Fixed-Income Investment Opportunities:  
The Yield-Enhancing Opportunities in  
Noncallable High-Coupon Commercial Mortgages

Introduction

Commercial real estate interest rates have risen somewhat after falling to their lowest levels in eight years. This environment creates a new set of incentives for commercial mortgage lenders to liquidate premium mortgages. This differs from the typical strategy of liquidating low-rate mortgages to take advantage of the opportunity to lend at higher yields that was used in the inflation period of 1979-85. The current interest rate environment also creates opportunities for investors to earn high yields, with minimum risk, relative to new mortgage originations through the purchase of premium mortgages. The yield differential, which is 50-100 basis points above equivalent new commitments, arises from a funding bias on the part of institutions that are unwilling to pay above par for commercial mortgages, even with strong call protection. The bias arises from mispricing the risks associated with purchasing well call-protected commercial mortgages at a premium.

The Opportunities

The high-coupon commercial mortgage is the result of the 1979-85 period of high interest rates. For the first time, mortgages were being issued at levels that were well above equity capitalization rates, which were typically 9%. These high-coupon mortgages were originated at rates of 11%-15% (see Figure 1). For borrowers to satisfy the traditional debt service coverage requirements of institutional lenders, loan-to-value ratios were forced down to 55%-65% from 75%-80% before the rate increases in 1979. Some lenders, in exchange for relief from high mortgage interest rates, required some form of participation in the economic performance of the underlying collateral — through operating cash flows, profits from sales or both. The lower loan-to-value ratios for nonparticipating loans were required to maintain the 1.2:1 debt service coverage ratios demanded by lenders at the time (see Figure 2). The mortgage prices in Figure 2 are based upon an interest-only loan with seven years remaining to term. The assumed discount rate is the coupon rate available on new issue mortgages, which is 9.75% as of August 7, 1987.

Even when the price of the mortgage is based on current discount rates, and property value is determined as of the origination date, the loan-to-value ratio remains well within the traditional 75%-80% underwriting standard. Indeed, the property could withstand about a 10% reduction in both income and value and still be within reasonable current underwriting standards. Obviously, if the mortgage were valued at a yield to allow for a 100-basis-point premium, the loan-to-value ratios would be even lower.
The Risks

Several questions arise when considering the purchase of a commercial mortgage above par. In particular, there are three fundamental financial risks associated with this transaction: (1) various issues with respect to default (as with any mortgage); (2) condemnation; and (3) casualty. The ability to enforce remedies provided for in the mortgage contract usually means that mortgage payments are accelerated, which is not effective if the premium is lost.

In the case of casualty or condemnation, the holder of a mortgage with the usual provisions would receive no more than par value and thus suffer a capital loss on the unamortized premium paid. The risk of condemnation is modest in that it is unlikely that a government would condemn a new, high-value structure for public use. The economics of such a “taking” would be prohibitive for the condemning entity.
The risk of a casualty loss that is large enough to trigger repayment of the mortgage is also small, but perhaps greater than that of condemnation. An investor can be protected, to some extent, by knowing the quality of construction, the fire rating of the building and whether the building is subject to significant earthquake or flood risk. Even if a casualty loss occurs, a lender only loses the premium if rebuilding is not desired. This may occur, for example, if a major tenant relocates. In the past nine years, only one major office building in the U.S. — the Norwest Bank Building in Minneapolis — was subject to a total casualty.

The risks of default, in general, and of willful default, in particular, are of the most interest to the purchaser of a premium mortgage. In the case of a default, the mortgagor customarily would be entitled to par value; thus, the premium paid for a mortgage would be lost in addition to any other credit loss caused by the default. This increases the severity of a loss associated with a default relative to a mortgage purchased at par.

The possibility of default is a function of the underwriting standards applied when the loan is originated and of the expected cash flow from the underlying asset. Given high-quality loans originated in accordance with the ratios presented in Figure 2, the risk of default would be consistent with the historic default experience among commercial mortgage lenders such as life insurance companies. From 1979 until 1986, the sum of delinquent loans and loans in the process of foreclosure from a survey of life insurance companies ranged from 0.77% in December 1979 to 3.05% in December 1986. However, given the current period of weak market fundamentals, past default history may not be an accurate predictor of future experience. Obviously, other considerations regarding the regional economy, site location, management quality, construction quality, and other factors must also be analyzed to determine the expected probability of mortgagor default. Proper due diligence at the time of purchase minimizes this problem.

A willful default is caused when a borrower seeks to restructure an essentially good loan through the foreclosure process. With declining mortgage interest rates, at some point it may be beneficial for a borrower to default on his mortgage and go through the foreclosure process; he would thereby avoid the contractual prepayment provisions of the mortgage and could ultimately refinance with another lender. In this case, not only does the mortgage holder lose associated legal fees and face reinvestment risk but the investor may also lose the unamortized mortgage premium, because the mortgagor is often only entitled to be paid par out of the liquidation proceeds. An additional loss would be the opportunity cost of being paid after the foreclosure process runs its course, as opposed to timely payment as set out by the original loan documents. Although there are enforceable ways to mitigate the problem in some states (for example, when mortgage documents include a specified reinvestment rate within the default clause of the mortgage), many seasoned loans do not include such provisions.

In many cases, the risk of willful default is more theoretical than real. A foreclosure is treated as a sale by the Internal Revenue Code, so that the tax consequences of a sale would tend to make a willful default unlikely. In a sense, this risk is similar to a cash call in a "nonrefundable" bond, when the bond covenants allow a call to be financed from the internal cash flow of a corporation.

The risk of cash flow discontinuation as a result of casualty, condemnation or default can also be reduced through the pooling of premium mortgages, which diversifies the risk of call for any of these reasons.

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1 Semiannual Survey of Mortgage Loan Delinquencies and Foreclosures, American Council of Life Insurance.
2 It is technically possible to foreclose on each individual payment without triggering full acceleration of the principal.