MEMORANDUM

May 2, 2014

TO: File No. S7-14-11

FROM: Mark T. Uyeda
Office of Commissioner Michael S. Piwowar

RE: Meeting with CRE Finance Council

On April 29, 2014, Commissioner Michael S. Piwowar and his legal counsel, Mark T. Uyeda, met with the following individuals from the CRE Finance Council: Stacy Stathopoulos, senior vice president, industry standards & strategic relations; Christina Zausner, vice president, industry policy & analysis; and Martin Schuh, legislative & regulatory affairs. Also in attendance was outside counsel to CRE Finance Council, Scott A. Sinder of Steptoe & Johnson LLP. The CRE Finance Council participants provided the attached summary of key recommendations in their comment letter, which was the subject of the discussion.

CRE Finance Council

Summary of Key Recommendations

Risk Retention Re-Proposal Comment Letter (October 30, 2013)

In developing our comments in response to the Risk Retention re-proposal of 2013, CRE Finance Council members sought to work within the main requirements and to only address fatal and other significant flaws in the rule. No recommendation was included unless all four CREFC forums that engaged on the risk retention comment letter – Issuers, IG Investors, B-piece Buyers, Servicers – had majority support. On each of the issues included in this note, the IG Investors voted in favor by approximately two-thirds or more. CRE Finance Council's most important issues are summarized below.

1. **Eligible Horizontal Retained Interest Test:** The proposed test and the alternative pose a fatal flaw for the CMBS market, and will severely limit the flow of non-bank capital. Any CMBS transaction would fail from day 1 through much, if not all, of its life on two dimensions:
    - **Low Principal Payout until the end of the bonds:** The principal payout of the bonds mirrors that of the underlying loans. Because of the long amortization schedules and inclusion of IOs in the pools, principal is mostly paid out at the end of the bonds; and
    - **Fair Value:** Investors require a discount for the B-piece bonds, in order to offset expected credit losses.

    Our members maintained that pre-funding of losses to the B-piece buyer is not a material concern in the CMBS market, because:
    - The price at which the B-piece is sold will be disclosed; and
    - The Operating Advisor role is important as a counter balance to the special servicer.

2. **Senior-Subordinate Structure:** If a typical B-piece currently represents roughly 2.5% - 3% of the fair value of a transaction, then the re-proposal actually assumes that the capital supporting the retained interest will roughly double. To meet the rule requirements, the B-piece buyer will have to purchase higher into the stack, through the BBB's and even into some of the A- bonds. There is no natural buyer for this type of conflated tranche. Allowing for two B-piece buyers using the *pari passu* structure as required does not resolve the issue. If a buyer type were to emerge, it would have to be from amongst the larger firms and funds, and many of the currently active, smaller B-piece buyers believe they would be shut out of the market.

    A senior-subordinate structure within the B-piece would allow the marketplace to divide the thicker tranche into two slices, re-establishing normal investment grade and non-investment grade boundaries, and allowing today's natural buyers to continue to access the market. The junior-senior construct would also serve incentives equally to both large and small investors. At the same time, our members agreed that both the junior and senior B-piece investors should share in due diligence responsibilities and hold their respective pieces for 5 years, as per the re-proposal.

3. **Single Borrower – Single Credit Exemption:** SBSC transactions represent roughly 20% of the CMBS market today. They perform materially better than CMBS conduit deals, private label RMBS, and even compare favorably to corporate debt. Cumulative losses in CMBS conduits total 2.79%, but only 0.25% for SBSC deals.

    SBSC borrowers and properties are considered to be very credit-worthy. Indeed, the level of transparency is high and investors can perform extensive due diligence. A very large majority of our IG Investors voted in favor of the recommendation, saying that they wanted access to these tier I and trophy properties. Bearing in mind that SBSC borrowers are capable of accessing other markets, our members believe that they would likely leave the CMBS universe, if even a relatively small proportion of risk retention costs were to be transferred to them.

4. **QCRE definition:** Overall, our members agreed to maintain the QCRE definition as a meaningfully limiting factor. Historically, the percentage of loans originated since 1997 that meet the QCRE definition as re-proposed is 3.6%. However, we did recommend several changes intended to retain certain high-quality loans in the pools. Using CRE Finance Council's expanded definition, QCRE-eligible loans originated since 1997 would increase to 15.6%.

   Interestingly, QCRE-eligible loans as per the re-proposal experienced 0.74% of cumulative loss historically, versus only 0.57% of loss on the CREFC QCRE-eligible loans. CREFC members have recommended that the following loans be made eligible for the qualified loan exemption:

   - **IO loans with a starting LTV of 50%.** IO loans can be attractive to the borrower for obvious reasons. It follows then that there is a relatively large concentration of IO loans in the best performing markets, such as New York City multifamily and office.
   - **Shorter-term loans.** Often, the more credit-worthy borrowers seeking to finance top tier properties plan to sell at some point in the medium-term. This makes 5- and 7-year loans very attractive to the better borrowers with high-quality properties.
   - **Loans with 30-year amortization.** 30-year amortization is by far the most common schedule in the marketplace. 25-year amortization is largely reserved for hospitality. The impact of the shorter schedule is minimal on a typical 10-year loan's LTV, and the performance differential is minimal.

   We also asked for the removal of the requirement that all loans with appraised cap rates less than the prevailing Treasury swap rate plus 300 basis points due to similar concerns regarding the potential for negative selection in the pools. Top properties command low cap rates.

   Members took a conservative approach to the issue of QCRE-eligibility, seeking to make the exemption an achievable, yet, meaningful target that would benefit the overall health of the pools.

5. **5% Quorum for Vote to Remove Special Servicers:** There was unanimous support for an increase in the quorum threshold. While the members agree that investor information capture could be improved, enhancements to CMBS practices are underway. The threshold set in the risk retention rule should anticipate these changes. CREFC's recommendation that the quorum be set at 20% with representation by at least 3 investors is believed to be achievable in today's environment.

Data Source: Trepp