

of the trust, the servicer is obligated to obtain insurance which, in pool transactions, may be provided by a blanket policy covering all pool properties. Generally, the blanket policy must be provided by an insurance provider with a rating of at least "BBB."

Each servicer, special servicer and subservicer is required to maintain a fidelity bond and a policy of insurance covering loss occasioned by the errors and omissions of its officers and employees in connection with its servicing obligations unless the rating agency allows self-insurance. All fidelity bonds and policies of errors and omissions insurance must be issued in favor of the trustee or other issuer by insurance carriers which are rated by the rating agency with a claims-paying ability rating no lower than two categories below the highest rated certificates in the transaction but no less than "BBB." Subservicers may not make important servicing decisions (such as modifications of the mortgage loans or the decision to foreclose) without the involvement of the master servicer or special servicer, and the trustee or any successor servicer may be permitted to terminate the subservicing agreement without cause and without cost or further obligation to the issuer or the holders of the rated certificates.

Loans secured by credit tenant leases require special analysis. Credit enhancement for credit tenant loans is based on an analysis of the probability that the lessee will file bankruptcy, and the likelihood that the lessee will disaffirm the lease and loan structures that may present a risk other than that of the lessee filing bankruptcy.

Environmental reports for each property are generally required. A reserve is usually required for any reported remediation costs, and any actions covenanted must be completed within a specified period. Risks that cannot be quantified or that have not been mitigated through either remediation or reserves are assumed to pose a risk to the trust and are reflected in the credit enhancement requirements. Properties with certain types of asbestos problems, or those that are assumed to have such problems given their date of construction, are assumed to have higher losses due to the clean-up costs and increased difficulty or cost in leasing or selling the asset. Seasoned or acquired pools that may not have current reports for each property are also assumed to have higher environmental losses.

In general, although there are other types of credit support available, subordination is the only type of credit support used in CMBS. However,

protection is also provided to subordinated classes through the concept of a "directing class" which has evolved to give those holders of rated subordinated certificates in the first loss position some control over the servicing and realization on defaulted mortgage loans. In a typical transaction, the servicer might be required to obtain the consent of the directing class before proceeding with any of the following: any modification, consent or forgiveness of principal or interest with respect to a defaulted mortgage loan; any proposed foreclosure or acquisition of a mortgaged property by deed-in-lieu of foreclosure; any proposed sale of a defaulted mortgage loan and any decision to conduct environmental clean up or remediation. The directing class might also have the right to remove a servicer, with or without cause, subject to the rating agency's confirmation that appointment of the successor servicer would not result in a qualification, withdrawal or downgrade of the then-applicable rating assigned to the rated certificates, compliance with the terms and conditions of the pooling and servicing agreement and payment by the directing class of any and all termination or other fees relating to such removal. Holders of CMBS enjoy additional protection, in that the master servicer or servicer occupies a first-loss position and usually holds an equity stake in the offering, which gives it an incentive to maximize recoveries on defaulted loans. The master servicer and servicer are in a first loss position because they hold the most subordinated equity position interest(s) in the trust. Accordingly, they absorb losses before any other classes of securityholders.

Additional cash flow stability is created through call protection features on the commercial mortgages held in the trust. Call protection prevents the borrowers from prepaying the mortgage loans during a fixed "lock-out period." In certain transactions, under the terms of the mortgage agreement, the borrower is only allowed to prepay the loan at the end of the lock-out period if it provides "yield maintenance"²⁴ whereby it is required to contribute a cash payment derived from a formula which is calculated based on current interest rates and is intended to offset the borrower's refinancing incentive. This amount also effectively compensates the

trust for the loss of interest payable on the mortgage loan.

Another mechanism, referred to as "defeasance", assures stability of cash flow and operates as follows. If a borrower wishes to have the mortgage lien released on the property (for example, where it is being sold), the original obligation either remains an asset of the trust and is assumed by a third party, or a new obligation with the same outstanding principal balance, interest rate, periodic payment dates, maturity date and default provisions is entered into with such third party. The new obligation replicates the cash flows over the remaining term of the original obligor's obligation. In either case, the property or assets originally collateralizing the obligation are replaced by collateral consisting of United States Treasury securities or any other security guaranteed as to principal and interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States (referred to herein as "government securities").

Defeasance generally operates so that, pursuant to an assumption and release or similar arrangement valid under applicable state law, the original obligor is replaced with a new obligor.

The new obligor is generally a bankruptcy-remote special purpose entity (SPE), the assets of which consist of government securities. In the defeasance of a mortgage loan held in a CMBS pool, a new entity must be created (the SPE) which becomes the obligor on the mortgage loan and holds the government securities being substituted for the original collateral securing the mortgage loan. This newly formed entity is required by the rating agencies to be an SPE in order to assure that the owner of the securities to be pledged has no liabilities or creditors other than the CMBS pool trustee, has no assets or business other than the ownership of the government securities and is not susceptible to substantive consolidation with the original mortgage borrower in the event of the original mortgage borrower's bankruptcy. Such an SPE is purely passive and does not engage in any activities other than the ownership of securities. Although there is no prescribed market requirement as to ownership of the SPE, the securitization sponsor (e.g., the original mortgage lender) is usually its owner, except that in certain circumstances the original mortgage borrower may own the SPE for a variety of reasons; e.g., to be entitled to any excess value of securities pledged as collateral at maturity of the new defeasance note over the amount

²⁴ The Applicant represents that the yield maintenance provision in the mortgage agreement would meet the definition of a "yield supplement agreement" currently permitted under section III.B.(3)(b) of the Underwriter Exemptions.