Dominion Bond Rating Service

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Who Is Minding The Store? Part II

In part two of our series that attempts to understand and identify exactly when and why the economic objectives of the various classes of investors diverge, we focus on B-piece buyers' reliance on principal repayment in order to achieve target rates of return.

B-piece buyers are known by most participants within the CMBS industry as the unofficial "gatekeepers" to all CMBS deals. Their influence stems from the access to more detailed information on the loans; the ability to "kickout" loans or take price adjustments for loans perceived to be more risky; and the ability to negotiate transactions documents and appoint a special servicer. While taking on the first loss piece aligns the credit interests of the B-piece buyer with the investors of the rest of the pool, given today's economics, their reliance upon principal repayment may diverge from that of senior and mezzanine tranche investors.

Unlike the borrowing instruments of the 90's: repurchase agreements or lines of credit; CDOs and Re-REMICs provide more leverage at a reduced cost of capital. These structures also eliminate the seller's exposure to interest rate risk and market value fluctuations in the underlying collateral in addition to capitating potential losses, enhancing the yield on the residual classes.

As interest rates have fallen, loan proceeds are being constrained by refinance DSCR or LTV resulting in increased DSCR over the fixed rate term of the loan, resulting in substantially lower default risk over the term. The result of this shift in the timing of risk is that B-piece buyers have become relatively confident that they will receive timely interest payments during the term of most of the mortgages.

At current market levels, the below investment-grade classes typically represent 2.5% to 3.75% of the pool and yield an overall return near 12% or 13%. In recent transactions, a diversified pool of such bonds in a Re-REMIC or CDO structure can generate 60% to 70% of investment-grade bonds[1] that can be sold with a weighted average yield near or below 6%. The resulting yield on the residual classes can be as high as 30%. At this rate and assuming all bonds are purchased at par, the B-piece buyer's capital can be returned in as little as three to five years. This quick return of capital can shift B-piece buyers' risk analysis from balloon risk analysis to a time to default analysis. If all five-year balloons are simply extended for two years (which may now be done without incurring special servicing fees) and then defaulted, with losses wiping out all below investment-grade tranches, the resulting internal rate of return can still be over 20%. Although these investors will always fight for the next dollar, it is important to note that return of principal is not necessary to meet enviable rate of return goals.

Refinance risk is the largest concern for newly issued CMBS paper, and as shown above DBRS feels that the majority of refinance risk is being born by the CDO and Re-REMIC buyers and the non-AAA investment grade CMBS buyers, not the B-piece buyers. DBRS recognizes the importance refinance risk plays in today's low interest rate environment and realizes that the current lending environment, characterized by the prevalence of interest only loans, stabilized as opposed to in-place cash flow and sub-6% cap rates, will not likely continue forever.

Let there be no mistake, it is not DBRS' intention to suggest that any B-piece investor is using the CDO and Re-REMIC financing strategy soley as a risk shifting tool. In fact, we have witnessed many of these groups exhibiting strict adherence to underwriting standards. Market participants need to understand who their B-piece buyer is and how vigilant they are during the initial formation of the pool, as B-piece buyers are far from a homogenous group.

[1] Although DBRS' loss given default assumptions for CMBS subordinate classes or B-notes preclude our reaching such levels of investment grade proceeds.

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