LESSON FIVE: TYPES OF PERMANENT FINANCING

1.1 LIFE COMPANY OR PORTFOLIO LOANS

Life companies are large providers of permanent loans. They view stabilized real estate assets as an "investment class" for their portfolio, such as stocks and bonds. Life companies are generally the *most conservative lenders.* Typically life companies provide the *lowest interest rates.* Typically life companies provide the *lowest loan proceeds.* Typically life companies are the *most "picky"* about the asset quality and the market. In general, life companies hold their loans on their balance sheet and make profit on the spread between the rate and their cost of funds.

Active life company lenders include: Metlife, Prudential, and New York Life.

1.2 BANK LOANS

Banks have been traditional providers of real estate loans, but they have not been prolific in the long-term, fixed rate market. Many banks have started "conduit desks" or syndication desks, where the banks originates and holds the loan for a short period of time, then sells the loan to other lenders while keeping a fee. Banks will generally write loans for 3-5 years, but not 10 years.

1.3 COMMERCIAL MORTGAGE BACKED SECURITIES (CMBS) OR CONDUIT LOANS

This market came of age in the early 1990s out of the Resolution Trust Corporation (RTC) and the Savings and Loan crisis. This has been the most prolific advances in commercial real estate finance. Below is the summary of the CMBS process.

THE CMBS PROCESS:

- A fixed rate stabilized loan is originated by a CMBS lender, also known as a "Conduit Lender."
- Loans are "pooled" or put together with many other loans.
- The loans are diversified by:
  - Size
  - Market
  - Sponsor
  - Asset type

- In theory, the risk of loss in a “diversified pool” is less than one loan or a “non-diversified pool.”
- The loans are then “packaged” into a securitization or bonds. These are known as commercial mortgage backed securities.
- The bonds are then “tranched” and rated by the rating agencies (S&P, Moody’s, & Finch).
- The loans are separated into different risk tranches or bonds (see Exhibit A for CMBS Chart). These are:
    - AAA: highest rating – investment grade
    - AA: second highest – investment grade
    - A: third highest – investment grade
    - BBB: fourth highest – non investment grade
    - BB: fifth highest – non investment grade
    - B: rated piece – non investment grade

- After the tranching takes place, the investment bank sells the bonds to investors.
- The investment bank may not hold or keep any of the bonds, and they make a fee by selling the bonds.
- The profit is made because the “parts” are worth more than the “whole.” In the beginning, (early 1990s) this was 6-7 points. Today, it is about 1 point.
- The “easiest” bonds to sell are those known as AAA. These also have the lowest mount of yield.

CMBS LOAN OVERVIEW:

- Conduit lenders are typically the most “aggressive” lender in terms of proceeds and asset quality. Typically, conduits charge the highest interest rate and provide the most proceeds.
- Conduit lenders will typically accept lower quality assets (C-buildings) because they will be part of a diversified pool and then sold.
- It is important to note that most CMBS or conduit lenders are sellers of paper, and do not hold risk. The risk of the transaction is “rated” (or predicted) by the rating agencies.
- Investors take comfort in these ratings (similar to corporate bond ratings) and buy the paper once they are transformed into bonds/ securities.
- Thus, the true holder of risk are the bond buyers who own the non-investment grade tranches: B, BB, and BBB.

1.4 AGENCY LENDERS: FREDDIE MAC (FHLMC), FANNIE MAE (FNMA), & FHA/HUD

Agency lenders are quasi-government entities that provide permanent financing on stabilized multifamily properties. Agency lenders are excellent alternatives to life company and conduit lenders. Agency lenders must be accessed by approved mortgage companies that represent the agency lenders. Below are a few examples of agency lenders.

THE AGENCY LENDERS:

FREDDIE MAC: Some mortgage firms have Freddie Mac licenses. These mortgage banks originate loans for Freddie Mac directly.

FANNIE MAE: Mortgage companies aligned with Fannie Mae are known as DUS lenders (Delegated Underwriting and Servicing). In this model, the mortgage lender shares some of the first loss risk.

FHA: Also known as HUD. They provide the most proceeds, 40 year amortization, and will do business with all levels of sponsorship. This is a government subsidized lending program. FHA deals typically take a long time to close. (Note: HUD will finance nursing homes and assisted living facilities).