

Editor's Statement

BY MAURA M. COCHRAN, CRE, SIOR



Through a Muddy Crystal Ball

The views expressed here are those of Maura Cochran, Bartram & Cochran, Inc., and Marc Thompson, Bank of the West, and not necessarily those of the The Counselors of Real Estate.

“THE MARKETS ARE IN DISARRAY, LIQUIDITY HAS VANISHED AND none of us has adequately been able to describe a new model for capitalization of the real estate industry.” So summarizes the status of the real estate capital markets by the economists who spoke at the recent Counselors of Real Estate meeting in Chicago. Indeed, many of the conversations at the meeting focused on the CMBS market, the lack of trust in the rating agencies and potential solutions to what is best described as a frozen capital market. Some members argued for fundamental changes such as a resolution to the conflict of interest that characterizes the rating agencies. Others believed that commercial real estate was being unfairly penalized as a result of the residential housing subprime debacle. They would return to the status quo once the financial system ultimately, albeit painfully, absorbs the subprime debt. Everyone seemed to agree that research on the situation was not much more than “Monday morning quarterbacking.”

The industry, so far, has avoided responding to the looming issue of how it is going to evolve. While an editorial in *Real Estate Issues* is not adequate to resolve this vexing and complicated issue, I have attempted to summarize some recent news articles, and I have also had the opportunity to

discuss the topic with two industry thought leaders who are active in capital markets.

Roger Lowenstein, in his *New York Times Magazine* article “How Moody’s and Other Credit-Rating Agencies Licensed the Abuses that Created the Housing Bubble—and Bust,” summarizes how the failure of the rating-agency system led to the subprime meltdown.¹ There are obviously many issues that have contributed to the problem. He cites Frank Portney, a professor at the University of San Diego School of Law, who believes that the conflict of interest has been caused by Moody’s, Fitch and Standard & Poor’s functioning as both the gatekeepers and the gate openers. And the perception of a conflict of interest would not be an issue, were the underlying underwriting accurate. Unfortunately, the agencies used a statistical model that relied on historical patterns of default that proved to be a poor indicator of future performance.

While rating agencies and underwriting practices set the stage, the problem took on monumental stature because of the desire of financial institutions to monetize their debt. “By providing the mortgage industry with an entrée to Wall Street, the agencies also transformed what had been the sleepest corners of finance,” wrote Lowenstein. “No longer did mortgage banks have to wait 10 or 20 or 30 years to get their money back from the homeowners. Now they sold their loans into securitized pools and—their capital thus replenished—wrote new loans at a much quicker pace.” But, to do this, the purchasers of these securities needed to have a credit risk rating so that a “AAA” would be treated as any other “AAA” investment.

Aaron Lucchetti's article in the *Wall Street Journal*, "As Housing Boomed, Moody's Opened Up," states "... [the rating agencies] are under fire for putting top ratings on securities that ultimately collapsed in value.² Investors, many of whom relied on ratings to signal which securities were safe to buy, have lost more than \$100 billion in market value. The credibility of the ratings system is in tatters as new downgrades of mortgage securities come almost weekly. Investigators from Congress, the Securities and Exchange Commission and several state attorneys general are examining the rating firms' practices."

The *Wall Street Journal* interviewed Moody's Investment Service President Brian Clarkson (who has announced his retirement) on his perspectives. He said, "We think there needs to be significant changes in the way these deals are being done in order for us to get comfortable. There has to be a lot more third-party oversight; somebody has to verify what's actually in them; you have to have strong representations and warranties."

When asked whether Moody's could have spotted the problems with fraudulent mortgages earlier, Mr. Clarkson replied, "We knew that there was fraud. We may have thought it was X; (it turns out) it was X to the 10th power... I hate going through this because it sounds defensive, but the fact is that there were people who were supposed to be doing due diligence on this who just didn't do it."

When asked about the prospects for reforming ratings, he said, "The ratings go to the creditworthiness of an instrument. Instead of trying to put things like volatility or pricing into the rating, we are looking at a different scale, like we did in banks. We feel like we have to. We've been asked by some regulators, 'You're on notice that people are using ratings for purposes that they weren't intended, so what are you going to do?' In banks, what we did was we came up with a bank financial-strength rating, which is a different scale (separate from the one that starts with triple-A). We've had that for 12 or 13 years, and very few people use it because they want the comfort of using the one that they actually know. We're not saying people will use volatility ratings or price ratings or transition ratings, but we feel like we have to put them out there. If you're concerned about volatility, here's the scale of volatility. It could be a triple-A-5 for example, with five being the most volatile."

Real Estate Issues wanted to look at this issue more closely. Why has that portion of the CMBS industry not associated with subprime housing taken such a hit? Why have major players, such as Prudential Financial Inc., (which last year contributed \$3.6 billion of mortgages to the CMBS market), Merrill Lynch and Wells Fargo announced that they are exiting the business? But at the same time Principal Financial's chairman, Barry Griswell, states that the securitization business is still not only viable, but that "we think this will come back and be a very profitable business force in the future. So for our way of thinking, this is not the time to discontinue the business or get out of it. Good days are ahead in the business, we believe." In fact, Principal said that it saw a \$70 million improvement in the value of its CMBS portfolio just in the month of April.

What is going to happen next? How can trust be restored to the market? Are other financial instruments being created to replace the CMBS model?



Dottie Cunningham, chief executive officer of Commercial Mortgage Securities Association (CMSA), the trade organization that represents the commercial real estate capital market finance industry, and

Marc Thompson, CRE, FRICS, CCIM, senior vice president and lending manager for Western Region of Bank of the West, provided their insights into those questions.

Q. How have the subprime problems affected the CMBS industry?

A. DOTTIE CUNNINGHAM: There were only \$6 billion dollars of CMBS issuances in the first quarter of 2008, down from \$60 billion in the first quarter of 2009. We believe that the main reason is that it is difficult for originators to know how to price deals in such a volatile market; but this is not due to the underlying fundamentals of the commercial real estate loans securing the outstanding bonds. The reality is that the subprime residential mortgage-backed securities (RMBS) has nothing to do with CMBS, but it has caused credit market volatility that is affecting all asset-backed products.

The volatility in the trading on the CMBX Index, which we believe is being caused by momentum traders rather than fundamental traders, also distorts the true picture of the value of CMBS bonds. As many investors use this

index as a mark-to-market tool, this has required many investors to write down their CMBS investments, whether the bonds are in default or not, and despite the continued performance of the bonds and the underlying real estate.

A. MARC THOMPSON: The subprime problems are affecting the CMBS industry in terms of “AAA” rated debt spreads increasing from 20 bps to 130 bps. Rate spreads have dramatically increased. In addition, investors do not trust the existing risk assessment system. There exists today a very shallow market for CMBS and RMBS, with very few participating buyers able to assess the risk and rewards.

Q. How have the rating agencies responded?

A. DOTTIE CUNNINGHAM: The rating agencies have been focused on RMBS business, which is where they are feeling the most pressure. The agencies have, or are planning, to put out questions for comment, which CMSA has or will respond to. The SEC is actively looking at the rating agency industry to determine what steps it may wish to take to regulate the industry. The rating agencies have been developing internal policies to mitigate the conflict of interest issue, but are still evaluating what changes may be required as to their ratings. One idea that has been discussed both by the rating agencies and the regulators is to develop a new ratings scale for all structured finance products. CMSA opposes this idea as it will only cause investor confusion, further eroding the liquidity of the market for borrowers.

A. MARC THOMPSON: The failure of the credit rating agencies is, in my opinion, their poor assessment of credit loss risk. I believe we are still in the beginning of the downturn in this secular investment or income-property real estate cycle. Out of the total \$3.3 trillion in income-property loans including CMBS, the credit loss risk is, in my analysis, to be between \$750 billion and \$1.1 trillion. This credit loss exposure is projected over the next three to five years, using my three approaches to valuing income property real estate debt held in CMBS, commercial banks and other financial intermediaries. Using a similar approach on \$7 trillion in RMBS portfolios, the credit loss exposure is projected to be between \$1.6 trillion to \$2.3 trillion over the same three- to five-year period.

In my view, the CMBS industry does not appear to be responding except in support of past originations. However, I do not currently serve on industry association boards at this time to know for sure.

Q. How solid are the rating agencies underwriting of CMBS?

A. DOTTIE CUNNINGHAM: Our members, who include many of the investors in the bonds, are not that unhappy with the rating agencies. They would like to see more transparency and standardization in both the ratings methodologies and surveillance press releases. Overall, the ratings assigned to CMBS are holding up, as evidenced by the delinquencies on the bonds, which are currently at a historically low level of 0.4 percent. Such delinquencies are expected to increase to a more expected ratio of 1–1/2 to 2 percent, but assumptions for increased delinquencies were imbedded in the ratings.

A. MARC THOMPSON: I support the credit rating agencies as a means to assess credit loss risk independently for investors, provided they understand how to assess it. Up to this point, credit rating agencies did not know what they did not know. Since 2005, the appreciation of both residential and income-property real estate ballooned because of poor credit quality assessments by the credit rating agencies. Speculation risk on the underlying collateral supporting the value of these securities went unassessed. Until that risk is appropriately assessed and removed from AAA tranches, investor confidence will remain very uncertain.

Q. How is the industry responding? Is anyone creating an alternative to the rating agencies?

A. DOTTIE CUNNINGHAM: The feeling on The Street is that the rating agencies are here to stay, but need to be more transparent.

CMSA is responding by being very actively engaged on several fronts. We are focusing our energies on educating the press, regulators and legislators. Earlier this year we adapted a very aggressive public relations strategy. Many reporters needed more accurate information as to the commercial real estate market, and we have been providing them with access to such information. We have also been educating the regulators/legislators as to the differences between RMBS and CMBS, and are actively engaged in their discussions regarding securitization and credit rating agency reforms. The delinquency rate on the bonds, as mentioned, is only 0.40 percent compared to 8 percent in the early 1990s. Rental rates and occupancies remain stable in all but a few markets, and overbuilding is not the problem that it was in the early 1990s downturn. So, overall, the commercial market feels pretty good. If we could just get the capital markets back in gear, we could all get back to business.

A. MARC THOMPSON: At this point, credit rating agencies should not be relied upon as an independent assessment of credit quality on mortgage-based securities, commercial mortgage-backed securities, collateralized debt obligation, or asset-backed securities. They do not get it, in my opinion. I recommend separate credit rating agencies that are real estate debt industry focused, chaired by a real estate banker with real estate credit risk officers trained to understand speculation risk as measured against an index like SPCREX for CMBS and S&P Case/Shiller® Index for RMBS. In addition, property stand-alone risk could also be accurately assessed to determine credit loss risk. This would provide a better method to accomplish a reassessment of credit loss risk and reestablish confidence in the CMBS industry since having credit rating agencies change their ways will be relatively more challenging. The question is, what methodology of credit loss risk would be acceptable to the industry and still add confidence to the CMBS market? My independent proposal would be financially painful and therefore less likely to be adopted.

SUMMARY

The rating agencies are so entrenched into the financial system that to start over is not a viable alternative. If the past is any prediction of the future, any reform is going to need to be regulated. The deferral government process has started that process with hearings. All regulatory agencies are going to need impartial, unbiased, high-level advice, as they study the matter and make recommendations. Who is more qualified than the Counselors of Real Estate to contribute to the thought leadership on this topic? Your insights and comments are appreciated. The dialogue will continue.



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ENDNOTES

1. *New York Times Magazine*, April 27, 2008, "Triple-A Failure," by Roger Lowenstein
2. *Wall Street Journal*, April 11, 2008, "As Housing Boomed, Moody's Opened Up," by Aaron Lucchetti