Understanding CMBS

A Borrower's Handbook

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Introduction

Over the last decade, commercial mortgage backed securities ("CMBS") have become a driving force in commercial real estate finance. According to industry statistics[1], over $1.2 trillion of U.S. CMBS debt was issued over the 1990 to November 2009 period. Of this total, an overwhelming 50% of the securities were issued during the 2005 to 2007 period. Today, CMBS represents approximately 28% of total outstanding U.S. multifamily and commercial mortgage loans[2]. While CMBS issuance has declined in recent years due to the current economic recession, the efficiencies created by commercial mortgage securitization guarantee the market's return.

One of the largest issues facing CMBS borrowers today is a complex loan servicing structure that has had trouble keeping pace with escalating borrower and investor reporting demands over the last decade. While borrower loan servicing requirements have expanded due to more complex CMBS loan structures, CMBS investors have also demanded more reporting, transparency and control. With the economy now in recession, servicers are having a difficult time handling an unprecedented number of requests and borrowers are struggling to figure out a complex servicing structure that includes numerous stakeholders and approvals.

[1] Commercial Mortgage Securities Association's Compendium of Statistics, Exhibit 3.
[2] Commercial Mortgage Securities Association's Compendium of Statistics, Exhibit 10.

"...the efficiencies created by commercial mortgage securitization guarantee the market's return."

The purpose of this handbook is to provide CMBS borrowers with the background information they need to understand how the CMBS servicing system works and what the various responsibilities are of the numerous entities that are involved in the servicing process. The article concludes with a number of recommendations that borrowers should consider when negotiating an extension request or workout with a special servicer.

CMBS Explained

CMBS exists because the financial structure produces efficiencies that benefit both the lender and borrower. While some loan requirements, such as yield maintenance or defeasance, appear punitive to borrowers on surface, they actually produce efficiencies on the bond side of the CMBS structure that lower costs and reduce loan interest rates. Like yield maintenance, additional efficiencies are created through the securitization process that lower borrowing costs and make CMBS loans attractive. A few of the more important efficiencies include:

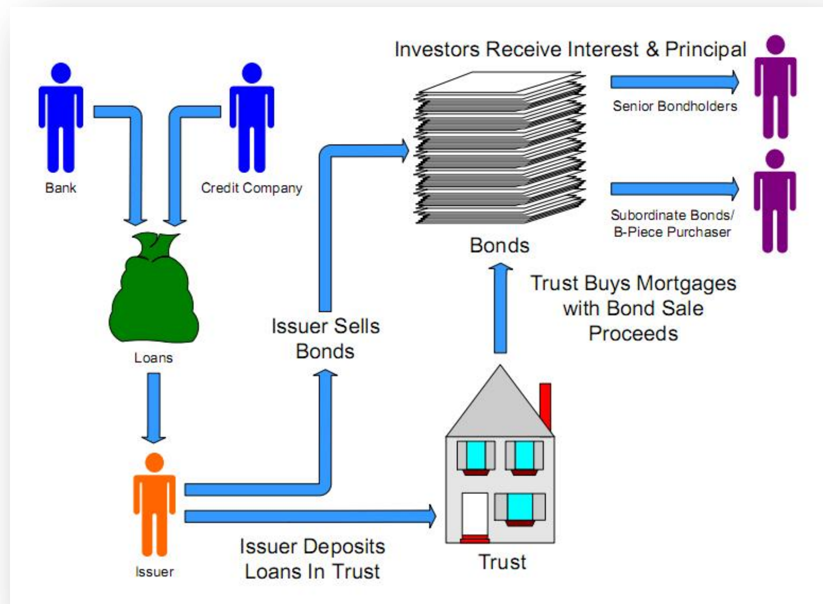
1. ***Diversification.*** By grouping together large pools of loans that vary by product type and geographic market, CMBS issuers are able reduce loss exposure by limiting default risk in any one market or industry sector.
2. ***Improved Liquidity.*** Commercial mortgage loans are large balance assets that usually possess long terms of five to

ten years. Both variables reduce liquidity and increase borrowing costs. Securitization helps solve these problems by enabling investors to purchase lower balance bonds that possess a variety of payment structures and maturities.

3. ***Standardization.*** The standardization of loan documents, reporting and servicing practices ensures that each CMBS trust operates in a similar manner. This promotes industry conformity and helps reduce securitization and servicing costs.
4. ***First Loss Subordinate Bond Structure.*** Risk is further reduced by a senior/subordinate bond structure that places portfolio losses on subordinate bondholders first. These bondholders are commonly referred to as "B-Piece" buyers and consist of sophisticated real estate investors that thoroughly evaluate each loan pool prior to purchasing the bonds. This structure prevents lenders from issuing high-risk mortgages since B-Piece buyers possess the ability to kick out mortgages that do not meet their credit requirements.
5. ***Bond Ratings.*** Credit risk for every CMBS transaction is further evaluated by an independent rating agency. These agencies specialize in evaluating risk and provide investors with a standardized credit score that measures the likelihood of default for each established bond class. Ratings, which are monitored throughout the life of the transaction, enable investors to quickly monitor and evaluate default risk, which, in turn, promotes liquidity.

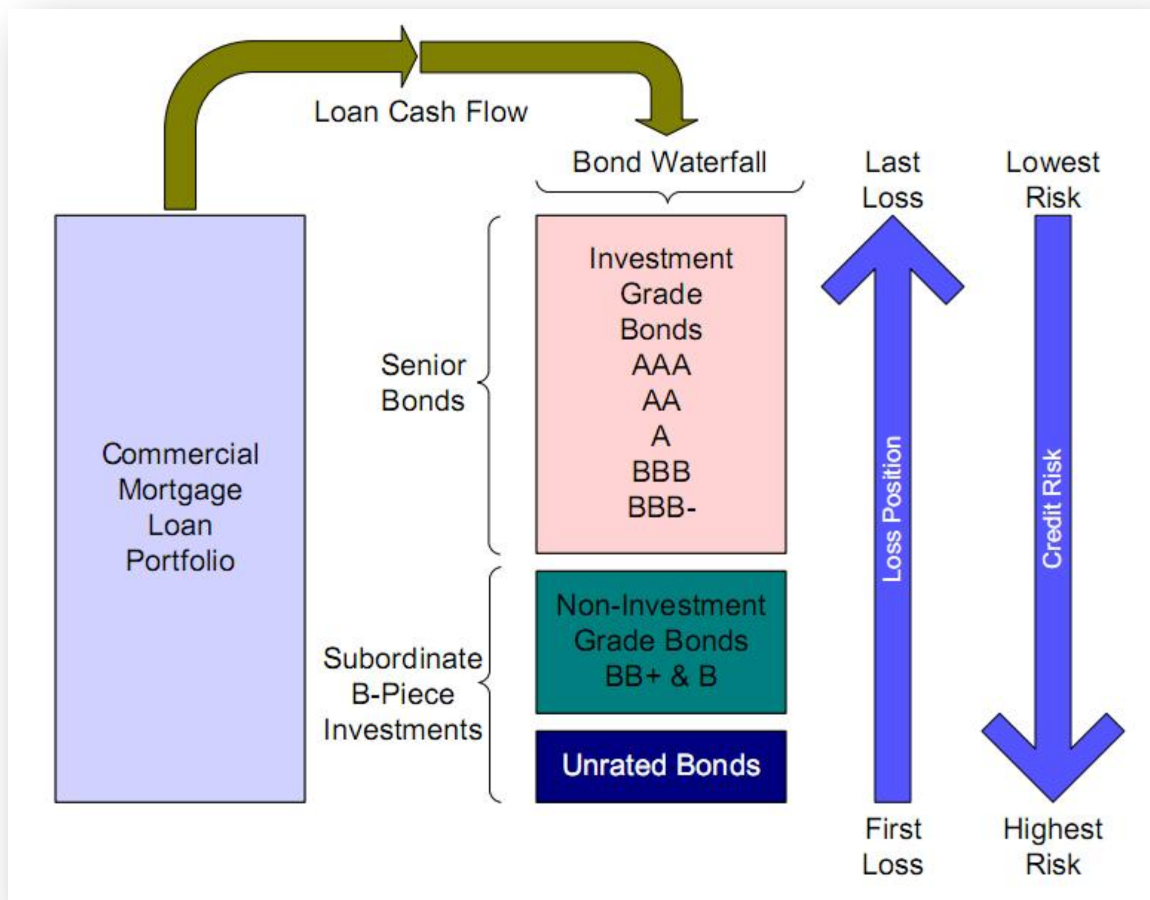
The chart below details the basic securitization process. Commercial loans are originated by a bank or credit company and transferred to an issuer that pools the mortgages together into a diversified loan portfolio that is sold to a trust. The trust purchases the mortgages through the sale of bonds by the issuer to senior and subordinate bond investors.

In many transactions, the originator and issuer are related entities. In other words, the entity securitizing the mortgage pool also originates most of the mortgages. After the mortgage pool is assembled and a bond structure has been established, rating agencies are retained to assess default risk for the established bond classes and the issuer selects a B-Piece investor to purchase the subordinate bonds. After the B-piece purchaser finishes its due diligence and the bonds receive a final rating, the bonds are sold and the commercial mortgages are purchased by the trust. If the issuer is successful, it will profit by receiving more in bond sale proceeds than it cost to originate or purchase the loans.



The next diagram better illustrates the relationship between the loan portfolio and the securitized bonds. Generally speaking, all of the cash flow that originates from the loan portfolio is pooled together and distributed to the bondholders by a trustee. Cash flow in the form of principal and interest is paid to the most senior bondholder first and continues down the bond waterfall until no remaining cash is available for distribution. When a loan pays off, the most senior bonds receive principal first. As a result, principal is not returned to the most subordinate bondholders until the last loans in the portfolio pay off. Losses work in the opposite direction with the most subordinate bonds receiving the first losses.

While almost every CMBS transaction uses a similar waterfall structure, it is important to keep in mind that the provided example is extremely simplistic. Actual bond structures are far more complex and loan cash flow is distributed in multiple ways depending on the type of bond. Moreover, the actual financial structures possess credit enhancements, such as interest, principal and servicing advances, that add to the complexity. Nonetheless, a grasp of the basic bond model is a good first step towards better understanding the CMBS process and its many participants.



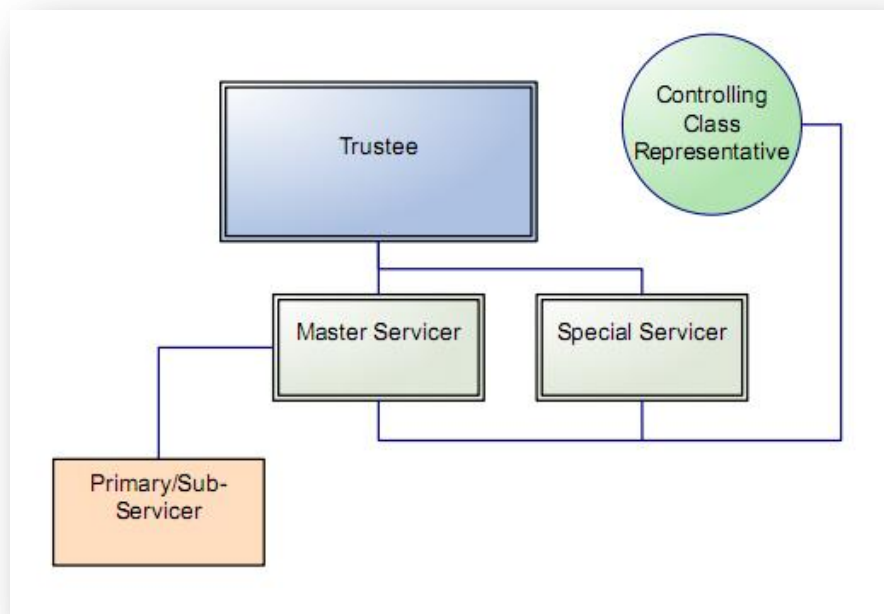
Trust Management

Understanding the management structure of a CMBS trust can be an arduous process for many borrowers. Unlike a bank or large credit company that handles most aspects of the loan servicing process internally, trusts retain separate companies to perform each major servicing function. Some of these companies are selected through a competitive bidding process to reduce operating costs. While a lower cost structure helps push down loan interest rates, it can also negatively impact a servicer's ability to effectively manage a loan portfolio if it bids too low of a fee.

The trust's Pooling and Servicing Agreement ("PSA") outlines the many responsibilities for each servicing entity. This agreement governs almost every aspect of the loan and bond administration process ranging from the collection loan payments and distribution of bondholder funds to the management of foreclosed property and sale of defaulted loans. The agreement also standardizes practices and procedures to ensure that they meet REMIC[3] requirements and protect bondholders[4]. Under the PSA, loan servicers are required to uphold an established servicing standard. This standard requires servicers to manage the loan portfolio with the same care, prudence and diligence that it uses to manage loans on behalf of other third parties or itself, whichever is the higher standard.

[3] Real Estate Mortgage Investment Conduit
[4] CMSA and MBA's Borrower Guide to CMBS.

The organizational chart that follows details the basic reporting structure for a typical CMBS trust. ***The Trustee*** is responsible for supervising the master and special servicers. This role usually involves ensuring that the servicers act in accordance with the PSA. Administratively, the trustee's role is generally limited to distributing payments received from the servicers to the bondholders and holding all of the physical loan documents on behalf of the bondholders. Borrower contact with the trustee rarely occurs.



The Master Servicer is responsible for day-to-day loan servicing practices including collecting loan payments, managing escrow accounts, analyzing financial statements, inspecting collateral and reviewing borrower consent requests. Under some situations, master servicers subcontract some of their responsibilities to a ***Primary or Sub-Servicer.*** This usually occurs when the original lender of the loan believes that continued borrower contact is important throughout the life of the loan. While the master servicer may

delegate general administrative duties such as financial statement review and the performance of site inspections, major decision making authority, such as assumption and lease approvals, is usually always retained since the master servicer is ultimately responsible for all of the sub-servicer's actions.

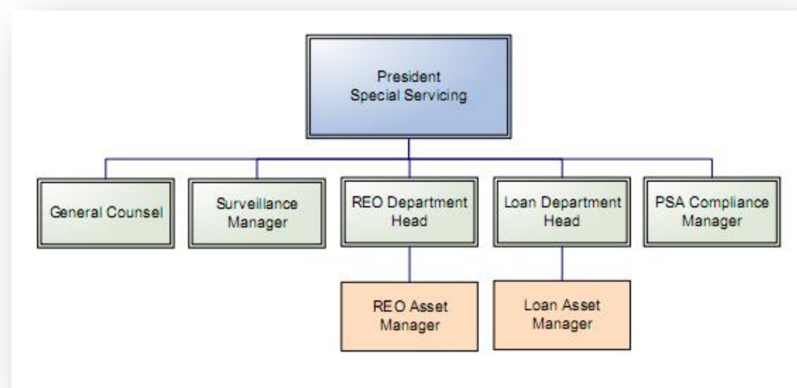
Borrower requests relating to most actions that are allowed under the loan documents are handled by a master or primary servicer. If a request is not provided under the loan documents, the master servicer will likely require the consent of the special servicer and possibly the directing certificateholder.

All nonperforming mortgages are transferred to a ***Special Servicer***. Mortgages are usually sent to the special servicer when:

1. They mature and the borrower cannot obtain replacement financing;
2. Are more than 60 days past due; or
3. It is determined that a default is imminent and will not be cured independently by the borrower within a short period of time.

The special servicer is responsible for performing customary workout-related duties including, extending maturity dates, restructuring loans, appointing receivers, foreclosing the lender's interest in a secured property, managing the foreclosed real estate and selling the real estate. The special servicer is also responsible for consenting to actions that are not expressly provided for under the loan documents or fall outside the master servicer's responsibilities under the PSA. All of the workout-related responsibilities are handled by highly skilled asset managers that have a strong understanding of real estate law, finance and CMBS reporting requirements. Nonperforming loans are usually assigned based on a manager's understanding of a specific property type or geographic market. Consent-related requests are usually handled by a separate department that is staffed with loan underwriting professionals.

The organizational structure of a special servicing shop is traditionally flat. Asset managers usually specialize in managing either loans or real estate owned ("REO") assets. Loan and REO functions are managed by department directors or vice presidents that report to the special servicer's president or division head. All special servicing actions must be approved by the special servicer's credit committee. At a minimum, the committee usually consists of the division head, REO manager and loan department manager. Managers from other departments, such as loan surveillance, PSA compliance and legal may also sit on the committee.



While special servicers usually possess broad powers to restructure loans, they must be able to demonstrate that any modification, waiver or amendment is likely to produce a greater recovery to the bondholders on a net present value basis. Special servicers are not afraid to invest in, stabilize and hold REO for long periods if they are confident that the strategy maximizes value. As a result, borrowers must demonstrate

that they are providing more than sweat equity to a proposed restructure.

Special servicers usually prepare an Asset Status Report within the first 30 days of transfer that provides it with the authority to take immediate action on any urgent needs and provides general authority to begin negotiating with the borrower. Once the asset manager has fully evaluated the asset, a more comprehensive plan is written that outlines the recommended strategy for resolving the loan default and demonstrates how the strategy maximizes bondholder value. After the special servicer's credit committee has approved an Asset Status Report or Business Plan, it is forwarded to the directing certificateholder for final consideration. Upon approval of the directing certificateholder, the special servicer has the authority to commence any of the approved actions. Any new actions that are not provided in the plan must be resubmitted to the special servicer's credit committee and directing certificateholder for approval.

Special servicers are also responsible for consenting to actions involving performing loans. Customary performing loan consents that often require special servicer approval include:

1. Loan assumptions;
2. Releases of collateral not provided under the loan documents;
3. Easement grants that materially affect use or value;
4. Property management changes relating to large balance loans;
5. Major lease requests (for example, leases that are over 30,000 square feet and represent more than 20% of a property's income); and,
6. Consents involving performing loans that have been placed on the master servicer's Watch List.

The Directing Certificateholder *or* ***Controlling Class Representative***, is the investing entity that owns the largest percentage interest in the most subordinate outstanding bond class. This entity, or B-Piece investor, represents the interests of all subordinate bondholders and possesses approval rights over most major special servicing decisions. These decisions typically include:

1. Asset Status Report and Business Plan approvals;
2. Foreclosure actions;
3. Modifications, amendments and waivers of monetary and non-monetary terms;
4. Acceptances of discounted payoffs;
5. The sale of real estate owned assets;
6. Releases of collateral that are not provided in the loan documents;
7. Environmental compliance concerns;
8. Substitution of collateral not provided in the loan documents;
9. Releases of reserves and letters of credit not provided in the loan documents; and
10. Waivers of due on sale or encumbrance clauses.

Directing certificateholders possess the right to appoint the trust's special servicer. Under most situations, the directing certificateholder appoints itself or an affiliated entity as the special servicer. As a result, the directing certificateholder and special servicer are often, but not always, the same company.

When the directing certificateholder is a separate entity, the approval process can take longer. Most PSAs require directing certificateholders

with approximately 10 business days to reject any servicer's recommendation. Because the directing certificateholder and special servicer communicate almost every day, most major decisions are fully discussed prior to the submission of a formal approval request. Nonetheless, infrequent differences of opinion can delay a potential workout. These situations can be frustrating for borrowers since they are prohibited from contact with the directing certificateholder. In the end, the special servicer is responsible for resolving all conflicts and making a final decision that is in the best interest of ***all*** certificateholders pursuant to the Servicing Standard.

Rating agencies also play an important role in the CMBS process. The two primary responsibilities are monitoring the performance of the trust's loan portfolio and reviewing borrower consent requests. Rating agencies constantly monitor the performance of each trust and issue new bond ratings as default risk changes. Accordingly, they work very closely with master and special servicers to ensure that the bond ratings accurately reflect the performance of the underlying loan pool. Special servicers are in constant communication with rating analysts who are responsible for monitoring the CMBS trusts. Rating analysts review Asset Status Reports, closely evaluate loan Watch Lists and perform numerous coverage calculations to ensure their ratings are accurate.

Rating agencies also have a role in the borrower consent process. This role, however, is generally limited to the 10 largest loans in the portfolio and does not include consenting to actions taken by the special servicer on nonperforming loans. Moreover, rating agencies do not "approve" consents. Rather, they issue a rating confirmation letter, which is a statement that a proposed action will not, in and of itself, cause a downgrade or withdrawal of the current bond ratings[5]. While the master or special servicer may be obligated under the PSA to seek a ratings confirmation for a specific action, the decision to issue a confirmation is at the discretion of the rating agency, and in many cases the agency will elect not to review the transaction. Specific large-loan consent requests that often require rating agency review include:

"Rating agencies play an important role in the CMBS process."

1. Loan Assumptions,
2. Defeasance Requests,
3. Collateral Substitution,
4. Changes in Management,
5. Hotel Flag Changes, and
6. Releases of Collateral.

PSAs require each rating agency to be recognized by the U. S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization ("NRSRO"). The most well known CMBS NRSROs are Moody's Investor Service, Standard & Poors, Fitch Ratings and Realpoint, LLC. All rating agency contact occurs through the servicer and most loan documents obligate the borrower to pay any fees associated with their review.

[5] U.S. CMBS Criteria for Reviewing Post-Closing Actions, Fitch Ratings, April 24, 2009.

Working with a Special Servicer

With the continued escalation of loan defaults, special servicer contact is becoming a commonplace reality of the declining market. As loan maturities increase over the coming year, falling values and scarce financing will create significant borrower unrest. Borrowers that lose tenants and cannot cover debt service will be further stressed as they struggle to save their properties. While there is no one solution for every borrower, it is important to remember that there is always a solution for every loan. The 12 recommendations that follow should help guide you to the one solution that works for you.

1. **Don't' Panic.** Take a deep breath and develop an initial plan to resolve the default before you start negotiating. Even if the plan is not a perfect, it will help you better articulate your needs and establish your priorities.
2. **Keep Paying.** Do not stop paying your mortgage to get the special servicer's attention. If sufficient cash flow exists to pay debt service, then continue to pay. If the borrower's principals do not have the ability to fund a debt service shortfall, then forward all your net cash flow. Speak with your attorney before you reduce your payment amount to ensure that you do not create any personal liability.
3. **Read Your Loan Documents.** Make sure you understand all of your rights and liabilities under the loan documents and retain an attorney that has experience with CMBS debt. Do not violate any of the "bad boy" provisions under the guaranty.
4. **Read the PSA.** Since most PSAs are public documents, you should be able to get a copy from the SEC's online EDGAR reporting service. While the documents are difficult to read, the major sections usually do not vary much from trust to trust. Article III normally contains most of the information you will need to develop a good understanding of any special servicer restructuring limitations and the various entities that are responsible for reviewing and approving transactions. Asset managers are occasionally lazy when it comes to reviewing trust approval requirements and wait until they have finished their negotiations before looking at the PSA. This can create problems if the PSA restricts them from agreeing to any terms that have already been negotiated. These problems can be avoided by reading the PSA before negotiating with the special servicer.
5. **Make Realistic Requests.** Do not request a discounted payoff if you know you can refinance the full amount of your mortgage and don't expect any debt relief if you can't provide a plan that improves the special servicer's position. Remember that in almost every situation, you must be able to demonstrate that the proposed workout results in a higher net present value recovery to the trust.
6. **Provide Evidence.** If your loan is maturing, obtain actual refinance quotes from several lenders. Use the quotes or rejections to substantiate your extension claim. If you are restructuring a loan, provide evidence of actual comparable leases and sales that have occurred in the market that substantiate your valuation and cash flow assumptions.
7. **Develop a Comprehensive Plan.** Hire an expert that is skilled in writing CMBS business plans or work with the asset manager to establish the key pieces of information that are needed for the approval of your request. Develop a detailed plan that demonstrates the strengths of your proposal and uses third-party sources to substantiate your assumptions. Put the plan in writing and send it to the asset manager for their review.

8. **Negotiate Honestly.** Loans are often assigned to asset managers based on the collateral's geographic location and property type. As a result, your asset manager will likely be managing multiple assets in your market and will have a good handle on rents and sales. Asset managers possess significant workout experience and are represented by highly skilled CMBS attorneys. Positional negotiating techniques and inaccurate disclosures frustrate asset managers and damage your credibility.
9. **Cash Helps.** If the borrower's principals possess the ability to invest new equity or debt to stabilize the project, work with the special servicer to ensure that the invested funds receive priority treatment in the new capital structure.
10. **Expect to Pay Fees.** Fee income is an important source of special servicing revenue. Read your loan documents to determine the reasonableness of any fees that are being requested. Negotiate any fee that appears to be unreasonable and speak with a qualified commercial mortgage expert to establish the reasonableness of the special servicer's demands.
11. **Know When to Give the Keys Back.** If you find yourself in a situation where you cannot stabilize the asset, work with the special servicer to maximize value and minimize potential tax liabilities. Consider a consensual receivership where the special servicer agrees to allow the modification and assumption of your debt by a future purchaser. An orderly sale with financing will likely minimize losses.
12. **Practice Patience.** Special servicers are extremely busy and restructures and extension requests take time. Persistence is important, but too much can cause the asset manager to push back. If you have time-sensitive needs, inform the asset manager in writing.

About Kenneth J. Cusick

Kenneth J. Cusick is the Managing Member of Cusick Financial, LLC and is a member of Brownstone Capital's Debt Restructuring Group. Mr. Cusick possesses over 25 years of commercial real estate experience and has worked with commercial loan securitization since the early 1990s. Please be advised that the information contained in this article is for general background purposes and Kenneth J. Cusick, Cusick Financial, LLC and Brownstone Capital, LLC do not guaranty its accuracy or the accuracy of any recommendation. The information and views expressed herein do not constitute legal, tax, financial or accounting advice for any transaction. Every CMBS loan is unique and it is incumbent upon you to hire the appropriate experts to determine your specific needs. Please email Ken Cusick at ken.cusick@cusick.com or kcusick@brownstonecapital.com if you need assistance on an individual matter.