

Governance Issues and Default Resolution in Commercial Mortgage Backed Securities

by

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Submitted to the Department of Architecture in Partial Fulfillment of the Requirements for the
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ABSTRACT

With the increasing role of CMBS in commercial real estate lending, it has become crucial to understand the agency and governance risks that are created with the CMBS servicing structure. This study is an investigation of three key relationships within CMBS servicing, (1) between the servicers and different investor classes, (2) between the master servicer and the real estate owner/borrower, and (3) between the special servicer and the real estate owner/borrower. Through interviews with industry professionals and careful reading of the documentation that drives CMBS governance structures, the study reveals several different conflicts of interest that could significantly impact both the cash flow available to various trust investors and the underlying value of the real estate asset securing the mortgage.

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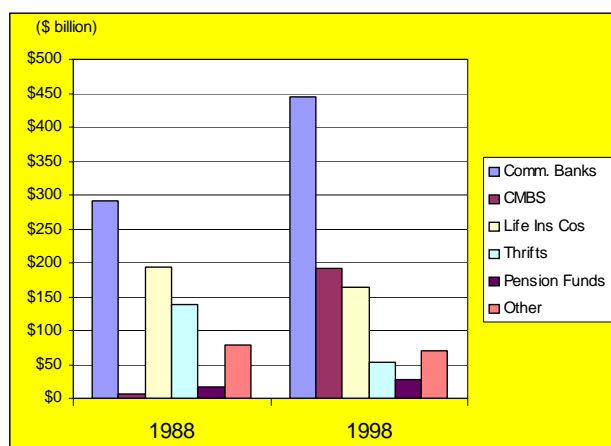
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CHAPTER 1-Introduction and Statement of the Problem

Overview: The Increasing Influence of CMBS on Commercial Mortgage Lending

The real estate debt markets have seen a radical shift over the past 25 years with the increasing dominance of commercial mortgage-backed securities (CMBS). What was once a market controlled by local lenders making loans on local projects, now has been significantly altered by the increasing impact of CMBS. CMBS issuance has increased rapidly and had reached \$100 billion worldwide by the end of 2003, “stealing” market share from traditional sources of commercial mortgage capital: pension funds, life insurance companies, commercial banks, and thrifts.

Figure 1: CMBS Market Share¹



As can be seen in the chart to the left, CMBS continues to grow as a percentage of all commercial mortgage debt outstanding. By all indications it will continue to grow. Many academic and industry studies have sought to understand the implications of CMBS on mortgage pricing, lending efficiency, and default rates. This study recognizes the

importance of going a step further to understand the implications on default resolution and the new layers of agency risk that the CMBS servicing structure imposes on both investors and borrowers. Understanding these risks will add value both to the lender and CMBS pool investor in order to more accurately price risk, as well as to the real estate equity holder/borrower, such that he is aware of these potential issues when he chooses a mortgage execution strategy.

¹ David Geltner, Public MIT lecture notes for Real Estate Finance II, Spring 2004.

What began as a solution for rescuing the loan portfolios of thrifts and banks that had been decimated by the deep real estate recession of the late 1980's and early 1990's, has now become an intricate industry. With a history originating in the Wall Street bond markets, which had already revolutionized the residential home loan markets in the 1980s with its invention of residential mortgage-backed securities (RMBS), CMBS is a market-driven securitization product aimed at both adding liquidity for traditional mortgage issuers and providing bond-like investment vehicles backed by real estate for a variety of investors, including pension funds, insurance companies and international players.

While CMBS has been remarkably successful in providing liquidity to borrowers and an increasingly near-infinite array of investment choices along the risk-reward spectrum, it has radically affected the methods of mortgage lending. As the industry has grown more sophisticated in its methods for pricing risk, it has become subject to the credit ratings system of the more traditional corporate bond markets. Loans which are generated for CMBS issuance via a "conduit" are becoming increasingly standardized and must fit within certain sets of standards, thus removing most options for "creativity" from commercial lending products. In addition, the traditional real estate relationship banking model, where the same individual or institution is responsible for originating, closing, and ongoing relationship management (or "servicing" in the CMBS world), has been done away with in the case of CMBS loans. An originator will close the loan, but almost immediately sell it into a CMBS issuance, which is then parceled out to various investors.

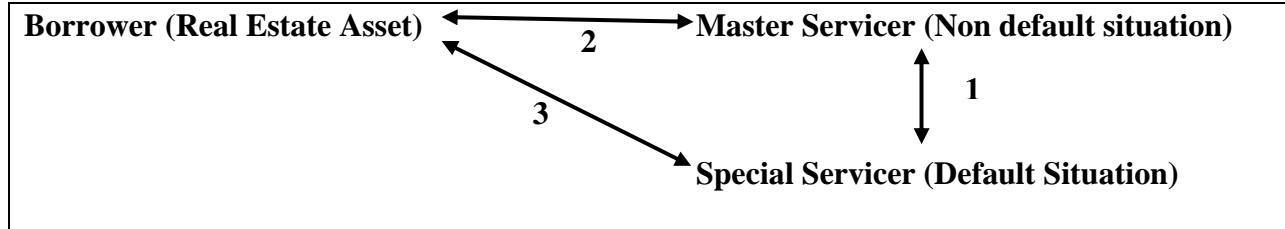
Increasingly, the pushback against a "conduit execution" as a viable option for a commercial mortgage has become "who will I be dealing with when something goes wrong?" Whereas a borrower historically dealt with the banker who made him his loan, with a conduit

execution, he must now deal with a servicer who represents all of the investors in the CMBS issuance (of which it may also be one!) The servicers are responsible for collecting payments, handling loan amendments, and resolving any type of default situation on behalf of the CMBS trust. By definition, appointing a servicer to manage a CMBS transaction does actually eliminate a significant agency risk by removing the headache of having to get deal with the twenty or more various investors who all now have an interest in an individual loan through the CMBS trust. However, this new standardized structure actually creates additional layers of agency risk that this study seeks to explore in significant detail. Apparently, borrowers are willing to take on these additional layers of agency risk, in order to reap the benefits of efficiency and rate made available by the widespread emergence of the CMBS product.

Real Estate Servicing Relationships and the Agency Risk They Create

In taking a closer look at servicing, two new layers of agency risk are now apparent. A layer of risk is imposed on the real estate equity holder/borrower and a separate layer of risk is created that intensifies conflicts of interest among the varying investors and their servicing representatives. In an attempt to better define the risks created by CMBS, this study seeks to isolate and investigate three separate relationships where these agency and governance risks are present. The first relationship deals with the internal conflicts of interests among the different servicing entities, which adds risk for the investors in the trust. The other two relationships deal with the relationships between the borrower and both the master servicer and the special servicer, adding new layers of agency risk for the real estate equity. A chart that summarizes these relationships is found below:

Figure 2: Significant Real Estate Servicing Relationships



1. Master servicer and the special servicer on behalf of the trust investors. In addition to collecting payments and ongoing monitoring, the master servicer typically handles less significant loan issues when there is no event of default, while the special servicer is responsible for “working out” or resolving default situations. Due to the governance structure of the CMBS trust, conflicts of interest (agency risk) often arise due to the various constituencies that are “represented” by the special servicer. This topic has been researched in some detail by the academic literature and is summarized in Chapter 3. Some of the initial groundwork for this study was to look at the standardization of this relationship across CMBS transactions, as the structures imposed significantly influence the actions of the servicers with regards to the next two relationships. Typically, this relationship is standardized and is almost solely focused on preserving cash flow for the investors in the trust versus preserving the value of the underlying real estate asset.
2. Master Servicer and Real Estate Equity Holder. In a non-default scenario, the borrower will deal solely with the master servicer with regards to both real estate and loan-related issues. The study looks at the impacts of the CMBS servicing structure on the underlying real estate by comparing it to a held-for-portfolio or unsecuritized mortgage. Here, the study is concerned with looking at how real estate issues are handled: signing a new lease, making a capital expenditure large enough to warrant approval, etc. Results of the

study indicate that for various reasons servicers are not very responsive to borrowers unless the cash flow to the investors has been or is threatened to be interrupted, resulting in significant ramifications for the real estate equity holder.

3. Special Servicer and Real Estate Equity Holder. In a default scenario, servicing control is transferred from the master to the special servicer. Typically, these special servicers are real estate professionals, who are seeking to maximize recovery on behalf of the trust investors. Here again, the study investigates the impacts of the CMBS servicing structure on the underlying real estate by comparing it to a held-for-portfolio mortgage. Results of the study are mixed, but seem to suggest a higher proclivity for the special servicer “waiting out” a default situation in hopes that it will correct itself than in a traditional mortgage scenario, which also has interesting ramifications for the borrower.

Throughout the study, major questions arise in how servicers are compensated, and whether that compensation really matches the incentives to protect the entire trust’s value. However, what is best for the CMBS trust in its entirety does not always benefit the underlying real estate asset and does not always benefit the junior security holder (whom the special servicer represents), making “real estate” level decisions very tricky.

By analyzing the documentation that actually governs these investments (primarily servicing agreements and the mortgages themselves) and speaking with a wide array of professionals that utilize these documents (servicers, conduit lenders, B-piece investors, securitization attorneys, and real estate borrowers), we attempt to categorize the framework that CMBS and mortgage debt investors work within. The study attempts to concisely summarize the rights and responsibilities of those involved in the CMBS default resolution process. It then

analyzes the balances of power within the relationships outlined above as they pertain to various issues of governance, in an attempt to understand how the governance patterns actually affect the underlying real estate asset.

While servicing documentation is fairly standardized, which arguably makes the CMBS work, real estate is heterogeneous and there are examples where the terms of these agreements do not necessarily seek first to preserve the underlying value of the real estate asset. Ultimately, trade-offs are a part of every business, and the lower cost of capital via increased liquidity brought about by CMBS issuance comes at a “price” for the borrower. The borrower agrees to be subject to added layers of “agency risk” via the servicing documentation that he may not otherwise have in a more traditional mortgage execution. Interestingly, the study finds that despite the rigid, standardized structure of the CMBS trust and servicing documents, the borrower in some cases actually “benefits” from less intensive control over the real estate asset by the master servicer and an increased proclivity for “working out” a default in lieu of a foreclosure by the special servicer. While not the originally anticipated results, they have interesting ramifications for the future of the CMBS industry and commercial real estate lending in general.

CHAPTER 2-Literature Review-A background to CMBS

Commercial mortgage-backed securities are a relatively recent financing innovation, yet with the increasing ease of data analysis via spreadsheets and rigorous econometric modeling, the literature around CMBS is already deep and varied. However, the majority of the research has focused on pricing analysis and default/foreclosure probabilities, while only tangentially touching on the subject at hand. Prominent studies include Harding & Sirmans [forthcoming], Esaki [1999], and Fabozzi [1999]. It is important to understand this empirical background in order to understand the magnitude of the arena of specially serviced loans and the overall results of the servicers' efforts.

Commercial mortgage-backed securities (CMBS) are a collection of commercial real estate loans, typically diversified by property type, size, and geographic location. These loans are collected from commercial banks, insurance companies, pension funds, and investment bank conduits, all of whom make loans with the intent of "selling" them into a common trust in order to provide the benefits of diversification, similar to a mutual fund. The trust is then divided into tranches, which are then rated by Standard & Poors, Fitch, and/or Moody's. The lower-rated tranches, which are typically much smaller, have lower payment priority, a higher probability of taking a principal loss, and a higher spread. These tranches are finely divided, so as to provide for most any point on the risk/reward spectrum. Payments are then made to the master servicer on behalf of the trust, and are then dispersed accordingly. Defaulting loans are handled by a special servicer; any losses are first applied to the most junior securityholder, typically referred to as the "B-piece."

With early payoff and non-payment driving losses to CMBS investors, Snyderman [1991] was the first to attempt to rigorously estimate an average lifetime default rate for CMBS,

resulting in an estimate of 12.1 percent.² Later studies in by Snyderman and Esaki in 1994 and 1999, found results of 13.8 and 16.4 percent respectively.³ In addition to default rates, Snyderman and Esaki [1999] both attempted to estimate how much the trust could expect to lose once a default has occurred. The studies estimated this “loss severity rate” on foreclosed loans to be 32 and 34 percent.⁴

In an attempt at replicating and updating earlier studies by Snyderman and Esaki, Srivastava [2003] utilized a new set of almost 79,000 securitized commercial mortgages in an attempt to better quantify default frequency, loss severity, economic loss, and imputed yield. In order to more rigorously quantify loss severity, Srivastava estimates an opportunity cost for the estimated duration of the foreclosure process. His study captured a set of time variables, including dates of default, bankruptcy, and eventual foreclosure that begin to shed light on the default resolution process. Srivastava’s estimation of the “timing” aspect of the default resolution process proves to be an interesting precursor to our study: there is a real cost to the lender working out a defaulted loan. Unlike Snyderman before him, Srivastava’s study showed that default rates actually peaked in the third year, yet was consistent with prior estimates of loss severity estimates with a result of 33.78 percent.⁵

Stepping back, it is important to understand the theories behind secured debt in general, not merely in CMBS or commercial real estate mortgages. Securing debt with hard assets is the oldest form of lending. A recent study in the Michigan Law Review [Mann 1997] traced the

² Mark P. Snyderman, “Commercial Mortgages: Default Occurrence and Estimated Yield Impact,” *Journal of Portfolio Management*, (Fall 1991).

³ Mark P. Snyderman “Update on Commercial Mortgage Defaults,” *Real Estate Finance Journal*. (Summer 1994), p. 22-32.

⁴ Howard Esaki, Steven L’Heureux, and Mark Snyderman, “Commercial Mortgage Defaults: An Update,” *Real Estate Finance*, (Spring 1999).

⁵ Rohit Srivastava., “Default Study of Commercial Mortgages in CMBS Pools,” MIT Masters thesis, 2003.

loan histories of 100 secured loans with various types of collateral in an attempt to determine the characteristics of loans that are eventually forcibly foreclosed upon. His results were surprising, finding that most work-out situations never reach the point of needing to exercise force in liquidating a secured position, solved in the interim by refinance/renegotiation, the borrower declaring bankruptcy, etc.⁶ This proves to be an interesting insight for this study, which seeks to understand why this may or may not be different in the case of a special servicer attempting to resolve a defaulted CMBS loan.

Among those who have looked more at the default resolution process for real estate loans, studies have focused on the residential home loan market or commercial real estate “whole loans” as opposed to securitized (CMBS) loans. Among the commercial loan studies, a recent investigation by Ciochetti and Riddiough has proved helpful.⁷ The authors have conducted comprehensive studies on the commercial mortgage foreclosure process and have further categorized those defaulted loans by the termination outcome: standard foreclosure, loan modification, or whether the lender was made whole by an outside party who purchased the property just prior to foreclosure. These studies are different from prior studies, including Snyderman [1991] and Fibozzi [1999] in that they focus solely on loss recovery once a loan defaults. The study’s limitation in terms of direct applicability to our work is that all were performed on held-for-portfolio loans made by life insurance companies, which have a somewhat different legal and governance framework. An article with a similar methodology is by Phillips and Rosenblatt, which regressed different independent characteristics of “problem”

⁶ Ronald J. Mann, “Strategy and Force in the Liquidation of Secured Debt,” *Michigan Law Review*, (November 1997).

⁷ Timothy Riddiough and Brian Ciochetti, “Foreclosure Loss and the Foreclosure Process: An Examination of Commercial Mortgage Performance,” *Real Estate Research Institute Working Paper Series*, (Spring 1997).

residential home loans (size, LTV etc), against three default resolution strategies (bankruptcy protection, surrender of deed to the lender, and pre-foreclosure sale).⁸

In another study by Ciochetti and Riddiough the authors work with 480 mortgages, looking primarily at foreclosure time-period, net loss recovery and yield degradation. A key result is that the average delinquency/foreclosure time-period for all loans is slightly greater than one year:

Loans previously modified are found to average much shorter foreclosure periods, suggesting that lenders may attempt to minimize losses once a modification strategy is determined to be unsuccessful. Loans subject to judicial foreclosure procedures are found to take approximately 2.5 months longer to foreclose than those foreclosed through non-judicial means.⁹

Net loss recovery is found to average 73 percent of the outstanding loan balance. On average, all loans subject to foreclosure are found to suffer 5.4 percent in yield degradation; which the authors define as the difference between promised and realized return.¹⁰ The authors' work is useful for understanding the performance of defaulted CMBS loans as well, but, importantly, the study highlights the need for a further understanding of the shifting of default risk to lower priority tranches within CMBS in order to accurately rate and price CMBS securities.

Archer et al [2002] take issue with a solely statistical evaluation of the default resolution process, claiming that a low Loan-to-Value (LTV) does not necessarily mean a lower risk of default, as often lenders require lower LTVs when originating a loan to mitigate increased perceived risk. Their study finds that the strongest predictors of default are property-level

⁸ Richard A. Phillips and Eric M. Rosenblatt. "The Legal Environment and the Choice of Default Resolution Alternatives: An Empirical Analysis." *Journal of Real Estate Research*, (1997), pp.145-54.

⁹ Brian A. Ciochetti and Riddiough, Timothy J., "Timing, Loss Recovery and Economic Performance of Foreclosed Commercial Mortgages," (March 1998).

¹⁰ Ibid.

characteristics, including zip code location and initial debt service coverage ratios.¹¹ While not as directly applicable to our work, these findings are worth mentioning, as it highlights the fact that there is more affecting the resolution process in CMBS than just understanding leverage, default rate probabilities and loss severities.

Most of these studies do an excellent job at quantifying losses, but do not spend much time investigating the impact of the servicing structure on the default resolution process or their impacts on the value of the underlying real estate asset. More fundamentally, whether the governance policies, procedures and standards that are in place are actually “best practices” is never questioned. Several of the studies assume that the servicing structure is working correctly because of the relatively constant loss severity rates and workout durations. The studies do not attempt to understand the agency risk impacts of the servicing structure on defaulting loans, as compared to a more traditional held-for-portfolio execution. Seeing this missing piece, this study seeks to further investigate the impact of the CMBS governance and servicing structure on mortgage lending, default resolution, and ultimately the value of the underlying real estate asset.

¹¹ Wayne Archer, Peter Elmer, David Harrison, and David Ling. “Determinants of Multifamily Mortgage Default,” *Real Estate Economics*, Vol. 30 No. 3, (2002), pp 445-473.

CHAPTER 3-Relationship #1-the Master Servicer and the Special Servicer

Overview of the Servicing Industry

Before attempting to understand how the servicing structure impacts the value of the underlying real estate asset, it is important to understand the theoretical justification for the servicing structure. Referring back to the introduction, this chapter seeks to define the theory and the “nuts and bolts” behind the first set of relationships created via the CMBS structure: those that govern the master and the special servicer as they attempt to protect the rights of the various securityholders. Understanding how these entities seek to maximize value for their constituent investors lays the framework for how a servicer interacts with an individual real estate equity holder. The chapter also explores the conflicts of interests between the servicers and different classes of the CMBS security, contributing to the first level of agency risk for investors, as first mentioned in Chapter 1.

With a few exceptions, the best literature surrounding servicing and governance issues has actually been generated by industry research analysts. The rating agencies keep an updated literature for purposes of informing the market about the criteria they use when issuing ratings on CMBS transactions, which in turn directly affects the structure pricing of the CMBS securities. Most of the standardization within the industry that is discussed at length later in the chapter has been codified by these agencies: Standard and Poor’s, Moody’s, and Fitch.

Two recently published articles provide a significant service to understanding the precise nature of CMBS governance. One, “US CMBS Legal and Structured Finance Criteria” by Standard & Poors [2003], describes all of the relatively standardized legal processes and structures that underpin the industry, servicing basically a legal handbook for the industry.¹²

¹² Gale C. Scott, ed. “U.S. CMBS Legal and Structured Finance Criteria,” *Standard & Poors, Structured Finance Publications*, (May 1, 2003).

While useful, it does not qualitatively address issues with much substance. Instead, it provides the baseline from which all transactions are expected to start from. This work will be referenced extensively throughout this chapter, as an illustrative summary of the similarities between deals and as confirmation of the author's own reading of several Servicing and Pooling Agreements.

In somewhat of a contrast, Fitch ratings issued the "State of the CMBS Servicing Market" [2003], as a qualitative analysis of some of the more significant "issues" affecting the CMBS industry. It seeks to both question the accepted norms and look at items that actually do differ between CMBS deals. Among the more significant issues raised in this study include competition for servicing contracts and the resulting consolidation of servicers, increasing investor and regulatory requirements, the impact of technology and outsourcing, and the increasing complexity of transactions.¹³ These issues will be handled in more depth periodically throughout the study as they relate to how the broadly accepted CMBS governance framework is (or is not) responding to current trends in the industry.

Theories of Governance

A CMBS security is typically structured in such a way that there is a hierarchy of returns and priority on payment as one moves up the stack of tranches. The unrated or B pieces form the true first-loss pieces of the transaction: when a defaulted loan results in a partial repayment of principal, it negatively impacts these classes first. In return for this higher risk, these tranches receive a much higher ex-ante return. Moving up the capital stack into the A-rated tranches, the risk/reward equation reverses. The highest rated bonds are the first to be paid back, and hence

¹³ Richard Carlson and Stephanie Petosa. "State of the CMBS Servicing Market" *Fitch Ratings, Structured Finance Publications*, (January 6, 2003).

have the tightest spread and shortest duration. In general terms, the master servicer on a transaction collects payments and monitors “performing” loans. The special servicer takes over a particular loan usually once it goes beyond the 60-day past-due stage and is charged with either returning it to the performing asset pool or extracting the most value from it on behalf of the trust, if it needs to be liquidated. A useful model is found in Chen and Deng [2003], and is reproduced below.¹⁴

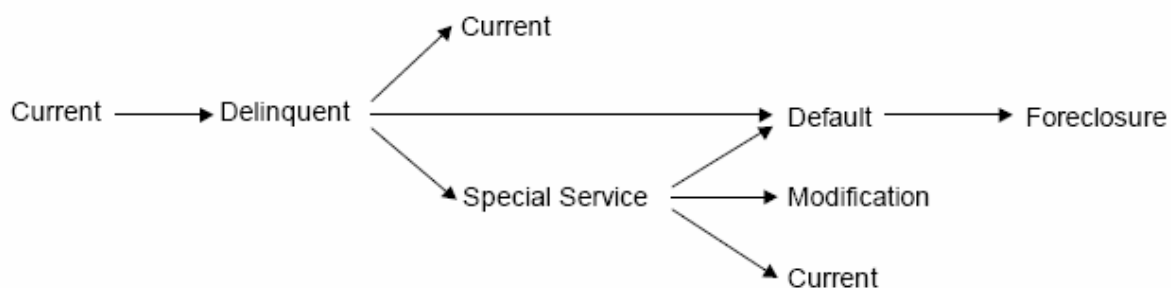


Figure 1. The Default Process

Keeping these basic tenets of CMBS governance and structure in mind, several academics have thought about how the process of default resolution, liquidation, and renegotiation should be handled in such a security. Most notably, Riddiough [1997] attempts to answer the question of whether the senior or junior security holder should exert the controlling influence over special servicing issues. He argues that a combination of better asset level information and the “first-loss” nature of the junior security holder make it the most effective controller of special servicing issues.¹⁵ This is the opposite of typical corporate situations where the senior debtholders normally drive the process of working out a default situation.

¹⁴ Jun Chen and Yongheng Deng, “Commercial Mortgage Workout Strategy and Conditional Default Probability: Evidence from Special Serviced CMBS Loans,” USC working paper, (March 2003), p. 4.

¹⁵ Timothy Riddiough, “Optimal Design and Governance of Asset-Backed Securities,” *Journal of Financial Intermediation*, Vol. 6, (April 1997), p. 124.

Riddiough goes on to describe a junior securityholder, who typically has superior asset valuation information that the senior securityholder does not have or simply does not care about, because there is so much subordination behind him. The fact that the junior securityholder has better information (and is usually a true real estate professional as opposed to a trader, portfolio manager, or accountant) gives it more leverage to work with the borrower in a default situation. The fact that any loss is coming out of his pocket first provides incentives to the junior securityholder to fully utilize its superior information and negotiating leverage.¹⁶

Riddiough does point out potential conflicts. Having the junior securityholder control default resolution should maximize the ex-post security value, but, in theory, it makes the up-front security design much more difficult.

Because the junior securityholder's claim has equity-like payoff characteristics, she will generally prefer to "play for time" by extending the loan term. This, in turn, may generate an ex post wealth transfer from the senior securityholder to the junior securityholder and therefore reintroduce information sensitivity into senior security valuation. In response to this combined moral hazard/adverse selection problem, the security can be redesigned. Doing so results in adjusting subordination levels upward to eliminate the preference for loan extension.¹⁷

This results in a senior security that effectively has a discounted value due to the extension-related default risk. The securities are hence redesigned by increasing subordination to prevent a corresponding discount in price.

Higher subordination levels reduce the proceeds from senior security issuance, however, and may ultimately result in the issuance of risky (i.e., discounted) junior debt. As a consequence, issuers may instead find it advantageous to impose restrictions on loan extension in order to reduce subordination levels, and therefore to improve issuance proceeds.¹⁸

In addition to Riddiough's theoretical analysis of CMBS security design, Chen and Deng [2003] have recently completed a study that statistically analyzes default resolution in CMBS

¹⁶ Ibid., p. 138.

¹⁷ Ibid., p. 138.

¹⁸ Ibid., pp. 124-5.

and have partially inferred the impact of security design on their results. The authors find that special servicers make their strategic decisions based on: (1) the real estate space market conditions (market-level NOI growth rates and vacancy rates) and (2) the equity position in the mortgage.¹⁹ From their analysis, they make the final conclusion: “special service seems to be functioning as it reduces the probability that a troubled loan will default (or need to be foreclosed on).”²⁰ This study plans to take a closer look at how servicing rights and governance actually work in practice, in an attempt to decide whether Chen and Deng’s final conclusion is warranted.

As can be seen above, several scholars have investigated the theoretical framework surrounding the relationship between the servicing entities and the investors. The remainder of this section will actually lay out how this is done in practice: the nuts and bolts that govern the relationship between servicing entities that both create and, and at the same time, attempt to mitigate the first layer of agency risk created by the CMBS structure. This section provides a framework for understanding how servicing entities (on behalf of varying security holders) are permitted to negotiate amongst themselves and how this significantly impacts the ways that they address the real estate asset. The servicers’ relationship with the borrower (relationships #2 and #3 from above) will be further explored in Chapters 4 and 5.

The rights of the subordinated tranche...nuts and bolts issues of control

In reality, CMBS trusts are structured very similarly to Riddiough’s theoretical framework for governance that is discussed above. Industry professionals estimate that roughly 80 to 90 percent of the documentation that governs CMBS primary, master, and special servicers is common across transactions. The master and special servicers can be represented by the same

¹⁹ Chen and Deng, op. cit., p. 21.

²⁰ Ibid., p. 22.

institution, and the special servicer and the B-piece buyer are often the same entity. As noted above, the B note buyers take the most risk, and usually buy into the CMBS trust at a discount with initial ex-ante expected yields of up to 28 percent. However, this return is significantly reduced with even small amounts of losses, and hence there is an incentive to minimize losses from the outset. Since they are the first “at-risk” piece, as Riddiough predicts and special servicing professionals confirm, the B-piece, will, in theory, make the best decisions and usually have their own special servicing unit to protect their interests.

However, conflicts can arise within this structure, as the special servicer is actually entrusted with maximizing value for everyone, not merely the B-piece, leading to the first layer of agency risk created by the CMBS servicing structure. The “servicing standard” or fiduciary responsibility of the special servicer is to make decisions that are in the best interests of all investment classes. In the event of default, the AAA investor most likely will be looking for the quickest resolution even if it involves a small loss of principle, because there is so much subordination behind him. As summarized by one special servicer, this is opposed to the B-piece, who will be more likely to delay and “work out” the loan more deliberately, as any loss that is incurred will significantly affect his return immediately.

The division of rights is complicated for the special servicer. The B-piece holder essentially directs the special servicer on key issues such as foreclosure, lease assignments, loan assumptions, and any sort of payment default. The special servicer is quick to follow the direction of the B-piece buyer, as the B-piece usually reserves the right to remove them virtually without cause, and replace them with a new servicer, who will be more likely to align itself with the direction of the B-piece holder. This clearly clouds the special servicer’s overarching goal to maximize the benefit for all classes. The balance usually is found in how the special servicer is

compensated (via direct fees, liquidation fees, success fees, and others), which will be discussed below. In reality, a complex web of checks and balances, all the while influenced by the servicers' overall profitability, govern the world of default resolution.

Actual rights, options and remedies of the special servicer

As mentioned above, servicing agreements are actually quite standardized across deals. Given the lack of such a summary among the academic literature, the following sections outline the most crucial actual rights and options that servicers typically have in a CMBS transaction. Most pooling and servicing agreements are hundreds of pages long, thus leaving the following summary of those issues that are most significant to the structure and to the agency risk imposed on investors.

While discussed at greater length in Chapter 5, the junior securityholder via the special servicer has “final say” over a wide variety of amendments in a default resolution situation.

These amendments include:

- Foreclosure
- Modification or waiver of a monetary term, including the timing of payments, or any material non-monetary term
- any proposed sale of an REO Property out of the trust for less than the outstanding principal balance. For purposes of this study, REO is defined as Real Estate Owned, or a property which is in the possession of a lender as a result of foreclosure.
- any acceptance of a discounted payoff with respect to a specially serviced mortgage loan

- any determination to bring an REO Property held by the trust into compliance with applicable environmental laws or to otherwise address hazardous materials located at the REO Property
- any release of collateral or acceptance of substitute collateral for a mortgage loan in the trust
- any release of "holdback", earn-out or performance reserve funds, or return of any related letter of credit delivered in lieu of such reserve funds, to the borrower under any pooled mortgage loan
- any waiver of a due-on-sale or due-on-encumbrance clause, and
- any acceptance of an assumption agreement releasing a borrower from liability under a pooled mortgage loan.

All of the above are different strategies that the special servicer will utilize to work out a defaulted mortgage, not unlike a typical portfolio mortgage lender would do. What is so different from a governance point of view is that the vast majority of the investors (however protected they are from principal loss by subordination) have no say in matters of such significance. While the servicing standard maintains that the special servicer must do what is best for all investors, the key issue to keep in mind with regards to agency risk is “what is to keep the special servicer “honest” in going about its default resolution process?” Obviously, a special servicer’s reputation drives a master servicer’s and investors’ comfort in the actions of the special servicer, but are the additional controls, both structural and compensation-based, described below enough to mitigate the risk? Riddiough’s theoretical governance structure dictates that “what’s best for the junior securityholder ultimately is best for the senior

securityholder.”²¹ In a majority of situations this is the case, but, after talking with industry professionals, it is apparent that there are instances when this may not be true.

Structural Checks and Balances

The aforementioned list of methods special servicers use to address defaulting loans in most cases deal with amendments to the terms of the underlying mortgage. However, as with most legal documents, the pooling and servicing agreements that govern the CMBS trust can also be amended should the transaction in question change over the course of its life. If a change were to occur, it is standard to have a two-thirds vote to amend minor issues. 100 percent approval is needed on major issues, such as timing or amount of payments. However, after speaking with a variety of professionals, it is rare that an amendment is actually enacted to the actual pooling and servicing agreement, but the option is there. Similarly, the same “bad boy” carveouts are present in these agreements as are present in most legal documents. Upon major cases of negligence, the trustee, who usually is a passive party in the servicing process, can actually replace either or both the servicers.²² Again, it is rare that these events of default are present, as the reputation risk for a servicer in such a highly competitive business would in most cases not warrant the improprieties listed therein. With this knowledge, what other safeguards exist to keep servicers honest and with significant enough “skin in the game” to ensure best results for all securityholders?

One such structural issue was probably not initially intended to keep servicers in check, but instead to provide sufficient liquidity for the operation of the trust. CMBS trusts require that a financially liquid party (usually the servicer) be liable for “matching” payments: to advance

²¹ Riddiough 1997, op. cit., p. 130.

²² Scott, op. cit., p. 61.

funds to the securityholders of the trust when the payment dates of the underlying mortgages do not match up with the payment of the trust. This mismatch can be due to the terms of the underlying mortgage or is due to a defaulted payment from the underlying mortgage. It is important to note that these advances are not intended to provide credit support, due to the fact that these advances are ultimately reimbursable from proceeds payable to the senior bondholders, but provide liquidity only.²³

In some situations, this is another profit-center for the servicer, as it actually charges interest when it advances funds on such a basis. However, in exchange, the servicer now has its own cash at risk. In addition, at times, the servicer is required to advance funds to the borrower from reserve accounts in support of items at the real estate level (i.e.-an environmental concern or tenant improvement expense) or to advance in a situation where the advance may not be “recoverable” and hence could take away from the return of the senior investors. In the case of potentially problematic assets, these advances should be ultimately repayable via future payment from interest, insurance or liquidation proceeds, or ultimate workout of the mortgage loan; in the meantime the servicer essentially is protecting the asset with its own cash: it now truly has skin in the game. If the ultimate goal is to get it’s advances back, it will work hard towards a solution that benefits all levels of securityholders.

Recently, the key issue with regards to advancing has been the definition of “recoverable.” Several industry professionals have mentioned that it has ultimately become one part of the pooling and servicing agreement that is actually starting to differ between transactions depending on the parties involved. The argument over when an advance becomes recoverable is an important one, as it really opens the door for dangerous agency risks for senior bondholder. Recently, several trusts have documented within their pooling and servicing agreements a time

²³ Ibid., pp. 55-7.

limit for advancing funds against loans that are in default, in an attempt to clarify the line between a prudent servicer working out a loan to ultimately benefit all classes and an overly aggressive servicer, who recklessly continues to advance in a “non-recoverable” manner at the expense of the senior bondholders, in hopes that the defaulting asset will eventually work itself out and he will not take a large loss.

Compensation

The structural sections of the pooling and servicing agreements and advancing are useful, but the ultimate balancing factor is compensation. The typical fees in the servicing documentation are fairly standardized across deals, but play a crucial role in the performance of the special servicer and aligning his interests with those of all securityholders. For the most part, these fees provide proper incentives to the special servicers to act in the best interest of the entire pool (times when this is not the case will be discussed further in Chapters 4 and 5). Compensation is a crucial issue: the manner in which servicers are compensated can create conflict and significantly impact business decisions at the asset level. Cho and Han [2003] aptly discuss the differences in the fee structure of servicing agreements.

Because special servicers usually possess more expertise in managing delinquent loans, they charge a higher fee that is in the magnitude of 50 to 100 basis points for servicing delinquent loans and 150 to 200 basis points for foreclosure and liquidation (Han 1996). As a comparison, the regular annual servicing fee is in the range of 3 to 17 basis points (Han 1996 and Shilling 1995).²⁴

A careful reading of several pooling and servicing agreements yielded the following summary of the most significant fees due to the different parties in a servicing arrangement:

²⁴ Chen and Deng, op. cit., p.2.

Master Servicer

- Master Servicing Fee: typically in the neighborhood of 5 to 10 basis points
- (split with Special Servicer)-late payment charges, default interest and modification fees, assumption fees, earnouts, and consent or waiver fees for modification.

Special Servicer

- Special Servicing fee: approximately 25 basis points per annum based on principal amount on specially serviced mortgage/REO property
- Workout fee: typically 1.0 percent, which is paid on total principal balance plus default interest once it is worked out after having been a specially serviced mortgage loan. What is important to note is that although workout fees are intended to provide the special servicer with an incentive to better perform its default resolution duties, the payment of any workout fee may actually reduce amounts payable to the senior securityholders, as workout and liquidation fees are structurally superior to principal reimbursements. This is another agency risk for senior bondholders, who must trust that the lucrative workout and liquidation fees paid to the special servicer ultimately serve all bond classes per the “servicing standard.”
- Liquidation fee: typically 1 percent with respect to any specially serviced loan for which the special servicer obtains full, partial or discounted payoff from the related borrower (or if it generates liquidation, condemnation or insurance proceeds). Again, this fee “comes off the top” and impacts the principal reimbursement of the investors.
- (split with Master Servicer)-late payment charges, default interest and modification, assumption, assumption application, earnout, consent/waiver fees

Another source of compensation is the servicer's float, which is essentially interest that the servicer earns due to the fact that some payment dates on the loans are sooner than payments on the bonds. In addition, the servicer can earn a "float" on the reserve accounts that it manages. Deals are priced with regards to servicing fees up-front with certain assumptions about earnings from the "float" and fees. In deals where reserves are minimal (and hence the float is minimal), the actual servicing fee should increase to compensate. However, this often surprisingly is not considered when the underlying mortgage assets are originated, because the servicer is a separate entity. The aggressive pricing tactics of originators often force servicers to accept smaller servicing fees. When the origination organization and the servicer are from the same institution, collaboration is often times easier. As highlighted by one servicing professional, this prevents some of the price squeezing on the servicing fee that often occurs by originators, who are trying to reduce the fees to investors in order to achieve a tighter execution at the front end of a CMBS transaction.

There can be some difference in how special servicers approach some more minor real estate and compensation issues. In some transactions, if the borrower wants to assume its loan, the special servicer does the background work and presents its recommendation to the rest of the trust via the master servicer for approval. However, some special servicers are not equipped to handle this type of task (usually driven by the infrastructure of that particular special servicer) and they allow the master servicer to do the analysis. The special servicer just checks off on that work and they split the fee that would normally be due solely to the special servicer.

The structure of these payments and the servicing agreement in general sometimes creates situations where neither the master servicer nor the special servicer wants control of an asset. If a special servicer gets a payment because of a technical default, it will take the asset,

cure the default, and then push it back to the master servicer, since it has already collected its fee and will try to minimize future work after this payment. However, the master servicer does not receive any sort of workout fee and hence will try not to take it back, because it only wants performing loans, and will be concerned that another default may occur; otherwise known as “servicer ping pong” according to one special servicing professional.

A summary of the potential types of conflicts and how they affect the related parties.

Despite the compensation and structure build into the servicing agreements, the nature of the governance structure creates situations where an agency risk arises, causing conflicts of interests between servicers and different investor classes:

- **Conflict due to the servicer, representing the junior class, being the first loss piece.**

As mentioned above, when a mortgage loan is in default and the value of the mortgaged property is not sufficient to pay the loan in full, the junior classes are in the first loss position. With a sizable loss looming, the junior classes may wish to extend the loan, where as the senior classes may not be impacted with an immediate foreclosure. The conflict arises when the mortgage is extended “beyond a point where it is in the best interest of the holders of the rated securities as a collective whole.”²⁵ In continuing to extend the loan, the servicer continues to advance as well. If these advances are deemed unrecoverable, they would be charged against all the investors in the trust.

- **Servicer wants to act correctly but is deterred by the junior bondholder.** Sometimes a servicer may attempt to make a decision according to the servicing standard that benefits all bondholders and is then instructed by the “directing class” not to take action.

²⁵ Scott, op. cit., p. 62-4.

The entire trust now faces the threat that the junior bondholders made the wrong judgment. “In all transactions, however, the holders of the rated securities must be insulated from this risk by the servicer's obligation to act always in accordance with the servicing standard regardless of the instructions of the directing class.”²⁶ Despite the “servicing standard” that is expected of the special servicer, ultimately the junior securityholder has the ultimate control and can exert that control at the expense of the other classes of investors.

- **Decisions are made by a “B” interest outside of the trust.** As Appendix A describes, transactions that have large loans often have a "B" interest outside of the trust or others may have mezzanine financing associated with them.

Other conflicts of interest may arise if the servicer holds an interest in a mezzanine loan or an equity interest in the related borrower. If the servicer holds such an interest, it has an incentive to avoid foreclosing the related mortgage loan because a foreclosure would result in a loss of its investment.²⁷

Often, these mezzanine debt investors that are outside the CMBS trust are given “cure” rights in order to take care of a default situation before allowing the loan to be handed over to the ultimate judgment of the special servicer. This can further delay payment to the trust bondholders.

- **Sale of Defaulted Mortgage Loans and REO Properties**

Virtually all CMBS transactions allow special servicers to sell defaulted loans and REO properties at par in order to recoup at-risk principal. Obviously, sometimes “par” is not achievable and the property needs to be sold at a discount. There is now a quite obvious

²⁶ Ibid., p. 63.

²⁷ Ibid., p. 64.

potential conflict of interest. Many B-piece buyers seek this opportunity and if the theories of governance are correct, have much better information to make an educated bid. The servicer is now in a precarious situation: he must represent the best interests of the trust (and the rated security holders) by getting the maximum value for the asset, while the junior security holder, who controls the special servicer's employment at will, wants to buy out the asset. What protects the interests of all parties in such a situation?

In such a situation, the trustee in a sense takes the role of arbiter or overseer, as he must verify that the price for an REO property is fair via an independent appraisal. What becomes more of a "judgement call" is with regards to a defaulted mortgage loan. While seemingly more straightforward (i.e.- the purchase price should equal the principal balance plus any accrued unpaid interest expense), the "fair value" is somewhat more difficult to determine.²⁸ The special servicer must balance this amount with what it could anticipate receiving in through a workout process, in theory estimating "opportunity cost" and the risk that there will be some sort of additional material change in the defaulted mortgage during a sometimes lengthy process. So, again, if the special servicer or junior securityholder exercises a purchase option on a defaulted mortgage, ultimate review must revert to the master servicer or the trustee to ensure that the value is actually "fair."²⁹ In the meantime, the special servicer is expected to attempt to pursue other strategies for resolving the default, but if it really wants the property or mortgage in question, how is the special servicer ultimately held accountable? Will it still work as hard in the best interests of the ENTIRE pool of security holders or at times would it be in the best interests of the special servicer to "drag its feet" to ensure a favorable outcome for itself?

²⁸ Ibid., p. 61.

²⁹ Ibid., p. 61

The rating agencies must evaluate whether there is sufficient protection within the pooling and servicing agreements to prevent such an occurrence from happening, but is an approval right by the master servicer or trustee enough? The compensation that a special servicer receives for working out a loan comes in to play here as an additional incentive to balance.

All of the previous situations are examples where the servicing structure imposed by CMBS has agency risk implications for the different classes of investors of the trust and can significantly alter the way that a servicer will act with regards to a particular asset. In most cases, industry professionals indicate that this structure is sound, but there are more than a handful of contentious situations that would be less strenuous in a held-in-portfolio situation where the lender and the borrower negotiate one-on-one, as the next two chapters attempt to highlight in greater detail.

CHAPTER 4-Relationship #2-The Master Servicer and the Real Estate Asset

As described above, the history of CMBS structures began in the bond markets. Most everything about them was designed to standardize the contracts. As reinforced by one industry veteran, it is important to note that these documents were created by tax and bond attorneys, such that the rating agencies could easily “sign off” on them. To quote the same veteran, who succinctly highlights one of the initial motivations behind this study:

The original purpose of this structure was to facilitate a quick transfer of credit risk from the banking industry to the capital markets. Bonds have relatively simple payment terms and are quite often so generic that their terms do not reflect the underlying collateral because the bond buyer (at least the senior bond buyer) is essentially buying the rating. Nobody is focused on “what happens if...?” scenarios, because the goal was simply to move the paper to the capital markets, not how do we make the structure work in the inevitability of a default under the bonds.

In short, CMBS were NOT created by real estate professionals, who would be more likely to be concerned with what happened when a real estate issue needed to be resolved. This leads us to relationship #2, that between the real estate asset holder and the master servicer. As we mentioned before, the master servicer is primarily concerned with maintaining the cash flow to the bond holders. Since the vast majority of the CMBS investor base is made up of senior bonds, the documents actually support the senior bond holders more than necessary, that is reinforcing a more “bond-like” structure.

In effect, what exists are two levels of documentation: the servicing-specific pooling and servicing agreements, which predominantly are concerned with the value of the trust and the individual mortgages, which are obviously more concerned with the underlying real estate asset and its associated value. The servicing contracts themselves are not really designed to “fit” the

underlying real estate: in essence, there are two separate sets of documents that are coordinated in a more or less standard fashion.

In the ordinary course of the master servicer's business, i.e.-timely payment collection, this structure works well. However, issues begin to surface when a covenant governed by the underlying mortgage document needs resolution, but no payment default exists. For example, the borrower needs approval to sign a new significant lease or to make a major capital expenditure on the project with an accompanying advance from a reserve account. These types of situations can be tricky for master servicers, who have thousands of different mortgages in their portfolios.

One solution that some industry veterans have proposed is standardizing the underlying mortgages that are sold into the trusts. In theory, this would make the job of the master servicer easier, if he knew exactly how a mortgage handles certain situations. The merits of such an argument are debatable, as a standardized mortgage does not best service the real estate, which is by its nature heterogeneous and needs some flexibility. Regardless, at the heart of the issue is how the documents are actually enforced: the problem is not in the documents themselves, but the attention paid by the master servicers to the issues raised by them. If a loan is performing, the master servicer is less likely to care about real estate related issues. Of course, the ways in which the mortgage is actually enforced are quite different once a default occurs and the special servicer is involved. This is relationship #3 and will be covered in the next chapter.

Upon talking to borrowers and securitization attorneys, master servicers are not responsive to the needs of the owners in these types of situations. Owners who are trying to follow the contract that they originally signed are attempting to do the right thing, often to be stonewalled by the master servicer. On securitization attorney's view was that master servicers

almost treat borrowers as a nuisance: “if [the master servicers] only return every 5th call, the borrower won’t bother you as much.” What actually contributes to this lack of effective responsiveness on the part of the master servicer is addressed in the next section.

Making this problem even worse is the increasing use of “sub-servicers,” a situation where a master servicer will contract out parts of its servicing workload. In this situation, not only does a borrower not know what individual to talk to when he calls, at times he may not even know the institution that is handling his loan.

Property owners displayed significant frustration with master servicers’ lack of interest, capabilities and incentive to work with the borrower. One property owner complained that they will only refer to exactly what the document says once a borrower gets a live person on the phone. This same owner highlighted significant issues when dealing with any change to “dealpoints” and funding tenant improvement money from reserve accounts when more funds were needed than originally anticipated. “A bank will at least talk to you, but working with a conduit lender is like talking to a wall,” complained one borrower, who once had an experience with a master servicer taking 120 days to act on a simple \$4 million loan assumption. Despite having any real grounds, the borrower actually had to threaten a lawsuit on the master servicer, just to get them to take action.

Reasons for the lack of responsiveness on the part of the master servicer

1. Compensation

The major issue that drives this lack of responsiveness is the increasing tightening of the spreads earned by master servicers. Basically, a 10 basis point servicing fee, and sometimes less, is not enough to keep the master servicer responsive to non-default

related issues. The rating agencies have supported the establishment of an industry-wide minimum master servicing fee; recent proposals were not less than 15 basis points. Until recently, in fact, one rating agency actually used a 15 basis point master servicing fee as a baseline when underwriting and pricing transactions, whether or not that is what the servicer actually was paid or not. While the information demands of investors continue to increase, the master servicing professionals are earning less and less. The bottom line is that master servicers do not get paid enough to pay attention to real estate related issues. So long as the senior investor is getting paid on time, the master servicer sees his job as complete.

2. Lack of real estate knowledge

In general, master servicers are not real estate professionals. Those institutions that have both master and special servicing functions staff these areas quite differently: the special servicing or workout groups employ the higher-earning, real estate professionals. While master servicers have invested significant amounts of money in personnel to generate automated systems and intricate reports, industry professionals have questioned how good that data actually is. In addition, the data is only as good as the individual who is using it. The master servicers simply are not staffed with the expertise to react appropriately to complex real estate issues. As Riddiough predicts, the special servicers will usually be at an advantage because they have better information. They hire real estate professionals who know how to interpret the relevant data and make crucial decisions with that information.

A good example of this was the recent terrorism insurance debate that arose after the September 11th tragedy. Maintenance of insurance is a master servicing issue, yet

many servicers had to bring in investment bankers and real estate professionals from the lending conduits to evaluate the existing policies. Understandably, that was a very difficult issue for the entire real estate industry, but without the real estate expertise, it was difficult for master servicers to get up the curve and adequately take care of it in a timely fashion.

3. “Its not my job”-holding master servicers accountable

Ultimately, the master servicers are not being held accountable for the work that they are doing (or not doing, as the case may be). Some of the blame goes back to the conduit underwriting process, as underwriters will in theory take more risk when they are not underwriting for themselves. The real problem is that the master servicer does not have a stake in the resolution and has no incentive to be creative in working out a complex real estate issue in a non-default situation or to make advances on projects that may go into default.

There really is no way to build in data points or metrics to measure the master servicers’ performance. Ultimately, the investor cares about the maintenance of his return. This is illustrated by the fact that there really is not much perceived difference between master servicers, and investors will not pay a premium based on who the servicer is. Master servicing is viewed as a mechanical type of fee service, but in reality the abilities of the master servicers to maintain the real estate value of the underlying collateral have not really been tested by a major recession, and it most likely will take a severe real estate downturn to show whether or not this is a point of major concern for the industry.

Current trends that will add to the master servicing agency risk

As the CMBS industry evolves, so must the governance and default resolution strategies that accompany it. Fitch Ratings recently published a comprehensive article highlighting current trends in the servicing industry that they will be paying close attention to over the next several years. After highlighting their specific concerns, in light of this study, we have attempted to relate our findings on governance and default resolution to these particular trends.

Competition within the servicing industry

As is typical with maturing industries, competition has significantly reduced the potential fees available to master servicers. As of yet, these affects have not been as significant on special servicing fees, but if firm theory holds, it is seemingly only a matter of time before this happens as well. Fitch's primary concern is that as fees continue to be competitively bid down, the reduced fee will not be sufficient to attract a replacement servicer should the need ever rise, and therefore has suggested setting a minimum price for master servicing.³⁰

We share Fitch's concerns regarding increased competition, but more from a governance perspective. With the increased competition and reduced fees, it will be much more difficult to keep a master servicer interested in continuing to properly monitor the performance of the underlying assets. As this study has shown, a lack of response to real estate related issues has already become fairly commonplace. We are concerned that with a further reduction of fees to the master servicer, there may be increased agency risk to the securityholders. This is especially concerning if this tightening of the fee structure begins to affect special servicing contracts as well, as the special servicer will not be properly incentivized to do what is best for all

³⁰ Carlson, op. cit., p. 1.

securityholders, and from an economic perspective may be more likely to serve its own best interests or just to not perform as well.

Somewhat related to these concerns, Fitch highlights increased investor requirements with regards to the frequency and detail of reporting that is required of the servicer. While servicers are becoming more and more efficient with technology, there is some concern that servicers may not be paid enough to provide the increasing level of detail demanded by investors.³¹ While technology does assist with efficiency, we are concerned that the industry will fall prey to over-reliance on technology, and the quality of servicing will decline when the watchful eye and “instinct” of a servicing professional is replaced with a computer model.

The tightening of the fee structure has also led to a number of servicers exiting the business, as they increasingly cannot be profitable without scale. Servicing may quickly turn into an industry that is dominated by a few dominant players. For many of the reasons cited above, from a governance and default resolution perspective, this will continue to overemphasize the standardization of the business and not allow for the much needed intervention of trained real estate professionals. However, this trend does not seem to be occurring in the special servicing industry, where the impact of consolidation would seemingly be more severe.

Servicers historically had been able to compensate for fee reductions with the “servicers’ float.” Financial ingenuity led servicers to realize that they could place the various mortgage payments and loan reserves that they temporarily held prior to payout in short term investment vehicles. In the rapidly declining interest rate environment of the past several years, these short term investments provided smaller and smaller yields, further squeezing the servicer’s income.³²

³¹ Ibid., p. 1.

³² Ibid., p. 2.

As the economy begins to improve over the next several years, this should not be as much of an issue going forward.

Complex Loan Calculations.

CMBS structures are becoming more and more complex (please see Appendix A for a description of some of these structures and the problems they cause). In addition to these complex structures, as the first generation of CMBS transactions enter their later years, more and more loans are seasoning. This leads to increased prepayment due to the sunseting of lock-out periods and more complex yield maintenance calculations.³³ While servicers have invested in technology to ensure that these types of complexities are taken care of correctly, deals will only get more complex going forward. With the aforementioned reduction in fees, there will be less incentive for servicers to perform as well, in theory. In addition, the reduction in the number of servicers would suggest that servicers could afford to be less concerned about their reputation in the future as there will be more of a sense of being “the only game in town.” Ultimately, this is less than positive news for investors and the underlying real estate, as mistakes under these complex structures further complicate default resolution processes, further increase agency risk, and may cause actual default situations to be missed or, conversely, to unnecessarily put loans into default.

Outsourcing

Finally, Fitch highlights the common practice of servicer outsourcing. A trend consistent with many other US industries, outsourcing has become an accepted norm for servicers for

³³ Ibid., p. 3.

certain routine servicing functions, such as property inspections, real estate tax monitoring, and billing statement creation and mailing is long established and accepted in the CMBS industry...within the last few years, servicers have begun outsourcing functions that they traditionally performed themselves, such as operating statement analysis, insurance policy analysis, and loan assumption and modification reviews.³⁴

While outsourcing these types of functions has certain cost effectiveness advantages, the trend is concerning for governance structures that are becoming more and more complex and already have delicate balances between parties. Adding another layer of agency risk via new 3rd parties who may be difficult to quality control is a difficult proposition. In addition to questions over the expertise of the outsourcee, increasing reliance on third-party vendors will most likely lead to more conflict in time-constrained default resolution scenarios, especially with the increasing proportion of outsourcing that occurring overseas.

Conclusions about Relationship #2

With regards to the relationship between the master servicer and the borrower/real estate asset in a non-default situation, several of the real estate attorneys and investors that I have spoken with have reiterated the fact that it is very difficult to get in touch with anyone when a “real estate” issue needs to be approved or resolved as mandated by the underlying mortgage document. In most cases, it seems to be that unless a monetary default exists and cash flow has been or is about to be interrupted the master servicer is not very likely to respond. Several professionals have mentioned the fact that master servicers simply are not being paid enough to be responsive to such issues and are primarily concerned with ensuring the continuance of the cash flow to the investors.

This lack of responsiveness can wreak havoc on the day-to-day business of a property owner. One large investor, who had previous experience with more than twenty conduit loans,

³⁴ Ibid., p. 4.

said he now actively chooses not to do business with conduits whenever he can avoid them. His experiences highlight the fact that CMBS is not the correct execution for every borrower, especially for a value-added, development business model that needs flexible and responsive lenders. These types of business models employed by one borrower we spoke with are capital-event driven and hence flexibility is of the utmost importance. For such a borrower, the benefits provided by the conduits (higher loan proceeds, better amortization schedules and a better net spread) do not make a conduit execution worthwhile.

Contrary to my initial assumption, this may actually allow for more flexibility for the borrower as opposed to a more traditional “held-for-portfolio” loan, if he is unofficially “freed” from the approvals mandated by his mortgage. Empirical evidence does not suggest that borrowers are actually choosing a conduit execution for this reason or actually taking advantage of the lack of responsiveness in this way for major real estate issues, but theoretically it is a malfunction in the system that could be abused by borrowers. However, one borrower reported that for some minor issues, such as monitoring an insignificant environmental concern with no remediation needs, they do not really feel the need to go full out with the master servicer with regards to approvals and the “letter of the law” prescribed by the documents. They likely would not get a response anyway!

From a theoretical perspective, mortgage debt is viewed by the market as a check for equity holder to “do the right thing” at the asset level. As the “if it ain’t broke (or not making its payments, in this case), don’t fix it” mentality continues to permeate the master servicing market, this “monitoring service” historically provided by the lender will erode away.

CHAPTER 5-Relationship #3: The Special Servicer and the Real Estate Asset

As we have seen thus far, the structures of the pooling and servicing agreements and the underlying mortgages create interesting relationships among investors, servicers, and borrowers. Whereas the agency risk created in the first two relationships partially arose from a lack of concern for or applicability to the underlying real estate asset, the third relationship between the special servicer and the borrower is almost solely concerned with the value of the underlying real estate. More specifically, it is concerned with by what means the special servicer can extract the most value for the benefit of the trust investors.

As we mentioned in chapter 3, special servicing is a tedious balancing act, where the first layer of agency risk, the conflict between the best interests of the entire trust and those of the B piece holder, underlie every action taken. Ultimately, the special servicer utilizes any of the strategies listed previously to extract value for the trust, including loan modification, foreclosure on the asset, sale of the mortgage, and advancing on problem assets to give them more time to resolve on their own. This chapter attempts to characterize the actions of the servicer in default situations in an attempt to further understand the impact of the CMBS structure on the resolution process, as this relationship is the most similar to a more traditional mortgage portfolio management/workout scenario: real estate professionals on both sides attempting to successfully negotiate a resolution that has the least negative implications. As is most often the case, we are working under the assumption that the borrower wants to retain ownership of his asset and the servicer is trying to extract as much value as possible without having to own the asset himself.

Similarities between CMBS and Held-in-Portfolio loans: asset intensive underwriting of value

As is typical with most mortgage loans, the master servicer conducts property inspections annually, sometimes every two years for smaller transactions that have had no history of default. Property owners are required to prove the maintenance of insurance and environmental compliance to the master servicer as well. In addition to collecting periodic operating statements, this is usually the extent of the understanding of the underlying real estate at the master servicer level. As we mentioned above, it is questionable as to how closely the master servicer pays attention to the results

All of this changes when a loan enters special servicing: the first thing that happens is an immediate property inspection where the underlying real estate value is rigorously assessed.³⁵ As with any mortgage, updating the “value” of the underlying piece of real estate is a crucial aspect of the ongoing management of a transaction. In addition to the regularly scheduled updates required by the mortgage, pooling and servicing agreements carefully regulate advances based on the appraised value of the real estate. Certain events will actually trigger “appraisal reduction events.” Going back to earlier discussions of “recoverable” versus “non-recoverable” advancing, these events typically limit the servicer by forcing him to advance less of the interest on delinquent debt service payments based on how much the value of an underlying property has declined. This is an attempt to protect senior bondholders from being stuck with as large of a check, if the advances eventually are deemed “non-recoverable,” thereby forcing the senior bondholders to sacrifice their own yield to pay back the special servicers. These events require a new appraisal when a loan is 60 days past due, 60 days after any payment term has been modified, immediately after any borrower files for bankruptcy, or immediately upon a mortgage

³⁵ Scott, op. cit., p. 61.

property becoming an REO property.³⁶ What is different from the master servicing relationship is that rather than being merely a formality, these appraised values are being examined by real estate professionals, and the results have significant impact on how the resolution process proceeds; very similar to the actions of a lender in a traditional mortgage loan.

The servicer is held accountable to ordering a new appraisal with some significant penalties against the property.

If the servicer does not obtain an updated appraisal within 120 days following the event that triggered the appraisal reduction event, the pooling and servicing agreement should provide that there will be a deemed appraisal reduction (usually an amount equal to 25 to 30 percent of the principal amount of the related loan) until the appraisal is obtained (*language from a typical servicing agreement*).

Seemingly, a servicer that does not act with a sense of urgency in ordering a new appraisal can cause some serious headaches for the borrower. The standard write-down of 25 to 30 percent in the value of the asset is significant and could cause a major conflict with the borrower due to the loan-to-value problem it creates. It ensures that the special servicer will act with haste to establish a value for the asset.

The values that are determined through these processes are crucial not only for advancing through the resolution process, but also for determining appropriate value if the special servicer determines that a foreclosure or sale of the loan is the necessary next step in the default resolution process. Heretofore, this process is not very much different from a traditional mortgage situation. The first action item in a payment default situation is a rigorous evaluation of the asset value, something that the master servicer has not really done up until the point of default.

³⁶ Ibid., pp. 57-8.

Whereas the senior bond investor relies on an analysis of diversification by product type, asset type, geography, tenant concentrations, sponsor risk, etc, the special servicer/B-piece owns the most junior tranche of the bonds, and hence loan-to-value analysis and replacement cost analysis is much more important than a third party's view of the bond risk. In the words of one special servicing professional:

The special servicer primarily focuses on each asset, and does not rely on portfolio diversification and subordination levels to save his butt, so the analysis is much more thorough, with an eye to residual recovery, not simple coupon payment.

Key differences between a held-for-portfolio and a CMBS resolution process:

1. The interference of outside parties.

In general, pooling and servicing agreements do not contain more specific “real estate” controls, instead relying on the underlying mortgages to provide structure around such issues as the signing of new significant leases, major capital expenditures, etc. Hence, an important section within any pooling and servicing agreement is the section that provides for modification of the underlying mortgage loan, where these issues are addressed in detail.³⁷ In general, the special servicer has quite a bit of latitude in how he modifies the mortgage in order to resolve a default situation. However, the rating agency does come into play with how the servicer modifies payment-related items (basically any item that could impact the investment grade securityholders), while giving the servicer much greater latitude with any underlying real estate modifications. In fact, the rating agencies will actually influence clauses in pooling and servicing agreements that preclude the servicer from extending a maturity date beyond a certain amount of time, usually two years.

³⁷ Ibid., 58-9.

In addition, the servicing standard applies to any decision that the special servicer makes with regards to modifying the underlying mortgage. “In making any modification, the servicer must determine that the modification is reasonably likely to produce a greater recovery on a net present value basis than immediate liquidation.”³⁸

A modification of the underlying mortgage invites yet another stakeholder into the sphere of influence over the servicer’s decision making process. The rating agencies require conformation to certain standards for any modification that involves any change (substitution, addition, or release) in the underlying real estate collateral. In addition, it requires notification of most other significant modifications. Much like equity analysts, the rating agencies follow CMBS transactions on an on-going basis. As such, the default resolution process has an additional player (actually three additional players, as most deals are rated by two, if not all three, of the rating agencies).

This adds yet another layer of the agency risk in the borrower/servicer relationship. If the special servicer’s creativity in resolving a default is limited by the standards of outside parties, this could negatively impact the borrower either through an even less desirable result, delay, or simple “fear of the unknown.”

2. *Agency risk: who am I working for?*

The agency risk described in relationship #1 significantly influences the special servicer’s interaction with the borrower. The question surrounding who the special servicer is ultimately working for can impact the decisions it makes at the real estate asset level. A good example refers back to the issue of what is supposed to happen with non-

³⁸ Ibid., p. 58.

recoverable advances. Are the advances taken from an interest or principle short fall to the senior investors? One special servicing professional provided the following example:

If there is an environmental contamination at the asset level, the servicer will take cash from the interest which could lead to default on bonds up to the AAA and unnecessarily scares everyone even though they will eventually get their money back. By permitting limited amounts of advancing, only the below investment grade bonds have their principal affected. The result is not a full default, but instead just slightly lengthens the duration for the investment grade pieces.

While this all makes sense, it is obviously very difficult for the special servicer to make everyone happy in the course of a default resolution. As is seen above, either the investment grade bondholders see a slight increase in their duration or the B-note takes a near complete loss. The dynamics of a particular transaction can obviously significantly affect the relationship between the borrower and the special servicer.

3. Limited Options

In some situations, the pooling and servicing documents (usually for the benefit of the senior investors) preclude the special servicer from working out the real estate asset with an eye towards highest and best use. As mentioned before there is a lack of flexibility and a real disconnect between what is perceived to be in the bondholders' best interests versus what is in the best interests of the individual real estate assets.

If an asset is a vacant office building and the highest and best use is redevelopment is a strip center, the securitization documents or the loan documents may preclude this result, even though the change in use benefits all classes of bond holders, as well as the issue.

It usually comes down to the matter of time. The senior bondholder has enough subordination behind him to take a loss on a property in order to resolve a matter to her

satisfaction. The junior bondholder is exactly opposite, but when the options of the junior bondholder are limited by the documents, this can significantly impair his ability to work with a real estate equity holder.

How does this impact the borrower?

Many professionals seem to be in agreement that in most cases “real estate” issues are not really dealt with until a mortgage goes into default and the cash flow to the investors is interrupted. So, why does this matter at all? Could it be that this may actually weaken the equity holders’ bargaining position in the default resolution process, as now the borrower is not only in payment default but is also in default of many of the real estate level covenants (for example, the borrower may not have received approval for new leases or funding capital expenditures).

In a default situation, the real estate equity holder may benefit from a CMBS execution as well, but for a different reason. Several industry professionals have highlighted the fact that many special servicers seem more likely to wait and work out a deal that is in default. In a comparable situation, a mortgage lender may be more likely to foreclose on a transaction and take a partial loss, whereas a special servicer, at the behest of the B-piece, is more willing to wait out a bad situation, so as not to take a full loss. It does not hurt that in the meantime, the servicer is being paid a “workout” fee by the trust, which a typical portfolio lender is definitely not receiving. Again, discussions with industry professionals have not confirmed that this benefit is being “valued” or even perceived by borrowers, but theoretically it may give them the benefit of an increased timeline to cure a defaulting deal. In fact, the same borrower, who had decided to avoid CMBS conduits due to concerns around master servicing, also had concerns about special servicing that would give him pause about choosing a conduit execution. He cited the fact that

some special servicers actually at times are more difficult to deal with than a typical lender would be. He had recently attempted to buy a deal out of a CMBS trust. In order to approve the assumption, the special servicer forced to him to provide additional collateral. “The [servicer] changed the deal because he could.” While at times the servicer’s flexibility is impaired by rating agency oversight, in cases such as this, where the outcome benefited the trust via improved collateral, the servicer has significant latitude to exact restitution for its own benefit and that of the trust.

The real issue is the agency risk discussed in the first relationship. The special servicer has a significant say and is in a conflict position. The B-piece’s agenda is to take more risk than if they owned the entire asset. They are more likely to work out an asset when they maybe should not, because they are worried about their first loss piece. This disproportionate loyalty to the B-piece can be an issue for a special servicer: they are primarily “fee creatures,” and have significant incentive not to take actions that would negatively impact the B-piece if they want repeat business versus worrying about a loan to a borrower that they have no relationship with. But it is a catch-22: if the special servicer is not providing servicing that is satisfactory to the B-piece, they can be replaced, which may allow the property to deteriorate even more, putting the borrower and investor in a higher risk position. The special servicer itself has no skin in the game, and will not do what is best overall unless directed by the B-piece.

CHAPTER 6-Conclusion

The emergence of CMBS has dramatically changed how commercial real estate lending is done. Providing benefits of improved liquidity, origination efficiency, and pricing, CMBS has also drastically changed the “face” of lending. The borrower no longer has access to a local lender, or, for that matter, a consistent lender throughout the life of his loan. The structures created to support CMBS trusts force the borrower to deal with many different parties: special servicers, master servicers, senior investors, and B-piece investors. Often times the borrower gets lost within these structures, and is not sure where to turn when he needs assistance with his loan or who he is negotiating with when his real estate asset is in trouble. Even if he finds the right phone number to call, he often comes face to face with an entity that is more concerned with preserving cash flow for the benefit of the trust investors than in the underlying value of the real estate asset.

This paper has looked at the key relationships that drive the servicing structure and has attempted to look at the additional agency risk now impacting the borrower and investors in the trust. While characterizing this risk, the study has attempted to keep an eye towards how the default resolution process differs between a CMBS execution and a traditional held-for-portfolio execution. The interview process and review of servicing documentation has yielded some interesting results.

Finding 1-Servicing agreements are precisely standard across deals, and provide a certain set of options to servicers in how they can manage a transaction. There is not much room for “customizing” the deals up front with a few exceptions. While the mortgage documents do vary in their respective covenants and “deal points,” the actual real estate is not really considered in

the servicing agreements. There are plenty of controls in the servicing documents aimed at maximizing the value of the trust through the preservation of current cash flow, but “real estate specific” covenants do not really exist for the most part.

Finding 2- The servicing structure imposed by CMBS has significant agency risk implications for the different classes of investors of the trust and can greatly alter the way that a servicer will act with regards to a particular asset. The fact that the junior securityholder, represented by the special servicer, has control in a default situation can cause significant conflicts of interest with senior bondholders: the junior “first-loss” piece normally prefers an extension, while senior piece prefers quicker discounted payoffs due to the significant amount of subordination behind it. Adding to the “willingness to wait” in a default situation, the special servicer takes comfort that its advances will be recoverable at the expense of the senior bondholder and is well compensated for “working out” the loan. In a comparable situation, a mortgage lender may be more likely to foreclose on a transaction and take a partial loss, whereas a special servicer, at the behest of the B-piece, is more willing to wait out a bad situation, so as not to take a full loss. This could actually be a benefit for borrowers, but discussions with industry professionals have not confirmed that this benefit is being “valued” or even perceived by borrowers. However, in theory, it does give them the benefit of an increased timeline to cure a defaulting deal.

Finding 3- As mentioned in Finding 2, most of the asset level real estate governance is still found in the mortgage document itself, while the form of the mortgage has not really changed to accommodate the CMBS and servicing structures. However, the way that the mortgage documents are enforced on a day to day basis is significantly different. Most master servicers do

not pay much attention to the real estate level governance issues found in the mortgage as long as the mortgage is current and cash flowing. Several professionals have mentioned that master servicers simply are not being paid enough to be responsive to such issues. This lack of responsiveness can wreak havoc on the day-to-day business of a property owner and has driven some borrowers to choose to avoid doing business with conduits whenever they can avoid them. Current market trends of outsourcing, competition for fees, and complex loan structures promise to further stress the profitability of the servicing industry and hence the quality of service it provides.

An interesting question is raised about whether this actually could be a point of “flexibility” for a borrower as opposed to a more traditional “held-for-portfolio” loan: if a master servicer wants no part of the “real estate issues,” the borrower seemingly is unofficially “freed” from the approval requirement mandated by his mortgage. Empirical evidence does not suggest that borrowers are actually choosing a conduit execution for this reason or are actually taking advantage of the lack of responsiveness in this way for major real estate issues. However, theoretically, it is a malfunction in the system that could be abused by borrowers, and actually raises another type of agency risk for all investors in CMBS trusts.

More fundamentally, mortgage debt has historically provided oversight that property owners to “do the right thing” at the real estate asset level. While not as necessary as intense as in a construction loan in this regard, holding a mortgage from an active lender assures some sort of “quality control” at the asset level. The problematic lack of responsiveness at the master servicing level will erode this monitoring function to the detriment of not only the security holders, but of the equity as well.

Finding 4-Default resolution is different when looking at CMBS special servicing activity as compared to a more traditional held-for-portfolio execution. The agency risk brought about by the interference of many parties with different interests can negatively impact a default resolution process from the asset point of view. In addition, the influence of the rating agencies actually can limit acceptable options for working out a defaulting mortgage. Often times, the value of the real estate is second to preserving value for bondholders.

The study makes it very clear that CMBS is different enough in its processes to definitively conclude it is not the correct execution for every borrower, especially for a value-added, development business model that needs flexible and responsive lenders. For some borrowers, the benefits provided by the conduits (higher loan proceeds, better amortization schedules and a better net spread) do not make a conduit execution worthwhile. On one hand, this is good news for commercial bankers and life insurance lenders: they are still needed. On the other hand, it could point to more work and a more risky portfolio for banks: the more traditional, “bread and butter” loans are all going to be gobbled up by CMBS trusts, leaving held-for-portfolio lenders with the majority of higher-risk transactions that need “flexibility” and “creativity,” not always the words a banker wants to use to describe the majority of loans in his portfolio.

Appendix A-Complexities to the CMBS Structure

CMBS trusts are complicated enough structures on their own, but with the prevalence of mezzanine financing and large loan securitizations, the structures have gotten even more complicated.

Mezzanine Financing

Mezzanine debt is another level of debt that is used to “lever up” a property beyond what the first mortgage lender is willing to lend. This debt is held outside of the trust and, instead of being secured by a direct lien on the underlying real estate asset, it is secured by a pledge of the equity holders’/property owners’ partnership interests. The senior first loan must participate in a “lockbox” with the trust servicer and hence is not impacted by the mezzanine loan in terms of payment priority. While the mezzanine loan has its own separate agreement with the equity holder, an intercreditor agreement governs the interests of both debt holders, often restricting the sale of the mezzanine piece to a qualified institutional lender.

In this type of situation, the first mortgage lender (and hence now the CMBS trust) does care about who its mezzanine lender is because it impacts the property at the real estate level. Most major real estate decisions must first be approved by the mezzanine lender or his representative (often called a servicer to make things more complicated) and then passed along to the servicer of the trust. For non-payment types of events, this can restrict the options of the trust in its resolution of issues.

In the case of payment default, however, the control does revert back to the representative of the first mortgage (the CMBS special servicer). The only rights for the mezzanine lender in such a situation are the right to cure the default on the first mortgage (most mezzanine investors

seek at least 60 days) and to buy it outright at par. As mentioned before, the second option can be limited by the intercreditor agreement, depending on the type of entity of the mezzanine lender.

Single-Asset and Large-Loan Securitizations

Often times a single building, usually a mall or “trophy” office tower, can be securitized or participated. These deals bring a variety of structures and a variety of new governance issues. There are significant differences between fixed rate conduit deals that make up the majority of CMBS and floating-rate “large-loan” securitizations. In fixed rate deals, the subordination goes to unrated and non-investment grade levels levels, hence putting the special servicer’s money at risk. In large loan securitizations, there are no below investment grade tranches and hence no certificate holder that is in a true “first loss” position. Either there is no B-note (just several “A-pieces” that are pari-passu with regards to repayment) or the B-note is sold to a private investor. In the former case, the A pieces are usually placed in several different CMBS transactions. In the latter case, the directing class rights are now with the subordinated B-note that is held outside of the securitized trust.

Many transactions, especially prevalent since the September 11th tragedy, have actually included a combination of the structures above, providing even further future complications for servicing and default resolution. These participated loan structures include various numbers of pari passu notes and a subordinated B note. The senior notes are then diversified among separate CMBS issuances, each having its own master and special servicers. In an example where there were 4 pari passu notes, “the loan could have four master servicers, up to five special servicers, an operating advisor elected by the junior noteholder (the B note), and a controlling class holder

from each of the four securitizations (the B pieces). Each of these parties would have influence over the administration or workout of a participated loan.”³⁹

This type of securitization makes governance much more difficult and can potentially negatively impact the value of the real estate if all of these servicers are getting paid servicing fees on the same asset. In addition, the additional levels of “bureaucracy” can lead to significant delays without proper attention to deal and a hierarchy of governance and raises the question of whether there is a “cost” that is applied to these structures to compensate for the additional agency risk. Perhaps the best way to take care of potential issues is to address problems before they arise by determining roles and responsibilities of each servicer in varying scenarios or simply by designating a “head” special servicer.

Each special servicer needs to agree on which will workout the loan if problems arise, taking into account the rights of each B piece holder, as well as the B note holder. Coordinating the junior investors’ rights becomes more complicated when there are additional layers of debt with control and consent rights...Conflicts are reduced by appointing a lead master servicer and a lead special servicer, but the resolution of conflicts cannot always be clearly defined and allocated.⁴⁰

Just because the structures are different does not change the servicing standard, the typical 60 day time limitation, or the normal provisions that are ensured to the junior securityholder via the special servicer. However, when a loan is participated out further into a first mortgage and a mezzanine loan held outside of the trust, a new lender now has customary rights, including appointing its own operating advisor (who operates similar to a special servicer)

³⁹Daniel Chambers and Zanda Lynn. “Participated CMBS Loans: Too Many Cooks in the Kitchen?” *Fitch Ratings, Structured Finance Publications*, (November 18, 2003), p. 2.

⁴⁰ *Ibid.*, p. 2

making advances to cure defaults, buying the senior note out of the trust or to direct certain proposed actions of the special servicer.⁴¹ What is interesting is that a B-note holder's rights

exist as long as the value of the property exceeds the amount of the senior note by a defined margin; in other words, there is equity in the B note's value. As the value has dropped and B note holders' rights have been appraised away, the B piece for the trust regains influence over the special servicer, although the B note holder often retains consultation rights.⁴²

This is not an unimportant nuance, and brings into question significant governance questions. In some cases, would it be most beneficial for the special servicer of the trust to desire the value to be impaired to a point that the B-note holder is no longer in control as the most junior investor? While certainly not what is best for the real estate, if the B-note holder's representative is not as savvy, or if the special servicer of the trust sees some other avenue for maximizing value, removing the control of the B-note may be in the best interests of the trust.

How deals with many "B-pieces" resolve complex default situations in practice is actually a place that there has been some customization of the pooling and servicing agreements.

Recent deals have been inconsistent in how, and to what extent, each of the B piece holders, as well as the B note holder, can influence the actions of the special servicer. Earlier deals simply vested control of a workout to the lead special servicer, often appointed by the B note holder, while nonlead trusts were passive. However, it is becoming increasingly common for each B piece holder of the participant trusts to be given rights to influence potential workout strategies.⁴³

There are several options to resolving a deadlock: a vote with a simple majority, allowing the largest interest in the loan to control the resolution process, or a unanimous vote. Governance complications, and hence more agency risk, abound with each option with some significant concern for a unanimous vote option. This seemingly could lead to disastrous delays and a less than optimal resolution if parties with vastly different strategic directions begin to compromise

⁴¹ Ibid., p. 2.

⁴² Ibid., p. 3.

⁴³ Ibid.,p. 3.

away their various controls. In the meantime, what happens to the cash flow to the senior securityholders, who is obligated to make advances, and, perhaps most importantly, who is directing what happens at the real estate level in these often time-sensitive default scenarios?

As is evident here, CMBS structures are getting more and more complex. While the industry will eventually adapt to the creative structuring, increasing the number of players with a financial stake in the first-loss piece of the transaction could lead to disastrous agency risk problems, and continue to impair all of the three servicing relationships discussed in this paper.

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