The Miranda Warnings Revisited: Conduits on Parole

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Four years ago Rick Jones and I contributed an article to *CMBS World*® presenting a series of questions mortgage bankers were advised to raise with their borrowers considering a loan earmarked for a commercial mortgage-backed security (CMBS).[1] The premise of the 2001 article was to provide loan officers with a laundry list of structural restrictions and potential post-closing pitfalls unique to loans wrapped in a real estate mortgage investment conduit (REMIC or "conduit" loan). The list was cleverly labeled "The Miranda Warnings" and the article was posted to the industry, fulfilling our altruistic need to caution our customers on choosing the conduit course.

The reaction to our exposé was predictable, but had some unintended consequences. The good news is that we did raise the level of CMBS issue and process awareness among those in the origination food chain. The bad news is that our very high-strung friends on Wall Street quit inviting us to closing dinners, and the B-piece mafia took out contracts on us.

Having successfully emerged from the witness protection program, and ready to offend those we missed the first time around, I am now prepared to offer a sequel to the original Miranda Warnings.

When we left off, borrowers were confused, mortgage bankers were employing a "don't ask, don't tell" policy, servicers hands were tied by REMIC rules, and investment banks were carving up every conceivable cash flow with the skill of a Ginsu master. So, where are we today?

Generally the CMBS origination market has been very healthy over the last four years, leveling off to a $100 billion/year pace worldwide, spiking at $127 billion in 2004. If borrowers are truly disgruntled about the CMBS execution, they are signing up for more abuse in droves. Commercial securitization is apparently not going away despite the problems on the back end. This is evidenced by the fact that, although there has been roughly $412 billion in worldwide commercial loans securitized over the last four years[2], there has only been a $121 billion net increase in outstanding CMBS during the same time period ($280 billion to $401 billion according to the Federal Reserve). This means that we are refinancing old conduit loans with new conduit loans. Our borrowers couldn't possibly be hoodwinked a second time around, could they?

Clearly some things have improved, which will be detailed. Other issues still persist, which will also be covered. What is very clear is that most of the blame for the post-closing problems has been effectively shifted from the conduit sponsors to the master servicers. Every industry conference now has the requisite "Let's Beat Up the Servicers" panel, where the moderator, other panelists, and everyone in the room pummel some poor servicing contestant. Master servicers say they are not adequately compensated for the increasing workload. Investment bankers and investors say that master servicers are paid what they bid for. Both are correct, but that doesn't solve the problem. The problem is that roughly 75% (approaching $1 trillion) of all third-party commercial loan servicing will soon be in the hands of a dozen mega-master servicers. The CMBS industry will take a hit if there is a major master servicer meltdown.

On the positive side, we have seen some softening of the hard and fast loan modification restrictions implied in the original 1986 REMIC tax rules. CMBS servicers, and their attorneys who must issue opinions, have been modestly more flexible approving minor collateral modifications, although at some point the prohibition in the regulations against altering a "substantial amount" (10% is often used as a benchmark) of the collateral for a nonrecourse loan usually kicks in. Other modifications that affect the note and mortgage, and proposals that affect greater than a "substantial amount" of the collateral, are still almost impossible unless you have a clairvoyant borrower who manages to negotiate the future modification into the loan documents.

The most promising development will be the passing of the proposed REMIC Modernization Act (H.R. 1010 / S. 580). Reintroduced this past April and backed by a large number of trade organizations, the Act introduces and defines the term "Qualified Modifications," allowing for certain collateral changes without the risk of losing the REMIC's tax-free status. If passed, the new tax rules will provide much more flexibility on tenant expansions and reconfigurations, sale of outparcels, collateral additions and

releases, certain substitutions and other borrower requests that would potentially mitigate Miranda Warnings 3, 4, 5, 7, 10, 11 and 12 (see below). Let's hope it passes.

And now, the 2001 original "The Miranda Warnings" for CMBS borrowers, with a 2005 update:

Warning No. 1: If you pursue this securitized loan product, you may be required to meet a series of complex and sometimes expensive requirements regarding the need for a new single purpose entity, adoption of separateness covenants, employment of independent directors, and delivery of a non-consolidation opinion.

Update: There continues to be very few exceptions to this requirement. In fact, SPEs have become the standard for non-securitized loan investors as well. However, several interesting developments have occurred. First, conduit sponsors have been more vigorously resisting the use of so-called "recycled SPEs," whereby an existing SPE property owner is inserted as the borrower for the new conduit loan, primarily to avoid transfer taxes in certain states. The concern has been the trailing contingent liabilities that the new financing may inherit. Second, market pressures have raised the maximum loan amount required to avoid a non-consolidation opinion and an independent director on the SPE board from roughly $12 million to $15-$20 million. Third, the proliferation of tenant-in-common (TIC) borrower structure, particularly in light of the Delaware statutory trust IRS ruling and its effect on the 1031 exchange market. We probably will be seeing a lot more TIC borrowers, all of which must be SPEs. Sounds expensive, doesn't it?

Warning No. 2: There will be several companies servicing your loan with whom you probably have no relationship, and these new servicers will actually read and follow the letter of your loan documents.

Update: As mentioned it the introduction, this is where most of the energy over the post-closing problems have now shifted. There are now about a half dozen large servicers left actively piling up master servicing contracts in an effort to outgrow their competitors. These remaining master servicers are compelled to provide more services (primarily as a result of increasing CMSA™ IRP requirements), while actually receiving less remuneration due to the competitive bidding process. In an effort to make the math work, many master servicers have begun outsourcing asset management responsibilities to offshore subcontractors, primarily in India. Others are charging additional processing fees for handling routine borrower requests in an effort to boost ancillary income.

While this is going on, more mortgage banker originator/sub-servicers are selling their sub-servicing rights to the conduit sponsor or master servicer because of the headaches associated with servicing a few conduit loans in a CMBS transaction. This means more loans are being handled by servicers that do not have a relationship with the borrower. The master servicers have also been busy buying each other, selling servicing to each other, and setting up "private label" (secret servicing) shops to provide contract back-office processing for the named primary servicer. Special servicers are also insisting on being more involved, inserting themselves into the approval process on assumptions, lease reviews, replacement reserve draws, and other routine borrower requests, adding time and expense to the process. Rating agencies are also more involved than ever, particularly on larger loans. As one master servicer put it: "We simply have too many cooks in the kitchen."

Commercial loan servicing on CMBS loans has shifted from a customer service activity to a commodity. Servicing rights are booked as an asset when originated or purchased (FASB 125 and 127) and amortized accordingly. CMBS servicing is also bought, sold, transferred, and bifurcated when needed to make a transaction work. Bottom line: If you are a borrower, you may never really know who is handling your loan processing and requests.

Warning No. 3: The bondholders can actually utilize that useless "back 40" included in the mortgaged property and you may not be able to have that parcel released for sale in a few years as you had planned.

Update: This is where the new REMIC legislation should have a huge impact. Under the new rules, if it is determined that the "back 40" is basically worthless, or that the outparcel sale is in the best interests of the loan, the servicer (master and/or special) would have the discretion to approve the release provided the loan continues to be secured by an interest in real property following the release. The theory being that the substituted cash collateral reserve is more valuable than a non-earning piece of land. The servicer would also need to make a judgment as to whether the new tenant occupying the "back 40" or outparcel improvements would actually help or hurt the mortgaged property's net operating income (NOI). However, until the new REMIC rules kick in, releases of this nature will be subject to the conservative 10% benchmark, unless pre-approved in the loan documents.

Warning No. 4: You may not be able to develop Phase 2 and obtain the necessary cross easements until after you pay off the loan.

Update: The reconnaissance on this issue suggests that obtaining easements, particularly out-of-the-ordinary ones, is still difficult, time consuming and expensive if not pre-approved. Remember that the property collateralizing each loan must be distinct and not combined or crossed with subsequent phases separately financed. Thus, obtaining cross easements for access, utilities, amenities, parking, and

so forth continues to be problematic. There has also been a trend to insert into Phase 1 loan documents covenants restricting the developer from aggressive or predatory pricing and tenanting while leasing Phase 2, which could hurt the occupancy or financial performance of Phase 1. However, phased developments are usually well planned and documented, so plan on modifying your loan documents ahead of time.

Warning No. 5: Don't even think about adding 20,000 square feet to that Food Lion.

Update: When we wrote the original Miranda article four years ago CMBS loan property additions and expansions were problematic due to a somewhat vague definition and untested interpretation of what constituted an "economically significant loan modification" (Treasury Regulation language). The safe fallback position was that, since adding 20,000 square feet to a Food Lion required a modification to the mortgage, any possible adverse REMIC tax consequences triggered by an IRS mortgage disqualification could certainly be avoided by simply denying the borrower's expansion request.

Several positive developments have occurred. First, master and special servicers and their attorneys (who usually must issue a REMIC opinion) have been given more discretion on minor changes in the security when the modification does not result in a change in the expected cash flows of the loan, which is the real test. Second, collateral changes and expansions have often been necessary to reposition underperforming properties in older CMBS pools. Third, borrowers have figured out that, if they know ahead of time that they may want to expand the Food Lion, they may as well negotiate the pre-approval (sound familiar?) in their loan documents, thus avoiding a modification.

Warning No. 6: You will be bugged every 90 days for quarterly operating statements and rent rolls. (By the way, can you use our form (it's better) and please send the data to our website in comma delimited format?)

Update: Four additional years of persistently pressing borrowers for quarterly operating statements have taken its toll. Rating agencies have rigidly required, and master servicers have relentlessly pursued, this interim data. At least one master/special servicer (we'll let you guess which one) has even gone so far as declaring an event of default and charging the borrower default interest on late/missing quarterly information. Borrowers have succumbed and are now forwarding this mostly meaningless and unstabilized information to the servicers at a 90% compliance rate. The data is then, of course, shipped to the experts in India to decipher (see Warning #2, above). How an analyst in Bangalore is able to scrutinize CAM charges on a property in Paducah is perplexing. Borrowers are not, however, emailing their statements to the servicers in comma delimited format. What arrives is unaudited, unstabilized, unclassified, and/or on the back of a napkin.

Warning No. 7: You will be asked to provide a REMIC opinion when your loan gets modified. (Can you guess who pays for it?)

Update: The update here is that tax attorneys are printing REMIC opinions like confederate money. The rating agencies appear to be driving this requirement by rarely considering approving a modification they review without one. Servicers, who of course do not want to unilaterally stick their neck out, will usually require the borrower pay for an opinion. Basically, REMIC opinions have become little lawyer-provided liability insurance policies that are stapled to the back of the modification request. What's baffling is that only about 5% of the opinions being provided are actually specifically required by the PSA. It is apparently just too scary not to obtain one. The good news is that opinions on many of the typical modifications (assumptions, releases, etc) have become routine and relatively cheap, usually a couple thousand dollars. Theoretically the new REMIC legislation should eliminate the need for most REMIC opinions, although I have my doubts.

Warning No. 8: Be prepared to transfer a substantial portion of your liquid assets to the loan servicer in the form of holdbacks and monthly tax, insurance and replacement reserves.

Update: The general rule still is: come to the closing table with cash—lots of it. The extra proceeds you may have received leveraging your property will likely be redeposited in the form of tax, insurance, replacement reserve, lease commissions/tenant improvement, deferred maintenance and capital improvement holdbacks and monthly escrows. Other than waiving reserves on investment-grade triple-net tenants and for specific insurance premiums on blanket policies, the CMBS lending sector has held the line requiring these impounds despite competitive pressure from the life, bank and agency lending sectors that have more flexibility. Borrowers, by and large, have accepted the impound requirements as a cost of securing a conduit loan. Mortgage bankers have done a better job explaining it. Conduit lenders have done a better job disclosing it. Master servicers have been more responsive in releasing the funds.

There are two potentially problematic sidebars. First, master and special servicers have selectively been renegotiating escrow requirements in connection with a modification approval, usually an assumption. Although it may make sense, borrowers view this as holding their sale hostage for an unrelated issue. They would argue that, unless unusual property deterioration has occurred, the original underwriting reserves should stand as they would if the property were not being sold. This occasionally occurs

in the life, bank and agency sectors, but any customer service problems are usually mitigated because the mortgage banker and lender have a relationship with the borrower. Master servicers and bondholders do not typically have that strong a bond with the borrower. Second, we are seeing more hard and soft (springing) rent lockbox agreements put in place. These arrangements in effect create mortgage payment reserves. They probably add value to the loan in the secondary, but they are annoying to the borrower and a nuisance to the servicer.

Warning No. 9: If the deal was for the Walgreens, you'll not be able to swap for that Eckerds next year. Bondholders don't barter.

Update: The proposed REMIC legislation probably won't fix this one. Wholesale substitution of the entire mortgaged property, even if the substitute property is more valuable, simply won't fly. Anything short of that, including the demolition, renovation, reconfiguration, and addition to the existing improvements on the same land parcel will be possible under the new, less restrictive rules. Bottom line: If you own a Walgreens, keep it. JC Penney sold off all their Eckerds stores last year anyway.

Warning No. 10: If you are planning to sell your property soon and want to transfer your mortgage pursuant to an assumption, better plan on starting early.

Update: This has been a real problem area over the years. The conduit lenders and their master servicers have taken a bloody beating on this one at the hands of the borrowers and their mortgage bankers. However, we have seen some recent improvement here as well.

Master servicers are not in the business of taking underwriting risk, which includes approving new borrowers on behalf of the bondholders without specific assumption criteria, which is rarely built into the loan documents. Without specific assumption processing and underwriting guidelines, servicers must fall back on the "servicing standard" as feebly defined in the PSA.[3] As a result, each master servicer cautiously developed and implemented their own CMBS assumption underwriting standards and processing procedures. Initially, of course, the standards were inconsistent and the process time consuming. Borrowers objected and complained to their mortgage bankers (often the sub-servicer) who, of course, blamed it on the omnipotent master servicer.

The good news here is that the industry has figured out how to underwrite conduit assumptions. The bad news is that we still can't process the paperwork timely. This is largely due to (1) the backlog of borrower requests in master servicer back offices, (2) special servicers now being inserted into the approval process, and (3) outsourcing.

Warning No. 11: You really ought to know what defeasance is. If you don't, ask. It's better to appear stupid and ask (you are not, actually) than to prove it by not asking.

Update: Four additional years of waving our arms around on this scary topic have not put a dent in CMBS origination volume. Borrowers are simply not afraid. They either are prepared to face the consequences of an early payoff, or they still do not understand defeasance. Could be that those explaining it do not understand it either. In any event, the defeasance process has become more streamlined, and the out-of-pocket costs have stabilized in the $55,000 range. There has also been an effort to substitute agency securities (Fannie Mae and Freddie Mac) instead of U.S. Government Treasuries, which is cheaper. According to Commercial Defeasance LLC, approximately 700 loans have been defeased to date. This is still a small fraction of total CMBS loan volume. Most borrowers continue to transfer their property pursuant to a mortgage assumption, or hold to maturity, if possible. This will all change if treasuries jump 200 basis points. It should also be pointed out that life insurance company lenders, as well as Fannie Mae and Freddie Mac, are offering loan products with a defeasance prepayment option.

Warning No. 12: This may be the last time you will be able to borrow money on this property until your grandchildren are in college.

Update: Our free capital market system has a way of finding solutions to our borrowers' problems, in this case the "how do I leverage up my deal" problem. Borrowers with seasoned CMBS loans may want to cash out on equity and appreciation. Others may need additional debt to renovate or upgrade their property. Borrowers seeking new financing now have many non-conduit loan choices that are not limited to the 75%-80% maximum loan to value ratio (LTV). The market's solution was the resurgence of the mezzanine debt market, and the introduction of the CMBS B-note.

Mezzanine loans are structured as debt of the borrowing entity's owner, usually secured by a pledge of the owner's interest in the borrower (partnership, stock, etc). There is no additional lien on the property. Most conduit lenders now offer mezz loans as part of their suite of products, or through a growing number of third-party lenders specializing in mezz debt. Borrowers are now "pre-wiring" their first mortgage documents to provide for this additional financing down the road. Mezz debt on seasoned CMBS loans has also become more acceptable as LTVs have dropped; making the servicer's underwriting decision less agonizing.

B-notes entail debt owed by the actual borrower of the A-note and are secured by the same mortgage. The A-note receives payment priority and is securitized. The B-note is typically not securitized, and must purchase the A-note to

protect its interests in event of default. The overall level of mezzanine and B-note debt in a transaction is highly scrutinized by rating agencies and CMBS investors, so it should be interesting to see how much tolerance the industry has for CMBS debt leveraging.

Epilogue

So, are things better or worse? Based on the above updates I think we can safely put the conduits on parole. The CMBS industry, primarily through its trade groups (CMSA™, MBA and others) and the leadership of certain individuals, has finally stepped up and aggressively addressed most of the self-inflicted and structural problems. We still have far to go, but certainly the industry deserves much credit over the last four years mitigating borrower-related issues. Most of the conduit sponsors that were around four years ago are still with us today and are very successful. This means that the service we provide to our industry's ultimate customer, the borrower, has improved.

Finally, borrowers, let me leave you with these recommendations:

1. Read the MBA and CMSA™'s "Borrower Guide to CMBS." It is an excellent summary of the industry, its players and process. It can be obtained on either trade group's website (www.mortgagebankers.org, www.cmbs.org).
2. Make your mortgage banker or conduit lender tell you who will be servicing your loan.
3. Do not count on the proposed REMIC legislation to save your future modifications. First, it may not pass. Second, implementing the new rules will require servicers to make decisions, which they will be reluctant to make. Pre-wire your modifications into the loan documents to the extent you can be specific.
4. Rely on the counsel of your mortgage banker. Most represent many lenders and can offer advice and alternatives on different lending programs and structures.

And mortgage bankers, you have only one recommendation:

1. Staple a copy of this article to all CMBS applications until further notice. There are no more excuses for an uninformed borrower. Hopefully I will not have anything to write about in four more years. ❑

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[1] CMBS World®, *Fall 2001 issue.*

[2] *Source: Commercial Mortgage Alert.*

[3] *See "Standards? What Standards? Servicers Search For Answers," Commercial Mortgage Insight, June 2002.*