The Outlook for UK CMBS

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Executive Summary

- Well-underwritten and well-structured CMBS provide a relatively liquid vehicle for investing in real estate-backed debt;
- CMBS can play a supporting role in financing UK real estate; the successful issue of Chiswick Park, the first 'true' CMBS in four years, is encouraging;
- To re-establish an active market, CMBS must attract a wider investor base: insurance companies, pension funds, sovereign wealth funds, asset managers and private equity funds;
- In the short term, regulatory uncertainty, lack of expertise and structural issues will inhibit insurers and other institutional investors from entering the CMBS market;
- Longer-dated, fixed-interest CMBS would appeal to institutional investors if prepayment issues can be addressed;
- New EU regulation requiring issuers to keep 5% of any new CMBS on their balance sheet will make securitisation more expensive for banks but promote better underwriting;
- Most borrowers are reluctant to use CMBS but, with bank lending restricted, they may not have a choice;
- Some structural issues remain, notably:
  - the use of Class X bonds to remunerate arrangers;
  - 'tranche warfare' – how decisions are taken when CMBS loans run into trouble;
  - servicing standards and fees;
  - bondholder voting and communication;
- Greater transparency, improved reporting and more standardised documentation will help restore confidence in CMBS and promote liquidity.

Introduction

Re-establishing a sustainable market in commercial mortgage-backed securities (CMBS) will be challenging. The financial crisis provided an extreme stress-test for commercial real estate loans in the UK; no scenario envisaged property values plunging 40% and a simultaneous global squeeze on bank finance. These shocks destabilised the CMBS market, effectively shutting it down for almost four years, and also revealed structural weaknesses in the instruments.

That said, it is important to note that most UK CMBS and loans are performing, indeed better so than balance sheet bank lending. Loan-to-value covenants have been breached and maturities have been extended but, in most cases, bondholders have continued to receive their coupons. Of the £42bn CMBS loans that Standard & Poor's monitor, only 6.7% have missed an interest or principal repayment, against the 12.6% estimated for balance sheet loans by De Montfort University.[1] The non-monetary breach rate for CMBS - 3.8% in April 2011 - is also lower than for traditional loans.

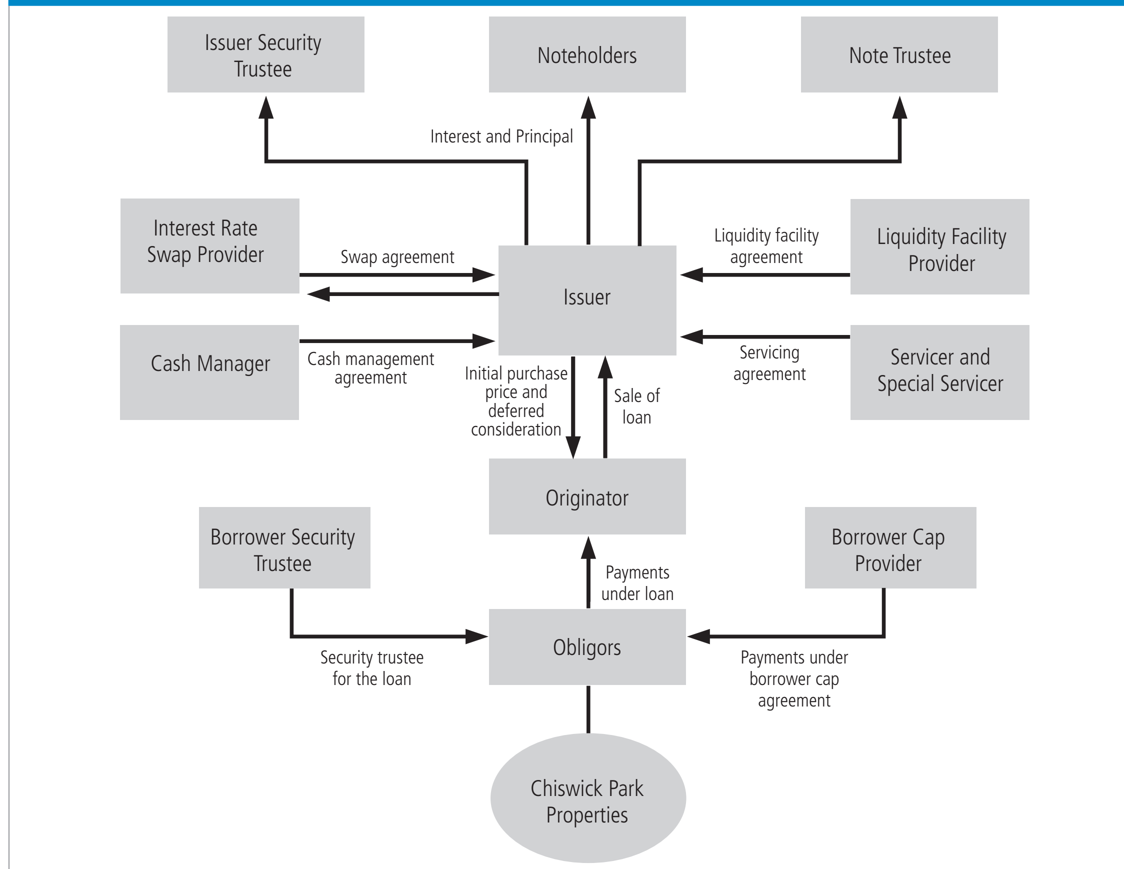
Current market activity

To relaunch an active market CMBS need to develop a broader investor base. New investors will have to be convinced that the instruments are fit for purpose. In this respect, the recent success of Deutsche Bank's DECO 2011-CSPK securitisation of Chiswick Park, an office complex in west London is encouraging. While there were five CMBS issued during 2009-2010, these are not considered 'true' CMBS because they are a single tranche of long-dated, fixed-interest debt underpinned by long-term leases to strong tenants: Tesco and the UK government. Thus, they are more akin to investment-grade corporate bonds, involving primarily credit risk rather than property risk. Chiswick Park is the first true CMBS to be fully placed with investors in nearly four years.

[1] The UK Commercial Property Lending Market Research Findings 2010 Year End, Bill Maxted and Trudi Porter, De Montfort University May 2011.

Figure 1 illustrates the Chiswick Park CMBS, showing the flows of money as well as the roles and the inter-relationships between the key parties to the transaction.

Figure 1: Diagrammatic overview of Chiswick Park securitisation



The collateral for the Chiswick Park securitisation is a £302.3m loan secured on a West London office complex. The loan, originated by Deutsche Bank, is held by DECO 2011-CSPK, the trust which, in turn, issued £302.3m of senior listed bonds (notes). The interest generated by the loan pays the coupons (interest) on the bonds.

These bonds are divided into three classes, A, B and C, each paying a different floating rate of interest and having different seniority in the order in which interest and principal are paid. Class X is a tranche of bonds, used to remunerate the arranger, that is paid any excess interest the loan generates over what is due to Classes A, B and C. Table 1 sets out the structuring of the bond issuance, see below at page 12.

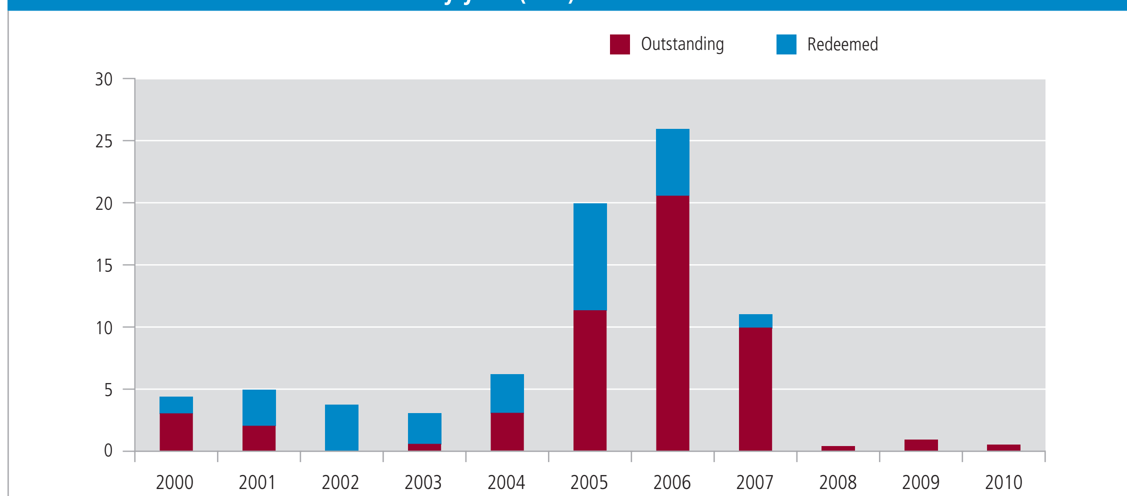
The UK's real estate debt legacy

Currently, a great deal of equity capital is looking for a profitable home in real estate. There is also some £356bn of UK real estate loans that needs refinancing. CMBS could provide a bridge, channelling equity from insurance companies, pension funds, private equity funds and others into real estate debt. Well-underwritten and well-structured CMBS offer these investors an alternative indirect route into real estate, one that avoids the management issues and illiquidity of owning assets directly. Though investors may choose to hold CMBS to maturity, they are tradable securities and, thus, theoretically more liquid than either real estate or bank debt.

However, CMBS have only ever played a supporting role in financing UK real estate. They currently account for 18% of the bank lending that is secured on UK real estate, whereas in the USA they represent 45% of the market.

For two boom years, 2005 and 2006, UK CMBS issuance spiked to £20-25bn annually (see Chart 1). However, this level of issuance was fuelled by an overheated property market and investment banks' conduits. These programmes, which originated loans and took them completely off the banks' balance sheets by selling them as CMBS to investors, accounted for the vast majority of the issuance in those years.

Chart 1: Public issuance of UK CMBS by year (£bn)



Source: Bloomberg, BofA Merrill Lynch Global Research

Pre-crisis, most UK CMBS were bought by banks and structured investment vehicles (SIVs). The latter engaged in arbitrage by issuing short-term (under one-year) debt at low interest rates and buying longer-term (over one-year) financial assets that paid higher interest, such as CMBS and asset-backed securities. Mainly owned by banks but held off -balance sheet, these SIVs were highly leveraged. Today, the financial landscape is very different: most SIVs have disappeared, victims of the liquidity crisis. Banks, too, are very unlikely to play as big a role as investors in future. Basel III,[2] the new global regulatory regime for banks, makes it more expensive for them to own CMBS, especially the riskier tranches. Also, several high profile defaults and disputes have seriously damaged CMBS' reputation.

In addition, up to half of the UK real estate that needs refinancing may not be suitable for securitisation. The UK CMBS market has never featured the jumbo-sized, granular pools of smaller loans that characterise the US market and, crucially, does not have the processes currently to package these up in a standardised format that would be trusted by investors. Hence, it is focused on large-ticket, good quality assets or portfolios that would otherwise require a club or syndication to finance them. However, according to recent estimates, only 25-38% of banks' lending is secured on prime assets. Savills assess that up to half of the outstanding bank debt, £175bn, is secured on poor secondary and tertiary property.[3] These assets are simply not good enough to go into CMBS.

Most of those interviewed for this research concur that it will take time for CMBS to regain the level of issuance seen at the peak of the market. Many believe they will never attain the market penetration that they have in the USA, but remain, as one interviewee put it, "a small cog in the overall financing wheel".

That said, all agree that CMBS have the potential to play an important role, not least because commercial real estate financing urgently needs a capital markets instrument that can channel equity into debt, distribute risk and add liquidity. Properly designed and executed, CMBS can do this.

[2] Basel III : A global regulatory framework for more resilient banks and banking systems, Basel Committee on Banking Supervision, revised version June 2011

[3] Financing property 2011, Savills

Regulatory overkill

All the market professionals interviewed for this research are extremely concerned that a flood of regulatory changes will stifle any revival of the CMBS market.

Firstly, Basel III is simultaneously increasing the amount of capital banks must hold to ensure solvency during periods of financial turmoil and making it more costly for them to hold CMBS, as noted above. Secondly, article 122a of the European Union's Capital Requirements Directive now requires banks to keep 5% of an issue on their balance sheet. In combination, these two measures make CMBS more expensive for banks to originate and issue. They will not underwrite loans to securitise if it is not going to be profitable.

In addition, Solvency II,[4] a separate exercise, will introduce a new risk-based regulatory regime for EU insurers. This too does not appear to favour CMBS (see below).

Moreover, the increased information and reporting requirements that regulators are attaching to CMBS will place an onerous burden on issuers. CMBS loans will require much more transparency than those that are not securitised, setting up a regulatory arbitrage with balance sheet lending. Unless there is a level playing field, borrowers will naturally gravitate towards the less onerous option.

Where are the CMBS investors?

As previously noted, banks are now constrained in their ability to invest in CMBS. However, there are others who might buy UK CMBS: notably, insurance companies, pension funds, asset managers, charitable and non-profit foundations and sovereign wealth funds. These 'hard money' equity investors channel a massive volume of capital into a wide range of financial markets; European insurers alone hold €6.7 trillion of European bonds, equities and other investments. However, their participation in the UK CMBS market is currently quite small. Most invest in CMBS as part of their allocations to asset-backed securities, so CMBS compete with other securitised products such as car loans, residential mortgages and credit card debt.

Over the longer term, these institutional investors could and should become a much bigger force in the UK market. Well-designed CMBS, as previously mentioned, provide an attractive way to invest in real estate-backed debt instruments that can be traded on a secondary market. In the shorter-term, however, there are significant factors inhibiting these investors, the first of which is, perhaps, Solvency II, which will transform how European insurers allocate their money.

Just as Basel III applies to banks, so Solvency II attaches different capital weightings to different investments according to their perceived riskiness. It is not yet completely clear how these weightings, which are still being calibrated, will shape insurers' allocations. Their main channel into real estate has been either buying assets directly or indirectly, via third party funds and listed real estate equities. Two or three insurers also lend directly on UK commercial real estate.

As currently formulated, Solvency II will make it more expensive for these organisations to hold structured debt like CMBS, whereas gilts, covered bonds and loans secured on real estate are treated much more favourably.

Another issue for institutional investors is that many lack the in-house expertise to analyse CMBS. Unlike US CMBS or UK residential mortgage-backed securities, UK CMBS are not generally backed by large, geographically diversified pools of relatively homogenous assets that can be subjected to macro-level statistical analysis. They are much less granular, containing fewer loans. Thus, the quality of the location, building, tenant and borrower/sponsor is critical in assessing the collateral and the risks involved. This requires significant real estate expertise.

[4] Directive 2009/138/EC of the European Parliament and of the Council. At the time of writing, Solvency II is scheduled to go live in a two-stage process. Supervision will start on 1 January 2013, but insurers will not be expected to meet Solvency II requirements until January 2014.

It will take time for these investors to establish their teams and become fully conversant with CMBS. For many, this will not be cost-effective and they may outsource investment to third-party asset managers who have the capacity to analyse and price CMBS.

Longer-term opportunity

It has been suggested that if UK CMBS were to offer longer durations and fixed-rate coupons, insurance companies and pension funds might be attracted to invest more. To match their liabilities, these institutions tend to hold more long-term debt than other investors, typically sovereign debt and corporate bonds.

The US CMBS market works on this model. There, CMBS typically offer fixed rates for terms of 15 years or longer. The insurance companies and pension funds account for 16% of CMBS purchased. The UK's fixed-income bond market is very large and liquid; in 2010 the turnover was £4.8 trillion and the dominant investors are insurance companies and pension funds.

However, most UK CMBS bonds, including half of the Chiswick Park issuance, are floating-rate bonds of short maturity (five to seven years). With a few exceptions, UK borrowers are reluctant to tie themselves into longer commitments. Most turn their assets over a short time frame and want flexibility to sell or refinance the properties that provide their collateral security. UK CMBS currently provide this.

With longer-dated, fixed-interest CMBS, early repayment is an issue for investors. The problem lies in reconciling their need for certainty of income over the duration of the CMBS with borrowers' need for flexibility. In US CMBS, this is achieved by defeasance, where a borrower substitutes a government bond or other eligible security of equivalent yield as collateral for its loan in the CMBS. Defeasance is not prepayment, since the loan is not repaid; both it and the CMBS continue through to their maturity date. Investors continue to receive their payments and the borrower is free to sell or refinance the property.

Because most UK CMBS are short-term, floating-rate securities, early repayment has not been a major issue. However, in the UK, listed fixed-income bonds do include some version of a 'Spens clause',[5] a formula that allows borrowers to pay off their debt before the maturity date. It provides for a cash payment equivalent to the amount which, if reinvested in a gilt of equivalent maturity, generates the same cash flows as the original bonds. The activation of a Spens clause constitutes prepayment, however, not defeasance, since the debt is repaid and bonds redeemed.

For borrowers, the cost of releasing their collateral, whether through defeasance or a Spens-style prepayment, will depend on how interest rates have moved and what discount rate is used to value the cash flows. For investors, defeasance is deemed preferable because the loan (backed by new collateral) and bond remain live, thus avoiding the need to reinvest their cash. Although there is no legal obstacle to incorporating it in CMBS, defeasance has not been used in the very few longer-term, fixed-rate CMBS that have been issued in the UK.

If CMBS could lengthen their maturities, they would broaden their attractiveness to new investors and borrowers. Some early securitisations, notably those of the Broadgate and Canary Wharf office complexes in London, were longer-term, fixed-interest structures. If, as is likely, shorter-term bank finance remains tight, borrowers may be pushed towards longer maturities. Indeed, several UK property companies have recently started to diversify the length of their debt, using bonds or insurance company loans. For example, in 2011 the Peel Group financed a portfolio of properties with a £205m, 20-year loan from insurer Aviva, whilst Great Portland Estates raised £160m via a private placement of seven- and 10-year bonds.

[5] Named after Lord Patrick Spens, the merchant banker who introduced it.

Arrangers

Article 122a of the European Union's Capital Requirements Directive seriously restricts banks' ability to arrange and issue CMBS. It requires originators/issuers to retain an exposure to the debt or, as industry jargon terms it, 'keep skin in the game'. Since 1 January 2011, 5% of any new CMBS issue must be kept on the bank's balance sheet. With the Basel III capital weighting attached to CMBS, this makes securitisation more expensive for banks and constrains their capacity to lend.

Supporters of this measure argue that it will promote good underwriting by banks, as they now have a stake in the longer-term performance of their issues. This, in turn, should promote the long-term health and sustainability of CMBS.

Borrowers

For some borrowers, the historic attraction of CMBS financing was its competitive pricing, especially on larger loans. However, many borrowers did not appreciate how inflexible and complicated securitisations could be when loans run into problems or, indeed, even with performing loans that they wanted to modify. In these cases, the time and expense of dealing with trustees and servicers and obtaining bondholder approvals can be substantial. Borrowers complained about being unable to negotiate with a single party with authority to act.

Sophisticated borrowers, whose securitisations have been trouble-free, say they would repeat the exercise but, in most cases, these are single-borrower CMBS, whose loans are not pooled with others'. One CMBS borrower interviewed felt that being in a multi-borrower CMBS adversely affected its loan. In this case, the borrower thought that the servicer dealt much more harshly with an extension of the loan, which was performing, than would have been the case had it been a straightforward bank loan. This was attributed to the servicer's fear that a less hard-line approach would set a precedent in dealing with other (lower quality) loans in the collateral pool.

The vast majority of borrowers are likely to prefer balance sheet loans with a relationship lender and would resist having their loans securitised. However, they may not have a choice. With debt in short supply, lenders have the upper hand. Indications are that banks are taking a tough line with borrowers, insisting on a level of disclosure that supports CMBS and the right to securitise or sell a loan.

Re-engineering CMBS

Many of the problems associated with pre-crisis CMBS stem from poor underwriting and poor documentation. These issues are being addressed by industry groups and regulators. In particular, the 5% retention required by Article 122a is meant to promote better underwriting by aligning issuers' interests with those of investors. Documentation, too, is being overhauled (see below).

However, the financial crisis has also highlighted some fundamental structural problems with CMBS. For the market to thrive, CMBS need to be re-engineered so that market participants, particularly investors, are confident that the product will work properly under stress. Put simply, CMBS need to be a less complex, more transparent product. In practice, this means fewer tranches of bonds, a sharper delineation of roles and more efficient procedures, plus better and more consistent information.

Table 1: Profile of Chiswick Park Bond Issuance

Notes	Initial principal amount	Issue price	Interest reference rate	Relevant margin	Expected maturity date	Final maturity date	Ratings S&P/DBRS
Class A	£235,000,000	100%	three-month Sterling LIBOR	1.75%	22 May 2016	22 May 2021	AAA/AAA
Class B	£30,000,000	100%	three-month Sterling LIBOR	2.75%	22 May 2016	22 May 2021	AA/AA
Class C	£37,242,500	100%	three-month Sterling LIBOR	3.75%	22 May 2016	22 May 2021	A – /A
Class X	£100,000	100%	—	—	22 May 2016	22 May 2021	NR/NR

All the notes, other than Class X, bear interest of three-month LIBOR plus the margin specified. After the expected maturity date, the notes (other than Class X) will pay the lesser of three-month LIBOR and 8.25% per annum, plus the margin specified.

Class X notes will bear interest that is effectively the excess of interest accrued on the loan at its standard margin after deducting the aggregate interest accrued on the other classes of notes and the annual fees of issuer-related parties, e.g. cash manager, liquidity facility provider, servicer, note trustee. However, if there is a 'trigger event' - a loan default, the expected maturity date, or a transfer of the loan to special servicing - then all Class X interest will accrue, but will not be payable until all the interest due to Classes A, B and C have been paid in full.

Deutsche Bank's Chiswick Park deal has tackled many of these problems. However, it is an evolutionary rather than a revolutionary product. The main areas of concern are considered below.

Remunerating arrangers: Class X bonds

Class X bonds are a vexed issue. This is the mechanism through which CMBS arrangers are rewarded in some issues: Class X bonds capture the excess interest left over after the interest on the bonds and certain expenses have been paid. These bonds are not entitled to repayments of principal and do not have any claim on the underlying assets but, typically, they rank on a par with, or just below, senior bondholders for interest payments.

This method of collecting what is, effectively, a fee spread out over the life of the loan has attractions for arrangers as they can book the net present value of this income as an asset on their balance sheet from day one. Arrangers can also sell the Class X bonds and realise this value, although, in practice, prepayments have made it difficult to sell these bonds in UK CMBS.

The problem, as highlighted by the recent crisis, is that Class X's seniority has allowed these bondholders to continue collecting excess interest payments when an issue has run into difficulties. Investors, particularly those whose bonds were under water, resented seeing income, which could be used to amortise loans, improve properties or pay their coupons, going to Class X bondholders.

These concerns have been addressed in the Chiswick Park deal, where payment to Class X bondholders is cut off either at the loan's expected maturity date or if it defaults or goes into special servicing. However, some investors remain uncomfortable with Class X bonds and would like to see an altogether different method of remunerating arrangers. The Commercial Real Estate Finance Council Europe, an industry association of those active in the commercial real estate finance market, has set up a Class X Working Group which is currently reviewing this subject.

Controlling 'tranche warfare'

When a securitisation runs into difficulty, different classes of bondholders in a CMBS may have very different views on what should be done, often based on the seniority of their tranche of bonds in the capital stack of the issuance. For example, junior classes may favour extending a loan's maturity to give the borrower time to resolve issues or, at the other end of the spectrum, senior classes may want early enforcement and sale of the collateral to repay bondholders. The conflicting interests can make it extremely difficult to obtain the bondholder approvals that are required for action; in extreme cases, they lead to open warfare among (and sometimes within) the tranches.

In a CMBS, the most junior bonds often have controlling rights, on the basis that they are the first to bear losses. Once a loan goes into special servicing, important modifications will require their consent and this controlling class also has the power to replace the special servicer appointed to look after a loan if it defaults or requires special attention. In restructurings and workouts, this gives the controlling class the power to delay or block action.

In most CMBS, control will be moveable, shifting up the structure to be with the most junior tranche that still has money at stake in the deal. However, determining where value breaks in the capital stack of a CMBS can be difficult if valuations are not undertaken or are subject to challenge. Most of the pre-crisis CMBS did not provide for regular, mandatory valuations of the underlying properties held as collateral. Hence, establishing the controlling class has been an issue. The Chiswick Park deal provides for desktop valuations to be used if no formal valuation has been carried out within the previous year.

Some investors, borrowers and lenders are unhappy that control can wander up (and, in theory, down) the capital stack. They believe control should rest with the senior class of bondholders, albeit with checks.

Mezzanine debt

CMBS transactions often involve not only a senior loan but also additional leverage in the form of mezzanine debt. Intercreditor agreements spell out the rights and obligations of these different classes of creditors and, traditionally, senior lenders have priority in payments and decision-making. As subordinate debt, mezzanine lenders typically had more limited rights to enforce or recover their debt, but in return received an additional reward for taking more risk.

In the UK, intercreditor agreements are not standardised and, in pre-crisis CMBS, mezzanine lenders negotiated provisions giving them greater control. For example, mezzanine lenders' consent might be required to amend the senior loan terms or, in the case of a work-out, for any refinancing or sale of the asset backing the loans.

These kinds of controlling rights give mezzanine lenders considerable power and can lead to conflicts and complications in working out troubled CMBS. For example, the borrower or an allied third party could buy back the mezzanine debt, thus acquiring the right to block any enforcement action on the senior loan. There have been also been cases of CMBS work-outs where mezzanine lenders used the threat of withholding consent to negotiate inducements or better terms for themselves. Moreover, some of the intercreditor agreements in pre-crisis CMBS were poorly drafted and ambiguous.

Chiswick Park involves not only the £302 million senior loan, which was securitised, but also £61 million of subordinate mezzanine debt provided by GIC, Singapore's sovereign wealth fund. The securitisation has been structured to address the issues raised by the mezzanine loan. It is not secured on the properties, so the lender does not have the right to foreclose on them if the borrower defaults on the mezzanine loan. However, the intercreditor agreement does require the mezzanine lender's consent for certain changes to the senior loan terms, e.g. to the principal, margins, fees, amortisation schedule or permitted disposal regime. Moreover, the mezzanine lender's ability to interfere with an enforcement of the senior loan is limited.

Bondholder consents and communication

Important decisions require bondholders' approval. However, like most European bonds, CMBS are not registered, so there is no central list of who the bondholders are. Investors and servicers alike are frustrated by the difficulty in identifying and communicating with bondholders. However, setting up a register and keeping it up-dated would be expensive and time-consuming. Moreover, some investors want to remain anonymous. Consequently, requiring disclosure of holdings might dissuade investment in CMBS, thus reducing the liquidity of the market.

Table 2 compares the structure of the Chiswick Park securitisation with that of a club bank loan.

Table 2: Securitisation vs. club loan: Chiswick Park compared

	Chiswick Park securitisation	Club bank loan
Senior debt (£302m)	One lender only (the issuer). Issue funded via three tranches of bonds sold to c.20 investors.	Group of banks.
Mezzanine loan (£61m)	One investor; subordinate mortgage; no enforcement rights on senior loan.	One investor; subordinate mortgage; no enforcement rights on senior loan.
Arrangement fees and payments	Arrangement fee used to meet up front securitisation costs, with balance to arranger. Class X bonds pay the excess margin income to arranger.	Arrangement fee split equally among club.
Minor modifications to terms	Servicer can approve subject to compliance with servicing standard.	Majority (67%) of club banks must agree; mezzanine lender consent required.
Major modifications to terms	If approved by all classes of bondholders; mezzanine lender consent required.	Club banks must all agree; mezzanine lender consent required.
Servicing standard	Maximise timely recovery of loan.	Maximise recovery of loan.
Primary servicer fees	Standard servicing fee but can charge modification fees for work-out. Standard servicing fees paid from margin.	No servicing fees as such. Typically an agency fee is paid to the facility agent bank.
Primary servicer termination	Without cause if approved by extraordinary resolution of each class of bonds that is still solvent.	Facility agent can be replaced by majority lender and borrower consent.
Special servicer fees	Default/restructuring costs set at outset. Special servicing fee (0.125% pa) and liquidation fee (0.5% of principal receipts). [This is lower than historically, to reflect large loan size and single borrower.]	No special servicing fees as such. Typically a loan default/restructuring will lead to an increase to loan margin and one- off restructuring fees paid to lenders.
Special servicer termination	Without cause by majority vote of controlling class of bondholders.	No special servicer. All lenders involved in work-out.
Reporting	Quarterly loan-level reporting to investors using E-IRP 2.0 template and public disclosure of key information.	Quarterly loan-level reporting disclosed only to lenders.

The voting process in CMBS has also proven cumbersome, time-consuming and sets a high threshold - typically 75% - for motions to be passed. Some bondholders fail to exercise their votes, further complicating matters. Chiswick Park uses 'negative consent' to deal with the latter problem. Rather than requiring a positive vote, motions are passed if sufficient bondholders do not actively object. The voting process has also been streamlined by, for example, shortening notice periods for convening bondholder meetings and reducing the majorities required to approve resolutions.

CMBS have not traditionally included a mechanism for servicers to consult bondholders about changes and actions they may be considering, particularly on restructurings. In some recent work-outs, bondholders have set up ad hoc committees, allowing them to participate in the restructuring and helping the flow of information among the parties. The servicing standard for Chiswick Park now explicitly provides for a bondholder committee.

Trustees

The trustee holds documents and has the authority to act for bondholders, though it typically delegates this authority to the servicer or special servicer. There is widespread dissatisfaction with the way trustees have exercised their role in CMBS in recent years. They are perceived to be more concerned with limiting their liability rather than taking decisions. However, it is recognised that their potential liabilities are extremely large, while their fees are relatively small. It has been suggested that CMBS should incorporate an independent third party to act as liaison between investors and the trustee/servicers.

Servicers, servicing standards and fees

Servicers play a pivotal role in CMBS. They are the intermediaries linking borrowers, bondholders and the trustee. Primary servicers manage and monitor loans day-to-day, collecting payments from borrowers, distributing them and reporting to bondholders. Special servicers deal with loans that are seriously troubled or in default.

Faulty documentation and a lack of clarity about what decisions servicers can make have bedevilled pre-crisis CMBS. Servicing standards in the UK tend to be generally worded, requiring the servicer to act as a reasonably prudent lender would and recover as much of a loan as possible. In UK CMBS servicers have usually been expected to act for all classes of bondholders. However, different tranches can have very different interpretations of what this means in practice. When tranche warfare breaks out among bondholders, servicers are caught in the crossfire.

Chiswick Park tackles this by stipulating that neither the primary servicer nor the special servicer has any specific obligation to any bondholder or even the bondholders collectively. Rather, the focus is on maximising the recovery of the loan as a whole, from the perspective of the CMBS issuer as lender.

However, servicers' accountability remains an issue. There is no objective test of whether a servicer is meeting the required standard; this has never been tested in law. While most investors and borrowers would like more precision on the extent of discretion servicers have, they do not want the role turned into a box-ticking exercise.

Both investors and servicers interviewed suggested that the most effective way of holding primary servicers accountable would be to give bondholders the sanction of replacing them without cause. In most pre-crisis CMBS, it is difficult to replace primary servicers for anything other than insolvency or negligence, while special servicers can be ousted by the controlling class. In the Chiswick Park securitisation, investors can replace the primary (but not the special) servicer without cause if each class of bondholder passes an extraordinary resolution.

It is also generally acknowledged that the fees currently paid to servicers should be changed. The typical servicing fee may not fully compensate primary servicers for any efforts to restructure or work out loans. In contrast, special servicers, who are charged with these responsibilities, command commensurately higher fees.

At the very least, this structure creates a conflict of interest. It disincentivises primary servicers from taking early action to solve problems ahead of a default, while also, perversely, providing an incentive for a loan to be transferred into special servicing, when it is likely to be less able to bear the higher fees. Chiswick Park allows servicers to charge borrowers a modification fee for additional work; other suggestions include a single blended fee for primary and special servicing.

Investors and borrowers are also worried about the conflicts of interests that could arise when a servicer is not independent, but owned by the bank that originated the loan and arranged the issue, and which may also be a bondholder. In theory, these roles are kept separate by Chinese walls, but the possibility of information leaking from one part of the organisation to the other and influencing decisions is of concern to other bondholders as well as borrowers.

Disclosure, transparency and standardisation

Investors, servicers, regulatory authorities and, indeed, some lenders and originators would like to see greater disclosure and more standardised documentation for CMBS. A more transparent market would help restore confidence in CMBS and create a more liquid market. It would aid investors and other market professionals better to understand, analyse and price CMBS and, thus, make better decisions. The issue is how to introduce greater standardisation without stifling innovation.

Financial regulators, aided by industry bodies, are pressing for more transparent CMBS. Article 122a of the European Union's Capital Requirements Directive requires sponsors and originators to provide investors with detailed loan-level information over the life of the transaction. This applies to new securitisations from 1 January 2011 and to existing CMBS where new exposures are added or substituted after 31 December 2014.

In addition, the Bank of England is setting out new requirements that both new and existing CMBS must meet if they are to be posted as collateral with the Bank. From July 2011, originators/issuers have had to make all transaction documents, including intercreditor and servicer agreements, swaps documentation and trust deeds "freely and readily available to interested third parties". Later in 2011, the Bank of England will be introducing detailed guidelines for quarterly CMBS loan-level information and reporting.

The Commercial Real Estate Finance Council Europe has worked with the European Central Bank and the Bank of England to develop a standardised data template, European Investor Reporting Package (E-IRP) version 2.0, for this reporting. Furthermore, the template has been designed to work for all commercial real estate loans, not only CMBS.

Conclusions

When properly structured and underwritten, CMBS are an elegant and efficient way of channelling equity into real estate debt. They can add substantially to the liquidity of the market, boosting the volume of lending available for commercial real estate via a tradable security that provides investors with an income stream backed by real assets.

Thus, CMBS can play a significant part in financing UK real estate. But, for the market to re-open fully and grow, CMBS must broaden their appeal to institutional investors: insurance companies, pension funds, asset managers, sovereign wealth funds and charitable or non-profit foundations.

It will take time for these investors to become sufficiently comfortable to enter the market in a substantial way. Regulatory uncertainties and lack of expertise are key inhibiting factors. There are also issues with the documentation and structuring of CMBS, although these are not intractable.

Accordingly, CMBS cannot provide a quick fix for refinancing the £365bn of UK commercial real estate debt that is currently overhanging the market. Longer term, however, the CMBS market should re-establish itself as a significant source of real estate debt.

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