

# CRE

# FINANCE WORLD

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## HIGHLIGHTS

**Hype or Reality?  
The Retail Apocalypse  
and its Effect on Mall Loans**

**2020 Vision:  
Strength in Industrial**

**WeAnalyze:  
Risks to Landlords and  
Lenders in Uncertain Times  
for WeWork**

## PLUS

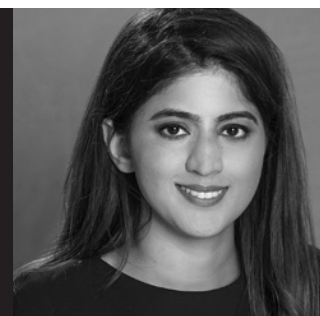
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## The Re-Emergence of European CMBS Transactions

**European CMBS transactions have re-emerged at a steady pace for the first time since before the financial crisis. The structuring of recent deals draws on certain features currently used in US CMBS transactions; however, there continue to be certain key structural areas where European CMBS transactions differ from their US counterparts. European loan-on-loan financings also seem to be gaining significant traction in Europe, although it is important to note that European loan-on-loan financings are also subject to the EU Securitization Regulation that has applied since January 1, 2019.**

### The Increasing Interest in European CMBS

Following the end of the “Credit Crisis,” a handful of European CMBS transactions were executed. In 2015, however, the market ceased as a result of adverse pricing conditions compared to the European market for syndicated loans. Beginning in 2017, under more favorable pricing conditions, the European CMBS market re-emerged. Those transactions began to include a number of US CMBS features, driven mostly by the demands of US borrowers.

#### EXHIBIT 1

#### Annual European CMBS Transaction Volumes



Source: AFME & SIFMA via <https://www.sifma.org/resources/archive/research/reports/>

There is currently a steady issuance of European CMBS, with a host of new players in this recently revived European CMBS landscape. In addition to new borrower sponsor groups, there are new lenders, arrangers, investors, and even a new rating agency, Kroll Bond Rating Agency (KBRA) Europe, which rated its first European CMBS last year and rated five additional transactions in 2019.

### Diverse Assets

European CMBS transactions generally include loans secured by a range of property types, including student housing, hotels, offices, and retail, across the various geographical regions. In addition, the European market seems to be following US trends by including newer property types, illustrated by the emergence of logistics assets in the European space. While European CMBS transactions backed by brick-and-mortar retail have not consistently performed well, reflecting the heightened demand for online shopping, recent European CMBS transactions have included loans secured by “last-mile” distribution centers that allow storage and shipping of assets to customers in a short time frame. In addition, 2019 saw the first European CMBS transaction secured by cold storage warehousing loans.

A wide range of jurisdictions—including Italy, Germany, the Netherlands, Scandinavia, Ireland, and the UK—are reflected in European CMBS transactions. French CMBS transactions also contribute to the recent spate of new issuance. These French CMBS transactions have addressed issues in legacy transactions that hindered effective enforcement in the French market by utilizing a “double Luxco” structure (i.e., setting up two Luxembourg HoldCos, intended to mitigate the risk of the borrower sponsor group from filing for protective measures in the French courts), giving increased comfort to investors and rating agencies that the security arrangements for the related loans will be more effective.

### True Sale Versus Agency

The majority of European CMBS transactions are structured as “true sales” of pre-existing loans to a newly incorporated special purpose vehicle (SPV). While the originator generally takes the risk of execution on any eventual CMBS transaction when the loan is initially advanced by the loan originator, the interest rate pricing can be advantageous to the related borrower since the loan originator expects to transfer its commitment to the CMBS transaction. As a result, the loan originator can price that interest rate based upon the expected execution. In exchange for this lower coupon, the borrower and related sponsor group are required to co-operate with the issuer in connection with the related CMBS transaction—for example, by assisting with disclosure on the assets in the prospectus.

There are also “agency” transactions whereby the loan is advanced by the SPV to the borrowers on the same day as the issuance of the notes through the CMBS



transaction. In this structure, the initiating bank/arranger has no lending exposure and acts only as the arranger of the CMBS. However, the arranger's profit is limited to the fees earned in acting as the placement agent/arranger on the transaction.

## Key Structural Differences Between US and European CMBS

- **Separation of principal and interest until acceleration in European CMBS.**

Unlike US CMBS transactions where all available funds are commingled from the outset of the transaction, interest and principal are applied down separate waterfalls in European CMBS transactions until note acceleration. Interest is typically applied sequentially and is also applied to pay senior expenses (such as amounts due to agents and service providers), which rank ahead of interest payable on the rated notes. Until the occurrence of a material event of default in respect of the loan, principal recoveries are generally applied pro rata among all classes of notes and, after a material event of default, are applied sequentially. Traditionally, European CMBS loans do not amortize other than in property releases and circumstances such as after a permitted change of control or where it is considered expedient to provide for amortization in order to help the leverage profile of the portfolio.

- **European CMBS loan documents apply financial covenants in certain situations.**

US CMBS generally do not have financial covenants based on debt yield or loan-to-value at the transaction level that would cause an event of default, which is the reverse position to European CMBS. Depending on the strength of the borrower sponsor group, some European CMBS have adopted the US approach, although in such transactions, financial covenants start to apply after a permitted change of control (usually to global entities that have other significant commercial real estate assets under management) or an initial public offering.

- **European CMBS loans generally permitted to prepay at all times with the payment of a prepayment premium.**

Unlike US CMBS loans, where there is typically a "lockout" period in a conduit CMBS transaction during which prepayments on a loan cannot be made – or, in certain single asset single borrower securitizations, where a specified percentage of the loan may be prepaid without payment of a prepayment premium – European CMBS have not yet wholly adopted the US approach. Prepayment premiums in European CMBS generally apply for an initial period of time, although a few recent deals permit a certain amount of the loans to be prepaid from origination, without payment of a prepayment premium.

- **Prepayment amount for property sales or transfers reference multiple factors.**

In the same vein as US CMBS transactions, property sales or transfers (i.e., partial release of collateral) in European CMBS loans require a prescribed allocated loan amount and release premium to be paid. This is an area where European CMBS vary from transaction to transaction. The release premium could, for example, reference an allocated loan amount for the property or be based on the actual disposal proceeds received or on the then-current loan-to-value.

- **Liquidity facility provider instead of servicer making advances.**

European CMBS transactions address liquidity shortfalls in respect of senior expenses, interest payments and property protection amounts (determined by the servicer as being payable to third parties, such as insurers and parties providing services connected with the operation of the properties). This differs from US CMBS where shortfalls in principal amounts also may be covered. A committed liquidity facility provider is in place at the outset in the selected loan documents of the CMBS transaction. The liquidity facility provider must have a requisite rating. In European CMBS, this is usually the same bank as the arranger. Reimbursement of the liquidity facility provider ranks as a senior priority in the waterfalls.

- **Class X notes.** These notes are paid from the excess of the spread payable under the loan over the spread payable to the notes and are paid in different priorities depending on the performance of the transaction. This contrasts with US CMBS, where the interest-only notes are paid in a senior priority at all times. If, for example, there is a loan-to-value or debt yield trigger, and notwithstanding that any financial covenant may not have been breached, the interest that would have been payable to the Class X notes in European CMBS is diverted. Further, after a material event of default in respect of the loan, such diverted funds are applied to the interest waterfall, or after a note acceleration, to the post-acceleration priority of payments (since, as mentioned above, after acceleration, all funds are applied together). At this point, the waterfalls will switch the priority of the Class X notes (that used to rank at the same level as the Class A notes as regards interest payments), thereby subordinating the Class X notes beneath all other classes of notes. In European CMBS transactions, such diversion of funds and subordination of the Class X notes is viewed by investors as a compensatory factor to offset the lack of financial covenants in the related loan documents on day one. Because the absence of financial covenants is a recent innovation in European CMBS, investors have this bargaining influence, notwithstanding the presence of influential borrower sponsor groups in European CMBS.

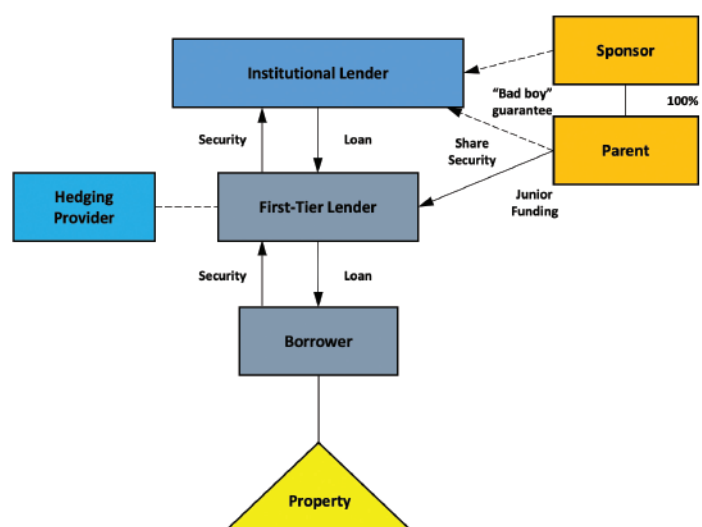
- **Long tail periods.** Pre-financial crisis-established European CMBS transactions have often required protracted workout periods. As a result of extremely lengthy creditor negotiations and court proceedings, more recent European CMBS transactions have relatively long tail periods (the period between the scheduled maturity date of the loan and the final maturity date of notes). It is more difficult to enforce security in certain European jurisdictions because of a longer creditors' process in the courts of the relevant jurisdiction.

- **Interest rate capping after scheduled maturity date of the loan.** At this point in European CMBS transactions, any hedging will have expired, and so interest rates payable on the notes are capped during the tail period to mitigate against any increases to EURIBOR or LIBOR. Further, the available funds cap limits the amount of interest payable to the most junior noteholders if there are insufficient funds to meet the interest obligations of the issuer (e.g., as a result of a significant amount of early prepayments being made on the underlying loans.)

## European Loan-on-Loan Financings

### EXHIBIT 2

#### Example of "Loan-on-Loan" Financing



## US Influence on the European Loan-on-Loan Market

The European “CRE loan-on-loan” market came of age after the credit crisis when borrowing from traditional lenders was not available. The product consists of a facility provided to finance the purchase or origination by an SPV of one or more mortgage loans. The facility benefits from overcollateralization through junior debt or equity provided by the sponsor. The typical terms provide that: (a) the facility is uncommitted, (b) the advance rate varies depending on the loan asset being financed, (c) the term is 1 to 5 years, (d) security for the facility is the loan assets themselves, and (e) the facility is generally non-recourse. Sponsors have been using the European CRE loan-on-loan product as a way to increase returns and diversify funding sources. Although the development of the product largely followed the US CRE “repo” product, there has been a divergence of approach between the two jurisdictions in respect of a number of product features, including the level of recourse to the sponsor, the use of “bad boy” guarantees, margining, and mark-to-market requirements. The level of loan asset due diligence required for a European loan-on-loan transaction is also likely to be more involved than that required for a US transaction as most European loan-on-loan portfolios include assets from any number of European jurisdictions, all with different title and security regimes.

## Possibility of European CRE CLOs

European CMBS tend to comprise only a handful of loans. The conduit structures seen in US CMBS have not had the same impact in recent European CMBS. European loan-on-loan financings can encompass a range of granular assets that may not be eligible for conventionally-rated European CMBS. Therefore, the notion of a European CRE CLO market grows stronger. The key issue is whether sufficient ramp-up of assets is achievable under European loan-on-loan financings to warrant the establishment of a CRE CLO market.

## EU and US Risk Retention and Reporting Regime

### Background to the EU Securitization Regulation

The EU Securitization Regulation (Regulation (EU) 2017/2402) has applied since January 1, 2019. Broadly, it covers:

1. Articles 6 and 7 impose risk retention and disclosure requirements on EU sponsors, originators, original lenders and issuers (a US branch of an EU entity would be captured by these requirements, but a US subsidiary would not); and
2. Article 5 imposes due diligence requirements on EU institutional investors investing in securitizations, including securitizations outside the EU such as US CMBS. Investors that are captured are EU-regulated entities, including credit institutions, alternative investment firms, occupational pension funds, UCITS funds and insurance firms. The due diligence requirements include verifying compliance with the EU Securitization Regulation (including in respect of credit grants).

### Risk Retention

- **Article 6 of EU Securitization Regulation.** If a European CMBS or loan-on-loan financing is a “securitization” for the purposes of the EU Securitization Regulation, pursuant to Article 6, a 5% material net economic retention piece is required to be held by the originator, original lender or sponsor of the transaction. (Note: “sponsor” has a different meaning for the purposes of the EU Securitization Regulation compared to elsewhere in this article where the term “borrower sponsor group” is used.) The methods of retention are specified in Article 6(3). In a European loan-on-loan financing structure as per Exhibit 2, the borrower sponsor group will typically retain 5% of the junior funding, representing a retention of the first loss tranche.

- **US safe harbor.** If a European CMBS cannot rely on the foreign transaction safe harbor provision of the US risk retention rules (Regulation RR, 12 C.F.R. §244.1, et seq.), a 5% retention piece is required to be held. European transactions that tend to fit within this category are where the “sponsor” is chartered, incorporated or organized under US law. European loan-on-loan financings that are structured as per Exhibit 2 are not required to be compliant with the US risk retention rules since the rules require there to be an issuance of “asset-backed securities.” To be treated as a “securitization” for the purposes of the EU Securitization Regulation, there does not need to be an issuance of securities, so a private transaction may fall within its scope. It should be noted that the European loan-on-loan financing construct is given as an example, but the definition of “securitization” under the EU Securitization Regulation captures a range of private transactions that do not involve the issuance of securities.

- **Eligible vertical interest.** Where a European CMBS is a “dual-compliant” transaction, an “eligible vertical interest” is commonly retained to satisfy both US risk retention rules and the EU Securitization Regulation. An eligible vertical interest is defined to mean a single vertical security or an interest in each class of ABS interests in the issuing entity. The eligible vertical interest tends to take the form of an “issuer loan” from the seller (of the CMBS loan) to the SPV or an uncertificated trust interest. The notes issued by the SPV will bear an aggregate outstanding principal balance of 95% of the CMBS loan and the retention piece will hold the remaining 5%. The retention piece represents a right of the retention holder to receive a pro rata percentage (5% divided by 95%) of all amounts paid to the noteholders. Structuring the retention piece in this manner may also satisfy European risk retention rules by having it constitute no less than 5% of the nominal value of each of the tranches sold or transferred to investors.

### Disclosure Requirements

- **Reporting templates.** Article 7 of the EU Securitization Regulation sets out disclosure requirements for securitizations, including ongoing reporting requirements. On October 16, 2019, the European Securities and Markets Association (ESMA) published final versions of asset-level reporting templates for securitizations, including one for commercial real estate (Annex III to the regulatory technical standards). In addition to asset-level reporting templates, there is an investor reporting template (Annex XII to the regulatory technical standards) that applies to all securitization asset classes. Annex XIV provides for the reporting of inside information or significant event information relating to the securitization that the originator, sponsor and SPV are required to make public. Further, even if it does not constitute inside information, or if inside information does not apply to a transaction (i.e., where securities are not listed on an EU-regulated exchange), any material breach of the obligations under the transaction documents, any material change in the structural features or risk characteristic of the securitization, or any material amendment to the transaction documents is categorized as a “significant event” and required to be reported in accordance with Annex XIV.
- **Application date of templates.** The templates were adopted by the European Commission on October 16, 2019. If the usual European Union legislative timetable is followed, the templates should apply on a date falling in February or March 2020.
- **Commercial real estate template.** The CREFC US 8.0 template overlaps substantially with the fields in the ESMA commercial real estate template, and so market participants familiar with the CREFC template have been conducting extensive mapping exercises in respect of the two templates.

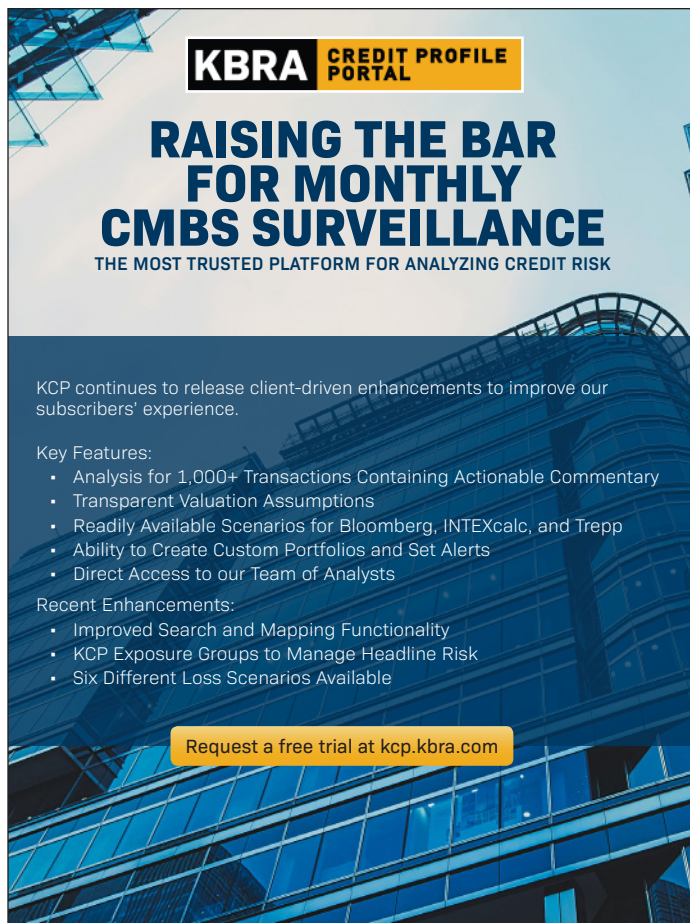
- **Frequency of ongoing reporting.** Whereas US CMBS transactions report monthly using the CREFC US 8.0 template, European CMBS report quarterly. The EU Securitization Regulation requires the information to be made available each quarter – at the latest, one month after the due date for the payment of interest.
- **Current transitional reporting.** While the application date for the ESMA templates is awaited, European CMBS (along with other securitization asset classes) are required to report, on a transitional basis, in accordance with interim CRA3 templates.
- **Application of disclosure to securitizations that do not issue securities.** It is important for parties investing in European transactions to note that the requirements described above apply not only to public CMBS transactions but also to loan-on-loan financings or other private transactions that constitute “securitizations” for the purposes of the EU Securitization Regulation.

#### Extraterritorial Disclosure Requirements for EU Institutional Investors Purchasing US CMBS

- **Uncertainty around Article 5(1)(e).** An area that has received significant attention since January 1, 2019, particularly from US issuers and arrangers, relates to the due diligence requirements applicable to EU institutional investors where there is not an EU sponsor, originator or issuer. The extraterritorial question arising frequently is whether EU institutional investors that are purchasing US CMBS require, pursuant to the due diligence requirements of Article 5(1)(e) of the EU Securitization Regulation, the relevant US CMBS to be Article 7 disclosure-compliant.
- In relation to disclosure for EU institutional investors under Article 7, symptomatic of the uncertainty referred to above, a varied approach is being taken. Some US CMBS transactions contemplate that there may be a delay for US issuers in being able to comply with the templates once the templates start to apply, since it may take some time to set up systems to process the information required by the corresponding data fields. Further, some EU institutional investors may become comfortable that current CREFC US reporting is substantially the same as the requirements of the data fields in the ESMA templates.

#### Conclusion

The re-emergence of European CMBS as a revised asset class and the development of loan-on-loan financings towards the possible re-emergence of a new European CRE CLO asset class reflect a positive time for the European structured real estate finance market. However, structuring issues can vary from deal to deal since the European market is fairly bespoke. Therefore, with the added impact of the EU Securitization Regulation, careful consideration should be given at the outset of European CMBS transactions and loan-on-loan financings.



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