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Investors considering using a loan to own strategy should contact an experienced professional for guidance

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Last year I wrote about the loan to own phenomenon that invaded the real estate community. This phenomenon was created, in large part, by illiquid capital markets as investment banks such as Lehman Brothers and Bear Stearns ceased to exist and loans they held were packaged in billion dollar pools in order to liquidate them quickly. Billion dollar loan portfolios dominated the market in 2008 and early 2009. Late 2009 witnessed significant up ticks in smaller loan sale activity. Some examples were:
* A $9.9 million loan one off secured by a hotel in San Diego, CA.
* Amcore Bank of Chicago, IL marketed approximately $200 million of distressed loans. This portfolio was marketed unsuccessfully in 2009 as a portfolio sale and in 2010 bids were accepted on individual loans.
* A community bank offered a $38.3 million portfolio for sale in four smaller pools between $6 million to $13 million and offered investors the opportunity to bid on any one of more combinations of those pools.
* Capital One, holder of a portfolio of $256.5 million of loans, divided its portfolio into approximately 14 pools ranging from $5.5 million to $37 million and permitted bids on individual loans in the group.

Some of the reasons for this shift were that: (i) capital for traditional real estate acquisitions was tight and the bid/ask differential between buyers and sellers was large; (ii) few buyers existed for billion dollar pools of delinquent loans; and (iii) purchasers of the large portfolios needed to replenish their liquidity and sales of smaller loan portfolios accomplished that. As smaller portfolio loan sales closed, stimulation in the market increased and one off sales became popular. Many first time loan purchasers entered this market looking to increase the meager returns earned on cash deposits by executing a loan to own strategy (e.g., the acquisition of distressed secured debt at a discount with the eye towards foreclosing and owning the underlying collateral) To accommodate these buyers, liquidating subsidiaries were formed to make the loan sale arena easier for first time buyers and smaller players to navigate.

The Financial Reform Bill imposes new capital and leverage requirements designed to prevent institutions from becoming too big to fail and creates a new financial stability oversight counsel. Until final regulations are adopted, affected institutions may be very conservative with loan activity, restricting the availability of capital and making it difficult for funds and other purchases of smaller loans to raise acquisition capital. New registration requirements for hedge funds will also limit their flexibility to invest in certain transactions, all in an attempt to limit "systemic risk". In fact, we now will have "systemic risk regulators" who will oversee and obtain "systemic risk data" regarding private funds further restricting the free flow of capital. Many of these funds that were established to purchase loans on a loan to own basis may also become subject to government regulations as "non-bank financial companies". A "nonbank financial company" is a company that derives 85% or more of its and its subsidiaries' consolidated annual gross revenues or consolidated total assets from activities that are "financial" in nature. A nonbank financial company has to register with the federal reserve within 180 days of a final determination by the oversight council that it is to be supervised by the federal reserve. This level of supervision for nonbank financial institutions at the federal level is unprecedented, and could certainly slow down the free flow of capital causing the pool of buyers to shrink.

Most funds raise capital by selling securities to private investors. Typically, these are accredited investors under Regulation D of the Federal Securities Laws. Changes were made to the accredited investor standards to account for inflation since dollar thresholds were first introduced over 25 years ago. For example, one change excludes the value of an investor's primary residence when calculating net worth. These changes were relatively modest compared to what was proposed in earlier versions of the bill, but may still decrease the pool of investors for certain private placements, including placements designed to raise capital for loan sale purchases, further constricting the market. The Reform Bill also established a whistle blower program, which not only encourages private notification of securities violations, but creates a bounty of up to 30% of funds recovered for information provided. The SEC has already set aside almost half a billion dollars for future whistle blower payouts. How selective will the SEC be in enforcement of these complaints remains to be seen. Most certainly, larger funds will draw greater attention and aggressive SEC oversight may also compromise the free flow of capital causing the pool of buyers to shrink.

It may be years before regulations are adopted so the immediate impact of the Reform Bill on funds created to acquire loans on a loan to own basis may be minimal. However, a significant recent change in tax laws may pose more of a concern. At the end of last year, Treasury Regulations were amended to permit certain loans to be modified without putting the REMIC status of the trust at risk. Previously, any significant change to the collateral was treated as if a new loan were being made. Now collateral can be released and/or substituted so long as the loan continues to be "principally secured by real estate". This has prompted a significant transfer of securitized loans to special servicers to implement loan modifications. Once a loan is transferred to the special servicer, the asset manager assigned to the loan has three options: (i) sell the loan; (ii) modify the loan; or (iii) foreclose on the property. Often the holder of the lower traunch debt had an affiliation with the special servicer, which allowed that holder input on what option was exercised. When this affiliation exists, the holder may be more inclined to modify the loan, make it performing and continue to collect fees for servicing the loan. This continues the fee income stream and keeps open the possibility of realizing something from the lower traunch debt. If the loan is modified and put into performing status with all defaults cured and/or waived, the ability to foreclose and own the underlying property is compromised, limiting its attractiveness to a loan to own purchaser.

Prior to the adoption of the new Treasury Regulations, the most common form of loan modification was a simple extension of the maturity date. This type of modification is expected to continue since there is approximately $31.6 billion of fixed-rate CMBS loans of the 2005-2008 vintage that are scheduled to mature by the end of this year. Most analysts believe 60-70% of all loans from the 2005-2008 vintage will fail to qualify for a takeout loan at maturity due in large part to tougher underwriting standards and decreased property values. What seems to be occurring, however, is that special servicers are effecting combination modifications instead of simple extensions of the maturity date. Most combination modifications involve some softening of required principal amortization which softens the debt service burden on the borrower. This should allow these loans to be serviced as performing loans.

Combination modifications may very well continue to take workout share away from the special servicer's other options, namely foreclosure/liquidation/sale. The effect on loan sales remains to be seen; but if the ability to foreclose is compromised, the loan to own pool of investors will constrict since such investors are less inclined to simply clip a coupon and receive an interest payment. Provided the combination modifications are discriminate and the economic recovery continues and even proves to be stronger than the current consensus, borrower's positions with current and prospective tenants should improve, eventually allowing the property to increase cash flow or, at a minimum, soften the cash flow decline many properties are and will be experiencing. This will result in more "performing" assets and a potential decline of loan to own purchasers. However, if extensions and other types of modifications are used indiscriminately and/or the economic recovery falters, loans modified may be transferred back to the special servicers in the next two to three years creating a second buying opportunity for loan purchasers. Also, there has been a substantial consolidation in the marketplace of special servicers. This could result in purchasing opportunities for these with access to the remaining special servicers especially if they are able to purchase these loans before significant modifications are made.

While the current credit markets have created an opportunity for savvy commercial real estate investors to obtain significant returns by purchasing distressed debt secured by commercial real estate, recent changes in the regulatory environment may slow or limit that opportunity in the near term. Time will tell. Investors considering implementing a loan to own strategy would be wise to contact experienced professionals with knowledge of credit markets and current market conditions in order to properly evaluate the proper time and manner to execute this strategy.

Martin Pomeroy, esquire, is a partner at Bernkopf Goodman LLP, Boston.