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The Imminent CRE CLO Tsunami: What Servicers Need to Know to Ride the Wave

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The authors explain that, given the distinctions between commercial real estate collateralized loan obligation ("CRE CLO") servicing and commercial mortgage-backed securities servicing, and given the attractiveness of floating rate product at this point in the real estate cycle, it is no wonder that CRE CLO lending is set to take off in 2018.

With commercial real estate borrowers seeking commercial mortgage-backed securities ("CMBS") alternatives for a number of reasons (interest rates, loan proceeds, servicing fees, capital improvement needs and the overall borrower experience), commercial real estate collateralized loan obligation ("CRE CLO") issuers are eager to increase their CRE market share in 2018. Leaders in the commercial real estate market recently announced that they intend to float $16 billion of CRE CLOs in 2018, up from just $7.7 billion in 2017.[1] With existing CRE CLO issuers expanding their footprint and new CRE CLO issuers entering the marketplace, the demand for servicing and asset management expertise in the CRE CLO space will increase as well. Many servicers see CRE CLO servicing as a welcome break from the rigid and regulatory-intensive CMBS servicing of publicly issued securities—bound by real estate mortgage investment conduit ("REMIC") rules on one end and federal securities laws on the other. However, CRE CLO servicing comes with its own potential challenges.

Basic CRE CLO Structure and the Role of the Collateral Manager

At the most basic level, a CLO (similar to a CMBS securitization) is a portfolio of direct and/or indirect interests in commercial real estate loans, held by a special purpose vehicle. The portfolio serves as collateral securing the debt securities issued by the special purpose vehicle (usually in the form of notes). Investors can choose from various risk/return investment tranches with cash flows distributed to investors based on the priority of those tranches. The active participants in a CRE CLO are the collateral manager and/or the operating advisor, the trustee, the servicer, the special servicer, the advancing agent and

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the controlling class of noteholders. While the trustee, servicer and special servicer serve in similar capacities to their roles in CMBS, the collateral manager is unique in CRE CLOs, serving as an active participant responsible for the daily management of the vehicle. The controlling class in a CRE CLO is the seniormost tranche as opposed to the juniormost tranche in CMBS; though, in some instances, you will also have a directing class of junior noteholders as well. The collateral manager's responsibilities, among others, include the selection of assets for the CRE CLO issuer to purchase or sell based on a review of their credit quality. The collateral manager is also responsible for monitoring and maintaining certain required performance metrics of the CRE CLO—including over-collateralization, interest coverage and weighted average life tests.[2]

Servicers of CRE CLOs should first familiarize themselves with the various parties, the governing documents, and the general life cycle of the vehicle, as those will play an integral role in the servicer's day-to-day operations. A CRE CLO can either be actively managed—meaning the collateral manager is responsible for buying or selling assets in order to maintain or improve the quality of the pool (a differentiating feature of CLOs)—or it can be static—meaning no new assets are added to the pool (or such additions are limited to very specific circumstances). In actively managed CRE CLOs, by having the power to buy and sell assets in the pool, the collateral manager has the unique capability to create gains and minimize losses for the investors—acting as the "stockbroker" for the CRE CLO. So even though the assets in the pool may be below investment grade, the active management of the collateral manager reinvesting and replacing loans as the vehicle continues is many times a credit positive for the noteholders.

In the life cycle of an actively managed CRE CLO, there are two periods where the collateral manager actively manages the pool composition. Typically, not all assets will be purchased at the time of closing, and the collateral manager has a ramp-up period, on average six months, in which it purchases the remaining assets for the initial pool before the various performance tests become applicable. This is followed by a reinvestment period, which is generally three to four years. Many of today's CRE CLOs are actively managed, requiring the servicers to work with the collateral manager (or the controlling equity class) and constantly monitor the pool's performance. The need to continue to purchase assets for the CRE CLO and also to replace assets as loans default requires an issuer with an active pipeline of deals ready to replenish the portfolio when necessary. It should be noted that unlike CMBS, where the pools are always "static" and considered to be "true sales" for purposes of the asset contributors, in actively managed CRE CLOs, the financings are considered to be "on balance sheet" and are not accorded true sale treatment for purposes of risk-based capital accounting.

Diversity of Loan Assets and the Demand for Floating Rate Product

Unlike CMBS conduit lending, CRE CLO lending allows for floating interest rates, shorter loan terms, significant construction and future funding obligations. Mezzanine loans, loan participations and split promissory notes may also be held in a CRE CLO. The flexibility of a CRE CLO allows lenders to expand the

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lending products offered to borrowers. With a rising interest rate environment, investors are viewing floating rate products as an astute way to hedge against rising interest rates. Borrowers are interested in the shorter loan terms and the opportunity for additional capital for construction and renovation. Particularly with the pressures facing retail CRE, these loan products aim to give these properties the capital they need to adapt to the new "Amazon-driven" retail economy—and to be better situated in three to five years to obtain lower-cost, long-term financing. It is this increased demand for floating rate, short-term bridge loans that is one of the foremost contributing factors to CRE CLOs regaining momentum. However, assets with large renovation reserves, funding obligations, mezzanine loan components and participations all add to the hurdles a CRE CLO servicer will encounter. With the CLO structure accommodating and even facilitating particularly structured and complex assets, a servicer is going to need to review with great care the operative documents creating these assets (e.g., future funding participation agreements, mortgage-mezzanine intercreditor agreements, co-lender agreements). These agreements are typically highly negotiated among sophisticated parties, so the burden is on the servicer to understand and work with these agreements in the context of the greater transaction.

Asset Management and High-Touch Assets

The servicer must consider that the pool composition on day one may not be the same pool composition when the CRE CLO is ultimately wound up. Additions during the ramp-up period and substitutions during the reinvestment period can leave servicers feeling like they have a revolving door of collateral to monitor. No matter how many changes have occurred, the servicer is always bound to complete the standard CRE Finance Council reporting on an ongoing basis. These reports are vital to collateral managers' ability to ensure the credit quality of the portfolio.

The transitional nature of the underlying assets in a CRE CLO will also require a higher degree of servicer attention. Bridge loans, one of the main constituents of a CRE CLO, focus on commercial properties that are in need of significant renovations or upgrades. Servicers of CRE CLOs need to be more hands-on during the life of a bridge loan as they find themselves handling numerous reserve disbursement requests and monitoring construction. With considerably more servicing touchpoints, servicers are not just reviewing borrower-prepared financials each year, but are instead reviewing detailed construction disbursement requests, lien waivers and permitting documents, while also regularly inspecting the property. These loans are also more structured (with participations likely inside and outside the CRE CLO), requiring the servicer to seek consents from various participants in connection with any major servicing decisions.

The Tax Consequences of CRE CLO Servicing

Though originating lenders will always try to plan for the asset's foreseeable future, as business plans are actually implemented, what was contemplated at closing may not always come to fruition. Borrowers are looking for flexibility on the servicing side to deal with these unforeseen circumstances. One gripe that CMBS borrowers often mention is the multiple

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layers of approvals, including approval of the special servicer required for any major consent. While originators of CRE CLO loans may promise borrowers a no holds barred servicing experience, the servicer's ability to deliver on that promise is limited by certain tax restrictions. The CRE CLO special purpose entity is an offshore tax entity (commonly organized in the Cayman Islands or a special purpose Delaware statutory trust) that is not subject to U.S. federal tax on its net income. How does this impact servicer flexibility? While the loans are performing, modifications that are considered significant result in a deemed sale and re-origination of the loan under the tax rules, which has the potential to cause the CRE CLO issuer to be treated as engaging in a U.S. trade or business ("ETB")—subjecting its net income to U.S. tax. Informal IRS guidance suggests that not more than five of these significant modifications should occur in year or the CRE CLO issuer runs the risk of being treated as ETB.[3] On the other hand, if the loan is in default or it is reasonably foreseeable that it will be in default, a servicer seen as acting to protect its investment in modifying a loan should not be deemed by the IRS to be re-originating.[4]

The collateral manager must carefully assess whether the request is a "modification" and whether that modification is "significant." Generally, a modification is any change to a loan, except changes contemplated by operation of the loan document terms; provided, however, that changes in obligor, changes in the recourse nature of the loan and changes as a result of the exercise of bilateral options are always considered modifications notwithstanding the terms of the loan documents.[5] A bilateral option is equivalent to a negotiation. Consider, for example, a loan agreement that sets forth a debt yield requirement for a partial release that the borrower does not satisfy. If the lender still allows the borrower to partially release such collateral, it would be the exercise of a bilateral option and therefore a modification.

Once the collateral manager has determined the request is a modification, it will then need to determine if the modification is significant, which is generally governed by an "economically significant" test. Examples of significant modifications would be a change in interest rate, term, priority, recourse, adding or releasing substantial collateral, or assumptions of a recourse obligation by a new obligor. Given the severity of the tax implications, servicers and collateral managers should cautiously analyze any modification request and consult with their counsel to navigate through any issues. If a request is considered a significant modification and the servicer is concerned that granting the request could cause the CRE CLO to be treated as ETB, the originator of the loan generally will need to buy back the loan, modify the loan in-house and then hold the loan on its books for a period of time to "season" the loan before placing the loan back in the vehicle.[6] The timeframe and guidelines for seasoning the loan are market driven and will be set forth in the CRE CLO issuing documents.

Because a CRE CLO is a foreign entity, it cannot own property in the United States and will need to go through additional administrative procedures in order to foreclose on one of its assets. Foreclosure will need to be in the name of a permitted issuer subsidiary ("PIS"), which is a new entity formed in the United States and taxed as a corporation. Although

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the initial foreclosure may provide some additional administrative procedures, once foreclosed, the PIS has far greater flexibility than a REMIC and can freely rehabilitate the asset before marketing it for sale. A REMIC would be subject to a 100 percent tax if it engages in certain prohibited activities, including:

(1) entering into a lease in which it receives income other than "rents from real property";

(2) engaging in construction on the foreclosed property other than completing improvements that were more than 10 percent constructed pre-foreclosure; and

(3) engaging in any trade or business other than through engagement of an independent contractor after an initial 90-day grace period.

The PIS, on the other hand, is able to engage in these activities freely without negative tax consequences.

Protecting the Servicing Experience

Given the recent wave in CRE CLO issuance and its benefits, there is no indication CRE CLOs are slowing down anytime soon. Although the structure is seemingly straightforward, CRE CLO issuers, collateral managers and servicers alike need to be cognizant of the servicing restrictions and nuances affecting CRE CLO servicing so as to consciously avoid the pitfalls suffered in CMBS. Borrowers in CMBS have complained about lack of responsiveness, hefty servicing fees and the bifurcated approval process for major decisions—requiring both the servicer and special servicer to agree on any proposal before implementation. Though CRE CLOs are also designed with separate servicers and special servicers, for the most part, the special servicing role is either held by the originating lender or shared with the servicer. This cuts down on the need for the servicer to formally present proposals to the special servicer and wait for the special servicer's response. The originating lender is the entity with the strongest borrower relationship and is incentivized to work with and provide timely responses to its borrowers, even after the borrower's loan has been securitized in the CRE CLO. The controlling class of noteholders in a CRE CLO is often related to the originating lender, consolidating the number of parties involved in approving major lending decisions and thus simplifying and accelerating the approval process.So long as the parties involved in the CRE CLO post-closing remain interconnected in this fashion, the borrowers will likely appreciate their servicing experience and continue to come back to this floating rate, short-term lending product again and again.

Conclusion

Given the distinctions between CRE CLO servicing and CMBS servicing, and given the attractiveness of floating rate product at this point in the real estate cycle, it is no wonder that CRE CLO lending is set to take off in 2018. However, CRE CLO servicing is complex—with servicers having to navigate highly structured deals and monitor transitional and high-risk assets. The servicing standard requires the servicer to make decisions based on what is deemed best for all investors. To uphold such a standard, particularly with transitional assets, requires servicers to quickly respond to consent requests and sometimes creatively work out deals in distress—all while balancing the interests of the collateral manager to not run afoul of tax restrictions. Experience and a thorough under-

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standing of the CRE CLO nuances is vital. So long as the attractive pillars of CRE CLO servicing continue with consolidated servicing and lending relationships, the next question will be whether CRE CLO lending will attract stabilized properties and established borrowers as the next wave of maturities comes our way.

NOTES:

[1]*New Sponsors to Lift CLO Volume This Year*, COMMERCIAL MORTGAGE ALERT, February 9, 2018, at 1.

[2]Most CRE CLOs will require that the principal value of the CLO's pool of assets exceed the principal value of the notes issued by the CRE CLO debt tranches. If this test is not met, cash distributions will be diverted from the equity and junior tranches to the senior tranches. In addition, in an effort to maintain interest income from the portfolio, the CRE CLO will be required to maintain a minimum interest coverage ratio for each rated note class, which compares the interest income received against liabilities due. Another protection in place (intended to mitigate against the potential for long amortization periods) is testing the weighted average life, which, simply, is the average length of time each unpaid dollar of principal remains outstanding.

[3]*See* PLR 9701006 (Jan. 3, 1997); CCA 201423019 (June 6, 2014).

[4]*See* Rev. Rul. 73-460, 1973-2 C.B. 424.

[5]*See* Treas. Reg. § 1.1001-3(c).

[6]In light of AM 2009-010 (Oct. 2, 2009), in which the activities of a U.S. lending agent caused a foreign lender to be considered ETB, tax advisors are particularly cautious with actual or imputed origination activities of foreign issuers, including modifications of collateral manager guidelines.

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