety commercial real estate loans before withdrawing from the market.

In short—no, I don't think that the sky is falling, as some in the industry do, but the retention requirement will increase the cost of financing commercial real estate through the CMBS market, and if some market participants—maybe even most market participants, including borrowers and issuers and investors—find it to be a less profitable product than before, we are almost certainly expected to experience some unintended consequences.

Chalker: *As a risk manager, is there anything out there overall, with all this change, that you think participants in the CRE capital markets, including the investors, should be aware of going forward?*

Gordon: Well, let me take that in two parts—one, talking about the future of commercial mortgage-backed securities, and the other, the future of commercial real estate itself. On the CMBS side, one of the largest concerns is that the market facilitates appropriate risk-adjusted pricing, or at least that the market doesn't impede it. Returning to the department of unintended consequences, one thing to keep in mind is that the volume of CMBS outstanding is actually shrinking as loans mature, or are paid off, or default and then are resolved. The best estimate is that over the last year about $50 billion of CMBS have left the universe. So, if issuance this year is on the order of $40 to $50 billion, then the volume of CMBS outstanding will be flat to down slightly. In other words, delinquencies, pay-downs, maturities decrease the outstanding value at about the same rate as new securities are created. And that's actually a troubling prospect, because a flat to shrinking market in the face of continued investor demand, or interest, increases the odds of mispricing the risk in the asset class, and when risk is mispriced on a large scale, history tells us that bad things can happen.

On the commercial real estate side, with regard to the underlying assets, the tremendous amount of underwater loans that are maturing over the next several years is going to make it difficult for real estate to see valuation increases. We could see a return to valuing the income-producing aspect of commercial real estate with less importance placed on the future value, or reversionary value. It's always been difficult to make that future value estimation, not only because of uncertainty about the cash flow, but also because of uncertainty of how one might value that cash flow at some future time. In other words, what will the cap rate or capital market environment be like at that future time? That could make commercial real estate a more annuity-like investment. Might sound boring, perhaps, but sometimes boring is good.

Chalker: *Well, thank you, Sally, for joining us today.*

Gordon: Well, thank you. It was my pleasure, and thank you for inviting me.

Chalker: *This concludes our conversation today with Sally Gordon, managing director at BlackRock Inc. For more podcasts on this topic and others, visit the Fed's website at frbatlanta.org. If you have comments or questions, please email podcast@frbatlanta.org, and thank you for listening.*