

# REAL ESTATE CAPITAL MARKETS ADVISOR

An informational newsletter from Goodwin Procter's Real Estate & RE Capital Markets Group

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## A Look at Commercial Real Estate Debt: Where We Are Now and Where We May Be Going

Like other parts of the economy outside the immediate context of the banking and financial system, the commercial real estate industry so far has felt the impact of current economic woes principally in the form of dramatically tightened credit markets. But worse is expected as rents fall and business failures increase in the current recession. Here are some thoughts on the current environment and what the future may hold, focusing principally on mortgage debt.

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### Mortgage Refinancing

The enormous volume of commercial (including multifamily) mortgage loans originated over the last three years or so has had the effect of pushing the bulk of scheduled maturities out a number of years. According to JP Morgan, of more than \$600 billion of outstanding CMBS fixed-rate debt, only \$16 billion is scheduled to mature in 2008 and \$19 billion in 2009 (for a total of \$35 billion), reflecting the fact that fixed-rate loans mostly have maturities of ten years. Scheduled maturities of fixed-rate CMBS debt reach peaks of \$98 billion in 2015, \$128 billion in 2016 and \$127 billion in 2017, and 65% to 85% of those loans are interest-only for the entire or partial term. As for the near future, \$28 billion of the \$35 billion maturing in 2008 and 2009 has been amortizing over the full term, bettering the odds that the balloon can be covered.

There are of course shorter maturities in floating-rate CMBS loans. Wachovia has identified \$30 billion of large-loan floating-rate deals that are scheduled to mature before May 2009, the majority of which were originated in 2006 and 2007. Of that amount, 95% apparently have extension options, although it remains to be seen whether borrowers will be in a position to meet the terms necessary for exercise, such as loan-to-value or debt service coverage tests, or have the ability (including access to the equity capital necessary) to reduce principal to meet such tests.

It is expected that commercial mortgage loans held outside the CMBS world will follow a similar pattern. Overall, the fact that the largest waves of maturities in commercial real estate mortgage debt are some years off may be reason for less near-term pessimism than in the residential market, but much depends on whether properties can continue to perform (for these purposes, a property ordinarily is still performing even if a mezzanine lender has taken control, so long as the senior mortgage debt is not in default).

This big picture is of little comfort to those commercial property owners (or their mezzanine lenders) who have mortgage debt maturities approaching. They are on the lonely front lines of the credit squeeze. Insurance companies and other balance sheet lenders, enjoying their newfound popularity in the market, are providing extensions or refinancing mortgage loans for some existing customers and what they perceive as the cream of the remaining crop, but overall, sources of capital to refinance mortgage loans remain relatively scarce. Rates and upfront and back-end fees have increased and underwriting standards have tightened significantly. The future may hold more of the same: certain lenders are already notifying some borrowers as far as a year in advance that they will not refinance existing mortgage debt.

In the CMBS world, many servicers (including independent special servicers) do not appear to be eager to take over properties. They generally have been willing to extend for 30 or 60 days to allow additional time when necessary for borrowers to actually close on third-party refinancings. Where third-party refinancing is not available and they can do so under applicable pooling and servicing agreements and other documentation, such servicers appear willing to extend performing loans with adequate debt service coverage ratios for a year with a modest interest rate bump and no repayment of proceeds.

Anticipating that many properties cannot be refinanced without a partial paydown, many funds and other capital sources are looking to provide mezzanine financing or preferred equity, but are proceeding very cautiously. Properties that are unable to meet requirements for current or accrued pay and expected equity returns will fall into the nonperforming category and wind up as real estate owned.

Those with mortgage loans maturing beyond the near term will either wait for the credit markets to improve or try to arrange extensions if they can be had on what seem to be attractive terms.

Construction loans and other loans with future funding obligations are presenting particular headaches. Borrowers and lender syndications have had to deal with the inability or unwillingness of some lenders to fund their portions of advances. Projects seeking construction financing have found the market exceedingly thin, particularly in large loans. One telling example is a \$700 million project under construction that hit difficulty in loan syndication and initially tried to stay the course by reducing its leverage from 76% to 51%, but is now looking at scaling back the project dramatically.

Long term, almost everybody seems to think the CMBS market ultimately has to return in some form, but it will take a while and it won't be as big, leaving a gap to be filled by other lenders and private real estate equity capital. In order for the securitization market to return to health, it will be necessary to understand and address the systemic drivers that led to its breakdown, and investors will have to believe that they are able to assess risk accurately or at least more safely.

## **Troubled Commercial Mortgage Loans**

The delinquency rate on CMBS remains low for now. Fitch's loan delinquency index was only 0.45% (45 bps) at the end of September, consisting of 488 loans totaling \$2.5 billion in unpaid principal out of \$556 billion in Fitch's rated portfolio. Fitch reports an additional 246 nondelinquent loans that are already in special servicing due to imminent default or other nonmonetary reasons, and while not all of them will become delinquent, if they did the delinquency rate would double to 90 bps. In any event delinquencies are expected to rise due to the weak economy and strained credit markets.

Mortgage loans securitized in 2005 - 2007 represent particular challenges. Not only did originations in those years dramatically exceed the volume of previous years, but underwriting standards across the commercial real estate industry eased as property valuations rose to near market peaks and loans were increasingly interest-only as noted above. Fitch observes that historic CMBS default curves show defaults peaking in years three through eight, but there is a notable trend of loans in the 2006 and 2007 vintages being transferred to special servicing one or two years after securitization. Goldman Sachs has projected that losses on commercial mortgages originated in 2007 could reach 11%. So trouble is brewing.

Suspensions that the U.S. Treasury intends to use its authority under the Emergency Economic Stabilization Act of 2008 not to purchase troubled debt as originally contemplated, but to provide capital infusions to the financial system, have now been officially confirmed by Secretary Paulson. The total already committed on capital infusions to banks and AIG is \$290 billion, only \$60 billion shy of the first half of the \$700 billion total that was authorized. Secretary Paulson has announced that the second half will be directed towards relieving pressures on consumer credit such as credit card debt, car loans and student loans, although Congress has the power to reject Treasury's request for the second \$350 billion and many lawmakers are unhappy with the Bush administration's reluctance to provide capital infusions to the auto industry and to do more to address residential foreclosures. Even if the Treasury comes back to purchasing troubled assets, presumably with a supplement to the \$700 billion, given the severity of current problems in the residential mortgage market, it seems likely that such efforts will focus solely on purchasing or restructuring residential debt, and commercial real estate debt will have to await private buyers without much, if any, Treasury support in establishing a market.

## **Regulatory Approaches**

No doubt there will be tightening of financial regulation in order to address the perceived causes of the current financial meltdown. But in order to allow existing mortgage loans to be restructured it will also be necessary to solve inhibitions that exist within the REMIC structure (for both RMBS and CMBS). These fall into two categories—changes to the REMIC rules under the tax code, and structural reforms.

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First, the tax rules need to be loosened that require the REMIC to hold a substantially fixed pool of mortgages and not be actively engaged in a lending business (in contrast to the flexibility available in CDOs). Although workouts of defaulted mortgage loans have always been allowed under the REMIC rules, some recognition has recently been given that waiting for default may not be the most sensible approach. In 2007 and 2008, the IRS expanded safe harbors to allow servicers to make residential mortgage loan modifications under foreclosure prevention programs for a limited period of time. On the CMBS side, nothing of the kind has yet occurred. The IRS proposed in December 2007, but has not yet adopted, additional safe harbors for performing CMBS that would allow changes in collateral, credit enhancement and recourse, but only if supported by an appraisal. Other safe harbors requested by the American Securitization Forum were not included in the proposed regulation.

Second, there are structural inhibitions to workouts of securitized mortgage loans. Under typical MBS documents, decision-making is split between the servicer and a controlling junior debt class that changes based on an appraisal to determine who is still in the money. Servicers have fees at stake and other conflicts of interest they are expected to overlook, and they have reason to fear litigation from any class that is disappointed with the outcome of a workout or a sale of troubled debt outside of foreclosure. These concerns have long been recognized as inherent in the MBS structure, but now is when the stress testing begins. In the residential context, where loans are recourse, the economic harm is visible and the political impacts are great, the conditions may be ripe for some regulatory fix, whether in the form of a liability shield or something more intrusive (despite the Contract Clause of the Constitution). That could be a guide for similar regulatory intervention for the CMBS market, although it must be recognized that very different political considerations will apply to CMBS.

### **Investment Opportunities**

Many real estate funds and other investors are looking for opportunities to purchase debt and other distressed assets. The first wave of debt purchase transactions over the last year and a half was a means for holders to move debt off their balance sheets that didn't make it into securitization, especially B notes and mezzanine tranches. Purchasers typically have been buying for yield based on the discount offered, but there has also been some "loan to own" activity. Borrowers are also buying back their own debt where possible. Investors are pursuing servicers, banks and other contacts for available debt and other troubled assets, and we expect that purchase activity will continue and accelerate as the economic picture becomes more clear and liquidity eases in the credit markets. We also expect to see investors who lack experienced real estate personnel teaming up with real estate managers and operators in joint ventures or fee-based arrangements.

We will continue to follow developments and will provide more information as available.

For further information about the issues raised in this newsletter, please contact your usual Goodwin Procter attorney or any of the attorneys listed below.

<b>Minta E. Kay</b>	mkay@goodwinprocter.com	617.570.1877
<b>Gilbert G. Menna</b>	gmenna@goodwinprocter.com	617.570.1433
<b>Dean C. Pappas</b>	dpappas@goodwinprocter.com	213.426.2525
<b>Christopher B. Price</b>	cbprice@goodwinprocter.com	212.813.8951
<b>Samuel L. Richardson</b>	srichardson@goodwinprocter.com	617.570.1878
<b>Andrew C. Sucoff</b>	asucoff@goodwinprocter.com	617.570.1995
<b>Adam N. Weisenberg</b>	aweisenberg@goodwinprocter.com	617.570.1473

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