

Commercial Mortgage
Servicer Report

Capital Servicing Co., Ltd.

Rating

Special Servicer CSS3+ (JPN)*

*Japan.

Analysts

Tokyo

Yumiko Sugii
813 3288 2701
yumiko.sugii@fitchratings.com

Masako M. Osako
81 3 3288 2704
masako.osako@fitchratings.com

New York

Stephanie M. Petosa
1 212 908-0720
stephanie.petosa@fitchratings.com

Company Contact

Capital Servicing Co., Ltd.
Carl N. Everett
81 3 3224 3660

■ Summary

Fitch Ratings (Fitch) has assigned Capital Servicing Co., Ltd. (CSC) a special servicer rating of 'CSS3+(JPN)' based on the company's ability to specially service non-performing loans (NPLs) secured by commercial real estate and to appropriately report to clients. The rating also takes into account the servicer's strengths and Fitch's concerns as listed below.

■ Strengths

- Strong commitment from Lehman Brothers (Lehman).
- Comprehensive policies and procedures and appropriate internal auditing.
- Steady growth and diversification in servicing assets.

■ Concerns

- Being in its startup phase, the servicer's financial condition still requires improvement.
- Systems under development.

■ Mitigants

- Steady growth in the servicing portfolio. Lehman has expressed its intention to retain CSC as its exclusive servicer.
- The current systems are appropriate for the present volume of business.

■ Company Overview

CSC is a Japanese licensed servicer whose primary business is to service Lehman's Japanese NPL and real estate portfolios.

CSC was formed in September 1998. A year later, CSC obtained a servicing licence from the Ministry of Justice (MOJ) and became the 23rd licensed servicer. In December 1999, servicing operations were commenced. Gate Capital, one of the US asset management companies Lehman used, supported CSC in database and other IT development, the formation of policies and procedures and asset management strategies. Subsequently, the role of Gate Capital was substantially taken over by Hatfield Philips, into which Lehman consolidated all of its related servicers in the US including Gate Capital.

Hatfield Philips, Lehman's US servicing arm, which indirectly owns 75% of CSC, whilst the remaining 25% is owned indirectly by a CSC employee. Fitch rates Hatfield Philips as 'CPS2' and 'CSS2'. Lehman Brothers Holding, Inc., to which Hatfield offers exclusive loan servicing, is rated 'A+/F1' by Fitch.

Lehman has been actively purchasing Japanese NPLs since 1998. Its cumulative investment at 31 March 2002 amounted to JPY1,575billion in terms of UPB (unpaid principal balance). Lehman has exclusively used CSC for the servicing of its NPL assets in Japan, except for one pool, for which the seller requested servicing by its own subsidiary. Even though the servicing agreement between Lehman and CSC does not have an exclusivity provision because of Lehman's policy, Lehman has expressed its continued commitment to CSC's servicing operation.

Portfolio Statistics (CMBS only)

From Inception through March 31, 2002

	JPY m	No. of Borrowers
Total loans serviced (since inception)	1,556,929	3,229
Dispositions:		%
Total since inception	39,776	100.0%
Foreclosure	17,965	45.2%
Voluntary Sales	8,870	22.3%
DPO	905	2.3%
Others	12,037	30.3%

Although the largest asset class CSC currently services is NPLs secured by commercial real estate, the company has also been expanding servicing of non-performing residential loans, performing and sub-performing loans, in addition to "ponkasu" loans, i.e. unsecured loans after disposition of collateral. Our rating analysis focuses on the company's commercial-mortgage servicing.

In October 2001, CSC was appointed primary servicer for a securitised pool of residential loans. It has also concluded an advisory agreement with a housing-loan guarantee company for the management of its NPLs.

In the future, CSC sees growth opportunities in the new business lines such as property management, residential-loan management and securitisation servicing.

Financials

For the fiscal year ended 30 November 2001, total revenue increased by 44% to JPY373.4m as servicing fees rose in line with growth in total assets serviced. Other fees such as due-diligence and licence charges also surged. Net income for the year was JPY22.5m, while the loss carry-forward as of end-November amounted to JPY272.6m, as the servicer is still in the startup phase. To take full advantage of the tax loss carry-forward, CSC is carefully managing revenues.

Servicing fees for the largest pool owned by Lehman are calculated based on the balance of serviced assets, without any incentive charges. For other pools, fee rates are flexible with certain incentive fees. Another major income source is due diligence fees, which accounted for about 20% of total revenues for the 21 months to September 2001.

As at November 2001, CSC's balance sheet revealed high liquidity. Total assets net of investors' cash and deposits amounted to JPY323m, 71% of which was current assets. Without any outstanding external loans, total liabilities were less than half current assets. Initial capital of JPY500m was partly eroded by a loss of JPY273m carried over, but this deficit will shrink as CSC has already broken-even on a monthly basis.

Employees

As of October 2001, CSC had a total of 30 employees, consisting of three executives/legal, nine in asset management, two in residential loan management, two in REO management, four in valuation, and 10 in finance/accounting/general administration.

The following four executives play key roles in CSC's management:

(1) Mr. Carl Everett, the representative director, who has 22 years' experience in workout and real estate development in the US. After being involved in setting up another Japanese servicer, he joined CSC in 1999.

(2) The senior vice president and controller joined CSC in July 2000. He oversees the accounting/finance-related operations, policies and procedures and systems. Prior to CSC, he was, for one year, a mortgage product controller at Lehman Brothers Japan. Prior to that, he was at Sanford C. Bernstein for 5½ years in various positions including portfolio administrator and business analyst.

(3) A legal counsel who has been practicing law since 1981. Her main responsibilities at CSC include monitoring the servicer's compliance with various related laws including the Servicer Law and giving asset managers legal advice.

(4) The portfolio manager (PM), whose main responsibilities are: 1) supervising and educating asset managers, 2) overseeing the company's overall daily operations, and 3) supporting the representative director in corporate management. He also liaises with MOJ officials. He joined CSC in October 1999 initially as an asset manager, and in August 2001, was appointed as the PM and is devoted full-time to management. Prior to joining CSC, he was with a major Japanese city bank for 30 years and, for the most recent eight years, was engaged in NPL workout.

The asset management department's primary task is to manage non-performing commercial-mortgage loans. The department consists of six asset managers, three senior and three junior, and two assistants, supervised by a portfolio manager.

The senior managers have on average, 16 years' of related-industry experience, including workout experience of five years and real estate experience of four. Their average tenure with CSC is 16 months. The junior asset managers' experience is on average nine years in related industries and five in workout. One of them also had two years' experience in real estate.

Two assistants help asset managers in administrative support, legal case monitoring, closing document review and document custody. They also produce letters of introduction to obligors and input data into the systems.

The REO manager has 19 years' experience as an architect, engaged in construction projects and city planning both in Japan and the US. He also supervised various aspects of projects such as budgets, purchases, selection of contractors and reporting. Despite his lack of marketing experience, by working closely with the representative director, who has extensive experience in this field, he has mastered marketing skills and was involved in the successful sale of two large REO properties.

To deal with the bilingual environment, CSC has hired a full-time interpreter. The company also offers

weekly English lessons to all asset managers. Case memos written in Japanese are translated into English by assistants, while narratives are minimised by utilising templates.

Staff turnover is moderate. Between inception and July 2001, only two staff members left for other job opportunities, three left for further education, and one was dismissed.

During the 12 months to September 2001, asset managers received an average 15 hours in-house training (excluding English lessons), primarily on IT skills, investment analysis and business plans/approval memos. In addition, asset managers attended two outside seminars on workout/restructuring and bankruptcy/collection laws totalling six hours. CSC offers a tuition reimbursement programme. Weekly asset manager meetings also serve as training for asset managers, where the portfolio manager reviews case memos. In addition, an off-site asset manager meeting is to be held every January to review performance, exchange ideas and set goals for the coming year.

■ Technology

CSC's servicing systems adequately meet the requirements for daily servicing operations and client reporting.

As of November 2001, CSC used three types of data systems:

- 1) An internally-developed servicing system "Japan CMA database" using a Microsoft-Access platform.
- 2) For corporate accounting, off-the-shelf software, common among US small enterprises, is used to track the company's general ledger and balance sheets, monitor cash movements and make cash payments.
- 3) CSC also uses a sales comparable database provided by an external real estate vendor, for due diligence services.

Japan CMA database's main purpose is to track the status of loan portfolios in areas such as collections, strategies, values and legal balances, and to efficiently produce various reports for clients, management and the MOJ. Key screens are in two languages so that non-English speaking asset managers can directly monitor the status of their assets online. Assistants to asset managers are responsible for data inputs and updates.

Although the system's capacity meets CSC's current servicing needs, management is considering switching to a more robust platform in view of the rapid growth in volumes of assets serviced and the number of system users.

System improvements are currently being carried out to deal with capacity constraints, loan-level data management and integration of various data on to one platform.

A full-time employee is responsible for the daily maintenance of systems with the support of an independent IT consultancy that offers a 24 hour-seven days a week service. Another important responsibility of the IT staff is to familiarise employees with the systems through training.

System security measures are comprehensive. Access is restricted by user IDs and passwords. The room where the servers are located is secured. CSC periodically tests the system's ability to withstand attack.

Backup procedures are in place. The two servers are backed up daily, Monday through Friday, copies of which are stored on-site. A copy of the backup tape is couriered twice a month to an overseas sister company.

A comprehensive disaster recovery and business resumption plan is also in place. The plan is maintained by the office manager, and is reviewed annually to ensure it is current and appropriate. In an emergency the designated director will determine a temporary business operation plan. Temporary office space will be arranged if it is necessary to evacuate the building and/or the area (e.g. in the event of a fire or an earthquake).

■ Policies and Procedures

CSC maintains appropriate internal control with current and comprehensive policies and procedures as well as various audits. In addition, the in-house lawyer and portfolio manager ensure CSC's compliance with the Servicer Law as well as the MOJ's decrees and guidance.

The policies and procedures manuals cover the following key areas: (1) portfolio policy and administration policy, (2) accounting, (3) human resources, (4) general affairs and (5) IT. The manuals are updated semi-annually with all updates reviewed by middle and senior management, with

credit committee oversight if applicable. They are accessible on-line for all employees, but irregular alterations cannot be made.

Regular internal audits cover all material aspects of servicing and accounting operations, which are intended not only for internal control but also for preparation for external audits. Frequency of audit varies by area and depends on its importance. Past internal audits have found no material departure from the policies and procedures.

To date, CSC has been subject to the three types of external audit: (1) MOJ audit, (2) annual financial audit, (3) annual agreed-upon procedures.

The first MOJ audit was conducted in September 2001. The Ministry found a few minor deficiencies, and CSC has already corrected most of them. The remaining issue will be resolved in the near future when the necessary database enhancement is complete.

The first financial audit was performed for the fiscal year ended November 2000 in line with the Japanese Commercial Code. Ota Showa, a major Japanese accounting firm, opined that CSC's financial statements were fairly presented.

Agreed-upon procedures were performed from July through September 2000 by an audit firm to evaluate the effectiveness of the servicing operations. The auditor reviewed mainly the following areas and found no exception: (1) appropriateness of bank accounts, (2) timely and accurate fund transfer procedures, (3) appropriate classification of cash collections, (4) handling of postage stamps and petty cash, (5) fidelity bonds and (6) documentation. Fitch notes that the agreed-upon procedures, although not commonly practiced by Japanese servicers, adds an additional comfort to investors.

■ Special Servicing

Between inception and end-March 2002, CSC serviced loans totalling JPY1,585bn in UPB extended to 4,908 borrowers.

Excluding residential loans, UPB and the number of borrowers stood at JPY1,556bn and 3,229, respectively. Total collections since inception through to March 2002 were JPY39.8bn.

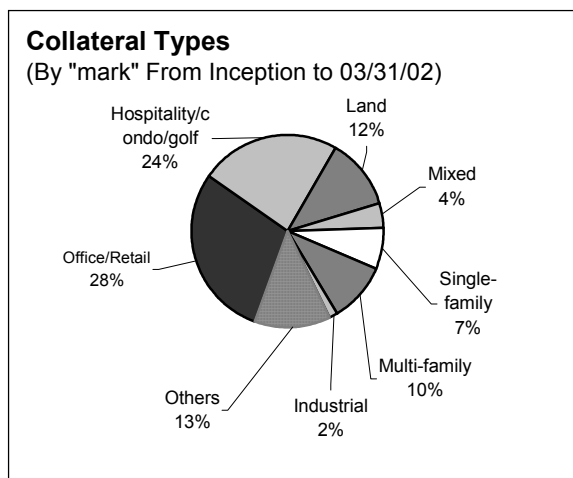
A collection target, or "mark", is set for each asset purchased by Lehman. Determined at underwriting,

it includes outlay for purchase, servicing and other costs, in addition to an expected profit margin. According to CSC, Lehman expects no less than the "mark". CSC encourages above-mark performance with an asset manager incentive plan. The incentive includes bonuses for CSC's asset managers who exceed their targets. Since inception, CSC has achieved a 4.33% return over the "mark".

By type of resolution, foreclosure accounts for 45.2% of total resolutions to date, followed by voluntary sales of 22.3%. This high concentration in foreclosure is partly attributable to the staffing constraint in the early days. As the number of asset managers has increased in the past 12 months management expects more voluntary sales and less foreclosures in the future. In terms of performance against the "mark", voluntary sales were 8.23% in excess of the target, while foreclosure resulted in a moderate 0.23% excess.

The average time to resolution is about 11 months and in line with other servicers Fitch has analysed. By type of resolution, voluntary sales took 314 days on average, while foreclosure took about a month longer. DPO was much speedier, taking only 220 days on average. Client approval is required for all credit bids and when the estimated collection is less than the targeted mark amount.

CSC has a valuation department with four real estate appraisers. In a portfolio acquisition, the department works closely with Lehman's acquisition team from an early stage, such as in due diligence procedures. Asset managers can benefit from the team's knowledge of the underwriting processes. In a large acquisition, asset managers help the valuation team.



Initial loan set-up processes:

(1) Loan Boarding: Whenever possible, data will be uploaded from data tapes. Remaining fields will be manually input by asset management administrators.

(2) The portfolio administrator verifies all asset data such as property, "mark" and UPB, and corrects any discrepancies in the various closing documents. The asset administrator will also check the existing portfolios for any duplicate borrowers.

(3) If necessary, letters of introduction are prepared by asset managers' assistants and sent to obligors within 30 days of the purchase of loans.

(4) New assets are assigned to asset managers by pool, at the discretion of the portfolio manager, while loans after collateral disposition will be assigned to one specific asset manager.

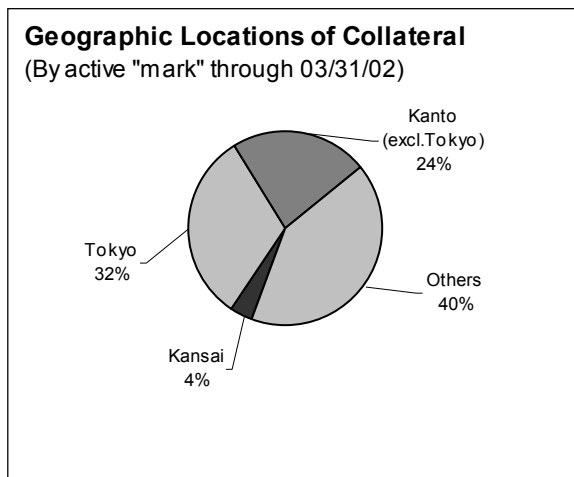
As of March 2002 the average number of active loans and collateral properties per asset manager was over 200 and 85 respectively. Although this was slightly higher than the industry standard, CSC has adequately managed the asset managers' workloads by hiring an asset manager specialising in "ponkasu" loans. Accordingly, the average number of assets valued at over JPY25m per manager is 25.

For each new portfolio, an asset manager will prepare a business plan for at least the top 10 assets, which should represent more than 75% of the pool in value. Each asset manager updates the business plans for his/her top 20 assets semi-annually.

A weekly watch list is produced and reviewed by management to monitor properties proving difficult to resolve or requiring close attention (e.g. minimum bid price below the mark, anti-social elements).

Foreclosure cases are monitored by each asset manager on the CMA database. A director, the portfolio manager and the auditor review foreclosure reports produced by the systems weekly.

CSC manages real-estate owned (REO) for a Lehman vehicle. Its REO management department consists of two professionals, a manager and two associates. Property status, rent rolls, cash flows and bank accounts are reported to investors monthly. Between inception and end-March 2002, CSC managed six REOs. To date, it has sold two and gained 19% over the mark. The average time from REO acquisition to resolution was 20 months.



CSC maintains an efficient and effective cash processing system. In principal, cash receipts and payments are managed through an electronic banking system. The accounts are automatically swept every business day. To co-investors with Lehman, transfer is made weekly. Most of the clients have an automatic sweep. Unidentified cash receipts are temporarily assigned to suspense accounts. Asset

managers will be notified of such “unallocated” collections, and will identify them. Physical delivery of money and securities are insured up to JPY30m.

Proper expense control is in place. All investor expenses have to be approved by a director, portfolio manager or the CFO. Additional approval is required before submitting the payments to electronic-banking systems. Excess cash is invested in short-term liquid assets such as bank CDs.

CSC is appointed as the document custodian by the existing clients. Procedures for document management are adequate. CSC keeps the original loan documents in a fireproof vault within its office. An assistant to the asset managers is in charge of loan document management.

CSC uses third-party professionals for appraisals and environmental audits. For complicated restructuring plans, such as equity participations, it seeks the advice of external legal counsel and tax consultants. Recently, CSC began using a few sub-servicers for “*ponkasu*” assets. Performance of sub-servicers are closely monitored.

Copyright © 2002 by Fitch, Inc. and Fitch Ratings, Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided “as is” without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified, and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at any time for any reason at the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services Act of 1986 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.