TESTIMONY OF THE COMMERCIAL REAL ESTATE FINANCE COUNCIL

Before the
UNITED STATES HOUSE FINANCIAL SERVICES COMMITTEE

HEARING ON: "ALTERNATIVES FOR PROMOTING LIQUIDITY IN THE COMMERCIAL REAL ESTATE MARKETS, SUPPORTING SMALL BUSINESSES AND INCREASING JOB GROWTH"

JULY 29, 2010

The Commercial Real Estate (CRE) Finance Council is grateful to Chairman Frank, Ranking Member Bachus, and the Members of the Committee for holding this hearing to focus attention on the state of the commercial real estate market, and for giving us the opportunity to share our views on the market and policies to facilitate its recovery.

Today, the $7 trillion commercial real estate market in the United States faces 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. Since 2009, the CRE problem has quickly shifted from a crisis of confidence and liquidity to a crisis of deteriorating commercial/multifamily property fundamentals, plummeting property values and rising defaults. Our testimony will focus on three key areas:

1) The challenges facing the $3.5 trillion for CRE loans outstanding;

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) A suggested approach that policymakers should consider to help support a broad and lasting CRE recovery.

While the CRE Finance Council does not at this time formally endorse further government-sponsored or created programs, our 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; investors such as insurance companies, pension funds, and money managers; rating agencies; accounting firms; master and special servicers; and other service providers. The CRE Finance Council is a leader in the development of standardized practices and in ensuring transparency in the CRE 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 enhance the commercial mortgage market, such as the Dodd-

Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[1] the SEC's proposed changes to Regulation AB, and the FDIC's proposed securitization "Safe Harbor" rule. One of our missions is to raise awareness about the importance of securitization, which has been a crucial and necessary tool for growth and success in CRE, and the CRE Finance Council continues to participate actively in the public policy discussions regarding proposals that impact securitization and CRE finance overall.

The Current State of CRE Finance

CRE is a lagging indicator, and it is just now beginning to be affected by 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. Not surprisingly, CRE has come under 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 several interconnected challenges that compound each other and that, when taken together, will exacerbate the capital crisis and prolong a recovery:

- **Severe U.S. Recession**. **–** With a prolonged recession (first housing-led, and then consumer-driven) and unemployment at 9.7% (as of May 2010), 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.

- **Significant Loan Maturities**. **–** Approximately $1 trillion in CRE loans mature over the next several years, but perhaps most significantly, many of those loans will require additional "equity" to refinance given the decline in CRE asset values

- **CMBS Restarting – Slowly**. **–** 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, commercial mortgage-backed securities (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, on average; for approximately 25% of all outstanding CRE debt, and as much as 50% at the peak, while readily identifiable properties funded by CMBS exist in every state and Congressional district. However, the volume of new CRE loan originations and thus of new CMBS has plummeted from $240 billion in 2007

[1] Pub. L. No. 111-203.

(when CMBS accounted for half of all CRE lending) to $12 billion in 2008, $2 billion in 2009, and $2.4 billion through June 2010. While there is revitalized activity in the CMBS space, there is a mismatch between the types of loans that investors are willing to finance and the refinancing that existing borrowers are looking for to extend their current loans.

Current State of Small Business Lending Finance

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. Today there are more than 40,000 CMBS loans less than $10 million in size that have a combined outstanding balance of $158 billion, which makes CMBS a significant source of capital for lending to small businesses. Second, 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 outstanding debt (mostly construction loans, land loans, etc.) is not securitized.

As many independent research analysts have 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 the 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.

While the market has evolved from a crisis of liquidity there is still an unfortunate combination of circumstances that leave the broader CRE sector and the CMBS market with three primary problems: 1) 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); 2) a 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 bonds (this 3- 6 month "pre-issuance" phase is known as the "aggregation" or "warehousing" period); and 3) the tremendous uncertainty created by the multitude of required financial regulatory changes, which serve as an impediment to private lending and investing, as the markets attempt to anticipate the impact these developments may have on capital and liquidity.

A Framework for Recovery

The importance of the securitized credit market to economic recovery has been widely recognized. Both the previous and current Administrations share the 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."[2] 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

[2] Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) available at http://www.ustreas.gov/press/releases/tg18.htm.

States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions."[3]

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 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 most important thing policymakers can do is to avoid creating an environment that stifles the private market's efforts to restart. Accordingly, the following suggestions serve as a blueprint for how public policy initiatives can best support and sustain a recovery of the CRE market:

1. Increase Coordination of Regulatory and Accounting Reforms

As you know, the Dodd-Frank Act signed into law last week adopts regulatory reforms that will change the nature of the securitized credit markets at the heart of recovery efforts. The securitization reforms were prompted by some of the practices that were most typical in the subprime and residential securitization markets, and the CRE Finance Council did 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 (Financial Accounting Standard (FAS) 166/167), risk-based capital changes, and risk "retention" (i.e., "skin-in-the-game") proposals from various regulatory agencies like the SEC and FDIC, in addition to those adopted in Dodd-Frank.

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 the impact these developments may have on capital and liquidity. Indeed, the confusion that ensued last week about expanded credit rating agency liability in Dodd-Frank, which shut down the new issue public ABS market because issuers could not obtain ratings, highlights the importance of this first point, which is the need for coordination in implementing reforms.

This will be especially necessary as regulators work to implement the risk retention requirements in Dodd-Frank, and we commend Congress for creating a framework in Dodd-Frank which recognizes that risk retention rules need to be coordinated (i.e. considered "jointly") and customized to fit the unique aspects of the various classes of asset-backed securities.

We note, however, that the danger of uncoordinated regulation continues because there are at least two separate agency rulemaking proposals pending (e.g. the SEC's proposed changes to

[3] 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.

regulation AB and the FDIC's proposed "Safe Harbor" rule) that would impose their own separate risk retention frameworks on various segments of the securitization markets. We urge that any such rulemaking be done in the context of the "joint" risk retention rulemaking framework Congress has established in Section 941 of Dodd-Frank, rather than unilaterally by individual agencies.

The hazards of inconsistent and uncoordinated policies have been emphasized by many policymakers in the recent past. Federal Reserve Board Member Elizabeth Duke, among other policymakers, 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.[4]

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[4] "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.

See also Daniel Tarullo, Federal Reserve Governor, Statement Before The House Committee on Financial Services (Oct. 26, 2009) ("A credit exposure retention requirement may thus need to be implemented somewhat differently across the full spectrum of securitizations in order to properly align the interests of originators, securitizers, and investors without unduly restricting the availability of credit or threatening the safety and soundness of financial institutions."); John C. Dugan, Comptroller of the Currency, Statement on the Federal Deposit Insurance Corporation's Advance Notice of Proposed Rulemaking on Securitizations (Dec. 15, 2009), at 1-3 ("[R]ecent studies note that a policy of requiring a rigid minimum retention requirement risks closing down parts of securitization markets if poorly designed and implemented. Before proposing and implementing such a requirement for all securitizations, further analysis is needed to ensure an understanding of the potential effects of the different ways in which risk could be retained.").

Similarly, the International Monetary Fund has warned that "[p]roposals 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." International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, Global Financial Stability Report: Navigating the Financial Challenges Ahead (October 2009), at 109 ("Conclusions and Policy Recommendations" section) available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

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.

In recognition of the importance of coordination, and concern about the impact of securitization reform on credit availability, Section 941(c) of Dodd-Frank directs that two separate studies be conducted before any final rulemaking is completed on the new retention requirements. First, regulators are directed to study the combined impact of recent securitization accounting rule changes (FAS 166 and 167) and other regulatory changes (such as risk retention) on credit availability, and to make statutory and regulatory recommendations on how to lessen the impact. Second, the Financial Stability Oversight Council is directed to study the macroeconomic effects of risk-retention requirements on an economic recovery, including whether any adjustments should be made to the requirements.[5]

We urge that regulators conduct the studies of securitization issues required by Dodd-Frank swiftly but carefully, and that regulators work in a coordinated fashion in developing a thorough understanding of the securitization markets that will be affected by the rules they are to design. This is critical because the overall impact of the securitization reforms (and the very future of these markets) will remain uncertain until the complete package of regulations is finalized.

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

Throughout the debate regarding securitization reform, the CRE Finance Council has urged that the reforms be tailored to account for the differences that exist among the various types of asset classes (e.g. residential mortgages, commercial mortgages, student loans, auto loans, etc.). Such customization is critically important to ensure that measures designed to strengthen the financial markets and foster investor confidence do not inadvertently create negative implications for capital, liquidity and credit availability.

Tailoring regulation is especially important in addressing assets such as CMBS, which have innate characteristics that minimize the risky securitization practices that policymakers sought to

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[5] *See* Dodd-Frank, § 941 (c) (the Federal Reserve, in coordination and consultation with the OCC, OTS, FDIC, and SEC, must conduct a study of the combined impact on each individual class of ABS of the risk retention requirements in the legislation and the new securitization accounting rules in FAS 166 and 167, and must report statutory and regulatory recommendations for eliminating any negative impacts on the viability of ABS markets and credit availability no later than 90 days after the legislation is enacted), and § 946 (the newly created Financial Services Oversight Council must study the macroeconomic effects of the risk retention requirements that would be required by the legislation, and must report its findings to Congress within 180 days of the legislation's enactment).

address in Dodd-Frank. More specifically, the unique characteristics that set CMBS apart from other types of assets relate not only to the type and sophistication of the borrowers, but to the structure of securities, the underlying collateral, and the existing level of transparency in CMBS deals, each of which are briefly described here:

- **Commercial Borrowers**: Part of the difficulty for securitization as an industry arose from practices in the residential sector 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. In contrast, commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases (i.e. "income-producing" properties). 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 that allow the lender to seize the collateral in the event of default.

- **Structure of CMBS**: There are multiple levels of review and diligence concerning the collateral underlying CMBS, which help ensure that investors have a well informed, thorough understanding of the risks involved. Specifically, in-depth property-level disclosure and review are done by credit rating agencies as part of the process of rating CMBS bonds. Moreover, non-statistical analysis is performed on CMBS pools. This review is possible given that there are far fewer commercial loans in a pool (traditionally, between 100-200 loans; while some recent issuances have had between 30 and 40 loans) that support a bond, as opposed, for example, to residential pools, which are typically comprised of between 1,000 and 4,000 loans. The more limited number of loans (and the tangible nature of properties) in the commercial context 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. We also note that certain types of securitized structures are written so conservatively that they do not include a traditional "B-Piece." Such structures, for example, include extremely low loan-to-value, high debt-service-coverage-ratio pools that are tranched only to investment grade.

- **Greater Transparency**: CMBS market participants already have access to a wealth of information through the CRE Finance Council Investor Reporting Package (IRP), which 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. Our reporting package has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market. By way of contrast, in the residential realm, transparency and disclosure are limited not only by servicers, but by privacy laws that limit access to borrowers' identifying information. Importantly, the CRE Finance Council is currently working with market participants to make even further improvements to the IRP.

As policymakers are aware, a risk retention provision is included in Dodd-Frank.[6] Congress specifically concluded that with respect to commercial mortgages and CMBS, "skin-in-the game" measures or the "alignment of risk" could take a number of permissible forms, including representations and warranties, underwriting controls and guidelines, and the potential retention by an originator, securitizer, or a third-party investor who performs due diligence and retains this risk in accordance with the statute. The Council's membership is united in the view that the alignment of the interests of lenders, issuers and investors in the securitization process is essential.

As such, Dodd-Frank ensures that risk retention rules are coordinated and customized to fit the unique aspects of the various classes of asset-backed securities. And as mentioned, Congress also directed that a study be done of the effects of risk retention requirements particularly as they interact with other regulatory standards like accounting rules, to give policymakers a more complete understanding of these matters.

In conjunction with the retained risk requirement, Dodd-Frank includes a provision that will preclude hedging of any retained credit risks. We urge regulators to adhere to the Dodd-Frank intent that this prohibition not be implemented in such a manner that results in the imposition of undue constraints on "protective" mechanisms that are legitimately used by securitizers to maintain their financial stability.

This is necessary because 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

[6] Dodd-Frank, § 941 (b) (adding Securities Exchange Act § 15G (c)).

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, the risk retention rules should not seek to prohibit securitizers from using market-oriented hedging vehicles, and should 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.

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 Transparency

Dodd-Frank includes extensive credit rating agency reform provisions, and the CRE Finance Council and its members generally are supportive of any reforms that require credit rating agencies (CRAs) to provide more information about individual ratings and their rating methodologies.

In terms of credit ratings performance, the CRE Finance Council devoted significant resources over the last few years toward efforts 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 scheme for structured finance products. Differentiated ratings is a concept that has been debated and rejected by the SEC, and 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.[7]

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

[7] 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 investor community, such as publication of more specific information regarding CRA 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.

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 they have to be primarily managed as "passive" loan holding companies to retain its existing tax treatment. As deterioration occurs in the CRE market, broad loan modification proposals must not unduly change the terms of contracts in ways that undermine investors settled expectations. In this regard, the Council believes that the IRS has rightfully 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." Such a ruling is crucial to avoid creating significant uncertainty for the market and driving away investors that are critical to the lending market and an overall CRE recovery. Therefore, we commend the IRS for their approach and encourage them to continue to preserve investor contractual rights, while allowing prudent decision making and the taking of appropriate action with respect to securitized loans that are in "imminent default."

4. 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 a 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.

Using Securitization as an Exit Strategy

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's (RTC) pioneering efforts showed, the securitization of commercial real estate 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.

Creating a U.S. Covered Bond Market

Second, the CRE Finance Council supports "H.R. 5823, the U.S. Covered Bond Act of 2010," ("covered bond") that this Committee passed earlier this week as re-introduced by Capital Markets Subcommittee Raking Member Garrett, Subcommittee Chairman Kanjorski and Ranking Member Bachus, that would include high-quality CMBS as eligible collateral in a newly created U.S. 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 that 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."[8] 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 jurisdictions[9], 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 and we applaud the Committee's passage of the covered bond bill earlier this week.

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

[9] 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.

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.

Other Measures for Consideration

Finally, the Council wishes to point out additional measures that could be helpful in addressing the "equity gap," such as focusing on accounting relief with respect to consolidation, and allowing insured depository institutions to phase in the recognition of losses on an extended amortization schedule rather than being forced to immediately recognize such losses. Such measures would allow losses to be recognized as necessary and re-focus efforts on lending.

Likewise, the "Community Recovery and Enhancement Act of 2010" is being introduced today by Reps. Shelley Berkley (D-NV) and Devin Nunes (R-CA) in order to create tax incentives for commercial borrowers to promote equity investments in their properties. The CRE Finance Council is examining this proposal with interest as it is intended to address directly the "equity gap" by incentivizing borrowers and helping "resize" loans to bring them into accord with current underwriting standards.

<u>Bolstering Small Business Mortgage Lending</u>

The challenges facing the CRE market are beyond the scope of what any one program could (or should) do in attempting to provide a solution. As noted above, the most significant problem in the commercial real estate marketplace has quickly shifted from a crisis of confidence and liquidity to a shortage of equity, as CRE property values have fallen considerably while more than $1 trillion in CRE loans come due.

The Council notes that efforts to provide additional liquidity, if tailored properly, could help stabilize property values and alleviate the "equity gap" that exists in the massive wave of impending loan maturities. Given the impact of macroeconomic conditions on CRE (property values, unemployment, consumer confidence and business performance), however, we wish to emphasize the reality that the most significant (and controllable) action that can be taken for CRE in the short term is to ensure that financial reforms provide certainty and confidence that promote private lending and investing.

Small Business Lending Facilities

H.R. 5297, the "Small Business lending Fund Act of 2010," would create a $30 billion program intended to support community banks and to incentivize small business lending by making loans to smaller banking institutions and tying the effective interest rate on those loans to increases in small business lending activity. Given the CRE challenges faced by small institutions and small businesses, it is logical that such a program also incorporate small commercial mortgages by specifying the inclusion of "income-producing" CRE loans.

The Council applauds efforts by Representative Walt Minnick (D-ID) to clarify the definition of "small business lending" to expressly incorporate commercial real estate loans in the program and to provide an additive tool for recovery.

Such a proposal, if implemented properly, could assist in recapitalizing small banks, while incentivizing them to increase CRE lending to small businesses. This could help in reducing losses to the FDIC's Deposit Insurance Fund and refueling the flow of credit in local communities that is critical to supporting job growth.

The Council also stresses that any such measures must be structured carefully to promote private lending by ALL small business lenders, including both community banks and other financial institutions, and to maintain a level playing field among other lenders who are also active in this market, such as small and medium-sized life insurance companies, among others.

The Commercial Real Estate Stabilization Act of 2010 (CRESA)

While additional liquidity in the CRE finance market is helpful, any approach should focus on alleviating existing debt, and incentivize financial institutions and borrowers to deal with this "equity gap" in existing loans. Specifically, a large obstacle has been the reality that the face value of many outstanding loans either exceeds the current value of the underlying properties or the requisite value of the maximum loan that can be issued on the underlying property (the "Loan-to-Value" ratio for underwriting).

The Council commends Congressman Minnick's efforts on H.R. 5816, the "Commercial Real Estate Stabilization Act of 2010" (CRESA). The proposal seeks to establish a commercial real estate credit guarantee program that could result in making the cost of credit less expensive for commercial borrowers that have sufficient equity in their properties. Furthermore, securitization of such loans should be encouraged in order to maximize the utility of any such proposal, which may free-up balance sheet capacity, and thus promote additional private lending.

Accounting: As discussed earlier, accounting issues can pose an additional impediment to the revitalization of lending and investing, particularly when combined with new capital rules and retention requirements. CRESA directs the regulators to address accounting issues in the context of this program, which further highlights these challenges and the need for these issues to be addressed on a broader scale.

Eligible Institutions: Commercial mortgage lending for small businesses is the focus of a broader array of institutions than just smaller banks and includes small, mid-sized and larger institutions, as well as life insurers and other non-bank lenders. In fact, as noted above, the average CMBS loan is less than $10 million. Therefore, it is imperative that all lenders have the ability to compete on a level playing field, which will provide greater benefits to the market and better serve these small business borrowers. CRESA, as introduced however, requires 50 percent of the credit instruments guaranteed under the program to be created by institutions of $10 billion in asset-size or smaller, while the remaining 50 percent may be created by other institutions. This "50/50" designation will create an uneven playing field for potential market participants on new loans and issuance that could restrict available capital and minimize competitive benefits for borrowers. The CRE Finance Council urges the Committee to remove this "50/50" designation altogether to place the focus on small commercial mortgages of $10 million or less, and not on which entity is originating these loans, in order to better serve small businesses seeking access to credit.

Risk Retention: CRESA requires the Oversight Board to promulgate "risk retention" rules for the program within 60 days of enactment. At the same time, Dodd-Frank dictates that risk-retention rules should be promulgated "jointly" and by "asset class." The Council applauds the sponsors for reinforcing the need to customize retention for the unique nature of CMBS, and we urge the Committee to require any retention under this or any similar program to incorporate the framework for developing retention regimes under Dodd-Frank. As discussed earlier, the development of multiple regulatory retention regimes would create confusion and further uncertainty in manner that could be inconsistent with Dodd-Frank.

Conclusion

There are enormous challenges facing the CRE market, driven by the multitude of factors listed above, including macroeconomic conditions, such as business performance, unemployment, and depreciation of property values. These CRE challenges are more pronounced in smaller financial institutions with non-securitized debt (such as construction loans, land loans, etc). Significantly, problems in the CRE market have quickly shifted from an issue of liquidity to an "equity gap" between loan amount and property value. We applaud the efforts of Congress to examine the CRE market. 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.

Today, 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 for smaller businesses 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 a CRE recovery, the markets require certainty both in terms of: 1) recovery efforts aimed at lending and liquidity (e.g. 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.

Ultimately, given the macroeconomic challenges facing the market, there is nothing more significant (and controllable) that can be done in the short term than to ensure that financial reforms strengthen our markets and promote confidence that will support, rather than impede, an economic recovery. In this regard, regulators must carefully follow the framework established in Dodd-Frank to tailor risk retention mandates by "asset class," and to consider reforms in a more complete context in light of the enormous number of changes (accounting, capital rule changes, etc.) to avoid significant harm to capital, liquidity and credit availability in the CRE market at this challenging time. Today, this uncertainty and lack of coordination serves as an impediment to a CRE recovery.

And 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.