The Dawn of CMBS 4.0: Changes and Challenges in a New Regulatory Regime

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Commercial real estate has been financed in the U.S. capital markets through creation of commercial mortgage-backed securities (CMBS) since the early 1990s, peaking at $240 billion in 2007 and representing about 25% of all commercial real estate financing. The premise is straightforward: loan originators pool mortgage loans secured by a variety of property types located in diversified geographic locations meeting minimum underwriting criteria into a trust, and then that trust issues certificates of beneficial ownership in the pool allocating payments of principal and interest to investors in sequential priority by class (or tranche) based on their desired levels of risk, return and tenor. [See Appendix]. The senior/subordinate structure delivers lower risk and lower yield to the senior certificate holders, and higher risk with higher yield to junior certificate holders generating the profits for sponsors and originators that drive the deal. [See Appendix – CMBS Profit Structure].

Prior to the Great Recession, the CMBS market was not subject to substantial regulation, other than securities laws generally and Regulation AB in particular. But in 2009 structured finance was blamed for the economic collapse, and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") brought a surge of rule-making that has participants scrambling to manage the cost and administrative burden of compliance.

It has been a bumpy recovery, but after bottoming out in 2009, CMBS has gradually returned to a respectable critical mass as it adapts to piece-meal regulatory creep and anticipates what comes next. The long awaited "Risk Retention Rule" becomes effective for CMBS on December 24, 2016[1], one of many regulatory and structural changes that have shaped CMBS structure from pre-crisis (CMBS 1.0), to now (CMBS 4.0):

A. <u>Risk Retention</u>.

The essence of the Risk Retention Rule is to require sponsors to retain 5% of the credit risk of the transaction with a goal of better aligning the interests of sponsors with those of investors, i.e., being willing to "eat your own cooking." For CMBS, an exception was allowed in the Dodd-Frank Act to permit the "B-Piece Buyer," the investor that purchases the riskiest part of the transaction, to meet the sponsor retention requirement, a structure fundamental to CMBS transactions. The rationale for the exception is that B-Piece Buyers are sophisticated investors who perform extensive due diligence on the assets and acquire the below investment grade securities specifically to pursue the related higher yields with a complete and informed understanding of the related risks.

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1 Credit Risk Retention, joint final rule implementing Section 941 of the Dodd-Frank Act, codified in Section 15G of the Securities Exchange Act of 1934, Federal Register Vol. 79, No. 247 at 77602 (Dec. 24, 2014) approved jointly by the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (the Fed), the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), the Department of Housing and Urban Development (HUD) and the Federal Housing Finance Agency (FHFA).

The legislative feat of this exception was viewed positively by the industry, but as the details of proposed regulations emerged, it became clear that it was far from the panacea participants expected. With the final rule, there are still suboptimal conditions and requirements, but industry participants have moved forward to adapt.

The options under Risk Retention are:

a. Sponsor retains a 5% vertical interest.

b. Sponsor retains a 5% horizontal interest of the most subordinate securities, determined at "fair value," which will result in an interest approximating the bottom 8-10% of the stack (by par amount).

c. Sponsor retains an L-shaped interest, combining a vertical interest and horizontal interest which, in the aggregate, equals 5% of fair value.

d. Sponsor sells a horizontal interest to a Third Party Purchaser ("TPP", that is, the B-Piece Buyer). The law permits two TPPs acquiring the Risk Retention Interest together, but only on a pari passu, or equal, basis and not senior/subordinate between them.

Option d. (using a TPP to meet risk retention) presents a number of hurdles in order to achieve compliance, both legal and practical, including:

i. 5 year hold, after which the TPP may only sell to another qualifying TPP. Participants have concerns that it will be difficult to sell after the initial period, and thus become effectively a 10-year hold.

ii. TPP must commit more capital per deal: 5% of fair value is expected to be 8-10% of the stack, requiring significantly more capital per deal than in pre-Risk Retention deals. Moreover, the horizontal interest likely will include investment grade certificates, which are not an economic or desirable instrument for B-Piece Buyers to acquire and hold. What new capital sources will be required for the TPP and are they accessible?

iii. TPP compliance with the holding period and other requirements of the rule and assuring the issuer/sponsor of its ability to do so for the term of the deal. Since the issuer/sponsor is responsible for TPP compliance, there will be liability and indemnity issues to be addressed once its threshold comfort level with this delegation is achieved. Unfortunately, the rule does not provide guidance regarding liability or compliance failure issues.

iv. Disclosure of pricing and methodologies and other information previously undisclosed. The sponsor must disclose the following for each TPP: name of TPP; experience in CMBS; fair value and purchase price of the horizontal interest, including valuation methodology, key inputs and assumptions, and quantitative information regarding discount rates, default rates, prepayment rates and recovery times; and material terms of the horizontal interest.

v. The TPP may not receive any financing from or otherwise be affiliated with a sponsor, depositor, or servicer (except that a special servicer may be affiliated with the TPP) and it is subject to restrictions on hedging the credit risk (interest and currency risk hedging are permissible).

vi. The TPP must conduct a review of the underwriting standards, collateral, and expected cash flows of all the loans in the pool.

In addition to the hurdles facing use of a TPP to meet the Risk Retention Rule requirements, issuers and sponsors are confronted with a number of other decisions, consequences, and impacts of the new rule that do not present easy answers, including:

a. Having sufficient dedicated capital to acquire and hold the Risk Retention Interest (whether horizontal, vertical, or L-shaped) and still make CMBS a profitable undertaking. By definition, this analysis must include the impact of Risk Based Capital (RBC) requirements.

b. How much of the increased costs (because there <u>will</u> be increased costs) should be absorbed by the sponsors vs. passed on to borrowers? Will the required pricing make CMBS no longer competitive with other CRE financing options for borrowers? And how do originators price loans to borrowers in anticipation of determining the answers to all these questions? Early estimates of additional cost predicted up to 50 basis points, but some have scaled that back to 15-30 basis points.

c. What options are presented by the sponsor acquiring the interest through a Majority Owned Affiliate (MOA), which is permitted by the rule, but at the same time raises questions about financing, structure, composition and transfer limitations?

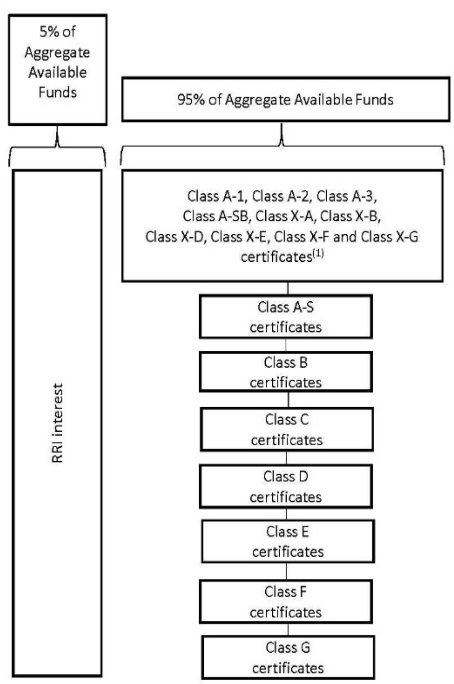
d. What structure will provide the perfect balance among investor demand, borrower demand, regulatory compliance and profitable deployment of capital?

With this backdrop, early indications show no single structure emerging as the best option. Bank and non-bank issuers are considering all four options; B-Piece Buyers are considering a greater role in the origination and sponsorship of deals; and some originators have come to the realization it no longer makes economic sense to participate. Bottom line: it will take months and several attempts with each structure to determine the cost and benefit for each participant, which will vary depending on factors such as RBC impact and cost of funding; thus, there will not likely be one size that fits all.

The first transaction to test the market using the vertical interest was sponsored by Wells Fargo Bank, as retaining sponsor, and Bank of America and Morgan Stanley as co-sponsors, each taking a proportionate slice of the vertical interest (based on loan contribution) in the WFCM 2016-BNK1 CMBS transaction which closed August 18, 2016.

The WFCM BNK1 transaction was structured to comply with both the EU Risk Retention regulations, which are in effect, and the U.S. Risk Retention Rule, four months prior to its effective date. The vertical interest represents a top to bottom 5% interest in the performance of the entire loan pool, participating in the payments received and losses incurred without the benefit of structure afforded the investor certificate holders, and truly having the characteristics of a loan participation rather than a structured security. The vertical interest is not entitled to any voting rights with respect to certificate holder decisions, but the holders may appoint a Risk Retention Consultation Party that has non-binding consultation rights with the special servicer in handling specially serviced loans. The vertical interest is graphically represented below:

Vertical Risk Retention Structure



(1) The Class X-A, Class X-B, Class X-D, Class X-E, Class X-F and Class X-G certificates are interest-only certificates.

This foray into the Risk Retention regime was well received by investors, pricing at the tightest levels seen in over a year at 94 basis points (bp) over swaps for the benchmark Class A certificates. Commentary indicated a positive response to three large banks retaining a vertical interest in the pool, aligning their interests with those of investors for the life of the transaction.

The ensuing months will reveal the direction of sponsors, issuers and investors. Reports show a market with differing views and direction, and some analysts have published studies assessing the cost and return on equity between the differing approaches based on specified assumptions.[2] Two conduit originators who previously paired with large bank conduit issuers have filed their own shelf registration statements providing for the flexibility to either retain the required risk retention piece or sell to a TPP, and a third originator is currently in the market with a proposed retained horizontal interest structure utilizing another issuer's shelf.[3] Time will tell how their structures and assumptions bear out, and how the CMBS market will sustain itself during the uncertainty of this transition period.

B. Regulation AB and Other Rules Affecting CMBS Issuance.

While Risk Retention will likely have the most significant impact on CMBS, a number of other rule makings from the SEC and other agencies empowered through Dodd-Frank have been issued over the past few years. Certain key regulations are summarized here:

1. Regulation AB, initially enacted in 2004 for Asset-Backed Securities Disclosure and Regulation (Regulation AB) was updated by so-called "Regulation AB II" containing disclosure requirements for asset level data and additional requirements for shelf-registration eligibility.[4] New requirements for shelf registration using Form SF-3 include the following:

    a. CEO Certification: the chief executive officer of the depositor must personally sign and bear liability for a certification to the effect that he/she has reviewed the prospectus, is familiar with the character of the assets and structure, and based on his/her knowledge:

        i. the prospectus does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements not misleading;

        ii. the prospectus fairly presents the characteristics of the assets, the structure, and the related risks; and

        iii. there is a reasonable basis to conclude that the securitization is structured, but is not guaranteed, to produce expected cash flows at the times and in the amounts to service the scheduled payments of interest and ultimate payments of principal in accordance with their terms.

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2 See, e.g. J.P.Morgan, U.S. Fixed Income Markets Weekly, August 26, 2016 postulating that the two preferred methods of compliance would be the horizontal or L-shaped risk retention.

3 See Form SF-3 for Starwood Commercial Mortgage Depositor, LLC as registrant, and Form SF-3 for Ladder Capital Commercial Mortgage Securities LLC, as registrant, as filed with the SEC on Edgar: www.sec.gov/Archives. Jefferies LoanCore is reportedly in the market proposing to retain the risk retention piece using the Deutsche Bank shelf in COMM 2016-COR1.

4 Final Rule, Asset-Backed Securities Disclosure and Regulation, SEC Release Nos. 33-9638; 34-72982, File No. S7-08-10 (August 24, 2014) (the "Release") weighing in at 683 pages if you printed out the double-spaced pdf version.

The purpose, according to the Release, was to increase internal oversight within the issuer. And issuers (at the insistence of their CEOs, no doubt), have undertaken greater due diligence practices, including stepped up requirements for co-sellers in multi-seller conduit deals. The certification, coupled with investor concerns regarding lesser capitalized originators, has put pressure on issuers to scale back the number of originators they include in an offering. And the due diligence costs and procedures continue to pile on.

b. Asset Representations Reviewer. Each transaction must include an independent review party that is charged with undertaking a review of underlying documents for loans that are 60 days or more delinquent ("Delinquent Loans") to determine compliance with the representations and warranties regarding the pool assets. This duty occurs only after a threshold of delinquent assets specified in the documents has been reached ("Asset Review Trigger") and may include a minimum investor demand, which may not exceed 5% of total investors' interest in the pool, to trigger a vote on whether to commence a review. While this is a low investor percentage, the threshold for the Asset Review Trigger does not appear overly sensitive: it may vary depending on the asset quality of a pool, the number of loans, and the loans size. Recent transactions have provided for Asset Review Triggers that occur when either (i) loans with an aggregate outstanding principal balance of 25% or more of the pool are Delinquent Loans, or (ii) at least 15 loans are Delinquent Loans and their aggregate outstanding principal balance constitutes at least 20% of the aggregate outstanding pool balance.

The Asset Representations Reviewer must be provided access to underlying documents and deliver its report to the trustee within specified time periods. However, it is not charged with taking any enforcement action or determining whether the breach is material or actionable. Rather, the special servicer is tasked under the pooling and servicing agreement (PSA) with determining whether the results of the asset review merit pursuing any remedies that the trust may have against the related mortgage loan seller for a breach of representations and warranties in the mortgage loan purchase agreement concerning loans it sold.

One might ask whether the Asset Representations Reviewer role is necessary or beneficial. Since the special servicer is specifically tasked with working out troubled loans and maximizing the net proceeds to the trust on a net present value basis for the benefit of the certificate holders pursuant to the Servicing Standard and other terms of the PSA, one would expect that role to include the above duties, and indeed it should. The inclusion of a separate independent party to review representations and warranties that has no authority to pursue claims does not appear additive to the process or attentive to perceived weaknesses, at least in the CMBS market.

c. <u>Dispute Resolution Procedures</u>. Transaction documents must provide that if an asset/loan subject to a repurchase request is not resolved by the end of the 180-day period following receipt of notice to the responsible repurchase party, then the party submitting the request will have the right to refer the matter to either mediation or arbitration. The SEC acknowledged that the dispute resolution provision could result in increased costs and is not limited to repurchase requests connected with the Asset Representations Reviewer provisions; consequently it decided that the arbitrator would determine which party should bear the costs, or in the case of a mediation, the parties must mutually agree with the help of the mediator. The goal was to provide investors with a process for valid claims while also curbing potentially frivolous claims. The process also has the merit of an expedited resolution proceeding (arbitration or mediation) that avoids the prospect of languishing in a years long court battle.

d. <u>Investor Communication</u>. Shelf transactions must also incorporate an investor communication request process allowing investors to request communication with other investors regarding exercise of their rights under the PSA. The investor need only provide its name and how to communicate with the requesting investor, and the issuer must cause that information to be included in ongoing distribution reports when requested. This provision was in response to concerns about the inability to locate other investors in order to enforce rights under the transaction documents.

2. <u>Due Diligence Reporting: SEC Rules 15Ga2 and17g-10</u>. On August 14, 2014 the SEC adopted final rules regarding nationally recognized statistical rating organizations (NRSROs) and relating to due diligence services provided in public and private securitizations. The requirements became effective for offerings priced on or after June 15, 2015, and provide as follows:

a. Rule 15Ga-2 requires the issuer or underwriter for a transaction that is to be rated by an NRSRO to file Form ABS-15G with the SEC containing findings and conclusions of any third party due diligence report obtained in connection with the rating.

b. Rule 17g-10 requires the due diligence provider to certify in Form ABS Due Diligence-15E as to its identity, the scope and manner of diligence performed, and a summary of findings and conclusions.

The challenge under these rules is defining what constitutes "due diligence services." Participants agree that accounting "agreed upon procedures" normally performed on comparing data tapes to the loan source documents fall within the definition. However, as a general matter, none of the other services customarily provided in connection with CMBS loan origination, such as appraisals or zoning, would be considered "due diligence services" for purposes of Rule 15Ga-2 or Rule 17g-10. Seasoned portfolios, however, may present a situation calling for additional filings.[5]

3. Operating Advisor/Trust Advisor. The concept of Operating Advisor originated in the aftermath of the great recession as investment grade investors wanted a new actor inserted into the structure when they experienced losses in 2009 and 2010 for the first time and their trust levels with special servicers diminished. Thus, prior to the particulars being crystalized in the Risk Retention Rule, transactions incorporated the concept in response to investor demand. The role has evolved so that the Operating Advisor has little responsibility or authority prior to the occurrence of a Control Termination Event (see "Control Changes" discussion below), which eliminates certain key rights of the Directing Holder. In general, the Operating Advisor must review Asset Status Reports for defaulted loans, evaluate proposals by the special servicer in handling defaults, and recalculate Appraisal Reduction Amounts and other calculations performed by the special servicer. After a Control Termination Event, it must also prepare an annual report of the special servicer's performance. The Operating Advisor may recommend to the certificate holders that the special servicer be removed, which can be effected by a vote of not less than 20% of certificate holders with a quorum of 25% of those entitled to vote. The Risk Retention Rule incorporated the Operating Advisor concept for transactions that utilize the TPP to satisfy Risk Retention and sets forth specific criteria, including non-affiliation with other parties, no other financial interest in the transaction, and a standard of care, all of which become effective December 24, 2016.

4. Improved Investor Reporting. The CMBS industry has long been at the forefront of investor reporting. In fact, as the Dodd-Frank regulations emerged and calls for greater transparency and disclosure were voiced, the Commercial Real Estate Finance Council (CREFC) Investor Reporting Package (CREFC IRP) ™ was recognized as a model for other asset classes. Begun in 1997 by the trade association, it has evolved and improved over the years. Version 7.1 was launched in June 2015, updating servicer watchlist and portfolio review guidelines, loan modification reports and best practices; with more than 850 fields of information, the CREFC IRP represents a standardized set of bond, loan and property-level information used in virtually all U.S. CMBS. The Securities and Exchange Commission (SEC) in preparing Regulation AB II for securitization even acknowledged that there was a general preference for the CREFC IRP in lieu of proposed requirements for asset level reporting. The final Regulation AB II called for monthly reporting on Schedule AL which had substantially the same information as the CREFC IRP. Demonstrating the dynamic and responsive nature of this industry effort, version 8.0 was launched September 30, 2016 (prior to the rule effectiveness) to incorporate the full Regulation AB II Schedule AL for uniformity, and updated servicing files, defined terms, servicer remittance items and guidance for multi-structure reporting to address the complexity of current transactions that have multiple pari passu loans with intercreditor arrangements and reporting across several pools. The report is available at www.crefc.org.

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[5] See "SEC Rule 15Ga-2 and SEC Rule 17g-10 Compliance Principle Based CMBS Guidelines" at www.crefc.org/standards.

5. Rule 15Ga-1 Repurchase Requests. Pursuant to Sec. 943 of the Dodd-Frank Act, effective February 12, 2012, sponsors must file a Form ABS 15G and disclose in the prospectus for each CMBS transaction a record of loan repurchase requests due to a breach of a loan representation or warranty. Sponsors must disclose the status of such requests, including whether the demand was rejected, is in dispute or has been withdrawn. Disclosure regarding repurchase requests is required to reflect activity for a period of 3 years prior to the date of the related prospectus.

C. **Other Regulatory Impacts:**

The Risk Retention Rule and Regulation AB took center stage for the regulatory rollout, but they are not exclusive. The Dodd-Frank Act spawned other regulations impacting CMBS, such as the Volcker Rule, and U.S. and international banking regulators have also weighed in with capital intensive and administratively complex regulations and proposals. A few include:

1. Volcker Rule – Restrictions on proprietary trading by banks has caused most to cut or drastically reduce their trading desks. The result is a loss of liquidity and reduced ability to make markets, hampering investor appetite for CMBS.

   Chairman Jeb Hensarling (R. Tex.) of the House Financial Services Committee has launched a repeal and replace effort for the Dodd Frank Act, with the "Creating Hope and Opportunity for Investors Act" ("CHOICE Act") proposing to repeal the proprietary trading restrictions in the Volcker Rule, among other things. While acknowledging the unlikelihood of passage this fall, the chairman is signaling a policy direction.

2. US Banking Regulators and Basel Committee on Bank Supervision (BCBS): Various proposals and regulations that U.S. banking regulators have adopted or are considering in comment period and that impact CRE lending include:

   a. Liquidity Coverage Ratio (LCR) requires banks to hold liquid assets for cash outflows over a 30-day period, utilizing the "highly qualified liquid assets" (HQLA) framework which tends to penalize the CMBS markets.

   b. Risk-Based Capital rules with more stringent weighting on commercial mortgage loans and CMBS holdings.

   c. Net Stable Funding Ratio (NSFR) proposed rulemaking by the OCC, FDIC and Federal Reserve based on BCBS regulatory proposals would increase the duration of the liability side of the balance sheet, and as proposed would likely lead to a decline in bank loan growth, including repurchase agreement financings.[6]

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[6] See Joint CRE Trade Associations Letter to U.S. Banking Regulators Regarding NSFR Proposed Rule, August 5, 2016, available at www.CREFC.org/resources. ("Joint Trade Letter").

d. Fundamental Review of the Trading book (FTRB) proposed by BCBS, and expected to require up to twice the capital currently required, thus severely impacting CRE finance and CMBS liquidity.

Commentators to the proposed banking regulations do not question the need for some degree of regulation, rather they raise concerns about its growing complexity, redundancy, and negative impact on the availability of capital and liquidity (See Joint Trade Letter). That is in addition to the magnitude of the cost of compliance, which reportedly rose over 100% to $70 billion for the top six banks from year end 2007 to 2013.[7]

D. **Structural Changes to CMBS Brought About by the Industry.**

1. Fair Value Purchase Option Eliminated. This assignable option, in deals until changes in accounting rules no longer required them in 2010, allowed the special servicer or controlling holder to exercise the option to purchase a defaulted mortgage loan or assign the option. Investors derided the provision as enabling insiders the opportunity to buy loans at a discount, even though structural protections existed in the PSA to avoid such conflicts and a Fitch survey in May 2012 indicated it had been utilized only 11 times from 2001-2012. Transactions now require an appraisal and sale to the highest bidder unless the special servicer determines the bid is not in the best interest of the certificate holders. The special servicer or an affiliate may also bid and purchase the defaulted loan, but in such case the trustee must determine the fair value purchase price.

2. Cap on Liquidation and Workout Fees; Disclosure of Fees. The fallout of the market in 2009 led to an abundance of special servicing work. Prior to that time defaults were below 1%. The flurry also showed that the PSA servicing fee provisions did not capture all possible situations, including where the borrower may be charged fees that are in addition to fees payable by the trust pursuant to the PSA. The General Growth Properties bankruptcies further highlighted that a special servicer might charge and receive fees in excess of the standard 1% Liquidation/Workout Fee. In response, current transactions limit the Liquidation and Workout Fees to 1% of the principal of the loan, capped at $1 million (avoiding a perceived windfall on large loans) and sometimes with a stated minimum. Similarly, special servicing fees continue at 25bp, but may have a stated minimum to account for smaller loan principal balances.

   Modification Fees payable to the special servicer are now subject to an offset against Liquidation and Workout Fees earned with respect to a restructure or modification of the same loan within an 18-month period. Permissible Special Servicer Fees include customary banking fees, treasury management fees, title agent fees and insurance agent commissions. In some cases they may include appraisal fees, but there is a potential concern about an affiliate conducting appraisals for the special servicer. Disclosable Special Servicer Fees constitute all the remainder, such as brokerage fees,

[7] "The Cost of New Banking Regulation: $70.2 Billion," by S. Chaudfuri, Wall Street Journal, July 30, 2014. See also, "Compliance Costs Community Bankers $4.5 Billion Annually, Survey Shows," by D. Dahl (December 1, 2015) at www.stlouisfed.org.

rebates or commissions in connection with the workout, foreclosure or disposition of a loan or REO, and any fee-sharing arrangements.

3. Control Changes. A majority of the Controlling Class, representing the lowest class with at least 25% of its original balance outstanding, has the right to appoint the Directing Holder, which in turn is afforded the ability to (i) consent to certain actions taken by the special servicer and (ii) terminate and appoint a new special servicer with or without cause. A number of changes to this construct have occurred:

    a. The determination of the Controlling Class now takes into account reductions in principal balance due to Appraisal Reductions, thus a more timely assessment of the status of the class without waiting until actual loss realization.

    b. Consent vs. Consultation: The consent right applies only until such time as the Controlling Class (which in some transactions is specifically limited to the bottom 2 or 3 classes) has a principal balance equal to at least 25% of its original balance after giving effect to Appraisal Reduction Amounts (such event, a "Control Termination Event"). Thereafter, the Controlling Class has consultation rights with the special servicer until such time as the principal balance of the class is less than 25% of the original balance due to application of Realized Losses.

    c. The right to terminate the special servicer with or without cause ends upon the occurrence of a Control Termination Event.

    Importantly, and notwithstanding anything to the contrary in the PSA, the Special Servicer is required to disregard any direction, instruction or failure to consent from the Directing Holder that would cause it to violate the loan documents, applicable law, or the PSA, including the Servicing Standard.[8] Imposition of the Servicing Standard override is key to the integrity of the CMBS structure. A party with no duty to the certificate holders should not have an unrestricted right to call the shots on defaulted loan resolution. However, the Directing Holder's rights to terminate the Special Servicer without cause and to enter into fee sharing arrangements with the Special Servicer continue to present tension on investor and rating agency comfort levels with the override as the principal means of protecting investor interests.

4. Elimination of Interest Payments on Appraised Out Certificate Balances. The loan liquidation waterfall in PSAs dating prior to 2010 often provided for payment of all accrued and unpaid interest to certificate holders prior to application of principal. The consequence was that upon liquidation of a loan at a loss, the most subordinate class would receive accrued but unpaid interest, and yet more senior certificate holders could sustain a principal loss. The PSA waterfall now typically calls for payment of interest first

[8] The novice to PSA review must proceed with caution. The current market version PSA has around 500 pages, exclusive of exhibits. Rights granted in one section may be subject to override in the next. The autosearch functions shows as many as 171 "notwithstandings" in a PSA. That compares to 92 in a pre-crisis sample containing a mere 291 pages, exclusive of exhibits.

to certificate holders after giving effect to Appraisal Reduction Amounts, next to principal, and then to any unpaid interest due to reduced P&I Advances from application of the Appraisal Reduction. This is more consistent with the intent and expectation of investors under the senior/subordinate structure.

5. Excluded Loans and Excluded Special Servicers: Conflicts. Participants in commercial real estate finance play a variety of roles, which may include acting as servicer, investor and lender, all in the same affiliate group. Consequently, it is possible for an affiliate of a special servicer for a securitization to have a relationship with a borrower in the pool as investor, property manager, controlling party or as mezzanine lender ("Borrower Party"). If that borrower defaults and the special servicer is required to resolve the loan on behalf of the trust, there is an inherent conflict of interest. Transactions with that possibility have dealt with the conflict by requiring an independent special servicer to be appointed solely with respect to that "Excluded Loan" upon such event.

   In a similar vein, the Directing Holder is often given access to information and strategic planning gathered or prepared by the special servicer in connection with resolving defaulted loans and the exercise of its consent or approval rights. If the Directing Holder is a Borrower Party with respect to the borrower on a defaulted loan, it should be precluded from having access to such sensitive information, which would potentially give the defaulting borrower an advantage in negotiations with the special servicer.

   These steps reduce the potential for conflict of interest and leakage of sensitive information to defaulting borrowers and are positive developments that enhance the integrity of the CMBS structure.

E. Other Structure Issues, Case Law & Legislative Developments

1. Co-Lender Agreement (CLA) Issues. Large trophy office, mall, hotel, and other property loans are frequently financed through CMBS. But their size dictates either a stand-alone deal, or breaking the loan into multiple pari passu notes placed in two or more conduit transactions to avoid "lumpiness" and concentration; or even a combination of stand-alone plus several conduit deals. The CLA has therefore become a staple of large loans, and has increased in complexity for CMBS. Some of the issues with split loans include:

   a. Determining which Note will be the "lead" for both servicing and Directing Holder purposes.

   b. Coordinating timing and delivery of payments and reporting across multiple pools.

   c. Consistency in the use of defined terms from one conduit or stand-alone deal to the next.

   d. Managing "servicing shift" provisions, where the lead servicing transaction is designated for a subsequent securitization, and thus servicing "shifts" from the first transaction closed to the "lead" securitization when it subsequently closes.

e. Coordination of servicing provisions that are standard or substantially similar for future deals into which a note will be contributed in order to assure uniformity of treatment and accuracy of disclosure of terms.

f. Standard of Care: Rated structured finance transactions require that service providers meet minimum criteria; including for servicers the Servicing Standard (sometimes referred to as Accepted Servicing Practices, but uniform in substance). In addition, parties are entitled to a limitation of their liability under the transaction except for costs and expenses arising out of their own negligence or breach, and are further entitled to indemnification from the trust or other parties for costs and expenses other than those arising out of their own negligence or breach. "Gross negligence" generally requires a showing of "recklessness" and thus if adopted would enable a service provider to be both unaccountable for its own negligence, and even indemnified for it. Thus, a "gross negligence" standard for any service provider is not appropriate for the integrity of a rated, structured transaction. Some CLAs provide for a gross negligence standard, which should be normalized to a negligence standard, especially insofar as it relates to servicing obligations or any other information or service provider obligations.

2. New York Statute of Limitations (SOL) Ruling. To the extent investors and other participants were unaware, the New York Court of Appeals confirmed in 2015 that the SOL on a breach of a representation or warranty by a loan seller into a securitization begins to run at the closing of the securitization, which is also the effective date of the transfer of the loans and making of the representations pursuant to the related mortgage loan purchase agreement (MLPA).[9] The case involved residential mortgage backed securities, but obviously applies to CMBS as well. It is not clear whether significant instances of rep and warranty breaches arise later than 6 years from closing, but it would seem unlikely given the extensive diligence that occurs in connection with securitization. Nonetheless, since MLPAs and PSAs typically are governed by New York law, and most do not expressly provide for a waiver of the SOL and survival of rep and warranty enforceability, investors and other participants should plan accordingly.

3. Borrower and Servicer Concerns. The attraction of CMBS loans to borrowers has long been the dual benefit of more proceeds and lower rates. That has muted borrower complaints about lack of responsiveness, excessive fees, inflexibility, and, well, other unpleasant allegations. While the industry has undertaken a number of programs to make the borrower experience more informed and less painful, most would acknowledge that there is much room for improvement. It came to a head recently as a group of issuers and investors sent a letter to CREFC raising concerns about servicer

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[9] Ace Securities Corp. v. DB Structured Products, Inc., New York Court of Appeals, June 11, 2015. See also, Moody's Investors Service, "New York High Court Rules that Reps and Warranties End Six Years from Deal Closing, a Credit Negative for RMBS and CMBS." June 15, 2015.

fees, approval request timing and cost, special servicing reports and disclosure, and other issues. CREFC has undertaken to create a task force to address the concerns. That is appropriate and timely for an industry that cannot afford to ignore key components of the engine of its growth.

4. Independent Manager/Member Structure. Non-recourse loans require the borrower to be a special purpose entity (SPE) including certain "bankruptcy remote" attributes. One such attribute includes requiring an "Independent Director or Manager" whose vote is required in order for the entity to file for voluntary bankruptcy (involuntary bankruptcy typically requires 3 creditors to file). This structure is not "bankruptcy proof," but at least ensures that an objective and independent party must assent to the filing, so that a borrower may not do so only due to frantic owners seeking relief in contradiction to the basic premise of the non-recourse loan. Most structures are careful to define "independent," and they typically do not include a lender affiliate, because that may be viewed as tantamount to the borrower waiving its right to access the bankruptcy courts, which is void as against public policy.

   A recent Delaware bankruptcy court decision makes it clear that any lender attempt to block borrower rights under the Bankruptcy Code, in this case, through issuance to the lender of a common unit interest in the limited liability company (LLC) and requiring a unanimous vote of all unit holders to file a voluntary bankruptcy petition, is void as against public policy. See In re: Intervention Energy Holdings, LLC, (Bankr. D. Del.) 2016 Westlaw 3185576 (June 3, 2016). The structure in the Intervention Energy case is not customary in CMBS SPE structures, but the case illustrates the court's negative view of lender provisions that try to circumvent public policy considerations: "a provision . . . the sole purpose and effect of which is to place into the hands of a minority equityholder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief . . . whose primary relationship with the debtor is that of creditor . . . is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy." Id. at *6.

   Lenders utilizing the Independent Director/Manager must be aware of the limitations of the structure, and avoid crossing the Intervention Energy line. A much more effective incentive to reduce the risk of borrower voluntary bankruptcy in an SPE structure is the Non-Recourse Carve-Out Guaranty from a financially capable individual or entity affiliate that imposes full liability in the case of a voluntary or collusive filing. Those agreements have been consistently upheld in favor of the lender and provide ample incentives for the guarantor and borrower to abide by the premise of non-recourse financing.

5. Legislative Horizon. While few expect any legislative activity this year given the divisive partisan climate in Congress and this year's rather unique presidential election, a CMBS bill was sent to the House from the House Financial Services Committee with bi-partisan support. Styled the "Preserving Access to CRE Capital Act of 2016," and the result of CREFC and other parties' diligent efforts, it is designed to address three Risk Retention Rule issues for the industry:

i. Exempt single asset/single borrower transactions, particularly since they are typically low leverage loans and often do not provide for a conduit style B-piece.

ii. Allow the eligible horizontal interest to be acquired by up to two TPPs, but using a senior/subordinate structure, rather than only a pari passu structure.

iii. Modify the qualifying commercial real estate (QCRE) loan exemption to permit more loans to meet the exemption. As written, the QCRE would allow less than 8% of loans funded in CMBS.[10] The incredible irony is that the counterpart on the residential side, the qualifying residential mortgage (QRM), was denuded of any meaningful underwriting criteria, so that it currently applies to over 85% of all residential loans. One look at the respective performance, underwriting, and other metrics of CMBS vs. RMBS during the crisis leaves no question about who received the short end of that ineffectual regulatory stick.

F. <u>Metrics Comparison</u>.

No recap would be complete without a comparison of recent pool metrics compared to those just before the economic crisis. Data points for pool comparison show a strengthening of loan-to-value ratios, debt service coverage ratios and other fundamental loan metrics that bode for stronger loan pools over those from 9 to 10 years ago. This improvement in loan quality is coupled with credit enhancement/subordination levels that would previously be associated with the opposite; that is, current subordination levels are twice what they were in the heady pre-crisis days; and therefore present an overall credit quality improvement for CMBS investors. The addition of the Debt Yield metric also gives a better picture of a loan's ability to provide cash flow for refinancing. Did this improvement come about through investor demand? Self regulation? Self preservation? Well, there is no indication loan quality improvement resulted from the regulatory onslaught, rather in spite of it, and in fact future financings may be in jeopardy because of it.

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[10] <u>See</u> Testimony of the CEO of CREFC before House Financial Services Committee, Subcommittee on Capital markets and Government Sponsored Enterprises, February 24, 2016, at <u>www.crefc.org/resources</u>.

CMBS DEAL METRICS

	WFCM 2016-BNK1[1]	CD 2016-CD1	2015	2007[2]
Pool Balance ($ Mil.)	870.6	703.2	1,030	3,249
Number of Loans	40	32	72	218
WA Mortgage Rate (%)	4.29	4.04	4.45	5.90
Issuer WA DSCR (x)	2.35	2.49	1.79	1.34
Issuer WA LTV (%)	55.6	56.8	64.1	71.7
Issuer NCF Debt Yield (%)	11.26	11.12	9.89	
% of Pool with Pari Passu Participations	45.9	50.1	25.1	
% of Pool with Subordinate Secured Debt	9.2	23.5	4.4	37.5
% of Pool with Mezzanine Financing	9.2	21.4	9.1	
% of Pool, Interest-Only Loans	37.5	33.8	23.3	55.5
% of Pool, Partial Interest-Only Loans	28.9	34.9	43.1	61.6
Credit Enhancement (%)				
AAAsf (Junior)	21.875	19.500	24.000	11.82
B-sf	3.750	3.375	4.500	1.59

[1] Structured as first U.S. Risk Retention compliant transaction where 3 sponsors retained an aggregate 5% vertical interest in the pool, though rule not effective until 12.31.16. Sponsors were Wells Fargo Bank, Morgan Stanley and Bank of America. Closed August 2016.

[2] Some data not available.

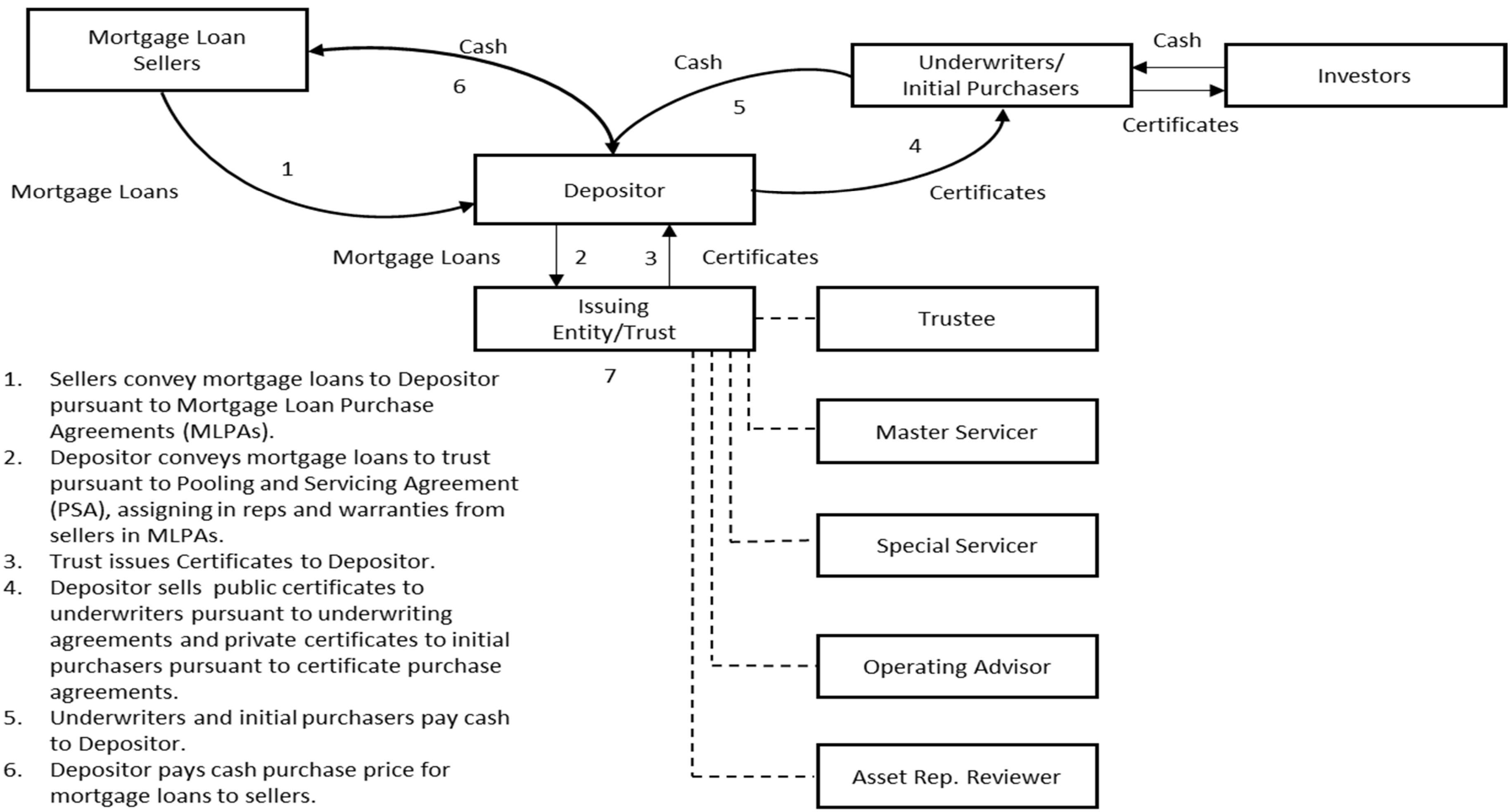
Source: Fitch Ratings

G. **Conclusion**.

The resilience, durability and adaptability of the CMBS industry in dealing with regulatory proposals amidst financial meltdown has been visible over the last 7 years. It is interesting to note the changes and improvements brought about without regulators. While the Dodd-Frank Act, Risk Retention, and the BSBC groups continue to gin out ever increasing regulations, it remains to be seen how CMBS will look in 2017. CMBS will likely endure as an essential component of CRE finance, but it will be less profitable and more difficult in the burgeoning regulatory framework. The adaptability of the industry, while commendable, feels more like a frustrating and desperate plea to Washington: if legislators and regulators would spend more time determining the root cause of problems, they might create remedies more closely suited to accomplishing their goals. Amen to that.

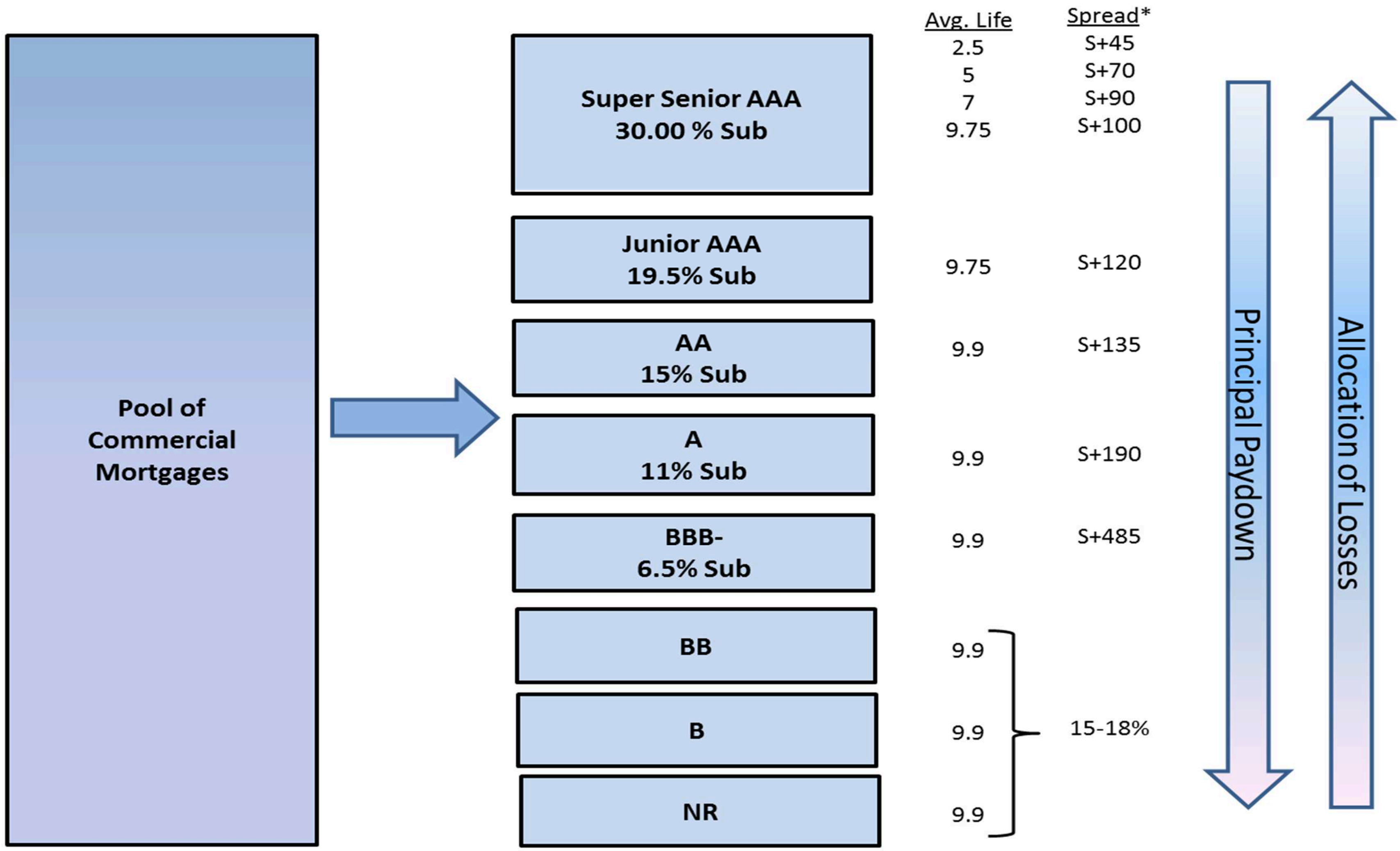
APPENDIX

CMBS STRUCTURE



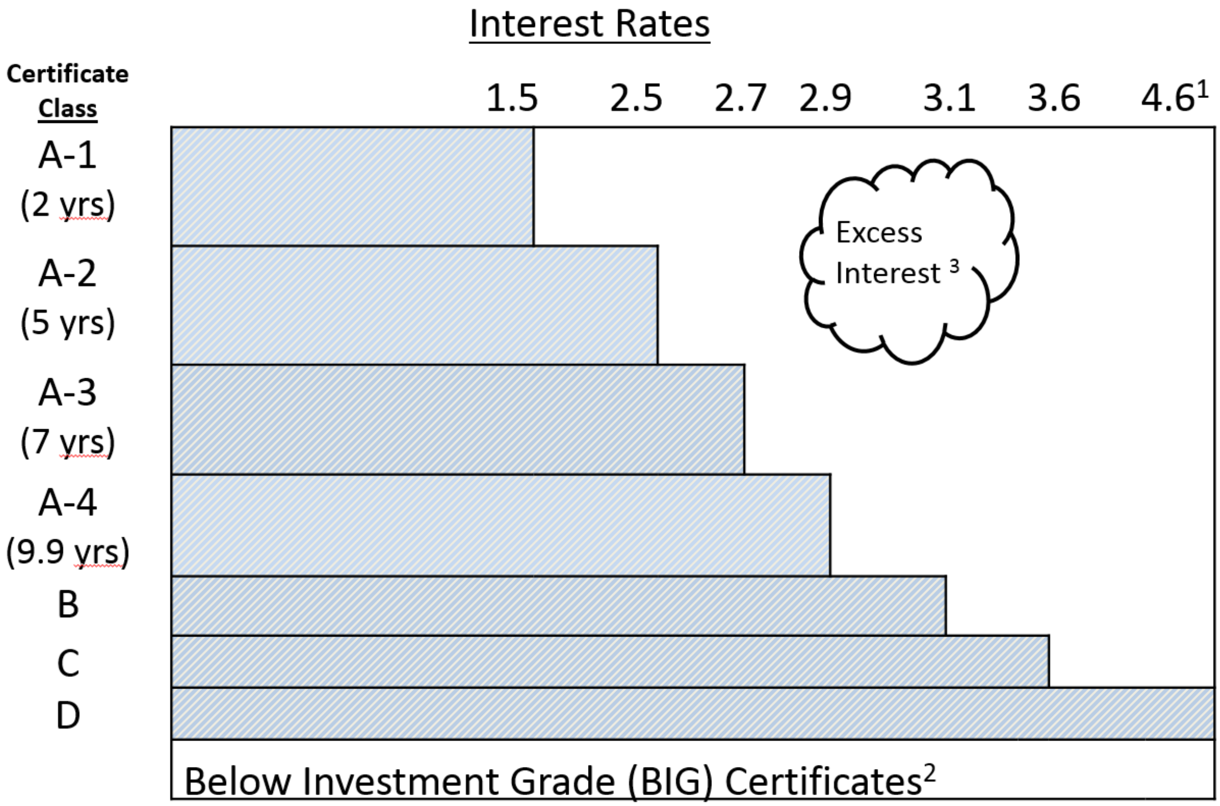
1. Sellers convey mortgage loans to Depositor pursuant to Mortgage Loan Purchase Agreements (MLPAs).
2. Depositor conveys mortgage loans to trust pursuant to Pooling and Servicing Agreement (PSA), assigning in reps and warranties from sellers in MLPAs.
3. Trust issues Certificates to Depositor.
4. Depositor sells public certificates to underwriters pursuant to underwriting agreements and private certificates to initial purchasers pursuant to certificate purchase agreements.
5. Underwriters and initial purchasers pay cash to Depositor.
6. Depositor pays cash purchase price for mortgage loans to sellers.
7. Loans and Trust managed on behalf of investors pursuant to terms of PSA.

CMBS Structure: Credit Tranching



* Priced off comparable tenor swaps. Swap Rate allows for anticipated variance in projection of LIBOR; thus accounts for choice between fixed and floating rate. Mortgages are therefore also priced off swaps. Example based on August 2016 deal.

CMBS Profit Structure



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1 Mortgage Pool WAC = 4.6%;
Certificate Rate may be subject to WAC Cap.

2 BIG Certificates (approx. 6.5% of total) are sold at a discount to achieve required yield, often 15-18%

3 Excess Interest available for payment on Interest Only (IO) Certificates (and from investment grade certificates sales at a premium); proceeds from sale of IO Certificates make up for discount on sale of BIG Certificates and remainder represents profit, typically 1 to 2 points.