



COMMERCIAL MORTGAGE  
SECURITIES ASSOCIATION

# Borrower Guide to CMBS



MORTGAGE BANKERS  
ASSOCIATION



## W E L C O M E T O C M B S

Over the last decade, a substantial and growing amount of real estate has been financed through conduit loans that have been securitized and sold as *Commercial Mortgage Backed Securities* (“CMBS”). CMBS has become an increasingly significant component of the total commercial real estate debt market, reaching consistently in excess of \$60 billion annually. The development of the CMBS industry has generally benefited Borrowers through increased loan proceeds and competitive rates.

This guide was created by industry participants, in conjunction with the Commercial Mortgage Securities Association (“CMSA”) and the Mortgage Bankers Association (“MBA”), as part of the industry’s desire to educate and improve the transparency of the CMBS market by providing existing and prospective Borrowers with a brief summary of the parties involved in the CMBS process and issues that may arise from obtaining a loan that is subsequently securitized.

## W H A T I S C M B S ?

Commercial real estate first mortgage debt is generally broken down into two basic categories: (1) loans to be securitized (“CMBS loans”) and (2) portfolio loans. Portfolio loans are originated by a lender and held on its balance sheet through maturity. In a CMBS transaction, many single mortgage loans of varying size, property type and location are pooled and transferred to a trust. The trust issues a series of bonds that may vary in yield, duration and payment priority. Nationally recognized rating agencies then assign credit ratings to the various bond classes ranging from investment grade (AAA/Aaa through BBB-/Baa3) to

below investment grade (BB+/Ba1 through B-/B3) and an unrated class which is subordinate to the lowest rated bond class.

Investors choose which CMBS bonds to purchase based on the level of credit risk/yield/duration that they seek. Each month the interest received from all of the pooled loans is paid to the investors, starting with those investors holding the highest rated bonds, until all accrued interest on those bonds is paid. Then interest is paid to the holders of the next highest rated bonds and so on. The same thing occurs with principal as payments are received. This sequential payment structure is generally referred to as the “waterfall.” If there is a shortfall in contractual loan payments from the Borrowers or if loan collateral is liquidated and does not generate sufficient proceeds to meet payments on all bond classes, the investors in the most subordinate bond class will incur a loss with further losses impacting more senior classes in reverse order of priority.

The typical structure for the securitization of commercial real estate loans is a real estate mortgage investment conduit (REMIC). A REMIC is a creation of the tax law that allows the trust to be a pass-through entity which is not subject to tax at the trust level. The CMBS transaction is structured and priced based on the assumption that it will not be subject to tax with respect to its activities; therefore, compliance with REMIC regulations is essential.

CMBS has become an attractive capital source for commercial mortgage lending because the bonds backed by a pool of loans are generally worth more than the sum of the value of the whole loans. The enhanced liquidity and structure of CMBS attracts a broader range of investors to the commercial mortgage market. This value creation effect allows loans intended for securitization to be aggressively priced, benefiting Borrowers.

## THINGS TO CONSIDER BEFORE CLOSING A CONDUIT LOAN

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Many misconceptions about CMBS lending still exist among Borrowers, mortgage bankers and brokers, especially with respect to how loans are serviced once they have been securitized. While basic loan administration for CMBS loans is substantially the same as for portfolio loans, some key differences exist between servicing for CMBS versus portfolio loans. Borrowers should be informed of the rules governing CMBS servicing as well as the mechanics for processing servicing requests. Borrowers need to carefully consider what types of servicing requests they may have over the life of the loan and try to address how these requests will be handled in their loan documentation before the loan closes.

## THE POOLING AND SERVICING AGREEMENT

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Once the loan is transferred to a trust and securitized, the loan is serviced in accordance with the applicable loan documents and the Pooling and Servicing Agreement (PSA) for the trust. The PSA governs the allocation and distribution of loan proceeds and losses to the bondholders. It also describes in detail how the loans are to be serviced and includes guidance to ensure that the trust continues to comply with the REMIC provisions of the tax code in order for the trust to maintain favorable tax treatment. A key difference between traditional portfolio loans and CMBS loans is that, while each portfolio lender will apply its own individualized standards, CMBS servicers administer loans in accordance with PSAs which generally standardize practices and procedures to meet REMIC requirements and to protect the bondholders. Examples of REMIC restrictions relative to CMBS loan servicing requests are provided in more detail on the following pages.

All CMBS servicers (primary, master and special) are required to act in accordance with the “servicing standard” as defined in the applicable PSA. Although the definitions may vary slightly from deal to deal, the standard usually requires the servicer to use the same care, skill and diligence as it uses to service and administer comparable mortgage loans on behalf of third parties or on behalf of itself, whichever is the higher standard. Due consideration is given to customary and usual standards of practice utilized by institutional commercial mortgage lenders or servicers under comparable circumstances.

## CMBS INDUSTRY PARTICIPANTS

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The following parties are typically involved with a loan once it has been securitized:

- Primary or Sub-Servicer
- Master Servicer
- Special Servicer
- Directing Certificateholder / Controlling Class / B-Piece Buyer
- Trustee
- Rating Agency(ies)

### Primary or Sub-Servicer

In some cases the Borrower may deal with a Primary Servicer that may also be the loan originator or *Mortgage Banker* who sourced the loan. The Primary Servicer maintains the direct Borrower contact, and the Master Servicer may sub-contract certain loan administration duties to the Primary or Sub-Servicer. The Master Servicer remains responsible to the trust for the Primary Servicer’s performance and actions. While the Master Servicer maintains all of the responsibilities and duties to the trust under the PSA, a sub-servicing agreement between the Master Servicer

and Primary Servicer typically mirrors the servicing provisions under the PSA so that the Primary Servicer's discretion is fairly limited and subject to the same servicing standard as the Master Servicer. Given their role in the origination of the loan, the originator or Mortgage Banker's involvement as a Sub-Servicer allows for Borrower relationships to be maintained while adding to the collective servicing knowledge about the loan.

### Master Servicer

The Master Servicer's responsibility is to service the loans in the pool through maturity unless the Borrower defaults. The Master Servicer manages the flow of payments and information and is responsible for the ongoing interaction with the performing Borrower. The Master Servicer is responsible for collecting the payments from the Borrower, holding and making disbursements from escrows and performing most routine loan administration functions. The Master Servicer is also responsible for collecting and analyzing rent rolls, operating statements and other financial and property information from the Borrower, as well as conducting periodic physical inspections. A Primary Servicer may perform many of these responsibilities to the extent a subservicing arrangement is in place.

The Master Servicer is generally required to process all Borrower requests related to consents, waivers and modifications related to performing loans. The Master Servicer's ability to waive, consent or modify terms of any mortgage loan is governed by the PSA. Many material servicing requests or modifications will also require the consent or approval of the Special Servicer. In some cases those decisions are further subject to approval by the Directing Certificateholder or review by Rating Agencies as described below.

## Special Servicer

Upon the occurrence of certain specified events, primarily a default, the administration of the loan is transferred to the Special Servicer. A Borrower will receive notification from the Master or Special Servicer if its loan has been transferred to Special Servicing. Besides handling defaulted loans, the Special Servicer also has approval authority over material servicing actions, such as loan assumptions.

The Special Servicer is a specialist in dealing with defaulted mortgage loans and is usually selected by the Directing Certificateholder. In many cases the Special Servicer is a related entity to the Directing Certificateholder. Like the Master Servicer, the Special Servicer has a duty to the trust and is subject to the servicing standard. The standard usually mandates that the Special Servicer must act to maximize the recovery on the mortgage loan to the bondholders (as a collective whole) based on an analysis of collection alternatives using a net present value methodology. The Special Servicer will consider multiple alternatives as part of its analysis including loan modification, foreclosure, deed-in-lieu, negotiated payoff or sale of the defaulted loan. Frequently the Directing Certificateholder also has the ability to direct the Special Servicer's actions with respect to defaulted loans, provided the servicing standard is maintained.

## Directing Certificateholder / Controlling Class / B-Piece Buyer

The investor in the most subordinate bond classes is commonly referred to as the "*B-piece Buyer*." B-piece Buyers generally purchase the B-rated and BB/Ba-rated bond classes along with the unrated class. The most subordinate bond class outstanding at any given point is considered to be the Directing Certificateholder, also referred to as the Controlling Class. Given that losses come out of the lowest rated bonds, the PSA provides the Directing Certificateholder the opportunity to play an active role in monitoring the performance of each loan, make decisions on key asset issues and appoint and/or terminate the Special Servicer.

## Trustee

The Trustee's primary role is to hold all the loan documents and distribute payments received from the Master Servicer to the bondholders. Although the Trustee is typically given broad authority with respect to certain aspects of the loan under the PSA, the Trustee typically delegates its authority to either the Special Servicer or the Master Servicer. As holder of the loans, the Trustee will be named in enforcement actions related to the loans (such as lawsuits or non-judicial foreclosure actions) yet in most instances the Trustee is acting by and through either the Master Servicer or the Special Servicer. All Borrower interaction is handled by the servicers, and the Borrower rarely, if ever, interacts with the Trustee.

## Rating Agency(ies)

There will be as few as one and as many as four Rating Agencies involved in rating a securitization. Rating agencies establish bond ratings for each bond class at the time the securitization is closed. They also monitor the pool's performance and update ratings for investors based on performance, delinquency and potential loss events affecting the loans within the trust.

The bond ratings assigned at the time the securitization closes assume that the credit quality of the loan pool will not change significantly over time. As such, some decisions cannot be made with respect to the loans in a securitized pool without rating agency confirmation that such actions will not cause a downgrade of any of the bond class ratings. Rating Agency confirmation is frequently required with respect to actions on the largest loans in the trust, but certain items such as approval of subordinate financing may also require Rating Agency confirmation regardless of the size of the loan. The Rating Agencies will work directly with a servicer in processing these types of requests and will not interact directly with the Borrower.

# CMBS SERVICING

## WHO TO CONTACT

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Borrowers should always initiate their requests with the Primary or Master Servicer, as they know who the players are in the securitization, what the process is, what information is needed for the specific request and whose consent is required. Even if the request must ultimately be approved by the Special Servicer or Directing Certificateholder, these parties will still generally look to the Primary or Master Servicer for a recommendation. It is common practice for servicers to send an introductory letter to the Borrower at the time a loan is closed or securitized, which typically includes a contact address. In the event such correspondence is not available, Borrowers should review their monthly billing statement to locate the identity of the Primary or Master Servicer for their loans and obtain contact information.

## COMMON BORROWER REQUESTS

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Just as portfolio lenders service loans to protect their interests, CMBS servicers will act to protect the interests of the certificateholders as a whole. Unlike portfolio loans, where servicing decisions are guided by the lenders' own internal policies, CMBS servicers' discretion in servicing loans is governed by the PSA and, in some instances, restricted by the REMIC regime.

Complying with REMIC regulations is central to most CMBS transactions to maintain the trust's favorable tax treatment. One of the primary restrictions imposed upon the trust by the REMIC regime is the requirement that the loans constitute a "static pool." This means that substitution of collateral cannot occur nor can the loan be materially modified unless specifically provided for in the loan documents or unless the loan has defaulted or default is deemed imminent. Many Borrowers offer good solutions to problems that are, however, not permissible under REMIC regulations and are frustrated when the CMBS servicer must reject

their request. Even so, the requirements the REMIC tax regime has on CMBS servicing are limited and, in large measure, can be ameliorated by advanced planning. **It is, consequently, extremely important at the loan origination stage to think through, in advance, the needs of the property over the life of the loan and what features and flexibility should be specifically spelled out in the loan documents at origination.** This will help avoid a possible REMIC restriction and provide the servicer with clear direction as to how requests are to be handled.

The list below sets forth examples of activities that are prohibited or permissible under REMIC rules.

#### REMIC Prohibition\*

- Defease the loan within 2 years of the securitization date
- Change interest and amortization payments

#### REMIC Permissible\*\* (with advance planning only)

- Release a material portion of or expand the collateral
- Substitute collateral
- Uncross loans
- Change escrow payments
- Release lease termination payments to the Borrower

#### REMIC Permissible\*\*\* (but loan or servicing documents may still restrict)

- Prepay the loan during a lockout period
- Waive or reduce a prepayment premium
- Allow secondary financing
- Release a guarantor of non-recourse carveouts
- Modify existing casualty/condemnation proceeds distributions
- Allow an assumption of the loan pursuant to the loan documents
- Allow an assumption of the loan not pursuant to the loan documents
- Modify Borrower reporting requirements
- Release escrows
- Release casualty or condemnation proceeds pursuant to docs

\* *Actions prohibited under REMIC regime, regardless of language in the underlying documents.*

\*\* *Actions permissible under REMIC regime, provided specifically set forth for in the loan documents.*

\*\*\* *Actions permissible under REMIC regime, regardless of whether provided for in the loan or servicing documents or the PSA. If addressed in the loan documents, Servicers will generally follow the loan documents when deciding how to act upon Borrower request.*

## PREPAYMENT AND DEFEASANCE

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CMBS bonds are generally call protected. Call protection is an attractive feature of CMBS to many bond investors and implies that the underlying CMBS loans cannot be prepaid without some form of compensating payment being made to enable investors to maintain their expected yield. Bond investors are willing to accept tighter yields on CMBS because of the call protection. This results in more aggressive pricing to Borrowers. Call protection in CMBS is achieved through either defeasance or some form of prepayment calculation.

The form of call protection unique to CMBS loans is defeasance. Defeasance is the substitution of government securities for the property collateral. A Borrower desiring to obtain a release of its property from the trust may purchase and pledge to the trust a collection of government securities that are specifically selected to generate sufficient cash to make all monthly payments due on the loan through and including any balloon payment due on the maturity date. Defeasance is not prepayment. Technically the note remains outstanding, but is repaid from cash flow from the government securities purchased rather than through cash flow generated by a property. The property is released to the Borrower free from the mortgage lien. In an interest rate environment higher than the loan coupon, a Borrower may even be able to defease its loan at a discounted price (less than par). A Borrower will incur out-of-pocket costs if its loan is defeased for legal, accounting and rating agency fees. Defeasance is prohibited for at least the first two years following securitization due to REMIC prohibitions on substitution of collateral.

Prepayments differ from defeasance in that the note is actually paid off and removed from the trust. Prepayments are frequently accompanied by the payment of a sum of money designed to compensate investors for the loss of yield. This is often referred to as yield maintenance. Yield maintenance is a present value calculation that enables investors to reinvest the loan payoff proceeds at then current treasury yields through the original loan maturity and maintain the same yield as if the loan had not paid off early. Yield maintenance should not be viewed as a “windfall” to the trust as it only allows investors to maintain their expected yield on the bond classes. The amount of yield maintenance at any point in time depends on the level of current treasury yields relative to the loan coupon. The lower treasury rates are relative to the loan coupon, the greater the yield maintenance amount. Prepayments at par are frequently allowed in many CMBS loans near the end of the loan term, commonly the last 3-6 months. More flexible prepayment terms are, however, available on floating rate CMBS than on fixed rate CMBS.

Each Borrower should carefully consider whether prepayment or defeasance is its right course of action, especially considering the potential fees involved. In certain higher interest rate environments, defeasance may provide a less expensive option for the Borrower to release the property from the trust. The out-of-pocket costs associated with defeasance, however, may make defeasance a more costly alternative for smaller loans or in a stable to lower interest rate environment.

## THANK YOU

On behalf of the Commercial Mortgage Securities Association (“CMSA”) and the Mortgage Bankers Association (“MBA”), we collectively want to thank you for investing the time to learn more about Commercial Mortgage Backed Securities (“CMBS”). The industry has brought substantial liquidity to the real estate market over the past 15 years and it is through Borrowers’ increased knowledge, awareness and ultimate input that we can make the industry more effective and efficient for all. We welcome your feedback and encourage you to continue to look for new products and take advantage of education seminars produced by the CMSA’s Education/Research Committee ([www.cmbs.org](http://www.cmbs.org)) and MBA’s CampusMBA ([www.campusmba.org](http://www.campusmba.org)). To find specific information on CMSA events such as the CMBS Investors Conference and Annual Convention visit [www.cmbs.org/events](http://www.cmbs.org/events). To find specific information on MBA’s CREF/Multifamily Housing Convention & Expo, Asset Administration and Technology Conference and Commercial/Multifamily Regional Servicing Forums visit [www.mortgagebankers.org/conferences](http://www.mortgagebankers.org/conferences).





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