CMBS market shrugs *as critics* TAKE AIM

Amid allegations of loan origination impropriety that coincided with the onset of the Covid-19 pandemic, the CMBS industry sees little to worry about.

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Dealing with the growing number of delinquencies and trying to drum up loans in the time of Covid-19 is a tall order for the commercial mortgage-backed securities (CMBS) market. But the industry is waging war on another front: a small but dogged group of critics has emerged to allege widespread impropriety in the loan origination process.

Charges that CMBS issuers embellish loan documents to exaggerate the performance of underlying properties are strongly denied throughout the industry. Indeed, transparency has been a top theme of the industry post-Global Financial Crisis. Collateral properties in CMBS deals, pandemic or otherwise, are subject to voluminous disclosure of information.

Industry players say that lessons were taken to heart after the financial crisis, the evidence being that loan performance since the chastened market reformed a decade ago — dubbed CMBS

[1] Heather Vogell, WhistleBlower: Wall Street Has Engaged in Widespread Manipulation of Mortgage Funds, *ProPublica*, May 15, 2020.
[2] Cezary Podkul, Commercial Properties' Ability to Repay Mortgages Was Overstated, Study Finds, *Wall Street Journal*, August 11, 2020.

2.0 — was nothing short of stellar for a long time. As of Q1 2020, only 1.8% of CMBS loans were 30 days or more delinquent, the lowest level since Q4 2008, per Wells Fargo and Intex.

Whether through luck or design, the reports alleging malfeasance came just as the impact of Covid-19 hit and loan defaults suddenly shot up (see Exhibit 1). The CMBS delinquency rate spiked to 9.6% as of July, according to Trepp, almost entirely because of sharp increases in hotel and retail loans. Depending on one's vantage point, that either supports the claims or gives credence to questions about whether they are being promoted to help industry litigation consultants gin up business as loan defaults increase.

Studies allege improprieties in underwriting

The first shot came in May from an article in ProPublica[1] that outlined allegations made in a whistleblower complaint filed with the Securities and Exchange Commission by John Flynn, the chief executive of CRE Loan Advisors, a consulting firm for distressed commercial borrowers. In the article, Flynn alleged that CMBS loan originators commonly erased past expenses or inflated income to enable properties to qualify for more loan proceeds.

That means not only that borrowers have less chance of repaying loans, but also the severity of losses on loans that default is higher than expected based on the official documentation. Flynn claimed in the article to have found inflated numbers on $150 billion of CMBS loans securitized between 2013 and 2019.

The Wall Street Journal[2] published an article in mid-August that highlighted the results of a survey produced by John Griffin and Alex Priest, professors at the McCombs School of Business at the University of Texas at Austin. The professors looked at $650 billion of CMBS securitized between 2013 and 2019 and found that net operating income fell short of underwritten income by 5% or more in 28% of loans. The paper alleged that loan appraisers use artificially low capitalization rates to inflate values that allows properties to qualify for larger loans.

Griffin and Priest also identified banks that had "sizeable and persistent differences in income overstatement… with some large and leading originators having over 40% of their loans exhibit 5% or greater income overstatement." The study contended that 29.8% of loans originated by originators with a history of high-income overstatement were on a rating agency watchlist in May 2020, relative to only 10.9% of loans by originators with low levels of past income overstatement.

"Originators have financial and reputational incentives to originate high quality loans, but they also profit from passing along lower quality loans that appear to be of higher quality," the study noted.

The industry fires back

The industry responded swiftly to the Wall Street Journal piece. "As a transparent, well reported market, we believe the claims about the CMBS industry in this document are baseless and misinformed," said Lisa Pendergast, executive director of the industry trade group CRE Finance Council.

Rebuttals to the claims that CMBS programs inflate financial performance of properties fall into several categories.

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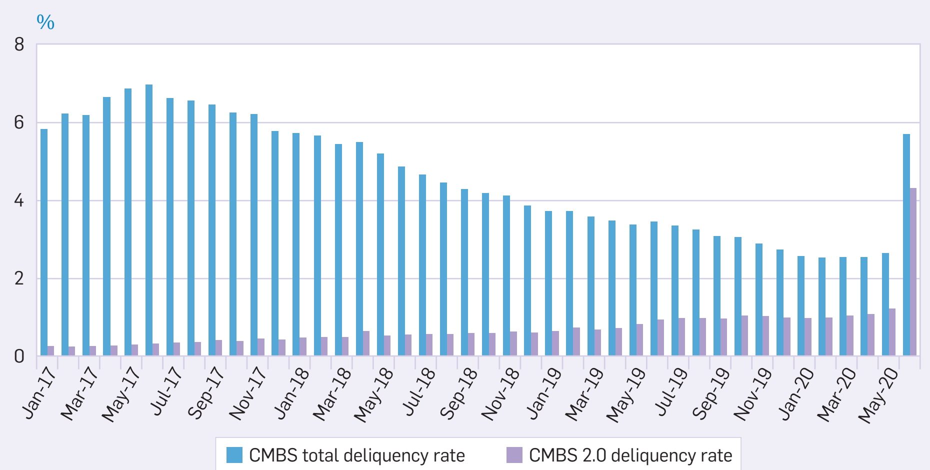
Exhibit 1: CMBS delinquency rate



Source: Moody's Investors Service, Trepp.

One is that property income and expenses naturally fluctuate from year-to-year, especially among property types that have shorter-term leases such as hotels and apartments. The UT study did not measure positive changes in underwritten income, so it's not clear whether there is systematic bias to understate revenue or if income is just hard to forecast. In any event, a 5% loss of income is not enough to put many loans in danger of default. Moreover, ebbs and flows at a property level are an accepted characteristic of CRE lending.

A second rebuttal is that the CMBS market is set up with layers of checks and balances that were acknowledged but given short shrift in the two studies. Once CMBS pools are set, individual loans are re-underwritten by rating agencies and the investors who purchase the first-loss classes, which are known as B-piece buyers. Rating agencies underwrite individual loans to stressed scenarios and assign ratings to the securities that are sold to investors, usually after imposing significant haircuts on a property's net operating income.

B-piece investors have a major role in scrubbing pools because they bear the loss of income if loans default. Issuers at various times have complained that B-piece buyers are too strict in their refusal to buy bonds unless loans not deemed of high enough quality are removed. A major reason loan quality deteriorated in the run-up to the 2008 market meltdown was that the B-piece buyers re-securitized their holdings, reducing the incentive to perform proper due diligence and transferring the risk on the buyers of collateralized loan obligations they issued. One of the important Dodd-Frank Act reforms addresses this phenomenon by requiring CMBS B-piece buyers (or deal sponsors) to hold bonds for five years without hedging or financing.

A third avenue of rebuttal of the UT study is the reliance on a watchlist, which is not a meaningful predictor of default. Servicers put loans on a watchlist when property performance deteriorates from prior periods but that does not mean a property is in danger of imminent default.

Perhaps the most pertinent rebuttal is CMBS performance over the last decade. By any standard, the market has not exhibited the frothiness of the 2005–07 era, when loans were underwritten 'pro-forma,' or with assumptions that property income would grow during the life of the loan. In the early 2000s, underwriting became progressively more aggressive until the market collapsed. Lenders have remained disciplined in this cycle. In 2019, according to CREFC, the average issuer loan-to-value ratio was 58.4% and debt service coverage was a conservative 2.25. That means net income was more than twice the average mortgage payment, giving most loans a cushion in the event income deteriorates.

Covid-19 has prompted default rates to shoot up but limited almost entirely to hotels (23.8% as of July, according to Trepp) and retail (16.1%) (see Exhibit 2). Default rates of multifamily (3.3%), office (2.4%) and industrial (1.2%) remain low. Industry proponents say the pandemic was impossible to plan for. "The pandemic has forced many commercial real estate owners to shutter their businesses, resulting in property owners experiencing dramatic declines in property-level cash flow," Pendergast said.

Critics of the study also suggest that selecting May as the measurement date obscures rather than clarifies the quality of loan underwriting. "If debt service coverage of a conference hotel is underwritten at 2 times and somehow research suggests that a 'true' debt service should have been 1.9 times, that has no direct impact on the hotel's performance

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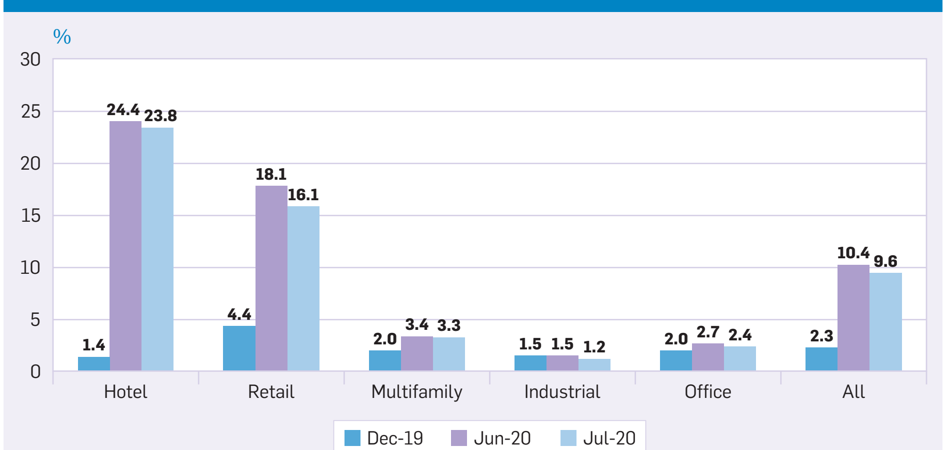
Exhibit 2: CMBS loan delinquency rates by property type



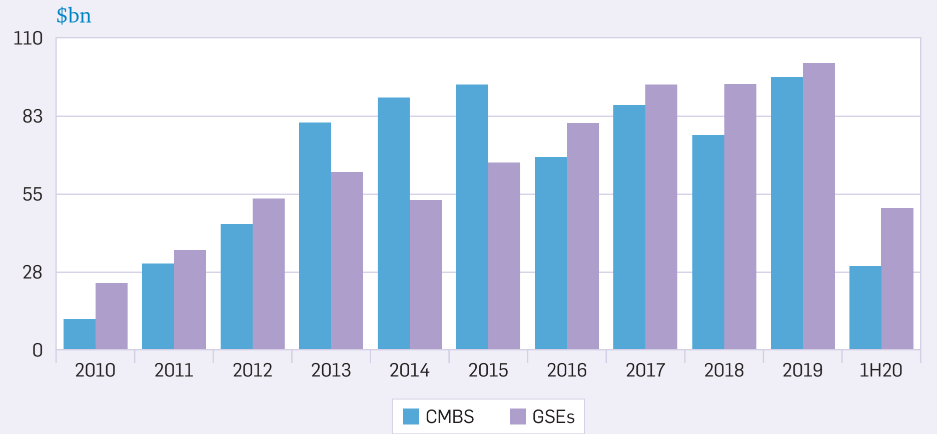
Source: Trepp.

when occupancy is at 15%," says Brian Olasov, executive director of financial services consulting at Carlton Fields. "The pandemic reveals little about property performance other than that properties with limited revenue don't perform well."

Griffin and Priest say that the pandemic demonstrates the underlying issues they discuss in their report.

"Although modelers design securities to withstand distress, crises often provide substantial information regarding security quality, as they provide an actual stress test for evaluation," the UT study said.

Exhibit 3: Securitization volume



Source: Commercial Mortgage Alert.

Bigger problems in the Covid-19 era

The industry has largely shrugged off the reports. Some of the indifference could stem from having larger problems as a result of the pandemic. CMBS is dealing with a spike in delinquencies, while bracing for more impact from the weak economy and focusing on lobbying federal and state governments to boost aid packages for tenants and to shape policies such as foreclosure and eviction moratoriums.

Meanwhile questions arise about forbearance and the impact of social distancing on demand for space. These questions include: Which retail properties will survive? Will corporations cut back on office needs? Will demand for urban apartments weaken?

CMBS loan originations slowed to a crawl when major metros shut down in March and bond spreads blew out (see Exhibit 3). Triple-A conduit CMBS, which jumped from 77 basis points over swaps pre-Covid to 330 basis points in late March, has fallen to 97 basis points, per CREFC. With Treasury rates so low, CMBS borrowing rates are once again attractive, but most new business is refinancing since transaction activity is tepid.

Aside from the focus on Covid-related issues, few are shocked at the studies. Some investors say they expect issuers to present loans in the most favorable manner, and that if the systematic overstatements were severe it would have manifested in higher default rates leading up to Covid-19.

There's also a sense that the industry has been discussing these issues for more than a decade and has taken steps to address them. In recent years, regulators have imposed a stricter framework that includes requiring banks to hold 5% of bonds they issue, while industry trade groups such as CREFC have overseen the implementation of an expansive infrastructure to prevent the type of documentary embellishment alleged. For example, when the SEC implemented reforms to the sweeping regulation covering securitized asset types as diverse as car loans, credit cards and commercial mortgages, they required a new asset schedule incorporating 140 separate data fields on the underlying loans. Under a CREFC framework, CMBS captures more than 800 fields for each loan.

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Olasov notes: "CMBS is one of the most poked, prodded and probed of all credit risk products going through the hands of professional skeptics including auditors, investors, site inspectors, appraisers and rating agencies, each of which can make downward adjustments to borrower-provided financial information. This list doesn't include the underwriters. Moreover, borrowers' insatiable appetite for leverage that drove deal sizes in CMBS 1.0 is a relic from a bygone era now that LTVs persistently hover below 60%." ◆

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