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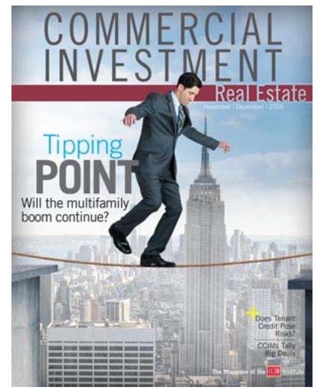
FINANCING FOCUS

Evolving Landscape

New CMBS bill could result in tougher environment for financing.



By Mitch Paskover | Nov.Dec.16

In the ever-evolving regulatory landscape, a new CMBS bill, under the Dodd-Frank Wall Street Reform and Consumer Protection Act, is slated to take effect in December. This bill, comprised of a new set of risk retention rules, will require CMBS lenders to retain a portion of the value of the loans they issue as opposed to selling them off as bonds.

These risk retention rules were originally designed to protect issuers from risky lending, a factor which precipitated the market crash in 2008. What are the implications of this new bill? How will this affect the financial landscape in December?

Based on our in-depth knowledge of providing financing within the commercial real estate industry, here are the main factors expected to affect the financial landscape moving forward.

Reducing CMBS Lenders

The new bill will require lenders to hold on to approximately 5 percent of the loans they issue, which may result in fewer CMBS lenders and an overall reduction in the amount of loans being originated.

This new shift in regulations will require issuers to use more of their own capital, driving down overall profit margins for lenders and increasing total cost of capital. Smaller CMBS lenders who do not have the sheer capital or capability to hold on to the 5 percent required will likely be priced out of the market, leaving only the larger CMBS lenders.

Before the Great Recession, approximately 40 CMBS lenders originated loans throughout the U.S. When the housing bubble burst, however, the number of CMBS lenders dwindled to 10 to 15 lenders. As the market eased back into recovery, CMBS lenders rebounded by approximately 20 new lenders.

After this new bill takes effect, a similar impact will occur and smaller lenders will leave the market. Also, larger CMBS lenders may decrease the number of loans being originated due to the increase in the cost of capital. This could not have happened at a worse time.

More than $145 billion of CMBS loans will mature in 2017. About 40 to 45 percent of these loans that are coming due this year will likely not be in a position to pay off at maturity.

Seeking Capital Sources

The decrease in CMBS lenders and overall loans originated may also play a role in driving demand for other capital sources, such as life insurance companies, banks, and agencies. As CMBS lenders adjust to these changing regulations, they will likely exercise greater caution when it comes to underwriting and originating loans, adopting a more conservative approach to high loan-to-value lending. In the past, CMBS was the most viable option for high-leverage loans, as other sources of capital tend to view them as a higher risk option.

Now CMBS lenders will be more selective in the loans they underwrite due to the increased cost of capital, driving borrowers to seek out other options for sourcing deals and propelling demand for larger portfolio lenders. Anticipating this shift in demand, mortgage banking firms can prepare by ensuring additional capital options, such as larger life insurance companies, portfolio lenders, and banks, are available for their clients.

Propelling Gateway Markets

CMBS issuers are typically the go-to source for deals in secondary and tertiary markets. With fewer issuers after this bill takes effect, an increase in demand is expected in gateway markets from investors.

CMBS issuers will typically originate financing in certain markets that other lenders are hesitant to enter, especially secondary and tertiary markets. With these new changes in legislation, it may be tougher and more costly for investors to obtain financing. The result may drive demand for properties in primary coastal or gateway markets, where deals require less leverage and borrowers can turn to banks or life insurance firms at a lower rate.

Although growth in demand for the gateway markets is probable, the remaining CMBS lenders will serve as the top options for Class B and C assets in secondary and tertiary markets. The cost of these loans will simply increase, and lenders will be more selective in their underwriting when lending in these markets.

Exception to the Rule

The one exception to the new CMBS bill is qualified loans. For loans that meet certain criteria, lenders will not be required to hold 5 percent of the loan.

For a loan to qualify as a qualified loan, the amortization and loan-to-value rates must be lower. For example, for a 10-year loan, the amortization must not exceed 25 years, and the leverage cannot exceed 65 percent. The debt coverage ratio must also be within the 1.5 and 1.7

range.

Ultimately, both lenders and borrowers are looking ahead to when this bill takes effect, and how it will affect the financial market moving forward. Although the CMBS market may experience higher costs of capital and a decreased number of lenders, demand for this type of financing will remain a viable source for higher leverage properties in secondary markets.

Mitch Paskover

Mitch Paskover is president of Continental Funding Group, a national mortgage banking firm providing capital and financial services. Contact him at mitch@contifunding.com.

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