



Glossary of Terms

Commercial Mortgage-Backed Securities (CMBS)

Commercial Mortgage Securities Association (CMSA)

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Sally Gordon
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Glossary of Terms

Commercial Mortgage-Backed Securities (CMBS)

Note: All words in **bold type** within a definition are themselves defined elsewhere.

“A” Pieces: Security classes, or **tranches**, that are rated as **investment grade**, therefore appropriate for regulated institutional investors (i.e., triple-A, double-A, single-A, and triple-B). Also called **senior pieces**.

ACLI: see **American Council of Life Insurers**.

ACES: see **Alternative Credit Enhancement Structure**.

Accrual Rate: The periodic rate at which interest is *charged or due* on a mortgage. This may differ from the **pay rate**.

Accrued Interest: Interest which is charged or due on a loan but has not yet been paid. Frequently the accrued interest is added to the principal balance and commonly must be paid before any principal reductions are allowed.

ADA: see **Americans with Disabilities Act, 1990**.

Additional Bonds Test: A test or screening mechanism to assess the amount of new bonds that can be issued by a firm or entity. Since bonds are secured by assets or revenues of a corporate or governmental entity, the underwriters of the bond must insure that the bond issuer can meet the debt service requirements of any additional bonds. The test usually is based on the issuer meeting specific financial benchmarks, such as what portion of the issuer’s revenues or cash flow can be devoted to paying interest.

Adjustable Rate Mortgage (ARM): A mortgage loan for which the interest rate adjusts on specific dates (e.g., monthly, every six months, annually). The rate is stated as a margin over a published index such as the 10-Year Treasury or the 11th District Cost of Funds Index (COFI).

Administration Rate: The annual rate of the servicing fee and trustee fee, expressed as a percentage of the outstanding principal balance of each loan.

Advances: Payments made by the **servicer** on behalf of delinquent loans (**special servicer**) or performing loans (**master servicer**) so that payments on the certificates can be paid as scheduled. Advances can be required not only for principal and interest but also for property protection, taxes, insurance and foreclosure costs. The servicer has a proxy claim to subsequent collections and foreclosure proceeds as reimbursement for advances up to an amount that was stipulated as “recoverable.” Servicers do not have to advance fees that are deemed “non-recoverable” by the **trustee** or an officer of the servicers; also see **nonrecoverable advance**. Servicers are usually paid prime plus one per cent for their advances.

Agency Securities: Securities issued by government or quasi-government agencies such as the **Fannie Mae (Federal National Mortgage Association)**, **Freddie Mae (Federal Home Loan Mortgage Corporation)**, or **Ginnie Mae (Government National Mortgage Association)**. Agency securities are not rated by rating agencies but nonetheless have an implied triple-A rating.

Aggregation Risk: The risk assumed while mortgages are being warehoused during the process of pooling them for ultimate securitization. The mortgage holder faces the risk that the value of the mortgages will decline before the securitization can be executed due to factors such as adverse interest rate movements or credit losses.

All-In Cost: The term applied to the total costs of a securitization. Usually quoted in basis points to reflect what would have been added to the yield if the expenses had not been applied to the creation of a security.

Allocated Loan Amount: The portion of the principal amount of a **blanket mortgage** associated with each individual property. This term is applicable when several properties are financed under one blanket mortgage with each property allocated its share of the total mortgage balance.

Allocation of Realized Losses: A CMBS provision that defines how realized losses will be allocated to each class of certificate holders.

American Council of Life Insurers (ACLI): A trade association for life insurance companies based in Washington, DC. They collect data from a number of participating life companies on commercial real estate portfolios, including data on mortgage delinquencies, and disseminate those data. The data on delinquencies represent approximately 85% of all mortgages held by life insurance companies.

Americans with Disabilities Act (ADA), 1990: This Act requires that public buildings be devoid of architectural and communications barriers for the disabled.

Amortization: Continuous repayment schedule of loan principal over a period of time until the debt is paid off.

Appraisal Reduction: Following certain events based on loan delinquency, an appraisal will be performed to determine if the property value justifies any further advances by the **master servicer**. If the value is reduced below the loan balance plus authorized advances, the master servicer will stop or reduce principal and interest payments on that loan to the **Trustee**. The Trustee will then reduce principal and interest payments to the certificate holders in order of their priority, beginning with the first-loss security.

ARM: see **Adjustable Rate Mortgage**.

Asking Rent: Rental rate offered by the landlord to a prospective tenant. The rent paid can be less than the asking rent after tenants negotiate for an actual rental rate and **concessions**.

Available Funds: All funds available or collected from borrowers, including regular payments of principal and interest, prepayments or servicer advances.

Available Funds Cap: A limit on the amount of interest payable to certificate holders, to the extent of interest accrued on a group or pool of mortgage loans.

Average Life: The time until all scheduled principal payments and unscheduled principal payments (i.e., prepayments) are expected to have been made. The average life of a CMBS is typically compared to the comparable Treasury (often an **interpolated Treasury**) to determine the expected yield on the CMBS.

“B” Pieces: A term applied to the classes or **tranches** of CMBS rated double-B and lower. Also called “B.I.G.,” or below-investment grade.

Balloon Mortgage: A mortgage requiring monthly payments of principal and interest in which the period over which the loan is amortized is greater than the term of the mortgage. Principal and interest payments are made until maturity of the mortgage, at which time full payment of the remaining principal, the balloon payment, is due. For example, a seven-year balloon mortgage, with scheduled payments to amortize the loan in 30 years, will see part (but not all) of the principal paid down through year seven, at maturity.

Balloon Risk: The risk that a borrower is unable to make a balloon or lump-sum payment at maturity. Also see **Refinance Risk**.

Bank Insurance Fund (BIF): A fund administered by the **FDIC** which insures deposits of BIF member institutions, thereby protecting depositors from losses in the event of bank failure. The BIF is funded by premiums paid by member institutions, primarily commercial banks, and was established by **FIRREA** in 1989 along with the **Savings Association Insurance Fund (SAIF)**. While the FDIC is not a government agency backed by the full faith and credit of the U.S. Treasury, depositors and financial markets treat the BIF as if it had an implicit guarantee.

Bankruptcy Remote Entity (BRE): A legal entity devised to hold identifiable assets (e.g., mortgages) and/or individual borrowers in such a way as to insulate them from the effects of bankruptcy in a larger pool of assets. For example, a developer might segregate selected mortgages in a BRE that are destined for a CMBS; if other of the developer's mortgages were to default, the cash flow from the segregated assets would then not be interrupted or seized by a bankruptcy court, hence assuring a continuous cash flow to bondholders of a CMBS. Also see **Special Purpose Entity**.

Basis Risk: The risk that the cash flow from the underlying mortgage loans does not mirror the required payouts to bondholders because the offered certificates are tied to different indices than are the mortgages (e.g., mortgages are at fixed rates but bonds are at floating rates). This raises the possibility of the certificates accruing interest at higher interest rates than the underlying mortgage loans. Also see **Basis Risk Shortfall**.

Basis Risk Shortfall: When the aggregate amount of interest on the certificates is greater than on the collateral, the difference is known as the basis risk shortfall. Also see **Basis Risk**.

Below Investment Grade: see “**B**” Pieces.

BIF: see **Bank Insurance Fund**.

Blanket Mortgage: A single mortgage collateralized by more than one property with the same owner. Also see **Cross-Collateralization** and **Cross-Default**.

Bondable Lease: A lease in which a credit tenant assumes nearly all of the obligations of ownership, therefore making the lease payments net of any offsets or deductions to the lessor or owner. With a credit tenant, the lease becomes an obligation of the corporation, thus offering greater assurance of payment.

Bottom-Up Approach to Investing: An investment strategy which begins by searching for outstanding performance among individual securities or tranches of securities before considering the impact of macro-level economic trends. This approach assumes that an investment in an individual CMBS will perform well, even if the industry does not perform well. Also see **Top-Down Approach to Investing**.

Bucket: A grouping of loans by a single, shared attribute. For example, an issuer might speak of loans satisfying a term bucket (meaning that all the loans have the same or nearly the same average life).

Bullet Mortgage: A mortgage that requires monthly payments of interest only until the final mortgage payment, or bullet payment, when full payment of principal is due.

Call Protection: Protection against early prepayment of mortgages. If mortgages prepay early, then the bonds collateralized by those mortgages would be called or paid down, thereby affecting the total yield on the original bonds. Also see **Prepayment Penalty**.

Capital Markets: Markets in which capital funds, both debt and equity, are traded. Included are private placement sources of debt and equity as well as organized markets and exchanges. Also see **Primary Market**.

Capitalization Rate (Cap Rate): Defined as the net operating income (I) for the year divided by the appraised value of the property (V) [$I/V = R$]. It is used as a measure and/or benchmark for a property's value based on current performance. Cap rates also serve as an indicator of investor expectations. See also **Going-In Cap Rate** and **Reversionary Cap Rate**.

Cash Flow: Cash flow is examined at the level of both the security and the individual property. At the security level, the certificate holders of CMBS receive *all principal and interest cash flow* from a pool of mortgages in a sequential, defined manner. Early prepayments or extended maturities change those cash flows and therefore can have a material effect on how and when some certificate holders receive their sequential payments, hence affect the total yield on the bonds. The cash flow on a CMBS is thus unlike that in the direct commercial mortgage market, wherein the cash flow contract is divided between receipt of principal payments and interest payments. In assembling the assets in a CMBS, the cash flow of an *individual property* is carefully scrutinized to calculate the ability of the property to generate sufficient revenue to service the debt that is in effect the collateral for the security.

Cash Flow Investment: Any investment of funds received under qualified mortgages for a temporary period before distribution to holders of an interest in the REMIC. Amounts invested typically are placed temporarily in passive assets, i.e., investments limited to producing passive income characterized as interest-payable at the next regularly scheduled payment date.

Cash Flow Note: An indebtedness which is repaid on a periodic basis directly by all or a portion of the cash flow derived by the collateralized real property and not specifically based on an interest rate.

Cash-on-Cash Return: The short-term return on an investment in a property defined as the cash flow received divided by the cash equity invested in a property; expressed as a percentage. Also called an **Equity Yield Rate (EYR)**.

Casualty: A property damaged or destroyed by an unexpected or unusual event.

CERCLA: see **Comprehensive Environmental Response, Compensation Liability Act, 1980**.

Certificate: An actual certificate that defines the beneficial ownership in a trust fund.

Certificate Holder: The owner of record that actually owns a certificate (security).

Circle: The underwriter's way of designating potential purchasers and the amounts that they might purchase of a securities issue during the registration period, before actual selling is permitted. Registered representatives canvas prospective buyers and report any interest to the underwriters, who then "circle" the names on their list and the possible amounts of the purchases.

Closed-End Mortgage: A mortgage bond issued with an indenture that prohibits repayment before maturity and the repledging of the same collateral without the permission of the bondholders. Also called a *closed mortgage*. It is distinguished from an open-end mortgage which is reduced by amortization and can be increased to its original amount and secured by the original mortgage.

CMBS: see **Commercial Mortgage Backed Security**.

CMSA: Commercial Mortgage Securitization Association, a CMBS trade association.

Collar: In a new issue underwriting, the lowest rate acceptable to a buyer of bonds or the lowest price acceptable to the issuer. Also refers to the index level at which a circuit breaker is triggered.

Collection Account: An account established by the **master servicer** in the name of the **trustee** for the benefit of the **certificate holders**. Usually all payments and collections received on the mortgages and from advances made by the **servicers** are deposited into this account.

Comfort Letter: 1. An independent auditor's letter, required in securities underwriting agreements, to assure that information in the registration statement and prospectus is correctly prepared and that no material changes have occurred since its preparation. It is sometimes called a *cold comfort letter* — cold because the accountants do not state positively that the information is correct, only that nothing has come to their attention to indicate that it is not correct.

2. Letter from one to another of the parties to a legal agreement stating that certain actions not clearly covered in the agreement will or will not be taken. Such declarations of intent usually deal with matters that are of importance only to the specific parties and do not concern other signers of the agreement.

Commercial Mortgage Backed Security (CMBS): Securities collateralized by a pool of mortgages on commercial real estate in which all principal and interest from the mortgages flow to **certificate holders** in a defined sequence or manner.

Commercial Property: An income-producing property, e.g., multifamily housing, retail, office, warehouse, industrial or hotel.

Commission: As in “the commission.” Shorthand for the **Securities and Exchange Commission (SEC)**.

Comprehensive Environmental Response, Compensation Liability Act (CERCLA), 1980: Legislation that outlines environmental problems and potential legal liabilities attendant to environmental contamination, e.g., asbestos, RCB, radon, or leaking underground storage tanks (LUSTS). The act establishes potential lender liability for environmental clean-up on a mortgaged property. Also see **Phase I**.

Concessions: A relief or reduction in total payments for a period of time, used as an incentive to attract or retain tenants in lease agreements. Concessions can include reduced or free rent for a portion of the lease period and/or above-market tenant improvement and work letters. The use of concessions in leasing is a response to current market conditions, but the existence of concessions in a building's leases makes it more difficult to calculate net cash flow and, therefore, debt service coverage ratios.

Conduit: The financial intermediary that functions as a link, or conduit, between the lender(s) originating loans and the ultimate investor(s). The conduit makes loans or purchases loans from third party correspondents under standardized terms, underwriting and documents and then, when sufficient volume has been accumulated, pools the loans for sale to investors in the CMBS market. Also see **Real Estate Mortgage Investment Conduit (REMIC)**.

Constant Prepayment Rate (CPR): A percentage of the outstanding collateral principal that is expected to prepay in one year. A CPR represents an assumed *constant* rate of prepayment each month (expressed as an annual rate), rather than a variable rate of prepayment. Also see **PSA Standard Prepayment Model**.

Contributions Tax: A tax imposed on a REMIC triggered by certain contributions of properties made to a REMIC after the day on which the REMIC issues all of its interests. Each **pooling and servicing agreement** will include provisions designed to prevent the acceptance of any contributions that would be subject to such a tax.

Controlling Party: A party designated in a CMBS that has the right to approve and direct certain actions of the **special servicer** with respect to specially serviced loans.

Convexity: A measurement of the rate of change of **duration** of a security. Convexity implies that prices rise at an increasing rate as yields fall, and prices decline at a decreasing rate as yields rise.

Corporate Guaranty: A guaranty made by the issuer (issuer guaranty) or a third party to cover losses due to delinquencies and foreclosures up to the guaranteed amount. The rating of the guarantor is commonly required to be, at a minimum, equal to the highest rating of the securities. A form of **credit enhancement**.

Corrected Mortgage Loan: A mortgage loan that had previously incurred a default or related event; been transferred to the **special servicer** for handling, becoming a specially serviced mortgage loan; had cured the default by any of a number of avenues available to special servicer; finally becoming a corrected mortgage loan and being returned to the **master servicer** for routine administration. Also known as a Reperforming Loan.

CPR: see **Constant Prepayment Rate**.

Credit Enhancement: Provisions in addition to the mortgage collateral to support a desired credit rating on mortgage backed securities. Provisions made by issuers to compensate for default risk in CMBS include **subordination, reserve accounts, cross-collateralization, cross-default provisions, and advance payment agreements**.

Credit Facility Loan: A mortgage loan entered into for the purpose of providing the borrower flexibility with respect to adding, releasing or substituting collateral. These loans generally have lower LTV and higher DSCR requirements.

Credit Lease: A lease signed by a lessee with an investment grade credit rating, which presumably increases the assurance of timely rental payments for the duration of the lease.

Cross-Collateralization: A provision in a mortgage or deed of trust by which the collateral for one mortgage also serves as collateral for other mortgage(s). Thus, should the collateral on the one mortgage fall short in repayment of the debt, the collateral of the other mortgage(s) could be claimed as well (but only in the event of such a shortfall). CMBS backed by cross-collateralized properties have reduced delinquency risk; cross-collateralization therefore adds value to the structure. A set of properties with the same owner might be *both* **cross-defaulted** and cross-collateralized. A form of **credit enhancement**.

Cross-Default: A provision in a mortgage or deed of trust by which a breach of terms or default under the loan documents of one loan will automatically trigger a default under other mortgage(s). A set of properties with the same owner might be *both* cross-defaulted and **cross-collateralized**. A form of **credit enhancement**.

Cured: A delinquent mortgage is said to be cured when all missed payments have been made and loan payments are current. The label also applies to a property that suffered from some environmental problem or contamination that has been redressed.

Cut-Off Date: The date on which the portfolio securing the CMBS is firmly identified, and the numbers from that pool are used for the final calculations before issuing the securities.

Dark Space: Vacated retail space for which the tenant is still paying rent despite having vacated the space. “Induced” smaller tenants might exercise their right to cancel leases when a major tenant “goes dark” or no longer occupies the space.

Debt Service: The scheduled payments due on a loan. Payments include principal, interest and other fees that are required by the loan agreement.

Debt Service Coverage Ratio (DSCR): A measure of a mortgaged property’s ability to cover monthly debt service payments, defined as the ratio of **net operating income** or **net operating cash flow** to the debt service payments. A DSCR less than 1.0 means that there is insufficient cash flow by the property to cover debt payments.

Default: A loan that has violated any terms and conditions of the mortgage.

Defeasance: The act of making an investment whole. The supplementing of existing investment terms available (typically through a cash payment) to make the currently available market yield equivalent to that of a pre-existing investment that is being terminated. Most commonly used in bond finance. Synonymous with **yield maintenance**. A common **prepayment** option.

Deferred Interest: The amount by which the interest a borrower is required to pay on a mortgage loan is less than the amount of interest accrued on the outstanding principal balance. This amount is usually added to the outstanding principal balance of the mortgage loan.

Deferred Maintenance Account: A reserve account established by a borrower to cover repairs or future property maintenance costs. Also called a *replacement reserve account*.

Delinquency: A loan payment that is at least 30 days past due. Usually when the loan is more than 90 days delinquent, the lender has the right to begin foreclosure proceedings.

Delivery Date: The date on which the securities will be delivered to the purchasers, or to the **Trustee** if the Trustee is the custodian for the Depository Trust Company (DTC). The DTC handles the security certificates for purchasers by acting as custodian of the certificates and issuing a form showing the “book entry” for safekeeping to the certificate holder.

Demand Notes: Notes or loans that are short-term and might include a provision that repayment can be “demanded,” or the note called, at the discretion of the lender. Demand notes often require all cash flow, net of debt service, to be used to amortize a mortgage loan if the borrower fails to show progress towards refinancing (e.g., an appraisal, engineering report, or environmental study) or is unable to obtain a signed commitment or sales contract on the underlying property.

Demand Notes (Fast Pay): If the balloon payment of a **balloon mortgage** is not met, the borrower is required to apply all excess cash flows generated by the property to pay down the remaining loan balance to accelerate amortization.

Depositor: The entity that accumulates the mortgages and transfers them to the Trust simultaneously with the issuance of the securities to the certificate holders. The depositor can be the seller of a portfolio of mortgages or an entity established just for the purpose of holding the mortgages until the pool accumulation is completed.

Derived Investment Value (DIV): A valuation procedure created for the RTC to price existing commercial mortgages. DIV is based on expected cash flows and a discounted cash flow model to generate an estimate of the price to be paid by an investor for an existing mortgage. Typically used for RTC and bulk sales of non- or sub-performing loans. Expected cash flows can include foreclosure costs and proceeds.

Determination Date: The date of the month (usually the 15th or the next business day) that is used as a cut-off date for calculation of the payments due on the securities.

Discount Margin (DM): The difference between the price of a security and the face amount of the security.

Discount Rate: The rate applied to each year's cash flow from a property to determine the net present value (NPV) of a series of cash flows. Based on the periodic weighted average cost of capital or the required return for a real estate investment.

Disposition Fee: "Workout fees" paid to a special servicer for making a loan current or liquidating a problem loan or foreclosed property. Can also include late fees, modification fees and loan administration charges. These fees are negotiated with each CMBS.

Distribution Date: The date of the month (usually the 20th or the next business day) the payments on the securities will be paid to the certificate holders.

DIV: see **Derived Investment Value**.

DM: see **Discount Margin**.

Double-Net Lease: see **NN Lease**.

DSCR: see **Debt Service Coverage Ratio**.

Due Diligence: Legally, due diligence is a measure of prudence, activity or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances. The degree of prudence is not measured by any absolute standard but depends on the relative facts of the special case. Prevailing industry standards are used as the primary benchmark from which prudence is judged.

In CMBS, due diligence is the foundation of the process because of the reliance securities investors must place on the specific expertise of the professionals involved in the transaction. It is physically and financially impossible for most CMBS investors to inspect properties or evaluate financial records, or to perform the many duties required to prepare, analyze, deliver and service commercial mortgages. Due diligence protects these investors from unethical improprieties and unprofessional practices. Due diligence is said to be the cornerstone of securities law. Also see **Up-Front Due Diligence**.

Duration: An indication of the percentage change in the price of a security relative to a change in interest rates. It provides a measure of the price volatility of the security; the greater the duration, the greater the price volatility relative to a change in interest rates. Positive duration means that the price of a security moves in the opposite direction of a change in interest rates; conversely, negative duration means that the price moves in the *same* direction as a change in interest rates. Duration is the weighted average term-to-maturity of the security's cash flows when the weights are the present values of each cash flow as a percentage of the present value of all cash flows of the security.

Earn-Out Loans: A loan agreement which provides that the original principal balance may be resized by an additional advance as the operating performance of the property is able to service additional debt. Earn-out loans are made on properties of which performance is expected to improve in the near term due to such factors as renovations, retenanting or repositioning. Earn-out loans specify certain resizing criteria such as minimum **debt service coverage ratios (DSCRs)** and, in some cases, minimum **loan to value ratios (LTVs)**. Also see **Reverse Earn-Out Loans**.

Economic Recovery Tax Act (ERTA), 1981: Tax reform which created tax incentives for construction of commercial real estate. The practical effect was to fuel excess building, particularly of multifamily properties, which were only economically viable in that tax-advantaged environment. Also see **Tax Reform Act, 1986**.

Employee Retirement Income Security Act of 1974 (ERISA): Legislation which stipulates the standards of risk that are appropriate and acceptable for private pension plan investments. A fiduciary of an employee benefit plan, i.e., a pension fund subject to ERISA, may invest in CMBS only if the certificates meet specified investment guidelines.

Environmental Risk: Lender liability and/or risk of loss of collateral value due to the presence of hazardous materials, such as asbestos, RCB, radon, or leaking underground storage tanks (LUSTS) on a property. Properties in a CMBS are required to have at least a **Phase I** environmental clearance. Even when properties show no current environmental problems, however, rating agencies sometimes in effect "price in" the possibility that properties are at risk of not meeting future environmental standards. Also see **Comprehensive Environmental Response, Compensation Liability Act (CERCLA); Phase I**.

Equity Kicker: A loan or investment provision that allows the lender/investor to receive an equity-based return in addition to normal rates upon some event. Typically this involves a lender/investor receiving a disproportionate percentage share of the proceeds of refinancing or sale.

Equity Yield Rate: see **Cash-on-Cash Return**.

ERISA: see **Employee Retirement Income Security Act of 1974**.

ERTA: see **Economic Recovery Tax Act**, 1981.

Escrow Account: A deposit jointly held by a borrower and a lender which provides reserved funds for key operating or capital expenses. Typical escrow accounts are held for real estate taxes, insurance, tenant improvement, leasing commissions, necessary structural repairs or environmental remediation, or reserves for replacement. Also called an **Impound Account**.

Excess Interest/Excess Spread: Interest received from repayments that is greater than the interest on the certificates. It is defined as the difference between the interest paid on the mortgage loans (net of servicing fees) and the interest accrued on the certificates.

Expense Ratio: The ratio between operating expenses and operating revenues.

Expense Stops: Lease clauses that stipulate the maximum amount of a landlord's or owner's obligation for expenses; expenses greater than the stipulated amount (i.e., the "stop") are paid by tenants, pro-rated by the amount of space occupied by each tenant.

Extension/Extension Option: A period of time given to a borrower to repay a mortgage loan through refinancing or sale of the property past the contractual termination of the mortgage or an automatic provision permitting extension of the original term of the mortgage. In order to prevent placing a property in foreclosure, thereby incurring additional costs, servicers may grant an extension to a borrower who has a balloon payment due.

Extension Advisor: A third party who has the right, or obligation, to approve loan extensions and modifications recommended by the **master servicer** or **special servicer**. Not all CMBS have third party extension advisors.

Extension Risk: Potential inability to refinance **balloon mortgages** in a timely manner, thereby requiring that the life of the security be extended beyond the expected life.

Face Rent: Rental rate before any adjustments for lease concessions (if any).

Fannie Mae, (Federal National Mortgage Association - FNMA): A **government sponsored enterprise (GSE)** or a “corporate instrumentality” of the government. Fannie Mae is a quasi-private corporation, with stock that trades. It does not receive a government subsidy or appropriation and is taxed like any other corporation. Fannie Mae purchases and pools conventional mortgages, i.e., those not insured by the **Federal Housing Administration (FHA)**, the Veteran’s Administration (VA), or the Farmer’s Home Administration (FmHA), but also buys mortgages from FHA, and then issues securities using the pool of mortgages as collateral. Fannie Mae was the first agency to pool mortgages backed by adjustable-rate mortgages and created the first pass-through collateralized by multifamily mortgages through a swap program. Holders of Fannie Mae certificates are guaranteed *full and timely* payment of principal and interest.

FASB: see **Financial Accounting Standards Board.**

FASIT: see **Financial Asset Securitization Investment Trust.**

FDIC: see **Federal Deposit Insurance Corp.**

Financial Accounting Standards Board (FASB): An industry group that establishes the prevailing standards for the accounting treatment of assets and liabilities.

Federal Deposit Insurance Corp. (FDIC): The FDIC oversees the insurance fund for both commercial banks (the **BIF**) and saving institutions (the **SAIF**) and assures the viability and liquidity of retail financial institutions. The FDIC is also the principal regulator for some banks, while the Comptroller of the Currency is the regulator for other banks.

Federal Financial Institutions Examination Council (FFIEC): An interagency body of regulatory agencies that establishes standards and reporting requirements to which depository institutions are subject. The FFIEC includes five regulatory agencies: the Comptroller of the Currency, the chairman of the **FDIC**, a member of the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the Chairman of the National Credit Union Administration.

Federal Housing Administration (FHA): A division of the Department of Housing and Urban Development (HUD) that insures residential mortgages.

FFIEC: see **Federal Financial Institutions Examination Council.**

FHA: see **Federal Housing Administration.**

Financial Asset Securitization Investment Trust (FASIT): A REMIC-like tax structure intended to permit the securitization of a wide variety of asset classes, including mortgages. This new vehicle expands and improves upon the existing REMIC rules. With respect to CMBS, it permits the replacement of pre-paid loans after initial sale of the security, permits the inclusion of hedging investments and permits the pooling of mixed asset types. The legislation was passed in 1996 as part of the “Small Business Job Protection Act of 1996” (HR 3448).

Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), 1989: Legislation which created the **Resolution Trust Corporation (RTC)** to restructure the losses experienced by failed financial institutions. Also created the **Bank Insurance Fund (BIF)** and **Savings Association Insurance Fund (SAIF)** under the administration of the FDIC. FIRREA required thrifts to meet risk-based capital requirements, in which “risk” was equated with credit risk. Title XI of FIRREA sets forth appraisal guidelines which are frequently followed in the appraisal of commercial real estate assets for CMBS.

FIRREA: see **Financial Institutions Reform, Recovery and Enforcement Act.**

First Loss Piece: The lowest class or tranche of a CMBS which will absorb credit losses from a pool of mortgages first before any other classes are affected.

Foreclosure: The process by which a lender takes back title to a property on which the mortgagee has **defaulted**. A **servicer** may take over a property from a borrower on behalf of a lender. A property usually goes into the process of foreclosure if payments are more than 90 days past due.

Freddie Mac (Federal Home Loan Mortgage Corporation - FHLMC): A **government sponsored enterprise (GSE)** or a “corporate instrumentality” of the government. Freddie Mac is a quasi-private corporation, with stock held by Federal Home Loan Banks, under the regulatory control of the Department of Housing and Urban Development (HUD). Under the direction of the Federal Home Loan Bank Board (FHLB), Freddie Mac is charged to buy mortgages from S&Ls to enhance their role in and provide liquidity to the secondary market for single family mortgages (i.e., mortgages not backed by a government agency) and then issues securities using the pool of mortgages as collateral. It also issues participation certificates (PCs), most of which are backed by pools of conventional mortgages, but some pools are comprised of mortgages that are insured by the **Federal Housing Administration (FHA)** and/or guaranteed by the Veterans Administration (VA). Holders of Freddie Mac PCs are assured *timely* payment of interest and *eventual* payment of principal.

Full Service Lease: see **Gross Full Service Lease.**

Fusion Deal: The combination within one CMBS of conduits loans, small loans and large loans that previously would have been disaggregated into separate securities.

Ginnie Mae (Government National Mortgage Association - GNMA):

A government-related agency that is part of the Department of Housing and Urban Development (HUD) and uses the “full faith and credit” of the U.S. government in borrowing. GNMA guarantees securities collateralized by mortgages initially issued by approved lenders (thrifts, commercial banks, and mortgage banks) that pooled the mortgages, using the mortgages for collateral for the security. In so doing, GNMA supports the **Federal Housing Administration (FHA)** mortgage market as well as mortgages from the Veterans Administration (VA) and the Farmers Home Administration (FmHA). GNMA guarantees pass-throughs, but does not issue them, and will only guarantee a pool in which the underlying mortgages are insured or guaranteed by either the FHA, VA, or FmHA.

GLA: see **Gross Leasable Area.**

Going-In Cap Rate: The capitalization rate applied to the first year’s income. Also see **capitalization rate** and **reversionary cap rate.**

Government Sponsored Enterprise (GSE): One of several agencies formed to provide a secondary market for residential real estate loans, including **Fannie Mae (Federal National Mortgage Association - FNMA)**; **Freddie Mac (Federal Home Loan Mortgage Corporation – FHLMC)**; and **Ginnie Mae (Government National Mortgage Association - GNMA).**

GPM: see **Graduated Payment Mortgage.**

Graduated Payment Mortgage (GPM): An indebtedness whereby the individual payments on the loan are graduated based on a pre-defined schedule. This may include an interest rate or principal payments which change at fixed increments over the life of a loan.

Gross Full Service Lease: Lease structure under which the landlord pays all building expenses. Also called a *full service lease* or a *gross rent lease.*

Ground Lease: A lease on undeveloped land or a lease covering the land but not improvements or buildings on that land, i.e., the land and buildings are separately owned. Also called a leasehold.

GSE: see **Government Sponsored Enterprise.**

Haircut: A casual expression for reducing the estimated income or cash flow expected to emerge from a property. For example, one might speak of a rating agency giving a “haircut” to a property or portfolio in lowering the expected cash flow on which the debt service coverage ratio is calculated.

Hurdle Rate: A break-even debt service calculation that establishes the maximum interest rate a mortgaged property can handle at maturity if the property must be refinanced. It is calculated using current net operating income and an interest-only mortgage with a reasonably short maturity of less than five years. The hurdle rate is usually calculated to answer the question, Can all loans refinance at maturity if interest rates are at a “disaster level?” Also called *break even debt service analysis*.

HVAC: Heating, ventilation, and air conditioning. The capacity of HVAC systems becomes an issue in office property because modern, competitive space requires significant HVAC capability to accommodate intense computer utilization.

Hyper-Amortization: The accelerated paydown of a class in a CMBS or of an individual property loan achieved by allocating the scheduled principal and interest to that class.

Impound Account: A deposit jointly held by a borrower and a lender which provides reserved funds for key operating or capital expenses. Typical escrow accounts are held for real estate taxes, insurance, tenant improvement, leasing commissions, necessary structural repairs or environmental remediation, or reserves for replacement. Also called an **Escrow Account**.

Independent Director: A non-affiliated individual of the board of directors of a (borrowing) entity. The vote of the independent director is required for certain actions by the entity, e.g., declaration of bankruptcy, thus insulating the entity from deleterious control by affiliated principals. This is often a key component of **special purpose entity (SPE)** and **bankruptcy remote** structures.

Industrial Property: Property used for light or heavy manufacturing, research and development (R&D) or warehouse space. Also includes office/warehouse space and flex space.

Institutional Property: A property used by special institutions, such as a university, hospital, or a government agency. Institutional properties may be similar to other property types, but since they are designed for a specific purpose, they can be difficult to adapt for other uses.

Interest Only Strip (I/O): When the interest rate on the underlying mortgages(s) exceeds the interest rate or coupon paid on the security backed by the mortgage(s), the excess interest is “stripped” and sold as a separate payment stream, an interest-only (I/O) strip. The strip is usually described in the **(notional) amount** of the original security class(es) from which it was stripped and then sold for a small fraction of the price of the whole security or similarly rated class(es). I/Os can be very volatile securities. For example, if several loans prepay earlier than expected, then there may not be an interest stream from which to pay the interest on the strip, so the I/O could end up with a much shorter life than originally expected.

Interest Paid vs. Interest Impacted: An important clause in the CMBS structure that determines how and when losses are allocated, e.g., are losses allocated before principal is paid or after principal is paid. This clause impacts the yield of the lowest class of certificate holders most profoundly.

Interest Rate Cap: Limits the interest rate or the interest rate adjustment to a specified maximum on either a periodic or lifetime basis. This protects the borrower from rising interest rates and is typically purchased by the borrower.

Interest Shortfall: The aggregate amount of interest payments from borrowers that is less than the accrued interest on the certificates.

Interpolated Treasury: A “hypothetical” Treasury rate based on the relative rates of two other Treasuries. For example, if a 4-year CMBS **tranche** (or any other bond) is priced to yield a rate benchmarked to Treasuries, the price will be set at approximately the midpoint between the 3-year and 5-year Treasury rates since there *is* no 4-year Treasury.

Investment Grade: Investments that are rated triple-A, double-A, single-A and triple-B are investment grade, therefore appropriate for regulated institutional investors. Also see “**A**” pieces and **Senior Pieces**.

Investor Reporting Package: The CMSA Investor Reporting Package is the established reporting standards for the CMBS industry. The IRP is a standardized set of bond, loan and property level information provided for all CMBS securitizations.

Involuntary Payment: Prepayment on a mortgage loan due to a default.

I/O: see **Interest Only Strip**.

Issuer Guarantee: see **Corporate Guarantee**.

LC: Life insurance company, often shortened to life company. “LC” is also a common shorthand for **Letter of Credit**.

Lead Manager: The investment bank charged with the principal responsibility for coordinating the issuance of a new security. This firm also typically has the largest role in the underwriting of the security, and their name appears in the most prominent position on the tombstone advertisement announcing the issuance of the security.

Lease Assignment: An agreement between a commercial property owner and a lender that assigns lease payments directly to the lender. Otherwise, lease payments would go to the owner, who would then forward mortgage payments to the lender. In a CMBS, lease payments would go directly to the servicer under a lease assignment. A form of **credit enhancement**.

Leasehold Improvements: The cost of improvements for a leased property, often paid by the tenant.

Letter of Credit (LOC or LC): An obligation by a third party to cover losses due to delinquencies and foreclosure. The rating of the third party is commonly required to be, at a minimum, equal to the highest rating of the securities. A form of **credit enhancement**.

LIBOR: see **London Interbank Offered Rate**.

LIHTC: see **Low Income Housing Tax Credit**.

Liquidation: The sale of a **defaulted** mortgage loan or of the **REO** property that previously secured the loan.

Liquidation Fee: That portion of the **special servicer's** compensation that is payable when the special servicer obtains a full or discounted payoff on any specially serviced loan or obtains any liquidation proceeds on any specially serviced loan or REO property. The fee is calculated by applying the liquidation fee rate as stipulated in the **pooling and servicing agreement** with regard to the related payment or proceeds.

Liquidity: A measure of the ease and frequency with which assets, e.g., CMBS, are actively traded in the secondary market. Large-size CMBS issues with similarities in collateral and structure are often traded more readily in the secondary market, thus increasing the degree of liquidity of CMBS issues.

LOC: see **Letter of Credit**.

Loan-to-Value Ratio (LTV): Briefly, the ratio of the loan amount to the appraised value of the property. More specifically, LTV is the ratio between the principal amount of the mortgage balance, at origination or thereafter, and the current value of the underlying real estate collateral. The ratio is commonly expressed to a potential borrower as the percentage of value a lending institution is willing to finance. The ratio is not fixed and varies by lending institution, property type, geographic location, property size and other potential variables.

Lock-Box Provision: A provision wherein the trustee is given control over the gross revenues of the underlying properties in a CMBS. Property owners only have a claim to cash flows net of expenses. Expenses include debt service, taxes, insurance and other operating expenses.

Lock-Out Period: A period of time after the loan origination during which a borrower cannot prepay the mortgage loan.

London Interbank Offered Rate (LIBOR): The short-term (1-year or less) rate at which banks will lend to each other in London. Commonly used as a benchmark for adjustable rate financing. LIBOR terms are usually for one, two, three or six months or one year.

Loss Severity: Rate of loss on a liquidated mortgage. Defined as the ratio of
(a) the outstanding principal on the mortgage loans minus the realized loss, divided
by (b) the outstanding principal on the mortgage loans.

Loss to Lease: The difference between the market rental rate for a property and the rent being paid for a similar property. It is an indicator of changing market conditions. For example, if a property were leased for a one year term at \$1,000 per month, and the current market rate were \$1,100 per month on similar properties, the loss to lease would be \$100 per month.

Low Income Housing Tax Credit (LIHTC): A tax credit given to owners for the construction or rehabilitation of low income housing. To qualify for the credit, the property must have

- (a) at least 20% of the units occupied by individuals with incomes of 50% or less of the area median income, or
- (b) at least 40% of the units occupied by individuals with incomes of 60% or less of the area median income.

Also called *Section 42 properties* after the section of the Internal Revenue Code which authorizes the credit.

LTV: see **Loan-to-Value Ratio.**

Mark-to-Market: Adjustments of estimated value or cash flows to reflect current market levels. In a falling or weak market this is likely to create a downward adjustment of current value based on lower expected future income streams if rental rates on existing leases are greater than rental rates being charged for new leases in the market (i.e., if there are several above-market leases in a building that are “burning off”). The opposite is true in a strong or rising market.

Mark-to-Market Regulations: In December, 1996 the IRS released final regulations relating to the requirement that a securities dealer mark-to-market those securities that are being held for sale to customers. This mark-to-market requirement applies to all securities owned by a dealer, except to the extent that the dealer has specifically identified a security as held for investment. The mark-to-market regulations provide that, for purposes of this requirement, a REMIC Residual Certificate is not treated as a security and thus generally may not be marked to market.

Master Servicer: A firm engaged to service the mortgage loans collateralizing a CMBS on behalf and for the benefit of the certificate holders. Responsibilities vary according to the servicing agreement. Common responsibilities include the following:

- (a) collect mortgage payments and pass the funds to the trustee;
- (b) advance any late payments to the trustee;
- (c) provide mortgage performance reports to bond holders; and
- (d) pass all loans to the **special servicer** that are nonperforming or become REO.

Master Servicing Fee: The principal compensation paid to the **master servicer** for servicing activities. The fee is payable monthly on a loan-by-loan basis from interest on the loans. The base fee is computed on the principal amount for the same period and accrued at the applicable fee rate for a specific deal. Additional compensation to the master servicer may include retainage of all assumption and modification fees, late payment charges and similar fees to the extent actually paid by mortgagors for loans which are not specially serviced mortgage loans.

Mezzanine Debt: Any debt which is paid after a first mortgage. Often refers to a short-term second or third mortgage which will be taken out (paid off or earned out) in the short term upon changes in property performance. The term “mezzanine” implies temporary indebtedness, but a long-term second mortgage is technically mezzanine debt.

Mezzanine Pieces: Those security classes (or tranches) rated in the middle range of a multi-class security, i.e., more secure than the first-loss tranche but less secure than senior class(es).

Mezzanine Investor: A party who actively invests in mezzanine debt either by issuing such debt or pooling mezzanine security classes.

Modeling/Cash Flow Modeling: When pools of loans are converted to securities, all payments, including balloon maturities, are chronologically collated into a cash flow pool and then sequentially allocated to the various classes of securities created with the issuance of CMBS. Despite elaborate computer programs designed to estimate expected cash flows based on multiple variables, rarely do all loans in a pool perform exactly as the primary loan documents prescribe. Investment bankers have invested a great deal of time and money to develop their cash flow modeling capability.

Multifamily Property: A building with five or more residential units or apartments.

Multifamily properties are usually distinguished as high rise, low rise, or garden apartments. Multifamily properties are typically distinguished by quality as follows:

- (a) Class A: Properties are above average in terms of design, construction and finish; command the highest rental rates in the market; have a superior location in terms of desirability and/or accessibility; and generally are professionally managed by national or large regional management companies.
- (b) Class B: Properties frequently do not possess design and finish reflective of current standards and preferences; illustrate adequate construction quality; command average rental rates in the market; are generally well-maintained; have unit sizes that are somewhat larger than current standards; and are managed by national or regional management companies. A majority of the apartments collateralizing CMBS are of “B” quality.
- (c) Class C: Properties provide functional housing; exhibit some level of deferred maintenance; command below-average rental rates; are usually located in less desirable areas; are occupied by tenants who provide a less stable income stream to property owners than Class A and B tenants; and are generally managed by smaller, local property management companies.

NAIC: see **National Association of Insurance Commissioners.**

National Association of Insurance Commissioners (NAIC): Insurance companies are regulated by the states in which they are domiciled, and these regulators have an association that is headquartered in Kansas City. Although NAIC recommendations are not binding on members, they are generally followed and, as a result, NAIC rulings can be important to the CMBS market. For example, the NAIC determines the reserves that life companies are required to retain against either mortgages or bonds. There was recently a controversy over whether a CMBS collateralized by a single asset was really a mortgage (requiring higher reserve levels) or a bond (with lower capital reserve requirements).

NCREIF Index: The National Council of Real Estate Investment Fiduciaries (NCREIF) compile numerous indices on commercial real estate performance based on data provided principally by pension funds’ equity real estate. Often used as a benchmark for real estate investment performance.

Negative Amortization: Occurs when interest accrued during a payment period is greater than the scheduled payment and the excess amount is added to the outstanding loan balance. For example, if the accrual rate on an ARM exceeds the pay rate, then the borrower’s payment will not be sufficient to cover the interest accrued during the billing period. The unpaid interest is typically added to the outstanding loan balance.

Net Effective Rent: The actual revenue from rental payments after certain expenses are deducted. The gross rent less operating expenses, rental concessions, tenant improvements, *et al.* equals the net effective rent. Obviously, net effective rent can be negative, and often was at the trough of the commercial real estate market.

Net-Net Lease, or Double-Net Lease: see **NN Lease**.

Net-Net-Net Lease, or Triple-Net Lease: see **NNN Lease**.

Net Operating Cash Flow (NOCF): The revenues earned by a property's on-going operations less the expenses associated with such operations and the capital costs of tenant improvements, leasing commissions and capital replacements costs (or reserves). Briefly, NOCF is **net operating income (NOI)** less **tenant improvements (TI's)**, leasing commissions and capital repairs.

Net Operating Income (NOI): Total income less operating expenses and adjustments but before mortgage payments, tenant improvements, replacement reserves and leasing commissions. NOI is commonly used as a basis for many financial calculations, e.g., **debt service coverage ratios**.

NN Lease: A lease that typically requires the tenant to pay for property taxes and insurance in addition to the rent. Also called a *net-net lease* or a *double-net lease*.

NNN Lease: A lease that typically requires the tenant to pay for property taxes, insurance and maintenance in addition to the rent. Also called a *net-net-net lease* or a *triple-net lease*.

NOCF: see **Net Operating Cash Flow**.

NOD: see **Notice of Default**.

Non-Consolidation Opinion: An attorney's statement which affirms that the assets of an entity would not be substantially consolidated with those of its affiliates by a bankruptcy court per Section 105 of the bankruptcy code. This is often a key component of **special purpose entity (SPE)** and/or **bankruptcy remote structures**.

Non-Performing Loan: A loan that is not paying principal and/or interest as stipulated. A non-performing loan might be making payments but at a rate less than the full principal and interest payments required in the mortgage note.

Nonrecoverable Advance: No advance is required to be made by a **master servicer**, **special servicer** or **trustee** if, in their judgment, such **advance** would not be recoverable from related proceeds or another specifically identified source.

Notice of Default (NOD): To initiate foreclosure proceeding involving a public sale of the real property securing the deed of trust or a mortgage, the **trustee** under the deed of trust or mortgage lender records in the public records a Notice of Default and Election to Sell (NOD) the real property collateral. NOD also includes the right to be informed of a borrower's default on a major contract such as a ground lease.

NOI: see **Net Operating Income.**

Notional Amount: A stated dollar amount on which a calculation is based, such as the payment on an **I/O strip.**

OAS: see **Option Adjusted Spreads.**

Office Property: Property designed to be used principally as a place of business, ranging from major multitenant buildings to single tenant buildings built to a tenant's specific needs. Office properties include major multitenant-CBD, multitenant-suburban, single tenant-built to suit, or a combination office/showroom.

OID: see **Original Issue Discount.**

Open Prepayment: A provision which permits repayment of all or a portion of a loan during a specified period without fee or penalty.

Option Adjusted Spreads (OAS): A representation of the incremental return (or risk premium) over comparable Treasuries (as a risk-free base) that incorporates interest rate volatility and possible variations in cash flow due to changes in rates. OAS does not, however, factor in credit quality. The technique was first applied to residential mortgage backed securities (MBS) to price the prepayment risk an investor assumes in residential MBS. In residential MBS, borrowers have a legal "option" to pay off their loans when interest rates decline, thereby creating reinvestment risk and possibly causing a reinvestment loss for the investor. This option is significantly reduced in CMBS, however, due to commonly used prepayment penalties.

Optional Termination: A legal provision in a CMBS that defines who can liquidate a CMBS prior to the last payment on the mortgages in the pool; the provision also addresses when and under what circumstances this can occur.

OREO: see **Other Real Estate Owned.**

Original Issue Discount (OID): The sale of a bond below, or at a discount to, the par price. The increase in value of the bond as it approaches maturity is part of the total return calculation, but various investors are required to treat this part of their total return differently. The tax considerations of owning a CMBS REMIC are very complex, with at least part of the issue subject to OID tax considerations, and a violation of the REMIC qualification for a CMBS can cause onerous tax penalties.

Other Real Estate Owned (OREO): A term used primarily by banks to identify real estate on the books that was taken back through foreclosure of a mortgage loan. The term "Other" REO is used by banks to distinguish foreclosed real estate from bank real estate owned, which is typically corporate real estate assets. Nonetheless, the industry commonly uses the term REO for foreclosed real estate. Also see **Real Estate Owned (REO).**

Overcollateralization: The outstanding *collateral* principal of a security in excess of the outstanding *certificate* principal. A form of **credit enhancement**.

Pass-Through Securities: A security representing pooled debt obligations repackaged as shares that passes income from debtors through an intermediary to investors. The most common type of pass-through is a mortgage-backed certificate, many of which are government-guaranteed (e.g., by **Ginnie Mae**), in which homeowners' principal and interest payments pass from the originating bank or savings and loan through a government agency or investment bank to investors, net of service charges. Pass-throughs representing other types of assets, such as auto loans or student loans, are also widely marketed. Such securities can be structured as straight pass-through, partially modified pass-through or modified pass-through securities.

- (a) Straight pass-through: Pays principal and interest to the investor as and when received from the underlying mortgage loan pool.
- (b) Partially modified pass-through: Pays certain sums whether or not such sums have been paid by the pool's mortgagors.
- (c) Modified pass-through: Involves a guaranty of all scheduled principal and interest payments to investors whether or not such payments have been paid by the mortgagors.

Pay Rate: The periodic rate at which interest is *paid* on a mortgage. This may differ from the **accrual rate**.

Percentage Lease: Rent payments which include a minimum or base rent plus a percentage of the gross sales ("overage") if sales are greater than a stipulated amount. Percentages commonly vary from one to six percent of the gross sales depending on the type of store and sales volume. Commonly used for large retail stores.

Phase I: An assessment and report prepared by a professional environmental consultant which reviews the property, both land and improvements, to ascertain the presence or potential presence of environmental hazards at the property such as underground water contamination, PCB's, abandoned disposal of paints and other chemicals, asbestos or a wide range of other potential environmental contaminants. This Phase I Environmental Site Assessment (ESA) provides a review and makes a recommendation as to whether further investigation is warranted (a Phase II Environmental Site Assessment). The latter report would confirm or disavow the presence of an environmental hazard and, should one be found, will recommend additional review and/or mitigation efforts that should be undertaken. Also see **Comprehensive Environmental Response, Compensation Liability Act (CERCLA)**.

PML: see **Probable Maximum Loss**.

Pooling and Servicing Agreement: A legal contract defining the responsibilities and the obligations of the **master servicer** and the **special servicer** for managing a CMBS, including required advances. This primary document governs much of the CMBS process. Sometimes abbreviated as PSA.

Preliminary Prospectus: A *preliminary* prospectus or private placement memorandum includes all (or nearly all) of the information that will be included in the final prospectus but is subject to amendment. It is identified by the red printing on the front cover, hence the colloquial name of “**red herring**” or, more briefly, “the red.” Despite the name, there is no implication that the document is in any way diversionary (as the common use of the term “red herring” might suggest). It is a valuable marketing tool for securities transactions because it allows investors to make some preliminary assessment of the utility of the particular security for meeting their investment goals. Also see **prospectus**.

Prepayment: A whole or partial prepayment by the borrower greater than and/or earlier than a scheduled payment on a mortgage loan. Estimating the probability or scale of prepayments in a pool of mortgages is one of the more problematic risks in assessing the ultimate yield on the security or any class in the security. Also see **Involuntary Prepayment** and **Voluntary Prepayment**.

Prepayment Interest Shortfall: The difference between the interest accrued on the corresponding certificates and the interest accrued from a prepayment. This commonly occurs when prepayments are made prior to the payment due date, and interest received from the prepayment is less than the interest on the certificates. To the extent that any such shortfall is allocated to a certain class of offered certificates, the yield on that class will be adversely affected.

Prepayment Premium or Prepayment Penalty: A stipulation in loan documents requiring a borrower to pay a penalty for any prepayments made on a mortgage loan. Some prepayment premiums are structured as **yield to maintenance**. Other prepayment premiums are set at a fixed rate, which often decreases in steps as the loan matures. For example, a mortgage loan might have a prepayment premium of 5% for the first seven years, which decreases at a rate of 1% per year over the next five years (4% in year eight, 3% in year nine, etc.), so that after year twelve there is no prepayment premium.

Prepayment Risk: The risk that a borrower will repay the remaining principal or an amount other than the scheduled payment on a mortgage prior to maturity, thus shortening the life of the loan. In order to reduce prepayment risk, commercial mortgages commonly have **lockout periods**, **prepayment premiums** and/or **yield maintenance**.

Primary Market: Loans directly from lenders to borrowers. When such loans are sold by the initial lender to another investor, they constitute the **secondary market**.

Priority of Distributions: The CMBS provision that defines how, when and to whom the **available funds** will be distributed.

Private Label Securities: Securities backed by mortgages that are issued by the private sector, including conduits, banks, thrifts and other financial institutions. These securities are also known as non-agency securities and are not backed by agencies such as **Fannie Mae, Freddie Mac, or Ginnie Mae.**

Private Placement: The sale of securities or bonds to institutional investors who meet specific criteria of net worth and/or income and who are deemed to be sophisticated investors, e.g., insurance companies. Private placement securities are generally exempt from registration requirements of the **Securities Act of 1933**. Investors are permitted to scrutinize the financial data of private placements that would not otherwise be publicly released due to confidentiality restrictions. As a result, private placements are particularly suitable for the lower-rated tranches of CMBS because investors have access to more information on which to base a decision. Also see **SEC Rule 144A.**

Probable Maximum Loss (PML): An analysis generated by a computer model which determines the economic severity of earthquake risk for a property by defining the damage ratio due to the worst possible earthquake scenario. Generally, properties with PML's over a certain threshold (perhaps 20%) are required to carry additional insurance coverage. PML levels are typically required in earthquake-prone areas.

Prospectus: The document filed with the Securities and Exchange Commission (SEC) that stipulates all the material information about a security. The final prospectus is commonly called "the black" to differentiate it from the preliminary prospectus which had been distinguished by red lettering on the cover to avoid confusion between the preliminary and final prospectus. In the case of a CMBS, the prospectus lists various details, including (but not limited to) the properties collateralizing the security, the terms and conditions of payment to security holders, the payment sequence among classes, the contingency plan in the event that mortgages are not paid as expected, and the treatment of defaults and prepayments. **ALL** relevant information about a security **MUST** be spelled out in the prospectus. Also see **red herring.**

PSA Standard Prepayment Model: A standard prepayment model for residential MBS developed in the 1980's by the Public Securities Association (PSA) and various Wall Street firms. The PSA changed its name to the Bond Market Association in 1997. The PSA model specifies a standard prepayment percentage (in terms of an annual percentage) each month from origination through the thirtieth month. Thereafter, the prepayment rate remains constant. The base is at 100% PSA. Here the annual prepayment rate is 0.2% **constant prepayment rate (CPR)** the first month, 0.4% CPR the second month, increasing each month by 0.2% CPR until the thirtieth month at 6% CPR (30 X 0.2%). Thereafter the prepayment rate is held constant at 6% CPR. To determine the prepayment rate for any PSA scenario, multiply the corresponding CPR at 100% PSA by the given PSA rate, e.g., for 200% PSA at the fourth month, 4 X 0.2% CPR X 200% = 1.6% CPR. Also see **constant prepayment rate (CPR)**.

Qualified Institutional Buyer (QIB): A QIB is defined within the meaning of **Rule 144A** under the Securities Act. A QIB must have a minimum net worth and/or income and be knowledgeable of the risks of the investment. Most CMBS can only be sold to QIBs.

Qualified Mortgage: A mortgage that can appropriately be included in a CMBS. Includes any obligation (including any participation or certificate of beneficial ownership interest) which is principally secured by an interest in real property and which is either

- (a) transferred to the **REMIC** on the **startup day**, or
 - (b) purchased by the REMIC within the three-month period beginning as of the startup day, pursuant to a fixed price contract in effect on the startup day.
- Additional obligations qualifying as secured by real property for the purposes of being termed a qualified mortgage include
- (a) obligations secured by stock held by tenants/stockholders in a cooperative housing corporation;
 - (b) debt securities backed by mortgages on timeshare ownership interests in a condominium development; and
 - (c) REMIC **regular interests** (not **residual interests**) transferred to the REMIC on the startup day in exchange for any interest in the REMIC.

Qualified Reserve Asset: An intangible asset held for investment as part of a "qualified reserve fund," which is defined as any reasonably required reserve to provide for full payment of expenses of the **REMIC** or amounts due on **regular interests** in the event of defaults on **qualified mortgages** or lower than expected returns on cash flow investments. The creditworthiness of the qualified mortgages and the extent and nature of any guarantee are factors to be considered in determining the reasonableness of the amount of reserve. The reserve must be reduced in a timely manner as payments on the qualified mortgages are received.

Rate Step-Ups: A pre-agreed upon increase in mortgage rates. Rate step-ups might be contractual and expected at intervals or be triggered by certain events, e.g., if the borrower (particularly with a balloon mortgage) fails to show progress towards refinancing (such as an appraisal, engineering report, or environmental study) or is unable to obtain a signed commitment or sales contract on the underlying property.

Rating Agency: The agency that examines the securities and their underlying collateral and rates the securities based on its benchmarks. Ratings range from triple-A, the highest rating, to triple-C, the lowest rating possible. They are a major influence on CMBS structure and pricing. The four rating agencies of CMBS are Dominion Bond Rating Service, FitchRatings, Moody's Investor Service and Standard & Poor's.

RBC: see **Risk Based Capital**.

Real Estate Investment Trust (REIT): A legislated tax election option which allows a corporation or partnership specially formed to invest in real estate (e.g., by acquiring or providing financing for real estate properties) and/or securities backed by real estate. REITs are required to pass through 90% of taxable income to their investors but are not taxed at the corporate level. The major types of REITs are equity, mortgage, and hybrid; equity REITs are the most common.

Real Estate Mortgage Investment Conduit (REMIC): Legislated financial vehicle which allows for the issuance of multi-class securities with no adverse tax consequences. A REMIC is a pass-through entity that can hold loans secured by real property without the regulatory, accounting and economic obstacles inherent in other forms of mortgage-backed securities. A REMIC is a bankruptcy-remote legal entity which distributes the cash flow to bondholders of various classes (or **tranches**) of securities without being taxed at the entity level. REMICs have facilitated the sale of interests in mortgage loans in the **secondary market**. Embedded in the **Tax Reform Act, 1986**.

Real Estate Owned (REO): Common label for a mortgaged property that has been acquired by a trust fund or lender through foreclosure or deed in lieu of foreclosure. Also see **Other Real Estate Owned (OREO)**.

Realized Loss: The amount unrecovered from the sale of a foreclosed mortgage loan or REO property. It is equal to the amount of

- (a) the outstanding principal balance of the loan,
- (b) *plus* all unpaid scheduled interest,
- (c) *plus* all fees applied to the sale of the property,
- (d) *minus* the amount received from liquidation.

Recreational Property: A property designed for a recreational specialized use. Includes sports arenas, country clubs and marinas.

Red Herring, or “Red”: A *preliminary* prospectus or private placement memorandum that is subject to amendment. It is identified by the red printing on the front cover, hence the name, and there is no implication that the document is in any way diversionary (as the common use of the term “red herring” might suggest). It is a valuable marketing tool for securities transactions. Also see **prospectus**.

Refinance Risk: The risk that borrowers are unable to refinance mortgages at maturity, thereby extending the life of a security collateralized by those mortgages. Also see **Balloon Risk**.

Regular Interests, or Regular Certificates: A **REMIC** may be comprised of only two forms of interest or certificates: regular and residual interests. The terms and maturities of regular interests, the primary form of interest in a **REMIC**, must be fixed on the **startup day** and must state a specific amount to which the holder is ultimately unconditionally entitled. Generally, regular interests must provide for interest payments or other similar amounts at or before maturity at a fixed rate.

REIT: see **Real Estate Investment Trust**.

Release Provision: 1) A provision to release certain collateral under a mortgage for a pre-agreed upon amount.
2) If a borrower prepays the loan associated with one property in a pool of mortgages that are **cross-collateralized** and **cross-defaulted** (a “crossed” pool), the borrower must additionally prepay a portion of all other loans in the pool. This provides protection against a borrower “cherry picking” properties out of a crossed pool.

REMIC: see **Real Estate Mortgage Investment Conduit**.

Remittance Report: A report sent to each certificate holder on each distribution date by the servicer which provides detailed information about the current distribution; copies of the remittance reports are also sent to the underwriter and trustee. There are no fixed standards for the information to be included in remittance reports and, in fact, there is a wide variety of formats — some have a minimal amount of typewritten information while others are computer generated and supply more detail.

Rent Step-Up: A lease agreement in which the rent increases at given intervals for a fixed amount of time or for the life of the lease.

REO: see **Real Estate Owned**.

Reperforming Loan: see **Corrected Mortgage Loan**.

Replacement Reserve Account: see **Deferred Maintenance Account**.

Reps and Warranties: The representations (or “reps”) and warranties made by a mortgage lender about the quality of the loans. Many reps and warranties survive the securitization process, i.e., are still enforceable once the mortgage has been included in a security.

Reserve Funds: A portion of the bond proceeds that are retained to cover losses on the mortgage pool. A form of **credit enhancement**. Also called *reserve accounts*.

Residual: Refers to any cash flow remaining after the liquidation (full pay-off) of all classes of securities in a CMBS. Multiple-asset, multiple-class CMBS frequently have a residual.

Residual Interests, or Residual Certificates: Every **REMIC** must have one and only one class of residual interests, although there may be multiple owners of residual interests. All distributions of residual interests must be prorated; however, a residual interest does not have to entitle the holder to any fixed or minimum distributions in order to qualify as such. Residual interests may accrue income or cash flow in several ways, including the following:

- (a) the rate(s) differential(s) between the underlying mortgages and the **REMIC regular interests**;
- (b) income or cash flow resulting from **over-collateralization**;
- (c) buy-down reserves, sinking funds or prepaid insurance; and
- (d) income from **qualified reserve funds** or cash flow investments in excess of what is required to service regular interests.

Also see **regular interests**.

Resolution Trust Corporation (RTC): Created by the **Financial Institutions Reform, Recovery and Enforcement Act (FIRREA)**, 1989. An agency designed to assume the assets of failed financial institutions, principally savings and loan institutions (S&Ls or thrifts) and dispose of those assets. The RTC can be credited with profoundly expanding the CMBS market by assuming a large volume of these securities, often with substantial **credit enhancement** to make them palatable to investors. The RTC charter expired in 1995, and all remaining assets and duties were transferred to the **FDIC**.

Retail Property: Property types range from super-regional shopping centers with a gross leasable area greater than one million sq. ft. to small stores with single tenants. Also see **Shopping Center**.

Reverse Earn-Out Loans: A mortgage loan that, like an earn-out loan, is made on a property or properties that do not yet possess stabilized cash flows. Unlike an earn-out loan, a reverse earn-out is sized at origination on the basis of specific criteria (generally DSCR) not yet achieved, or achieved but not yet shown to be consistent. If specified criteria (generally a DSCR of 1.2x-1.4x) are not met by a specified date, the loan is resized down. The difference between the outstanding balance of the loan and the resized balance must be paid down by the borrower from other sources, which may not result in a further encumbrance of the property, or with an outside preferred equity investment. Also see **Earn-Out Loan**.

Reversionary Cap Rate: The capitalization rate applied to the expected ultimate sale price/value of a building after a several year holding period. Typically about 50 basis points higher than a **going-in cap rate**.

Reversion/Reversionary Value: Reversion is the ultimate or theoretical sale of a building after a several year holding period. The reversionary value is thus the expected value of the building at that time.

Right of Substitution: The ability to replace collateral, parties or other components in a contractual obligation. For example, a mortgage may allow the release of certain property from the collateral as long as other acceptable collateral replaces it.

Right to Cure: In the event that a contractual obligation between two parties (e.g., a ground lease) is breached or defaulted, the right to cure permits a specified and interested third party (e.g., a lender) to assume the responsibilities of one of the parties (e.g., the borrower) to perform under the agreement (e.g., pay rent) on behalf of the defaulting party to preserve their interests (e.g., their lien position). Also see **Cured**.

Risk Based Capital (RBC): The amount of capital (or net worth) an investor must identify and allocate to absorb a potential loss on an investment or investment class. This requirement was established by institutional regulatory bodies in the last few years because of losses at various types of financial institutions. The amount of risk-based capital that is required varies among asset classes depending on perceived risk (e.g., is different for mortgages or rated bonds) and is typically expressed as a percent of the amount at risk.

RTC: see **Resolution Trust Corporation**.

Rule 144A: see **SEC Rule 144A**.

SAIF: see **Savings Association Insurance Fund**.

Savings Association Insurance Fund (SAIF): A fund administered by the **FDIC** which insures deposits of SAIF member institutions, primarily thrifts or savings and loan associations (S&Ls), funded by premiums paid by member institutions. Established by **FIRREA** in 1989 along with the **Bank Insurance Fund (BIF)**.

Seasoning: The length of time since origination of a mortgage loan. The longer a loan has been outstanding and performing to its terms, the better “seasoned” it is. The presumption is that more seasoned loans have a lower probability of default. A loan that has been outstanding for perhaps three years but shows a poor pay history (e.g., several late pays, particularly beyond 30 days), is not considered seasoned because of its performance.

SEC: see **Securities and Exchange Commission**.

SEC Rule 144A: The sale of bonds not registered with the Securities and Exchange Commission (SEC) is restricted to the conditions set forth by this rule of the SEC originally contained in the Securities Act of 1934. Unregistered certificates can only be sold to “qualified investors,” principally institutional investors, who can demonstrate that they meet certain standards of net worth and/or income and are therefore deemed to be sophisticated investors. The rule under which some securities are privately placed. Also see **Private Placements**.

Secondary Market: The trading of securities that had been previously issued.
Also see **primary market**.

Secondary Mortgage Market Enhancement Act (SMMEA), 1984: Originally passed to assist the residential mortgage market in accessing the capital market by eliminating legal restrictions that impeded certain investor groups from participating in residential MBS. At this time, if a security is rated double-A or better from at least one national rating agency, and if it is backed by a first-lien mortgage on residential property (including multifamily and congregate care), then the security is said to be “SMMEA eligible,” and hence a permitted investment for S&Ls, federally-chartered banks, and state regulated financial institutions (life companies and state-chartered banks). Lobbying is underway to modify investment guidelines so that qualified investors are permitted wider access to the CMBS market as well as residential MBS.

Securities: In the CMBS market, securities are the generic term applied to Certificates of Ownership of the funds or assets of a trust fund. These undivided interests are issued by the trustee in amounts of \$100,000 until less than \$100,000 remains, then in amounts of \$1,000. The certificates are usually issued in lettered classes starting with Class A, the highest-rated class. Each class is risk-rated by one or more of the major **rating agencies**. If the higher risk first-loss class is included in the security and sold rather than being held by the seller, the class is rated as “NR” (not rated). The “not rated” risk-rating is used for securities not qualifying for the minimum risk rate.

Securities Act of 1933: This act established registration requirements and antifraud provisions. It requires new issues to be registered with the SEC and meet prospectus requirements. New issues can be exempt from these requirements if certain conditions are met.

Securities and Exchange Commission (SEC): The regulatory agency charged with establishing the proper procedures for the registration and sale of publicly-traded securities and monitoring that these procedures are maintained in the interest of a fair public market.

Securitization: A term used to describe the process of raising funds through the sale of securities. It usually creates a new financial instrument representing an undivided interest in a segregated pool of assets such as commercial mortgages. The ownership of the assets is usually transferred to a legal trust or special purpose, bankruptcy-remote corporation to protect the interests of the security holders.

Self-Amortizing Loans: Loans for which the full amount of the principal will be completely paid off at the loan's termination pursuant to the loan's payment schedule.

Senior Pieces: Security classes, or **tranches**, that are rated as investment grade, therefore appropriate for regulated institutional investors (i.e., triple-A, double-A, single-A, and triple-B). Also called **A pieces**.

Senior/Subordinate Structure: A common structure used in CMBS involving a prioritization of cash flows. For example, in a simple two class senior/subordinate structure (also known as an A/B structure),

- (a) Class A will receive all cash flow up to the required scheduled interest and principal payment;
- (b) The subordinate class, Class B, provides credit enhancement to Class A, and
- (c) Class B will absorb 100% of losses experienced on the collateral until cumulative losses exceed Class B's amount; thereafter Class A will absorb all losses.

Also known as a *sequential pay structure*.

Sequential Pay Structure: see **Senior/Subordinate Structure**.

Servicer: Institution acting for the benefit of the certificate-holders in the administration of mortgage loans in a CMBS. Functions include reporting to the **trustee**, collecting payments from borrowers, advancing funds for delinquent loans, negotiating workouts or restructures (as permitted by the **pooling and servicing agreement**) and taking defaulted properties through the foreclosure process. Also see **Master Servicer** and **Special Servicer**.

Servicing Advances: Generally defined as customary, reasonable and necessary out-of-pocket costs and expenses incurred by the **master servicer** or **special servicer** in connection with the servicing of a mortgage loan after an event of default, delinquency or other unanticipated event or in connection with the administration of an REO property. These advances are paid by the master servicer or sometimes the special servicer and are generally reimbursable from future payments and other collections. In all cases, the required servicing advances are detailed in the **pooling and servicing agreement**.

Servicing Transfer Event: An event that triggers the transfer of the management of a mortgage loan from the **master servicer** to the **special servicer**. A servicing transfer event occurs when a borrower has defaulted or, in the reasonable judgment of the master servicer, is likely to default and be unable to **cure** within a reasonable time. In this event, the master servicer can transfer the day-to-day handling of the account to the special servicer until such time as the special servicer determines that the default has been cured and that the loan is now a **corrected mortgage loan**.

Shadow Anchor Retail: A major retail tenant which provides significant drawing power to a retail center but which itself may not be part of the particular shopping center or the specific collateral. For example, imagine a shopping center for which a WalMart serves as anchor for a shopping center consisting of several in-line stores. If that WalMart is not owned by the shopping center, the store nonetheless serves as a shadow anchor to the other property and in-line stores.

Shell Rent: A portion of rental rates that is intended to amortize the costs of extraordinary tenant improvements.

Shopping Center: There are customary distinctions among shopping centers, standardized by organizations such as the Urban Land Institute (ULI).

- (a) Neighborhood Center. Less than 100,000 SF. Provides daily essentials and everyday goods and services.
- (b) Community Center. 100,000 - 400,000 SF. Commonly a supermarket, discount and/or department store anchor accompanied by smaller stores providing frequently used goods and services.
- (c) Regional Center. 400,000 - 800,000 SF. Typically two anchor stores plus smaller in-line stores and service providers.
- (d) Super-Regional Mall. More than 800,000 SF. Typically three or more anchors plus in-line stores.
- (e) Power Center. Typically at least two anchor stores which are strong attractions in and of themselves but typically not including smaller in-line stores or service providers.

SMMEA: see **Secondary Mortgage Market Enhancement Act, 1984**.

SPA: see **Standard Prepayment Assumption**.

SPC: Special Purpose Corporation. see **Special Purpose Entity.**

SPE: see **Special Purpose Entity.**

Special Purpose Entity (SPE): A bankruptcy-remote entity established by the borrower(s) at the loan level and the issuer at the securities level whose sole asset is the property or properties being financed. The SPC protects the lender and, ultimately, the certificate holders of a security, from having the underlying property involved in bankruptcy proceedings against the borrower on the property; in the event of a bankruptcy or insolvency of the borrower or issuer, an automatic stay would apply and delay payments to investors. **Rating agencies** generally request counsel to provide “true sale” opinions on the sale from the transferor to the issuer and “non-consolidation opinions” confirming that the entity is indeed bankruptcy remote. Also called a *special purpose corporation (SPC)* or *special purpose vehicle (SPV)*.

SPV: Special Purpose Vehicle. see **Special Purpose Entity.**

Special Servicer: Some transactions have a separate special servicer, in addition to the **master servicer**, who is responsible for managing loans that go into default and conducting the “work-out” or foreclosure process, e.g., liquidating of loans and advancing the proceeds to the **trustee**. There are various types of special servicers:

- (a) Those that retain first-loss pieces;
- (b) Those that invest in **B-pieces** in return for special servicing rights; and
- (c) Those that are appointed solely because of their specialized asset-management expertise.

Special Servicing Fee: That portion of the **special servicer’s** compensation that accrues with respect to each specially serviced mortgage loan and each mortgage loan that has become **REO**. The fee is calculated on a loan-by-loan basis per the applicable **pooling and servicing agreement**.

Spread Accounts: A **reserve account** funded on an on-going basis by collateral interest in excess of bond interest that is not directed to any particular class. This account absorbs mortgage losses up to a stated cap, providing additional credit support for the security, hence is a form of **credit enhancement**.

Standard Prepayment Assumption (SPA): Prepayment rates on loans are commonly measured relative to a prepayment standard or model, such as the Standard Prepayment Assumption prepayment model or the **Constant Prepayment Rate (CPR)** prepayment model. SPA represents an assumed *variable* rate of prepayments each month (expressed as an annual percentage) relative to the then outstanding principal balance of a pool of loans. Different prepayment assumptions than this baseline are often expressed as percentages of SPA. CPR, in contrast, represents an assumed *constant* rate of prepayments each month (expressed as an annual percentage) relative to the then outstanding principal balance of a pool of loans for the life of such loans.

Standby Fee: That portion of the **special servicer's** compensation which accrues with each mortgage loan, including specially serviced mortgage loans and those which have been converted to **REO**. This fee accrues at the standby fee rate, is calculated in the same manner as the master servicer's fee and is payable by the **master servicer** from its **master servicing fee**.

Startup Day: The first day on which interests in the REMIC are issued.

Stress Test: A series of tests performed by the **rating agency** which project the performance of the mortgage pool under varying scenarios or stress-related assumptions. The rating agency determines the likelihood of timely repayment using historical loan experience for the collateral type and its own statistical database concerning probability of default and severity of loss. The stress tests to which the pooled loans are submitted include analysis of the mortgage documents, real property collateral, tax structure, geographical distribution, loan servicing and administration issues. For example, a stress test might assess the impact of a change in interest rates on **debt-service coverage ratios (DSCRs)**.

Stripped Interest Certificates: Classes of securities that are entitled to distributions of interest with nominal or no distributions of principal.

Stripped Principal Certificates: Classes of securities that are entitled to distributions of principal with nominal or no distributions of interest.

Structure: Refers to the tax and legal structure of a CMBS, such as pass-through structure, a bond structure, a collateralized mortgage obligation (CMO), or a **real estate mortgage investment conduit (REMIC)**. The structure can determine the tax benefits or penalties, and the rights of the CMBS holders and the issuer in the event of a failure or default within the terms of the security. Most CMBS are **senior/subordinated**, multiple class pass-throughs classified as REMICs.

Structuring: The process of experimenting with various combinations of mortgages and security classes to achieve the highest price for a CMBS based on capital market factors prevailing at that time.

Subordinate Ground Lease: An agreement to occupy and use a parcel of land in which the rights attributable to such an agreement are junior, or secondary, to another indebtedness or obligation.

Subordinate Lien: A collateralized indebtedness in which the rights attributable to such indebtedness are junior, or subordinate, to another indebtedness or obligation, i.e., a second mortgage.

Subordination: Structuring a security into classes, in which the risk of credit loss is disproportionately distributed. It is commonly recognized as a **senior/subordinate** structure. A form of **credit enhancement**.

Sub-Performing Loan: A loan that is making payments, perhaps even the full principal and interest payments required in the mortgage note, but with a debt coverage ratio that would be unacceptable if underwritten at this time. Many investors also classify a loan as sub-performing even if monthly payments are current if the **loan-to-value ratio (LTV)** or other primary value indicator suggests that the loan is unlikely to be able to pay off in full at maturity.

Sub-Servicer: A servicer who contracts with **master servicers** and **special servicers** to perform some of the real estate services required under **pooling and servicing agreements**, such as property inspections, foreclosure services or individual loan administration. The master or special servicer is legally responsible for the activities of the sub-servicers. Sub-servicers are more likely to be engaged for specialized property types or if there is a small number of loans, a subset of the total portfolio, in a given area.

Substitution: see **Right of Substitution**.

Survivability: Many **reps and warranties** which are made by the lender survive the securitization process, i.e., are still enforceable once the mortgage has been included in a security.

Tape Cracking: The ability to import collateral information from different servicers, trustees or underwriters. The information is converted from its raw form and imported into a database so that one consistent database is available for multiple users.

Tax Reform Act (TRA), 1986: Reversed many of the tax reforms of 1981. Properties that were profitable in the tax environment of 1981-1986 were not economically viable after the TRA. Many markets had become oversupplied due to tax advantaged construction of properties which the underlying economic and demographic demand could not support. As a result, TRA triggered a sharp drop in new construction, particularly of apartments. Also see **Economic Recovery Tax Act, 1981**.

Tenant Improvements (TI): The expense to physically improve the property or space, such as new improvements or remodeling. Often, tenants are provided with a market rate TI allowance (expressed in dollars per square foot) that the owner will contribute toward improvements; amounts above the TI allowance might be paid for by the tenant. In a soft real estate market, more generous TI allowances might be necessary to attract tenants, thus adding greater uncertainty to the expected cash flow from a building.

Third Party Pool Insurance: Protects investors from any losses on the mortgage loans. The bond insurer, paid an annual fee by the issuer, will absorb the losses. The CMBS is usually never rated higher than the credit rating of the third-party issuer. A form of **credit enhancement**.

TI: see **Tenant Improvements**.

Top-Down Approach to Investing: An investment strategy in which an investor first looks at large-scale trends in the general economy, then selects those industries and companies that are likely to benefit from those trends. For example, an investor who thinks that the general economic environment is favorable for real estate might further examine which specific real estate financial vehicles are most appropriate, then review and assess specific transactions that meet investor requirements. Also see **Bottom-Up Approach to Investing**.

TRA: see **Tax Reform Act, 1986**.

Tranche: A term applied to describe the discretely-rated classes of CMBS securities, e.g., the triple-A tranche. Each class or tranche is typically paid a coupon stipulated at the time of issue and principal based on a predetermined payment sequence. Typically, lower-rated tranches have higher coupons and longer lives, since they receive interest payments (the coupon) but no principal payments until the higher-rated tranches have been retired or paid off.

Triple-Net Lease: see **NNN Lease**.

Trustee: The trustee for a CMBS holds the mortgage collateral documents, issues the certificates of beneficial ownership (the securities), passes all funds from the **master servicer** to the bondholders, and distributes statements on distributions and the status of the collateral. Acts as a supervisor to the master servicer and **special servicer**. Ensures that the servicers act in accordance with the **pooling and servicing agreement**. If there is a violation of the agreement, the trustee has the right to assume the authority of or appoint a new servicer. The trustee represents the trust that holds the legal title to the collateral for the benefit of all class holders of the security. Trustees must carry out their duties according to the indentures established within the trust indenture. Some trustees actually collect the proceeds from the master servicer and distribute them to the security holders while other trustees subcontract the distribution to “paying agents.” Such a subcontract does not release the trustee from the legal obligation to protect the interests of the security holders. There are also bankruptcy trustees and trustee for deed of trust.

Up-Front Due Diligence: The **due diligence** completed on individual loans and properties that are expected to be packaged for securitization.

Value: Unless otherwise specified, the value of a mortgaged property is its fair market value determined in an appraisal obtained by the originator when the loan is first made. There are, however, other concepts of “value,” including **derived investment value (DIV)** and investment value.

Voluntary Prepayment: Prepayments made by the borrower to reduce or pay off the outstanding principal. Most occurrences are due to borrower refinancing at lower interest rates.

Waterfall: A term used to describe the cash flow pay-out priority of a CMBS. The cash flow from the pool of mortgages typically pays principal plus interest to the highest-rated **tranche**, while paying only interest on the lower-rated tranches (the coupon payment having been stipulated at the time of issue). After all of the certificates from the highest-rated tranche have been retired or paid down, the cash flow then is dedicated to paying principal as well as interest to the next-highest rated tranche. While all tranches receive interest or coupon payments, *principal* is paid to each tranche in sequence until each successively-rated tranche is paid down, in accord with the sequence stipulated in the **prospectus** at the time of issue. Since lower-rated tranches receive principal payments only after higher-rated tranches are paid down, they typically have longer average lives, i.e. are paid off later. The “waterfall” analogy refers to the visual image of a champagne waterfall, in which the flow of champagne/cash first fills up the highest tier/triple-A bucket, then spills into the next tier/double-A bucket, then the next tier/single-A bucket, etc.

WAC: see **Weighted Average Coupon.**

WAL: see **Weighted Average Life.**

WAM: see **Weighted Average Maturity.**

Weighted Average Coupon (WAC): The average coupon or interest payment on a set of mortgages, weighted by the size of each mortgage in the pool.

Weighted Average Life (WAL): The average time until all scheduled principal payments are expected to have been made, weighted by the size of each mortgage in the pool.

Weighted Average Maturity (WAM): The average time before a set of mortgages will be retired, weighted by the size of each mortgage in the pool.

Workout Fee: That portion of the **special servicer's** compensation payable with respect to each corrected mortgage loan, per the **pooling and servicing agreement**. This fee is payable out of and is calculated by applying a workout fee rate to each collection of interest and principal (including scheduled payments, prepayments, balloon payments and payments at maturity) for a mortgage loan as long as it remains a **corrected mortgage loan**. This fee ceases to be payable if the loan becomes a specially serviced mortgage loan again or becomes an **REO** property.

Yield Maintenance: A **prepayment premium** that allows investors to attain the same yield as if the borrower had made all scheduled mortgage payments until maturity. Yield maintenance premiums are designed to make investors indifferent to prepayments and to make refinancing unattractive and uneconomical to borrowers. Also see **Defeasance**.

Yield Spread: The difference in yield between a security and a benchmark, typically U.S. Treasuries of the same maturity.

Yield to Average Life: Calculation used in lieu of **yield to maturity** or yield to call, predicated on the expected term of the bond class rather than its final maturity.

Yield to Maturity: Calculation of the rate of return an investor will receive if a long-term, interest-bearing investment, such as a bond, is held to its maturity date. It takes into account purchase price, redemption value, time to maturity, coupon yield and the time between interest payments.