Securitization of Commercial Mortgage Loans

Tips for originator's counsel to help assure safe passage.

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IF A COMMERCIAL mortgage lender originates a loan with the intention of securitizing it, the last thing he wants to hear is that something in the loan creates a serious issue or problem for securitization.

Of course, an "issue" or a "problem" will usually not make the loan ineligible for securitization. Instead, it usually means that the rating agencies will "ding" the loan, either slightly or substantially, and give it less credit when determining the size of the highest-rated tranches of bonds to be issued through the securitization. But any such reduction means a less profitable execution. Therefore every "issue" and every "problem" matters for every loan.

The originator must also look beyond the rating agencies, and think about the "B-piece buyers," a small group of investors who buy the lowest ranked classes of bonds in each securitization. A loan must not only satisfy the rating agencies (i.e., not lead the rating agencies to penalize the originator for any characteristics of the loan), but it must also satisfy the B-piece buyers, who do not hesitate to "kick out" individual loans from a securitization as the price of buying bonds. Therefore, an originator must consider the agendas and appetites of the B-piece buyers as well.

In the brief space available, this article reviews a handful of issues that originator's counsel should consider in documenting any loan intended to be securitized, to increase the likelihood of safe passage through the securitization and B-piece-buyer machinery. Many other issues will arise in any loan, some major, many minor, all potentially the source of trouble if handled incorrectly.

Splitting the Note

In today's market, mortgage lenders often break a large loan into two or more pieces, even before putting any of it into a securitization. The typical transaction chops the loan into an "A note" and a "B note," with the A note destined for securitization and the B note destined for resale to someone looking for slightly more return with slightly more real estate risk.

The relationship between the note holders is governed by an intercreditor agreement, which lets the B note holder control important decisions and enforcement, while giving the A note holder comfort that the loan will be properly serviced and its value preserved. Intercreditor agreements also address a wide range of other issues about the relationship between the two lenders.[1]

An originator will often prefer to set up the multiple notes—and sell them—simultaneously with the loan closing, thus eliminating any risk that the originator will need to hold any paper long term. Sometimes the originator achieves only part of this goal, by structurally creating the various pieces, but leaving some or all of them to be sold post-closing. Or an originator may believe a deferred sale will increase the selling price (lower the yield demanded) or meet other business goals of the originator.

In cases where the originator has not yet determined how it wishes to slice and dice the loan—A note, B note, C note, whatever—or if it just wants the ability to change its mind post-closing, the originator should think about building some flexibility into the loan documents. The loan agreement should, for example, build in the right for the lender to require the borrower to break one note into two, so that the originator can create an A/B note structure after the fact.

As between borrower and lender, the major business issues that frequently arise include:

- Who will pay the legal fees for the originator's post-closing conversion of one loan into two? The answer depends on whether the flexibility was "baked into" the commitment letter as part of the fundamental deal structure, including the degree to which the borrower participated in formulating the tranching and rates of the component notes.

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• The borrower will want to make sure that its obligations under the A note and B note "add up" to the same obligations the borrower would have had without the bifurcation. The lender will usually agree to this, though sometimes subject to a "rate creep" exception described below.

• If the borrower prepays the loan from any source—including every real estate lawyer's favorite, casualty or condemnation—must the servicer apply the amortization against the A note and B note in proportion to their outstanding balances? If no such requirement exists, then the amortization could go first against the lower-interest note (the A note), with the result that the borrower's blended interest rate would rise over time. Originators will usually agree to protect borrowers from this so-called "rate creep," but sometimes they will not, and in such cases the A/B note structure leaves the borrower bearing a risk it would not otherwise have needed to bear.

• The borrower will want to make sure that all consent rights and reporting requirements remain the same after the bifurcation. Typically, the borrower will continue to deal with one servicer, and will never see the A note holder or the B note holder. But the borrower will want comfort on this point.

If the originator has not yet lined up its subordinate note buyers for a particular deal, it will want to write the loan documents in a way that maximizes their appeal to the largest possible universe of B note buyers.

As one example, depending on the nuances of the wording of the documents, some offshore financial institutions may find that certain forms of B note are not tied closely enough to the real estate—and instead rely too much on promises from the originator—and will not meet the investors' need to limit their investments to mortgage loans. An originator can prevent that problem by assuring that the A note and B note are structured to give the holder direct interests in a mortgage, and hence direct interests in real estate. A minor difference in structuring may make all the difference in the world to these investors.

As another example, some investment funds that have investors that are pension funds may want to buy B notes. As a matter of ERISA law (Employee Retirement Income Security Act), any such purchase may lead to the imposition of severe regulatory burdens on the investment fund, unless the investment vehicle qualifies as a "venture capital operating company" (VCOC). (Pension fund investment vehicles may also qualify as "real estate operating companies," based on tests rather similar to those discussed here, or conceivably for other exemptions from ERISA burdens.)

To constitute a VCOC, an investment vehicle must invest at least 50 percent of its assets in "venture capital investments," which the federal Department of Labor defines as investments in operating companies in which the VCOC has or obtains certain management rights, beyond those typically obtained by a similar institutional investor. Although "management rights" are not clearly defined, the Department of Labor has issued an advisory opinion that provides some guidance as to what types of rights the VCOC must have.[2]

Interestingly, the list does not vary dramatically from what a mortgage lender will require in a loan agreement. However, every "watering down" of the VCOC's rights may increase the likelihood that the loan will not be deemed a "venture capital investment." Ultimately, if the originator wants to achieve the largest possible pool of B note buyers, the borrower will have to accept a package of VCOC provisions that will not raise potential issues with the Department of Labor.

If real estate—both debt and equity—continues to outperform the stock market, it is reasonable to expect that more and more categories of investor will find their way into the B note market. An originator that wants to maximize flexibility will watch for new market entrants and assure its documents cater to their needs.

Partial Releases

As a common pitfall in REMIC structuring (REMIC stands for "real estate mortgage investment conduit"), the tax code prohibits the REMIC from permitting a "significant modification" of the loan after it has been deposited in the REMIC.[3] If the REMIC grants a partial release of the property, that can constitute a "significant modification" unless the documents already contemplated the partial release at the time the loan was deposited in the REMIC.

Therefore, if the borrower or the lender anticipates that the transaction may later require a release of some collateral, they need to "bake into" the loan documents a requirement for the lender to grant that release, along with all other appropriate provisions for that release. The holder of the loan should have no discretion in deciding whether to grant a partial release of the mortgaged property; each release should be "as of right" if the borrower satisfies objective standards specified in the loan documents. The holder of the loan (the REMIC or its servicer) should play a purely clerical role in determining whether these requirements have been met.

Such an approach is, of course, rather counterintuitive for most lenders, who instinctively want to maximize their control over their collateral and their discretion in granting consents to the borrower. A lender may also fear that if the loan ultimately cannot be securitized, the lender may be forced to live with objective—virtually automatic—partial release provisions that it otherwise would never accept. Such a lender's concern can, however, be effectively addressed. The loan agreement can provide for a discretionary partial release regime before securitization, with more objective criteria springing into place as soon as the loan is securitized.

The need for objective criteria by no means implies that the criteria cannot be stringent. It means instead that they must be more precise. The lender cannot defer analysis by saying that everything about the release must be "acceptable to lender in its sole discretion"—a standard that might not even do the lender much good, as it still invites claims that the lender acted in bad faith by demanding too much.

Rating agencies want to see extensive, and detailed, release requirements. Toward that end, originators often attach "forms" of the documents to be executed for a partial release, as a further effort to make the process as automatic and discretion-free as possible. When the rating agencies see a rigorous and well-thought-through release procedure, this tells them the originator did its diligence, looked for issues about the collateral and the partial release, and decided exactly what type of release would make sense and why. This level of discipline, if evident throughout the loan agreement, can help an originator achieve a successful securitization.

An originator might not be able to expunge all possible exercise of judgment from the release process. Some required deliveries might inevitably call for subjective judgment, such as the delivery of satisfactory title insurance endorsements. In such cases, the partial release provisions might require that the delivery be deemed acceptable to the holder of the loan if it would be satisfactory to, for example, "a prudent institutional mortgage lender acting reasonably."

Similar issues of "discretion" versus "following the rules" can arise in any other context where a loan contemplates the lender will do something for the borrower at some later date. If the originating lender agrees to be overly flexible—without precisely defining what the borrower and the loan holder will have to do—then the loan may create issues for securitization.

Prepayments

Loan documents will typically require the borrower to partly prepay the loan in the event of a partial release, especially if the released parcel produces income that the originator considered in underwriting the loan. The required prepayment will often exceed a "proportionate" allocation of the loan based on the relative appraised value of the released parcel. This way, the lender can improve the loan-to-value ratio for the loan after taking into account the release.

Any possibility of a prepayment, though, whether through partial release or otherwise, may reduce the value of the loan in a securitization. This is because investors purchase Commercial Mortgage Backed Securities (CMBS) bonds in expectation of a fixed future income stream over a fixed period. The ability of a borrower to prepay any portion of a loan, and thus reduce its monthly interest payments, means that some bondholder will receive its principal back sooner than anticipated. The possibility of that surprise may diminish the value of the CMBS bonds.

An easy way to solve this problem is to prohibit prepayment entirely—whether in whole or in part, as in the case of a partial release. But borrowers want flexibility. The securitization market has responded by allowing a borrower to "defease" the loan instead of prepaying it. Defeasance allows the loan holder (the REMIC) to receive the stream of payments when, and in the amounts, it expected—which makes the bondholders happy—while the borrower achieves some of the benefits of prepayment.

An originator will be most likely to create a defeasance mechanism for large partial releases or for prepayments of the entire loan. Smaller prepayments may be less likely to require this extra measure with its attendant cost to the borrower.

Borrowers that wince at the transaction cost of defeasance may try to negotiate the right to deposit cash collateral in place of government obligations. But the use of cash collateral instead of government obligations would run afoul of another technical REMIC rule. Specifically, the REMIC rules allow a REMIC to hold only a small amount of assets other than real property. Cash collateral counts toward that limit, but government obligations held as defeasance collateral do not.

Standardized Loan Documents

We all know that lawyers tend to bring complexity and creativity into situations that might intuitively seem simple. In the CMBS world, sticking with the standard form and keeping it simple goes a long way toward making the rating agencies and hence the securitization market happy. Use standardized defined terms and standardized loan provisions. If an originator or its counsel forces rating agencies to read new and complicated language, this will make the rating agencies nervous, and give them more of a reason to delve deeper into the loan to ask questions, raise issues, and if they try hard enough usually find at least a couple of problems.

The importance of using standardized forms is especially acute for intercreditor agreements. Intercreditor agreements are extraordinarily important to any deal structure. The rating agencies always review them thoroughly to assure that the senior lender has the appropriate rights and controls. As previously noted, this area has become quite standardized in recent years, both for A/B intercreditor agreements and, even more so, for intercreditor agreements between mortgage lenders and mezzanine lenders. Any intercreditor agreement should be based on, and stray as little as possible from, the "standard" intercreditor agreements now widely used in the industry. Any party seeking to use a different form of intercreditor agreement should have a compelling reason to do so.

This article has touched on a few important issues that mortgage lenders and their counsel should consider when structuring and documenting loans destined for the securitization market. Of course, this article is by no means exhaustive; every loan will create its own set of unique rating agency considerations and challenges. However, the concepts in this article can help maximize the sale value of a loan, while still providing room to respond to the business needs of the borrower.

1. Until recently, the negotiations over these agreements often seemed to be as grueling as the negotiations of the loan itself. In the last few years, however, the relationship between the A note and B note has achieved a fair level of standardization. For more on that relationship, see David M. Stewart, "Note Holder Rights in 'A/B' Mortgage Loans," N.Y.L.J., Nov. 29, 2004. In effect, the parties use intercreditor agreements to create synthetic senior and subordinate mortgages governed by a private set of rules, instead of the common law rules that governed "real" senior and subordinate mortgages and were deemed utterly unacceptable in securitization. See Joshua Stein, "Subordinate Mortgage Financing: The Perils of the Senior Lender," Real Estate Review, Fall 1997, at 3.

2. U.S. Department of Labor, Employee Benefits Security Administration, Advisory Opinion, March 26, 2002 (2002-01A, ERISA Sec. 401(b)).

3. Code of Federal Regulations, Title 26, §1.860G-2(b).