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Risk-retention rules, maturity wave could spur CMBS defaults in 2017

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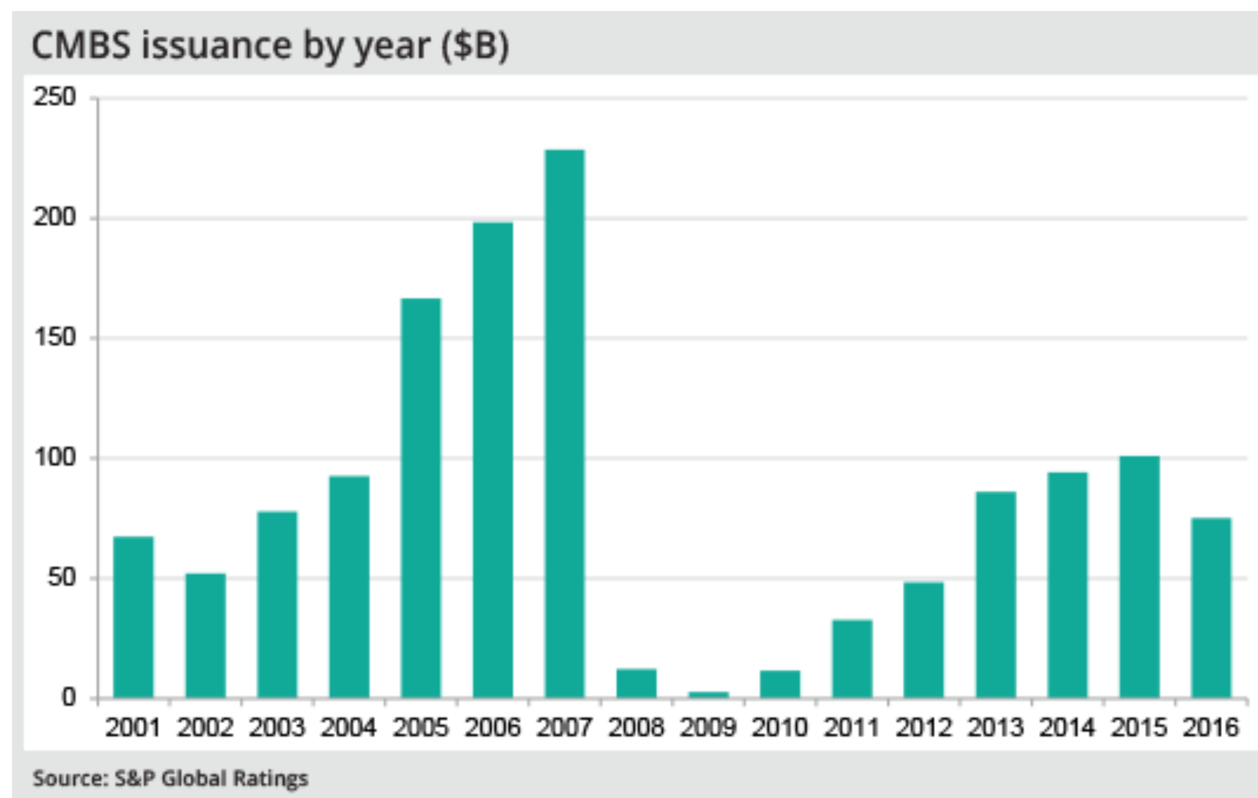
New risk-retention rules could make CMBS lenders uneasy and dampen issuance in early 2017, just as borrowers are seeking to refinance a wave of aggressively underwritten 2007-vintage loans.

The spike in maturities will coincide with a change in structured finance regulations, taking effect Dec. 24, that market participants say could affect commercial mortgage-backed securities in unpredictable ways. Under the new rules, issuers — typically large banks that bundle commercial loans into bonds — will be forced to hold a 5% slice of transactions that they securitize on their books, as a way of ensuring that they retain some accountability.

Neither the regulations nor the maturities should spell disaster for the CMBS market, which has been functioning smoothly in recent months, observers say. Yet their confluence may lead to increased defaults and hurt commercial real estate valuations, forcing some borrowers to recognize real estate losses that have been hidden since the last decade's financial crisis.



If CMBS lenders pull back in the first half of the year, when many of the 2007 loans are due to mature, other types of lenders could step into the void, including banks and insurance companies. Lenders may blanch at some of the expiring loans' credit quality, though, and banks in particular may be reluctant to add to their commercial real estate exposure at a time when many believe the real estate cycle is at or near a peak.

"The issue with the loans that are coming due in early 2017 is that they were underwritten at the absolute peak of the market and the underwriting on them was aggressive," Lea Overby, a managing director at Morningstar Credit Ratings, said in an interview. Because conduit lenders tend to tolerate higher credit risk than banks and insurers, CMBS is the logical home for many of the loans coming due, she said.

The problem is that CMBS issuers are still working through the subtleties of the risk-retention rules, which are part of the Dodd-Frank Act. Until then, Overby said, "we're in this position where we've got too much loan demand versus not enough loan supply."

Edward Shugrue, CEO of Talmage LLC, a CMBS investor, adviser and special servicer, said in an interview that early 2017 could be a period of tumult and transition in the market.

"Lots of unknowns typically translates to volatility," Shugrue said in an interview. "Which typically translates to opportunity, and some rewards for half the group, and some penalty for the other half of the group."

Riskier loans coming due

Roughly $92 billion of CMBS is expected to mature in 2017, according to S&P Global Ratings. That total — a remnant of the $228.6 billion of CMBS issued in 2007, at the industry's peak before the financial crisis — consists of loans that have not refinanced, paid off or defaulted in the intervening decade.

CMBS issuance bottomed out after the crisis in 2009 at $2.7 billion, and rebounded to $101 billion in 2015. S&P Global Ratings expects roughly $75 billion in total issuance for 2016, while Trepp, a research firm, expects roughly $67 billion in total issuance for the year, with a sum in the same range for 2017.

Some of the loans set to mature in 2017 are "a little scary" because their debt yields — the returns that lenders would expect upon taking back the underlying properties — are relatively low, Darrell Wheeler, head of research for Global Structured Finance at S&P Global Ratings, said in an interview.

Maturing CMBS loans by year, 2016 - Q4 2018 ($B)

Debt yield range	Q4 2016	2017	2018
No debt yield	0.0	0.2	0.2
8% <	2.8	26.9	0.8
8%-10%	5.1	24.8	1.6
10%-12%	3.3	17.7	1.9
> 12%	4.5	22.2	7.0
Total	15.8	91.7	11.2

Source: S&P Global Ratings

Lower debt yields mean lower net operating income relative to the total loan amount. Of the total maturities for the year, $26.9 billion in loans have a debt yield below 8%, a figure that matters because historically, CMBS loans with debt yields below 8% are able to refinance only 46% of the time, Wheeler said. By extension, maturity defaults in 2017 could exceed $12 billion.

Manus Clancy, senior managing director at Trepp, said the recent rise in interest rates could hurt "cuspy" 2007-vintage loans' ability to refinance, by cutting into borrowers' already thin debt service coverage ratios. Even though there are other real estate lenders in the market, costlier CMBS is "a net negative for people who are teetering between getting refinancing and not being able to get refinancing," Clancy said.

Structures still uncertain

Though President-elect Donald Trump has criticized Dodd-Frank, market participants believe his election is unlikely to affect the new regulations, at least at first, because the rules take effect before he takes office and his administration appears to have other priorities. Still, much remains uncertain about the way the rules will be implemented, and the way that issuers will structure deals to comply.

"Everybody knows what the direction is: You want to have skin in the game, and they've made some guidelines as to what could work," Shugrue said. "But frankly, to be clear, nobody is 100% clear as to what will work."

Until a safe way forward is clear, there is "real consternation" in the market over the details of risk retention, and it will depress issuance, he added.

At the very least, the general consensus in the market is that issuers, unaccustomed to holding the risk of the CMBS deals they structure, will reassure themselves by charging borrowers more for loans. While risk retention will pressure issuers to focus on collateral quality, the wider pricing could reduce CMBS lenders' ability to compete for high-quality loans, Moody's said in a note. For weaker borrowers, the change in pricing could make refinancing more difficult.

On the bright side for the market, early deals testing risk-retention structures have been well-received by investors, including a securitization that packaged deals from Wells Fargo, Morgan Stanley and Bank of America.

Clancy said the deals succeeded in part because investors liked seeing issuers retain risk. Considering the encouraging signs, it is possible that risk retention might not hurt pricing, and issuance volume, as much as some observers fear, he said.

Period of transition

Even if 2017 issuance repeated a 2016 total in the $70 billion range, though, that would not be enough to refinance all the loans that are expected to mature. Shugrue said a series of uncertainties, including Trump's election, political instability in Europe and rising interest rates, could weigh on a market that craves stability. The wave of maturities is yet another concern.

While the maturity wall is not a surprise, "I think there's a large amount of unrealized write-downs that are going to go from unrealized losses to realized losses," Shugrue said.

Troubled properties are well-known to CMBS market participants, but their transition into special servicing and foreclosure could nevertheless affect sentiment, he added.

"We've already priced it in, but what we haven't seen is the impact of that transformation from knowing about the event to seeing the event transpire," he said. "Anytime you go from knowing something's going to happen to it actually happening, often there are some unintended consequences."