Conduit loan servicing: Who's who and what's what?

The thing most borrowers fail to realize about conduit loans is that once a loan has been securitized, they are not working with a "lender" anymore. The loans are pooled into a securitization called a Real Estate Mortgage Investment Conduit (REMIC). The REMIC is a trust and it has no lenders, only fiduciaries of the "certificate holders." Once the loans have been pooled and securitized, the players are as follows:

Master Servicer - The Master Servicer collects payments, escrows, reserves and financial information on behalf of the REMIC Trustee. The Master Servicer visits each asset (at its expense) every year for large loans, every other year for small loans. As of April 2012, Wells Fargo is the largest Master Servicer in the country with over $500 billion in master and prime servicing. The second largest is PNC Real Estate/Midland Loan Services. Master Servicers are rated and evaluated by the rating agencies. If a loan becomes delinquent, the Master Servicer is usually obligated to make the first three or four payments to the certificate holders as well as pay trust expenses on delinquent assets. This way, if a borrower is late or misses a payment, but makes it up quickly, the certificate holders have had no disruption in payments. The Master Servicer is reimbursed when the borrower makes up the payment or when the property goes into foreclosure and is later sold. Because the certificate holders are relying on the Master Servicer to make these payments, the creditworthiness of the Master Servicer is a key to the selection process.

Special Servicer – The Special Servicer is the party designated to "work-out" loans or foreclose on loans if they go into default. The Special Servicer may agree to modification, waiver or amendment of any term, extend maturity, defer or forgive interest or prepayment charges and permit the release or substitution of collateral, borrower or guarantor as long as it is "in the best interest of the certificate holders." If a loan is in default for more than two payments (60 days) or defaults at maturity, it is assigned to the Special Servicer who takes over direct discussions with the borrower. The Special Servicer can also get involved if it gets notice of "imminent" default. The Special Servicer makes all final decisions about dispositions of defaulted property and Real Estate Owned (REO). Often they are also the holders of the "first loss pieces" of the pool. Because they are taking the most risk, as part of their agreement to take that risk, they usually insist on being the Special Servicer as a requirement of their investment. There are only a handful of special servicers in the country.

Trustee - All cash flows from the Master Servicer are placed in bank accounts held in a custodial account for the certificate holders. The Trustee conveys the mortgage loans and documents to the trust and the Trustee calculates and distributes all of the checks to the various bondholders. The Trustee also facilitates the distribution of servicer information to rating agencies and investors.

Pooling and Servicing Agreement (PSA) - The duties and obligations of each of the above parties are spelled out in the PSA. A PSA is signed by all parties when the REMIC is formed. Each PSA is unique, but very similar. The PSA also designates a "Controlling Class" who will provide input on recommendations for Special Serviced Loans and REO. The PSA usually requires the Special Servicer to obtain an appraisal once a loan is transferred to the Special Servicer. This is usually done at the borrower's expense.

The three most common issues that arise with conduit structures related to loan maturity are as follows:

1. **Imminent Default.** Assume that a loan has not yet matured and/or is not yet in default, but that default is imminent. The Borrower wants to talk to their "lender" to get relief in the form of an extension, an accrual, a reduction in payment or amortization, etc. Typically the borrower's only contact is with the Master Servicer, who typically does not have the power to make any alterations to the existing loan. That power rests with the Special Servicer, who normally won't know anything about the loan until the property goes into default, or until the borrower makes contact with them directly. The borrower may be willing to make the payments, and all the borrower wants is assurance that when the loan comes due the "lender" won't pull the plug on them. Many borrowers want to know who they can talk to. They need to find a way to talk to their Special Servicer. If they do reach the Special Servicer, they should be prepared to pay for an appraisal before the Special Servicer will engage in any meaningful discussion, and also demonstrate that they have searched exhaustively for takeout financing.

2. **A loan matures with no replacement lender, and the property is worth <u>less</u> than the current debt.** Assume that a loan is maturing and the borrower has made contact with the Special Servicer to tell them that there is no replacement financing. For purposes of this example, assume the property is worth less than the debt. So, if the property were foreclosed on, the pool would take a loss. One might think that the Special Servicer would be glad to extend the loan. After all, they are the ones that take the first "hit."

If the Special Servicer is willing to extend the loan, they have to get permission from the Controlling Class Representative (CCR), who is a fiduciary for all the certificate holders. The CCR was designated when the REMIC was created and the PSA was signed. The largest class of certificate holders is always the AAA rated tranche who aren't likely to lose any money if the deal gets foreclosed and sold at a discount because they have first lien on the proceeds. Without permission from the CCR, the Special Servicer could be liable if they made any decisions that did not protect all classes. This is one reason why Special Servicers may be reluctant to extend a loan.

Most AAA holders are anxious to get their investment back as soon as possible. Most PSAs give the Special Servicers the right to extend loans up to a maximum of three years, but a typical extension is usually 60 days to six months.

3. **A loan matures with no replacement lender, and the property is worth <u>more</u> than the current debt.** Assume that a loan has matured and the property is worth more than the debt. Remember, there are no "pockets of money" to use for refinance. Special Servicers, although legally allowed by the PSA to forgive any portion of the debt, rarely do so because often that would negatively affect one or more of the bondholders at the expense of the others. Instead, the Special Servicer, on behalf of the conduit, will almost always foreclose and sell the asset.

   All of the aforementioned parties are "fiduciaries" for the pool; that is, they are required to act in the best interest of all the investment classes of certificate holders.

   In this economic environment it is critical to understand your specific loan terms, and any default risks they may pose, so you can plan accordingly. The “friendly banker” you knew five years ago may not be the party you will be dealing with tomorrow.

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