WHAT IS THE COMMERCIAL MORTGAGE LOAN SERVICING STANDARD?

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Servicing Management – October 2002

This sounds like a simple question, but I challenge anyone to define it, look it up, explain it, or at least point to who is responsible for promulgating the "Servicing Standard" for mortgage bankers and other third party and portfolio commercial mortgage loan servicers. The term is being bandied about and dropped into contracts so often you would think its definition was etched in a stone tablet displayed in some temple for the world's real estate professionals to examine. It is not. At best, the industry can say it has a generally accepted, but inconsistently applied, limited set of loan and asset administration guidelines that, by and large, are not written down anywhere. This probably won't cut it in a post-Enron world.

What does the Enron debacle have to do with commercial mortgage loan servicing standards? More than you might think. Preliminary consensus is that Enron fell at least in part because its accounting practices were inadequate, incorrect and/or misleading. There are also allegations that Enron's auditors, Arthur Anderson, didn't follow proper auditing procedures and/or accounting standards when it reviewed and certified Enron's Financial Statements. Enron's bookkeepers were supposed to account for and report the company's financial activities in accordance with Generally Accepted Accounting Principals (GAAP) as established by the accounting industry's private sector standard setter, the Financial Accounting Standards Board (FASB). Since 1973 the FASB has issued hundreds of standards in the form of statements, concepts, interpretations, technical bulletins, exposure drafts, research reports and discussion memorandum providing accounting guidance to almost every industry, including energy and mortgage banking. The FASB's cumulative set of guidelines is impressive and comprehensive. So what happened to Enron?

There are three possibilities with respect to Enron's questionable accounting:

1. Enron, its management and its independent CPA, Arthur Anderson, did not follow Generally Accepted Accounting Principals.
2. Generally Accepted Accounting Principals required or allowed for misleading bookkeeping.
3. Generally Accepted Accounting Principals did not provide adequate or complete guidance with respect to Enron's bookkeeping.

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Most of the hoopla in the press and in various congressional hearings is focused on the first scenario. Americans need a villain here and Enron's senior management did line their pockets on the way to bankruptcy. But what if the so-called "questionable bookkeeping" was actually in accordance with GAAP but misleading (#2), or simply not addressed by GAAP (#3)? If you are a stockholder or employee of a public company, this far more frightening. This means our accounting standards, in some cases, may be bad or missing, as opposed to some rouge corrupt or incompetent CFOs, CEOs or CPAs not following the rules. This should not be surprising. As comprehensive as the FASB's body of standards is, it can hardly keep up with each industry's evolving and unique financial arrangements and transactions. It is also not unprecedented for the FASB to pull or modify previously issued standards.

This is where the unsettling comparison to the commercial mortgage banking industry lies. By most counts there is over 1.5 <u>trillion</u> dollars in commercial mortgage debt outstanding in this country, much of it being serviced by third party mortgage bankers and master servicers for lenders and investors. This means these mortgage bankers and master servicers are handling, monitoring and safeguarding other people's money and real estate assets, and they are doing it with an incomplete and inconsistent set of standards and guidelines. There are undoubtedly holes in the FASB's dike of standards, but the commercial mortgage loan servicing industry's dike is, at best, half built.

Back in the days when mortgage bankers only serviced commercial loans for life insurance companies, pension funds and financial institutions, servicing standards were less of an issue. Most lenders had a cursory set of asset management requirements incorporated into their correspondent agreement or manual. What wasn't written down was communicated, usually verbally, on a case-by-case basis. However, these requirements varied from lender to lender. They still do in many important areas. The agencies (primarily Fannie Mae and Freddie Mac) really had the most comprehensive set of procedures and guidelines, primarily because they used their single-family guidelines as a starting point years earlier. For everything else, there was a "this is how we have always done things" approach to commercial mortgage loan servicing.

Everything changed in the early 1990's when a secondary market for commercial mortgage backed securities really developed. Because the investor was now many CMBS bondholders rather that a single institutional investor to verbally communicate with, the documentation and contracts became important with respect to the servicer's responsibilities and liabilities. Servicers were now acting in a fiduciary capacity for a tax-exempt trust (REMIC, FASIT, Grantor Trust) pursuant to a prospectus filed with the SEC in accordance with the Securities Act of 1933. The servicer's, or in most cases, the master servicer's responsibilities are spelled out to some extent in the trust's Pooling and Servicing Agreement (PSA) and its exhibits. Although more comprehensive than most whole loan servicing contracts, the PSA still has instructional holes that are intended to be filled by the document's repeated reference to the omnipotent "Servicing Standard".

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In almost every PSA definition the Servicing Standard simply requires the servicer to service the loans in the trust:

1. with the same care, skill and diligence as it does for itself or other third party loans,
2. with a view to timely collection and maximization of recovery, and
3. without regard to any conflicts of interest.

If you're a commercial loan servicer, this doesn't provide much guidance. Specifically:

Item 1: This requirement basically says to service the loans in the trust the same way you service other loans. The problem is that, as previously mentioned, specific servicing standards and procedures vary significantly between servicers and lenders, meaning that different sub, master and special servicers will employ different standards and procedures within and between trusts.

Item 2: This requirement is more of a goal than a standard or procedure. It really identifies what the objective is rather that how to get there.

Item 3: This requirement is more of a constraint than a standard or procedure. It could actually be inconsistent with Item 1 if the servicer has an interest in the loan or owns some of the trust's bonds.

These three Servicing Standards do not, for example, instruct the servicer when to make collection calls, what method of escrow analysis to use, how to underwrite an assumption, how much should the deductible be on a hazard insurance policy, what are the credit rating requirements on new retail tenants, or when an inspection is required on a replacement reserve draw. These specific standards and procedures, and many others, are not elucidated in the servicing sections of the PSA either, leaving each servicer (and there could be many sub-servicers in a single CMBS transaction) to employ those standards and procedures unique to its servicing portfolio.

Servicers will be open for scrutiny and liability when required to apply a differing set of specific standards and procedures based on their own portfolio and practices. Using two different methods of escrow analysis, for example, could require different amounts on deposit for a loan. If a loss occurred when the property was foreclosed, the servicer may be held accountable for a less conservative method of escrow analysis, basically reducing the amount of bondholder collateral at liquidation. Again, in the whole loan world, any holes in the third party servicing agreements are filled by calling the lender and seeking instruction. In the CMBS world, the servicer is on an island with his PSA. There is no one to call. All interpretations and decisions are made by the servicer, the special servicer or, in some transactions, the controlling class certificateholders (the B-piece buyer).

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There have been a number of negative side effects to the CMBS Servicing Standard deficiency. Because standards and procedures are being inconsistently applied, and the parties to the PSA know it, there has been an effort to capture as much loan and property level information as possible for dissemination to the trustee and bondholders. Master servicers are also requiring sub-servicers to provide a growing amount of data to help ensure completeness and consistency. This is overkill. The CMBS industry's obsession with capturing hundreds of bits of loan and property level data every month is no substitute for strong and consistently applied servicing standards and procedures. In addition, borrower request approvals, unless specifically provided for in the loan or trust documents, are time consuming, expensive or impossible to obtain. Servicers simply do not want to incur liability for making judgment calls on requests where a clear decision making path is not evident in the loan and trust documents, and where a variety of industry practices can be employed. All this has made servicing loans in CMBS transactions very expensive to servicers and often frustrating to borrowers.

So why hasn't the commercial mortgage loan servicing industry developed a set of generally accepted standards similar to what the FASB has done for CPAs and Fannie Mae and Freddie Mac has accomplished for the single-family mortgage loan servicers? The simple answer is that we have not needed global standards. Up until the early 1990's there was little public investment in commercial mortgage loans. Loans were purchased from or originated through mortgage bankers by private, mostly institutional investors, such as life insurance companies, banks, pension funds and the government sponsored entities (GSE's). These private investors were able to customize their standards. CPAs needed to have generally accepted standards so investors would have confidence in the financial statements of public traded companies. Likewise, single-family mortgage bankers needed consistent standards when servicing home loans collateralizing publicly traded Ginnie Mae, Fannie Mae and Freddie Mac securities. Now that commercial loans are being originated into CMBS conduits, and whole loan investors are securitizing pools of portfolio loans, servicing standards cannot be customized. These standards really must be standardized.

The next obvious question is: Who should be responsible for establishing and promulgating commercial mortgage loan servicing standards for mortgage bankers? Like the accounting profession, there is no government agency or regulator charged with this task. There may be if we're not careful. The answer is that we need to set standards for ourselves through our industry trade groups, primarily the Mortgage Bankers Association (MBA) and the Commercial Mortgage Securities Association (CMSA). The good news here is that we have actually started this process, through these two trade groups, on an ad hoc basis. Various committees and task forces of these two trade organizations have been hard at work creating a body of procedures, guidelines and standards pertaining to commercial mortgage loan servicing. A partial listing of this work (publications and reports) is included at the end of this article. Some of these guidelines and reports have been incorporated into recent PSAs and formally adopted by whole loan institutional investors.

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In order for our emerging standards to be generally accepted, however, they need to cover all important asset administration activities and be consistently applied. We need to expand on the good work that has been done to date. The completed product should be formalized, possibly codified, disseminated and updated continually to keep up with industry changes. The burden to do this will and should rest with the industry's practitioners and trade groups. To not do this may invite criticism that commercial mortgage bankers and master servicers cannot police themselves, and should not be entrusted with holding, securing and monitoring the nearly $400 billion in mortgage-backed trust assets on behalf of the certificateholders. Even more scrutiny will come to bear if there is an Enron-type meltdown in some segment of the real estate market. As they say in Texas: "Remember the Resolution Trust Company!"

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