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The Line Reports from the CMSA: Part III - The Senior Bondholders Push-Back

Posted on **January 22, 2010** by Peter K. McKee, Jr.

A panel of investors from the top of the capital stack—money managers, hedge funds, and other long-term investors—introduced the first of several CMSA forums aimed at specific constituencies. A spirit of activism underlay the group's coalescing in the first place. As one panelist put it: "In the past we were passive and didn't get our hands dirty. Now we recognize we have to interact with rating agencies and regulators, as well as others in the industry."

For CMBS 2.0, the panel described three investor priorities:

- obtaining investor-friendly practices for newly-offered CMBS;
- developing best practices in the loan resolution process; and
- defining acceptable parameters for REMIC financing associated with REO property.

For newly-offered CMBS, the senior bondholders had a number of specific servicing and disclosure suggestions:

- "Out-of-the-money" interest accruals should not prime principal, because this incentivizes b-buyer/special servicer delay. Senior bondholders are worried that b-buyers might defer recognizing losses so long as they're entitled to interest accruals in such cases.
- Special servicing decisions must employ market rates of return. Valuation is so volatile in this market that the net present value determinations that drive the servicing standard should be market-based. Coupon-based (the interest rate stipulated in the Note) NPV determinations have skewed decision-making in senior bondholders' eyes.
- Change of control should be based on realized losses *plus* appraisal reduction amounts. The way that most pooling and servicing agreements (PSAs) are structured, changes to the controlling certificateholder (the first-loss piece) are based solely on realized losses. This change effectively accelerates control changes and addresses the senior bondholders' concerns that b-buyers/special servicers are delaying realizing loan losses to avoid losing control. As loan losses burn through the bottom parts of the deal structure, the "A" or even "AA" bondholders could end up as the controlling class. Beyond seeking more detail on how that process is effected, the panel noted that investors in that position can have consolidation issues.
- More detailed loan-level disclosure must be delivered. This is a discussion that will be ongoing with issuers, loan sellers and rating agencies.

For loan resolution policies and investor reporting, there was a strongly-held view that current practices were not always in the best interests of senior bondholders. As one panelist put it:

"What are special servicers doing and why? This remains a dark corner fraught with conflicts of interest, and it needs some light."

In the loan resolution context the servicing standard requires the special servicer to maximize the net present value to the trust, but investors feel shut out from updated information and the special servicers' rationale that underlies workout decisions.

Senior bondholders were looking for investor-oriented best practices to be identified and followed in loan resolutions, both for legacy deals and new issuance. Legacy deals are constrained by the terms of existing PSAs, of course, but, given the number of large loans being transferred to special servicing and the potential losses, investors were keen to know more about servicing strategies and the supporting justification for them.

The third priority for senior bondholders revolves around proposals to use REMIC financing to sell real estate the REMIC trust has taken back through foreclosure or the exercise of default-related remedies (REO). Current REMIC guidelines do not allow trust financing in this context.

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Special servicers and members of the owner/borrower-supportive Real Estate Roundtable have been lobbying the Treasury Department to change REMIC regulations to permit the financing of REO sales using REMIC funds. In investors' eyes, the discussion needs to include strict parameters for any such financing, including controls on the duration of such financing, as well as equity contribution and loan-to-value requirements that minimize default risks going forward. Panelists pointed out that the related extension risk directly impacted the timing and duration of bond payments, and thus bond prices. One panelist's remark was emblematic: "The judge in GGP gave five to seven year extensions to loans with a 2.00x debt service coverage. What will they do with loans that have a 1.00x DSCR? The senior bondholders ended up subsidizing a pop in GGP's stock price."

The panel also discussed creating flexibility in PSAs going forward to accommodate more volatile economic circumstances facing commercial real estate. Investors are concerned that defaulted loans are not being resolved, and that there will be a pile-up when the non-resolved existing loans combine with newly arriving defaulted loans.

For new issuance, investors expect lower leverage, high DSCRs, renewed focus on debt yields, sustainable underwritten net operating income, more disclosure and smaller transactions with better borrowers.