Research Note: Comparing Historical Loan Loss Rates of CMBS and NMTC

Joseph L. Falkson, PHD, MBA[1]

Overview

As the New Markets Tax Credit (NMTC) Program matures, and seeks recognition among the standard array of financial products servicing the Nation's Real Estate investment market, potential investors are interested in how NMTC loan loss rates compare with other, more familiar products' loan loss rates.

In order to address this issue, the author filed a Freedom of Information Act (FOIA) request with the US Department of the Treasury's CDFI Fund, the agency that administers the NMTC Program, seeking a full census of the NMTC loan history, since the program's inception.[2] These data were provided in January 2014 and the 10-year (2003-2013) NMTC loan loss rate was calculated at 0.9%.[3] This exceptionally low loss rate may be attributed to a number of factors relating to how the NMTC Program is managed by the Treasury Department, including its strong regulatory oversight.[4] This paper places the NMTC loan loss rate in the broader context of the US Real Estate financial sector by comparing the NMTC program's loan loss rate to comparable data from the collateralized mortgage-backed securities (CMBS) sector.

The Data

Both Moody's and Standard & Poor's (S & P) rating agencies routinely track the historical loss rates in the CMBS sector. They have been doing such tracking since the mid-1990s (S & P) and 2000 (Moody's). Both firms' methodologies are highly similar: they each perform quarterly statistically valid sampling of the CMBS universe and measure the conduit losses for each year of securities origination and provide a cumulative update of the conduit losses for all periods up to the present quarter. The firms also determine the weighted average loss severity for each quarter. The NMTC Program tracks NMTC loans through the annual community investment impact system (CIIS) reports filed by each community development entity (CDE).[5]

Thus, we have available for comparative analysis three historical data sets, each emanating from three different sources, covering roughly the same and overlapping time periods: Moody's, 2000-2013; S & P's, 1995-2012, and NMTC, 2003-2013. Since the loan loss numbers we are interested in comparing are the most recently available cumulative losses for each database, a legitimate statistical claim for comparability across the data sets may be made.

The Results

The following table presents the most recent available results:

Database Source[6]	Moody's CMBS	S & P's CMBS	CDFI's NMTC
Tracking Time Period	1998-2013	1995-2013	2003-2013
Cum. Tracking Data Point	June 2013	Dec. 2012	Dec. 2013
Cum. Loan Loss	2.8%	3.24%	0.9%

Analysis

The loan loss rate for the NMTC program has been less than one-third of the Moody's CMBS tracking database and a little more than one-fourth of the S & P tracking database. It is unlikely that this result is an artifact of the data or a statistical aberration. While it is possible that the longer time periods of the CMBS tracking surveys could have meant that the earlier financial bubbles of the late 1990s have loaded up these databases with weaker loans than the later tracking NMTC database, the author thinks this is unlikely and not what is really going on with these data. For a comparably distressed period, 2006-2008, the CMBS loan losses for the S & P database climbed to 4.27%, 3.51%, and 4.30% respectively. During this same period, the NMTC loan loss rate also increased, but only to about 2.0% overall for the 3-year period. Thus, narrowing the comparative period to a common era of severe financial distress still yielded a substantially lower loan loss rate for the NMTC investment pool.

What are the implications of these data for the possible securitization of pools of NMTC loans? First, NMTC loans ought to be marketable at a lower price than comparable, non-NMTC loan pools. Second, over time the probability is high that a tranche of securitized NMTC loans is more likely to be supported by a pool of higher quality loans than a comparable tranche of CMBS securities. This means that, as the NMTC securitized instruments mature over time without significant defaults and write offs, subsequent securitizations backed by these loans will trend upward in the ratings. This will increase their profitability, over time.

Notes

1. Dr. Falkson holds a PhD in Political Science from The University of Michigan—Ann Arbor where he studied quantitative research methods in the political behavior program and conducted research at the University's Survey Research Center. Subsequently, Dr. Falkson received the MBA from The Wharton School, where he studied finance and quantitative research methods.

2. The NMTC database obtained by the author is a full census of every loan made by the NMTC Program from January 2003 to December 2013.

3. The author personally analyzed the excel workbook containing 10,188 lines of loan information.

4. The NMTC Program is a credit enhanced program funded substantially by the US Taxpayer through the IRS. It can only lend to Low Income Communities (LICs) whose projects do not qualify for regular, commercial financing. So, by definition, NMTC projects are not Park Avenue projects. They are located in the Nation's redeveloping urban and rural areas. To compensate commercial lenders and private investors and induce them to take on the heightened risk inherent in these projects, the IRS and the CDFI Fund, both units of the Treasury Department, have set up a highly complex program structure centering around the enhanced origination/due diligence, and oversight/monitoring functions required of CDEs. From project selection through program servicing and sub-servicing, Treasury requires CDEs to engage in a monitoring and control process far more strenuous than usually required in standard, commercial real estate lending. The price of failure to the CDEs is recapture of the NMTCs and removal from the NMTC Program. This explains why the 10 year loan loss rate has been so low, less than 1%.

The paradox of the NMTC Program and the industry that has grown up around it is that it has demonstrated conclusively that, with heightened financial incentives, due diligence, regulatory oversight, and risk management, investing and lending in real estate projects in the Nation's low income communities can be undertaken safely and confidently. That is why the biggest banks have bought billions of dollars worth of NMTCs and why they continue to have such a high appetite for the program. And, in order to protect their tax credit equity investments, they must insure that the leverage loans, which, for seven years, are inextricably woven into the fabric of the Program, are maintained in a safe and secure manner alongside the tax credit equity.

5. The Community Investment Impact System (CIIS), administered by the CDFI Fund, collects annual reports from individual CDEs, which include a number of data points related to their operations and investment activities. In particular, the CIIS collects specific financial information about each transaction sponsored by a CDE and the current status of the project, including whether the NMTC loan is current or written off.

6. Sources: Moody's Loss Severity Conduit Financing Quarterly Surveys; S & P's Loss Projections for North American CMBS Transactions; CIIS Database, NMTC Loans, 2003-2013.