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## CMBS 2.0: Still in Need of Work

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**Since their arrival in the 1980s, commercial mortgage–backed securities (CMBS) have held great promise for commercial real estate borrowers. They greatly increased capital flows into commercial real estate and offered lower-cost loans in exchange for cumbersome loan documentation and less flexibility to make changes to the loan and collateral once it was funded.**

Lenders prospered as they collected loan-origination fees while being able to quickly sell those loans to CMBS packagers who seemed to have an unlimited appetite. According to *the Compendium of Statistics* published October 11, 2011, by the CRE Finance Council, over $1 trillion of commercial real estate loans were originated for securitization during the ten years that ended in January 2007. Call this CMBS 1.0.

However, the residential subprime mortgage crisis in 2007 made it dismayingly clear that elaborate structuring and geographic diversification would not protect investors from ill-conceived loans. The market for CMBS abruptly dried up as buyers lost faith in loan originators and rating agencies.

Slowly rising from the ashes, the CMBS industry is addressing the structural problems that caused the meltdown. The fixes—embodied in CMBS 2.0—are now emerging. Some, such as greater transparency and risk retention by originators, are aimed at preventing CMBS industry practices from taking down the economy. Others will impose even stricter requirements on borrowers in hopes of reducing loan defaults in the next downturn.

**CMBS Loans in a Healthy Economy**

Even from the outset, it was clear that commercial real estate loans intended for securitization would not be ideal for every borrower or project. For one thing, the resulting mortgage pool must follow strict real estate mortgage investment conduit (REMIC) rules or it will be subject to double taxation—a disaster for CMBS bondholders. Those REMIC rules prohibit unanticipated modifications—even beneficial ones—to the loans or collateral once they are in the pool.

In order to sell the securities, sponsors need to obtain ratings from agencies such as Standard & Poor's and Moody's. Such agencies impose elaborate and minutely detailed requirements regarding the loans in the pool—and the structure and management of the pool itself—in hopes of making it difficult for the borrower to default or to end up mired in another company's bankruptcy.

Borrowers are required by the agencies to set up special-purpose

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entities with exhaustive restrictions on the conduct of the borrower's business, to hire independent directors with veto power over bankruptcy filing, and to provide complex and expensive legal opinions on bankruptcy and REMIC issues.

The lack of future flexibility and the expensive and overblown loanorigination requirements dissuaded many would-be borrowers under CMBS 1.0. Many who took the loans, attracted by their low interest rates, later regretted the difficulty of dealing with changes in their projects' circumstances, or the inability to make adjustments at all.

Over time, many borrowers have adopted an "anything but CMBS" attitude. Unfortunately, CMBS 2.0 seems poised to address CMBS 1.0's regrettable failure to take into account the likelihood of a general recession mainly by adding to the many largely pointless inconveniences imposed on borrowers.

**CMBS Loans When Things Go Poorly**
If CMBS loans are inconvenient in a good market, they can be remarkably problematic in a down market. When tenants go bankrupt and the property will not support the loan, something needs to change. The good news is that once the loan is in default or in "imminent risk of default," the REMIC rules *do* allow for changes to deal with the problem. The bad news is that it is difficult to find someone with whom to discuss those changes.

Servicing of loans in a CMBS pool is governed by a lengthy pooling and servicing agreement (PSA), a document the borrower never sees. The PSA divides servicing responsibilities between a master servicer, who collects and distributes mortgage payments, and a special servicer, who deals with consents and problems. Servicers are required to act in the best interests of bondholders, but those interests may diverge among the various classes of bondholders. Many servicers also own lowerpriority bonds and thus also want to avoid losing whatever position they hold in the CMBS pool without incurring liability to other bondholders and borrowers.

The result is that it is difficult for a borrower to locate the people making decisions on the loan, to get the attention of those people to discuss solutions, to figure out what the servicer could do if the conversation could occur, and to predict how or when decisions will be made regarding the loan.

Of greater concern is that the servicers appear to hold less allegiance to the terms of the loan documents to which the borrower is party than they do to the PSA to which the borrower is not party. In many situations, with respect to both performing and nonperforming loans, servicers have declined to go along with the exercise of bargained-for financing, transfer, leasing, improvement, and other rights, or charged substantial fees for consenting to permitted activities. Even in cases in which servicers acquiesce in the exercise of rights clearly set forth in the loan documents, reaching that point can take months longer than the loan documents allow, costing the borrower hundreds of thousands of dollars in transaction fees.

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**CMBS 2.0: Solution, or More of the Problem?**

Most CMBS 2.0 reforms are aimed at achieving greater transparency in CMBS underwriting in general, more risk retention by originators to discourage overly enthusiastic lending, more disclosure to investors, and structural improvements to management and decision making within the CMBS pools. At the loan level, CMBS 2.0 tries to lock the barn door even more tightly than before. Loan-to-value ratios and debt-service-coverage ratios are substantially more conservative now than in 2007, though few structural reforms have been adopted to resist the inevitable market forces that will relax them.

At least in the near term, borrowers should expect to have a harder time negotiating flexibility and concessions into loan documentation. Those documents will include stronger and longer nonrecourse carveout ("bad boy") guarantees, even though the old versions did a good job of dissuading bankruptcies. In reaction to the rampant appointment of replacement, questionably independent directors that occurred in the case of General Growth Properties, borrowers now may not be allowed to hire independent directors who serve the same role for affiliates. Borrowers' counsel may also find negotiation of nonconsolidation opinions—already an *Alice in Wonderland* exercise—to be more contentious, and the result to be closer to the lenders' counsel model than before.

**Some Things to Pay Attention to in CMBS Loans**

Borrowers considering a CMBS loan should do the following:

- Understand that you will spend a lot of time and money on requirements that will do no one but lawyers any good—more than you spent already under CMBS 1.0—so the deal size and interest rate must be sufficient to offset a lot of transaction cost.
- Drive a hard bargain to obtain the leeway you may need to enter into leases or make changes to the borrower or the collateral, such as admitting or replacing investors or improving the project. If this leeway is not provided for in the loan documents, the servicers are not going to consent to it later.
- Pay close attention when drafting provisions permitting preapproved changes in order to ensure that they are as automatic as possible, leaving the servicer as little leverage as possible to resist the changes, impose conditions, or charge fees.
- Recognize that notwithstanding your successful tough negotiations, the servicers—understaffed, needing fee income, and mired in the relationships created by the PSA—may choose to ignore your bargained-for rights. There will be little you can do about it, and even if they honor your rights, it is going to take a lot of time and money to get through the consent process.
- Pay close attention to new, broader language in bad-boy guarantees, especially those removing the nonrecourse protection.

Finally, if all this leaves you a little uncertain about a CMBS loan, you should take a good hard look at that "stodgy" life company loan instead.

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