# RERC Partner Profile

Kent Steele has more than 20 years of experience in commercial real estate appraisal, market analysis, counseling, and expert testimony. He has been affiliated with RERC since 1999.

Mr. Steele has completed appraisal assignments throughout the U.S., with in-depth experience in the West, Southwest, Midwest, Southeast, Northeast and Mid-Atlantic regions. Assignments have included the appraisal of investment-grade office, apartment, industrial, hotel, retail, and special-purpose properties for a variety of clients, including commercial and investment banks, pension funds, conduits, attorneys, investors, and the U.S. Bankruptcy Court. Special assignments have included client counseling activities, market segmentation and feasibility analyses, highest and best use analysis, litigation support, and expert testimony. Additionally, Mr. Steele has published an article on highest and best use analysis in the *Appraisal Journal,* and articles on the self-storage industry and on the CMBS market in the *RERC Real Estate Report*, and has given presentations at numerous professional seminars on a variety of topics.

Interesting projects completed include a proposed NASCAR track site in Baltimore County, Md.; the Eagle Ridge golf resort in Galena, Ill.; railroad corridors in northern Illinois; residential condo conversions of numerous properties throughout the country; adaptive reuse assignments for a variety of properties throughout the U.S.; and historically-significant office buildings in downtown Washington, D.C. and Detroit.

Prior to his work with RERC, Mr. Steele served as president of National Realty Counselors, Inc. He also served as a senior appraiser at GMAC Commercial Mortgage and Urban Real Estate Research in Chicago. Previous affiliations have been with Real Property Advisors in Hinsdale, Ill., Kushman Associates in Naples, Fla., and Charles M. Merkle & Associates in Landover, Md.

**Kent D. Steele, CRE, FRICS, MAI**

RERC Managing Director Kent Steele, CRE, FRICS, MAI, recently opened an office in suburban Chicago, focusing on valuation, valuation consulting, market studies, and other consulting for all major property types throughout the U.S.     Contact Kent at:

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# The CMBS Market: Déjà Vu, All Over Again

*By RERC Managing Director, Kent D. Steele, CRE, MAI, FRICS and Arthur J. Burrows, CRE*

## The Emergence

Back in the 1980s, the deregulated savings and loan (S&L) industry found itself in a high interest rate environment with a large concentration of low interest rate home loans on their balance sheets. In their pursuit of higher yielding investments, the S&L industry expanded into commercial real estate lending. By the late 1980s, the commercial real estate markets were severely overbuilt—there was too much liquidity, too little discipline, and too much development. In large part, the dramatic deterioration of the commercial real estate markets led to the collapse of the S&L industry.

Created by Congress under legislation known as the Financial Institute Reform, Recovery, and Enhancement Act (FIRREA), the Resolution Trust Corporation (RTC) mandate was to dispose of S&L commercial real estate assets (debt and equity). However, the magnitude of loan portfolios required a level of liquidity in the capital markets which did not then exist. This need for liquidity, to redistribute real estate loans across the capital markets from the banking sector, served as an impetus for the emergence of the commercial mortgage-backed securities (CMBS) market in the late 1980s. The anticipated dollar volume of these RTC loan sales and the associated fees justified the cost to develop the infrastructure and standardization associated with creating a viable public market for the securitization of commercial mortgages into bonds. The FIRREA legislation also included risk-based capital requirements that ultimately made liquid (i.e., securitized) rated real estate preferable from a reserve perspective for regulated institutions.

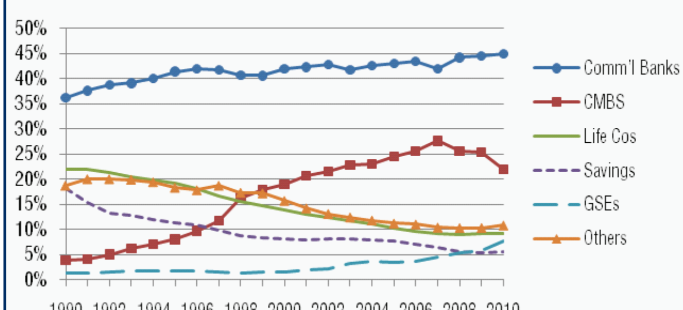
Critical to the creation of the CMBS public market was the role of the rating agencies, which assigned credit ratings to the bond classes, or tranches, based upon risk (payment priority), yield, and duration. Ranging from investment grade (AAA/Aaa through BBB-/Baa3), down the credit curve to below investment grade (BB+/Ba1 through B/B3), to the unrated classes of bonds, these ratings allowed investors to select the appropriate level of risk and the commensurate return. Following the securitization, or bond issuance, master servicers administered the loans by collecting payments from the pooled loans and distributing these payments to bondholders, sequentially, from the highest-rated bonds downward. A loan default would result in the transfer of the loan administration to a special servicer; losses were incurred beginning with the lowest rated bond class.

An important aspect of the CMBS structure was the pass-through classification, or tax-exempt status for income tax purposes, of the entity that holds the loans and issues the bonds. A real estate mortgage investment conduit (REMIC) was the typical special-purpose vehicle used for the pooling of the loans and the issuance of the bonds, while the legal form was typically a trust. REMIC pools were required to remain static, and with few exceptions, could not be expanded or modified materially after formation. The REMIC rules were specific as to what activities were allowed and what activities were prohibited, which limited the options of special servicers in dealing with defaulted loans. Maintaining entity-level tax-exempt status was critical and determined what actions could or could not be taken by special servicers, and also explained why special servicers, in some cases, could not take actions similar to those of other lenders, such as life insurance companies and commercial banks. Just as it remains today, the trustee's role was to maintain all of the loan documents and to supervise the master servicer or special servicer, including ensuring that the servicers acted in accordance with the pooling and services agreements.

## The Growth

Prior to the emergence of the CMBS market, commercial real estate loans (primarily whole loans) had historically been held by depository institutions (banks and S&Ls), life insurance companies, and pension funds. However, as shown in Exhibit A, the emergence of the CMBS market in the early 1990s dramatically changed the commer-

**Exhibit A. Holders of Commercial/Multifamily Loans**



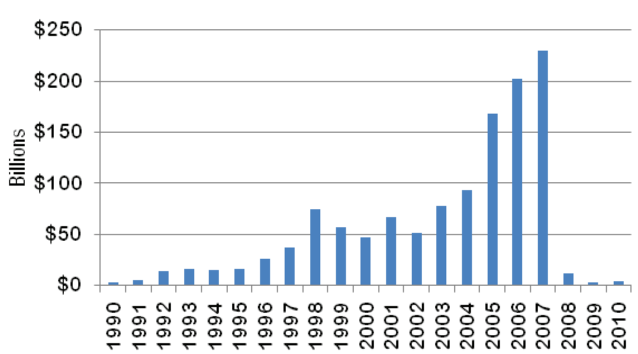

Source: Flow of Funds Accounts, Federal Reserve cial loan investor profile. There were a series of crossover points at which the percentage of loans, in terms of dollar amount, held by CMBS investors exceeded the percentage held by the traditional investors in commercial mortgages. By 1996, the percentage of commercial loans held under the CMBS market surpassed those held by the S&L sector; by 1998, loans held by life insurance companies were surpassed; and by 1999, only commercial banks held a greater share of the commercial mortgage market. As reflected in Exhibit A, the growth of the CMBS market as a percentage of the overall market continued until 2007, peaking at 27 percent. Exhibit B shows the dramatic annual growth in the CMBS market, with $230 billion of bonds issued in 2007.

The dramatic growth of CMBS issuance in 2005 through 2007 reflected "valued/priced to perfection" underwriting. Loans increasingly included interest only (I/O) periods, pro forma income versus in-place income, higher loan-to-value percentages, lower debt service coverage ratios, and declining use of escrows. Compounding the effect of the "priced-to-perfection" model was the declining interest rate environment, which supported higher levels of debt. As we soon learned, there was no cushion in the value model if pro forma numbers were not achieved.

## The Collapse

The stunning collapse of the CMBS market in 2007 and 2008 had its roots in the meltdown of the residential subprime mortgage market, the catalyst for the 2008 credit crunch. While the residential and commercial loan markets were (and still are) considered separate markets, they do share investors. Across the financial markets, the increasing use of and higher levels of leverage, along with complex structured instruments, drove returns and asset values higher—the ingredients for a bubble. As subprime delinquency rates (60+ days) quadrupled from 5 percent in June 2006 to 20 percent in December 2007 (see Exhibit C), investors concluded that they had neither identified nor priced the underlying risk. This experience in the

**Exhibit B. Annual CMBS Issuance**




Source: Commercial Mortgage Alert, 2010 thru 3Q

residential mortgage-backed security (RMBS) market cast similar doubt on the CMBS market, resulting in a dramatic flight to quality (i.e., U.S. treasuries).

As shown in Exhibit B, CMBS bonds issued in 2007 totaled $230.1 billion versus $12.1 billion in 2008, a 95-percent decline, and $2.9 billion in 2009, a 99-percent decline! Similar to the bursting of any bubble, the market had evaporated.

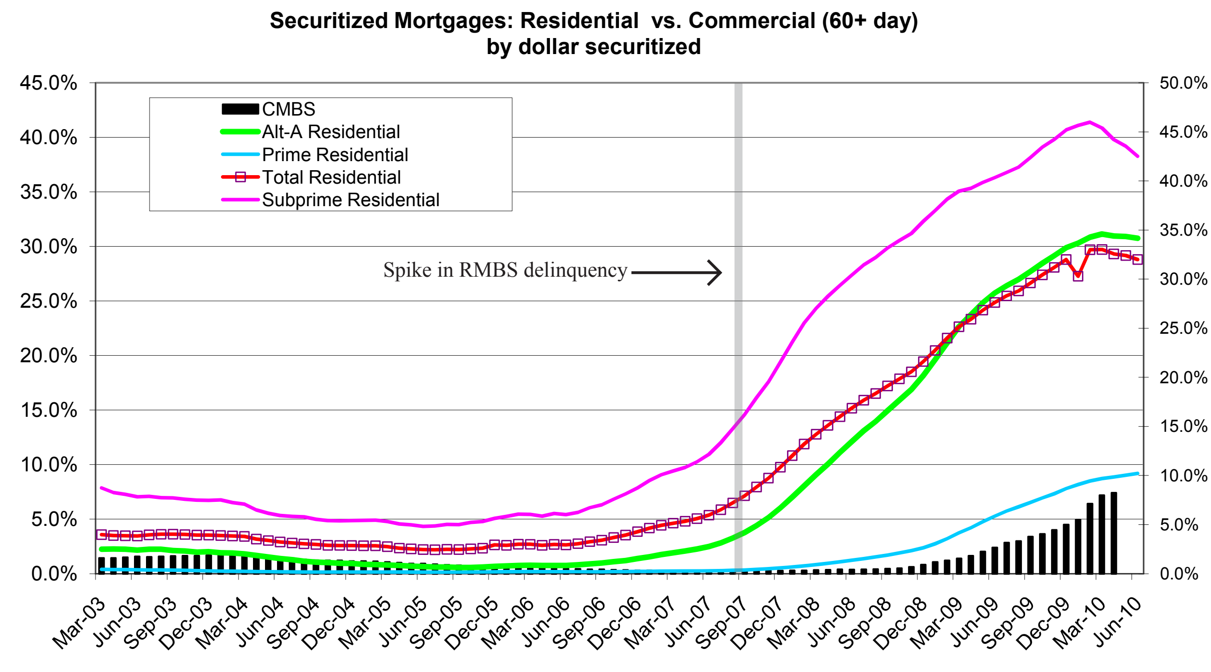
## The Re-emergence

Prior to the interruption of capital flows from the CMBS market several years ago, owners and investors had grown increasingly reliant on CMBS financing for their lending needs. Since that interruption, however, other lenders have been reluctant or unable to fill the void. Within the past year, life insurance companies have become more active lenders, as commercial mortgage loan spreads over U. S. treasuries are attractive relative to alternative investments. They are, however, focused on core assets, a relatively small percentage of the overall real estate market. With high concentrations of construction loans, many commercial banks are unable to resume commercial lending.

As reported by Commercial Mortgage Alert, $5.6 billion of bonds were issued from January 1, 2010 through September 30, 2010, versus $0.6 billion for the same period in 2009; approximately $15 billion of CMBS bonds are expected to be sold in 2010, according to a recent article in the *Wall Street Journal*. While there were no CMBS desks open in 2009, there are now seven or eight, including J.P. Morgan, Goldman Sachs, Wells Fargo, Morgan Stanley, and Bank of America. Going forward, the challenge will be finding loans that qualify under the current CMBS underwriting guidelines, given overall tenant credit, vacancy rates, and the lack of job growth.

The quality of the properties expected in these new pools and the underwriting of the loans following the dramatic re-pricing of commercial real estate should provide investors with superior risk-adjusted returns relative to those of the 2005 through 2007 priced/valued to perfection vintage loans that are experiencing high rates of default. The new structures, which give bond holders greater rights, are less complicated with fewer loans (of better quality) and tranches. Ironically, the CMBS market may be jump-started again by the actions of a federal agency as the Federal Deposit Insurance Corporation contemplates selling an estimated $32 billion in loans from failed banks in early 2011. As this activity progresses, sources inside the industry suggest that we should soon be seeing CMBS issuance levels approximating those found in 2003.

## Exhibit C. CMBS vs. RMBS Delinquencies




Source: CMSA, JPMorgan, LoanPerformance,Trepp, Inc.

Delinquency figures are dollar based (not loan count) and includes loans that are 60+, 90-day delinquent in addition to loans in process of foreclosure and REO. Residential includes loans on residential investment properties, manufactured housing and a limited amount of multifamily holdings. CMBS are commercial mortgages, all properties types, securitized as commercial mortgage backed securities. Historical data subject to quarterly revisions.