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Assessing the status of commercial mortgage lenders in today's market

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As we enter the second year of the liquidity crunch in the commercial mortgage lending market, it is a good time to figure out which lenders are still active in the market. At their peak, CMBS (securitized) lenders accounted for approximately 40% of new originations. With these lenders now completely out of the market, a giant void has been left for others to fill. While certain lenders have stepped up and increased origination volumes, it has not been enough to fill the space CMBS lenders once occupied. This has left the commercial mortgage market desperately searching for other potential sources.

Securitized Lenders

(Commercial Mortgaged Backed Securities)

The CMBS market ground to a halt over the past year because lenders were unsure about how to price their loans. In the first half of 2008, CMBS only securitized a total of $12.1 billion, compared to $237 billion in all of 2007 and $37.4 billion in June 2007 alone. The break even pricing for CMBS lenders is between 350-400 basis points over the ten year treasury, which is too high in the current market. The spread must be closer to 300 basis points over the 10-year treasury before CMBS lenders can begin lending again. Their exit strategy is highly dependent on the bond market, and it therefore needs to stabilize before CMBS lenders can enter back into the market. This is not expected to happen until 2009.

Agencies (Freddie Mac and Fannie Mae)

Both Fannie Mae and Freddie Mac, who only lend on multifamily properties, have stepped up over the past year and significantly increased their origination volumes. This, in combination with the weakness in the for-sale housing, has worked to buoy the multifamily market. Fannie Mae and Freddie Mac are still writing loans in the 200-250 basis point range over comparable treasuries for five to 10-year fixed-rate deals. These deals are being closed at 75% loan-to-value with 1.25X debt service coverage. Also, both of these lenders have floating-rate programs in the 250 basis point range over their index with similar underwriting criteria as above. The funds available through these agency lenders have given multifamily borrowers a viable option currently unavailable to other property types.

Insurance Companies

Like Fannie Mae and Freddie Mac, insurance companies also increased origination volume over the past year. This was largely due to the disappearance of CMBS (securitized) lenders from the market, who once competed with insurance companies for long-term fixed-rate debt. The majority of insurance companies, however, have set allocations for commercial mortgages. With their increase in origination volume, many insurance companies are nearing their limits for the year. Two other factors have impacted insurance company allocations to commercial mortgages: 1) insurance company funds have decreased due to the weak economy and 2) many insurance companies have decided to allocate more money to CMBS bonds because insurance companies derive more benefits from holding bonds than commercial mortgages.

Commercial Banks

Commercial banks also benefited when CMBS lenders exited the market last year. They have enhanced their returns because the loans they originate are being made at higher spreads but for lower leverage. Using deposits as a funding source, commercial banks have been able to maintain their pace of originations and have become some of the most active lenders in the market over the past year. While their funding source has not been affected by the economic downturn, commercial banks do have significant exposure to homebuilders and developers. Many banks are currently saddled with non-performing development and construction loans. According to the FDIC, $45.4 billion of the $631.8 billion in outstanding construction loans at the end of the first quarter were delinquent. When second quarter earnings are announced by banks over the next few weeks, the amount of delinquent development and construction loans that builders cannot repay is expected to increase. Unfortunately, this will decrease banks' ability to originate new loans.

Outlook

Obtaining commercial mortgages will continue to be a difficult task due to the weak economy and the individual problems each lender faces. Lenders are currently tightening their loan criteria, which has translated into lower loan proceeds and higher interest rates. While market fundamentals are weakening slightly, they are still in relatively good shape. If market fundamentals do not weaken dramatically, we should start to see an improvement in liquidity as soon as 2009.

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