Incentive Issues And The Performance Of Participating Commercial Mortgages

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This research considers the performance of a small sample of participating mortgages in the context of certain incentive issues. This is important for the following reasons:

- Participating mortgages, most of which were originated in the 1980's, constitute a significant percentage of the real estate holdings portfolio for several large pension funds.
- There has, to my knowledge, not been a systematic study of the holding period performance of this investment class to date.
- There has not been a formal discussion of some of the incentive/agency issues that are relevant to the performance of participating mortgages.
- There is a need to consider issues related to "benchmarking" the performance of fixed income security returns.

Based on detailed contractual and cash flow information obtained on 37 participating mortgages (approximately $700 billion in originations) from a large pension fund, I calculate holding period returns on a loan-by-loan basis as well as at certain levels of aggregation. These returns are then compared with Treasury security, commercial mortgage and real estate equity returns to develop a sense for relative performance.

As a total portfolio, these mortgages have yielded 8.5 percent through June 1993. Yield differences are most pronounced when examined by year of origination, with mortgages originated after 1985 performing relatively poorly. Not surprisingly, this period corresponds with the general downturn in the commercial real estate market. Performance differences by property type and geographical region are less pronounced.

Relative to other asset classes, participating mortgage performance is mixed. 10-year Treasury securities have outperformed participating mortgages, although commercial equity performance appears to be inferior. A comparison to a portfolio of standard commercial mortgages is inconclusive, primarily due to limitations in the commercial mortgage data.

In summary, based on the sample used in this study, results suggest that participating mortgages may be susceptible to adverse selection incentives in which borrowers choose participating loans for higher risk projects. This conclusion is based on default rates of about 50 percent on the portfolio. The question of whether contract mortgage rates were high enough to offset the incremental credit risk is unclear. Clearly, more research is required on this subject.