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THE WEEKLY UPDATE ON REAL ESTATE FINANCE AND SECURITIZATION

Small-Balance Lenders Shift Gears

The commercial MBS market slowdown is causing originators of small-balance commercial mortgages to adjust their strategies.

Principal Real Estate Investors has scaled back its operation, laying off a small-balance conduit team. Meanwhile, Principal and **KeyBank,** which also started originating small-balance commercial MBS mortgages last year, have decided to use **Fannie Mae** as an exit strategy instead of securitization.

Key reached an agreement this month to join Fannie's small-balance-loan program, said managing director **Charles Krawitz,** a **LaSalle Bank** alumnus who joined Key last summer to beef up its small-balance program.

Principal is on track to reach an agreement shortly, according to a Fannie spokesman. That marks a new direction for Principal. In late 2006, the insurer launched a Dallas-based team to originate and securitize loans of $250,000 to $5 million. But the group has now been disbanded. About 10 staffers were dismissed in the first week of June, on top of a half-dozen layoffs in March.

Among those cut in the latest round were **Bill Woodhouse,** who was the director of credit and leader of the small-balance team, and senior underwriters **Cari Robinson** and **Tom Southworth.** Woodhouse was at **Washington Mutual** before he joined Principal. Robinson was formerly with **Marcus & Millichap Capital.**

Key and Principal have shifted their strategies in response to the ongoing freeze-up in the commercial MBS market, which has made securitization uneconomical. They intend to sell to Fannie eligible multi-family loans that were originally written for securitization, and to write future loans to Fannie's specifications. For example, Principal's Dallas conduit team originated 50 loans totaling about $130 million for securitization, and has sold most of them to Fannie. While Principal has disbanded that team, other staffers at the insurance company will originate small-balance loans for sale to Fannie.

Before the collapse of the subprime market last year sent shockwaves across the mortgage sector, small-balance securitizations were being touted as the next frontier for CMBS. The entry of major lenders like Key and Principal heralded a major change for a market that had been the domain of local and regional banks that parked loans in the their portfolios.

Instead, the fixed-income downturn brought the securitization market to a halt. Small-balance commercial mortgages were particularly hard-hit by the subprime meltdown. Because borrowers are often owners of mom-and-pop businesses, and loans typically are the size of mortgages on large homes, the sector is closely tied to the performance of the housing market.

CBA Commercial, which was launched in 2004 by boutique merchant bank **Cheslock Bakker & Associates** and had securitized small-balance loans, went out of business last October after a last-minute bid to line up equity fell apart. Portfolio lenders **Impac Commercial Mortgage** and **Greenpoint Mortgage** also dropped out of the small-balance sector.

The securitization debacle has been a boon for the mortgage agencies, whose implied triple-A ratings and government backing have enabled them to pick up market share. Fannie and **Freddie Mac** have become the dominant originators of multi-family mortgages — including small-balance loans.

"That's been the only game in town, selling to Fannie and Freddie," said **Randy Fuchs,** a principal at **Boxwood Means,** an analytics firm that follows the small-balance market.

In 2001, Fannie launched a small-balance program called 3Max Express. The effort, which has since gone through a number of changes, has attracted 16 lenders, including many that also belong to the agency's "DUS" program, under which lenders are pre-approved to write loans for sale to Fannie.

Since the real estate market started turning down last summer, additional lenders not associated with the DUS program have joined the small-balance program, including **Royal Bank of Canada, Imperial Capital** and **First National Bank of Alaska.** Though Key is a DUS lender, Principal is not.

Fuchs said fourth-quarter volume stood at $29.9 billion, down 5.1% from $31.5 billion in the third quarter. Small-balance lending had experienced several years of steady growth up until then. First-quarter figures are not yet available, but Fuchs expects another decline. However, he noted that even with the declines, small-balance activity remains robust by historical measures.

Fannie's small-balance program is geared to loans up to $3 million in size, though it will consider up to $5 million depending on the property and market. Given Fannie's mission, only multi-family and manufactured-housing loans are considered.

Since the sector exists in the gray area between commercial and residential mortgages — many small-balance loans are on owner-occupied businesses — there is some room for consideration. "If it's a business with six floors of apartments above it, then we'll probably take that loan," said **Richard Wolf,** head of the small-balance program. ❖