Statutory Issue Paper No. 113

Mezzanine Real Estate Loans

STATUS
Finalized June 11, 2001

Original SSAP and Current Authoritative Guidance: SSAP No. 83

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting guidelines of Mezzanine Real Estate Loans (MREL).

SUMMARY CONCLUSION

2. For statutory accounting purposes, a MREL shall be defined as a debt obligation that is not a security, which is secured by a pledge of equity interest in an entity that owns real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer) that:

   a. Either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer;

   b. Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

   c. Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations).

3. MREL's meet the definition of assets as specified in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

4. Reporting entities holding MREL's shall follow the accounting and disclosure requirements defined within *SSAP No. 37—Mortgage Loans* (SSAP No. 37).

5. In order for a MREL to qualify as an admitted asset, the MREL agreement (the agreement) shall:

   a. Require that each pledgor abstain from granting additional security interests in the equity interest pledged; and

   b. In addition to satisfaction of the requirements set forth in paragraphs c and d below, the MREL lender shall employ techniques to minimize the likelihood or impact of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower. These techniques may include (by way of example and not limitation) one or more of the following: (i) separateness covenants, (ii) cash management techniques, (iii) exceptions to the non-recourse provisions for damages arising out of the mezz borrower's failure to comply with covenants prohibiting additional debt, transfers of the real estate, transfers of pledged interests, and violation of the single asset/single

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purpose covenants, (iv) full recourse liability in the event of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower, and (v) loan guaranties; and

The selection of techniques that are applied in the instance of any particular MREL to achieve said purposes requires an exercise of judgment by the MREL lender. The reasonableness of the techniques utilized in any particular MREL will be assessed in light of the credit characteristics of the MREL borrower, any guarantors and the underlying real estate at the time of origination. Utilizing this standard provides flexibility to the MREL lender and provides a basis for the regulator and auditor in analyzing the reasonableness of the judgment of the MREL lender; and

c. The real estate owner and, if different, the mezz borrower shall:

i. Hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower (if different), the equity interest in the real estate owner;

ii. Not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower (if different), holding an ownership interest in the real estate owner; and

iii. Not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower, if different).

d. At the time of the initial investment, the MREL lender shall corroborate that the sum of the first mortgage and the MREL does not exceed 100% of the value of the real estate as evidenced by a current appraisal. Acceptable appraisal methods are described in paragraph 11 of *SSAP No. 40—Real Estate Investments*.

e. The MREL lender shall report in Appendix A-001 to its annual statement the amount and percentages of its total admitted assets held in MREL and the largest three investments held in MREL except that such detail shall not be required for assets held in MREL totaling less than 2.5% of its total admitted assets.

Effective Date

6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date for years ending on or after December 31, 2001.

DISCUSSION

Definition of MREL

7. An MREL is a loan secured by a pledge of direct or indirect equity interests in an entity that owns real estate (the "real estate owner"). The real estate owner is typically the borrower under a mortgage loan secured by the same real estate. The MREL borrower ("mezz borrower") may be the real estate owner or one or more of the holder(s) of the direct or indirect equity interest(s) in the real estate owner. As used herein, "direct equity interests" means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in the real estate owner, and "indirect equity

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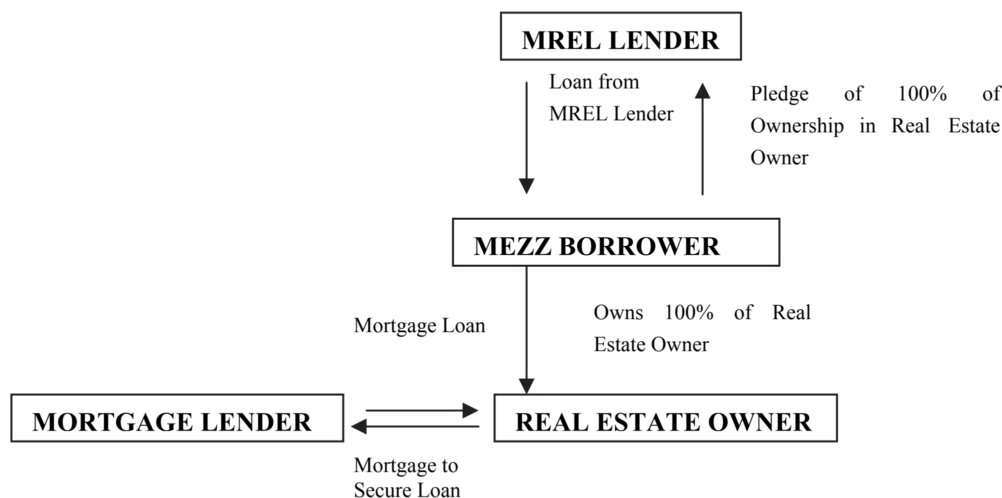
interests" means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in a member, partner, shareholder or other holder of direct equity interests in the real estate owner. The following illustrates one typical MREL structure:



Typical Sources and Market Characteristics of MRELs

8. Significant portions of large real estate loans are now originated with the intent of securitizing[1] the real estate mortgage loan. Mortgage loans targeted for securitization are typically subject to uniform underwriting and structuring requirements, including requirements that (a) the mortgage loan satisfy a loan to value ratio of 65% or less, (b) prohibit encumbrance of the real estate to secure additional debt, and (c) the borrower satisfy certain SPE (special purpose entity) requirements (as described below).

9. In many instances, the subject real estate project requires financing in excess of 65% of the value of the property. By utilizing a MREL, the real estate owner is able to obtain a low cost first mortgage loan and the mezz borrower is able to obtain additional project financing in the form of the MREL without jeopardizing the securitization of the first mortgage loan by subjecting the real estate to additional liens.

10. Like its securitized mortgage loan counterpart, MRELs typically have common underwriting and structuring characteristics. As noted above, MRELs are secured by a pledge of the mezz borrower's equity interest in the real estate owner. Similar to securitized loan requirements, the documents evidencing the MREL require that (a) the mezz borrower abstain from granting additional security interests in its equity interest in the real estate owner, and (b) both the real estate owner and the mezz borrower be a special purpose, bankruptcy remote corporation, limited liability company or limited partnership (a "SPE"). In the case of a limited partnership SPE, the general partner of such SPE must in turn be a SPE (and if the real estate owner is a limited partnership, the general partnership interest is also pledged to secure the MREL). The SPE requirements are intended to protect both the mortgage lender and the MREL lender from the risks associated with bankruptcy filings and consolidation of claims relating to affiliated entities.[2]

[1] A "securitized" real estate loan is a loan combined with other loans secured by real estate for sale in the secondary market, typically in the form of a commercial mortgaged backed security.

[2] In order to comply with typical SPE requirements, an entity must, among other things: (i) hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower, the equity interest in the real estate owner; (ii) not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower, the ownership of the real estate owner; (iii) not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower); and (iv) have at all times an independent director or member whose vote is required for, among other things, a voluntary bankruptcy filing.

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MREL Lender Remedies

11. Should the mezz borrower default on its obligations under the MREL, the MREL lender has the right to assume ownership and control of the real estate owner by realizing upon its security interest in the equity interest in the real estate owner. Similar to foreclosure of a junior mortgage position, the goal of this remedy is to gain control over the ownership and operation of the real estate and thereby preserve both the good standing of the mortgage loan and the equity in the real estate that will ultimately repay the MREL.

12. Unlike foreclosure of a junior mortgage, the remedies afforded a MREL lender can typically be exercised very quickly and reach conclusion much faster than foreclosure; in most jurisdictions, a MREL lender can exercise remedies under the applicable Uniform Commercial Code (UCC)[3] without the need for judicial action. Further, most MRELs are structured with cash management requirements that protect both the mortgage lender and the MREL lender from misapplication of rents and other income generated by the real estate. Finally, unlike most holders of junior mortgage liens, MREL lenders are typically able to negotiate notice and cure rights from the holders of the mortgage debt. These rights give the MREL lender the ability to preserve the good standing of the mortgage loan (thereby avoiding accrual of default interest and ultimately foreclosure) while the MREL lender exercises its remedies and gains control over the real estate, while remaining subordinate to the first mortgage obligation.

Remedy Comparison

13. Below is a description of several different forms of subordinated real estate investments, the security that the investment relies upon for repayment and the related default/foreclosure scenarios for each type of investment:

	First Mortgage	**Second Mortgage**	**Mezzanine Real Estate Loan**	**Comm. Mtg Back Security (AA & Down)**
Security	First lien on property (deed of trust)	Second lien on property (deed of trust)	Lien on ownership interest in the real estate owner	Rights to subordinated cash flow from trust
Default/Fore-Closure Remedy	Become owner of property free and clear of all liens	Become owner of property subject to first mortgage	Control owner of property subject to first mortgage	Become holder of subordinated interest in cash flow and prop. Residual
Comment		If 1st mortgage not kept/brought current by 2nd then 1st may foreclose	If 1st mortgage not kept/brought current by MREL Lender then 1st may foreclose	

14. As shown above, the downside credit outcome for a MREL is essentially the same as the outcome for a second mortgage. Both investment types rely on excess cash flow beyond the first mortgage for

[3] See Exhibit A for a detail question and answer with respect to the requirements of the UCC for MRELs.

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payment, and in a default scenario both ultimately result in the lender controlling real property with a first mortgage in place that requires current payments.

15. Foreclosure of a second mortgage varies by state law (judicial vs. statutory) and for a MREL is generally the same in all states under the UCC. The MREL remedy process is typically quicker than the judicial process and is similar in time to states with a statutory foreclosure process.

16. MRELs are also documented with monthly payment requirements and hard maturity dates. Like loans secured by a second mortgage, MRELs' typical return characteristics do not vary with the amount of cash flow available for payment. MRELs are passive investments, with no or very little authority over management of the real property prior to default, but similar to other debt instruments have protective covenants (rules), which, if violated, trigger the right to exercise the remedies discussed above.

17. MRELs meet the definition of assets as specified in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of SSAP No. 37 and this issue paper (particularly, paragraph 5). Recording MRELs as admitted assets is consistent with the recognition concept in the Statement of Concepts (i.e., the existence of readily marketable assets available when both current and future obligations are due). Due to their similarity to second mortgages, the requirement to account and disclose MRELs in accordance with SSAP No. 37 is concordant with the principle of consistency in the Statement of Concepts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

18. As MRELs are not currently defined or identified as admitted assets within the Accounting Practices and Procedures Manual, they are currently nonadmitted in accordance with SSAP No. 4

19. The Invested Assets Working Group addressed the admissibility of MRELs at its August 28, 2000 working group meeting. The following represents an excerpt from a report containing its recommendation as to the admissibility of such assets:

> In addition to reviewing the material you provided, the IAWG also heard a presentation (including recommendations) from Interested Persons on Mezzanine Loans. The IAWG agrees that Mezzanine Loans meet the definition of assets contained in *SSAP No. 4—Assets and Nonadmitted Assets* and should be admitted assets if they conform to the requirements of *SSAP No. 37—Mortgage Loans*. However, we also believe Mezzanine Loans should be treated as an entirely new type of asset class. Accordingly, the IAWG recommends that any proposed regulatory accounting guidance first precisely define a mezzanine loan by reference to its structural features and legal characteristics. For example, we understand that the borrower takes ownership rights in the entity owning the property. This legal interest is not the same thing as an interest in real estate secured by a mortgage lien. Therefore, it will be important to identify how the state Uniform Commercial Code will define an ownership interest and how an insurer investor perfects a security interest in ownership rights. Ownership rights in the entity may also subject the insurer to owner related liabilities that should be considered in accounting guidance. Further, to the extent the real estate is to play a significant role in recovering the value of the loan in a default situation, it is also important to understand how the insurer effectively ensures that the borrower cannot further encumber its real estate. In this regard, the IAWG noted that the written discussion paper presented by the Interested Persons did not provide an authoritative description of the structural or other characteristics of this type of asset. The IAWG also recommends that the Risk Based Capital Task Force should determine the appropriate Risk Based Capital treatment for Mezzanine Loans.

Generally Accepted Accounting Principles

20. See *Issue Paper No. 37—Mortgage Loans* for applicable GAAP references.

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RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 4—Assets and Nonadmitted Assets*
- *SSAP No. 37—Mortgage Loans*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*
- *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114*
- *FASB Emerging Issues Task Force Issue No. 84-19, Mortgage Loan Payment Modifications*
- *FASB Emerging Issues Task Force Issue No. 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations*
- *AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans*

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ISSUE PAPER 113 – EXHIBIT A

Uniform Commerical Code Questions and Answers

As further background on the treatment and structure of a mezzanine real estate loan, the following questions and answers are presented.

1. How is a security interest of this type characterized under the UCC?

   - Either investment property, general intangible or instrument
   - Security interest in shares of a corporation should be investment property. See § 9-102(a)(49); § 8-102(a)(15); § 8-103(a)
   - Partnership or limited liability company- generally a general intangible. See § 9-102(a)(42)
   - If such interests represented in writing could be classified as "instruments". See § 9-102(47).
   - Possibility of misclassification of an interest in a closely held corporation as an instrument. See In re U.S. Physicians, Inc., 236 B.R. 593 (Bankr. E.D. Penn. 1999)
   - Require borrowers to opt into Article 8. See § 8-102(a)(15)(iii)(b) investment property.

2. How does the insurer perfect its security interest?

   - A security interest in investment property is perfected by either obtaining "control", See § 9-314, or filing a financing statement. See § 9-312(a).
   - An interest that is perfected by control has priority over one perfected by filing. See § 9-328.
   - A secured party has control of investment property when the secured party may transfer that property without further consent from the owner. See § 8-106.
   - If the collateral is a certificated security in bearer form control is achieved by possession. See § 8-106(a).
   - If the collateral is a certificated security in registered form control is achieved when the secured party takes possession of the certificate and the certificate is endorsed to the party or is registered in the party's name upon issue or transfer. See § 8-106(b). Certificated securities are accompanied by executed stock powers.
   - If the collateral is an uncertificated security control is achieved by "delivery" of the security, which can be achieved by the secured party becoming the registered owner, or the issuer providing that it will comply with instructions of the secured party without further action from the registered owner. See § 8-106(c). A pledge or security interest in uncertificated securities is typically acknowledged by the issuer delivering an "Initial Transaction Statement". See § 8-408.
   - An interest in a general intangible is perfected by filing a financing statement. See § 9-310.
   - An interest in an instrument may be perfected by filing a financial statement, See § 9-312(a), or by possession. See § 9-313.
   - Security interest extends to all proceeds generated by the pledged securities. See § 9-306(1).
   - Typically, regardless of the nature of the securities pledged, the secured party will file UCC financing statements as a precautionary measure.

3. What steps does the insurer take to realize on the collateral?

   - Once the borrower is in default, the secured party may possess the collateral either through the judicial process or any other peaceful means. See § 9-610(b).
   - If the secured party has perfected by control it has the ability to foreclose on the collateral without additional steps. See § 9 - 601.
   - The UCC provides that disposition of collateral following default must be conducted in a commercially reasonable manner. See § 9-610(b).

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4. Does the answer differ under the old UCC and the amended UCC, due to take effect in 2001?

- The most significant change relevant to these transactions is that a security interest in an instrument may now be perfected by filing; where the prior Article 9 allowed perfection of an instrument only by possession. See § 9-312(a).
- Where a subsequent purchaser is unaware of the secured party's interest, the interest may be extinguished upon purchase. See § 9-330(d). This risk is minimized by the secured party obtaining an Initial Transaction Statement confirming registration of the pledge of uncertificated securities and by the secured party taking possession of certificated securities together with executed stock powers.
- The filing of a financing statement does not constitute notice. See § 9-331.

5. Could a fraudulent borrower further encumber the real estate and thus defeat the insurer's interest in the real estate?

Yes, but some factors that mitigate the risk:

- Typically, a mezzanine loan will have a hard lockbox. Since no cash will flow to a subsequent encumbering lender, most mortgagees would be dissuaded from loaning funds with the security of a second mortgage.
- Until securitization sometimes second mortgage is required for just this reason.
- The Special Purpose Entity (SPE) organizational documents will prohibit such a mortgage. Any reputable lender will ask for opinion of counsel that the mortgage is authorized. Reputable counsel would obtain copies of the organizational documents before rendering an opinion and the lender might request such documents as well.
- Sometimes the secured lender is given special member status where its vote/consent is required for specified actions such as the grant of subordinate liens.
- Violation of the entity's organizational documents would subject the grant of a subordinate mortgage to challenge as an ultra vires act.
- The securitized first mortgage will make the grant of additional liens on the property an event of default. No reputable mortgagee would lend money with the risk of an immediate default under the first mortgage. The risk of such a default might also deter the borrower from placing the mortgage on the property.
- The granting of an additional lien will likely trigger liability under the non-recourse carveouts under the first and mezzanine loan documents. Fraud is typically a carve-out from the non-recourse provisions of the documents and violation of the SPE covenants may also be a carve-out. There may be an express carveout for voluntary liens. Assuming the entity/individual guarantying the non-recourse carveouts (typically entities or individuals affiliated with both the mortgage borrower and the mezzanine borrower) has assets available to satisfy claims, the triggering of a significant non-recourse carveout liability is a substantial deterrent. Payments under the carveouts would also provide a source of repayment to the mezzanine lender.

6. Could a lender inherit borrower liabilities for say, environmental remediation?

Yes, but some factors that mitigate the risk:

- Mezzanine lenders typically require Phase I Environmental reports and further testing if the Phase I indicates a problem.
- Prior to foreclosing on the ownership interest in the property owner, the mezzanine lender would update its initial Phase I.

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- It is common to obtain for the benefit of the Mezzanine Lender as well as the First Mortgagee an environmental indemnification. The value of this will depend upon the creditworthiness of the indemnifying party.
- The SPE covenants will limit the activities the entity may engage in which if honored would limit the obligations that a mezzanine lender would assume. Violation of the SPE covenants would trigger personal recourse liability in those situations when the SPE covenants are carve-outs to the non-recourse provisions.
- The lender protections against environmental liabilities in a first mortgage situation may be overrated since to sell the property with significant environmental problems is likely to result in significant loss. Most often the lender assesses the environmental liability and may elect to take title and cure the problem before selling. The mezzanine lender may similarly elect to take title and cure the problem if that makes economic sense.
- The mezzanine lender assumes ownership of stock/membership interest/partnership interests in a SPE that holds title to potentially contaminated real estate. By avoiding any action that would cause a court "to pierce the corporate veil" (a difficult standard for a plaintiff to overcome) the mezzanine lender's sole exposure it its investment in the SPE. The Lender can be further insulated by transferring ownership of the real estate SPE to an SPE created by the mezzanine lender.

7. Are there similar types of structural risks introduced by this structure that should be part of the criteria for determining whether mortgage loan treatment is appropriate?

You have identified the three major risks:

- Certainty of ability to foreclose
- Possibility that junior mortgages or liens could encumber the property with no ability to foreclose out the mortgages or liens
- Liability for entity level obligations

There are some distinct advantages:

- A mezzanine lender can gain control over the property in say 30 days as compared to years in judicial foreclosure states.
- The lockbox structure, atypical in a classic second mortgage, prevents the borrower from milking the property and diverting cash.
- The SPE structure, atypical with second mortgages prior to the advent of securitized transactions, limits the activities of the borrower to the single mortgaged property making it less likely that other activities or properties adversely affect the mortgaged property.
- The Intercreditor Agreement with the First Mortgagee is likely to be more advantageous than any agreement reached by a second mortgagee. Cure rights can frequently be obtained.

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