Operational Risk Assessments Research

Finding the Fast Lane--Consent Requests and Borrower Satisfaction Pose Relentless Challenges for CMBS Servicers

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Morningstar Perspective

A critical and perennial need for the commercial mortgage-backed securities industry is ensuring it attracts borrowers by providing them with a positive servicing experience, especially in light of increased competition from other financing sources. CMBS servicers and special servicers face significant obstacles to achieve timely service when handling consent requests, one of their most important borrower-focused responsibilities, because of the number of parties required for approval as well as the complexity and variability of the transactions. In recent years, many servicers have adjusted their operations and enhanced technology to strengthen consent processing and improve service levels, and both the Commercial Real Estate Finance Council and Freddie Mac have worked to standardize documents and requirements and streamline processes. Morningstar Credit Ratings, LLC's examination of the aggregated consent-processing times of four large-volume master servicers indicates that amid substantial request volume, their average completion times during the past few years have been fairly constant and even quicker in some periods. However, despite their efforts, CMBS servicers remain under scrutiny. Most notably, as reported by *Commercial Mortgage Alert*[1], a group of issuers and investors submitted a letter to CREFC voicing concerns with servicers' and special servicers' practices, including consent-request management and the overriding issue of borrower satisfaction. Although many variables can affect consent-processing time frames, including some that may be beyond their control, CMBS servicers remain challenged to circumvent the roadblocks and find new avenues to boost performance.

[1] "CREFC Addressing Servicer Critics" *Commercial Mortgage Alert.* Sept. 16, 2016

Hazards and Detours: The Obstacles to Timely Consent Processing

Consent requests in CMBS transactions can encounter potential delays at every turn. Many variables can impede processing timelines. Chief among these are the multiparty approval process as required by most CMBS deal documents, the transaction's complexity, and information requirements.

Multiparty Approval Process

CMBS consents typically involve multiparty approvals in which the designated primary or master servicer takes the lead role to interact with the borrower, obtain the required documents and information, underwrite the request, prepare the written case for internal review, and procure any required external-party approvals. Additionally, the lead servicer normally must obtain consent from the transaction's special servicer for actions defined as major decisions, such as loan assumptions, property-management changes, collateral substitutions or releases, or large-tenant leases. The final approver for most consents is the controlling-class representative, or CCR, which is usually, or at least initially, the most subordinate investor class (in many cases, the CCR and special servicer are affiliated parties). CCRs typically respond, but their consent also may be deemed as given if they do not respond within a certain number of days. However, for CMBS transactions with an appointed trust advisor, the CCR's approval rights can diminish, and the trust advisor's involvement can expand if the transaction's performance degrades. Finally, the servicer may need rating agency consent in some situations, although such consent is sometimes passively granted. While this conventional consent-approval flow may contribute to a thorough analysis by garnering additional viewpoints, it invariably adds time.

Transaction Complexity and Information Requirements

Servicers also point to the often daunting information and document requirements as another speed bump. For example, loan assumptions--one of the most prevalent, complex, and time-sensitive request types--involve many submission items, including financial statements, legal documentation, and sales contracts involving the proposed new borrowing entity. The loan-assumption process and its document requirements, as well as those for other consent types, can vary among loan originators, servicers, and pooling and servicing agreements. Updated valuations and required municipal approvals can extend consents involving collateral releases or changes of use. As a result, some consulting firms have established business lines to assist borrowers with loan assumptions and other consents. Accordingly, servicers often mention borrower-related delays and missing documentation to explain why certain consents took a long time to complete.

Further contributing to the challenges of timely consent processing, according to some servicers, is that loan structures have become increasingly complex in the past couple of years, possibly because of competition among lenders and their desire to accommodate borrowers' financing demands. Additionally, servicers noted that loans originated in recent years tend to have more compliance requirements and performance-driven trigger events than loans issued before the financial crisis. These elements can compound the underwriting of a consent request.

Navigating Through Traffic: Operational Enhancements and Best Practices

Confronted with heavy consent-processing workloads, many CMBS servicers have bolstered staffing and refined their organizational structures with consent-management teams and subject-matter experts. In addition, they have enhanced their technology to facilitate transaction management and are working to improve borrower-communication channels.

Staffing and Organizational Management

Morningstar calculated that the average portfolio-management staff experience of the four dominant CMBS master servicers (Wells Fargo Commercial Mortgage Servicing, Midland Loan Services, KeyBank, N.A., and Berkadia Commercial Mortgage LLC), which includes employees engaged in consent requests and borrower-relationship management, increased to 18 years as of June 2016 from 15 years as of December 2013. Additionally, their total portfolio-management staff increased by 53% during that time, while their total combined volume of loan assumptions, leasing consents, property releases, and defeasance requests increased by approximately 31% between 2013 and 2015. To manage consent volume, which can include other types of credit-related requests, some servicers may engage vendors to assist with compiling information, data input, and cash flow modeling. For situations in which one entity is both the master servicer and special servicer, the servicer may consolidate the consent review to one team. However, in Morningstar's experience, the servicer commonly has its special-servicing group also review the same request, because such an approach can add an extra level of control without unduly extending review time. As a best practice, both servicers and special servicers should have policies and procedures for approvals denoting sound controls through appropriately delegated levels of management authority.

To facilitate borrower communication, many servicers have modified their operations from a strict siloed or functional approach to a relationship-manager structure, enabling borrowers to have a single point of contact. Wells Fargo, for example, also has a team catering to borrowers with the largest and most complex loans. Midland Loan Services has developed an ombudsman process for its master- and special-servicing consent approvals in which staff assist borrowers with problematic situations and facilitate in finding solutions. Some CMBS special servicers have established asset-management teams for consent processing and, with their nonperforming loan volumes declining in recent years, have been able to reallocate staff to assist with consents. Because not every borrower request may be feasible or permissible, a few servicers noted that they strive to inform a borrower at the earliest possible point if a request cannot be met. However, servicers stated that they aim to accommodate borrowers as permitted within the confines of servicing agreements and loan documents. Some servicers have formally surveyed borrowers to track contentment levels, using the survey scores and comments to identify areas for improvements.

Technology Advancements

Morningstar believes that some servicers' upgraded servicing systems, along with their proprietary applications, have stronger workflow-management capabilities to track pending consent requests, approval queues, required information and documents, and processing times. Some servicers can prepare their consent-request cases directly in their asset-management and workflow systems that provide electronic approvals and templates customized for different consent types. Servicers also have been expanding the capabilities of their borrower web portals to be more interactive with secured email and chat capabilities, compliance alerts, and document-exchange features. These tools certainly do not supplant the need for a borrower to have telephone access to a responsive and knowledgeable servicer contact person. However, Morningstar believes that servicers will continue to leverage their borrower websites as a complementary means to improve borrower communication.

Educating Borrowers

Servicers frequently comment that CMBS borrowers often are not sufficiently aware of the provisions, obligations, and fees delineated in their loan documents, especially as they relate to consent requests. Furthermore, servicers believe that lenders should educate borrowers during the loan-origination process about the nuances of CMBS financing. While such efforts might help, they may not be realistic expectations. As a result, the burden of increasing borrowers' understanding of CMBS requirements continues to rest with servicers. Educational tutorials designed specifically for CMBS borrowers could potentially produce worthwhile results.

Highway Improvements: Freddie Mac's and CREFC's Efforts to Streamline and Standardize

Freddie Mac has been at the forefront to reform consent-processing practices and requirements for its multifamily-loan servicers as part of the larger goal of improving borrower satisfaction. Most notably, in 2014, Freddie Mac expanded and refined its existing servicing standard, which has been the cornerstone of its guidebook for servicers and essentially mandates that all servicing-related parties practice transparency, act collaboratively, and communicate proactively. Freddie Mac established rigid servicer-compliance guidelines to cap legal and other transaction fees, streamline the chain of approvals, and shorten consent-processing timelines. In particular, Freddie Mac expects its servicers to complete assumptions, ownership transfers, or other consents it defines as complex within 30 days of receiving a complete information package from the borrower. For matters it deems routine, Freddie Mac set a 15-day time frame. Another differentiating aspect of Freddie Mac's consent-request process for its securitizations is that servicers must send their consent packages directly to the CCR and bypass the special servicer[2]. Freddie Mac noted that it continues to enhance its consent-management process with more granular tracking of request deliverables and that its securitization-program servicing agreements require the servicers to comply with its guide and standards. Also, Freddie Mac teamed with KeyBank last year in a pilot project to construct a data-sharing interface between Freddie Mac's consent-request tracker and KeyBank's asset-management application to reduce data-entry redundancy.

Another positive stimulus to establish consistent consent-underwriting practices is CREFC's initiative to standardize documents and information requirements. Through a task force, the trade organization in September of this year formally adopted and has made available a standardized loan-assumption closing checklist and underwriting guidelines for loan assumptions.

Speedometer Readings: Searching for Positive Trends

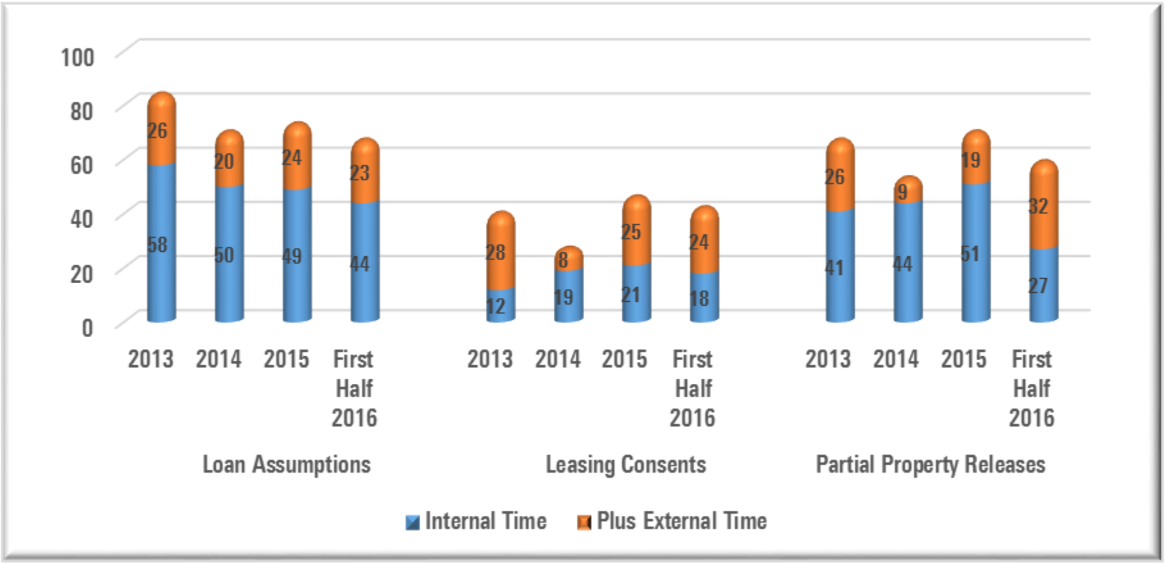
Using aggregated data from the four previously mentioned CMBS master servicers, Morningstar examined average consent-processing times for 2013 through June 2016 for three common borrower requests that typically involve external-party approvals: loan assumptions, leasing consents, and partial releases of property collateral.

As shown in Exhibit 1, it is difficult to find definitive evidence of absolute year-over-year time-reduction trends. Clearly, the case-specific circumstances of many requests, and other factors, can easily skew the averages. Servicers also do not define their start and completion dates in the same way. However, Morningstar's analysis found mostly narrow fluctuations for average completion times, while the servicers confronted high processing volume in these periods. As stated in Morningstar's June 2016 report[3] on master servicers' portfolio-growth trends, although their consent volume decreased 11% in 2015, it followed a 46.8% jump in 2014. For 2015, these servicers still processed more than 8,800 requests involving loan assumptions, leasing consents, partial releases, and defeasance. Additionally, loan assumptions, as a high-profile consent type, show a positive trend regarding servicers' average internal-approval times, which declined in each subsequent period, while their total processing times dropped after 2013 and remained fairly stable since.

[2] Dent, Pamela. "Understanding the Freddie Mac Servicing Standard", *CRE Finance World, Winter 2015, Vol. 17 No. 1, page 40*

[3] Merriam, Michael. "Commercial Mortgage Servicing Trends—Challenges Ahead in Quest for Portfolio Growth", June 16, 2016 - *Morningstar Credit Ratings*

Exhibit 1 – Master Servicers' Average Consent-Processing Times (Days)*



*Based on data (mostly CMBS loans) aggregated from Berkadia Commercial Mortgage, KeyBank, Midland Loan Services, and Wells Fargo.

<u>The Special Servicer as Designated Driver</u>

Another wrinkle to consent processing, and in contrast to the traditional model, are cases of some CMBS servicing agreements permitting the special servicer to bypass the master servicer, or its designated subservicer, and unilaterally underwrite the consent request (aside from any required approval from the CCR, which is often a related party, or consultation with a trust advisor). The special servicers handling such consents will often note the merits of this alternate approval structure based on time-efficiency gains and their rigorous analytical diligence. With reduced nonperforming loan volume in recent years, some special servicers have redeployed personnel and established teams to work exclusively on consent requests. Correspondingly, the special-servicer-control approach can ease master servicers' workloads. However, critics cite concerns that this alternate approval process potentially increases the opportunity for the special servicer to pursue terms and conditions that may unduly exceed a loan's original underwriting, which, in turn, can sour the borrower's servicing experience.

Morningstar analyzed assumption and lease-consent times of loans with this approval structure for two special servicers, Torchlight Loan Services, LLC and Rialto Capital Advisors, LLC. The results offer support for the time-efficiency argument. These special servicers' total loan-assumption processing time averaged 35 days in 2015, based on 24 requests, and averaged 56 days in the first half of 2016 based on 37 requests. For leasing consents, the two special servicers, based on 37 requests in 2015 and 64 in the first half of 2016 under this structure, averaged 21 days in both periods. Although their volume when acting in this role was much less than the master servicers' total volume, the special servicers' averages were consistently below Morningstar's calculated master-servicer averages.

The Road Ahead

In many respects, servicers have made inroads to strengthen their consent processing and borrower-relationship management. However, the recent letter to the CREFC, and subsequent action to establish a task force, indicates that discontentment persists. While CMBS can potentially offer attractive financing terms, providing a high-quality servicing experience is integral to the sector's sustainability and growth. The inherent structural requirements and complexities of CMBS transactions may always constrain them from competing on equal footing with portfolio lenders when it comes to consent requests. Nonetheless, Morningstar believes that servicers, motivated at the very least by competition and reputation, should remain critical of their own performance and continue to pursue process improvements to raise borrower satisfaction.