



GLOBAL CMBS NEWSLETTER

Issue 104, February 2, 2006

Jack Toliver

Managing Director
(312) 332-0889
jtoliver@dbars.com

Mary Jane Potthoff

Senior Vice President - CMBS
(312) 332-0837
mjpotthoff@dbars.com

Erin Stafford

Senior Vice President –
CMBS Surveillance
(312) 332-3291
estafford@dbars.com

Toronto Office

200 King Street West
Suite 1304
Toronto, ON M5H 3T4
Canada
(416) 593-5577

New York Office

One Exchange Plaza
55 Broadway
Suite 1502
New York, NY 10006
U.S.A.
(212) 806-3277

Chicago Office

101 North Wacker Drive
Suite 100
Chicago, IL, 60606
U.S.A.
(312) 332-3429

London Office

75 Cannon Street
London, EC4N 5BN
United Kingdom
(0) 20 7556 7392

Andrea Flynn

Publisher
(312) 332-3429
aflynn@dbars.com

Who is minding the store? Part III

In part three 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 the role of the investors in the longer term interest-only (IO) strip.

The coupon or “strip” received by holders of the IO bonds is often equal to the difference of the weighted average coupon of the mortgage pool and the weighted average coupon promised to the remaining bondholders in the CMBS transaction. The balance of the IO bonds is notional and reflects the bond balances that it is referencing. IO bonds can be very volatile and are most sensitive to any activity that would reduce the principal balance of a bond to which it references. Therefore, principal repayments of loans with high coupons more adversely affect the IO bonds. Principal repayments occur as a result of prepayments, amortization and liquidations following default. Both prepayments and amortization have been addressed in either the structuring or pricing of the bonds. Investors can model the amount of amortization that will reduce bond balances by adhering to the bond repayment schedule. Prepayments have been addressed by effectively taking away the borrower’s option to prepay the loan by allowing them to defease the loan or charging a prepayment penalty. Defeasance ensures a steady stream of principal and interest payments and mimics the monthly payments of the mortgage with payments from Government Securities. Prepayment penalties, typically a percentage of the loan, are charged in addition to the outstanding loan balance and are thought to sufficiently compensate the IO buyer for the early repayment and the resulting reduced future strip.

Having accounted for both amortization and prepayments, IO buyers are left to model the risk of term defaults resulting in liquidations. Today competition is fierce and debt is cheap so borrowers are leveraging up. Exposure to highly leveraged loans does not necessarily impact IO investors. Given low interest rates and declining requirements of amortization, loans are able to support more debt and still keep the same or better term default profile.

Now you might ask, with low term defaults and low prepayment risk, does it get any better? The answer is yes. For a large and growing percentage of the loans in CMBS pools refinancing will require significant cash flow growth, a sub 5% 10-year Treasury, or both. The resulting extension risk frequently represents significant upside to the IO investors. IO investors have already recouped the interest they expected by balloon.

Therefore, balloon default resulting in extension is found money for the IO investor. The fact is that, IO investors generally benefit from extensions and recognize economic benefit to increasing refinance risk. As such, the IO investors are yet another class of investors that is not reliant on the borrowers actually paying-off the underlying loans in CMBS transactions.

Author: Abbey Fitzgerald, Vice President – CMBS Surveillance,
312-332-0137, afitzgerald@dbars.com.