nerej
EST 1963 | CELEBRATING 55 YEARS

Debunking CMBS loan myths: A secure source of commercial real estate lending - by Ian Lane

February 23, 2024 - Front Section

Ian Lane

Following the failure of Silicon Valley Bank and other regional lenders this year, and the increased regulatory scrutiny and the shift of deposits to larger banks, it is no surprise that regional banks have tightened lending standards for commercial real estate (CRE) loans. Such a pullback of regional lenders has left a significant void in the commercial real estate finance market. In light of this and the fear of further bank meltdowns, investors should consider commercial mortgage backed security (CMBS) loans as a secure and viable option for financing commercial real estate projects.

Historically, CMBS loans have been an extremely useful financing tool and were one of the key tools used to help reinvigorate the real estate lending market after the savings and loan crisis of the 1980s and 1990s. As Ethan Penner, one of the early players in the CMBS markets is quoted as saying, “CMBS was born in haste to solve a catastrophe”.1 The CMBS market has persisted to this day, but despite its usefulness, the perpetuation of several myths has prevented many real estate investors from considering CMBS as a viable financing source. This is even more so in the Boston finance community (contrasted with New York City) where regional banks have traditionally garnered the lion’s share of CRE financing opportunities, and the local real estate investor community as a whole is more removed from the people at Wall Street firms that originate CMBS loans.

This article will debunk some of the more common myths.

Myth One: CMBS loans are much more expensive for borrowers than other types of loans.
Depending on where things stand in the bond markets, CMBS loan interest rates can be incredibly competitive and often have lower interest rates than offered by bank lenders. Furthermore, CMBS loans typically offer fixed rates, which allow a borrower to lock in a good interest rate for 10 years versus the 5 years that are typically offered for bank loans. Also, the non-recourse nature of CMBS loans is very attractive for loan sponsors since it shields their personal assets from liabilities. Furthermore, a borrower is often able to borrow more loan proceeds with CMBS loans that offer 75% LTV ratios, thus avoiding the need to seek additional loan proceeds through more expensive financing sources such as mezzanine loan debt or preferred equity. Finally, underwriting approvals for CMBS loans are based largely on the quality of the underlying property and its cash flows rather than the credit rating of the borrower sponsor, so borrower sponsors with less than stellar credit or histories of foreclosures or bankruptcies will likely find better pricing in the CMBS markets.

If there are increased costs versus a traditional loan, this is often a function of borrowers and their counsel not being familiar with the intricacies of CMBS loans and the subsequent poor planning and execution that results from that and not knowing which points can be negotiated. For instance, on smaller CMBS loans, a CMBS lender will often agree to waive expensive legal opinions such as the non-consolidation bankruptcy opinion and the so-called special Delaware opinions and independent director requirements.

Myth Two: CMBS lenders have no long-lasting relationships with borrowers and are lenders of last resort.

This myth is belied by our experience. Many of our CMBS loans are with repeat borrowers. They show loyalty to CMBS lenders and their counsel when they demonstrate a smooth execution over several past transactions. Also, CMBS lenders win over loyal customers when they accommodate a borrower's request to show creativity in maximizing loan proceeds that conventional lenders are unable or unwilling to do.

Myth Three: CMBS loans are not negotiable with zero flexibility.

The unique qualities of the CMBS business model often lend it to the commonly held belief that CMBS loans are nonnegotiable or their lenders lack flexibility. However, one just needs to appreciate the acronym to understand that, by definition, securities look and feel differently than conventional real estate loans, and for good reason. CMBS loans need to satisfy the rating agencies and bondholders. Nevertheless, amid the various, complex rules and regulations surrounding securities, there is much flexibility, and in some cases more than can be experienced with a balance sheet lender. The CMBS lender is in the business of moving loans to investors. To do so, it must check off certain securities market requirements. Once that is done, the CMBS lender is able to negotiate property substitutions, out parcel releases, cash management structure, reserve release provisions, and subordinate financing to tailor to the borrower's needs. The conventional lender may have a more restrictive internal policy or a federal/state regulatory environment that hinders its ability to provide the same degree of flexibility. But the CMBS borrower should not be shy, rather they should express their needs at the commencement of the underwriting process.

Myth Four: The CMBS loan industry will not survive.

Although no longer accountable for nearly one-quarter of the $3.1 trillion commercial real estate market, CMBS loans have settled into an impressive yearly range of $60 billion, and according to Trepp that could be expected to grow given the turmoil in the regional banking sector.

Furthermore, longer interest-only periods, higher loan-to-value ratios (i.e., more loan proceeds) and nonrecourse provisions combined with the ability to lock in 10-year terms with a fixed rate will once again increase the attractiveness of CMBS loans. It is also pertinent to recall one of the main reasons for the existence of the CMBS loan industry: to spread risk. CMBS has always been used as a tool to diversify portfolios, price loans appropriately to reflect risk, and ultimately lower interest rates for borrowers.

Conclusion

In summary, CMBS is and will continue to remain a secure source of CRE lending and should not be overlooked by investors when looking for sources of financing. Despite its benefits, however, CMBS is not for the uninitiated borrower. There are several rules of the industry that must be mastered. It is critically important to work with an experienced and trustworthy CMBS lawyer to help avoid the commonly experienced pitfalls of CMBS.

Ian Lane is a legal adviser at Sherin and Lodgen's real estate department, Boston, Mass.

1. Today’s CMBS: Born of Necessity in Capital-Starved Times - Orest Mandzy (Trepp CRE Direct)