

## French Real Estate Market and Commercial Mortgage Default Study

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### Overview

*In anticipation of the growing French securitization market and as a part of its analysis for rating the first French commercial mortgage-backed securitization (Belenus Securities PLC), Fitch researched the French real estate market to quantify default frequency and loss severity and developed a methodology to analyze French real estate.*

*The results of this research indicate that the current French recession is equivalent to an 'AA' stress scenario, which means that securities rated 'AA' or higher would not experience losses. The recession is generally believed to have commenced in 1990 and has not yet ended. Unlike two minor downturns in 1974 and 1980, this recession did not benefit from rising prices due to inflation. Rental rates have fallen 30% or more, while property values have dropped 50%. Banks with a large proportion of real estate loans were particularly affected as borrowers began to default. Some banks have recognized the new market levels, worked-out individual loans accordingly, and developed a corporate strategy consistent with their aggregate losses. The French government has bailed out some banks by infusing large sums of capital.*

*Fitch's commercial mortgage default study incorporates an analysis of published reports and documents from independent third parties and regulators, a review of current market transactions, and interviews with lenders, economists, investors, developers, brokers, and appraisers. Each source of information was evaluated both individually and as a reflection of its position in the overall French market.*

*After analyzing the current 'AA' recession, as well as additional historical data, Fitch created a French performing loan model based on loan-to-value ratios (LTVs) reflecting default probabilities of 25%-100% and loss severity of 65%-100%. Characteristics of the*

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real estate, the related loan, and the pooled transaction all play an important role in determining credit enhancement requirements for French securitizations. Fitch's rating levels for the recently issued Belenus Securities PLC transaction were derived with the aid of this model. As more information becomes available with respect to French real estate performance, Fitch expects to refine and enhance the model.

### Key Factors Leading to the Recession

For the first time in decades, supply exceeds demand in France. Years of unbridled prosperity, political egos, and European ambitions led to an oversupply in virtually all markets and property types.

### Supply

**Politics:** The 1980s were a decade of strong ambitions for France in the building of a greater Europe. Elected officials encouraged development to accentuate the prominence of Paris in Europe and to "modernize" France. At the local level, decentralization laws gave mayors more authority with respect to urban development and many measured their sphere of influence by the real estate projects launched during their term of office and the affiliated growth in the tax base.

**Bank Lending:** The late 1980s saw an explosion in real estate lending. Banks sought to restore their shrinking margins on traditional activities by focusing on the more lucrative business of real estate. However, the banks' underwriting had been liberal. According to a 1990 Commission Bancaire survey, the two most important underwriting criteria for French banks were absorption assumptions and borrowers' net worth, rather than the fundamentals of high debt service coverage ratio, low loan-to-value ratio (LTV), and prime location. According to the Commission Bancaire, between 1988–1990 the real estate share (residential and commercial loans combined) in bank portfolios doubled for the general banks (2.6% to 5.3%) and tripled for specialized banks (9.9% to 30.3%).

**Development:** Between 1985–1990, office construction doubled nationwide and tripled in the Paris region, and, as a result, office stock doubled between 1975–1995. Construction of industrial and warehouse space also doubled between 1985–1990. Multifamily construction more than doubled between 1985–1989, from 53,000 units to 125,000 units. Most of the retail growth came from shopping centers, which first appeared in France in the late 1960s, and increased 55% between 1985–1989. The hotel stock, which was previously dominated by small hotels averaging 30 rooms in Paris and downtown southern provinces, has seen significant suburban, low-end, and suite facility construction.

### Demand

Demand did not keep pace with an unrestrained growth in supply. The steep increase in service jobs in the 1980s slowed considerably. Lack of consumer confidence, a rise in unemployment, and only slight gains in productivity combined to maintain demand at a low level across property types. Vacancy rates soared from historical low levels of only a few percentage points to the current levels. For example, the office vacancy rate is 10%.

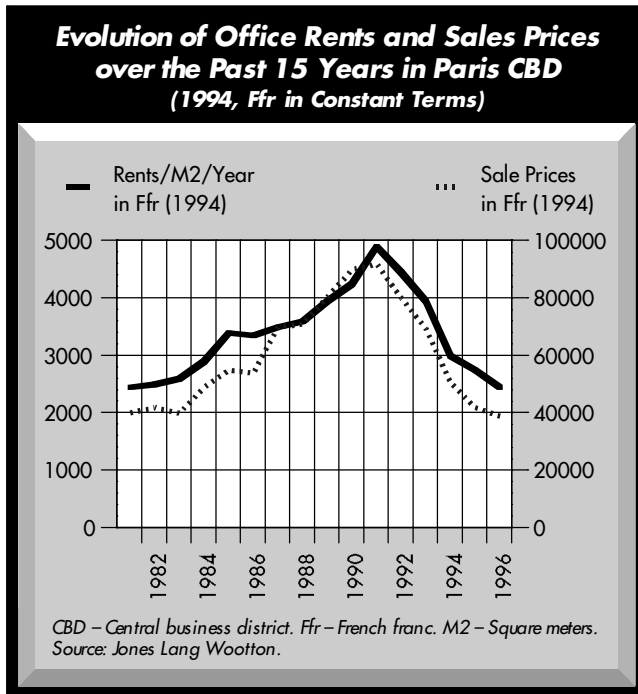
In the 1974 recession brought about by the oil crisis, inflation served to camouflage the downward trends as rents continued to climb in unison with the commercial real estate construction index. The next dip in the cycle occurred in 1980–1982, but again double-digit annual inflation offset the values in constant francs. Without the artificial buoyancy of inflation during this recession, and with such a massive oversupply, rents and values have dropped considerably.

### 'AA' French Recession

The French economy slowed in 1990. Now in its seventh year, the recession has been more severe and lengthy than expected.

**Government:** The government's emphasis has been to reduce the national deficit, meet the Maastricht Treaty common currency requirements, lower interest rates, and stem the rise in unemployment. However, the unemployment rate continues to be a concern. At about 10% or more since 1991, and at approximately 13% in mid-1996, the unemployment rate is one of the highest in Europe. Despite pressures to mitigate well known commercial real estate market impediments such as high transfer taxes and rigid lease structures imposed by laws and decrees, there have been no significant government measures to help the commercial real estate markets. However, the French government financially supported state-controlled institutions that had generated major losses, such as Credit Lyonnais and Comptoir des Entrepreneurs. The government also continued its privatization campaign, including banks and insurance companies that are major real estate players — Banque Nationale de Paris (BNP), Union des Assurances de Paris (UAP), and Assurances Generale de France (AGF).

**Financial Institutions:** Loose underwriting and relationship lending increased banks' real estate exposure. After the market recognized the severity of some losses, a significant slowdown in loan production occurred as early as 1993, culminating in a quasi-freezing of lending and the use of defeasance structures in 1994–1995. Defeasance structures were used by some banks as a vehicle for removing "bad" real estate assets from their balance sheet by selling them to a "bad" bank. More recently, loan production has increased modestly but with more conser-



vative origination criteria, such as lower LTV requirements of 65%–80%.

**Real Estate Profession:** The building industry, which represented 12% of the gross domestic product in 1990, lost more than 80,000 jobs between 1992–1993, and bankruptcies almost tripled between 1990–1995 according to Banque de France. Active developers in the Paris region totaled 267 in 1990 but dropped to 85 in 1995. Well known developers like COPRA or Groupe Pierre 1er disappeared, while even the stronger competitors struggled. The largest developer, Bouygues, saw its revenues fall nearly 50% between 1990–1995.

**Market Rents:** Most submarkets and products are approaching what appears to be the trough of a difficult cycle. Only the better products in all category types have stopped deteriorating. The lesser quality buildings are still struggling, and further deterioration, albeit slight, is expected. Overall, rents and values are back to 1981 levels, and vacancy rates have reached new heights for all property

### Office Vacancy Rates

(%)

	As of Sept. 1, 1996
Paris	10.5
Inner Suburb	10.6
Outer Suburb	9.4
Average for the Paris Region	10.1

Source: Bourdais.

types. Most rents remain under downward pressure, with tenants renegotiating their base rents and expense reimbursements.

For example, office rents, which had risen dramatically as new space was brought on the market and new market level leases were written between 1985–1990, have dropped by at least one-third, and values are one-half of what they were at the peak of the cycle. For products with inferior quality and location, drops in values have been even more severe. The 10% overall office vacancy rate mentioned in many surveys includes public sector and owner-occupied buildings; if these are excluded, the vacancy rate for speculative, multitenanted buildings is 17%.

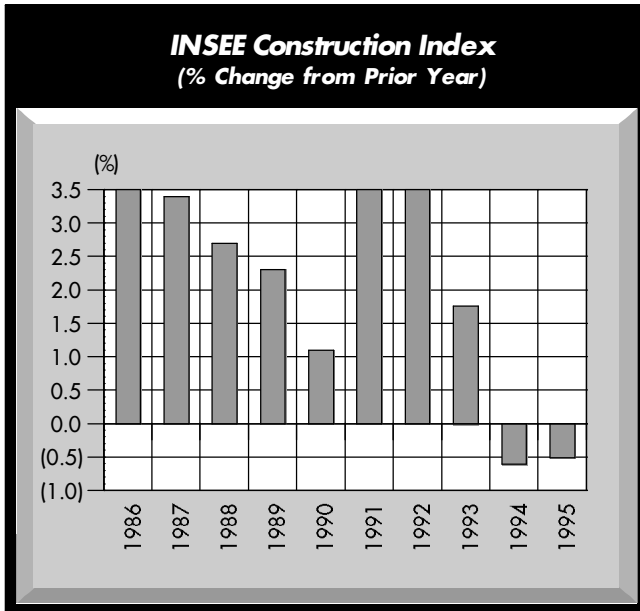
**Investment:** Except for a few bulk transactions, there have been few commercial real estate sales. The volume of transactions decreased from a peak of almost French franc (Ffr) 28 billion in 1990 to barely Ffr3 billion in 1995, its lowest level in 30 years.

Capitalization rates in France have historically been lower than in other countries and have been based on gross revenue rather than net revenue. French office capitalization rates have doubled from a low of 4%–5% in the early 1990s. Multifamily and retail capitalization rates have also increased. Rates on shopping centers have held at fairly low levels because of restrictive zoning laws. The capitalization rates on all property types are expected to continue to edge upward in the next couple of years.

### French Legal System

The French legal system, through applicable laws and regulations, generally favors the lessee over the landlord, the borrower over the lender, and the borrower's employees over the lender, all to the detriment of real estate credit. Some particular provisions that affect real estate values are described below.

**Lessee Options:** The lessee is favored through the 1953 Decree, which grants a lessee the option to terminate its lease in years three, six, or nine (3.6.9 lease) and entitles each lessee to renew its lease upon expiration (the purpose of the renewal right is to enable the tenant to continue to operate its business as a going concern without losing the intangible value attributed to its location). In the event the landlord refused the renewal, the lessee would be entitled to damages covering the loss of intangible value and moving costs. Furthermore, the rate at which rent increases for existing leases may not exceed the published quarterly Index of Construction Costs INSEE (Indice du Cout de la Construction). The net effect of these regulations is that: tenants tend to stay in one location for an extended period; rent increases are limited by the INSEE index, which often results in below market rents; and, in a declining market, lessees take advantage of the 3.6.9 lease to renegotiate



rents down every three years. At the same time, the construction cost index, on which existing French leases are pegged, dropped below zero for the first time.

**Borrower Protection:** The borrower benefits from long and litigious foreclosure and bankruptcy procedures. Foreclosure proceedings can take at least one year and often longer. Bankruptcy proceedings, asset recovery, and access to collateral can take an average of two to three years. In the meantime, the lender may not receive any cash flow from the collateral or any debt service payments at all, notwithstanding the fact that the lender may have an assignment of rents or may not be adequately protected by the value of the collateral. Setting aside amicable settlement procedures, bankruptcy procedures begin with an observation period lasting at least six months and up to 20 months, during which interest payments are stopped and the court examines potential resolution scenarios. The court may choose to either sustain the business as a going concern or sell off all or a portion of the assets and impose court ordered loan modifications (*Redressement Judiciaire*) or to liquidate the assets entirely (*Liquidation Judiciaire*). From a practical point of view, a lender should not count on obtaining any cash payments until the court imposed modification becomes effective or proceeds from liquidation are distributed. In addition, the lender should be aware that in the interest of protecting jobs and being socially responsible, paying the salaries of employees of the borrower comes ahead of the lender's first lien position.

**Assignment of Rents:** Perfection of an assignment of rents requires the borrower, lender, and tenants to agree to or to be on notice of such assignment (depending on the legal form of the assignment). For lenders, the logistical administration of notifying each tenant and each sub-

sequent tenant (or obtaining their consent) of the assignment of rents is uneconomical and, therefore, rarely accomplished. However, upon a loan default, a lender may send a bailiff to the tenant with notification to pay the lender; the tenants usually comply. In any event, the assignment of rents is valid with respect to only base rent.

The end result of the aforementioned rules and decrees is a legal system that serves to increase losses once a loan defaults due to the lengthy period necessary to recover asset value.

## Default Study

The purpose of the default study is to identify the default probability and the loss severity for typical French commercial real estate loans under a specific stress scenario. In this case, Fitch determined that the current French recession is an 'AA' stress scenario. The probability that a loan will go into default under a given stress scenario and the associated loss is predicted on cumulative historical data. Given that the market has not yet fully stabilized, there is still a lingering 'AA' stress (or tail period) that will affect the default probability of existing loans — particularly those that may be either maturing or secured by a property where tenants could renegotiate existing above-market lease rates down in the near future.

Fitch placed significant emphasis on the independent research of Immo Presse, which collected data from banks from 1988–1995. Fitch's study used the data from 14 banks that reported information for 1992–1995. Fitch focused on Immo Presse reports of total commercial real estate portfolio balances, nonperforming real estate loans, defeasance structures, and provisions for real estate loans. The statistics reported by Immo Presse are supported by other published reports, as well as Fitch interviews with representatives from financial institutions and government agencies.

## Default Probability

The first step in determining default probability is to establish a base or typical French loan portfolio. Bank underwriting criteria during the time leading up to the 'AA' recession is a fundamental element of the base portfolio. Based on individual portfolio data and conversations with various lenders, it is evident that the prevailing lending theory assumed that as long as the cash flow of the collateral could pay current interest, then the principal and transfer taxes would naturally be repaid or secured by ever-rising real estate values. As a result of this theory, lenders would generally lend 100% of the real estate value, as well as the transfer tax, which could be equivalent to another 20% of value. Therefore, the typical French commercial real estate loan was in the 100% LTV range.

## Real Estate Portfolio Defaults and Losses

(%)

Institutions	1994				1995			
	Total Real Estate (Ffr Mil.)	Non-Performing/Real Estate	Provisions/Non-Performing	Defeasance	Total Real Estate (Ffr Mil.)	Non-Performing/Real Estate	Provisions/Non-Performing	Defeasance
A	60.0	13.0	48.0	Yes	45.0	11.0	57.0	Yes
B	10.1	51.0	54.0	Yes	7.2	67.0	60.0	Yes
C	23.9	45.0	62.0	No	23.0	47.0	63.0	No
D	27.3	73.0	58.0	No	30.0	76.0	70.0	No
E	23.8	57.0	51.0	No	14.2	82.0	54.0	No
F	18.0	48.0	67.0	No	21.0	42.0	68.0	No
G	26.5	37.0	45.0	No	29.4	35.0	52.0	No
H	13.9	54.0	63.0	No	15.7	50.0	96.0	No
I	6.5	40.0	58.0	Yes	5.5	53.0	66.0	Yes
J	N.A.	N.A.	N.A.	Yes	N.A.	N.A.	N.A.	Yes
K	4.9	51.0	52.0	No	6.0	60.0	58.0	No
L	0.8	50.0	75.0	No	N.A.	N.A.	N.A.	Yes
M	3.9	56.0	55.0	No	2.8	64.0	61.0	No
N	2.2	45.0	50.0	No	N.A.	N.A.	N.A.	No
Total	221.8	41.0	56.0	—	199.8	45.0	65.0	—
Total after Inclusion of Defeasances	311.3	58.0	78.0	—	289.3	68.0	84.0	—

N.A. – Not available. Source: Immo Presse.

Portfolios reviewed generally contained loans secured by a mix of property types located primarily in Paris.

To estimate 'AA' default probability for typical French portfolios, Fitch looked at each financial institution's non-performing real estate loans as a percentage of its total real estate portfolio. The weighted average ratio of non-performing loans to total real estate portfolio went from 36% in 1992 to 45% in 1995 according to data in the Immo Presse study. Including assets put in defeasance structures, the ratio increases to 68% in 1995. For purposes of determining default probability, Fitch assumed that, in addition to the reported nonperforming loans, all loans that had been removed from a particular portfolio by way of a defeasance structure were also in default.

Based on the Immo Presse study, along with confirmation from other published reports and interviews with representatives from financial institutions and government agencies, Fitch found that the default probability for a typical French real estate portfolio under the current stress scenario was approximately 70%. Given that there is still a tail period of this current 'AA' recession, the cumulative default probability for the entire 'AA' stress period is estimated to be 80%. Given that lower LTV loans are less likely to default than higher LTV loans, Fitch expanded upon this default probability analysis by creating a default probability curve designed so that default probabilities range from 25% for loans with low LTVs to 100% for loans with excessive LTVs.

The default curve indicates that the greatest rate of change in the slope of the default probability curve is in the range of 75%–120% LTV, where default sensitivities are the greatest.

### Loss Severity

To measure loss severity, Fitch reviewed commercial real estate bank loan loss provisions, recent bulk sales, and overall market conditions previously discussed.

**Bank Loss Provisions:** According to Immo Presse, loss provisions in 1992 ranged from 15%–67%, with a weighted average of 21% of loan balance. In 1993, loss provisions increased sizably to a weighted average of 43%. After inclusion of defeasance structures, and assuming 100% provisions for all defeased loans, the same annual average provision ratios escalated to 63% in 1993, 78% in 1994, and 84% in 1995. Some of the increased provisions may have been a result of delayed pursuit of borrowers. As banks have gained experience from previous workout or foreclosure situations, they believe they have become more timely and aggressive, thereby reducing the overall cost of liquidation or resolution. In addition, courts have become more expeditious.

**Bulk Sales:** Reports related to 1996 and 1997 portfolio sales of loans and real estate indicate proceeds ranging from 24%–55% of book value, depending on transaction size, loan status as performing or nonperforming, and property quality, type, market position, and location. Infor-

## French Performing Loan Model

(%)

% of Pool	Fitch Loan-to-Value Ratio	Default Factor	Loss Severity	Expected Loss	Weighted Pool Loss
4	< 36	25	65	16.3	0.7
3	36-50	30	65	19.5	0.6
5	51-65	35	65	22.8	1.1
25	66-75	40	65	26.0	6.5
16	76-85	50	65	32.5	5.2
20	86-95	60	65	39.0	7.8
10	96-120	75	65	48.8	4.9
10	> 120	85	65	55.3	5.5
2	Negative/No Value	100	100	100.0	5.0
5	No Gross Rents*	85	70	59.5	1.2
Total Base 'AA' Credit Enhancement Level					38.5
Plus 'AA' Add-On					10.8
Total Final 'AA' Credit Enhancement Level					49.3

\*No property operating information.

mation about the Barclays Bank, UAP, and the first Creditsuez transactions indicate proceeds of almost Ffr1.5 billion for portfolios totaling approximately Ffr5.0 billion, a recovery of about one-third. More recent portfolio sales (1997 Creditsuez and Groupe Consortium de Realisation) also indicate recoveries in the same range.

The bulk sales are indicative of a wholesale price of commercial real estate portfolios. Incorporated in the purchase price is the: purchaser's estimate of liquidation value; cost to foreclose and withstand a borrower bankruptcy; expected interim cash flow from the collateral; future value of the asset and profit; and overall mix of collateral quality, location, property type, age, and market positioning.

**Quantifying 'AA' Loss Severity:** Immo Presse indicates a range of average losses of 56%–65% before inclusion of defeasance loans and 63%–84% after defeasance loans, while bulk sales generally indicate losses ranging from 45%–76% and averaging 66%. Based on this information, Fitch estimates that the average loss severity for a typical French commercial real estate loan is 65%. While Immo Presse indicates that loss provisions may be higher if one assumes 100% provisions for all defeased loans, Fitch recognizes that this is an extremely conservative assumption. Furthermore, bank provisions are not regulated and, therefore, may not be entirely consistent. Fitch is not preparing a model based on the absolute worst-case scenario, but rather a conservative analysis consistent with an 'AA' rating. Fitch has found the bulk sales information to be a good indicator of general market anticipated losses but recognizes that this is conservative assumption. Furthermore, a one-by-one asset sale might generate higher aggregate recoveries than a bulk sale. Upon reaching this general conclusion, Fitch confirmed its opinion with lenders and government representatives, who indicated that the

65% loss estimate would be conservative without being an absolute worst case.

## French Performing Loan Model

The default probability and loss severity findings under an 'AA' stress are the foundation of the French performing loan model. They reflect and are inclusive of the volatility of French real estate values in relation to rents, the legal system and protectionist government, the underwriting criteria and loan documentation, the behavior of borrowers, the creditor's approach to recovery, and the market willingness to purchase commercial real estate.

**LTV Approach:** Given that French underwriting is based almost exclusively on LTV analysis and guarantees and that loan files are generally void of operating statements and debt service coverage analysis, Fitch chose to create its French performing loan model based on LTV. As French lenders and asset managers become focused on obtaining operating statements and underwriting based on debt service coverage ratios, Fitch will consider preparing a debt service coverage model. The current LTV model is based on the best available information, with values adjusted by Fitch to be reasonably conservative.

**Underwriting and Site Inspection:** In determining values of commercial real estate, the French market capitalizes gross rents rather than net operating income. The general explanation for this methodology is that, historically, most leases were net leases requiring the tenant to pay the expenses associated with occupying the premises and most buildings were nearly 100% occupied. Now, due to the oversupply, expenses are generally negotiated, and vacancy rates have risen. The capitalization rates were not reflective of the risk inherent in real estate investing, but were actually lower than bond rates. Therefore, the value

## Fitch Capitalization Rates

(%)

Office	9.0–10.5
Retail	9.0–11.5
Multifamily	6.5–8.0
Industrial/Activity	13.0–14.0
Hotel	11.5–13.0

Note: Fitch assumed average property quality. Capitalization rates vary based on location.

of the real estate reflected neither the different expenses among similar properties nor the risk of real estate investment.

Fitch reunderwriting reflects new market conditions by marking to market revenue streams and analyzing expense information when available for individual loans or related loans (loan families) and then applying the higher of the Fitch capitalization rate or the capitalization rate used by the appraiser or the originator. Fitch capitalization rates are designed to reflect the asset's property type, quality, and location, in addition to required returns for risks taken at the time a borrower must refinance a loan. Fitch capitalization rates are higher than historical French capitalization rates. For instance, Fitch French capitalization rates for average-quality properties range from 9.0%–11.5% for retail and 9.0%–10.5% for office.

Fitch reunderwrites a sample of related loans and visits a sample of properties constituting at least 40% or more of the aggregate outstanding principal balance of the loans. The Fitch sample generally includes the largest loans, assets with unusual characteristics, and collateral representing a cross-section of property types, geographic location, age, and quality. If the initial sample does not capture the significant properties of a pool, additional properties may be seen or underwritten.

**Subordination Levels:** To determine the appropriate subordination or credit enhancement requirements, Fitch analyzes individual loans, as well as the pool characteristics and concentrations. After determining LTV based on Fitch underwriting, a particular loan or loan family will be grouped with other loans with similar LTVs. Based on the Fitch default curve, the appropriate default probability will be assigned to each group of loans. The appropriate loss severity then will be assigned to each loan group. The percentage that each particular group of LTV loans constitutes of the pool will be multiplied by the default probability and the loss severity to determine the base credit enhancement requirement for that particular group of loans. Adding together the credit enhancement requirements for each group of loans gives the total base credit enhancement requirement for the pool.

Other factors, in addition to LTV, affect the default probability and/or loss severity of specific loan pools. These

additional characteristics (add-ons) are also analyzed and quantified and constitute an aggregate pool level credit enhancement requirement that is added to the base credit enhancement level. The sum of the base credit enhancement level plus the add-ons equal the 'AA' subordination. Consistent with other types of structured transactions, credit enhancement requirements for other rating levels are derived from this 'AA' subordination level relative to different risk levels. For instance, 'BBB' securities are expected to withstand a lower level of stress than 'AA' rated securities. Therefore, credit enhancement levels for 'BBB' rated securities are approximately 40% less than 'AA' levels.

## Additional Characteristics

Qualitative, collateral, and structural issues are also evaluated to determine how one pool may react differently from another pool with similar LTVs. These features independently affect either the likelihood of default or the severity of loss. Therefore, Fitch "fine-tunes" base default and loss factors to reflect the following additional characteristics.

**Loan Diversity:** A pool of loans should contain many loans and many different borrowers to minimize the risk of a default of the largest loans creating a catastrophic event for the pool as a whole. Therefore, Fitch assumes that the largest three loans or related loan families will default to determine credit enhancement requirements. Pools with a concentration in a few large loans will require greater



credit enhancement than large, diverse pools with no significant loan concentration.

**Geographic Location:** The typical French real estate loan portfolio is concentrated in Paris because of its market share of French real estate. To the extent a pool is concentrated in another geographic location, credit enhancement would reflect the atypical concentration.

**Property Information:** Property level information is critical to the underwriting of any real estate securitization. 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. no rent roll, operating statement, or appraisal), Fitch will assume additional losses and/or higher default probabilities.

**Amortizing and Balloon Loans:** Loans that are fully amortizing are less likely to default than balloon loans, which have refinancing risks upon maturity. Therefore, Fitch will give credit for loans that fully amortize with constant principal requirements over the life of the loan. No additional credit enhancement is required for typical balloon loans, since the base default probability and loss severity numbers already capture this characteristic.

**Floating-Rate Loans:** In a rising interest rate environment, floating-rate loans are subject to greater stresses as interest requirements increase. Fitch generally assumes a greater probability of default for loans with floating interest rates.

**Collateral Security:** The collateral securing the real estate loan ultimately determines the recovery on a defaulted loan. In the event a lender does not have the equivalent of a first lien perfected security interest in the underlying real estate, the loss associated with such loan will be greater than that of the typical real estate loan. The value attributed to the collateral must be net of prior lienholders. Fitch addresses the collateral security position when determining LTV; only net value after prior liens is used to determine LTV.

In some instances, French commercial real estate loans are secured by a pledge of shares from a commercial real estate company, secured by a third-party guaranty or pledge of business assets, or unsecured loans to corporate real estate companies. Fitch views such secondary forms of security or unsecured loans negatively. Fitch assumes a 100% probability of default and a higher loss severity, depending on the collateral type.

**Property Type:** French underwriting typically did not take specific property type risks into consideration. However, not all property types reacted the same way to the recession. Land, office buildings, and budget hotels suffered the most, while multifamily assets and shopping centers were less affected. Fitch analyzes a sample of each property type and applies gross income haircuts and capitalization rates based on property type in the underwriting process.

**Property Quality:** First class properties have suffered fewer losses than lower quality buildings. For instance, offices with modern facilities, large floor plates, computer capabilities, and prime locations have remained in demand. Unrenovated buildings, which are not very flexible, have difficult layouts, antiquated systems, and are not conveniently located, had their tenants demanding much lower rents. Fitch assumes a greater loss for loans secured by poor quality assets and a smaller loss for top quality assets. Asset quality on a French scale ranges from excellent ("A") through average ("C") to poor ("E"). Factors evaluated in the site inspections include location, quality, submarket characteristics, competition, visibility, access, traffic count, functional obsolescence, deferred maintenance, occupancy, tenant mix, and other relevant property-specific qualities.

**Environmental Risk:** In France, environmental appraisals are not yet a standard part of the underwriting process. Some buildings are being assessed for asbestos, but the legal clean-up requirements are not fully developed at this point. Therefore, absent knowledge of a significant environmental risk, there are currently no add-on requirements. However, this issue is likely to become more important in the future.

**Servicer:** The servicing of a portfolio is critical to the success of asset recoveries. A servicer with experience in working out troubled assets, knowledge about the legal system, a record of sound recoveries, and good reporting capabilities will be viewed more favorably than a servicer that may be slow to react to delinquencies. As the French third-party servicing market matures, distinctions among servicers will become clearer. Credit is given for servicers holding the first loss portion of a transaction because they are incentivized to obtain the highest recovery value to protect their investment.

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

**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 excess spread is available as additional credit support to the rated securities.

## Servicing

The servicer of any pool must be acceptable to Fitch. Fitch 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 reviews the size and diversity of the servicing portfolio and computer capabilities. Collection procedures for delinquencies are also important. Servicing advances

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

Fitch believes the most important area of any commercial loan servicer is the workout and foreclosure area. The servicer review includes a discussion of workout methodologies, recent results, and staff workout experience. Fitch also analyzes foreclosure procedures and the average loss on foreclosures. The real estate owned area is also carefully considered, including a discussion regarding property management issues and strategies.

Fitch also evaluates provisions of the servicing agreement. The agreement should provide sufficient flexibility for the servicer in its dealings with various borrowers. As commercial and multifamily loans tend to have unique characteristics, it would be difficult to predetermine the process a servicer should be required to follow in a workout or foreclosure situation. Therefore, Fitch 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. Factors considered include the size and complexity of the pool as well as the specific duties of the servicer.

### **Financial and Legal Structures**

In addition to considering the risks associated with transaction collateral, Fitch 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 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, appraisal reduction features, 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 French 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 address the timely use of proceeds in the event the issuer files bankruptcy or is consolidated with the seller. Legal opinions of the issuer and seller will address these particular concerns, and other documents will confirm the soundness of the parties and their actions with respect to the transaction. Real estate documents will be reviewed as necessary to identify, quantify, or eliminate risks. For instance, in the absence of a particular representation or warranty (such as an assignment of rents) documents may be reviewed to determine the character or severity of the risk. Particular attention is paid to legal provisions that may be unique to the French Napoleonic code.

### **Outlook**

The French government, financial institutions, real estate professionals, lessees, and real estate investors are expected to guard against future losses by making some changes in the way they conduct their business. The government has instituted some controls and is continuing to encourage privatizations; financial institutions have tightened lending criteria and accelerated pursuit of nonperforming loans; real estate appraisers are adopting discounted cash flow analysis; real estate developers have slowed construction activity; lessees have negotiated some modified rent payments; and foreign investors have re-entered the French market. Securitization is expected to increase as property level information becomes more readily available and as lenders and investors continue to seek profitable exit strategies.

By the time this 'AA' recession has gone through the trough of the cycle and market conditions stabilize, the average default probability of a typical loan is expected to be 80%, and the associated loss severity is expected to be 65%. Fitch will continue to monitor the recession and its implications for the commercial real estate market.

### **Surveillance**

Fitch will provide on-going surveillance for each rated transaction. Surveillance information is available on Bloomberg by typing FTC and GO, and on the Internet at [www.fitchinv.com](http://www.fitchinv.com).





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