

## Downturn Stymies Small-Balance Mortgages

The market for small-balance commercial mortgages, touted as the next big thing in securitization only a few months ago, has hit a wall along with the rest of the commercial MBS industry.

A few major players, including **Impac Mortgage Holdings** and **Greenpoint Mortgage Funding**, have exited the sector. Others, such as **LaSalle Bank** and **Johnson Capital**, have diminished their activity. And some newcomers, like **KeyBank** and **RBC Capital**, have scaled back expectations.

While fallout from the subprime-loan crisis has helped flatten the entire CMBS market, the small-balance-loan sector has been hit particularly hard. The reason: The sector overlaps with the residential mortgage market. The borrowers are often owners of mom-and-pop businesses, and loans typically are the size of mortgages on large homes. So the sector is closely tied to the performance of the housing market.

"A lot of the borrowers are single investors without the resources and equity of institutional buyers," said **Randy Fuchs**, a principal of **Boxwood Means**, an analytics firm that tracks the small-balance market.

Figures for third-quarter originations were not yet available, but Fuchs said all indicators suggest that a sharp decline occurred. "Even earlier this year, the numbers were still strong but they were beginning to drop," he said, attributing that to a softening of property values just before the subprime crisis hit. "It's not going to get prettier, that's for sure."

The credit crunch has significantly depressed property prices, a fact that many property owners have not yet come to grips with, Fuchs added, saying that the trend has scotched potential property sales and refinancings.

Lenders agree. "We give out quotes, but a lot of the time the deal never gets done," one lender said. "The sale doesn't happen."

Nevertheless, lenders and analysts feel that the market will eventually bounce back strongly. "It may take another five to six months to come back, but I think this is a very viable market," Fuchs said. "It's the last commercial mortgage origination frontier. I think it will shake out, and I think it will be the better for it."

The small-balance-loan market has historically been highly fragmented, with a patchwork of regional and specialty lenders accounting for much of the business. That started to change last year, as bigger lenders looking for new ways to generate revenues entered the market, often with securitization as their exit strategy.

But the liquidity crunch has led to a shakeout in the industry. Greenpoint Mortgage was shut down in August by its parent company, **Capital One**. Impac was sidelined last month by massive layoffs. Lenders say LaSalle has been all but absent, partly

because of the uncertainty following its purchase by **Bank of America**.

Johnson Capital, which planned to originate more than \$180 million of small-balance mortgages this year through its new Johnson Capital Express platform, now expects to fall about 40% short of that goal.

RBC's small-balance program, announced in March with the hiring of former LaSalle executive **Cheryl Higley**, was delayed in getting off the ground and, when it did, ran straight into the shockwave from the subprime meltdown. Managing director **Dan Smith**, who joined RBC last year to launch a U.S. commercial mortgage program for parent Royal Bank of Canada, said the bank had hoped to originate up to \$200 million of small-balance mortgages this year, but now expects to finish the year with \$75 million or so.

Smith attributed part of the shortfall to the fact that some borrowers, dissatisfied by the tighter lending standards now being employed, think they will get a better deal by waiting. "I'm not sure that borrowers see this as a permanent shift yet," he said.

While RBC's strategy is to securitize its small-balance loans, the crunch has led it to begin negotiating to sell its multi-family mortgages to **Fannie Mae** and **Freddie Mac**.

At least one small-balance player — **Principal Real Estate Investors** — sees the chaos as an opening. The firm has hired 12 producers for its Principal Commercial Mortgage Edge program, which it launched in June to originate recourse loans of up to \$5 million. The program emphasizes speed of execution and low fees.

But a Principal spokesperson said that the firm's existing non-recourse program, which has been in place for about four years, has felt the impact of the market downturn.

While Key, which hired LaSalle alumnus **Charles Krawitz** in June to beef up its small-balance-loan program, has also suffered from the market slowdown, the company remains bullish on the sector.

Krawitz said Key still plans to team up with another lender for a joint securitization in the first quarter of 2008. He said the sector remains ripe with opportunities for lenders able to offer more-sophisticated approaches than the regional lenders that have dominated the market.

Ironically, even as the small-balance market remains stalled, more servicers are interested in expanding into the sector. **Fitch**, which rates two small-balance-loan servicers, expects to issue ratings for two or three more by yearend. "Some of the companies are purely residential servicers," said **Mary Kelsh**, a Fitch senior director, adding that they expect "returns will be better in the commercial market." ❖