CRE CONDUITS

by Steve Brown

Over the years, conduit lending has poured over the banking industry like water cascading over a 1,000 foot waterfall. Besides getting wet from these conduits, independent banks have seen loan refinancing accelerate and pricing rapidly compress. Before we go over the waterfall however, we provide some basic information to make sure everyone is ready. To begin, CRE loans can basically be broken down between those originated by a bank (and held on the balance sheet) and those that are originated for securitization. Those originated for securitization are called commercial mortgage backed securities ("CMBS") transactions. CMBS are also referred to as conduits. Note that the term "conduit" actually comes from the underlying tax structure of the securitization, which is a real estate mortgage investment conduit ("REMIC"). A REMIC was created by the tax laws and allows a trust to be a pass-through entity not subject to taxes. Conduits can hold loans of all sizes (typically $1mm to as much as $50mm), property types (shopping centers, multifamily, self storage, warehouse, office buildings, industrial, hotels, seniors, etc.), terms (generally from 5Y to 20Y with as long as a 30Y amortization), prepayment structures (prohibited, yield maintenance, or points are all acceptable), geographic location and credit quality. The conduit issues securities that have been sliced into various classes (i.e. different durations, credit quality, interest rates, spreads, cashflow structures and payment priorities) in order to cater to different investors with different risk/return profiles. Along the credit spectrum, investors can choose from investment grade (AAA/Aaa through BBB-/Baa3) to below investment grade (BB+/Ba1 through B-/B3) to even an unrated class (which is subordinate to the lowest rated bond class). Driven by extremely high investor interest in the sector and the ability to make lots of money, Wall Street firms have significantly ramped up conduit loan origination. This is one reason why a record $43B of CMBS is expected to be issued this month (issuance for all of 2006 was about $200B). Unfortunately for independent banks, the enhanced liquidity and structure of conduits has also attracted a much broader range of investor to the CRE sector. This has increased competition, tightened spreads and increased standardization (allowing borrowers to more readily compare loan deals between lenders). In addition, while conduits have some restrictions due to their tax structure, contrary to popular industry myth, they also have lots of flexibility. For instance, conduits can release, expand or substitute collateral; change escrow payments; release lease termination payments to the borrower; allow the loan to prepay during a lockout period; waive or reduce a prepayment premium; allow secondary financing; allow an assumption of the loan; modify borrower reporting requirements. In addition, most conduit loans are non-recourse and therefore require no personal guarantees. Given the flat yield curve and the fact that conduits readily originate long-term fixed rate loans, independent banks are facing a significant threat. Just how big that threat becomes remains to be seen, but bankers should not take it lightly. In fact, according to FRB data, conduits now represent about 20% of all outstanding CRE loan origination.

BANK NEWS

M&A

Bank of Nova Scotia ("BNS"), Canada's 3rd largest bank, will purchase 10% of First BanCorp ($17.4B, PR) for about $94.8mm. In addition to the share purchase, the agreement gives BNS 5 business days to counteroffer any proposed purchase of First BanCorp during the next 18 months.

M&A

Globe Homestead Bank ($30mm, LA) will sell itself to a local investor group for an undisclosed sum.

Competition

Wells Fargo announced that beginning in March, it will keep branches open until 6pm on Saturdays. The bank hopes extending hours will help it attract new clients, while ramping up service to existing ones.

Cell Phone Banking

BofA and Discover (Morgan Stanley) both announced that they will role out new cell phone banking platforms in March that will allow users to pay at point of purchase, transfer balances and check accounts via a web-enabled cell phone.

Product Creation

Bankers trying to think up new products to help capture new customers may be interested to know about 40% of businesses these days have a chief innovation officer (or equivalent).

ATM Fees

Our story last Friday about banks that reimburse non-network ATM fees received a strong response. From several of our astute banks we learned that the reimbursement of ATM fees could constitute interest and be a violation of Regulation Q (truthful advertising of interest). Obviously the way to avoid this is to not tie the rebate to balances. To be sure, check with your professionals or regulators before implementing any suggestions.

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