Finding a Roadmap

A long-time veteran of the commercial mortgage-backed securities (CMBS) market—indeed someone instrumental in its founding—Tom Wratten, CMB, reflects on what the CMBS market needs to do to wrestle free from the current credit-market logjam. ❖ This former Air Force fighter pilot, who flew 130 combat missions in Vietnam, is better known in the mortgage world for his critical early work in moving the commercial real estate finance business into the world of securitization. The accolades are many, and go back to the early 1980s. Wratten was the founding chair of the Commercial Real Estate Finance Council for the Mortgage Bankers Association (MBA) and served on the group's board of governors from 1982 to 1992. ❖ Along the way, Wratten chaired the first MBA Commercial Real Estate Finance/Multifamily Housing Convention and was chair of MBA's commercial mortgage securitization committee. He also served as a founding chair of the precursor organization to what is now the Commercial Mortgage Securities Association (CMSA). Wratten was also founding chair of the securitization committee for the American Council of Life Insurance (ACLI). On top of all that, he served as the founding chief executive officer for Midland Loan Services, Kansas City, Missouri.

A veteran of the commercial mortgage-backed securities business offers his unique and time-tested perspective on the current credit crunch and how it's affecting the commercial real estate finance business.

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Mortgage Banking interviewed Wratten recently to get his thoughts on the current state of the CMBS market and the credit crunch.

Q: *What is happening now in the capital markets, and how is it impacting commercial real estate finance?*

A: A collapse in investor confidence has roiled capital markets and precipitated a credit crunch. Much of this considerable distress is the washout of residential mortgage markets. [Those events] are well-documented at this point. Obviously, the subprime meltdown spilled over and fomented a broad investor apprehension of all mortgage investment vehicles, which was further amplified by the financial crisis at Bear Stearns & Co. Inc., New York.

Homeownership is a cornerstone of the consumer-driven American economy. The other cornerstones are job growth, profitable industry and capital formation—each of which help propel commercial real estate. However, residential markets, our larger sibling, are tethered to commercial real estate in ways that often make it difficult to distinguish their woes from ours.

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The homeownership rate spent 50 to 60 years in the 60 percent to 65 percent range, following the creation of the Federal Housing Administration [FHA], the Department of Veterans Affairs [VA] home loan program, Fannie Mae, Freddie Mac and, later, the residential mortgage-backed securities [RMBS] vehicles. It worked well until we pushed it to unsustainable levels. Now we must pay the price for that excess.

Q: *Have similar market excesses happened before, and what has the industry learned from them?*

A: Yes, excesses have occurred several times in various sectors, and often crash the party as unwelcome guests. For example, with barrels of oil now trading hands for more than $110, one might be inclined to forget the early 1980s, when Penn Square Bank, a small lender peddling energy loans from an Oklahoma shopping center, lit the fuse for a banking industry meltdown. And there were the construction and development real estate investment trusts [REITs] of the early 1970s.

Also recall the aggressive CRE [commercial real estate] syndications and junk bonds of the 1980s, and the savings-and-loan [S&L] crisis of the early 1990s. Let's also not forget the technology meltdown at century's end. And, of course, every student of history can recite the granddaddy of them all—the 1929 stock market crash, which, less well-known, was preceded by a real estate crisis in 1926.

I've just touched the surface of past excesses, some of which have led to national recessions or worse. Only time will tell, but the subprime crisis, higher energy prices and other factors may well have landed us in a recession at this very moment. The economists are still deliberating.

Many of these cycles led to new innovations in CRE finance. Unfortunately, most of these innovations also proved problematic at some point. The 1969–1970 cycle brought us legislation that created real estate investment trusts. The REITs of those years were excessively funded, which led to a CRE crisis in the mid-1970s, when most (not equity) REITs failed.

CRE markets had recovered and were in balance when the 1980–1982 cycle heralded the 1981 Economic Recovery Tax Act, which authorized the accelerated cost recovery system [ACRS] with its accelerated-depreciation schedules. Those schedules, along with high inflation, encouraged non-economic CRE overbuilding that abruptly ended with the 1986 Tax Reform Act—too late to avoid the impact of overbuilding that led to the S&L crisis and the failure of numerous limited partnerships. Notably, the 1986 Tax Reform Act created the real estate mortgage investment conduit [REMIC] as a vehicle to enhance the residential capital market.

The 1990–1992 cycle was a true CRE depression, as well as a national recession. Even the most conservative lenders were challenged to sustain their lending operations, and all lenders were subjected to regulatory scrutiny.

The 1980–1982 cycle gave incentives to the life companies to seek ways to promote liquidity in their mortgage portfolios, which formed the basis for today's commercial mortgage-backed securities market. Unfortunately, this initiative faded by the late 1980s. The creation of the Resolution Trust Corporation [RTC] enabled the industry to complete the financial engineering for a true CRE capital market, and today's CMBS infrastructure was permanently launched. [See Figure 1 for stages of CMBS development.]

Q: *Can these crises be eliminated?*

A: No, I don't think so. Despite the concerted efforts of regulators and industry groups, the risk of financial excesses is a component of a free market and a risk of investing. These crises certainly cause a government rush to correct after the fact, which often just creates another crisis at a later date. However, much progress on prevention has been made over the decades.

The creation of the Securities and Exchange Commission [SEC] and securities legislation helped dampen, but did not eliminate, the volatility of the bond and stock markets in subsequent decades. Many professional organizations try to self-regulate, and have accomplished notable things—such as the Financial Accounting Standards Board [FASB] effort of the certified public accountants [CPAs]. But even that effort didn't prevent the excesses that caused the collapse of Enron Corporation. Major governmental initiatives will likely take root in the current presidential election environment, and we may see some sweeping changes in the regulatory structure for financial institutions outside and within the CRE capital market.

Such changes will affect how we function going forward. Regulation may curtail some investment banks from prospecting in markets and limit some insurance companies that have large CRE mortgage exposure. On the other hand, foreign capital is now a major contributor to our capital markets, and this flow of money may well take up the slack in domestic capital availability.

This isn't unprecedented, as the United States has long absorbed foreign capital to sustain its dynamic growth. In the postwar era, our great wealth and the diminished capacity of our trading partners enabled and required us to largely self-fund our economic progress. Today the world is catching up, and so much more of the world is benefiting from free markets and relatively freer people. While certainly we can't hang our hat on the prospect of foreign capital to bail out unwise practices, it should be noted and accepted that international investors are here to stay.

I believe we are entering a new phase in the evolution of the CRE capital market. I call it the fifth phase, and have named it the Global Phase [see Figure 1, taken from an article the author wrote for *Urban Land* magazine in 1998, which identifies the other four phases].

Q: *How do you feel about the CRE capital market and its future prospects?*

A: Actually, I feel good about it—although I felt we were tempting fate in the last couple of years. From rating agencies, the upgrade vs. downgrade ratio was 1.59 to 1 in March 2008, and delinquencies remain low. Those facts, I hope, don't foretell a CRE debt crisis.

The original goal for a CRE capital market was to create debt liquidity to avoid the credit crunches of the past, like the 1980–1982 and 1990–1992 credit crunches that so devastated CRE values and our industry. To have asset liquidity, you had to create a marketable or tradable form of security, which took a major effort for a fractured, non-standardized, cottage industry to accomplish. After a fledging start in the mid-1980s, the S&L crisis and subsequent advent of the RTC enabled us to complete the final engineering to develop a functioning CRE capital market.

I believe our market has performed admirably over the last decade and will continue to do so well into the future, though it continues to need engineering updates—just like any industry. I don't believe we will change the capital market platform, but some of the vehicles may need to be altered.

The institutions that "accumulated" the mortgages before the final securitization are now under the microscope by regulators. The result may be a need for a new type of business entity to absorb the "accumulation" role in the market. The infrastructure is in place for a [CMBS] recovery, even though some of the capital may be from new sources.

Q: *What further engineering of the CRE capital market is needed now, in your view?*

A: I have two opinions, but first let's review the systemic checks and balances we have built in already.

Almost every aspect of the market is on a transparent bid-and-ask pricing model with multiple participants. This allows appropriate risk pricing and placement of each function and risk. This self-interest discipline has worked quite well, and allowed for the enormous growth of the CRE capital market. It has also placed the various levels of risk in the hands of those qualified to analyze and manage it.

My first concern relates to the rating agency selection process. However, I must defend the rating agencies against any unwarranted criticism. They have been generally conscientious in their duties. Cautionary warnings of a housing bubble were noted by CRE agency executives and analysts long before it burst.

The weakness arises from the appearance that rating agencies are "shopped" by issuers for the highest price possible, not for the best price or best execution. This perception needs to be altered or eliminated. With three predominant agencies, you have at least a minimal population for a bid/ask pricing mechanism that could free the agencies from some, or all, of the pressure for higher ratings. However, that would not eliminate the investor's fiduciary responsibility to analyze both the ratings

Figure **1** **The Four Stages of the Commercial Mortgage Secondary Market**

Design Phase (1980–1988)	Engineering Phase (1990–1993)	Manufacturing Phase (1994–1996)	Recycle Phase (1997–2007)
CRE liquidity	Industry unbundled	Private goes public	Portfolio lenders become sellers
Credit enhancement	Services priced	Capital-market discipline	Whole-loan secondary market
CMBS software model	Third-party servicers	Public awareness	Whole-loan risk-rating
Investment banks trained	Asset management	CMBS manufactured	Secondary-market costs identified
Rating agencies involved	CRE analysis refined	Lobby efforts	Centralized forums
Market primed	Due diligence refined	Defined specialties	Centralized market
	Portfolio management proactive	Risk bifurcation	Main Street/Wall Street
	Regulatory action		Private-placement market
	Risk-rating refined		Efficiency established
	Procedures established		New universe in CRE
	CMBS institutionalized		Pricing in-depth
	Information explosion		Risks insured
	Software for all phases		
	Multifamily capital		
	Total process engineered		
	A new profession established		

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and the rating agencies' depth of expertise and due diligence. This scrutiny could add another layer of checks and balances to the CRE capital market, and could enhance global investor confidence in the asset class.

My second concern is how [should we] accumulate and hold commercial mortgages in a pool, before the securitization is closed and funded. This role has been filled primarily by investment and money-center banks. However, as we have seen recently, an abrupt credit crisis can place them in great financial peril, as they are left holding long-term assets funded with highly leveraged and volatile short-term capital.

This has happened before in 1988, in 1998 and, to a lesser degree, in 2001. I believe it is a vulnerable link in our capital market infrastructure that needs more engineering. This mismatch can be very profitable for the accumulators. But if they are highly leveraged, a spike in interest rates can jeopardize their balance sheets rapidly.

Let's consider a way to develop an efficient portfolio seller-servicer program that encourages existing (or creates new) portfolio lending institutions to become more active in selling their commercial mortgages into a pool just before the securities issue is to be closed and sold as a rated security.

Considerable work was accomplished by the life insurance industry in the early 1990s on the issue of the mark-to-market value of commercial mortgages. The resulting model of "hold in portfolio to maturity" vs. "hold for resale" of commercial mortgages could possibly be a foundation for an initiative to create a new business model to accomplish this important function for our industry.

I believe we also would have to finally create a whole-loan risk-rating system at the same time to make a portfolio seller-servicer program function effectively. Our early effort to make a whole-loan risk-rating system work was hampered by the lack of reliable data on commercial mortgage historical performance by property type, location, size, loan-to-value [LTV] ratio, rate, maturity and so on. Given today's abundance of data and research, coupled now with highly trained CRE capital market professionals, we surely must have sufficient resources to support a beginning effort to model the accumulator of the future.

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Q: *What do you think the industry should do to unlock the current CMBS credit logjam?*

A: An important aspect of today's capital market is how the participants interact with each other. Since the 1990–1992 cycle, we have created the Mortgage Bankers Association's [MBA's] Commercial Real Estate Finance [CREF]/Multifamily Housing Convention, which brings together the whole industry to discuss and manage the commercial mortgage creation process. And we launched the Commercial Mortgage Securities Association [CMSA] in 1994 to manage and distribute CRE capital globally. These forums have made data resources and technical efficiencies available to improve the marketplace that didn't exist before 1992. They create venues where we can address industry-wide concerns, both internally and externally, and take action to correct or improve our marketplace.

When the ship is under attack, everyone must coordinate his or her defenses, and that applies here. We have been found guilty by association in regard to the residential crisis, and need to rally the industry to be proactive. I suggest these steps:

■ Continue to work with the other real estate–focused trade associations through the Capital Consortium, representing the multiple participants within the CRE industry. In addition to the MBA, participating organizations include the CMSA, American Securitization Forum [ASF], Real Estate Roundtable and National Association of Realtors® (NAR). Reconvene the Capital Consortium to organize and execute a plan to inform and educate global investors and government regulators about the CRE capital market, its performance, differences, safeguards and systemic checks and balances.

■ Create a task force of experienced professionals from both Main Street and Wall Street to aggressively focus on the role of the accumulator in the CRE capital market. The credit crisis has severely restricted the activity of the current accumulators. This impact is almost solely responsible for the precipitous decline in volume of CRE financing we have experienced in the last year. The CMBS market will not recover until the accumulators recover.

There are too few life companies and bank syndications to offset the accumulators' role currently performed by the investment banks. Let's try to find a way to help solve this problem. We, the industry—particularly the MBA, and lately CMSA—have a track record of task-force effectiveness. Some examples of prior success include the first CRE bankruptcy reform legislation, lobbying the American Council of Life Insurance for new life-company mortgage investment rules, standardized servicing reporting, ratable documents, accounting for CMBS and so on. Let's be proactive for the benefit of our industry and the public.

■ Promote sound asset management at the property level by owners, servicers, investors and managers. When capital liquidity depresses values, the intrinsic value of the property remains relatively unchanged when maintained properly. Therefore, the right strategy is to strongly focus on maintaining that value and wait for the return of liquidity to maximize value. We should manage assets intensely and focus on value added and net present value analysis.

■ Develop public recognition of the emerging professional standards within the commercial real estate industry—i.e., CMB [Certified Mortgage Banker], CRI [Chartered Realty Investor]. Until recently, the CRE industry was viewed by institutional investors as a local insider business, without transparency or accepted standards for data, disclosure and ethics. The capital market infrastructure has altered that perception considerably. This out-

come has enabled us to attract institutional capital worldwide, something heretofore unavailable to the CRE industry. We must continue to enhance this trend and ensure that the global investing public has full trust in our business practices. Without this trust, we will struggle to attract capital from the non-participant institutional sources that have driven the marketplace for the last decade.

■ Analyze the market mechanisms to update or build in more checks and balances to ensure investor confidence in our ethical and professional standards of practice. This will ensure that investors can rely on the accuracy of the data they use to make investment decisions.

■ Create forums and discussion groups within membership constituencies. Focus on those things we can do to improve performance and reporting at the property level, which is the foundation of our industry and the future of the CRE capital market. After property market fundamentals, cost of capital is the most important component of the real estate investment decision. Accurate and plentiful data on the property markets and their trends will become even more important.

Q: *Where is the CRE industry headed over the next few years, and what structural changes can we expect?*

A: I believe we are entering a new phase for our capital market, and that will likely affect the practices of CRE investors and their mortgage bankers.

The major prior phases include: The Design Phase of 1980 to 1988, which laid the foundation and established the need for a functioning CRE capital market. The Engineering Phase of 1990 to 1993 created the mechanics of the capital market infrastructure and set the stage for the Manufacturing Phase of 1994 to 1996. With the Manufacturing Phase, we went to full production of CMBS and permanently established a fully functioning capital market for CRE debt instruments. We moved into the Recycle Phase in late 1997, as the market began to provide capital and liquidity to support the recurring life spans of typical CRE investments. The international debt crisis of 1998 caught some investment banks off-guard, but the impacts were short-lived and our market moved forward, essentially uninterrupted until the subprime crisis began to spill over in late 2007.

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Without rehashing all the details in the evolution of the CRE capital market, let's just say that all the goals were met except one—the risk-rating of individual whole loans. Pooled LTVs, DSCRs [debt-service coverage ratios] and multi-tenant real estate were substituted for whole-loan risk ratings, and single-tenant and specialized properties were waved aside into the private-placement and portfolio markets.

With the maturation of the CMBS market, we have created a well-oiled machine that runs on capital, and that capital has suddenly become restricted and more costly. Given the current regulatory environment, in the near future we may not have the open access to capital we once had. It may be that domestic capital will prove sufficient to handle the demand—but if not, we will have to think globally.

A lot of U.S. dollars are in foreign banks looking for better returns than are available from U.S. Treasuries. CMBS markets may have their problems to sort out, but I would submit that these securities are generally less volatile and risky than your typical alternatives in the equity markets and in some other fixed-income markets.

Foreign investment is a material component of the CRE debt and equity markets, both public and private. If the CRE markets remain stable and the industry enhances the trust of global money managers, there is reason to believe they will see opportunity in our markets and invest accordingly.

To enhance our attractiveness to any source of capital, we must make available facts, data and informed analysis about our CRE markets. To borrow from the stock market, alpha and beta tabulations on a whole-loan basis may be in our future. Commercial real estate finance is an essential component of our national economy and a major contributor to its well-being.

Q: *What do you think market participants should do right now?*

A: When the capital markets finally adjust and settle back down, market liquidity will price the business risk associated with owning commercial real estate and their debt instruments at the appropriate level. Only the effects of the 1990–1992 cycle lasted longer than two years, and several companies and individuals actually prospered during that time.

Having solid core assets is the fastest, and finest, recovery tool we can possibly have. Be a real professional—not only with your capital sources, but also with your borrowers. Keep asset management and reporting quality as the highest priorities in both relationships.

For the most part, we are not responsible for this credit event, so let's not be a victim of it. Don't isolate yourself. Participate in industry forums and events, stay informed about the capital markets and pass along that knowledge to your clients. Build your professional skills and expertise. Be ready for the turnaround when it comes, albeit at lower levels initially than 2007.

Commercial real estate is in decent shape. It's our capital market that supports (or controls it) that is having a struggle, just like during the 1980–1982 era. In the past we have altered the business model after every cycle, but I don't think we will this time. Let's take this opportunity to improve our current model and infrastructure. The capital will return. Remember, our population growth rate is approximately 1.1 percent per year. That level of growth dictates an underlying national demand for all the jobs, homes, stores, offices and everything else humans can occupy or use, equal to, say, the population of Atlanta every year.

My final advice: Stay in the market until 2010. **MB**