

Reviving the Commercial Mortgage-Backed Securities Market: The Background and The Way Forward

Author

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by Charles Schilke, JD '88

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Present at the Creation and Destruction of CMBS

The fateful first week of August 2007, I found myself a consulting attorney to the major Wall Street law firm that creates commercial mortgage-backed securities (CMBS), and which indeed helped to create CMBS at their inception in the 1980s. I worked with a team of nearly 100 global finance and capital markets lawyers, churning out multi-hundred million dollar issuances of CMBS nearly every week at the peak of the market in 2006 and 2007. The work involved analyzing vast pools of mortgages that had been assembled from all over the United States, preparing legal and financial reports on each potential CMBS issuance for the rating agencies, then complying with the complex securities regulations that allow CMBS to be sold on real estate capital markets around the world.

We created CMBS for literally all of the largest financial firms anywhere, including US-based firms like Goldman Sachs, Morgan Stanley, JPMorgan Chase, Citibank, Bear Stearns, Lehman Brothers, and Merrill Lynch, and for foreign-based firms like Deutsche Bank, Societe' General, and Nomura. This was real estate financial legal work on a scale that probably never previously existed. In retrospect, I see that more of the paper documenting CMBS must have passed through my firm than anywhere else, so that we were in effect at Ground Zero of the real estate financial crisis, and that I had a truly historic vantage point on the boom and crash of the CMBS market—particularly since I was living both in Manhattan and Washington, DC at the time, exposing me to both the transactional business and regulatory aspects of the real estate financial crisis.

It was a heady financial world, connecting Main Street mortgage producers nationwide with the financial muscle of Wall Street. When having lunch in the firm's 39th floor cafeteria with a dead-on view of the Statue of Liberty and New York Harbor, I often thought about how successfully America had linked the political freedom symbolized by Lady Liberty and immigration with the economic freedom symbolized by Wall Street and CMBS. People and mortgages from all over the world had both converged in Lower Manhattan.

Then, suddenly, over the first weekend in August, it all stopped.

The second week in August, an eerie silence descended upon the firm. As week followed week, it became clear that the CMBS market had been mortally wounded.

As of this writing [March 2009], CMBS issuance has not even begun to revive.

But most responsible financial people, among whom I count myself, agree that CMBS issuance must revive if the United States economy, and the wider world economy, is to revive—and prosper.

Since I'm one of the people who actually created these securities, I have an intimate acquaintance with them which may be valuable to share with those whose curiosity about them has been aroused by the financial crisis. None of the economics PhDs and

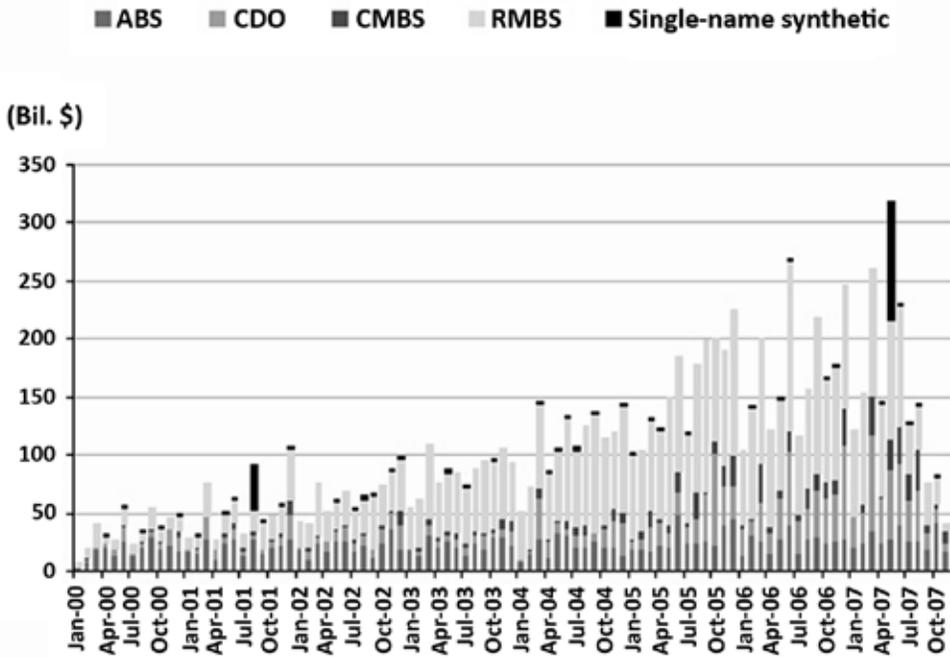


figure 1
Seven Year Growth and Decline of
CMBS Issuance

ABS: Asset-Backed Securities (other than real estate assets)
 CDO: Collateralized Debt Obligation
 CMBS: Commercial Mortgage-backed Securities
 RMBS: Residential Mortgage-backed Securities

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other senior people who are addressing the real estate financial crisis appear themselves ever to have actually created a CMBS, so I hope to make some contribution to the general understanding here---to cut through the panic and get down to some concrete specifics as to what the issues with CMBS really are, how to alleviate panic, how to prevent panic in the future, and how to enable some form of CMBS to revive and go forward.

It seems to me that the understandably emotional reaction evoked by the financial crisis which has stopped CMBS dead in its tracks has largely blinded the American public to (1) the serious problems with commercial real estate finance before CMBS, a situation which CMBS largely mitigated and to which we cannot and should not return, and (2) the very real possibilities for a chastened and more transparent CMBS in the future with the potential to revive this key market.

BC: Before CMBS

To date, I have read literally hundreds of accounts of the financial crisis, but I have not seen a single account that mentions, much less emphasizes, the condition of American commercial real estate finance before the widespread issuance of CMBS began to really take off in the mid-1990s. While some accounts draw contrasts with the real estate downturn of the late 1980s and early 1990s generally, none that I have read gets into any depth on the condition of American commercial real estate finance at that time.

Since I began my real estate legal and financial career in 1988, I can again speak from personal experience: American commercial real estate finance during that period left much to be desired. In a long-standing pattern that largely persists even today, a developer or investor who sought to finance a property would visit the loan officer of the local bank, often a trusted friend, and borrow the required funds. The bank would retain the loan and service it over its 20- or 30-year lifetime, or perhaps sell it on to an insurance

company to hold and service on a long-term basis.

The main problem with the traditional regional bank lending approach was that it failed to diversify the risk of financing a property outside of the metropolitan area in which both the property and the bank were located. Thus, when commercial real estate came crashing down in the late 1980s, it took down the regional banks that financed commercial real estate in the community in which it was located along with it.

Moreover, since the early 1990s, regional and local commercial banks have gone through successive merger waves that have produced national and even international commercial banks like JPMorgan Chase, Citibank and HSBC, so that regional banks simply do not exist in the form in which they existed in the late 1980s.

While commercial real estate organizations have not consolidated to the same extent as commercial banks, they too have experienced successive merger waves that have also produced integrated multifunctional national and international real estate organizations like CB Richard Ellis, Jones Lang LaSalle, and DTZ.

Because failing to diversify risk outside of a given metropolitan area under the regional bank lending system was undesirable, and because the consolidation of the commercial banking and commercial real estate industries made the regional bank lending system increasingly untenable, a new approach was needed.

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Why CMBS

Enter commercial mortgage-backed securities. Yes, residential mortgage-backed securities had existed under Fannie Mae and Freddie Mac for decades. And yes, CMBS were starting to come into their own by the mid-1980s. But the real estate recession of the late 1980s and early 1990s, the failure of regional banks during that recession, and the resulting desperation for real estate capital, produced a quantum shift of commercial real estate finance from regional banks to Wall Street and the world of CMBS.

Above all, CMBS solved the geographic portfolio diversification issue. By pooling mortgages from properties all over the country, securitizing them into a CMBS, then selling the CMBS on world capital markets, the risk of a given property could be diversified far out of a given metropolitan area. Now, CMBS investors in Frankfurt and Hong Kong and Buenos Aires could in effect each own a small piece of an office park in Metropolitan Washington whose mortgage was part of the CMBS pool.

Moreover, the diversification of risk in this way tended to lower the overall risk of a given property, and hence to lower the cost of typical CMBS money relative to regional bank money. CMBS thus became both a reliable and cheap source of real estate capital, contributing substantially to the increasingly liquid markets of the late 1990s and early 2000s. The cost of CMBS money was relatively low even taking into account the high legal and financial transactions costs of creating CMBS relative to basic regional bank loan documentation.

In addition, CMBS produced an efficient division of labor among financial institutions. The fundamental business of a bank is to sell money at the highest interest rate the bank can command—ideally, not to collect payments or service bad loans, which though perhaps traditional bank functions are not truly fundamental. CMBS led to the emergence of separate “servicers” which collected payments, and of “special servicers” to work out problem loans. This produced a division of labor that freed up the banks to devote all their time to selling money, and created specialist firms in collection and workouts which were better than banks at performing these tasks.

Another dimension of the division of labor CMBS produced was the development of a variety of intermediary financial institutions—basically hedge funds, private equity firms, and specialist investors, the so-called “shadow banking system”—let’s use the less

judgmental term “specialized banking system”. Ingeniously, the firms of the specialized banking system developed considerable expertise in tranches of CMBS with various levels of risk, often high levels of risk. At least arguably, it was far more efficient for these specialized banking organizations to hold these tranches according to their relative appetite for risk and reward than for commercial banks to hold all of them.

And as a consequence of both of these types of division of labor, the sheer velocity of bank lending accelerated, as the “loan sales and trading” business—a largely unregulated debt business basically outside the scope of SEC equity regulation—burgeoned. Freed of the need to service loans, and with a variety of specialized banking organizations eager to purchase commercial real estate loans with varying levels of risk, bank officers made loans and offloaded them to financial intermediaries as rapidly as possible. Rather than make a loan and hold it for decades, now banks would hold the loan for mere weeks or even days, accelerating the flow of bank lending many times over, enabling banks to be paid for the principal and interest for the entire term of the loan as soon as the bank could sell it to an intermediary, and contributing mightily to the extreme liquidity of the financial system.

In addition, the due diligence by the financial people and lawyers who created CMBS, and the rating of different CMBS issuances by the financial rating agencies—Moody’s, Standard & Poor’s, and Fitch—made real estate interests in the form of CMBS widely accessible to general investors who were not experts in real estate. This expanded the market for real estate investment, increased diversification in the portfolios of these investors, and increased liquidity.

Finally, CMBS solved another significant problem: management risk. When a property is directly managed by a real estate company, it is subject to the vagaries of the decision-making of that company’s management. But anything with a regular payment stream like the monthly payments on a mortgage may be securitized by creating a separate entity whose sole purpose is receive the payments, and diverting the payment stream from the overall real estate company into the special purpose entity. Once this is done, management no longer controls the income stream, the income stream is no longer subject to fluctuating management decisions, and the CMBS based upon that management-immunized income stream is that much more appealing to investors.

With these numerous attractions for investors, world financial markets welcomed CMBS. By 2007, [AMOUNT--\$230 billion?] of CMBS was being issued. London and Continental Europe developed sizable CMBS markets, Latin American CMBS had emerged, and East Asian CMBS began to come onstream.

How to Make Your Own CMBS

With high market demand for CMBS and with our Wall Street investment banking clients putting together CMBS deals at full throttle in its heyday—what for convenience we will call “paleo-CMBS”—how did the lawyers on the firm’s CMBS team actually create a CMBS?

1. **Bankers Provide Mortgage and Related Documents.** The investment bank clients provided the mortgage documentation for each of the mortgages in the pool, as well as other relevant legal documentation, such as leases, ground leases, and reciprocal easement agreements.
2. **Lawyers Prepare Templates With Financial Information.** Following templates provided by the banks, individual lawyers would analyze and prepare in-depth summaries of each of the relevant provisions of these documents, particularly highly detailed lease abstracts. The focus was on the financial provisions in the documents

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that guaranteed the secure flow of the regular payments in the income stream. Each of the templates had 30 or 40 different variables, so the documentation was reviewed in very considerable detail.

There was more variation among templates from each of the investment banks than might be imagined, indicating that each of the investment banks appears to have had a relatively distinctive approach to creating and evaluating CMBS.

3. Lawyers Prepare Templates for Rating Agencies. Following templates provided by the rating agencies, and drawing upon the above document analysis, individual lawyers prepared extremely detailed summaries of all documentation and the CMBS issuance generally, again with a focus on the financial provisions, often running to 80 or more pages.

Again, there was more variation among templates from each of the rating agencies than might be imagined, indicating that each of the rating agencies appears to have had a relatively distinctive approach to evaluating CMBS.

4. Lawyers Negotiate With Rating Agencies. Particularly if the rating agencies had issues with the template submitted, some negotiation between the lawyers and the rating agencies ensued as to the ultimate form of the CMBS issuance. The ratings agencies are often cast as the villains in the CMBS debacle, and doubtless they engaged in at least some practices many would find objectionable. At first blush, one might think that negotiations of this kind have a nefarious purpose. However, deeper reflection reveals that such negotiations are absolutely indispensable in this situation. It would actually be the height of irresponsibility to bring a CMBS to market without being quite certain how the rating agencies are going to rate it—to do otherwise would put the banks holding the underlying mortgages, the underwriters, the issuer, and investors all at unnecessary risk.

5. Lawyers Comply With Securities Regulatory Law and Collaborate with Bankers to Bring CMBS to Market. In the final stage, lawyers on the CMBS team ensure that all of the offering documents comply with the applicable securities laws. Again, there may be negotiation with the SEC; again, it would be irresponsible not to engage in this kind of dialogue.

In the course of the process of creating CMBS in this way, I uniformly worked with extremely talented and extremely ethical finance people and lawyers—who were indeed very well compensated for so being. As the above account suggests, the creation of CMBS is extremely labor-intensive, with some of the most skilled white-collar high-end financial and legal labor imaginable.

Once an issuance of CMBS was brought to market, however, the job of our legal team was done. Given the enormous volume of CMBS legal work during the boom, it was on to the work for the next issuance, and the immediately past CMBS issuance was quickly forgotten.

Moreover, since our client banks were themselves usually selling off or trading the loans, given the similarly enormous volume of CMBS financial work during the boom, it was on to the next issuance for the financiers as well, and they too quickly forgot about the immediately past CMBS issuance, as the next huge issuance descended upon them.

It is hard to convey to the general public who were not part of the CMBS creation process that the people who were doing CMBS at its peak were simply so busy that they had no time whatsoever to think about the big picture of what it was all adding up to in the larger economy.

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Specific Problems of the Paleo-CMBS System

What was wrong with the paleo-CMBS system? Without denying that nefarious or at least dubious activity by many different players seems likely to have occurred, there were latent structural problems with the seemingly viable parts of the paleo-CMBS system with unintended consequences that are probably more crucial than any nefariousness to the ultimate failure of the paleo-CMBS system.

CMBS succeeded admirably in diversifying real estate risk all over the world. The division of labor produced by CMBS, the development of the loan sale and trading business, and consequent increased velocity of bank lending and enhanced market liquidity, had many highly positive economic effects, particularly in the short run.

But at least 4 major issues remained in the paleo-CMBS system:

- (1) *Diversifying* risk does not *eliminate* risk. Thus, in a general international financial crisis like the current one, which touches most major countries in the world, the effectiveness of the geographic diversification of real estate risk is significantly diminished.
- (2) Under the paleo-CMBS system, while risk was substantially diversified, risk was not transparently diversified. That is, once a given CMBS was created and issued, and the responsibility of the lawyers and financiers creating the CMBS was discharged, investors mostly lacked ready access to information about the mortgages in the pool that had been securitized. When problems began to emerge in CMBS markets, CMBS investors could not readily determine the payment status of the mortgages in the pools underlying the CMBS. Without ready access to this mortgage payment information, acting from an abundance of caution, and making the worst-case assumption about CMBS due to the lack of information, investors began to flee CMBS. The result of this understandable yet excessive individual prudence was collective panic which devalued CMBS out of all proportion to the real increase in risk, producing a kind of negative stampede effect.
- (3) Closely related to the general transparency issue, many investors were baffled, or at least professed to be baffled, by the fancier variants of CMBS. Mixing a few riskier loans into a pool of unrisky loans and creating a CMBS based on the overall pool was an ingenious way to diversify the risk of risky loans, but proved offputting to investors seeking clarity when the CMBS market deteriorated. Creating collateralized debt obligations (CDOs) from tranches of earlier CMBS issuances produced securities appropriate for some specialized investors, but again produced baneful effects upon transparency and investor flight as the financial crisis intensified.
- (4) The paleo-CMBS system was highly dependent upon the reliability of the rating agencies. As the rating agencies derived an increasing percentage of their revenues from CMBS ratings, the potential for mischief increased.

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Toward Neo-CMBS

Amid the real estate financial crisis and the frozen CMBS market, nearly everyone appears to have forgotten the most fundamental policy at the root of CMBS. *CMBS makes*

trillions of dollars worth of hard real estate assets that would otherwise be inaccessible to the financial system available in a tradable, fungible form.

Conversely, *Without CMBS, trillions of dollars worth of hard real estate assets are not available to the financial system.* If CMBS does not revive in some fashion, society will have trillions of dollars fewer in financial, or at least potential financial, assets, and the American economy will in effect revert to a quantum of financial assets that sets society back financially for some number of years.

In effect, while the CMBS market was active, culminating in 2007, society implicitly decided on a probabilistic basis, based on the likelihood of minimal default among the mortgages in a given CMBS pool that [NUMBER--\$230 billion?] in CMBS were in some sense “safe” to issue annually.

Since the fall 2008 financial crisis, with the CMBS market frozen, society has implicitly decided that during the CMBS heyday we had somehow gotten ahead of ourselves, and that the likelihood of default of the mortgages in a given CMBS pool is so great that ZERO CMBS are in some sense “safe” to issue annually.

Surely, the optimal policy, and optimal annual CMBS issuance, lies somewhere between these two extremes. The number is somewhere between zero and what it was in 2007. But how do we determine this number?

At least a rough initial approach to determining this number would be to take the dollar of issuance number for all CMBS-related products issued in 2007, and subtract the dollar of issuance number for the sum of (1) all CDOs, including CDOs-squared, CDOs-cubed, and any higher-order CDOs, (2) subprime CMBS, and (3) CMBS in which risky mortgages were deliberately mixed with non-risky mortgages (since the number of CMBS in which risky mortgages were deliberately mixed with non-risky mortgages is likely to be very great, an alternative way to calculate this number might be to simply to aggregate the number of mortgages for all non-CDO, non-subprime CMBS issued in 2007, and subtract the aggregate number of risky mortgages that were deliberately mixed in).

The upshot of the above is that, in order to restart the CMBS market, at least initially the government and private sector alike should limit CMBS issuance only to CMBS based on mortgages that either are currently unrisky, or perhaps were unrisky in some baseline year like 2005, before the crest and excess of the CMBS boom in 2007. This might be accomplished by interim government regulation, some industry self-regulation, or a combination of both. During this period, the subprime mortgage, CDO, and perhaps the loan sale and trading markets, which have caused a disproportionate number of investor issues with CMBS, should be closed.

As the CMBS market restarts, any interim government regulation and industry self-regulation may be scaled back or eliminated over time in keeping with market developments.

Restarting the subprime mortgage, CDO, and perhaps the loan sale and trading markets, should wait until some time after “unrisky” CMBS issuance succeeds in a thoroughgoing and self-sustaining manner. Possibly, one or more of these markets should never be revived—even some senior bank officials who issued CDOs in the paleo-CMBS era now say that CDOs should be abolished. Quite likely, substantial new government regulation and/or industry self-regulation will be needed to revive these markets and protect investors and borrowers, which may be scaled back or eliminated over time in keeping with market developments.

And neo-CMBS can have far greater transparency: Why not a website for each CMBS issuance accessible to investors which monitors the payment status of each mortgage in the CMS pool, so that the investor can fully understand the condition of the CMBS he owns? Surely this enhanced investor control would encourage investors to re-enter the CMBS market.

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Greater transparency of this kind will in turn reduce the dependency of investors upon the rating agencies, enabling investors to make their own decisions more effectively, and reducing the great pressure upon the rating agencies and the potential for mischief. At the same time, providing investors with the transparency to monitor CMBS from the moment of creation until maturity helps to mitigate the lack of overall responsibility for CMBS over its whole lifetime due to the division of labor among bankers, lawyers, servicers, special servicers, and others.

Remember: without CMBS, society loses trillions of dollars in potential or actual financial liquidity, setting the financial system, American economic progress, and the world economy back for years.

Thus, we cannot and should not cease to issue CMBS, but we must avoid the excesses of paleo-CMBS and embrace some form of neo-CMBS. A moderate amount of the right kind of regulation may well make CMBS a better financial instrument than ever.

The way forward for CMBS is to take the scum out of the bathwater, and keep the baby.

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