Big Bambu

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At the CRE Finance Council convention in New York this week, an exuberant band played at a networking cocktail party, economists reported upbeat data and issuers and originators boldly committed to start pushing money out the door. That was the good news. The bad news: the band members were moonlighting investment bankers and lawyers, the servicers didn't share the same optimism and the uncertainty of regulatory and accounting reform still looms.

More on that later. But a more tangible event was simultaneously occurring thirty blocks away, on the roof of the Metropolitan Museum of Art. There, a soaring 50-foot tall structure of bamboo poles offers an inspiring model for the way forward.

Created by two artists and a team of mountain climbers from 5,000 interlocking bamboo poles and 50 miles of mountaineering rope, the structure will continue to grow and evolve until the end of October, when it will be dismantled.

The artists wanted to build the structure, which they call Big Bambu, to explore change and evolution. They view it as a microcosm of life: unfinished yet complete, simple yet complex, interconnected with chaos as an underlying principle. Visitors can not only admire the structure, they can touch it and take guided tours on winding paths to the top. Delicate and fragile in appearance, particularly from 30 feet in the air while standing on narrow bamboo poles as the wind whistles through, the structure is surprisingly stable and strong. It had to be. The rigorous approvals required by New York's Fire and Building Departments, not to mention the legal constraints (almost half of the tour is spent reading and acknowledging the legal waivers and indemnities and adhering to airport-strict rules) make its existence even more of a marvel.

In that sense, Big Bambu is the perfect metaphor for the recovering real estate market. If a group of conceptual artists and mountain climbers—bringing an entirely different perspective to construction—can negotiate legal and regulatory hurdles to build a complex structure from bamboo and rope, then surely sophisticated real estate market participants can overcome the myriad economic and regulatory constraints to reconstruct our vital finance structure.

Back at the CREFC convention, CMBS issuers acknowledged that CMBS lending was really one giant tarnished brand at this point. Only after lending recommences and a market is created can individual lenders and programs begin to differentiate themselves. In their view, the key issues which must be addressed to have a functioning lending market are (i) too few transactions to establish price points, (ii) adequate sources of warehouse capital, (iii) the ability to hedge aggregation rate risks, and (iv) regulatory issues. Investment banking issuers committed to begin originating and offering warehouse capital to assist with building confidence and solve three of the risks.

Regulatory issues remain the biggest risk. In the view of the issuers, the Reg AB requirements just represent more disclosure and additional hard work. They're willing to do that. What they're really concerned about is risk retention. Is risk retention just the cost of doing business? Possibly, they say, but one that doesn't logically need to be there. Even so, a 5% risk retention could be acceptable if there was certainty that securitization would receive a true sale treatment (which permits loan sellers to take the contributed loans off their balance sheets and reduce capital requirements). The proposed accounting rules call this into question. Despite all of the structural demands being made by investment grade investors (e.g., skin in the game, control rights over b-piece owner and servicer, investor reporting, operating advisors), the issuers would accept them all if true sale treatment was guaranteed.

Portfolio lenders had different concerns. They are being forced to pare down their exposure to real estate. Management at one Midwestern bank, for example, has required its real estate portfolio to be reduced from 20% of total assets to 10%. Regulators are imposing similar reductions on life companies. With shorter term debt, banks are constantly dealing with maturity issues. And it is a harder portfolio to downsize since so much of the loans are not on stabilized assets (i.e., land and construction loans).

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Risk management is the highest priority. Unlike CMBS loans with REMIC and pooling and servicing constraints and protocols, portfolio lenders can be proactive in managing bad debt and can engage in creative resolution techniques.

New lending opportunities are highly competitive. Everyone is chasing the same kind of collateral and competing on price, not product or structure. Given the low interest rate environment, the portfolio lenders see no compelling reason to make 10-year loans. From a relative value perspective, investing in CMBS is actually a greater return than other fixed income investments.

Life companies didn't really compete with CMBS during the boom. As a result, the 10-year loans at 65% LTV which are now maturing are very financeable. Their concern is that eventually demand will again stretch the credit box; they wonder whether they have the discipline to hold the line and not start competing with CMBS pricing and proceeds in this next cycle.

Standing several stories high amid chaotic ribbons of bamboo can change your perspective. Regardless how delicate or well capitalized, we're all connected in many complex ways. By being bound together in a visionary plan, we can create secure and breathtakingly beautiful structures.