Securitization 2.0

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For nearly two decades, securitized, or conduit, lending filled the capital void that existed in the aftermath of the savings and loan crisis. Eventually, the complexity of these securitized loan pools (also called commercial mortgage backed securities, or CMBS) combined with increasingly aggressive underwriting practices left this largely unregulated industry in a state of disarray. Many borrowers, who for years benefited from low rates, high leverage and easy qualifying standards, are now faced with maturing loans and fewer financing options—a new capital void.

CMBS origination volume was $230 billion in 2007. CMBS volume plummeted to $12 billion in 2008 and $3 billion in 2009 as the industry was essentially dismantled. Spreads on AAA CMBS bonds soared to over 1,000 basis points over treasuries, but have since declined to a level where new loan originations are again feasible. Over the past few months there has been an improvement in market conditions as measured by credit spreads and the re-opening of many previously shuttered conduit shops.

While borrowers welcome any steps toward a return to normalcy, many are likely to question if the conduit lending market—let's call it "Securitization 2.0"—Is truly back and if new loans are being funded. Mortgage brokers will play a key role identifying lenders that are originating new loans and also educating borrowers on the underwriting criteria and structure that is required.

So who are the players in this new CMBS market? Mostly the same ones as the last go around. Many national banks have announced that they are going to be making new loans for securitization or in some cases have already closed loans. There are also funds, staffed by former CMBS executives that are originating loans with the intent of teaming with other lenders for securitization.

What properties currently qualify as collateral for these new pools? What are the underwriting guidelines and structure of the loans? While evolving, conduit loans are being processed and closed, and we are seeing the following approaches to underwriting:

- In almost all cases, larger loans are being pursued (ideally, loan amounts of $10 million and above, but a minimum of $5 million for most lenders). We expect minimum loan sizes to drop as lenders increase staffing.
- Most major property types are accepted, but the appetite for hospitality properties will lag others. Stabilized properties are a must. The presumption is "story deals" are not included for now.
- Lower LTVs—at least by historical conduit standards. Most deals are maxed out at 70 percent LTV, particularly on refinances, with 10-11 percent loan yields (NOI / loan amount) based on trailing income and expenses.
- Cash out is available, but often will be underwritten at a more conservative LTV and loan yield. Length of ownership and use of the loan proceeds may mitigate this concern.
- Ten year loan terms are the most common, but some lenders are originating shorter terms (five years).

- Amortization—maximum 30 years, but shorter is preferred.
- Spreads quoted over swap rates and will be based on the most recent feedback from CMBS investors. As of the writing of this article, most interest rates are in the low 6 percent range regardless of term.
- Origination fees to the lender—most lenders are charging a minimum 0.50 percent loan fee.
- Prepayment—typically defeasance.
- Liability—non-recourse except for standard carve-outs.
- Reserves—taxes, insurance, replacement and re-tenanting reserves (where applicable) are required, and it is more difficult to have these waived.

By now, you're probably saying to yourselves, "This is very familiar ... what's changed? What am I missing? What is going to be different so that it all works this time?"

The rules for "Securitization 2.0" are still being written. Thus, the initial deals have strict requirements as to default provisions, reporting, entity structure, etc. Many conduit lenders are returning, but the first loans to be closed are larger, low leverage loans with strong sponsorship. Further, the documentation is demanding as literally no one knows exactly what the market will buy. The first new conduit securitizations will be filled with "bulletproof" loans. This bodes well for increased securitization activity as we expect these deals to be highly over subscribed due to asset quality and conservative underwriting. This is exactly how conduit lending started in the mid-1990s, and we expect that the industry will eventually be "inclusive" of more typical properties.

Credit guidelines for key principals (carve out guarantors) are also evolving, and this is an area where mortgage brokers can be value added. Borrowers increasingly have recent defaults or properties that are not currently servicing debt. Lenders will closely assess how borrowers "behaved" with any prior defaults—did they make best efforts to cooperate with the lender – and the projected performance of their other properties going forward. Mortgage brokers should include with loan submissions background information on any defaulted loans associated with the key principal(s). Include details on why the property did not perform and efforts made by the borrower to work through the problem. Part of the standard submission should include a borrower's schedule of real estate owned, including current debt service coverage ratios for each of their real estate assets. We suggest providing a brief "business plan" for any properties in a borrower's portfolio with less than a 1.20x debt coverage ratio.

We believe conduit lending will play a key role in the stabilization and turnaround of commercial real estate, but that it will take time for them to develop significant volume.

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