



July 18, 2011

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Federal Reserve System  
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The Honorable Mary L. Schapiro  
Chairman  
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The Honorable Martin J. Gruenberg  
Acting Chairman  
Federal Deposit Insurance Corporation  
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Washington, DC 20429

John G. Walsh  
Acting Comptroller of the Currency  
U.S. Department of the Treasury  
250 E Street, SW  
Washington, DC 20219

The Honorable Timothy F. Geithner  
Secretary  
United States Department of the Treasury, and  
Chairman, Financial Stability Oversight Council  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

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

Ladies and Gentlemen:

The Commercial Real Estate Finance Council (“CRE Finance Council”) appreciates the opportunity to comment on the proposed rule for credit risk retention for asset-backed securities,<sup>1</sup>

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<sup>1</sup> Proposed Rule, Credit Risk Retention, 76 Fed. Reg. 24090 (Apr. 29, 2011) (hereafter, “NPR” or “Proposed Rule”).

which was jointly published by your respective agencies (collectively, the “Agencies”) pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>2</sup>

CRE Finance Council members recognize that an extraordinary amount of thought and work went into the development of the Proposed Rule, and particularly appreciates the Agencies’ efforts to craft provisions that seek to address the unique characteristics of the commercial mortgage-backed securities (CMBS) market.

Our comments will concentrate on our members’ concerns about the details underlying the CMBS provisions in the Proposed Rule, especially: (1) the Premium Capture Cash Reserve Account; (2) the conditions for third party risk retention; and (3) the terms and conditions applicable to loans that would meet the exemption for qualified commercial mortgage loans.

The CRE Finance Council represents a broad and diverse constituency of participants within the commercial real estate finance industry. Specifically, our association includes: portfolio, multifamily, and CMBS lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers. Our industry plays a critical role in the provision of financing capital to office buildings, industrial complexes, multifamily housing, shopping and retail facilities, hotels, and other types of commercial real estate that help form the backbone of the American economy.

Given our broad membership, we wish to make clear that, with respect to some issues, our members have varying opinions on whether and how the Proposed Rule will affect commercial real estate finance, and on suggestions for alternative approaches. This divergence of views in certain areas is the natural consequence of the breadth of our membership. Therefore, our comments will point out where our members have a difference of opinion. More importantly, our comments also reflect the overall consensus views of our members. Furthermore, while not all of the CRE Finance Council’s recommendations enjoy unanimous support amongst our members, our suggestions nevertheless seek to provide practical solutions for the entire marketplace while meeting the goals of the proposed risk retention structure.

Considering the important role that commercial real estate plays in the economy and the critical function that securitization, in turn, serves in commercial real estate we must emphasize at the outset that the stakes in this rulemaking process are very high. Failure to achieve a balanced and workable set of risk retention rules could be counterproductive and significantly restrict the overall amount of capital that is available in the commercial real estate finance market, leading to increased costs for CRE borrowers and, ultimately, damage to economic and job growth.

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<sup>2</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”), Pub. L. No. 111-203, §941(b), 124 Stat. 1376, 1896 (2010) (creating Securities Exchange Act § 15G (i)(2)).

Under the terms of the Act, the risk retention requirements will not go into effect until two years after publication of final rules for asset-backed securities other than those backed by residential mortgages.<sup>3</sup> Accordingly, there is time for a thoughtful and deliberative rule development process.

As such, the CRE Finance Council respectfully submits the following comments that we believe will both meet the intent of the regulations and provide workable solutions for the CRE marketplace. We look forward to continuing to work with the Agencies during the rulemaking process.

## **I. EXECUTIVE SUMMARY**

The CRE Finance Council and its members recognize and acknowledge that the concept of risk retention in the Act arose against the backdrop of securitization market structures that were far from perfect, including CMBS structures. While historic losses for CMBS vintages dating back to 1995 are well below 5%, losses peaked for the 2006-08 vintages.

Furthermore, we recognize that within the non-investment grade component of the CMBS structure, the ability to sell off the purchased risk through a collateralized debt obligation (“CDO”) was not a sound business practice, which has led to the CRE Finance Council’s support of certain provisions within the proposed retention rules. Moreover, while the CMBS industry has always valued its transparency as vastly superior to that of other asset classes, further transparency should be embedded in our processes and we recognize that improved disclosure during the offering process and over the life of CMBS will help investors play their crucial role in managing and reducing risks. Finally, the recent downturn made clear that certain conflicts of interest exist in CMBS structures that had not been sufficiently acknowledged or recognized prior to the downturn, and that there is work remaining to be done to identify and adopt processes that better align interests within CMBS structures.

For these reasons, the CRE Finance Council responded to market difficulties with market-driven best practices initiatives to facilitate improvements in the market’s structure including model representations and warranties, improved initial disclosures (Annex A), and improved ongoing disclosures (Investor Reporting Package™). Likewise, the CRE Finance Council has endorsed the concepts of credit risk retention, including appropriate limits on the ability to transfer the retained risk to a third party.

We appreciate the Agencies’ efforts to craft risk retention rules that would take into account the unique characteristics of the CMBS market. We accordingly offer suggested modifications to the Proposed Rule to help the risk retention framework function in a practical and rational manner in the CMBS space, while still meeting both the Agencies’ and the Act’s objectives. The following is a

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<sup>3</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”), Pub. L. No. 111-203, §941(b), 124 Stat. 1376, 1896 (2010) (creating Securities Exchange Act § 15G (i)(2)).

summary of our core suggestions and also serves as a table of contents of [Part IV](#), which encompasses our Proposed Rule analysis and recommendations; all [bolded and underlined](#) titles and letter section references below and throughout the letter also function as hyperlinks if you are viewing these materials electronically:

- [Retention Flexibility \(Part IV.B., page 10\)](#): The Proposed Rule should be clarified to ensure that CMBS sponsors have flexibility to structure the requisite retention to share or allocate it in any way provided that it satisfies the base 5% retention requirement.
- [Representations and Warranties \(Part IV.C., page 12\)](#): Many investors believe that appropriate representations and warranties are a valuable form of skin-in-the-game. Furthermore, the Act ascribed value to enhanced representations and warranties as a concept of skin-in-the-game. Therefore, the CRE Finance Council recommends that use of representations and warranties (and associated breach remedies) that are based on an industry standard and are negotiated and acceptable to investors should satisfy either some portion or all of the risk retention requirement.
- [Large Loan Exemption \(Part IV.D., page 15\)](#): There are securitization structures in addition to the conduit-fusion model that is contemplated in the Proposed Rule, and these structures – including single-asset or single-borrower transactions, and large loan transactions with pools of less than 10 loans – should be exempt from the risk retention framework due to their inherent high degree of transparency.
- [The Premium Capture Cash Reserve Account \(“PCCRA”\) \(Part IV.E., page 16\)](#): The PCCRA cannot economically achieve the stated goal for creation of such accounts, and would have far-reaching adverse impacts on commercial real estate securitization, and accordingly should be eliminated as a requirement for commercial mortgages.
- [Third-Party Retention \(Part IV.F., page 23\)](#): For the third-party retention framework, we suggest modifications to the proposed structure to eliminate significant disincentives for market participants to use the third-party retention option and to provide clarifications on certain other key issues, but otherwise to work within the structure proposed by the Agencies:
  - [Operating Advisors \(Part IV.F.1., page 25\)](#): We believe that the independent Operating Advisor (“OA”) framework should be retained in the risk retention rule but with modifications:
    - [Consultation/Oversight Authority for Special Servicers \(Part IV.F.1.a.-c., page 27\)](#): Oversight authority should be delegated to the OA when the retaining third-party (which in the case of CMBS, would be the non-investment grade, “B-piece” buyer) is the controlling investor class, rather than only when the special servicer is affiliated with the B-piece buyer. We also recommend that the OA be charged with ensuring that special servicers adhere to the

requirements and obligations imposed on them under the controlling CMBS pooling and servicing agreements, including transparency obligations which should track the CREFC Investor Reporting Package™ disclosure requirements that are strongly supported by all CMBS constituents. Specifically, we recommend that, while the B-piece buyer is the controlling class, the OA oversight role is reactive to any investor complaints concerning the special servicer. However, when the B-piece is no longer in control (i.e., is “out of the money”) we propose that the OA oversight role become proactive. We recommend this approach because senior investors have expressed a desire for the oversight enhancements that an OA could provide regardless of whether the special servicer is affiliated with the B-piece buyer, and some B-piece buyers believe that this approach could be workable, although we acknowledge that there are a number of B-piece buyers that believe an OA should not have a role until after the B-piece buyer is no longer the controlling class of certificate holder.

- [Special Servicer Removal Powers](#) (**Part IV.F.1.d., page 29**): We recommend a new threshold and a modification of the OA’s authority to remove a special servicer while the B-piece is the controlling interest, so that this framework better balances the interests of B-piece buyers, whose investment is first in line to absorb losses and who have a particular interest in consulting with the special servicer concerning troubled loans in order to protect their investment.
  - [OA Independence](#) (**Part IV.F.1.e., page 31**): The requirement that the OA have no financial take in the deal other than its fees should be eliminated because we believe that it will artificially limit the universe of potential OAs.
  - [Attachment B](#) (**page 52**) contains a chart that summarizes our OA-related recommendations and requested clarifications to the generally acceptable B-piece buyer conditions are also outlined in [Part IV.F.5.](#)
  - [Attachment C](#) (**page 54**) includes suggested revisions to the Proposed Rule that would effectuate CRE Finance Council’s third-party retention recommendation.
- For the third-party retention framework more generally, we also recommend:
- [Transfer Restrictions Holding Period](#) (**Part IV.F.2., page 31**): allowing transfer of the retained interest to a “qualified transferee” that meets the same requirements as the rule would impose on the B-piece buyer; and limiting the holding period for the retained interest to five years;

- [B-piece Buyer Compliance Self-Certification](#) ([Part IV.F.3., page 33](#)) replacing the sponsor's monitoring obligations with one that requires the B-piece buyer to certify its compliance; and
  - [B-piece Buyer Retention Risk Sharing](#) ([Part IV.F.4., page 33](#)) clarifying that the risk retention obligation may be shared between sponsors and B-piece buyers, and between more than one B-piece buyer.
- [Qualified Commercial Loan Exemption](#) ([Part IV.G., page 38](#)): To ensure that the qualified commercial loan exemption is an effective mechanism that can be used in the CMBS market, we recommend modifying some of the proposed quantitative exemption criteria to capture 20-30% of commercial real estate mortgages – a percentage we believe is appropriate for the CRE mortgage market considering its characteristics – as opposed to capturing fewer than 1%, which is the amount we believe would qualify under the criteria as proposed. We also recommend an exemption for structures besides the conduit-fusion model addressed by the Proposed Rule, such as single-borrower deals and large loan deals with pools of 1-10 loans, that typically have an inherently low risk profile. And we suggest that there be a sliding scale exemption mechanism so that if a certain percentage of loans in a pool meet the exemption criteria, a corresponding reduction in percentage risk retention would be available. A chart summarizing CREFC's view on each of the elements included in the proposed rule is attached as [Attachment D](#) (page 62).

Finally, to ensure that U.S. risk retention regulations are not developed in isolation, the CRE Finance Council suggests in [Part V](#) that attention should be devoted to the question of international harmonization with the European Union's Solvency II risk retention framework which will impact a subset of the CMBS buyer base.

Considering the Act's direction that the risk retention rules for CRE and other non-residential assets shall go into effect two years after publication of the final rules, we believe there is time to get the rules right. Therefore, we respectfully request a series of public hearings, roundtables and other forums to allow both market participants and the Agencies the opportunity to fully vet the rules. We also respectfully request that if the Agencies make significant or material changes to the Proposed Rules after receiving public comments, a re-proposal of the rule would follow rather than issuance of a final rule. To provide just one example of how critical it will be to employ such a deliberative process, we are aware that some are considering proposing modifications to the PCCRA concept that could make securitizations ineligible for public offering under the SEC's rules. While we recognize that if the Agencies were to consider such proposals they would be doing so as a means to mitigate the concerns raised by the premium capture concept, an outcome that yields potential unintended results of this nature could have the same negative impact on the securitization market as the currently proposed construct. For this reason, our members believe that re-proposal of any significant or material changes would help to achieve a superior result both in terms of meeting regulatory goals and fostering a well-functioning securitization marketplace.

## **II. THE CRE FINANCE COUNCIL**

The CRE Finance Council is the collective voice of the entire \$3.5 trillion commercial real estate finance market, including portfolio, multifamily, and CMBS lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers.

Our principal functions include setting market standards, facilitating the free and open flow of market information, and education at all levels. Securitization is one of the essential processes for the delivery of capital necessary for the growth and success of commercial real estate markets. One of our core missions is to foster the efficient and sustainable operation of CMBS. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to produce the best possible regulatory structures. We look forward to continuing to work with policymakers on this effort.

The CMBS market is very different from those of other asset classes and is already making some positive strides toward a recovery. The CRE Finance Council is committed to building on existing safeguards in the CMBS market, promoting certainty and confidence that will support a timely resurgence in the short term and a sound and sustainable market in the long term. In this regard, we have been working with all market constituencies to develop industry standards supported by all constituents in the market which provide marked improvements in the CRE finance arena. Prime examples of our work include enhancements of both the CRE Finance Council's "Annex A" initial loan-level disclosure package and the Investor Reporting Package ("IRP")<sup>TM</sup> for ongoing disclosures and surveillance by investors.

As discussed, the CRE Finance Council's members fully acknowledge that the CMBS market's structure was not perfect during the recent financial crisis, had its share of excess leverage, and lacked necessary transparency in some cases for investors. Our industry's response to these factors, in addition to endorsing the concept of credit risk retention, has included the development of market standards by our members across all market constituencies, who devoted an extraordinary amount of time over the past year to working collaboratively and diligently on them. The market standards are for:

- (1) Model Representations and Warranties;
- (2) Underwriting Principles; and
- (3) Refinements of Annex A

all of which we previously have shared with the Agencies and the Department of the Treasury. The CRE Finance Council has also been actively engaged in an initiative to standardize certain basic terms of CMBS Pooling and Servicing Agreements ("PSAs"), as consistency in these terms across transactions will serve as an added enhancement of transparency. We anticipate that these new market standards initiatives, along with the unparalleled ongoing disclosure offered by our recently enhanced IRP, will create increased transparency, disclosure, and accountability. And we believe that these

improvements will go a long way toward meeting both investor needs and implementing the objectives of the Act.

A full overview of the current state of the CRE finance marketplace, and the mechanics of commercial mortgage securitization are provided in the [Attachment A](#) (page 44).

### **III. THE ACT'S CMBS OPTIONS RETENTION FRAMEWORK**

We very much appreciate and understand that this regulatory initiative is within the framework of the guidance provided by Congress in the Dodd-Frank Act. That Act, which very clearly recognized the unique characteristics of CMBS, provides the outline for, and gives the Agencies the tools to develop, a regulatory structure that we believe can successfully improve the alignment of interests of commercial borrowers, lenders, and investors to produce a more efficient, transparent and sustainable capital market.

As further context for our comments with respect to the NPR, we think it is useful to focus on some of the key elements of the Act as it applies to commercial real estate. In this regard, the Act requires retention (with some exceptions) of not less than 5% of the credit risk for any asset. When reading the rule, we understand that the Agencies are seeking to ensure that loans are well underwritten, and that actual credit losses are minimal as a result of high-quality underwriting. However, “credit risk” is not defined in the statute. As we understand the term in the statutory language, bearing in mind the Webster’s dictionary definition for “risk,” we believe credit risk refers to the likely expected losses with respect to the asset. Based upon the CMBS vintages that have fully seasoned at least ten years from 1995 through 2001, credit losses with respect to pools average, across cycles 2.5%. Arguably, therefore, retention of 5% of credit losses would amount to 5% of the average expected credit losses with respect to loans and CMBS, which would be far smaller than 5% of “par” as has been carried forward in the NPR. As all the stakeholders in this regulatory process work toward establishing a regulatory structure that will achieve the Act’s fundamental goal of risk alignment, it should be kept in mind that a 5% first loss tranche in fact represents a very high percentage of actual likely credit losses.

The Act directs the Agencies to develop a framework that requires a securitizer to retain “not less than 5% of the credit risk for [an] asset.”<sup>4</sup> Congress also recognized in Dodd-Frank that there are different means to facilitate appropriate risk alignment for commercial mortgages, by instructing that the “permissible types, forms, and amounts of risk retention, . . . may include” –

- retention of a specified amount or percentage of the total credit risk of the asset;
- 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

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<sup>4</sup> Dodd-Frank § 941(b) (creating Exchange Act § 15G (c)(1)(B)(i)).

pool before the issuance of the asset-backed securities, and meets the same standards for risk retention as the Federal banking agencies and the Commission require of the securitizer;

- a determination by the Federal banking agencies and the Commission that the underwriting standards and controls for the asset are adequate; and
- provision of adequate representations and warranties and related enforcement mechanisms....”<sup>5</sup>

This provision of the Act clearly equips the Agencies with all the tools necessary to develop a regulatory scheme that is tailor-made to the specific needs and realities of the commercial real estate capital markets.

#### **IV. PROPOSED RULE ANALYSIS and RECOMMENDATIONS**

The Proposed Rule incorporates several of the options outlined in the Act, and the CRE Finance Council’s members particularly appreciate the Agencies’ efforts to develop a third-party risk retention framework (discussed in more detail below in [Part IV.F.](#)). We also believe that the Proposed Rule’s risk retention exemption, which is based on the Agencies’ perception of underwriting standards that lead to commercial mortgages with “low credit risk” under new Securities Exchange Act Section 15G(c)(1)(B)(ii), is a productive start to a discussion of categories of commercial mortgage loans or loan pools that would merit a risk retention exemption (discussed below in [Part IV.G.](#)).

We believe, however, that the Agencies can more fully embrace the opportunity within the structure of the Act to implement rules that meet the goals of alignment of fair and efficient capital markets, minimizing negative externalities, and maximizing the ability of the capital markets to fulfill their role in supporting commercial real estate and the broader U.S. economy. Most significantly, for example, the Proposed Rule should allow for additional flexibility within the “base” risk retention structure; should address the option for risk retention in the form of adequate representations and warranties; and should exclude certain types of CMBS structures from the risk retention framework.

Moreover, CRE finance market participants are concerned that other elements of the Proposed Rule will ultimately lead to constraint of the CMBS market even as the Proposed Rule attempts to fulfill the Act’s mandates to incorporate a degree of flexibility and customization by asset class. These areas are:

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<sup>5</sup> Dodd-Frank § 941(b)(creating Securities Exchange Act § 15G(c)(1)(E)).

- (1) Premium Capture Cash Reserve Account;
- (2) The conditions for retention by a third party; and
- (3) The criteria for meeting the Qualified Commercial Mortgage exemption.

The CRE Finance Council offers suggested modifications to the Proposed Rule where possible, to help the risk retention framework function in a practical and rational manner while still meeting both the Agencies' and the Act's objectives. We also seek clarification on a number of technical matters, as well as guidance on the Agencies' expectations with respect to international harmonization of risk retention regimes.

A. The "Base" Risk Retention Framework for Commercial Mortgages

Generally, the proposed risk retention regulation contains "base" risk retention requirements that apply to all asset classes. The base requirements include options for the securitizer to hold the required 5% retained interest, such as: a "vertical slice," which involves holding 5% of each class of ABS interests issued in the securitization; a horizontal residual interest, which requires that the securitizer retain a first-loss exposure equal to at least 5% of the par value of all the ABS interests issued in the transaction; an "L-shaped" option which involves a combination of the vertical and horizontal options; and for commercial mortgages, there is an option to have a third-party purchaser hold a 5% horizontal first-loss position, subject to several conditions.<sup>6</sup>

On the whole, the CRE Finance Council believes that this menu of options for holding the retained interest will be beneficial, as flexibility will be necessary to avoid the inefficient and impractical structuring of securitizations that would undoubtedly flow from a one-size-fits-all approach. We accordingly commend the Agencies for the thought and effort devoted to developing these options, and our concerns regarding the vertical, horizontal and L-shaped risk retention options relate to matters where additional clarification is desired by the industry.

B. The Base Retention Options Should Incorporate More Flexibility to Account for Marketplace Realities

While the Proposed Rule would permit a CMBS sponsor to allocate risk to a third party in certain circumstances (allocating risk to an originator, or to a B-piece buyer), these circumstances should be expanded in recognition of market realities and to facilitate liquidity in the CMBS market.

More specifically, first, with respect to the L-shaped structure, the Proposed Rule would permit a sponsor to satisfy its risk retention requirements by retaining: (1) half of the interest required under the vertical risk retention provision in § \_\_.4, and (2) either an eligible horizontal residual interest in

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<sup>6</sup> Proposed Rule § \_\_.3-§ \_\_.6 (section numbers refer to those in the Proposed Regulation).

the issuing entity, or establishing and funding a horizontal cash reserve account that satisfies the requirements of § \_\_.5 (in either case in an amount equal to at least 2.56% of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction other than those ABS interests retained by the sponsor under clause (1) – i.e., half of the horizontal risk retention as provided in § \_\_.5, adjusted to avoid double-counting).<sup>7</sup> Moreover, the L-shaped structure, as proposed, contemplates that only the sponsor would retain the required interest.

The terms of this provision is unduly restrictive, as it does not allow for tailoring the nature of the retained risk exposure to the sponsor's particular needs and the circumstances of the particular securitization. Such tailoring may be necessary because of the market for more senior interests in the CMBS, the size of the horizontal interest as dictated by the subordination requirements of investors or rating agencies, or other factors. A sponsor seeking to employ an L-shaped risk retention structure to fulfill its risk retention obligation should be permitted to do so by retaining percentages different from those specified in the rule for L-shaped retention; the rule should be indifferent to the specific percentage so long as the total equals 5% plus the double-counting adjustment.

Second, in CMBS transactions, it is not unusual for different investors to purchase the various tranches in the B-piece because different entities have different yield requirements. One entity may purchase the unrated and B tranche, and another entity may purchase the BB tranche, for example. In each of these cases, any principal losses would cause the investor to miss its yield target and suffer the resulting consequences, which provides adequate incentive to ensure a careful vetting of the investment prior to commitment. Yet, the Proposed Rule's horizontal interest structure only contemplates retention by the sponsor, or by a single B-piece buyer in the case of the third-party retention option. The Proposed Rule should accordingly allow: (1) sharing of risk retention between a B-piece buyer and a sponsor, in either the form of multiple horizontal tranches or in the form of L-shaped retention with a third party retaining the horizontal first loss portion and a sponsor retaining a vertical portion; (2) sharing of risk retention among multiple B-piece buyers to retain the horizontal interest; or (3) allowing multiple parties to retain "rake bonds" in a large loan transaction.<sup>8</sup>

Third, while the Proposed Rule provides for apportionment of the risk retention obligation between a sponsor and originator(s),<sup>9</sup> it limits the allocation to originators that contribute at least 20% of the pool's securitized assets. The CRE Finance Council recommends eliminating this limitation, as it will have the effect of restricting relatively smaller lenders' access to the securitization markets. If other participants in a CMBS transaction (the securitizer, larger loan sellers) must retain risk on behalf of the smaller contributors, they will be less likely to include these smaller originators in transactions

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<sup>7</sup>See *id.* § \_\_.6.

<sup>8</sup>There are transactions in which a single whole loan is deposited in a securitization, and the tranching of a senior portion and junior portion is achieved by creating "rake bonds" within the securitization. Rake bonds derive cash flow from that single asset rather than from an entire pool of loans, and stand in the first loss position.

<sup>9</sup>See Proposed Rule § \_\_. 13.

(or they will charge the smaller participants for the cost of retaining risk against their contributions). In addition, the logic of this restriction is flawed, as a proportional risk retention obligation for a smaller contributor is likely to represent a greater allocation of such smaller institution's balance sheet, making the retention proportionally just as significant.

**CRE Finance Council Recommendation: The Proposed Rule should allow:**

- (1) a sponsor seeking to employ an L-shaped risk retention structure to fulfill its risk retention obligation by retaining percentages different from those specified in the rule for L-shaped retention, so long as those percentages equal 5% plus the double-counting adjustment;**
- (2) sharing of risk retention between a B-piece buyer and a sponsor, in either the form of multiple horizontal tranches or in the form of L-shaped retention with a third party retaining the horizontal first loss portion and a sponsor retaining a vertical portion;**
- (3) sharing of risk retention among multiple B-piece buyers to retain the horizontal interest; or**
- (4) allowing multiple parties to retain "rake bonds" in a large loan transaction.**

**The Proposed Rule also should eliminate the provision that restricts allocation of risk retention only to originators that contribute at least 20% of the pool's securitized assets.**

**C. A Value Should Be Ascribed to Appropriate Representations and Warranties to Satisfy Risk Retention**

As the CRE Finance Council has emphasized to policymakers, for many investors, an appropriate set of representations, warranties<sup>10</sup> and associated disclosures of exceptions are a more valuable form of skin-in-the-game than an issuer holding a 5% vertical or horizontal interest in a transaction. On the other hand, for other investors, representations and warranties are a complement to, rather than a replacement of, the 5% base risk retention structure contemplated by the Proposed Rule.

In any case, the Act ascribes some value to enhanced representations as a form of skin-in-the game, citing representations, warranties, and related enforcement mechanisms as among the "permissible types, forms, and amounts of risk retention" the Agencies could prescribe for commercial

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<sup>10</sup> Representations and warranties relate to factual assertions made about loan attributes, underlying property characteristics, and lender due diligence. A breach of representations and warranties can lead to a lender being required to buy back the loan at par, which is beneficial to investors because once a breach is discovered, the market value of the loan is typically below its par value.

mortgage pools.<sup>11</sup> It is admittedly difficult to assign a specific quantitative value to representations and warranties. However, owing to the structure of the Act, it is also appropriate to consider that representations and warranties, along with a proper set of disclosures (such as the CRE Finance Council's Annex A for initial disclosures and IRP for ongoing disclosures), should be assigned some risk retention value between 1% and 5%.

Attributing a value to representations and warranties is not an uncommon view. For example, in a May 11, 2011 hearing before the United States House of Representatives Financial Services Subcommittee on Government Reform and Oversight Subcommittee, Dr. Anthony Sanders, a real estate finance professor at George Mason University, opined that:

To be sure, five percent risk retention would be the simplest approach to implement to encourage improved loan origination and underwriting. Unfortunately, risk retention also appears to be the least useful approach.

...risk retention does not directly address origination risk. Representations ("reps") and warrants that are found in Mortgage Loan Purchase Agreements (MLPAs) and related documents directly address origination risk.

...There are more effective alternatives to risk retention: transparency and improved representations and warranties.<sup>12</sup>

In furtherance of these perspectives, and with an eye toward addressing concerns that began to emerge at the onset of the economic crisis and that prompted policymakers to craft risk retention requirements, the CRE Finance Council independently developed a series of market reforms to strengthen the securitization market and foster greater investor confidence.

One of the CRE Finance Council initiatives builds upon existing customary representations and warranties for CMBS to create "Model Representations and Warranties" that represent industry consensus viewpoints.<sup>13</sup> The CRE Finance Council's model was the result of several hundred hours of work by its Representations and Warranties Committee over the course of many months in 2010, and represents the input of more than 50 market participants with diverse views who worked to achieve industry consensus.

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<sup>11</sup> Dodd-Frank § 941(b)(creating Securities Exchange Act § 15G(c)(1)(E) (iv)).

<sup>12</sup> "Transparency as an Alternative to the Federal Government's Regulation of Risk Retention," Testimony of Dr. Anthony Sanders, Distinguished Professor of Real Estate Finance, George Mason University (May 11, 2011), at 2 (available at [http://oversight.house.gov/index.php?option=com\\_content&view=article&id=1281%3A5-11-11-qtransparency-as-an-alternative-to-the-federal-governments-regulation-of-risk-retentionq&catid=34&Itemid=1](http://oversight.house.gov/index.php?option=com_content&view=article&id=1281%3A5-11-11-qtransparency-as-an-alternative-to-the-federal-governments-regulation-of-risk-retentionq&catid=34&Itemid=1)).

<sup>13</sup> The other CRE Finance Council initiatives involve the development of principles-based underwriting guidelines (discussed below in Part IV.G), and updates to the CMBS "Annex A" initial disclosure package for investors.

The CRE Finance Council Model Representations and Warranties were specifically crafted to meet the needs of CMBS investors in a way that also is acceptable to issuers, and were developed with an emphasis on investor concerns about transparency, disclosure, and the need to encourage sound consistently-applied underwriting practices. Such Model Representations and Warranties for CMBS are designed to be made by the loan seller in the MLPA. The CRE Finance Council's model will require issuers to present all prospective bond investors with a comparison via black line of the actual representations and warranties they make to the newly created CRE Finance Council Model Representations and Warranties. And in addition, loan-by-loan exceptions to the representations and warranties must also be disclosed to all prospective bond investors. The Model Representations provide a clear benchmark for comparison, and the need to black line to the Model Representations is a disclosure best practice that makes any variations from the Model Representations easy for investors to evaluate. Use of the model Representations as a reporting template is a disclosure best practice that helps investors understand what underwriting and documentation practices were applied, and what was found in the underwriting process. This provides investors with a key tool necessary if they are to police the quality and completeness of underwriting procedures, and do their part in promoting good origination practices while not promoting bad practices that generate risks that can damage market sustainability.

In this regard, it is important for the Agencies to be aware that, unlike in the residential loan context, it is the normal course for there to be representation and warranty exceptions in CMBS transactions. This is the case because the facts and circumstances of each loan transaction are unique. For example, tenant verifications may vary from loan to loan depending upon the number and size of tenants, or certain environmental concerns may exist with respect to a property and property-specific steps may have been taken by a borrower to remediate those conditions. Some properties have conditions leading to representation exceptions that cannot, as a practical matter, be cured by lenders but which can be adjusted for by other measures, such as putting less debt on the property, building up reserves or other loan-level credit supports, insuring the identified risks, or adjusting for the risk in the credit enhancement or pricing of the corresponding bonds. Properties that have unique features need and should attain financing provided that the loans are properly sized and structured, and investors attain the information needed to properly assess and price their risk. It would not be good public policy to render large swaths of commercial real estate un-financeable just because the property has unique elements that would give rise to a representation exception. Investors understand that any large pool of commercial mortgages will generate many representation exceptions. What they seek is a clear disclosure of those exceptions, so that they can assess the quality of the prospective investment in the related bonds, in light of all of the key facts pertaining to the collateral pool.

The adoption of the CRE Finance Council Model Representations and Warranties is a step that both strengthens risk retention and empowers investors with a robust information tool that can help them do their part in policing CMBS market practices. Some investors believe that the use of robust, standardized representations and warranties should be the key risk retention feature that regulators endorse because it helps those investors actively monitor securitization quality rather than passively delegating that policing role to issuers, B-piece buyers, rating agencies or others. Other investors

prefer a regime where robust and standardized representations are a part of a multifaceted risk retention regime, provided that no portion of the risk retention regime is so inflexible or ill-constructed that it threatens to shut down or significantly chill origination and investment activities in the CMBS market, given that the vibrancy of this market is essential to the ongoing health of our economy. But the industry is united behind the need for, and efficacy of, adopting the Model Representations and Warranties as a critical element in the solution.

Additionally, as part of the Model Representations and Warranties project, the CRE Finance Council also has developed a framework for addressing and resolving claims for breach of representations and warranties. We believe these enforcement standards will satisfy the Act's requirement for "related enforcement mechanisms" when coupled with adequate representations and warranties.<sup>14</sup> The CRE Finance Council standards provide for mandatory mediation before litigation, and represent an industry consensus view on how to resolve disputes in an expedited, reliable, and fair fashion while also avoiding unnecessary costs.

And the industry continues to work on further enhancements with respect to representations and warranties, including frameworks that may involve helping borrowers play a bigger role in providing enhanced disclosure.

**CRE Finance Council Recommendation:** Many investors believe that appropriate representations and warranties are a more valuable form of skin-in-the-game than a percentage risk retention requirement. Therefore, the CRE Finance Council recommends that use of enhanced representations and warranties (and associated breach remedies) that are based on the industry standard and are negotiated and acceptable to investors, along with the use of proper disclosures (such as exceptions and the CRE Finance Council's Annex A and IRP) should be assigned a value between 1% and 5% of the base risk retention requirement. The CRE Finance Council is looking forward to working with the Agencies to determine the correct value to assign to such a disclosure and transparency package.

**D. Certain CMBS Structures Should Not Be Included in the Risk Retention Framework**

It appears that the base risk retention requirements, as well as the framework for a risk retention exemption, focus on the conduit-fusion model CMBS transaction to the exclusion of other transaction structures. For CMBS, there are a number of other structures that should not be subsumed within the risk retention framework because of their high degree of transparency. These structures are single-asset transactions; single-borrower transactions; large loan transactions (fixed and floating) with pools of 1-10 loans; and large loan transactions having only an investment-grade component.

The rationale for excluding such transactions is compelling: since they involve very small pools of loans (or a single loan), a prospective investor is able to conduct the closest possible scrutiny

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<sup>14</sup>Dodd-Frank § 941(b)(creating Securities Exchange Act § 15G(c)(1)(E) (iv)).

of each loan. More specifically, because each loan is a large portion of the overall deal, each loan has its own separate asset-level description in the text of the offering document. Indeed, because of the small number of loans, these securitizations share characteristics with more traditional corporate debt offerings, where investors can look through the structure to assess the quality of the underlying credit in a way that is not characteristic of most other forms of ABS. And the fact that these transactions are offered pursuant to exemption from the registration requirements of the Securities Act means that investors can be given access to full loan files, including diligence materials such as property financials, appraisals, engineering reports, and environmental reports, and also means that these transactions can only be offered to sophisticated investors (Qualified Institutional Buyers and Institutional Accredited Investors).

We note further that with respect to investment-grade-only deals, the purchaser of the lowest tranche (typically rated BBB or A) would not agree to all of the restrictions the Proposed Rule would impose on a B-piece buyer, so the application of the proposed risk retention framework to such transactions would mean the end of the market for investment-grade-only deals, and a corresponding contraction in capital availability.

**CRE Finance Council Recommendation: The Proposed Rule should exclude the following types of CMBS structures from the risk retention requirements: single-asset transactions; single-borrower transactions; large loan transactions (fixed and floating) with pools of 1-10 loans; and large loan transactions having only an investment-grade component.**

E. Premium Capture Cash Reserve Account

The base risk retention regime includes a restriction on the ability of securitizers to monetize excess spread on underlying assets at the inception of the securitization transaction, such as through sale of premium or IO tranches.<sup>15</sup> This provision requires securitizers to establish a “premium capture cash reserve account” (“PCCRA”) when a transaction is structured to monetize excess spread, and to hold this account in a first-loss position – even subordinate to the retained interest – for the life of the transaction.

At the outset, it is important to recognize that, for issuers of CMBS, timing is critical to whether securitization is a profitable undertaking and, therefore, whether there is any incentive to issue CMBS at all. Issuers that pool loans and package them into asset-backed securities take the risks and bear the costs associated with this aggregation process while attempting to earn a reasonable return on capital. In other words, issuers fairly immediately absorb all downside risk associated with the transaction. As previously explained, the IO strip is the primary mechanism for issuers to recover some of these costs within a reasonable timeframe; that is, an issuer also fairly immediately enjoys any upside yielded by the transaction. If a mechanism is imposed that delays recovery of these costs for several years – even if the mechanism is not the premium capture account but is something that has the

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<sup>15</sup> Proposed Rule § \_\_.12.

same effect – *it fundamentally alters the economics of securitization by creating a timing mismatch: it forces the issuer to immediately absorb all the downside risk/losses associated with their interest rate exposure while requiring the issuer to wait years to recognize any potential profit for taking that risk.*

Uniformly, industry participants have characterized the PCCRA as the most unexpected and confusing aspect of the Proposed Rule. Adding to the element of surprise is a real lack of clarity about the Agencies’ intention in adopting the PCCRA concept. The Proposed Rule’s Supplementary Information describing the PCCRA advises that the purpose of the account is “to adjust the required amount of risk retention to account for any excess spread that is monetized at the closing of a securitization transaction. Otherwise, a sponsor could effectively negate or reduce the economic exposure it is required to retain under the proposed rules.”<sup>16</sup> The amount to be deposited in the PCCRA is defined as gross proceeds received by the issuer (net of closing costs) minus 95% of the par value of all ABS interests issued as part of the transaction (or minus 100% if the CMBS third-party purchaser risk retention option is used).<sup>17</sup> Industry participants initially read the text of the Proposed Rule as having the effect of preventing the value of the retained interest from falling below 5% of the transaction’s par value. Based on subsequent statements from certain of the Agencies’ representatives,<sup>18</sup> however, the CRE Finance Council now understands that the purpose of the PCCRA may be to ensure that 5% of the transaction proceeds, instead of par value, are retained.

In the Proposed Rule, the Agencies expressed the expectation that “few, if any, securitizations would be structured to monetize excess spread at closing and, thus, require establishment of a premium capture cash reserve account,” which the Agencies appear to believe would avoid having securitizers use monetized excess spread to negate the effects of the new risk retention requirement.<sup>19</sup> But the capture of 5% of proceeds raises a much more fundamental concern than whether excess spread would negate the effects of risk retention, and would instead bring about far-reaching, adverse consequences for the economics of commercial real estate securitizations and incentives to securitize, including the potential for increased interest rates for borrowers and elimination of profit for securitizers.

Even more fundamentally, the CRE Finance Council does not believe the PCCRA, as proposed, can economically achieve retention of 5% of proceeds in CMBS transactions. We will begin our

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<sup>16</sup> Risk Retention NPR, 76 Fed. Reg. at 24113.

<sup>17</sup> *Id.* at 90.

<sup>18</sup> We refer to a presentation dated April 7, 2011, entitled “Federal Reserve Bank of New York: Understanding Premium Capture,” prepared by an official with the Federal Reserve Bank of New York (“NY Fed”). Although the CRE Finance Council is not aware of this material having been publicly distributed by the NY Fed, the material has been made widely available. We acknowledge that this material is labeled as reflecting only the views of its author and may not reflect the views of the NY Fed or the other Agencies.

<sup>19</sup> See Risk Retention NPR, 76 Fed. Reg. at 24113.

discussion with this latter point, but we also emphasize here that the PCCRA is one of the issues that highlights the importance of having a re-proposal of the risk retention rules. If the Agencies choose to adopt an alternative to the PCCRA, rather than eliminating it as the CRE Finance Council suggests, any such alternative would need to be fully vetted to avoid unintended adverse consequences. We are aware, for example, that the Agencies may be asked to consider an alternative to the Proposed Rule's formula for calculating the PCCRA that involves creating an IO strip on a loan-by-loan basis, in an amount corresponding to the excess over what is needed to achieve CMBS gross proceeds. This alternative has been touted as a simulation of what portfolio lenders create in their own portfolios. Putting aside the many concerns that such an alternative would generate for lenders other than portfolio lenders, for whom the alternative will not work, a more fundamental concern is raised due to the fact that under federal securities laws, such a structure would likely be deemed to create a participation, which renders it ineligible for a public offering under the SEC's rules. Quite plainly, a premium capture mechanism that would have, as an unintended consequence, the effect of depriving CMBS issuers of access to the public market would have a grave negative effect on CMBS issuance, and on capital availability in the commercial real estate market as a whole. Therefore, any alternative that the Agencies may seek to adopt should be the subject of a re-proposed rule.

1. PCCRA Cannot Economically Achieve Retention of 5% of CMBS Transaction Proceeds.

The classes that comprise the non-investment grade "B-piece" of a CMBS transaction are priced at a significant discount—typically an average of approximately 50% of par—which provides yields in the mid-teens that B-piece buyers require.<sup>20</sup> This discounting means that a B-piece that is 5% of par may be equal to less than 2.5% of deal proceeds, falling well below a 5% proceeds risk retention requirement.<sup>21</sup>

Therefore, to reach 5% of transaction proceeds (and avoid application of the PCCRA), the B-piece buyer would have to hold a much larger tranche of the transaction – large enough that the market value would equal 5% of the proceeds. In the average transaction, this would amount to between 10-13% of the face amount of the bonds. This would require the B-piece buyer to purchase not only the non-investment grade classes but also certain investment grade classes.

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<sup>20</sup> Note, however, that the underlying loans are funded at par, and credit enhancement is fully funded from the transaction's inception so there is no counter-party risk. The discounted price of the B-piece does not affect these aspects of the transaction. Note further that the discount and corresponding returns for the B-piece are commensurate with the risk assumed; B-piece buyers will not take a first-loss position unless they are satisfied that they have the possibility of attaining the returns they expect.

<sup>21</sup> In 2011 multi-borrower deals, for example, B-piece holders retained an average of 5.1% of the transaction's par value. See Citigroup CMBS Weekly (Apr. 29, 2011), at 11 (available at <http://www.crefc.org/GovernmentRelations.aspx?id=19475>).

Under such a scenario, B-piece buyers would require that investment-grade bonds they purchase be sold to them at above-market yields (resulting in below market prices) in order to meet their return targets. Mortgage spreads would have to be increased on the loans aggregated in the trusts to compensate for these above-market yields.<sup>22</sup> The cost increases that would be necessary to achieve retention of 5% of proceeds would be so large, however, that the CRE Finance Council has concluded that a 5% of proceeds requirement cannot be realistically accomplished.

Figure 1 provides a hypothetical example of a \$1 billion CMBS transaction and the impact of a market proceeds approach:

**Figure 1.**

Figure 1. A Hypothetical Example: Effects of 5% Proceeds Retention on \$1 Billion CMBS Transaction

|                                      | Scenarios     |                   |                        |                           |
|--------------------------------------|---------------|-------------------|------------------------|---------------------------|
|                                      | 1 (Base Case) | 2                 | 3                      | 4 (Worst Case)            |
| Underlying Mortgage Loan Rate (%)    | 4.99          | 4.99              | 5.36                   | 5.98                      |
| CMBS Revenue (%)                     | 2.0           | 2.0               | 2.0                    | 2.0                       |
| Bonds Yields by Rating               |               |                   |                        |                           |
| A                                    | 5.14          | 5.14              | 5.14                   | 20.00                     |
| BBB                                  | 5.64          | 5.64              | 10.00                  | 20.00                     |
| BBB-                                 | 6.14          | 6.14              | 12.00                  | 20.00                     |
| BB, B, NR                            | 16.00         | 16.00             | 20.00                  | 20.00                     |
| B-Piece Investment Details           |               |                   |                        |                           |
| Yield                                | 16.0          | 10.9              | 14.5                   | 20.0                      |
| Face Amount (\$) / Par Value (\$)    | 50,000,000    | 82,750,000        | 102,797,500            | 137,250,000               |
| Face Amount (%) / Par Value (%)      | 5.0           | 8.3               | 10.3                   | 13.7                      |
| Market Value (\$)                    | 20,552,646    | 50,761,980        | 50,905,055             | 50,823,537                |
| Market Value (%)                     | 2.0           | 5.0               | 5.0                    | 5.0                       |
| Bonds B-Piece Investor Must Purchase | BB, B, NR     | BBB-, BB, B, m NR | % BBB, BBB-, BB, B, NR | % A, BBB, BBB-, BB, B, NR |

**Scenario 1. The Base Case.** This scenario reflects CMBS transactions as they are typically structured today. B-pieces are generally retained at 5% of the transaction's par/face value, which in

<sup>22</sup> One analysis estimated that CMBS spreads would need to widen by 3 to 5 percentage points to compensate the investors who typically buy B-pieces, and that by extension, the illiquidity discount will add 10-15 basis points to conduit financing spreads, with the end result being that the PCCRA would cost the market an additional \$8 billion, which will ultimately be paid by borrowers. See Deutsche Bank, CRE Debt Research Report, "How to 'Fix' the Proposed Risk Retention Rules for CMBS" (Apr. 12, 2011), at 2 (available at <http://www.crefc.org/GovernmentRelations.aspx?id=19475>)

this case is \$50 million. However, because the B-piece is priced at a discount, the market value of the B-piece investment is \$20.55 million or 2.0% of the transaction. This current structure would fail to meet 5% proceeds retention as proposed.

**Scenario 2.** This scenario shows the effect if the B-piece buyer purchases a large enough portion of the transaction to equal 5% of proceeds. A B-piece buyer would have to buy not only the bonds purchased in Scenario 1, but also investment-grade bonds rated BBB-. The purchase of these lower-yielding bonds reduces the B-piece buyer's yield from 16.0% to 10.9%. A B-piece buyer has no incentive to accept this lower total yield as its cost of capital is relatively more expensive, and most B-piece buyers have yield requirements in the 16-20% range,<sup>23</sup> and thus would be precluded from making such a purchase.

**Scenario 3.** Scenario 3 illustrates the outcome if more credible B-piece yields are incorporated. A 20% yield figure is used for the core B-piece. Not only is 20% closer to today's market yields of 16% to 18%, but the higher yield reflects the changes made to the B-piece buyer's investment by the overall risk retention framework. These changes include hedging restrictions, transfer restrictions, and a new independent Operating Advisor with powers that could materially change a B-piece buyer's ability to protect its investment through oversight of special servicing. For some of these same reasons, a higher yield is used for the BBB- class (12%). Moreover, a B-piece buyer would need to buy additional investment-grade bonds (the BBB-rated class) to achieve retention of 5% of proceeds; again the issuer would have to offer the investor a higher yield than market, for the same reasons explained above. What we have ignored thus far is that the higher yield paid to B-piece buyers to incentivize them to buy higher rated bonds must be compensated for in some fashion.<sup>24</sup> Scenario 3 introduces the assumption that the securitization sponsor will keep its profit figure constant compared to the figure in Scenario 1. Keeping profits constant results in a 36 basis point increase in the mortgage spread on the underlying loans to borrowers. To understand the effect a 36 basis point increase would have on the market for CMBS loans, it is helpful to analogize to an individual shopping for a home mortgage: if the individual is offered a loan at 4.75% from one type of lender, and a loan at 5.00% from another type of lender, with all other things equal, why would the person take the 5.00%

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<sup>23</sup> A yield target in this range is commensurate with the risk involved in assuming the first loss position.

<sup>24</sup> Although it might be suggested that a 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, 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. Moreover, such an approach has a technical and structural problem: The excess spread is generated on the senior tranches of CMBS, created in part by the sequential allocation of principal (thereby permitting the tranches of bonds to be priced along the yield curve). The excess spread evaporates as the loans amortize and senior bonds are paid down. The B piece is the last tranche to get paid, and therefore, its yield would diminish in later periods, which would not be acceptable to investors that expect a mid-teens yield for the life of their investment.

loan? It follows that a 36 basis point difference would have an enormous and adverse impact on the ability of CMBS lenders to compete with other sources of capital.<sup>25</sup>

**Scenario 4.** This is the worst case (but not unrealistic) scenario. The sponsor is unable to find a B-piece buyer that will accept below-market yields, and the entire 5% of proceeds must be sold at a 20% yield. In order to keep the sponsor's profit constant, a 99 basis point increase in the mortgage spread on the underlying loans to borrowers is necessary. Moreover, the B-piece buyer must buy up into the investment grade, or A rated tranche to achieve retention of 5% of the proceeds.

2. The PCCRA Would Have Far-Reaching Adverse Impacts on Commercial Real Estate Securitization.

It is evident from the above model that, even if the PCCRA could be used and the transaction could still realistically attract B-piece buyers to achieve retention of 5% of the proceeds, it would have significant adverse impacts on transaction structures, borrower costs, and the market as a whole.

First, as Figure 1 illustrates, selling 5% of proceeds to a B-piece buyer would make securitization so inefficient and expensive that there would not be a rational reason to securitize. The market would respond by shutting down. While the industry is aware of some policymakers' efforts to explain that elimination of securitizers' profit is not the goal of PCCRA, the fact is that a securitizer could not achieve retention of 5% of proceeds even if it combined the entire B-piece with the IO tranche. This means that, notwithstanding the stated intent, an attempt to comply with the PCCRA would effectively extract all potential profits, as they would have to be placed in the PCCRA and held in the first-loss position for the life of the transaction

Second, a requirement for retention of 5% of proceeds *will* result in increased borrower costs. The only question is how much more CMBS loans would cost for the businesses, large and small, that need the loans. More broadly, regardless of the increased borrower costs, the higher cost of CMBS loans will make securitized loans less competitive with other, unregulated sources of capital such as REITs and specialized lenders, and with other regulated sources such as banks and life insurance companies. This market distortion will eventually cause a migration of riskier loans to the higher-cost securitization markets, and will ultimately lead to higher risk of loss.

Third, as can be seen from Scenario 2 in Figure 1, the 5% proceeds requirement necessitates that B-piece buyers purchase double the amount of bonds than they ordinarily would (from \$20.55 million to more than \$50 million). There is simply not enough capital in the B-piece market to purchase double the volume that exists in today's market. Indeed, there is already widespread concern

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<sup>25</sup> It should be kept in mind that the greatest adverse impact on the competitiveness of CMBS loans will fall upon small and regional banks, which have the largest share of the upcoming CRE loan maturities, and are the ones that banking regulators have expressed the greatest concern about in terms of CRE exposure. See, e.g., Remarks of John C. Dugan, Comptroller of the Currency, before the Independent Community Bankers of America National Convention (March 19, 2010) (available at [www.occ.gov/news-issuances/speeches/2010/pub-speech-2010-32a.pdf](http://www.occ.gov/news-issuances/speeches/2010/pub-speech-2010-32a.pdf)).

that there is not enough B-piece capital to meet the market's existing needs. To double the existing needs with a 5% of proceeds approach will only exacerbate these concerns and lead to a shortage of capital, increased costs to all borrowers and less competition in lending markets. Moreover, forcing the B piece buyer, whose natural investment profile makes them the right buyer for the bottom tranches, but not the more senior tranches, eliminates one of the primary efficiencies provided by the securitization markets – the ability to match risk/duration/return profiles of different classes of bonds with the investors who will price that profile most efficiently. Forcing more senior tranches on the junior investors robs the securitization process of its ability to provide that pricing efficiency, and therefore, its ability to provide efficient capital to the commercial real estate market.

And the question must be asked – to what end? Because a B-piece buyer holds the first-loss position, B-piece buyers presently re-underwrite all the loans in the pool. Furthermore, the proposed rules would formalize this requirement. And a 5% of proceeds approach unfairly discounts the B-piece buyer's incentive to perform adequate diligence: B-piece buyers have yield targets, and therefore, any principal losses will cause them to miss those yield targets and to suffer the resulting consequences. Additionally, the size of the investment that a B-piece buyer makes in a typical CMBS conduit transaction is still of sufficient magnitude to ensure a careful and thorough vetting of the investment prior to commitment. The B-piece buyer performs the same diligence whether it buys 2% of the proceeds or 5%, because the B-piece buyer is in the first-loss position, regardless. It follows that B-piece buyers' diligence and underwriting will not be enhanced by imposing a 5% of proceeds retention requirement as opposed to a 5% par retention requirement.

In summary, compelling the B-piece buyer to purchase investment-grade bonds is a non-economically sustainable model for securitization. The B-piece buyer's business model is not to purchase lower risk and lower yielding investment-grade bonds. The B-piece buyer, if it purchased at these levels, would not reduce its yield targets. Consequently, the cost of borrowing would be vastly increased for the underlying mortgage borrower.

**CRE Finance Council Recommendation: The Act clearly contemplated the B-piece buyer as a modality for risk retention, and we appreciate the Agencies' effort to incorporate such a framework into the Proposed Rules. Unfortunately, we believe that adding the PCCRA would create a structure in which the B-piece buyer cannot practically achieve necessary risk retention. Ultimately, the CRE Finance Council cannot offer an alternative recommendation to the PCCRA, because the 5% of proceeds concept does not work in the CRE space. We accordingly recommend that the PCCRA be eliminated as a requirement for CMBS. If what is desired as a policy matter is an appropriate and effective alignment of interests, we do not believe the PCCRA will accomplish this goal for CMBS without ultimately disrupting the entire securitization structure. A more effective means of achieving such ends are the use of enhanced disclosure and transparency. We look forward to working with the Agencies to ensure that a risk retention framework is put into place that meets both the goals of the Act and a structure that can work efficiently in the commercial real estate finance marketplace.**

F. Conditions for a Third Party to Retain Risk

As previously discussed, the Act specifies that for commercial mortgages, risk retention rules may allow for a third party to hold the retained interest.<sup>26</sup> The Proposed Rule would implement this directive by permitting a third-party purchaser to hold a 5% horizontal first-loss position, subject to several conditions enumerated in the Proposed Rule.

On the whole, the CRE Finance Council is encouraged that the Proposed Rule includes the third-party risk retention option (which will also be referred to here as the “B-piece buyer” option, since in the commercial mortgage context, it would be a B-piece buyer that would agree to retain the risk instead of or in concert with a securitizer). Our members accordingly commend the Agencies’ efforts to develop a framework that recognizes the unique characteristics of CMBS, and, as discussed in detail below, our members believe a number of the B-piece retention conditions are consistent with, or can be incorporated into, current market practice.

The proposed structure for an operating advisor, however, creates disincentives for market participants to use the B-piece retention option, which will frustrate the intent of Congress that there be options to help preserve market liquidity.

While the CRE Finance Council recognizes the reasons for including a third-party to balance certain conflicts of interest among the B-piece and other investor classes, we believe an alternative framework for the role of an Operating Advisor would better serve the Agencies’ objectives. Our recommended approach would preserve the Operating Advisor’s ability to act “on behalf of the investors as a collective whole,”<sup>27</sup> while defining its authority in a manner that does not discourage B-piece buyers from using the third-party retention option.

Finally, we note that there is a lack of clarity with respect to some of the conditions that would govern the third party retention option, and we look forward to working with the Agencies to ensure that the marketplace understands the intent, structure, and reasoning behind these conditions.

**CRE Finance Council Recommendation: To address these concerns, the CRE Finance Council offers the following suggested modifications to this aspect of the Proposed Rule:**

- **With respect to the independent Operating Advisor (“OA”) framework:**
  - **Modify the framework so that the OA’s authority to oversee the performance of the special servicer and remove the special servicer depends on whether the B-**

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<sup>26</sup> Dodd-Frank § 941(b)(creating Securities Exchange Act § 15G(c)(1)(E)(ii)).

<sup>27</sup> 76 Fed. Reg. at 24109.

**piece is the controlling investor class, rather than depending on special servicer affiliation with the B-piece buyer;**

- **Clarify the “consultation” authority in the Proposed Rule to specify that, when the B-piece buyer is no longer “in the money,”<sup>28</sup> the OA would be made responsible for oversight of the special servicer to ensure that the servicing standard in the pooling and servicing agreement (“PSA”) is met. When the B-piece buyer is still “in the money,” the OA’s role would be effective upon any investor complaints about the special servicer’s performance;**
  - **Modify the OA’s authority to remove a special servicer so that removal will require a minimum affirmative investor vote for failure to comply with the special servicer’s obligations, as defined by the PSA, when a B-piece buyer is the controlling class; and**
  - **modify the independence criteria for OAs to recognize the marketplace reality that few institutions will be qualified to serve as CMBS OAs, and include disclosure and internal control mechanisms to mitigate conflicts-of-interest;**
- **Allow transfer of the retained interest to a “qualified transferee;”**
  - **Eliminate the permanent holding period requirement for the retained interest and replace it with the ability to transfer to a qualified transferee within the first five years with no restrictions on transfer thereafter;**
  - **Replace the sponsor’s monitoring obligations with one that requires the B-piece buyer to certify its compliance; and**
  - **Clarify that the risk retention obligation may be shared between sponsors and B-piece buyers, and between more than one B-piece buyer.**

Each of these recommendations is discussed in more detail below, followed by a discussion of the aspects of the rule we believe are workable with minor clarifications or modifications. For ease of reference, all of the CRE Finance Council’s recommendations pertaining to third-party retention are outlined in recommended regulatory text, which is appended hereto as **Attachment C** (page 54), and is in the form of a blackline against the regulatory text in the Proposed Rule. In addition, a chart comparing the Proposed Rule’s OA provisions to the recommendations we outline below is appended as **Attachment B**, (page 52). We look forward to discussing these recommendations with the

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<sup>28</sup> In accordance with current industry practice, a B-piece buyer is defined as being the controlling class or first-loss position holder until principal payments, appraisal reductions and realized losses have reduced the B-piece buyer’s position to less than 25% of the original face amount of the B-piece buyer’s interest.

Agencies so that we meet regulatory goals while assuring the final solutions can work properly for the CMBS marketplace.

1. Suggested Modifications to the Operating Advisor Framework for CMBS.

The Proposed Rule would not permit the third-party purchaser to have “control rights” either directly, or indirectly through an affiliate, that are not collectively shared with all other investors in the securitization. The Proposed Rule states that this prohibition includes control in the form of acting as a servicer or special servicer (collectively referred to as the “servicer”) for the securitized assets.<sup>29</sup> The rationale for this provision is to counter any conflict of interest that a third-party-affiliated servicer might have vis-à-vis the remainder of certificate holders in the securitization that are not affiliated with it. There is an exception to this prohibition, however, as the Proposed Rule states that it will not prohibit a third party “from acting as, or being an affiliate of, a servicer for any of the securitized assets, and having such control rights that are related to servicing,” if the transaction documents provide for the appointment of an independent OA.

As the Agencies are aware, the CMBS market has evolved on its own over the past few years to incorporate the use of OAs. The OA concept began with the Treasury Department’s Term Asset-Back Securities Lending Facility (“TALF”) program for CMBS in 2009, and the market continued to incorporate OAs in subsequent non-TALF transactions though not in precisely the same manner. The use of OAs in transactions which have come to market since 2009 has been fairly consistent and in response to investor concerns. The exact responsibilities of an OA and its relationship to other transaction participants has been the subject of negotiation by those participants and, as such, has been market driven. Accordingly, the CRE Finance Council does not oppose the Proposed Rule’s inclusion of an OA framework. However, we do recommend modifications with respect to some of the details so that the OA construct will work, as a practical matter, in the CMBS space and will be flexible and responsive to market input.

As a preliminary matter, we note that while the Proposed Rule appears to call for an OA to be in place if a B-piece buyer has any “control rights that are related to ... servicing” that are not shared with all other classes of bondholders, the OA’s oversight and replacement authority over the servicer only comes into play when the servicer is, or is affiliated with, the B-piece buyer. In other words, as the CRE Finance Council reads the proposal, an OA would be present from the transaction’s inception, but the OA’s affirmative power over the servicer would be dormant unless the servicer is the B-piece buyer or the B-piece buyer’s affiliate.

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<sup>29</sup> The concept of certain investors having special rights may have generated some confusion among policymakers. To be clear, the CRE Finance Council is only aware of the existence of special “control rights” that pertain to servicing. A B-piece buyer may, for example, serve as the special servicer, or may be affiliated with the special servicer. A B-piece buyer may also have the right to select a special servicer; and a B-piece buyer may have the right to consult with or direct the special servicer regarding servicing matters. Hereafter, we will refer to the “control rights” contemplated in the Proposed Rule as special servicing rights.

The threshold for an OA to assume affirmative power over special servicing, and the scope of the OA's oversight role, are issues that have generated perhaps the greatest divergence of views among the CRE Finance Council's senior bondholder and B-piece buyer-members. Different constituencies within our membership would deal with the threshold and responsibilities of an OA in different ways. But the Agencies should be aware that none of our constituencies agrees with the OA framework as it has been proposed, and that has motivated the CRE Finance Council's endeavor to find and discuss a workable consensus alternative with the Agencies.

Many B-piece buyers and special servicers believe that the market driven definition of an OA that currently exists in CMBS transactions is adequate; that is, an OA should have no oversight or removal rights as long as the B-piece buyer is the controlling class of certificate holder. These constituents feel that the addition of an OA will add needless complexity and confusion to the CMBS structure, and that an expanded role for an OA would do little to address the regulators' expressed concerns about promoting better investor access to information, ensuring compliance with servicing standards, and mitigating conflicts of interest in servicing. More clarity in PSAs concerning disclosure obligations and greater reliance on existing PSA provisions on auditing and compliance are viewed as more practical solutions by these constituents. Once the B-piece buyer is no longer the controlling class of certificate holder, B-piece buyers have expressed support for introduction of an OA.

Senior investors, on the other hand, would like to see the OA have a more substantial role during the time period when the B-piece is the controlling certificate holder, as explained in more detail below. But even those who would expand the role of the OA believe that it can be better defined than as currently set out in the Proposed Regulation.

Notwithstanding the divergent and strongly held views of different investor constituencies regarding the contours of an OA framework, the CRE Finance Council's members devoted significant time and effort to developing a reasonable consensus recommendation.

Our consensus recommendations on oversight are based on the view that the OA should ensure compliance with the PSA and assist in improving transparency through dissemination of relevant information, and that these roles can be better defined through a combination of regulatory definition and improved PSA clarification. And with respect to removal, the consensus is that as long as the B-piece buyer retains control, an OA should be able to initiate removal of the special servicer only if the OA can show the special servicer is guilty of willful misconduct, bad faith, or negligence. Absent such a showing, removal of the special servicer should be the decision of the B-piece buyer that is the controlling class of certificate holder and has its capital at risk as the first loss.

The CRE Finance Council acknowledges that these positions do not enjoy unanimous support among its members. But our membership does believe it is critical to suggest alternatives to the proposed OA framework that will be practical while still seeking to achieve regulatory goals, and a significant number of our investor-members negotiated and reached consensus on the views offered herein.

a. Give OA Oversight of Transparency Matters

Although the Proposed Rule focuses on the presence of an OA to mitigate any conflict of interest that a B-piece buyer/affiliated servicer might have vis-à-vis the senior certificate holders in the securitization, the CRE Finance Council believes that there are other structural enhancements that could be facilitated by the presence of an OA, chiefly, the desire by senior certificate holders to receive more timely and accurate information regarding servicing when the B-piece buyer is the controlling certificate holder and accordingly has control rights over special servicing (which essentially is always the manner in which the deals are structured). Presently, senior certificate holders report that information, particularly regarding workouts and loans in special servicing, is not always received in a satisfactory manner.

CMBS market participants seek to address this concern while also acknowledging the need of B-piece buyers in the first-loss position to have input into loan workout decisions in order to protect their investment. The B-piece buyer's investment is first in line for losses if securitized assets default. The B-piece buyer therefore has a critical interest in seeing that the underlying loans perform, which is why the B-piece buyer is given consultative or approval rights in special servicing. In general terms, the B-piece buyers' interests are most closely aligned with senior investors' at this point. B-piece buyers are logically concerned about the potential for another party to be interposed, by regulatory mandate, in a control position in the process or decisions regarding special servicing and workouts, as this may adversely affect a B-piece buyer's ability to protect its investment (and adversely impact its desire to make such investments going forward).

**CRE Finance Council Recommendation: To balance these concerns, the CRE Finance Council recommends modification of the OA provision such that:**

- **from the transaction's inception, an OA would be in existence and would be made responsible for oversight of the special servicer to ensure that the PSA is followed by the special servicer. The OA's powers and responsibilities would be defined in the PSA subject to the following consideration: when the B-piece buyer is the controlling class of certificateholder, the OA's oversight role would be reactive to investor complaints; the PSA should provide that if investors have complaints concerning the special servicer's performance of its obligations under the PSA, the OA will respond and attempt to resolve those investor complaints and will have the power to enforce any special servicing obligations that are not being satisfied;**
- **The PSA should provide that when the B-piece buyer has been appraised out of control, the OA's role would be proactive: the OA will conduct its oversight to ensure the special servicer's compliance with the PSA whether or not there has been a complaint from investors; and**

- **the B-piece buyer is no longer in control (i.e., is “out-of-the money”) if the sum of principal payments, appraisal reductions and realized losses have reduced the B-piece buyer’s initial positions to less than 25% of its original face amount.**

b. Clarify that the OA’s Authority Pertains only to the Special Servicer (§ \_\_.10 (a)(4))

The Proposed Rule only refers to “servicers” in the third-party risk retention provision, and does not appear to recognize that there are different types of servicers in CMBS transactions, a master servicer and a special servicer. The OA’s authorities as defined in the rule should apply only to the special servicer. This is the case for several reasons.

First, in a CMBS transaction, it is the special servicer that has authority or consent rights with respect to all material servicing actions and defaulted loans. The master servicer, in contrast, has very little discretion as compared to the special servicer as its servicing duties are typically set forth in detail in the PSA and its authority to modify loans is very limited. In fact, the master servicer is customarily prohibited from taking any material servicing action on a performing loan without the consent of the special servicer. Moreover, any control right held by a B-piece buyer with respect to servicing is typically exercised through the special servicer, and the B-piece buyer does not generally provide any direct input into master servicer decisions.

Second, the B-piece termination right is another structural feature of CMBS deals that applies to special servicers but not to master servicers. The B-piece buyer’s right to terminate and replace the special servicer without cause is one method of control by the B-piece buyer over special servicing. The master servicer, however, is not subject to this termination without cause. The master servicer typically can be terminated by the trustee only upon the occurrence of one of the negotiated events of default with respect to the master servicer. In the event of such a default, certificate holders evidencing a specified percentage of voting rights (25% in many deals) of all certificates can direct the trustee to take such termination action. Because the B-piece buyers do not have the “termination without cause” right with respect to the master servicer and because all certificate holders already have the ability to vote on termination of the master servicer for cause, the rationale for OA oversight is not present with respect to the master servicer.

Lastly, if the OA has the right to remove the master servicer, this would be problematic for the master servicer’s servicing rights assets. Master servicers usually purchase their servicing rights from the sponsors in the securitization and these rights retain an ongoing value. Therefore any termination rights beyond those based on negotiated events of default jeopardize the value of the master servicer’s servicing asset. For all of these reasons, the OA’s powers should not extend to oversight and removal of the master servicer.

**CRE Finance Council Recommendation: The Agencies should clarify that the OA’s powers relate only to special servicers.**

- c. Eliminate OA Consultation Authority as Proposed (§ \_\_.10 (a)(4)(iii)(B) & (C))

Under the Proposed Rule, if the servicer is, or is affiliated with, the B-piece buyer, such servicer would have to “consult” the OA in connection with and prior to any major decision regarding the securitized assets, including sale of the loan or asset, material modifications or waivers of loan agreement provisions, foreclosure, or any acquisition of a property. Additionally, the OA would be charged with reviewing the actions of such servicer and providing investors and issuers with a periodic report on the OA’s opinion as to whether or not the servicer is operating in compliance with the servicing standards set forth in the transaction documents.

Market participants are concerned that the term “consult” in the Proposed Rule is too vague. B-piece buyers who are in the first-loss position anticipate that “consult” could result in having their servicing decisions second-guessed or delayed when their investment is first in line to absorb any losses. B-piece buyers also question the efficacy of introducing a new disinterested third party into the information flow about servicing decisions. Senior investors, for their part, question whether the vague direction to “consult” will provide them with what they actually need – timely information about loans in special servicing and workouts. Senior investors report that they are not receiving the information they need in a timely manner, or at all.

**CRE Finance Council Recommendation: The CRE Finance Council therefore recommends eliminating the “consultation” role and replacing it with OA oversight of the PSA contractual agreements when the B-piece buyer is the controlling class, as discussed above.<sup>30</sup>**

- d. Modify OA Replacement of Servicer Authority (§ \_\_.10 (a)(4)(iii)(D) & (E))

With respect to a servicer that is, or is affiliated with, a B-piece buyer, the Proposed Rule would give the OA authority to recommend that such servicer be replaced if the OA determines, “in its sole discretion exercised in good faith, that the servicer has failed to comply with any standard required of the servicer as provided in the applicable transaction documents and that such replacement would be in the best interest of the investors as a collective whole.” If such a recommendation is made, the servicer would be required to be replaced unless a majority of each class of certificate holders eligible to vote on the matter votes to retain the servicer.

The rationale for this approach, as we understand it, is that the affiliation can give rise to a conflict of interest on the part of an affiliated servicer vis-à-vis the senior certificate holders, because the servicer could be incentivized toward conduct that boosts servicing fees once the B-piece buyer’s

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<sup>30</sup> Note that all of the CRE Finance Council’s recommendations go hand-in-hand. Thus, if the Agencies elected to maintain the “consultation” right as drafted in the Proposed Rule, the CRE Finance Council recommends that such right remain dormant unless the special servicer is the B-piece buyer or its affiliate, as proposed.

interests are no longer aligned with the senior investors or under circumstances where fee potential outweighs the direct harm borne by the B-piece buyer. However, as discussed, the CRE Finance Council's members believe that a more logical dividing line for the rule to incorporate OA supervision is to make controlling class status the determining factor.

It follows that the Proposed Rule's approach to servicer replacement also employs too blunt an instrument, because it sets the bar for servicer replacement too low when the B-piece buyer is still the controlling class of certificates. As an alternative, the CRE Finance Council recommends a different replacement mechanism. The goal is to balance B-piece buyer concerns with those of senior investors, and to provide the OA with replacement authority from the inception of the transaction, while creating an minimum investor approval mechanism, versus mere override provisions, as agreed upon by the transaction parties.

**CRE Finance Council Recommendation: To remove a special servicer:**

- **from the transaction's inception, it would be the OA's role to make a determination whether willful misconduct, bad faith, or negligence has occurred on the part of the special servicer. While the B-piece buyer is the controlling class of certificate holder, such determination would only be initiated upon an investor's complaint. Once the B-piece buyer is no longer the controlling holder, such determinations could be initiated by the OA;**
- **if the OA seeks to make such a finding, the OA must provide notice to the special servicer and give the special servicer an opportunity to discuss/explain its conduct within a reasonable timeframe (as negotiated by the parties);**
- **if there is no resolution and the OA adheres to its conclusion that willful misconduct, bad faith, or negligence has occurred on the part of the special servicer, then (i) the OA must disclose any conflicts-of-interest it may have including any bond holdings it, its affiliates, or funds that it manages, may have (see Part IV.F.1.e below), (ii) the OA's recommendation and rationale should be publicly posted on the trustee website and other public venues commonly monitored by CMBS investors to give all investors an opportunity to review it, (iii) the B-piece buyer and special servicer should each have the opportunity to post any rebuttal arguments against the removal recommendation, and (iv) the removal question must be put to an affirmative minimum vote by investors in the non-controlling classes (i.e., the classes other than the B-piece buyers) as specified by the PSA;**
- **if the special servicer is removed using this process, the B-piece buyer (if still in control) gets to name the special servicer.**

**To remove a special servicer once the B-piece buyer is no longer in control, a separate removal and voting mechanism could be negotiated by the parties as part of the pooling and servicing agreement.**

e. OA Independence Criteria

The Proposed Rule would require the OA to be “independent,” meaning the OA could have no affiliation with other parties to the securitization and could have no direct or indirect financial interest in the securitization transaction other than fees from its role as OA.<sup>31</sup> As previously mentioned, OAs are already employed in the CMBS market; given the knowledge and experience of these institutions, they will certainly be among the best candidates to serve as OAs under the proposed regulatory framework. Some of these institutions are also large, however, and as such, they or funds which they manage may also be purchasers of CMBS.

**CRE Finance Council Recommendation:** We accordingly suggest the elimination of the Proposed Rule’s prohibition on an OA having a financial interest in the transaction other than the fees received for serving as OA. It would be counter-productive to preclude present-day OAs from serving in that capacity going forward, as such a framework would leave only smaller firms with little or no experience as the only eligible candidates and could result in diminution of available investment capital. Independence concerns should instead be addressed by the OA’s disclosure, at the time it initiates proceedings to replace a special servicer, of whether the OA has any conflicts of interest. OAs would also be expected to be walled off if the OA is affiliated with any party to the transaction.

2. Transfer Restrictions/Holding Period (§ \_\_.10 (a)(6) and § \_\_.14(a))

The Proposed Rule would generally prohibit transfer of the retained interest, except in cases where the transfer is to a consolidated affiliate. This highly circumscribed transfer provision applies to B-piece buyers as well as sponsors, and its limited scope is particularly problematic for B-piece buyers. Investors of all types, including B-piece buyers, will not want – and in some cases are barred from accepting – a permanent inability to transfer an investment. Even beyond this, no fiduciary of capital for others would ever agree not to sell an investment for the entire life of the investment.<sup>32</sup>

We note that the inability to transfer the retained interest to a qualified transferee would frustrate the risk retention framework outlined in the Act. For commercial mortgages, the statute essentially allows the sponsor to transfer the retained interest to a “qualified transferee” in the form of the B-piece buyer, who meets all of the qualifications outlined in the statute (e.g., retaining a first-loss

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<sup>31</sup>See § \_\_.10(a)(4)(iii)(A).

<sup>32</sup> Investor capital is usually structured as an open fund (i.e., with an investor having the ability to redeem at any time), or as a closed fund with a specified life typically not exceeding seven years with one or two 1-year options to extend the investment. Permanent holding restrictions, accordingly, would be incompatible with these structures.

position, conducting the requisite diligence, etc.), and those outlined in the Proposed Rule. If the B-piece buyer cannot transfer its interest, we will have few, if any, B-piece buyers able to bid for the bottom of the CMBS capital stack. This will frustrate the direction in the Act to utilize the B-piece buyer as a risk retainer. Further, as the statute allows a CMBS sponsor to transfer the retained interest to a B-piece buyer, there is no reason, as a policy matter, that a B-piece buyer should be unable to transfer the retained interest to an entity that meets the same qualifications.

To balance these anticipated difficulties with the regulators' expressed concerns about proper alignment of interests, the CRE Finance Council suggests a modification to permit transfers to a "qualified transferee." The "qualified transferee" would be required to meet the same criteria as are set forth in the final rule for B-piece buyer retention. With such a requirement, the qualified transferee concept would satisfy policy goals of facilitating appropriate alignment of risk and encouraging sound underwriting because the original B-piece buyer would expect any flaws in loan underwriting to be discovered by a qualified transferee and to be priced into the value of their investment in the secondary market, which would provide additional assurance that the original B-piece buyer has maximum incentive to fully diligence a mortgage pool before investing. Moreover, the qualified transferee would have ample incentive to police underwriting itself, since it has no incentive to purchase a bond with poorly underwritten loans.

A related concept is the holding period for the retained interest. While the proposed rule does not specify a particular holding period, a permanent retention obligation is implied by the structure of the rule, its prohibitions on the sale or transfer of the retained interest, and its many specifications for the retained interest that apply until all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved.<sup>33</sup>

A permanent risk retention obligation will create both balance sheet capacity problems (eventually a sponsor would be holding enough retained interests that it would have no more capacity to lend) and the inability to attract investment capital (due to the unwillingness of investors to irrevocably tie up capital for the entire life of an investment).

**CRE Finance Council Recommendation:** For these reasons, the CRE Finance Council suggests an alternative holding period framework, which limits transfer to a qualified transferee (as discussed above) for the first five years after the transaction's inception, and would impose no restrictions on transfer thereafter. The goal of risk retention is to affect behavior, ensuring good underwriting, good loans and good disclosure. Such needs are not met by a hold-to-maturity requirement.

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<sup>33</sup>See, e.g., \_\_\_\_ (requirements for cash reserve account held in lieu of an eligible horizontal residual interest).

### 3. B-Piece Buyer Compliance (§ \_\_.10 (b))

The Proposed Rule requires sponsors to “monitor a third-party purchaser’s compliance” with the risk retention rule’s requirements for third-party retention, and notify the bondholders of any non-compliance. This standard is not practical, as sponsors do not have access to all the information needed to perform such monitoring. For example, a sponsor cannot, and will not, know if a B-piece buyer puts on a prohibited hedge, as such information is not publicly available. Moreover, it would be extraordinarily burdensome to monitor for the myriad types of transactions that might not be in compliance.

**CRE Finance Council Recommendation: A more workable solution from a practical perspective is to have the B-piece buyer certify annually that it is in compliance with the final rule’s requirements for third-party retention. This certification could be made by the B-piece buyer to an Operating Advisor, and the Operating Advisor could be given the authority to enforce the compliance obligation through the trustee, in addition to the other duties suggested above for the Operating Advisor. A similar approach is taken in the auditing world when companies require their third party technology service providers to supply them with an annual statement of auditing standard (“SAS”) 70. The SAS 70 gives the company a comfort level with the third party provider’s control environment.**

### 4. Sharing Risk Retention Obligation Between Sponsors and B-Piece Buyers and/or Multiple B-Piece Buyers

As discussed above in Part IV.B, the Proposed Rule does not address the fairly common circumstance of multiple buyers of the below-investment-grade tranches, or the possibility of apportionment of risk retention between a sponsor and a B-piece buyer. In CMBS transactions, different investors may purchase the various tranches in the B-piece. This is the case because different entities may have different yield requirements. One entity may purchase the unrated and B tranche, and another entity purchases the BB tranche.

**CRE Finance Council Recommendation: In order to account for the manner in which CMBS transactions are structured, the CRE Finance Council recommends that the Proposed Rule specify that the retained interest may be held by the sponsor and one or more B-piece buyers.**

### 5. Generally Acceptable B-Piece Buyer Conditions

The following conditions in the Proposed Rule are generally acceptable and workable in the CMBS marketplace, although some clarification or minor adjustments are suggested to make them workable as a practical matter:

a. Horizontal, First-Loss Position (§ \_\_.10 (a))<sup>34</sup>

The third-party purchaser must retain an eligible horizontal residual interest in the securitization in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option. It follows that the interest acquired by the third-party purchaser must be the most junior interest in the issuing entity, and must be subject to the same limits on payments as would apply if the eligible horizontal residual interest were held by the sponsor.

This requirement could be incorporated into existing industry practice, as B-piece buyers currently purchase a horizontal first-loss position.

**CRE Finance Council Recommendation: However, for the reasons explained in Part IV.E above regarding the Premium Capture Cash Reserve Account, we note that the retained first-loss interest should be “5% of the credit risk for an asset” as set forth in the Act, which we believe is 5% of the par value of the transaction, rather than 5% of the transaction proceeds.**

b. Composition of the Collateral (§ \_\_.10 (a)(1))

The Proposed Rule would require as a condition of B-piece retention that at the close of the securitization, at least 95% of the total unpaid principal balance of the securitized assets in the transaction must be “commercial real estate loans.”<sup>35</sup> This requirement would not be inconsistent with existing industry practice, and should not present a difficulty. We note, however, that the definition of “commercial real estate loans” should be clarified to ensure that certain common types of commercial transactions are not inadvertently omitted from the third-party retention and qualified CRE loan exemption frameworks. First the definition of “commercial real estate loan” specifically excludes “loans to REITs.” There is no discussion in the Proposed Rule that addresses the rationale for excluding loans to REITs from this definition or what the Agencies consider loans to REITs to be. Some industry participants believe that exclusion of loans to REITs is intended to cover loans to REITs that are not secured by commercial or multifamily property. This interpretation seems reasonable, as we cannot conceive of a policy reason to treat traditional CMBS loans differently under the Proposed Rules based on whether or not the borrower is a REIT. **As such, we request the Agencies to clarify that “loans to REITs” means unsecured loans made to REITs and would not cover CMBS loans made to REITs or subsidiaries of REITs that otherwise satisfy the requirements of the definition of commercial real estate loan.**

Second, “commercial real estate loan” specifically excludes “land loans.” The term “land loan” is not defined in the Proposed Rule. It is common for CMBS loans to be made to a borrower that owns

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<sup>34</sup> All section numbers in this part refer to the sections in the proposed regulation.

<sup>35</sup> See Proposed Rule §§ \_\_.10 (a)(1) and \_\_.16 (defining “commercial real estate loan”).

the fee interest in the property that secures the mortgage but ground leases the land to an unrelated third-party ground lease tenant that owns and operates the improvements on the land or subleases the land to a tenant that owns and operates the improvements on the land. The source of funds available to pay the borrower's CMBS loan are the lease payments made by the tenant under the ground lease. **In order to provide more certainty that such a CMBS loan would not be considered a "land loan," we request the Agencies to clarify that a "land loan" means a loan secured entirely by unimproved land.** This change would make it clear that the exclusion applies only to loans secured entirely by unimproved and unleased raw land, which is what we believe the provision is intended to capture.

Third, to qualify as a "commercial real estate loan," the primary source of repayment of such loan must be expected to be derived either from the proceeds of sale or refinancing or from rental income associated with the property other than rental income derived from any affiliate of the borrower. This would appear to exclude rental income on loans that utilize a Master Lease structure. Under such structures, the borrower under the loan leases the property to an affiliate that operates the property (or in some cases subleases the property to third party tenants). It is unclear from the Proposed Rule why there is a distinction between leases to unaffiliated tenants and affiliated tenants. In both cases there is a tenant conducting its operations at a commercial property and the rent is used for repayment of the loan. **We accordingly request that the Agencies strike the clause "other than rental income derived from any affiliate of the borrower."**

There are also other federal regulations that limit what REMICs can invest in, and these rules contain their own definition of "qualified" collateral, which do not incorporate the definitions in the risk retention rules. For example, the REMIC rules require that "substantially all" of the assets consist of commercial real estate loans. "Substantially all" may or not be the same as the 95% in the Proposed Rule. For this reason, **we recommend that the concept of qualified collateral in the Proposed Rules be synchronized with that in the REMIC rules or eliminated as an unnecessary duplicate regulatory requirement.**

c. Source of Funds (§ \_\_.10 (a)(2))

The third-party purchaser must pay for the first-loss subordinated interest in cash at the closing of the securitization without financing being provided, directly or indirectly, from any other person that is a party to the securitization transaction (other than a person that is a party solely by reason of being an investor). **The CRE Finance Council does not believe such a requirement would present an obstacle to use of the B-piece retention option, so long as the rules clarify that the prohibition on "indirect" financing does not prohibit the B-piece buyer from obtaining financing from a party for an unrelated transaction.** This clarification is necessary because many institutions may have extended financing to a B-piece buyer for a host of other purposes but not directly for the purchase of other securities.

d. Third Party Asset Review (§ \_\_.10 (a)(3))

The third-party purchaser must perform a review of the credit risk of each asset in the pool prior to the sale of the asset-backed securities, including, at a minimum, underwriting standards, collateral, and expected cash flows of each commercial loan in the pool. These requirements in the Proposed Rule are consistent with existing industry practice. As previously explained, a B-piece buyer typically conducts its own extensive due diligence, which may include, for example, site visits to every property that collateralizes a loan in the loan pool, and essentially re-underwrites all of the loans in the proposed pool. Because of this, the B-piece buyers often negotiate the removal of any loans they consider to be unsatisfactory from a credit perspective and in other circumstances they negotiate a price reduction to adjust for credit concerns related to the CMBS collateral.

**The CRE Finance Council does recommend, however, that the B-piece retention provision clarify that in performing the necessary review to qualify for the B-piece retention option, the B-piece buyer is acting only for its own account, and that performance of any asset review for purposes of the rule does not give rise to any liability on the B-piece buyer's part to other bondholders in connection with this review.**

e. Sponsor Disclosures (§ \_\_.10 (a)(5))

The Proposed Rule would require the sponsor to provide a number of disclosures concerning the third-party purchaser and other information concerning the transaction. Most of these disclosures should not be problematic, but we do recommend elimination of the requirement that the sponsor disclose the price paid for the interest the B-piece buyer will retain. B-piece purchase price information is not made public. A price disclosure requirement accordingly raises confidentiality concerns among the investors. **We therefore suggest that purchase price disclosure not be required by the rule.**

Compliance with the following sponsor disclosure requirements in the Proposed Rule should not present a problem: (i) the name and form of organization of the third-party purchaser, (ii) a description of the third-party purchaser's experience in investing in CMBS, (iii) the amount of the eligible horizontal residual interest that the third-party purchaser will retain (or has retained) in the transaction (expressed as a percentage of ABS interests in the issuing entity and as a dollar amount), (iv) the material terms of such interest, (v) the amount of the interest that the sponsor would have been required to retain if the sponsor had retained an interest in the transaction pursuant to the horizontal menu option, (vi) the material assumptions and methodology used in determining the aggregate amount of ABS interests of the issuing entity, including any estimated cash flows and the discount rate used, also must be included in the disclosure.

Finally, we note that the sponsor would be required to provide potential investors with the representations and warranties concerning the securitized assets, a schedule of any assets that are determined not to comply with such representations and warranties on a representation by

representation basis, and what factors were used to make the determination that a securitized asset should be included in the pool notwithstanding that it did not comply with such representations and warranties, such as compensating factors or a determination that the exceptions(s) were not material. The Agencies should be aware that these are disclosures the industry already provides, with the exception of the basis for deciding to include exception loans in the pool. **The CRE Finance Council recommends that detailed information underlying exception decisions not be required for CMBS transactions.** In the CMBS context, the decision whether to include a loan in a pool is based on subjective, qualitative factors, as opposed to objective, quantitative factors as in the residential context. It follows that it would be difficult and burdensome to collect and disseminate such information. **We accordingly recommend that the provision of such explanatory material, which appears to be more geared toward residential transactions, should be eliminated from the B-piece retention requirement.**

The Proposed Rule's sponsor disclosure provision notes the CRE Finance Council's development of industry standard representations and warranties, and asks whether black lines should be required against industry standards.<sup>36</sup> Our members desire to emphasize that the CRE finance industry is ready to implement the industry standard representations and warranties if the risk retention regulations provide that such industry standards, coupled with enhanced disclosures, can be employed to satisfy, in whole or in part, risk retention obligations.

In this regard, it must be reiterated that exceptions to representations and warranties are normal course in every transaction because the facts and circumstances of each transaction are unique. **Therefore, the use of representations and warranties that are based on the industry standard and are negotiated and acceptable to investors, should satisfy risk retention in whole or in part; provided that, as the Proposed Rule suggests, a blackline of the transaction representations and warranties against the industry standard, as well as an exception list, are provided to all investors before the offering is priced, with sufficient time provided for investors to review the representations and the exceptions.**

f. Hedging and Financing Restrictions (§ \_\_.10 (a)(6) and § \_\_.14)

The B-piece retention option would require that the third-party purchaser comply with the hedging and financing restrictions that would be applicable to such interest if retained by the sponsor. It is not anticipated that this requirement would present compliance difficulties, although two clarifications are desired. First, with respect to hedging, the Proposed Rule would allow hedging based on asset-backed securities indices if: "(i) any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represents no more than 10 percent of the dollar-weighted average of all instruments included in the index; and, (ii) all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest pursuant to subpart B of this part and

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<sup>36</sup>See NPR, 76 Fed. Reg. at 24111.

that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average of all instruments included in the index.”<sup>37</sup>

As the CRE Finance Council reads this provision, if a B-piece buyer purchased MS 2011-C1 bonds, for example, the Proposed Rule’s hedging restriction would preclude the B-piece buyer from shorting the same transaction but would allow the B-piece buyer to invest in an index in which MS 2011-C1 is included, provided it does not exceed the 10% limit referenced above. **We seek confirmation that this reading is consistent with the Agencies’ intention.**

Second, with regard to financing restrictions, **the Proposed Rule should clarify that it does not prohibit the use of recourse financing or the use by a REIT of general obligation bonds.** The Proposed Rule clearly contemplates allowing the sponsor to rely on recourse financing, by prohibiting the sponsor from pledging the retained interest as collateral for any obligation “unless the obligation is with full recourse to the sponsor or consolidated affiliate.”<sup>38</sup> The stated rationale for this approach is that a limited recourse financing supported by the sponsor’s risk retention interest may transfer some of the risk of the retained interest to the lender during the term of the loan, a concern that would be ameliorated by limiting financing to recourse financing, which gives the lender greater rights against the borrower. This same rationale should apply to B-piece buyers who retain the risk. The CRE Finance Council therefore suggests that the financing provision be clarified accordingly.

#### G. Qualifying Loan Exemption (QLE)

As the CRE Finance Council has previously explained, our membership does not believe that commercial mortgage underwriting lends itself to the application of discrete quantitative underwriting criteria because the heterogeneous nature of commercial real estate assets requires subjective assessments.<sup>39</sup> For example, a lender could consider two loans that are both 1% over a loan-to-value cut-off, but the assets are of different types and are in different geographic locations. A loan for an office building in an East Coast metropolitan city that is 1% over the LTV cut-off represents an altogether different risk from a loan on a strip mall in a tertiary market with a declining population that is 1% over the cut-off. As a result, the CRE Finance Council’s best practices initiatives in the area of underwriting focused on the development of underwriting principles and procedures characteristic of a thorough underwriting process, and a disclosure regime that focuses on the manner in which that underwriting process was performed. Nevertheless, our members believe the “Qualified Commercial Mortgage” exemption framework in the Proposed Rule is a productive start, and we appreciate the Agencies’ efforts to recognize a category of commercial real estate loan pools as “low risk” and subject to a 0% retention requirement.

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<sup>37</sup> Proposed Rule § \_\_.14(d)(2)).

<sup>38</sup> NPR, 76 Fed. Reg. at 24116.

<sup>39</sup> See the CRE Finance Council’s comment letter to the Agencies dated Dec. 15, 2010 available at [www.sec.gov/comments/df-title-iv/asset-backed-securities/assetbackedsecurities-29.pdf](http://www.sec.gov/comments/df-title-iv/asset-backed-securities/assetbackedsecurities-29.pdf).

The CRE Finance Council has two overarching concerns about the Agencies' proposal, however. First, we are concerned that the proposed quantitative criteria, when taken together, are so narrowly drawn as to render the exemption ineffective. The CRE Finance Council's members have reviewed the proposed criteria and determined that even if only three of the approximately 33 criteria are applied (LTV of not more than 65%, DSCR of not less than 1.7x and a straight-line amortization period of not more than 20 years), it is estimated that less than 0.4% (or \$2.9 billion) of the \$671 billion in conduit loans that have been securitized since the beginning of the CMBS market would qualify for exemption.

Our second concern is that there is also a huge disparity between the anticipated quantum of qualifying commercial real estate mortgages (less than 0.4%) and the anticipated quantum of qualifying residential mortgages (10-20%). This disparity is ironic considering that the mortgage crisis did not originate in the CRE sector. Moreover, we are aware that the residential mortgage-backed security industry believes that a more appropriate quantum of qualifying residential mortgages would be some number in excess of 20%.

**CRE Finance Council Recommendation:** We recommend modifying some of the proposed quantitative exemption criteria to capture 20-30% of commercial real estate mortgages – a percentage we believe is appropriate for the CRE mortgage market considering its characteristics – as opposed to capturing fewer than 1%, as would be the case under the rules as they have been proposed. Our members believe that a number of the Agencies' proposed criteria are workable and indeed are already part of most lenders' current underwriting practices. Certain other criteria, on the other hand, should be modified to make qualification a slightly more realistic possibility and mitigate the possibility of market distortions, and can be revised without significantly increasing the risks of a default. Overall, from a policy perspective, there needs to be a better balance between protecting against default and needlessly restricting credit for commercial properties.

Criteria that are workable include the requirement that a lender perform a two-year look back at the sponsor's financial stability and an analysis of its payment history on its other debts; the appraisal, insurance, and environmental assessment requirements; and requirements that relate to lien priority, payments, and internal and supervisory controls for the depositor. These are reasonable and prudent requirements and are already a part of most lenders' current underwriting practices.

In contrast, requiring a two-year look forward and analysis of a sponsor's ability to service debts is not reasonable, as lenders have no mechanism by which to perform such an analysis. Moreover, the vast majority of CMBS loans are non-recourse to the borrower and are not backed by payment guarantees, so a review of the sponsor's future financial stability is not as relevant as it might be in the qualified residential mortgage context. The analysis is really focused on the property and its historical and expected performance given that these are non-recourse loans. The sponsor's financial condition is reviewed but it is secondary to the property. This is also a metric that would be difficult to measure, and is more of the nature of a process than an underwriting metric.

We also suggest slight modification of the Proposed Rule's 60%-65% combined loan-to-value ("CLTV") ratio requirement, so that a more accurate metric for measuring the likelihood of repayment – LTV at origination and at maturity, is employed.

A summary of the CRE Finance Council's recommendations concerning the exemption criteria is provided in a chart appended hereto as [Attachment D](#) (page 62). Following is more detailed discussion of the most critical criteria.

1. Amortization and Interest-Only Periods ((§ \_\_.19(b)(2)(iii))

The Proposed Rule would require the borrower to be qualified based on a monthly payment amount derived from no more than a 20-year straight-line amortization of principal and interest over the term of the loan. Additionally, there could be no period of time during which the borrower is only required to pay interest.

**CRE Finance Council Recommendation: The CRE Finance Council recommends that the rule not focus on amortization, but should focus instead on LTV at origination and at maturity. Amortization is designed to reduce the outstanding principal balance at loan maturity to a level that can be easily re-financed. But it is not a reliable indicator of credit risk in the CRE market, because if a lender starts with a very low-leveraged loan (i.e., 50% or less) this endpoint is less relevant. The regulation should focus on the likelihood of repayment, and loan-to-value is a better metric in this regard than amortization. It follows that amortization should be permitted to vary based on LTV, and the elimination of the discrete amortization requirement in the rule would be more workable from a practical perspective.**

Thus, for example, the requirement should be 65% LTV at loan origination and 55% LTV at maturity, which implies a 25-year amortization schedule. As a further example, loans that are below 50% LTV should be able to be interest-only for the loan term, while loans that are in excess of a 50% LTV should be able to have at least a portion of their loan term be interest-only.<sup>40</sup> In addition to being more practical, we observe that this suggestion also more closely aligns with industry practice than the Proposed Rule, because the CRE finance industry does not employ straight-line amortization, and utilizes a 30-year, rather than 20-year, amortization period.

2. Debt Service Coverage Ratio (DSCR) ((§ \_\_.19(b)(2)(vi & vii))

The proposed exemption criteria call for a DSCR of 1.50 -1.70x depending on the type of asset. However, a better test would be based on a minimum debt yield, defined as net operating income

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<sup>40</sup> We also observe that the concept of "combined loan-to-value" ("CLTV") is not relevant for CMBS, as CLTV does not directly relate to the credit backing the first mortgage. The loan-to-value figures in § \_\_.19 should accordingly be revised to be "LTV."

divided by the outstanding loan balance. Because minimum debt yield is defined in terms of these two metrics, it is not dependent upon where interest rates are at the time the loan closes, and does not effectively impose a penalty based on amortization, as is the case with a DSCR.

**CRE Finance Council Recommendation: The CRE Finance Council therefore recommends that a minimum debt yield test be substituted for the DSCR test and that a 12% minimum debt yield, which it recommends, is quite conservative, as market debt yields are currently around 10%.**

### 3. Collateral Restrictions ((§ \_\_.19(b)(3)(ii)(A)& (b)(4))

Under the proposed exemption criteria, a borrower would generally be prohibited from creating any other security interest with respect to any property that serves as collateral for the loan. However, the subordinate financing market is a significant market that is essential to borrowers and the CMBS market generally, and there are a large number of real estate finance investors that specifically invest in the subordinate loan space and many borrowers rely on that market to transact.

Restricting or abolishing subordinate financing for borrowers in the CMBS market would lead to unnecessary losses because borrowers would not be able to refinance existing CMBS or other debt. Such restrictions will be particularly problematic in coming years, as CRE borrower demand to refinance is expected to be at an all-time high with \$600 billion in CMBS loans and more than \$1.2 trillion in outstanding commercial mortgages maturing through 2017.

**CRE Finance Council Recommendation: Accordingly, the CRE Finance Council recommends that subordinate mortgage financing should be permitted subject to a combined maximum LTV.**

### 4. Need for Sliding Scale Exemption Mechanism

In light of the historical loss data for CMBS (discussed in Attachment A below), the CRE Finance Council believes that 5% retention at par is not the sole effective means of mitigating risk. There should be a “step” function for exempt CMBS loans in a pool, such that if a certain percentage of loans in the pool meet the exemption criteria, a reduction in the risk retention percentage is warranted. For example, if 20% of a pool is comprised of exempt loans, the pool would receive a 1% risk retention reduction; if 50% of pool loans are exempt, a 2.5% risk retention reduction could be obtained.

Another reason to allow blended QLE/non-QLE deals is the cost and risk of having to hold both QLE and non-QLE loans for longer periods of time in order to reach critical mass for the execution of a QLE or non-QLE transaction – this increases costs of funds, risk and capital requirements. The CMBS market also regards a unified market to be more desirable in terms of liquidity and investor expectations, as opposed to having a segmented market as is the case for RMBS (with prime, subprime, and Alt-A assets, for example).

**CRE Finance Council Recommendation:** The CRE Finance Council therefore recommends allowing a sliding scale retention reduction for pools partially comprised of QLE loans.

## **V. INTERNATIONAL REGULATORY HARMONIZATION CONCERNS**

In the context of discussing proposed disclosure requirements concerning the retained interest, the Proposed Rule notes that some of the risk retention structures proposed by the Agencies (vertical, horizontal, seller's interest and representative sample) are similar to those proposed in the European Union capital requirement directive relating to securitizations.<sup>41</sup> The CRE Finance Council commends the Agencies for recognizing that the U.S. risk retention framework will not exist in isolation. In fact, a subset of the CMBS buyer base will be affected by the EU Solvency II risk retention requirement, which will govern regulatory requirements for EU insurance companies beginning in October 2012, and which will restrict EU insurance companies from investing in securitizations unless the originator complies with the 5% retention requirement set out in the EU's Capital Requirements Directive II for banks. Given this fact, U.S. risk retention regulations should devote some attention to the need for a degree of functional equivalency with the EU obligations.

## **VI. CONCLUSION**

The CRE Finance Council again recognizes that an extraordinary amount of thought and work went into the development of the Proposed Rule, and our members believe that the Agencies' efforts to craft provisions that seek to address the unique characteristics of the CMBS market represent a productive step toward developing a risk retention framework that will be practical from the industry's perspective and attain the goals of the Act. Given the important role that commercial real estate plays in the economy, and the critical function that securitization, in turn, serves in commercial real estate, the Agencies must take the necessary time to get this right, and the CRE Finance Council looks forward to working with the Agencies on this endeavor.

Sincerely,



Stephen M. Renna  
CEO  
CRE Finance Council

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<sup>41</sup> See Risk Retention NPR, 76 Fed. Reg. at 24101, n.55.

## **ATTACHMENTS**

- A Background Materials Re The Current State of CRE Finance and the Basics of CMBS
- B Summary of CRE Finance Council Recommendations Regarding Operating Advisor (“OA”) for Third-Party Risk Retention
- C Suggested Revision to Regulatory Text for §\_\_.10 Third-Party Risk Retention for CMBS
- D QLE Comparison of Proposed Rule to CREFC Recommendation

## **ATTACHMENT A**

### **BACKGROUND MATERIALS RE THE CURRENT STATE OF CRE FINANCE AND THE BASICS OF CMBS**

#### **A. The Current State of CRE Finance**

A robust commercial real estate sector is essential for a healthy American economy: it provides the space where nearly all Americans work and, in the case of multifamily housing, where many of us live. Commercial real estate also comprises the strip malls, grocery stores, and other retail establishments where goods are sold and food purchased; the small business spaces on “Main Street” that drive local economies; the industrial complexes that produce steel, build cars, and create jobs; the hospitals where doctors tend to the sick; and the hotels where relatives, vacationers, and business persons stay.

Commercial real estate was adversely affected by the prolonged economic recession, albeit relatively late in the overall economy’s downward cycle. What started as a “housing-driven” recession due to turmoil in the residential/subprime markets (in which credit tightened severely) quickly turned into a “consumer-driven” recession, impacting businesses and the overall economy. Not surprisingly, commercial real estate has come under strain in light of economic fundamentals existing over the last three years, including poor consumer confidence and business performance, high unemployment and property depreciation. Unlike in previous downturns, the stress recently placed on the commercial real estate sector is generated by a “perfect storm” of several interconnected challenges that compound each other and that, when taken together, have exacerbated the capital crisis and will unduly delay a recovery.

At the same time, the CRE industry faces an increasing number of mortgage maturities for which capital will be required, either in the form of debt or equity, to avoid further declines in commercial property values. Through 2017 for example, approximately \$600 billion of CMBS loans and more than \$1.2 trillion in outstanding commercial mortgages will mature. Borrower demand to re-finance these mortgages will be at an all-time high.

Even in normal economic conditions, the primary banking sector lacks the capacity to meet CRE borrower demand. That gap has been filled over the last two decades by securitization (specifically CMBS), which utilizes sophisticated investors – money managers, pension funds, mutual funds, life insurance companies and endowments among others – who bring their own capital to the market and fuel commercial lending.

In addition to fueling lending, securitization is an important source of revenue for the banking sector in general. Starting in the late 1970s and early 1980’s, bank deposits plummeted as a high interest rate environment, coupled with rate ceilings for regulated banks, opened the door for greater

competition from alternative investment vehicles. The situation became so extreme that by 1981, 3-month Treasury bills were offering rates nearly 8 percent greater than those offered at regulated banks. At the same time money market mutual funds flourished, growing from \$3.9 billion in assets in 1977 to \$292.2 billion in 1986, and stand at nearly \$3 trillion today.<sup>42</sup> Even after rate ceilings were phased out in 1986, competition from alternative investment vehicles had eroded the cost advantage and profit margins of the traditional banking technique of deposit-based lending. The impact on the deposit levels at traditional banks was severe and by the mid-1990s, deposits made up only about 20 percent of traditional bank liabilities, compared to approximately 60 percent in 1960 and before. Seen as a percentage of total money supply in the U.S., deposits in banks fell from 97 percent in 1984 to a low of 64 percent in 2002. The decline in profitability and relatively low levels of deposits in traditional banks forced them to seek alternate sources of revenue generation. Securitization is one of those alternative sources.

In the commercial real estate sector, CMBS accounts, on average, for approximately 25% of all outstanding commercial real estate debt, and accounted for as much as 50% at the market's peak in 2007, when the volume of new commercial real estate loan originations and thus new CMBS reached \$240 billion. However, the prolonged liquidity crisis caused new CMBS issuance to plummet to \$12 billion in 2008 and \$2 billion in 2009.

The CMBS market is re-starting, but slowly, with \$12.3 billion in issuance in 2010, and \$30-\$40 billion in issuance expected in 2011 depending upon economic conditions and the outcome of proposed regulatory and accounting changes.<sup>43</sup> This source of capital for commercial real estate must grow for CRE – and the economy in general – to prosper.

The importance of the securitized credit market to economic recovery has been widely recognized. Both the previous and current Administrations share the view that “no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small.”<sup>44</sup> The importance of restoring the securitization markets is recognized globally as well, with the International Monetary Fund noting in a Global Financial Stability Report issued last year that “restarting private-label securitization markets, especially in the

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<sup>42</sup>See “Securitization: A Vital Link in the Financing Chain,” GartenRothkopf (June 3, 2011) (available at [http://www.crefc.org/uploadedFiles/CMSA\\_Site\\_Home/Government\\_Relations/Financial\\_Reform/Risk\\_Retention/Securitization\\_2011\\_06\\_06\\_SM\\_v4.pdf](http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Securitization_2011_06_06_SM_v4.pdf)).

<sup>43</sup> Market analysts have anticipated that regulatory uncertainty will likely delay recovery of the securitization markets, including one observer that recently concluded that the delay would persist for at least another twelve months. See “A Guide to Global Structured Finance Regulatory Initiatives and their Potential Impact,” Fitch Ratings (Apr. 4, 2011), at 1 (available at [http://www.fitchratings.com/creditest/reports/report\\_frame.cfm?rpt\\_id=571646](http://www.fitchratings.com/creditest/reports/report_frame.cfm?rpt_id=571646)). Nevertheless, as previously discussed, the CRE Finance Council believes that at this stage speed is less important than the Agencies taking the appropriate amount of time to get the risk retention rules right.

<sup>44</sup> Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) available at <http://www.ustreas.gov/press/releases/tg18.htm>.

United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions.”<sup>45</sup>

Significantly, it is also important to be aware of the importance of securitization to smaller businesses that seek real estate financing. As of July 2010, there were more than 40,000 CMBS loans less than \$10 million in size with a combined outstanding balance of \$158 billion, which makes CMBS a significant source of capital for lending to small businesses. In fact, the average CMBS securitized loan is \$8 million. Therefore, when considering the Proposed Rules, the Agencies should be mindful that provisions that could halt or severely restrict securitization of CRE loans will have a disparate adverse impact on small businesses and their associated jobs, and on capital and liquidity in commercial real estate markets in smaller cities where smaller CRE loans are more likely to be originated. Restrictions on capital and liquidity in these markets will result in slower economic growth and additional job losses.

We urge the Agencies to bear in mind that risk retention rules must not be developed in isolation. As the Federal Reserve Board cautioned in its recommendations to Congress on risk retention, the totality of the regulatory changes that are being put into motion – including the various new disclosure and credit rating agency reform provisions included in the Act, the securitization accounting changes that must be effectuated, the new Basel capital requirements regime, and European Union Solvency II risk retention requirements – should be considered to develop a rational overall framework for appropriate alignment of risk:

[R]ulemakings in other areas could affect securitization in a manner that should be considered in the design of credit risk retention requirements. Retention requirements that would, if imposed in isolation, have modest effects on the provision of credit through securitization channels could, in combination with other regulatory initiatives, significantly impede the availability of financing. In other instances, rulemakings under distinct sections of the Act might more efficiently address the same objectives as credit risk retention requirements.<sup>46</sup>

#### B. Important Characteristics of CMBS

As regulators shape a risk retention framework for CMBS, it is important to be aware of the innate and unique characteristics of CMBS that help minimize the risky securitization practices that policymakers sought to address in the Dodd-Frank Act, which set CMBS apart from other types of

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<sup>45</sup> International Monetary Fund, “Restarting Securitization Markets: Policy Proposals and Pitfalls,” Chapter 2, Global Financial Stability Report: Navigating the Financial Challenges Ahead (October 2009), at 33 (“Conclusions and Policy Recommendations” section) available at <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>.

<sup>46</sup> Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010), at 84 (available at <http://federalreserve.gov/boarddocs/rtpcongress/securitization/riskretention.pdf>).

asset securitizations. More specifically, these characteristics relate not only to the type and sophistication of the borrowers, but to the structure of issued securities, the nature of the underlying collateral, and the existing level of transparency in CMBS deals, each of which is briefly described here:

- *Commercial Borrowers:* Part of the difficulty for securitization as an industry arose from practices in the residential sector, where loans were underwritten in the subprime category for borrowers who may not have been able to document their income, or who may not have understood the effects of factors like floating interest rates and balloon payments on their mortgage's affordability. In contrast, commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases (i.e. "income-producing" properties). Additionally, securitized commercial mortgages have different terms (generally 5 to 10 year "balloon" loans), and they are, in the vast majority of cases, "non-recourse" loans that rely on the credit of the underlying collateral, the ability of the management, and the stability of tenants for repayment.
- *Structure of CMBS:* There are multiple levels of review and diligence concerning the collateral underlying CMBS, which help ensure that investors have a well-informed, thorough understanding of the risks involved with their investment. Specifically, in-depth property-level analysis and review are done by all investors as part of their investment due diligence of CMBS bonds. Moreover, non-statistical, in-depth analysis is performed on CMBS pools. This review is possible given that there are far fewer commercial loans in a pool (traditionally, between 100 to 200 loans; while some recent issuances have had between 30 and 40 loans) that support a bond, as opposed, for example, to residential pools, which are typically comprised of between 1,000 and 4,000 loans and lend themselves more to statistical analysis of past performance rather than an understanding of pool collateral. The non-statistical analysis of CMBS pools includes gathering detailed information about the nature of the income-producing properties and the integrity of their cash flows, the credit quality of tenants, and the experience and integrity of the borrower and its sponsors.
- *First-Loss Investor ("B-piece Buyer") Re-Underwrites Risk:* CMBS bond issuances typically include a first-loss, non-investment grade bond component. The third-party investors that purchase these subordinate securities (referred to as "B-piece" or "first-loss" buyers) conduct their own extensive due diligence (usually including, for example, site visits to every property that collateralizes a loan in the loan pool) and re-underwrite all of the loans in a proposed pool. Because of this, the B-piece buyers typically either negotiate the removal of any loans they consider to be unsatisfactory from a credit perspective or negotiate price adjustments if the loans are to remain in the pool. They specifically negotiate with bond sponsors or originators to purchase this non-investment-grade risk component of the bond offering. This third-party investor due diligence and negotiation occurs on every deal that includes a B-piece. We do note, however, that certain types of securitized structures are written so conservatively that they do not include a traditional "B-

piece.” Such structures, for example, include low loan-to-value, high debt-service-coverage-ratio pools that are tranching only to investment grade.

- *Greater Transparency:* CMBS market participants already have access to a wealth of information through initial offering documents that provide significant details on the loans, the properties that secure the loans, the borrowers, and the deal structure. In addition, the CRE Finance Council-developed Investor Reporting Package<sup>TM</sup> provides access to loan-, property-, and bond-level information while securities are outstanding, including updated loan and bond balances, ongoing property performance, the amount of interest and principal received, and updated bond ratings. Our reporting package has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market. By way of contrast, in the residential realm, transparency and disclosure are limited by, among other things, privacy laws that limit access to borrowers’ identifying information. The CRE Finance Council constantly monitors usage of the IRP and recently released version “5.1” which incorporates further improvements and a new “Loan Modification Template.” Also, as discussed in more detail in Part IV.C above, CRE Finance Council working groups – comprised of all CMBS constituencies (investors, issuers, etc.) – have built on existing safeguards in CMBS to create “best practices” that could be used immediately in the market to enhance disclosure, improve underwriting, and strengthen and standardize representations and warranties to ensure alignment of interests between issuers and investors.

### C. Mechanics of Commercial Mortgage Securitization

CMBS are bonds collateralized by pools of commercial mortgage loans from which all of the principal and interest paid on the mortgages flows to investors. The standard CMBS transaction involves a senior/subordinate structure, with bonds varying in yield, duration, and payment priority, as classified (or “tranching”) by the issuer according to credit characteristics. In many cases, the issuer strives to diversify the characteristics of the underlying loans (e.g., by asset type or location) to mitigate the overall credit risk of the pool. In other cases, the pool contains a more homogeneous collection of loans. The purpose of such variations is, in any event, to offer investors a variety of choices on the risk-return spectrum.

The ability to diversify pool characteristics and to tranche CMBS by risk profile yields efficiencies that are the hallmark of the securitization process: when a large number of loans are securitized, the pool typically has asset-type and/or geographic diversity that can provide the loan pool with a lower aggregate risk profile than the individual loans in the pool. Moreover, the separation of the securities by risk profile allows the securities to be more efficiently priced and sold to investors that specialize in investing in a particular part of the debt stack. These efficiencies can produce “excess spread,” which is created when the weighted average interest rate for loans contributed to the CMBS is greater than the weighted average interest rate paid to the CMBS bond purchaser. In the CMBS space then, excess spread is not simply the result of CMBS lenders imposing a loan pricing

premium merely to extract excess spread, but is the logical and desirable product of CMBS's structural efficiencies.

Excess spread may be monetized by the issuer through the issuance of interest-only ("IO") bonds, which are securities backed by the excess interest (the interest above that required to pay the regular certificate coupons) generated by the pool of underlying commercial mortgages. The IO strip is the primary mechanism for issuers to recover their overhead and hedging costs and make a reasonable return on capital. It follows that elimination of the IO strip, or imposition of any mechanism that would require all proceeds from an IO strip to be placed into a reserve account and held until all other bonds are paid off, would effectively eliminate the financial incentive for issuing CMBS.

With respect to the subordinate classes of bonds in a transaction, those classes bear the initial risk of loss – or credit risk – associated with the loans. The potential for loss arises if the amount owed is not paid. That is, if someone lends money to a borrower, the lender's credit risk is the risk that the borrower fails to repay what is owed, with interest, when it is due. This risk – credit risk – is not directly related to whether changes in the market interest rate or other factors may increase or decrease the market value of the loan. And such changes do not affect the amount the borrower owes, or influence whether that amount will be repaid by the borrower. For these reasons, it would be inappropriate to assume that the credit risk associated with a transaction, as the term "credit risk" is generally understood in the market, should be defined by reference to the market value of a loan or the ABS to which the loan is contributed.

Another important fact to note from this discussion is that interests in CMBS have historically been retained at par value. As mentioned, the subordinate classes of bonds bear the initial risk of loss in a securitization. In the case of CMBS, it is the B-piece buyer that holds a horizontal first-loss position. The amount of credit risk associated with the B-piece is equal to the maximum amount of losses that can be incurred until the amount of such subordinated interest is reduced to zero. To use a very simple example, consider a sponsor that holds a pool of \$100 million in performing loans bearing market interest rates. The sponsor may structure a securitization in which notes having a total principal amount of \$95 million are issued and sold to investment-grade investors, and a horizontal first-loss component with a principal amount of \$5 million is purchased by a B-piece buyer. In this example, the maximum theoretical credit risk to the B-piece buyer is \$5 million, which represents 5% of the face value of the pool assets.

Because the B-piece buyer bears the *first* risk of loss, however, this interest must be sold at a significant discount to par value, with the price being dependent on several factors such as the expected rate of losses on the pool assets. If the B-piece interest in the foregoing example is worth only \$2.5 million (and a 50% discount is not uncommon given B-piece buyers' yield requirements), the B-piece would not meet a regulatory requirement for retention of 5% of transaction proceeds. On the contrary, as discussed in more detail in Part IV.E above, any attempt to reach retention of 5% of transaction proceeds would force the sponsor to engage in inefficient and uneconomical restructuring of the transaction, requiring the B-piece buyer to purchase not only the non-investment grade classes

but also certain investment grade classes. From a practical perspective, B-piece buyers would be unwilling, and in many cases unable, to participate in such transactions.

D. Historical Loss Data Puts the Experience of Various Asset Classes into Context

If historical loss data are examined, the experience of various classes of asset-backed securities can be placed into relative context, an exercise the CRE Finance Council urges the Agencies not to ignore. For example, a review of current delinquencies and actual losses for every CMBS vintage dating back to 1995 reflects that actual losses are well below 5%, averaging just 2.5% for vintages that have seasoned at least ten years from 1995 through 2001. More recent vintage CMBS pools are projected to experience loss rates that are higher, yet are well below losses in more troubled sectors such as residential housing loans. For example, as described in Figure 2 below, a recent Morgan Stanley study projects that 2005 through 2007 vintage CMBS will bear average losses around 7% to 8%. By way of comparison, the estimated losses to investment grade tranches over the lifetime of 2005-2007 vintage non-agency RMBS are estimated to range from 15-45% for subprime and 15-35% for Alt-A.



**Figure 2.**

## Securitized Products Have Not Performed Equally

|  | Estimated Losses to Investment Grade Tranches <sup>1,2</sup> |      |          |      | Outstanding Market Size <sup>3</sup> |
|--|--|------|----------|------|--------------------------------------|
|  | To Date  |      | Lifetime |      | Billion (\$)                         |
|  | Low  | High | Low      | High |                                      |
| ABS CDO <sup>4</sup>                         |  |      |          |      |                                      |
| Mezzanine ABS CDO (2005-2007 Vintage)        | 60%  | 70%  | 75%      | 90%  | 80                                   |
| High Grade ABS CDO (2005-2007 Vintage)       | 30%  | 35%  | 60%      | 70%  | 170                                  |
| Non-Agency RMBS                              |  |      |          |      |                                      |
| Subprime (2005-2007 Vintage) <sup>5</sup>    | 5%   | 15%  | 15%      | 45%  | 467                                  |
| Alt-A (2005-2007 Vintage) <sup>6</sup>       | 5%   | 15%  | 15%      | 35%  | 626                                  |
| Jumbo Prime (2005-2008 Vintage) <sup>7</sup> | 0%   | 2%   | 3%       | 10%  | 341                                  |
| Agency RMBS <sup>8</sup>                     | 0%   | 0%   | 0%       | 0%   | 6,739                                |
| CMBS (2005-2007 Vintage)                     | 0%   | 0%   | 2%       | 15%  | 769                                  |
| CLO (2004-2008 Vintage) <sup>9</sup>         | 0%   | 0%   | 0%       | 1%   | 319                                  |
| Credit Card ABS                              | 0%   | 5%   | 0%       | 5%   | 222                                  |
| Auto Loan ABS                                | 0%   | 0%   | 0%       | 0%   | 129                                  |
| Student Loan ABS (FFELP)                     | 0%   | 0%   | 0%       | 2%   | 249                                  |
| Student Loan ABS (Private Credit)            | 0%   | 0%   | 5%       | 35%  | (included above)                     |

**Notes:**

<sup>(1)</sup> Losses to investment grade tranches have been calculated using estimates of pool losses and applying a generic capital structure for each category of securitized products.

<sup>(2)</sup> Investment grade tranches defined as tranches originally rated BBB/Baa and higher.

<sup>(3)</sup> Outstanding market size for Agency RMBS includes \$5.468 billion of pass-throughs and \$1.270 billion of agency CMOs as of Q2, 2010. Market size estimates are based on data from SIFMA and S&P for all categories except CLO and ABS CDOs which are Morgan Stanley estimates. 2005-2007 vintage issuance of ABS CDOs were \$140 billion and \$260 billion for mezzanine and high grade ABS CDOs respectively.

<sup>(4)</sup> ABS CDO losses are based on Morgan Stanley estimates.

<sup>(5)</sup> For subprime, pool losses to date are based on ABX 2006-1 for low and ABX 2007-2 for high. Expected life time losses are based on "Subprime RMBS Loss Projection Update: February 2010", Moody's Investors Service, Feb 24, 2010.

<sup>(6)</sup> For Alt-A, pool losses to date are based on Morgan Stanley proprietary Indioes - 2006-2 Fixed for low and 2007-2 Hybrid for high. Expected life time losses are based on "Alt-A RMBS Loss Projection Update: February 2010", Moody's Investors Service, Feb 24, 2010.

<sup>(7)</sup> For Jumbo Prime, pool losses to date are based on PrimeX Indioes - FRM1 for low and ARM2 for high. Expected life time losses are based on "Prime Jumbo RMBS Loss Projection Update: January 2010", Moody's Investors Service, Jan 20, 2010.

<sup>(8)</sup> No credit losses assumed due to government guarantees for Agency RMBS. There may be losses in premium bonds due to prepayments.

<sup>(9)</sup> CLO, credit card, auto and student loan ABS losses are based on Morgan Stanley estimates.

**Morgan Stanley**

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This data demonstrates that there is a significant difference in the performance of CMBS versus those asset classes that played a catalytic role in the mortgage crisis. And while the CRE Finance Council recognizes the need for improvements to the CMBS market, we do believe that it is important, as a policy matter, for the Agencies to consider the actual performance of the asset classes as risk retention regulations are being crafted.

## **ATTACHMENT B**

### **Summary of CRE Finance Council Recommendations Regarding Operating Advisor (“OA”) for Third-Party Risk Retention**

| Issue  | Proposed Rule   | CRE Finance Council Recommends   |
|--|---|--|
| OA kick-in: when B-piece buyer retains and – | Servicer is affiliated with B-piece buyer.  | B-piece is controlling class (i.e., until principal payments, appraisal reductions & losses reduce position to less than 25% of original face amount of B-piece).  |
| OA’s general roles                           | “Consultation” with servicers and authority to remove servicer absent shareholder veto. | <p>-- Oversight role begins on day 1 of a CMBS transaction.</p> <p>--OA oversight role is reactive to investor inquiries/complaints if the B-piece is in control, and proactive if the B-piece has been appraised out.</p> <p>--OA Oversight is defined as an investigative role that covers compliance with the PSA. OA first works to find a resolution to the complaint, and also investigates if there is a potential breach of contract.</p> <p>--OA can recommend removal if determines that willful misconduct, bad faith, or negligence has occurred;</p> <p>--PSA to specify any OA role after control event.</p> |
| Servicing disclosure requirements            | Not addressed.  | As specified in the PSA or other contractual agreement.  |
| Servicers subject to requirements.           | “Servicers” (i.e., rule doesn’t distinguish between master and special).                | Special servicer.  |
| OA investigative role                        | Will “review and report” on actions of servicers.                                       | <p>--Initiated by investor inquiry or complaint.</p> <p>--Oversight to ensure compliance with PSA servicing standards and information dissemination requirements;</p>  |

| Issue                                 | Proposed Rule  | CRE Finance Council Recommends  |
|---------------------------------------|--|---|
|                                       |  | <p>--OA can initiate investigation;</p> <p>--if OA decides to proceed with removal recommendation, special servicer and B-piece buyer will have opportunity to respond.</p> |
| OA removal authority                  | Can remove upon determination in OA's sole discretion that servicer has failed to comply with servicing standard in PSA and replacement would be in best interest of investors as a whole. | Can recommend removal if OA determines that willful misconduct, bad faith, or negligence has occurred on the part of the special servicer.                                  |
| Voting mechanism for servicer removal | Veto of decision to remove servicer, by a majority of each class of certificate holders.   | Approval of OA's special servicer removal recommendation, based upon a minimum affirmative investor vote as specified within the PSA or other contractual agreement.        |
| OA independence criteria              | No affiliation with transaction parties; no financial interest in transaction.   | Require disclosure of any conflicts of interest; require mitigation measures such as walling off if there is any conflict.  |

## **ATTACHMENT C**

### **Suggested Revision to Regulatory Text for § \_\_.10 Third-Party Risk Retention for CMBS**

#### § \_\_.10 Commercial mortgage-backed securities.

(a) Third-Party Purchaser. A sponsor satisfies the risk retention requirements of § \_\_.3 of this part with respect to a securitization transaction if one or more~~a~~ third parties~~y~~ purchases an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as would be required of the sponsor under § \_\_.5(a) of this part and all of the following conditions are met:

(1) Composition of collateral. At the closing of the securitization transaction, at least 95 percent of the total unpaid principal balance of the securitized assets in the securitization transaction are commercial real estate loans.

(2) Source of funds. The third-party purchaser:

(i) Pays for the eligible horizontal residual interest in cash at the closing of the securitization transaction; and

(ii) Does not obtain financing, directly or indirectly, for the purchase of such 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), other than a person that is a party to the transaction solely by reason of being an investor. For the avoidance of doubt, this prohibition on indirect financing does not preclude the third party from obtaining financing from a party to the transaction for a purpose or transaction that is unrelated to the retained interest.

(3) Third-party review. The third-party purchaser conducts a review of the credit risk of each securitized asset prior to the sale of the asset-backed securities in the securitization transaction that includes, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each commercial real estate loan that is collateral for the asset-backed securities. Such review by the third party shall be solely for its own account, and shall not give rise to any liability on the part of the third party to any other bondholder.

(4) ~~Affiliation and~~Control rights.

(A) The underlying securitization transaction documents should provide for the appointment of an operating advisor (the “Operating Advisor” or “OA”).

(B) The third party shall be defined as the controlling class of certificateholder until principal payments, appraisal reductions, and realized losses have reduced the third party’s position to less than 25% of the original face amount of the third party’s interest.

(C) The Operating Advisor's duties and authority should be defined in the transaction documents, and should include the following:

(i) From the transaction's inception, an OA would be made responsible for oversight of the special servicer to ensure that the transaction documents is followed by the special servicer, subject to the following consideration: when the B-piece buyer is the controlling class of certificateholder, the OA's oversight role would be reactive to investor complaints. The transaction documents should provide that if investors have complaints concerning the special servicer's performance of its servicing obligations under the transaction documents, the OA will respond and attempt to resolve those investor complaints;

(ii) The B-piece buyer is no longer the controlling class of certificateholder if the sum of principal payments, appraisal reductions and realized losses have reduced the B-piece buyer's initial position(s) to less than 25% of its original face amount.

(iii) The transaction documents should provide that when the B-piece buyer is no longer the controlling class of certificateholder, the OA will conduct its oversight to ensure the special servicer's compliance with the transaction documents whether or not there has been a complaint from investors;

(iii) From the transaction's inception, the Operating Advisor should have the authority to make a determination whether willful misconduct, bad faith, or negligence has occurred on the part of the special servicer. However, while the B-piece buyer is the controlling class of certificateholder, such determination may only be initiated upon an investor's complaint. Once the B-piece buyer is no longer the controlling certificateholder, such determinations may be initiated by the OA;

(iv) If the Operating Advisor seeks to make a finding that willful misconduct, bad faith, or negligence has occurred on the part of the special servicer, the Operating Advisor must provide notice to the special servicer and give the special servicer an opportunity to discuss and/or explain its conduct within a reasonable timeframe, as negotiated by the parties;

(v) If there is no resolution and the Operating Advisor concludes that willful misconduct, bad faith, or negligence has occurred on the part of the special servicer which warrants the special servicer's removal, then:

(1) the Operating Advisor must disclose any conflicts-of-interest it may have including any bond holdings it, its affiliates, or funds that it manages, may have;

(2) the Operating Advisor's recommendation and rationale should be publicly posted on the trustee website and other public venues commonly monitored by CMBS investors to give all investors an opportunity to review it;

(3) the third party and special servicer should each have the opportunity to post any rebuttal arguments against the removal recommendation, and,

(4) the removal question must be put to an affirmative vote by investors in the non-controlling classes.

(vi) The OA may call for removal of the special servicer based upon satisfaction of a minimum affirmative investor vote, as specified by the transaction documents.

(vii) If the special servicer is removed using this process, the third party (if still the controlling class of certificateholders) shall name a replacement special servicer.

(viii) If the Operating Advisor is affiliated with any other parties to the securitization transaction, or has any financial interest in the securitization transaction other than in fees from its role as Operating Advisor, the Operating Advisor shall disclose any such conflicts of interest as required by paragraph (v)(1) of the subsection, and shall undertake appropriate and prudent measures, including walling off business units and staffpersons, as necessary to mitigate conflicts of interest.

~~Except as provided in paragraphs (a)(4)(ii) or (iii) of this section:~~

~~(A) The third party purchaser is not affiliated with any party to the securitization transaction (including, but not limited to, the sponsor, depositor, or servicer) other than investors in the securitization transaction; and~~

~~(B) The third party purchaser or an affiliate of such third party purchaser does not have control rights in connection with the securitization transaction (including, but not limited to, acting as a servicer for the securitized assets) that are not collectively shared with all other investors in the securitization.~~

~~(ii) Notwithstanding paragraph (a)(4)(i)(A) of this section, the third party purchaser may be affiliated with one or more originators of the securitized assets so long as the assets originated by the affiliated originator or originators collectively comprise less than~~

~~10 percent of the unpaid principal balance of the securitized assets included in the securitization transaction at closing of the securitization transaction.~~

~~(iii) Paragraph (a)(4)(i) of this section shall not prevent the third party purchaser from acting as, or being an affiliate of, a servicer for any of the securitized assets, and having such controls rights that are related to such servicing, if the underlying securitization transaction documents provide for the following:~~

~~(A) The appointment of an operating advisor (the "Operating Advisor") that:~~

~~(1) Is not affiliated with other parties to the securitization transaction;~~

~~(2) Does not directly or indirectly have any financial interest in the securitization transaction other than in fees from its role as Operating Advisor; and~~

~~(3) Is required to act in the best interest of, and for the benefit of, investors as a collective whole.~~

~~(B) Any servicer for the securitized assets that is, or is affiliated with, the third party purchaser must consult with the Operating Advisor in connection with, and prior to, any major decision in connection with the servicing of the securitized assets, including, without limitation:~~

~~(1) Any material modification of, or waiver with respect to, any provision of a loan agreement (including a mortgage, deed of trust, or other security agreement);~~

~~(2) Foreclosure upon or comparable conversion of the ownership of a property; or~~

~~(3) Any acquisition of a property.~~

~~(C) The Operating Advisor shall be responsible for reviewing the actions of any servicer that is, or is affiliated with, the third party purchaser and for issuing a report to investors and the issuing entity on a periodic basis concerning:~~

~~(1) Whether the Operating Advisor believes, in its sole discretion exercised in good faith, that such servicer is operating in compliance with any standard required of the servicer as provided in the applicable transaction documents; and~~

~~(2) What, if any, standard(s) the Operating Advisor believes, in its sole discretion exercised in good faith, with which such servicer has failed to comply;~~

~~(D) The Operating Advisor shall have the authority to recommend that a servicer that is, or is affiliated with, a third party purchaser be replaced by a successor servicer if the Operating Advisor determines, in its sole discretion exercised in good faith, that:~~

~~(1) The servicer that is, or is affiliated with, the third party purchaser has failed to comply with a standard required of the servicer as provided in the transaction documents; and~~

~~(2) Such replacement would be in the best interest of the investors as a collective whole;~~

~~And~~

~~(E) If a recommendation described in paragraph (a)(4)(iii)(D) of this section is made, the servicer that is, or is affiliated with, the third party purchaser must be replaced unless a majority of each class of ABS interests in the issuing entity eligible to vote on the matter votes to retain the servicer.~~

(5) Disclosures. The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form, and, with respect to subparagraphs (i) through (vii), under the caption “Credit Risk Retention”:

(i) The name and form of organization of the third-party purchaser;

(ii) A description of the third-party purchaser’s experience in investing in commercial mortgage-backed securities;

(iii) Any other information regarding the third-party purchaser or the third-party purchaser’s retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular securitization transaction;

(iv) A description of the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest that will be retained (or was retained) by the third-party purchaser, as well as the amount of the purchase price paid by the third party purchaser for such interest;

(v) The amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest in the securitization transaction that the sponsor would have been required to retain pursuant to § \_\_.5(a) of this part if the sponsor had relied on such section to meet the requirements of § \_\_.3 of this part with respect to the transaction;

(vi) A description of the material terms of the eligible residual horizontal interest retained by the third-party purchaser;

(vii) The material assumptions and methodology used in determining the aggregate amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used; and

(viii) The representations and warranties concerning the securitized assets, and a schedule of any securitized assets that are determined do not comply with such representations and warranties, ~~and what factors were used to make the determination that such securitized assets should be included in the pool notwithstanding that the securitized assets did not comply with such representations and warranties, such as compensating factors or a determination that the exceptions were not material.~~

(6) Hedging, transfer and pledging. The third-party purchaser complies with the hedging and other restrictions in § \_\_.14 of this part as if it were the retaining sponsor with respect to the securitization transaction and had acquired the eligible horizontal residual interest pursuant to § \_\_.5 of this part.

(b) Allocation of risk retention between sponsor and a third party. A sponsor choosing to retain a portion of each class of ABS interests in the issuing entity under the vertical risk retention option in § \_\_.4 of this part or an eligible horizontal residual interest pursuant to § \_\_.5(a) of this part with respect to a securitization transaction may offset the amount of its risk retention requirements under § \_\_.4 or § \_\_.5(a) of this part, as applicable, by the amount of the ABS interests or eligible horizontal residual interest, respectively, acquired by one or more third parties if the third party or parties complies with the conditions in this section.

~~(c)~~ Duty to comply.

~~(1) The retaining sponsor shall be responsible for~~ third party shall certify annually that it is in compliance with this section. Such certification shall be provided to the Operating Advisor, and if there is no Operating Advisor, to the Commission.

~~(2) A retaining sponsor relying on this section:~~

~~(A) Shall maintain and adhere to policies and procedures to monitor the third party purchaser's compliance with the requirements in paragraph (a) of this section (other than paragraphs (a)(1) and (a)(5)); and~~

~~(B) In the event that the sponsor determines that the third party purchaser no longer complies with any of the requirements of paragraph (a) of this section (other than paragraphs (a)(1) and (a)(5)), shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the securitization transaction of such noncompliance by the third party purchaser.~~

\* \* \*

§ \_\_.14 Hedging, transfer and financing prohibitions.

(a) Transfer. For a period of 5 years following the initiation of the securitization transaction, a retaining sponsor or third party may not sell or otherwise transfer any interest or assets that the sponsor or third party is required to retain pursuant to subpart B of this part to any person other than an entity that is and remains a consolidated affiliate, or a person or entity that meets the requirements in § \_\_.10. For the avoidance of doubt, there shall be no restrictions on the sale or transfer any interest or assets that the sponsor or third party is required to retain pursuant to subpart B of this part after the expiration of 5 years following the initiation of the securitization transaction.

\* \* \*

§ \_\_.16 Definitions applicable to qualifying commercial mortgages, commercial loans, and auto loans.

Commercial real estate (CRE) loan:

(1) Means a loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (fifty (50) percent or more) of repayment for which is expected to be derived from:

(i) The proceeds of the sale, refinancing, or permanent financing of the property;  
or

(ii) Rental income associated with the property ~~other than rental income derived from any affiliate of the borrower~~; and

(2) Does not include:

(i) A land development and construction loan (including 1- to 4-family residential or commercial construction loans);

(ii) Any other land loan secured entirely by unimproved land;

(iii) A loan to a real estate investment trust (REIT)that is not secured by commercial real estate or a multifamily property; or

(iv) An unsecured loan to a developer.

## **ATTACHMENT D**

| <b>CATEGORY</b>                               | <b>PROPOSED RULE</b>   | <b>CREFC RECOMMENDATION</b>   |
|---|--|---|
| Definition of a “Commercial Real Estate Loan” | Specifically excludes “loans to REITs” as eligible.  | Include loans to REITs as eligible if secured by commercial or multifamily property.  |
| Debt Service Coverage Ratio                   | At least 1.5-1.7x depending on loan type.  | Replace with minimum debt yield of 12%.   |
| Qualified Tenant                              | Minimum DSCR calculated only based on income derived from “qualified tenants,” defined as a tenant that (1) is subject to a triple net lease that is current and performing with respect to the CRE property, or (2) was subject to a triple net lease that has expired, currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to closing, and is current and performing with respect to all obligations associated with the CRE property. | Eliminate; it is common industry protocol for many office leases and leases of other CRE product categories to not be structured as triple net leases. Rental income from tenants with gross leases using an expense stop are common and sound and should not be excluded. Many considerations are taking into account when determining how much credit to give to rental income from month-to-month tenants. |
| Amortization and Interest-only Periods        | All loan payments required to be made under the loan agreement are based on straight-line amortization of principal and interest over a term that does not exceed 20 years; borrower must be qualified for the CRE loan based on a monthly payment amount derived from a straight-line amortization of principal and interest over the term of the loan, but not exceeding 20 years. Borrower is not permitted to defer repayment of principal or payment of interest.                                     | Each loan should have some form of amortization but the amount of which should be able to vary based on LTV (loans that are below 50% LTV should be able to be interest only for the loan term, while loans that are in excess of a 50% LTV should be able to have a portion of their loan term be interest only).  |
| CLTV  | Less than 65% at origination, or less than 60% if the capitalization rate used at appraisal is $\leq$ (10 yr swap rate + 300 bp)   | -- Beginning LTV of 65% or less and ending LTV of 55% or less;<br><br>--Eliminate “Combined” as CLTV is not directly relevant to the credit backing the first mortgage.   |

| CATEGORY                                      | PROPOSED RULE  | CREFC RECOMMENDATION  |
|---|--|---|
| Sponsor Credit                                | Require 2 yr look forward and 2 yr look back.  | -- 2 yr look forward – eliminate.<br>-- 2 yr look back – support.   |
| Buy Back Requirement                          | A sponsor that has relied on the QLE will not lose it for the entire transaction if the sponsor repurchases the non-compliant loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) within 90 days after the determination that the loans do not comply, among other requirements.                              | Eliminate; the appropriate place to address the buy-back requirement is in the representations and warranties. 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. |
| Maturity                                      | Not less than 10 years   | Fixed rate loans should be no less than 5 years and floating rate loans should be no less than 3 years  |
| Financial Disclosure                          | Require the borrower to provide to the originator and any subsequent holder of the commercial loan, and the servicer, the borrower's financial statements and supporting schedules on an ongoing basis, but not less frequently than quarterly, including information on existing, maturing and new leasing or rent-roll activity for the property securing the loan, as appropriate.      | Require the borrower to provide the property's financial statements, rather than the borrower's, because for CRE the review is focused on analysis of property performance.   |
| Collateral restrictions/subordinate financing | Loan docs must contain covenants that prohibit:<br><br>-- the creation or existence of any other security interest with respect to any collateral for the CRE loan;<br>-- the transfer of any collateral pledged to support the CRE loan; and<br>-- any change to the name, location or organizational structure of the borrower, or any other party that pledges collateral for the loan. | Subordinate financing should be permitted subject to a combined maximum LTV.  |
| Borrower insurance requirements               | Maintain insurance that protects against loss on the collateral at least up to the amount of the loan  | Support.  |
| Junior lien exception                         | Junior lien on any property that serves as collateral for the CRE loan is permitted if such loan finances the purchase of machinery and equipment  | Support.  |

| CATEGORY                 | PROPOSED RULE   | CREFC RECOMMENDATION  |
|--------------------------|---|---|
|                          | and the borrower pledges such machinery and equipment as additional collateral for the CRE loan.  |   |
| Fixed/Floating Rate      | Only Fixed Rate Loans or Floating Rate with Interest Rate Cap   | Support.  |
| Floating Rate Issues     | Loans permitted to have an adjustable interest rate if the borrower, prior to or concurrently with origination of the CRE loan, obtained a derivative that effectively results in a fixed interest rate.  | Floating rate loans should be allowed with a min. term of 3 years (w/ an interest rate cap agreement that is commercially reasonable based on the debt yield, cash flow and reserves (i.e. debt service reserves, TI/LC, etc.)) |
| Appraisal                | Obtained a written appraisal of the real property securing the loan that:<br>-- Was performed not more than six months from the origination date of the loan by an appropriately state-certified or state-licensed appraiser;<br>-- Conforms to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) and the appraisal requirements of the Federal banking agencies and<br>-- Provides an „as is” opinion of the market value of the real property, which includes an income valuation approach that uses a discounted cash flow analysis. | Support.  |
| First Lien               | The CRE Loan must be secured by the first lien on the commercial real estate  | Support.  |
| 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.  |

| CATEGORY                      | PROPOSED RULE  | CREFC RECOMMENDATION |
|-------------------------------|--|----------------------|
| Defer Principal and Interest  | The borrower is not permitted to defer repayment of principal or payment of interest; and  | Support.             |
| Interest Reserve              | The originator does not establish an interest reserve at origination to fund all or part of a payment on the loan.   | Support.             |
| Payments at Closing           | At the closing of the securitization transaction, all payments due on the loan are contractually current.  | Support.             |
| Internal Supervisory Controls | The depositor of the asset-backed security must certify 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) (the QLE criteria) and has concluded that its internal supervisory controls are effective. | Support.             |