Distressed Apartment Loans

Related Conditions

A series of events which had their genesis in late 2003/early 2004, and have continued into the present have resulted in a near certainty of loan distress – current, or proximate – among apartment borrowing categories relating to:

- Properties acquired during the 2004-2007 period
- Properties completed since early 2008
- Properties currently under construction
- Fractured condominiums

Apartment properties falling within those parameters are generally distressed, consequently in-place loans (construction, or permanent) are also distressed, or have considerable near-term potential to become distressed.

The condition relates to three circumstances:

- Acquisition loans during the 2004-2007 period were generally aggressive, many combining a high leverage first, with mezzanine financing. The condition was further exacerbated by often generous lender underwriting.
- Economic conditions, which began to turn down in late 2007, have deteriorated at an accelerating rate since, resulting in considerable weakening of apartment rental market conditions. Pro-forma incomes, forecasted to rise, have, in the norm, reduced. For most, income reduction has been considerable.
- Paradoxically, even if incomes had remained unchanged, loan underwriting has undergone markedly tightened parameters, resulting in funds available to refinance a particular loan being greatly reduced.
- Lenders are required to appraise current property values, and mark down loan values to current market values – all greatly reduced.
- Properties acquired for purposes of conversion to condominiums, but which were either not sold to individuals, or were partially converted, are returning to rental status under distressed conditions.
- Condominiums, originally constructed for sale, are converting to rental.

Within the subject of properties distressed as a result of loan problems, two principal categories are of concern: Conventional loans, and; CMBS (Commercial Mortgage Backed Securities) loans. Distinctions between, and within, the two categories generally define as:

Conventional Loan Sources

Conventional loan sources include private banks, and non-banks, and government agencies – HUD, Fannie May, and Freddie Mac:

- ***Bank Loans* –** Bank loans, issued by Federally insured institutions, are subject to regulatory guidelines issued by state, or Federal, agencies, and more particularly are subject to Federal Deposit Insurance Corporation (FDIC) guidelines. Banks generally work directly with the borrower for loan placement.
- ***Non-Bank Loans*** – Non-bank loans are funded by private business organizations, and government agencies. Private lenders include:
    - *Pension Funds* – Pension fund loans are usually placed by servicers – pension fund advisors (such as AEW), or through mortgage banking/mortgage broker firms.

- *Insurance Companies* – Insurance company loans are typically placed through mortgage bankers and mortgage brokers, but can also be direct between the lender and borrower.
- *Corporations* – As example, GE Credit. Corporate lenders place their loans directly with the borrower, or through mortgage bankers/mortgage brokers.

- ***Government Agency Loans*** – Government agency-provided loans are referred to as Government Sponsored Enterprises (GSEs), and are made available through three sources:
  - *Fannie Mae and Freddie Mac* – Fannie Mae and Freddie Mac loans are typically placed through mortgage brokers, some of which are authorized to provide their own underwriting. These "DUS" lenders, through a special arrangement with Fannie Mae and Freddie Mac, not only generate loan prospects, but also underwrite the loans they place.
  - HUD – 221(d)4/223(f) – HUD loans have, until recently, been notably limited in use, but are becoming more prevalent. The HUD 221(d)(4) loan is made available for new development; the 223(f) loan is made available for acquisition and renovation of an existing property. Financing under both formats can be relatively attractive. A HUD loan advantage is there is no personal liability required of the borrower, and payment terms are attractive.

Aside from Fannie, Freddie, and HUD loans, the rest of the lender community has in common that formats are also relatively conventional. That is, a specific time period is attached, and the borrower may, or may not, be required to agree to personal liability. In the case of bank construction loans, or A & D (Acquisition and Development) loans, borrower personal obligation is universal; HUD loans do not require borrower personal obligation. Banks and HUD most often provide construction financing for smaller new developments (up to $25,000,000), and some small banks provide permanent financing, but principally limit permanent financing to smaller loans.

Pension funds and insurance companies typically provide the larger loans for major projects (i.e. larger than $25,000,000 in size).

CMBS (Commercial Mortgage Backed Securities) Loan

CMBS loans (other than government – Fannie Mae and Freddie Mac – sponsored) are no longer available. CMBS loans were placed during a several year period extending through third quarter, 2007, and were typically placed through mortgage brokers, or bank-owned affiliates chartered for that particular activity. Loans of this type were bundled, then sold through a securitized pool sponsored by a Wall Street securities firm (i.e. JP Morgan, Merrill-Lynch). Pool sponsors are designated, "Master Servicer". Pools were sold as bonds, created to provide ascending levels of return by separating the pools into "tranches" – a sort of something for everyone – extending through several levels of risk from "Junk" to "Triple A".

Tranches were then sold independently of each other, consequently there is little, or no, communication among tranche investors until a loan becomes troubled, a disproportionately high probability under current economic circumstances.

To provide a manner of dealing with potential problems, Special Servicers are assigned to all CMBS loans. When a Commercial Mortgage Backed Securitized loan encounters problems (a loan in arrears two payments is assigned to the Special Servicer), or matures without take-out financing being available, the Special Servicer charged with optimizing bondholder positions takes over responsibility for dealing with related issues. Toward this, Special Servicers are authorized to reduce, forebear, or extend loan maturity dates. This places considerable onus on Special Servicers to play ball with borrowers in the quest for recovering as much principal and interest as possible for the bondholders. But there is a hitch in the process: Not all bondholders have the same interests.

Distressed Apartment Loans

Cash flows from properties securing loans included in pools are dedicated to paying interest on the series of bonds, ranging from “AAA”, to “B”, to “unrated” (junk) bonds, with each paid according to assessed degree of risk. Loan maturity date extensions are a natural line of least resistance for the Special Servicers to follow, but that action reduces AAA bondholder returns; other tranches, if the property is foreclosed, may be wiped out. And therein lies the problem. No one will be happy, but the Special Servicer will make the call regarding an ultimate resolution.

What We Will See With Distressed Loans

Bank/Non-Bank Loans – Terminology you will see relating to a distressed bank/non-bank loan includes:

- *Preforeclosure* – When a loan is delinquent – late in payment – a lender will issue a “Notice to Cure” to the borrower. In the event debt service payments are not brought current, foreclosure is the next step.
- *Foreclosure* – A “Notice of Acceleration” is issued when a delinquency isn’t cured. At this point, the loan is in default, a date has been set for a “Trustee Sale”; the borrower has to pay off the loan, or lose the property at a sale conducted by the County Sheriff. Anyone can bid on the property and secure title at the Sheriff’s (trustee) sale. The outcome is that either the lender will acquire the property, or an investor will complete the transaction.

  A foreclosure under a deed of trust is typically completed at the end of 90 days from the Notice of Foreclosure. In Texas the period is reduced to 45 days from the time Notice of Foreclosure has been delivered to the borrower.
- *REO* (“Real Estate Owned”) – This is a bank-owned property which has been acquired through a foreclosure action. The lender has become the rightful owner; the borrower has no further rights.
- *Bankruptcy* – When a lender has moved to foreclose on a property, a borrower has the right to request protection by the court, delaying foreclosure until a case can be made for some other alternative. We aren’t likely to see as many bankruptcy actions this cycle as a court has the authority to complete a “cramdown” which gives the borrower relief in the form of loan amount, and/or loan rate, reduction, resulting in the lender losing substantial loan value. A borrower may also place a property into bankruptcy simply because a default has been declared for a reason other than property non-performance, in which case the borrower seeks protection from an unwarranted action.

Other Definitions That May Be Of Help To You

Other terminology associated with the distressed loan category that may be of use to you, includes:

- *Mezzanine Financing* – a high-risk, junior position, loan placed by private lenders – typically hedge-funds. A hedge-fund is a private investment fund formed for a specific purpose, typically high-risk investment. Because mezzanine funding is in junior position to a first encumbrance, when a foreclosure is completed the mezzanine lender loses their investment.
- *A & D (Acquisition and Development) Loan* – An A & D Loan supports acquisition of a property, and also funds planned improvements to be made to the property. Typically A & D loan debt service is interest only, and is short term, intended to be replaced by take-out financing in the form of a permanent loan when upgrades are complete, and property operations are stabilized at the upgraded level.
- *Fannie Mae/Freddie Mac* – The Federal National Mortgage Association (FNMA), and the Federal Deposit Mortgage Corporation (FDMC) also provide loans sourced through bundled securitized pools. The difference between a Fannie Mae/Freddie Mac pool and the CMBS pools, is there are no Fannie/Freddie tranches, and

Distressed Apartment Loans

Fannie Mae and Freddie Mac are quick to initiate action to foreclose, and take properties back for resale when a foreclosure action is completed.

- *Trustee* – A trustee can be assigned through agreement between a borrower and a lender to oversee a property until a foreclosure, or some other negotiated action is completed, or by the court when a bankruptcy action has been initiated. In this instance, a trustee is distinguished from an individual responsible for conducting a trustee sale, a process initiated typically by a county sheriff, with the foreclosure sale conducted on the courthouse steps.

- *TALF* – Joint economic committee chair, Carolyn Maloney, states "about 700 billion dollars of the 3.5 trillion dollars commercial real estate market loans currently in place must be refinanced before the end of 2010 to prevent hefty bank losses." Commercial mortgage backed security (CMBS) loans are likely to total between 9%-12%, or 90 billion dollars, of the commercial real estate market's losses according to Dueutsche Bank Securities Research Analyst, Richard Parkus. Mr. Parkus is of the opinion that improvement in the market is not likely until 2012.

  With that condition in mind, the Term Asset-Backed Securities Loans Facility (TALF) Program was passed with the anticipation of restarting the commercial mortgage backed securities market. The theory is by 2009-year-end TALF may add some liquidity to the market. But there are restrictions that considerably inhibit that prospect; Bonds must have a AAA, rating, and; trade dates of July 2, 2009, forward. A further question has to do with the existing CMBS loan eligibility based on acceptable delinquency rates.

  As currently structured, TALF ends June 30, 2009.

Current Loan Availability

Unlike the 2004 – 2007 period when transaction activity peaked, current apartment loan availability is greatly constricted. Banks, insurance companies, and pension funds have, at least for now, limited their willingness to loan on apartments.

For existing property acquisition or refinancing the only reasonably available permanent financing currently is through HUD, Fannie Mae and Freddie Mac. And with that, borrowing standards are tight, typically requiring:

- Loan to Value – 65-70%
- Debt Coverage Ratio – 1.30/1.35
- Underwriting Parameters – Trailing 12 month actual operations.

A contradiction to these parameters is a HUD 221(d)(4) loan made available for new construction. A HUD 221(d)(4) is typically funded at an 85% loan to value and incorporates a 40 year term. Unlike a bank construction loan which is typically limited to a 24 to 36 month period, requires a borrower personal guarantee, and separate take-out (permanent) financing, the HUD loan converts to a permanent loan when certain conditions relating to occupancy and income are met.

Non-bank lenders have full authority to negotiate a work-out with borrowers. Bank loans, on the other hand, have little flexibility. When a foreclosure has been initiated, the foreclosure process must be completed. At the time a loan has been designated as "distressed", the loan is required to be placed into a balance sheet category referred to as "Scheduled". And when a loan has been designated as Scheduled, the bank has already reserved for loss in the full amount of the loan balance remaining. This means that banks are more likely to rid themselves of properties held in REO status, or to write down their loan in a "short sale" agreement with a borrower and prospective purchaser in sale of a property prior to foreclosure.

Distressed Apartment Loans

There is reasonable potential for distressed CMBS loans to undergo marked changes in loan amounts and terms made available to qualified buyers, with loans restructured and remaining in place. Some buyers of properties encumbered by CMBS loans are apparently choosing to simply acquire the loans, then foreclose on a troubled borrower.

The general economy most likely will begin to look better by 2009 year-end, but the real estate economy has a long way to go before the commercial side of things – a category much larger than residential loan problems – is resolved. Apartments will benefit; office, retail and industrial projects are years from recovery.

The Elephant in the room is the over one billion dollars in post-mature Commercial Mortgage Backed loans, and more are coming. Over fifty billion dollars reportedly will be needed during the next four years to refinance maturing CMBS commercial loans, and, as of now, capital to do that is insufficient. The securities industry refers to this as a "technical weight" on the bond market. The number goes to over 700 billion dollars when maturing loans related to the entire commercial real estate industry from other sources are included.

For now, the short-term credit underwriting mismatch is considerable. Most existing loans cannot qualify for full replacement under the revised Fannie/Freddie 65-70% loan-to-value standards, which reduced from a prior, more attractive, 80%. The problem, of course, is that weakened real estate fundamentals resulting from recession – negative absorption, and reduced net operating incomes – combines with the more conservative underwriting standards. Under this condition over 70% of commercial loans of all types, including multi-family, are incapable of qualifying for full replacement.

The consequence is the required market adjustment holds near certain potential to take on much too similar characteristics to conditions encountered during the Resolution Trust Corporation's late 1980s/early 1990s reign of terror on the real estate industry. For transaction-oriented participants, an active time.