Commercial Mortgage Securities Association™ (CMSA)

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ON BEHALF OF THE

COMMERCIAL MORTGAGE SECURITIES ASSOCIATION

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

Hearing on "Covered Bonds: Prospects for a U.S. Market Going Forward"

December 15, 2009

Overview

The Commercial Mortgage Securities Association ("CMSA")[1] is grateful to Chairman Frank, Ranking Member Bachus, and the Members of the Committee for giving CMSA the opportunity to share its views concerning the future prospects for a covered bond market in the United States. Our members believe that covered bonds can provide a powerful additional source of liquidity for financial institutions, particularly at the present time, given that capital markets remain largely dormant for many asset classes, despite significant borrower demand.

Given severely limited credit availability in the commercial real estate ("CRE") market, we applaud this hearing and extraordinarily timely legislative proposals, offered by Capital Markets Subcommittee Ranking Member Scott Garrett and Chairman Paul Kanjorski, that would include high-quality commercial mortgages and highly-rated commercial mortgage-backed securities ("CMBS") as eligible collateral in their proposed framework to facilitate a covered

[1] CMSA is a global trade organization representing the full range of commercial real estate market finance 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 markets.

bond market. Significantly, commercial mortgages and CMBS are already permitted in covered bond pools in most European jurisdictions[2], 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 aggregating collateral for a covered bond issuance, in contrast with the aggregation difficulties now being experienced in the CMBS market.[3]

[2] 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.

[3] One of the difficulties that has hindered the re-start of securitization is that institutions no longer have sufficient short- or long-term balance sheet capacity to take on aggregation risks – the non-credit risks (like interest rate changes) they must currently bear between the time a loan is made and when it can be securitized (a process that takes months across a pool of loans).

It has been widely acknowledged by market participants and financial policymakers that no government economic recovery plan will succeed without re-starting the securitization markets, and covered bonds should be viewed in the same light – that is, as an important and timely component of any economic recovery plan. Legislation will be needed to create a robust covered bond market; however, as only legislation will offer the degree of assurance the markets need that the assets securing covered bonds will go to bondholders, as contractually required, rather than to the Federal Deposit Insurance Corporation ("FDIC"), in the event that an issuing bank is taken over by FDIC and defaults on a covered bond obligation.

For these reasons, we applaud the Committee for considering a legislative proposal to facilitate establishment of a covered bond market that includes commercial real estate mortgages and CMBS. Additionally, CMSA urges financial policymakers to incorporate the much needed tools that would provide this regulatory framework in the financial regulatory reform legislation in order to support consumers and businesses that are critical to our economic recovery.

The Current State of the CRE Market

Because CMSA's 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 support and practical feedback 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.

However, the recent turmoil in the financial markets coupled with the overall downturn in the U.S. economy brought the CMBS market to a standstill earlier this year, and while the market is now showing a few signs of life, it is far from recovering. These circumstances create many pressing challenges, specifically:

- Little to no liquidity or lending – 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 approximately $1 billion of private label CMBS issuance in 2009, as the lending markets remain sluggish;

- Significant loan maturities through 2010 – 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

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

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 under the above conditions. This unfortunate combination of circumstances leaves the CRE sector and the CMBS market with several overarching problems: 1) a liquidity gap (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) there is general apprehension among CMBS sponsors to aggregate loans for securitization, since they do not have the short or long-term balance sheet for this risk,[4] and there is no definite assurance that private sector investors will buy the securities, all of which serves to simply perpetuate the cycle of severely constrained credit markets.

We believe that the development of a robust covered bond market in the United States can assist in easing the CRE credit crisis, as covered bonds can provide banks with a means to allocate capital that can be used to fund CRE mortgages among others. While covered bonds cannot replace CMBS as a capital source because of the more circumscribed nature of covered bonds (e.g., limitations on quality of collateral, and the fact that covered bond transactions remain on-balance sheet), the effect of a covered bond market as another financing tool will be beneficial overall.

The additional source of liquidity for the CRE market that covered bonds can provide will be all the more important because recent changes in accounting rules and other regulatory changes may further erode liquidity and hamper lending in the commercial sector, even as the rest of the economy attempts to recover. The challenges for the CRE sector highlight the importance of the amendments the Committee has adopted to help support a recovery in the CMBS market and the overall CRE sector. These amendments to the securitization reform bill include a reduction in the maximum risk retention (i.e., "skin-in-the-game") requirement from 10% to 5%, and customization of the risk retention provisions to reflect the unique nature of the

[4] As previously noted, in the absence of a warehouse lending facility or similar mechanism to facilitate aggregation of loans for pooling in a securitization, CMBS sponsors have been reluctant to securitize. This is especially true now when there still is uncertainty as to whether there will be willing investors at the end of the process.

CMBS market[5], which utilizes a third-party investor who purchases the first-loss position and re-underwrites all loans during the pre-issuance period.[6] We commend the Committee for its foresight, and for its continued consideration of other tools, like covered bonds, that could aid the recovery of the CRE market.

The FDIC has already established a policy to facilitate a covered bond market in the residential mortgage sector. The current difficulty in securitizing commercial real estate mortgages and the overall state of the CRE market reflect that now, more than ever, the additional source of liquidity that covered bonds could provide is needed, and should be permitted, for the CRE mortgage market.

A Primer on Covered Bonds

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

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[5] There are significant differences between CMBS and other asset-backed securities markets, including:

1. the borrower (sophisticated business with income producing property who has a non-recourse loan);
2. the structure of CMBS (100-300 loans in a CMBS bond; non-statistical analysis performed on CMBS pools; rating agencies and investors gather and review information about the property, loan and business);
3. the existence of third-party investor, or "B-piece buyer", who purchases the first-loss position, conducts extensive due diligence, and re-underwrites proposed loans in a potential pool (with "kickout" rights);
4. 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®).

[6] CMSA supports retention provisions that are customized to reflect the unique nature of the CMBS market, which utilizes a third-party investor who purchases the first-loss position and re-underwrites all loans during the pre-issuance period. Such language would maintain and strengthen the safeguards that exist in the CMBS market by explicitly recognizing the important role of third-party investors who purchase the first-loss position and provide extensive due diligence. Additionally, it would not preclude retention by the originator/issuer, but instead grant additional flexibility to allow a third-party investor to satisfy the retention requirement. The retention issue is of particular concern in light of new accounting standards, FAS 166 and 167, which could result in significantly less credit availability.

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."[7] 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

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

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.

A Potential "Additive" Financing and Liquidity Tool for the CRE Market

CMSA believes that legislation is needed to create a robust covered bond market because only legislation will offer the degree of assurance the markets need that the assets securing covered bonds will go to bondholders, as contractually required, rather than to the FDIC if an insolvent IDI in receivership defaults on a covered bond obligation.

Furthermore, incorporating highly rated CMBS and high quality commercial mortgage loans as collateral for covered bonds will help generate additional liquidity for the CRE mortgage market; thus, supporting other initiatives such as TALF and PPIP that have already been undertaken by the government to ease the credit crisis. Covered bonds clearly cannot take the place of the securitized credit markets (such as CMBS) but covered bonds will undoubtedly be a useful adjunct to securitization.

Banks require adequate liquidity and funding sources for commercial mortgage loans just as they do for residential mortgage loans. As of September 30, 2009, FDIC insured institutions held approximately $1,089,900,000,000 of commercial mortgage loans.[8] The origination of commercial mortgage loans is part of the core lending business of IDIs. Moreover, the funding of commercial mortgage loans is vital to the U.S. economy. IDIs have frequently looked to securitization as a source of funds for commercial mortgage lending. However, as FDIC Chairman Bair noted in testimony before the Senate Committee on Banking, Housing and Urban

[8] Source: FDIC quarterly banking profile. Includes "non-farm non-residential" loans only; does not include construction and development loans or loans held by foreign branches of domestic banks.

Affairs on March 4, 2008, “upheavals that began in residential markets now affect commercial real estate capital markets, resulting in sharply curtailed liquidity....Securitizing commercial real estate loans has become difficult.” For these reasons, covered bonds can create a much needed supplemental source of funding in the current market.

Moreover, covered bonds will provide a desirable additional funding strategy even following a recovery of the securitized credit markets for commercial real estate. Covered bonds are typically rated “AAA” or “AA.” Their high rating, as well as the combination of high quality securities and the fact that there are dual sources of repayment (i.e. both the issuing entity and the cover pool) generally attract a different, more conservative class of investors than securitization, thereby expanding the pool of capital available to fund commercial mortgage loans. An expanded capital pool means greater lending capacity, which can only help ease the current credit crisis and help avoid or minimize future ones.

Further, the higher rating of covered bonds generally translates into a lower cost of funding for the issuer, which ultimately has a positive effect on the availability of credit. Covered bonds also can supply capital to banks in a form that offers substantial benefits from a risk management perspective. As Chairman Bair has emphasized, on-balance-sheet funding tools like covered bonds encourage especially strong underwriting. This is equally true with respect to underwriting of commercial mortgage loans.

Beyond the opportunities for the CRE market, it should be kept in mind that a covered bond market can do the same for other types of asset-backed securities, such as auto loans, student loans, small business loans, residential mortgages and credit card receivables. Equally important, a broader covered bond market would be extraordinarily helpful to smaller banks that do not have ready access to securitized credit markets because these institutions lack a critical mass of collateral in one asset category. The ability to use diverse asset cover pools that could be available through a broad covered bond regime will give smaller banks a useful new source of capital. As such, we commend the Committee for considering a covered bond proposal that expands eligible collateral to other ABS classes in addition to CRE mortgages and CMBS.

Finally, we note that European nations' experience with covered bonds is instructive, and can provide guidance to policymakers that a comprehensive covered bond market will support the nation's economic system. As mentioned, covered bonds originated in Europe, and have a long, stable history of expanding credit opportunities for consumers and businesses.

European banking regulations reflect a considerable degree of confidence in the soundness of covered bonds. Indeed, these regulations (known as the CRD Directive) give qualifying covered bonds a significantly more favorable risk weighting treatment (generally two to three times more favorable, depending on the applicable risk-weighting scheme) than other senior debt issued by the same institution. The overseas regulations also include loan eligibility standards for covered bonds that permit unlimited use of commercial mortgage loans that meet the required eligibility standards, and permit use of CMBS to the same extent as use of RMBS. In fact, a 2007 Fitch Ratings study of 61 cover pools issued by 48 issuers in 11 countries found that commercial mortgage loans constituted 11% of the assets in all mortgage cover pools reviewed in the study; a similar study in 2006 (51 cover pools, 38 issuers) found that commercial mortgage loans constituted 29% of the assets in reviewed mortgage cover pools. The use of commercial mortgage loans as covered bond collateral is so well-established in Europe that the European Covered Bond Council, in preparing tables showing collateral types for its Covered Bond Fact Book, does not differentiate between residential and commercial mortgage loans but treats them as a single category.

Critically, however, in order for any U.S. covered bond market to be successful and globally competitive, U.S. regulatory requirements pertaining to covered bonds need to be on equal footing with regulatory requirements in Europe so that U.S. financial institutions, as well as consumers and businesses that benefit from such credit, are not at a competitive disadvantage. Specifically, for example, we would recommend that regulatory policymakers adopt capital requirements for covered bonds similar to what our European counterparts have adopted, fostering the same type of regulatory convergence that policymakers have attempted to achieve in other areas, such as accounting standards.

As a result of the widespread use of commercial mortgage loans to secure covered bonds in Europe, rating agencies that rate covered bonds are familiar with and experienced in rating covered bonds with cover pools that include commercial mortgages. Moreover, a cover pool with a mix of commercial and residential mortgage loans as well as CMBS and RMBS may have positive implications on the rating process because it diversifies the risk profile of the cover pool. This would add to the viability of a robust U.S. covered bond market. Accordingly, we applaud legislative proposals that incorporate high-quality commercial mortgages and highly-rated CMBS in the definition of "eligible mortgage," as well as other types of assets, and that will improve the ability of financial institutions to utilize covered bonds as part of a prudent liquidity management framework for their loan portfolios.

<u>Conclusion</u>

The commercial real estate sector continues to face enormous challenges. Our members appreciate the efforts that have already been undertaken by policymakers to help bring capital and liquidity back to the CRE mortgage market. To enhance these efforts, CMSA urges Congress to pass a legislative framework for a covered bond market in a timely manner in order to provide a level playing field for U.S. institutions globally, and to offer a degree of assurance needed by investors that the assets securing covered bonds, including CRE mortgages and CMBS, will go to bondholders as contractually required, if an issuing bank is taken over by the FDIC.

Today, financial markets overseas have this regulatory framework that has provided an important and additional tool that promotes the efficient allocation of capital and overall lending. Such a framework is much needed in the Unites States to give consumers and businesses the opportunity to benefit from the same sources of credit availability, and to support our overall economic recovery.