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Conduits
A Source of Funds for Commercial and Multifamily Borrowers

By Wayne E. Etter, Chris Price and Candace Rhodes

The real estate market crisis of the 1980s caused a large number of commercial real estate assets and mortgages to fall into the hands of the Resolution Trust Company (RTC). The RTC was established by the 1989 Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) to dispose of property acquired by the federal government when it acquired the assets of failed savings and loan associations. This agency was forced to seek alternative ways to dispose of billions of dollars of commercial real estate loans. Many of the mortgage loans acquired by the RTC were placed in pools and used as collateral for bond structures known as commercial mortgage-backed securities (CMBS). The principal and interest payments by the individual borrowers were passed through to the investors who purchased the CMBS.

This process, known as *securitization*, aided the disposal process by offering real estate investors a way to diversify their risk exposure, target specific risk/return levels and enhance their liquidity.

Pension funds, life insurance companies, commercial banks and saving and loan associations were, until the early 1990s, the only significant source of commercial and multifamily mortgage loans. Commercial and multifamily mortgage loans made by these lenders are normally held in that institution's own loan portfolio as an investment. Mortgage bankers sometimes facilitate the process by acting as intermediaries between borrowers and mortgage lenders.

Today, *conduits* are organizations that originate commercial and multifamily mortgage loans for the purpose of issuing a CMBS instead of holding these loans in their loan portfolio. Like mortgage bankers, conduits are intermediaries too, but they are intermediaries between real estate borrowers and investors that buy CMBS. Conduits are usually special capital market groups, subsidiaries of financial institutions such as commercial banks and security firms.

Conduits have greater flexibility than lenders that traditionally make loans for their own portfolio. Life insurance companies and pension funds, for example, often focus their mortgage lending activities on large, high-quality properties because these types of loans are consistent with their investment needs. Conduits, on the other hand, can focus on the needs of many types of investors who have a wide variety of investment requirements. Consequently, they lend on large and small properties in a variety of geographical areas as well as a variety of property types. As long as there is investor demand for CMBS, conduits can continue to lend.

The volume of CMBS has grown dramatically in the 1990s (Table 1). Although the initial increase in activity was the result of RTC transactions in 1992, the RTC disposed of all its assets and had shut down by the end of 1995. During 1992-95, however, the establishment of underwriting standards, rating criteria, valuation techniques and standardized security structures paved the way for the recent growth in securitized mortgage lending. As reported in Table 2, CMBS represented 11.8 percent of 1997 mortgage originations.

Table 1: CMBS Loan Originations, 1990-98 (in millions of dollars)

Year	Volume
1990	$ 4,828.8
1991	8,196.7
1992	13,997.3
1993	17,504.6
1994	20,331.8
1995	18,970.9
1996	29,694.3
1997	43,998.7
1998	78,295.3

Source: *Commercial Mortgage Alert*, January 11, 1999.

Table 2: 1997 Mortgage Loan Originations (in millions of dollars)

Institutional Lenders	Amount	Percent of Total Originations
Life Insurance Companies	$ 25,277	6.7
Banks and Mortgage Companies	264,959	70.6
S&Ls and Mutual Savings Banks	24,788	6.6
Pension Funds	9,641	2.6
Total	$324,665	
Publicly-Issued Mortgage Securities		
Government Credit Agencies	$ 4,276	1.1
Commercial Mortgage Securities	44,269	11.8
Mortgage REITs and Public Real Estate Limited Partnerships	1,885	0.5
Total	$50,430	
Total Originations	$375,095	99.9

Note: Total does not equal 100 percent because of rounding.

Source: *Investment Property and Real Estate Capital Markets Report*, July 1998.

***THE VOLUME** of CMBSs has grown significantly in the last ten years with the establishment of more consistent underwriting standards, rating criteria and standardized security structures.*

How the CMBS Market Operates

Conduits originate commercial and multifamily mortgage loans with the specific intention of securitizing them. Because securing a rating for the CMBS is essential to the security's sale, rating agencies play a vital role in this process. To facilitate the loan's review by the rating agencies, the mortgage loan documention is somewhat standardized.

Each loan placed in the loan pool by the originating conduit is reviewed by one or more rating agencies as part of the process of readying the CMBS issue for sale to investors. Despite the standardization of the loan documentation, commercial and multifamily mortgages are not homogeneous products; the rating agencies must analyze each loan. The rating agencies estimate the effect of a depressed real estate market on each property's operating performance and expected ability to service its debt. The expected risk of default decreases as the debt service coverage ratio increases and the loan-to-value ratio decreases.

Pass-Through Class	Interest Rate (Percent)	Ratings
Class A	6.525	Highest
Class B	6.734	2nd highest
Class C	6.881	3rd highest
Class D	7.117	4th highest

Based on this expectation, the rating agencies assign the loans to risk classes called *tranches*. For example, those properties with the largest debt service coverage ratios (say 1.25 or more) and the smallest loan-to-value ratios (say 70 percent or less) are placed in the lowest-risk tranch, *i.e.*, the tranch with the highest rating. In a depressed market, these properties are expected to have the lowest probability of default. Because there is some probability of default, the rating agencies also estimate the percentage of the mortgage loan that can be recovered in the event of default.

For example, assume that a $100 million loan has a debt service coverage ratio of 1.25 and a loan-to-value ratio of 70 percent. Further assume that the rating agency believes that 75 percent of the total value **can be** recovered in the event of default. In this case, only $75 million is placed in the tranch with the highest rating. If the rating agency believes that it is **probable** that an additional 15 percent will be recovered, this additional $15 million might be split between the two next highest rated tranches. The remaining10 percent has the **lowest probability** of recovery in the event of default and will be placed in the lowest rated tranch.

To illustrate the importance of this process to the issuer and the investor, a simple example will be used. Assume the

Cheat Sheet

Commercial mortgage-backed security (CMBS)—a bond or other financial obligation secured by a pool of mortgage loans.

Conduits—organizations that originate commercial and multifamily mortgage loans for the purpose of issuing a CMBS. They are intermediaries between real estate borrowers and investors that purchase CMBS.

Mortgage banker—organizations that originate and service commercial and multifamily mortgage loans.

Securitization—the process of creating a security marketable in the capital markets and backed by a package of assets such as mortgage loans.

Subordination level—the amount of total loss required in lower-risk categories (tranches) before losses in the next highest category occur.

Tranches—categories that contain mortgage loans with similar risk of default.

individual mortgage loans comprising a CMBS issue are sorted into four tranches—A, B, C and D. Then, a complex process that is fully described in the prospectus for each CMBS issue is used to allocate the collected principal and interest payments to the four classes. This, in turn, provides investors with an array of risk/return choices.

The Class A tranch receives the lowest pass-through rate because it has the lowest expected risk. This tranch has the lowest expected risk for two reasons. First, as explained previously, the mortgage loans believed to have a high probability of repayment were assigned to it by the rating agencies.

Second, the Class A certificate holders have the greatest access to the principal and interest payments made by all the individual borrowers to repay their individual loans, which comprise the collateral for the entire CMBS issue. On the designated dates for principal and interest payments to the certificate holders, the Class A, B, C and D certificate holders receive interest payments if there are sufficient funds available for this purpose.

If there are not sufficient funds available to pay the interest to all of the classes, Class A has the highest priority, Class B has the next highest priority and so on. Furthermore, until they are repaid, only the Class A certificate holders receive principal payments. This makes the Class A tranch less risky than the other tranches. When the principal and interest due the Class A certificates are repaid, then Class B certificate holders begin receiving principal and interest payments and so on until all of the classes are fully repaid.

The effects of default on each of the classes are determined by the amount of default and the recovery percentage on the loan. If some of the mortgage loans default, the Class D certificate holders will not be fully repaid unless all of the loss that results from the default is recovered. If a sufficient dollar amount of the mortgage loans default and the recovery percentage is low enough, the Class D certificate holders might not recover any principal and the Class C certificate holders may lose as well. For the Class C certificate holders to be endangered, total losses must exceed the amount of mortgage loans that are placed in Tranch D. The amount of total losses required to endanger Class C certificate holders is called the Class C *subordination level.* For the Class B certificate holders to be endangered, total losses must exceed the amount of mortgage loans that were placed in Tranches C and D and so on. Thus, Class B subordination level is greater than that of Class C.

As described above, the CMBS market has developed mechanisms for matching CMBS to specific investors' risk and return requirements. Those investors who demand low risk must accept a lower return; those investors who demand high returns must accept higher risk.

Underwriting Spread

The conduit also must negotiate a borrowing rate with the borrower. The borrowing rate is determined by two factors: the yield on U.S. Treasury securities and "the spread," established by considering the difference between the rate that CMBS investors will require to purchase the certificates in each of the tranches that make up the CMBS issue and the yield on a selected maturity of U.S. Treasury securities. The spread between the rate paid by the borrower and the rate demanded by the investor must be wide enough to provide the conduit an underwriting profit. Table 3 reports these spreads for ten-year U.S. Treasury securities for May and November 1998. If too many of the loans are classified as higher risk by the rating agencies and placed in the higher risk tranches, the conduit will have to offer investors a higher return to get the issue sold or the underwriting profit will be inadequate. Underwriters have no incentive to pursue the underwriting of new CMBS when underwriting profits are inadequate.

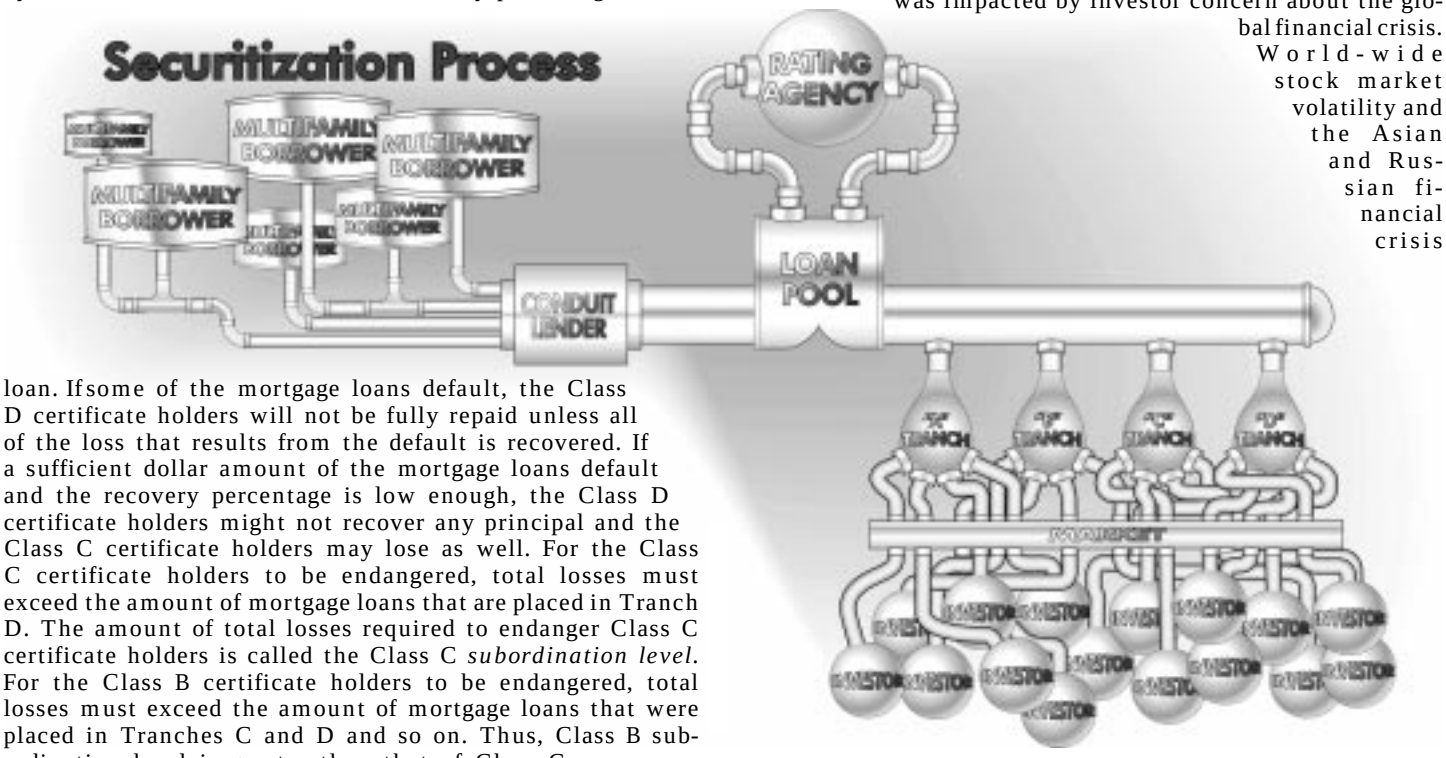
Table 3: CMBS Spreads Over Ten-year U.S. Treasuries, May and November 1998

Rating	May 1998	November 1998
AAA	80 basis points	125 basis points
AA	90	155
A	105	175
BBB	135	255
BB	250	575
B	450	825

Source: *Investment Property and Real Estate Capital Markets Report*, July and October 1998.

Obviously, underwriting conditions were splendid from 1996 through mid-1998. But, in mid-1998, the CMBS market was impacted by investor concern about the global financial crisis. World-wide stock market volatility and the Asian and Russian financial crisis in particular were important because they caused investors to seek the safety of U.S. Treasury securities (causing their prices to rise and their yields to decline). Because the conduits quote their lending rates in terms of the number of basis points over the yield on U.S. Treasury securities (one basis point equals 0.01 percent), borrowers expected their lending rates to fall.

On the other hand, CMBS investors became concerned about the possibility that the commercial property market was becoming overheated and demanded higher yields on new CMBS issues. To accommodate their demands, the spread between U.S. Treasury securities and mortgage lending rates widened (as reported in Table 3) because U.S. Treasury rates



were falling and the demanded yields by investors were rising, but some borrowers balked at the higher spread. If the borrower balks at the higher rates, the conduit's only options are to accept a much smaller underwriting fee or not make the loans. Although these events slowed the CMBS lending during the last part of the year, 1998 originations were nearly double the 1997 volume. According to *Commercial Mortgage Alert*, experts predict that 1999 originations will be about $58.5 billion, a 25 percent decrease from 1998.

The explosive development of the CMBS market is a powerful advance in financing commercial and multifamily real estate. This market provides mortgage lending for a variety of commercial property types and sizes. It cannot function, however, in the absence of investor demand for these securities and terms that the borrowers are willing to accept.

The CMBS market grew rapidly during 1996, 1997 and 1998—despite the market's slowdown during the last half of 1998 because of the global financial crisis. This three-year experience indicates that commercial real estate finance has become a part of the broader world of Wall Street.

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