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In Practice

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Making CRE loans CMBS-ready

This In Practice article considers some of those terms in a loan agreement that are essential to enable a loan secured by commercial real estate (CRE) to be securitised via a commercial mortgage-backed securitisation (CMBS).

As was the case prior to 2008, the current driver for all new European CMBS deals stems from the adoption by investment banks of the originate-to-distribute business model for financing CRE. Simply put, the deployment of this model comprises a bank advancing a loan to a borrower to finance CRE. This loan then sits on the bank's balance sheet prior to its securitisation, which in summary involves the loan being sold to a special purpose vehicle, which in turn funds the acquisition by the issuance of notes. Despite the low volume of CMBS issuance since the summer of 2015, newly originated CRE loans continue to be structured and documented to enable distribution via CMBS.

SECURITISATION-FRIENDLY TERMS

In all instances where a lender is looking to maintain an unfettered right to distribute a loan via securitisation, it is essential that the underlying loan agreement caters for this with the inclusion of the following:

- **No restriction on securitisation**: there should be no consent requirements or restrictions relating to the securitisation, assignment, sub-participation or declaration of trust with respect to a loan.
- **Amending finance documents**: a further assurance obligation should be placed on the borrower to allow reasonable amendments to the finance documents that are necessary for the successful securitisation of a loan.
- **Disclosure of information**: there should be a comprehensive disclosure obligation on the borrower, to ensure that sufficient information is made available to rating agencies and others, to facilitate the rating of the CMBS and satisfy information disclosure requirements under applicable law, regulation or stock exchange rules. In addition, to assist with the marketing to CMBS investors, it is not unusual for the inclusion of a right of a lender to provide certain information to investors or potential investors regarding a securitisation.
- **No confidentiality restrictions**: given the foregoing disclosure requirements, it is crucial that the necessary carve outs are made to the confidentiality restrictions.

RATING AGENCY CRITERIA

Although not all CMBS transactions will be rated, in most cases if desirable ratings levels can be achieved, then an originator is likely to consider rating the notes on the basis of achieving more favourable pricing on the notes. The corollary of this is that, if a loan is being originated with a CMBS exit in mind, then the loan agreement will typically contain a number of provisions which are required to ensure compliance with rating agency criteria.

For example, a loan agreement will typically contain stringent requirements mitigating counterparty risk (account bank, hedge provider, insurer) such as the inclusion of minimum rating requirements and replacement mechanisms in the event that these ratings triggers are breached as a result of a rating downgrade of these entities.

REGULATORY CONSIDERATIONS

From a borrower's perspective, clearly one of the most onerous obligations relating to a CMBS is associated with the range and breadth of the disclosure requirements. The main driver for this has been a raft of EU legislation, the cornerstone of which has been the EU Prospectus Directive (as amended and implemented); however, in recent years this has been extended by the implementation of the Capital Requirements Regulation (CRR) for credit institutions, the Alternative Investment Fund Manager Regulation for Alternative Investment Fund Managers and the Credit Rating Agencies Regulation (CRA3). These have imposed obligations (directly or indirectly) on various parties to ensure 'skin in the game' and also (sometimes on-going) disclosure of information to investors.

The proposed EU Securitisation Regulation, announced last year, proposes to consolidate this, currently rather disjointed, regulatory regime for securitisations. Although this is a welcome development, the devil is in the detail and there are a number of issues still to be resolved with the proposed regulation. Although the regulatory regime governing securitisation is still in flux (which is now further exacerbated by the potential for the UK to leave the EU following the referendum on 23 June 2016), nevertheless the broad requirements on borrowers regarding the provision of assistance and information are likely to continue to be imposed.

CONCLUSION

As long as CMBS continues to be a viable mechanism for distributing CRE debt, then those borrowers that continue to demand more competitive pricing on loans should continue to expect the provisions outlined above (and others) to be contained in their respective loan agreements. As new legislation continues to be introduced, existing legislation and rating agency criteria are finessed, then loan agreements will also evolve to meet these changing requirements. Although at times, this may appear arduous for borrowers, they should take solace in the fact that a loan that can be distributed by CMBS should ultimately afford them better pricing on the origination of their loan. ■

Biog box

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