

## Concerns with REMIC Proposals to Authorize Loan Modifications and Restructure Contracts

### Commercial Mortgage Securities Association

#### Background

The principle vehicle for the securitization of Commercial Mortgage-Backed Securities (CMBS) is a statutorily-created trust, known as the “real estate mortgage investment conduit” (REMIC). An individual REMIC holds a pool of commercial mortgage loans (generally 150-200 loans) that are “securitized” and allowed to issue multiple classes of securities (backed by the trust assets) and pass through income directly to investors that purchase the bonds, without tax consequences to the trust if certain qualifications are met. One of the statutory requirements for a REMIC is that it must hold a “static” pool of loans and only very limited modifications may be made to the loans without the Internal Revenue Service (IRS) considering that the modifications constitute a “new” loan, which would result in the REMIC losing its tax exempt status. At present, the REMIC rules permit loan servicers to facilitate modifications only when there is a risk of “reasonably foreseeable or imminent default,” which is codified in the widely accepted servicing standard specified in the Pooling and Servicing Agreement (PSA).

For the past several years, the Commercial Mortgage Securities Association (CMSA), individually and as part of a larger industry coalition, has been actively seeking additional servicer flexibility within the REMIC rules to improve the efficiency of the REMIC structure, enhance the protection of asset value for investors and eliminate certain constraints on borrowers. However, some more recent reform proposals would go much further by seeking to change the terms of commercial real estate loans well in advance of what would be customary under the widely accepted servicing standard (“reasonably foreseeable or imminent default”), contrary to the expectations of and disclosure to investors in CMBS, and without a clear set of principles to govern servicers’ decision to modify the loans.

As such, the CMSA **strongly opposes** the sweeping REMIC regulatory proposals that are specifically aimed at modifying loans and restructuring contracts in this manner for a number of reasons that are outlined here.

#### Timing

Some proposals would change the REMIC laws to authorize servicers to modify the terms of mortgages (either extending the due date for repayment, lowering the interest rate or payment forgiveness) well in advance of the maturity deadline (e.g. as long as 60 months or more) if the servicer has a “reasonable” belief that the borrower “may be” unable to obtain any needed refinancing to repay the loan. Under these proposals, a “reasonable” belief can be formed merely on the basis of a borrower representation that in the future (e.g. 5 years from now), it “may be” unable to obtain refinancing. One thing the current market conditions have made clear is that it is extremely difficult to anticipate where the market will be in one year, much less so in 5 years. Moreover, reliance solely on borrower representations as to market conditions justifying a loan modification is inconsistent with the servicing standard which obligates the servicer to act prudently and in the best interests of the certificate holders, and typically involves independent assessment and evidence of market conditions. Finally, our servicer members have stated they do not want or need the proposed change, and in fact it would be counterproductive in their ability to manage servicing demands.

#### Impact on Credit Availability and Markets

Investors are a critical ingredient in restarting our securitized credit markets, which are a centerpiece of the Administration’s “Financial Stability Plan” to provide liquidity and facilitate lending. Such proposals, if adopted, would have a grave, adverse impact on CMBS investors, whose importance to liquidity in the commercial real estate mortgage market cannot be overstated given that investors are a significant source of the capital that is available for commercial lending.

a. Destruction of Contract Certainty

Put simply, CMBS investors contract for certainty. Investors expect and demand to know that when a mortgage is executed it provides for certainty in cash flows over a specific period of time and that the loan will be re-paid by a certain date. Investors do understand the risks associated with defaults, and are prepared to accept liquidations or modifications effected by the servicers in accordance with the existing pooling and servicing agreement and the servicing standard. Although that standard already contemplates modifications to loans in default or for which there is a reasonable belief that there will be an imminent default, bond investors would be hesitant to buy bonds if the constraints on that modification are essentially eliminated as some have proposed, especially when the cash flows and duration could be restructured at any time under that relaxed standard. In sum, because investors expect contract certainty, proposals that effectively eliminate that certainty will serve to undermine investor confidence in CMBS, having the opposite effect of the Administration's other market recovery efforts.

b. Extension Risk

Another major aspect of these proposals that prompts concern is the indefinite duration of potential extensions and the long-term implications of such policies regardless of whether modifications are offered on a temporary basis. Even if such proposals are temporary, some would authorize the use of unfettered discretion to modify all existing loan agreements, including loans that are early in their maturity cycle and thus may not mature for several more years. Again, this would effectively eliminate any degree of contract certainty for investors. In saying this, we are mindful of the fact that investors already factor in some extension risk due to the current uncertainties in the commercial real estate capital finance marketplace and they also understand that such risk can grow if there is further market deterioration. However, the removal of any limiting principles as some have proposed is simply too far from current standards and expectations to be acceptable.

c. Increased Liability Exposure

Additionally, as mentioned above, special servicers already have the authority to modify a commercial mortgage when there is a reasonably foreseeable risk of default, and this includes situations where market and property specific circumstances indicate that a payment default is likely to occur in the future. Moreover, servicers are very capable and experienced in reviewing each loan on a case by case basis in order to make a decision that is in the best interest of all of the bondholders. If servicers are given an effectively unlimited modification authority as some have proposed, they would be subjected to increased liability from multiple parties adding substantial costs and burdens to securitized credit markets.

d. Additional Issues

- The authorization of unbridled power to restructure loan contracts would trigger a chain reaction of circumstances that will likely complicate a resurgence of the CMBS market.
- Pooling and Servicing Agreements would contractually prohibit the level of unrestrained servicer discretion advocated in such proposals. Moreover, in the limited circumstances in which such flexibility is permitted, application will vary widely across servicers, leading to even more unsettled investor expectations.

- With market conditions deteriorating, it is anticipated that more loans will default and investors are prepared for this scenario because of the structural subordination that investors paid and accounted for when they bought these bonds based on their risk appetite (e.g. AAA investors will lose principal last, but the risk/reward profile is expected and maintained). Even if investors become comfortable with loan modifications several years in advance from a credit standpoint - which they have strongly rejected in concept -, they would demand additional spread premiums for CMBS bonds that would make CMBS lending uncompetitive and undermine the securitization structure.
- If broad, sweeping rights to modify/extend loans are granted or encouraged by regulation, servicers that are already dealing with significant increased activity levels anticipate they will be overwhelmed with inquiries and demands by virtually all borrowers hoping to take advantage of the new rules to negotiate a better deal. This will adversely affect the ability to deal with those loans most appropriately in special servicing and in need of modification.
- Rating agencies would have difficulty rating a deal with so much uncertainty, which could make it difficult or impossible to obtain AAA ratings on CMBS deals.

### Conclusion

Given the state of the securitized credit markets (in particular CMBS) and the paramount importance of restoring certainty and confidence for investors who are critical to these markets and to providing much needed liquidity for lending, our members strongly believe that REMIC proposals for sweeping loan modifications and contract restructuring are both unnecessary under current regulations and ill-advised. Likewise, we would urge extreme caution at this junction given the government's efforts to restart the securitized credit markets as central component of the Financial Stability Plan and our nation's overall economic recovery. Investors expect and demand contract certainty, and significant changes of this nature will undermine their confidence in CMBS, as well as programs aimed at the facilitation of restarting the capital markets. Accordingly, such sweeping proposals are strongly opposed by CMSA in order to promote the ongoing strength, liquidity and viability of commercial real estate capital market finance.