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ON BEHALF OF THE COMMERCIAL MORTGAGE SECURITIES ASSOCIATION

Before the

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

Hearing on "Securitization of Assets: Problems and Solutions"

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The Commercial Mortgage Securities Association ("CMSA") is grateful to Chairman Reed, Ranking Member Bunning, and the Members of the Subcommittee for giving CMSA the opportunity to share its perspective concerning the securitized credit markets for commercial real estate. In responding to the specific questions the Subcommittee has asked witnesses to address, we will focus on securitization in the commercial real estate ("CRE") mortgage context and address the following issues: 1) the challenges facing the $3.5 trillion market for commercial real estate finance; 2) the unique structure of the commercial market and the need to customize regulatory reforms accordingly to support, and not undermine, our nation's economic recovery; and, 3) efforts to restore the availability of credit by promoting and enhancing the viability of commercial mortgage-backed securities ("CMBS").

CMSA & The Current State of the Market

CMSA represents the full range of CMBS market participants, including investment and commercial banks; rating agencies; accounting firms, servicers; other service providers; and investors such as insurance companies, pension funds, and money managers. CMSA is a leader in the development of standardized practices and in ensuring transparency in the commercial real estate capital market finance industry.

Because our membership consists of all constituencies across the entire market, CMSA has been able to develop comprehensive responses to policy questions to promote increased market efficiency and investor confidence. For example, our members continue to work closely with policymakers in Congress, the Administration, and financial regulators, providing practical advice on measures designed to restore liquidity and facilitate lending in the commercial mortgage market (such as the Term Asset-Backed Securities Loan Facility ("TALF") and the Public-Private Investment Program ("PPIP")). CMSA also actively participates in the public policy debates that impact the commercial real estate capital markets.

The CMBS market is a responsible and key contributor to the overall economy that historically has provided a tremendous source of capital and liquidity to meet the needs of commercial real estate borrowers. CMBS helps support the commercial real estate markets that fuel our country's economic growth. The loans that are financed through those markets help provide jobs and services to local communities, as well as housing for millions of Americans in multi-family dwellings.

Unfortunately, the recent turmoil in the financial markets coupled with the overall downturn in the U.S. economy have brought the CMBS market to a standstill and created many pressing challenges, specifically:

- <u>No liquidity or lending</u> – While the CMBS market provided approximately $240 billion in commercial real estate financing in 2007 (nearly 50% of all commercial lending), CMBS issuance fell to $12 billion in 2008, despite strong credit performance and high borrower demand. There has been no new private label CMBS issuance year-to-date in 2009, as the lending markets remain frozen;

- <u>Significant loan maturities through 2010</u> – At the same time, there are significant commercial real estate loan maturities this year and next – amounting to hundreds of billions of dollars – but the capital necessary to re-finance these loans remains largely unavailable and loan extensions are difficult to achieve; and

- <u>The U.S. economic downturn persists</u> – The U.S. recession continues to negatively affect both consumer and business confidence, which impacts commercial and multifamily occupancy rates and rental income, as well as business performance and property values.

Significantly, it is important to note that the difficulties faced by the overall CRE market are not attributable solely to the current trouble in the CMBS market, but also stem from problems with unsecured CRE debt, such as construction loans. As described by Richard Parkus, an independent research analyst with Deutsche Bank who has testified before both the Joint Economic Committee and the TARP Oversight Panel, 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, 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.

As recently as early this year, default rates in the CMBS market, which have historically been low (less than .50% for several years) still hovered around a mere 1.25%. Unfortunately, the economic recession that began as a crisis of liquidity in some sectors transformed into a crisis in confidence that affected all sectors, and it was only a matter of time before CMBS was affected. No matter the strength of our fundamentals and loan performance, once investors lost confidence and began to shy away from mortgaged-backed securities, CMBS could not avoid the contagion.

This unfortunate combination of circumstances leaves the broader CRE sector and the CMBS market with several overarching problems: 1) a liquidity gap, i.e., the difference between borrowers' demand for credit and the nearly non-existent supply of credit; 2) an equity gap (the difference between the current market value of commercial properties and what is owed on them, which will be extremely difficult to refinance as current loans mature); and 3) the fact that potential CMBS sponsors are very reluctant to take the risk of trying to aggregate loans for securitization, since there is no assurance that private sector investors will buy the securities, all of which serves to simply perpetuate the cycle of frozen credit markets.

Unique Characteristics of the CMBS Market

There are a number of important distinctions between CMBS and other asset-backed securities ("ABS") markets, and those distinctions should be considered in fashioning any broad securitization-related regulatory reforms. These differences relate not only to the structure of securities, but also to the underlying collateral, the type and sophistication of the borrowers, as well as to the level of transparency in CMBS deals.

Commercial Borrowers

Commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases. This characteristic stands in stark contrast to the residential market where, for example, 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.

Additionally, securitized commercial mortgages have different terms (generally 5-10 year "balloon" loans), and they are, in the vast majority of cases, non-recourse loans. This means that if the borrower defaults, the lender can seize the collateral, although it may not pursue a claim against the borrower for any deficiency in recovery. This dramatically decreases the cost of default because the loan work-out recoveries in the CMBS context tend to be significantly more efficient than, for example, the residential loan foreclosure process.

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 only 100-300 commercial loans in a pool that support a bond, as opposed, for example, to tens of thousands of loans in residential mortgage-backed securities pools. This limited number of loans 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 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.

Greater Transparency

A wealth of transparency currently is provided to CMBS market participants via the CMSA Investor Reporting Package® (CMSA IRP®). The CMSA IRP 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, as well as loan-level and property-level information on an ongoing basis. The "CMSA IRP" has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market.

Current Efforts to Restore Liquidity

Private investors are absolutely critical to restoring credit availability in the capital finance markets. Accordingly, government initiatives and reforms must work to encourage private investors – who bring their own capital to the table – to come back to the capital markets.

Treasury Secretary Geithner emphasized this need when he stressed during the introduction of the Administration's Financial Stability Plan that "[b]ecause this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small." The importance of restoring the securitization markets is recognized globally as well, with the International Monetary Fund noting in its most recent Global Financial Stability Report 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."[1]

As a centerpiece of the Financial Stability Plan, policymakers hope to restart the CMBS and other securitization markets through innovative initiatives (such TALF and the PPIP), and CMSA welcomes efforts to utilize private investors to help fuel private lending. In this regard, the TALF program for new CMBS issuance has been particularly helpful in our space, as

[1] 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.

evidenced in triple-A CMBS cash spreads tightening almost immediately after the program was announced, as one example.

To this end, CMSA continues to engage in an ongoing dialogue with many members of the relevant Congressional committees, as well as with key policymakers at the Treasury Department, Federal Reserve and other agencies, and with participants in various sectors of the commercial real estate market. The focus of our efforts has been on creative solutions to help bring liquidity back to the commercial real estate finance markets. We appreciate policymakers' recognition, as evidenced by programs like TALF and PPIP, that a major part of the solution will be to bring private investors back to the market through securitization. We also appreciate the willingness of Congress and other policymakers to listen to our recommendations on how to make these programs as effective as possible.

However, there is still a long way to go toward recovery in the CRE market, despite the early success of the TALF program. The market faces the overarching problems of the liquidity and equity gaps. This is driven in part by the absence of any aggregation mechanism – securitizers are unwilling to bear all of the non-credit risks (like interest rate changes) they must currently take on between the time a loan is made and when it can be securitized (a process that takes months across a pool of loans). This is especially true now when there still is uncertainty as to whether there will be willing investors at the end of the process.

CMSA also is committed to working on additional long-term solutions to ensure the market is able to meet ongoing commercial borrowing demands. For example, CMSA supports efforts to facilitate a U.S. commercial covered bond market in order to provide an additional source of liquidity through new and diverse funding sources. We will continue to work with Congress on the introduction of comprehensive legislation that would include high quality commercial mortgage loans and CMBS as eligible collateral in the emerging covered bond marketplace.

Financial Regulatory Reform and Commercial Real Estate

The Administration has proposed new and unprecedented financial regulatory reform proposals that will change the nature of the securitized credit markets which are at the heart of recovery efforts. The securitization reform proposals appear to be prompted by some of the practices that were typical in the subprime and residential securitization markets. At the outset, we must note that CMSA does not oppose efforts to address such issues, as we have long been an advocate within the industry for enhanced transparency and sound practices.

As a general matter, however, policymakers must ensure that any regulatory reforms are tailored to address the specific needs of each securitization asset class. As discussed above, the structure of the CMBS market has incorporated safeguards that minimize the risky securitization practices that policymakers hope to address. Thus, the securitization reform initiatives should be tailored to take these differences into account. In doing so, policymakers can protect the viability of the markets that already are functioning in a way that does not pose a threat to overall economic stability, and ensure that such markets can continue to be a vital component of the economic recovery solution.

CMSA and its members are concerned that certain aspects of the Administration's securitization reform proposals could undermine rather than support the Administration's many innovative efforts to re-start the securitization markets, effectively stalling recovery efforts by making lenders less willing or able to extend loans and investors less willing or able to buy CMBS bonds – two critical components to the flow of credit in the commercial market.

The two aspects of the securitization reform proposal that are of utmost concern to CMSA are a plan to require bond issuers or underwriters (referred to as “securitizers” in the Administration’s draft securitization reform bill) to retain at least 5 percent of the credit risk in any securitized asset they sell, and an associated restriction on the ability of issuers to hedge the 5 percent retained risk. Again, CMSA does not oppose these measures *per se*, but emphasizes that they should be tailored to reflect key differences between the different asset-backed securities markets.

Significantly, we are not alone in advocating a tailored approach. The IMF, which recently expressed concern that U.S. and European retained risk proposals may be too simplistic, 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.”

5% Risk Retention for Securitizers

The retention of risk is an important component regardless of who ultimately retains it: the originator, the issuer, or the first-loss buyer. As explained above, the CMBS structure has always had a third-party in the first-loss position that specifically negotiates to purchase this risk. Most significantly, these third-party investors are able to, and do, protect their own interests in the long-term performance of the bonds rather than relying merely on the underwriting and representations of securitizers or originators. First-loss buyers conduct their own extensive credit analysis on the loans, examining detailed information concerning every property – before buying the highest risk bonds in a CMBS securitization. In many cases, the holder of the first-loss bonds is also related to the special servicer who is responsible on behalf of all bondholders as a collective group for managing and resolving defaulted loans through workouts or foreclosure.

Thus, the policy rationale for imposing a risk retention requirement on issuers or underwriters as “securitizers” that could preclude them from transferring the first-loss position to third parties is unnecessary in this context, because, although the risk is transferred, it is transferred to a party that is acting as a “securitizer” and that is fully cognizant, through its own diligence, of the scope and magnitude of the risk it is taking on. In effect, when it comes to risk, the first-loss buyer is aware of everything the issuer or underwriter is aware of.

Because the CMBS market is structured differently than other securitization markets, policymakers’ focus in this market should be on the proper transfer of risk (e.g., sufficient collateral disclosure, adequate due diligence and/or risk assessment procedures on the part of the risk purchaser), analogous to what takes place in CMBS transactions. Therefore, CMBS securitizers should be permitted to transfer risk to B-piece buyers who – in the CMBS context at least – act as “securitizers.” To require otherwise would hamper the ability of CMBS lenders to originate new bond issuances, by needlessly tying up their capital and resources in the retained risk, which in turn, would squelch the flow of credit at a time when our economy desperately needs it.

CMSA therefore suggests that securitization legislation include a broader definition of “securitizer” than is presently in the Administration’s draft bill, to include third parties akin to the CMBS first-loss investors. Such an approach will provide explicit recognition of the ability to transfer retained risk to third parties under circumstances in which the third party agrees to retain the risk and is capable of adequately protecting its own interests.

Prohibition on Hedging of Retained Risk

In conjunction with the retained risk requirement, there also is a proposal to prohibit "securitizers" from hedging that risk. Rather than adopting an outright ban on hedging the retained risk, however, the measure needs to be designed to strike a balance between fulfilling the legislation's objective of ensuring that securitizers maintain an appropriate stake in the risks they underwrite. Such tailoring is necessary to avoid imposing undue constraints on "protective" mechanisms that are legitimately used by securitizers to maintain their financial stability.

Several risks inherent in any mortgage or security exposure arise not from imprudent loan origination and underwriting practices, but from outside factors such as changes in interest rates, a sharp downturn in economic activity, or regional/geographic events such as a terrorist attack or weather-related disaster. Securitizers attempt to hedge against these market-oriented factors in keeping with current safety and soundness practices, and some examples in this category of hedges are interest rate hedges using Treasury securities, relative spread hedges (using generic interest-rate swaps), and macro-economic hedges (that, for example, are correlated with changes in GDP or other macro-economic factors). The hallmark of this category is that these hedges seek protection from factors the securitizer does not control, and the hedging has neither the purpose nor the effect of shielding the originators or sponsors from credit exposures on individual loans.

As such, hedges relate to generally uncontrollable market forces that cannot be controlled independently. There is no way to ensure that any such hedge protects 100% of an investment from loss – particularly as it pertains to a CMBS transaction that, for example, is secured by a diverse pool of loans with exposure to different geographic locations, industries and property types. Therefore, loan securitizers that must satisfy a retention requirement continue to carry significant credit risk exposure that reinforces the economic tie between the securitizer and the issued CMBS even in the absence of any hedging constraints.

For these reasons, securitization reform legislation should not seek to prohibit securitizers from using market-oriented hedging vehicles. Instead, if a limitation is to be placed on the ability to hedge, it should be targeted to prohibit hedging any *individual* credit risks within the pool of risks underlying the securitization. Because these types of vehicles effectively allow the originator or issuer to completely shift the risk of default with respect to a particular loan or security, their use could provide a disincentive to engage in prudent underwriting practices – the specific type of disincentive policymakers want to address.

Retroactive Changes to Securitization Accounting

Beyond the specific securitization reform proposals that have been circulated by the Administration in draft legislation, there are two other policy initiatives that greatly concern CMSA because of the adverse effect these initiatives can have on the securitization market: retroactive changes to the rules for securitization accounting, and differentiated credit rating symbols for structured finance products.

Retroactive changes to securitization accounting rules known as FAS 166 and 167, which were recently adopted by the Financial Accounting Standards Board ("FASB"), throw into question the future of securitized credit markets.[2] The new rules eliminate Qualified Special Purposes Entities ("QSPEs"), which are the primary securitization accounting vehicle for all

[2] More specifically, these two standards provide accounting guidance on when a sale of a financial instrument has occurred and how to account for the sale, and guidance on when a securities issuer, B-piece buyer or servicer needs to consolidate the securities and liabilities on its balance sheet. The current rules facilitate securitization by allowing issuers to receive "sales treatment" for the assets they securitize, such that these assets are reflected on the balance sheet of the investors that purchase the bonds, rather than the issuers' balance sheet. Moreover, under present rules, investors reflect only the fraction of the securitization deal that they actually own on their balance sheet.

asset-backed securities including CMBS, as well as change the criteria for the sales treatment and consolidation of financial assets. These accounting standards are important to issuers and investors, and for the liquidity of capital markets as a whole, because they free up balance sheet capacity to enable issuers to make more loans and do more securitizations, and they enable investors to invest more of their capital into the market. Under the new rules, however, issuers may not receive sales accounting treatment, while investors may be forced to consolidate an entire pool of loans on their balance sheet, despite owning only a small fraction of the loans pool.

The implementation date of FAS 166 and 167 is January 1, 2010, and it will be applied retroactively. The elimination of QSPEs therefore will impact trillions of dollars of outstanding asset-backed securities, including investors in these assets. These significant and retroactive changes will pose a serious threat to unlocking the frozen credit markets and another impediment to the Administration's wide-ranging efforts to restart the securitized credit markets. CMSA and a diverse coalition of 15 trade groups have raised concerns about the timing and scope of FAS 166 and 167 given the impact these rule changes could have on credit availability. These concerns have been echoed by the Federal Reserve and other banking regulators, which wrote to FASB in December 2008 to highlight the adverse impact these rule changes could have on the credit markets.

More recently, Federal Reserve Board Member Elizabeth Duke capsulized the concerns shared by the industry when she cautioned that:

> [i]f the risk retention requirements, combined with accounting standards governing the treatment of off-balance-sheet entities, make it impossible for firms to reduce the balance sheet through securitization and if, at the same time, leverage ratios limit balance sheet growth, we could be faced with substantially less credit availability. I'm not arguing with the accounting standards or the regulatory direction. I am just saying they must be coordinated to avoid potentially limiting the free flow of credit.... As policymakers and others work to create a new framework for securitization, we need to be mindful of falling into the trap of

> letting either the accounting or regulatory capital drive us to the wrong model. This may mean we have to revisit the accounting or regulatory capital in order to achieve our objectives for a viable securitization market.[3]

Policymakers and standard setters, including FASB and the SEC, need to proceed cautiously and deliberately in this regard, so that accounting rule changes do not hamper the recovery of the securitization markets.

Credit Rating Agency Reform

One aspect of the reforms currently being considered for credit rating agencies is a previously rejected proposal to require credit ratings to be differentiated for certain types of structured financial products (requiring the use of "symbology," such as "AAA.SF"). Generally speaking, "differentiation" is an overly simplistic and broad proposal that provides little value or information about credit ratings. Thus, CMSA's members, and specifically the investors the symbology is geared to inform, continue to have serious concerns about differentiation, although we are strong supporters of more effective means of strengthening the credit ratings system in order to provide investors with the information they need to make sound investment decisions.

In fact, a broad coalition of market participants – including issuers, investors, and borrowers seeking access to credit – remain overwhelming opposed to differentiation because it will serve only to increase confusion and implementation costs, while decreasing confidence and certainty regarding ratings. Such effects would, in turn, create market volatility and undermine investor confidence and liquidity, which could exacerbate the current constraints on borrowers' access to capital, at a time when other policymakers are employing every reasonable means to get credit flowing again.

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[3] "Regulatory Perspectives on the Changing Accounting Landscape," Speech by Governor Elizabeth A. Duke at the AICPA National Conference on Banks and Savings Institutions, Washington DC, September 14, 2009, available at http://www.federalreserve.gov/newsevents/speech/duke20090914a.htm.

In this regard, it is worth noting that the concept of differentiation has been examined extensively and rejected in recent years by the House Committee on Financial Services, as well as by the SEC and the ratings agencies themselves[4], for most (if not all) of the foregoing reasons. Nothing has changed in the interim.

Accordingly, Congress should not include a differentiation requirement as part of any credit rating agency reform bill, but instead should include language consistent with that already passed last year by the House Committee on Financial Services in the Municipal Bond Fairness Act. That legislation would require CRAs to use ratings symbols that are consistent for all types of securities, recognizing the fact that a single and consistent ratings structure is critical to bond investors who want the ability to compare a multitude of investment options across asset classes. Ultimately, investors (who are critical to the nation's economic recovery) expect and demand a common rating structure to provide a meaningful foundation for our markets and ratings system. Such consistency will promote certainty and confidence among investors and all market participants.

In terms of credit ratings performance CMSA 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, 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.

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[4] In early 2008, the CRAs sought feedback on various differentiation proposals, which elicited overwhelming opposition from investors. For example, see the results of Moody's Request for Comment: "Should Moody's Consider Differentiating Structured Finance and Corporate Ratings?" (May 2008). Moody's received more than 200 responses, including ones from investors that together held in excess of $9 trillion in fixed income securities.

In comments filed with the SEC in July 2008, CMSA 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.

Fundamentally, CMSA believes that one of the keys to long term viability is market transparency. As previously mentioned transparency is one of the hallmarks of our market, as exemplified by the unqualified success of our Investor Reporting Package. As we endeavor to continually update our reporting package and provide additional standardized information to market participants, one of our most important proactive initiatives is the ongoing process of creating model offering documents and providing additional disclosure fields with regard to additional subordinate debt that may exist outside the CMBS trust. To this end, CMSA is working with the Federal Reserve Board to ensure the expanded disclosure meets their information needs under TALF.

Conclusion

There are enormous challenges facing the commercial real estate sector. While regulatory reforms are important and warranted, these proposals should not detract from or undermine efforts to get credit flowing, which is critical to economic recovery. Moreover, any policies that make debt or equity interests in commercial real estate less liquid will have a further negative effect on property values and the cost of capital. Accordingly, we urge Congress to ensure that regulatory reform measures are tailored to account for key differences in the various securitization markets.