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CMBS In 2017 And A Look Ahead

By **Stuart Goldstein and Gregory Prindle**
January 4, 2018, 11:00 AM EST

Stuart Goldstein

Gregory Prindle

Whether you were waiting for a “wall” or a “wave” to hit the commercial mortgage-backed securities market last year, 2017 did not deliver the massive amount of CMBS refinancings predicted by many at the end of 2016. While the volume of CMBS originations exceeded $228 billion during the heyday period of 2007, by all accounts it looks like 2017 ended with just over $88 billion in CMBS volume. While this represents a healthy increase over 2016, given the volume in 2007, it would be reasonable to expect that there were significant maturity defaults and/or a staggering amount of extensions. Not so: 2017 was on track to see a default rate of less than 5 percent in CMBS loans and no significant increase in the number of extensions relative to recent years. Even these reduced numbers might seem impressive compared to some of the dire predictions surrounding last year’s implementation of risk retention to CMBS. However, that prediction fizzled as the industry adapted to the regulations and navigated the new rules throughout the year. In this article, we will review what happened during 2017 and look ahead to what the industry might see in 2018.

Let us begin with a look back at 2017.

What Wall?

The CMBS market continued to grow in 2017. New-issue CMBS in the U.S. for 2016 was approximately $76 billion and is on pace to annualize at approximately $88.8 billion for 2017 (based on data through the third quarter of 2017). Through the third quarter of 2017, new-issue CMBS reached approximately $66.6 billion, up 33 percent from the same period for 2016 (approximately $49.8 billion).

However, as noted above, excitement over the increase in issuance is tempered by thoughts of what might have been. What derailed the “wave” just as it was expected to peak? In a trend that began in recent years, the CMBS market lost market share to other participants in the commercial real estate lending market. Balance-sheet lenders, such as insurance companies, retail banks and debt funds, were searching for yield as interest rates remained low and commercial real estate loans provided a good relative value proposition. A substantial portion of the mortgage loans that traditionally would have been originated through the CMBS market were financed through syndications to these balance sheet

lenders. According to market participants, the CMBS market share of new commercial mortgage loan origination fell from approximately 44 percent in 2007 to less than 20 percent in 2017.

While CMBS lenders have historically cited higher capital markets interest rates and tighter underwriting standards as primary reasons for losing loans to balance sheet lenders, borrowers have recently voiced another reason: they had become frustrated with the perceived rigidity and expense of CMBS servicing. As a result, beginning in 2016, lenders, issuers and servicers began taking steps to improve the borrower experience in CMBS transactions. In 2017, those steps continued, as many deals throughout the market incorporated provisions intended to shorten servicer response times, reduce unnecessary lender consents and fees, and limit fees paid by borrowers by placing greater controls on transfers to special servicing. Issuers have tried to balance the needs of investors — particularly B-piece buyers — with those of borrowers. We may see whether that effort will pay off in 2018 as CMBS lenders continue to look for ways to work with borrowers in order to stem the tide of balance-sheet lenders' growing share of the commercial real estate loan market.

Risk Retention Arrives

Heading into 2017, there was substantial uncertainty and apprehension surrounding the implementation of risk retention to CMBS transactions. The final risk retention rules were adopted in late 2014, and although the CMBS industry had spent more than two years preparing for the rules to go into effect, many feared the worst.

Many market participants forecasted a substantial reduction in the number of sellers contributing loans to securitizations due to the prospect of having to hold a risk retention instrument on their balance sheet or the expense involved in having a third-party purchaser retain the related risk retention interest. In actuality, there was a thinning of the herd, as the number of loan sellers contributing loans to CMBS transactions dropped 21 percent from 37 in 2016 to 29 through the third quarter of 2017.

Initially, many market participants doubted that any lender would retain its own risk retention interest. However, the vertical and "L" shaped options were routinely utilized throughout the year. For those unwilling to hold their own risk retention pieces, the key questions were whether they could offset enough of their retention requirements to third-party purchasers and what interest rates would be required by TPPs to purchase such interests. Issuers were pleasantly surprised by the answers to both questions. Of the 36 conduit transactions through the third quarter of 2017, 13 were vertical risk retention, 12 were horizontal and 11 were an "L" shaped combination of vertical and horizontal. Of the 43 single-asset or single-borrower (SASB) transactions through the third quarter of 2017, 21 were vertical risk retention and 22 were horizontal. While a few of the horizontal retention transactions involved sponsor retention, the vast majority of the tranches of horizontal retention interest were sold to TPPs. Therefore, it is safe to say that over 50 percent of the CMBS transactions through the third quarter of 2017 involved a TPP.

On the B-piece buyer front, leading up to the beginning of 2017, some potential buyers were raising funds in order to retain CMBS risk retention on a long-term basis, while others indicated they would not be interested in retention. Some of the more familiar B-piece buyers ultimately embraced the TPP role, while others either sat out 2017 entirely or merely refrained from being a TPP. While TPP risk retention did bring some new entrants to the space to help fill the void, the run-up in yields on horizontal risk retention interests never seemed to materialize and kept many out of the market. It remains to be seen if an overall cap to the volume of CMBS originations will be set by the availability of either the balance sheets of issuers and loan sellers utilizing the vertical or "L" shaped options and/or the overall

participation and balance sheet availability of TPP investors.

Accounting Sale Treatment

As the risk retention rules moved from theory to reality, CMBS issuers, lenders, service providers, and their attorneys and accountants worked to resolve issues throughout the year. Retaining parties examined the best manner to hold risk retention, operating advisers deliberated with issuers over their new obligations, and a debate over accounting treatment threatened to stall CMBS issuance.

A risk retention structure relying on a sale to a TPP necessarily subjects the related risk retention interest to various transfer and financing restrictions. As a result of these restrictions on the ability of the buyer to transfer and monetize the related interest, certain of the "Big Four" accounting firms were hesitant to treat the sale to a TPP as a sale for accounting purposes. The other Big Four firms, as well as other market participants, argued, among other things, that the restrictions were imposed merely to comply with risk retention rules and therefore should not preclude derecognition. All CMBS eyes were on this debate. Without sale accounting treatment, a loan seller would be less likely to participate in a TPP securitization because the assets could stay on the loan seller's balance sheet. The Securities Industry and Financial Markets Association sought guidance from the U.S. Securities and Exchange Commission, which confirmed in December 2017 that the restrictions placed on the TPP would not cause the transferor to fail to meet the conditions for sale accounting treatment.

Increase in SASBs

Through the third quarter of 2016, there were 24 SASB transactions totaling approximately $11.6 billion. Through the third quarter of 2017, SASBs had nearly doubled to 43 transactions totaling approximately $25.3 billion. These transactions included the securitization of loans secured by iconic buildings like the Willis Tower in Chicago, as well as Caesars Palace Las Vegas as it emerged from bankruptcy. This increase reflects the competitiveness of CMBS lenders for large floating rate loans where the capital markets are seemingly better able to provide borrowers with additional proceeds, as well as favorable pricing by converting those mortgage loans into various CMBS classes of certificates to meet different investors' appetites and by using mezzanine loans to provide additional leverage. In addition, it reflects the desire of "AAA" investors for "trophy" assets that are often simpler to underwrite.

Increase in CRE CLOs

Through November 2017, there were 15 CRE collateralized loan obligation, or CLO, transactions totaling approximately $4.4 billion, which is more than double the seven transactions totaling approximately $1.7 billion that the market saw in 2016. There were 11 unique sponsors in 2017, as certain lenders began to turn to CRE CLOs in increasing numbers for funding. In addition, more lead managers entered the market and were willing to provide their clients with warehouse lines for interim financing.

So what should we expect to see in 2018?

Will There Be Any Relief?

As discussed above, 2017 saw the rollout of risk retention for CMBS as well as the continued growth of regulations affecting CMBS lenders, issuers, underwriters and investors. The current administration has shown a propensity for reducing regulations and trying to roll back Dodd-Frank rulemaking. For example, on Oct. 6, 2017, the U.S. Department of Treasury released the second of several anticipated

regulatory reform reports, titled "A Financial System That Creates Economic Opportunities: Capital Markets," to the president. The report addresses certain elements of the capital markets, including the securitization markets. Among its recommendations that could affect the CMBS market would be the review of the five-year holding period for TPPs and sponsors with respect to the related risk retention interest and potential expansion of qualifying underwriting exemptions across eligible asset classes (including CMBS).

Additionally, the Financial Choice Act of 2017, which was passed by the House of Representatives on June 8, 2017, would limit the risk retention requirements of the Dodd-Frank Act only to asset-backed securities that are "comprised wholly of residential mortgages." Moreover, the Trump administration has shown an inclination to give greater capital relief, and any potential reduction in regulatory capital requirements would greatly increase the potential for secondary market trading resulting in potentially better pricing.

While this might be cause for optimism, the industry must also recognize the slow pace with which the regulatory world often moves (i.e., rulemaking, review, potential second release, review and regulatory agreement, final rule, new compliance date). After all, it took over six years from the passage of Dodd-Frank for risk retention to go into effect. With many vacancies in the various administration departments yet to be filled, it would seem unlikely that significant regulatory relief would come early, if at all, in 2018.

Where Will All the Loans Come From?

As discussed above, 2017 saw substantial growth in the number of SASB transactions executed. Yet, the most interesting trend was the record number of SASB transactions executed in the third and fourth quarter of the year. We expect the same drivers that facilitated these transactions in 2017 to continue, and even accelerate, in 2018. In addition, the need for transitional floating rate loans will continue to grow to fund the execution of business plans of buyers that aim to improve, turn around and/or stabilize properties. As competition tightens for commercial real estate, buyers will continue to seek value in these types of properties. In addition, as rates increase and capital markets pricing tightens due to a continued search for yield and relative value, it is possible that a portion of the loans that otherwise would have been originated by the CMBS market in 2017 but were instead funded by balance-sheet lenders will return to the CMBS market in 2018. This is especially true if the industry is successful in its focus on the borrower experience discussed above. That said, the "wave" or "wall" has passed, and with post-recession volumes paling in comparison to the origination levels for 2007 described above, it is difficult to see from where any significant increase in volume would otherwise come. Therefore, it would be safe to assume that originations for 2018 would be at best similar to 2017, both in volume and in diversity of type.

CRE CLOs — The Next Wave?

While 2017 saw a dramatic increase in the number of CRE CLOs executed, there is every reason to believe that this trend will continue and, in fact, accelerate in 2018. The need for transitional floating rate loans is expected to continue to grow, and the market has seen tremendous growth on the investor side for CRE CLO bonds. As long as the rates achievable through a capital markets execution are inside of the rates that can be offered by traditional warehouse lenders, we should see the market for this product expand, both in terms of volume and by the number of issuers. Issuers enjoy the match term and non-mark-to-market character of these transactions. The market should also see continued growth in the number of actively managed CRE CLOs as opposed to static transactions. The ability of an issuer to

recycle principal to add additional collateral to a pool represents an opportunity for cost savings and, as witnessed in 2017, acceptance has grown throughout the market for at least some management with respect to the pool of assets in a transaction.

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Although the expected wave of refinancings never materialized as anticipated in 2017, CMBS volume was up in comparison to 2016 despite the implementation of risk retention and regulatory and accounting speed bumps. As some new participants entered the market, others left or never entered. The market optimistically looks forward to 2018 as the search for product will continue and hope for reduced regulations springs eternal.

Stuart N. Goldstein is the managing partner of Cadwalader Wickersham & Taft LLP's Charlotte, North Carolina, office, co-chairman of the firm's capital markets practice and a member of the firm's management committee.

Gregory M. Prindle is a partner in Cadwalader's capital markets practice in New York.

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