Yield Book Mortgage Research

CMBS Commentary

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What does SVB failure mean for CMBS?

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While the swiftness of SVB failure shocked the market, it is in essence a classic example of poor asset/liability management, a mismatch between short-term deposits and long-term investment in fixed rate securities which have seen decimated valuation due to rapidly rising rates since 2022. A forced sale upon liquidity stress (caused by tech-concentrated client withdrawal) crystalized the loss, triggering a bank run which sealed the fate of SVB.

CMBS investments typically have heavy exposure to long duration fixed rate securities. For example, the largest AAA tranche in a CMBS conduit deal is fixed rate with 10-year WAL. Such tranche issued in 2021 at par might have seen a price decline as much as 20 points because of significantly higher required yield (due to higher rate and wider spreads). Hence any investor holding a portfolio of this type of bonds can potentially be sitting on huge unrealized loss, barring proper rate hedge.

Duration can be lengthened even for short CMBS bonds as many loans facing near-term maturity struggle to qualify for refinancing with lower DSCR ratio due to higher rate and extension becomes the only way out if special servicer allows. Economic slowdown and a recession can also exacerbate the duration risk for CMBS as loans fail to refinance due to reduced net operating income and end up getting extended.

On the other hand, flight to safety in the wake of SVB failure may push down treasury yield (and hence CMBS required yield), leading to a rebound of asset values. In addition, Fed may take a more cautious stance in tightening as it tries to maintain banking system stability. As a result, CMBS loans may become cheaper to refinance, helping to reduce credit defaults. That said, Fed can potentially be in a conundrum where they may struggle to rein in the inflation without aggressive rate hikes, and hence there could be a fresh wave of rate volatility down the road.

Meanwhile, credit spreads will likely widen amid a jittery market condition and a sustained period of risk aversion, putting a downward pressure on the valuation across CMBS securities. And banks and lenders will tighten lending criteria and curtail lending volume, which would hurt loan origination volume and deal flows for CMBS.

While government intervention seems to take effect for the time being, we anticipate elevated uncertainty in 2023 as the market tries to figure out how far the contagion will spread and how long the fallout will last. A severe and prolonged shock to financial system will likely accelerate or deepen a recession, with great ramification for economy and commercial real estate.

In time of distress and volatility, Yield Book is uniquely positioned to help clients assess the duration risk and the valuation of their CMBS holdings. Specifically, the Yield Book agency CMBS prepay models (GN PL, FN DUS, Freddie K) provide prepay speeds projection for more accurate duration calculation, and the Yield Book non-agency CMBS credit model takes into account the maturity refinancing risk and extension options based on credit metrics. Clients will be able to run the models through their portfolio securities and analyze the duration risk exposure. They can also mark to market their portfolio for risk adjusted yield/price and estimate unrealized loss. Furthermore, clients are equipped to run various stressed scenarios to incorporate and express their own views of the market and the collateral performance.

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