

Methodology

*CMBS North American Surveillance*

MAY 2011



*Insight beyond the rating.*

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# CMBS Surveillance

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## Introduction

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Commercial mortgage-backed securities (CMBS) transactions are dynamic. A variety of events can affect the collateral of a CMBS pool and the cash flow necessary to ensure timely and ultimate payment of CMBS bonds. During the life of a transaction, loans go delinquent, take losses, defease or prepay; tenants vacate; markets improve or soften; property values increase or decrease, to name only a few things that can change. When initially establishing a rating, DBRS assumes that changes in the performance of the underlying loans can and do occur; therefore, it assigns ratings designed to withstand a certain level of volatility within the underlying commercial mortgage loans. Surveillance is critical to measuring and communicating to the investment community whether or not a change has the potential of affecting the ratings assigned to the bonds. The magnitude of the changes that occur with each loan and the loan's relation to the other loans in a transaction can determine whether or not a rating action is necessary.

This methodology details DBRS's surveillance procedures as they relate to all CMBS rated by DBRS (inclusive of public ratings, private ratings and CMBS collateral contributed to asset-backed commercial paper (ABCP) and collateralized debt obligations (CDOs)) and describes the analysis taken to arrive at any rating actions arising from the surveillance. This methodology will give the reader greater transparency into the DBRS CMBS rating philosophy. DBRS expects its ratings to hold throughout a cycle; however, DBRS is committed to performing surveillance and releasing performance update reports at a level that increases the transparency of its ratings.

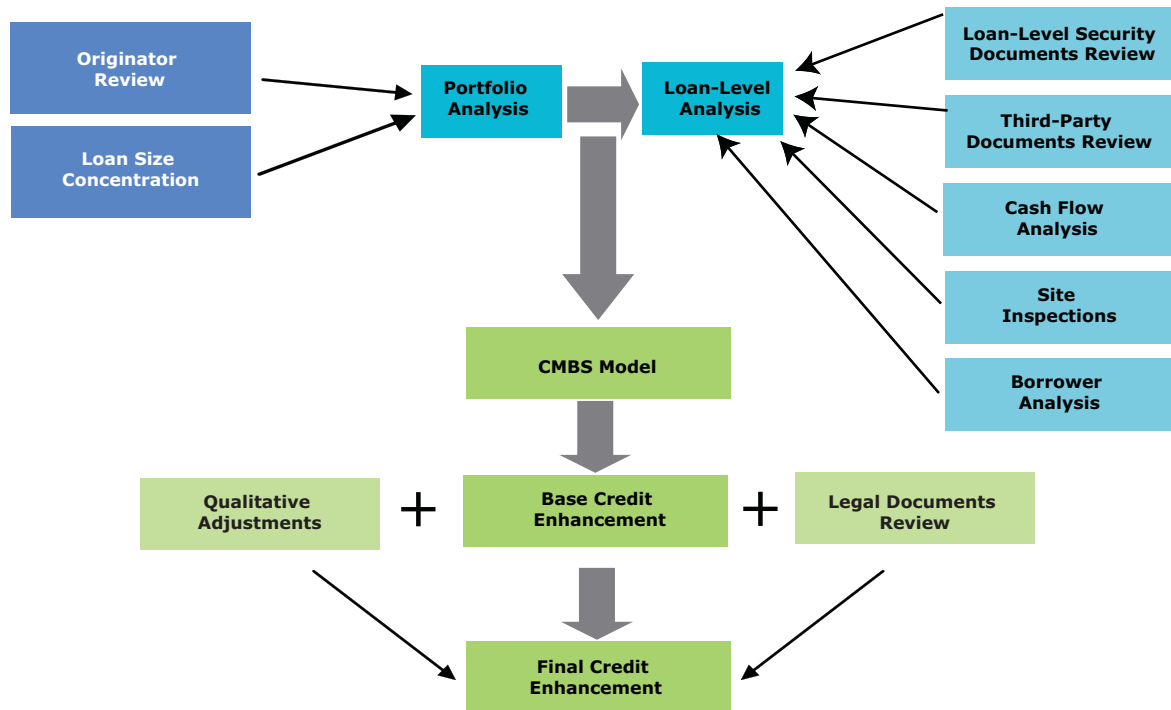
### APPLICATION OF CMBS SURVEILLANCE METHODOLOGY

The following diagram describes the overall process to analyze a CMBS Surveillance transaction:

- (1) DBRS will conduct loan and property level analysis.
- (2) DBRS will use the results from the portfolio and loan level analysis as inputs into the CMBS model. The resulting number will provide the base credit enhancement.
- (3) A review of the legal documents that govern the transaction is undertaken and consideration of any qualitative factors is made.
- (4) The final credit enhancement levels are compared to a liquidation scenario and a final rating action is determined.



### DBRS Rating Process for CMBS Transactions



The CMBS Model is a substantial component of the DBRS rating process. A material deviation from the rating implied by the CMBS Model would be a three-notch rating difference. The quantitative and qualitative factors that could result in a material deviation are included in this methodology.



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## Rating Actions

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A number of steps must occur before DBRS changes the rating of a transaction. Each month, all DBRS-rated CMBS transactions are reviewed for statistical changes and cumulative credit evolution. Following the monthly review of the portfolio, a full review process is initiated on a transaction when there are significant changes in the collateral. If no significant changes in collateral have occurred, DBRS aims to conduct an annual in-depth review of all its rated transactions.

The loans belonging to the pool are analyzed by the surveillance analysts. Due to concentrations within CMBS transactions, DBRS considers the cumulative impact on small loans as well as the changing credit dynamics on large loans. Each of the ten largest loans and the pool's troubled loans are subject to an in-depth review. Troubled loans are identified as those that are delinquent or those assigned to the DBRS HotList (loans that are perceived by DBRS to have a higher likelihood of default). The pool is then re-modeled to account for all changes to its collateral and financial performance.

During the review process, changes to the ratings may be recommended. There are four types of rating actions that can be taken following the review of a transaction: upgrade, downgrade, confirmation and interest in arrears. On occasion, there will be classes of CMBS where interest payments are in arrears but the cumulative or ongoing shortfall is expected to be ultimately recoverable or paid. When the interest shortfall is a question of timing in the shorter term and not of ultimate payment, DBRS notes this with the Interest in Arrears rating action for the class affected. In addition, ratings can be placed Under Review with Negative, Positive or Developing Implications or trends can be added or changed. Classes within transactions are placed Under Review when something occurs that would change the credit makeup of a pool in one direction or the other. DBRS will typically keep a class Under Review until more information becomes available to help determine the magnitude of the action needed. A rating will typically maintain the Under Review status for only a short period of time as information gaps are often waiting to be filled by the servicer. CMBS uses trends of Positive, Negative and Stable to indicate a change in the credit dynamics of the pool that are not significant enough to warrant a rating action. For example, there may be a number of loans performing with poor financial performance yet remain current. This situation may not be sufficient in and of itself to sway the model, but real estate cash flows can change rapidly. It should be noted that transactions do not need to be placed Under Review or have a change in trend prior to a rating action taking place.

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## Monthly Review

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Each month, DBRS performs a review of its entire CMBS portfolio for changes. There are some changes that occur in CMBS transactions monthly for which DBRS receives advance information, such as new defeasances, loan assumptions and/or loan modifications for large assets. DBRS needs to review any changes in delinquencies when the remittance report is made available. Every month, DBRS reviews changes that occur at both the bond level and the collateral level. In some instances, these changes prompt additional steps that DBRS will take in monitoring the transaction.

Changes that directly affect the bonds and need to be addressed immediately include losses, classes paid in full and interest shortfalls to a rated class. If the portfolio is monitored monthly, none of these things should be a surprise; however, each will have different consequences as it occurs. The results of DBRS's monthly review are published in the Monthly CMBS Surveillance Report, which can be found at [www.dbrs.com](http://www.dbrs.com) under Monthly Reports.



## **BOND-LEVEL REVIEW**

### ***Losses***

Losses occur as specially serviced assets are resolved and sold from the pool. Losses erode credit enhancement. As losses occur, DBRS will review the actual loss compared with the estimated loss. If the actual loss is greater than anticipated, it may spark a detailed review of the transaction.

### ***Classes Paid in Full***

As classes are repaid in full, DBRS will retire the ratings in its ratings database and on the website. The ratings for the class will now be Discontinued – Repaid (or Not Rated – Paid in Full (NR-PIF)).

### ***Interest Shortfalls***

Interest shortfalls occur when fees accumulate from specially serviced loans or when the full monthly payment is not being advanced. If interest shortfalls occur on a rated class and are anticipated to continue for an extended period, DBRS will amend the rating action to Interest in Arrears. DBRS will at that time release a press release explaining the cause of the interest shortfall and the expected timeline that the shortfall will occur.

## **COLLATERAL-LEVEL REVIEW**

Changes that affect the collateral and ultimately the bond performance are also monitored monthly.

### ***Delinquencies and Specially Serviced Loans***

Changes in delinquencies and specially serviced loans are scrutinized. Every month, DBRS contacts the special servicer to determine any changes in the status of specially serviced loans. If new delinquencies appear, DBRS will want to know more about these loans and whether the borrower has been contacted.

### ***Prepayments and Defeasance***

Prepayments and defeasance in large part are credit positive to a CMBS transaction. For sequential-pay transactions, prepayments cause the credit enhancement to increase for the existing bonds. In addition, when a loan is defeased or when the existing mortgaged property collateral is replaced with government securities, this effectively upgrades the risk profile of the loan to or close to AAA.

### ***Watchlist Changes and Additions***

Loans move on or off servicer watchlists when a loan meets or no longer meets certain criteria identified in the CMSA Investor Reporting Package. The criteria were established to be a guideline to highlight loans that may have a higher likelihood of default. DBRS reviews each loan and the servicer commentary on the watchlist monthly to try to understand the situation. Some loans have concerns that can be mitigated with external research and others are legitimate concerns that may result in an in-depth review.

### ***Debt Service Coverage Ratios and Loan-to-Value Ratios***

DBRS also looks at the financial reporting of a transaction monthly. If DBRS is awaiting financials to complete a deal review or if financials reveal large variances (both positive and negative), it may prompt more investigation. This is done through monitoring weighted-average debt service coverage ratios (DSCRs) and DSCR stratifications. Loan-to-value ratios (LTVs) should continue to decline as loans amortize. Therefore, huge variances in LTV are typically not observed, but DBRS will investigate to the extent it occurs.

After all of the bond and collateral reviews are completed, the portfolio is assessed and performance update reports and deal reviews are completed as necessary.



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## Rating Agency Confirmations

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As mentioned earlier, the loans securing the CMBS transactions have proven to be very dynamic. A Rating Agency Confirmation (RAC) is often requested when there is a material change in a pool's assets or in the transaction's participants. The RAC is a review undertaken by the rating agency to ensure that such changes do not affect the creditworthiness of the pool as a whole.

RAC requests reflect changes that occur at both the trust and the loan levels, such as substitution of the special or master servicer; changes to material legal documents; additional indebtedness; loan assumptions; defeasance, collateral substitution, re-lease or redevelopment; property management changes; and changes in franchise affiliations (flags) of hotel properties. DBRS believes that ratings initially assigned to CMBS must reflect the possibility of changes in collateral that may be allowed for in the borrower's loan documents and of which DBRS will receive notification. Each type of RAC request requires a specific methodology to determine whether or not the change would in and of itself cause a downgrade to the trust.

RACs are generally limited to "significant" loans as defined by an individual transaction's legal documents. This most commonly refers to the loans that are greater than 5% of the trust and/or \$20 million or more.

Upon receipt of a loan assumption or modification RAC request, DBRS considers whether the change weakens, strengthens or is neutral to the subject collateral, the property management, the borrower, the guarantee on the loan and/or the financial viability of the loan. In addition, all legal documents attached to the request must be sound as must the case memo provided by the servicer or special servicer.

An RAC request satisfactory to the rating agency will result in the issuance of a no-downgrade letter to the master servicer, stating that the change will not, in and of itself, result in a downgrade, withdrawal or qualification to the ratings of the certificates. In this way, the RAC provides a check against the variety of changes that affect a pool's underlying assets and/or a guarantee that the current bond ratings remain relevant. Generally, DBRS finds that the credit work presented by the servicers is thorough since the servicer is also working for the benefit of all bondholders when consenting to these requests.

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## Detailed Analysis

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### **BOND-LEVEL SURVEILLANCE**

DBRS considers things such as interest shortfalls, class repayment, losses and general credit enhancement at each rating category. Part of the monthly review is to look for and assess interest shortfalls and losses that occur each month. Interest shortfalls, if not repaid, will be an embedded loss to the lowest outstanding class of bonds. Any type of loss will erode credit support to the rated securities. DBRS also looks at current losses and projected losses from the specially serviced loans. The resulting credit enhancement will need to be compared with a model that has the most recent annual financial performance of the remaining collateral. Bond-level surveillance in its true sense cannot be done without the full review of the collateral.

### **COLLATERAL (LOAN-LEVEL) SURVEILLANCE**

Collateral surveillance includes loan-level surveillance and modeling. Focus is on property analytics, with a review of the property's rent roll, operating statements and servicer site inspections. Cash flow is further analyzed by scrutinizing revenue and expenses and looking at voluntary versus involuntary expenses. Each property is assigned a cash flow, which may be subject to DBRS re-underwriting or a general haircut, depending on how fresh the numbers are and the confidence level of the servicer. During the loan-level review process, DBRS develops a HotList.



### ***HotList***

DBRS performance update reports identify which loans DBRS considers to be HotList loans. The HotList loans are perceived by DBRS to have a higher likelihood of mid-term and/or balloon default or simply a period of time when tenant bankruptcy or property or occupancy issues may cause uncertainty for cash flow. DBRS will explain why the loans are on the list, commenting on the challenges and potential upside of each. Investors will be able to use the DBRS HotList as a supplement to the servicer watchlist in order to easily identify which loans have potential credit issues and may affect the overall performance of the transaction. When DBRS identifies a loan that is likely to experience a cash flow stress event, it is added to the HotList. Structural features such as reserves or cash trap events could mitigate these risks and keep the loan from appearing on DBRS's HotList.

Throughout the life of the transaction, DBRS will review the loans initially placed on the HotList, monitor their performance and identify additional loans to be added or removed. DBRS will add loans as credit issues arise and remove loans that are no longer a concern or have strong mitigating factors. The criteria that would indicate a higher risk of default within the term or at maturity are identified in Appendix A.

### ***Term Risk***

At issuance, DBRS identifies loans that are potential HotList candidates due to perceived risks of default within the term. These loans are then added to the HotList and monitored until the potential issue is remedied. Other loans that were not identified at issuance but have given reason for concern after issuance are also tracked by DBRS and added to the HotList if warranted.

### ***Balloon Risk***

It is important to monitor liquidity near a loan's maturity date because its severity of loss could be greatly affected if it cannot be refinanced. At any given time, the availability of capital will differ based on property type and a property's location. Balloon defaults and extensions may occur more often if there is a lack of lenders in the area. Loans that do default are likely to have greater losses because there are fewer participants in less-efficient markets. As the loan's maturity date nears, DBRS will adjust refinance constants based on what is available at the time in the market. If current market constants are higher than what the loan is currently paying, the loan could have difficulty refinancing. Loans that may have a higher propensity to default at balloon include loans with a refinance DSCR below 1.0 times (x), loans with large lease expirations prior to the maturity or shortly thereafter, interest-only loans and loans with lower DSCRs secured by properties located in rural and tertiary markets.

### ***Extension Risk***

Expanding upon balloon risk, DBRS will also assess the loans that may cause bonds to extend. This differs from balloon risk in that there are certain loans that need to refinance in order for bonds to be repaid. For example, with many interest-only loans in pools from recent vintages, five-year AAA bonds do not receive enough scheduled principal from amortization in order to pay off at the expected maturity. Therefore, reliance upon certain loans with shorter terms to meet its maturity date becomes increasingly important. DBRS identifies these loans at the outset of each transaction. As the bonds season closer to the expected maturity, DBRS will address the extension risk in relation to its balloon risk in its annual review.

## **PROPERTY TYPES REVIEW**

When analyzing the dynamics of each loan, one must consider the property that secures it and the nuances associated with each property type. Because of the terms of their leases, some properties are viewed as more stable than others. For example, an office building with five- to ten-year leases is going to have more predictable revenue than a hotel that rents rooms daily. While a hotel may have a more volatile cash flow, it can adjust more rapidly for market rate increases and decreases. For this reason, we highlight some of the credit concerns that our analysts are reviewing when doing analysis of the loans within a CMBS transaction. Superior locations will clearly help a property perform even in soft markets. In addition to the location of the asset and market conditions, there are several unique attributes to each property type that DBRS considers.



### *Office*

- Above-market leases that roll within the term or shortly after loan maturity.
- Tenant improvement and leasing commission (TI/LC) reserves sufficient for re-leasing.
- Master leasing.
- Location.

### *Industrial*

- Functionality and clear height, including specialized improvements, loading facilities and truck turn-around radius.
- Leases rolling within the term and relation to market.
- Office build-out and flex space.
- Location.

### *Retail*

- Sales of the anchor tenants and in-line space.
- Co-tenancy clauses.
- Competition in the market from major discounters.
- Location in relation to residential and high-traffic nodes.

### *Multi-Family*

- Concessions offered at the property.
- Affordability of housing in immediate area and replacement costs.
- Employment diversity and trends in the area.
- Location.

Other property types that are often in CMBS transactions include manufactured housing communities (MHC), hotels, self-storage units and even some health-care and retirement communities. These are all considered individually as performance can fluctuate if the property has seasonality issues or high tenant turnover.

## **MODEL AND RECOMMENDATIONS**

After all the analysis is complete, we run the model, compare it with the model at issuance and the current credit enhancement of each of the classes within the transaction.



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## Appendix A: Challenges and Mitigating Factors for DBRS HotList Loans

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### HOTLIST LOAN EXAMPLE 1

Loan with a term debt service coverage ratio (DSCR) at or below 1.0 times (x) at issuance and/or thereafter.

#### *Performance Challenges*

- Any hiccup in cash flow could cause a loan with a low DSCR to default.

#### *Mitigating Factors*

- A stabilized increase in cash flow mitigates low coverage. If historical financials are available, DBRS will examine revenue growth or contraction and any changes in voluntary and involuntary expenses. If revenue appears to be stable with a primary increase in voluntary expenses, the loan is less likely to default than an asset operating at similar coverage with declining revenue and an increase in involuntary expenses.

### HOTLIST LOAN EXAMPLE 2

Management-intensive property viewed as an operating business rather than a real estate asset.

#### *Performance Challenges*

- These assets tend to have a potential for higher cash flow volatility. The properties are subject to additional risk given a liquidation scenario, considering a substantial decline in value due to the value assigned to the going concern of the operating company rather than the real estate.

#### *Mitigating Factors*

- Proven, ongoing, stable performance able to weather market cycles.
- Experienced operator and/or manager.
- Short amortization schedules.

### HOTLIST LOAN EXAMPLE 3

Multi-tenant property with concentrated rollover during the term.

#### *Performance Challenges*

- Considerable downtime between leases is likely to significantly alter the cash flow of the property and its ability to service the debt when not offset by accumulating reserves. This is a greater concern in office properties where there is lease rollover with limited expense recaptures.

#### *Mitigating Factors*

- Reserves for lease renewal or lease-up of vacated space at comparable rents allowing for concessions and free rent.



## HOTLIST LOAN EXAMPLE 4

Loan with a disproportionate expense ratio.

### *Performance Challenges*

- The cash flow volatility is greater in assets with high expense ratios. Therefore, a slight decline in revenue could cause a multiplicative cash flow decline.
- Properties with historically high expense ratios may also be of concern. Hotels may be particularly volatile if they experience a decline of revenue per available room (RevPAR), average daily rate (ADR) and/or occupancy or a substantial increase of involuntary expenses.

### *Mitigating Factors*

- A consistent track record of increasing revenues and expense management.

## HOTLIST LOAN EXAMPLE 5

Property located in a particularly soft or declining market.

### *Performance Challenges*

- Incentives and concessions factor into market rental rates. When concessions are prevalent, the borrower's ability to increase rents at lease expiry is limited.
- A market economic change may also have an impact on a property's performance. For example, the low interest rate environment, which resulted in increased home ownership, had a direct impact on multi-family properties, causing a decrease in demand for apartments and an increase in concessions offered.

### *Mitigating Factors*

- Signs that the market is rebounding, including positive absorption and a discontinuation of concessions.
- Demonstration of the property outperforming the submarket.

## HOTLIST LOAN EXAMPLE 6

Property with single-tenant, owner-occupied or shadow-anchor risk.

### *Performance Challenges*

- The credit risk of a non-investment-grade single-tenant property may be compounded by the limited marketability of a special-purpose asset. Likewise, the decline in the performance of non-credit single-tenant owner-occupied businesses may be difficult to detect.
- The deterioration in the credit quality of a large shadow-anchor tenant will have an impact on the attractiveness of the property and affect the draw.

### *Mitigating Factors*

- Lease term extension options and whether they have been exercised.
- Credit quality of the tenant.
- Demonstrated as a strategic or desirable location, critical to the operations of the tenant.



## HOTLIST LOAN EXAMPLE 7

Bankruptcy of an operator, major tenant or borrower.

### *Performance Challenges*

- The ability of a tenant to reject the lease and vacate or renegotiate to market rates.
- Potential for property maintenance neglect due to bankruptcy of operator or borrower.

### *Mitigating Factors*

- Below-market lease rates and the desirability of the location of the asset.
- Strong loan performance.
- Ownership structured as bankruptcy-remote special-purpose entity.

## HOTLIST LOAN EXAMPLE 8

Loan in continued technical default with no indication of stable performance or loan that is a chronic late payer.

### *Performance Challenges*

- Loans in technical default or borrowers making chronic late payments may not only indicate a lack of commitment by the borrower but also the diversion of funds, which can result in deferred maintenance at the property and ultimate value erosion.

### *Mitigating Factors*

- Servicer site inspections that indicate significant maintenance expenses or improvements being done on the property and reserve distribution.

## HOTLIST LOAN EXAMPLE 9

Property with dysfunctional or obsolescent space.

### *Performance Challenges*

- Difficult to lease at market rental rates if the current tenants roll.

### *Mitigating Factors*

- Properties with significant excess cash flow and/or reserves can allow space to be re-leased at rates below market rents.

## HOTLIST LOAN EXAMPLE 10

Extended period of non-reporting by borrower.

### *Performance Challenges*

- Loans that have not provided the servicer with financial statements and/or occupancy information for several years may be viewed as having increased term risk.

### *Mitigating Factors*

- On-time loan payments and current status.
- Properties located in stable markets with strong DSCRs at issuance.
- Tenants on long-term leases beyond loan maturity.

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