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Property Finance

An International Approach

GIACOMO MORRI
ANTONIO MAZZA
Country reports edited by Alessandro P. Scarso

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Property Finance

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An International Approach

GIACOMO MORRI
ANTONIO MAZZA

with an outline of the most relevant legal issues in selected jurisdictions

Country reports edited by
ALESSANDRO P. SCARSO

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To Mum, Dad and my sister Michela
Giacomo

To my parents, brothers and sisters
To my wife Marcella and my wonderful children
Martina, Sveva and Lorenzo
Antonio

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Foreword

I'm very honoured to be invited by the authors and by Prof. Alessandro P. Scarso to write a foreword for the thoughtful book *Property Finance – An International Approach*.

As I had the privilege to be the first reader of this book, I believe it to be the most practical and concise guidebook on property finance. Based on the introduction to the fundamentals of property finance, the authors have explored the cutting edge issues of structured real estate financing, loan agreement, bullet payments, effects of financial leverage on real estate investments, structured real estate financing case studies, hybrid forms of financing, the Basel Accords, and effects on real estate financing. This book has a distinctive feature of question and case orientation.

This book has not followed the writing style of the classic textbook. Quite the contrary – the authors present the legal issues first, and then concentrate on providing feasible legal solutions to complete the property financing transactions from various perspectives. Therefore, this book is very appealing to bankers, lawyers, and business people as well as the students of law schools and business schools, who want to gain a clear picture of the legal system on property finance within a short time.

The devil is in the detail. In addition to offering various tailor-made alternatives to meet the different purposes of property financing transactions, this book has also paid appropriate attention to the legal details, which are easily ignored in commercial practice. For instance, the due diligence process, especially legal due diligence, is carefully elaborated on in this book, as most of the failures of property financing transactions could be traced back to the failure of due diligence.

This book is a reader-friendly work in terms of its useful reader's manual and the selection of some of the major jurisdictions on property finance in the seven country reports. These country reports represent not only the developing countries and the developed countries, but also the civil law system and the common law system. The comparative research on property finance in different jurisdictions is extremely important in the era of globalization, as any transaction of property finance could trigger legal effects on the international participants or on the property located in another jurisdiction. This book has successfully pointed out the key differences of property finance systems in different countries. Of course, the authors also encourage readers to identify the commonalities from the various jurisdictions by offering a uniform questionnaire applicable to the seven jurisdictions.

As a Chinese business law scholar, I'm more than pleased to find that Chinese legal rules on property financing have been introduced very accurately. It is true that China has developed a set of sophisticated principles and institutional arrangements on property financing based on its own market conditions and the best international practices. In addition to the statutes

such as the Property Right Law of 2007 and Security Law of 1995, the judicial interpretations of the Chinese Supreme Court have also played significant roles in clarifying the ambiguous legal articles.

Of course, it is an open question whether Chinese law recognizes the independent security. In the answer to Question 3 of the country report of China, it is said that "Chinese law so far still does not acknowledge independent security, meaning any type of security, even after establishment, is dependent on the main debt, i.e. the loan contract". To my knowledge, Chinese courts do recognize the independent security established in the international business transactions, on the ground of the exceptional sentence in Article 5 of the Chinese Security Law, "A guarantee contract is an accessory contract to a principal contract. If the principal contract is invalid, the guarantee contract shall be invalid. Where the guarantee contract stipulates otherwise, such stipulations shall apply." In 2013, I was invited to offer legal opinions to the Chinese Supreme Court on the possibility of recognizing the independent security in domestic business transactions in the draft of judicial interpretation on independent security. I strongly support the use of independent security in domestic business transactions.

Last but not least, I'm very grateful for the hard work of the prominent authors. When I have to choose a book among hundreds of competing works on the same topic in the bookstores, I usually pay more attention to the reputation and the background of the authors. Giacomo Morri, Antonio Mazza and, as far as the editing of the country reports is concerned, Alessandro P. Scarso completed this book not only on the basis of many years of teaching and research, but also on the basis of their rich experience in the practice of property finance. As a Chinese legal scholar, I personally have benefited greatly from reading it. I'd like to take this opportunity to encourage Chinese and other international readers to share the valuable knowledge presented here.

Beijing, August 2014

Prof. Dr. Junhai Liu
Director, Business Law Center, Law School, Renmin University of China (RUC)
Vice Chairman, China Consumers' Association
Vice Chairman & Secretary General, China Consumers' Protection Law Society
Panelist, CIETAC, BAC, HKIAC, VIAC, ICDR/AAA, WIPO, KCAB, APRAG, KLRCA

Foreword

Real Estate plays a vital role in the economy. The findings of research commissioned by EPRA and INREV which evaluates the role and importance of commercial real estate in the European economy indicate that real estate in all its forms accounts for nearly 20% of economic activity. The commercial property sector alone directly contributed €285 billion to the European economy in 2011, about 2.5% of the total economy and more than both the European automotive industry and telecommunications sector combined. It directly employs over four million people, which is not only more than the car industry and the telecommunications sector, but also greater than banking. Investment in new commercial property buildings and the refurbishment and development of existing buildings on average totals nearly €250 billion each year – representing over 10% of total investment in the European economy and equivalent to the GDP of Denmark. The long-term cash flows generated from property investment provide an important source of diversified income in the portfolios of European savers and pensioners. Property in its various forms represents €715 billion – over 6% – of European pension funds and insurance companies' total investments. Direct ownership is their most common form of property investment but indirect forms of investment – either through non-listed funds or listed property companies and REITs – are becomingly increasingly important.

Relative to its importance, real estate remains under researched whilst at the same time real estate education on an undergraduate as well as a postgraduate level falls behind other sectors with regards to number and quality of educational offerings. It is surprising to note that despite the importance of capital structuring decisions the understanding of market participants remains limited on the way in which the multitude of possible structuring choices of varying equity and debt pieces influences real estate investment risk. The effects of the Global Financial Crisis and the subsequent rapid move from an abundance of lenders – be it in the form of banks, insurance corporations, and other financial intermediaries, willing to provide significant amounts of capital – to a marked unwillingness to continue to provide the previous levels of debt in combination with complete withdrawal of some players from global debt markets, together with increasing requirements of lenders with regards to covenants and margins, have started a painful learning process within the real estate industry across all market participants. As the drying up of the debt market has demonstrated, debt and equity markets are in a very dynamic continuously changing mode and are constantly evolving to meet the requirements of borrowers, lenders, and equity investors.

Antonio Mazza and Giacomo Morri, the authors of this book on property finance, solve the perceived dichotomy between real estate practitioners and academia in an ideal way. Mazza and Morri provide a unique property finance textbook that is based on robust economic and finance principles and comparable to those in the area of managerial finance. The structure

of the book fulfils the needs of all actors involved in property finance decision making processes as well as those of students in masters programmes with a specific interest in the field of real estate. The book follows a traditional approach by first differentiating and explaining the basics of general financing decisions as a framework and then quickly relates to real estate financing practices in the leading western economies as well as China and India. What makes this book so valuable and distinctive is the seamless blending of theory and practice. The foundation on theory allows an understanding of the real estate capital markets, its institutions, regulations, and structures and the practical examples, calculations, and reference to case studies position this book in an exceptional way.

I do hope that this book will be picked up by its target readership and thus improve the level of knowledge and professionalism in property finance.

Amsterdam – Brussels, August 2014

Prof. Dr. Matthias Thomas
Chief Executive Officer, INREV (European Association for Investors in Non-Listed Real Estate Vehicles)

Preface

The Global Financial Crisis (GFC) has confirmed the importance of proper and accurate finance models in the property market. Since then, a period of deep change has commenced, with new structures, characteristics, and perspectives in the property market arising. Moreover, the change also extends to the property market's relationships with other sectors, primarily capital markets and banking. The GFC which has engulfed the world's largest markets has revealed, amongst other things, one common element: players with a global presence will be in a better position to overcome local crises as they can offset cyclical recessions in certain countries against growth periods in others. A global presence enables companies to recoup losses incurred in the developed markets with profits from emerging countries. With this end in view, international investors build up real estate portfolios through the acquisition of properties located around the world in order to allocate the risk among different markets.

The same dynamic is at work in the real estate finance sector. Financial institutions specializing in granting commercial real estate loans have for some time appreciated that the globalization of their reference market represents a major opportunity, as it enables them to finance the property market throughout the world, thereby preventing a real estate crisis or recession in any individual country from causing them to default. This approach is also appreciated by all stakeholders of these financial institutions including shareholders and the holders of covered bonds, which are often used as a source of real estate finance.

The aim of this book is to describe and present factors common to any structured real estate finance irrespective of where it is to take place. These factors may be global or local in reach.

The global factors relate to the technical, economic, legal, and financial variables which must be analysed by operators when engaging in an operation to finance the purchase of property anywhere in the world. These involve economic and financial issues (the substance of the finance), as well as legal considerations (the form of the finance).

Amongst other topics, Part One addresses issues relating to the processing of real estate operations by banks and financial institutions, negotiations relating to structured property finance, the drafting of term sheets and the insertion of covenants, as well as guarantees usually requested by financial institutions. Part One is supplemented by various forms of practical support, such as examples and financial models which illustrate problem areas and set out the principal operational and technical instruments.

Any structured finance operation however is inconceivable without taking into account local factors concerning the investment object – the property – and hence the assessments which local market experts must make in order to establish its value and return. Needless to

say, such factors involve, *inter alia*, civil law and tax and town planning legislation in force in the country in which the property to be financed is located. In particular, in relation to real estate finance, the statutory framework regulating guarantees under loan agreements and the procedural rules governing the terms on the enforcement of personal and real guarantees are of utmost significance.

It is precisely for this reason that Part Two of the book sets out the peculiarities of seven among the most important legal systems by asking questions of relevance to leading domestic lawyers specializing in real estate finance. The reader can thus consider the problems relating to any given jurisdiction in greater depth and compare and contrast the positions under different legal systems.

Such a twin-track approach is extremely practical and detailed on the one hand, whilst adopting a bird's eye view on the other, thereby aiding readers to quickly grasp the key areas of structured financing in the real estate sector, whilst enabling from the outset the most important operational instruments commonly used around the globe to be understood and, above all, put to use.

It is our hope that this book will contribute to a better understanding of the fascinating world of property finance.

San Clemente – Chia, July 2014

Giacomo Morri, Antonio Mazza

Preface to Part Two

The core skills required in the field of *property finance* – taken in its broad sense to include both the financing and marketing of real estate as well as the securitization of real estate and rental income receivables – are common to all professional operators, irrespective of where a real estate loan is applied for or granted.

The authors of this study have taken this fact as their starting point: from the identification of the borrower to the various stages of due diligence for structured financing; from the specific loan drawdown arrangements to repayment plans; from issues relating to loan syndication to forms of "direct" participation by the lender in the business risk associated with the loan through hybrid financing. In this context, it is instructive that the largest specialist operators often have a significant local presence, as part of their constant and on-going quest for the ideal mix between financial return and risk, which is evidently dependent upon the optimization of investment portfolios and the individual propensity for risk.

Leaving aside for one moment the fact that, from a strictly technical point of view, core skills are identical, it is clear that the formalities associated with structured financing cannot occur in isolation from the legal framework. The relevance of the statutory framework is not strictly limited to the regulation of the contractual instrument of choice. It is indeed indispensable that a close examination of the various ramifications of the legal position, considered overall, be carried out: from issues falling under civil law *lato sensu* (including the enforceability of guarantees, along with the liability of the guarantor in cases involving the issue of a comfort letter) to various questions under corporate law (including the frequent instances of loans granted to Special Purpose Vehicles [SPVs] within a group context, which are hence subject to inter-group financing arrangements, *de facto* administration, and prospective liability on the part of the controlling entity); from tax law (needless to say, tax implications cannot be left out of the definition of structured financing) to procedural issues under civil law and the law on bankruptcy, both from the perspective of non-performing loans (a scenario which evidently cannot be neglected within an overall assessment of real estate financing) and with reference to the access to voluntary schemes of arrangement by a borrower or to insolvency proceedings.

From the inter-disciplinary perspective set out above, and in keeping with the supranational dimension chosen, the authors have paired up the "technical" part, which seeks to illustrate core skills relating to real estate financing, with a part summarizing legislative aspects in selected jurisdictions, drawing on the contributions of renowned property finance experts from the individual legal systems considered.

It goes without saying that – due to obvious requirements of brevity, as dictated by the mandate of the study – it would not have been possible to provide an exhaustive illustration of the various complex legal aspects associated with real estate financing operations: also for that reason, an "operational" approach has been preferred which, rather than providing pointless technical explanations, provides operators with an immediate outline of the most significant aspects of the specific regulations applicable to property financing within each legal system considered.

Against this backdrop, irrespective of the structural differences between land law in civilian and common law legal systems, operators will find a straightforward explanation as to why, for example, the instrument of the *Grundschuld* is preferred in Germany over the traditional mortgage as the principal instrument used for real estate lending. An explanation will be provided for the failure to use letters of responsibility or the reticence in requesting comfort letters in the People's Republic of China, even where the borrower is a SPV controlled by an industrial group. The study will also suggest why Italian lenders tend to shrink from initiatives that encroach further on the management of borrowers in distress (even though – at least as a matter of principle – Italian lenders have voting rights in the borrower's shareholder meeting).

The extension of the scope of the study to legal issues undoubtedly also reflects the broad professional experience built up by the authors in the real estate financing sector. This reflects their awareness that decisions specifically relating to real estate financing cannot fail to adopt an inter-disciplinary perspective. The analysis is complemented by the skilful pairing up of illustrations of fundamental theoretical issues from property finance with their "operational" implications, as is eloquently demonstrated by the examples illustrating individual structured financing operations.

Publication of the study by Giacomo Morri and Antonio Mazza comes in the wake of the end – in Europe as well as the USA – of the long recession sparked off by the US sub-prime mortgage collapse.

As is known, the economic and financial crisis – the most serious peacetime crisis since the Great Depression – was caused to a significant extent by the progressive distancing of increasingly sophisticated real estate financing operations from the theoretical fundamentals of text-book finance.

Against this background, a real estate financing study that strikes a happy medium between theoretical aspects of property financing and the practical implications of instruments underlying real estate financing (and hence of the instruments enabling risk to be measured and allocated correctly) undoubtedly aims to achieve a greater awareness on the part of property finance operators – hailing predominantly from the private sector – of their individual responsibilities. Indeed, an acknowledgement of the central role played by the private sector and of its own responsibilities was, perhaps not by chance, very recently recognized by US President, Barack Obama, as a "rock-solid foundation to make sure the kind of crisis we just went through never happens again".[1]

Milan – Frankfurt, August 2014

Alessandro P. Scarso

[1] B. Obama, Remarks on Responsible Homeownership, speech given in Phoenix (AZ) on 6 August 2013: "First, private capital should take a bigger role in the mortgage market. […] I believe that while our housing system must have a limited government role, private lending should be the backbone of the housing market […] Second, no more leaving taxpayers on the hook for irresponsibility or bad decisions. We encourage the pursuit of profit – but the era of expecting a bailout after your pursuit of profit puts the whole country at risk is over".

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Special thanks are also due to Paolo Benedetto (SDA Bocconi and Europrogetti & Finanza), a dynamic academic and real estate professional who has worked alongside the authors for a number of years. Our gratitude to him not only for his contribution to the book, but also for his sterling work as project manager and his on-going and scrupulous review of the entire book, as well as his unfailing and indispensable help throughout all stages of the project.

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Naturally, responsibility for all errors lies solely with the authors.

Giacomo Morri, Antonio Mazza

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PLUTA specializes in insolvencies and restructurings of all kinds on a national as well as on an international scale. With more than 300 employees and offices in Germany, Italy, Poland and Spain, PLUTA offers legal and advisory services to companies, institutions, and individuals on debt restructuring arrangements, schemes of arrangement, distressed M&A, banking and finance (including real estate finance, asset and project finance, structured finance products, and syndicated lending) as well as on a broad range of corporate matters. PLUTA constantly ranks in the top tier of German law firms specializing in insolvency administration, as verified by the rankings of INDat, JUVE and the German magazines, *Focus*, and *WirtschaftsWoche*.

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Reader's Manual

Part One addresses economic and financial issues common to any real estate finance. Chapter 1 [*Introduction to Property Financing*] offers an overview of structured financing, highlighting the differences between corporate finance (where the lender's object of analysis is a legal entity) and project finance (which focuses on cash flows and also the manner in which the banks procure the capital used for lending). Chapter 2 [*Structured Real Estate Financing*] is dedicated to bank loans to the real estate sector, while Chapter 3 includes a detailed discussion [*Loan Agreement*] of the structure of a bank finance agreement along with its principal clauses. Again adopting a highly practical approach, Chapter 4 [*Loan Repayment, Interest and Renegotiation*] addresses the manner in which interest is charged. A broad overview of the capital repayment plan as well as the possibility to renegotiate the terms where difficulties are encountered in repayment are also dealt with. Chapter 5 [*Effects of Financial Leverage on Real Estate Investments*] provides a further discussion of financial models and outlines, by means of examples, the mechanics of financial leverage and the consequences associated with various levels of investment risks. To enable a better understanding of the contractual and financial dynamics of real estate finance, examples of typical real estate operations which analyse the term sheets of the relative loan agreements and construct models for assessing their financial sustainability are provided in Chapter 6 [*Structured Real Estate Financing Case Studies*]. The more practical part concludes with a section on hybrid financing [Chapter 7 *Hybrid Forms of Financing*], alongside more traditional forms of bank lending (pure debt), introducing a form of capital that is in part remunerated with reference to the outcome of the transaction. The concluding Chapter 8 [*Basel Accords and Effects on Real Estate Financing*] illustrates the effects of the Basel Accords on real estate finance, bringing the reader back to problems which are perhaps less practical; while not encountered on a daily basis, they are nevertheless of great importance in understanding the dynamics of real estate finance.

In Part Two the peculiarities of property finance in seven jurisdictions (China, England and Wales, France, Germany, India, Italy, and Spain) are addressed in greater detail by prominent lawyers specializing in property finance through answers provided to a predetermined set of questions. The latter cover most of the issues presented in Part One, thus providing a hands-on insight into structured finance transactions in the respective domestic jurisdictions.

The book contains numerous examples of contractual clauses and financial models that transpose financing contracts into figures. In particular, the calculation tables are freely available in Microsoft Excel format along with all active formulas, which will enable readers to run their own simulations in order to understand how financial models are constructed. The

files relating to the examples are available on the website www.morri-mazza.com along with further discussions and updates on the main issues addressed:

- new academic and professional papers;
- link to websites on the topics;
- PowerPoint presentations for every chapter, in order to summarize the main ideas or for teaching purposes.

Moreover, personalized and tailor-made PowerPoint presentations will be prepared and made available free to teaching staff.

This book is intended for all players (financial institutions, investors, technical advisors, lawyers, brokers, etc.) who wish to engage with the capital markets using the common language of real estate finance. It is structured in a user-friendly manner, enabling readers to gain an overarching vision of the principal problems associated with real estate finance, whilst providing detailed practical analysis of the contractual and financial foundations of operations. It is also directed at university students who wish to consider any of the many issues (economic, financial, technical, or legal) associated with structured real estate finance in more detail.

Needless to say, although the book aims at outlining factors common to any structured real estate finance, and – hence – sets out the principles, rules, and techniques applicable internationally, as a matter of convention the examples are presented in Euros. Of course, nothing would change were the dollar, renminbi, or any other currency to be used. The choice to refer to the Euro appeared best to express the international outreach of this book, as it is a symbol of internationalization, having brought together a range of countries within a single currency.

Any comments, critiques, suggestions, or information from readers are very welcome. Please feel free to contact the authors by e-mail at authors@morri-mazza.com.

PART One

CHAPTER 1

Introduction to Property Financing

The concept of financing, understood in its broad sense, embraces all sources of capital investment and, as such, the definition covers both debt and equity indiscriminately. The term financing is indeed taken to apply to any form of capital which may be used to finance an investment project, ranging from the more traditional forms to those which are more innovative, and including both the use of equity capital as well as the various forms of debt capital.[1]

The procedures for investment financing are extremely important since they make it possible to improve the investment's ultimate economic result due to the lower cost of the invested capital when debt is used. Moreover, in order to undertake a profitable investment, it must also be financially sustainable, e.g. it must be possible to secure the necessary resources. Eventually, this must all occur in a balanced manner in order to ensure that there is not an excessive financial risk due to the fixed cost of interest payment.[2] Indeed, were the latter to exceed a certain threshold, it would reduce the economic benefit of lower capital costs and, at the same time, make the investment overly complex due to the excessive restrictions imposed by lenders.[3]

1.1 FORMS OF FINANCING: DEBT AND EQUITY

The various forms of capital used to finance an investment can be arranged along a continuum ranging from the two extremes of (pure) debt and (pure) equity. In order to understand where best to place each form of financing it may be of assistance to define some of the main characteristics of these two main forms.

[1] Whilst this book will mainly address the issue of real estate financing through debt capital and bank lending, it is fundamental also to consider the full capital structure: general considerations relating to equity capital in terms of the measurement of expected returns and collection procedures also apply to the real estate sector. A choice has therefore been made to dedicate greater attention to forms of debt capital which are specific to the real estate sector, giving only marginal consideration to problems relating to equity capital when issues relating to hybrid financing (such as mezzanine finance and preferred equity) are addressed.

[2] On financial risk please see also Chapter 5.

[3] In the book the term lender is mainly used for the bank, but the term financier is also commonly used synonymously.

1.1.1 Debt

Debt capital is characterized by:

- an explicit cost defined under contract;
- the absence of any link between its cost (e.g. leading to different remuneration for the lender) and the actual return of the investment financed;
- tax deductibility in most cases.

The cost of debt is explicit since it depends upon a contractual agreement between the borrower[4] and the lender. This cost is precise and defined and (subject to certain limits such as in cases of default) is independent of the actual return of the investment financed since a set amount of money must be paid. Furthermore, the procedures and maturity dates for repayment are determined in advance and specified under contract.

Moreover, under most tax regimes, interests on debt are tax deductible,[5] thereby contributing to enhance the equity's return by reducing the tax burden. Although the financial advantage of using debt[6] results from this characteristic, debt financing continues to be used for various reasons, even where there are no tax benefits, such as:

- capital rationing (lack of equity capital);
- risk diversification;
- increase in projected earnings (in return for a greater risk);
- greater control over management.

Real estate investments, due to their large size, usually involve a significant debt-financing element. In fact, most operators work under capital rationing constraints, since they do not have access to all the capital which is necessary in order to implement all value creating projects with positive net present value (NPV). In particular, the real estate market is not efficient enough to swiftly allocate resources to projects with positive NPVs which therefore often cannot be implemented due to the lack of adequate financing. In addition, for many investors the recourse to debt financing is fundamental since they may wish to distribute their equity capital over several investments in order to reduce the concentration of risk within the portfolio as a whole. This is often the case of tax exempt investors, that notwithstanding the absence of tax shield benefit, use leverage in order to have a better diversified property portfolio.[7]

In other cases, such as for opportunistic funds, the quest for a high return results in the financial risk[8] being added to the (sometimes already significant) operating risk, without however directly creating value (in the sense of generating a higher NPV), since the higher return (greater cash flow to equity) is counterbalanced by a higher risk (equity expected return or consequently a higher discount rate).

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[4] In the book the term borrower is mainly used as synonymous with client, the entity receiving money.

[5] Interest due on loans is often tax deductible, although there are limits in certain jurisdictions. The issue will be considered in greater depth in Part Two of the book which is dedicated to specific legal systems.

[6] Starting from the seminal work of Modigliani and Miller (1958), there is a wealth of literature focused on the advantages of debt. On the importance of tax deductibility please see Miller (1988).

[7] Geltner et al. (2007).

[8] On leverage and risk please see also Cummings (2010) and Geltner et al. (2007).

Finally, whilst it may be less relevant for real estate investments, the need to service the debt limits management's discretion and facilitates investor control, as agency costs.[9]

Properties are apparently well suited to be financed with high amounts of debt because they can easily be provided as security as they cannot be concealed, their value is quantifiable with a fair degree of precision, and they represent sound collateral thanks to the possibility of mortgage guarantees. Moreover, the bankruptcy cost[10] is lower than that registered in other sectors (such as manufacturing or services) because the value of a property,[11] especially if it already exists or is already generating income, is less influenced by the owner and hence by the company going concern. The situation is different for companies in which the disposal value of individual assets is often irrelevant compared to the operating value of the company. However, complexity may increase significantly even in the real estate sector, and in particular in development projects, leading to an increase in the bankruptcy costs when the developer's role becomes fundamental for the successful completion of the operation.

The possibility of guaranteeing the debt by mortgaging the properties in respect of which the loan is granted apparently reduces the exposure of lenders to the risks generally associated with these type of investments, and therefore disposes them more favourably towards financing these operations. However, the value of guarantees[12] is heavily influenced by the legislative regime and the time-scales for enforcement procedures which enable them to be effectively implemented.

Real estate financing agreements may come in many different forms, and are specifically tailored to the characteristics of the individual operation, the parties involved, and market conditions.[13]

Within a sector which has undergone significant changes over time, lenders also play a significant role in promoting the use of more advanced techniques, such as mezzanine and private equity financing,[14] instead of traditional bank financing instruments alone. Depending upon the level of risk which lenders decide to accept, they may accordingly receive a share of the profits and play a more significant role in the capital structure.

Existing financing methodologies may be subdivided into two main categories:

1. financing instruments identifying a specific contractual form (such as mortgage loans, financial leases, or ordinary shares);
2. financing techniques which specify financing methods made up of multiple instruments (such as hybrid mezzanine financing with a mortgage loan and an equity kicker).

The financing technique therefore assumes that various financing instruments will be used in conjunction with one another in order to best satisfy more complex and detailed requirements.

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[9] Jensen and Meckling (1976).

[10] Warner (1977).

[11] Brueggeman and Fisher (2011).

[12] In Part Two of the book guarantees in different legislative systems are analysed.

[13] The examples and methodologies which will be presented cover only some of the solutions most frequently used when concluding loan agreements. However, since the contracts concerned are negotiated on a case by case basis, the clauses may be created and amended taking account of the specific requirements of each individual case. As a matter of fact, operations on commercial properties are increasingly characterized by their implementation through ad hoc structured loans.

[14] On mezzanine finance and private equity see also Willis and Clark (1989).

1.1.2 Equity

The definition of equity includes all forms of capital contributed by shareholders and any money pertaining to such contributions. In addition to paid-in capital or contributed capital, equity also includes retained earnings and treasury stock, if any. Equity is characterized by:

- an implicit opportunity cost;
- a remuneration which depends upon actual economic performance, and is payable after all other investors;
- non-tax deductibility.

Contrary to the position for debt financing, equity is characterized by the lack of a maturity date for repayment, or indeed of any formal obligation to repay. Expected remuneration will depend mainly on the perception of the overall risk, including the operational risk (investment type, procedure, and sector) and the financial risk (amount of capital with higher seniority than equity).

Finally, there is also a form of mixed capital, consisting in mezzanine financing or preferred equity, which covers all hybrid forms which cannot be classified either as debt, or as equity capital (for example profit participating loans, convertible bonds, and subordinated loans), since they share the characteristics of both.[15]

1.2 A DIFFERENT APPROACH TO PROPERTY FINANCING

A different way of conceptualizing financing is to consider the two parties, the shareholder (equity) and the bank (debt), simply as two partners which contribute capital to the same investment in different ways. The equity contribution will grant entitlement to control or manage the transaction[16] and to a residual payment after the partner bank has been remunerated. The bank, by contrast, on the one hand has less control (or even indirect control through covenants and guarantees), but nonetheless has a priority right to payment.

However, it must be recalled that taxes play an important role within the capital structure,[17] since the weight of the capital provided by the two partners has a different effect on the net result. Essentially, a high investment by the bank partner (e.g. the presence of a high level of debt financing) has an effect on taxes (since interests are deductible) and hence on the net remuneration of the other partner providing equity capital.

When analysing a real estate financing deal it is appropriate to put oneself in the shoes of the sponsor[18] of the initiative (usually the equity investor) who has to assess the sustainability of the capital structure; the same considerations work taking into account the (apparently) different perspective of the bank (the lender). In any case, the aims of the two parties should be aligned

[15] On hybrid forms of financing please refer to Chapter 7.

[16] This term will be used with reference to the real estate investment to be financed.

[17] On capital structure choices in the property sector:

- on the European market please see Morri and Cristanziani (2009) and also Brounen and Eichholtz (2001);
- on the U.S. market please see Feng et al. (2007) and Morri and Beretta (2008);
- on the U.K. market please see Ooi (1999).

[18] The term "sponsor" usually refers to the partner which brings capital (equity), expertise, strategies, and possibly contacts for the success of the project.

with each other, that is in searching for investments which correctly remunerate invested capital. It is accordingly clear that the techniques for analysing the investment should not be different for the sponsor of a project (the equity investor) and the bank (the debt investor or simply the lender).

1.3 CORPORATE FINANCE AND PROJECT FINANCE

Compared to other forms, real estate financing is characterized by a common feature, namely the procurement of the financial resources required by the borrower from the value of the property provided as security, and hence from its projected cash flows.

Whilst they may be straightforward from a financial point of view, real estate assets may also be financed using highly complex structures and techniques, and no longer solely through traditional means such as a mortgage loan. For a long time, financing in the real estate sector has been based on a limited number of instruments. Mortgage loans have been predominant for a long time and banks have regarded such a state of affairs in a favourable light since it makes it possible to tie in the borrower for a relatively long period of time, in addition to the rather contained level of risk thanks to the mortgage guarantee. Today, however, particularly since the Global Financial Crisis, banks too appear to be dedicating greater attention to real estate financing by privileging project finance solutions, in which the individual transaction is assessed from the same perspective as that of the equity investor. The reliability of the borrower in terms of management capacity does remain important, although the focus of analysis is becoming increasingly centred on the project itself.

The distinction between companies and projects may often appear to be somewhat theoretical since in reality it is not equally easy to draw this distinction, given the significant overlap between real estate projects and investments and SPVs. Consider the differences between a project finance arrangement[19] (which, as the name suggests, is an instrument for financing a project), under which the return is associated with the project's ability to generate cash flows to remunerate investors, and a mortgage loan (which is an instrument for financing an asset), the disbursement of which in many cases depends upon the value of the asset and the registration of a mortgage on it.

An investment project secures sources of finance, whether through debt or equity, according to its future capacity to generate cash flows to make payments. Depending on the object of the loan a particular approach may be adopted:

- corporate finance, focusing on the loans disbursed to a party (e.g. a company);
- asset based, in which lending activity is directly associated with a specific asset (e.g. mortgage loan or financial lease);
- cash flow based, under which loans are disbursed to a project (e.g. real estate developments or projects operating under concession as Private Public Partnerships).

Depending upon which of the previous approaches is adopted, the guarantees requested by the lender will differ, and so consequently will the risk profile. Within a corporate finance approach, an assessment of the corporate situation will take on significance in guaranteeing

[19] There is a wide literature on project finance; a selection of relevant books and articles includes Gatti (2013), Dewar (2011), Esty and Sesia (2011), Lynch (2011), Hoffman (2008), Yescombe (2002) and Fabozzi and Nevitt (2000).

the loan, whilst within an asset based approach the collateral value of the guarantee will predominate. Finally, under a cash flow based approach the quality and volatility of the project's cash flows will be paramount. The last two approaches are becoming increasingly predominant for real estate financing when there are no guarantees external to the project, whilst corporate financing is often reserved to larger real estate companies or funds, although this will always be accompanied by guarantees on properties.

When choosing between corporate finance and project finance approaches, a fundamental difference lies in the principles used in order to ascertain creditworthiness. Moreover, whilst project finance arrangements may be more flexible because tailor made to a specific transaction, by contrast they have a more complex structure.

According to the corporate finance approach, lenders will assess the economic and financial equilibrium of the company which intends to carry out the investment, using the company accounts as their basic instrument, but also the impact which new investments and the relative financing will have on these accounts. It is also necessary to predict the company's future performance by identifying the internal factors (such as strategies and assets) and the external factors (such as the conduct of competitors, and the performance of the market, the industry, and the economy in general) which influence it.

From the project finance perspective on the other hand, the assessment concerns the economic and financial equilibrium of the project to be financed, which is separated in legal and financial terms from other assets of the sponsors through the creation of a dedicated SPV, thereby ring-fencing the investment in order to isolate it from the sponsors' core business or other assets. In this way, should the project be unsuccessful, the sponsors' assets will not be affected in any way; similarly, should other projects be unsuccessful, the relevant creditors will not in turn be able to seek satisfaction on the ring-fenced property. The situation therefore involves a non-recourse form of financing.

Corporate finance involves the granting of bank loans, but also bond issues, that is debt securities issued by financial institutions or companies providing for repayment of the capital loaned either upon maturity or in instalments determined in advance prior to maturity. In this way there is a clear separation between the investment and the loan and there is no clear correspondence between the in and out cash flows.

In contrast in the case of a structured financing, the assessment as to the convenience of the project may already be made with reference to a specific form of financing.

The choice between corporate finance and project finance approaches depends upon various factors, including whether it is preferable to include the new project within the sponsors' assets and to attempt to secure financing through the traditional lending channels, or whether it is more appropriate to incorporate a specific vehicle which will secure financing in its own right.

1.4 BANK FINANCING

Real estate bank financing may be classified under three principal headings depending on the borrower and the purpose of the loan.

1. Property loans granted to private (retail clients) intended:
   - **(a)** for the purchase of a residential property;
   - **(b)** to refinance the purchase of a residential property with a new loan;
   - **(c)** to provide liquidity in order to cover an expense or home refurbishment.

2. Property financing granted to companies intended to cover the company's financial requirements (e.g. new investments or capital expenditures on existing properties).
3. Structured property financing granted to companies or real estate funds (including SPVs), intended:
   (a) to finance the acquisition of an income producing property or a trading portfolio of properties;[20]
   (b) to finance the construction/reconstruction costs of properties to be leased or sold.

There is a substantial difference between the first two classes of financing and the third one. Within retail or corporate real estate financing, the bank's due diligence is focused on the capacity of the borrower (either a private individual or a company) to generate sufficient income to repay the loan. The property is only a guarantee which the bank may enforce in order to extinguish the loan, should the borrower become insolvent. On the other hand within structured real estate financing, the bank's due diligence is focused on the property and its immediate or projected capacity to repay the loan through the income generated from lease or sale.

1.4.1 Property Loans to Private Individuals

The main guarantee which is requested by the banks for the first type of loan is the creation of a first ranking mortgage on the property – either owned or pending purchase – by the private individual applying for the loan.

For these loans the bank will verify the ability of the borrower to repay the loan out of his or her income, either from their job or other sources. If there is no or inadequate income,[21] the loan may be granted only once a guarantee has been issued by a third party in receipt of sufficient income. As a general rule, monthly loan repayments should not exceed one third of the net monthly income of the borrower (and/or guarantor).

Because of the ease with which the technical, legal, and economic due diligence phase of the operation can be standardized, loans for residential properties are offered by all commercial banks and now also more and more via the internet.

1.4.2 Property Financing to Cover Financial Requirements

Also for property loans the main guarantee provided is the establishment of a first ranking mortgage over one or more properties of the company or of the company shareholders. The ability to repay the loan is generally assessed on the basis of a profitability indicator of the company (usually EBITDA[22]).

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[20] Property portfolios bought at discount ("wholesale") with the purpose of the sale of individual properties ("retail") over time.

[21] As a general rule, periodic loan repayments should not exceed a percentage of the net income of the borrower (and/or guarantor): for example, in the Italian market, monthly loan repayments should not exceed one third of the net monthly income, while UK banks use a multiplier (currently between 4 and 5) of gross annual income which the loan cannot exceed.

[22] EBITDA, or *Earnings Before Interest, Taxes, Depreciation and Amortization*, is a profitability indicator focusing on the company's income which is based solely on gross ordinary revenues, that is before interest (financial management), tax (tax management), depreciation of assets, and amortization.

However, these loans are closer to corporate loans that are related to the business carried on by the borrower and to its capacity to generate cash flows through its core business (which for example may involve manufacturing, commerce, or the provision of services by anything from a major conglomerate through to a small trader).

In some cases, guarantees are offered by a company which, like the borrower, belongs to an aggregation of companies, all of which are legally independent in terms of their assets and corporate identity, but which are associated on an organizational level (a group of companies). The business group will generally be headed by a parent company, which may be a pure holding company when it directs and controls the other companies through the holding of equity interests, or operational when its role is limited in carrying out the economic and financial functions necessary in order to guarantee the orderly activity of the subsidiary companies.

Generally speaking, the existence of a business group will not always constitute sufficient justification to permit a company to provide guarantees in favour of another company from the same group. In several jurisdictions (especially those influenced by the Civil Law) it is necessary that there are also some indirect benefits for the guarantor, resulting from the pursuit of a group interest. If the asset in relation to which the loan guaranteed is requested will have a positive impact for all of the companies involved (including both the guarantor and the guaranteed company), this will establish a justified reason for the guarantee. However, if there is no such interest then the guarantee will have no effect. For this reason, the business plan which can justify the provision of sureties by one of the companies in the group for the debts of another group company should be rigorously documented. This financial and investment plan has to be agreed to by all group companies and provides for the distribution of benefits between all parties in line with the costs incurred.

Property loans intended for companies are generally granted by banks which also carry on corporate financing business or which have a bank or division operating in this sector within the reference banking group.

1.4.3 Structured Real Estate Financing

Structured real estate financing operations (the project finance approach) will preferably be directed at SPVs. The separation between the real estate project to be financed and the operations of the sponsors of the asset will ensure that they are economically and financially isolated (ring-fenced financing) and will in turn benefit both the sponsors of the asset as well as the lending banks.

The parties involved in the due diligence process for the loan application (surveyors, financial analysts, and lawyers) working for structured real estate financing companies will require a high degree of specialization in the real estate sector.

The following chapters will focus on structured bank lending (according to a project finance approach) directed at financing commercial real estate operations; residential loans to private individuals and corporate loans are not the focus of this book.

1.5 FUND RAISING, SECURITIZATION, AND SYNDICATION

This paragraph will illustrate two important aspects which characterize the activity of banks providing finance to real estate investments: fund raising, e.g. the systems by which the banks collect money on the market in order to reallocate it to the disbursement of real estate loans,

and loan syndication, e.g. the procedure whereby the initial lending bank shares the loan with other banks, or assigns all of the amounts due through securitization. Whilst the collection of funds is a necessary part of a bank's operations (as a financial intermediary), syndication and securitization are optional activities which have favoured the consistent disbursement of real estate loans even by smaller banks.

1.5.1 Traditional Funding and Securitization

Within this context it is important to recall that according to the traditional system for granting real estate loans, once the bank has obtained the funds, it grants the borrower the loan and the relative receivable remains due to the bank for the full term of the loan. Consequently, the relationship between the bank and the borrower has the same duration as the loan and any default on the loan will only affect the lending bank, which therefore has a strong interest in processing the loan application properly and in adopting a medium to long-term view of the operation.

Under the traditional system, the value of loans granted was thus directly proportional to the banks' assets, which have to guarantee, amongst other things, the relative credit risk on loans granted. In contrast, under a system based on securitization,[23] the banks assign their loans (even immediately after the operation is concluded) to third parties (which are not necessarily banks) which, in a nutshell, issue stocks on the market in order to finance the operation. The lending bank need not have any interest in attending to the fund raising activity (it will raise short-term funds), nor necessarily in establishing a lasting relationship with the borrower. After the assignment, any default by the borrower will be of no consequence for the original lending bank, but only for the parties which bought the notes issued on the market as part of the securitization process. The amount loaned in circulation is potentially infinite because it is no longer associated with the rigid capital requirements applicable to the banks.

In general, the technique of securitization consists in the conversion of various forms of assets into securities which can be readily traded on the market. This technique makes it possible to discount to the transaction date the present value of future cash flows which will be generated by the securitized assets. The transaction therefore makes it possible to finance the cash flows which one party, defined as the originator of the transaction, will be entitled to receive in future as a result of the collection of receivables or the sale of assets.

The securitization starts with the sale of those assets and is subsequently completed with the issue of the notes on the financial market. The cash flows resulting from loans, mortgages, and other assets (such as immovable properties) provide the guarantee for the notes issued and the means of ensuring their repayment.

More precisely, the assets at issue in the transaction are transferred for consideration from the originator to the transferee, which acquires them in return for payment of a fee: this transaction is financed through the issue of notes which are placed on the retail market or with institutional investors.

The former transactions were first concluded on the US market in the second half of the 1970s in order to transform the receivables of financial institutions into cash. However it was

[23] For further references on securitization please see also Stone and Zissu (2012), Fabozzi et al. (2007), Sabarwal (2006) and Fabozzi and Dunlevy (2001).

only later that this instrument was applied on a large scale to mortgage loans within the real estate market and the mortgage loans market.

Securitization offers banks a way of securing financing by enabling them to assign the loans they have granted to investors, thereby freeing up capital for new credit transactions.

1.5.2 Funding for Real Estate Loans and Syndication

The traditional fund raising systems are the "German system" and the "French system". The German system of fund raising is characterized by the close relationship between the fund raising activity and the lending activity which is reserved to specialist banks in certain countries. Very often this link is established upon conclusion of the loan agreement and must also be maintained for the full repayment term of the loan. The French fund raising system is characterized, by contrast, by a separation between the fund raising activity and lending.

The banks are free to choose which system of fund raising they wish to use, whether French, German, a mixture of both, or others, given that fund raising activity is essentially free from constraints. Nevertheless, the banks must adopt suitable measures in order to control and manage the risks associated with these activities, including the risks resulting from the mismatching of balance sheet asset and liability maturity dates and the risks inherent in medium to long-term lending to businesses. One of the most important and delicate activities within a bank is that carried out by the treasury department which has to keep under control the following critical issues:

- What happens if the bank uses current account deposits for granting loans (or part of them), and all of the funds are withdrawn by clients from current accounts, which are instant access accounts?
- What happens if the maturity of the funding does not match the maturity of the loans?
- What is the stable level of current account deposits which may be relied on for a corresponding medium to long-term commitment?
- What happens if interest rates rise or fall? Are there sufficient guarantees to cover that risk?
- What happens if the fund raising is in Euros and lending in dollars (or vice versa)?

Under the French system banks usually resort to the interbank market in order to raise funds and buy money at a cost which depends upon the market's perception of the risk of the borrowing bank. For this reason, a bank with a high rating may offer more beneficial terms to its clients than banks with worse ratings, precisely because it can secure funding at a lower cost.

Under the German fund raising system, funds could be secured on an ad hoc basis and are referred to as covered bonds. Covered bonds (*Pfandbrief*), which were established more than a hundred years ago in Germany, were introduced in other countries such as the United Kingdom, the Netherlands, and Italy. Previously each issue was defined on the basis of genuine contractual agreements. They are now used in 22 European countries.

In contrast to securitization operations, covered bonds guarantee a return on capital and interest since part of the bank's assets are burdened and are earmarked exclusively for the remuneration and repayment of these instruments, which are in any case also guaranteed by the issuing bank.

For the bank issuing the covered bond, the difference compared to securitization is that their issue does not make it possible to remove the transaction from the bank's balance sheet

(precisely due to the existence of the guarantee), which means that the bank will continue to bear the credit risk, and is required to make the relative capital allocations in its accounts.[24]

Covered bonds offer greater security compared to traditional bonds, and consequently greater liquidity accompanied by higher ratings and lower returns.

Covered bonds should accept a lower return compared to normal medium and long-term fund raising systems: covered bond holders may enforce their rights directly against the assets set aside which are beyond the reach of the bank's other creditors. If for example the bank's credit rating were "B" and that of the covered bond were "A", the bank would have an undoubted advantage in issuing this instrument in order to raise funds for its own real estate lending operations. As a consequence banks issuing covered bonds can lend to their clients at lower rates because of the lower cost of funding.

Covered bonds are mainly characterized by:

- the guarantee relating to the ring-fencing of the receivables assigned to the vehicle which ensures that they will be dedicated, along with the cash flows generated by them, exclusively to satisfying the subscribers of the covered bonds;
- certain guarantees of the issuing bank relating to its assets and a self-standing commitment by the vehicle in the event of default by the issuer.

1.5.3 Syndication of Real Estate Loans

If the lending bank is not able or willing to underwrite the loan in full, or if it is required to reduce its credit exposure towards certain clients or sectors, it will be necessary to involve other banks: this operation is generally referred to as "Syndication".

Syndication may occur upon conclusion of the loan agreement, or after it is concluded. In the former case, the operation will be concluded in a pool with other banks (also referred to as a club deal). In such cases no particular problems arise either with regard to the conclusion of the agreement or to the guarantees of equal ranking which will be provided to all of the banks. In such cases it is settled practice to conclude an interbank agreement to regulate relations between the banks, also specifying which of them is to act as the agent bank with the task of coordinating the interaction – which does not always run seamlessly – between the various banks during negotiations with the borrower and of administering and monitoring the loan during the post-disbursement stage (the agent bank is normally the one which establishes relations with the client).

In other cases, especially when it is not possible to wait for a long time in order to conclude the club deal, the bank will finance the transaction with a bridge loan, e.g. a short to medium-term loan. Before the bridge loan matures the bank and/or the borrower will contact the other banks in order to make provision for the mortgage on a pooling basis with a medium to long-term loan which will redeem the existing loan.

The problems associated with this structure are well known because the bank granting the bridge loan may not make a firm commitment also to sign the long-term loan in full, with the result that if it is not able to arrange the club deal before the bridge loan matures, there may be a default risk on the transaction.

[24] On capital requirements please see Chapter 8. Basel Accords and effects on real estate financing.

In cases of construction financing (to be disbursed on the basis of a work in progress[25]) the agent/arranger bank may underwrite the full amount of the loan and sign the relative agreement (also accepting all guarantees) and may start making the initial disbursements. It will then start (or continue) to look for other banks which, once the transaction has been accepted, will sign a new financing agreement solely in respect of the part underwritten, requesting the borrower to issue the relative guarantees to them with the same ranking as those granted to the agent bank (and with the agreement of the latter). At the same time the agent/arranger bank will reduce its contractual commitment by an amount equivalent to that underwritten by the underwriting banks.

[25] WIP: in a broad sense both construction and commercialization work in progress.

CHAPTER 2

Structured Real Estate Financing

In a similar manner to project finance operations, structured real estate finance involves the funding of a transaction in which the bank accepts the cash flows generated, or which may be generated, from the property financed as collateral for the repayment of the debt.[1]

The due diligence carried out by the bank when granting these loans involves an assessment of the economic and financial equilibrium of a specific real estate asset or project, which will preferably be legally and economically independent of the other initiatives carried out by the sponsors which conclude the transactions. The real estate project to be financed will generally be implemented by its sponsors by creating a special purpose vehicle (SPV) which permits the investment to be separated in economic and legal terms.

A real estate project is assessed by the banks and its sponsors principally with reference to its capacity to generate revenues from the lease and/or sale (also partial) of the properties financed. The cash flows associated with the real estate transaction provide the source for servicing the debt as well as paying a return on the equity capital invested by the sponsors.

The guarantees may be real (e.g. pledge on SPV shares, mortgage on the property) or contractual (e.g. assignment of receivables as collateral, contractual covenants), although it is the contractual guarantees which actually assure the banks that the cash flows generated by the real estate asset will be the primary source for servicing the debt. These loans may be of two different kinds.

- *Non-recourse* or *without recourse*, when no right of recourse is specified (for example through the issue of guarantees or comfort letters) against the sponsors of the project or third parties. The capacity of the real estate project to generate sufficient cash flows (which are only potential in cases involving development projects) in order to repay the debt, along with a contractual structure that guarantees the success of the real estate investment and the repayment of the underlying debt, are the main elements to be assessed by the lending banks.
- *Limited recourse*, that is with recourse limited to situations in which rights of recourse are provided against the sponsors or third parties upon occurrence of situations specified in advance under contract. For example, in a development project where construction costs are only partially financed by the bank, the latter will demand from the sponsors a commitment or a guarantee to inject into the project both any capital shortfall arising during the construction phase, as well as funds to cover unexpected costs.

[1] Vinter (1994).

Obviously, the bank will also carry out a financial credit check for non-recourse loans in order to verify the solvency of the shareholders and/or of the financial group of the borrowing company. The aim is to avoid any default by the transaction's sponsors affecting, even indirectly, the real estate project financed as well as to assess the resoluteness and reliability of all parties involved in the transaction.

The cash flows result from rent (either property leases or going concern leases), whilst in development projects they will be generated from the sale (or lease) of the individual units when construction work has been completed.

Debt financing is generally available for all types of real estate, provided that they can generate cash flows, both actual (for existing income producing properties) or expected (for development projects). Accordingly, the following properties, existing or to be developed, will be eligible to be financed:

- offices;
- high street retail/shopping centres/retail parks/factory outlets;
- entertainment centres/theme parks;
- multiplexes;
- hotels;
- logistic warehouses and industrial;
- retirement homes;
- residential portfolios (to rent and/or to sell).

The loan may be intended to support construction costs or to pay the acquisition price. In the former case, it will be necessary to provide a precise estimate of the costs of the project and of the cash flows which the property may generate once completed: the granting of the loan may also be conditional upon the sale of units successfully sold (particularly in case of residential development projects). In the latter case, it will be necessary to pay particular attention to the relevant clauses in the lease agreements.

The capital structure of a real estate project may be made up of three parts:

- equity (shares and shareholder loans);
- debt capital;
- hybrid financing (mezzanine finance and preferred equity).

The debt amount financed will mainly depend on three elements:

- the reliability of the borrower;
- the transaction for which the loan is intended and its operational risk;
- any guarantees provided.

This amount may be granted as one single credit line, although alternatively secondary credit lines may also be granted, such as for example a specifically dedicated VAT line.

In all cases, the equity that is to be injected by the sponsor cannot usually be less than 20–30% of the overall cost of the property. In development projects, this equity level often corresponds to the acquisition cost of the area to be developed. Since lower equity percentages will entail higher leveraging and higher risks for the bank, credit lines exceeding 70–80% of the construction cost (also defined as mezzanine finance) come with significantly higher costs.

2.1 BANK ROLES

Sometimes there might be the need to arrange a syndicated loan,[2] which means involving several different lenders in providing parts of the same loan. This might happen when the debt amount is particularly large and therefore too much to be provided by a single lender or above its risk exposure levels. In order to assemble a multibank lending syndicate, a bank will receive a mandate as syndicate manager from the borrower. After the agreement with all the participating banks has been reached, the syndicate manager is usually appointed as the agent bank,[3] i.e. the bank which manages the relations with the borrower for the full term of the loan (in particular, monitoring compliance with covenants, collection of instalments, reports to oversight authorities and recovery actions). In particular the agent bank is responsible for notifying other banks of advances or drawdowns by the borrower and changes in interest rate.

When determining the role and responsibility of the agent bank an interbank agreement is concluded in which, *inter alia*, the agent bank is charged with carrying out all activities concerning the conclusion of agreements relating to the credit facilities, drawdown and the administration of those facilities, as well as carrying out (according to a mandate which may vary in scope) procedural, preventive, or enforcement measures against the borrower or any other guarantors or obligors in order to protect the rights created under the loan agreement.

2.2 BANK LOAN CONTRACTUAL FORMS

Different contractual forms may be used in order to finance a real estate transaction, provided that such contracts are appropriate for securing the financial resources from the value of the collateralized property.

Bank loans may come in various forms and are the funds mainly used by companies in order to obtain part of the financial resources necessary to cover their needs. These loans may be classified into two groups.

1. *Bank account overdraft facilities*, where amounts exceeding those deposited may be withdrawn, thus giving rise to account overdrafts (negative balances for the borrower and positive balances for the bank). These forms are flexible in nature because they make it possible to switch between withdrawals and repayments. They may be subdivided into unsecured overdrafts, secured overdrafts, documentary overdrafts, credit lines, and bank account advances on stocks or goods.
2. *Fixed maturity loans* – such loans are disbursed in one or more predetermined instalments and must be repaid at specific maturity dates.

The granting of a revolving secured credit line is the most flexible form of financing for real estate, especially for development/refurbishment projects. The bank grants access to credit up to a maximum limit, which may be used according to the borrower's requirements. This credit line is generally granted in order to finance a specific transaction. The borrower undertakes to redeem the original credit line through full or partial repayments along with

[2] On syndication of real estate loans please see paragraph 1.5.3.
[3] Often used synonymously with lead bank or lead manager.

the payment of the accrued interests, and may use the cash made available to it according to its own requirements through one or more withdrawals returning the principal with subsequent repayments. The borrower may also borrow back any part of the facility which has been repaid.

2.3 LOANS FOR DEVELOPMENT PROJECTS

Various contractual techniques may be used in order to finance development projects based on the work in progress (WIP). An initial conditional loan agreement specifies the term of the loan and the duration of the initial pre-amortization period during which construction work is to be carried out. Subsequently, individual loan instalments will be disbursed during the pre-amortization stage (namely, the stage during which interest only is paid) initially agreed to. Consequently, all instalments will have the same amortization period, although they may have a different pre-amortization period. A maximum time limit for the repayment of the loan is agreed which may also be amended upon disbursement (as well as the agreed interest rate, which may also be amended). Building construction will subsequently be financed by preliminary disbursements to finance development costs. Upon conclusion of construction works, the definitive loan agreement will be concluded, which will regulate the amortization system (e.g. capital repayments) for the sums financed, consequently determining the interest rate, the frequency of repayments, and the definitive terms of the loan.

2.4 PARTS AND STAGES OF A STRUCTURED LOAN

A structured real estate loan comprises various stages. In order to ensure clarity of explanation, these will be first listed in logical sequence according to the order in which they occur; subsequently their salient points will be described:

1. initial meeting between the bank (lender) and the client (borrower) in order to analyse the real estate project and the related financial requirements (see paragraph 2.4.1);
2. technical appraisal and feasibility analysis of the real estate project:
   - analysis of expected costs and revenues;
   - market and catchment area studies;
   - analysis of operating income and definition of the financial plan;
   - estimate of open market value and mortgage lending value of the property (see paragraphs 2.4.2 and 2.4.3);
3. financial due diligence or solvency analysis of the parties involved:
   - borrowing company and group;
   - building company;
   - buyer;
   - tenants;
4. legal due diligence, during which the contract and related guarantees are prepared (see paragraph 2.4.5);
5. tax due diligence, during which the tax law aspects of the loan agreement and the implications of the new loan and the related guarantees on the borrower's fiscal position are ascertained;

6. identification of the risk mitigation instruments identified during the creditworthiness, legal and technical analysis, and the resulting finalization of:
   - security package;
   - insurance policies;
   - hedging of interest rate risk;
   - contractual covenants;
7. identification of the transaction's credit risk in accordance with the various approaches contemplated under the Basel Accords;
8. loan pricing, also on the basis of the results of the credit risk assessment;
9. issue of an offer to the borrower (term sheet, see paragraph 2.4.1);
10. negotiation of the terms and conditions proposed in the term sheet and acceptance;
11. continuation of the review stage: drafting and negotiation of the loan agreement and of the security package;
12. conclusion of the agreement, issue of guarantees and insurance policies;
13. monitoring of the loan involving a control of guarantees and contractual covenants;
14. syndication or securitization of the loan, if appropriate.

2.4.1 Analysis of the Transaction and Term Sheet

Generally speaking, the information exchanged between the bank and the borrower during the initial stages of negotiations will contain the following information:

- a description of the project's sponsors;
- an illustration of the structure of the company applying for the loan;
- the project business plan, setting out in particular the deadlines for the various project stages along with economic and financial projections, including pro forma accounts, cost forecasts, the project's capital structure, and the cash flows generated through it.

In some cases, especially where the sponsor is assisted by a financial advisor, an information memorandum will be presented. This is a single document setting out the details of the real estate project to be financed along with the project's sponsors and a working proposal for its capital structure. In other cases, especially where it is necessary to involve more than one bank in the project, the sponsor will ask the bank itself to draw up this document in order to carry out a preliminary review of the bankability of the project.

This stage is extremely important, since it is vital that the project is presented in such a way that enables the bank to understand the characteristics of the real estate project in terms of revenues, costs, cash flows, and risks. This will make it possible to verify whether the underlying assumptions presented by the prospective borrower are tenable. In other words, when disbursing a structured loan, the bank will carry out an analysis which is very similar to that carried out by an equity investor when investing in a real estate project.

During the first meeting with the bank, the borrower will generally present the structure of the transaction and the amount of the loan requested. He may also ask the bank to draw up a document before a particular date setting out the main terms and conditions of the loan with a view to initiating formal negotiations. This document is referred to as the "term sheet" and it is used by the parties in order to conduct negotiations on the main terms and conditions of the loan. It is updated when the real estate project is finalized and during the loan negotiations. Essentially, this document summarizes all of the terms and conditions, the parties involved,

the contracts to be signed and the guarantees to be provided, as well as the deadlines for concluding the transaction. The document also specifies:

- the parties which will sign the subsequent loan agreement and their roles;
- the amount and term of the loan; if the amount is not approved in advance the amount is to be capped at the lowest of either:
  - specific amount;
  - specific max % of LTV and/or min ICR and/or min DSCR;[4]
  - specific % of the purchase price/construction costs (loan to cost);
- the purpose of the loan;
- the property description;
- the forms and procedures regulating the drawdown and the repayment of the loan;
- the determination of the applicable interest rates, margin, and fees that will be paid to the bank arranging the loan (also called the arranger) and/or to the other participating banks when a pool financing is organized;
- the interest hedge (in case of variable interest);
- the repayment;
- the interest period;
- the security package to be issued;
- the main rights and obligations of the parties, and any special terms, condition precedent, and conditions required by the concession or the nature of the construction work planned;
- the covenants which will be required upon conclusion of the agreement;
- the temporary limitation of the term sheet;
- the representations and warranties;
- events of default;
- any other terms and conditions which must be complied with in order to obtain the approval of the bank and the drawdown of the loan;
- choice of law/jurisdiction.

Due to its characteristics and to the high level of detail in the conditions which the term sheet may contain, the problem arises as to whether it amounts to a genuine preliminary agreement or, instead, to a non-contractual undertaking, namely a pre-contractual act intended to "crystallize" the state of negotiations or the preliminary agreements reached, thereby facilitating the conclusion of the overall agreement. The settled view is that the term sheet is a pre-contractual act which is as such capable of establishing a pre-contractual liability and an obligation to compensate damage as protection for the legitimate expectation created for the counterparty.

In fact, although the contents of the term sheet may differ significantly and be more or less binding depending upon the level of agreement that has been reached, the parties themselves usually wish to specify that the term sheet does not have the status of a preliminary agreement by including explicit clauses to that effect. The efficacy of the term sheet is generally conditional upon the subsequent approval of the conditions contained in it by the credit committee of the parties involved. Generally speaking, the bank will include a clause at the end of the term sheet stating that.

[4] Loan to Value Ratio (LTV), Interest Cover Ratio (ICR), and Debt Service Cover Ratio (DSCR) are financial covenants; for a complete description please refer to paragraph 3.15.2.

"The term sheet constitutes only a draft outline of the terms and conditions on which the bank would be prepared to consider making available a facility and is in no way to be construed as an offer or commitment to provide finance. Any decision regarding the provision of finance requires the approval of the lender's credit committee.

In this way (no binding offer) the term sheet is not considered (in most jurisdictions) an offer which already leads to a requirement to allocate equity on the side of the lender.

The above applies unless the borrower requests a binding commitment, that is an irrevocable proposal corresponding to a binding commitment by the bank (which is generally requested when the loan has been negotiated with various banks in competition with one another, following a kind of tender procedure conducted by the project's sponsor). In such cases the bank will have to take a specific decision to authorize the signature of the term sheet.

The term sheet may be drawn up during different stages of the loan negotiations:

(a) during a preliminary stage, if the borrower requests an offer from more than one bank:
  (i) in this case the borrower will attend the first meeting with the bank with an information memorandum containing a detailed analysis of the real estate project and its financial requirements;
  (ii) interested banks will formulate their offer before a predetermined date on the basis of the data contained in the information memorandum, specifying that the subsequent approval of the loan will be conditional, *inter alia*, on the verification of the accuracy and validity of the information contained in the memorandum, which will be carried out by the bank's analysis team;
  (iii) the term sheet will be signed by the borrower and the bank which has made the best overall offer;

(b) during an advanced stage of negotiations: in this case, the bank may request the costs of the due diligence to be paid up-front on a preliminary basis, regardless of whether it actually decides to grant the loan.

Though it does facilitate the parties' negotiations, the signature of the term sheet is not essential in order to conclude a financing agreement.

2.4.2 Real Estate Valuation

The valuation phase is mainly intended to estimate the value of the real estate asset which will be provided as collateral. Estimating the value of properties involves ascertaining its value as expressed in monetary terms, in other words pricing the utility of an economic asset. Banks will generally ask an external surveyor to value the real estate asset, determining the Open Market Value (OMV) and the Mortgage Lending Value (MLV).

OMV is the basis of value supported by RICS Red Book[5] and it is defined as

"the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion".

[5] RICS (2012).

MLV in contrast, according to TEGoVA,[6] is

"the value of property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, normal and local market conditions, the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the Mortgage Lending Value."

Despite cross-border mortgage lending and the European Mortgage Lending Value (EMLV) of the European Mortgage Federation, only the definition is consistent. If one compares the definitions and the concepts of the OMV and the MLV, the latter is in many respects very similar to the former. However, the MLV as a "*long-lasting/sustainable*" value introduces additional parameters to smooth market trends. This is made by adaptation of the rental income to a stable obtainable rent level, adjustment of the capitalization rates to the long-term development of the market and customization of the administration and management costs.

MLV may be used by the financial services industry in the activity of lending secured by real estate. The MLV provides a long-term sustainable value limit, which guides internal banking decisions in the credit decision process (e.g. loan-to-value, amortization structure, loan duration) or in risk management.

MLV facilitates the assessment of whether a mortgaged property provides sufficient collateral to secure a loan over a long period. Given that MLV[7] is intended to estimate property value for a long period of time, it cannot be grouped together with other valuation approaches used to estimate the OMV on a fixed date.

Additionally, MLV can be used as a risk management instrument in a number of ways in the context of:

- capital requirements for credit institutions as detailed in the Basel Accords;
- funding of mortgage loans through covered bonds secured by real estate as the cover assets;
- the development of capital market products converting real estate and real estate collateral into tradable assets (e.g. mortgage-backed securities[8]).

The concept of MLV is defined in detail by legislation, directives, and additional country specific regulations.

Regarding the technical transposition of the definition mentioned above, the long-term validity of MLV requires compliance with a certain number of steps aimed at eliminating short-term market volatility or temporary market trends. The valuer must address the following key issues when determining the MLV of a property:

- The future marketability and saleability of the property has to be assessed carefully and prudently. The underlying time perspective goes beyond the short-term market and covers a long-term period.
- As a principle, the long-term sustainable aspects of the property such as the quality of the location and construction must be taken into account.
- As far as the sustainable yield to be applied is concerned, the rental income must be calculated based on past and current long-term market trends. Any uncertain elements of possible future yield variations should not be taken into account.

[6] TEGoVA (2009).
[7] Reif (2006).
[8] On mortgage-backed securities please see also Fabozzi (1995).

- The application of capitalization rates is also based on long-term market trends and excludes all short-term expectations regarding the return on investment.
- The valuer must apply minimum depreciation rates for administration costs and capitalization of rents.
- If the MLV is derived using comparison values or depreciated replacement costs, the sustainability of the comparative values needs to be taken into account through the application of appropriate discounts where necessary.
- The MLV is generally based on the current use of the property. The MLV shall only be calculated on the basis of a better alternative use, under certain circumstances, e.g. if there is a proven intention to renovate or change the use of the property.
- Further requirements, for example with respect to compliance with national standards, transparency, content, and comprehensibility of the valuation, complement the legal framework for the calculation of MLV.

There are important differences between OMV and MLV. The OMV is internationally recognized for the assessment of the value of a property at a given moment in time. It estimates the price that could be obtained for a property at the date of valuation, notwithstanding that this value could alter very rapidly and no longer be up-to-date. In contrast, the purpose of MLV is to provide a long-term sustainable value, which evaluates the suitability of a property as a security for a mortgage loan independently from future market fluctuations and on a more stable basis. It provides a figure, usually below OMV and therefore able to absorb short-term market fluctuations whilst at the same time accurately reflecting the underlying long-term trend in the market.

Figure 2.1 shows that the MLV does not pursue the market cycle. It stands out from the varying OMV as a stable line. The MLV in stable markets will hardly differ from the OMV.

2.4.3 Basics of Property Appraisal

Properties may be valued according to various techniques which can be classified under three main approaches (Comparison, Cost, and Income methodologies), the application of which may involve different criteria.[9]

(a) Comparison methodologies:
- Sales Comparison Approach;
- Hedonic models;[10]

[9] For further references on property valuation please see Cummings and Epley (2013), Hoesli and Morri (2010), Scarrett (2010), Baum and Crosby (2008), Geltner et al. (2007), Schram (2006), Kahr and Thomsett (2005) and Hoesli and Macgregor (2000).

[10] The hedonic (regression) models have been developed in many countries in order to value residential real estate: they are based on the notion that the supply of and demand for heterogeneous assets are comprised of supply of and demand for each characteristic of those assets (Lancaster 1966 and Rosen 1974). Generally speaking, it is relatively easy to observe real estate supply and demand on the market: the supply of a certain type of asset consists in the assets put up for sale, whilst the demand is represented by the investors who intend to purchase that type of asset. Since these are observable elements, real estate supply and demand as a whole may be classified as explicit supply and demand. On the other hand, supply and demand in relation to each characteristic feature cannot be observed directly, and such cases are accordingly conceptualized as implicit supply and demand.

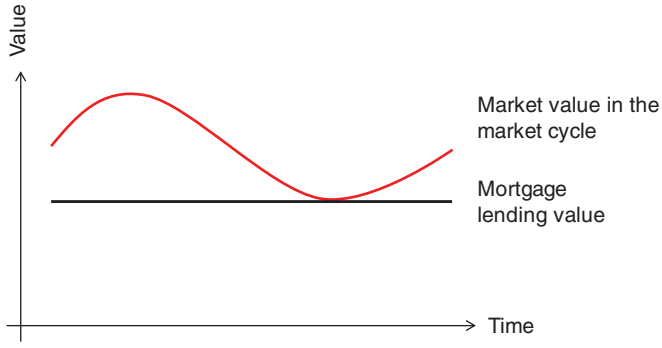

FIGURE 2.1 MLV and OMV

(b) Cost methodology;
(c) Income methodologies:
- Direct Capitalization Approach;
- Financial Approach (DCF analysis models).

The different methodologies are based on different principles and they should also be adopted jointly if required by the complexity of the asset to be assessed. In order to establish which approach is to be used in different situations, it is appropriate to compare them briefly with one another.

Under the Sales Comparison Approach, the value of an asset is obtained on the basis of the prices for concluded transactions which may be defined as comparable. This approach is based on the assumption that no rational buyer will be willing to pay a price that is higher than the cost of buying similar assets with the same utility. This assumption is premised on the two fundamental principles of substitution and equilibrium between supply and demand. According to the substitution principle, the value of an asset is the price that should be paid for a perfectly identical asset, whilst according to the equilibrium principle, the price of an asset is directly dependent upon the market (supply and demand) and is therefore the synthesis of the negotiation process.

The Cost Approach is based on the principle that no rational buyer will be willing to buy a property at a price which is higher than the cost of land in the same area plus the cost of building a property with comparable characteristics, after accounting for the loss in value resulting from the ageing of the building. The valuation is therefore based on the measurement of three different elements: the value of the land, the construction costs for a building with similar characteristics, and the adjustment factors that take account of depreciation due to time and obsolescence. A fundamental element within this approach is also the principle of highest and best use, according to which the value of an asset is dependent upon the most probable use which is physically possible, financially feasible, and legally permitted and which offers the highest return on investment.

Finally, the Income methodologies are based not only on the principles of substitution and equilibrium between supply and demand discussed above, but also on the principle of expected future economic benefit, according to which a rational buyer will not be willing to pay a price higher than the present value of the economic benefits which the real estate

asset will be capable of generating over its lifetime. These approaches therefore presuppose the determination of an economic benefit (which may be defined as single income or future cash flows) and a time coefficient which takes account of risks inherent in its future economic benefit (capitalization rate or discount rate). The economic benefit of an income producing property is principally the rental income which it may generate net of operating expenses:[11] it becomes fundamentally important to identify the level of rental income which the asset is able to generate by analysing a sample of comparable properties on the rental market. It is therefore necessary to analyse rental transactions (rather than transfers of ownership, as occurs under the Comparison methodologies) in order to determine future income flows.

Consequently, the Income methodologies work well when assessing a real estate asset with the following characteristics:

1. ownership rights are transferred relatively infrequently (e.g. commercial properties in general such as shopping centres, large office buildings, and logistic parks);
2. there is a significant rental market (with a clear distinction between users and owners[12]) on the basis of which comparable market rents can be determined;
3. the value of the property is not directly dependent upon a physical measure (e.g. price per square metre), but rather upon its capacity to generate income in a manner not strictly related only to its surface area (e.g. shopping centres, hotels, or cinemas).

2.4.3.1 Comparison methodologies In order to apply the Comparison methodologies it is necessary to have a sufficiently broad historical set of transactions relating to similar assets. By definition, there are never strictly speaking absolutely identical properties since each is unique at the least in terms of its location. However, in practical terms, it is possible to identify the main characteristics which contribute to determining the attractiveness of a property and subsequently its value. The price of a property is always a function of the matching of supply and demand, and will tend to change in line with market trends.

There are also other approaches which fall under this category, including for example the Multiplier Approach. When applied to economic dimensions, multipliers make it possible to determine the value of an asset: nonetheless, the lack of a precise scientific foundation has not limited its development, thanks to the ease and immediacy with which it can be used. Multipliers are generally adopted when determining the value of a given business, rather than a specific real estate asset. As such, the valuation will generally refer to the business's core operations and the characteristics of the property used for it. Cinemas, hotels, golf courses, and fitness centres are just some of the types of assets for which appraisers in practice commonly adopt rules of thumb or market based multipliers. The object of the valuation will therefore be both the property and the business carried on within it (cinema, sports centre, hotel etc.).

[11] This principle remains valid also for owner-occupied properties, since the economic benefit consists in the alternative cost of the property on the market, or the opportunity cost forgone by exploiting the property for personal use.

[12] In many countries this is not the case for residential properties where there is a high percentage of owner-occupied properties.

The Sales Comparison Approach uses data for comparable properties which have been recently sold in order to determine the value of the property. It is possible to estimate the value of a property on the basis of sale prices for comparable properties by applying adjustments which take account of the specific features of each property. The use of this approach involves three steps:

1. selection of comparable properties;
2. normalization of the sale prices for comparable properties;
3. adjustments.

First and foremost it is important to select properties which are comparable to that which is to be valued. It is therefore necessary to analyse, value, and verify the existence of equivalent properties, and to analyse the prices at which they have been sold, taking account of the elements which impinge upon supply and demand. Properties are compared taking account of their physical characteristics (age, quality, state of maintenance etc.) and location. It is necessary that the characteristics of the properties considered to be comparable are as similar as possible to those of the property to be assessed and that the comparable properties have been sold recently (generally during the last three to six months) at normal market conditions:[13] in order to do so at least three or four properties have to be chosen. Prices agreed to in situations resulting from testamentary succession or, normally but not always, from auctions should not be considered since they do not meet the prerequisites of normality.

The second step involves the normalization of the sale price for comparable properties by expressing it in terms of a unit for comparison. For most properties, the unit considered will be the surface area, and hence the calculation will be made with reference to prices per square metre.[14] The unit of measurement considered may differ for certain types of properties, depending upon which unit is generating revenues. The unit of measurement is specific for each different type of property,[15] and can be extracted from the sample of comparable properties analysed. The final value of the property will be obtained by multiplying the average price for the unit of measurement extracted from comparable transactions by the units of the property to be assessed.

The third and last step involves making adjustments, since no two properties will ever be perfectly identical, for example due to differences in age, state of maintenance, orientation, noise levels, and accessibility. After collecting all information relating to the property and the market, it will be necessary to verify the differences between the information obtained and the individual property to be assessed. For this reason the criterion will never apply to properties which, by their nature, are effectively unique from all points of view. Even for properties which may appear *ex ante* to be entirely homogeneous, such as each half of a semi-detached house, there may be differences in terms of orientation or noise (for example, one half of the house may be closer to a road). This step is important because it could call into question the choice of comparable properties.

[13] Under conditions which meet the requirements defined above in order to determine the OMV.

[14] Or per square foot, according to the unit of measurement adopted in a specific country.

[15] Each different type of property has its own unit of measurement: price per square metre for residential and office, price per door or per window for high street retail, price per parking space or berth, price per seat in cinemas, or price per room in hotels etc.

Practitioners often consider that two properties are not comparable if it is necessary to make an adjustment in excess of 20% of the price per unit. If this is the case, it will be necessary to select other properties which are genuinely comparable to the property to be valued or using a different methodology.

2.4.3.2 Cost methodology The Cost methodology is based on the principle that in most cases an investor will not be willing to pay a price for a property which is higher than the land on which it is built plus the cost of rebuilding it after accounting for any depreciation. The Cost Approach is therefore based on a principle of replacement. In effect, the potential buyer will choose between purchasing an existing property and building a property with the same characteristics on a similar plot of land, taking account of the level of depreciation of the existing property. The sale price may differ from the equilibrium value of the replacement cost if for example some of the characteristics of the property do not match up with what the buyer is looking for or if the buyer wishes to take possession of it immediately. Under the former scenario the value will be lower, whereas in the latter it will be higher.

Calculating the value of a property is equivalent to looking for the correct value of the property originally built to which the value of the land is added. Under this approach, the first cost calculated is that of rebuilding the property as new. Although this can be done in various ways, the most frequently adopted solution is to value the surface area according to a construction cost per square metre or cubic metre. Estimating the value of a building by multiplying the number of square metres by the average construction cost per square metre is a relatively simple operation. However, the various constituent parts of a property do not have the same cost per square metre: in order to avoid excessive distortions, it is possible to break up the total number of square metres into the main elements (garage, residential units, commercial units etc.) and multiply the surface area of each component by the relevant construction cost.[16]

Once the cost of reconstruction as new has been estimated, in order to determine the value of a property it is appropriate to quantify the property's loss in value compared to the cost of rebuilding as new. This value loss may occur for three main reasons:

1. wear and tear;
2. functional obsolescence;
3. economic obsolescence.

The level of wear and tear of the property depends upon its age, building quality, level of ordinary and extraordinary maintenance, as well as its use. This last factor is for example dependent upon the title according to which the property is used: all other things being equal, an owner-occupied property is indeed usually in better condition than a rented property. The location of a property may also have an impact upon the extent of the level of wear and tear of a property, for example due to factors such as exposure to the elements and pollution.

A loss in value may also be caused by functional obsolescence, that is the failure of the property to meet up with the functional requirements of contemporary buildings, taking account of construction standards and market requirements. There are several examples of this,

[16] The cost calculation is often estimated in a very detailed manner, including cost for single parts of the building.

such as in residential units the number of bathrooms, the presence of a lift, the type of heating, the quality of insulation and soundproofing for the building and in offices the connection to new computer technologies, energy efficiency, and green building standards.[17] All of these elements have changed significantly over time, and are also reflected under current legislation. For example, a flat without a lift or with an antiquated heating system will be functionally obsolescent.

Economic obsolescence is perhaps the hardest element to quantify. Here it is necessary to assess whether there is real demand for this type of property or whether there is no demand for some of its characteristics, including even its current intended use. This class should only include factors which can impinge upon the building's value, since any negative impact on the value of the land will already appear in the calculation of its value. A detached house with luxury fittings for which there is no demand illustrates the fact that a property's value does not vary in proportion with its cost. Even though some very luxurious fittings, such as gold-plated taps, have a very high installation cost, they will only be of value if there is demand for this type of characteristic. Hotels located in a region which no longer attracts clients enable one to sketch out the impact of economic obsolescence, which may have an effect on the value of the building without necessarily affecting the value of the land. If it is possible to transform the building in which the hotel is located to other uses, for example residential units, it may be the case that the value of the land does not suffer. On the other hand, the value of the building will fall by the amount necessary in order to adapt it to the new use, in addition to other depreciating factors. In any case, the boundary where the impact on value is to be measured is rather difficult to determine.

The measurement of the degree of depreciation of a property, and hence the corresponding amount, is often relatively difficult, especially if the building is particularly old. The simplest way of measuring depreciation starts from an annual depreciation rate, for example 2% per annum if the lifetime of the building is estimated to be 50 years. It is also possible to consider a non-linear depreciation of the property by choosing lower rates for the initial years during which the property is used and subsequently moving to higher rates. Whilst these solutions are simple, they are often unsatisfactory. In fact, it may be more appropriate to consider the useful life (and hence the rate of depreciation) of each constituent part of a building.

Alternatively, rather than attempting to determine the useful life of an old property or of each constituent part in order to calculate a depreciation coefficient, an estimate may be made of the cost of refurbishment necessary in order to ensure that the property has a useful life that is comparable to a new property. The renovation cost will then be deducted from the cost of reconstruction as new in order to obtain the value of the renovated property.

The estimated value of the property is obtained by adding the value of the land to the corrected construction cost. The value of the land may be determined using information relating to the recent sale of plots located within a comparable area, according to the comparison approach.

When valuing greenfields as well as brownfields (i.e. abandoned buildings), the residual value criterion is often used, which involves identifying the highest and best use of an area, taking account of applicable local planning regulations. From an economic point of view,

[17] On green buildings market values please see Morri and Soffietti (2013).

the best possible use of land is often a property which generates the highest possible rental income or sale prices. This means that first of all one must choose the type of building and the floor area ratio which make it possible to achieve this objective. Secondly, an estimate will be made of the price for which the property may be sold on the market, from which the construction cost for that type of building will be subtracted. The calculation will also have to take account of the profit which the developer wishes to make on the operation, depending upon the time and risk involved as well as the financial costs, thereby obtaining the maximum amount which he will be willing to pay for the land. The application of this methodology may entail the simple summation of costs and revenues, or it may require the discounting of projected cash flows in a manner similar to the approach described in the following paragraph.

2.4.3.3 Income methodologies Income methodologies seek to determine the value of a property by estimating its capacity to generate economic benefits during its life. The reference to income and cash flows results from the fact that similar methodologies can be and in fact are, applied to all other asset classes.[18] These approaches are premised on the fundamental assumption that a rational buyer will not be willing to pay a price which is higher than the present value of the benefits which the asset will be able to produce in its lifetime. This principle, which operates alongside the principles of equilibrium and replacement on which the Comparison Approach and Cost Approach are based, implicitly assumes that this price may not be higher than the cost of buying similar properties with the same level of utility.

The Income methodologies make it possible to express the value of a property as a function of the same factors which determine the value of any asset: projected income and the risk associated with securing this income. In fact, according to these approaches, the value of an asset is dependent upon the future economic benefits which it will be able to produce over the course of its lifetime.

The practice and theory of real estate appraisal are dedicating increasing attention to the Income methodologies, which are well adapted to valuations for properties which generate a regular income flow (consider income producing properties such as offices, shopping centres, hotels etc.). The price of the space (rent) is dependent upon supply and demand, and it is possible to ascertain it from the market analysis of rent levels recently agreed under new leases (annual rent per square metre or square foot).

The value also depends upon the possibility of selling the property in cases where it is destined exclusively for a specific function and in which there is a low level of fungibility. Here, the surface area is not the main driver of value, and hence a different criterion has to be used in order to estimate the value of that space. In cases involving a fungible property (i.e. office, logistic), it can simply be asserted that the future cash benefits will result from the sale or rental payments; on the other hand, for properties with a specific a business operating within them (such as hotels or shopping centres) it will be important to determine the maximum sustainable rent.

[18] The other criteria introduced in the previous paragraphs are specific to real estate assets, whilst the income approaches are entirely equivalent to the techniques used in corporate valuation and for any other asset class (e.g. shares and bonds).

The Income methodologies involve the application of two different criteria which are based on different ways of measuring projected income, with different assumptions regarding the relationship between income and value:

- the Direct Capitalization Approach is used in order to convert the forecast for expected income over one single year into an indication of value, whereby the estimated income is divided by an appropriate capitalization rate (one income and one rate);
- the Financial Approach (based on DCF analysis models) is used in order to convert all future economic benefits into a present value, discounting all expected benefits (cash flows) at an appropriate discounting rate (expected total return).

Whilst the two criteria follow the same principles, there are significant methodological differences between them and the results may also be different. In particular, the differences between the Direct Capitalization Approach and the Financial Approach relate to the following points:

- the definition of economic benefit which the asset is able to produce:
  - the Direct Capitalization Approach is based on an accounting measure of income (revenues);
  - the Financial Approach identifies a cash flow (which may only occasionally coincide with the equivalent revenues);
- the time horizon considered:
  - the Direct Capitalization Approach determines the value of an asset through an annual income and a capitalization rate related to this single reference period;
  - the Financial Approach works with a multi-period process through the analysis on a time horizon extended to more than one period;
- the calculation algorithm:
  - the Direct Capitalization Approach is based on the capitalization of a future benefit, transforming a current indicator of income into an indicator of value;
  - the Financial Approach uses the discounting principle in order to anticipate future cash flows.

The Income methodologies are based on two different rates:

1. the capitalization rate, which compares the value of an asset with one single-period income (Direct Capitalization Approach);
2. the discount rate, which is used to discount the cash flows generated by an asset and which represents the total return required by the market for an investment with the same level of risk (Financial Approach).

Both rates are expected measures of returns:

1. the capitalization rate is the expected yield, that is a measure of income return only (yield equal to income divided by price or OMV);
2. the discount rate is the expected internal rate of return, that is a measure of total return (including both income and capital gain returns).

2.4.3.4 Choosing the correct approach to valuation Real estate valuation is a fundamental problem when disbursing loans and, in order to be reliable, it is necessary that the approach used corresponds to the purpose of the valuation and the type of asset considered.

The Comparison methodologies usually predominate in the valuation of residential properties since it is easier to obtain comparable data from the ownership market than from the rental market. Moreover, even though they may differ from one another, at times significantly, residential properties are nonetheless more homogeneous in nature, and in many countries, being a prevalence of owner-occupied properties, their value is less affected by lease agreement conditions.

Conversely, for commercial properties the Income methodologies prevail, precisely due to the relative infrequency of transactions and the highly heterogeneous nature of properties; cash flows and yields are more homogenous than physical characteristics. Consider the case of shopping centres: the number of transactions within a given geographical market may even be nil over a certain period of time, which means that it will be necessary to refer to properties sold in other similar markets in order to obtain an indication of the relative yield. Moreover, the value of a shopping centre, as well as that of all properties in which the activity carried on inside has a direct impact on their economic value, is only indirectly dependent upon the surface area of the property. In this specific case, the shops' capacity to generate revenues is the key element in determining the rent, and is dependent upon factors such as the merchandising mix, the presence of anchor tenants, the overall quality of the project, and its location.

In addition, the Financial Approach appears to be the most complete for commercial properties, since it requires a consideration of all parameters necessary in order to determine the projected cash flows. This criterion has developed significantly over recent years, above all within sophisticated approaches which make it possible to measure the value's sensitivity to changes in different parameters. It therefore amounts to a risk management instrument, which is particularly precious and meets with the increasingly stringent legal requirements of some institutional investors. This approach is particularly suited also to the valuation of income generating residential properties as blocks of apartments and residences. The Income methodologies are increasingly establishing themselves in more mature markets in which the separation between owners (predominantly institutional investors) and users (both companies and families) is increasing: this therefore leads to the creation of a very significant rental market which makes it possible to determine the income generating capacity of properties in more detail.

Finally, the Cost Approach is the only possible way of valuing atypical assets, especially those for which there is no rental market and no sale market. In this case the Cost Approach will be useful, although it must be remembered that the value of this type of property will inevitably be dependent upon supply and demand dynamics which are reduced (or indeed entirely absent in cases involving some infrastructure non-producing cash flow). Finally, this approach makes it possible to determine the value of an area on a residual basis.

The appraiser should base his assessment on the different approaches when estimating the value of a property. Accordingly, for residential properties, it may be possible for example to pair up a comparison approach with an estimate made on the basis of the Direct Capitalization Approach. For commercial properties, on the other hand, the comparison approach may be used in conjunction with the Financial Approach. It is appropriate to insist on the need to analyse the differences in value resulting from the adoption of the different approaches. An analysis of these differences should prevail over a simple calculation of the average of the values obtained. In fact, it will make it possible to try to understand the reasons for the differences thus ensuring that the values allocated to the various different parameters for the valuation are plausible.

2.4.4 Due Diligence Process

The technical due diligence and the subsequent property valuation must be followed by a wider due diligence process, the purpose of which is to:

(a) carry out an administrative check, ascertaining whether the necessary commercial permits (if required) in order to manage real estate assets with rent agreements or going concern leases have been obtained, or verifying the status of the application to obtain those permits;
(b) review the compliance with the town planning requirements and building regulations, including consultation of the general city plan, building regulations and any town planning accords and/or plans, as well as an analysis of the relevant permits (building permit and works building notice); in several countries the sale of a property is prohibited under the town planning and building law if it has been built without the necessary consent;
(c) review mortgage and land registry documents in order to ensure that the documentation filed with the land registry corresponds to the property in its actual state;
(d) carry out a structural and technical plants check on the building and its facilities as well as of the state of maintenance;
(e) carry out an environmental check to ascertain whether there are any sources of pollution, including in the land, and hazardous material (e.g. asbestos, fuel tanks);
(f) check the energy certification documents and certificates.

2.4.5 Legal Due Diligence

The legal due diligence comprises the following stages:

1. verification of full ownership of the property to be mortgaged by the party offering the security;
2. verification that the property is not subject to any other securities or charges, or any other formality specified in the public land registers which may be otherwise detrimental to the mortgage security;
3. verification of the legal capacity of all individuals involved in the loan agreement and in the issue of the relative guarantees;
4. verification of the lease agreements in which the claims are granted/assigned/pledged to the lender;
5. for some transactions (for example in case of the acquisition of the property by way of a share deal), a corporate and tax due diligence are also requested.

Depending upon the legislative arrangements, these stages of the review will generally be conducted by the solicitor or barrister responsible for the drafting of the loan agreement or for authenticating the signatures, who will then draw up the reports attesting ownership of the properties provided as security and the fact that they are free from other charges.

CHAPTER 3

Loan Agreement

There are no standard terms and conditions for commercial structured real estate financing agreements, and each agreement is negotiated individually without any predefined standard form contracts. Moreover, the rules applicable to loan agreements differ from country to country, as more closely detailed in Part Two of the book.

The following rules and clauses are those which frequently appear in structured real estate loan agreements:

- parties[1] to the transaction (bank, borrower company, and guarantors, if applicable);
- object and purpose of the loan;[2]
- conditions precedent;
- amount of the loan;
- loan repayment schedule;
- allocation of the loan;
- interest rate;
- interest rate risk hedging;
- fees charged by the bank;
- frequency and procedures of drawdown;
- events of default (i.e. situations which will end the agreement or establish entitlement to terminate or withdraw);
- collateral;
- insurance;
- representations and warranties by the borrower;
- contractual covenants;
- duties to provide information;
- costs, taxes, and ancillary charges;
- clauses relating to assignment/transfer/syndication;[3]
- choice of law and jurisdiction.

[1] The loan agreement must be concluded by individuals representing these parties, duly vested with the power to sign, enter into contractual obligations, and provide collateral on behalf of the parties.

[2] For example, in order to purchase a single property, a portfolio of properties, or to fund a development project.

[3] Where provided for under the relevant legislation.

The contents of the aforementioned contractual clauses will differ depending upon the relevant legislation in force in the country in which the agreement is concluded. In common law countries, all matters are regulated under the loan agreement as it is the only source of rules governing the relationship between the parties (bank and borrower). In civil law countries on the other hand, contracts should be more concise as it is possible to refer to statutory provisions as a source of regulation for the contractual relationship, which means that the sources of law applicable to the relationship are the contract and the reference legislation, which can often not be set aside in the contract.

Having clarified this aspect, the following sections will describe the most significant contractual clauses which are common to the various legal systems, while the clauses specific to each country will be described in Part Two.

3.1 OBJECT AND PURPOSE OF THE LOAN

The clause relating to the object is generally drawn up as follows.

> *Subject to the terms of this agreement the Lender makes available to the Borrower a medium term loan facility for the amount up to the commitment.*

A structured loan sometimes specifies the intended use of the loan and consequently, in addition to the obligation to repay the loan and to pay interest, places the borrower under a further obligation to allocate the amounts received in order to fulfil a specific purpose. For example, agreements relating to the provision of credit in the construction sector will contain a clause requiring the borrower to allocate the amount to the construction of the property.

> *Purpose: The Loans may only be used for financing the construction cost of the properties.*

3.2 CONDITIONS PRECEDENT

The effectiveness of the loan agreement could be conditional upon the lender having received, by no later than the date of execution of the contract, a set of documents in form and substance satisfactory to him.

The most common conditions precedent to effectiveness and to initial funding are the following:

- *Constitution*: a certified true copy of the constitutional documents of the borrower entity.
- *Certificates*: a good standing certificate of the borrower entity issued by the competent companies register, dated not earlier than a few calendar days[4] before the first funding date and including a non-insolvency statement.
- *Legal opinions*:
  - a legal opinion from an approved legal counsel to the borrower, addressed to the lender which states the borrower's due incorporation, power, and capacity to enter into the loan agreement to which the borrower is a party and the fact that the execution and performance of the loan do not conflict with the constitutional documents of the borrower;

[4] A five day term is quite common.

- a legal opinion addressed to the lender in respect of each guarantor's power (if present) and capacity to enter into any guarantees.

The lender is not obliged to provide any further funding tranche until some conditions are fulfilled to his satisfaction, the most common of which are the following:

- *Funding Notice*: the borrower has delivered a funding notice requesting the funding portion.
- *Commitment*: the principal outstanding after providing the funding portion will not be greater than the commitment amount.
- *No default clause*: no default or event of default has occurred or will result from the funding portion being provided.
- *Authorizations*: all corporate authorizations which are required to be obtained by the borrower to deliver the funding notice have been obtained.

Each certified document given to the lender by the borrower must be certified to be a true copy of the original document by a director of the borrower, no more than a few days before the date on which it is provided.

Usually no funding notice may be given, if at any time the borrower has already required the provision of a certain defined funding portion (regardless of the amount of any undrawn commitment).

3.3 AMOUNT OF THE LOAN

The amount loaned depends mainly on three variables:

- the project which the loan is intended to fund, and hence the value and/or construction cost of the property and its profitability;
- the collateral provided;
- the borrower's creditworthiness.

This amount may be granted in one single line of credit, or alternatively through secondary lines such as for example a loan to cover the costs resulting from the acquisition.

For loans intended to pay for the construction costs of a property, the amount will be specified in the agreement, and will be drawn down in line with the state of progression of work (stating the maximum amount of drawdown, subject to the conclusion of supplementary agreements). The amount which is actually drawn down will depend upon the covenants stipulated in the agreement (including in particular LTC, LTV, DSCR, and ICR), as in the following example of clause.

> *The lenders make available to the borrowers a term loan facility in an aggregate amount equal to the lower of:*
> - the total commitments;
> - 70% of the cost;
> - 50% of the value of the properties (as determined from the initial valuation).

The facility can also be drawn down in different tranches when the project requires cash (i.e. development project). Moreover, in countries where a tax on financing is applied,[5] tranches allow deferral of the point in time when the tax is payable.

[5] Please refer to Part Two for details on different countries.

3.4 INTEREST RATES

The interest rates specified in a loan agreement include the standard rate (base rate plus margin) and the default rate.[6]

Loan agreements may be subdivided into two major classes[7] with regard to the standard interest rate: fixed-rate loans and floating-rate[8] loans.

The type of interest rate and the spread will be negotiated between the parties. It is clear that the more risky the operation, the higher the spread will be: this element must remunerate amongst other things the bank's intermediation services and absorb the credit risk[9] component.

The actual interest rate agreed upon will track a reference rate:

- If a fixed rate is chosen, the IRS[10] (Interest Rate Swap) rate is often used (in Figure 3.2 an example of EURIRS rates is presented)
- If a floating rate is chosen, in the Euro countries the reference rate will be the EURIBOR (Euro Interbank Offered Rate), whilst for other major currencies the LIBOR[11] (London Interbank Offered Rate) is used (in Figure 3.1 an example of EURIBOR rates trend is presented).

For fixed-rate loans, the interest rate remains the same for the full term of the loan (or for a pre-set period), and the precise amount of the instalments due is known from the outset.[12]

This type of loan, under which the borrower is not exposed to interest rate rises, does however entail two negative aspects: a greater potential cost (in the event of a fall in interest rates) and generally an interest rate which is higher than a floating rate on a loan with equivalent characteristics.

For floating-rate loans, the interest rate is not set at the start for the full term of the loan, but is regularly reviewed in line with changes in the reference rate (EURIBOR or LIBOR from 1 to 12 months). A floating rate will offer a lower initial cost, but will entail full exposure by the borrower to the interest rate risk.[13]

If the borrower delays any payment a default rate is applied. It is usually determined as the sum of the interest rate and a negotiated overdue margin and calculated on the number of days of delay in the payment. If, for example, there is a 15 day delay on the payment of a €1,000 loan instalment, and the default rate is set at 7%, the amount due is €2.88 (€1,000 * 15 days / 365 days * 7%).

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[6] Also referred to as the overdue rate.

[7] Especially for residential mortgages, there are numerous other variants, such as for example mixed loans providing for both fixed and floating rates (where changes may be made between one and the other at set intervals) or contracts providing for a variable rate subject to a cap, see paragraph 3.5 for further details.

[8] Also called the variable rate.

[9] On credit risk please see also Altman et al. (2004).

[10] The Interest Rate Swap is conventionally calculated setting the floating side (normally at Euribor or Libor) and then quoting the fixed rate that is payable for that maturity.

[11] Benchmark rates of the money market at which interbank term deposits are offered by one prime bank to another prime bank for different periods of time. Loans for property are normally linked to this rate and expressed as a margin over benchmarks, e.g. 50 basis points over Libor or Euribor (one basis point equates to one hundredth of a percentage point).

[12] For further details on instalments dynamics please see Chapter 4.

[13] Banks usually require hedging on interest rate risk as detailed in paragraph 3.5.

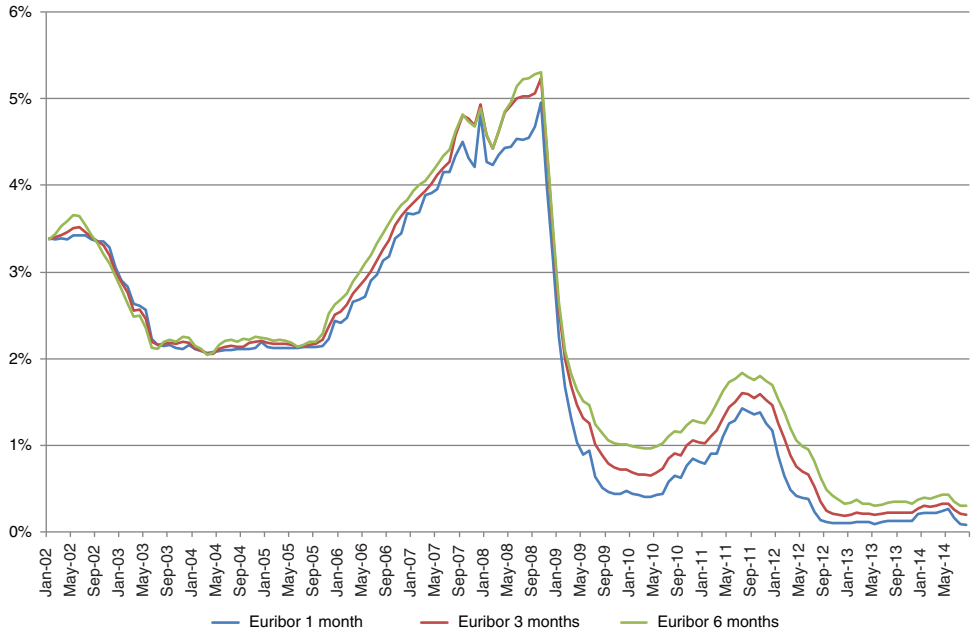


FIGURE 3.1 EURIBOR rates trend[14]

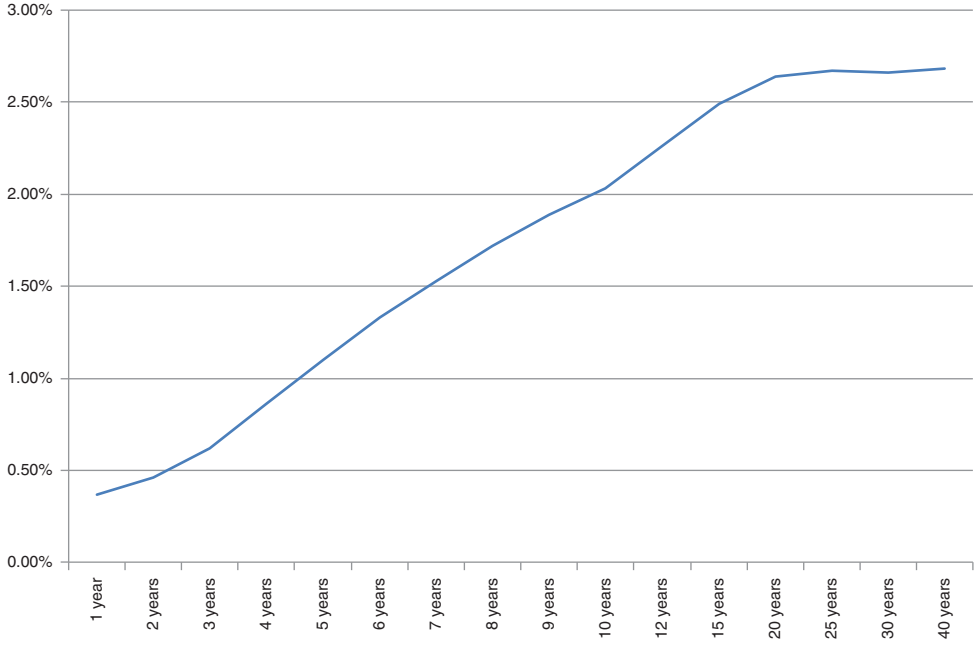


FIGURE 3.2 EURIRS rates on different maturities on a fixed date[15]

[14] Data source Thomson Financial Datastream.
[15] Data source Thomson Financial Datastream. Data referred to 8th July 2014.

3.5 INTEREST RATE RISK HEDGING

In structured real estate loans, cash flows from the project (e.g. rental payments and/or amounts received from the sale of properties financed) are used in order to repay the loan instalments. It is therefore necessary to strike a balance between incoming cash payments (rent and/or sales) and outlays (instalments plus costs) for the real estate project financed. An increase in the instalment following a rise in the floating rate could lead to a potential default on the deal. For this reason, if a fixed interest rate is not chosen, it will be necessary to hedge against the interest rate risk. The various forms of hedging[16] which are considered are principally Caps, Collars, and Swaps.

3.5.1 Interest Rate Cap

An Interest Rate Cap, or simply a Cap, is an instrument for hedging against the risk of an interest rate rise; the borrower will continue to pay the floating rate whilst he will also acquire (generally from a bank, though not necessary the lender) for a fee the right to apply an Interest Rate Cap. If the interest rate exceeds the agreed Cap, a third party defined as the counterparty will pay the bank the difference between the Interest Rate Cap and the actual interest rate at the time each instalment falls due.[17]

It is clear that an Interest Rate Cap will be chosen in order to ensure that debt servicing[18] remains at sustainable levels, and hence that operating cash flows (e.g. rental payments) and financial covenants (e.g. DSCR and ICR) will be calculated on the basis of the level of Cap chosen.

The lower the Interest Rate Cap, the higher the fee the borrower will be required to pay to the counterparty (and vice versa).

3.5.2 Collar

The Interest Rate Cap cost may be reduced or eliminated by using a Collar, which by contrast enables a kind of uniformity to be imposed on the instalments due. In practice, a Collar is comprised of a combination of a Cap and a Floor (the latter being the exact opposite of a Cap, in that it sets a minimum interest rate rather than a maximum rate), thereby creating a range within which the interest rate may vary. A transaction incorporating a Collar will entail the purchase of a Cap and the sale of a Floor. If the interest rate exceeds the Cap, the difference will be paid by the counterparty, whilst if it falls below the Floor, the difference will be paid to the counterparty. Figure 3.3 shows an example of hedging using Caps and Collars.

3.5.3 Interest Rate Swap

Another form of interest rate hedging may be obtained by procuring an Interest Rate Swap (IRS). Under such contracts the parties undertake to pay or collect at pre-determined dates amounts calculated on the basis of the differences between various interest rates. In practice,

[16] See Hull (2012) and Fabozzi et al. (2007).

[17] For a numeric example see paragraph 4.4.3 Loan with Interest Rate Caps.

[18] The whole amount due in the period, as sum of interest and principal.

Time		**1**	**2**	**3**	**4**	**5**	**6**	**7**
Spread	a	2%	2%	2%	2%	2%	2%	2%
Cap	b	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%
Floor	c	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Eurirs	d	4%	4%	4%	4%	4%	4%	4%
Euribor	e	2.5%	2.75%	3.25%	4.75%	4%	2.25%	0.75%
Difference	f = d - e	1.5%	1.25%	0.75%	–0.75%	0%	1.75%	3.25%
Fixed rate	**g**	**6%**	**6%**	**6%**	**6%**	**6%**	**6%**	**6%**
Floating rate	h = a + e	4.5%	4.75%	5.25%	6.75%	6%	4.25%	2.75%
Cap	i = min (b; h)	4.5%	4.75%	5.25%	6.5%	6%	4.25%	2.75%
Floor	j = max (c; h)	4.5%	4.75%	5.25%	6.75%	6%	4.25%	3.5%
Collar	k = max (if (b>h; h; b); c)	4.5%	4.75%	5.25%	6.5%	6%	4.25%	3.5%
Fixed - Floating	*l = g - h*	*1.5%*	*1.25%*	*0.75%*	*–0.75%*	*0%*	*1.75%*	*3.25%*
Fixed - Cap	*m = g - i*	*1.5%*	*1.25%*	*0.75%*	*–0.5%*	*0%*	*1.75%*	*3.25%*
Fixed - Floor	*n = g - j*	*1.5%*	*1.25%*	*0.75%*	*–0.75%*	*0%*	*1.75%*	*2.5%*
Fixed - Collar	*o = g - k*	*1.5%*	*1.25%*	*0.75%*	*–0.5%*	*0%*	*1.75%*	*2.5%*

FIGURE 3.3 Hedging using Caps and Collars

a Swap may be regarded as an exchange of interest rate payments between two parties which are seeking hedge against changes in the interest rate.

A Swap involves an exchange of interest payments calculated on a certain agreed reference principal (notional) for a predetermined period of time until the term of the agreement: the borrower will pay a fixed level of interest to the counterparty, whilst the latter will pay a floating rate, and the reference principal under the agreement is at no time exchanged between the contracting parties.

The contracting parties will exchange interest rate payments based on a fixed rate and a floating rate, whereby the fixed rate is due to the seller (usually a bank) and the floating rate is due to the buyer (borrower); the difference between the two rates will establish the amount payable and the party to which it will be due. As long as the floating rate does not exceed the fixed rate agreed upon during the term of the contract, the counterparty bank will have a cash inflow; however, if the floating rate (e.g. EURIBOR) exceeds the fixed rate agreed upon, the counterparty will have a cash outflow which will be used to pay the interest rate on the loan.

In contrast to fixed-rate loan agreements, interest rate Swap agreements are concluded separately with a counterparty which is not necessarily the lending bank; in such cases, the payments (cash outflows for the counterparty and cash inflows for the borrower) must be clearly earmarked for the loan by an express commitment or assignment. Moreover, in some cases, these contracts may be transferred from one loan agreement to another and, in the event that the loan is redeemed, may result in entitlement or liability to payments on the part of the borrower, depending upon the level of the interest rate at the time of redemption.

EXAMPLE 3.1

Given a floating-rate loan with interest tracking the EURIBOR 3 month rate, a 5 year IRS is bought at a fixed rate. The term of the operation extends to 5 periods, following which the variable exchange rate will apply once again.

Under the terms of the agreement entered into prior to drawdown, the borrower will pay to the bank (IRS agreement counterpart) the fixed-rate interest payments (equal to 2.5%) at each maturity date and will receive the floating-rate interest payments, calculated on the basis of the EURIBOR 3 month fixing.

In the example in Figure 3.4, the borrower will use the interest payments received in order to pay interest on the loan where the EURIBOR 3 months exceeds the IRS.

Notional	**€ 10,000,000**			
Period (A)	**Floating-rate (B)**	**Fixed-rate(C)**	**Difference % (B – C)**	**Net flow**
1°	2.2%	2.5%	(2.2% – 2.5%) = –0.3%	–€ 30,000
2°	2.4%	2.5%	(2.4% – 2.5%) = –0.1%	–€ 10,000
3°	2.6%	2.5%	(2.6% – 2.5%) = 0.1%	€ 10,000
4°	2.5%	2.5%	(2.5% – 2.5%) = 0%	€ 0
5°	2.7%	2.5%	(2.7% – 2.5%) = 0.2%	€ 20,000

FIGURE 3.4 Effects of hedging with a Swap

An Interest Rate Swap contract provides for the conclusion of numerous agreements between the seller of the IRS (the bank) and the buyer (the borrower):

- the reference amount on which the interest rate flows exchanged is to be calculated (notional amount);
- the currency in which the reference amount is denominated;
- the fixed rate, also known as the IRS rate, representing the price of the Swap.

The defined level of the interest rate is the principal element of the agreement, and will depend upon numerous factors, such as:

- the term of the agreement;
- the parameter chosen as a reference for the floating rate (generally the 3 or 6 month EURIBOR or the LIBOR for non-Euro transactions) and any other element characterizing the transaction;
- the fixing date on which the floating rate is set;[19]
- the frequency[20] of payments at the fixed or floating rate when interest payments are due (annually, quarterly, or every six months).

A simple example may assist in clarifying the IRS mechanism.

Alongside the simple structure presented, it is possible to use Swap agreements based on the hedging requirements for the specific loan. In particular, an amortizing Swap enables the

[19] In general this falls two working days prior to the start of each period.
[20] The same maturity dates are often chosen for the two rates.

notional principal to be reduced in line with the term of the loan. For example, the parties may agree for a particular loan that the interest rate difference is calculated on a different notional amount at the end of each period, which is reduced in line with the repayment plan for the loan which it is intended to cover.

A Swap may be combined with a Swaption, an option granting the buyer the right, but not the obligation, to conclude a Swap agreement on a given future date according to terms specified in advance (term and reference rates).

The combination of a Swap and a cancellation option will create a cancellable Swap, which entitles one of the counterparties to cancel the IRS at a certain date without any requirement to pay penalties.

Finally, rather than concluding a hedging agreement or choosing a fixed rate of interest, the parties may incorporate a "*Drop Lock*" clause into the loan agreement, namely a clause under which the borrower provides the bank with an irrevocable mandate to convert the floating rate into a fixed rate when the IRS reaches a specific agreed threshold.

EXAMPLE 3.2

If the contractual rate tied to the EURIBOR is 1%, the IRS at the time the agreement is concluded is 3%, and an IRS threshold rate of 4% is set (Drop Lock level), when the IRS rate reaches 4% the bank must immediately convert the floating rate into a fixed rate in order to ensure that any further increases do not result in any liability on its part; the IRS threshold of 4% therefore has the goal of protecting the bank if further rate rises are expected. Since they are irreversible, such clauses often give rise to disputes.

3.6 LOAN ALLOCATION

Loans relating to property portfolios which provide for redemption of the loan through the sale of individual properties will allocate the debt to individual properties in an Allocated Loan Amount (ALA) table. This allocation is fundamental since, if the borrower sells one of the properties, but no provision has been made for the transfer of the debt to the buyer, the seller will be required to repay an amount equal to a percentage (which is generally greater than 100% and is defined as the release factor or release price) of the debt allocated to the property mortgaged which has been sold as stated in a table agreed upon between the parties and appended to the agreement.

This mechanism is used in order to reduce the risk for the lender since the reduction in the debt is more than proportional to the reduction in the value of properties provided as collateral: in this way, even if the "best properties"[21] are the first to be sold, the bank's effective exposure will be reduced by a proportion in excess of the properties sold (in order to avoid a situation in which the bank has a residual loan with the same LTV, but which is guaranteed by properties which are vacant and/or difficult to market). A simple example is presented to explain ALA.

[21] There are no good or bad properties, there are only properties correctly priced or not. "Best properties" are usually those undervalued, so easier to sell compared to "Worst properties" whose estimated value could be higher than the correct OMV.

EXAMPLE 3.3

A lender finances a portfolio made up of 10 properties of identical value totalling €1,000 with a loan of €600 (LTV 60%); an ALA of €60 will be allocated to each individual property with a release factor of, for example, 135%. This means that, upon each sale, the bank will have to be repaid 135% of €60, e.g. €81.

It will therefore be necessary to sell eight properties in order to entirely repay the loan, which means that with each sale, the LTV ratio (representing the risk of the deal for the lender) falls faster than the value of unsold properties. In this case after five properties have been sold, €405 will have been repaid, leaving an outstanding debt of €195 against a residual value of €500, thus reducing LTV to 39%. Figure 3.5 shows the Allocated Loan Amount and the release factor effect on the loan.

Properties	10
Single property value	€ 100
Portfolio value	€ 1,000
LTV	60%
Portfolio financed amount	€ 600
ALA per property	€ 60
Release factor %	135%
Release factor	€ 81

Disposals	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Portfolio value BoP	€ 1,000	€ 1,000	€ 900	€ 800	€ 700	€ 600	€ 500	€ 400	€ 300	€ 200	€ 100
Sale amount		€ 100	€ 100	€ 100	€ 100	€ 100	€ 100	€ 100	€ 100	€ 100	€ 100
Loan Balance BoP	€ 600	€ 600	€ 519	€ 438	€ 357	€ 276	€ 195	€ 114	€ 33	€ 0	€ 0
Principal repaid		€ 81	€ 81	€ 81	€ 81	€ 81	€ 81	€ 81	€ 33	€ 0	€ 0
Loan Balance EoP	€ 600	€ 519	€ 438	€ 357	€ 276	€ 195	€ 114	€ 33	€ 0	€ 0	€ 0
Portfolio value EoP	€ 1,000	€ 900	€ 800	€ 700	€ 600	€ 500	€ 400	€ 300	€ 200	€ 100	€ 0
LTV	*60%*	*58%*	*55%*	*51%*	*46%*	*39%*	*29%*	*11%*			

FIGURE 3.5 Allocated Loan Amount (ALA) table

3.7 LOAN REPAYMENT SCHEDULE

In general, this clause sets out the repayment schedule for the loan and the regularity (monthly, quarterly, half-yearly, or annually). Depending upon the specific contractual terms and the object of the loan agreement, the parties may choose between a range of mandatory repayment procedures that are illustrated in Chapter 4. Some of the most common are:

1. bullet payments;
2. interest-only repayment plans (semi-bullet);
3. balloon payments;
4. fixed repayment plans.

Repayment of the amount borrowed may be made either in advance by the borrower in one single instalment, or alternatively the borrower or the lender may request that advance payment may be made if certain prerequisites are met (e.g. a change of control of the borrower, change of the sponsors, change of the tenants, disposal of the property).

The borrower must repay the outstanding amount of the loan borrowed in full on the final maturity date together with all other amounts then due or outstanding from that borrower under the finance documents.

As stated in this example of a clause, prepayments could be mandatory or voluntary.

1. Mandatory prepayment – disposal of a property:
   (a) The borrower must, on the disposal of the property, prepay the loans in full.
   (b) Any prepayment under this clause must be made on the date on which the disposal becomes effective or (if earlier) the date on which the relevant proceeds are received by the borrower.

2. Voluntary prepayment and cancellation:
   (a) The borrower may, by giving the lender not less than five business days' prior notice, prepay the whole or any part of the loan pro rata (provided that any prepayment in part must be in a minimum amount of … and an integral multiple of ...).
   (b) The borrower may, by giving not less than five business days' prior notice to the bank, cancel the unutilized amount of the total commitments in whole or in part.

3.8 FEES

Fees represent a further element of the lender's remuneration and a cost for the borrower. The most common are:

- Arrangement Fee;
- Commitment Fee;
- Agency Fee;
- Syndication Fee;
- Prepayment and Cancellation Fee or Early Repayment Fee.

The Arrangement Fee is a form of early remuneration[22] which is paid by the borrower to cover the loan organization activity prior to initial drawdown and is calculated as a percentage of the total loan negotiated.

The Commitment Fee is equivalent to a percentage of the loan agreed upon which is not used, and must be paid to the bank (in general every quarter) from the time when the agreement is concluded. The Commitment Fee shall accrue from the date of this agreement and is payable in arrears on the utilization date.

The Agency and Syndication Fees are paid by the borrower as consideration for arranging the loan and for loan syndication activity. They are generally paid regularly (on an annual basis) or up-front to the arranging bank.

The Early Repayment Fee, which may naturally be waived by the bank, is required in return for the borrower's right to repay the loan in advance: this fee, which is specified under contract, is calculated as a percentage of the principal repaid early. This is a clause which benefits the debtor since under loan agreements, the repayment term for the amount drawn down is deemed to be set in favour of both parties, which means that the debtor may not redeem an obligation to repay the loan over a particular period of time without the bank's approval. Payment of an early redemption fee therefore performs the function of indemnifying the bank, which will be remunerated both for the risks and charges resulting from the redemption of the loan facility, as well as for the fact that it will no longer receive regular remuneration for its financial intermediation (through the loan spread), which essentially amounts to its remuneration for the activity carried out.

The following is an example of common clauses.

- Arrangement Fee
  - The Borrower shall pay to the bank an Arrangement Fee in the amount equal to ….
- Prepayment and Cancellation fee
  - The Borrower must pay to the bank a prepayment and cancellation fee on the date of prepayment of any part of the Loan and on the date of cancellation of any part of the Total Commitments.
  - The amount of the prepayment and cancellation fee is:
    - if the prepayment or cancellation occurs on or before (Date), 2.5% of the amount prepaid or cancelled;
    - if the prepayment or cancellation occurs after (Date) but on or before (Date), 2% of the amount prepaid or cancelled;
    - if the prepayment or cancellation occurs after (Date) or before (Date), 1.5% of the amount prepaid or cancelled;
    - if the prepayment or cancellation occurs after (Date), 0.5% of the amount prepaid or cancelled.
- Commitment Fee
  - The Borrower must pay a Commitment Fee computed at an annual rate of 50% of the margin on the undrawn, uncancelled amount of the lender's commitment.

[22] Normally it is paid at the closing of the financing agreement and for this reason is also referred to as an up-front fee.

Loan Amount	€ 1,000,000		Agency Fee		€ 500	
Arrangement Fee	1.10%		Syndication Fee		€ 700	
Commitment Fee	0.45%		Fixed Interest Rate		5.00%	
Time	**0**	**1**	**2**	**3**	**4**	**5**
Loan Balance BoP		€ 350,000	€ 650,000	€ 850,000	€ 1,000,000	€ 550,000
Committed amount	€ 1,000,000	€ 650,000	€ 350,000	€ 150,000	€ 0	€ 0
Drawdown %	35%	30%	20%	15%		
Drawdown	€ 350,000	€ 300,000	€ 200,000	€ 150,000	€ 0	€ 0
Repayment %					45%	55%
Repayment					€ 450,000	€ 550,000
Loan Balance EoP	€ 350,000	€ 650,000	€ 850,000	€ 1,000,000	€ 550,000	€ 0
Arrangement Fee	€ 11,000	€ 0	€ 0	€ 0	€ 0	€ 0
Commitment Fee	€ 0	€ 2,925	€ 1,575	€ 675	€ 0	€ 0
Agency Fee	€ 500	€ 500	€ 500	€ 500	€ 500	€ 500
Syndication Fee	€ 700	€ 700	€ 700	€ 700	€ 700	€ 700
Interest	€ 0	€ 17,500	€ 32,500	€ 42,500	€ 50,000	€ 27,500
Total cash flow	*€ 337,800*	*€ 278,375*	*€ 164,725*	*€ 105,625*	*–€ 501,200*	*–€ 578,700*
Actual cost	***5.77%***					

FIGURE 3.6 Loan and bank fees

In order to calculate the overall cost of a loan, it is necessary to calculate the IRR on the comprehensive stream of cash flows which takes account not only of drawdown and principal repayments, but also of all the other costs (e.g. financial charges, taxes, and fees).

In Figure 3.6 an example of loan fees is presented.

The actual cost of the financing is calculated using the internal rate of return formula and it also represents the actual return for the lender. Due to the various fees it is higher than the agreed interest rate only.

3.9 FREQUENCY OF DRAWDOWN AND PROCEDURES

The first loan drawdown[23] is generally conditional upon the provision of all guarantees in the forms and according to the priority ranking specified in the agreement and upon completion of legal, tax, and technical due diligences confirming all assumptions made at the time the loan was granted.

Following receipt by the bank, any requests for drawdown are irrevocable and are subject to a range of conditions. In particular, they must specify the drawdown date, which must under all circumstances be later than the date on which the drawdown is requested, and for example must coincide with the date of conclusion of acquisition of the property in relation to which the borrower has requested drawdown.

[23] Also called disbursement.

The request must also specify the amount requested for drawdown in relation to the respective financing line.

3.10 EVENTS OF DEFAULT

The financing agreement contains all provisions that trigger the default of the financing, with the consequence that the lender is entitled to ask for the total repayment of the capital. Some examples of event of default clauses follow.

Each of the events set out in this Clause is an event of default.

- Non-payment
  - A Borrower does not pay on the due date any amount payable pursuant to a Finance Document at the place and in the currency in which it is expressed to be payable unless:
    - its failure to pay is caused by administrative or technical error or a disruption event; and
    - payment is made within three business days of its due date.
- Breach of obligation
  - A Borrower does not comply with any term of:
    - Clause..;
  - a Borrower does not comply with any term of the Finance Documents unless the non-compliance:
    - is capable of remedy; and
    - is remedied within ten days of the earlier of the bank giving notice and the Borrower becoming aware of the non-compliance.
- Misrepresentation
  - A representation made or repeated by the Borrower in any Finance Document or in any document delivered by or on behalf of a Borrower under any Finance Document is incorrect in any material respect when made or deemed to be repeated, unless the circumstances giving rise to the misrepresentation:
    - are capable of remedy; and
    - are remedied within ten days earlier of the Bank giving notice and the Borrower as appropriate, becoming aware of the misrepresentation.
- Cross default
  - Any financial indebtedness of the Borrower is not paid when due nor within any originally applicable grace period.
  - Any financial indebtedness of the Borrower is declared to be or otherwise becomes due and payable prior to its specified maturity as a result of an event of default.
  - Any commitment for any financial indebtedness of the Borrower is cancelled or suspended by a creditor of that Borrower as a result of an event of default.
- Insolvency
  - The Borrower is, or is deemed for the purposes of any law to be, unable to pay its debts as they fall due or insolvent or admits inability to pay its debts as they

fall due, suspends making payments on any of its debts or announces an intention to do so or, by reason of financial difficulties, commences negotiations with its creditors generally with a view to rescheduling any of its indebtedness.
    - A moratorium is declared in respect of any indebtedness of the Borrower.
- Insolvency proceedings
    - Except as provided below, any of the following occurs in respect of the Borrower:
        - any step is taken with a view to a moratorium or a composition, assignment or similar arrangement with any of its creditors;
        - a meeting of its shareholders, directors or other officers is convened for the purpose of considering any resolution for, to petition for or to file documents with a court, its winding-up, administration or dissolution or any such resolution is passed;
        - any person presents a petition, or files documents with a court, for its winding-up, administration or dissolution;
        - an order for its winding-up, administration or dissolution is made;
        - any liquidator, trustee in bankruptcy, judicial custodian, compulsory manager, receiver, administrative receiver, administrator or similar officer is appointed in respect of it or any of its assets;
        - its shareholders, directors or other officers request the appointment of, or give notice of their intention to appoint, a liquidator, trustee in bankruptcy, judicial custodian, compulsory manager, receiver, administrative receiver, administrator or similar officer; or
        - any other analogous step or procedure is taken in any jurisdiction.
- Creditors' process
    - Any expropriation, attachment, sequestration, distress or execution affects any asset or assets of the Borrower having an aggregate value in excess of Euro ... and is not discharged within ... days.
- Unlawfulness and repudiation (Finance Documents)
    - It is or becomes unlawful for the Borrower to perform any of its obligations under the finance documents.
    - Any Finance Document is not effective in accordance with its terms or is alleged by the Borrower to be ineffective in accordance with its terms for any reason.
    - The Borrower repudiates a Finance Document or evidences an intention to repudiate a Finance Document.
- Cessation of business
    - The Borrower ceases or threatens to cease to carry on business other than as a result of a disposal permitted by the Finance Documents.
- Compulsory purchase
    - Any part of a property is compulsorily purchased or the applicable local authority makes an order for the compulsory purchase of all or any part of a property; and
    - In the opinion of the lender (acting reasonably), taking into account the amount and timing of any compensation payable, the compulsory purchase has or will have a material adverse effect.
- Major damage
    - Any part of a property is destroyed or damaged; and

(*continued overleaf*)

- In the opinion of the lender (acting reasonably), taking into account the amount and timing of receipt of the proceeds of insurance effected in accordance with the terms of this agreement, the destruction or damage has or will have a material adverse effect.
- Material adverse change
  - An event or series of events occur which, in the opinion of the lender (acting reasonably) has, or is reasonably likely to have, a material adverse effect.
- Acceleration
  - On and at any time after the occurrence of an event of default which is outstanding the bank may, and shall if so directed by the lender by notice to the Borrower:
    - cancel the total commitments whereupon they shall immediately be cancelled;
    - declare that all or part of the loan, together with accrued interest, and all other amounts accrued or outstanding under the Finance Documents be immediately due and payable, whereupon they shall become immediately due and payable; and/or
    - declare that all or part of the loan be payable on demand, whereupon they shall immediately become payable on demand by the bank on the instructions of the majority lenders.

3.11 PROPERTY INSURANCE

The borrower is responsible for all insurance costs in order to restore the original value of the collateral property (in cases involving partial damage) or to redeem the debt in full in the event that the property provided as collateral is destroyed (for example as the result of fire or explosion). In cases involving leased properties, an insurance policy may also be required which provides partial compensation for losses resulting from the inability to let out a damaged property.

Furthermore, should the value of the collateral fall, due *inter alia* to a general or local fall in property prices as certified by an official surveyor's report based on objective market parameters, the contract will grant the bank a right to require that the collateral be increased accordingly, or the provision of suitable collateral and/or the partial redemption of the loan.

The following is a detailed example of clauses.

INSURANCE COVER

(a) The Borrower undertakes to:

(i) implement and maintain all risks insurance policies in relation to the property for amounts and insurance risks consistent with the best market practice, and in form and substance satisfactory to the Bank (the "Insurance Policies");

(ii) maintain the Insurance Policies with leading insurance companies with adequate experience of the relevant area;

(iii) duly and punctually pay each premium and each further amount due under the Insurance Policies and promptly provide, upon the Agent's written request, copies of receipts or other documentary evidence of such payment;

(iv) refrain from making amendments to any Insurance Policy without the prior consent of the Borrower (on consultation with the Bank) and refrain from acting in any way that may make any Insurance Policy invalid or ineffective;

(v) promptly upon entering into any new Insurance Policy,

(a) provide details of each such Insurance Policy (including any actual or potential claim for damages) to the Bank;

(b) ensure that the receivables arising under such Insurance Policy are assigned by way of security pursuant to the Security Assignment, and comply with all steps and formalities required thereunder for validity and enforceability;

(vi) upon request by the Bank, where the Bank reasonably concludes that the insured value or the risks covered by an Insurance Policy are inadequate, procure the increase in the insured value and/or modification in the categories of risk covered in relation to such Insurance Policy to the extent and in the manner that Bank may reasonably deem appropriate.

(b) Where the Borrower fails to achieve or comply with the requirements and obligations under this clause, the Bank shall have the right (but not the obligation) to procure performance and/or enter into a new policy on the Borrower's behalf, in which case the Borrower shall be obliged to repay any amount incurred by the Bank in connection with the same within 15 Business Days of the relevant written request being made by the Bank.

3.12 REPRESENTATIONS AND WARRANTIES

Representations and warranties constitute statements by the borrower on an on-going basis during the term of the loan and are used to inform the parties to the loan agreement of the fact that the loan was granted on the basis of the economic, financial, legal, and tax situation disclosed by the borrower at the time the agreement was concluded; should any substantial discrepancies or breaches emerge between the information provided and that subsequently ascertained, the bank may terminate the agreement and/or to refuse to advance funds.

These agreements generally take the following form. The borrower makes the representations and warranties set out in this clause to each finance party.

A very detailed example of clauses follows.

- Status
  - it and each finance party is a corporation, duly incorporated with limited liability and validly existing under the law of its jurisdiction of incorporation.
  - it and each finance party has the power to own its assets and carry on its business as it is being conducted.
- Legal validity
  - each transaction document to which it and/or each finance party is a party is, subject to any general principles of law limiting its obligations which are specifically referred to in any legal opinion required to be delivered under this agreement, its legally valid, binding and enforceable obligation;

(*continued overleaf*)

- each transaction document to which it and/or each finance party is a party is in the proper form for its enforcement in the jurisdiction of its incorporation.

- Non-conflict with other obligations
  - the entry into and performance by it and each finance party of, and the transactions contemplated by, the transaction documents do not and will not conflict with:
    - any law or regulation applicable to it or that finance party;
    - its or the relevant finance party's constitutional documents; or
    - any agreement or instrument binding upon it or the relevant finance party or any of its or the relevant LeaseCo's assets.
- Power and authority
  - It and each finance party has the power to enter into, perform and deliver, and has taken all necessary action to authorize its entry into, performance and delivery of, the transaction documents to which it is a party and the transactions contemplated by those transaction documents.
- Validity and admissibility in evidence
  - Save as referred to in this clause, all authorizations required or desirable:
    - to enable it and each finance party lawfully to enter into, exercise its rights and comply with its obligations in the transaction documents to which it is a party; and
    - to make the transaction documents to which it and each finance party is a party admissible in evidence in its jurisdiction of incorporation,
  - have been obtained or effected and are in full force and effect.
- Governing law and enforcement
  - Subject to any general principles of law limiting its obligations and referred to in any legal opinion required under this agreement:
    - the choice of … law as the governing law of the finance documents will be recognized and enforced in the jurisdiction of incorporation of each finance party;
    - any judgment obtained in … in relation to a finance document will be recognized and enforced in the jurisdiction of incorporation of each finance party; and
    - its and each finance party's irrevocable submission under this agreement to the jurisdiction of the courts of … not to claim any immunity to which it or its assets may be entitled are legal, valid and binding under the laws of its jurisdiction of incorporation of each finance party.
- No default
  - No event of default is outstanding and no default will result from the execution of, or the performance of any transaction contemplated by, any transaction document.
  - No other event or circumstance is outstanding which constitutes a default under any other agreement or instrument which is binding on it or to which its assets are subject to an extent or in a manner which has or is reasonably likely to have a material adverse effect.
- Information
  - In this sub clause Information means the business plan and all other written Information provided by or on behalf of the Borrower in connection with the transaction documents.

- Any factual Information contained in the Information was true and accurate in all material respects as at the date it was provided or as at the date (if any) at which it is stated to be given.
- The financial projections contained in the Information have been prepared on the basis of recent historical Information and on the basis of reasonable assumptions.
- Each expression of opinion, expectation, intention or policy contained in the Information was made after careful consideration and enquiry and is believed by the Borrowers to be fair and reasonable as at the date at which it is stated to be given and can be properly supported.
- The Information did not omit as at its date any Information which, if disclosed, would make the Information untrue or misleading in any material respect.
- As at the utilization date, nothing has occurred since the date any of the Information was delivered to an administrative party which, if disclosed, would make the Information untrue or misleading in any material respect.

- Valuation
  - All factual written Information supplied by it or on its behalf to the valuer for the purposes of each Valuation was true and accurate as at its date or (if appropriate) as at the date (if any) at which it is stated to be given;
  - Any financial projections contained in the Information referred to in paragraph ... have been prepared as at their date, on the basis of recent historical Information and assumptions believed by it to be fair and reasonable;
  - It has not omitted to supply any information which, if disclosed, would adversely affect the valuation; and
  - In the case of the initial valuation only, nothing has occurred since the date Information referred to in paragraph ... was supplied and the utilization date which, if it had occurred prior to the initial valuation, would adversely affect the initial valuation.
- Information for Report on Title
  - The written factual Information supplied by the Borrowers or on their behalf to the lawyers who prepared any Report on Title for the purpose of that Report on Title was true and accurate in all material respects as at its date or (if appropriate) as at the date (if any) at which it is stated to be given;
  - the Information referred to in paragraph ... was at the date it was expressed to be given complete and did not omit any Information which, if disclosed would make that Information untrue or misleading in any material respect; and
  - as at the utilization date, nothing has occurred since the date of any Information referred to in paragraph ... which, if disclosed, would make that Information untrue or misleading in any material respect.
- Financial statements
  - The audited financial statements of the Borrower recently delivered to the bank:
    - have been prepared in accordance with accounting principles and practices generally accepted in its jurisdiction of incorporation, consistently applied; and
    - fairly represent its financial condition (consolidated, if applicable) as at the date to which they were drawn up,
    - except, in each case, as disclosed to the contrary in those financial statements.

(*continued overleaf*)

- There has been no material adverse change in the consolidated financial condition of either Borrower since the date to which the financial statements referred to in paragraph ... were drawn up.

- No other business
  - Neither Borrower has traded or carried on any business since the date of its incorporation except for the acquisition (including the funding of the acquisition), ownership and management of its interests in the relevant Property.
  - Neither Borrower is party to any material agreement other than the transaction documents.
  - Neither Borrower:
    - has or has had, any employees;
    - has any Subsidiaries;
    - has any obligation in respect of any retirement benefit or occupational pension scheme of any person.
- Ranking of Security
  - The security conferred by each security document and the LeaseCo security agreement constitutes a first priority security interest of the type described, over the assets referred to, in that security document or the LeaseCo security agreement and those assets are not subject to any prior or pari passu security interest.
- Litigation proceedings
  - No litigation, arbitration or administrative proceedings of or before any court, arbitral body or agency are current or (to the best of its knowledge and belief) pending or threatened against it which (a) are reasonably likely to be adversely determined and (b) if adversely determined, would have a material adverse effect.
- Environmental law
  - To the best of its knowledge and belief (after due enquiry) and save as disclosed in the Report on Title or the valuation:
    - the Borrower:
      - has obtained all requisite environmental approvals required for the purposes of its ownership and operation of its Property as it is operated as at the date of this agreement; and
      - is, and has been, in compliance with the environmental approvals referred to in paragraph ... and all environmental laws where failure to do so could reasonably be likely to have a material adverse effect;
    - no environmental claim is pending or threatened against it, and no circumstances are existing which could reasonably be expected to result in an environmental claim against it, which, if substantiated, is reasonably likely to have, a material adverse effect; and
    - no material generally known to be hazardous to health or safety has been used, or stored or dumped, or is present, at the Property in a manner which could reasonably be expected to have a material adverse effect.

3.13 DUTY TO PROVIDE INFORMATION

In order to secure greater protection, the lender must also negotiate a series of clauses which are capable of providing it with timely information on the "state of health" of the borrower and regarding the transaction. Under the terms of these clauses, the borrower is obliged to inform the lender of any disputes, arbitral proceedings, or administrative procedures initiated after conclusion of the agreement which may have a substantial detrimental effect.

Other clauses have been finalized with the goal of monitoring the real estate operation during the term of the loan. The borrower may be required to inform the bank with sufficient advance notice of its intention to sell or exchange the property or to establish any other real right of possession over it. Particularly restrictive clauses on the borrower may require it to secure the prior approval of the lender if the property financed is subject to a new property management agreement.

The abovementioned duties of disclosure will also include a right for the lender to appoint a surveyor in order to ascertain the OMV of the property. An example of a disclosure obligation follows.

Information Undertakings shall remain in force from the date of this Agreement for so long as any amount is outstanding under the Finance Documents or any Commitment is in force.

The undertakings in relation to the Corporate Guarantor shall remain in force during the period of validity of the Corporate Guarantee.

- The undertakings in this Clause (Information Undertakings) in relation to the Corporate Guarantor shall remain in force during the period of validity of the Letter of Patronage and the Hedging Letter of Patronage.

FINANCIAL STATEMENTS

The Borrower shall supply to the bank:

- as soon as the same become available, but in any event within … days after the end of each of the financial year the unaudited and audited (when available) financial statements of the Borrower, the Guarantor, the Corporate Guarantor and the Quotaholder for that financial year;
- as soon as the same become available, but in any event within ... days after the end of each of the financial half-years the unaudited financial statements of the Borrower, the Guarantor and the Corporate Guarantor for that financial half-year;
- promptly, such further information regarding the financial condition of the Borrower as any Finance Party (through the Agent) may reasonably request, subject to any limitation arising from mandatory provisions of law.

REQUIREMENTS AS TO FINANCIAL STATEMENTS

- Each set of financial statements and other documents delivered by the Borrower pursuant to Clause ... (Financial statements) shall be certified by a legal representative of

(*continued overleaf*)

the Borrower, the Guarantor, …. as the case may be, as fairly representing the financial conditions as at the date as at which those financial statements were drawn up.

- The Borrower shall procure that each set of financial statements delivered pursuant to paragraph (a) and (b) of Clause ... (Financial statements) is prepared using (i) GAAP or IAS with reference to the Borrower and (ii) applicable local general accounting principles set forth by applicable law or IAS, the Corporate Guarantor and the Guarantor as the case may be.
- The Borrower must notify the Bank of any proposed change in GAAP or IAS, the accounting practices or reference periods used and deliver to the bank sufficient information, in form and substance as may be reasonably required by the Bank, to enable the Lenders to determine whether Clause ... (Financial covenants) has been complied with.

REPORTS AND UPDATED BUSINESS PLANS

- Without prejudice to the right of the Lenders to request at any time and at their own expense a Valuation Report, the Borrower shall supply the Bank with:
  - a Valuation Report at the Borrower's expense;
  - a quarterly Lease and Property Report, carried out at the Borrower's expense;
  - an Updated Business Plan specifying in detail the updates/and or variations to the Initial Business Plan or preceding Updated Business Plan, as appropriate, it being understood that should the Project Monitor report on any variation that causes costs overrun and those details are not satisfactory to the Bank, then the Agent shall have the right to request a more detailed explanation to the Borrower;
  - a report setting out:
    - the progress of the Development substantially in the form agreed with the Agent and based on the standard usually produced by the Borrower for internal purposes;
    - a cash flow analysis;
    - details of any material breaches of the Preliminary Sale and Purchase Agreement and the steps being taken to remedy such breaches;
  - an update in relation to the Property which shall confirm that there are no Securities.
- All reports listed in paragraphs ..., shall be supplied as soon as they are available and:
  - in the case of Valuation Reports, no more than once a year starting from the issue of the Initial Valuation and no later than 60 days after the occurrence of an event of default;
  - in the case of each of the Lease and Property Reports and Updated Business Plans, quarterly starting from the First Utilization Date until the Maturity Date;
  - in the case of the report provided for in paragraph ..., monthly starting from the First Utilization Date until the Maturity Date;
  - in the case of the report provided for in paragraph ... every 12 calendar months starting from the First Utilization Date.

- Each of the Valuation Reports shall be provided in originals and signed (or countersigned as the case may be) by an authorized signatory of the Borrower.

KNOW YOUR CLIENT REQUIREMENTS

- The Borrower shall promptly, on the request of the Lender, supply any documentation to enable the Lender to carry out and be satisfied it has complied with the control of the "Know Your Customer" under all applicable law.
- The Borrower expressly confirms to the Finance Parties that all funds made available according to this Agreement have been or shall be utilised for his own direct benefit and to such purposes the Borrower confirms that:
  - it is acting in its own name and not as lender or trustee or Bank on behalf and/or interest of third parties,
  - the transactions contemplated by the Finance Documents do not infringe any law, regulation or any other provision or procedure of administrative or governmental nature aimed at preventing Money Laundering.

INFORMATION: MISCELLANEOUS

- The Borrower shall supply to the Bank:
  - promptly upon execution thereof the Sale and Purchase Agreement and the Leasing Mandate Agreement;
  - copies of all valuation reports commissioned to external valuers, in relation to the Property;
  - the details of any litigation, arbitration or administrative proceedings which are current, threatened in writing or pending against it and/or the Property and which in case of a negative outcome would have a Material Adverse Effect;
  - promptly upon and only in case it becomes aware of the relevant claim, the details of any claim which is current, threatened in writing or pending against the Vendor or Developer, but in any event only related to claims existing, respectively, prior to the execution of the Preliminary Sale and Purchase Agreement or any other person in respect of the Finance Documents such information as the Bank may reasonably require in writing concerning the Property and compliance with the terms of the Transaction Documents within 20 Business Days of receipt of the Bank's request;
  - in case from the information supplied to or received by the Bank there emerges the reasonable need to obtain information on the creditworthiness of the Guarantor and the Corporate Guarantor, promptly such further information or explanation regarding the financial condition of the Guarantor and the Corporate Guarantor as any Finance Party through the Bank may reasonably request; and

(*continued overleaf*)

- details of any other event (including, for the avoidance of doubt, any Permitted Security Interest over the Property as and when it may arise) which might be considered prejudicial to the Borrower and/or the Property and/or the Development and/or the rights of the Finance Parties arising under the Finance Documents.
- The Borrower shall communicate to the Project Monitor details of the Development Team and any material modification.

NOTIFICATION OF DEFAULT

The Borrower shall notify the Bank of any Default (and the steps, if any, being taken to remedy it) immediately upon becoming aware of its occurrence.

COMPLIANCE CERTIFICATE

The Borrowers must supply to the Bank a certificate on each Interest Payment Date:

1. certifying that no default is outstanding (or if a default is outstanding, specifying the default and the steps, if any, being taken to remedy it); and
2. setting out calculations in reasonable detail of ICR/DSCR/LTV as at that Interest Payment Date and evidencing that the Borrower is in compliance with its obligations concerning to the ICR/DSCR/LTV.

3.14 COSTS, TAXES, AND ANCILLARY CHARGES

In addition to the fees due to the bank, the agreement must also specify the costs which are to be borne by the borrower, including the costs of regular notices provided for under bank transparency legislation. The agreement may grant the right to vary the interest rate or any other price or condition to the detriment of the borrower; such a right must be expressly provided for in the agreement and the relative clause must be specifically approved by the borrower, subject in addition to compliance with bank transparency legislation.

3.15 CONTRACTUAL COVENANTS

A covenant is a contractual clause agreed upon during the negotiation stage which grants the bank the right to renegotiate or terminate the agreement following the occurrence of the events expressly specified in the clause. Under a covenant a borrower will undertake not to carry out acts which could be detrimental to the rights of the bank or otherwise increase the risk of default, whereby the bank is generally granted the right to renegotiate or terminate the loan where the conditions of the covenant are breached (negative covenant), or alternatively to act in such a manner as to enable the bank to monitor the loan over time (positive covenant).

Under some covenants, the borrower undertakes to repay the loan (in full or in part) should any situations arise which increase the risk associated with the transaction for the bank.

Compliance with covenants may result in:

- improvements to the financial terms of the loan, or more stringent financial terms in the event of a deterioration in the parameters of valuation of the creditworthiness of the company and/or transaction (in order to offset the lower or higher credit risk of the transaction and the resulting spread applied);
- termination where a change in the conditions deemed to be fundamental at the time the loan was granted requires the bank to request early repayment of the loan (event of default).

In particular, covenants may be divided between:

- balance sheet covenants;
- financial covenants.

3.15.1 Balance Sheet Covenants

Under balance sheet covenants, the clause is based on individual or consolidated balance sheets, usually with reference to the past performance of the main economic and financial parameters of the borrower company and/or its sponsors (in cases involving SPVs) and setting out "red lines" in order to ensure that the assets and financial structure of those entities remain compatible with the level of debt taken on.

Balance sheet covenants include commitments on the part of the borrower company to maintain for the full term of the loan:

- a net balance sheet capital level which is not lower than a specified minimum;
- the ratio of total indebtedness to net capital within a given limit;
- a current liquidity indicator which is not lower than a specified minimum;
- financial charges within a specified percentage limit of turnover.

3.15.2 Financial Covenants

Financial covenants are closely related to the real estate transaction being financed. The following financial ratios are those most commonly used in the aforementioned covenants.

Interest Cover Ratio[24] (ICR) is the ratio between the operating income,[25] the income gained from the lease and/or sale of the properties, and the amount of interest due to the bank on the loan over the same period.

Depending upon the type of property, this ratio may exceed 120–170%. If the ratio is lower than this, but still higher than 100%, the bank may activate other guarantees, request the provision of equity, or withhold all assigned rental payments (known as a "*Cash Sweep*" clause[26]) until the ratios have been re-established. A figure below 100% will result in an event of default, since the interest due on the loan will no longer be covered by the operating income.

[24] Also known as Interest Coverage Ratio.

[25] In cases involving the financing of hotel operations in which the hotel operator is also the owner of the property, the relevant cash flow is calculated as the difference between total earnings and the sum of all operating costs, provisions for Furniture, Fixtures & Equipment, and the management fee, according to the Uniform System of Accounts for the hotel industry.

[26] A Cash Sweep clause is a provision according to which, in the event that one or more financial covenants (ICR, DSCR, LTV) are not complied with, the borrower must repay the excess amount of the loan and/or

Debt Service Cover Ratio (DSCR) is the ratio between the operating cash flows gained from the lease of the properties and the amount of the instalments (principal and interest) due to the bank on the loan over the same period. Depending upon the type of property and the financial structure of the transaction, this ratio must at all times exceed 120–140%. Below this ratio the arrangements applicable to the ICR apply.

Loan to Value Ratio (LTV) is the amount of the loan granted or the residual amount due to the bank as a percentage of the OMV of the property at the time the indicator is calculated. Depending upon the type of property and their risk, this ratio must not exceed 60–80% of the value of the properties (although for mezzanine financing may be as high as 90%); obviously, these percentages vary over time in line with market conditions. In the event that the limit is breached, the borrower must reduce the loan in order to restore the agreed LTV, and if it fails to do so, the bank may terminate the agreement.

Loan to Cost Ratio (LTC) means, at any given time, the amount of the loan granted or the residual amount due to the bank by the borrower as a percentage of the construction cost of the property at the time it was calculated. Depending upon the type of property, this ratio must not exceed 60–70% of the construction cost of the properties (although for mezzanine financing may be as high as 80–85%). In the event that the limit is breached, the borrower must reduce the loan in order to restore the agreed LTC, failing which the bank may terminate the agreement. This ratio is usually used to regulate drawdown amount in construction financing rather than being used as a covenant.

It is a straightforward matter to render changes to the financial terms of the loan conditional upon these ratios: an increase in ICR and/or DSCR and/or a fall in LTV/LTC may result in a reduction in the spread for the transaction (and vice versa).

Yield on Debt means, at any given time, the net rental payments relating to the property financed as a percentage of the amount of the loan due by the borrower to the bank at the same time (Net Operating Income/Loan amount). For bullet financing arrangements, an exit yield on debt clause may be inserted specifying the minimum ratio which must apply upon maturity of the loan (Net Operating Income/Loan amount after … years' loan term).

Project Cover Ratio (PCR) means the present value of cash flows for the entire lifetime of the project as a portion of the present value of the debt. This makes it possible to assess the capacity of the cash flows generated to repay the debt over the entire lifetime of the project, thus also including the period after that stipulated for repayment. In order to be satisfactory it must be higher than 1, and the higher that value, the greater protection will be provided to lenders, given the financial solidity of the project. On the contrary, the borrower will attempt to maintain its value as close to 1 as possible in order to maximize the use of financial leverage.[27] However, it is not possible to define a standard absolute value, as the banks also take into account other qualitative factors. Moreover, its significance is limited since the level of this ratio may depend upon the cash flows generated after the repayment period specified in the loan agreement has ended.

Loan Life Cover Ratio (LLCR) means the present value of cash flows between the date of valuation and the deadline for repayment of the debt and the residual (or outstanding) debt on the date of valuation. This ratio will be meaningless before the property has entered its operational stage. However, it is more useful than the previous ratio (PCR) since it focuses its analysis exclusively on the cash flows generated during the period specified for repayment

provide supplementary guarantees approved by the Bank to satisfy the covenants. A typical request is the use of excess free cash flow generated by the transaction in order to reduce the outstanding debt amount.

[27] On the role of leverage in a real estate portfolio please see Anson and Hudson-Wilson (2003).

of the loan. This ratio should also be higher than 1 in order to ensure that the loan is repaid in accordance with the repayment plan specified, whilst at the same time leaving funds available to remunerate shareholders.

The last two ratios are predominantly used in infrastructure project finance deals rather than properties.

A simple numerical example describes the procedure for calculating some of the covenants presented above.

EXAMPLE 3.4

A property currently valued €1,000 is leased and generating cash flows of €70/year. OMV as well as real estate cash flows are assumed to increase by 2% per annum, therefore keeping the property yield constant at 7%. The financing agreement states a different interest rate according to the LTV over time (6% when LTV is above 45%, 5% otherwise), decreasing due to a fixed repayment plan. Calculations for LTV, ICR, DSCR, and Yield on Debt are reported in Figure 3.7.

The following is an example of a financial covenants clause.

LOAN TO VALUE

- The Borrowers must ensure that the Loan to Value does not, at any time, exceed ...%.
- If the Borrowers are not in compliance with paragraph ..., they shall have a period of ten business days to remedy such breach by either:
  - prepaying the Loans in the amount which would, upon such prepayment, result in the Borrowers being in compliance with paragraph ...;
  - depositing the amount referred to in paragraph ... into the cure account.
- The Bank shall, provided no default is then outstanding, transfer any amount credited to the cure account pursuant to this sub clause together with interest accrued thereon to either general account (in accordance with the instructions of the Borrowers) once the Borrowers are in compliance with paragraph ... above without taking that amount into account.

INTEREST COVER RATIO

- The Borrowers must ensure that Interest Cover is, as at each Interest Payment Date, equal to or greater than …%.
- If the Borrowers are not in compliance with paragraph ..., they shall have a period of ten business days to remedy such breach by:
  - prepaying the Loan in the amount (calculated by the Bank) which, taking into account the resulting reduction in the projected annual finance costs (as defined

(*continued overleaf*)

Property Market Value	€ 1,000
Annual MV increase	2.00%
Property Yield	7.00%
Initial LTV	65.00%
Maturity (years, max 35)	20
LTV treshold	45.00%
Interest rate	
Under LTV	Above LTV
5.00%	6.00%

	Period	0	1	2	3	4	5	6	7	8	9	10	18	19	20
a	Market Value	€ 1,000	€ 1,020	€ 1,040	€ 1,061	€ 1,082	€ 1,104	€ 1,126	€ 1,149	€ 1,172	€ 1,195	€ 1,219	€ 1,428	€ 1,457	€ 1,486
b	Real estate CF	€ 70	€ 71	€ 73	€ 74	€ 76	€ 77	€ 79	€ 80	€ 82	€ 84	€ 85	€ 100	€ 102	€ 104
	Loan Balance BoP		€ 650	€ 618	€ 585	€ 553	€ 520	€ 488	€ 455	€ 423	€ 390	€ 358	€ 98	€ 65	€ 33
	Drawdown	€ 650													
	Repayment		€ 33	€ 33	€ 33	€ 33	€ 33	€ 33	€ 33	€ 33	€ 33	€ 33	€ 33	€33	€ 33
c	Loan Balance EoP	€ 650	€ 618	€ 585	€ 553	€ 520	€ 488	€ 455	€ 423	€ 390	€ 358	€ 325	€65	€33	€ 0
c/a	LTV	65%	64%	59%	55%	51%	47%	43%	40%	36%	33%	29%	7%	4%	2%
	Interest rate applied		6%	6%	6%	6%	6%	5%	5%	5%	5%	5%	5%	5%	5%
d	Interest paid		€ 39	€ 37	€ 35	€ 33	€31	€ 24	€ 23	€ 21	€ 20	€ 18	€ 5	€ 3	€ 2
e	Debt service (instalment)		€ 72	€ 70	€ 68	€ 66	€ 64	€ 57	€ 55	€ 54	€ 52	€ 50	€ 37	€ 36	€ 34
d/b	ICR		183%	197%	212%	229%	248%	323%	353%	388%	429%	477%	2051%	3138%	6401%
e/b	DSCR		100%	105%	110%	115%	121%	139%	146%	153%	161%	169%	267%	285%	305%
b/c	*Yield on Debt*	11%	12%	12%	13%	15%	16%	17%	19%	21%	23%	26%	154%	314%	

FIGURE 3.7 Examples of financial covenants

in the definition of Interest Cover), would result in Interest Cover being at the minimum level required under paragraph ...; or
  - depositing into the cure account the amount (calculated by the Bank) which is equal to the amount by which projected annual rental (as defined in the definition of Interest Cover) was less than the level necessary for the Borrowers to have been in compliance with paragraph ... on the relevant Interest Payment Date.
- The rights set out in paragraph ... (the Cure Rights), taken together, may not be exercised by the Borrowers more than six times prior to the final maturity date or on more than two consecutive Interest Payment Dates. For these purposes, each time an amount credited to the cure account under paragraph ... is taken into account for the purposes of paragraph ... (irrespective of whether a further deposit is made to the cure account) constitutes the exercise of a cure right.
- The Bank shall, provided no default is then outstanding, transfer any amount deposited in the cure account pursuant to this sub clause together with interest accrued thereon to either general account (in accordance with the instructions of the Borrowers) on the expiry of two consecutive Interest Periods commencing on the first Interest Payment Date to occur (following the date of such deposit) upon which the Borrower is in compliance with paragraph ... without taking that amount into account.

YIELD ON DEBT

- The Borrowers must ensure that the Yield on Debt, on each Interest Payment Date occurring on or after the fourth anniversary of the date of this Agreement is not less than …%
- If the Borrowers are not in compliance with paragraph ..., they shall have a period of ten business days to remedy such breach by:
  - prepaying the Loans in the amount which would, upon such prepayment, result in the Borrower being in compliance with paragraph ...;
  - depositing the amount referred to in paragraph ... into the cure account.
- The Bank shall, provided no default is then outstanding, transfer any amount credited to the cure account pursuant to this sub clause together with interest accrued thereon to either general account (in accordance with the instructions of the Borrowers) on the expiry of two consecutive Interest Periods commencing on the first Interest Payment Date to occur (following the date of such deposit) upon which the Borrowers are in compliance with paragraph ... without taking that amount into account.

CHAPTER 4

Loan Repayment, Interest, and Renegotiation

In the first part[1] of this chapter the most commonly used loan repayment schedules and interest calculation techniques are described, while in the second part issues related to loan renegotiation and restructuring are dealt with.

Since it is very important to have a loan repayment schedule that fits the operating cash flows of the financed real estate project, the described loan repayment schedules are the most typical scheme, but any kind of variation is possible depending on the financing agreement.[2]

4.1 BULLET PAYMENTS

Loans providing for bullet payments, also called zero amortizing (interest only) constant payment loans, require the payment of the entire principal of the loan (and in rare cases also all of the interest[3]) upon maturity of the loan. As the name easily brings to mind, the periodical payment will simply be in the form of an interest payment. Thus, the outstanding loan balances at the beginning of each period (BoP) will be a constant value equalling the loan value.

4.2 PRE-AMORTIZING (SEMI-BULLET)

Pre-amortizing (or semi-bullet) is an interest-only repayment plan that stipulates the payment of interest only for a certain period of time. The period is referred to as the interest-only period, as against the subsequent repayment period during which interest is paid regularly and the principal loaned is repaid. They are common in development projects to fund construction costs: only after the property has been built and/or marketed is the principal repaid.

[1] Also with the contribution of Andrea Artegiani, MSc Bocconi University.
[2] For further details on financial calculation see also Kolbe et al. (2003).
[3] Please see paragraph 4.5.1 for further details.

EXAMPLE 4.1

In the example in Figure 4.1 only interest is paid during the life of the loan and the principal is repaid only at the maturity date.

Loan Amount	€ 1,000,000					
Interest rate	6%					
Maturity	5					
Interest-only repayment plan (bullet)		**1**	**2**	**3**	**4**	**5**
Loan Balance BoP		€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 1,000,000
Drawdown	€ 1,000,000					
Interest accrued		€ 60,000	€ 60,000	€ 60,000	€ 60,000	€ 60,000
Interest paid		*€ 60,000*	*€ 60,000*	*€ 60,000*	*€ 60,000*	*€ 60,000*
Capital Repayment						*€ 1,000,000*
Debt service (instalment)		€ 60,000	€ 60,000	€ 60,000	€ 60,000	€ 1,060,000
Loan Balance EoP	€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 0

FIGURE 4.1 Repayment of a loan with bullet payments

4.3 BALLOON PAYMENT

Loans providing for balloon payments require the payment of interest and the redemption of part of the principal during the term of the loan; the outstanding principal will then be repaid in full upon maturity (by selling the property or refinancing), unless the term of the loan is extended.

In this case there is a non-zero outstanding loan balance at the end of the loan term, thus allowing the borrower to make periodical payments that are lower than those under the provision of a fully amortizing loan. The value of the outstanding loan balance at the end of the loan term is generally referred to as a balloon payment (BP).

In order to calculate the value of the constant periodical payment (CP) the present value of an annuity formula is applied, solving it for CP. The value in time of the balloon payment is also considered, assuming 12 periodic (monthly) payments (per annum).

$$PV = \sum_{t=1}^{n} \frac{CP}{\left(1+\frac{i}{12}\right)^{t}} + \frac{BP}{\left(1+\frac{i}{12}\right)^{n}}$$

EXAMPLE 4.2

In the example in Figure 4.2 during the initial phase (interest-only maturity) only interest is paid, while the principal is repaid only later (from Year 4).

Loan Amount	€ 1,000,000					
Interest rate	6%					
Interest only Maturity	3					
Maturity	5					
Pre-amortizing (semi-bullet)		**1**	**2**	**3**	**4**	**5**
Loan Balance BoP		€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 500,000
Drawdown	€ 1,000,000					
Interest accrued		€ 60,000	€ 60,000	€ 60,000	€ 60,000	€ 30,000
Interest paid		*€ 60,000*	*€ 60,000*	*€ 60,000*	*€ 60,000*	*€ 30,000*
Capital Repayment		*€ 0*	*€ 0*	*€ 0*	*€ 500,000*	*€ 500,000*
Debt service (instalment)		€ 60,000	€ 60,000	€ 60,000	€ 560,000	€ 530,000
Loan Balance EoP	€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 1,000,000	€ 500,000	€ 0

FIGURE 4.2 Pre-amortizing (semi-bullet)

from which CP can be calculated as:

$$CP = \left(PV - \frac{BP}{\left(1+\frac{i}{12}\right)^{n}} \right) \Bigg/ \sum_{t=1}^{n} \frac{1}{\left(1+\frac{i}{12}\right)^{t}}$$

4.4 FULLY AMORTIZING REPAYMENT PLANS

Fully amortizing is the most commonly used form of repayment for financing in the real estate sector. A constant periodical payment – monthly, quarterly, or annually – is calculated based on the loan value at a fixed interest rate. Each periodical payment thus contains both an interest payment component and the repayment of principal. The interest payment component is simply calculated applying the relevant interest rate (fixed or floating) to the outstanding loan

EXAMPLE 4.3

In the example in Figure 4.3 during the initial phase interest is paid and the principal is partially repaid, while the balance will be repaid only at maturity.

Loan Amount	€ 1,000,000					
Interest rate	6%					
Intermediate Repayment	50%					
Maturity	5					
Baloon		**1**	**2**	**3**	**4**	**5**
Loan Balance BoP		€ 1,000,000	€ 875,000	€ 750,000	€ 625,000	€ 500,000
Drawdown	€ 1,000,000					
Interest accrued		€ 60,000	€ 52,500	€ 45,000	€ 37,500	€ 30,000
Interest paid		*€ 60,000*	*€ 52,500*	*€ 45,000*	*€ 37,500*	*€ 30,000*
Capital Repayment		*€ 125,000*	*€ 125,000*	*€ 125,000*	*€ 125,000*	*€ 500,000*
Debt service (instalment)		€ 185,000	€ 177,500	€ 170,000	€ 162,500	€ 530,000
Loan Balance EoP	€ 1,000,000	€ 875,000	€ 750,000	€ 625,000	€ 500,000	€ 0

FIGURE 4.3 Repayment of a loan with balloon payments

balance at the beginning of the period, while the repayment of the principal is the difference between the constant payment and the interest payment.[4]

For loans which are repayable in instalments, a repayment plan will be agreed upon in advance, which may come in different forms.

4.4.1 Fixed-Capital Loan Repayment Plan

In fixed-capital repayment plans each instalment will repay a fixed principal component, along with a decreasing interest component calculated on the outstanding debt; only the latter component varies over time. This form is very common in residential loans. In other words, instalments remain the same until the end of the plan; the principal component increases over time, whilst the interest component falls in line with the reduction in the outstanding debt (clearly, if a floating-rate rate is chosen, the amount of interest due and hence the amount of each instalment may rise or fall).

[4] In Microsoft Excel the PMT and PPMT formulas respectively are used to calculate the amount of the instalment and the outstanding capital.

EXAMPLE 4.4

A more complex example is presented in Figure 4.4 where a borrower is taking out a loan amount at an annual nominal fixed interest rate, for a 20 year term with a balloon payment. The fixed monthly payment is calculated as follows.

Partially Amortizing, Costant Payment Mortage	
Loan Amount	€ 100,000
Maturity (years)	20
Interest rate (annual)	6%
Interest rate (monthly)	0.49%
Baloon payment	€ 60,000
Fixed Monthly Payment	**€ 574.97**

(1) Month	(2) Loan Balance BoP	(3) Monthly Payment	(4) Interest	(5) Capital Repayment	(6) Loan Balance EoP
1	€ 100,000.00	€ 574.97	€ 486.76	€ 88.21	€ 99,911.79
2	€ 99,911.79	€ 574.97	€ 486.33	€ 88.64	€ 99,823.14
3	€ 99,823.14	€ 574.97	€ 485.89	€ 89.08	€ 99,734.07
4	€ 99,734.07	€ 574.97	€ 485.46	€ 89.51	€ 99,644.56
5	€ 99,644.56	€ 574.97	€ 485.02	€ 89.94	€ 99,554.61
236	€ 61,394.16	€ 574.97	€ 298.84	€ 276.13	€ 61,118.03
237	€ 61,118.03	€ 574.97	€ 297.50	€ 277.47	€ 60,840.55
238	€ 60,840.55	€ 574.97	€ 296.14	€ 278.83	€ 60,561.73
239	€ 60,561.73	€ 574.97	€ 294.79	€ 280.18	€ 60,281.55
240	€ 60,281.55	€ 574.97	€ 293.42	€ 281.55	€ 60,000.00

FIGURE 4.4 Partially amortizing constant payment loan

In order to calculate the value of the constant periodical payment (CP), the present value of an annuity formula is used:

- PV is the value of the loan amount
- n is the number of periods per annum

$$PV = \sum_{t=1}^{n} \left[\frac{CP}{1 + \frac{i}{n}} \right]^{t}$$

EXAMPLE 4.5

An example is presented in Figure 4.5.

Loan Amount	€ 1,000,000					
Interest rate	6%					
Maturity	5					
Fixed-instalment repayment plan		**1**	**2**	**3**	**4**	**5**
Loan Balance BoP		€ 1,000,000	€ 822,604	€ 634,563	€ 435,241	€ 223,959
Drawdown	€ 1,000,000					
Interest accrued		€ 60,000	€ 49,356	€ 38,074	€ 26,114	€ 13,438
Interest paid		*€ 60,000*	*€ 49,356*	*€ 38,074*	*€ 26,114*	*€ 13,438*
Capital Repayment		*€ 177,396*	*€ 188,040*	*€ 199,323*	*€ 211,282*	*€ 223,959*
Debt service (instalment)		€ 237,396	€ 237,396	€ 237,396	€ 237,396	€ 237,396
Loan Balance EoP	€ 1,000,000	€ 822,604	€ 634,563	€ 435,241	€ 223,959	€ 0

FIGURE 4.5 Loan repayment procedures: Fixed-instalment repayment plan

from which it can be easily derived:

$$CP = \frac{PV}{\sum_{t=1}^{n}\left(1+\frac{i}{n}\right)^{t}}$$

The same formulas applied to monthly constant periodical payments are:

$$PV = \sum_{t=1}^{n}\left[\frac{CP}{1+\frac{i}{12}}\right]^{t}$$

from which it can be easily derived:

$$CP = \frac{PV}{\sum_{t=1}^{n}\left(1+\frac{i}{12}\right)^{t}}$$

At the end of the loan, the original debt amount will be completely amortized and reimbursed.

4.4.2 Floating-Rate Loan Repayment Plan

In the case of a floating-rate loan (interest rate adjusted loan) the outstanding loan balance at the end of each payment period depends on interest rates level in the market (e.g. EURIBOR or LIBOR).

EXAMPLE 4.6

In the example in Figure 4.6 a loan is drawn down at a nominal fixed interest rate for a term of 20 years with monthly payments. A constant monthly payment is calculated together with its amortization pattern.

Fully Amortizing, Costant Payment Mortage	
Loan Amount	€ 100,000
Maturity (years)	20
Interest rate (annual)	6%
Interest rate (monthly)	0.49%

Fixed Monthly Payment	**€ 707.29**

(1) Month	(2) Loan Balance BoP	(3) Monthly Payment	(4) Interest	(5) Capital Repayment	(6) Loan Balance EoP
1	€ 100,000.00	€ 707.29	€ 486.76	€ 220.54	€ 99,779.46
2	€ 99,779.46	€ 707.29	€ 485.68	€ 221.61	€ 99,557.85
3	€ 99,557.85	€ 707.29	€ 484.60	€ 222.69	€ 99,335.16
4	€ 99,335.16	€ 707.29	€ 483.52	€ 223.77	€ 99,111.39
5	€ 99,111.39	€ 707.29	€ 482.43	€ 224.86	€ 98,886.53
236	€ 3,485.40	€ 707.29	€ 16.97	€ 690.33	€ 2,795.07
237	€ 2,795.07	€ 707.29	€ 13.61	€ 693.69	€ 2,101.39
238	€ 2,101.39	€ 707.29	€ 10.23	€ 697.06	€ 1,404.32
239	€ 1,404.32	€ 707.29	€ 6.84	€ 700.46	€ 703.87
240	€ 703.87	€ 707.29	€ 3.43	€ 703.87	€ 0.00

FIGURE 4.6 Fully amortizing constant payment loan (fixed-rate)

There are several benefits related to using such an interest based index, that is:

- interest rates are a reflection of investors' future expectations;
- interest rates are thus forward looking;
- adjustments can be more timely.

In the residential loan market there are also *Hybrid Adjustable Rate Loans* where the loan generally functions as a fixed-rate loan during the initial three, five, or seven years. After this period the loan is adjusted to reflect new prices and interest rates in the economy. Payments after these initial periods are generally adjusted every year.

An example is presented in Figure 4.8. A loan amount of €100,000 for a 20 year term is taken out at a 6% nominal annual interest rate. The initial monthly payment would then be €707.29.

The outstanding loan balance at the end of Period 1 is calculated solving the following formula for FV equal to zero:

$$PV = \sum_{t=1}^{n} \frac{CP}{\left(1+\frac{i}{12}\right)^{t}} + \frac{FV}{\left(1+\frac{i}{12}\right)^{n}}$$

with CP = €707.29, PV = €100,000, i = 6%, n = 12

If at the end of Year 1 nominal annual interest rates rise to 6.5%, the new monthly payment would be calculated using the same formula as above but solving for CP with:

- FV = 0
- PV = outstanding loan balance at the end of Year 1
- n = 29
- i = 6.5%

It should be noted that a floating-rate loan does not completely eliminate any risk for the lender. Indeed, it might be the case that the interest rate applicable to the loan is now adjusted to 6.5%, but then during the next two months interest rates rise to 6.75%. The lender will then incur a loss for the remaining time until the next adjustment takes place. This simply means that the shorter the time between adjustments, the lower the risk incurred by the lender. This risk, of course, should be reflected in the level of interest rate settled in the loan agreement.

Figure 4.7 shows the loan pattern for an interest rate adjusted loan. It is similar to what was previously seen in the case of a fully amortizing loan. The difference now is that it is more an exercise of recalculating the periodic interest payments owed to the lender every time the reference interest rate in the market changes, as showed in the example in Figure 4.8.

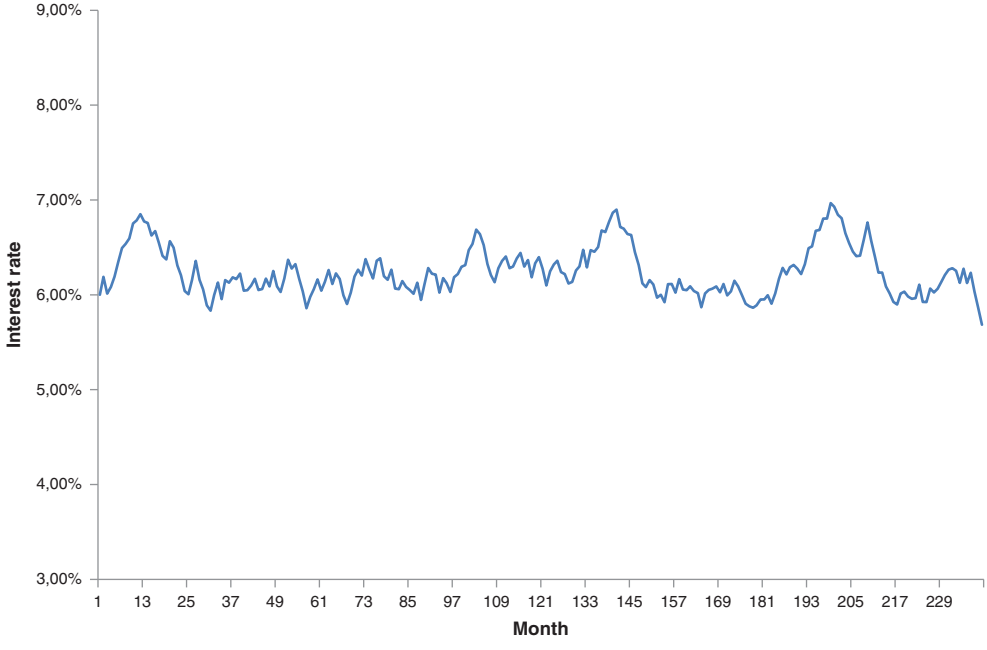


FIGURE 4.7 Example of floating-rate pattern

EXAMPLE 4.7

Fully Amortizing, Constant Payment loan, Floating rate	
Loan Amount	€ 100,000
Maturity (years)	20
Interest rate (annual)	6%
Interest rate (monthly)	0.49%

(1) Month	Interest rate (annual)	Interest rate (monthly)	(2) Loan Balance BoP	(3) Monthly Payment	(4) Interest	(5) Capital Repayment	(6) Loan Balance EoP
1	6.00%	0.49%	€ 100,000.00	€ 707.29	€ 486.76	€ 220.54	€ 99,779.46
2	5.94%	0.48%	€ 99,779.46	€ 704.31	€ 481.34	€ 222.97	€ 99,556.49
3	5.81%	0.47%	€ 99,556.49	€ 697.28	€ 469.97	€ 227.31	€ 99,329.18
4	5.82%	0.47%	€ 99,329.18	€ 697.51	€ 469.23	€ 228.28	€ 99,100.90
5	5.76%	0.47%	€ 99,100.90	€ 694.39	€ 463.56	€ 230.83	€ 98,870.07
236	7.19%	0.58%	€ 3,571.00	€ 726.68	€ 20.72	€ 705.96	€ 2,865.04
237	7.06%	0.57%	€ 2,865.04	€ 726.50	€ 16.33	€ 710.16	€ 2,154.88
238	6.94%	0.56%	€ 2,154.88	€ 726.36	€ 12.08	€ 714.28	€ 1,440.60
239	6.81%	0.55%	€ 1,440.60	€ 726.26	€ 7.94	€ 718.32	€ 722.28
240	6.77%	0.55%	€ 722.28	€ 726.23	€ 3.95	€ 722.28	€ 0.00

FIGURE 4.8 Fully amortizing constant payment loan, floating-rate

4.4.3 Loan with Interest Rate Caps

In this type of loan, in order to limit the upside risk of an elevated payment for the borrower, a Cap (acting as a limit) is imposed on the increase that the interest rate may follow.[5] There could be some loan agreements where such a limit is imposed on the overall amount owed by the borrower to the lender and not simply on the interest rate. Of course, an Interest Rate Cap also acts as a sort of payment Cap limiting the payment amount that the borrower may owe to the lender. In other words, it is simply a matter of different formulations aimed at the same purpose of preserving the ability of the borrower to make repayments.

In case of a loan amount of €100,000 for a 20 year period taken out at a 6% nominal annual interest rate, the initial monthly payment would be €707.29.

The Interest Rate Cap states that 6% is the maximum interest rate applicable, as shown in Figure 4.9 where the interest rate pattern both for the market interest rate and the actual loan interest rate is represented.

[5] Please see also paragraph 3.5 for further detail on the Interest Rate Cap and other hedging techniques.

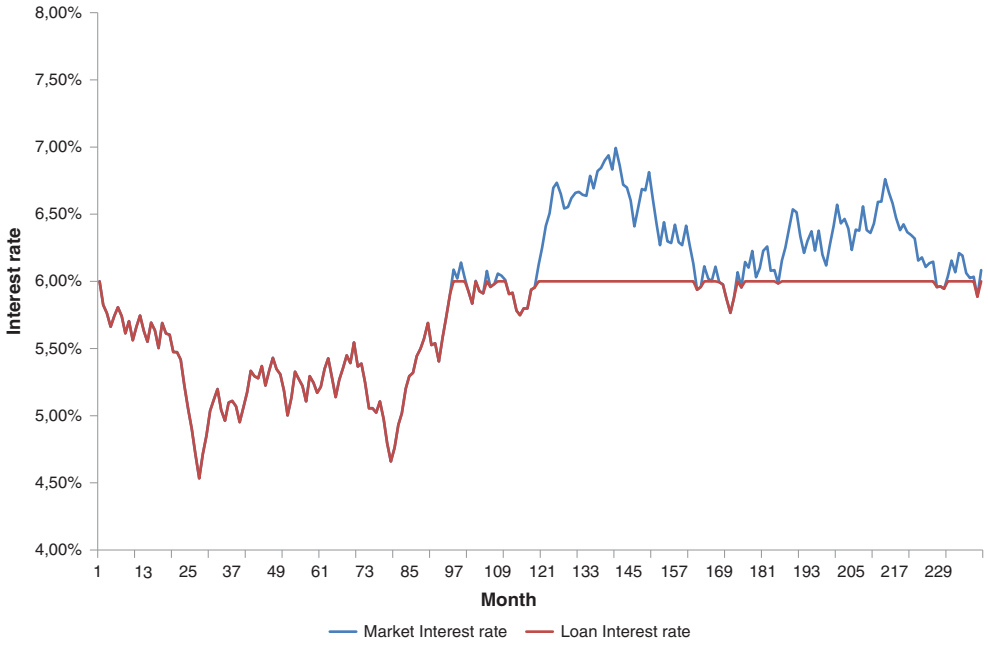


FIGURE 4.9 Interest rate with Cap pattern

Basically, whenever prevailing interest rates in the market are below the 6% level, monthly payments are based on that interest level, while in case interest rates are above that level, 6% is the interest rate applied to service the loan.

EXAMPLE 4.8

The following example in Figure 4.10 reports the monthly loan pattern for such an Interest Rate Cap loan agreement. Calculations of monthly payments and end of period balances are performed similarly to the previous example, but now, the interest rates to be used in such calculations should be based either on the composite interest rate or on the lower capped interest rate.

Fully Amortizing, Constant Payment Loan, Floating rate with cap	
Loan Amount	€ 100,000
Maturity (years)	20
Initial Interest rate (annual)	6%
Cap rate (annual)	6%
Interest rate (monthly)	0.49%

(1) Month	Market Interest rate (annual)	Loan Interest rate (annual)	Loan Interest rate (monthly)	(2) Loan Balance BoP	(3) Monthly Payment	(4) Interest	(5) Capital Repayment	(6) Loan Balance EoP
1	6%	6%	0.49%	€ 100,000.00	€ 707.29	€ 486.76	€ 220.54	€ 99,779.46
2	5.95%	5.95%	0.48%	€ 99,779.46	€ 704.46	€ 481.56	€ 222.90	€ 99,556.56
3	6.02%	6%	0.49%	€ 99,556.56	€ 707.28	€ 484.60	€ 222.69	€ 99,333.87
4	6.15%	6%	0.49%	€ 99,333.87	€ 707.28	€ 483.51	€ 223.77	€ 99,110.10
5	6.23%	6%	0.49%	€ 99,110.10	€ 707.28	€ 482.42	€ 224.86	€ 98,885.24
236	5.57%	5.57%	0.45%	€ 3,474.40	€ 704.34	€ 15.72	€ 688.62	€ 2,785.78
237	5.49%	5.49%	0.45%	€ 2,785.78	€ 704.24	€ 12.44	€ 691.80	€ 2,093.98
238	5.48%	5.48%	0.45%	€ 2,093.98	€ 704.22	€ 9.32	€ 694.90	€ 1,399.09
239	5.61%	5.61%	0.46%	€ 1,399.09	€ 704.33	€ 6.37	€ 697.95	€ 701.13
240	5.58%	5.58%	0.45%	€ 701.13	€ 704.31	€ 3.18	€ 701.13	€ 0.00

FIGURE 4.10 Floating rate with Cap

In a loan agreement with this setup, the lender will lose the opportunity to make more money every time interest rates move beyond the fixed Cap level. Compared to loans where there are no restrictions on interest rate movements, the lender should now be remunerated for the risk of losing money; this remuneration for risk should be expressed with a loan agreement that is initially based on an interest rate higher than similar loan contracts with no such Interest Rate Cap restrictions.

4.5 OTHER REPAYMENT SCHEDULES

The possibility to create repayment schedules is virtually limitless. In this paragraph some other techniques, although not very common, are presented.

4.5.1 Negative Amortizing Constant Payment Loan

In a negative amortizing constant payment loan the borrower and the lender negotiate a loan agreement according to which the outstanding loan balance at the end of the loan term will be greater than the loan amount itself and thus the periodic payment will be lower than the interest amount due periodically. The outstanding loan value at the end of the loan term will be simply the sum of the loan amount plus all the annual differences between the interest payments and the monthly payments.

EXAMPLE 4.9

In the example in Figure 4.11 the borrower takes out a loan amount of €100,000 at a nominal yearly interest rate of 6% for a 20 year period. The final amount owed at the end of the loan period will be €125,000 and thus the monthly payment is €431.62.

(*continued overleaf*)

Negative Amoritizing, Costant Payment Mortage	
Loan Amount	€ 100,000
Maturity (years)	20
Interest rate (annual)	6%
Interest rate (monthly)	0.49%
Final payment	€ 125,000

Fixed Monthly Payment	**€ 431.62**

(1) Month	(2) Loan Balance BoP	(3) Monthly Payment	(4) Interest	(5) Capital Repayment	(6) Loan Balance EoP
1	€ 100,000.00	€ 431.62	€ 486.76	–€ 55.13	€ 100,055.13
2	€ 100,055.13	€ 431.62	€ 487.02	–€ 55.40	€ 100,110.54
3	€ 100,110.54	€ 431.62	€ 487.29	–€ 55.67	€ 100,166.21
4	€ 100,166.21	€ 431.62	€ 487.56	–€ 55.94	€ 100,222.15
5	€ 100,222.15	€ 431.62	€ 487.84	–€ 56.22	€ 100,278.37
236	€ 124,128.65	€ 431.62	€ 604.20	–€ 172.58	€ 124,301.23
237	€ 124,301.23	€ 431.62	€ 605.04	–€ 173.42	€ 124,474.65
238	€ 124,474.65	€ 431.62	€ 605.89	–€ 174.27	€ 124,648.92
239	€ 124,648.92	€ 431.62	€ 606.73	–€ 175.11	€ 124,824.03
240	€ 124,824.03	€ 431.62	€ 607.59	–€ 175.97	€ 125,000.00

FIGURE 4.11 Negative amortizing loan

Monthly payments (CP) and the remaining components of this loan agreement can be easily calculated by using the same formula of the present value of an annuity used for the previous illustration of the partially amortizing, constant payment loans, again solving the formula for CP setting PV = €100,000 and this time BP = €125,000.

4.5.2 Declining Payment Loan with Constant Amortizing

In this variant of repayment, the constant amortization of the loan amount is first computed. The monthly payment is then calculated as the sum of this constant amortization plus the interest payment on the outstanding loan balance at the beginning of the period. The monthly payment will be decreasing to a value close to the amortization value.

EXAMPLE 4.10

Figure 4.12 shows an example where a borrower takes out a loan for €100,000 for a 20 year term at an annual nominal interest rate of 6%. The amortization will be equal to €416.67.

Constant Amortizing Loan	
Loan Amount	€ 100,000
Maturity (years)	20
Interest rate (annual)	6%
Interest rate (monthly)	0.49%

Amortization	**€ 416.67**

(1) Month	(2) Loan Balance BoP	(3) Interest	(4) Amortization	(5) Monthly Payment	(6) Loan Balance EoP
1	€ 100,000.00	€ 486.76	€ 416.67	€ 903.42	€ 99,583.33
2	€ 99,583.33	€ 484.73	€ 416.67	€ 901.39	€ 99,166.67
3	€ 99,166.67	€ 482.70	€ 416.67	€ 899.37	€ 98,750.00
4	€ 98,750.00	€ 480.67	€ 416.67	€ 897.34	€ 98,333.33
5	€ 98,333.33	€ 478.64	€ 416.67	€ 895.31	€ 97,916.67
236	€ 2,083.33	€ 10.14	€ 416.67	€ 426.81	€ 1,666.67
237	€ 1,666.67	€ 8.11	€ 416.67	€ 424.78	€ 1,250.00
238	€ 1,250.00	€ 6.08	€ 416.67	€ 422.75	€ 833.33
239	€ 833.33	€ 4.06	€ 416.67	€ 420.72	€ 416.67
240	€ 416.67	€ 2.03	€ 416.67	€ 418.69	€ 0.00

FIGURE 4.12 Constant amortizing loan

4.6 RESTRUCTURING AND RENEGOTIATION OF REAL ESTATE LOANS

Restructuring and renegotiation are the terms commonly used in order to classify all situations involving deferment periods, extensions, amendments to contractual clauses, as well as the settlement of outstanding debts due to banks by borrowers which are temporarily unable to comply with their obligations.

Generally speaking, the term restructuring is used to classify transactions concluded between the lender and the borrower and is intended to redefine the overall agreement of the latter's debt exposure. Within this context, these transactions are also classified using the term consolidation. Renegotiation instead generally involves one individual financial relationship or, otherwise, a homogeneous series of relationships in which some elements of the loan agreement (term, interest rate, repayment plan) are amended, not necessarily in order to deal with a situation in which the borrower has defaulted. Usually they are characterized by granting certain facilities to a borrower who is encountering temporary difficulties in honouring the terms of the loan or they represent the conclusion of market transactions aimed at securing the client's loyalty. These may involve changes to interest rates, payment terms, maturity dates, and repayment plans (the waivers), or alternatively the granting of a new loan to replace the previous one, which will then be redeemed with the proceeds of the new loan.

Generally speaking, these transactions may relate both to unsecured short-term debts as well as to medium- and long-term debts backed up by a mortgage security.

Restructuring techniques may involve any of the following:

1. the grant of a new loan;
2. the deferral of payment deadlines and the concession of respite periods;[6]
3. the definition of a loan restructuring agreement.

In many cases restructuring may involve a moratorium on the payment of overdue instalments (generally on the principal in order to permit the borrower to overcome the temporary difficulties without defaulting on the loan). For example, in a case where a tenant paying a significant amount in rent terminates its lease earlier or does not renew the lease upon expiry, it may be necessary to reduce the amount of the instalments falling due pending the arrival of a new tenant by negotiating a suspension on payments of the principal.

4.6.1 Grant of a New Loan

Restructuring could also involve the grant of a new loan, thereby enabling overdue outstanding debts to be paid. The new loan will mean that it is necessary to conclude a new loan agreement and reconstitute all of the securities *ex novo* (including the mortgage).

The borrower will therefore have to bear all of the costs (including taxes) relating to the redemption of the existing loan, as well as those relating to the granting of the new loan. Depending upon the legislative arrangements the bank's guarantee may be weakened since, firstly, the period of time necessary in order to constitute and/or consolidate the mortgage will re-commence and, secondly, it will be open to a new risk of revocation, since both the establishment of the new mortgage as well as the payment redeeming the previous loan may be revoked.

4.6.2 Deferral of Payment Deadlines

A deferral replaces the overdue time limit with a new time limit. A distinction is drawn between a deferral and a respite period: in the latter case the borrower only ceases to be in arrears with payments after it has complied with the obligation within the deferred time limit.

[6] Please refer to paragraph 4.6.2 for an explanation of the respite period.

In other words, the respite period implies a situation in which a time limit is replaced only if the performance occurs before expiry of the new time limit set by the lender. This means that a deferral involves the replacement of the overdue time limit with a new one, with the result that the borrower is no longer in arrears (and does not pay the default interest). During a respite period on the other hand, the status of the loan as being in arrears continues until obligations are honoured upon conclusion of the respite period. In both cases the bank stops demanding the repayment of the loan and does not enforce the guarantees, signing a "*standstill agreement*" with the borrower.

4.6.3 Restructuring Arrangement

The conclusion of a restructuring agreement is generally premised upon a *standstill agreement* (i.e. a *pactum de non petendo*), which is a common feature both of loan restructuring agreements (concluded between a debtor and (all of) its creditors in order to resolve a crisis situation) as well as loan renegotiations (concerning the individual relationship between the bank and the borrower).

The *standstill agreement (pactum de non petendo)* may be defined as an agreement which has the purpose of granting a deferral of loan payment deadlines which are overdue or have not yet fallen due. Such an agreement does not redeem the loan, but rather amends the terms [of repayment] of original loan agreement, thus preventing the lender from enforcing the – as a matter of principle – overdue loan instalments , the payment of which is deferred until the end of the amortization of the original loan. This means that the overdue loan instalments (overdue interest, overdue capital repayments, and interest on arrears) are repaid by the borrower along with the outstanding debt on a deferred basis, following the original repayment plan in place for the outstanding debt and including, if necessary, a deferral of the final maturity date.

When concluding this arrangement, the parties generally execute an agreement (entitled "Variation of the amortization plan" or "Loan renegotiation agreement" or "Loan restructuring agreement" or again "Loan restructuring agreement with variation to the repayment plan") in which, after referring in the preamble to the original agreement(s) grounding the obligation which is to be renegotiated, the borrower acknowledges that it owes certain amounts of money to the lender by way of residual capital, overdue loan instalments (overdue capital and interest payments), and interest on arrears.

As regards default interests, the bank will generally require that the borrower pays such interest (either in full or in part) before concluding the restructuring agreement. Alternatively, a separate agreement may be concluded to regulate their repayment. The payment of default interest (either in full or in part) is an indication of the borrower's actual intention (and financial capacity) to honour his obligations.

The renegotiation agreements concluded by bank and borrower acknowledge the level of the debt and set forth arrangements to govern the repayment of the overdue amounts along with the outstanding debt. Such agreements may come in various forms.

- An agreement that the interest provided for under the loan agreement (which have not changed) will accrue on the overdue amounts instead of interest on arrears. Accordingly, the borrower undertakes to repay the overdue amounts in instalments along with the outstanding debt, following the repayment plan put in place for the outstanding debt. This operation is defined as the "capitalization of arrears". In order to determine instalment amounts (to repay both the outstanding debt as well as the overdue amounts) which are

lower than those originally agreed to and which are sustainable for the borrower, the term of the loan will be extended accordingly.

- An agreement that fixed-rate loan repayments will be made at a level which is sustainable for the borrower (and hence lower than that originally agreed to) until the original maturity of the loan. Instalments paid are allocated by the bank first to the payment of the interest share provided for under the original repayment plan, and thereafter as principal repayments (again as specified under the original repayment plan). The unpaid residual principal on each instalment is then capitalized and, along with the outstanding debt (which is also capitalized), will be repaid by the borrower at the end of the life of the loan either as a lump sum or again by fixed-rate loan repayments. In the latter case, the parties will agree to amend the repayment term for the loan. The amounts capitalized will accrue interest at a rate which is, normally, equivalent to the interest rate for the loan, although if no such agreement is reached interest will accrue at the default rate on these overdue capital instalments.

In these restructuring agreements the parties generally confirm all of the terms, clauses, and conditions contained in the original loan agreement which will not be amended in the restructuring agreement, and will expressly preclude any intention to novate the obligations created under that agreement. Moreover, the guarantors will continue to be parties in order to confirm the securities provided for the original loan. In many cases a clause is included whereby the bank reserves the right to restore all of the original contractual terms and conditions if the borrower fails to abide by the restructuring agreement.

CHAPTER 5

Effects of Financial Leverage on Real Estate Investments[1]

This chapter presents the effects of financial leverage on real estate investments. As such, the chapter has three main objectives:

- to examine the impact of financing on the risk-return ratio as a function of two critical elements:
  - the loan to value ratio;
  - the difference between unlevered returns on investments and the debt servicing costs;
- to clarify the circumstances in which financial leveraging is appropriate;
- to provide some illustrations of the use of financial leverage.

The conduct of the analyses carried out in this chapter implies the inclusion of certain assumptions for the purpose of simplification regarding the return generating process and recourse to financial leverage.

A mono-period model has been used, as a variant of the Modigliani and Miller theorem,[2] which assumes that there are no failure costs associated with the investment:

$$K_e = \frac{K_a - K_d LTV}{1 - LTV}$$

with:

$$K_e = \left(levered\right)\ equity\ return,\ K_d = cost\ of\ debt$$

$$K_a = \left(unlevered\right) total\ return,\ LTV = loan\ to\ value\ ratio$$

[1] Edited by Federico Chiavazza, MRICS, lecturer in the Administration, Control, Corporate and Real Estate Finance Area of the SDA Bocconi School of Management. He is coordinator of the Real Estate Portfolio & Asset Management and Real Estate Development executive courses. After completing a degree in Corporate Economics at Bocconi University and a period of professional activity and further research, he was awarded a Master of Science in Real Estate by New York University. He currently pursues his academic activities in parallel with his work as a professional as a Partner at Avalon Real Estate, and as an advisor for some of the major players in the real estate sector.

[2] See Modigliani and Miller (1958).

A situation involving financing with no failure costs implies that there is no correlation between the loan and total return. Consequently, the volatility of the equity return may be calculated according to the following expression:

$$\sigma_e = \frac{\sigma_a}{1 - LTV}$$

with:

$$\sigma_e = volatility\ of\ \left(levered\right)\ equity\ return$$

$$\sigma_a = volatility\ of\ \left(unlevered\right)\ total\ return$$

5.1 AN ILLUSTRATION OF FINANCIAL LEVERAGE

As the name suggests, since financial leverage reduces the equity contribution, it plays a pivotal role in either increasing or decreasing the returns generated by the investment. This definition may be illustrated through an example.

EXAMPLE 5.1

Suppose we analyse a real estate investment with an initial value of €10 million. The investor may choose whether to invest without financial leverage (an unlevered approach) or alternatively using borrowed capital to cover 50% of the overall investment (a levered approach). If the annual cash flow generated by rental payments for the real estate units (operating income) is equal to €800,000, assuming an interest rate applicable to the borrowed capital of 7%, the investor will receive net cash flows of €450,000 if it has opted for a levered approach. Net cash flow on the other hand will be €800,000 if the investor has invested according to an unlevered approach.

Now let's assume that the property's value increases by €100,000; the total return on the asset, subdivided into its two components of income return (the ratio between net cash flows and the equity made available for the investment) and appreciation return (the ratio between the increase in value over the period and the equity made available for the investment) will be equal to 11% for a levered investment and 9% for an unlevered investment. In this case, financial leverage has a virtuous effect, enabling the investor to increase the return on the investment.

Alternatively, let us assume that the same investment suffers a fall in value of €300,000. In this case, assuming that income return is the same as in the previous case, the appreciation return will fall by 3% for an unlevered investment, but by 6% if a debt-financing approach is chosen. The net effect on the total return for the investor in the event that a levered financing approach is chosen will consequently be negative, moving from 5% for unlevered to 3% for levered. The above described effect is summarized in Figure 5.1.

		Positive Leverage		**Negative Leverage**	
		Unlevered	***Levered***	***Unlevered***	***Levered***
Initial Value		€ 10,000,000	€ 10,000,000	€ 10,000,000	€ 10,000,000
Debt Financing @ **50%**	50%	€ 0	€ 5,000,000	€ 0	€ 5,000,000
Initial Equity		€ 10,000,000	€ 5,000,000	€ 10,000,000	€ 5,000,000
Operating free cash flow		€ 800,000	€ 800,000	€ 800,000	€ 800,000
Interest payment @ **7%**	7%	€ 0	€ 350,000	€ 0	€ 350,000
Net free cash flow		€ 800,000	€ 450,000	€ 800,000	€ 450,000
Property value variation		€ 100,000	€ 100,000	–€ 300,000	–€ 300,000
Income Return (Net free cash flow/Equity)		8.00%	9.00%	8.00%	9.00%
Appreciation Return (Property value variation/Equity)		1.00%	2.00%	–3.00%	–6.00%
Total Return		**9.00%**	**11.00%**	**5.00%**	**3.00%**

FIGURE 5.1 Impact of financial leverage on investor returns

What is the mechanism according to which financial leverage affects investor returns?

- *Positive leverage*: the impact of financial leverage is beneficial when the return on non-debt-funded investment (unlevered) exceeds the cost of debt financing. In the former case in the above example, the unlevered return on investment is equal to 9%, whilst debt servicing costs are 7%. With a financial leverage of 50%, the return on equity will increase to 11% (compared to a return which would otherwise be 9% without debt financing).
- *Negative leverage*: in contrast, the impact of leverage has a penalizing effect when the cost of debt financing exceeds the unlevered return on the investment. In the latter case in the above example, the unlevered return is equal to 5% whilst debt servicing costs remain unchanged at 7%. With leverage of 50%, the return on equity will fall to 3% (compared to a return which would otherwise be 5% in the absence of any debt financing).

Since it is generally not possible to ascertain the future return on investment when it is necessary to decide whether or not to adopt a levered approach, the choice is directly dependent on considerations over the greater or lesser certainty (volatility) in the future operational performance of the investment.

5.2 THE EFFECTS OF AN INCREASE IN VOLATILITY

It is clear that the performance of the investment made according to an unlevered approach will offer more stable returns over time. By contrast, the volatility of returns will significantly increase or decrease as the level of leverage for the investment increases.

Figure 5.2 illustrates the impact of financial leverage on the volatility of returns. The analysis considers a hypothetical average unlevered total return of 9.5%, with volatility of

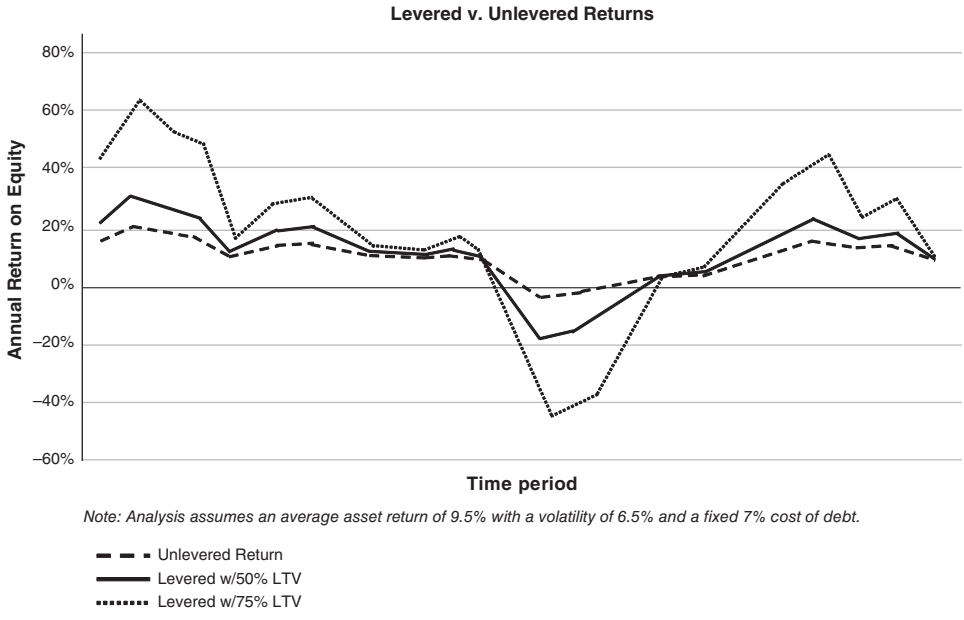


FIGURE 5.2 Volatility and returns on investment

6.5%. The thick broken line represents a potential performance in returns which is in keeping with these assumptions. The broken lines represent the returns on the same investment made with financial leverage (debt to equity ratio) of respectively 50% and 75%, with debt servicing costs constant at 7%.

5.3 THE EFFECT OF FINANCIAL LEVERAGE ON RETURNS

The return on equity is a function of:

- the LTV;
- the spread between total return and debt servicing costs.

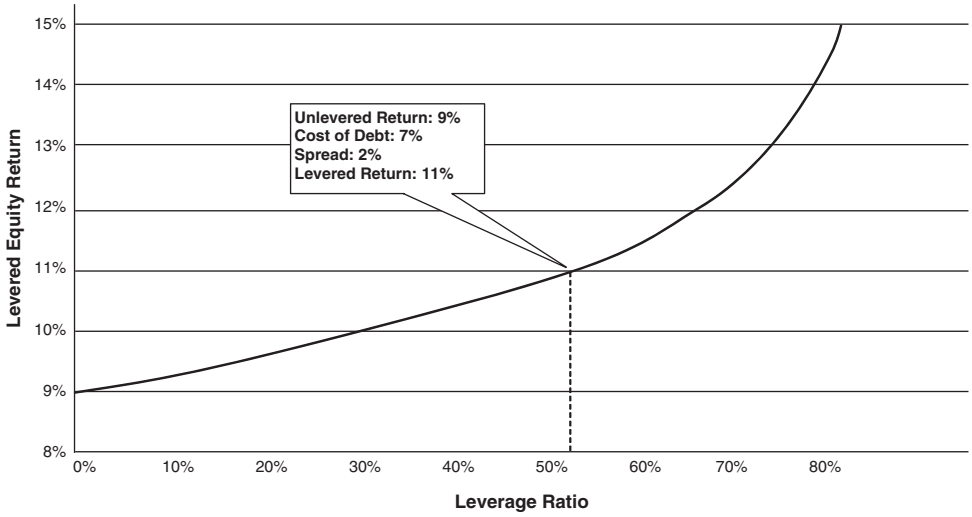
Figure 5.3 is based on the same assumptions as those listed in the first example involving positive financial leverage (unlevered total return of 9% and debt servicing costs of 7%). This ratio shows a progressive improvement of the return on equity due to the use of leverage.

For example, assuming a loan to value of 50%, the investment will generate the total return of 11% stated in the previous example.

Where loan to value exceeds 50%, the return on equity will increase quickly, whilst it will grow much more slowly if the LTV is less than 50%.

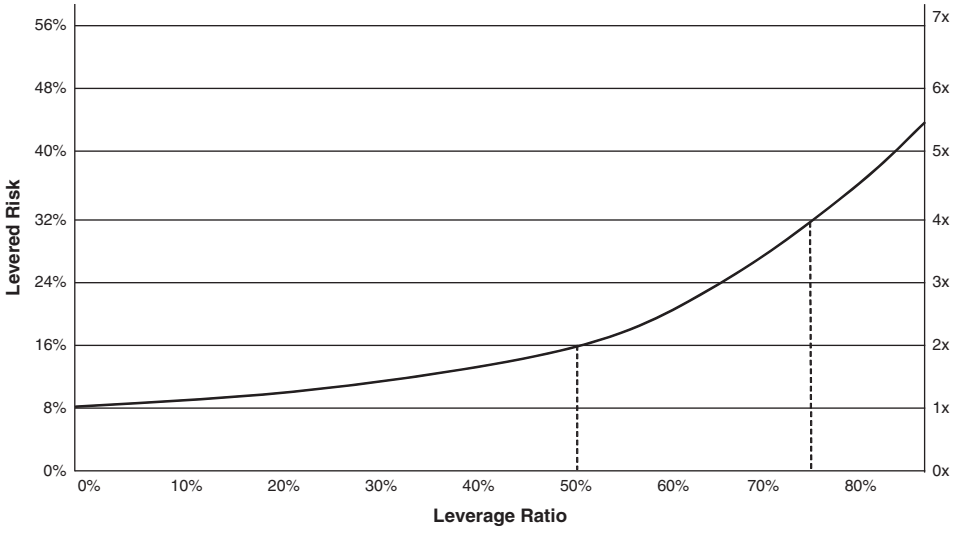
5.4 THE EFFECT OF FINANCIAL LEVERAGE ON RISK

Any increase to the return on an investment resulting from an increase in the LTV will be geometric. Similarly, the volatility of the investment will increase at a similar geometric rate, as illustrated by Figure 5.4.



Note: Analysis assumes a 9% unlevered return and a 7% cost of debt.

FIGURE 5.3 Performance of equity return if the LTV changes



Note: Analysis assumes an 8% unlevered risk and a 7% cost of debt.

FIGURE 5.4 Performance of risk against changes in the LTV

For the purposes of this illustration, it has been assumed that the volatility of a debt-free investment (unlevered) is 8%. Consequently, the volatility of the levered equity return will be 16% with 50% leverage, and 32% with 75% loan to value. For LTVs lower than 50%, the impact of financial leverage on the volatility of equity return is essentially less incisive.

Leaving aside certain simplifications and the mathematical assumptions underlying Figure 5.4, the volatility of the investment doubles (compared to an equivalent debt-free investment) with a leverage of 50%, whilst it quadruples with a leverage of 75%.

5.5 "NO FREE LUNCH"

The combination in Figure 5.5 of the effects of the two figures set out above illustrates the impact of financial leverage on the risk-return ratio. The result is that the trade-off between risk and return is essentially constant.

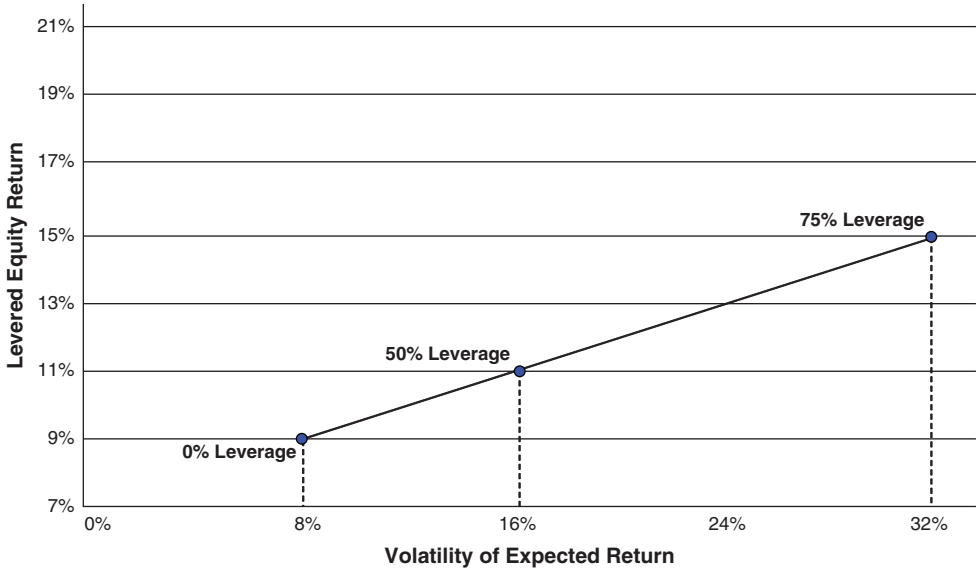
Within the financial literature, this trade-off is referred to as the "*No Free Lunch theorem*",[3] in order to indicate that, absent market imperfections, the high returns generated through financial leverage will be completely offset by the related increase in risk. In other words, the risk premium (understood as the expected return less the no-risk rate divided by volatility) is constant at any level of financial leverage.

In this case too, the increase in volatility and return will be particularly high in cases in which the LTV exceeds 50%.

5.6 THE MECHANICS OF FINANCIAL LEVERAGE

Ample attention has been dedicated above to positive returns as a function of different LTVs; however, there is no guarantee for the decision-making body that recourse to financial leverage will lead to positive results. Were the use of leverage to have a negative effect (resulting in a negative spread between unlevered total return and debt servicing costs), then the impact of leverage on equity return would operate geometrically as is the case for positive effects, that is reducing returns at a rate which is more than proportional to the increase in the LTV.

In Figure 5.5 the slope of the line is dependent on the assumptions made (for example the positive spread between unlevered total return of 9% and debt servicing costs of 7%).



Note: Analysis assumes a 9% unlevered return, 8% unlevered risk and a 7% cost of debt.
Risk-adjusted returns are equal to: (levered return - risk free rate) / return volatility.

FIGURE 5.5 Expected return and volatility against changes in leverage

[3] Wolpert and Macready (1997).

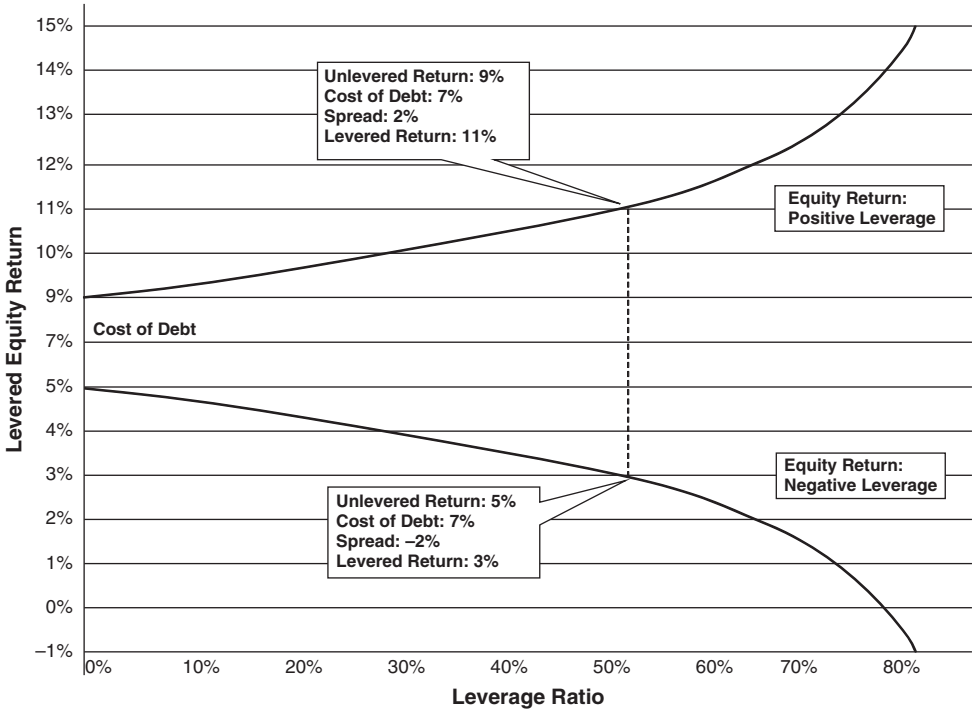


FIGURE 5.6 The impact of financial leverage on real estate investment

However, as mentioned above, future returns are by definition uncertain and, consequently, the decision to use financial leverage at present could lead to a later result for investors which may be either positive or negative.

Figure 5.6 shows the positive and negative effects of financial leverage. The impact is premised on a LTV of 50% in both cases. If the same spreads (–2% to +2%) between the total return and the debt servicing costs considered in the first example are used, the impact of financial leverage will also be identical.

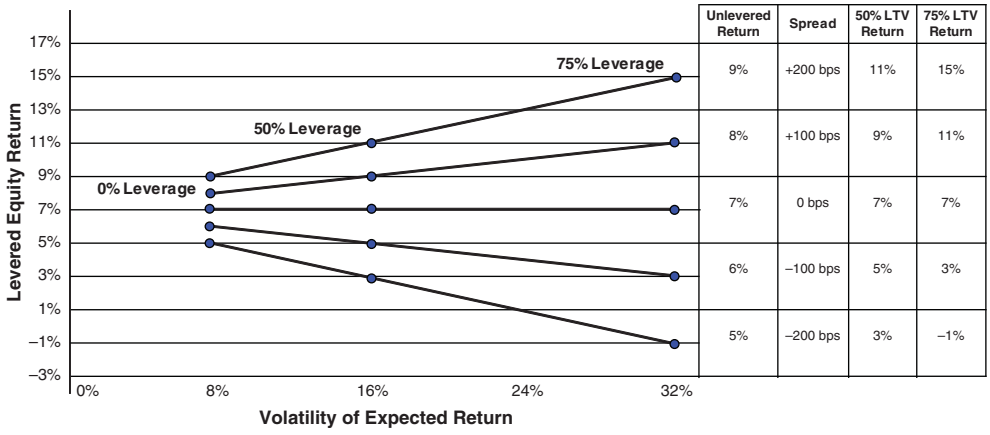
5.7 THE EFFECT OF THE SPREAD

The spread between unlevered total return and debt servicing costs is the only element which determines whether financial leverage will have a positive or negative effect.

Whilst the LTV impinges on the quantity of the leverage effect, the spread is essential in order to decide whether it will be positive or negative, and hence whether its use will be prudent.

Figure 5.7 explains the above. The graph shows variations in unlevered total return (between 5% and 9%), whilst debt servicing costs remain fixed at 7%. The result is a spread ranging from –2% to +2%. When the spread moves from negative into positive territory, two principal consequences may be noted:

- the slope of the line representing the risk-return ratio also changes from negative to positive;
- the starting point for the risk-return ratio increases.



Note: Analysis assumes a 7% cost of debt and a 8% unlevered risk.

FIGURE 5.7 Spread and levered equity return

Both consequences indicate the primary importance of understanding and identifying the spread within a real estate investment as correctly as possible.

5.8 A BRIEF SUMMARY OF WHEN TO USE FINANCIAL LEVERAGE

This paragraph is intended to clarify that the effective use of financial leverage depends on the answers to certain key questions.

What is the spread between expected unlevered total return and debt servicing costs?

If the spread is not positive then the leverage will reduce shareholder returns, whilst if it is positive it will increase returns.

Is the spread sufficiently broad in order to offset the greater risks which financial leverage requires the borrower to take on?

Recourse to leverage increases volatility under all circumstances, and hence the spread must compensate the borrower for the increase in the risk profile.

Are there satisfactory alternative investments for equity capital not used in the project?

Since part of the project will be financed through borrowed capital, any amount of equity capital not invested in the project should be allocated to alternative projects with a satisfactory return. An approach of this type should provide for diversification of the real estate portfolio, since investment in multiple assets will have the effect of reducing non-systemic risk.

Are cash flows expected to be sufficiently stable and will they increase sufficiently?

As described above, the comparison between the total return on the investment and debt servicing costs is the sole decisive factor when determining whether recourse to financial leverage will be beneficial or not. In turn, the total return on investment will depend upon constituent elements, such as future growth in costs and earnings and fluctuations in the

reference Interest Cap Rate, which are difficult to predict at the time choices are made regarding borrowing options.
Consequently, projections of future cash flows will play a decisive role in borrowing choices relating to the project.

What is the degree of certainty for the assumptions underlying the investment plan?
Since future returns are inherently uncertain and since recourse to financial leverage increases volatility, it is fundamentally important to determine whether the uncertainty associated with the project will have any considerable effects either on return (positive or negative leverage) or the degree of risk inherent in that return. The combination of a reduced spread between total return and debt servicing costs, associated with a high operating risk for the project, may lead to risks which are very different from those envisaged.

The following points provide a summary of the essential elements to be taken into account when using financial leverage:

- Recourse to leverage may have a substantial effect on returns. In other words, financial leverage can have either a positive or a negative impact. A definitive judgment on the advisability of leverage can only be made *ex post* by calculating the returns actually achieved.
- It is necessary to carry out a critical analysis of the spread between unlevered total return and the costs for servicing the debt contracted. If the spread is positive, then leverage will operate in favour of the investor. If by contrast the spread is negative, then financial leverage would depress investor returns. Where the LTV increases, the returns on an investment will increase exponentially.
- In all cases, financial leverage increases the volatility of the return on the investment. When the effects of leverage on the risk-return ratio are considered together, it is clear that recourse to financial leverage will require an on-going review of returns, according to the *no free lunch* theorem. This theorem asserts that the benefits expected to accrue through recourse to financial leverage will be offset by an increase in expected volatility.

CHAPTER 6

Structured Real Estate Financing Case Studies

In order to achieve a better understanding of how structured financing works in the real estate sector, this chapter[1] will illustrate some practical examples.[2] Three case studies are presented from the borrower perspective: an income producing property (investment transaction), the acquisition of a property portfolio aimed at its disposal by single assets, and a residential development project. The fourth case study is presented instead from the lender perspective, by describing the analysis carried out by the credit committee of the lending bank. Even if the perspectives of the two parties may appear different, the analyses are similar with respect to the element of risk and the major financial elements considered.

For each operation an example of a possible term sheet relating to the structured financing will be presented, including comments on various items (some common items of minor importance will not be presented in the subsequent term sheets), along with the economic analysis carried out by the lending bank in order to assess the feasibility of the loan applied for, under the conditions proposed in the term sheet. For the purposes of simplicity, the models used will not contain any considerations relating to tax issues (both income and transaction taxes) and will present an extremely simplified cash flow model (before tax and without presenting the profit and loss account). The same considerations will also remain valid if a more detailed economic model is applied.[3]

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[1] Written also with the contribution of Paolo Benedetto, SDA Bocconi Teaching Fellow and Head of Valuation Department in Europrogetti & Finanza. He has participated at the Executive Program in Real Estate Finance by SDA Bocconi and he holds a Master of Science in Finance with honours and an undergraduate degree with honours in Institutions and Financial Markets Management from Bocconi University. He has been an exchange student at the MBA Program of the University of Western Australia in Perth and at the Schulich School of Business, York University in Toronto. He has been member of the local organizing committee of ERES 2010.

[2] All of the names used in this chapter are fictitious and any similarity to the names used by actual business enterprises is entirely coincidental.

[3] For further details on the models please visit www.morri-mazza.com where you can freely download all the Excel spreadsheets used in the book and other materials.

6.1 STRUCTURED FINANCING FOR AN INCOME PRODUCING PROPERTY

6.1.1 Description of the Transaction

The loan is intended to provide part of the necessary capital for an investment in an income producing property. The buyer's strategy is to hold and lease the property for five years and then to divest. Proposed figures for the real estate investment are shown in Figure 6.1.

Price	€ 140,000,000
Annual gross rent	€ 10,080,000
Annual operating expenses	€ 514,080

FIGURE 6.1 The income generating investment

It is assumed that rental payments, operating costs, and the OMV of the property will increase by 2.5% per annum in line with projected inflation. A summary of operating cash flows is extrapolated on the basis of the previous figures, which will be carefully analysed by the lender in order to ascertain their reliability and feasibility. Moreover, the OMV of the property for each period will also be estimated; in the example the OMV is estimated by Direct Capitalization Approach[4] (constant rent on entry yield[5]), consequently the OMV will grow over time by the rate of inflation. Free operating cash flows are shown in Figure 6.2.

6.1.2 Term Sheet for an Income Producing Property

The bank's due diligence for structured real estate financing operations concerns the economic and financial equilibrium of a specific real estate investment which is legally and economically independent of the other assets of the equity investor, e.g. the sponsor of the deal. For this reason the loan is usually granted to a newly constituted SPV or to a legal subject which

	0	1	2	3	4	5
Property market value	€ 140,000,000	€ 143,500,000	€ 147,087,500	€ 150,764,688	€ 154,533,805	€ 158,397,150
Gross rent per year		€ 10,080,000	€ 10,332,000	€ 10,590,300	€ 10,855,058	€ 11,126,434
Annual operating expenses		–€ 514,080	–€ 526,932	–€ 540,105	–€ 553,608	–€ 567,448
Property cash flows		**€ 9,565,920**	**€ 9,805,068**	**€ 10,050,195**	**€ 10,301,450**	**€ 10,558,986**
Investment	–€ 140,000,000					
Divestment %						*100%*
Divestment						€ 158,397,150
Operating cash flows	**–€ 140,000,000**	**€ 9,565,920**	**€ 9,805,068**	**€ 10,050,195**	**€ 10,301,450**	**€ 168,956,136**

FIGURE 6.2 Free operating cash flows

[4] Please refer to paragraph 2.4.3.3 for details on the Direct Capitalization Approach.
[5] Market yield is assumed constant during the holding period.

is capable of guaranteeing it legal protection (e.g. a real estate fund). This is not compulsory, but ring-fencing the financing enhances the creditor's guarantees.

AMOUNT OF THE LOAN

Acquisition Line is equal to the lowest of the following amounts*:*

- €100,000,000;
- an amount guaranteeing LTV no higher than 70%, calculated on the OMV, as determined by an independent appraiser appointed by the Bank;
- an amount guaranteeing an ICR no lower than 170%.

	V1	*V2*	*Min*
Max Amount			€ 100,000,000
LTV Constraint	*70%*	*€ 0*	€ 98,000,000
ICR Constraint (Max interest = CF/ICR)	*170%*	*€ 5,627,012*	€ 118,463,406
Acquisition Financing			**€ 98,000,000**

FIGURE 6.3 Maximum loan amount

Since the economic scale of the deal may not yet be exactly known at the time the loan is negotiated, and hence as reported in the term sheet, the amount of the loan is not specified at a fixed level, but rather stated with reference to several variables, as shown in Figure 6.3.

DETAILED DESCRIPTION OF THE PROPERTY

The description must be as detailed as possible in order to enable the Property to be identified in such a way as to ensure that it is correctly valued and that it is possible to draft the preliminary notary's/legal report to the loan agreement.

PURPOSE OF THE LOAN

To partially finance the purchase price of the Property provided as security. No finance party is bound to monitor or verify the utilization of the loan.

This is a contractual purpose, not a legal one.

TERM

Five years from drawdown.

The term is compatible with the borrower's strategy: purchasing the property, earning income from rents (after deducting the loan repayments), and divesting after five years with capital gain expectations.

DRAWDOWN PROCEDURES

In one single instalment following conclusion of the relative loan agreement, conditional on the fulfilment of various conditions precedent. The amount is paid directly to the seller (subject to the issue of an irrevocable mandate to the bank issued by the SPV) at the time the deed of sale and the loan agreement are executed. The guarantees will also be established at the same time.

REPAYMENT

In one single instalment upon maturity under the loan agreement and, if the property is sold, using the proceeds of the sale of the property.

Full or partial prepayment of the loan will be permitted on any date subject to a minimum of 30 days' notice in writing to the Bank and subject to the payment to the Bank of breakage costs (if any) plus prepayment fee equal to 50 bps for each full year of prepayment before maturity.

The loan is structured to be repaid at property disposal. This provision is aimed at providing financial flexibility to the borrower, in order to be able to sell the property even before the expected holding period. On the other hand, the lender requires a prepayment fee to compensate the need to reinvest the money received in advance.

INTEREST RATE

Acquisition Line: floating 12 months EURIBOR plus margin interest will be payable annually in arrears.

In this specific case the property generates cash flows (rental payments) which are assigned as security and permit to pay interest on debt.

The interest rate may track any EURIBOR rate between 1 and 12 months or, if a fixed rate is chosen, the EURIRS for the period corresponding to the term of the loan agreement. The reference period for the interest rate chosen depends on the intervals between interest payments (monthly, quarterly, half-yearly, or annually), the availability of the funding which the bank must obtain on the interbank market, and the level of the corresponding EURIBOR rate.

At the time the loan is negotiated, the 12 month EURIBOR rate is 0.55%. However, the financial sustainability analysis is carried out assuming a higher interest rate of 1.25% (equal

to the Cap which will be bought to hedge interest rate risk), in order to verify whether the operation will be able to service the debt even if interest rates increase.

MARGIN ON ACQUISITION LINE

- 3% per annum on the amount financed when LTV is under 60%;
- 3.5% per annum on the amount financed when LTV is between 60% and 70%.

The margin is subject to negotiation and mainly depends on the credit risk of the borrower, on the risk of the transaction, on the cost of funding for the bank, and ancillary on revenues associated for the bank. Obviously, due to the increased financial risk, the higher the leverage (LTV), the higher the spread (and vice versa).

INTEREST RATE RISK AND HEDGING

The borrower undertakes at its own expense to hedge interest rate risk fluctuations and this contract has to be approved by the Bank. The hedging rate, excluding the margin, may not exceed an annual rate of 3%, and the rights and receivables under that agreement will be assigned to the Bank as security.

The parties agree on a floating interest rate; the rate at which the Cap is set (excluding the margin) represents a threshold above which the operating cash flows (rental payments after deduction of property operating costs) may no longer be capable of guaranteeing that the contractual commitments will be honoured. It is clear that the interest rate at the time the term sheet is drawn up will be lower than the Interest Cap Rate. The borrower will pay a premium to buy the hedging instrument. Alternatively, the borrower may conclude a Cap & Floor contract or take out a Swap.

The example shown in Figure 6.4 assumes an Interest Rate Cap for five years with an up-front cost calculated as a percentage of the loan amount.

Hedging		
Euribor 12 months (current rate)	0.55%	Spread (LTV treshold)
Cap (BP assumption)	1.25%	60%
Upfront cap cost	1.5%	
Financing line	***Current***	***Cap***
Int. Rate Acq. Line >LTV	3.55%	4.25%
Int. Rate Acq. Line <LTV	4.05%	4.75%

FIGURE 6.4 Interest rates for an income producing property lending

ARRANGEMENT FEE (UP-FRONT FEE)

Equal to 1% calculated on the Loan Amount, due and payable upon signing of the loan agreement.

This fee partially covers the loan structuring costs and partially remunerates the bank in advance for its lending activity. The fee amount is related to the total commitment, regardless of the drawdown periods.

SECURITY

(a) First ranking mortgage over the Property;
(b) Assignment of the rents and any other rights arising out of any rental agreement in relation to the Property as and when these are entered into and out of any other contracts in relation to the Property and payment into a security escrow account with a pledge in favour of the Bank (Rent Account);
(c) Pledge on 100% of the borrower's shares;[6]
(d) Assignment of rights and receivables related to the all risks insurance policies that cover the Property provided as security issued. This title of insurance should be provided by primary standing insurance companies approved by the Bank. The Bank will have a pledge on them;
(e) Assignment of rights and receivables resulting from the signature of the hedging agreement to hedge interest rate risk.

Also according to the Basel Accords,[7] guarantees have the principal function of covering the credit risk which the bank assumes when granting the loan, which is reflected in the margin. The correct and balanced establishment of the security package therefore makes it possible to moderate the credit risk and, accordingly, to reduce provisions made by the bank in its accounts (beneficial for the bank) and to reduce the spread (beneficial for the borrower).

Various instruments may provide hedging for the credit risk: personal sureties, voluntary mortgages, pledging of receivables in addition, naturally, to the pledging of shares of the SPV.

Whilst the other guarantees merely grant satisfaction, e.g. they are only capable of guaranteeing compliance with all or part of the contractual obligations when a particular specified event occurs, the pledge of shares also grants the lending bank voting rights, permitting it to monitor the financed property more effectively in case of problems.

[6] An SPV financing is in place.
[7] Please refer to Chapter 8.

CONDITIONS PRECEDENT AT THE SIGNATURE OF THE LOAN AGREEMENT

In addition to the usual conditions for this type of transaction (verification of powers of signature, company resolutions etc.), the signature of the loan agreement will be subject to the following conditions precedent:

- verification of the value of the Property provided as security by an appraiser appointed by the Bank;
- presentation of an all risks insurance policy covering the property provided as security issued by a primary standing insurance company approved by the Bank and pledged to the latter;
- presentation of a true copy of all leases for the Property;
- completion of a legal and tax due diligence, concerning corporate and contractual documentation, that is procedurally and substantively satisfactory for the Bank;
- completion of a Money Laundering[8] due diligence.

The term sheet is generally drawn up by the bank on the basis of the information provided by the borrower. If it is accepted by the borrower, the Bank must verify these data and perform the technical, legal, tax, and financial due diligence.[9]

CONDITIONS PRECEDENT FOR DISBURSEMENT OF THE LOAN

In addition to the usual conditions for this type of transaction (verification of powers of signature, company resolutions etc.), disbursement will be subject to the following conditions precedent:

- the legal validity of the Securities;
- a report drawn up by a notary/lawyer attesting:
  - the registration of a first-rank mortgage;
  - the formalization of the assignment of rental payments;
  - that no applications for the initiation of bankruptcy proceedings have been filed against the borrower.
- a declaration by the borrower attesting that there are no further debts in addition to those declared upon conclusion.

These are standard conditions typical of all real estate financing operations and must be met prior to disbursement.

[8] The term Money Laundering refers to the process, which can be undertaken via various methods, of creating the appearance that large sums of money obtained from illegitimate means and serious crimes, such as terrorist activity or drug trafficking, originate from a legitimate source.

[9] Please refer to paragraphs 2.4.4 and 2.4.5 for details on the due diligence process.

OTHER CONDITIONS

In addition to the standard contractual conditions for this type of transaction (including but not limited to default interest, prohibition on changes in the company object, prohibition on the assignment of rights/obligations vested in the borrower under the loan agreement, obligation on the borrower to send its annual accounts to the bank etc.), the loan agreement will also provide that:

- the loan agreement itself will take precedence over capital repayments of shareholder loans and/or infra-group receivables;
- any legal and/or notary's fee, tax, or duty relating to the property provided as security and the relative insurance premiums will be paid by the borrower;
- the borrower issues a mandate to the Bank to appoint an appraiser in order to assess the value of the property provided as security at regular intervals and at the borrower's expense; further valuations may be requested by the Bank, but will only be borne by the borrower in the event of a breach of financial covenant or a default occurred under the loan agreement;
- the Bank must be informed of any event of a technical, corporate, or fiscal nature which may have a substantially negative effect on the borrower's capacity to comply with any obligation associated with the loan and which may cause substantial detriment to the borrower's economic, asset, and financial situation.

The loan must be monitored during its whole life and all conditions specified at the time it is granted must continue to obtain for its full term. The borrower must support the Bank, and allow it, on verifying whether those conditions continue to apply until repayment in full.

FINANCIAL COVENANTS

The Loan to Value Ratio (LTV, equal to the ratio between the amount of the loan and the value attributed to the property provided as security by the surveyor appointed by the Bank) may not exceed 70% at any time during the term of the loan.

The Interest Cover Ratio (ICR, equal to the ratio between the total sum of the annual rents generated by the property provided as security and the amount of annual interest due to the Bank) may not fall below 170% at any time during the term of the loan.

Financial covenants may be summarized as follows:

- LTV Default > 75%
- LTV Cash Sweep >70%
- ICR Default < 150%
- ICR Cash Sweep <170%

The financial covenants are necessary in order to impose objective limits on the amount which will actually be negotiated in the loan agreement and have the function of monitoring the

loan until it is repaid. This has direct effects on the rating of the transaction, and may also have an impact on the Bank's regulatory capital (a downgrading will require increased provisions, whilst for example a revaluation of the property will make it possible to reduce provisions).

The monitoring of the rating also makes it possible to take timely action in order to prevent possible default on the transaction.

In the event that the covenants specified above are not complied with, the borrower must repay the excess amount of the loan and/or provide supplementary guarantees approved by the Bank.

If on an interest payment date a Cash Sweep event is outstanding or no Cash Sweep event is outstanding, but a Cash Sweep event was outstanding on the immediately preceding Interest Payment Date, the borrower must ensure that the entire balance of the rents in excess of the corporate operating costs amount is used to repay the loan.

COVENANT/UNDERTAKING

In addition to the primary commitments and obligations which are typical for these types of transactions, the contractual documentation will contain specific commitments by the borrower whereby, unless it has obtained prior written authorization from the Bank, it is required to refrain from:

- disposal of company assets other than in the ordinary course of business;
- any extraordinary activities such as merger or acquisition;
- incurring any other financial indebtedness;
- granting real or personal guarantees (negative pledge);
- undertaking other loans;
- change of ownership in the borrower;[10]
- disposal of the financed property.

The borrower is a SPV with the exclusive purpose of completing the specific transaction and may not carry out other transactions which may be detrimental to the existing financial equilibrium.

[10] The lender has to know in advance and/or permit the change of the ownership of the shares (or quotas) of the borrower for several reasons, but in particular for the following:

(a) in several jurisdictions, the bank has to record the "beneficial owner" of the transaction due to the anti-Money Laundering law; changing the ownership could change the "beneficial owner" (to be recorded) and therefore the Money Laundering risk;

(b) if the borrower belongs to a business group of companies, a change of ownership could change the credit exposure of the group (the old and/or the new one) and therefore their credit risks (furthermore, all the banks have a maximum exposure of credit versus any group of companies);

(c) the change of ownership could change the sponsor of the transaction and, consequently, the members of the board of directors of the borrower; therefore, in accordance with the Basel Convention, it could change the rating of the borrower, its credit risk (acceptable or not acceptable to the lender) and the cost of the transaction (the "margin" or "spread");

(d) in several jurisdictions, if the lender has the pledge of the shares (or the quotas) of the borrower, the lender should permit the mentioned transaction.

EVENT OF DEFAULT

The conditions subsequent stated are those typical for financial transactions of this type. The Bank is entitled to terminate the agreement or, depending upon the circumstances, to request the partial repayment of the loan and/or supplement of the guarantee if:

- the borrower fails to pay one or more instalments of the loan or repeat late payments;
- the borrower does not comply with any obligations imposed on it under the loan agreement with reference to the action required for the purposes of disbursement;
- the assets provided as security are subject to enforcement procedures;
- the borrower and/or third party mortgage guarantor do not promptly comply with one or more of the obligations provided for in relation to the mortgaged properties;
- the borrower carries out any act which reduces its asset level or its financial or economic solidity, or becomes subject to any bankruptcy procedure;
- a breach occurs of one or more of the obligations in respect of which express provision has been made for the full or partial termination of the loan agreement;
- the documentation submitted and the notices provided to the Bank are inaccurate;
- the borrower does not promptly arrange the repayment of tax payable otherwise resulting from the loan or the establishment of the relative guarantees, and such charges will under all circumstances be deemed to be imposed on the borrower even if they are honoured by the Bank;
- the borrower is submitted to a procedure of insolvency.

In the event that the loan agreement expires or is terminated, the lender will be entitled to require the immediate full or partial return of the amounts due for capital, interest (including default interest), and ancillary amounts. The overall amount due will accrue interest on arrears starting from the expiry or termination of the loan agreement.

TECHNICAL, LEGAL, AND OTHER EXPENSES

These are paid by the borrower, which must also reimburse all adequately documented out-of-pocket expenses which may be incurred by the Bank in relation to the conclusion of the financing operation.

These expenses, which may not under any circumstances exceed Euro …, will include those associated with the preparation of the legal and technical due diligence reports and periodic appraisal.

The Bank excludes any liability occurring from any tax implications at the borrower's end.

SYNDICATION

The Bank reserves the right to securitize, syndicate, or sell all or part of the loan without prior consent of the borrower. The borrower will assist in any Syndication efforts by the Bank without risk, cost, or expense to the borrower including but not limited to the borrower's legal costs or expenses. The Bank may provide such information relating to the borrower or the Property in conjunction therewith as it is customarily provided by the Bank in respect of such transaction.

The Bank may pool the operation with one or more banks under a club deal or may thereafter assign the receivable to a third party by securitization/syndication post-closing.

Term sheet expiration: 31st January 201x.
Law: ...
Language: English
Court of Jurisdiction: ...
Limiting Condition: The above constitutes only a draft outline of the terms and conditions on which the Bank would be prepared to consider making available a facility and is in no way to be construed as an offer to provide finance. Any decision regarding the provision of finance requires the approval of the Bank's credit committee.

Once a certain stage has been reached, the term sheet, initially used in order to facilitate negotiations, will become a summary document and the basis for the final loan agreement. Once the borrower (which will negotiate the various terms) has accepted, the Bank will initiate or continue the internal due diligence procedure, the results of which will be summarized in the complex proposal to the competent bodies to adopt the decision authorizing the granting of the loan. After this, if the loan is approved, the contents of the loan decision will be notified to the borrower (although these may also differ from those contained in the term sheet) and the loan agreement may be concluded.

Figure 6.5 sets out the Acquisition Financing Line and contains calculations of the agreed LTV, ICR, and Yield on Debt for each of the loan periods as well as the transaction flows (real estate and levered).

The IRR of each cash flow shown in Figure 6.6 represents the return on the transaction or the cost of the loan. It is noted that since the cost of the debt (5.39%) is lower than the return on the real estate investment (9.33%), the final return (final levered cash flow) is significantly higher (16.93%).[11]

[11] Regarding the effects of financial leverage on the return on an investment, see Chapter 5.

Acquisition Financing Line	0	1	2	3	4	5
Loan Balance BoP		*€ 98,000,000*	*€ 98,000,000*	*€ 98,000,000*	*€ 98,000,000*	*€ 98,000,000*
Drawdown	€ 98,000,000					
Arrangement fee	–€ 980,000					
Upfront cap cost	–€ 1,470,000					
Financing tax	–€ 245,000					
Repayment	€ 0	€ 0	€ 0	€ 0	€ 0	–€ 98,000,000
Loan Balance EoP	*€ 98,000,000*	*€ 98,000,000*	*€ 98,000,000*	*€ 98,000,000*	*€ 98,000,000*	*€ 0*
LTV		*68%*	*67%*	*65%*	*63%*	*62%*
Interest paid		–€ 4,655,000	–€ 4,655,000	–€ 4,655,000	–€ 4,655,000	–€ 4,655,000
CF Acquisition Line	**€ 95,305,000**	–€ 4,655,000	–€ 4,655,000	–€ 4,655,000	–€ 4,655,000	–€ 102,655,000
Covenant ICR		205.5%	210.6%	215.9%	221.3%	226.8%
Covenant Check		*OK*	*OK*	*OK*	*OK*	*OK*
Yield on Debt		9.8%	10.0%	10.3%	10.5%	

FIGURE 6.5 Financing line

Cash Flow Summary	0	1	2	3	4	5	IRR
Property cash flows	–€ 140,000,000	€ 9,565,920	€ 9,805,068	€ 10,050,195	€ 10,301,450	€ 168,956,136	*9.33%*
CF Acq. Line	€ 95,305,000	–€ 4,655,000	–€ 4,655,000	–€ 4,655,000	–€ 4,655,000	–€ 102,655,000	*5.39%*
Equity free cash flow	**–€ 44,695,000**	**€ 4,910,920**	**€ 5,150,068**	**€ 5,395,195**	**€ 5,646,450**	**€ 66,301,136**	***16.93%***

FIGURE 6.6 Summary of cash flows

6.2 STRUCTURED FINANCING FOR A REAL ESTATE PORTFOLIO ACQUISITION

6.2.1 Description of the Portfolio Acquisition

The investor requesting the loan described below (the borrower) intends to purchase a leasehold portfolio with a view to selling the properties individually, with the expectation of capital gains resulting from the portfolio disposal asset by asset. Block sales of real estate portfolios occur at lower prices compared to the sum of the value of the individual properties since the former are assets for which there is a more limited market, which means that a discount has to be granted in view of the reduced liquidity (illiquidity premium). For this reason a positive margin can be created between the purchase price for the portfolio and the sale price of the individual properties.

Price	Net rent	OMV
Property 1	€ 580,125	€ 8,925,000
Property 2	€ 871,650	€ 13,410,000
Property 3	€ 360,750	€ 5,550,000
Property 4	€ 1,735,500	€ 26,700,000
Property 5	€ 965,250	€ 14,850,000
Portfolio	**€ 4,513,275**	**€ 69,435,000**

FIGURE 6.7 Portfolio description

The rental payments can be used to pay interests, whilst the loan will be repaid as the individual properties are sold as shown in Figure 6.7.

The portfolio is acquired with a deposit of 25% of the price upon signature of the preliminary sale and purchase agreement, with the balance due upon completion of the sale process, when the loan will be drawn down.

The appraisal value (OMV) represents the expectations as to the sale price of the individual properties following the portfolio split. A net increase in rents of 2.5% per annum in line with inflation is assumed.

Since it is not possible to determine the order of sale *ex ante*, a hypothetical sequence will be presented in Figure 6.8, including the relevant residual OMV of the portfolio. The selling sequence is only one of the many different scenarios that can occur according to which property is sold and in which time period. Figure 6.9 shows the expected operating cash flows of the transaction.

6.2.2 Term Sheet for the Financing of a Real Estate Portfolio

THE BANKS AND THE BORROWER

- Lending banks: Bank X and Bank Y with equal shares, potentially in relation to different credit facilities;
- Agent bank: Bank X;
- Borrower: the company Z.

The lender reserves the right to establish a pool of banks to disburse the loan, or to syndicate the transaction either before or after it is concluded. The loan is granted under a club deal between two banks that reserve the right to grant one or more loan facilities, though they remain committed to granting the entire loan.

	1	2	3	4	5	6	7	8	9	10
Property 1	€ 8,925,000	€ 8,925,000	€ 8,925,000	Sold	Sold	Sold	Sold	Sold	Sold	Sold
Property 2	€ 13,410,000	€ 13,410,000	€ 13,410,000	€ 13,410,000	€ 13,410,000	Sold	Sold	Sold	Sold	Sold
Property 3	€ 5,550,000	€ 5,550,000	€ 5,550,000	€ 5,550,000	€ 5,550,000	€ 5,550,000	Sold	Sold	Sold	Sold
Property 4	€ 26,700,000	€ 26,700,000	€ 26,700,000	€ 26,700,000	€ 26,700,000	€ 26,700,000	€ 26,700,000	Sold	Sold	Sold
Property 5	€ 14,850,000	€ 14,850,000	€ 14,850,000	€ 14,850,000	€ 14,850,000	€ 14,850,000	€ 14,850,000	€ 14,850,000	€ 14,850,000	Sold
Portfolio	**€ 69,435,000**	**€ 69,435,000**	**€ 69,435,000**	**€ 60,510,000**	**€ 60,510,000**	**€ 47,100,000**	**€ 41,550,000**	**€ 14,850,000**	**€ 14,850,000**	**€ 0**

FIGURE 6.8 Portfolio divestment simulation

Cash Flow	0	1	2	3	4	5	6	7	8	9	10
Acquisition	-€ 14,625,000	-€ 43,875,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0
Property disposal 1		*€ 0*	*€ 0*	*€ 0*	*€ 8,925,000*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*
Property disposal 2		*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 13,410,000*	*€ 0*	*€ 0*	*€ 0*	*€ 0*
Property disposal 3		*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 5,550,000*	*€ 0*	*€ 0*	*€ 0*
Property disposal 4		*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 26,700,000*	*€ 0*	*€ 0*
Property disposal 5		*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 14,850,000*
Investment CF	**-€ 14,625,000**	**-€ 43,875,000**	**€ 0**	**€ 0**	**€ 8,925,000**	**€ 0**	**€ 13,410,000**	**€ 5,550,000**	**€ 26,700,000**	**€ 0**	**€ 14,850,000**
Rent property 1		€ 145,031	€ 145,938	€ 146,850	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0
Rent property 2		€ 217,913	€ 219,274	€ 220,645	€ 222,024	€ 223,412	€ 0	€ 0	€ 0	€ 0	€ 0
Rent property 3		€ 90,188	€ 90,751	€ 91,318	€ 91,889	€ 92,463	€ 93,041	€ 0	€ 0	€ 0	€ 0
Rent property 4		€ 433,875	€ 436,587	€ 439,315	€ 442,061	€ 444,824	€ 447,604	€ 450,402	€ 0	€ 0	€ 0
Rent property 5		€ 241,313	€ 242,821	€ 244,338	€ 245,865	€ 247,402	€ 248,948	€ 250,504	€ 252,070	€ 253,645	€ 0
Real Estate CF	**-€ 14,625,000**	**-€ 42,746,681**	**€ 1,135,371**	**€ 1,142,467**	**€ 9,926,840**	**€ 1,008,101**	**€ 14,199,594**	**€ 6,250,906**	**€ 26,952,070**	**€ 253,645**	**€ 14,850,000**

FIGURE 6.9 Cash flows from the operations

STRUCTURE OF THE OPERATION AND PURPOSE OF THE LOAN

Lines A1, A2, and A3: medium-term loan following payment of part of the net purchase price for the properties to be mortgaged.

PROPERTIES TO BE MORTGAGED ("SECURITY PROPERTIES")

The portfolio comprises the properties described in the enclosed document.

LOAN AMOUNT

For Line A1, the Amount is capped at the lowest of either:

- €15,000,000;
- 40% of the market value of the Security Properties as determined by an appraiser appointed by the Agent Bank;
- 40% of the purchase price for the Security Properties.

For Line A2, the Amount is capped at the lowest of either:

- €15,000,000;
- cumulatively with line A1, 60% of the market value of the Security Properties as determined by an appraiser appointed by the Agent Bank;
- cumulatively with line A1, 60% of the purchase price for the Security Properties.

For Line A3, the Amount is capped at the lowest of either:

- €15,000,000;
- cumulatively with lines A1 and A2, 70% of the market value of the Security Properties as determined by an appraiser appointed by the Agent Bank;
- cumulatively with lines A1 and A2, 70% of the purchase price for the Security Properties.

The ICR for the total amount loaned must not be lower than 150%, the LTV must not exceed 70% of the current value of the portfolio, and the LTC must not exceed 80% of the acquisition price of the portfolio.

Figure 6.10 shows the amounts loaned for each line.

Financing Line	**A1**	**A2**	**A3**
Value	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*
Constraint LTV %	*40%*	*60%*	*70%*
Constraint LTV	*€ 27,774,000*	*€ 41,661,000*	*€ 48,604,500*
Constraint LTC %			*80%*
Constraint LTC			*€ 46,800,000*
Difference with prev. Lines		*€ 26,661,000*	*€ 16,800,000*
Committed amount	**€ 15,000,000**	**€ 15,000,000**	**€ 15,000,000**

FIGURE 6.10 The amounts loaned for each line

The financing lines have been divided because they have different risk profiles. Furthermore, the banks have reserved the right to subscribe to the lines separately (for example, Line A1 Bank X, Lines A2 and A3 Bank Y).

Lines A1, A2, and A3: drawdown in one or more instalments upon payment of one or more advances on the purchase price of the Security Properties.

TERM OF ALL OF THE LINES GRANTED

Three years.

The term is in line with the borrower's strategy of purchasing the portfolio of properties and then selling them individually to third parties.

REPAYMENT

Lines A1, A2, and A3: repayment will be within three years from the signing of the loan agreement out of the proceeds of the sale of the properties or in one single instalment after three years.

The loan will be repaid as sale procedures are concluded in relation to the sale of the individual properties. In particular, in relation to each individual sale, the borrower will repay at least 120% of the amount of the loan allocated to the corresponding unit according to criteria to be agreed to between the bank and the borrower.

Based on the release pricing requested, an allocated loan amount table is drawn up (Figure 6.11) allocating a quantity of debt to each property, which must be repaid at the time of sale.

	OMV	% Value	ALA	120% *Release Pricing*
Property 1	€ 8,925,000	13%	€ 5,784,187	€ 6,941,024
Property 2	€ 13,410,000	19%	€ 8,690,862	€ 10,429,034
Property 3	€ 5,550,000	8%	€ 3,596,889	€ 4,316,267
Property 4	€ 26,700,000	38%	€ 17,303,953	€ 20,764,744
Property 5	€ 14,850,000	21%	€ 9,624,109	€ 11,548,931
Portfolio	**€ 69,435,000**	**100%**	**€ 45,000,000**	**€ 54,000,000**

FIGURE 6.11 Allocated loan amount table

OPTIONAL REPAYMENTS

Full or partial loan prepayment will be permitted upon any expiry of quarterly interest periods subject to a minimum of 30 days' notice in writing to the Bank and subject to the payment to the Bank of a prepayment fee equal to 100 bps for each full year of prepayment before maturity. The 1% penalty will not be due in the situations specified in the "Loan Repayment Procedures".

Figure 6.12 shows the Release Price for every divestment.

Release Price	1	2	3	4	5	6	7	8	9	10
Property 1	€ 0	€ 0	€ 0	€ 6,941,024	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0
Property 2	€ 0	€ 0	€ 0	€ 0	€ 0	€ 10,429,034	€ 0	€ 0	€ 0	€ 0
Property 3	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 4,316,267	€ 0	€ 0	€ 0
Property 4	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 20,764,744	€ 0	€ 0
Property 5	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 2,548,931
Repayment	**€ 0**	**€ 0**	**€ 0**	**€ 6,941,024**	**€ 0**	**€ 10,429,034**	**€ 4,316,267**	**€ 20,764,744**	**€ 0**	**€ 2,548,931**

FIGURE 6.12 The release price according to sale forecast

INTEREST RATE AND MARGIN

For all of the credit facilities, a floating rate based on the EURIBOR 3 month rate, plus a margin for the Bank.

The borrower must hedge against the interest rate risk in a manner deemed appropriate by the Bank.

Per year for the full term of the loan:

- Line A1: 2.5%;
- Line A2: 3%;
- Line A3: 3.5%.

The margins are different because the Lines have different risk profiles. Moreover, the Bank could require that a Cap is stipulated (as in the previous case study) in order to hedge against the risk of an interest rate rise leading to payments of financial charges reaching unsustainable levels. The financial sustainability analysis is conducted assuming a value for the EURIBOR (0.50%) which is higher compared to market conditions at the time the loan is granted (e.g. 0.20%). Considering the short-term nature of the loan, it was chosen not to simulate hedging for interest rate rises.

FREQUENCY OF PAYMENTS

Quarterly in arrears.

FEES

- Flat-rate organization and conclusion fee: equal to 1.2% of the overall amount committed, due upon drawdown.
- Loan management fee due to the Agent Bank: equal to €50,000 per annum, to be paid quarterly.

Figure 6.13 shows the interest rates for every financing line.

SECURITY

- First ranking mortgage over the Security Properties.
- Commitment not to grant mortgages and/or establish third party rights detrimental to the Bank over the properties.
- Pledge over 100% of the shares of the SPV.
- Commitment by the shareholders of the borrower not to change the shareholder structure.
- Commitment that loan capital repayments will have priority over the repayment of any shareholder loans and/or infra-group payables.
- Commitment not to grant and/or take out new loans and not to distribute dividends and/or return equity to shareholders without the prior written approval of the Bank.
- Insurance policies over the Security Properties, issued by a primary standing insurance company approved by the Bank, accompanied by proof of payment and with the Bank as the designated beneficiary. The coverage limit under these policies must be equal to the amount loaned or the rebuilding cost of the properties to be mortgaged, if higher.

Interest	A1	A2	A3
Euribor 3 months (max)	0.5%	0.5%	0.5%
Spread	2.5%	3%	3.5%
Yearly int. Rate	3%	3.5%	4%
Quarterly int. Rate	0.74%	0.86%	0.99%
Initial annual interest	€ 450,000	€ 525,000	€ 600,000

FIGURE 6.13 Interest rates for a real estate portfolio acquisition lending

(*continued overleaf*)

- Hedging against the interest rate risk approved by the Bank. The rights resulting from such contracts must be assigned to the Bank.
- Assignment and payment into an escrow account with a pledge in favour of the Bank of all (current and future) rental or lease payments made, including prepayments, by the tenants and/or tenants of the Security Properties, as well as any other income which may result from the management of the properties.
- Assignment of any surety issued by the tenants and/or tenants of the Security Properties to secure payment of the relative rental and/or lease payments.
- Payment into an escrow account with a pledge in favour of the Bank of all income received as deposits, advance payments, and/or settlement of sale prices of the Security Properties either as a whole or individually.
- A mandate to sell the Security Properties issued to a party approved by the Bank.

COVENANTS AND OTHER CONDITIONS

In addition to the standard contractual conditions for operations of this kind, the loan will be subject to the following additional conditions:

- The Loan to Value Ratio (LTV, equal to the ratio between the amount of the loan and the value attributed to the property provided as security by the appraiser appointed by the Bank) may not exceed 70% at any time during the term of the loan.
- Interest Cover Ratio (ICR, equal to the ratio between the total sum of the annual rents generated by the property provided as security and the amount of annual interest due to the Bank) may not fall below 150% at any time during the term of the loan.
- Provision to the Bank of the borrower's accounts each year within 30 days of approval.
- Provision to the Bank of an up-to-date report on the borrower's accounting situation at least once every half-year.
- Provision to the Bank of a report on progress in the marketing of the Security Properties at least once per quarter.
- A commitment to bear any charge, including notary's fees, taxes, and duties relating to the Security Properties as well as the relative insurance premiums.
- A commitment to inform the Bank of any event which may have a negative effect on the borrower's capacity to honour its contractual obligations.
- The Bank shall be entitled to visit the Security Properties at least once per quarter.

DOCUMENTS REQUIRED AT THE START OF THE LOAN APPLICATION PROCESS

Provision to the Bank of the following documentation:

- a copy of this document signed on every page by the legal representative of the Company (the borrower) as acceptance;

- verification of the solvency of the current tenants of the Security Properties;
- a survey of the Security Properties carried out by an appraiser approved by the Bank certifying compliance with town planning and administrative regulations as well as the sustainability of the rental payments provided for under current leases.

REQUIRED ACTION PRIOR TO CONCLUSION OF THE LOAN AGREEMENT

In addition to the usual conditions applicable to these types of operation, conclusion shall be conditional upon:

- establishment of all of the Securities listed above;
- corporate, legal, and tax due diligence.

DOCUMENTATION REQUIRED PRIOR TO CONCLUSION OF THE LOAN AGREEMENT

In addition to that typical for this type of operation, provision to the Bank of the following documentation:

- copies of the loan agreement;
- duplicate of the mortgage registration;
- a definitive report prepared by the notary/lawyer instructed attesting the first ranking registration of the mortgage in favour of the Bank in the relevant land registers;
- an original version of a bankruptcy certificate for the borrower attesting that the company is not bankrupt and that no applications have been made seeking a declaration that it is bankrupt;
- the original of a pledge in favour of the Bank of the insurance policies specifically required under the Securities;
- a true copy of the deeds of purchase for the Security Properties.

Figure 6.14 sets out the three loan facilities relating to the purchase, assuming that Line A3 is repaid first, followed by Line A2. Figure 6.15 summarizes the Purchase Line including covenants tests.

Finally, Figure 6.16 summarizes the cash flows for the operation (real estate cash flows and levered cash flows) and the cash flows from the loan facility, along with the relative annual IRR, which represents the cost of the loan. It is noted that, due to the fact that the cost of the debt (on average 4.49%) is lower than the return at operating level (19.01%), the final return (final levered cash flow) is significantly higher (49.71%).

Line A1	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Loan Balance BoP	*€ 0*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 2,548,931*	*€ 2,548,931*	
Drawdown	€ 15,000,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*€ 15,000,000*
Arrangement fee	–€ 180,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*–€ 180,000*
repayment	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	–€ 12,451,069	€ 0	–€ 2,548,931	*–€ 15,000,000*
Loan Balance EoP	€ 15,000,000	€ 15,000,000	€ 15,000,000	€ 15,000,000	€ 15,000,000	€ 15,000,000	€ 15,000,000	€ 2,548,931	€ 2,548,931	€ 0	
Interest Payment	–€ 111,256	–€ 111,256	–€ 111,256	–€ 111,256	–€ 111,256	–€ 111,256	–€ 111,256	–€ 18,906	–€ 18,906	€ 0	*–€ 816,604*
Line A1 CF	**€ 14,708,744**	**–€ 111,256**	**–€ 111,256**	**–€ 111,256**	**–€ 111,256**	**–€ 111,256**	**–€ 111,256**	**–€ 12,469,975**	**–€ 18,906**	**–€ 2,548,931**	*–€ 996,604*
Line A2	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Loan Balance BoP	*€ 0*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 12,629,942*	*€ 8,313,675*	*€ 0*	*€ 0*	
Drawdown	€ 15,000,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*€ 15,000,000*
Arrangement fee	–€ 180,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*–€ 180,000*
Repayment	€ 0	€ 0	€ 0	€ 0	€ 0	–€ 2,370,058	–€ 4,316,267	–€ 8,313,675	€ 0	€ 0	*–€ 15,000,000*
Loan Balance EoP	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 12,629,942*	*€ 8,313,675*	*€ 0*	*€ 0*	*€ 0*	
Interest Payment	–€ 129,562	–€ 129,562	–€ 129,562	–€ 129,562	–€ 129,562	–€ 109,090	–€ 71,809	€ 0	€ 0	€ 0	*–€ 828,708*
Line A2 CF	**€ 14,690,438**	**–€ 129,562**	**–€ 129,562**	**–€ 129,562**	**–€ 129,562**	**–€ 2,479,149**	**–€ 4,388,076**	**–€ 8,313,675**	**€ 0**	**€ 0**	*–€ 1,008,708*
Line A3	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Loan Balance BoP	*€ 0*	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 8,058,976*	*€ 8,058,976*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	
Drawdown	€ 15,000,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*€ 15,000,000*
Arrangement fee	–€ 180,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*–€ 180,000*
Repayment	€ 0	€ 0	€ 0	–€ 6,941,024	€ 0	–€ 8,058,976	€ 0	€ 0	€ 0	€ 0	*–€ 15,000,000*
Loan Balance EoP	*€ 15,000,000*	*€ 15,000,000*	*€ 15,000,000*	*€ 8,058,976*	*€ 8,058,976*	€ 0	€ 0	€ 0	€ 0	€ 0	
Interest Payment	–€ 147,801	–€ 147,801	–€ 147,801	–€ 79,408	–€ 79,408	€ 0	€ 0	€ 0	€ 0	€ 0	*–€ 602,220*
Line A3 CF	**€ 14,672,199**	**–€ 147,801**	**–€ 147,801**	**–€ 7,020,432**	**–€ 79,408**	**–€ 8,058,976**	**€ 0**	**€ 0**	**€ 0**	**€ 0**	**–€ 782,220**

FIGURE 6.14 Detailed breakdown of the loan facilities

Acq. Line SUMMARY	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Drawdown	€ 45,000,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*€ 45,000,000*
Repayment	€ 0	€ 0	€ 0	–€ 6,941,024	€ 0	–€ 10,429,034	–€ 4,316,267	–€ 20,764,744	€ 0	–€ 2,548,931	*–€ 45,000,000*
Loan Balance EoP	€ 45,000,000	€ 45,000,000	€ 45,000,000	€ 38,058,976	€ 38,058,976	€ 27,629,942	€ 23,313,675	€ 2,548,931	€ 2,548,931	€ 0	
Portfolio Value	€ 69,435,000	€ 69,435,000	€ 69,435,000	€ 60,510,000	€ 60,510,000	€ 47,100,000	€ 41,550,000	€ 14,850,000	€ 14,850,000	€ 0	
LTV	**65%**	**65%**	**65%**	**63%**	**63%**	**59%**	**56%**	**17%**	**17%**		64.8%
Covenant Test	***OK***	***OK***	***OK***	***OK***	***OK***	***OK***	***OK***	***OK***	***OK***		
Interest	–€ 388,619	–€ 388,619	–€ 388,619	–€ 320,226	–€ 320,226	–€ 220,347	–€ 183,065	–€ 18,906	–€ 18,906	€ 0	*–€ 2,247,532*
Rent	€ 1,128,319	€ 1,135,371	€ 1,142,467	€ 1,001,840	€ 1,008,101	€ 789,594	€ 700,906	€ 252,070	€ 253,645	€ 0	*€ 7,412,312*
ICR	**290%**	**292%**	**294%**	**313%**	**315%**	**358%**	**383%**	**1333%**	**1342%**		290.3%
Covenant Test	***OK***	***OK***	***OK***	***OK***	***OK***	***OK***	***OK***	***OK***	***OK***		
Arrangement fee	–€ 540,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*–€ 540,000*
Loan Tax	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	*€ 0*
Bank Agent Fee	–€ 12,500	–€ 12,500	–€ 12,500	–€ 12,500	–€ 12,500	–€ 12,500	–€ 12,500	–€ 12,500	–€ 12,500	€ 0	*–€ 112,500*
Acquisition Line CF	**€ 44,058,881**	**–€ 401,119**	**–€ 401,119**	**–€ 7,273,750**	**-€ 332,726**	**–€ 10,661,881**	**–€ 4,511,832**	**–€ 20,796,150**	**–€ 31,406**	**–€ 2,548,931**	*–€ 2,900,032*

FIGURE 6.15 Summary of loan facilities and covenants

CF Summary	0	1	2	3	4	5	6	7	8	9	10	Total	IRR Y
Real Estate CF	-€ 14,625,000	-€ 42,746,681	€ 1,135,371	€ 1,142,467	€ 9,926,840	€ 1,008,101	€ 14,199,594	€ 6,250,906	€ 26,952,070	€ 253,645	€ 14,850,000	*€ 18,347,312*	19.01%
Acquisition Line CF	€ 0	€ 44,058,881	-€ 401,119	-€ 401,119	-€ 7,273,750	-€ 332,726	-€ 10,661,881	-€ 4,511,832	-€ 20,796,150	-€ 31,406	-€ 2,548,931	*-€ 2,900,032*	4.49%
FCFE	**-€ 14,625,000**	**€ 1,312,200**	**€ 734,252**	**€ 741,348**	**€ 2,653,089**	**€ 675,375**	**€ 3,537,713**	**€ 1,739,074**	**€ 6,155,920**	**€ 222,240**	**€ 12,301,069**	*€ 15,447,281*	**49.71%**

FIGURE 6.16 Cash flows and return

6.3 FINANCING OF A REAL ESTATE DEVELOPMENT PROJECT

6.3.1 Description of the Residential Development Project

The loan is designed to finance construction costs for a residential development project[12] and will be repaid following the sales of the individual properties (apartments) as they are concluded, without any provision for a transfer of the loan. Expected timing and cash flows are shown in Figure 6.17.

The borrower will purchase the land with its own capital (fully equity financed) and request a bank loan equal to cover the full amount of the construction costs (LTC 100% on capital expenditure only). It is assumed that 25% of the price of the apartments will be received upon signature of the preliminary sale agreements, and the balance upon conclusion of the sale (final deed).

6.3.2 Term Sheet for the Development Project Loan

PROPERTY PROVIDED AS SECURITY

Property located in …, under construction, in respect of which construction permit no. … of … has been issued.

AMOUNT AND PURPOSE OF THE LOAN

In order to cover the costs of building the property provided as security, and ensuring the issue of sureties as guarantee for any advance payments received from end buyers of the properties provided as security, the Bank will structure a loan including the following facilities.

Principal facility

The lowest of the following amounts will be loaned:

1. €52,000,000;
2. 100% of the construction cost for the properties (excluding the cost of the land), as determined by an independent appraiser appointed by the Bank;
3. 60% of the value of the property provided as security, as determined by an independent appraiser appointed by the Bank, assuming that it is exploited in full according to the transformation project referred to above.

Certain European legal systems contain a requirement that sureties/insurance have to be provided in order to guarantee the return of advance payments/deposits. Under certain legal systems these amounts must always transit through the current account of the banks financing the operation.

[12] For more details on development projects and their financing please see also Brueggeman and Fisher (2011).

Timing	0	1	2	3	4	5	6	7	8	9	10	
Area %	100%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Construction%	0%	0%	10%	15%	20%	20%	20%	15%	0%	0%	0%	
Preliminary Contract %	0%	0%	0%	0%	10%	20%	20%	25%	25%	0%	0%	
Final Deed%	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	50%	50%	
Cash flows	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Area	–€ 18,000,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	***–€ 18,000,000***
Construction	€ 0	€ 0	–€ 4,500,000	–€ 6,750,000	–€ 9,000,000	–€ 9,000,000	–€ 9,000,000	–€ 6,750,000	€ 0	€ 0	€ 0	***–€ 45,000,000***
Preliminary Contract	€ 0	€ 0	€ 0	€ 0	€ 2,062,500	€ 4,125,000	€ 4,125,000	€ 5,156,250	€ 5,156,250	€ 0	€ 0	***€ 20,625,000***
Final Deed	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 30,937,500	€ 30,937,500	***€ 61,875,000***
RE Cash Flow	**–€ 18,000,000**	**€ 0**	**–€ 4,500,000**	**–€ 6,750,000**	**–€ 6,937,500**	**–€ 4,875,000**	**–€ 4,875,000**	**-€ 1,593,750**	**€ 5,156,250**	**€ 30,937,500**	**€ 30,937,500**	**€ 19,500,000**

FIGURE 6.17 Timing and cash flows for a real estate development project

Surety facility

The lowest of the following amounts will be made available:

- €18.000.000;
- 100% of the advance payments/deposits received from end buyers of the units built within the property provided as security, paid into an escrow account with a pledge in favour of the Bank.

The independent appraiser may be a surveyor employed by the bank or an independent professional, and is also required to draw up works in progress reports for the purpose of drawdowns. A form of project monitoring is also specified, for which specialist individuals (watchdog) are responsible for regular checks that construction work on the property is continuing in accordance with the schedule provided to the bank upon conclusion of the loan agreement (and in particular according to the tender contract or contracts), and in accordance with the business plan agreed on. The purpose of this is also to ensure that timely action is taken if unexpected events occur during construction which result in delays in work and inevitable increases in construction costs and financial charges. The maximum financed amounts for both financing lines are shown in Figure 6.18.

	Construction Line		Surety Facility	
Max Amount		€ 52,000,000		€ 18,000,000
LTC %	100%	€ 45,000,000	100%	€ 20,625,000
LTV %	60%	€ 49,500,000		
Financed Amount		***€ 45,000,000***		***€ 18,000,000***

FIGURE 6.18 Loan amount

INTEREST RATE AND MARGIN

Floating-rate (EURIBOR 3 months) + margin, paid quarterly in arrears.
Development facility

- 3.5% on an annual basis during the construction stage;
- 2.5% on an annual basis after completion of construction.

GUARANTEE FEE

1% on an annual basis, paid quarterly in arrears.

	Construction Phase	Built Phase	Surety Facility
Spread	3.5%	2.5%	**1%**
Euribor 3 months	0.5%	0.5%	
Interest rate (yearly)	**4%**	**3%**	**1%**
Interest rate (quarterly)	*0.99%*	*0.74%*	*0.25%*

FIGURE 6.19 Interest rates for real estate development project lending

The entire analysis is conducted assuming a value for the EURIBOR (0.5%) which is higher compared to market conditions at the time the loan is granted (0.2%) with the intention of probing the financial sustainability of the project in the event of an interest rate rise. The test could also be repeated according to different base rate scenarios. The rates used for the calculation are converted on a quarterly basis.[13] Figure 6.19 shows the interest rates for every financing line.

PRINCIPAL FACILITY

This will be drawn down in various instalments, with amounts not lower than €500,000 at intervals of at least one month depending upon the WIP, as ascertained by an independent appraiser appointed by the Bank, subject to compliance with the prerequisites referred to above.

GUARANTEE FEE

Made available in instalments in return for payment into the escrow account of the corresponding advance payments/ deposits received from end buyers. The sureties line is in turn guaranteed by the advance payments made by the promissory buyer.

The facility could also be provided with a different guarantee (such as a corporate guarantee issued by the sponsors), depending on laws in the country.

TERM

Three years.

The term must be consistent with the time-scales for construction and marketing activities.

[13] The formula to transform an annual interest rate into its correspondent quarterly rate is as follows: $r_4 = (1 + r)^{1/4} - 1$, where r_4 = quarterly interest rate and r = annual interest rate.

REPAYMENT

The loan will be repaid in one single instalment upon maturity, or alternatively in line with concluded sales for the properties built. In particular, upon each individual sale, the borrower will be required to repay at least 125% of the amount of the loan allocated to the corresponding unit in accordance with criteria to be agreed upon between the bank and the borrower.

Full or partial prepayment of the loan will be permitted upon any expiry of quarterly interest periods subject to a minimum of 30 day notice in writing to the Bank and subject to the payment to the Bank of breakage costs (if any) plus prepayment fee equal to 50 bps for each full year of prepayment before maturity.

Repayments made in line with the sales of properties as described above will not be regarded as advance repayment.

In line with the completed sales and partial repayments of the loan, the bank will arrange for the parallel redemption of the mortgage, following return of the sureties issued against the guarantee fee.

After ownership of the property has been transferred and the price has been paid in full, the surety no longer has any effect and must be returned to the bank for cancellation.

LOAN STRUCTURING COSTS

1.25% of the amount loaned, to be withheld upon the first drawdown.

The structuring costs do not include the appraiser's fees.

COMMITMENT FEE

1.5% on an annual basis, calculated on the residual amount to be drawn down from the Principal Facility (the difference between the loan approved and the amount actually drawn down), to be paid upon conclusion of each quarter after conclusion of the loan agreement.

This is a commission due in respect of non-usage which remunerates the bank's commitment to maintain the facility which has not yet been drawn down for the period of time agreed. Within the example, for the purposes of clarity, it is assumed that there is only one loan agreement which immediately provides a facility for the full amount necessary in order to cover the construction costs. Normally various loans or tranches are granted depending upon the actual

cash requirements of the project in order to avoid an excessive burden in the cost of the commitment fee. Due to this commission, it is very important to forecast the expected cash flow of the project in order to avoid committing to a large amount of unnecessary money.

OTHER COSTS

In addition to the costs relating to the appraiser's estimate and checks regarding the works progression reports drawn up by a surveyor instructed by the Bank, the borrower will bear all other costs incurred by the Bank relating to the preparation, conclusion, and administration of the loan.

The borrower undertakes to pay these expenses upon first demand on the basis of a budget agreed to in advance with the Bank, which may not exceed a total of Euro …

Figure 6.20 shows in details the evolution of the loan facilities (construction line and bank guarantee).

SECURITY

- First ranking mortgage over the Security Property as guarantee for the Main Facility;
- Payment into an escrow account with a pledge in favour of the Bank of all income received as advance payments/deposits relating to the sale of the properties as guarantee for the Guarantee fee;
- Payment into an escrow account with a pledge in favour of the Bank of all income received from the sale of the properties, as well as the relative advance payments/deposits not used to cover the Guarantee fee; it is acknowledged that these amounts may be used in order to cover the cost of construction of the property provided as security, with a parallel reduction of the amount loaned;
- Pledge over shares of the SPV;
- Assignment to the Bank of all rights, including receivables, resulting from tender contracts relating to the transformation of the property provided as security, which must be drawn up in a manner approved by the Bank;
- Assignment to the Bank of a performance bond payable upon first sight, equal to 10% of the total value of the construction tender as guarantee for completion of the work;
- Assignment of the rights and receivables resulting from the all risks insurance policies covering the property provided as security, issued by primary standing insurance companies approved by the Bank and pledged to the Bank;
- A commitment by the borrower's shareholders to guarantee payment of any costs not specified in the business plan enclosed and ensure that the bank's claims take priority over any amounts due to them, or over any infra-group loans.

The security package covers all current and future claims of the bank against the borrower under the finance documents.

Construction Line	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Loan Balance BoP	*0*	*0*	*€ 0*	*€ 4,500,000*	*€ 11,250,000*	*€ 20,250,000*	*€ 29,250,000*	*€ 38,250,000*	*€ 45,000,000*	*€ 45,000,000*	*€ 16,875,000*	
Drawdown	0	0	€ 4,500,000	€ 6,750,000	€ 9,000,000	€ 9,000,000	€ 9,000,000	€ 6,750,000	€ 0	€ 0	€ 0	***€ 45,000,000***
Arrangement fee	0	0	–€ 562,500	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	***–€ 562,500***
Repayment	0	0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	–€ 28,125,000	–€ 16,875,000	***–€ 45,000,000***
Loan Balance EoP	*0*	*0*	*€ 4,500,000*	*€ 11,250,000*	*€ 20,250,000*	*€ 29,250,000*	*€ 38,250,000*	*€ 45,000,000*	*€ 45,000,000*	*€ 16,875,000*	*€ 0*	
interest Construction	*0*	*0*	*–€ 44,340*	*–€ 110,851*	*–€ 199,531*	*–€ 288,212*	*–€ 376,893*	*-€ 443,403*	*€ 0*	*€ 0*	*€ 0*	***–€ 1,463,231***
interest Built	*0*	*0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*–€ 333,768*	*–€ 125,163*	*€ 0*	***–€ 458,931***
Total Interest	0	0	–€ 44,340	–€ 110,851	–€ 199,531	–€ 288,212	–€ 376,893	-€ 443,403	–€ 333,768	–€ 125,163	€ 0	***–€ 1,922,162***
Commited capital not used	0	0	€ 0	€ 33,750,000	€ 24,750,000	€ 15,750,000	€ 6,750,000	€ 0	€ 0	€ 0	€ 0	
Commitment fee	0	0	€ 0	–€ 125,857	–€ 92,295	–€ 58,733	–€ 25,171	€ 0	€ 0	€ 0	€ 0	***–€ 302,056***
CF Line A1	**0**	**0**	**€ 3,893,160**	**€ 6,513,292**	**€ 8,708,174**	**€ 8,653,055**	**€ 8,597,936**	**€ 6,306,597**	**–€ 333,768**	**–€ 28,250,163**	**–€ 16,875,000**	**–€ 2,786,718**
Surety Facility	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Surety amount BoP	*0*	*0*	*0*	*0*	*€ 0*	*€ 1,800,000*	*€ 5,400,000*	*€ 9,000,000*	*€ 13,500,000*	*€ 18,000,000*	*€ 9,000,000*	
New Surety	0	0	0	0	€ 1,800,000	€ 3,600,000	€ 3,600,000	€ 4,500,000	€ 4,500,000	€ 0	€ 0	***€ 18,000,000***
Surety Expiry	0	0	0	0	€ 0	€ 0	€ 0	€ 0	€ 0	–€ 9,000,000	-€ 9,000,000	***–€ 18,000,000***
Surety amount EoP	*0*	*0*	*0*	*0*	*€ 1,800,000*	*€ 5,400,000*	*€ 9,000,000*	*€ 13,500,000*	*€ 18,000,000*	*€ 9,000,000*	*€ 0*	
Cost	0	0	0	0	–€ 4,483	–€ 13,450	–€ 22,416	–€ 33,624	–€ 44,832	–€ 22,416	€ 0	***–€ 141,222***

FIGURE 6.20 The loan facilities

COVENANTS

In addition to the standard contractual conditions for operations of this kind (including but not limited to: default interest, a prohibition on the modification of the company object, a prohibition on the assignment of rights/obligations vested in the borrower under the loan agreement), and the conditions precedent applicable in the event of breach, the borrower shall comply with the following additional requirements:

- The Loan to Value Ratio (LTV, equal to the ratio between the Principal Facility and the completion value attributed to the property provided as security by an independent appraiser approved by the Bank) may not exceed 60% at any time during the term of the loan;
- The Loan to Cost ratio (LTC equal to the ratio between the Principal Facility and the cost of the works financed, including the cost of the land) may not exceed 75% at any time during the term of the loan;
- A commitment by the borrower and their partners not to grant third parties real rights on the borrower's assets and/or shares unless approved in writing by the Bank (Negative Pledge);
- A commitment by the borrower and its shareholders not to change the current shareholder structure unless approved in writing by the Bank;
- A commitment by the borrower to provide the Bank with an up-to-date report on its accounting situation every half-year;
- A commitment by the borrower to provide the bank with copies of extracts of all escrow accounts with a pledge in favour of the Bank in accordance with this loan agreement at monthly intervals;
- A commitment by the borrower to provide the bank with its accounts each year within 30 days of approval along with those of parent companies and companies from the group of origin;
- The grant to the Bank of the right to arrange for appraisers instructed by it to visit the property provided as security at least once per year in order to enable monitoring of compliance with banking legislation and adherence to works progression upon each drawdown.

DOCUMENTATION REQUIRED PRIOR TO CONCLUSION OF THE LOAN AGREEMENT

In addition to those typical for this type of operation (verification of powers of signature and company resolutions etc.), conclusion of the loan agreement will be conditional upon presentation of the following documentation: preliminary report prepared by the notary/lawyer instructed attesting full ownership of the property provided as security and the lack of any burdens and/or detrimental charges against it.

DOCUMENTATION REQUIRED PRIOR TO DRAWDOWN

In addition to those typical for this type of operation, drawdown will be conditional upon the presentation of the following documentation:

- A definitive report prepared by the notary/lawyer instructed attesting:
  - ownership of the property provided as security and that it is free from detrimental charges;
  - registration of the first ranking mortgage in favour of the Bank;
- Copies of the loan agreement;
- Appraisal of the value of the property provided as security upon drawdown by an appraiser approved by the Bank;
- Verification of the start of work and the progression of work by an appraiser approved by the Bank;
- Building regulations due diligence.

For the Guarantee fee:

- Verification of payment into an escrow account with a pledge in favour of the Bank of the full amount of the income received as advance payments on the sales of the properties.

For the full term of the loan it is necessary to monitor compliance with the covenants, including in particular the ratio between expected OMV[14] and debt (Figure 6.21).

Figure 6.22 finally summarizes the cash flows and loan facilities.

6.4 FINANCING A SHOPPING CENTRE: CREDIT APPLICATION

This paragraph[15] presents an example of an executive summary to be presented and discussed in front of a lender's credit committee regarding the potential financing of a core shopping centre through a Mortgage Loan facility. The credit application presents information on the borrower, on the sponsor, and detailed analysis on the property which is the object of financing. In case of a positive outcome of the discussions and support/approval from the committee, a binding term sheet can be issued by the lender and necessary legal documentation (mortgage loan agreement and security package) can be discussed and implemented.

6.4.1 Players Involved

Players involved in the transaction are the borrower, the fund, and the fund manager/sponsor, and will be described in the following section. In view of the non-recourse nature of the

[14] In this example the OMV is calculated as the weighted average of the construction cost and the sale price (after completion costs) in line with the percentage completed.

[15] Written by Michele Monterosso, Director ING Commercial Banking, Real Estate Finance and RE&O in Italy. He joined ING in late 2006, in charge of origination, execution, and monitoring of commercial real estate loans within the ING REF division. Since July 2012, he has also been working for the ING RE&O arm where he is in charge of the wind-down of a combined real estate portfolio in excess of €3 billion (Lease and Real Estate Development positions across Italy). Michele started his career as analyst at KPMG and in the valuation department of DTZ. He holds an honours degree in Business Administration and Corporate Finance from Bocconi University in Milan, and is a member of the Royal Institute of Chartered Surveyors.

	1	2	3	4	5	6	7	8	9
Debt	€ 0	€ 4,500,000	€ 11,250,000	€ 20,250,000	€ 29,250,000	€ 38,250,000	€ 45,000,000	€ 45,000,000	€ 16,875,000
Average OMV	€ 18,000,000	€ 24,000,000	€ 32,437,500	€ 42,975,000	€ 54,075,000	€ 65,175,000	€ 75,750,000	€ 82,500,000	€ 41,250,000
LTV		**18.75%**	**34.68%**	**47.12%**	**54.09%**	**58.69%**	**59.41%**	**54.55%**	**40.91%**
Covenant Test		*OK*	*OK*	*OK*	*OK*	*OK*	*OK*	*OK*	*OK*

FIGURE 6.21 Financial covenants: LTV

	0	1	2	3	4	5	6	7	8	9	10	Total	IRR Y
Real Estate CF	–€ 18,000,000	€ 0	–€ 4,500,000	–€ 6,750,000	–€ 6,937,500	–€ 4,875,000	–€ 4,875,000	–€ 1,593,750	€ 5,156,250	€ 30,937,500	€ 30,937,500	**€ 19,500,000**	**21.90%**
CF Construction Line	€ 0	€ 0	€ 3,893,160	€ 6,513,292	€ 8,708,174	€ 8,653,055	€ 8,597,936	€ 6,306,597	-€ 333,768	–€ 28,250,163	–€ 16,875,000	**–€ 2,786,718**	**5.58%**
CF Bank Guarantee Line	€ 0	€ 0	€ 0	€ 0	-€ 4,483	-€ 13,450	–€ 22,416	–€ 33,624	–€ 44,832	–€ 22,416	€ 0	**–€ 141,222**	
Levered CF pre constraints	**–€ 18,000,000**	**€ 0**	**–€ 606,840**	**–€ 236,708**	**€ 1,766,190**	**€ 3,764,605**	**€ 3,700,520**	**€ 4,679,223**	**€ 4,777,650**	**€ 2,664,921**	**€ 14,062,500**	***€ 16,572,060***	**38.49%**
Escrow Account BoP	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 1,766,190*	*€ 5,532,999*	*€ 9,240,422*	*€ 13,931,174*	*€ 18,726,204*	*€ 21,414,489*		
Increase	€ 0	€ 0	€ 0	€ 0	€ 1,766,190	€ 3,764,605	€ 3,700,520	€ 4,679,223	€ 4,777,650	€ 2,664,921	€ 0	***€ 21,353,108***	
Interest	€ 0	€ 0	€ 0	€ 0	€ 0	€ 2,204	€ 6,903	€ 11,529	€ 17,381	€ 23,364	€ 26,718	***€ 88,099***	
Drawdown	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 21,441,207	***€ 21,441,207***	
Escrow Account EoP	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 1,766,190*	*€ 5,532,999*	*€ 9,240,422*	*€ 13,931,174*	*€ 18,726,204*	*€ 21,414,489*	*€ 0*		
Levered CF to Equity	**-€ 18,000,000**	**€ 0**	**-€ 606,840**	**-€ 236,708**	**€ 0**	**€ 0**	**€ 0**	**€ 0**	**€ 0**	**€ 0**	€ 35,503,707	***€ 16,660,159***	**29.15%**

FIGURE 6.22 Summary of cash flows and loan facilities

proposed financing, the analysis is mainly focused on the borrower/SPV directly holding the property, representing the main collateral of the facility and the source of the necessary cash flows to grant the necessary debt service. Creditworthiness is therefore mainly impacted by quality of the property. Other players involved in the transaction are the fund (controlling entity of the borrower) and the fund manager being the investment and asset manager in charge of the management of the fund portfolio as well as the entity with a direct relationship with the lender (sponsor of the transaction).

6.4.1.1 The Borrower The Borrower of the proposed financing is Prime S.r.l., a limited liability company directly owning Prime Shopping Centre (SPV), a shopping mall (the "Property") with a current GLA of 30,000 m^2 to be further completed by a 10,000 m^2 extension. The Borrower is fully indirectly controlled by Prime FCP, a closed end real estate fund reserved to institutional investors (the "Fund"), managed by Prime Ltd ("Fund Manager" or "Sponsor"). The Sponsor is a global real estate investment and fund asset management firm with more than €50 billion total assets under management. Please refer to the chart in Figure 6.23 for the transaction structure diagram.

Approval is requested for a Mortgage Loan facility up to €75 million secured by the Property (max 50% LTV). The purpose of the facility is (i) to refinance the existing financial indebtedness (outstanding €50 million) and (ii) to create liquidity within the Borrower to finance the construction and development costs related to the realization of an extension of approximately 10,000 m^2 of GLA, bringing the total GLA of the Property to approximately 40,000 m^2, with the OMV of the Property expected to increase from the current €150 million (very recent valuation report prepared by an independent appraiser following RICS standards) to approximately €200 million. Initial LTV of 50% is therefore expected to fall in the 37.5% range upon completion of the extension. Please find in the Figure 6.24 the main terms and conditions of the proposed Mortgage Loan facility (term sheet).

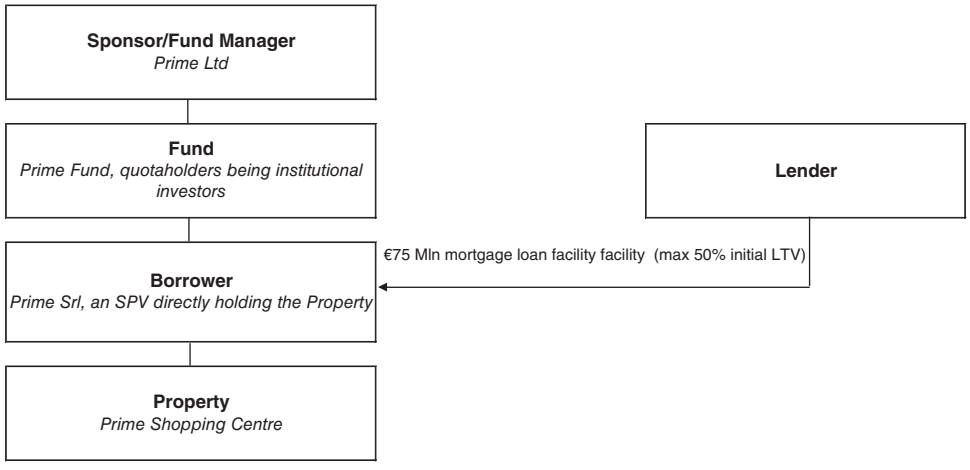

FIGURE 6.23 Structure chart of the transaction – purpose of application

Borrower	Prime S.r.l.
Facility Amount	€75m
Availability	• €50m within one month after the closing date • €25m within 12 months after the closing date
Margin	400 bps
Closing fee	125 bps payable on the entire Facility Amount at closing date
Commitment fee	100 bps per annum on undrawn Facility Amount payable in quarterly instalments
Maturity	5 years
Interest periods	3 or 6 months
Repayment	Bullet at Maturity
Main securities	• First ranking mortgage on the Property (including extension) • Pledge on quotas of the Borrower • Pledge on the Borrower bank accounts • Assignment of the Property lease contracts receivables • Assignment of hedging receivables • Assignment of insurance receivables and insurance loss payee clause
Financial covenants to be tested semi-annually	• LTV ≤ 50% (years 1) • LTV ≤ 40% (years 2, 3, 4, 5) • ICR ≥ 2.0x on an historical basis (looking back) • ICR ≥ 2.0x on a projected basis (looking forward)
Main additional covenants	• No change of control for the Borrower • No change of Fund Manager for the Fund
Voluntary Prepayments	Allowed subject to prepayment penalties equal to 2.0% in year 1, 1.5% in year 2, 1.25% in year 3, 1.0% in year 4 and 0.5% in year 5, to be calculated on the prepaid amounts
Cancellation fee	2.0% calculated on undrawn amounts (if any), payable at the end of Availability
Hedging	Mandatory hedging with a minimum notional equal to €50 Mln and until Final Maturity through an IRS or a Cap with base rate (excluding Margin) not higher than 2.0%

FIGURE 6.24 Summary of main terms and conditions

6.4.1.2 Business Strategy Sponsor Prime Ltd is a global real estate investment and fund asset management firm with more than €50 billion total assets under management, listed on the London Stock Exchange. The Fund was established in 2010 with a 10 year tenor, with the aim of allowing institutional investors to access a specialist sub-sector of the property market such as shopping malls. The Fund has built a prime portfolio of 15 class-leading shopping malls located across Europe (Germany, France, Italy, Benelux, Scandinavia), which are dominant in their respective catchment areas. Total real estate portfolio amounts to €1 billion, with NAV equal to €0.6 billion. The current strategy of the Fund is to extend some of its core properties (including the Property) through additional extensions to further increase their attractiveness and dominance in the respective catchment areas. Prime Ltd is a specialist in the investment and management of retail properties, granting to the Fund portfolio the highest standards in terms of asset management and operating functions such as tenant management, leasing, marketing, rent collection, and reporting activities. The Fund is showing a successful performance, with actual IRR equal to 11% (with annualized distributions to investors equal to 6%).

6.4.2 Financial Analysis and Key Figures

Since the proposed financing is intended to be granted to the SPV directly holding the Property with no other permitted financial indebtedness at Borrower level and without recourse to the Fund or other Sponsor managed entities, the financial analysis is focused on the cash flow projections generated by the Property. However, a brief financial analysis of the Fund is also presented, it being the obligor that indirectly controls the Borrower.

6.4.2.1 Property/Borrower cash flow projections Figure 6.25 shows the projections under the expected scenario of operation of the existing 30,000 m^2 currently fully let and completion of the 10,000 m^2 extension (construction at an advanced stage with full pre-letting through binding proposals) within 12 months from signing of the facility. Projections are run on a five year timeframe matching maturity of the facility.

The main assumptions of this expected scenario are as following.

1. Current annual Gross Rental Income (GRI) generated by the lease contracts currently in place for the 30,000 m^2 phase equal to €11 million in total, taking into account contractual Minimum Guaranteed Rent only and conservatively not considering any form of turnover rent generated by the Property.
2. Additional rent arising from the 10,000 m^2 extension equal to €3.7 million (€366/m^2/year in line with rental levels generated by existing portion) from Year 2.
3. Annual GRI increase in line with expected inflation estimated at 2.0% per annum.
4. Non-recoverable costs equal to 20% of annual GRI, including property tax, insurance premium, property management fees, ordinary maintenance.
5. Existing tenants will not exercise their respective options to break.
6. Interest rate is equal to 5.30% (5 year IRS at 130 bps plus 400 bps margin).

Under this scenario, as highlighted in Figure 6.25, ICR[16] starts at 2.35x[17] in Year 1, to be constantly above 3.15x starting from Year 2 (covenant set at min 2.0x would be therefore amply

[16] Calculated as the ratio between NOI and Interests.

[17] "x" stands for "times", i.e. ICR equal to 2.35x means that the NOI is 2.35 times the interest amount.

Inflation		2%	2%	2%	2%	2%	2%
Minimum Guaranteed Rent		€ 11,000,000	€ 14,720,000	€ 15,014,400	€ 15,314,688	€ 15,620,982	€ 15,933,401
Gross Rental Income		**€ 11,000,000**	**€ 14,720,000**	**€ 15,014,400**	**€ 15,314,688**	**€ 15,620,982**	**€ 15,933,401**
Total non-recoverable costs	20%	€ 2,200,000	€ 2,944,000	€ 3,002,880	€ 3,062,938	€ 3,124,196	€ 3,186,680
Net Operative Income		**€ 9,350,000**	**€ 12,512,000**	**€ 12,762,240**	**€ 13,017,485**	**€ 13,277,834**	**€ 13,543,391**
Interest on Mortgage Loan	5.3%	€ 3,975,000	€ 3,975,000	€ 3,975,000	€ 3,975,000	€ 3,975,000	€ 3,975,000
Mortgage Loan EoY		€ 75,000,000	€ 75,000,000	€ 75,000,000	€ 75,000,000	€ 75,000,000	€ 75,000,000
Property MV EoY		€ 150,000,000	€ 200,000,000	€ 200,000,000	€ 200,000,000	€ 200,000,000	€ 200,000,000
ICR		**2.35**	**3.15**	**3.21**	**3.27**	**3.34**	**3.41**
Debt Yield (%)		**12.5%**	**16.7%**	**17%**	**17.4%**	**17.7%**	**18.1%**
LTV (%)		**50%**	**37.5%**	**37.5%**	**37.5%**	**37.5%**	**37.5%**

FIGURE 6.25 Property cash flows analysis

met), with a comfortable Debt Yield (ratio between NOI and outstanding financial indebtedness) of 12.5% in Year 1 and above 17% starting from Year 3. Property OMV is expected to increase from current €150 million to €200 million, reflecting a gross running yield in the 7.3% range. OMV is projected flat, conservatively not considering inflation or market effect. On the basis of these assumptions, LTV starts at 50% to fall in the 37.5% range upon completion of the extension, within the financial covenant step-down mechanism in place (max 50% in Year 1, max 40% starting from Year 2). Such a step-down mechanism triggers mandatory repayments in case of reduction of OMV below certain thresholds and adequately protects the lender in bullet structures without contractual ordinary amortizations in place.

6.4.2.2 Fund financial analysis *Balance Sheet*: According to the last audited balance sheet, the Fund shows total assets of €1 billion represented by Fixed Assets (90%) and Current Assets (10%). Fixed Assets (15 properties throughout Europe) are largely composed of direct real estate investments increased by 20% mainly due to acquisitions performed over the last year completing the asset allocation of the Fund.

Financial Indebtedness stands at €320 million, of which €310 million is long-term bank loans with average maturity above four years. NAV stands at €670 million. The Fund is currently 34% geared with Fund LTV target being 50%. Net Financial Position stands at €230 million representing a comfortable 26% on Real Estate Assets (direct investments plus participations plus developments). The Fund shows a balanced financial structure with a Current ratio[18] of 5.0x and is very conservatively geared with a Solvency ratio[19] of 67% as shown in Figure 6.26.

Profit & Loss: In terms of P&L, last year Gross Rental Income generated by the properties directly held by the Fund was equal to €70 million, with increase compared to the previous year's figure driven by a combination of new rental income coming from new acquisitions and from positive inflation effect on annual rental income.

The portfolio of assets is of prime quality and supported by diversified tenants that maintained strong performances. Direct Net Rental Income stands at €59 million whereas EBITDA stands at €49 million resulting in an EBITDA margin of 69% and well above interest expenses of €16 million, thus reflecting a comfortable ICR in excess of 3.1x.

Net Result for the period is €38 million, also positively affected by aggregate revaluations registered in the fair value of the portfolio (€10 million). Figure 6.27 shows the profit & loss account and the key ratios.

6.4.3 Risk Appraisal

This financing represents the opportunity for the Lender to start the relationship with the Fund and to consolidate the existing global relationship which is in place with Prime Ltd. This new financing opportunity presents tangible cross-selling opportunities with financial markets

[18] Calculated as the ratio between Current Assets (Cash, Cash equivalents, and Net Account Receivables) and Short Term Liabilities (Bank Loans with expiry <12 months and Net Account Payables). The subject ratio represents a measure of the capability of a borrower/counterparty to meet its short-term financial obligations.

[19] Calculated as the ratio between NAV and Total Assets, showing an immediate measure of the equity value in a real estate fund/company.

Prime Fund €/Mln

Total Assets	**€ 1,000**	**Total Liabilities**	**€ 330**
Fixed Assets	**€ 900**	**Long Term Liabilities**	**€ 310**
RE Investments	€ 850	Bank Loans	€ 300
RE under development	€ 40	Other Long Term Payable	€ 10
RE Participations	€ 10		
Current Assets	**€ 100**	**Short Term Liabilities**	**€ 20**
Cash	€ 80	Bank Loans	€ 10
Net Account Receivables	€ 20	Net Account Payable	€ 10
		NAV	**€ 670**

Key Ratios	
NFP (€ Mln)	€ 230
NFP/EBITDA	4.7
LTV (%)	34.4%
NFP/RE Assets (%)	25.6%
Current Assets/Short Term Liabilities	5.0
Solvency %	67%

FIGURE 6.26 Balance sheet

(potential hedging products related to the Mortgage Loan facility) and payment cash management (management of bank accounts of the Borrower).

6.4.3.1 Structure risk The Borrower is an existing SPV directly holding the Property and fully indirectly owned by the Fund. The Fund has an average annualized distribution yield since inception equal to 6%. Given the strong performance of the Property, the Borrower is significantly contributing to such distributions. Since the Borrower is a SPV without recourse to other entities, the structure risk is considered average,[20] though adequately mitigated by a strong security package (first ranking mortgage on the Property plus additional securities such as pledge on SPV quotas, pledge on Borrower bank accounts, assignment of lease contracts, hedging and insurance receivables) and an adequate set of financial (LTV, ICR) and non-financial covenants (change of control, change of Fund Manager clauses[21]).

6.4.3.2 Real estate analysis *Property*: The Property is a prime shopping mall with a total GLA of 30,000 m^2 divided into 150 units. The Property was completed and opened five years ago and has a successful track record in terms of visitors and turnover. Given the successful and stabilized performance and in view of the significant catchment area of the Property, an extension of 10,000 m^2 GLA has been started and is expected to be completed in Year 1, bringing the total size of the scheme to 40,000 m^2. The Property is well equipped with 3,000 car spaces

[20] A non-recourse structure is considered "average risk" since it is not guaranteed by parent companies, but only by the credit capacity of the SPV/Borrower and, ultimately, of the Property.

[21] Since actual cash flows of the property depend also on the capacity of the Fund Manager, if the Fund Manager changes, the Lender has the right to get the money back.

Prime Fund €/Mln	
Rental Income from RE Assets	€ 70.0
Other Income from RE Participations	€ 1.0
Gross Rental Income	€ 71.0
Property Expenses	-€ 10.5
Property Management Fee	-€ 1.4
Net Rental Income	**€ 59.1**
Fund Mgmt Exp.	-€ 10.0
EBITDA	**€ 49.1**
Dep/Rev from RE Asset/Participations	€ 10.0
EBIT	**€ 59.1**
Interests Expenses	-€ 16.0
Taxes	-€ 5.0
Net Result	**€ 38.1**

Key Ratios	
ICR	3.1
EBITDA Margin	69.2%
EBITDA/Bank Loans	15.8%
NFP/EBITDA	4.7

FIGURE 6.27 Profit and loss

resulting in a very good ratio of one space per 10 m^2 of GLA. The Property is open all year round and trades through a wide range of prime brands, from 10 a.m. to 9 p.m. including Sundays, and is closed only three days a year.

Location: The Property is located in a densely populated area. The catchment area demonstrates a large population with above national average per capita disposable income and above national average levels of consumption. More specifically, approximately 3.5 million inhabitants live in the 0–60 minute drive time isochrone, whereas the 0–30 minutes radius counts more than 2 million inhabitants. Upon completion of the planned extension, it is expected that the Property will further consolidate its leading position within the abovementioned catchment area.

Tenancy: The Property is fully let to 150 tenants with a diversified tenant rent-roll both in terms of GLA and passing rent. Annual Minimum Guaranteed Rent (MGR) from lease contracts in place is equal to €11 million, reaching an amount of €13 million including turnover/variable component and income from temporary lettings/mall income. Total MGR is expected to reach €14.7 million upon opening of the extension (additional GLA entirely pre-let through binding agreements bringing additional annual rent of €3.7 million). The tenancy has a predominant fashion component and hosts a number of national and international prime fashion/designer collection brands, casual clothing brands, sport brands, footwear, and other accessories. Top ten tenants represent 20% of total MGR. The average rental level is €366/m^2/year on MGR basis. Weighted Average Life of leases at first break stands at approximately five

years with next expiry peaks in 2017 and 2018. The Property has totalized a total turnover of €120 million over the last 12 months (equivalent to €4,000/m^2) resulting in an average current effort ratio (MGR/Turnover) of 9.1% which can be considered very good for a retail asset of this type and location.

Valuation: The OMV of the Property has been assessed by an international independent appraiser following RICS standards and covering all Fund portfolio on a semi-annual basis. Last year's valuation reports an OMV of €150 million, reflecting a gross initial yield on existing MGR of 7.3% in line with current market conditions and comparable evidence for prime shopping malls. This value is a fair assessment for a prime retail scheme such as the subject Property and adequately reflects its location, tenancy, and level of competition.

Reputation risk: Considering Sponsor/Fund Manager solid track record as investor and asset manager on a global scale as well as the strong performance of the Fund and the proven track record of the Borrower/Property, reputation risk is considered below average.

6.4.3.3 Repayment Given the very low leverage at Fund level (less than 40%) and the relatively easy access to credit recently proven by the Fund controlled SPVs, refinancing risk is assessed as acceptable. On the basis of figures taken from the annual report of the Fund on existing lenders and amounts of the respective facilities in place, no breaches of financial covenants have occurred. It is therefore expected that the Borrower will repay the facility through a disposal of the asset to another core institutional investor or through a refinancing.

6.4.4 Risk Rating and Risk-Reward

The facilities are in line with the lender secured lending policy paper in terms of amount, level of covenants, tenor, and quality of the collateral:

- Risk rating: equivalent to investment grade;
- Risk adjustment return on capital: above thresholds;
- Sanity check:[22] significantly above minimum thresholds of profitability set by the lender's committee, in view of pricing of the transaction (400 bps) that adequately remunerates the RWAs of the deal.

6.4.5 Conclusion and Recommendation

The credit application is presented to the lender's credit committee with a recommendation such as the one below, so that the committee can take its final decision which is formalized through a separate decision sheet.

[22] Ratio between revenues generated by the transaction and risk-weighted assets (RWA) allocated on the subject deal. More specifically, RWAs are function of EAD (Exposure At Default), LGD (Loss Given Default), PD (Probability Of Default), and tenor/maturity of a loan.

Considering:

1. that the Property has a very strong and consolidated track record and is the top performer in its large catchment area;
2. the moderate initial LTV (50%), that will further decrease upon completion of the planned extension (below 40%);
3. the very good risk-reward profile of the transaction;
4. the strong reputation of the Sponsor/Fund Manager as retail investors and asset managers on a global scale, with strong commitment to the Italian market;
5. the opportunity for the Lender to consolidate the relationship with a key client like Prime with tangible cross-selling potential;

approval is recommended with respect to this financing request.

CHAPTER 7

Hybrid Forms of Financing

Hybrid forms of financing, also defined as mezzanine debt financing and preferred equity, cover a range of flexible financial instruments with different technical characteristics, and may be combined to offer tailor-made solutions for specific financing requirements. These are not forms of capital financing which may be classified under traditional pre-existing forms, such as for example loan agreements, but rather forms of capital financing that are situated half-way between senior debt and equity, and which draw characteristics from both types of capital. This typically refers to mezzanine debt financing, which is fundamentally a subordinate debt, when the debt component is predominant, whilst the term preferred equity is used when the equity capital component prevails, and where there is hence a sharing of risk. For the sake of simplicity, the discussion of hybrid financing will refer to the more general term mezzanine,[1] unless it is specified in each individual case whether the debt or equity component prevails, depending upon the actual structure of the contract. Preferred equity solutions involve structured joint venture agreements in which there are two different classes of shares or fund units, under which the income and cash earned from the initiative may be distributed differently.

7.1 DESCRIPTION

The term mezzanine financing came into common use at the start of the '70s in the United States, and subsequently also in Europe in the wake of the merger and acquisition deals implemented with considerable reliance on borrowed capital. The name originates from a credit position which is paid out after the senior debt in different ways and to differing extents during the repayment of capital and interest, both during ordinary operations and following liquidation if the borrower becomes bankrupt. Nevertheless, in all cases it occupies a privileged position compared to traditional equity.

Thanks to its twofold nature, mezzanine financing is a highly flexible instrument which may make provision for different arrangements as regards the structure of projected cash flows, in such a manner as to adapt itself as far as possible in line with the requirements of the

[1] For further references please see also Watkins et al. (2003).

project financed. Depending upon the way in which the financing is structured (e.g. whether the debt or the equity characteristics prevail) it may come in the form of junior debt or preferred equity.

The use of mezzanine financing enables the debt ratio to be increased in order to obtain a higher equity expected return[2] or to meet financial needs in cases involving capital rationing.

Mezzanine financing is often applied within the real estate sector to trading and development deals, since it enables projects to be completed whilst retaining control over the initiative and participating in the profits, but with a lower equity stake. Mezzanine solutions are used in order to increase leveraging, which may be achieved without changing the level of financial risk for senior lenders, whose financial position will remain unchanged both in terms of their protection in the event of liquidation as well as the assets provided as collateral for the financing.

In particular, it is used in situations in which shareholders intend to maximize the financial leverage effect without being forced to issue additional senior debt.

EXAMPLE 7.1

The simple example set out below represents an investment project with a value of €5 million financed according to three different forms of structured financing shown in Figure 7.1:

1. *Unlevered*: only equity with 15% unlevered expected return (only operational risk).
2. *Traditional financing*: senior debt (cost 6% per annum) and equity with an expected return of 24% (operational risk and moderate financial risk).
3. *Mezzanine financing*: senior debt (6% per annum), mezzanine in the form of junior debt (for the sake of simplicity, at an average overall cost of 10% per annum), and equity with a levered expected return of 40% (operational risk and high financial risk).

Within the three scenarios considered, both the equity needs of the project and the WACC[3] are progressively reduced; if the property is sold for €6 million, the profit for each Euro invested in equity (equity multiple[4]) will increase exponentially as shown in Figure 7.2.

Structured financing, which also includes mezzanine financing, enables the (expected) return to be increased, albeit in return for a greater risk for shareholders, whilst lowering the equity necessary in order to complete the project.

[2] Regarding the effects of financial leverage on the return on an investment, see Chapter 5.

[3] Weighted Average Cost of Capital of a single investment or a company.

[4] Equity multiple means the total profits of a deal plus the equity divided by the equity. If profits are €50 and equity is €100, the equity multiple will be 1.5 (i.e. (€50+€100)/€100).

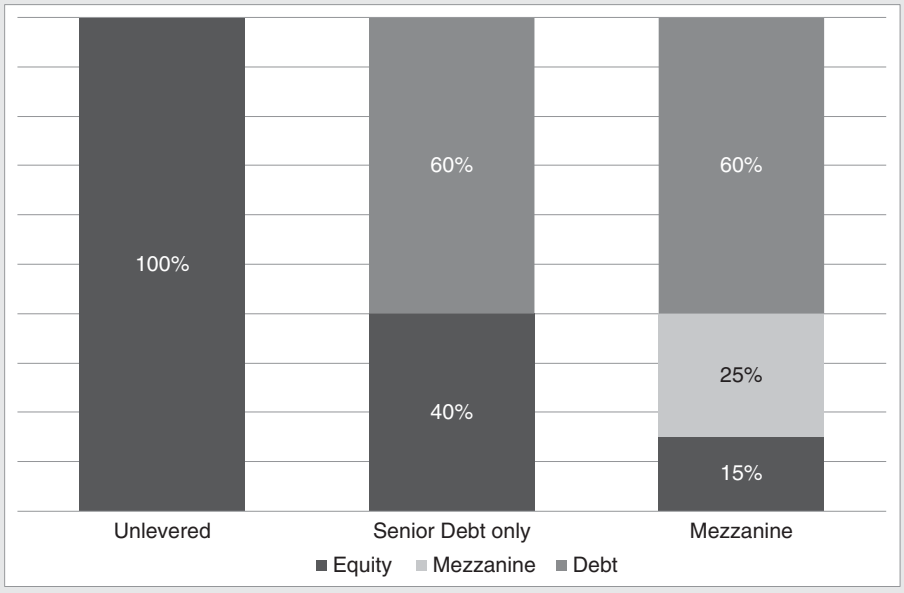

FIGURE 7.1 Examples of different financial structures

	Unlevered	Senior Debt only	Mezzanine
WACC	**15.0%**	**11.9%**	**10.8%**
Exit	€ 6,000	€ 6,000	€ 6,000
Equity	€ 5,000	€ 2,000	€ 750
Profit	€ 1,000	€ 4,000	€ 5,250
Equity Multiple	1.20	1.50	2.33

FIGURE 7.2 Effects of different financial structures

EXAMPLE 7.2

A second simple example is proposed in which an income producing property is purchased, though with the possibility of a requalification project. The purchase value is €10 million, which generates cash flows (for the sake of simplicity, after all operating costs) of €700,000. A restructuring project costing €3 million (capital expenditure) would enable annual cash flows to be increased to €1.1 million. As in the previous example, there are three different scenarios.

(*continued overleaf*)

1. Unlevered, equity only:
   - initial equity: €10 million;
   - post capex equity: €13 million;
2. *Traditional financing with senior debt* (6% per annum) for an amount equal to 70% (LTC) on the initial investment and without capex financing:
   - initial equity: €3 million;
   - post capex equity: €6 million;
3. *Mezzanine financing*: alongside senior debt, mezzanine financing in the form of junior debt is used (for the sake of simplicity, at an average overall cost of 10% per annum) for an amount equal to 20% of the initial investment (which increases the overall LTV from 70% to 90%), thus financing 90% of capital expenditure:
   - initial equity: €1 million;
   - post capex equity: €1.3 million.

It is clear that, also in this different example, the current profitability of the operation will increase whilst the sponsor's parallel need for equity will fall, albeit in return for a higher financial risk. Results are shown in Figure 7.3.

		Unlevered	Senior Debt only	*Mezzanine*
	Current cash flow (i.e. rent)	€ 700	€ 700	€ 700
	Initial Investiment	€ 10,000	€ 10,000	€ 10,000
	Capital expenditure	€ 3,000	€ 3,000	€ 3,000
	Operating cash flow	€ 1,100	€ 1,100	€ 1,100
70%	Debt		€ 7,000	€ 7,000
	Cost of debt		6%	6%
20%	*Mezzanine financing*			€ 2,000
	Cost of Mezzanine financing			10%
90%	*Mezzanine Capex*			€ 2,700
	Mezzanine Cost			10%
	Equity (initial)	€ 10,000	€ 3,000	€ 1,000
	Equity (after capex)	€ 13,000	€ 6,000	€ 1,300
	Profit (initial)	€ 700	€ 280	€ 80
	Profit (after capex)	€ 1,100	€ 680	€ 480
	Initial yield	7%	9.33%	8%
	Initial yield (after capex)	8.46%	11.33%	36.92%

FIGURE 7.3 Effects of different financial structures

7.2 PROCEDURES FOR ESTABLISHING MEZZANINE FINANCE AND COST

In general, a mezzanine finance[5] contract is structured in such a way as to combine characteristics of both debt and equity, which means that the cost (or the expected return for the lender) is higher compared to a senior bank loan, whilst it is lower than the return expected by shareholders. The cost (or expected return) of mezzanine finance is therefore dependent upon its two constituent elements:

- subordinate debt, which comes in the form of a bank loan with an interest rate which under normal market conditions will be between 400 and 600 bps above the market rate for an equivalent maturity;
- an equity kicker, which makes it possible to benefit from any increase in the market value of the venture capital for the project financed, also providing for a form of profit share.

It is evident that the two components are inversely proportionate to each other: a higher rate of interest on subordinate debt will entail, assuming operational risk remains the same, lower return from the equity kicker, and vice versa.

For low levels of LTV, mezzanine financing is predominantly comprised of subordinate junior loans. However, as LTV increases it becomes increasingly necessary for the lender to secure higher returns in the face of increasing risk. On the other hand, the borrower needs to have access to a flexible form of capital, the cost of which will be aligned to the project's actual return. For this reason, once certain levels of LTV are exceeded, mezzanine financing also includes an equity kicker component which, in a manner which is more similar to equity, has a variable cost associated with the economic result of the project.

Mezzanine financing may therefore be more similar to debt or to equity, depending upon whether the emphasis for establishing returns is placed on:

- the former component (interest on the subordinate debt), in which case it is automatically regarded as equivalent to a form of debt with a higher cost;
- the equity kicker component (capital gain associated with expectations of successful completion of the project financed), in which case fixed interest payments are reduced and the mezzanine structure is more readily perceived as reduced-risk venture capital, or preferred equity.

Mezzanine financing may be implemented using subordinate loans (which attract higher financial charges compared to senior debts), preference shares with protective covenants in order to reduce risk, preferred loan stock, or again a combination of different financial instruments which, taken together, offer a risk/return profile in between debt and equity. Whichever form is used, it must be structured in such a manner as to guarantee mezzanine lenders a higher return compared to senior lenders, but lower than that granted to shareholders.

7.2.1 The Debt Component

The debt component takes the form of structured financing, as bonds are only rarely issued in the real estate sector and are usually used by property companies. The debt component is

[5] On mezzanine finance and private equity see also Willis and Clark (1989).

usually medium to long-term, it is lower ranked than senior debt as regards interest and capital repayments, and it has a privileged status over equity only. It is characterized by the fact that remuneration consists in the payment of an interest rate which is higher than that paid for senior debt.

Generally speaking, as is the case for senior debt, junior debt is backed up by collateral. The debt component may come in different forms, the most common of which are set out below:

- *Zero Coupon bonds*: without interest payments during their life, but issued at a discount from their face value.[6] When a Zero Coupon bond matures, the investor receives a lump sum including the initial investment and the accrued interest payments. The advantage of using Zero Coupon bonds for the borrower is represented by the postponement of interest payments. This essentially represents the granting of a pre-amortization period to the debtor.
- *Stepped interest*: during an initial period the investor receives interest payments that are lower than those prevailing in the market. Later, interest payments rise only momentarily at a level corresponding to that of interest currently offered by the market and in the final period leading up to maturity date the lender enjoys interest payments that are above the market level. This form of debt is suitable in case project cash investment is large during its initial stage, as real estate development projects.
- *Roll-up*: debt provision substantially opposite to Stepped interest, with initially elevated interest payments falling at a later stage. This solution is best in case of projects with large cash flows during the short-to-medium-term phase.
- *Payment in Kind debt (PIK)*: this provides an additional return essentially by capitalizing the interests, which get added to the outstanding principal on each interest payment date. The return is based on the investor receiving a new note on each interest payment date rather than cash. The effect of PIK interest is to compound the return earning interest on interest.

Although they are used less frequently, the following bonds may be used to structure mezzanine financing in the real estate sector:

- non-convertible bonds;
- convertible bonds;
- bonds cum warrant.

Since non-convertible bonds involve a pure debt, an equity kicker must be used alongside, whilst in the other two cases the presence of a mechanism for conversion into equity means that the lender may participate directly in the variable result.

Usually when bonds are used no provision is made for the regular payment of interest, which involves the issue of Zero Coupon bonds where interest results from the difference between the discounted value and the nominal value. Moreover, the bond is paid out after ordinary creditors.

However, bonds are not frequently used within the real estate sector since investments are generally financed on an individual project level, and not according to a corporate finance approach.[7] Project bonds may be used in financing large scale projects through SPVs.

[6] The face value is the amount a bond will be worth when it matures or comes due.

[7] On the difference between project and corporate finance please see paragraph 1.3.

7.2.2 Equity Kicker

An equity kicker enables the mezzanine lender to benefit from any increases in the OMV of the asset financed. In financing deals incorporating an equity kicker, the debt component may attract lower interest rates, whilst offsetting the lower return in other ways. This means that complex transactions may be financed by granting lenders an equity stake in the profits of the operation being financed.

A capital contribution occurs when the lender participating in the mezzanine operation considers that, in view of an increase in the debt ratio, it is running a risk which is comparable or similar to that of shareholders, and hence expects a return in line with their expected IRR. However, in order to achieve that result, it is not possible to increase the interest rate on the debt, since this would introduce excessive rigidity into the financial structure; it is in such cases that an equity kicker is used enabling a variable link to be created between the return and the actual economic result, without encumbering the project financed with greater fixed costs due to financial charges.

Mezzanine lenders are able to benefit from any increase in value of the asset financed:

- directly, through the sale of ordinary or preferred shares;
- indirectly, through the allocation of warrants or call options on shares in the company financed,[8] which will enable them to subscribe to a particular quantity of shares at a strike price which factors in the expectation of the return from the mezzanine deal based on the risk accepted.

The most common equity kickers are:

- warrants;
- call options on shares in the SPV;
- preferred shares[9] which are convertible into ordinary shares;
- back-end fees paid when the debt component has been repaid in full.

Warrants, generally speaking, have a long maturity period, even though the period of time during which they may be exercised is very short. Equity kickers in the form of warrants are often combined with a put option granting the provider of mezzanine finance the option to sell the warrants prior to maturity at a pre-set strike price, which is dependent upon the operating cash flows and the final result. In return for the granting of that put option, the borrower generally obtains a call option, which may be exercised after expiry of the put option, enabling it to repurchase the warrants issued prior to maturity at a strike price which is also pre-set: in this way it is possible to determine the minimum and maximum returns on the mezzanine financing in advance (or the cost from the borrower's point of view). If call options are used, the strike price will be calculated in such a manner as to satisfy the requirements of the mezzanine lender in a manner commensurate with the level of risk taken on.

The two components of mezzanine financing – subordinate debt and the equity kicker – may be brought together within the same instrument by using debt and equity stocks such as subordinate convertible bonds with deferred interest payments (deferred coupon bonds, payment in kind, and split coupon bonds) or with Zero Coupon. The return on convertible bonds is lower than that for non-convertible bonds, since the former enable the creditor to choose

[8] SPVs are common when a mezzanine financing is structured.

[9] Preferred shares give some profit distribution advantages in compensation for reduced voting rights.

whether to continue to finance the issuer company, or to convert the bonds before a pre-set deadline into shares in that company at pre-set rates (conversion index).

These forms of financing are more typical of corporate operations, whilst bonds are not normally issued in the real estate sector, which tend to use forms of structured bank financing, in addition to the equity kicker component.

It is not necessary to use ordinary shares for the equity kicker in mezzanine financing; there are also other types of venture capital, such as preferred shares, which come in different forms in each legal system, though these are generally characterized by certain fundamental differences compared to ordinary shares:

- participation in profits, with the exclusion of any liability for losses;
- repayment upon maturity;
- privileged dividend rights as specified in the memorandum.

7.3 COVENANTS IN A MEZZANINE FINANCING

Mezzanine financing is characterized by the existence of numerous covenants,[10] a bundle of agreements, restrictions, and limitations which are usually imposed on the borrower either by senior lenders or mezzanine lenders. The purpose of covenants is to prevent the borrower from concluding transactions which could result in a change to the financial structure at the time the financing was granted, with the result that the mezzanine debt may no longer be repaid according to the procedures and time limits specified.

Covenants do not have a direct effect on the cost of financing, but impose significant indirect costs by considerably limiting freedom of action in relation to the project financed. The purpose of these restrictions is to protect the mezzanine lenders from taking on further risk compared to the senior lenders. For this reason, mezzanine lenders, or mezzanine investors, are considered to be more similar to venture capitalists than to senior-ranking lenders.[11]

Covenants come in the form of contracts which prevent the borrower from engaging in value-reducing conduct which may have the effect of transferring wealth between the holders of different categories of capital stocks, to the detriment of mezzanine lenders. They may be used in different forms and combinations, although it is possible to identify some general principles. The most common restrictions, classified under negative and positive covenants, are set out below.

In a mezzanine financing, negative covenants entail a series of prohibitions or limits on the borrower's freedom of action (distribution of profits, further investment costs etc.). The most common negative covenants are the following.

- *Negative pledges*: protect unsecured lenders from being granted a lower ranking than other junior creditors by the provision to them of guarantees or pledges by the borrower, intended to preserve the creditors' position in the event of bankruptcy.
- *Debt limits*: impose an obligation on the borrower to maintain an equity to senior debt ratio above a level specified in advance under contract.
- *Dividend tests*: the prohibition on the payment of dividends above a pre-set amount without the prior approval of the mezzanine lender.

[10] Please see also paragraph 3.15 for details on covenants.

[11] Batey (1996–1997).

- *Poisoned puts*: protection against the risk of a re-leverage operation, enabling the mezzanine lender to impose its obligations on the issuer in the event of a change in control of the borrower.
- *Restrictions on capital repayment*: the ability to object to decisions by senior lenders to make changes to the order of payments and the method used to calculate interest.
- *Reinforcement of the guarantee towards the mezzanine lender* if the borrower company is in breach of its obligations for a certain period of time.
- *Prohibition on the conclusion of extraordinary financing operations* (mergers and acquisitions, transfers of operations, corporate acquisitions etc.) without the prior approval of the mezzanine lender, as well as limitations on the award of bonuses to management and on the distribution of dividends in excess of certain limits.

Positive covenants amount to obligations to act in a particular way (e.g. not to set aside funds, but to repay the subordinate debt). Common features include the following:

- The obligation to maintain a minimum level of liquidity (current assets to current liabilities ratio).
- Compliance with certain financial ratios specified under contract at the time the loan is drawn down. These entail in particular the duty to maintain certain levels of company solvency: typical restrictions include the obligation to maintain a minimum debt (senior debt plus subordinated debt) to equity ratio, or the obligation to maintain a minimum level of liquidity (current assets to current liabilities ratio).
- Covenants intended to ensure that cash flows will be used in order to accelerate repayment of the loan in the event of scenarios which are more favourable than those projected. A typical example is the requirement that greater debt repayments must be made in the event that, following the sale of properties (or other assets), cash in excess of the levels forecast is obtained;[12] a typical case is that involving a release price whereby a greater quantity of debt than that allocated must be repaid in the event of a partial sale (e.g. a property portfolio with disposal by single assets).

Mezzanine lenders may request certain forms of control over company decision making and appoint one or more directors to the board of the company.

Agreements may also be concluded between the borrower company and the mezzanine lenders on the re-acquisition of securities issued at future dates or following the occurrence of certain events. These covenants will specify the repurchase price of the equity kickers, which may be determined on the basis of different pay-off alternatives.

7.4 ECONOMIC MECHANICS OF HYBRID FINANCING

The definition of hybrid financing is extremely complex and requires the stipulation of a highly detailed contract.[13] This section will provide several examples which describe its mechanics and effects from both economic and financial perspectives. In particular in the following paragraphs two different examples will be presented:

- mezzanine financing for an income producing property;
- the use of preferred equity within a development project.

[12] Della Bella (1996).

[13] For further references on the legal structure please see also Forte (2004).

7.4.1 Mezzanine Financing for an Income Producing Property

This example will highlight how the leveraging mechanism of mezzanine financing has an impact on shareholder returns in the event that an income producing property is purchased, which is financed out of debt capital that is only due for repayment at the time of divestment (bullet).

Investment in an income producing property with a six-year holding period is analysed, assuming annual increases in rent and the value of the property. The deal may be financed using senior debt, with repayment in the last year and annual financial charges. For the sake of simplicity, transaction costs and taxes are not considered in the example; other figures are shown in Figure 7.4.

The following sections will also consider the possibility of using mezzanine financing which provides for:

- subordinate junior debt with repayment in the last year and annual financial charges;
- an equity kicker (EK), paid upon maturity of the loan, calculated on the mezzanine financing capital at an interest rate equal to the difference between the IRR of operating cash flow and financial charges (Kd) on the senior debt, multiplied by an equity kicker multiplier set under contract at 50%.

The use of mezzanine financing enables the investment to be made with reduced equity and increases profits for shareholders. Profitability increases due to the greater recourse to debt, albeit at greater cost and risk. Cash flows and IRRs are shown in Figure 7.5.

In Figure 7.6 mezzanine effect on cash flows and return is shown. The EK is calculated upon maturity of the loan (Period 6), on the mezzanine financing capital (€3,000) at an interest rate (1.23%) equal to the difference between operating cash flow IRR (6.63%) and Kd on the

Acquisition price	€ 15,000		
Net Operating Income	€ 800		
NOI annual variation	3%		
Property Value annual increase	2%		
Capital structure	**LTV**	**Kd**	**EK**
Senior Debt	65%	5%	
Mezzanine	20%	8%	50%

FIGURE 7.4 Example hypothesis

IRR		0	1	2	3	4	5	6
	Property Acquisition & Sale	-€ 15,000	€ 0	€ 0	€ 0	€ 0	€ 0	€ 16,892
	Net operating Income		€ 800	€ 824	€ 849	€ 874	€ 900	
6.63%	*Operating cash flows*	*-€ 15,000*	*€ 800*	*€ 824*	*€ 849*	*€ 874*	*€ 900*	*€ 16,892*
	Senior debt	€ 9,750						-€ 9,750
	Interests on Senior debt		-€ 488	-€ 488	-€ 488	-€ 488	-€ 488	-€ 488
9.43%	**Levered cash flows**	**-€ 5,250**	**€ 313**	**€ 337**	**€ 361**	**€ 387**	**€ 413**	**€ 6,655**

FIGURE 7.5 Cash flows with senior debt only

IRR		0	1	2	3	4	5	6
	Property Acquisition & Sale	–€ 15,000						€ 16,892
	Net operating Income		€ 800	€ 824	€ 849	€ 874	€ 900	€ 0
6.63%	*Operating cash flows*	*–€ 15,000*	*€ 800*	*€ 824*	*€ 849*	*€ 874*	*€ 900*	*€ 16,892*
	Senior debt	€ 9,750						–€ 9,750
	Interests on Senior debt		–€ 488	–€ 488	–€ 488	–€ 488	–€ 488	–€ 488
9.43%	*Levered cash flows post senior debt*	*–€ 5,250*	*€ 313*	*€ 337*	*€ 361*	*€ 387*	*€ 413*	*€ 6,655*
	Mezzanine	€ 3,000						–€ 3,000
	Interests on Mezzanine		–€ 240	–€ 240	–€ 240	–€ 240	–€ 240	–€ 240
11.07%	***Pre EK Cash Flows***	**-€ 2,250**	**€ 73**	**€ 97**	**€ 121**	**€ 147**	**€ 173**	**€ 3,415**
	Equity Kicker							–€ 146
10.35%	**Free Cash flows to Equity**	**–€ 2,250**	**€ 73**	**€ 97**	**€ 121**	**€ 147**	**€ 173**	**€ 3,269**

FIGURE 7.6 Levered cash flows of shareholders with mezzanine financing

IRR		0	1	2	3	4	5	6
5.00%	Senior debt	-€ 9,750	€ 488	€ 488	€ 488	€ 488	€ 488	€ 10,238
8.00%	Mezzanine (Debt only)	-€ 3,000	€ 240	€ 240	€ 240	€ 240	€ 240	€ 3,240
8.65%	Mezzanine (including EK)	-€ 3,000	€ 240	€ 240	€ 240	€ 240	€ 240	€ 3,386
10.35%	Equity	-€ 2,250	€ 73	€ 97	€ 121	€ 147	€ 173	€ 3,269

FIGURE 7.7 Return for different types of capital

senior debt (5%), multiplied by an equity kicker multiplier set under contract at 50% times the number of periods of the loan (6). Therefore:

$$EK = €3{,}000 * (6.63\% - 5.00\%) * 50\% * 6 \text{ periods} = €146$$

Figure 7.7 sets out cash and profitability levels for the different forms of financing for the investment analysed.

Particular attention should be dedicated to the sensitivity of shareholder profitability to changes in two elements:

- the yield of the property expressed by the Net Operating Income (NOI, vertical axis);
- the amount of mezzanine financing (horizontal axis).

The use of mezzanine financing enables shareholders to achieve significantly higher profits, albeit in exchange for increased volatility. In particular, it is noted that in the event of a reduction in NOI, the negative leverage effect of the mezzanine financing will reduce the ultimate profitability of the equity.[14] Some simulations are shown in Figure 7.8.

[14] On the financial leverage effect please refer to Chapter 5.

		LTV Mezzanine					
	10.35%	**0%**	**5%**	**10%**	**15%**	**20%**	**25%**
NOI Variation	***–4.0%***	7.86%	7.77%	7.65%	7.48%	7.20%	6.69%
	–3.0%	8.08%	8.02%	7.93%	7.82%	7.63%	7.28%
	–2.0%	8.29%	8.26%	8.22%	8.16%	8.06%	7.89%
	–1.0%	8.51%	8.51%	8.51%	8.51%	8.51%	8.50%
	0.0%	8.74%	8.77%	8.81%	8.86%	8.96%	9.12%
	1.0%	8.96%	9.02%	9.11%	9.22%	9.41%	9.76%
	2.0%	9.20%	9.29%	9.41%	9.59%	9.88%	10.40%
	3.0%	9.43%	9.55%	9.72%	9.96%	10.35%	11.06%

FIGURE 7.8 Relationship between changes in NOI and mezzanine financing

Capital Structure	LTC	Rate
Senior Debt	55%	7%
Preferred Equity	15%	13%

FIGURE 7.9 Capital structure

7.4.2 Preferred Equity for Development Projects

This example illustrates the effect of mezzanine financing on a development project in which repayment of the senior debt is associated with incoming cash flows earned from property sales.

A development project which provides for an initial stage involving negative operating cash flows (purchase of the land and construction), followed by a stage involving positive cash flows from property sales will be analysed.

The project is financed using senior debt at 55% LTC with a yearly cost of 7%, the drawdown of which occurs on the basis of a WIP report in proportion with operating cash flows, whilst repayment is made at the level of the entire operating cash flow when positive. Financial charges are paid during the relevant period. For the sake of simplicity, transaction costs and taxes are not presented.

Furthermore, the possibility of using preferred equity for part of overall financing needs at 15% LTC is also considered, subject to the following privileges:

- priority repayment before equity for the full amount of available cash flow after senior debtors have been paid;
- preferred share of profits up to the target IRR of 13%.

A summary of financing conditions is shown in Figure 7.9.

This contractual scheme may be obtained simply by using a vehicle with two different classes of shares (e.g. real estate fund with different classes of units):

- *Class A*: priority in remuneration and repayment, with a limit on return (mezzanine);
- *Class B*: residual remuneration and repayment, but without a limit on return (equity).

The operating cash flows for the project are illustrated in Figure 7.10; post senior financing effects are illustrated in Figure 7.11. Residual financing needs, after the senior debt has been drawn down, will be covered initially out of preferred equity and thereafter with equity.

IRR		0	1	2	3	4	5	6	7	*Total*
	Cash in	€ 0	€ 0	€ 0	€ 0	€ 10,400	€ 23,400	€ 29,900	€ 36,300	*€ 100,000*
	Cash out	€ 13,000	€ 10,400	€ 15,600	€ 21,000	€ 0	€ 0	€ 0	€ 0	*€ 60,000*
12.94%	**Operating cash flows**	**-€ 13,000**	**-€ 10,400**	**-€ 15,600**	**-€ 21,000**	**€ 10,400**	**€ 23,400**	**€ 29,900**	**€ 36,300**	***€ 40,000***
	Loan Balance BoP	€ 0	€ 7,150	€ 12,870	€ 21,450	€ 33,000	€ 22,600	€ 0	€ 0	
	Debt drawdown	***€ 7,150***	***€ 5,720***	***€ 8,580***	***€ 11,550***	***€ 0***	***€ 0***	***€ 0***	***€ 0***	***€ 33,000***
	Debt post drawdown	€ 7,150	€ 12,870	€ 21,450	€ 33,000	€ 33,000	€ 22,600	€ 0	€ 0	
	Debt Reimbursment	*€ 0*	*€ 0*	*€ 0*	€ 0	*€ 10,400*	*€ 22,600*	*€ 0*	*€ 0*	*€ 33,000*
	Loan Balance EoP	€ 7,150	€ 12,870	€ 21,450	€ 33,000	€ 22,600	€ 0	€ 0	€ 0	
	Interest charges	€ 501	€ 901	€ 1,502	€ 2,310	€ 1,582	€ 0	€ 0	€ 0	*€ 6,795*
15.62%	**Levered cash flows**	**-€ 6,351**	**-€ 5,581**	**-€ 8,522**	**-€ 11,760**	**-€ 1,582**	**€ 800**	**€ 29,900**	**€ 36,300**	***€ 33,205***

FIGURE 7.10 Operating profitability and levered cash flows

IRR		0	1	2	3	4	5	6	7	*Total*
15.62%	**Levered cash flows**	**-€ 6,351**	**-€ 5,581**	**-€ 8,522**	**-€ 11,760**	**-€ 1,582**	**€ 800**	**€ 29,900**	**€ 36,300**	***€ 33,205***
	Preferred Equity BoP	€ 0	€ 1,950	€ 3,510	€ 5,850	€ 9,000	€ 9,000	€ 8,200	€ 0	
	Preferred Equity drawdown	***€ 1,950***	***€ 1,560***	***€ 2,340***	***€ 3,150***	***€ 0***	***€ 0***	***€ 0***	***€ 0***	***€ 9,000***
	Preferred Equity post drawdown	€ 1,950	€ 3,510	€ 5,850	€ 9,000	€ 9,000	€ 9,000	€ 8,200	€ 0	
	Preferred Equity Reimbursment	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 800*	*€ 8,200*	*€ 0*	*€ 9,000*
	Preferred Equity EoP	€ 1,950	€ 3,510	€ 5,850	€ 9,000	€ 9,000	€ 8,200	€ 0	€ 0	
19.46%	***Levered cash flows post Pr. Eq.***	***-€ 4,401***	***-€ 4,021***	***-€ 6,182***	***-€ 8,610***	***-€ 1,582***	***€ 0***	***€ 21,700***	***€ 36,300***	***€ 33,205***
	Preferred Equity cash flows	*-€ 1,950*	*-€ 1,560*	*-€ 2,340*	*-€ 3,150*	*€ 0*	*€ 800*	*€ 8,200*	*€ 0*	
13%	*Accrued Preferred Equity cash flows*	*-€ 4,588*	*-€ 3,248*	*-€ 4,311*	*-€ 5,136*	*€ 0*	*€ 1,022*	*€ 9,266*	*€ 0*	*-€ 6,995*
	Preferred Equity Profit	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*	*€ 0*		
13%	**Preferred Equity final cash flows**	**-€ 1,950**	**-€ 1,560**	**-€ 2,340**	**-€ 3,150**	**€ 0**	**€ 800**	**€ 8,200**	**€ 6,995**	*€ 6,995*
16.54%	**Equity cash flows**	**-€ 4,401**	**-€ 4,021**	**-€ 6,182**	**-€ 8,610**	**-€ 1,582**	**€ 0**	**€ 21,700**	**€ 29,305**	*€ 26,210*
	Total Equity									***€ 24,795***

FIGURE 7.11 Cash flows with preferred equity

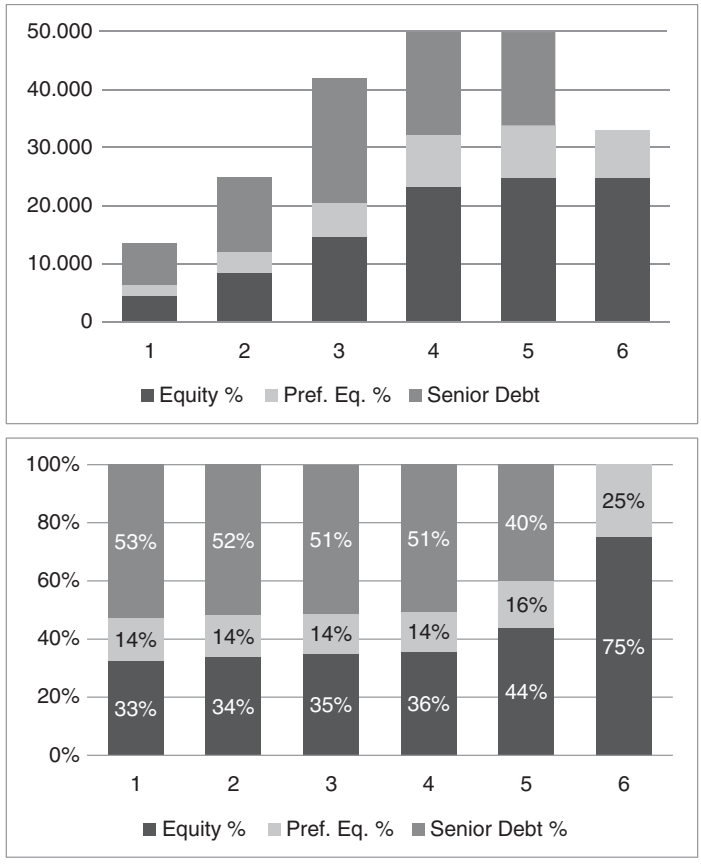

FIGURE 7.12 Cash flow distribution over time

It is noted that available cash flows after the debt has been serviced are allocated in full to investors in preferred equity until the target return has been achieved. For the purposes of that calculation, all cash flows of preferred equity, both negative and positive, must be capitalized until the end of the project at the preferred equity target rate of return (13%): the total sum, as an absolute value, represents the cash flow enabling the target return to be achieved.

The use of mezzanine financing means that the investment can be carried out with a reduced amount of equity and an increase in profits for shareholders.

Investors in preferred equity obtain a higher return compared to senior debt lenders, although this corresponds to a higher risk; it should be pointed out that this return is in any case limited by a Cap, although it is preferred over equity, which will only achieve a return after the minimum guaranteed return on preferred equity has been paid out. For the sake of simplicity, the structure presented in the example provides for only one threshold; in practice, however, it is commonplace for various levels to be stipulated, with the result that preferred equity is allocated a different quota depending on the different target returns achieved, thus enabling genuine participation in risk and profits.[15]

Figure 7.12 shows the cash flow distribution for different investors in euros and as a percentage.

[15] On the risk and profits split refer also to paragraph 7.5.

		LTC Preferred Equity						
	16.54%	**0%**	**5%**	**10%**	**15%**	**20%**	**25%**	**30%**
IRR Target Pref. Eq.	**5%**	15.62%	16.42%	17.41%	18.59%	*20.05%*	21.88%	24.27%
	8%	15.62%	16.24%	17.01%	17.94%	*19.09%*	20.56%	22.51%
	11%	15.62%	16.02%	16.53%	17.15%	*17.93%*	18.94%	20.31%
	14%	*15.62%*	*15.77%*	*15.97%*	*16.21%*	*16.51%*	*16.92%*	*17.49%*
	17%	15.62%	15.48%	15.3%	15.07%	*14.77%*	14.37%	13.78%
	20%	15.62%	15.14%	14.51%	13.70%	*12.61%*	11.06%	8.66%
	23%	15.62%	14.74%	13.58%	12.04%	*9.86%*	6.56%	0.84%
	26%	15.62%	14.29%	12.48%	9.98%	*6.26%*	-0.05%	-15.34%

FIGURE 7.13 Effects of change in the conditions applicable to preferred equity

Finally, Figure 7.13 simulates the effect on ROE of a contractual change in preferred equity as a function of equity capital invested and of the minimum target return.

7.5 WATERFALL PAYOUT AGREEMENT

Development projects are characterized by the presence of developers, highly skilled players looking for capital to operate in large scale projects, and capital investors, willing to reach high returns, but not skilled enough to manage a development scheme. Since equity investors cannot afford to invest capital in a complex development scheme alone, because of both high operating and financing risk, they invest together with a third party developer that invests only a small portion of equity capital. However some strong alignment of interests and a risk split mechanism is required.

The capital structure is theoretically not limited to equity, debt, and other hybrid capitals, but among the different capital holders agreements can be set out in various ways in order to align their interests and split risk and profit in different ways. The traditional capital structure represents an inverse hierarchy of risk and payment priority, where debt holders are paid first, carrying the lowest risk, but with a maximum prefixed return equal to the effective interest rate. At the other extreme of the line, equity investors support a higher risk being subject to a fluctuating return depending on the success of the project; finally, the developer, whose equity contribution is limited, but whose skills are essential to the success of the project, takes on the highest quantity of risk.

Internal Rate of Return Waterfall Payout Agreements (WPA) allow all equity investors, both the equity partner and the developer, to participate in the scheme splitting profit and risk in a predefined way. The purpose is to create a scheme that shifts downside risk away from equity investors and provides greater upside potential return for the developer, with the final aim to raise capital in a more effective way.

This mechanism allows the equity partners, usually large financial institutions with huge real estate portfolios (but not specific technical development skills), and developers, operating companies with high intangibles (technical skills) and relatively little available capital, to operate together. The former will be able to invest money in real estate in a high risk/return profile area, the latter will be able to work on larger projects (or on more projects) compared to

the available capital. Both will participate in profits and their interests will be aligned because the developer final remuneration is mainly linked to the actual project performance, rather than a fixed development management fee only.

While the developer skills are often essential for the success of the project, its return is subordinate to both bank and shareholder capital returns. A traditional development payout split gives a preferred return to the equity investor and to the developer, according to some expected IRR thresholds; then the two partners split the rest in predefined proportions (e.g. 80/20).

By using a WPA this situation is rectified by positively compensating for a successful project, by minimizing the downside risk for equity capital investor at the same time. The mechanics works as follows: if returns are lower than expected, a greater part of profit goes to the equity capital investor, but if returns are higher than expected, the developer receives a larger proportion. In this way, a WPA enhances the level of satisfaction of both parties, working as explained in the following example.

EXAMPLE 7.3

Qirefinvestors is a financial institution with a several billion Euro portfolio looking for opportunistic investments in real estate; it has a strong financial analysis background, but it does not have any specific property development management skills.

Technicarc is an experienced developer with a successful track record of more than thirty years in developments ranging from offices to shopping centres; they operate in several countries and on different projects at the same time, receiving development fees, including performance fees, and trying to minimize the amount of equity capital on every project. Their new project is called Oldtimer Village, a modern concept of the shopping centre for vintage car enthusiasts, with an expected investment estimated at €18 million,[16] while the deal closing is expected in five years at a disposal value of €27 million.[17] The capital structure is represented by a bank loan[18] and equity provided by Qirefinvestors (equity capital partner) and, in a smaller amount, by Technicarc (developer capital) as shown in Figure 7.14.

A traditional development payout split would give a preferred 8% return to Qirefinvestors and 7% to Technicarc; they would then split the rest of the profit 80/20%.

The Base Scenario represents a successful project, with returns higher than the cost of capital for all the tranches of the capital structure, as shown in Figure 7.15.

Using a WPA, as shown in Figure 7.16, a more progressive split is possible. Qirefinvestors could get a greater part of returns at lower profit levels, while Technicarc would get a greater part at higher profit levels. The split is determined on the future value calculation of the total equity, based on the expected rate of returns. The partners agree to split profits as follows.

(*continued overleaf*)

[16] For simplicity an initial period investment only is considered, but the same results could be reached with a more realistic development cash flow time distribution.

[17] For simplicity no taxes or other costs are considered.

[18] For simplicity a Zero Coupon bond is assumed, but the same results could be reached with a more common development loan.

		Project data	*Base Scenario*
	a	Years to conclusion	5
	b	Investment	€ 18,000,000
	c	Loan BoP	€ 14,000,000
	d	Interest rate	6%
	e	Equity partner capital	€ 3,000,000
f = b - c - d		Developer capital	€ 1,000,000
*g = c * (1 + d) ^ a*		Loan EoP	€ 18,735,158
	h	Sale Price	€ 28,000,000
i = h - e - f - g		Total profit	€ 5,264,842
j = h - g		**Cash to distribute to all Equity**	**€ 9,264,842**

FIGURE 7.14 Development project assumptions

	Traditional Payout - Base Scenario			
h	Sale Price	€ 28,000,000		
		Equity partner	***Developer***	***Total***
e; f	*Return of capital*	*€ 3,000,000*	*€ 1,000,000*	*€ 4,000,000*
k; l	Target IRR	*8%*	*7%*	
*m; n = (e; f) *(1 + k; l) ^ a*	Preference earned	€ 4,407,984	€ 1,402,552	
o = min (j; m) / p = min (j; n)	Preference received	€ 4,407,984	€ 1,402,552	€ 5,810,536
q; r; s = j - o - p	Profit Split ratio	80%	20%	€ 3,454,306
*t = q * s; u = r * s*	Profit Split	€ 2,763,445	€ 690,861	
v = o + t; w = p + u	**Total**	**€ 7,171,429**	**€ 2,093,413**	**€ 9,264,842**

	Cash Flow - Base Scenario	**0**	**5**	**IRR**
	Project	-€ 18,000,000	€ 28,000,000	9.2%
	All Equity	-€ 4,000,000	€ 9,264,842	18.3%
	Equity partner	-€ 3,000,000	€ 7,171,429	19.0%
	Developer	-€ 1,000,000	€ 2,093,413	15.9%

FIGURE 7.15 Development project results with a traditional payout split

In order to create a more progressive split the invested capital of each investor is capitalized at the target rate of return. All cash flows, both negative and positive, must be capitalized at the target rate of return until the end of the project. The total sum, as an absolute value, represents the cash flow enabling the target return to be achieved.

Waterfall Payout Agreement		
Target IRR	*Equity Partner*	*Developer*
7%	100%	0%
10%	85%	15%
12%	60%	40%
> All Equity IRR	50%	50%

FIGURE 7.16 Waterfall Payout Agreement

Waterfall Payout - Base Scenario							
Sale Price	€ 28,000,000						
Cash to distribute to all Equity	€ 9,264,842						
Total profit	€ 5,264,842						
Target IRR	***Time 0***	**Time 5**	***Profit***	***Split***	***Equity partner***	***Developer***	***Total***
7%	-€ 4,000,000	€ 5,610,207	€ 1,610,207	100%	€ 1,610,207	€ 0	
10%	-€ 4,000,000	€ 6,442,040	€ 831,833	85%	€ 707,058	€ 124,775	
12%	-€ 4,000,000	€ 7,049,367	€ 607,327	60%	€ 364,396	€ 242,931	
18.29%	-€ 4,000,000	€ 9,264,842	€ 2,215,475	50%	€ 1,107,738	€ 1,107,738	
				Profit	***€ 3,789,399***	***€ 1,475,443***	***€ 5,264,842***
				Profit%	***72%***	***28%***	
				Equity	***€ 3,000,000***	***€ 1,000,000***	***€ 4,000,000***
				Total	***€ 6,789,399***	***€ 2,475,443***	***€ 9,264,842***
				IRR	**17.74%**	**19.88%**	**18.29%**

FIGURE 7.17 Waterfall Payout in the Oldtimer Village project

	Worst Scenario	*Base Scenario*	*Best Scenario*
Sale Price	€ 25,500,000	€ 28,000,000	€ 31,000,000

FIGURE 7.18 Oldtimer Village project scenario analysis (sale price)

In the example all the equity until a 7% return is reached is paid to Qirefinvestors (the difference between all equity capitalized at 7% per annum minus all the initial equity, equal to a profit of €1,610,207) while no profit is paid to the developer Technicarc. That amount is then subtracted from the rest of the profit and the same calculation based on all equity is run at 10%, representing the second threshold of the split. The profit is thereafter split among equity in the predefined proportion (85% to Qirefinvestors and 15% to Technicarc in the example) and so on. After reaching the all equity IRR, the two partners split equally all the rest of the profit (€2,215,475 in the example in Figure 7.17).

(*continued overleaf*)

	Time 0	Worst Cash Flow	Worst IRR	Base Cash Flow	Base IRR	Best Cash Flow	Best IRR
Project	-€ 18,000,000	€ 25,500,000	**7.21%**	€ 28,000,000	**9.24%**	€ 31,000,000	**11.49%**
Loan	-€ 14,000,000	€ 18,735,158	**6%**	€ 18,735,158	**6%**	€ 18,735,158	**6%**
All Equity	-€ 4,000,000	€ 6,764,842	**11.08%**	€ 9,264,842	**18.29%**	€ 12,264,842	**25.12%**
Equity partner	-€ 3,000,000	€ 5,510,946	**12.93%**	€ 6,789,399	**17.74%**	€ 8,289,399	**22.54%**
Developer	-€ 1,000,000	€ 1,253,896	**4.63%**	€ 2,475,443	**19.88%**	€ 3,975,443	**31.79%**

FIGURE 7.19 Oldtimer Village project scenario analysis (results)

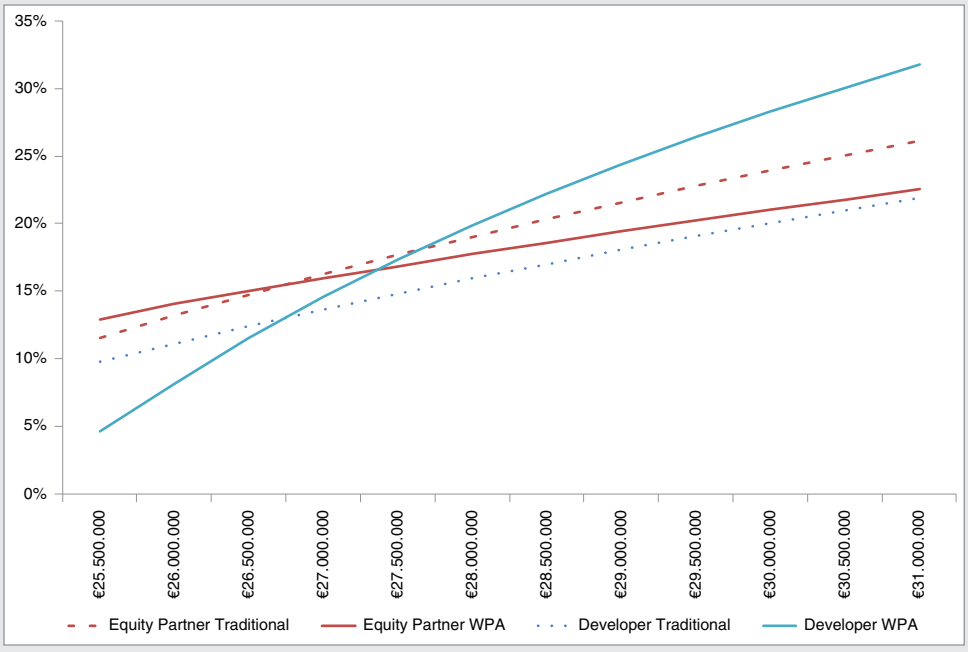

FIGURE 7.20 Equity partner IRR for different sale price

To better understand the use of a WPA, results are calculated in different scenarios, by simulating a different sale price (Figure 7.18).

The returns for the two investors are pretty different in the different scenarios, as shown in Figure 7.19.

The WPA, compared to the traditional profit split based only on one threshold, allows enhancement of the developer commitment, because of his lower return for lower project performance, by providing him a higher return when the project is successful.

The following graphs and tables (Figure 7.20, Figure 7.21, Figure 7.22 and Figure 7.23) show the IRR and profit for different sale prices.

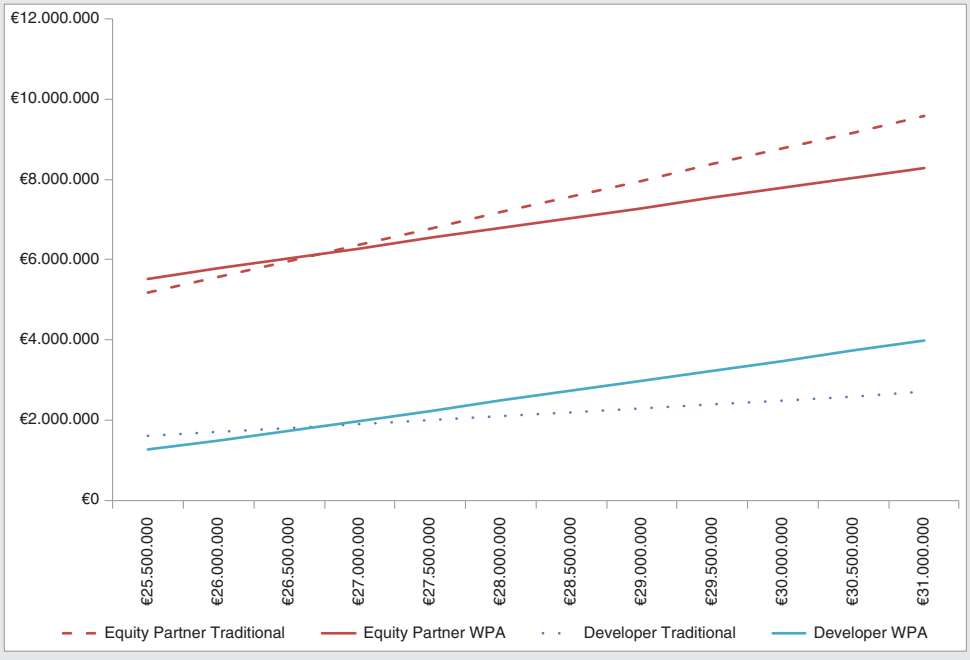

FIGURE 7.21 Equity partner profit for different sale price

Sale Price	*Equity*	*Equity Partner Traditional*	*Equity Partner WPA*	*Developer Traditional*	*Developer WPA*
€ 25,500,000	11.08%	11.51%	12.93%	9.77%	4.63%
€ 26,000,000	12.68%	13.18%	14.05%	11.11%	8.09%
€ 26,500,000	14.19%	14.76%	15.02%	12.39%	11.53%
€ 27,000,000	15.62%	16.26%	15.96%	13.62%	14.59%
€ 27,500,000	16.99%	17.68%	16.86%	14.79%	17.35%
€ 28,000,000	18.29%	19.04%	17.74%	15.92%	19.88%
€ 28,500,000	19.54%	20.34%	18.60%	17.01%	22.20%
€ 29,000,000	20.74%	21.59%	19.43%	18.06%	24.37%
€ 29,500,000	21.90%	22.78%	20.24%	19.07%	26.39%
€ 30,000,000	23.01%	23.93%	21.03%	20.05%	28.29%
€ 30,500,000	24.08%	25.04%	21.79%	21%	30.09%
€ 31,000,000	25.12%	26.12%	22.54%	21.92%	31.79%

FIGURE 7.22 IRR for different sale price

(*continued overleaf*)

Sale Price	*Equity*	*Equity Partner Traditional*	*Equity Partner WPA*	*Developer Traditional*	*Developer WPA*
€ 25,500,000	€ 6,764,842	€ 5,171,429	€ 5,510,946	€ 1,593,413	€ 1,253,896
€ 26,000,000	€ 7,264,842	€ 5,571,429	€ 5,789,399	€ 1,693,413	€ 1,475,443
€ 26,500,000	€ 7,764,842	€ 5,971,429	€ 6,039,399	€ 1,793,413	€ 1,725,443
€ 27,000,000	€ 8,264,842	€ 6,371,429	€ 6,289,399	€ 1,893,413	€ 1,975,443
€ 27,500,000	€ 8,764,842	€ 6,771,429	€ 6,539,399	€ 1,993,413	€ 2,225,443
€ 28,000,000	€ 9,264,842	€ 7,171,429	€ 6,789,399	€ 2,093,413	€ 2,475,443
€ 28,500,000	€ 9,764,842	€ 7,571,429	€ 7,039,399	€ 2,193,413	€ 2,725,443
€ 29,000,000	€ 10,264,842	€ 7,971,429	€ 7,289,399	€ 2,293,413	€ 2,975,443
€ 29,500,000	€ 10,764,842	€ 8,371,429	€ 7,539,399	€ 2,393,413	€ 3,225,443
€ 30,000,000	€ 11,264,842	€ 8,771,429	€ 7,789,399	€ 2,493,413	€ 3,475,443
€ 30,500,000	€ 11,764,842	€ 9,171,429	€ 8,039,399	€ 2,593,413	€ 3,725,443
€ 31,000,000	€ 12,264,842	€ 9,571,429	€ 8,289,399	€ 2,693,413	€ 3,975,443

FIGURE 7.23 Profit for different sale price

7.6 INTERCREDITOR AGREEMENT

In a mezzanine financing senior creditors require some restrictions for mezzanine lenders in order to avoid the transfer of value to creditors with different seniority. The so-called "intercreditor agreement" regulates creditors' claims and reduces the level of risk by defining the security ranking under ordinary conditions and in case of default. The agreement clearly expresses all the creditor claims, covenants, and guarantees.

In the remainder of the paragraph parts of an example[19] of an intercreditor agreement are presented to better understand the main elements of this document. There is a general scheme that comprises all the key elements of the contract with respect to:

- the acknowledgement of their duties, rights, and reciprocal obligations by both lenders;
- the definitions and rules of construction and the approval of loans and loan documents;
- the transfer of mezzanine loan or senior loan;
- the foreclosure of separate collateral (where all guarantees are described and the lenders state that other guarantees not mentioned are no longer valid);
- the levels of subordinations of mezzanine loan;
- the payment subordination (where all payment rules are stated).

In the initial part both lenders acknowledge their duties, rights, and reciprocal obligations. Certain definitions and rules of construction and the approval of loans and loan documents are set out.

[19] The following quoted paragraphs are taken from Forti and Stafford (2002) and reproduced by permission of the publisher CRE Finance World.

"(a) Mezzanine Lender hereby acknowledges that (i) it has received and reviewed and, subject to the terms and conditions of this Agreement, hereby consents to and approves of the making of the Senior Loan and, subject to the terms and provisions of this Agreement, all of the terms and provisions of the Senior Loan Documents, (ii) the execution, delivery and performance of the Senior Loan Documents will not constitute a default or an event which, with the giving of notice or the lapse of time, or both, would constitute a default under the Mezzanine Loan Documents, (iii) Senior Lender is under no obligation or duty to, nor has Senior Lender represented that it will, see to the application of the proceeds of the Senior Loan by Borrower or any other Person to whom Senior Lender disburses such proceeds, and (iv) any application or use of the proceeds of the Senior Loan for purposes other than those provided in the Senior Loan Documents shall not affect, impair or defeat the terms and provisions of this Agreement or the Senior Loan Documents.

(b) Senior Lender hereby acknowledges that (i) it has received and reviewed, and, subject to the terms and conditions of this Agreement, hereby consents to and approves of the making of the Mezzanine Loan and, subject to the terms and provisions of this Agreement, all of the terms and provisions of the Mezzanine Loan Documents, (ii) the execution, delivery and performance of the Mezzanine Loan Documents will not constitute a default or an event which, with the giving of notice or the lapse of time, or both, would constitute a default under the - 10 - Senior Loan Documents, (iii) Mezzanine Lender is under no obligation or duty to, nor has Mezzanine Lender represented that it will, see to the application of the proceeds of the Mezzanine Loan by Mezzanine Borrower or any other Person to whom Mezzanine Lender disburses such proceeds and (iv) any application or use of the proceeds of the Mezzanine Loan for purposes other than those provided in the Mezzanine Loan Documents shall not affect, impair or defeat the terms and provisions of this Agreement or the Mezzanine Loan Documents. Senior Lender hereby acknowledges and agrees that any conditions precedent to Senior Lender's consent to mezzanine financing as set forth in the Senior Loan Documents or any other agreements with the Borrower, as they apply to the Mezzanine Loan Documents or the making of the Mezzanine Loan, have been either satisfied or waived."

Another important clause is related to the transfer of the mezzanine loan or senior loan.

"Mezzanine Lender shall not Transfer more than 49% of its beneficial interest in the Mezzanine Loan unless either (i) a Rating Agency Confirmation has been given with respect to such Transfer, in which case the related transferee shall thereafter be deemed to be a 'Qualified Transferee' for all purposes of this Agreement, or (ii) such Transfer is to a Qualified Transferee. Any such transferee must assume in writing the obligations of Mezzanine Lender hereunder and agree to be bound by the terms and provisions hereof. Such proposed transferee shall also remake each of the representations and warranties contained herein for the benefit of the Senior Lender.

Senior Lender may, from time to time, in its sole discretion Transfer all or any of the Senior Loan or any interest therein, and notwithstanding any such Transfer or subsequent Transfer, the Senior Loan and the Senior Loan Documents shall be and remain a senior obligation in the respects set forth in this Agreement to the Mezzanine Loan and the Mezzanine Loan Documents in accordance with the terms and provisions of this Agreement."

A section is dedicated to the foreclosure of separate collateral, where all guarantees are described and the lenders state that other guarantees not mentioned are no longer valid.

"Mezzanine Lender shall not exercise any rights it may have under the Pledge Agreement and the other Mezzanine Loan Documents or applicable law with respect to a foreclosure or other realization upon the Equity Collateral (including, without limitation, obtaining title to the Equity Collateral or selling or otherwise transferring the Equity Collateral) without a Rating Agency Confirmation unless (i) the transferee of title to the Equity Collateral is a Qualified Transferee, (ii) the Premises will be managed by a Qualified Manager promptly after the transfer of title to the Equity Collateral, and (iii) if not in place prior to the transfer of title to the Equity Collateral, hard cash management and adequate reserves for taxes, insurance, debt service, ground rents, capital repair and improvement expenses, tenant improvement expenses and leasing commissions and operating expenses will be implemented under the Senior Loan promptly after the transfer of title to the Equity Collateral; provided, that the implementation of such hard cash management and reserves would not cause a 'significant modification' of the Senior Loan.

Nothing contained herein shall limit or restrict the right of Mezzanine Lender to exercise its rights and remedies, in law or in equity, or otherwise, in order to realize on any Separate Collateral that is not Equity Collateral."

Levels of subordinations of mezzanine loan are also stated.

"Mezzanine Lender hereby subordinates and makes junior the Mezzanine Loan, the Mezzanine Loan Documents and the liens and security interests created thereby, and all rights, remedies, terms and covenants contained therein to (i) the Senior Loan, (ii) the liens and security interests created by the Senior Loan Documents and (iii) all of the terms, covenants, conditions, rights and remedies contained in the Senior Loan Documents, and no amendments or modifications to the Senior Loan Documents or waivers of any provisions thereof shall affect the subordination thereof as set forth in this Section. Mezzanine Lender hereby acknowledges and agrees that the Mezzanine Loan is not secured by a lien on the Premises or any of the other collateral securing the Senior Loan or any other assets of the Borrower.

Every document and instrument included within the Mezzanine Loan Documents shall be subject and subordinate to each and every document and instrument included within the Senior Loan Documents and all extensions, modifications, consolidations, supplements, amendments, replacements and restatements of and/or to the Senior Loan Documents.

This Agreement shall not be construed as subordinating and shall not subordinate or impair Mezzanine Lender's first lien priority right, estate and interest in and to the Separate Collateral and Senior Lender hereby acknowledges and agrees that Senior Lender does not have and shall not hereafter acquire, any lien on, or any other interest whatsoever in, the Separate Collateral, or any part thereof, and that the exercise of remedies and realization upon the Separate Collateral by Mezzanine Lender or a Loan Pledgee in accordance with the terms and provisions of this Agreement shall not in and of itself constitute a default or an Event of Default under the Senior Loan Documents."

Another important clause is the Payment subordination, where all payment rules are stated.

"All of Mezzanine Lender's rights to payment of the Mezzanine Loan and the obligations evidenced by the Mezzanine Loan Documents are hereby subordinated to all of Senior Lender's rights to payment by Borrower of the Senior Loan and the obligations secured by the Senior Loan Documents, and Mezzanine Lender shall not accept or receive payments from Borrower and/or from the Premises prior to the date that all obligations of Borrower to Senior Lender under the Senior Loan Documents are paid. If a Proceeding shall have occurred or a Continuing Senior Loan Event of Default shall have occurred and be continuing, Senior Lender shall be entitled to receive payment and performance in full of all amounts due or to become due to Senior Lender before Mezzanine Lender is entitled to receive any payment on account of the Mezzanine Loan. All payments or distributions upon or with respect to the Mezzanine Loan which are received by Mezzanine Lender contrary to the provisions of this Agreement shall be received and held in trust by the Mezzanine Lender for the benefit of Senior Lender and shall be paid over to Senior Lender in the same form as so received to be applied to the payment or performance of the Senior Loan in accordance with the terms of the Senior Loan Documents. Nothing contained herein shall prohibit the Mezzanine Lender from making Protective Advances notwithstanding the existence of a default under the Senior Loan at such time.

Mezzanine Lender may accept payments of any amounts due and payable from time to time which Mezzanine Borrower is obligated to pay Mezzanine Lender in accordance with the terms and conditions of the Mezzanine Loan Documents and Mezzanine Lender shall have no obligation to pay over to Senior Lender any such amounts.

Mezzanine Lender may take any Equity Collateral Enforcement Action provided, however, that (i) Mezzanine Lender shall, prior to commencing any Equity Collateral Enforcement Action, give the Senior Lender written notice of the default which would permit Mezzanine Lender to commence such Equity Collateral Enforcement Action and (ii) Mezzanine Lender shall provide Senior Lender with copies of any and all material notices, pleadings, agreements, motions and briefs served upon, delivered to or with any party to any Equity Collateral Enforcement Action and otherwise keep Senior Lender reasonably apprised as to the status of any Equity Collateral Enforcement Action.

In the event of a casualty to the buildings or improvements constructed on any portion of the Premises or a condemnation or taking under a power of eminent domain of all or any portion of the Premises, Senior Lender shall have a first and prior interest in and to any payments, awards, proceeds, distributions, or consideration arising from any such event (the 'Award'). If the amount of the Award is in excess of all amounts owed to Senior Lender under the Senior Loan Documents, however, and either the Senior Loan has been paid in full or Borrower is entitled to a remittance of same under the Senior Loan Documents other than to restore the Premises, such excess Award or portion to be so remitted to Borrower shall, to the extent permitted in the Senior Loan Documents, be paid to or at the direction of Mezzanine Lender, unless other Persons have claimed the right to such awards or proceeds, in which case Senior Lender shall only be required to provide notice to Mezzanine Lender of such excess Award and of any other claims thereto."

Specific provisions govern the roles of lenders in case of bankruptcy of the borrower:

"Each of Mezzanine Lender and Senior Lender hereby waives any requirement for marshalling of assets thereby in connection with any foreclosure of any security interest or any other realization upon collateral in respect of the Senior Loan Documents or the Mezzanine Loan Documents, as applicable, or any exercise of any rights of set-off or otherwise.

Each of Mezzanine Lender and Senior Lender assumes all responsibility for keeping itself informed as to the condition (financial or otherwise) of Borrower, Mezzanine Borrower, the condition of the Premises and all other collateral and other circumstances and, except for notices expressly required by this Agreement, neither Senior Lender nor Mezzanine Lender shall have any duty whatsoever to obtain, advise or deliver information or documents to the other relative to such condition, business, assets and/or operations. Mezzanine Lender agrees that Senior Lender owes no fiduciary duty to Mezzanine Lender in connection with the administration of the Senior Loan and the Senior Loan Documents and Mezzanine Lender agrees not to assert any such claim. Senior Lender agrees that Mezzanine Lender owes no fiduciary duty to Senior Lender in connection with the administration of the Mezzanine Loan and the Mezzanine Loan Documents and Senior Lender agrees not to assert any such claim.

No payment or distribution to Senior Lender pursuant to the provisions of this Agreement and no Protective Advance by Mezzanine Lender shall entitle Mezzanine Lender to exercise any right of subrogation in respect thereof prior to the payment in full of the Senior Loan Liabilities, and Mezzanine Lender agrees that, except with respect to the enforcement of its remedies under the Mezzanine Loan Documents permitted hereunder, prior to the satisfaction of all Senior Loan Liabilities it shall not acquire, by subrogation or otherwise, any lien, estate, right or other interest in any portion of the Premises or any other collateral now securing the Senior Loan or the proceeds therefrom that is or may be prior to, or of equal priority to, any of the Senior Loan Documents or the liens, rights, estates and interests created thereby.

If Mezzanine Lender is deemed to be a creditor of Borrower or any SPE Constituent Entity in any Proceeding (i) Mezzanine Lender hereby agrees that it shall not make any election, give any consent, commence any action or file any motion, claim, obligation, notice or application or take any other action in any Proceeding by or against the Borrower without the prior consent of Senior Lender, except to the extent necessary to preserve or realize upon Mezzanine Lender's interest in the Equity Collateral; provided, however, that any such filing shall not be as a creditor of the Borrower, (ii) Senior Lender may vote in any such Proceeding any and all claims of Mezzanine Lender, and Mezzanine Lender hereby appoints the Senior Lender as its agent, and grants to the Senior Lender an irrevocable power of attorney coupled with an interest, and its proxy, for the purpose of exercising any and all rights and taking any and all actions available to the Mezzanine Lender in connection with any case by or against the Borrower in any Proceeding and (iii) Mezzanine Lender shall not challenge the validity or amount of any claim submitted in such Proceeding by Senior Lender in good faith or any valuations of the Premises or other Senior Loan collateral submitted by Senior Lender in good faith, in such Proceeding or take any other action in such Proceeding, which is adverse to Senior Lender's enforcement of its claim or receipt of adequate protection."

CHAPTER 8

Basel Accords and Effects on Real Estate Financing

The Basel Accords on Capital Requirements are intended to ensure stability within the banking system, which necessarily has a knock-on effect on the stability of the economic system, stipulating, *inter alia*, the capital requirements for banks in relation to the risk taken on as part of their ordinary business.

The general principle on which these accords are based is that the risk taken on by a bank must be adequately backed up by its supervisory capital, which may be defined in summary terms as the capital which the banks must set aside in their balance sheets in order, *inter alia*, to cover the risks resulting from credit exposure towards their clients. Consequently, the greater the risk involved in operation, the more the bank will have to set aside funds to its supervisory capital, although these provisions may vary depending upon the risk of losses due to debtor default, which must be monitored and updated until the credit facility has been paid back in full.

The Basel Accords on the capital requirements for banks were concluded by the Basel Committee on Banking Supervision, which was established by the governors of the central banks from the G10 countries at the end of 1974 and operates under the auspices of the Bank of International Settlements, an international organization charged with the promotion of cooperation between central banks and other equivalent bodies, with the goal of pursuing monetary and financial stability.

In 1988 the Basel Committee introduced the capital measurement system commonly referred to as the Basel Accord on Capital Requirements (or "Basel I"), which was endorsed by the central authorities of more than one hundred countries, and which laid down the obligation for banks to set aside capital to cover 8% of loan capital in order to ensure solidity to their operations.

In January 2001 the Basel Committee published the consultation document entitled *The New Basel Capital Accord*, setting out new regulations on capital requirements for banks. In June 2004, following many months of consultations and controls, the final text (known as "Basel II") was adopted, whilst the implementation of the agreement – originally planned for 2006 – took place in a different manner in the various countries.[1]

[1] To have an update of Basel Committee members' progress in adopting the Basel Conventions, please look at "Progress report on Basel implementation", Bank for International Settlements (www.bis.org). This report focuses on the status of domestic rule-making processes according to the internationally agreed timeframes.

Between 2010 and 2011 the members of the Basel Committee on Banking Supervision agreed to change the previous Basel I and Basel II Accords through a new Accord named Basel III. The third instalment of the Basel Accords was developed in response to the deficiencies in financial regulation revealed by the late-2000s financial crisis.

8.1 BASEL II

Basel II consists of three pillars:

1. minimum capital requirements,
2. supervisory review of capital adequacy, and
3. public disclosure.

For the purposes of this chapter, attention will be focused on the first pillar because, more than the others, the first pillar has a direct consequence on the cost of the credit facilities, on the procedure for handling the credit facilities and therefore on the relationship between banks and clients. Basel II – Pillar I is based on the concept of a capital ratio where the numerator represents the amount of capital a bank has available and the denominator is a measure of the risks faced by the bank (referred to as risk-weighted assets).

The resulting capital ratio may be no less than 8%. Under Basel II, the regulations that define the numerator of the capital ratio (e.g. the definition of regulatory capital) as well as the minimum required ratio of 8% have not changed compared with Basel I.

The modifications have instead occurred in the definition of risk-weighted assets, that is in the methods used to measure the risks faced by banks.

The new approaches for calculating risk-weighted assets are intended to provide improved bank assessments of risk and thus to make the resulting capital ratios more meaningful.

Basel II explicitly covers only two types of risks in the definition of risk-weighted assets:

1. credit risk;
2. market risk.

Other risks are presumed to be covered implicitly through the treatment of these two major risks.

The treatment of market risk arising from trading activities was the subject of the Basel Committee's 1996 Amendment to the Capital Accord. Basel II envisions this treatment remaining unchanged.

The Pillar I proposals to modify the definition of risk-weighted assets in Basel II have two primary elements: (1) substantive changes to the treatment of credit risk; and (2) the introduction of an explicit treatment of operational risk that will result in a measure of operational risk being included in the denominator of a bank's capital ratio. In both cases, a major innovation of Basel II is the introduction of three distinct options for the calculation of credit risk and three others for operational risk: the standardized approach, the IRB Foundation methodology, or the IRB Advanced methodology.

8.2 BASEL III

Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision, and risk management of the banking sector. These measures aim to improve the banking sector's ability to absorb shocks

arising from financial and economic stress, whatever the source, improve risk management and governance, and strengthen banks' transparency and disclosures.

The reforms target both bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress, as well as macroprudential, system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.

These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system-wide shocks.

Basel III will require banks to hold 4.5% of common equity (up from 2% in Basel II) and 6% of Tier I capital (up from 4% in Basel II) of risk-weighted assets (RWA).

Basel III also introduces:

- additional capital buffers:
  - a mandatory capital conservation buffer of 2.5%, and
  - a discretionary countercyclical buffer, which allows national regulators to require up to another 2.5% of capital during periods of high credit growth;
- a minimum 3% leverage ratio;
- two required liquidity ratios:
  - the Liquidity Coverage Ratio, which requires a bank to hold sufficient high-quality liquid assets to cover its total net cash flows over 30 days;
  - the Net Stable Funding Ratio, which requires the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress.

8.3 THE BASEL ACCORDS AND REAL ESTATE FINANCING

The bank's equity capital may be compared with a liquidity cushion protecting it against unexpected unfavourable events.

The bank's directors will approve its "lending policy" on an annual basis, which must specify first and foremost the limits within which the bank's organs may authorize the granting of loans (within real estate financing operations, these limits involve for example maximum LTV ratios and minimum DSCR and ICR); within these limits, the directors may require the return on loans (margins and fees) to be commensurate with the level of risk of the transaction being financed, having regard also to any guarantees which may have been provided.

Simply put, it is as if the bank's shareholders were to invest (using the supervisory capital set aside) a further equity amount in the loans made to its clients (also because all or part of this provision will be used to cover any losses suffered by the bank in the event of a default on the operation financed). The provision entails a cost for the bank's shareholders, which must be covered by the debtor through payment of interest and related fees.

The more risky the transaction, the more the bank will demand adequate guarantees and adequate fees, again within the perspective of the healthy and prudent management of commitments.

According to the indications provided by the Basel Committee, the credit risk of structured real estate financing operations (as the other financing operations) may also be assessed by the bank in three different ways:

- Standardized approach;
- IRB Foundation methodology;
- IRB Advanced methodology.

8.4 STANDARDIZED APPROACH[2]

The standardized approach requires that banks slot their credit exposures into supervisory categories based on observable characteristics of the exposures (e.g. whether the exposure is a corporate loan or a residential mortgage loan) and establishes fixed risk weights[3] corresponding to each supervisory category and makes use of external credit assessments to enhance risk sensitivity compared to the previous accord. The risk weights for sovereign, interbank, and corporate exposures are differentiated based on external credit assessments.

The use of external ratings for the evaluation of corporate exposures is considered to be an optional element of the framework. If external rating is not applied to an exposure, the standardized approach mandates that in most cases a risk weighting of 100% would be used, implying a capital requirement of 8%.

An important innovation is the expanded range of collateral, guarantees, and credit derivatives that banks using the standardized approach may recognize (so-called credit risk mitigants).

The risk weights for residential mortgage exposures are being reduced relative to the previous accord, as are those for other retail exposures, which will now receive a lower risk weight than that for unrated corporate exposures. In addition, some loans to small and medium-sized enterprises may be included within the retail treatment, subject to meeting various criteria.

Lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk weighted at 35%. In applying the 35% weight, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. Supervisors should increase the standard risk weight where they judge the criteria are not met.

In view of the experience in numerous countries that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades, the Basel Committee holds to the view that mortgages on commercial real estate do not, in principle, justify other than a 100% weighting of the loans secured.[4]

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[2] This paragraph and the following one have been adapted from Basel Committee on Banking Supervision (2003a).

[3] On risk weights please see Resti and Sironi (2007).

[4] The Committee, however, recognizes that, in exceptional circumstances for well-developed and long established markets, mortgages on office and/or multi-purpose commercial premises and/or multi-tenanted commercial premises may have the potential to receive a preferential risk weight of 50% for the tranche of the loan that does not exceed the lower of 50% of the OMV or 60% of the mortgage lending value of the property securing the loan. Any exposure beyond these limits will receive a 100% risk weight. This exceptional treatment will be subject to very strict conditions. In particular, two tests must be fulfilled, namely that (i) losses stemming from commercial real estate lending up to the lower of 50% of the OMV or 60% of loan-to value (LTV) based on mortgage-lending-value (MLV) must not exceed 0.3% of the outstanding loans in any given year; and that (ii) overall losses stemming from commercial real estate lending must not exceed 0.5% of the outstanding loans in any given year. That is, if either of these tests is not satisfied in a given year, the eligibility to use this treatment will cease and the original eligibility criteria would need to be satisfied again before it could be applied in the future. Countries applying such a treatment must publicly disclose that these and other additional conditions (that are available from the Basel Committee Secretariat) are met. When claims benefiting from such an exceptional treatment have fallen past their due date, they will be risk-weighted at 100%.

The benefit of this method of calculation is that the bank does not need to put in place adequate structures in order to identify the risk of the operation since it uses external assessments and standardized weighted coefficients.

The drawback is that the bank uses general risk measurement coefficients which are very prudential, especially for exposure to borrowers which do not have an external rating; consequently, the spreads and fees requested from borrowers are generally higher compared to those which would be charged if other methods were used. The further drawback is that this system does not consider relations between the bank and the borrower, but between the bank and the category of clients (either in economic or legal terms) using qualitative and quantitative statistically based variables, thereby creating a potential risk for the bank (and the economic system) and/or a potential loss of profit for the bank due to the imprecise identification and assessment of the risk of a loss (which, if properly calibrated, may be higher or lower).

Essentially, this method requires significant amounts to be set aside (on such a level as almost to discourage the general use of the method) and banks are not requested to carry out a detailed due diligence on the transaction in order to quantify the actual level of risk.

If applied to structured real estate loans (which involve more significant amounts), this method for calculating risk would require the bank to set aside large amounts of money (in absolute terms), which would not necessarily be justified by the actual risk of the operation, and would not be consistent with the due diligence conducted in accordance with the calculation methods specified below.

It should be added that "beneficial" weightings for mortgage loans cannot be applied to structured loans, as repayment of such debts is by definition significantly dependent on the cash flows generated by the underlying property provided as a guarantee and not on the basic capacity of the debtor to repay the loan out of other funds.

8.5 IRB FOUNDATION AND ADVANCED METHODS

In contrast to the Standardized Approach in which the risk weightings depend on the external rating assigned to the counterparty (or the guarantor), under the IRB methods these weightings depend on the internal assessments made by the bank in relation to debtors (or in certain cases, in relation to operations) which result in the allocation of an internal bank rating.

"Rating system" means the overall structured and documented body of methodologies, organizational and control processes, and organizational arrangements for databases enabling relevant information to be collected and processed in order to arrive at overall assessments of the:

(a) creditworthiness of a borrower, and
(b) level of risk of individual credit transactions.

In order for the rating to express the current level of risk of the borrower, it is necessary for it to be updated systematically at intervals specified by the bank; in all cases, a review will have to be carried out at least once per year.

Should information arise during a review of the procedures and/or conditions for the granting of the loan which may imply changes in the creditworthiness of the borrower, it will be necessary to update the rating, even prior to the following review deadline specified under internal rules.

The rating system must not only be an instrument for calculating capital requirements, but must also play a significant role in management. In consideration of this fact, the banks can only be authorized to use the method based on internal ratings in order to calculate capital requirements if the rating system plays an essential role in the management of risk, in the decision making process, in the approval of loans, in the internal allocation of capital, and in the bank's corporate governance functions.

The rating system enables the bank to allocate an internal rating to debtors (e.g. to classify counterparties in relation to their degree of risk) and to make an appraisal of the constituent elements of the risk.

The internal rating is an assessment, in relation to a given period of time, which is made on the basis of all reasonably available information – of both a quantitative and qualitative nature – and is expressed by a classification on an ordinal scale of the capacity of a current or potential borrower to honour its contractual commitments. Each rating is associated with a likelihood of default.

The rating classes must be ordered in line with the credit risk; this implies that the likelihood of default by debtors will increase when moving from a lower risk class to a higher risk class.

The IRB approach does not allow banks themselves to determine all of the elements needed to calculate their own capital requirements. Instead, the risk weights and thus capital charges are determined through the combination of quantitative inputs provided by banks and formulas specified by the Basel Committee.

The formulas, or risk weight functions, translate a bank's inputs into a specific capital requirement. The IRB approaches cover a wide range of portfolios with the mechanics of the capital calculation varying somewhat across exposure types. It relies on four quantitative inputs:

1. *Probability of default (PD)*, which measures the likelihood that the borrower will default over a given time horizon;
2. *Loss given default*[5] *(LGD)*, which measures the proportion of the exposure that will be lost if a default occurs;
3. *Exposure at default (EAD)*, which for loan commitments measures the amount of the facility that is likely to be drawn down if a default occurs;
4. *Maturity (M)*, which measures the remaining economic maturity of the exposure.

Given a value for each of these four inputs, the corporate IRB risk-weight function produces a specific capital requirement for each exposure.

The foundation and advanced IRB approaches differ primarily in terms of the inputs that are provided by the bank based on its own estimates and those that have been specified by the supervisor. Figure 8.1 summarizes these differences.

A major element of the IRB framework pertains to the treatment of credit risk mitigants, namely collateral, guarantees, and credit derivatives. The IRB framework itself, particularly the LGD parameter, provides a great deal of flexibility to assess the potential value of credit risk mitigation techniques. For foundation IRB banks, therefore, the different supervisory LGD values reflect the presence of different types of collateral.

Advanced IRB banks have even greater flexibility to assess the value of different types of collateral. With respect to transactions involving financial collateral, the IRB approach seeks

[5] In general terms on the idea of Loss Given Default please see also Altman et al. (2005).

Data Input	Foundation IRB	Advanced IRB
Probability of default (PD)	Provided by bank based on own estimates	Provided by bank based on own estimates
Loss given default (LGD)	Supervisory values set by the Committee	Provided by bank based on own estimates
Exposure at default (EAD)	Supervisory values set by the Committee	Provided by bank based on own estimates
Maturity (M)	Supervisory values set by the Committee or At national discretion, provided by bank based on own estimates (with an allowance to exclude certain exposures)	Provided by bank based on own estimates (with an allowance to exclude certain exposures)

FIGURE 8.1 Differences between the foundation and advanced IRB approaches[6]

to ensure that banks are using a recognized approach to assess the risk that such collateral could change in value.

It is clear from the above that these methodologies depart significantly from the standard method because, operating as primary inputs in the calculation of the capital amounts which are to be set aside, they involve internal assessments of the credit risk by the bank with a view to obtaining a coefficient that reflects the risk of the operation more accurately, and is perfectly suited to structured real estate financing operations.

In addition, if this method is used the bank will be forced to carry out an analysis which results in the identification of all risks associated with the operation to be financed which, if not sufficiently covered by the relative guarantees, could also lead to a decision not to finance the operation, thereby safeguarding all stakeholders and, in general, the economic system.

The allocation of a rating dependent upon the level of risk of the loan, and its annual review, must be carried out and approved by parties which do not draw any direct benefit from the granting of the loan.

It is important to stress that the IRB methods also take particular account of instruments intended to reduce the credit risk, specifically real and personal guarantees. Recognition of the role of guarantees is achieved using complex methodologies which have an impact on the calculation both of the PD and the LGD.

Guarantees play an important role in the effective reduction of the risk of losses due to debtor default as they transfer all or part of this risk to other parties or assets, and hence reduce the risk expected in the event of a default.

The Advanced IRB includes a rigorous series of minimum criteria on the suitability for use of these methodologies; essentially, the bank must demonstrate that it is structured in an appropriate manner in order to be able to generate the four inputs referred to above. It follows from this that only a specialist bank will be capable of correctly assessing the credit risk for a structured real estate financing operation and thus to set aside an appropriate amount of supervisory capital within its balance sheet (if it decides to finance the proposed operation),

[6] Basel Committee on Banking Supervision (2003b), page 5.

which once again is entirely beneficial for the stakeholders, the bank, and the entire economic system.

As mentioned above, the rating system must play an important management role, which means that the banks may be authorized to adopt the method based on internal ratings for calculating capital requirements only where the rating system plays an essential role in the management of risk, in the decision making process, in the approval of loans, in the internal allocation of capital, and in the bank's corporate governance functions.

All stages of the bank's due diligence in relation to a structured real estate financing operation must be directed at the assessment of the rating and the risk of a loss. Within such operations, the rating must be based on at least three different assessments:

- the quality of the borrower;
- the property financed;
- the operation which is to be financed, taking account also of the guarantees provided as backing for the loan.

As regards the borrower, the rating should be based on the following factors:

- analysis of balance sheets, capital and financial ratios and capacity to generate cash flow;
- level of equity capital invested in the operation;
- assessment of the quality and expertise of company management;
- quality of the internal control system, level of transparency towards the bank of management and forecast data;
- experience of the company and the group of origin;
- credit history of the company and the group of origin;
- transparency, reliability, and clarity of the information provided;
- presence of judgments by third party professionals, such as certification bodies, rating agencies, and analysts.

At least the following aspects will have to be considered in relation to the property financed:

- value of the property, year of construction, regular performance of maintenance work and utility systems, construction materials, finishing, architectural image etc.;
- quality certification for the building, such as energy performance certificates;
- macro and micro economic context;
- attractiveness of the property (such as for example a shopping centre), including in relation to other competing real estate developments in the vicinity;
- adequate property management models which also enable an optimum state of conservation to be attained along with a reduction in costs;
- flexibility of the property permitting an alternative use;
- rental income, which may differ in line either with external events common to all real estate investment (macro-economic risk) as well as specific events relating to the individual property.

Risks may be listed as follows:

- changes in interest rates, employment rates, and inflation;
- changes to tax law or government policy;
- risk associated with the use of the property;
- risk associated with the location of the property;

- risk associated with the inherent characteristics of the property assessed;
- risk of the user which ensures the profitability of the property, which may be broken down into the following elements: sector of origin of the user, which assesses the correlation between the general economic cycle and the economic cycle of the sector in which the user operates; sector of goods to which the activity relates, which analyses above all the suitability of the particular characteristics of the property for the specific requirements of the business;
- level of solvency of the user, which calculates cash flows, liquidity, and capital solidity ratios for the user, including in relation to the property lease or lease of a business division concluded with the borrower (whereby all of the terms of such contracts are analysed, and the clauses of which may not depart from those generally dictated by market practice, in particular in relation to the financial terms).

Finally, all data must be compared with the real estate financing requested in order to assess the following factors, again with the purpose of establishing the risk of a loss:

- term of the loan;
- contractual guarantees and covenants;
- interest rate hedging;
- LTV, DSCR, and ICR;
- cash flow and business plan.

It is also clear from the above that the monitoring of real estate financing operations plays a fundamental role, especially for banks which use internal rating methods (Foundation or Advanced IRB) in order to calculate capital requirements. In fact, in order for the rating to express the current level of risk associated with the client for these banks, it needs to be updated systematically at predetermined intervals, and under all circumstances during an annual review.

This means that the credit management facilities responsible for carrying out these controls must be able to carry out these checks, and that they must also have adequate contractual instruments at their disposal (such as for example contractual covenants[7]) in order to enable all necessary information to be obtained from the borrower.

This means that there must be a seamless overlap between the bank's due diligence activity, the allocation of a rating, and regular monitoring, whilst also avoiding potential conflicts of interest between various parts of the bank.

[7] On covenants please refer to paragraph 3.15.

PART

Two

Outline of the most relevant legal issues in selected jurisdictions

CHAPTER 9

China[1]

1. What are the principal securities lenders will require borrowers to provide?

In China, the bank loan has long been the major – if not unique – property finance resource. Since 2011, real estate loans have been tightened up following the central government's policy attempting to control soaring property prices in major cities. Real estate trust and property funds are increasingly important in the property financing sector in China.

Under Chinese law, there are preconditions before banks or trust companies may grant loans. Such preconditions require that the project company should have obtained the land use right and planning related licences and that the project owner has injected at least 30% of the total project investment. In the meantime the borrowing of money from private funds does not need to fulfil such statutory preconditions. In addition China puts more restrictions over financing by foreign invested real estate companies.

To mitigate the risks, Chinese lenders usually ask for one or more of the following securities:

- mortgage over the land use right, buildings, and/or building under construction;
- pledge of the project owner's equity in the project company (share pledge);
- assignment or pledge of the anticipated income or premium from the project;
- suretyship.

2. What statutory provisions apply to such securities?

The key statutory law stipulating securities is the PRC Security Law. As the law only provides rather general provisions, the judicial interpretations issued by the Supreme People's Court in 2000 play a very important role in security law judicial practice. Further, concerning mortgages of real property, the Property Right Law also provides the principal provisions.

[1] Edited by Taylor Wessing Shanghai, PRC. Taylor Wessing is a leading International law firm with a single-minded approach: to help its clients succeed by thinking innovatively about their business issues. Taylor Wessing numbers around 900 lawyers working across 22 offices in Europe, the Middle East, and Asia, offering an integrated service across the full range of practice areas, with core strengths in corporate finance, real estate, IP, and private wealth. The firm also has particular expertise in advising clients in North America, Brazil, and India.

Various regulations, measures, rules, and circulars issued from time to time by administration authorities as well as local governments also form an extremely important part of Chinese law. Such administrative and local rules usually deal with the implementing details for certain trades of the securities, for example real property mortgage, share pledge, third party guarantee etc. Therefore one needs to look into all such rules in order to get a full picture of how a specific security is regulated under the law and implemented in practice.

3. What are the formal requirements for the establishment of such securities? Does the establishment of a share pledge require their "cession by security"?

First of all, a security agreement is usually viewed as a contract addressing complex legal relationships and therefore needs to be concluded in writing. Further, Chinese law and legal practice so far still does not acknowledge independent security in domestic transactions, meaning that any type of security, even after establishment, is dependent on the main debt, i.e. the loan contract. Invalidity of the respective loan contract may invalidate the security agreement.

To establish a *real property mortgage*, the following preconditions need to be met (Arts 180, 184, 185, and 187 of the Property Right Law):

(a) There shall be a written mortgage agreement with necessary provisions including specification of the secured debt, the mortgaged real property, as well as scope of the security interest etc.
(b) The mortgagor shall have the right to set a mortgage on such real property;
(c) The real property shall not be prohibited from being mortgaged by laws or administrative regulations (e.g. land ownership in China is prohibited from mortgaging);
(d) The mortgage must be registered with the competent authority to effectively set up the mortgage.

It is also possible to provide mortgage security by means of vessels, aircraft, automotive vehicles, large machinery or equipment etc. A legally valid and binding mortgage over such "moving" assets is established at the time when the contract becomes valid. However, if the mortgage is not registered with the competent authority (which may not always be the same one), it might not bind a bona fide third party (Art. 188 of Property Right Law).

To establish a *share pledge*, below the following preconditions need to be met (Arts 208, 210, 223, and 226 of the Property Right Law; Art. 5 of the RPC Measures for Registration of Share Pledge):

(a) There shall be a share pledge contract in written form with necessary provisions including specification of the secured debt, the pledged shares, scope of the security interest, and delivery time etc.
(b) The pledger shall have the right to pledge the share;
(c) The share shall be transferable and pledgeable in accordance with the law (e.g. the shares frozen by court shall not be pledged before the freezing order is lifted);
(d) The share pledge is approved by commercial authority (applicable for pledging with shares of a foreign invested company);
(e) The share pledge must be registered, jointly by pledger and pledgee, with the competent authority to effectively set up the share pledge.

There is no "cession by security" or similar concept/practice under PRC law.

To assign or set up a *pledge via income or account receivables*, the following preconditions need to be met (Arts 208, 210, 223, and 228 of the Property Right Law):

(a) There shall be a written contract with the necessary provisions including specification of the secured debt, the pledged shares, scope of the security interest, and delivery time etc.
(b) The pledge must be registered with the credit reference service institution (e.g. Credit Reference Center of People's Bank of China) to effectively set up the pledge.

Suretyship under Chinese law is where a third party (usually an affiliate of the debtor) promises, in case the debtor is not able to repay the loan, to perform the repayment obligations. There needs to be a suretyship contract concluded between at least the surety and the creditor. No further registration is required, unless a cross-border suretyship is involved.

Suretyship is legally divided into two types, general suretyship and suretyship of joint and several liability. Under a general suretyship, the creditor may only claim for suretyship liability against the surety after it has exhausted the legal remedies and it still is not able to recover the debt; whilst under a surety of joint and several liability, the creditor may choose to claim, at any time during the suretyship term, against either or both of the surety and debtor for debt recovery.

4. What claims are secured? For what amount? In the case at issue, does the novation of the underlying debt lead to the maintenance/ extinguishment of the securities assisting the original debt?

According to the Chinese Property Right Law, secured claims and the amount thereof (unless otherwise agreed by the parties) shall include the following:

(a) principal of the loan plus applicable interest,
(b) contractual or statutory penalty,
(c) damage claims,
(d) expenses for safekeeping of the property used as security and expenses for enforcing the security.

The scope of security may be freely negotiated by the parties in the contract.

Novation of the underlying debt without prior consent by the guarantor does lead to extinguishment of the securities assisting the principal debt. Under Chinese law, the security shall be dependent on the principal debt. If there is novation of the underlying debt without prior consent by the guarantor, the security cannot be automatically assigned to guarantee the new debt but rather a new security shall be created (Arts 175, 192, and 204 of the Property Right Law).

5. Is it possible to "divert" such securities (namely, the securities *in rem*) in order for them to act as collateral for other claims, should the original Loan Agreement be terminated?

Under Chinese law, a security contract is attached to a specific principal (loan) contract (Arts 172 and 192 of Property Right Law). Accordingly a security may not be diverted independently from the secured loan contract and secure other claims. For example, for property conveyance in China, the related mortgage always needs to be first released by the original owner and then re-mortgaged by the new owner for financing purposes.

For maximum amount securities (mortgage or pledge), the securities cover all debts incurred during a designated period or even before (if agreed by the parties) the designated period (Arts 203 and 222 of the Property Right Law).

For real property mortgages, re-mortgaging the same property to a third party used to be explicitly prohibited (Art. 35 of PRC Guaranty Law). This prohibition seems to have been liberalized by judicial interpretation (Arts 50 and 51 of SPC Guaranty Law Interpretation). However, since the later published PRC Property Right Law is silent on the topic, the legal validity of re-mortgage is not yet entirely clear (speech by Mr Song Xiaoming, Judge of People's Supreme Court, at an international property right law seminar), and in practice such re-mortgaging is often restricted by banks such that it is available only "within the remaining value".

6. What rights does a share pledge attribute to the pledgee? Are there any arguments against exercising such rights? What are the formal requirements for its establishment?

There is no specific provision regarding rights of pledgees in cases of share pledge.

As general pledge rules are applicable to both movables and rights, pledgees are entitled to:

(a) Possession of the pledged property (Arts 208 and 229 of the Property Right Law);
(b) Collection of the fruits out of the pledge property accrued from the pledged property, unless otherwise stipulated in the pledge contract (Art. 213 of the Property Right Law).

From the perspective of share pledge by publicly listed companies, "fruit" is specified to include "shares offered to shareholders for free and dividends etc." and such incurred fruit shall be jointly pledged (Art. 35 of PRC Measures for Administration of Share-Pledged Loans of Securities Companies).

A pledgee is not allowed to use or dispose of the pledged property, unless otherwise agreed by the pledgor (Art. 214 of the Property Right Law).

Arguments for exercising such rights include (i) challenging the preconditions as specified in Question 3 above for establishment of such pledge, or (ii) excluding the right to collect fruits via mutual agreement (Art. 213 of the Property Right Law).

For the formal requirement to establish a valid share pledge, please refer to Question 3 above. It was not until 2008 that China issued the regulations relating to the registration of share pledges (*Measures for the Registration of Share Pledge with Industry and Commerce Administration Authorities* effective as of 1 October 2008). Before that, all companies in China in which foreign companies had invested had great difficulties in officially setting up a share pledge.

7. Will securities be automatically preserved, should the Borrower's debt be restructured?

Chinese law provides that during the restructuring period of a debtor, realization of the securities shall be suspended. However, in case there is possible damage or significant depreciation in value of the collateral, which may impair the secured creditor's right, the secured creditor may apply to the people's court to resume his right to realize the security (Art. 75 of the PRC Enterprise Bankruptcy Law effective as of 1 June 2007).

8. In the case of default, how will the securities *in rem* be enforced?

The parties may agree on how to realize the securities (Art. 195 of the Property Right Law).

In case no agreement is reached, the parties may file an application to the people's court for realization of the securities *in rem* (Arts 195 and 220 of the Property Right Law) in one of the following two ways.

(a) When there is no civil right dispute over the security or the secured debt, the parties may file for the "special procedure for realization of securities *in rem*" at court ("*Confirmation Procedure*"). After confirming that the request is "in conformity with the law",[2] the court shall issue a ruling to sell/auction the property, based on such ruling and the parties may apply to court for execution (i.e. sale/auction of the property (Arts 179, 196, and 197 of the PRC Civil Procedure Law)).

(b) When there is civil right dispute, the parties first need to file a normal civil case with the court to decide on the civil rights ("*Litigation Procedure*"). Based on the judgment, the parties may apply to court for enforcement of the judgment (Art. 224 of the Civil Procedure Law).

9. What is the average overall duration for the enforcement of a mortgage following enforcement proceedings?

For the Confirmation Procedure, it takes a maximum of 30 days for the court to issue the ruling after accepting the case, and a maximum of six months to enforce such ruling.

For the Litigation Procedure, it normally takes six months for the first instance trial, three months for the second instance trial (in case of an appeal), and a maximum of six months for the court to enforce the judgment.

In practice the above timeline may be substantially extended if additional procedures are incurred.

10. Are banks entitled to enforce a mortgage directly/through a receiver without having recourse to the competent court? What is the average overall duration of such proceedings?

In case the principal debt cannot be repaid, banks may mutually agree with the mortgagor (or in case of receivership, the receiver) to realize the mortgage. After failure to reach an agreement between the bank and the mortgagor (or in case of receivership, the receiver) to transfer the mortgaged property via mutual agreement, the bank shall file an application to court for enforcement.

Average duration: as provided in Question 9.

11. What taxes and levies apply to the establishment of such securities and to their cancellation?

In general under Chinese law, there is no tax incurred in the establishment and cancellation of any securities.

[2] PRC law is silent on the extent to which the court shall review the request. Some judges' commentaries take the view that the court should only do a formality check, e.g. whether the secured debt is due, whether the security is duly established etc.

12. Are claims of public/tax authorities granted preferential treatment? Are public/tax authorities able to claim against the property in priority to the first-rank mortgage granted to the lender?

Claims of public/tax authorities are granted preferential treatment, which can be claimed against the mortgaged property in priority over the mortgage granted to the lender in China. The statutory repayment sequence after real estate mortgage realization is:

(a) the expenses for mortgage realization;
(b) tax incurred from the mortgaged property;
(c) repayment of the secured loans/interest etc.;
(d) repayment of the loss incurred to the creditor due to the debtor's breach of contract (Art. 47 of the PRC Real Estate Mortgage Measures).

CHAPTER 10

England and Wales[1]

1. What are the principal securities lenders will require borrowers to provide?

- A legal mortgage over any real estate which the borrower currently owns legal title to.
- A fixed charge over all current and future assets of the borrower.
- To the extent not captured by the fixed charge, a floating charge over all current and future assets of the borrower.
- An assignment of rental income, insurance policies and any other material contracts.
- A share charge over the entire share capital of the borrower.

2. What statutory provisions apply to such securities?

Section 136 of the Law of Property Act 1925 (the "LPA 1925") states that for a legal assignment to be effective it must:

- be in writing and signed by the assignor (or mortgagor);
- be absolute (that is, unconditional and, in the case of a debt, of the whole amount);
- not purport to be by way of charge only; and
- be notified in writing to the third party against whom the assignor could enforce the assigned rights (that is, the person who owes the obligation to the assignor).

[1] Edited by Nabarro LLP – Nabarro is a major corporate law firm renowned for their positive, practical approach. They operate in a number of industry sectors and legal disciplines with a single aim: to deliver the highest quality advice as clearly and concisely as possible, no matter how complex the situation. Nabarro has 104 partners leading more than 300 lawyers offering a broad range of corporate legal services to major national and international clients. The firm's headquarters are in central London with a network of offices in Dubai, Singapore, Sheffield and Brussels. In addition, it draws on longstanding relationships with an international network of alliance firms for cross-border work. The specialist banking, finance and restructuring team provides expert advice on a range of matters including: real estate finance, PFI and project finance, acquisition finance, asset finance, asset based lending, Islamic finance, treasury finance and syndicated lending, mezzanine finance and other structured credit products, debt portfolio acquisitions, insolvency, corporate restructuring and transaction planning.

If an assignment does not comply with section 136 of the LPA 1925, then it will take effect as an equitable assignment.

There is a statutory requirement under s. 870 of the Companies Act 2006 (the "CA 2006") to register security given over assets at Companies House within 21 days beginning with the day after the day on which the charge is created.

Under s. 859A of the CA 2006, a company registered in England and Wales, Scotland, or Northern Ireland that has created a mortgage or charge on or after 6 April 2013, or any person interested in that mortgage or charge, may, subject to certain exceptions, deliver to the Registrar of Companies for registration a s. 859D statement of particulars of that mortgage or charge. A similar regime applies to limited liability partnerships. This concept of effectively voluntary registration contrasts with the situation under s. 860(7) of the CA 2006 (which applied to charges created on or after 1 October 2009 but before 6 April 2013) which sets out categories of security that must be registered. In reality, however, because of the sanctions for non-registration of security, a prudent lender will deliver to the Registrar for registration a s 859D statement of particulars for any security it takes, save in relation to those charges specifically excluded from the registration regime by s. 859A(6) of the CA 2006.

If a charge is not registered at all, or is not registered within the period allowed for delivery, then under s. 859H of the CA 2006, the security becomes void (so far as any security is conferred by it) against a liquidator, administrator, and any creditor of the company. If a charge is rendered void against a liquidator or administrator (because it is not registered within the period allowed for delivery), when the company that created the charge goes into liquidation or administration, the holder of the unregistered charge will rank as an unsecured creditor. The charge is only void so far as any security on the company's property or undertaking is conferred by it. It does not render void any contract or obligation for repayment of the money secured by that charge. Pursuant to s. 859H(4), when a charge becomes void under s. 859H of the CA 2006, the money secured by it immediately becomes payable.

3. What are the formal requirements for the establishment of such securities?

Formalities for a legal mortgage over the real estate of the borrower – a legal mortgage can only be taken over a legal interest in property. It must be in writing and executed as a deed by the mortgagor. To take effect as a legal mortgage, a mortgage over registered title must be registered at the Land Registry. If the security is not registered, it will usually take effect as an equitable mortgage, but its existence should still be noted on the title register. It is not possible to take a legal mortgage over property that is not in existence at the time the mortgage is created. Any such mortgage will take effect as an equitable mortgage over the future property.

For unregistered land only, a legal mortgage can also be created by way of a demise for a term of years, subject to a provision for cesser on redemption (i.e. that where a legal mortgage is created by the granting of the lease, for example, such lease will determine on repayment).

Formalities for a fixed charge or floating charge over all current and future assets of the borrower – these must be in writing and signed by the security provider. They do not have to be executed as deeds by the security provider, but almost always are. If the security is intended to cover real estate not yet owned by the security provider, the security document must also be signed by the security holder. To create a fixed charge, the chargor must have sufficient control over the asset being charged (i.e. the chargor cannot be free to sell the asset without the consent of the lender). Whether the charge is classed as a fixed or floating charge will not fall to the

intention of the parties, but will be determined based on fact alone. Without the requisite control over the asset, the charge will be a floating charge.

Any charge granted by a UK company or limited liability partnership must be registered at Companies House within the 21 day period commencing the day after the security is created or it will be void on insolvency and against other creditors and will become immediately repayable.

Formalities for an assignment by way of security of rental income, insurance policies, and any other material contracts of the borrower – an assignment will almost always be in writing. The security must be executed as a deed if it grants the lender a power of attorney. A lender taking a security assignment may require that the assignment complies with s. 136 of the LPA 1925 ("section 136") so that it takes effect as a legal assignment. Non-compliance with the provisions of section 136 will result in the assignment taking effect as an equitable assignment. One of the main advantages of taking a legal assignment is that the assignee will obtain the right to sue, in its own name, the relevant third party against whom the assignor has its contractual rights, without the need to join the assignor in the proceedings. However, if the assignment takes effect as an equitable assignment only, the assignee can achieve the same result by ensuring that the assignment or charge grants the lender a power of attorney so that it can bring court proceedings in the assignor's (or chargor's) name. Alternatively, it might authorize the lender to appoint a receiver to enforce the assigned (or charged) rights in the security provider's name but at the lender's direction. Nevertheless, lenders favour making it a requirement that the security assignments they take comply with section 136 where possible.

To comply with section 136, an assignment must be:

(a) in writing signed by the assignor;
(b) of the whole right;
(c) unconditional;
(d) expressed as an assignment (that is, a title transfer) rather than a charge (that is, the mere appropriation of an asset without transferring its title);
(e) notified in writing to the debtor or other person against whom the assigned right is enforceable; and
(f) of legal rather than equitable rights (such as future property).

Future property may be assigned or charged under English law, but if it is assigned the assignment will not comply with the requirements of section 136 and will take effect as an equitable assignment. Legal assignments are generally construed as being only possible in relation to property which already exists.

To perfect a security assignment, it is advisable (though not always commercially possible) to notify the debtor or other obligor. For instance, giving notice to a counterparty may, in certain circumstances, give priority to the security holder against any other party that may take a security interest after that time. Priority over such assets is generally determined by the timing of the giving of such notice.

A security assignment or charge of claims or receivables granted by a UK company or limited liability partnership must be registered at Companies House within the 21 day period commencing the day after the security is created or it will be void on insolvency and against other creditors.

Formalities for a charge over shares – in practice, charges over shares are usually created in writing and executed as deeds. The security holder will also usually take possession of the share certificates and a stock transfer form executed by the security provider but with

the transferee details left blank. This should enable the security holder on enforcement of its security to upgrade its security to a legal mortgage (by transferring title to itself or a nominee) independently, as a prelude to exercising its statutory and / or contractual power of sale.

A charge taken over shares is vulnerable to a sale to a third party with no notice of the security. The security holder's possession of the share certificate may reduce the risk of such a sale. However, this may not prevent a fraudulent chargor from claiming to have lost its certificate and obtaining a replacement from the company for this purpose. It is possible for a holder of equitable security over shares to apply to court to serve a "stop notice" on a company to protect against wrongful dealings in the shares, although this procedure is rarely used in practice.

The Financial Collateral Arrangements (No. 2) Regulations 2003 (Regulations) disapply any other statutory requirement to register a security interest that constitutes a "security financial collateral arrangement". This includes most fixed securities over financial instruments that may otherwise be registrable at Companies House. However, the extent to which this disapplies the requirement to register floating charges over financial instruments, or over "related rights" such as rights to dividends, is unclear. Under the Regulations, "security financial collateral arrangements" expressly include floating charges over financial instruments, but only if the security assets are in the possession or under the control of the security holder. This is often not the case with floating charges.

In practice, security interests in financial instruments, including shares, granted by UK companies and limited liability partnerships are often registered at Companies House, in part because of these uncertainties.

4. Are there any specific statutory provisions relating to the abovementioned securities; should they be provided in respect of a real estate financing?

Yes, some of the most important statutory provisions are as follows:

(a) S. 52(1) of the LPA 1925 requires the creation of a legal mortgage over land to be made by way of a deed. Pursuant to s. 1(2)(c) of the LPA 1925, even though title is not transferred to the lender (as it is with a mortgage of other assets) this type of security interest gives the lender equivalent rights and creates a legal interest in the land.

(b) S. 27 and para 8 of Sch 2 of the Land Registration Act 2002 requires that a legal mortgage over registered land must be registered in the charges register of the title of that registered land.

(c) S. 29, 32, and 33 of the Land Registration Act 2002 require an equitable mortgage or fixed charge of a legal interest in registered land to be protected by registration of a notice on the title of the property.

(d) S. 32 of the Land Registration Act 2002 states that a floating charge can be protected by registration of a notice on the charges register of the relevant title. In practice, most floating charges will not be protected in this way given that there will be a wide discretion for the borrower to dispose of assets that are subject to a floating charge without the lender's consent.

(e) Under s. 85(1) and 86(1) of the LPA 1925, the holder of a first legal mortgage has a statutory right to take possession of the title deeds. Although deposit of the title deeds is not a necessary feature of a first legal mortgage, and the holder of an equitable charge or subsequent legal mortgage may take the deeds if they are available, in practice the holder of a first legal mortgage will take deposit.

5. Should the answer to the above be in the affirmative, what are both the formal and substantive requirements which have to be met for their application? What advantages/ benefits arise therefrom?

Formal requirements include registering the security at Companies House and the relevant restrictions being noted against the property at the Land Registry (see above). This will ensure the security is valid and enforceable under English law and substantively that third parties are put on notice of this security.

6. What liabilities are secured? For what amount? In the case at issue, does the novation of the underlying obligation lead to the maintenance/ extinguishment of the securities assisting the original debt?

Under English law, all present and future monetary claims can be secured whether they are actual or contingent claims (for example, the liability to reimburse a creditor under a counter-indemnity). There is no need to specify a maximum amount or a maturity date.

The liabilities secured (commonly known as secured liabilities) will be either, "all monies" or refer to specific liabilities. If the security is "all monies", then all liabilities and obligations owed by the security provider (and/or a third party) to the lender(s) will be secured by that security. In addition, the creation of any additional liabilities owing by the borrower to the lender(s) will be secured, without the need to amend the security documents or take additional security.

If, however, the security is for specific liabilities, this means that only certain liabilities and obligations (as defined in the relevant security document) owed by the security provider (and/or a third party) to the lender(s) will be secured by that security.

If the underlying debt is novated then unless the security interest is also transferred, the security would need to be released both pursuant to the terms of the security document and in equity as a result of the equity of redemption (the equitable right of a chargor to recover assets subject to a charge, on repayment) as the chargor would no longer have any outstanding liabilities or obligations to the lender in favour of whom the security was granted. The exception to this would be if:

(a) the security was held by a security trustee on trust for the lender; and
(b) the loan agreement included wording noting that the lender includes any successor or assignor.

In this scenario, once the underlying debt had been transferred to the new lender, the existing security would continue to be valid security and be held by the entity appointed as security trustee in favour of the new lender.

7. Is it possible to "divert" such securities (namely, the securities *in rem*) in order for them to act as collateral for other claims, should the original loan agreement be terminated?

Whether existing security can act as collateral with regards liabilities other than pursuant to the original loan agreement will depend on what the secured liabilities under the security document are. If the security document secures all liabilities and obligations owed by the security provider to the lender, then it would be possible for the existing security to act as collateral in respect of liabilities other than those pursuant to the original loan agreement. However, if the

secured liabilities are limited to those owed pursuant to the original loan agreement then the chargee would not be able to enforce this security in respect of any claims other than those arising out of the terms of the loan agreement.

8. What rights does a share pledge attribute to the pledgee? Are there any arguments against exercising such rights?

The rights attributed to the chargee will depend upon the terms of the charging document. Commonly the chargee will have the right to transfer the shares into its own name upon an enforcement event together with a right to exercise voting rights and receive dividends. A chargee is also entitled to exercise a power of sale and to appoint a receiver if the charge has been created by deed (which means the implied powers under s. 101 of the LPA 1925 will apply) or if it has been granted those powers in the charging document.

In practice, it is rare for the chargee to transfer the shares into its own name as it would at that point become the registered owner and therefore be liable for any outstanding liabilities in respect of the shares.

With regard to the formal requirements for creating a share charge, please see the response to Question 5 above.

9. What taxes and levies apply to the establishment of such securities and to their cancellation?

There is no mortgage tax payable under English law when taking security over property in England and Wales. The chargor is required to pay nominal registration fees at Companies House and the Land Registry when registering their interest in the asset but these fees are not substantial and are not related to the value of the real estate.

10. In the case of default, how will the securities *in rem* be enforced?

Receivership Fixed charge holders may appoint a receiver.

A receiver of mortgaged property can typically be appointed either as an "LPA receiver" pursuant to the LPA 1925, or a "fixed charge receiver" pursuant to the terms of the mortgage document. Sometimes the terms are used inter-changeably but the circumstances under which an LPA receiver can be appointed are restricted under the LPA 1925. Therefore, in modern security documents, it is typical for the lender to grant itself the right to appoint a fixed charge receiver in less restricted circumstances, thereby affording the receiver all of the powers of an LPA receiver under the LPA 1925 plus the additional powers expressly set out in the security document.

The receiver's primary function is to ensure payment of the debt owed to the mortgagee, usually by way of sale of the charged property. The process is not for the benefit of creditors as a whole and there is no statutory moratorium during this process.

Administration In addition, a qualifying floating charge holder may appoint an administrator who has a duty to act in the best interests of the borrower's creditors as a whole.

The essential characteristics of a qualifying floating charge are:

(a) that the charge must by its terms give the holder power to appoint an administrator; and
(b) the charge (or that and other charges taken together) must relate to the whole or substantially the whole of the company's property.

11. Will securities be automatically preserved, should the borrower's debt be restructured?

Generally, securities are preserved until the debt is repaid and the security is formally released.

However, a scheme of arrangement (a "Scheme") may be used to overcome this generalization as, once approved, a Scheme binds both secured and unsecured creditors.

A Scheme is a statutory procedure which permits a company to make an arrangement or compromise with its members or creditors (or any class of them) which, if approved by the requisite majority of such members or creditors and sanctioned by the court, will be binding on all of them, whether or not they vote in favour of it. The relevant law is found in Part 26 (ss 895–901) of the CA 2006.

In summary, creditors will only be bound by a Scheme if:

(a) it is approved by those creditors, or, if the Scheme involves more than one class of creditors, by each class of creditors, at meetings convened by the court. A Scheme is treated as being approved by creditors if it receives the support of a majority in number representing 75% in value of the creditors (or each class of creditors) present and voting at the relevant meeting, either in person or by proxy; and

(b) it is sanctioned by the court at a formal court hearing and a copy of the court order is filed at Companies House.

The CA 2006 does not dictate the subject matter of a Scheme and therefore any proposal is determined by agreement between the company and its creditors. Notably, a Scheme does not require the company to be insolvent and is often used outside of the insolvency context, for example in mergers, takeovers and internal reorganizations.

12. Are banks entitled to enforce a mortgage directly/through a receiver without having recourse to the competent court?

A secured creditor may enforce his security outside of court proceedings by the appointment of a receiver or (less usually) an administrative receiver. There is no prescribed time period for enforcement – this will very much depend on the extent of negotiations and due diligence pre-appointment (please see Question 13).

A receiver is appointed over specified charged assets. An administrative receiver is appointed where the secured creditor has a charge over the whole or substantially the whole of the company's assets and accordingly has power to run the company, although his primary duty will be to the secured creditor.

As a result of reforms introduced by the Enterprise Act 2002, the holder of a floating charge created on or after 15 September 2003 may not appoint an administrative receiver unless one of the statutory exceptions applies. These exceptions include floating charges granted in connection with public-private partnerships, utilities, project finance and certain financial markets.

If one of the exceptions applies or for pre-existing charges, an administrative receiver can only be appointed when the company is in breach of the terms of the debenture, enabling the secured creditor to exercise its security rights. The administrative receiver, although an agent of the company, is primarily concerned with the recovery of sufficient assets to pay out to the debenture holder.

A secured creditor with a "qualifying floating charge" may also appoint an administrator (which may also be done using an out-of-court procedure).

Where there are two or more charge holders (each being or including a floating charge) over the company's property, a junior-ranking charge holder who wishes to appoint an administrator must give at least two days' notice to those having priority or alternatively secure their written consent. Case law has confirmed that notice must be given to a senior charge holder even if his charge is not currently enforceable.

13. What is the average overall duration for the enforcement of a mortgage following enforcement proceedings?

There is generally no prescribed time period for the enforcement of a mortgage.

When appointing a receiver, the overall duration will very much depend on:

- the extent of negotiations between the parties and due diligence pre-appointment of a receiver; and
- the time it takes the receiver to realize the charged assets and use the proceeds to discharge the debt due to the charge-holder.

In contrast, the appointment of an administrator ceases to have effect at the end of a one year period beginning with the date on which it took effect. However the court may, on application, extend an administrator's term of office for a specified period.

14. Are claims of public/tax authorities granted preferential treatment? Are public/tax authorities able to claim against the Property in priority to the first-rank mortgage granted to the lender?

Other than the costs of preserving and realizing the fixed charge assets (including the office-holder's costs relating to those assets), there are no priority claims which rank ahead of secured creditors with a fixed charge in relation to the proceeds of sale of those assets.

In addition to the costs of preserving and realizing the floating charge assets, certain priority claims rank ahead of secured creditors with a floating charge. These priority claims are preferential debts and payments to unsecured creditors out of the prescribed part. As a result of changes in legislation, there are comparatively few preferential debts; these include sums owed to occupational pension schemes in respect of unpaid contributions and remuneration owed to employees to a set amount. The Enterprise Act 2002 abolished Crown preference with respect to tax payments to HM Revenue and Customs departments and various social security contributions.

CHAPTER 11

France[1]

1. What are the principal securities which lenders will require borrowers to provide?

- mortgage and special real estate privilege;
- pledge on intangible personal assets;
- providing of a surety;
- comfort letter;
- assignment of property as a security;
- assignment of professional claims;
- trust.

2. What statutory provisions apply to such securities?

Mortgages or "*hypothèques*" Articles 2393ff. of the French Civil Code (hereinafter "FCC") provide that a mortgage gives a creditor, which has proceeded to a registration, the right to sell the property of the debtor even if a third party is in possession thereof or to become owner of the real property if the debtor defaults, in order to secure his claim.

The mortgage can be conventional (Art. 2393 FCC), legal (Art. 2396 FCC), or judicial (Art. 2412 FCC).

The mortgage is an accessory, indivisible right without loss of possession. The grantor of the mortgage shall be the owner of the property and have the legal capacity to alienate.

A mortgage can be registered on real estate and all its accessories and on the usufruct and the bare ownership of such real estate and accessories (Art. 2397 FCC). A mortgage can also

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be registered on the right of superficie and on the right of the emphyteutic tenant. It covers any improvement on the real estate made by the owner or a third party.[2]

In principle, the mortgage must be registered on present real estate and so cannot be registered on future real estate. But French law provides three exceptions (Arts 2419 and 2420 FCC):

- If the present real estate is insufficient to guarantee the debt, the debtor can provide a mortgage on his future property if both the parties sign a declaration which notes this insufficiency;
- When the mortgaged property becomes inadequate to guarantee a debt following the destruction or deterioration of the property, the creditor can obtain another mortgage on another property of the debtor;
- The debtor can grant a mortgage on an immovable of which construction has already begun or if he already has the right to do it.

Regarding the conventional mortgage, the mortgage contract must be written in the presence of a notary. This formality is required for the validity of the mortgage.

Furthermore the mortgage is established on the date of the inscription. Indeed the mortgage has to be published in order to be enforceable against third parties (Art. 2425 FCC). This requirement is fulfilled by an inscription in the relevant mortgage registry *(Conservation des hypothèques/Livre foncier in Alsace-Moselle)* and must indicate the real estate on which the mortgage is granted, the debt instrument which gives rise to the inscription, the secured receivable, and its accessories (Arts 2426 and 2428 FCC).

Ordinance number 2006-346 of 23 March 2006 has introduced two new conventional mortgages:

- The *equity release* (Art. 2422 FCC: *hypothèques rechargeables*). This mortgage allows a debtor to provide a mortgage that he can then re-use to ensure a claim other than the initial one.
- The *reverse mortgage* (Arts L 314-1 and L 314-2 of the French Consumer Code (hereinafter "ConsC"): *prêts viagers hypothécaires*). The reverse mortgage is a contract under which a bank or any other financial institution agrees to a loan for a borrower in the form of a lump sum or periodic payments, secured by a mortgage on the property of the borrower which is his residence and whose repayment – principal and interest capitalized annually – cannot be required until the death of the borrower or on the disposition or division of property of the mortgaged property if they occur before the death.

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[2] The mortgage is defined in Art. 2393 FCC. According to the official translation of Art. 2393 FCC,
"A mortgage is a right in rem on immovables allocated to the discharge of an obligation.
It is, by nature, indivisible and subsists in entirety on all the immovables allocated, on each one and on the portion of those immovables.
It follows them, in whatever end they may pass." (see www.legifrance.gouv.fr/content/download/1950/13681/.../Code_22.pdf).
In the Glossary to the official translation of the French Civil Code, the right of superficie is expressly classified as an "Untranslatable French Term". The explanation/outline offered is "Right of ownership over buildings and plantations, different and independent from the right of ownership of the land":
Empyhteusis is defined as the hereditary lease of land (see Art. L 451-1ff. Rural Code): it not only confers peaceable enjoyment of the immovable on the hereditary tenant, but confers a right in rem, which entitled the tenant to improve the land and to build on the land.

Furthermore the abovementioned ordinance provides that a mortgage can now *cover more than one debt, present or future* (Art. 2421 FCC). Moreover the mortgage is granted to secure the amount of claim provided by the notarial deed (Art. 2423 FCC)

This security confers a preferential right on the creditor for the amount of the secured property plus accessories (Art. 2193 FCC).

If the receivable is assigned because of an assignment or in case of a succession, the mortgage follows the secured receivable and the mortgagee retains his right. This assignment has to be published.

A third party who wants to acquire the real estate on which a mortgage is granted has the option not to pay the acquisition price and to propose that the secured creditor pay a certain amount of the claim in return for the cancellation of the mortgage (Arts 2476 to 2487 FCC). The creditor can accept or refuse the proposal. He has a 40 day period to require the public auction of the real estate, proposing a price 10% above the third party's proposed price. If there is no additional supply, the creditor has to acquire the real estate and the third party is deemed never to have been the owner.

Finally mortgages are extinguished in the following cases, which have to be distinguished:

- Lapse of registration: the creditor can renew the inscription but if he fails to do so in time, the mortgage subsists but is unenforceable against third parties (Art. 2436 FCC);
- Cancellation, in whole or in part, of the inscription (Art. 2440 FCC). The cancellation can be made by the creditor who renounces his security (the receivable subsists but not the mortgage) or his receivable (here the claim and the mortgage are extinguished) or it can be judicial;
- Extinguishment of the receivable: the security follows the receivable. But if only a part of the receivable is extinguished then the mortgage subsists over the whole of the real estate;
- In case of recourse to the procedure provided by Arts 2476 to 2487 FCC ruling the acquisition of the real estate by a third party.

The special privileges Articles 2373ff. FCC provide for privileges on real estate.

Creditors mentioned in Art. 2374 (for example: the seller of the real estate for the payment of the price, the money lender for the financing of the acquisition of the real estate, the heirs for the guarantee of the sharing among them) have a right of preference over other creditors of the equivalent amount of their receivable. The creditors have to complete a few formalities and specifically to register their privilege within a certain timeframe.

Pledge on intangible personal property or "*nantissements de meubles incorporels*" Articles 2355ff. FCC provide that a pledge is a contract in which intangible personal property is offered to the creditor or a third party and agreed upon by the parties as security for the payment of a debt. It includes the pledge of debt securities.

There is no specific provision regarding *share pledges* or the pledge of intangible assets of a business. They do however fall within the category of pledges laid down by Arts 235ff. FCC. But there are specific rules for *share accounts*, modified by an ordinance of 24 February 2005 transposing a Community Directive dated 6 June 2002 concerning the financial guarantee contracts and an ordinance of 8 January 2009 concerning financial instruments.

The base of those pledges is the account and not the shares it contains.

The pledge is realized in respect of the parties but also in respect of the issuing company and the third parties (Art. L 211-20 I of the French Monetary and Financial Code (hereinafter "MFC")) by a declaration signed by the account owner. This declaration is required for the validity of the pledge.

In addition, there are no specific provisions concerning the *pledge of rental income*. It is a security that can be taken under French law, but it does fall within the category of pledges laid down by Arts 2355ff. FCC.

The secured creditor will have a right of preference on the account (Art. L 211-20 IV MFC).

For a pledge on an account, the pledge extends to the credit balance of this account on the day the pledge was taken (Art. 2360 FCC).

The pledge of debt securities includes the pledge of *insurance policies* (Art. L 132-10 of the French Insurance Code).

The pledgee then has a right *in rem* over his debtor's debtor. The pledge can cover one or more debt securities; current securities (such as a rental income) as well as future ones (an upcoming sale, or the future benefits of a company), even if their existence is not absolutely certain yet (Arts 2356 and 2357 FCC). The pledge may concern the whole of the debt securities or only a part thereof, unless the debt is indivisible (Art. 2358 FCC).

The pledge on debt securities requires a solemn contract between the parties, under penalty of nullity of the contract (Art. 2356 FCC).

The contract of pledge is enforceable against third parties on the date of its formation (Art. 2361 FCC). The contract is enforceable against the debt securities' debtor at the moment he is notified of the existence of the contract, unless he directly took part in the formation of the contract (Art. 2362 FCC).

After that the debtor is notified of the contract, he shall therefore rightfully pay the pledgee, and no longer his original creditor (Art. 2363 FCC).

The payment in relation to the debt securities is subtracted from the secured value. On the other hand, the pledgee shall keep those payments on a deposit account and pay the difference to the debtor if the debt security is executed and overreaches the pledged debt security. If a debtor should default, and eight days after a letter of formal notice has received no response, the pledgee may seize the deposited sums, to the extent of the unpaid debt (Art. 2364 FCC).

"Providing of a surety" or the French "cautionnement" French law provides this surety which involves three parties: a creditor, a debtor, and a third party providing the creditor with a surety for the original debt, called the guarantor. In other words, the guarantor pays the debt when the debtor defaults (Art. 2288 FCC).

Even though the French Civil Code does not impose it, it is advisable that the surety is written in the presence of a notary in order to prove the existence of a legal act, its validity, and for it to be enforceable against third parties. Otherwise, certain formalities need to be completed, such as the written form of the guarantor, unless he is taking part in the contract as part of his business activity. Other formalities regarding a surety provided for a consumer need to be completed (see Question 4 for more details).

The surety can be simple or several. The surety is simple when the creditor is bound to exhaust the main debtor's property (see Art. 2299 FCC). A simple surety requiring seizure and sale must point out to the creditor the property of the principal debtor and furnish him a sufficient sum to have proceedings carried out (Art. 2300 FCC).

Furthermore, in the case of a simple surety, the guarantor has a right of "division". It means that if there is more than one surety for the same debt (called "the co-guarantors"), each surety – normally liable for the entire debt – requires the creditor to split its action and consequently reduce it to their own share of the debt.

For a several surety, the guarantor shall expressly have agreed to be severally liable, unless he is taking on the guarantee as part of his business activity. In that case, it is considered that the guarantor is severally liable.

Comfort letters This is an obligation to act positively or to refrain from doing something in order to support a debtor for the execution of an obligation towards a creditor provided for under Art. 2322 FCC and called "*lettre d'intention"*. The support may vary from the payment of a debt to a "gentlemen's agreement" to reach a business target.

The comfort letter does not cover an original debt, and it is neither identical nor similar to a surety.

Assignment of property as a security In order to guarantee the credit, the debtor has the option to assign the ownership of one or more of his goods to his creditor. If the debtor pays his debt, the creditor has to give him back the ownership of the good. In case the debtor defaults, he allows the creditor to keep the ownership of the good, however it shall be limited to the value of the receivable. French law provides two instruments: the sale with right of redemption and the security trust.

The latter includes the assignment of professional claims.

Assignment of professional claims ("*Cession Dailly*") The assignment of professional claims is the most widely used security in business activities, given its simplicity and practicality.

Pursuant to Art. L 313-23 MFC, a credit institution has the option to ask their client to assign to them their current or future trade debts as a security.

If the client pays his debts, the assigned receivable shall be returned to him.

Should the debtor default, the creditor – a credit institution – retains ownership of the claims, which is enforceable against third parties on the date written on the assignment certificate, even though those other creditors are privileged. No further formality is required to enforce it.

The assignment of professional claims is very advantageous in that regard compared to the traditional assignment of a claim – which is deemed cumbersome – as it is limited to one debt at a time, on the one hand, and shall be notified by a judicial officer to other creditors, on the other hand.

Trust ("*Fiducie*") The French trust (Arts 2011ff. FCC) can also be used as a security. The debtor, as the settlor, transfers the ownership of an asset or of more than one asset to his creditor, which is the trustee of the trust and which is also the beneficiary of the trust assets as a security, should the debtor later default. The creditor-trustee-beneficiary shall give the trust assets back to the debtor-settlor, should the debt no longer exist. On the other hand, should the debtor default, the creditor will be granted ownership of the trust assets upon the other creditors of the debtor.

There can be more than one settlor, and more than one beneficiary.

The validity of the trust depends on two indications mentioned in the contract aimed at protecting the settler: the guaranteed debt and the estimation of the value of the transferred real estate.

As for the assignment of professional claims, the assignment of debts through a trust is enforceable upon third parties on the date that the trust contract or its amendment is made. It is enforceable upon the debtor of the pledged debt only when notified to him by the debtor or the trustee.

The trust – used as a security – can cover other debts than those initially mentioned in the contract. The trust is then rechargeable and extendable to new debts (Arts 2372-5 and 2488-5 FCC).

In case of an insolvency proceeding, a distinction is made between a trust the assets of which are still under the material possession of the insolvent debtor, and one where the assets are in the possession of the trustee-beneficiary. If the trustee-beneficiary materially retains the trust assets, the judge may allow the debtor to pay that trustee-beneficiary in order to get the assets back, if the judge deems so necessary in order for the debtor to maintain his business activity (Art. L 622-7, II of the French Commercial Code (hereinafter "CommC"). This implies that in comparison the trustee-beneficiary is much less well protected if the insolvent debtor retains material possession of the assets. Indeed, in that case, the debtor does not have to execute the payment to get the assets back.

3. What are the formal requirements for the establishment of such securities?

See Question 2 above and Question 5 below for the formal requirements of such securities.

As seen above, the scope of the pledge is not the account's securities, but the account itself.

The share account pledge is established between the parties and upon the issuing legal person and third parties with a declaration signed by the account holder.

This declaration shall include the consent to pledge the securities' account, as well as information such as the date, the amount of the pledged debts, and the nature of the elements on the account (Art. D. 211-20 MFC).

The declaration is a condition for the validity of the pledge. The pledgee has a preferential right and shall claim the property of the pledged securities. He has a legal retention right on the pledged securities (Art. L 211-20 IV).

As for the "cession by security", there is no such requirement *per se* for the constitution of a share pledge, however there are special requirements regarding the share account (see Question 2).

4. Are there any specific statutory provisions relating to the abovementioned securities; should they be provided in respect of a real estate financing?

Concerning sureties, the French legislation aims at protecting the less informed party on its contractual obligations with reference to real estate financing.

In particular Arts L 313–317ff. ConsC provide a set of rules concerning a natural person who is standing as surety for a consumer in reference to real estate financing.

Concerning privileges, French law provides special privileges for money lenders in Arts 2373ff. FCC.

Concerning mortgages, French law provides specific rules, especially concerning rechargeable mortgages, in order to protect the borrower and grantor of the mortgage in Arts L 313-14–L 313-14-2 ConsC and even regarding reverse mortgages in Art. L 314-1.

5. Should the answer to the above be in the affirmative, what are both the formal and substantive requirements which have to be met for their application? What advantages/ benefits arise therefrom?

Concerning the sureties: A natural person who provides a surety for a consumer in relation to a real estate loan, shall comply with certain provisions.

Two main rules apply: the guarantor shall be *informed*, and his obligation shall be *proportionate*.

Information: While the loan contract is executed, the lender is required to report to the guarantor a characterized payment incident from the debtor. This incident is defined as one being potentially written on the national file for payment incidents. If the lender fails to do so, he loses his claims over penalties or default interest, due between the date of the first unreported incident and the date of the information to the guarantor (Art. L 313-9 ConsC).

The guarantor shall sign, under penalty of nullity of his obligation as a guarantor, the following, and only the following (Art. L 313-7 ConsC):

> *"As I act as guarantor for X … for the maximum amount of … covering the payment of the principal, and the interest and, potentially, the penalties or default interest for the period of …, I undertake to pay the lender the amount due on my income and my assets if X … doesn't cover it."*

If the guarantor is severally liable, a cap, including interest and accessories, shall be stipulated expressly in the contract. An uncapped surety for a real estate (or a movable property) loan is therefore forbidden (Art. 313-8 ConsC).

Proportionality: the guarantor of a real estate loan for a consumer is protected against excessive obligations:

> *"A credit institution shall not avail itself of a loan contract for a credit operation concluded with a natural person, whose obligation was, at the time of the conclusion, obviously disproportionate to his assets and income, unless the assets of the guarantor, which is called on, allow him to face his obligation."*

If the obligation of the guarantor is still disproportionate at the time he is called upon, his payment is unenforceable with regards to the credit institution (Art. L 313-10 ConsC).

For a guarantor, which is a legal person, the surety is not necessarily limited in time and amount. However, a credit institution which is granted such a surety shall inform the guarantor each year as to the amount and the deadline of the guaranteed debt; and as to the fact that the guarantor can withdraw his guarantee any time he wants, if no deadline is provided in the surety contract.

As seen above, the lender is required to report to the guarantor a characterized payment incident from the debtor.

Concerning the privileges of the lender of money, it supposes a property purchase agreement and a loan. The privilege concerns the property acquired and all its attachments (incorporated constructions). It guarantees the amount of the loan and the interest at the rate stipulated

by the loan contract and in the limit provided by Art. 2432 FCC, i.e. three years. These rules protect the lender of money for the financing of real estate.

Concerning the rechargeable mortgage, French law protects the grantor of the mortgage in the case of a property loan. Article L 314-14-1 ConsC provides precisely the conclusion of the property loan granted by a reverse mortgage in order to protect the consent of the grantor.

According to the abovementioned article, the grantor must be given a document on the situation of the mortgage containing mandatory information. The failure to comply with these formalities is punishable by a fine of €3.750 and forfeiture of the lender's right to interest on the loan; in such cases, the borrower is bound only to repay the principal as scheduled in the loan agreement.

Concerning the reverse mortgage, French law protects the borrower from the risks of the constitution of a reverse mortgage: canvassing is forbidden (Art. L 314-4 ConsC), the publicity has to be informative and honest (Art. L 314-3 ConsC), and a prior offer has to mention the main elements of the loan and has to be maintained for a minimum period of 30 days (Arts L 314-5 and L 314-6 ConsC).

The borrower then has a 10 day period of reflection during which he cannot accept the offer (Art. L 314-7 ConsC). The contract has to be notarized, otherwise it is invalid. Failure to comply with these requirements is an offence subject to criminal prosecution (Arts L 314-16–L 314-19 ConsC).

6. What liabilities are secured? For what amount? In the case at issue, does the novation of the underlying obligation lead to the maintenance/extinguishment of the securities assisting the original debt?

- *For mortgages*: a distinction should be made for the different types of mortgages:
  - It is now possible to cover *different debts, present or future*, with a mortgage (Art. 2421 FCC).

    Future debts shall be determinable.

    A determined amount shall be written in the notary act, constituting the mortgage, and in the mortgage registration.

    If the mortgage covers different future debts for an undetermined period of time, the grantor can cancel the debt at any time with three months' notice (Art. 2423 FCC).
  - The *rechargeable mortgage* allows the grantor to use the mortgage as covering new debts, the amount not exceeding the value of the mortgaged property. This amount has to be written into the constitution act.

    However, the amount of the remortgaging can be higher than the initial secured debt.

    The newly covered debts are hypothetical, thus unknown and the identity of the creditor is also unknown. It can be the first grantor or a third party. The mortgage is then still valid after the extinguishment of the originally covered debt (Art. 2422 FCC).
  - For a *reverse mortgage*: the claim is the property of the home owner, who was granted a loan. The value of the claim is not known at the time the mortgage is constituted. This amount is determined when the reverse mortgage contract terminates, which is either at the death of the borrower, or when the mortgaged property is sold. In that case, any novation of the underlying debt leads to the extinguishment of the assisting reverse mortgage.

- *For sureties*: the obligation covers a specific underlying debt. The guaranteed obligation determined in the contract cannot qualitatively and quantitatively exceed the amount of the debt it covers. However it is possible to only cover a portion of it (Art. 2290 FCC).
- *For pledges on intangible personal property*: it is possible for this kind of pledge to cover one or multiple claims present or future (e.g. different rental incomes, future profits of a company, debt flows).

  A future debt, though potential, shall have an existence "close to certainty". It could also only cover a portion of the debt, except where the latter is indivisible (Art. 2358, subarticle 1° FCC).

  However, the pledge does not extend to as yet unknown debts and is not extended after the extinguishment of the covered debt.
- *For comfort letters*: a comfort letter does not give an identical or similar obligation to the person granting the letter. It is a security *in personam* not attached to a specific obligation, but rather to a person (usually a mother company for its subsidiary, or a CEO for his company).

  The comfort letter provides an obligation of means or of results and not a specific amount of a claim.
- *For the assignment of professional claims*: it is possible to assign future debts, if those are designated or clearly designable.
- *For the special privileges*: it guarantees the amount of the loan and the interest at the rate stipulated by the loan contract and within the limit provided by Art. 2432 FCC, i.e. three years.

It is important to note that a cession plan in the insolvency is not considered as a novation of the debtor's debt. Therefore this debt, and by analogy, the surety assisting the original debt, are maintained as before.

7. Is it possible to "divert" such securities (namely, the securities *in rem*) in order for them to act as collateral for other claims, should the original loan agreement be terminated?

- For mortgages:
  - It is possible to divert a mortgage that covers *different debts, present or future*, but only if it replaces determinable debts, as the mortgage was undertaken.
  - The *rechargeable mortgage* allows the novation of debts, as well as the novation of the grantor.
  - The *reverse mortgage*: a "diversion" is impossible.
- *For pledges*: a "diversion" to unknown debts is impossible.
- *For sureties*: a "diversion" is impossible.
- *For comfort letters*: it is considered that in case of novation of the original debt, the obligation is no longer valid in respect of the provider of the comfort letter.
- *For assignments of professional claims*: a "diversion" is impossible.
- *For special privileges*: a "diversion" is impossible.

8. What rights does a share pledge attribute to the pledgee? Are there any arguments against exercising such rights?

See Question 2 above.

After the share pledge contract is duly formed, the debtor has the obligation to pay directly the pledgee, who has a retention right. This rule is of practical importance, should the debtor default.

Three options are available to the pledgee (Art. 2365 FCC):

- He may ask the court to order him the right of ownership over the pledged debt securities (Art. 2347 FCC).
- He may grant ownership of the pledged debt securities according to the conditions of the contract that allows such enforcement. However this option is not available if it is used after the court decision to open insolvency proceedings or if this contract stipulation was agreed on after the opening of insolvency proceedings (Art. L 622-7 CommC).
- If the pledge was duly notified to the debtor, the pledgee is the only one who can receive payment for it. It is not a preferential right, but rather an exclusive right (Art. 2363 FCC).

  The executed payment will be charged on the pledged debt securities. If the payment overreaches the pledged debt security, the pledgee owes the debtor the difference.

Concerning the pledge of shares, the right to vote in corporate meetings belongs to the owner of the shares and not to the pledgee. Also the annual profit distributions belong to the grantor of the pledge and are not transferred to the pledgee.

If a loss of value of the shares is the result of the grantor's conduct, the pledgee has an option to appoint a "management observer" (*observateur de gestion*) in order to avoid the depreciation of their securities.

In case of decrease of capital the pledge is extinguished and is not extended to the newly issued shares. The creditor loses his right.

Finally, see Question 2 above concerning the share account pledge.

9. What taxes and levies apply to the establishment of such securities and to their cancellation?

- *For mortgages*: applies cadastral taxes for the registration of mortgages (0.70%). This does not apply to a *rechargeable mortgage* when it is registered again to cover new debts. However, for both, notary fees and the salary of the mortgages' registrar are to be paid (Art. 844 of the French General Tax Code (hereinafter "GTC").

  The renewal of the mortgage is not subject to the payment of taxes. The cancellation of a mortgage is free of taxes but the salary of the mortgage's registrar is due.

  The salary of the registrar is due for the registration of each mortgage or privilege and is paid at a rate of 0.05% of the value of the guaranteed asset or debt (Art. 293, Annex III GTC).

10. In the case of default, how will the securities *in rem* be enforced?

See Question 11 below for the enforcement in the case of insolvency proceedings.

Except for the case of insolvency proceedings against the debtor, the following ordinary law scheme applies:

- *For a mortgage*: the creditor has several options pursuant to Arts 2458 and 2459 FCC. He can obtain the sale of the mortgaged property and be paid through the sale proceeds; or he can obtain the judicial grant of ownership of the mortgaged property; or he can obtain

the ownership of the mortgaged property through a conventional agreement between him and his debtor:

- *Sale of the mortgaged property* (Art. 2458 FCC): the creditor summons his debtor to pay pursuant to Art. R 321-5 of the French Enforcement Proceedings Code. This summons is published to the mortgage register within two months (Art. R 321-6). A hearing of the debtor is organized within two months of the registration of this summons (Art. R 322-5).
- The judge can then order the private sale of the property or order a forced sale (Art. R 322-15 of the Enforcement Proceedings Code). If the private sale is chosen, a new hearing is planned within four months, which can be extended to three additional months for conclusion of the contract of the private sale (Art. R 322-21).
- The sale proceeds are deposited in a locked-in account at the "*Caisse des Dépôts et Consignations*" (Art. R 322-23).

  The different registered mortgage creditors have a preferential right to the sale proceeds of the mortgaged property, unless they agreed with the debtor that the sale proceeds will be used to pay, partially or entirely, their claims (Art. 2475 FCC).

  The property is transferred with the mortgages and privileges attached to it pursuant to Art. 2461 FCC. Unless the third party owning the property has proceeded to the redemption of his property (Art. 2462 FCC), by following certain formalities (Art. 2478 FCC), the secured creditor can exercise their resale right as long as the claim is not paid (Art. 2464 FCC).
- *Judicial grant of the mortgaged property*: this procedure is restricted in order to protect the debtor. Therefore the option is not open for the principal residence of the debtor (Art. 2458 FCC).

  In order to avoid unjust enrichment of the secured creditor, the property shall be assessed by an expert, designated by the parties, or the judge. If the assessed value exceeds the value guaranteed through the mortgage, the creditor owes the debtor the difference. If there are other mortgage creditors, the difference shall be kept in a deposit account (Art. 2460 FCC).
- *Conventional grant of the mortgaged property*: the same restrictions apply as for the judicial grant of the property (Art. 2459 FCC).

  The property is assessed in the same way as the judicial grant, and the sale proceeds are kept as a deposit. However, as this procedure is even easier to enforce, the conventional grant shall be done in the presence of a notary and the agreement is subject to the land registration (Art. 2460 FCC).

  It is important to notice that this conventional agreement is *impossible* if the debtor is subject to an insolvency proceeding (Art. L 622-7, I CommC, referring to Art. L 631-14, paragraph 1, and Art. L 641-3).
- *For a surety*: the creditor has a right to be paid from the guarantor for his claim only if the debtor defaults, pursuant to Art. 2298 FCC. The guarantor cannot be asked for payment before the payment deadline.

  After the deadline, his surety is limited to the creditor's claim against the debtor, or to the extent of the surety he provided, which could be less than the entire claim (Art. 2290 FCC). The surety is limited to the principal and does include or not the accessories of the debt (e.g. penalties). If the surety is unlimited in its amount, it is extended to the accessories of the debt if the guarantor has granted it (Art. 2293 FCC).

If the surety covers future debts, only those which resulted before the surety was cancelled are enforceable.

Should the original debtor default, the creditor shall inform the guarantor, if he is a natural person. Otherwise he loses his claim on penalties and payment delays resulting between the date of the first default and the date of receiving the information thereof (Arts L 313-9 and L 341-1 ConsC).

- *For a pledge on intangible personal property*: should the original debtor default, the pledgee has three options to enforce his claim (Art. 2365 FCC):
  - the judicial grant of ownership of the pledged debt security (Art. 2347 FCC);
  - the conventional ownership grant of the pledged debt security, with the abovementioned same prohibition as for the mortgage if insolvency proceedings are opened against the debtor (Art. L 622-7 CommC);
  - After the deadline, the pledgee is the only one who can receive payment for it. It is not a preferential right, but rather an exclusive right (Art. 2363 FCC) (see Question 8).

11. Will securities be automatically preserved, should the borrower's debt be restructured?

In theory, the securities will be automatically preserved in the case of insolvency proceedings, but are not enforceable after a court decision opening the insolvency proceedings. Nonetheless, these rules are subject to certain exceptions (Art. L 622-21 CommC).

Securities shall be filed to the insolvency proceeding within 2 months after the notification of the opening of this proceeding (Art. L622-24 CommC).

The claims which are not filed within this timeframe are not enforceable against the debtor during the execution of the plan if the undertakings mentioned in the plan or decided by the court have been kept. During the execution of the plan, they are also not enforceable against co-debtors which are natural persons; or persons that provided a security *in personam*; or persons who provided a surety *in rem* (Art. L 622-26 CommC).

Initially, the following proceedings shall be defined for the best understanding of the following analysis:

- The "observation period" is the period after the opening of the insolvency proceedings during which an insolvency plan is prepared. This period aims at determining the situation of the insolvent debtor and the options available: e.g. cession of parts or the whole activity of the debtor, receivership, or liquidation (Art. L 622-1 CommC).
- In the safeguard procedure, the debtor is granted the protection of the law after a court decision, and his creditors can no longer file enforcement proceedings against the debtor at the time of the procedure (Art. L 620-1 CommC).

The abovementioned rules regarding the registration of claims in the insolvency proceedings are not applicable to the *surety guarantor*. If a creditor cannot enforce a payment individually against the debtor, he can nonetheless enforce the payment against the surety guarantor, as long as he is not himself subject to insolvency proceedings.

The prior creditor can take protective measures or obtain a payment order against the guarantor, even after the opening judgment.

The surety is maintained and is enforceable against the surety guarantor, even if the creditor cannot enforce his claim against the insolvent debtor.

As seen above, the creditor shall submit his claim to the insolvency proceeding against the guarantor, if the guarantor is insolvent. He shall do so whether the guarantor gives a

guarantee *in rem* or *in personam.* He shall further do so, even if the original debtor is solvent and is not in default of payment.

In that regard, he will be able to call upon the guarantor, should the original debtor later default.

However, if the guarantor, who is a natural person, is a co-debtor of the insolvent debtor; or has provided a personal surety; or has secured or transferred an asset as a surety the claim against him is not enforceable in the "observation period", up until a judgment opening the insolvency plan or deciding the liquidation.

After this period of protection, the judge may even grant the guarantor an extended payment deadline up to two years, from the moment when the claim is enforceable again, if the situation of the guarantor so requires (Art. L 622-28, paragraph 2, CommC).

The creditors can take protective measures against the guarantor during the "observation period" to avoid frauds on his part (Art. L 622-28, paragraph 3, CommC).

Retention rights are an exception to the abovementioned prohibitions. They are not considered as securities, giving them an advantage over any other claim, either privileged or covered by a security. However, retention rights are not enforceable during the observation period and the enforcement of the plan, unless the retained property is part of a business cession plan (Art. L 622-7 CommC for the observation period and the execution of the plan; Art. L 641-13, II for the liquidation proceedings).

- During the "observation period", during the execution phase of a safeguard or continuation plan, and if the property is covered by the following rights: a special privilege; a pledge or a mortgage; a share of the sale proceeds of the secured properties is deposited in a locked-in account at the "*Caisse des Dépôts et Consignations*", which is a public financial institution. The creditors receive payment after the enactment of a plan, according to their respective ranking (Art. L 622-8 CommC).

  However, the creditors benefiting from those rights will receive payment after the creditors benefiting from the privilege of subsequent debts (Art. L 622-17 CommC), who themselves receive payment after the employees and their "super-privilege" (Arts L 143-10, L 143-11, L 742-6, and L 751-15 of the French Labour Code).

  There is no option for a *judicial award of a pledge* during the "observation period", in order to respect the equal treatment between creditors. It is also not awarded after a continuation plan, a receivership, or a safeguard procedure, if the secured debt resulted prior to the opening judgment of the insolvency proceedings (Art. L 622-7 CommC).
- In the *liquidation*: the *mortgaged creditors* are paid after the privileged employees and the procedural costs which resulted after the opening of the insolvency proceedings for the requirements of the procedure, but before the subsequent privileged creditors.

  In the liquidation, unlike in the cession plan, the property transfer shall comprise redemption of the security *even if the secured creditor is not fully paid off*, which would very likely be the case since other creditors receive payment before him (including the "super-privilege" of employees, and the procedural costs of the insolvency).

  If the assets of an insolvent company are transferred through a *cession plan* to a transferee, the securities attached to the property will be transferred with them, if they cover a credit given to the company in order to finance a property.

  The transferee shall then pay the creditor the amount of the transferred security still due to him. As the creditor still has his claim on credit payment deadlines that the insolvent debtor didn't pay, the transfer of the assets coincides, from a substantive viewpoint, to a transfer of debt.

The creditors, who have a retention right, can exercise this right against the transferee. The transferee then has the option to pay the creditor's claim back in totality and not just the remaining rental.

However, the original lender and the transferee may reach an agreement governing their situation. The creditor has the option to withdraw his securities (Art. L 642-12 CommC).

For *pledges*: the creditor may ask the court for the judicial award of the pledged asset before the assets of the debtor are liquidated (Art. L 642-20-1 CommC).

Consequently, the secured creditor who obtains the judicial award of the property of the pledged asset will be paid even before creditors with higher rankings.

Finally, from the date of the opening of insolvency proceedings, the interest stops running. That includes penalties and increased charges, unless they result from a loan contract concluded for one year or more, or from a contract with deferred payments concluded for one year or more. Natural persons, which are co-debtors, or which have given a personal security, or which have pledged or given a property as a security, can avail themselves of these provisions (Art. L 622-28 CommC).

12. Are banks entitled to enforce a mortgage directly/through a receiver without having recourse to the competent court?

See Question 10 above and Question 13 below.

13. What is the average overall duration for the enforcement of a mortgage following enforcement proceedings?

See Question 10 above.

In the ordinary law procedure, from the point when a summons to pay has been registered, the procedure usually lasts not more than 12–15 months.

In the case of a prior insolvency, the enforcement of the mortgage is only possible after the "observation period", lasting six months, which is renewable once upon request of the debtor, the receiver, or the public prosecution office (Art. L 621-3 CommC).

In the case of a prior insolvency, which is extended, the overall duration for the enforcement should not exceed two years.

14. Are claims of public/tax authorities granted preferential treatment? Are public/tax authorities able to claim against the property in priority to the first-rank mortgage granted to the lender?

The Tax authorities have both a general and a special privilege upon movable assets. *A privilege grants the creditor a right that is always superior to securities, even superior to mortgages* (Art. 2324 FCC).

However, for a real estate, the mortgaged creditors receive prior payment upon the price of the sold estate. The tax authorities are only privileged upon the remaining value (that is to say, after the mortgaged creditors have received payment), which is a movable asset.

For the effective recovery of the direct taxes, the tax authorities have two different privileges which are specific securities.

First, the general tax privilege pursuant to Art. 1920 GTC is enforceable on movable assets and on the intangible assets of a business and other remaining assets (cash; rental incomes and other incomes of an immovable property, as long as they were not transferred to a third person and that there were no prior seizures of the immovable property; cash left after the privileged creditors have received full payment upon the security).

Second, the special tax privilege pursuant to Art. 1920, 2. 1° and 2° GTC, is enforceable upon harvests, rental incomes, and other incomes of an immovable property. The special privilege gives the tax authorities a resale right, according to which they can seize all incomes resulting from immovable properties, even though the immovable properties were sold, either privately or judicially.

Those incomes can be seized directly in the hands of a third party through a third party notification only if those incomes were not regularly transferred, disregarding that the seized incomes were deposited in a locked-in account.

However, the privilege of tax authorities is subject to a few exceptions: the creditor materially possessing an asset, or the beneficiary retaining an asset of a trust; the super-privilege of employees' salaries, and the privilege of social security funds; the privilege regarding procedural costs (prior as well as subsequent to the insolvency proceeding); as well as a few others such as the privilege of the costs of preservation of goods; the pledge on machinery and equipment; and commercial warrants will be paid prior to the tax privilege and, as seen above, the mortgage creditors to the extent covered by the mortgage.

CHAPTER 12

Germany[1]

1. What are the principal securities lenders will require borrowers to provide?

The term property finance in Germany is understood to mean the financing of the acquisition or development of real property. Typically, the financing is provided by loan, not share capital and is to be repaid principally out of the revenues produced by the property. The loan is made to a single purpose project company owned by the project sponsors and the lender will look only to the SPV for repayment. The SPV will typically be constituted as a limited liability company under German law (*Gesellschaft mit beschränkter Haftung* – hereinafter "GmbH"). The loan agreement will contain covenants as to the minimum value of the property (e.g. the loan must not exceed 80% of the value of the property during the life of the loan and a ratio of income cover). The transaction documents include the loan agreement (including separate and local syndicates, if any), an intercreditor agreement, security documents, interest hedging agreements, a subordination agreement (e.g. subordinating the repayment of capital injections by the parent company) and, in the case of construction finance, completion and cost overrun guarantees. While the agreements governing the acquisition of the property are typically governed by German law, it has become common for finance documents (with the notable exception of the security agreements) to be subject to the laws of England and Wales.

Security interests typically include:

- a land charge over the property, usually in the form of a *Grundschuld* (ss. 1192 and 1113 et seq. German Civil Code (*Bürgerliches Gesetzbuch* - hereinafter "BGB"));[2]

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[2] German law is cognizant of two types of land charges, namely the *Hypothek* (ss. 1113 et seq. BGB) and the *Grundschuld* (ss. 1192 and 1113 et seq. BGB). The *Hypothek* differs from the *Grundschuld* in that its creation requires a secured claim and that it ceases to exist by operation of law to the extent that the secured claim is reduced by repayment. Refilling a *Hypothek* with fresh claims hence requires a new agreement to this end. As a consequence, the *Hypothek* is a much less flexible security interest than the *Grundschuld*: while the first may only be employed to secure precisely specified claims existing at the time of its establishment, the latter may be employed to secure future claims. Consequently, the *Hypothek* plays only a minor role in property financing. A bank will typically request the granting of a *Grundschuld*. The present German Country Report refers solely to land charges in the form of *Grundschulden*.

- security assignments of the revenues produced by the property (*Sicherungsabtretung* – ss. 398 et seq. BGB);
- a pledge (*Pfandrecht*) over the collection account (and, as the case may be, all other accounts) of the SPV (ss. 1273 et seq. BGB);
- a pledge (*Pfandrecht*) over the shares in the SPV (ss. 1273 et seq. BGB); and
- a guarantee issued by the parent company of the SPV.

2. What statutory provisions apply to such securities?

The types of security mentioned above under Question 1 are primarily governed by the provisions of the BGB, the Order on the Land Register (*Grundbuchordnung* – hereinafter "GBO"), the Insolvency Act (*Insolvenzordnung* – hereinafter "InsO"), and the Act on the Foreclosure Sale of Property (*Zwangsversteigerungsgesetz* – hereinafter "ZVG").

As a general rule, the choice of laws other than those of the Federal Republic of Germany (which may be advantageous in respect of Art. 13 of the EU Regulation on Insolvency Proceedings) is admissible. In particular, the parties are free to choose a law other than that of the Federal Republic of Germany for pledges over bank accounts (Art. 14(3) of the Rome I Regulation on the law applicable to contractual obligations – hereinafter "Rome I"), pledges over shares in a German GmbH (Art. 14(3) Rome I), the security assignment of revenues generated by the property (Art. 14(1) Rome I), and a guarantee issued by the parent company of the SPV (Art. 3(1) Rome I). Land charges such as the *Grundschuld*, however, are mandatorily governed by German law as according to German Private International Law property interests are governed by the law of the country in which the property is situated (Art. 43 of the Introductory Code to the German Civil Code – hereinafter "EGBGB").

3. What are the formal requirements for the establishment of such securities?

In order for a *Grundschuld* to come into existence, the following requirements must be met: firstly, there must be an agreement for security (*Sicherungsvertrag*). This agreement stipulates which claim(s) shall be secured, under which conditions, and how the lender may enforce the security interest. Secondly, an agreement for creation of the *Grundschuld* (*dingliche Einigung*) must be concluded (s. 873 BGB). Both agreements are typically contained in one deed. No particular form is required. Note, however, that the land registry will only enter the *Grundschuld* into the land register if the agreement for the establishment of the *Grundschuld* is authenticated by either a notary or a public authority entitled to authenticate deeds such as the city council (s. 19 GBO). The agreement for the creation of the land charge may under very special circumstances require the consent of public authorities (see *Palandt/Bassenge*, BGB, 73rd ed. 2014, s. 873 recitals 18–25). Thirdly, land charges must be entered into the land register (s 873, BGB). The priority of the *Grundschuld* will not be affected by (a) any prepayment of any portion of the secured obligations or (b) any reduction of the outstanding amount of the secured obligations from time to time, notwithstanding any rights of third party creditors for the deletion of lower-ranked land charges after the secured obligations have been paid in full in accordance with s. 1179a BGB.

A *security assignment* of revenues requires, firstly, the conclusion of an agreement for security. Secondly, the parties must agree on certain identifiable revenues to be assigned. This is a critical requirement because under German law a security interest cannot exist in an asset which is neither identified at the time of the agreement for creation of the security nor

identifiable as subsequently falling within its terms (so-called *Bestimmtheitsgrundsatz*). A security assignment of claims governed by German law can only be created by the legal owner of such claims and is subject to existing third party rights. No particular form is required. The security assignment need not be communicated to the debtors of the borrower. A claim governed by German law may not be assigned or assignment may be limited or excluded as a result of an agreement between the creditor and the obligor thereof. Although a contractual agreement cannot validly preclude an assignment if the assigned claim results from a transaction entered into between two businesses (*Kaufleute*), any payment on such claim to the assignor will, nevertheless, extinguish such claim in a corresponding amount despite the assignment being excluded or limited by such parties.

A *pledge* over a bank account or shares in a GmbH requires, firstly, that an agreement for the creation of security be entered into. A pledge over a bank account or shares in a GmbH can only be created by the legal holder of the account or the owner of such shares, respectively, and is subject to existing third party rights. With the pledge being an accessory security interest, such agreement must precisely stipulate the secured obligations. While no special form is required for an account pledge, the valid creation of the pledge over the shares in a GmbH requires notarization of the underlying share pledge agreement (s. 1274(1) BGB; s. 15(3) of the German Act on Limited Liability Companies – GmbHG). Secondly, the agreement must be notified to the account bank (which will typically be the bank granting the financing loan) or the GmbH, respectively (s. 1280 BGB; cf. *Bayer*, in *Lutter/Hommelhoff*, GmbHG, 18th ed. 2012, s. 15 recital 97). Unless waived by the account bank, such pledge will rank behind the lien established in favour of the account bank relating to the accounts according to the standard terms and conditions of the account bank. Unless waived by the account bank, the pledge over the bank account does not limit any other statutory right of the account bank such as the right to set-off or withhold funds as the account bank is entitled under any agreement entered into between the holder of the account and itself. Under German law a pledge constitutes an accessory security interest, which is dependent on the secured indebtedness and, as such, will automatically lapse upon full discharge, settlement, or novation of the secured indebtedness.

A *guarantee* simply requires the agreement of the parties by which one person agrees to answer for some existing or future liability of another, and by which the guarantor's liability is in addition to, and not in substitution for, that of the principal. Choice of law is admissible. No specific form is required. The situation is different if the parties opt for a German *Bürgschaft* instead of a guarantee. Should they do so, the agreement needs to be in writing (pursuant to s. 766 BGB). This difference, together with the accessory nature of the *Bürgschaft*, has caused the guarantee to become the form of personal security interest most widely used in property financing.

As a general remark, under German case law the value of collateral transferred for security purposes must not be excessive as compared with the secured claim. Any creation of security violating this rule will be deemed void if the value of collateral exceeds the nominal amount of the secured obligations significantly, which will be assessed with reference to the time when the collateral was granted (*Palandt/Ellenberger*, op. cit., s. 138 recital 97).

4. Are there any specific statutory provisions relating to the abovementioned securities; should they be provided for with reference to real estate financing?

No. German law is not cognizant of a special regime for property finance.

5. Is it possible to "divert" such securities (namely, the securities *in rem*) in order for them to act as collateral for other claims, should the original loan agreement be terminated?

As a general principle, it is for the parties to determine the scope of the security interest. In particular, the parties may agree that a certain security acts as collateral for any and all liabilities arising out of the business relationship between the lender and the borrower (*Palandt/Bassenge*, op. cit., s. 1191 recitals 19, 44 on the *Grundschuld*). This general principle is somewhat restricted by the rule that accessory security interests (such as the *Hypothek*, the pledge, and the *Bürgschaft*) are dependent on the secured obligations which must therefore be precisely specified at the time the agreement is concluded. Accessory security interests will automatically lapse upon full discharge, settlement, or novation of the secured obligations. Debt restructuring or other forms of later alterations of the secured obligations hence require fresh agreements. The fact that the novation or alteration requires fresh agreements is the prime downside of accessory security interest. While it may – technically – be quite easy to enter into new agreements, the "hardening periods" of the rules on the avoidance of certain transactions in bankruptcy (ss. 129–137 InsO) begin afresh which bears a higher risk of avoidance in the case where the borrower is adjudicated bankrupt.

6. What rights does a share pledge attribute to the pledgee? Are there any arguments against exercising such rights?

In the event of default, the pledgee may auction the shares pursuant to the provisions of the German Civil Code (s. 1277, BGB) unless the shareholder agrees to different means of enforcement (e.g. a private sale), which agreement must not be made before the pledge has become enforceable (see *Palandt/Bassenge*, op. cit., s. 1277 recital 3). The pledgee may, however, not exercise voting or veto rights or other administrative rights of the shareholder (see *Bayer*, in: *Lutter/Hommelhoff*, op. cit., s. 15 recital 99). Also, the pledgee will in the absence of an agreement not participate in annual profit distributions (*Bayer*, loc. cit.) it being understood that such right may be separately assigned or subject to a separate pledge.

The main argument against conferring shareholders' rights to the pledgee by agreement is that if this is done their loan may be reclassified as equity. Such reclassification entails (a) that the claim for repayment of the loan of the pledgor will be a claim subordinated by operation of law should the pledgee be adjudicated bankrupt (pursuant to s. 39(1) no 5 InsO), (b) that the security interest provided for such claim is no longer enforceable, and (c) that payments received by the lender/pledgee one year prior to the filing of the bankruptcy petition have to be repaid to the bankruptcy receiver (s. 135(1) nos 1 and 2 InsO). These harsh consequences of reclassification explain why institutional lenders completely refrain from exercising shareholders' rights.

7. What taxes and levies apply to the establishment of such securities and to their cancellation?

The creation of security interests does not trigger tax consequences. The registration of a land charge in the land register will trigger moderate fees. The realization of the security interest will typically be due to income tax (*Einkommensteuer/Körperschaftsteuer*) and turnover tax

(*Umsatzsteuer*). Under German law a borrower may be forced – under certain circumstances – to withhold amounts owed to a lender for tax purposes, in particular if such borrower is incorporated or has its registered seat in a jurisdiction which is not a party to a double taxation treaty with the Federal Republic of Germany. However, this is not the case if the lender under the relevant facility agreement is not secured by immovable property situated in the Federal Republic of Germany. The foreclosure sale of real estate will trigger court fees.

8. In the case of default, how will the securities *in rem* be enforced?

In the absence of an agreement allowing for private sale, land charges are realized by foreclosure sale (*Zwangsversteigerung*) in accordance with the provisions of the Act on the Foreclosure Sale of Property. It is in essence a public auction. Pledges over bank accounts are enforced by a transfer of the monies in the account. A court order will only be needed if the bank refuses to transfer the monies (an issue that will not arise where the account bank is at the same time the financing bank). Pledges over shares are, in the absence of an agreement allowing for private sale, realized by public auction (see s. 1277 BGB). The security assignment of rentals is enforced by a notification of the assignment vis-à-vis the lessees of the real estate. If the lessees refuse to pay the borrower, civil action must be taken.

9. Will securities be automatically preserved, should the borrower's debt be restructured?

Not necessarily. Accessory security interests such as the *Hypothek*, the pledge, and the *Bürgschaft* automatically lapse in the event of full discharge, settlement, or novation of the secured obligations. Fresh agreements will be needed. In the case of non-accessory security interests such as the *Grundschuld*, the security assignment, and the guarantee, the effects will depend on the underlying agreement for security. In this agreement the parties are free to stipulate that the security shall cover future obligations, in particular obligations arising in connection with a debt restructuring.

10. Are banks entitled to enforce a mortgage directly/through a receiver without having recourse to the competent court?

No. If the borrower does not explicitly agree to means of realization other than foreclosure sale (*Zwangsversteigerung*), such foreclosure sale is mandatory. The purpose of German law is to protect the borrower against under value sales of their property. German law is in any case not cognizant of a receiver or the like.

11. What is the average overall duration for the enforcement of a mortgage following the enforcement proceedings?

The foreclosure sale (*Zwangsversteigerung*) of real estate may take between 9 and 36 months depending on the court. If the parties agree to realize the security interest by private sale, a much shorter time period is needed.

12. Are claims of public/tax authorities granted preferential treatment? Are public/tax authorities able to claim against the property in priority to the first-rank mortgage granted to the lender?

No. German insolvency law is not cognizant of any priority. In particular, claims of public authorities such as tax authorities are not afforded preferential treatment. Nor may those authorities claim against the property in priority to the first-rank mortgage granted to the lender. The most notable exception to this is the land tax (Grundsteuer) which is granted preferential treatment in insolvency and in the event of a foreclosure sale according to s. 10 ss. 1 No. 3 ZVG.

CHAPTER 13

India[1]

1. What are the principal securities lenders will require borrowers to provide?

Principal Securities are divided into movable and immovable property. Immovable property includes: land, buildings, anything attached to the land or permanently fastened to it and any interest in immovable property. The security granted over such immovable property is a mortgage. Any property that is not immovable is movable property. It includes pledge, hypothecation, and charges. Charges can be fixed or floating. Intellectual property rights and assignment of rental income also come under movable property.

2. What statutory provisions apply to such securities?

Answered with question 3.

3. What are the formal requirements for the establishment of such securities?

The statutory legislations governing real estate are: Indian Contract Act 1872, Transfer of Property Act 1882, Registration Act 1908, Specific Relief Act 1963, Urban Land (Ceiling And Regulation) Act 1976, Land Acquisition Act 1894, The Indian Evidence Act 1872, The Indian Stamp Act 1899, Securities and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002.

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There are specific statutory provisions with respect to the securities which provide for real estate financing in India. One of the usual modes of raising money for financing real estate funds in India is by way of mortgage. The transferor is called a mortgagor, the transferee a mortgagee; the principal money and interest of which payment is secured for the time being are called the mortgage- money, and the instrument (if any) by which the transfer is effected is called the mortgage- deed. The Transfer of Property Act 1882 defines various kinds of mortgages of immovable property in India such as simple mortgage, mortgage by conditional sale, usufructuary mortgage, English mortgage, mortgage by deposit of title deeds, or anomalous mortgage depending upon the nature of the transaction.[2] A bird's eye view of the kinds of mortgages available in India is as follows.

Mortgage

- *Simple mortgage*: Where, without delivering possession of the mortgaged property, the mortgagor binds himself personally to pay the mortgage-money, and agrees, expressly or impliedly, that, in the event of his failing to pay according to his contract, the mortgagee shall have the right to cause the mortgaged property to be sold and the proceeds of sale to be applied, so far as may be necessary, for the payment of the mortgage-money; the transaction is called a simple mortgage and the mortgagee a simple mortgagee.
- *Mortgage by conditional sale*: Where the mortgagor ostensibly sells the mortgaged property – on condition that on default of payment of the mortgage-money on a certain date, the sale shall become absolute, or on condition that on such payment being made the sale shall become void, or on condition that on such payment being made the buyer shall transfer the property to the seller, the transaction is called a mortgage by conditional sale and the mortgagee is referred to as a mortgagee by conditional sale.

  Provided that no such transaction shall be deemed to be a mortgage, unless the condition is embodied in the document which effects or purports to effect the sale.
- *Usufructuary mortgage:* Where the mortgagor delivers possession expressly or by implication, the mortgagor binds himself to deliver possession of the mortgaged property to the mortgagee, and authorizes him to retain such possession until payment of the mortgage-money, and receive the rents and profits accruing from the property or any part of such rents and profits and appropriate the same in lieu of interest, or in payment of the mortgage-money, or partly in lieu of interest and partly in payment of the mortgage-money, the transaction is called a usufructuary mortgage and the mortgagee is referred to as a usufructuary mortgagee.
- *English mortgage*: Where the mortgagor binds himself to repay the mortgage-money on a certain date and transfers the mortgaged property absolutely to the mortgagee, but subject to a proviso that the mortgagee will retransfer it to the mortgagor upon payment of the mortgage-money as agreed, the transaction is called an English mortgage.
- *Mortgage by deposit of title deeds*: Where a person in any of the following cities, namely, the towns of Calcutta, Madras and Bombay and in any other town which the State Government concerned may, by notification in the Official Gazette, specify in this behalf, delivers to a creditor or his agent documents of title to immovable property, with intent to create a security thereon, the transaction is called a mortgage by deposit of title deeds.

[2] Section 58: "Mortgage", "mortgagor", "mortgagee", "mortgage-money" and "mortgage deed" defined.

- *Anomalous mortgage*: A mortgage which is not a simple mortgage, a mortgage by conditional sale, a usufructuary mortgage, an English mortgage, or a mortgage by deposit of title deeds within the meaning of this section is called an anomalous mortgage.

The Act further prescribes rights and liabilities of the morgager such as the right to redeem,[3] right to inspection and production of documents,[4] right to redeem two mortgages separately or simultaneously,[5] right to usufructuary mortgage to recover possession,[6] accession to the mortgaged property,[7] etc. The said Act also provides for renewal of the mortgage lease. The Act further prescribes various implied contracts of the mortgager such as that the mortgager will defend the mortgaged property, the mortgager will pay all public charges accruing in respect of the mortgaged property, the mortgager will pay rent where the mortgage property is under lease, etc.[8] On the other hand, rights and liabilities of the mortgagee have also been enlisted under the provisions of the Act such as the right to foreclosure of sale, right to sue for mortgage money, etc.[9] There are further provisions concerning "marshalling" wherein the rights of competing mortgages are settled. In marshalling the creditor who has the means of settling his debt out of several funds shall so exercise his rights as not to take from another creditor the funds which form his own security. The contribution on the other hand settles rights of the mortgagers of several shares in one property mortgaged. The contribution requires that a fund which is equally liable with another to pay a debt shall not escape because the creditor has been paid out of that other fund alone.[10]

Share pledge Pledging of shares in India as collateral has become the usual way of raising working capital or a term loan to increase the holding or fund an acquisition. The share pledge has become a common practice adopted by borrowers and intermediaries in the share market to raise finance from the lenders namely banks, financial institutions, etc.

Transfer by means of a pledge in general is governed by ss 30 and 53 of The Sale of Goods Act 1930 which also includes share pledge transfer. There are other statutes, namely the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, the Securities and Exchange Board of India Act 1992, the Depositories Act 1996, the Securities Contracts (Regulations) Act 1956, the Companies Act 1956, etc., which specifically deal with the transactions pertaining to transfer of shares including pledge of share securities and various other provisions pertaining to its execution and enforcement.

Assignment of rental income earned from an immovable property is similar to an anomalous mortgage and hence would be governed by the provisions of the Transfer of Property Act 1882.

Pledge of a rental income as a revenue will be governed by the provisions of the respective legislation as indicated for the pledge in general above.

[3] Section 60 of the Transfer of Property Act 1882.
[4] Section 60B of the Transfer of Property Act 1882.
[5] Section 61 of the Transfer of Property Act 1882.
[6] Section 62 of the Transfer of Property Act 1882.
[7] Section 63 of the Transfer of Property Act 1882.
[8] Section 65 of the Transfer of Property Act 1882.
[9] Sections 67–77 of the Transfer of Property Act 1882.
[10] Section 82 of the Transfer of Property Act 1882.

Assignment of insurance policies is basically governed by the provision of s. 38 of the Insurance Act 1938. The said provision provides for an endorsement to be done on the same instrument as the insurance policy or through a separate document for the transfer of the insurance policy.[11]

Since there is no specific legislation for the transfer by way of a comfort letter in India, a transfer by way of a comfort letter in general will be governed by the general principles of the Indian Contract Act 1872. A transfer by way of surety will also be governed by the provisions of the Indian Contact Act, 1872.[12] The relevant provisions of the said Act deals with rights and liabilities and discharge, etc. of a surety in a contract of indemnity and/or guarantee.

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[11] Section 38 of the Insurance Act 1938 – Assignment and transfer of insurance policies.

(1) A transfer or assignment of a policy of life insurance, whether with or without consideration, may be made only by an endorsement upon the policy itself or by a separate instrument, signed in either case by the transferor or by the assignor or his duly authorized agent and attested by at least one witness, specifically setting forth the fact of transfer or assignment.

(2) The transfer or assignment shall be complete and effectual upon the execution of such endorsement or instrument duly attested but except where the transfer or assignment is in favour of the insurer shall not be operative as against an insurer and shall not confer upon the transferee or assignee, or his legal representative, any right to sue for the amount of such policy or the moneys secured thereby until a notice in writing of the transfer or assignment and either the said endorsement or instrument itself or a copy thereof certified to be correct by both transferor and transferee or their duly authorized agents have been delivered to the insurer. Provided that where the insurer maintains one or more places of business in India, such notice shall be delivered only at the place in India mentioned in the policy for the purpose or at his principal place of business in India.

(3) The date on which the notice referred to in sub-section (2) is delivered to the insurer shall regulate the priority of all claims under a transfer or assignment as between persons interested in the policy; and where there is more than one instrument of transfer or assignment the priority of the claims under such instruments shall be governed by the order in which the notices referred to in sub-section (2) are delivered.

(4) Upon the receipt of the notice referred to in sub-section (2), the insurer shall record the fact of such transfer or assignment together with the date thereof and the name of the transferee or the assignee and shall, on the request of the person by whom the notice was given, or of the transferee or assignee, on payment of a fee not exceeding one rupee, grant to the policy without obtaining the consent of the transferor or assignor or making him a party to such proceedings.

(5) Subject to the terms and conditions of the transfer or assignment, the insurer shall, from the date of the receipt of the notice referred to in subsection (2), recognise the transferee or assignee named in the notice as the only person entitled to benefit under the policy, and such person shall subject to all liabilities and equities to which the transferor or assignor was subject at the date of the transfer or assignment and may institute any proceedings in relation to the policy without obtaining the consent of the transferor or assignor or making him a party to such proceedings.

(6) Any rights and remedies of an assignee or transferee of a policy of life insurance under an assignment or transfer effected prior to the commencement of this Act shall not be affected by the provisions of this section.

(7) Notwithstanding any law or custom having the force of law to the contrary, an assignment in favour of a person made with the condition that it shall be inoperative or that the interest shall pass to some other person on the happening of a specified event during the lifetime of the person whose life is insured, and an assignment in favour of the survivor or survivors of a number of persons, shall be valid.

[12] Sections 126–147 of the Indian Contract Act 1872.

4. Are there any specific statutory provisions relating to the abovementioned securities, should they be provided for within real estate financing?

Answered with question 5.

5. Should the answer to the previous question be in the affirmative, what are both the formal and substantive requirements which have to be met for their application? What advantages/benefits arise therefrom?

The formal and substantive requirements which will be required by the borrowers to provide for the execution of their application are as follows:

(a) *First-rank mortgage*: For execution of the mortgage, the initial requirement will be to get an agreement/contract executed between the mortgager and mortgagee (parties to the contract) along with the transfer of the title deed and/or immovable property as per the nature of the mortgage property. The said agreement/contract will have to be duly notarized, stamped, and executed as per law.

(b) *Share pledge*: In order to conduct a share pledge transaction, a share pledge agreement/contract needs to be executed between the pledger/pawner and the pledgee/pawnee. The said agreement will have to be notarized, stamped, and executed as per law.

The stamp duty is levied as a percentage of the value of the total transaction mentioned in the agreement/contract.

Further, an application under s. 58 of the Securities and Exchange Board of India (Depositories and Participants) Regulations 1996 will also be required to be made by the beneficial owner to the depository through participants who have his account in respect of such securities.

(c) *Assignment of rental income, pledge of rental income, providing of sureties, comfort letters, assignment of insurance policies*: In this case as well, the initial requirement will be to get an agreement/contract executed between the parties and the bill accordingly stamped as per the amount of consideration involved. The said agreement/contract will also have to be notarized and executed as per law.

All the options for borrowing money/taking a loan could be availed of depending upon availability of the subject/asset requirement to be transferred in lieu of the loan to the loan provider. However, the most advantageous and convenient option is "share pledge". Moreover, the pledging of shares is the preferred and most lucrative option practised these days.

The establishment of a share pledge requires its cession by security. Pledge of shares can either be offered as 100% security under the transaction or may be partial or as collateral; lenders follow their own method of advancing under pledge transactions.

6. What liabilities are secured? For what amount? In the case at issue, does the novation of the underlying obligation lead to the maintenance/extinguishment of the securities assisting the original debt?

The secured claims/debts are tied to an asset that is considered collateral to a debt. Sundry creditors and mortgages are also a kind of secured debt of a company.

In the absence of an agreement to the contrary, the novation of the underlying debt maintains the securities assisting the original debt.

7. Is it possible to "divert" such securities (namely, the securities *in rem*) in order for them to act as collateral for other claims, should the original loan agreement be terminated?

The loan agreement is terminated on payment of the borrowed sum of money along with the interest as applicable. The securities can be diverted, to act as collateral for other claims for availing of a fresh loan against the same or another lender. However, in case of breach of contract or termination because of non-payment on time, the securities under charge or lien cannot be acted upon by the pledgor.

8. What rights does a share pledge attribute to the pledgee? Are there any arguments against exercising such rights?

Sections 173–176 of the Indian Contract Act 1872[13] set out the rights of a pledgee. According to s. 173 the pledgee may retain the pledged shares not only for payment of the debt or the performance of the promise, but for the interest of the debt, and all necessary expenses incurred by him in respect of the possession or for the preservation of the goods pledged. Section 174 prohibits the pledgee, in the absence of a contract to that effect, from retaining the shares pledged for any debt or promise of other than the debt or promise for which they are pledged. As per s. 175, the pledgee is also entitled to extraordinary expenses incurred by him. Section 176 provides for the course of action for the pledgee when the pledgor defaults. In case of default, the pledgee may bring a suit against the pledgor for default and retain the share pledged as collateral security or he may sell them by giving the pledgor a reasonable notice of sale. If the proceeds of the sale are greater than the amount so due, the pledgee shall pay over the surplus to the pledgor. The arguments depend on the facts of the case. Section 177 sets out the pledgor's right of redemption.

9. Will securities be *automatically* preserved, should the borrower's debt be restructured?

The Corporate Debt Restructing (CDR) System came into existence in accordance with the guidelines issued by the Reserve Bank of India on 23 August 2001. The objective of this system was the revival of the corporates undergoing financial crises and to allow the reimbursement of the money lent by the banks and financial institutions.[14] It assists companies that cannot repay their loans by extending the payback period, reducing the interest rate, providing a repayment holiday (or moratorium), converting part of the loan into equity, and even writing down the loan amount.

This mechanism is a voluntary non-statutory system based on a Debtor-Creditor Agreement (DCA) and on an Inter-Creditor Agreement (ICA). It rests on the principle of approvals by super-majority of 75% creditors (by value) which makes it binding on the remaining 25% to fall in line with the majority decision.

The system includes only multiple banking accounts, syndication/consortium accounts, where all banks and institutions together have an outstanding aggregate exposure of Rs.100 million and above. It covers all categories of assets in the books of member-creditors classified in terms of RBI's prudential asset classification standards. Even cases filed in Debt Recovery

[13] Sections 173–176 of the Indian Contract Act 1872. Also see *Guide to Companies Act* – A Ramaiya.
[14] Information taken from www.cdrindia.org.

Tribunals/Board for Industrial and Financial Reconstruction/and other suit-filed cases are eligible for restructuring under CDR.

Reference to CDR may be initiated by:

- The corporate, if supported by a bank/FI having a minimum 20% share as above; or
- Creditors having a minimum 20% share in either working capital or term finance;
- The request is not entertained if the corporate has indulged in fraud or misfeasance.

The legal basis of the CDR is provided by the Debtor-Creditor Agreement (DCA) and the Inter-Creditor Agreement (ICA). All banks/financial institutions are required to enter into the legally binding ICA with necessary enforcement and penal provisions. The ICA provides that if 75% of creditors (by value) agree to a debt restructuring package, the same would be binding on the remaining creditors. The DCA has a legally binding "stand still" agreement for 90/180 days whereby both the debtor and creditor(s) agree to "stand still" and commit themselves not to have recourse to any legal action during the period. "Stand still" is mandatory for allowing the CDR System to undertake the necessary debt restructuring exercise without any outside/judicial intervention. During "stand still", the borrowers undertake that they will not approach any other authority for seeking relief and the directors of the company will not resign.

10. In the case of default, how will the securities *in rem* be enforced?

Section 176 states the course of action for the pledgee when the pledgor defaults. In case of default, the pledgee may bring a suit against the pledgor for default and retain the share pledged as collateral security or he may sell it by giving the pledgor reasonable notice of the sale.

11. What is the average overall duration for the enforcement of a mortgage following enforcement proceedings?

Answered with question 12.

12. Are banks entitled to enforce a mortgage directly/through a receiver without having recourse to the competent court? What is the average overall duration of such proceedings?

Usually, a bank sends a demand notice when dues are not paid by the mortgagor. If the mortgagor does not respond to the mails, the bank sends a legal notice through its legal department. A bank waits for three months before declaring an asset a non-performing one. After the end of this period, the bank can officially term the home loan a non-performing asset (NPA) and start the process of recovering the property through the Securities and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI Act). In practice, even after invoking the Act, the bank gives the borrower a two month notice period to repay the dues.

The last stage is usually when the borrower receives the notice from the Debt Recovery Tribunal [for loan amount of more than Rs. 10 Lakh (US$1 million)]. An agreement may be reached with the bank if the borrower has a good track record.

A suit for enforcement of mortgage can be filed within 12 years from the date on which the cause of action has arisen.[15]

[15] Limitations Act 1963.

13. What taxes and levies apply to the establishment of such securities and to their cancellation?

India mandates stamp duty on documents executed, depending on the charges specified by state jurisdiction.

The security documents are usually evidenced in writing and signed by the borrower and the lender. Certain security documents are required by law to be in writing, for example a mortgage (except for an equitable mortgage) and assignment of a patent.

Notarization of documents is preferable at the evidence stage. Documents related to immovable property must be registered and incur registration fees. However, registration fees are nominal as compared to stamp duty.

14. Are claims of public/tax authorities granted preferential treatment? Are public/tax authorities able to claim against the property in priority to the first-rank mortgage granted to the lender?

The claims of public/tax authorities are considered as secured debts of secured creditors and hence are granted preferential treatment. Although a mortgage is also a kind of secured debt, in claiming against the property public/tax authorities, claims and government claims are given priority to the first-rank mortgage in a situation such as the winding up of a company.

CHAPTER 14

Italy[1]

1. What are the principal securities lenders will require borrowers to provide?

Securities which lenders will normally require borrowers to provide are:

- a first-rank mortgage on the financed property;
- the pledge over the shares of the borrower;
- the assignment of rental income;
- a pledge over the bank account where the rental income will be paid in as well as an order for the collection of the rental income;
- the assignment of insurance policies covering risks related to the destruction or deterioration of the financed property;
- the irrevocable mandate to sell the financed property;
- the commitment to treat intragroup claims as subordinate debt (irrespective of – and in addition to – any statutory provision, cf. for instance, s. 2467 Codice civile [Italian Civil Code – hereinafter "CC"]) as well as the issuance of a comfort letter or a "Letter of Responsibility" issued by the parent company/-ies, if any.

2. What statutory provisions apply to such securities?

The mortgage, the pledge, as well as single agreements (for instance, the assignment of rental income, the mandate, and unilateral declarations [for instance, the "comfort letter"]) are (primarily) ruled by the CC. Besides, ss 38–42 of the Consolidated Banking Act (*Testo Unico Bancario* – Legislative Decree no 385 of 1 September 1993 – hereinafter "CBA")[2] provide for a set of rules applicable to banks granting loans backed by mortgages (so-called "real estate loans" – *credito fondiario*).

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[2] S. 38-42 CBA (i.e. Chapter VI [containing provisions concerning certain credit operations], Section I [Real estate and public works credit], CBA).

3. What are the formal requirements for the establishment of such securities?

Mortgage A mortgage gives the creditor a right to seize the property bound to secure their claim – also against a third party transferee – and a priority over other creditors in the payment of their claim from the proceeds of the enforcement proceedings related to the mortgaged immovable property. Should a mortgage have been established by private deed, in order for it to be registered in the land register it will have to be authenticated by a notary (or any other authority to whom such power has been conferred) or judicially verified. The applicant shall present the original document establishing the mortgage or, if such writing has been deposited in public archives or filed with a notary, an authenticated copy thereof, in which the existence of the aforementioned requirements shall be certified. The original or the authenticated copy remains deposited in the land register (see s. 2835 CC). Should the grounds for the registration of the mortgage be a public deed made in Italy or a court decision or other judicial provision of equal weight, a copy of such deed shall be submitted to the land register (s. 2836 CC).

Pledge According to ss 2787(3) and 2800ff. CC, the pledge of claims and other rights (including shares) is established solely where the pledge agreement has been made in writing and the debtor of the claim given in pledge has been notified of the establishment of the pledge, or when the pledge was approved by such debtor in writing: for the priority treatment over other creditors to apply, the notification or the approval have to bear a "certain date" (pursuant to s. 2704 CC – see below).[3] However, if the claim is evidenced by a pawn ticket or other written document issued by duly authorized institutions which professionally engage in credit transactions upon pledge, the date of the writing can be established by any kind of evidence (see s. 2787(3–4) CC).

Assignment of rental income The assignment of claims (for instance, the assignment of rental income) is not subject to any formal requirement. Notwithstanding such freedom of form, in order to hold such assignment against third parties (for instance, against bankruptcy receiver, who is considered a third party for such purposes), a "certain date" is necessary (pursuant to s. 2704 CC),[4] which implies that lenders normally either have the signatures of the private deed authenticated by a notary or will execute a public deed.

Commitment to treat intragroup claims as subordinate debt For the commitment to treat intragroup claims as subordinate debt a private deed is sufficient. Shareholders' financings are treated as subordinate debt by operation of law pursuant to s. 2467(1) CC, according to which the reimbursement of financings of shareholders in favour of the company is subrogated to the

[3] According to s. 2704 CC, ruling the date of private deeds as to third parties, "The date of a private writing in which the signature has not been authenticated is not certain and cannot be asserted against third parties, except from the day on which the writing was registered or from the date of death or supervening physical incapacity to sign of the person or persons who signed it, or from the date on which the contents of such writing are reproduced in public acts (2699), or from the date on which other circumstances occur which establish with equal certainty that the writing was drawn up previously."

[4] See previous footnote.

payment of other creditors and, if made in the year preceding the adjudication of bankruptcy, must be repaid. For the purposes of the preceding paragraph financings of shareholders in favour of the company are those howsoever made available at a time when, also in consideration of the business purpose of the company, a large imbalance of the debts as opposed to the net assets existed or where the company was in a financial condition such that a contribution would have been reasonable (s. 2467(2) CC).

Section 2467 CC applies also where a company or entity exercising coordination and direction (the so-called "Guiding Company") of another company (the so-called "Guided Company") operates in its own or in others' entrepreneurial interest in breach of the principles of correct corporate and entrepreneurial management (pursuant to s. 2497 CC).[5]

Comfort letter Comfort letters are usually issued as private deeds. Notwithstanding the wide range of their prospective content (the legal scope of such letters ranges from clearly non-committal language over a legally grey area to letters which come close or are identical to guarantees by the parent company for the respective subsidiary's financial standing and ability to meet its financial obligations at all times), their utility lies in the fact that the parent company issuing such letter does not have to show its commitment, if any, as a contingent liability in its balance sheet.

4. Are there any specific statutory provisions relating to the abovementioned securities, should they be provided for within real estate financing?

S. 38–42 CBA provide for a set of rules applicable to banks granting loans backed by mortgages (so-called "real estate loans" – *credito fondiario*). According to s. 38(1–2) CBA, real estate loans designate medium and long-term loans (i.e. having a duration exceeding 18 months) granted by banks and backed by mortgages on immovable property. The Bank of Italy – in compliance with the resolutions of the Interdepartmental Credit and Savings Committee (*Comitato Interministeriale per il Credito e il Risparmio*) – shall determine the maximum amount of such loans, which shall be defined with reference to the mortgaged property, to the cost of the construction and refurbishment works to be carried out, as well as with reference to already existing mortgages.

[5] The existence of coordination and direction powers (pursuant to sections 2497ff. CC) is presumed, whenever one company either controls or exercises a "dominant influence" over the other pursuant to s. 2359(1–2) CC, according to which "The following are considered controlled companies:

1.) companies in which another company has a majority of the votes exercisable at the ordinary shareholders' meeting;
2.) it holds a sufficient number of voting rights to exercise a dominant influence in the ordinary shareholders' meeting;
3.) it exercises a dominant influence on the basis of contractual arrangements of whatever type.
For the purposes of the application of numbers 1) and 2) of the first subsection the votes pertaining to controlled companies, to fiduciary companies and to an interposed person are also included in the computation: the votes available on behalf of third parties are not included in the computation."

5. Should the answer to the previous question be in the affirmative, what are both the formal and substantive requirements which have to be met for their application? What advantages/benefits arise therefrom?

Mortgages securing real estate loans shall not be subject to the (bankruptcy) avoidance action,[6] should the debtor be adjudicated bankrupt at a later date, provided the mortgage has been registered in the land register at least ten days prior to the publication of the court decision adjudicating the bankruptcy (see s. 39(4) CBA). Similarly, payments made by the debtor in respect of real estate loans are not subject to the avoidance action (pursuant to s. 39(4) CBA).

A further benefit lies in the fact that the financing bank is entitled to file an action seeking the attachment of the mortgaged property also *after* the borrower's adjudication of bankruptcy. In such cases, the custodian of the attached property, the court-appointed administrator, or the bankruptcy receiver shall pay to the bank any income from the mortgaged properties until satisfaction of the latter's claims, net of any expense for administration and taxes (pursuant to s. 41(3) CBA), notwithstanding the bankruptcy receiver's right to intervene in the enforcement proceedings.

Where the proceeds from the sale of the mortgaged property exceed the quota allotted to the bank, the excess shall be assigned to the bankruptcy proceedings (s. 41(2) CBA).

According to s. 39(5) CBA, upon discharge of each fifth of the original debt, borrowers shall be entitled to a proportional reduction of the mortgage amount. They shall also be entitled to the partial release of one or more mortgaged properties where documents produced or professional valuations establish that the encumbered properties constitute sufficient security for the amount still owed. Bank claims arising from loans with indexing clauses shall be secured by the mortgage up to the total amount effectively owed as a result of the application of such clauses. The adjustment of the mortgage shall be effected automatically where the mortgage registration lays down the indexing clause (s. 39(3) CBA).

6. What liabilities are secured? For what amount? In the case at issue, does the novation of the underlying obligation lead to the maintenance/extinguishment of the securities assisting the original debt?

Mortgage The registration of a mortgage places in the same rank of priority claims related to the expenses for the deed establishing the mortgage, those incurred for the registration and renewal, and the ordinary expenses necessary for joining the enforcement proceedings (pursuant to s. 2855(1) CC). Parties can expressly stipulate that claims for additional judicial expenses be included in the mortgage, provided a corresponding registration is made.

Regardless of the kind of mortgage concerned, the registration of an interest-bearing principal causes the interest thereof to be placed in the same rank of priority, provided that the rate of such interest is mentioned in the registration (s. 2855(2) CC). The extension of the mortgage to the interest is limited to that of the two years prior to and of the year of the attachment, even if an extension to a greater number of years has been agreed upon (s. 2855(2) CC).

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[6] The avoidance action in the shape and form described below is known as the so-called "bankruptcy" avoidance action (pursuant to s. 67 BA) as opposed to the "ordinary avoidance action" ruled in the Civil Code (see s. 2901 CC): which entitles a creditor to demand that acts by which the debtor disposes of his/her assets to the prejudice of a creditor's right be declared ineffective as to the latter.

The registration of the principal causes the interest, matured after expiration of the year in which the attachment occurred, to be placed in the same rank of priority, but solely with reference to the interest at the legal rate and until the date of the public auction of the property by court order.

As far as real estate loans are concerned, banks' claims deriving from so-called indexation clauses also enjoy the same rank of priority (pursuant to s. 39(3) CBA).

Pledge The creditor has the right to be paid with preference out of the proceeds of the sale of the thing received in pledge (see s. 2787 CC). The preference also extends to interest for the year current at the date of attachment or, in the absence of attachment, at the date of notification of the order of payment (*atto di precetto* – pursuant to s. 480 Code of Civil Procedure [hereinafter "CCP"]). Moreover, the preference extends to interest which has subsequently matured, limited to the legal rate, until the date of the sale of the thing given in pledge.

In the case of novation of the underlying obligation, the maintenance/extinguishment of securities assisting the original debt will depend – both with reference to the mortgage and the pledge – on the parties' agreement: as a general rule, privileges, pledges, and mortgages backing the original obligation are extinguished unless the parties do not expressly agree to preserve them (see s. 1232 CC).

7. Is it possible to "divert" such securities (namely, the securities *in rem*) in order for them to act as collateral for other claims, should the original loan agreement be terminated?

No. No such property interest as the German *Grundschuld* exists in Italian Land Law.

8. What rights does a share pledge attribute to the pledgee? Are there any arguments against exercising such rights?

According to s. 2352(1) CC, in the case of pledge or usufruct of shares, the right to vote belongs to the pledgee or the usufructuary, unless otherwise agreed upon. Notwithstanding such attribution of the right to vote, lenders are reluctant to exercise it[7] for fear that such conduct may be classified as *de facto* management (*amministrazione di fatto*) of the borrower and – hence – result in their liability for actions of the borrower.

9. What taxes and levies apply to the establishment of such securities and to their cancellation?

As a matter of principle, any mortgage registration in the land register is subject to a registration tax amounting to 2% of the secured claim (ss. 6ff. Legislative Decree no 347 of 31 October 1990). Similarly, the cancellation of a mortgage is subject to a registration tax amounting to 0.5% of the secured claim.

As far as the establishment of a pledge is concerned, a registration tax amounting to 0.5% of the secured claim will be levied, should the pledge be granted by a person different from the borrower; in contrast, should the borrower provide a pledge, a lump-sum registration tax amounting to €168.00 is applicable.

[7] Namely, with reference to the convening of a shareholders' meeting of the borrower, and to (a) the revocation of existing directors and (b) the appointment of new directors.

Loans with a maturity exceeding 18 months granted by banks and other credit institutions, and any act related thereto, including any security of any kind granted by whomsoever, are not subject to the mortgage tax, to the registration tax, to stamp duties or fees as a substitute tax amounting to 0.25% of the loan amounts due by the lender (see Decree of the President of the Republic no 601 of 29 September 1973).

Loans other than the above are subject to VAT, but are exempt. Therefore, the registration tax applies solely where the relevant deed is a public deed or is deposited with Italian authorities. In any event, the registration tax is levied in a lump-sum amounting to €168.00 (indeed, as a general rule, no registration tax at a proportional rate is applicable to transactions subject to VAT [pursuant to ss 5 and 40 Consolidated Act on Income Taxation – cf. Statute no 917 of 22 December 1986).

10. In the case of *default*, how will the securities *in rem* be enforced?

Mortgage Should lenders intend to have the financed property sold by court order under the mortgage deed:

(a) they must have an "enforcement deed" (*titolo esecutivo*). Italian law classifies – amongst others – public deeds or deeds bearing a signature authenticated by a notary or any other public authority on whom such power has been conferred as an "enforcement deed";

(b) the "enforcement deed" will have to be notified to the borrower together with an order of payment (*atto di precetto* – such notification is not necessary in the case of real estate loans, as s. 41 CBA explicitly waives such formal requirement);[8]

(c) lenders may file a petition seeking the sale of the financed immovable property by notifying an attachment order (*atto di pignoramento*) to the borrower after 10 days but not later than 90 days from the date of the notification of the order of payment (*atto di precetto* – cf. ss. 480–481 CCP);[9]

(d) the competent court first arrange a sale without a public auction (*vendita senza incanto*) of the financed property and will set forth a term falling not earlier than 90 days and not later than 120 days at which anyone, except for the borrower, may submit an offer to purchase the mortgaged property; in the case where more than one offer has been submitted, the competent court will order a bidding process among the offerors to take place (cf. s. 573 CCP);

(e) should no offer be submitted, the court will order that the financed property be sold at a public auction (*vendita con incanto*);

(f) in the event the mortgaged property remains unsold, lenders may request the court to dispose the transfer of the financed property to the lenders to satisfy *pro tanto* their claims towards the borrower.

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[8] S. 41 CBA provides for specific rules on attachment of immovable property for real estate loans: indeed, the attachment of the mortgaged immovable property shall be commenced or continued by the bank also after the adjudication of bankruptcy of the borrower. The bankruptcy receiver shall be entitled to intervene in the attachment. The sum recovered following the attachment of the immovable property, exceeding the amount of the bank's claim, shall be attributed to the bankruptcy proceedings.

[9] Should the borrower file an action challenging the formal "correctness" of the enforcement proceedings, an ordinary trial before the competent court would commence and, in case of "serious circumstances" (*gravi motivi*), the enforcement proceedings may be stayed by the competent court.

The proceeds of the sale of the mortgaged property, after deduction of the expenses related to the enforcement procedure and the costs for the cancellation of mortgages, will be allocated (a) firstly, in satisfaction of the lenders' claims secured by the mortgage, following an order of priority based on the ranking of the mortgage and (b) secondly, in satisfaction, *pari passu*, of the claims, if any, of unsecured creditors of the borrower.

Pledge In order to enforce a pledge, the pledgee may either pursue the "ordinary" enforcement procedure or the enforcement proceedings peculiar to pledges (pursuant to ss. 2796ff. CC).

In the "ordinary" enforcement proceedings, the pledgee will have to:

(a) notify the "enforcement deed" and the order of payment (*atto di precetto*) to the borrower and to the third party who has given the shares in pledge (should the latter not coincide with the borrower – cf. s. 603 CCP);
(b) not earlier than 10 days but not later than 90 days after notification of the order of payment (*atto di precetto*), the lender may request the competent court to arrange for the sale of the movable property (generally: shares) at a public auction;
(c) the borrower and the third party-pledgor (if any) may raise objections vis-à-vis the lender, challenging the latter's right to foreclose or the compliance with statutory provisions ruling the attachment proceedings. The competent court, may stay the proceedings whenever it deems that "serious circumstances" (*gravi motivi*) exist.

On the contrary, should the pledgee opt for the enforcement of pledges laid down in ss. 2797ff. CC:

(a) he will have to serve a written notice upon the borrower and upon the third party, requesting the payment of the amount due and stating that failure to abide by such request will result in the sale of the shares;
(b) should, within 5 days from the date of receipt of the abovementioned notice, the amount due not have been paid, and should no objection be raised by the borrower and/or the shareholder, the lender is entitled to proceed with the sale of the shares at a public auction;
(c) in case an objection is raised by the borrower and/or the third party, an ordinary trial before the competent court will commence and the proceedings will be stayed.

As an alternative to the sale of the shares at a public auction, lenders are entitled to file a petition before the competent court requesting the transfer of the shares to them (by way of satisfaction *pro tanto* of their claims). In such a case, the court will appoint an expert who will provide an appraisal of the value of the shares.

The "ordinary" procedure may be commenced solely by creditors holding an "enforcement deed" and – as a matter of principle – should be preferred to the procedure laid down under ss. 2797ff. CC, as in the latter procedure any objection filed by the debtor triggers an automatic stay of the enforcement proceedings (whereas in the "ordinary" procedure the competent court will stay the proceedings solely where it deems that "serious reasons" exist).

Acting upon the complaint of the pledgor, the court may limit the sale solely to one thing out of a plurality of pledged things, provided its value appears to be sufficient for the payment of the outstanding debt.

11. Will securities be *automatically* preserved, should the borrower's debt be restructured?

Preliminary remark Generally, securities are preserved until the debt is repaid and the security is formally released. However, a scheme of arrangement may provide for the waiver of securities either on a voluntary basis or as a consequence of a cramdown which would – by definition – also bind dissenting creditors. In such a case, whilst a rearrangement scheme may provide that secured creditors are not satisfied in full, the latter may not be awarded less than they would receive due to their preferential interests (see below with reference to the Judicial Composition with Creditors).

The Italian Bankruptcy Act (see Royal Law Decree no 267 of 16 March 1942 and its most recent amendments[10] – hereinafter "BA"), rules – amongst others – the following schemes of arrangement:

(a) the so-called "validated" Reorganization Plan (*piano attestato di risanamento*) pursuant to s. 67(3) letter (d) BA;
(b) the Restructuring Arrangement (*accordo di ristrutturazione dei debiti*) pursuant to ss. 182-*bis*ff. BA;
(c) the Judicial Composition with Creditors (*concordato preventivo*) pursuant to ss. 160ff. BA.

(a) The "validated" Reorganization Plan (*piano attestato di risanamento*) The *Reorganization Plan* is an out-of-court settlement with single creditors. According to s. 67(3) letter (d) BA, any debtor meeting - in the abstract - the requirements to be adjudicated bankrupt, may draw up a Reorganization Plan indicating how they intend to exit their distressed situation and to comply with their ongoing payment obligations. Should the Reorganization Plan be "validated" by an independent expert, i.e. should the latter confirm its "reasonableness" with reference to the debtor's prospective of overcoming the distressed situation by abiding with such Reorganization Plan assuming full payment of the creditors refusing to accept it, all actions taken in order to implement it may not be challenged by the bankruptcy receiver, should the debtors be adjudicated bankrupt at a later date (pursuant to s. 67(3) letter (d) BA).

Clearly, the "validation" of the Reorganization Plan aims primarily at allowing its implementation, as prospective contractual partners would otherwise – for fear of being exposed to the avoidance action, should the debtor be declared bankrupt at a later date – refrain from entering into agreements provided for therein, i.e. deemed necessary to turn around the distressed business (different from transactions falling in the debtor's ordinary course of business and in accordance with customary terms and conditions including any payment and issuances of securities).[11]

At the same time, it protects dissenting creditors, as – due to the exemption from the avoidance action – the bankruptcy receiver (obviously, in case the debtor were to be adjudicated bankrupt at a later date) would be barred from recovering the debtor's assets with reference to transactions provided for in the "validated" Reorganization Plan.

"Validated" Reorganization Plans are frequently used and preferred over other schemes of arrangement ruled in the BA due to the absence of any court scrutiny, and – hence – to the

[10] Cf. Legislative Decree no 5 of 9 January 2006, Legislative Decree no 169 of 12 September 2007, Law Decree no 78 of 31 May 2010, Statute no 134 of 7 August 2012, Statute no 98 of 9 August 2013 and Statute no 9 of 21 Febuary 2014.

[11] Indeed, such transactions would be exempt from the avoidance action pursuant to s. 67(3) letter (a) BA.

fact that they may be kept confidential (only listed companies are required to disclose details of the "validated" Reorganization Plan). On the downside, Reorganization Plans – as will be outlined below – do not protect the distressed business from judicial actions brought by (single) creditors.

(b) The Judicial Composition with Creditors (*concordato preventivo*) The Judicial Composition with Creditors is a court-ordered procedure the purpose of which is to prevent the adjudication of bankruptcy through an arrangement between the debtor and its creditors. Any distressed business eligible to be adjudicated bankrupt may apply to the bankruptcy court in order to be admitted to the Judicial Composition with Creditors.

Any kind of arrangement to turnaround the company, also by means of transfer of goods to the creditors and other extraordinary transactions, is admissible.[12] The debtor may also propose a partial payment of secured and/or "preferred" creditors.

According to s. 161(2–3) BA, the petition seeking admission to the Judicial Composition with Creditors will have to encompass the following documents:

- an updated report of the economic and financial situation of the business as well as of its assets;
- a statement of the assets and liabilities of the debtor, of its claims, and of existing "causes of pre-emption", if any;
- a list of any creditors holding property interests or rights in any item owned by the debtor or which the latter possesses;
- the overall value of all assets, and a list of the individual creditors of shareholders having unlimited liability (i.e. in the case of partnership companies), if any;
- a plan which analytically describes the methods and the timing of the implementation of the Judicial Composition with Creditors;
- a report (drafted by an expert appointed by the debtor, in compliance with s. 67(3) letter (d) BA), confirming the veracity of the information provided by the debtor and the feasibility of the proposed Judicial Composition with Creditors;[13]
- the amicable settlement proposal directed at tax authorities, if any (pursuant to s. 182-*ter* BA).

Following the filing of the petition, the court must assess the completeness of the documents submitted by the debtor (see s. 161(2–3) BA).[14] Should the court admit the debtor to the Judicial Composition with Creditors, it will issue an order appointing a Deputy Judge to supervise the proceedings as well as a Judicial Commissioner to administer it (pursuant to s.

[12] For instance, and merely by way of example, the assignment of assets or the transfer of shares or financial instruments to creditors as a means to satisfy their claims is perfectly admissible.

[13] The expert opinion allows both creditors and the court to assess in detail the reliability of the Judicial Composition with Creditors in light of a third party opinion about the debtor's financial position, as well as the available assets on which the arrangement scheme rests.

[14] The distressed debtor may also merely lodge with the bankruptcy court the petition seeking admission to the Judicial Composition with Creditors with the annual accounts of the past three years, without submitting any other document, reserving themselves to file the prescribed documents (see s. 161 BA) within a term which will be fixed by the competent court, and which may vary between 60 and 120 days (pursuant to s. 161(6) BA).

163 BA).[15] Furthermore, the competent court will provide that a meeting of creditors shall be convened (which will review and assess the proposed Judicial Composition with Creditors) and will establish a term (of maximum 15 days) within which the debtor shall deposit funds sufficient to (partially) cover the costs of the proceedings. The order granting such admission is published in the companies' register (pursuant to ss. 166 and 17 BA).[16]

On the contrary, should the conditions listed above not be met, the bankruptcy court will not admit the debtor to the Judicial Composition with Creditors and may direct that bankruptcy proceedings be commenced, provided the State Prosecutor or a creditor have filed a corresponding petition (pursuant to s. 162 BA).

For the voting on the arrangement scheme proposed by the debtor within the Judicial Composition with Creditors proceedings, creditors may be sorted into classes, according to their position and uniform economic interests (see s. 160(1) letter (c) BA). Should the debtor make such a division, a different treatment may be granted solely with reference to different classes of creditors (i.e. *par condicio creditorum* will have to be observed between creditors of the same class).

The arrangement scheme underlying the Judicial Composition with Creditors must be approved by creditors representing:

- the majority of claims admitted to vote; and
- if the creditors are divided into different classes (according to their position and uniform economic interests), the majority of classes (see s. 177 BA).

Secured creditors who will be paid "in full" under the proposed arrangement scheme are not admitted to vote, unless they waive wholly or in part their priority rights (see s. 177 BA).

Should the proposed arrangement scheme provide for the partial payment of secured creditors, these will be treated as unsecured creditors in relation to the unpaid portion of their claims (in relation to such portion, they will be entitled to vote).

Once approved, the Judicial Composition with Creditors is binding on all creditors. Therefore, the Judicial Composition with Creditors entails the possibility of a cramdown, both with reference to dissenting (minority) creditors and/or to (majority) creditors belonging to a class rejecting the arrangement scheme, so long as the majority of both claims (by value) and classes of creditors approved it.

In any case, the treatment provided for in the Judicial Composition with Creditors for each class may not have the effect of altering the order of "causes of pre-emption" provided for by law (see s. 160(1-*bis*) BA). In addition, and to the extent that such arrangement schemes were to provide that secured creditors are not satisfied "in full", the latter may in no event receive less than the amount they would be awarded by virtue of their priority

[15] The Judicial Commissioner is – amongst others – under a duty to:
- review the schedule of liabilities and the list of creditors attached to the debtor's petition, taking into
- account the accounting records of the debtor;
- draft a schedule of the debtor's assets;
- give notice to the creditors of the debtor's arrangement scheme and of the date and place set by the court for the creditors' meeting;
- give a full report on the debtor's petition and on the proposed arrangement scheme at the meeting of creditors (see ss 171–175 BA); and
- outline the arrangement scheme submitted by the debtor at the creditors' meeting.

[16] The competent court may also order the publication of the order granting the admission to the Judicial Composition with Creditors in newspapers (pursuant to s. 166 BA).

right (pursuant to s. 160(1-*bis*) BA): to this end, the prospective proceeds from the sale of the debtor's property on which secured creditors have been granted priority rights will have to be appraised (by an expert meeting the requirements laid down in s. 67(3) letter (d) BA).

The preliminary phase ends with the creditors' vote on the proposed arrangement scheme. After acknowledging the creditors' vote in favour of the proposed arrangement scheme, and the absence of any cause of ineffectiveness and/or invalidity, the court "sanctions" the Judicial Composition with Creditors within six months after the debtor's petition was filed with the clerk of the court (pursuant to s. 181 BA). The sanctioning (*omologazione*) of the Judicial Composition with Creditors by the competent court terminates the composition procedure.

(c) The Restructuring Arrangement (*accordo di ristrutturazione dei debiti*) A Restructuring Arrangement is a debtor-in-possession proceeding. The Restructuring Arrangement is an out-of-court relief of financial difficulties, whose purpose is to allow a business to overcome the distressed situation it is in.

Restructuring Arrangements are largely based on freedom of contract, as they essentially amount to an arrangement between the debtor and his creditors which, provided it receives the support of the creditors representing at least 60% of overall claims, will have to be "sanctioned" (*omologato*) by the competent court in order to become effective, i.e. to determine the exemptions laid down in the BA.

Any business in a distressed situation which - in the abstract - meets the requirement to be adjudicated bankrupt may submit a Restructuring Arrangement to it's creditors, together with an expert report assessing the feasibility of the proposed arrangement scheme and confirming the debtor's ability to pay dissenting creditors "in full" within 120 days from the date of the sanctioning of the Restructuring Arrangement by the competent court (if the debt is due on the date of the submission) or from the due date (if the debt is not due on the date of the submission (pursuant to s. 182-*bis*(1) BA)).[17]

The filing of a Restructuring Arrangement with the competent court[18] is published in the companies register. Such publication triggers a 60-day moratorium on any interim relief or enforcement action over the assets of the distressed business in relation to pre-existing debts. In addition, any time limitation and/or forfeiture is suspended, and no priority rights may be granted (pursuant to s. 182-*bis*(3) BA).

In order for the Restructuring Arrangement to be sanctioned by the bankruptcy court, the following requirements have to be met:

- the arrangement scheme has been approved by creditors representing at least 60% of its overall debts; no specific claim-filing procedure exists: it is for the lawyers and/or chartered accountants assisting the debtor to contact the latter's creditors in order to obtain their approval to the Restructuring Arrangement: in any case, no cramdown applies to creditors who disapprove the arrangement scheme;

[17] Similarly to the Judicial Composition with Creditors, the debtor filing a Restructuring Arrangement will have to lodge with the competent court the documents listed in s. 161 BA (pursuant to s. 182-*bis*(1) BA).
[18] The petition seeking the sanctioning of the Restructuring Arrangement will have to be lodged with the court of the place where the company has its "main headquarters": it will be published in the companies register and becomes effective from the date of its publication (pursuant to s. 182-*bis*(2) BA).

- an independent expert confirms the feasibility of the Restructuring Arrangement and the debtor's ability to pay dissenting creditors, with particular reference to the full payment – within 120 days – of creditors refusing to approve the arrangement scheme (pursuant to s. 182-*bis*(1) BA);
- the Restructuring Arrangement has been published in the companies register.

The sanctioning of the Restructuring Arrangement by the bankruptcy court exempts any action taken or payment made by the distressed business in accordance with the Restructuring Arrangement from the avoidance action, should the debtor be adjudicated bankrupt at a later date (see s. 67(3) letter (e) BA).[19]

In an effort to further preserve a business as a going concern, Statute no 122 of 30 July 2010 has provided for the applicability of the moratorium related to any interim relief sought or enforcement action brought by individual creditors also where negotiations with creditors have not yet been finalized (pursuant to s. 182-*bis*(6) BA), provided the debtor files a petition to the competent court which, besides the proposed Restructuring Arrangement, encompasses:

- an updated report of the economic and financial situation of the business and of its assets;
- a statement of the assets and liabilities of the debtor, of its claims, and of existing "causes of pre-emption", if any;
- a list of any creditors holding property interests or personal rights on any item owned by the debtor or which the latter possesses;
- the overall value of all assets, and a list of the individual creditors of shareholders having unlimited liability (i.e. in the case of partnership companies), if any;
- a plan which analytically describes the methods and the timing of the implementation of the proposed Restructuring Arrangement;
- a statement, by the debtor, of the on-going negotiations with creditors aimed at collecting the latters' support to the proposed Restructuring Arrangement;
- a statement by an independent expert confirming the feasibility of the proposed Restructuring Arrangement (if accepted by the creditors) and the debtor's ability to pay creditors who have already expressed their non-approval of the Restructuring Arrangement (pursuant to s. 182-*bis*(6) BA).

The court will assess the completeness of the documents submitted, will order their communication to the creditors, and will fix a hearing within 30 days from the filing of such petition (pursuant to s. 182-*bis*(7) BA). At the hearing, the court will ascertain whether all requirements for the (prospective) sanctioning of the Restructuring Arrangement are met, specifically with reference to the full payment both of dissenting creditors and of creditors with whom negotiations have not yet been finalized (both will have to be paid "in full" – cf. s. 182-*bis*(7) BA). Should the competent court allow such petition, it will grant a moratorium on any interim relief sought or enforcement action brought by individual creditors (such moratorium will have retroactive effects as from the date of the publication of the submission of the petition in the companies register) and on the establishment of priority rights, and will fix a term which may not exceed 60 days for the lodging of both the Restructuring Arrangement and the expert's report confirming its feasibility (see s. 182-*bis*(7) BA).

[19] Within 30 days from the date of its publication in the companies register, any creditor and/or any other interested party may file a complaint objecting to the proposed Restructuring Arrangement (pursuant to s. 182-*bis*(4) BA). The competent court will examine the complaints and take a decision related to such objection, laying down its reasons (pursuant to s. 182-*bis*(4) BA).

12. Are banks entitled to enforce a mortgage directly/through a receiver without having recourse to the competent court?

Banks are not entitled to enforce a mortgage without having recourse to the competent court.

13. What is the average overall duration for the enforcement of a mortgage following enforcement proceedings?

The time necessary to finalize the enforcement proceedings under the mortgage deeds is hardly predictable. According to statistics published by the Bank of Italy, the enforcement proceedings on mortgaged immovable property may easily exceed five years. In order to limit any delaying tactics (for instance, the filing of actions challenging the enforcement proceedings) by the borrower during the enforcement procedure, which would significantly delay the sale of the immovable property, lenders may wish to enforce the mortgage deed after having enforced the pledge and obtained the transfer of the shares (see above under Question 10).

14. Are claims of public/tax authorities granted preferential treatment? Are public/tax authorities able to claim against the property in priority to the first-rank mortgage granted to the lender?

As a general rule, so-called "privileges" grant preferential treatment to certain creditors in view of the source of their claim. The establishment of a privilege may depend on the parties' agreement and may be conditional upon special forms of publicity.

Privileges may be *general* or *special*: the former can be exercised upon all movable property of the debtor; the latter upon the latter's specified movable or immovable property. The CC contains very detailed rules regulating both (a) priority conflicts between "preferred" creditors, i.e. creditors whose claims are assisted by a privilege, and "secured" creditors, i.e. creditors whose claims are assisted either by a pledge or by a mortgage, and (b) the order of priority of claims assisted by a privilege (see ss. 2777ff. CC).

As a basic principle, a *general* privilege cannot be exercised in derogation of third parties' rights on the movable property subject to such privilege (pursuant to s. 2747(1) CC). Unless the law provides otherwise, a privilege on *specified* movable property will prevail over rights acquired by third parties *after* the establishment of such privilege, provided the situation upon which such privilege is conditioned (still) exists (pursuant to s. 2747(2) CC).

Unless the law provides otherwise, a privilege on *specified* movable property may not be exercised in priority over the rights of a pledgee (pursuant to s. 2748(1) CC). On the contrary, unless the law provides otherwise, creditors assisted by a privilege on immovable property enjoy preferential treatment as opposed to mortgage creditors (pursuant to s. 2748(2) CC).

A privilege assisting a claim extends to ordinary costs of (participation in) the enforcement proceedings and to the interest due both for the current year at the time of seizure and for the preceding year. A privilege extends to interest (within the legal rate) subsequently accrued until the time of the forced sale.

With specific reference to the preferential treatment granted to claims of public/tax authorities, the CC provides for a set of privileges (both *general* and *special*) with reference to:

- claims related to the payment of direct taxes, to the payment of the VAT, and to the payment of the income tax due to local bodies (for instance, the income tax of both natural and legal persons as well as the regional tax on productive activities and the local tax on

income): such claims enjoy a *general* privilege on the movable property of the debtor (pursuant to s. 2752 CC);

- claims related to the payment of indirect taxes, which enjoy a *special* privilege on the movable property to which such taxes relate and on other property indicated in the pertinent laws, with the effects indicated therein (pursuant to s. 2758 CC);
- claims related to the payment of the income tax of both natural and legal persons, as well as the regional tax on productive activities, and the local tax on income due for the two years preceding the year in which the proceedings are conducted: by way of example, claims related to the tax or the portion of the tax attributable to business income, have a *special* privilege on the movable property used for the operation of commercial enterprises and on the merchandise which is located in the premises used for the operation itself, or in the home of the entrepreneur. The privilege applies even if the property belongs to a person different from the entrepreneur, unless the property has been stolen or lost, the merchandise has been entrusted to the entrepreneur for processing, or in case of goods not yet nationalized having a regular customs bill (see s. 2759 CC);
- claims related to the payment of indirect taxes as well as those deriving from the application of the municipal tax on the increase in the value of immovable property, which have a privilege on the immovable to which they relate (pursuant to s. 2772 CC): such privilege may not be enforced to the prejudice of the rights that third parties have previously acquired on the immovable property (for instance, a bank which has registered a mortgage before such taxes were due). Indeed, s. 2772(4) CC derogates from the general provision under s. 2748(2) CC, according to which creditors whose claims enjoy a privilege on immovable property are preferred to the mortgagee, unless otherwise provided for by law.

CHAPTER 15

Spain[1]

Preliminary remark Although the current country report has been drafted by referring to the Spanish Civil Code (hereinafter referred to as "SCC"), within Spain regional law applies to single provinces or territories. In the latter case, the provisions of the Spanish Civil Code shall apply on a subsidiary basis.

1. What are the principal securities lenders will require borrowers to provide?

- the establishment of first-rank mortgages;
- the establishment of share pledges;
- the assignment of rental income;
- the pledge on rental income and the order of collection of rental income;
- the providing of sureties;
- the issuance of comfort letters;
- the assignment of insurance policies;
- the granting of an irrevocable mandate to sell the financed property.

2. What statutory provisions apply to such securities?

Article 1857 SCC sets forth that for a pledge or a mortgage to be effective:

- it must secure the performance of a principal obligation;
- the thing pledged or mortgaged must be owned by the pledgor or mortgagor;
- the person constituting the pledge or the mortgage has to either be in a position to freely dispose of the thing to be pledged or mortgaged or, should that not be the case, the corresponding authority has to be conferred upon them.

Should the principal obligation upon its maturity not have been discharged, the pledged thing or the mortgaged immovable property may be disposed of to pay the secured creditor. The creditor is not entitled to appropriate the things pledged or mortgaged, nor is he entitled to dispose of them directly (see Art. 1858 and 1855 SCC).

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The pledge and the mortgage are indivisible, also where the debt were to be divided with reference to the successors of either the debtor or the creditor (see Art. 1860 SCC).

Pledge According to Art. 1866 SCC, the contract establishing a pledge entitles the creditor to retain the thing pledged in his possession or in that of the third party to whom it has been delivered at the time of its establishment until the secured obligation is discharged.

A pledge may be established on movable property, universalities of movables, claims and property interests (*ius in re*) on movable property, provided such interests are capable of possession.

For the establishment of a pledge the pledged thing has to be handed over to the creditor or to a third party designated – by mutual consent – by the debtor and the creditor (see Art. 1863 SCC). In order to hold the existence of a pledge against a third party its establishment has to bear a "certain date" which – as such – will have to be set forth in a public instrument (see Art. 1865 SCC).

According to Art. 1867 SCC, the creditor is under a duty to safeguard the thing received in pledge, and – hence – will be liable, according to due diligence, for its loss or deterioration. The pledgor is under a duty to reimburse the expenses incurred by the pledgee in the conservation of the thing.

In any case, the creditor cannot – without the consent of the pledgor – use the thing pledged, unless such use is necessary for its preservation.

Furthermore, the pledgee cannot establish (an additional) pledge on the pledged thing or grant the enjoyment of such thing to any third party (pursuant to Art. 1870 SCC).

The pledgor cannot claim restitution of the pledged thing unless the principal and interest have been entirely paid up and the expenses connected with the pledge have been reimbursed.

Should the debtor incur an additional liability with the creditor prior to the payment of the secured debt and whilst the creditor retains the pledged thing, statutory provisions entitle the creditor to extend such pledge to both obligations, notwithstanding the absence of any agreement between debtor and creditor as to the extension of the pledge to secure the additional liability.

A pledgee whose claim has not been paid in due time may dispose of the pledged thing. Such disposal must take place in a public auction, summoning the debtor and/or the owner of the pledged thing (see Art. 1872 SCC).

Mortgage The formal requirements for the registration and cancellation as well as the effects of the mortgage are laid down both in the Spanish Civil Code and in the Mortgage Act (hereinafter "MA").

The mortgage binds the property which it encumbers – irrespective of its possessor – directly and immediately to the exact performance of the secured obligation. Similarly to Germany, the establishment of a mortgage occurs at the time of its registration in the land register (or, should a mortgage be established with reference to registered movables, at the time of their registration in the corresponding public register).

Mortgaged loans may be assigned to a third party in whole or in part. According to the Spanish Mortgage Act, voluntary mortgages are created by individuals who either are entitled to dispose of the thing on which a mortgage will be established or have been conferred the corresponding authority to grant mortgages (see Art. 138 MA).

In order to establish a (voluntary) mortgage the public deed establishing it has to be registered in the land register. Article 142 MA establishes that mortgages created to guarantee future obligations or subject to a condition precedent will be effective against third parties from the moment they are registered, provided that the obligation is carried out or the condition maintained.

Claims secured by a mortgage can be totally or partially assigned (see Art. 1526 SCC). The transfer of the mortgage securing a claim requires a public deed and will have to be registered in the land register.

3. Are there any specific statutory provisions relating to the abovementioned securities, should they be provided for with reference to real estate financing?

According to Art. 145 MA, a voluntary mortgage is established at the time the public deed establishing it is registered in the land register.

4. Should the answer to the previous question be in the affirmative, what are both the formal and substantive requirements which have to be met for their application? What advantages/ benefits arise therefrom?

As far as mortgages are concerned, formal requirements include the entering into of a public deed and the registration of the security in the land register.

5. What are the formal requirements for the establishment of such securities? Does the establishment of a share pledge require their "cession by security"?

As far as mortgages and pledges are concerned, cf. Question 2 above.

The establishment of a share pledge requires the handing over of the pledged thing to the creditor or to a third party (see Art. 1963 SCC). However, due to the intangible character of shares, the cession by the security is not required.

6. What claims are secured? For what amount? In the case at issue, does the novation of the underlying debt lead to the maintenance/ extinguishment of the securities assisting the original debt?

Pledge Should the debtor incur an additional liability with the same creditor while the creditor retains the pledge, i.e. prior to the payment of the original debt, the creditor is entitled to extend such retention until the payment of both claims, even in the absence of any agreement that the pledge is also to secure the second obligation (see Art. 1866 SCC).

Mortgage According to Art. 104 MA, a mortgage grants a *jus in rem* (right against the property), i.e. the attachment of a mortgage will start when the cause of action arises and will not be eliminated even by change of ownership.

7. Is it possible to "divert" such securities (namely, the securities *in rem*) in order for them to act as collateral for other claims, should the original loan agreement be terminated?

A diversion of securities in order for them to act as collateral for other claims is admissible according to Spanish law: it does not require the termination of the original loan agreement.

8. What rights does a share pledge attribute to the pledgee? Are there any arguments against exercising such rights? What are the formal requirements for its establishment?

The Corporate Enterprises Act (see therein Art. 132) sets forth that if stakes or shares are pledged, the partner's or shareholder's right shall be exercised by the owner, unless otherwise indicated in the by-laws. In order to establish a share pledge, the underlying agreement has to be entered into by public deed (see Art. 3 of the Statute on Chattel Mortgages and Non-dispossessory Pledges) and will have to be registered in a public register.

9. Will securities be *automatically* preserved, should the borrower's debt be restructured?

Generally, securities are preserved until the debt is repaid and the security is formally released. However, this effect does not apply if the debtor were to have recourse to a scheme of arrangement (a "Scheme").

A Scheme is a statutory procedure which permits a company to enter into a debt arrangement or compromise with its creditors (or any class of them): if approved by the requisite majorities and sanctioned by the competent court, it will be binding on all creditors, whether or not they voted in favour of it. In Spain such schemes of arrangements are currently rarely used.

10. In the case of *default*, how will the securities *in rem* be enforced?

Article 90.1 of the Insolvency Act lays down that claims secured by a mortgage or a pledge enjoy preferential treatment (see Art. 90.1 Insolvency Act). Payment of secured claims shall be performed from the proceeds of the sale of the mortgaged or pledged thing (see Art. 155.1 Insolvency Act).

If the same asset or right secures a plurality of claims, payments shall be made according to priority of time for of each claim. The sale of things securing claims shall be performed by having recourse to an auction, except where, at the request of the insolvency administrator or the secured creditor, the court authorizes a direct sale (i.e. in the absence of an auction), or the assignment of the mortgaged or pledged thing to the secured creditor, or the person appointed by the latter.

11. What is the average overall duration for the enforcement of a mortgage following enforcement proceedings?

The average overall duration for the enforcement of a mortgage is approximately one and a half years. The recent introduction of statutory provisions granting more far-reaching protection to debtors has determined an increase in the average duration of foreclosure proceedings (see Statute of 14 May 2013, introducing measures to strengthen the protection of mortgage debtors and ruling debt restructurings and social rents).

12. Are banks entitled to enforce a mortgage directly/through a receiver without having recourse to the competent court? What is the average overall duration of such proceedings?

According to Art. 129 MA, the foreclosure action may lead to the out-of-court sale of the mortgaged property (in accordance with Art. 1858 SCC), provided an out-of-court sale has been provided for at the time of the establishment of the mortgage.

13. What taxes and levies apply to the establishment of such securities and to their cancellation?

In order to establish a voluntary mortgage, both a public deed and its registration in the land register are necessary. The taxes and levies for the establishment, registration, and cancellation of securities are established in Royal Law Decree of 17 November 1989, no 1427.

14. Are claims of public/tax authorities granted preferential treatment? Are public/tax authorities able to claim against the property in priority to the first-rank mortgage granted to the lender?

According to Art. 91 Insolvency Act, tax claims and claims of public authorities enjoy a general preference. Also claims secured by a (voluntary or legal) mortgage, either on movable or immovable property, are granted preference (see Art. 90.1 Insolvency Act). Payment of preferential claims shall be performed against the properties, goods, and rights vested (see Art. 155.1 Insolvency Act).

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