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The Current CMBS Experience – And a Path Forward

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The Competitive Landscape for CMBS

> *"I have been in the CMBS business for 25 years. The stigma associated with CMBS servicing has not really improved. Often times, it really is an important factor as to why borrowers choose to avoid doing a CMBS loan."* – Loan Originator

Among market data, one is telling – only about 40% of CMBS loans are from prior CMBS borrowers. The CMBS industry is not attracting repeat borrowers in sufficient numbers and must improve to maintain a sustainable market. With the so-called "wall of maturities" turning into more of a picket fence, with 2016 issuance at an anemic $76 billion, the reverberation of the borrower/broker mantra "ABC—anything but CMBS," and issuer and investor concerns that have prompted a special CRE Finance Council task force all lead to the conclusion that it's time to assess and adapt to revive our industry.

Other non-CMBS lenders and loan products have also changed the competitive landscape. The legacy appeal of CMBS to borrowers has been its 10-year duration, lower interest rates, and greater net loan proceeds. This advantage has eroded. Interest rate advantages relative to other loan products have compressed, and CMBS lenders have faced higher compliance costs in the wake of Dodd–Frank and its progeny. Structured bank products, fund loans, life company loans, CLOs, crowd-sharing offerings, and more favorable agency take-out options on multifamily loans have given borrowers financing alternatives.

The 10-year duration characteristic of CMBS loans may also be mismatched with borrowers who expect to reposition assets over a shorter time period and need more flexibility than CMBS affords. You would expect that locking in lower interest rates for a longer term would be appealing in a rising interest rate environment. What's the problem? Three factors come into play. First, the retail sector is seeing tectonic shifts in consumer attitudes and requires flexibility in its brick-and-mortar strategies. Second, other shorter-term loan products have been stretching their duration to get closer to CMBS durations with greater flexibility and less call-protection-related cost. Third, borrowers question whether exit strategies reliant on assuming CMBS loans are viable.

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For stabilized assets, CMBS can still provide advantageous price and proceeds, but absent improvements in CMBS terms or servicing, borrowers with more operationally intensive or potentially changing assets may move to other products that permit greater operational and collateral flexibility.

In connection with Alston & Bird's annual Servicing Symposium, we conducted a survey, held discussions with clients and industry participants across the country, and solicited feedback through Alston & Bird's Finance 411 seminars. Based on our findings, there is much to do to find a viable path forward.

Loan Documentation

> *"The loan should have scheduled hurdles to meet where more things are deemed approved. I don't need a person at the servicer trying to 'learn me' something and a B-piece buyer looking to enhance its deal."* – Borrower
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> *"The documents need to be streamlined and simplified. No reason to have the horrible documentation that is in place currently except to line the pockets for the law firms. Attorneys are ruining CMBS."* – Loan Originator
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> *"Are originators actually writing unserviceable loans that lead to delays and disputes between borrowers and lenders?"* – Master Servicer

Most commercial loan documentation is complicated and must adequately address property and cash flow issues that drive repayment. But CMBS is more complicated because of tax, regulatory, and investor considerations and the interplay between the loan documents and the pooling and servicing agreement (PSA) that implements the securitization.

The industry has to strive for a shorter, clearer, and less confusing documentation process. Financial covenants and definitions vary greatly from lender to lender. For example, we have identified 15 different definitions of "net operating income" and encountered other problems such as "springing cash traps" that had no provision for "unspringing." Documentation confusion and inconsistencies lead to post-closing frustration and delay. Can anyone expect a primary or master servicer to manage the simplest of reporting requirements when they have to apply different standards and methodology? Moreover, while lender discretion typically allows flexibility in on-book lending, it creates the possibility of gaming behaviors in CMBS. Consequently, a move to objective criteria in loan documents should mean more predictable outcomes for borrowers and servicers.

Master Servicer

> *"Master servicers should be empowered to make more decisions directly and should be compensated more so they can be less overworked and therefore more responsive to borrowers."* – Loan Originator
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> *"The lack of responsiveness or the frequent 'kicking of the can' by servicers (e.g., continuing to ask for more needless documentation (not borrower's words, but lender's words)) inhibits the originator's credit side from getting structure that is really important to mitigate or address rollover and the general credit profile of the financing."* – Loan Originator
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> *"The assumption process is horrible. The timing of response to any requests is horrible. Lender counsel is dismissive and unresponsive. We will no longer borrow from CMBS lenders because of servicer and servicer counsel issues."* – Borrower

Master servicers play an important role during the term of any CMBS loan. For the most part, they are the first and last point of contact for the borrower and the responsible reporting person and liaison for all parts of the complicated structure of most CMBS deals. Some master servicers have taken a hard look at their consent requirements and fee structures and are trying to improve the timing and execution on routine matters. The complicated nature of CMBS transactions often causes issues that need to be addressed and can make CMBS servicing more "high touch" than many other loan types. Master servicers are not immune from finger pointing because they agreed to undertake the servicing function for a fee. Some master servicers may say that, given the increased deal complexity and regulatory burdens, they're working twice as hard for half the fee. But the response is likely to be "Who cares? It's what you agreed to do!"

The market rules, but one does have to note the critical nature of the master servicer function and the related costs. We have seen the number of master servicers fall since the last crisis, and a viable servicing model is as essential as willing CMBS borrowers. Master servicers need to have clear and concise instructions on what they can and cannot do and receive reasonable compensation for those services, which calls for changes to be made in both loan documents and PSAs. Limiting the universe of controlling class and/or special servicer required consents would speed the process. On a minor note, designing a better reporting requirement so master servicers can identify members of the bond class entitled to exercise controlling holder rights would save time.

Special Servicing

> *"You have come very close to imploding the industry because of your unwillingness to hold the B-piece buyer at bay."* – Borrower
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> *"Investment sales brokers will advise borrowers that CMBS is a poor choice if they want to sell in the future, particularly to an institutional borrower that does not want to deal with the headaches that the loan servicers impose, such as delayed process, significant additional costs not included in the supposed '1 percent fee,' and servicers that attempt to restructure deals during the process. Borrowers often feel bullied and it's shameful."* – Loan Originator

What is the role of the special servicer in today's market? Originally the concept of special servicing was to act as the vanguard for default and unusual situations during the life of the loan—loans are only transferred to special servicing upon an actual or imminent event of default so that specific attention can be paid to default resolution. Special servicers are rated by how they perform in a default situation and their ability to recover on the value of the asset. However, their post-crisis role has evolved to include review and approval of many borrower requests involving performing loans. This expanded role for the special servicer has caused some friction in the process. Special servicers are not rated on their performance on performing loans, and one of the main complaints about the CMBS experience is the lengthy approval process on assumptions and major consents that require special servicer input and approval.

What is the best way to address the need to process requests in a timely and efficient manner and avoid aggressive efforts to use consents and assumptions to improve the credit position of a loan or to extract a fee that was never specified or contemplated? Loan documents can establish objective criteria so that decisions are straightforward, and PSAs need to do a better job of defining consent requirements, fee expectations, and timing of approvals or denials. Borrowers surveyed were not opposed to paying more in fees to have better communication and responsiveness.

Pooling and Servicing Agreements

> *"The absolute rigidity that servicers feel they are forced to impose by the documents makes responding to real-life situations an exercise in bureaucratic futility for the borrower—it borders on Kafkaesque."* – Borrower

Our survey reflected strong, negative feedback during our research for the operative document: the PSA. The typical PSA is a byzantine amalgamation of rules that is challenging even to those most familiar with it. The typical PSA contains more than 500 pages, before exhibits; more than 100 pages of definitions; and "notwithstanding" used more than 170 times! So, for the business people forced to interpret and live with these documents during the 10+ years of a deal, the task is daunting.

The PSA was originally intended to create common standards and procedures so that all servicers were reading from the same playbook. The master servicer handled performing loan requests, the special servicer dealt with defaulted loans, and investors, including first loss or B-piece investors, had little authority. Over the course of time, PSAs have been negotiated to give the first loss or B-piece investors (or in PSA parlance, the directing certificate holder (DCH)) authority over decisions relating to the CMBS loan, effectively protracting or prohibiting many CMBS borrower requests and making it difficult for servicers to apply a consistent standard. This authority now extends to almost any activity that is not considered "routine" where a servicer exercises discretion in permitting or denying a particular borrower request whether the loan is performing or nonperforming.

The increased special servicer role, together with B-piece investor "fee sharing" arrangements, has pressured the special servicers to charge consent and other fees and demand that borrowers enhance credit, and has increased costs, review time, and frustration in the CMBS process among borrowers and other CMBS participants. The current decision structure has become intolerable for borrowers, and they have spoken with their feet. It is time for the CMBS industry to agree on certain standards and processes within the PSA that allow servicers to do their jobs and borrowers to execute their business plans with more predictability and consistency.

Issuer

> *"Originators need to better inform borrowers about the role of servicers in CMBS securitizations. More attention needs to be paid to the actual documents that are signed by borrowers."* – Special Servicer

In early CMBS, the role of the issuer was perceived to be primarily organizational. It would gather the loans and place them into the securitization, and then its role would be essentially over. However, as the Securities and Exchange Commission took greater interest in asset-backed securities after the market collapse of 2008 and with the advent of "risk retention," and the greater regulatory scrutiny placed on all asset-backed securitizations, the issuer is no longer simply the organizer. The issuer is obligated to report and take responsibility for certain regulatory matters (including risk retention whether it acts as sponsor or sells to a third-party purchaser). Moreover, issuers, and originators, have an interest in educating their frontline people on how best to guide the borrower through the origination process, planning for anticipated events and needs during the life of the loan, and incorporating accurate and workable terms, conditions, triggers, and procedures. The issuers will need to take a proactive role in loan document reform and PSA improvements.

Rating Agency

The rating agency role is critical; many investors require minimum ratings from one or more rating agencies to meet their investment criteria. However, with the advent of rules and regulations that govern communication between rating agencies and market participants, the rating agencies' job of assessing risk has become much more complicated. The once free flow of communication is perceived to no longer flow, perhaps an unintended consequence of regulations trying to create more transparency. A review and reconsideration of Rule 17g-5 is merited. Additionally, rating agencies review and approve service providers, particularly servicers. This is an opportunity to provide guidance on servicing practices that are credit positive, versus those that negatively impact structure, performance, and uniformity.

Finally, rating agencies and investors have long relied on the servicing standard to protect the integrity of the CMBS structure in the face of varying conflicts. The right of the DCH to terminate the special servicer without cause puts tension on the special servicer, but even more so the demand for fee sharing, which is not prohibited in the PSA. While some argue that the market should dictate whether fee sharing is permissible, one has to question what the benefit is to the trust—or the industry—of allowing fees to be taken away from the servicer and shared with an entity that has no obligation or duty to the trust. And it's not much of a "market" when the servicer has little bargaining power: share or get fired. It may be time for rating agencies, as well as issuers and investors, to reevaluate those two stress points on the special servicer as it strives to fulfill the servicing standard.

Borrower Advocacy

Our feedback indicates broad agreement on the need to improve the borrower experience, but as so aptly stated by one of our clients, it's tough to improve the borrower experience when you don't include the borrower in the process. Borrowers vote with their feet, and if the CMBS experience does not work for them or fit their business model, they will seek out and find alternate funding sources. Some participants suggested having a borrower advisor involved in the process, similar to an operating advisor, when needed to take a subjective look at issues and suggest possible solutions. The rigidity of the CMBS experience has limited communication and input from the borrower and requires certain procedures be followed under the PSA, but borrowers are frustrated by that experience when the response refers to a document that they are not a party to but that governs the servicing of their loan for the full term. This sure seems like a problem that can be resolved by proactive issuers and originators in fixing loan documents and PSAs. Surprisingly, our survey revealed that borrowers have a good understanding of underlying loan documentation and even the PSA. Do they still want/need CMBS loans? Have they given up or have they just gone somewhere else? It's much easier to tell who is not calling when the phone doesn't ring.

Making Progress

Based on our findings, we think progress can be made in several key areas:

Loan documents changes: lender discretion vs. objective criteria

- Lease Approvals: specify the approval process and set major lease thresholds; this is a high touch point, and setting reasonable standards to reduce approvals is key. Some are limiting approvals to 30% of net leased area or 30,000 square feet.
- Assumptions: set objective "qualified transferee" criteria and reduce subjectivity in approvals; include required guarantor NW, liquidity, and experience; and consider the need for property manager criteria. Consider the impact of deferred maintenance, reserves, and lease rollovers, which have been a sore spot as approvals effectively subjected to reunderwriting on assumptions.

- Reserves and Escrows: set a streamlined process with objective criteria; be sure definitions for NOI, NCF, and other terms are consistent across the documents; be wary of terms that are ill-defined or overly subjective; consider reduced requirements for threshold amounts.
- Fee Schedules: identify which procedures require a fee and establish a fee schedule and criteria/approval checklist. Avoid delay or multiple restarts of the approval period by including all required deliverables in the initial filing.
- Triggers: be careful and consistent in definitions; clearly identify all triggers and consider listing them in one easily identifiable place to facilitate servicing; be sure to provide terms for a trigger to "unspring"; include the borrower organizational chart in loan docs. Note: drafting matters!

PSA changes

- Approvals: minimize the number of parties required for sign-off; pay fees to those doing the work; specify maximum time frames for responding.
- Defined Terms: standardize so they are consistent across platforms.
- DCH: establish a regime for identifying the directing DCH and requiring any successor or newly appointed DCH party to notify the PSA parties. Many PSAs have already updated this criterion.

Education

- Borrower Guide/FAQs: add/update to facilitate better navigation through CMBS.
- Originators: educate/train to better guide their borrower customers through planning and preparing for their needs through the life of the loan.
- Issues Under Borrower Control: discuss and address those that add to time and cost at origination and through loan life.
- Institutional Knowledge: accumulate to create best practices and communicate this among servicers, originators, issuers, and investors. Establish feedback loops and continue to improve documentation and procedures.
- Identify and report bad actors.

With more effective and efficient documents, improved education, communication, and transparency, and commitment from all parties, CMBS can remain a viable and thriving industry.

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