CMBS 002

CMBS 002

A Primer for Borrower's Counsel

Prepared In Cooperation with

The Education/Research Committee of the Commercial Mortgage Securities Association

Commercial Mortgage Backed Securities "CMBS"
is an important source of capital for borrowers and
commercial real estate professionals to understand and use

CMBS — The Big Picture

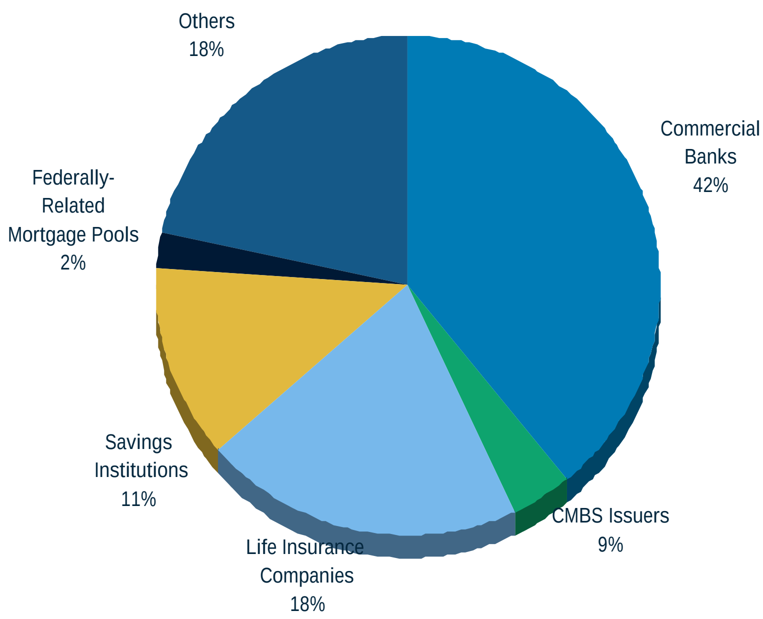
- Securitization of consumer receivables began in the 1980's, residential mortgages in the 1970's, and commercial/multifamily mortgages in the mid-1990's

- 2006 volume of CMBS totaled over $302 billion worldwide, including over $207 billion of U.S. new CMBS issued in 2006

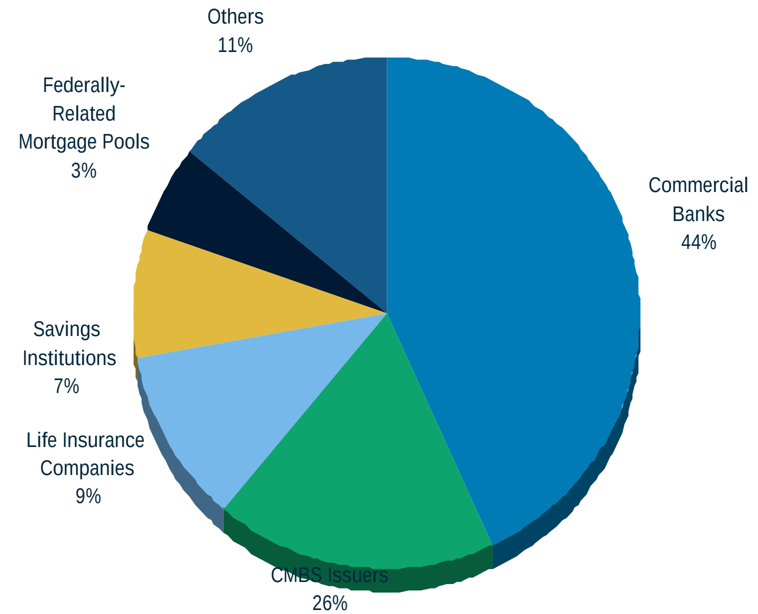
CMBS — The Big Picture

- $770 billion of the $2.95 trillion U.S. commercial and multifamily mortgage loans outstanding are held as securities, a significant increase over the past decade

(1996)



2006



Source: Federal Reserve, Flow of Funds

CMBS 002 – INTRODUCTION TO CMBS LOANS FOR BORROWER'S COUNSEL

- **Part 1:** Understanding the Process and Untangling the Players

  A brief description of the Process, and its Players and their roles in delivering CMBS funds to borrowers

- **Part 2:** What's Different for Borrower Client about a CMBS Loan?

  - Borrower Structure: Single purpose/bankruptcy remote
  - Structuring: REMIC Requirements
  - Exit Strategy: Prepayment vs. Defeasance
  - Collateral is King: Uniformity, Reporting, Reserves & Cash Management

- **Part 3:** Servicer's Practical Advice:

  Know Your Deal/Plan in Advance

- **Part 4:** Make CMBS Work For You

  CMBS Suitability for various types of Borrowers and Loans

- **Appendix:** More Information

  An appendix with typical Loan terms; CMBS References

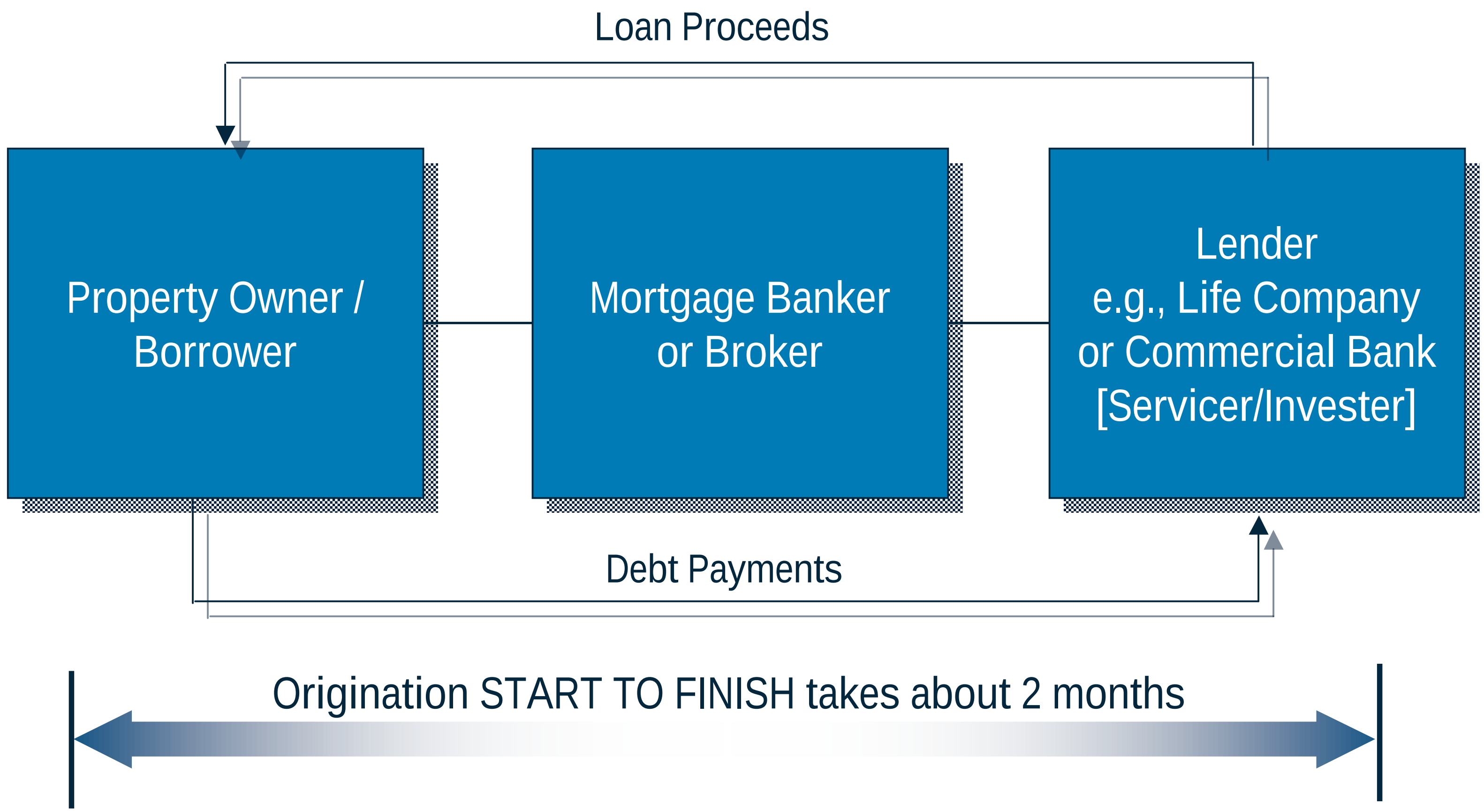
CMBS 002 — Part 1

Understanding the Process and Untangling the Players:
A Description of the Process, and its Players and their Roles in Delivering CMBS Funds to Borrowers

(Main Street Meets Wall Street)

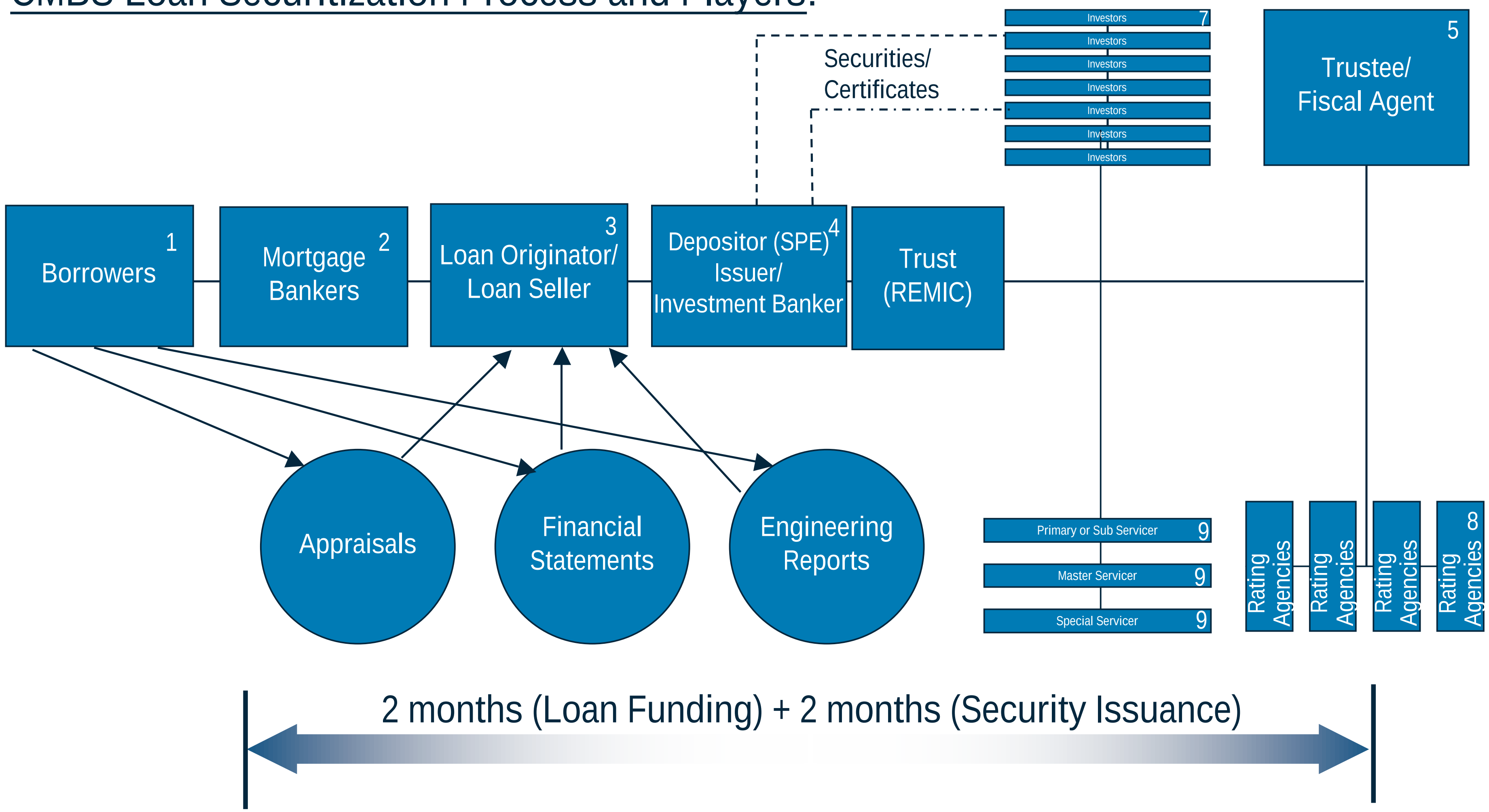
Part 1: Understanding the Process and Untangling the Players

Conventional Mortgage Financing Loan Process and Payments:



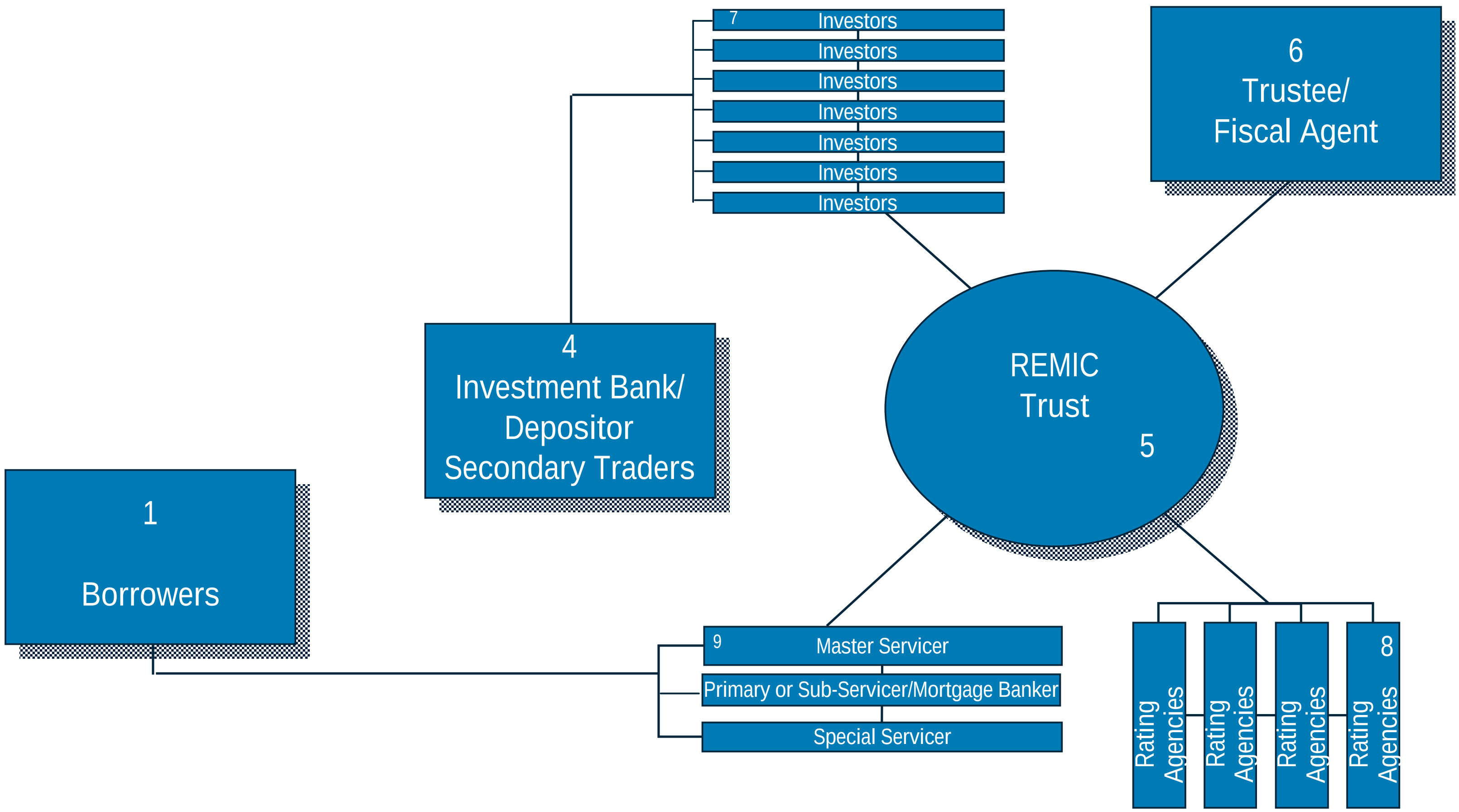
Part 1: Understanding the Process and Untangling the Players

CMBS Loan Securitization Process and Players:



Part 1: Understanding the Process and Untangling the Players

Primary NEW (Non-Lawyer) CMBS Players after Securitization:



Part 1: Understanding the Process and Untangling the Players

Primary NEW (Non-Lawyer) CMBS Players after Securitization:

4	Depositor:	An SPE entity set up by the investment bank sponsoring the securitization. It purchases commercial mortgage loans and immediately sells loans to a Trust(s) in exchange for certificates issued by the Trust. When the certificates are sold to investors, the cash proceeds are used to pay the mortgage loan sellers due under a Mortgage Loan Purchase Agreement ("MLPA").
4	Investment Banker:	Has responsibility for structuring the securitization and selling the bonds/certificates (on behalf of the depositor) to investors. After the securitization closes, may help maintain a secondary market for the bonds/securities/certificates.

Part 1: Understanding the Process and Untangling the Players

Primary NEW (Non-Lawyer) CMBS Players after Securitization:

5	Issuer/REMIC Trust:	A Real Estate Mortgage Investment Conduit or “REMIC” (also referred to as “the Trust”) is an entity which owns a pool of mortgage loans and elects to be treated as a REMIC for tax purposes. The Trust is formed by the Depositor(s) pursuant to a pooling and servicing agreement (“PSA”). The Trust owns the commercial mortgage loans, and holds the loans on behalf of the Investor(s). The Trust issues multiple classes of investment interest (bonds/certificates) each with different payment, yield and maturity features. The Critical features of a REMIC Trust is: • not subject to entity level federal income tax if in compliance with the IRS rules governing REMIC • Trust ONLY own loans secured by real estate; • Mortgage loans are “fixed” when deposited in the REMIC • Trust can not make loans, buy new loans or sell performing loans.
6	Trustee:	Pursuant to the PSA, Trustee is responsible for administering the pool of loans on behalf of the REMIC(s).

Part 1: Understanding the Process and Untangling the Players

Primary NEW (Non-Lawyer) CMBS Players after Securitization:

7	Investors: (Public Market)	Different investors [aka "Certificate Holders"], each with varying risk appetites, purchase various certificates rated from AAA/Aaa (highest rated credit quality, lowest expected bond yield) to B/B (lowest rated credit quality, highest expected bond yield) plus unrated certificates.
8	Rating Agencies:	Assigns risk of loss ratings on certain bonds/certificates issued for a securitization transaction. After the securitization funds, the rating agencies will continue to monitor performance of the Trust's assets and certificates. There are 4 independent rating agencies: Moody's Investors Service, Standard and Poor's, Fitch Ratings, and Dominion Bond Ratings.

Part 1: Understanding the Process and Untangling the Players

Primary NEW (Non-Lawyer) CMBS Players after Securitization:

9	Master Servicer:	Pursuant to the PSA, the master servicer is responsible for servicing the performing mortgage loans owned by the Trust. These responsibilities include processing and (in most cases) approving borrower requests, collecting debt service payments and escrow/reserve payments due from the borrowers, and collecting, compiling and disseminating property specific and borrower information.
9	Primary or Sub Servicer:	The primary or sub-servicer may be the originating mortgage bankers, typically hired by the master servicer. Typically, has no authority to make decisions regarding loan modifications. The primary or sub-servicer is often the initial point of contact for servicing questions and loan issues.
9	Special Servicer:	The special servicer is responsible for servicing any mortgage loan that defaults. The special servicer is selected by the "B Piece" investor and may be an affiliate.

CMBS 002 — Part 2

What’s Different for Borrower Client about CMBS Loan?

Borrower Structure: Single purpose/bankruptcy remote
Structuring: REMIC Requirements
Exit Strategy: Prepayment vs. Defeasance
Collateral is King: Uniformity, Reporting, Reserves & Cash Management

What’s Different For Borrower Client in a CMBS Loan?

Borrower Structure Single Purpose/Bankruptcy Remote Requirements

Borrower must be Single Purpose (Single Asset) and Bankruptcy Remote

[Also Known as SPE, SPC, SPV – SPE-BR, etc.]

SPE: An entity which is structured with a single purpose (usually single asset to avoid becoming insolvent due to its own conduct and is insulated from harmful affects of the insolvency of others)

Bankruptcy Remote – Not Bankruptcy Proof

What's Different For Borrower Client in a CMBS Loan?

<u>Borrower Structure Single Purpose/Bankruptcy Remote Requirements</u>

- SPE requirements stems from Rating Agency (and Public Market) desire:
  - To examine only the quality of the collateral
  - To minimize risk factors relating to bankruptcy unrelated to loan and collateral
    - By limiting cash demands and potential liabilities unrelated to the collateral
    - By limiting likelihood that collateral will be consolidated into the bankruptcy of an affiliated entity

      [Evidenced and accomplished through SPE, Loan Separateness Covenants, Independent Directors, and Opinions]

What's Different For Borrower Client in a CMBS Loan?

Borrower Structure Single Purpose/Bankruptcy Remote Borrower /Loan Requirements

Desired Protection	Accomplish Through	Effects on Borrower Client
PROHIBITION AGAINST INCURRING LIABILITIES	Single Purpose/Single Asset Borrower Entity; Structure and Loan Covenants	Borrower must be organized as SPE Separateness covenants must be in loan documents
INSULATION FROM LIABILITIES OF 3RD PARTIES	Structure and Loan Covenants; Limitations on indebtedness – Debt is limited to mortgage and trade payables only	SPE organizational documents will include restrictions Counsel to provide Nonconsolidation Opinions
PROTECTION AGAINST BORROWER DISSOLUTION	Structure and Loan Covenants; Restrictions on Borrower Entity	SPE organizational documents will include restrictions Counsel to provide Nonconsolidation Opinions
PROTECTION AGAINST VOLUNTARY BANKRUPTCY	Structure and Loan Covenants; Appointment of Independent director	SPE Organizational Documents will require consent of Independent Director(s) Borrower must Appoint Independent Director Separateness covenants must be in loan documents

What's Different for Borrower Client about a CMBS Loan?

Structuring: REMIC Requirements

Certain features of the Loan Pool and Individual Loans at the Origination and Servicing Level are in place to maintain the REMIC Status.

- REMIC REQUIREMENTS - Result in limitations on ability to (1) release or substitute collateral, (2) substantially modify Loan Documents or (3) rely on collateral other than real property and rent from real property.

For a mortgage-backed conduit entity to qualify as a REMIC, substantially all of the assets of REMIC must consist of "qualified mortgages" and "permitted investments" as of the close of the third month beginning after the startup day (i.e., the day on which the REMIC issues its regular and residual interests) and at all times thereafter. *I.R.C. § 860D(a)(4).* "Real property" means land and improvements. The loan pool is fixed at formation of REMIC.

What's Different for Borrower Client in a CMBS Loan?

EXIT STRATEGY – Prepayment vs. Defeasance

- Lender/Investors expect stated return over term and require call protection.
- Prepayment Disrupts Investors Return vs. Borrowers need for a release of the property to refinance or sell.
- In a Conventional Loan, typical Prepay Restrictions address Lender return protection concerns through lock out periods and yield maintenance payments.
- However, in a CMBS Loan, uncertain payment stream from early prepayment more negatively effects CMBS Structure and Pricing because,

REMIC rules prohibit prepayment proceeds from being reinvested so yield maintenance is not effective hedge.

What’s Different for Borrower Client in a CMBS Loan?

EXIT STRATEGY – Prepayment vs. Defeasance

CMBS Loan Documents will be Drafted to satisfy REMIC conditions to Provide a Mechanism for “Defeasance”

- Loan documents must expressly allow defeasance.
- Mortgage release can not occur within the first two years after REMIC start-up.
- Substituted collateral must consist only of U.S. Treasury Securities (mortgage lien/security title on the real property must be released).
- Portfolio of government securities must be non-callable and match payment stream.

What's Different for Borrower Client in a CMBS Loan?

EXIT STRATEGY – Prepayment vs. Defeasance

Defeasance preferred CMBS alternative to prepayment.

Defeasance allows Substitution of other Non Real Estate collateral for the Real Estate collateral previously provided by the security instrument.

- Satisfies Borrower's request for release of the real property.
- Avoids typical prepayment negative impacts [e.g. disruption/uncertainty].
- Satisfies CMBS lender desire to remain competitive without prepayment rights.
- Limits uncertainty by providing the lender with substitute collateral.
- No payment disruption – since debt remains outstanding as an asset of REMIC with a regular payment stream.

What’s Different for Borrower Client in a CMBS Loan?
Collateral is King

More Upfront Reserves and Cash Management Requirements.

- Cash flow is more important
- Mitigation of default risk through control of cash flow
- Higher loan sales price upon securitization
- Advantages over receivership action following event of default.
- Reduced risk that Borrower will divert rents pre-default
- Less resulting counterclaims by Borrower

What's Different in a CMBS Loan?
Collateral is King

MORE UPFRONT RESERVES and Cash Management Requirements:

Typical Types of Reserves	General Characteristics
Tax & Insurance Impound	Same as portfolio loan – but Lender less likely to waive; typically lump sum deposit for prorated year and one month extra then 1/12th monthly during term
Deferred Maintenance Reserve	Address Immediate identified needs (scheduled) derived from Lender Physical Condition Report – usually 125% of estimated cost and time frame to complete
Repair & Remediation/FF&E Reserves	Anticipate all future needs - generally more aggressive by property type (lump sum deposited 1/12 monthly over term)
Payment Reserves	Not common for established properties but more than for portfolio loans – more likely for start up/new common development properties without history
Leasing/Tenant Improvement Reserve	More common than for portfolio loans based on industry current occupancy and rollover; lump sum required if major turnover anticipated
Environmental/ADA Reserves	Derived from Physical Condition Report and Environmental Reports or promulgated governmental requirements - generally 125% of estimate restructured costs and generally combined with insurance

What's Different for Borrower in a CMBS Loan?
Collateral is King

MORE UPFRONT RESERVES and Cash Management Requirements:

Most Frequently required with . . .

- Highly leveraged loans [e.g. LTV>75%; DSCR<1.10]
- Capital intensive property types
  - Hotels
  - Nursing Homes
- Larger loans [e.g. over $10MM]
- Small loans with weak-credit Borrower cashing out equity

What's Different for Borrower in a CMBS Loan?
Collateral is King

More upfront Reserves and Cash Management Requirements

Type of Cash Management-Lockbox/ By Classification	By Collection Process	By Borrower Access to Cash Management Account ("CMA")	By Whether Collection Process and CMA Implemented
Hard or In-Place	Lender controlled [e.g. single tier] – no money to B – no access to B	No Borrower access (CMA is blocked account)	Collection process and CMA implemented at closing
Soft of Springing	Borrower controlled [e.g. two-tier] – may become hard	Borrower either has direct access or all funds swept daily to Borrower's operating account	Collection process and CMA will be implemented after "Cash Management Event" [aka "trigger event") occurs e.g.: • Expiration/termination of major lease; • decline in occupancy below threshold; • loss of hotel franchise; • event of default Soft until trigger event is Sprung

CMBS 002 — Part 3

Servicer’s Practical Advice:

Know Your Deal/Plan in Advance

Servicer's Practical Advice

Know Your Deal/Plan in Advance

- REMIC REQUIREMENTS RESTRICT RIGHT OF SERVICER TO MAKE LOAN DOCUMENTS MODIFICATIONS AFTER CLOSING
  - Identify Defined Terms and Explain Consequences to Client (*See glossary*)
  - Focus on Structuring Requirements
  - Obtain Lender's Guidelines in advance; SPE, title and survey requirements, TEC and SNDA forms (subject to Third Party providers and Seller, if applicable)
  - Identify Reserve Disbursement Requirements and Timing
  - Anticipate Borrower and Collateral Requirements ("Hardwire" into Documents)
  - Explain Cost and Timing Difference of Defeasance vs. Prepayment

Servicer's Practical Advice

Know Your Deal/Plan in Advance

ISSUE	RECOMMENDATION
Borrower Structuring Issues for Acquisition -	• Obtain lender's guidelines before forming entity • Confirm that a new entity can be formed as Single Purpose/Single Asset entity that meets Lender stated requirements • Understand that Entity will need to adhere to Separate Covenants • Check with Borrower Accountants
Borrower Structuring Issues for Refinance – Who is existing Owner?	• Confirm whether current owner is single purpose/single asset [Address same issues as above) and if not: Confirm owner can be converted to a SPE (meeting Lender's requirements) and/or Property can be transferred to a New SPE, without significant cost (Consider state transfer tax requirements or alternatives)

Servicer’s Practical Advice

Know Your Deal/Plan in Advance

ISSUE	RECOMMENDATION
Reserve Needs and requirements for depositing and disbursing may be more onerous and can not be altered once established	• Identify and understand need for immediate maintenance, lease turnover, renovations requirements or expectations in advance • Build protocol for reasonable access mechanisms for disbursement in to Documents that are consistent with plans and obtainable • Make sure Servicer has sufficient time and necessary information to respond promptly
Property has future Development Needs and Potential	• Identify any excess Land and plans for subsequent Phase development • Build mechanism for partial releases, which is consistent with plans, into documents

Servicer’s Practical Advice

Know Your Deal/Plan in Advance

ISSUE	RECOMMENDATION
Know your Lender/Servicer	Set up clear notice requirements – with requirements for Hello – goodbye letters naming personal contacts and alternatives Keep full set of documents Request copies of all assignment documents Keep Document timeline for all Reserve and Cash Requirements and Triggers

CMBS 002 — Part 4

Make CMBS Work For You:

CMBS Suitability for various types of Borrowers and Loans

Make CMBS Work for You

Suitability for Properties and Borrowers:

Mortgages Most Suitable For CMBS	Mortgages LESS Suitable For CMBS	Issue or Mitigation
Properties with stabilized and fairly regular cash flows	Turn-around assets where cash flow might change materially in the near-term or medium-term future Properties that might need major reconfiguration Properties with highly uneven cash flows	Turn around properties may require significantly higher reserves and cash control to mitigate uncertainty
• Generic/conventional property types (retail, office, multifamily)	• Unconventional property types (nursing homes, hospitals, assisted living facilities, marinas, golf courses) • Operating businesses	• More Difficult to underwrite income for a business and may not be considered real estate; usually more complex structures
Either fixed- or floating-rate loans, but probably not less than 5- or 7-year terms and preferably 10-year terms	Very short term loans, i.e., less than 3 years	If a borrower wants to pre-pay the mortgage, be prepared for defeasance which can be costly and inefficient for small mortgages (i.e., under $5mm)

Make CMBS Work For You

Suitability for Properties and Borrowers:

Mortgages Most Suitable For CMBS	Mortgages Less Suitable For CMBS	Issue or Mitigation
Properties where no modification is necessary, or properties where modifications can be made pre-securitization.	Properties with incomplete information or where information for the asset is difficult to consolidate or compile.	If properties need modifications, borrower can speed things up if securitization horizon is longer term and by providing all necessary information before a loan is sold into a securitization and requesting simultaneous review by all parties (servicer and, possibly, rating agency)
• Properties and/or borrowers that are capable of and amenable to timely (quarterly) reporting to third parties on property performance, preferably electronically.	• Properties and/or borrowers that do not lend themselves to regular and timely reporting.	• CMBS has strict reporting requirements for Public markets. If information is not available or Borrower is unsophisticated in reporting, it may be difficult to satisfy demands
Borrower has the flexibility to acquire ownership of the property in (or convey ownership to) a newly-formed entity, whose organizational documents contain single purpose bankruptcy remote and securitization friendly operating covenants.	Properties that can not easily or economically be acquired in or owned properties that can not easily or economically be conveyed to a new entity.	Conveyance could trigger transfer tax liabilities or borrower may have 1031 or other transfer restrictions that prohibit maintenance of SPE covenants

Make CMBS Work For You

Suitability for Properties and Borrowers:

Mortgages Most Suitable For CMBS	Mortgages Less Suitable For CMBS	Issue or Mitigation
Properties with extremely low probability that the borrower will want or need to release or further develop a material portion of the mortgaged property, expand current improvements or add property to the mortgage collateral. No repositioning properties.	Properties with high potential for future development, out parcels, excess land and where borrower is unsure about prospects for future use and development of the property and cannot anticipate the criteria for future loan modifications or subordinate debt requirements.	Servicers can not modify Loans after closing so there is less flexibility post closing in meeting development objectives or working out short term cash flow issues. However, if needs can be anticipated, certain rights for releases or debt service reserves can be built in to documents to eliminate needs for changes after closing.

CMBS 002— Appendix: Typical Loan Terms

Typical Terms for a CMBS Loan

Loan Amount Minimum:	$3,000,000
Loan Amount Maximum:	Standard conduit maximum of $30MM on large loan, however "stand-alone" execution is unlimited amount
Location:	Nationwide
Eligible Properties:	Multi-family, retail, office, industrial, as well as mobile home parks, self-storage and lodging considered in some conduit programs
Term:	*Fixed Rate:* 5–7–10-year maturities with balloon or 15–20-year fully amortizing *Floating Rate:* Up to 3–5 years with extension options
Amortization:	Maximum 30 years, sometimes shorter
Loan-to-Value:	Maximum 80%
Debt Service Coverage:	Minimum 1.20x
Interest Rate:	Fixed over Treasury or floating over LIBOR (subject to floor)
Prepayment:	*Fixed Rate:* Lock-out with defeasance option *Floating Rate:* Prepayable after 12 months with exit fee
Assumable:	Permitted subject to lender approval and 1% assumption fee
Loan Fee:	0% to1% of loan amount depending on loan size and asset strength
Security:	First lien mortgage on completed and leased properties
Subordinated Debt:	Not permitted, though in some cases, may be structured in up front
Borrowing Entity:	Single asset or special purpose entity required in most cases
Third Party Reports:	Current engineering report and Phase I environmental reports meeting conduit specifications are required Seismic reports are required for California properties and other risk locations
Appraisal Report:	Current appraisal conforming to FIREA and USPAP guidelines required
Reserves:	Taxes and insurance resources required; replacement reserve, property specific reserves and deferred maintained reserves may be required