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Although Conduit CMBS Issuance is Low, Leverage is in Check

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Before the risk-retention rules were implemented, conduit issuance of commercial mortgage-backed securities reached $62 billion in 2015, and then volume dropped to $40 billion in 2018. It would be a miracle if it hits that level in 2019, according to the CMBS panel on the last day of CREFC's annual conference. The panelists shared their thinking on why issuance declined and has stayed low. One reason for this is the slew of other commercial mortgage financing alternatives that compete against conduit CMBS. Historically, conduit CMBS was an efficient source of nonrecourse debt, said one panelist, but now conduit CMBS ranks last in the menu of options that borrowers have.

As with most aspects of finance, the crisis may explain this. The same panelist mentioned that a whole generation is now averse to the product after the CMBS 1.0 fallout. When their 10-year loans matured, they didn't refinance and exited the business. Typically, there is a natural flow of CMBS from refinancing, but 2009 loans are nonexistent for 10-year, fixed-rate conduit deals.

The panelists agreed that the industry is more disciplined than it used to be. Leverage has gone down, with the average loan-to-value ratio slipping to 57% from 64% in 2015. The amount of loans with an LTV above 70% is low, at around 10%. However, there is one area of concern someone mentioned--the prevalence of interest-only loans--saying that the number of interest-only loans is at or close to precrisis levels. With the collateral being equal in both cases, panelists agreed that full-term amortization on a higher leverage loan is better than a lower leverage interest-only loan. One panelist wondered why the normal course of action is to have interest-only payments at the beginning of a loan's life. Why isn't it switched so the loan amortizes first and then transitions to interest-only payments? He believes in most cases that the asset would perform better, but he did mention that borrowers might not like the switch. Particularly for single-tenant properties, his firm looks to see how much cash borrowers are taking out.

Even though market participants worry about the length of this bull cycle, one panelist said that credit enhancement levels are not getting worse. This is a positive sign. In addition to declines in underwriting standards, the prior crisis saw lower credit enhancement before the shoe dropped.

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