CMBS: Designed With Investor Protection in Mind

We believe commercial mortgage-backed securities (CMBS) have a number of structural and other features that may help the market weather the current volatility successfully.

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Chart 1. Historically, CMBS Defaults Have Been Extremely Rare

Default rates of commercial mortgage backed securities, 1986-2018

Default Rate (%)

AAA CMBS — Average Default Rate = 0.03%

AA CMBS — Average Default Rate = 0.07%

A CMBS — Average Default Rate = 0.07%

Year	AAA CMBS	AA CMBS	A CMBS
1986	0	0	0
1987	0	0	0
1988	0	0	0
1989	0	0	0
1990	0	0	0
1991	0	0	0
1992	0	0	0
1993	0	0	0
1994	0	0	0
1995	0	0	0
1996	0	0	0
1997	0	0	0
1998	0	0	0
1999	0	0	0
2000	0	0	0
2001	0	0	0
2002	0	0	0
2003	0	0	0.19
2004	0	0	0
2005	0	0	0
2006	0	0	0
2007	0	0	0
2008	0	0	0
2009	0.20	0.37	0.39
2010	0.07	0.42	0.26
2011	0	0	0
2012	0	0	0
2013	0	0	0.22
2014	0	0	0
2015	0	0	0
2016	0	0.53	0.28
2017	0	0	0
2018	0	0	0

Source: S&P Global Ratings. Data based on a study of defaults by S&P Global; most recent data available. Subject to change based on changes in the market.
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Commercial Mortgage

In Brief

- During the current market volatility, the commercial mortgage-backed securities (CMBS) market has seen notable spread widening, with some areas facing liquidity challenges.
- But history has shown that CMBS defaults have been extremely rare, especially among senior tranches, and underwriting standards for CMBS have improved substantially from the pre-financial crisis environment.
- CMBS are issued in a so-called "waterfall" structure, with each tranche within the structure carrying different levels of potential credit protection. Senior tranches, with higher credit ratings, carry the most credit enhancement.
- We believe high-quality CMBS not only remain excellent credits, but also represent an attractive investment opportunity at current levels.

Over the last several weeks, U.S. fixed income markets have come under significant pressure as investors grapple with the COVID-19 virus and the associated restrictions likely to seriously dampen economic growth. Healthy markets sort through a myriad of data points to arrive at conclusions about asset values, and we can see that occurring across markets generally. However, we see some areas of the market that are also suffering through liquidity challenges that, while spurred by the current risk-off sentiment, do not reflect deeper credit concerns for the asset classes affected, in our view.

Commercial mortgage-backed securities (CMBS) certainly fit that description, in our opinion. The Option Adjusted Spread (OAS) on the benchmark Bloomberg Barclays Non-Agency CMBS Index, which had been as low as 84 basis points (bps) earlier in March 2020, spiked to 363 bps by March 25. While we believe some spread widening is justified based on the overall risk environment and the uncertainty surrounding the long term economic impact of COVID-19, in our view a large portion of the move has been driven by transient illiquidity in the fixed income markets. We believe high-quality CMBS not only remain excellent credits, but also represent an attractive investment opportunity at current levels.

What Are CMBS?

CMBS are fixed-income securities backed by commercial real estate loans. Institutional borrowers, typically take out loans to finance the purchase of commercial property. A commercial lender (e.g., a commercial or investment bank) would lend the funds, and the property then is used as collateral for the loan, much the way a home would act as collateral to a residential mortgage.

Loan proceeds are used for a variety of property types, including apartment buildings, hotels, offices, retail stores, industrial properties, and hospitals. The rental income generated from the property's occupants then flows through to the bond investors. Ultimately, CMBS provide an opportunity for investors to gain exposure to the commercial real estate market in a diversified manner through investment in securitized products, in lieu of a direct investment in property.

CMBS are typically backed by loans representing 40-80% of the value of the mortgaged property, with the balance representing equity, providing a meaningful cushion for owners of CMBS.

Backed Securities

Table 1. Example of CMBS Structure

Bond Class (Original Ratings[1])	Legacy CMBS[2] Typical Original Subordination (%)	CMBS 2.0[3] Typical Original Subordination (%)
Super Senior AAA	30	30
Mezzanine AAA (AM/AS)	20	20-25
Junior AAA (AJ)	12-14	N/A
AA	9-12	14-18
A	6-9	10-14
BBB	4-6	6-8
BB	2-4	4-5
B	1-2	2-3
Unrated CMBS	0	0

Source: Principal Global Investors. Information as of March 31, 2020.

[1]Current ratings may be significantly lower. [2]Legacy CMBS defined as bonds issues prior to 2009. [3]CMBS 2.0 defined as bonds issued post 2009 through 2014. The mechanics and structure of assets in any portfolio may differ materially from those outlined above. Over time, as loans in the pool default, the subordination levels may change (defaults pick up, subordination levels fall). Therefore, the table above uses hypothetical subordination levels as they would be at the time of deal structuring.

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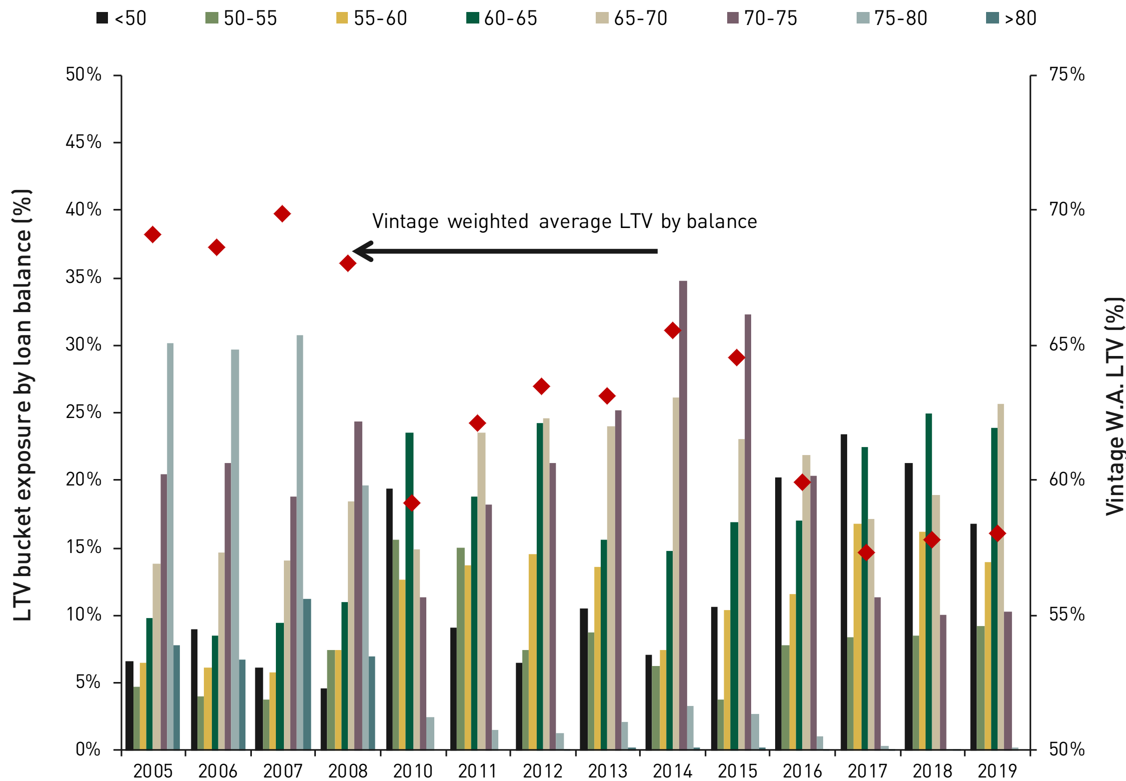
Potential Structural Protection

CMBS are issued in a so-called "waterfall" structure, with each level of the structure (known as a tranche) carrying different levels of potential credit protection (see Table 1). Senior tranches carry the most credit enhancement, around 30% at the AAA rating level, with potential protection declining down the structure. When losses occur, they accrue to the most junior tranches first and continue to do so until that tranche is depleted, with subsequent losses allocated to the next junior tranche in the same fashion, providing insulation to the senior tranches that can offer protection even in the case of a default with a subsequent sale of the property at a steep discount.

Today, CMBS are considerably more conservatively structured than those that weathered the 2008-09 global financial crisis (GFC), providing what we believe is even greater structural protection to senior tranches. In addition, deal fundamentals have improved, with lower loan-to-value levels and better interest expense coverage (see chart 2 on the following page).

Chart 2. CMBS Underwriting Standards Have Improved Substantially Since the 2008-09 Financial Crisis

Loan-to-value (LTV) exposure by loan balance, weighted average (2005-2019)



Source: ICE BofA Indices. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. LTV=Loan-To-Value Ratio. W.A.=Weighted Average. GFC=Global Financial Crisis 2008-09.

But even the weaker "legacy" structures managed to survive the GFC with minimal defaults and even lesser losses realized by senior tranches. This came despite a very weak commercial real estate market that witnessed about a 40% top-to-bottom market decline from 2007 to 2009 (see Chart 1 on the first page).

Current Environment

We believe that the majority of the recent spread widening in CMBS has been driven by the liquidity challenges facing fixed income markets generally. However, once the various programs that have been rolled out by the U.S. Federal Reserve (and perhaps others yet to come) effectively address liquidity issues, it's clear in our opinion that the economic environment will, for a time, remain challenging. We believe this event is starkly different from 2008, however, in that the economic weakness is very likely to be over a relatively discrete time period. This is important for the decision making of the sponsors and special servicers in CBMS structures. They are likely to want to keep their options open--and the current structures of existing deals operating.

We've seen predictions of delinquencies for commercial real estate running anywhere from 15%-40%. While we think these estimates represent rather extreme outcomes, even if they were to come to pass, we believe senior pieces of CMBS structure would likely weather such a scenario without too much trouble. It's important to recognize that delinquencies do not mean defaults--there is a process each mortgage would likely go through as payments are missed by the mortgagee which in many cases ensures cash continues to flow to bondholders.

Even if mortgagees facing a longer-than-anticipated period of business interruption are unable to cure their loans by getting current and are thereby forced into default, because of the structural protection afforded to higher-quality tranches, properties would need to be liquidated at losses of 60% or more to impact the senior tranches of the structure. Such is the level of protection we believe is afforded investors at the top of the CMBS stack. We believe this combination of procedural and structural protections positions this asset class well to weather the COVID-19 slowdown.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results.

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A **basis point** is one one-hundredth of a percentage point.

Credit enhancement: Structured financial products such as asset-backed securities and commercial mortgage-backed securities derive their value from underlying assets such as mortgages or credit card receivables. Some of those assets are riskier than others. For such investment products, credit enhancement serves as a cushion that absorbs potential losses from defaults on the underlying loans. Structured products are issued in classes, or tranches, of securities, each with its own credit rating. The tranches are categorized from the most senior to the most subordinated, or junior. Credit enhancements are attached to the highest-rated tranches, giving their buyers priority in any claims for repayment against the underlying assets.

Commercial mortgage-backed securities (CMBS) are secured by mortgages on commercial properties rather than residential real estate. The underlying loans that are securitized into CMBS include those for properties such as apartment buildings and complexes, factories, hotels, office buildings, office parks, and shopping malls.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

The **Bloomberg Barclays U.S. CMBS Investment Grade Index** measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300mn. The index is divided into two subcomponents: the U.S. Aggregate-eligible component, which contains bonds that are ERISA eligible under the underwriter's exemption, and the non-U.S. Aggregate-eligible component, which consists of bonds that are not ERISA eligible. The U.S. CMBS Investment Grade Index was launched on January 1, 1997. The Bloomberg Barclays Non-Agency CMBS Index is a subset of the broader index.

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