Clients&FriendsMemo

A Tale of Two Continents - European CMBS v U.S. CMBS & CRE CLOs

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U.S. CMBS issuance equalled approximately $171[1] billion during 2018. In the same period, European CMBS issuance equalled approximately €4 billion which, whilst not close to the issuance levels of the U.S. CMBS market, represents a significant increase for the European market compared to any other period since the financial crisis. Issuance of U.S. CRE CLOs during 2018 equalled approximately $14.5 billion.[2] The activity levels in 2019 for all of these products continue at a strong pace reflecting the global demand for commercial mortgage backed securities.

Why is a comparison of European CMBS against U.S. CMBS & CRE CLOs important?

While both jurisdictions are seeing sustained growth in their markets, the European and U.S. markets are not always directly comparable. For example, European CMBS is secured by properties in various jurisdictions and, therefore, the legal frameworks[3] and requirements, in addition to the associated risks, may vary from transaction to transaction. However, the size and consistency of the U.S. market and the presence of significant loan sponsors (which often have growing European operations) mean that developments in U.S. CMBS will have a strong influence on structural features that are incorporated into European CMBS. In addition, the growth of commercial mortgage direct lending and loan on loan finance in Europe (which will require additional sources of take-out financings) are strong indicators of the development of a CRE CLO market in Europe. To help anticipate the continued development of these products in Europe, we have set forth below a comparison of certain important considerations and trends in the CMBS and CRE CLO markets and related jurisdictions.

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[1] Includes agency and pre-originated Senior Loans. *See* footnote 13 in https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20 for an explanation of agency v pre-originated.

[2] Currently, there is not an equivalent market for CRE CLOs in Europe.

[3] Generally, the note level documentation is governed by the laws of England and Wales even if the assets are located outside the UK.

Comparison Table of European CMBS, U.S. CMBS & CRE CLOs

	EUROPEAN CMBS	U.S. CMBS	U.S. CRE CLOs
Transaction structure	***Few securitised loans per CMBS*** • Generally, 1-5 Senior Loans[4] are securitised in a CMBS.[5] • Recent CMBS have securitised a broad range of real estate, *e.g.*, "last mile" logistics, offices, care homes, hotels, light industrial, and retail assets. A significant number of Senior Loans comprise acquisition financing facilities granted to loan sponsor groups.	***Typically more granular*** • U.S. CMBS securitise any real estate type (*e.g.*, office, retail, hotel, multifamily or industrial properties) in a pooled "conduit" or a single asset/single borrower ("**SASB**") securitisation. • Approximately 1/4 to 1/3 of the overall market are SASB securitisations. • SASB CMBS commonly include "trophy" properties in prime markets with lower LTV and/or higher DSCR.	***More securitised loans per CRE CLO*** • Typically 20-40 loans or participations are securitised in a CRE CLO. • Pool is typically a diversified mix of transitional loans. Recent CRE CLOs have included loans secured by senior healthcare facilities and mezzanine loans. • The majority of CRE CLOs are managed and allow principal proceeds to be reinvested during a reinvestment period. Many static CRE CLOs allow the issuer to reinvest principal proceeds in future advances made on loans in the original pool.
Notes	***Floating rate*** • Typically floating rate.[6] Interest rate caps tend to be entered into to hedge the interest rate risk on the underlying assets. • An event of default under the CMBS Notes will be	***Fixed rate or floating rate*** • Structured as pass-through certificates. Certificates are entitled to principal and interest, to the extent received, in accordance with the priorities of payments waterfalls. As a result, the certificates may	***Floating rate*** • Typically floating rate. Interest rate caps tend to be entered into to hedge the interest rate risk on the underlying assets. • An event of default will occur if there is a failure to

4 In this briefing, the European CMBS structure envisaged is a senior loan (the "**Senior Loan**") secured over real estate assets, granted to (1) a property owning company (or its holding company) (the "**Senior Borrower**") by (2) the lender (the "**Senior Lender**") of the Senior Loan. The Senior Lender sells the Senior Loan to the issuer (the "**Issuer**") of the CMBS notes (the "**CMBS Notes**"). There can be multiple Senior Loans in a CMBS.

A separate loan (the "**Mezzanine Loan**") may also be entered into. The Mezzanine Loan is structurally and contractually subordinate to the Senior Loan and is entered into by a holding company (the "**Mezzanine Borrower**") that is higher in the group structure than the Senior Borrower. The lender (the "**Mezzanine Lender**") benefits from the real estate assets on a subordinated basis to the Senior Loan. The Mezzanine Lender has cure rights in respect of the Senior Loan and in certain circumstances, is entitled to purchase the Senior Loan at par (*i.e.*, typically the outstanding principal amount of the Senior Loan plus accrued, unpaid interest plus break costs). Separate share security, typically over a holding company and the Mezzanine Borrower, is granted for the benefit of the Mezzanine Lender only and entitles the Mezzanine Lender to enforce the share security if there is an event of default under the Mezzanine Loan.

There are some principles discussed in this briefing which may equally apply to a Mezzanine Loan but since this briefing is focused on the Senior Loan which is securitised for the purposes of the CMBS and the Mezzanine Loan is subordinate, this briefing does not discuss the Mezzanine Loan in further detail.

5 Although there are exceptions and there are occasional conduit CMBS.

6 For details of interest rate capping mechanisms used for CMBS notes, *see further* https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20

	EUROPEAN CMBS	U.S. CMBS	U.S. CRE CLOs
	triggered if there is a failure to pay principal or interest.[7]	incur shortfalls in principal and interest relative to expected payments and will not be in default as a result.	pay interest on the senior notes (or in some transactions, on any class of notes).
Financial covenants	***Increasing flexibility in financial covenant regime*** • A recent U.S. trend that is increasingly reflected in some European transactions is more flexibility in the financial covenant regime, *e.g.*, in some transactions, financial covenants may not apply until there is a permitted change of control. Regardless of financial covenants not applying, cash traps apply upon LTV and debt yield triggers.[8]	***Lack of financial covenants*** • In general, there are no financial covenants based on LTV or debt yield triggers that would cause an event of default. • Debt yield (but not LTV) triggers or DSCR triggers in some Senior Loans cause cash traps. • Typically cash sweeps are based on DSCR and/or debt yield triggers.	***Cash sweeps*** • Typically cash sweeps are based on DSCR and/or debt yield triggers.
Permitted change of control	***Increasing flexibility in change of control*** • The permitted change of control definition typically allows a Senior Loan sponsor to change the ownership of the real estate portfolio without mandatory prepayment if there is, *e.g.*, (1) an IPO; or (2) a sale to an entity owning CRE assets with a minimum specified market value, provided that, at the time of the sale: (a) an LTV test is satisfied; and (b) experienced property managers are in place.[9]	***Weakened change of control provisions*** • The eligibility standards for a transferee are increasingly negotiated in recent deals with institutional sponsorship, allowing ownership of the real estate portfolio to be transferred to a less-experienced, deep-pocketed Senior Loan sponsor as long as such sponsor engages a qualified manager to manage the portfolio.	***Weakened change of control provisions*** • The eligibility standards for a transferee are increasingly negotiated in recent deals with institutional sponsorship, allowing ownership of the real estate portfolio to be transferred to a less-experienced, deep-pocketed Senior Loan sponsor as long as such sponsor engages a qualified manager to manage the portfolio.
Valuations	***Valuations determine the controlling class*** • The aim of obtaining post-closing valuations is to prevent a value-impaired	***Valuations can be "deemed" under certain circumstances*** • If a valuation has not been obtained within 60-120 days after an event that	***Valuations can be "deemed" under certain circumstances*** • The valuation assigned to defaulted mortgage assets is generally the lowest of

[7] In respect of the Class A CMBS Notes. An event of default for failure to pay principal or interest is only triggered under the other classes upon their final maturity date.

[8] *See further* "*Financial covenants and change of control provisions*" in https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20

[9] *See further* "*Financial covenants and change of control provisions*" in https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20

	EUROPEAN CMBS	U.S. CMBS	U.S. CRE CLOs
	class from exercising disproportionate influence. The ability to commission valuations becomes acute after a Senior Loan event of default. If a valuation determines that there is a valuation reduction amount to be applied in respect of the Senior Loan, this can affect which class of CMBS Notes is the controlling class.[10] [11]	triggers an appraisal reduction amount calculation, the appraisal reduction amount for a property is deemed to be 25% of the outstanding principal balance of the Senior Loan for the purposes of determining the interest payment amount to be advanced by the servicer (which is the equivalent to the liquidity facility commitment in European CMBS). When an actual valuation has been produced, the appraisal reduction amount is updated.	the principal balance *minus* appraisal reduction amounts, the market value, and the valuation based on a Moody's recovery rate. • The valuation assigned to modified mortgage assets is generally based on appraisals but may be determined in the same manner as defaulted mortgage assets if appraisals are not obtained in a timely manner.
Prepayment fees	***Prepayment fees apply during initial period*** • Prepayment fees tend to apply to voluntary prepayments of the Senior Loan from day 1 although fees may cease to apply a couple of years after the Senior Loan has been entered into. Some recent Senior Loans permit a specified amount of the relevant Senior Loan to be prepaid from day 1 without any prepayment penalty. • Prepayment fees do not tend to apply to, *e.g.*, prepayments that are exercising cure rights or prepayments from amounts held in a cash trap account.	***Fewer requirements to pay prepayment fees*** • In conduit CMBS, it is typical to have a lockout period[12] applicable to the Senior Loans followed by some form of prepayment protection.[13] • In SASB CMBS, a specified percentage of the Senior Loan is sometimes permitted to be prepaid without any prepayment penalty during a spread maintenance period or yield maintenance period. Otherwise, there is typically a lockout period followed by some form of prepayment protection as with conduit CMBS.	***Prepayment fees apply during initial period*** • As a result of the transitional nature of the loans in CRE CLOs, there are generally weaker prepayment protections compared to Senior Loans in CMBS.

[10] For an explanation of the controlling class concept, *see further* "*Controlling class and ad hoc noteholder committee*" in https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20

[11] A valuation reduction amount also reduces the liquidity facility commitment.

[12] A "lockout period" is a period of time during the loan term where the Senior Borrower is not permitted to prepay the Senior Loan.

[13] Prepayment protection can come in the form of a yield maintenance or spread maintenance period or through defeasance. A "**spread maintenance period**" or "**yield maintenance period**" is a period of time during the loan term where the Senior Borrower is permitted to prepay all (or, in some cases, a portion) of the mortgage loan with the payment of an additional amount, generally calculated based on the number of months remaining until the loan is freely prepayable and is intended to compensate the lender for the loss of the yield from its expected future interest payments. Defeasance refers to the process by which a borrower will substitute certain securities (typically U.S. treasury securities) with specified rates and maturities that provide cash flow that will satisfy the remaining Senior Loan payments. The real estate securing the Senior Loan is released from the lien of the mortgage in connection with the defeasance.

	EUROPEAN CMBS	U.S. CMBS	U.S. CRE CLOs
Property releases	***Prepayment amount may reference various factors*** • The regime for property releases varies across transactions. Each property is ascribed an allocated loan amount ("**ALA**"). To release the property, typically, an amount incorporating the ALA and a release premium ("**RP**") is payable. • The structuring of the RP varies from transaction to transaction, *e.g.*, it may reference a pre-determined amount above the ALA (*e.g.*, the RP might be of 10% of the ALA). Or, the RP may reference other factors such as the lease profile of the property, the actual disposal proceeds received for the property or the then current LTV (*e.g.*, if the LTV is less than a specified threshold, a lower proportion of the ALA is payable but if the LTV exceeds the threshold, then a higher proportion of the ALA is payable). • To address "cherry-picking" risk, within the same transaction, a higher ALA or RP may be set for high-performing properties so that a greater proportion of the Senior Loan is repaid, thereby avoiding leaving an overly leveraged portfolio containing a disproportionate number of low-performing properties. The debt yield might also be tested. • If the proceeds of the release proceeds are required to be applied on a *pro rata* (instead of sequential) basis in the priorities of payments waterfall, this may expose the senior CMBS Notes to	***Prepayment protection varies based on product type*** • A Senior Borrower may obtain a release of a property by paying a portion of the ALA plus any RP, and to address "cherry-picking" risk, provided it satisfies a debt yield, LTV and/or DSCR test. • The credit neutral RP is generally 15% of the ALA for a released property, but in recent deals, the RP has been reduced to 10% or 5%, while in certain other deals, the RP increases to 20% or a higher percentage if the amount of prepayments exceeds a threshold amount. Further, in some recent deals, only the debt yield or DSCR test is required.	***Prepayment amount references debt yield and/or DSCR test*** • A borrower may obtain a release of a property by paying a portion of the ALA plus any RP, and to address "cherry-picking" risk, provided it satisfies a debt yield and/or DSCR test. • The RP is typically 10% to 20% of the ALA for a released property.

	EUROPEAN CMBS	U.S. CMBS	U.S. CRE CLOs
	weaker performing properties. This may be counteracted through features such as: higher RPs or attributing different pay models to different loans in a multi-loan portfolio (*e.g.*, modified pro rata).		
Application of principal and interest	***Separation of principal and interest until acceleration*** • Generally, the Senior Loan does not amortise through its term but there are exceptions, *e.g.*, a degree of amortisation is required in certain transactions after a permitted change of control or in certain transactions, Senior Loans might amortise from day 1 to manage the overall leverage profile of the portfolio. • Receipts of principal are typically applied through a combination of pro rata, sequential and modified pay models.[14] • The typical day 1 position is for principal to be applied pro rata.[15] A trigger event (*e.g.*, a material Senior Loan default) switches payment of principal to a sequential basis. • Interest is typically applied sequentially. • Principal and interest priorities of payments waterfalls are kept separate until acceleration of the CMBS Notes, at which point all available funds are applied sequentially in a	***Combined principal and interest waterfall at all times*** • Principal and interest receipts from the Senior Loan and P&I Advances, net of senior expenses, (collectively referred to as "**Available Funds**") are applied sequentially on a monthly basis to pay principal and interest on senior certificates first regardless of whether there is a default under the Senior Loans. • In some SASB transactions, a proportion of prepayments (*e.g.*, 20% of the Senior Loan amount) or any monthly principal amortisation payment may be applied to each class on a *pro rata* basis provided there is no default under the Senior Loan.	***Separation of principal and interest until acceleration*** • Generally, the underlying loans do not amortise through their initial terms but may amortise during extensions. • Receipts of principal are typically applied through a sequential pay model, although a few recent transactions have allowed a small portion of principal to be distributed pro rata. • Interest is typically applied sequentially. • Principal and interest priorities of payments waterfalls are kept separate until acceleration of the CRE CLO Notes, at which point all available funds are applied sequentially in a combined priorities of payments waterfall. • A minority of CRE CLOs use a combined CMBS priorities of payments waterfall.

[14] *Sequential* – principal is applied to the most senior CMBS Notes until these have been repaid in full.

Pro rata – principal is applied to each class according to its share of the aggregate amount of outstanding CMBS Notes.

Modified pro rata – principal is applied in a combination of sequential and *pro rata* models.

[15] Also, refer to "*Property releases*" further above.

	EUROPEAN CMBS	U.S. CMBS	U.S. CRE CLOs
	combined priorities of payments waterfall.		
Liquidity	***Liquidity Facility or RFN Notes*** • A committed liquidity facility is provided by a rated liquidity facility provider or reserve fund notes ("**RFN Notes**") provide liquidity to the transaction.[16] Both funding mechanisms rank at a senior level in the priorities of payments waterfall. • Generally, the RFN Notes are redeemed on each payment date by the liquidity reserve excess amount which is released from the liquidity reserve account as the senior CMBS Notes amortise.	***Master servicer*** • The master servicer provides liquidity advances in the form of principal and interest advances ("**P&I Advances**") on payments due on the Senior Loans. The master servicer must meet certain ratings thresholds and is typically backstopped by the certificate/bond administrator. • P&I Advances are included as part of Available Funds and accrue interest "advance interest" payable at a senior level of the priorities of payments waterfall until the outstanding P&I Advances are reimbursed.	***Advancing agent*** • There is usually an advancing agent for classes rated as to the timely payment of interest. If the advancing agent is not rated, it will be backstopped by a rated entity. • Interest advances are included in interest proceeds and accrue interest at an "advance rate" payable at a senior level of the priorities of payments waterfall until the interest advances are reimbursed, subject to an overall cap on company administrative expenses.
Reporting	***Quarterly*** • Quarterly. • ESMA reporting template for commercial real estate,[17] which is required to be complied with from the date when the ESMA reporting templates apply.[18]	***Monthly*** • Monthly. • CREFC U.S. 8.0 template.[19] • A minority of U.S. CMBS have been structured to comply with the EU Securitisation Regulation, which may require reporting in accordance with the ESMA reporting templates.	***Monthly*** • Monthly reporting using the CREFC U.S. 8.0 template.

[16] *See* "Liquidity support provided by notes" in https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20.

[17] Annex 3 (https://www.esma.europa.eu/policy-activities/securitisation) to the draft technical standards on disclosure requirements published by ESMA on 31 January 2019.

[18] For a detailed discussion of the transparency and reporting requirements under the Securitisation Regulation, see further https://www.cadwalader.com/resources/clients-friends-memos/esmas-final-draft-disclosure-technical-standards, https://www.cadwalader.com/resources/clients-friends-memos/securitisation-regulation---transparency-and-article-14-crr-issues-where-do-we-go-from-here, https://www.cadwalader.com/resources/clients-friends-memos/the-commission-fails-to-endorse-esmas-draft-disclosure-technical-standards-under-the-securitisation-regulation, and https://www.cadwalader.com/resources/clients-friends-memos/further-delays-in-the-expected-application-date-of-the-disclosure-templates-for-eu-securitisation-reporting

[19] For a comprehensive analysis between the European and U.S. reporting templates, please contact one of the authors at Cadwalader, Wickersham & Taft LLP.

Conclusion

- It is inevitable that there will be a gradual tendency towards further U.S. transaction features being implemented in European transactions.[20] This is significantly driven by U.S. loan sponsors which require, *e.g.*, financial covenants applicable to the loan sponsor group to be the same in their U.S. and European financings. However, there will be investor resistance to certain U.S. transaction features that are sought to be introduced to the European market, *e.g.*, where an even more permissive regime is sought in respect of financial covenants than previously seen. There has to be a balancing exercise in the European market where a combination of factors such as unusual or untested assets or assets that are perceived to present more risk also affect investor demand. Related to this, the approach to structuring European CMBS will continue to differ from the U.S. market where an European transaction comprises a number of jurisdictions or unusual underlying assets which may require bespoke features to be incorporated that cannot be carried across into other transactions.[21] Notwithstanding this, there are still features in U.S. CMBS which could be usefully incorporated in European CMBS to the advantage of European investors, *e.g.*, deemed valuations.[22]

- Furthermore, the development of CRE CLOs for the European market is a strong contender for the future of European commercial mortgage backed securities. This is particularly relevant for the anticipated capital markets take-outs of loan on loan financings,[23] as a result of the granularity and diversity of assets that may be offered by CRE CLOs.

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[20] *See* https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20 for background to the U.S. CMBS features being reflected in European CMBS since the recent re-emergence of the European CMBS market.

[21] For example, *see* the varying approaches to "*Property Releases*" in the comparison table.

[22] *See* "*Valuations*" in the comparison table.

[23] *See* "*Loan on loan financing*" in https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20

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