

# Operational Risk Assessments Research

## Commercial Mortgage Servicing Trends—Battling CMBS Headwinds, Servicers Pursue Alternatives to Sustain Volume

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### Morningstar Perspective

By intensifying their portfolio-diversification efforts, commercial mortgage servicers are overcoming lower commercial mortgage-backed securities' issuance and the much publicized wave of maturing CMBS loans. With shrinking CMBS loan portfolios, the four major master servicers ranked by Morningstar Credit Ratings, LLC capitalized on the securitization programs of government-sponsored enterprises, or GSEs, and other lenders' output to fuel new opportunities and replenish payoffs. Master servicers last year collectively achieved a narrow net gain in total servicing volume. Improving loan-origination and CMBS-issuance forecasts for the second quarter may lead to more servicing portfolio growth.

Although master servicers experienced minimal growth last year, handled fewer borrower requests for most types of consents, and managed smaller loan watchlists, their work demands did not ease. They had a year-over-year uptick in asset transfers to special servicers with matured loans, overwhelmingly from 2007-vintage transactions, representing a growing share of the transfers and expanding the specially serviced portions of their CMBS portfolios. Morningstar expects that trend to persist for the next few months. While its latest CMBS maturity report found that the payoff rate of maturing CMBS loans in March improved to 75.1% from 64.3% in February, Morningstar projects that only about 60% of nondefeased loans maturing in 2017 will refinance without complications.

Servicers also are contending with the extensive investor-reporting and compliance-tracking requirements of newer CMBS, securitizations from the GSEs, and other third-party clients. Furthermore, servicers have had to address high levels of loan-boarding and elevated payoff activity. Finally, as legacy CMBS transactions conclude, servicers are administering more trust terminations,

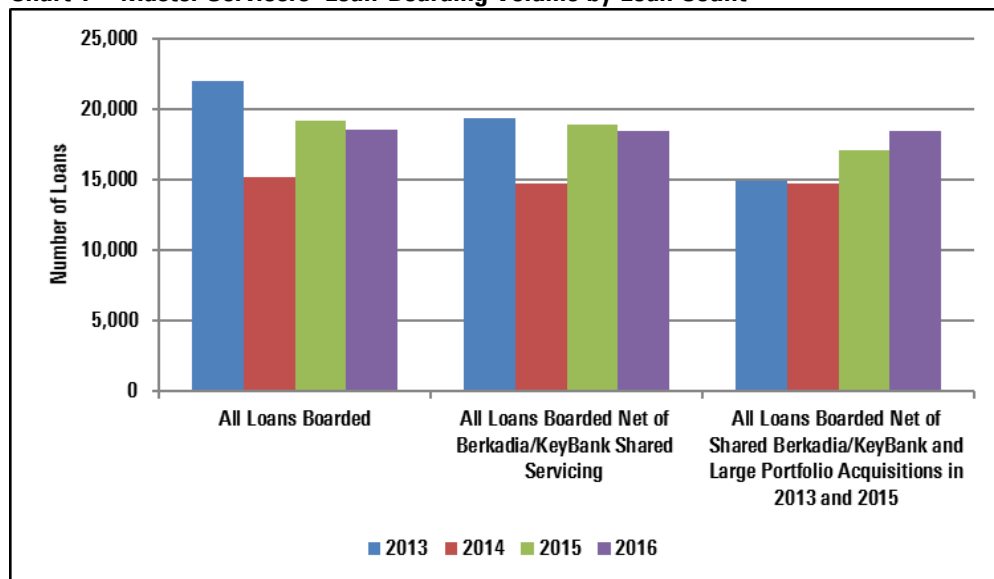
which require additional risk mitigation to protect the remaining bondholders. The confluence of these challenges resulted in master servicers' staffing levels holding steady.

To assess the portfolio profile and activity of the commercial mortgage servicing industry, especially the CMBS sector, Morningstar analyzed the semiannual data files it received from the four largest servicers, according to the Mortgage Bankers Association's 2016 Year-End Survey of Commercial/Multifamily Mortgage Servicing Volumes: PNC Real Estate/Midland Loan Services, Wells Fargo Bank N.A., Berkadia Commercial Mortgage LLC, and KeyBank N.A. As the master servicers for most CMBS transactions and collectively servicing upwards of 100,000 loans, including all investor types, these companies are an excellent representation of not only the CMBS sector but also the commercial mortgage servicing industry.

### GSE and Other Servicing Opportunities Offset the CMBS Slowdown

While real estate lending and CMBS issuance rebounded in the latter half of 2016, activity was below 2015 levels. However, GSE securitizations propelled master servicers to collectively board, in either a primary- or master-servicing role, approximately 85% more loans onto their systems in the second half of 2016 compared with the first half. Thus, they finished 2016 with loan-boarding volume just 3.5% below their 2015 total. However, when excluding a large portfolio acquisition in 2015 by KeyBank and adjusting for other KeyBank loans boarded by Berkadia through a sharing agreement, the servicers' new-loan volume, in fact, rose in 2016 (Chart 1).

**Chart 1 – Master Servicers' Loan-Boarding Volume by Loan Count**



Source: Morningstar Credit Ratings, LLC.

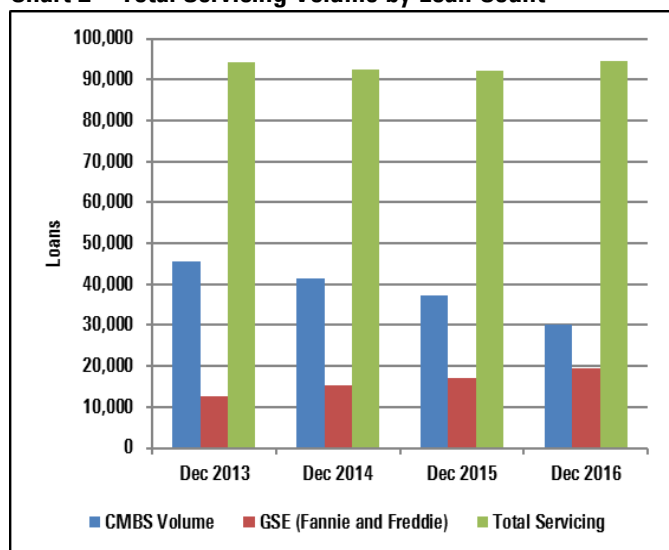
Additionally, the loan-boarding counts may be understated because data from one of the master servicers include only CMBS loans. Generally consistent with these results, the Mortgage Bankers Association reported \$490.6 billion in commercial and multifamily mortgages closed in 2016, down 3% from the prior year. Additionally, the MBA, in its 2016 Rankings of Commercial/Multifamily Mortgage Firms' Origination Volumes, identified each of the four master servicers, through their parent or affiliates, among the most active loan originators for GSEs and investor types other than CMBS.

Morningstar's latest CMBS maturity report notes that the payoff rate for matured, nondefeased loans rose to 75.1% from 64.3% in February, it remained below the 80.3% rate for January and 75.6% rate for 2016. While Morningstar forecasts maturity payoffs for 2017 to drop below these rates, and possibly to about 60%, matured CMBS loans, principally emanating from the high-water mark of CMBS issuance activity in 2007, have been paying off in large numbers to impede servicers' portfolio growth. Nonetheless, as a group, master servicers in 2016 marginally increased their combined portfolios by unpaid principal balances, and slightly increased their aggregate servicing volume by loan count (Charts 2 and 3). Three of the four master servicers experienced year-over-year gains in their portfolios by UPB, and two of the four master servicers increased their portfolios by loan count. However, their average loan size increased, as servicers noted that most of their new loans tend to have larger balances than those paying off.

The CMBS component of master servicers' portfolios continued to decline by UPB, loan count, and as a percentage of total servicing. Master servicers in 2016 added new CMBS servicing assignments, but issuance volume was not enough to offset the accelerated legacy-loan runoff rates. CMBS issuance volume slid to \$76.00 billion in 2016, down 24.8% from the prior year, according to *Commercial Mortgage Alert*, a trade publication. The average transaction size also declined to \$457.8 million in 2016 from \$631.3 million in 2015. Conversely, their servicing volume of GSE portfolios, led by Freddie Mac's prolific K-deal securitization program, continued to increase by UPB, loan count, and as a percentage of total servicing (Charts 2-5). As reported by *Commercial Mortgage Alert*, GSE securitization issuance climbed 21.6% in 2016 to \$75.17 billion, an amount nearly equal to new CMBS volume.

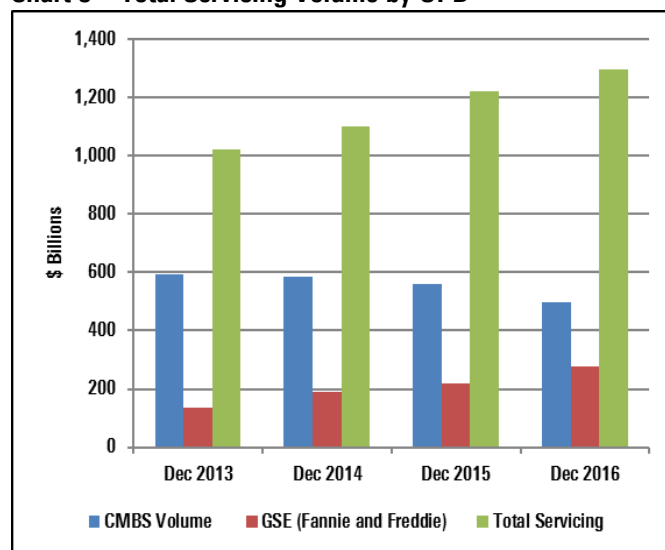
Master servicers procured assignments from third-party clients to diversify their portfolios. In addition to capitalizing on more GSE-backed issuance, servicers expanded relationships with commercial mortgage originators and investors encompassing real estate funds, private-equity companies, insurance companies, and other capital providers. The master servicers added assignments through shared-servicing, private-label, and subservicing arrangements and through specialty loan surveillance, reporting, and due-diligence work. For example, Berkadia Commercial Mortgage, through its KeyBank agreement and other relationships, promotes itself as a servicer's servicer. Similarly, Midland Loan Services reported a 13.5% gain by loan count last year in its shared-servicing work in which it licenses technology to and provides selected servicing functions for other servicers and lenders.

**Chart 2 – Total Servicing Volume by Loan Count\***



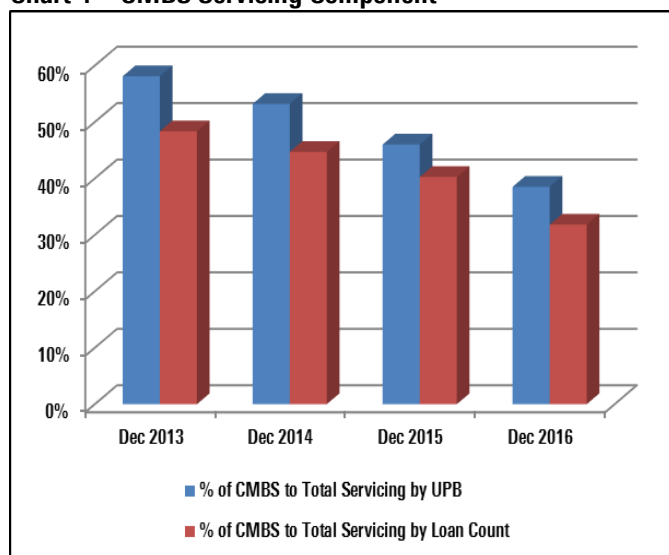
Source: Morningstar Credit Ratings, LLC.

**Chart 3 – Total Servicing Volume by UPB\***



Source: Morningstar Credit Ratings, LLC.

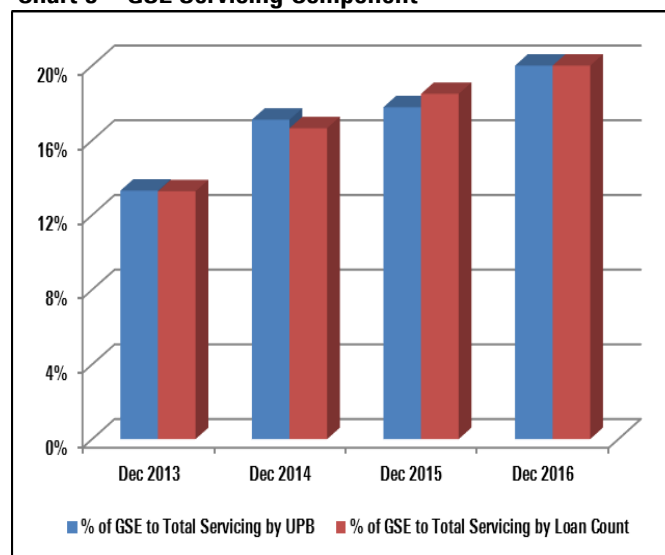
**Chart 4 – CMBS Servicing Component\***



Source: Morningstar Credit Ratings, LLC.

\*To reduce duplication, totals and percentages exclude CMBS primary-only serviced loans and exclude the KeyBank loans in Berkadia's portfolio through a shared-servicing agreement.

**Chart 5 – GSE Servicing Component\***

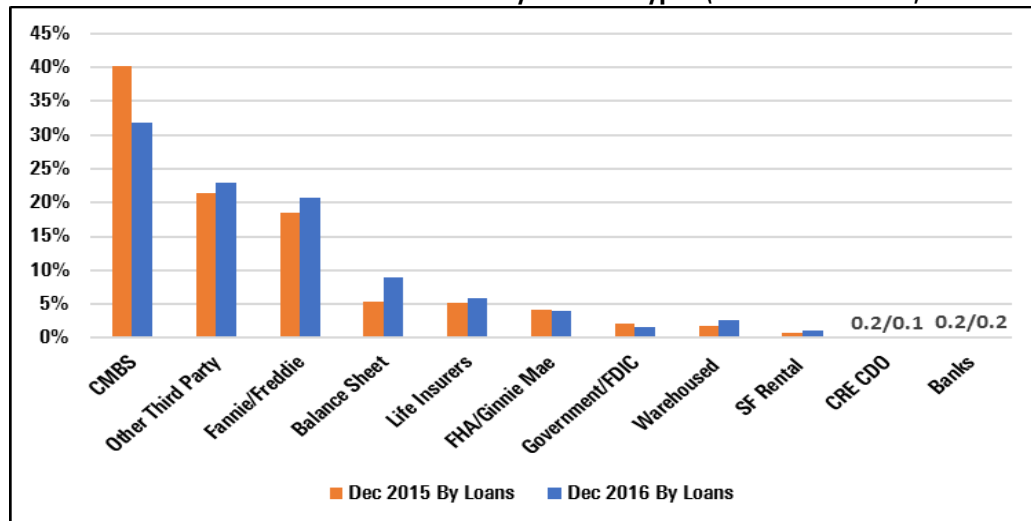


Source: Morningstar Credit Ratings, LLC.

The combination of these alternative opportunities and receding CMBS volume is changing the composition of master servicers' portfolios. Although CMBS loans dropped to 31.8% of the servicers combined portfolios at year-end 2016, they remained the dominant investor type. However, loans serviced for other clients gained ground. Not only did the share of GSE loans move higher (to 20.7% from 18.5%) in master servicers' portfolios, but life insurance-client loans (to 5.9% from 5.2%), balance-sheet loans (to

9.0% from 5.4%), and other third-party-owned loans (to 23.0% from 21.5%) also rose. Single-family rental loans claimed slightly more of the servicing pie (to 1.1% from 0.8%), with Midland Loan Services as the servicer for most of these transactions (Chart 6).

**Chart 6 – Master Servicers’ Total Portfolios by Investor Types (2015 Versus 2016)**

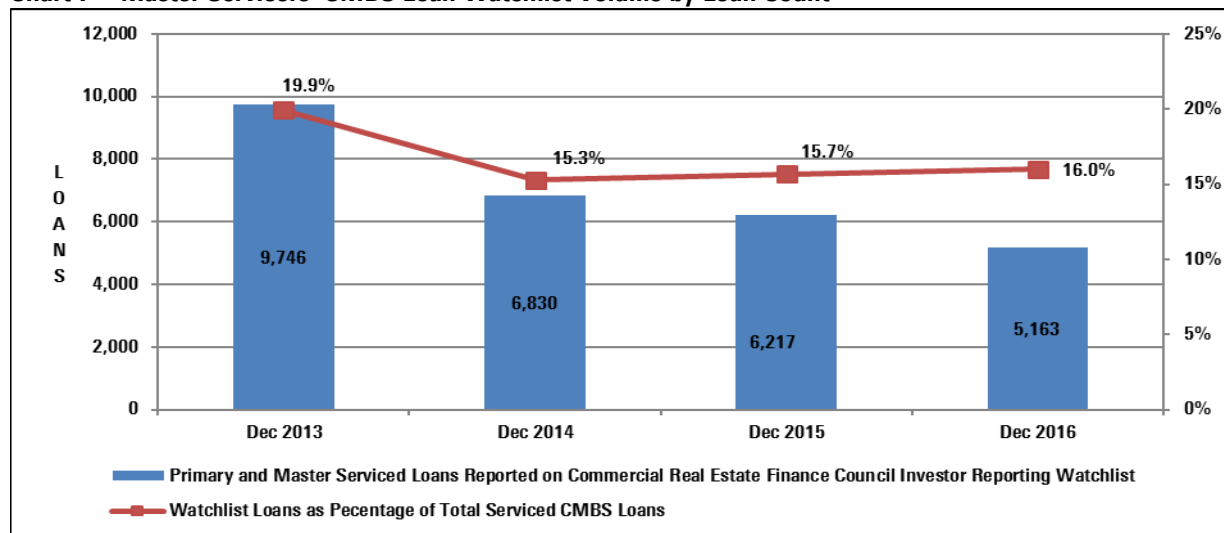


Source: Morningstar Credit Ratings, LLC. \*To reduce duplication, calculations exclude CMBS primary-only serviced loans and Berkadia loans in KeyBank’s portfolio through a shared-servicing agreement.

### Watchlists and Outstanding Advances Declined as CMBS Special Servicing Increased

The number of CMBS loans on master servicers’ watchlists fell 17.0% last year. However, their watchlist loan counts as a percentage of total CMBS servicing edged higher (Chart 7). This likely reflects shrinking CMBS portfolios and more imminently maturing CMBS loans.

**Chart 7 – Master Servicers’ CMBS Loan Watchlist Volume by Loan Count\***



Source: Morningstar Credit Ratings, LLC. \*Revised for 2013-15. Totals also account for KeyBank-Berkadia shared-servicing loans.

### Special-Servicing Transfers and Active Volume

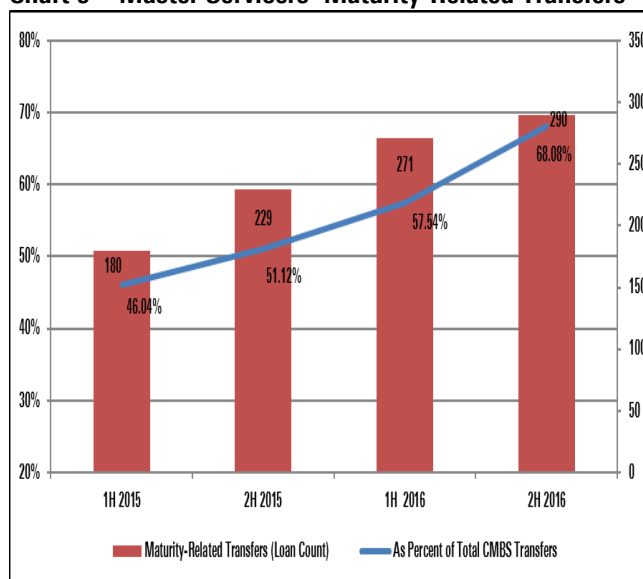
Master servicers' CMBS loan-transfer activity swelled 39.5% by UPB in 2016. The expanding volume of matured loans has been a major factor. Matured loans accounted for about 68.1% of master servicers' transfers during the second half of 2016, up from 46.0% in the first half of 2015 (Charts 8 and 9). Additionally, the percentage of specially serviced loans in master servicers' CMBS portfolios grew by UPB and loan count. These trends are consistent with Morningstar's CMBS delinquency tracking, which found the dollar volume of CMBS loans in special servicing was \$2.03 billion greater at year-end than at the beginning of 2016.

However, the percentage of all master servicers' loans in special servicing by UPB and loan count declined for the past two years (Chart 10). Morningstar expects master servicers' transfer interaction with special servicers to remain elevated in the months ahead as more matured loans are likely to encounter refinancing difficulties. Morningstar's December 2016 CMBS maturity report noted that the volume of legacy CMBS loans scheduled to mature this year stood at \$77.56 billion. Although the scheduled volume was \$104.21 billion from a year-earlier figure and declined to \$47.45 billion as of March, it remains sizable. Morningstar's CMBS delinquency reports found that loan transfers to special servicing in the first quarter of this year were up 38.6% by count from the same quarter last year and 32.8% higher from the fourth quarter. Furthermore, one master servicer noted that 91% of its loans transferred to special servicers during the first quarter involved balloon-payment or maturity-related loan defaults, up from 77% in the fourth quarter and 60% in the first quarter of 2016.

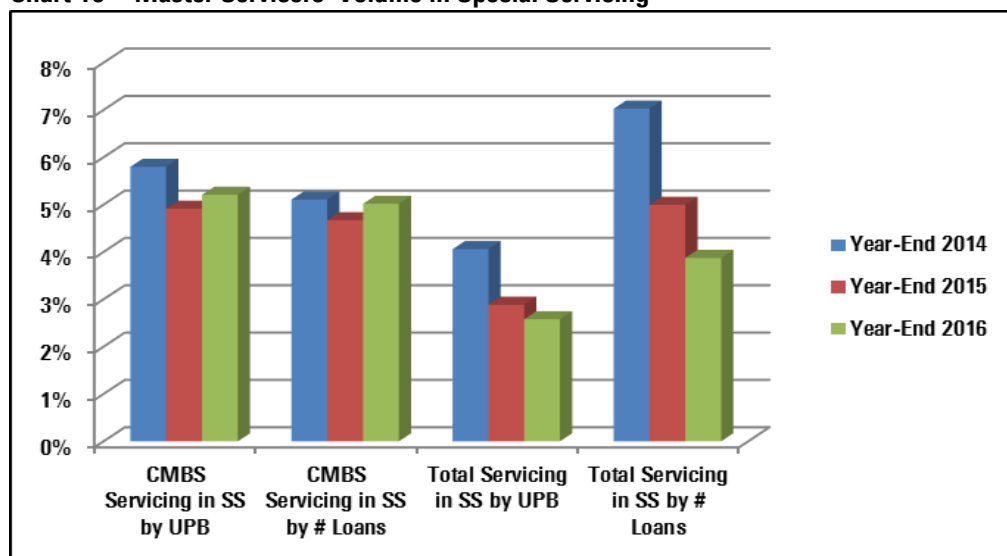
**Chart 8 – Master Servicers' CMBS Loan Transfers\***



**Chart 9 – Master Servicers' Maturity-Related Transfers\***



Source: Morningstar Credit Ratings, LLC. \*Excludes primary-only loans and net of KeyBank/Berkadia shared servicing.

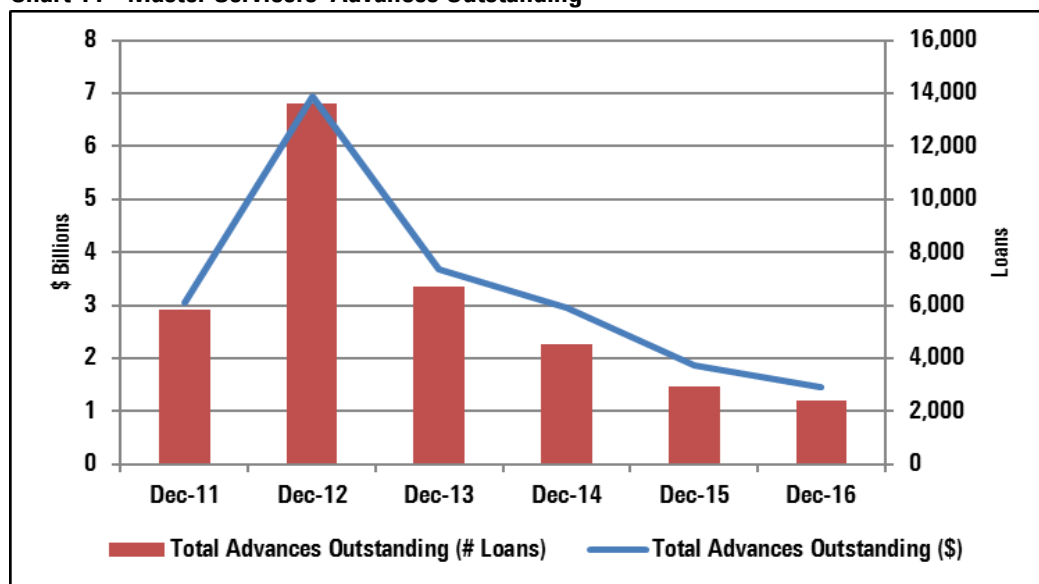
**Chart 10 – Master Servicers' Volume in Special Servicing\***

Source: Morningstar Credit Ratings, LLC. \*Excludes primary-only loans and net of KeyBank/Berkadia shared servicing.

### Payment Advances Outstanding

CMBS transactions stipulate that investors receive timely payment of interest and principal, and master servicers advance funds based on scheduled, rather than actual, borrower payments. They monitor collateral value to determine the recoverability of each loan-level advance, which may include property-protection expenses, and they may decide to cease advances. Although the duration of some advances may be brief to cover timing differences, most advances involve specially serviced loans. In recent years, master servicers adopted more conservative advancing-to-value thresholds, which represent the point at which they may elect to cut off advances. Additionally, advance-recoverability decisions often become more acute when CMBS transactions wind down to a few remaining assets, and especially if some of the assets are highly distressed. In such situations, master servicers may be more likely to stop advancing and act quickly to seize on the narrowing opportunities to recover the outstanding amounts.

Advancing activity generally follows loan-delinquency and special-servicing volume. As asset liquidations have outpaced special-servicing loan transfers involving debt-service payment defaults, master servicers' outstanding advances by dollar volume and loan count continued to shrink in 2016 (Chart 11). Additionally, as a trend reversal, the average age of the first principal and interest advance for each loan dropped to 423 days at year-end 2016 from 537 days at year-end 2015. This marks the first decline in the five years that Morningstar has tracked advances and likely reflects the removal of some long-term specially serviced loans.

**Chart 11– Master Servicers’ Advances Outstanding\***

Source: Morningstar Credit Ratings, LLC. \*Includes principal, interest, and property-protection advances.

### Easing of Leasing Consents and Defeasance as Servicers Pursue Processing Improvements

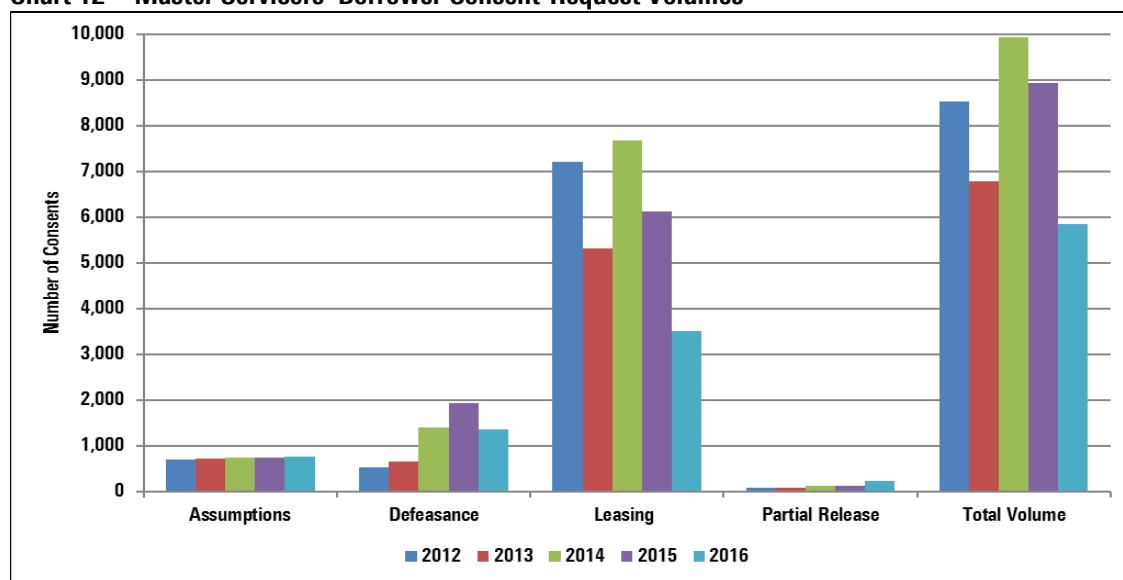
Master servicers processed 30.1% fewer defeasance requests in 2016. For the second consecutive year, they processed substantially fewer leasing-related consents: a 42.8% drop in 2016 following a 20.2% decrease in 2015. Loan-assumptions have increased by small increments in the past four years, although partial-release activity, while remaining comparatively low, nearly doubled last year. Notwithstanding those increases, total consent volume of the four types Morningstar tracks (loan assumptions, defeasance, partial property releases, and leasing-related) fell 34.5% in 2016. Even with the decline in absolute volume, master servicers’ total consent-management activity, at nearly 5,850 reported requests for these types, remained substantial (Chart 12). Additionally, servicers handle other consent requests such as reserve account disbursements, property-manager changes, and transfers of borrower/partnership equity interests.

Defeasance volume in 2016 was near 2014 levels, as CMBS borrowers continued to view it as an attractive way to capitalize on favorable real estate market conditions despite the processing costs. This activity, combined with other loan payoffs, caused the percentage of defeased loans in master servicers’ CMBS portfolios to increase. Defeased loans comprised 9.2% of master servicers’ CMBS portfolios as of Dec. 31, 2016, up from 8.4% a year earlier.



As discussed in a 2016 Morningstar report, effective consent processing and the need to cultivate positive borrower experiences have been challenging issues for CMBS servicers<sup>1</sup>. However, several servicers, including the master servicers, on their own and in conjunction with a Commercial Real Estate Finance Council task force, have increased their efforts to implement operational improvements and systemic changes to streamline approvals and reform borrowers' transactional costs<sup>2</sup>.

**Chart 12 – Master Servicers' Borrower Consent-Request Volumes\***



Source: Morningstar Credit Ratings, LLC. \*Processed as a master or primary servicer. CMBS loans comprise most of the volume.

### Master Servicers' Staffing Held Steady

More investor-reporting and compliance demands, combined with fluctuating loan-boarding, loan-payoff, payment-default, and consent-request volume, challenge servicers' efforts to optimize personnel levels and manage employee turnover to ensure operational stability. Although master servicers benefited from strong new-loan boarding activity in 2016, elevated loan-payoff volume, increased CMBS special-servicer interaction, and steady consent-request processing, along with other work such as CMBS trust terminations, resulted in master servicers' aggregate staffing levels remaining unchanged for the year (Chart 13).

Correspondingly, the number of loans serviced per employee, after declining for three years, did not change (Chart 14). However,

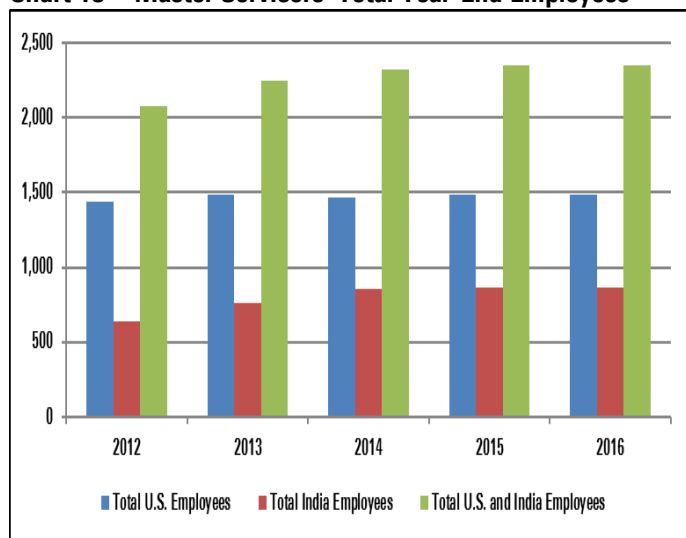
<sup>1</sup>Merriam, Michael S., "[Finding the Fast Lane—Consent Requests and Borrower Satisfaction Pose Relentless Challenges for CMBS Servicers](#)" (Oct. 24, 2016).

<sup>2</sup>"CMBS Providers Act on Borrower Complaints." *Commercial Mortgage Alert* (March 17, 2017).

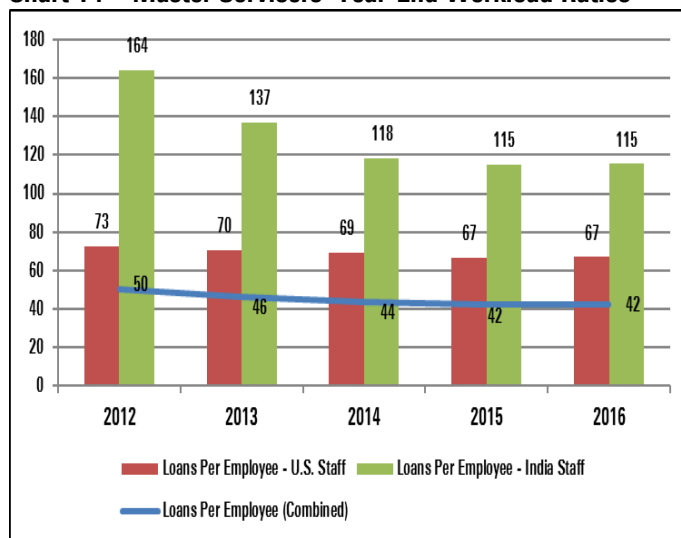
the servicers' staffing levels were not static, as they collectively experienced a 12.5% U.S.-based staff-turnover rate (net of intracompany transfers) and filled 231 positions.

The master servicers' aggregate staff counts and employee-workload ratios reflect that two servicers, Wells Fargo and Berkadia, leverage operations in India. India staff comprised 54.5% of their total employees at year-end 2016, up from 51.2% at year-end 2015. Additionally, Wells Fargo's share of the two servicers' combined India staff increased to 49.8% from 41.2%. In recent years, these two servicers have expanded the number and complexity of tasks performed at their India offices. The combined turnover rate for India-based staff was 20.4% in 2016, with Wells Fargo and Berkadia having similar turnover percentages.

**Chart 13 – Master Servicers' Total Year-End Employees\***



**Chart 14 – Master Servicers' Year-End Workload Ratios\***



\*Source: Morningstar Credit Ratings, LLC. Based on their entire master- and primary-servicing portfolios.

### Expectations as the Year Progresses

Commercial mortgage master servicers have diversified their client base as a hedge against depressed CMBS issuance and more loan payoffs. Subject to market conditions, the expected falloff of maturing CMBS loans in the second half of 2017 (corresponding to the near cessation of CMBS issuance a decade earlier) should ease portfolio runoff and offer servicers improved traction for growth. Furthermore, strengthening loan-production and CMBS-issuance activity are encouraging signs for servicers. Although first-quarter new CMBS issuance, at \$15.22 billion, was down 21.1% from the year-earlier period, projections for the second-quarter indicate a turnaround, as approximately \$16.6 billion of new conduit and single-borrower deals are in the pipeline through May, according to *Commercial Mortgage Alert*. Additionally, the Mortgage Bankers Association reported that loan originations increased 9% in the first quarter compared with the same period last year. Morningstar expects master servicers to exploit the servicing

opportunities from the new CMBS transactions, despite their inherent reporting and portfolio-management challenges, as they pursue other sources for business expansion.

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