

## TRENDS IN REAL ESTATE AND TITLE INSURANCE

ALM

# CDOs Impact the Debt Markets

*As a result, the liquidity and supply of capital are increasing, while  
the opportunities for lenders are again in flux.*

**BY SHERI P. CHROMOW  
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**T**HE GROWTH of collateralized debt obligations, or CDOs, and the increasing appetite of CDO managers for more and more debt securities, are having a significant impact on real estate debt markets.

Much like the growth of commercial mortgage-backed securities, or CMBS, over the last two decades, the growth of CDOs is increasing the liquidity of real estate debt markets and the available supply of debt capital. At the same time, CDOs have again altered the landscape for real estate lenders, increasing the profitability of some debt participants while reducing both the yields and opportunities for others.

In simpler times 20 years ago, lenders made commercial real estate loans and held them until they were either repaid in accordance with their terms or refinanced. The lender's yield on these loans was simply equal to the interest charged plus any fees collected in connection with the transaction.

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If lenders wanted to spread the risk of any particular loan, they would simply bring in other lenders in a syndicate to fund and hold a portion of that loan. While so-called "balance sheet" or "portfolio" lending and syndicated lending still exist in the real estate markets, their popularity and position in real estate debt markets fundamentally changed with the advent of commercial mortgaged-backed securities in the 1990s.

In a CMBS transaction, mortgage loans are sold by one or more lenders that originated those loans to a special purpose vehicle formed to pool the loans. That vehicle then issues debt securities that are supported by the pool of mortgage loans.

This basic structure, of course, has been around for a long time and was originally developed for residential mortgage securitizations. The structure was developed by government-sponsored entities such as Fannie Mae and Ginnie Mae to increase the liquidity in the residential mortgage market and reduce the risk to residential mortgage lenders, in order to encourage them to make more loans and foster increased home ownership.

Commercial mortgage-backed securitization added an additional refinement to the structure by dividing the securities issued into classes that have different priorities with respect to the proceeds from the pool of mortgage loans. The highest priority class of securities would have first call on both the regular payments of principal and interest as well as recoveries on any defaulted mortgage loans. Conversely, the lowest priority class would bear the first loss on any defaulted loans.

The exact size of the various classes is determined by subordination models developed by credit rating agencies such as Standard & Poor's and Moody's, so that the highest rated class will be rated "AAA," the next priority class "AA" and so on. The lowest priority classes are either rated in the so-called "junk" categories or are not rated at all.

Tranching CMBS securities creates different categories of them with different risk profiles and different ratings. Classes of securities with different risk profiles will then be priced differently (i.e., assigned different interest rates by the underwriter selling the securities) with the more risky classes of security bearing a higher

interest rate to attract investors, so that the bundle of securities in a given CMBS transaction can appeal to many different investor appetites for risk and yield.

While this feature made it easier to sell CMBS securities, the volume of CMBS transactions really exploded when investment bankers discovered that by tranching the CMBS securities, the weighted average interest rate required by investors to sell the entire pool of CMBS securities was actually less than the weighted average interest rate paid by the borrowers in the pool. This arbitrage effect meant that the originating lenders could actually sell the loans into the securitization pool for an amount in excess of 100 percent of the principal balance of the loans in the pool.

Thus, CMBS securitization became more than a means to provide lenders with increased liquidity to make more loans—it became profitable in and of itself.

The interest rate arbitrage in CMBS securitizations arises because of imperfections in debt markets. Logically, in a perfectly competitive market with perfect information, the weighted average interest rate on the mortgage loan pool and the weighted average interest rate on the CMBS securities should be the same no matter how the securities are tranced, because the underlying risk is the same.

The market is not perfect, however, and often one person's imperfection is another's opportunity. In particular, by tranching a pool of loans that would not, on average, qualify for an investment grade rating, arrangers can create classes of more senior securities that would qualify for an investment grade rating (often those classes represent a large portion of the total CMBS securities offered).

Because many funds, pension funds, insurance companies, university endowments and other institutional

investors are limited to investing in highly rated securities (or are limited in their ability to invest in lower rated or unrated securities), the competition for so-called "investment grade" securities is increased, and yields on those securities are pushed downward. This distortion in yields for the highly-rated CMBS securities can help create the arbitrage element of the securitization.

The profitability of CMBS securitization led to the entry into, and rapid dominance over the commercial

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mortgage market of, a new type of player—the CMBS lender.

### **Enter the CMBS Lender**

CMBS lenders are lenders who make mortgage loans solely for the purpose of putting pools together for CMBS securitization. Some CMBS lenders were banks that had formerly done portfolio lending but saw the greater potential of this newer business model.

The other major players were the large investment banks that rapidly entered the market in a big way. As these CMBS operations grew, they needed to generate or acquire increasing amounts of mortgage loans to fill the pools. They competed aggressively with traditional portfolio lenders and drove down interest rate margins.

Today, it is quite difficult for these traditional lenders to compete with CMBS lenders. Unable to compete, many of these lenders have been forced to focus on types of real estate loans that

are either structurally unsuited to CMBS (such as construction lending) or provide financing above the debt levels permitted by rating agencies for CMBS loans (based on loan to value ratio and debt service coverage test criteria).

For example, a loan to be placed into a CMBS pool may be limited to 65 percent of the applicable property's appraised value. Non-CMBS lenders may then make a subordinated loan to the applicable borrower (commonly referred to as a "B" Note) to bring the total debt up to 85 percent of appraised value, or make a loan to the partners or members of the property owner, secured by the partnership or member interests in the property owner (commonly referred to as a "mezzanine" loan).

### **Deconstructing CDOs**

CDOs share common features with CMBS securitizations but they are both a broader and more flexible form of structured finance.

Like CMBS, CDO securitizations involve transfer of a pool of loans or debt obligations to a special purpose securitization vehicle and the issuance by that securitization vehicle of securities that are divided into prioritized classes. CDOs differ from CMBS, however, in that they are not limited to a single type of debt obligation (such as commercial mortgage loans).

CDOs can include corporate bonds, CMBS securities and other asset-backed securities. In fact, there have been recent CDOs in which the pool was largely comprised of other CDO securities.

CMBS securitizations are static because they involve a fixed pool that simply winds down as the mortgage loans are paid down. While CDOs can be done with a static pool, they are more frequently "managed." In a "managed" CDO, the CDO documents establish a specified "ramp-up" period (usually three months to a year), a reinvestment period during which the

CDO manager has the ability to buy and sell debt obligations, and a wind down period during which the pool assets are liquidated and the CDO securities are repaid.

### **Cash Flow or Market Value**

CDOs are also classified as either “cash flow” or “market value.” Cash flow CDOs function like CMBS securitizations—the securities are paid from the cash flow produced by the collateral.

In a market value CDO, periodic payments of principal and interest are paid both from cash flow produced by the collateral and by sales of the collateral. The CDO documents require that the collateral pool be marked to market on a regular basis and if the value drops, payments to the most junior classes are suspended. Market value CDOs provide additional flexibility to CDO managers as they do not have to match the cash flow from the pool assets with the periodic payments under the CDO securities.

CDOs did not enjoy a particularly stellar track record in their earliest incarnations.

CDOs developed in the late 1980s and early 1990s were largely comprised of unsecured corporate bonds, most of which were high yield bonds. These CDOs were put together primarily to take advantage of perceived interest rate arbitrage. That is, high yield bonds could be acquired cheaply (recall this is the period after the collapse of the “junk bond” era), packaged and re-sold to investors at a profit.

Unfortunately, when some of these high yield corporate bonds defaulted, the CDO securities would often be subject to downgrade by the rating agencies. Since many investors are required to periodically adjust the value of their investments on their balance sheets to reflect the then market value, a CDO downgrade

would lead to large investor losses. These types of risks made CDOs unpopular with institutional investors into the mid-1990s.

CDOs have regained popularity over the past decade as they have moved away from a reliance on high yield corporate bonds and toward a greater percentage of asset-backed securities. Responding to market concerns, CDO arrangers made structures more conservative, and the volume of CDO issuance has steadily climbed.

Estimates of the size of the CDO market vary because many CDOs are privately placed, but some experts estimate that there may be as much as \$2 trillion in CDO securities presently outstanding. Others estimate that the annual volume of CDO issuance could reach \$300 billion by 2010.

### **Effects on Debt Markets**

The growth of CDOs is affecting real estate debt markets in a number of ways.

First, CDO managers are including more and more CMBS securities in CDO pools. CMBS securities have generally performed well in the market, are perceived to be conservatively underwritten and are characterized by a healthy level of transparency compared to corporate bonds. CDOs are thus fueling additional demand for CMBS, driving yields down further and making it even more difficult for non-CMBS real estate lenders to compete.

Additionally, CDO managers are now looking to include mezzanine loans and “B” notes in their collateral pool, encroaching on one of the few remaining areas in which traditional lenders can find deals.

Finally, there have been a number of CDOs done in recent years that were solely focused on real estate debt of various types. Real estate CDOs could represent a powerful new force in the real estate debt markets.

Like CMBS before them, the growth

of CDOs has had significant positive effects on real estate markets. By expanding the secondary market for real estate debt obligations, CDOs have increased liquidity in the market. Because of their flexibility, CDOs have conferred this benefit on a wider variety of real estate debt obligations than CMBS (which is largely only an option for first mortgage financing of completed projects).

Increased liquidity and increased competition to acquire real estate debt has driven down rates to borrowers, lowering the cost of owning and operating commercial real estate. The increased use of securitization, both CMBS and CDO, has also helped to spread the risks of commercial real estate debt to an ever-widening group of investors.

The growth of CDOs may have some significant downsides as well.

Real estate is a fairly specialized industry. Even with the growth of CMBS, subordinate CMBS securities as well as “B” Notes and mezzanine loans tended to be held by experienced real estate investors who could underwrite the assets and had the skills necessary to take over defaulted loans, re-position projects and minimize losses.

CDOs tend to have a higher proportion of higher yielding debt, so managers are attracted to the more junior positions in real estate capital structures. It remains to be seen, however, whether CDO managers have the skills to be real estate owners. If not, the potential losses to investors should there be a downturn in the real estate markets could be significantly greater than would be the case under debt structures a decade ago.

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