

TESTIMONY OF KENT BORN

ON BEHALF OF THE COMMERCIAL REAL ESTATE FINANCE COUNCIL

Before the

UNITED STATES HOUSE FINANCIAL SERVICES COMMITTEE

**SUBCOMMITTEE ON
OVERSIGHT & INVESTIGATIONS**

**Hearing on “Commercial Real Estate: A Chicago Perspective
on Current Market Challenges and Possible Responses”**

May 17, 2010

My name is Kent Born. I am a Senior Managing Director for PPM America, a Chicago-based investment management firm affiliated with Jackson National Life Insurance Company (Jackson). Jackson is one of the leading writers of annuities and life insurance in the United States. My primary responsibility at PPM America is managing a portfolio of commercial mortgage-backed securities (“CMBS”), which currently totals approximately \$6.0 billion. I also am a past President of the Commercial Real Estate Finance Council (“CRE Finance Council”), which until March was named the Commercial Mortgage Securities Association (“CMSA”), on whose behalf I am testifying today. The CRE Finance Council is grateful to Chairman Moore, Ranking Member Biggert, and the Members of the Subcommittee for giving the CRE Finance Council the opportunity to share its perspective on the state of commercial real estate and the markets that fuel its growth and overall viability.

Today, the \$7 trillion commercial real estate (“CRE”) market in the United States is facing serious 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. Our testimony will focus on three key areas: 1) the challenges facing the \$3.5 trillion market for CRE finance; 2) the unique structure of the commercial market and the need to customize and coordinate reforms accordingly to support, and not undermine, our nation’s economic recovery; and 3) suggested public policy measures that should be considered to help support a broad and lasting CRE recovery. These 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.

The CRE Finance Council

The CRE Finance Council represents the full range of commercial real estate finance 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. The CRE Finance Council 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, the CRE Finance Council 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”). The CRE Finance Council continues to participate actively in the public policy issues and proposals that impact commercial real estate finance.

THE CURRENT STATE OF THE MARKETS

The Current State of CRE Finance

CRE is a lagging indicator, and it now is feeling the impact of a prolonged recession. In fact, what began 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. It should come as no surprise that CRE would experience strain in light of the economic fundamentals today and over the last year, 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 four interconnected challenges that compound each other and that, when taken together, will exacerbate the capital crisis and prolong a recovery:

- **Limited Liquidity/Lending with CMBS Dormant.** – 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, and endowments, among others – who bring their own capital to the table and fuel lending. CMBS accounts for approximately 25% of all outstanding CRE debt, with as much 40% of outstanding debt at its peak, while readily identifiable properties funded by CMBS exist in every state and every congressional district. However, the volume of new CRE loan originations, and thus of new CMBS, has plummeted from \$240 billion in 2007 (nearly half of all CRE lending) to \$12 billion in 2008, and to approximately \$2 billion in 2009. That said, and thanks in part to the success of the TALF program, the CMBS market is beginning to show new signs of life, as there were three “single-borrower” CMBS issuances in December and the first multi-borrower CMBS was issued just last month.
- **Significant Loan Maturities.** – At the same time, approximately \$1 trillion in CRE loans mature over the next several years, but the capital necessary to refinance these loans is still relatively constrained and more significant, many loans require additional “equity” to refinance given the decline in CRE asset values.
- **Severe U.S. Recession.** – With a prolonged recession and unemployment at 9.9%, there is no greater impact on CRE than jobs and the economy, as commercial and multifamily occupancy rates, rental income and property values have subsequently been severely impacted and perpetuate the downturn. Those impacts persist even as the recession has abated.

- **“Equity Gap.”** – The biggest challenge today is the reality that CRE assets have depreciated in value by 30% to 50% since 2007, creating an “equity gap” between the loan amount and the equity needed to extend or re-finance a loan, which impacts even “performing” properties that continue to support the payment of monthly principal and interest on the underlying loans.

Significantly, it is important to note several additional points with respect to the current state of CRE finance. First, the average CMBS securitized loan is \$8 million, which makes CMBS a significant source of capital for lending to small businesses. Without a revival of the CMBS markets, loans for smaller businesses will continue to be significantly constrained, placing more pressure on small and regional banks, with troubling effects on local economies. Second, the dormant (or near dormant) CMBS market has virtually eliminated the key outlet for “take-out” financing particularly for small institutions – securitizing bank balance sheet construction loans after the projects are ready to come on line, for example. Third, more than 1,500 U.S. banks (mostly smaller community banks) have CRE exposure greater than 300% of their tier 1 capital, meaning that they are considered “at risk” under the metrics employed by the FDIC. This debt (construction loans, land loans, etc.) is not securitized.

As Richard Parkus, an independent research analyst with Deutsche Bank who has testified before both the Joint Economic Committee and the TARP Oversight Panel, has 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 this 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.

For more than a year after the subprime crisis, default rates in the CMBS market, which were historically 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 left the broader CRE sector and the CMBS market with several overarching problems: 1) an initial liquidity gap, i.e., the difference between borrowers’ demand for credit and the nearly non-existent supply of credit; 2) hesitancy of lenders and issuers to take the risk of trying to make or “aggregate” loans for securitization, given the uncertainty related to investor demand to buy such bond (this 3-6 month “pre-issuance” phase is known as the “aggregation” or “warehousing” period); and 3) most significant, a severe and current “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) – all of which continue to perpetuate challenges in the credit markets and overall CRE market.

Unique Characteristics of the CMBS Market

Critical to this conversation is an understanding that the CMBS market does have important and inherent differences from other classes of Asset-Backed Securities. 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 sophisticated businesses with “income-producing” properties that have 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. As such, in CRE both the properties and other relevant information are more tangible to the various market participants.

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.

Structure of CMBS

A CMBS pool is typically composed of 100-300 loans. This size is in contrast to consumer ABS classes (homes, autos, credit cards, etc.) that have pools with thousands of loans. 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 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.

Greater Transparency

A wealth of transparency currently is provided to CMBS market participants via the CRE Finance Council Investor Reporting Package® (CRE Finance Council IRP). The CRE Finance Council 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 “IRP” is constantly reviewed by market participants to improve disclosure, and it 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

As a centerpiece of the Administration's Financial Stability Plan, policymakers hoped to restart the CMBS and other securitization markets through innovative initiatives like TALF. TALF did help provide liquidity to the CMBS markets by offering low-cost loans to CMBS bond investors. While it did not lead to an overnight increase in new lending for a variety of reasons (e.g., "aggregation" challenges, the equity gap) the program was able to stimulate investor demand and free up the balance sheets of financial institutions, creating a "multiplier effect" to make new loans or buy bonds.

More specifically, TALF also helped produce the first private CMBS issuance in more than 18 months at the end of last year in the form of a conservative "single-borrower" deal (i.e. one large commercial mortgage to a single borrower, sold to investors, as opposed to more traditional "conduit" deals which commonly involve a diversified pool of 100-300 loans made to different borrowers). This first issuance led to a few more similar "single-borrower" deals at year end, and the first true multi-borrower deal in over two years which was issued just last month, all *without* government support.

The progress thus far has been welcome and positive, but it will be critical for the CMBS market to move toward more traditional "conduit" deals in order to provide the capacity necessary to address the enormous challenges discussed above. Likewise, as mentioned earlier, the conduit deals are necessary to reach more local/regional communities and smaller loans (e.g. \$8 million loans, which is the average loan size in CMBS), but until the "conduit" market evolves further, we are likely to see more large loan single-borrower deals.

A FRAMEWORK FOR RECOVERY

Both the previous and current Administrations share Treasury Secretary Geithner's view that "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 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."¹ In part, this is because – as noted above – there is simply not enough capacity in the primary banking sector to meet the financing demands of borrowers, and additional liquidity is needed to help stabilize property values and alleviate the equity gap that exists in the massive wave of impending loan maturities.

As such, 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

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>.

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

1. Increase Coordination of Regulatory & Accounting Reforms

Congress currently is moving toward finalizing a package of financial sector regulatory reforms that will change the nature of the securitized credit markets at the heart of recovery efforts. The securitization reform proposals appear to be prompted by some of the practices that were most typical in the subprime and residential securitization markets. At the outset, we must note the CRE Finance Council does not oppose efforts to address such issues, as we have long been an advocate within the industry for enhanced transparency and sound practices.

This is an extraordinarily difficult time to make significant changes, particularly in an uncoordinated manner. Yet, we are seeing a growing number of reforms that include unprecedented and retroactive accounting standards (FAS 166/167), risk-based capital changes, and “retention” (or “skin-in-the-game”) proposals, among others. When taken together, these extensive changes create tremendous uncertainty and serve as an impediment to private lending and investing as the markets attempt to anticipate what impact these developments may have on capital and liquidity. The overall impact (and the very future of these markets) will remain unclear until the complete package of reforms is finalized.

As mentioned above, financial policymakers have gone to great lengths to provide liquidity and facilitate lending through the securitized credit markets, but some reforms undermine a recovery in these markets. For example, as a general matter, there is concern that a 5% risk “retention” mandate could greatly impair the ability to originate CMBS by significantly increasing the cost of securitization and reducing its utility, not to mention draining the much needed capital and liquidity to make loans or buy bonds. It is only logical that if “originators” and/or “securitizers” are required to retain a percentage of every loan made or bond issued, it could quickly restrict and limit balance sheet, liquidity, and overall lending capacity. In fact, depending on how it is structured, a 5% risk retention could change the CMBS structure altogether, impacting capital and liquidity in the CRE market, during a still nascent recovery for both the CMBS and CRE markets.

Of equal concern, under the new and retroactive accounting rules (FAS 166 and 167) mentioned above, some financial institutions could be required to account for 100% of securitized assets on balance sheet (i.e., “consolidation”), despite having retained only a small percentage of the securitized pool. As financial regulators have repeatedly noted, a retention mandate creates additional uncertainty under FAS 166 and 167 related to who would “consolidate” 100% of assets on balance sheet. Much worse, it would require some lenders (i.e., banks) to hold even more capital (beyond the retention) against a highly distorted and inflated accounting disclosure, despite no change in real credit risk. The result, as repeatedly outlined by market analysts, is an uncertain and slowed market recovery in which lenders and investors forgo deals in the short term, while in the long term the overall volume of lending transactions is reduced considerably. Put simply, it effectively limits access to credit and raises the cost of lending in an already troubled environment.

Concerns with inconsistent and uncoordinated policies were highlighted by Federal Reserve Board Member Elizabeth Duke, among other policymakers, who cautioned that:

If 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.²

To this end, the final regulatory reform package should include an important provision included in the House-passed bill that would require regulators to examine and report on the combined impact of the new securitization retention requirements and the new accounting rules on credit availability before any final rulemaking is done on the new retention requirements.

2. Regulatory Reforms Should Account for Differences That Exist in the CRE Market.

The 5% Retention

While “skin-in-the-game” can come in many forms, legislative proposals have fixated on mandating a 5% retention by “originators” and/or “securitizers” in all asset-backed markets (residential mortgages, commercial mortgages, student loans, auto loans, small business loans, etc), with little examination by asset or separation by actual ‘root’ causes of the economic crisis. As an example, a recent report of the TARP Congressional Oversight Panel highlighted that the most distressed CRE loans include non-securitized debt held by smaller institutions (which had 100% “retention” on these loans), which raises serious questions about the best way to strengthen lending for each type of loan and asset class.

It is critical that the most appropriate and direct form of “skin-in-the-game” (e.g., a percentage retention; underwriting standards and controls; stronger “representations and warranties,” etc.) be considered by asset class and with limited negative complications. Most important, policymakers must ensure that any regulatory reforms are customized to address the specific needs of each securitization asset class and coordinated by all policymakers to provide the certainty and confidence necessary to promote private lending and investing, and a recovery for both CRE and the overall economy.

² "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>.

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. As such, the holders of the first-loss bonds are intimately familiar with the loans, properties and bonds issued, and they are fully cognizant, through their own diligence, of the scope and magnitude of the risk being taken.

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, any regulatory reform law should ensure that regulators can permit CMBS securitizers to transfer risk to B-piece buyers who – in the CMBS context at least – act as “securitizers” to satisfy any retention obligation. This approach would be a “true” retention (and alignment of interests) by someone performing due diligence, purchasing and retaining a first-loss position. To not consider ways to maintain and strengthen this structure could needlessly and unnecessarily tie up valuable capital, which would halt the flow of credit at a critical time for CRE.

Regulators need both direction and discretion to determine the most direct and effective form of “skin-in-the-game” by asset class. This also would be consistent with the recent IMF admonition that:

Proposals 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.³

In this regard, the CRE Finance Council is very encouraged that the House-passed bill included a bipartisan and unanimously adopted amendment that would allow regulators to consider various ways to satisfy a retention requirement, including an “originator,” a “securitizer,” or “third party investor” who performs due diligence, purchases a first-loss position and *retains* this risk to ensure an alignment of interest. Likewise, the Senate bill requires that reforms be considered by asset class, while an important amendment was also unanimously approved to incorporate explicit language recognizing the “third party” retention model and other important forms of “skin-in-the-game” for commercial mortgages. These developments are very positive and would strengthen these markets, while also promoting an overall CRE recovery. And, given the impact on credit, a broad coalition of groups (including borrowers and realtors, among other associations) have written policymakers on this issue that is critical to the CRE market, which faces more than \$1 trillion in loan maturities in the next few years.

Prohibition on Hedging of Retained Risk.

³ IMF *Global Financial Stability Report* 2009, at 109.

In conjunction with the retained risk requirement, both the House and the Senate bills include provisions that would prohibit “securitizers” from hedging any retained credit risks. Rather than adopting an outright ban on hedging the retained risk, however, the legislation or the supporting conference reports should clarify that this prohibition is not intended to impose 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 made clear that it is intended to prohibit only the hedging of 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.

Granting regulators the flexibility to customize retention requirements to each asset type and market should enable the regulators to utilize the most effective retention regime for each asset class, including – for CMBS – by creditor, securitizer or third-party investor that re-underwrites.

3. Provide Investors with Certainty & Confidence.

Private investors bring their own funds to the table and provide much needed capital that fuels overall lending. In addition to the issues discussed above, there are two areas where increased certainty is critical.

Credit Rating Agency Reform.

Both the House and the Senate regulatory reform bills include titles on credit rating agency reform. 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.

One aspect of the reforms currently being considered, however, 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, CRE Finance Council’s members – and specifically the investors the symbology is geared to inform – continue to oppose any differentiation requirement, 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 overwhelmingly 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.

In this regard, it is worth noting that the concept of differentiation has been examined extensively and rejected in recent years by this Committee, as well as by the SEC⁴, 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, but instead should include language consistent with that already passed in 2008 by this Committee 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 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, 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, 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.

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

⁴ We note that the CRAs have recently announced an intention to use differentiated ratings (after previously rejecting them), despite strong market opposition. In fact, 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.

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, the CRE Finance Council and its members believe that one of the keys to long term viability is market transparency. As noted above, 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.

REMIC Reform.

Real Estate Mortgage Investment Conduits – or “REMICs” – are the basic tax entity used to hold the pools of ABS loans. The basic IRS rule with respect to REMICs is that REMICs have to primarily be managed as passive loan holding companies. As deterioration occurs in the CRE market, there may be building pressure to consider government-induced modification programs. The CRE Finance Council has been opposed to loan modification proposals that would change the terms of contracts in ways that undermine investors settled expectations. Thus far, the IRS rightfully has only moved to reassert that there will not be tax consequences for modification of loans that are in imminent default, without changing the terms of the “pooling and serving agreement” (or “PSA” contract). If, however, the policy moves beyond this ruling to require modifications or to create such a government program for commercial mortgages, this could create significant uncertainty for the market and drive away investors that are critical to the lending market and an overall CRE recovery. Any future REMIC reforms must therefore provide investors certainty by preserving any underlying investor contractual rights while continuing to allow prudent decision making and the taking of appropriate action with respect to securitized loans that are in “imminent default.”

4. Programs Should Support Transition to Private Market.

As noted above, the TALF and PPIP programs have helped facilitate liquidity in the CMBS markets by stimulating private investment. To date, TALF, for example, has helped to reduce rate spreads on CMBS secondary trading and to produce the first private-label CMBS issuance in more than 18 months. .

This progress is welcome and positive, but it will be critical for the CMBS market to move toward more multi-borrower “conduit” deals if it is to provide the capacity necessary to deal with the enormous challenges discussed above, including the need to provide capacity for smaller loans. . One challenge in reviving “conduit” deals has been the inability of institutions to bear the “balance sheet risk” during the “pre-securitization” phase (generally 3-6 months), which is the time between when the loan is made and when it is packaged and sold to investors (known as the “aggregation” or “warehousing” phase). In a vibrant market CMBS market with new issuance, the private sector is able to create an index of bonds that can be used as a hedging tool against aggregation/warehousing risk. Unfortunately, in the absence of significant CMBS issuance, it is very difficult for the private

market to create a hedging tool to address the balance sheet risk of aggregating pools of commercial mortgages to smaller property owners and issue larger, well diversified multi-borrower CMBS.

This ‘chicken and egg’ conundrum has led many participants to suggest that the most efficient and effective use of TALF in the short term – since the program is being suspended next month – would be as a temporary hedging tool until a private sector vehicle can be established. At this point, however, the CRE Finance Council and its members believe that programs like TALF should not be viewed as catalysts, but only as a fallback or backstop should the markets falter in their ongoing re-emergence. Moreover, to the extent such programs continue to be employed, it is imperative that the goals and expectations of the programs going forward – as well as their benefits and limitations – are clearly communicated and understood.

5. Proactive Measures That Should Be Taken.

Significantly, the many challenges discussed earlier are interconnected and compound one another. Therefore, policymakers should approach policy initiatives with an acute understanding that the CRE problem has quickly shifted from a crisis of confidence and liquidity to shortage of equity, as there is high demand to service creditworthy borrowers. The equity gap remains the most significant and difficult challenge for financial institutions and commercial borrowers of all sizes. However, there remains heightened concern at the small and regional bank level, as it is expected that the FDIC will seize several hundred additional institutions with both performing and troubled loans (including large amounts of CRE debt that is *not* securitized) that will need to be re-sold and re-financed.

There are a myriad of potential options that could be deployed to bolster a CRE recovery, but it is worth highlighting two items. 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. Preliminary proposals to establish federal government guarantees for bonds collateralized by small business loans are the types of RTC-like solutions that could play an important role if properly structured. These proposals should be examined carefully and extensively to understand short terms needs and challenges, as well as long term consequences for the market.

Second, the CRE Finance Council supports the “covered bond” bill sponsored by Capital Markets Subcommittee Chairman Paul Kanjorski and Ranking Member Scott Garrett that would include high-quality CMBS as eligible collateral in their proposed framework to facilitate a covered bond market. Covered bonds originated in Europe, and are securities issued by a financial institution and backed by a specified pool of loans known as the “cover pool,” to which bondholders have a preferential contractual claim 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 which 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."⁵ 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 handle certain types of covered bond obligations where 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 jurisdictions⁶, which also accord the appropriate and necessary 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.

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

⁵ Covered Bond Policy Statement, Final Statement of Policy, FDIC, 73 Fed. Reg. 43754, 43754 (July 28, 2008).

⁶ 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.

aggregating collateral for a covered bond issuance, in contrast with the aggregation difficulties now being experienced in the CMBS market. We therefore applaud Chairman Kanjorski and Ranking Member Garrett's inclusion of commercial loans and CMBS as permissible covered bond collateral in their legislation.

Conclusion

There are enormous challenges facing the CRE markets, driven by a multitude of factors listed above, including macroeconomic factors, such as business performance, unemployment, and depreciation of property values. The CMBS market is showing some positive signs with the re-emergence of "single-borrower" deals and the successful offering of the first multi-borrower deal in two years, but it remains largely dormant (particularly for "conduit" deals). Such private lending and investing is critical to providing liquidity and facilitating overall lending, particularly in more regionally diverse areas (as opposed to just large loans in "single borrower" deals) that will support an efficient CRE recovery.

To resuscitate private lending and the investing that is essential to support that lending, the markets require certainty both in terms of: 1) recovery efforts aimed at lending and liquidity (i.e. TALF, PPIP, etc); and 2) regulatory (i.e. "retention") and accounting (FAS 166 and 167) reforms. Such efforts and reforms cannot be made in a vacuum, especially considering the expansive number of issues and the vast number of financial regulators (Fed, Treasury, FDIC, OCC, SEC, FASB, etc.) involved in these deliberations and determinations.

The oversight of CRE, a greater understanding of the challenges ahead, and potential ways to support a market recovery, should be examined carefully and regularly at the current time. In the legislative arena, there is nothing more significant that can be done in the short term than ensuring that financial reforms strengthen our markets and promote confidence without unnecessary or unintended negative consequences. In this regard, any risk retention mandate must be tailored by "asset class" (e.g. residential mortgages, commercial mortgages, student loans, auto loans, etc.), and considered in entirety with all other reforms (accounting, capital rule changes, etc.) or risk doing significant harm to capital, liquidity and credit availability in the CRE market at this challenging time.

Today, we are seeing conflicting policies, which creates uncertainty and serves as an impediment to a CRE recovery. Overall, any policies must be both customized by market and coordinated in order to provide the certainty and confidence that is necessary to promote private lending and investing, and an overall recovery in CRE and the broader economy.