CRE Finance Council

WHERE CAPITAL AND IDEAS MEET

TESTIMONY OF LISA PENDERGAST ON BEHALF OF
THE COMMERCIAL REAL ESTATE FINANCE COUNCIL

Before the
UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES, INSURANCE AND INVESTMENT

HEARING ON: "THE STATE OF THE SECURITIZATION MARKETS"

MAY 18, 2011

The Commercial Real Estate (CRE) Finance Council is grateful to Chairman Reed, Ranking Member Crapo, and the Members of the Subcommittee for holding this hearing to examine the state of the securitization market. Commercial real estate is the backbone of the American economy. Commercial real estate houses the space where everyone in your states goes to work and, in the case of multifamily, live. Specifically, commercial real estate comprises the office buildings where employees work; the strip malls, grocery stores and other retail establishments where goods are sold and food purchased; the small business spaces on main street that drive local economies; the industrial complexes that produce steel, build cars, and create jobs; the hospitals where doctors tend to the sick; and the hotels where relatives, vacationers and business executives stay.

The CRE Finance Council represents all constituencies in the broader CRE finance market that provides the money to finance these businesses, and we appreciate the opportunity to share our views on the current state of the Commercial Mortgage-Backed Securities (CMBS) sector of the securitization markets. As explained in detail below, the CMBS market is in the early stages of what we hope will be a robust recovery. At this moment, the securitization risk retention framework mandated by Dodd-Frank is the biggest threat to sustaining that recovery. While we are thankful to both Senator Crapo for his amendment to Dodd-Frank that created specific a CMBS retention framework, and to the regulators for considering that framework in their deliberations, we have serious concerns with the proposed rules. Specifically, there are three areas under the rules that could negatively affect the industry if implemented as proposed, including the: (1) Premium Cash Capture Reserve Account; (2) Conditions for a third party to purchase the risk; and (3) the exemption for qualified commercial loans. Under the terms of the statute, those rules will not go into effect until 2013. It is critical that the six agencies that are charged with implementing the CMBS components of that securitization risk retention framework take whatever time they need now to get the rules right. We therefore ask you to communicate with the regulators and urge them to take their time finalizing this important set of rules by extending the current June 10th rulemaking response date and by then re-proposing the draft rule which – hopefully – will incorporate and respond to the extensive industry feedback that they will receive.

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Introduction & Overview

The $7 trillion commercial real estate market in the United States is just emerging from a period of serious duress brought on by the severe economic downturn, and significant hurdles remain to recovery in the near term. The challenges posed by the distress the CRE market has experienced will continue to have an impact on U.S. businesses that provide jobs and services, as well as on millions of Americans who live in multifamily housing. Since 2009, the CRE problem shifted from a crisis of confidence and liquidity to a crisis of deteriorating commercial property fundamentals, plummeting property values and rising defaults. Through 2017, approximately $600 million of CMBS loans and over $1.2 trillion in outstanding commercial mortgages will mature, many of which are secured by smaller CRE properties; borrower demand to refinance those obligations will be at an all-time high.[1]

Prior to the onset of the economic crisis, commercial mortgage-backed securities ("CMBS") were the source of approximately half of all CRE lending, providing approximately $240 billion in capital to the CRE finance market in 2007 alone. After plummeting to a mere $2 billion in 2009 at the height of the crisis, the CMBS market began to see signs of life in 2010 with $12.3 billion in issuance. Thus far in 2011, just under $10 billion CMBS have been issued, with projections for full-year volume ranging from $30 to $50 billion. Furthermore, the total CMBS issuance for 2011 is expected to range from $30 to $50B, depending on a number of factors including economic conditions and the manner in which regulatory and accounting changes are implemented.

One of the overarching questions faced at this juncture is whether CMBS will be able to satisfy the impending capital needs posed by the refinancing obligations that are coming due. Without CMBS, there simply is not enough balance sheet capacity available through traditional portfolio lenders such as banks and life insurers to satisfy these demands. It is for this reason that Treasury Secretary Geithner noted two years ago that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to businesses – large and small."[2] Similarly, then-Comptroller of the Currency John C. Dugan noted that, "[i]f we do not appropriately calibrate and coordinate our actions, rather than reviving a healthy securitization market, we risk perpetuating its decline – with significant and long-lasting effects on credit availability."[3]

Against this backdrop, Congress adopted a credit risk retention framework for asset-backed securities in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[4] At the same time, the CRE finance industry has taken direct steps to strengthen the CMBS market and to foster investor confidence through the completion of "market standards" in the areas of representations and warranties; underwriting principles; and initial disclosures. Scores of members of the CRE Finance Council across all of the CMBS constituencies worked diligently on these market reforms for over a

[1] The Dodd-Frank NPR: Implications for CMBS, April 12, 2011, Morgan Stanley at 1.

[2] Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) available at http://www.ustreas.gov/press/releases/tg18.htm.

[3] Remarks by John C. Dugan, Comptroller of the Currency, before the American Securitization Forum (Feb. 2, 2010), at 2 (available at http://www.crefc.org/uploadFiles/CMSA_Site_Home/Government_Relations/CMBS_Issues/TALF_Treasury_Plans/DuganRemarksatASF201.pdf.).

[4] Pub. L. No. 111-203.

year. We anticipate that new market standards, coupled with the unparalleled disclosure regime already in place in the CMBS market, will create increased transparency and disclosure in underwriting and improved and enforceable industry representations and warranties, all of which we believe will go a long way toward meeting both investor demands and the Dodd-Frank risk retention objectives.

We are thankful to Senator Crapo, who added a provision to Dodd-Frank requiring the regulators to specifically address some of the unique issues and opportunities posed by the CMBS asset class in crafting the risk retention rules for CMBS. And we are grateful to the regulators who have abided by this mandate in issuing their initial set of proposed risk retention rules for comment.

That said, the proposed rule is long and complicated, containing over 300 pages of analysis and roughly 170 questions open for comment. As explained in detail below, several facets of the proposal are controversial. Indeed, as the regulatory process moves forward, many will argue that implementing certain requirements – or the failure to implement certain requirements – will be a death knell for the market. The more likely outcome is that the failure to get the details right will restrict the overall amount of capital that is available through the securitization finance markets. The proposed rules impose additional costs on and will – in some cases – disincentivize issuers and disrupt the efficient execution of capital structures that securitization provides.

If not properly constructed, the risk retention rules could potentially result in a significantly smaller secondary market, less credit availability, and increased cost of capital for CRE borrowers. This may result in balance sheet lending (i.e., portfolio lending) at more competitive rates (which would be counter to historical experience), thus attracting the safest risks to the portfolio space and leaving the smaller and/or riskier loans for the CMBS where borrowers will have to pay higher rates. Further, small borrowers – those that are not concentrated in the major urban areas and that need loans in the sub-$10 million space – would be the primary victims of these changes. For these reasons, 23 separate trade organizations, representing many different types of borrower constituencies, as well as lenders and investors in different asset classes, jointly signed a letter last year urging careful consideration of the entirety of the reforms to ensure that there is no disruption or shrinkage of the securitization markets.[5]

As our members continue to work through the proposed rule to better crystallize our views, we cannot overstate the stakes, given that this rule will directly impact credit availability and the overall economic recovery. The agencies need to satisfy the somewhat arbitrarily imposed Congressionally-mandated rule promulgation schedule, and we are concerned that the ultimate judgments they reach may not be as soundly thought through as a more generous schedule would allow. We therefore ask that you consider extending those deadlines; this may be especially appropriate given the fact that under the Dodd-Frank provisions the rules for non-residential asset-backed securities would not go into effect for an additional two years and our industry could still abide by that final effective date even if more time were allotted prior to finalizing the actual rules.

We also ask that you urge the regulators to take advantage of such an extended rule promulgation schedule by both (a) holding public roundtables to ensure that the public understands the intent behind each proposed provision, and (b) re-proposes the rules for further comment after initial comments are received on June 10th. As one prominent commentator has noted:

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[5] A copy of the March 25, 2010 letter is attached.

> Still, that there appeared to be such a wide gap between regulators' intentions and the market's interpretation for the proposal's language suggests that a single round of formal market feedback, after which the regulators finalize the rules, may not be enough. This would especially be the case if the final rules indeed contained substantial revisions to key provisions, such as the premium capture account. Such revisions could introduce fresh confusion or misrepresentation of the regulators' intentions.[6]

As noted, such a deliberate approach and a re-proposal of the rules need not alter the effective implementation date for the industry, given that the statute does not dictate that the rules be effective until 2013 and the CMBS industry does not need two years to effectuate the new retention requirements.

The balance of our testimony will focus on six key areas:

(1) A description of the CRE Finance Council and its unique role;

(2) The current state of CRE finance, including the challenges that loom for the $3.5 trillion in outstanding CRE loans;

(3) A framework for a recovery, including the unique structure of the commercial market and the importance of having customized regulatory reforms;

(4) The CRE Finance Council's market standards initiatives, which have been designed to build on existing safeguards in our industry, to promote certainty and confidence that will support a timely resurgence of the CRE finance market in the short term, and a sound and sustainable market in the long term;

(5) The CRE Finance Council's general reactions to the recently proposed regulation to implement Dodd-Frank's risk retention requirement; and

(6) Actions that can be taken to ensure that the CMBS securitization market continues to heal and recover.

Discussion

1. The CRE Finance Council

The CRE Finance Council is the collective voice of the entire $3.5 trillion commercial real estate finance market, including portfolio, multifamily, and CMBS lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers.

Our principal missions include setting market standards, facilitating market information, and education at all levels, particularly related to securitization, which has been a crucial and necessary tool for growth and success in commercial real estate finance. To this end, we have worked closely with

[6] Citigroup Global Markets CMBS Weekly at 10 (April 29, 2011).

policymakers in an effort to ensure that legislative and regulatory actions do not negate or counteract economic recovery efforts in the CRE market. We will continue to work with policymakers on this effort, as well as our ongoing work with market participants and policymakers to build on the unparalleled level of disclosure and other safeguards that exist in the CMBS market, prime examples of which are our "Annex A" initial disclosure package, and our Investor Reporting Package™ ("IRP") for ongoing disclosures.

While the CMBS market is very different from other asset classes and is already seeing positive developments, the CRE Finance Council is committed to building on existing safeguards, to promote certainty and confidence that will support a timely resurgence in the short term and a sound and sustainable market in the long term. In this regard, we have worked with market participants to develop mutually agreed upon improvements needed in the CRE finance arena that will provide an important foundation for industry standards. Prime examples of our work include both the CRE Finance Council's "Annex A" initial disclosure package and the Investor Reporting Package™ for ongoing disclosures.

Furthermore, our members across all constituencies have devoted an extraordinary amount of time over the past year to working collaboratively and diligently on the completion of market standards for: (1) Model Representations and Warranties; (2) Underwriting Principles; and (3) Annex A revisions, all of which we previously have shared with the regulators charged with implementing the Dodd-Frank risk retention rules: the Securities and Exchange Commission, Federal Reserve Board, Federal Deposit Insurance Corporation, Department of the Treasury, and the Office of the Comptroller of the Currency. We anticipate that these three new market standards initiatives, along with the unparalleled ongoing disclosure offered by our existing IRP, will create increased transparency and disclosure in underwriting and improved industry representations and warranties and enforcement, which we believe will go a long way toward meeting both investor demands and Dodd-Frank objectives.

2. <u>The Current State of CRE Finance</u>

CRE is a lagging indicator that is greatly impacted by microeconomic conditions, and as such, began to be affected by the prolonged economic recession relatively late in the overall economy's downward cycle. What started as a "housing-driven" recession due to turmoil in the residential/subprime markets (in which credit tightened severely) quickly turned into a "consumer-driven" recession, impacting businesses and the overall economy. Not surprisingly, CRE has come under strain in light of the economic fundamentals today and over the last three years, including poor consumer confidence and business performance, high unemployment and property depreciation. Unlike previous downturns, the stress placed on the CRE sector today is generated by a "perfect storm" of several interconnected challenges that compound each other and that, when taken together, has exacerbated the capital crisis and will prolong a recovery:

- **Severe U.S. Recession**. – There is not greater effect on CRE than jobs and a healthy economy. With a prolonged recession and an unemployment rate at or above 8.8% for the last 24 months, , commercial and multifamily occupancy rates, rental income and property values have subsequently been negatively impacted, thus perpetuating the economic downturn. Those impacts persist even as the recession has abated.

- **"Equity Gap."** – During the worst of the economic crisis, our industry saw CRE assets depreciate in value by 30% to 50% from peak 2007 levels, creating an "equity gap" between the outstanding loan amount and the current value of the CRE property, thus requiring additional equity to extend or re-finance a loan. This dynamic affects even "performing" properties that continue to support the payment of monthly principal and interest on the underlying loans. While there has been some lessening of the equity gap in the past year as the slide in property values slowed, the market is at a sensitive point on the climb toward recovery and a shortage of capital at this stage could cause a resurgence of the equity gap problem.

- **Significant Loan Maturities**. – Approximately $1.2 trillion in CRE loans mature over the next several years. Perhaps most significant is that many of those loans will require additional "equity" to refinance given the decline in CRE asset values.

- **CMBS Restarting** – **Slowly**. – Even in normal economic conditions, the primary banking sector lacked the capacity to meet CRE borrower demand. That gap has been filled over the course of the last two decades by securitization (specifically, CMBS) which utilizes sophisticated private investors – pension funds, mutual funds, life insurance companies and endowments, among others – who bring their own capital to the table and fuel lending. CMBS accounts, on average, for approximately 25% of all outstanding CRE debt, and as much as 50% at the peak, while readily identifiable properties funded by CMBS exist in every state and Congressional district. However, a prolonged liquidity crisis caused the volume of new CRE loan originations and thus new CMBS to plummet from $240 billion in 2007 (when CMBS accounted for half of all CRE lending) to $12 billion in 2008 and $2 billion in 2009. In 2010, the CMBS market began to see signs of life with $12.3 billion in issuance, while issuance is expected to range between $30 and $50 billion in 2011, depending upon a number of economic conditions and uncertainty related to regulatory and accounting changes. While there is revitalized activity in the CMBS space, there is a mismatch between the types of loans that investors are willing to finance and the refinancing that existing borrowers are looking for to extend their current loans.

While the market has evolved from the initial liquidity crisis, there is still an unfortunate combination of circumstances that leave the broader CRE sector and the CMBS market with three primary problems: 1) the "equity gap" (again, the difference between the current market value of commercial properties and the debt owed on them, which will be extremely difficult to refinance as current loans mature),; 2) a hesitancy of lenders and issuers to take the risk of "originating" or "aggregating" loans for securitization, given the uncertainty related to investor demand to buy such bonds (this 3-6 month "pre-issuance" phase is known as the "aggregation" or "warehousing" period); and 3) the tremendous uncertainty created by the multitude of required financial regulatory changes, which serve as an impediment to private lending and investing, as the markets attempt to anticipate the impact these developments may have on capital and liquidity. Indeed, market analysts have concluded that regulatory uncertainty will likely delay recovery of the securitization markets, including one observer that recently concluded that the delay would be for at least another twelve months.[7]

The importance of the securitized credit market to economic recovery has been widely recognized. Both the previous and current Administrations share the view that "no financial recovery

[7] *See* "A Guide to Global Structured Finance Regulatory Initiatives and their Potential Impact," Fitch Ratings (Apr. 4, 2011), at 1 (available at http://www.fitchratings.com/creditdest/reports/report_frame.cfm?rpt_id=571646).

plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small."[8] The importance of restoring the securitization markets is recognized globally as well, with the International Monetary Fund noting in a Global Financial Stability Report last year that "restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions."[9]

Current State of Small Business Lending Finance

Significantly, it is also important to be aware of the importance of securitization to smaller businesses that seek real estate financing. The average CMBS securitized loan is $8 million. As of July 2010, there were more than 40,000 CMBS loans less than $10 million in size with a combined outstanding balance of $158 billion, which makes CMBS a significant source of capital for lending to small businesses. Therefore, when evaluating securitization reforms like the proposed risk retention rules, policymakers should be mindful that changes that could halt or severely restrict securitization of CRE loans will have a disparate adverse impact on small businesses, and on capital and liquidity in CRE markets in smaller cities where smaller CRE loans are more likely to be originated.

As many independent research analysts have noted, while the overall CRE market will experience serious strain (driven by poor consumer confidence and business performance, high unemployment and property depreciation), it is the non-securitized debt on the books of small and regional banks that will be most problematic on a relative basis, as the projected default rates for such unsecuritized commercial debt have been, and are expected to continue to be, significantly higher than CMBS loan default rates.

3. A Framework for Recovery – Customized Reforms That Take Into Account the Unique Characteristics of the CMBS

The private investors who purchase CMBS, and thereby provide the capital that supports the origination of loans for CMBS, are absolutely critical to restarting commercial mortgage lending in the capital markets that are critical to a CRE recovery. Accordingly, government initiatives and other reforms must support private investors – who bring their own capital to the table – in a way that gives them certainty and confidence to return to the capital markets. This type of support can and will vary by asset class. The Board of Governors of the Federal Reserve issued a "Report to the Congress on Risk Retention" as required under the Dodd-Frank mandate, concluding just that:

> simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the Act – namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans . . . the Board

[8] Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) available at http://www.ustreas.gov/press/releases/tg18.htm.

[9] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (October 2009), at 33 ("Conclusions and Policy Recommendations" section) available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

> recommends that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets. Such an approach could recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized. Asset class–specific requirements could also more directly address differences in the fundamental incentive problems characteristic of securitizations of each asset type, some of which became evident only during the crisis.[10]

CMBS has innate characteristics that minimize the risky securitization practices that policymakers sought to address in Dodd-Frank. More specifically, the unique characteristics that set CMBS apart from other types of assets relate not only to the type and sophistication of the borrowers, but to the structure of securities, the underlying collateral, and the existing level of transparency in CMBS deals, each of which are briefly described here:

- **Commercial Borrowers**: Part of the difficulty for securitization as an industry arose from practices in the residential sector, for example, where loans were underwritten in the subprime category for borrowers who may not have been able to document their income, or who may not have understood the effects of factors like floating interest rates and balloon payments on their mortgage's affordability. In contrast, commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases (i.e. "income-producing" properties). Additionally, securitized commercial mortgages have different terms

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[10] Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010), at 3 (available at http://federalerserve.gov/boarddocs/rtpcongress/securitization/riskretention.pdf). *See also* Daniel Tarullo, Federal Reserve Governor, Statement Before The House Committee on Financial Services (Oct. 26, 2009) ("A credit exposure retention requirement may thus need to be implemented somewhat differently across the full spectrum of securitizations in order to properly align the interests of originators, securitizers, and investors without unduly restricting the availability of credit or threatening the safety and soundness of financial institutions."); John C. Dugan, Comptroller of the Currency, Statement on the Federal Deposit Insurance Corporation's Advance Notice of Proposed Rulemaking on Securitizations (Dec. 15, 2009), at 1-3 ("[R]ecent studies note that a policy of requiring a rigid minimum retention requirement risks closing down parts of securitization markets if poorly designed and implemented. Before proposing and implementing such a requirement for all securitizations, further analysis is needed to ensure an understanding of the potential effects of the different ways in which risk could be retained.").

Similarly, the International Monetary Fund has warned that "[p]roposals for retention requirements should not be imposed uniformly across the board, but tailored to the type of securitization and underlying assets to ensure that those forms of securitization that already benefit from skin in the game and operate well are not weakened. The effects induced by interaction with other regulations will require careful consideration." International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, Global Financial Stability Report: Navigating the Financial Challenges Ahead (October 2009), at 109 ("Conclusions and Policy Recommendations" section) available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

(generally 5-10 year "balloon" loans), and they are, in the vast majority of cases, "non-recourse" loans that allow the lender to seize the collateral in the event of default.

- **Structure of CMBS**: There are multiple levels of review and diligence concerning the collateral underlying CMBS, which help ensure that investors have a well informed, thorough understanding of the risks involved. Specifically, in-depth property-level disclosure and review are done by credit rating agencies as part of the process of rating CMBS bonds. Moreover, non-statistical analysis is performed on CMBS pools. This review is possible given that there are far fewer commercial loans in a pool (traditionally, between 100 to 200 loans; while some recent issuances have had between 30 and 40 loans) that support a bond, as opposed, for example, to residential pools, which are typically comprised of between 1,000 and 4,000 loans. The more limited number of loans (and the tangible nature of properties) in the commercial context allows market participants (investors, rating agencies, etc.) to gather detailed information about income producing properties and the integrity of their cash flows, the credit quality of tenants, and the experience and integrity of the borrower and its sponsors, and thus conduct independent and extensive due diligence on the underlying collateral supporting their CMBS investments.

- **First-Loss Investor ("B-Piece Buyer") Re-Underwrites Risk**: CMBS bond issuances typically include a first-loss, non-investment grade bond component. The third-party investors that purchase these lowest-rated securities (referred to as "B-piece" or "first-loss" investors) conduct their own extensive due diligence (usually including, for example, site visits to every property that collateralizes a loan in the loan pool) and essentially re-underwrite all of the loans in the proposed pool. Because of this, the B-piece buyers often negotiate the removal of any loans they consider to be unsatisfactory from a credit perspective, and specifically negotiate with bond sponsors or originators to purchase this non-investment-grade risk component of the bond offering. This third-party investor due diligence and negotiation occurs on every deal before the investment-grade bonds are issued. We also note that certain types of securitized structures are written so conservatively that they do not include a traditional "B-Piece." Such structures, for example, include extremely low loan-to-value, high debt-service-coverage-ratio pools that are tranched only to investment grade.

- **Greater Transparency**: CMBS market participants already have access to a wealth of information through the CRE Finance Council Investor Reporting Package™, which provides access to loan-, property-, and bond-level information at issuance and while securities are outstanding, including updated bond balances, amount of interest and principal received, and bond ratings. Our reporting package has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market. By way of contrast, in the residential realm, transparency and disclosure are limited not only by servicers, but by privacy laws that limit access to borrowers' identifying information. Importantly, the CRE Finance Council released version "5.1" of the IRP in December, 2010 to make even further improvements. The updated IRP was responsive to investor needs, including disclosures for a new "Loan Modification Template." Also, as referenced above and as discussed in greater detail in Section 5 below, CREFC working groups –

comprised of all CMBS constituencies (issuers, investors, etc) – have created standard practices that could be used immediately in the market to enhance disclosure, improve underwriting, and strengthen representations and warranties to ensure alignment of interests between issuers and investors. These consensus standards build on existing safeguards in CMBS and go beyond Dodd-Frank requirements for CRE loans.

4. The CRE Finance Industry's Market Standards

Another way in which the CMBS space is unique is the nature of the engagement of the industry participants. In the wake of the on-set of the economic crisis and with an eye toward addressing issues that prompted policymakers to craft risk retention requirements, the CRE Finance Council and its members have been independently working on a series of market reforms with a view toward strengthening the securitization markets and fostering investor confidence. Our members across all constituencies have devoted an extraordinary amount of time over the past year to working collaboratively and diligently on the development of market standards in the areas of representations and warranties and their enforcement; underwriting principles; and initial disclosures, all of which have similar aims of strengthening our market and fostering investor confidence.

We anticipate that the new industry market standards, coupled with the ongoing disclosure regime offered by our existing IRP, will create increased transparency and disclosure in underwriting and improved industry representations and warranties, which we believe will go a long way toward meeting both investor demands and Dodd-Frank objectives. We believe that these standards will be used both (1) in the marketplace immediately, and (2) by the regulators as they continue to contemplate how to properly construct the final risk retention rules.

Having previously shared these projects with the regulators charged with implementing the Dodd-Frank risk retention rules, the CRE Finance Council also wishes to provide some information to Congress as well about the projects.

Representations and Warranties

Building upon existing customary representations and warranties for CMBS, the CRE Finance Council has created Model Representations and Warranties that represent industry consensus viewpoints. Representations and warranties relate to assertions that lenders make about loan qualities, characteristics, and the lender's due diligence. The CRE Finance Council's model was the result of 200-plus hours of work by our Representations and Warranties Committee over the last six months, and represents the input of more than 50 market participants during negotiations to achieve industry consensus.

The Model Representations and Warranties were specifically crafted to meet the needs of CMBS investors in a way that is also acceptable to issuers. Such Model Representations and Warranties for CMBS will be made by the loan seller in the mortgage loan purchase agreement. Issuers are free to provide the representations and warranties of their choosing, and the representations and warranties will necessarily differ from one deal to another because representations and warranties are fact based. However, issuers will be required to present all prospective bond investors with a comparison via black line of the actual representations and warranties they make to the newly created CRE Finance Council Model Representations and Warranties. Additionally, loan-by-loan exceptions to the representations and warranties must be disclosed to all prospective bond investors.

Finally, the CRE Finance Council also has developed market standards for addressing and resolving breach claims in an expedited, reliable and fair fashion by way of mandatory mediation before any lawsuit can be commenced, thereby streamlining resolution and avoiding unnecessary costs.

For many investors, strengthened and new representations and warranties coupled with extensive disclosure are considered a form of risk retention that is much more valuable than having an issuer hold a 5% vertical or horizontal strip. The CRE Finance Council believes that its Model Representations and Warranties are a practical and workable point of reference that has been vetted by the industry, and we intend to explore whether industry standard representations and warranties such as the CRE Finance Council's model could be adopted by regulators to serve as "adequate" representations and warranties as contemplated by the Dodd-Frank menu of options for risk retention for commercial mortgages.

Moreover, industry-standard representations and warranties could be used in at least two other regulatory contexts. First, the conditions on third-party retention in the proposed regulation contemplate securitizer disclosures regarding representations and warranties, and the possible use of blacklines against industry standard representations and warranties. We are exploring the possibility of suggesting use of the CRE Finance Council's model for this purpose.

In addition, Dodd-Frank Section 943(1) directs the SEC to develop regulations requiring credit rating agencies (CRAs) to include in ratings reports a description of the representations, warranties, and enforcement mechanisms available to investors for the issuance in question, along with a description of how those representations, warranties and enforcement mechanisms differ from those in "issuances of similar securities." CRAs have played an important role in the CRE Finance Council's development of Model Representations and Warranties, and we believe the Model Representations and Warranties can facilitate CRAs' fulfillment of their new reporting requirements under Dodd-Frank Section 943(1).

Loan Underwriting Principles

Commercial mortgages securitized through CMBS do not easily lend themselves to the development of universally applicable objective criteria that would be indicative of having lower credit risk as envisioned under Dodd-Frank or otherwise. This is because these non-recourse loans are collateralized by income streams from an incredibly diverse array of commercial property types that cannot be meaningfully categorized in a way that would allow for the practical application of such objective "low credit risk" criteria. For example, it is difficult to meaningfully compare property types such as hotels, malls, and office buildings, and credit risk profiles can also vary by geographic location, so that it would be even more difficult to compare a resort in Hawaii to a shopping mall in Texas or an office building in New York. In short, commercial properties are not homogeneous and do not lend themselves to a "one size fits all" underwriting standard that could be deemed "adequate."

The industry accordingly created a framework of principles and procedures that are characteristic of a comprehensive underwriting process that enables lenders to mitigate the risk of default associated with all loans, and a disclosure regime that requires representations as to the manner in which that underwriting process was performed. The intent of the Underwriting Best Practices is to be responsive to investors and market participants; provide for the characteristics of low-risk loans; and provide for common definitions and computations for the key metrics used by lenders.

Our membership believes that this principles-based underwriting framework can and will generate the underwriting of lower credit risk CMBS loans and, when combined with necessary and appropriate underwriting transparency, will allow investors to make their own independent underwriting evaluation and be in a position to better evaluate the risk profiles of the loans included in the CMBS issuances in which they are considering investing. It is also critical to note that the majority of the underwriting principles and disclosures outlined in our best practices are already standard industry practices, though they had not previously be formally outlined or presented.

The Underwriting Principles were developed with a view toward reducing risk through use of market analysis; property and cash flow analysis; borrower analysis; loan structure and credit enhancements; risk factors such as macro and property-type risks. With respect to defining numerical underwriting metrics, our project recognized the impossibility of imposing uniform metrics since the characteristics of a "low risk" CRE loan could vary by property type, area of the country, and even by operator, and low risk loan-to-value ratios differ by geographic area.

While we have long maintained that it is not possible or even advisable for regulators to attempt to define uniform underwriting "standards" for CRE loans due to the heterogeneous nature of commercial mortgages underlying CMBS and the dissimilarity of this market to residential, we recognize that regulators have attempted to do just that in the qualified commercial loan provisions of the proposed risk retention regulations. We wish to point out, in any event, that such criteria exclude many low-risk loans from qualifying for the exemption, and should not be viewed as the sole framework for assessing whether a commercial mortgage is low risk.

"Annex A" Initial Disclosures

The CRE Finance Council's "Annex A" has long been a part of the package of materials given to investors as part of CMBS offering materials, and provides detailed information on the securitized mortgage loans. In conjunction with the SEC's Spring 2010 proposal to revise its Regulation AB, our members commenced an initiative to review, update and standardize Annex A, which has resulted in changes to Annex A incorporating numerous additional data points concerning the assets underlying CMBS. This work was the effort of both issuers and investors.

These changes, together with the information already required by Annex A, closely conform Annex A with the Schedule L asset-level disclosure framework proposed by the Commission under Regulation AB. The CRE Finance Council's newly created standardized Annex A provides numerous additional data points concerning the assets underlying CMBS, including, but not limited to:

- Changes to the Loan Structure Section with regard to Disclosures on supplemental debt. Examples include, but are not limited to, detail of all rake, B-note, subordinated mortgage, mezzanine debt and preferred equity as well as information regarding the debt owner, coupon, loan type, term, amortization, debt service calculation, debt yield, cumulative DSCR and LTV calculations through the capital structure.

- Additionally, issuers will now be providing a breakdown of net operating income into revenue and expenses for historic and underwriting basis.

- Added information on the fourth and fifth largest tenants at a property to the tenant information section – most Annex As in the past would contain information on the three largest tenants at a property, that information being square footage leased, % of overall net rentable square feet, and lease expiration date.

In fact, Annex A provides more information than required under Schedule L and is available to market participants in more expedited fashion. At the same time, the new standardized Annex A is consistent with the existing practices that CMBS market issuers and other participants have developed to provide CMBS investors with clear, timely and useful disclosure and reporting that is specifically tailored for CMBS investors. We believe that such consistency will avoid unnecessary increases in transaction costs while still delivering enhanced clarity and transparency.

It follows that the CRE Finance Council's Annex A is a practical and workable framework that has already been vetted by the industry, and we believe it can be adopted by the SEC to implement the asset-level and loan-level disclosure requirements in Dodd-Frank Section 942(b), and those in Proposed Schedule L to SEC Regulation AB.

5. <u>Preliminary Views on the Proposed Risk Retention Rule</u>

The proposed risk retention regulations, released in late March, do attempt to fulfill the Congressional mandate embodied in the Crapo amendment by offering different options for satisfying the risk retention requirements (*e.g.*, vertical, horizontal or L-shape retention structures) and by providing asset-class specific options including a set of CMBS-specific provisions to satisfy the retention mandate. As a community, our members appreciate the efforts to create rules by asset class, given the unique nature of the CMBS market.

At the same time, the proposed risk retention regulations are complex, and we are in the process of studying and discussing them with the different CMBS constituencies included under the CRE Finance Council umbrella (including lenders, issuers, servicers and investors, among others) in order to fully evaluate their potential impact and to provide useful feedback to regulators on their proposal. As the Board of Governors of the Federal Reserve Report cited above also noted, the totality of the regulatory changes that are being put into motion – including the various new disclosure and credit rating agency reform provisions included in Dodd-Frank, the accounting changes that must be effectuated, and the new Basel capital requirements regime – must be considered *in toto* in making this evaluation:

> [R]ulemakings in other areas could affect securitization in a manner that should be considered in the design of credit risk retention requirements. Retention requirements that would, if imposed in isolation, have modest effects on the provision of credit through securitization channels could, in combination with other regulatory initiatives, significantly impede the availability of financing. In other instances, rulemakings under distinct sections of the Act might more efficiently address the same objectives as credit risk retention requirements.[11]

Viewed through this lens, there are elements of the proposed retention regime that raise potential concerns in the market and, overall, the proposal has prompted more questions than it answers. Our preliminary view, however, is that the structural framework of the CMBS-specific

[11] *Id.* at 84.

provisions could provide a workable foundation for implementing the risk retention rules as Congress envisioned in Dodd-Frank. That said, there are areas where the rule could have unintended adverse consequences for securitization and the broader CRE finance markets. At the same time, the purpose of many important provisions is unclear, and they will likely need to be refined to ensure that they accomplish their intent in the least disruptive manner. Needless to say, the stakes are high with the impact on credit availability weighing in the balance and we look forward to working with Congress and the regulators to ensure a regulatory framework that supports a sound and vibrant securitization market, which is critical to consumers in the U.S. economy.

The Proposed Risk Retention Regulation for Commercial Mortgages

By way of background, the proposed risk retention regulation contains "base" risk retention requirements that generally apply to all asset classes. The base requirements include a number of options for the securitizer to hold the required 5% retained interest, such as: a "vertical slice," which involves holding 5% of each class of ABS interests issued in the securitization; a horizontal residual interest, which requires that the securitizer retain a first-loss exposure equal to at least 5% of the par value of all the ABS interests issued in the transaction; and an "L-shaped" option which involves a combination of the vertical and horizontal options. The CRE Finance Council believes generally that the menu of options for holding the retained interest will be beneficial in that this flexibility will foster more efficient and practical structuring of securitizations than a one-size-fits-all approach, and we commend regulators for the thought and effort they put into developing these options.

The retained risk would be required to be held for the life of the securitization. No sale or transfer of the retained interest would be permitted, except in limited circumstances.

Notably, the base retention regime includes a restriction on the ability of securitizers to monetize excess spread on underlying assets at the inception of the securitization transaction, such as through sale of premium or interest-only ("IO") tranches. As discussed below in greater detail, this provision, which requires securitizers to establish a "premium capture cash reserve account" where a transaction is structured to monetize excess spread, and to hold this account in a first-loss position even ahead of the retained interest, has generated considerable confusion throughout the market, and the purpose of the provision is unclear. It should be noted that this particular provision is one that is prompting significant concerns about a potential adverse impact on the viability of the CMBS market, as well as questions about whether it can be implemented as a practical matter without shutting down the market for new CMBS issuance.

Hedging of the retained interest is generally prohibited, although the proposed regulation gives securitizers the ability to use tools, such as foreign currency risk hedges, that do not directly involve hedging against the specific credit risk associated with the retained interest. The continued ability to use market risk hedges is a matter the ABS issuer community viewed as critical to the viability of securitization, and we believe that the proposed rule is generally responsive to market's concerns in that regard.

With respect to CMBS specifically, the Crapo Dodd-Frank amendment mandated that the regulators consider several specific alternatives for risk retention to strengthen the CRE market and to support a recovery for commercial mortgages, including:

(1) adequate underwriting standards and controls;
(2) adequate representations and warranties and related enforcement

mechanisms; and/or
(3) a percent of the total credit risk of the asset held by the securitizer, originators or a third-party investor.

The proposal does not address the representations/warranties alternative at all but we are hopeful that the regulators will consider the role of the CRE Finance Council developed market-standards discussed above when it considers revisions to the risk retention regime. In addition to the base risk retention rules, there are two important provisions specific to commercial mortgages that relate to the other statutory alternatives. First, there is an option to have a third-party purchaser hold a 5% horizontal first-loss position. The third-party retention option is subject to several conditions, which are being closely examined, but market participants have noted a lack of clarity with respect to some of the conditions, and there are concerns that some of the conditions may create significant disincentives for use of this retention option. An unworkable third-party retention option would render the rule more inflexible, which may run counter to the intent of Congress when it outlined third-party risk retention as one of the options for the CRE market in Dodd-Frank.

Second, there is a commercial mortgage loan exemption that would subject qualified commercial mortgage loans to a 0% retention obligation, if several criteria are met. While we understand that regulators intended that only a small subset of "low-risk" loans would qualify for the exemption, our initial examination of the CRE exemption provision reflects that the parameters for qualified commercial mortgages are so narrow that virtually no CRE mortgage could qualify. This stands in contrast to other asset classes, where we understand that proposed exemptions could cover an appreciably larger percentage of the universe of loans.

Three components of the proposed rules have generated the most internal discussion and debate.

Premium Capture Cash Reserve Accounts

First, there is considerable confusion and concern within the CRE finance community about the proposed rule's requirement that securitizers establish a "premium capture cash reserve account" when a transaction is structured to monetize excess spread at the inception of the securitization transaction, such as through an IO tranche. One issue is that the purpose of such a requirement is unclear. The narrative to the proposed rule states that the purpose of the premium capture is to prevent sponsors of the securitization from "reduc[ing] the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized,"[12] presumably by extracting all of their profit on the deal at the outset. However, we were informed through preliminary discussions with the regulatory agencies, for example, that the premium capture feature was designed to ensure that the retained interest, whether held by the sponsor or a third party, represents 5% of the transaction proceeds.

The effect of the proposal as drafted would be for all revenue from excess spread (which is virtually all revenue) to be retained for the life of the transaction. An analogy, for example; would be to consider if the rule were applied to your local sandwich shop owner. The owner , for example, spends money up front - say $1000 - to purchase bread, meat, cheese, mustard and other sandwich making supplies. He then sells all his sandwiches to customers for $3000, a gross profit of $2000. He uses that profit to pay his workers; buy more sandwich supplies and to invest in his business. However, under

[12] Risk Retention NPRM at 89.

the PCCRA, he can only collect the cost of the sandwich on the day he sells it to his customer. The net profit of $2000 must go into an escrow account, and cannot be put to use for 10 years. Under this business strategy, it is difficult to imagine that many delis would be left open in the country.

Such a mechanism will inhibit an issuer's ability to pay operating expenses, transaction expenses, and realize profits from the securitization until, typically, ten years from the date of a securitization. Thus, while the proposed rule's narrative expressed regulators' expectation that the premium capture feature would merely prompt securitization sponsors to stop structuring securitizations to monetize excess spread at closing,[13] the broader impact would be to make the securitization business very unattractive to sponsors, which in turn, would shrink capital availability. For this reason, many in our industry have significant concerns about the premium capture component having an adverse impact on the viability of the CMBS market.

Conditions for Retention by a Third-Party Purchaser

Second, the third-party retention option that was specifically designed for CMBS also has generated substantial discussion. Under the proposal, the option is subject to several conditions. Most notable among the conditions is a requirement that an independent Operating Advisor be appointed where a third-party purchaser retains the risk and also has control rights (itself or through an affiliate) that are not collectively shared with all other classes of bondholders, such as servicing or special servicing rights. The Operating Advisor would have to be consulted on all major servicing decisions, such as loan modifications or foreclosures, and would have the ability to recommend replacement of the servicer or special servicer if it determines that the servicer or special servicer is not acting in the best interests of the investors as a whole. Only a majority vote of each class of bondholder would prevent the servicer or special servicer from being replaced in this instance.

As a preliminary matter, certain aspects of the Operating Advisor provision are not sufficiently fleshed out, and our membership believes that additional clarity will be necessary for an Operating Advisor framework to function efficiently. For example, other than requiring the Operating Advisor to be independent, the proposed rule provides no specifics on qualifications for an entity to serve as an Operating Advisor, such as whether the entity should have expertise in dealing with the class of securities that are the subject of the securitization. CMBS servicing can be a complex and highly fact-specific enterprise and CMBS transaction parties, including B-piece buyers who might hold the retained interest under the proposed rule and who may handle servicing or special servicing, are sophisticated and very experienced in these matters. It is unlikely that such a B-piece buyer would accept the appointment of an Operating Advisor lacking in CMBS expertise to oversee servicing. Nor should this be desirable from the regulators' perspective, since an unqualified Operating Advisor is unlikely to add value, and would only add to transaction costs.

B-piece buyers and issuers also have raised concerns that the Operating Advisor requirement may create other significant disincentives for use of the third party retention option. For example, some question whether it is necessary for an Operating Advisor to have the authority to oversee servicing and have replacement rights from the deal's inception, when a B-piece buyer's capital is at risk in a first-loss position, which gives a B-piece/servicer incentives that are more fully aligned with those of other investors. Moreover, there are concerns that the addition of another administrative layer in the

[13] *See id*. at 90.

securitization process may make the servicing and workout of securitized loans more difficult from the borrower's perspective.

Some investment-grade investors have expressed interest in the Operating Advisor construct, but there clearly is room to better hone the powers of and the limitations on the requisite Operating Advisor. For example, one suggestion being discussed to address concerns of B-piece buyers and investment-grade investors may be to have the Operating Advisors' recommendations to replace servicers approved by a majority vote of investors, rather than requiring a majority to disapprove as the proposed rule currently contemplates.

We note that there is precedent in the market for use of independent Operating Advisors in these circumstances, as the industry has developed a fairly standard Operating Advisor framework with input from B-piece buyers, investors, and issuers in the past few years. The most practical analogue to examine among past transactions are those that only involved an independent Operating Advisor once the B-piece buyer/servicer is "out of the money" and its interests theoretically would not align with those of other bondholders. Such a structure might solve the alignment of interest concern while also addressing B-piece buyers' reluctance to have servicing decisions second-guessed by a third-party when the B-piece buyer's investment is first in line should there be losses.

Exempt Commercial Mortgages

There is a commercial mortgage loan exemption that would subject "qualified" commercial mortgage loan pools to a 0% retention obligation, if several criteria are met. Regulators have stated that they only intended for a relatively small percentage of loans, meeting a set of "low-risk" characteristics, to qualify for the exemption. While the CRE Finance Council understands this objective, our initial examination of the CRE exemption provision reflects that the parameters for qualified commercial mortgages are so narrow that virtually no CMBS mortgages could qualify.

The exemption's 20-year maximum amortization requirement, for instance, presents perhaps the most significant hurdle to qualification, since commercial mortgages are amortized on a 30-year basis. Rather than utilizing an amortization period as a criterion, a better metric for assessing the risk characteristics of a loan may be to use the loan-to-value ration at origination and maturity. Also problematic is the requirement that borrowers covenant not to use the property as collateral for any other indebtedness, which appears to effectively prohibit subordinate debt. Currently, borrowers typically are permitted to have subordinate debt upon lender approval (e.g., loans that have subordinate debt funded concurrent with the first mortgage). It follows that an outright prohibition on subordinate debt, regardless of lender approval, may be viewed by borrowers as an undue restriction of their ability to manage their finances.

That said, as part of its market standards initiative, the CRE Finance Council submitted an underwriting principles framework white paper to the regulators during the rule-making process highlighting the difficulty in creating universally objective metrics that would indicate that a loan is "low risk" in the very heterogeneous commercial mortgage space. Given the proposed rule, however, we are taking a fresh look at these issues and attempting to evaluate whether the "qualified CRE loan" construct could be re-worked to be of value for CRE loans. There are loan segments outside of the typical conduit loan structure – like large loan and single borrower securitization deals – that may be more suited for the exemption treatment and we are evaluating what the appropriate "low risk" metrics should be for such deals.

Additionally, a fourth area of concern about the proposed rule that should be highlighted relates to the duration of retention, and a prohibition on sale or transfer of retained interest. As mentioned, the proposed rule contemplates holding the retained interest for the life of the bond, and imposes a permanent prohibition on the sale or transfer of retained risk. Both of these features would restrict the flow of capital into the markets for an unnecessarily long time period, a situation that is even less desirable in light of the $1 trillion in commercial mortgage maturities that will occur in the next few years, at the same time the CMBS market is struggling to recover. We also note that in the third-party retention context, a permanent prohibition on the sale or transfer of retained risk would not be acceptable to many B-piece buyers.

Our members are evaluating the extent to which the proper alignment of risk can be achieved without making the mandated retention permanent. We also believe that it is not necessary to completely restrict any sale or transfer of retained interest to achieve the risk retention regulation's goals. A modification to the proposed rule to, for example, allow transfer of a B-piece buyer's or sponsor's retained interest to a "qualified" transferee, who would have to comply with the obligations imposed on the transferor and meet other criteria, would address this concern.

On all of these issues as well as for the more technical issues that will emerge during the course of our evaluation, we intend to work with regulators on modifications that will facilitate proper alignment of risk without unduly restricting market capital and liquidity.

6. <u>Proactive Measures That Would Encourage a Securitization Market Recovery</u>

Significantly, the many challenges discussed earlier are interconnected and mutually compounding. To address the challenges and to help to facilitate a revitalized securitization market, we suggest the following:

Take a Deliberate Approach to the Proposed Risk Retention Rules

As discussed at length above, with so many questions remaining unanswered, the current proposed rule reads like an advance notice of proposed rulemaking. We are concerned that the 60-day public comment period, which ends June 10, 2011, does not give the industry sufficient time to fully analyze the impact of the proposed rules. Furthermore, given our expectation that we will be asking for significant changes, we believe that it will be appropriate for the regulators to jointly re-propose the rules to allow industry a sufficient opportunity to digest and comment on the revised retention framework. The sheer complexity of these markets demands a thoughtful and deliberate approach to rulemaking, and a more iterative process helps achieve this crucial goal. As part of this process, it is critical to evaluate workable counter-proposals that could make the risk retention regime work in a way that will minimize adverse unintended consequences to credit availability and the overall economy while achieving an appropriate alignment of risk as Congress intended.

Furthermore, our members believe it would be extremely helpful to have more interactive discussion between regulators and the public, particularly as the industry seeks to ensure that it correctly understands both the regulatory goals and intent of certain provisions, , and to work cooperatively to develop acceptable alternatives. We are aware that the staffs of the Commodity Futures Trading Commission and the Securities and Exchange Commission have planned a two-day joint public roundtable on issues associated with the rules to govern swaps under Dodd-Frank. We believe that a similar opportunity to have a dialogue with the relevant agencies to discuss risk retention rules would be beneficial to all, and could even foster a more efficient rulemaking process since the aim would be to inform the agencies' understanding of industry concerns while the agencies are still in the process developing final rules, rather than afterward.

Create a U.S. Covered Bond Market

The CRE Finance Council supports "H.R. 940, the U.S. Covered Bond Act of 2011," ("covered bond") that the House Financial Services Capital Markets Subcommittee passed last week by voice vote. The bill, which was re-introduced by Capital Markets Subcommittee Raking Member Garrett and Congresswoman Maloney, would include high-quality CMBS as eligible collateral in a newly created U.S. covered bond market. Covered bonds, which were originated in Europe are securities issued by a financial institution and backed by a specified pool of loans known as the "cover pool."Bondholders have a preferential contractual claim to the pool in the event of the issuer's insolvency. In the United States, a typical covered bond transaction involves an insured depository institution ("IDI") selling mortgage bonds, secured by the cover pool, to a trust or similar entity (known as a "special purpose vehicle" or "SPV"). The pledged mortgages remain on the IDI's balance sheet securing the IDI's promise to make payments on the bond, and the SPV sells "covered bonds," secured by the mortgage bonds, to investors. In this fashion, the IDI generates more capital that can be used, in turn, to make more loans or provide financial institutions with a bigger cushion for their regulatory capitalization requirements. In sum, covered bonds are an elegant mechanism for generating more liquidity in the capital markets.

A problem arises, however, if the IDI becomes insolvent and the FDIC assumes control as a receiver or conservator. Once the FDIC takes over, there can be uncertainty about whether the FDIC would continue to pay on the bond obligation according to the bond's terms, or whether it will repudiate the transaction. If the IDI is also in default on the bond, there also can be uncertainty regarding the amount that investors would repaid, or at the very least, delay in allowing investors access to the bond collateral. The transactions can be hedged to alleviate some of these risks, but this increases transaction costs. In the face of such risks, investors were reluctant to invest in covered bonds to any significant degree; the FDIC reported in July 2008 that only two banks had issued covered bonds. The FDIC recognized that covered bonds could be a "useful liquidity tool" for IDIs and the importance of "diversification of sources of liquidity."[14] Therefore, to provide a measure of certainty to encourage investment in covered bonds, the FDIC issued a Policy Statement in 2008 setting forth directives explaining how it would address certain types of covered bond obligations in cases in which it has assumed control of an IDI. Unfortunately, the FDIC limited the scope of its Policy Statement to covered bonds secured by "eligible assets," and limited the definition of "eligible assets" to residential mortgages. As a result, a market for covered bonds in the CRE mortgage sector has not developed.

Significantly, however, commercial mortgages and CMBS are already permitted in covered bond pools in most European jurisdictions[15], which also accord the appropriate and necessary

[14] Covered Bond Policy Statement, Final Statement of Policy, FDIC, 73 Fed. Reg. 43754, 43754 (July 28, 2008).

[15] Legislative frameworks for covered bonds in the following countries specifically permit the use of commercial mortgage loans as collateral: Austria, Bulgaria, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Latvia, Luxembourg, the Netherlands, Norway, Poland, Portugal, Romania, Spain, Sweden, the United Kingdom. In addition, all European jurisdictions that permit the use of residential mortgage-backed securities ("RMBS") in cover pools also permit the use of CMBS.

regulatory treatment, including capital requirements, with respect to covered bonds to facilitate the market and to better serve consumers and businesses seeking access to credit. It follows that in order to be globally competitive, any U.S. covered bond regime should include commercial mortgages and CMBS, and that the overall regulatory framework should be closely aligned with the approach used by our European counterparts. Such a framework will give U.S. consumers and businesses access to the same sources of credit availability, supporting our overall recovery and we applaud the Committee's passage of the covered bond bill two weeks ago.

While covered bonds should not and cannot replace CMBS as a capital source for the CRE mortgage market, facilitating a commercial covered bond market will be additive. Covered bonds can provide yet another source of liquidity for financial institutions to help raise much needed capital to fund CRE loans, and in turn, ease the current CRE credit crisis, which persists despite high borrower demand. Indeed, in the current environment, covered bonds could be a helpful means of raising capital relative to CMBS, particularly today as the cost of capital related to a covered bond deal could be less volatile than for CMBS. Such conditions also could assist financial institutions in aggregating collateral for a covered bond issuance, in contrast with the aggregation difficulties now being experienced in the CMBS market.

Ensure Credit Rating Transparency

Dodd-Frank includes extensive credit rating agency reform provisions, and the CRE Finance Council and its members generally are supportive of any reforms that require CRAs to provide more information about individual ratings and their rating methodologies.

In terms of credit ratings performance, the CRE Finance Council devoted significant resources over the last few years to affirmatively enhance transparency in credit ratings. Such enhancements will be far more effective in providing investors with the information they need to make the most informed decisions than a differentiated ratings structure. Instead of differentiated ratings for structured finance products – a concept that has been debated and rejected by the SEC, what CMBS investors have consistently sought is new, targeted transparency and disclosures about the ratings of structured products, to build on the already robust information CRAs provide in their published methodology, presale reports, and surveillance press releases.[16]

Conclusion

Today, the CMBS market is showing some positive signs that it is slowly moving toward recovery. However, with $1 trillion in commercial mortgage loans maturing in the next few years, it will be critically important that risk retention regulations be implemented in way that does not severely constrict or shut down altogether the securitization markets. The CRE Finance Council appreciates the

[16] In comments filed with the SEC in July 2008, the CRE Finance Council (filing under its former CMSA name) listed a number of recommendations for enhancements that would serve the investor community, such as publication of more specific information regarding NRSRO policies and procedures related to CMBS valuations; adoption of a standard pre-sale report template with specified information regarding methodology and underwriting assumptions; and adoption of a standard surveillance press release with specified information regarding the ratings. Such information would allow investors to better understand the rating methodology and make their own investment determinations.

fact that the general construct of the proposed risk retention rule attempts to customize and provide options for the commercial mortgage asset class. At the same time, our members strongly believe that the proposal needs clarification in many areas. And we also have concerns about the impact of some of the details, including concerns that these aspects could make securitization an untenable prospect for issuers and third-party investors.

The CRE Finance Council believes these concerns can, and should, be addressed in an extended rulemaking process that we hope you will encourage, and we anticipate working with regulators on clarifications and refinements that can achieve an appropriate alignment of risk while also avoiding undue restriction of capital and liquidity in the CRE finance market.