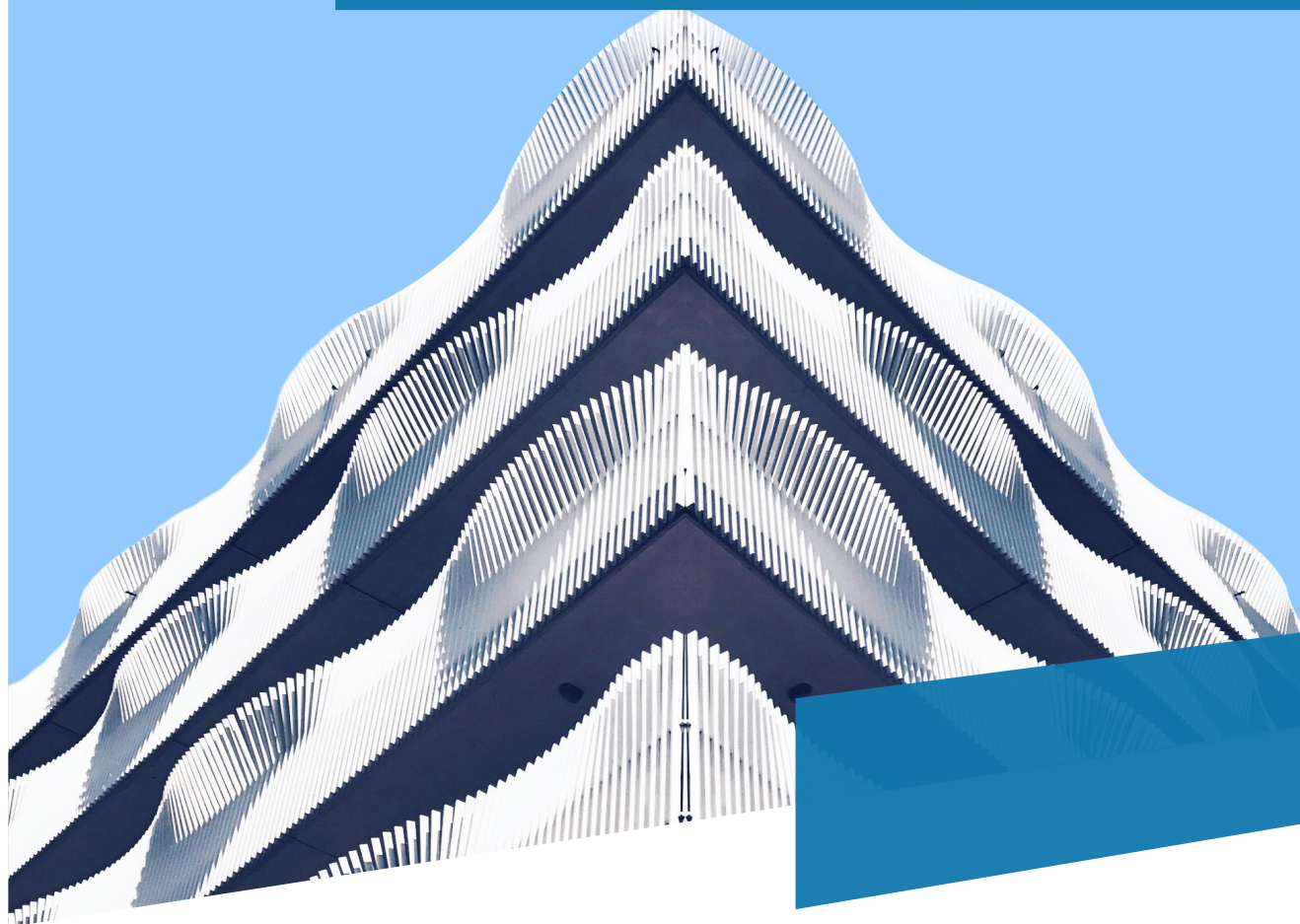
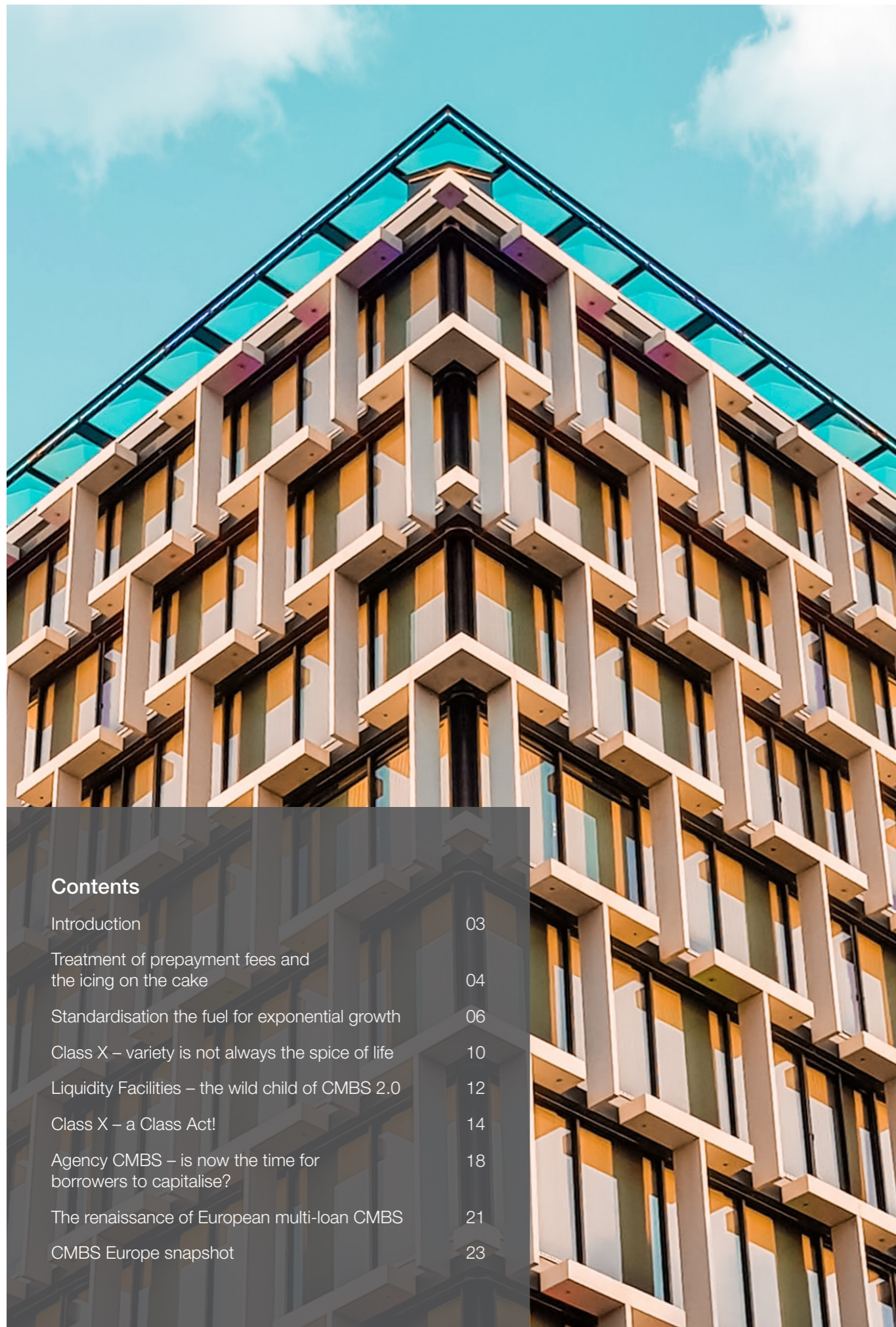


It is time for **European CMBS** to flourish

The trends, the changes, and the future.
2021





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Introduction

The economic fallout of COVID-19 will be hugely significant for the European CMBS market, as a perfect testing environment has been created to truly examine the resilience and robustness of CMBS 2.0. Indeed, the impact of COVID-19 will be a true litmus test as to whether those structural reforms that emanated from the CREFC guidelines issued in November 2012 (Market Principles for Issuing European CMBS 2.0) and the investor principles of March 2013, have been sufficient to enable CMBS to not only weather the impending economic storm but to actually flourish.

Having considered a number of potential issues imposed by the impact of COVID-19 and in turn those mitigants put in place to stave off such risks (e.g. longer tail periods, existence of special servicers, loan level caps, cleaner loan structures), market participants should be quietly confident that the product is more than capable of weathering the COVID-19 storm. A clear nod to support this proposition is that despite the macro-economic uncertainty, over the summer of 2020 BAML closed a CMBS backed by UK logistics assets (Taurus 2020-2 UK). In other words, this issuance can be considered a massive endorsement of not only the likely robustness of CMBS 2.0 but also a clear indication that there is appetite for this type of fixed income product.

The true acid test though is whether CMBS can flourish by demonstrating that it has a much more integral role to perform in financing commercial real estate than it has played since the GFC. Although it is far too early to say, CMBS does have the following important attributes, which will inevitably put it in good stead:

- It provides an efficient mechanism to transfer commercial real estate loan risk away from the banking sector;
- It provides investors with a more liquid alternative to the loan syndication market;

- It brings about much needed openness and transparency to the commercial real estate lending market;
- When compared to banks hampered by provisioning and regulatory pressure, CMBS affords special servicers a lot more flexibility to work-out and enforce loans over an extended period of time.

Taking all these points together, it is clear that CMBS exhibits a number of hugely positive features, which is especially true when it is compared against balance sheet lenders. Also, given the public commentary on the performance of CMBS loans, the asset class has the potential to play a role in educating the wider market on what actions are being taken to resolve and address issues on problematic loans. Indeed, in light of the unprecedented and dynamic nature of the COVID-19 situation, this active flow of real-time market information could prove to be invaluable to the commercial real estate lending industry as a whole.

Ultimately only time will tell how CMBS fares, but if all of the above all holds true and the asset class not only weathers the COVID-19 storm but truly flourishes, then CMBS will rightfully re-establish itself as an important finance tool and once again earn itself a proper seat at the European commercial real estate finance table.

In view of the huge latent potential of CMBS in Europe, we have considered a number of trends and changes to those structural features that are endemic to the asset class. Set out in this publication are a number of our thought leadership pieces that not only reflect on these points but also consider the implication for the future of European CMBS.



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Treatment of prepayment fees and **the icing on the cake**

Thinking back to Autumn 2006, I distinctly recall attending a conference hosted by the European CMSA that was focussed on the advent of CRE CDO's. At the time, the emergence of these structures was seen as an extremely exciting development as it marked a natural progression for the maturing CRE finance market (following the success of the product in the US). Additionally, it showed there was an overriding need for the asset class as a means of absorbing the ever increasing numbers of B-Notes, CRE mezzanine loans, CMBS bonds and other forms of structured CRE debt that was beginning to flood the market.

Despite there being a general acceptance that this was a natural and welcome step in the evolution of European CRE finance, a number of issues were raised such as the lack of standardisation and the availability of suitable underlying collateral. The chief concern though was around prepayment risk, which was a very real issue at that point in time on account of escalating interest rates coupled with the exponential growth of CMBS issuance that provided increasingly favourable pricing for borrowers.

Although the heightened level of prepayment risk was not cataclysmic for CMBS, this issue was construed as a fly in the ointment. From an investors perspective prepayments were certainly not welcome, especially if redemptions happened relatively soon after issuance. From the structurers point of view, given this was an issue that was very much under the spotlight, it created a structural nightmare in terms of devising how principal should be applied. This was especially true in those transactions that featured multiple loans of varying quality, a difference in interest rates and a wide geographical spread of underlying properties. The modified pro-rata application of principal repayments really went through the structuring mill, which manifested itself with some hugely complex CMBS structures as the structurer sought to ensure that principal was applied in such a way to ensure that credit enhancement erosion for the senior notes was limited, that the weighted average rate on the notes was kept in check whilst at the same time ensuring that the class X would not be adversely impacted.

In essence, prepayments were a necessary evil and were a natural by-product of the economic forces at the time. For the greater good of the product, measures were taken to mitigate prepayment risk through a combination of lock-out periods and prepayment fees. Although a useful deterrent, there are two important points to be mindful of. Firstly, there was no absolute prohibition on prepayment after the lock-out period had burned away. Secondly, prepayment fees were invariably for the sole benefit of the Class X or the loan seller as deferred consideration and thus not shared with those noteholders who suffered from the pain and inconvenience of the early redemption.

If we turn to CMBS 2.0, this in-equitable distribution of prepayment fees has sought to be addressed through noteholders now being entitled to a quantum of the prepayment fees and therefore a vast improvement from the previous status quo. Although credit should be given to CMBS 2.0 for this more equitable division of the spoils, one thing that has become clear is that how these prepayment fees are allocated varies widely:

- Some transactions allocate a percentage (say 50 per cent.) of prepayment fees to the noteholders, where other transactions just stipulate that all amounts should be paid to the noteholders.

- Other transactions include a detailed formula which ensures that the prepayment fees are split between the Class X and the noteholders in the same ratio as interest on the underlying collateral is applied between the two classes of investment. An enhancement to this (from the Class X perspective) has been to exclude administrative costs from the formulation, thus increasing the amount that benefits the Class X.
- Another structural nuance (which benefits the noteholders) is that following the occurrence of a Note Acceleration Event, 100 per cent of the prepayment fees are directed to the noteholders at the detriment of the Class X.
- A further modification has been the application of a cap to the amount of prepayment fees that a certain class of notes is entitled to receive, the quantum of which ratchets down over time.

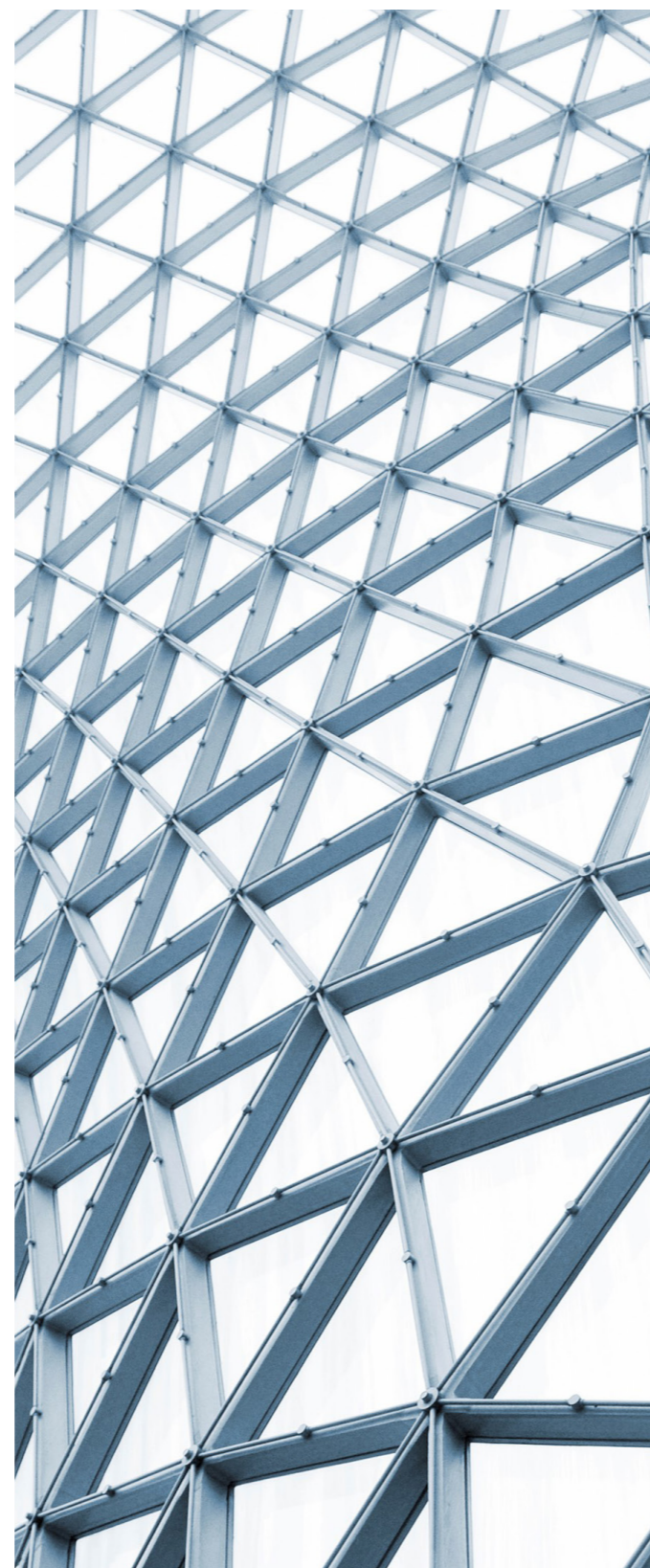
The treatment and application of prepayment fees can therefore be said to be one of the bedrocks of innovation for CMBS 2.0. Indeed, like other aspects of CMBS which we have written about (Standardisation the fuel for exponential growth (page 6); Class X – variety is not always the spice of life (page 10); Liquidity Facilities – the wild child of CMBS 2.0) (page 12), this is yet another area of the structure that would certainly benefit from greater standardisation. Although for now CRE CDO's have been confined to the history books of European structured CRE debt prepayment risk certainly has not, and although the equitable distribution of prepayment fees has been a huge leap in the right direction, the standardisation of this would be the icing on the cake.

Standardisation **the fuel** for exponential growth

Whether you are a supporter of using CMBS to finance commercial real estate or not, the simple fact is that it provides an efficient mechanism to transfer commercial real estate loan risk away from the banking sector, whilst at the same time providing much needed transparency to the commercial real estate lending market. In light of these hugely positive attributes, not only will CMBS continue to have a role in financing commercial real estate, but if market participants play their cards right, then we could once again witness the return of exponential growth of issuance.

The key to unlocking the latent potential of CMBS as a financing tool lies with continuing to build the trust and confidence of investors, regulators and market participants as a whole. Indeed, giant steps forward have been achieved on this front through arrangers taking heed of the structural reforms proposed by CREFC (Market Principles for Issuing European CMBS 2.0) and the investor principles of March 2013. The Securitisation Regulation has also acted as a beacon of best practice through encouraging and incentivising securitisation structures to be simple, transparent and standardised.

Although the European legislature's decree that CMBS is not capable of qualifying as a simple, transparent and standardised securitisation and therefore able to reap the reward of some favourable regulatory capital treatment, the structuring of deals as simple, transparent and standardised should still be considered best practice. This is essential for harnessing the trust and confidence of the market that is ultimately required to fuel exponential growth.



If we turn to the recent crop of CMBS deals, it is apparent that there is a lot more standardisation than was the case prior to the Global Financial Crisis of 2007. However, if a more forensic review of these structures is undertaken and comparisons made across deals, then it becomes clear that structures are not as standardised as they could be. This is something that we have already identified with regard to Class X (Class X – variety is not always the spice of life) (page 10), but the same could be said to be true with regard to payment waterfalls. High level observations of these variances include:

- Although all deals have a revenue waterfall, a principal waterfall and a post enforcement waterfall, some transactions also have an intermediate waterfall which kicks in once there has been a material default on a loan. To add to the complexity, if there is a risk retention loan in place (which is not always the case), then there will also be a corresponding loan waterfall for each note waterfall, meaning some deals could have eight waterfalls where as others just three.
- With regard to the revenue waterfalls, these do vary from one transaction to another. For example, some deals provide a separate bucket for prepayment fees where others do not. Also, in situations where there is no intermediate waterfall, there is likely to be separate buckets for the sequential application of principal and excess floating rate amounts.
- Principal in some structures is applied pursuant to a waterfall which makes provision for work-out and liquidation fees as well as caters for surplus proceeds. Other transactions are a lot simpler and only specify what amounts of principal are due to certain classes of notes and their relevant order.
- The application of principal varies widely, with some deals at one end of the spectrum having a straightforward modified pro-rata waterfall with cash trap proceeds being applied sequentially and the remainder amounts pro rata. At the other end of the spectrum, sequential proceeds are actually based on the amount of principal received on a loan based on the relevant loan's principal amount outstanding. In addition, some transactions (but definitely not the majority) provide for the reverse sequential application of certain amounts of principal.
- With regard to liquidity support, we have seen this take a variety of forms whether by way of a reserve or a facility provided by an affiliate of the arranger or a third party (see further Liquidity Facilities – the wild child of CMBS 2.0). (page 12) Given these variances in liquidity support, this also manifests itself with different types of payment buckets across deals.
- Finally, although all deals have the essential payment components (various administrative fees, interest, principal, pre-payment fees, excess floating rate amounts, default interest) there are also a number of additional payment buckets that differ across deals. Similarly, there are also variations to the treatment of the payment of Class X amounts, especially after these have been subordinated.



When looking at the above list, it is clear that each of the points is independent and separate. If one or more of these is adjusted (even slightly), the consequence is that when you compare one transaction against another, the payment structure can look substantially different. This is especially true if you also factor in some of the nuances that we have identified with regard to the structuring of the Class X. Although on a case by case basis taking into account the underlying collateral and the benefit of a structure, then the rationale for a particular variance does become apparent. The issue lies with the fact that as far as payment waterfalls go there is a lack of standardisation in European CMBS.

Given that CMBS by its very nature features underlying collateral that is not hugely granular, and that to date we have not witnessed (unlike in the US) the volume of issuances that actively encourages a more standardised and commoditised approach to structuring a deal, it is inevitable that there is a level of variance as transactions are finessed, improved and structured to cater for the unique attributes of the underlying collateral whilst at the same time maximising returns. Until we reach the point in time that there is a steady flow of issuance, structures have been tried and tested and ultimately CMBS becomes more commoditised, variance in CMBS will continue to be endemic to the asset class, albeit the magnitude of variance will likely diminish as the market continues to mature.

Market participants and structurers in particular should therefore be hugely cognizant of this lack of standardisation, and although it is correct that they should be modifying and finessing transactions to improve the overall product, such changes should not be at the detriment of investor confidence. Accordingly it is imperative that where possible, material changes should be incremental and standardisation should be actively promoted not only within CMBS programmes but also across programmes. If this can be achieved, it will improve CMBS consumer confidence and with it provide the vital fuel to spur the exponential growth that the product rightfully deserves.

Class X – variety is not always the spice of life

When it comes to the nuts and bolts CMBS, one of the key features that will be at the very forefront of any Arranger's mind will be the mechanism by which 'excess spread' (i.e., the positive difference between amounts received on the underlying loans and the liabilities of the issuer – or, in other words, profits) is not only extracted from structures in an efficient manner, but also in such a way as to maximise returns. Although this is a standard feature for CMBS, a review of recent transactions reveals a high degree of variance in extraction structures across deals.

Typically excess spread is distilled from a structure by the issuance of a Class X Note, which in essence is a class of notes that has a relatively low face value, is cash collateralised and bears a variable rate of interest which is paid (subject to certain credit events) *pari passu* with interest on the most senior class of notes. Indeed, the right to receive variable interest is the only tangible right attached to a Class X Note (if you ignore the standard entrenched rights relating to the note itself) given that holders of such an instrument have no controlling powers, no voting rights and no ability to direct the note trustee to take action.

Turning to the witnessed level of variance in the recent crop of deals, then in many respects a high degree of variance is inevitable given the complexities of what a Class X Note is trying to achieve and the myriad of different approaches that can be deployed by Arrangers in achieving this. Although at a basic level the Class X Note is simply structured to extract the arbitrage between interest payable under the loans and the coupon payable on the notes, the reality is that the financial engineering is complex when structurers also have to factor in the mechanics for skimming prepayment fees, default interest and deferred amounts while at the same time making allowance for the fact that its constituent components (namely, the administrative fee rate, and the weighted average interest of the underlying loans and notes) are at constant state of flux from one note payment date to another. In circumstances where the risk retention instrument comprises an issuer loan, this level of complexity and indeed variance across deals is heightened yet further.

When it comes to CMBS structures, one thing that is certain is that the market has never shied away from complexity and, accordingly, the product is no stranger to constant innovation and betterment, which although in Darwinian terms are worthy attributes, when it comes to Class X Notes a lot more prudence would be welcome. Indeed, historically Class X Notes have attracted negative press stemming from the inequitable way that these were structured in the CMBS 1.0 vintage of deals as well as the fact that they were the subject of a number of pieces of litigation that made their way to the High Court. Given this negative backdrop, the fact that Class X amounts are a significant monetary line item of any waterfall and that, after all, it is the Arranger that stands to benefit most from these instruments, then in our view if there is one structural feature of CMBS 2.0 that should be standardised across deals, the Class X Notes should surely be it.

There is credence to the view that variance in Class X structures is inevitable given that the structuring of a Class X Note is a moveable feast and accordingly 'one size does not fit all'; however, for the greater good of the product, the standardisation of a Class X structure across deals would be a hugely positive thing for the market to achieve. Not only would such standardisation add both certainty and clarity to a historically contentious part of the structure, but it would also foster a higher level of trust and much welcome transparency for investors. While the CMBS 2.0 market moves from strength to strength, the standardisation of profit extraction should only be seen as a good thing. And who knows? The foundations of a Class X Note market could be the welcome by-product of such a development. Apart from anything else, given the volume of litigation that has graced the English courts in recent years that has specifically centred around the entitlement of Class X Noteholders and the importance of Class X to the overall economics and viability of a deal, market participants risk failing to take heed at their peril.

Liquidity facilities – the wild child of CMBS 2.0

In this piece we will consider the most (arguably) integral form of credit enhancement for any CMBS deal, the liquidity facility.

Liquidity facilities are structured as 364 day committed revolving credit lines that can be drawn by a CMBS issuer to satisfy the payment of any shortfall in expenses, the payment of any shortfall in interest on notes, as well as the payment of any amount owed to a third party that directly relates to the underlying commercial real estate (a so called property protection drawing). Anyone that is familiar with the 1.0 vintage of deals will testify that such transactions exhibited a huge degree of variance when it came to the structuring of the liquidity facility, which can largely be attributable to the myriad of different CMBS 1.0 structures as well as the need to accommodate individual liquidity facility provider requirements.

With the emergence of CMBS 2.0 many market participants had hoped that there would be greater standardisation of these facilities and a higher degree of uniformity adopted between individual deals. In that vein, market participants will no doubt welcome the vastly improved documentation which includes fixes for many of the mechanical shortcomings that were endemic in CMBS 1.0. However, when it comes to actually creating uniformity with respect to key structural features relating to liquidity facilities, the new deals continue to be plagued with a similar level of heterogeneity as was the case with the previous deals.

Indeed, a structural vagary that was rife in CMBS 1.0 was the fee structure associated with a standby drawing. Historically these fees were structured in such a way that following a standby drawing either: (i) the liquidity provider received the same commitment fee as well as any income derived from the investment of the standby loan in eligible securities; or (ii) the standby loan was treated as if it was a normal liquidity drawing and thus the provider received a full amount of interest (although typically that portion of interest that exceeded the commitment fee was subordinated to payment of interest on notes). The new deals in the market reveal that this vagary is still rife with a compendium of different interest payment structures currently being employed which not only constitute a variance of the two structures outlined above but also new structures which include in one instance a structure whereby interest on standby drawings ratchet upwards over time.

Similarly with regard to appraisal reduction, there continues to be a range of mechanisms which mitigate liquidity provider concerns stemming from underlying stress in real estate values. In this context it is noted that a number of deals continue to follow the traditional “appraisal reduction” approach, where the amount of a liquidity facility is reduced by an appraisal reduction factor that is calculated by applying a haircut to the underlying value of the real estate. Other deals have adopted a more binary mechanism with the inclusion of a complete drawstop that is triggered when the underlying commercial real estate is determined to be insufficient to cover all amounts payable to the liquidity facility provider as well as all liabilities (including indemnified losses) that rank senior. Although both approaches have their merits, nevertheless this again demonstrates that a modicum of variation continues to be present in the new era of deals.

However despite this continued trend of variation, when it comes to drawings to cover interest shortfalls, the new transactions are (not surprisingly) consistent on this point. As market observers are aware, one of the most striking nuances of CMBS 1.0 compared to other structured products relates to a draw on a liquidity facility to cover an interest shortfall. Unlike other asset classes where the draw on a liquidity line was limited to the amount necessary to keep various classes of notes current, in the case of CMBS, drawings were instead dependent on whether there was likely to be a shortfall in the amount of interest received on an underlying loan. The corollary of this is that despite there being sufficient interest received on the underlying loans to service the payment of coupon on notes, nevertheless there could still be drawing on the liquidity facility if there had been a shortfall in the payment of interest on a loan, thus a welcome feature for anyone entitled to receive excess spread from the deal. Given the inequitable position of such structures, this nuance has now been eradicated and all new deals only allow interest shortfall drawings to cover the shortfall in the payment of interest on notes. In effect the new vintage of deals has removed the ability for there to be excessive liquidity drawings to meet loan interest shortfalls and thus the beneficiaries of excess spread are now only entitled to receive “true” excess spread (see Class X – a Class Act!) (page 10).

It would therefore appear that when it comes to the structuring of liquidity facilities these can be considered the wild child of CMBS 2.0. Although the structuring of liquidity facilities has definitely changed for the better, certainly one feature that has not changed is that in today’s market there is still a great deal of variety between different liquidity facility structures. In an ideal world, CMBS 2.0 would have heralded in a new dawn of deals where standardisation of this important credit enhancement tool would have been the norm, however instead we are confronted with a market where one size certainly does not fit all.

Although critics of the CMBS product could readily cite the failure to standardise these liquidity facilities as a flaw in the new vintage of deals and an opportunity missed by the architects of CMBS 2.0, the reality is that this heterogeneity can be firmly attributable to the regulatory cost of the liquidity facility provider of providing these credit lines. Under Basel III (European Regulation (EU) No 575/2013, 26 June 2013) liquidity facilities have become incredibly expensive for CMBS structures and therefore arrangers of pretty much all new rated CMBS 2.0 deals have had little choice but to provide the credit line themselves or via an affiliated company. In effect, by forcing the arrangers to keep liquidity facilities “in-house”, the regulators have inadvertently removed the commercial tension and cross pollination that is essential to create a standardised credit enhancement tool and with it the opportunity to further standardise the CMBS product.

Class X – a Class Act!

Class X – a Class Act!

No matter what the vintage of deal, an essential component of structuring a CMBS transaction is to ensure that the “excess spread” (i.e. the positive difference between amounts received on the underlying loans and the liabilities of the issuer) can flow to the originator or its nominee. Although skimming the margin of the underlying loans is one means by which the excess spread can be obtained, the more prolific mechanism and arguably the most controversial feature of CMBS 1.0 has been the utilisation of Class X notes.

In itself, an X note would seem rather innocuous, it is a class of notes that has a relatively low face value, it is cash collateralised and bears a variable rate of interest which is paid pari passu with interest on the most senior class of notes. Indeed, the right to receive interest is the only tangible right attached to an X note, given that holders of such an instrument have no controlling powers, no voting rights and no ability to direct the note trustee to take action.

As it is essential for the economics of CMBS that there is a mechanism for the originator to receive the excess spread, the mere existence of an X note in itself is not controversial however what is controversial, is the determination of what constitutes excess spread. In CMBS 1.0, the excess spread was determined to be the excess of scheduled interest due on the outstanding loans over the aggregate of interest due on the notes and ordinary administrative costs. With such a formulation of excess spread, an issue arises by the fact that it applies to interest actually due on the loans rather than interest actually received.

The consequence of this is that given the presence of a liquidity facility that can be drawn on to make up the shortfall in amounts received under the loan, then despite a borrower failing to pay interest on a loan this in fact will have no impact on the amount of excess spread received by the holder of an X note.

The controversy of CMBS 1.0 X notes is further exacerbated by the presence of a non accruing interest (NAI) mechanism which provides that when a loss on an underlying loan is crystallised a corresponding amount of such loss is applied on a reverse sequential basis to the principal balance of the higher yielding junior notes. Assuming the interest on the underlying loan where the loss has been crystallised is less than the coupon of the impacted junior notes, then absurdly the holder of the X note is set to gain a greater amount of interest and therefore derive a greater benefit from a situation where there is an underlying loss on a loan. Finally, to compound these controversies yet further, given that the payment of excess spread ranks pari passu with payment of interest on the most senior class of notes, then the holder of X notes will always be entitled to receive excess spread before the payment of principal on any class of Notes.





In summary, although the structuring of an X note is a legitimate right of the originator, the structures employed were clearly distortive given that they allowed “excess spread” to be extracted from the deal when in reality there was no excess spread in existence. Further, losses on loans had no negative impact on X note payment stream and if anything given the presence of NAI mechanics, losses could in fact enhance payments under the X note. Unsurprisingly, X notes were one of the main structural features addressed in CREFC’s Market Principles for Issuing European CMBS 2.0, where they made the following recommendations:

- there should be clear and concise disclosure on how excess spread is calculated and who is entitled to receive such amounts;
- there should be greater disclosure around some of the X notes more controversial structural features such as their ranking in the priority of payments and the role of any liquidity facility; and
- X note should be structured to specifically take into account the loan default interest, modified interest (following a workout), loan maturity date and loan default.

The concerns raised by the CMBS 1.0 have clearly been taken on board in CMBS 2.0, and the new vintage of deals exhibit structural nuances that have addressed the potentially inequitable features highlighted above. Deutsche Bank’s Deco 2014-Bonn provides a great example of how these imbalances have been corrected, which first and foremost includes clear disclosure on how excess spread is calculated and its constituent components.

In terms of structure, the Deco 2014-Bonn transaction provides that the liquidity facility cannot be drawn on to make good any shortfall in amounts received under the loan, thus any amounts received under an X note will solely emanate from income received from the securitised loan. Further, the amount that the Deco 2014-Bonn X holder is entitled to receive is capped at the excess of the amount of all available funds over all payment liabilities, with any X note amount that is greater than this capped amount deferred until the issuer has sufficient funds to make such payment. Finally, under certain circumstances (following the expected maturity date of the CMBS notes, the occurrence of a special servicer transfer event or service of a note acceleration notice), the right to receive excess spread is subordinated to payment of all interest and principal on the notes. These features are not unique to the Deco 2014-Bonn deal or indeed the Deco family of deals and a review of a number of other CMBS 2.0 transactions reveal the presence of similar structural features.

For the economics of CMBS, it is crucial that the originator of the loan is able to extract excess spread and the presence of X notes is integral to that. Between CMBS 1.0 and CMBS 2.0 there has been a clear structural shift in the structuring of X notes, from an instrument where holders could extract money out of a deal even when the loan or the deal is non-performing to the current situation where holders of X notes can only receive excess spread when there is indeed true profit and the deal is performing. The paradigm shift in the structuring of X notes is a real testament of the industry’s ability to listen to market participants, adopt recommendations and adapt the CMBS product so that it not only meets the needs of investors but also continues to safeguard the true economics of a deal – taking X notes from being suspect to a real class act!

Agency CMBS – is now the time for borrowers to capitalise?

As was the case prior to the global financial crisis, 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 commercial real estate assets. This trend is showing no sign of abating in the CMBS 2.0 era. Although this is a proven and effective mechanism for producing much needed CMBS product, it is important for market participants to be aware that these conduit deals are not the only CMBS structures in the market and that agency deals could potentially be an invaluable tool for any sophisticated borrower that is looking to directly tap the capital markets to raise cheaper finance.

In terms of the structuring of agency and conduit deals, although both transactions ultimately result in the issuance of notes secured by commercial real estate, the structures employed to achieve this vary. In the case of the latter, the structure involves a bank advancing a loan to a borrower which then sits on the bank's balance sheet prior to being distributed (either by itself or in a pool of other loans) via securitisation, syndication or a combination of the two methods. Given the bank owns the loan prior to the securitisation, conduit deals will also typically contain structures that allow the originating bank to extract 'excess spread', being the difference (after taking into account expenses) between the weighted average coupon on the notes and the weighted average interest received on the underlying loans. Agency deals, on the other hand, remove the role of the bank as an intermediate lender, and thus are structured in such a way that the borrower, through an affiliated entity (the note issuer), will directly raise finance by issuing CMBS notes into the capital markets.

Although we are now seeing a greatly welcomed resurgence of conduit deals, the originate-to-distribute business model is not as compelling as it once was, given the regulatory costs associated with holding commercial real estate loans on the balance sheet (prior to distribution) and the balance sheet cost of retaining a material net economic interest of 5 per cent of issued notes (the retention). However despite this relative drag on costs, the originate-to-distribute model has proven itself to be profitable and will increasingly become more profitable assuming that bond prices continue to tighten, that there continues to be an increase in the volume of issuance and that arrangers manage to keep the temporal period between origination and distribution to a minimum.

Meanwhile, with the rise of conduit deals to prominence, agency structures have once again fallen under their shadow. Although it is fair to say that both these structures have their merits and weaknesses, their credentials will vary depending on the angle from which these transactions are viewed. From a borrower's perspective the most appealing feature of an agency deal is that finance raised through these structures is greatly cheaper, as they only have to service the coupon on the notes and therefore are not required to stump up additional amounts to cover the payment of excess spread and any regulatory costs of the lender incurred prior to distributing the loan and satisfying the 5 per cent retention requirement. A further appeal of these structures is that, given a borrower has created the agency structure and therefore appointed individual transaction parties to their role, they inherently give a borrower a greater level of control and influence than they would otherwise enjoy in a conduit deal.

Although, from a borrower's perspective, the economics of such a deal would appear to be a no-brainer, the reality is that the structuring of these agency deals compared to a plain vanilla financing is certainly a more time- and resource-intensive process which carries with it a greater level of execution risk. These risks are particularly pertinent in the case of a maiden CMBS deal. However such concerns can be offset by the fact that a borrower could potentially derive huge benefit from the economy and efficiencies of scale of putting in place repeat financing using a similar structure with the same parties. A further drawback with an agency deal is that the amount of financing required must be large enough (typically public rated CMBS deals are in excess of €200 million) to make a public rated agency deal an attractive financing proposition. Although this is a difficult hurdle to overcome and in effect reduces the universe of potential borrowers that are able to put in place a public rated CMBS deal, borrowers should remember that these are not the only type of deals in the market and that CMBS technology is regularly used to implement a smaller note issuance through the issuance of privately placed, unrated notes.

The re-emergence of the originate-to-distribute model and CMBS's role as an integral part of this have got to be viewed as an extremely positive development for borrowers, lenders and investors alike. In particular, borrowers will no doubt hugely welcome the opportunity of obtaining the cheaper debt that these conduit lenders are able to provide. However borrowers that demand and require ever cheaper financing should definitely consider rolling up their sleeves and directly tapping the capital markets with an agency CMBS. Given that in today's market we are currently awash with cheap credit, however, these agency deals may seem a step too far for even the most yield-hungry borrower. That said, with the positive pricing currently being achieved on recent CMBS deals, there is a real opportunity for sophisticated and commercially savvy borrowers to really embrace agency CMBS technology and thus benefit from the fruits of the CMBS resurgence.





The renaissance of **European multi-loan CMBS**

The European CMBS 2.0 market was launched in June 2011 and in the years that have since followed, the asset class has demonstrated itself to be largely confined to the securitisation of large balance sheet loans. This is a stark contrast to the position immediately prior to the global financial crisis (GFC) when CMBS deals featuring eight or more loans were in plentiful supply. Indeed this “heyday” of European CMBS can be exemplified by one primary issuance that took place in March 2007 that was comprised of thirty two loans secured by commercial real estate (CRE) located in five different jurisdictions. Now that we are more than four years into this new era, many market observers are beginning to question whether the European market will once again reach the dizzy heights of CMBS 1.0 or whether deals featuring one or two large loans is in fact the new market norm.

In order to understand what direction the market is heading, it is essential to consider the evolution of deals prior to the GFC. CMBS 1.0 exploded into life in the mid-noughties and with it multi-loan transactions were a common feature from the very outset. Fuelled by a favourable regulatory environment and an abundance of cheap debt, CMBS was able to flourish as an off-balance sheet tool for funding CRE. Against this backdrop, there was a huge amount of innovation in the market with deals featuring increasing levels of complexity and ingenuity culminating in some notable multi-loan deals, such as the thirty two loan transaction mentioned above.

Given the overwhelmingly favourable market conditions the CMBS 1.0 product evolved in a vacuum and was not subject to the tests, challenges and scrutiny that a product of this magnitude generally receives and requires. In effect CMBS 1.0 had managed “to run before it could walk”, the corollary of which was that a number of unknown structural issues soon became endemic. With the onset of the GFC, the CMBS 1.0 product was subjected to a long awaited litmus test and with it many of the structural shortcomings were soon exposed. Indeed, a review of the new CMBS deals in the market reveal that the structural concerns raised by CMBS 1.0 have largely been addressed in the structuring of this new vintage of notes.

Since June 2011 we have now entered into a new era for the CMBS product. Given that so many market participants were adversely impacted by CMBS 1.0's structural flaws, the fragility of the global economic market as well as the high level of regulatory uncertainty, the new deals have so far evolved and developed at a much more measured rate than their predecessors. The trend for CMBS 2.0 has therefore been the utilisation of simplified structures which has largely been achieved by confining deals to the securitisation of single large loans. The use of these structures has proved invaluable in the rehabilitation of the product as these transactions have allowed confidence to once again return to the CMBS market as well as enabled an increasing number of arrangers to re-launch their CMBS platforms.



Although simplified CMBS structures are currently en vogue, this status quo is unlikely to subsist in the coming years. Given the limited availability of sizeable CRE loans that are suitable for a CMBS, the inevitable next step for the European market is the structuring of deals that are capable of accommodating the securitisation of a greater number of smaller loans. Assuming that this does happen (and there is every sign that it will), this would have a profound impact on the European CMBS market as it would not only hugely increase the universe of borrowers that could benefit from loans destined for CMBS but would also open up the floodgates for the level of primary issuance given the large number of loans that could be potentially originated with a CMBS exit in mind. Indeed as borrowers prepare themselves to face a sustained period of escalating interest rates, the opening up of CMBS to smaller CRE loans and with it the opportunity of obtaining cheaper debt will be a greatly welcome development.

It is not just borrowers that will herald in such a structural shift, but fixed income investors will also welcome such a development given their increasing appetite for investment in CMBS that has been spurred on by the continued low interest rate environment, the ECB's introduction of large scale quantitative easing as well as their own relentless search for yield. Accordingly on the basis that the securitisation of a greater volume of smaller loans will lead to an increased amount of primary issuance and a smoother flow of deals, this is likely to precipitate the deeper and stronger investor base required to absorb and competitively price such an increased volume of deals. Similarly investors that are already in this space would finally have the justification to put in place the internal resources and infrastructure required to invest in this asset class with any real volume.

Given that in the sixteen months that followed the launch of Europe's first CMBS 2.0 multi-loan deal in July 2014, seven of the fifteen public rated deals that have been brought to market were multi-loan deals, then the European market is already displaying a structural shift towards transactions featuring a larger number of smaller loans. This is a huge step forward for CMBS as a financing tool, as this development not only signifies that investors have appetite for the product but also that they are comfortable with the more complicated CMBS structures that are required to be put in place for such deals. Building on the success of these transactions and fuelled by the increasing levels of demand from borrowers seeking cheaper CRE debt, it is highly likely that the European market will witness a marked increase in the number of multi-loan deals along with a trend towards a larger number of loans being securitised in such structures.

Although at this juncture in the market it is hard to say whether the new vintage of deals will ever reach the dizzy heights of a thirty two loan transaction, what is apparent is that with the renaissance of multi-loan deals, the market has taken its first steps towards this CMBS 1.0 myth becoming a CMBS 2.0 reality and with it confining a market monopolised by the securitisation of large balance sheet loans to the evolutionary history books of CMBS 2.0.

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“ The recent spate of deals not only re-affirm and endorse this message, but in fact positively demonstrate that CMBS not only has a role in financing European commercial real estate but the fact, that it can be extremely profitable for those market participants (borrowers, arrangers and fixed income investors alike) that wish to embrace this technology. ”

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