Commercial Real Estate Finance Outlook 2011: A Roundtable Discussion

Moderated by Brian P. Lancaster
Royal Bank of Scotland
Global Banking & Markets

Regulation of Commercial Real Estate and CMBS: 10 Things to Watch in 2011

By Brendan T. Reilly
CRE Finance Council

The Outlook for CMBS Refinancings: How Big a Problem?

By Alan L. Todd, CFA, Meghan C. Kelleher and Joshua D. Younger, J.P. Morgan

Enforcing Defaulted CMBS Loans through Receivership Sales

By Maura O’Connor and James Cochran, Seyfarth Shaw LLP
CRE Finance World

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The Voice of Commercial Real Estate Finance Worldwide

CRE Finance World is published quarterly by the CRE Finance Council
30 Broad Street, New York, NY 10004-2304  212.509.1844  www.crefc.org
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CRE Finance World is published quarterly by the CRE Finance Council. CRE Finance World invites and welcomes the submission of articles for publication.

Articles may be submitted for consideration to:
Laura Baran, Strategic Initiatives Coordinator
CRE Finance Council
30 Broad Street, 28th Floor
New York, NY 10004
LBaran@crefc.org

Articles appearing in CRE Finance World have been peer reviewed by members of the CRE Finance World Editorial Board and do not necessarily reflect the views of the CRE Finance Council.

VOLUME 13, NUMBER 1 WINTER 2011

CRE Finance World® is published quarterly by the Commercial Real Estate Finance Council (CREFC®), 30 Broad Street, 28th Floor, New York, NY 10004-2304, phone: 212.509.1844, email: info@crefc.org, website: www.crefc.org.

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COMMERCIAL REAL ESTATE FINANCE OUTLOOK 2011:
A ROUNDTABLE DISCUSSION
JANUARY 4, 2011

MODERATOR:

BRIAN P. LANCASTER, HEAD OF MBS, CMBS AND ABS STRATEGIES, RBS GLOBAL BANKING & MARKETS

PANELISTS:

STACEY BERGER, EXECUTIVE VICE PRESIDENT, PNC REAL ESTATE/MIDLAND LOAN SERVICES

DAVID BRICKMAN, VICE PRESIDENT, MULTIFAMILY CAPITAL MARKETS, FREDDIE MAC

VICTOR CALANOG PHD, HEAD OF ECONOMICS & RESEARCH, REIS INC.

RICHARD COPPOLA, MANAGING DIRECTOR AND HEAD OF COMMERCIAL MORTGAGE INVESTMENTS, TIAA-CREF

MARTIN CROPP, MANAGING DIRECTOR, PRINCIPAL GLOBAL INVESTORS

DAN RUBOCK, SENIOR VICE PRESIDENT, MOODY'S INVESTORS SERVICE, INC.

DOUG TIEL, HEAD OF REAL ESTATE ADVISORY, RBS GLOBAL BANKING & MARKETS

MARK WARNER, MANAGING DIRECTOR, BLACKROCK
Victor, let’s start with yourself and discuss commercial real estate conditions. Were there big surprises for 2010 when it comes to how specific properties or geographic markets fared relative to your forecast and expectations at the start of the year?

Brian, thanks for having me participate in the session. I’ll focus on fundamentals, specifically rents and vacancies. I think that the office and retail sectors performed pretty much as expected: we saw record declines in 2009 both in terms of rents and occupancies, but we all remember that time as the year when the world stopped moving. We expected 2010 to be similarly challenging for office and retail properties, given that commercial real estate typically lags the overall economy by about 12 to 18 months after a recession has ended. Office and retail didn’t disappoint: fourth quarter numbers for office vacancies place us at 17.6%, a level unseen since 1993. Vacancies for all types of retail properties continued to rise to around 10.4% through the middle of the year, but remained there in the third and fourth quarter. However, different types of retail properties performed in varying ways. Neighborhood and community center vacancies continued to rise to close to 11% by the end of the year. That’s a vacancy level we haven’t seen since 1991. Larger property types actually saw vacancies decline slightly in the third and fourth quarters to the mid to high 8s, suggesting that it was a damaging game of musical chairs: regional malls may have benefited from tenants leaving smaller retail centers.

The biggest surprise for me has to be the strength of the multifamily sector’s recovery this year. Sure, we predicted that this would be the first sector to recover, but it beat expectations not just in terms of how soon the turnaround happened, but also in terms of the magnitude of the recovery. We expected to see a turnaround sometime in the second quarter, given the usual seasonal resilience this sector displays at or around the summer months when US households make decisions to move. However, we began seeing strong occupancy and rent growth numbers as early as February of this year, and during traditionally colder months when households stay put. Throughout the year we also saw over 200,000 apartment units’ leases up, and it wasn’t just from new buildings coming online. When we recorded about 90,000 units absorbed in the third quarter, it was the largest figure we had ever recorded for net absorption since REIS began publishing quarterly data in 1999.

So, I was pleasantly surprised with the strength and vitality of the apartment sector. Office and retail properties pretty much performed as expected, so I haven’t had to change our forecasts for this property type in a material way for the last eight quarters.

Victor, what’s going on with the apartment market? Why is it posting record positive results for net absorption of space - economic growth has been lackluster and unemployment is still high? And David, if you could give your perspective as a GSE Multifamily Lender. How do you think the multifamily markets will fare in 2011?

Despite lackluster economic growth and continuing uncertainty in the labor markets, households appear to be returning in droves to the rental market and signing leases. I think it’s important to think about how this is happening on the margin. First, this reflects some optimism about an improving job market. Yes, it’s still pretty bleak out there. It may take individuals anywhere from six to nine months to find a job, but that is far better than the situation in early to mid-2009, when the nation was shedding hundreds of thousands of jobs a month.
In other words, pent-up demand from renters tired of living with their families or roommates may be driving these results. Another factor seems to be flat or declining trends in house prices and mortgage rates. There is an incentive to sign twelve-month leases for an apartment rental, versus committing to a down payment for a home and a 30-year mortgage, particularly if home prices and mortgage rates are expected to stay low.

Since the job market remains rocky, potential buyers may also prefer to rent units for now until they are secure in their new or existing jobs.

This suggests that unless the promise of economic recovery and job growth is actually delivered, the demand for rental apartments may moderate in 2011. However, what’s going to continue to benefit the multifamily sector this year is the dramatic pullback in new deliveries that we fully expect to see. Even as demand moderates, it is probably not going to be reduced to the same extent as supply and inventory growth, which is set to fall by anywhere from 50 to 70% relative to 5-year averages. So in short, I’m pretty bullish about the apartment sector’s prospects in 2011.

David, is that consistent with your view as well?

I will very much echo Victor’s comments and even add that across our portfolio of over $100 billion in multifamily property we did indeed see the first quarter as the turning point in terms of seeing robust growth pretty much in all markets throughout the year from that point forward.

As far as the outlook going forward and what contributed to that strong growth, certainly the decline in home ownership because of declining house prices and credit availability has been a benefit to the rental market. Both factors have contributed to the growth in demand for rentals. But I would emphasize a little bit more the supply side. The constrained supply that we’ve seen in apartments in the past few years really did help in limiting the increase in vacancies and certainly now as we’re seeing some stabilization and actually growth in demand, again coming primarily from the shift from home ownership to rental providing that upward momentum in terms of increased occupancy and rent growth. Going forward into next year, even though I think there is a limit to how much that shift from home ownership to rental may continue. I think we will start seeing the improvement in the economy and reductions in unemployment starting to have a positive economic affect on the demand side of that equation.

Victor, in the office sector, are we going to see a turnaround in 2011? It’s been 18 months since the recession ended. The supply situation seems stable vs. previous downturns. Also, you’ve been pretty bearish on retail. What about those sectors, office and retail?

I’ll tell you something not so secret since it was on the second page of the Wall Street Journal today. The turnaround may already be here. Fourth quarter results are in, and occupied space increased at the national level by 2.5 million square feet. That is the first instance of positive net absorption we’ve recorded since the end of 2007, putting a stop to eleven straight quarters of reductions in occupied stock. What’s certainly serving the office sector well this time around is the fact that inventory growth from 2004 to 2008 was less than half that of the prior five years from 1998 to 2003. We added about 49 million square
feet per year, on average, from 2004 to 2008. The comparable number is a 102 million square feet annual average from 1998 to 2003. So when the recession hit, characterized by a massive pullback in demand, there wasn’t as much of a glut in supply to really depress fundamentals.

Granted, 2009 was nothing short of devastating. National effective rents fell by close to 9% across the nation, the largest annual decline in effective rents in 30 years of REIS history. Effective rents fell by about 20% in New York City, more than twice the decline that office properties registered in the 12 months following 9/11. So I’m not downplaying the severity of this downturn. However, consider that in the prior recession office properties registered four years of effective rent declines, from 2001 to 2004, leading with back to back declines of 7-plus percent in 2001 and 2002. This time around effective rents fell by close to 9% in 2009, and fell by only around 2% in 2010. We may see positive, if tepid, rent growth this year. So yes, office properties entered the downturn with pretty favorable supply conditions, and it looks like we’re seeing signs that the sector is climbing out of the hole.

How quickly we climb out of the hole, of course, is largely dependent on whether recovery in labor markets accelerates this year, or remains moribund. Brian, did you want me to go on with retail?

**Moderator:**

**BRIAN LANCASTER**

Yes, just a few quick comments on retail.

**VICTOR CALANOG**

Well, I think that I remain fairly pessimistic about the retail sector and unlike the office sector, there wasn’t much of a pullback when it comes to retail property construction at any point in the last decade. We have more retail space per man, woman and child than any other country in the world. Retail sales are largely dependent on consumer spending, and since this recession was the first time in 17 years that the American consumer cut back, it was no surprise that retail properties suffered. I had mentioned earlier that we’re at a 10.9% vacancy rate, the highest level we’ve observed in 19 years. I fully expect the vacancy rate to continue rising to around 11.3% this year. Once it rises past 11.1%, we’ll have broken the highest vacancy rate REIS has recorded in 30 years (we last saw it in 1990).

But let me not end on a pessimistic note. You might think I’m an economist or something. I’ll share a few bright spots. First, there was a pretty big and very much welcome pullback in new construction for retail in 2010. We expected 12 million square feet to come online, but either through delays or cancellations, only about 4 million square feet were delivered. That’s the lowest annual level of new completions on record. That helped keep the vacancy rate flat at 10.9% through the third and fourth quarters. We are expecting, however, some of those delayed projects to come online this year, and they will probably come online mostly vacant unless they offer very generous terms.

What do I need to see before I’m more optimistic? Let me be pretty specific about that. Annualized GDP growth higher than 2.8% over the next two quarters, driven not by ephemeral factors like inventory build-up but consumer and business spending. A continued moderation in new projects being brought to market, at least until the economy is on more solid footing. We may yet have vacancies staying below the record 11.1% if these conditions materialize. I’m actually assigning about a 60% probability that we’ll record unexpectedly positive results for retail properties this year. But I need to see how supply conditions turn out over the next quarter or two before I revise our current projections.
Stacy, are any of the improvements or changes that we are starting to see in the commercial real estate property markets impacting the servicing business in terms of losses, severities? Transactions are picking up and brokers seem more optimistic. Is that impacting the speed of liquidations at the servicer level or is it too early at this stage?

Thank you, Brian, for inviting me to the Roundtable. I appreciate the opportunity to participate. We have seen a significant increase in the pace of resolutions and liquidations in our special servicing portfolio and we’ve also seen a slowing of the pace of transfers in. We attribute this to a combination of both improving market conditions as well as increased liquidity and availability of debt and equity. Special servicing transfers started accelerating in the fourth quarter of 2008. To no one’s surprise the most troubled balloons defaulted first. In the second half of 2010 the pace of special servicer transfers appears to have leveled off. There continue to be very large assets or portfolios that transfer into special servicing and others that get resolved and those have some distorting factor when you’re looking at the overall market statistics. Generally we are seeing an accelerated pace of resolutions and liquidations. The timeframe associated with the resolution of distressed assets is typically 12-18 months for assets to be sold, paid off or worked out. A combination of factors is positively impacting the special servicing business but the economy and improvements in commercial real estate finance are certainly an important factor.

I am echoing Stacey’s comments with regard to the financing market helping out on the resolution of the loans that are in trouble. For the first time over the last 30 or 45 days we’ve actually seen financial properties come out of special servicing - either people buying the assets from the special servicer or through DPS. So I feel for the first time on the lending side we can help provide that financing to new equity to help solve that problem in the future.

Brian, I appreciate the opportunity to participate. I would say that the improvement in the financing market has also been very beneficial in helping bring in spreads by reducing some of the highest loss estimates on existing legacy deals from 2005-2007. I think as an industry we’re facing somewhere between $30-$40 billion per year of 5 year loans maturing and some of the 10 year loans maturing from even earlier originations. That said, being able to ballpark the debt yield needed on a new loan and where those coupons are on new loans has reduced the worst case scenario of how many loans will have to be worked out or foreclosed upon and so the substantial benefit I think as you’ve seen is on the pricing of AM and AJ classes. I wouldn’t discount the effect not just of the new issuance but the new issuance’s feedback onto legacy assets and deals. So yes, I think we’re all happy to see the new issue market resuscitate itself and it’s also having a very beneficial impact by reducing the range of estimates for cumulative losses.

Thanks, Mark. Stacey, servicers have come in for criticism regarding a lot of the problems that have occurred over the last couple of years. Is the servicing structure broken? Are there ways to improve borrower and investor customer service; that is to provide better information and transparency to investors?
Stacey Berger: I don’t think the servicing structures are broken. Certainly there are some bumps and bruises and dents. I actually think the servicing structure has held up very well under much more adverse credit conditions than anybody anticipated. With that said, I think servicers do bear some responsibility for being understaffed and ill-prepared. Some of these issues are related to the economics of the business. Many of the master servicers underestimated the resources and expenses associated with administering specially serviced loans. Some did a poor job of tracking covenants and administering lockboxes. The economics of the CMBS servicing business are not at all transparent. Master servicers bid to acquire CMBS’s servicing rights. The servicer is typically selected based on price and the highest bidder isn’t necessarily the one with the best quality or borrower customer service. With interest rates as low as they are today, the value of float and fees are having a significant impact on servicing rights valuations as well as increased costs associated with specially serviced loans.

A number of the issues that have been problematic with investors are being addressed in new issue CMBS but the one I think is the most troublesome is how high-quality borrower customer service can be encouraged. Other issues which have been addressed are related special servicing structure and the combination of special servicing and subordinate investment. A number of the larger players who are active subordinate investors and special servicers expected that those businesses would be somewhat synergistic or at least that servicing fees would provide a hedge against losses on the investment side. I don’t think that business model has held up particularly well. A number of those companies have been sold or recapitalized. It will be interesting to see how that business model holds up going forward.

There are a couple of other interesting things in the new issue CMBS. One of the big issues that caused concerns with investors was what we described as “double dipping” which is related to the special servicers charging fees to borrowers for certain activities and then charging the trust for similar activities. This practice is contractually allowed in the pooling and servicing agreement so it is hard to blame special servicers for taking fees that they are entitled to. Not all of the special servicers have chosen to do that, but it is one of the big areas that have been addressed in terms of servicing fees on new deals.

Moderator: Brian Lancaster

Thanks, Stacey. There has been considerable press regarding senior CMBS investor concern as to whether the special services are following the Servicing Standards, that is maximizing recovery on a net present value basis without regard to their own economic interest. Can you discuss servicer compensation issues in that regard as well as some of the differences between master and special servicing in old and new CMBS deals? Is CMBS 2.0 better?

Stacey Berger: In terms of the servicing standard both master and specials take the CMBS servicing standards very seriously. A breach of the servicing standard could potentially have very severe consequences, including loss of the servicers indemnification which could have significant consequences. The servicing standard is actually subjective and from a servicer’s standpoint we think that’s a good thing. It provides special servicers significant latitude in resolving or liquidating distressed commercial assets. Special servicers have different philosophies and strategies. Over time it is going to be interesting to see the comparative results between special servicers in terms of loss severities and whether special servicers who are affiliated with subordinate investors experience different loss severities than those that are independent.
In terms of new features and structures, the changes are actually fairly incremental. In some deals there are resolution fee caps which cause concerns for special servicers in terms of creating the right incentives to maximize net recovery. One of the most important features appointment of an operating advisor/senior trust advisor. This is still evolving and there have been a couple of different flavors of how those have been implemented. Some transactions have nothing, some have a very active operating advisor and some have senior trust advisors that provide an oversight role and also provide senior investors the ability to replace the special servicer without cause on a supermajority vote of the bond holders or when change of control take place, provide the mechanism for the senior investors to replace the special servicers.

**MODERATOR:**
**BRIAN LANCASTER**

Can the type of servicing issues roiling the residential market happen in the CMBS market? There have been some clients that have asked that question.

**STACEY BERGER:**

I think it’s a really interesting question. One of the things that you look at in comparing residential and commercial servicing is really the business models. Residential mortgage securitizations have a more vertically integrated business model where the lender originates, securitizes, services and refines the portfolio. First losses aren’t sold to third parties and the scale is much bigger in terms of both the number of loans and the transactions. That said, some of the infrastructure problems, collection, loss mitigation and foreclosure issues that the residential industry is facing certainly have implications for the commercial business.

I think that the CMBS servicing and special servicing structures held up remarkably well. But again, some of the litigation that is coming out of the residential industry definitely has concerns for the servicers and investors in the commercial space.

**MODERATOR:**
**BRIAN LANCASTER**

Mark, CMBS spreads and valuations have come pretty far over the last year. What do you think were the drivers of this rally – is it investors searching for yield in a low rate environment or is there something more fundamental going on in terms of improving outlook as you mentioned, expectations of lower loss levels, etc. or some combination of both?

**MARK WARNER:**

Brian, I think it’s a combination of a couple of factors. One is that we started out 2009 with spreads as wide as we did. We benefited substantially from TALF and PPIP programs. Then we started 2010 with a substantially wider spread level than we have today and the market rebounded as did the markets for equities, high yield corporate bonds and investment grade corporate bonds. So we definitely were brought along by the tide that lifted all of the spread sectors and the risk assets, but we also had a very substantial tailwind in that spreads were very wide relative to corporate bonds and the substantial help in liquidity provisions from the Fed helped all of these asset sectors. So when we saw rates at a very low level and the need for yield was very substantial, CMBS with 30% credit enhancement was a very attractive place.

We still don’t believe that cumulative losses are likely to hit close to that 30% level and are comfortable with the fact that the 20% credit enhancement securities were less likely to be pierced and so their prices started to increase in the second half of 2010 substantially. So I think when you look back and you disaggregate all of the returns for 2010, you saw lower rated classes. Many of them had formerly been rated AAA, but they were downgraded to
single-A or BBB and outperformed the bonds that had been steady at AAA. I think this is really indicative of a market that has found the bottom and had gotten more comfortable that ultimately cumulative losses and the workout scenarios don’t pierce through the credit enhancement of the AMs, and certainly it is unlikely that many of the A4s will get impacted.

I think that the only area of the market that started to get a little concerned in the 4th quarter was the A2 bonds where convexity issues and possibilities of prepayment from modified loans started to affect pricing. Loans extended without yield maintenance penalties started to impact pricing where bonds were above 101% or 102% price. Overall, I think the combination of improved liquidity, repair of the financial sector and return of leverage availability all contributed to the improvement in pricing.

Assets started to trade in 2010, even though it was relatively small volume compared to the peak in 2006 and 2007. You started to see some assets liquidated and you saw large assets liquidated, people found money to buy them at better yields than they previously could or at a higher cap rates, and you saw that the liquidation of smaller assets with balances less than $10 million started to accelerate and that’s given people better confidence in their loss estimates. It’s a combination of all of those that has really helped and the new issue market has also provided a benchmark. So there is a much better understanding now on where a loan can get made and where does it execute when that loan is carved up into between AAA through BB and this substantially improves confidence in pricing by lenders so they know where their execution is likely to be. They can hedge duration, but knowing where the spreads are, I think, has been a substantial confidence booster.

**Moderator:**

Given the performance last year are you bullish or bearish on CMBS in 2011? Has CMBS run its course in terms of performance or do we have further tightening to go? And if so, what parts of the market do you feel most positive about and which ones are you more bearish on?

**Mark Warner:**

Well, as a dedicated CMBS portfolio manager CMBS is kind of near and dear to my heart but I think relative to other sectors like corporates, it could still tighten. Relative to where it was back two years ago, three years ago or even four years ago, for AAA assets that are likely to remain AAA that you wish you had bought the deals with 30% credit enhancement. I think they can tighten further. The amount of excess return or duration-adjusted return will vary with the credit rating of the assets. New issue 2011 first quarter deals may come at 120 or 125 basis points over swaps. Asset spreads in the low 100s seem to be very attractively priced AAA assets.

Ratings constraints still exist for the mutual fund industry and the insurance industry, and for some endowments. Ratings still matter because risk-based capital charges and internal risk assessments are in part based on ratings. The stability of ratings for 2010 and 2011 originated assets is important to a large portion of the buyer base. The combination of high-quality ratings and lower leverage on the loans, compared to 2006 and 2007, make these AAA assets very attractively priced. There seems to have been significant demand for these in the last several deals. They are not as large as the deals used to be. It doesn’t require as many asset managers to be involved to fully subscribe their tranches, so it is less of a difficulty for the underwriting community to place them. On the AAA assets, I think we may look back and all wish that we had bought them when they all had 3 digits in their spread, but it’s certainly going to remain to be seen how many people will enter the market and participate - and that’s one reason why I think they are as attractively priced today.
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**Moderator:**
**BRIAN LANCASTER**

Do you think the fact that new CMBS has been private will limit investor appetite and limit the growth of the market this year? Do you see that as a constraining factor?

**Mark Warner:**
At this point with deal size only somewhere between $500 million and $1 billion bringing the transactions under Rule 144A does not seem to hinder their liquidity. If you started to bring $3 billion transactions then the additional capacity of some buyers that are constrained to buy only public deals may become important. I think the tension we face is that the availability of information is much greater for 144A issues and for a lot of the buyers who found that the lack of liquidity in 2008-2009 was very troubling. The additional liquidity provided by good information or better ongoing availability of information is not something that I really want to give up just to get larger class sizes and therefore be able to get very large A4 classes or last cash flow classes created. I think there is some tension here in the marketplace but I think that right now deals over around $1 billion hadn’t been a problem. Getting the information under a public document is something that we have to really examine. As an industry we need to get better reporting two, three, four years after a deal is closed. While we all hope we don’t face a recession this severe again, we are likely to face economic conditions that cause us to need to be able to price and monitor the assets with less difficulty. We need to be able to answer those questions about CMBS and property level performance; otherwise the price volatility in the asset class becomes too great. We saw that on the residential side with a substantial increase in price volatility and people really unsure what underlying asset performance was.

**Moderator:**
**BRIAN LANCASTER**

A classic question I often get from investors is there anything that keeps me up at night. Is there anything that keeps you up at night beside Wall Street bond sales people?

**Mark Warner:**
I think like all of my peers who trade and invest in spread assets, and that would include CMBS, asset-backed, and corporate bonds. We are not divorced from the issues about job growth, unemployment and credit availability, whether it’s auto loans or credit card debt. Our borrowers and ultimately their tenants are very sensitive to the availability of credit. Domestic spread assets can’t be divorced from economic growth and we can’t assume that we are divorced from peripheral European sovereign debt issues. We’re all very much in the camp that better job growth is definitely going to help CMBS.

**Moderator:**
**BRIAN LANCASTER**

Dan Rubock, in 2011 we are going to see a slew of regulatory proposals and rules coming out: Dodd-Frank, EU directives, etc. What are the recent regulatory and legislative changes that have been or that you think will be important to the ratings and ratings process, and do you seen them as positives or negatives?

**Dan Rubock:**
Well, there are positives for transparency and there are positives for credit considerations; I think generally, the thrust of the regulations is to give the investors more information. These initiatives are going to come with increased costs, perhaps increased time in getting things out of the door, but who can be against mom, apple pie and transparency? Their cost is going to be reflected. I think it is going to ultimately ripple through and will settle and the CMBS market will be able to absorb and understand that. Disclosure requirements have been kicking around for a while. SEC Reg AB will increase disclosure. The FDIC Safe Harbor just kicked in on January 1st and essentially mandates increased disclosure. The new reps and warranties regs that the SEC is going to have to promulgate
180 days after Dodd-Frank (which I guess is mid January before the CREFC convention) will be requiring various disclosures by issuers and by rating agencies in their pre-sale reports. That would be a positive for investors. Of course, investors being selective in buying deals may make issuers, perhaps, more vigilant in loan underwriting. Things ripple back as well.

Things like risk retention are going to have to be worked out between the various regulatory agencies. The FDIC came out with their new Safe Harbor which is going to require a vertical 5% risk retention. Perhaps insured institutions are going to do an end-run around that by using subsidiaries, but eventually the FDIC retention requirements are going to be “auto-corrected” with the SEC’s under Dodd-Frank. There are potentials in Dodd-Frank of not necessarily requiring risk retention: good underwriting standards, good reps and warranties; we will see where the CREFC task force on reps and warranties comes out. I think it will be a great help in focusing investor attention and perhaps standardizing the reps and warranties that investors will be able to read and blackline against and the rating agencies will be able to comment on. Rating agencies may have to, under the possible SEC regs, compare and contrast reps and warranties against what the “market standard” might be; the CREFC reps could be that standard.

SEC Reg 17 (g)(5) has been also an issue, some could call it an obstacle. It’s a new requirement for resolving conflicts of interest, perceived conflicts of interest, with the ratings model. It has added quite a sticky production to putting out new deals. What is going to be particularly challenging will be the interface of 17G5 with servicing on new deals that aren’t grandfathered. There are going to be, again, costs in terms of rapidity of response time between servicers and rating agencies in getting monitoring information. Information is going to have to be posted to websites rather than having the free and open exchange - a human conversation. But I think just like new deals are being rated and are being rated accurately, the monitored deals are going to be able to withstand the additional belts and suspenders, which the 17G5 will require, but that will be a challenge that the CMBS market will be able to adjust to and overcome.

There have been a couple of credit positive regulations, for instance, the REMIC changes that were announced over a year ago gave great flexibility to modifications that were able to address balloon issues. There are some disagreements within the CMBS community about whether that was positive or negative for credit vs. relative value, but ultimately it is something that’s now within the framework of CMBS.

One other thing as well, §933 of the Dodd-Frank Act put a variety of new responsibilities or constraints on the rating agencies. §933 requires reasonable investigation and verification. Is that a good thing? Sure, it’s something that increases investor confidence in ratings. So generally, we have an array of new legislative initiatives and regulations that increase transparency, while increasing operational complexity and costs, but CMBS is going to be able to adjust, survive and perhaps thrive.

**Moderator:**
**Brian Lancaster**

What did the deals you rated in 2010 look like and what are the deals in 2011 going to be like?

**Dan Rubock:**

The projections for 2011 have varied widely. There was greater activity in 2010 than people expected. We left the year with quite a rush, quite a bang. I think the total volume was somewhere around $11 billion. We’re projecting 2011 volume at around $40 billion. The deals are going to have greater diversity. They are going to have probably
somewhat higher leverage. There was a chunk of deals we saw in the last quarter - how representative of 2011 they will be is an open question - but there were somewhat larger deals than previously, we are talking about deals from the $750,000,000 to $1 billion plus range. We’ve seen some larger deals with average size loans perhaps in the $50 million range so there could be higher deal sizes with higher loan balances. We saw a tendency to originations in some major markets: New York, D.C. and the other attractive core cities, call them. You are going to see an increase in new players in the market. All of the major banks have launched deals and there are going to be some new banks, perhaps some smaller contributors are going to be joining the club.

Market leverage is increasing somewhat. Moody’s LTVs have been in the 70s or 80s. Perhaps it will stay steady, but there might be some pressure again for increased LTVs but that will be moderated by increasing diversity.

**Moderator: Brian Lancaster**

Do you think there are going to be any changes in deal structures or is there any chance of a floater by the end of the year? Do you think there will be any shifts in the composition by the way of property types, away from what we’ve seen last year?

**Dan Rubcock:**

Well, hotels will be popular. There have been a chunk of those single buyer/borrower deals. We will see a number of single buyer, multi-property transactions. Those were leaders of course, in the emergence of the market last year.

**Moderator: Brian Lancaster**

What is your outlook with delinquencies, loss severities, CPPI rating changes?

**Dan Rubcock:**

As to CPPI, people have pressed us, have we reached the bottom? The last CPPI that came out saw a price increase of 1.3% for the month of October and that is the second consecutive month of a price increase and that was followed by three rather large monthly declines. The first ten months of 2010, half have had price increases and half measured declines. So you are having a lot of bumping around on the bottom. The repeat sales transactions remain fairly low and so we think prices will remain fairly choppy until transaction volumes pick up. 2011 will be a year with great expectations, but in 2012 you may very well have a somewhat stronger recovery. 2011 could remain a very uncomfortable time for a lot of Americans and for commercial real estate. There will be substantial improvements perhaps in 2012, but 2011 is going to remain somewhat choppy.

The hotel and multifamily sectors turned positive in 2010. They are the first to rebound. Hotel Rev Pars are increasing, and we agree with Victor that multifamily is going to be looking up. The sharply diminished level of new supply will lead to major market improvements even with a long term average rate of house formation. Office is a possible positive but impact on office demand could lag.

As far as expected loss estimates for conduits, we are still looking at our base case of losses of 5.7% on original balances and 7% on recently reviewed balances. Of course, those are striated by the vintages of the deal. For delinquencies, we are still continuing to anticipate a rise to between 9% to 11% and special servicing perhaps to be in the high teens to up to the 20% level.

That is our current outlook.
Doug Tiesi, what is your estimate for 2011 CMBS issuance? Dan mentioned $40 billion, are you in that ballpark?

First of all, thank you for your invitation to participate in the forum.

RBS’ estimate is that we are projecting CMBS this year in the $30 and $40 billion, which is a pretty large range. It’s basically a 200% increase over the 2010 level. I think it’s pretty easy for a number of players, including ourselves, to show big growth in the market, but the reality is that there are significant headwinds in the market right now to achieving those numbers and that is why the ranges are so wide. First of all, there is an assumption out there, and I’m sure Mark will chime in at this point; that there is an unlimited capacity to put CMBS bonds out there and as long as there is good disclosure and they get good ratings that the investors will be there. But, with $7-$8 billion coming to market over the next 45 days, it is going to be a test we will need to pass first. Have we created the bonds that the investors want and are they satisfied that we have met their criteria? Will spreads stay constant or widen a bit under the weight of supply?

There are also capacity restraints with respect to B pieces. I think for the first time, given the number of transactions coming the first quarter, there is more choice among the investor community there and I think you will potentially see some impact on the amount and characteristics of loans originated in the first half.

The other area where I think is very interesting on the rates side is with the movement of rates. The 10 year swap rate moved by 70-80 basis points in a very short period of time they are still showing a lot of volatility. It is also taking small universal loans that potentially could have been re-financeable or financeable through capital market which are obviously heavily cash flow based, out of that bucket. We’ve seen a little bit of a slow-down toward the end of the year of requests from financing groups that previously met the criteria to be put into a deal. And, as always, we’ll hear from Rick and Marty, that there is competition from balance sheet lenders. Whether it be from the insurance side or whether it be the commercial banks. They are fighting for their share of assets at this point. But overall, assuming the economy continues to improve, and cash flows improve on the underlying assets, I am comfortable we will hit the 30 number and maybe even 40. It’s not just on automatic pilot at this point and time. There are a lot of things that we as lenders need to be cautious on and make sure that we are doing our part to put together pools that have good credit and make sense for the investors so that they are satisfied and come back to take the increasing size over time.

We’ve seen Credit Suisse and Barclays recently rejoin the CMBS business. Do you think there is risk that we get so much competition that you could drive collateral values down below bond values and choke off issuance prematurely? The competition for assets is so heated vs. the investor base out there.

As I stated before, there is a limited amount of capacity for bonds and B pieces. I think the key is that the lending community needs to be careful that we don’t grow too fast or do things that cause the investor community to take a step back. We are relying on the investor community to expand their portfolios to meet the refinancing needs of the next two years.
I am very confident that, assuming the economy shows some growth, there are more than enough loans out there to be refinanced. Everyone can see the maturity profiles of CMBS and balance sheet real estate loans. What I’m cautious about, and what I think we all need to be aware of on our side of the business, is making sure that we respect the principals of putting appropriate leverage on our assets and making sure that we provide the disclosure to the investors so they can make appropriate risk decisions.

MODERATOR: BRIAN LANCASTER

Has the increased competition affected loan underwriting standards and leverage levels?

Dan said he saw leverage going up in 2011.

DOUG TIESE

Yes, there has been some impact. Generally what we found on our side is that leverage has increased. Now, mind you, this is from some historically low levels of leverage. Under CMBS 2.0, we initially saw pools with weighted average LTVs between 55-60%. We will probably see that start to increase into the 60’s. This is market value not rating value. There are loans in some of the more recent transactions that have been up near 75% and in some cases have reached past the magic 75% number. Generally what we’re finding is that the assets with the higher leverage tend to be of a higher quality. Their cash flows can appropriately handle that amount of leverage. But once again, we have to be cautious on leverage. In CMBS 1.0, DSCR was another area where there was a pushing of the envelope. Currently, right now DSCRs have remained, in my mind, conservative, but as rates start to increase, I would imagine you’ll see that pushed a bit into 2011.

With regard to underwriting standards, I have been pretty pleased with the fact that lenders have refrained from pro forma underwriting and focused on in-place cash flows. In most cases they are appropriately haircutting those cash flows to reflect market conditions. So even if you have a property that might be 98% occupied in a market that’s 80%, you will see those haircuts put in place so that the property can lose tenants and still perform. That’s been very positive.

On the structural side, there is probably more structure in the beginning of CMBS 2.0 with respect to reserves for lease roll over and lease expirations. We are starting to see those start to be whittled back a bit, but for the loans where there is a significant roll you typically do see structure, which I think is very positive and hopefully we can see that remaining in place to provide good protection for investors and B piece buyers.

DAN RUBACK

I’d like to add to the chorus there. For structure on the asset level, we’ve seen a marked improvement; generally, in expanded bad boy recourse carve outs, although there has been a little back sliding lately on that. But generally, more consistent and expanded recourse carve outs. There are more detailed reps and warranties from the borrowers themselves. What has been particularly marked has been the new SPE provisions in the loans. Independent directors provided by national corporate service providers, limitations on fiduciary duties, prior notice and in some cases, cause requirements. These are all in the wake of GGP, of course. There has been increased hard cash management for most loans of $20 million or more. Cash management waterfall tests. There has been borrower liability for special servicing fees, liquidation fees, work out fees, What’s important for monitoring - this is echoing what was said before - increased financial reporting, quarterly, annual and for larger loans, audited statements. No pro forma rents, decreased master leases, fewer mezz loans, but perhaps mezzanine loans will increase somewhat as things get a little more active; fewer TICs. I think we’ve had a definite increase in firmness of
lenders in originating these loans. I just want to say that there has been an improvement in asset level structure.

**Doug Tiese**: I think this is actually a really important point because this is going to be very important for the investment community to speak with their wallets. When they see characteristics that they like about the underlying structure of the loans, they need to vote and buy these bonds and show that there is a differentiation in spread because that is what speaks best to lenders. You can economically incentivize the whole lending community to make the right decision and I hope when investors are looking closely at the bonds that are being created that they look that deep and they say this is worth more to me than if that structure was not there. That is what I think a lot of us in the lending community are hoping for 2011.

**Moderator: Brian Lancaster**: Mark, are you going to differentiate?

**Mark Warner**: I don’t think structure can be driven by the investors very easily. The disclosure of differences in structure between deals is not transparent to investors. Industry standards in the wake of our experiences with GGP are still being developed by b-piece buyers and rating agencies who have access and time to do that level of analysis on documents. If the investor community can’t get the information to differentiate between structures, then every bond trades the same. If investors really think this is important, we need to resolve this as an industry and come together around standards that easily allow investors to look at blacklines. This is slowly happening with reps and warranties, except rep exceptions were never provided to the investor and now they are. So, a lot of things have happened with CMBS 2.0. Our primary goal should be to drive down the cost of owning this asset class relative to corporate bonds where every 90 days you get financials and every year you get audited financials. If you want billions of dollars to get allocated to the CMBS sector, you have to make it more consistent, more transparent and less expensive to own. In the past 5 years it’s been a very expensive sector to own. It is only recently that we are making some strides to make it less costly and I think we can make it less costly going forward.

**Moderator: Brian Lancaster**: Before we turn to the portfolios lenders, Doug, where would you say CMBS is more competitive in terms of origination vs. the balance sheet lenders?

**Doug Tiese**: There are basically three or four areas that we focus on because we realize there is a competitive end from our perspective. One is we look at leverage and I think the obvious answer is higher leverage is more competitive because some of the balance sheet lenders won’t go to the 65, 70 or 75% leverage point on some of these assets and I an obvious point. But I think one area that is very interesting is the low leverage where we have a higher proportion of AA and AAA where across the capital is inside where balance sheet competitors can lend so we’re seeing say sub?? 60% loans in some cases above 65 or 70% loans you almost have the barbell effect there. So that middle road where we start to have price and some investment price where we start to lose out on some of the better assets to the balance sheet lenders.

As always secondary asset with really strong cash flow profiles tend to perform well under the CMBS cash flow analysis. When you talk about asset types, retail which is a bit out of
favor works very well in CMBS. Hospitality, to a lesser extent offices and then where assets are completely not working right now are on the industrial side. And very few industrial assets are making it past the balance sheet lender into the CMBS world and obviously the multifamily and apartment building stuff's domain in GSE at this point and time.

One thing that we are finding that also interesting is that 10 year is more competitive than 5 year product out there. That generally is the result of the need for new tenure assets from the investment grade and investment base looking to corporate bond out there. Where 5 and 7 year new issue competes with the legacy CMBS product as that starts to age over time.

So those are the areas where we are seeing CMBS generally work.

Rick and Marty, portfolio lending seems to have been fairly active in 2010, what has been driving that? What can we expect in 2011?

Also, Doug where he felt the CMBS originators are driving that? What can we expect in 2011?

I think it really is a combination of a lot of what we’ve heard today and that is a function of the compression of spreads in all fixed income asset classes. As well as the sense that we’ve got a little bit more stability or more stability at least in our outlook about where values are going and where the asset class is going as a whole. In my view there was a wholesale shift back to commercial mortgage whole loans in the latter part of 2009 where a lot of the portfolio lenders saw good relative value, which is a term we’ve been preaching for a long time now, as compared to other fixed income asset classes. There was this wholesale shift into the space. Many of us remember that the loans you underwrite in this type of economic environment are probably the best and most safe loans you will ever underwrite and that was indeed what was available to us early in 2010. One of the surveys that I saw showed that the projected value of just life companies, not even other portfolio lenders, predicted a 70% increase of origination in 2010 vs. 2009 which was admittedly a low volume year for most lenders. I think that the combination of underwriting, returning to more conservative levels that were the characteristics that were originally portfolio lender like quality helped. I think leverage levels improved significantly and while spreads tightened, it was still good relative to other alternatives.

Many of us looked at our portfolios probably in the latter part of 2008 first part of 2009 and lo and behold they actually held up remarkably well compared to everything we were all reading in the press and everything we were seeing going on around us and that lent some credence to appetite and the resumed appetite I guess is the way to describe it, certainly in our view.

My response would be very similar, Rick. Across the board we saw an improving economy and stabilizing commercial real estate market which allowed us to take a much greater interest in this space. On an overall basis, our mortgage production was just shy of triple what it was in 2009. These positive factors allowed us to take advantage of the relative value available. Most portfolio lenders are asset/liability matching type investors and the relative value, especially early in the year, compared to what other fixed income investments were offering, was much stronger. I think that in addition to that, the
stabilization that we started to see in the overall CRE market occurred at a level where values in many cases, were below replacement costs. That, as Rick stated earlier, put us in a position to put some very solid loans on our books. All in all, there was adequate volume in the low leverage space at good premiums over other investments that allowed us to be very competitive and put that money out in a space that we were comfortable with.

**MODERATOR:** Given the tightening of spreads, how does the overall appetite look for whole loans in 2011? Where would you expect to find opportunities in the coming year?

**MARTY CROPP:** Overall, the majority of our clients, including conservative core up to the higher in the debt stack players are still very committed to the space and in fact, many are showing increased interest. For 2011, we are anticipating anywhere from a 25 all the way up to as much as 40% increase in the amount of volume we are doing. Again, this is across the board so we expect a very active year from that standpoint.

Also, an additional comment regarding where we have been most competitive, I think that traditionally we have been most competitive just in the space we have been talking about, the core low leverage and also on the fixed rate space. I think the perceived flexibility a portfolio lender can provide in areas such as property substitution, additional dollar funding, etc. still puts us in a pretty good position in the space where we are focused on being competitive.

**RICK COPPOLA:** I would echo what Marty was saying. I think that the appetite for 2011 is looking certainly as strong as we were seeing in 2010. I think Overall estimates that I’ve seen show portfolio lenders are kind of within that $30 billion range which is kind of normal for us on a historical basis. I think that in terms of the place where we see value, certainly in 2010 we were looking at larger loan sizes but I think that speaks to what we said earlier about some of the limits on the conduit side. I’ve seen a lot of business in that over $50 million range and frankly, we had been focused almost exclusively on the core markets and the large CBD office and large retail mall, financing opportunities where there was less competition for those transactions, certainly in early 2010. It heated up obviously throughout the year and I think next year will be competitive as well. But we like the space and again relative to corporate spreads we see good value so we see an increased appetite.

**MODERATOR:** The market seems to be bifurcated between “core” and “non-core.” We hear this often and looking at what is happening in terms of commercial property markets, and actually in terms of lending, with the portfolio lenders tending to concentrate on core, do you see this changing at all in terms of your lending stance or are you going to stay focused on core, on primary markets in 2011? Any possibility of focusing on secondary and tertiary markets?

**RICK COPPOLA:** We are certainly focused on core as I mentioned a lot of major CBD markets and dominant retail properties. Really we still have the view that we are operating on economic uncertainty so historically, those markets have serviced well. We are not really looking to increase the risk profile in our overall portfolio so we are focusing on the best assets in those markets with well capitalized borrowers. The debate today is what we just said. There will be more capital in 2011 than there was in 2010. There was more in 2010 than we expected. The competition was pretty fierce and you know, we are all expecting this refinancing bubble to come through but we still haven’t hit yet. We are starting to see bits and pieces of the recapitalizations but the wave that most of us are expecting has not
commenced in full force. So we are looking for other opportunities. And it goes back to, we are also cash flow eccentric and so we’ve gone to other markets. We’ve gone to San Antonio this year, we’ve gone to Denver. We are looking at the rent rolls and we are saying, alright, give me a good rent roll with clarity of cash flow and we can make a reasoned evaluation and we can make a good conservative loan and get paid a little bit extra. So I think there will be a little bit of that perhaps stretching a little bit but not stretching vis à vis 2006 and 2007 stretching for good markets and properties with strong fundamentals.

**Moderator:** Brian Lancaster

Historically, portfolio lenders were a big player in buying rake bonds and B notes in the legacy CMBS market. What is your view of such investing going forward? Is there a role for portfolio lenders in the CMBS 2.0?

**Marty Cripp:**

Certainly I would expect portfolio lenders to continue to consider the purchase CMBS bonds that make sense, but I think it’s going to go along the lines we were just talking about from the standpoint that they are going to stay lower the risk spectrum. To the extent that there are some opportunities offering great relative value with respect to other investment options, I expect them to participate. It remains to be seen if the price going forward will offer relative value vs. other investments opportunities.

**Rick Coppola:**

Yeah, I would echo that. When we were active in the subordinate debt space in what we consider the conservative B notes which was taking those core assets up to maybe leverage was up to 70% leverage there was more clarity in pricing. We are pretty comfortable in that space and certainly with the types of assets that we typically focus on. But we would like a little more clarity on pricing for sure. I think there is more to come on that in 2011 and I think like Marty, a lot of us have different buckets of money to manage and we could see some good interest in that space going into 2011 and even perhaps even a little higher into the capital stack.

**Moderator:** Brian Lancaster

Before I turn to David, Life Co’s typically struggle to compete with the agencies. In 2010 it seemed they were a little more competitive. What was your experience, how were you more competitive? What is your view for 2011 to be as active?

**Marty Cripp:**

I would suggest that we will remain active in that space. Certainly the agencies can be a competitive as anybody in the multifamily space, as we all know, but on certain low leverage opportunities we can price very competitively. In the short term fixed rate loan market we have been very price competitive and in addition, we have been able to compete with agencies in a market where there is a lot of rate volatility with the ability to rate lock at application. This has proven to be very attractive to the borrowing community.

While we still expect the agencies to be the force in the multifamily sector we do expect to get our fair share based on some of those attributes.

**Rick Coppola:**

I would absolutely agree and I would add that with the spread compression in pretty much all of the property types, the four major food groups anyway, we were taking the opportunity to perhaps round out the diversification of our portfolio a little bit because the yield differential between property types compressed. But I agree the agencies are as competitive as ever and they tend to win the majority of multifamily transactions.
MARTY CROPP: One other comment, I don’t want to backtrack too much but just a quick one. We are also in the CMBS production arena and to leverage off the comments made earlier about trying to find more transparency, I think it is important whether it is at the rating agency level or the investor level to make sure there is adequate transparency so that players across the board can make differentiation calls on the product that is being originated. This would be an important factor for all producers to recognize, allowing them to decide how they want to compete. This clarity would give the market segment additional opportunity to expand.

DAVID BRICKMAN: Marty, I just wanted to ask you something. One thing that we’ve seen from the portfolio lenders is occasionally a greater tolerance for some degree of lease-up risk, which generally the agencies have a more difficult time with. Would you say that also?

MARTY CROPP: I think that’s a good point. If we are very comfortable with our overall loan exposure relative to replacement cost of a property and we have a very good read on the positive economic growth outlook of a given area, we are often able to commit slightly sooner to a given level of proceeds vs. having, in place the trailing numbers that sometimes are required on your end of the equation.

MODERATOR: BRIAN LANCASTER: GSE and FHA make up I think is estimated at 80 or 90% of multifamily mortgages origination last year. Do you think this will continue the following year? If not, who do you think will gain share and how might the competitive landscape change? Do you think CMBS deals at some point will be made up of a significant part of multifamily?

DAVID BRICKMAN: Yes, the share is likely to go down. I think a couple of the wildcards obviously being anything related to GSE reform or policy mandate, but leaving those on the side for a moment, we do see significant growth in multifamily in 2011. In 2010 we actually saw some explosive growth. We saw strong increases in volumes throughout the course of the year and our fourth quarter alone was perhaps equal to or close to the previous three quarters of the year in terms of purchases. Just going through the year and ending 2010 with that strong pace going on suggests strong momentum going into 2011. Obviously rates going up dampen that a little bit, but where we generally come out is that multifamily originations will likely be up something like 50% perhaps even more in 2011. So the pie certainly gets larger and the overall volume that agencies do, will increase, but I think we will increasingly see competition from the portfolio lenders. Both the Life Companies but even more perhaps from the local and regional banks who to date have perhaps been quiet and I think as they increase that’s will take a little bit of the agencies share down. I think it’s 80 or 90 now maybe it goes to 70 to 80 so it’s not a significant change, it is and will continue to be primarily an agency and FHA market but I think we will start to see a little bit more competition from the other conventional players. As far as CMBS specifically, I actually don’t think CMBS is likely to make major inroads in of 2011. I think in conventional core multifamily I think is pretty well covered between the agencies and portfolio lenders and then as far as some of the areas in multifamily that aren’t as well served, I think there is still some credit challenges that investors will have to overcome given the historical multifamily and CMBS deals. And so I imagine that it will probably take a little bit longer for any multifamily CMBS to pick up. Not that there won’t be a little bit here and there but I don’t think CMBS will have a large component of multifamily for some time to come.
The administration said this was going to be a year in which GSE reform is going to be center front. Could you talk a bit about what implications you think the different proposals might have privatization, nationalization, etc on the multifamily mortgage market as well as on the property markets. Can you comment on regulatory changes for GSE reform as to how they might affect values?

I’d be happy to, Brian. I want to say at the onset that anything that I say should not be construed as any form of advocacy or recommendation merely just analysis of the potential proposals. And to that end, the devil is in the details. If we think some form of complete privatization really means that there is no longer any more government attachment than there is in any of the other property types I think we would obviously be looking at some form of spread increase and potentially some form of credit rationing in multifamily. I don’t know that the results would be as catastrophic as I know some people believe. We in our business model actually are doing something that is a hybrid of CMBS and an agency execution and lends itself to direct analysis of what the cost of capital would be if we didn’t have a government guaranty and that number roughly comes out to an increase of 50 to 100 basis points in terms of mortgage spreads which in turn would probably translate into a similar amount in increase in cap rates or reduction in property value or something on the 10 to 20% range. It is probably a greater transmission of value to property markets than we normally see and you normally wouldn’t think mortgage spreads translate one for one into cap rates but given the negative policy signal that would be reasonably likely with a complete privatization.

In the case of complete nationalization, presumably we stay relatively similar to where we are in terms of activity, little changes. I think the issue there probably becomes a little bit more in terms of the credit rationing perhaps some other bifurcation of the market in terms of what would be within scope for the new agencies and what wouldn’t. You’d probably have actually a greater increase in mortgage rates segments that are not considered...no longer in scope of the GSEs, so depending on an exact scope of the proposal, it looks like we would have between 0 to 100 basis points of increase in mortgage rates and decline in cap rates depending on the specifics.

The agency multifamily securitization right now is composed largely of two securitization types. Single loan securitization such as DUS projects as well as structured securitizations REMIC, Freddie Mac and k-deals. Do you think the market will move towards one or the other type of product in 2011?

No, I think there is a significant role for both of them. We at Freddie Mac have embraced a structured securitization model more than the project loan model. I tend to think that is more suited for institutional investors and particularly as you move into a world in which the majority of multifamily done by the agencies is securitized it eliminates some of the idiosyncratic issues you have in a single loan securitization structure and so it probably expands the investor base and facilitates greater structuring at the security level. Having said that, I don’t think there is going to be any retrenchment from project loans, there will continue to be strong interest demand for single loan securitization and we at Freddie Mac continue to look closely at it. Single loan securitizations facilitate greater flexibility in structuring at the mortgage level and I think is still needed and in strong demand by borrowers.
Can you talk further about the prospects of securitization with multifamily loans? The agencies have securitize the vast majority of their multifamily purchases, and life insurance companies and banks have been increasingly competitive. Do you think there will be any non-agency securitizations of multifamily loans in the future? Do you think the caps on agency portfolios and the mandate that they shrink their portfolios will increase securitization activity?

I'll take the latter first and would say no, and again, subject to things that can change over the course of the year. I think that both agencies are currently pursuing the kind of organic run off in terms of their portfolios. Certainly we at Freddie Mac are not looking to do any bulk sales or securitizations of our portfolio.

As for non-agency securitizations, I think that we will start to see some growth. Very limited in 2011. We may have growth in the conduits to the extent that there is interest in this segment of the market that the agencies don’t serve very well. But this segment has traditionally been served by regional banks, I am thinking specifically of the smaller balance loans, and some of the lower quality B and C class assets. Other parts of the credit space like this have historically been the domain of banks. I think we may see some securitizations in that as liquidity eventually needs to return and eventually will return to those segments there will need to be vehicles for raising capital, but I don’t think we are going to see any conventional core conduit securitizations. I will let the life companies speak to their own business strategies, but I don’t think we will see much from them in terms of multifamily securitizations in 2011.

What about the prospect for distressed securitization?

I think there is a reasonable prospect that we might see something in that arena particularly given the large number of distressed multifamily assets that are out there particularly held by the special services or in bank portfolios and given the relatively healthy outlook for multifamily and the growth that we’ve seen particularly on the property side in terms of transactions, I think there is some likelihood that we will see those types of securitizations to occur in the near term in the multifamily arena.

David, thanks. Unfortunately we’ve pretty much run out of time. To all of you I greatly appreciate all of your comments and insights. You’ve certainly raised a number of interesting issues on a huge range of topics that we could have spent far more time discussing and debating. But for that we’ll have the January Conference in DC. I look forward to seeing you all there.
The New Year marks the end of an extraordinary decade that closed with unprecedented efforts and countless hours spent working with policymakers on ways to provide liquidity and promote lending, and to reform our financial system and market regulation.

2010 was an extraordinary and defining year for commercial real estate (CRE) finance. January began with relatively cautious optimism on the heels of the first private CMBS deal in six quarters using the TALF program; April marked the first multi-borrower CMBS deal in two years; in May, the SEC proposed major changes to the offering process through Regulation AB; July brought passage of the historic “Dodd-Frank” reform law; in August, the FDIC overhauled its “Safe Harbor” rule with a risk retention mandate; in November, the nation voted for a historic shift in Congress; and in December, the “Bush” tax cuts were extended for two years in hopes of spurring economic growth.

We expect 2011 to be even more active on both the deal and public policy fronts. Indeed, market analysts predict $30 to $50 billion of new CMBS issuance, but all of these estimates have been hedged by economic conditions and the tremendous regulatory uncertainty that exists in the market today. Undoubtedly, the most significant policy issues in 2011 relate to the implementation of Dodd-Frank, which contains approximately two dozen mandated rules, reports, and studies that directly affect CRE finance. And, it is not only the impact of these rules on an individual basis, but their interaction with other regulatory changes and factors – such as new accounting standards; changes to risk-based capital; the SEC’s Regulation AB; and economic performance – that will shape the future of CRE finance and “CMBS 2.0” for years to come.

As we begin 2011, we direct your attention to 10 areas to watch in the year ahead:

1. “It’s The Economy, Stupid” – We often dive “into the weeds” during conversations about the future of CRE finance. The toughest point to make, but most relevant at any level, is that CRE finance is different from the residential and subprime market – from the borrowers, structure of loans and deals to the level of transparency, and significantly, the susceptibility to macroeconomic conditions. Clearly, CRE has been affected by the economic downturn, which began as a housing crisis (with 20 percent of residential mortgages underwater today), evolved into a simultaneous crisis of liquidity and consumer confidence impacting both credit access and business performance, and has resulted in extraordinarily high unemployment above 9.5%. The CRE Finance Council (CREFC) is committed to strengthening market practices that will support a timely and sustainable recovery, but ultimately, a “recovery” in the CRE market will hinge on the economy.
As a political matter, the 2010 election provided to revive the above Clinton adage. As a public policy matter, there will be heightened focus on the economy, and we will closely follow actions by Congress, the Administration, and the Federal Reserve. Among the key questions are whether: (1) the tax deal provides a boost to investment and economic growth; (2) the much-reported Administration overtures to business result in new economic proposals; and (3) additional action is taken by the Fed, and what impact that action has on the economy and bond markets.

2. **FDIC “Safe Harbor” Rule** – The rule – which includes a 5% retention mandate for insured depository institutions (IDIs) seeking the “Safe Harbor” – is in effect until the joint retention rules in Dodd-Frank (discussed below) are finalized in April. At that time, IDIs must adhere to the final Dodd-Frank rules, while non-IDIs will have a two-year implementation window (i.e. April 2013) under Dodd-Frank.

The Safe Harbor rule has raised serious questions about whether they will impact credit availability or steer lending toward less regulated institutions not subject to such rules in the next couple of years. The immediate practical impact in the market has been significant confusion, uncertainty about how the rule aligns with the new Dodd-Frank law, and questions about whether the federal statute ultimately will be followed. CREFC has stressed the need for regulatory certainty and coordination, but lingering confusion in the market is reflected in the outpouring of inquiries about the interpretation of the Safe Harbor rules. The SEC also released Regulation AB prior to Dodd-Frank, however, the Commission held off finalizing its proposal to align the timing and scope with the joint rules in April.

3. **“Retention” Rules** – Today, uncertainty related to changing regulation makes the risk and cost associated with extending a loan or buying a bond inestimable, and serves as the greatest (yet, most controllable) impediment to a recovery. With lending reforms acutely focused on securitization, and more specifically, residential and subprime mortgage-backed securities, CREFC has urged policymakers to reject a “one-size-fits-all” approach.

Lost among a sea of reforms – e.g. derivatives, proprietary trading, resolution authority, etc. – a 5% risk retention requirement became the focal point of securitization reform for all asset classes. Ironically, many observers simultaneously noted the Congressional Oversight Panel’s finding that the CRE market experienced the greatest deterioration among small and regional banks that made and held loans on balance sheet – i.e., that had 100% retention.

CREFC successfully worked with policymakers on a provision in Dodd-Frank to provide a menu of options to align interests in the commercial mortgage market – including underwriting guidelines and controls; adequate representations and warranties; as well as retention by a securitizer, originator, or third-party investor that performs due diligence, purchases and retains a first-loss position.

What’s next? Dodd-Frank ultimately is the overriding mandate for securitization reforms, and regulators (the Fed, SEC, FDIC and OCC) must jointly consider rules for all institutions by asset class and finalize them by April. This includes the CRE provision, and a “qualified mortgage” exemption for high quality home loans. The “effective date” is April 2012 for RMBS, and April 2013 for CMBS and consumer ABS, which reinforces the focus of policymakers.

Naturally, each regulator will approach these issues from very different and specific vantage points, and the reconciliation of these viewpoints is a subject of much anticipation. The central question is whether rules will be tailored to each asset class as mandated by Dodd-Frank, or whether a rigid cookie-cutter approach is utilized. Financial policymakers (for example, the Fed study, the OCC, the IMF, among others) have warned that the economy could stall if rules are not implemented jointly, calibrated by asset class, and examined in the context of other reforms such as accounting and risk-based capital changes.

The pressing April deadline, coupled with a focus on the residential mortgage and “qualified mortgages,” could curtail deliberation for other asset classes. Certainty is critical, but the need to thoroughly examine the most effective (and least disruptive) policy is paramount, as market participants agree that even proposed rules could stir the markets. The good news is that CREFC has completed and shared several “Best Practices” initiatives with the financial policymakers.

4. **“Best Practices”** – CREFC has looked to build on existing safeguards to support a timely resurgence in the short term and a sound and sustainable market in the long term. The Best Practices encapsulate consensus views on the critical issues of: initial disclosure known as “Annex A” (which is in addition to the CREFC “Investor Reporting Package™” for ongoing disclosure); underwriting principles; and representations and warranties. A cross-section of constituencies spent an extraordinary amount of
time and effort to develop these Best Practices, and their purpose is twofold: 1) to create industry standards for use in the market immediately; and 2) to assist policymakers in the implementation of Dodd-Frank.

Under Dodd-Frank, the SEC is required to adopt rules that provide investors with asset-level or loan-level data to independently perform their own due diligence. Although “Annex A” has long been part of the materials available to investors at offering, CREFC updated the Annex A, adding data and aligning it with the asset-level disclosure framework (Schedule “L”) proposed in Regulation AB to avoid unnecessary transaction costs.

Dodd-Frank also requires federal regulators to identify underwriting standards “that indicate a low credit risk with respect to that loan.” Since commercial mortgages are heterogeneous and do not lend themselves to universally applied and objective criteria, CREFC created a framework of principles and procedures that outline characteristics of a thorough underwriting process, which are reinforced through disclosure and representations. Additionally, CREFC has worked to create model representations and warranties for use in a loan purchase agreement, and that serve as an important form of “skin-in-the-game.”

These Best Practices together represent, and go beyond, the retention options regulators must consider under Dodd-Frank. The initiatives provide standards that can be used in advance of the April 2013 effective dates, and they will be the subject of considerable attention in the upcoming weeks.

In the meantime, the evolution of deals and industry use of the Best Practices will be the most significant matters impacting the market and potential reforms. On a related note, it will be important to separate truly market issues (such inclusion of an operating advisor, senior trust advisor, etc.) from regulatory reforms mandated by Dodd-Frank.

5. Credit Rating Agency Reforms – Equally overshadowed, credit rating agency (CRA) issues have flown largely under the radar screen. Ironically, the most immediate impact from Dodd-Frank was caused by the new CRA liability, which threatened to shut down securitized lending before the SEC offered a temporary fix.

The first quarter of 2011 will see at least eight SEC rules for CRAs, such as: enhanced disclosures for ABS, including on methodologies and performance; conflicts of interest for sales and marketing practices; and consistency in rating symbols and definitions. While many rules have not been issued, each must be finalized by July 21st, which may feel like light-years these days but is just around the corner. The SEC also must create an Office of Credit Ratings (OCR). The opening of the OCR office and appointment of a director will be key indicators that reforms are underway.

The SEC must also conduct two CRA studies. One will examine standardizing rating terminology and market stress conditions under which ratings are evaluated (comments due February 7th), and a second will report by 2012 on whether to require an independent entity to assign CRAs for initial ratings of structured finance products. Before being watered down, this restrictive amendment – authored by Sen. Al Franken (D-MN) – received more than 60 votes despite opposition from then-Banking Chairman Chris Dodd (D-CT) and Ranking Member Richard Shelby (R-AL), an indication of the climate facing CRAs.

Lastly, regulators must remove ratings references from federal rules by next July. This will impact how the banking regulators calculate capital, and not unlike other areas in which ratings are prevalent, the concern over alternatives has left several policymakers referring to ratings as a “necessary evil.”

Budget funding for the SEC will also play a role in the timing of any rules (including for the CRAs), as the SEC needs 800 additional employees to implement Dodd-Frank, while Congress has yet to increase their budget.


Sen. Tim Johnson (D-ND) now takes the helm of the Senate Banking Committee with a smaller majority. Senate Republicans, including Ranking Member Shelby, have called for an outright repeal of Dodd-Frank, while Chairman Johnson has started to draw a line, stating “[i]t’s a matter of minor changes taking place. There is not only resistance from the Senate, but the veto is possible too, so we should focus on realistic solutions to our problems.”

Across the Capitol, House Republicans take control of committees and pledged to pursue strict oversight of Dodd-Frank implementation. Oversight and the budget process are perhaps the sharpest tools presently in their arsenal, given Democratic Senate and White House.
REGULATION OF COMMERCIAL REAL ESTATE AND CMBS: 10 THINGS TO WATCH IN 2011...................... (CONT.)

House Financial Services Committee Chairman Spencer Bachus (R-AL) and Capital Markets Subcommittee Chairman Scott Garrett (R-NJ) have been vocal critics of securitization reforms, raising concerns about the impact on access to credit. During Dodd-Frank debate many Republicans opposed the provision in favor of an underwriting-focused approach.

The million dollar question is whether Congress will compromise on big-ticket items, including a "corrections" bill or GSE reform (see below). At a minimum, oversight is expected to play a prominent role in implementation, as Members on both sides of the aisle recognize the unprecedented nature of reforms and have publicly vowed to shine a spotlight on critical issues, including those related to credit availability and the economy.

Chairmen Johnson and Bachus have both expressed concerns about the looming challenges facing CRE, citing it as the "next shoe to drop." While this should sharpen the focus on reforms impacting CRE, it is unlikely that Congress will consider programs to support the CRE market, and market participants are not pursuing comprehensive vehicles. Separately, some tax proposals could encourage important equity investments in CRE, but questions remain about the political appetite and cost. Beyond RTC-like deals from the FDIC and NCUA, little activity is expected.

7. CRE Loan Modifications? – With roughly $1 trillion in loan maturities on the horizon, a huge issue will be the ability to refinance CRE loans in the face of significant equity gaps, poor economic conditions, and tremendous regulatory uncertainty.

Policymakers undoubtedly will follow the circumstances as they unfold, and developments could fuel action. Banking regulators were continuously ridiculed for their action (or inaction) to enforce 2009 guidance on CRE loan modifications, and they face new legislation on the issue.

Obstacles to loan modification programs in the residential market led policymakers to consider REMIC changes for RMBS and a servicer “safe harbor” to encourage modifications. Treasury previously considered REMIC changes for CRE, and the IRS ruled that there are no tax consequences if servicers exercise PSA discretion to modify loans in “imminent default,” but they rightfully did not take damaging action to change the underlying contracts. While more aggressive action would be detrimental to a CMBS resurgence and overall CRE recovery, market participants should remain guarded based on evolving market conditions and the residential experience. Likewise, with advocates clamoring for a national servicing standard for mortgages in the retention rules, a watchful eye must be kept on any extension to CRE.

8. New Accounting and Capital Standards – Policymakers and market participants continue to raise concerns about the timing and scope of accounting reforms and the practical implications of such policy, individually and combined with other reforms. Concerns surround securitization accounting, Fair Value Accounting, and now lease accounting raised by CRE borrowers. As an indication, one of the only bipartisan hearings in the 111th Congress focused on “mark-to-market,” as Members of Congress in both parties lambasted FASB and pleaded for them to carefully consider proposed changes. FASB continues to reaffirm that it simply sets accounting standards, and leaves to banking regulators the choice of adjusting risk-based capital rules to fit accounting changes.

Arguably, the most significant policy issues last year were not in Dodd-Frank; instead they were considered outside of Washington in Connecticut, and overseas behind closed doors with Basel III. Clearly, accounting issues and regulatory capital will play a huge role in our financial markets, and regulators are working on implementing Basel II, at the same time they consider Basel III. Time will tell about new capital standards and the market impact.

And alas, will there ever be international accounting convergence?

9. GSE Reform – The Administration will release an eagerly anticipated roadmap for housing finance reform in January. GSE reform remains one of the most politically charged issues; the election impacts this priority as much as any issue before Congress.

The legislative challenge will be left to a divided Congress. Many House Republicans previously demanded GSE privatization, but a deliberate approach is expected. Ironically, for years private institutions lobbied to erode, if not abolish, the GSE stronghold, but today they are the biggest proponents of careful action with the housing market in a fragile state.

Given the stakes, there are serious questions about whether Congress and the Administration are willing and able to compromise on housing finance reform. And, what will be the market or political fallout of passing or not passing a bill? Absent legislative consensus, particular attention should be paid to whether the Administration uses its existing regulatory powers to address the GSEs outside of the legislative process.
Debate on this issue, similar to other areas, will occur largely through the prism of the single-family market given the GSEs’ role in that space. Multifamily is very unique, and there is an increased focus of rental housing in today’s economic climate. Given the differences in multifamily and the overall experience, portions of this issue could (and should) easily be considered as two separate items; although it remains too early to tell.

10. Covered Bonds – There is no replacement for securitization, but CREFC supports the creation of a U.S. covered bond market as an additive financing tool. Last year, a covered bond provision was dropped from Dodd-Frank in the eleventh hour, but with the leading proponent, Rep. Garrett, now a Subcommittee Chairman, a bill will likely sail through the House this year.

Senate action is uncertain, but several senior Senators have expressed interest and virtually no opposition has been raised by market participants or Members of Congress. Some concerns over jurisdiction and resolution authority were raised by regulators, but advocates are confident these can be addressed and would not slow the bill’s momentum.

The outlook is promising considering that covered bonds are positioned as a no-cost, pro-credit availability legislative item. The real unknown is whether a covered bond market could become a viable financing source, which could depend on the outcome of Dodd-Frank reforms and regulatory capital changes.

A FINAL CALL TO ARMS

2011 will obviously be another critical and defining year for CRE finance. If you have any doubt about the gravity of the issues facing our industry, or the path we are taking, we encourage you to get involved, as the CRE Finance Council is a member-driven organization.

And, if there was ever any doubt about the future of this market space, one need only look to the hard work and dedication of the CREFC members and leadership, who could not be more committed to ensuring a recovery in the sector. It is your efforts that allow us to function effectively as an association and to represent the entire commercial real estate finance marketplace in Washington, DC.

Happy New Year, and we look forward to working with you in the months ahead!
Over the next seven years, approximately $500bn of fixed-rate CMBS collateral is scheduled to mature. Of this, the vast majority ($421bn, or 83.6% of the maturing balance) originally had 10-year terms, while the remainder of the maturing balance consists of roughly $49bn (9.5%) 5-year and $35bn (6.9%) 7-year loans. Of note, nearly all of the 5-year loans will mature in 2011 and 2012 (Exhibit 1).

In recent years, these loans in particular have represented the greatest refinance risk for CMBS investors. If we look at all loans originally scheduled to mature in the first three quarters of this year, we find that while nearly 80% of 10-year loans refinanced successfully, just under half the 5-year loans did the same (Exhibit 2). The 5-year loans that are now coming due were not only aggressively underwritten, but they also had little time to recover from the collapse in prices that began in 2008. This stands in stark contrast to 10-year loans that were originated in 2000 and 2001, which have had time to appreciate in value and may still be worth more now than they were when they were originated.

To better assess the current characteristics of the fixed-rate loans that are expected to mature next year, we isolated all conduit loans currently scheduled to refinance in 2011, which total just over $48bn. A substantial percentage of that balance, however, has been fully defeased, and therefore does not need to refinance (Exhibit 3). Approximately $10bn, or 20.8% of the total maturing balance can be traced to these fully defeased...
loans. Looking at the defeased fraction by loan term, we found that it was highest among 10-year loans, which were 36% defeased versus 7% and less than 1% for 7- and 5-year loans, respectively. These 10-year loans were generally defeased into the peak of the market as borrowers refinanced their properties, taking advantage of skyrocketing CRE prices and the loose, high-leverage credit environment. In fact, nearly two-thirds of the 10-year loans expected to mature next year were defeased in 2006 and 2007.

After excluding defeased loans from our sample, the total refinance needs for fixed-rate CMBS in 2011 is approximately $38bn. When we categorized these loans by term and loan type (Exhibit 4), we found that 90% of the maturing 10-year loan balance was amortizing, and only 7% and 2% were partial- or full-term interest-only, respectively. By contrast, 73% of the maturing balance of 5-year loans was interest only for the full term, 19% was interest-only for part of the term, and only 8% was fully amortizing. Loans with original terms of 7-years were more evenly distributed among the various amortization types: 43% and 36% of the maturing balance was full- or part-term interest-only, respectively, while 21% were amortizing.

Borrower coupons also varied with loan term, reflecting the different credit and rate environments in which these loans were originated (Exhibit 5). The coupon distribution for 10-year loans had a relatively narrow range: the average was approximately 7.5%, with more than three quarters having coupons between 7% and 8%. Loans with original terms of seven years had a somewhat broader distribution and lower average coupon of 5.7%. 5-year loan coupons were marginally higher, with an average of 6.2%, which is likely the result of the wider loan spreads at origination for 5-year loans relative to 7-year loans. Obviously, the 10-year loans maturing next year will almost certainly enjoy a lower coupon than they currently pay, which further supports their ability to refinance.

Next, we separated these loans into buckets based on their securitized balances and again, noticed that there were clear trends (Exhibit 6). First, we noticed that a relatively large percentage of the maturing balance owed to larger loans; approximately two-thirds can be attributed to loans with securitized balances greater than $10mm. These larger loans also primarily had 5- and 7-year terms. While just over half of the maturing balance of 10-year loans came from those with securitized balances in excess of $10mm, nearly 90% of both 7- and 5-year loans were comparably large. Furthermore, the larger the balance, the more likely a loan was to be from a later
Looking by sector (Exhibit 7), we found that of the core property types, office and retail properties accounted for approximately 34% and 31% of the maturing balance, respectively, followed by multifamily (19%), industrial (5%) and lodging (5%). As a side note, this is roughly proportional to their exposure within the conduit universe. Where a property is located also has a large impact on its ability to successfully refinance. At present, the nascent recovery in commercial real estate is highly tiered. Borrowers and lenders have a strong preference for trophy properties in top-tier markets and comparatively little interest elsewhere. We can see this by comparing improvements in cap rates with 2010 transaction volume by MSA, for the office sector. Though there is some scatter, data collected by Real Capital Analytics show that declines in cap rates over the past year tended to be greater in the most active markets (Exhibit 8). Should these trends continue (and with relatively tight credit and weak economic growth expected to continue next year, there is no reason to expect otherwise) we can anticipate the availability of CRE financing for maturing loans will vary considerably depending on the market.

We therefore identified loans scheduled to mature in 2011 that were located in “Top-Tier,” “Primary,” “Secondary,” and “Other,” markets (Exhibit 9). We defined these according to the trailing twelve month transaction volume, as measured by RCA; the top five markets were labeled as Top-Tier, the next five were Primary, the 10 following Secondary, and the remainder Other (Exhibit 10). Properties located in Top-Tier and Primary markets account for roughly 43% of the maturing balance in 2011. Primary and Secondary markets have the highest percentage of 5-year loans at 44% and 51% by balance, respectively, compared to approximately 30% in both Top-Tier and Other markets. There was also a sizable group of loans (12% of the total, by balance) that was not associated with a particular MSA and was therefore categorized as “N/A.” Nearly two thirds of these loans had 5-year terms.

In order to better quantify the level of refinance risk that CMBS investors should expect next year, we wanted to examine the distribution of the anticipated balloon LTVs in our sample. Two issues, however, immediately arose. First, the LTVs quoted by the issuer often relied on pro-forma expectations, particularly for later-vintage loans that were very aggressively underwritten. Second, most of the properties...
collateralizing these loans have not been reappraised in several years. As a result, even the most recent reported valuations often do not take into account the collapse of the commercial real estate market.

To account for different underwriting standards across vintages, we applied a property value haircut, which we calculated as the ratio between the average stressed and underwritten LTV across all conduit deals for a given vintage using estimates from three major rating agencies (Moody’s, S&P, and Fitch). Broadly speaking, this procedure resulted in property value haircuts of 32%, 22%, and 18% for 5-, 7-, and 10-year loans, respectively, which reflects the deterioration of underwriting standards and increasing availability of leverage between 2001 and 2006.

After we applied these haircuts, we wanted to estimate the effects of commercial property price declines for properties that had not been recently reappraised. To do this, we aggregated NCREIF appraisal data (current as of 2010Q3) by Census Division and property type (including the office, retail, multifamily, and industrial sectors) to derive 40 quarterly, appraisal-based property price indices. We then used these price indices, in combination with the current loan balances as of the most recent appraisal, to estimate balloon LTVs for all loans scheduled to mature next year.

The results of this exercise are summarized in Exhibit 11. According to our estimates, loans totaling $13.7bn (roughly 35% of the total) are currently underwater, which we defined as having a current LTV of greater than 100%. These loans overwhelmingly had 5-year terms (78% by balance), which makes sense considering they were the most aggressively underwritten and were originated near the peak of the market when valuations and leverage were each significantly inflated relative to earlier vintages. By contrast, 87% and 66% of the maturing balance of 10- and 7-year loans, respectively, have current balloon LTVs below 70. These loans, and in particular those with 10-year terms, had time to enjoy capital appreciation before prices collapsed in 2008.

Finally, we examined the DSCR distribution for loans expected to mature next year. As we did to arrive at a recent property valuation, we included a haircut designed to encode the effect of underwriting standards for each vintage to estimate a given property’s “true” cash flow. We calculated these haircuts by taking the average percentage difference between the stressed and underwritten cash flow for a given vintage, as estimated by the three major rating agencies. The resulting haircuts...
were approximately 6%, 3%, and 4% for 5-, 7-, and 10-year loans that are set to mature next year, respectively.

These haircuts were then applied to the most recently reported DSCRs, as measured from net cash flow (Exhibit 12). We found that just over half (53%) of the maturing balance was supported by a DSCR greater than 1.3x. As expected, however, 5-year loans were the worst performers with only 40% above a DSCR of 1.3x as compared to 53% and 76% for 10- and 7-year loans, respectively. However, generally speaking there were relatively few loans experiencing very low cash flow relative to debt service. Only 6% of the total maturing balance had a DSCR less than 0.7x.

As we have noted in the past, however, it is important to bear in mind that commercial real estate borrowers may not simply hand in the keys when their DSCR drops below 1.0x. Instead, they often choose to exercise their call option on the asset, and come out of pocket to meet their debt service obligations rather than realize a large loss that will likely wipe out any hope of recovering their equity in the asset. As a result, of all loans in the conduit universe reporting a DSCR less than 1.0x, approximately 70% are still listed as “Current.”

Over the past year and a half, special servicers have often chosen to extend and modify loans facing difficulty refinancing, particularly if the properties are performing, rather than crystallize a large loss via liquidation. In fact, more than $4bn of loans originally scheduled to mature next year have already been extended. Therefore, we believe that in many cases, loans with high LTVs but solid DSCRs up for refinancing next year will be modified and extended, rather than liquidated.

The accelerating rate of modifications also begs the question: which loans currently scheduled to mature next year were originally scheduled to do so earlier. In total, we estimate that approximately $2.3bn of the $38bn in maturing balance next year owes to extended loans. The vast majority are 5-year loans from the 2004 and 2005 vintages that were originally interest-only for the full term (Exhibit 13). While it is very difficult to predict how these loans will fare next year, it is important to keep in mind that they represent a small fraction (roughly 6%) of CMBS refinance needs in 2011. Furthermore, to the extent that these properties are performing, and the commercial property market continues to recover, we think it is likely that special servicers will once again prefer to extend, rather than liquidate maturing loans that are having difficulty refinancing.
ENFORCING DEFAULTED CMBS LOANS THROUGH RECEIVERSHIP SALES:
RISKS & REWARDS OF THE MODIFICATION, SALE & ASSUMPTION TRANSACTION UNDER CALIFORNIA’S “ONE ACTION” RULE

MBS servicers are talking about a new way to enforce a defaulted CMBS loan (i.e., a commercial real estate loan held by a CMBS trust). Instead of a traditional foreclosure on the collateral, followed by a sale to a new buyer, some servicers are doing the following:

1. filing a lawsuit to have a receiver take possession of the mortgaged property; and
2. arranging for the receiver to market and sell the mortgaged property subject to the loan.

As part of such a transaction, the servicer would likely reduce the loan principal and otherwise modify the loan terms to make buying the property subject to the loan attractive to an independent buyer (the "assuming buyer"). In return, the assuming buyer would typically provide some amount of “fresh cash” to the servicer and would formally assume the modified loan. The fresh cash would be used to pay down a portion of the loan; otherwise, the modified loan and the lien against the property would remain in place. This transaction is sometimes referred to as a modification, sale and assumption transaction or “MSAT.”

If doing an MSAT seems somewhat complicated, it is. Why bother? The answer lies in the rules (primarily the REMIC rules) that govern what a CMBS servicer can and cannot do to enforce a defaulted loan and realize on the collateral securing it.

Unlike a bank, a CMBS servicer that forecloses on a property cannot provide a new loan to facilitate a sale of the property to a new buyer. However, the servicer can generally modify the terms of a defaulted loan, and usually the servicer can also permit a loan (whether or not the loan is in default) to be assumed by a buyer of the property securing the loan. When both techniques are used in a single transaction, the servicer is able to provide the functional equivalent of a “loan to facilitate” made by a bank, effectively providing financing for the new buyer’s purchase.

Since financing for commercial real estate acquisitions is relatively difficult to arrange in the current market, the ability of the servicer to provide financing for an acquisition through an MSAT expands the universe of prospective buyers. This can result in a potentially greater recovery (higher net present value) than that which could be obtained by an all-cash sale after a foreclosure.
How much bigger could that recovery be? A lot. For example, in a recent Arizona case, a receiver (Trigild’s Bill Hoffman) was able to arrange for several Phoenix-area apartment complexes to be sold subject to the existing loan (on modified terms) for a total purchase price that was 75% greater than the best all-cash offer ($123 million vs. $70 million).

In some states, the two-step approach outlined above appears to work without any problem. But in California, the situation is more complicated. If the current borrower consents to the MSAT (which it often does in exchange for a complete or partial reduction in the guarantor’s liability under the guaranty), this approach would almost certainly be enforceable. If the current borrower does not consent to the MSAT, however, things get tricky. To understand why, we must first take a look at California’s one action rule, set forth at California Code of Civil Procedure Section 726(a).

Basically, California’s one action rule provides that generally a lender may bring only one type of “action” (i.e., court proceeding) to recover on its secured loan: a judicial foreclosure. In general, a lender who violates the one action rule by pursuing another type of action against the borrower (e.g., a suit on the note) runs two risks:

1. The first risk is that the borrower will assert the one action rule as an affirmative defense in the lender’s action against it. In that case, the lender will be required to amend its complaint to seek judicial foreclosure rather than monetary damages or whatever other form of relief the lender originally sought.

2. The second, more serious risk is that the borrower will not assert the one action rule as an affirmative defense in the lender’s action and the lender will prosecute its other (non-foreclosure) action to judgment. In that event, the lender will generally lose its real property security (i.e., the lien of its deed of trust will no longer be valid). This is sometimes referred to as the “sanction aspect” of the one action rule.

Fortunately for lenders, there are various exceptions to California’s one action rule. One of these exceptions relates to receivers. Under this exception (the “receivership exception”), codified at California Code of Civil Procedure Section 564(d), an action by a secured lender to appoint a receiver under California’s receivership law is not considered an "action" for purposes of California’s one action rule. In addition, Section 568.5 of the California Code of Civil Procedure gives receivers the right to sell property in their possession, provided that (a) the sale is pursuant to a court order and (b) the sale is confirmed by the court.

The challenge is that the interaction of the two California statutes is a gray area in the law: the language of the statutes governing receivers does not expressly state that the receiver has the right to sell mortgaged real property belonging to the original owner to an assuming buyer, while leaving the existing loan and its lien in place. In other words, a non-consensual MSAT is not expressly authorized.

Although we think it makes both economic and legal sense for a receiver to have the ability to sell the property subject to the existing loan, because there are no reported court cases squarely addressing this issue, we cannot say for sure that such a course of action would be upheld in court. Of course, as lender’s lawyers, we must help our clients find a practical solution designed to achieve their desired goals and to minimize their risks, even if the applicable law is not clear.

If a CMBS servicer wishes to enforce a defaulted loan in California by arranging for a sale of the property through a receivership to an assuming buyer without the current borrower’s consent, the MSAT must be structured to minimize the legal risks.

So what are those primary risks? Simply put, that either (a) the current borrower might make a one action rule challenge to the validity of the MSAT or (b) the assuming buyer might later make a one action rule challenge to the enforceability of the secured loan (and the related lien against the real property).

The gist of any challenge by the current borrower to an MSAT would be that, under the one action rule, a judicial foreclosure is the only action that the servicer may pursue to enforce the loan. To avoid or defend against this possible challenge, the servicer could seek a court order authorizing the receiver’s sale of the property subject to the lender’s lien pursuant to California’s receivership law (which, as noted, permits a receiver to sell property in its possession if a court so orders). In its motion and proposed order, the servicer would need to ask the court to make a specific finding that such a sale would not violate the one action rule because of the receivership exception to that rule. If the servicer were to obtain such an order, the current borrower’s rights to attack the order permitting the MSAT would be cut off at the end of the applicable appeal period. So the risk of a one action rule
challenge by the current borrower can be mitigated by obtaining such an order permitting the MSAT, then waiting until the appeal period for the order has run before actually closing the MSAT.

The gist of any challenge by the assuming buyer would be that the lender's action in obtaining a court order allowing a receiver to sell the property constituted its only allowed action to enforce the loan and, therefore, the lien of the deed of trust would no longer be valid after the sale. The assuming buyer could argue that although the receivership exception allows the appointment of a receiver for ordinary purposes (such as the preservation of property or the collection of rents), it does not authorize the receiver to sell the property without the original borrower's consent as a substitute for foreclosure. Bottom line, the assuming buyer could argue that the sale of the property without the original borrower's consent was, essentially, the "one action" allowed to a lender -- which in turn, would mean that the lender's lien was extinguished by the sale, as if the sale through a receiver were a nonjudicial foreclosure.

It seems unfair to allow the assuming buyer to invalidate the lien in favor of the lender who enabled the assuming buyer to acquire the property in the first place. However, the risk of a one action rule challenge by the assuming buyer cannot be discounted because (1) there are no published cases squarely addressing this issue, as noted, (2) California courts are notoriously hostile to lenders on one action issues, and (3) the court's order allowing the receiver to sell the real property would in fact take away the original borrower's title to the real property, which is the essence of a foreclosure action. The worst part of this risk is that there may be no time limit on when the assuming buyer must assert the "sanction aspect" of the one action rule.

How can a servicer structure the MSAT to avoid these risks? The best steps that the servicer can take to mitigate the risks of a one action rule challenge to the MSAT include the following:

(a) if interests of third parties are to be adversely affected (e.g., if liens of subordinate lienholders are to be discharged), naming such third parties as defendants in the underlying lawsuit and serving them with all appropriate papers;

(b) obtaining appropriate court orders, including (i) an order appointing the receiver that gives the receiver the power to market and sell the property, and (ii) a separate order approving the sale, assumption and other terms negotiated in the MSAT that specifically addresses the one action rule and makes other critical findings of fact and conclusions of law (the "sale order");

(c) recording the sale order in the local real estate records;

(d) waiting until all applicable orders (particularly the sale order) are final and non-appealable before closing the MSAT;

(e) in the loan assumption documents, requiring the assuming buyer to affirmatively acknowledge and agree to critical findings of fact and conclusions of law in the sale order, particularly those related to the one action rule; and

(f) if circumstances permit (i.e., if there would be no loss of lien priority), carefully structuring the loan assumption so that it constitutes both (i) an allowable assumption transaction under the REMIC rules (and any applicable pooling and servicing agreement restrictions) and (ii) a novation (the substitution of a new obligation for an existing one) under California law. Taking this step should preclude the assuming buyer from arguing that the lender had already brought an action to enforce the loan because, under California law, the modified loan assumed by the buyer would be deemed to be a new obligation.

In all MSATs, of course, obtaining title insurance will be vital. The assuming buyer will not purchase the property unless it can obtain appropriate title insurance. Similarly, the lender will not consent to the MSAT unless the validity and priority of the lien securing the modified loan is insured (whether via an endorsement to the existing policy of title insurance or the issuance of a new policy of title insurance).

We have resolved this issue with a number of national title insurers. Generally, title insurers will insure both the lender and the assuming buyer for an MSAT if the first four or five steps above are taken. Obviously, discussing these issues as early as possible, preferably when proposing the order appointing the receiver, is advisable so that the underwriting team at the applicable title insurance company is willing to insure the MSAT at closing.

In conclusion, while selling a property subject to the loan may provide significantly enhanced recoveries for CMBS trusts and their servicers, MSATs are not entirely risk-free in California and require careful structuring. However, with careful structuring by the servicers and their counsel, these risks may be reduced to an acceptable level, particularly in light of the improved loan recoveries that such transactions make possible.
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