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# Commercial Loan Modification

*By Ted Schmidt*

The commercial real estate market had been described by many as a “tsunami” and “the next shoe to drop.” The ocean has receded and curious onlookers are gathering at the shore, observing people collecting fish on the dry ocean floor, along some of the most highly leveraged condo projects and luxury hotel suites in the country. Multibillion dollar deals that were made in an environment of optimism and increasing rents as far as the eye could see have come undone and crashed ashore amidst the carnage of investor losses. What is happening now was inevitable and years in the making.

When the tech bubble burst at the beginning of the millennium, we were faced with the possibility of a mild recession. After Sept. 11, the Federal Reserve enacted a policy of very low interest rates to spur economic growth. These rates were brought down to a one percent federal funds rate and persisted for several years. This fed the fuel of demand for higher yielding investments and spurred a boom in commercial mortgage-backed securities (CMBS). CMBS are bonds that are sold on Wall Street to investors all around the world. The bonds are used to fund investments on portfolios of commercial loans. The income stream from the property is passed from the property owner to the bond holders.

Underwriting standards became relaxed as intense lending competition vied for a diminishing population of qualified borrowers. Ratings agencies gave CMBS bonds AAA ratings. Subsequent losses in the CMBS market led to the seizure of the CMBS market at the end of 2007. That market has started to recover somewhat, with the issue of new CMBS partially funded by the Federal Reserve’s Term Asset Lending Facility (TALF) program. The TALF allows banks to leverage their existing CMBS portfolios for new loans from the Fed at extraordinarily low rates.

Portfolio lenders, which are made up of regional banks, insurance companies, pension funds and others that lend money directly to commercial property owners, have pulled out of the market and are actively trying to reduce their exposure to commercial real estate. Most of the loans made in the bubble years of 2004-2006 had short maturities of three to five years. The assumption was that property values would keep rising and refinancing would be automatic.

With the two primary markets for commercial real estate finance effectively in “lock-down” mode, property owners and lenders are in a precarious position. With the stimulus package passed last year, Congress changed accounting rules which allowed banks to keep loans on their books at full value, rather than using “mark-to-market” which forces lenders to show the true market value of an asset on their books rather than the inflated book value. Lenders cannot take the losses on their book because they are already undercapitalized and risk being shut down by regulators.

Borrowers cannot service the debt, refinance or sell. There is a reality gap between borrowers and lenders, buyers and sellers. The only buyers out there are “vulture” investors who are picking up properties at steep discounts and cap rates not heard of since the 1980s.

These circumstances have paved the way for a new industry—commercial modification consulting. This new industry faces as many challenges as those they serve. With the proliferation, social backlash and regulation of for-profit residential modification companies, commercial modification companies have additional credibility obstacles to overcome by association to the residential modification business.

There are many misconceptions about the commercial mortgage modification business especially in how it relates, in scope, to the residential business. Let’s have a look at the numbers. There are about 125 million single family homes in the United States. The commercial property marketplace is much smaller in terms of the number of property owners. There are about five million commercial properties in the U.S. With the default rate on commercial loans running just

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around three percent, this represents approximately 150,000 properties in which the owner is in need of modification consulting. There are more potential clients that are not in default, but this number represents a nominal market place population of fewer than 50,000 individuals since many commercial property owners have more than one property.

With the passage of SB 94 in California last year, thousands of entrepreneurs and their employees lost their jobs. Many are exploring commercial modification as a new line of work.

The misconceptions about the commercial modification business start with the numbers and continues with the scope of work required to complete a successful modification. In residential modifications, 70 percent of the deals were cookie-cutter deals that fit nicely within the Obama Administration's modifications plans like the Home Affordable Modification Program (HAMP), Making Home Affordable and other programs put forth by the Federal deposit Insurance Corporation (FDIC) and Federal Reserve. There are rarely any negotiations. The loan mod company simply submits a package that has been underwritten according to the guidelines published by the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac, and approved by the loan mod company before being sent to the loan servicer. This is why many companies claimed a 90 percent or more rate of success. They were easy to do, if you knew how to get it done.

The commercial modification business involves real negotiations, in-depth market research, financial analysis and hours of tedious data collection, discovery, verification and reporting. Most of this is foreign to the residential mortgage broker-turned loan modification consultant.

The services offered by a commercial modification consultant would include a go-forward plan to salvage the owners' investment in the property. Every case is different, and the services offered would depend on the needs of the client.

Possible outcomes of a commercial modification include:

- **Term extension:** This is when the bank agrees to extend the maturity on a loan that cannot be refinanced because of high loan-to-value (LTV), but has cash flow sufficient to service the debt. This type of modification can often be done with a phone call to the bank and rarely requires assistance from a consultant.

- **Permanent modification:** Often, a complex transaction that the bank is reluctant to do as it often reduces the value of the asset on the banks books.

- **Principal reduction:** These are usually only done in relation to a short sale or short refinance where the bank accepts less than the full value to settle the debt. The bank won't reduce the principal so the property owner can make a profit.

- **New equity partner:** The bank is more likely to work with a borrower that is willing to release equity in the property to a new investor that comes in with cash.

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- **Bankruptcy:** Unlike residential property, when an individual is in bankruptcy, the judge can "cram down" or reduce the principal or otherwise modify the terms of the mortgage.

In evaluating the best possible and most likely course to take the consultant would produce property valuations based on the liquidation "fire sale" value, and a "go-forward" value based on the owner remaining in control.

Fee for service and contingency fee agreements include some of the business models that have emerged by consultants in this niche industry. Some firms are organized like law firms and charge their clients on an hourly basis drawn from a retainer. These firms only guarantee to perform the work they are contracted for and don't offer the client a guarantee of a modification to their loan.

Other firms charge a set upfront fee with a guarantee of performance. This guarantee is fictitious since only the bank can agree to a modification. A third party cannot compel them to act. Presumably, the property owner pays several thousand dollars upfront with the promise that if his loan doesn't get modified, that the money will be returned.

Yet other firms charge no upfront fee and the property owner signs a promise to pay once the loan has been modified. This type of agreement would have a contingency fee for a principal reduction and could be in the several hundred thousand dollars for the typical $5 million loan.

Many people coming out of the mortgage industry and other fields are looking at the commercial modification as a new business. Leveraging their existing relationships, commercial mortgage brokers, attorneys, commercial real estate agents and residential loan modification consultants are adding commercial modifications to their menu of services they can offer their clientele.

Several national companies have emerged that are offering affiliate programs. These programs typically pay out 10 to 20 percent of their fees to referrers and offer marketing and sales support. Anyone interested in referring business to a national commercial modification company ought to exercise prudent due diligence and look into the background and experience of those offering these types of programs and services.

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