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David Goldfisher - Why special servicers write down CMBS loans

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The 2011 commercial real estate debt market capitalization is roughly $3.5 trillion with CMBS, Commercial Mortgage Backed Securities, accounting for $754 billion or 22% of the entire market.

According to Trepp's April Delinquency Report, the CMBS delinquency rate was 9.22%. This category includes loans 30 days delinquent, in foreclosure or REO. Fixed rate CMBS product delinquency rates from January 2011 through April 2011 are at peak levels.

The special Servicer's system is clogged with CMBS deals that need to be restructured and renegotiated. Borrowers must step up to the plate with new capital and present actionable solutions. Presently, three Special Servicers, LNR Partners Inc., CW Capital LLC, and CIII Asset Management LLC, manage 75% or approximately $550 billion of defaulted CMBS loans. Eight special servicers manage 98% of these troubled mortgages. Often, the special servicer is the controlling class bondholder who holds the 1st loss position in a pool and is obligated to a servicing standard that demands the highest Net Present Value for the entire Trust (all bondholders). The Special servicer is under intense pressure to carefully scrutinize and pursue all viable workout options. Special servicers commonly dual track workout pathways considering the borrower's restructure proposal while proceeding towards foreclosure.

A recent industry report detailing the prior 12 months of special servicer losses indicates that when a special servicer works with a cooperative borrower, the Trust suffers approximately a 50% loss compared to a 65% loss when exercising their foreclosure option. Since the borrower can reinstate or make a loan current at any time prior to the scheduled foreclosure, the special servicer frequently chooses to work with the borrower to modify the existing loan terms, write down or write - off principal. The loan may be written down if the servicer identifies a sizeable and documentable gap between the property's cash-flow/value and the current indebtedness that in the servicer's opinion will not be bridged by the loan maturity date. The loan may be modified if the borrower's obstacle to servicing the debt is perceived to be a temporary issue healed by an interest rate reduction, amortization elimination, loan extension and a general improvement in market conditions. The special servicer may pursue a note sale if the borrower does not present an executable and NPV appropriate deal or cannot contribute the new required capital. The foreclosure route is time intensive and costly especially in states that are governed by judicial foreclosure statutes. States such as Connecticut, Maine, New Jersey, Pennsylvania, Maryland, Delaware and New York require lenders/servicers to process foreclosures through the courts.

Servicer's work well with organized, communicative and honest borrowers who can close on a fair market deal rather than pursue a foreclosure with unquantifiable monetary results.

Some of the challenges facing a Borrower when approaching a servicer are 1.) getting the servicer's attention, 2.) identifying the servicer's menu options - conversations are often one-sided where the borrower is the only party talking, 3.) presenting salient and critical financial and business points at the right time and in a palatable tone, 4.) Staying focused and being available on the servicer's timetable for a six to fourteen month duration.

Seasoned CMBS workout specialists can be an effective choice to serve as the borrower's advocate with servicers. Over the last several years of negotiating with servicers, certain borrower advocacy firms have mastered the nebulous servicer language and know how to order off the servicer's hidden menu.

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