July 11, 2011

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Subject: **Credit Risk Retention — *OCC* (Docket No. OCC-2011-0002, RIN 1557-AD40), *Federal Reserve System* (Docket No. R-1411, RIN 7100-AD-70), *FDIC* (RIN 3064-AD74), *FHFA* (RIN 2590-AA43), *SEC* (File No. S7-14-11, RIN 3235-AK96), *HUD* (Docket No. FR-5504-P-01, RIN 2501-AD53); *MBA Commercial and Multifamily Mortgage Finance Comment Letter***

Ladies and Gentlemen:

The Mortgage Bankers Association[1] ("MBA") welcomes the opportunity to respond to the proposed rule on credit risk retention ("Proposed Rule")[2] issued by the Office of the

[1] The Mortgage Bankers Association is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. For additional information, visit MBA's Web site: www.mortgagebankers.org.

[2] 76 Fed. Reg. 24090 (April 29, 2011).

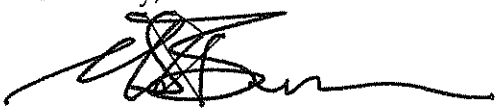
Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Securities and Exchange Commission, Federal Housing Finance Agency, and Department of Housing and Urban Development (collectively, the "Agencies"). MBA's membership of over 2,200 companies includes all elements of real estate finance such as mortgage companies, mortgage brokers, commercial banks, Wall Street conduits, life insurance companies, servicers and others in the mortgage lending field. MBA commends the Agencies for the extensive effort and coordination to implement the risk retention provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The views and recommendations contained in the attached letter are from the **commercial and multifamily mortgage finance ("commercial") perspective**. The views of MBA's members related to the single family residential ("residential") markets will be submitted separately. Because the Proposed Rule establishes unique risk retention frameworks for residential mortgage backed securities ("RMBS") and commercial mortgage backed securities ("CMBS"), MBA is submitting two comment letters.

MBA believes that risk retention is an important step to ensuring a safe and reliable real estate finance system. At the same time, it is essential that any risk retention requirements be implemented appropriately so as not to constrain liquidity. In particular, MBA notes that one element of the Proposed Rule, the Premium Cash Capture Reserve Account ("PCCRA"), would be highly detrimental to *both* residential and commercial mortgage securitization markets. The PCCRA would be placed in a first-loss position from which all losses of a securitization would be first subtracted. Both commercial and residential members have reported that this would severely and negatively alter the structure of both RMBS and CMBS in a manner that calls into question the viability of new CMBS and RMBS issuances. Both the residential and commercial letters provide a more comprehensive examination of the PCCRA and numerous other issues.

MBA is committed to facilitating the establishment of a fully-functioning, transparent, liquid and responsible securitization market for commercial and residential mortgages. We look forward to working with the Agencies to finalize the Proposed Rule in a manner that aligns interests among market participants and reinvigorates the mortgage finance system.

Sincerely,



Michael D. Berman, CMB
President & Chief Executive Officer, CWCapital
Chairman, Mortgage Bankers Association

Attachment

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Ladies and Gentlemen:

The Mortgage Bankers Association[1] ("MBA") welcomes the opportunity to provide its views and recommendations from the commercial and multifamily mortgage finance perspective in response to the proposed rule on credit risk retention ("Proposed Rule").[2]

[1] The Mortgage Bankers Association is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters

The Proposed Rule implements the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934,[3] as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act"),[4] and was jointly issued for comment by the Office of the Comptroller of the Currency, Treasury ("OCC"), Board of Governors of the Federal Reserve System ("Federal Reserve Board"), Federal Deposit Insurance Corporation ("FDIC"), U.S. Securities and Exchange Commission ("Commission"), Federal Housing Finance Agency ("FHFA"), and Department of Housing and Urban Development ("HUD") (collectively, the "Agencies"). Section 15G generally requires the securitizer of asset-backed securities to retain not less than five percent of the credit risk of the assets collateralizing the asset-backed securities. Section 15G includes a number of exemptions from these requirements, including an exemption for commercial mortgage-backed securities ("CMBS") that meet certain conditions.

MBA recognizes the extensive effort and coordination that were required to develop and publish the Proposed Rule. We commend the Agencies for their thoughtful consideration of the numerous and complex aspects of the Dodd-Frank Act's risk retention provisions. In developing our response to the Proposed Rule, MBA worked with its broad-based commercial/multifamily real estate ("CRE") finance membership, including CMBS issuers, originators, servicers, and investors, as well as mortgage bankers, portfolio lenders, attorneys and accountants.

Public Policy Principles Underlying Risk Retention Recommendations

MBA is committed to facilitating the establishment of a fully-functioning, transparent, liquid and responsible securitization market for commercial and multifamily real estate mortgages. Because the CMBS market involves a complex set of interactions among numerous stakeholders, policy actions for this market should:

- Advance an alignment of interests among investors, issuers, originators, servicers and borrowers;

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professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies, including all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

[2] 76 Fed. Reg. 24090 (April 29, 2011).

[3] 15 U.S.C. § 78o-11.

[4] Public Law 111-203, 124 Stat. 1376-2223 (July 21, 2010).

- Support credible, safe and sound lending practices that reflect the needs and sophistication of issuers, investors, and the owners of commercial and multifamily real estate properties;

- Support the efficient flow of mortgage capital from investors to borrowers;

- Help restore investor confidence and the ability of investors to accurately assess the risks in the collateral and the securitization structure;

- Ensure risks are properly assessed, mitigated and/or priced by those who assume or control them;

- Increase transparency across all aspects of the market, assuring adequate information for investors while protecting individual privacy and proprietary business models; and

- Provide flexibility to allow for a number of different forms of risk retention and risk allocation.

Summary of Core MBA Recommendations

Consistent with these policy principles, MBA's recommendations, discussed in greater detail throughout this letter, are as follows:

- **Premium Capture Cash Reserve Account ("PCCRA").** MBA expresses strong objections to the PCCRA and recommends its elimination. As proposed, we believe that it would be exceedingly disruptive to the CMBS market (which relies on the Interest Only ("IO") tranche for expense recovery and a return on capital), and effectively would remove the financial incentive to issue CMBS, potentially eliminating CMBS as a potential source of permanent mortgage capital for commercial/multifamily real estate borrowers.

  MBA believes that the following methodologies to calculate the retained credit risk should replace the PCCRA. For the **vertical slice**, the *net sale proceeds* multiplied by 5 percent would be the appropriate methodology that would obviate the need for the PCCRA. For the **horizontal slice**, we believe the methodology should be based on the par value (defined as the par values of the securities, which for REMIC purposes equates to the unpaid principal balance of the loans securitized) multiplied by 5 percent, and that the net weighted average coupon ("WAC") of the qualifying horizontal slice be no less than that of the entire pool. These methodologies also should determine the manner in which the required risk retention position is calculated under the vertical and horizontal risk retention structures.

- **Risk Retention Structures and Optional "Menu" Approach.** MBA supports the optional menu approach for risk retention structures in the Proposed Rule because it provides flexibility for a broad range of market participants. MBA also recommends additional risk retention structures that are consistent with risk retention requirements, such as variations on the vertical slice that effectively retain substantially similar credit risk (whether at the loan-level or in a single security), as well as the GSE multifamily risk retention models. Other structures should be permissible where strong contractual obligations exist and the sponsor is financially positioned to meet those obligations.

- **Risk Retention Hold Period and Hedging of Credit Risk.** The CMBS market provides extensive and robust transparency with regard to the performance of underlying loans, which allows investors the opportunity to determine loan performance and identify loans or securitizations that are not performing as expected. Accordingly, the required risk retention hold period should be three years for all risk retention holders, including issuers, originators, and first-loss B-piece buyers. In addition, at the time of issuance, the retention period (whether the three year minimum hold period or a longer voluntary duration) must be declared and disclosed by the holder of risk retention, which would encourage the market to consider the holding period in pricing the issuance based on the confidence of the sponsor in the pool's assets. After the three years (or other declared period), the risk retention holder would be permitted to transfer, sell, or hedge the risk retention. Where a third-party purchaser assumes the risk retention position, the party that subsequently assumes the position (after the applicable holding period) should be a qualified transferee.

- **Financing of Risk Retention Interests.** MBA recommends allowing sponsors and third-party purchasers to use some financing to fund its risk retention position, including first-loss, horizontal "B-piece" interests. Prohibiting all such financing would limit the incentive to engage in securitizations and, in particular, reduce the number of third-party purchasers willing to assume the risk retention role and increase the cost of securitization (and ultimately, the cost to borrowers). MBA recommends that no distinction be made between the sponsor's ability to finance its risk retention interest compared to third-party purchasers.

- **Third-Party Risk Retention and Operating Advisors.** In lieu of an Operating Advisor with broad unilateral powers beginning at the inception of the securitization, we recommend the following framework that enhances disclosure, establishes dispute resolution mechanisms, and creates an appropriate, targeted role for the Operating Advisor. Specifically, a special servicer (affiliated with the third-party "B-piece" purchaser fulfilling a risk retention role) should be required to provide enhanced disclosure of relevant information in one consolidated place that is maintained by a

third-party source independent of the B-piece buyer/special servicer. The pooling and servicing agreement ("PSA") or other governing documents would require access to information about completed workouts and other publicly-available information about the special servicer's activities that enables investors to evaluate the activities of the special servicer and whether the servicing standard is being met.

The risk retention rule also should require the PSA or other governing document to set forth a dispute resolution mechanism available for investors, including the ability of investors to demand an investigation of possible noncompliance by the special servicer on demand from a specified percentage of certificate-holders.

Finally, the Operating Advisor's role should begin when a change in control event occurs through the application of appraisal reductions and realized losses to a level specified in the PSA. Upon the change in control event, the Operating Advisor's role would be that of oversight, serving as a watchdog and playing a monitoring role, and to investigate claims of noncompliance initiated by the specified percentage of certificate-holders.

- **Disclosures Regarding Third-Party Purchasers.** MBA recommends appropriate disclosures by third-party purchasers serving in a risk retention role that aligns the interests of CMBS investors but refrains from requiring disclosure of proprietary information or other information unrelated to its role as a B-piece investor. The issuer and/or third-party purchaser would be required to represent/declare that the purchase price paid for the eligible horizontal interest was adequate to fulfill the risk retention role.

- **Underwriting Standards for Zero Risk Retention.** Because underwriting is both an art and a science, a metrics-only approach for specifying underwriting standards is not well suited for identifying low-risk loans. MBA's recommended underwriting requirements strive to be responsive to the Proposed Rule requirement of identifying low-risk loans, while at the same time recognizing the inherent challenges with defining such loans through a metrics-only approach. Our recommendations enhance greater transparency, modify the regulatory metrics to take into account unique aspects of commercial/multifamily real estate finance, and seek to establish strong, industry-developed representations and warrantees with meaningful remedial mechanisms.

  MBA therefore recommends revised metrics for a low-risk loan and changes to the Proposed Rule that would make the standards consistent with long-held CRE lending practices, ultimately providing a more meaningful exemption under the low-risk loan statutory directive.

Organization of MBA Comment Letter

Our letter is organized as follows:

- **Section I** provides an overview of the commercial mortgage and CMBS markets, including the ongoing and extensive loan-level transparency that exists. Because of the unique characteristics of commercial mortgages and the structural features of CMBS, credit risk-management largely drives the securitization of this asset class.

- **Section II** describes the legal framework that governs risk retention under the Dodd-Frank Act, identifies the statutory requirements applicable to commercial mortgages, and underscores the asset-class-specific regulation contemplated by Congress and other policymaking bodies.

- **Section III** discusses the proposed Premium Capture Cash Reserve Account ("PCCRA"). This section discusses the regulatory intent underlying PCCRA and its mechanics. We then express MBA's opposition to the PCCRA and recommend the risk retention calculation methodologies that should replace the PCCRA.

- **Section IV** discusses the forms of risk retention set forth in the Proposed Rule. This section expresses general support for the "menu of options" approach in the Proposed Rule and provides recommendations for additional structures that would provide broader flexibility and optionality for a range of market participants, as well as modifications to the structures in the Proposed Rule.

- **Section V** addresses issues relating to the duration, transfer and hedging of credit risk positions. The section describes the extensive and ongoing transparency that exists at the loan level, which supports a holding period short of the life of the securities; our alternative approach, therefore, is presented.

- **Section VI** focuses on rules that would govern third-party purchasers fulfilling the risk retention role. This section discusses the existing role of third-party B-piece purchasers in the CMBS market, the Operating Advisor, the hedging, transfer and financing restrictions on B-piece buyers, disclosure requirements, and definitional clarifications.

- **Section VII** comments on the proposed underwriting standards for zero-risk retention. This section discusses the principles that should guide the underwriting criteria for low-risk loans, including the fact that underwriting relies on both qualitative and quantitative analyses. Nonetheless, we underscore that the underwriting standards in the Proposed Rule contain some fundamental lapses and, therefore, recommend that they should be revised in material ways.

Finally, our submission includes appendices that supplement several topic area discussions.[5]

I. OVERVIEW OF COMMERCIAL/MULTIFAMILY MORTGAGES

A. Commercial Real Estate Finance

Commercial and multifamily real estate — apartment buildings, office buildings, shopping malls, industrial facilities, health care and hotel properties — house virtually all of the nation's businesses, and a full one-in-seven of its households.[6]

Commercial mortgages are generally long-term loans (typically maturing 5, 7 or 10 years after they are made and amortizing over a longer period), collateralized by the commercial property itself. They typically have a balloon payment on their maturity. Many commercial mortgages, particularly those with 10-year terms, have prepayment restrictions; that is, if the property owner wishes to repay the mortgage prior to its maturity date, the lender/investor must be compensated for the lost interest income that was due. Commercial mortgages are underwritten based on a detailed analysis of the property, its income and its value. A common characteristic among the categories of CRE is that the majority of property income is generated through lease income.

In addition to analysis of the sponsors and the property market, underwriting focuses on a property's net operating income and its value to determine the appropriate size of the loan. The net operating income is assessed to ensure that the property's cash flows can support the property operation, reserve funds for necessary capital improvement and cover mortgage payments due on the loan. Rents, other income, expenses, and other factors are taken into account and the resulting net operating income is compared to the required debt service to derive a debt service coverage ratio. Notably, in CMBS, this critical operating income analysis is re-performed generally on a quarterly basis as operating statements are received from the property owner. Should the property owner default on the mortgage, the lender/special servicer has a variety of options including modifying the mortgage, extending the mortgage, foreclosing on the property, or selling the non-performing mortgage to another lender/investor. Appendix A contains a more detailed description of the CRE finance market.

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[5] Throughout MBA's comment letter, we also reference, in footnotes, specific questions posed in the Proposed Rule. The Appendix also includes analyses that support the recommendations discussed herein.

[6] US Census Bureau, 2007 American Housing Survey.

B. Commercial Mortgage-Backed Securities

In CMBS transactions, commercial and multifamily mortgages, which typically vary in size, property type and location, are pooled together, and a series of securities are structured ("tranched") so that the principal and interest payments from the mortgages flow through to security investors in a waterfall, with investors in the most secure bonds being paid first, and investors in the least secure bonds being paid last. Because the lower risk securities generally pay a lower yield and the higher risk securities pay a higher yield, the structure allows investors to buy bonds with the risk/return profile they desire. The CMBS market represents about 26 percent of the outstanding balance of commercial and multifamily mortgages.[7]

The typical structure for the securitization of CRE loans is a real estate mortgage investment conduit ("REMIC"), which allows the trust to be a pass-through entity that is not subject to tax at the trust level. The CMBS transaction is structured and priced based on the assumption that it will not be subject to tax with respect to its activities and is assumed to be passive; therefore, compliance with REMIC regulations is essential.

The various bond classes issued by a trust are assigned credit ratings by two or more nationally recognized credit rating agencies.[8] Each month, the interest received from all of the pooled loans is paid to the investors, starting with those investors holding the highest priority bonds (generally rated AAA), until all accrued interest on those bonds is paid. Then interest is paid to the holders of the next priority bonds and so on. The same process is followed with principal as payments are received. This sequential payment structure is generally referred to as a "waterfall." If there is a shortfall in contractual loan payments from the borrowers or if loan collateral is liquidated and does not generate sufficient proceeds to meet payments on all bond classes, the investors in the most subordinate bond class will incur the first-losses, with further losses continuing up the waterfall structure.

Investors choose which CMBS bonds to purchase based on the level of credit risk/yield/duration that they seek. Because higher priority securities have the higher priority on interest and principal payments, they have the lowest level of potential risk and the lowest yield. The differing payment priority and yields of the various CMBS bond classes allow investors to align their bond purchases with their individual risk/reward profile.

The CMBS market features unique characteristics that impact the structure, processes and transparency related to securitization.

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[7] MBA Commercial/Multifamily Quarterly Data Book, Q1 2011.

[8] "Investment grade" ratings range from AAA/Aaa through BBB-/Baa3. Non-investment grade securities are rated from BB+/Ba1 through B-/B3. A portion of the bonds are subordinate to the lowest rated bond class (B-/B3) and are unrated.

- CMBS is secured by fewer, larger, heterogeneous assets which allows for thorough due diligence and detailed disclosure.

- CMBS has standardized information reporting across the industry for upfront and ongoing disclosure of pool, loan and property information that highlights risk.

- The standard CMBS package of reports (Investor Reporting Package or "IRP") evolves with the market. It currently includes data files, surveillance reports, templates to ensure a standard approach to calculations and event reports. The IRP is reviewed periodically and updated based on suggestions from industry participants.

- IRP standard reporting is distributed to the investors monthly and is generally available on servicers', trustees' and third-party data providers' websites, allowing investors to access such detailed information as: Mortgage property level net operating income and debt service coverage ratios; most recent inspection report information; payment records; and borrower financial statements. In all, the IRP includes four servicer data files, ten surveillance reports/worksheets, six templates, two event reports and two trustee files. Information available to investors ranges from payment and delinquency information to property level financial data to watchlist reports and bond level reports. These reports have evolved from inception in 1997 (the current version is 5.1) and are the result of market changes. The reporting package was specifically developed in response to the investor's need to evaluate portfolios in a consistent and timely manner.

- CMBS is generally structured with a "first loss bond" — or "B-piece" — that is purchased predominantly by real estate investors who thoroughly review and analyze individual real estate risk. These investors have the opportunity to review mortgage pools on a mortgage-by-mortgage basis and reject specific mortgages excluding them from a pool.

- Flexibility is built into the CMBS structure to permit the workout of a troubled loan and to avoid foreclosure when other options provide the highest net present value to the bond holders.

Importantly, credit risk analysis and assessment have always been dominant features of the CMBS market. While analysis, pricing, and trading of many other types of asset-backed securities have often been driven by prepayment assumptions and considerations, the existence of prepayment restrictions on the underlying commercial and multifamily mortgages has meant that credit risk, rather than interest rate changes and other factors that affect refinancing

volumes, have been the main focus of CMBS originators, securitizers, rating agencies, investors and others.[9]

II. COMMERCIAL REAL ESTATE MORTGAGES UNDER THE DODD-FRANK ACT

A. Statutory Framework Governing Commercial Real Estate Mortgages

Consistent with the discussion above, the Dodd-Frank Act provides specific direction —and broad latitude — to regulators on the treatment of CRE mortgages. The Dodd-Frank Act generally provides that "the Federal banking agencies and the Commission shall jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party."[10] While many provisions of the Act are generally applicable across asset classes, Congress directed the Agencies to consider the unique characteristics of CRE mortgages.

Section 15G(c) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended by the Dodd-Frank Act, generally sets forth the "Standards for Regulations"[11] with regard to risk retention; subparagraph (B) of section 15G(c)(1) "require[s] a securitizer to retain —

(i) not less than 5 percent of the credit risk for any asset —
  (I) that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer; or
  (II) that is a qualified residential mortgage that is transferred, sold or conveyed through the issuance of an asset-backed security by the securitizer, if 1 or more of the assets that collateralize the asset-backed security are not qualified residential mortgages; or

(ii) less than 5 percent of the credit risk for an asset that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if the originator of

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[9] During the mid-2000s, when competition among investors to purchase CMBS — and among securitizers to issue CMBS — increased and lending and underwriting terms became more competitive, the credit focus of the CMBS market led to the creation of "super senior" AAA CMBS securities. Super senior bonds have higher subordination levels than are required for them to be rated AAA. Because investors are willing to pay more (*i.e.,* accept a lower yield) to buy these more credit-event remote bonds, this natural market recognition and response to changing credit risks has became a regular part of the CMBS market.

[10] Exchange Act § 15G(b)(1).

[11] Exchange Act § 15G(c).

> the asset meets the underwriting standards prescribed under paragraph (2)(B)."[12]

While subparagraph (B) of section 15G(c)(1) above sets forth a "5 percent of credit risk" standard, that provision (which establishes the "qualified residential mortgage" concept) focuses primarily on single-family residential mortgages.

Subparagraph (E) — which is *devoted exclusively* to risk retention in *commercial mortgage* securitizations — references subparagraph (B) of section 15G(c)(1). Subparagraph (E) provides broad authority to the Federal banking regulators and the Commission, permitting them to "specify the permissible *types*, *forms*, and *amounts* of risk retention that would meet the requirements of subparagraph (B)"[13] with respect to commercial mortgages. In doing so, the Agencies "may include . . . retention of a *specified amount or percentage* of the total credit risk of the asset . . . ."[14]

Two observations are clear from this statutory language. First, the regulators possess broad latitude in determining the "specified amount or percentage of the total credit risk of the asset" in the context of commercial mortgage securitizations.

Second, the statutory focus is "credit risk." Intuitively, credit risk in the case of CMBS refers to potential principal losses to bond holders associated with loan defaults. It therefore follows that the manner in which the percentage of "credit risk" is calculated should take into account the risk retention structure. Indeed, the Dodd-Frank Act's legislative history directs regulators to make *appropriate adjustments* to the amount of risk retention required: "The Committee expects that these regulations will recognize differences in the assets securitized, in existing risk management practices, and in the structure of asset-backed securities, and that the regulators will make *appropriate adjustments* to the amount of risk retention required."[15]

In the case of the 5 percent "vertical" risk retention slice, risk retention of 5 percent of each and every security class issued would be required. Consequently, the "at risk" portion of the vertical slice would be concentrated in the 5 percent share of the first-loss tranche(s). In the case of horizontal risk retention, however, *all* of the 5 percent risk retention would be concentrated in the first-loss position. Consequently, the amount of credit risk assumed by a 5 percent "vertical" slice of each security class fundamentally differs from a 5 percent first-loss, "horizontal" position, and accordingly, requires customized methodologies for calculating required risk retention amounts

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[12] Exchange Act § 15G(c)(1)(B).
[13] *Id.* (emphases added).
[14] Exchange Act § 15G(c)(1)(E)(i) (emphasis added).
[15] S. Rep. No. 111-176 at 130 (2010) (emphasis added).

— as well as under the PCCRA. Appendix B provides examples of vertical and horizontal risk retention and their associated risk profile.

As discussed below, the manner in which the "credit risk" retained is calculated is integrally tied to the risk retention structure adopted. We urge the Agencies to utilize the statutory flexibility for commercial mortgages with regard to the calculation of the "amount or percentage of the total credit risk" — for purposes of the various risk retention structures permitted and the PCCRA — taking into account the character of the credit risk retained.

B. Importance of Asset Class-Specific Regulation

Section 941 of the Dodd-Frank Act expressly contemplates differentiation among the securitization of various asset classes. The Dodd-Frank Act's legislative history underscores the asset class-specific regulation contemplated by the drafters: "The Committee believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes."[16]

The Federal Reserve Board, in its *Report to the Congress on Risk Retention* issued in October 2010, recognized considerable heterogeneity across asset classes in securitization transactions.

> Thus, consistent with the flexibility provided in the statute, the Board recommends that *rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets. Such an approach could recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized. Asset class-specific requirements could also more directly address differences in the fundamental incentive problems characteristic of securitizations of each asset type, some of which became evident only during the crisis*.[17]

Consequently, a one-size-fits-all approach to risk retention would be ill-advised, resulting in credit curtailment in certain sectors and unintended consequences across a number of asset classes. As the Federal Reserve Board further recommended, rulemaking authorities should:

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[16] S. Rep. No. 111-176 at 130 (2010).

[17] Board of Governors of the Federal Reserve System, *Report to the Congress on Risk Retention* (Submitted to the Congress pursuant to section 941 of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010) (October 2010) (hereinafter, "Federal Reserve Board Risk Retention Study") at 3. Section 941(c) of the Dodd–Frank Act required the Federal Reserve Board to conduct a study and issue a report not later than 90 days after the date of enactment on the effect of the new risk retention requirements to be developed and implemented by the federal agencies, and of Statements of Financial Accounting Standards Nos. 166 and 167 (FAS 166 and 167) (emphases added).

> *Consider the economics of asset classes and securitization structure in designing credit risk retention requirements.* Given the degree of heterogeneity in all aspects of securitization, a single approach to credit risk retention could curtail credit availability in certain sectors of the securitization market. A single universal approach would also not adequately take into consideration different forms of credit risk retention, which may differ by asset category. Further, such an approach is unlikely to be effective in achieving the stated aims of the statute across a broad spectrum of asset categories where securitization practices differ markedly.[18]

Accordingly, MBA recommends that the Agencies move cautiously in developing rules that generally apply across asset-classes. Where appropriate, the risk retention rule should be crafted in a manner that recognizes the economics and market dynamics of the particular securitization market. We urge the Agencies to adopt this approach as they consider the commercial/multifamily real estate sector.

III. PREMIUM CAPTURE CASH RESERVE ACCOUNT

The Proposed Rule was drafted, for the most part, to implement specific provisions of the Dodd-Frank Act. The concept of the PCCRA was created on a whole-cloth basis without specific foundation in the Act. Given the PCCRA's potential departure from the Dodd-Frank Act's base risk retention level, MBA worked with its members to closely examine the PCCRA and recommend a replacement structure that falls within the legislative intent of the Dodd-Frank Act, while at the same time ensuring adequate monetary value in the horizontal risk retention slice that may be purchased by a third-party.

We discuss our opposition to the PCCRA and our replacement recommendations below.[19]

A. Regulatory Intent Underlying PCCRA

The Proposed Rule defines the PCCRA and the intent of the regulators:

> Accordingly, as proposed, if a sponsor structures a securitization to monetize excess spread on the underlying assets—which is typically effected through the sale of interest-only tranches or premium bonds—the proposed rule would ''capture'' the premium or purchase price received on the sale of the tranches that monetize the excess spread and require that the sponsor place such amounts into a separate ''premium capture cash reserve account." The amount placed

[18] Federal Reserve Board Risk Retention Study at 83-84 (emphases added).
[19] Discussion responsive to Question 83 of Proposed Rule.

> into the premium capture cash reserve account would be separate from and in addition to the sponsor's base risk retention requirement under the proposal's menu of options, and would be used to cover losses on the underlying assets before such losses were allocated to any other interest or account. *As a likely consequence to these proposed requirements, the Agencies expect that few, if any, securitizations would be structured to monetize excess spread at closing and, thus, require the establishment of a premium capture cash reserve account, which should provide the benefits described above.*[20]

The Agencies appear to have designed the PCCRA in such a way that issuers would effectively be prevented from earning any profit by selling bonds for more than their par value. Since the IO strip is the primary mechanism for issuers to recover their overhead and hedging costs and make a reasonable return on capital, the elimination of the IO strip would effectively eliminate the financial incentive for issuing CMBS. MBA strongly believes that the PCCRA would fundamentally and radically alter the incentives for creating CMBS and would result in a dramatic downturn or stoppage of new CMBS issuance.

Through the PCCRA, the Proposed Rule appears to stigmatize profits associated with "excess spread." However, such profits in CMBS are a natural by-product of the securitization process, rather than a securitization "premium" placed on securitized loans. Excess spread is created when the total unpaid principal balance of the loans contributed to a CMBS is less than the amount CMBS bond purchasers bid to purchase the resulting securities. This spread is created primarily by two factors associated with securitizations:

- Because a large number of loans are typically securitized, the loan pool typically has geographic and/or product diversity, which provides securitized pools of loans with a lower aggregate risk profile than individual loans.

- The tranche structure allows the CMBS securities to be separated by risk profile, which in turn allows them to be more efficiently priced and sold to investors that specialize in each layer of the CMBS debt stack.

Because CMBS securitizers are in continual competition with other lending sources (banks, life insurance companies, other securitizers, etc.), the ability of CMBS lenders to place a pricing premium solely to generate excess spread is limited by the competitive market environment.

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[20] 76 Fed. Reg. at 24113 (emphasis added).

B. Mechanics of the PCCRA

The manner in which the PCCRA would operate is described in the excerpt below from the Proposed Rule:

> Specifically, the proposal would require that a sponsor retaining credit risk under the vertical, horizontal, L- shaped, or revolving asset master trust options of the proposed rules establish and fund (in cash) at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between (i) the gross proceeds received by the issuing entity from the sale of ABS interests in the issuing entity to persons other than the sponsor (net of closing costs paid by a sponsor or the issuing entity to unaffiliated parties); and (ii) 95 percent of the par value of all ABS interests in the issuing entity issued as part of the transaction. . . .
>
> If the sponsor will retain (or caused to be retained) credit risk under the representative sample, ABCP, or CMBS third-party purchaser options of the proposed rules, the sponsor would have to fund in cash at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between (i) the gross proceeds received by the issuing entity from the sale of ABS interests to persons other than the sponsor (net of the closing costs described above), and (ii) 100 percent of the par value of the ABS interests in the issuing entity issued as part of the transaction.[21]

For example, for an IO strip that amounted to 2 percent over par, a PCCRA would have to be created for this 2 percent. This 2 percent position would be held in a separate account and all losses associated with the securitization would be first deducted from this now "super junior" position. The funds held in the PCCRA would have a lower payment priority than the former first-loss position held by the B-piece buyer. Essentially, any losses associated with a CMBS would be taken directly out of the issuers' financial returns that are reflected in the 2 percent PCCRA.[22]

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[21] 76 Fed. Reg. at 24113.

[22] As a practical matter, in the context of CMBS, the PCCRA's targeting of IO tranches is simply not an effective way to align interests. The size and duration of the interest-only securities vary from transaction-to-transaction, as they are created in response to the difference in interest rates between loan origination and securities issuance, differences in fixed coupons for bonds with varying ratings, and variations in the bond investors' appetites for discounted or premium bonds. For example, in a rising rate environment, there is typically little excess interest remaining to create an interest-only security, while in a falling rate environment, the securitizer must create a larger interest-only security to accommodate investors demand for par-priced bonds. Using this cash flow (which varies significantly

MBA notes that in addition to providing the economic incentive to initiate a securitization, the funds targeted by the PCCRA also must pay for staff salaries, office overhead, and any other expenses not directly attributable to the securitization. They also represent the positive return on a successful securitization that must necessarily cover losses on unsuccessful securitizations. The PCCRA would lock-out issuers from any potential profits until the maturity date of each tranche. Looking at this on a present value basis, any profit potential from the PCCRA would be greatly reduced, even assuming perfect performance for every loan underlying a CMBS. However, even for well underwritten CMBS loans, a certain number of defaults are expected to occur for a variety of reasons, such as declining economic conditions or changing borrower circumstances. Because the PCCRA would place the issuer's profits on CMBS in a first-loss position, through the normal course of some loan defaults, the issuer's financial incentive to engage in the securitization would be greatly reduced or eliminated.

In addition to the fundamental flaws of the PCCRA discussed above, for bank issuers of CMBS, the following issues also come into play:

- The potential consolidation of the entire CMBS on the balance sheet.
- Unfavorable risk-based capital treatment of 100 percent for the first-loss position.
- Tensions with bank safety and soundness regulatory principles.

As proposed, the PCCRA would remove the financial incentive to issue CMBS and would eliminate CMBS as a potential source of permanent mortgage capital for commercial mortgage borrowers. At an April 2011 hearing, Chairman Scott Garrett raised the following concern about the PCRRA:

> There are many other very important issues that members need to learn more about today like the specific underwriting standards proposed for the Qualified Residential Mortgage (QRM), how private mortgage insurance should factor in to that criteria**,** *and the "premium capture cash reserve accounts" requirement and its possible tremendous negative effect on the residential and commercial securitization markets*.[23]

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among transactions in response to market demand) as a form of risk retention by securitizers is impractical and would do little to align the interests of securitization sponsors with investors.

[23] On April 14, 2011, Chairman Scott Garrett (R-NJ) of the House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises conducted a Subcommittee hearing on "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention." (emphasis added).

The CRE finance industry echoes the concern raised by Chairman Garrett. Consequently, MBA strongly opposes the PCCRA.

Even if the market attempted to respond to the PCCRA by directing the interest due to the IO strip containing the excess spread to the AAA CMBS tranche, it would still provide significant challenges to the CMBS business model. First, issuers that relied on excess spread to fund their operations would be required to wait three to four years, when the first tranches of CMBS begin to pay off, before receiving the initial payments of their excess spread.[24] These same issuers, however, would be required to pay any losses associated with CMBS issuance immediately. Consequently, even with this modification to the PCCRA, CMBS issuers would still not be able to offset the losses associated with the issuance of one CMBS with the gains from another CMBS issuance, which could place some issuers in a precarious cash flow position.

Second, because excess spread would be paid back over time starting in year three or four and continue to year 10 of a CMBS issuance, the present value of these payments would be significantly less than if they were taken up front even if the tranche experienced no credit losses. MBA is concerned that either singularly or in tandem these challenges will result in fewer CMBS lenders and a less competitive and robust CRE lending environment.

Finally, as previously mentioned, the lack of specific authorization for the PCCRA in Dodd-Frank Act and the stifling impact it would have on securitization bring into doubt whether the PCCRA is consistent with the legislative intent of the Dodd-Frank Act. MBA members that are CMBS issuers and investors agree that the PCCRA would seriously jeopardize the flow of capital to the CRE sector because it would greatly curtail or stop new CMBS issuance.

C. PCCRA and Risk Retention Calculation Methodologies

To address the goals of the PCCRA, MBA anticipates regulators will look to calculate the amount of risk retention as 5 percent of net proceeds. This approach has merit in the context of vertical risk retention, because it ensures that five percent of the economic value of the total credit risk of the underlying securities is retained. This methodology for the vertical slice, in our view, would obviate the need for the PCCRA. (Further discussion on vertical risk retention is presented in the Risk Retention Structures section below.)

This approach, however, becomes unworkable in relation to a horizontal risk retention position. Because first-loss positions sell at a discount to par, typically 40 percent to 50 percent of par, the B-piece of a CMBS issue is typically configured to equal 5 percent of par, equating to 2 percent

[24] CMBS are comprised of loans with different planned and actual maturity dates, allowing for different CMBS tranches to have different expected lives. Loan maturities ranging from 3 or 4 to 10 years coupled with defaults, repayments and other factors all affect the expected lives.

to 3 percent of net proceeds. Because buyers of the most subordinate class are exposed to all of the losses of the underlying mortgage loans and even well-underwritten loans inevitably experience losses, they typically require investment yields significantly higher than the net weighted average coupon on the loan pool. These higher yields cause the underlying securities to be sold at discount to par. Consequently, requiring a B-piece buyer to purchase 5 percent of net proceeds would push them into BBB- or even BBB bonds as well — levels that would easily exceed 5 percent of the total credit risk of the entire issue. (Additional discussion on horizontal risk retention is presented in the Forms of Risk Retention Section below.)[25]

Even with the elimination of the PCCRA, setting the horizontal, first-loss purchaser risk retention requirement at 5 percent of net proceeds (gross proceeds – expenses) would be highly disruptive to the CMBS market and would effectively nullify the statutory language offered by Senator Mike Crapo ("Crapo Amendment") to the Dodd-Frank Act that allows the first-loss purchaser to assume the risk retention role under certain conditions.[26]

The MBA strongly recommends that the PCCRA be eliminated and replaced with the following risk retention methodologies.

D. MBA's Recommendations to Replace the PCCRA

MBA recommends that the PCCRA be eliminated. The Agencies, in our view, can accomplish the policy objectives of risk retention — without undermining the economic incentive to engage in a securitization transaction — by adopting the following methodologies to calculate the risk retained by the sponsor or third-party purchaser.

For the **Vertical Slice**, we believe *net sale proceeds* multiplied by 5 percent would be the appropriate methodology. This is consistent with the Dodd-Frank Act of requiring 5 percent risk retention because 5 percent of each CMBS tranche would be required to be purchased.[27]

For the **Horizontal Slice**, we believe the methodology should be based on the par value (defined as the par values of the securities which for REMIC purposes equates to the unpaid principal balance of the loans securitized) multiplied by 5 percent, and that the net weighted average coupon ("WAC") of the qualifying horizontal slice be no less than that of the entire pool.[28]

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[25] MBA notes that because CMBS is required to be structured so that the cumulative value of the loans must equal the par value of the CMBS, unlike some other forms of ABS, overcollateralization cannot be used to create excess spread for CMBS. However, CMBS benefits from low-prepayment risk due to prepayment exclusions or penalties.

[26] Responsive to Questions 12a and 22 in Proposed Rule.

[27] Paragraph responsive to Questions 22, 23a and 83 in Proposed Rule.

[28] Responsive to Questions 22, 23a, 29a,b and 83 in Proposed Rule.

For the horizontal risk retention purchaser, allowing risk retention to be calculated based upon 5 percent of the par value allows for the first-loss position to be appropriately sized. Such an approach ensures that B-piece buyers absorb the risks associated with 5 percent of the outstanding principal balance and would allow B-piece buyers to focus on the portion of the capital stack in which they are most familiar and have the greatest analytical expertise. Under this approach, five percent of the par value would be consistent with the Dodd-Frank Act's requirement for risk retention to be set at "not less than five percent of credit risk."

Requiring the coupon of the qualifying horizontal slice to be no less than the net WAC addresses a major concern of the Agencies. In the Proposed Rule, the Agencies have expressed strong concerns that the first-loss CMBS tranche can be "structured" in a manner in which little to no sale proceeds would be associated with the first-loss position. By requiring the first-loss position to have a coupon that can be no less than the net WAC, the ability of the issuer to transfer proceeds from the first-loss position to an IO is limited.

The statutory framework governing risk retention unambiguously provides the Agencies with the authority to adopt this approach. As discussed above, the Dodd-Frank Act requires the Agencies to "specify the permissible *types*, *forms*, and *amounts* of risk retention that would meet the requirements of subparagraph(B)"[29] with respect to commercial mortgages and, in doing so, the Agencies "may include — retention of a *specified amount or percentage* of the total credit risk of the asset . . . ."[30] Likewise, relevant legislative history underscores the importance of regulatory adjustments to the amount of risk retention required: "The Committee expects that these regulations will recognize differences in the assets securitized, in existing risk management practices, and in the structure of asset-backed securities, and that the regulators will make *appropriate adjustments* to the amount of risk retention required."[31]

Establishing tailored calculation methodologies consistent with the extent and character of the credit risk retained — that both obviates the need for the PCCRA and meets the core risk retention requirement — falls squarely within the regulatory authority provided by Congress. Indeed, the Proposed Rule already recognizes different forms of credit risk retained through its differential treatment for vertical risk retention ("not less than five percent of *each class of ABS interests*") versus horizontal risk retention ("at least five percent of the *par value of all ABS interests*").[32]

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[29] *Id.* (emphases added).
[30] Section 15G(c)(1)(E)(i) (emphasis added).
[31] S. Rep. No. 111-176 at 130 (2010) (emphasis added).
[32] Proposed Rule §§ __.4, .5, 76 Fed. Reg. at 24158-59.

The Agencies should adopt a similar tailored approach with respect to the PCCRA and its inapplicability to CMBS. We believe that these refinements strike the appropriate balance between requiring the first-loss purchaser to maintain a substantial financial interest in the CMBS with the ability to size the first-loss position appropriately. The adoption of the horizontal and vertical risk retention methodologies proposed above would eliminate the need for the PCCRA.

IV. RISK RETENTION STRUCTURES

MBA applauds the Agencies for providing flexibility through allowing various optional forms of risk retention. The Agencies' "menu of options" approach in the Proposed Rule offers a variety of structures through which securitizers and other market participants can meet the risk retention requirements. This menu includes: vertical, horizontal, L-shaped, revolving asset master trust, representative sample, and asset-backed commercial paper conduits.

Flexibility and optionality — including the availability of a broad range of risk retention structures — is critical to a well-functioning CMBS market, given that different forms of risk retention would accommodate varying business models, accounting treatments and regulatory capital requirements. This, in turn, would attract a broad range of market participants to support a liquid and vibrant CMBS market. Conversely, an overly stringent and prescriptive rule would stifle well-designed securitization transactions and restrict market participation to a limited number of institutions.[33] In this regard, we underscore the Federal Reserve Board's recommendation on the risk retention rulemaking to: "Consider the potential effect of credit risk retention requirements on the capacity of smaller market participants to comply and remain active in the securitization market."[34]

Such flexibility would be consistent with international risk retention regimes such as Article 122a of the Capital Requirements Directive ("Article 122a") that was implemented on January 1, 2011 by the European Banking Authority and applies to 30 countries.[35] Article 122a allows issuers to choose between four risk retention options that include the vertical and horizontal risk retention slices. Other options include placing on a random basis loans from a securitization on the issuer's balance sheet and "originator interest" for revolving securitizations. For multinational firms, the flexibility afforded by the risk retention regime will

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[33] Discussion is responsive to Questions 13 and 14 in Proposed Rule.

[34] Federal Reserve Board Risk Retention Study at 84.

[35] Implementation Guidance for Article 122a was provided in Guidelines to Article 122a for the Capital Requirements Directive, Committee of European Banking Supervisors, December 31, 2010. On January 1, 2011, the European Banking Authority (EBA) took over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors. The EBA has 27 voting members and 3 non voting members.

allow them to harmonize their U.S. risk retention compliance efforts with their operations in European Union jurisdictions.

MBA also notes that a broad number of optional risk retention structures would allow the market, over time, to identify structures that provide a better execution, consistent with governing risk retention requirements. We believe that in the context of risk retention, markets will tend to gravitate toward executions that provide greater transparency and efficiencies, at a lower cost to participants. The market will differentiate simple-to-understand, transparent structures that work well under capital, accounting and other governing regimes. The flexibility provided by the optional menu approach is absolutely necessary to support this outcome, given the policy objective of establishing a deep, liquid market (with a diverse range of market participants) and the fact that, ultimately, only experience will demonstrate which structures are more favorable than others.

The Proposed Rule sets forth a number of risk retention structures which sponsors (and other parties) can utilize to meet the risk retention requirements under the Dodd-Frank Act. MBA strongly supports the "menu of options" approach in the Proposed Rule. Our specific comments, including additional recommended structures, are discussed below.

A. Vertical Risk Retention Option

MBA supports a 5 percent vertical slice as an optional mechanism for retaining necessary economic risk, among a number of different forms of risk retention and risk allocation that provide flexibility for market participants.[36] The Proposed Rule, however, should provide additional flexibility within the 5 percent vertical structure in a manner that would refrain from elevating form over substance. So long as the risk retained is equivalent to "an economic interest of at least 5 percent of the aggregate credit risk of the assets collateralizing an issuance of"[37] the CMBS, the sponsor should be permitted to satisfy the 5 percent vertical retention requirement.

In addition to the vertical risk retention structure described in the Proposed Rule, MBA strongly recommends that the Agencies adopt the following structures as optional forms of vertical risk retention:

- A single, separate security collateralized by the same pool of assets and receiving the same principal and interest allocation as if the security were held as multiple *pari passu*

[36] Our support here of the 5 percent vertical slice as a risk retention option is consistent with MBA policy and guiding principles. *See* MBA Letter, dated Dec. 22, 2010. Responsive to Question 16 in Proposed Rule.

[37] 76 Fed. Reg. at 24099.

interests in each security class. This structure would result in the sponsor retaining the same credit risk as the traditional vertical slice, but with the use of a single security, it would provide simplification from an operational and asset management perspective.[38]

- A participation (seller's) interest in the assets of the pool equivalent to 5 percent of the risk of each security class. Under this option, the sponsor would own a 5 percent *pari passu* interest in each loan or in the pool of loans held outside of the securitization trust. This risk retention structure would be attractive to certain segments of sponsors, including many commercial banks, because of their existing infrastructure to share risk on a *pari passu* basis and their favorable capital treatment for whole loan positions.[39]

These structures, we submit, reflect risk retention that is equivalent to or greater than that retained through a vertical slice. Allowing these structures would expand the types of institutions that participate in the market while accommodating varying business model, capital and accounting considerations.

B. Horizontal Risk Retention Option

The Proposed Rule permits a sponsor to meet its risk retention obligations through an eligible horizontal interest in the issuing entity in an amount that is equal to at least 5 percent of the par value of all ABS interests in the issuing entity. This approach would "expose the sponsor to a five percent first-loss exposure to the credit risk of the entire pool of securitized assets."[40]

We strongly support the availability of a horizontal risk retention structure as an option. We reiterate, however, that the manner in which the five percent risk is calculated is critical to the viability of this risk retention structure, as we discuss in the Premium Capture Cash Reserve section above with regard to the role of the B-piece purchaser in assuming horizontal risk retention. MBA also recommends additional flexibility regarding the manner in which horizontal retention is achieved. For example, more than one party (or a joint venture) should be permitted to assume horizontal risk, so long as the sum of the risk retained is equivalent to 5 percent or more. MBA therefore recommends the availability of multiple "eligible risk retention classes."[41]

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[38] Paragraph responsive to Question 19a,b in Proposed Rule
[39] Paragraph responsive to Question 19a,b in Proposed Rule
[40] 76 Fed. Reg. at 24102.
[41] We note, however, that only one Operating Advisor, in the role we recommend below, would be required. Paragraph responsive to Question 16 in Proposed Rule.

C. L-Shaped Retention Option

The Proposed Rule allows a sponsor to use an equal combination of vertical and horizontal risk retention as a means of retaining the required 5 percent exposure to the credit risk of the securitized assets. We support the availability of the L-Shaped structure as an option, but request additional flexibility. The rule, for instance, should avoid specifying that the vertical and horizontal components must be equal. We believe that the risk retention rule should be indifferent regarding the amount of vertical versus horizontal retention, so long as overall risk retention is equivalent to 5 percent or more of the credit risk. Sponsors also should be permitted to achieve the L-Shaped retention requirement utilizing all of the structures we recommend under the vertical and horizontal retention options.[42]

We also recommend that the rule allow a combination vertical and horizontal retention structure. Under this approach, a securitizer could hold a progressively larger portion of a security as one goes down the capital stack. The portion of risk retained of a given class must not exceed the portion retained of any class that has a lower repayment priority.[43] We would be pleased to discuss this and other structures that would provide additional flexibility to market participants.

D. Seller's Interest in Revolving Asset Master Trusts Option

The Proposed Rule allows sponsors to hold a "seller's interest" that is *pari passu* with the investors' interest in the assets underlying the securities. We believe that this option should not be limited to revolving asset master trusts. CMBS, which involve static pools of collateral, should be eligible for this form of risk retention. We see no reason why this structure should be restricted to revolving trusts. The structure could function in a manner similar to the vertical risk retention structure option recommended above, where the risk retention interest is held outside of the securitization trust.[44]

E. Representative Sample Option

MBA appreciates the availability of a representative sample approach to risk retention. As proposed, however, the structure would not be available for commercial mortgage securitizations in light of the requirement that the designated pool must contain at least 1,000 assets. CMBS pools, which have a smaller number of larger loans, would not meet this

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[42] Paragraph responsive to Questions 16 and 40a in Proposed Rule.
[43] Responsive to Question 19a in Proposed Rule.
[44] Paragraph responsive to Questions 16 and 46 in Proposed Rule.

requirement. We therefore recommend that the representative sample option be amended to make it available for CMBS sponsors.[45]

Consistent with our recommendations above, we believe that the *pari passu* retention structure discussed above — whether as a variation of the vertical slice, "seller's interest" or the representative sample option — should be a permissible risk retention structure. The sponsor would own a 5 percent *pari passu* interest in each loan or in the pool of loans held outside of the securitization trust. This approach would effectively represent a 100 percent "representative sample" in the underlying assets of the securities.[46]

F. Additional Risk Retention Structure Options

MBA believes that the rule should permit risk retention through contractual risk retention among counterparties, to the extent that the party retaining the risk is financially positioned to support those representations. While this form of risk retention is not "funded" in the traditional sense, loss-sharing agreements, for example, can be an effective form of risk retention and functionally serve the same purpose as vertical risk retention.[47] One approach that the Agencies should consider is allowing this form of risk retention for entities subject to regulatory capital requirements.

In addition, Government-Sponsored Enterprises' ("GSEs") executions in the multifamily finance sector are an example of this type of approach. For many years, the GSEs have been securitizing multifamily mortgages using structures which contain various forms of risk retention, including guarantees and structured credit enhancement. Fannie Mae through its Delegated Underwriting & Servicing Program ("DUS")[48] and Freddie Mac through its Program Plus Seller/Servicers and Multifamily K Certificates[49] have been utilizing securitization structures to provide liquidity to the multifamily housing market. The GSEs have imposed various standards to backstop their counterparty risk under these programs.[50]

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[45] Paragraph responsive to Questions 14a, 16, 47 and 49 in Proposed Rule.
[46] Paragraph responsive to Question 19a in Proposed Rule.
[47] Responsive to Question 19a in Proposed Rule.
[48] *See, e.g.*, http://www.fanniemae.com/mbs/mbsmultifamily/dusmbs.jhtml?p=Mortgage-Backed+Securities&s=Basics+of+Multifamily+MBS&t=DUS+MBS.
[49] *See, e.g.*, http://www.freddiemac.com/mbs/html/product/kcerts.html.
[50] For example, "DUS" lenders approved by Fannie Mae must meet applicable guidelines, including the sharing of risk with Fannie Mae on any of the loans they originate and sell. This risk sharing obligation is secured by the full credit of the lending entity, the value of all of its assets and servicing portfolio, and by a liquidity reserve held in a bank acceptable to Fannie Mae (typically in the form of cash or letter of credit). This liquidity reserve is required to be increased over time as the lender's risk sharing portfolio increases.

It should be noted that the multifamily businesses at both Fannie Mae and Freddie Mac have experienced superior credit performance (well below 1 percent default rate) during the recent downturn. We recommend that structures substantially similar to these be permitted forms of risk retention, enabling other institutions to utilize them as well.[51]

G. Risk Retention Calculation Methodologies and "Originator" Definition

When addressing risk retention, the Dodd-Frank Act provided for the standard amount of risk retention to be "not less 5 percent for of the credit risk for any asset" and for CMBS, the Agencies could specify an "amount or percentage of the total credit risk of the asset." The methodology by which "an economic interest of at least 5 percent of the aggregate credit risk of the assets collateralizing an issuance of"[52] CMBS is calculated is critically important.

As discussed in the context of the PCCRA, we recommend that the following methodologies satisfy the Dodd-Frank Act's risk retention requirement (and replace the PCCRA): For the **vertical risk retention**, *net sale proceeds* multiplied by 5 percent; for **horizontal risk retention**, the par value (defined as the par values of the securities, which for REMIC purposes equates to the unpaid principal balance of the loans securitized) multiplied by 5 percent, and that the net weighted average coupon ("WAC") of the qualifying horizontal slice be no less than that of the entire pool.

We urge the Agencies to incorporate these methodologies in the final rule. Additionally, we urge that each of the other proposed risk retention options specify the methodology for calculating the amount of retention.

Finally, the Proposed Rule defines "originator" as the person that "creates" a loan or other receivable.[53] MBA, consistent with discussions with officials from the Agencies, does not interpret this term to cover mortgage bankers who do not fund loans or are not part of the lending decision — as they do not "create" the loans. We will rely on this straightforward interpretation of this definition, unless the Agencies determine otherwise.

V. DURATION, TRANSFER AND HEDGING OF CREDIT RISK[54]

While alignment of interests is at the heart of risk retention, we believe that risk retention on the part of sponsors, B-piece buyers or other permissible parties need not be for the life of the securities or loans underlying the transaction in order to accomplish public policy objectives.

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[51] Paragraph responsive to Question 19a in Proposed Rule.
[52] 76 Fed. Reg. at 24099.
[53] § __.2 Definitions, 76 Fed. Reg. at 24157.
[54] Discussion responsive to Question 102a,b in Proposed Rule.

Alternatives should be considered based on the collateral-level transparency that exists in the CMBS market.

The statutory basis for a duration period that is less than the life of the securities is clear: The Dodd-Frank Act provides that, "The regulations prescribed under subsection (b) *shall* . . . specify . . . (ii) the *minimum duration of the risk retention* required under this section . . . ."[55] Congress, in our view, both directed the Agencies to develop a minimum duration period for risk retention and clearly contemplated the possibility of a minimum holding period that is short of the life of the securities. We urge the Agencies to provide guidance to this effect for commercial mortgages.

The CMBS market provides extensive and robust transparency with regard to the performance of the underlying loans. Loan-level performance data and other information are available from multiple sources including, but not limited to, servicer and trustee investor reporting sites, rating agencies and independent data providers (*e.g.*, TREPP, Intex, Bloomberg and others). Such transparency of information in CMBS allows investors the opportunity to determine loan performance and identify loans or securitizations that are not performing as expected.

Much of the data used in underwriting commercial and multifamily mortgages are updated throughout the life of the loan. Properties are physically inspected and operating statements are collected (generally quarterly), "spread" into a common form and format, and analyzed. The debt service coverage ratio is calculated based on updated operating statements. This information, as well as the payment records of the loans and other information, is made readily available to investors through mortgage servicers, security trustees and numerous third-parties, including data aggregators, investment bank analysts and other market participants. The "watchlist" report alone contains 29 specified events that require reporting. The result is that investors are able to track the actual performance of individual loans — and the properties that back them — relative to the conditions and assumptions at underwriting.

In addition, the Investor Reporting Package ("IRP")[56] sets forth protocols for reports, data files and templates that provide investors the ability to monitor bond, loan and property performance. The IRP also sets the standard for analysis of operating statements, identification of deteriorating loans and provides surveillance information through reports such as the watchlist and REO status. Reports provided to investors evolve with the market — IRP version 5.1 was released in December 2010 and includes the following:

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[55] § 15G(c)(1)(C)(ii) (emphasis added).

[56] The Investor Reporting Package provides standards for the post-securitization monitoring of the underlying performance of the collateral.

Report Type	Name	Frequency
Surveillance	Watch List Report	Monthly
Surveillance	Delinquent Loan Status Report	Monthly
Surveillance	REO Status Report	Monthly
Surveillance	Historical Modification & Corrected Loan Report	Monthly
Surveillance	Comparative Financial Status Report	Monthly
Surveillance	Loan Level Reserve/LOC Report	Monthly
Surveillance	Advance Recovery Report	Monthly
Surveillance	Total Loan Report	Monthly
Surveillance	Operating Statement Analysis Report	Monthly
Surveillance	NOI Adjustment Worksheet	Monthly
Servicer Data File	Loan Set-Up	Securitization
Servicer Data File	Loan Periodic Update	Monthly
Servicer Data File	Property File	Monthly
Servicer Data File	Financial File	Monthly
Trustee Files	Bond Level File	Monthly
Trustee Files	Collateral Summary File	Monthly
Servicer Template	Appraisal Reduction Template	As necessary
Servicer Template	Servicer Realized Loss Template	As necessary
Trustee Template	Reconciliation of Funds	Monthly
Trustee Template	Historical Liquidation Loss	Monthly
Trustee Template	Historical Bond/Collateral Realized Loss Reconciliation	Monthly
Trustee Template	Interest Shortfall Reconciliation	Monthly
Event Report	Significant Insurance Report	As necessary

Should a property that collateralizes a commercial mortgage not supply sufficient net operating income to meet its debt service, its revenue not match that of underwriting, its expenses exceed those underwritten, or there be physical needs at the property that were not identified in the underwriting, the transparency of the CMBS market allows investors to know within just a few quarters.

Consequently, the Agencies should consider alternatives that reduce the duration of risk retention. A three-year duration term, for instance, would provide all participants in a securitization sufficient time to determine quality of underwriting, given that differences from actual property performance would become visible through the data reported each quarter, and clearly within a couple of years of origination. After this period, a sponsor who wishes to transfer the risk (or hedge its risk) would see any deficient underwriting or other performance factors reflected in the price of the interest the sponsor wishes to sell (or the price of the hedge position).[57]

[57] Paragraph responsive to Question 102a,b in Proposed Rule.

Accordingly, MBA recommends the following approach to determine the required duration period for the retained risk:

- All risk retention holders, including issuers, originators, and first-loss third-party (B-piece) purchasers, must hold the risk retention position for a minimum of three years. (As discussed below, where a third-party purchaser assumes the risk retention position, the party that subsequently assumes the position after the applicable period should be a qualified transferee.)

- At or prior to the issuance of CMBS, the sponsor or holder of the risk retention position must make a declaration — through disclosure to investors — regarding the length of the holding period, whether the minimum three years or a longer period.

The latter disclosure is designed to encourage the market to consider the holding period in pricing the issuance based on the confidence of the sponsor in the pool's assets. This approach, coupled with a three-year "floor" holding period, would incentivize sponsors to consider a longer risk retention period. We urge the Agencies adopt this proposal, which, we believe, would align the interests of investors with the securitizer, while encouraging market-driven outcomes.[58]

VI. THIRD-PARTY PURCHASERS IN RISK RETENTION ROLE

A. Role of B-Piece Buyers

MBA appreciates the Agencies' recognition of the unique characteristics of the CMBS market in the Proposed Rule that allows for ''retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities, meets the same standards for risk retention as the Federal banking agencies and the Commission require of the securitizer."[59]

The Proposed Rule recognizes that the allocation of a first-loss position to a third-party purchaser or "B-piece" buyer has been common practice in CMBS transactions. This practice has been instrumental in enhancing the attractiveness of CMBS as a viable fixed-income investment. B-piece buyers are typically experienced and sophisticated investors and have extensive expertise in negotiating and restructuring CRE loans and properties. The B-piece

[58] Paragraph responsive to Question 102a,b in Proposed Rule.
[59] Exchange Act § 15G(c)(1)(E).

buyer specifically negotiates for the purchase of the first-loss component of a transaction. Because of the inherent risk of their first-loss position, B-piece buyers conduct their own extensive due diligence and re-underwriting of the loans in a pool prior to securities issuance. The level of due diligence is determined by the B-piece buyer based on the particular loans in the pool. As a condition of purchasing the first-loss position, B-piece buyers routinely question and even reject loans that are unsatisfactory from a credit perspective.[60]

MBA believes that certain aspects of the Proposed Rule would create significant disincentives for the use of the third-party retention option, where the B-piece buyer serves the risk retention role. The absence of these investors or their limited presence would have a detrimental effect on the CMBS market, the availability of credit and borrowing costs. This, in effect, would undermine the intent behind the "third-party purchaser" statutory provisions in the Dodd-Frank Act.[61]

The risk retention rule, therefore, should be crafted in a manner that provides sufficient incentives for B-piece buyers to serve as holders of risk retention under the rule, while recognizing and supporting the interests of senior and all other investors in the CMBS. MBA's recommendations are as follows.

B. Operating Advisor[62]

The Proposed Rule requires that an independent Operating Advisor be appointed where the risk retention requirements are met by a third-party purchaser who retains the risk and has control rights (itself or through an affiliate) that are not collectively shared with all other classes of bondholders (such as special servicing rights). Under the Proposed Rule, the Operating Advisor must be consulted on all major special servicing decisions, such as loan modifications, loan waivers, loan extensions and/or property foreclosures, and sales or acquisitions. The Operating Advisor would have the ability to recommend removal and replacement of the special servicer if it determines, in its sole discretion, that the special servicer has failed to comply with the servicing standard provided in the applicable transaction documents and that such replacement is in the best interest of investors as a collective whole. Only a majority vote of each class of bondholder could prevent or "veto" the removal and replacement of the special servicer.

While MBA recognizes the reasons for including an independent party to balance certain conflicts among the first-loss and other investor classes, we have strong concerns about the Operating Advisor role as set forth in the Proposed Rule and recommend an alternative

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[60] Paragraph responsive to Question 68a,b in Proposed Rule.
[61] Exchange Act § 15G(c)(1)(E).
[62] Discussion responsive to Question 74 in Proposed Rule.

framework governing its role and that of the special servicer. MBA recommends the following proposal that is designed to:

- Strengthen disclosures on the activities of special servicers — and the accessibility of such information — to inform all CMBS investors of information related to nonperforming loans when such information can be disclosed,

- Require that the PSA or other governing document set forth a mechanism to address possible noncompliance by the special servicer, and

- Specify a targeted role for Operating Advisors, consistent with current market practice.

First, the Rule should require enhanced disclosure by a special servicer (affiliated with the risk retention requirement-satisfying B-piece buyer) of relevant information in one consolidated place. The Rule should require that the PSA or other governing documents require access to information about completed workouts and other publicly-available information about the special servicer's activities be made available with a third-party source that is independent of the B-piece buyer/special servicer, consistent with applicable securities disclosure laws. A website maintained by the trustee or certificate administrator (*e.g.*, investor Q&A websites) could serve as this comprehensive resource that enables investors to access information to evaluate the activities of the special servicer and whether the servicing standard is being met.

Second, the Rule should require that the PSA or other governing document set forth a dispute resolution mechanism available for investors, including the ability of investors to demand an investigation of possible noncompliance by the special servicer upon request from a specified percentage of certificate-holders. The PSA would be required to specify how the costs of resulting investigations would be borne and that such investigations would be performed by independent parties.

Third, we believe that the Operating Advisor's role should begin when a *change in control event* occurs through the application of appraisal reductions and realized losses to a level specified in the PSA. The Operating Advisor's role would be that of oversight, serving as a watchdog and playing a monitoring role, and to investigate claims of special servicer noncompliance initiated by a specified percentage of certificate-holders. Following the change in control event, the Operating Advisor would engage in substantive, periodic reviews of the special servicer, the details of which could be specified in the PSA, and provide its findings on a regular basis to CMBS investors and the sponsor and the servicers. Any pattern or practice of acting in a manner contrary to all of the investors' interests would be highlighted in such reports. The Operating Advisor would have the authority to impose penalties and remedies, as set forth in the PSA, if the Operating Advisor determines that a special servicer has breached the PSA's terms.

Conversely, the Operating Advisor would not possess veto or decision making authority as it relates to decisions or actions of the special servicer. We also do not believe that "consultation" with the Operating Advisor with regard to "any major decision in connection with the special servicing of the securitized assets"[63] is necessary. The ambiguities and practical difficulties in determining the meaning of "consult," "major decision," and the manner in which disputes among the parties would be resolved would lead to "bottleneck" inefficiencies, second-guessing of special servicing decisions, and likely increase servicing (and ultimately, borrowing) costs — all of which would be contrary to the interests of CMBS investors.

Nor do we believe that an Operating Advisor should possess unilateral "authority to recommend that a special servicer that is, or is affiliated with, a third party purchaser be replaced by a successor special servicer if the Operating Advisor determines, *in its sole discretion* exercised in good faith" that the special servicer is not acting in accordance with the servicing standard unless "a majority of each class of ABS interests in the issuing entity eligible to vote on the matter votes to retain the special servicer."[64] Beyond the blunt character of this instrument, we believe that the removal of a special servicer, taking into account the recommendation of the Operating Advisor, should be initiated by the investors themselves (rather than simply providing investors veto authority, as the Proposed Rule contemplates). The Operating Advisor should function as an "advisor" to certificateholders — rather than as a decisionmaker with extraordinary remedial authority.

Finally, we ask for clarification regarding the qualifications of an Operating Advisor, other than the requirement that it be independent. The Proposed Rule also does not provide conditions for its appointment, removal or replacement. Clarity on these and other aspects of the Operating Advisor are important; we would appreciate the opportunity to work with the Agencies to develop these requirements.

C. Hedging, Transfer and Financing

The Proposed Rule requires that the third-party purchaser of the retained interest hold the investment for the life of the securities, and imposes a permanent restriction on the sale or transfer of retained risk (with some exceptions). We believe that the risk retention rule should permit B-piece buyers (or other parties holding the risk retention interest) to transfer the interest after a certain period of time to other "qualified B-piece buyers." The potential duration of risk retention — whether on the part of a sponsor or B-piece buyer — is discussed above. As

[63] §__.10(a)(4)(iii)(B), 76 Fed. Reg. at 24161.
[64] §__.10(a)(4)(iii)(D), (E), 76 Fed. Reg. at 24161 (emphasis added).

indicated in the Duration/Hold Period discussion above, all forms and holders of risk retention should be subject to the same risk retention duration period.[65]

The Proposed Rule also prohibits hedging of the credit risk associated with the retained securitized assets. While the volatility of a first-loss B-piece investment makes it difficult to hedge credit risk, we do not believe that the hedging prohibition is appropriate for B-piece buyers. Like other prudent investors, B-piece buyers should be permitted to manage their investments, which include the ability to hedge exposure using all available market tools. We believe that this restriction, coupled with the proposed unlimited holding period, could make B-piece investments extremely unattractive.[66]

The Proposed Rule prohibits direct or indirect financing of the retained interest from any other person that is a party to the securitization transaction (including, but not limited to, the sponsor, depositor, or an unaffiliated servicer). MBA does not agree that a blanket prohibition against direct or indirect financing is appropriate for B-piece buyers. B-piece buyers, like other investors, should have some flexibility to pursue financing from a willing lender.

At the same time, market participants recognize the negative effect that excessive financing via CDO issuance historically had on market discipline and, in turn, the quality of CMBS loan underwriting. Thus, while MBA believes that some financing of risk retention positions should be allowed, limits should be imposed to prevent the party holding risk retention from economically transferring risk to non-qualified parties. MBA, therefore, recommends allowing third-party purchasers to use some financing to fund its purchase of B-piece interests within regulatory-determined parameters. Prohibiting all such financing would reduce the number of third-party purchasers willing to assume the risk retention role and increase the cost of securitization (and ultimately, the cost to borrowers). MBA also recommends that no distinction be made between the sponsor's ability to finance its risk retention interest compared to third-party purchasers. MBA acknowledges that regulators will likely require that such financing be provided on a recourse basis.

D. Disclosures

MBA believes that there should be a safe harbor for the types of information about the B-piece buyer that must be disclosed. Requiring "disclosure of any other information regarding the third-party purchaser that is material to investors" is overbroad.[67]

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[65] Paragraph responsive to Question 102a,b in Proposed Rule.
[66] Paragraph responsive to Questions 70, 97, 102a,b and 105 in Proposed Rule.
[67] Responsive to Questions 73a,b and 77 in the Proposed Rule.

We do not believe that disclosure of the actual purchase price paid by the third-party purchaser is necessary. Discounts vary based on a number of market conditions that are unrelated to asset quality. As an alternative, the issuer or third-party purchaser could provide a contractual representation or declaration to investors that the purchase price paid for an eligible horizontal residual interest was adequate to fulfill applicable regulatory requirements.[68]

In addition, MBA does not believe disclosure of the financial resources of the third-party purchaser is necessary or relevant. Purchase by the third-party investor of the eligible horizontal residual interest with cash, whether financed or not, is sufficient evidence of financial resources. MBA believes that the more relevant disclosure would be the qualifications of the third-party purchaser to undertake due diligence and to review, analyze and make decisions regarding the mortgage collateral. Such disclosure would include the background and experience of the B-piece buyer, such as the length of time a B-piece buyer has been in business and the size of such B-piece buyer's portfolio.[69]

E. Definitional Clarifications

We ask that the risk retention rule define additional terms, including "special servicer" and "B-piece." The term "special servicer" should mean, with respect to any CMBS transaction, the party that has been engaged by the related trust to manage any assets which have been subject to certain adverse events (usually identified in the related servicing agreement and referred to as "servicing transfer events").

Servicing transfer events typically include mortgage loan defaults, borrower bankruptcies, or determinations by the master servicer or special servicer that the occurrence of a default is imminent. Assets that have been subject to servicing transfer events are typically referred to as "specially serviced mortgage loans." The typical servicing agreement obligates the special servicer to manage the specially serviced mortgage loans with a view to the maximization of recovery of principal and interest on a net present value basis on the specially serviced mortgage loans. Strategies available to the special servicer typically include workout/modification, foreclosure followed by sale of the related property, or sale of the specially serviced mortgage loan.

In addition, the term "B-piece" should mean, with respect to any commercial mortgage-backed securities transaction, the most subordinate class(es) of securities in the transaction. The "B-piece buyer" typically purchases the B-piece in connection with the initial offering of the related securities.

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[68] Paragraph responsive to Question 71a,b in the Proposed Rule.
[69] Paragraph responsive to Question 72 in the Proposed Rule.

The classes included in the B-piece have the highest exposure to losses on the underlying mortgage loans, and therefore typically pay yields that are higher than the yields applicable to the more senior classes. The B-piece buyer typically purchases the B-piece at a price that is discounted to par. Since the B-piece has the highest exposure to the risk of loss on the underlying mortgage loans, CMBS transactions have traditionally offered the B-piece buyer two significant rights: (a) the right to consent to significant servicing actions by the special servicer (such as modification of mortgage loan terms or exercise of remedies against the related borrower), and (b) the right to replace the servicer without cause at any time.

VII. UNDERWRITING STANDARDS FOR ZERO RISK RETENTION

The Dodd-Frank Act allows the regulatory agencies to consider for reduced risk retention CRE loans under the following conditions:[70]

> (iii) a determination by the Federal banking agencies and the Commission that the underwriting standards and controls for the asset are adequate. . . .
>
> (B) CONTENTS.—For each asset class established under subparagraph (A), the regulations prescribed under subsection (b) shall include underwriting standards established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan.

The Dodd-Frank Act charges the Agencies with developing underwriting requirements that would represent a "low credit risk" loan. In the Proposed Rule, the Agencies provided a series of the terms and conditions for a CRE loan that would qualify as low risk and hence, not subject to risk retention.

A. Underwriting Criteria for Zero Risk Loan

MBA believes that the following principles should guide the development of "low-risk" underwriting criteria.[71]

- Underwriting is both an art and science that relies on both qualitative and quantitative analyses that should be performed by trained and experienced professionals. The combination of both analyses results in well underwritten loans and leads to sound investment decisions.

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[70] Exchange Act § 15G(c)(1)(E)(iii),(c)(2)(B).

[71] Section responsive to Questions 153 and 156a,b in Proposed Rule.

- Defining a low risk loan solely by its compliance with a prescriptive set of loan and property performance metrics does not ensure that the loan will be low risk. Low risk loans will also have attractive qualitative features (location, market conditions, property profile, tenancy, etc.) that are not readily defined by metrics.

- As proposed, certain finance terms and practices that are presented in the underwriting standards for zero risk retention ("underwriting standards") require significant modification in order to reflect reasonable CRE and CMBS practices.

- As proposed, elements of the underwriting standards must be replaced by alternative concepts that, taken in aggregate, will greatly simplify and clarify loans that qualify for zero risk retention.

- As proposed, the underwriting standards would greatly limit the amount of qualified loans for zero risk retention, which would make it difficult for issuers to aggregate qualified mortgage in sufficient quantity to securitize.

- Underwriting standards should be paired with industry-developed representations and warranties to provide additional certainty to the CMBS market. Such representations and warranties would serve as an important tool that adds accountability, transparency and clarity to the market.

In reviewing the loan terms and conditions that would qualify a loan for zero risk retention, an analysis was performed by Morgan Stanley (see Appendix C). The results of this analysis are highlighted below:

> Specifically, there are approximately thirty underwriting requirements that must be satisfied in order for a commercial mortgage pool to be exempt from risk retention. We estimate that if just three of these requirements are applied (LTV of 65% or less, DSCR of 1.7x or higher and an amortization period of 20 years or less at securitization**),** *approximately 0.4% ($2.9 billion) of the $671 billion conduit loans that have been securitized since the beginning of the CMBS market would have qualified. If the rules were loosened to 1.5x DSCR, 70% LTV and 25-year amortization, 3% ($17.5 billion) would have qualified***.**[72]

According to this study, using only three (LTV, DSCR, 20 years or less amortization) of the approximately 30 qualification requirements, only 0.4 percent of the conduit loans since the inception of the CMBS market would meet the underwriting criteria for zero risk retention. The statutory directive to develop underwriting standards that "indicate a low credit risk" should

[72] North America CMBS Strategy, Morgan Stanley Research, April 12, 2011, p. 4 (emphasis added).

result in a meaningful exemption beyond a *de minimis* portion of commercial mortgages that would meet the proposed underwriting criteria. MBA therefore believes that the Agencies should revisit the proposed criteria.[73]

B. Recommendations for CRE Loan Underwriting Standards[74]

MBA worked closely with its members to identify the underwriting loan criteria that would result in a low risk loan. MBA has proposed changes to the underwriting standards that better reflects market terms and conditions and is more realistic in defining a low risk loan. Based upon member input, we have made specific recommendations for each of the underwriting requirements in the Proposed Rule. Our analysis was grouped into three response categories: (1) underwriting requirements that MBA recommends; (2) underwriting requirements that need to be modified; and (3) underwriting requirements that MBA supports.

MBA's underwriting recommendations are presented below[75]:

Underwriting Standards MBA Recommends to Eliminate		
Definition of a Commercial Real Estate Loan	(2) Does not include: ~~A loan to a real estate investment trust~~	**Eliminate** - We think that this may have been a drafting error. CRE Loans secured by properties owned by REITs that meet the other requirements of this rule should not be excluded.
Debt Service Coverage Ratio	Replace concept of DSC Ratio with minimum Debt Yield. Debt yield is the net operating income divided by the outstanding loan balance.	**Eliminate** - A DSC ratio test is highly dependent upon where interest rates are at the time the loan closes and/or matures. **Add** – A better test would be based on a minimum Debt Yield, which is consistent across interest rate environments.
Qualified Tenant		**Eliminate** – It is common industry protocol for many office leases and leases of other CRE product categories *not* to be structured as triple net leases. Rental income from tenants with gross leases using an expense stop are common and should not be excluded. Many considerations are taken into account when determining how much credit to give to rental income from month-to-month tenants. We recommend the concept of Qualified Tenant be eliminated from the criteria.
Amortization		**Eliminate** - Eliminate this section because straight line

[73] Paragraph responsive to Question 156a in Proposed Rule.
[74] Section responsive to Questions 153, 156 a, b and 157 in Proposed Rule.
[75] Table addresses qualified CRE loans for zero risk retention (see 76 Fed. Reg. at 24132-24134).

		amortization and an amortization period of 20 years or less do not recognize the realities of the commercial mortgage market. MBA's recommendation recognizes the effects of amortization through the use of an ending LTV (see below).
DSCR (Min)	Minimum Debt Yield is 12% (14% for hotels). Debt yield is defined as property net operating income divided by loan balance.	**Eliminate** – Replace DSCR with Debt Yield. DSCR test is too dependent upon where interest rates are at the time the loan closes. A better test seems to be based on a minimum debt yield (versus a minimum DSCR).
Borrower Credit	Recommend review of 3 years historical operating information on the property. (Shorter timeframe acceptable for newer properties provided historical information since property completion is reviewed.)	**Eliminate** – Two year look forward of borrowers' financial stability and requiring lenders to speculate on the ability of the Borrower/Guarantor to continue to pay its debts on a going forward basis. A vast majority of CMBS loans are non-recourse loans that are not backed by payment guarantees so a review of the Sponsor's future financial stability is really not as relevant as it might be in connection with a qualified residential loan. In addition, forward looking projections on the financial condition of the borrower would be difficult to perform and is not standard market practice. **Support** - Requiring lenders to perform a 3-year look back at the property performance is standard practice; provided a provision for newer properties is included as these may represent some of the best collateral
Amortization & Interest Only Periods	No eligibility criteria based on amortization and IO periods.	**Eliminate –** Introducing the concept of ending LTV eliminates the need to dictate amortization or IO periods.
Buy Back Requirement	Industry representations and warranties would include a representation that the loans met the Eligibility Criteria. To the extent an individual loan is determined to not have met the Eligibility Criteria at time the securitization, the sponsor would be required to repurchase the loan at par plus accrued interest if such breach is deemed to have material and adverse impact on the investors in the securitization.	**Modify** – The appropriate place to address the buy-back requirement is in the representations and warrantees. In addition, the proposed rule does not provide for a materiality test for the breach, which could result in otherwise well underwritten loans being required to be repurchased.
Underwriting Standards MBA Recommends to Modify		
Borrower Verification	Verified and documented the current financial condition of the property sponsors;	**Modify** - Sponsor is the appropriate entity to review as most CMBS borrowers are special purpose entities.
Beg LTV (Max) ~~End LTV (Max)~~ And 10 Year	(5) The ~~C~~LTV ratio for the loan is: (i) Less than or equal to ***60 percent*** at time of loan origination (**55 percent for hotel properties**)~~;~~ ~~or~~ and (ii) Less than or equal to ***50 percent*** at loan maturity **(45 percent for hotel properties)** with valuation based	**Modify** – LTV Standards (see text in bold in adjacent column) while **eliminating** "Combined LTV," as CLTV is not directly relevant to the credit backing the first mortgage. We recommend separate LTV for hotel properties.

Loan Duration	on appraisal value at time of loan origination (6) All loan payments required to be made under the loan agreement are . . . (ii) To be made no less frequently than monthly	Cap rates reflect the risk premium investors demand to invest in commercial properties. As a result, properties with lower risk command lower cap rates and properties with higher risk command higher cap rates. The proposed differentiated LTV based on cap rate would result in weaker projects qualifying as "low risk loans" with lower LTVs, while stronger projects with lower cap rates would be subject to higher LTV restrictions. This appears counter to the intention of the rule. MBA recommends deleting the cap rate test. Incorporation of an ending LTV eliminates the need to prescribe specific amortization terms and loan terms.
Financial Disclosure	(i) Require the borrower to provide to the originator and any subsequent holder of the commercial loan, and the servicer, the **property's** financial statements and supporting schedules on an ongoing basis….	**Modify** – Technical change to reflect actual practice focused on analysis of property performance.
Collateral Restrictions	(ii) Impose **restrictions** on: (A) The creation or existence of any other security interest with respect to any collateral for the CRE loan **should be limited to subordinate financing in the form of mezzanine debt, b-notes or preferred equity and should be permitted subject to a combined maximum LTV, say 75%. No second mortgage liens should be allowed**; (B) The transfer of any collateral pledged to support the CRE loan; and (C) Any change to the name, location or organizational structure of the borrower, or any other party that pledges collateral for the loan;	**Modify** – The subordinate financing market is a significant market that is essential to borrowers and the CMBS market generally. Numerous real estate finance investors specifically invest in the subordinate financing space and many borrowers rely on that market. Loan assumptions, transfers within the borrowing entity, releases of property/collateral and other similar provisions should require lender/servicer approval unless specifically set forth in the loan documents.
Borrower Property Requirements	(A) Maintain insurance that protects against loss on any collateral for the CRE loan at least up to **the lesser of** the current amount of the loan **or 100 percent of replacement** cost, and names the originator or any subsequent holder of the loan as an additional insured or loss payee; (4) The loan documentation for the CRE loan prohibits the borrower from obtaining a loan secured by a junior lien on any property that serves as collateral for the CRE loan ~~.unless such loan finances the purchase of machinery and equipment and the borrower pledges such machinery and equipment as additional collateral for the CRE loan.~~	**Modify** – 100 percent or replaced cost is used because under certain conditions the replacement cost may be higher than the loan amount. Insurance policy names the originator or subsequent loan holder as an additional insured or loss payee in order to protect the interests of the loan holder in the event of property casualty. Lenders do not want loan documents to allow property to be used as collateral for purchase of machinery and equipment.
Loan Interest Rate	(iii) The interest rate on the loan is: (A) A fixed interest rate; or (B) An adjustable interest rate and the borrower, prior to or concurrently with origination of the CRE	**Modify** – Industry practice allows interest rate caps as well as interest rate swaps. Focus should be on limiting the potential increase in debt service to a level not supportable by the property's net operating income.

	loan, **purchases an interest rate cap at a level deemed acceptable by lender.**	
Underwriting Standards MBA Recommends to Support		
First Lien	The CRE Loan must be secured by the first lien on the CRE.	**Support** - Standard CMBS practice.
Appraisal	Obtained a written appraisal of the real property securing the loan that……	**Support** - Consistent with CMBS practice.
Environmental Assessment	Conducted an environmental risk assessment to gain environmental information about the property securing the loan and took appropriate steps to mitigate any environmental liability determined to exist based on this assessment;	**Support** - Consistent with CMBS practice.
Defer Principal and Interest	(ii) The borrower is not permitted to defer repayment of principal or payment of interest; and …	**Support** – Consistent with CMBS practice.
Interest Reserve	The originator does not establish an interest reserve at origination to fund all or part of a payment on the loan.	**Support** - Consistent with CMBS practice.
Payments at Closing	At the closing of the securitization transaction, all payments due on the loan are contractually current.	**Support** - Consistent with CMBS practice.
Fixed/Floating Rate	Only Fixed Rate Loans or Floating Rate with Interest Rate Cap	**Support** – Consistent with CMBS practice.
Internal Supervisory Controls	(10) (i) The depositor of the asset-backed security certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security meet all of the requirements set forth in paragraphs (b)(1) through (9) **[Subject to the changes proposed by MBA for certain items contained in these paragraph**s] of this section and has concluded that its internal supervisory controls are effective;	**Support –** This is consistent with new SEC regulations that require the issuer evaluate its internal supervisory controls.

C. Necessary Corrections for CRE Loans[76]

MBA notes that whether or not the recommendations above are accepted in aggregate or in part, there are certain changes that are necessary in the Proposed Rule to ensure consistency with current CRE real estate practices and standard definitions (that is, the underwriting requirements that need to be modified, noted above). These include:

- REIT Loans – Secured loans to REITs that are made on specific assets should qualify as CRE loans.

- Debt Service Coverage Ratio – The debt service coverage ratio (DSC) should be based on the debt associated with the first mortgage, not all debt.

- Qualified Tenant – Based upon the definition, the qualified tenant is based upon requirements that narrowly fit actual leasing practices. For example, all leases must be NNN, however, for the majority of office tenants, leases are full service gross. MBA recommends removing this requirement.

- Borrower Financial Conditions – Verification and documentation of the current financial condition of the sponsor versus the borrower.

- Straight Line Amortization – Very few loans are done on straight line depreciation basis and this would require a change to the finance structure of CMBS loans.

- Borrower Financial Projection – The Proposed Rule requires that an analysis be performed to determine if the borrower can meet its debt obligations for the next two years. Projecting ability of the borrower pay its debts for the next several years is highly problematic because it can be challenging to obtain the total financial picture of the borrower. Instead, the CMBS industry has relied on the residual value of the CRE that was pledged to provide assurance that the loan obligation will be paid.

- Machinery Purchase – Borrowers should not be allowed to place a junior lien of the property for equipment purchases.

- Loan to Value – We do not believe the restrictions based on cap rates warrant a change in the LTV. Giving preferable treatment to properties with higher cap rates directly promotes the inclusion of loans on properties that investors view as higher credit risks.

[76] Section responsive to Question 156a of Proposed Rule.

- 20-Year Loan Term and Straight Line Amortization – Straight line amortization is generally not used in commercial mortgage lending. Twenty year amortization does not recognize the realities of CRE finance.

- 10-Year Loan Term – The minimum 10-year loan term would lock-out a key part of the market, including the securitization of bank portfolio loans. Banks typically hold CRE loans with terms ranging from 3 to 7 years.

MBA also calls for underwriting standards to be paired with industry-developed representations and warranties. The Proposed Rule only addresses representations and warrantees directly in the section that addressed the first-loss position buyer serving the risk retention role. MBA supports industry efforts to develop representations and warrantees with meaningful remedial mechanisms. Pairing underwriting standards with industry-developed representations and warrantees would enhance investor confidence.

In addition, an important area of concern that is not addressed in the table above involves an insurance issue. MBA supports the inclusion of a borrower covenant regarding insurance in the definition of low credit risk loan. We note, however, that the commercial property and casualty insurance industry does not deliver insurance policies on a timely basis. We further note that this is not within the control of the lender, servicer or borrower and that the industry does not generally consider this a default under the loan documents. Until the commercial property and casualty insurance industry makes it a practice to deliver policies or legally valid evidence of the insurance in place timely, the lender/servicer will continue to pursue policies or other legally valid evidence of insurance only as required by the servicing standard defined in the PSA.

Although we recommend substantial changes in the proposed CRE loan underwriting standards, MBA is in strong support of elements of the Proposed Rule that address the following topic areas: first lien, appraisal, environmental assessment, defer principal and interest, interest reserve payments at closing, fixed/floating rate, and internal supervisory controls (see underwriting requirements that MBA supports, discussed above).

MBA's proposed underwriting requirements strive to be responsive to the Proposed Rule requirement of identifying low risk loans while at the same time recognizing the inherit challenges with defining a low risk loan through a metrics only approach. While not perfect, we believe that the MBA proposed structure much more closely approximates a low risk loan than the Proposed Rule, which would disqualify virtually every conduit CMBS loan that has ever been made. Should the Agencies proceed with the underwriting criteria as proposed, it would provide tacit recognition that the Agencies did not recognize underwriting criteria as a viable construct for reducing risk retention.

* * *

Thank you for the opportunity to submit comments on this critically-important rulemaking. Please do not hesitate to contact MBA if you have any questions or if further briefing would be helpful.

Sincerely,

E.J. Burke
Chair, Commercial Real Estate/Multifamily Finance Board of Governors
Mortgage Bankers Association

Attachments

APPENDIX A

The Commercial/Multifamily Mortgage Market

COMMERCIAL REAL ESTATE[1]

Apartment buildings, office buildings, shopping malls, industrial facilities, health care and *hotel properties* are all examples of commercial real estate. These properties house all of the nation's businesses, and a full one-in-seven of its households.[2] Some non-residential commercial properties are owner-occupied, meaning the business that occupies the space also owns it, and some are "income-producing," meaning the commercial property is leased out to businesses that pay rent to use the space. *Income-producing properties* are run much like other businesses; the rent payments received from lessees are income; maintenance, utility and other costs are expenses; and the property owner looks to make a *return on its investment* through a) earning income in excess of expenses and b) capital appreciation of the property/business itself.

FINANCING COMMERCIAL AND MULTIFAMILY PROPERTIES

Like other businesses, commercial real estate is typically financed through a combination of sources. The property is typically owned by a *limited liability corporation* (LLC) whose sole purpose is to own that particular property. The corporation has *equity investors,* and will typically take out a *mortgage* collateralized by the property, and sometimes *other debt*. The equity, other debt and mortgage loan collectively represent the *capital stack* of value of the property.

Should the property owner default on the debt obligations, the mortgage lender has a *direct claim* on the property, while the provider of other debt financing (sometimes called mezzanine or corporate debt) has a claim on the ownership interest of the LLC. For this reason, mortgage lenders are typically described as being at the bottom, or the safest position, of the overall financing capital stack. This is why lenders are willing to accept mortgage interest rates that are typically lower than the rates required for other types of financing, e.g., mezzanine debt or equity investments. If the value of the property increases or decreases, the mortgage amount and other debt levels remain in place and the increased/decreased value accrues to the equity owners.

COMMERCIAL/MULTIFAMILY MORTGAGES

Commercial mortgages are generally *long-term loans* (typically maturing 7 or 10 years after they are made and amortizing over a longer period), *collateralized* by the commercial property itself. They typically have a *balloon payment* on their maturity. Because of the nature of LLC ownership of the property, many commercial mortgages are *non-recourse,* meaning that in the case of default, the lender can foreclose on the property, but is limited in its ability to seek repayment of the loan from other assets of the borrower. Many commercial mortgages, particularly those with 10-year terms, have *prepayment restrictions,* meaning that if the property owner wishes to repay the mortgage prior to its maturity date, they must compensate the lender/investor for the lost interest income that was due.

Commercial mortgages are underwritten based on a detailed analysis of the property, its income and its value. In addition to analysis of the sponsors and the property market, underwriting typically focuses on a property's net operating income and its value.

The *net operating income* is assessed to make sure that the property's cash flows can support the mortgage payments due on the loan. Rents, other income, expenses, and other factors are taken into account and compared to the required debt service to derive a debt service coverage ratio (DSCR). An average mortgage loan made by a life insurance company in 2006 and 2007 had a *debt service coverage ratio* of 1.5 to 1.6 — meaning the property's income was 50 percent to 60 percent higher than the level required to pay the mortgage debt payments.[3]

The *property's value* is calculated through appraisals and other means to make sure that the value of the property exceeds the mortgage loan amount. The property's value is assessed and compared to the mortgage loan amount to derive a *loan to value ratio* (LTV). An average mortgage loan made by a life insurance company in 2006 and 2007 had a loan to value ratio of 63-66 percent – meaning that the collateral value of the property exceeded the loan amount by roughly half.[4]

Should the property owner default on the mortgage, the lender/servicer has a variety of options including modifying the mortgage, extending the mortgage, foreclosing on the property, or selling the non-performing mortgage to another lender/investor. Should the lender *foreclose,* they can then seek to recoup their losses through a sale of the property, which has

1 Many regulatory definitions of "commercial real estate" include construction lending, which is often driven by the acquisition, development and construction of single-family homes. Most industry practitioners instead focus on the more coherent group of income-producing commercial properties, which are addressed here. For more information on the distinctions, see "Commercial-Multifamily Delinquency Rates: Mixing Performance Measures Gives a Misleading Picture of Commercial Property Loan Performance." http://www.mortgagebankers.org/files/Bulletin/InternalResource/63450_CREFDelinquencyRateJuly2008.pdf

2 US Census Bureau, 2007 American Housing Survey.

3 American Council of Life Insurers, Commercial Mortgage Commitments.

4 Ibid.

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value as an asset. Commercial properties also have cash streams, in the form of the tenants' lease payments, which can defray the lost principal and interest payments.

COMMERCIAL / MULTIFAMILY MORTGAGE PARTICIPANTS

A wide range of participants play key roles in the commercial mortgage market. *Originators* work with property owners to assess different financing options and to identify and underwrite the mortgage. *Lenders* underwrite and close the loan and provide the funding. *Investors,* whether the initial lender or one who buys a whole loan or CMBS, receive principal and interest payments in return for their initial funding. *Servicers* manage the loan on behalf of the lender / investors. In addition to managing the collection and distribution of principal and interest payments, servicers also perform tasks such as periodic property inspections, analysis of property financials and insurance reviews and manage the issues related to delinquency, default, foreclosure and real estate owned (REO). When CMBS are created, *securitizers* pool loans and underwrite and create securities, *rating agencies* analyze and rate the risks of the various tranches and *trustees* oversee the securities and the various relationships created. Many other participants also play critical roles in the commercial mortgage market, including *appraisers, property engineers, attorneys, accountants, data and technology providers,* and more.

LENDERS AND INVESTORS

Commercial and multifamily mortgages have long been a key staple in the portfolios of banks, life insurance companies, pension funds and others. The relatively long-term nature and stability of the mortgages, and their cautious position in the capital stack, mean that they often match well with these lenders' risk and asset / liability profiles. With their different investment objectives, different lenders / investors differ in their approaches to mortgage lending.

Banks and thrifts are the largest overall holders of commercial and multifamily mortgages.[5] Commercial mortgages made by banks and thrifts are more likely to be on smaller properties and to borrowers who have a variety of relationships with the bank. Banks often make these loans with recourse to the borrower, meaning the borrower's assets serve as additional collateral for the loan. Banks and thrifts have to match their relatively short-term sources of funds (checking accounts, savings accounts, CDs, etc.) with relatively short-term investments of those funds. As a result, they tend to make shorter-term or adjustable-rate mortgages. Of the $1 trillion nonresidential commercial mortgages reported held by banks and thrifts at the end of 2009, 42 percent were for owner-occupied properties and 58 percent were for income-producing properties.[6]

Life insurance companies hold 9 percent of the outstanding balance of commercial and multifamily mortgages. Life insurance companies have long-term liabilities, in the form of life insurance policies, and typically look for long-term investments. Life company loans tend to be ten-year, non-recourse loans, and to be fairly conservatively underwritten. Life company mortgages tend to be on income producing properties.

Fannie Mae and Freddie Mac hold multifamily mortgages that account for 6 percent of the balance of commercial and multifamily mortgages. In addition, they and *FHA / Ginnie Mae* guarantee multifamily mortgages in securitized pools that account for an additional 5 percent of the balance. These entities only purchase and guarantee residential mortgages and their holdings and guarantees represent 40 percent of the multifamily mortgage market.

The *commercial mortgage-backed securities* (CMBS) market holds 20 percent of the outstanding balance of commercial and multifamily mortgages. Through the CMBS market, commercial and multifamily mortgages are pooled together, and a series of securities is structured ("tranched") so that the principal and interest payments from the mortgages flow through to security investors in a waterfall, with investors in the most secure bonds being paid first, and investors in the least secure bonds being paid last. Because the lower risk securities generally pay a lower yield and the higher risk securities pay a higher yield, the structure allows investors to buy bonds with the level of protection they desire. Fannie Mae and Freddie Mac, life insurance companies, banks and others have all been investors in CMBS, generally in the AAA, or safest, securities.

A wide range of additional lenders / investors hold the remaining balance of commercial and multifamily mortgages. These include the *federal government, state and local governments, finance companies, mortgage real estate investment trusts (REITs), pension funds,* and *other businesses and individuals.*

AFFORDABLE RENTAL HOUSING

While some families rent as a lifestyle choice, many families rent because their income, credit rating or savings for a down payment are not sufficient to purchase a home. For these families, rental housing is a necessary first step toward homeownership or a longer-term necessity. Many of these families choose to rent single-family homes, but a large number choose multifamily housing (developments containing 5 or more units / apartments). Of the approximately one-third of US households that rent, 15 million rent apartments in multifamily structures.[7]

5 Federal Reserve Board, Flow of Funds Account of the United States.

6 Federal Deposit Insurance Corporation (FDIC), Quarterly Banking Profile.

7 US Census Bureau, 2007 American Housing Survey.

The federal government provides support for the financing of affordable rental housing in a number of ways. The *Department of Housing and Urban Development* (HUD) subsidizes a number of multifamily rental properties through programs funded over the past 40+ years in various forms (e.g., interest rate subsidies, project-based and tenant-based rental assistance, etc.). Many of these older assisted properties need rehabilitation and are being refinanced through HUD's FHA insurance programs and through Fannie Mae and Freddie Mac multifamily programs. HUD also produces *new assisted housing developments for seniors* through the Section 202 program which provides a capital grant to reduce development costs and also provides rental assistance to lower-income elderly households.

The *FHA multifamily insurance programs* are used to produce and rehabilitate privately owned and operated workforce housing without any federal subsidy. The FHA multifamily programs charge mortgage insurance premiums that are adjusted annually, when necessary, to ensure they do not require federal appropriation of funds and, instead, actually generate revenue for the federal government. Much of the processing of these loans is delegated to approved lenders; however, each loan is reviewed and approved by FHA field staff prior to issuance of a commitment for insurance.

Since 1992, both *Fannie Mae and Freddie Mac* have been required to facilitate the financing of housing for underserved families and markets through legislatively established affordable housing goals. The goals were recently amended and now specify a goal for multifamily housing that requires a percentage of multifamily units financed by the GSEs to be affordable to lower-income families. While no subsidy is provided by the GSEs, they must facilitate the financing of loans for these markets.

The *low income housing tax credit* (LIHTC) program, initiated in 1987, is the only tax incentive specifically designed to promote the production of low-income rental housing. The LIHTC creates an incentive for private investors to provide equity for rental housing developments targeted at lower income households by granting tax credits to these investors. The LIHTC annually supports the construction or rehabilitation of approximately 135,000 rental units.

THE MORTGAGE BANKERS ASSOCIATION

The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field.

For more information visit www.mortgagebankers.org or call (202) 557-2700.

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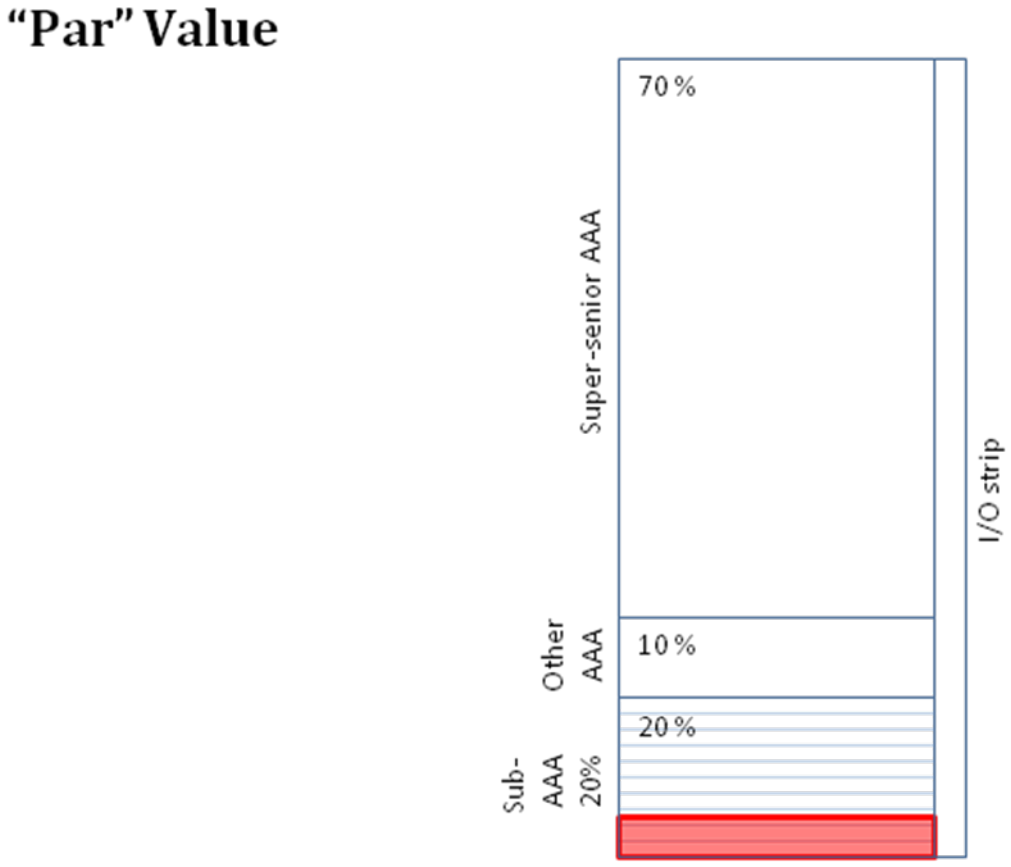
APPENDIX B

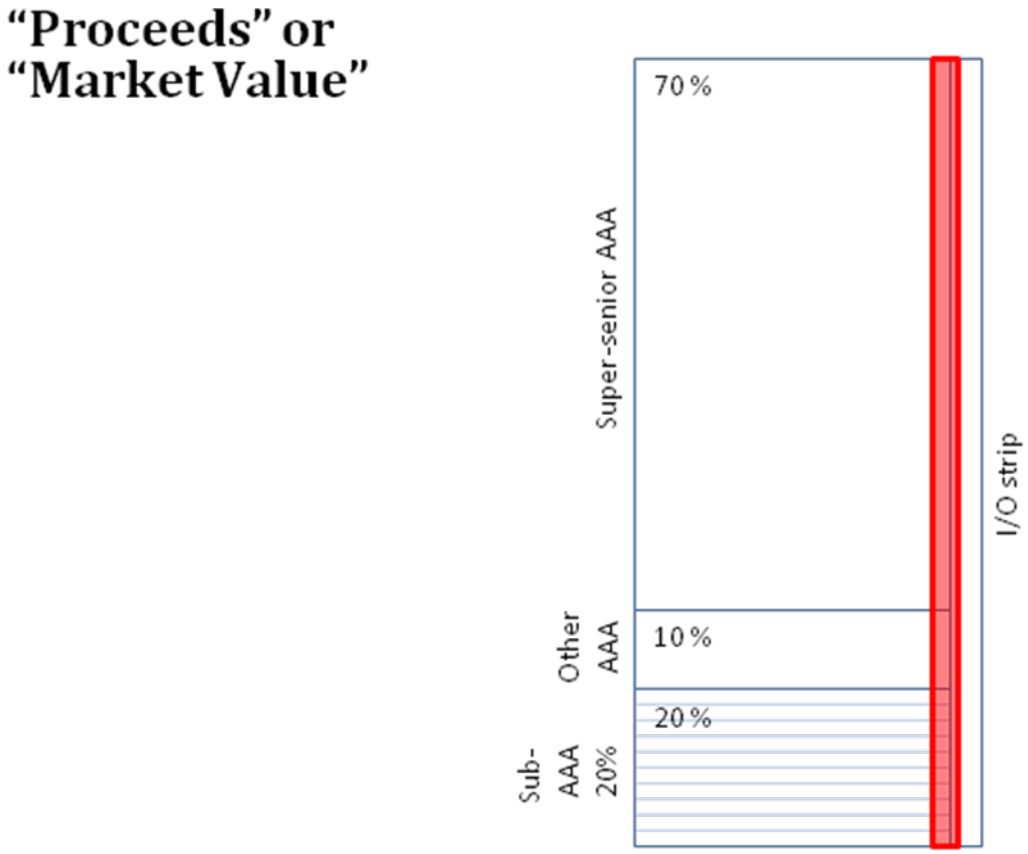
HORIZONTAL RISK RETENTION IN RED



Source: MBA

Horizontal Risk Retention - Concentrates risk at the bottom of the credit waterfall, which represents the most at risk portion of the CMBS.

VERTICAL RISK RETENTION IN RED



Source: MBA

Vertical Risk Retention – Allocates risk retention evenly throughout the CMBS tranches. The at-risk portion of the CMBS is in the lower end of the sub-AAA rating categories. The likelihood of losses for horizontal risk retention is much higher than vertical risk retention because only a small percentage of the vertical risk retention tranches are likely to experience losses. Thus, the risk retention calibration for these two methodologies should take into account their respective divergent risk profiles.

APPENDIX C

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April 12, 2011

North America

CMBS Strategy

CMBS Market Insights

The Dodd-Frank NPR: Implications for CMBS

Regulators released their Notice of Proposed Rulemaking (NPR) for Dodd-Frank Risk Retention on March 29. Critically for CMBS, the proposal *does* allow risk retention to be satisfied by a B-piece investor.

However, the proposal also contains two key provisions that work against each other and, in our view, would be extremely difficult to satisfy simultaneously. These provisions, which market participants did not expect, are (1) risk retention is 5% of total deal proceeds, not 5% of par, and (2) the B-piece investment is non-transferable and must be retained by the B-piece buyer for the life of the deal. Non-transferability of the B-piece investment could have a severely negative impact on its market value, making it extremely difficult to reach 5% of deal proceeds in an economically viable way.

While there are a number of other issues in the proposed regulations that are also problematic, the above two provisions are key in that if they cannot be successfully addressed, we expect that activity in the CMBS market will be dramatically curtailed.

Given the fragile state of commercial real estate markets, particularly for smaller properties, and the fact that approximately $600 billion of CMBS loans and $1.2 trillion of bank CRE loans, much of them distressed, need to be refinanced over the next five to six years, the impact on the commercial real estate market could be profoundly negative.

In terms of relative value considerations, the possibility of such a worst-case outcome would likely be positive for bonds from CMBS 2.0 deals as well as bonds from senior parts of legacy capital structures on the basis of restricted future supply. However, the impact on riskier legacy bonds could be decidedly negative, as our loss estimates under such a scenario would be dramatically higher.

The Dodd-Frank NPR: Implications for CMBS

Overview

On March 29, federal regulators released their Notice of Proposed Rulemaking (NPR) regarding risk retention for US securitization markets, as mandated by the Dodd-Frank Act. Market participants have until June 10 to provide comments and feedback on the proposals to regulators. The new rules will take effect two years after they are finalized.

This note summarizes the most important elements of the proposal as they pertain to the CMBS market and examines their implications. Our colleagues published a review last week of the proposal, with a focus on the impact on the residential, consumer ABS and CLO markets.[1]

The proposed regulations contain the expected 5% risk retention requirement for issuers, which could be satisfied in a variety of ways, including the retention of a vertical slice, horizontal slice or L-shaped slice. The proposal also contains an option, critical to CMBS, that allows risk retention to be satisfied by a qualified third-party B-piece buyer. There are, however, a number of significant restrictions on the B-piece buyer that must be satisfied.

There is also a second, and unexpected, option allowing CMBS issuers to avoid risk retention on deals where underwriting is sufficiently conservative. This option is analogous to the Qualified Residential Mortgage designation – if loans meet a set of highly restrictive underwriting criteria, the issuer is exempt from retaining risk in the deal.

Unfortunately, the proposed regulations also contain two provisions that, taken together, could be extremely challenging to satisfy and if not addressed would, in our view, result in a dramatic curtailment in CMBS activity. The first provision relates to the fact that while the 5% risk retention requirement is stated in the NPR in a way that suggests 5% of par value, regulators are, in fact, targeting 5% of total deal proceeds or market value.[2] In fact, the premium capture cash reserve account, discussed below, is designed to effectively increase "risk retention" to 5% of deal proceeds.

[1] "Securitized Market Insights – Risk Retention Proposal: Implications to Securitization", 4/6/11.

[2] Required risk retention is stated to be "at least five percent of the aggregate credit risk of the assets collateralizing an issuance of ABS". That regulators are targeting 5% of deal proceeds instead of 5% of par was clarified in a call between the CREFC and the Fed on April 8.

At the same time, the proposal contains a provision prohibiting B-piece buyers from selling their B-piece investments. This provision could substantially reduce the amount a B-piece buyer would be willing to pay for a B-piece investment, and thus its market value. At the same time that the regulatory proposal attempts to ensure that risk retention is significantly greater than 5% of par value, the non-transferability condition for the B-piece actually works to reduce its market value. In our view, it is unlikely that the two provisions can be met simultaneously in a way that is economically viable.

On the other hand, a non-transferability restriction of one or two year duration, allowing the B-piece to be sold to a *qualified* investor after that, may work. Indeed, much of the value added by a B-piece investor comes from their thorough screening of the loan for fraud and other potential problems, which is typically most important at the early stages of a transaction.

In the event that these issues are not resolved, we would expect a substantial curtailment in CMBS activity as the incentive for issuers to structure securitizations would be severely reduced. The impact would likely be a dramatic decline in the amount of financing available to the commercial real estate sector, especially for small to medium-sized properties. This, of course would increase the cost of borrowing and almost surely push cap rates up as well.

Increasing financing rates and cap rates would come at a time when approximately $600 billion of CMBS loans and $1.2 trillion of CRE loans in banks, much of it distressed, need to be refinanced over the next five or six years. In our view, the impact of such a scenario on CMBS losses alone could be very large.

The Premium Capture Cash Reserve Account: AKA Risk Retention of 5% of Deal Proceeds

Upon release of the NPR, there are many questions concerning the nature and intent of one unexpected element, the premium capture cash reserve account.

As stated in the NPR, this condition requires that the sale of any IO securities or the proceeds from the monetization of any excess spread be used to fund an upfront reserve account. This reserve account would then be used as subordination for the B-piece, becoming, in effect, the first loss piece. Such a structure would prevent issuers from

realizing any profit in the deal up front, and possibly any profit at all, since the average loss for conservatively underwritten conduit deals (1.5%-3.0%) is roughly the same order of magnitude as the proposed reserve accounts. Thus, it was assumed that the motivation for the reserve account construct was to increase the total amount of risk retention by including issuer's profits in the securitization via the reserve account.

During a conference call between the CREFC and the Federal Reserve on Friday, April 8, regulators clarified what the proposed regulations were trying to achieve. In particular, the intention of the premium capture reserve account was to ensure that issuers (or the combination of issuers and B-piece buyers) held risk retention of 5% of total deal proceeds or market value, rather than 5% of par.

Risk Retention – A Final Take

As noted above, language in the NPR suggested that required risk retention would be 5% of par. This could have been satisfied by a B-piece buyer holding the bottom 5% slice of a deal. However, the classes that make up the B-piece price at a deep discount, typically less than 50% of par, which provides the mid teens yield required by B-piece investors. But a B-piece that is 5% of par may be worth less than 2.5% of deal proceeds, which would be well short of satisfying the intended risk retention requirement.

One possible solution would be to redirect sufficient excess spread in the deal to increase the coupon on the B-piece and thus boost its market value to close to par. (Note that this is similar to the premium capture cash reserve account construct.) However, there is no guarantee that this is feasible. If interest rates or credit spreads rise significantly during the warehousing period leading up to the securitization, there may not be sufficient excess spread. In any case, the execution would generally be highly inefficient since B-piece buyers would be unwilling to pay up for the low risk excess spread. Making the deal economics work would necessitate charging higher interest rates on the underlying loans.

An alternative strategy would be to the convince B-piece buyer to buy a much larger bottom slice of the deal, large enough that the market value would be 5% of proceeds. The feasibility of this approach is unclear, but again, B-piece buyers do not typically buy BBB-rated bonds, which have relatively low credit risk and thus low yields. Presumably, they would only be interested to the extent that they could buy the additional bonds very cheap to fair value.

In any case, as long as there is non-transferability of the B-piece, we think it is unlikely that any potential fixes are likely to work.

Restrictions Related to the B-Piece Buyer

Apart from the problematic provision regarding non-transferability of the B-piece, the B-piece buyer would be restricted from hedging the asset-specific credit risk in the deal, although hedging of interest rate risk and non-asset-specific credit risk would be permitted.

There are also proposed restrictions on the B-piece buyer having control rights. Specifically, in order for the B-piece buyer to have control rights, or to function as the special servicer, the deal needs to be structured with an operating advisor who is unaffiliated with any other party to the transaction and represents the interests of all certificateholders. The special servicer would be required to *consult* with the operating advisor on all major decisions regarding the servicing of the loans. The operating advisor would also be responsible for reviewing the actions of the special servicer and determining whether they are performing in accordance with the servicing standard.

The role of the operating advisor is analogous, in some respects, to that of the trust advisor, which is emerging in CMBS 2.0. One important difference, however, is that the operating advisor has consultation rights from the start of the deal, whereas the trust advisor in certain CMBS 2.0 transactions has consultation rights only after the B-piece buyer is appraised out of control.

The most profound difference, however, one that is highly problematic, is that the operating advisor has discretion to recommend the replacement of the special servicer, and if such a recommendation is made, *the special servicer must be replaced unless 51% of each eligible certificate class votes to retain the special.* Requiring that 51% of each eligible class vote not to replace the special servicer in response to an operating advisor replacement recommendation seems onerous, and is effectively equivalent in our view to giving the operating advisor the unilateral right to replace the special servicer. The operating advisor could use the threat of recommending replacement to exercise undue influence over the special servicer. In our view, it would be more appropriate to require that certificateholders vote affirmatively in order to remove the special servicer.

It is unclear who would choose the replacement special servicer, but it seems likely that it would be the operating

advisor. Presumably, once chosen, the replacement special servicer would again be directed by the B-piece buyer.

In our view, B-piece buyers would require a higher yield under a construct in which the operating advisor has the right to replace the special servicer.

Issuer monitoring of B-piece buyer compliance is another problematic area of the proposed regulations. In particular, the issuer has an ongoing responsibility for ensuring the B-piece buyer remains in compliance with the risk retention restrictions, including neither selling nor improperly hedging the investment. In practical terms, this type of oversight is virtually impossible. There is no way for the issuer to know if a B-piece buyer puts on a restricted hedge.

Qualifying Commercial Mortgages

As noted, the proposed rules provide two options under which the issuer is exempt from risk retention. The first entails the B-piece buyer satisfying the risk retention requirement in place of the issuer. The second requires that the collateral pool satisfy a set of particularly conservative underwriting standards. Specifically, there are approximately thirty underwriting requirements that must be satisfied in order for a commercial mortgage pool to be exempt from risk retention. We estimate that if just three of these requirements are applied (LTV of 65% or less, DSCR of 1.7x or higher and an amortization period of 20 years or less at securitization), approximately 0.4% ($2.9 billion) of the $671 billion conduit loans that have been securitized since the beginning of the CMBS market would have qualified. If the rules were loosened to 1.5x DSCR, 70% LTV and 25-year amortization, 3% ($17.5 billion) would have qualified.

These results contrast with the residential mortgage case, where, according to an analysis undertaken by Morgan Stanley Securitized Products Research, the proportion of the current outstanding market that would meet the QRM requirements is approximately 20%.[3]

Key Requirements:

- **LTV: Max of 65% (or 60% if appraisal cap rate is less than or equal to 10yr swap plus 300bp).** In our view, LTV does not provide entire credit picture and cap rate spread provision is too narrow as well; could be rendered anachronistic in certain market contexts.
- **DSCR: Min of 1.7x (or 1.5x for stabilized, "qualifying" NOI).** To "qualify" the loan must be secured by either (1) a 5+ unit residential property with 75% of NOI derived from rents and tenant amenities or (2) commercial property that derives at least 80% of its revenue from qualified tenants. A qualified tenant is a tenant that is (or was and is now month to month) subject to a performing triple net lease.
- **Term and Amortization: minimum term of 10 years, maximum amortization schedule of 20 years:** The proportion of conduit loans originated since 1995 that have a 20-year or less amortization schedule at securitization is 2%, the proportion with an amortization of 25 years or less is 7%. The percent of a loan that amortizes in 10 years, on a 20-year schedule is 43%, under a 25-year schedule, 30%. Assuming a 65% LTV and a 20-year amortization schedule on a 10-year loan, property value would have to decline 63% before the debt incurred a loss (equity would be hit at a 29% property value decline). Under the same LTV and term assumptions, but with a 25-year amortization schedule, the property value could decline 55% before the debt incurred a loss (equity would be hit at a 20% property value decline).
- **Loan documents must include covenants that restrict the ability to create additional security interests in the property.** Additionally, the underwritten property may not be pledged as collateral for another loan, even if it is subordinate.

There are two requirements that are particularly curious to us. The first requires originators to verify each borrower has the resources to service their debt. However, commercial mortgages are non-recourse loans. Borrowers effectively purchase the option to default, and it is assumed by market participants that they will exercise their default option optimally. Here, ability to service the debt reflects only the ability of the property to generate sufficient NOI to service the debt.

Second, loans secured by properties owned by REITs are explicitly excluded. We believe this reflects the Fed's experience with bonds containing loans secured by GGP. We think this illustrates concern regarding a REIT's relatively greater ability to successfully put properties into bankruptcy.

Final Thoughts and Relative Value

In our view, the regulatory proposal contains a number of constructive elements. However, there are also several highly problematic provisions. The most significant of these are the combination of risk retention being 5% of total deal

[3] "Securitized Market Insights - Risk Retention Proposal: Implications to Securitization", 4/6/11.

proceeds and the non-transferability of the B-piece investment. These two conditions seem to be intrinsically at odds, and we think it is unlikely that both can be achieved simultaneously in a way that is economically viable for securitizations.

Taking CMBS capacity offline at this time would severely diminish the amount of financing available to the commercial real estate sector, particularly for small and medium-sized properties, and would result in higher borrowing costs and cap rates. Nearly all of the improvements in commercial real estate markets over the past 18 months have been a reflection of improvements in financing markets rather than fundamentals, which suggests that markets remain fragile.

A major disruption in CMBS financing would be likely to lead to sharply higher losses, particularly in CMBS loans scheduled to mature over the next several years. It would also be likely to have negative spillover effects on the ability of smaller regional and community banks to work out their problem CRE portfolios.

We are currently in the process of recalibrating our credit models in order to more accurately assess the impact on our loss estimates for legacy CMBS securities in a worst-case outcome. While the analysis is not complete, it is clear that the potential impact is very significant.

In our view, such an outcome could potentially be a positive for bonds from CMBS 2.0 transactions as well as 2006-2007 super seniors and AMs, purely on the basis of restricted future supply. For those sectors that already appeared rich on the basis of our loss projections, the impact is likely to be negative. This includes tranches below AJ from CMBX series 3, 4 and 5. The most significantly affected classes would likely be the "high convexity" classes A.1, A.2, AA.3, AA.4 and AA.5.

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Global Stock Ratings Distribution

(as of March 31, 2011)

For disclosure purposes only (in accordance with NASD and NYSE requirements), we include the category headings of Buy, Hold, and Sell alongside our ratings of Overweight, Equal-weight, Not-Rated and Underweight. Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, Not-Rated and Underweight are not the equivalent of buy, hold, and sell but represent recommended relative weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Not-Rated to hold and Underweight to sell recommendations, respectively.

	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1195**	**42%**	**469**	**47%**	**39%**
Equal-weight/Hold	**1153**	**40%**	**406**	**40%**	**35%**
Not-Rated/Hold	**114**	**4%**	**22**	**2%**	**19%**
Underweight/Sell	**389**	**14%**	**108**	**11%**	**28%**
Total	**2,851**		**1005**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

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04-12-11 sm

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