CMBS Workouts - "Keep your friends close and your enemies closer"

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Loan defaults in fixed-rate, commercial mortgage-backed securities (CMBS) continue to grow. According to Fitch Ratings, the default rate hit 12.9% at the end of the second quarter of 2011, up 228 basis points from December 31st, 2010.

The sheer volume ($60.86 billion) of problematic CMBS loans in the special servicer's pipeline has dictated that the servicer develop efficient loan servicing platforms. The servicer has to be vigilant in striking the right balance between upholding its fiduciary responsibility to all bondholders, meeting the financial objectives set forth in the trust's PSA (Pooling and Service Agreement) and allocating its own resources properly, namely its time.

The best way for a borrower to execute on a desired loan resolution is to not propose workout resolutions that don't fit within the servicer's spectrum of acceptability. An advanced understanding of the servicer's, controlling class member's, and bondholder's tolerance points is important to engage the servicer in a meaningful dialogue.

The special servicer's chief priority is to fairly represent all the bondholders of the trust; which include AAA investors through the subordinated B piece investors (also referred to as controlling class members). While the special servicer interfaces with the borrower and is responsible for certain decisions during the loan resolution process, the servicer is hired by and in some respects accountable to the controlling class member for final approval on any restructure proposal. The controlling class member is the most subordinate bondholder within the trust and therefore suffers the first loss when a loan is written down or otherwise disposed of at a loss.

A few of the questions a borrower needs to consider prior to sending in a loan resolution proposal include: 1) Who is my servicer and controlling class member? 2) What is each bondholder's current loss status within a pool? 3) What recent loan resolutions has my servicer recently executed and am I better off proposing a discounted payoff or an A/B note restructuring?

None of these questions can be answered formulaically. The Henley Group has canvassed multiple servicers and controlling class members for this article and offers the opinion that "the motivations' of these parties play as important of a role as the loan economics."

Certain controlling class members have been notorious for not accepting discounted payoffs of loans of any size. They prefer to move forward with Borrowers who can execute on an A/B note and invest capital. The "A" Note loan balance is ascribed a value based upon a servicer's valuation. The balance of the unpaid principal is converted into a "B" note that may or may not accrue interest and may be paid back on a pre-determined basis upon a recapitalization or sale of the property.

On the other hand, one of the largest controlling class members (who is also a special servicer) accepts discounted payoffs and prefers not to do A/B note modifications for loans under $30 million. The Henley Group believes that "this is a resource allocation decision and that given the cumbersome nature of structuring an A/B note, the controlling class has determined that they'll focus their restructuring efforts on loans having the greatest financial impact on the pool."

A borrower's responsibility is to gain a deep appreciation for the positions of the servicer and the trust's bondholders before crossing "enemy" lines.

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