CMBS Lending Rebooted: Return to Basics

By Peter J. Mignone, Partner, SNR Denton

After more than a two-year slumber, the commercial mortgage-backed securities (CMBS) market has finally emerged from the deep freeze caused by the economic crisis. Lenders whose business is to securitize commercial mortgage loans in the secondary market have returned to originating these loans. Obviously, this development is welcome news for the commercial real estate industry. Prior to the recession, CMBS loans had been an important source of liquidity for the industry, comprising approximately 27 percent of the total outstanding mortgage debt secured by commercial real estate. With the hundreds of billions of dollars of commercial real estate loans scheduled to mature in 2011 and 2012, the rebirth of the CMBS market will no doubt play an important role in the real estate industry's road to recovery.

In a typical pooled-CMBS transaction, numerous individual mortgage loans secured by commercial and multifamily properties of varying type (for example, apartment buildings, retail, office and hotels), size and geographic location are pooled and transferred to a discrete, bankruptcy-remote trust. The trust issues a series of bonds, backed by those mortgage loans, which vary in yield, duration and payment priority. Rating agencies then assign credit ratings to the various bond classes ranging from investment grade to below investment grade. There is also typically an unrated class which is subordinate to the other bond classes. Each month, the cash flows (that is, debt service payments) received from the pooled mortgage loans are paid to the CMBS bond investors pursuant to a sequential payment structure known as a "waterfall," with any cash flow shortfalls being allocated to the most subordinate bond class in reverse order of priority. This pooling of diverse loans underpins the issuance of securities with varying risk profiles and yield, which more efficiently matches the demand for capital by borrowers with the investment preferences of bondholders. The result is increased liquidity to the real estate industry critical to the stabilization of commercial real estate values.

With the rebirth of the CMBS market (which is often referred to as "CMBS 2.0"), many market observers have asked how will CMBS loans differ than their previous generation counterparts. While the CMBS issuance market is currently evolving and will continue to do so, particularly in light of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] the "changes" in the origination of CMBS loans for the most part reflect a pendulum swinging back in line with traditional prudent real estate credit decisions.[2]

Risk Evaluation

Probably the single biggest difference between CMBS 2.0 loans as compared to later-vintage CMBS loans made prior to the downturn is the CMBS lenders' attitude toward risk, which in large part is directly dependent on the risk perceptions of CMBS investors and the rating agencies that rate the securities these investors purchase. Because of the losses suffered by many commercial real estate investors during the economic crisis, it comes as no surprise that commercial real estate market participants today are much more cautious and conservative when assessing investment decisions. CMBS lenders, of course, are not immune to these market sensitivities.

This increased conservatism is manifesting itself in how CMBS lenders are underwriting new CMBS loans. When underwriting mortgage loans, lenders attempt to assess the risk of loan default and minimize that risk when, and to the extent,

possible. Below are examples of this more rigorous underwriting, which may not be surprising to the reader. In fact, critics of CMBS might even argue that if more CMBS lenders had adhered to more stringent underwriting standards in the years immediately preceding the economic crisis, the pain endured during the downturn perhaps might have been less severe.

- **Data Collection and Verification** — Underwriting starts with the collection of borrower and property information. Once gathered, underwriters seek to verify this data from a variety of sources. Today's more conservative lending environment is likely resulting in lenders paying closer attention to these processes. As a result, borrowers might be asked to provide more detailed borrower and property-level information at the outset. In addition, underwriters might be more likely to identify inaccuracies during the verification process, which in turn may require borrowers to provide supplemental information to address these inaccuracies.
- **Underwritten Cash Flow** — One of the best predictors of borrowers' ability to pay debt service is stabilized cash flow based on in-place rents. Underwriters today are not inclined to give underwriting "credit" for projected increases in cash flow unless there are compelling reasons to do so based on verifiable facts and market realities. In fact, the CMBS market today is comprised almost entirely of fixed rate loans secured by stable, income-producing properties; the market for new CMBS loans secured by transitional properties (which typically would have floating interest rates) has not yet returned. As a wise man once said, "Hope resides in the realm of equity, not debt."
- **Leases with Borrower Affiliates** — In the past, borrowers would sometimes execute leases with their affiliates as a means of increasing underwritten cash flow. If these borrower affiliates were considered creditworthy, lenders were tempted to give underwriting credit to these leases under the theory that creditworthy affiliates would still be required to make rent payments even if the related loans were to go into default. Of course, in defaulted loan situations (which is when the lenders need the rents the most), it is quite possible (perhaps likely) that affiliated tenants will also stop paying rent at that time. Accordingly, CMBS lenders today are more likely to be critical of leases with borrower affiliates and therefore not include rents from these leases in underwritten cash flow calculations.
- **Economic Ratios** — Underwriters use a variety of ratios to benchmark the level of risk associated with mortgage loans. The two most common ratios used are the loan-to-value ratio (LTV), which is the proposed loan amount divided by the property's value, and the debt service coverage ratio (DSCR), which is the property's net operating income (NOI) for a certain period of time divided by debt service due under the loan for the same period. Both ratios, when properly calculated and utilized in the underwriting process, allow lenders to cushion their loan positions against market downturn risk.

With all other relevant factors being the same, lower LTV ratios suggest a greater buffer to absorb declines in property values during the term of the loans, and higher DSCR ratios imply that properties can withstand declines in property cash flows and still pay debt service on the loans when due. LTV ratios and DSCRs used to size CMBS mortgage loans today are generally lower (with respect to LTVs) and higher (with respect to DSCRs) than where they were in the years immediately prior to the downturn.

In times of low interest rates and cap rates, however, DSCRs and LTV ratios alone might distort the lenders' view of the possibility of

default risk. To address this issue, some CMBS lenders are now using a third ratio, the debt yield, with increasing frequency. The debt yield, which is calculated by dividing the property's NOI by the loan amount, represents the cash-on-cash return lenders would realize if they purchased the properties at closing rather than finance them. Obviously, higher debt yields imply less risky loans.

It should be noted, however, that barely a year into the recovery, it has been observed that LTV ratios, DSCRs, and debt yield ratios used in the making of CMBS loans have become less stringent as compared to the first loans made in CMBS 2.0 (although, at least with respect to LTV ratios and DSCRs, apparently still better that where they were in the years immediately preceding the downturn). This erosion can be explained by the fierce competition among non-CMBS and CMBS lenders[3] vying to win lending assignments. As the recovery continues, one could reasonably predict that this relaxation would be a natural by-product of the business cycle's becoming more mature. What has surprised some market observers, however, is the speed at which this erosion has occurred. Whether the erosion continues, and if so, at what pace, will likely be closely watched by market participants as the recovery progresses.

- **Cash Equity** — CMBS underwriters today are likely to look more favorably when sponsors have hard cash equity invested, as opposed to sponsors that have "cashed out" their investments. All things being equal, sponsors with cash equity at risk are more likely to be incentivized to "do whatever it takes" to avoid defaulting under their loans. Not surprisingly, requiring sponsors to have cash equity at risk goes hand-in-hand with the requirement of lower LTV ratios for new loans.

Required Deal Terms

CMBS lenders' return to conservatism is also manifesting itself in the deal terms these lenders are requiring for their loans. Below are some examples of loan terms CMBS lenders have been requiring in today's market.

- **Cash Management** — It was not uncommon in older-vintage CMBS loans for lenders not to require property cash flow to pass through lender-controlled accounts. Of course, when loans go into distress, one of the first concerns of lenders is to ascertain how to gain control of the properties' cash flow. Without cash management mechanisms already in place prior to the occurrence of the default, lenders must rely on borrower cooperation to implement cash management (which might not be forthcoming in defaulted-loan situations or even possible if borrowers are in bankruptcy) or otherwise seek the appointment of a receiver (which can take time, be costly and might require a showing of cause in some jurisdictions). If cash management mechanisms are already in place at the closing of the loans, either lenders already control the cash flows or can easily gain control by simply sending notices to the cash management banks. Because of the leverage it provides lenders *vis-à-vis* borrowers, especially in distress situations, it is likely that borrowers obtaining CMBS loans today will be required to implement lender-controlled cash management at closing.

- **Amortization** — One risk lenders attempt to mitigate when underwriting loans is the borrowers' failure to repay the loans at maturity. Requiring amortization payments during the loan term helps reduce this maturity risk because borrowers will have less principal to refinance at maturity. In the years prior to the downturn, interest-only loans had become increasingly common. While interest-only loans are typically characterized by lower monthly debt service payments, these loans are typically more susceptible to maturity default in the event property values decline (and especially

susceptible to maturity default when combined with high LTV ratios) because the likelihood of takeout lenders refinancing entire loan balances is decreased. Because of today's lenders' increased sensitivity to this risk, interest-only loans are not as prevalent in today's CMBS market unless the properties have very low LTV ratios, are located in strong markets and are owned by very reputable sponsors.

- **Deep Pocket Guarantor** — CMBS mortgage loans generally are non-recourse except for so-called "recourse carveouts" or "bad boy carveouts." The purpose of these exceptions is to disincentivize borrowers from performing certain actions that are harmful to the lenders' interests. As a practical matter, of course, having recourse to borrowers that only own properties which the lenders already have encumbered is not very valuable to lenders. For these recourse carveouts to be meaningful deterrents, lenders must be able to enforce this recourse against creditworthy affiliates of the borrowers. Prior to the downturn, it was not unheard of for certain CMBS loans to not have "deep pocket" recourse carveout guarantors backstopping the borrowers' promises not to engage in certain nefarious conduct such as fraud and misappropriation of rents. Today, the overwhelming majority of CMBS loans will have recourse carveout guarantors of significant creditworthiness. In addition, some CMBS lenders are also requiring that these guarantors satisfy minimum financial covenants throughout the terms of the loans.
- **Additional Recourse Carveouts** — Some CMBS lenders today are also revisiting the list of the recourse carevouts and expanding this list to include additional actions that traditionally were not exceptions to non-recourse in CMBS loans. Generally speaking, this expansion varies among lenders and often is driven by specific experiences lenders may have had recently with borrowers during the downturn, particularly in defaulted loan situations where the borrower-lender relationship may not have been amicable. For example, more CMBS lenders are now requiring recourse liability if borrowers fail to cooperate with lenders' efforts to sell or securitize the loans or if borrowers frivolously interfere with any lender enforcement actions.

Independent Directors

As a result of the General Growth Properties (GGP) bankruptcy case,[4] CMBS lenders today have also made three refinements to the traditional requirement that the vote of independent directors must be obtained in connection with borrowers' decisions to voluntarily file for bankruptcy. The theory underpinning the required vote of independent directors is to ensure that the bankruptcy filing is truly in the best interests of the equity owners in the borrowers as those interests relate to the mortgaged properties. In addition to reminding us that bankruptcy-proof entities do not exist, the GGP bankruptcy highlighted three omissions in the traditional independent director provisions:

- Prior to filing bankruptcy, GGP had terminated the existing independent directors, who were employees of a nationally-recognized company that provides independent professional directors, and replaced them with directors who technically met the standard of independence in the borrowers' organizational documents. Traditionally, CMBS lenders required that the borrower organizational documents contain requirements that the independent directors simply satisfy a standard test of independence from borrowers without requiring that the independent directors be provided by a nationally-recognized service provider. Today, however, CMBS lenders typically require that independent directors be provided by nationally-recognized companies that provide this service, rationalizing that this requirement

will prevent the eleventh-hour appointment of independent directors who technically satisfy the independence test but may still be beholden to the borrowers.

- GGP had also replaced the independent directors without notifying the lenders in advance. Traditional CMBS loans typically did not require this advance notice. CMBS lenders today are requiring that borrowers provide lenders advance notice prior to replacing the independent directors. This advance notice requirement is intended to serve as an early warning signal that borrowers might be contemplating bankruptcy.
- Lastly, in the GGP case, the court held that the independent directors of the solvent borrowers (which were organized under Delaware law) were required to consider the interests of the equity owners in each borrower. Delaware law, however, permits the fiduciary duties of directors to be limited under the relevant partnership or operating agreements. Accordingly, CMBS lenders today might specifically require that borrowers be organized under Delaware law and that the borrowers' operating agreements or partnership agreements require the independent directors to consider, when deciding whether to file bankruptcy, only the interests of borrowers as stand alone business entities and the borrowers' creditors (and not to consider the interests of any equity owners in the borrowers beyond their economic interest in the properties).

Tax Law Changes

Recent changes in the tax regulations also may have an impact on the way CMBS loans can be serviced, particularly in times of distress. The principal investment vehicle used in the securitization of commercial loans is a REMIC ("real estate mortgage investment conduit") trust. REMICs have particularly favorable tax benefits in that even unrated and below investment grade securities are characterized as indebtedness for federal income tax purposes. This means that non-US investors and tax-exempt entities can buy these securities free of any withholding tax on interest payments or withholding under the Foreign Income Real Property Tax Act. In addition, REMICs are not subject to entity level taxation.

Under the REMIC tax rules, the REMIC trust must hold a substantially fixed pool of mortgage loans. Any "significant modification" of mortgage loans held by a REMIC trust could cause the trust to lose its REMIC tax status because a "significant modification" produces, for tax purposes, a deemed exchange of the original debt instrument for a new instrument. The REMIC rules, however, provide that certain modifications are not deemed to be "significant." In particular, if modifications to the terms of mortgage loans are "occasioned by default or a reasonably foreseeable default," the modifications are not treated as a "significant modification" for REMIC tax purposes. While this safe harbor is intended to facilitate workouts of mortgage loans that are in default or where default is reasonably foreseeable, there were instances in the recent downturn where certain CMBS loans were actually performing, but proactive CMBS borrowers nevertheless wished to negotiate loan modifications that would help their loans survive the storm caused by the credit crisis and the corresponding liquidity crunch. Unfortunately, servicers of CMBS loans struggled to reconcile these borrowers' requests with the then-existing REMIC rules.

In September 2009, the IRS issued guidance attempting to address this issue. In Rev. Proc. 2009-45, the IRS relaxed certain restrictions on modifications of commercial mortgage loans in order to maximize the ability to modify troubled loans by adding a standard called "significant risk of default." Even if mortgage loans are performing with no history of default, servicers could determine that there is a significant risk of default upon the maturity of the loans or at some earlier date and therefore allow for

modifications without jeopardizing the REMIC status. However, while the Revenue Procedure did not specify a window of time for the "significant risk of default," the example contained in the guidance has a maturity date of 12 months. Without further clarification from the IRS, it is quite possible that servicers might be reluctant to modify performing commercial loans that have a maturity greater than one year in reliance of this Revenue Procedure.[5]

Conclusion

In 2008, the CMBS lending market entered a deep-freeze, but after a tumultuous two-year period, the market has finally rebooted itself. Aside from the refinements in traditional independent director requirements and certain technical revisions to the REMIC rules, this reset is primarily characterized by a return to more conservative investment decision-making by lenders. As the market matures, it is possible (perhaps even likely) that these conservative principles might be relaxed. Hopefully, however, market participants today will have learned from the mistakes of the past so that the CMBS market may continue to provide the real estate industry with the liquidity necessary for the stabilization of commercial property values and the long-term health of the industry. ★

1 For example, the Dodd-Frank Act requires that issuers of CMBS satisfy risk retention requirements tailored to CMBS, where no such requirement previously existed. In addition, CMBS securitizations today have developed different approaches that attempt to address CMBS investors' concerns that the traditional relative control rights between senior and junior bondholders did not adequately address potential conflict of interests issues between the bondholders.

2 Although mortgage loans intended for securitization have been traditionally characterized with certain "structured" features (for example, requiring borrowers to be special purpose, bankruptcy remote entities), one might be surprised to learn that CMBS mortgage loans are not much different than non-CMBS mortgage loans. Both CMBS lenders and non-CMBS lenders strive to make prudent and sound loans while attempting to appropriately assess default risk and mitigate that risk whenever possible. (Incidentally, some of these structured features have become increasingly common in non-CMBS mortgage loans.)

3 No fewer than 20 CMBS lenders are reportedly in the market currently.

4 See In re General Growth Properties Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

5 The IRS has also issued guidance on releases and substitutions, whether voluntary or by condemnation. With respect to voluntary releases and substitutions on both performing and non-performing loans, even those contemplated at the origination of the loans pursuant to the loan documents, after the release, the mortgage loans must remain principally secured by real property (that is, have an LTV ratio below 125 percent) and such values must be ascertained by any reasonable method, including by new appraisals, original appraisals that are updated, recent sales prices or other commercially reasonable valuation method. With respect to releases due to condemnations, if the LTV ratios of the loans are greater than 125 percent after the condemnations, the proceeds of the condemnation awards must be used to pay down the mortgage loans in order for the loans to retain their REMIC eligibility.

Peter J. Mignone is a partner in the Real Estate practice at SNR Denton. His practice is focused in the areas of commercial real estate finance and the capital markets. Mr. Mignone represents institutional lenders in a variety of loan transactions, including permanent, bridge and construction loans, mezzanine financings, credit facilities, split loan structures, and multi-state transactions. He also represents secondary market participants in the purchase and sale of real estate debt instruments, including the financing of such transactions, and is actively engaged in the restructuring of distressed loans.