

**THE TOP TEN ISSUES IN NEGOTIATING SECURITIZED LOANS,
FROM A BORROWER'S PERSPECTIVE**

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My experience indicates that the amount of success that a borrower's counsel has in negotiating the following loan issues is proportionate to the size of the conduit loan and the aggressiveness of the borrower's counsel in negotiating these issues. Conduit lenders are now actively pursuing loans, and are quite reasonable in negotiating the terms of conduit loan commitments.

Conduit loan document terms are essentially similar to the terms of conventional loan documents. The opportunities for most effective borrower representation occur when negotiating the conduit loan commitment which contains the essential terms of the conduit loan, rather than upon review of the actual loan documents. The following ten headings cover negotiation of a typical conduit loan commitment, from the perspective of the borrower's lawyer.

I. REVIEW OF EXISTING LOAN DOCUMENTS

It is crucial for the borrower's counsel to start with a review of the existing loan documents, with all amendments and modifications. Prepayment prohibitions, prepayment penalties and/or advance prepayment requirements may be discovered in the existing loan documents, which were either unknown to the borrower, or not communicated by the borrower to the borrower's counsel. Obviously, an existing lock out period or prepayment prohibition ends the negotiation of the conduit loan commitment. A prepayment penalty in the existing loan must be calculated and factored into the cost of the refinanced loan transaction. An equally critical concern to a borrower's counsel is the existence of an advance prepayment notice requirement and/or a specific date for permissible prepayment of the existing loan (often the last day of the calendar month).

In one loan transaction, the existing prepayment penalties and the advanced prepayment notice requirements were known by the borrower but not communicated by him to his loan broker or attorney. When the payoff letter

was obtained from the existing lender shortly before the conduit loan closing, the prepayment constraints were discovered. The borrower paid a substantial additional interest payment to the existing lender because he did not communicate this critical information to his counsel. Therefore, it is advisable for conduit borrower's counsel to review all of the loan documentation applicable to the existing loan at the beginning of the conduit loan transaction. This advice also applies to representation of a borrower on a conventional loan.

II. COMPETING LENDERS

In representing conduit borrowers, I have been more effective in negotiating the terms of a conduit loan commitment when I was simultaneously negotiating loan commitments from two competing conduit lenders on a single loan transaction. The two prospective conduit lenders will often modify their respective loan commitments and grant loan concessions in an attempt to obtain the loan. Typically, during the negotiation of competing conduit loan commitments, the competing conduit lenders will continue to offer significant loan concessions until a loan commitment is chosen by the borrower. In this situation, a borrower will typically execute a conduit loan commitment with substantial concessions from its original draft. Therefore, if possible, you should persuade your client to obtain loan commitments from at least two potential conduit lenders.

III. TRUE COST OF THE LOAN

One of the most confusing and difficult tasks in representing a borrower in a conduit loan transaction is understanding and ascertaining the amount and timing of the various fees, deposits and charges which a borrower will be required to pay to the lender for the conduit loan, and whether those deposits are applied to other fees and charges when the conduit loan is closed.

A typical conduit loan commitment includes the borrower's payment in advance of an expense deposit for the lender's third party reports. The third party reports obtained by lenders will usually include: (i) an MAI appraisal of the property securing the payment of the conduit loan, (ii) a Phase I environmental audit of

the property securing the payment of the conduit loan, and (iii) an inspection by a third party of the property securing the payment of the conduit loan. The borrower must usually deposit these expenses with the lender when the conduit loan commitment is executed. The expense deposit amount typically varies from \$7,500.00 to \$12,000.00. If the entire expense deposit is not paid by the lender to the third parties for the reports, the balance is refunded to the borrower at closing.

If the borrower's counsel is unable to negotiate for the lender to pay for the lender's attorney's fees (see Item VIII below), a conduit loan commitment may also include the borrower's payment in advance of a deposit for the lender's attorney's fees. The attorney's fees deposit typically varies from \$7,500.00 to \$10,000.00. If the lender does not have to pay the entire attorney's fees deposit amount to its attorney, the balance of the attorney's fees deposit is refunded to the borrower at the closing.

Some conduit lenders attempt to charge the borrower with a commitment fee of one percent of the estimated loan amount. The commitment fee is deemed earned by the conduit lender in consideration of the conduit lender's issuance of the loan commitment. The borrower typically pays the commitment fee concurrent with his acceptance of the loan commitment. Most loan commitments provide that the loan commitment fee is non-refundable.

Some conduit lenders also attempt to charge the borrower with an application fee for processing the loan commitment. Loan commitments typically provide that the application fee is non-refundable, whether or not the conduit lender approves the loan.

Most loan commitments also contain a rate lock deposit of one or two percent of the estimated loan amount, paid either when the borrower accepts the terms of the loan commitment, or immediately before the borrower locks his loan interest rate.

It is imperative that the borrower and his counsel fully understand what fees the borrower will pay in connection with the loan commitment, and what fees and deposits will be credited back

to him at closing. Most conduit lenders can be persuaded to either waive or reduce the application fee, and to extend the payment of the rate lock deposit until the borrower and the lender are prepared to lock the interest rate on the loan. Different conduit lenders have different deposit and fee structures, so it is critical for the borrower's counsel to fully understand the amounts and timing of those deposits and fees, and to communicate that information to the borrowing client.

IV. LOAN TO VALUE AND DEBT SERVICE RATIOS

Typical conduit loan commitments provide that notwithstanding the loan amount designated in the commitment, the maximum amount of the loan funded at closing will be the lesser amount permissible under: (i) a designated loan to value ratio, and (ii) a designated debt service coverage ratio.

The loan to value ratio is a designated percentage of the property's appraised value. Most conduit lenders require an 80% loan to value ratio. In other words, if the appraised value of the property is \$1,000,000.00, the conduit lender will not loan more than \$800,000.00 to the borrower. If the loan to value ratio is less than 80%, the borrower's counsel should negotiate with the conduit lender to increase the ratio to at least 80%. It is occasionally possible to obtain a loan to value ratio in excess of 80%.

The debt service coverage ratio is a designated ratio based on the property's adjusted net income and the debt service (principal and interest). Most conduit lenders typically provide for a debt service coverage ratio of 1.25:1. In other words, the lender may adjust the maximum amount of the loan so that the actual net income from the property will be at least one hundred and twenty-five percent (125%) of the debt service. If the property's actual net income is less than the borrower and lender initially project, or the interest rate is higher than the borrower and lender initially project (therefore causing the debt service amount to increase), the debt service coverage ratio may result in a lower loan amount. The conduit borrower's counsel should negotiate the debt service coverage ratio to be 1.25:1 or lower. If the debt service coverage ratio requested by the

lender is greater than 1.25:1, borrower's counsel should negotiate towards an decrease of the ratio to 1.25:1 or lower if possible.

Both the loan to value ratio and the debt service coverage ratio can dramatically affect the loan amount. A good borrower's counsel should aggressively negotiate the level of both ratios.

V. ELIMINATING THE INTEREST RATE ADD ON

The interest rate on most conduit loans is calculated by adding an agreed spread to a fixed index. Generally, the parties negotiate a spread of between 120 to 170 basis points added to the ten-year Treasury Rate. Conduit loan commitments often also provide that after that first calculation is performed, the resulting interest rate is rounded up to the nearest 1/8th of a percent. In most instances, this feature effectively raises the interest rate. Borrower's counsel should request that the interest rate round up calculation be eliminated. Most conduit lenders will waive this rounding up feature. This concession must be sought when negotiating the terms of the conduit loan commitment.

VI. INTEREST RATE CALCULATION

Conduit lenders typically include a provision in conduit loan commitments providing for the computation of interest on the assumption that there are only 360 days in a calendar year. Texas courts allow three methods of calculating interest: (i) based on a 365-day year, where the annual interest rate is divided by 365 and the resulting daily rate is multiplied by the number of days in the payment period, (ii) based on a 360-day year of 12 months of 30 days each, or (iii) based on a daily rate calculated by dividing an annual interest rate by 360, and by multiplying this rate by the number of days in the payment period. See Terry L. Hart, Negotiating a Loan Commitment; Borrower's and Lender's Perspective, University of Houston Law Center, Advanced Real Estate Short Course, November, 1995. Under the first method of calculation, the annual interest rate is divided by 365 and the resulting daily rate is multiplied by the number of days in the payment period. Under the second method, the annual interest rate is divided by 360 and each month is treated as having 30 days.

Interest for each month is the same. For a calendar year, the interest under this method is the same as the interest calculated by using the first method. This method is used in preparing amortization tables so that monthly payment amounts will be equal, even though the months have different numbers of days. Under the third method of calculation, the annual interest rate is divided by 360 to yield a daily interest rate. That rate is then multiplied by the number of days in the payment period. Therefore, for a calendar year of 365 days, the third method produces 5/360 more interest than the first two methods. See Jay Hailey, Drafting Loan Documents That Work, State Bar of Texas, Advanced Real Estate Law Course, May 1988.

Conduit borrower's counsel should make certain that the conduit loan commitment does not calculate interest using this third method. As a representative of the borrower you should negotiate the most favorable interest rate possible for the borrower and should try to eliminate the third method of interest rate calculation if it is in the conduit loan commitment. If asked, most conduit lenders will modify the commitment to provide for the first or second interest rate computation method.

VII. LOAN ASSUMPTION FEES

Most conduit loan commitments allow the loan to be assumed by a third party one time during the term of the loan, if the third party satisfies the lender's credit and underwriting criteria and a loan assumption fee is paid to the conduit lender. Conduit loan commitments typically require a one percent loan assumption fee. A conduit borrower's counsel should negotiate a waiver or reduction of the loan assumption fee. The terms on the loan's assumption should be aggressively negotiated because conduit loans tend to have a lock-out feature which precludes the loan's prepayment for the first years of the loan, and a defeasance or assessment payment if the conduit loan is paid off during the balance of the conduit loan term. Borrower's counsel should make the loan assumption requirements as reasonable, and as inexpensive as possible. Most conduit lenders are now willing to substantially reduce or waive loan assumption fees.

VIII. LENDER'S ATTORNEY'S FEES

As with conventional loans, most conduit loan commitments require the borrower to pay the lender's attorney's fees. Recently, because of the competitive nature of the conduit loan market, conduit lenders have become willing to (i) place a ceiling on the amount of the lender's attorney's fees, and/or (ii) pay either all or a portion of the lender's attorney's fees. Again, the effectiveness of the borrower's counsel on negotiating this concession will depend directly on the size of the loan, the number of other real estate properties which the borrower owns and may refinance in the future, and the existing relationship of the borrower with the conduit lender.

IX. LOAN POINTS

Several years ago it was standard for conduit borrowers to pay two points to the lender in connection with conduit loans. Recently, the payment of one point has become common. In certain situations, it may be impossible to negotiate a further reduction in the amount of the points. In one recent conduit loan transaction, the loan fee that the borrower paid was one-half (1/2) of a point. In another, the loan fee was reduced to 8/10s of a point on a portfolio of four conduit loans. When the right borrowing situation is present, borrower's counsel should try to negotiate a reduction in the amount of the loan points that the borrower will pay to the conduit lender.

X. IT NEVER HURTS TO ASK

As with any real estate loan transaction, a conduit borrower's negotiating strength changes as lending market conditions change. It is my perception that we are currently in a borrower's market where the borrower can strongly and aggressively negotiate loan commitments. Borrower's counsel should not hesitate to ask for any conduit loan commitment concession. Recent experience indicates that conduit lenders are extremely reasonable in the negotiation of loan commitments and satisfying the borrower's requests in negotiating loan commitments.

Some conduit lenders are even adding unusual incentives to entice the borrower to place

his loan with a particular conduit lender. In one instance, when it appeared as if the borrower would place his loan with a different conduit lender, the initial conduit lender included in the loan package a two week cruise in the Mediterranean for four people, in an attempt to persuade the borrower to place his loan with that lender. As a borrower's counsel, do not be surprised at any offer or concession that you might receive from a conduit lender in an attempt to persuade your client to execute its loan commitment. On the other hand, it is my experience that few provisions in the actual loan documents are negotiable. As a representative of the borrower, most of your effective negotiation of the loan terms is concluded once you have completed your negotiation of the loan commitment. The conduit loan documents, although lengthy, are typical of what a borrower's counsel would review in a conventional loan transaction. Borrower's counsel's role in connection with the standard non-negotiable conduit lender's loan documents is to review such documents, help the client understand the import of same and overcome borrower's counsel's or borrower's desire to negotiate the terms of such documents as they are truly non-negotiable.

CONCLUSION

In today's conduit lending climate, the borrower's attorney has a chance to obtain substantial benefits for his client. Because conduit lenders are aggressively seeking to add to their conduit loan portfolios, borrower's counsels are able to aggressively negotiate loan commitment terms. Through good negotiation, you should be able to save your borrowing client significant fees and maximize the amount of his loan.