Blog Post

The Line Reports from the CMSA: Part IV - Servicers Face A New Reality

Posted on **January 26, 2010** by Peter K. McKee, Jr.

A panel of representatives from CMBS and portfolio lending, including the primary, master and special servicing functions, met during the CMSA Conference last week. An unusually candid discussion followed that focused on the business challenges that servicers face, and the effects of the current credit environment on their operations.

The business model for servicers has been turned on its head.

The servicing model for pre-2009 CMBS (so-called "CMBS 1.0") was predicated on using future issuance to replace loans that were defeased, refinanced or otherwise were "run-off" out of the servicing portfolio. Master servicers expected income streams from handling low-touch cashiering functions for performing loans, evaluating lender consent-related transactions such as loan assumptions (with healthy transaction fees), and earning interest rate float on escrows and reserves required by the constituent loan documents in the underlying pool of loans. As if in response to Dr. Phil's "How's that working for you?", panelists described how the transfer of increasing volumes of loans to special servicing had eroded master servicer fee income, how the market deterioration had choked the usual traffic of consent requests (at least on the master servicing side), and how float on reserves had all but disappeared in the current rate environment. Negligible new issuance has done little to counter-balance portfolio run-off.

While master servicing is hurting, distressed loan-focused special servicing is a growth business. There is some run-off as loans get resolved, but asset management (property management and leasing, for example) and loan resolution functions will require more resources as we move slowly through the current commercial real estate cycle. Special servicers face the problem of handling ever greater problem loan volumes with available resources, and performing their high-touch role both efficiently and consistently.

The servicing of Fannie and Freddie loans is for the moment growing modestly (with new loans at least meeting run-off). The wildcard for this segment is the GSE's role going forward. There is increasing impetus in Congress to restructure the GSEs, although most acknowledge that any transition would have to be calibrated and incremental to minimize market shocks. (More on this in future posts.)

Life company loan portfolio volumes were described as shrinking by one panelist and increasing by another, but both shared the view that revenues were down. There were fewer loan modifications and assumptions that generate transaction fees.

Loans from miscellaneous sources—including FDIC and TALF-related financings, are expected to increase, and asset management functions are likewise seen as a source of future demand.

Accompanying this shift in business is a human resources problem: servicing skill sets are not interchangeable, and each segment of the industry has different strengths. Primary servicers draw on relationship skills and their familiarity with their borrowers' business needs. Master servicers have sophisticated accounting and back office infrastructure that is not readily replicated. Special servicers have loan resolution specialists attuned to various loan origination platform requirements. This is not a "plug-and-play" scenario, but rather one that usually involves in-depth training. There are costs in moving talent from one sector to another, and more work product is being required of servicers to boot.

"Everyone is doing more with less," said one master servicer.

What is the impact of the current credit environment on servicing operations?

The panel described a "quicksand of values." Property values are down and volatile, as is sponsor credit. Obtaining reliable values underlies most special servicing decisions (including advancing), so market and credit volatility are critical issues. One special servicer described multiple appraisals on the same property as differing by 50%, so they use a combination of internal "normalized" values, broker opinions of value and appraisals. Other panelists said that good appraisers were in high demand, so delivery timing was impacted. The low number of market-based transactions (as opposed to foreclosures, for example) has been contributing to the volatility in appraised values.

Maturing loans get on the special servicers' radar at least one year in advance. On loans that mature where some bridge to refinancing is necessary, extensions are considered. For loans where a refinancing is unlikely, specials are increasingly looking to loan sales. "Many borrowers are just testing servicers to see if they can get better terms, so you have to see what's real."

The discussion turned to current lending activity. "The GSEs are still lending," said one panelist, adding "Banks and life companies took their real estate lending allocations and dedicated that to workouts of their existing portfolios in the first 3 quarters of 2009, then turned to new lending in the fourth quarter."

A life company servicer put it this way: "At a May 2009 meeting of our industry, only 4 of 32 lenders said they were lending; by October, 28 of the 32 said they were doing so. Allocations for 2010 are up slightly, and that allocation is for new lending rather than workouts."

In response to an investor question about the adequacy and timeliness of loan information deliveries from the special servicer, a panelist pointed out that CMBS loan information was on a monthly cycle, and that borrowers had become increasingly adept at obtaining information that could affect loan workout negotiations. "Special servicers have to be guarded about what they put out," he said, "since that could blow up negotiating positions we have developed."

While investors want up-to-date rent roll information, the servicers pointed out that borrowers would be concerned about other owners poaching tenants if rent roll information were to be publicly available. Special servicers are concerned that the wrong facts could give rise to lender liability claims as well. One servicer said that borrowers are increasingly shopping disclosure requirements as they evaluate finance options.

Property-level business plans, another item investors want promptly, are not always permitted by the pooling and servicing agreement (PSA) to be provided to parties other than the trustee. A special servicer observed that investors were really after a summary of the business plan which, once workout negotiations have been finalized, should not be a problem. In general, the panel bemoaned the complexity of PSAs, and the need to impose some standardization as a way of increasing servicing efficiencies. Even for a straightforward issue such as the permitted investment of escrowed funds, the differences between PSAs are extensive and require high-touch oversight.

When asked about the future of the servicing business, one servicer expected the costs of servicing to increase and operating margins to tighten.

What about extensions? Are there any observable trends? One special servicer said that, where approved, extensions were typically in 6 to 12 month bursts, and conditioned upon some borrower "skin in the game." Less sophisticated borrowers were often blindsided by the lead time required to execute a refinancing upon loan maturity. "Where there's equity in the property and the sponsorship is committed, we'll extend the loan. But we're not a bank. Our goal is to get them refinanced. For CMBS and GSE loans in particular, special servicers have to get out front and anticipate which loans will have refinancing challenges."

Another panelist described an asset-by-asset approach. "Does the borrower add value? Are they part of the solution? Is there a plan for the loan's take-out? If not, we think it's better to foreclose."

The Line's take? The new realities of the servicing business put a premium both on understanding borrowers' needs and navigating an increasingly complex regulatory and compliance landscape. There is value to the niche or boutique servicers in aggregating primary servicing, which is a matter of knowing the assets and relationships that comprise a portfolio. But there's a movement away from having smaller servicers handling cashiering or investor reporting functions that require a deeper compliance and accounting infrastructure. At a time when "doing more with less" is required, achieving efficiencies in a more demanding and complex environment, and being mindful of customer service all the while, will be quite a challenge. Still, the panelists' discussion was insightful, and reflected both an awareness of the issues and a resolve toward seeking solutions. We'll avidly await how quickly those solutions evolve.

As for the servicer-borrower dynamic, servicers took the borrowers' side in pushing back against what they perceived to be overreaching investor demands for transparency. In the context of workout discussions, however, the press of mounting volumes and claims on resources are pushing servicers to find efficiencies that comport with their contractual obligations. There seems to be a sorting that's going on—patterns are identified (based on borrower and property attributes) and resolution typologies developed. Borrowers are sorted accordingly. Faster response times will be needed as delinquencies increase, so the emphasis on process efficiency is obvious. And, for reasons of liability avoidance, process consistency as well.