

Global CMBS Newsletter

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EXTENSIONS WITHIN CMBS

The word “extension” is becoming as taboo as the word “prepayment” was when the CMBS industry first started. Prepayments were limited to liquidations resulting from defaulted loans because the lock-out and prepayment penalty/defeasance provisions were sufficient to prevent performing loans from early prepayment. Today, extension gives rise to a host of other questions and has the potential to polarize allegiances within the CMBS transaction. First, a clarification must be given when it comes to the Scheduled Final Maturity compared to the Final Rated Maturity in terms of extensions and ratings. Second, we reflect on the credit of the loans that is driving extensions and the impact those extensions could have on the ratings.

Scheduled Final Maturity or Principal Window versus the Final Rated Maturity

The assumptions used in setting the Principal Window or Scheduled Final Maturity of the CMBS bonds generally corresponds to a set of assumptions on the performance of the underlying mortgages. The following are some of those basic assumptions:

- i. no losses on the underlying mortgage loans;
- ii. no extension of maturity dates of mortgage loans that do not have “anticipated repayment dates”;
- iii. payment in full on the anticipated repayment date or stated maturity date of each mortgage loan having an anticipated repayment date or stated maturity date; and
- iv. a 0% CPR.

It literally does not get better than this....

Scheduled Final Maturity and Principal Window are specifically defined in the Prospectus Supplement designed to market the various classes of certificates. Disclosures related to the Scheduled Final Maturity or Principal Window go so far as to state that the scheduled final distribution date may be earlier or later than stated, and in some cases, substantially earlier or later.

The ratings are based on timely payments of interest and ultimate payments of principal by the Final Rated Maturity date, which can be as short as two years beyond maturity, or as long as three years beyond the longest amortization period of the mortgage loan or the amortization period of an anticipated repayment date (ARD) loan. Therefore, the ratings are not swayed by an extension past the Scheduled Final Maturity; in fact, DBRS’s ratings do not even take the issuer’s estimate of Scheduled Final Maturity into account.

That said, we do look at the refinance profile of each asset as it approaches maturity when maintaining the ratings. Repayment of the five or seven year classes within this Principal Window as outlined in the Prospectus is dependent upon the assumptions (i) to (iv) above for a specific group of loans maturing within those windows. The AAA ratings do not reflect the likelihood of repayment within the Principal Window. The ratings simply address the likelihood of full principal repayment prior to the Final Rated Maturity.

We do expect extensions to be common in 2009, with over \$49.1 billion of fixed and floating rate CMBS loans maturing this year (source: Wachovia). Whether these extensions simply push the refinance problem out into the future, further compounding the issue with the 2010 maturities, or actually buy the borrowers enough time to de-lever their assets and find a take-out capital source is difficult to assess and we cannot answer that question. However, what you have today is an unprecedented tightening in the credit markets which has left financing difficult to obtain, let alone at leverage levels of loans originated in the past five years. The market also has a scarcity of buyers because of the falling values and fear that tomorrow’s value will be significantly discounted from the value assigned today.

By having a Final Rated Maturity that is well into the future, the CMBS structure allows servicers to be able to take a more patient, longer-term approach in order to weather periods of illiquidity versus holding fire sales on performing assets. DBRS's CMBS ratings methodology recognizes reversionary dynamics of the market. And as much as our model anticipated a reversion to historical mean in capitalization rates and loan spreads, it also accounts for the fact that this period of illiquidity will not last forever. At some point, be it two, three or five years from now, the market for commercial real estate will return. Equity will be available for the four major asset classes at yields of 8% to 10% and leverage will be available with a debt yield in excess of 11%.

In this way, the CMBS structure helps borrowers faced with refinancing in today's market and helps to maintain ratings. However, extensions of maturity date alone, without a considerable amount of capital infusion or amortization, will not be able to fix the highly levered, low debt service coverage ratio, interest-only loans (i.e., those loans that cannot meet mean reversionary debt parameters). Those loans will remain candidates for disproportionate losses; and thus CMBS transactions with exposure to those loans will experience a higher incidence of negative rating actions.

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