CMBS 2.0: An Overview of Changes and Challenges

By Patrick C. Sargent

Patrick C. Sargent is a partner with Andrews Kurth LLP and a member of the Real Estate Finance and Structured Finance Practice Groups in Dallas, TX. He has represented participants in every facet of securitization and structured finance transaction and is past President of the Commercial Real Estate Finance Council. Mr. Sargent can be reached at psargent@andrewskurth.com.

For over 20 years an increasing percentage of commercial real estate has been financed efficiently through the packaging of commercial mortgages into commercial mortgage backed securities (CMBS) sold into the capital markets. Issuance exploded in 2007 to over $230 billion, right before the broader economy imploded into the Great Recession, after which issuance plummeted: $12 billion in 2008, and a paltry $2.9 billion in 2009. In 2010, lenders returned to the market with issuance of a still anemic $12 billion. Yet investors made it clear they wanted more transparency, better underwriting, and stronger alignment of risk. Thus began an effort to bring about changes that would encourage a return to the sector by investors as well as loan originators and issuers, led in part by the Commercial Real Estate Finance Council (CREFC), a key industry group composed of participants in all aspects of CMBS. Meanwhile, Congress, trying to address the economic catastrophe, passed the Dodd-Frank Act in July of 2010, calling for significant financial market regulations and studies. The new and evolving changes in the market for CMBS, which include self imposed industry standards and implementation of legislative and regulatory mandates, are referred to as CMBS 2.0.

Unfortunately, the third quarter of 2011 finds the Great Recession unabated, unemployment still painfully high, the US economy barely growing and dire European markets negatively impacting recovery in US markets. Commercial real estate remains overleveraged, with over $1 trillion in loans maturing during the next three years. There is a huge equity gap due to a precipitous drop in valuations, and fundamentals do not give encouragement for a quick rebound. Consequently, owners and buyers struggle to salvage fledgling properties, or even refinance performing properties that have suffered valuations drops. This is true even though new capital sources have entered the market and traditional sources have considerable lending allocations. We do not have a lack of capital; we suffer from substantial valuation losses and market volatility.

Even with this negative backdrop, CMBS has managed to change the trajectory in issuance from severe downward to a positive, albeit bumpy and moderate, increase. Most participants expect around $30 billion in issuance for 2011. Recent volatility in the capital markets has tempered that outlook somewhat, as CMBS spreads have widened and planned transactions have slowed. Congress and the Administration, rather than forging a recovery, have demonstrated an intractable partisanship, offering the country little confidence they can bring about a restoration of the economy, reduction of the excessive national debt or, more importantly, a reversal of the severe unemployment problem. Thus, the tepid recovery for CMBS still faces many challenges.

WHAT HAS CHANGED FOR LENDERS?

Lenders, chastened by investor reaction to pro forma underwriting, lack of escrows and reserves and overleveraging, for the most part have imposed a greater discipline on new loan origination. Underwriting is more conservative, tax and insurance escrows and tenant finish reserves are more common and cash

management and lockbox structures appear with greater frequency. Moreover, lease rollover, purchase options, and tenant credit risk have taken on increasing scrutiny, as investors have demanded more information about these risks. On the retail side, co-tenancy rights, and "go-dark" provisions also receive more attention.

In the past, the debt service coverage ratio (DSCR) and loan to value ratio (LTV) were key metrics for assessing a potential loan's credit risk. In legacy CMBS, a typical loan would have a minimum 1.25 DSCR and up to 80 percent LTV. As will be shown later, those have changed to roughly 1.5 to 1.7 DSCR and 55 to 65 percent LTV, reflecting the more conservative underwriting. Significantly, lenders are now using another metric that better assesses the property's ability to handle loan payment terms: "debt yield," which is calculated by dividing net operating income (NOI) by the loan amount and multiplying by 100 percent. This measure gives a more clear and consistent picture, for example, than applying DSCR measures to a loan that has a low interest rate, is interest only or has amortization variances. In today's market a minimum 10 percent debt yield is common.

Sponsor background, which has always been important even in a market that boasts non-recourse lending, has received increased focus as well. Lenders perform more extensive background searches and probe further into sponsor histories to get a better idea of what to expect when times turn bad. Usually, that includes control parties as well as any owner of at least 10 percent of the borrower equity.

Lenders have also been whipsawed by an increasingly unpredictable cost of funds and pricing for securitization. Even though the Federal Reserve has kept interest rates at historic lows, market volatility has made loan pricing and hedging virtually impossible. For example, spreads on 10 year triple A CMBS in May were around 110 to 125 basis points (bp). If a lender originated loans at rates of 200+ over swaps, it could expect to make two points or more of profit on the securitization. However, midsummer the triple A spreads widened to over 200 bp, and that profit quickly turned into a loss. In fact, a rule of thumb is that an increase of 15 bp in triple A spreads equates to a one point loss on expected profit. Lenders reacted by increasing spreads to swaps for new loans, but the three month aggregation period for a securitization precludes timely reaction to the volatile market. Lenders and issuers are struggling to find a hedge that will enable them to aggregate loans without leaving them completely exposed to market volatility. In the meantime, loans are being priced at much wider spreads to swaps, or in some cases, at the lender's breakeven point plus a spread. This makes predictability for lenders and borrowers alike difficult. Moreover, it increases the challenge for lenders with a higher cost of funds to participate at all. A shakeout in the recently revived conduit lender market may be looming.

Because of lower LTV and higher DSCR requirements, as well as debt yield expectations, few loans can be financed or refinanced without additional capital. Thus, mezzanine debt and B notes are prevalent in CMBS 2.0, though overall leverage is less than was typical for loans in legacy CMBS deals. In some cases, there is even a return of preferred equity structures to facilitate the necessary capital.

WHAT DO BORROWERS FACE?

As is customary for CMBS non-recourse loans, lenders still require that borrowers meet single purpose entity (SPE) criteria, that is, an entity whose organizational documents: (1) limit its purpose to owning, operating, leasing, and financing the property; (2) limit the indebtedness it may incur to the mortgage and limited accounts payable; and (3) establish separateness covenants governing how the entity conducts its operations in order to minimize the risk that the borrower would not be recognized as a separate entity in the event of an affiliate bankruptcy, possibly resulting in a substantive consolidation of the borrower with its affiliate. For larger loans, typically above $20 million, lenders may require the borrower to have one or more independent directors and deliver a non-consolidation opinion.

These are not new requirements, but this structure was tested with the bankruptcy filing of General Growth Properties (GGP) and 166 of its SPE subsidiaries that had CMBS loans. In the GGP bankruptcy proceeding, the court stated several times that it was not effecting a substantive consolidation of the parent with its subsidiaries. In fact, the integrity of the SPE structure indeed survived. However, a few lessons have been learned from the GGP bankruptcy and are being implemented for new loan originations.

For example, the definition of "independent director," whose vote is necessary for a voluntary bankruptcy filing by borrower, specifies that the director must be from a firm that has provided independent directors for structured

financing transactions for a period of at least five years, in some cases specifying a list of such firms. Second, the borrower may not replace the independent director without 30 days prior written notice to the lender. Third, the duty of the independent director to act is limited to the entity itself, and specifically excludes any consideration of the corporate enterprise, that is, the parent or other affiliates. The court in the GGP case specifically recognized the corporate enterprise consideration, an established tenet of Delaware director duty jurisprudence, in deciding the directors did not file in "bad faith." Typically, SPE borrowers are formed under Delaware law where the foregoing requirements generally are enforceable.

Given that CMBS loans are non-recourse, lenders usually require a sponsor of the borrower to execute a Non-Recourse Carve-Out Guarantee, which provides liability for certain "bad boy" actions by the borrower or its affiliates. There typically are two types of liability:

1. Liability for losses or expenses incurred due to fraud, material physical waste, failure to pay taxes or insurance, misappropriation of rents, violation of environmental laws or any action impeding or interfering with the lender exercising its rights and remedies; and
2. The entire loan becomes fully recourse for any voluntary bankruptcy filing, a collusive involuntary filing or a property transfer or debt incurrence in violation of the loan documents.

Requiring the guarantee is consistent with the premise of the non-recourse loan: pay the loan in accordance with its terms; and if you cannot pay, then give the property back and walk away without personal liability. But, if you commit any of the specified bad boy acts, which are within the borrower's control as opposed to unforeseen economic or market disruptions, then you will be liable.

These guarantees were required under legacy CMBS, but it is likely they will be even more prevalent in CMBS 2.0. They should not be taken lightly by guarantors, as they have been held enforceable by courts according to their plain language in part due to the sophistication of the parties, and notwithstanding challenges as void as against public policy or as an unenforceable penalty or liquidated damages.[1] In fact, courts have upheld the guarantee even in circumstances that likely were not anticipated by the parties, such as violation of certain separateness covenants that are poorly worded or bear no causal connection to the loss incurred. In one case, the borrower cooperated with lender to turn the property over after it was unable to pay debt service, but the guarantor was sued for the deficiency based on violation of the SPE covenant to remain solvent (which, by the way, is not a proper SPE covenant; the customary phrasing is "currently is solvent, and intends to remain solvent, but this does not require equity owners to make capital contributions"). The court found that language to be a sufficient basis for liability and upheld enforcement of the guarantee as worded.[2] Consequently, borrowers and lenders would be well advised to review carefully the triggers that impose liability to be sure they adequately protect the lender from bad acts, but do not impose liability for events outside borrower's control or which bear no connection to the loss.

Borrowers should expect loan terms that are not quite as generous as they found pre-2008. There will be fewer interest only (IO) loans, lower LTV and higher DSCR requirements, more frequently imposed lockbox arrangements and heightened demand for tenant estoppels and review of lease terms. As mentioned, they may need to access additional capital from higher yield sources. Still, even with more stringent terms, it is important to note that interest rates remain at all time lows, ranging from 5 to 7 percent for qualifying loans. This is because even though spreads to swaps have jumped to 350 to 450 bp, the 10-year Treasury has dropped below 2.0 percent, so that swaps hover around 2.1 percent. But, those rates and spreads, of course, may have already changed yet again. Conduit loans historically appealed to borrowers due to higher proceeds and lower rates. That remains true, just to a lesser extent.

SECURITIZATION DIFFERENCES

On the capital execution side, recent deals have exhibited a number of changes from legacy CMBS. For example, deal sizes are around $1 billion, less than half the size of vintage 2007 CMBS deals, containing fewer loans with higher loan balances. Part of the reason for the size is the shorter time frame required for aggregation, thus reducing the market volatility risk. The certificate classes are both fewer and thicker, and subordination levels are higher. Reflecting investor wariness, an "Operating Advisor" has been added to oversee Special Servicer actions and report on decisions made and overall compliance with the servicing standard under the trust. The ability to remove the Special Servicer also has been extended under certain circumstances to the

investment grade investors, rather than only the "B-piece" or first loss investors. Increasing opportunities for investors to get feedback and response to questions have been built into structures. Due to regulatory uncertainty and pending additional rules, until August 2011 all CMBS 2.0 deals had been private transactions, usually offered via Rule 144A. Based on investor demand mentioned above, these transactions included increased disclosure for loan level data.

Legacy CMBS deals were a combination of public registered offerings for the investment grade securities, and private offering of the below investment grade securities. Because the investment grade securities had the benefit of subordination, they did not receive as much information as did the private securities buyers, who absorb the first loss on loan defaults. Disclosure for CMBS transactions can be extremely detailed and involved, and thus issuers prefer not to file publicly the extensive individual loan data and reports, or be liable under the securities laws for third party reports that may be given to private investors without such liability. The issuer is still responsible for providing investors with all information necessary to make an informed investment decision under applicable federal and state securities laws, but that level is different for lower risk investment grade bonds than for higher risk first loss investors who have greater access with a confidentiality agreement. Because a number of investors require the liquidity of publicly registered securities, issuers have recently returned to the hybrid structure offering publicly registered securities again in order to tap the broader investor base.

Some of the deal size, subordination, and loan level differences can be seen in the comparison of data from two recent transactions versus the average for 2007 vintage CMBS as compiled by Fitch Ratings. Exhibit 1 illustrates the conservative underwriting found in two recent CMBS 2.0 deals. Whether that will continue remains to be seen. At this point, however, the percentage of CMBS loans (by principal amount) in special servicing has risen to 12 percent, and over 90 percent of that figure represents loans from the 2005-08 vintage. Prospects for CMBS 2.0 performance should be better.

LEGISLATIVE AND REGULATORY DRIVERS

No crisis is complete without the obligatory federal response. The Dodd-Frank Act, which passed on July 21, 2010, brought to bear over 2,300 pages of law, calling for over 80 studies and 300 new regulations to fix the financial mess that led to the Great Recession. The short term will not reveal whether that work product has the intended effect, but market reactions reflect a frustration with a drawn out process that preserves market uncertainty and a reluctance to put capital to work until the legal and regulatory frameworks become stabilized. A summary of those affecting CMBS follows.

Risk Retention

The hallmark of the Dodd-Frank Act was the call for new Risk Retention regulations to force lenders and securitizers to have "skin in the game" and retain meaningful risk rather than foist it on an unsuspecting, though sophisticated, investor market. The Notice of Proposed Rulemaking (NPR) for Risk Retention Rules was issued on March 29, 2011 with responses initially due June 10. Given the heft of the NPR, an extension was granted until August 1, and many trade organizations, investors, and financial institutions weighed in with their

Exhibit 1

Pool Data	WFRBS C4	DBUBS C3	Average 2007
Pool Principal Balance	$1.48b	$1.39b	$3.25b
Number of Loans	76	43	218
Issue weighted DSCR	1.77	1.71	1.34
Issuer weighted LTV	61.6%	58.0%	71.7%
Issuer weighted Interest Rate	5.36%	5.53%	5.9%
% of Pool with Sub Debt	21.1%	51.3%	37.5%
% of Pool with IOs	16.7%	8.3%	55.5%
% of Pool with Partial IOs	3.1%	35.4%	61.6%
Subordination to AAA	16.875%	20.875%	11.82%

responses to the extensive regulatory proposal. The list of those involved in oversight alone will give an idea of how this process will likely lumber along: The Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the Treasury and the Financial Stability Oversight Council (FSOC).

Key issues that respondents raised fall into six categories:[3]

1. Request for flexibility in structuring and allocating the 5 percent risk retention requirement.
2. Representations and Warranties. Updated and enhanced reps and warranties together with a more expedited breach remedy based on industry standards should satisfy all or a portion of the risk retention requirement. Note: the Dodd-Frank Act expressly mentioned enhanced representations and warranties as a permissible form of risk retention, though the NPR gave no benefit or credit to them. Lenders and issuers understandably are concerned about upgrading reps and warranties and related remedies if there is no regulatory benefit and investors are unwilling to pay more for the related securities. Currently issuers and lenders are exploring a proactive move toward adopting these enhancements.
3. Large Loan Exemption. Single asset and single borrower stand alone transactions often have extensive disclosure and frequently involve only investment grade rated securities, thus reducing the need for risk retention and other requirements under the NPR. Consequently, their exclusion would be appropriate.
4. Premium Capture Cash Reserve Account. This feature first proffered in the NPR essentially calls for issuers to put all profits into a subordinated reserve account; that is, proceeds from the sale of any interest only classes [the monetization of the profit on the pool of loans] and any premium over par received on sales of securities. Thus, issuers and loan sellers could not realize any profit on a securitization until the end of the transaction, typically 10 years. What readily became obvious to all but the regulators is that this rule would effectively shut down capital markets execution as a source of funding. It was not part of Dodd-Frank and should be excluded in the final rules.
5. Third Party Retention. Dodd-Frank contemplated, and the NPR elaborated on, a method of allowing third parties, B-piece investors, to satisfy the risk retention requirement for CMBS. Several elements of that framework drew comment, including Operating Advisor oversight, rights to remove Special Servicers, permitted transfers and holding periods for the B-piece investor, and certain compliance certification issues.
6. Qualified Commercial Loan Exemption. The NPR devised this classification as meriting zero risk retention, which would be great but for the scope and breadth of the 33 proposed metrics. For example, even if just the 1.7 DSCR, 65 percent LTV and 20 year amortization metrics were applied to loans originated through the history of CMBS, less than 0.4 percent would meet the definition, most notably the amortization. Interestingly, the metrics for residential loans—where the bulk of the underwriting and disclosure problems originated—are expected to result in 10-20 percent of loans qualifying. Responses recommended metrics that would result in closer to 20-30 percent of commercial loans meeting the definition.

FDIC Safe Harbor

Structured finance participants have been accustomed to several of the esoteric legal opinions required in these transactions, including the "true sale" opinion from the transferor of assets to the SPE issuer of securities. The true sale opinion typically analyzes the issue in the context of bankruptcy law, specifically the US Bankruptcy Code and related case law, which begins with an assessment of a debtor's rights in the assets as prescribed by state law. The opinion then analyzes whether those assets are "property of the debtor's estate" under Section 541 of the Bankruptcy Code. But in banking, the FDIC has authority under the Federal Deposit Insurance Act to take over troubled institutions, and the Bankruptcy Code has no application.

To facilitate these opinions and give more certainty to the issue, over 10 years ago the FDIC promulgated Rule 360.6 as a safe harbor for achieving true sale treatment. Unfortunately, due to changes in accounting rules, Rule 360.6 had to be modified, and the FDIC took the opportunity to regulate the entire securitization framework incorporating risk retention, disclosure, and structural requirements (not unlike the corresponding concepts in Dodd-Frank and the NPR) in order for banking institutions to avail themselves of the "true sale" safe harbor.

The irony of the new rule, which became effective January 1, 2011, is that risk retention itself is a factor that weighs against true sale treatment under case law. The onerous provisions of the rule have been avoided in transactions thus far as issuers subject to FDIC regulation have determined not to use the safe harbor, and instead rely on a more extensive legal analysis that ultimately concludes the assets have been sold and would not be part of the bank's receivership or conservatorship estate. Once the Dodd-Frank Risk Retention rules become finalized, the FDIC safe harbor for true sale will need to be conformed. Because the Dodd-Frank rules do not become effective for up to two years following passage, institutions regulated by the FDIC will continue to navigate around the safe harbor in CMBS issuances.

Regulation AB II

The SEC devised Regulation AB in 2005 as a means for specifying disclosure requirements for the securitization industry, formerly a round peg in the square whole of Securities Act of 1933 laws and regulations. In April 2010, it issued its proposal to update Regulation AB (Regulation AB II) and expand its coverage to private securities issued under Rule 144A and Regulation D. However, with the passage of Dodd-Frank and the call for a uniform and coordinated regulatory system, the SEC delayed pushing Regulation AB II until the related regulatory scheme became more settled. Recently, the SEC re-proposed Regulation AB II to address shelf registration eligibility requirements, and to remove aspects from the original proposal that are now dealt with under Dodd-Frank, such as the risk retention and ongoing reporting requirements. The re-proposal modifies the executive officer certification, but still provides certification as to adequacy of disclosure and the design to produce cash flows sufficient to service the securities. Transaction documents should appoint a credit risk manager and set forth dispute resolution procedures. Issuers must also be willing to provide an investor with the opportunity to request communication with other investors.

Further revision and update to Regulation AB II will likely follow comparable rules being finalized under Dodd-Frank, since they must be coordinated and not conflict. The only comfort in the ongoing regulatory one-up-man-ship between the agencies is that ultimately the various regulations must be reconciled. Sadly for the industry and capital market certainty, that is still a ways off.

Accounting

With all the legislative, regulatory, and political wrangling, one of the most significant developments that became effective January 1, 2010, has almost been forgotten. Financial Accounting Standards 166 and 167 had significant impact on how issuers and securitizers thereafter accounted for what used to be an off balance sheet financing. These standards were also the impetus for the FDIC safe harbor change discussed above, since they changed the basis for certain of the Rule 360.6 criteria. So, companies are dealing with the accounting fallout as well as legislative and regulatory change and uncertainty, all at a time when the economy needs a boost, rather than a straightjacket.

INDUSTRY INITIATIVES

As mentioned above, in the grip of the market decline, industry participants gathered together to rebuild and improve on the structure and foundations of what had been a thriving CMBS market, providing jobs, investment opportunities, and efficient commercial real estate financing. They set aside their personal objectives and proceeded to assess what had gone wrong and what could be fixed (a nice example for our government leaders and representatives to follow). In efforts coordinated through CREFC, market standards for (1) Model Representations and Warranties and related Model Dispute Resolution Procedures, (2) Principles Based Underwriting Criteria, and (3) Updates and Refinements to Annex A Disclosure were all developed and embraced by membership. These market standards were shared with legislators and regulators for consideration in the Risk Retention regulation development. The Model Representations and Warranties also reflect the enhanced underwriting and due diligence underway in CMBS 2.0.

Additional work continues in the area of standardizing CMBS documentation, updating, and improving ongoing reporting through the CREFC Investor Reporting Package, and establishing industry standards and best practices. These innovations have in many cases been implemented and have contributed to the improvement of CMBS 2.0.[4]

CONCLUSION

CMBS 2.0 represents an improvement over legacy CMBS by virtue of enhanced underwriting, increased transparency and disclosure, and development of industry standards responsive to investor and other participant input. Borrowers

struggling with value depressed properties will have a challenge finding suitable financing, but only because of more conservative underwriting and market volatility, and not because of lack of capital. Thus, additional capital sources will be required, such as mezzanine debt or preferred equity in many cases. For lenders and issuers, the jittery markets make loan pricing and profits in securitization a challenge to predict. Unfortunately, the regulatory uncertainty, coupled with intractable partisanship in Washington, do not bode well for certainty and stability any time soon. Nonetheless, we have halted the downward trajectory of issuance and have improved prospects for financing and growth compared to the past three years, albeit at a tepid pace. Any ray of hope is worth celebrating.

NOTES

1. *See, e.g.*, Blue Hills Office Park LLC v. J.P.Morgan Chase Bank, 477 F.Supp. 2d 366 (D. Mass. 2007); First Nationwide Bank v. Broookhaven Realty, 223 A.D.2d 618 (NY 1996).
2. Wells Fargo Bank, trustee for holders of GMAC Comm. Mortgage Securities, Inc., Mortgage Pass-Through Certificates, Series 2002-C3 v. Cherryland Mall Limited Partnership, Case No. 10-28149-CH, Grand Traverse Cty Cir. Ct, Mich. The ruling is on appeal and several industry associations have filed briefs in support of the guarantor. The position advocated by the securitization trust is not consistent with the premise of non-recourse lending and is a back-door effort to change the loan into full recourse contrary to the expectations of lender and borrower, which was expressed in testimony by an officer of the original lender.
3. Data source: CREFC Response Letter dated July 18, 2011, found at *www.crefc.org*.
4. The materials and other resources are available at CREFC's Web site: *www.crefc.org*.