MARKETS

Slowdown in Shadow Lending Tightens Credit on Main Street

A $98 billion drop in bonds backed by loans makes it harder for businesses, shopping-mall owners and consumers to refinance debt

Some shopping malls are feeling the squeeze of a slowdown in shadow banking. *PHOTO: L.E. BASKOW/LAS VEGAS SUN/ASSOCIATED PRESS*

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America's shadow banking system slowed sharply through the end of June, with the value of bonds backed by personal, corporate and real-estate loans falling $98 billion from the first half of 2015.

That drop, which excludes bonds from state-backed issuers like Fannie Mae, represents a 37% decline from a year earlier, according to industry newsletter Asset-Backed Alert, and is making it harder for businesses, shopping-mall owners and consumers to refinance their debt.

The pullback was triggered by the investor flight from riskier types of bonds around the New Year and persisted even as broader market conditions improved. One contributing factor is a regulation that will require producers to hold some of the securities they create, a requirement that makes the business less profitable and has slowed the packaging of new loans into bonds. Another is uncertainty raised by Britain's vote to leave the European Union.

The resulting drop-off in issuance is roughly equal to the volume of loans that Fifth Third Bancorp, one of the country's largest regional banks, has on its balance sheet, according to data provider SNL Financial. It represents another weight on an economy already notable for weak business investment.

The drop-off is particularly acute in the market for commercial mortgage-backed securities. At $31 billion so far this year, CMBS issuance is down nearly 44% from the same period in 2015. Thousands of real-estate owners who tapped the market during the boom years of 2006 and 2007 need to refinance their maturing debts this year and next. Many will have to find alternative sources of funds, said Paul Fitzsimmons, head of CMBS research at Kroll Bond Rating Agency.

Anthony D'Agostino recently struggled to refinance the loan he and three other doctors used to pay for the building that houses their private medical practices in Naples, Fla. They built the two-story, Spanish-style building with palm trees outside in 2006 with a $4.8 million loan that became part of a commercial mortgage-backed security.

As the loan on the Banyan Professional Center neared maturity this spring, Dr. D'Agostino said a local bank he contacted offered steep terms including a 20% down payment, and gave a low appraisal for the building, which limited how much the bank would lend.

"It was ridiculous," Dr. D'Agostino said. "We had never been late with payments, and our building is fully occupied. It should have been a no-brainer."

A month after the previous loan came due, he found a new loan from a regional bank with more reasonable terms. By then, the servicer on his earlier loan was threatening legal action over the delayed repayment. “It was a difficult process,” he said.

Owners of more than 400 commercial properties—including hotels, apartment buildings and warehouses—whose loans came due between January and May this year didn’t pay off by their maturity dates, according to data from Trepp LLC, which tracks loans in commercial mortgage-backed securities.

About a quarter of those loans ended up paying off afterward in full or with losses to bondholders. The rest are still being worked out. Through mid-June, some $4.5 billion in CMBS loans were transferred to special servicers that specialize in debt workouts, according to Fitch Ratings, which called it an “an accelerated pace” that is likely to continue.

“It’s absolutely taking more time to line up financing,” said Ari Hirt, a managing director at Mission Capital Advisors, which arranges real-estate debt and equity financing.

The securitization market has long been a mainstay of the U.S. financial system, including how it helps provide financing to less creditworthy borrowers who can’t easily get loans from banks. By pooling dozens, hundreds or even thousands of loans into vehicles that issue bonds to investors, banks and other lenders can boost the volume of loans they make beyond what they can store on their own books. Investors, meanwhile, can pick from bonds with different risk profiles, comforted that properly structured instruments should pay in full even if some underlying loans default.

During the 2007 housing downturn, the concept backfired when scores of bonds backed by subprime home loans plunged in value as housing prices fell and mortgage defaults surged. Banks and investors suffered billions of dollars in losses from these products, which were at the heart of the financial crisis. Bonds backed by corporate loans, commercial mortgages and auto loans, by contrast, largely performed within expectations, and the market for those assets have rebounded since the crisis.

There are currently more than $10 trillion in outstanding securities backed by U.S. consumer, business and other loans, according to the Securities Industry and Financial Markets Association. About $7 trillion are backed by government-affiliated agencies such as Fannie Mae and Freddie Mac. The remainder consists of collateralized loan obligations, commercial mortgage-backed securities and other bonds underpinned by outstanding credit-card debt, auto loans and esoteric assets like solar-panel leases and vacation timeshares. Last year, $452 billion of these nonagency bonds were issued in the U.S., and $168 billion in such securities have been issued in the year to date, according to Asset-Backed Alert.

Slowdowns in the market quickly filter through to borrowers. GK Development Inc., the owner of a shopping center in Lufkin, Texas, whose anchor tenants include T.J. Maxx, J.C. Penney and Sears, had $26.5 million in debt that came due in March. GK President Garo Kholamian said the company worked for several months to refinance it with a new 10-year loan from New York-based lender Greystone & Co.

But amid turmoil early this year in the CMBS market, where Greystone would have sold the loan, the lender backed out. Mr. Kholamian said he spent several weeks scrambling to find an alternative, ultimately taking out a five-year loan from a small Texas bank that will keep the loan on its books.

Rob Russell, head of CMBS production at Greystone, said the firm declined the transaction because of uncertainty around the future of the traditional malls as more shoppers move online.

Big companies are feeling the squeeze as well. Issuance of collateralized loan obligations, which are securities backed by loans to companies that lack investment-grade credit ratings, has slumped 54% from last year to $26 billion, though volume has picked up since April. Close to $100 billion in CLOs were issued last year.

CLOs have in the past bought around two-thirds of leveraged loans that are sold to investors, but the drop in issuance has pulled CLO participation down to 50%. A dozen companies that launched sales of new leveraged loans this year ended up reducing their size, according to S&P Global Market Intelligence LCD.

“It’s definitely reduced the flow of money to companies,” said Hiram Hamilton, global head of structured credit at Alcentra, a money manager owned by Bank of New York Mellon Corp.