THE START OF A BUMPY RECOVERY FOR CMBS
It seems like ages ago that commercial mortgage-backed securities (CMBS) enjoyed a phenomenal year. But 2007 (remember?) saw $240 billion of new issuance, representing nearly 50% of U.S. commercial real estate (CRE) finance, more than $900 billion outstanding, delinquency rates under 50 basis points, and defaults barely a blip on performance. Yet even during those heady days, investors, lenders, and other market participants were wondering whether we had fallen prey to an excessive exuberance that would cause us to overlook fundamental underwriting dictates and subject our portfolios to inappropriate risk. Today we are compelled to confess that sin and seek redemption. It was not just “greedy” Wall Street. All market participants bear responsibility for the failure—originators trying to meet volume quotas, borrowers overleveraging, investors relying too heavily on ratings alone, rating agencies fighting for market share, bankers eager to make a trade. And none of the participants considered that the laws of gravity ultimately would apply to CRE valuations.

At least initially, the problems facing CMBS investors were principally in the technical areas rather than in the CRE fundamentals. There was no fundamental justification for AAA CMBS to be trading at 600 bps over swaps, much less 1,600 bps over in late 2008. Those prices would translate to losses far beyond what anyone’s models envisioned and weren’t supported by loan performance even at highly stressed levels. The problem, of course, began in a residential market driven by 100% LTV loans, insufficient income verification or requirements, loans with “teaser” rates that stepped up to levels beyond what homeowners’ incomes could support, and questionable appraisals. The implosion of the residential market and the closure of the consumer ATM machine has had a lagging impact on CRE. The retail market hit the skids as consumers finally started saving rather than spending, hotels suffered as business travelers stayed home, apartment loan delinquencies rose, and office leases were impacted by business downsizing. Throw in the bankruptcy, liquidation, or other failure of at least five of the largest financial institutions, and you have the perfect storm.
Government Programs and Proposals

With that backdrop, we began 2009 battered, shaken, and scared. The government had just entered the fray to save the banking industry with the Troubled Asset Relief Program (TARP), but instead of purchasing troubled assets, it just funded troubled banks. The relief for investors appeared in an offshoot of that program. Treasury Secretary Geithner announced in February the Term Asset-Backed Securities Loan Facility (TALF), which was intended to provide attractive financing to investors that purchased certain AAA-rated, asset-backed securities (ABS). He noted that the securitized credit markets are crucial to providing liquidity and facilitating private lending, both of which are essential to any economic recovery. “Because this vital source of lending has frozen up,” he said, “no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses—large and small.” TALF represented a welcome shot in the arm for structured finance participants. Members and staff of the Commercial Mortgage Securities Association (CMSA) had engaged in numerous meetings and correspondence with Treasury, the Federal Reserve, and Congress at the onset of the crisis in an effort to provide information, resources, and ideas on what would most benefit the CRE finance industry. CMSA was thus pleased and encouraged when Secretary Geithner announced in May of 2009 that TALF would be expanded to CMBS. That announcement alone brought spreads on CMBS in about 500 bps to 700 bps—not a cure but a start.

With that step forward, however, the Obama administration then took a step back in issuing its Regulatory Reform Proposal in the summer of 2009. Several points in that proposal drew criticism from many members of the finance industry, most notably the risk retention requirement for loan originators. While the idea of risk retention, or “skin in the game,” has merit, it does not recognize the role that B-piece buyers play in CMBS. These sophisticated investors evaluate all the loans in a securitized pool and specifically negotiate to buy the riskiest classes of bonds. Accordingly, CMSA argued that there needs to be consideration given to the different structures and investors in each asset class. Fortunately, the bill passed by the House in December included the flexibility of allowing the risk retention requirement to be met by investors that specifically negotiate and purchase the lowest or riskiest classes of bonds. The risk retention requirement, coupled with new accounting requirements announced by the Financial Accounting Standards Board effective January 1, 2010, that mandate consolidation of certain financing vehicles and elimination of true sale treatment for certain transactions under FAS 166 and 167, could still have an adverse impact on credit availability.

Another troubling regulatory proposal prohibits hedging of risks that loan originators face in aggregating loans for securitization. This prohibition, which intuitively runs counter to prudent risk management, could hinder new loan origination if lenders are unable to adequately hedge against aggregation and volatility risks. Moreover, yet another proposal called for ratings differentiation on structured finance securities products. Investors who use ratings have uniformly stated they do not want a rating symbology change and have advised that it would further impede liquidity in the marketplace. Many investors have charter or other investment guidelines that specify ratings criteria, and a change in ratings would only prolong and delay their ability to invest in CMBS or ABS and thus delay recovery. The degree to which any of these proposals survives in final legislation will directly impact credit market recovery.

Other Challenges to CMBS

Besides regulatory and legislative changes and proposals, 2009 witnessed a possible threat to the integrity of the bankruptcy-remote structure used for borrowers in CMBS and other structured loans with the bankruptcy filing by General Growth Properties and 166 of its special purpose entity (SPE) subsidiaries. Two rulings thus far have made it clear that the court would not order substantive consolidation of the entities, and therefore SPEs were bruised but remain intact. However, the case highlights that SPE structures are bankruptcy-remote, that they are not bulletproof, that deviation from SPE criteria (especially cash management provisions) will be to a lender’s peril, and that some SPE criteria, such as the independent director qualifications and removal provisions, may need to be modified.

In the recent Extended Stay Hotel bankruptcy filing, senior bondholders attempted to obviate the trust structure and the requirement that only the special servicer act on behalf of the trust in negotiations directly with the borrower. Further, initial rulings have given the debtor borrower access to certificateholder information rather than recognizing the contractual provisions of the trust agreement that grant the special servicer sole authority to manage and
negotiate defaulted loans. If this case ultimately disregards bondholder agreements in the governing documents and rewards senior bondholder circumvention, uncertainty would be created for investors that would hamper financial market recovery.

**New Issuance and the Future of CMBS**

With all the negative news from CMBS and structured finance in the past two years, the end of 2009 saw a glimmer of hope. A $400 million loan to Developers Diversified Realty backed the first new-issuance CMBS in November, of which $325 million was TALF-eligible; however, only $72 million utilized TALF financing. Two more new CMBS issues priced prior to year-end without TALF financing: a $460 million Flagler transaction and a $500 million Inland REIT transaction—not a large volume by any measure—but they demonstrated investor receptivity and, most notably, that government program assistance, such as TALF, is not essential to attract investors. In fact, it appears that investors prefer not to be tethered by terms that are incorporated into TALF financing structures. That is good news for recovery in the industry.

Following are some notable characteristics of those deals:

- Each was a single-borrower loan and thus leaves open the question of how and when lenders will aggregate traditional conduit loans to diverse borrowers for securitized pools.
- They represented more stringent underwriting, with 50% to 70% LTV ratios.
- None of the rated classes went below BBB–, thus fewer, thicker classes, while the riskier credit tranches have not yet surfaced.
- The TALF requirements introduced an operating advisor concept, providing an independent person to oversee the special servicer with the right to recommend its removal. Some senior bondholders who are not comfortable with the coupled B-piece/special servicer role favor this mechanism, but it remains to be seen whether any B-piece investor would take the risk of buying the first loss position without a degree of control over the special servicer.

CMBS, with a broad member constituency, including servicers, investors, lenders, issuers, trustees, and rating agencies, has encouraged dialogue and development of satisfactory proposals to address structural and best-practice approaches to help rejuvenate the illiquid credit markets. A number of those efforts are under way. For example, market participants and regulators alike have called for increased transparency in transactions, and CMBS has traditionally been one of the most transparent asset classes, providing more than a hundred data fields on properties within a given pool in disclosure documents at origination. Making the scope and content of this disclosure uniform will be a big step in the right direction. Through the CMSA Investor Reporting Package (IRP), which has long been utilized as the required reporting format in CMBS transactions, trustees and servicers must provide standardized reporting through the life of the transaction. The IRP is dynamic, and at this time is being reviewed and evaluated for improvement. In fact, the CMSA IRP has been used as a model by other ABS participants for their disclosure and reporting.

The lack of available financing also highlights the challenges presented by restrictive real estate mortgage investment conduit (REMIC) regulations governing most securitizations. For example, under current law the trust may modify a defaulted loan (or one for which default is reasonably foreseeable) but cannot provide trust-level financing on a property that the trust has foreclosed on (REO). Servicers would like the flexibility to sell REO with the option of “seller financing” in order to attract a better price, but senior bondholders are leery of that discretion. At a minimum, it appears that a limit on a new loan term plus a significant buyer equity injection would be required. For example, discussions have focused on a loan term that would not exceed two years past the original loan maturity date. Buyer equity must be meaningful but could be in the form of principal pay down, capital improvements, reserves, or a letter of credit. Hopefully, progress on this issue will be forthcoming, as it will require a regulatory change to REMIC regulations. However, the sometimes tense discussions concerning existing defaulted loans and special servicer authority in making modifications may augur for increased oversight by senior bondholders or at least more restrictions on discretion in future deals. An appropriate balance will need to be drawn.

Bond structures likely will be simplified. Thicker bond classes are preferable to investors, with greater levels of subordination. Traditional loan underwriting with lower LTV and higher debt coverage based on proven, in-place cash flows will also likely be mandated—no more pro forma rent calculations, no more escrow waivers, and no “covenant lite” documentation. It is unlikely we will see the mega deals that were done at the end of the cycle. Rather,
single-borrower and single-property transactions will be more common until loan originators can get a handle on aggregation risks. Even then, pools will not likely exceed $1 billion anytime soon, and a healthy, normalized new-issuance market for CMBS probably will be closer to $100 billion per year rather than the frothy $240 billion in 2007.

The role of rating agencies is also likely to be impacted. Proposed legislation has called for greater transparency in disclosing rating methodology so that investors can better understand the credit approach taken. In addition, the conflict of interest presented by issuer-paid fees is under scrutiny, together with other conflict of interest issues. Regulators are vying for the oversight role; legislators are assessing what controls and checks and balances are necessary; and the rating agencies themselves are trying to be proactive as they watch the walls close in.

In addition to these regulatory and structural fixes, a number of technical issues need to be addressed. For the first time, the protocols, procedures, and checks and balances typically (but perhaps not uniformly) built into the Pooling and Servicing Agreement (PSA) governing the securitized trust are now being tested. While the structure generally works remarkably well, areas need improvement and clarification and there is a need for consensus on best practices. For example, when a loan becomes specially serviced, typically after default or imminent default, the special servicer must get an appraisal and calculate whether there is an “appraisal reduction amount.” That is, the amount by which the outstanding balance of the loan, together with servicing advances and other costs, exceeds 90% of the appraised value. Currently, most deals use the appraisal reduction amount as a reduction of the loan balance solely for purposes of calculating any debt service advances that are made by the servicer. This process raises two questions. First, many PSAs provide that upon liquidation all accrued but unpaid interest is first paid to bondholders, including amounts with respect to the appraisal reduction amount, even if there is a principal loss realized equal to or greater than that amount. Many senior bondholders argue that interest should not be payable with respect to the principal loss amount. Second, PSAs generally provide that the controlling class that selects the controlling certificateholder is determined based on the certificate balance after giving effect only to realized losses. Some argue that it should be calculated based on the appraisal reduction amount, which would be an earlier proxy for estimated losses. New CMBS transactions should address these issues.

Additional issues involve controlling certificateholder rights and loan seller representation and warranty breaches. Uniformity on whether controlling certificateholders have consent or consultation rights, as well as the list of actions to which they relate, is critical. Any resolution of controlling certificateholder rights will likely be drawn into the issue of senior bondholder oversight and special servicer authority discussed above. As defaults have increased, so have disputes over loan seller representation and warranty breaches. Standardization of representations and warranties and a streamlined process for resolving claimed breaches and remedies is imperative. Since legal proceedings can last not just months, but years, a quicker process for resolution is essential, particularly where resolution of the related defaulted loan is similarly delayed. With the pause in the market and a glimmer of rekindling CRE finance, this is an opportune time to refine and standardize these provisions.

The Road Ahead

With all the regulatory and legislative changes that may impact future CMBS, sifting through the increasing defaults and delinquencies of vintage transactions will continue to consume energy and resources: from 1.5% at year-end 2008 to more than 5% for 2009. Some of those loans may make it into new CMBS through refinancings or foreclosure sales, but there will be a challenge in addressing the “equity gap” that exists for many borrowers due to the steep drop in valuations. Bank, life company, and private equity sources are not sufficient to meet the looming maturities and credit needs. Capital market finance in some form will have to bridge the gap.

One thing is clear: There is a strong appetite for well-sponsored and well-underwritten CRE debt, including loans suitable for CMBS execution, which are slowly but surely beginning to emerge into transactions. This momentum requires participation by market and industry participants in efforts to formulate best practices, establish industry standards, such as the CMSA IRP, and maintain dialogue and advocacy with legislative and regulatory authorities that have a significant impact on CRE finance. CMSA is leading the charge on those fronts and welcomes input and participation.

Patrick C. Sargent is a Partner with Andrews Kurth LLP and the President of the Commercial Mortgage Securities Association.