Market Analysis

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CMBS Choking on High Spreads

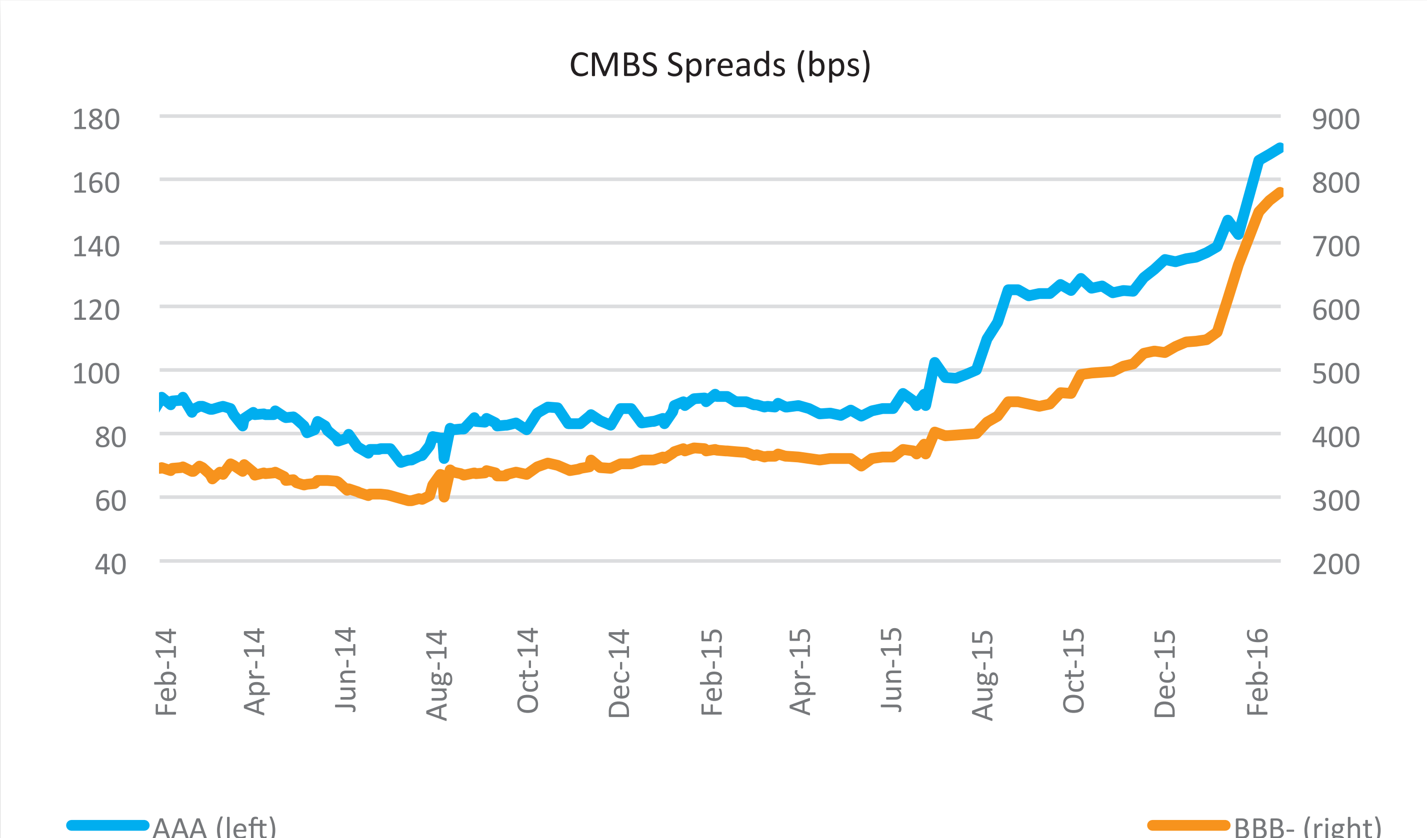
Recent volatility in the fixed-income market is proving to be disastrous for CMBS programs, which have virtually stopped lending, with no clear end in sight.

CMBS prices have dropped precipitously since last fall, which in turn has forced securitization programs not only to widen loan spreads but to decline to lock in rates until closing. Few borrowers will agree to those terms, so most CMBS programs have essentially put their pencils down for the moment. Meanwhile, the market's troubles come as it is struggling to deal with new regulations, scheduled to take effect in 2017, that some are concerned will have a chilling effect on volume.

Through Feb. 26, issuers had floated $11.4 billion worth of CMBS, one-third less than the $16.9 billion issued through the same period in 2015, according to "Commercial Mortgage Alert." The prospect is that volume will remain weak through the end of the first quarter—or even longer.

The withdrawal of CMBS lending has left a void in the markets most serviced by that product. CMBS lenders concentrate on loans in secondary and tertiary markets, and on out-of-favor property types. In 2015, CMBS constituted 16% of all commercial mortgages originated, but 28% of the loans funded in tertiary markets, 32% of hotel loans and 28% of retail loans, according to Real Capital Analytics Inc.

The heart of the immediate problem is bond-market volatility, as CMBS spreads have widened sharply since last summer. The widening is due to a combination of factors, including the higher spreads of corporate bonds and other fixed-income products and concerns about sovereign bonds and prospects for CMBS.



Source: JP Morgan

New-issue triple-A-rated CMBS currently is priced to yield roughly 165 basis points over the 10-year Treasury, about 100 basis points over its low-water mark in late 2014. Triple-A CMBS spreads were under 100 basis points through September 2015, and have climbed steadily since then.

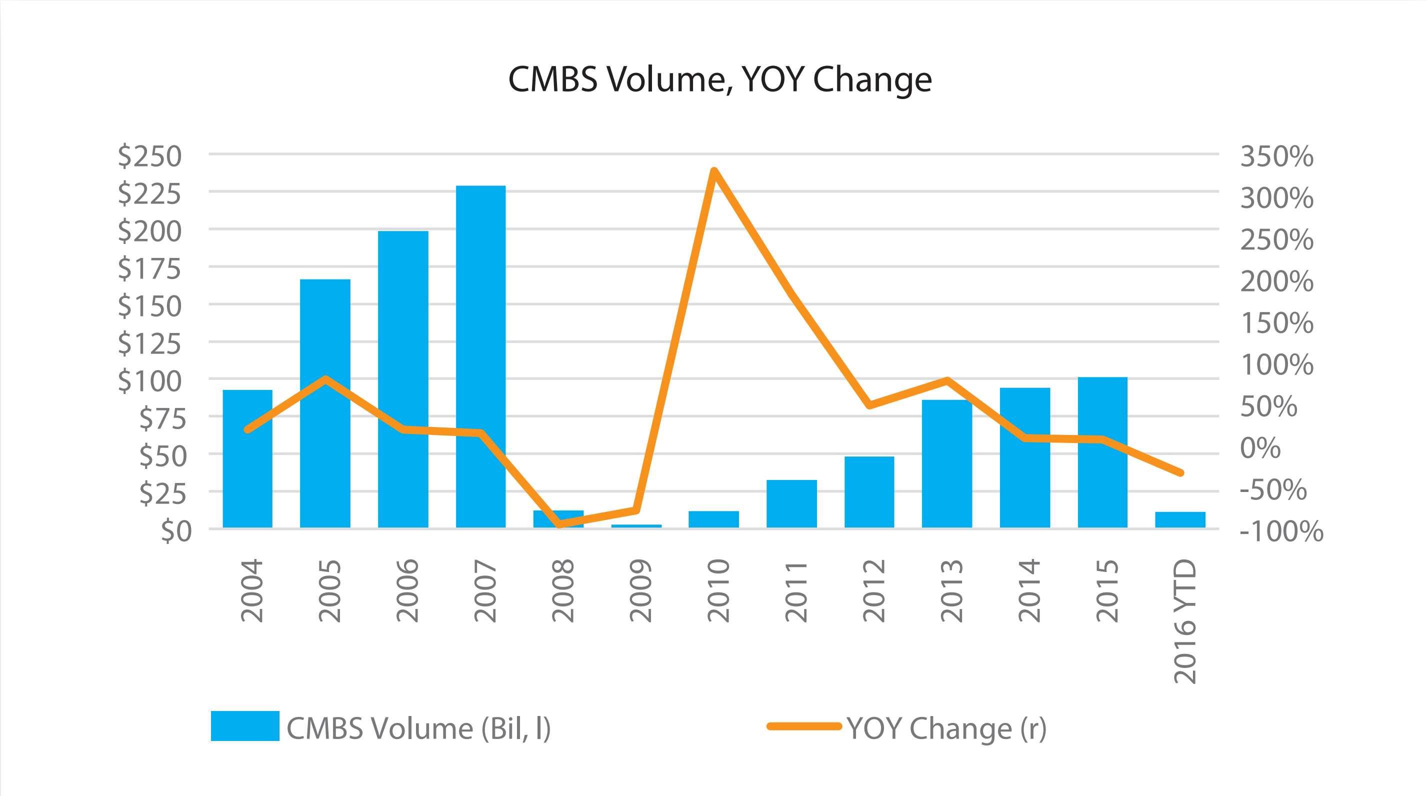
The price at which CMBS programs can sell their bonds effectively represents the cost of capital for the market. As a result, as spreads rise, CMBS programs must increase loan rates offered to borrowers. At current prices, CMBS lenders are offering loans at 5.25 to 5.5%, which is 75 to 100 basis points more than the loan rates offered by life companies and banks.

Worse, because bond spreads have been so volatile, CMBS programs are hesitant to commit to offered rates. When CMBS lenders fund mortgages, the loans are warehoused until there is enough volume to create a diversified trust that is sold to investors. CMBS issuers hold pricing risk between the time the loans are funded and securitized. If bond spreads rise (which causes the value to fall) between origination and funding, the issuer loses the difference. The opposite is true, as well—securitization programs profit when CMBS spreads decline between origination and issuance—but with spreads in a generally declining mode, few issuers want to take the risk at the moment.

In practice, that means that CMBS lenders will not commit to offered loan rates until the loan is closed, a practice known as "re-trading," which borrowers are reluctant to accept.

The upshot is that few new loans are being originated by CMBS lenders. The market will see some issuance that involves loans originated at the tail end of 2015 and in early 2016, but beyond that the prospect for new deals is dim until market conditions change.

Given its sensitivity to the market, CMBS activity can pivot on a dime if bond market conditions change. With bond investors spooked about the impact of global financial issues—including the slowdown of economic growth in China, the drop in commodity prices and the impact of the bear market on U.S. stocks—spreads might not move back down to 2015 levels anytime soon. What's



Source: Commercial Mortgage Alert

more, CMBS already is in semi-crisis mode related to the January 2017 implementation of "risk retention" rules mandated by Dodd-Frank that require issuers (or an authorized investor) to retain 5% of CMBS pools.

Because the owners of the 5% retained strip are not allowed to sell it for five years, the reduced liquidity will decrease the value of junior bonds, further adding to the pricing woes of CMBS issuers. That is leading issuers to mull new structures.

The question for the larger commercial real estate market is, if the CMBS market's troubles are extended for any period of time, which type of lender will step up to take on the types of loans that are concentrated with CMBS programs? Life companies are unlikely to move down in quality level, which means that commercial banks or even specialty lenders will have the opportunity to step up. If not, debt availability for second-tier properties in secondary and tertiary markets will be lessened in upcoming months.

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