HIGHLIGHTS:

**Election Outcomes: What They Mean For 2017**
Marty Schuh, Vice President, Legislative and Regulatory Policy, CRE Finance Council
Jeff Forbes, Founding Partner, Forbes-Tate
Jeff Strunk, Partner, Forbes-Tate

**Is CMBS Servicing Broken?**
Stacey M. Berger, Executive Vice President
PNC Real Estate/Midland Loan Services

**BREXIT Q&A**
Peter P. Cosmetatos, Chief Executive Officer, CREFC Europe
Interviewed by Christina Zausner, Vice President, Industry and Policy Analysis, CRE Finance Council

**Why Risk Retention Might Not Be So Bad For CMBS**
Paul Fiorilla, Associate Director of Research, Yardi Systems
Maximize your visibility and benefits - Elevate your company’s profile.

Take advantage of exciting opportunities within our Sponsorship Guide, including:

- New Partner Conference Sponsorship Benefits
- Sustaining Sponsorship
- Additional After-Work Seminar Benefits
- Young Professional Supporter
- Improved List of January Conference Sponsorship Items
- and more.

CRE Finance Council Sponsorship Opportunities

Connect with key decision makers across the commercial real estate finance industry:

- January Conference, Miami Beach, FL
- High Yield & Distressed Realty Assets Summit, New York, NY
- Commercial Real Estate Finance Summit-West, Santa Monica, CA
- Annual Conference, Washington, DC
- After-Work Seminars, Nationwide
- Women’s Network, Nationwide
- Education Sponsorship, Nationwide
- and more...

Sponsorship Application and an updated selection of Sponsorship Opportunities now available online... crefc.org

Contact Sara Thomas 202.448.0857 or Julia Byrne 202.448.0858 for sponsorship related questions. sponsorship@crefc.org
Contents

3. Letter from the Editor
Victor Calanog PhD, Chief Economist & Senior Vice President, Reis, Inc.

4. Welcome Letter
Lisa Pendergast, Executive Director, CRE Finance Council

8. Election Outcomes: What They Mean For 2017
Marty Schuh, Vice President, Legislative and Regulatory Policy, CRE Finance Council
Jeff Forbes, Founding Partner, Forbes-Tate
Jeff Strunk, Partner, Forbes-Tate

CRE Finance World Magazine Editor-in-Chief Paul Fiorilla sat down with Marty Schuh, Jeff Forbes, and Jeff Strunk for election predictions and their impact on real estate capital markets.

9. Is CMBS Servicing Broken?
Stacey M. Berger, Executive Vice President, PNC Real Estate/Midland Loan Services

14. BREXIT Q&A
Peter P. Cosmetatos, Chief Executive Officer, CREFC Europe
Interviewed by Christina Zausner, Vice President, Industry and Policy Analysis, CRE Finance Council

16. Why Risk Retention Might Not Be So Bad for CMBS
Paul Fiorilla, Associate Director of Research, Yardi Systems

18. Alternative Mezzanine Lenders: New Kids on the Block
Julian M. Wise, Partner, Schulte Roth & Zabel LLP
Daniel Aires, Associate, Schulte Roth & Zabel LLP
Aaron Schwed, Associate, Schulte Roth & Zabel LLP

21. Mezzanine Lenders: Opportunity or Overcrowded?
Jilliene Helman, Chief Executive Officer, RealtyMogul.com
Martin M. Q. Nguyen, Associate, Commercial Debt & Equity, RealtyMogul.com

25. Bail-In and Contractual Recognition: The Impact on US and Other Non-EU Counterparties and the Potential Impact of Brexit
Michael Speranza, Counsel, Katten Muchin Rosenman UK LLP

27. Finding the Fast Lane – Consent Processing and Borrower Satisfaction Relentlessly Challenge CMBS Servicers
Michael S. Merriam, Senior Vice President, Operational Risk Assessments, Morningstar Credit Ratings, LLC

31. CMBS Default and Loss Study: Defaults Slow, Losses Grow
Larry Kay, Director CMBS Surveillance, Nitin Bhasin, Managing Director
Pramit Sheth, Senior Director, Kroll Bond Rating Agency, Inc.

38. HV-CRE - Initial Observations and Final Conclusions
Dev Strischek, SunTrust
here do markets and the economy stand as we wrap up 2016? We have entered a decidedly softer phase in the cycle, with expectations about rent growth and occupancy gains markedly lower relative to 2015. While this is quite in line with weaker GDP growth and job creation figures, optimists point out that despite greater global uncertainty — with several of our major trading partners struggling to even grow their economies — the US has yet to fall into a recession. But are we in an extended seventh or eighth inning, or are we near the end? And what do the November elections hold for the immediate future?

Commercial real estate fundamentals are markedly weaker, but this hardly seems like a surprise. Business spending and private investment have largely been put on hold, almost as if firms were awaiting the results of the November elections before they put longer term plans in motion. Job creation has been respectable — “solid” in September, according to one member of the Federal Reserve’s Open Market Committee — but hardly glowing, and just enough to keep the unemployment rate at or below 5%. Will the Fed raise rates later this year, despite the global turmoil? A couple of the articles explore the impact of Brexit on the EU, and CRE financing in general here in the US.

We noted in last Summer’s issue that capital markets appear to have stalled, but in this issue there are glimmers that other sources like mezzanine lending appear to be emerging to take advantage of financing needs. Another piece explores how CMBS defaults aren’t necessarily spiking, but how losses appear to be rising — and why. And while headlines focus on the November presidential elections, upcoming regulatory changes like the enforcement of risk retention requirements loom shortly before the year ends. One piece explores the potential bright side of risk retention — or at least why it’s not all bad for CMBS. Where else might risk lie? One article explores how high volatility CRE loans are to be treated by current regulatory standards.

Finally, we are publishing an interview where industry players Marty Schuh, Jeff Forbes and Jeff Strunk share their thoughts on how the next President and different branches of government might work together (or not), and how the upcoming change in the executive office is likely to affect legislation and regulation affecting commercial real estate financing. The editorial committee learned much from reading all the article submissions, and we are proud to present this issue.

Regards,

Victor Calanog PhD
Co-Managing Editor
Welcome Letter

A warm welcome to all of our CRE Finance Council members and friends,

I am pleased to present you with our Autumn 2016 edition of CRE Finance World (CREFW) magazine, a publication dedicated to all of CRE Finance and in circulation since 1999.

As a frequent contributor to the magazine over the years, I am proud to say that the reports in this edition are spot on and reflective of the challenges and opportunities the current environment presents. There is something of interest for everyone in CRE Finance — from borrowers to lenders to third-party service providers, and investors in CMBS and distressed real estate assets.

In a now global marketplace, the UK’s decision in June to begin the process of exiting the European Union surprised and riled financial markets around the globe. Our two Brexit-related articles provide important insights into how the UK is likely to manage its departure and what impact its exit may have on not only the UK but also other EU member states.

In the US, new regulatory regimes and the upcoming presidential election have the potential to unsettle both the global political arena and financial markets. Read the insightful Q&A with CREFC’s own Legislative and Regulatory Policy specialist Marty Schuh and Forbes-Tate lobbyists Jeff Forbes and Jeff Strunk who weigh in on everything from handicapping the presidential candidates’ prospects to the potential ripple effects a Clinton or Trump win might have in the US House and Senate.

New US regulations may indeed prove to be potent disruptors, but also provide opportunities for new entrants in the CRE finance sector. Securitization markets will closely monitor the implementation of CMBS risk-retention rules on December 24, 2016; watching for whether risk retention bolsters credit quality as initially believed. Read ‘Why Risk Retention Might Not Be So Bad for CMBS’ for insights on how the various forms of retention — horizontal, vertical, or L-shaped — may be adopted by issuers and investors. New regulatory capital rules present CRE bank lenders with a new set of challenges, including the treatment of ‘High Volatility CRE (HV-CRE) loans. Learn the developing rules of the road in ‘HVCRE: Initial Observations and Final Confusions.’ Stressed valuations in 2006 and 2007-vintage CMBS loans maturing in 2016 and 2017 translate into a greater need for mezzanine loans; read ‘Mezzanine Lenders: Opportunity or Overcrowded?’ for an overview of the current environment for CRE mezzanine lending. Finally, the Autumn issue provides its readers with a vibrant review of CMBS loan performance, secondary CMBS trading opportunities and pitfalls and one of the better recaps of the challenges facing CMBS servicers today.

As always, we encourage you to read and enjoy this issue of CREFW, and urge you to provide the CRE Finance Council and our authors with your comments and views by clicking the ‘Comment Here’ link found at the end of each report. Your thoughts and comments are vital in ensuring that future editions of CREFW address what’s important to you and the industry.

Finally, hats off to our authors and thought leaders, as well as CREFW’s Editorial Board, who take time out of their days to share their expertise and knowledge to help all of us better understand and navigate the ever-changing landscape of CRE finance.

Lisa Pendergast
Executive Director
CRE Finance Council
A Different Kind of Credit Ratings Agency

Morningstar Credit Ratings is redefining the credit industry’s expectation of what a ratings agency should be. Our insightful analysis provides informative opinions and greater transparency of the analytical process. Our focus on client service provides investors and issuers with a responsive alternative in the credit ratings and analysis business.

We provide the information investors want to know. Investors can use our analysis to help make better-informed decisions because our analysts deliver a distinct Morningstar opinion on credit risk. And we’re transparent about our evaluation process, providing key details for the underlying assets in a transaction and how we reach our analytical conclusions.

Experience analyzing new and complex asset types. We were the first agency to publish a single-family rental methodology. Our experienced CMBS, RMBS, and operational risk teams joined forces to develop a methodology that worked for the market. To monitor risk after the initial rating, we produce timely and insightful performance reviews and ratings surveillance on all Morningstar-rated deals.

We strive to maintain an active dialogue with market participants. Whether it’s a discussion about a new or complex transaction type, our analytical approach, or a question about our opinion on a particular issue, we welcome the conversation. You can always count on Morningstar to respond to your questions and deliver a meaningful perspective on credit risk.

Visit global.morningstar.com/different1 to learn more or call +1 888 736-1924.

©2016 Morningstar. All Rights Reserved. Morningstar’s NRSRO ratings, outlooks, and analysis are provided by Morningstar Credit Ratings, LLC. Morningstar Credit Ratings, LLC is a wholly owned subsidiary of Morningstar, Inc., and is registered with the U.S. Securities and Exchange Commission as a nationally recognized statistical rating organization (NRSRO).
Election Outcomes: What They Mean For 2017

CRE

Finance World magazine Editor-in-Chief Paul Fiorilla sat down with Marty Schuh, Jeff Forbes, and Jeff Strunk for election predictions and their impact on real estate capital markets.

1. What are your expectations for the next President and who will control Congress? How will this outcome affect policy and regulations involving commercial real estate?

MS: This election — indeed, this period in history — is unlike any other in my adult life. The Republican primary saw the power of the “latent, yet unlikely” voter — people who were content to sit out the previous 3-5 elections and thus show up in polling as “unlikely” voters. However, these unlikely voters drove the Republican primary electorate numbers up by 62% versus 2012. This was particularly prevalent in states with open primaries (or those without need for party affiliation to vote in the primary).

Given this backdrop, traditional polls are proving highly unreliable — witness the “smart money” all on the wrong side of the Brexit vote. Given this uncertainty and the manifest distaste with any institutional candidate in this election, I think that Trump has the edge. Now, this is dependent on a number of factors: 1) yet more damning emails surrounding Clinton's private email server (promised by WikiLeaks); 2) an “October surprise” of some international discomfort (this happens every election); 3) low voter turnout for Clinton (which appears likely). Don’t start calculating state projections based on any map from 2012 — this election has no template, no precedent.

If Trump prevails, almost by default the Senate will remain in Republican hands, although certainly with a slimmer majority. The House is not seen as competitive this election given the precious few swing districts that are not drawn to suit one party or the other.

A Trump victory would be a net positive to commercial real estate on the whole in my opinion, but on certain issues there is uncertainty. Trump has telegraphed his distaste for the repeal of Glass/Steagall — even inserting language into the party platform calling for reinstatement of the Act. Another possible risk is to the EB-5 immigrant visa program (which grants certain foreign investors green cards in exchange for their investments).

JF: I expect Hillary Clinton to be the next President of the United States, although we have recently seen some of the normal ebbs and flows of a presidential campaign. She has so many more paths to the 270 electoral votes needed to win than does Trump that he would have to almost run the table in battleground states to prevail. Unless Mrs. Clinton struggles during the debates or something else unforeseen happens, she is well positioned in the race. I ultimately see her winning, and likely comfortably.

The Senate is tougher to predict. It is going to be close and will probably come down to a handful of races that are true tossups, particularly in places like New Hampshire, Pennsylvania, and Nevada. There is still a lot of time before Election Day, but whichever party controls the Senate next year will do so by a slim margin. I have a harder time seeing Republicans holding the Senate without Trump winning the White House than do some others.

Despite increasing chatter among Democrats, I do not think we can win back the House this cycle, but I do expect us to pick up seats. There are not enough races truly in play for Democrats to net the 30 seats we would need to win the majority.

Assuming Mrs. Clinton wins, I do not think you will see a dramatic change from the last eight years on issues important to CREFC members. I believe that much of her policy agenda towards the commercial real estate industry, and the broader financial services sector, will look similar to that of the Obama Administration. If anything, I think she could spend her first term further separating herself from the banking industry to avoid a “Bernie Sanders 2.0” situation in the 2020 primary. You cannot underestimate the influence that Bernie Sanders, Elizabeth Warren, and others have had on the ideological bent of the Democratic Party or the impact that her drawn out primary with Senator Sanders had on Mrs. Clinton and her advisers.

JS: Polls have tightened, but there appear to be too many factors working in Clinton’s favor for Trump to overcome. I also do not get the sense that a large number of Republicans are enthusiastic about supporting Trump, and some may elect to stay home on Election Day. Interestingly, Republicans in a number of Senate races seem to be outperforming Trump. It will be close, but the chances of Republicans maintaining control of the Senate are better than many would have imagined a few months ago. It will be interesting to see whether Republicans in swing states can maintain enough separation from Trump to hang on even if he loses. Like Jeff said, Pennsylvania, New Hampshire, and Nevada are bellwether races, and I would add Florida to that list. I expect Republicans to maintain their majority in the House, although they will likely lose seats. How many seats Republicans lose is dependent on the outcome of the Presidential, but at a minimum we will give back a few seats that we won when it turned into a wave in 2014.
It is difficult to predict how Trump would approach financial services policy should he win. Despite his business experience he has articulated some populist, non-traditional points of view for a Republican on these issues. Uncertainty seems to be the general response to Trump among DC Republicans — no one is quite sure what his agenda will look like. That is one thing about him that could spook the financial markets — it is impossible to know exactly what he is going to do given the lack of detail in the policy positions he has outlined during the campaign. Some on Capitol Hill believe that the recently introduced Financial CHOICE Act could be the template for his financial services agenda, but nothing is certain.

2. What does the post-election governing makeup mean in terms of how difficult or easy it will be to pass legislation in the next term? Will CREFC have a chance to advocate for and pass any legislation? Or will the next president just rely on executive power and agency rulemaking like we are seeing currently?

MS: If we stick with our thesis that Trump carries the White House and Congress remains in Republican hands, this would bode well for efforts on a number of fronts. First, efforts to replace Dodd-Frank would gain notable traction. Trump has met privately with House Financial Services Chairman Jeb Hensarling and apparently is fond of the recently unveiled Choice Act that replaces or repeals many parts of the landmark banking reform package passed in 2010. Secondly, we would expect a major focus on the GSEs and FHA reform. Republicans are still chafed that the Dodd-Frank Act left the housing giants largely unscathed in the wake of the housing crisis. As a reminder, the Choice Act repeals the statutory authority for risk retention (Section 941 of Dodd-Frank) in addition to repealing the Volcker Rule and so-called “Durbin Amendment” capping fees banks may charge on debit card transactions.

Readers might recall the Financial Services Committee (PATH Act) and the Senate Banking Committee (Johnson-Crapo) have each passed a housing reform package only to see the efforts stall against partisan headwinds and White House resistance.

Additionally, the House this Congress has passed dozens of bipartisan bills dealing with securities filings, start-up capital and a host of other stimulative effects that have either languished in the Senate or have drawn a veto threat from the White House. A Republican trifecta would free many of these bills (they would, however, need to be re-introduced and passed again next Congress beginning in January). Although they have no direct impact on commercial real estate, they are providing additional oversight of the SEC and other regulatory agencies under a more direct Congressional approval process.

JF: I do not think there is much opportunity for substantive legislating next year no matter what happens electorally. Even if Mrs. Clinton wins and Democrats narrowly take control of the Senate, the 2018 Senate map is much more favorable for Republicans and they will have a good opportunity to regain control. Mitch McConnell, should he be Minority Leader, would not have much incentive to give a new Clinton Administration any big wins. Everything he does will be about positioning Republicans for the 2018 mid-terms right from the outset. That said, I expect the pace of regulatory action and executive orders to be similar under Mrs. Clinton as it has been during the Obama Administration.

One thing you may see is an uptick in investigations into the financial services industry. There are a number of Senators who could launch highly visible investigations into the industry if the political dynamic is such that they cannot advance actual legislation. In short, I think you will see a lot of activity without much action next year.

JS: Unfortunately, I agree with Jeff on this one as well. I have a hard time seeing Senator McConnell and others being incentivized to work with the Administration on many big-ticket items given how well positioned Republicans appear to be for the 2018 mid-term elections. It is sad that we are talking about 2018 before this year’s elections have even taken place, but that is the reality of what the political system has become.

That said, I think the best chance for some real legislating is if Republicans retain a narrow Senate majority. In that case I believe that Senator McConnell would be motivated to show that Republicans can responsibly govern and may be willing to work with Mrs. Clinton on certain things (should she win). An infrastructure package or some kind of tax reform bill are possible areas for collaboration.

Otherwise, I think you could also see an enhanced focus on investigations on the Republican side, but looking into the Administration. House Republicans will not let up in their penchant for investigating Mrs. Clinton should she become President. If Trump wins and Republicans control both the House and Senate then I think you will see him pursue an aggressive agenda, likely starting with immigration reform.

3. Back to Congress — we’ve seen what the lack of party unity has done over in the House of Representatives with the ouster of Speaker Boehner and the pickle that his successor Paul Ryan often finds himself in. Given their probable majority, will the current intraparty gridlock mature into a governing caucus next year?
MS: Again, using the same thesis on the election, we believe that a governing coalition will mature over in the House. It would also not surprise us if the Republican Caucus leadership ranks change a bit. Will Leader Kevin McCarthy (R-CA) become Speaker McCarthy? We shall see. House Speaker Paul Ryan (R-WI) has made his ambition for a large-scale tax reform package well known. He would be in a stronger position to affect that if he were to re-assume his former post as Chairman of the powerful Ways and Means Committee. Over in the Senate, the election carries real consequences for seats in Illinois (Mark Kirk), Wisconsin (Ron Johnson), New Hampshire (Kelly Ayotte), Ohio (Rob Portman) and Florida (Marco Rubio). It is possible that we could see the Senate flip from Republican to Democrat even under a Trump win (although highly unlikely given the key states that will decide the election).

If the House stays in Republican hands, as expected, the number of Tea Party and Freedom Caucus members will likely increase as a number of retirements this year were reliable votes for Leadership and less likely to cross the Speaker on must-pass legislation. If the Freedom Caucus numbers do increase, a governing coalition will need to be formed by the Speaker (whoever that is) — one that includes the more rambunctious members who control the votes necessary to move without Democrats being involved in passage of key legislation. Over in the Senate, Chuck Schumer (D-NY) will be a noticeable change from the current Minority Leader, Harry Reid (D-NV). Schumer is seen as more of a dealmaker open to compromise for the sake of progress.

JF: The short answer to this is no, with one possible exception. If Mrs. Clinton wins I could see she and Speaker Ryan mortgaging their respective political futures to do something significant on tax reform, and possibly budget. Both would have to decide that they are willing to risk their political futures to do something transformative, but the contours of a deal could be there if they were willing. Cutting such a deal with a Democratic President may well cost Mr. Ryan his speakership and making major concessions to Republicans could imperil Mrs. Clinton’s reelection chances, but that is the one opportunity I see for a drastic change to the current paradigm.

JS: I think we are looking at more of the same next year from House Republicans. The reality is that significant differences exist within the Republican Conference and those will endure after the election. Moreover, House Republicans are likely to lose at least a handful of seats from their majority (possibly 12-15) and most of these will be more “establishment” Republicans. Conservative voices within the Conference, including the Freedom Caucus, are only going to gain additional clout next year. Speaker Ryan will remain limited in the agenda that he can pursue given the ongoing divide within the Conference.
Is CMBS Servicing Broken?

Stacey M. Berger
Executive Vice President
PNC Real Estate/
Midland Loan Services

Is the CMBS servicing and special servicing business model broken? Borrowers, originators, investors and other market participants have convincingly argued that poor servicing quality is a major impediment to the CMBS market recovery. Primary, master and special servicers are facing significant challenges as a result of a variety of economic, operational, contractual and regulatory issues. Servicers have a major investment in their platforms and a vested interest in the continued growth and success of the CMBS market. They are not the bad guys (nor innocent bystanders) in this story.

The dissatisfaction with CMBS servicing should not be a surprise to any knowledgeable market participant. While most of the interactions between borrowers and servicers regarding loan administration matters are routine, some borrowers have found it difficult to navigate lease approvals, credit decisions and more complicated requests. Borrowers’ experience with more complicated matters can be inconsistent depending on their servicers and their approval processes. Borrowers often cite difficulties in getting the right level of attention to address their issues. Some master and special servicers do a much better job of managing the borrower customer service experience than others.

The current dissatisfaction with servicers is not new, and market participants have sought to make the industry more efficient through the history of CMBS. Today, servicers face a more complex servicing structure and increased volume of activity. Many of these issues can and should be successfully addressed. CMBS issuers and servicers — working together — have the ability to make many of the changes necessary to fix CMBS servicing issues. Without change, dissatisfied borrowers may pursue alternative financing sources, which potentially leaves CMBS as the lender of last resort.

A number of factors have created an environment in which servicers are challenged to accommodate a myriad of conflicting demands when acting as lender on behalf of a passive trust for loans they did not underwrite or originate. The CMBS servicing construct is complex with responsibilities allocated among multiple parties for routine servicing and loan administration activities; asset management approvals and consents; major credit decisions; and default management. These responsibilities and the approval rights are shared between primary, master and special servicers and controlling class holders as defined in the Transaction Pooling and Servicing Agreement (PSA). Borrowers who are not a party to the PSA are challenged to understand the specific roles, responsibilities and interrelationships of the servicers that affect their loans, causing them frustration when they require an approval or consent specified in their loan agreement. This complicated mechanism — along with increasingly complex loan structures requiring additional servicer approvals and consents, as well as covenant monitoring, increased investor reporting and new regulatory requirements — has put significant operational burdens on servicers. Servicing economics have been negatively impacted with reduced servicing fees, ancillary income and interest income (as a result of historically low interest rates).

CMBS servicing economics are challenging, and servicers have been forced to adapt. The master servicing market has primarily consolidated down to three active companies — all regulated financial institutions. Special servicers have scaled down their staffing and operations due to significantly lower default rates and reduced revenues from changes in their compensation structure. Many mortgage bankers can no longer afford to retain the primary servicing and borrower relationships for CMBS loans they originate.

In addition to borrowers, senior and subordinate investors are appropriately dissatisfied. Market participants are ready to engage in active dialogue to address necessary changes in CMBS servicing. The Commercial Real Estate Finance Council (CREFC) and industry participants are establishing constructive dialogue to address CMBS servicing issues.

Most servicers are highly motivated to make changes to improve and satisfy the demands of borrowers and investors. There are alternative servicing constructs that may serve as models for change. Freddie Mac has demonstrated in its multifamily capital markets execution that commercial real estate securitization servicing can be improved.

**CMBS Servicing Economics**

There are two easily understood economic premises that define the dimensions of the current CMBS servicing issues:

1. You get what you pay for
2. Incentives matter

On most CMBS transactions, the master servicers purchase the primary and master servicing rights for newly issued CMBS transactions from the issuers on a competitive bid basis. These mortgage servicing rights entitle the servicer to receive servicing fees, ancillary income from borrower paid fees and interest income from escrow and reserve deposits, debt service and payoffs. The primary and master servicing fees are established by the transaction issuers, and are paid from a portion of the interest-component of monthly debt service payments.
In structuring CMBS transactions, investment bankers can allocate the total interest paid by borrowers to CMBS bondholders, including interest only (I/O) bonds, or to servicing fees. The profit on any securitization transaction is a direct function of the sale of servicing fees and I/O strips. If the I/O investors are willing to pay more for the interest than the servicers, then issuers will sell more of the interest available to them and less to the servicers. Currently, primary and master servicing fees are established at less than one basis point. By comparison, the servicing fees on the CMBS legacy transactions, which mature in 2016 and 2017, were typically set at two to three basis points.

The interest income from float on escrow and reserves, debt service and payoffs historically represented 50 to 75 percent of total CMBS servicing revenue. In the current economic environment, historically low short term interest rates have significantly reduced the revenue from float for primary and master servicers. Borrower paid ancillary fees are another important source of revenue and compensation for unpredictable and episodic events such as assumptions, defeasance, lease approvals, reserve releases and other borrower-initiated actions. These fees are typically split between the primary, master and special servicers (who may also have fee sharing arrangement with the B-piece investor). Originators have also reduced or capped these fees to appease borrowers.

CMBS servicers’ revenues have been significantly reduced as a result of the lower servicing fees on newly originated loans versus loans that are maturing and paying off; lower interest earnings from float and reduced ancillary income. The sale of mortgage servicing rights to the highest bidder does not provide any economic incentive to reward servicing quality. You get what you pay for.

Servicing expenses have also risen as originators and issuers have increased the complexity of loans, including the number of lockbox/cash management loans, complex performance covenants and the number of actions requiring lender approvals or consents. Is the credit of these loans improved by the added security and is the benefit worth the increased burden imposed on both borrowers and servicers?

In addition to their default management and resolution activities, special servicers play a critical role in the approval and consent process for many performing loans, oftentimes associated with borrower-initiated asset management requests. Special servicers and directing certificate holder/controlling class holder have approval or consent rights for routine matters such as lease approvals and management changes. The complications around these fairly routine lender approvals add time, expense and frustration to the borrower experience, and increases the cost to administer by primary and master servicers. Borrowers’ experiences have been inconsistent as many special servicers expedite the review and approval process and charge reasonable fees while other special services are much more difficult and objectionable in their dealings.

Issuers should consider reducing the number of the required approvals and consents granted to the special servicer and directing certificate holder to only assignments, assumptions and other significant credit matters. The master servicer could have the authority to review and approve all other routine borrower-initiated asset management requests. Additionally, the primary and master servicers would retain all the borrower paid fees, increasing their compensation and matching it to the responsibility. Special servicers would retain the responsibility for major credit decisions on performing loans. This change would significantly reduce CMBS borrowers’ frustration and expedite routine asset management matters, as well as provide more accountability for approval timing and fees.

**Special Servicing Issues**

A major issue identified by CMBS investors is the relationship between special servicers and the controlling class holder or directing certificate holder. There are two different relationships extant in the current market. Some special servicers are independent third party service providers engaged by unaffiliated B-piece investors. These special servicers are terminable without cause by the respective B-piece investors. Other special servicers are owned or affiliated with a B-piece investor. Some have expressed concerns that affiliated special servicers have potential conflicts of interest related to the economics associated with special servicing fees and bond investment returns, as well change of control as a result of realized losses. These issues are more problematic on legacy transactions than for CMBS 2.0 transactions. Investors are requesting more transparency with respect to the special servicer and directing certificate holder relationships and decision making on specific special servicing resolutions.

Special servicers’ highest compensation is associated with the management and resolution of defaulted loans. This revenue is significantly impacted by the current low volume of specially serviced loans and reduced fees. The industry changes made to special servicer compensation associated with CMBS 2.0 have resulted in reducing special servicing revenues and, in combination with low default rates, have encouraged certain special servicers to pursue aggressive special-servicing transfers and associated fees.
Is CMBS Servicing Broken?

Some investment grade investors have questioned whether special servicers controlled by B-piece investors’ strategies on legacy transactions, including the protracted holding periods for REO assets and the coordinated bulk sale of specially serviced assets timed to “jump” bond classes and maintain control rights, are in the best interests of all investors or are economically self-motivated. These strategies have the combined effect of negatively impacting the revenues of the special servicers that have been replaced on legacy assignments, and heightening the investor perceptions that the entire special servicing paradigm is broken.

The new issue CMBS B-piece market has seen an influx of investors that incorporate the use of fee management agreements with their third party special servicers. These fee sharing arrangements are fairly standard practice in the industry between third party special servicers and B-piece investors, and create an alignment of interests without co-investment in the B-piece. The market has established fairly standard levels of special servicing base fees, resolution and liquidation fees. However, if special servicers enter into fee sharing arrangements with B-piece investors they are typically receiving only a portion (up to half) of the fee revenue.

CMBS investors have also voiced concern over the quality and availability of information related to special servicers’ default management, resolution and liquidations activities. Disclosure during an adversarial workout is challenging for a special servicer; however, after a resolution or liquidation the results should be made available to investors. While CREFC has made significant efforts to improve its Investor Reporting Package related to special servicing resolution activity, there are still inconsistencies between servicers in terms of the content provided.

Changes to the PSA Servicing Standard

Some CMBS market participants have proposed changes to the Servicing Standard as set forth in the transaction Pooling and Servicing Agreements as a vehicle to improve the overall quality of servicing on behalf of borrowers, investors and other market constituents. Any changes to the CMBS Servicing Standard should be carefully considered:

• Changes to new issue transactions should not affect servicer behavior and compensation on existing legacy transactions where the majority of issues exist.

• A number of the issues are already addressed in the CMBS Servicing Standard and are ineffective as a result of a lack of consequences for failure to conform.

Changes to the Servicing Standard will pose an additional burden and expense for master and special servicers to administer CMBS transactions with multiple agreement formats and different provisions.

History has demonstrated that there are unintended consequences of changes which affect CMBS servicing responsibilities and compensation. A number of changes implemented in CMBS 2.0 to address “abusive” behavior and potential conflicts of interest between affiliated special servicers and B-piece investors may have contributed to issues currently troubling borrowers and investors in their interactions with special servicers related to performing loan asset management requests and maturing loans.

One change that should be considered is giving an expanded role to the Operating Advisor to provide an arbiter of disputes between the master and special servicer, and to provide investors with a means to investigate abusive behavior. These responsibilities and procedures would need to be developed and documented, and an appropriate compensation scheme for the Operating Advisor’s activities would need to be developed.

The Freddie Mac Multifamily Servicing Model

Freddie Mac developed a servicing model for its multifamily capital markets execution (CME) program to address a number of the borrower customer service issues that have plagued CMBS. The program was designed to provide their borrowers with a securitization servicing experience that was comparable to that for Freddie Mac Program Plus portfolio loans and differentiated from CMBS servicing. The Freddie Mac CME program has a number of structural and compensation features that are designed to address and improve borrower customer service and may be appropriate for CMBS. The most important features of the Freddie Mac program include:

• The borrower relationship is maintained through primary servicing retained by the originating mortgage banker.

• Freddie Mac sells the master servicing rights on a competitive bid basis but the fees are typically two to three basis points (versus 0.25 to 0.5 basis points for CMBS).

• The primary and master servicing is administered consistent with the Freddie Mac servicing guide which is referenced in the Pooling and Servicing Agreement but can be changed by Freddie Mac.

• Freddie Mac requires the use of a third party special servicer that is independent and unaffiliated with the transaction B-piece investors.
• Borrower-initiated asset management requests are managed by the primary servicer and approved by the master servicer and directing certificate holder without special servicer involvement and associated fees.

• The special servicers are paid an annual surveillance fee to provide a minimum level of compensation regardless of activity level.

• Freddie Mac actively monitors servicer performance including compliance with required approval and consent time frames.

Improve Performance Reporting to Improve Servicer Quality

The CMBS market has shown limited ability to differentiate comparative servicing quality. Servicing issues are identified on an anecdotal basis. Three rating agencies have active servicer evaluation and ranking processes with established criteria and annual published servicer review reports. However, differences in master and special servicing quality are not rewarded in the market in terms of issuers that select the servicers or by investors making decisions on investing in transactions.

Would information that provides investors, borrowers and issuers the ability to compare servicer performance make a difference? Would publishing comparative special servicers’ asset management approval and consent times make them more accountable if they are neglecting contractual requirements? Is there a difference in special servicing performance in terms of resolution and liquidation time, expense and net recoveries between special servicers owned or affiliated with B-piece investors versus those that are independent third party service providers that can be terminated without cause? This type of analytical information would provide market participants the ability to make a comparative decision between master and special servicers, as well as create an incentive to improve servicing quality. CMBS investors could make qualitative decisions on master and special servicers and vote via their investment decisions.

Is There an Alternative Servicing Model?

A radical alternative that would significantly improve CMBS servicing is to change from the current practice of issuers selling primary and master servicing rights to a fee for services model. Servicers could be selected on the basis of both economics and quality of service. Servicing assignments would be terminable by the issuers without cause, allowing them to influence servicer behavior and demand quality borrower customer service. These may be important considerations to issuers that originate loans and hold vertical risk retention strips. This model could also encourage mortgage bankers to retain primary servicing and create an opportunity for new entrants into the master servicing market.

Many of the CMBS master and special servicing issues can be addressed so that borrower and investors are positively impacted and the future of the CMBS industry is improved significantly.

Stacey M. Berger is Executive Vice President of Midland Loan Services, a PNC Real Estate business. Midland is a leading provider of loan servicing, asset management and technology for the commercial real estate finance industry, including CMBS servicing. The views expressed by Mr. Berger are his own, and this article was prepared for general informational purposes only and does not purport to be comprehensive. The information and views in this publication do not constitute legal, tax, financial or accounting advice or recommendations to engage in any transaction. The views expressed in this publication are subject to change due to market conditions and other factors.
Morgan Stanley is a global leader in the origination, financing, securitization and trading of both commercial mortgages and commercial mortgage backed securities (CMBS). As a direct lender, Morgan Stanley provides expedient and attractively priced fixed and floating rate financings on a broad range of stabilized and transitional commercial property types worldwide.

Learn more at morganstanley.com.
s the initial cloud of dust clears following the UK’s referendum on European membership, CREFC’s Christina Zausner caught up with Peter Cosmetatos, CREFC Europe chief executive, for the lowdown from London.

First, let’s have some Brexit basics.

In June, the UK voted by a 52:48 majority to leave the European Union. Notably, London voted to remain — as did Scotland and Northern Ireland (the only part of the UK that has a land border with the EU). The referendum was technically advisory, so it fired a starting gun of sorts, but the real countdown begins when the UK government formally tells its European partners it wants out. That involves serving a so-called Article 50 notice to start a two-year negotiation of exit terms, and is expected to happen in early 2017. In the meantime, new Prime Minister Theresa May keeps saying that “Brexit means Brexit” — but while that may reassure supporters of Brexit that there will be no backsliding, what more does it tell us?

The key question for the UK’s business community is whether, and on what terms, it will retain access to the EU single market for goods and services (including the ability to ‘passport’ financial services into EU markets from the UK). For the EU, the single market entails the free movement of goods, services, capital and workers, but the UK’s referendum is widely seen as mandating the UK to restrict immigration by EU workers and re-establish national control over borders. So:

• Will the EU and its continuing member states allow the UK to enjoy the free movement of goods, services and capital while rejecting the free movement of workers?

• If the UK is forced to choose, will it prioritise privileged access to the single market or control over immigration?

• If the UK sacrifices single market privileges to control immigration, what will that mean for financial services?

Watch this space.

What would be markers of success for the May government?

The obvious domestic political goal will be to see out this parliamentary term and win the next general election, due in 2020. Brexit presents all sorts of challenges, but with the opposition Labour and Liberal Democrat parties in a state of acute disarray, the odds seem to be in May’s favour. Two additional factors should help.

First, May has shrewdly maintained a statesmanlike distance from the Brexit fray, putting a newly created Brexit ministry, as well as the Foreign Office and international trade into the hands of leading Brexiteers. If they succeed, so does she as Prime Minister; but if they fail to deliver a palatable deal, May, who was a low-key opponent of Brexit before the referendum, will not necessarily be tarred with the same brush.

Secondly, economic and market confidence has held up quite well after the shock of the referendum, providing unexpected breathing space after all the dire warnings of imminent catastrophe from Remain supporters before the vote. Whatever the longer-term consequences of Brexit, the world clearly has not ended. Practical people can look ahead with optimism.

How is Brexit changing the economic dynamics within the UK?

The near-term impact is simply increased uncertainty and risk aversion, translating into somewhat lower transaction and investment volumes, but also prompting some opportunistic activity (not least from overseas investors drawn by a weaker pound). An early test for real estate was a July rush for the exit from open-ended real estate funds for retail investors, which led to funds closing for redemptions or imposing delays or financial penalties on those seeking to withdraw their money. That crisis passed.

Longer term, the economic consequences are hard to judge, because they will depend on the form Brexit eventually takes. Different sectors and geographies will be affected in different ways, depending on their reliance on the EU single market and flows of international trade, capital and people. Finance and auto manufacturing are among the more vulnerable parts of the economy.

What are the big milestones for the UK in the near future, particularly further monetary easing measures and negotiations to re-establish relations as a non-EU actor?

The Bank of England drew some criticism for moving too quickly to ease policy after the referendum — it remains to be seen how its monetary policy committee will react to new economic data. One interesting area to watch will be whether a weaker pound leads to inflation, given the British consumer’s appetite for imported goods.

Economic data will remain volatile for some time, as everyone tries to figure out what to do while the UK’s post-EU future is resolved. That will take time. After the government has decided on its negotiating priorities, it will initiate the two-year exit negotiation
under Article 50 — an exercise that may be further complicated by a run of national votes in countries like Germany and France over the next year or so. Only after that process is complete and the UK is out of the EU is it technically allowed to negotiate new trade deals.

What do you think the prospects are for London’s status as the European (and global) financial center?

I don’t think any other European city will replace the City of London — but it’s not hard to see the City’s importance waning, as some financial institutions choose to move some operations to countries that remain in the EU. While some cities will no doubt benefit — Frankfurt, Paris, Dublin and Amsterdam, for example — a smaller City of London will likely be a loss to the UK.

How fractured is parliament in the wake of Brexit?

The government seems reasonably stable and robust, despite the fact most Conservative MPs (like most MPs) opposed Brexit. That is partly because Theresa May commands broad respect, but also partly because the opposition is not functioning properly. The Liberal Democrats ended their participation in the 2010-15 coalition government by being almost completely wiped out in the 2015 general election. The main opposition Labour party is struggling to find a leader and an identity acceptable to both the mostly centrist parliamentary party and left-leaning party activists.

It remains to be seen how the devolved administrations in Scotland and Northern Ireland will behave as the Brexit story unfolds.

What do you think the chances are for Frexits? Swexits?

At this stage, it is too hard to call — so much depends on the internal economics and politics of each country. Further fragmentation doesn’t feel imminent, and everyone will want to see what kind of deal the UK ends up with. But centrifugal, populist forces are undoubtedly in the ascendency. The migrant crisis and persistent Eurozone sovereign debt and banking sector problems still pose very serious risks to the future of the EU.

What do you think the prospects are for fund flows to the UK CRE sector going forward?

UK CRE fundamentals are broadly healthy, not least because the level of gearing in the system is sensible, so the market can function even if prices fall. The part of the market that is arguably most overvalued — prime central London — also remains attractive to international capital, and benefits from a weaker pound. Plainly, the CRE sector will see falling rental growth if the wider economy weakens, but the prolonged uncertainty around Brexit will present many buying opportunities for the more adventurous.

In the background, monetary policy remains critical. While loose money supports asset prices (including CRE), it confuses the picture as regards relative returns and risk-adjusted returns, and thus capital allocation, across asset classes. I think one can lose sleep both about what happens if economic weakness demands intervention and monetary policy tools are exhausted, and about the implications if meaningful inflation returns.

Are there specific challenges for the UK CRE sector of a technical nature that are emerging?

Besides Brexit-related economic uncertainty, I think it’s mostly the familiar challenges: demographics, climate change, housing supply (including the emergence, at long last, of multifamily as an investment sub-sector), and the evolving impact of technology on retail and leisure.

What do you think the political climate in the UK is like now in relation to financial sector regulation? As an example, if the EC starts to seriously entertain the proposal that risk retention requirements be raised to 20%, could/would the UK possibly use Brexit as an excuse to maintain the current 5% requirement?

There is indeed a possible silver lining here — but it may not be so simple. For starters, it will probably only be if the UK loses straightforward access to the EU single market that it will have meaningful flexibility in the area of financial regulation — so it’s arguably a consolation prize rather than the primary goal. Furthermore, both politically and commercially, the UK needs good quality financial regulation — even more than with tax, competitiveness is not the be all and end all. And unfortunately CMBS in particular has plenty of other problems to worry about besides risk retention.

While the UK might manage to use Brexit to avoid some of the worse ideas European policymakers have had for financial regulation, it seems inevitable that the EU’s financial policymaking literacy will be weakened by the UK’s reducing involvement (which we are already seeing). So the likelihood of more hostile or poorly thought through EU legislation seems greater with the UK on the way to the exit.
Why Risk Retention Might Not Be So Bad for CMBS

After a year of fretting over the damage that risk retention rules would do to the CMBS market, the first deal that used the structure was a home run for the issuers. Now some in the industry are wondering: Will the regulation ultimately do more good than harm?

The debate surrounding risk retention—a requirement that issuers of CMBS retain 5 percent of the securities sold—has centered on just how negative the impact would be. The laundry list of concerns focused on whether it would dry up capital to buy the first-loss classes and whether it would make securitization programs less competitive by increasing the cost of lending.

Yet when the first glimpse of risk retention came into view this month, the results were surprisingly positive. Although risk retention is not mandatory until the first quarter of 2017, Wells Fargo, Bank of America and Morgan Stanley teamed up to securitize an $870.6 million pool of loans in which they retained 5 percent of the bonds. The Wells Fargo-led transaction, which priced on Aug. 4, was extremely well received by investors. The 9.9-year triple A-rated class was priced to yield 94 basis points over swap spreads, 15 basis points less than market spreads a week earlier and nine basis points less than a comparable deal that priced the following week, according to "Commercial Mortgage Alert." The risk retention deal's triple-B-minus class was priced to yield 425 basis points over swap spreads, compared to market spreads of 584 basis points a week earlier.

There are various theories as to why the deal priced so well. One is that CMBS issuance has been thin in recent months, so investors were starved for paper to buy. Another is the quality of the collateral: Because the deal was the first of its kind, the issuers were keen to make sure the loans in the pool were pristine. Even granting those conditions, however, it is clear that investors like the idea of banks “eating their own cooking,” so to speak, and they paid a premium for that comfort.

Vertical vs. Horizontal

The key to making the deal work was the “vertical” structure, which means that the issuers retained 5 percent of each class in the transaction, a total of $43.5 million. In order to get more favorable capital treatment, the banks created a synthetic class that enabled them to classify the collateral for accounting purposes as whole loans rather than securities. That whole-loan treatment allows the banks to set aside considerably less capital than they would have to to hold securities, which in effect makes the deal more profitable.

Since 93 percent of the transaction carries an investment-grade rating of triple-B-minus or higher, the amount of collateral held by the banks that is in danger of defaulting is fairly small. What’s more, the banks stand to collect regular income for the collateral that they hold.

When risk retention was first contemplated, the market largely assumed that a different structure—known as “horizontal”—would be the most common. Under a horizontal structure, the bottom
5 percent of the deal would be sold to a “B-piece” buyer. CMBS issuers have historically sold the most junior tranches to B-piece investors. These classes are sold at high yields, typically between 15 and 20 percent, but also carry the highest risk because they bear the brunt of defaults.

A big drawback to the horizontal structure is that B-piece buyers typically purchase less than 5 percent of the deal structure, while the risk retention regulations prohibit the owners of the 5 percent strip from selling the bonds for five years. The concern was that forcing the B-piece buyer to purchase higher-rated classes they do not want and then prohibiting them from trading the positions would dry up demand, or at the very least drive down prices for B pieces to the point that it would become prohibitively expensive for the securitization programs.

Using the vertical structure eliminates most issues with the B piece, as the junior bonds (minus the 5 percent strip retained by the issuers) can be sold in the normal process. The Wells Fargo team sold the junior classes to Rialto Capital at a reported 17 percent yield. What's more, no matter what structure is employed, the number of active B-piece buyers in the market has allayed fears that there would be a shortage of capital to buy junior bonds under risk retention.

**Only the Beginning**

Even though the first risk retention CMBS transaction was a success with the vertical structure, it's far too soon for the market to celebrate. For one thing, bank examiners have yet to rule on the whole-loan accounting treatment employed by the banks. If that treatment is ultimately disallowed, it would make the vertical structure less economical.

Another issue is that the vertical structure requires banks to hold loans on their balance sheets, and eventually they could get to the point where they are full of commercial mortgage holdings and cut back on lending. This might not be a big issue with giant money-center banks such as Wells Fargo and Bank of America but could be with midsize banks and specialty lenders that have smaller balance sheets and less capacity to book loans.

As the CMBS market enters uncharted waters, expect a large amount of experimentation and deals with many different structures — be they vertical, horizontal or “L-shaped,” which is some combination of the two.

Even so, however, the fact that the first risk retention hurdle was cleared without a hitch is encouraging to a market that has struggled in the face of a host of new regulatory burdens and pricing hurdles. Through mid-August, CMBS issuance in 2016 was only $41.4 billion, down 44 percent from the $71.2 billion issued during the same period in 2015, according to CMA.

**Chart 3**

CMBS Issuance (Bil)

If CMBS prices fall as a result of regulations that include risk retention, some fret that the market will find itself permanently unable to compete with banks and life companies. So at least for now, the market can exhale and plan to get back to business.

“The vertical structure makes a lot of sense for larger issuers, especially those with a large balance sheet," said Tom Fink, a senior vice president at analytics firm Trepp. "It is as close to business as usual as you can get.”

Some investors are even more positive about the impact of the vertical structure, saying that it will force lenders to write better loans that will make the product more popular with investors. Plus, the banks will make money on the portion of the deal that they hold, in what will amount to a win-win situation.

“Banks will find a way to hold the loans with lower capital costs. They will do more business, deals will get larger and they’re not putting much capital at risk. It’s positive across the board," said one veteran investor. “The industry is going to come to love it.”
uring the past year, the United States real estate industry has seen many newcomers enter the field of mezzanine lending. In some cases, as a result of the increase in regulations governing traditional banks (as more particularly described below), traditional banks’ inability to continue making generous mortgage loans has created mezzanine lending opportunities for “alternative lenders.” These alternative lenders include private equity funds, real estate investment trusts and, in some cases, private developers/operators. Naturally, there has been a rush to fill the void created as a result of, among other things, mortgage loan originators limiting the size of their loans to loan-to-value ratios (LTV) of 50% to 60%, prompting some to wonder whether the mezzanine lending market is oversaturated. However, the increased competition facing mezzanine lenders is tied to a variety of factors, including the underlying location of the property, property type, identity of the sponsor and the lenders’ reputation within the industry. Yet, unless new regulations are passed to govern the alternative lending field, alternative lenders will continue to capture a larger share of the market.

Mezzanine lenders in primary markets such as New York, Chicago, Los Angeles and Miami face the greatest threat from competitors. With more lenders vying for the same deals, lenders are engaging in more aggressive underwriting, which results in downward pressure on yields. Notwithstanding this increased competition, additional opportunities continue to arise for alternative lenders as many traditional banks have exited the construction and development deal space. Furthermore, the impending high-volume maturation of commercial mortgages over the next few years should produce healthy borrower demand for mezzanine debt. However, since mezzanine debt transactions are heavily negotiated (given the mezzanine lender’s first-loss position), lenders that can execute quickly, in addition to possessing established real estate operating experience, will be better positioned to succeed in this competitive field.

The Banking Industry
Since the 2008 recession, the banking industry has faced increased scrutiny and regulation, in the form of Dodd-Frank and Basel III, among others. These regulatory regimes have limited the ability of traditional banks to originate loans secured by real estate by forcing them to hold more capital on their books (which, theoretically, reduces the risk that lenders will engage in “shoddy” underwriting). Consequently, traditional banks are becoming increasingly sensitive to which types of deals they are willing to hold on their books (and which types of sponsors they’re willing to finance).

If a traditional bank agrees to enter into a financing arrangement secured by real property, the new regulatory landscape requires structural changes to both the underwriting and origination process. Prior to 2008, traditional banks would routinely lend up to 85% of the LTV. Now, many traditional banks are hesitant to exceed an LTV of more than 50% to 60%. This has forced borrowers to seek mezzanine debt in order to fill capital stack gaps, thereby avoiding having to contribute more of their own equity into a deal. Accordingly, many analysts believe that there will continue to be healthy demand for mezzanine debt.

The Rise of Alternative Lenders
Alternative lenders, who are not subject to the aforementioned regulatory requirements, have jumped in to fill this gap. These alternative lenders are mostly private equity firms and real estate investor groups, some of whom remain active in the mortgage loan origination space, though others have decreased their mortgage loan originations amidst what they consider to be an overheated market. Given their mandates to deploy increasing amounts of excess capital, many of these groups are turning to the mezzanine space with the hope of attracting higher yields. While taking the mezzanine (or junior) position comes with increased risk, because mezzanine lenders have their own collateral, they have the ability to foreclose under the Uniform Commercial Code. Consequently, if the loan goes sideways, a mezzanine lender will be able to take control of the borrower in 30-60 days (and thereby control of the property) under the Uniform Commercial Code, whereas a mortgage lender is forced to navigate the often lengthy judicial foreclosure process.

Additionally, alternative lenders offer borrowers a number of advantages compared to traditional banks. The first is their ability to execute quickly. Whereas traditional banks and their “compliance” departments often slow the pace of closing to a crawl, alternative lenders aren’t saddled with layers of rigid oversight. This is especially important when a borrower is using the funds to acquire a piece of property (or interest in real property), as many purchase and sale agreements contain “time is of the essence” clauses.

Furthermore, alternative lenders can aid borrowers in obtaining additional capital. For example, an alternative lender with strong real estate operational experience who agrees to provide mezzanine financing on a construction deal will often provide greater comfort to a traditional bank considering originating mortgage financing on the same deal. The presence of an alternative lender in the mezzanine position enhances a mortgage lender’s outlook, as the
Markets

While the number of alternative lenders vying for deals continues to increase across the country, the biggest increases are taking place in the primary markets (New York, Chicago, Los Angeles and Miami). In these markets, lenders are sometimes reducing pricing, limiting covenants and increasing their LTV ratios in order to outbid their competitors. As a result, the quest for double-digit yields continues to shrink.

The secondary and tertiary markets remain less competitive and continue to provide opportunities for alternative lenders willing to take on higher-risk projects. In addition to higher returns, lenders in these markets generally have more negotiating power. As such, these markets will likely continue to be an attractive option for mezzanine lenders willing to take on added risk and looking to avoid the excess crowding plaguing the primary markets.

Relationships

While pricing is almost always the determining factor for borrowers when sourcing debt, in a transaction with both mortgage and mezzanine debt, a mortgage lender will almost always have the right to consent to the borrower’s choice of mezzanine lender. This is where an alternative lender’s reputation and experience become increasingly important, as mortgage lenders are unlikely to agree unless the mezzanine lender has a proven track record.

One illustration that highlights the importance of both a lender’s reputation and experience arises in the context of the negotiation of intercreditor agreements. Mezzanine lenders who partner up with traditional banks for the first time often experience difficult, drawn-out negotiations over the terms of this complex agreement, which sets forth the various rights and remedies of the respective lenders. However, in a situation where the parties have previously completed a deal together, they will generally be able to avoid much of the negotiation process by simply relying on precedent. This can be an important component for borrowers concerned about a lender’s ability to execute. Consequently, mezzanine lenders who have successfully built relationships and partnerships within the industry will be better positioned to capitalize on future lending opportunities.

Deal Types

While an increase in bidders for deals has driven down prices, opportunities remain for lenders willing to enter some of the more risky sectors of the mezzanine debt markets. For example, as traditional banks continue to withdraw from originating debt in connection with construction or new development projects (choosing instead to focus on more straightforward acquisitions and refinancings), alternative lenders continue to increase originations for these types of deals. Mezzanine lending in the construction arena often requires an “active” lender with strong real estate operational experience, which is a natural fit for many alternative lenders. Given the increase in peer-to-peer lending, the question remains as to whether this is a temporary phenomenon or indicative of a more seismic shift in the industry. Nonetheless, unless the newly enacted regulatory schemes are loosened or eliminated, alternative lenders will continue to seize these opportunities.

One concern that has emerged regarding peer-to-peer financing in the construction field is “predatory lending.” Borrowers have become increasingly wary of “lenders” who they view as originating mezzanine financing solely with an eye toward eventually seizing control of the borrower (and thereby the property). Consequently, if a borrower views his or her mezzanine lender to be “predatory,” depending on the leverage of the borrower, the lender may be confronted with restrictive contract clauses during the negotiation process, all aimed at heavily obstructing the lender’s ability to foreclose and take over the project. The rise of predatory lenders continues to provide opportunities for alternative lenders with proven track records and solid reputations.

Alternative Sources of Capital

Borrowers who are unsatisfied with the current options for mezzanine funding have been increasingly searching for creative and alternative ways to finance their deals. Over the past decade, a number of well-known established investors and developers have turned to alternative financing options such as EB-5 and foreign bond markets. Although closing a transaction navigating these routes is often time-consuming and fraught with regulatory hurdles, borrowers appear to be willing to endure the process given the
significant pricing differential compared to the pricing offered by traditional banks. While mezzanine debt typically carries double-digit interest rates, some borrowers have been able to secure rates as low as 3% or 4% from these alternative sources. However, as demand for these sources has intensified, rates have increased. For example, EB-5 capital currently carries a rate in the neighborhood of 7%. Moreover, with the constant influx of newcomers to the mezzanine lending space, mezzanine interest rates continue to fall, further shrinking the interest rate differential. Thus, borrowers looking to avoid a protracted process will likely continue to pursue “traditional” mezzanine financing.

**Looking Ahead**

Demand for mezzanine debt should continue to increase over the next few years due to the looming wave of loan maturities. Industry experts expect nearly $1 trillion worth of commercial mortgages to mature over the next three years, likely creating a shortfall between maturing loans and the amount of senior debt available for refinancing. This gap should create considerable opportunity for mezzanine lenders.

According to the Commercial Observer, in 2015, alternative lenders originated 68% more mortgage and mezzanine debt than they did in 2014. Unless a new regulatory regime is created to regulate the alternative lending space, alternative lenders will continue to gain a greater share of the mezzanine lending market. Finally, though some mezzanine lenders are bound to face significant challenges in originating mezzanine debt in primary markets, lenders who remain flexible (regarding location, project type and identity of the sponsor) will continue to seize opportunities provided by an ever-shrinking and over-regulated traditional banking system.
Mezzanine Lenders: Opportunity or Overcrowded?

As the overall market returns to pre-recession levels, mezzanine finance has begun seeing a resurgence in interest from both borrowers and lenders. Mezzanine financing, which is used in multiple facets of commercial real estate ranging from acquisitions, development, and refinancing, has become an important source of capital for projects seeking higher last dollar loan-to-value (LTV) ratios above what first mortgage lenders currently provide. However, given the renewed interest from lenders for mezzanine financing, one could argue that there are too many players on the court as the purported demand for mezzanine debt picks up from upcoming refinancing needs.

Mezzanine financing is a cyclical product that historically has drawn a wide array of investors, ranging from private investment funds, life insurance companies and real estate crowdfunding platforms. These investors seek the higher yields that accompany subordinate debt to help offset the current low interest rate environment for fixed income investments. The number of participants in the mezzanine lending space has historically spiked ten years following a period where there was a high volume of first position mortgage originations and today’s market is no exception. While bank’s balance sheets continue to be the largest source of commercial mortgages, the commercial mortgage backed securities (CMBS) market is the second largest source. The most recent instance where there were a significant number of mezzanine lenders in the market was towards the peak of the last cycle, from 2005 to 2008, as the 1995 to 1998 vintage of CMBS loans came due.

The question now is whether the marketplace for mezzanine debt continues to provide prudent investment opportunities or whether the space is in fact overcrowded? Whether you are a mezzanine lender or a borrower looking for mezzanine financing, understanding the current status of the market can assist in your strategic business decisions.

“To compensate for the added competition in the market, without having to sacrifice returns, mezzanine lenders turned to aggressive loan structuring to accommodate borrowers. This saw debt service coverage ratios and overall last dollar leverage pushed to new levels as aggressive underwriting standards were implemented in order for lenders to remain competitive.”
It is important to note that many of these deals were originated and underwritten at the top of the market, when lenders were keen to deploy their investment capital. That being the case, underwriting standards at origination for these loans were much more aggressive than present underwriting standards. Morningstar reports that of the loans maturing in 2016, roughly 21.1% have a loan-to-value ratio ("LTV") between 80% and 100% and 25.7% have LTVs greater than 100%. Of the loans maturing in 2017, roughly 21.8% have LTVs between 80% and 100% and 19.5% have LTVs greater than 100%. Note that these LTVs on maturing loans are based on current underwriting parameters, as opposed to parameters at origination.

At a high level, the delta between the leverage of the existing debt obligation that is maturing and the leverage at which the loan can be refinanced provides an opportunity for mezzanine lenders to fill the gap in the capital stack. Currently, mezzanine lenders are underwriting loans at a maximum last-dollar LTV of 85% while charging rates ranging from 10% to 14%, based on anecdotal evidence.

Rising Demand Suggests a Crowded Playing Field

As stated earlier, as the volume of refinancing need increases, so does the supposed amount of lenders in the mezzanine space as players begin to chase opportunity for higher returns. According to Preqin, 40 mezzanine funds closed in 2015, raising a total of $20.1 billion at an average proportion of 106% of targeted raise. This compares to the 42 funds that raised $28.2 billion in the market during the previous peak in 2008. Due to the impact of the global financial crisis, the number of mezzanine funds in the market decreased to 28 funds which raised $8.4 billion in 2009 — the lowest number of funds closed in a given year and lowest total capital raise amount for the period analyzed (2008-2016 YTD).

While these metrics have yet to test the highs set during the previous cycle, it could be considered evidence of a mezzanine debt marketplace that is heating up. As competition builds up in the chase for yield, deal structures typically become more aggressive. Returns on mezzanine loans originated in 2006 and early 2007 typically ranged from the mid to high-teens, based on anecdotal evidence. However, per a Wall Street Journal article dated December...
Mezzanine Lenders: Opportunity or Overcrowded?

2007, mezzanine debt on loans during this period yielded returns as high as 20%. To compensate for the added competition in the market, without having to sacrifice returns, mezzanine lenders turned to aggressive loan structuring to accommodate borrowers. This saw debt service coverage ratios and overall last dollar leverage pushed to new levels as aggressive underwriting standards were implemented in order for lenders to remain competitive.

As an additional point, one could argue that most of the low hanging fruit have already been picked – that most of the refinancing deals with the easiest execution have already been refinanced. This could imply that the market is oversaturated with lenders without enough borrowers with deals to justify the amount of capital ready to be deployed. This situation, in addition to any indication of the implementation of aggressive underwriting standards by mezzanine lenders would suggest that the market is, in fact, overcrowded.

Unknown Supply Suggests Plenty of Opportunities

It is important to note that while there are data available for the amount of closed mezzanine funds and capital raised by these funds, these metrics can only imply the amount of supply of mezzanine capital in the marketplace. The same can be said of CMBS maturity data, as the amount of maturing senior debt loans can only imply the potential demand for mezzanine debt. Without direct data recording the total volume of mezzanine originations, we can only use anecdotal data to come up with opinions on the mezzanine lending marketplace.

With that being said, we can note various data points presently seen in the market: 1) mezzanine loan pricing currently is nowhere near the levels seen during the previous cycle; 2) last dollar leverage ratios remain capped at 85% loan-to-value; and, 3) debt service coverage ratios and debt yield requirements remain at relatively conservative levels. Using this anecdotal evidence, one could conclude that competition in the mezzanine lending space has not heated up to the point where lenders have to be more aggressive with terms and structure in order to win deals, as it was at the end of the previous cycle.

While one could alternatively argue that the lack of aggressive underwriting can be compensated by lower returns or that aggressive underwriting typically leads to lower yields, the counter-effect of lower returns would be that it is not attractive enough to draw non-typical investors to mezzanine debt, as was the case prior to the global financial crisis. In order to draw non-typical investors to the mezzanine space, yields have to remain high. If yields remain high, there are more competitors in the marketplace and with more competitors in the marketplace, that typically means lenders have to sacrifice elsewhere, other than yield, to remain aggressive. The primary implication, assuming that this is in fact the case, would imply that there is still room in the mezzanine lending space as the bulk of the wall of maturities comes due through the next two years.

New Trends in Mezzanine Lending

In addition to the shifting market environment, market participants must be cognizant of emerging trends in the mezzanine space. Requirements for investment and commercial banks are continuing to change as new laws and financial regulations are instituted and interpreted. However, not all implications from these regulations are necessarily obstructive for the mezzanine lending landscape. In some cases, new laws and regulations have opened up previously untapped channels for mezzanine lending as a whole.

The most notable of these recently developed regulations is the Third Basel Accord, more commonly referred to as Basel III. Basel III, expected to be fully implemented by 2019, is intended to strengthen bank capital requirements by increasing bank liquidity and capital requirements and decreasing bank leverage. These requirements were drafted as a response to the insufficient financial regulation that led to the global financial crisis and it is anticipated that it will impact the absolute amount of leverage available for commercial real estate transactions, including mezzanine lending. While intended to prevent a future adverse liquidity situation, such as what sparked the global financial crisis, the increased liquidity and capital requirements may potentially impact pricing on mezzanine loans. According to some estimates, lenders may have to increase pricing by up to 200 basis points to make up for the added capital requirements of Basel III.

On a different note, since the passage of the Jumpstart our Business Startups (JOBS) Act in 2012, the mezzanine lending space is beginning to see the entrance of alternative lending platforms, such as RealtyMogul.com. While the JOBS Act is generally associated with crowdfunding, which constitutes donations or equity investments, the new law also allows for marketplace lending, which includes all types of financing in the form of debt. The JOBS Act aimed to make the process of raising capital simpler, cheaper, and faster.

“One could argue that most of the low hanging fruit have already been picked – that most of the refinancing deals with the easiest execution have already been refinanced. This could imply that the market is oversaturated with lenders without enough borrowers with deals to justify the amount of capital ready to be deployed.”
which allowed for the entrance of marketplace lending platforms into the mezzanine space. As the Act continues to evolve, what was historically only accessible to large institutional funds or wealthy, accredited investors is slowly becoming available to more investors — regardless if they are institutional, accredited, or not — who are drawn to the lower risk of a debt product with potentially higher yields. While real estate marketplace lending is still in its relative infancy, it is estimated that $2.5 billion in investments were raised in 2015 through alternative lending platforms and that figure is projected to grow to $3.5 billion in 2016. As real estate marketplace lending continues to mature as an industry, we may potentially see these platforms competing with institutional funds for deals.

**The Bottom Line**

In conclusion, while there is no hard data on the volume of mezzanine debt originations, the multiple factors covered above provide the basis for one to draw conclusions on the current state of mezzanine lending. Data shows that there is indeed an upcoming wave of refinancing demand in the form of maturing CMBS loans. On the other hand, until reliable origination data on mezzanine financing is collected, the amount of supply available in the market will remain uncertain. Monitoring overall deal structure can provide the best indication of how heated the current market conditions are.

Finally, developments such as Basel III and the JOBS Act, as well as a more disciplined approach to underwriting, serve as a cautionary yet intrepid reminder that, compared to historic trends, there can be fundamental market-wide differences in a post-2008 world. Whether these differences are new regulations or new channels of capital, mezzanine lending is a constantly evolving investment space that is reliant on multiple marketplace factors. As with any investment, prudent market participants — whether lender or borrower — must take note of this in their individual assessments of the market environment.

**Co-Authors:**

Jilliene Helman
Jilliene is the CEO and Co-Founder of RealtyMogul.com and is responsible for the company’s strategic direction and operations. Jilliene, who sits on RealtyMogul.com’s board, has underwritten over $5 billion of real estate and was previously a Vice President at Union Bank, where she spent time in Wealth Management, Finance and Risk Management. Jilliene is a Certified Wealth Strategist®, holds Series 7, Series 63, and Series 24 licenses and has a degree in Business from Georgetown University.

Martin M. Q. Nguyen
Martin is responsible for the financial analysis and qualitative screening of commercial real estate debt and equity requests. Since joining RealtyMogul.com, Martin has underwritten and analyzed over $1.25 billion worth of national commercial real estate across all asset classes. He graduated in three years from the University of Hawaii at Manoa with a B.B.A. and double majors in Finance and International Business.
Follwing the 2008 banking crisis, governments around the world found themselves having to bail out large financial institutions by injecting capital to help those institutions continue to service their debts. In Europe, the most high profile of these bailouts were those in Greece, Portugal and Iceland. The UK also was affected with many of the UK’s best known banks being included in a bank rescue package totalling some £500 billion (approximately $850 billion at the time, closer to $650 billion now). As banking institutions were bailed out by the government, it was, of course, the taxpayer who footed the bill and, as a result, Lloyds Bank PLC and The Royal Bank of Scotland PLC remain partly owned by UK PLC even now.

What this meant in practice was that the creditors of those bailed out institutions — the depositors, bondholders and so on — were spared at the expense of the taxpayer.

The European Union (together with many taxpayers) considered this to be unjust, and sought to ensure that such mass quasi-nationalisation of financial institutions would not need to happen again. The process began in earnest in 2009 when the European Commission published a consultative communication that outlined the beginnings of a new framework for crisis management arrangements in the banking sector. Following further consultation the legislative framework began to form and in 2013 the Bank Recovery and Resolution Directive (2014/59/EU) (BRRD) was approved by the European Parliament and Council. Member states had until December 2014 to implement the BRRD into national legislation and until January 2015 to apply its provisions (January 2016 in respect of bail-in).

In the UK this was done by way of statutory instruments extensively revising the Banking Act 2009 (*Banking Act*), and by amending the Financial Services and Markets Act 2000 to give the Bank of England, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) new powers. The revisions also made extensive changes to the UK special resolution regime and introduced the Banking Act. The SRR applies to banks, building societies, certain investment firms, central counterparties and banking holding companies. The aim of SRR is to provide a mechanism for ensuring that financial institutions can fail without undue disruption to the financial systems, without interruption to the economy and (perhaps most crucially) without it being at the taxpayers’ expense.

The SSR is composed of five stabilisation options:

1. transfer to the private sector;
2. transfer to a bridge bank;
3. transfer to an asset management vehicle;
4. bail-in; and
5. transfer to temporary public sector ownership.

**What is Bail-in?**

The aim of bail-in is to absorb losses and recapitalise a financial institution by using that institution’s own resources. The central banks of EU-member states have powers to make special bail-in provisions that write down or convert the claims of shareholders and unsecured creditors into equity. In this way, ordinary taxpayers, who otherwise have no connection and no previous liability to the failing institution, do not find themselves exposed to the cost of saving it.

Bail-in is already happening in practice. In April 2016 the Austrian Financial Market Authority (FMA) became the first EU-member state to use the new law to shore up an €8 billion ($9.1 billion) hole in the balance sheet of Heta Asset Resolution AG (the “bad bank” residual asset of Hypo Alpe-Adria-Bank International AG). The FMA did this by (amongst other things) insisting on a 53.98 percent bail-in for all eligible preferential liabilities, cutting Heta’s senior liabilities by 54 percent and extending the maturities of all eligible debt to the end of 2023.

**What is the Contractual Recognition of Bail-In Powers?**

Financial institutions established in EU-member states are bound by the BRRD and its provisions by virtue of the obligation of member states to implement the directive into national legislation.

Outside the EU, however, the BRRD does not automatically apply and there is a risk that a counterparty may challenge (and the courts may fail to give effect to) a subsequent bail-in. In order to avoid this, Article 55 of the BRRD has, since 1 January 2016, required financial institutions established in EU-member states to include terms, in any agreements governed by non-EU laws, that specify that the payment and other liabilities in those agreements may be subject to bail-in under the BRRD. The type of liabilities caught may be quite broad, may include contractual and non-contractual liabilities, and may extend to loan agreements, hedging arrangements, guarantees, intercreditor arrangements and security documents amongst others.

So far as the loan markets are concerned, both the Loan Markets Association (LMA) and the Loan Syndications and Trading Association (LSTA) have published suggested bail-in clauses in respect of loan documentation and these are gradually being accepted by the market as standard. The Association for Financial Markets in Europe (AFME) has produced a similar model clause for...
use in the capital markets (although for the moment this is limited to use by UK financial institutions for debt securities governed by New York law) and the International Securities Lending Association (ISLA), International Capital Markets Association (ICMA), and the International Swaps and Derivatives Association (ISDA) are considering protocols for securities lending, repo and derivatives.

The penalties for the failure by a financial institution to comply with article 55 depend on the law of that institution's jurisdiction. In England and Wales, the PRA has the ability to take disciplinary action against financial institutions “in accordance with standard PRA policy” for any breach of PRA rules, which include the obligation to include contractual recognition provisions in relevant contracts. Because of this, the ability of counterparties to negotiate the contractual recognition provisions or indeed to strike them out altogether is limited.

Counterparties have, understandably, begun to challenge the provisions; most recently a US borrower client successfully seeking to reserve the right to contest both a bail-in and the applicability of bail-in provisions before the US Federal Court. But the main LMA and LSTA template clauses are swiftly becoming market standard and financial institutions are resisting changes.

The Impact of Brexit

On 23 June 2016 the UK electorate voted to leave the EU. Brexit itself is likely to take some time, with commentators now of the opinion that the relevant notice under Article 50 of the Lisbon Treaty, formally commencing the exit process, may not be delivered by the UK until Q2 2017 at the earliest, which means that formal dissolution of the UK’s membership of the EU will not take place until at least 2019.

Before then there is likely to be considerable negotiation in respect of the UK’s relationship with the EU and its individual member states, as well as the negotiation of trade agreements globally. A large part of the exit process will need to be devoted to the many EU regulations that currently apply to the UK and that will, once the two-year exit timetable envisaged by the Article 50 process comes to an end, no longer be binding. In addition, there are a number of EU directives that require national implementation and have been implemented, and one of those is, of course, the BRRD.

The UK is currently an EU-member state and the financial institutions established in the UK are therefore institutions to which the BRRD applies. The position post-Brexit is uncertain and may change. Stabilisation requirements of some sort are likely to continue, but whether it will be by way of a formal implementation of BRRD (that is, the effective continuation of the BRRD requirements as transposed into national laws and the SRR) or an altered, “home-grown” version is subject to debate. While the impact of BRRD is likely to continue to be felt in the UK (once the BRRD no longer applies, entities in the UK that enter into contracts with EU financial institutions are likely to be required to accept contractual recognition provisions), whether contracts between non-EU parties and UK financial institutions will be subject to contractual recognition provisions post-Brexit is an entirely different matter.

Conclusion

Following the implementation into national legislation of the BRRD and of bail-in obligations as of 1 January 2016, financial institutions established in an EU-member state would be wise to ensure that any non-EU law governed contracts (most obviously, finance documents, for example where an EU established lender is granting banking facilities to a US borrower subject to New York law) that impose payment or other liabilities contain contractual recognition of bail-in provisions substantially in the form of the LMA or LSTA suggested bail-in clause.

Counterparties may find that some minor negotiation is possible, but expectations should be managed. The likelihood of substantive changes to the increasingly market standard LMA/LSTA bail-in clauses is slim. Counterparties should therefore seek advice on the impact of effectively agreeing to be bailed-in.

2 http://www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf
5 http://www.bankofengland.co.uk/praa/Documents/publications/ss/2015/ss4215.pdf
6 See http://www.bankofengland.co.uk/publications/Documents/other/praa/approachforenforcement.pdf and http://www.bankofengland.co.uk/praa/Documents/publications/sop/2016/approachforenforcementupdate.pdf for details of the PRA’s approach to deciding whether action should be taken and, if so, its approach to setting the level of penalty applicable. Factors include the “seriousness of the breach,” the “size and financial position of the firm,” and “the effect or potential effect of the breach on the advancement of the PRA’s statutory objectives.”
A critical and perennial need for the CMBS industry is ensuring it attracts borrowers by providing them with a positive servicing experience, especially in light of increased competition from other financing sources. CMBS servicers and special servicers face significant obstacles to achieve timely service when handling consent requests, one of their most important borrower-focused responsibilities, because of the number of parties required for approval as well as the complexity and variability of the transactions. In recent years, many servicers have adjusted their operations and enhanced technology to strengthen consent processing and improve service levels, and both the Commercial Real Estate Finance Council and Freddie Mac have worked to standardize documents and requirements and streamline processes. Morningstar Credit Ratings, LLC’s examination of the aggregated consent-processing times of four large-volume master servicers indicates that amid substantial request volume, their average completion times during the past few years have been fairly constant and even quicker in some periods. However, despite their efforts, CMBS servicers remain under scrutiny. Most notably, as reported by Commercial Mortgage Alert1, a group of issuers and investors submitted a letter to CREFC voicing concerns with servicers’ and special servicers’ practices, including consent-request management and the overriding issue of borrower satisfaction. Although many variables can affect consent-processing time frames, including some that may be beyond their control, CMBS servicers remain challenged to circumvent the roadblocks and find new avenues to boost performance.

Hazards and Detours: The Obstacles to Timely Consent Processing

Consent requests in CMBS transactions can encounter potential delays at every turn. Many variables can impede processing timelines. Chief among these are the multiparty approval process as required by most CMBS deal documents, the transaction’s complexity, and information requirements.

Multiparty Approval Process

CMBS consents typically involve multiparty approvals in which the designated primary or master servicer takes the lead role to interact with the borrower, obtain the required documents and information, underwrite the request, prepare the written case for internal review, and procure any required external-party approvals. Additionally, the lead servicer normally must obtain consent from the transaction’s special servicer for actions defined as major decisions, such as loan assumptions, property-management changes, collateral substitutions or releases, or large-tenant leases. The final approver for most consents is the controlling-class representative, or CCR, which is usually, or at least initially, the most subordinate investor class (in many cases, the CCR and special servicer are affiliated parties). CCRs typically respond, but their consent also may be deemed as given if they do not respond within a certain number of days. However, for CMBS transactions with an appointed trust advisor, the CCR’s approval rights can diminish, and the trust advisor’s involvement can expand if the transaction’s performance degrades. Finally, the servicer may need rating agency consent in some situations, although such consent is sometimes passively granted. While this conventional consent-approval flow may contribute to a thorough analysis by garnering additional viewpoints, it invariably adds time.

Transaction Complexity and Information Requirements

Servicers also point to the often daunting information and document requirements as another speed bump. For example, loan assumptions — one of the most prevalent, complex, and time-sensitive request types — involve many submission items, including financial statements, legal documentation, and sales contracts involving the proposed new borrowing entity. The loan-assumption process and its document requirements, as well as those for other consent types, can vary among loan originators, servicers, and pooling and servicing agreements. Updated valuations and required municipal approvals can extend consents involving collateral releases or changes of use. As a result, some consulting firms have established business lines to assist borrowers with loan assumptions and other consents. Accordingly, servicers often mention borrower-related delays and missing documentation to explain why certain consents took a long time to complete.

Further contributing to the challenges of timely consent processing, according to some servicers, is that loan structures have become increasingly complex in the past couple of years, possibly because of competition among lenders and their desire to accommodate borrowers’ financing demands. Additionally, servicers noted that loans originated in recent years tend to have more compliance requirements and performance-driven trigger events than loans issued before the financial crisis. These elements can compound the underwriting of a consent request.

Navigating Through Traffic: Operational Enhancements and Best Practices

Confronted with heavy consent-processing workloads, many CMBS servicers have bolstered staffing and refined their organizational structures with consent-management teams and subject-matter experts. In addition, they have enhanced their technology to facilitate transaction management and are working to improve borrower-communication channels.
Staffing and Organizational Management

Morningstar calculated that the average portfolio-management staff experience of the four dominant CMBS master servicers (Wells Fargo Commercial Mortgage Servicing, Midland Loan Services, KeyBank, N.A., and Berkadia Commercial Mortgage LLC), which includes employees engaged in consent requests and borrower-relationship management, increased to 18 years as of June 2016 from 15 years as of December 2013. Additionally, their total portfolio-management staff increased by 53% during that time, while their total combined volume of loan assumptions, leasing consents, property releases, and defeasance requests increased by approximately 31% between 2013 and 2015. To manage consent volume, which can include other types of credit-related requests, some servicers may engage vendors to assist with compiling information, data input, and cash flow modeling. For situations in which one entity is both the master servicer and special servicer, the servicer may consolidate the consent review to one team. However, in Morningstar’s experience, the servicer commonly has its special-servicing group also review the same request, because such an approach can add an extra level of control without unduly extending review time. As a best practice, both servicers and special servicers should have policies and procedures for approvals denoting sound controls through appropriately delegated levels of management authority.

To facilitate borrower communication, many servicers have modified their operations from a strict siloed or functional approach to a relationship-manager structure, enabling borrowers to have a single point of contact. Wells Fargo, for example, also has a team catering to borrowers with the largest and most complex loans. Midland Loan Services has developed an ombudsman process for its master- and special-servicing consent approvals in which staff assist borrowers with problematic situations and facilitate in finding solutions. Some CMBS special servicers have established asset-management teams for consent processing and, with their nonperforming loan volumes declining in recent years, have been able to reallocate staff to assist with consents. Because not every borrower request may be feasible or permissible, a few servicers noted that they strive to inform a borrower at the earliest possible point if a request cannot be met. However, servicers stated that they aim to accommodate borrowers as permitted within the confines of servicing agreements and loan documents. Some servicers have formally surveyed borrowers to track contentment levels, using the survey scores and comments to identify areas for improvements.

Technology Advancements

Morningstar believes that some servicers’ upgraded servicing systems, along with their proprietary applications, have stronger workflow-management capabilities to track pending consent requests, approval queues, required information and documents, and processing times. Some servicers can prepare their consent-request cases directly in their asset-management and workflow systems that provide electronic approvals and templates customized for different consent types. Servicers also have been expanding the capabilities of their borrower web portals to be more interactive with secured email and chat capabilities, compliance alerts, and document-exchange features. These tools certainly do not supplant the need for a borrower to have telephone access to a responsive and knowledgeable servicer contact person. However, Morningstar believes that servicers will continue to leverage their borrower websites as a complementary means to improve borrower communication.

Educating Borrowers

Servicers frequently comment that CMBS borrowers often are not sufficiently aware of the provisions, obligations, and fees delineated in their loan documents, especially as they relate to consent requests. Furthermore, servicers believe that lenders should educate borrowers during the loan-origination process about the nuances of CMBS financing. While such efforts might help, they may not be realistic expectations. As a result, the burden of increasing borrowers’ understanding of CMBS requirements continues to rest with servicers. Educational tutorials designed specifically for CMBS borrowers could potentially produce worthwhile results.

Highway Improvements: Freddie Mac’s and CREFC’s Efforts to Streamline and Standardize

Freddie Mac has been at the forefront to reform consent-processing practices and requirements for its multifamily-loan servicers as part of the larger goal of improving borrower satisfaction. Most notably, in 2014, Freddie Mac expanded and refined its existing servicing standard, which has been the cornerstone of its guidebook for servicers and essentially mandates that all servicing-related parties practice transparency, act collaboratively, and communicate proactively. Freddie Mac established rigid servicer-compliance guidelines to cap legal and other transaction fees, streamline the chain of approvals, and shorten consent-processing timelines. In particular, Freddie Mac expects its servicers to complete assumptions, ownership transfers, or other consents it defines as complex within
30 days of receiving a complete information package from the borrower. For matters it deems routine, Freddie Mac set a 15-day time frame. Another differentiating aspect of Freddie Mac’s consent-request process for its securitizations is that servicers must send their consent packages directly to the CCR and bypass the special servicer. Freddie Mac noted that it continues to enhance its consent-management process with more granular tracking of request deliverables and that its securitization-program servicing agreements require the servicers to comply with its guide and standards. Also, Freddie Mac teamed with KeyBank last year in a pilot project to construct a data-sharing interface between Freddie Mac’s consent-request tracker and KeyBank’s asset-management application to reduce data-entry redundancy.

Another positive stimulus to establish consistent consent-underwriting practices is CREFC’s initiative to standardize documents and information requirements. Through a task force, the trade organization in September of this year formally adopted and has made available a standardized loan-assumption closing checklist and underwriting guidelines for loan assumptions.

**Speedometer Readings: Searching for Positive Trends**

Using aggregated data from the four previously mentioned CMBS master servicers, Morningstar examined average consent-processing times for 2013 through June 2016 for three common borrower requests that typically involve external-party approvals: loan assumptions, leasing consents, and partial releases of property collateral.

As shown in Exhibit 1, it is difficult to find definitive evidence of absolute year-over-year time-reduction trends. Clearly, the case-specific circumstances of many requests, and other factors, can easily skew the averages. Servicers also do not define their start and completion dates in the same way. However, Morningstar’s analysis found mostly narrow fluctuations for average completion times, while the servicers confronted high processing volume in these periods. As stated in Morningstar’s June 2016 report on master servicers’ portfolio-growth trends, although their consent volume decreased 11% in 2015, it followed a 46.8% jump in 2014. For 2015, these servicers still processed more than 8,800 requests involving loan assumptions, leasing consents, partial releases, and defeasance. Additionally, loan assumptions, as a high-profile consent type, show a positive trend regarding servicers’ average internal-approval times, which declined in each subsequent period, while their total processing times dropped after 2013 and remained fairly stable since.

**Exhibit 1**

**Master Servicers’ Average Consent-Processing Times (Days)**

*Based on data (mostly CMBS loans) aggregated from Berkadia Commercial Mortgage, KeyBank, Midland Loan Services, and Wells Fargo.

**The Special Servicer as Designated Driver**

Another wrinkle to consent processing, and in contrast to the traditional model, are cases of some CMBS servicing agreements permitting the special servicer to bypass the master servicer, or its designated subservicer, and unilaterally underwrite the consent request (aside from any required approval from the CCR, which is often a related party, or consultation with a trust advisor). The special servicers handling such consents will often note the merits of this alternate approval structure based on time-efficiency gains and their rigorous analytical diligence. With reduced nonperforming loan volume in recent years, some special servicers have redeployed personnel and established teams to work exclusively on consent requests. Correspondingly, the special-servicer-control approach can ease master servicers’ workloads. However, critics cite concerns that this alternate approval process potentially increases the opportunity for the special servicer to pursue terms and conditions that may unduly exceed a loan’s original underwriting, which, in turn, can sour the borrower’s servicing experience.

Morningstar analyzed assumption and lease-consent times of loans with this approval structure for two special servicers, Torchlight Loan Services, LLC and Rialto Capital Advisors, LLC. The results offer support for the time-efficiency argument. These special servicers’ total loan-assumption processing time averaged 35 days in 2015, based on 24 requests, and averaged 56 days in the first half of 2016 based on 37 requests. For leasing consents, the two special servicers, based on 37 requests in 2015 and 64 in the first half of 2016 under this structure, averaged 21 days in
“While CMBS can potentially offer attractive financing terms, providing a high-quality servicing experience is integral to the sector’s sustainability and growth.”

special servicers’ averages were consistently below Morningstar’s calculated master-servicer averages.

The Road Ahead
In many respects, servicers have made inroads to strengthen their consent processing and borrower-relationship management. However, the recent letter to the CREFC, and subsequent action to establish a task force, indicates that discontentment persists. While CMBS can potentially offer attractive financing terms, providing a high-quality servicing experience is integral to the sector’s sustainability and growth. The inherent structural requirements and complexities of CMBS transactions may always constrain them from competing on equal footing with portfolio lenders when it comes to consent requests. Nonetheless, Morningstar believes that servicers, motivated at the very least by competition and reputation, should remain critical of their own performance and continue to pursue process improvements to raise borrower satisfaction.

DISCLAIMER
The content and analysis contained herein are solely statements of opinion and not statements of fact, legal advice or recommendations to purchase, hold, or sell any securities or make any other investment decisions. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MORNINGSTAR IN ANY FORM OR MANNER WHATSOEVER.

CMBS Default and Loss Study: Defaults Slow, Losses Grow

After peaking in 2010, US commercial mortgage annual loan defaults have been on a steady decline. The trend continued during the first six months of 2016, as loan defaults fell by 26% to 199 compared to 268 during the same period in 2015. Through June 2016, a total of 14,459 loans defaulted for a 15.6% cumulative default rate by loan count.

Losses took a different path during the same time period with a 52% increase on a first-half (1H) 2015 to 1H 2016 comparison. As of June 2016, the cumulative loss rate was 4.0% with a loss severity of 49.7%. The time to resolve a loan, which has trended higher since 2010, increased to 36.1 months in 1H 2016 compared to its 21.5 month long term average over the study period.

In the post-recessionary period there was significant noise surrounding what was deemed to be ‘Kick the Can CMBS Economics’ given the time it took to resolve many specially serviced loans. In retrospect, it may have served the industry well, as it likely contributed to higher recoveries than would otherwise have been achieved if assets were sold into distressed markets. Fortunately, the winds were against the industry’s back, given improving property fundamentals, attractive yields compared to alternative investments and rising property valuations for commercial real estate (CRE).

In many respects, the tide may be turning for future resolutions, as CRE prices have reached, or even exceeded peak levels in many markets, while CMBS mortgage originations may be further impacted by the impending risk retention rules. In addition, 36.5% of the maturing loans in 2017 are bricks and mortar retail, the overall refinance rate may be negatively impacted due to structural secular shifts in that sector, which may also contribute to increased loss severities for defaulted retail loans.

Loan Defaults

Maturity Defaults on the Rise

Kroll Bond Rating Agency’s Default and Loss Study analyzed 92,415 commercial real estate loans from 693 fixed-rate conduit transactions. The study population included in excess of $1.0 trillion of loans with one year of seasoning that were primarily originated for securitization between July 1995 and June 2015. Loan information was gathered through June 2016, the study cutoff date, from Trepp. The data was subsequently reviewed, analyzed, and arrayed in a manner that facilitated our analysis.

With the addition of 199 defaulted loans YTD June 2016, the cumulative default rate edged up to 15.6% from 15.4% at year-end 2015. We define the cumulative default rate as the number of defaulted loans divided by the total number of loans in the study population. Maturity defaults, as a percentage of total defaults, increased to 69.7% Y-O-Y (1H) 2016 from 61.6% during the same period in 2015. But even with this shift, the cumulative term default rate of 11.3% is over 1.5x the cumulative maturity default rate of 7.1%. We define term default as any loan that defaults more than 12 months prior to its maturity date.

Default Rate Follows Jobs

Given the impact of job growth on property fundamentals, CMBS defaults tend to track the unemployment rate. In the 2001 recession (March 2001–November 2001), the unemployment rate peaked at 6.30% in June 2003, and the annual default rate (the number of defaulted loans in a given year divided by the number of loans outstanding at that time) subsequently rose to a high of 1.4% — a figure the industry did not see again until the Great Recession.
Shortly in the aftermath of the Great Recession, which occurred from December 2007 to June 2009, the unemployment rate hit its peak at 10.0% in October 2009. The annual CMBS default rate subsequently reached a historic high of 5.2% in 2010. Spurred by the Great Recession, 2009 and 2011 posted the next highest annual default rates over the study period, at 4.5% and 3.9%, respectively. Although the 2009-2011 period represented only three years of the 22-year study period, it contributed to one-half of total defaults, reflecting the severity of the downturn in the economy and property markets.

The degradation in credit performance was the result of weakening property fundamentals, as well as market illiquidity and falling property values brought on by the recession. Poor origination quality in the period leading up to the recession was also to blame — particularly in the 2006–2008 period. These years are currently the only vintages with cumulative default rates in excess of 20.0%. As job growth fueled tenant demand, and low levels of construction constrained supply in the post Great Recession period, property fundamentals strengthened, and defaults fell precipitously.

In addition to the peak vintages, the 2000 and 2001 vintages had relatively high cumulative default rates of 19.9% and 19.2%, respectively. One half of these defaults occurred at maturity, which is in sharp contrast to the 2006-2008 vintages, where 86.3% of the defaults occurred during the term. While a dearth of refinancing capital largely contributed to the 2000 and 2001 maturity defaults, properties in the latter vintages experienced cash flow pressure as a result of lower rental rates and occupancies, which contributed to higher term defaults.

Default activity among the Post-Crisis vintages (2010–2015) has been relatively limited. This is likely a function of time, as the latter years, particularly 2014 and 2015, have yet to season. It is also reflective of loan origination quality in the years that immediately followed the crisis, as well as favorable economic and property conditions.

**Secular Changes Influence Property Type Defaults**

Of the five core property types, lodging has the highest cumulative default rate of 22.4%, much of which occurred during the loan term. As lodging assets typically lack long term leases, they are more susceptible to declining cash flows in a downturn as operators try to stem declining occupancy levels by offering reduced rates. When this occurs, operating income suffers, as does the property’s ability to generate cash flow that is sufficient to meet debt service payments.
Among the other core property types, the cumulative office default rate ended June 2016 at 21.4%, almost doubling its rate of 12.1% in 2010. Similarly multifamily had a cumulative default rate in 2010 of 12.2%, but saw its rate rise much slower, to 14.6% in June 2016. The cumulative office default rate has risen more rapidly, as demand in that sector has been impacted by corporate downsizing, particularly in the financial services area, and also from reductions in the average space used per employee. Conversely, multifamily has benefitted from favorable demographics and the decreasing rate of home ownership that have led to increasing rents and occupancies from 2010 to present, although such increases are starting to come under pressure as new supply has come on in many markets.

For the other core properties, industrial’s gain has been brick and mortar retail’s loss. The industrial cumulative default rate has slowly increased to its current rate of 15.3%. However, the number of annual defaults among the core property types fell the most for industrial (almost 50%) since 2014. This is likely the result of increased demand from retailers, which have rented more warehouse space due to increased consumer spending. The demand for warehouse/distribution centers space also reflects the growth in e-commerce from on-line and traditional merchants that have been expanding their omni-channel retail operations.

Chart 6
Annual Loan Defaults by Property Type
Against this backdrop, brick and mortar retail has struggled, and has been further impacted by store closures and tenants downsizing into smaller spaces. As exhibited in the table, the number of annual retail defaults over the last three years has declined very little compared to the other core property types. We anticipate increased defaults in the retail sector given the volume of loans that will reach maturity. Retail accounts for 36.5% of maturing loans next year, almost twice the next largest sector, office at 18.9%.

Of the Non-Core property types, healthcare has the highest cumulative default rate at 26.2%. In the late 1990’s, healthcare property operations were significantly impacted by changes in government reimbursement rates, particularly for skilled nursing homes. At the other end of the default spectrum, cooperative housing has exhibited strong credit performance with a cumulative default rate of 0.9%, the lowest amongst all property types. Continued strong performance by cooperative loans is expected as they tend to be low leveraged and usually situated in core markets.

**Partial-Term IO Default Timing**

Full-term IO loans had the largest percentage of defaults occur at maturity (84.9%). Absent deleveraging, there is a greater chance that loans may default at maturity should capital market conditions change and require more stringent loan leverage and/or debt service coverages. If the property hasn’t experienced meaningful cash flow growth during its loan term, the likelihood of default is even greater.

**CMBS Default and Loss Study: Defaults Slow, Losses Grow**

“During the period of 2005-2008, larger loans tended to default more than earlier vintage cohorts.”

Full-term IOs accounted for 16.6% of the 2005-2008 vintage originations, and of these, 20.6% defaulted. Outside of this cohort, 5.8% of full-term IO loans defaulted.

Partial-term IO loans defaulted more often compared to both full-term and amortizing loans. This behavior was likely influenced by the property’s inability to meet an increased debt-service burden following the expiration of the loan’s IO period. Within 24 months from the first amortization period, over 40% of the partial-term IO term defaults occurred.

**Large Loan Defaults Defy Popular Belief**

Conventional wisdom holds that larger loans tend to default less than smaller loans, as they are generally made to sophisticated, well capitalized sponsors that are more selective in their real estate holdings. As a result, they could be more committed to a property and support debt service payments during times of economic dislocation. However, for those loans securitized during the period of 2005 to 2008, larger loans tended to default more. Some of this behavior is likely attributable to leverage, as approximately one-third of the 2005 to 2008 cohort loans with balances of $100 million or more had LTVs in excess of 75%. For the pre 2005 cohorts, only 7% of these loans had LTVs in excess of 75%.
Loan Losses

Losses Jump Y-O-Y

Through our study period, 12,646 loans, or 87.5% of the 14,459 defaulted loans, have been resolved. The resolved loans had a cut-off principal balance of $146.0 billion. Of the resolutions, 78.9% incurred losses totaling $42.4 billion. In the first six months of 2016, there were $10.9 billion of resolutions, which represents a 32.7% increase from the same period in 2015. After declining from peak levels in 2012, losses jumped by 51.8% Y-O-Y in the first half of 2016 to $2.8 billion, half of which occurred in January 2016 ($1.4 billion).

Chart 10
Default Rates by Loan Size and Securitization Cohort

In addition to increased losses, loss severity moved 540 bps higher on a Y-O-Y basis through June 2016, to 49.7% for loans resolved with losses greater than 2% of the loan’s cut-off principal balance. For all resolved loans, including those that were resolved with losses less than 2%, the loss severity was 33.0%. Loss severity is generally dependent on several factors including origination quality, property prices, market conditions, and the special servicer’s disposition strategy. Of these, property prices may have the strongest influence on loss severities.

*Resolutions and Loss Severities based on securitization balance

Chart 11
Resolutions and Losses

The 2007 vintage year has the highest amount of losses, at $12.7 billion, followed by the 2006 vintage at $10.8 billion. The highest cumulative loss rate belongs to the 2008 vintage (11.7%) which is more than 500 basis points higher than the 2007 vintage (6.6%). As the capital markets froze with the onset of the Great Recession, CMBS issuance in 2008 slowed to a trickle, at $10.8 billion from $193.0 billion in the prior year. The low issuance volume for the 2008 vintage contributed to it having the highest loss rate among all the vintages.

2006 and 2007 Vintages Account for 55% of Losses

After prices peaked in August 2007, the cumulative loss rate rose steadily from 0.4% to 4.0% in June 2016. During this period, approximately 92.1% of the study’s losses were realized. We calculate the cumulative loss rate as the sum of all losses divided by the total principal balance of the study population.

US CRE Pricing Indices and Cumulative Loss Rate

Source: CoStar Group

After prices peaked in August 2007, the cumulative loss rate rose steadily from 0.4% to 4.0% in June 2016. During this period, approximately 92.1% of the study’s losses were realized. We calculate the cumulative loss rate as the sum of all losses divided by the total principal balance of the study population.

2006 and 2007 Vintages Account for 55% of Losses

The 2007 vintage year has the highest amount of losses, at $12.7 billion, followed by the 2006 vintage at $10.8 billion. The highest cumulative loss rate belongs to the 2008 vintage (11.7%) which is more than 500 basis points higher than the 2007 vintage (6.6%). As the capital markets froze with the onset of the Great Recession, CMBS issuance in 2008 slowed to a trickle, at $10.8 billion from $193.0 billion in the prior year. The low issuance volume for the 2008 vintage contributed to it having the highest loss rate among all the vintages.

2006 and 2007 Vintages Account for 55% of Losses

After prices peaked in August 2007, the cumulative loss rate rose steadily from 0.4% to 4.0% in June 2016. During this period, approximately 92.1% of the study’s losses were realized. We calculate the cumulative loss rate as the sum of all losses divided by the total principal balance of the study population.
Loss Severity Exceeds 50% for Most Property Types

The cumulative loss rate for core properties ranges from 3.7% (multifamily) to 4.9% (lodging). The range for non-core property types is wider, from a low of 0.1% (cooperative housing) to 9.2% (healthcare). Based on aggregate loss volume; retail and office dwarf the remaining core property types, at $12.9 billion each. The amount of aggregate losses for these two sectors are a function of their representation in the study’s population, as retail accounts for 30.5% of the total, and office at 28.2%. With aggregate losses fairly comparable for these two sectors, but with office accounting for a smaller percentage of the population, its cumulative loss rate of 4.3% is higher than retail at 4.0%.

When reviewing the loans that were resolved with losses greater than 2% among the core property types, retail (51.2%) slightly edged out lodging (51.0%) and office (50.8%). Four of the six non-core property types had higher loss severities than core properties. This, in our view, is likely due to there being a more limited universe of buyers than for core property types, resulting in less liquidity, especially during distressed times.
Loan Resolutions

Loan Recovery Time Trends Higher

Starting in 2011, resolution times trended higher. From the time of a loan’s default (60+ days delinquent) until it’s resolved, the resolution time YTD June 2016 increased to 36.1 months from 28.7 months during the same period in 2015. With lengthier resolutions, severities also increased, as longer periods for servicer advances and carrying costs added to losses. With the increase in the recovery time 1H2016, the average long term recovery time increased from 20.9 months at year-end 2015 to 21.5 months for the study period.

Loans collateralized by operating businesses tend to take the longest to resolve as evidenced by healthcare at 25.4 months and lodging at 25.2 months. Some other examples of operating businesses that have been financed through CMBS with longer recovery times include car washes and parking garages. As with loan size, there are fewer lenders that want to finance these more volatile, labor intensive property types.

Multifamily had the shortest recovery time for the core property types at 20.6 months. For non-core properties it was cooperative housing at 9.7 months.

Chart 20
Resolution Timing by Core Property Types

Chart 21
Resolution Timing by Non-Core Property Types
Economist Milton Friedman once observed, “Pick at random any three letters from the alphabet, put them in any order, and you will have an acronym designating a federal agency we can do without.” HV-CRE offers a bonus, five letters and a hyphen spelling out High Volatility-Commercial Real Estate and also a regulatory concept many bankers believe they could do without. Since January 1, 2015, US banks have been required to hold 150% capital against their commercial loans that finance the acquisition, development, or construction (ADC) of real commercial property.

These ADC facilities include land acquisition loans, land development loans, tract development loans, construction loans for commercial properties, loans to finance repositioning or rehabilitation and bridge loans. Term financing for stabilized, income producing properties are not subject to the higher capital requirement. The higher capital requirement for ADC lending reflects regulatory concern that ADC lending is riskier than other kinds of bank financing, and so it is classified as High Volatility-Commercial Real Estate (HV-CRE).

HV-CRE: What’s In, What’s Out

Generally, regardless of size, any existing and future ADC loan extended to either a real estate developer-investor (REDI), or an owner-occupied (O-O) borrower must be reported as HV-CRE if it exceeds the appropriate FDICIA LTV supervisory limit or lacks the minimum equity requirement of 15% based on the property’s “as completed” appraised value satisfactory to REVAL when originated as a construction loan.

Exhibit 1

<table>
<thead>
<tr>
<th>ADC Loans to REDI borrowers, Co-REDI borrowers and Owner-Occupied borrowers that finance</th>
<th>Flag as HV-CRE</th>
<th>Do not Flag as HV-CRE</th>
</tr>
</thead>
</table>
| Commercial land loans:  
  • Land acquisition*  
  • Lot acquisition*  
  • Land development | • Raw land LTV > 65%  
  • Lots LTV > 75%  
  • A & D LTV > 75% | • Raw land < 65%  
  • Lots < 75%  
  • A & D < 75% |
| Commercial construction loan | Regardless of LTV, if the minimum upfront equity contribution** of 15% is not met | LTV < 80% and minimum upfront equity contribution** of 15% is met |
| Renovation, rehabilitation or reposition loans (Rehabilitation, modernization, or conversion to another use that involves extensive improvements or modifications) | Regardless of LTV, if the minimum upfront equity contribution** of 15% is not met | LTV < 80% and minimum upfront equity contribution** of 15% is met |
| Bridge loans (Short-term financing to allow newly constructed or acquired commercial properties to reach stabilization) | > 80% LTV | < 80% LTV |
| 1-4 family ADC loans | NA, excluded from HV-CRE | Loans to finance 1-4 family ADC |
| Agricultural land loans | NA, excluded from HV-CRE | Loans to finance farmland |
| Community development loans | NA, excluded from HV-CRE | Affordable housing including multifamily |

* Value means the lesser of cost or market value for purpose of LTV calculation  
** Equity must be comprised of cash and/or real property at its purchased price, not its current market value. The 15% equity is calculated on “as completed” appraised value satisfactory to the bank, not total costs.
In addition to this table, appended to this article is a flowchart that illustrates the logic in determining whether an ADC loan is HV-CRE.

**Pricing: Pay to Play**

Construction loan pricing should include the 150% risk weighting’s additional capital costs, and depending on a bank’s capital ratio and tax bracket, an HV-CRE ADC loan typically needs 50 to 100 bps to cover the capital costs. Upon completion, any permanent financing drops the risk weighting from 150% back to a 100% risk weighted asset for capital purposes.

**Real Estate Credit Administration (RECAD): Pay to Pay the Pros**

Because HV-CRE is a 150% risk-weighted asset, the sooner construction can be completed, the sooner the construction loan can be converted to a permanent loan or taken out by another lender, and the Bank can eliminate the 150% capital charge. If a bank has not already implemented real estate credit administration unit (RECAD), the investment certainly would be cost-justified by turning over construction management and monitoring to a professional group.

**Current HV-CRE Issues: Just the FAQs**

Spokespersons for the regulatory agencies have stressed that their examiners have been directed to look for a consistent, ongoing process for identifying and monitoring HV-CRE loans. If the banks are trying to do the right thing, that is the goal for this year. During this breaking-in period, several issues have arisen and the following list identifies and explains them:

- Rule by FAQ
- Inconsistent enforcement among the regulatory agencies
- Exclusion of 1-4 family ADC
- Inclusion of owner-occupied properties
- 15% minimum equity based on “as completed” appraisal
- Land equity counted at cost instead of at market value
- Return of capital vs return on capital
- Long-term impact of higher bank construction rates on bank competitiveness with non-banks
- Long-term impact of higher bank construction financing costs on cap rates

**Rule by FAQ.** Unlike other recent Dodd-Frank and Basel-related regulation, the regulatory agencies opted for the Frequently Asked Questions (FAQ) guidance approach. FAQs are convenient for the agencies in that they are easy to revise and change, but they only offer explanation and interpretation of a specific rule or policy, and there is not yet a final rule. The rule process is more formalized, but it permits comment by us bankers, and bankers have had a couple of years to tote up tips, suggestions, and recommendations. Instead, a couple of pages out of the July 2013 Basel III Final Rule on Capital are the current sole governance, but those pages offer little guidance. The FAQs seem to have been written without real estate subject matter experts on hand, and several of the issues listed here might have been resolved with some initial input from bank commercial real estate lenders and credit approvers. The regulatory agencies have acknowledged that they are working on an HV-CRE rule by the end of the year.

**Inconsistent Enforcement among the Regulatory Agencies.** Abundant anecdotal experience documents the differences in HV-CRE interpretation by the OCC, Fed, and FDIC. A prime example is the return of capital vs return on capital, and this article will amplify that point shortly. The Shared National Credit (SNC) program presents another opportunity for disagreement. Led by the OCC, the SNC review examines exposures of $20 million or more shared by at least 3 banks. Fed and FDIC banks face potential criticism for HV-CRE underwriting that complies with their interpretation but is at odds with the OCC. The ongoing differences among the FDIC, the OCC, and the Fed on leveraged financial transactions (LFTs) and high risk borrowers (HRBs) demonstrate that even with final rules, the agencies often enforce the rules very differently.

**Exclusion of 1–4 Family ADC.** If bankers were surveyed on what they considered to be the riskiest ADC lending before the Great Recession struck, the top of the list would have included 1–4 family ADC. This puzzling exception may be best explained by the need for homebuilding to be part of the administration’s economic strategy for recovery.

**Inclusion of Owner-Occupied Properties.** Instead, the initial governance elected to pursue owner-occupied properties, a property type most banks have found to be relatively low risk because repayment derives from the operation of the resident borrowing entity and only secondarily on the real estate.

**15% Equity Based on “As Completed” Appraisal.** This requirement contains several problems. First, common lending practice is to base the minimum equity on total construction costs, not an...
appraisal, and certainly not an “as completed” appraisal. If the promulgators had talked with the appraisal community, they would have discovered that this type of appraisal is not commonly used because of its limited value. Further, it penalizes borrowers who have pre-sold or pre-leased their properties because they will have to inject more equity into their higher-value projects than spec developers. The 15% minimum equity comes with other challenging requirements. The equity must be received by the bank before construction begins and held by the bank until completion. Marketable securities and CD’s must be cashed in and the proceeds deposited with the bank instead of being held as collateral. Wait, there’s more! The loan agreement must stipulate that contributed capital remains in the project until the credit facility is taken out by permanent financing, sold, or paid in full. Of course, when HV-CRE kicked in at the beginning of 2015, there was no grandfathering of existing loans, so none of those existing loan agreements contained this language.

Land Equity Counted at Cost Instead of at Market Value. Whether the borrower acquired the land 20 years ago or last month, the land can be counted only at original cost to the borrower. This rule obviously penalized long-term landowners and potentially encourages land flipping, hardly a practice tolerated by the regulators in the past. Unable to count the land’s appreciated value, the owner now has to raise additional equity, and the time needed for that effort may hurt the project’s feasibility. Nevertheless, of all the shortcomings of existing HV-CRE governance, the regulatory agencies seem to be unwilling to give up this land-at-cost requirement.

Return of Capital vs Return on Capital. Yet another sore point is the fight over cash flows from partially completed properties. The bank already holds the borrower’s 15% equity, so does the bank also have a right to the cash flows from rents or sales of completed units in the overall project? Regulators seem to be divided themselves; one group argues that the lender should also hold the cash flows to build up the project equity while others support the view that the borrower is entitled to the cash flow as long as the borrower meets the 15% equity hurdle.

Long-term Impact of Higher Bank Construction Rates on Bank Competitiveness with Non-Banks. Banks that survived the Great Recession are encountering non-bank competition from insurance companies, fintech organizations, and other non-regulated financial organizations who are not encumbered by the HV-CRE capital requirements and its 50-100 basis point pricing premium. The consequence is that construction lending is moving away from bank regulatory oversight into a much less controlled environment with lesser construction underwriting and management.

Summary and Closing: There Must Be Some Way Out of Here

All joking aside, it is time for the regulatory agencies to give some relief to the bankers. For starters, consider the following:

- Promulgate a proposed final rule on HV-CRE and invite comments from the banking community
- Exclude owner-occupied properties from HV-CRE
- Base the 15% equity requirement on total cost, not on “as completed” value
- Count land at its current market value, not at original cost
- Permit the borrower to keep any cash flow from rents or sales cash flow as long as the borrower maintains the 15% equity minimums

What is most needed now is open dialogue and judicious debate, and while both the regulators and the bankers may not get everything they seek, the Rolling Stones offer this sage advice in You Can’t Always Get What You Want:

“*You can’t always get what you want
But if you try sometime you find
You get what you need.”

Exhibit 2
High Volatility Commercial Real Estate (HVCRE) Decision Tree

Notes
A. Appreciated value of the land does not count towards contributed capital.
B. Distribution of capital, e.g., distributing any profits to owners or sponsors, is not allowed during construction and distribution restriction language must be included in loan documentation.
C. This Decision Tree is only a tool and is not a supplement to or replacement of official credit policy.

1. 12 CFR 217.2
2. SR 15-06 Question 9 of FAQs
3. 12 CFR 208.22 and 12 CFR 228.12(g)(3)
4. 12 CFR 208, Appendix C
Much rests on the valuation of real property, especially when there is a property dispute or complicated filing.

So, your choice of a valuation professional should give you unshakeable certainty. MAI, SRPA and SRA Designated members of the Appraisal Institute are widely recognized as among the most qualified real property professionals practicing today. In fact, Appraisal Institute Designated members:

• Meet the highest educational standards in the profession;
• Have extensive real-life valuation experience; and
• Complete a comprehensive demonstration of knowledge requirement to achieve designation.

Excellence? Appraisal Institute Designated members raise it to a whole new level.

Find An Appraiser at: appraisalinstitute.org/excellence.
Ideas Are the New Currency

Which is why it pays to think big. You’ll get a powerful, integrated financial platform, and keen market insights and strategy from our team of experts. Because at Key, we see what others don’t.

To learn more, contact:

Joe DeRoy
CMBS Program Manager
joe.a.deroy@keybank.com
913-317-4260

Dan Olsen
Sr. Vice President, Servicing
dan.olsen@keybank.com
214-414-2564

Visit key.com/realestate

Banking products and services are offered by KeyBank National Association. All credit, loan and leasing products subject to credit approval. Key.com is a federally registered service mark of KeyCorp. ©2016 KeyCorp. KeyBank is Member FDIC.

Trusted Intelligence. Market Clarity.

See what your competition is missing.

Because your best interests come first...

NATIXIS

... our bankers offer both CMBS and Portfolio loans.

Natixis provides flexible and creative structures, a simplified process and professional execution, delivered by bankers empowered to make decisions.

Natixis (Standard & Poor’s: A/Moody’s: A2/Fitch Ratings: A) is the international corporate, investment, insurance and financial services arm of Groupe BPCE, the 2nd-largest banking group in France (Market shares: 22.4% in customer savings deposits, and 20.7% in customer loans - Source: Banque de France Q3 2015)

Phone (212) 891-5700 • real-estate@us.natixis.com • www.re.natixis.com

CRE FINANCE COUNCIL

JANUARY CONFERENCE

Register Today!

JANUARY 9-11, 2017
LOEWs MIAMI BEACH HOTEL, MIAMI, FLORIDA
THE MARKET STANDARD IN MONTHLY CMBS SURVEILLANCE

SUPERIOR ANALYSIS

- ONLY platform utilizing a multi-valuation approach with multiple loss scenarios
- ONLY product in the market offering full transparency of valuation assumptions
- ONLY service forecasting both default and resolution timing
- ONLY provider offering commentary and valuations for all top 10 Loans

WITH BEST IN CLASS SERVICE

- Coverage of over 95% of CMBS universe, including legacy conduit, 2.0/3.0, FRE-K, & SB/LL
- Impeccable customer support and full access to entire analytical staff
- Fully integrated with Trepp Analytics

MARKET FEEDBACK

" Kudos to KBRA, you’ve really put out a great product."
" KBRA has nailed it."
" The best product in the market today, hands down."
" Groundbreaking."

Visit kcp.kbra.com for a FREE trial!
CONTACT: Marc Iadonisi · miadonisi@kbra.com · 215 882 5877