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Roundtable

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EUROPEAN CMBS 2.0

Taking a second look at CMBS

As Europe's real estate securitisation market comes back to life, our panel of industry experts discuss its chances of a return to pre-crash health and whether issuers have learned from the mistakes of CMBS 1.0. David Hatcher reports

Europe's CMBS market is gradually reawakening, with the number of active banks and borrowers using this part of the debt capital markets slowly increasing, in line with broader investment volumes.

There is healthy demand from a select pool of investors set up to buy what is a labour-intensive product to underwrite, attracted by CMBS yields' relative value. But a number of obstacles still stand in the way of Europe's market becoming anywhere near as efficient and effective as that of the US.

Distressed pre-crisis CMBS structures are still being unravelled, with high-profile claims being brought against valuers. These have affected the market's reputation and more cases may emerge as out-of-the-money investors look to claw back losses. Meanwhile, CMBS has not been helped by unfavourable capital treatment imposed by European regulators.

This has led the industry to try to clarify new standards and modus operandi for documentation and division of responsibility. A wholly accepted format for CMBS issuance is yet to emerge, but there is an acceptance that the process is improving and evolving.

The market hasn't truly taken off again, but if these concerns can be addressed, the successful post-crisis deals have set a template for others to follow; there were over €8bn of deals in 2013, about €4bn in 2014 and two priced and sold so far this year, with more in the pipeline.

Real Estate Capital's latest roundtable gathered together leading participants from different areas of the market to tackle the issues that face European CMBS, and assess the prospects for future issuance.

PETER HANSELL: In 2013 we had a year of very significant issuance, largely dominated by the refinancing of German multi-family transactions. That comes almost in five-year cycles and a number of those will be taken out by corporate financings in future.

Last year we saw a more traditional base of CMBS, with a range of transactions across European jurisdictions, but the volume was significantly down on 2013. In 2015 I think there will be a further development of the market and volumes will be significantly up on 2014, although I don't believe it will get to anything like 2013 volumes. However, this is an important further step towards establishing the product as a regular part of the European financing market. ▶

MATTHIAS BALTES: The important development marked by German multi-family transactions in particular was that they started to reach a wider audience. In 2011-2012 you had the odd deal, but they were on an almost bilateral basis with a closed group of investors. Starting with Taurus 2013, multi-family deals were placed with around 40 investors, providing a more diversified and stable group to market future transactions to. By 2014 we'd reached a stage where the first time a deal was seen was when it hit the ticker, rather than there having to be lots of soundings beforehand.

The market has also seen complexity increase incrementally. German multi-family cashflows are probably among the most stable you can find in this asset class. Since then we have moved forward from single-borrower, single-loan deals with only a certain type of collateral. We are still a long way off from multi-borrower deals across multiple jurisdictions and sectors.

MATTHEW O'SULLIVAN: With the German multi-family deals, a very large amount of financing had to be redone and it was not easy for the local pfandbrief market to absorb all of that. We have been through a period when lots of banks had stepped away but now they are back in the market, so CMBS has to be done when there is a deal that is not readily financeable in the bank loan market.

That can be just due to its size or because the jurisdiction has added complexity. Look at the Stratford shopping centre deal, for example: it's a prime shopping centre, but it was so large that it was brought to the capital markets [Westfield's agency CMBS secured on the London mall raised £750m].

We have seen Italian deals, as the bank loan market doesn't work perfectly there at the moment. The Taurus UK 2014-1 deal was very much a portfolio of secondary UK assets with an asset management story from Apollo, which might not have been easy in the normal loan market. You are still unlikely to see really clean, easy underlying assets in the CMBS market because they will probably go to the normal loan market.

PH: If there is a wide syndication market for a loan, a bank will typically syndicate it, as it's easier and more straightforward. If a bank has three separate €100m deals, then maybe it is easier to securitise them than to do separate syndications, but I think that part of the market will grow more slowly.

Banks are naturally very cautious about aggregating significant debt volumes on their balance sheet at any one time. Given that there is volatility in the market, that does represent a risk.

NEW CMBS OPPORTUNITIES

In Italy, after closing deals, debt can be very difficult to syndicate, so securitisation offers another option. Other markets will be Greece, further east potentially, or down into Spain – those will be where the opportunities are. It will be where the syndication market is not as active.

MB: CMBS works best when a number of conditions are in place; it's not just location. Factors you would look at include the size of the deal, if the properties are secondary, or if there are a large number of properties to analyse. Also, it could be that a sponsor needs certainty of execution in a very short timeframe, so not having to club together a group of banks that often have different views can be advantageous.

PH: The more deals that you have coming through, the more trading there is and that in itself encourages more investors to come in, creating a ripple effect around Europe's securitisation market, which makes it work more efficiently and it becomes more widely used.

PETER WALKER: Another boost is that the cost of borrowing for CMBS-financed loans is likely to come down, whereas the cost for bank-financed loans is likely to rise because of increasing regulatory capital requirements. ▶

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CMBS STILL FACES TOUGH EU TREATMENT

European regulators have been making warmer noises about securitisation, recognising the potential of debt capital markets to free up banks to lend and help fund the eurozone's flagging economy.

Asset-backed securities are now eligible for the European Central Bank's asset purchase programme (quantitative easing). An EU green paper on capital markets union (CMU) is out for consultation. The Basel Committee and the EU's executive European Commission are reviewing asset-backed securities and a new class of 'high-quality' ABS may be created. The EU is even considering reducing capital charges on some ABS – but not CMBS.

MATTHEW O'SULLIVAN: If there's some kind of unification and it turns out certain CMBS tranches are eligible, that could be positive in terms of CMBS becoming a larger, more liquid market. But without banging a drum about it, it requires a change in capital treatment too. I look at the Type 1 treatment and Solvency II – I believe it's 2.14 per year of duration on a AAA-type ABS product, which on a typical five-year, floating CMBS deal is 10.7% of capital to hold. That still feels very, very high. For covered bonds, it's a fraction of the figure for securitisations. For us, that doesn't make sense.

We've talked about insurers as entrants to the long-term real estate loans market being partly pushed by the capital treatment. I think even if CMBS becomes part of one unified definition of what is high-quality securitisation, if it is in there without a change in the capital treatments, I don't know if that will make enough of a significant difference. It's difficult for the buyer base to massively broaden before there are those changes. You may get more foreign investment from jurisdictions where capital treatment is not so punitive.

MATTHIAS BALTES: I tend to agree. The good news is it's mostly upside. We are planning to not assume we will get a massively favorable result. We can quite well accommodate the market we have to operate in now and perhaps we might see some additional boost from this side as well.

MO'S: CMBS pricing doesn't feel like it can come down much more because of potential investors' capital constraints. Insurers, which have to work on the standard Solvency II formula, are basically priced out of CMBS and even banks aren't probably naturally going to be large holders of CMBS.

I don't think spreads will tighten dramatically unless regulatory requirements change. Until then, I don't think volumes will get to 20 or 30 times what they were last year. This year, my gut feeling is that volumes will be up, but not by much.

MB: I don't think regulatory restraints will stop organisations from issuing CMBS, as those who are able and willing to lend should really be able and willing to sell. We have not only heard that there are going to be more issuers but also some have made clear statements that they'll be issuers this year.

This is a healthy development, because to a degree you need to provide the supply to justify the demand, ie investors with capacity taking an interest in the market. It gives them more to look at. If there's a deal once a quarter it's not really worth it for them. But if there are 20 deals a year, it's a much more interesting environment.

M'OS: We definitely have the benefit of having invested in the market for a long time, so have to commit resources to CMBS as we have a portfolio regardless. We also have other in-house resources in property, which is helpful.

> "EVERYONE WAS HAPPY TO CONTRIBUTE TO THE EVOLUTION OF CMBS 2.0 BECAUSE AS AN INVESTOR, YOU WANT CLARITY TO SEE IF YOU WANT TO BE INVOLVED IN A DEAL"
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CMBS is almost certainly the highest resource requirement of any asset-backed security, as you don't have the granularity of others and every loan or property counts. If we were starting again, to commit the amount of resources we do to this space we would need a better pipeline than there is.

LESSONS TO BE LEARNED

GEORGINA SQUIRE: When new deals are structured, a number of lessons need to be learned from those that went wrong in the past. We are working to find routes of recovery for those that own notes in pre-crisis CMBS. For example, in the Titan case, we grappled with the issue of who should bring a claim if something goes wrong. We looked to assign the note holders' rights, but that was difficult. We eventually decided to pursue the claim through the issuer.

There have been quite testing and difficult issues. There are questions about whether there should be more valuation information in the documentation and in my view there should be. There was nothing in the Titan documentation referring to whether the special servicer had the right to bring the claim or not. Working out how you get instructions and deal with these sorts of issues is really important, as well as determining the special servicer's rights.

Equally, there was nothing in the documentation saying what to do with any money coming back from a claim; whether it should be fed through the waterfall on the day of the judgement, because that obviously only benefits those that own notes at that point in time, or should it go to those that held the notes when the claim started?

MB: The move from CMBS 1.0 to the standards [drawn up by CREFC Europe] under CMBS 2.0 didn't mean that a single party previously holding most benefits had to give them up for the sake of a single other party. As part of the renewal process, everyone has had to give a bit. Servicers have in terms of the risks they take on or because their mandates can be terminated at the investors' discretion; the investors have, because they are accepting certain limits to their rights; and borrowers have had to change in terms of the information they are prepared to give on a deal. Meanwhile, the issuer has had to adapt on how an X note is structured. So everyone has had to move.

GS: There were also issues over what class X would be able to recover out of the Colliers/Titan case. There was debate as to whether they should receive anything out of it due to their role in initiating the loan structure.

PW: We are thoroughly going through deals and making sure we can realise as much as possible for investors from all sources. The difference cases such as Titan make is that they provide clarity over what sort of actions are likely to be successful and the best strategy when trying to pursue claims.

GS: It's important to only pursue good claims – if you bring a good claim, it should be settled, but if you bring a risky claim, there's an increased risk that it will be fought and in doing so it will cost a great deal. We may look at a lot of loans and only bring a claim in a few. We're looking at some CMBS structures that have a number of loans in them and some where there is one particular loan with some inexplicable change in value.

PW: There has been huge progress in CMBS 2.0 in terms of not only transparency and access to documentation, but also in the clarity of the documentation itself. New CMBS generally set out the rules much more clearly, so that investors know what they're getting in to when they're investing. From the point of view of a servicer, there is also greater clarity as to the rights and obligations in each transaction.

MO'S: Everyone was happy to contribute to the evolution of CMBS 2.0 because, as an investor, you ultimately want clarity to see if you want to be involved in a transaction.

PW: That will be a prerequisite to growing the market and investor base. It's a market demand we've got to meet. We now have a set of principles, to which there is a good deal of adherence and deviation from which will need to be justified to investors.

One key difference between the UK and US is that it's very difficult to standardise across the European continent because of country differences in law, practice and culture. Although it's difficult to standardise, you can set out reasons why standardisation is not achievable, and if you can do that, it's a big step forward for the market. ■

Peter Walker
Walker is a director of Capita Asset Services, Europe's largest independent, multi-asset-class servicer and special servicer. He has 30 years' experience in the financial services industry and has been a board member of loan servicing and asset management companies in the UK and Europe since 1999.

Matthias Baltes
Baltes runs the commercial real estate finance team at Bank of America Merrill Lynch, one of the largest originators and issuers in the European commercial real estate market. The bank has been one of a handful at the forefront of new CMBS deals in the past two years, advising on and arranging seven issues worth €5bn.

Georgina Squire
Squire is head of law firm Rosling King's dispute resolution team. CMBS is a specialism within the firm. Rosling King led the recent successful case against valuer Colliers on behalf of stakeholders of Titan Europe 2006-3. She is now working with other legacy debt owners to try to recover monies for them out of past structures.

Peter Hansell
Hansell is head of real estate at Cairn Capital, which has acted as an adviser on legacy debt work-outs and as an arranger of new CMBS transactions. It is one of Europe's only non-bank arrangers of CMBS, and has structured and placed three European CMBS transactions in the past two years, totalling more than €800m.

Matthew O'Sullivan
O'Sullivan is head of commercial securitisation at M&G Investments, which is one of Europe's largest investors in CMBS. M&G has been investing in the asset class since the mid 1990s, as well as in other asset-backed securities. The group was active throughout the global financial crisis and has been since then.

LIQUIDITY IS A HIGHLY RATED QUALITY

To promote a liquid trading market for CMBS notes, issuers are increasingly looking to have deals rated, despite this being more expensive.

Some also want their deals to adhere to US rule 144a – an approval that allows the notes to be more freely traded among institutional investors in the US, without having to conform to the more stringent regulations applicable to sales to the public.

MATTHEW O'SULLIVAN: Generally we're fortunate in that many of our funds don't require external ratings. Obviously we have lots of conversations with rating agents but we have the resources to fully underwrite and put internal ratings on deals.

At the end of the day, we don't mind having a rating agency on a transaction, as it's always nice to have another set of eyes that has looked at it. Rated deals always have the benefit of greater liquidity, too.

MATTHIAS BALTES: We have done unrated deals in the past and we wouldn't rule them out in the future, but if you have a €500m class A tranche that is unrated, it doesn't matter what country it is, it will be a very illiquid product.

PETER HANSELL: At the investment-grade level, if you want to get AAA pricing, then you've got to have an AAA rating on it. Investors can't just say "because the loan-to-value level is, say, 25%, it has an implied AAA rating". An actual rating can be important from a regulatory perspective too.

We've found rule 144a is another positive factor from a liquidity perspective. It's another way of broadening your investor pool. When deals are smaller, it's not so important, but when you have large deals that might not just be readily absorbed by the European market, it's beneficial.