SOLVING THE MASTER SERVICER / SUB-SERVICER DISCONNECT

Master Servicers and Sub-Servicers have been sparring over asset administration, cash management and investor reporting responsibilities since the mid-1990's. However, disputes and confusion usually focused on the ownership of certain servicing responsibilities and the Sub-Servicer's relationship with the borrower, and resulted primarily because there were now two or three servicers on the loan, rather than one. The roles and responsibilities of each were unclear as a result. Recent market conditions, including a CMBS production fall off, a servicing fee strip compression, an onerous reporting and modification approval process, and more complicated transactions, have created an environment where CMBS servicers are now lobbing grenades back and forth. Having spent time on both sides of the DMZ, and having lobbed some of the same grenades as both a Master Servicer and a Sub-Servicer, I can sympathize with both points of view. Now I tell people we are a life company correspondent, and keep my head down.

Recognizing the growing discontent between the CMBS servicers, the Asset Administration Committee of the MBA organized an afternoon of Master Servicer / Sub-Servicer roundtable discussions at its annual conference held last June in San Antonio. The goal of the Committee was to promote direct communication between Master Servicers and Sub-Servicers on important topics affecting their relationship with their borrowers and investors. The roundtables were charged with (1) identifying the most important issues and trends, (2) exploring the nature of the conflict from both points of view, and (3) prioritizing the topics. The following is a summary compilation of each side's top five issues:

Sub-Servicer Issues:

1. **Processing and approving loan modifications and borrower special requests is time consuming, expensive or simply impossible.** This includes those modifications and requests that need Master Servicer, Special Servicer or Rating Agency approval, such as assumptions, releases, extensions, easements, expansions, substitution of collateral, secondary financing, lease issues and certain escrow disbursements. Borrowers and Sub-Servicers, who are accustomed to processing these requests with relative ease in a whole loan environment (life company, agency), are becoming frustrated with the restrictions and servicer layering that accompany a REMIC transaction.

2. **The timeframe Sub-Servicers are given to comment and negotiate the PSA and SSA is unrealistic.** Although they recognize that the Master Servicer is assigned only a month or two prior to the transaction closing date, Sub-Servicers are now only given a couple of days to a week to review hundreds of pages of contract. Several

deals have actually closed (funded and PSA finalized) before Sub-Servicers were provided with documents to comment on.

3. **CMBS reporting requirements are onerous and inconsistent.** Sub-Servicers are specifically referring to the CMSA Investor Reporting Package (IRP), which includes periodic reporting, primarily monthly, to the Master Servicer via three (3) data files and eight (3) supplemental reports. The IRP has been a moving target under development for five years and has grown to include hundreds of fields of information. In addition, some Master Servicers are modifying the IRP to include dozens of additional fields, making it difficult for the Sub-Servicers to consistently program monthly reports across CMBS transactions they service for different Master Servicers.

4. **Sub-Servicer monitoring and documentation requirements imposed by the Master Servicer are burdensome and redundant.** In addition to the above #3, Sub-Servicers are also required to send Master Servicers copies of bank statements and reconciliations, tax receipts, insurance policies and certificates, operating statements (monthly, quarterly, annual), property inspections, new leases, financing statements and year-end statements. Monthly and quarterly reports summarizing much of the information required above are also provided. Sub-Servicers are also obligated to prepare annual certifications and are subject to Master Servicer audits as well as audits performed by their CPA's and regulators.

5. **Requirements and responsibilities of the Sub-Servicer are not adequately explained and, therefore, not fully understood by the Sub-Servicers.** This includes the very nature of the CMBS structure and the relationship of the various parties to the transaction, which can vary widely from deal to deal. Again, Sub-Servicers are accustomed to some flexibility and work directly with their whole loan investors. It is important that Sub-Servicers understand the restrictions and process imposed when a commercial loan is wrapped in a REMIC bond so they explain these limitations and each party's role in the process to their borrowers.

Master Servicer Issues:

1. **Sub-Servicers are not communicating with Master Servicers in a complete or timely manner.** This primarily pertains to specific borrower and property level issues and requests that require upstream analysis and approval and are time sensitive. There also appears to be no sense of urgency when Sub-Servicers are asked to respond to documentation requests and Master Servicer issued compliance letters highlighting performance exceptions. In addition, communication among the Issuer and the CMBS servicers on legal docs, duties and fees is poor during the compressed transaction closing period, hurting the paper trail and causing confusion with respect to servicing responsibilities.

2. **Many Sub-Servicers do not understand what they are getting into when they originate and expect to service a loan for a conduit.** This is the flip side to Sub-

Servicer Issue #5, above. Many Sub-Servicers are not prepared to take on the complex and often arduous role of CMBS primary servicer, and either do not read or fully understand the requirements of the PSA and SSA. This includes having both adequate staff and systems to meet the requirements. As a result, Master Servicers have to help train and educate the Sub-Servicers they are accountable for.

3. **Sub-Servicers are not realistically managing their expectations, as well as the expectations of their borrowers.** This includes expectations primarily relating to the viability and timing of those modifications and special requests included in Sub-Servicer Issue #1 (assumptions, releases, expansions, etc.), as well as the default / workout process. The lack of understanding (mentioned in #2, above) contributes to an optimistic outlook as to what can be accomplished within the CMBS structure. As a result, borrowers are being misled and Master Servicers, Special Servicers and Rating Agencies are being blamed for killing or delaying borrower requests and transactions.

4. **The periodic submission of information and the scheduled transmission of data by the Sub-Servicer are often inaccurate and incomplete.** Master Servicers contend that annual property inspections and operating statement analysis are not being consistently performed by the Sub-Servicers in accordance with SSA and PSA requirements or the CMSA IRP format. The monthly reporting cycle, in the form of the IRP files and reports, is transmitted with missing and incorrect data, forcing the Master Servicers to manually complete the database prior to forwarding the reports to the trustee and investors. In addition, Sub-Servicers are not providing timely notice of default trigger events, as defined in the PSA.

5. **Defeasance.** Two issues have emerged here. First, since defeasance is complicated and a relatively new mechanism used to calculate prepayment penalties on conduit loans, Sub-Servicers cannot advise their borrowers as to the nature, process or fees associated with defeasing a loan. Although most SSA's provide that the Sub-Servicer assist the Master Servicer in defeasing the loan, most Sub-Servicers do not have the technical expertise to do so. The second issue is who is entitled to the servicing strip once the loan is defeased. Since most SSA's are silent on the matter, the choices are (1) all to the Master Servicer, (2) all to the Sub-Servicer, and (3) pro-rata as before the payoff of the mortgage.

As can be seen from the above, some of the same issues emerged from both sides of the table, albeit from a different perspective.

What happens next?

The roundtables were not charged with finding solutions to the issues. There simply wasn't enough time. However both Sub-Servicers and Master Servicers did have an opportunity to express their concerns and react to accusations from the other side. Those that participated agreed that a greater appreciation for the other side's position was achieved.

If CMBS bifurcated servicing is to survive, it seems clear that communication between Sub-Servicers and Master Servicers needs to be improved on both a loan and pool level. Sub-Servicers, if they are to properly represent their borrowing customers, must become familiar with the requirements, restrictions and process inherent to CMBS servicing. Master Servicers, if they are to properly represent their investing customers, must be responsive to borrowers' requests and supportive of Sub-Servicers' workload.

The MBA, and hopefully the CMSA, will continue to assume a leadership role in identifying areas of conflict and work with its membership to bridge the CMBS servicing disconnect. Although many of the issues described above are systemic to the CMBS industry and are difficult to change or reverse, much can be accomplished through industry-sponsored conferences, task forces and continuing education programs. The Asset Administration Committee has recently released three publications that should help educate CMBS servicers, define their roles, and standardize some of the work:

1. A guide describing the types of contracts commercial mortgage bankers must negotiate and execute to originate and service CMBS loans.
2. A white paper and matrix identifying the generally accepted roles and responsibilities of master servicers and sub-servicers.
3. A standard electronic property inspection form.

I took an unofficial survey at the conference and asked individual Sub-Servicers and Master Servicers the following question: "Who is your customer?" The overwhelming Sub-Servicer response was "the borrower". The Master Servicers' response was less definitive, identifying "the bondholders", "the trustee", "the B-piece buyer", "the rating agency" and "the investment bank" all as customers in some combination. Neither Sub-Servicer or Master Servicer really viewed each other, or each other's customers, as a customer. This may be the heart of the disconnect. Things would probably improve if we simply expanded our definition of a customer. Probably easier said than done.

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