



CRE Finance Council®

The Voice of Commercial Real Estate Finance

Written Testimony of Drew Fung

on behalf of the Commercial Real Estate Finance Council

Senate Banking Committee, Subcommittee on Securities, Insurance, and Investment

**Hearing entitled “Improving Communities and Business Access to Capital and Economic
Development”**

May 19, 2016

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Welcome

Thank you Chairman Crapo and Ranking Member Warner for the opportunity to testify today. My name is Drew Fung. I am a Managing Director and Head of the Debt Investment Group at Clarion Partners. I am testifying today on behalf of the Commercial Real Estate Finance Council, or (“CREFC”), where I am a Member of the Executive Committee.

CREFC is the collective voice of the roughly \$3 trillion commercial real estate finance market. CREFC’s 300 member firms include balance sheet, Agency and Commercial Mortgage-Backed Securities (“CMBS”) lenders as well as loan and bond investors and servicing firms. Our industry plays a critical role in financing properties of all types in all 50 states including apartments, nursing homes, grocery and retail, just to name a few.

My testimony will focus on the CMBS industry. In today’s economy, CMBS is an essential financing vehicle for the U.S. economy. However, a plethora of new rules and regulations could dramatically affect CMBS liquidity, and thereby undermine the viability of this critical source of funding.

Introduction

The legislators and regulators had a daunting mission in restoring the health of the financial services sector following the financial crisis and the Great Recession. Eight years later, we have the benefit of empirical data and anecdotal experience about the very real costs of a

macroeconomic crisis and also, the costs of regulation. Underpinning this data, it is now also a generally held view that deceleration in growth is likely to be a longer term feature of the national and global economies.

It is within the context of this growth picture that we must revisit our regulatory regime, and specifically its deleveraging objectives. It is critical to note that the Group of Twenty (G20) first added financial regulation to its agenda in 2009, broadening and enhancing the role that the international regulatory bodies played in determining home country requirements. At that time, goals for reducing leverage in the system were based on trends and observations ending with the deepest points of the mark-to-market losses. At the same time, there was little attention paid to the economic effects of regulation. It still remains a challenge to determine the collective effects and costs of the cumulative regulations aimed at the structured finance marketplace, partly because the rules are still being written, partly because some final rules have yet to take effect, and partly because they are so complex. Even so, many countries are seriously reconsidering the burden of the future regulatory agenda, given entrenched headwinds to growth. Some are not only contemplating, but also actively pursuing, relief for securitized products in order to support growth.¹

More recently, the CMBS market has seen excessive and sustained dislocation, also referred to as “illiquidity”. To a certain degree, geopolitical events are to blame for some of the distress that many markets experienced in February and March, yet these events do not account for all the distress. While other fixed income asset classes started to trade more normally in recent

¹ The below article discusses some of the measures being considered by the European Union:
<http://www.wsj.com/articles/eu-proposes-new-capital-rules-to-boost-securitization-1443610493>

months, CMBS continued to exhibit numerous signs of relative distress. What accounts for this lagging effect on CMBS?

Market participants are unanimous in their belief that regulation is driving much of the present strategic decisions, and the effects of that regulation are causing the market to grow thinner and more fragile. Despite the fact most participants agree that credit trends in the commercial property market remain healthy, issuers and investors alike have shed staff, cut their budgets and reduced allocations. Some even closed their doors.

Weeks after researchers and other market watchers released their 2016 issuance forecasts (as high as \$125 billion), many if not most, reissued forecasts at roughly half of their original numbers. Commercial Mortgage Alert published an estimate of \$50 – 60 billion in their most recent issue (05/13/16). In other words, with little to no stress, and despite the fact that many other fixed income asset classes regained their stride after the February pounding of oil prices and other macroeconomic challenges, the CMBS market continued to see record levels of volatility.²

While the regulators periodically revisit the deleveraging question in speeches and analyses, the U.S. regulators, in particular, seem unwilling to meaningfully investigate the role that regulation is playing in the fracturing of markets, fund flows and the global slowdown. This frustration was felt by CREFC members while submitting comments during the agency rulemaking processes. There are countless instances in which our trade association and others provided well researched and documented analyses of the CMBS and other structured products markets. Yet, the regulators answer with rule requirements that are less tailored than they need to be for each asset-class, let alone CMBS, in order to maintain the organic efficiencies of the market in favor of

² As measured by the standard deviation of swap spreads, which are the benchmark off of which CMBS are priced. Higher standard deviations indicate lack of liquidity. Current readings in CMBS suggest that the market is undergoing significant stress.

simplifying the regulatory regime globally. Now that the CMBS market is exhibiting severe distress, and there is evidence of a negative feedback loop between poor liquidity conditions, lending rates and capital raising, the effects of regulation must be addressed, and done so quickly.

A strong contingent of CREFC's members believe that regulatory burden is responsible for reducing liquidity in and weakening the resilience of our market, despite the impact of geopolitical forces. Many believe that liquidity is the CMBS linchpin and that the regulations are causing permanent damage to it. Yet, even buy-and-hold investors, such as the pension fund universe (that is reportedly 6.99% invested in real estate)³ need market liquidity in order to be able to meet their own regulatory and fiduciary requirements.

CREFC and its members believe that thoughtful regulation can be a net positive and that some of the new regulatory requirements have improved the marketplace and the alignment of interest between issuers and investors. While the broad intent of the regulations is well-founded, the overwhelming burden of rules that lack tailoring to the characteristics of different asset classes provides little marginal prudential improvement, if at all. At the same time, these rules generate significant costs to the end users (i.e., borrowers and consumers) and to savers whose investments are devalued as a result. Consequently, there is a growing chorus of urgent concerns from all ends of the industry that regulation is institutionalizing inefficiencies and may even severely disable liquidity for the CMBS market permanently.

Moreover, lenders and investors agree that a dislocation in CMBS will travel quickly throughout the commercial real estate ("CRE") debt and equity markets, impacting valuations and fundamentals. Certain aspects of the marketplace are so fragile today -- even before half of the

³ According to a recent survey, U.S. institutional tax-exempt exposure to real estate debt and equity grew to \$835 billion. One of the largest Asset Managers, TIAA-CREF, has \$82 billion, or 9.4%, in exposure of a total of \$866 billion in AUM as of 3/31/2015. <http://www.pionline.com/article/20141027/PRINT/310279999/real-estate-managers-back-over-1-trillion-again>

planned regulations come into place -- that CMBS is experiencing severe pricing volatility, a marked contraction in issuance and reduction in capacity. We are working on borrowed time to investigate the solution and to initiate remediation, especially given the current schedule of new rules in the pipeline.

CMBS the Asset Class and Historical Performance

The securitization of commercial mortgages began out of the necessity to clean up the balance sheets of taxpayer-backed depository institutions in the late eighties and early nineties. A combination of excess development in the wake of strong commercial property demand, a subsequent economic downturn, tax reform and loose credit from depository institutions led to a drastic overbuilding of office properties. By 1989, 534 depository institutions had become insolvent due to imprudent loans. Congress created the Resolution Trust Corporation (RTC) in 1989 to dispose of the failed institutions' assets. In turn, the RTC pooled the mortgages and sold them off as diversified bonds, creating the first CMBS transactions. Since then, the market has become much more transparent and investor-centric.⁴

Credit retracted nationally across industries in the nineties. Not only had the universe of lenders shrunk dramatically, but the few banks that could lend on property were reluctant to do so, prompting innovative financiers to bypass the banking system for the capital markets. They pooled commercial loans and sold bonds tied to those loans to sophisticated institutional investors from pension funds and insurance companies. By 1998, issuance topped \$50 billion per year, and by 2007, issuance topped \$200 billion per year.⁵

⁴Alan C. Garner, "Is Commercial Real Estate Reliving the 1980s and Early 1990s," <https://www.kansascityfed.org/publicat/econrev/pdf/3q08garner.pdf> (2008)

⁵Sam Chandan, "The Past, Present, and Future of CMBS," <http://realestate.wharton.upenn.edu/research/papers/full/730.pdf> (2012)

One of the attractive features of CMBS was that institutional investors (entities with monthly, quarterly or actuarially-driven cash flow obligations) could achieve greater diversification across geography and asset class than by purchasing or originating whole loans themselves. Instead of owning a \$50 million loan on a *single* property, the investor could purchase \$50 million worth of bonds equally diversified on a pro-rata basis across 40-100 loans in 10-30 individual markets. And importantly, the investor could decide how much risk they wanted to take based on a bond's seniority in the capital structure and the duration of the security. The most secure bonds received cash flow payments first, while the riskiest bonds last. In the event of a distressed sale, bond holders are paid before the borrower who contributed the equity. Typically, these securities offer more yield, transparency and diversification than similarly-rated corporate bonds.

At the asset level, an investor, generally a business entity (a partnership or corporation), seeks to purchase a commercial property and obtain debt financing for that transaction. Each commercial property can be thought of as a self-contained business with an income statement and balance sheet. The rents charged to use a property – including monthly apartment, office, or retail rents – serve as the “sales” or revenue for the business.

Similarly, a property has expenses in the form of third-party property management fees (landscaping, maintenance, etc.), property taxes, insurance, leasing expenses (as in the case of an apartment leasing manager, or a retail leasing agent, who go and find renters for the property), and non-capitalized annual repairs to the property. These expenses subtracted from total revenues represent the property's profit and loss, or “P&L”. It is through this number that all applicable underwriting calculations, such as debt service coverage ratio (“DSCR”), whether from the investor or lender, are calculated.

The property owner's ability to pay off debt is not measured (since all CMBS loans are non-recourse), but rather, the *property's*, or business's ability to service monthly payments is measured. A mid- to long-term holder of commercial property, regardless of property type, buys a building based on how much cash flow, or yield, the asset will generate each year, and considers hundreds of data points (ongoing surveillance of CMBS is reported on a monthly basis via the CREFC Investor Reporting Package (the "IRP"), a monthly report with over 750 data fields and supplemental reports providing insight into asset, loan, and bond level performance, as well as the final disposition of specially-serviced CMBS loans⁶, in addition to a business plan that includes market information ranging from demographics, supply and demand factors for the asset type, and relative positioning to comparable products.

Post-financial-crisis (also known as "CMBS 2.0"), there are two distinct CMBS markets: the conduit market and the single-asset single-borrower ("SASB") market. The conduit market pools commercial mortgages ranging in size from \$2 million to over \$100 million (but generally not more than \$100 to \$300 million). These loans are collateralized by stabilized, cash-flowing properties with three years of operating history and professional ownership. As thousands of small banks either closed their doors or were purchased by larger firms in the wake of the 2008 credit crisis, conduits remain a substantial source of debt for secondary and tertiary market real estate operators. Conduit financing provides capital for grocery-store shopping centers, strip malls, family owned hotels, shopping malls, and apartment buildings.

The other type of CMBS lending is SASB loans. These loans typically are larger than \$250 million and are made on a single, large property or portfolio of properties owned by one borrower

⁶ For information on the IRP, please visit: <http://www.crefc.org/irp> or see Appendix A. This information anticipated by almost 20 years asset-level information now required by the SEC for other asset classes.

such as large, well-capitalized, public and private real estate companies. Last year, SASB made up over one-third of the total CMBS market, up from roughly 10% historically.

Institutional investors enthusiastically invest in SASB bonds. The demand for this market came about as banks and insurance companies were unable or unwilling to offer their balance sheets to finance trophy buildings or portfolios of properties. The credit characteristics of these loans are highly desirable – often many times oversubscribed by investors. Due to the durable nature of CRE’s cash flow, and subsequently the CMBS bonds, the asset class as a whole has performed extremely well. The all-time cumulative loss rate for SASB transactions is 0.25%, and 2.79% for conduit transactions.⁷

SASB transactions performed better in the depths of the crisis than most fixed income markets perform under *efficient* market conditions. Due to the structure and transparency of SASB deals, investors were (and still are) able to make informed decisions. With performance characteristics such as these, it is fairly improbable that regulation could benefit the market. Indeed, when members of the regulatory community have been asked this question, often the answer is that it is difficult for the agencies to grant exceptions. CREFC discussed these issues at length with the Agencies responsible for crafting the risk retention, and our list of submissions to the regulators can be found in Appendix B.⁸

Why CMBS: Borrower Access to Credit

CMBS provides the most democratic and cost effective method of financing for small real estate assets. While SASB financing makes it possible to spread the risk of a large dollar loan on

⁷ As of 08/31/2013, per CREFC’s comment letter to regulators.

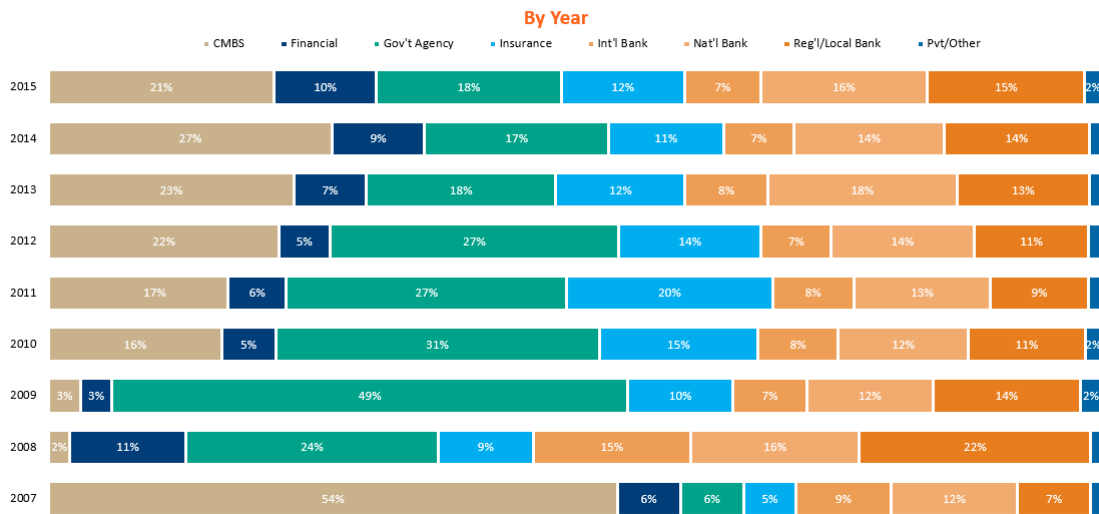
⁸ See CREFC’s Letter to various regulators on Risk Retention:

http://docs.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Risk%20Retention%20Proposed%20Rule%20Comment%20Letter.pdf

a single property, conduit financing is an essential component of the main-street CRE market. If traditional credit providers – banks and life companies – service the borrowers who need mid-sized loans, then CMBS serves the ends of the barbell, with SASB transactions that are too big for a single institution to handle on one end, and loans on small, privately owned real estate companies and syndicates that make up 90% of CRE ownership on the other.

In 2015, CMBS provided 21% of all of all CRE loans. This is the sector’s largest financing source, followed only by agency debt (18%) and regional banks (16%). Annual originations by banks and life companies ebb and flow, but have generally been steady and limited to specific niches. While CMBS’s 50% market share in 2007 was arguably too high, as witnessed prior to the crisis, securitization has proven to pick up a large portion of the slack that portfolio lenders and the Agencies typically eschew.

Lender Composition



One of the most popular sentiments expressed by all types of CREFC members (buy- and sell-side) is that the broader CRE market needs CMBS in order to function efficiently and to fill the gap in financing needs posed by underserved borrowers in smaller cities and suburban areas.

For instance, Idaho currently has over \$1.1 billion worth outstanding loans distributed across cities including Boise, Twin Falls, and Meridian. Similarly, Virginia and Massachusetts currently have over \$26 billion and \$17 billion, respectively, in outstanding CMBS financing (please see Appendix G for a breakdown of each state's outstanding CMBS loans).

The CMBS market represents a core source of capital that cannot easily be replaced. When new issuance is halved in a single year, especially one in which there are significant refinance needs, it is realistic to expect a broader market disruption. During liquidity interviews, CREFC members had significant concerns over the impact a declining new issuance market would have on bond values, and more importantly, property values. Members noted that all things being equal, removing 20% of available debt capital from the marketplace would surely depress property values. Members also noted that they did not see a ready alternative to CMBS financing – that is, long-term, fixed rate mortgages. Instead, bank participation will be declining as the regulatory regime is ramped up across all banks, big and small, and as the regulators enforce limits on CRE exposures.

Maintaining availability of CMBS financing is even more critical following regulatory warnings regarding CRE concentrations at banks. Many bank lenders in our membership report intentions to maintain, instead of grow, loan levels, which means that any reduction in the CMBS market should represent a reduction in capital availability across the sector. While some 1Q 2016 data series indicated that loan levels are still growing, the spurt in the first quarter represents loans that were negotiated before the end of the year and the prudential agencies published a warning to the CRE lenders.⁹ Indeed, the April 2016 Senior Loan Officer's Opinion Survey

⁹ <https://www.federalreserve.gov/bankinforeg/srletters/sr1517.htm>

reflected a tightening of underwriting standards across the industry for the first time in this cycle, [FRB: Senior Loan Officer Opinion Survey on Bank Lending Practices](#) and this is considered to be a leading indicator of future trends. Industry watchers report that the CRE loan pipeline has contracted in 2Q 2016, which should be reflected in the second half of the year.

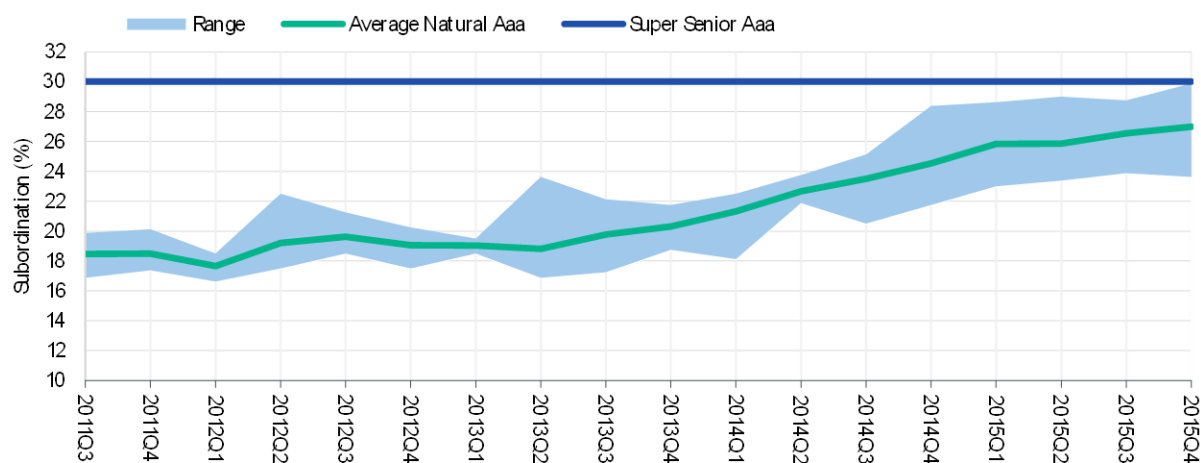
Evolution of the CMBS Market Before and After the Crisis

The CMBS market is generally viewed in two historical segments – CMBS 1.0, which existed before the crisis, and CMBS 2.0, which commenced after the crisis. The reason that the two phases are delineated is that the CMBS market has greatly evolved in several critical ways since the crisis: 1) pro-forma (aspirational) underwriting is infrequently mentioned and in fact, underwriting criteria have been tightening;¹⁰ 2) CMBS deals include much greater levels of subordination, or cushion, to absorb potential losses (see exhibit below); 3) collateralized debt obligations (“CDOs”) backed by CMBS are no longer issued; and, 4) even greater transparency and information is provided to investors.

¹⁰ <http://www.federalreserve.gov/boarddocs/snloansurvey/201605/>

Aaa Credit Enhancement

» Moody's Natural Aaa (sf) Subordination Levels Converge on the 30% Super Senior Level



Source: Moody's Investors Services

Recent economic conditions were primed to result in a return of aggressive lending and funding. Environments marked by low rates and improving credit trends, as we saw in recent years, are prime ecosystems for higher leverage, because the economics work. However, risky leverage did not return to the CMBS market. In fact, the opposite happened. The levels of loan and deal level leverage remained much lower than in CMBS issued prior to the crisis (CMBS 1.0). Importantly, the double leverage that came with CDO funding seems to be wrung out of the system.

Early regulatory and industry intervention at the beginning of the crisis were indeed the integral in weeding out the most ambitious lending and financing forms from the CMBS industry. The combination of accounting changes and additional requirements of the rating agencies, as well as other rules helped to stabilize the CMBS market starting in 2010. While the Term Asset Backed Loan Facility (TALF) did support several CMBS transactions, the TALF's activities in the commercial market were limited. In other words, the market participants agreed on a new

architecture which instilled the requisite confidence from both buy- and sell sides. This caused the market to rebound with little assistance from the TALF facility established to liquefy the market during the crisis.

Indeed, CREFC members played a vital role in this stabilization, as our community contributed a critical new feature of the CMBS 2.0 (post-crisis CMBS) marketplace – additional transparency measures in the form of the IRP, described in detail above, and in Annex A, which is the deal package. (See Appendix A for more details on CREFC IRP). These two transparency measures are proof that through the leadership of CREFC, the CMBS industry has self-regulated over the years as investors demanded standardized deal documents and up-to-date performance data.¹¹ However, regulators gave the industry little credit for these self-imposed reforms.

In 2009, CMBS issuance had collapsed to almost \$0 from a height of \$231 billion in 2007. Issuance rebounded to roughly \$100 billion in the private label market last year. Until recently, many bonds had excess bidders and the CMBS market enjoyed inflows of capital correspondent with performance. It seemed that despite low interest rates, market participants generally agreed that CMBS was functioning well in the main.

As a result, CMBS 2.0 has continued to evolve. First, more stringent accounting and rating agency rules resulted in greatly reduced economic incentives for CDO structuring. Now that CMBS are not re-leveraged through CDOs, the dollar value of investable capital is lower today than it was when interest rates were higher. Second, the rating agencies have all significantly revised their models and required much greater amounts of subordination. As a result, the bonds at the bottom of the stack that absorb losses have roughly doubled. Third, better transparency in

¹¹ A full list of these self-regulatory measures is available in CREFC's letter to the Federal Reserve System, the FDIC, Treasury, the SEC, and the OCC:
http://docs.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Risk%20Retention%20Proposed%20Rule%20Comment%20Letter.pdf

the form of Annex A and the IRP, now in its 8th version, has reinforced better underwriting standards and more extensive due diligence. While the market is constantly evolving, CREFC believes that these positive conditions are not temporary, but rather more permanent features of the CMBS 2.0 market and the upcoming CMBS 3.0 market.

Regulatory Regime and the Question of Effectiveness

The CREFC community is generally supportive of prudent regulation that appropriately weighs the cost of the requirements with the corresponding benefit it is expected to achieve. In our comments to the various regulators, including the Securities and Exchange Commission (“SEC”), we made this fact known and expressed a desire to work with them in identifying solutions that would enhance positive market practices, including those put in place by the CMBS market itself. Currently, the CMBS market is subject to an extraordinary amount of direct regulation, and many of these measures have the impact of treating CMBS more harshly than other asset classes (e.g., Fundamental Review of the Trading Book and Liquidity Coverage Ratio). Further, there are innumerable rules that indirectly impact the market by greatly changing the conditions under which the entire financial system operates. These rules then drive the conditions in which CMBS functions. Of the subset of these new rules that affect CMBS most directly, there are:

- the accounting changes FAS 166 / FAS 167;
- rating agency rules;
- Regulation AB II (a set of disclosure requirements);
- reporting requirements to the TRACE facility;
- Volcker Rule (which sanctions CMBS market making but presents a set of very high hurdles for compliance);

- Basel III leverage ratio (which affects how market making desks fund themselves with repurchase agreements);
- Liquidity Coverage Ratio (LCR);
- Net Stable Funding Ratio;
- Risk based capital rules; and
- Risk Retention rule (which requires that issuers hold 5% of a securitization).

Last year, CREFC produced a study¹² of the regulatory impacts on the CRE sector overall and found through interviews and quantitative analysis that taken together, regulation has done some good things for our sector, but it has also reconfigured the structure of the markets in such a way that makes it ultimately less resilient in times of stress. These outcomes generally run counter to broader policy goals of maintaining sound functioning markets and supporting sustainable growth. Broadly speaking, the rules under the Dodd-Frank Act and also the various components of Basel III discriminate against longer-term assets and those that are not highly standardized, such as residential mortgages. At the same time, there is little acknowledgment of the unique transparency in the CMBS market or how the market functions differently than other asset classes that tend to be traded on more of a quantitative, and less on a fundamental, basis.

¹²

http://www.crefc.org/CREFC/Publications/Regulatory_Impact_Study/CREFC/Resources/Regulatory_Impact_Study.aspx?hkey=47af34d5-3cea-43e1-942f-309fd7508928

Regulatory Timetable for Key Dodd-Frank, Basel III Rules

Domestic Initiatives

Basel III

		HIGH VOLATILITY CRE	RISK-BASED CAPITAL REVISIONS	LIQUIDITY COVERAGE RATIO (LCR)	NET STABLE FUNDING RATIO
	2014		Final (securitization and banking book) and proposed (credit risk/capital floors) global standards	Final rules adopted	
Dodd-Frank risk retention final rule		Conformance for Non-Advanced IRB Institutions	Proposed "Fundamental Review of the Trading Book" (FRTB) global standards	Partial conformance	
Reg A.B II partial conformance Volcker rule partial conformance	2015		Final target global standards		US proposed rule
Reg A.B II full conformance Risk retention full conformance	2016		U.S. target adoption	Full conformance	Final rule
Volcker rule full conformance	2017		Full conformance		Full conformance
	2018+				

Sources: CRE Finance Council (CREFC) Regulatory Impact Study; Chardan Economics

CMBS Liquidity and Market Resiliency

The universal concern of all industry participants is that the constant march of new regulatory requirements will create such a drag on margins that a critical mass of participants will exit. Many CREFC members have commented on this likely end game for CMBS now that they can envision a more complete regulatory timeline.

Starting with the risk retention rule, which goes into effect on December 24, 2016, borrowers, issuers, and investors are keenly analyzing implementation at this time. CREFC gathered estimates last year and found that the regulation would likely add roughly 10% to the interest rate the borrower pays. This number was calculated assuming stable conditions and *before* CMBS participants started to consider the implementation challenges in earnest. Based on a sampling of issuers and investors more recently, CREFC found that on average, our members believe that much of the current spread widening is driven by regulatory burden, suggesting that the 10% of marginal costs originally estimated will prove to be lower than the actual costs incurred in a volatile trading environment such as the one prevailing for some time now. Given that risk retention is the next piece of regulation to move into effect for our sector, it can reasonably be credited as the greatest driver of costs to the borrower at this time and one of our industry's top priorities. The regulatory factor is often cited as the driving force beyond continued spread volatility at this time, while other fixed income asset classes revert back to more stable trading environments.

CREFC and the majority of its members have often supported differentiated treatment for SASB bonds, because the asset class has performed better than most other fixed income sectors, and in some ways, is simply the best performing sector through the crisis. Yet, the six regulators that were obligated to promulgate the risk retention rule, chose to include SASB deals in the coverage universe, even though there was very little, if anything, more than rules and restrictions

could accomplish with the sector.¹³ The risk retention rule was written with conduit structures in mind, yet will also be applied to the SASB universe, despite the fact that the requirements cannot be adopted without wholesale restructuring the SASB model and the market with it.

Additionally, it is important to note that risk based capital rules and the LCR are steep for our sector, and, more importantly, they treat CMBS relatively poorly compared to other financial instruments. Additional rounds of Basel capital requirements will make CMBS even less viable. Based on a series of interviews conducted with market leaders since the beginning of 2016, the FRTB, which changes capital requirements for all inventories kept for market making purposes, has been cited as one of the most concerning pieces of regulation, if not the most.¹⁴

Even though the Basel Committee on Banking Supervision (BCBS), reduced the magnitude of the charges applied to CMBS in the final version of the FRTB published on January 14, of this year, these requirements place CRE backed-deals on par with subprime residential mortgages. In turn, it will be even more challenging to allocate capital to CMBS businesses, and ensures increased fragilities. The LCR, which is the first of two new liquidity requirements under Basel III, is also an example of a punitive approach toward all non-sovereign asset classes, but particularly, securitizations and CMBS. The LCR requires that CMBS issuers apply an additional cost to the production of their assets, even after they have been sold. The recently proposed Net Stable Funding Ratio follows the LCR's construction and is expected to additionally disadvantage CMBS relative to other asset classes.

Other Countries Easing Regulatory Treatment of Securitizations

¹³ With an historical realized loss of 0.25%, SASB deals have performed remarkably well, which explains the spike in investors' demand for these bonds in recent quarters.

¹⁴ Even after the Basel Committee on Banking Supervision reduced the risk weighted requirements for structured products in their final version of the standards published on January 14, 2016, industry participants anticipate that new U.S. rules may require that market makers maintain more capital than the market value of certain CMBS bonds.

In contrast to the tightening of the regulatory regime in the U.S. anticipated in the near future, the European Union is using the securitization markets to help restart growth. Policy makers across many jurisdictions and throughout legislative and banking authorities have recognized in many ways that the securitization markets can provide safe and alternative funding to the banking system. As such, the European Central Bank (ECB) is utilizing the financial technology as part of its small and medium sized business program.

Additionally, the ECB and other European regulators have begun to consider how to ease the burden on safer securitizations through reduction of risk based capital requirements and other mitigating measures. Importantly, they have noted that compliance and accounting measures have increased the discipline in the markets and believe that an offset in the capital and liquidity requirements would be warranted.

The European authorities are not the only jurisdictions contemplating a reduction in the regulatory burden on structured products. In light of slowing growth globally, other regulatory agencies have considered certain changes too, including China, Japan and Australia.

Regulation and Market Liquidity

In short, these regulations are and will continue to have a significant impact on CMBS. The precipitous decline in CMBS liquidity (e.g., inventories, turnover, trade size), especially the prolonged spikes in swap spreads, are particularly troubling. These trends suggest that the market is trading inefficiently; in the absence of credit concerns, anticipation of the next round of regulation must be driving much of the volatility. Moreover, certain trends suggest that the pattern may be sustained for some time, if not deepened becoming a negative feedback loop as many have warned:

- a. The number of market making platforms is declining rapidly, especially those that provide “balance sheet” and that can hold inventories. Based on a partial survey of the market in April, it appears that at least one in five people have been downsized this year, and at least one institution, the number is reversed; of five original market-making staff, one remains. One member investor speculated that there were ten true dealers with capacity to hold inventories and to make markets across a range of new issues last year; that number was halved by year-end 2015 and as of this writing, the number is now down to two or three true market makers.
- b. As expected, the investors who relied on liquidity – those who care more about total returns than relative value – have exited *en masse* in lock step with the liquidity providers, leaving a distinct and troublesome gap at the lower end of the bond stack.
- c. Yet, buy-and-hold investors have reacted decisively to the distress in the market too by reducing allocations to the sector and many are actively retreating from the conduit market. All are concerned about the ability to price their investments accurately in a volatile market.
- d. The proportion that CMBS represents in the Barclays Aggregate Index, which is the one of most often used fixed income benchmark indices, has declined significantly to 1.2% from a high of 5.7%, meaning that the demand for CMBS will continue to decline.
- e. While there were roughly 40 conduit lenders and sellers last year, they too are closing their doors and now number roughly 28.
- f. The pipeline of new issues has been moving at a slow pace since April. The SASB deal calendar, especially, seems to be drying up in the summer with a couple of

small deals scheduled in June and none in July.¹⁵ Both sides of the business are seeing smaller deal sizes, which also indicates general lack of liquidity and is a concern for both buyers and sellers.

- g. The primary hedging instrument for the industry, the CMBX, has begun to trade very differently than the underlying cash bonds, which also indicates inefficiencies in the market and portends a deepening of the dislocation if pricing of the two products, the bond and the hedging instrument, do not become reasonably more correlated in their movements again.

Demand for liquidity relative to market supply is stark. A survey of issuers, traders, investors and other market participants conducted by CREFC in early February suggests that, market-making capacity was already undercapitalized by one quarter to one half. Since then, additional traders have lost their seats, draining further capacity from the system.

Recommendations and Conclusions

Considering all of the perverse impacts of regulations – both individually and in the aggregate – our list of recommendations would be long, and mostly within the regulatory purview. As such, we began this process first by petitioning the regulatory community for correction and clarification. Regulators accepted some of our recommendations but also declined a good number. It is for this reason that we now seek Congressional intervention.

From the legislative perspective, we urge the members of this Committee to work together in a bipartisan fashion to introduce the companion to the bill sponsored by Representative French Hill of Arkansas. H.R. 4620, the “Preserving Access to CRE Capital Act” addresses the challenges posed by the risk retention rule in a targeted, fair and responsible fashion. Though the

¹⁵ Commercial Mortgage Alert, 05/13/16.

recommendations in the bill do not affect the core requirements codified in the Dodd-Frank Act, Section 941,¹⁶ they are meaningful and would have a positive impact on the marketplace. The majority of CREFC issuers, investors and servicers support the bill, however, there is a minority contingent of investors who support the final regulation without modification.

Introduce and Report Out of Committee a Companion to H.R. 4620

CREFC strongly supports the recommendations below, which restore the proper balance between protective measures and a healthy, functioning CMBS market for the borrowers and employers in every Congressional district. Specifically, the recommendations would: (1) exempt from the risk retention requirements the highly-sought and extraordinarily transparent SASB transactions; (2) set reasonable parameters for regulating and designating as “qualified” certain high-quality commercial loans (QCRE Loans) under the risk retention rules; and (3) provide flexibility in structuring the retained interest to suit investors without modifying the amount nor relaxing the general restrictions surrounding the retained interests.

First, the recommendations would address the issues related to the transparent and high-performing SASB transactions by making them exempt from the risk retention requirements. As mentioned above, SASB transactions are marked by superior performance — the SASB segment booked a mere 0.25 basis points in cumulative losses between 1997 and 2013. This financing option is ideal for borrowers seeking to finance apartment complexes, hotels, office buildings, and, of course, gateway market “trophy” properties. Despite this superior performance, current regulations do not include an exemption for SASB transactions, which threaten to raise borrowing costs, decrease borrower choice in this market, and induce them to seek other modes of financing that may be less transparent and low risk (e.g., corporate bond markets).

¹⁶ Issuers / sponsors must retain 5% of the credit value of the bonds for five years, during which time the bonds cannot be hedged (except for interest rate and foreign exchange).

Second, the recommendations would put in place common-sense parameters for considering which CRE loans would be deemed “qualified” under the risk retention requirements. Currently, only a small percentage of CMBS loans would be considered as QCRE loans, and exempt from the risk retention requirements. Although modeled after the Qualified Residential Mortgage (“QRM”) exception, the application of QCRE has vastly different consequences. Surprisingly, private label residential mortgage-backed securities were given a generous set of qualifying requirements under the QRM standard; in fact, it is estimated that nearly all of today’s RMBS loans would qualify for an exemption. Yet, conversely, in the CMBS space, the qualifying conditions are so onerous that only 3%-8% of all CMBS conduit loans written since 1997 would qualify for an exemption from the core 5% risk retention requirement. This has little sense of proportion or compelling rationale.

H.R. 4620 would moderately widen the underwriting requirements for QCRE, thus helping maintain credit quality in this space, along with stable pricing and availability of financing for a broad swath of business owners. Specifically, the bill would allow pools of unrelated/unaffiliated, or conduit loans will be allowed to amortize over not more than 30 years (from the current 25-year standard); permit low-LTV interest-only loans to be treated as “qualified” where no authority was granted previously; and permit loans less than 10 years in term as qualifying for exemption under the QCRE rule. We expect that this would raise the QCRE percentage to about 15% of all loans, still well below all the RMBS loans that will qualify under the QRM exception. In other words, the parameters are targeted and responsible. In no way would it allow a blanket carve-out for the CMBS community, rather it would only truly apply to transparent and highly-performing loans.

Third, under the risk retention rules, there are special rules for CMBS that allow a third-party investor to purchase the B-piece (known under the rule as the eligible horizontal residual

interest, or “EHRI”). The risk retention rule allows up to two third-party investors to share the 5% retention burden, but requires them to hold their positions *pari passu* (i.e., horizontally). The proposed legislation supported by CREFC would allow third-party purchasers to share the retention obligation *pari passu* or in a senior-subordinate (i.e., vertical) structure. H.R. 4620 does nothing at all to change the core retention requirement or any of the other requirements surrounding the B-piece investors. The core 5% retention requirement and all other general requirements (e.g., substantive due diligence, holding the interest for five years, etc.) would remain intact.

The legislation allows for a reasonable amount of flexibility in how the B-piece is held internally by two purchasers. This flexibility will allow the B-piece buyer to match investor capital with the additional capital investment (the retained risk amount) that the rules require. For CMBS, the required amount of risk retained will be about two times that of what is currently invested by B-piece buyers in a typical CMBS deal. That is a massive amount of incremental capital B-piece buyers have to raise in order to be risk retention compliant. And that investment is essentially non-transferable – meaning that the funds raised will be “parked” in a single deal for at least five year. Obviously, this comes with an illiquidity premium that investors will seek – further increasing costs to borrowers. The senior-sub structure will be used to help align investors with this new retained risk requirement. It will not affect at all the amount of risk that must be retained, the underwriting due diligence required by the rules or the holding period requirements of the rules. It simply gives the industry flexibility to achieve the risk retention goals of the regulations and is supported by 14 real estate trade associations.¹⁷

Conclusion

¹⁷ See appendix B for Industry Support Letter to House Financial Services Committee

CREFC would like to thank the members of this Subcommittee for providing us the opportunity to submit this statement. CREFC asks that the Subcommittee give serious consideration to the negative consequences of the latest round of rulemaking – consequences far beyond the CMBS markets. More to the point: without a robust and competitive CMBS marketplace our members anticipate a liquidity-driven stress event that could potentially take years to rebalance as market participants leave the arena for other lines of business. This imbalance will have far-reaching and profound effects on communities in a very visible way, by constricting the funding for commercial properties that we all come to rely on daily for our groceries, housing, workplaces, healthcare, education, and goods and services. In short, the roughly \$200 billion of maturing CMBS debt in the next two years will need to be financed regardless of the actions Congress takes. In the absence of intervention and continuity of a competitive CMBS marketplace, we fear that buildings currently funded could fall into foreclosure, resulting in blighted, perhaps empty structures and loss of principal for America’s pension and other investors and retirees.

We remain optimistic that there is time to correct this looming liquidity crunch, and we are eager to work with members of the Committee, and with Congress, to ensure that the discretely tailored recommendations become law.

Appendix A: CRE Finance Council Investor Reporting Package

The key items of interest included in the CRE Finance Council Investor Reporting Package (IRP) include the following data and supplemental reports that are filed monthly or on an as needed basis.

- Master Servicer Files
 - Loan Setup
 - Loan Periodic Update
 - Property Files
 - Financial Files
- Property Income Statements (Borrowers and Property)
- Special Servicer Loan File
- Special Servicer Property File
- Schedule AL File (Required by SEC)
- Trustee Data Files
 - Bond Level Summary
 - Collateral Summary
- Supplemental Data Reports to be filled out by Servicers
 - Servicer Watchlist/Portfolio Review Guidelines
 - Delinquent Loan Status Report
 - REO Status Report
 - Comparative Financial Status Report
 - Historical Loan Modification/Forbearance and Corrected Mortgage Loan Report
 - Loan Level Reserve/LOC Report
 - Total Loan Report
 - Advance Recovery Report
- Supplemental information to be supplied by Servicers:
 - Appraisal Reductions
 - Servicer Realized Losses
 - Reconciliation of Funds
 - Historical Liquidation Losses
 - Interest Shortfall Reconciliations
 - Significant Insurance Event Report
 - Loan Modifications
 - Loan Liquidations
 - REO Liquidations
 - 1099 A/C Tax Forms for Servicers

Appendix B: Industry Support Letter for H.R. 4620

February 29, 2016

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Re: H.R. 4620 to Amend the Securities Exchange Act of 1934 to Modify Requirements for Qualified Commercial Real Estate

Dear Chairman Hensarling and Ranking Member Waters:

The undersigned organizations express strong support of H.R. 4620, the “Preserving Access to CRE Capital Act,” a bill that makes minor, but important, modifications to credit risk retention rules for commercial real estate loans. The credit risk retention rules are a product of six federal agencies and cover all securitized assets and were intended to incentivize better underwriting. Despite best efforts by the regulators to write one set of rules encompassing all differing securitized asset types, the rule in its current form, will not achieve the objective, especially when operationalized at the same time as so many other new requirements that are also targeting securitizations. H.R. 4620 makes minor modifications to the rule, while maintaining the core components of the risk retention, to ensure continued liquidity and affordable financing options for commercial real estate borrowers in every Congressional district.

Specifically, the Preserving Access to CRE Capital Act would allow very prudently underwritten, low-risk commercial real estate mortgages to meet the criteria for qualified commercial real estate (“QCRE”) loans under the risk retention rules. The revisions, in fact, were based on performance and correlate to those loan characteristics that performed the best from 1997-2013. As “qualified” loans, they would not be subject to risk retention and the associated punitive costs associated with it. The bill also provides relief for prudently underwritten, single asset-single borrower loans. Barring some form of relief, many smaller commercial markets across the country will not be able to finance projects that could spur development and create jobs in the areas that need it most.

In contrast, the same rule exempted over 90% of residential loans being made in this country currently. Whereas for commercial loans, it grants only 3-8% of all loans the same “qualified” treatment, which is too small a target to influence underwriting trends. 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 trillion commercial real estate debt market, currently comprising roughly 26 percent of the overall market. In secondary and tertiary markets, the percentage of liquidity is even greater. Chances are, you know a borrower by name and an address by heart in your district that utilizes this type of capital.

CMBS provides financing to retail, office, apartments, industrial, health care and many other types of commercial real estate. If the rule is not modified before going into effect at year-end, a large percentage of borrowers across the country will not be able to refinance their loans without additional capital and higher monthly costs. Following the stress this will cause elsewhere in the system, valuations will be hurt and savers' investments will suffer as a result of the reduced liquidity in the system.

This bill remedies an oversight by regulators that would impair, for no discernable safety and soundness reason, the availability of capital to commercial real estate borrowers and therefore increase borrowing costs. Recently, CMBS has led the market by providing roughly 45% of lending for America's tertiary markets and nearly 30% for secondary markets.

We strongly urge committee passage on HR 4620.

Sincerely,

Commercial Real Estate Finance Council (CREFC)

cc: Members of the Committee

Appendix C: CREFC and Industry Background Industry-led Reforms

Since the crisis, CMBS market participants have sought to address industry weaknesses. A broad variety of stakeholders have taken steps to promote greater levels of discipline in loan origination, structuring, monitoring, and disclosure.

As part of its core mission, CRE Finance Council works closely with its members, including the majority of CMBS issuers, B-piece buyers and servicers, as well as leading investors in the asset class, to establish best practices. In response to the crisis, CRE Finance Council members developed and enhanced several sets of documentation and practice standards, which materially add to market transparency, standardization and efficiency.

The below templates and standards were developed by working groups under the auspices of the CRE Finance Council and staffed by volunteers from the CRE lending, investing and servicing communities. These resources are reviewed and refreshed ongoing, so as to remain relevant and meaningful.

1. ***CREFC Investor Reporting Package (U.S. and EU Versions)***: Standardized and comprehensive package of bond, loan and property level information used extensively in the CMBS marketplace. This data is collected prior to issuance and throughout the life of the transaction.
 - a. ***CREFC Special Servicing Disclosure Reports added to IRP™***: New disclosure reports adopted December 2012 providing increased transparency surrounding special servicer activities, including information regarding affiliates, fees, loan modification decisions, and the final disposition of specially-serviced CMBS loans.
 - b. ***Standardized Annex A***: Provides a deep data dive on the largest loans within the transaction, including enhanced granularity regarding operating statements and additional data with respect to escrow accounts and reserves.
2. ***Pooling and Servicing Agreement (PSA)***: First offered to the public by CREFC's predecessor, Commercial Mortgage Securities Association. Since the crisis, numerous enhancements and modifications have been made, including more specific deal terms and conflict resolution standards for issues involving servicers.
3. ***Model Representations & Warranties***: Standardized set of representations and warranties for inclusion in transaction documentation regarding the accuracy of loans in the pool, including more than 50 parameters. This is a critical feature of CMBS documentation as it enables investors to pursue loan repurchases in the event of material breaches; representations and warranties essentially function as a loan-level form of "skin-in-the-game" for the originators, issuers and sponsors.
4. ***Principles-Based CRE Loan Underwriting Framework***: Set of principles establishing industry best practices in underwriting processes and characteristics, encouraging standardization and lower risk-taking in lending.

Appendix D: Links to CREFC Comment Letters and Submissions

Risk Retention

- June 19, 2014: [Follow-up to Meeting at the Board of Governors of the Federal Reserve System](#)
- February 28, 2014: [Submission to the Agencies regarding risk retention and treatment of SASB & QCRE](#)
- October 30, 2013: [Joint Trade Association comment letter regarding the risk retention proposed rule](#)
- October 30, 2013: [CREFC comment letter regarding the risk retention proposed rule](#)
- July 18, 2011: [CREFC comment letter regarding the original risk retention proposed rule](#)

Reg AB II

- March 28, 2014: [CREFC comment letter regarding asset-backed securities](#)
- October 4, 2011: [CREFC comment letter regarding asset-backed securities](#)
- August 2, 2010: [CREFC comment letter regarding asset-backed securities](#)

Basel Capital Requirements

- March 27, 2015: [Joint trades comment letter regarding capital floors](#)
- August 12, 2014: [Joint trades comment letter regarding treatment of securitization](#)
- July 25, 2014: [CREFC response to BCBS – IOSCO survey on treatment of securitization](#)
- March 24, 2014: [Joint trades comment letter on securitization framework](#)

Basel Liquidity Requirements

- March 13, 2014: [CREFC comment letter regarding the liquidity coverage ratio](#)

Volcker Rule

- February 13, 2012: [CREFC comment letter regarding the Volcker Rule](#)

Appendix E: Timetable for Regulatory Implementation

Rule	Impacted Sector	Concern	Effect	Secondary Effect	Regulator	Status	Fully Effective
Supplementary Leverage Ratio (SLR)	Banks	Risk weightings do not fully capture the risk of a bank	Banks less leveraged	Higher prices/preeds for repo	Fed, FDIC, OCC	Final rule released	January 1, 2018
Liquidity Coverage Ratio (LCR) / High Quality Liquid Assets (HQLA)	Banks, Shadow banking	Banks during the financial crisis did not have enough liquid assets to weather prolonged periods of stress	More difficult for banks to hold non-liquid assets	Higher spreads/less liquidity for RMBS, CMBS	Fed, FDIC, OCC	Final rule released	January 1, 2017
Net Stable Funding Ratio	Banks, Shadow banking	Mismatch between duration of assets and liabilities	Banks punished for liquidity mismatch	Reduction in repo funding	Fed	Not yet proposed	January, 2018 (esL)
CCAR	Banks	Banks and regulators did not have a prospective look at impact of adverse economic scenarios/banks overly aggressive with capital management	Conservative capital management; trapped capital	Reduced lending to marginal credits	Fed	Rule in force	March, 2011
Living Wills	Banks, Nonbank SIFs	No orderly way to unwind large, interconnected firms	Firms required to plan liquidation	Regulators able to force shedding of business lines, products	Fed, FDIC	Rule in force	December 31, 2013
Intermediate Holding Company (IHC)	Banks	U.S. subsidiaries of foreign banks are undercapitalized for their potential risk, allowing for a regulatory arbitrage with U.S. banks	U.S. subsidiaries of foreign banks exiting U.S. market	Fewer counterparties with repo capacity; less liquidity	Fed	Final rule released	July 1, 2016
G-SIB Capital Surcharge	Banks	The largest banks are so large and systemically important on a global scale, they need another layer of capital	Largest banks forced to hold more capital, especially if they use short-term funding	Market share shift to regionals	Fed	Final rule released	January 1, 2019
Total Loss Absorbency Capital (TLAC)	Banks	Banks failed during the financial crisis because they could not raise capital	More longer-term debt issued by banks that can be converted to capital	Increased funding costs for G-SIFs	Fed	Draft rule proposed	January 1, 2022 (proposed)
Margin Requirements for Short-Term Funding	Shadow banking	Too much risk is being taken in short-term wholesale funding	Increase in non-agency repo cost	Decreased liquidity	Fed	Not yet proposed	2018 (esL)
Volcker Rule	Banks, Insurers	Banks using proprietary information to trade against clients' best interests	Elimination of bank proprietary trading desks	Reduction in secondary liquidity could affect M2M	Fed, FDIC, OCC, SEC, CFTC	Rule in force	July 1, 2015
Risk Retention	CRE mREITs	Securitizers do not have enough 'skin in the game' and have not been an effective check on the system	Securitizers must hold share of risk	Higher yields in ABS market; reduced capital in B-piece market	Fed, FDIC, OCC	Final rule released	December 24, 2016
Nonbank SIFI designation	Insurers, asset managers	Certain nonbank financial firms do not have sufficient federal regulation	Designated firms may need to hold more capital	Uneven playing field vs. non-designated firms	FSOC, Fed	Authority effective, capital standards pending	May, 2012
Fundamental Review of the Trading Book	Banks, Shadow banking	VAR models do not accurately reflect risk in trading books	Overhaul of risk measurement	Could prompt selling non-agency inventory, negative M2M impact for mREITs	Basel	Proposed framework released	January, 2018 (targeted)
Guidance on Commercial Real Estate Lending	Banks, CRE mREITs	Possible asset bubble in CRE/are banks taking on too much risk	More scrutiny on banks making CRE loans	Banks less willing to make CRE loans, market share shift to mREITs	Fed, FDIC, OCC	Document released	December, 2015
Guidance on Leveraged Loans	Banks	Banks taking on too much risk in the loans they provide for buyouts	More scrutiny on banks making leverage loans	Banks less willing to make leveraged loans, fewer leveraged buyouts	Fed, FDIC, OCC	Document released	March, 2013
Money Market Fund Reforms	Money market	Fixed NAV provides false assurance that funds will not 'break the buck'/concerns about runs when NAV falls below \$1	Funds pushed to more liquid collateral	Funds could become repo counterparties	SEC	Final rule released	July, 2016
Liquidity Rules for Asset Managers	Asset Managers	Fund managers will not be able to meet redemptions if there are mass redemptions/reducing confidence in mutual funds/ETFs	Shift funds toward more liquid securities	Increased cost of capital for smaller companies; negative impact on bond fund ETFs	SEC	Draft rule proposed	2016-2017 (esL)
Derivative Rules for Asset Managers	Asset Managers	Fund managers taking on too much risk/juicing performance with over reliance of derivatives	Derivative limits for funds	Lower returns for funds; decrease in leveraged ETFs	SEC	Draft rule proposed	2016-2017 (esL)
Stress Tests for Asset Managers	Asset Managers	A failure of an asset manager would shake confidence among retirement savers	Potential higher capital standards and limitations on capital management for asset managers	Could lower returns for funds	SEC	Not yet proposed	2017 (esL)
Additional Rules for Asset Managers	Asset Managers	Current regulations of asset managers have not been updated to reflect their risks	Heightened scrutiny on asset managers, potentially limiting business activities	Could lower returns for funds	SEC	Not yet proposed	2018 (esL)
Fiduciary Standard Rule	Insurers, Asset managers	Investment advisors are not acting in the best interests of their clients	Move all brokers to 'best interest' standard	Lower profitability for broker/dealers and asset managers; limited buyers for certain assets	SEC	Not yet proposed	TBD
Block Trade TRACE Reporting	Banks/Bond trading, Insurers	More transparency is needed in bond market trading	Block trades must be disclosed within 15 minutes	Reduced liquidity and larger bid/ask spreads on FI products; could impact M2M	FINRA	Rule in force	January, 2015

Source: FBR Research

Appendix F: Relevant Regulations and Impacts

The below explanation of the regulatory regime has been excerpted from the CRE Finance Council regulatory impact study [Regulatory Design, Real Outcomes](#) that was published in November 2015.

- The Group of 20 (G20) added financial institution regulation to its agenda in 2009 and designated the Financial Stability Board (FSB) to oversee implementation of extensive remediation that regulators sought in response to the financial crisis.
- In the United States, much of the regulatory agenda is embodied by the Dodd-Frank Act, though policy makers are rolling out additional planks of the G20 agenda outside of Dodd-Frank.
- Much of this regulation applies to the CRE sector, including capital, liquidity, risk retention, Volcker, some asset management requirements, and various reporting and disclosure rules.
- Going forward, there are material changes to come for the CRE sector:
 - Basel III remains a work in progress.
 - Newer elements of the regulatory agenda, especially those extending to the asset management sector and to short-term financing, have not yet been exposed.
 - The question of how regulators will treat systemically important financial institutions (SIFIs) and how that regulation may impact the flow of funds to and within the CRE sector remains a key consideration for the industry.
- While major questions regarding regulatory intent remain to be answered, CRE market participants have observed that questions regarding unintended consequences often arise during the implementation phase. This means that even after a rule is published, the

industry requires a period of dialogue with the regulators to answer outstanding questions of interpretation.

- As the regulatory conformance schedule in the U.S. currently extends into 2019, it is likely that the industry will be absorbing major changes from new rulemaking and implementation into the next decade.

For the CRE bank lending sector, capital and liquidity requirements present the greatest financial challenges of the new rules. For the CMBS sector, the credit risk retention rule is the biggest game changer. As of this writing, Basel III capital and liquidity rules are still evolving, and the credit risk retention (CRR) rule will go into effect late in December 2016. Though the Volcker rule allows CMBS underwriting, it restricts secondary trading to market making. Other meaningful rules, such as Volcker, are in effect or going into effect shortly.

Going forward, the regulators are shifting their focus and plotting course on a number of nonbank fronts. Because much of the crisis can be traced to “liquidity transformation”, or the use of short-term debt to fund longer term assets, the regulators have aggressively addressed these activities within the banking sector already, but intend to extend requirements and oversight to bilateral repurchase agreements (i.e., those that occur outside of the banking system) and possibly to other types of short-term financing.

Collectively, the regulators are also in the beginning phases of articulating priorities around the asset management industry as a whole, though the SEC did finalize rules related to the money market mutual funds already in 2014. In addition, SEC commissioners have mentioned consideration of requirements relating broadly to portfolio composition, risk management and stress testing.

Finally, the agencies continue to work slowly through the questions of SIFI designation and treatment. As of this writing, the authorities have decided to pursue regulation of asset management activities instead of designations, though they hold out the possibility of also designating asset managers and subjecting them to prudential requirements. Because the systemically important insurers (SIIs), many of which have been designated already, and the potential asset manager SIFI designees are prominent CRE lenders and investors, the issue is an important one to the sector. Not only can new requirements influence business strategy at these firms, but they can influence activities across the sector indirectly.

SII capital and liquidity treatment has not been proposed here in the U.S. However, for these institutions, rating agency requirements have represented binding requirements, or the outer bound threshold. Until new regulatory rules have been rolled out in the US, it is not clear which regime will present the strictest set of requirements.

Perhaps the most prominent regulatory issue at this time is the matter of market making and liquidity. Many rules affect the willingness of bank dealers to support secondary market trading, including Volcker, risk based capital, the liquidity coverage ratio, the leverage ratio (which impacts the repo market), and others. Over the course of 2014 and 2015 public discourse on the nature of liquidity and the sources of its contraction has moved between regulators, Congress, business leaders, and the press. For CMBS, turnover volume remains lower than during the crisis, suggesting that the market is indeed structurally different since rulemaking. Market participants generally cite requirements around capital and repos as the primary drivers of the dealers' pullback on balance sheet allocation to the business.

What follows below is a brief set of explanations of rules and other regulatory activities:

Credit Risk Retention (CRR)

The CRR rule, which requires that all sponsors (or B-piece buyers) hold 5% of a transaction for at least five years, was adopted at the end of 2014 and becomes effective at the end of 2016. It is alternately called the “eat-your-own-cooking” rule and is intended to achieve better underwriting in CMBS pools. The requirement is expected to add costs of 10 bps to 50 bps under (2015) conditions.

Revisions to Basel III Risk-Based Capital

The Basel Committee on Banking Supervision (BCBS) is actively revising the foundational concepts underlying the risk-based capital framework and will likely produce final versions of several new standards late in 2015 and early in 2016.

Initiatives regarding capital floors, treatment of credit risk (portfolio lending) and securitizations will impact costs across CRE business lines at large- and medium-sized banks in the future. Based on some industry analysis produced in relation to the BCBS document, “Revisions to the securitisation framework”, we believe that for commercial asset classes with maturities of five years or more, higher capital requirements are expected for most tranches.

The BCBS is also finishing work on the “Fundamental review of the Trading Book” (FRTB), which applies to all assets held for market making purposes. As of this writing (4Q15), the FRTB work stream is possibly one of the most controversial aspects of rulemaking financial system-wide. On average, the requirements as proposed will more than double capital charges for senior and junior bonds, and will be particularly onerous for CMBS as compared to other asset classes. Based on an informal survey of the dealer community, there is a strong majority view that a material number of dealers would drop out of the market, and early estimates of bid-ask spread widening range of hundreds of basis points. Importantly, the industry would have to conform to these requirements after other rules enter into effect.

Basel III Liquidity Ratios

Basel III mandates that large banks adhere to two liquidity ratios—the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR was adopted in 2014 and went into effect at the beginning of 2015. Meanwhile, US regulators are expected to propose the NSFR in (2016).

The LCR adds costs to whole loans that have drawdown features, such as construction loans. The rule also disadvantages private-label and some GSE-sponsored CMBS. Where banks had used CMBS to help manage their asset and liability (ALM) exposures (the difference in duration between their assets and their liabilities), the rule excludes the vast majority of CMBS from the High Quality Liquid Asset (HQLA) designation, which is becoming fairly synonymous with banks' ALM portfolios.

Based on the BCBS's final standards regarding the NSFR, it appears that this rule when adopted in the US will likely add operating costs to balance sheet loans.

Volcker Rule

The Volcker Rule is impacting the industry on many levels. While CMBS are generally allowed under the rule, and most CRE whole loans appear not to be subject to the trading restrictions, the Volcker rule will require the support of substantial infrastructure representing an ongoing cost of doing business.

Registration and Disclosure Rules

New shelf registration requirements and Regulation AB II and other reporting requirements will add costs to CMBS. The new shelf registration requirements will add an estimated \$20,000 per transaction, according to a senior partner at a law firm. FINRA reporting requirements are considered to contribute to reduced secondary trading liquidity.

Total Loss Absorbency Capital

The first international level proposal for Total Loss Absorbency Capital (TLAC) was published by the Financial Stability Board (FSB) at the November 2014 G20 Summit. TLAC essentially acts as a capital floor for large banks and would override risk-based capital at the holding company level, requiring that large banks hold 16% to 18% capital and high-quality debt, not including buffers. Based on analysis performed by The Clearing House, the FSB's proposal will require that banks establish a cushion that is 2.6x to 5.2x the historical need for capital in a crisis.

The Federal Reserve adopted a final rule relating to part of the TLAC, which established the capital base according to the leverage requirements (total assets to risk-based capital) at 2x the international standards for global systemically important banks (G-SIBs).

Appendix G:

Outstanding Loan Balance: Idaho, Massachusetts, Virginia; Data provided by Trepp

Idaho				Idaho			
Loan Status	Loan Count	Current Balance	%	# Loans	Current Bal	Avg DSCR	Avg LTV
Current	261	1,181,667,793	99.2%	264	1,191,306,275	1.57	69.24
Performing Beyond Maturity			0.0%				
30 Days			0.0%				
60 Days			0.0%				
90+ Days			0.0%				
Non-Performing Beyond Maturity			0.0%				
Foreclosure			0.0%				
REO	3	9,638,482	0.8%				
Total	264	1,191,306,275	100.0%				
Idaho				Idaho			
Property Type	Loan Count	Current Balance	%	Orig Year	Loan Count	Current Balance	%
Coop Housing			0.0%	1997			0.0%
Industrial	4	16,597,211	1.4%	1998	1	930,938	0.1%
Lodging	15	119,117,885	10.0%	1999	1	1,394,621	0.1%
Multifamily	147	483,470,743	40.6%	2000			0.0%
Mixed-Use	6	27,285,035	2.3%	2001	3	2,105,025	0.2%
Office	13	156,872,960	13.2%	2002	1	654,977	0.1%
Other	37	109,583,551	9.2%	2003			0.0%
Retail	36	265,538,679	22.3%	2004	3	21,314,521	1.8%
Self Storage	6	12,840,212	1.1%	2005	3	7,767,710	0.7%
Total	264	1,191,306,275	100.0%	2006	13	101,128,019	8.5%
				2007	41	261,689,021	22.0%
				2008	3	4,392,218	0.4%
				2009	2	4,146,955	0.3%
				2010	7	28,232,572	2.4%
				2011	16	59,249,427	5.0%
				2012	14	67,739,837	5.7%
				2013	44	179,644,273	15.1%
				2014	42	154,890,719	13.0%
				2015	50	215,439,318	18.1%
				2016YTD	20	80,586,127	6.8%
				Total	264	1,191,306,275	100%

Massachusetts				Massachusetts			
Loan Status	Loan Count	Current Balance	%	# Loans	Current Bal	Avg DSCR	Avg LTV
Current	1,320	17,062,084,814	97.4%	1,346	17,510,422,363	1.65	71.06
Performing Beyond Maturity			0.0%				
30 Days			0.0%				
60 Days	2	29,460,179	0.2%				
90+ Days	2	12,880,289	0.1%				
Non-Performing Beyond Maturity	1	8,555,719	0.0%				
Foreclosure	6	107,914,717	0.6%				
REO	15	289,526,645	1.7%				
Total	1,346	17,510,422,363	100.0%				
Massachusetts				Massachusetts			
Property Type	Loan Count	Current Balance	%	Orig Year	Loan Count	Current Balance	%
Coop Housing	1	903,210	0.0%	1997			0.0%
Industrial	44	527,395,280	3.0%	1998	11	20,443,927	0.1%
Lodging	33	1,104,117,588	6.3%	1999	5	3,599,060	0.0%
Multifamily	787	6,581,421,689	37.6%	2000	1	664,108	0.0%
Mixed-Use	28	1,396,641,242	8.0%	2001			0.0%
Office	96	4,235,285,910	24.2%	2002	3	2,257,861	0.0%
Other	178	947,368,552	5.4%	2003	5	14,916,727	0.1%
Retail	154	2,604,549,494	14.9%	2004	19	273,644,228	1.6%
Self Storage	25	112,739,398	0.6%	2005	15	193,228,136	1.1%
Total	1,346	17,510,422,363	100.0%	2006	76	1,486,142,180	8.5%
				2007	133	3,648,820,651	20.8%
				2008	17	119,457,505	0.7%
				2009	17	167,105,731	1.0%
				2010	39	432,343,646	2.5%
				2011	60	912,951,257	5.2%
				2012	119	1,610,374,642	9.2%
				2013	193	2,547,881,026	14.6%
				2014	242	2,371,090,256	
				2015	271	2,085,006,065	
				2016YTD	119	1,617,494,014	9.2%
				Total	1,345	17,507,421,019	75%

Virginia			
Loan Status	Loan Count	Current Balance	%
Current	2,220	26,387,324,787	94.2%
Performing Beyond Maturity	2	44,652,972	0.2%
30 Days	3	113,133,205	0.4%
60 Days	1	14,549,522	0.1%
90+ Days	1	2,725,026	0.0%
Non-Performing Beyond Maturity	4	32,480,578	0.1%
Foreclosure	17	670,870,890	2.4%
REO	35	735,981,181	2.6%
Total	2,283	28,001,718,159	100.0%

Virginia			
Property Type	Loan Count	Current Balance	%
Coop Housing			0.0%
Industrial	56	469,497,998	1.7%
Lodging	161	1,964,333,665	7.0%
Multifamily	1,268	13,220,794,464	47.2%
Mixed-Use	30	526,801,305	1.9%
Office	208	5,807,665,413	20.7%
Other	181	821,741,297	2.9%
Retail	332	4,949,167,296	17.7%
Self Storage	47	241,716,720	0.9%
Total	2,283	28,001,718,159	100.0%

Virginia	
# Loans	2,283
Current Bal	28,001,718,159
Avg DSCR	1.56
Avg LTV	73.79

Virginia			
Orig Year	Loan Count	Current Balance	%
1997	7	27385276.73	0.1%
1998	25	38353782.42	0.1%
1999	13	27045940.2	0.1%
2000	1	6583658.81	0.0%
2001	1	462,302	0.0%
2002	4	2,237,925	0.0%
2003	19	34,545,914	0.1%
2004	26	284,169,296	1.0%
2005	33	212,483,976	0.8%
2006	164	2,278,302,118	8.1%
2007	284	5,347,515,548	19.1%
2008	32	328,847,048	1.2%
2009	7	163,122,723	0.6%
2010	44	447,616,044	1.6%
2011	111	2,108,556,668	7.5%
2012	192	2,607,747,745	9.3%
2013	333	4,261,706,977	15.2%
2014	364	3,182,714,576	
2015	425	4,431,304,353	
2016YTD	198	2,211,016,289	7.9%
Total	2,283	28,001,718,159	73%

Appendix H: Overview of Regulatory Process – International and Domestic

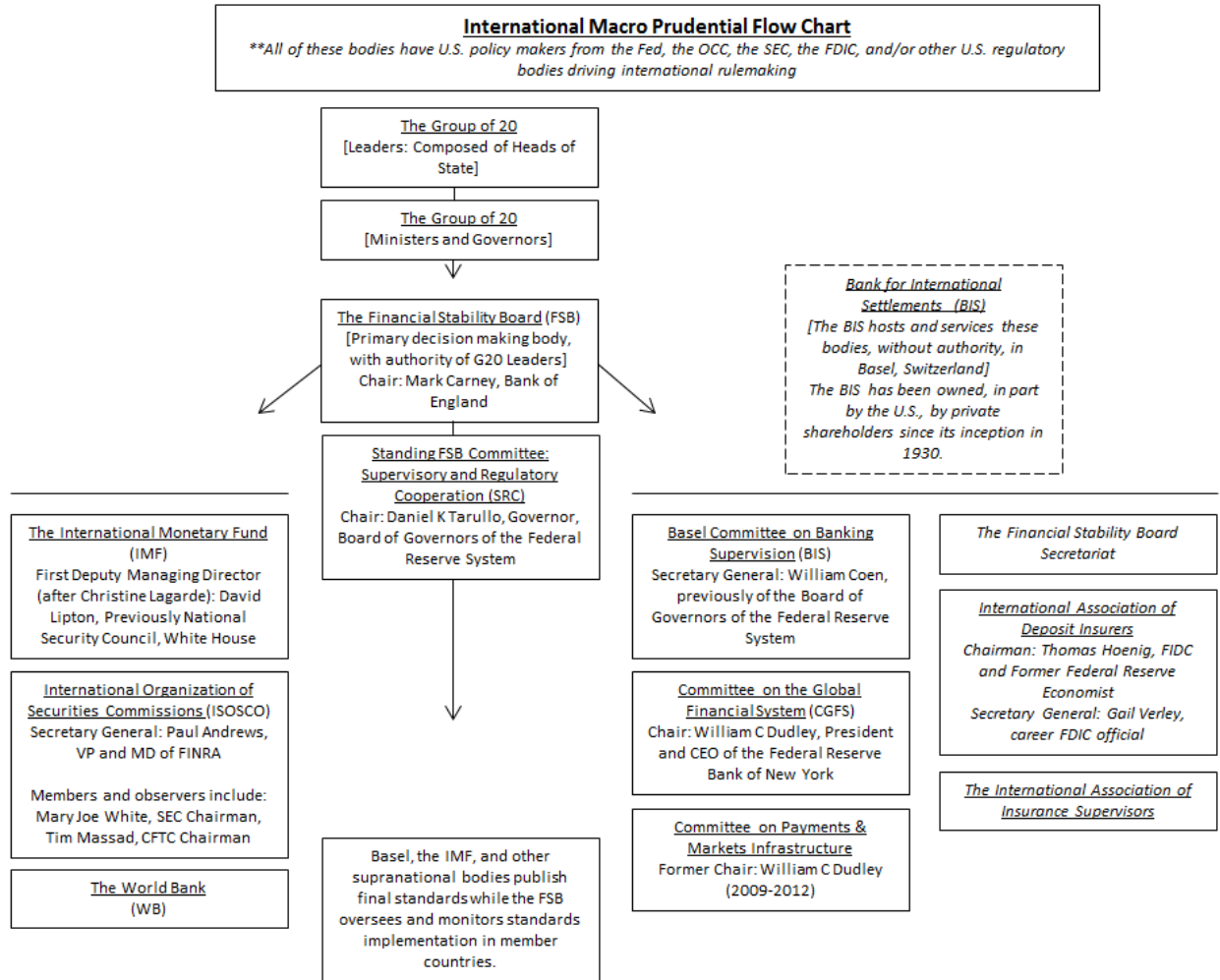
After the financial crisis, the banking industry and the media focused on the new capital and liquidity requirements the Basel Committee for Banking Supervision (BCBS) passed on to U.S. regulators through Basel III. The international regulatory infrastructure is much more layered than is widely known and yet, it is also heavily influenced by U.S. policy-making goals. Today, the BCBS and similar standard setting bodies answer to two supranational groups, the Group of Twenty (G20) and the Financial Stability Board (FSB), which often draw their leadership from the Federal Reserve System (FRS) and other U.S. agencies. Additionally, officials from the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC), and other regulatory bodies often contributed to and even led the development of the regulatory agenda internationally, directly contributing to the increase in capital and liquidity standards contained in Basel III and other rules being adopted at home. Essentially, the G20 and FSB act as the executive, decision-making arm that sets the international agenda, while the various Basel committees consult, research, and publish the rules that carry out these international regulatory goals.

What is the Systemic Risk Agenda? Who are the Macro Prudential Regulators?

In the post-financial crisis era, nations recognized and felt the impact and toxicity of excess financial leverage. Rightfully so, leaders called for a coordinated response effort, and more importantly, a framework to prevent similar crises in the future. The largest nations and emerging market economies under the leadership of the G20, met to expand existing supranational regulatory bodies as well as create new ones. Collectively, these nations set out to weed out systemic risk and promote economic growth and stability.

Since 2009, an aggregation of supranational bodies led by the FSB, with the distinct power granted by the leaders of the G20, leads the international regulatory rulemaking, implementation, and oversight process. Organizations, including the BCBS, International Organization of Securities Commissions (IOSCO), Bank for International Settlements (BIS), Committee on the Global Financial System (CGFS), The World Bank (WB), and the International Monetary Fund (IMF), all serve various decision-making, research, implementation, and oversight roles within, but underneath, the supervision of the G20 and the FSB.

No single nation is “in charge” and no single body exists to implement policy or regulations from the international level; individual jurisdictions are responsible for tailoring and adopting requirements through their own legislative and / or rulemaking frameworks. Sovereign nations are responsible for implementing and monitoring their own capital, liquidity, and risk management rules across their banking and financial services industries. With each subsequent international financial crisis, supranational standard setting bodies have emerged with more influence and the ability to create “soft law” in the wake of financial turmoil.



The Group of 20 (G20)

The G20 is generally considered one of the preeminent organizations on international matters, especially international financial regulation. Self-appointed in 2009, the body expanded upon the G7 to include larger developing economies in order to better account for systemic risk, and includes the 19 member countries plus the European Union (EU). G20 member countries account for 86% of global GDP, 90% of global banking assets, and 94% of the global bond market.

The G20 is split among two levels: 1) G20 Leaders, made up of heads of state; and 2) G20 Governors, made up of central bankers and treasury officials and their equivalents. The leaders

meet on a near-annual basis to review work of the G20 Ministers and set the agenda for the ministers' future work, while ministers execute the Leaders' agenda on an ongoing basis.

Financial Stability Board (FSB)

The FSB is the primary global decision making body, and has been since the G20 created the FSB in 2009 to coordinate international financial regulation.

“The FSB promotes international financial stability; it does so by coordinating national financial authorities and international standard setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies...the FSB, working through its members, seeks to strengthen financial systems and increase the stability of international financial markets. The policies developed in the pursuit of this agenda are implemented by jurisdictions and national authorities.”

The FSB Charter derives its authority from the G20 Leaders' statement explaining that the FSB should be “given a broadened mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced capacity” including responsibilities such as reviewing, coordinating, and addressing gaps among the “international standard setting bodies” (i.e., Basel, etc.) and “oversee action needed” to address financial system vulnerabilities.”

The FSB's previous iteration, the Financial Stability Forum, served a consultative function with international standard setting bodies. However, in 2009, the heads of state of the largest economies of the world improved the FSB's mandate to implement the overarching regulatory agenda and ensure implementation of the rules published by international standard setting bodies.

The FSB is currently chaired by Mark Carney, Governor of the Bank of England. Carney directs the Plenary, a committee of 69 members from FSB member countries, international financial institutions, and international standard setting bodies. Members of the Plenary include representatives from the G20 countries, the World Bank, the IMF, the BIS, the ECB, the European Commission, the BCBS, the IAIS, IOSCO, IASB, CGFS, and the OECD.

The Secretariat of the FSB is located in Basel, Switzerland, and is hosted by the Bank for International Settlements. The Secretariat has 33 members and supports the policy development and activities of the FSB. The Secretariat is noted here because of its proximity and closeness to the “Basel Process,” explained in the next section. The proximity and location of the FSB in Basel further engenders the close thinking of the economists, central bankers, and regulators that work out of the various committees hosted by the Bank for International Settlements.

The Bank for International Settlements (BIS)

The Bank for International Settlements hosts a number of international standard setting bodies – notably the Basel Committee on Banking Supervision and the Committee on the Global Financial System – that are physically housed at the BIS facilities. In fact, all but IOSCO are located in Basel.

The best-known committee, the BCBS, was formed in 1974 by the Group of 10 (G10) in the wake of economic turmoil – the collapse of fixed exchange rates, rising oil prices, interest rate fluctuations, and bank failures. Prior to the creation of the BCBS, the BIS served as an international meeting place and information exchange for central bankers. It became the supranational regulatory body it is today in the early 90’s after the Federal Reserve formally joined the Basel Process and the BIS.

BCBS membership includes central banks and regulatory authorities (in the U.S.: FRS, OCC and FDIC); and other international groups including the BIS, the IMF, the Basel Consultative Group (a liaison group to non-members), the European Banking Authority, and the European Commission. “The Basel Process is based on three key features: synergies of co-location, flexibility and openness in the exchange of information, and support of the BIS’s expertise in economics, banking, and regulation.”

BIS Ownership and Founding

The BIS is a private, for-profit firm. It was created principally as a bank – to take deposits and make loans, while providing trustee and agent services for its central bank clients. It formed in 1930 as a commercial bank with public shares, which were primarily offered to central banks. Eighty-six percent of BIS stock is owned by central banks while 14% is owned privately by public shareholders. Ownership entitles shareholders to dividend payments but only member central banks are entitled to sit on the BIS board or attend board meetings – which are notoriously secretive making its importance and banking services difficult to quantify.

Today, the U.S. sits on the board of BIS and has since 1994 when it quietly joined the organization. In 1930, the Federal Reserve was barred from owning shares or from formal BIS board participation, instead, shares were held in a trust by First National City Bank.

Importantly, the bank's charter and statutes explicitly state that the bank was set up to execute the monetary policy of its member banks. If a member bank disagrees with a financial transaction that the BIS plans to execute, member banks (who collectively own the BIS) have the ability to dissent and stop a transaction.

International Organisation of Securities Commissions (IOSCO)

The International Organisation of Securities Commissions, also known as IOSCO, is the international body that connects the world securities' regulators – in the U.S., the Securities and Exchange Commission. It was established in 1983 and operates out of Madrid, Spain – a notable departure from most of the standard-setting bodies based out of Basel.

The organization's stated purpose is to maintain fair and transparent markets while addressing systemic risks. It is governed by the IOSCO board, comprised of 33 securities regulators, including Tim Massad, Chair of the CFTC, and Mary Jo White, Chair of the SEC.