CMBS Emerging Market Dominance

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The real estate capital markets demonstrate a remarkable ability to change and adapt. Perhaps, the most significant example is the emergence of the Commercial Mortgage Backed Security (CMBS) that, in large part, was a response to the collapse of the Savings and Loan (S&L) industry and the creation of the Resolution Trust Corporation (RTC) in the late 1980's. At the time, there was a need to create liquidity to dispose of billions in real estate assets at a time when capital was not readily available. The creation by major bond rating agencies of a set of commercial mortgage underwriting standards allowed for the securitization of pools of mortgages into bonds. The introduction of this new "mechanism" profoundly changed commercial real estate lending and the behavior of the capital markets, all to the benefits of today's borrower and lender alike. In the late 1980 and early 90's, commercial banks and life insurance companies were the primary sources of commercial real estate loans. Savings and Loans brief venture into commercial real estate lending in search of high yield alternatives to low yielding, long term, fixed rate home loan portfolios, was part of their undoing. Generally, banks and S&L's were local in nature. It was not until the late 1970's that there was a push to build banks on a national scale. The major institutions were generally found on the east and west coasts or in large metropolitan areas. Limitations were place on bank's real estate loans, especially after the S&L collapse. Overall, deposits determined maximum loan size limits. The short-term (time) nature of their deposits, dictated the term (maturity) of their loans. A depository relationship often influenced loan structure. Construction lending was ideal. At this time, there was, for the most part, a clear delineation between the role of the bank, as a short-term lender and the life insurance company as a long-term lender. The life company's ability to predict the term of their contract and their promise to pay a fixed benefit made them an ideal source for long-term, fixed rate loans. Then, as today, the life company allocated a percentage of their assets, between 5% and 30% to commercial real estate loans. These percentages influenced the amount of loan activity (total dollars) and the size of individual loans (not to exceed 1% of total assets). Loans were kept on their balance sheet. Lending activity could extend to any state where the life company was licensed to conduct business. Also, differences in "regulatory oversight" gave it an advantage over the federally insured institution. Unlike banks, life companies had the ability to lend on a non-recourse basis. But without a bank's deposit relationship or compensating balances, the life company emphasized, among other things, asset quality and stability of cash flow. It was against this somewhat disconnect and ad hoc market framework that CMBS was introduced. CMBS set in motion a series of changes, all with far reaching consequences. Securitized lending enabled commercial banks to offer a long term, fixed rate mortgage product that was sold rather than kept "on book." For the first time, the commercial banks had a non-recourse option to offer. This provided a means to broaden their customer base. Life companies incorporated the CMBS into their menu to stay competitive with the investment banking firms offering securitized loans. CMBS has also has put pressure on the life company origination system, in some cases, allowing borrowers easier access to these institutions and sometimes cutting the cost of the special correspondent "middle man" who controlled this major source of capital. In effect, CMBS has intensified the competition between lenders for borrowers who now see the differences between lending sources, as a matter of small degree. CMBS has compelled these institutions to broaden the scope of their loan business to include a wider range of property types. Today, we see a remarkably low cost of capital for property types like, hospitality, which, in the past, was difficult to finance. Lenders who historically tended to specialize are now more disposed to finance all property types. CMBS have also helped create a "true" national lending market. This has provided often overlooked tertiary markets with greater access to capital. CMBS has transcended local and regional boundaries and lender preferences. But most importantly, the CMBS mechanism created a highly transparent and efficient marketplace, the extent of which has to not seen before. Evidence of this is the recent performance of the long-term mortgage interest rate market. While faced with rising U.S. Treasury benchmarks, quoted spreads actually compressed and the resulting coupon rates

Summary

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remained virtually unchanged. The emergence of CMBS provided the borrower with access to a financial market with impressive depth, more diverse loan structures and capital for varied property types with fewer geographic constraints but it has “leveled the playing field” among financial institutions vying for real estate loans. The CMBS market has become the facilitator of a highly competitive process that provides not only borrowers with the lowest cost of capital but lenders access to more financing opportunities.