# Ex-Merrill Banker Seeks to Resurrect European CMBS: Mortgages

By Neil Callanan - Jul 24, 2012 12:00 AM GMT+0100

Nassar Hussain, a London-based managing director of Merrill Lynch & Co., was so concerned by the cheap mortgages being offered to commercial real estate borrowers in 2007 that he sold his holdings, resigned and moved to Dubai to work in private equity.

Five years after Europe's property markets and lending collapsed, Hussain is back in the U.K. capital leading efforts to revive demand for new commercial mortgage backed securities, a product he says is essential to revive Europe's struggling banks. As chairman of the Commercial Real Estate Finance Council Europe committee on CMBS, he plans to make the debt more attractive by ending a system where banks get paid even when the underlying loans default.

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"In the last few years, securitization has been a bit of a negative word," said Hussain, 44, managing partner at Brookland Partners LLP, which has advised on 18 billion euros ($22 billion) of real estate debt transactions since he set the company up in 2009. "Without a liquid and deep capital markets funding base, the problems in the banking market are going to take significantly longer to overcome," he said.

Only 210 million pounds ($326 million) of CMBS were originated in Europe this year compared with $42 billion of 2006 loans that were later rolled into the securities, according to data compiled by Bloomberg. The loans six years ago were granted at a time

when cheap financing was pushing up values of skyscrapers, shopping centers and apartment buildings from London to Berlin.

## Difficulty Refinancing

Commercial property owners have 260 billion euros of debt coming due in Europe this year, according to broker DTZ. Refinancing will be difficult, with many banks unwilling to increase lending until they can sell existing loans to meet regulatory requirements.

Central to Hussain's proposed CMBS reforms are changes in so-called Class X notes, through which banks and other lenders generate income after mortgages are packaged and sold to investors. Banks and other originators currently continue to receive payments on the notes even when borrowers default or have loans restructured, eroding the returns for other noteholders, the Finance Council said in April 2011.

Under the new guidelines, Class X notes will not continue to generate a payoff when some loans default, Conor Downey, a partner specializing in real estate finance at law firm Paul Hastings, said in an interview in the City of London financial district.

## 'Badly Structured'

"There's a perception in the market that European CMBS is a badly structured product and that it doesn't work in the way that people had anticipated," said Downey, who's also a member of the Finance Council committee. "It's unfair because European CMBS has actually performed well. Losses on European triple A CMBS are running at less than one percent."

Still, while relative yields on European commercial mortgage debt packaged into securities narrowed 135 basis points, or 1.35 percentage points, this year to 440 basis points, the spreads are wider than a year ago and more than four times the level in November 2007, according to JPMorgan Chase & Co. data.

CMBS deals done before the financial crisis included provisions that were too complex or vague, Downey said. That resulted in disputes among bondholders about the returns they were entitled to when a loan defaulted, hurting the reputation of the securities.

The new CMBS market principles will be presented today by the Finance Council at the Paul Hastings office in London. Buyers will be promised increased access to

documentation on properties secured by the loans, both before and after the CMBS are sold.

‘Much Simpler’

“The drafting will become much simpler, much clearer” under the new guidelines, Downey said. “There will be much better disclosure and much better descriptions of the underlying documents.”

The new guidelines, known informally as CMBS 2.0, will also recommend that the arranger provides a cash-flow model for investors once a deal is closed, which should help increase trading of the bonds after the securitization is closed, Hussain said.

Europe’s banks, forced to sell real estate assets to conform with new regulations, will gain a new way to refinance debt if the CMBS changes attract buyers, he said. With securitization markets frozen, banks such as Royal Bank of Scotland Group Plc have been buying properties they foreclosed upon using other units of the bank. They then sell the properties to investors, often helping the buyer finance the purchase.

Transforming Liabilities

“Until securitization comes back properly, the transactions banks are using to fund their loans are really only transforming their liability from one type to another type,” Downey said by e-mail,

Convincing insurance companies and other investors to buy new notes may prove difficult. Four out of five loans packaged into European commercial mortgage-backed securities maturing in the first quarter were not repaid on time, Moody’s Investors Service said in a May 31 report. That’s more than twice the 2009 level.

Those figures don’t show that Class A notes in European CMBS notes have been largely unaffected by turmoil in real estate markets, according to Hussain.

Insurers and pension funds may be deterred by proposed regulatory changes that would make the capital penalty for buying the highest-rated CMBS notes about eight times higher than for AAA-rated corporate bonds, said Christian Aufsatz, a London-based securitization analyst at Barclays Capital.

‘Not Bullish’

The investment bank's research desk is "not bullish on European securitization new issuance volume, in particular not CMBS," Aufsatz said by telephone. He expects insurers to be interested in buying some new CMBS, "but if you want to issue 20 to 30 billion pounds annually, then it's doubtful you would find sufficient demand."

Sales of CMBS in the U.S. to pension and life insurance companies has increased thanks to new ratings, "more robust" underwriting of loans and credit enhancements that reduce the risk of bondholders' losses, Richard Hill, a Stamford, Connecticut-based analyst at RBS said in a telephone interview.

More than $13 billion of the new type of CMBS was issued in the U.S. this year through July 14, he said. Buyers now tend to be "real money as opposed to fast money," he said, referring to the absence of collaterized debt obligation investors in the market. U.S. CMBS sales in 2007 totalled a record $232 billion.

Insurance companies have bought about 17.7 percent of so-called CMBS 2.0 and CMBS 3.0 bonds in the U.S. after revisions were made there, compared with 12.6 percent of the earlier version of the securities, Hill wrote in an April 11 report.

Europe will need to learn how to convince those same money managers and insurers to become buyers, Downey said.

"We have a generation of bankers that haven't had to sell to pension and life companies," Downey said. "People have to develop contacts, figure out what these investors want and tailor the product to their needs."

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