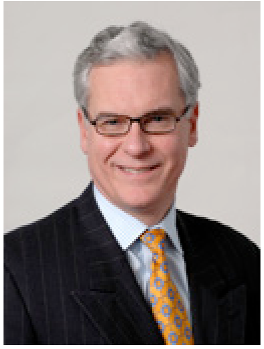
Commercial Real Estate 2011 Recap: And The (Annual) Golden Turkey Award Goes To....

November 22, 2011 by Rick Jones



With Thanksgiving approaching and the holiday season in full swing, we here at *Crunched Credit* would like to present our annual "Golden Turkeys".

The Golden Turkey for the Most Confounding Regulation: The Premium Capture Reserve Account

Back in March, the credit risk retention NPR was released. Perhaps the most unexpected (and unwelcomed) part of the rule was the Premium Capture Cash Reserve Account (PCCRA). The PCCRA provisions actually say that issuers may not profit from securitizations or recoup costs up front. The NPR says that a securitizer who monetizes either an IO or earns a premium on the sale of P&I bonds has to put that money aside to serve as a first loss reserve for any losses on the mortgage loans for the life of the deal--on top of the 5% risk retention requirement. Neither a PCCRA nor a reasonable facsimile thereof was contemplated in the Dodd-Frank Act. Needless to say, PCCRA has generally not gone over very well: Confound it!!

The Golden Turkey for the Best Self-Inflicted Wound: The "Bad Boys"

And by "bad boys", we mean those who have violated the "bad boy" recourse carve-outs in their loan documents. Although most commercial real estate loans are non-recourse (i.e. the lender can only look to the value of the property securing the loan to settle the borrower's obligations if there is a default under the loan), most contain certain "bad boy" carve-outs (for example, the borrower filing for bankruptcy or misappropriating funds) from the non-recourse nature of the loan, permitting the lender, in certain circumstances, to look to the borrower (as well as the guarantor) to satisfy the borrower's obligations. Some borrowers, victims of the great recession, have opted to file for bankruptcy in an attempt to stop the bleeding and dam the "bad boys". Oops. Lenders confronted by misbehaving borrowers have enforced the "bad boy" provisions, and, shockingly, the lenders have been successful! The New York Supreme Court has, on 2 separate occasions in March and July, upheld the "bad boy" provisions. While putting the borrower into bankruptcy may seem like a good solution, if doing so will violate the "bad boy" recourse provisions, it will make a bad situation worse.

The Golden Turkey for the Best All-Around Performance: Europe

I defy anyone to explain European monetary and fiscal policy. No amount of magical thinking or psychotropic drug therapy can make this make sense. The explosive dysfunctionality of common monetary and fractured fiscal policies have been baked in the cake since inception and ignored by a sheer act of will. The inevitable denouement from this toxic brew was certain;

not whether but when. While perhaps a common currency made sense from the perspective of keeping German troops out of Belgium, it was a disaster in a world where the business cycle was alive and well. The profligacy of European economies, the attendant sovereign debt crisis, the European banking crisis, world banking tensions and European recession can all be laid at the feet of the profound suspension of reality that this was some sort of a good idea.

The Golden Turkey for Pouring Gasoline onto Fire: Basel III

OK, I get the notion that banks need more capital, that the socialization of risk needs to be decoupled from market rewards, and that the system really did go casters up. But…on the cusp of a recovery, we have: the SIFIs (for the blessedly uninitiated, systemically important financial institutions), the Volcker Rule, Skin in the Game and Basel 2.5, Basel 3.0, and on and on. While we are desperately trying to re-start the economy, it seems ideologically bold, to be charitable, to embark simultaneously on dozens of untested, game-changing linked policy initiatives that will, if they do nothing else, constrain capital formation. Isn't that a bit like citing the Titanic's kitchen's for unsanitary brioche pans?

The Golden Turkey for the Abbot Arnaud-Amaury Lookalike Contest

The good Abbot has won notoriety through the ages for the investiture of the City of Béziers during the Albigensian heresy. For, when confronted with the fact that many of the good citizens of Béziers were non-heretical Christians, he said something along the lines of, "Kill them all, God will choose the innocent". Our illustrious chattering class seems to have concluded, on both the red meat right and the loony left, that trashing bankers makes good copy and good politics. Sticks and stone are bad enough, but an un-relenting policy of demonization makes for fertile ground for bad policy prescriptions, opportunistic litigation, and prosecutorial grandstanding. Whack the bankers, whack them all! Whack a mole! One would not be shocked if our banking sector was left with precious little energy for the aggressive pursuit of capital formation. The fact that the banking sector is working hard to do its job and support commercial real estate with capital is a tribute to our bankers.

The Golden Turkey for Unintended Consequences: 17-g-5

This is a very crowded category. The more we try to prescriptively engineer financial and market outcomes with legislation, the more we encounter the goblin of unintended consequences. You'd think at some point we'd create an OMB for unintended consequences to make a sustained effort think through the chances for unintended consequences before our elected representatives pose behind the President to get their picture taken and cop a commemorative pen. And then we all get to regret the legislative product. And the winner is: Rule 17-g-5. This is a rule introduced earlier this year which required issuers to maintain password protected data sites accessible to all NRSROs to see all the information in connection with a structured finance product rating recorded in these sites so that other, unretained rating agencies could analyze the data, publish an unsolicited rating and, therefore, keep everyone honest. Certainly, the Hobbesian instinct behind this notion to utilize the power of raw market capitalism to achieve the goal of breaking the perceived cozy relationship between rating agencies and bankers was estimable, but it didn't work. To my knowledge, no unsolicited rating has occurred. And it's pretty clear why. The cost of producing a rating on a CMBS transaction is enormous. If no one's going to pay you for it, it's hard to understand why an agency would undertake all that work to make a point. Moreover, here's what makes this prize so well earned: the requirement that all information made available to the retained agencies be made simultaneously available to all NRSROs has meant that banks have had to become punctilious about controlling information flow to avoid violating the shared information rule. In consequence, the NRSROs are getting much less information as conversation has been cut off and everything has been reduced to written submission. Moody's showed courage this year by writing a thought piece that said 17g-5 was reducing the quality of ratings. They are right. Now that's a useful outcome, right?

The Golden Turkey for the Best Idea Ever, that doesn't Work: Covered Bonds

In the past few weeks, the companion bill to the U.S. Covered Bond Bill 2011 has been introduced into the Senate. The Senate bill tinkers with the version re-introduced by Congressman Garrett into the House earlier this year and, in some respect, improves the enabling legislation. We've been introducing covered bond bills and talking about covered bonds for years. Not much has happened. No one has actually made a compelling case that there are major financial institutions in the United States of America that want to use covered bonds. No one has ever made a compelling argument that this is accretive to the cost of capital without an offsetting negative impact on the market. Finally, there is no evidence that anyone in our dysfunctional bicameral legislature actually thinks a bill will pass anytime soon. Now don't get me wrong, we at Dechert love the covered bond, and hope one day to be retained by serious players with serious budgets to make one of these transactions really work. But frankly, and to misquote Winston Churchill, "Never has so much been said by so many about so little".

The Golden Turkey Send off: Here's to you Mr. Politician

Whether you are a Keynesian economist (like many politicians pretend not to be) or a follower of F. A. Hayek (like all of the Republican potential nominees proclaim to be), one thing is for certain, we can all agree that the markets are volatile and 2011 is not the year to be an incumbent politician. So, with Thanksgiving right around the corner and the end of the year drawing closer, we at *Crunched Credit* would like to give a friendly send-off to those politicians who have done much to keep the news entertaining but little to calm the markets. To all of "them" (we all know who they are, even if they don't) and to the rest of "them" still standing, "It's the Economy, Stupid"!!!

By the Crunched Credit Team.