ARH OVERVIEW OF THE LOAN SERVICERS' ROLE AND MODIFICATION REQUESTS

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If you have taken out a commercial mortgage in the last few years, there is a likelihood that you already have or soon will find yourself in need of critical loan modifications, allowance for additional indebtedness or maturity extension tests which otherwise are not provided for under your current mortgage. Furthermore, if your loan was securitized and you have already had the unfortunate task of dealing with a loan servicing company, you might already realize how difficult and frustrating the process can be. Simply getting your account manager to return a phone call can be a daunting task. In connection with a loan modification request, it is important to understand the function and mindset of the master, primary and special servicers in order to successfully: 1) identify the issues for which a solution will need to be developed, presented to, and approved by the servicers, 2) understand the factors that determine whether this solution will ultimately be approved, and 3) navigate the complex process which brings multiple parties to a successful resolution.

The Role of the Master, Primary & Special Servicers

The master servicer represents the securitization trust that distributes interest payments to the bond holders of the Commercial Mortgage Backed Securities ("CMBS"). Your loan was one of hundreds forming a pool of loans that ultimately were packaged as bonds and offered to investors. The master servicer appoints one or more primary servicers for each securitization to collect mortgage payments, your periodic financial statements and do other administrative and loan monitoring work while the loan is performing. If there is a default or an imminent threat of default (a distressed loan yet still performing) the loan gets transferred to a special servicer who is charged with fixing the problem either through renegotiation or foreclosure. The primary servicer has virtually no authority to discuss any modifications or concessions that deviate from the black letter terms of the loan documents. The complicating factor here is that you, as borrower, cannot communicate with the special servicer in advance of a default to suggest preemptive action that could improve the property's performance and ability to continue to service the debt. A complex tri-party agreement between the master, primary and special servicers called a "Pooling & Servicing Agreement" controls what authority each servicer has with respect to loan administration and the obligations between each - the borrower is not a party to this agreement nor will it be provided to you if requested.

The above pertains to the loan administration approach for a fixed rate CMBS loan. A far more complex administration structure exists for floating rate loans that have a senior first mortgage, subordinate first mortgage and then one or more levels of mezzanine debt.

Aberdeen Realty Holdings (ARH), due to its established relationships with primary and special servicers and its expertise in navigating the servicers' process for dealing with borrower requests, has been successful in bridging the gap between the various servicers and has obtained approvals to material modifications while the loan remains with the primary servicer through facilitating special servicer consent and rating agency confirmation (in certain instances). In other cases, ARH has petitioned the primary servicer to transfer the performing loan, absent a default, to the special servicer so that the required modifications could be discussed and implemented before the loan would begin accruing oppressive default interest.

Extrinsic Factors Affecting Loan Modification Requests

Understanding the prism through which servicers must view borrower requests for modifications and concessions is critical to developing a viable strategy that includes formulating requests to which the servicer will likely consent. CMBS rules, in short, require the special servicer to maximize repayment to bondholders. The "special" is not given much flexibility to renegotiate as they might be subject to legal action from bondholders who believe a renegotiation benefits the borrower to the detriment of the bondholders, or benefits the holders of the lower rated tranches of bonds versus the more highly rated bonds in the securitization (e.g."AAA" bonds) . This often results in the special servicer being reluctant to accommodate a borrower's modification requests, even where doing so could arguably improve the operating performance and viability of the loan collateral (your property).

As is generally the case with more complex capital structures involving mezzanine loans, the "first loss" note holder controls the modification and workout process. Similarly, with the less complex fixed rate securitizations, special servicers typically hold a first loss investment in the pool of loans creating the securitization called the "B-Piece" since it is subordinate to the bonds and held outside of the securitization trust. Thus special servicers are not only acting as the "collection agent" for the securitization they are also concerned with protecting their own investment. However, that being said, special servicers are not trained to be transaction specialists or dealmakers by trade and therefore have a limited ability to devise and implement complex modifications and/or recapitalizations that may involve additional 3rd party debt or equity.

What makes their predicament worse is dealing with distressed or nonperforming loans against the backdrop of the severely constrained capital of lenders. In other words, there is no bridge financing to see a property through this economic crisis to better times thus removing one of the tools previously used to mitigate loan term and maturity defaults. Adding to that, the lack of clarity in current and future economic conditions frustrates the servicer's ability to get comfortable with borrower's requested modifications since it typically only deals with an immediate issue resulting in "kicking the can down the road" while falling short of defining a clear exit strategy. Additionally, the fact that special servicers have had little distressed loan work over the past 15 years compounds the problem of successfully resolving distressed loans. Over the last decade or more the default rate remained below 2% of outstanding CMBS and for much of the period, fell below 1% while the structural complexity of CMBS loans has increased. As a result, these departments were thinly staffed with few highly experienced workout specialists which now leaves servicers in uncharted territory when dealing with the flood of modification requests and workouts of problem CMBS loans.

The Right (and Wrong) Approach to Servicer Discussions

Servicers appreciate and respond to borrowers that understand the complex framework which controls the servicers' ability to discuss potential modifications and will engage in discussions with borrowers that take a well-constructed, analytical and comprehensive approach to dealing with the loans' particular issues. They do not respond well to uninformed requests, threats or an "I'll do as I please, just stop me" approach. This ill-informed approach will catapult a problem loan into foreclosure. And yes, the special servicer will foreclose the mortgage when they lose confidence in the borrower's ability to execute a strategy that will maximize recovery of the full principal amount of the loan.

Understanding a Servicer's NPV Analysis to Loan Modification Requests

As a borrower today looking to renegotiate commercial mortgage terms, it is important to understand the thought process and motivations of the servicer, acting on behalf of the bond investors. From the investor or servicer's standpoint, two options generally exist to address problem or nonperforming loans: modify the mortgage or leave it as is (and foreclose if continued default). Each choice generates expected cash flows, and the present values of these two cash flows are likely to be different. If the loan is modified appropriately, the likelihood of full repayment by the borrower should increase. If not, foreclosure is more likely, with investors absorbing the associated losses.

As is the case with any investor, when faced with a choice between two alternative investments - specifically, between the timing and amounts of the cash flows for each investment - they will typically elect the choice that generates a higher present value. Similarly, servicers, in order to determine the best option to elect (foreclosure or loan modification) undertake an analysis of the mortgage's Net Present Value (NPV). If the NPV of the modified loan is higher than the NPV of the loan left as is, a modification is said to be "NPV positive." Thus, the servicer will be incentivized to modify the loan terms. However, if the NPV of the modified loan is lower than the NPV of the loan left as is, the servicer will likely choose to decline the borrower's request even though it may lead to default and foreclosure.

In order to effectively prepare for negotiation with a servicer it is critical for a borrower to undertake this same iterative analysis for each modification or concession, then again on an aggregate basis, and finally define for the servicer how its request to change one or more inputs involving rate, cash flow or duration is, in fact, "NPV Positive".

Seek Assistance, a "DIY" Approach is Not Suggested

As is the case for most individuals resolving tax issues, computer problems or household electrical shorts, a "do it yourself" approach can lead to unfortunate but avoidable results. ARH is a full service, commercial real estate investment advisory, asset management, capital markets and brokerage services firm representing borrowers and lenders in analyzing and resolving a wide variety of real estate issues at the single asset and portfolio level. Over the prior year, the ARH team has proven to be an asset to property owners advising and representing them in negotiations with servicers on commercial mortgage issues for over two dozen loans with an aggregate principal amount in excess of $162 million. For more information on ARH's full range of services please visit the firm's website at www.arh-ltd.com.