Commercial Mortgage-Backed Securities (CMBS)

Commercial mortgage-backed securities are bonds offered to investors that are collateralized by a pool of commercial mortgage loans from which all of the principal and interest paid on those mortgages flows to investors. To create these investment vehicles, mortgage loans of varying dollar amounts, property type, and location – and containing a myriad of individualized terms and conditions – are pooled and transferred to a trust. Bonds then are issued backed by the pool of assets held in the trust. Those bonds vary in yield (the amount of return on the bonds), duration (the length of time before the bond is expected to be paid off), and payment priority (the order in which investors are paid a return on their investment).

Borrowers, lenders, and investors all benefit from CMBS. Borrowers often benefit via access both to larger pools of capital than would otherwise be available in traditional lending markets and to lower interest rates. Lenders benefit from CMBS because the securitization enables them to access the capital markets with their loan products. Investors benefit because CMBS creates a potentially attractive and credit-worthy investment vehicle that caters to their desired risk profile, investment term, and yield. The participants and steps in a commercial real estate finance transaction, from the negotiation of the individual mortgage loan through the creation and administration of the corresponding commercial mortgage-backed securities, are outlined below.

A. The Lender and the Borrower – The Initial Loan

The starting point of the entire CMBS transaction is an individually negotiated commercial mortgage loan. Unlike the typical mortgage that an individual obtains in connection with the purchase of a home, commercial mortgage loans are non-standardized. A residential mortgage typically uses standard loan documents that are not modified or negotiated. For commercial real estate, the loan documents are separately and extensively negotiated for each and every loan between the parties and their respective counsel, and for good reasons. First, there are many types of commercial real estate that serve as the collateral for the loan that vary both by type of project – apartment buildings, hotels, shopping malls, office towers, and warehouses, for example – and by location, encompassing properties located in dense urban areas, seaports, suburbs, and more rural locales. These variations result in loan structure differences concerning escrow requirements, tenant reserves, property management criteria, lease approvals, and, of course, prepayment terms. Second, the payments of principal and interest are expected to be paid out of the income generated by the use of the real estate that provides the collateral for the associated loans. Third, the borrowers typically are sophisticated and have very different needs and requirements in their respective loan situations. They are legal entities, such as corporations or partnerships, and usually are represented by counsel who advise them throughout the lending process.

B. The Issuer and the Trust – Structuring and Pooling the Loans

The individually negotiated commercial mortgages are the building blocks of the commercial mortgage-backed security, and the “issuer” is the architect. The issuer gathers together the loans that are to be securitized and then defines the classes of bonds that are offered to investors. The issuer typically is an investment bank that evaluates and aggregates the loans for the CMBS trust and submits summaries of the loans in electronic spreadsheet form and hard copy text to the rating agencies so that they can be evaluated.

For CMBS, a key responsibility of the issuer in structuring the investment vehicle involves aggregating the loans – a process referred to in the industry as “pooling” the loans. In selecting the loans for the pool, the issuer strives to create a desired mix of loans to produce an attractive investment opportunity for investors. In some cases, the pool contains loans that are highly diverse in terms of industry, size, type, and location; in other cases, the pool contains a more homogenous collection of loans. The purpose of such varied pools is to offer investors a variety of choices along a risk-return spectrum.
The issuer creates a trust to hold the pool of secured commercial mortgage loans and appoints a trustee to hold the loan documents and to oversee the distribution of payments to investors. That trust generally is structured as a statutorily-created holding entity known as a Real Estate Mortgage Investment Conduit (“REMIC”). REMICs were authorized by Congress in the Tax Reform Act of 1986 to allow trusts that satisfy the REMIC requirements to issue multiple classes of securities backed by the trust assets (here, commercial mortgage loans) without any adverse tax consequences to the trust.1 The REMIC framework enables the trust to hold the loans that are secured by real property without the same level of regulatory, accounting, and economic obstacles that exist in other forms of mortgage-backed securities. REMICs are analogous to limited partnerships or limited liability corporations in that they are created to allow an entity to pass through its income and its liabilities directly to its investor beneficiaries. The REMIC trust itself generally pays no tax on the income generated by the trust assets; instead, taxes are paid only by the individual investor(s) holding the residual interest(s) in the REMIC. As a result, the applicable rules require the REMIC to operate as a holding entity for an unchanging (or “static”) pool of loans, except in the case where a loan is in default. If modifications are made to a securitized loan that is not in default, the REMIC runs the risk of being viewed as a business entity rather than a holding entity, and thus may be required, for example, to pay entity-level taxes.

From the pooled loans in the trust, the issuer defines different classes of bonds to be secured by the pool of mortgage loans. The specifications for such classes of bonds then are submitted to a rating agency, which in turn rates each class of bonds.

C. The Issuer and the Rating Agencies — Rating the Bonds
An indispensable part of structuring CMBS involves submitting the bonds secured by the individual loans to one or more rating agencies. Rating the bonds is the linchpin of the securitization process because the ratings serve as objective third-party opinions on the quality of each bond in the structure. To obtain the ratings, the issuer submits the proposed loan pool to the rating agencies, which establish bond ratings for each class of bonds by examining the terms of the commercial mortgages.

To establish a rating for each class of bonds, the rating agencies thoroughly review a large number of critical characteristics of the loans in the underlying pool and assign a credit rating to each bond class based upon that evaluation. This analysis includes an examination of the volatility and reliability of the cash flows associated with the property; the type, quality, and competitiveness of the property; the experience and reputation of the borrower and manager; the location of the real estate; the quality of the tenant; and the key terms of the loan agreements themselves — including the prepayment terms.2

In conducting this evaluation, the rating agencies rely on detailed summary information submitted in standardized formats. To support that submission, issuers also are required to provide assurances in the form of representations, warranties, and covenants. For example, the following representations and warranties normally are provided:

* “None of the terms of a mortgage loan have been impaired, waived, altered or modified in any way, except by written instruments all of which are included in the related mortgage file”;3 and

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• “The mortgage note, mortgage and assignment of leases for each mortgage Loan contain customary and enforceable provisions for commercial mortgage loans secured by properties such as the mortgaged properties, so as to render the rights and remedies of the holder adequate for the realization against the mortgaged property of the benefits of the security, including realization by judicial, or if applicable, non-judicial foreclosure subject to the effect of bankruptcy and similar laws affecting the rights of creditor and the application of principles of equity.”

These are but two provisions on a long list of standard representations and warranties regarding the loans, the property, the borrower, and the authority and solvency of the participants in the transaction. Other representations and warranties address, *inter alia*, the enforceability of the individual loan documents, the maintenance of all risks insurance coverage including terrorism insurance, maintenance of escrows and prepayment terms, and compliance with environmental laws and regulations applicable to the underlying properties.

Based on a careful evaluation of the business and contractual terms of the underlying loan agreements and of the representations and warranties, the rating agency assigns a rating to the bonds.

**D. The Investor’s CMBS Investment**

After they are rated, the securitized bonds then are offered to investors. Typically, CMBS investors include pension funds, insurance companies, money managers, mutual funds, and commercial banks. These investors, in turn, represent millions of individual investors who have entrusted these entities with their savings, retirement monies, and other investments. Borrowers make principal and interest payments on the loans and, from those payment streams, disbursements are made to each class of investors in what is known as a “waterfall” payment sequence, meaning the payments cascade downward from the highest-rated bondholders to the lowest-rated bondholders. The holders of the highest-rated class of bonds are paid first. Bondholders who have acquired lower classes of bonds then are paid off in turn, but the yield is associated with the risk.

There is investment risk in that some of the mortgages in the pool may not perform as expected. If losses accrue, they are charged upstream to the bondholders, with the lowest grade bondholders bearing the loss initially. By dividing bonds into classes, different types of investors can manage their exposure to real estate risk by selecting their position on the waterfall, based on how much risk they wish to bear – the higher the rating, the lower the risk and the lower the interest rate.

**E. The Servicer – Enforcing the Terms of the CMBS Loans on Behalf of the Trustees**

An indispensable player in the CMBS market is the servicer. The servicer acts on behalf of (and for the benefit of) the bondholders and the trust to ensure the continued performance and viability of CMBS by servicing the mortgage loans that constitute the collateral for the bonds. The responsibilities and obligations of the Master (or lead) Servicer are set forth in a Pooling and Servicing Agreement (“PSA”) that the Master Servicer enters into with the trustee and commonly includes the obligations to:

- collect mortgage payments and transfer the collected funds to the trustee, who distributes them to the certificate holders;
- advance any late payments to the trust;
- provide mortgage performance reports to bond holders;

4 *Id.*

5 Other participants to the transaction (other than the borrowers) also are required to submit representations and warranties related primarily to their promises to perform their obligations with respect to the CMBS going forward.
- refer all loans that are in default or likely to soon be in default to a “Special Servicer” which develops and implements strategies for such troubled mortgage loans; and
- interpret and enforce the specific contractual terms of each loan in the pool, including the all risks insurance/terrorism coverage covenant.

The individual terms of each mortgage loan, thus, explicitly take precedence in the servicing of the mortgage loan over the terms of the PSA in order to uphold the integrity of the contract between the borrower and the lender.

Many primers on the structuring of CMBS are available including the Borrower Guide to CMBS available on the Commercial Mortgage Securities Association (www.cmbs.org) website.
Commercial Mortgage Backed Securities (CMBS) in the U.S. Real Estate Finance Market

Commercial Mortgage-Backed Securities
In 1990, most of the $1.1 trillion of U.S. commercial and multifamily mortgage loans were held by financial institutions. After the real estate credit crunch of the early 1990’s, the government and private real estate property owners turned to the capital markets as a viable source of debt financing.

At year end 2006, $770 billion (26%) of the $2.95 trillion of U.S. multifamily and commercial mortgage loans outstanding were held as securities, which included 40% of all new commercial loans. In comparison, the public market capitalization of all real estate investment (REITs) stood at $438 billion at December 31, 2006.

**1990 - $1.1 Trillion**

- Commercial Banks 36%
- CMBS Issuers & Federally related Mortgage Pools 4%
- Life Insurance Cos. 22%
- Savings Institutions 18%
- Government Sponsored Enterprise Portfolios 1%
- Others 19%

**2006 - $2.95 Trillion**

- CMBS Issuers & Federally related Mortgage Pools 26%
- Commercial Banks 44%
- Life Insurance Cos. 9%
- Savings Institutions 7%
- Government Sponsored Enterprise Portfolios 3%
- Others 11%

**Source:** Federal Reserve Board, Flow of Funds

Growth of CMBS Market

Through continued innovation, strong performance and acceptance by real estate borrowers and securities investors, the CMBS market has grown from $41.6 billion in CMBS outstanding in 1990, representing 3.8 percent of commercial and multifamily mortgage debt outstanding, to $804 billion currently, representing 27 percent of mortgages outstanding. CMBS has become a part of balanced fixed income investment portfolios, along with corporate and municipal debt and mortgage and other asset-backed securities.

Further, CMBS is accepted as an important sector within the global bonds markets as demonstrated by its inclusion in two of the important bond indices. CMBS was added to the Lehman U.S. Aggregate Index in January 1999 and, in 2004, the Merrill Lynch index. Growth in U.S. CMBS issuance continues to be robust climbing 81 percent in 2005 to $168.7 billion and 20.1 percent in 2006 to a $202.7 billion. Through the end of the second quarter of 2007, U.S. CMBS issuance stands at $137.0 billion, 54.2 percent ahead of last year’s record breaking pace.
The emergence of CMBS as a capital source for commercial mortgage lending has brought liquidity to commercial real estate that did not exist prior to 1990. Investors, which could not previously invest in individual unrated whole loans, can now invest in CMBS. Part of the benefit of CMBS is the added liquidity it offers relative to individual whole loans, allowing a wider range of investors to make commercial mortgage investments. CMBS is the vehicle which connects the public global fixed income market with the real estate capital markets.

**CMBS Offers Liquidity to the Market**

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**Investors in CMBS in 2006**

(as of May 1)

Source: Morgan Stanley
Summary

The CMBS process from beginning to end is made possible by a number of market participants and financial services companies that are represented by CMSA. They include lenders who make initial loans, investment banks that package them into bonds, trustees that hold the loans that serve as the collateral for those bonds, the rating agencies that rate the bonds, investors who purchase the bonds, and the loan servicers who service the loans on behalf of investors.

The CMBS market, now the second largest source of capital for commercial and multifamily real estate lending, provides a liquid, viable and transparent funding method for real estate borrowers and a wide array of global fixed income investors. It has helped fuel the growth and stability of the commercial real estate market by providing competitively priced loans for borrowers, while providing investors with low-risk investment opportunities at attractive yields.