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Catch a Wave: Commercial Mortgage Special Servicers Prepared for Maturities

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Morningstar Perspective

Commercial special servicers, the entities that resolve underperforming and nonperforming commercial mortgage loans, will be seeing an uptick in their portfolios as a large number of pre-2009 loans in commercial mortgage-backed securities transactions reach maturity. Morningstar Credit Ratings, LLC expects $52.42 billion in CMBS loans to mature for the rest of 2016 and another $99.47 billion in 2017, based on the March 2016 remittance data, the most recent available, and it will become more difficult for many of these loans to be refinanced because of rosy underwriting assumptions made at issuance. The uptick in special-servicing activity follows several years of low portfolio volumes as loan delinquencies dropped. Because of this, special servicers have had to trim their operations while maintaining their asset-management capabilities. Despite these changes, Morningstar-ranked special servicers, when viewed as a whole, should be suitably positioned, with some no doubt better positioned than others, to handle higher volumes of maturing CMBS loans unable to refinance and retain the necessary internal controls and technology to do so in a sound, risk-averse manner.

Declining Portfolio Volumes and Consolidating Operations

One of the changes affecting many special servicers has been the sharp falloff in their active portfolios of loans and real estate owned properties held for sale. The 10 most-active special servicers ranked by Morningstar collectively held 8,483 unresolved loans and REO assets as of Dec. 31, 2015, down from 15,454 on Dec. 31, 2013. This development has been the result of delinquency rates falling in the past few years amid positive economic conditions, the corresponding reduction of loans transferred to special servicers, special servicers successfully modifying and liquidating loans and avoiding some foreclosures, and special servicers quickly selling REO assets. The delinquency rate for CMBS loans stood at 2.83%, as of the March remittance period, the latest figures available, down 94 basis points from the year-earlier period, and well off the historical peak of 8.53% set in May 2012. The delinquent balance amounted to $21.96 billion, down from $29.55 billion in the year-earlier period.

The improving performance of CMBS loans has led a number of companies to change their organizational structures. Some special servicers that previously had dedicated loan and REO asset managers consolidated these responsibilities. While a few companies have found this to be a successful formula even in times of high volume, we find the best practice is to have separate managers for loans and REO assets. This helps lower workloads and allows for specialists who can devote their time when large complex assets need to be managed and liquidated. Some special servicers that have sizable REO portfolios retained separate loan and REO managers. One large-volume CMBS special servicer not only has dedicated asset managers for REO management, but also dedicated managers specifically for loan and REO sales. If loan delinquencies begin to spike, the special servicers that consolidated their operations may revert to their original organizational models.

Asset Manager Experience and Capacity are Preserved

Despite their declines in portfolio volumes and resulting staff reductions, most special servicers ranked by Morningstar have succeeded in retaining the experience levels of their asset-management staff. Based on a review of 10 Morningstar-ranked special servicers, asset managers' average years of experience dipped to 15.7 years as of Dec. 31, 2015, from 17.3 years as of Dec. 31, 2013. The total number of asset managers dropped by 32% during the same two-year period. For all of these special servicers, including three companies with primarily small-balance and land assets in their portfolios, the ratio of assets to asset manager declined to 42:1 from 51:1. However, for the seven special servicers with portfolios of larger-balance CMBS assets, the workload ratio was little changed at 12:1. Because most CMBS special servicers stated their targeted workload ratio maximums are in the 15:1 to 18:1 range, a 12:1 ratio means the servicers have some excess capacity to accommodate an increase in portfolio activity.

Many special servicers said that some of the reductions in their special-servicing staff in the past few years involved asset managers transferring to other business lines such as loan-origination and acquisition due diligence, performing-loan surveillance, and borrower consent requests management. In some cases, former asset managers redeployed to the special servicer's companion primary servicing platform. As a result, many special servicers professed to have contingent asset-management resources beyond what is discernible from their immediate staffing organizational charts. Finally, Dallas and Miami are the two most prominent office locations for special servicers. Special servicers in these cities believe their local labor markets will continue to offer a strong pool of potential asset-management talent.

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Technology Advances Have Strengthened Special-Servicing Operations

Most of the Morningstar-ranked special servicers have maintained or enhanced their investment in asset-management technology. Most special servicers we have reviewed support loan resolution plans on their asset-management systems. In addition, those affiliated with primary- or master-servicing platforms linked their system to the servicing database, so essential servicing data such as balance, interest rate, and payment histories can automatically populate the asset-management systems. Most have minimized the use of side applications and have centralized most, if not all, asset-management functionality in the main system. This leads to greater efficiencies in the asset-management and disposition process. Additionally, many special servicers have leveraged their systems to manage their asset-resolution approval processes, allowing for speedier execution; time is of the essence in asset-resolution cases. While special servicers traditionally preferred to build proprietary asset-management systems that fit their specifications and workflow processes, some companies purchased systems provided and supported by third-party technology vendors. One advantage to this is the lower cost, as it precludes the need to hire software development personnel and invest in technical support. Morningstar believes either approach is sound, as long as the companies maintain business resumption and disaster-recovery support and the systems can house the necessary information for all asset-management activities within one consolidated application.

Control Practices Remain Generally Intact

Most special servicers we rank have maintained or expanded their internal controls. For instance, many have intensified the level of audit and quality control over their asset-management practices and functions. In many cases, special servicers have added internal risk-management functions to augment third-party or parent company audits. One nonbank special servicer requested its parent company’s internal audit department to place it on a 12-month review cycle rather than the existing 18-month cycle, which corresponded to the special servicer’s operational risk score. Also, at the asset level, most companies that had property-management audit protocols have maintained those programs, and the few that did not have these protocols initiated them. We believe property manager audits are best practice and help insure the integrity of cash flow at the property level. Both regulated and nonregulated entities have emphasized compliance with pooling and servicing agreement requirements as well as third-party client guidelines. In many cases, this has meant the addition of compliance personnel.

Certain companies may not use a committee-type process to deliberate and approve proposed asset resolutions because they have smaller volumes or more smaller-balance assets. However, most Morningstar-ranked special servicers--particularly those handling large, complex assets--do use a committee process, which we regard as a best practice.

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Improved Transparency Regarding Conflicts of Interest

Another area where special servicers have made strides since the Great Recession is managing conflicts of interest. All special servicers ranked by Morningstar strive to provide transparency around how they use affiliates to sell or purchase assets in a securitized pool. They also stopped collecting fees from the trust and the borrower, especially if doing so would trigger higher losses. Others have refrained from using affiliates to manage or dispose of troubled assets. In the case of one company, there are internal policies that prohibit purchasing assets from CMBS trusts for the fair-market value, the buyer and seller's agreed-upon value of an asset. This is especially important because, while newer-issue CMBS transactions have heightened restrictions in this regard, most of the pre-2009 transactions that will mature soon do not.

Looking Ahead

We believe that special servicers, in most cases, have adapted well to the lower delinquency rates in commercial loan pools and the rapid runoff of their portfolios. While facing cost pressures and personnel retention challenges, most of our ranked special servicers have controlled voluntary turnover rates and engaged in effective resource management, including technology reinvestment at some companies, to avoid hindering their asset-management capabilities. As volumes pick up again this year and next year, the Morningstar-ranked special servicers should be able to handle the load.

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