Regulatory Reform and Commercial Real Estate Finance

Commercial Mortgage Securities Association (CMSA) – September 2009

Background: Challenges and Recovery Efforts

As policymakers consider regulatory reform proposals, it is critical to understand and address the tremendous challenges facing the $3.5 trillion commercial mortgage market, which impacts businesses that provide jobs and services, as well as millions of Americans who live in multi-family housing. Today, these challenges are exacerbated by several conditions:

1) Limited to no liquidity or lending – Commercial Mortgage-Backed Securities (CMBS) issuance fell from $240 billion in 2007 (50% of all commercial lending) to $12 billion in 2008, despite strong credit performance and high borrower demand. There has been no new issuance year-to-date 2009, as the lending markets remain frozen;
2) Significant loan maturities in 2009 – Hundreds of billions in commercial loans mature in 2009, yet the capital necessary to re-finance these loans remains largely unavailable and loan extensions are difficult to achieve; and
3) The U.S. economic downturn persists – The U.S. recession continues to negatively affect both consumer and business confidence, which in turn has led to falling commercial and multifamily occupancy rates and rental income.

The securitized credit markets are crucial to providing liquidity and facilitating private lending, both of which are essential to any economic recovery. As Treasury Secretary Geithner stressed during the introduction of the Financial Stability Plan, "Because 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." As such, CMSA urges policymakers to consider the following issues in the context of recovery efforts and regulatory reform efforts to protect the viability of these markets and to ensure that they remain a vital component of the economic recovery solution.

The CMBS Market Is Unique

There are a number of important differences between CMBS and other asset-backed securities markets. These differences relate not only to the structure of securities, but also the underlying collateral assets and the type and sophistication of the related borrowers:

Borrowers

- Commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases.
- Securitized commercial mortgages are in the vast majority of cases non-recourse loans – meaning if the borrower defaults, the lender can seize the collateral, but may not pursue a claim against the borrower for any deficiency in recovery.

Structure of CMBS

- In-depth property-level disclosure and review are done by rating agencies.
- Non-statistical analysis is performed on CMBS pools. There are typically only 100-300 commercial loans in a pool that support a bond, as opposed to tens of thousands of loans in the residential market. The limited number of loans that secure a CMBS pool 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 Buyer Re-Underwriting of Risk

- Additionally, because fixed-rate conduit/fusion CMBS offer higher risk non-investment-grade bonds, the investors in these lowest-rated securities, referred to as "B-piece" investors conduct extensive due diligence and re-underwrite all of the loans in the proposed pool, with the option to remove any loans they consider to be unsatisfactory from a credit perspective.
- This diligence occurs on every deal before the investment-grade bonds are issued.

Greater Transparency

- CMBS market participants have access to loan, property and bond-level information at issuance and while securities are outstanding through the CMSA Investor Reporting Package® (CMSA IRP®), as well as through other third-party sources which provide access to the financial underpinnings of the securitized commercial loans and their ongoing performance.
- The "CMSA IRP" is now serving as a model for the residential asset-backed securities market.

Reform Proposals Should Be Customized To Reflect Key Differences in Markets
The new and unprecedented financial Regulatory Reform Proposal (which appears to be aimed at the residential market) would undoubtedly change the nature of all securitized credit markets at the heart of the Financial Stability Plan. At a time when policymakers hope to restart the CMBS market, certain aspects of such proposal could have the opposite and unintended result of 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 following five issues are of the utmost concern:

1) <u>5% Retention for Originators/Sponsors</u> –

- The retention of risk is an important component regardless of who ultimately retains the risk: the broker/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 who specifically negotiates to purchase this risk. These investors conduct extensive credit analysis on the loans, examining detailed information concerning every property – before buying the highest risk bonds in a CMBS securitization. In most 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.
- Since the CMBS market is structured differently than other securitization markets, the focus should be on the proper transfer of risk. In order to permit the transfer of risk from one party to another, there must be sufficient collateral disclosure, an appropriate marketing and due diligence period, and meaningful representations and warranties made by the transferor relating to the information presented and the precedent due diligence and/or risk assessment procedures conducted. Assuming the foregoing conditions are satisfied, the seller should be permitted to transfer risk, even if it is concurrently required to acknowledge certain contingent liabilities or amortize related fees and other profits over the life of the financial asset.
- The Treasury's reform proposal includes an originator/sponsor 5% risk retention requirement, but it also would provide the authority to grant exceptions or adjustments to the retention requirement in certain cases. Given the unique structure of CMBS, the exception authority should be crafted to allow structured finance vehicles that include investors akin to the CMBS B-piece buyers to qualify, subject to the appropriate transfer of such risk.
- Should retention of securities by issuers be required, we believe that such risk should be able to be hedged provided the counterparties to such transactions have the same level of disclosure, ability to conduct due diligence, and can rely on issuer representations and warranties.

2) <u>Prohibition on Hedging of the Retained Risk Portion</u> –

- In the event that loan originators/sponsors are required to retain five percent of the credit risk of securitized exposures, they should be allowed to hedge certain risks, as leaving such positions unhedged places the financial stability of the loan originator at risk.
- Several risks inherent in any mortgage or security exposure arise not from imprudent loan origination and underwriting practices, but by 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.
- Loan originators/sponsors should be allowed to hedge against such risks as not doing so runs counter to standard safety and soundness practices. Since there is no way to ensure that any hedge protects 100% of an investment from loss – particularly as it pertains to a CMBS transaction that is secured by a diverse pool of loan with exposure to different geographic locations, industries and property types – loan originators and sponsors will continue to carry significant credit risk exposure that reinforces the economic tie between the originator and the issued CMBS.

3) <u>Ratings Differentiation</u> –

- CMSA market participants, particularly investors, overwhelmingly oppose ratings differentiation for structured finance products as an unhelpful change with unintended consequences.
- Such a distinction (e.g. "AAA.SF") would be inconsistent with the current structure of ratings and confusing for investors, while providing little additional information or value to investors.
- Such a change would negatively impact the securitization markets by prohibiting certain investors from buying bonds until their investment policies are revised and a new analytical and monitoring infrastructure is developed to interpret the new ratings. This could significantly delay the positive impact of government initiatives to reinvigorate commercial mortgage lending.

Conclusion:
As outlined above, there are enormous challenges facing commercial real estate. While regulatory reforms are important and warranted, these proposals should not distract from or undermine efforts to get credit flowing, which is the critical mission of the Financial Stability Plan. Further, 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.

There are serious concerns that a number of regulatory and accounting proposals in the Treasury's Regulatory Reform Proposal complicate efforts to restart the securitized credit markets, which is a centerpiece of the Administration's recovery efforts (through TALF, PPIP, etc). For these reasons, CMSA urges policymakers to examine these issues thoroughly and to ensure that they are carefully considered to reflect key differences in markets.