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CMBS 2.0: The Future of European CMBS?

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The almost moribund European CMBS market has seen little issuance since 2007. As of the date of this article, only three issues have come out of Europe bringing the total CMBS issuance for 2010 to less than €3 billion. That's a far cry away from the €100 billion plus figures that was seen at the height of the market.

This low volume of issuance appears to be a bit of a paradox within commercial real estate finance. For one, banks are not originating at anywhere near the levels they had done in heydays of the CMBS market; by all accounts, many of the banks have simply shut their doors to real estate finance. However, at the same time, pension funds, insurance companies and other fixed income investors continue to look for suitable fixed income products to meet their liability driven investment requirements. There have been numerous conferences with pension fund and insurance investors on panels saying that they want to see issuance of new real estate bonds. We've seen this sort of thing before in the U.S. markets back at the end of the savings and loan crisis. At that point, CMBS came in and saved the day by opening up the larger capital markets to real estate investment at a time when banks were no longer in the real estate lending business. However, this time things are different; part of the problem is that the investor market is much more cautious now, given that some CMBS structures have not performed as well as others.

In the U.S., the market appears to be on progress for a revival. In 2010, there were at least six, multi-sponsor conduit deals that came to market there. A recent survey of the commercial real estate industry by the Urban Land Institute, a leading trade organisation, indicates that the U.S. CMBS market is expected to reach $100 billion in issuance by 2013.

In reviving the U.S. market, the arrangers have focused on making certain revisions to the standard CMBS structures in order to remove certain perceived conflicts of interests in those structures. They've called this initiative CMBS 2.0, which is meant to signify the new leaf for CMBS, evolving from its experiences in order to rebuild the market.

This article will summarise what has happened to date with respect to CMBS 2.0 in the U.S., as well as focus on how CMBS 2.0 might have an impact in helping to revive the European CMBS market.

CREFC June 2010 New York Conference: The Investment Grade Bondholder Discussion Paper

As in Europe, the discussion on new structures began long before any new issuance. As a matter of fact, it was not until after the first U.S. conduit issue of 2010, the $309.7 million RBS Commercial Funding Inc. 2010-MB1, that the discussions turned serious.

In June 2010, the Commercial Real Estate Finance Council (the "CREFC") held its annual conference in New York where its Investment Grade Bondholders Forum (the "IGB Forum")

published a discussion document titled "Best Practices for CMBS Restart" (the "IGB Discussion Paper"). The purpose of this discussion paper was to create a more detailed dialogue as to what changes should be made to U.S. CMBS structures, at least from the perspective of an investment grade bondholder. The IGB Discussion Paper contained a "wish list" of proposals that the IGB Forum members wanted to see implemented in future CMBS transactions.

Certain of the highlights of the proposals contained in the IGB Discussion Paper can be summarised as follows:

- Alignment of Interests
    - Risk Retention: Issuers should retain a 5 per cent. vertical strip of every bond issued;
    - Servicers and Special Servicers
        - Servicers should be paid a 1 per cent. fee on any loans repurchased by originators for breach of representations and warranties;
        - Servicers should only be entitled to purchase loans from transactions through competitive bid processes, rather than through any call option structured in the CMBS transaction;
        - Borrowers should be responsible for payment of special servicing fees and costs associated with modifications and defaults;
        - Special servicers should base their workout decisions on an NPV calculation using a pre-selected formula (previously special servicers acted only subject to general obligations to "maximise recoveries on a present value basis");
        - Modification and extension fees should be shared between servicer and the transaction, rather than paid entirely to the servicers and special servicers;
    - Operating Advisor
        - The operating advisor should represent all bondholders (previously only particular classes of bondholders were given this right, usually the most junior class or the most junior with an expectation of some level of recoveries based on a valuation);
        - Bondholder consultation with special servicers should be conducted through independent third-party operating advisers (which could be replaced on a simple majority vote of bondholders);
        - Operating advisors will receive a fee for their role, paid for through the transaction;
        - Operating advisers should have significantly increased reporting and information maintenance obligations;
        - Operating advisers (of the type described above) would have the right to replace servicers acting on a simple majority vote of bondholders (previously the most junior class or the most junior with an expectation of some level of recoveries based on a valuation were given this right);

- Improvements on Disclosure
    - Representations and Warranties: Each deal should deliver to investors, 5 days prior to issue, a black-line showing deviations from the standard form of representations and warranties along with a report of exceptions;
    - Extensive disclosure and reporting packages (including property and tenant reporting) should be publically available for all deals;
    - A documentation package (including loan level documents for loans accounting for more than 5 per cent. of the pool) should be supplied to investors 5 days prior to issue;
    - Rating agencies should provide detailed analysis of the 20 largest loans and any loan accounting for more than 5 per cent. of the pool in pre-sale reports;
    - Trustees should maintain deal websites containing all relevant deal documents, reports and other information;
- Improvements on Process
    - Representations and Warranties: A standard set of minimum loan representations and warranties should be developed through a consultation process;
    - Bondholder voting would be conducted on a simple majority basis with a low quorum of 25 per cent. (European deals typically require much higher percentages);
    - Strengthened SPV covenants for borrowers in order to reduce risk of insolvency;
    - Deals should have at least two ratings, one selected by the issuer and one by the SEC; and
    - Trustees should be charged with maintaining lists of investors who can be relied on by the operating adviser for voting purposes.

The IGB Discussion Paper was not actually endorsed by the CREFC, as it only represented the perspective of one segment of the CMBS investor base. While the IGB Discussion Paper was very focused on the perception that junior investors in CMBS structures hold too much power, particularly with regard to the process of enforcement and realisation on the underlying loan security, junior investors in the U.S. have responded by pointing to their expertise developed over many years of loan work-outs and how this can benefit all investors. In the U.S. there are many investment-grade investors that prefer having certain junior investors as the “watchdogs” on their transactions.

However, the investment-grade investors continued to press their point forward, noting that it seemed incongruous for so many rights to be given to a junior investor that represents an overall small portion of the entire securitisation, while the most senior class of investors (which often represents 50 per cent. or more of the total capital structure) have almost no rights in CMBS structures.

Notwithstanding these arguments from the investment-grade investors, the U.S. model for CMBS has been largely a distribution model, which means a successful transaction is largely dependent on the pricing and placement of the junior bonds. Therefore, arrangers are well aware that a

successful placement of a CMBS transaction will be adversely impacted by a loss of rights by the junior investors.

First Steps Towards CMBS 2.0: GSMST 2010-C1

In August 2010, Goldman Sachs, Citigroup and Starwood joined together to issue the $788.5 million GS Mortgage Securities Trust 2010-C1 ("GSMST Transaction"). The GSMST Transaction was really the first deal in the U.S. to implement significant changes into the standard CMBS transaction. Some of those changes appear to directly address the concerns raised in the IGP Discussion Paper. Although the term had been used for some time before, the GSMST Transaction is considered the first U.S. CMBS transaction to implement CMBS 2.0.

A summary of the highlights of the structure changes introduced in that transaction include the following:

- Servicer and Special Servicer
    - An operating advisor was appointed at the beginning of the transaction and can be replaced based upon a vote of all noteholders; only noteholders in value, based on current valuations, are allowed to vote on any replacement of the operating advisor;
    - The operating advisor is required to consult with the special servicer in connection with major decisions with respect to the loans and, in so doing, rather than just representing the controlling class of bonds, it will represent the interests of the noteholders as a collective whole, as if those noteholders constituted a single lender;
    - The special servicer is required to consult with the operating advisor and the controlling class representative in connection with major decisions with respect to the loans, but those consultations will not be binding on the special servicer;
    - The right to terminate the special servicer is exercisable through a bondholder vote requisitioned by at least 15 per cent. of the bondholders and exercisable on a vote of at least 75 per cent. of the aggregate of all bondholders or 50 per cent. of each class; therefore, the controlling class alone cannot replace the special servicer;
    - The deal removes the servicer's "Fair Value Market Option" and instead requires all asset sales to be conducted through open auction processes;
    - The "Servicing Standard" for the transaction provides guidance on determining the reference rate for determining the "net present value" when considering various options when servicing an asset; this guidance would set a floor at such reference rate to the most recently issued 10-year US Treasury bonds;
    - Requires the servicers to apply 50 per cent. of modification fees received from borrowers towards transaction costs and expenses; if such amounts exceed outstanding expenses, they are to be held in an account for future expenses; at the end of the transaction, any remaining amounts will first be used to pay any shortfalls on the notes with any remaining amounts to be paid to the servicer and special servicer as further compensation;

- Improvements on Process
    - All valuations that are used in connection with any calculations cannot be less than 9 months;
    - The transaction creates a voluntary register of bondholders for the purpose of better coordinating the exercise of the approval rights;
- Improvements on Disclosure
    - Creates a deal website that will contain, among other things, the following: (i) all special notices delivered, (ii) summaries of asset status reports, (iii) all appraisals in connection with an appraisal reduction plus any subsequent appraisal updates, and (iv) an investor Q&A forum;

The deal was reported[1] to have been significantly over-subscribed and the B-Piece was successfully placed with Elliott Management. Reports also indicate that the structural innovations featured in the deal were well received by investment-grade investors[2].

Further Improvements: DB COMM 2010-C1, JPMC 2010-C2 AND WFCMT 2010-C1

In October 2010, three new deals came to market in the U.S. that also adopted some of the CMBS 2.0 changes. The first of these to come to market was the J.P. Morgan Chase Commercial Mortgage Securities Trust 2010-C2 ("JPMC 2010-C2"). This was J.P. Morgan's second conduit issue for 2010 and it contained some significant changes from its prior conduit issuance.

In particular, the transaction contained the following enhancements:

- Servicer and Special Servicer
    - Replacement of Special Servicer
        - All of the bonds that are rated below investment grade (i.e., BBB or its equivalent) are defined as the "Control Eligible Bonds". The most junior class of the Control Eligible Bonds may replace the special servicer, provided that current valuations on the properties reflect that 75 per cent. of the outstanding face amount of its bond position remain in value (which is unusual for U.S. structures, which typically limit bond control changes to actual realised losses rather than valuation changes);
        - Once all of the Control Eligible Bonds have been valued out (a "Control Event"), the special servicer can be replaced if 75 per cent. of all of the noteholders vote for such a change;
    - Senior Trust Advisor
        - This entity is given the authority to "oversee" the performance of the special servicer in the transaction on behalf of all of the bondholders to determine if the special servicer's resolution and disposal practices conform with the servicing standard for the transaction;
        - The Senior Trust Advisor is required to prepare an initial assessment of the special servicer for bondholders based upon a review of such special servicer's performance in working out troubled loans on other transactions;

- Upon the occurrence of a Control Event with respect to the controlling party, the Senior Trust Advisor will have the following rights:
    - it may consult with the special servicer on work-outs;
    - it is responsible for verifying the special servicer's calculations of loan and property values; and
    - it is required to approve the transfer of loans into special servicing;
- While the Senior Trust Advisor cannot replace the special servicer or require the special servicer to follow its advice, it is tasked with the responsibility of mobilising bondholders to replace the special servicer if it deems such action is necessary after a Control Event;

- Improvements on Disclosure
    - Servicing Agreement: all bondholders were provided access to the servicing agreement;
    - Representations and Warranties: all bondholders were provided the full representations and warranties, along with exceptions; the representations and warranties were set for the primary condition of the loan assets; if the representations and warranties are later deemed to be incorrect, the originator of the loan may be required to repurchase the loan from the loan pool at its original sale price.

Shortly after the pricing of the JPMC 2010-C2 transaction, Deutsche Bank's COMM 2010-C1 ("DBC 2010-C1") and Wells Fargo's WFCMT 2010-C1 Mortgage Trust ("WFCMT 2010-C1") were brought to the market. Both of these transactions introduced similar concepts as the JPMC 2010-C2 transaction to limit the ability of the subordinate bondholders to control the appointment of the special servicer. In particular, both transactions utilise valuation reductions on the properties as a means of eliminating the ability of the subordinate bondholders to control the selection of the special servicer. However, both of these deals allow the most junior class of bonds outstanding to retain certain consent and consultation rights with respect to the loans for as long as they have not been written down as a result of actual realised losses on the loans. Also, the Senior Trust Advisor made it into the WFCMT 2010-C1 transaction.

The Position in Europe

The changes to the current U.S. CMBS transactions are a helpful starting place for Europe to consider. The concerns in the U.S. are equally the concerns in Europe; improvements to disclosure, improvements to process and improvements to structure that will better align the interests of the various transaction parties with those of the bondholders.

However, Europe is a different market than the U.S. and, as a result, there are additional items that need to be considered if the European CMBS market is to revive.

Fixed Rate CMBS Transactions

All of the six U.S. conduit deals that have been issued in 2010 were fixed rate transactions, which reflects the market demand for fixed rate paper. Fixed rate transactions are uncommon in European real estate bonds. The reason for this is somewhat complex, but partly reflects that a significant amount of the demand for CMBS in Europe has historically been from bank investors.

Further, it also reflects that the bond market and borrowers under real estate loans never came into an agreement as to how to compensate bond investors for a prepayment on a fixed rate instrument.

In the U.S., structured solutions were found for this problem long ago, with the market generally accepting three very specific options with respect to prepayments of the underlying mortgage loans in CMBS transactions. In particular, these options are:

- Lockout: It is typical to have provisions in the underlying loan documents that would restrict prepayment at least for a specified period;
- Yield Maintenance: Upon a prepayment, the borrower is required to pay a prepayment fee that is typically calculated as the greater of: (a) the net present value of the interest income stream that would have been paid on the loan, if it had not been prepaid, through to its specified maturity (which is discounted based on the excess of the loan rate over the current U.S. treasury yield for the same term); and (b) 1 per cent.;
- Defeasance: Instead of repaying the loan, the borrower achieves release of its property from the security of the loan by replacing the property as security with U.S. treasury bonds that will provide the necessary cash stream to cause repayment of the loan according to its original terms. The total cost for defeasance is fairly comparable to the cost of repaying a loan and paying a yield maintenance premium; however, the borrower gets the added benefit of the "yield curve effect" which, for longer dated loans, could possibly result in a significant cost savings for the borrower compared to a yield maintenance fee.

If a yield maintenance fee is paid, this amount is distributed to the bondholders in proportion to the amount of principal that is allocated to them as a result of the prepayment. The allocation of the yield maintenance fee is further allocated, as among those bonds that have received principal, based upon their respective interest rates over the relevant discount rate.

This manner of "prepayment management" has been acceptable to bondholders in U.S. CMBS transactions as an adequate means of managing their prepayment risk in fixed rate CMBS bonds.

In Europe, unfortunately, there is no current structure in place for managing the prepayment risks in fixed rate CMBS bonds. The closest structure in the market is the use of spens formula for prepayments on bonds generally. The calculation for spens formula is fairly similar to how yield maintenance is calculated (without the 1 per cent. floor component and with the gilt rate replacing U.S. treasuries). However, as discussed above, there are other options that should be considered with respect to allowing borrowers under the loans to manage their prepayment costs in a transaction.

In any event, with any of yield maintenance, defeasance or spens formula, the effect of all of these structures is to make it difficult for the borrower to profit from a situation where interest rates have fallen below the fixed rate charged under its loan. If the borrower attempted to refinance its loan (and, therefore, prepay its higher interest rate debt), the present value of any gain from such a change in interest rates would be retained by the original lender of the higher interest rate debt. At the same time, this appears to be a fair trade off, as the lender is, at the same time, taking all risks as with respect to any rise in interest rates.

This structure of compensation that exists in U.S. transactions is not actually much different than the current structure for the prepayment of a European loan. In Europe, where the CMBS bonds are floating rate, either the borrower or the lender (or securitisation vehicle) is required to enter into a hedging instrument to avoid any risk of a floating rate interest as against the fixed cash flow the borrower receives with its rents. Such hedging instruments effectively achieve the same

limitation that U.S. yield maintenance and European spens formula attempt to achieve with respect to fixed rate bonds; if the borrower wants to prepay its loan, it remains at risk for any change in interest rate that exists at the time of such prepayment. However, in a European deal, instead of the prior lender keeping the benefit (or taking the risk) of such change in interest rates, instead the hedge counterparty is the one that retains the benefit (or, alternatively, retains the risk) through the payment of a break fee by the party whose interest has fallen "out of the money." If the market is able to transfer the interest rate dynamics to protect the lender (instead of the hedge counterparty) in the situation of a prepayment, it will be possible to offer an acceptable construct that protects fixed rate bond investors from prepayment risk.

Unless there is sufficient market demand for floating rate product in Europe, it will be necessary for the market to consider whether it can structure fixed rate product for investors. Therefore, it will be necessary to consider whether it is possible to implement structures with prepayment fees and defeasance as options for providing fixed rate bond investors the necessary premiums they will require to manage prepayment risks.

Representations and Warranties

Representations and warranties are meant to be the method of setting for the basic conditions of the loans. Typical representations and warranties will cover items such as the enforceability of the loan and the ranking of the security. If it turns out, at a later stage in the CMBS transaction, that the representation or warranty was not true when it was delivered at the commencement of the transaction, the entity that sold such loan to the securitisation is typically required to repurchase such loan at a price equal to its initial sale price plus all costs to the CMBS vehicle as a result of the circumstances related to the breached representation. The representations and warranties are meant to provide the guidepost in which the rating agencies and investors can understand some of the fundamental parameters of the loans in the CMBS transaction.

Traditionally, European CMBS transactions did not feature representations and warranties as extensive and detailed as US CMBS transactions. However, this is an element of CMBS in Europe that clearly requires improvement.

European CMBS transactions should follow the published criteria of the rating agencies for representations and warranties. Also, the full list of representations and warranties should be made available for investors to review along with a clear list of any exceptions or deviations from those representations and warranties.

Hybrid of Servicing and Agency

In addition to the debate as to possible conflicts of interest in servicing structures, European investors have also been concerned with whether servicers and special servicers have sufficient powers and protections to properly undertake their roles and how servicers and special servicers might be able to get more direction from investors as to how to proceed in default situations.

Prior to the advent of European CMBS, the only way in which a lender could take a position in a commercial real estate loan was either by originating the loan or participating in the syndicate of such loan. Syndicated loans still account for over 75 per cent. of European real estate finance. Such loans typically adopt standardised documents (in particular the LMA credit agreement) and use agents and trustees to administer the loan and its security. These agents and trustees conduct a dialogue with their syndicates of lenders as to important loan actions, are empowered to take specific actions with the agreement of specified majorities of the lenders and have the benefit of wide-ranging indemnities and exclusions of liability and responsibility. The syndicated loan structure is very familiar to many investors in European CMBS transactions. While not perfect in

dealing with all situations, the syndication structure of loan management has certain benefits in allowing the agent to follow guidance of the lenders for certain actions and to be protected against liability if it follows those procedures before taking certain action with respect to the loan.

Many in the European CMBS market have been considering whether the role and powers of CMBS servicers and special servicers might benefit from the implementation of similar structures in a CMBS transaction. Such structures would be more of a hybrid between a typical CMBS structure and a typical syndicated loan. While not being required to do so, the servicer would have the option to seek guidance from the bondholders in situations where they were less confident with how to proceed as a means of liability management. An advantage is seen in adopting a familiar and well-tested model and the protections available to such parties could be a solution to a perceived reluctance by some servicers and special servicers to take radical action in distressed situations.

Conclusion

Although the re-start of the European CMBS market still seems some time off, the existence of a debate as to its shape has to be seen as encouraging and a sign of the commitment of the market to ensuring that the product survives the current crises. European CMBS is certain to change not least because of the efforts of legislators and regulators and the need to find and maintain a new investor base for the product. The radical nature of the debate on CMBS 2.0 and the willingness of the industry to "think the unthinkable" can only be seen as a positive sign, although at this stage the final shape of CMBS 2.0 in Europe clearly requires further thought.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] Commercial Mortgage Alert 6 August 2010 "Strong Demand For CMBS Offerings."

[2] Commercial Mortgage Alert 6 August 2010 "Investors Hail Reforms In CMBS Deal."