

Blog Post

CMBS 2.0 Reps and Warranties Take Center Stage

Posted on **July 28, 2010** by Peter K. McKee, Jr.

For several months investment-grade bondholder, b-piece investor and special servicing (collectively, "investor") interests have been in the laboratory, working on a version of loan representations and warranties that protects their interests and cures the perceived ills of pre-recession CMBS loan underwriting. At the behest of the Commercial Real Estate Finance Council (CREFC), investor interests are now meeting with loan originator, loan seller and issuer (collectively, "issuer") interests to see if there is consensus for a set of so-called "model" reps and warranties. The notion is that issuers would be free to make whatever loan reps they chose, but would have to disclose differences between the model reps and theirs. There is an obvious negative presumption attached to reps that depart from the model set.

Much is at stake: not only loan processing requirements that lenders make of borrowers, but also the fundamental allocation of risk between issuers and investors and its inevitable loan pricing impacts. Further, there is the relative certainty that a regulatory response (in the form of the SEC's Regulation AB) will fill any vacuum created by lack of consensus.

First, full disclosure: this law firm represents loan originators and issuers, as well as special servicers. The editorial viewpoint adopted here is my own, formed by a sense of what loan origination practices have worked or not, and viewed in the context of market precedents and the historical allocation of risk between origination and investor interests.

What is the current market saying about reps and warranties?

There have been a few deals in the market in the last six months, and others that are queued up. Have those reps looked different from pre-recession reps? Actually, no. Investors in those deals have not pushed for loan reps to be more stringent, though, to be fair, this could be a reflection of the more conservative loan underwriting and deal structure that has prevailed to this point in the securitization market's return.

So the investors' draft of model reps, however desirable it may seem, is not essential to the return of a functioning market. Is it a good idea nonetheless?

It depends.

If a consensus can be reached that takes market precedent into account, and, in response to identified loan origination problems that are reps-appropriate, imposes specific procedures and mitigating response to loan risks, many issuers would sign off on that if they could adapt (and they thought borrowers could adapt) with minimal disruption.

On the other hand, if the model reps become an investor wish-list that approaches an implied loan guarantee by the loan seller, creates the prospect of litigation abuse with vague and overbroad reps, or imposes impractical requirements on loan originators, then we have a major problem that could tarnish CMBS altogether. If that sounds shrill, consider the effects of increased loan transaction cost and time, pricing for new contingent or retained risk, and the damage to the perception of the sector if loans fall consistently short of the standard set by the "model" reps.

Stay tuned.