MEMORANDUM

October 1, 2010

To: File S7-08-10

From: Scott H. Kimpel
Office of Commissioner Troy A. Paredes

Re: Asset-Backed Securities

On September 29, 2010, Scott H. Kimpel and Dawn L. Jessen, Counsel to Commissioner Troy A. Paredes, met with the following representatives of the Commercial Real Estate Finance Council: Lisa Pendergast, Mark Warner, Douglas Tiesi, Kathleen Olin, Brendan Reilly, and Michael P. Flood. The participants discussed the Commission's proposed rulemaking on asset-backed securities.

Attachment

CRE Finance Council

A Framework For A Sustainable Commercial Real Estate Recovery

The $7 trillion commercial real estate (CRE) market is under duress, and there are significant hurdles to recovery in the near term. The challenges posed by the distressed CRE market 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. This paper provides suggested public policy measures that can be taken in an effort to help support a broad and lasting CRE recovery. The suggestions are designed to address the current state of the CRE market and must be undertaken in light of the unique structure of the CRE securitization markets; introductory overviews of each are thus provided at the outset.

Current State of the Market

Unlike previous downturns, the stress placed on the CRE sector today comes from a number of different but connected factors that when taken together will exacerbate the capital crisis and prolong a recovery:

- **Limited Liquidity/Lending with CMBS dormant.** The volume of new CRE loan originations and thus new securitizations in the commercial mortgage-backed securities (CMBS) market has plummeted from $240B in 2007 (half of all CRE lending in 2007) to $12B in 2008, and approximately $2B in 2009.

- **Significant Loan Maturities**. Approximately $1 trillion in CRE loans mature over the next several years, but the capital necessary to refinance these loans remains largely unavailable and many loans require additional equity to refinance given the decline in CRE asset values.

- **Severe U.S. Recession.** The economic downturn in the U.S. that began in December 2007 negatively impacted key CRE indicators such as employment and business performance, as well as commercial and multifamily occupancy rates, rental income and property values, and those impacts persist even as the recession abates.

- **"Equity Gap."** CRE assets have depreciated in value by 30% to 50%, creating an equity gap between the loan amount and the equity needed to extend or re-finance a loan, which impacts even performing loans that continue to support the payment of principal and interest.

The Uniqueness of the CRE Securitization Markets

Even in robust economic times, the primary banking sector lacked the lending capacity to meet borrowers' financing demands. Such a shortfall was filled over the last 17 years by the securitization markets. Policymakers correctly recognize that no economic recovery plan will succeed unless it helps re-start and stabilize the securitized credit markets. Any such efforts, however, must be tailored in light of the unique features of the CMBS market, including:

- **Borrowers/sponsors and type of loans**. CRE borrowers/sponsors are sophisticated businesses with "income-producing" properties supported by cash flows based on business operations and/or tenants under leases. Most CMBS loans have 5- to 10-year terms with 20- to 30-year amortization schedules (referred to as "balloon" mortgages). They are generally non-recourse to the borrower with exceptions for certain acts and omissions.

- **Structure of CMBS**. A CMBS pool is typically comprised of 100 to 300 loans that allow for a non-statistical, in-depth analysis of the collateral. Market participants (investors, rating agencies, etc.) gather detailed information about income-producing properties, including cash flows, the credit quality of tenants, etc.

- **Existence of a third-party investor, or "B-Piece investor."** In CMBS, typically a sophisticated third-party investor – known as the "B-piece investor" – purchases the "first-loss" position and re-underwrites ALL loans prior to securities issuance. This diligence and negotiation occurs on a deal before bonds are issued.

- **Enhanced reporting and transparency**. Tremendous transparency of loan, property and bond level information is provided via the CMSA Investor Reporting Package®.

A Framework For Recovery

Although there is not a single "magic bullet" that can or will alleviate the entirety of the challenges currently posed by CRE and the CMBS financing mechanism, the following suggestions together could serve as a blueprint for public policy initiatives that could best support and sustain the requisite CRE recovery.

1. **Increase Coordination of Regulatory and Accounting Reforms.** It is critical that policies are customized by market AND coordinated by all policymakers to provide the certainty and confidence necessary to promote private lending and investing, and a recovery in CRE and the overall economy. For instance, the combination of unprecedented and retroactive accounting standards (FAS 166/167), risk-based capital changes, and "retention" (or "skin-in-the-game") proposals creates tremendous uncertainty and serves as an impediment to private lending and investing, as the market anticipates what impact this may have on capital and liquidity. The overall impact (and future of these markets) remains unclear until the reforms are finalized. To this end, policymakers should enact an important provision in the House-passed regulatory reform bill that would require regulators to examine and report on the combined impact of the new "skin-in-the-game" (or "retention") requirements and accounting rules on credit availability before any final rulemaking on the retention.

2. **Regulatory Reforms Should Account for Differences That Exist in the CRE Market.** Regulators should be given the authority to tailor any market reforms to ensure that they will support a recovery in CRE finance in light of the unique CMBS features outlined above. Similar to the bipartisan provision in the House-passed reform bill, any retention regime should not be "one size fits all," rather it should grant regulators the flexibility to customize retention requirements to each asset type and market. Such reforms should enable regulators to utilize the most effective retention regime, including by creditor, securitizer, OR a third-party investor who re-underwrites the loans, purchases a first-loss position and retains this risk.

3. **Provide Investors With Certainty and Confidence.** Private investors bring their own funds to the table and provide much needed capital that fuels overall lending. In addition to the above items, there are two areas where increased certainty is critical. First, any credit rating agency reforms should require CRAs to provide more information about individual ratings and their rating methodologies. However, and unlike the recent European ruling, such CRA reforms should NOT require ratings "differentiation" or "symbology" (e.g. AAA.SF) for U.S.securitized products that investors have explicitly rejected because such differentiation creates confusion and causes massive implementation issues. Second, in the "REMIC" (Securitization Tax Vehicle) context, Treasury has rightfully clarified that there will not be tax consequences for the modification of commercial mortgages in imminent default, and has relaxed rules regarding certain changes to collateral and mortgage terms. Any future REMIC reforms must continue to permit prudent decision making and provide certainty to avoid driving away investors.

4. **TALF & PPIP Programs Should Support Transition to Private Market.** TALF and PPIP have helped facilitate liquidity by stimulating private investment, but the expectations and future of the program remain unclear. To date, TALF, for example, has helped to reduce credit spreads on CMBS secondary trading and to produce the first private-label CMBS loan in over a year in the form of a "single-borrower" securitization (that is, one large commercial mortgage sold to investors). This first CMBS new issue was followed by two additional private "single-borrower" CMBS that priced at year-end 2009 *without* government support from TALF. This progress is welcome and suggests the future of the program should be clearly revealed as a "fallback" and not a "catalyst." In the meantime, the program – which expires in two parts this year – should be tailored to support a transition to a sustainable private market. For example, it will be critical for the CMBS market to move toward "conduit" deals (i.e., a diversified pool with 50 or more loans of all sizes and secured by different commercial and multifamily asset types to multiple borrowers) in order to provide the capacity necessary to satisfy the enormous challenges discussed above, and to reach more regionally diverse areas of the country. Any modifications to TALF that will support additional loan origination would facilitate the re-emergence of conduit lending.

5. **Support Additional Sources of Capital/Liquidity.** There are at least two potential sources of new capital that could be deployed to bolster a CRE recovery. First, as the Resolution Trust Corporation (RTC) pioneered, the securitization of commercial mortgages can be used as an effective exit strategy for the government *AFTER* an institution has failed and its assets (including CRE loans that were not securitized) are seized by the FDIC. Such a proven mechanism can minimize government and taxpayer exposure, while providing liquidity and capacity to the CRE market. Second, policymakers also should create a regulatory framework to facilitate a covered bond market that includes commercial mortgages and CMBS as eligible collateral. This market has been utilized with great success in Europe, and over time it could generate new capital through the sale of covered bonds secured by high-quality commercial mortgage loans and CMBS.