Chapter 4

Legacy of European CRE Lending, The Lessons Learned During The Downturn and CMBS 2.0

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4.1 Introduction

This Chapter will develop on the discussion set out in Ch.1, by providing a brief overview of the legacy of CRE lending in Europe over the past decade with a focus on the size of the CRE debt market and CRE debt maturities, origination levels and performance. During this period, as highlighted in the previous chapters, the European CRE debt markets witnessed unprecedented growth levels, but have since the second half of 2007, along with various other sectors, suffered from significant liquidity and performance issues. These issues have impacted both the bank and capital markets, reducing the availability of debt and with limited alternative lenders entering the market at the time of writing, it has, as highlighted in Ch.2, created a significant funding gap. As discussed, banks were the largest providers of CRE debt in Europe with approximately 75 per cent of market share and it is expected that it will take a number of years before the banking sector recovers and even then there is likely to be significantly reduced appetite to originate CRE debt exposure to the levels seen during the boom years.[1]

As well as alternative lenders, the capital markets are expected to play a larger role in future CRE debt financing, but this will be subject to the various participants having confidence in and a proper understanding of CMBS structures. The financial crisis has exposed some of the weaknesses in historical CMBS transactions. This Chapter also explores some of the key lessons learned since the advent of the financial crisis, in relation to the structuring of CMBS transactions in the context of the issues that many market participants have had to face relating to loan defaults and enforcement, consensual extensions and restructurings, availability of information, voting mechanisms and the role of transaction counterparties. The CREFC, through its CMBS 2.0 Committee, has also issued a

[1] See further Ch.9.

consultation paper on July 24, 2012 on the market principles for issuing European CMBS 2.0. Many participants from the industry contributed valuable time to the discussions and debates of the CMBS 2.0 Committee and it is hoped that the final market principles when issued will improve and increase overall confidence in future CMBS structures. Please note that the author is Chair of the CREFC's CMBS 2.0 Committee[2] and the contents of this chapter are the views of the author and not the CMBS 2.0 Committee or the CREFC.

4.2 Legacy of European CRE Lending

4.2.1 Size of the European CRE debt markets

As highlighted in Ch.1, the banking market has dominated CRE lending in Europe and banks significantly increased their exposure to CRE in the years 2000 to 2007. European banks are estimated to have, at the time of writing, an estimated exposure to real estate loans of approximately €2.4 trillion (according to Morgan Stanley analysts).[3] The current balance of outstanding European CMBS loans is estimated at approximately €100 billion. Unlike North America, alternatives to the banking market in Europe have been limited and even CMBS in Europe accounts for less than 10 per cent of outstanding debt levels (compared to approximately 22 per cent in North America) with the remainder being provided by banks and the covered bond market. Insurance companies and pension funds have historically provided very little CRE debt in Europe although this is now changing, as they adapt to new opportunities in the market and regulatory capital changes under Solvency II.[4] In contrast, in North America Insurance companies (and others) accounted for approximately 20 per cent of the CRE debt markets. Europe is now also witnessing the emergence of various senior and mezzanine debt funds that are looking to fill part of the gap that has been left by the banks and CMBS, as discussed in more detail in Ch.1.

4.2.2 New CRE debt origination

As will be highlighted in this book, European banks are in the process of reducing their overall exposure to CRE debt due primarily to capital and funding constraints. Funding for banks has become much more expensive save for those that are able to issue *Pfandbrief* in Germany[5] and in addition with the implementation of Basel III, more capital will be required resulting in lower returns on capital. A number of banks (including RBS, Lloyds,

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2 See further Appendix 3.

3 See the *Morgan Stanley Research Report* (Blue Paper: Banks Deleveraging and Real Estate, March 2012).

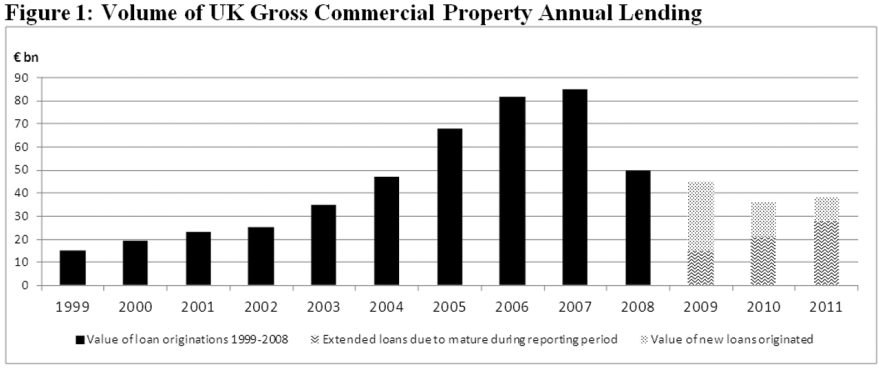
4 See further Ch.16.

5 See Ch.2.

Commerzbank, Soc Gen, various Irish banks) have announced large reductions in their CRE debt exposure and this is likely to continue in 2013 and beyond.

There is little data available in terms of new CRE lending in Europe, however, the *De Montfort Study* provides an insight into volumes of UK commercial property lending through to 2011. It is clear from Figure 1, that the level of new loan originations for the United Kingdom has reduced significantly each year from 2008 onwards whilst the level of extensions has continued to rise.

Figure 1: Volume of UK Gross Commercial Property Annual Lending

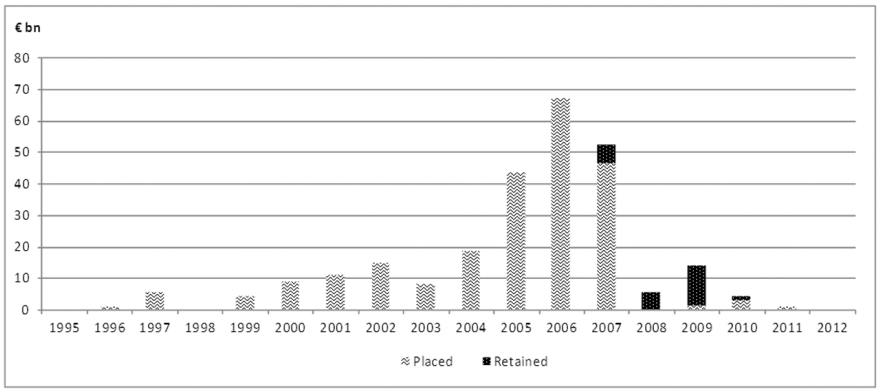


Source: De Montfort Study "The UK Commercial Property Lending Report – 2011 End-Year

In terms of CMBS issuance, there has been very limited new supply for 3rd party placement since 2007 as set out in Figure 2 below. Whilst a number of transactions have been completed many of these have been retained and/or used for repo purposes with the ECB or Bank of England. At the time of writing, Tesco has completed £3 billion of CMBS issuance in the form of five transactions since 2009 but, as referred to in Ch.1, these have been fully amortising and credit linked to Tesco and as such they are bought off the back of Tesco's corporate risk and rating as opposed to the underlying real estate risk. There have been three transactions that would constitute CMBS transactions in the traditional sense and these are from Deutsche Bank's platform comprising the Chiswick Park, Merry Hill loans (where the loans were secured against shares rather than the underlying real estate) and the Vitus German multifamily, Flore 2012-1. It was hoped these transactions would represent a re-opening of the CMBS markets, but due to market conditions, limited new investor appetite and legacy issues with CMBS, this has not yet fully materialised. At the time of writing, whilst there has been increased interest in conduit lending from banks, this has not resulted in loan origination on balance sheet and it is expected that many of the earlier

deals will be agented CMBS transactions with a focus on more conservative asset classes such as German multi-family (as per Vitus, Flore 2012-1). (See Figure 2).

Figure 2: European CMBS Issuance



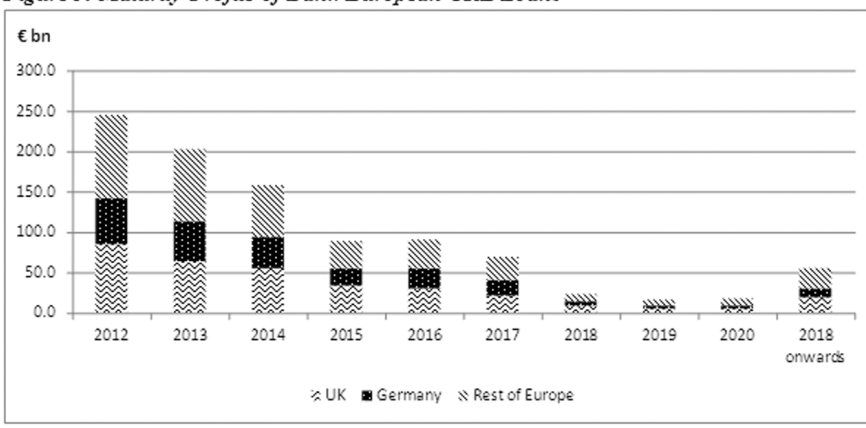
Source: Bloomberg, Bank of America Merrill Lynch Global Research 2012

4.2.3 CRE loan maturities

As set out in Figure 3 below, the peak years for maturities for loans originated by banks in Europe is 2012–14 with the largest peaks being in 2012 and 2013 and the largest exposures being in the United Kingdom and Germany. The maturity profile shifts from year to year depending on the level of extensions completed by banks so the peak may be extended to the next year in question until such time as the policies on extensions change. The banks appear to have been reasonably flexible with extensions provided cashflow coverage has been sufficient.

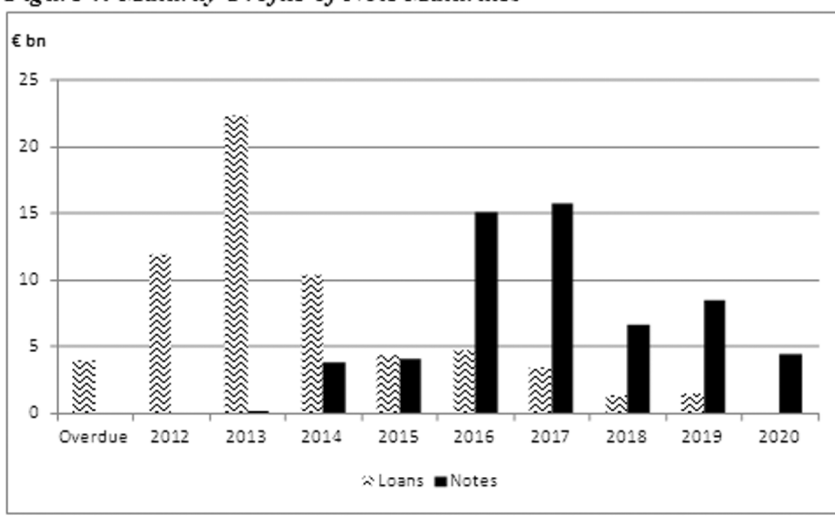
The peak years for maturities for loans originated as part of CMBS issuances is 2013, followed by 2012 and 2014. Generally speaking, CMBS loan servicers have tended not to be as liberal as the bank market with extensions, although in less creditor-friendly jurisdictions extensions and standstills have been more common. Another feature of CMBS transactions is the tail to final maturity of the notes which is required for rating purposes to allow sufficient time for a loan (or from the maturity date of the last loan in a pool of loans) to be refinanced or worked-out from its maturity date. Typically on note maturity, control over loan enforcement passes to the most senior noteholders and this is likely to increase the incidence of asset sales. The peak years for note maturities are not until 2016 and 2017, see Figure 4.

Figure 3: Maturity Profile of Bank European CRE Loans



Source: CBRE, Bank of America Merrill Lynch Global Research 2012

Figure 4: Maturity Profile of Note Maturities



Source: Bloomberg, Bank of America Merrill Lynch Global Research 2012

4.2.4 CRE loan performance

4.2.4.1 Comparative default rates

There have been certain views in the market that CMBS loans have performed particularly badly. This is a misconception and is likely to be due to the negative publicity surrounding all securitisation transactions following the US sub-prime crisis as well as the media coverage on certain high profile CMBS work-outs. To date, CMBS loans have performed well in comparison to CRE loans originated and held on the balance sheets of banks and in comparison to other structured finance asset classes.

Based on research published by BAML in January 2012 in the United Kingdom, as of 2011, 7 per cent of CMBS loans were in default compared to 26 per cent of balance sheet loans. In Europe, as of September 2011, 11 per cent of CMBS loans were in default in comparison 10 per cent of balance sheet loans (see Figure 5 below). Given both the availability of publically available information and the more flexible approach taken by banks to extensions and restructurings, the performance of CMBS loans would be expected to be better than the reported figures.

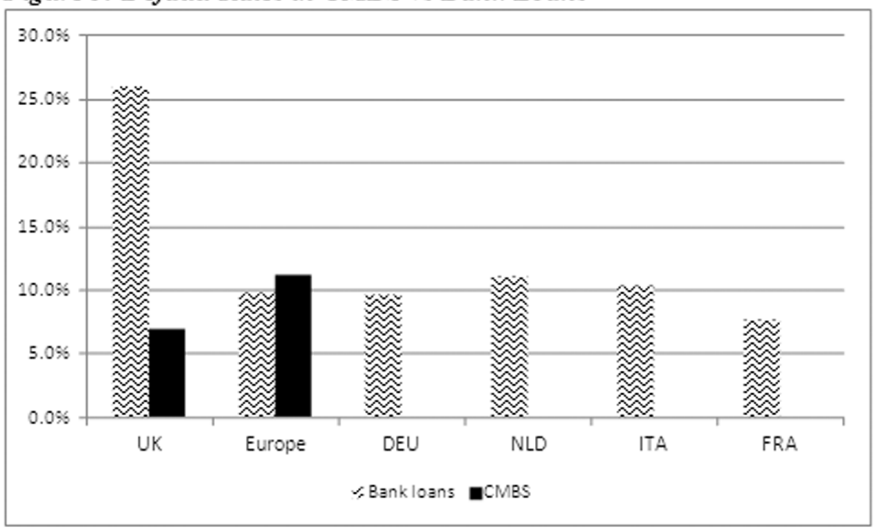
CMBS loans have typically comprised "cleaner" assets than those contained in balance sheet loans and, on the whole, any debt below investment grade was sold separately as part of a B note or junior debt which were predominantly acquired by commercial banks, building societies and specialist funds including CDO funds.[6] (See Figure 5).

The default rate of CMBS loans was higher than corporate and retail loans in Europe, but the differential drops significantly if balloon defaults are excluded. In addition, the peak years for maturities in the European leveraged loan market are 2014 to 2015 (two years later than the European CMBS market) and there would be an expectation that default rates for corporate loans will increase over time. (See Figure 6).

In relation to other structured finance asset classes, on a global basis, from 1990 to 2011 CMBS performance compares favourably to RMBS and structured credit generally both at investment grade and non-investment grade ratings in Fitch's Global Structured Finance Average Annual Impairment Rates (see Figure 7). During this period, CMBS had an average annual impairment rate of 3.34 per cent compared to 6.73 per cent for structured finance generally. Impairment of European CMBS loans however increased markedly in 2011 and is likely to deteriorate further in 2012 and 2013 as the markets experience the peak in maturities with limited refinancing capacity available.

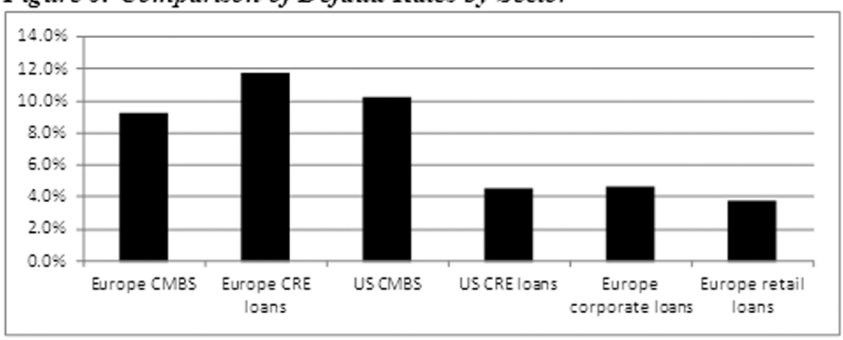
[6] See further Chs 14 and 15.

Figure 5: Default Rates in CMBS vs Bank Loans



Source: Bank of America Merrill Lynch Global Research 2012

Figure 6: Comparison of Default Rates by Sector



Source: Bank of America Merrill Lynch Global Research 2012

"Figure 7: Fitch global structured finance average annual impairment rates: 1990–2011"

Sector	Global SF	ABS	CMBS	RMBS	SC
AAA	0.53%	0.01%	0.02%	0.79%	0.91%

AA	1.79%	0.04%	0.16%	2.29%	2.25%
A	3.55%	0.17%	0.38%	5.25%	6.01%
BBB	6.43%	0.45%	1.10%	9.72%	6.68%
BB	13.14%	3.10%	3.42%	18.44%	12.64%
B	21.98%	14.79%	12.91%	26.50%	25.67%
CCC	57.75%	39.64%	37.31%	66.97%	53.02%
Invest-ment Grade	2.83%	0.15%	0.41%	4.09%	3.62%
Non-Invest-ment Grade	22.39%	10.50%	10.85%	28.03%	25.00%
All	6.73%	0.90%	3.34%	8.91%	8.13%
Source: "Fitch Ratings Global Structured Finance 2011 Transition and Default Study" March 16, 2012					

4.2.4.2 Causes of delinquencies

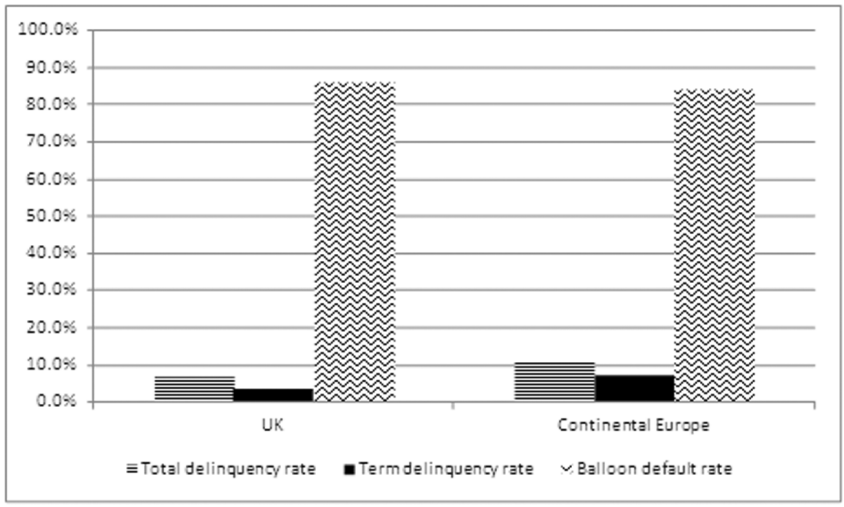
Based on BAML research from 2007 to 2011, approximately 85 per cent of loans in UK and European CMBS transactions failed to repay at their maturity date. Whilst this improved in 2011, it is likely to increase again in 2012 and 2013 as the market approaches the peak in maturities. The level of defaults during the loan term have been relatively low with 3.3 per cent in the United Kingdom and 7.3 per cent in Europe. The most notable defaults on CMBS transactions have revolved around those that are secured on secondary assets (e.g. Opera Uni-Invest, EPIC Industrious, REC6 Alburn, Gemini Eclipse) and most defaults generally relate to the significant drops in property value resulting in higher leverage and the limited refinancing capacity available in the market. (See Figure 8).

The analysis from Moody's in Figure 9 below, sets out the reasons for CMBS loans transferring across to special servicing and confirms the increased incidence of loans defaulting on maturity, especially in 2012. However, it also shows a marked increase in payment defaults during the term of the loan and LTV defaults are also likely to increase as servicers tend to call for valuations closer to the maturity of a loan.

4.2.4.3 Default rates

Figures 10 and 11 below, confirms the continued increase in the rate of special servicing transfer events and loan defaults and these are expected to continue to rise into 2012 and 2013 as we reach the peak of maturities.

Figure 8: Composition of CMBS Delinquencies



Source: Bank of America Merrill Lynch Global Research 2012

Figure 9: Reasons for Transfer of CMBS Loans into Special Servicing

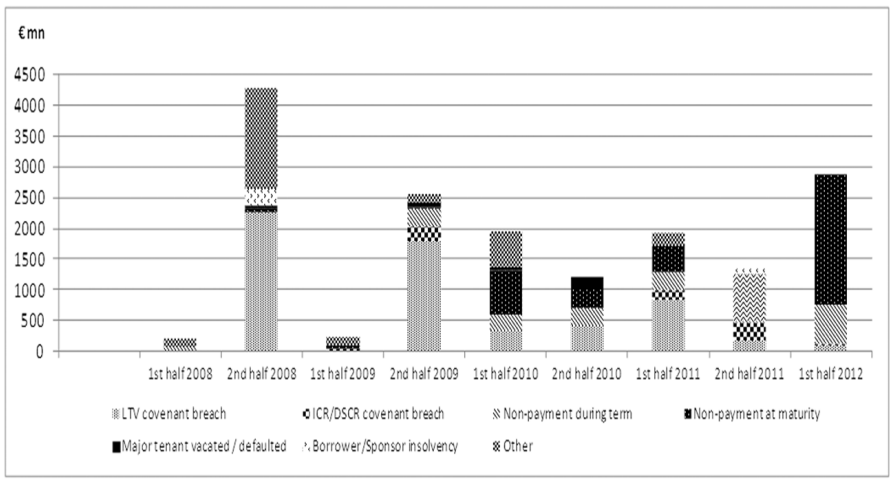
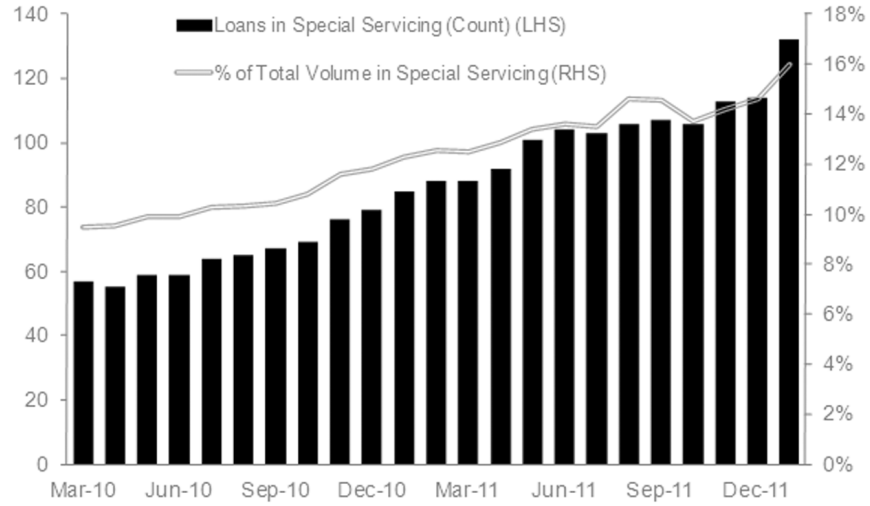
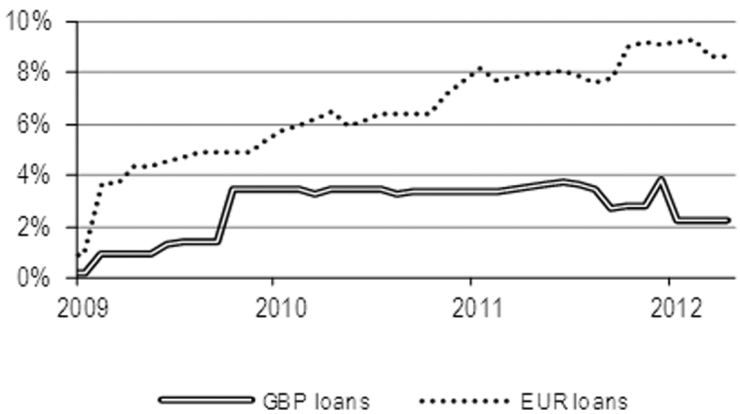


Figure 10: CMBS Loans in Special Servicing



Source: Moodys Investor Service, Morgan Stanley Research 2012

Figure 11: European CMBS Loans Delinquency Rate



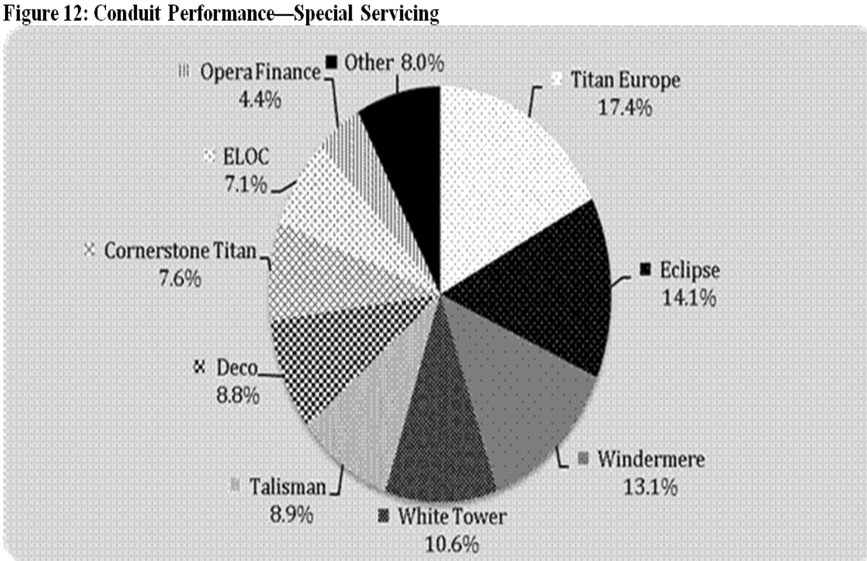
Source: Bank of America Merrill Lynch Global Research 2012

4.2.4.4 Conduit performance

There are different methodologies for measuring the performance of the CMBS conduits established by various banks in Europe. The three CMBS conduits that have tended to face most criticism from investors have been Titan Europe (Credit Suisse), Talisman (ABN Amro) and Eclipse (Barclays) and this may be due to a variety of reasons including default rates and loan and CMBS structuring.

Figure 12, (Pie chart detailing Conduit Performance—Special Servicing), from Moody's, sets out specially serviced loans per conduit as a percentage of total CMBS loans in special servicing that Moodys rated. Based on the latest statistics from Moodys the conduits with the highest incidence of loans in special servicing were Titan (Credit Suisse), Eclipse (Barclays) and Windermere (Lehmans).

Figure 12: Conduit Performance—Special Servicing



Note: Although not explicitly stated in the rating agency research reports, where the source refers to a rating agency report, the statistics only include loans rated by that rating agency, i.e. where a particular loan is not rated by that rating agency, it does not form part of those statistics.

4.3 Improving CMBS structures: Lessons learned during the downturn and CMBS 2.0

As mentioned in the introduction to this Chapter above, a number of lessons have been learned in relation to the structuring of CMBS transactions, in the context of the issues that many market participants have had to face since the advent of the financial crisis relating to (i) loan defaults and enforcement, (ii) consensual extensions and restructurings, (iii) availability of information, (iv) voting mechanisms and (v) the role of transaction counterparties. In order to encourage future CMBS issuance, it is important that these lessons are incorporated into future CMBS structures as part of what the industry refers to as CMBS 2.0. The rest of this chapter sets out some of the key issues faced as part of the experiences of restructuring a number of CMBS transactions from a structuring perspective.

4.3.1 Noteholder identification, liaison and voting provisions

One of the key issues that has arisen during CMBS loan restructurings, at the time of writing, is the time it takes to identify noteholders and then the ability for noteholders to organise themselves in a meaningful manner.[7] Noteholders also do not wish other noteholders or the market generally to become aware of their CMBS holdings and wish to ensure that if they become restricted from trading due to receiving material non-public information as part of private deal discussions that they are appropriately and promptly cleansed. To avoid noteholders becoming restricted inadvertently it is also very important that as part of any informal discussions they do not disclose to each other price sensitive information or engage in actions/discussions which in themselves would result in them becoming restricted.[8]

Noteholders have sometimes also shown apathy to less significant changes to CMBS transactions that have still required a general meeting. In addition, the existing system which relies on the issuance of RIS notices or messages being sent through clearing systems has not always proved to be effective in reaching the beneficial owners of the notes and a number of general meetings fail as a result of not reaching appropriate quorum levels. Whilst the situation has, at the time of writing, improved quite materially it could be further improved by simplifying the voting process for certain limited matters and creating a forum through which noteholders can register their interests in a transaction on a confidential basis.

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7 See further Ch.10.
8 See further Ch.7.

4.3.1.1 Noteholder identification and liaison

The ability to identify noteholders and organise them in a meaningful manner has increased in recent years through the role played by a number of financial advisory firms specialising in CMBS restructurings and tender offers. However, for future transactions, a CMBS noteholder "forum" could be utilised to facilitate the identification of and communications between noteholders. The participating noteholders should be primarily responsible for the operation of any meetings and subsequent actions undertaken by the forum. A "forum co-ordinator" could also be appointed at the outset with experience of interacting with and/or representing noteholders, or, they could be the party that manages the relevant investor reporting website (e.g. the cash manager). On the issue date of each transaction, the lead manager(s) would provide the forum co-ordinator with a list of the initial investors which would form the basis of the forum. Future noteholders would be invited to identify themselves to the forum co-ordinator who would use this information to contact noteholders for the purposes of the forum.

Any noteholder that is a member of the forum or any transaction party (including the issuer, cash manager, trustee, servicer and special servicer) should have the right to request the forum co-ordinator to send a notice on its behalf to the other members of the forum to arrange meetings. It would be necessary for any such notice that is issued, confirms whether any discussions with other noteholders will comprise any "price sensitive information" and the proposed mechanism and responsibility for "cleansing" the same.

4.3.1.2 Voting rights: Negative consent

Negative consent processes can be used for certain limited matters to reduce the time taken to pass resolutions, deal with noteholder apathy and save time and costs by avoiding formal general meetings. They have already been incorporated into recent CMBS issuances under the DECO programme. In such a process, a meeting of the noteholders does not actually take place and it only requires noteholders to participate if they wish to object to a particular proposal. A formal notice detailing the resolution would still be distributed, but the notice will contain a statement requiring noteholders to inform the note trustee in writing within a certain number of days if they object to such a resolution. Unless more than a specified percentage makes a written objection to the resolution, it will be deemed to be passed. A negative consent process should preferably only be used for technical or administrative matters by the transaction counterparties and should exclude significant issues, such as basic terms modifications, and waiver or acceleration of a note event of default.

4.3.1.3 Voting rights: Connected parties

In a number of transactions, borrowers or transaction counterparties or their affiliates have acquired CMBS notes or junior debt and this has created clear conflicts of interest when voting is being undertaken or rights are granted on matters that may impact the holder of such debt. Should a borrower or equity sponsors or any actual/prospective transaction counterparty or their affiliates acquire or otherwise control notes, the relevant holder of the notes should be prohibited from exercising any voting or rights or attending any meeting of the noteholders.[9]

4.3.2 Servicing and controlling party rights

4.3.2.1 Servicing standard

There has been much debate on the appropriateness of the servicing standard used by servicers in CMBS transactions. As will be discussed in the following three chapters, the typical language requires the servicer/special servicer to maximise recoveries at the loan level on a present value basis taking into account the interests of the lenders as a collective whole as opposed to any individual tranche (other than taking into account subordination). In addition, it may apply generic standards such as applying the standards of a reasonably prudent lender.

The responsibility of the servicer is therefore to focus at loan level only and to ignore the impact of matters that occur at note level such as liquidity facility drawings, servicer advances and sequential payment triggers. This can sometimes create unusual results where a servicer strategy may maximise recoveries at loan level but may negatively impact the level of recoveries at note level or recoveries as between different noteholders due to the manner in which certain structural features at note level operate. A number of these matters can be addressed by changing the structural features at CMBS level such as the appraisal reduction mechanism on liquidity facilities (e.g. so that liquidity facilities are not drawn on junior tranches when the prospect of recovery on those tranches is very low) or improving the definition of sequential triggers (so for example once has loan continues past its original maturity date regardless of an extension that loan is included in the cumulative percentage of loans required for a sequential trigger to operate).

The role of the servicer can become difficult and unduly complex if it has to start taking into account the interests of individual noteholders, however, whilst the servicer clearly need not take into account note level facilities or mechanisms (other than any swap termination payments that reduce or increase the level of recoveries at loan level) in determining and applying

[9] See further the DPO section of Ch.14.

their strategy under the servicing standard, they should be more open to hearing (with no obligation to act upon) representations from noteholders (on the impact of the servicer's proposed strategy on note level facilities or mechanisms). In addition, servicers should improve their overall communication with noteholders through regular public meetings (and presentations being distributed to the market) which provide information on loan performance and work-out/recovery strategy. By making these meetings/presentations public there is no risk of market abuse or inadvertently restricting noteholders.

The discount rate applied by servicers can have a significant impact on the course of action a servicer decides to take when applying the servicing standard and it is important that servicers have consistent principles for the evaluation of any discount rate to be applied pursuant to a PV calculation under the servicing standard. This is not always the case.

4.3.2.2 Appointment of servicers and special servicers at outset

Certain agented CMBS transactions have no servicer at all (e.g. Mall Funding, LoRDS1) and certain CMBS conduits (Real Estate Capital in particular REC5 Plantation Place and REC6 Alburn) have not had a special servicer identified and appointed at the outset. This has created various issues and all CMBS transactions, whether conduit or agented, should have an independent third party servicer and special servicer designated as part of the structure at the outset. Where there is no concept of a servicer it results in an increased emphasis on the role of note trustees who by their very nature do not wish to exercise any of the type of discretion that servicers exercise on a daily basis. Consequently costly and time consuming general meetings may be required in order to give note trustees directions on what actions to take, e.g. enter into standstill arrangements.

4.3.2.3 Representations on appointment of replacement special servicer

There has been much market discussion on whether, on lucrative special servicing appointments, the replacement special servicer has financially incentivised the party with the right to replace the special servicer to influence their appointment. Whilst this issue can be addressed through democratising the power to replace amongst a broader group of noteholders (as referred to below) any replacement special servicer should also be required to represent and warrant prior to its appointment that it has not offered any inducement or other incentives to any controlling party or any transaction counterparty or their advisers involved in the appointment process.

4.3.2.4 The role of the servicer in making loan amendments/restructuring discussions

Many borrowers complain of the uncertainty they face when dealing with servicers in understanding what authority the servicer has to agree certain types of loan amendments and if the servicer does not have the authority then there should be a much clearer noteholder process. This Chapter has already touched upon the latter relating to noteholder identification and liaison. The servicer also needs to know that they have the requisite power to act on a range of clearly defined matters through engaging appropriate professional advisors and organising and liaising with noteholders. In so doing, the servicer's liability concerns for actions it may take are addressed and the servicer may have to face greater liability as a result of not taking the action. The servicing agreement should explicitly state that the servicer, on behalf of the issuer, can and is expected to take such action to agree amendments to loan documentation that the servicer believes are consistent with its obligations under the servicing standard.

4.3.2.5 Restructuring negotiations without the servicer

In a number of restructurings, borrowers have attempted to negotiate restructurings directly with noteholders through an ad-hoc group and to side-step the role of the servicer. This has created issues where certain noteholders have felt disenfranchised from the process, or, where different terms have been struck with different noteholders. A servicer is typically required to take into account the interests of all noteholders and the servicer's involvement should reduce the likelihood of such instances arising. The transaction documentation should provide that the servicer be informed of any meetings between the borrower and noteholders and have the right to attend such meetings. The borrower should only have the right to meet with the noteholders without the servicer being present, if for whatever reason, the servicer does not wish to participate.

4.3.2.6 Restructuring discussions constituting possible event of default

Historically, facility agreements have stated that there will be an event of default if the borrower "commences discussions with one or more of its creditors with a view to rescheduling any of its indebtedness". Such language has inhibited discussions between borrowers and servicers as to potential restructuring strategies on certain restructurings. The servicing agreement should clearly permit the servicer to waive such a provision in advance of such discussions or allow for "without prejudice" discussions to take place.

4.3.2.7 Loan sales by servicers

In many CMBS transactions, the sale of loans by the servicer is not permitted and this reduces the potential options that are available to servicers where it determines that a sale of a loan is likely to maximise recoveries.[10] This was sometimes prohibited due to the accounting requirements faced by conduits established by US investment banks. Where such prohibitions do not apply, the CMBS transaction documents should permit the possibility for a loan sale, provided it is consistent with the applicable servicing standard and a sale of the loan would be the optimal method after considering the estimated proceeds for all other potential methods of realisation along with the risks and costs with respect to such other methods.

4.3.2.8 Ability of servicers to raise capital for essential capex or opex

On certain CRE and CMBS transactions the borrower has, at the time of writing, on occasions entered into insolvency in less creditor-friendly jurisdictions or assets are sold at potentially lower recovery values due to the inability to raise additional capital to fund costs and expenses necessary to improve or preserve the value of the underlying property (e.g. payment of property protection expenses, buildings insurance, capex to reposition a property) or short term opex to avoid insolvency. Greater flexibility would be available in these instances if the servicer had the ability, subject to certain controls, limitations and caps, to raise additional capital (where it is not already provided for in the liquidity facility or through a servicer advance facility) to fund such costs and expenses.

4.3.2.9 Controlling party, dynamic control valuation event and replacement of the special servicer

As will be discussed in the following three chapters, CMBS transactions have a concept of a "controlling party" that is appointed with respect to each loan in a CMBS transaction. The controlling party for a particular loan typically has certain rights, most notably the ability to appoint an operating adviser, replace the special servicer and have consultation or consent rights in relation to certain amendments for such loan.

In some CMBS transactions, the controlling party does not change based on a control valuation event, or in many deals, once the control passes to the notes, the most junior tranche of notes is not subject to a control valuation event and the valuable rights associated with it (in particular the replacement of the special servicer) remain with a lender or class of notes that are heavily out of the money and whose interests are not aligned with more senior noteholders. This has, to date, potentially created situations

[10] See further Ch.7.

where controlling parties have undue influence on special servicers and therefore the outcome of a restructuring/work-out process and demand for acquiring debt which has such valuable controlling party rights has increased dramatically notwithstanding that any special servicer will be required to act independently pursuant to the servicing standard.

The calculation of which party is the controlling party or controlling class (in the case of the CMBS notes) should therefore always be dynamic and based on a specified valuation process and the principal amount outstanding of the relevant tranche whether reduced due to amortisation, pre-payment or write-offs.

In addition, it is important that the rights of the controlling class do not unduly empower the holder(s) of a single tranche of debt and that the ability to replace the special servicer. Accordingly, while the controlling class should benefit from consultation rights, the right to replace the special servicer should be assigned more broadly to a wider group or class of noteholders or a broader group of noteholders should have a veto right on the appointment of a replacement special servicer by the controlling party.

4.3.2.10 Replacement of the primary servicer and other transaction parties with a pure service function

Whilst a special servicer can be replaced, it is usually very difficult to replace other transaction counterparties, which has not, in the past, always encouraged high levels of performance. This could be rectified by providing for the replacement of all transaction counterparties. For example, if requested by more than 10 per cent of noteholders in aggregate, a noteholder vote can take place to replace transaction parties without cause (including the primary servicer, the cash manager, forum coordinator, the note trustee and if appropriate mechanisms are put in place, the security trustee).

4.3.3 Role of note trustees

The role of the note trustees has also come under much debate as CMBS transactions can sometimes be subject to increased costs or delays due to the requirements placed on note trustees and the unwillingness of certain note trustees to exercise any level of discretion whatsoever.[11] In certain instances, general meetings have been called on matters where the cost and process was arguably unnecessary (e.g. REC 3 Foundation—replacement of asset/property manager) or where a process is delayed due to the note trustee looking for additional indemnities, before proceeding with a course of action. The role of note trustees should therefore be limited to the oversight of mechanical processes and checking compliance with or, if

[11] See further Ch.10.

appropriate, passive monitoring of prescribed objective criteria. Note trustees should generally not be required to exercise any discretion, but where note trustees are asked to exercise any discretion then the note trustees should have the ability to obtain appropriate expert advice including legal, accounting, financial or property advice, at a reasonable cost which is charged to the transaction. The note trustee should place primary reliance on the use of the expert advice to make any determination and rely on the standard market liability terms of professional advisers rather than seeking additional indemnities in addition to the standard deal level senior ranking indemnity already provided. The documentation should also establish at the outset, whether any role of the trustee allows the trustee to request additional indemnification (and from whom). A trustee should only be permitted to withhold exercising discretion in the absence of an indemnification where both the reliance on expert professional advice and the standard deal indemnity are clearly insufficient in relation to the level of any potential claim they may face.

4.3.4 Valuations

Valuations are an essential tool in assessing the credit risk on a loan, both at the outset and on an ongoing basis. They provide important information in relation to the level of leverage and implied equity in a deal, and the quality, marketability, performance and suitability of the underlying real estate collateral as well as important market data on comparables. Valuations are, however, not always an exact science and there will always be a certain degree of variation between different valuers. Lenders have sometimes historically accepted the practice by borrowers of "valuation shopping" where borrowers select and present their choice of valuer at the outset who they know will give the highest potential valuation. The borrower may also have the ability to select and instruct the valuer of their choice on future valuations. In addition, a number of CMBS transactions have no provision for adequate periodical valuations and even where they do servicers have been reluctant to call for valuations unless the loan maturity is approaching. Consequently, many CMBS transactions report LTVs that are historical in nature and have no bearing to the actual leverage on the underlying properties and therefore the credit risk of the loan.

It is important that underlying loan agreements provide for annual valuations commissioned by the servicer. The servicer should have the discretion to waive the provision of an annual valuation pursuant to the servicing standard, provided it sets out the reasons for the exercise of such waiver in the quarterly reporting. A valuation should always be obtained every twelve months where a loan event of default has occurred and is continuing. Whilst the potential identity of any valuer can be discussed with the borrower and the controlling party, the determination of which valuer should be used, should ultimately only be made by the servicer. If the servicer reasonably believes that there has potentially been a material

decline in the value of the underlying property, it should also have the power to request an additional valuation (except if it has only been a few months since the annual valuation), which should (unless an event of default has occurred) be a desktop valuation. Noteholders should also be able to direct the servicer to request either a desktop valuation or a full valuation if a valuation has not been obtained within 12 months.

4.3.5 Transaction structure features

4.3.5.1 Class X notes and excess spread

CMBS transactions are typically structured so that the aggregate interest that accrues on the loans exceeds the aggregate amount of interest that accrues on the CMBS notes and certain CMBS level expenses. This excess amount is commonly referred to as the excess spread. One of the most contentious issues in existing CMBS transactions has been the extraction of excess spread by the arranging bank or the creation of tradeable securities out of the excess spread which are then sold or retained by the arranging bank to third parties.[12] Many CMBS transactions provided revenue for the originating or arranging bank through the extraction or sale of at least a portion of this excess spread and this revenue stream was structured and defined in a number ways including class X notes, deferred consideration, residual interest or retained interest. Whilst part of this revenue stream could be utilised to recover certain upfront transaction costs of the CMBS transaction, it could also yield significant profits for arranging banks and certain class X note structures have permitted ongoing revenue extraction even when the underlying loans are stressed or distressed and there are significant shortfalls to noteholders or liquidity facility drawings.

The main historical issues with such revenue streams and in particular class X notes have been the lack of disclosure of the detailed structure, certain structural features (e.g. how extraneous expenses are met) that potentially result in shortfalls for noteholders which would otherwise be met by excess spread, shortfalls to noteholders or liquidity facility drawings at a time when the beneficiary of the revenue stream continues to receive payments and the potential for default interest, consent fees, increased margins and ongoing excess spread to be paid to such beneficiary after the loan maturity.

In order to mitigate against these issues clear disclosure is required on (i) the existence and nature of any such excess spread revenue streams, (ii) the calculations by which it is determined; (iii) whether it is to be retained by the originating bank, servicer/special servicer or the borrower or their affiliates; (iv) which expenses will or will not be effectively absorbed by the this revenue stream; (v) whether such revenue is paid senior or subordinate

[12] See further Ch.5.

to payments due on the other CMBS notes; and (vi) whether the liquidity facility drawings or servicer advances can be used to support the revenue payments.

Furthermore, holders of such excess spread revenue streams should not benefit from default interest, increased loan margins, consent fees on a restructuring and interest after loan maturity and careful consideration should be given to switching off the revenue payments after there have been material loan defaults.

4.3.5.2 Principal payments—definitions and sequential triggers

Issues have arisen on CMBS transactions on how different types of principal receipts should be allocated in all scenarios such as the application of the allocated loan amounts and release premiums whether due to property sales or property refinancings. It is important that this is clearly defined, together with ensuring that the party responsible for determining the allocation receives all information required in order to determine how to treat the allocation of the relevant principal.

Many CMBS transactions further have a sequential trigger based on the cumulative number of loans as a percentage of the principal amount outstanding of the total portfolio being in default (with no standardisation on the percentage of defaults or the nature of defaults). There has also been some debate, as well as court hearings, on whether loans that are extended as part of a restructuring should form part of the sequential trigger, as they would have otherwise defaulted. To provide clarity, loans which are subject to a material payment default, after any applicable grace or cure period, or that reach their original maturity date (unless an extension is specifically provided for and permitted in the original loan documentation), regardless of whether a standstill or extension is agreed by all of the parties, should be included towards the sequential trigger threshold calculation.

4.3.5.3 Liquidity facilities (and servicer advances)

In many CMBS transactions, the appraisal reduction mechanism in liquidity facilities has not been structured to fully take into account whether interest paid on certain tranches will be fully recoverable. With the significant decline in real estate values and performance since the advent of the financial crisis, many senior noteholders find themselves in a position where the liquidity facility is being drawn to cover interest shortfalls on junior tranches that have no prospect of recovery. In these instances, the repayment of the liquidity facility will ultimately come from proceeds that would have been paid to more senior noteholders, thus reducing their recoveries.

Appropriate mechanisms should therefore be considered which restrict the amount that can be drawn from the liquidity facility to pay interest on certain notes, if there has been a decline in the collateral performance/ value. For instance, the liquidity facility may not be available to pay interest shortfalls on any notes that have been valued out in accordance with the definition of a control valuation event, or, on the basis of a calculation of estimated recovery proceeds from time to time, they will suffer a principal loss of at least 90 per cent of their principal amount outstanding.

To avoid uncertainties on renewals of liquidity facilities, as has sometimes been the case, the procedure for renewing the liquidity facility should also be clearly laid out in the documentation with clear responsibility allocated to a single transaction counterparty (typically the cash manager) to deal with the renewal process.

4.3.5.4 Hedging

As will be discussed in Ch.8, hedging structures in some CMBS transactions have come under criticism due to the extended maturity of swaps compared to loans (e.g. Gemini Eclipse, Titan NHP), the lack of disclosure (e.g. LoRDS1) and favourable rights for the swap counterparty (Gemini Eclipse). The use of long dated swaps has typically been due to borrowers looking to achieve the lowest funding costs (where there is a negative yield curve), favourable ratings treatment as a result of locking in part of the refinancing risk on loan maturity and for the bank/swap counterparty potentially increased profits.

Generally, the maturity date of any hedging should be similar to the maturity of the loan and there should be full disclosure of the hedging details and structure. To the extent that the maturity date of any hedging arrangements extends beyond loan maturity, consideration should be given to including the hedging termination costs in the calculation of any LTV or control valuation event calculations.

4.3.5.5 Note maturity

To date, the European CMBS markets have only witnessed a single transaction reaching note maturity (Opera Uni-Invest) and this unique event created some uncertainty on who has responsibility on note maturity and the process to be followed.[13] The CMBS transaction documents need to contain adequate provisions to address what will happen if the notes are not repaid at their maturity date. For instance, if a loan remains outstanding twelve months prior to the final maturity date of the CMBS notes, the special servicer could be charged with providing various work-out options for noteholders to consider which should also include an analysis of the

[13] See further Ch.3.

optimum method of enforcement and which type of insolvency procedure to use. If no option proposed by the special servicer receives approval by the requisite number of noteholders, the note trustee for the CMBS should be deemed to be directed by the noteholders to appoint the relevant insolvency practitioner based on the analysis of the special servicer, or, if none, the analysis of its own professional advisers, in order to realise the secured assets of the issuer at such time as the security for the CMBS becomes enforceable in accordance with its terms.

4.3.5.6. Asset and property management

In legacy CMBS deals, insufficient consideration was given to how asset/property management issues would be addressed where borrowers, or their affiliates, were also the asset managers/property managers and whether such borrowers or their affiliates were fully qualified to undertake such roles. The role of the asset/property manager is an extremely important one especially when there are property performance issues and the ability to replace the asset/property manager is fundamental, especially on a loan event of default. On a number of restructurings, or defaults, it has not been possible to replace the borrower, or its affiliate as an asset/property manager, unless an insolvency process is followed. In certain jurisdictions, the insolvency process may be unduly costly, time consuming and the special servicer may lose control of the recovery process to a local insolvency administrator appointed by the courts (e.g. Germany).[14]

It is important that any asset manager or property manager should be reputable, with relevant experience in managing properties of a similar nature. The terms of their appointments should be set out in separate agreements and such terms should be in line with market standards, particularly in relation to fees and the duties of the parties. It is recommended that should the asset management and property management be carried out by the borrower or one of its affiliates, the terms of such appointment are on an arm's length basis and can be terminated by lenders (directly or indirectly) through duty of care agreements on a loan event of default occurring.

4.3.5.7 Less creditor-friendly jurisdictions

Where properties are located in less creditor-friendly jurisdictions, the corporate structure of the borrower group and the related security structure should be designed to provide the lenders with an efficient and effective process for taking enforcement. In many instances, since the advent of the financial crisis, borrowers have been in a position to hold lenders/servicers to ransom, by threatening to push their companies into insolvency unless certain fees are paid or they are given an ongoing role in any restructuring

[14] See further Chs 6 and 17.

or sell-down which also attracts certain fees. Also, junior lenders threaten to withhold their consent to a restructuring and thus cause an insolvency event unless certain fees are paid. This is typically in jurisdictions which are less creditor-friendly such as France, Germany and Italy.

Offshore holding companies or trust or fiduciary structures should, if possible, be put in place together with appropriate share pledges to allow enforcement proceedings to take place in creditor-friendly jurisdictions. In addition, measures should be taken to ensure that the COMI of the holding company will remain in the creditor-friendly jurisdiction. Further, all intercreditor agreements with other subordinate creditors should contain release provisions in order to allow the servicer or special servicer to enforce over its security without obstruction as a result of these other subordinate debt positions.

4.3.5.8 Synthetic securitisations

In certain synthetic CMBS transactions, it is unclear in whose interests the servicer is required to act, the noteholders or the originating bank who continues to hold the underlying commercial mortgage loans. The originating bank has also usually acquired credit protection through a credit default swap (CDS). This creates conflicts of interest as it is usually the bank which is also the servicer and losses on the commercial mortgage loans will result in the bank receiving payments under the CDS. Restructurings can also constitute credit events under the CDS documentation which requires negotiations with the beneficiary (i.e. the bank) in order that certain payment mechanisms can be agreed. It is therefore rare for loans in synthetic CMBS transactions to be restructured unless the bank also owns a junior loan/equity and is therefore incentivised to consider and take forward a restructuring.

The servicing arrangements for synthetic CMBS securitisations should be structured to adequately protect noteholders. The servicer should be appointed by the issuer and the note trustee rather than by the originator, so that the servicer will act in the best interest of those parties and the servicer should be required to service the loans in accordance with a servicing standard similar to that used on cash CMBS transactions. As far as possible, the servicing arrangements should be designed to closely match the arrangements used on cash CMBS and create adequate incentives for the servicer to act in the best interests of the noteholders (and, where applicable, the junior lender) without creating any conflict between the duties of the servicer and the interests of the lender of record as swap counterparty, even where the lender of record is itself performing servicing functions (whether as master servicer or delegate servicer).

The ability of the credit default swap protection buyer (typically the lending bank) to influence any amendments or modifications to a loan and the

definition of credit events in the credit default swap documentation should be fully disclosed in detail. Also careful consideration should be given to the definition of restructuring event so that it also reflects the nature of restructurings that have occurred in recent years, which have primarily involved extensions where the determination of future receipts of principal or interest is not always certain.

4.3.5.9 Warranties

In the period up to 2007, the loan representations and warranties given by originating banks to the Issuer were diluted with little resistance from noteholders or rating agencies. The representations and warranties covered a range of areas relating to origination, due diligence, the properties and the security. Breach of a representation and warranty typically resulted in the originating bank buying back the relevant loan. There have only been a few cases of loan buy backs for such breaches in European CMBS (e.g. the Tintagel House Loan in the Bellatrix (Eclipse 2005-2) CMBS bought back by Barclays Bank (Servicer: Capita Asset Services)) and this is primarily due to the limited level of representations and warranties that were given and not all servicers fully pursing such claims. The European CMBS industry needs to produce a set of detailed and objective representations and warranties for use in future transactions. Any disclosure or exception to a representation and warranty should be set out immediately below the specific representation and warranty.

4.3.6 Disclosure and transparency

4.3.6.1 General

The European CMBS industry requires significant improvement in (i) the overall levels of disclosure and (ii) standardisation of disclosure across transactions. This applies to pre-issuance and post-issuance disclosure of property and loan information, valuation reports, loan level and CMBS level documentation (in particular intercreditors), hedging, property and loan data and cashflow models. It is also important that both primary and secondary investors have access to the same level of information. Improving disclosure is a necessary pre-requisite to rebuilding investor confidence in CMBS and encouraging ongoing liquidity in the sector.

Key disclosure issues that have arisen on transactions include:

- Limited information on junior, pari-passu or super senior debt and any related entrenched rights, purchase and cure options and enforcement rights;
- Entrenched rights of junior lenders or control parties not disclosed in sufficient detail;

- Limited information on hedging, including nature of hedging, structure, maturity or the mark-to-market valuation;
- Limited information on structural features such as class X notes or control party mechanics;
- Lack of access to documentation in most cases limited to CMBS documents and even then access is available only at the Issuer's office in person;
- Very limited or current valuation information is made available;
- Ongoing loan level reporting lacks detail and any meaningful commentary;
- On certain deals basic information such as the LTV of the securitised loan is not provided;
- RIS notices are not always issued when key events occur;
- Lack of provision of transaction data at all or in an appropriate format;
- Provision of cashflow models to enable ongoing modeling, assessment and pricing of CMBS Notes has not been consistent;
- Enhanced information is made available to primary investors compared to secondary investors.

Disclosure matters must be adequately addressed in the full chain of documentation commencing with the loan and through to the servicing agreement and cash management agreements. It must also be addressed at the time of issuance, as otherwise it is too late to remedy. Information and data provided by the borrower in its regular reporting should be in a format that can be used in the loan level reports prepared by the servicer (i.e. in an electronic and downloadable format) and should be provided within a timeframe that enables servicers to prepare reports with adequate time prior to the note interest payment dates.

Access to information should also be made available to all in an electronic downloadable format through the servicer or the cash manager on an investor reporting website maintained by a party to the transaction, a third party website or both.

There should also be greater disclosure in relation to:

- Conflicts of interest, e.g. ownership of debt by the special servicer; the appointment of affiliated entities by transaction counterparties and the related fees;
- The identity of the borrower and the ultimate sponsor(s) holding a certain percentage of the equity;
- Key information in respect of the transaction counterparties including the business, experience, financial standing and ownership of the key transaction parties. In relation to the servicer and special servicer, there should be disclosure on their experience in relation to the loans and collateral (and the country in which the collateral is located) which form part of the CMBS and the ability of the servicer or special

servicer to implement potential work-out strategies with or without consent (e.g. restructuring, enforcement, sale of loan);

- Fees payable to the transaction counterparties and their professional advisers where these are being met out of transaction cashflows should be fully disclosed;
- The recipients of any material ancillary cashflows such as loan prepayment penalties, loan consent fees, loan default interest or gains on hedge terminations.

It is important that the CMBS industry does not create disclosure requirements that result in borrowers deeming CMBS to be far too onerous as a funding source, with commercially sensitive information being made available publicly to all, including competitors and tenants. This would result in a competitive advantage to the balance sheet lending market (where the information would only be seen by the lending banks) and whilst this is not at the time of writing, a real threat, as the banking market hopefully continues to improve, it will become increasingly so. Some will argue that the cost of accessing the capital markets comes with increased disclosure requirements, however, it is important that there is some recognition of trying to achieve an appropriate balance and hence subject to certain restrictions (e.g. not resulting in market abuse) information should not be disclosed would prejudice ongoing commercially sensitive negotiations by the borrower (e.g. sale, lease renewal or rent review negotiations) which in the reasonable opinion of the servicer would be materially prejudicial to noteholders.

4.3.6.2 Transaction documents

CMBS level transaction documents (including the servicing agreements) should be made publicly available. Loan level documents which deal with cash flows and security, which have a significant impact on the CMBS (e.g. the loan agreement, intercreditor agreement and hedge agreements) should be made available. In the absence of any of the above documents being made publicly available, the summaries in the offering circular should be detailed and should include all material information (and failure to disclose such information should constitute a breach of warranty).

4.3.6.3 Investor reporting[15]

Key improvements in CMBS investor reporting would include:

(i) Enhanced loan level reporting, including more commentary on individual loan performance and the properties on which each loan is secured;

[15] See further Ch.12 and Appendix 4.

(ii) Enhanced portfolio level reporting, including a summary of the aggregated loan portfolio and property characteristics and commentary on any significant changes to overall portfolio performance;
(iii) Watch listed loans and events, including the reasons for transfer to the list;
(iv) Specially serviced loans and events, including the reasons for transfer to the list;
(v) Recoveries and application of proceeds on any property or loan disposals, including the application basis (i.e. pro-rata, sequential or reverse sequential as between loans);
(vi) Loan covenant breaches and causes as well as any cures or remedies by the borrower or junior lender (to the extent not covered in portfolio level reporting);
(vii) Any recovery action taken in relation to a loan, including enforcement/foreclosure, loan sale(s) and restructurings/work-outs; rationale for selecting a particular recovery option over another (all to the extent publically disclosable) (this may alternatively be included in the portfolio level commentary above);
(viii) For worked-out loans, a detailed loss determination including cost items and distribution of recoveries. Breakdown of the collateral sale proceeds, e.g. sale price, sale costs, receiver cost, special servicer costs (special/work out/liquidation fees), legal costs, and allocation of the net sales proceeds in the waterfall of payment;
(ix) Any loan extensions exercised (or exercisable) in the period or historically;
(x) Any previous restructurings agreed between the finance parties;
(xi) Details of controlling party (where there is an A/B structure) or controlling class;
(xii) Details of any control valuation events that may have occurred in the period (and details of the basis on which control passes from the junior loan to the securitised loan;
(xiii) List of all material triggers/events referred to in the offering circular, such as counterparty-related triggers, performance triggers, issuer events of default and available funds caps, and in particular sequential payment triggers;
(xiv) Details of issuer level fees and costs in the period including transaction counterparties and professional advisers (where fees are paid out of transaction cashflows);
(xv) List of all key parties and their current ratings (both short-term and long-term) together with any related trigger levels.
(xvi) Details of any hedging including: counterparty and notional, applicable rates, mark-to-market valuations, payments made/received, any collateral postings;
(xvii) Appropriate issuer level commentary including commentary on:
- Any liquidity facility drawings in the period;
- Any sequential payment mechanism triggers in the period;
- The application of any available funds caps, deferred interest or similar interest shortfall mechanisms; and

- Details of any rating action and a summary of the reasons for action taken in the period.

4.4 Conclusion

The European CRE debt markets will continue to face challenging times over the next several years whilst additional refinancing capacity is established, legacy issues are worked through and banks, insurance companies and pension funds become more familiar with the revised regulatory framework. Whilst banks will continue to be the core providers of real estate debt capital, alternative real estate lenders including the insurers and new debt funds will establish themselves with varying degrees of success. The capital markets offer the broadest and deepest potential investor base and should play a much larger role in the new landscape. Europe's experience with CMBS to date has been mixed with a number of concerns over structural and disclosure issues but with strong relative performance to date of (i) CMBS loans to balance sheet loans and (ii) CMBS to other structured finance products. There is of course a continued risk that performance of CMBS loans and therefore CMBS could deteriorate further as we hit the peak of maturities. Many of the structural features of European CMBS were borrowed from the United States, adapted on an ad-hoc basis by certain issuers and then adopted by other issuers without careful consideration. Industry wide initiatives led by organisations such as the CREFC (and its CMBS 2.0 Committee) and publications such as this together with pressure from new investors, will be crucial in ensuring that the structures in CMBS 2.0 are far more robust and more appropriate for the European CMBS markets. What shape the new capital markets based debt products will take in coming years is uncertain but CMBS 2.0 is expected to comprise a core part of any capital markets offering.