News Article

Multi-borrower issues

Stewart Hotston interviewed by Structured Credit Investor

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Euro CMBS servicers adapting to new challenges

The role of CMBS servicers in Europe has changed significantly post-crisis. Challenges remain, however, as the market prepares to begin restructuring a raft of multi-borrower transactions.

Nassar Hussain, managing partner at Brookland Partners, confirms that the role of primary servicers has changed dramatically since the crisis - from reactive to proactive and solutions-orientated. He notes that many have adopted a policing role in CMBS restructurings that goes beyond the legal requirements in the servicing standard.

"The typical standard is to act with due care and attention, check compliance with financial covenants, and ensure timely payments and maximisation of recoveries all at the loan level. But now servicers are promoting disclosure and managing conflicts of interest between the bond level and mezz level as part of broader restructuring roles," Hussain says.

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He adds: "Servicers will have an important dialogue with lenders and noteholders when the market restarts, so the identity and role of servicers will continue to be important. Those that don't adapt will be left behind."

Further, it appears that if primary servicers take a pro-active approach, they can get paid appropriately to reflect the additional work they are asked to do and the additional risk they are asked to bear. "Borrowers are learning that if they don't incentivise transaction counterparties such as servicers to do far more work than they were originally contracted to do, they may not achieve the same results," Hussain continues.

Stewart Hotston, director Hatfield Philips International, suggests that before the financial crisis hit primary servicers were perceived almost as shepherds, but this has now changed. "Having to exercise discretion represents a change in the role of the primary servicer," he explains. "Frequently, there are gaps in the documentation where no-one's assigned the ability to make a decision; therefore, in such cases, the servicing standard can be used to take action."

He adds: "We can see the whole picture, which no-one else has the luxury of seeing, and so we attempt to hold it all together to create a consensual action plan. There is definitely pressure to do more as a primary servicer in a potential restructuring situation."

But this brings its own problems. For example, there are some cases where the consents and waivers mean that a restructuring to preserve a loan can only be done in special servicing. However, counter-intuitively, a loan can only go into special servicing when there's been a default.

Another issue is liability. Given that primary servicers often have to step into roles to which no specific party has been assigned, they are exposed to making decisions when they don't necessarily have the rights to.

Hotston says such situations beg the question about whether a distinction between primary and special servicers is necessary at all. "Why should there be, when both parties are trying to preserve the loan?" he asks.

At present, there isn't as much blurring of roles as there could be between primary and special servicers. The distinction is based on how the US market operates, with Hotston noting that the model has some positives, but they're outweighed by the drawbacks.

He says: "We'd prefer a blurring of the two roles to enable us to preserve value better as a primary servicer when there's no reason to put a loan into special servicing. We may approach noteholders about existing arrangements, but - given difficulties around consent and fees - it seems much more likely to be something for future transactions."

Hotston anticipates that such documentation will likely be revisited in the future. "Lawyers are reflecting on the fact that they may not have given leadership in the drafting of this documentation. There is openness towards revisiting legals and how to improve them."

Nevertheless, primary servicers have also strengthened their efforts in relation to junior lenders. They don't have a public profile and so HPI, for one, has established a dedicated team in this area. Junior lenders will be needed to make the market work in the future, so they need to be supported, according to Hotston.

"Their risk appetite has changed and they generally prefer lower LTVs. But they still have money and are looking to reinvest, albeit with a different approach," he adds.

However, Hussain suggests that servicers could improve their offering even further by considering the economic impact on investor returns in terms of loan extensions and the impact on note waterfalls when they exercise discretion. "Servicers typically focus on the loan level and don't interact with investors as much as they should," he remarks.

At present, one particular area of tension is between senior noteholders and both junior creditors and X note holders. Because interest to junior creditors and X note holders typically does not switch off until a loss is crystallised, it enables such holders - including originating banks - to continue taking cash out of a deal even if it is performing poorly. Recently, Citi agreed not to increase the margin on its X note as part of the Tahiti restructuring, while Goldman Sachs agreed to give up a portion of the revenue from its X note in the Fleet Street 2 restructuring.

Indeed, among the restructuring challenges that servicers face is marshalling support from the majority of all classes of noteholders for a given action, according to Hotston. He says that some ask for consent fees just for turning up, while others are strategically passive and so don't get involved.

Liquidity facilities are another problematic area in that most providers have exited the market and so it is difficult to extend the facilities if a loan is to be extended beyond current note maturities. Without such a facility, the sponsor could be left with a significant cashflow mismatch.

Rating agencies are suggesting that this could be detrimental and that they could therefore downgrade impacted transactions. Liquidity reserves are an alternative, but bring regulatory capital issues - to the extent that it may be more economic for sponsors not to securitise.

A further two challenges exist for CMBS restructurings. First is in the case where a loan appears in more than one deal and so it is necessary to restructure several affected transactions at the same time.

Second is in multi-borrower deals. "The loans all have different profiles and business cases, as well as differing B lender interests," Hotston explains. "However, focusing on multiple borrowers at one time is easier for servicers than for investors as the servicer already knows terms of each loan they manage."

He points out that many multi-borrower deals will have to be restructured over the next few years. "From mid-2011, there is a wall of refinancing for about 60% of all loans in CMBS deals (equivalent of around £80bn-£90bn) over the next 2.5 years, with most loans maturing within a year of each other."

According to Hussain, it makes sense to take a holistic approach on multi-borrower CMBS deals and restructure multiple loans and the bonds at the same time. "Multi-borrower restructurings are a question of negotiating with each borrower on a loan-by-loan basis and adjusting the note structure to reflect the chosen strategy. One issue is to ensure that if there is an increase in loan margins, this goes to the noteholders and not the X note holder, for instance," he explains.

Brookland Partners is currently involved in the first restructuring of a German multifamily transaction, which involves two servicers on the GSW loan (securitised in Windermere IX and Fleet Street 3) working together. The GSW loan is one of two in Windermere IX, but one of many in Fleet Street 3.

Meanwhile, Hussain indicates that a true European CMBS market is unlikely to re-emerge in the near term because the investor base isn't ready. "There are a number of legacy issues that need to be resolved; for example, the wall of refinancing that is due. At the moment, banks are simply extending every year. Hopefully, this will be resolved if/when markets start to recover, but if an unforeseen event occurs or banks are forced to sell, we could see a double-dip."

Nevertheless, a number of mezzanine funds - such as Pramerica, Duet, BlackRock, La Salle and M&G - have begun to exploit the funding gap in the commercial real estate sector and raise capital, albeit only around US$1bn so far. These funds are primarily focused on originating new mezzanine loans.