

Best Practices for CMBS Restart
A Discussion Document from the CMBS Investment Grade Bondholder Forum
Commercial Real Estate Finance Council

As of 6/11/2010

Executive Summary

Alignment of Interests

- Risk retention
 - 5% vertical strip of every bond class in a CMBS transaction to be held by **issuer**
 - First loss tranche(s) to be held by B-piece buyer
 - Retained vertical strip can not be sold and its credit risk should not be hedged during the life of the transaction.
- Servicer
 - Fees paid by the borrower directly to the special servicer should be split 80%/20% between the trust and special servicer.
 - Failure to produce contractual information results in withholding of fees.
 - Special Servicer should be paid 1% fee if a loan is effectively put back because of a breach.
 - Special servicer may only purchase defaulted loans in a competitive bid process.
- Defaulted loan payment seniority at the loan level: trust and servicing costs; then servicer advances; sequentially all original principal; interest accrued but not advanced
- Discount rate: Special servicer should base its workout decisions using CMBS investor opportunity cost or the loan market rate as described.
- Borrower will be directly responsible for all fees and this is incorporated into the mortgage note.
- A&B notes are represented by the same Special Servicer and/or the B-note absorbs all workout related costs including the trust fees and expenses. B-notes and Mezzanine lender have cure rights only.
- SPE provisions: enhanced SPE separateness provisions and disincentives for filing bankruptcy.
- Rating Agencies – produce a defined set of reporting deliverables pre and post issuance as described.
- Operating Advisor: independent third party paid by the trust to oversee and advise the operations of the trust as described

Transparency

- New issue- timing, additional information, representations & warranties and rating agency recommendations.
- Ongoing reporting meets described requirements.
- Investor registration maintained by the trustee.

The Best Practices recommendations broadly relate to all future CMBS issuance. These recommendations are conceptual and many of the mechanics need to be formulated. The document is broken down into two broad categories: 1) Alignment of Interest; and 2) Transparency.

1. Alignment of Interests

Issuer/Underwriter/B-piece

- Risk retention:
 - The **issuer** of the transaction should retain a vertical strip equivalent to 5% of the cash value every bond class.
 - In addition, where applicable, a third-party buyer (i.e. traditional B-piece buyer) should take a “first-loss” position; conduct extensive due diligence on the transaction (effectively re-underwriting all of the loans in the proposed pool).
- These retained interests should meet the following requirements:
- Issuer retention should not be sold; B-piece buyer, can sell, but transfer restrictions apply (e.g. do not sell into CDO).
 - Its credit risk should not be hedged during the life of the transaction.
 - Recourse financing against the retained securities is acceptable, so long as the recourse entity is a significant affiliate (e.g. wholly-owned subsidiary) of the retaining entity’s parent company.
 - For the issuer retention, if a transaction is co-sponsored, any one of the contributing sponsors could satisfy the retention requirement.
 - Any retained interest should be based on cash value, net of any discounts, reserves or other cash considerations from the originator.
- Standard representations: the IG Bondholder Forum will put forth a recommended set of minimum representations and work through an association-level task force to come to consensus and endorse such minimum representations. Such association adopted minimum representations should be present in any transaction, and the issuer should state its compliance with these standard minimum representations.

Servicers

- Compensation: the fees paid to special servicers should be reformed as follows:
 - Any modification or extension fees collected directly from a borrower should be used to reduce the fees owed by the trust; and to the extent the collected fees are greater than the fees owed by the trust the excess will be split 80% to the trust as a partial liquidation recovery (see “Payment seniority at the loan level” in the next section) and 20% as incentive to the special servicer. At balloon the excess principal should be applied to the special servicer workout/liquidation fee. The intent is that the trust shares in excess fees collected.

- Failure to produce any contractually agreed upon information (including the IRP and all supplemental CREFC reports) will result in the withholding of the responsible party's servicing fees on a loan specific basis until the next payment period after the information is adequately provided (to be enforced by the Operating Advisor in conjunction with the trustee).
 - The special servicer should be responsible for examining all defaulted loans for the existence of breaches to representations and warranties, and should seek a putback or other restitution due as a remedy per the warranties, and should be entitled to a 1% fee to be borne by the entity that warranted the representation (along with any legal fees) for any loans that are effectively put back.
- Loan Purchase Option: The Special Servicer may only purchase a defaulted loan out of the trust through a competitive bid process run by the Trustee. This would be run in a similar fashion to an REO sale in which the Special Servicer chooses to participate.

Across Bond Classes

- Payment seniority at the loan level: any cash received on a defaulted loan should be allocated **sequentially** to the appropriate trust and servicing costs; **then** a) principal, until all of the original loan's principal is paid off; then b) interest accrued on loan balance including any interest that was reduced via an appraisal reduction.
- Payment seniority for distribution of additional interest: any additional interest collected due to modifications or ARD should be distributed sequentially in the bond payment waterfall as a principal distribution.
- Expanded Appraisal Reduction Amount definition: a modified loan will continue to have an appraisal reduction amount associated with it even if it is current on its new contractual payments; this amount will be used in calculating bond holding percentages for voting purposes.
- Controlling rights: the right and obligation to advise the special servicer should reside on an independent third party operational advisor paid by the trust; this advisor will be obligated to act in the best interest of all bondholders. This operational advisor could be replaced by a simple majority of bondholders.
- Servicer replacement: the right to replace servicers should reside on the operating advisor with the approval of the majority of bondholders following the process described below and in the Operating Advisor section.
- Bondholder voting: votes should be solicited from registered bondholders (see Market Transparency section), and a simple majority measured as a percentage of bond holdings from voting investors (rather than as a percentage of all bondholders) should be the threshold for any decisions. Votes will carry the weight of investor dollar holdings net of any appraisal reductions that may affect these holdings. For a voting to be valid the operating advisor will need the vote of at least 25% of eligible bondholders, and decisions will be made using a simple majority rule on votes from voting bondholders.

- Discount rate: the special servicer should base its workout decisions on an NPV calculation that uses a discount rate which reflects one of the two formulations:
 - The opportunity cost of funds for the CMBS Trust, collectively for all bondholders. This can be measured with the Barclays CMBS Index (or any successor index) weighted across credit categories; or
 - The market rate of interest a successful bidder would apply if the asset that is being specially serviced were to be exposed for sale on a fair market basis. A proxy for this may be the discount rate used on a current appraisal of the asset.

Borrower and Junior Lenders

- Borrower will be responsible for reimbursing the Trust for any fees paid in connection with a default or modification (e.g. fees can be capitalized on the loan amount). Furthermore, performing borrowers will be directly responsible for any special servicing fees on their loans to the extent their actions led to the transfer of the loan to special servicing. These terms should also be incorporated in the mortgage note.
- Liquidation proceeds sharing: the borrower should only be entitled to liquidation proceeds that are over and above the original loan amount and unpaid interest per the loan's original terms.
- Loan modifications: intercreditor agreements should contain clear language making any modification to a senior loan permissible only to the extent that the modification will respect the seniority of claim of the senior loan over any junior loans.
- SPE provisions: enhanced SPE separateness provisions and disincentives for filing bankruptcy should be put in place, including:
 - Two SPE directors that are not affiliated with the sponsor, which may not be replaced by the sponsor.
 - The guarantor of the non-recourse carve outs must make both initial and periodic ongoing certifications that the operations and accounting is being kept separate and independent at the SPE level from the operations and accounting of any other entity.
 - There is recourse to the guarantor in the case of a bankruptcy filing of the borrowing entity, or any attempt to cooperate with such a bankruptcy filing.
 - The guarantor at risk in the case of a breach of any of the provisions above should be either a warm body or an entity that has substantial assets independent of those that are within the SPE.
- Cure rights: When a mortgage defaults, a mezzanine lender should have cure or senior debt payoff rights only, and B-notes should be part of the trust OR should not be allowed when the A-note is securitized. The B-note should absorb all workout related costs.

Rating Agencies

- Contractual deliverables: ratings contracts should bind rating agencies to produce a minimum defined set of reporting deliverables both pre and post issuance. Parameters should include the minimum content and periodicity of these deliverables (see Transparency section).
- Compensation: new rating fees should be the only ones paid upfront, and surveillance fees should be paid over time if and when the agencies comply with their agreed upon reporting deliverables.

Operating Advisor

- Responsibilities will include:
 - advisory rights with respect to special servicing resolution plans;
 - preparation of reports to all certificate holders on special servicing outcomes, to be disclosed after special servicing decisions have been executed;
 - scheduling and organizing bondholder votes when required (i.e. replacing special servicer or other party, etc.);
 - obtaining and maintaining the same information that gets provided to rating agencies on an on-going basis;
 - acting as a liaison between investors and trustee/servicers with respect to data integrity issues to ensure all data fields are correct and complete;
 - actively monitor servicer reporting practices, which may include substantive and compliance testing of reporting and servicing functions on a periodic basis; and
 - advising the trustee to withhold compensation to servicers or other parties for failure to produce the contractually agreed information.
- Voting process: the operating advisor will conduct the bondholder voting process by requesting votes from registered bondholders.

2. Transparency

- All the information requested in these guidelines should be publicly available; servicers/trustees will not require investors to agree to “terms of use” statements on web sites potentially restricting access by certain investors due to various representations included in such statements.

New Issue

- Issuance timing: issuers should provide investors a complete set of documentation at least 5 business days before pricing a transaction – see minimum documentation requirements.
- Standardized Annex A: this report should have a specific, standard layout to facilitate processing; it will be created by the CREFC and will include multiple data fields including, but not limited to, the following:

- Annual financial metrics (occupancy, revenue, expenses, NOI, NCF, DSCR, etc.) for each of the last 3 years. *[Reference Appendix 1]¹*;
- Complete debt stack (in place and permitted) for each property, including key leverage metrics for each layer of debt (DSCR, LTV, debt yield, etc.); and
- Complete rent roll that identifies all tenants (use equity tickers for standardization), lease inception and expiration schedule, leased area, rent, sales per square foot, corporate rating, where applicable, etc. *[Reference Appendix 2]*.
- Minimum documentation: issuers should provide investors at a minimum with the following documents at least 5 business days prior to pricing (some of this information may be provided as part of the offering documents):
 - Prospectus – in plain English;
 - PSA – in plain English;
 - Annex A;
 - Pre-sale rating reports (to be provided by the rating agencies);
 - Loan level documentation for loans representing 5% or more of the pool (appraisals, environmental assessments, intercreditor agreements, etc.);
 - Compensation disclosure for all relevant parties (i.e. rating agencies, underwriters, servicers, advisors, etc.);
 - Investor relations directory containing contacts at each relevant institution (master servicer, special servicer, rating agency, market maker, trustee, etc.) that investors can call directly with any inquiries once the deal goes live. This directory should be updated on an ongoing basis by the master servicer; and
 - Disclosure of any non-compliance with these Best Practices.
- Representations and Warranties: five business days prior to the pricing of each transaction, all prospective investors should receive:
 - A blackline that compares the reps and warranties for the given transaction to the Model Representations and Warranties *[Reference Appendix 3]*. This blackline is for the full-form reps and warranties that are in the loan purchase agreement rather than the short-form summary of those reps and warranties that has heretofore often found its way in to offering documents; and
 - The report of exceptions to the reps and warranties, with loan-specific details.
 Investors are seeking to strengthen underwriting standards. It is anticipated that the Model Representations and Warranties will include reps designed to embody good underwriting practices.
- Ratings: in their pre-sale report rating agencies should provide detailed analysis of any loans that represent more than 5% of the pool, but at least the 20 largest loans. This report should also contain the expected loss for each bond and each loan in the transaction. *[Reference Appendix 4]*
- Ratings agencies chosen: the issuer should select one rating agency, and the SEC should select a second rating agency for each transaction, both of which should be paid by the trust.

¹ This Discussion Document references Appendices that will contain sample recommendations that are still under final review by working groups within the Investment Grade Bondholders Forum. The Appendices will be made available once they receive final approval from the Forum.

- Rating agencies not hired: if a rating agency not hired to rate a transaction wishes to independently rate that transaction, it should comply with the minimum information standards in these guidelines AND should provide that information in a pre-sale report at least 5 business days before the transaction prices. If the pre-pricing timeline requirement is not met, then the agency can provide its independent rating only after the first year of a transaction or their determination that there has been a material change in the credit worthiness of the bonds since deal origination.

Ongoing Reporting

- IRP: servicers and trustees should contractually agree to provide investors with a complete IRP as amended by the CREFC from time to time, to the best of their abilities. *[Reference Appendix 5]*
- Property financials: financial reports for each property should be provided on a quarterly basis with a lag of no more than 3 months. All information should be presented on an annualized basis, with the servicer disclosing the methodology it used for annualizing. This disclosure should include line items that detail all the debt payments that must be serviced by the property in and outside the trust, with the corresponding debt service coverage ratios. The identity of each lender, the loan balance, and a summary of the payment terms for each loan should be included in the disclosure.
- Loan workout information: for any specially serviced loan the servicer should provide the operating advisor with a business plan that includes the following minimum information on any workout strategy:
 - Full appraisal report;
 - NPV calculation and assumptions for all workout strategies considered;
 - Disclosure of any consideration received by subordinate lenders;
 - Disclosure of losses expected as a result of reductions in loan rate or principal balance;
 - Detailed schedule of servicing fees collected from the trust and any other sources in relation to the servicing of the loan;
 - Disclosure of shortfalls taken over multiple months;
 - Detailed disclosure of terms, assumptions and projections for modifications that include a bifurcation of loans (A/B notes); and
 - Upon resolution of the special servicing situation, the operating advisor should report to all certificate holders what course of action was taken by the special servicer, and why that was the best course for the collective good of all certificate holders.
- Ratings: rating agencies should provide a detailed surveillance report for each transaction at least once per year. The scope of this report should be disclosed pre-offering, in the rating agency presale report. Analysis should include discussions of material changes regarding any loans that represent more than 5% of the pool, but at least the 20 largest loans, plus a review of defaulted and specially serviced loans that comprise 1% or more of the pool balance.

- Rating agencies should provide a report with their analysis leading to their rating affirmation for any events that require their approval in the transaction documents.
[Reference Appendix 4]

Market transparency

- Investor registration: the Trustee, in collaboration with the Custodian, should maintain a current list of investors in each transaction, to be updated at least monthly. The Operational Advisor will be entitled to request this list in order to contact investors for any action that may require a vote.
- Data repository: the trustee should house all deal related documentation on its website, and should provide a web board or similar messaging mechanism to publicly channel responses to specific investor questions so as to adhere to fair disclosure requirements. The trustee should receive all reports directly from the producing party, in order to avoid the current hand-off of reports that often results in under-reporting. Any revised documents should be hosted on this website, and the trustee should clearly identify the addition of such revisions.