TESTIMONY OF PAUL VANDERSLICE ON BEHALF OF
THE COMMERCIAL REAL ESTATE FINANCE COUNCIL

BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE IMPACT
OF DODD-FRANK ON CUSTOMERS, CREDIT AND JOB CREATORS

July 10, 2012

The Commercial Real Estate ("CRE") Finance Council is grateful to Chairman Garrett and the Members of the Subcommittee for holding this hearing to examine the impact of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank")[1] on credit availability.

The CRE Finance Council is the collective voice of the entire $3.1 trillion commercial real estate finance market, including portfolio, multifamily, and Commercial Mortgage-Backed Securities ("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 missions include setting market standards, facilitating market information, and providing education at all levels, including securitization, which has been a crucial and necessary tool for growth and success in commercial real estate finance. Because our membership consists of all constituencies across the entire CRE finance market, the CRE Finance Council has been able to develop comprehensive responses to policy questions that promote increased market efficiency and investor confidence.

We appreciate the opportunity to share our views on the impact of Dodd-Frank regulations on credit availability in the CMBS component of the securitization markets. As explained in more detail below, the cumulative impact of the regulations implementing the Dodd-Frank Act poses a serious threat to sustaining the nation's overall economic recovery. It is critical that the agencies charged with implementing the Dodd-Frank Act coordinate their rulemakings and consider the cumulative impact of the numerous regulations on credit availability in the CRE finance market before promulgating final rules. We are not suggesting that this consideration should impede issuance of final rules. Indeed, the tremendous uncertainty

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[1] Pub. L. No. 111-203.

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created by the multitude of required financial regulatory changes serves as a direct, independent impediment to private lending and investing, as the markets attempt to anticipate the impact these developments may have on the availability of commercial real estate credit, capital and liquidity.

Executive Summary

- The commercial real estate market in the United States is funded by $3.1 trillion in commercial mortgages and has approximately $1.5 trillion in equity.

- Approximately $2 trillion of the commercial mortgage debt is scheduled to mature over the next five years.

- Traditional portfolio lenders – primarily banks and life insurance companies – are projected to be capable of funding less than $200 billion per year of this demand, and they simply lack the balance sheet capacity to completely satisfy the aggregate CRE financing need. This fact leads to a natural funding gap between the credit portfolio lenders can provide and the credit necessary to refinance existing debt and to fund new commercial loans that are essential to economic recovery and growth.

- For the last two decades, CMBS has filled the CRE funding gap between what these traditional portfolio lenders can supply and the needs of CRE borrower demand. Some traditional portfolio lenders also rely on the availability of CMBS as an exit strategy and the majority of portfolio loans therefore are structured to be eligible for securitization.

- The CMBS industry is in the midst of a very fragile recovery. Currently, there is approximately $600 billion in outstanding CMBS, with only between $30-35 billion in new issuance projected for 2012. While we are recovering, the industry has not seen issuance this low since 1997. There is growing concern that the size of the CMBS market will soon be insufficient to support the vast infrastructure necessary to sustain a viable CMBS market.

    - This insufficiency could be particularly problematic for the secondary markets – or, better said, the businesses in the small and midsized towns across America that CMBS traditionally funds.

- As the market attempts to recover, CMBS also confronts a series of exogenous headwinds that include, among others, weak growth in the U.S economy and the intensifying sovereign crisis in Europe.

- That said, the complex and overlapping sets of Dodd-Frank and other, related financial sector regulations are a controllable component of these headwinds.

- The CRE Finance Council fully supports many aspects of Dodd-Frank, including risk retention, better disclosure and more transparency.

- In fact, the SEC pointed to the CRE Finance Council CMBS disclosure package as a model for the entire ABS industry, and we are working as an industry to continue to perfect this transparency model.

- However, we are concerned that each individual regulation may be going beyond Congressional intent and, when these regulations are aggregated, the combined effect will curtail credit further than you intended.

- As an example, the Premium Capture Cash Reserve Accounts ("PCCRA") included in the proposed risk-retention regulations, but not contemplated in the Dodd-Frank Act itself, are intended to bolster the retention regime. However, they will do so (if they do so at all) at the expense of borrowers in terms of restricted credit availability and increased borrowing costs. Investors also would be affected, as they will not have sufficient CMBS product to provide the risk diversification and yield needed to meet, for example, life insurance and pension benefit payment obligations.

    - According to a recent survey of the CRE Finance Council Board, 78% of the respondents – and 73% of the Investment Grade Investor respondents the PCCRA is purportedly designed to protect – believed that implementation of the PCCRA requirement would hinder CMBS.

    - In addition, in a separate survey, 92% of issuer respondents said that imposition of the PCCRA would decrease loan origination volume from current levels. Almost 62% of those respondents said that volume decreases would be more than 50%. Some indicated reductions would be as high as 90-100%.

    - All respondents indicated that the cost of liquidity to borrowers would increase – over 92% said the cost increase would be 50 basis points or more; 46% indicated that the cost increase would be more than 100 basis points.

- The Basel III proposed capital credit rules also will function to decrease credit availability, especially from smaller banks, and increase the cost of that credit to borrowers.

- The regulators are required to ensure that the benefits of any proposed regulations are fully justified by the cumulative costs they will impose. We recognize the fine line that regulators must walk between the need to safeguard the markets and allow healthy liquidity to flow. Ultimately, the question is, "What is the appropriate level and extent of regulation?"

- The Board of Governors of the Federal Reserve Report also recognizes the importance of considering the totality of the regulatory changes before promulgating final rules. It

noted recently that retention requirements could, in combination with other regulatory initiatives, significantly impede the availability of financing.

- Therefore, we urge Congress to use its oversight authority to ensure that the regulators are following both Congressional intent and Administrative Policy by fully evaluating the potential costs and benefits before adopting final securitization-related rules.

- It also is imperative that the regulators get the rules done; they just need to be done right.

Discussion

Industry Background

Commercial real estate is a multi-trillion dollar component of the American economy. Commercial real estate provides the space where we work, shop, live, meet and recreate. Specifically, commercial real estate comprises the apartments, manufactured housing, office buildings, strip malls, grocery stores, and other retail establishments where goods are sold and food purchased; the small business spaces on main street; 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 executives stay.

The commercial real estate market in the United States is still emerging from a period in which it faced serious duress brought on by the severe economic downturn, and significant hurdles remain to recovery. Prior to the onset of the economic crisis, CMBS was the source of approximately half of all CRE lending, providing approximately $240 billion in capital to the CRE finance market in 2007 alone. In addition, many portfolio lenders also rely on the availability of securitization to provide a safety valve exit strategy, and it has been estimated that in 2007, for example, as many as 80% of all loans were securitization eligible. After plummeting to a mere $2 billion in 2009 at the height of the crisis, the CMBS market began to see signs of life in 2010 with $12.3 billion in issuance; issuance of approximately $30 billion in 2011; and issuance of $18 billion in 2012 (to date). The total CMBS issuance for 2012 is expected to be between $30-35 billion.

In the next five years, however, approximately $2 trillion in outstanding commercial mortgages – including $600 billion in CMBS loans – will mature, many of which are smaller properties located in secondary markets where traditional portfolio lending often is not available. Borrower demand to refinance those obligations will be at an all-time high.[2] Last year alone, for example, approximately $700 billion in commercial mortgages matured but there was capital available to refinance only $200 of the $700 billion in loans. Bank portfolio lending provided $80 billion of the $200 billion in financing; life insurance company portfolio lending provided another $50 billion; Government Sponsored Enterprises (GSEs) provided another $40 billion, almost exclusively to finance multi-family housing projects; and the $33 billion balance was

[2] The Dodd-Frank NPR: Implications for CMBS, April 12, 2011, Morgan Stanley at 1.

supplied by CMBS. For the $500 billion of mortgages where capital was unavailable for refinance, those loans were either extended, foreclosed or borrowers were required to input additional equity into the underlying property.

Portfolio lenders – primarily banks and life insurance companies – simply lack the balance sheet capacity to satisfy total CRE borrower demand. This will be even truer due to the new constraints on their portfolio lending capacity that will be imposed by the new Basel III capital requirements. Going forward, the maturity-related refinancing alone will average about $250-300 billion per year, and the portfolio lenders and the GSEs can only fund slightly more than one-half of that burden. The rest of the overall financing load (including both refinancing and new lending demand) has been filled over the course of the last two decades by CMBS, which utilizes sophisticated institutional investors – pension funds, mutual funds, and endowments, among others – who bring their own capital and expertise to the table and fuel lending. CMBS lending is especially critical for small businesses as the average CMBS securitized loan is $8 million and, as of July 2010, there were more than 40,000 CMBS loans that were less than $10 million.

One of the overarching questions we are facing at this juncture is whether CMBS will be able to continue to help satisfy the impending capital needs posed by the refinancing obligations that are coming due. Without CMBS, there simply is not enough balance sheet capacity available through traditional portfolio lenders, such as banks and life insurers, to satisfy these demands. And without a securitization exit strategy, there also would be less credit available from portfolio lenders and the cost of that credit also would increase.

It is for these reasons that Treasury Secretary Geithner noted more than three years ago that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to businesses – large and small."[3] Similarly, then-Comptroller of the Currency John C. Dugan noted that, "[i]f we do not appropriately calibrate and coordinate our actions, rather than reviving a healthy securitization market, we risk perpetuating its decline – with significant and long-lasting effects on credit availability."[4]

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

[4] Remarks by John C. Dugan, Comptroller of the Currency, before the American Securitization Forum (Feb. 2, 2010), at 2 (available at http://www.crefc.org/uploadFiles/CMSA_Site_Home/Government_Relations/CMBS_Issues/TALF_Treasury_Plans/DuganRemarksatASF201.pdf.).

The Outlook for the CMBS Industry

The CMBS market is in the early stages of what we hope will be a robust recovery. But, make no mistake; the recovery is in a very fragile and challenged state today. There are over $2 trillion in commercial loans across America that must be refinanced by 2017. At an issuance rate of about $30 billion per year and with an overall market of under $600 billion of outstanding CMBS issuances, the CMBS industry is struggling to both heal and maintain itself.

The overall size of the CMBS market is shrinking as the rate of legacy loans maturing and rolling off the books is greater than the rate of new issuance. At this rate, the size of the CMBS market eventually will lose the critical mass necessary to continue to be a viable market. This would deal a blow to CRE liquidity as issuance of new CMBS will face a serious headwind of there being no viable secondary market for investors to trade and exit their positions.

A new issuance market of approximately $30 billion a year is not nearly large enough to provide the capacity for pending CRE mortgage maturities that must be refinanced. In a survey of CREFC Board of Governors, 76% of respondents noted that the annual level of CMBS issuance required to provide healthy liquidity levels to the CRE marketplace would be between $50-100 billion. 22% said it should be over $100 billion. Whether one considers this a self-serving industry viewpoint or not, the fact underpinning it is that the status quo is not an acceptable business model. Investment capital will flow to where it will get its best risk-adjusted return.

In addition, it is a costly enterprise to establish and maintain a CMBS securitization platform. It is a personnel intensive business that requires capable and experienced finance professionals. There must be sufficient volume in the industry to house and pay the teams of originators, analysts, traders, brokers and other specialists and intermediaries required to run an efficient CMBS platform. A $30 billion per year rate of issuance is simply insufficient and is stressing the industry's financial ability to maintain that requisite infrastructure. If firms determine that their CMBS platforms are not viable and profitable enough, they will reduce or close them. In fact, many analysts predict that the CMBS market will be too costly to maintain if the secondary market falls below $300 billion. Once this capacity leaves the system, it will take a long time to bring it back.

The CMBS marketplace faces many headwinds on its road to recovery. The sovereign crisis in Europe affects credit and economic confidence around the globe. In the United States, we face stubbornly high unemployment and low job growth. Consumer confidence is weak. The business sector is cautious about capital expenditures as it nervously assesses the uncertainty in the public and private sectors. Investment of all types seems to be on hold for 2012 as we await the outcome of the presidential election and what Congress and the President will do regarding the numerous fiscal policy imperatives that lie ahead. "Taxmaggedon", budget sequestering, raising the debt ceiling, the deficit, and the federal government's credit rating all loom ominously on the horizon.

The Dodd-Frank CMBS Statutory Framework & Market Reforms

Against this backdrop, Congress adopted a credit risk retention and transparency framework for asset-backed securities in Dodd-Frank. It is essential to highlight at the outset that The CRE Finance Council supports that Dodd-Frank statutory framework and advocated for the inclusion of the risk retention requirements in that framework. We believe the Dodd-Frank legislation outlines how an effective risk retention construct and enhanced transparency can be achieved, and provides the appropriate flexibility to do so for both regulators and market participants.

The CRE finance industry also has taken its own direct steps to strengthen the CMBS market and to foster investor confidence through the completion of "market standards" in the areas of representations and warranties; underwriting principles; and initial disclosures. Scores of members of The CRE Finance Council across all of the CMBS constituencies worked diligently on these market reforms for more than a year.

Those market reforms built on a CMBS transparency regime anchored by The CRE Finance Council's trademarked disclosure packages that already had been the universally acknowledged leader in asset-backed securities market transparency. Specifically, our Investor Reporting Package™ for ongoing transparency and our Annex A™ for initial CMBS issuances are the disclosure packages demanded by investors and required to be used under every CMBS contract. The SEC recognized CREFC's IRP in its proposed Reg AB II changes as a model disclosure for other ABS classes. But the industry has not rested on its laurels. We are continuously updating our disclosure product to remain the market leader, and we have recently begun to develop a robust set of servicer disclosures that will be added to the IRP in reaction to investor demands for more loan work-out process transparency.

Cumulatively, The Regulatory Regime Should Preserve –
And Not Unduly Restrict – Access To Affordable Credit

Dodd-Frank requires the agencies to issue an array of implementing rules and the agencies have issued a series of proposed rules in accordance with these requirements. We agree with the overarching Dodd-Frank objective that these rules should enhance investor ability to invest with the confidence that the investment markets are fair, transparent and safe. Safe markets, however, do not mean riskless markets, as all investment carries some amount of risk. But, investors should have confidence that, with adequate transparency, proper retention, and the ability to conduct their own requisite due diligence, they can fairly, reasonably and reliably assess the risk factors underlying any CMBS investment opportunity.

The question is, "What is the appropriate level and extent of regulation?" Not enough and investor safety and confidence can be compromised. Too much and industry capacity is diminished with no real marginal increase in benefit to investors. Larger businesses and high profile properties in the country's major urban centers will continue to enjoy ready access to CRE portfolio financing. But smaller businesses and businesses in the secondary markets that are the core of our national economy – main street America cities and towns like those listed

below – will not have adequate access to the financing that is their lifeline without a viable CMBS market:

- Paramus in New Jersey's 5th Congressional District, where CMBS financed a $9 million industrial facility whose principal tenant, Topcon America, is a leading provider of laser-based ophthalmic equipment;

- Inglewood in California's 35th Congressional district, where CMBS financed a local grocery store, as well as an $8 million industrial loan which houses a variety of local manufacturers and distributors;

- Tempe in Arizona's 5th Congressional District, where CMBS financed almost 20 different multifamily projects, which provided housing to over 5,000 families;

- Granada Hills in California's 27th Congressional District, where CMBS financed the Granada Hills Town Center which provides grocery, pharmacy and hardware stores for the community of 450,000; and

- Naperville in Illinois' 13th Congressional District, where CMBS provided $16 million to finance an assisted living facility.

The investors that provide the capital for these borrowers do not benefit from regulation if it erodes their CMBS returns to the point where CMBS is no longer competitive with their other investment options. As the Board of Governors of the Federal Reserve aptly noted, the agencies implementing the Dodd-Frank securitization credit retention requirements must "ensure that the regulations promote the purposes of the Act without unnecessarily reducing the supply of credit."[5] Federal Reserve Board Governor Tarullo also separately has highlighted the importance of implementing retention "in order to properly align the interests of originators, securitizers, and investors without unduly restricting the availability of credit or threatening the safety and soundness of financial institutions."[6]

The Proposed Regulations' Potential Threat to CRE Credit Availability

The proposed rules – especially when considered cumulatively – pose a threat to the continued recovery and on-going viability of CMBS and the credit it supplies. Each rule, in and of itself, may have its own justifiable merit and its compliance requirements may not seem

[5] Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010), at 3 (available at http://federalerserve.gov/boarddocs/rtpcongress/securitization/riskretention.pdf).

[6] Daniel Tarullo, Federal Reserve Governor, Statement Before The House Committee on Financial Services (Oct. 26, 2009).

unduly burdensome. However, the multitude of proposed Dodd-Frank-related rules, including risk retention, will have a significant impact – both individually and when considered as a package – on credit availability in the CRE market.

As the International Monetary Fund has cautioned, the proposed retention rules and "effects induced by interaction with other regulations will require careful consideration."[7] Unfortunately, the agencies generally have failed to consider the impact of individual rules on credit availability, and they have made no effort whatsoever to evaluate the cumulative impact of all of the proposed rules. The following examples underscore the importance of agency coordination and study of the cumulative impact of regulations on credit availability before finalizing the proposed rules.

The PCCRA: The Premium Capture Cash Reserve Account rule proposal would require securitizers to retain all revenue from excess spread (which is virtually all revenue) for the life of the transaction in a separate account for the life of the security and to hold this account in a first-loss position even ahead of (and subordinate to) the B-piece investor retained interest unless 5% of the fair market value of the issuance is retained in accordance with the credit retention requirements. Such a mechanism will inhibit an issuer's ability to pay operating expenses, transaction expenses, and realize profits from the securitization until, typically, 10 years from the date of a securitization, assuming there were no losses on the portfolio.

Furthermore, this premium not only reflects profits, but also is used to recoup the costs associated with the origination platform used for the securitization process. Essentially, issuers would take a loss on every CMBS securitization if they are required to establish a PCCRA. Finally, the PCCRA would also fully expose current CMBS issuers to changes in interest rates. In a simple example, if $100 in loans has a 5% origination interest rate, but the market rates drop to 4% at securitization, a 1% premium is charged on the certificates to reflect this change. Unfortunately, the PCCRA, as written, would capture this premium.

Alternatively, if rates rose from 5% to 6% from origination to issuance, the certificates would be required to have a 1% discount to sell. The securitizer would then absorb the loss. In short, the PCCRA fundamentally alters the economics of the securitization by creating a timing mismatch: it exposes the issuer to all the downside risk/losses associated with their interest rate exposure while requiring the issuer to wait until all the mortgages mature to recognize any profit for taking that risk. Without either a profit motive or the ability to recoup the origination costs, it would be unlikely that many CMBS issuers would continue to securitize at the same volumes if at all.

It is understandable, therefore, that many in our industry have significant concerns about the PCCRA having an adverse impact on the viability of the CMBS market by reducing credit

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[7] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, Global Financial Stability Report: Navigating the Financial Challenges Ahead (October 2009), at 109 ("Conclusions and Policy Recommendations" section) available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

availability and increasing the cost of borrowing. In response to a recent survey of the CRE Finance Council Board, for example, 43 of the 55 respondents (or 78.2%) believe that imposition of the PCCRA requirement will hinder CMBS and the other 12 respondents were equally divided between believing the requirement would help CMBS and being undecided. The 15 Investment-Grade Investor Board Member responses are similar, as 11 of those respondents (or 73.3%) believe that imposition of the PCCRA requirement will hinder CMBS; only one Investment Grade Investor responded that they believed it would be helpful; and the remaining three respondents were undecided.

In addition, in a separate survey, over 92% of issuer respondents said that imposition of the PCCRA would decrease loan origination volume from current levels. Almost 62% of those respondents said that volume decreases would be more than 50%. Some indicated reductions would be as high as 90%-100%. All of the respondents indicated that the cost of liquidity to borrowers would increase – 92% said the cost increase would be 50 basis points or more and 54% indicated that the cost increase would be 100 basis points or more.

In line with these views, Mark Zandi, Chief Economist of Moody's Analytics, concluded that the PCCRA requirement would significantly increase the cost of credit for borrowers "on the order of an increase of 1 to 4 percentage points depending on the parameters of the mortgages being originated and the discount rates applied."[8] Bank of America estimated that "the actual rate *increase* to borrowers as a result of the PCCRA would be approximately 2 to 5%."[9] Deutsche Bank concluded that implementing the PCCRA would conservatively cost $8 billion and would indirectly cost hundreds of billions in the lost opportunity cost of missed deal opportunities.[10] Given these estimates, it is not surprising that the risk retention rules in Europe do not include the PCCRA or anything else like it, and implementing the PCCRA provisions thus also would be inconsistent with the goal of harmonizing our regulatory rules with international requirements.

Members of Congress also have expressed concern with the PCCRA proposal. Chairman Garrett wrote a joint letter with Chairman Bachus of the Committee on Financial Services to the agencies expressing concern that the PCCRA "would greatly reduce or perhaps even eliminate the securitization market for many asset classes, thereby reducing a vital source of capital that businesses of all types need."[11] They urged the agencies to conduct a cost-benefit analysis to determine the effect of the PCCRA *before* finalizing the risk retention rule.

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[8] Christian deRitis, Director, and Mark Zandi, Chief Economist, Moody's Analytics, Special Report: A Clarification on Risk Retention (Sept. 20, 2011).

[9] Response of Bank of America, Credit Risk Retention Proposed Rule, Appx. B at v n.98 (July 13, 2011), available at http://www.fdic.gov/regulations/laws/federal/2011/11c84ad74.PDF.

[10] Harris Trifon, Research Analyst of Deutsche Bank Securities Inc., CMBS CRE Debt Research: How to "Fix" the Proposed Risk Retention Rules for CMBS (Apr. 12, 2011).

[11] Letter from Committee Chairman Spencer Bachus and Subcommittee Chairman Garrett (Mar. 26, 2012).

Last month, a bipartisan letter from 12 senators reiterated the concern that the PCCRA "would negatively impact capital formation," stated that the PCCRA "goes well beyond Congressional intent" in Dodd-Frank, and therefore urged the agencies to reconsider inclusion of PCCRA in the final rule.[12] Similarly, for these reasons, more than 20 separate trade organizations representing many different types of constituencies – borrowers and lenders and investors in different asset classes – jointly signed a letter in 2010 urging careful consideration of the entirety of the reforms to ensure that there is no disruption or shrinkage of the securitization markets.[13]

Finally, in a recent IOSCO report, it was noted that out of 16 countries that have implemented risk retention, none of them have a PCCRA or other comparable concept to the proposed U.S. rules.[14] Inclusion of the requirement therefore also is in conflict with the Administration's goal to harmonize international regulations.

Third-party Risk Retention/B-Piece Transferability. The CRE Finance Council appreciates that the regulators have sought to develop risk retention regulations that are tailored to the unique characteristics of the CRE finance market and to offer some flexibility in certain respects. The proposed Dodd-Frank credit risk retention rules recognize, for example, that CMBS bond issuances typically include a first-loss, non-investment grade bond component and the rules expressly permit these "B-piece investors" to bear the mandated retention obligation provided that they conduct their own extensive due diligence. The B-piece investor due diligence usually includes site visits to every property in the loan pool, a full review of all transaction documents and independent third-party reports, and essentially re-underwriting every loan in the proposed pool. That re-underwriting includes a tenant analysis, borrower analysis, cash-flow modeling, and competitive property and demographic analyses along with other financial and statistical reviews.

The proposed rule would, however, prohibit a B-piece investor from selling its B-piece investments if they are bearing the retention obligation, which will reduce the incentive for B-piece investors to invest in CMBS. No other investor is subject to this type of buy-and-hold mandate, and B-piece investors (and their owners) may balk at making an investment that they then will be unable to sell or transfer. In light of the proposed limitation on B-piece transferability and the risk retention rules, Morgan Stanley has concluded that "it is unlikely that the two provisions can be met simultaneously in a way that is economically viable" because both proposals reduce the market value of CMBS.[15]

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[12] Bipartisan Letter from 12 Senators (June 19, 2012).

[13] A copy of the March 25, 2010 letter is attached.

[14] Global Developments in Securitization Regulation, International Organization of Securities Commissions, June 2012, at 16.

[15] The Dodd-Frank NPR: Implications for CMBS, April 12, 2011,Morgan Stanley at 1.

Basel III Rules: The Basel III proposed rules will further reduce credit for capital invested in securitized investments relative to whole loans. The proposal to implement the Basel international capital standards would assign a 150% risk weight to "high-volatility commercial real estate" exposure, which increases the current risk weight of 100% for CRE exposures.[16] Furthermore, a recent study pointed out that the largest banks will better be able to adjust to the increased capital required by Basel III. Smaller and mid-sized banks will be more constrained due to the differences in the size of their balance sheets.[17] While we are still studying the impact of the Basel III rules on the CRE market, the proposed rule could further limit credit for CRE investments, especially from smaller banks. The question remains - will the cost of increased capital standards not only create an unlevel playing field among large and small institutions, but also not allow commercial liquidity to flow responsibly?

Conflicts of Interest: Another proposed rule would prohibit "material conflicts of interest" in securitizations. The proposed rule does not, however, define "material," and the SEC plans to rely on interpretive guidance in the future to determine whether activities are consistent with the rules. Market participants face greater uncertainty in determining whether their activities could be viewed as violating the regulation. The proposed rule could have unintended consequences for securitization, which could impact the availability of credit at a time when credit markets are constrained. Indeed, the SEC recognized that its proposed conflict of interest rules "might have unintended effects, such as potentially limiting investment opportunities for investors if a securitization participant refrains from structuring and selling ABS in reaction to this proposal."[18]

Volcker Rule: In implementing the so-called "Volcker Rule," which is codified in Section 619 of Dodd-Frank and is intended to bar banking institutions from engaging in proprietary trading activities for their own accounts, the agencies have proposed a broad definition of "Covered Fund." This broad definition would sweep in certain types of securitization issuers and activities even though securitization and securitization "market making" activities are specifically exempt from the scope of the rule under the statute.[19] Failure to appropriately limit the "Covered Fund" definition could create a host of functional difficulties

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[16] Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements, Notice of Proposed Rulemaking (June 7, 2012).

[17] Financials: CRE Funding Shift: EU Shakes, US Selectively Takes, May 25, 2012, Morgan Stanley at 15.

[18] Proposed Rule; Prohibition Against Conflicts of Interest in Certain Securitizations, Release No. 34-65355; File No. S7-38-11, 76 Fed. Reg. 60320, 60330 (Sept. 28, 2011).

[19] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Notice of Proposed Rulemaking, 76 Fed. Reg. 68846 (Nov. 7, 2011).

for banks and affected nonbank financial companies that have engaged in sound and long-established interactions with these securitization entities. This conflicts with the rule of construction in Dodd-Frank that directs that the Volcker Rule should not be construed to limit or restrict lawful securitizations sponsored or participated in by banks and regulated nonbank financial entities.

While we have pointed out concerns with five regulations that will affect liquidity in the CMBS space, there are 12 more regulations with cost-benefit concerns to take into account when looking at the cumulative effect, including; but not limited to: the SEC's proposed changes to Regulation AB; the FDIC's final "Safe Harbor" rule; the "Franken Amendment" requirements related to credit ratings for structured products; the SEC's rule 17g-5 credit rating transparency; and the SEC's rule 17g-7 for reporting repurchases.

The combined impact of these proposed rules on the industry is further compounded by recent securitization accounting changes (known as Financial Accounting Standard (FAS) 166 and 167). The new regulatory capital guidelines and accounting changes could significantly limit the capacity and the overall amount of capital that can be directed toward such lending and investing at the same time when the securitization markets are attempting to recover from a historic decline and regulators are drafting new rules intended to govern the industry.

Evaluating & Understanding the Cumulative Effect of Proposed Regulations on the CRE Market is Both Essential & Required

Before promulgating final rules, it is critical that the agencies charged with implementing the Dodd-Frank Act coordinate their rulemakings and consider the cumulative impact of the numerous regulations on credit availability in the CRE finance market. This cumulative impact analysis is important to help Congress and the regulators understand the total impact of the regulations on the CRE market.

The cumulative cost effect of these regulations will determine whether financing companies decide to grow, shrink or leave the commercial lending business altogether. And, as explained in detail above, the regulations under Dodd-Frank are likely to *negatively* impact credit availability by restricting the overall amount of capital that is available through the securitization finance markets and by making the CMBS capital that is available more expensive to access. The proposed rules impose additional costs on and will – in some cases – disincentivize issuers and investors and disrupt the efficient execution of capital structures that securitization provides.

As Morgan Stanley put it in a recent report, the cumulative impact of the proposed regulations has the potential to cause a "dramatic decline in the amount of financing available to the commercial real estate sector, especially for small to medium-sized properties. This, of course would increase the cost of borrowing and almost surely push cap rates up as well."[20] A more recent Morgan Stanley report reiterated that if the risk retention rules are implemented as

[20] The Dodd-Frank NPR: Implications for CMBS, April 12, 2011, Morgan Stanley at 1.

proposed, "CMBS is severely marginalized giving rise to a potentially very large US CRE financing gap," which would "mean much more expensive financing and further pressure on commercial real estate prices as well."[21]

If not properly constructed, the Dodd-Frank related rules could potentially result in a significantly smaller secondary market, less credit availability, and increased cost of capital for CMBS borrowers. Small borrowers – those that are not concentrated in the major urban areas and that need loans in the sub-$10 million space – would be the primary victims of these developments. And these borrowers – or would-be borrowers – reside in every Congressional district and are a driving economic force nationwide. Moreover, if the CMBS market is so overburdened by regulation that the very viability of that market is threatened, this also may constrict the availability of portfolio loans because, as discussed above, portfolio lenders rely on access to the CMBS market as a safety-valve exit strategy.

The Board of Governors of the Federal Reserve Report has previously recognized the importance of considering the totality of the regulatory changes before promulgating final rules:

> [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.[22]

Federal law requires just this type of assessment. President Obama's Executive Order 13563, for example, expressly requires that, "to the extent permitted by law, each agency must, among other things:

> "(1) propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs, (2) tailor its regulations to impose the least burden on society, taking into account, among other things, and to the extent practicable, the cost of cumulative regulations; (3) select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits; (4) to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated

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[21] Morgan Stanley Blue Paper, Financials: CRE Funding Shift, at 9 (May 25, 2012).

[22] Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010), at 84 (available at http://federalerserve.gov/boarddocs/rtpcongress/securitization/riskretention.pdf).

> entities must adopt; and (5) identify and assess available alternatives to direct regulation[.]"[23]

The Courts also have noted the "unique obligation" of the SEC "to consider the effect of a new rule upon efficiency, competition, and capital formation, and its failure to apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation makes" the very issuance of that rule impermissible.[24]

Needless to say, the stakes are high with the impact on credit availability weighing in the balance. As required by the Executive Order, Congress should insist that the agencies coordinate their rulemaking efforts to minimize the potential negative impact on credit availability in the CRE market. They also should be required to factor the cost to credit into final regulations and to report their analysis to Congress. This analysis would help Congress and regulators understand the burden of the Dodd-Frank related regulations as currently proposed, as well as their impact on the CRE market.

The Financial Stability Oversight Council would be well suited to conduct a study analyzing the cumulative impact of Dodd-Frank regulations on the availability of credit in the CRE market. The CRE Finance Council is prepared and willing to work with regulators to help them understand and assess the impact of their proposed rules.

It is critical to note that we are not suggesting that this consideration should impede issuance of final rules. Indeed, the uncertainty related to regulatory changes and their interaction with accounting rules itself is now a significant, independent impediment to the expanded private lending and investing that is critical to a CRE – and therefore broader economic – recovery. Some paralysis is developing in the investor, issuer and servicer communities as they struggle to attempt to understand what the final regulatory framework will look like and how it will affect their interests. The rules do need to get done.

Conclusion

Today, the CMBS market is showing some positive signs that it is slowly moving toward recovery, but, with $2 trillion in commercial mortgage loans maturing in the next few years, it is critically important that regulations under Dodd-Frank be implemented in way that does not severely constrict or shut down the securitization markets. For it is the small businesses, factories, multifamily housing units, offices, hotels and nursing homes in your home districts where restrictions to CMBS lending will be felt most severely.

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[23] Federal Register, Volume 76, Number 14, Friday, January 21, 2011, at 3821. Although this rule technically does not apply to the independent agencies, it does apply with full force to the OCC which is one of the joint rulemakers here and to the Department of Treasury whose Secretary is charged under Dodd-Frank with chairing the credit risk retention joint rulemaking proceedings.

[24] *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (internal quotations and citations omitted).

The impact of the many Dodd-Frank regulations on credit availability and the cost of credit are interconnected and mutually compounding. Therefore, CREFC believes it is imperative that the regulators do what they should do and what they are required to do by law – take into account the cost of cumulative regulations, adopt regulations where the benefits justify the costs, and ensure regulations impose the least burden on society. It also is imperative that the regulators get the rules done right.

We look forward to continuing to work with Congress and the regulators to ensure a regulatory framework that supports a sound and vibrant securitization market, which is critical to the U.S. economy.