An Unfiltered View of CMBS Investments Is Hard to Find

Bondholders often are not told about the options that can help them avoid severe losses

By Ann Hambly

Remember the days before selfies and easy photo editing, when a picture of you captured you, as you were at that moment? No retakes, no manipulation, no filters, but a raw picture that included your scars, warts and any other unflattering features.

Today, however, you can ensure your selfie is the best version of you — not necessarily an entirely accurate version of you, but a version that's exactly as you want others to see you. You can erase the scars, warts, or even messed-up hair, and create a professional-quality portrait.

Similarly, there are a lot of commercial mortgage-backed securities (CMBS) selfies in the commercial mortgage industry. Make it a habit to read articles, write-ups and reviews on the CMBS industry and, very often, you will see that the information has been presented with most of the scars, warts and other unsightly details filtered out, or even erased. All you see is what the CMBS industry wants you to see. When you work in the industry, however, and are close enough to it, you see it for what it really is and learn to look beyond the surface to find the hidden warts and scars.

The filters that make CMBS offerings seem more attractive are there for a reason: Some of the scars and warts that are being smoothed over are indeed scary sights.

Improbable losses

How is it possible that almost every month there are resolutions on defaulted CMBS loans in which the loss severity is greater than 100 percent? Loss-severity exceeds 100 percent when the disposition proceeds are less than the costs of disposition, including servicing fees, advances and workout expenses. Surely there were better resolutions available that would have resulted in a smaller loss.

Had the loan been forgiven completely, for example, the loss would have been contained to 100 percent. In many of these cases, borrowers were willing to contribute their own money to the resolution. In that event, almost definitely, the result would have been a much smaller loss for bondholders.

In 2014, there were 12 loans with loss severities greater than 100 percent. In all but two of these instances, the special servicer foreclosed and sold the property as real estate owned (REO) by a lender.

The information being filtered here is that the bondholders rarely know what options the special servicer has available when making the decision to foreclose. In many instances, the borrower has offered something that would have surely resulted in a smaller loss or no loss at all, but bondholders are rarely informed about those details.

Modification mysteries

Consider these statistics for a moment: In 2013, eight of the 10 largest loans in default were modified and returned to the master servicer. In 2014, however, only four of the largest 10 were modified, and the remaining six were liquidated — sold at note auction, foreclosed and sold as REO, etc.).

Why is that? Is it that fewer borrowers wanted to modify their loans in 2014? Or, is it possible that there is another motivation driving the special servicers' decisions?

Again, the industry won't know for sure because CMBS bondholders rarely hear about the modifications proposed by a borrower, nor the other alternatives considered by the special servicer when making the decision to liquidate.

Also in 2014, the largest chunk of CMBS losses booked involved 13 loans, for which the combined realized loss was more than $50 billion. In 12 of those, the resolution method was either foreclosure with a sale of the REO or a note auction. In some cases the borrowers likely made proposals that would have resulted in smaller losses for the bondholders.

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Another factor increasing the severity of the losses is the length of time a loan is in special servicing. The totals for a servicer's fees and the advances required to keep the bondholders current grow every month a loan is in special servicing, and all of the fees and advances are recovered first, before any payoff money is passed through to bondholders.

In 2012 when defaults were at an all-time high, the average length of time a loan was in special servicing was 23 months. In 2013, the length of time increased to 30 months; in 2014, the length of time increased to 40 months. The latter is almost four years in special servicing to resolve an asset. Keep in mind that is an average, so there are plenty of loans in special servicing for much more than four years. Would it take that long to resolve the asset if the defaulted loan was on the special servicer's own books? It's highly doubtful.

Missing transparency

What are the reasons that we don't get an unfiltered view of the CMBS resolution process? Although the market relies on it, transparency is clearly lacking regarding special-servicer actions, particularly with regard to fees paid to the servicers or their affiliates (note-auction platforms, brokerage firms, etc.). Nor is there transparency with respect to what options the special servicer has available when making a decision to foreclose or sell a note at a severe loss. Absent a requirement for special servicers to report all offers received from a borrower relating to a workout, or a requirement that the special servicer publish a calculation of expected recovery options, the CMBS borrower and investors have no way of knowing whether the special servicer's actions could have resulted in a larger recovery.

Rating agencies have published reports addressing best practices for enhancing transparency surrounding the known conflicts of interest in the CMBS structure. If you Google "conflict of interest CMBS," there are pages and pages of write-ups on the subject. Yet, the most often published view of the CMBS industry is the equivalent of a selfie, with all the scars and warts smoothed over, or eliminated altogether.

To get a truly unfiltered view of the CMBS industry, bondholders must be able to examine all of the alternatives available to the special servicer prior to a decision being made to sell the note via a note auction or foreclosing on the asset. Only then will it be possible to see the industry as it actually is, with scars, warts and all. ■

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