CMBS could be a surprise winner from COVID-19 crisis

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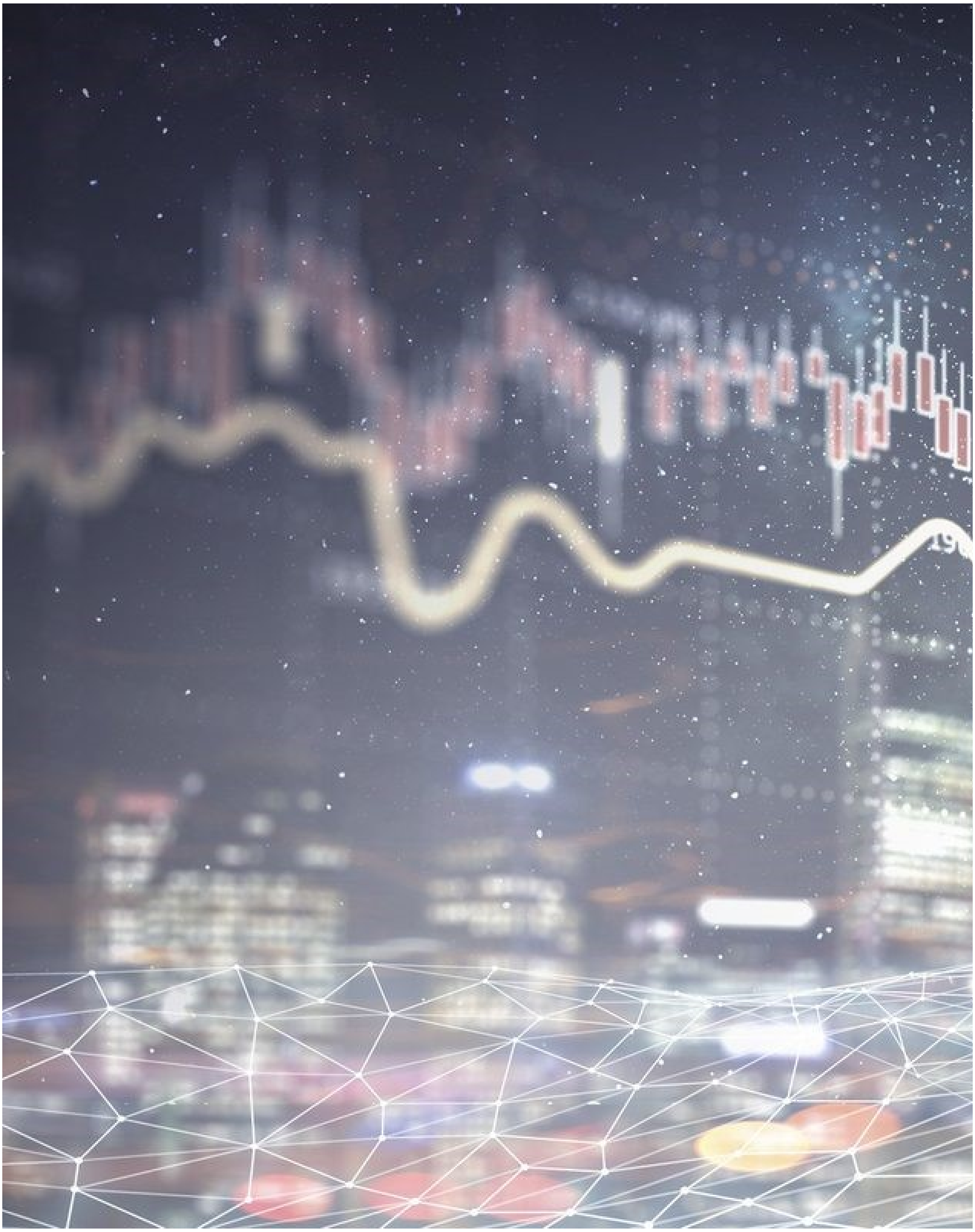
Advocates believe pandemic will show reforms are working and open up opportunities for more deals



What Proponents believe pandemic could turn out to be a good thing for CMBS

Why Crisis is expected to show that CMBS 2.0 reforms are working and could build case for more favourable regulatory treatment

What next CMBS may also provide additional liquidity during the crisis with agency deals likely to come to the fore

Considering how the commercial mortgage backed securities market unravelled following the global financial crisis, it may seem fanciful to imagine that the current crisis will foster a resurgence.

However, that is exactly what CMBS's proponents are hoping. They believe that the pandemic will put existing deals to the test and show that the reforms introduced in the wake of the crash are working. Furthermore, if banks' lending appetite doesn't recover fully for some time, it is argued that CMBS could step in and fill the void. This is after all how CMBS emerged in the first place, as an alternative source of finance during the savings and loan crisis of the late 1980s and early 1990s.

One of CMBS's most vocal cheerleaders is Reed Smith partner Iain Balkwill who admits that his views sometimes catch others by surprise. "When I shout about this being positive for CMBS through a Zoom call I get a sort of bemused look," he says.

The key reason why he is so optimistic is that the crisis offers an opportunity to test the effectiveness of CMBS 2.0, the code-name for the new look CMBS structures that emerged after the financial crisis.

"Thanks to all the refinements that have been made, CMBS as a structure looks robust and will weather the storm. You need to go through a period of financial stress which tests the product for people to turn around and say that it works."

Reforms put CMBS in better shape

A number of CMBS deals will be put to the test due to their exposure to COVID-hit sectors like retail and hotels

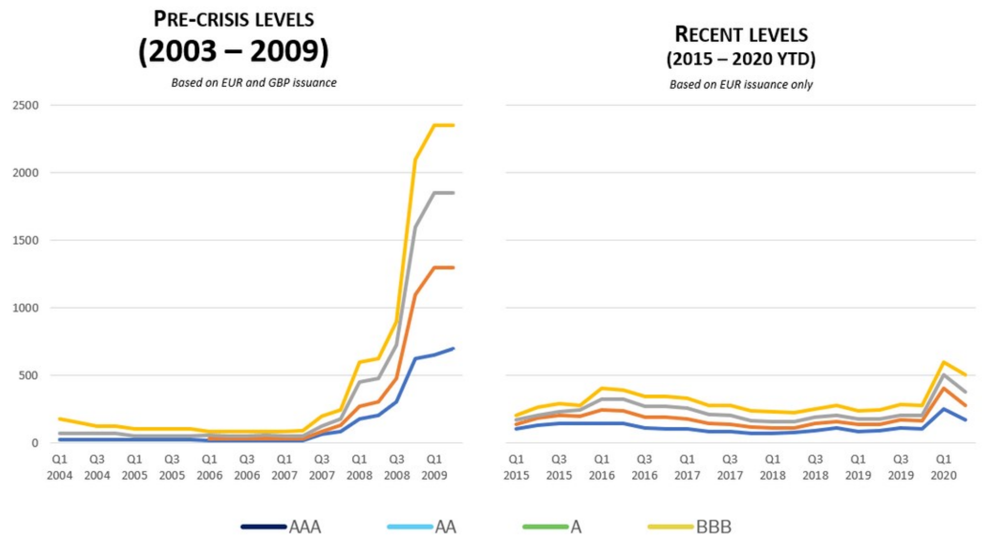
There is no question that the crisis will be a test. A number of CMBS deals in recent years have been secured by properties in COVID-hit sectors such as retail and hotels, including in the UK the Elizabeth Finance retail CMBS and the Helios (European Loan Conduit No. 37), Magenta 2020 and Ribbon Finance 2018 hotel CMBS deals.

The myriad changes to CMBS since the crash, which include greater transparency around the role of the servicer and special servicer as well as the advent of simpler structures and more standardised documentation, should help matters.

"We would expect less scope for intercreditor wrangling and potential conflicts of interest arising between special servicing and particular creditor groups," says Euan Gatfield, a managing director in Fitch Ratings' structured finance group.

He adds that some work-outs following the financial crisis ended up being protracted because out-of-the-money creditors with influence over the appointment of the special servicer had little incentive to advocate for anything that would crystalize their losses, not least because they could continue to receive interest so long as the deal was dragged out. By ensuring controlling creditor classes are reset so they always have skin in the game, CMBS 2.0 should help guard against this particular issue resurfacing.

Market changes guard against recurrence of issues faced during financial crisis



CMBS spreads haven't moved out to anything like the degree that they did during the financial crisis

Changes in the CMBS market itself will also make life easier for servicers. During the financial crisis, one of the biggest challenges was simply making contact with noteholders, something that isn't so much of an issue today because the pool of investors is much smaller.

Clarence Dixon, global head of loan services at CBRE, says: "Back in the GFC when you went out to noteholders you got no response or couldn't find out who the noteholders were, there were just so many, whereas today if I went out and requested consultation with noteholders of a certain class of notes in a CMBS I'd have a response in 24 hours."

Long-gone are the highly leveraged SIV structures that invested in CMBS with a view to exploiting the gap between the cost of short-term debt and the returns offered by CMBS deals. Apart from fuelling the fires of the financial crisis, the implosion of the SIV market magnified the stress in the CMBS market. The absence of SIVs is one of the reasons why, even when financial markets were reeling in March, CMBS spreads didn't blow out in anything the dramatic fashion that they did during the financial crisis.

This is not to say that the road ahead will be easy. Some familiar tensions are resurfacing, particularly over the degree of discretion that servicers should be afforded to act on behalf of noteholders, with some noteholders feeling that they would like to be involved more.

Servicers also find themselves in a difficult position because of the unusual circumstances and uncertain outlook. If there is a default, for example, should they put the deal into special servicing, knowing that market conditions may improve in the not too distant? And if they grant waivers, what if the situation with COVID deteriorates and the sponsor is then no longer interested in supporting the deal later on?

Brookland founder Nassar Hussain, who was chair of CREFC Europe's CMBS 2.0 Committee which formulated the CMBS 2.0 principles, says servicers can't just reply on what is written in the legal documentation.

"The servicer's role is not always easy as not every scenario will have been written into the legal documentation," he says. "The documentation cannot have fully envisaged a COVID pandemic. They have to exercise some commercial judgement or involve noteholders rather than just follow a strict letter of the law approach which may not maximise recoveries."

CMBS could provide additional liquidity

BAML launched the first post-COVID CMBS secured by a portfolio owned by Blackstone

Like Balkwill, Hussain is optimistic about the future of CMBS and believes the product could have an important role to play if banks continue to reticent about new lending.

In recent years, bank debt has been priced so competitively that CMBS has only really come into play for really large deals that are hard to digest in the banking market or for more operational assets and secondary property that carry a higher risk. Hussain believes that the crisis could pave the way for more mainstream assets to be financed through the CMBS market.

“The hope is that CMBS might just step in and provide some additional liquidity while banks are focused on managing their existing portfolios,” he says.

There are already some encouraging signs for CMBS advocates. At the end of last month, Bank of America Merrill Lynch launched Taurus 2020-2 UK DAC, which finances 86.8% of a £518.3m loan to Blackstone. The deal is understood to have priced at about 170bps over for the AAA bonds and 250 bps on a weighted average basis, which is higher than would have been achieved pre-COVID but is still considered a good result in the current market.

However, it doesn’t necessarily follow that there will be a lot of new issuance off the back of the deal. With Blackstone as the sponsor and the underlying portfolio consisting largely of industrial, Taurus 2020-2 UK DAC had all the right ingredients to be a success. Banks may be reluctant to pursue deals in other sectors and with other borrowers when it is hard for them to predict how rating agencies will respond and what sort of pricing will be achieved.

So-called ‘agency deals’ offer a way around this problem. Under this model, the borrower directly raises finance by issuing CMBS notes itself so the bank doesn’t take the risk of making a loan and then failing to achieve the pricing it needs when selling it into the bond market.

“What you could see is an increase in agency deals in a time like this,” says Hussain. “That’s what we saw after the financial crisis as banks weren’t willing to underwrite the risk in the same way as they did previously.”

It remains to be seen whether there will be a resurgence of CMBS in the coming months. There have been a number of false dawns over the past decade and the market remains a fraction of the size it was before the financial crisis. CFEFC Europe chief executive Peter Cosmetatos says this partly due to a “fundamentally hostile regulatory regime” which imposes punitive capital charges on insurers investing in even the safest CMBS bonds. His hope is that CMBS is shown to have weathered the storm during the pandemic, and that there may then be an easing of the regulatory requirements, potentially opening up the market to a wider range of investors.

There are a number of noteworthy benefits to CMBS. It transfers risk away from the banking sector, opens up a potentially more liquid alternative to syndication, brings greater transparency to the debt market and, in theory, offers more time to work through problem loans than banks are able to provide because of provisioning and other regulatory requirements. However, if it is to take off again and emulate the success of the US market, CMBS will need more regulatory support.