April 14, 2020

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The Honorable Jerome H. Powell
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave NW
Washington, DC 20551

The Honorable Steven T. Mnuchin
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable John C. Williams
President and Chief Executive Officer
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

The Honorable Mark A. Calabria
Director
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20219

RE: Joint Trades Request for Additional Support of Commercial Mortgage Markets

Dear Sirs:

Our organizations represent the owners, investors, managers and other stakeholders in the $16 trillion U.S. commercial real estate sector, which includes a broad range multifamily, lodging, office, industrial, retail and healthcare properties. U.S. commercial and multifamily real estate is supported by over $4 trillion in debt – mostly provided by commercial banks, life companies, government sponsored enterprises and commercial mortgage backed securities (CMBS).

Each of our organizations is grateful for your collective efforts to support the U.S. economy during the economic crisis resulting from the COVID-19 pandemic. We are particularly encouraged by the Federal Reserve and Treasury's timely decision to revive the Term Asset Backed Securities Facility (TALF), the Federal Reserve Bank of New York's (FRBNY) initiation of purchase of agency commercial mortgage-backed securities ("CMBS") [1], and we appreciate the recent announcement[2] that the Federal Reserve will broaden the range of TALF eligible collateral to include the triple-A rated tranches of both outstanding (legacy) CMBS, commercial mortgage loans and newly issued collateralized loan obligations.

We previously wrote to you on March 24, urging greater support for Agency and private label, non-agency commercial mortgage backed securities (CMBS). We then noted that it was already apparent that the damage to the commercial real estate sector will be both broader and deeper

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[1] "Statement Regarding Treasury Securities and Agency Mortgage-Backed Securities Operations," Federal Reserve Bank of New York (Mar. 23, 2020), available at: https://www.newyorkfed.org/markets/opolicy/operating_policy_200323.

[2] "Federal Reserve takes additional actions to provide up to $2.3 trillion in loans to support the economy", Federal Reserve (April 9, 2020), available at: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm

than it was during the 2008 crisis. Unfortunately, in the intervening days, conditions in the commercial real estate sector have deteriorated further, providing us with a more detailed understanding of the nature and scope of the problem.

The CARES Act permitted residential borrowers and tenants in properties financed by federally backed loans to postpone mortgage and rent payments if they are facing financial difficulties resulting from the COVID-19 pandemic. Many states and municipalities are currently considering measures to mandate rent forbearance. Last week, owners from across the spectrum of commercial and multifamily real estate reported that tenants did not meet—or fully meet—their April 1 rent obligations.

Commercial and multifamily real estate assets that were perfectly healthy just weeks ago now face massive stress and a wave of payment and covenant defaults. As the economy shuts down and American workers face massive layoffs, it is now clear that many tenants will not be able to meet their debt obligations. This will soon cascade through the over $4 trillion commercial real estate debt market and exponentially increase the pressure on the financial system.

We are encouraged by the steps taken by the Treasury, the Federal Reserve and the Federal Housing Finance Agency thus far, but more must be done. A non-functioning CMBS market will impair the overall lending market, especially given that banks and insurance companies look to CMBS to price risk for a number of products on their balance sheets.

Recommended Action

To this end, we write to urge that the TALF program be broadened to include a wider range of investment grade commercial real estate debt instruments. Specifically, we recommend that the following investment grade instruments be considered eligible TALF assets:

- Legacy and new issuance, investment grade, non-agency CMBS;
- Investment grade Agency Credit Risk Transfer (CRT) securities;
- Legacy and new issuance Single-Asset, Single-Borrower (SASB) CMBS;
- Commercial real estate (CRE) collateralized loan obligations (CLOs); and
- U.S. commercial real estate (CRE) first mortgage loans (which have capital charges equivalent to investment grade/NAIC CM 1 and 2 and loans in good standing, or can obtain a rating agency letter confirming that the pledged loan is rated at least single-A).

Background

As banks have de-levered over the last 10 years, the share of nonbanks providing financing to key sectors of our economy has increased significantly. Today, insurance companies, pension and other funds, and other large institutional investors provide the majority of funding to many lending markets through their purchase of asset-backed securities (ABS), commercial mortgage backed securities (CMBS), collateralized loan obligations, other structured products, and unsecuritized commercial real estate loans. To finance these purchases, these large investors often rely on bank repurchase agreement (repo) transactions.

These capital markets are currently frozen. Asset values have plummeted, not because they have lost significant actual value (e.g. missed mortgage, interest, or student loan payments) but because the overnight drop in demand due to COVID stay-home orders has implied a greater diminution in asset value. As a result, bank repo lenders are making margin calls on investment grade (IG) repo collateral and selling it at fire sale prices. Investors are hoarding liquidity because they do not know whether or when they will be able to replace it. There has not been a material issuance of any structured product in recent weeks. At a time when Main Street needs credit, it cannot get it because the secondary markets that provide liquidity to Main Street lenders are clogged.

If capital markets were restored to functionality, the amount of direct credit Main Street would need from a Fed-Treasury 13(3) lending facility would be reduced. With confidence that there is a liquidity backstop, large institutional investors would come off the sidelines. Spreads on IG assets are currently wide; there are ample opportunities for investors to find yields that meet and even surpass their investment objectives (e.g. paying out insurance claims, paying retired teachers, etc.).

In the current environment, the TALF would be far more effective if it took a broader range of investment grade (IG) instruments, below the triple-A rating. AAA collateral is under the least price pressure and needs the least help right now. Other liquidity facilities presently permit the Federal Reserve's acceptance of lower-grade collateral, including the Commercial Paper Funding Facility (accepting A2/P2 paper) and the Primary and Secondary Market Corporate Credit Facilities (both accepting BBB- obligations). Credit risk can be managed by applying bigger haircuts to non-AAA-rated instruments. Expanding the TALF in this manner could prevent significant numbers of business failures at this vulnerable time.

A broader, deeper, and more effective TALF would complement and minimize the direct lending that will be required of the Federal Reserve's other credit facilities supported by the $454 billion provided under the CARES Act. The current credit needs of the economy look larger than they are because the capital markets, which finance a huge swath of the economy, are temporarily shuttered. A more effective TALF would provide liquidity for all investment grade structured products and similarly rated assets.

We further note that an all-IG TALF would benefit from at least three layers of credit loss protection. First, the Fed would apply discounts ("haircuts") for collateral based on its rating, type, and historical performance. Markets stand ready to help the FRB with this analysis. Second, the Fed would use appropriately tailored advance rates for different collateral. Third, Treasury would supply credit protection or "equity" from the Exchange Stabilization Fund to capitalize any credit losses. Given other credit protections—and the fact that "investment grade" collateral is more durable in 2020 than it was in 2009 (there is significantly more absorbency and structural protection below the IG level in today's structured products)—Treasury's equity should attract 10x leverage from the Fed.

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We appreciate the opportunity to provide commentary on the economic effects of COVID-19 crisis on the commercial real estate sector and to recommend further action to shore up these faltering markets.

We respectfully urge that these additional measures to expand the scope of the TALF and support the highly illiquid non-bank financial sector be implemented to forestall further disruption and economic dislocations in the commercial real estate sector.

Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact Clifton E. Rodgers, Jr. (crodgers@rer.org) or Victoria Rostow (vrostow@nareit.com).

Sincerely,

American Hotel & Lodging Association
Asian American Hotel Owners Association
Building Owners and Managers Association International
International Council of Shopping Centers
Nareit
The Real Estate Roundtable