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Borrowers Having Commitment Issues

Rating agencies' pullback on securitization standards could hurt financial institutions that were too loose in a capital-saturated environment

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To outside observers, the structured-finance world has become a little promiscuous. But borrowers said they like lenders' looser standards because they allow them to play the field without consequence.

Which begs the question: How much commitment does an investor or developer want from their lender in a capital-heavy environment?

"We are in a speed-dating environment," said William Lindsay, founding partner of Pacific Coast Capital Partners. "When you could go on 30 dates in 30 days, why get married?"

With so much capital competing for a place to sleep at night, borrowers have their choice of partners at nearly every level of the capital stack.

Competition among lenders has led to a relaxing of underwriting standards and a lower expectation of returns, according to attendees of the Los Angeles Mortgage Association's third annual West Coast Structured-Finance Conference, which took place May 1. But in the past month there has been a pushback on the securitized loan side as rating agencies are starting to require lower loan-to-value ratios and less interest-only periods to qualify for A ratings.

Thomas Whitesell, senior vice president at Fremont Investment & Loan, said lenders are ignoring the risk because, facing so much pressure to get money out, they are looking only at what they can get on the spread. That pressure is pushing lenders into deals under which the fundamentals do not support initial costs and into arrangements with untested borrowers, according to Whitesell.

It also is pushing lenders into new lending vehicles, including collateralized-debt obligations, which have grown to account for \$3 billion in commercial real estate loans annually, according to a Moody's Investors Service report. Many lenders have had flings in the collateralized-debt-obligation world, but those who have stayed in those relationships too long could end up facing a nasty SEC because rating agencies have begun to tighten the reins on loans securitized into those packages.

During the past 18 months, agencies have allowed loans that should not be securitized and sold to be included in commercial mortgage-backed securities and collateralized-debt obligations, according to Jeff Friedman, co-founder and co-chief executive officer of Mesa West Capital.

In March, Moody's released a methodology report to justify the mezzanine loans it rates for collateralized-debt-obligation bundling.

"Mezzanine loans now have a natural capital-markets outlet, and Moody's rates them in their own right as stand-alone credits in the form of rakes and as part of collateralized-debt obligations," the report stated. "We no longer view them merely as an impediment to higher rat-

ings on the senior secured debt."

Moody's, Fitch Ratings and Standard & Poor's are talking about increasing the level of subordination required for collateralized-debt obligations by requiring securitized loans to carry higher interest rates.

Rating agencies took a look at collateralized-debt obligations and commercial mortgage-backed securities and basically said, "Stop," said James DeAngelo, senior vice president at CW Capital, during Jeffer, Mangels, Butler & Marmaro's Meet the Money Conference, which took place May 3 in Los Angeles.

The lending industry is of mixed opinion as to the effect of stricter securitization standards on current and future loans.

"I'm hopeful that there will be some discipline injected back into the marketplace," said Steve Tucci, director and regional manager at Merrill Lynch Capital. "We were seeing deals that should never have been securitized that went through anyway."

Brian Buchhagen, managing director at Legg Mason Real Estate Investors, said there are lenders who will buy BBB-rated loans, put them together and sell them as a AAA bundle.

"It doesn't make sense," he said.

Buchhagen does not want to see more discipline applied to collateralized-debt obligations, though, because loans wrapped up in deals will be so for several more years, and changing the way they are rated could lead to a market collapse.

"There will be a differentiation among managers, but these deals will be around for another seven years," he said. "Being a CDO issuer has become a bad word among competitors. I'm glad we did it when we did because it allowed us to stay competitive, but I wouldn't do it today."

Nonetheless, many other lenders are entering that arena to stay competitive in an environment where money remains more abundant than projects.

"CDOs are a blessing and a curse," said Jay Rollins, president and chief executive officer of JCR Capital. "I wish they didn't exist, and they do. It is impossible to compete in this space if you don't have one."

But Rollins sees a correction coming soon.

"Where the cliff is, I don't know," he said. "If it is six miles away or 60 miles, we don't know — and if it is a six-foot drop or 600-foot fall, we'll have to wait and see."

In other aspects of real estate, the industry's increased transparency is allowing developers to see the cliff before they get to it. D. Michael Van Konyenburg, president and chief executive officer of Eastdil Secured, said the transparency will allow responsible lenders to get out of bad projects before they tank.

"In this sea change that happened over the past five years, people have reduced their risk expectation in real estate because it is a much more transparent market," he said.

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Van Konyenburg added that capital will be cut off much sooner when a market is overbuilt or if market fundamentals shift because so much more information is available to lenders now than ever before. Thus, he said, there no longer will be boom-and-bust cycles of overbuilding and correction, allowing lenders to get in and out of bad relationships.

The transparency also will keep lenders from getting caught up in what Ian Williams, manag-

ing director at Wachovia Securities, called a Ponzi scheme. He offered the example of the flipping of **Equity Office Properties Trust** assets to obtain higher prices.

"A guy arguing that he wants a high-leverage loan because he got such a good deal on the fourth flip, the market is going to see through that," Williams said.

But lenders are giving Williams money nonetheless, just to be in the game.

"If we looked back a couple of years at the deals we did then, we're higher on the capital stack now," said Michael Fleischer, director of **Canyon Capital Realty Advisors**. "We'll deny it, but we have to be more creative [to be competitive]. Reality is, we are still going higher

and getting less for it."

Chris Kostanecki, managing director at **Sarum Investments**, said his company has no fear going 100 percent equity on a project, as long as it has made headway into development and thus has made his company more in-demand.

Whitesell has no fear targeting condominium projects, which many lenders have shunned, because he likes the quick exit strategies available. Despite their potential and realized problems, he said, condominium projects are easy to get in and out of, with potential for high returns.

"If [an office project] doesn't lease up, and the value isn't there at the end of the day, they are

handing the keys back to you," Whitesell said. "On condo projects, you can blow those things out — hand it off to a liquidator. You have a 20 percent, nonrefundable deposit from buyers; that is a much safer deal than the office."

But even on projects most lenders will not touch, such as condominium conversions in San Diego or South Florida, lenders must give more and get back less — proving that the only real commitment in the lending world is the lenders' desire to stay in it.

"We all are working harder just to make the same money, but that is the world we are in," Friedman said.

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