The **NAIC's Capital Markets Bureau** monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**

Part 2 of 2: Mortgage Loan and MBS Market Trends and Relative Insurance Industry Exposure – Commercial

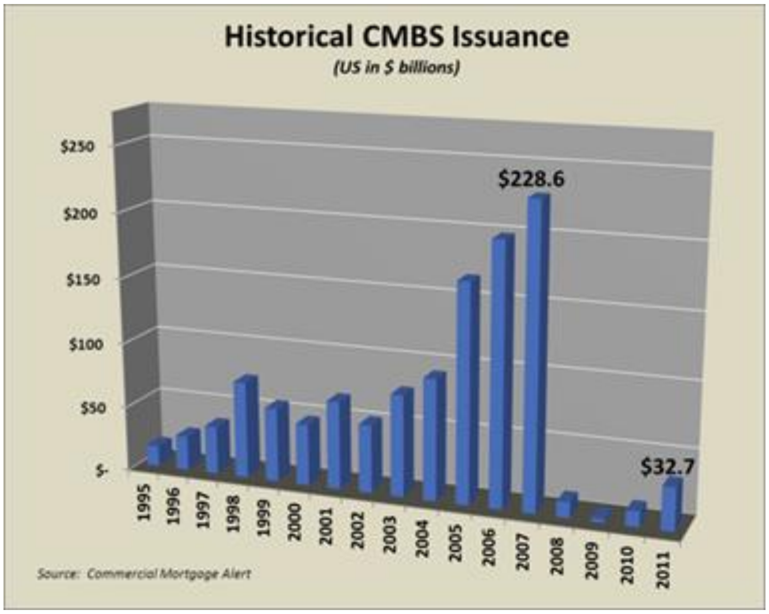
As of the end of August, U.S. structured finance year-to-date total asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLO) and residential mortgage-backed securities (RMBS) new issuance was approximately $202 billion. While ABS and CLO new issuance accounted for most of this total, CMBS new issuance accounted for approximately $26 billion through mid-September. Standard & Poor's (S&P) structured finance research expects that, based on current CMBS issuance amounts, year-end 2012 CMBS new issuance is expected to be about $40 billion. As of early September 2012, the CMBS new issuance pipeline was approximately $15 billion (over the next three months).

As discussed in a previous Capital Markets Special Report dated August 2012 titled, "Mortgage Loan and MBS Market Trends and Relative Insurance Industry Exposure – Residential," the fallout from a trend in lenient underwriting standards — particularly in 2006 and 2007 for both residential and commercial mortgages — resulted in more stringent lending practices, as underwriting standards have since tightened. A parallel trend exists in the CMBS market, which primarily consists of non-agency (or private-label) bonds that are not guaranteed by the U.S. government, nor do they have the support of any government-sponsored entities (GSEs). CMBS new issuance, however, has not been as negatively impacted as RMBS. Similar to the RMBS market, the CMBS market recovery is also "dependent on the broader economy," but its credit dynamics are a function of the nature of commercial vs. residential real estate.

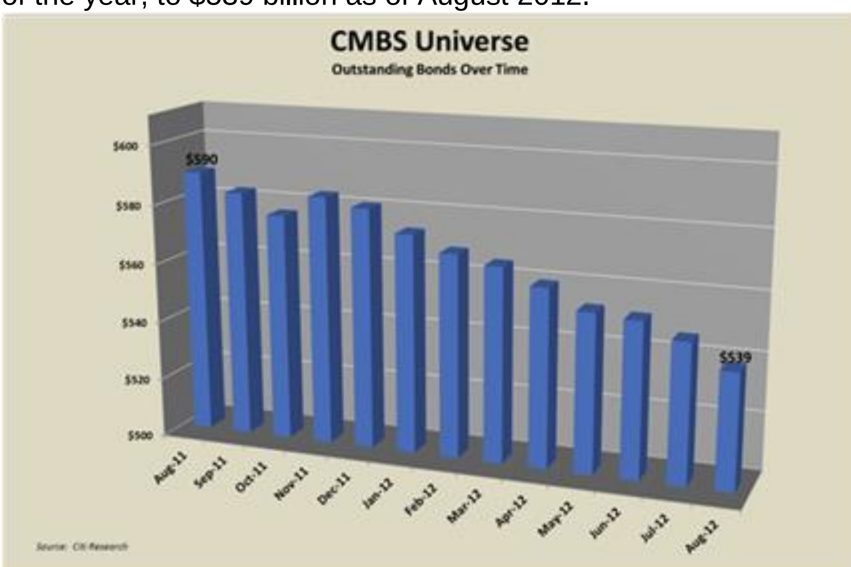
This week's Special Report focuses on understanding the status and developments within the CMBS market, which, in turn, requires an understanding of the performance and trends related to the underlying commercial mortgage loans that collateralize these securities.

CMBS Background

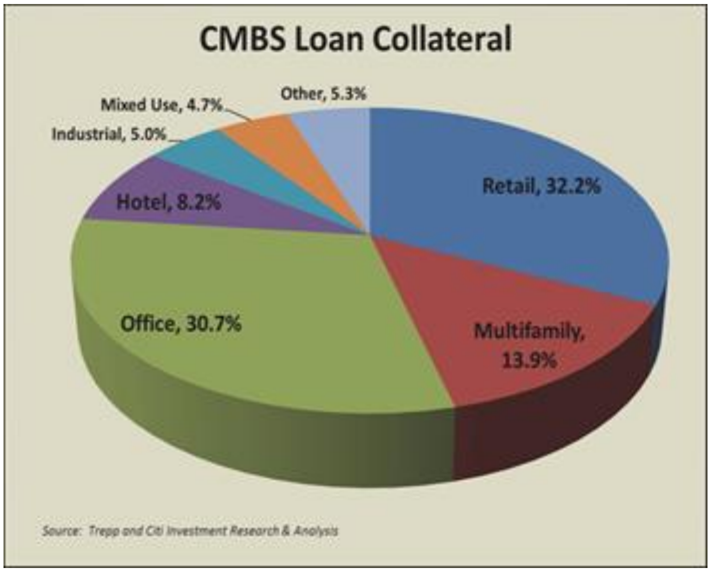
The Capital Markets Bureau first reported on the CMBS market in March 2011 with an article titled, "CMBS Market Showing Signs of Life Despite High Delinquency Rate." In 2007, CMBS new issuance was approximately $230 billion — its record peak. As a result of the ensuing financial crisis, new issuance decreased significantly to between $2 billion and $3 billion as of year-end 2009, and eventually bounced back to approximately $28 billion of new issuance in all of 2011. The commercial real estate market experienced signs of recovery in the first quarter of 2011, as well as in early summer of that year, evidenced by stabilizing vacancy rates and acceleration in sales volume. This was accompanied by CMBS spread tightening, acceleration in resolutions and, finally, stabilizing and then declining delinquency rates.



A historically moderate pace of new issuance is expected to continue in the second half of 2012, according to S&P. However, the size of the CMBS market has been shrinking as the balance of outstanding CMBS (conduit, large loan and single borrower) has decreased since the beginning of the year, to $539 billion as of August 2012.



Growing concern over the status of a U.S. economic recovery and ongoing uncertainty in the market has contributed to expectations of additional losses within the commercial real estate sector. Retail and office collateral are two major drivers of CMBS credit performance, and, as of August 2012, they comprised approximately 63% of CMBS collateral, according to Trepp, a data supplier to the CMBS industry. When combined with multifamily, the trio comprises approximately 77% of CMBS collateral.



Essentially, the commercial real estate market includes five major property types: office, retail, multifamily, industrial and lodging. All of these had, in some way, been unfavorably impacted by the most recent recession that occurred in 2008 to 2009, evidenced by rising delinquency rates in each category.

According to the National Association of Realtors (NAR), except for multifamily, vacancy rates have remained above historic averages observed since 1999 on most all other property types. While there is a positive demand for commercial property, current high unemployment and an overall slowdown in economic activity has reduced this demand to a moderated pace. Notwithstanding, due in part to the U.S. housing market crisis, there has been a higher demand for apartments which, in turn, has caused sharply declining vacancy rates and growth in rental rates.

According to the NAR, “Vacancy rates are marginally declining and rents are modestly rising in all of the sectors, but significant changes in the outlook are unlikely before the end of the year [2012].” In general, vacancy rates for the four property types shown in the table below have decreased from 2011 to 2012 and are expected to decrease again in 2013. In addition, rent growth has increased from 2011 to 2012 for all property types — particularly multifamily — and is expected to increase again in 2013.

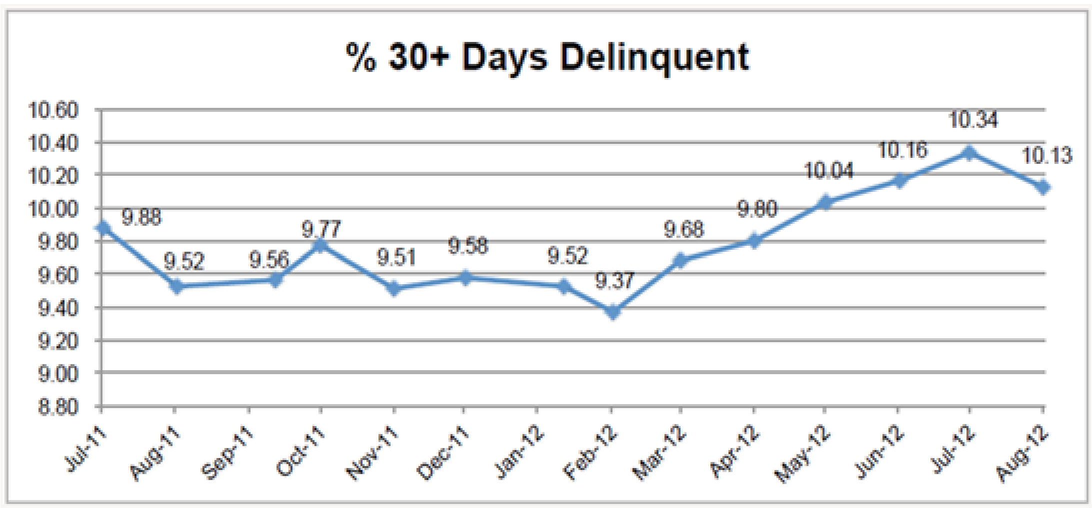
	2011	2012	2013*
Office			
Vacancy Rate	16.6%	16.1%	15.7%
Rent Growth	1.6%	2.0%	2.6%
Industrial			
Vacancy Rate	12.0%	10.8%	10.5%
Rent Growth	-0.5%	1.7%	2.4%
Retail			
Vacancy Rate	12.5%	11.0%	10.7%
Rent Growth	-0.2%	0.8%	1.3%
Multifamily			
Vacancy Rate	5.2%	4.3%	4.2%
Rent Growth	2.2%	4.1%	4.4%
*projected for full year			

Source: National Association of Realtors.

The commercial real estate market has been impacted regionally, as some areas of the U.S. were affected more so than others by the financial crisis. According to Trepp and Citibank research, as of August 2012, the three areas that accounted for half of all commercial mortgage loan delinquencies within CMBS were the Atlantic, Mid-Atlantic and Southern Pacific regions. For the U.S. insurance industry, CMBS represented approximately $164 billion on a book/adjusted carrying value (BACV) basis, or approximately 3% of total investments, as of year-end 2011. On an annual basis, the expected recovery value of the industry's CMBS holdings are derived based on internal models. The industry then compares these modeled recovery values to the CMBS carrying values (as a percentage of par) to determine appropriate NAIC designations, which are then mapped to a risk-based capital (RBC) factor. Based on this new process, approximately 93% in BACV of the industry's CMBS holdings carried NAIC 1 designations, while almost 2% were given an NAIC 2 designation. This translates into about 95% that are considered investment grade. In addition, for year-end 2011, the average expected recovery value for CMBS held by the industry was 96.7%.

Delinquencies and Defaults

Prior to mid-2008, CMBS delinquencies were less than 2%. Due in part to less stringent underwriting standards that were applied to 2005 through 2007 vintage loans, the delinquency rate on commercial mortgage loans rose as the financial crisis and U.S. housing sector crisis ensued. In July 2012, the delinquency rate for commercial mortgage loans that were 30 or more days past due reached 10.34% — a record high — and the fifth consecutive month that this rate has increased. However, as of August 2012, the delinquency rate declined a few basis points to 10.13%.



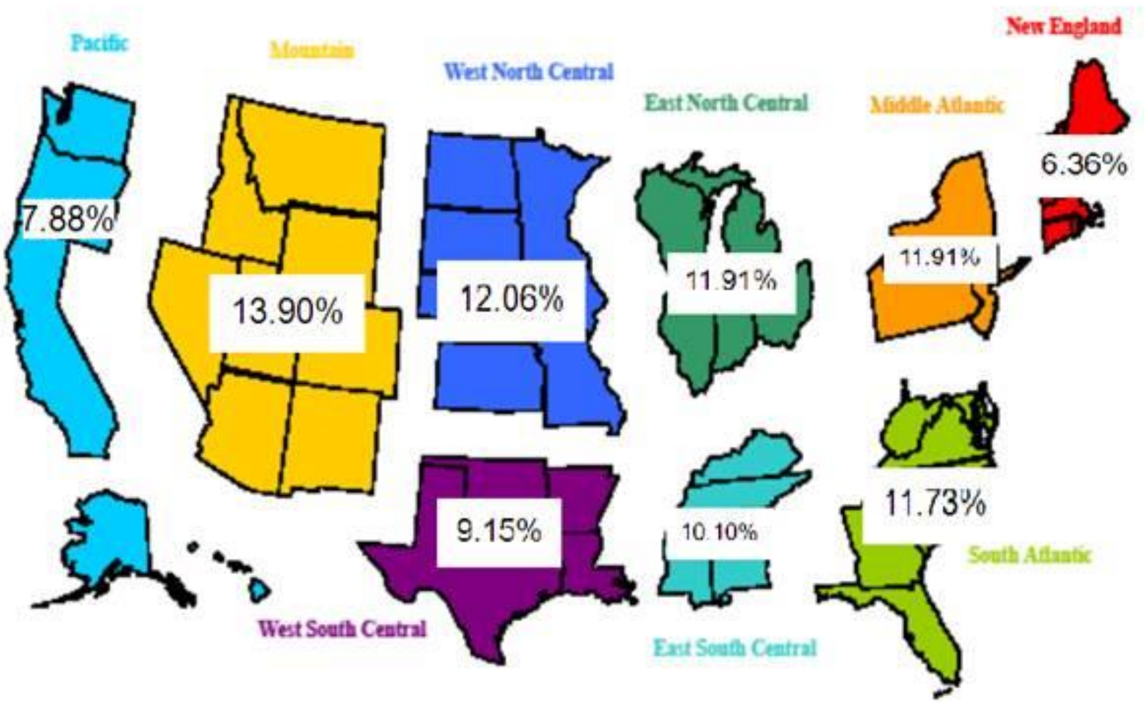
Source: Trepp.

The increase in the July delinquency rate was largely driven by increases in delinquencies of multifamily loans, as well as due to a general weakness in the all property types except retail, according to Trepp. Overall, there were $57.8 billion in delinquent loans as of August 2012. As shown in the table below, by property type, multifamily loans had the highest delinquency rate (14.9%) as of August 2012. In general, the delinquency rate for lodging, multifamily and office properties have improved; however, the delinquency rate for retail and industrial properties were weaker.

% 30+ Days Delinquent (Property Type)						
	Aug-12	Jul-12	Jun-12	3 Mo.	6 Mo.	1 Yr.
Industrial	12.12	11.72	11.54	12.82	12.37	11.24
Lodging	12.54	13.06	12.95	12.27	11.05	13.76
Multifamily	14.90	15.69	15.17	15.17	14.65	16.44
Office	10.56	10.69	10.45	10.26	9.04	8.17
Retail	8.18	8.03	8.17	8.07	8.00	7.38

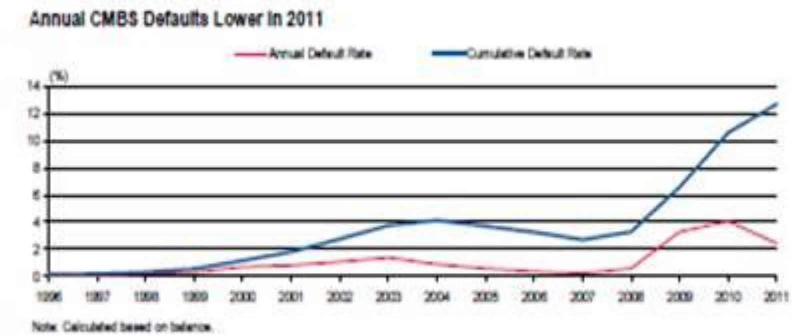
Source: Trepp.

While the Middle and South Atlantic regions account for the largest share of commercial mortgage loans, as indicated in the map below, the Mountain area of the U.S. had the highest CMBS mortgage loan delinquency rate (13.9%) as of July 2012. The Middle Atlantic area, however, accounted for the third-highest delinquency rate.

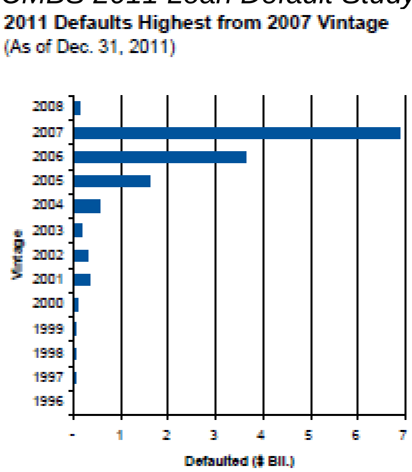


Source: Trepp.

According to Fitch Ratings, the number of newly defaulted commercial mortgage loans in 2011 was considerably lower than the number of newly defaulted loans that occurred in 2010: 950 loans in the amount of $13.7 billion defaulted for the first time in 2011 vs. 1,477 totaling $22.1 billion in 2010. Half of the new defaults in 2011 were 2007 vintage (i.e., 312 loans in the amount of $6.9 billion). The commercial mortgage loans that were newly defaulted in each of the aforementioned years are not to be confused with the total amount of defaulted loans outstanding during those years.



Source: Fitch Ratings: U.S. CMBS 2011 Loan Default Study, April 2012.



Source: Fitch Ratings: U.S. CMBS 2011 Loan Default Study, April 2012.

Loan Resolutions and Loss Severities

As of August 2012, there were $72.4 billion in commercial mortgage loans (almost 4,000 in number) with CMBS special servicers, according to Trepp. CMBS special servicers are firms that have specialized processes in place to work through loans requiring special attention — such as those currently in default or about to enter into default. Fitch research stated that, in 2011, CMBS special servicers resolved $19.6 billion in commercial mortgage loans, compared to $19.4 billion in 2010 — a slight improvement as special servicers "took advantage of improving property values to resolve older loans."

The table below shows delinquent loan resolutions and loss severity rates as derived by S&P. Overall, the loss severity rate across the major properties was 34.06% of total resolutions for the first quarter of 2012. Loans specifically related to lodging properties had the highest loss severity for the first quarter of 2012 at 53.37% of total resolutions.

Table 1

Delinquent Loan Resolutions and Loss Severity Rate

CMBS delinquent loan resolutions	2007	2008	2009	2010	2011	1Q 2012
Total delinquent loan resolutions ($000s)	**2,107,919**	**2,570,996**	**12,214,339**	**20,000,303**	**27,776,539**	**6,321,430**
Became current ($000s)	1,019,644	1,964,433	10,839,905	12,607,818	15,384,700	4,112,453
Became current (% of total resolutions)	48.37	76.41	88.75	63.04	55.39	65.06
Liquidated ($000s)	1,088,275	606,563	1,374,435	7,392,485	12,391,840	2,208,977
Liquidated (% of total resolutions)	51.63	23.59	11.25	36.96	44.61	34.94
Loss severity rate (%)	**27.02**	**31.21**	**50.43**	**46.61**	**42.59**	**34.06**
Lodging (%)	22.32	64.19	68.06	51.86	50.03	53.37
Retail (%)	22.15	17.27	48.71	52.68	47.98	47.07

Table 1

Delinquent Loan Resolutions and Loss Severity Rate (cont.)

Industrial (%)	34.24	4.74	38.37	46.98	33.18	50.44
Multifamily (%)	27.47	29.39	47.66	40.51	37.11	26.01
Office (%)	25.94	30.53	49.71	43.13	39.91	29.89
Health care (%)	26.75	39.22	15.37	36.28	45.12	0.22

N/A-Not applicable.

S&P: CMBS Quarterly Insights: The CMBS Delinquency Rate Reaches A New High As Liquidations and Loan Modifications Decline, May 2012.

Liquidations and Modifications

Special servicers strive to resolve loan losses via different strategies. According to Fitch Ratings, in 2011, special servicers pursued real estate owned (or REO; i.e., properties owned by the lender after an unsuccessful foreclosure sale) liquidations more often than other resolution methods. This means that REO liquidations were almost 40% of the special servicers' loan disposition methods. In 2011, 341 loans were liquidated totaling $3.3 billion, compared to 200 loans totaling $1.6 billion in 2010. In addition, in the first quarter of 2012, 262 loans totaling $2.21 billion were liquidated (94% of which incurred a loss).

Loan modifications are changes to the terms of the loan that are granted by special servicers. According to research by Fitch Ratings, the amount and number of loan modifications declined from 2011 to 2010. In 2011, 244 loans in the amount of $6.1 billion were modified (the majority of which — 231 — were modified without incurring any losses to the CMBS trusts), while 343 loans totaling $10.8 billion were modified in 2010. About 15% of the 2011 loan modifications were maturity date extensions, compared to 35% in 2010.

Current CMBS Market Trends

More than $40 billion of CMBS loans are scheduled to mature for the remainder of 2012 — the largest number of loans maturing this year than any other because of the issuance boom in 2007. This perhaps highlights a trend in the issuance of five-year term loans in 2007. The two S&P tables below show a comparison of first quarter 2012 and first quarter 2011 maturity, delinquency rate and loss severity statistics.

Table 1

First-Quarter 2012/2011 Fixed-Rate Final Maturities							
	Matured loan balance (bil. $)	No. of loans	Paid-off (%)	Specially serviced (%)	Extended (%)	Anticipated repayment date (%)	Resolution pending (%)
1Q 2012	11.58	780	59.9	26.4	8.1	1.6	4.0
1Q 2011	5.78	629	60.2	28.3	4.0	2.7	1.6

Table 2

First-Quarter 2012/2011 Delinquency Rate And Loss Severity Rate		
	Delinquency rate (%)	Loss severity rate (%)
1Q 2012	9.19	34.06
1Q 2011	9.12	34.61

S&P: CMBS Quarterly Insights: 2007-Vintage Year Loan Maturities Have Landed, And With Little Credit Impact, May 2012.

Note that S&P defines loss severity as the ratio of principal losses to the original principal balance. One noteworthy trend is that the balance of matured loans and the percentage of loans extended were both twice as high in the first quarter of 2012 compared to first quarter of 2011, largely attributable to 2007-vintage loans. The first quarter of 2012 payoff rate for floating rate loans was 73.1% (higher than 69.2% in the first quarter of 2011) and 43.7% for the fourth quarter of 2011. Currently, 49.1% of outstanding floating rate loans are being specially serviced.

Summary

The commercial mortgage loan market was not impacted as severely as the residential mortgage loan market in terms of delinquencies, defaults or downgrades to mortgage-backed securities. Current economic challenges have hindered growth in the commercial property markets, particularly when combined with tighter loan availability. However, vacancy rates are declining and rents are growing at a slow pace for most sectors. Currently, bondholders are showing confidence in U.S. commercial property, evidenced by an increase in investor interest in CMBS. Property values are also recovering, albeit unevenly, as buildings in the U.S.'s largest cities have recovered 41% from January 2010, compared to 18.7% in smaller cities.

The Capital Markets Bureau will continue to monitor trends in the commercial mortgage market and report as deemed appropriate.

September 17, 2012								
Major Insurer Share Prices			**Change %**			**Prior**		
		Close	**Week**	**QTD**	**YTD**	**Week**	**Quarter**	**Year**
Life	Aflac	$49.26	2.5	15.1	13.9	$48.03	$42.81	$43.26
	Ameriprise	58.36	4.4	11.6	17.6	55.89	52.29	49.64
	Genworth	6.00	5.5	5.1	(8.4)	5.69	5.71	6.55
	Lincoln	25.44	4.6	19.0	31.0	24.32	21.38	19.42
	MetLife	35.86	2.5	17.2	15.0	34.97	30.60	31.18
	Principal	28.86	4.2	10.5	17.3	27.70	26.11	24.60
	Protective	28.06	(0.4)	(4.7)	24.4	28.18	29.43	22.56
	Prudential	58.04	3.5	20.4	15.8	56.08	48.21	50.12
	UNUM	20.56	3.0	6.1	(2.4)	19.96	19.37	21.07
PC	ACE	$76.37	2.0	2.7	8.9	$74.86	$74.35	$70.12
	Axis Capital	35.92	1.7	7.4	12.4	35.33	33.43	31.96
	Allstate	39.79	4.0	13.1	45.2	38.26	35.17	27.41
	Arch Capital	40.99	1.6	2.5	10.1	40.35	40.00	37.23
	Cincinnati	39.52	2.4	3.1	29.7	38.61	38.34	30.46
	Chubb	75.98	1.6	4.0	9.8	74.81	73.06	69.22
	Everest Re	110.16	1.4	5.0	31.0	108.62	104.94	84.09
	Progressive	20.76	5.7	0.5	6.4	19.64	20.66	19.51
	Travelers	68.54	4.9	7.2	15.8	65.33	63.95	59.17
	WR Berkley	38.05	1.2	(3.2)	10.6	37.60	39.30	34.39
	XL	24.45	2.8	16.3	23.7	23.79	21.03	19.77
Other	AON	$52.69	2.1	11.3	12.6	$51.61	$47.35	$46.80
	AIG	34.75	4.5	9.3	49.8	33.27	31.78	23.20
	Assurant	37.68	3.4	8.2	(8.2)	36.43	34.84	41.06
	Fidelity National	19.73	(0.4)	2.2	23.9	19.81	19.31	15.93
	Hartford	20.01	5.0	15.0	23.1	19.05	17.41	16.25
	Marsh	34.79	2.0	7.1	10.0	34.10	32.48	31.62
Health	Aetna	$39.13	2.3	1.6	(7.3)	$38.26	$38.53	$42.19
	Cigna	47.18	2.6	9.9	12.3	45.97	42.92	42.00
	Humana	70.65	0.5	(7.8)	(19.4)	70.29	76.66	87.61
	United	54.45	1.3	(3.1)	7.4	53.74	56.17	50.68
	WellPoint	58.74	(1.1)	(5.7)	(11.3)	59.37	62.31	66.25
Monoline	Assured	$14.99	0.6	6.8	14.1	$14.90	$14.03	$13.14
	MBIA	11.62	1.4	6.7	0.2	11.46	10.89	11.59
	MGIC	1.68	4.0	(42.9)	(55.1)	1.61	2.94	3.73
	Radian	4.55	(2.6)	34.1	94.2	4.67	3.39	2.34
	XL Capital	24.45	2.8	16.3	23.7	23.79	21.03	19.77

September 17, 2012								
Major Market Variables			**Change %**			**Prior**		
		Close	**Week**	**QTD**	**YTD**	**Week**	**Quarter**	**Year**
Dow Jones Ind		13,553.10	2.3	5.3	10.9	13,254.29	12,871.39	12,217.56
S&P 500		1,460.88	2.2	7.1	16.2	1,429.54	1,363.98	1,257.60
S&P Financial		216.46	3.7	9.1	23.5	208.83	198.44	175.23
S&P Insurance		198.00	2.9	8.7	16.4	192.35	182.21	170.17
US Dollar $			**Change %**			**Prior**		
	/ Euro	$1.31	2.8	4.2	1.2	$1.28	$1.26	$1.30
	/ Crude Oil bbl	96.06	(0.2)	14.9	(2.8)	96.27	83.62	98.83
	/ Gold oz	1,757.10	1.9	9.9	12.1	1,725.00	1,598.90	1,566.80
Treasury Ylds %		%	**Change bp**			%	%	%
	1 Year	0.17	0.01	(0.03)	0.07	0.16	0.20	0.11
	10 Year	1.84	0.17	0.25	(0.04)	1.67	1.59	1.88
	30 Year	3.03	0.22	0.34	0.14	2.82	2.70	2.90
Corp Credit Spreads -bp			**Change %**			**Prior**		
	CDX.IG	61.01	(10.3)	(27.4)	(46.4)	68.04	83.99	113.83

September 17, 2012 Major Insurer Bond Yields				Weekly Change				
				Price			Spread	
	Company	Coupon	Maturity	Current	Change	Yield	B.P.	Change
Life	Aflac	8.500%	5/15/2019	$132.76	$0.00	3.03%	183	0
	Ameriprise	5.300%	3/15/2020	$115.94	$0.00	2.91%	153	0
	Genworth	6.515%	5/15/2018	$103.41	$0.00	5.80%	480	0
	Lincoln National	8.750%	7/15/2019	$129.32	$0.00	3.80%	257	0
	MassMutual	8.875%	6/15/2039	$146.43	$0.00	5.53%	262	0
	MetLife	4.750%	2/15/2021	$114.62	$0.00	2.78%	123	0
	Mutual of Omaha	6.800%	6/15/2036	$112.72	$0.00	5.80%	285	0
	New York Life	6.750%	11/15/2039	$133.84	$0.00	4.56%	163	0
	Northwestern Mutual	6.063%	3/15/2040	$124.64	$0.00	4.49%	155	0
	Pacific Life	9.250%	6/15/2039	$131.67	$0.00	6.69%	379	0
	Principal	6.050%	10/15/2036	$119.28	$0.00	4.70%	195	0
	Prudential	4.500%	11/15/2020	$108.56	$0.00	3.29%	176	0
	TIAA	6.850%	12/15/2039	$133.22	$0.00	4.68%	175	0
P&C	ACE INA	5.900%	6/15/2019	$122.97	$0.00	2.21%	98	0
	Allstate	7.450%	5/15/2019	$129.51	$0.00	2.59%	140	0
	American Financial	9.875%	6/15/2019	$127.11	$0.00	5.07%	381	0
	Berkshire Hathaway	5.400%	5/15/2018	$120.31	$0.00	1.63%	67	0
	Travelers	3.900%	11/15/2020	$111.06	$0.00	2.39%	83	0
	XL Group	6.250%	5/15/2027	$112.11	$0.00	5.07%	292	0
Other	AON	5.000%	9/15/2020	$113.87	$0.00	3.04%	153	0
	AIG	5.850%	1/15/2018	$115.11	$0.00	2.78%	184	0
	Fidelity National	7.875%	7/15/2020	$117.38	$0.00	1.19%	24	0
	Hartford	5.500%	3/15/2020	$109.33	$0.00	4.05%	269	0
	Marsh	9.250%	4/15/2019	$134.77	$0.00	3.31%	213	0
	Nationwide	9.375%	8/15/1939	$134.15	$0.00	6.64%	371	0
Health	Aetna	3.950%	9/15/2020	$109.26	$0.00	2.65%	107	0
	CIGNA	5.125%	6/15/2020	$113.92	$0.00	3.09%	164	0
	United Healthcare	3.875%	10/15/2020	$108.21	$0.00	2.73%	123	0
	Wellpoint	4.350%	8/15/2020	$108.42	$0.00	3.14%	169	0

Questions and comments are always welcome. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**.