The Real Estate Roundtable

August 1, 2011

Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attn: Jennifer J. Johnson, Secretary
E-mail: regs.comments@federalreserve.gov

Federal Deposit Insurance Corporation
550 17th Street, N W
Washington, DC 20429
Attn: Robert E. Feldman, Executive
Secretary, Comments
E-mail: Comments@FDIC.gov

Federal Housing Finance Agency
1700 G Street, NW, Fourth Floor
Washington, DC 20552
Attn: Alfred M. Pollard, General Counsel
Email: RegComments@fhfa.gov

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington, DC 20219
E-mail: regs.comments@occ.treas.gov

Department of Housing and Urban
Development,
451 7th Street, SW, Room 10276
Washington, DC 20410-0500
Attn: Regulations Division, Office of
General Counsel

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn: Elizabeth M. Murphy, Secretary
E-mail: rule-comments@sec.gov

Re: Proposed Rule (Release No. 34-64148), Credit Risk Retention - Federal Reserve Docket No. R-1411; FDIC RIN 3064-AD74; OCC Docket No. 2011-0002; SEC File No. S7-14-11; FHFA RIN 2590-AA43

Ladies and Gentlemen:

The Real Estate Roundtable is pleased to submit this letter in response to the joint-agency (Agencies) request for comments regarding the proposed rules to implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934 (the Proposed Rules) in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act).

The Real Estate Roundtable represents the principal owners, investors and managers of the U.S. income producing commercial and multifamily real estate sector. As such, we recognize the goal of the Agencies is to provide greater integrity and discipline in domestic and international capital markets. The Real Estate Roundtable and its members lead an industry that generates more than 20 percent of America’s gross national product, employs more than 9 million people and produces nearly two-thirds of the taxes raised by local governments for essential public services. Our members are senior real estate industry executives from the nation’s leading income-producing real property owners, managers and investors, the elected heads of America’s leading real estate trade organizations, as well as the key executives of the major financial services companies involved in financing, securitizing or investing in income-producing properties.

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Commercial real estate markets continue to recover from the most severe economic downturn since the Great Depression. Credit to the sector virtually shut down in 2008 and only began to return in a limited capacity in 2010. As one of the largest sources of credit for commercial and multifamily real estate in the United States, the commercial mortgage backed securities (CMBS) market is an important element of the over $3.2 trillion commercial real estate debt market, currently comprising roughly 26 percent of the overall market. In our view, it is essential to have a healthy and disciplined new-issue CMBS market.

Although the projected $30-50 billion in new issuance for 2011 is well below what is needed to refinance hundreds of billions of dollars in maturing commercial real estate debt, our focus is on restoring an appropriately sized and functioning marketplace for securitized commercial real estate debt. Yet, hopes for a broader recovery in real estate credit markets continue to be undermined by uncertainty in global credit markets and the broader economy – and further exacerbated by a lack of confidence in the credit rating process and the regulatory climate.

The Real Estate Roundtable supports the Agencies' efforts to promote economically responsible commercial real estate lending that reflects sound underwriting and risk management practices, and rational pricing of economic risk. Recognizing that unwarranted leverage played a role in the financial crisis — along with a failure to price risk appropriately, a failure to rate risk appropriately, and a failure of existing regulations to be applied appropriately — we continue to urge policymakers to take action that encourages stable valuations, enhanced transparency and sensible underwriting, and support efforts to establish appropriate systemic safeguards—all key factors for the return of a reliable credit system.

Concerns Regarding the Proposed Rules

Within this context, we believe that the Proposed Rules were intended to ensure that the commercial real estate lending market function with an appropriate level of integrity and discipline. Although risk retention may be intended to safeguard bondholders, it also introduces the potential to raise costs for borrowers or to limit the amount of credit and liquidity that are available, particularly to borrowers in secondary and tertiary markets.

As a result, we are extremely concerned about the serious and presumably unintended economic consequences that the Proposed Rules could have on the effective re-emergence of a reliable new issuance market for commercial mortgage backed securities (CMBS).

A key assumption underlying the Proposed Rules is that by requiring a CMBS sponsor to retain an economic interest in its securitized assets, the sponsor's interest will be more closely aligned with the interests of CMBS investors. However, we are concerned that the Proposed Rules do not acknowledge or account for existing "incentive alignment mechanisms"[1] and forms of risk retention such as the existing B-piece investor retention and special servicing structure for

[1] Federal Reserve Report, 3-4.

CMBS which serve to appropriately align incentives and create "skin in the game". The Proposed Rules should acknowledge and build on these forms of risk retention.

In the Federal Reserve's "Report to the Congress on Risk Retention"[2], the Board recommended that the Agencies responsible for implementing credit risk retention take into account a number of factors "in order to help ensure that the regulations promote the purposes of the Act without unnecessarily reducing the supply of credit."[3] This report notes that overcollateralization, subordination, third-party credit enhancement, representations and warranties and conditional cash flows all serve a similar purpose.[4] The Proposed Rules do not appear to address these factors.

Additional concerns have been raised by the Financial Stability Oversight Council in a Dodd-Frank mandated report[5] regarding the potentially negative macroeconomic effects that the proposed risk retention rules could trigger which warns that "if regulators set risk retention requirements at an inappropriate level, or design them in an inappropriate manner, the costs in terms of lost long-term output could outweigh the benefits of the regulations."[6] Given the fragile state of the U.S. economy and the commercial real estate finance markets, this broader economic view is of vital concern to commercial real estate – particularly for "smaller market participants".[7]

The Senate Banking Committee also urged the Agencies to fully understand the economic impact these credit risk retention rules could have on the overall economy by conducting a rigorous cost-benefit and economic impact study prior to implementation – given the "potential harm to our already weak economy and the public from ill-conceived rules."[8] Such an analysis should specifically address how the proposed CMBS risk retention requirements could affect overall credit capacity for commercial real estate and how a potential reduction in liquidity will affect borrowers, the credit markets and the overall economy.

In short, we strongly urge that a comprehensive cost benefit analysis be conducted of how the Proposed Rules will affect commercial real estate and the overall national economy before the rules are finalized.

Given the broad range of concerns among various industry participants regarding the Proposed Rules, we urge the Agencies to consider a re-proposal of the Rules following the public comment period, rather than issuance of a final rule. By adding this additional step, the Agencies could further refine the Proposed Rules and reduce the potential for an unintended negative impact on the securitization market.

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[2] Board of Governors of the Federal Reserve System, "Report to the Congress on Risk Retention" (October 2010).
[3] Federal Reserve Report, 3-4.
[4] Federal Reserve Report, 41-43.
[5] Financial Stability Oversight Council, "Macroeconomic Effects of Risk Retention Requirements" (January 2011).
[6] FSOC Report, 30.
[7] Federal Reserve Report, 3-4.
[8] Letter dated February 15, 2011 to The Honorable Timothy Geithner, Secretary, The Department of Treasury, et al., and letter dated May 4, 2011 to Elizabeth A. Coleman, Inspector General, Federal Reserve Board, et al.

We appreciate the opportunity to provide the Agencies, with our concerns about the Proposed Rules. Specifically, we have four primary areas of concern:

1. The potential imposition of a Premium Capture Cash Reserve Account (PCCRA);

2. The liquidity restrictions imposed on third party B-piece buyers;

3. The exclusion of loans to real estate investment trusts (REITs) from the Qualified Loan Exemption (QLE) for commercial mortgages and the establishment of a more realistic set of qualifying criteria; and

4. The mechanics involved with the Operating Advisor and the special servicers in each transaction.

I. Premium Capture Cash Reserve Account (PCCRA)

The proposed Premium Capture Cash Reserve Account (PCCRA) construct appears to be intended to insure the sponsor and/or qualified third-party purchaser of the 5% Risk Retention piece is holding a subordinate position in a CMBS transaction that has 5% of the market value of the entire securitized pool of commercial real estate (CRE) loans. The PCCRA is intended to absorb losses prior to the principal based 5% Risk Retention.

However, the PCCRA appears to be outside the scope of the Dodd-Frank Act's statutory language. It effectively overrides the specified exemptions to the Risk Retention Rules outlined in the Dodd-Frank Act offered in the form of: 1) qualified mortgage loans and; 2) a third-party purchaser of the 5% Risk Retention that satisfies specific due diligence requirements of the CRE loans.

We are concerned that the PCCRA construct will fundamentally alter the economics of securitization by forcing the issuer to immediately absorb all the downside risk and losses associated with their interest rate exposure, while requiring the issuer to wait years to recognize any potential profit for taking that risk. The imposition of such a construct will materially discourage a sponsor from operating a securitization business.

Although the proposed regulations would allow third-party CMBS investors ("B-piece buyers") to satisfy the new risk retention requirements in a variety of ways — including the retention of a "vertical" slice, a horizontal slice or an L-shaped slice — there are elements of the proposals that, if not appropriately calibrated, could undermine the economics of new CMBS issuance. Under the provision on interest-only (IO) strips, the Proposed Rule would direct issuers to bolster credit enhancement by re-directing both excess interest payments and any extra proceeds created by the issuance of bonds at above-par prices. Those cash flows would be channeled into a PCCRA that would cover any losses in the collateral pool and could not be disbursed until all of the bonds with principal balances pay off. In theory, this would block the ability of issuers to take their profit up front, as they do now, by directing the excess interest into an IO class sold at issuance. Elimination of the IO strip by requiring the proceeds from an IO strip to be placed into a reserve account and held until maturity, would effectively eliminate the economic incentive for issuing CMBS.

We remain concerned that even minor losses would wipe out the newly created reserve account, thereby creating a disincentive for lenders, even if they were willing to wait to collect their profits. It may be possible for issuers to capture profits upfront by charging higher prices for B-pieces, since those subordinate bonds would no longer have to absorb initial losses. However, B-piece investors might fear they will end up absorbing losses if insufficient funds have been accumulated in the reserve account.

Because it would require the first-loss position to be held for the life of the transaction, the PCCRA would effectively extract all potential profits and adversely impact transaction structures, borrower costs, and the market as a whole. There is already concern that there is not enough B-piece capital to meet the existing needs of the market. By requiring the B-piece buyer to hold a much larger tranche of the transaction – large enough that the market value would equal 5% of the proceeds – the B-piece buyer would have to purchase not only the non-investment grade classes but also certain investment grade classes. Such an approach will only exacerbate these concerns and lead to a shortage of capital, increased costs to all borrowers and less competition in lending markets.

Unfortunately, as currently proposed, the requirement to compel the B-piece buyer to purchase certain investment grade bonds would force them into an investment class currently outside their business model. B-piece buyers are in business to purchase and manage higher yielding investments with a higher risk profile as opposed to lower yielding investment grade bonds. If purchased at these higher levels, the cost of borrowing to the underlying mortgage borrower would be increased. Requiring the B-piece buyer to buy this enhanced segment of the pool is likely to eliminate many, if not most, B-piece buyers from the market place – thereby undermining the CMBS new issuance market.

Simply put, the proposed PCCRA construct should be withdrawn as unworkable.

II. Liquidity Restrictions

For commercial mortgages, the Dodd-Frank Act essentially allows the sponsor to transfer the retained interest to a "qualified B-piece buyer," who meets all of the qualifications outlined in the statute (e.g., retaining a first-loss position, conducting the requisite due diligence, etc.), and those outlined in the Proposed Rule. If the B-piece buyer cannot transfer its interest, there will be few, if any, B-piece buyers able to bid for the bottom of the CMBS capital stack. When taken together, the provisions in the Proposed Rules pertaining to retaining proceeds combined with the non-transferability of those proceeds could severely impact the B-piece market. We do, however, agree that it is important to restrict the level of non-recourse direct or indirect financing of the B-pieces purchased. In addition, we strongly feel that B-piece buyers should be able to sell an entity that contains a portfolio of B-piece loan investments.

To balance these anticipated difficulties with the regulators' expressed concerns about proper alignment of interests, we suggest a modification to permit transfers to a "qualified B-piece buyer." For commercial mortgages, the statute clearly allows the sponsor to transfer the retained interest to a "qualified transferee" in the form of the B-piece buyer, who meets all of the qualifications outlined in the statute (e.g., retaining a first-loss position, conducting the requisite diligence, etc.). Since the statute[9] allows a CMBS sponsor to transfer the retained interest to a qualified B-piece buyer, it makes no sense to restrict the B-piece buyer from transferring the retained interest to another B-piece buyer, presuming that entity meets the same qualifications. We, therefore, think that the Proposed Rules should be amended to permit such transfers to a "qualified B-piece buyer."

The "qualified B-piece buyer" would be required to meet the same criteria that are required for the initial purchase of the B-piece. The "qualified B-piece buyer" concept would satisfy policy goals of facilitating appropriate alignment of risk and encouraging sound underwriting, because the transferee would have ample incentive to scrutinize underwriting itself. It would have no plausible incentive to purchase a bond with poorly underwritten loans.

III. Qualified Loan Exemption (QLE)

Section 941 exempts certain types of securitizations from these risk retention requirements and authorizes the Agencies to exempt or establish a lower risk retention requirement for other types of securitizations.

We are concerned about the manner in which the Agencies would define a CRE loan. Specifically, the Proposed Rule's categorical exclusion of any loan to a real estate investment trust (REIT) -- no matter the quality of its underwriting or whether it is secured by commercial property -- would inappropriately penalize a REIT seeking to finance its property by unnecessarily increasing its borrowing costs compared to other non-REIT property owners.

There is absolutely no apparent policy rationale to be made that loans to REITs are inherently riskier than loans to other commercial real estate borrowers. An entity's status as a REIT is simply the result of a tax election. In order to qualify for the REIT election, the entity must meet strict income and assets tests to ensure its business is tied to real estate, it must also distribute at least 90 percent of its taxable income to its shareholders each year. While the REIT election ensures that a company is focused on real estate, it does not imply anything about the specific business practices of any individual REIT.

Therefore, there appears to be no basis for the Proposed Rule's blanket carve out of all loans to REITs – including those loans to REITs that are secured by real property and that meet the proposed underwriting standards – from the accepted class of "CRE loans."

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[9] Under Subtitle D—Improvements to the Asset- Backed Securitization Process, SEC. 941. Regulation of Credit Risk Retention, Section 15g

As the Agencies develop the final credit risk retention rulemaking, we strongly urge the complete deletion of any reference to loans to REITs as an exclusion in the definition of qualifying CRE loans.

We also recommend modifying the Proposed Rules so that a more realistic metric for measuring the likelihood of repayment is employed. The Proposed Rules would require a Debt Service Coverage Ratio (DSCR) of at least 1.5-1.7x, depending on loan type, and a Combined Loan-to-Value (CLTV) ratio of less than 65% at origination. We recommend replacing the DSCR requirement with a minimum debt yield of 12% and a beginning loan-to-value ratio (LTV) of 65% or less, as well as an ending LTV of 55% or less; the CLTV requirement should be eliminated as it is not directly relevant to collateral backing the first mortgage.

In a broader redraft of the proposed risk retention regulations, we would hope that a more realistic set of criteria could be developed for qualification to exempt certain CMBS from the risk retention construct.

IV. Operating Advisor

The Proposed Rule requires the appointment of an Operating Advisor (OA) that could remove a special servicer for cause and must be consulted on all loan workouts. In order to protect their investments, it is important for B-piece buyers to control the appointment of special servicers, which work out troubled CMBS loans. As a result, the potential loss of that authority could discourage investors from investing in this asset class. A similar Operating Advisor structure, known as senior trust advisors, has been part of some 22 private-label CMBS transactions since late 2009. However, under these constructs, they have far less power to control servicers than under the Proposed Rules. For example, advisors on the outstanding transactions may not unilaterally replace the special servicers. They can only initiate calls for bondholders to do so. The Proposed Rules would allow Operating Advisors to make the switch unless a majority of bondholders objects. As a practical matter, just finding all of the bondholders is hard enough – if not impossible. Additionally, the lack of control over a special servicer gives disproportionate control to the Operating Advisor and creates a disincentive for a B-piece buyer to make a specific investment.

First, it is important to establish the standard by which the Operating Advisor evaluates the special servicer. One such standard would be to include language in the controlling documentation (i.e., the pooling and servicing agreement) that would require the special servicer to maximize the net present value (NPV) of the loan without consideration of the impact of such action on any specific bondholder class. It also seems quite bureaucratic to require the Operating Advisor to be consulted on all loan workouts. As an alternative, the Operating Advisor should monitor all loan workouts and if the special servicer is not meeting the stated standard, the Operating Advisor can then take the appropriate action.

Also, if the Operating Advisor can recommend removal of a special servicer, there should be some reasonable appeal process mechanism. Two possible solutions are (a) a super-majority (66%) of the bondholders (taken as a whole – not a class by class vote) who actually vote; or (b) an arbitration mechanism. Another approach could involve a separate removal and voting mechanism that would be negotiated by the parties as part of the pooling and servicing agreement.

There also needs to be greater clarity about who is eligible to be an Operating Advisor and their specific role in each transaction. We recommend developing a specified list of "Qualified OA's" (similar to what exists for a Special Servicer). Such qualifying criteria may require a Qualified OA to have an existing servicing platform (not necessarily rated); have at least 25 full time employees; have $25 million in capital; and some metric for assuring that they will have an ongoing real estate market presence and the in-house expertise necessary to effectively carry out their responsibilities as an Operating Advisor.

Monitoring Impact of Proposed Rules

It is vital that the Agencies appropriately monitor the application and administration of the Proposed Rules to ensure that such application and administration is balanced, consistent and otherwise conforms to the Agencies' intentions. As one element of such monitoring, the Roundtable respectfully suggests that the Agencies sponsor periodic industry forums. These forums would permit institutions, their customers, and other interested parties to provide feedback to the Agencies on the implementation of the Proposed Rules in the field. Such forums, held on a semiannual basis, could serve as an early warning system to alert the Agencies regarding potential issues with respect to the administration and implementation of the Proposed Rules. This feedback would allow the Agencies to appropriately address any possible concerns regarding the impact the Proposed Rules is having on the new-issue commercial mortgage backed securities market and the overall stability of the real estate lending market.

Standardized Documentation

While we recognize that the collateral for each commercial property loan is different, unlike the underlying homogeneity of single-family residential mortgages, we think that there would be significant benefits from (1) using a standard pooling and servicing agreement (PSA), (2) having originator/contributors use standardized representations and warranties and (3) using standardized underlying loan documents. Using standardized underlying loan documents would greatly simplify the loan origination process and further minimize the cost to originate commercial mortgage loans. Imagine a world where commercial real estate closings were as straightforward and streamlined as single family mortgage closings.

Conclusion

We appreciate what the Agencies are trying to achieve, but, we have serious concerns about the impact the Proposed Rules will have on the new issue CMBS market, commercial real estate credit flows and the overall economy. Given the vast credit challenges facing commercial real estate, the fragile nature of the economy and the continued volatility in credit and capital markets, it is important to appropriately craft the Proposed Rules to ensure a properly functioning and reliable CMBS market.

Accordingly, we respectfully request that the Agencies consider a re-proposal of the rule following the public comment period, rather than issuance of a final rule. We also recommend that a comprehensive cost benefit analysis be conducted of how the proposed will affect commercial real estate and the overall national economy before the rules are finalized. By adding this additional step, the Agencies could further refine the Proposed Rules and reduce the potential for an unintended negative impact on the securitization market and the national economy.

Again, we appreciate this opportunity to comment, and we look forward to working constructively with the Agencies on this important matter.

We trust the Agencies may find our few comments useful. Should you have questions or require additional information, please contact Clifton E. Rodgers, Jr., by telephone at (202) 639-8400 or by email at crodgers@rer.org.

Thank for this opportunity to comment on this important issue.

Sincerely,

Jeffrey D. DeBoer
President and Chief Executive Officer