# *The Wall Street Journal* Report on CMBS Underwriting Is Based on Flawed Study/Lack of Understanding of Commercial Real Estate Underwriting

## CREFC Leadership Responds to WSJ Report on CMBS Underwriting

*CREFC Board of Governor's Chair Adam Behlman and Executive Director Lisa Pendergast comment on the August 11 report by The Wall Street Journal on CMBS underwriting. Also please see CREFC's response to the study on which the article is based; highlighting what we believe are substantial flaws in the study's analysis and conclusions.*

CREFC Chair Adam Behlman, in commenting on the study, noted that "comparing life-of-loan underwriting to a first-year cash flow is not only a faulty analysis given that lenders underwrite for the life of the loan, but also that the majority of those conduit lenders the author identifies as having the highest level of cash-flow differentials, have lower or significantly lower average levels of special serviced loans to date. The magnitude of special serviced loans are the ultimate barometer of the quality of the underwriting. In addition, it is unclear based on the information provided in the study whether all CMBS contributors were included, making the conclusions all the more questionable."

Lisa Pendergast, CREFC Executive Director added: "The CRE Finance Council firmly disagrees with the overall premise of this report. As a transparent, well reported market, we believe the claims about the CMBS industry in this document are baseless and misinformed. We are in an unprecedented moment – no one underwrote for a global pandemic. Pre-crisis default rates were a very low 1.88% in March 2020; that number rose five times plus that amount in June 2020 to 10.31%. 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. This is property revenue that they rely on to pay employees, undertake general upkeep of their properties, and service mortgage debt."

## CMBS and Commercial Real Estate in the Time of Pandemic – CREFC's Response to Recent Wall Street Journal Report on CMBS Underwriting

A study provided to CREFC by *The Wall Street Journal* links CRE underwriting concerns to the recent surge in delinquency rates on CMBS loans, with no recognition that 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. This is property revenue that they rely on to pay employees, undertake general upkeep of their properties, and service mortgage debt. Suggesting that origination standards have a bearing on loan performance in the face of a global medical disaster that has taken over 163,000 lives in the U.S. is both inappropriate and cavalier.

Linking commercial real estate underwriting to the heightened delinquency rates on loans originated over the last seven years fails to acknowledge the uniqueness of this crisis and its impact on every aspect of our daily lives – work, shopping, entertainment, travel, and schooling. COVID-19 has forever changed the way people live, work, and play. For most of us, the outbreak of a global and deadly pandemic isn't something we've ever experienced and the devastating consequences to human life and economies never contemplated.

The WSJ article reportedly examines nearly 40,000 CMBS loans with a market capitalization of $650 billion underwritten between January 1, 2013 and December 31, 2019 and calculates the difference between underwritten income at the time of loan issuance and first-year realized income. The study contends that actual first-year net operating income falls short of underwritten income by 5% or more in 28% of loans.

However, it is important to understand that lenders underwrite loan cash flows based on their assessment of average sustainable cash flow, not based on the cash flow for any single year or for the first year following origination. Taken in its entirety, the study suggests the author lacks an understanding around how income and expenses are normalized in the underwriting of a loan.

All loans are expected to experience some degree of volatility in cash flow during their term with such lenders attempting to incorporate structure that mitigates that volatility. Lender views of sustainable cash flow, for instance, may take into account average rent for a tenant rated investment grade whose lease has rent escalations, which would in itself result in a variance between underwritten and actual cash flow in the loan's first year, but does not mean this approach is flawed or inappropriate.

While the study claims that there were "economically sizeable and persistent" differences in income overstatement across loan originators; it failed to take into account the relative profile of the loans originated by each lender. For instance, lenders that originate loans backed by more volatile and complex property types such as hospitality and retail are more likely to have greater variances between underwritten and actual performance than say lenders who focus mainly on multifamily lending. The latter is one of the least volatile and complex asset classes, and not coincidentally have smaller variances in the study. Therefore, a proper study attempting to differentiate quality of underwriting across lenders would have controlled for such variables.

Moreover, CMBS market participants including investors and rating agencies perform their own detailed analysis on property financial data; all of which is disclosed in offering documents and lengthy presale reports published by the rating agencies. These market participants generally apply more conservatism around cash flows for properties that have been underwritten to materially higher levels than in the past, particularly if there is clear explanation supporting those levels.

The study also contends that CMBS loans with more income overstatement are priced with higher interest rates at issuance, after controlling for other market pricing factors. The authors conclude that this finding is "consistent with originators being aware of income overstatement in loans at the time of origination and charging borrowers accordingly" because loans with over-stated income are riskier. It is not surprising that lenders apply risk-based pricing, as loans with incremental perceived cash-flow volatility will be priced accordingly. Importantly, this is entirely different from the author's assertion that the cash flow for such loans with higher interest rates or loan spreads were intentionally misrepresented.

## CMBS Loan Performance Impacted Directly by COVID-Related Hotel and Retail Closures

The study contends that high levels of income over-estimation are reflected in the growing number of loans that are Watchlisted. This statement lacks any practical utility without explaining the reason why the loan was Watchlisted. Importantly, Watchlist criteria includes a trigger for occupancy decline, as well as many other credit events. This directly correlates with property cash flow.

Prior to the pandemic, CMBS loans by all measures were performing well. The overall CMBS delinquency rate in March 2020 was 1.88%; that number rose five times plus that amount in June 2020 to 10.31%, before falling modestly in July to 9.79%.

Breaking down the overall delinquency rate, hotel and retail – those properties most susceptible to social distancing regimens – have come under the most significant cash-flow pressures. Delinquency rates for hotel and retail were 23.6% and 16.9%, respectively, in July 2020, compared to 1.4% and 4.2% in December 2019. Other property types not as susceptible to the pandemic have experienced more modest increases in their delinquency rates with multifamily (needs based), industrial (benefitting from e-commerce), and office (long-term leases in place) rates in July rising to 3.0%, 1.1%, and 2.4%, respectively (see exhibit below).

Key to this discussion is an examination of today's conservative loan underwriting by CMBS lenders. Average loan-to-value (LTV) and debt-service coverage ratios (DSCR) are key determinants of a loan's viability and the efficacy of a lender's underwriting. LTV is the amount of the mortgage loan compared to the value of the property and DSCR reflects the relationship of a property's net operating income to its annual mortgage debt service. Average LTVs and DSCRs in 2019 were a conservative 58.4% and 2.25x, respectively. Unfortunately, given the pandemic, DSCRs on many properties that have been shuttered have fallen well below 1.0x with no or limited property-generated cash flow for now three to four months and limited prospects for it returning to its pre-COVID levels any time soon.

All CRE lenders regardless of platform underwrite for the life of the loan, not a specific point in time. During any given year, underwritten Net Cash Flow (NCF) could very well be less or more than any given 12-month period.

There are many reasons why there could be differences between underwritten cash flow and actual cash flow may vary, including:

- Non-recurring expenses at the property itself that forced the owner to incur capital costs and related litigation and other expense.
- Mischaracterized or redundant expenses (such as tenant pass-through expenses that have been double-counted, or capital expenditures miscast as operating expenses)
- Non-stabilized properties where a shorter period of annualized income may have been underwritten at securitization. An example of this would be where a property was recently completed or stabilized, and the originator underwrote an NOI that annualized a trailing three- to six-month period of revenues. In this case, the first year of reported

NOI would be potentially much lower than securitization NOI, particularly in situations where the securitization occurred later in the calendar year.

- Differences between cash-based and accrual-based reporting.
- Other appropriate expense adjustments that the loan underwriter makes when evaluating life-of-loan expenses the property will incur. Upward adjustments also occur, of course, as in the cases of property tax expenses, property insurance, and management fees. Another similar situation could occur if a property had a long-term investment grade lease(s), and the lender averaged rents during the term of the lease or loan. This would appear to inflate the underwritten NOI for that first reported year; however, it would be consistent with the conventionally accepted and disclosed underwriting methodologies of the industry.
- Up-front reserves or credit enhancements that burn off in the first year that are not credited to the NOI that year; for example leases executed and up-front reserves taken for free-rent periods where the tenant's full rent would start at a future date. For example, a tenant(s) with an abated rent period would be addressed typically with a reserve for at least the amount of the abated rent. This would allow for the originator to underwrite the full, unabated rent for that tenant(s). In this case, the first year reported NOI would clearly be lower than the securitization NOI as these upfront reserves are incorporated into the reporting NOI.
- All of these adjustments are footnoted and discussed in the original offering documents for investors to review and query issuers; all footnotes are comforted by accountants.

The study shared by *The Wall Street Journal* fails to acknowledge that all the loans in question are scrutinized by a host of parties beyond the loan originators, including:

- **Independent, third-party, asset-level appraisers** who prepare independent estimates of value (which include analysis of historical property net cash flow) and are compensated on a fixed fee irrespective of their conclusions;
- **Credit rating agencies** who review the loans, author extensive presale reports to investors, and assign structural credit enhancements to the bonds. The ratings agencies perform a re-underwriting of the underlying loans in a securitization, reaching their conclusions on credit worthiness. Importantly, three rating agencies generally rate all conduit CMBS transactions.
- **First-loss investors** who invest in the first-loss and non-investment-grade bonds in a CMBS transaction and are most exposed to potential losses. These investors perform detailed reviews of borrower provided source documents and lender cash flows, making their own judgments on creditworthiness.

Beyond today's conservative underwriting, CMBS structure is more robust than ever before and focused on protecting CMBS investors – pension funds, endowments, 401(k) accounts, and money managers – from losses with heighted credit enhancement across the capital stack. For example, credit-enhancement levels on junior AAA and BBB- ten-year conduit CMBS are a high 19.1% and 6.6%, respectively today for 2013 through 2020 vintages, compared to an average of 12-14% for junior AAAs and 3% for BBB- in CMBS 1.0.

The hallmark of the CMBS marketplace has always been its heightened transparency. CMBS servicers provide monthly reports via CREFC's published Investor Reporting Package™, which has been in place since 1997 and is available to all participants in the marketplace. Moreover, there are more CMBS loan performance data purveyors today offering investors loan and market data, which serves to further heighten already 'best-in-class' transparency.

Arguments that today's underwriting has led to rising levels of delinquencies with no acknowledgement of the very unique and devastating impact COVID-19 has had on commercial real estate is turning a deaf ear on the severity of the pandemic and its very specific impact on commercial real estate assets.

Conservative underwriting metrics, heightened transparency for an industry already recognized for being one of the more transparent asset-based markets, strong pre-COVID loan performance, and Dodd-Frank issuer/B-piece investor risk-retention protocols all suggest that the commercial real estate lending and the assets they finance are stronger today than they ever have been.

As for government assistance for CRE assets and borrowers, to suggest that commercial real estate owners who utilize the CMBS market to finance their properties and were in good standing on their debt commitments prior to COVID should not receive government support is not only ill founded but also puts at risk properties and communities across the country, reduces the tax base for these communities, and leaves many towns and cities with shuttered properties and blight.