

Friendly Loan Market Attracts Borrowers

Securitizers Capture a Growing Share of New Originations

The Fourth Quarter of 1996 was extremely active for traditional whole loan lenders and capped off a very profitable and healthy year in the commercial mortgage market. **During 1996, approximately \$20 billion of whole loans were originated by life insurance companies** reporting to the American Council of Life Insurance (ACLI). Throughout the year, life insurance companies and their competitors at pension funds, finance companies, banks and other "buy and hold" lenders enjoyed attractive spreads, solid underwriting, good real estate market fundamentals and steady deal flow. Problem loans remain at record lows, reflecting improved market fundamentals, as well as the prudent underwriting that has gripped the market for the past four years.

At the same time, the restructuring of the industry toward a public, securitized market continued unabated and actually gained considerable momentum throughout the year. During 1996, a whopping \$30 billion of new-issue commercial mortgage-backed securities (CMBS) were gobbled up by investors, as compared to \$18.6 billion in 1995 and \$20.3 billion in 1994, the previous high. A large portion of the mortgages underlying these 1996 CMBS were "seasoned" loans, originated in the 1980s and early 1990s. **Nonetheless, during 1996, new commercial mortgage originations targeted for securitization reportedly totalled \$14.5 billion, versus \$9.25 billion during 1995.**

Wall Street now dominates two extremes of the market. The securitizers have filled the void left by the defunct S&Ls for small lesser-quality loans. In addition, jumbo-sized high-quality mortgages often are amenable to "single-asset" securitizations. During 1996, however, the traditional lenders continued to dominate the market for \$10 million to \$50 million mortgages on institutional-quality offices, warehouses, apartments and retail centers. For the most part the market still remains the domain of several familiar names such as Principal Financial, TIAA, Northwestern Mutual, Metropolitan Life and Minnesota Mutual to name but a few. Noticeably absent are some of the biggest names from the 1980s like Equitable

Life, Travelers, Aetna, Prudential and others who are laying low or who have made the strategic decision to move toward CMBS investments and away from whole loans.

For the past two years, the active traditional whole loan lenders have been extremely competitive, attempting to win deals on spread, reduced commitment fees and closing costs, promptness and other non-underwriting variables. **Spreads have been locked in a range of 125 to 175 basis points. During 1996, however, the spread on most deals moved below 150 basis points.** Suburban office, apartments and warehouses are on everyone's shopping list. Lending on well-anchored neighborhood and community centers typically is dominated by mid- to small-sized life insurance companies. Small CBD office (i.e., \$50 million loans and below) will be fodder for 1997. Hotels still seem to be in the realm of the securitizers, as do large CBD office buildings and regional shopping centers.

by

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Executive Summary

- ◆ **The majority of loans on class "A" properties are being made at spreads of 150 bp and less.**
- ◆ **Wall Street now dominates the market for small lesser-quality loans and jumbo-sized high-quality mortgages.**

Commercial Mortgage Capital Sources

Lender Requirements*	4Q/95	4Q/96
Insurance Companies/Pension Funds (“A” Quality Real Estate)		
Rates	6.75–7.50%	7.50–8.15%
Spreads (UST)	125–175 bp	125–175 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.20x	1.20x
Term	7–10 yrs.	7–10 yrs.
Commercial Banks (“A” Quality Real Estate)		
Rates — Fixed	6.65–7.50%	7.25–8.15%
Rates — Floating	6.75–8.00%	6.60–7.60%
Spreads — Fixed (UST)	135–200 bp	125–175 bp
Spreads — Floating (LIBOR)	125–250 bp	100–200 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.15x–1.20x	1.15x–1.20x
Term	1–10 yrs.	1–10 yrs.
Conduits (“B & C” Quality Real Estate)		
Rates	7.50–8.25%	8.20–9.15%
Spreads (UST)	200–275 bp	200–275 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.20x	1.20x
Term	5–10 yrs.	5–10 yrs.
* Represents typical transactions, not full range.		

Source: Equitable Real Estate Investment Management, Inc.

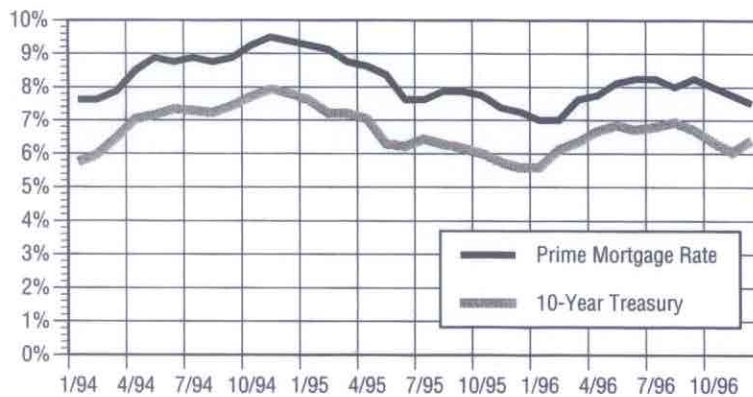
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Delinquency Rates by Property Type				
Sector	3Q/1995	2Q/1996	3Q/1996	12-mo. Change
Apartment	1.80%	0.99%	1.02%	-0.78%
Retail	1.95%	1.82%	1.75%	-0.20%
Office	4.32%	4.27%	4.14%	-0.18%
Industrial	3.96%	1.77%	1.47%	-2.49%
Hotel	5.20%	2.67%	2.80%	-2.40%

Source: American Council of Life Insurance

Private Debt 2

Prime Mortgage Rate vs. 10-Year Treasury Yield



Source: Barron's/John B. Levy & Company National Mortgage Survey

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Barron's/John B. Levy & Company National Mortgage Survey				
Fourth Quarter 1996		Term of Loan		
		25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	OCTOBER 7	7.625%	7.750%	7.875%
	NOVEMBER 4	7.375%	7.500%	7.625%
	DECEMBER 9	7.125%	7.250%	7.375%
PRIME MORTGAGE RANGE	OCTOBER 7	7.625-7.750%	7.750-7.875%	7.875-8.000%
	NOVEMBER 4	7.375-7.500%	7.500-7.625%	7.625-7.750%
	DECEMBER 9	7.250-7.375%	7.375-7.500%	7.500-7.625%
PRIME MORTGAGE RATE	OCTOBER 7	7.750%	7.875%	8.000%
	NOVEMBER 4	7.375%	7.625%	7.750%
	DECEMBER 9	7.250%	7.375%	7.500%

(For loans \$5 million and up)

Source: Barron's/John B. Levy & Company National Mortgage Survey; © 1996 Dow Jones & Co.

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Generally speaking, traditional lenders have been willing to walk up to the edge of prudent underwriting standards but as yet have not gone over. Guidelines for loan dollars, escrows, maturities and amortization periods remain within acceptable ranges. In certain hot markets, however, property valuations currently are approaching replacement cost; lenders need to be more cautious in 1997.

Diligent lending practices over the past several years are reflected in recent ACLI statistics. As of the Third Quarter 1996, delinquencies stood at 2.51 percent, compared to 2.35 percent at the end of 1995. These remain the lowest levels in 10 years. As most troubled loans run into problems within the first two years after origination, this suggests that lenders have learned a lesson from the recent real estate depression. Of course, the key question is how long memories will linger and how motivations will change now as the market becomes intensely more competitive.

Construction lending recently has received a considerable level of interest by commercial banks, several life insurance companies, credit companies and even Wall Street. Nationsbank, Principal Mutual, Northwestern Mutual, GE Capital, Salomon Brothers and a plethora of smaller local banks reportedly are rolling construction and mini-perm lending programs for 1997. **While vacancies are falling nationally and many markets now can absorb a level of new construction, it nevertheless is disconcerting that so many lenders seem poised to fund new construction.** For 1997 this is the single key variable to watch.

The vast majority of loans on class "A" properties are being made at spreads of 150 basis points and less. This means that seven- to 10-year mortgages on high-quality properties are achieving rates typically ranging from 7.75 percent to 8.25 percent and occasionally as high as 8.50 percent. These rates are based on 75 percent loan-to-value and 1.2x minimum debt-service-coverage ratios.

As more and more lenders move into the whole loan market and Wall Street continues to expand its role, traditional lenders will be hard pressed to meet their allocation targets in 1997. In this competitive environment, lenders will need to focus on the tricky task of how to maintain market share without sacrificing underwriting standards. **RECMR**

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