

# Canadian Commercial Mortgage Default Study

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## ■ Overview

In anticipation of an expanding Canadian commercial real estate securitisation program, Fitch IBCA has researched the Canadian real estate market to quantify default frequency and loss severity and has developed a methodology to rate securities backed by Canadian commercial real estate.

The results of this research indicate that the Canadian real estate downturn, experienced during the economic slump of the late 1980s and early 1990s, is equivalent to an 'A' stress scenario, which means that commercial mortgage securities rated 'A' or higher would not experience losses. The Canadian economic slump started toward the end of the 1980s and reached its trough in 1993. During that period, net effective rents on commercial properties decreased by 50%, vacancy rates increased to more than 20%, and values dropped up to 50%. Traditional lenders, such as life insurance companies and banks, withdrew from the lending market, further exacerbating the problem.

Fitch IBCA's commercial mortgage default study incorporates an analysis of the performance of more than 5,500 commercial mortgage loans during the downturn. Fitch IBCA also studied third-party published reports and interviewed lenders, economists, and real estate professionals.

From its analysis, Fitch IBCA created a Canadian performing loan model. Results indicate that default probabilities, based on debt service coverage ratios (DSCRs), are lower than U.S. benchmarks and were modelled to range from 15%–65%. Loss severities, once a loan defaults, are likewise lower than those in the U.S. and are estimated to be 30% on average. Additional losses are determined on a pool-by-pool basis depending on the real estate, the related loan, and the pooled transaction's attributes.

Reliable data on commercial mortgage performance are not widely available; therefore, evaluation of diverse assets is difficult. Because of the lack of uniformity of commercial mortgage assets and underwriting standards, commercial mortgage performance studies are not as precise as those for single-family mortgages.

Fitch IBCA's performance study results are used to create an analytical framework to rate securities backed by commercial mortgage pools. The study is a guideline for investors, investment bankers, and issuers. Each transaction has unique characteristics that may require special consideration or analysis. Fitch IBCA encourages discussion regarding characteristics of particular pools.

## ■ Canadian Economy

Canada's economy, the seventh largest in the world, depends largely on the export of commodities. Forestry contributes 20% of the nation's exports and mining 30%. However, this dependence has been tempered by surging manufacturing exports due to strong price competitiveness, low inflation, and North American Free Trade Agreement (NAFTA) membership. Toronto and Montreal together account for more than one-third of the nation's manufacturing. In 1989, a free trade agreement went into effect between Canada and the U.S. The pact was superseded in 1992 by the signing of NAFTA by Canada, the U.S., and Mexico.

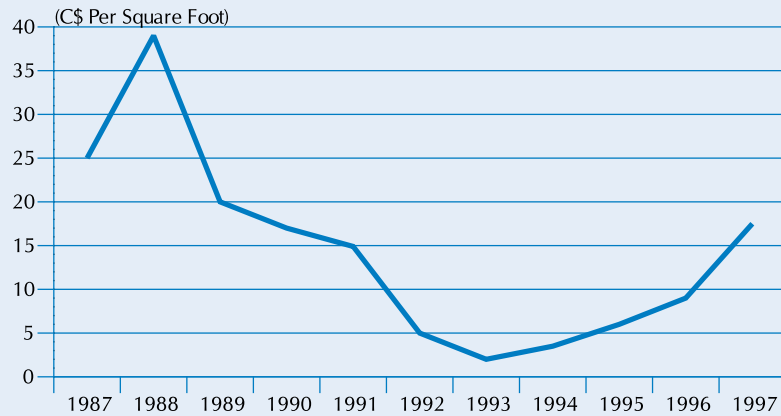
Fitch IBCA rates Canada 'AA' for foreign currency obligations and 'AAA' for Canadian dollar obligations. If Fitch IBCA changes these ratings, for any reason, investors will be notified.

## ■ Recent Canadian Economic Slowdown

Prior to the most recent slowdown, Canada had not experienced an economic slump since that of 1981–1982. At that time, the Canadian economy traditionally benefitted from a low dollar and a substantial trade

### Downtown Toronto Net Effective Rents

(Years Ended 31 Dec.)



Source: D.S. Marcil, Inc.

surplus with the U.S. through the export of unprocessed raw materials. By 1982, borrowings, used mainly for large government projects, had caused the federal deficit to reach C\$107.6 million.

Since 1985, Canada has run a tight fiscal policy and, since 1988, a tight monetary policy. In true economic terms, the recession occurred during 1990–1991. However, Canada entered its most recent economic slowdown in 1988, about one year before the U.S. experienced an economic slump. Together with the U.S. recession, the combination of fiscal and monetary restrictions was the major cause of the most recent Canadian recession. The rigorous fight against inflation in the late 1980s and early 1990s drove up interest rates so that, in 1990, prime interest rates averaged 13%, peaking in April 1990 at 14.75%. Interest rates were held high as the government initiated a broad program of privatisation.

The goods and services tax (GST), introduced in 1991, also contributed directly to the severity of the slowdown. At first, the recovery was export based and, although economists believed the recession had ended by 1992, domestic demand did not start to recover until 1994–1995. However,

the recovery occurred despite the uncertainty following the 1995 referendum on the Canadian constitution and the subsequent sovereignty referendum in Quebec.

#### ■ Canadian Real Estate Market

Although Canada is one of the largest countries in the world by land area, the majority of its population lives within 100 miles of its border with the U.S. Of the population, 60% lives in the 17 largest cities and more than 30% in Toronto, Montreal, and Vancouver.

The real estate market is similarly concentrated. Central Toronto contains 78 million square feet (sf) of office space and its suburbs 69 million sf. Total industrial space in Toronto amounts to 597 million sf. Central Montreal contains 46 million sf of office space and the suburbs 33 million sf, with industrial space totalling 250 million sf.

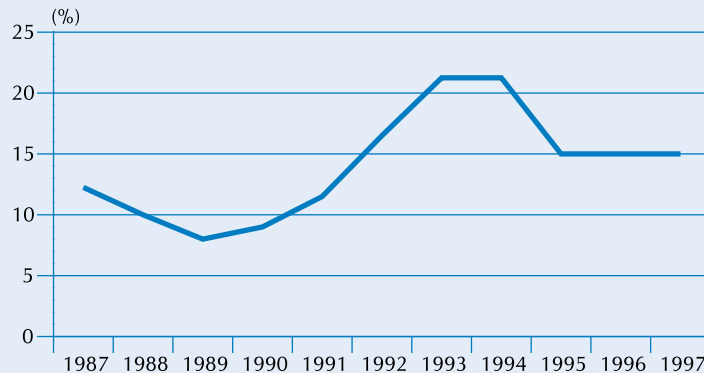
Generally, commercial leases extend five to 10 years. The more creditworthy a tenant, the longer the lease. Rent increases typically are set out in the lease, although increases for long-term leases (greater than 15 years) may be based on a cost of living index due to uncertainties faced later in the lease term.

#### Real Estate in the Slowdown

From 1990–1995, empty office towers became a symbol of the weakness of the Canadian economy. The doom and gloom of the early 1990s led one large real estate brokerage house to claim that a 12-year supply of office space existed. The real estate downturn was caused by both supply and demand factors: the excesses of the 1980s resulting from overzealous development in certain cities produced a precipitous fall in rents; and the poor performance of the Canadian economy devastated demand.

### Downtown Montreal Office Vacancy Rate

(Years Ended 31 Dec.)



Source: D.S. Marcil, Inc.

During the downturn, vacancy rates rose, net effective rents fell, tenant inducement packages became more generous, and property values decreased. Throughout Canada, net effective rents in class A space were estimated to have dropped 60% between 1989 and 1994. Space available for sublease was a major reason for the sharp decline in rents. Vacancies nationwide rose from 10.7% to 16.2% during the same period, and, for certain markets, the decline was even greater. A 10-year lease became, in effect, a five-year lease or shorter, as flexible lease termination rights were written into it.

Other concessions to secure a tenant included: the tenant was no longer required to return the space to base building standards; and the tenant did not have to pay for naming rights. As the industry emerged from the real estate downturn, the pendulum swung back toward the landlord with regard to the granting of concessions. However, leasing commissions is one area in which changes made during the downturn are still in use. Prior to 1990, commissions were calculated on a percentage basis; as net effective rents fell, the calculation method changed to dollars per square foot.

The introduction of the GST in 1991 compounded the slowdown's impact on retail stores as consumers stayed away. The industrial market was affected by rationalisation and bankruptcies in the manufacturing sector, which added considerable space to an already saturated market. The slowdown also forced corporate real estate professionals to rethink how real estate and space occupancy should be budgeted, putting more pressure on vacancy rates.

However, the downturn provided some self-correcting measures. In 1991, 17 million sf of new office space was introduced into the market, followed by 7.6 million sf in 1992. For the next three years, the combined total was only 5.2

million sf. In 1992, the debt problems of several major developers in Canada became evident. Most notable was the default of Olympia & York Development Ltd. Similarly, Trizec Corp. and Cadillac Fairview Corp. Ltd. defaulted in 1994.

During the same period, a credit crunch developed as the more traditional and stronger lenders withdrew from the market or tightened their underwriting standards. Borrowers facing a refinance of a maturing loan found that no lenders were willing to provide financing; as a result, defaults increased as balloon maturities came due. The Federal Insurance Companies Act of 1992, and the subsequent Minimum Continuing Capital and Surplus Requirements for Life Companies, made it more expensive for life companies to hold real estate assets due to the increased capital required to be held. In 1994, lenders changed their strategy of dealing with problem loans; distressed debt was sold at sizeable discounts, and lenders were more aggressive in their willingness to foreclose or take control of properties.

Also affected was the stability of several lenders with large exposures to real estate on their books. In 1993, Les Coopérants and Sovereign Life failed, the first insurance companies to do so in 65 years. In 1994, Confederation Life Insurance Co. (Confed), often considered too big to fail and once an investment-grade company, met its demise as a result of huge losses in its mortgage portfolio. However, although the losses were great, the growth in real estate exposure (as a percentage of total assets) was equally important. Many trust companies also experienced large losses due to their mortgage portfolios. To compete with banks, trust companies had been aggressive in their lending. When the slowdown came, many had to be bailed out in federally assisted transactions and/or were acquired by chartered banks. Central

Guarantee Trustco, the fourth largest trust company in Canada as of 1992, was rescued by Toronto Dominion Bank in that same year. Similarly, Royal Trustco was saved by The Royal Bank of Canada.

## ■ **Canadian Legal System**

Canada is a federal state made up of 10 provinces and two territories. The federal government regulates banking, insurance, money, bankruptcy, and insolvency, while the provincial governments regulate property and civil rights, including mortgages and consumer protection laws, the capital markets, and securities law. Provincial-based credit unions (caisses populaires), insurance companies, pension funds, and others are also regulated by the provinces.

The Canadian legal system consists of two distinct parts: a system derived from the English Common Law with statutory amendments and used in every province, except Quebec; and the Quebec system, which is derived from French civil law with statutory amendments. Because of the strength of the national banking system, the legal framework generally favours the lender over the borrower. Each province has its own laws with regard to the rights of a secured creditor that must be exercised within the framework of the federal legislation on bankruptcy and insolvency. For instance, in Quebec, the Quebec Civil Code is the applicable law with respect to the exercise of hypothecary (mortgage) rights. At the federal level, the Bankruptcy and Insolvency Act, the Winding Up Act, the Bank Act, and the Companies' Creditors Arrangement Act provide jurisdiction.

## **Lender and Borrower**

Relative to the U.S. real estate market, the Canadian market is more lender friendly. For instance, in Ontario, a "private power of sale" provision is incorporated or implied in every mortgage and allows the lender to serve a notice of sale on the borrower 15 days

after payment default. At that point, the borrower has 35 days to bring the mortgage current. Other remedies in Ontario include a judicial sale action, obtaining title through foreclosure or “quit claim deed,” and taking possession of the property through a receiver.

In general, Canadian lending institutions are hesitant to use all the remedies available to them, opting, instead, to “work out” the loan with the borrower over a period of time. Also, it is common for mortgages in Canada to contain a recourse covenant, which enables the lender to seize the borrower’s other assets to obtain repayment of the debt. Fitch IBCA believes that the lender friendly legal environment and the recourse nature of mortgage loans contribute toward fewer loan defaults and smaller losses in Canada than in the U.S.

### ■ Canadian Default Study

Fitch IBCA’s approach to pool risk analysis incorporates two measures of commercial mortgage performance: default probability and loss severity. To establish appropriate and relevant default and loss factors, Fitch IBCA reviewed historical data regarding commercial mortgage loan performance. Additionally, Fitch IBCA studied published reports and talked with representatives from other financial

institutions, real estate companies, and government agencies.

The foundation of Fitch IBCA’s default study used loan information provided by four Canadian lending institutions. The data collected consisted of 12,528 commercial real estate loans originated between 1982 and 1997, with a combined origination balance of C\$13,429 million. The data was made more appropriate for the default study and securitisation purposes by excluding loans with an origination balance less than C\$1 million, loans originated prior to 1986, and loans covered by a government guarantee. This left a sample pool that better approximated what Fitch IBCA believes will be a typical Canadian commercial real estate securitisation pool.

### Sample Pool

The sample pool consisted of 5,654 loans totalling C\$10,695 million and originated between 1986 and 1996. The average loan size was C\$1.9 million. Loans secured by multifamily properties made up 26%, retail 26%, office 25%, industrial 16%, and other property types 7%. The largest concentration were loans on properties located in Ontario, with 41%, followed by Quebec with 20%, British Columbia with 18%, and Alberta with 16%. The remaining 5% was distributed

among the other Canadian provinces and territories.

Loan originations peaked in 1989, the beginning of the slowdown, when nearly C\$1,250 million was originated. However, in the following year, originations amounted to slightly more than C\$800 million and, in 1993, dropped to C\$450 million. This is evidence of the reduction in lending as lenders exited the market, exacerbating loan defaults because refinancing was unavailable as loans matured. Office buildings displayed the greatest contraction in lending, indicative of the increased level of defaults experienced by that property type and discussed later in this report.

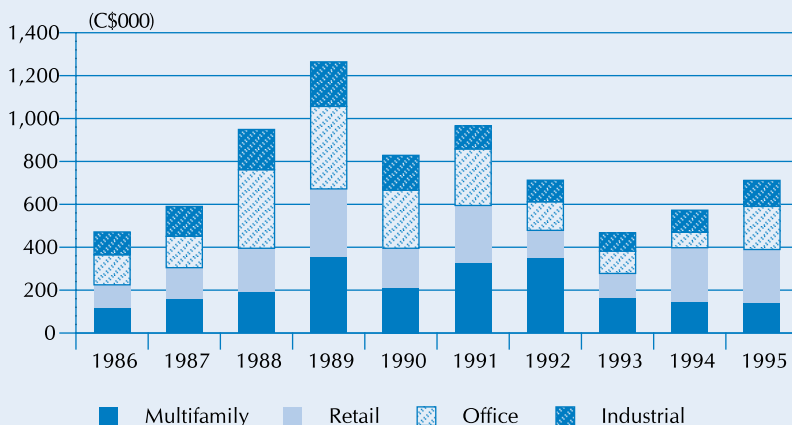
The Canadian default study seeks to identify the default probability and loss severity for typical Canadian commercial real estate loans under a specific stress scenario. For Canada, Fitch IBCA determined that the real estate downturn experienced in the late 1980s and early 1990s was an ‘A’ stress scenario. This compares to an ‘A’ stress for the U.S. real estate market during the same period and an ‘AA’ stress for the French real estate market shortly thereafter. An ‘A’ stress means that transactions structured to receive an ‘A’ or higher rating should have survived the Canadian recession intact. Transactions rated lower than ‘A’ would suffer losses.

### Default Probability

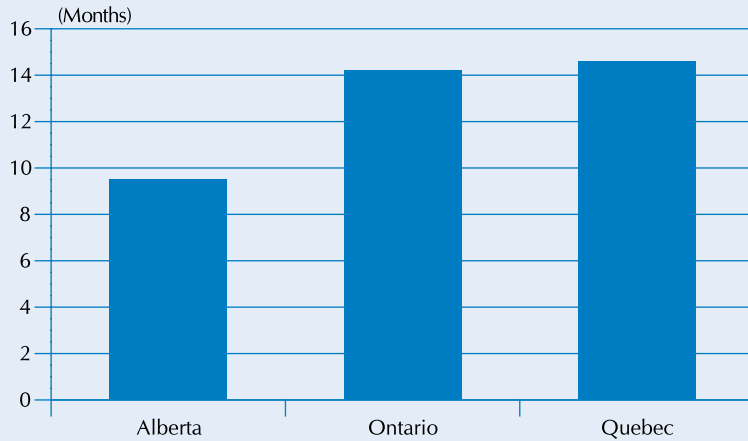
Default probability represents the likelihood that a given loan will become delinquent, ultimately resulting in a loss. The loss can result from either a loan restructure or the sale of the loan or property, with the proceeds being insufficient to recover principal, interest, and costs. The first step in determining default probability is to establish a base or typical Canadian loan portfolio. The portfolios reviewed generally contained loans secured by a mix of property types and were located according to the distribution of the Canadian population. All

### Originations by Property Type

(Years Ended 31 Dec.)



### Average Time to Resolve by Province



loans reviewed were recourse to the borrower. Generally, the loans were underwritten to terms similar to U.S. life company underwriting.

The probability that a loan will default under a given stress scenario is predicated on cumulative historical data. To estimate 'A' default probability for typical Canadian portfolios, Fitch IBCA analysed the sample pool's nonperforming real estate loans. Additionally, Fitch IBCA analysed all loans that were no longer on the books of the lending institutions but had experienced a "loss" of some kind. The loss may have resulted from the forgiveness of debt and/or interest, a loss on sale after the lender had exercised its remedies, or some other release from the original contractual terms of the loan. The "loss loans" were sorted by year of origination, and their origination balances were totalled and looked at as a percentage of the institution's total real estate portfolio originated in that same year.

For the period under study, 1986–1996, the four lending institutions originated 5,654 loans worth C\$10.7 billion. Of these, 325 loans defaulted in some way. The defaulted loans' origination balance was C\$860 million, or 8% of the total sample pool. However, originations in certain years fared worse than those in other years. For instance, in

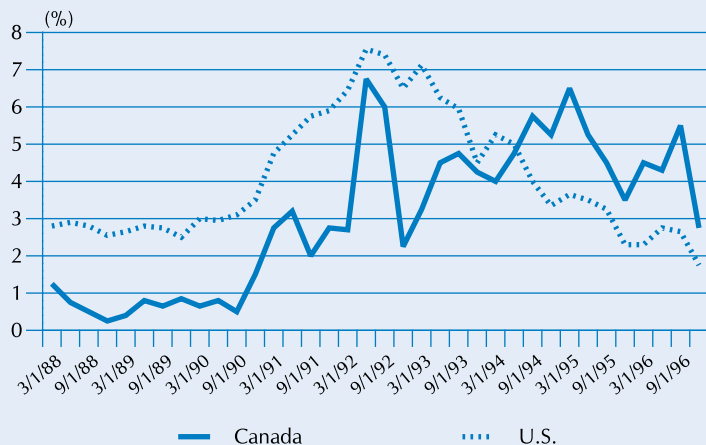
1987, 27% of that year's originations defaulted. Also, as loans mature and are unable to be refinanced at the current level of debt, the total number of loans that go into default will rise. Fitch IBCA believes that commercial mortgage loans are more likely to default further into the loan term or at the loan's maturity than they are at the beginning of the loan term. This is because the contracted rent, used in the underwriting of the loan, should continue for several years into the term of the loan but is at risk of being reduced as tenants fail to renew at lease maturity

or the current market rent at lease maturity is below the underwritten rent.

An interesting comparison of loan defaults can be made with the U.S. Fitch IBCA has rated commercial mortgage securitisations in the U.S. since 1992 and used, in the development of its U.S. model, information supplied by the American Council of Life Insurance. When comparing the delinquencies experienced by life insurers up to the end of 1990 in the U.S. against the experience of those same firms that also lent in Canada, a lower delinquency rate for Canada is easily apparent (*see chart below*).

Defaults by property type were not as uniformly spread as the sample pool. Office experienced the greatest default rate, with 50% of all defaults made up of loans on office buildings. Multifamily constituted 17%, industrial 13%, retail 10%, and other 10%. Office properties require large amounts of capital for tenant improvements and leasing commissions to attract and keep tenants. These expenditures may even be required to provide tenants with an incentive to renew. If there is a significant lease rollover and the borrower does not have access to capital, there is a greater chance the borrower will default. Additionally, in a soft

### Commercial Mortgage Delinquencies: Canada vs. U.S.



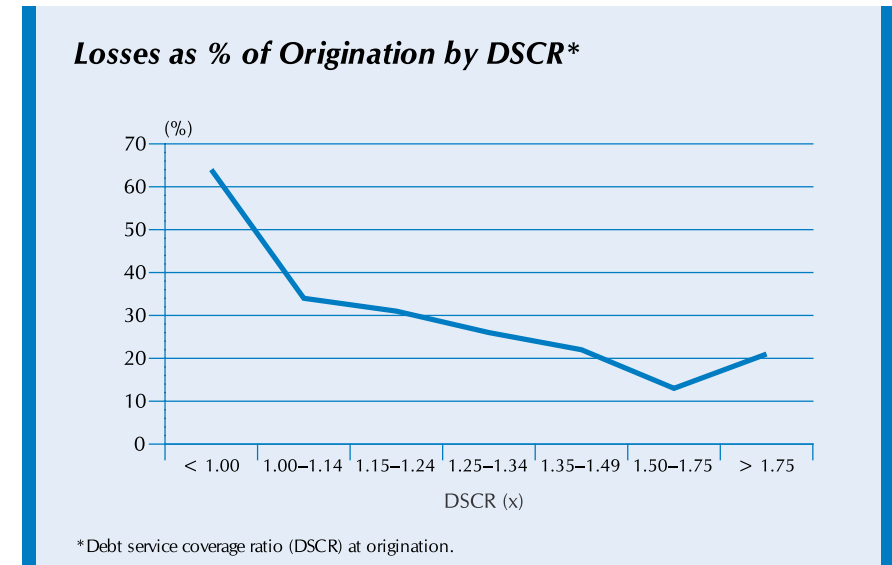
Source: American Council of Life Insurance.

market, other incentives, such as free rent periods, will also compromise the borrower's ability to pay.

**Loss Severity**

Losses from the 325 loans that defaulted amounted to only C\$181 million, or less than 2% of the total origination balance. This is considerably lower than Fitch IBCA's expectation. However, some loans may still suffer losses when it comes time to refinance them. Also, the total losses were cumulative over 10 years, and certain years experienced greater losses than others. For instance, 1994 was the worst year for a lender to resolve a defaulted loan, as the lender could expect losses to average 45% of the loan's origination balance. It should be noted that this was the same year lenders changed their strategy of dealing with problem loans. The average loss for the four worst years in which to resolve a defaulted loan (1993–1996) was slightly more than 30% of the loan's origination balance. Because this was the highest level of consistent loss on defaulted loans, Fitch IBCA used 30% as a base loss in an 'A' real estate recession for its Canadian performing model.

Office loans, with 57%, had a more than proportionate share of the losses suf-



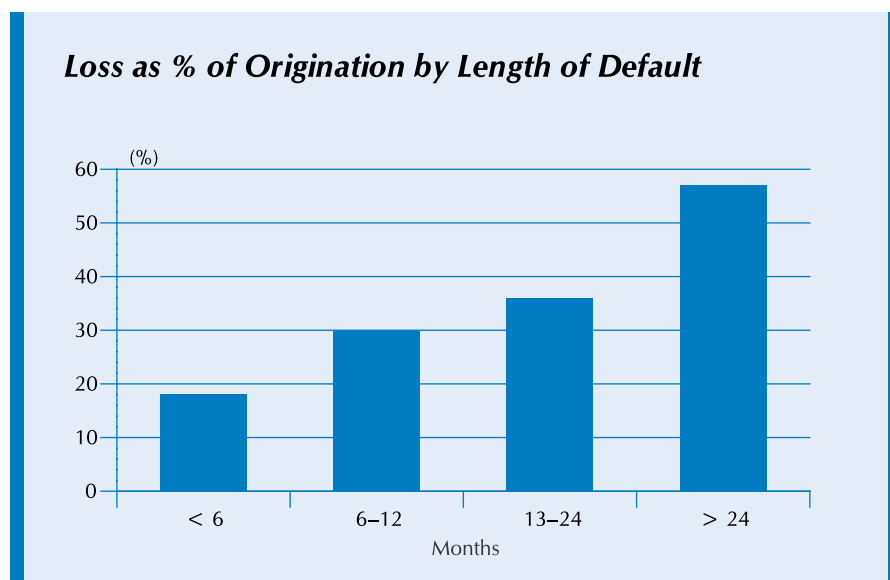
ferred. Office loans were followed by industrial with 16%, multifamily with 7%, and retail with 5%. Not only do office buildings have a greater probability of default due to their high capital costs, but they also experience volatility in rental levels and capitalisation rates, both of which impact values.

Not unexpectedly, the losses suffered by lenders increased the longer it took to work out the problem loan. Losses were below 30% of the origination bal-

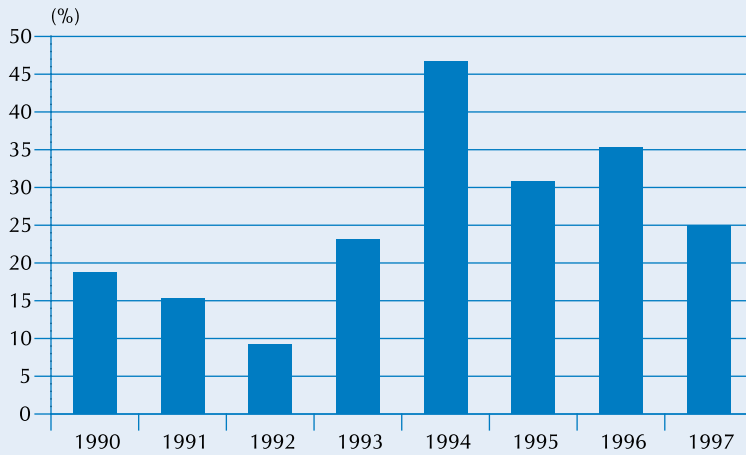
ance for loans that were worked out in less than 12 months but increased to more than 50% for loans that took longer than 24 months.

The average time to resolve a problem loan showed more geographic uniformity than expected. Fitch IBCA had expected a longer time to resolve loans in Quebec due to that province's more borrower friendly legal environment. However, analysis of the data indicated that the time to resolve a loan in Quebec was 14.6 months, which was only slightly longer than that experienced in Ontario, with 14.2 months. After speaking with lenders, Fitch IBCA considers that the expected increase in time to work out a loan in Quebec is accounted for when the loan is underwritten. In Alberta, the average time to resolve a loan was 9.5 months.

As expected, loans with low initial DSCRs showed greater losses than loans with higher coverages. However, the distinction was only apparent with loans below 1.00 times (x) DSCR. These loans experienced losses in excess of 60%, whereas loans with DSCRs greater than 1.00x experienced losses less than 35%, with an average of 24.5%.



### Loss as % of Origination by Year of Resolution (Years Ended 31 Dec.)



#### ■ Fitch IBCA Performing Loan Model

The default probability and loss severity findings under an ‘A’ stress are the foundation of the Canadian performing loan model. They reflect and are inclusive of the volatility of Canadian real estate values in relation to rents, the legal system, the underwriting criteria, the behaviour of borrowers, and the creditors’ approach to recovery. Fitch IBCA’s real estate analysis starts with DSCRs. Fitch IBCA believes that net operating income (NOI) is the most relevant measure of a commercial property’s ability to cover operating expenses and debt service.

Fitch IBCA evaluates debt service coverage for commercial loan portfolios on a loan-by-loan basis to determine the necessary level of credit enhancement for a particular rating. Loans within a pool are stratified according to DSCRs. The DSCRs are calculated after adjusting the property’s income and the loan’s current debt service to reflect “normalised” market conditions.

**Property Income:** Recent property financial statements are analysed and adjustments are made to provide a

stabilised cash flow. Items examined include: reducing above-market rents to market levels; vacancy adjustments for high occupancy properties; market rate property management fees; capital expense allowances to maintain the property in its current condition; and an allowance for future tenant improvements and leasing commissions at lease rollover. Generally, the loans that form the sample review (see page 8) are the loans that are reunderwritten. The percentage difference between the historical NOI and the adjusted Fitch IBCA cash flow is called the “haircut.” The average of the haircuts derived from the sample review pool is extrapolated to the NOIs of those properties not reunderwritten.

**Debt Service:** Fitch IBCA uses the higher of the loan’s current debt service or the debt service calculated using the

$$\text{DSCR} = \frac{\text{Fitch IBCA Net Cash Flow}}{\text{Fitch IBCA Stressed Debt Service}}$$

same principal amount and a property-specific interest rate (determined from interest rate levels reached in the most recent high level interest rate environ-

ment of 1987–1992). A market amortisation period, generally 25 years, is used and adjustments are made if the current loan has an adjustable interest rate or fully amortises in its current term. If the actual amortisation period is less than 25 years, Fitch IBCA would still use the longer period. This results in a higher Fitch IBCA DSCR and, thus, more favourable treatment, effectively giving credit for the faster amortisation.

The adjusted income and debt service are used to calculate the Fitch IBCA DSCR, and the loan is assigned a default probability accordingly. Categories of DSCRs range from less than 0.50x to greater than 1.75x, with lower ratios receiving higher default probabilities and higher ratios lower default probabilities. The default probabilities range from 15% at the highest DSCR to 65% at the lowest. They are based on the analysis of the historical data and are lower than those used in the U.S. performing loan model due to the recourse nature of the loans and the more lender friendly legal environment prevalent in Canada. Both provide the borrower with incentive to continue paying the contracted debt service even if it means coming out of pocket.

A loss severity factor is also determined for each loan. In the Canadian model, it is 30% and represents the average amount expected to be lost in a workout or foreclosure and subsequent sale of the asset. The potential loss for each loan, grouped according to DSCR, is derived by multiplying the default factor by the loss severity factor. The sum of the losses provides the preliminary credit enhancement at the ‘A’ level.

The ‘A’ level credit enhancement is then further adjusted according to the characteristics of certain pool-specific factors (add-ons), which are analysed and quantified and added to the preliminary ‘A’ level credit enhancement. The result-

ing credit enhancement represents the benchmark for the other ratings.

Credit enhancement requirements for other rating levels is derived from this 'A' subordination level relative to different risk issues. For instance, 'BB' securities are expected to withstand a lower level of stress than 'A' rated securities. Therefore, credit enhancement levels for 'BB' rated securities are approximately 50% less than 'A' levels.

### Add-Ons

The add-ons represent adjustments designed to measure qualitative risks peculiar to an individual pool and that are "added on" to the credit enhancement calculated in the quantitative portion of the model described above. Fitch IBCA focuses on several potential issues, primarily those listed below.

**Loan Diversity:** To encourage a well diversified pool, Fitch IBCA will default the three largest loans in the pool that, in its opinion, would not be classified investment grade. To qualify as investment grade, a loan would need to be well underwritten, be secured by an above-average property displaying sound historical financials, and have a good borrower payment history. Pools with a concentration in a few large loans require greater credit enhancement than large, diverse pools with no significant loan concentration.

**Borrower Concentration:** Any concentrations of borrowers greater than 5% will require additional subordination.

**Geographic Concentration:** Fitch IBCA expects a diversified Canadian pool to have a concentration of properties in On-

### Selected Refinance Constants

Property Type	Interest Rate (%)	Amortisation (Years)	Constant (%)
Multifamily	10.25	25	11.12
Office	10.75	25	11.55
Anchored Retail	10.50	25	11.33
Industrial	10.75	25	11.55
Hotel	11.50	20	12.80
Unanchored Retail	11.50	25	12.20

tario and Quebec. However, if the proportion for the two provinces exceeds 50% and 35%, respectively, additional credit enhancement will be required. Concentrations in other provinces may also require additional credit enhancement.

**Cash Flow Volatility:** Certain properties, such as hotels and unanchored retail, have more volatile cash flows than other properties, and Fitch IBCA adjusts the credit enhancement accordingly.

**Collateral Quality:** Typically, Fitch IBCA expects the pool to contain average, or "B" quality, properties. Properties classified as "B+" or better will require less subordination, while properties classified as "C+" or worse will require more subordination.

**Property Information:** Property level information is critical to the underwriting of any real estate securitisation. Those transactions that have limited information on the underlying collateral will be subject to conservative estimates in the underwriting process. For assets where virtually no property information is available (i.e. rent roll and operating statement), Fitch IBCA will assume additional losses and/or higher default probabilities.

**Excess Spread:** Excess spread is the excess of the interest paid on the loans, net of servicing fees, over the interest paid on the securities. Credit is given if the excess spread is available to support the rated securities.

**Basis Risk:** Additional credit enhancement is required if the interest rate of the underlying loans is not tied to the same index as that of the securities.

**Recourse Loans:** Typical lending practices in Canada include recourse provisions to the borrower. Thus, if a loan defaults and a loss is suffered, the lender can go after the borrower to make up the loss. This provides a strong incentive to the borrower not to default and may reduce losses that the lender would otherwise suffer if the mortgaged property was the only valuable asset. Lack of recourse provisions will require additional credit enhancement.

Other issues where add-ons are considered include subordinate debt, payment history, environmental and engineering issues, and the strength of any representations and warranties given on the mortgage loans.

### Sample Review

As an integral part of the review process, Fitch IBCA selects a sample of loans for site visits to the underlying collateral and a desk review of the asset summaries and files. The sample usually consists of loans representing approximately 30% or more of the outstanding principal amount of the pool. The smaller the number of properties in the pool, the larger the percentage of properties targeted for site visits.

### Cash Flow Volatility

Asset Type	Volatility Issue
Hotels	Operating Leverage
Restaurants	Service Industry
Unanchored Retail	Unstable Tenant Base
Single Tenant	Re-Leasing Stress
New Construction	Not a Proven Location or Tenant Mix

Generally, the largest loans, loans displaying problems or unusual characteristics, and a random sample of the other loans are selected. A cross-section of properties representing different regions and property types in the portfolio is visited.

Site visits focus on property tours, a review of comparable properties, and, where possible, a meeting with the property manager. Factors evaluated include location, access, vacancy, construction quality, and property condition. The sample review also forms the basis for reunderwriting the loans from which the average haircut is extrapolated to the rest of the pool.

### ■ Servicer

The servicer of any pool must be acceptable to Fitch IBCA. Fitch IBCA evaluates several factors related to the servicer and includes an on-site visit as part of the review process. Factors considered include company history, management structure and policies, experience of management and staff, staff training, and commitment to servicing.

Fitch IBCA reviews the size and diversity of the servicing portfolio and computer capabilities. Collection procedures for delinquent loans are also important.

### **DSCR Base Loss Assumptions\*** (%)

Fitch IBCA DSCR (x)	Default Probability	Loss Severity	Expected Loss
≥ 1.75	15	30	4.5
1.50–1.74	20	30	6.0
1.25–1.49	25	30	7.5
1.15–1.24	30	30	9.0
1.00–1.14	35	30	10.5
0.90–0.99	40	30	12.0
0.80–0.89	45	30	13.5
0.50–0.79	55	30	16.5
0.01–0.49	65	30	19.5

\*In an 'A' stress case. DSCR – Debt service coverage ratio.

Servicing advances may be required for real estate tax, insurance, and other property protection measures. Thus, servicers should have strong capital backing.

Fitch IBCA believes the most important area of any commercial loan servicer is the ability to deal with delinquent and problem loans. The servicer review includes a discussion of workout methodologies, recent results, and staff work experience.

Fitch IBCA also evaluates provisions of the servicing agreement. The agreement should provide sufficient flexibility for the servicer in its dealings with various borrowers. As commercial loans

tend to have unique characteristics, it would be difficult to predetermine the process a servicer should be required to follow in a workout situation. Therefore, Fitch IBCA believes servicers, once carefully chosen, should be allowed a good deal of discretion. Servicing agreements also should provide for adequate compensation that would attract an experienced servicer in the event the initial servicer must be replaced.

### ■ Trustee

The trustee is responsible for making certificateholder distributions, administering the structure's documents, and protecting the interests of each certificateholder in respect thereof. The trust

## **Qualitative Factors' Effects on Ratings**

Factors	Positive	Negative
Geographic Diversity	Nationally Diverse	Regionally or Locally Concentrated
Property Type	Diverse	Office
Operating Statements	> 75% of Portfolio with Current Statements	50% of Portfolio with Current Statements
Loan Diversity	> 50 Properties in Portfolio	Largest Loan 15% of Portfolio
Amortisation	Fully Amortising Loans	Negative Amortisation
Borrower Concentration	< 5% of Loans to a Single Borrower	Single Entity 20% of Portfolio
Recourse	Recourse to "Warm Body" (a person as opposed to a "shell" company)	Fraud Carve-Outs
Collateral Quality	Good Construction and Well Maintained	Significant Deferred Maintenance
Interest Rate	Fixed	Floating
Excess Spread	Available to Repay Rated Certificates	Negative Spread
Basis Risk	Matched Indexes	Different Indexes
Seasoning	Properties Have at Least Three Years' History	Recently Constructed Properties
Servicer	Experienced, Well Capitalized Company	Lacks Commercial Servicing Experience

### ***Performing Pool Required Information***

- Summary of Pool Characteristics  
(size, geographic location, and borrower concentrations)
- Mortgage Loan Data  
(maturity dates, percentage of balloon loans, such as coupon rate information on floating-rate loans, i.e. index, reset timing, and caps, among others)
- Recent Operating Statements and Rent Rolls
- Property Inspection Reports (Largest Loans)  
(pictures and locator maps are useful)
- Appraisals or Valuations  
(optional, but helpful)
- Servicer Information
- Transaction Structure

tee must be qualified to act on such behalf and must not represent a risk to the transaction. In addition, the trustee is often asked to act as a backup liquidity provider and must have an appropriate credit rating.

### ■ ***Financial and Legal Structures***

In addition to considering the risks associated with the transaction's collat-

eral, Fitch IBCA also evaluates the financial and legal structures of the transaction, based on information provided by the issuer, as well as the provisions of the governing documentation. Fitch IBCA pays particular attention to the priority of interest and principal distributions, the seller's representations and warranties, credit enhancement features, such as reserves, use of excess spread, liquidity facilities, support for

basis risk, and any other feature designed to address particular risks associated with the given transaction. Typical representations and warranties may confirm, among other things, that all loans are: performing; secured by a first lien on commercial real estate; governed and originated in accordance with Canadian law; legal, valid, and binding on all parties; and free of any legal dispute, settlement, or waiver, except as otherwise disclosed. The legal structure must provide for timely use of proceeds from the pool to pay investors in the event of any insolvency proceeding.

Real estate documentation is also considered part of the transaction. The analysis described in this report assumes loans in the pool are first mortgages with appropriate casualty insurance. Junior mortgages require significant additional credit support due to increased default risk. The analysis also assures that no additional loan advances are required and that loans are performing.



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