CREDIT WEEK STANDARD & POOR'S THE AUTHORITY ON CREDIT QUALITY

COMMERCIAL MORTGAGE SECURITIES

CreditReview

Rating criteria update

Criteria for rating commercial mortgage securities is updated reflecting developments in this sector. The worst-case model component of the criteria is replaced by a more qualitative analysis of the potential risks to the underlying real estate collateral. The use of a predetermined model no longer seems appropriate given the unique nature of each piece of real estate used as collateral in these financings. With the exception of this one important revision, however, the rating criteria for commercial mortgage securities have not changed dramatically since last published. This article articulates the criteria currently in use, using detailed examples to clarify the methodology and conceptual process of determining a rating.

Commercial mortgage securities are debt investments secured by the cash flow and collateral value of a mortgage on commercial real estate. The creditworthiness of the parent company is ignored in such a structured financing because the asset to be financed is isolated in a unique subsidiary and the debt is nonrecourse to the parent. A rating directly addresses the ability of a specified asset, through this unique subsidiary, to service payment obligations to the investor.

S&P's analysis of commercial mortgage securities encompasses both real estate and bond finance. S&P analyzes the performance of a property's mortgage and additional collateral, if any, to evaluate its quality, as well as the security's payment structure to evaluate the likelihood of timely and ultimate payment to security holders. S&P does not rate the physical real estate, but rather the securities backed by mortgages on the real estate and other collateral. While office buildings serve as collateral in the majority of rated financings, almost any income-producing real estate is eligible.

The basis for the rating is the risk associated with the collateral and the ability of the cash flows from that collateral to be received in a timely fashion by security holders. S&P performs a thorough review of the property and the determinants of its cash flow and value. The debt structure payment mechanisms that allow the proceeds from the properties to pass through to security holders also are evaluated. These elements are not considered as separate and distinct but rather in terms of the way they interact to exacerbate or migitate certain risks.

In many cases, the mortgage alone may not secure the rating sought by the issuer. In these situations, additional collateral will be necessary to achieve the rating. Such additional collateral is often referred to as credit enhancements, which may take the form of cash, letters of credit, or guarantees. In any form, these enhancements act as additional collateral for security holders.

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