GCR RATINGS

# CRITERIA FOR RATING COMMERCIAL MORTGAGE BACKED SECURITIES

# Contents

## Scope of the Criteria

1. This criteria titled 'Criteria for Rating Commercial Mortgage Backed Securities' ('CMBS Criteria') will be used to rate each commercial mortgage backed securities ('CMBS') transaction and will be accompanied by a transaction specific report that will disclose any additional observations or modifications to the Criteria. The Criteria should be read in conjunction with GCR Ratings' ('GCR') 'Criteria for Rating Structured Finance Transactions', updated and published in September 2018.

2. The methodology and assumptions detailed in this report will be further developed and enhanced as GCR rates a greater number of CMBS transactions.

3. This Criteria applies globally, although each individual jurisdiction and each specific transaction may give rise to additional observations and/or deviations, which will be disclosed in the transaction-specific reports.

## Summary of the Criteria Changes

4. This Criteria is an update to the version published in May 2017[1]. There are no significant amendments to the Criteria. The update of this Criteria will not have an impact on any existing transactions that have been rated under it. Going forward, all new transactions will be rated using this Criteria.

[1] This version of the criteria, published in September 2019, has been updated for formatting, naming conventions and alignment with GCR's updated Rating Symbols, Scales and Definitions only. This criteria is applicable to all previous publications referring to "Global Commercial Mortgage Backed Securities (CMBS) Rating Criteria, November 2018".

## Introduction

5. GCR's CMBS Criteria aims to summarise how GCR assesses credit risks within CMBS transactions globally (excluding the USA). The approach looks to analyse the risk of the underlying collateral on a loan by loan basis, the transaction structure, operational risk and counterparty risk, amongst others.

6. As transactions can vary significantly and each transaction is unique, in certain cases analysis may diverge from stated assumptions. For example assumptions may vary between countries and between structure types. If Criteria assumptions are amended or supplemented, these will be disclosed in individual transaction reports. In markets where there is little history of commercial real estate, few originators, undeveloped mortgage security rules etc., the Criteria may be supplemented as necessary.

## Rating Approach

7. GCR's rating approach is both quantitative and qualitative, with final ratings accorded by a rating committee. GCR will initiate its rating approach with a review of the underlying commercial real estate collateral. The performance of the underlying real estate that acts as collateral is key. GCR will review stability and generation of income flows, asset quality, tenant profile, marketability of the property and future expected income over the property's economic life. GCR will also consider property market standards within specified countries, transaction costs, legal analysis, and lease structures, amongst others. GCR will also run a cash flow analysis to determine how projected rental flows are applied in the priority of payments for the loan on each payment date. GCR will also determine whether the stressed property value at transaction maturity can repay the outstanding debt - if a default does not occur during the life of the transaction - in order to determine if an orderly sale would be achievable.

8. As commercial real estate loans can be large and lumpy in nature, poor performance of one loan can have a dramatic effect on the entire portfolio. Pro-activeness of the servicer can influence the outcome of a CMBS transaction. Therefore, GCR will review servicers of CMBS transactions to determine their capabilities to manage the transaction over its lifetime during an onsite review. GCR will also conduct an onsite review of the originator.

9. GCR expects to receive adequate data for its analysis as listed in Appendix A. If certain data is not available, GCR may make conservative assumptions to fill the lack of data. GCR will also analyse available market data in respect of yields and rental values, among other market related trends.

10. A loan-level analysis on the real estate will be undertaken to determine the gross credit enhancement available to the portfolio, as well as a legal analysis to identify loan level features and transaction parties' obligations.

11. A liability analysis will also be undertaken to determine net credit enhancement levels. This analysis will consider structural features of the transaction in respect of, amongst others, liquidity.

12. Ratings for CMBS transactions are accorded by a ratings committee after consideration of both qualitative and quantitative analysis.

## Qualitative Analysis

### Operational Risk

13. A key factor of the rating analysis is the ability of the originator and servicer to perform their functions under the transaction documentation. As part of the rating analysis, GCR will carry out both an originator and servicer review for each transaction. The review provides a qualitative input to the rating committee. The role of the servicer is particularly important given high concentration risk within portfolios, timely intervention and proactive management can have a dramatic impact on a portfolio. GCR will consider work out strategies of servicers within its analysis.

### Legal Analysis

14. GCR expects to receive full transaction legal documentation as well as legal opinions, as discussed in its Criteria for Rating Structured Finance Transactions, updated in September 2018.

15. As part of the legal review, GCR may also request a letter of confirmation from the issuer that the pool of assets (i.e. underlying properties forming security to the transaction) has not been dual-ceded to another party.

16. For a CMBS transaction, a bankruptcy-remote SPV is expected to be established to isolate the assets from the bankruptcy and insolvency of other entities which are party to the transaction. Typically a loan will be advanced to the SPV in order to acquire the real estate collateral. The same loan is then assigned to another bankruptcy-remote SPV (the issuer), which finances the acquisition by issuing notes to investors.

17. GCR will carry out both a loan level and issuer level legal analysis on CMBS transactions. As well as issuer-level documents and legal opinions, GCR also expects to receive borrower-level documents which may consist of mortgage security, constitutional documents, and inter-creditor agreements as well as loan-level legal and tax opinions.

18. GCR typically uses external counsel to review legal opinions.

### Counterparty Risk

19. GCR will review counterparty risk within the transaction. In order to support a rating higher than that of the originator, GCR expects transaction counterparties to meet the counterparty guidelines summarised in its Criteria for Rating Structured Finance Transactions, updated September 2018. GCR expects that at closing, the transaction documentation incorporates its counterparty guidelines. The underlying analytical assumption of the guidelines listed in the Criteria is that a jump-to-default of the relevant

counterparty within the specified remedial period is sufficiently remote to support the associated maximum achievable securities ratings.

## Commingling Risk

20. Where commingling risk exists, this should be appropriately mitigated and furthermore covered in the legal opinion provided. For a CMBS transaction, funds should be paid directly into the issuer's bank account or paid into the account of the seller/originator and then transferred to the transaction account within a predefined time frame (see GCR's Criteria for Rating Structured Finance Transactions for more details).

## Quantitative Analysis

## Collateral Risk

21. Collateral performance is crucial to the analysis and is the key factor in determining default probability and loss severity for any limited recourse CMBS transaction, whereby the lenders only have recourse to the collateral barring statutory exclusions. GCR will perform a detailed mortgage collateral analysis, which will include projecting stressed property income and stressed loan performance over the loan term. Redemption of the loan at maturity forms part of GCR's analysis, and GCR will therefore stress the expected property value as well as determine the likely income to be achieved.

22. The value of commercial real estate is driven principally by its ability to generate future income. Therefore, GCR will analyse the tenant profile as well as vacancy rates, lease terms, etc., within its analysis. Rental increases contracted at a fixed rate will be considered in the analysis. Gross rent, however, is determined by tenants performing under their leases, hence the analysis of the tenant profile.

23. GCR will calculate the projected income on existing leases, it will also stress the net income due from subsequent leases. Within this analysis, GCR will consider lease term, and lease renewal probability.

24. Vacancy can occur between lease renewals or upon default of a lease. The length of the vacancy period can be determined by many factors, e.g. the marketability of the particular commercial property with the buildings i.e. location and flexibility in rental pricing as factors, and is considered in the analysis. Vacancy can impact projected net income, as earned rent is reduced and costs increase. Cost increases can be driven by capital expenditure (in order to maintain properties so that they can be re-leased), property management costs, utility bills and maintenance during the vacancy period and letting fees (to contract new leases), amongst others. GCR will therefore stress vacancy costs during the vacancy period in its analysis to determine net rental income. Vacancy costs and declines in rental values impact the net rental income that can be achieved on the real estate. All these can be driven by market factors and are factored into the analysis.

25. GCR expects to receive independent valuation reports for all properties within the transaction portfolio, as well as perform an on-site review of the properties to determine their upkeep, maintenance and tenancy profile.

26. The value of the commercial real estate is principally determined in relation to its rental yield demanded by investors. A more secure or more desirable property will often be valued at a lower yield than a property deemed to be riskier. To value the commercial real estate, projected future income is capitalised. If an asset is highly liquid, the less volatility exists within valuations. Illiquid assets are subject to sharp increases in yields due to fears of potential collapses of income. Factors considered in valuations and onsite reviews include the property size, specification, location and economic market conditions. GCR will use this information to establish cap rates. Stressed cap rates are utilised to capitalise the property income over the projected period for each property. The total is then aggregated to calculate the total collateral value available to support each loan. In calculating the property value, transaction costs such as legal costs, estate agent costs, and registration and transfer fees are considered in the analysis.

27. Within its analysis, GCR will determine the net property income and net property value, as discussed above. GCR will also compare income generated on the portfolio against debt service payments under the debt financing. GCR will run a cash flow model to simulate the transaction in this regard. Performance related triggers will be an input into the modelling; if they are breached they often trap cash within a CMBS structure. However, if this de-leveraging mechanism does not cure the breached trigger, it is expected that the loan will default and become immediately due and payable. At this point, unless the debt is rescheduled, the work-out process will begin.

28. Performance triggers and events of default will be reviewed during GCR's analysis.

29. At loan maturity, if a default during the loan lifetime has not occurred, the stressed property value is compared to the outstanding debt secured under the mortgage, taking into consideration the entire loan balance. If the property value is sufficient to cover the securitised debt amount in full, GCR believes the borrower would undertake a sale of the properties to preserve its stake in the collateral.

## Loan Enforcement

30. Key aspects of enforcement are timing and recovery levels. Time to enforce security and the associated costs are often country specific and will vary within the analysis.

31. For CMBS, the transaction-specific considerations also have implications (i.e. property size, location, etc.) GCR will request estimated foreclosure costs from issuers in each jurisdiction where it rates CMBS transactions.

## Hedging

32. GCR assesses the impact of interest rate risk on the cash flows generated by the structured. Floating rate CMBS results in an interest rate mismatch with the underlying rent. Typically this mismatch is hedged by the borrower or the issuer entering into swap agreements. There may be costs associated upon swap termination, and swap breakage costs may have a negative effect upon recoveries. Fully balance-guaranteed swaps will not expose a transaction to market risk. GCR looks at the characteristics of the hedge agreement in place, if any, including the swap counterparty replacement mechanisms.

## Liquidity

33. For timely payment on notes to occur, transactions are typically structured with liquidity facilities to cover revenue shortfalls and timing mismatches. Revenue shortfalls may occur at certain times due to a loan's scheduled interest payment profile or periodic special servicing fees which will reduce the net revenues available to cover the note interest when due.

## Performance Monitoring

34. GCR expects to receive transaction reports on a monthly or quarterly basis. Periodically, GCR will expect to receive updated loan-by-loan information. For a CMBS transaction, cash flow modelling may not be continuously repeated over the life of the transaction if cash flows and the performance of the transaction remain in line with expectations. All transactions will be reviewed on an annual basis at a minimum, or as events may warrant. Declining performance of the transaction and changes in trends within the property or mortgage market may result in reviews being undertaken more frequently. GCR will aim to meet with the originator/servicer at least annually to discuss any updates to the origination/ servicing processes.

## Disclaimer

35. Note that GCR is not a legal, tax or financial adviser and will only provide a credit opinion of the rated securities. For example, a rating does not cover a potential change in the applicable laws nor can it be regarded as an audit. Moreover, GCR is not a party to the transaction documents nor does it provide legal, tax or structuring advice.

## Appendix A – Data requirements

GCR expects to receive sufficient data to analyse the underlying portfolio. A spreadsheet template may be provided for completion.

GCR expects to receive:

- Loan by loan information on the underlying collateral.
- Borrower information.
- Property information.
- Tenant information.
- Commercial unit information.
- Portfolio information.
- Counterparty information.

## Appendix B – Originator and Servicer Review Agenda

As discussed in the Criteria, GCR will carry out an on-site review for each originator/servicer. The review will include discussion on the following, amongst others:

- Company operating structure and history.
- Property maintenance.
- Conflict of interest.
- Legal department capabilities.
- Underwriting policies.
- Management/staffing.
- Origination.
- Underwriting and appraisals.
- Valuations.
- Servicing and collections.
- Work out processes.
- Data extraction capabilities.
- Systems.
- Disaster recovery plan.
- Mortgage regulation.
- Customer service.
- Quality control.
- Marketing.
- Audit.
- Audited Financial Statements (if applicable).

## Glossary of Terms/Acronyms

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| Administrator | A transaction appointed agent responsible for the managing of a Conduit or a Special Purpose Vehicle. The responsibilities may include maintaining the bank accounts, making payments and monitoring the transaction performance. |
| Advance | A lending term, to transfer funds from the creditor to the debtor. |
| Agent | An agreement where one party (agent) concludes a juristic act on behalf of the other (principal). The agent undertakes to perform a task or mandate on behalf of the principal. |
| Amortisation | From a liability perspective, the paying off of debt in a series of installments over a period of time. From an asset perspective, the spreading of capital expenses for intangible assets over a specific period of time (usually over the asset's useful life). |
| Arrears | General term for non-performing obligations, i.e. obligations that are overdue. |
| Asset | An item with economic value that an entity owns or controls. |
| Bond | A long term debt instrument issued by either: a company, institution or the government to raise funds. |
| Borrower | The party indebted or the person making repayments for its borrowings. |
| Call Option | A provision that allows an Issuer the right, not the obligation, to repurchase a security before its maturity at an agreed price. The seller has the obligation to sell the security if the call option holder exercises the option. |
| Capital | The sum of money that is used to generate proceeds. |
| Cash Flow | A financial term for monetary changes in operations, investing and financing activities. |
| Collateral | An asset pledged as security in event of default. |
| Commingling | The mixing of various transaction parties' funds in an account. |
| Coupon | Interest payment on a security. |
| Covenant | A provision that is indicative of performance. Covenants are either positive or negative. Positive covenants are activities that the borrower commits to, typically in its normal course of business. Negative covenants are certain limits and restrictions on the borrowers' activities. |
| Credit | A contractual agreement in which a borrower receives something of value now, and agrees to repay the lender at some date in the future, generally with interest. The term also refers to the borrowing capacity of an individual or company |
| Credit Enhancement | Limited protection to a transaction against losses arising from the assets. The credit enhancement can be either internal or external. Internal credit enhancement may include: Subordination; over-collateralisation; excess spread; security package; arrears reserve; reserve fund and hedging. External credit enhancement may include: Guarantees; Letters of Credit and hedging. |
| Credit Rating | An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories. |
| Credit Risk | The probability or likelihood that a borrower or issuer will not meet its debt obligations. Credit Risk can further be separated between current credit risk (immediate) and potential credit risk (deferred). |
| Debt | An obligation to repay a sum of money. |
| Debt Sponsor | Usually as Investment bank that brings a transaction to the capital markets, similar to an Arranger. |
| Default | A default occurs when: 1.) The Borrower is unable to repay its debt obligations in full; 2.) A credit-loss event such as charge-off, specific provision or distressed restructuring involving the forgiveness or postponement of obligations; 3.) The borrower is past due more than X days on any debt obligations as defined in the transaction documents; 4.) The obligor has filed for bankruptcy or similar protection from creditors. |
| Desktop | An assessment of the property value, with the value being compared to similar properties in the area. |
| Downgrade | The assignment of a lower credit rating to a corporate, sovereign of debt instrument by a credit rating agency. Opposite of upgrade. |
| Enforcement | To make sure people do what is required by a law or rule et cetera. |
| Environment | The surroundings or conditions in which an entity operates (Economic, Financial, Natural). |
| Excess Spread | The net weighted average interest rate receivable on a pool of assets being greater than the weighted average interest rate payable for the debt securities. |

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| Guarantee | An undertaking for performance of another's obligations in event of default. |
| Guaranteed Investment Contract | A contract that guarantees the principal and interest repayment over a period of time. Typically GIC are used in relation to a bank account. |
| Income | Money received, especially on a regular basis, for work or through investments. |
| Index | An assessment of the property value, with the value being compared to similar properties in the area. |
| Issuer | The party indebted or the person making repayments for its borrowings. |
| Junior | A security that has a lower repayment priority than senior securities. |
| Liability | All financial claims, debts or potential losses incurred by an individual or an organisation. |
| Liquidity | The ability to repay short-term obligations or short-term availability of liquid assets to a market or entity. |
| Liquidity Risk | The risk that a company may not be able to meet its financial obligations or other operational cash requirements due to an inability to timeously realise cash from its assets. Regarding securities, the risk that a financial instrument cannot be traded at its market price due to the size, structure or efficiency of the market. |
| Loan | A sum of money borrowed by a debtor that is expected to be paid back with interest to the creditor. A debt instrument where immovable property is the collateral for the loan. A mortgage gives the lender a right to take possession of the property if the borrower fails to repay the loan. Registration is a prerequisite for the existence of any mortgage loan. A mortgage can be registered over either a corporeal or incorporeal property, even if it does not belong to the mortgagee. Also called a Mortgage bond. |
| Loss | A tangible or intangible, financial or non-financial loss of economic value. |
| Market | An assessment of the property value, with the value being compared to similar properties in the area. |
| Obligation | The title given to the legal relationship that exists between parties to an agreement when they acquire personal rights against each other for entitlement to perform. |
| Option | Either a call or a put option. A call option gives the holder the right to buy assets at an agreed price on or before a particular date. A put option gives the holder the right to sell assets at an agreed price on or before a particular date. |
| Origination | A process of creating assets. |
| Originator | An entity that created assets and hold on balance sheet for securitisation purposes. |
| Owner Trust | Owner of a securitisation vehicle that acts in the best interest of the Noteholders. |
| Payment Date | The date on which the payment of a coupon is made. |
| Prepayment | Early or excess repayment of an obligation. Partial or full prepayment of the outstanding loan amount. |
| Prepayment Rate | The rate of prepayment in relation to the pool of obligations. Also called prepayment speed. |
| Principal | The total amount borrowed or lent, e.g. the face value of a bond, excluding interest. |
| Private | An issuance of securities without market participation, however, with a select few investors. Placed on a private basis and not in the open market. |
| Property | Movable or immovable asset. |
| Provision | An amount set aside for expected losses to be incurred by a creditor. |
| Rating Outlook | A Rating Outlook indicates the potential direction of a rated entity's rating over the medium term, typically one to two years. An outlook may be defined as: 'Stable' (nothing to suggest that the rating will change), 'Positive' (the rating symbol may be raised), 'Negative' (the rating symbol may be lowered) or 'Evolving' (the rating symbol may be raised or lowered). |
| Recovery | The action or process of regaining possession or control of something lost. To recoup losses. |
| Repayment | Payment made to honour obligations in regards to a credit agreement in the following credited order: 3.) Satisfy the due or unpaid interest charges; 4.) Satisfy the due or unpaid fees or charges; and 5.) To reduce the amount of the principal debt. |
| Reserves | A portion of funds allocated for an eventuality. |
| Seasoning | The age of an asset, the time period passed since origination. |
| Securities | Various instruments used in the capital market to raise funds. |
| Securitisation | Is a process of repackaging portfolios of cash-flow producing financial instruments into securities for sale to third parties. |
| Security | An asset deposited or pledged as a guarantee of the fulfilment of an undertaking or the repayment of a loan, to be |

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| | forfeited in case of default. |
| Senior | A security that has a higher repayment priority than junior securities. |
| Servicer | A transaction appointed agent that performs the servicing of mortgage loans, loan or obligations. |
| Shareholder | An individual, entity or financial institution that holds shares or stock in an organisation or company. |
| Spread | The interest rate that is paid in addition to the reference rate for debt securities. |
| Stock Code | A unique code allocated to a publicly listed security. |
| Structured Finance | A method of raising funds in the capital markets. A Structured Finance transaction is established to accomplish certain funding objectives whist reducing risk. |
| Subordinated Loan | A loan typically given by the Issuer to the securitisation vehicle that is more junior than a junior tranche. |
| Surveillance | Process of monitoring a transaction according to triggers, covenants and key performance indicators. |
| Timely Payment | The principal debt, interest, fees and expenses being repaid promptly in accordance with the contractual obligation. |
| Tranche | In a structured finance, a slice or portion of debt securities offered that is structured or grouped to resemble the same degree of risk associated with the underlying asset or with a similar degree of risk. A junior tranche has a higher degree of default risk than a senior tranche. |
| Transaction | A transaction that enables an Issuer to issue debt securities in the capital markets. A debt issuance programme that allows an Issuer the continued and flexible issuance of several types of securities in accordance with the programme terms and conditions. |
| Trust | A third party that acts in the best interest of another party, according to the trust deed, usually the investors. Owner of a securitisation vehicle that acts in the best interest of the Noteholders. |
| Trustee | A third party that acts in the best interest of another party, according to the trust deed, usually the investors. Owner of a securitisation vehicle that acts in the best interest of the Noteholders. |
| Ultimate Payment | A measure of the principal debt, interest, fees and expenses being repaid over a period of time determined by recoveries. |
| Valuation | An assessment of the property value, with the value being compared to similar properties in the area. |
| Waterfall | In securitisation, the order in which the cash flows are allocated to the transaction parties. |
| Weighted | The weight that a single obligation has in relation to the aggregated pool of obligations. For example, a single mortgage principal balance divided by the aggregated mortgage pool principal balance. |
| Weighted Average | An average resulting from the multiplication of each component by a factor reflecting its importance or, relative size to a pool of assets or liabilities. |