Chapter 1

The Commercial Mortgage Loans and CMBS Markets: Legacy and current positions

Andrew V. Petersen,

Partner and Practice Area Leader-Finance, K&L Gates LLP

1.1 Introduction

Commercial real estate (CRE) is a tremendously important asset, as the content of this book will discuss. However, the CRE lending and commercial mortgage-backed securities (CMBS) markets are, at the time of writing, largely unrecognisable to the markets that existed on the publication of the first edition of this book, published in 2006. Between the first edition[1] and the second edition, published in 2012,[2] such markets have witnessed seismic structural shifts. Numerous financial institutions with strong histories were consolidated or were nationalised and, through the chaos of the GFC, CRE and the CRE capital markets had a visible presence throughout, with nearly all real estate values across the globe suffering unanticipated catastrophic declines.

The provision of capital to the CRE industry, which tends by definition to be very capital intensive and of a longer-term nature was, during the boom period up to 2007, mostly funded by balance sheet banks using relatively shorter-dated funds, thus allowing them larger spreads through effectively taking maturity transformation risk. This position could not continue indefinitely. Due in a large part to the deterioration that began in the US sub-prime mortgage market in the second half of 2007, this position led through contagion, interdependence and interconnection, to a deep crisis for the global securitisation markets, across all asset classes, which developed in 2008 and in the subsequent years quickly morphed into the GFC.

With the GFC came a decrease in leveraged M&A transactions, falling share prices, a weakening of the global economy and the shutting down or freezing of the global real estate capital markets, ending the seemingly

1 A.V. Petersen, *Commercial Mortgage-Backed Securitisation: Developments in the European Market*, 1st edn (London: Sweet & Maxwell, 2006).
2 A.V. Petersen, *Commercial Mortgage-Backed Securitisation: Developments in the European Market*, 2nd edn (London: Sweet & Maxwell, 2012).

unstoppable growth of issuance in European and US CMBS markets witnessed prior to the summer of 2007. This development was not a cyclical change, as had occurred in the past, but a major structural change, giving rise to questions over the viability of the CMBS ''originate-to-distribute'' model, based in part on structural weaknesses revealed in the securities themselves. Such questions, dealt with throughout this book, will also need to be addressed post 2016, as many believe that the impact of this structural shift, still evident at the time of writing, may persist until 2020 and beyond.

Given this backdrop, and the backdrop of the UK's vote for Brexit in the June 2016 referendum on EU membership (the consequences of which continue at the time of writing) the markets witnessed an unprecedented level of intervention by the world's central banks and state bail-outs of the financial and capital markets, and this third edition will consider the ongoing effect of such interventions and their effects on these markets in the context of a post GFC world. In doing so, this Chapter will consider the legacy markets for CRE financing and CMBS and will examine the markets at the time of writing. In doing so, it is necessary to go back in time to examine the evolution of the CRE and CMBS markets in an effort to understand and to determine whether European CMBS will, going forward, once again be an important source of funding and risk diversification tool and resurge from the form in which it exists at the time of writing. Thus, when we consider the legacy European commercial mortgage loan and CMBS markets that exist at the time of writing, we can split such analysis up into three separate periods: up to 2007, 2007 to 2012 and post 2012.

1.2 The European CRE loan and CMBS markets prior to 2007

The first edition of this book chartered the introduction and development of the innovative CMBS product in Europe up to 2006. During this period, as a result of technological improvements and the lowering of global investment barriers that freed CMBS from the restrictions of US REMIC rules, the development of the product proved remarkable in its ability to address the needs of borrowers, loan originators and investors, in a way few would have thought possible. This transformation resulted in an explosion of issuance, as the CMBS market in Europe reached €46 billion (more than double the total for 2004), peaking at €65 billion in 2007. This issuance came off the back of a boom in CRE financing, fuelled by an overheated CRE market, fostered by the availability of plentiful and cheap funding, coupled with relatively low capital requirements that established real estate as a global asset class in its own right.

The European bank lending sector was, up to 2008, the key and biggest provider of financing to the CRE market, providing around 90% of the financing to the sector as banks with significant balance sheet capacity (but not strength, as it turned out) grew their exposure to real estate substantially during the period 1997 to 2007. This was predominantly as a result of falling interest rates which stimulated demand for real estate following the technology market crash and dotcom bust of early 2000s as investors sought solace in longer-term assets that effectively hedged interest rate risk. During the period from 1997 to 2007, given the relatively low development of other forms of financing, CRE financing was one of the fastest growing lending classes for banks, particularly in the UK, Germany, Ireland and Spain. The largest CRE lenders were made up of UK, German and Irish banks (in each case lending both domestically and internationally). Spanish banks also generated a large CRE exposure, although primarily domestic (see further the Spanish lending section contained in Chapter 18). Prior to this period, commercial and residential real estate debt was held on the balance sheets of mortgage lenders, such as banks, building societies and insurance companies. To the extent that a secondary market existed for this debt, it was largely a club syndication and participation market. Securitisation through the issuance of CMBS played a small (historically around 10–12% the total outstanding debt in the sector), but meaningful, role in funding European CRE throughout this development and it is important to understand its origins.

1.2.1 The birth of commercial mortgage-backed securitisation

Whilst the US claims to be the birthplace of CMBS, securities, in the form of European mortgage bonds, have existed in Europe for over 200 years. Nonetheless, it is true that CMBS in the modern form ultimately did not become popular in Europe until after the 1980s following the widespread acceptance in the US marketplace where many of the legal structural foundations of the modern CMBS market were put into place, paving the way for the growth of the modern CMBS industry. Such growth was based on the changing dynamics of real estate lending that had its origins in the 1970s, particularly as US government-sponsored enterprises, such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) began to facilitate increasing growth in home ownership by guaranteeing mortgage-backed securities backed by portfolios of US mortgages.

CMBS in the US received a further catalyst for growth with the advent of the savings and loan crisis of the late 1980s. The crisis led to a seminal event in the development of the modern US CMBS industry, with the passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in August, 1989. Among other things, it imposed stricter capital standards on regulated commercial lenders and created the Resolution Trust Corporation (RTC). The RTC was charged with resolving failed thrift institutions and disposing of the assets of these failed institutions. In the early 1990s, the RTC, and later the US Federal Deposit Insurance Corporation (the FDIC), began to reduce the inventory of assets that they had acquired from failed depository institutions during the savings and loan crisis. The biggest portion of the RTC's inventory consisted of a portfolio of mortgage loans, which by August 1990 was estimated to be more than US $34 billion that had been originated and held by depository institutions that the RTC controlled. It was quickly realised that selling those loans one by one was neither efficient, nor, in the final analysis, even achievable. As the market for mortgage-backed securities had developed dramatically up to this time, the RTC, in a significant step in the evolution of the mortgage capital markets, turned to the then novel concept of private-label securitisation of assets that did not conform to the Fannie Mae or Freddie Mac underwriting standards as a way to dispose of this overhang of now publicly owned private debt.[3]

The success of the RTC's CMBS programme resulted in private-label mortgage conduits bursting forth in the early 1990s as a way of funding and securitising vast pools of commercial and multi-family loans. It is during this period, through financial innovation, that the alchemy of securitisation truly prospered as the ''originate-to-distribute'' business model took hold where mortgages were originated with the sole intention of distributing them or selling them on in the market shortly after being written, thereby passing the risk of default to another financial institution. Such alchemy allowed risky mortgage assets to be mixed in a melting pot of potions to be turned overnight into highly-rated investment grade assets based on a wide range of investor demand and appetite. Meanwhile, the European securitisation markets, whilst lagging behind the developing market in the US, slowly metamorphosed into a European securitisation industry based on three types of securitisation methods:

- ''On-balance sheet securitisation'', such as covered mortgage bonds and Pfandbrief-style products;
- ''Off-balance sheet pass through'' securitisation, where assets are transferred to a trustee for the sole purpose of issuing asset-backed securities; and
- ''Off-balance sheet pay through'' securitisation. This development and growth was as a result of the diversity of the European markets in terms of the types of underlying assets, types of security and the applicable taxes, regulations and laws that permeate throughout Europe.

The introduction of the euro currency towards the end of the 1990s resulted in a reduction of the currency translation risks of cross-border transactions, translating into an increase in issuance fuelled by strong investor demand, which formed the basis for the creation of a relatively large European MBS

3 See further Ch.1 of the 1st edn. The RTC's famous ''Series C'' transactions marked the first time that commercial mortgages were packaged and securitised in large volumes. These programmes not only helped to resolve the overhang of the savings and loan crisis, but also created standard templates for securitisable loan terms, securitisation structures, loan servicing conventions, property information reporting templates and the like, paving the way for the growth of a vibrant commercial mortgage conduit securitisation industry.

market. A UK-centric, fixed rate market in the late 1990s quickly developed. During this time, CMBS transformed the CRE market. What was initially an isolated, self-contained business funded by domestic (and often geographically local) banks and insurance companies, investing a fixed ''real estate'' allocation of capital into the CRE markets for portfolio purposes and holding those mortgage loans on their balance sheets to maturity, transforming itself into a business funded by the broad global capital markets.

By the late 1990s, fixed income investors invested in rated bonds throughout the capital stack, up and down the risk curve enabling the spread of risk. A growing number of boutique, high-yield real estate players further emerged to invest in the below investment grade segment of the risk curve. CMBS led to an enormous increase in the availability of finance and became a major driver of economic growth in western markets. However, the autumn of 1998 witnessed the Russian rouble debt crisis which, whilst shaking the industry to its core, also matured the industry,[4] such that (for a time) there were tightened underwriting standards throughout the early years of the 2000s, a period which also led to a high-yield market for subordinate tranches of CRE loans.[5]

In the UK, prior to 2004 listed real estate companies or corporates were the major issuers of CMBS as it was mainly used as a financial or capital raising tool; a means for such entities to borrow directly from the capital markets to finance investments more efficiently on longer terms than borrowing directly from banks. CMBS proved attractive due to capital efficiencies resultant from the CMBS product with margins offered through a CMBS financing, often lower than through conventional bank debt funding. Thus, a price arbitrage developed between bank lending and CMBS lending. Then from 2005 to 2007, following the birth of banks' conduit programmes (described below), CMBS began lending in increasing amounts, direct to highly geared CRE investors, such as private equity funds and property funds, leading to a dramatic shift in the use of CMBS from a long term financing to a shorter term funding method. The loans originated by these programmes were often set up by investment banks or commercial banks, which would then deposit the loans to capital markets issuing entities for packaging and distribution to investors.[6] These investors, broadly speaking, saw bonds backed by commercial mortgage debt, not as an isolated ''alternative investment'' but simply as one among many core investment opportunities, which were pursued with more or less vigour depending upon perceptions of relative value. This led to a range of assets being financed through securitisation conduit programmes, such as operating businesses made up of pubs, hotels and nursing homes through to offices, retail properties and industrial properties. With this development, the CMBS industry morphed into a major source of capital, with 75% of all

[4] See further Ch.1 of the 1st edn.
[5] See further Ch.5.
[6] See further Ch.3 of the 1st edn and Ch.4 herein.

outstanding CMBS bonds that still exist at the time of writing, issued between 2005 to 2007, mostly all through conduit programmes. Thus through CMBS, CRE and its funding depended, in a very material way, upon direct access to the capital markets. It is worth setting out what exactly the CMBS product consists of for those readers unfamiliar with the product.

1.2.2 Key features of CMBS

CMBS is largely a mechanism for capital transfer established on a methodology of channelling capital into real estate debt based on cash flows generated by separate pools of commercial mortgages through the creation and issuance of securities. This methodology, based on an indirect real estate investment, is a means of providing liquidity to the markets by issuing securities whose payments are backed by illiquid real estate. In essence, illiquid assets are converted into securities that can be sold to investors, through a product, designed to spread risk, through the method of pooling and repackaging of cash-flow producing commercial mortgage loans by mortgage originators, usually in the form of off-balance sheet vehicles in the form of newly formed special purpose vehicles (SPVs). The SPVs issue securities backed by the CRE loans that are then sold to investors in the global capital markets. Instead of requiring the originator to hold all of the credit risk of a CRE loan until maturity, thereby inefficiently trapping capital of the originator, CMBS provides the originator a way of selling the CRE loan upon origination and using the funds received to originate further loans. The process produces fixed income fees for the bank through the creation, sale and underwriting/arranging of the product, and, on occasion, at the same time reducing the mortgage originators' capital requirements/capital relief. The process and its economics, will be discussed further in Chapter 4.

The move in the late 1980s and early 1990s to securitise US mortgage debt effectively remedied one of the primary impediments to real estate becoming a global asset class, that of illiquidity, at the same time serving as a useful credit portfolio risk management tool for CMBS originators. Cash flows from whole loans can be (i) isolated from the individual whole loans and reassembled in a number of ways (based on investor demand) to pay principal and interest (in normal market conditions at a lower amount than the rates received from the borrowers, thereby providing additional income to the CMBS originators), and (ii) stratified by interest rate, risk and duration, thereby boosting the volume of lending available for CRE, via a tradeable security that provides investors with an income stream backed by real assets. Such investor demand drives the value of the sum of the securities to equal or exceed the par amount of the loans backing these securities.

A very important feature of CMBS is the dispersion of risk through the tranching of credit risk based on subordination, so that the pool of mortgage assets (together with any credit enhancement) can effectively be tranched all the way from triple-A rated securities to non-investment grade securities that bear the first loss of risk on the assets in the pool. The securities in a CMBS are rated by international credit rating agencies (CRAs),[7] such as Moody's, Standard & Poor's, Fitch Ratings and DBRS, based on a methodology which recognises the different levels of risk, return, order of payment and degree of credit support. The credit ratings proffered by the CRAs became, over time, a crucial indicator of risk as investors relied on such ratings as they themselves were often not in a position to evaluate the quality of, or risk factors associated with, the underlying assets. Indeed, often investment criteria for senior tranche investors were based on the fact that two of the three largest CRAs had provided the same rating and thus an element of reliance of CRAs undertaking the task instead of investors took hold.

By creating tranched capital structures for investments in pools of mortgage debt, CMBS transactions permit investors in senior tranches ranging from triple-A, with the first claim on payments (thus reducing risk but also providing a lower return), to obtain highly-rated exposures to diverse pools of financial assets at a yield greater than that for comparably rated corporate or sovereign debt. Whilst investors in subordinate tranches (the so-called ''first loss'' piece, as these notes are the first to absorb losses and consequently receive the highest rate of returns), only receive payments once the senior tranches have been paid (i.e. based on a waterfall principle), such investors can obtain leveraged exposures to diverse pools of financial assets without the risk of margin calls.

Such tranching led to the investor base for CMBS becoming highly targeted based on differential risk-return appetites. Treasury departments of banks, structured investment vehicles (SIVs), asset backed commercial paper (ABCP) conduits, insurance companies and pension funds, were the major participants in the most highly-rated tranches, due to many of these entities being required to only hold highly-rated securities, which presents the risk of a forced sale in the event of a rating downgrade of the triple-A notes. The drive for these institutions into senior CMBS tranches was based on the need for a return on a product with triple-A credit ratings. That attracted similar high ratings as compared to government bonds or treasuries, but because interest rates were at historic low levels, offered much lower yields. On the other end of the scale, real estate investors, hedge funds and other opportunistic high yield investors with a high tolerance for risk or a keen understanding of the underlying real estate assets, invested in the most subordinate tranches that provided credit support for the more senior tranches. The participation of SIVs and the ABCP conduits, as leveraged buyers of CMBS, proved controversial, as they engaged in arbitrage by funding their investments through issuing short-term debt, by way of ABCP and repurchase or ''repo'' agreements or arrangements at low

[7] See further Ch.14. for a discussion of the role of the rating agencies in commercial mortgage lending and the wider debt capital markets.

interest rates and then buying CMBS longer-term securities that paid a higher rate of interest. SIVs were thus highly-leveraged vehicles, mainly held and treated as off-balance sheet by banks subject to capital requirements in relation to their balance sheets (as the banks had no direct claim to the bonds). As banks wanted to take on more debt to make the returns that MBS offered, the banks made such investments through SIVs and ABCP conduits. As soon as the ability to raise short-term funding in the market disappeared with the advent of the liquidity crisis, the SIVs were either liquidated (to the extent they were allowed to do so) or brought onto the balance sheet of the banks to protect and preserve the bank's reputation and positions in the market, thereby rendering them unable to purchase CMBS but more importantly still keeping the risk of default within the banking system. This effectively eradicated a large section of the investor base and as buyers for the product disappeared, the CMBS market effectively closed in the second half of 2007.

1.3 The CRE market: 2007 to 2012

Between 2007 and 2012, the CRE market witnessed a severe cut back from bank lenders, due to the uncertainty of value of the assets they had lent against during the boom years. Moreover, regulatory pressures surrounding the banks' capital and its use and a general contraction in the inter-bank lending market, with bank lenders less than enthusiastic to lend to each other, further contributed to such cut back. As a result, banks continued to shrink their balance sheets and the shadow banking sector (discussed below) continued to reduce their exposure to real estate. Further, the value of the assets held on the balance sheet of banks continued to cause concern, as one important consequence of the examination of such assets in the market that developed during this period was the increasing difficulty of valuing such assets. Such difficulty also highlighted tensions with international accounting standards, particularly the ''fair value'' system that requires banks to mark the value of their assets to market price. Post 2007, this resulted in banks and other holders of real estate debt marking values to a virtually non-existent market. When market value is the price that a fair-minded buyer is willing to pay to a seller that does not need to sell, there is a real question raised as to how one values the assets held on balance sheet that cannot be sold at any price because the market for such assets has effectively closed down. This problem was recognised by the Basel Committee, which in 2009 issued guidelines to banks to allow flexibility in marking asset values to illiquid market valuations, particularly where one or more of the transactions (i.e. asset sales) have occurred at less than expected value due to illiquid market conditions.

Overall, the CRE sector received a limited amount of financing from CMBS markets during 2007 to 2012. Most of the CMBS bonds not able to be securitised, due to the shutting down of the CMBS markets, were retained by banks and used to obtain liquidity from the Bank of England (in the UK) and the European Central Bank (ECB) (throughout Europe). Further, the markets witnessed a contraction of lending against CRE by other credit providers such as funds, hedge funds and other institutional investors, the so-called ''shadow banking'' sector. It is estimated that the shadow banking system comprised in excess of 80% of the total credit provided in the US economy prior to the financial crisis of 2007–08. Once the short-term money markets and CMBS markets effectively shut down in 2007–08, the shadow banking system shrank dramatically with important consequences. In particular, the declining profitability of the funds (particularly hedge funds) caused in some cases a dramatic rise in redemption requests from investors. Faced with a large number of redemption requests, some funds were forced to liquidate large portions of their CRE debt portfolios, in many cases through forced sales at well below book value for the assets (a process akin to the one witnessed immediately post the UK's vote for Brexit in the June 2016 referendum on EU membership). This had a knock-on effect on the broader CRE and CMBS markets by contributing to a general decline in value and liquidity.

1.3.1 European CMBS market between 2008 and 2012

In the UK, between 2008 and 2012, there were eight CMBS transactions issued. This contrasted with the period from 2004–07 where there were hundreds of new issuances. These included transactions from Deutsche Bank's DECO platform in 2011 and 2012, true sale securitisations of the Chiswick Park and Merry Hill loans and Vitus German Multifamily deal.[8] The other securitisations were from two corporates that used CMBS to raise funding totalling £3 billion. Tesco Plc brought four CMBS issues to the market, totalling £2.64 billion, backed by rental payments from properties occupied by Tesco Plc. Land Securities Plc issued £360 million of CMBS backed by rental payments from a UK government body. These issuances had several common characteristics that appealed to institutional investors: (i) they were single tranches with no subordinate debt; (ii) they were backed by investment grade credits; (iii) they carried fixed coupons; and (iv) were relatively long dated, with maturity dates ranging from 2027 to 2040. As such, they resembled investment grade corporate bonds and did not represent a true re-opening of the CMBS market, as investors were primarily taking credit risk rather than property risk.

1.3.2. Challenges to re-establishing a viable European CMBS market

Re-establishing a sustainable market in CMBS, since the markets were effectively frozen during this period, proved challenging. This was because CMBS became associated with a number of disadvantages.

Firstly, because of the insistence of CMBS loans being originated to SPVs, to minimise insolvency and other creditor risk, CMBS noteholders, following a

[8] See Deco 2011-E5, Deco 2012-MHILL and FLORE 2012–1.

default, had to rely on the underlying cash flow generated by the properties, since there was no guarantee against other funds. This led to performance issues, with some commentators and regulators branding CMBS as being ''toxic'' assets, which contributed to the GFC. In this regard, it is important to differentiate between the US and Europe (including the UK). As discussed above, in the US, certain products, such as subprime residential mortgage bonds and Collateralised Debt Obligations (CDOs)[9] created from these bonds, performed poorly through the GFC. The delinquency rate of US subprime loans in 2010 rose above 50%. In Europe, however, these same products were not created and the assets backing most securitised products, including CMBS, performed reasonably well during this period, with statistics suggesting that the CRE loans that were securitised were of higher quality on average than the CRE loans that were not securitised in the UK. This theme will be developed further in Chapter 15.

Secondly, being off-balance sheet and existing effectively in the shadow banking market CMBS historically has not been subject to banking supervision or regulations, thus creating the possibility of moral hazard based on weakening underwriting standards. As set out above, CMBS allowed a CRE loan originator to avoid the individual credit risk of its borrowers, however, it also (it was argued) reduced the originator's incentive to ensure the borrower had the ability to repay (based on higher levels of equity) or ensuring through strong underwriting, loan terms and provisions (for example, trapping of cash; interest reserve war chests) based on the real estate providing for payment. Thus, this argument, taken to its extreme, was based on the premise that, where the originator retained no risk and was compensated merely for making CRE loans, regardless of how well those loans were underwritten and without any regard to whether or not that loan would be repaid, there was no incentive for the originator to maintain strict underwriting standards (so called ''covenant light'' loans), leading to a shift in focus of the originator from maintaining high credit standards to generating maximum volume of product. As was witnessed with the spread of the contagion from a US sub-prime crisis to the GFC, the ease by which large financial institutions were able to package up loans into securities and sell those securities in the global capital markets allowed the risk of mortgage defaults to spread well beyond traditional mortgage lenders to investors that may or may not have understood real estate and the risk of having an indirect investment in it.

Finally, there was during the period of 2008 and 2012, and continues (to a lesser extent) at the time of writing, a considerable amount of overhanging CRE debt in need of refinancing. This is due to the fact that CMBS securities (generally around 10 years) are not matched to the underlying loans (typically around five to seven years) raising the risk that borrowers are not able to obtain refinancing at the time of their loan's maturity dates.

[9] See Ch.11 of the 1st edn.

1.3.3. Refinancing risk

Given the catastrophic decline in CRE values after 2007, most LTVs on CRE loans rose in excess of 100%. This resulted in many borrowers being in negative equity. As most CMBS loans do not amortise (preferring instead a single repayment bullet at maturity), it was predicted that those high LTVs would persist for many years to come. Thus, whilst it remained the case that most UK CMBS and loans continued to out-perform balance sheet loans, it was predicted that there was in 2012 refinancing risk for CMBS of around €75 billion, owing to a gradual maturing of existing CMBS. Based on a prediction that up to 50% of all UK CRE that required refinancing might not even be suitable for CMBS origination (not being standardised enough to be trusted by investors) and with an estimated €25 billion of equity capital outflow from real estate markets due to open ended funds terminations, it was predicted in 2012 that there existed a total financing shortage for the European CRE sector of around €400–€700 billion. Of the £56 billion of UK CMBS bonds outstanding, £27 billion was due to be repaid over the next 10 years. These bonds were predominantly of the ''conduit'' variety, which were issued by investment bank programmes from 2005 to 2007, as described above. Given CRE loans tend to have an average duration of five to seven years, preceding the peak in CMBS bond maturities in 2014, a wave of UK CMBS loans, totalling about £19 billion, matured in 2012 to 2014. This topic will be dealt with in further detail in Chapter 3.

Debt held against UK CRE continued to fall from £228.1 billion in 2011 to £212.3 billion in 2012, a drop of 6.8%.[10] The 2012 *UK Commercial Property Lending Market Report* by De Montfort University (*De Montford Report*), found that ''while the overall level of debt was falling and progress had been made in dealing with the distressed legacy debt, there was a long way to go with between £72.5 billion and £100 billion struggling to be refinanced on current market terms when the debt matures as it has a loan-to-value ratio of over 70%.'' The 2012 *De Montford Report* further recognised that although progress had been made in addressing the legacy situation, banks still faced a significant overhang of pre-recession CRE debt held on their balance sheets, with around £51 billion due to mature in 2012 and £153 billion—72% of outstanding debt—by year-end 2016.

Bright spots in the 2012 *De Montford Report* showed loan originations on the increase and new lenders to the market increasing their market share to circa 8%. However, this was a mere drop in the ocean compared to the level of deleveraging—in 2012 Morgan Stanley expected €1.6 to €3 trillion of total

[10] See *UK Commercial Property Lending Market Report* by De Montfort University, which remains the UK's largest independent property lending survey (the *De Montford Report*). In 2012, the survey of 72 lending teams from 63 banks and other lending organisations said that 2011 started with some optimism for the commercial property lending market, including the first CMBS issue since 2007, but that this changed dramatically during the second half of 2011 as the Eurozone sovereign debt crisis heralded ''extremely tough times'' to the economy.

loan reduction between 2012 and 2015, as banks endeavoured to increase capital, recover funding, improve profitability and generally refocus business models. Morgan Stanley derived this number from the sum of the specific CRE deleveraging plans already announced by some banks (approximately €300 billion of loans) and it estimated that up to €300 billion of exposure might not be entirely rolled over as banks retrenched and refocused their business, and thus reduced their cross-border loans or simply reduced LTVs. To put this into context, this was equivalent to five times the annual real estate transactions between 2008 and 2012 in Europe.[11]

1.4 The CRE market: 2012 to the present day

Since the second edition of this book published in 2012, there has been an upward trajectory in the CMBS market, although not necessarily in Europe. In the US, lenders issued $94 billion in new loans in 2014 and US CMBS issuance ended 2015 above $101 billion (although at the time of writing 2016 is unlikely to reach this amount). There were 16 CMBS transactions issued in the UK between 2012 and the end of 2015, twice the number in the previous period following the GFC. Notable transactions included the £450m Intu (SGS) Finance Series 1 and £350m Intu (SGS) Finance Series 3 issued as part of a £5 billion programme, the base prospectus of which was published in March 2013, the £463m Isobel Finance No. 1 Plc and the Westfield Stratford City CMBS in relation to a £750m loan secured by a charge over Westfield shopping centre in central London.

Some issuances, such as Westfield Stratford City Finance Plc had similar characteristics to those post 2008, where issues had single tranches and long maturity dates were the norm, in order to appeal to institutional investors since 2012. However, other transactions have been more complex than during 2008 to 2012. Few CMBS issued between 2012 and 2015 have had a maturity date beyond 2030; DECO 2013-CSPK Limited for example has an August 2019 maturity date. Rates payable on notes have been primarily floating, multi-tranched and with varied ratings. Magni Finance DAC, for example, has five note classes with ratings ranging from A to unrated junior notes. In addition, Mint 2015 was an example of an unusual multi-currency CMBS, which issued £251.2m and €131m notes, further to the securitisation of £75m and €30m mezzanine debt in 2014, backed by hotel properties in the UK and the Netherlands. This suggests some re-opening and recovery of the CMBS market and an increasing risk appetite of CMBS investors.

More importantly, the refinancing risk caused by the overhang of pre-recession debt, discussed above as identified by Morgan Stanley in 2012, has not been as severe as initially forecast. Moody's stated in December 2015 that ''the much vaunted 'refinancing wave' in 2016 and 2017, during

[11] See Morgan Stanley's Blue Paper 15 March 2012 ''Banks Deleveraging and Real Estate—Implications of a €400–€700 billion Financing Gap'' (the *Morgan Stanley Report*) p.17.

which loans originated with 10-year terms during the 2006 and 2007 pre-crisis peak mature, caused little more than a ripple'', noting that ''about half of the original issuance levels have since paid off or defaulted and of the remainder about three quarters appear well positioned to refinance, even if 10-year Treasury rates rise by up to 2%.'' In its CMBS Surveillance Maturity Report for February 2016, Morningstar predicted that the total remaining amount of loans still to mature in 2016 and 2017 is now approximately $150 billion—it expects $56.98 billion of CMBS loans to mature in 2016 and $99.88 billion in 2017. Morningstar has reported that most CMBS loans originated before the market's peak of 2006–07 have been able to refinance, and the delinquency rate is at a seven-year low as at February 2016.[12] See further Chapter 3.

UK CRE loan origination increased from £45 billion in 2014 to £53.7 billion in 2015 according to the 2015 *De Montford Report*. There has also been a continuing growth in the market share of non-bank lenders for loan originations, which has increased to 9%, and the market share of insurance companies has steadily increased to 16% of the market in 2015. This has begun to add diversity to funding sources in the CRE market. CREFC-Europe has endorsed the growing role of institutional capital in addition to bank lending in the CRE debt market as a means of enhancing financial stability, and delivering stable long-term income. The 2015 *De Montford Report* will be further discussed in Chapter 15.

This growth in market share has been partly attributable to deleveraging by banks; by the end of 2014, the CRE loan book of the six largest UK banks had shrunk by 56% to £68 billion.[13] At the time of writing, deleveraging appears to be drawing to a close. The total amount of outstanding CRE debt in the UK at year-end 2015 was £168.4 billion, representing a 1.9% increase from £165.2 billion at year-end 2014, and the first increase recorded since 2008, whereas it had dropped by 6–10% in each of the preceding five years.[14] According to the 2015 *De Montford Report* (the latest report at the time of writing), the deleveraging process has been secured by refinancing of assets at lower LTVs and an increase in equity-only CRE investment. This has been further supported by rising CRE values. By the end of 2015 lending refinanced before the end of 2007 together with new lending before the end of 2007 dropped to 15% of the total CRE debt stock in Europe. The pace of deleveraging between 2007 and the time of writing has varied between different countries. Ireland has significantly reduced its exposure and deleveraging in Germany and Spain appears to have decelerated. Spain, for example saw a 34% reduction in closed loan sale transactions in CRE and residential loans between 2014 and 2015. In Italy on the other

[12] See CMBS Surveillance: Maturity Report February 2016 Remittance https://ratingagency.morningstar.com [Accessed 24 August 2016].
[13] See APL CREFC Europe INREV ZIA ''Commercial Real Estate Debt in the European Economy 2016'' p.28.
[14] See Ch.15 and *UK Commercial Property Lending Market Report* (De Montfort University, 2015).

hand, the country's banks were slow to adopt deleveraging plans and only began significantly deleveraging in 2014; in 2015 it posted €5.3 billion of CRE and residential loan trades, which was 8.2 greater than in 2014 and 23 times greater than in 2013.[15]

However, 71% of respondents to the CREFC Market Outlook Survey in 2016 believed that CMBS spread volatility would be ''somewhat'' volatile, with geopolitical events, deteriorating credit standards, and contagion from volatility in other asset classes being likely causes of spread volatility in 2016. Although 65% of respondents to the 2016 CREFC Market Outlook Survey expected a total CMBS issuance of between $100 and $125 billion in 2016, there was only €885m placed issuance between January and July 2016 in Europe compared to €4.25 billion during the same period in 2015 and in the first quarter of 2016 there was a total of $17.8 billion priced in the US, down 32% against the previous year.

Looking beyond 2016, there therefore appears to be a mixed picture. In relation to new issuances, although there are signs of CMBS market recovery, heightened volatility may impact CMBS and factors in the financial world unrelated to the underlying performance of CMBS may negatively affect the CMBS market, as will be discussed in the final chapter of this book. Moreover, in relation to maturities, Morningstar projects that the borrowers' ability to pay off CMBS loans on time will become progressively more difficult through 2017, because of lax underwriting standards and estimated net cash flow projections that were never realised.

1.5. Conclusion

As stated above, the European CRE and CMBS markets have undergone a dramatic structural shift since 2007 and the central banks that regulate them have, since the advent of the GFC, faced unprecedented challenges. Such a structural shift has highlighted (as did the Russian rouble crisis of 1998), that in disintermediated credit markets, such shifts and crises can quickly morph into a GFC, where investors flee to the relative quality of government treasury securities and where subordinate interests cannot be sold for any price. During the GFC, SIVs (a historic readily available market for CMBS) largely disappeared, and alongside the shifting investor base, originators' business models changed—perhaps forever. Given these changes, it is predicted that, at the time of writing, CMBS will remain only a marginal provider of CRE capital over the medium term due, in a large part, to the seismic shifts that have brought regulatory challenges, such as:

[15] See CBRE Capital Advisors ''European Commercial Real Estate Finance 2016 Update'' and the Italian NPL Market section in Chapter 18.

- Basel III,[16] that by increasing the amount of capital financial institutions must hold to ensure solvency during periods of financial stress, in turn makes it more costly for such institutions to hold CMBS;
- Article 122a of the CRD, which came into effect in January 2011 (replaced in January 2014 by arts 405–409 of the Capital Requirements Regulation), the so called ''5% skin in the game'' provisions.[17] Bank and insurance investors in all securitisations now need to ensure that the transaction originators retain 5% ''skin in the game'', meaning that they retain a 5% interest (first loss or vertical) in every CMBS transaction they bring to market. The retention rule has not prevented the resumption of primary issuance in funding-motivated products like prime residential mortgage-backed securities (RMBS) and consumer asset-backed securities (ABS) because originators typically retained an equity interest even before the crisis. However, the risk retention rules have materially altered the economics of CMBS issuance, which was heavily reliant on a conduit ''originate to distribute'' model. Investment banks were the sponsors of these conduits and retaining 5% exposure in every new transaction over its lifetime translates into a significant drain on capital;
- significant derivatives legislation, with the European Commission's proposed derivatives legislation potentially forcing European CRE companies and funds to collateralise their interest rate swaps on floating rate loans. In Europe, CRE loans are typically floating rate and swapped to fixed in order to hedge the risk of interest rates increasing. If borrowers were forced to cash collateralise these swaps, the cost of borrowing on a floating rate basis would increase. Chatham Financial estimates that €64.9 billion of working capital could be required across EU Member States to comply with the legislation. If the proposed legislation is passed, borrowers may prefer to use fixed rate loans or to hedge via out of the money caps. Fixed rate loans could be conducive for issuing fixed rate CMBS, as is the norm in the US. However,

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16 Basel III was introduced due to criticism of Basel II, based on risk-weighted assets, with the risk weighting given to certain assets based on ratings given by CRAs. The lower the credit rating, the greater the risk weighting given to the asset. Unfortunately, the Basel II requirements, which have been widely adopted, resulted in financial institutions across the globe seeking out similar asset classes and similar highly-rated securities that would carry lower risk weighting, as under Basel II, banks were given the opportunity to define the risk weighting of each asset on their balance sheet using their internal risk models, under three methodologies (standardised, foundation or advanced internal ratings based (IRB)), which were characterised by increasing levels of sophistication. The introduction of the Basel II discipline often resulted in banks being able to reduce the risk parameters applied to their assets and thus reduce the level of equity held against them, a move that has since been widely criticised. As a result, falls in the market value of these highly-rated securities have been felt throughout the financial markets and capital adequacy rules designed to improve the stability of individual banks, have instead increased the level of systemic instability.

17 See further Ch.16 and the detailed discussion in Ch.17. The skin in the game provisions are attempting to combat the cyclicality and thus periodic crises of the CMBS markets by aligning the interests of the issuers and the investors. With a focus on minimising risk and strengthening underwriting standards, originators and those that securitise will be required to retain some of the risk of the loans they originate or package as part of a CMBS.

European borrowers have traditionally rejected fixed rate loans due to the prepayment penalties that are incurred if the property is sold and the loan prepaid; changes to the IFRS accounting standards; and shifting and conservative rating agency treatment[18];

- Solvency II, is an EU supervisory regime for insurers and reinsurers, introducing new capital requirements and tiering. Since 1 January 2016 Solvency II has required insurance companies to hold capital against the risk of loss in the market value of their assets. CMBS is classified as a Type 2 securitisation, excluding it from favourable treatment; even AAA rated tranches have a higher risk weighting than CRE equity. This means that CMBS has become more expensive for insurers relative to Type 1 securitisations and many other asset classes. The requirement for risk weighting can be removed through matching adjustments where longer-dated real estate debt investments are of a similar duration to long term insurance liabilities. The fact that there is prepayment and extension risk for the repayment of securitisations means that CMBS are unlikely to qualify as eligible for matching adjustment. On the other hand matching can be made possible in relation to direct CRE lending. This incentivises insurance companies to invest directly in CRE rather than securitised debt. It is unlikely therefore that the growth of alternative sources of direct lending in CRE will be replicated to the same extent in the CMBS market; and
- as a result of the Financial Conduct Authority's (FCA) guidance on "slotting", a method for assigning risk weights to lending exposures, greater scrutiny has been placed on the internal models used by banks in lending to specialised assets, including CRE. Slotting puts loans into four categories depending on their LTV and capital weightings can range from 50% to 250%. Banks have been expected to reduce their exposure to balance-sheet intensive asset financing and commercial real estate lending, which was previously one of their biggest on-balance-sheet activities. The British Bankers' Association, in a response to the European Commission noted that "the changes to the Securitisation framework and the imposition of the supervisory slotting approach for Specialised Lending (especially infrastructure lending) have lessened the attractiveness of these asset classes. We think that these rules overestimate the capital requirements leading to the adverse impact upon these asset classes."[19]

1.5.1 *Challenges to the wider European commercial mortgage market*

Based on the reasons highlighted throughout this chapter, it remains the case that, at the time of writing, CRE lending is less attractive for banks than it was prior to 2007. CRE lending has transformed from purely property

[18] See further Ch.14.
[19] See British Bankers' Association response to DG FISMA consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy and Ch.16.

focused to a relationship-driven business. Unlike in 2005–07, post GFC, the quality of the sponsor (ultimate equity owner of the property) of the non-recourse CRE loans and the prospects of ancillary business with the sponsor, have become more important than ever. As a consequence, quality prime sponsors stand the best chance of obtaining a loan secured by non-prime properties. Such transformation is based on a number of factors. In the *Morgan Stanley Report*, Morgan Stanley attributed the reduced appeal of CRE lending to five factors (that whilst published in 2012, are still relevant at the time of writing):

(i) Financing is not easy and is expensive, especially for long-term tenures. The boom in CRE financing between 2004 and 2007 was fostered by the availability of plentiful and cheap funding for the banks, coupled with relatively low capital requirements. That is not to say that all long-term lending is dead. Issuance of Pfandbriefe covered bonds in Germany, for example, although more expensive than in the past, still provides substantial financing for the industry.[20] However, volumes are greatly reduced, and this will continue to constrain new business;
(ii) capital is getting tighter, especially as under Basel III there is no differentiation of the risk associated with low LTV loans (the regime currently gives CRE loans secured on underlying assets as a higher risk weighting than unsecured corporate bonds).[21] This may mean that banks are no longer able to make a return on CRE lending that covers the cost of equity, and indeed in some cases they may be loss making;
(iii) CRE relationships are less profitable than corporate client relationships. Ultimately, despite the fact that banks have over-extended their balance sheets to the real estate sector, this is still a marginal activity and one that does not relate to their core client base. Also, compared to corporate lending, it provides lower ancillary revenues;
(iv) huge cyclicality makes the business less attractive. The peak-to-trough loan loss provisioning in CRE is significantly higher than that of any corporate lending activity; and

[20] See further Ch.2. and the German Lending Market section contained in Ch.18.

[21] This is subject to review under ''Basel IV''; in the first consultative document published by the Basel Committee on Banking Supervision in 2014, real estate risk weights were to be based on the LTV ratio and the debt-service coverage ratio rather than the previous 35% flat rate and under a second consultative paper published in December 2015, the Basel Committee on Banking Supervision has proposed to use the loan-to-valuation (LTV) ratio as the main risk driver for risk weighting purposes, and to use a three-category classification (from less to more risky) from general treatment for exposures secured by real estate where repayment is not materially dependent on rent/sale of the property; a more conservative treatment for exposures secured by real estate where repayment is materially dependent on cash flows (i.e. rent/sale) generated by the property; and a conservative, flat risk weight for specialised lending real estate exposures defined as ''land acquisition, development and construction''. See Basel Committee on Banking Supervision ''Second consultative document—Revisions to the Standardised Approach for credit risk'' December 2015 (issued for comment by 11 March 2016).

(v) there tends to be more pressure from governments and regulators to keep financing corporates and SMEs in sectors that are more crucial for the real economy.

Further, banks face other issues when trying to deleverage:

- lack of alternative financing is the single biggest issue banks encounter when trying to reduce their loan exposure. If borrowers cannot find alternative sources of funding, they cannot repay, unless they sell the underlying assets;
- falling property prices mean that borrowers find it hard to sell and repay, while quality of exposure declines and LTVs increase. This often makes loan extensions and other forms of restructuring of CRE loans that otherwise would be in breach of LTV covenants more likely; and
- swap transactions linked to loans may also prevent banks from selling down exposure more aggressively. As CRE companies prefer to take loans at fixed rates and banks tend to want to lend at variable rates, banks usually sell an interest rate swap contract to the company that takes the loan. These swap contracts are becoming an issue when banks try to offload the loans, as they may be forced to take losses on the swap, especially if contracts have been put together when interest rates were higher.[22]

Further challenges to the commercial mortgage loan market include a proposal put forward in April 2016 by the Basel Committee that banks, rather than using the IRB model (see fn.23), be subject to the same standard risk assessment model and recognise ‘‘slotting’’, already used by banks in the UK (as referred to above). The institutions that could be most affected by this latest Basel pronouncement are continental European banks that have incurred significant expenditure in implementing IRB risk assessment models to help them to maintain low costs of capital. If this regulation is implemented, it could increase the capital requirements for European banks interested in specialised income-producing loans, including CRE finance.

However, the fragility of the bank’s balance sheet during the GFC has highlighted how the CRE market needs CMBS and its access to global capital markets. This means that CMBS certainly has a supporting role to play and may eventually prove to be most competitive in financing yieldly, secondary properties that are not suited for on-balance sheet lending by banks. In other words, CMBS could eventually become the equivalent of the high yield market for CRE finance with LTV potentially limited to 50–60% and required spreads in excess of 500bp.

[22] See the *Morgan Stanley Report*, pp.22–26 and Ch.12.

Moreover, this chapter has shown that when discussing European CRE it is clear that globalisation cannot be ignored.[23] The globalisation or internationalisation of capital has played an integral role in the financial crisis, with both benefits and disadvantages. Such globalisation can provide for access to global markets, thus reducing financing costs and allowing for business cycles to be smoothed, but it can also allow for the rapid transmission of economic shocks between economies. As discussed above, investors are able to purchase a wide variety of securities offered on various international markets (by way of example, Swedish farmers had exposure to single parent families in Illinois), which has in turn allowed the impact of the sub-prime crisis in the US to spread around the world. Further, it also allows for regulatory arbitrage as financial institutions or investors transfer their operations and investments to jurisdictions they perceive as favourable. Regulatory arbitrage results in jurisdictions with inadequate regulation creating risks for other jurisdictions due to the interconnection of economies and markets.

As regards real estate, the GFC highlighted that, whilst real estate remains an essentially local illiquid asset, its financing is not and our real estate finance markets and economies are inextricably linked and interdependent and it is very hard to dislocate the economic forces that they produce. After all, one of the most striking developments in the global debt and capital markets over the last decade has been the powerful journey and metamorphosis of CRE in creating a truly global market for CRE finance, investment and development, an asset class that had been famously regarded by institutional investors as illiquid and cumbersome. However, if the last decade will be remembered for this development, the following decade will be remembered for the creation of the post-GFC banking and financial regulatory landscape that affects real estate (and its financing, investment and development) as discussed further in Chapters 16, 17 and 21.

The establishment of real estate as a separate asset class will not be reversed and it is undeniable that real estate will continue to be viewed as a popular asset class. Given that the GFC was as much due to a crisis of confidence as to any other factors, such re-emergence will, in a large part, be dictated by the confidence in our financial architecture. Any developments or products the CRE market participants can provide to help restore market confidence, such as greater regulation and transparency, more sustainable lending, improved reporting standards, clarity over servicing standards and servicer responsibilities[24] and more standardised and clear documentation (particularly uniformity surrounding intercreditor arrangements),[25] that will hopefully reverse credit rationing and soften the impact of widespread de-

[23] See A.V. Petersen, *Real Estate Finance: Law Regulation & Practice,* (London: LexisNexis, 2008 1st edition and 2014 2nd edition).
[24] See further Ch.21.
[25] See Chs 5, 6 and 7.

leveraging, as well as remove or reduce risk to investing in real estate, can only be a good thing. However, the overriding aim must be to strike a balance between market reform (through all of the above) and efficient markets. It is our financial architecture. Markets are essential to human development through economic advancement and human well-being and should not be impeded or innovation suffocated such that they cannot function. Nor should markets be allowed to operate with unintended consequences which sow the seeds for future crises. After all, this Chapter has highlighted that we have been down this road before and whilst this crisis remains structural rather than cyclical, the desire to reform must be accompanied by caution. The remaining Chapters in this book will examine the markets in this light, to determine whether the funding of CRE through commercial mortgage loans and CMBS can continue to adapt and evolve on a journey based on alchemy and financial innovation.