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## Will my lender beat me up too?

**Editor's note:** This is the complete article.

The market has been beating up apartment investors for the past year or so. Now a subscriber asks if lenders are about to beat investors up some more.

Here's our subscriber's question: "Like many owners we're experiencing loss of rent and value, which as you say will last well into 2010. We are well enough capitalized so we can make through the downturn. However, will our lenders cause us problems because our debt-service-coverage-ratios (DSCR) and loan-to-value percentages (LTV) are no longer what they were when we took out the loans in 2007?"

The question can really be divided into two questions. First, will lenders require him to pay down his permanent mortgage to a level where the DSCR and LTV match the original (or currently required) underwriting, even though he may have a few years remaining on the loan before it is due? A second question would be, will lenders require him to put in more of his own cash if it's time to refinance now?

We contacted some active lenders in our region to find out how they would answer both questions. We decided to share their comments in full, with some minor editing. Although the comments are mostly similar, each one offers a valuable perspective. And they give us an inside view of regulatory and market issues driving financing, underwriting, and compliance issues today. We also thought it would be useful for investors to see how consistent these lenders are.

### **S. Dail Bodziony, Columbia Bank**

If the question has to do with annual reporting for an existing loan, so long as the borrower is well-capitalized and the property has not experienced a significant decrease in actual net operating income (NOI), as a general rule, no curtailment would be required.

However, the lender will most likely increase the reporting requirements so the performance can be monitored on a quarterly versus annual basis. If the loan is coming up for renewal, again, it depends on how well-capitalized the borrower is.

If the borrower is looking for new financing away from his current lender, most lenders are no longer lending on a "story" but are relying on actual cash flow for DSCR and LTV. One area where regional banks, such as Columbia, are also becoming more focused on what is our "get out of jail free card" i.e., should the market weaken even further how are we going to get out at the end of our loan term.

The more liquid a borrower can keep himself, the better. As always, if the borrower perceives there is an issue, then there probably is an issue and open communication with the lender is a really good idea.



## **Christa Chambers, KeyBank Real Estate Capital**

Being well-capitalized is definitely an advantage in the current environment. Most lenders would expect borrowers to be prepared to put this capital to work and get the loan back on track. In most all cases, the lender would want to improve its position through a refinance or modification because the risk profile of the loan has changed since origination and thus the return to the bank has changed.

The revised loan terms will largely depend on the degree of the deterioration of the DSCR and LTV, the strength of the project cashflow, and the willingness and capability of the sponsor to de-lever the loan.

Typically the lender will want a combination of upfront paydown and accelerated amortization if the ratios are far from targeted ratios (standard 75% LTV and 1.25 DSCR). A bank may have more flexibility than a life company, agency or CMBS servicer to allow a smaller upfront payment in exchange for more cashflow to de-lever the loan over time, but again it depends on how far the project metrics have slipped.

## **Tracy Edgers**

This question is wholly dependent on the specific terms set forth in the loan documents. As long as there is not pending maturity, the lender generally does not have the right to require that the loan be "remargined" prior to maturity. This is the case for most permanent/long term mortgages.

However, in some cases for bridge loans or construction loans the loan agreement may have a provision giving the lender the option to reappraise the property and require that the loan be paid down to specific underwriting parameters. This provision essentially gives the lender the opportunity to to get back the original underwritten level of risk they bargained for. Given the recent dramatic value declines, it is even possible that when an underwater loan matures, the lender may be flexible in renegotiating an extension.

## **Tim Marymee, Washington Federal Savings**

That is a good question, and I can understand the concern of the apartment owner. I would say as long as the apartment owner remains current on their loan payment, and also keeps up with the property taxes and insurance on the property, the lender shouldn't require paying down the loan balance to meet current DCR and LTV requirements.

If their loan is at the end of the term and maturing, and they are looking to extend the loan term, then they would need to meet the current DSCR and LTV guidelines their lender requires.

The apartment owner could also read over the note and deed for their loan to see if there is anything in those documents that gives the lender the ability to require the borrower to pay down their loan if DCR's and LTV's drop below original levels during the loan term.

## **Bob McGrouther, Luther Burbank Savings**

A lender can only force a capital call to realign the LTV and/or DSCR if the note and deed specifically give the lender the power to do so. Most portfolio, apartment dedicated, boiler plate loan documents do not have such a provision. It is seen as part of the risk the lender initially took (which is one reason for tighter underwriting these days, the risk of such an eventuality is well past historical norms).

Such clauses are seen from time to time on mortgages dedicated to the secondary markets and



"boutique" documents from commercial banks; particularly on non-apartment income property. It is also sometimes possible to see a realignment on an assumption, again depending on the loan document language.

That does not mean the lender is not going "to cause us problems." All lenders have clauses in the loan documents requiring the borrower to periodically supply operating statements on the building, and borrower financial statements as well in many cases. Generally, these are to be supplied annually or quarterly, depending on the lender or statement type.

Historically, many lenders have been lax on the enforcement of these clauses, only rigorously enforcing them if a problem was detected with the loan. The occasional nasty letter would be sent if the statements were not sent, and there was rarely follow-up action. Now the Fed, FDIC, OTS, etc... are hammering lenders to force borrowers to provide this information.

Lenders in turn are adhering tightly to the note and deed, and in some cases attempting to push borrowers to provide more than the note and deed require. The reasons for this are:

- The Fed regulators want a continuous real time assessment as to the viability of a given lender (in case they need to allocate resources and/or take action);
- every loan that falls below certain performance criteria (for example, a 1.15 DSCR for Federally chartered banks, which is why nobody is approving at 1.15 anymore, no margin for error) must be reclassified by the bank, working capital must then be moved to loan loss reserves.

Reclassification has a twofold effect; it worsens the bank's operating and performance ratios in the eyes of the Fed and stockholders, and it lessens profitability as more and more working capital becomes "dead" capital. Once a lender detects a loan has fallen below standard, and the loan goes to the "watch list," the borrower and property will be under greater scrutiny. This will result in more frequent inquiries from the bank; they want the loan off the watch list as soon as possible for the above reasons, or to take necessary action promptly if the situation deteriorates.

Be assured all lenders will now be much more proactive in acquiring the periodic statements specified in the loan documents. This is true whether the lender suspects a given loan is now below standard or not. A borrower's failure to comply now commonly results in either a warning of technical default, or an outright technical default notice. The lender really has no choice in this; failure on the lender's part to do so incurs the wrath of the regulators.

All borrowers should reread the notes and deeds they signed. This will tell the borrowers what their responsibilities are or are not, and what remedies each party to the transaction has. The lender agreed to the terms as well, and are as bound as the borrower.

There are recent examples (usually resulting from a lender trying to enforce their normal internal policies on a note they acquired from another lender with different policies) of lenders overstepping the provisions of the loan documents. Should this occur, a borrower can refer the lender back to the note and deed.

This particular borrower sounds like he/she has the resources to weather the current situation. If a borrower does not believe they can honor the terms of the loan documents, they should contact their lender as soon as possible. Playing ostrich is the worst possible solution.

In the absence of information, a lender has no choice but to follow the terms of the loan documents. Depending on the situation, a lender may or may not agree to some type of mutually agreed upon "work out." Without communication, this possibility does not exist.



## **Darrell McKissic, Commerce Bank of Washington**

In reply to your subscriber's question, your assumption is correct. If anything changes; a default occurs, the term matures, an extension needs to be done or the loan needs to be modified for any reason the lender generally has the ability to restructure the loan.

Of course the documents will control this but in general most documents require the loan to perform as it was originally underwritten and if not the lender has the ability to resize the loan so that it meets current criteria. In addition most loans have a resizing provision, usually annually which allows the lender to test the performance of the collateral and measure it to DSR, LTV, etc. standards that were established at the time of the loan.

These standards are often slightly less the original underwriting standards. If these standards are not met then the lender can require the loan to be reduced to an amount that does meet them without a maturity, default etc. The enforcement of these standards can be different from lender to lender.

However the current regulatory environment has placed significant limitations on all lenders as to what they can do in these situations. The regulators have established guidelines that need to be followed as to principal curtailments, amortization schedules, length of term etc. for all modifications, extensions and renewals. If the lender doesn't follow these guidelines and does something less stringent it will affect the severity of the risk grade they assign to the loan.

If the risk grade is severe enough the lender must reserve funds to allow for the greater risk of this loan. The regulators review loan portfolios on a more regular basis now and if they find loans in which they don't agree with the bank's risk grade they can make the bank downgrade further. Since all banks want the regulators to feel they are in control the overall risk in their loan portfolios, this is another major tool to keep the banks in line.

## **Stuart Oswald, NorthMarq**

Unless the loan docs have specific DSCR and LTV covenants (which is relatively uncommon for multifamily loans) I would not expect the lender to require a pay down so long as the borrower is making payments and the loan is not in default. The loan would most likely go on the lender's watch list and the borrower could expect more scrutiny and increased reporting requirements.

## **Greg Piantanida, GP Realty Finance**

Each borrower needs to be familiar with their loan documents so see if there are any loan conditions that require minimum value or debt coverage. This would not apply to Fannie Mae, Freddie Mac, FHA or old WaMu loans. If you have borrowed from a bank then you may have an exposure. We can help a client respond to these issues.

## **Craig Russell, CW Capital**

The loan sizing at the time of the future refinance will be based on the then current program parameters and the property's performance at that time. The original underwriting and program are completely irrelevant. A loan made in 2007 was at the peak of the market. If the property was then fully leveraged, it would have a hard time refinancing without a cash contribution given the property's likely poorer performance and today's higher debt service coverage requirements and higher interest rates.

## **Jeff Stuart, Alliant Capital**

I can address how we would look at this as a potential refinance. The loan amount will be derived by the lesser of the underwritten net operating income based on a 1.25 DSCR - or 80% LTV. If that



loan amount is less than the current debt - then yes, the owner has a problem and will need to pay down their loan. The lender and owner created this problem by putting short term debt on a long term asset.

Matching the duration of the debt to the investment is important. There are several owners in this position - who purchased assets with short-term debt at the top of the market, thus creating a "time-bomb." If they do not have the wherewithal to pay down their debt, then they will likely be forced to sell.

## **Michael Wood, Norris Beggs & Simpson**

The short answer is if the borrower continues to pay the mortgage on time, the lender cannot force him to pay down the principal. With our life company lenders, if a loan experiences significant vacancy or loss of income such that the LTV or DSCR hits a certain threshold, the loan goes on a watch list and as the servicer of the loan, my company might put a call into to the Borrower just to inquire what is going on with the property but the lender cannot require the Borrower to pay down the loan.

It is basically the same with securitized loans. The real issue is if the Borrower were to have a loan maturity coming up. In that situation most lenders would require some principal paydown to extend or refinance the loan.

## **and finally...**

At this point, I have not heard anyone requiring loans to be paid down to required DSCR. However, if our client's DSCR is currently below its original underwritten levels we require a quarterly rent roll, operating statement and updated personal financial statement so that we can monitor the continued risk that loan may or may not pose to the Bank.

The internal loan risk rating is increased and management/senior management tracks these loans until the time in which they meet DSCR requirements. If a Bank's portfolio has a number of these loans they may, in defense of possible future defaults, ask that the principle be lowered to reduce or eliminate the DSCR risk. This is provided that their original loan documents on the subject property allow for this type of principle reduction payments.

A lender is always limited by what their documents indicate. If your documents do not allow for this type of demand on clients then a lender could end up putting themselves at risk for lawsuits for force placing terms on a borrower that their documents do not allow for.

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