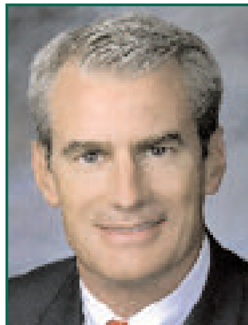
Impact of Subprime Loan Defaults and Tighter Underwriting on Commercial Real Estate



Stan Mullin, SIOR, CCIM, CRE, FRICS, and 2006-2007 SIOR President has been with the Grubb & Ellis Company in Newport Beach, California for 26 years. He specializes in industrial leasing and sales. He served as 2007 President for the Los Angeles based AIR Commercial Real Estate Association and has taught for AIR, BOMA, CAR, Grubb & Ellis, and SIOR.

By Stan Mullin, CCIM, CRE, FRICS, SIOR

In early fall of 2007, an article in the *Economist* reported that the value of property in the developed world had risen by roughly $25 trillion in just five years. That number is more than the combined GDP of all developed nations. To me, it raises the question, "From where did all that growth in value come?" The answer, to a large extent, is leverage…on an unprecedented scale.

Many property-related securities (one of a myriad of derivatives), that used subprime loans as collateral, made their way into the hands of hedge funds and some of those funds leveraged their capital a staggering 52 times. It was not uncommon for a hedge fund or investment bank to use $1 in equity and $20 in debt to purchase derivatives.

Leverage on this scale leaves very little margin of error. If the leveraged investment increases in value the return is high. But, if the investment is unsuccessful, even on a small scale, the losses can be staggering. Long Term Capital Management was bailed out of bad debts in 1998 almost taking the world financial markets with them. Profits were thin, so they (and others) used increasing leverage and progressively larger transactions to get their returns. Macklowe Properties' purchase of the EOP New York City office portfolio of eight buildings, totaling 6.5 million square feet, is one of the clearest examples of this in the commercial real estate world. Macklowe paid $6.8 billion for the portfolio, borrowed $7.6 billion, and only contributed $50 million in equity. This epitomized the unique level of leverage that the credit markets brought to the commercial real estate industry.

So who invested in this $440 trillion (highly leveraged) derivatives market? As you'll read in the first of this two-part article, a myriad of groups invested, including small towns inside the Arctic Circle.

In the fall 2007 edition of the *Financial Times,* former U.S. Treasury Secretary and Harvard Professor Larry Summers wrote that "the U.S. economy is in far deeper trouble than most people understand." In the winter of 2007-2008, Ken Lewis, CEO of Bank of America, said conditions in the credit markets were the toughest he has seen in his 32-year career. Brett Hammond, Chief Investment Strategist at fund manager TIAA-CREF, said, "The big picture here is that we've gone from a period where every piece of information was shrugged off or interpreted positively, to one where information is shrugged off if it's positive or else interpreted negatively." [1] This article seeks to better explain what has happened and some of the events that will likely take place in the credit markets that will affect the value of commercial real estate throughout the United States.

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We will start with a primer on what led to the current crisis in the capital markets. Subprime mortgages (also known as B-paper, near-prime, or "second chance" lending) played only a limited role.

Rise of Subprime Mortgages, but Not of Regulation

For the last five years, the United States has seen an unprecedented expansion of our credit markets. The issuance of debt for the residential mortgage market has been instrumental in this expansion. A key factor influencing the issuance of new debt and corresponding increased home values, has been the increased use of the subprime home mortgages (Most were eventually securitized and almost 50 percent of those were interest-only or option ARMs).

Beginning in 2003, mortgage brokers, subprime lenders (some of the largest were Ameriquest, Countrywide, Impac, New Century, Option One) and banks (Bank of America, Wachovia, Washington Mutual, etc.) began offering loans—later referred to as "liar loans"—to borrowers who under normal circumstances would never have qualified. Many borrowers had little or no equity, low or no income ("stated income"), no verified employment, or bad credit. (Contrary to conventional wisdom, in 2005, the peak year for subprime originations, roughly 55 percent of the borrowers could have qualified for "prime" loans with better terms.)

The view of Alan Greenspan, Federal Reserve Chief at the time, was that regulation of the banking industry should be nominal, in large part to promote greater home ownership. He routinely testified before Congress against proposed banking regulation. Joining Greenspan in attempting to block regulation of the banking industry were the subprime lenders themselves and the Mortgage Bankers Association. Ameriquest Mortgage Company alone handed out more than $20 million in political donations and played a large role in financing lobbying efforts against the Fair Lending Act in Georgia and New Jersey, pushing instead to relax their lending laws.[2]

The Coalition for Fair and Affordable Lending, the National Home Equity Mortgage Association, and the Responsible Mortgage Lending Coalition, were three of the prominent lobbying trade groups that represented the subprime industry that fought to block lending regulations.

Brokers: What, Me Worry?

At the time, many borrowers and their mortgage brokers and banks assumed that the rise in U.S. home prices would continue indefinitely. If values had continued to rise, the assumption was that there would be sufficient equity in housing to

allow the loans to be re-financed. However, at the end of December 2007, sales of new homes dropped to their lowest level in 12 years, and in fall 2007 Lehman Brothers forecasted that median U.S. housing prices would drop by 20 percent.

Most subprime loans offered a two to three percent annual introductory interest rate (“teaser rate”) for the first few years of the 30-year loan term; then the rate would re-set to a four- to five-point margin over LIBOR (London Interbank Offered Rate). This was often nine to 12 percent, which in many cases doubled the monthly payment for the remainder of the loan. Subprime loans eventually comprised $1 trillion of the $8 trillion mortgage market. *Even though a Standard & Poor’s report stated in March 2008 that most of the subprime mortgage write-downs at banks were nearly complete, between one to two million subprime loans are expected to result in foreclosure. Most economists believe that short-sales and losses in other areas of the mortgage and insurance market are likely to continue for the next few years.

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Even if the mortgage brokers doubted the borrowers’ ability to re-pay, they often did not indicate much concern because they were not at risk. After all, they didn’t issue the loan, the bank did, and their motivation was the origination fee, typically one to 1.5 percent of the loan amount, added to the loan principal at origination. In fact, most subprime lenders did not have the capital to make loans. They borrowed their capital from investment banks such as Bear Sterns, Citigroup, J.P. Morgan Chase, and Merrill Lynch. Subprime lenders would make money borrowing debt at one rate while simultaneously making loans at a higher rate.

Push to Originate Subprime Loans

Banks and subprime lenders were anxious to originate these loans for several reasons. First, the number of credit-worthy borrowers was in short supply because most of those with good credit had already refinanced. Second, unlike in prior periods in our banking history where loans were typically held with the originating institution, the secondary mortgage market (investment banks, institutional investors, and other banks) was interested in buying these higher-risk mortgages, which would free up new capital for the originating institution to lend. Banks and subprime lenders knew that, as long as they did not have to inventory these mortgages, their risk in originating this low-credit debt was minimal. Third, the fees that institutional investors would pay for these mortgages made the decision to underwrite, bundle (typically into groups of mortgages worth between $100 and $220 million), and easy sell these mortgages—A friend of mine who worked for one of the largest subprime lenders, now in bankruptcy, told me that if the mortgages they tried to sell on the secondary market were rejected, his employer would instruct employees to use white-out and “increase the income” shown on the tax returns of the borrowers. Once those “adjustments” were made, the previously declined bundled mortgages were successfully sold on the secondary mortgage market.

This cycle of moving mortgages seemed all right at the time, but what if that secondary mortgage market disappeared? That’s what happened around August 11, 2007: Many mortgage-backed assets held by Structured Investment Vehicles (SIVs) suddenly went bad. An SIV is a fund that borrows money by issuing/selling short-term securities at a low interest and then lends that money by buying long-term securities at a higher interest, making a profit for investors from the difference. SIVs are usually from $1 billion to $30 billion in size and invest in a range of asset-backed securities (mortgages were a substantial part of this pool), as well as some financial corporate bonds. The risk is two-fold. First, the SIV can become insolvent if the value of the long-term security that the SIV bought (i.e. mortgages) falls below that of the short-term securities the SIV issued/sold. Second, there is a liquidity risk because the SIV borrows short-term and invests long-term. What if the out-payments

become due before the in-payments are received. If the SIV cannot refinance short-term at favorable rates, the SIV will be forced to sell the asset in a depressed market.[3]

Liquidity Crunch on Commercial Paper Markets

This SIV situation is relevant to commercial real estate because in late 2006 and in 2007, the high default rates in subprime mortgages caused a widespread liquidity crunch in the commercial paper (CP) markets. Given that SIVs rely on short-dated CP to fund longer-dated assets, there is a constant need to renew funding. SIV managers saw commercial paper interest rates[4] drop dramatically in August 2007. Three-month T-Bills, which are short-term obligations, dropped from 4.9 to three percent; at the same time Aaa/AA rated Asset-Backed Securities (ABS), which are long-term obligations, increased from 5.3 to 6.2 percent. In August 2007, CP spreads widened up to 100 bp (basis points), and practically overnight, the debt market was almost completely illiquid (pricing risk and corresponding debt was almost impossible). Commercial real estate loan terms were changing up until the day of closing and lenders were liquidating in some cases, just prior to funding.

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For about five years (2003-2007) investment banks and others purchased portions of these bundled groups of mortgages, many of which were subprime. Their goal was, like a “hot potato,” to sell the mortgages as soon as possible. Why? Because they knew there was substantial risk tied to them—although perhaps not knowing the magnitude of the risk. Their businesses are fee driven, and the fees for re-casting and selling these mortgages were a fantastic source of revenue. In order to find buyers for these re-cast mortgages, these institutional investors had to offer additional real—or perceived—security to these pools of mortgages. Investment banks (Bear Sterns, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J. P. Morgan, Merrill Lynch, UBS, etc.) then created Collateralized Debt Obligations (CDOs) sometimes referred to as Collateralized Mortgage Obligations (CMOs).

CDOs and the Aura of Security

These CDOs (which have been around since the 1980s) are a device that re-packages the income from a pool of bonds, derivatives, or other investments. A mortgage CDO might own pieces of a hundred or more bonds, each of which contains thousands of individual mortgages. At this point, I’m sure you can begin to see the complexity of the investments and understand why it eventually became hard to determine the ownership of these mortgages. Early in 2008, for example, a court in San Diego stopped the foreclosure on a series of defaulted mortgages because the court could not verify the ownership of the debt on the defaulted properties.

Ideally, this diversification would make an investor less vulnerable to the problems that could occur if the individual purchased a single mortgage. Mortgage CDOs in a sense, are securities that use the mortgage debt as collateral for security (although the subprime mortgage offered very suspect “security”). The investment banks would sell these CDO securities to a diverse range of investors from insurance companies and banks to entities as remote as school boards in Kansas. (CDOs created by Citigroup were sold in 2001 and 2002 by Terra Securities to eight small towns near the Arctic Circle in Norway. Eventually, the investments lost roughly 55 percent of their original value—about $64 million. Although each of these groups had thought that they had purchased “high quality/safe investments, in reality what they bought was junk.)

Fortunately, the SEC precluded investment banks from selling these investments in sophisticated securities to widows and orphans (nonprofessional, low net worth investors).

Individually, many of these loans were considered a high risk of non-payment, but the

investment banks, which pooled the mortgages together, made the false assumption/statement/calculation that housing prices would continue to rise and that a relatively small portion of these mortgages would default.

From Supposedly Little Risk to Toxic Waste

The CDOs were divided primarily into three tranches and sold in a waterfall structure.

1. The first tranche of CDOs (the lowest risk, AAA rated commercial paper—the highest rating that Fitch Ratings, Moody's, and Standard & Poor's offer) would pay the lowest interest rate and these investors would be paid off first by the investment banks and would absorb the final 25 percent of losses in the portfolio. **Bond insurance was typically obtained on the underlying paper/assets, not on the CDOs themselves.*
2. The second tranche of mortgage-backed securities (mezzanine paper), typically rated AA-BB (considered average, or medium risk), would offer a higher interest rate, and these investors would be paid off second and would absorb 50 percent of losses in the portfolio after losses were taken by the equity tranche (below)
3. The investment banks didn't even bother to get a risk rating on the last tranche of CDOs, the equity tranche (often called "toxic waste"), which used the highest risk mortgages as collateral. The issuing banks would buy this tranche and pay themselves a high rate of interest, in similar fashion to the high return paid to buyers of junk bond debt. This tranche absorbs the first 25 percent of losses in the portfolio.

Risk Moves Offshore and Off the Books

But what about this highest risk pool of CDO securities? The investment banks (IBs) had no interest in showing their existence on their balance sheets, and fortunately for them—but not their stockholders—current accounting rules, via the Financial Accounting Standards Board, allowed the IBs to set up shell corporations in offshore locations like the Cayman Islands. Those shell corporations would take title to these equity tranches. Once these securities were taken off the balance sheets and title shifted, these instruments were called Specialized Purpose Entities (SPEs) (in Europe, they are referred to as Specialized Purpose Vehicles (SPVs)). These are limited companies or partnerships created to fulfill a narrow objective, typically to isolate financial risk—usually bankruptcy—but sometimes for specific taxation or regulatory risk. **At the end of 2007 and early in 2008, many banks, such as Citibank, announced they would bring the SPEs back onto their balance sheets.*

The downside for shareholders in these IBs is their lack of transparency. Shareholders would have no way of knowing about these kinds of transactions and the risk they might pose to the IBs, should they default. Financiers and regulators had hoped that all of this activity would disperse risk and possibly make the debt markets stronger. Instead, they have magnified and concentrated the effects of the subprime mortgage bust.

You can only imagine the dialog between the parties in the CDO line of ownership once borrowers on these home loans began to default (no change in the economy required because the ability to service the loans was suspect from the date of origination). It might go like this….

Kansas School Board member to the investment bank that sold them the CDO: "Hey, we're not getting our monthly interest payments."

Investment bank: "Sorry but as it turns out, the folks that took out these loans (the subprime borrowers) aren't able to make their monthly mortgage payments."

Kansas School Board member: "But we purchased the AAA rated/safest CDOs?"

Investment banker: "Yes I know, but as it turns out, these investments were riskier than the rating agencies thought. Sorry."

Kansas School Board member: "But you said housing values in the United States would remain high and that the borrowers could always refinance out of their initial subprime loans after their interest rate re-set kicked in?"

Investment banker: "Well, housing values haven't kept rising. Sorry, I was wrong."

Kansas School Board member: "Hey, what about our bond insurance on these CDOs?"

Investment banker: "Bad news again. It's pretty unlikely that the insurance company has the reserves to deal with this total collapse in our credit markets."

Effect on the Commercial Real Estate Market

The reduction in the amount of debt capital available for developers and users of residential and commercial real estate has a direct affect on their ability to obtain construction loans, credit lines, and commercial debt for operations. It also affects their ability to obtain equipment leases, and to acquire or sell commercial or residential real estate.

Prices rise and fall in relationship to the amount and cost of debit.

Like musical chairs, now that the secondary mortgage market has stopped buying bundles of mortgages from originating banks, those banks are now stuck holding onto their bad loans. In addition, the banks are facing several bad situations:

- Loss of fee revenue from the sale of bundled mortgages.
- Capital tied up with existing mortgages (precluding them from issuing new debt).
- Reduced origination fee income because new debt has low loan-to-value ratios.
- Risk of insolvency (e.g., Countrywide, Washington Mutual, etc.) because of losses from mortgage and home equity defaults and under-capitalization.

On a positive note, well-capitalized investors will benefit from the current market. As Carl Weinberg, Chief Economist at High Frequency Economics said about the credit markets, the falling dollar, the low (5.1 percent) unemployment rate, and rising exports, "It's not a silver lining, it's a platinum lining." [5] The Fed's decision to cut short-term interest rates to three percent from 5.25 percent in 2007 and subsequent reductions has pushed the dollar to its lowest levels since the American exchange rate was allowed to float freely in the 1970s. To the benefit of U.S. manufacturing exports, in January 2008, were up 16.3 percent over the prior year. It is a golden era for those with cash and those who produce for foreign markets.

Stronger Oversight of Lenders and Brokers

The recommendations released on March 14, 2008 by the President's Working Group on Financial Markets, led by Treasury Secretary Henry Paulson, should nominally strengthen state and federal oversight of mortgage lenders and brokers. The plan relies primarily on state regulators and private industry to tighten their oversight of financial markets, and calls on states to issue nationwide licensing standards for mortgage brokers (instituted through legislation). The plan also requires lenders

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- ***West Region*** – Greater Los Angeles, Inland Empire/Orange County, Northern California, San Diego, Southern Nevada, and Southwest Chapters

to make more complete disclosures about payment terms to borrowers and it would limit the possible conflicts of interest at companies such as credit rating agencies that assign levels of risk to packages of mortgages that are sold to investors. These changes would be instituted through regulations issued by federal banking and securities regulators and new committees run by industry executives.[6] Hopefully these actions will help prevent a recurrence of the economic hardships currently placed on our economy.

At a time when the presidential campaign is in full swing, one of the country's most venerable investment banks barely avoided liquidation (There was literally a "run" on Bear Stearns) the dollar is at an all-time low, and our financial markets are in turmoil, now, more than ever, the commercial real estate industry needs to work together to find solutions in the capital markets. In my view, and that of many others, a floor in U.S. residential values is required before risk can be priced, losses determined and written off, the debt markets restored, our financial markets stabilized, and the commercial real estate market returned to growth.

Pick up a copy of *The Trillion Dollar Meltdown* by Charles Morris (he wrote about this topic in advance) and Allan Sloan's *House of Junk*, which many regard as the most intelligent, best-reported explanation published anywhere of the financial practices of securitization of mortgage loans and the consequences.

Endnotes

1. *New York Times* 11/12/07 – "Bad Mood May Turn Worse,"
2. *Wall Street Journal* 12/31/07 – "High Finance Backfires In Alabama County,"
3. Wikepedia
4. ibid
5. *New York Times* 3/14/08 – "Economy Hammered by Toxic Blend of Ailments," by Vices Bajaj
6. *New York Times* 3/14/08 – "White House Offers Plan to Ward Off Credit Crises" by Stephen Labaton

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