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How I Learned to Live with the CRE CDO. And Love It! (With Apologies to Stanley Kubrick)

*Richard D. Jones**

The author of this article answers the question: commercial real estate collateralized debt obligation: helpful tool or weapon of mass financial destruction?

It is manifest destiny that the commercial real estate collateralized debt obligation ("CRE CDO") would return to the commercial real estate space. A lot of people do not believe that, however. This article examine whether the CRE CDO is returning.

The Question of Need

Let us start with the question of need. Do we really need this? Portfolio lenders in need of yield and securitization lenders in need of warehouse capacity are in a day-in, day-out search for leverage. The problem, of course, is that almost all leverage available in the commercial market tends to be short term, creating a durational mismatch against the underlying financial assets. That situation is bad. That mismatch killed a lot of players last time. The CRE CDO addresses this problem with durationally matched financing. It is also blessedly bereft of the repo mark-to-market. So that's the need. It's real.

CRE CDO: Tool or Weapon of Mass Financial Destruction?

So if there is need, is this a tool or, as so many now say, a weapon of mass financial destruction? My view: When used to finance the accumulation of new vintage whole loans, it is a tool and a good one. Investors and rating agencies have enormous experience assessing the risks and rewards of whole loan commercial mortgage exposure. An entire servicing industry exists that is an extremely competent and professional manager of whole mortgage loans.

What really distinguishes the CRE CDO from the common real estate mortgage investment conduit ("REMIC") pool is, of course, that it is not static; it is dynamic. Loans can be removed and added over time. And therein lies the tale.

Challenges

This presents two challenges for rating agencies and investors in assessing a bond. First, is management competent? Can it be trusted to manage a dynamic pool of mortgage assets to support the debt? Second, can a contractual box be created, which both provides adequate certainty that the aggregate credit quality and cash flows of the pool

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will be stable over time as the vehicle is dynamically managed, while providing the sponsor with sufficient flexibility to make the tool truly useful?

Okay, that is not easy, but neither is it insuperably hard. In the first place, the capital markets trade billions of dollars of rated debt each day, which is entirely dependent on the performance of the management operating large and small companies that issue unsecured investment grade debt. We know how to assess management. Moreover, we know what skills, systems, staffing and competencies are needed to manage commercial real estate exposure. In the last cycle, we did not do this bit terribly well in the CRE CDO space. But that does not mean it cannot be done this time. Second, we can build a set of eligibility criteria and collateral quality tests that are robust, conservative, understandable, transparent and executable. To be honest, we mostly did that in the pre-fall CRE CDO technology and rating agency criteria as to whole loans. If you strip out all of the enormous complexity needed to finance B notes, mezzanine, participations, future funding loans, synthetic assets, commercial mortgage-backed securities ("CMBS") and other CDO bonds (the CDO, indeed, was a toxic notion), we'd have a pretty good place to start. When you add a bit of rigor to limit the ability to game the criteria (no criteria is proof against gaming, but it can be limited), we'd have a workable place to start. Add more focus and more rigorous criteria around who or what can be a collateral manager and servicer, and the good bones of a structure for a robust and important financing device to warehouse financial assets have been built.

As mentioned, once you strip away all of the multi-asset class technology which was larded into these perfectly workable devices, here's the type of criteria we had.

Eligible loans must be:

- secured by income-producing commercial real estate;
- U.S. property;
- performing;
- generally consistent with CMBS criteria (fixed maturity, periodic payments of principal and interest, SPE-like borrower structure, etc.);
- serviced by a rated servicer;
- backed by customary representations and warranties from the originator (or the sponsor);
- fully advanced (we should all continue to fear the monster that was the future funding loan); and
- rating agency confirmed.

And then the pool, in the aggregate, must:

- meet diversity criteria as to geography, property type, loan size and single obligor concentration; and
- meet rating agencies new and improved tranching factors, recovery tests, diversity tests, weighted average coupon tests, weighted average spread tests, and some version of the old CDO monitoring tests.

A structure looking like that in the hands of a competent manager, with a track record, experience, skills, and scale to effectively utilize such a tool is a reasonable solution to a substantive and important unmet need in the financial markets.

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Conclusion

Oh sure, complexity has a tendency to eat away at clarity and simplicity, and no one should be foolish enough to think that when clear, understandable and transparent rules are created, fools, knaves and foolish knaves will not try to push the envelope over time. But we can cross that bridge when we get to it and, perhaps, more experienced and more chastened by recent experience, we'll hold the line better this time. For now, the market needs this vehicle, and we should encourage the development of new and improved ratings criteria for managers and eligible assets and find a way to reintroduce the CRE CDO to the investor community. Maybe we don't even need a new name.

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