The Banking Law Journal

Established 1889

An A.S. Pratt™ PUBLICATION FEBRUARY 2020

LexisNexis

THE BANKING LAW JOURNAL

VOLUME 137	NUMBER 2	February 2020

LexisNexis®

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ISBN: 978-0-7698-7878-2 (print)
ISSN: 0005-5506 (Print)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

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MATTHEW BENDER

(2020-Pub.4815)

Editor-in-Chief, Editor & Board of Editors

THE BANKING LAW JOURNAL (ISBN 978-0-76987-878-2) (USPS 003-160) is published ten times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com. Direct any editorial inquiries and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 646.539.8300. Material for publication is welcomed—articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys.

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POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

European CMBS 2.0: How Sustainability Is the Future of the Product

Chris McGarry, Tom Falkus, Adam Farrell, and Victoria Speers*

European commercial mortgage-backed securities have exhibited some growth in the past two years, but the market remains weak when compared to pre-crisis "CMBS 1.0" issuance and the far deeper market in the United States. The authors of this article discuss some of the key structural trends in the European market then consider how CMBS can become a product at the forefront of sustainable finance.

Post-crisis commercial mortgage-backed securities ("CMBS") issuance in Europe has been on the slow-burner with only a handful of transactions each year. The year 2018 saw European "CMBS 2.0" experience something of a revival with nine deals, totaling US$3.68 billion.[1] 2019 saw four deals price in the first half of the year; however, this is still a small fraction (< 1/10th) of the €47.6 billion "CMBS 1.0" annual issuance seen in 2007.[2] European CMBS issuance continues to lag well behind that in the United States and, in light of the ineligibility of the product for the "Simple, Transparent and Standardised" ("STS") label under the new European Securitisation Regulation, what is the future for European CMBS 2.0? Could European CMBS become a key tool in tackling climate change and advancing other United Nations sustainable development goals?

This article first discusses some of the key structural trends in the European CMBS market before considering how CMBS can become a product at the forefront of sustainable finance.

CMBS 2019 MARKET SNAPSHOT

On January 1, 2019, Regulation (EU) 2017/2402 (the "Securitisation Regulation") came into force. Whilst the risk retention level under Article 6 of the Securitisation Regulation remained unchanged (*i.e.* five percent), the

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[1] *Global Capital*, Securitization Priced Deals database.

[2] European Securitisation Forum ("SIFMA") Securitisation Data Report, Q4:2008.

introduction of the "not sole purpose test"[3] for originator retainers resulted in increased structuring considerations for CMBS which had previously utilized special purpose vehicle ("SPV") retainers. The new rules now require that originator retainers demonstrate that they have a broader business purpose (beyond acting as retainer) and experienced decision makers in order to pass the "not sole purpose" test.

The first CMBS transactions of 2019 also saw CMBS market participants grapple with the new reporting and transparency requirements under Article 7 (the "EU Transparency Requirements"). This typically sees the SPV issuer designated as the reporting entity whilst the master servicer and the delegate servicer are contractually obliged to assist the issuer with the reporting required by the EU Transparency Requirements.

TO BE A SECURITISATION OR NOT TO BE?

Although most market participants, with the help of experienced servicers, will become comfortable with the EU Transparency Requirements, we may see more transactions structured so that they fall outside of the Securitisation Regulation regime altogether. The benefits of structuring a CMBS this way include not having to comply with the EU Transparency Requirements and, for the originator or sponsor of the transaction, not having to hold risk retention for the life of the transaction. One 2019 transaction structured this way is Westfield Stratford City Finance No.2 Plc ("Westfield"). The Westfield deal saw the issuer issue one tranche of £750 million commercial real estate loan-backed notes. Accordingly, as a result of the lack of tranching, the Westfield deal was, by the EU definition, not a securitisation for the purposes of Article 2(1) of the Securitisation Regulation.[4]

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[3] The "not sole purpose test" is the general description given to the following test that originators must meet under Article 6(1) of the Securitisation Regulation: "For the purposes of this Article, an entity shall not be considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures."

[4] Article 2(1) of the Securitisation Regulation: "*'securitisation' means a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics*:

> *(a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;*
>
> *(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;*
>
> *(c) the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013."*

DUAL-COMPLIANCE

Whilst we may see more CMBS transactions structured so as not to be "securitisations," Westfield remains the only public CMBS structured in this way in 2019. The rest were all structured as "securitisations" and designed to comply with the Securitisation Regulation. Three of those deals have also been structured to comply with both the EU risk retention rules and the U.S. risk retention rules (commonly known as "dual compliance").[5] In one of the first dual-compliant CMBS deals to price in the Securitisation Regulation era, because the originator retainers were U.S. domiciled while the investors were European, the transaction needed to be structured to comply with both the EU rules (including the "not sole purpose test") and the U.S. rules. The EU and U.S. rules differ in how multiple originators are treated. The EU rules have not changed this year and the Final Draft Regulatory Technical Standards on risk retention replicate the old rule by requiring that where the underlying assets have been created by multiple originators, the "*retention requirement shall be fulfilled by each originator on a pro rata basis, with reference to the securitised exposures for which it is the originator.*"[6] The U.S. rules on the other hand require one entity to be designated as the "sponsor" of the transaction and for such entity to take full responsibility for holding the risk retention (such entity, the "Retaining Sponsor"). Notwithstanding this, the U.S. rules[7] do permit the Retaining Sponsor to transfer a portion of the retention notes to an "originator" (as defined under the U.S. risk retention rules); however, the Retaining Sponsor remains fully responsible for U.S. risk retention compliance from a regulatory perspective and it must subscribe for 100 percent of the retention notes from the issuer prior to onward transfer.

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[5] White & Case LLP acted for the U.S. domiciled originator retainers on one of the first dual-compliant CMBS deals to price in the Securitisation Regulation era.

[6] Article 3(2) of EBA Final Draft Regulatory Technical Standards: Specifying the requirements for originators, sponsors and original lenders relating to risk retention pursuant to Article 6(7) of Regulation (EU) 2017/2402, 31 July 2018.

[7] U.S. Credit Risk Retention Requirements means the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934, as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and implemented by final rules jointly adopted in October 2014 by the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development.

SDG CMBS

The United Nations General Assembly in 2015 identified a set of 17 sustainable development goals to be achieved by 2030 (the "SDGs"). The UN Commission on Trade and Development estimates that achieving the SDGs will require between US$3 trillion and US$5 trillion in annual investment in developing countries alone.[8] Fortunately, US$30 trillion of assets under management are currently earmarked for SDG investment[9] and CMBS 2.0 can tap into this demand with appropriately structured deals.

Examples of mapping types of commercial real estate to specific SDGs:[10]

- SDG #3 (*Good Health and Well-Being*): medical facilities, research facilities, care homes, buildings with green spaces.
- SDG #4 (*Quality Education*): schools and universities, tertiary campuses, technical and vocational learning centers, student housing.
- SDG #6 (*Clean Water and Sanitation*): water treatment plants, sewer and septic systems.
- SDG #7 (*Affordable and Clean Energy*): energy efficient new or refurbished buildings, energy storage, electric car charge points, solar-paneled buildings, smart grids, intelligent heating systems.
- SDG #9 and #11 (*Industry, Innovation and Infrastructure*) and (*Sustainable Cities and Communities*): construction of energy efficient buildings or refurbishment of buildings to improve energy efficiency, affordable housing, cleaner public transport infrastructure, bicycle infrastructure.
- SDG #12 (*Responsible Consumption and Production*): recycling plants, composting facilities.

SDG CMBS could address additional SDGs based on overlap amongst the goals.

MARKET DEVELOPMENTS

In 2016, ING announced that it would only offer new financing for office buildings that met their green requirements by 2017. "Brown" buildings would only be granted funding if they had an acceptable sustainability plan in place.[11]

[8] *SDG Bonds & Corporate Finance: a Roadmap to Mainstream Investments*, UN Global Compact Action Platform on Financial Innovation for the SDGs.

[9] Global Sustainable Investment Review 2018.

[10] *See* ANZ Sustainable Development Goals ("SDG") Bond Framework, February 2018.

[11] ING will only finance "green" office buildings in the Netherlands after 2017, ING.

In the U.S., Fannie Mae, now the world's largest issuer of green bonds, launched its green initiative aimed at multifamily buildings in 2010, and first issued a multifamily green MBS bond in 2012.[12] The product aims to incentivize owners to improve the sustainability of their buildings at the same time as increasing the affordability of housing for families with low to moderate incomes. Freddie Mac launched a similar program in 2016, aimed at housing for those who work in the community, such as teachers or firefighters, and issued their first green CMBS in June of this year. More recently in 2019, we have seen the LMA / LSTA publish the sustainability-linked loan principles.

CONCLUSION

European CMBS has exhibited some growth in the past two years but it remains weak when compared to pre-crisis "CMBS 1.0" issuance and the far deeper CMBS market in the United States. Investor demand for sustainable investment continues to grow and the CMBS market could be at the forefront in tapping into this demand for sustainable investment.

[12] Bringing billions and housing to the green bond market, Environmental Finance, February 2019.