CMBS loan losses: property type highlights and trends

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Summary

Fitch Ratings recently published the results of its annual default and loss studies (see Fitch Research on "2003 Conduit Loan Default Study", dated 27 May 2003, and "2003 Loan Loss Study", dated 5 August 2003, available on Fitch's website at www.fitchratings.com). The data reported in those studies have been further refined to provide an analysis of defaults and losses within the major property types.

The property type sector analysis highlights how certain default resolution characteristics and outcomes differ by property type and addresses differences in disposition modes, as well as in the timing, frequency, and size of losses experienced within particular property sectors. The analysis also contrasts the disproportionate representation each property type has in the universe of defaults and losses, measured against its contribution to the overall commercial mortgage-backed securities (CMBS) universe, and further examines loss severities based on property type.

The largest loss severity, 46.6%, is occurring in the retail sector, which contributes almost 29% of all CMBS collateral on a dollar basis. Retail loan losses represented 48% of the almost $306 million in total losses. Hotel loans, which account for less than 10% of CMBS collateral on a dollar basis, represented 29% of experienced losses.

Approximately one half the dispositions that had losses, 77 of 144 loans, were liquidations of real estate-owned properties (REO), which, on average sustained the highest loss severities. Another 40% of the loans with losses were disposed of by discounted payoffs (DPOs), resulting in much lower average loss severities.

At the start of 2003, 400 unresolved CMBS loans were in special servicing with an aggregate balance of $2.7 billion. Fitch anticipates approximately $2.87 billion in new defaults in 2003 and another $400 million in losses.

Methodology

The pool of loans used to track defaults and losses in Fitch's studies includes only fixed-rate conduit, large loan, and fusion CMBS transactions rated by Fitch from 1993 to 2002. It includes 29,542 loans in 200 multiborrower transactions, representing approximately 72% of the market share of similar transactions during that period. The defaulted loan population includes only those loans in default 60 days or more. In the presentation of defaults and losses by property type, multifamily and manufactured housing loans are combined.

Summary of defaults, resolutions, and losses

During calendar year 2002, 228 defaulted loans, totalling $1.15 billion, were resolved. By count, 55% of the loans either paid off in full or were sold without experiencing a loss. By dollar balance, those 125 loans accounted for 48% of the dollar balance of those resolutions. Total realised losses on the other 103 loans were $241.5 million, or 21% of the dollar balance of all 2002 resolved loans.

REO dispositions experienced the highest loss severity at 64.3%, followed by foreclosure sales with losses of 41.2%. It should be noted that of the pool of 144 loans with losses, only three were foreclosure sales. Note sales had an average severity of 39%, while negotiated DPOs had the lowest loss severity at 28.9%. As was cited in the aforementioned 2003 default study, the average loss severity for loans held in special servicing for 24 months or more was 62%, up from 42.4% in the previous Fitch study.

Cumulatively, of the almost 30,000 loans in the conduit universe in this study, 807 experienced at least one period of default. Those loans represent a 2.66% default rate by dollar balance and a 2.73% default rate by loan count. Cumulative losses totalling $305.9 million were realised in 144 of the total 416 resolutions of defaulted loans, representing 0.17% of the $177.2 billion of original loan balances in the CMBS transactions in this study and 14.9% of the original loan balance of the 416 resolved defaulted loans.

On a cumulative basis, REO dispositions experienced an average 51.6% loss severity, foreclosure sale losses 41.2%, losses on note sales 39%, and DPO resolutions 27.1%. As noted in Fitch's previous 2003 loss study, although it appears DPO dispositions result in lower losses than REO dispositions, loans resolved through DPOs likely reflect higher quality assets with upside potential.

Resolutions and dispositions by property type

Multifamily resolutions

In the multifamily sector, 112 loans totalling $366.2 million were resolved, with 70% of the loans either becoming current or paying off in full. On average, multifamily loans were resolved in 19.1 months, the longest period of the four core property types. Of the multifamily loans resolved, 29, or 26.8% on a dollar basis, had realised losses averaging 30.6%. On a dollar basis, 68.8% of the multifamily loans were REO liquidations that experienced an average loss of 33.8%. DPO resolutions experienced an average loss of 23.2%. Losses on note sales, accounting for 17.6% of the multifamily resolution dollar amount, averaged 24.2%.

Retail resolutions

While the number of retail loan resolutions was only slightly more than in the multifamily cohort, 119 versus 112, the dollar balance of retail resolutions far exceeded the balance of each of the other property types ($683 million). On average, retail loans were resolved in 15.7 months.

On a dollar basis, 48.4% of retail resolutions experienced losses averaging 46.6%, the highest loss severity of any property type. By dollar amount, DPO resolutions accounted for 60.9% of retail resolutions and experienced an average loss of 33.5%. REO liquidations, making up almost 36% of retail dispositions, experienced an average loss of 64.7%. The highest losses, at 82.4%, occurred among note sale dispositions, representing only 3.2% of retail dispositions.

Office resolutions

While office loans represent almost 21% of the dollar balance of CMBS collateral in this study, the third largest share behind retail and multifamily, this property type has experienced the fewest defaults and the lowest loss severity to date. The 22 resolved office loans represented just 3.9% on a dollar basis of all 416 default resolutions. Almost 73% of defaulted office loans became current. Six loans, representing almost 41% of the office loan defaults on a dollar basis, experienced losses averaging 22%. Office resolutions were the speediest of any property type, averaging 15 months. Three loans resolved by note sales experienced an average loss of 23.3%, while DPO liquidations realised average losses of 14.4% and REO resolutions 29.4%.

Fitch has a guarded outlook on office loans for the near future. Both the number of office loan defaults and the size of the losses taken by resolved office loans are expected to increase.

Cumulative resolutions by property type

As of 31 December 2002

	Multifamily	Retail	Office	Industrial	Hotel	Health care	Other[1]
Resolved loans							
Number of loans	112	119	22	28	97	19	19
Original loan balance ($)	366.2	683.0	79.6	109.8	430.7	285.5	91.6
Average months to disposition	19.1	15.7	15.0	17.9	16.7	33.6	15.1
Loans with losses							
Number of loans	29	42	6	7	49	7	4
Loss balance ($)	30.1	148.0	7.1	8.6	89.5	18.8	3.6
Property type with losses (%)	26.8	46.5	40.7	18.4	20.8	10.3	3.8
Property type average loss (%)	30.6	46.6	22.0	36.2	46.0	40.8	10.6

[1] Includes various nontraditional property types.

Industrial resolutions

On a dollar basis, industrial loans make up only 6.8% of all CMBS collateral and 6.7% of defaults resolved in this study. As of year-end 2002, 28 defaulted industrial loans, totalling $109.8 million, had been resolved with seven loans experiencing losses averaging 36.2%. Those seven loans represent only 18.4% on a dollar basis of the resolved industrial loans, almost 82% of which became current or paid off without losses. By balance, 37.7% of the loans with losses were resolved through REO dispositions, experiencing a loss severity of 52.1%. The remaining loans were resolved by DPOs, experiencing an average loss of 25.3%. Fitch’s outlook for industrial loans is similar to that for office loans; however, because industrial loans make up a relatively small portion of CMBS collateral, the anticipated rise in defaults and losses is expected to have less of an impact on total CMBS losses.

Hotel resolutions

A total of 97 defaulted hotel loans, with a collateral balance of $430.7 million, had been resolved by year-end 2002, the second largest group on a dollar basis behind retail. Of the total defaulted loans, 42.4% were resolved by either becoming current or paid in full. The 49 loans with losses, which on a dollar basis represented 20.8% of the resolved hotel loans, experienced average losses of 46% and took 16.7 months to resolve. REO liquidations accounted for 39.6% of the dispositions by dollar balance and experienced losses averaging 76.2%. Loans resolved by DPOs, roughly half the dispositions, experienced average losses of 24.1%. Hotel loans account for less than 9% of the collateral in this study. Because Fitch often does not rate hotel-only transactions, the relatively small hotel collateral contribution in this pool may understate the impact of hotel losses on the larger CMBS conduit universe. Hotel properties continue to be the most vulnerable to market changes.

Health care resolutions

In the health care sector, 19 defaulted loans totalling $285.5 million were resolved, with 57.9% becoming current. Seven loans, which only represented 10.3% of the dollar balance of resolved health care loans, experienced average losses of 40.8%. Health care loans took an average of 33.6 months to resolve, more than twice the time of most other property types. No health care loans were resolved through DPOs. By loan balance, 84% were resolved by REO liquidations, experiencing an average loss of 41.5%. The loss for health care loans disposed of through note sales was 73.6% and through foreclosure, 20.5%. Health care loans make up only 2.54% of CMBS collateral and, as such, are overrepresented in the group of loans with losses representing more than 6% of the total balance of losses. Nonetheless, the current decline in health care loan contributions to CMBS is expected to continue, minimising the impact this property type will have on CMBS performance in the long term.

Cumulative dispositions by property type - disposition method

As of 31 December 2002

	Multi-family	Retail	Office	Industrial	Hotel	Health care	Other	Total no of loans	% of dispositions
No of liquidated REO assets	20	16	1	4	23	5	2	71	49.31
% of original PT balance	68.8	35.9	37.2	37.3	39.6	84.0	50.0	–	–
WA loss on original balance (%)	33.8	64.7	29.4	52.1	76.2	41.5	37.5	–	–
No of discounted payoffs	5	25	2	3	20	0	2	57	39.58
% of original PT balance	13.5	60.9	39.5	62.7	50.5	0.0	50.0	–	–
WA loss on original balance (%)	23.2	33.5	14.4	25.3	24.1	0.0	20.5	–	–
No of foreclosures	0	0	0	0	2	1	0	3	2.08
% of original PT balance	0.0	0.0	0.0	0.0	3.3	10.4	0.0	–	–
WA loss on original balance (%)	0.0	0.0	0.0	0.0	58.6	20.5	0.0	–	–
No of note sales	4	1	3	0	4	1	0	13	9.03
% of original PT balance	17.6	3.2	23.3	0.0	6.6	5.6	0.0	–	–
WA loss on original balance (%)	24.2	82.4	23.3	0.0	32.8	73.6	0.0	–	–

REO - real estate owned; PT - property type; WA - weighted average.

Proportional property type contributions

With a combined contribution of 76%, the CMBS universe is dominated with collateral from the retail, multifamily (including manufactured housing), and office sectors. The retail sector, which makes up almost 29% of the CMBS universe, maintains an almost proportionate share of the default universe. However, in the loss universe, retail loans account for more than 48% of CMBS realised losses and have the highest property type weighted average loss, 46.6%.

Hotel loans, which make up 8.8% of CMBS collateral, account for more than 29% of the defaulted loan balance and represent roughly the same disproportionate share of the loss universe. Hotel loans are experiencing, on average, realised losses of 46%. On the other hand, multifamily loans, while accounting for more than 26% of all CMBS collateral, are significantly underrepresented in the default and loss universes.

The under representation of the office and industrial sectors in the default and loss universes is expected to change over the next 18-24 months, as both sectors continue to demonstrate increased defaults and losses. The health care sector, with disproportionately high defaults and losses, will likely remain a small contributor to CMBS collateral, but Fitch expects that it will continue to be overrepresented in both the default and loss universes for some time. Health care facilities, as is the case with hotels, are operating business subject to acute vulnerability to market events.

Proportional property type contributions

%, As of 31 December 2002

Property type	Balance of CMBS universe	Defaults in total default universe	Losses in total loss universe	WA loss severity by property type
Multifamily	26.38	13.97	9.84	30.61
Retail	28.98	28.01	48.37	46.60
Office	20.62	6.66	2.33	21.98
Industrial	6.80	4.45	2.82	36.18
Hotel	8.82	29.41	29.26	45.98
Health care	2.54	13.73	6.15	40.82
Other	5.87	3.76	1.23	10.75
Average loss severity - core property types[1]	–	–	–	33.84
Average loss severity - all property types	–	–	–	33.27

CMBS - commercial mortgage-backed securities; WA - weighted average.

[1] Include multifamily, retail, office and industrial properties.

The table above presents a summary of how each property type has performed in CMBS compared with other property types. It summarises default and loss history within each property type, as well as each property type's weighted average loss severity.

Defaults and losses in each property type universe

On a dollar basis, more than 14% of all health care collateral has experienced defaults. Total experienced losses in that sector represent 0.42% of all health care collateral. In the hotel sector, 8.9% of collateral has defaulted, but 0.57% has taken losses, the highest percentage of any property type sector. Retail loans, which account for such a disproportionate portion of the loss universe, have experienced defaults in 2.57% of collateral and losses of 0.29%. The remaining property types have all experienced less than a 0.1% loss in their total collateral. Overall, of the $177.2 billion in CMBS loans in this study, loans totalling $4.7 billion have defaulted at least once (2.66% of the collateral), with only 0.17% ($305.9 million) in realised losses. The 144 loans that experienced losses had original loan balances totalling $748 million. Almost 41% of that original loan balance, $306 million, was lost in the resolution of those defaulted loans.

The weighted average loss severity for all property types is 33.3%. For core properties, including multifamily, retail, office, and industrial loans, the weighted average loss is 33.8%.

Defaults and losses by property type

As of 31 December 2002

Property type	Balance of CMBS universe ($ bn)	No of loan defaults	Default balance ($ m)	% of defaults by property type	No of loans with losses	Original balance loans with losses ($ m)	Balance of losses ($ m)	Loss as % property type universe	Property type contribution to loss universe (%)
Multifamily	46.7	185	658.8	1.41	29	98.4	30.1	0.06	9.84
Retail	51.3	210	1,320.7	2.57	42	317.6	148.0	0.29	48.37
Office	36.5	58	314.2	0.86	6	32.4	7.1	0.02	2.33
Industrial	12.1	53	209.9	1.74	7	23.8	8.6	0.07	2.82
Hotel	15.6	207	1,386.5	8.87	49	194.8	89.5	0.57	29.26
Health care	4.5	61	647.5	14.41	7	46.1	18.8	0.42	6.15
Other[1]	10.4	33	177.4	1.71	4	34.9	3.8	0.04	1.23
Total	**177.2**	**807**	**4,715.1**	**–**	**144**	**748.0**	**306.0**	**0.17**	**–**

Defaults as % of originations	2.66
Losses as % of original loan balances	0.17

Note: Numbers may not add due to rounding.

[1] Includes various nontraditional property types.

The table on page 5 summarises, by dollar balance and number of loans, the default and loss experience of each property type in the CMBS universe.

Problem loan pipeline

At the close of 2002, 400 unresolved CMBS loans were in special servicing - 261 delinquent loans, 42 loans with pending foreclosures, and 97 loans that were already REO properties. The total balance of those loans was $2.7 billion, 60% of which consists of hotel ($950.7 million) and retail ($682.6 million) loans. Also included in that pool were 52 loans that, at that time, had been in special servicing for longer than 24 months.

In the second quarter of this year, the Fitch Loan Delinquency Index grew to 1.62%, a 23 basis point (bp) increase over first-quarter 2003. Based on ongoing performance analytic efforts, Fitch expects to see similar increases in the loan delinquency index in the third and fourth quarters of 2003, with an overall CMBS delinquency of 2% by year-end. In all, Fitch anticipates an additional $2.87 billion of loan defaults for the year. Furthermore, a preliminary evaluation of completed 2003 resolutions indicates that losses have increased by almost $300 million thus far, almost doubling the amount of losses on the books when the year started.

Forecast

Using the various property-specific default and loss rates that have been generated by the loss study, as well as the data gathered from ongoing performance analytics, Fitch estimates that final losses for 2003 will total around $400 million. Within the various property sectors, Fitch expects defaults in the multifamily, office, and industrial sectors to continue rising and that losses, on a percentage basis, will remain proportionally higher in the hotel and retail sectors, particularly within the 2003 pool of resolutions.

Despite weakened real estate fundamentals and a frustratingly slow economic recovery, CMBS investments remain a bright spot in the structured finance world. When analysing losses, it is easy to overlook how startlingly small these losses have been over the course the 10-year history of CMBS. Actual default and loss experience in CMBS is considerably lower than earlier expectations when CMBS was a fledgling investment vehicle.

While forecasting increases in defaults and losses as the universe of transactions expands and matures and acknowledging that net operating income in most property types has been declining over the past 18-24 months, Fitch believes investment-grade CMBS will continue to be well protected. The diversity of collateral in conduit transactions, along with higher levels of technology in the servicing sector and lower interest rates, has helped CMBS performance outpace that of other structured finance investments.

The characteristics of defaults and losses, when evaluated by property type, will continue to illuminate differences and inherent risks in each property type sector and allow investors and rating agencies to further hone their risk analysis.