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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

CRE Securitization — Time To Bring It Back

Law360, New York (April 29, 2014, 2:57 PM ET) -- During the past several years, commercial real estate securitizations were airbrushed off the financial products reviewing podium like a discredited Politburo member. Not here, never ever here; nope, never heard of it. This was a mistake rooted in populous politics and the conflation of the tools of finance with the tool users (OK, with some very unhelpful help from a few admittedly alarming design failures in the tool itself).

But now, eight years on, plenty of political and regulatory water has gone over the dam. As we said in a recent column, it's time for a reset and not just in the legal and regulatory arena, but in the market itself. Taking some liberties with recent news from Detroit, this nifty little coupe of a financial tool has had its successful recall, it's new and improved, the engineering errors of the early models have been fixed and we've sorted out that neither the underaged nor the ethically challenged ought to be allowed to take this little guy out for a spin.

Morgan Stanley released a research piece on April 7 on the evolution of commercial real estate loan collateralized debt obligations, or CREL CDOs (which with a heightened sense of political correctness we now call CRE securitizations), which identified 15 deals done since 2012. I can definitely add at least two more to that list. The Dechertteam has been issuer or underwriter counsel on nine of them and, therefore, I think we have a pretty darn good idea of what's happening in the market and where we can anticipate evolution.

Over the past couple of years, CRE securitizations have been all air bags, anti-lock brakes, reinforced cab construction and speed governors with precious little motor under the hood. Perhaps a natural reaction to the legacy deals, but we need to get this thing humming again.

I am reminded that when the "high speed" Acela trains were commissioned, they were supposed to go real fast. If you live in the Northeast, you know they don't. The reason? American anxieties about safety so larded the engineering of these things that they became incapable of traveling at high speed. Thus, a slow high-speed train! Built in Quebec, they were known by the workers who built it as "le cochon" —

the pig. We need our CRE securitizations not to be pigs!

Why? Because there is a large unmet need for financing of this type out there. Commercial real estate needs leverage while the underlying assets are unstabilized and being repositioned. Portfolio lenders want to leverage pools of assets. The repo market, while highly efficient on a spot basis, has its own baggage of limited term, lender discretion, margins and the like.

The CRE securitization is the perfect match term leverage technology for portfolio lenders. On the other side of the equation (push and pull), the regulatory straitjacket that banks have been fitted for is only tightening.

The chilling effect of the new culture of prescriptive rules, the criminalization of error, the early signs of a flight of talent out of the banking system, and the government's shameless and seemingly never-ending use of prosecutions, lawsuits and investigations to shake down the banks as private piggy banks to pay for political goodies continues to impair the banking system's ability to meet all the credit needs of the CRE market. So there is a need and there is a weakness in supply.

OK, having pushed the Detroit analogy perhaps way too far, here's how I think a CRE securitization should be built and built safely to meet the needs of the market and to get investors comfortable with the structure:

A CRE securitization should:

- Permit sponsors to reinvest for a period of years;
- Permit sponsors to trade for purposes of improving the collateral and generate returns;
- Allow for securitization of nonstabilized product that needs future funding to meet the needs of commercial real estate owners;
- Facilitate portfolio lenders with substantial ongoing investments to have a stable and durationally appropriate source of leverage;
- Place meaningful guardrails around collateral managers' and servicers' discretion to ensure investors, up and down the capital stack, can be comfortable that there is a strong and effective alignment of interest between manager and investors;
- Provide robust timely and accurate information about the performance of the vehicle, the manager and the investment to the investors;
- Provide meaningful protection to the bondholders through overcollateralization, cash-flow triggers and financial covenants, which will ultimately allow the deleveraging of the vehicle if credit metrics deteriorate;

- Be based on a ratings model that prevents gaming and inappropriate arbitrage of model criteria. The ratings criteria should be principal-based, transparent and understandable;

- Ensure management is up to the task, with the experience, track record, financial resources and integrity to be trusted in their respective roles;

- Be extra cautious with multisector transactions involving more than whole loans. (I'm really talking only about whole loans here!)

Many of these safeguards and guardrails are already in place. This can be done safely, right now. It's all about good and ethical sponsorship, effective management and capabilities. We know how to assess (and rate) managers, we can see and understand the types of assets the management team wants to acquire.

Look at the middle-market CLO business. It is a multibillion dollar model chugging along right next to our space. The middle-market CLO has had all the functionality and more that this sector needs and frankly, we got mortgages! Investors buy gobs of this stuff. Also, CRE does not have Volcker exposure. That's huge. CRE securitization should stand side-by-side with the CLO product as a highly competitive investment for the institution marketplace, and we need to prove that it is a safe investment.

The market needs CRE securitization vehicles that are both safe and functional. We know how to build the vehicle. At a very simplistic level, the market needs it; ergo, it must be developed.

I get it. I get investors are gun-shy about the structure, justifiably so. It is the market's job to show it is safe to come back into the pool. Belt and suspenders, fortress-type safeguards, duplicative systems and a Caesars' wife standard for sponsors and managers will get this done.

Once the gates are open, the nexus of need and the restrained supply of capital from the banking sector and the investors' need for acceptable risk-adjusted yield will make the CRE securitization an important permanent feature of the capital formation landscape.

Need a little courage here folks. A little conviction. A little creativity. The prize is huge. Shall we?

—By Richard D. Jones, Dechert LLP

Richard Jones is a partner in Dechert's New York and Philadelphia offices and co-chairman of the firm's finance and real estate group.