A Finger in the Dike

Rating Agencies Are Pressed to Keep Pace With Debt Securities

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COMMERCIAL REAL-ESTATE LENDING is booming again. But this time around something is different: When bankers make commercial mortgage loans now, they bundle the expected repayments together and sell them as securities, eliminating from their books the risk of default.

Now some analysts are wondering if the overburdened ratings agencies are up to assessing the risk of the exploding volumes of such commercial mortgage-backed securities, or CMBS. More than $40 billion in new loans have been securitized and sold already this year, as much as in all of last year. The total volume of CMBS issues in circulation has grown over the past six years to more than $160 billion, bigger than the total equity-market value of all real estate investment trusts. Another $40 billion is expected this year, making the CMBS market the fastest growing source of capital fueling the real-estate boom.

The Debt Page

The Property Report this week is devoted to issues about real-estate debt and lending.

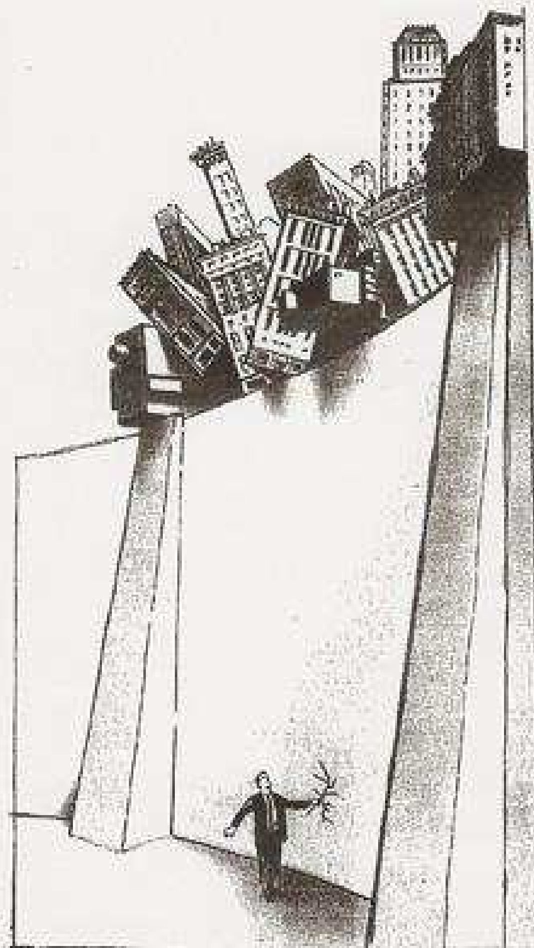
"Buying CMBS is like buying fine wine—you have to differentiate the vintage year," said Steven Wolgin, a former vice president at Standard & Poor's Ratings Group who is now a principal in investment company Odyssey Associates and a professor at Columbia University's business school. "You want to have bought in 1993, 1994, and 1995 because the loan-to-value ratios were low, the debt-service coverage was high, and the underwriting scrutiny was intense. Now the vintage years are gone and there is so much competition to make loans that the underwriting is razor-thin. We may look back to 1998 and say that the market didn't adequately reflect the risk."

LESS STRINGENT REQUIREMENTS

Lehman Brothers Holdings Inc.'s Lehman Brothers unit, **Credit Suisse Group**'s Credit Suisse First Boston Corp. unit, and **Nomura Securities** Co.'s spinoff, Capital Co. of America, dominate the business of packaging and selling CMBS paper, usually making fees of about 2% on pools commonly over $1 billion. The investment banks in turn pay credit-rating agencies to rank the notes. The total pools are sliced into smaller segments, with various payment priorities in the event of mortgage defaults.

The "triple-A" credit portions aren't threatened with a default unless all the subordinate levels are wiped out, although all rated securities might face downgrades and fall in value. Institutional investors such as pension-fund giant **TIAA-CREF** and **Metropolitan Life Insurance Co.** usually buy the highest-rated, least-risky CMBS paper, relying heavily on credit ratings. The riskiest portions, which face the first loss in the event of a default, are usually sold to mortgage real estate investment trusts. The trusts say they study the underlying mortgages carefully and plan on handling foreclosed properties.

The advent of the CMBS market means that loan-default risk is spread out more widely than in previous real-estate cycles. CMBS owners are also more diversified than the banks in the 1980s. But the growth of the CMBS market puts enormous pressure on the credit-rating agencies to set loan-underwriting standards.



Matt Collins

"We try to understand—and it's not always easy—what they think makes an optimal pool of loans, then we try to originate the loans that meet their criteria," says Andrew Stone, managing director of Credit Suisse First Boston. "The rating agencies affect what we tell the ultimate borrower."

Competition to make loans is weakening lending requirements. Mortgages are now available for more than 80% of a property's appraised value, compared to about 75% in 1997. Appraisals, however, are often "a little optimistic," says James Titus, a former director at Standard & Poor's who now works in CMBS packaging at **Donaldson, Lufkin & Jenrette** Inc.

Indeed, the CMBS market is booming even though stock-market investors have grown wary of real-estate stocks because of rising property prices and signs of new construction. At a recent CMBS industry conference in New York, "virtually all the discussion was about bigger deals, more money, and getting these silly rating agencies to stop being so conservative," says James Sullivan, an analyst at investment research company Green Street Advisors. "Nobody was talking about what investors worry about—what will the market look like in a year?"

The credit-rating agencies' sense of risk often lags behind the market, analysts say. "The credit-rating agencies have it backward," says Howard Esaki, a CMBS analyst at investment bank Morgan Stanley Dean Witter & Co. "They were too tough in the early 1990s, but now they are loosening their credit-support standards just as the real-estate cycle matures and underwriting standards are loosening too."

He adds that the agencies are sufficiently cautious but notes upgrades of existing issues outnumber downgrades by 16 to 1 this year.

DEFAULTS AHEAD

Credit-rating agencies don't look at projected future income the way equity analysts do, explains Tad Philipp, head of CMBS rating at credit-rating agency Moody's Investors Service Inc. Instead, they plan for the risk of a downturn by discounting recent cash flow.

As a result, their assessment of default risk goes down when real-estate values and payments go up—just as the possibility of a real-estate recession grows more likely, says Marshall Glick, a former credit analyst at Standard & Poor's who is now a CMBS analyst at fund company Alliance Capital.

"We would hardly be shocked if half of the B-rated bonds defaulted in a 10-year period," Mr. Philipp says. "What is different in CMBS is that the defaults will come in a cluster when real-estate prices fall—they will happen all at once. And clearly, we are nearing the top of a cycle."

Unlike other areas, all four agencies—including Fitch IBCA Inc. and Duff & Phelps Credit Rating Co. as well as Moody's and Standard & Poor's—have made the booming business a priority and achieved credibility with buyers. Since an issuer only needs two agencies to rate a CMBS pool, there is still competition for the business.

"The investment banks can play them off against each other to a certain extent," notes Steve Brown, another former credit-rating analyst now at fund company Cohen & Steers Capital Management. "They sometimes shop for ratings," agrees Mr. Wolgin of Odyssey.

Moody's and Standard & Poor's say they are constantly hiring to keep up with the rapidly expanding volume of CMBS deals, tripling their departments from less than 10 in 1992 to about 30 today. But the volume of deals has multiplied more than 16 times during that period, and the most experienced credit-rating analysts often defect to package deals for the issuers, notes Mr. Sullivan of Green Street.

The credit rating agencies are also paid to update their ratings each quarter, but information can often be hard to find. "Borrowers sometimes stop returning your calls after they have the loan," acknowledges Moody's Mr. Philipp. As a result, "trading CMBS paper is like trading stocks without quarterly reports," says Mr. Glick of Alliance.