

CMBS-driven lending boom was just as unreal as today's tight lending conditions

A binge so bad that the banks will take a long time to forget



John Rathbone

Some recent articles have suggested that the credit crunch may have nearly run its course. The more naive of these articles then assume that the funding of commercial property will revert to the glory days of 2006 and the first half of last year. Their authors are not living in the real world.

While the worst may be over for banks having to announce major write-downs, this does not mean that the world returns to normal. Almost all of the banks have seen their capital ratios battered and it will take a considerable time before these are repaired to the point that the banks can again be active lenders.

Disaster hit this market last week with the demise of, initially, Carlyle Capital Corporation, hotly pursued by Bear Stearns. CCC's assets were all AAA-rated bonds, so it had no credit issues. However, reportedly for every \$32 invested, \$31 was borrowed. It did not take much, therefore, of a movement in those bonds' value for CCC to be unable to meet its margin calls.

Bear Stearns was almost certainly one of CCC's secured lenders. The bank became the next victim of a lack of liquidity as depositors removed funds at a faster rate than it could sell assets, which also were largely highly rated bonds. However, no drawn-out Northern Rock-type saga here. In three days flat, the Federal Reserve and JP Morgan agreed a deal allowing an orderly disposal of Bear's assets, with the Fed funding most of Bear's more risky assets.

A serious problem for banks is the legacy of the huge amount of CMBS that was issued in the two years up to last July. Many of these issues were bought by highly geared hedge funds reliant on short-term funding from banks using the CMBS as collateral, in off-balance sheet structured investment vehicles (SIVs), which were then financed in the asset-backed commercial paper market. With the demise of that market, the SIVs have had to be refinanced by their originators and, therefore, the banks have the CMBS back on their books. This, of course, just adds to the loans they were unable to securitise before the crunch hit.

The result of having reams of unplaced issuance

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is that AAA-rated CMBS is currently offered at around 200 bps over LIBOR, with hardly a taker in sight. CCC's and Bear's portfolios also add to the amount of this unplaced stock. The institutions that were happy to soak up this paper a year ago at about 25 bps over Libor have gone on a buyers' strike. Unfortunately, this must influence the level at which banks are prepared to lend.

While having a direct relationship with the borrower is much more satisfactory than just buying a piece of paper, this can only be worth around 50 bps. On this logic, loans up to a maximum of 60% LTV should have a margin of at least 150 bps over LIBOR.

Pressure on banks

There have been no CMBS issues in the UK so far this year. The common view seems to be that no issuance of any size will take place in 2008 and, possibly, 2009 as well. The recent flurry of banks disposing of their CMBS origination teams bears witness to this outcome.

So what will happen to all the maturing CMBS issues that will have to be refinanced?

Unless the institutions have returned and are willing to replace maturing stock with new (or old) issues, they will have to be funded through bank balance-sheet lending. This, in turn, will put further pressure on the banks and will do nothing to assist in bringing down loan margins or the requirement for borrowers to provide additional equity to offset the likelihood of lower valuations.

This may read like doom-mongering, but it is important to realise that the CMBS-driven lending boom over the past couple of years was just as unreal as the lending conditions we have at the moment. As many have noted, the easy money provided by CMBS issuance was a major force in reducing property yields to unsustainably low levels. Finding a level at which the unplaced paper may find a home is going to be a long process, unless the central banks become permanent investors, and is likely to have a knock-on effect on property values as funding costs increase.

Property funding has had a massive binge and we are now suffering from the inevitable hangover. Unfortunately, the binge was so extreme that normal cures for overexuberance are not going to work in the near term. While the funding market will gradually recover, those who think the conditions of a year ago represented normality are in for a frustrating time, as the banks will take a long time to forget the lessons of the current crisis.

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