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MORTGAGE-BACKED SECURITIES

In the aftermath of the demise of the CMBS market, the question becomes: what's next? For a time securitization proved beneficial to commercial real estate borrowers and lenders, but the boom ended. How can the industry revive the CMBS model and make it work better? Here the author offers ideas for rebuilding confidence in commercial real estate financing and eventually perhaps CMBS. He suggests, among other things, that investors will demand more simplicity and clarity than in the past and that as the CMBS market gradually reemerges, it will be less aggressive but also less risky.

Goodbye to Securitization as We Knew It: Now for the New and Improved Model

BY JOSHUA STEIN

Securitization was great. Wall Street invented a new way to finance real estate, spreading risk far and wide and attracting hundreds of billions of new dollars of new financing to commercial real estate. For many years the machine worked very well. Then it didn't.

Is securitization dead? Will it ever come back?

Probably. With some changes, but still in a recognizable form. That's because the whole securitization structure fundamentally made sense, because it brought new sources of capital to commercial real estate with pricing that worked for both borrowers and capital providers. Securitization just got ahead of itself a bit.

To make investors comfortable about dipping their toes back into the securitization market, some elements of the securitization deal structure may change. And investors will need to feel more confidence in the information they receive—both about the specifics of the certificates they buy and generally about real estate values and the larger commercial real estate market.

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More Reliable Valuations. For securitization to return, first the commercial real estate market will need to develop some stability—undoubtedly at lower valuations, with lower rental and income levels—offering some comfort that "what you see is what you get," a sense that valuations can again be relied upon and won't drop further.

Of course, this will in turn require a firming of the economy, particularly employment levels and space needs for American business. Without that, no one can reasonably project real estate revenues or values. Until it happens, much of the bedrock of commercial real estate finance remains mush.

At some point stability will return. Today's real estate crisis is neither the first nor the last downturn in the history of commercial real estate. It is, however, the most extreme in recent memory—perhaps an inevitable reaction to one of the most extreme real estate booms in recent memory. But the market will eventually work itself out.

Along the way, property owners who need to sell will eventually need to accept that they may end up losing money on real estate; it's not the "sure thing" that it of-

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ten seemed to be for so many years. Correspondingly, buyers will need to recognize that not too many properties will sell for pennies on the dollar. Thus far, the expectations of both sides remain extreme and unrealistic. Hence, little if anything moves. The lack of transactions prevents any determination of value, and the logjam continues.

Most owners feel no real pressure to sell, knowing that trying to sell in the current market constitutes a painful exercise in futility. That may start to change when owners feel pressure to sell, which could eventually come from commercial real estate lenders dealing with matured loans that have no other exit strategy.

So far, however, lenders seem willing to ''kick the can down the road'' for now, deal with problems later, hope that markets recover. Today's lenders seem less anxious to pull the plug than did lenders in the previous downturn. They seem to prefer to work with borrowers in the hope that things will work out.

That could change if banking regulators start to put more pressure on bank lenders, but regulators hesitate to do that because they don't want to deal with the hundreds of additional bank failures that might result.

The hovering possibility that the federal government will ''do something'' to ''save'' commercial real estate also helps stand in the way of any market restoration. Today there is a sense that the federal government may step in and, in one way or another, enter into transactions on terms more favorable than the market. As long as that possibility exists, anyone who has any ability to wait to see what the federal government ultimately offers will do exactly that, so they can take advantage of whatever opportunities arise.

These pressures (or lack of pressures) make it likely that today's transactional vacuum will continue for some time, and with it the lack of a meaningful market sufficient to define pricing for commercial real estate.

Once the market does return, appraisers may again feel confident estimating values, and thus lenders may feel comfortable lending again. Those changes should eventually lead commercial mortgage-backed securities (CMBS) investors back to the table, but the entire marketplace for commercial real estate financing will see some significant changes in deal structures.

As a fundamental starting point, originators will probably go back to conservative, simple underwriting, looking to income in place rather than the possibilities of future increases in income. Loan-to-value ratios will drop and skepticism will return about the concept of additional debt (mezzanine lending, etc.), although the market may tolerate some of it.

Real estate financing will cost more, at least for a while, because it seems fair to say that the interest paid on commercial real estate debt did not fully reflect the risks of that debt. When lenders and bond buyers return to the market, they will expect greater compensation—not great news for real estate values and appreciation. This could, of course, again change over time.

The rating agencies will remain part of the picture, but the details of their role might change. CMBS purchasers will probably ask more questions about how the rating agencies got to their ratings, and why. Offering materials for CMBS did traditionally offer huge amounts of information about underlying loans included in each deal, but bond buyers may decide they want even more information. They may look more carefully at whatever information is ultimately offered.

Bond buyers are also likely to ask more questions about the models the rating agencies used in developing their ratings. For example, if a rating agency's model assumes a high likelihood of continued real estate appreciation, then almost any loan will look pretty good.

Premium on Simplicity, Clarity. One should also expect the securitization marketplace to favor simplicity and clarity, including deal structures that can be readily explained, understood, and evaluated. The further the CMBS (or collateralized debt obligation) income stream is from an actual tangible asset, the less appealing it will be.

Traditionally, once a CMBS issuance was rated, the primary monitor of that transaction and its ratings was the rating agency. Although that will probably continue, it may be reasonable to expect a more robust outside forum in reviewing and commenting on outstanding CMBS securities and their ratings. Exactly how that forum will look and how it will finance itself remain to be determined.

One might therefore expect to hear the argument that nonrecourse carveout guaranties are unenforceable because they represent an agreement by borrower's management to breach its fiduciary obligations to the borrower's investors. To the author's knowledge, no one has yet asserted that argument in court, but it is reasonable to expect it at some point.

Investors in CMBS paper will probably ask more questions about the originator's continuing financial interest in how individual loans in the portfolio perform. They may demand that the originator hold more of the ''first loss'' risk than in the past, simply to try to impose more discipline on the origination process. That may create accounting issues for originators. If so, it will be another challenge to resolve in order to restart the securitization machine.

The structure of individual transactions will probably change in response to some of the surprises that the courts—particularly the bankruptcy courts—are throwing at lenders. The General Growth Properties bankruptcy has caused some alarm in the lending side of the market, but thus far has not entirely undercut the notion of ''single purpose entities'' (SPEs). It remains to be seen just how far the GGP bankruptcy goes in that regard.

In response to GGP, loan originators and rating agencies will probably revisit the requirements for SPEs and figure out ways to beef them up. That could lead to the use of more layers of entities and new technology in setting up borrower entities.

For example, proposals have already been floated to expand the role of ''independent'' third parties in a bor-

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rower's organizational documents, to try to make it harder for the borrower to simply get rid of them and file bankruptcy anyway, as occurred in the GGP bankruptcy. These changes in borrower structure may also require waivers of ''fiduciary'' obligations running from the independent third parties to the investors in the borrowing entity.

Reactions to GGP Bankruptcy. Again, partly in response to the GGP bankruptcy, one might also expect to see tighter lockboxes, to enhance a lender's control over the revenue from any collateral. Lenders will probably also revisit the triggering events for blocking disbursements of net cash flow to the borrower. For example, if one particular property is doing just fine but affiliates of the borrower start to have problems, a lender may want to capture and hold all the cash from that one particular property, to try to protect the lender's position in an eventual bankruptcy.

When commercial real estate lending returns, it will probably continue to use nonrecourse carveout guaranties, because courts thus far seem to have enforced these documents according to their terms. As a result, these documents have apparently had their desired effect. By making the individual principals of a borrower personally liable for the entire loan if the borrower files bankruptcy or does other ''bad things,'' these guaranties have significantly incentivized most borrowers to ''behave.'' The courts have declined various invitations to set aside these guaranties, but further invitations will arise over time.

For example, a guarantor may argue that if bankruptcy represents the best way for a borrower to try to save its investment, a nonrecourse guaranty simply incentivizes the borrower's management to ''do the wrong thing'' for the borrower and its limited partners or other investors, because it incentivizes management not to throw the borrower into bankruptcy. One might therefore expect to hear the argument that nonrecourse carveout guaranties are unenforceable because they represent an agreement by borrower's management to breach its fiduciary obligations to the borrower's investors. To the author's knowledge, no one has yet asserted that argument in court, but it is reasonable to expect it at some point.

If the courts accept the ''fiduciary duty'' argument, then the next generation of nonrecourse carveout guaranties will include new provisions in response. For example, lenders who accept these guaranties may require the borrower's passive investors to consent to the guaranty and waive any fiduciary duties that the guaranty might otherwise be deemed to breach. Careful guarantors may want those waivers anyway, even if the lenders don't.

Cheap Money, but at a Cost. On the other side of the lending market, borrowers have learned the hard way that securitization offers (or at least offered) cheap money, but at a cost. Now that the markets have turned, borrowers have learned that the cost of securitization can include rigidity, nonresponsiveness, lack of communications, unpredictability, delays, and frustration. Borrowers may factor those considerations into their analysis of whether to return to the securitized-loan market when it reopens.

Borrowers may also try to negotiate into their loan documents provisions to ease the servicing process from a borrower's view. Just how far borrowers can push in this regard remains to be seen.

In a borrower's perfect world, the servicing arrangements for CMBS would make it much easier for servicers to modify loans, even without transferring those loans to special servicing. It is probably reasonable to expect further legislative or regulatory changes to allow more flexibility of that type.

As much as borrowers may like those changes, though, they may have little practical impact for existing securitizations, because even if governing law (or regulatory authority) allows more flexibility, the existing documents don't. And bond buyers may demand similar constraints in tomorrow's securitizations, because these constraints are thought to create more predictability for bond buyers, and predictability supports pricing.

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