

Methodology

*Commercial Mortgage Servicer
Evaluations*

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Insight beyond the rating.

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Introduction

In the commercial mortgage-backed securities (CMBS) market, servicers function in various capacities, including as master, primary or special servicers. Generally, in terms of servicing functions, a master servicer is responsible for oversight of the trust assets and reporting. A primary servicer has direct contact with the obligors, is responsible for the day-to-day administration of the trust's assets and payments and may share some responsibilities with a master servicer. A special servicer oversees the workout of distressed or seriously delinquent assets as explicitly designated in the transaction's legal documents. A single company may perform all three servicing roles within a transaction or the roles may be divided among multiple servicers.

Master servicers or, in some cases, the sole servicer performs an advancing function to ensure investors are paid interest on a timely basis when transactions are subject to obligors' delinquencies. Servicing may be performed by third-party servicers or the seller of the assets may retain servicing rights when the assets are sold to the trust. In the latter case, the seller of the assets continues to service the assets over the life of the transaction.

When rating a CMBS transaction, the capacity of the servicer is a key analytical consideration because servicing quality affects the performance of the trust assets from a delinquency, default and recovery perspective and, consequently, affects the ultimate repayment of rated securities. Because of the importance of the servicing role, DBRS performs regular on-site servicer reviews to gain full understanding of the company's operational capabilities from a servicing perspective.

Prior to beginning a CMBS servicer evaluation, DBRS submits a list of the topics covered in an evaluation and requests such documentation as policies and procedures, organizational charts and employee resumés or biographies. DBRS then meets with the servicer in its office to obtain a better understanding of staffing structure, management and technology deployment. The on-site review and overall evaluation focus on the eight primary criteria outlined below. Depending on the servicing role – primary, master or special – some areas will receive more or less attention.

DBRS performs evaluations of companies that service loans in CMBS transactions it rates. The results of the evaluations are used internally in DBRS's initial rating of a CMBS transaction as well as in its ongoing surveillance. Commercial mortgage servicers can engage DBRS to perform a public servicer evaluation. In these instances, the results of the evaluations are announced via a press release, and a servicer evaluation report is provided to the servicer and published on the DBRS website.



Servicer Evaluation

A DBRS servicer evaluation is a risk assessment of the ongoing operations of a loan servicer, which incorporates a review of the following eight primary criteria:

- Company structure and management experience.
- Asset administration, reporting and customer service.
- Loss management.
- Technology and systems.
- Financial condition and outlook.
- Staff and training.
- Procedures and controls.
- Outsourcing, offshoring and vendor arrangements.

Based on the results of the review, DBRS will assign the servicer's operation an evaluation of Superior, Good, Adequate or Weak. This report describes the roles of a servicer in a CMBS transaction, supplies DBRS's rationale for providing servicer evaluations to capital market participants, sets forth DBRS's servicer evaluation descriptions and elaborates on the components of the eight criteria highlighted above.

Roles of Servicers in CMBS

The servicer functions as a conduit between the obligors and investors; therefore, the quality of the servicer's capabilities is a key analytical consideration when assigning ratings to structured finance securities. A servicer protects the investors' interest in the securitized collateral and is a third party that can be relied on to make decisions on behalf of the noteholders.

PRIMARY SERVICER

The primary servicer is the main contact for the borrower and is responsible for administering the borrower's loan payments and enforcing the loan documents, including loan covenants and triggers. Whether the loans are sold into a trust or owned by the originators should not make any difference to the borrowers. The obligation of the servicer to respond to borrower requests such as loan balance inquiries, payoff requests, reserve disbursements, tax payments or escrow analysis remains the same, regardless of asset ownership. The primary servicer administers escrow accounts, among other things. As the main contact for the borrower, the primary servicer collects and applies payments and enforces reporting requirements. The primary servicer also administers escrow accounts, performs loan accounting and is generally responsible for property inspections and operating statement analysis. The primary servicer is often the first to identify potential loan performance problems. Therefore, a proactive primary servicer can help mitigate losses in a CMBS transaction. In all of its duties, the primary servicer is required to adhere to the standards set out in the servicing agreement to enforce the terms of the loan agreement with the borrower.

MASTER SERVICER

In CMBS transactions, the assets are pledged to the trust and the trustee and are generally administered by a master servicer on behalf of the investors. Accordingly, the master servicer may be called upon to maintain and enforce the trust's security interest in the assets. In doing so, the master servicer is contractually bound to operate within an agreed-upon servicing standard that stipulates it will service the loans in accordance with the pooling and servicing agreement and according to the same standard as other prudent lenders or as if it were servicing the assets for its own portfolio.



Another role of the master servicer is to track the performance of the asset pool and communicate its findings to the trustee, rating agencies and, ultimately, the investors. Information on payments that the servicer receives is accounted for in aggregate, disseminated to the trustees and ultimately published in the monthly investor reporting package and remittance reports. In addition to reporting on the aggregate flow of funds, CMBS master servicers report specific performance metrics such as delinquencies, defaults and losses; portfolio stratifications; individual loan details; and (property) financial statements. Servicers must also ensure the trust is compliant with ongoing regulatory changes, such as Regulation AB in the United States.

SPECIAL SERVICER

Although primary and master servicers play important roles, the main responsibility for risk management in CMBS transactions lies with the special servicer. The special servicer is named to the trust specifically to handle the workouts, resolution and disposition of defaulted loans. The special servicer contacts delinquent borrowers to establish payment plans to bring them current. At the same time, the special servicer often pursues foreclosure and other workout alternatives such as forbearance and modifications with the ultimate goal of minimizing losses to the trust. The special servicer works for all bondholders, but it is appointed by the holder of the controlling class, typically, the first-loss class. Therefore, special servicers are also subject to the servicing standard referenced above and must consider the positions of all bondholders when devising a workout strategy for each asset.

DBRS Rationale for CMBS Servicer Evaluations

Servicer evaluations provide a consistent measure for comparison by capital market participants. Specifically, servicer evaluations allow for cross-company comparisons as the criteria considered within the evaluations is from established industry benchmarks and best practices. Since the servicer is the only party that has regular interaction with the obligors of the pledged assets, the trustee, rating agencies and investors, among other parties, rely on the servicer's judgment, actions and accuracy in the receiving and reporting of data, which has an impact on the ultimate repayment of the rated debt.

Under a standardized approach, servicers can be directly compared through servicer evaluations that measure their respective servicing competence. DBRS has published defined criteria that are industry specific and publicly available at www.dbrs.com. To the extent possible, industry benchmarks are highlighted and each servicer's process is measured against those benchmarks. Each criterion is weighted based on its importance within the given sector. It is possible, based on the weighting of the criteria, that a servicer with business across multiple sectors or asset types could have different evaluations for each product type or sector.

As a result, a positive servicer evaluation in one sector does not necessarily mean that a servicer is qualified to enter into new business lines or service assets in other sectors. A servicer evaluation highlights a servicer's strengths, weaknesses and mitigants regarding the various servicing roles it plays within CMBS. Compared with full-service companies, scalability and staffing constraints may exist for a servicer with limited service offerings. DBRS reviews a servicer by product/asset type before an evaluation is assigned. Servicer evaluations can be changed or discontinued at any time if there is performance deterioration or improvement in the areas of evaluation outlined below.

DBRS monitors each evaluated servicer through regular on-site review meetings and discussions with management, in addition to ongoing surveillance activities in each of our structured finance surveillance groups.



Areas of Evaluation

As noted in the Servicer Evaluation section of this report, servicers are evaluated based on eight primary criteria. Each criterion is regularly reviewed and compared with the important items for that sector or asset type. DBRS refines its evaluation criteria periodically and publishes the updates.

COMPANY STRUCTURE AND MANAGEMENT EXPERIENCE

Company structure and management experience are essentially the core of servicing. As a result, DBRS seeks to evaluate the degree to which management has the experience, talent and well-conceived plans to deliver profitable returns. Furthermore, this criterion highlights management's capability in dealing with various market conditions and competitive forces in a dynamic environment.

DBRS considers the history and ownership of the company and reviews its recent accomplishments and planned initiatives. The overall servicing performance of the company over the past few years is reviewed. For example, the servicer's participation in industry initiatives and committees is assessed as a way of determining how engaged it is in the development of industry best practices. Additionally, the company's servicing portfolio statistics and stratifications are reviewed for changes or performance trends. It is important to explore significant movement in these areas as they can be important indicators of operational stress.

DBRS assesses the strength of the management team by reviewing the length of time it has worked together, including tenure with the company and experience with other servicing companies. Management teams with broad experience across all aspects of the servicing business, such as servicing acquisitions and transfers and default management, are well prepared to service commercial mortgage loans throughout all cycles of the commercial real estate market.

As part of its commercial mortgage servicer review, DBRS looks at the structure of the group. For instance, is the group organized by function, by portfolio or by a hybrid of the two? While any of the structures can be successful, each has unique management and quality control challenges.

ASSET ADMINISTRATION, REPORTING AND CUSTOMER SERVICE

Satisfactory quality control, asset administration and compliance within regulatory guidelines; response to investor and borrower requests; and acceptable industry practices are highly related and all contribute to good servicing performance. This area of servicing is tangible and quantifiable when benchmarked against regulatory guidelines and industry practices.

DBRS reviews servicing processes and controls throughout the life of the loan from new loan boarding through loan payoff and release. As part of its assessment, DBRS looks at the balance between automation and manual processing, including the controls in place, in order to gauge the efficiency of the servicer.

Areas addressed in this section of the evaluation include the following:

- New loan boarding.
- Payment processing.
- Customer service.
- Escrow management, including tax, insurance and reserves.
- Investor reporting.
- Cash management and lock-box administration.
- Loan surveillance, including document covenant/trigger compliance.
- Asset management, including assumptions, lease approvals and other borrower requests.
- Financial statement analysis and reporting.
- Property inspections.
- Loan payoff and release.



Some of these areas can be considered high-volume, process-oriented tasks (e.g., new loan boarding and payment processing), while others (e.g., asset management and covenant compliance) require a higher degree of credit analysis and, therefore, need to be staffed with employees with commercial real estate experience. When possible, DBRS attempts to quantify servicing performance and compare it with industry benchmarks. Areas where DBRS looks at servicing performance measures include the following:

- Time to board new loans to the servicing system.
- Percentage of lock-box rejects and the average time to reconcile.
- Amount of real estate tax penalties as a percentage of taxes paid.
- Timeliness of investor reporting.
- Percentage of annual financial statements collected.
- Time from financial statement collection to reporting.

These quantifiable measures are combined with qualitative review factors in DBRS's servicer evaluations.

LOSS MANAGEMENT

Loss management is not limited to the special servicer of the transaction. As the borrower's primary contact, servicers are on the front line when it comes to detecting loan performance issues. DBRS prefers that servicers have procedures in place that are designed to prevent and address potential areas of weakness within a serviced portfolio. The procedures a servicer follows to monitor the portfolio, provide optimal solutions and mitigate loss severity are considered at every level of servicing.

DBRS considers the role played by CMBS primary and/or master servicers in loss management in terms of detecting the early warning signs of a loan in trouble. A servicer's portfolio surveillance practice, including the administration of its loan watchlist, is a key component of loss management. Proactive servicers maintain a solid line of communication with the special servicers (whether internal or external) and keep them informed of potential problem loans as early detection often leads to lower loan losses or more amicable solutions.

Successful CMBS special servicers are expected to maintain experienced staff trained in all aspects of default management, resolution and commercial real estate management and disposition. Credit decisions made by committee or according to an established delegation of authority lead to stronger plans of action. Standardized asset status reports and business plans provide consistent investor reporting while maintaining quality control. Additionally, DBRS analysts review the servicer's disposition results in order to see how they compare with published industry averages.

Special servicers often rely on third parties with specialized expertise, such as attorneys, receivers, appraisers, commercial real estate brokers and property managers. Therefore, prudent servicers develop strong relationships with third-party vendors and maintain stringent vendor management and approval processes.

TECHNOLOGY AND SYSTEMS

It is unlikely that any company in the business of servicing can operate without the assistance of modern technology. However, DBRS believes it is more important, especially for large business volume and various product types, to possess sufficient and useful technology and employ it effectively than to simply have the most advanced technology.

It is critical that the systems be supported by the company. System support should include, but not be limited to, dedicated information technology (IT) resources responsible for continual systems evaluation and product enhancement to respond to industry reporting needs or to gain efficiency. In addition, the company should perform regular full-system backups and maintain comprehensive disaster-recovery and business-continuity plans that are tested on a scheduled basis.



DBRS requests the servicer provide demonstrations of key systems during the on-site review. System functionality and the degree of completeness of the technology used by the servicer are considered part of the overall servicer evaluation. For example, are individual systems (loan servicing, data warehousing, general ledger, imaging, etc.) integrated? Can the system handle all the functionality required by the servicer or are certain functions handled outside the system? DBRS prefers to see as few processes as possible handled manually outside the system of record.

FINANCIAL CONDITION AND OUTLOOK

The goal of assessing the financial condition of a servicer is to measure its earnings in terms of adequacy, quality, sustainability, predictability and diversity. DBRS analysts perform a medium- to long-term assessment of a company's ability to survive during a severe market downturn or to take advantage of market opportunities such as acquisitions. Support from a corporate parent is also assessed under this criterion because it will affect the availability of financial resources. Financial condition is especially important when evaluating master servicers, which are responsible for the advancing function in CMBS.

DBRS considers the pricing structure of servicing and the viability of the servicing platform as a stand-alone business. Review of the company's recent financial statements can provide a good indication of the viability of the servicing portfolio, but DBRS also explores the future funding needs of the business. The company's ability to provide service during periods of stress and its plan to manage servicing portfolio runoff or growth is an important part of DBRS's financial assessment.

STAFFING AND TRAINING

DBRS provides a medium- to long-term assessment of a company's ability to compete in the marketplace in terms of its talent pool and development. DBRS believes that providing employees with updated and relevant training, knowledge and career planning generally contributes to higher productivity and hence better servicing results. Consequently, DBRS reviews the servicer's recent past training programs in terms of content, volume (number of courses) and employee participation (average hours per employee per year), both for new hires and existing staff. Well-rounded training programs provide a mix of commercial real estate, technology and soft skills, such as time management or public speaking. Servicers that have a manager responsible for training initiatives are viewed favorably.

The experience and tenure of the servicer's management and staff are also key considerations. DBRS collects staffing data from the servicer and compares it with the data collected from other servicers. A servicer that maintains a management team made up of highly experienced and tenured individuals (compared with the levels of its peers) generally experiences operating efficiencies that are gained when people work together over a longer period of time. The level of experience of servicing staff, while important, can differ among servicers because of variations in organizational structures. For example, companies that employ a functional servicing model (as opposed to an all-inclusive model) would generally be expected to employ a larger servicing staff of less experienced employees.

PROCEDURES AND CONTROLS

DBRS considers properly documented policies and procedures an important factor in ensuring a consistent quality of servicing. The content, timeliness, usefulness and accessibility of documentation related to policies and procedures can provide employees with operating guidelines and reduce uncertainty and errors in the event of high staff turnover or the departure of key persons. This is especially true if the policies and procedures provide step-by-step instructions for servicing tasks.

DBRS reviews the company's policies and procedures manual to ensure that daily processes are documented and the servicer has a way to monitor adherence to the procedures stated therein. Quality control programs, including approval requirements, delegations of authority and management reports, such as key indicator reports, are also assessed. Servicers that measure servicing performance against established benchmarks demonstrate dedication to process improvements and are viewed favorably by DBRS.



Finally, DBRS expects servicers to participate in regularly scheduled audits, both internal and external, such as a Uniform Single Attestation Program (USAP) or Regulation AB audit. As part of the servicer evaluation, DBRS requests to review the servicer's latest audits, including findings and management's response. It is expected that the servicer will address any deficiencies discovered during the audit process in a timely manner.

OUTSOURCING, OFFSHORING AND VENDOR ARRANGEMENTS

DBRS believes it can be prudent to outsource or offshore servicing functions, such as escrow reviews, financial statement spreading and rent roll reviews, as part of peak volume management to handle the work overflow. Outsourcing and offshoring arrangements are reviewed carefully by DBRS to determine if proper supervision is maintained. DBRS prefers that all of these arrangements be extensively documented in the company's procedures and controls, with a backup plan in place should the outsourcer lose its ability to operate.



Appendix 1: Evaluation Definitions

SUPERIOR

A servicer evaluation of Superior indicates that a servicer has exhibited a thorough understanding of the eight servicing criteria, in addition to being assessed as Superior in the implementation and execution of all the facets of servicing. These servicers may be characterized as companies that have seasoned servicing professionals who have the capacity to handle peaks in workflow and who exhibit market leadership and experience through economic and credit cycles.

GOOD

A servicer evaluation of Good indicates that a servicer has exhibited a comprehensive understanding of the eight servicing criteria and received a positive assessment in most areas of servicing, but could benefit from improvement in some less critical areas or could gain from additional experience. Servicers in this category may have experience in servicing similar assets outside of securitization and are entering securitization servicing as an expansion of current business lines.

ADEQUATE

A servicer evaluation of Adequate indicates that a servicer has exhibited a full understanding of the eight criteria reviewed by DBRS, but it lacks a certain level of experience and consistency in implementation. These servicers may not have substantial volume to demonstrate their ability in execution or may be entering securitization servicing as a new line of business.

WEAK

A servicer evaluation of Weak indicates that a servicer has fallen short in one or more of the eight criteria, either through not exhibiting any of the benchmarked traits or through a lack of understanding of how to implement them correctly. A servicer with a Weak evaluation may have limited functions within the servicing agreements, and its ability to expand the services offered without further development is considered constrained.

Appendix 2: Servicer Evaluation Request

As part of the servicer evaluation process, DBRS submits a servicer evaluation request to the servicer to be completed prior to the on-site meeting. The current version of the servicer evaluation request can be accessed at the link below.

- [DBRS Primary/Master/Special Servicer Documentation Request](#)

Appendix 3: Related DBRS Servicer Evaluation Methodology

- *Canadian Residential Mortgage Servicer Evaluation: DBRS's Approach*
- *DBRS Structured Finance Servicer Evaluations*

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