

US CMBS: Conduit Loan Underwriting Continues to Slide - Credit Enhancement Increase Likely

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OPINION SUMMARY

The negative credit implications of the ongoing erosion of conduit loan underwriting, particularly the increase in leverage, now exceed the benefits of generally positive property market fundamentals. As a result, real estate capital market participants can expect to see higher subordination levels phased in to Moody's-rated CMBS deals over the next few months. The additional enhancement will be deal specific, but will typically be the credit support equivalent of half a notch to one notch throughout the capital structure. In addition, Moody's has fine tuned its analysis to take each local property markets position in the credit cycle into greater account. This will result in more precise differentiation in enhancement levels between deals based on loan composition.

SUBORDINATION PENDULUM TO REVERSE COURSE

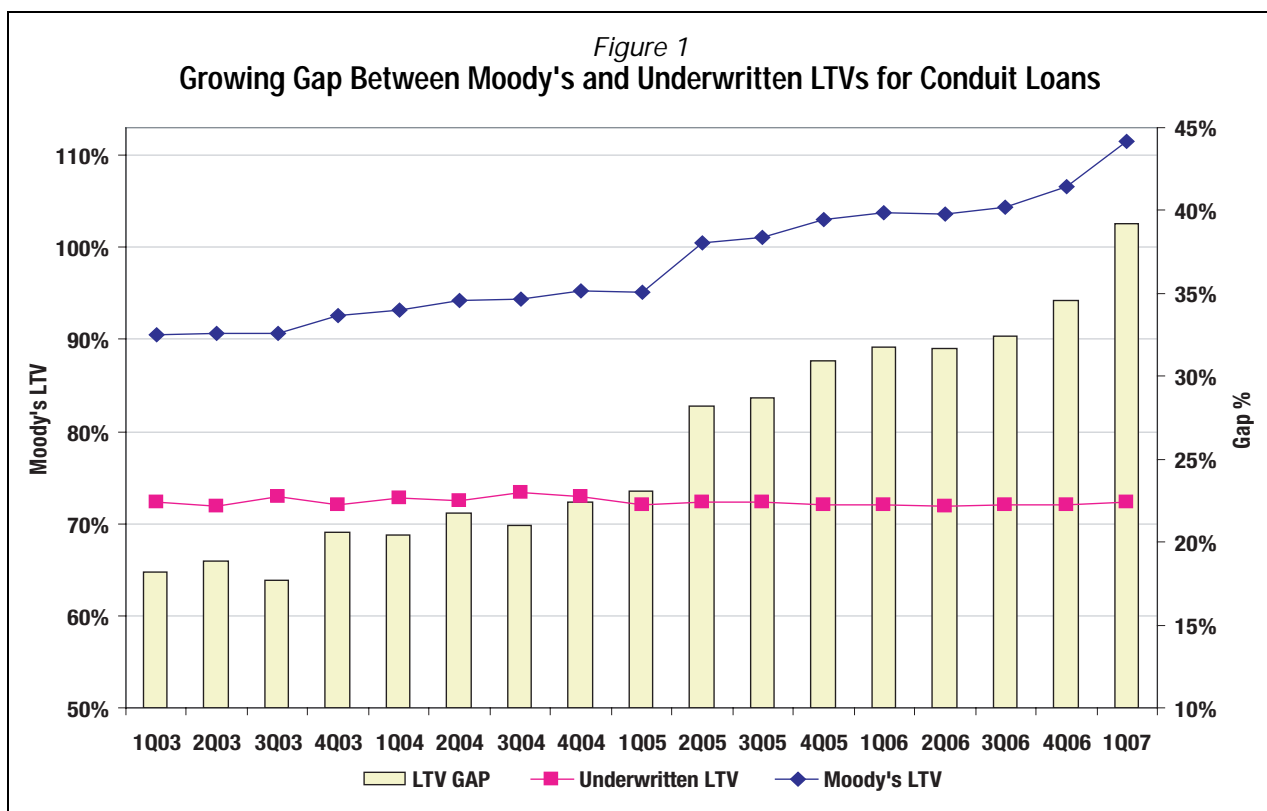
During the past few years the commercial mortgage market has witnessed a slow but steady erosion of underwriting quality. Subordination has gradually become somewhat out of alignment with the growing risks, and the fine tuning of Moody's approach and resulting increase in subordination in deals we rate are intended to rebalance them. After a decade of the subordination pendulum swinging exclusively in one direction, it is now poised to reverse course and move in the opposite direction.

The factors that are likely to lead to increased subordination include the following:

- LTVs (by Moody's criteria) have reached record high levels. As shown in *Figure 1*, the 5% increase during 1Q 2007 to 111.6% is one of the sharpest yet and comes on top of a long period of incremental increases. The gap between Moody's LTV (stabilized cash flow and cap rate basis) and underwritten has steadily grown and is now at an all time high of nearly 40%.



- Underwritten debt service coverage increasingly counts future income. That's for equity, not for debt.
- Cap rate compression and its supporting role in appreciation have largely played out. From here forward, increases in real estate values will have to come primarily from increased cash flows. Delinquency rates were sharply suppressed during the recent period of rapid appreciation, and as appreciation slows we believe delinquencies will start reverting toward more normal levels.
- Current vintage loans being made with high LTVs based on cyclically high valuations can not be counted on to defease and improve the credit quality of deals.
- The increased use of IO loans, averaging 85% of 1Q 2007 conduit deals, means less build up of protection from balloon risk at the loan level and little or no build up of subordination at the deal level.
- Fewer investment-grade shadow-rated loans are being added to deals to boost the overall deal credit profile. Diversity issues aside, without the presence of investment grade "fusion" loans a credit support level of three points is really just three points, not effectively grossed up to four as was the case in the recent past when one-third or more of pools was comprised of shadow rated investment grade loans.
- Junior classes have become exceedingly thin, exposing them to the risk that if one of the larger conduit loans defaults several classes at a time may be entirely wiped out, potentially setting the stage for more ratings volatility in investment grade classes.



THE GOOD OLD DAYS OF SUBORDINATION TIGHTENING

In prior years, CMBS subordination levels tightened in response to several factors, including:

- With the benefit of hindsight, deals were "over-enhanced" in the early days of CMBS largely due to limited availability of historic performance data and the absence of sophisticated risk management tools. Improved data and models permitted *some* downward drift in subordination levels without a corresponding increase in credit risk until the recent deterioration in underwriting.
- Subordination level tightening over the last few years also recognized the increased liquidity available to the asset class, especially the abundant and efficiently priced debt from the real estate capital markets. This decreased the likelihood that the liquidity crunch of the early 1990's would be repeated.
- Loans made in a generally rising market have a greater opportunity to migrate toward a higher DSCR over time, therefore potentially needing less upfront credit support.

- Falling cap rates and a fairly robust economic environment boosted values of the underlying real estate assets. Recently, default rates have been at a pace that is a small fraction of historic levels, is inherently unsustainable, and has facilitated credit complacency.
- Deal characteristics were often more favorable. Compositions included higher-quality large loans, and less aggressively sized conduit loans.

QUANTIFYING THE CREDIT IMPACT OF UNDERWRITING AND THE REAL ESTATE CYCLE

Moody's has long been mindful of the power of the real estate cycle on loan performance. Since December 2000 we have been using Red-Yellow-Green[®] to help calibrate our expectations of commercial mortgage performance. Our approach has been enhanced by increased usage of Moody's Commercial Mortgage Metrics (CMM). CMM has improved our ability to quantify to what extent, if any, a local market's position in the real estate cycle serves as a mitigant to underwriting issues.

CMM supplements our through-the-cycle analysis, which uses stabilized cash flows and cap rates. Moody's believes that having two complementary approaches to loan-level credit analysis supports ratings accuracy and enables greater differentiation between loans and deals. Such discrimination is especially valuable at this juncture in view of the continued slippage in conduit credit metrics. A forthcoming paper will provide greater detail on how CMM is utilized by Moody's in the CMBS rating process.

We have been testing CMM side-by-side with our traditional CMBS rating process for several quarters. A notable variance between the two systems often directs our attention to issues or factors that can be more effectively highlighted by one or the other technique. The dual-track approach is analogous to real estate appraisers' use of three approaches (replacement cost, comparable sales and discounted cash flow) to discern the value of a building.

LIKELY OUTCOMES

The continued erosion of credit standards in the marketplace has caused us - for the first time - to reverse course and push subordination levels back up. Indeed, further declines in underwriting quality or a deterioration in property market fundamentals will be met with additional increases in credit support.

We are now generally in the middle to later stages of the real estate cycle. While it is hard at this time to identify a specific, major credit issue just over the horizon, today's deals have become increasingly fragile. When market performance eventually does falter, current vintage CMBS deals will benefit from Moody's increase in credit support to help assure they perform at target expectations for each rating category.

In an ideal world, credit support levels would move both up and down on a fairly fluid basis in expectation of market developments. Indeed, Moody's goal is to adjust subordination levels in anticipation of potentially stronger or weaker performance - not in reaction to it.

In the interest of fairness and transparency, we are informing all participants in the CMBS market place at the same time of our recalibrated approach and intentions to increase subordination levels on Moody's rated CMBS. Additional research supporting this decision and detailing our enhanced methodology will be forthcoming over the next few weeks.

We anticipate several outcomes of our more finely tuned rating approach going forward

- There will be greater differentiation of subordination levels among deals.
- Enhancement levels are likely to be increased, on a deal-specific basis, by the credit support equivalent of half a notch to one notch at rating levels throughout the capital structure.
- Only those deals with the best possible market selection, a disproportionate share of investment grade quality large loans, or other credit-positive features can expect to receive subordination at or near 1Q 2007 levels.
- To the extent rating approaches diverge we may find it necessary to revisit our credit estimation practices for non Moody's rated collateral in CRE CDOs and synthetics.

MOODY'S SIGNALING PROCESS

Moody's has been signaling its growing discomfort with declining conduit credit trends for more than a year. Moody's signaling process included discussions in numerous special comments. In some cases, the mere title of a report makes the point; in other cases, sections of the report clearly conveyed our concerns.

The following is a brief review of Moody's research signaling declining conduit credit quality:

Jan. 31, 2007. *US CMBS and CRE CDO 4Q 2006 Review: Rising Tide of Liquidity Lifts All Boats.*

- Notes relationship between robust liquidity and relaxed underwriting standards.
- Gap between underwritten and Moody's LTV reaches record, nearly 35%.
- Moody's LTV reaches record, 106.5.
- Percentage of conduit loans with IO periods reaches record, 82%.

Oct. 31, 2006. *US CMBS and CRE CDO 3Q 2006 Review: The Double-A Environment: Ambivalence and Anxiety.*

- "The free ride from high coverage loans made in a falling rate environment, which propelled the spectacular track record we have all enjoyed, is now over."
- "Today's rising leverage and declining underwriting standards cancel out much of the benefits of the generally positive property market fundamentals, and it will now take less of a downturn to cause a spike in delinquencies than it would have in the past."

July 31, 2006. *US CMBS and CRE CDO 2Q 2006 Review: Credit Metrics and Spreads Send Conflicting Signals.*

- "While the declining spreads in the CMBS sector may be sending positive signals, they are conflicting with negative signals sent by some of Moody's conduit loan statistics, which portray a persistent and troublesome trend of rising leverage and declining amortization that has no clear end in sight."
- "Property price appreciation over the past few years has been so strong that the track records of aggressive and conservative players are far more similar than they would be had the market experienced a bout of distress. This makes it harder for investors to differentiate by past performance and more important to differentiate by the quality of loans now going into CMBS pools."

April 25, 2006. *US CMBS and CRE CDO 1Q 2006 Review: Commercial Mortgage Finance Enters Uncharted Territory.*

- "While there are many benefits from the record levels of liquidity brought to the real estate sector by CMBS and CRE CDOs, there are also ample signals that it is time for increased focus on credit."

Jan. 31, 2006. *US CMBS 4Q 2005 Review: Some Records Are Best Not Broken.*

- "Commercial mortgage loans as a percent of GDP now stand at 15.0%, tying a record level reached in 1988 at the apex of the last real estate cycle. Given the tremendous momentum in lending, the record is almost certain to be broken shortly." [It was.]
- "Cap rates are now at the lowest levels in the 40 years the ACLI has been keeping records. The big questions for CMBS credit, however, are whether current cap rates have overshot the sustainable mark and where do they go from here?"

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