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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

4 Considerations For CMBS Loans As Default Rates Soar

By **Andrew McIntyre**

Law360 (July 17, 2020, 6:06 PM EDT) -- As 90-day forbearance periods on mortgage payments are ending amid the continued COVID-19 pandemic, more commercial mortgage-backed securities borrowers are defaulting on their loans, and experts say keeping a few points in mind can go a long way as borrowers and servicers try to find the best way forward.

Special servicers, the entities that manage CMBS debt once it hits default, are increasingly seeking to work with borrowers as opposed to foreclosing. But those servicers face a variety of challenges along the way, including getting enough staff to handle the uptick in volume and doing a thorough analysis of each loan and property under time constraints, experts say.

The federal government could also provide relief for the commercial property owners who take out CMBS loans, although that too comes with obstacles, according to lawyers.

"Here, because of the unprecedented effect of the pandemic on the economy, the special servicer is going to be looking through a different lens," said Gayle Klein, a principal at McKool Smith PC. "And the decisions will be more difficult."

Here, Law360 looks at four considerations for borrowers and special servicers.

Negotiations With Servicers Will Take Time

One of the challenges that's been weighing on the sector is the sheer volume of loans that have recently hit special servicing. That's meant long wait times to correspond with special servicers, leaving borrowers in limbo over what the future holds.

Servicers, which include well-known banks like KeyBank but also lesser-known financial institutions like SitusAMC and PNC Bank division Midland Loan Services, have been ramping up their hiring to address the issue.

"There are a handful of special servicers who have most of these delinquent loans. Most of them had two or three people in special servicing. And suddenly they had hundreds of loans to handle," said Jim Butler, a partner and chairman of the global hospitality group at Jeffer Mangels Butler & Mitchell LLP. "These special servicers have gone on a wild hiring spree to try to hire back people who have experience."

Another factor that adds to the time delay is that special servicers are not set up to work directly with borrowers. While banks work directly with non-CMBS borrowers, the relationship is more complex with CMBS loans, since hundreds or thousands of individual loans are pooled and then sold as bonds to investors.

CMBS bondholders then get a monthly payment based on the mortgage payments from the borrowers. When one of those loans goes into default, a servicer steps in on the investors' behalf.

"Special servicers do not have any duty or relationship with the borrower," Butler said. "They owe that duty to the bondholders. Their duty is to collect, do what is best for the bond holders. … It's a different dynamic that's involved."

And what's also slowed the process is that it takes special servicers a good deal of time to properly analyze each loan and property in order to determine the best course of action.

Hotels Will Likely Be Quick to Look for Solutions

Hotels in particular have been hard hit as occupancy levels have plunged during the pandemic, and hotel owners will be at the front of a wave of borrowers seeking to ink deals with special servicers, experts say.

"The issue with the hotel is the 'lease' is only for 24 hours. Hotels feel the economic consequences sooner than other asset classes," said Suzanne Amaducci-Adams, head of real estate at Bilzin Sumberg Baena Price & Axelrod LLP. "There's not enough income to pay basic operating expenses. No business in the world can function properly on 20% income."

"It's an incredibly unusual concept in the hospitality industry for a hotel to be closed, unless it's closed for renovations. But to have this many hotels closed is really unfathomable," Amaducci-Adams added.

Butler said 20-24% of CMBS hotel loans are in delinquency, meaning borrowers have fallen behind on payments, while retail loans have been close behind, with 18-20% of those loans in delinquency. And hotel CMBS debt volume is also high, with roughly 20% of U.S. properties having CMBS loans, Butler said.

When it comes to working out deals with special servicers, the calculus largely depends on the individual property: what type of hotel it is, where it is and who the borrower is.

"This is close to a record spike in delinquencies of CMBS payments. I think we were 0.2% lower than the record peak after the Great Recession, but we are expected to blow through that, therefore achieving the highest delinquency rate of CMBS loans in history," Butler said.

Relief Could Come From Washington

The federal government has sought to provide relief to real estate borrowers over the past several months. The complicated structure of CMBS, however, has meant much of the relief hasn't been available for payments on such mortgages, although additional help could come.

A major issue is that CMBS loans generally do not allow borrowers to take on additional debt, and thus it's been difficult if not impossible to use proceeds from Paycheck Protection Program loans for CMBS debt payments.

The hallmarks of CMBS loans, higher proceeds and lower interest rates, generally come with a provision prohibiting additional indebtedness as a tradeoff.

One idea being discussed on Capitol Hill is for the next round of relief to come as preferred equity, as opposed to debt. More than 100 members of Congress sent a letter in late June to the Federal Reserve and the Trump administration asking for relief for CMBS borrowers.

"You need to do something specifically [geared] toward the commercial real estate industry," said Patrick Sargent, a partner at Alston & Bird LLP. "One hundred members of Congress on a bipartisan basis. When was the last time that happened? I'm encouraged by that."

"This is a pandemic that requires some dramatic steps. ... That would enable them to get that money without running afoul of those contract restraints found in CMBS," Sargent said.

But there are challenges to the equity approach, both on the Federal Reserve and the banking sides. Banks would likely have to be the entities that issue the equity, but they're not typically set up to issue such equity from the federal government.

"One of the challenges is the Fed's not really interested in doing preferred equity. They haven't wrapped their arms around that," Sargent said. "There are regulatory hurdles of banks owning preferred equity."

Onus Is On Borrowers to Make Their Case

While the hundreds of pages of CMBS loan documentation generally provide steps for dealing with defaults, those documents generally don't mention pandemics. So as special servicers try to figure out how to move forward, they're looking for concrete and viable plans from borrowers, lawyers say.

"Earlier on, servicers were very willing to work with the borrowers. Now, they really want to know, 'What is the plan to turn things around?' Not just, 'I need more time,'" said Carly Glover Saviano, a partner at Willkie Farr & Gallagher LLP. "They want to plan for, 'How are we using reserves? When are we back?' It has to be holistic, not just, 'Give me more time.'"

Indeed, the question is what kind of an alternative to foreclosure can a special servicer arrive at. There's no cookie-cutter answer to that, so servicers are looking for specific plans from borrowers that are tailored to the property in question. Servicers, for one, want to have a sense of when and how the borrower will start to bring in more income, thus having the funds to make future mortgage payments.

Special servicers can initiate foreclosure proceedings, but many are still trying to work out loans with borrowers rather than initiate that process. Foreclosure isn't typically attractive for special servicers, given that they don't have expertise in owning properties.

"We are in unprecedented times. It's not like you have mortgages in CMBS where you can mitigate damages by foreclosing, and foreclosing at a decent price that would make up for some of the damage," McKool Smith's Klein said.

Butler said special servicers would prefer not to take over properties and have been open to working with borrowers to reach agreements. But if the plans borrowers come up with aren't up to snuff, Butler said, "that's going to be apparent to special servicers. That will indicate that special servicers need to foreclose or install receivers."

--Editing by Aaron Pelc and Kelly Duncan.