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).

[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.

[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.