THE DODD-FRANK ACT'S IMPACT ON ASSET-BACKED SECURITIES

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

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THE DODD-FRANK ACT'S IMPACT ON ASSET-BACKED SECURITIES

Wednesday, February 26, 2014

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:37 p.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Huizenga, Stivers, Mulvaney; Maloney, Sherman, Lynch, Himes, Peters, Foster, and Kildee.

Ex officio present: Representative Hensarling.

Also present: Representative Barr.

Chairman GARRETT. Good afternoon, everyone. Today's hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order. Today's hearing is entitled, "The Dodd-Frank Act's Impact on Asset-Backed Securities." And we welcome the members of the panel.

But before we hear from the panel, we will have opening statements. And I will yield myself 5 minutes.

Today, we are here to examine, as I say, the impact of the Dodd-Frank Act on asset-backed securities (ABS). And we are privileged to have this panel of great witnesses. I would like to welcome all of our witnesses and thank them for agreeing to testify about the impact of this law on the $3 trillion ABS market. These securities are arguably the most important mechanism that American companies have to fund their operations, as well as the way nearly all homes and commercial properties are financed.

In many ways, Dodd-Frank is a perfect example of several unfortunate trends in the way that Congress and the regulators choose to deal with our Nation's problems. However, increasingly, whenever something goes wrong the knee-jerk reaction of Congress and the regulators seems to be to demand that the Federal Government do something, anything about it. Obviously, the 2008 financial crisis was a calamity that we are still recovering from today.

But as Representatives, we have a duty to understand what happened and see if there was a way the financial system could have been more stable. Unfortunately, we did not take the time to think through the various unintended consequences that could arise before passing Dodd-Frank, and so now we are dealing with the repercussions. So 4 years later, the evidence is mounting that Dodd-

Frank is a disaster for many sectors of the financial system, especially for asset-backed securitization. While our focus today is mitigating the worst of these consequences, I hope we as legislators will learn some lessons from this experience.

You see, successful government regulation is a difficult matter, especially when it touches on something as complicated and interconnected as our financial system. Passing bills without a more complete understanding of their impact, or for the sake of showing our constituents that we are doing something, is, in fact, a recipe for disaster. As the saying goes, "Act in haste, repent at leisure."

And so, we are here today about helicopter parents, who hover over their children making sure they never do anything dangerous. Today, we seem to have a Congress that functions like helicopter parents, and a regulatory system constantly worried that somewhere somebody might be putting their money at risk. The American people are not the Government's children. Investors don't need Congress or the Federal Reserve (Fed) or the Consumer Financial Protection Bureau (CFPB) to keep them safe. Risk-taking is the reason our markets exist, and without risk there can be no innovation, no improvement, and no prosperity. Sometimes, these risks pay off, and sometimes they don't. But win or lose, they serve a purpose in steering capital towards it most productive uses.

Our financial markets are not a T-ball league. There is no way everyone can be a winner. We will inevitably be poorer as a society if we stifle such risk-taking or shift the negative consequences onto the taxpayers. With Dodd-Frank and practically every other major law passed since 2008, we have increased the regulatory burden on the private sector. That burden falls most heavily on small- and mid-sized businesses, who are the biggest drivers of innovation and job creation in our economy.

Yet, we keep making it more expensive and more complicated and legally risky to start, or operate, a business. An outside observer might even conclude that we have decided that entrepreneurs and private markets were all a bad thing and we are passing laws designed to discourage them. At the same time, we give preferential treatment to government-backed financing. And so, over time, this different treatment will lead to fewer jobs, less innovation, a less stable economy, and greater losses to taxpayers.

It will also lead to more command and control from Washington, and more crony capitalism, where the well-connected get all the benefits. So Dodd-Frank takes a lowest common denominator approach to all aspects of the economy and especially to the ABS market. In terms of risk retention, all types of ABS are treated the same, as if they were subprime market mortgages, backed securities, or synthetic CDOs—the worst of the worst.

Perhaps the best example of this misguided approach to regulation is the treatment of collateralized loan obligations or (CLOs). CLOs are a type of ABS that are backed by syndicated loans to businesses, and they are a major source of financing to mid-sized companies that cannot cost-effectively issue corporate bonds. There are many different explanations for our financial crisis, but I have yet to hear someone claim the CLOs were responsible. And yet, the reproposed rules from Dodd-Frank risk retention gives the same broad-brush treatment to CLOs as it does to more risky types of securities. By all accounts, then, Dodd-Frank will effectively kill off the $300 billion CLO market by making it prohibitively expensive to arrange and manage a CLO.

So, why are we destroying this vitally important asset class? It makes no sense at all. I can only assume that CLOs just got swept up with all the other three-letter acronyms for financial products. This market funds businesses of different sizes all across the country. For example, in my district we have a major car rental company—in my district is a company that uses CLOs to finance its operations. Yet here we are today, sorting out the unintended consequences of a poorly written law and trying to prevent a totally artificial collapse of a major piece of the ABS market.

I am hopeful that we can work in a bipartisan manner to fix these regulatorily-created problems in this important market. And in the testimony today, I hope that our witnesses will provide us with concrete ways to correct these regulatory obstacles and ensure that these markets are still able to flourish. It is time that we stop being the helicopter Congress and start treating financial markets participants like the adults that they are.

And with that, I yield back, and now yield to the gentlelady from New York.

Mrs. MALONEY. Okay, thank you so much, Mr. Chairman. And I thank all my colleagues and I welcome all our panelists. Thank you all for being here. I think it is worthwhile to examine Dodd-Frank's impact on the securitization markets, because these are complicated markets that are constantly evolving. These markets are also very important to our economy. They provide financing for families buying a home, businesses that want to expand, and students who want to get an education.

However, we also need to keep in mind that some of these securities were at the center of the financial crisis that cost our economy a staggering $16 trillion. Too often, the incentives of the lender, sponsor, and investor were badly misaligned, with disastrous consequences. We need to prevent these toxic securities from coming back, without unduly disrupting the availability of credit. Dodd-Frank required the banks sponsoring the asset-backed security to have some kind of skin in the game which gives them an incentive to monitor the quality of the loans being securitized.

It is important to remember that this was not a novel idea. In some markets, investors in asset-backed securities had been requiring this for years. Dodd-Frank also aimed to bring greater transparency to securitization markets by requiring disclosure of detailed loan-level information so that investors know what they are buying.

The regulators, in implementing Dodd-Frank, have attempted to strike a careful balance, and I applaud them for their thoughtful approach. The regulators have been willing to make changes to the rule when unintended problems come up, like they did when the Volcker Rule inadvertently harmed community banks that owned certain CDOs, for example.

The regulators are now considering another tweak to the Volcker Rule that would provide targeted relief to CLOs. And both Chair Yellen and Governor Tarullo at our last hearing said that this issue is at "the top of the list," for regulators. I am pleased that regulators are willing to make these kinds of adjustments, but I also hope that the regulators will be just as quick to adjust their rules to close loopholes that the markets find and to prevent bad actors from evading the rules. I very much look forward to hearing from our witnesses on the real-world impact of these rules.

And I reserve the balance of my time for any other Member who would like to speak on this after your side. Or go ahead. Mr. Sherman, I yield to you for the rest of my 5 minutes. Thank you.

Mr. SHERMAN. I thank you for yielding. At these hearings, we need to focus on whether we have reached the proper definition of what securities and other assets need to be divested, whether we have the right time frame for such divestiture to take place, and maybe we will explore whether the bank renouncing certain ownership assets, certain indices of ownership, certain rights they have under some of these agreements, give them an opportunity to continue to hold them.

As to the chairman's discussion of helicopter parents, we have entities that are too-big-to-fail. We had better helicopter over them. Because if they go down, they will take the whole family with them. The way to deal with them is to break them up. Too-big-to-fail is too-big-to-exist. To tell them that they should engage in any kind of risky activity and we won't get involved would be an appropriate statement if we hadn't lived through 2008 and experienced what this Congress does when those that are too-big-to-fail are failing.

So if we are going to allow too-big-to-fail entities to exist, we are going to have to hover over them with a helicopter. I think the best solution is that too-big-to-fail is too-big-to-exist, and that way we can really end this excessive government involvement. Finally, one of our witnesses, Mr. Levitin, will point out that Section 939F of Dodd-Frank, the Franken-Sherman Amendment, has simply not been implemented. And this goes to the heart of why we had the meltdown.

The credit ratings agencies were giving triple-A to alt-A, and any pension manager who didn't invest in them was an underperformer. And until we deal with the credit rating agencies, and the fact that the umpire is paid by one of the teams, we are going to have meltdowns in one area or another. And unless I get the chairman to cosponsor our bill to end too-big-to-fail, those meltdowns are going to involve the taxpayer.

I yield back.

Chairman GARRETT. The gentleman yields back. I have not yet decided to cosponsor your bill to end too-big-to-fail because I know that this committee passed Dodd-Frank, which we were told already ended too-big-to-fail in this country.

With that, I will now yield to the vice chairman of the subcommittee, Mr. Hurt, for 2½ minutes.

Mr. HURT. Thank you for holding today's subcommittee hearing on the impact of Dodd-Frank on asset-backed securities. I thank the witnesses for being here, and I look forward to your testimony.

In the wake of Dodd-Frank, we have continued to see costly unintended consequences arise from regulations that were poorly devised and implemented. These regulatory impacts represent real costs to consumers, both families and small businesses on Main

Streets in every congressional district. With the recently-finalized Volcker Rule, we began to see these consequences almost immediately after it was released, as community banks were faced with taking large write-downs. While the joint regulators eventually corrected this error, there are still several other Volcker-related issues yet to be resolved, most notably with respect to CLOs and asset-backed securities.

In Virginia's 5th District, my District, many companies rely on the CLO market to finance their operations, including a financial information firm headquartered in Charlottesville, with over 2,600 employees, and an auto parts manufacturer in Southside. These companies, however, like so many others across the country face increased costs as the CLO market reacts to the Volcker Rule's treatment of CLOs as covered funds. I think most would be hard-pressed to characterize financing the operations of these Virginia companies as "hedge fund-style high-risk trading."

Yet according to one of the Volcker Rule's Senate sponsors, the purpose of the provision was to put a firewall between banks in exactly these activities. While that may have been the original intent, we now see how a flawed rule, written in a flawed process, can extend well beyond its original confines and impact our communities. I appreciate the bipartisan group of Members who want to correct this misapplication of the Volcker Rule, and I look forward to its resolution. And I look forward to the testimony of the witnesses.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman GARRETT. Mr. Peters is now recognized for 3 minutes.

Mr. PETERS. Thank you, Mr. Chairman, and thank you to our witnesses for being here today. And certainly, I would like to thank Chairman Garrett and Ranking Member Maloney for convening this important hearing.

I was first elected in 2008, which was during the height of the financial crisis. And our Nation at the time was shedding 800,000 jobs per month, and many small businesses in my home State of Michigan found themselves unable to access the capital and credit that they needed to continue operations, let alone grow and create jobs. During my time in Congress, my top priority has been ensuring that small businesses have the tools they need to grow, especially access to capital.

There certainly is no silver bullet, and our Nation's entrepreneurs rely on innovative programs like those implemented by the States, with the support of funding from the State Small Business Credit Initiative, or backed by the SBA as well as community banks, credit unions, funding from the markets through initial public offerings, venture capital, private equity firms, and many others. Collateralized Loan Obligations, or CLOs, are part of the spectrum of financing that keeps Michigan businesses moving forward. Michigan industries that currently rely on CLOs show the diversity of Michigan's economy and include not just auto manufacturing and parts suppliers, but media and communications firms, textile and apparel manufacturers, retail and supermarkets, and utilities, as well as gaming and hospitality.

We need to work together to ensure that Dodd-Frank implementation protects consumers and our economy as a whole without cutting off access to capital to small businesses. We also can't go backwards. We can't go back to allowing the use of government-insured money to make speculative bets on bets and then on further bets that threaten the entire financial system. We can't go back to shedding millions of middle-class jobs because of Wall Street overreach. Today, I hope our witnesses will address how we can find the balance in our markets we need to protect consumers, while maintaining liquidity and robust access to capital for our small businesses.

I hope our witnesses touch on how small businesses make use of CLOs, the impact a disruption on the CLO market would have on them, and where these firms would find alternative financing in the event of such a disruption. Most importantly, I hope that our panel and my colleagues focus on solutions.

Thank you, and I yield back.

Chairman GARRETT. Thank you. Mr. Barr is recognized for 2½ minutes

Mr. BARR. I would like to thank the chairman for hosting this hearing today, and for the opportunity to analyze the discussion draft that I have put forth to fix an overreach by regulators in implementing the Dodd-Frank law. Based on concerns expressed by committee members on both sides of the aisle in a February 5th hearing with the regulators, as well as a subsequent letter sent to the regulators by over a dozen Democratic members of this committee, I am extremely hopeful that we can work together in a thoughtful and bipartisan way to fix the chilling effect the Volcker Rule will have in providing financing to American companies through Collateralized Loan Obligations, better known as CLOs.

I am interested in getting this issue right because this is about jobs, business growth, and economic development in communities throughout the country. For example, CLO financing has been instrumental in building an infrastructure to bring cell phone service to rural areas. It has been used by companies in my district like Tempur-Pedic to raise funds fund to grow their business. In Kentucky, CLO financing has even helped companies which mine coal and provide health care.

Finally, the importance of fixing the Volcker Rule for legacy CLOs, those issued before December 31, 2013, has been made clear to me by a community bank in Kentucky which considers its investment in CLO debt securities as an important part of the bank's investment portfolio. According to this community bank, if it is forced by the Volcker Rule to liquidate its investments in CLOs and take losses, "the consequences could potentially translate to hiring freezes and/or layoffs for our employees and higher rates to our customers."

With Volcker, I am concerned that the medicine being prescribed, which would involve banks forced to sell billions of dollars of CLO paper in a fire-sale scenario, and the loss of credit availability for a wide swath of American companies, would be far more damaging to the credit markets than the perceived illness which the medicine is designed to fix, which would be the highly hypothetical scenario of banks ever suffering losses from holding triple-A CLO paper, which performed very well during the financial crisis.

During the February 5th hearing in this committee with the Volcker regulators, I asked Federal Reserve Governor Tarullo about grandfathering existing CLO investments. I was pleased that he responded by saying that he will look at this as the first issue on the agenda. As such, I am hopeful that today's hearing will help clarify this issue and what is at stake so that we can fix this unintended discrimination against CLOs as soon as possible.

Thank you, Mr. Chairman, and I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentleman from Massachusetts, for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. I am very happy that we have an opportunity to discuss the improvements made to the Dodd-Frank Act asset-backed securities legislation, the financial products that were at the very core of the financial crisis. I know this hearing was intended to address Dodd-Frank's effect on asset-backed securities in general, but I want to express very serious concerns about the draft legislation circulated by my friend from Kentucky.

Let me just say at the outset that I have enormous respect for the gentleman from Kentucky, and I do believe there is a real opportunity for some much-needed bipartisanship on the issues of voting rights for senior debt securities of CLOs and also the way Dodd-Frank addresses risk retention on CLOs. As a matter of fact, I signed, along with 16 of my Democratic colleagues, a letter to the regulators making clear that the voting rights provision in CLO contracts should not, on their own, create an ownership interest under the Volcker Rule and urging the regulators to provide limited relief to address this issue.

So I am sympathetic to the concerns from holders of these securities who are worried that they may have to divest them unless they get some relief. We are on the same page on that. But the discussion draft goes far beyond the limited relief that we requested. It completely exempts CLOs issued before December 31, 2013. And in discussions I have had with my staff, along with holders of these CLOs, they made very clear to us that it was not necessary to grandfather all CLOs issued before the Volcker Rule was finalized. They only needed the targeted relief we argued for in our letter.

So it is unnecessary, and reckless, I think, to expand the scope of relief for CLOs beyond what the holders of these CLOs have requested. And I am very concerned that expanding this limited relief will open up the Volcker Rule to gaming by the industry. This committee should be very, very cautious about rolling back regulations that are critical to Dodd-Frank reforms before regulators' ink is even dry on those reforms.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. The gentleman yields back. I believe that concludes all of our opening statements at this time. We will now turn to our panel. We thank you again for coming. A number of you have been here before. And for those of you who have not, and for those of you who have and may have forgotten, I always ask that you make sure you turn your microphone on, and that you pull the microphone as close as you can, because some of us just can't hear anymore.

And without objection, your entire written statements will be made a part of the record. We just ask you to summarize it during these 5 minutes.

I now recognize Ms. Meredith Coffey, executive vice president of the Loan Syndications and Trading Association. Thank you for being with us, and you are recognized for 5 minutes.

STATEMENT OF MEREDITH COFFEY, EXECUTIVE VICE PRESIDENT, LOAN SYNDICATIONS AND TRADING ASSOCIATION

Ms. COFFEY. Thank you, and good afternoon, Chairman Garrett and Ranking Member Maloney, and members of the subcommittee. My name is Meredith Coffey, and I am executive vice president of the Loans Syndications and Trading Association (LSTA). Now, importantly, the LSTA does not represent the CLO market. Instead, the LSTA represents the $3 trillion corporate loan market. And our concern is how regulation could severely diminish securitization, particularly CLOs, and how this could significantly hurt the corporate loan market.

Critically, this would hurt U.S. companies' access to loans they need to expand, to build factories, to build cellular networks, and engage in M&A as they grow and build—create jobs. We are grateful to be here today to testify on how important securitization is to lending and to U.S. companies. And, importantly, how regulation, if it is poorly implemented, could decimate this important market. Now, as background, U.S. CLOs provide approximately $300 billion of financing to U.S. non-investment-grade companies.

These companies include health care companies like community health and HCA; food companies like Del Monte and Dunkin Donuts; technology companies that are big, like Dell Computer, and small, like Netsmart Technologies; and many, many more. In fact, roughly 1,000 companies receive financing from CLOs and these companies employ more than 5 million people. It is a very important source of financing.

Unfortunately for these companies, CLOs face existential threats. The risk retention rules alone threaten to reduce the CLO market by 60 to 90 percent. If the CLO market is reduced so dramatically, companies that rely on CLOs could see a substantial shortfall in financing. Now, it may be these companies can seek other sources of financing. But if so, it will come with a far higher price tag. If companies could replace lost CLO capacity it would cost them $2.5 to $3.8 billion per year to replace the capacity.

So the choice for U.S. companies, really, would be to do without financing or face markedly higher financing costs. Neither bodes well for economic growth and job creation. And not only are CLOs an important source of financing for 1,000 U.S. companies, they have also proven to be safe investments. In the last 20 years, the cumulative default rate for CLOs was 0.41 percent. Not one of the 4,000 triple-A and double-A rated CLO notes defaulted, not one.

This compares extremely well to almost all other asset classes, even investment-grade corporate bonds. So what are the threats to CLOs and what are possible solutions? The first major threat is that the final Volcker Rule arbitrarily converts investment-grade CLO debt securities into the equivalent of equity through an expansive definition of ownership interest. In turn, banks would no longer be permitted to hold investment-grade CLO debt. The ramifications are huge.

U.S. banks hold $70 billion to $80 billion of investment-grade CLO notes. Moreover, foreign banks hold another estimated $60 billion. If banks were forced to sell, which they would be, this would materially disrupt the market. In fact, CLO issuance in January dropped nearly 90 percent from year-earlier levels, primarily due to concerns around the Volcker Rule. It has recovered somewhat in February. But do be aware, this is because the market participants took comfort that lawmakers, particularly members of this committee, are working to resolve this problem.

We appreciate how seriously the committee takes this issue and the bipartisan efforts to ensure American businesses continue to get the financing they need. The legislation that Representative Barr introduced would provide a prospective solution and would provide business borrowers with certainty. And the letter that Representatives Waters and Maloney, and 15 other lawmakers sent, has been instrumental in focusing the regulators on fixing this problem. We greatly appreciate your effort and your focus on this issue.

But the Volcker Rule is not the only existential threat that CLOs face. Risk retention threatens to shutter the CLO market, as well. The Dodd-Frank Act requires securitizers to retain 5 percent of the credit risk of any ABS. Even though CLOs have no securitizer, as defined in Dodd-Frank, the agencies have said the CLO manager is the sponsor and thus must purchase and retain 5 percent of any new CLO. So for a new $500 million CLO, a manager must find $25 million to purchase notes from that CLO.

Why doesn't this work? Unlike banks, most CLO managers are thinly-capitalized asset managers. They simply do not have the capital to invest $25 million to manage each new CLO. And because of this, risk retention would dramatically reduce the market.

While the agency's proposed rules do not work for CLOs, we have offered a workable alternative. A qualified CLO, which would be subject to many of the restrictions and protections, and for which managers could purchase and retain 5 percent of the equity of the CLO. This should be feasible for agencies and it should permit most of the CLO market to survive. Thank you again for inviting me to testify, and I would be delighted to expand on any of these issues.

[The prepared statement of Ms. Coffey can be found on page 30 of the appendix.]

Chairman GARRETT. Great. Thank you very much for your testimony.

Professor Levitin, greetings. And you are recognized for 5 minutes.

STATEMENT OF ADAM J. LEVITIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. LEVITIN. It is good to be here again. Good afternoon, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank you for inviting me to testify. I am here today as an academic who studies structured finance. I have no personal financial interest in these matters, and I am not speaking on behalf of any organization.

A key point we should not lose track of in this hearing is that structured financial products caused the financial crisis of 2008. Mortgage securitizations and CDOs were at the very heart of the crisis, and one of the pillars of the Dodd-Frank Act are provisions reforming the structured finance market. Unfortunately, Federal regulators have been unacceptably slow in implementing the Dodd-Frank Act's structured finance provisions.

Several key rules have not been finalized or, in some cases, not even proposed. In particular, the SEC has failed to fulfill its statutory duties under the Franken-Sherman and Merkley-Levin Amendments. The SEC does not seem to have internalized that its mission is not just investor protection, but also systemic stability. Although some rulemakings have been delinquent, regulators have finalized one of the most important rulemakings: Regulation VV, which implements the Volcker Rule.

The Volcker Rule prohibits banks from having ownership interests in certain investment funds. The Volcker Rule does this in order to prevent Federal Deposit Insurance from leaking out and covering speculative investment activity. Bank ownership interests in investment funds can give rise to implicit recourse to banks' balance sheets, and thus to the Deposit Insurance guarantee. This is a problem we have witnessed repeatedly in the structured finance context for various asset classes.

Over the past 25 years, banks have repeatedly rescued their credit card securitization vehicles. And in 2007, banks brought sponsored hedge funds and structured investment vehicles back on their balance sheets. As long as banks have ownership interests in investment funds, and investment funds include any type of structured product—it is always done through a fund—there will always be the specter of an implicit guarantee.

Accordingly, Regulation VV correctly defines ownership interest broadly to include not just formal equity ownership but also functional indicia of ownership: the ability to control an investment fund or to share in its profits or losses. This is just what the accounting rules require. The Regulation VV ownership prohibition does not apply, however, to funds that invest solely in loans. This has resulted in some questions about the status of Collateralized Loan Obligations, or CLOs.

Let's be clear about what a CLO is. A CLO is a securitization of interests in high-yield corporate loans. CLOs do not typically hold whole loans. Instead, they contain syndication pieces that are parts of multi-million or, quite often, multi-billion dollar high-yield corporate loans. CLOs are not financing small business. They are financing large business. They are providing an important piece of the financing for large business, but they are not providing all of it.

Like all securitizations, CLOs involve closed-end investment funds. CLOs are also generally actively managed. As closed-end, actively-managed, structured investment funds, CLOs are indistinguishable from CDOs, the very instrument that was at the heart of the financial crisis. The only difference one can point to is that CLOs' assets are concentrated in corporate loans rather than in other assets. Structurally, however, there is no difference between a CLO and a CDO, and the CLOs' markets solid performance in the past is not a guarantee of its future performance.

Regulation VV will necessitate banks to divest ownership interests in some unknown number of legacy CLOs whose assets are not restricted solely to loans. But this is no different than any other divestment required by Reg VV. And given the liquidity of the CLO market and the relatively long divestment window, the divestment should not result in a fire sale. To the extent that legacy CLOs are a concern, and I do not believe that we have an empirical basis for making that conclusion, there are surgical fixes available that do not require legislation.

Going forward, Reg VV will not have an impact on the CLO market. The CLO market has already figured out several transactional solutions to enable continued bank investment in the asset class. And as Ms. Coffey noted, the CLO issuance is actually up this month, after having been down in January. The other major rulemaking that I wish to briefly mention is the credit risk retention proposal under Section 941. And I just want to frame it in maybe a different way than it is usually thought of.

I think it is generally accepted that there is a—there can be conflicts of interest between securitization sponsors and securitization investors. We have two basic routes in which we can address this. We can either try and deal with it ex ante by making securitization sponsors essentially partners in the securitization, making them buy a piece of the securitization. And that means that they are going to have to have some capital for that, which is going to be a problem. Or we can try and deal with this on the back end by having effective representation and warranty enforcement.

I am not especially optimistic that we are ever going to get effective back-end enforcement. Therefore, I think we need to be thinking about how we can make risk retention work. Thank you.

[The prepared statement of Professor Levitin can be found on page 46 of the appendix.]

Chairman GARRETT. Thank you.

From the U.S. Chamber, welcome back, Mr. Quaadman. You are recognized for 5 minutes.

STATEMENT OF TOM QUAADMAN, VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you, Mr. Chairman, and thank you, Ranking Member Maloney. And I would also like to thank the members of the subcommittee for your continued leadership on issues of importance to Main Street businesses. I would also like to take a quick moment to thank Congressman Barr for developing legislation to address the CLO issue, as well as Ranking Member Maloney for spearheading the letter that was signed by many Members asking the regulators to fix the issues.

The Chamber has been very concerned with the impacts of the Dodd-Frank Act on the ability of Main Street businesses to access capital. Our view has been, with all the different major regulatory pieces of Dodd-Frank and other regulatory initiatives, that they need to be looked at holistically to see how they work in conjunction with other rulemakings and other initiatives such as Basel III and even money market fund reforms.

Shortly after the Volcker Rule was proposed in December 2011, we sent a letter to the regulators asking for such a holistic review to see how the Volcker Rule would impact the ability of businesses to enter the debt and equity markets and how it would interact with other regulations. And we also asked that the regulators conduct an economic analysis. With that letter, we included a survey that we had taken of small-, medium-, and large-sized businesses on the impacts and impediments and costs of the proposed Volcker Rule, at that time, with their ability to access different forms of capital.

And one of the solutions that we proposed at that time was also that the regulators hold roundtables. About a month later, after that letter was sent in, Governor Tarullo from the Federal Reserve testified from this table to the full Financial Services Committee, saying that the regulators involved in the Volcker Rule did not understand the marketplace activities and what participants were doing in the markets. I am sorry to say, 2 years past that hearing—despite, I think, good faith efforts to change some of the substantive issues with the Volcker Rule—I don't think the level of understanding of the regulators on marketplace activities has necessarily changed.

So as you have already heard, CLOs provide $300 billion in financing to small and medium-sized businesses as well as those businesses which can't find financing in other forms. And CLOs performed well during the financial crisis versus other securitizations. They are different in that the CLO managers have skin in the game, and there is an alignment of interests with the investor communities.

However, as we have seen, the CLOs have been impacted by the risk retention rules as well as by the Volcker Rule. These impacts are no longer theoretical. In January, Bloomberg reported that CLO issuances in the United States are down by at least 60 percent, and that CLO activity is now beginning to migrate over to Europe. So, there are solutions to the problems. As I said earlier, the regulators, in terms of the procedure in developing Dodd-Frank, played fast and loose with what their legal requirements were. However, we believe that the legislation proposed, or the discussion draft put forward by Congressman Barr does put a little bit of a stronger public policy statement to the regulators to get this problem fixed, though I do believe we have a unity of interests here to get the problem fixed.

These issues are not partisan, and we would hope that both sides can agree to a solution. Additionally, as I said, we thought these issues should have been resolved during the rulemaking process itself. While we think it is a good first step that the agencies have formed an interagency working group in the development of the Volcker Rule implementation issues, we also believe that there should be a working group of market participants; financial institutions; small, medium, and large businesses; global businesses; institutional investors; and others that can work with the regulators to actually "war game" Volcker throughout the conformance period in order to discover any unintended consequences. And then to also craft solutions to those unintended consequences.

As we have seen with CLOs today, as we had the hearing a couple of weeks ago with trust-preferred bonds, we are sort of getting into a "Whack-a-Mole" situation, where issues keep popping up one after the other. The other situation I think we all want to avoid is that we all wake up on July 23, 2015, when the conformance period is ended, and markets are volatile and businesses don't have access to different products because these unintended consequences had not been worked out.

We also believe the interagency working group, as well as this market participant working group, should report to the committee and the subcommittee regularly as to their progress. And I am happy to take any further questions you have.

[The prepared statement of Mr. Quaadman can be found on page 65 of the appendix.]

Chairman GARRETT. The gentleman yields back, and I thank the gentleman.

Mr. Vanderslice, you are now recognized. Welcome, first of all, to the panel. And you are now recognized for 5 minutes for your testimony.

STATEMENT OF PAUL VANDERSLICE, MANAGING DIRECTOR, CITIGROUP, ON BEHALF OF THE CRE FINANCE COUNCIL

Mr. VANDERSLICE. Thank you, Chairman Garrett and Ranking Member Maloney, for giving me the opportunity to testify today. I am co-head of the U.S. CMBS group, and head of the commercial mortgage distribution efforts for Citibank global markets. However, I am testifying today on behalf of the Commercial Real Estate Finance Council, or CREFC. CREFC members include multi-family and commercial lenders, loan and bond investors, and servicing firms of all types.

I will focus my comments today on the recently reproposed risk retention rules and CMBS. CMBS is an integral component of commercial real estate lending because it expands the pool of available loan capital beyond what balance sheet lenders, mostly banks and insurance companies, can contribute. In 2013, CMBS provided almost 25 percent of all CRE financing. That is over $80 billion in loans that were made. CMBS also provides about 34 percent of all CRE loans made in tertiary markets, and 24 percent of the loans made in secondary markets.

No other lending source comes close to servicing these markets to that extent. To give you a better sense of the significance of this industry, Mr. Chairman and Ranking Member Maloney, in your combined MSA alone, there are thousands of properties with outstanding CMBS loans totaling over $66 billion. And that is outstanding today. The proposed CMBS retention rules impose a burden on borrowers that is projected to appreciably increase their cost of funds.

A strong consensus across all CREFC constituencies was reached on a set of recommendations to the risk retention rules as reproposed this past August. CREFC and its members are supportive of the goal of risk retention in the proposed rules. However, we believe strongly that the rule should provide optionality and flexibility for achieving these goals. Simply put, there is more than one means to an end.

Allowing our industry this optionality and flexibility will allow risk retention to be achieved fully, but with the least possible amount of marketplace disruption. Today, I will focus on three key areas: single borrower-single credit transactions; b-piece structure; and qualified commercial real estate (QCRE) parameters. First, single borrower-single credit transactions (SBSC): There is a strong consensus across all CREFC constituencies to completely exempt single-borrower-single credit deals from the retention regime. SBSC deals involve only one loan, or a pool of cross-collateralized loans that essentially function as one loan. SBSC transparency is extremely high because granular loan details are reported to potential investors, and SBSC loss experience has been exceedingly low. Furthermore, because these transactions effectively contain only one loan, it is much easier for institutional investors to evaluate the credit of the transaction before investing, and they have broader access to data because the deals are typically done in the private market.

Second, b-piece structure. For CMBS only, the proposed rules allow a third-party b-piece investor to buy the first-loss position to bear the retention obligation. The actual amount of retention required under the reproposed rules is quite significant, effectively 5 percent of the cash proceeds or 5 percent of the fair value of the bond sales, which is about double the capital investment currently made by b-piece buyers in deals that we are doing today. To address this, the regulations allow two BP buyers to buy the retention obligation and co-invest side-by-side.

Although this helps to address access to capital, it creates a host of other issues for the b-piece investors. To address these issues, CREFC recommends allowing a senior subordinate structure for b-piece investors. This would still accomplish the retention regime objectives, but would be workable for the industry without materially increasing the cost of funds to the borrowers.

Third, QCRE parameters. The proposed rules would exempt qualified commercial real estate (QCRE) loans from the retention regime if specified underwriting parameters are fulfilled. The QCRE goal is to reward conservative underwriting. There was a broad consensus among CREFC members, including among investors, that QCRE parameters should be modified by making certain changes to the proposed QCRE loan parameters. Based on historical data from all CMBS deals since 1997, our recommendations would expand the universe of QCRE-eligible loans from around 3 percent of CMBS loans to about 15 percent.

Using the same data, the cumulative loss percentages for those qualifying loans would fall to less than 1 percent. This is all in contrast to the other qualifying asset exemptions under which the vast majority of assets will qualify. Mr. Chairman, we want to make risk retention work, not eliminate it. And we believe that the recommendations I have outlined today, and that CREFC has advanced in its comment letters, would help accomplish that objective.

And I would be happy to answer any questions you may have.

[The prepared statement of Mr. Vanderslice can be found on page 73 of the appendix.]

Chairman GARRETT. And I thank the gentleman for your testimony.

Mr. VANDERSLICE. Thank you.

Chairman GARRETT. Last, but never least, Mr. Weidner is recognized for 5 minutes.

STATEMENT OF NEIL J. WEIDNER, PARTNER, CADWALADER, WICKERSHAM & TAFT, ON BEHALF OF THE STRUCTURED FINANCE INDUSTRY GROUP (SFIG)

Mr. WEIDNER. Thank you.

Chairman GARRETT. You are welcome.

Mr. WEIDNER. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, my name is Neil Weidner. I am a partner in the capital markets group of Cadwalader, Wickersham & Taft. I have spent the majority of my 22 years of practice in the field of structured finance, and I have been actively involved in the CLO market since the late 1990s.

Today, I would offer testimony on behalf of the Structured Finance Industry Group, or SFIG, a trade industry group with over 240 institutional members that focuses on improving and strengthening the broader structured finance and securitization market. Securitization touches the lives of your constituents on a daily basis, and provides economic benefits that help Main Street to access affordable credit. SFIG believes in a well-regulated and liquid securitization marketplace for all asset classes.

I am here today to discuss two specific aspects of the Act which, if enforced in the current form, will have an adverse impact on individuals and businesses in your communities. The clearest example of this is the effect that the final implementation of the Volcker Rule and the proposed risk retention rules are having on the CLO market. The uncertainty due to Volcker is negatively affecting the marketplace today. Analysts have predicted that 2014 estimates of CLO issuance would drop by 18 percent, to $55 billion.

This equates to a loss of up to $10 billion in financing to U.S. companies. The proposed credit risk retention rules also present a serious threat to the long-term viability of the CLO marketplace. If implemented as currently proposed, CLO issuance and the amount of credit provided to U.S. businesses could be reduced by 75 percent or more. To put this in context, U.S. companies that employ 7.5 million people use the CLO marketplace to expand their businesses, including opening new factories, paying suppliers' invoices, or simply making payroll.

Without significant changes to the proposed regulatory framework, these companies, such as ManorCare, Pinnacle Foods, and Berry Plastics may lose the ability to receive affordable financing provided by the CLO marketplace. We appreciate the recent attention that Federal agencies and lawmakers on both sides of the aisle have given these issues. The market has reacted positively to the bipartisan focus of this committee and, thankfully, largely to your efforts and the prioritization by the regulators.

The CLO market experienced a slight upturn this month, that was alluded to. But as such, we urge the committee to maintain the momentum towards developing a near-term solution for the Volcker Rule. And absent a proper solution, there is a strong concern that the market will quickly contract again. We also look forward to continuing our constructive dialogue with the regulators on the proposed risk retention rules.

Without a workable solution for retention, the long-term viability of the CLO marketplace has also been called into question. However, SFIG believes there are simple, straightforward solutions for providing regulatory clarity to the participants in the CLO marketplace. With respect to Volcker, SFIG has asked for regulatory clarity regarding the definition of ownership interests as it relates to debt securities in CLOs. This approach does not require the reopening of the Volcker Rule.

We simply ask that regulators provide additional interpretive guidance, which can be in the form of a simple FAQ. Such an approach would help provide certainty both on a go-forward basis, and for existing CLOs, commonly referred to as legacy CLOs—that this issue, were this issued prior to the regulation—that were legacy CLOs that were issued prior to regulation.

In terms of risk retention, SFIG believes both the structured finance and alignment of interest of participants had contributed to the CLOs strong performance before, during, and after the crisis. In fact, from 1993 to 2012, no CLO debt security rated higher than A has ever experienced a principal loss. Such tranches represent up to 75 percent of the capital structure of a CLO. These are tranches that are bought by banks, including community banks such as the Federal Savings Bank of Elizabethtown, Kentucky.

Nevertheless, we continue to work constructively with the regulators to create flexibility to satisfy the retention requirements through an array of options as have been proposed for other asset classes. Specifically, SFIG believes that the agencies should consider adopting both a third-party retention option for CLO holders, as has been proposed for CBS, and a qualified CLO option. SFIG believes that these options offer flexibility for the industry in meeting retention requirements.

Further, SFIG is committed to continued engagement with the members of this committee and regulators, as we work on developing solutions for the CLO marketplace. Chairman Garrett, Ranking Member Maloney, Congressman Barr, and members of this subcommittee, we appreciate your leadership on these issues. And if we do not find solutions that work for both regulators and the marketplace, then the companies that create jobs, and make capital investments to grow their businesses and provide goods and services will suffer.

Thank you.

[The prepared statement of Mr. Weidner can be found on page 168 of the appendix.]

Chairman GARRETT. Thank you. Again, I thank the panel. At this point, I recognize myself for 5 minutes.

So let's start with some of the basics, I guess. Mr. Weidner, you were just wrapping up, so I will just throw it right back to you. You heard the assertion in testimony—CLOs and CDOs, are they essentially the same thing that we are talking about here?

Mr. WEIDNER. No.

Chairman GARRETT. Okay. Gee, I don't normally get just a short answer like that. I want to ask the Administration questions, so—

Mr. WEIDNER. No, no, I appreciate it. I will elaborate.

Chairman GARRETT. Great.

Mr. WEIDNER. What we are talking about is two different types of products. I think the only similarity that they really bear is the fact that they have three acronyms in their names. I think if you look at the performance of CLOs and the structural features that have been embed—that are a part of how CLOs are structured, you look at the granularity of the borrowers who are—there would be 100 to 200 borrowers who are typically part of the CLO.

Chairman GARRETT. Right.

Mr. WEIDNER. Across many different industries. What you have seen is the underlying asset class has been able to—has proven itself. There are a number of other structural features which has demonstrated, including through the downturn in the economy and through the recession that the actual product works.

Chairman GARRETT. Okay.

Mr. WEIDNER. As compared to ABS deals, which have had the comparison in terms of the performance results are significantly different.

Chairman GARRETT. Right. So it is a difference in performance. My guess is that you are going to give me the panel answer on this. The difference is that the underlying assets are different, as well. So, where we saw the problem in the crisis was in what type of assets. And what type of assets are we dealing with here?

Mr. WEIDNER. The types of assets that were put into CLOs are not the originate to distribute type assets. They are well-underwritten, they are granular in terms of those—there is a broader array and diversity. But it really goes down to the assets that have been included, and the structural features in the deal. That if the deal starts—

Chairman GARRETT. We were talking about mortgage-backed assets and some of the other cases, were we not, during the crisis?

Mr. WEIDNER. Yes, we were.

Chairman GARRETT. Right. Okay. And someone—Mr. Vanderslice or Mr. Quaadman, do you want to throw—the question here is who are we actually dealing with in this situation? Are we dealing with big businesses being financed, or are we dealing with middle-sized businesses that are being financed? I would assume that big businesses wouldn't necessarily need this, but who are actually—who are the customers, I guess—yes, that is the right word—Mr. Quaadman?

Mr. QUAADMAN. Sure. In fact, the LSTA and the Chamber are working together on a letter with corporate treasurers on the risk retention rule. And I could tell you, in going through the companies that use this, it is thousands of companies. It is primarily midsized and small companies.

Chairman GARRETT. But what—define that in size, somehow.

Mr. QUAADMAN. You are looking at small-cap and mid-size companies. You are not going to look at a Fortune 500 company, you are not going to look at companies of those sizes. Because they have many different ways to access capital. So, this is going to be much smaller businesses.

Chairman GARRETT. Okay, great.

Ms. Coffey, one of the things I was confused about—but I guess everybody is confused about this—is the two rules that are out there. Dodd-Frank has the 5 percent risk retention requirement, right, on the one hand? And then you have the Volcker Rule that prohibits a bank holding more than 3 percent equity in a covered fund, right? So, that is the current law. How does the industry deal with that, first of all?

Ms. COFFEY. I do believe there is language that suggests that for securitizations, there should not be a conflict between the risk retention rules and the Volcker Rule, other specific language that those—that one is exempt from the other. But I think if you combine the two—the concern with respect to the Volcker Rule and risk retention—

Chairman GARRETT. Well, no. Let me step back. You are saying the intent was that there should not be a conflict, but there is a conflict.

Ms. COFFEY. Correct, although I—

Chairman GARRETT. Mr. Weidner, do you want to jump in?

Mr. WEIDNER. Just to the extent that you are required to withhold, retain something greater for risk retention, it overrides the 3 percent.

Chairman GARRETT. Okay.

Ms. COFFEY. So to that end, there is not a conflict within the Rule. But, obviously, there are extreme conflicts as far as what the Volcker Rule would do for CLOs, existing CLOs. And risk retention, obviously, would dramatically reduce new CLO formation by 60 to 90 percent. So, they are very problematic.

Chairman GARRETT. Right. In my last 13 seconds, and with that reduction in the size, then, the cost to the market would be—I think we heard some numbers on that.

Ms. COFFEY. Yes. We have done research which indicates that if the CLO market was reduced by 60 to 90 percent, borrowers would end up paying $2.5 billion to 3.8 billion in additional interest payments per year simply because CLOs went away.

Chairman GARRETT. I understand. Thank you.

The gentlelady from New York?

Mrs. MALONEY. Thank you. And I would like to ask Meredith Coffey and others to comment if they so wish. Ms. Coffey, I understand that many in the CLO industry think that the new risk retention proposal won't work for the CLO market because CLO managers don't have the balance sheet to retain the 5 percent of each deal. I think that is a valid concern. But didn't the regulators take that into account when they proposed a separate loan arranger option for CLOs which would allow CLO managers to comply with the risk retention rule without keeping 5 percent of each deal on their own balance sheet? And can you explain why you don't think the loan arranger option will work?

Ms. COFFEY. Great. Thank you, Congresswoman Maloney. One of the issues around the arranger option on risk retention is that it would say that a bank originator would have to retain—hold and retain 5 percent of what they call a "CLO-eligible term loan bank." When that was reproposed in the rules in August, we went and engaged with our bank members and asked them if this was feasible or if there was some form that was feasible.

And ultimately, that became problematic, because the same banking regulators on the supervisory side did not want banks to agree to commit and retain, and never hedge, and never sell a position in a loan because the banking supervisors themselves say that they want banks to maintain the flexibility to work out of bad situations. So on one side you have the regulatory side of the body saying you must hold and retain 5 percent, and on the other side you have the supervisor saying we cannot have you agree to never, ever hedge or never, ever sell.

So you had a conflict there. When we were talking to banks and they told us about this conflict, we understood that ultimately that option was not feasible because they would ultimately not be permitted to do that. Again, with never hedging and never selling.

Mrs. MALONEY. I would like to ask anyone on the panel to comment, and yourself if you so wish. Are there alternative options that would work for CLOs while also complying with the spirit of the risk retention rule?

Ms. COFFEY. Yes. Actually, one of the things that I would like to hit on is what we call a "qualified CLO concept." And the idea behind a qualified CLO is having a CLO that is a high-quality CLO which meets a number of the agencies' objectives. So it would support strong underwriting, that is a big objective. It would facilitate the continuity of credit. It would ensure the alignment of interests with the managers and investors. And it would limit the disruption in the market and protect investors.

How would this qualified CLO do this? For a CLO to become a qualified CLO, its governing documents would have to require six major restriction categories. First of all, restrictions around asset qualities. The CLO must invest in higher-quality non-investment grade loans. Second, restrictions around the portfolio composition. It would have to be a highly diversified portfolio. Third, structural protections in the CLO, including mandating a minimum amount of equity in the CLO to protect the debt holders.

Fourth, alignment of interest between the CLO manager and its investor in a number of different forms. Fifth, transparency and disclosure, ensuring investors have just a wealth of information about the CLO itself and every single asset in the CLO. And sixth, regulatory oversight, basically requiring the CLO manager to be a registered investment advisor, being regulated by the SEC, and being subject to fiduciary responsibilities to its investors.

If we marry all of those together, I think ultimately what we have is a very high quality CLO that meets all the objectives of the agencies.

Mrs. MALONEY. Okay, thank you.

Professor Levitin, I would like to ask you about Mr. Barr's bill to deal with the CLO issue. While I support a narrow, targeted solution for CLOs as outlined in the letter that I wrote, I am also concerned about creating loopholes in the Volcker Rule. So in your opinion, could this draft bill create loopholes for banks to go around the Volcker Rule? And if so, is there a way to fix the language of the bill?

Mr. LEVITIN. Congresswoman Maloney, let me start by saying I have not actually seen the language of Mr. Barr's bill. I have seen some descriptions of it, and I would have concerns about whether it is overly broad and whether it might, in fact, create some loopholes for Volcker Rule evasion. What is not clear to me is the—let's put risk retention aside. For the Volcker Rule, there clearly is some amount of legacy issue that we may need to address.

Going forward, though, it is not at all clear why there needs to be any sort of intervention by Congress in order to address the CLO market for Volcker Rule purposes. The market is already starting to find solutions to make sure that CLOs do not—are either not covered funds, or that banks' investments do not qualify as ownership interests.

Mrs. MALONEY. My time has expired.

Chairman GARRETT. Thank you.

And now, to the vice chairman of the subcommittee, Mr. Hurt, for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. I just wanted to follow up on the chairman's line of questioning relating to the difference between CLOs and CDOs. And I wanted to direct my question to Mr. Vanderslice and Mr. Weidner. Professor Levitin says in his testimony that for all intents and purposes, CLOs are indistinguishable from CDOs. And he says that there is no clear difference between a CLO and either a CDO or a hedge fund.

That seemed to be the opposite of what Mr. Weidner was saying. So I was wondering if you, Mr. Vanderslice, and then Mr. Weidner, could discuss the difference between CLOs and CDOs in the context of the 2008 crisis. And the performance, and then how we as Congress look at this issue going forward to make sure that we are not—that we are taking the most prudent course. Mr. Vanderslice, if you don't mind?

Mr. VANDERSLICE. Yes, I am actually here just for CMBS. So I am going to defer to other witnesses.

Mr. HURT. Okay.

Mr. WEIDNER. Again, I think you need to look at the transaction. There are a couple of things we have outlined in the written testimony that we have submitted, that the types of features that the way CLOs have been structured are ones that have demonstrated its resiliency through the downturn. And I think that the types of features that are in those deals—they include the fact that 90 percent of these deals include senior secured loans. It is diversified across borrowers, diversified across industries.

The deals are actively managed by regulated investment advisors who have—or there is a regulatory overview of them. We have features where if the deal starts to underperform, it has the ability to delever itself. And there is an alignment of interest. The managers themselves receive the bulk of their compensation on this coordinated basis. And they are very much incented to manage in the portfolio in the way that one would hope.

And when—I think the real striking evidence for us is to say, okay, if we go through all that, that all sounds very nice. But if you actually look at the statistics going from 1993 to 2012, including going down for the recession, the historical performance numbers prove out that they have shown the resilience, see, because of the way they have been structured. And I would also like to think that part of the reason that they have been so resilient is, also, the underlying borrowers themselves, who are part of these pools. Did the deals get stressed? They did get stressed.

Deals that were down—every deal that I can tranche that I can thing of that was downgraded became upgraded, was upgraded back to where it was, a particular tranche. So I think there really is a separate analysis of what features make this a good product. And there is proven track history. Then when you look at ABS, the comparison—and certainly I think there have been some that have been submitted—it is a much different product. There was much less diversification and there are other issues.

Mr. HURT. All right, that is great. And then let me just—because my time is limited, unfortunately, I want to make this question to Mr. Quaadman. And I wanted to thank—first of all, thank the Chamber for its demonstrated push to try to require that the cost—that there be a cost-benefit analysis for the entire impact of Dodd-Frank, and not just looking at these impacts on an individual policy basis, but looking at them from a holistic standpoint.

But if you could try to quantify for people back home who will be affected by, or could be affected by the implementation—and we predict will be affected by the improper implementation of Volcker as it relates to these securities. What is the real impact for, as I mentioned in my opening statement, the auto parts manufacturer that relies on this financing to be able to operate. And how do you quantify the increased costs that absolutely get—I believe get—will get passed on to the customer, consumer?

Mr. QUAADMAN. Let me take that question in two separate ways. One is, in that letter from December 2011 with the server that we have put in with the regulators we found that with large borrowers, or large companies that were in the debt markets, their costs would increase by 25 to 50 basis points. Or with smaller borrowers, it would actually go up by 50 to 100 basis points. So when you take a look at the size of debt markets, you are talking in the tens of billions of dollars, potentially, when you put it all together.

When you are looking at CLOs here, particularly as this dries up—because remember what happened in January, the markets were reacting that these products were going to go away. The reason why they have come back a little bit in February is because you are here talking about solutions, the regulators are saying something. So the markets are sort of looking—while they may not be going away.

If they do go away, those small businesses and the businesses you are talking about, you are going to have to go to a more risky form of financing if you can even find it.

Mr. HURT. Okay.

Mr. QUAADMAN. So that is going to make our system that much less stable.

Mr. HURT. And jack up the costs.

Mr. QUAADMAN. And jack up the costs.

Chairman GARRETT. Thank you. The gentleman yields back. The gentleman's time has expired.

The gentleman from Massachusetts for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. I think that the arguments that you are making for changes in the risk retention rule are much more valid than an exemption from the Volcker Rule. So let me talk about risk retention and what we are requiring. I understand the structure is much different, and that Ms. Coffey, you have talked about this QCLO. Do you anticipate—I haven't drilled down on the documents, but do you anticipate that these are corporate loan only?

Because I think, generically, CLOs could also include bonds or derivatives. And to that extent, Mr. Levitin is right. They present some of the same risks that we are trying to get at for CDOs. So they are similar in that respect. So are you anticipating that this QCLO would be limited just to corporate loans?

Ms. COFFEY. Certainly. Thank you for the question. In our proposal, we recommended that in the asset quality bucket that in the QCLO that 90 percent of the assets would be senior secured loans to U.S. companies that are subject to annual audits and that whole thing. We were saying that perhaps up to 10 percent could be things like corporate bonds to those same companies. But I think that is a point of discussion.

But we ultimately see this as being a vehicle that is specifically focused on providing financing to U.S. companies.

Mr. LYNCH. What about the equity tranche where the risk is? How do you adjust that in the QCLO?

Ms. COFFEY. Certainly. One of the things that we said in the QCLO is that we should have structural protections that are mandated in a qualified CLO. And that the equity component of the qualified CLO should be at least 8 percent of the assets.

Mr. LYNCH. Okay. And what would you—so what would be the protection for the equity tranche? Are you saying 5 percent of the 8 percent? Is that—

Ms. COFFEY. What we are saying is the risk retention component of the CLO manager. Now, remember, a CLO manager is a thinly-capitalized asset manager.

Mr. LYNCH. Yes.

Ms. COFFEY. And so what we are saying is in order to do a QCLO, in order to manage CLOs going forward like they have done for the last 20 years and have seen no losses whatsoever, a CLO manager would have to purchase and retain 5 percent of the equity of that CLO.

Mr. LYNCH. Okay.

Ms. COFFEY. So a CLO manager would have to bring—find, and bring $2.5 million simply to run its business going forward.

Mr. LYNCH. All right.

Mr. Levitin, what do you think?

Mr. LEVITIN. I actually am somewhat sympathetic to the QCLO concept.

Mr. LYNCH. Me, too.

Mr. LEVITIN. The devil is in the details. But the concern with risk retention is that you are going to have a conflict of interest—without it, there is going to be a conflict of interest between whoever is putting together the securitization, whether it is CLOs or mortgages or what have you, and the investors. And as Ms. Coffey has outlined the QCLO concept, it seems to be—if all the things she laid out are actually done right, that probably addresses a lot of those concerns.

Mr. LYNCH. Yes. Okay. I guess I am going to reserve my right to object at some point. It sounds like you are on the right path. And I agree that structurally it presents a different set of problems than what we originally focused on. And it is sort of like the trust preferred security solution that we came up with recently. But I think it is, in Mr. Levitin's words, the devil is in the details here on how we get this done. But I think there could be a way forward.

I just hope that the Democrats and Republicans can work together here. I think, just a flat-out exemption, as in the language of the draft bill, is a non-starter. I don't think it is necessary, and I think that would get in the way of us coming to a general agreement here that I think would serve the industry and investors and taxpayers, as well.

I will yield back, thank you.

Chairman GARRETT. The gentleman yields back.

Mr. Stivers is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate the witnesses being here today, and I appreciate their testimony. So under the Volcker Rule, when you combine, I guess, the Volcker Rule, the qualified mortgage rule, the QRM rules, the risk retention rules, the proposed rules of Basel III and other capital requirements, what—I guess I will direct this question to Mr. Quaadman. What cumulative impact do you think all that will have on the ABS market?

Mr. QUAADMAN. I think overall it is going to have a negative impact. If you take a look at the way that business is financed, when you take a look at Basel III it is going to impact their commercial lines of credit. It even impacts their ability just to park cash in banks. When you take a look at risk retention, and with the Volcker Rule, in particular with CLOs, as we have talked about, that is going to be impacted, as well.

What we don't know yet with the Volcker Rule is how the Volcker Rule is going to start to impact other debt and equity instruments that corporate treasurers use and how they are underwritten.

Mr. STIVERS. I think Mr. Hurt asked some questions that you answered about what that will do to the cost of borrowing. And you brought up the ABS, or the CLO problem. And given that the last questioner talked about bipartisanship, I think on the CLO issue, there has been some bipartisanship. And I want to remind the committee of the remarks of the ranking member, Ms. Waters, on January 15th, when she said that, "I think that we are able to work with the regulators on some of the issues being identified, such as the CLO issue."

And I think there is a real acknowledgment that in the Volcker Rule, there is a problem with the CLO. I guess this question is for Ms. Coffey. What do you think the easiest way to fix the CLO rule would be?

Ms. COFFEY. With respect to the Volcker Rule?

Mr. STIVERS. Yes.

Ms. COFFEY. We are very heartened by the work that Mr. Barr has done on this with the prospective legislation. We think it goes a long way to addressing the issues both in dealing with the legacy issues of CLOs that were purchased over many years. We think that will be very helpful. And we also think the language that he proposed for clarifying what an ownership interest would be will be very helpful going forward.

One of the things, however, that has emerged since Mr. Barr has been working on his legislation is that we have heard from the regulatory agencies that they might expand their definition of what an ownership interest is, to like subsection D, subsection E, which talks about conflating, perhaps, interest payments with excess spread. And to the extent that continues to be a problem, we might want to provide additional support on that bill.

Mr. STIVERS. So what Ms. Coffey said, and I think it makes sense, is that Mr. Barr's approach is a good starting point for fixing the CLO problem. And I think while there have been some potential new issues brought up or are being discussed by the regulators that could require some additional changes, I think his approach is certainly a good start. And I want to applaud him for all the work that he has done on this issue, and thank him on behalf of manufacturers in my district that use asset-backed securities and on behalf of folks who have been purchasers of CLOs in the past. I think all the work he is doing will make a big difference for the future of the whole ABS market.

I guess my other question is on coordination. And we will just kind of ask the panel, since I have a minute and 15 seconds left. Do you agree with the statement that the regulators have coordinated all the regulations that I talked about well so that they interact well? If the answer is yes, raise your hand. I would like to note that no one raised their hand, and that I do believe there are real problems with the interactions of many of these rules and they haven't looked at the cumulative impact in how they interact with each other.

And while it was stated earlier that the risk retention rules may supersede some of the requirements on what the limits under the Volcker Rule are, it is still unclear what the interactions of many of these rules are doing together. And I think it is really important that the regulators sit down and try to coordinate these rules. Because as they come out drip, drip, drip one by one there is no real coordination on this and not enough coordination that makes them work well together.

Does anybody disagree with that statement? I would like to note for the record that everyone agreed with that statement.

Mr. WEIDNER. We agree. And I think what we see—what we are heartened to see is that there is now an effort to try to coordinate. And I think that is going to be very helpful, as we try to address these issues across multiple agencies and try to come to consensus. And—

Mr. STIVERS. It is a starting point. Thank you.

Mr. WEIDNER. It is a starting point. And I think that we are appreciative of that, but to this point I think it was something that was needed.

Mr. STIVERS. Thank you. I am out of time, so I will yield back. Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

Mr. Foster is now recognized.

Mr. FOSTER. First off, I would like to compliment the chairman and the bipartisan members of the committee who have engaged on this issue. I think it has been very productive and a breath of fresh air. And seeing the committee and the regulators coming in and trying to deal with, in particular, the legacy issues, which I think are really more an unintended consequence of this.

But I was more interested—my one question has to do with going forward. Ms. Coffey, you had mentioned the interest cost savings from borrowers, basically having to do with the existence of the CLO market. And the CLO market, by most accounts, has significantly healed itself by finding Volcker compliance ways of doing business. And so, it is at least partially recovered.

I was wondering what fraction of the lowered cost of interest rates really have been recaptured by that healing and the workarounds for the Volcker Rule versus what fraction—because of compromises in the structure that the market might have found all by itself without the Volcker Rule presumably has some increased interest rate cost. What fraction of the potential savings from CLO have been recaptured by the market healing itself?

Ms. COFFEY. I think that is an excellent question. The Volcker Rule is an immediate dislocation in the market that we are dealing with today. So, we are observing that right now. And any healing that we have seen with respect to Volcker has come from the comfort market participants are taking in the fact that lawmakers are taking this issue very seriously and working together to resolve it. So, we are hoping we can heal that.

The numbers I quoted before, the fact that you could see if CLOs go away, that it would cost U.S. companies $2.5 to $3.8 billion of annual interest. That excludes concerns around Volcker and was focused significantly on risk retention. If risk retention went forward the way it is currently written, it is estimated it would reduce CLO market by 60 to 90 percent. And that in and of itself, excluding Volcker, would cost U.S. companies $2.5 to $3.8 billion.

Mr. FOSTER. Okay. Is there now, or will there be—would it be possible in the future to quantify the impact of the restructures to work around Volcker that have taken place in the marketplace? To eyeball roughly what the economic damage was or was not?

Ms. COFFEY. I think once we come through and resolve this, which I do hope that we can do with your help, then I think we can look back and say, here is the damage that we avoided because we did resolve it. It may be a little too early to assess that now.

Mr. FOSTER. Okay. Well, thank you. That was my one question. I yield back.

Chairman GARRETT. Mr. Barr?

Mr. BARR. Thank you, Mr. Chairman. I appreciate the testimony of the panel. And Ms. Coffey, a question to you. You testified that it has been estimated that if Volcker is not changed, demand among banks for CLO notes could drop by 80 percent, significantly reducing CLO formation and reducing credit availability. If these borrowing—if borrowing costs do increase because of lack of credit availability, what will that mean to these businesses that rely on CLO financing?

Ms. COFFEY. Right. I think that is a very good question and very important going forward. I think one of the things that is important to understand is just how broad the Volcker problem is. Some people say it is hard to quantify exactly how much of a problem Volcker is. But in fact, that information is available and it is available publicly. Reuters published a publication and a chart that observed that 62 percent of U.S. CLOs have bonds in them, usually less than 3 percent, but do have bonds in them.

And all CLOs have bond buckets so they are able to invest in bonds. And hence, they would end up being covered funds. Moreover, these CLOs will not go away any time soon. There are about $300 billion of CLOs outstanding today. In July 2015, it is estimated there will still be $240 billion of CLOs outstanding. So, this is a big problem. This goes to the issue that you asked of what will this do to borrowers. If you have a situation where the Volcker Rule basically impedes U.S. banks and some foreign banks from investing in CLOs, you could see their appetite reduced by about 80 percent. They just will not participate in the CLO market.

And ultimately, that leads to our other point, in that we could see a significant cost of financing for U.S. companies. What happens when you have a significant cost of financing, or a decreased credit availability for companies? That means these companies which have over 5 million employees can't build new factories, and can't build new cellular networks; they can't expand. They can't combine and merge to build bigger companies that can compete effectively globally.

It ultimately would have a very destructive effect on U.S. companies.

Mr. BARR. With all respect to Professor Levitin, when he talks about systemic stability and the need to fulfill the Dodd-Frank's mandate for systemic stability, what does this actually do in practice in terms of the stability of the financial markets?

Ms. COFFEY. I think it certainly reduces financing for U.S. companies. And I think financing for U.S. companies is very important for the economic situation in the United States.

Mr. BARR. Professor, in all fairness, I will give you an opportunity to respond.

Mr. LEVITIN. I greatly appreciate that. I think there is a really important assumption underlying Ms. Coffey's analysis. And that is that to the extent that banks are not able to invest in CLOs, the pool of money that would be invested there just disappears from the economy. It doesn't. Banks may reduce their lending, but they can also put that money into other forms of asset classes. And it is actually a very complicated analysis that I don't think anyone has done to figure out really what the ultimate cost effect is going to be on cost to financing.

It may go up.

Mr. BARR. But we do—in January, we had a cratering of the CLO market. So we do know that without any kind of congressional intervention, we saw what it was going to do. Let me—because my time is running out.

Mr. LEVITIN. We saw that for 1 month, but we have this month also. I would just add to this that CLOs are one way that companies can finance themselves. There are other ways. It is not as if companies are not going to have financing routes. This isn't as if no one could get a mortgage. This is just one particular financing channel.

Mr. BARR. Professor, thanks for your testimony. Since my time is running out, I do want to get at kind of the crux of the matter here. In your testimony, you argued that structured financial products fueled the housing bubble and produced the financial crisis.

I would be interested to hear from the other members on whether or not there was any reason why either the Volcker Rule or the risk retention rules should not apply to CLOs in a way that they would apply to mortgage-backed securities. In other words, is there a reason why CLOs are different?

Mr. WEIDNER. If I could take the—I think we have consistently said, our membership, is that CLOs are not the type of originate-to-distribute type of securitization that is cause for concern, and has been really the impetus behind risk retention in terms of aligning interests in a way that ensures that the underlying assets are well-underwritten. What we have seen, and it is just very—we have seen the structural feature of these deals, the quality of the assets and how they have been actively managed, the rigorous reviews that they have.

There are a number—those types of things have led to the performance of those assets through very difficult times. So from our point of view, there is an alignment of interest. There hasn't been—who is to say who the sponsor of these are? The assets are acquired in from the market. So from our point of view, there isn't a driver here to say that risk retention is needed because we need someone to hold for the duration of the deal to make sure that the pool is being properly—is put together.

But one thing to appreciate about all this—and when you think about different type of ABS—CLOs are the only asset type that are actively managed. Pool assets are coming and going out, you could turn a portfolio over to 35 to 40 percent. So I think that what we are seeing is the structural feature and the criteria of what goes into underwriting an asset going in are the types of things that risk retention is getting at, which is to make sure that there are good underwriting standards of the assets that come in.

And so we see a difference as opposed to these other ABS assets, which are static, and you are wanting to make sure—most of these are static, and making sure that somebody retains an interest who is actually securitizing these assets. This is not that product.

Mr. BARR. Thank you.

I yield back.

Chairman GARRETT. Thank you. The gentleman yields back. And that completes our hearing for today. We have been called to votes. I once again want to thank each and every one of the witnesses, those who have been here before and new witnesses, as well.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And without objection, we are hereby adjourned.
[Whereupon, at 4:03 p.m., the hearing was adjourned.]

A P P E N D I X

February 26, 2014

LSTA
THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

Testimony of Meredith Coffey

Executive Vice President of the Loan Syndications and Trading Association

House Subcommittee on Capital Markets and Government Sponsored Entities Hearing on

The Dodd-Frank Act's Impact on Asset-Backed Securities

February 26, 2014

Good afternoon Chairman Garrett, Ranking Member Maloney and members of the Committee. My name is Meredith Coffey, and I am the Executive Vice President in charge of research and analysis at the Loan Syndications and Trading Association, or LSTA.[1] The LSTA is an association that represents the interests of all participants in the $3 trillion corporate loan market. Importantly, the LSTA does not represent the securitization market or the market for Collateralized Loan Obligations (or "CLOs"). Instead, the LSTA represents the corporate loan market – and our concern is how certain regulation could severely diminish securitization (particularly CLOs) and how this could markedly reduce U.S. companies' access to the loans they need to expand, build factories, build cellular networks and engage in M&A as they grow and create jobs. We are grateful to be here today to testify on how important securitization is to lending and to U.S. companies, and how regulation – if it is poorly structured and implemented – could decimate this important market.

My testimony will begin with an introduction to the U.S. corporate loan market, will then describe CLOs and address how regulation could inadvertently – but very adversely – affect this very important source of financing for U.S. companies. Finally, I will offer relatively simple ways that the agencies can address the unintended problems that their rules create for CLOs.

The U.S. Corporate Loan Market

[1] The LSTA, founded in 1995, is the trade association for the syndicated corporate loan market and is dedicated to advancing the interests of the market as a whole. The LSTA engages in a wide variety of activities intended to foster the development of policies and market practices designed to promote a liquid and transparent marketplace. More information about the LSTA is available at www.lsta.org.

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According to the Shared National Credit Review, which is run jointly by the Office of the Comptroller of the Currency ("OCC"), Federal Reserve and Federal Deposit Insurance Corporation ("FDIC"), banks and non-bank lenders provide more than $3 trillion in loan and loan commitments to companies. As of mid-2013, U.S. and foreign banks provided $2.4 trillion, while non-banks (like CLOs, finance companies, mutual funds and others) provided nearly $600 billion in these loans and commitments.[2] The companies that borrow these loans include blue chip investment grade companies like IBM, UPS, Exxon Mobil, McDonalds, Wal-Mart, Microsoft and John Deere. But not every company can be Wal-Mart or Microsoft – and almost all companies need financing. Large non-investment grade companies that rely on the corporate loan market include Community Health, Sears, Aramark, SuperValu Stores, Rite Aid, Goodyear Tire, and Delta Airlines who, together, employ hundreds of thousands of Americans. The loan market also provides financing for smaller, innovative companies like web.com, 2nd Story Software, Rocket Technology, Websense, and Hyland Software. Indeed, nearly 5,000 non-investment grade companies receive significant financing from the corporate loan market[3] – it is a critical funding source for them.

Unfortunately, many companies may lose their access to capital in the years to come. As a result of a series of regulations over many years, banks have increasingly been discouraged from lending to smaller, non-investment grade companies. Meanwhile, major non-bank sources of financing – particularly CLOs – may be greatly diminished by regulations such as risk retention and the Volcker Rule. It is this threat to financing for U.S. companies that drives the LSTA to testify today.

CLOs and the Loan Market

U.S. CLOs provide approximately $300 billion in financing[4] to U.S. non-investment grade companies like healthcare companies Community Health and HCA, food companies Del Monte and Dunkin Donuts, technology companies big (like Dell Computer) and small (like NetSmart

[2] *Shared National Credits Program, 2013 Review, available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131010a1.pdf.
[3] Thomson Reuters LPC DealScan database.
[4] *Thomson Reuters LPC Leveraged Loan Monthly*, January 2014, at slide 39.

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Technologies), and many more. According to Thomson Reuters, more than 1,000 companies receive financing from CLOs. In all, we estimate that companies that rely on CLOs employ more than five million people.

Unfortunately for these companies, the CLO industry is facing an existential threat. According to a study by Oliver Wyman, the risk retention rules alone threaten to reduce the CLO market by as much as 60 to 90%.[5] If the CLO market is reduced so dramatically, a substantial shortfall in financing for the companies that rely upon them would result. While it is possible that these companies may be able to seek other sources of financing, this other financing would likely be far more expensive. According to the Oliver Wyman study, if the CLO market were to shrink as anticipated, to the extent that supply of financing could be replaced, it would likely cost corporate borrowers $2.5-3.8 billion per year in additional interest costs to replace them.[6] So, the choice for U.S. companies would be to do without financing, or face markedly higher financing costs. Neither outcome bodes well for economic growth and job creation.

But what exactly are CLOs and why is regulation so troublesome for them? CLOs are straight-forward, long-only investment funds that invest in bank loans to U.S. companies. They are most akin to a mutual fund where an investment manager selects pieces of individual corporate loans to purchase and actively manages that portfolio of loans.[7] Critically, being long-only investments, CLOs are not complicated derivatives where some people have a stake in a portfolio's success while others have a stake in its failure. Nor are they originate-to-distribute structures that create loans for the sole purpose of selling and securitizing them. At bottom, a CLO is simply an actively-managed investment fund that uses securitization technology to provide its investors exactly the risk and return they are looking for.[8]

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[5] Oliver Wyman, *Risk Retention for CLOs: A Square Peg in a Round Hole* (Nov. 2013), at 14 ("Oliver Wyman Study"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17298.
[6] *Id.* at 21.
[7] These corporate loans are usually very large – $20 million to more than $1 billion – and pieces of these loans are syndicated to many different investors, including CLOs. A CLO would typically purchase a $1-10 million piece of a loan.
[8] The terms "CLO" and "open market CLO" are used interchangeably in this testimony. Both terms include CLOs that are actively managed, as described above, but do not include synthetic CLOs or "balance sheet CLOs." A "balance sheet CLO" means a CLO whose assets consist predominantly of loans originated and transferred to the

While CLOs are benign and proven investment products that have historically performed very well, they often are mistaken for collateralized debt obligations, or CDOs. In fact, they are quite different. Critically, the collateral is very different. CLOs invest in senior secured syndicated loans to U.S. companies, like Sears, HCA, SuperValu, Goodyear, Websense, among many others. The characteristics, credit risk and performance of each of these loans are very transparent. There is an active syndication and trading market for loans – in fact, more than $500 billion of U.S. syndicated loans traded in the secondary market in 2013.[9] Each loan is typically individually rated by a third party rating agency and there are two major pricing services that provide daily prices on these loans. Moreover, the typical CLO portfolio has only 100-150 companies in it; thus the manager can track these individual loans easily – and decide to sell a loan if it is underperforming. In addition, CLOs are diversified by industry, with no industry typically accounting for more than 15% of the portfolio. Finally, CLO investors receive a wealth of information regarding the CLO and the underlying assets on a regular basis. Every month, investors receive a trustee report that details the CLO's loan assets and, for each asset, reports its interest rate and maturity date. In addition, investors receive a report on the portfolio itself, how much each asset comprises of the portfolio and how the CLO is performing relative to its overcollateralization and interest coverage tests. Finally, the CLO investors receive a report on all purchases, repayments and sales during the month, as well as the identity of any defaulted loans.

Another critical difference between CLOs and CDOs is performance. In a report released in January 2014, Standard & Poor's wrote that it had rated over 6,100 CLO tranches in the 20 years between 1994 and 2013. In that time, just 25 CLO tranches defaulted, creating a 0.41% *cumulative* 20-year default rate.[10] Just eight investment grade CLO notes defaulted in that

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CLO by one or more of its affiliates other than in (i) open market transactions or (ii) from another open market CLO, and the assets and liabilities of such CLO are, immediately after issuance of its asset-backed securities in a securitization transaction, included under generally accepted accounting principles in the consolidated balance sheet of one or more of its affiliates.

[9] LSTA *Week in Review* (Jan. 24, 2014), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17433.

[10] Standard & Poor's, *Twenty Years Strong: A Look Back at U.S. CLO Ratings Performance from 1994 Through 2013* (Jan. 31, 2014), at 4-5, *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17549.

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timeframe – a cumulative 20-year default rate of 0.15% - and *not one of the 3,997 notes rated AAA or AA defaulted.*[11] This compares extremely favorably to other assets.

Why did CLO notes perform so well? This performance was due to the unique characteristics described above (asset performance, diversification and disclosure) as well as structural protections in CLOs and an alignment of interest that already exists between the CLO manager and its investors.

But, unfortunately, regardless of the critical role that CLOs play in the provision of credit to U.S. companies and notwithstanding their stellar performance, CLOs are currently set to be swept up – and devastated – by regulation that was not intended to be targeted at them. The major regulatory threats to CLOs today are risk retention and the Volcker Rule.

The Volcker Rule

In the final Volcker Rule ("Final Rule") that was issued on December 10, 2013, CLOs that contain any securities (other than cash-equivalent securities) are "covered funds" and banks are not permitted to hold "ownership interests" in covered funds. Most CLOs issued before the publication of the Final Rule either hold small amounts or have the ability to purchase securities and thus are covered funds.[12] Moreover, based on a single provision contained in the Final Rule (which did not even appear in the proposed rule), banks that hold debt securities technically appear to have an ownership interest in these CLOs. There are seven "indicia of ownership" in the Volcker Rule that are intended to ensure that debt with certain equity-like features are treated as ownership interests. Unfortunately, one of the indicia of ownership – "the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the right of

[11] *Id.* at 6.
[12] Roughly 62% of outstanding U.S. CLOs actually hold some bonds, generally less than 3% of the portfolio, according to Thomson Reuters LPC. In addition, almost all outstanding U.S. CLO's have the ability to acquire securities under their transaction agreements. U.S. Banks, which hold approximately $70 billion of CLO notes, mostly in the AAA and AA rated tranches, do not have the ability to require the manager to sell bond holdings. Thus, simply "selling the bond holdings" is not a realistic solution to the ownership interest problem. Contrary to what the regulators have suggested, therefore, this is not a minor, easily resolved problem. *See, e.g.,* Gruenberg, Martin, testimony February 5, 2014, before the U.S. House, Committee on Financial Services.

a creditor to exercise remedies upon the occurrence of an event of default or acceleration event)" – is a significant problem for CLOs.

CLOs provide the holders of their debt securities with a number of creditor rights designed to protect their debt interests. Most of these rights are vested in the "controlling class," typically the most senior class of debt securities then outstanding.[13] Most existing controlling class CLO debt security holders have the contingent right to participate in the removal and replacement of the CLO manager, but only "for cause," as such term is defined in the transaction documents. The definition of "cause" that would trigger the right of removal includes, for example:

- a willful breach by the manager of its obligations under the CLO transaction documents;
- the dissolution or insolvency of the manager;
- a material failure of a representation or warranty that is not timely cured; or
- fraud or criminal activity by the manager in connection with its investment management business.[14]

Most existing controlling class CLO debt security holders also have the right to participate in the replacement of a manager after the manager's resignation. The resignation of the manager is tantamount to a change of control of the issuer — a circumstance under which traditional bank lenders often receive consent rights or the right to be repaid.

These "for cause" and resignation events pose clear and direct threats to the interests of holders of debt securities as creditors of a CLO, and their ability to respond to and remediate these threats is properly viewed as an essential creditor's right, and not as an ownership interest.

[13] Since CLO debt securities are paid serially, any class of these debt securities can become the controlling class after the more senior classes have been paid in full.
[14] *See, e.g., Offering Circular for the Finn Square CLO LTD. Transaction* (January 2013), at 128-130, which contains typical "for cause" manager removal and replacement provisions, *available at* http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/14788/Prospectus%20-%20Standalone%20302052.PDF.

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Oddly, the Final Rule carves out from the definition of ownership interest a security whose rights to remove or replace a manager stem from the occurrence of an event of default but do not carve out such rights when they are ***triggered by provisions that are meant to prevent an event of default****.*

In the absence of interpretive guidance from the agencies or action from Congress, this provision threatens to seriously disrupt the CLO market. The provision arbitrarily converts CLO debt securities into the equivalent of equity securities even though they have none of the indicia of ownership that markets expect from equity securities. And, since banks are not permitted to hold ownership interests in "covered funds,"[15] which, as defined in the Final Rule includes CLOs that hold any securities, that artificial conversion of debt into equity solely by virtue of these limited voting rights, in turn makes CLO debt securities ineligible for banks to hold.

We are heartened by the bipartisan recognition by lawmakers of this problem. As discussed below, we support the draft legislation that Representative Barr has prepared,[16] and believe its passage would certainly address the problem. In addition, we greatly appreciate the letter to the regulatory agencies that Representative Waters, Maloney and 15 other lawmakers sent to the regulators regarding the Volcker Rule's application to CLOs."[17]

As the letter notes, the Volcker Rule, as written, would indeed have a very disruptive effect on the CLO market. U.S. banks hold an estimated $70-80 billion of CLO notes, which would have to be divested before July 2015. Non-U.S. banks, which also may be subject to the Volcker ownership prohibitions, hold another estimated $60-80 billion of such notes. Even the threat of such a divestiture roiled the CLO market in December and January. Due primarily to uncertainty

[15] Covered funds are defined in a way that includes securitization vehicles, such as CLOs, that rely on the section 3c-1 or 3c-7 exemptions from the Investment Company Act of 1940.
[16] *See* Discussion Draft of H.R. _____, introduced by Mr. Barr, "To amend the Bank Holding Company Act of 1956 to exclude certain debt securities of collateralized loan obligations from the proprietary trading prohibitions known as the Volcker Rule."
[17] Letter from Rep. Waters et al. to Chair Yellen et al. (Feb. 12, 2014), *available at* http://democrats.financialservices.house.gov/press/PRArticle.aspx?NewsID=1629.

around the Volcker Rule, in January 2014, U.S. CLO issuance dropped nearly 90% - to less than $2 billion – from the year-earlier period.

Indeed, this result occurred nearly a year and a half before banks would have to dispose of CLO notes under the Final Rule and demonstrates that the amount of damage a forced sale could create is astonishing. If U.S. and foreign banks were forced to sell $70-150 billion of CLO notes, prices would undoubtedly fall and create significant problems for both the selling banks and for the market as a whole. While no one knows exactly how much prices would decline, a variety of scenarios illustrate how significant the problem could be. If CLO note prices dropped just 1% on a mass sale – a very conservative estimate – that would translate to a $1.5 billion loss of value on the estimated universe of bank-held CLO notes. Similarly, a 5% price drop could create a realized loss of $7.5 billion, while a 10% price decline translates to a $15 billion loss. Critically, these substantial losses would not in any way be related to the credit-worthiness of the underlying notes which continue to perform very well. Instead, the losses would be due to forced selling, driven entirely by the implementation of the Final Rule which arbitrarily converts CLO debt securities into ownership interest.

This threat has the potential of greatly reducing banks' interest in holding new CLO notes. It has been estimated that if the Volcker Rule were unchanged, demand among U.S. banks for CLO notes could drop by 80%, significantly reducing CLO formation – and markedly reducing credit availability (or increasing the cost of credit) for U.S. non-investment grade companies.[18]

Fortunately, there is an easy solution for this disruption. The draft legislation prepared by Congressman Barr would resolve a significant portion the problem, by removing the threat of a fire sale of $70-150 billion of CLO debt securities, and clarifying, prospectively, that the ability to participate in the removal or replacement of a CLO manager for cause does not constitute an ownership interest.[19] We also believe that the agencies could do much to stabilize the market by

[18] *See* Thomson Reuters LPC "LoanConnector Content Teaser" (Feb. 10, 2014), *available at* http://share.thomsonreuters.com/loanpricing/lsta_teaser/lsta_teaser_20140214.html#4.*bern*.

[19] A number of our members have reported that certain of the agencies may be taking the position that two other subsections that define ownership interests, *i.e.*, §§ __.10(d)(6)(D) and (E), could apply to CLO debt securities and also render them ownership interests. We believe this interpretation is mistaken. A memorandum to the LSTA from

issuing simple regulatory guidance that would grandfather CLO notes issued prior to the publication of the Final Rule and clarify that CLO debt securities that contained the right to remove or replace a CLO manager for cause, or replace a manager upon its resignation, with no other indicia of ownership, will not be considered ownership interests[20]

We appreciate the work that members of the committee have done in providing a letter to the agencies recommending a solution, as well as Congressman Barr's bill that would address both grandfathering existing CLOs and resolving the ownership issue for new CLOs.

Risk Retention

As proposed to be implemented by the agencies, risk retention also poses an existential threat to CLOs and the financing that they provide for U.S. companies. To understand why, it is important to appreciate both the legislative goals and language of Section 941 of the Dodd-Frank Act, which addresses risk retention.

Section 941 of Dodd-Frank sought to use risk retention to align the incentives of "securitizers" with those of their investors. The very language of Section 941 suggests that it was intended to mitigate moral hazard in "originate-to-distribute" securitizations. The definition of a securitizer – that entity that "initiates or originates an ABS by ***selling or transferring assets***, directly or indirectly, to the Issuer" – must ***retain 5% of the credit risk of the assets***. The concept here is that a securitizer has a portfolio of assets on its balance sheet and, instead of selling 100% of the credit risk of the assets, it can only sell 95% - and must retain 5%.

While requiring the alignment of the interest of a "securitizer" in an originate-to-distribute securitization with its investors is reasonable, the application of risk retention to open market CLOs as proposed is extremely damaging. Actively-managed CLOs do not have a securitizer as

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the law firm of Clearly Gottlieb Steen and Hamilton addresses these issues in detail and strongly supports our view. Memorandum for Elliot Ganz, General Counsel, Loan Syndications and Trading Association (Feb. 3, 2014), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17547.

[20] The LSTA and other trade associations have submitted numerous letters to the regulatory agencies requesting this relief. They are available at http://www.lsta.org/WorkArea/showcontent.aspx?id=17404; http://www.lsta.org/WorkArea/showcontent.aspx?id=17355; and http://www.lsta.org/WorkArea/showcontent.aspx?id=17354.

defined in Dodd-Frank. There is no entity that initiates or originates a securitization by selling or transferring assets. Instead, a CLO acts as an investment fund; a CLO manager is hired to purchase assets from a number of individual banks or in the secondary market on an arm's length basis and actively manage the portfolio during a multi-year reinvestment period. Thus, the Dodd-Frank definition of securitizer simply does not correspond to open market CLOs. Ultimately, with no "securitizer" that matches the statute, the agencies decided to classify the CLO manager as the "sponsor" as it is the entity that ***selects assets for purchase***, and then manages the portfolio going forward. Because the agencies tagged the manager, the manager would need to purchase and hold 5% of the notional value – or $25 million of notes of any new $500 million CLO that is done.

There are two problems with the Agencies' proposed solution: First, as a matter of logic and statutory construction, it is contrary to the plain language definition of securitizer in Section 941 of Dodd-Frank to tag the *buyer* of assets as the securitizer, rather than the *originating seller*. Second, as a practical matter, it is economically unfeasible for nearly all open market CLOs to retain 5% of the notional amount of the CLOs they manage.[21]

Unlike banks, most CLO managers are thinly capitalized asset managers. They generally don't have the balance sheet or the funds to purchase $25 million of CLO notes for every new $500 million CLO they do. Consider a mid-sized CLO asset manager with 30 employees. If that CLO manager were planning to manage a new $500 million CLO, those 30 employees would need to come up with $25 million – quite possibly out of their own pockets. Most management firms simply do not have this capital. To illustrate the issue another way, CLO managers typically earn an annual 0.4%-0.5% management fee on the CLOs they manage. This means that a CLO

[21]A third problem has emerged for CLOs under the risk retention proposal as well: That the forms of retention are not equivalent. While the vertical, L-shape and horizontal retention options all require the same *dollar amount of retention* - $25 million for a $500 million CLO – they account for distinctly different amounts of *credit risk retention*. By definition, the vertical pro rata strip is 5% of the credit risk. However, because credit losses [eat up] the CLO capital stack from the bottom, the horizontal equity retention contains far more than 5% of the credit risk. A study by a Harvard economics professor indicated that nearly all of the credit risk would reside in holding equity equivalent to 5% of the CLO. *See* Letter from Professor Christine Ivashina to Directors, Commissioners, and Staff Members of Financial Regulator Agencies re: Notice of Proposed Rulemaking, Credit Risk Retention (Apr. 1, 2013), at Appendix A to LSTA Comment Letter on Risk Retention (Apr. 1, 2013) ("April Risk Retention Letter"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=16434.

management firm would earn approximately $2-2.5 million per $500 million CLO per year.[22] This is less than one-tenth the amount of money that CLO managers would need to find simply in order to be allowed to run their business – a business that they have been running successfully with infinitesimal losses to note holders for over 20 years.

Because CLO managers generally do not have the funds to meet the risk retention requirements as structured by the agencies, there would be a severe impact on CLO formation. The impact can be measured in several ways. First, at the request of the agencies, in June 2013 the LSTA developed and distributed a survey to managers to determine whether they would be able to issue new CLOs if they were required to purchase and retain 5% of the face value of those CLO notes. Managers running 509 CLOs responded to the survey; they estimated that they would ultimately be able to maintain fewer than 60 CLOs – a decline of more than 80%. The survey asked managers to estimate the impact on the CLO market in general. Ultimately, 85% of respondents said that the CLO market would be reduced by 75% or more.[23]

Second, the Oliver Wyman Study, which reviewed what has occurred when CLO managers were required to purchase and retain CLO notes,[24] estimated that CLO activity would decline by 60-90%.

This would have a severe impact on companies that rely on CLOs for financing. Their access to credit would likely decline significantly. If the companies were able to find replacement funding, Oliver Wyman shows that it would likely come at a much higher cost. As discussed above, the study estimates that the cost of replacement financing could be an additional $2.5-3.8 billion per year.

[22] This is maximum potential revenue, not profit; a very substantial proportion of the fee goes to paying expenses and would not be available for purchasing and retaining equity.
[23] *See, e.g.*, LSTA Comment Letter on Risk Retention (July 29, 2013) ("July Risk Retention Letter"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=16881.
[24] The Oliver Wyman study observes that in "2009 and 2010, in the wake of the crisis, there was a major pullback in the appetite for higher-risk, higher-return investments in the credit markets. As a result, virtually all CLOs formed in this period involved the CLO managers contributing the entire equity portion of the CLO's liability structure. In 2009, when CLO managers had to provide all of the equity for their CLOs, the volume of newly formed CLOs dropped to approximately 2% of what had been formed in 2004, and were only about 1% of the 2012 volume. In the more stabilized market of 2010, CLO formation volumes were 14% of the 2004 volumes (and less than 8% of 2012 volumes)." Oliver Wyman Study, *infra* note 10, at 15.

CLOs played no role in the Financial Crisis and have an extraordinary 20-year track record. It is very unfortunate that a regulation targeted at an entirely different problem is likely to decimate CLOs. It is a problem that cries out for a solution.

Proposed Solution for Risk Retention and CLOs

In its comment letters, the LSTA has demonstrated that the plain language of the text of Section 941 does not apply to CLO managers[25]. Nevertheless, because the impact of the proposed rules would be so severe for the industry, the LSTA and other trade bodies have worked constructively with the agencies to forge a solution that the agencies find acceptable and that will not dramatically impair the CLO market.[26]

Most recently, based on work with our membership, the LSTA, SFIG and SIFMA submitted a comment letter[27] on January 10, 2014 advocating a form of risk retention that is designed to meet the objectives and concerns set forth in the proposed rules and in discussions with agencies' staff, while also avoiding the dramatic reduction in the scope and market role of open market CLOs. Under the proposed approach, open market CLOs that meet a series of criteria would qualify to satisfy the credit risk retention requirement through the CLO manager's purchase of five percent of the CLO's *equity* and through credit risk retained by the manager through the deeply subordinated compensation structure. The criteria are designed to protect investors and improve asset selection through loan asset and portfolio restrictions, leverage limitations, manager regulation, alignment of manager interests with investors, and transparency.

The proposed approach provides a range of protections for investors and ensures sound asset selection practices without requiring a different construction of Section 941 or a complete

[25] *See* LSTA Comment Letter on Risk Retention (Aug. 1, 2011) ("August Risk Retention Letter"), at 7–14, *available at* http://www.sec.gov/comments/s7-14-11/s71411-223.pdf; April Risk Retention Letter, at 16–19; LSTA Comment Letter on Risk Retention (Oct. 30, 2013) ("October Risk Retention Letter), at 4–7, *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17146, (collectively, with the July Risk Retention Letter, the "LSTA Risk Retention Letters").
[26] *See* the LSTA Risk Retention Letters.
[27] LSTA, Structured Finance Industry Group, and Securities Industry and Financial Markets Association Comment Letter on Risk Retention (Jan. 10, 2014) ("January Risk Retention Letter"), *available at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17403.

exemption for open market CLOs. At the same time, the approach provides a workable solution for most CLO managers while preserving the role of open market CLOs in ensuring credit price competition, broad access to credit markets, and varied product offerings to investors. Adoption of the proposal is well within the agencies' authority and can be implemented without seeking further comment on newly proposed rules.

Under the proposed approach, the rules would apply distinct risk retention requirements to a manager of an open market CLO that meets a series of requirements designed to ensure high quality underwriting and to protect investors. A CLO meeting the requirements would be treated as a "Qualified CLO." The manager of a Qualified CLO would be able to satisfy the rules' risk retention requirements by retaining a five percent interest in the CLO's equity – in addition to retaining credit risk through a deeply subordinated and deferred compensation structure.

Essentially, the Qualified CLO creates six overlapping restrictions that meet a number of the agencies' objectives: It supports strong underwriting, it facilitates a continuity of credit, it ensures the alignment of interests of the managers and the investors, it limits the disruption in the market, and it protects investors. In effect, for a CLO to become a Qualified CLO, its governing documents would have to include requirements and restrictions around (1) asset quality; (2) portfolio composition; (3) structural features; (4) alignment of the interests of the CLO manager and investors in the CLO's securities; (5) transparency and disclosure; and (6) regulatory oversight.

To ensure appropriate asset quality, at least 90% of the Qualified CLO's assets must be cash and senior secured loans to companies; it cannot purchase ABS interests, derivatives, loans in default, margin stock, or equity convertible notes; loans must be held by three or more investors or lenders unaffiliated with the CLO manager; and no more than 60% can be loans that rely on incurrence covenants (as opposed to maintenance covenants). In effect, the asset quality tests require the CLO to purchase high quality non-investment grade loans that have a low expected loss.

The next layer of protection comes from the composition of the portfolio. Not only must the CLO purchase higher quality non-investment grade loans, but it must do so in a diversified manner. To ensure this objective, no more than 3.5% of its assets can be invested in loans to any single company and no more than 15% can be invested in loans to any one industry. With robust diversification, the whole portfolio should be stronger than the sum of its assets.

The next layer of protection comes from the CLO structure itself. In order to differentiate Qualified CLOs from CDOs and to provide additional protection for the debt tranches, the Qualified CLO must have equity of at least 8% of the face value of the CLO assets. To add further creditor protections for the debt tranches, the Qualified CLO must be subject to interest coverage and overcollateralization tests that divert cash to pay down the notes if the portfolio underperforms.

Next, the Qualified CLO ensures the alignment of interests between the manager and its investors. First, it must be an open market CLO, not a balance sheet CLO.[28] Next, the equity investors must have the ability to remove the manager for cause. In addition, the majority of the managers' fees must be subordinated to the rated CLO notes. Moreover, the manager must purchase and retain 5% of the CLO equity. Finally, for each of the first two years, the manager cannot receive distributions on its retained equity of more than 30%. These protections – the ability to fire the manager, subordinating most of the income of the manager, requiring funded retention that is not paid out upon closing – align the interests of the manager and investor.

The next protection in the Qualified CLO – transparency and disclosure – ensures that the investor has enough information to make an informed judgment about the CLO. To be a Qualified CLO, the manager must provide a monthly report that provides significant information on the assets (obligor name, CUSIP, interest rate, maturity date, type of asset and market price where available) and on the portfolio (the aggregate balance, the adjusted collateral principal amount, and the percentage of adjusted collateral represented by each name). In addition, the

[28] *See infra* note 14.

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report must detail each Overcollateralization and Interest Coverage test and their status, all purchases, repayments and sales, as well as the identity of each defaulted asset. With all this information, the QCLO is extraordinarily transparent, unlike some of the securitizations that played a material role in the financial crisis.

The final protection is built around regulation: The Qualified CLO manager must be a registered investment advisor, with all the regulations and responsibilities – not least the fiduciary responsibilities – that go along with this.

With these six overlapping protections, a Qualified CLO will have a sound structure, will invest in higher quality non-investment grade loans in a diversified manner, will ensure alignment of interests between the CLO manager and investor, will ensure that the investors are sophisticated and further ensure that these sophisticated investors receive all the information they need to make informed judgments. Furthermore, it will offer all these benefits while limiting the disruption that the current risk retention proposal would impose on the CLO and financing markets. Thus, the Qualified CLO approach would accomplish precisely the objectives of Section 941, related to ensuring prudent asset selection and underwriting, protecting investors, ensuring access to and competition in the provision of capital, and achieving related public interest benefits.

This proposal is eminently doable. The agencies have ample authority under each of three statutory sources to adopt rules implementing the approach outlined above. Section 941 of Dodd-Frank requires the agencies to shape its rules according to the public interest as well as provides additional, permissive exemption authority, each of which, properly construed, would encompass the proposed approach to CLO risk retention. In addition, the agencies have the authority to adopt rules implementing the proposed approach as a permissible interpretation of the term "credit risk" under Section 941. Apart from these specific sources of authority, more

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general statutory authorities empower the finance agencies,[29] and the Securities and Exchange Commission in particular,[30] to issue rules that would implement the proposed approach.

Conclusion

CLOs have been a benign and proven source of financing for U.S. companies for 20 years. CLOs survived the worst financial crisis since the Great Depression with extremely low default and loss rates. Moreover, they continue to provide nearly $300 billion in financing to U.S. companies. Unfortunately, inadequately structured and implemented regulation has the potential to shut down this market. In particular, both the Volcker Rule and risk retention pose existential threats to CLOs. Fortunately, there are ways to fix the implementation of the Volcker Rule and risk retention to allow them to work as their drafters intended, while still permitting CLOs to function and provide financing to the one thousand companies that currently rely upon them.

[29] Section 23 of the Securities Exchange Act of 1934 ("Exchange Act") provides: The [Securities and Exchange] Commission, the Board of Governors of the Federal Reserve System, and the other agencies enumerated in section [3(a)(34)] of this title shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which they are responsible or for the execution of the functions vested in them by this chapter, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof."

[30] In addition to the exemption authority provided in Section 941, the Commission also has broad general exemption authority under the Exchange Act, which likewise readily encompasses adoption of the proposal described above. Under Section 36 of the Exchange Act, the Commission "by rule, regulation, or order, may conditionally or unconditionally exempt ... any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Among the provisions of "this chapter" is the credit risk retention provision. For the reasons explained above, the proposal is both "necessary" and "appropriate in the public interest" and is "consistent with the protection of investors."

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Written Testimony of

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Before the United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government-Sponsored Enterprises

"The Dodd-Frank Act's Impact on Asset-Backed Securities"

February 26, 2014
2:00 pm

Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation, structured finance, contracts, bankruptcy, and commercial law.

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Professor Levitin currently serves on Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholar's Medal.

Professor Levitin has not received any Federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

Mr. Chairman Garrett, Ranking Member Maloney, Members of the Committee:

Good afternoon. Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in financial regulation and structured finance, among other topics. I also serve on the Consumer Financial Protection Bureau's statutory Consumer Advisory Board. I am here today solely as an academic who has written extensively on structured finance and financial regulation and am not testifying on behalf of the CFPB or its Consumer Advisory Board.

Today's hearing is on the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act on the ABS and CLO markets. My written testimony is confined to ABS excluding mortgage-backed securities (MBS), both because MBS are traditionally categorized as distinct from ABS, and because this Committee has previously heard testimony from me regarding reform of the mortgage securitization market.[1]

The Dodd-Frank Act set forth three major regulatory provisions affecting ABS and CLOs: the Volcker Rule restrictions on bank investments and transactions,[2] the additional disclosure requirements for credit rating agencies,[3] and the "skin-in-the-game" credit risk retention requirement.[4] I address each in turn below. I leave unaddressed some more minor provisions in the Dodd-Frank Act that related to ABS.[5] I am troubled that the SEC, in particular, has failed to act on some of the most important rulemakings related to ensuring systemic stability. I also believe that some of the proposed regulatory implementations, particularly the Qualified Residential Mortgage (QRM) rulemaking, leave something to be desired. Nonetheless, I would urge this Committee not to move precipitously and to give the Dodd-Frank reforms a chance to take effect so that they can be properly evaluated.

I. THE FINANCIAL CRISIS AND REFORM OF THE ABS MARKET

As an initial matter, three general observations about the ABS market are in order.

A. Structured Finance Caused the Financial Crisis

First, we are now five years past a financial crisis caused by structured financial products. Structured financial products fueled the housing bubble, and structured financial products ensured that the collapse was more painful and messier. Bank

[1] *A Legislative Proposal to Protect American Taxpayers and Homeowners by Creating a Sustainable Housing Finance System: Hearing Before the H. Fin. Serv. Comm.*, 113th Cong., (2013) (statement of Professor Adam J. Levitin, Geo. U. L. Center).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619 (codified at 12 U.S.C. § 1851).

[3] *Id.* § 943 (2010) (codified at 15 U.S.C. § 78o-7 note).

[4] *Id.* § 941 (codified at 15 U.S.C. § 78o-11).

[5] *E.g., id.*, §§ 942 (amending 15 U.S.C. §§ 78o-d and 77g to provide that the SEC undertake a rulemaking requiring that ABS issuer disclose information on the securitized assets), 945 (amending 15 U.S.C. § 77g to require a SEC rulemaking providing that ABS issuers undertake and disclose a review of the securitized assets).

investment in structured financial products meant that an outsized proportion of the risk on the assets underlying the structured products was concentrated on critical financial intermediaries, thereby necessitating a federal bailout. And because of the contractual complexities of structured financial products, both understanding where losses lay and attempting to restructure troubled debts was more complicated. Not surprisingly, then the crisis resulted in the collapse of the ABS market, as investor confidence in structured products was greatly shaken.

Regulation of the structured financial products market is essential for the on-going stability of the United States economy. The Dodd-Frank Act's reforms of the ABS market and the Volcker Rules attempt to undo some of the linkages between too-big-to-fail depositories and speculative investments are an attempt to deal with the systemic stability problems in the structured finance market. Arguably, the Dodd-Frank reforms and their regulatory implementations could have gone further. In particular, the Securities and Exchange Commission needs to issue a revised Regulation AB and to take action under section 939F of the Dodd-Frank Act (the Franken-Sherman amendment) to address conflicts of interest in credit ratings.[6]

The SEC also needs to finalize a rulemaking under Dodd-Frank Act section 621 (the Merkley-Levin amendment). Section 621 was written in response to the Senate Permanent Subcommittee on Investigation's examination of the Goldman Sachs ABACUS CDO scandal, involving an underwriting making proprietary bets against its own synthetic securitization. Section 621 prohibits ABS underwriters and sponsors from engaging in any transaction that would produce a conflict of interest with an investor in an ABS transaction for the first year after the ABS are issued.[7] The SEC has still not even proposed rules under section 621, despite being statutorily required to do so by April 2012.[8] Until the SEC finalizes rules under section 621, the statutory conflict of interest prohibition does not take effect.[9]

The SEC needs to take its systemic stability mandate just as seriously as it does its investor protection mandate (and to recognize that even apparently sophisticated institutional investors often need regulatory protections, as the investment failures of 2008 should have made clear). Reform of the structured finance markets is one of the three pillars of the Dodd-Frank Act, along with an attempt to address too-big-to-fail, and improved consumer financial protection. Leaving structured finance reform unfinished, much less rolling back the progress that has been made, invites future crises.

B. There Have Been Major Changes Affecting the Structured Finance Market Besides the Dodd-Frank Act

Second, the Dodd-Frank Act reforms have not been the only or even the most important changes affecting the ABS market in the past few years. By far the most important change was the Financial Standards Accounting Board's adoption of Statement of Financial Accounting Standards 166 and 167, which resulted in many securitizations being brought back onto the balance sheets of their sponsors and decreased the incentive

[6] *Id.* § 939F (codified at 15 U.S.C. § 78o-9).
[7] *Id.* § 621 (codified at 15 U.S.C. § 77z-2a).
[8] *Id.* § 621(a) (codified at 15 U.S.C. § 77z-2a(b)).
[9] *Id.* § 621(b) (codified at 15 U.S.C. § 77z-2a note).

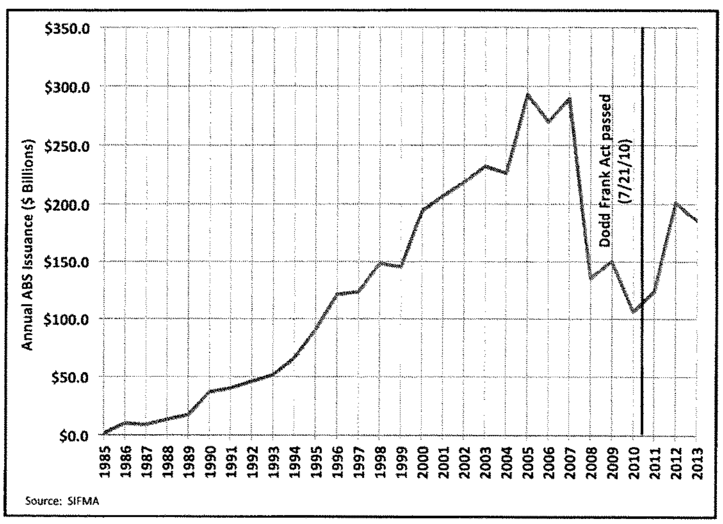
for banks to engage in securitization in order to obtain regulatory capital relief. Securitized assets also became relatively less attractive investments for banks and insurance companies because the Basel III capital standards made certain securitization assets more costly in terms of regulatory capital requirements for banks, just as changes in the National Association of Insurance Commissioners risk-based capital breakpoints increased the amount of capital that insurance companies have to hold against securitized assets.

Market changes unrelated to the Dodd-Frank Act also affected three particular ABS markets—commercial mortgage securitization (CMBS), auto loan securitizations and student loan securitizations. The CMBS market collapsed when the commercial real estate bubble imploded in 2008. The travails of the US auto industry and the general economic downturn in 2008 resulted in a notable decline in auto loan ABS. And the shift from government guaranteed to direct government lending in the student loan market in 2010 reduced the issuance of student loan backed ABS.

C. The ABS Market Is Rebounding Without Congressional Action

Third, the ABS market is rebounding, as Figure 1, below, shows. While I would hesitate to attribute this rebound to the Dodd-Frank Act reforms, the reforms do not appear to have impeded the market. Thus, while there are particular details of the Dodd-Frank reforms or their regulatory implementation that leave something to be desired, when one steps back and looks at the big picture of the ABS market, there are grounds for optimism. The prudent course of action is to give the Dodd-Frank reforms a chance to take effect before evaluating them.

Figure 1. Annual ABS Issuance, 1985-2013



II. VOLCKER RULE

Section 619 of the Dodd-Frank Act, known as the "Volcker Rule," prohibits banks from engaging in proprietary trading and from ownership interests in certain investment funds. To understand what the Volcker Rule aims to do vis-à-vis ownership interests in structured products it is necessary to understand the connection between proprietary trading and the financial crisis. Underlying the financial crisis was a giant proprietary "carry trade" by financial institutions. A carry trade is simply a funding arbitrage, whereby low cost funding is used to invest in higher yielding assets. When a carry trade works, it is inherently profitably. But if the cost of the funding is fixed and the assets underperform, a carry trade can be disastrous.

Regulatory capital rules permitted banks to hold minimal capital against highly rated positions on their trading books. Accordingly, these highly rated positions were cheaper to fund relative to investments. Therefore, banks loaded up their trading books with senior tranches of structured financial products, which they used to earn a levered carry on the spread between returns on the structured financial products and funding costs.[10] This carry trade, enabled by the Basel capital requirements, significantly increased demand for structured financial products, as structured finance is the only way to generate large amounts of AAA-rated securities. The structured products carry trade thus provided much of the financing for the housing bubble, but also leaving banks extremely exposed when the bubble burst.

Although structured products were held on banks' trading books, they were rarely in fact traded. The problem with bank investment in structured products was less one of "proprietary trading," than one of "proprietary holding." Many of these structured products that were held on bank balance sheets were collateralized debt obligations (CDOs), which are close-end investment funds that are usually actively managed. A CDO is functionally indistinguishable from a hedge fund. Thus, the Volcker Rule is in part a response to the financial crisis created by bank holdings of actively managed, close-end investment funds. Collateralized loan obligations (CLOs) are simply another flavor of actively managed close-end investment fund. ***For all intents and purposes, CLOs are indistinguishable from CDOs.*** Thus, the concerns animating the Volcker Rule apply to CLOs every bit as strongly as they do to CDOs and hedge funds.

A. Regulation VV Under the Volcker Rule Prohibits "Ownership Interests" in "Covered Funds"

Federal financial regulators recently finalized the joint regulations implementing the Volcker Rule. The joint rulemaking is codified separately for the OCC, FDIC, SEC, and Federal Reserve Board. However, I will refer to the rulemaking under its Federal Reserve Board moniker, Regulation VV.[11]

[10] *See* Gillian Tett, *Super-senior losses just a misplaced bet on carry trade*, FIN. TIMES, Apr. 18, 2008.

[11] The different agencies' regulations are to be codified at 12 C.F.R. pt. 44, 12 C.F.R. pt. 351, 17 C.F.R. pt. 253 and 12 C.F.R. pt. 248 respectively.

As Reg VV relates to the ABS and CLO market, it provides that after July 21, 2015, a bank may not have an "ownership interest" in a "covered fund."[12] Furthermore, banks are subject to limitations on their other relationships with covered funds.[13]

Certain ABS and CLO investments qualify as "ownership interests" in "covered funds". A quick tour into the regulatory definitions is necessary to understand why. As a starting point, however, keep in mind that the Volcker Rule prohibition applies only if there is both (1) an ownership interest and (2) it is in a covered fund. Either condition by itself is insufficient to trigger the Volcker Rule prohibition.

A "covered fund" is any entity that would be an investment company, as defined in the Investment Company Act of 1940, without regard to the exemptions under section 3(c)(1) or 3(c)(7) of that Act that usually exempt structured financial products from investment company regulation.[14]

The Volcker Rule's coverage of "funds" is important because securitization always involves an investment in a fund. The fund might be in the form of a trust or corporation or LLC that are at least nominally separate from the financial institution that sponsors the securitization. The fund might be actively managed or it might be passively managed according to a fixed set of detailed investment instructions. Irrespective of its form, the fund is the entity that holds the securitized assets—loans, securities, derivatives, or other rights to a cash flow—and the fund is also the entity that issues various securities (debt and equity).[15] Thus, the Volcker Rule's initial coverage trigger is just that there is a fund (meaning investment company), which covers all sorts of funds.

Reg VV exempts from the definition of "covered fund" any ABS issuer that meets certain requirements. The most critical of these requirements for exemption from "covered fund" status is that the ABS issuer's assets are comprised solely of "loans," cash equivalents, certain interest rate and foreign exchange derivatives related to the hedging the risks on the loans, and "special units of beneficial interest and collateral certificates."[16] "Loans" are defined as excluding securities and derivatives.[17] Thus, any ABS issuer that has securities (such as bonds) or prohibited derivatives (such as credit default swaps) among its assets will not qualify for exemption from the definition of "covered fund."

B. Volcker Rule and ABS

The Volcker Rule investment prohibition does not apply to most ABS (other than CLOs, addressed below) because most ABS issuers do not have any securities or

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[12] 12 C.F.R. § 248.10(a)(1). The regulations' effective date in April 1, 2014, but the divestment requirement does not go into effect until July 21, 2015. *See* Board Order Approving Extension of Conformance Period, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

[13] 12 C.F.R. § 248.14.

[14] 12 C.F.R. § 248.10(b).

[15] Some securitizations involve two funds, one of which holds the assets and issues obligations to a second fund, which in turn issues different securities. This two-fund structure involving an intermediate securitization is common for securitizations of credit card receivables, equipment leases, and floor plan loans, as well as some foreign mortgage securitizations.

[16] 12 C.F.R. § 248.10(c)(8).

[17] 12 C.F.R. § 248.2(s).

prohibited derivatives among their assets. The assets of most ABS issuers (the fund) are either loans or special units of beneficial interest or collateral certificates as well as certain permitted ancillary assets such as interest rate and currency derivatives.[18] Accordingly, banks are free to invest in most forms of ABS under the Volcker Rule.

If, however, an ABS issuer invests in any securities (including in ABS other than collateral certificates and special units of beneficial interest) or prohibited derivatives, such as credit default swaps, then the ABS issuer does not qualify for the exemption from being a "covered fund".[19] Accordingly, the Volcker Rule prohibition *might* apply, based on (1) whether the bank's investment would be an "ownership interest" and (2) whether the fund meet the definition of an investment company (without regard to certain exempts). Thus, resecuritizations of ABS (collateralized debt obligations or CDOs) might be "covered funds" because their assets include securities (the ABS). Even so, an analysis of a bank's particular holdings in such resecuritization would be necessary to determine if they constituted an "ownership interest," which is unlikely to be the case for most ABS other than some CDOs. The Volcker Rule thus does not affect most ABS.

C. Volcker Rule and CLOs

The Volcker Rule's regulatory implementation will potentially require banks to divest from some collateralized loan obligations or CLOs, a particular species of ABS. I do not find this of particular concern. If divestment is required for CLOs, it is no different than the divestment from any other type of fund mandated by the Volcker Rule. Moreover, the application of the Volcker Rule to CLOs will not chill the CLO issuance market.

1. What Is a CLO?

A CLO is a securitization of corporate loans, or more precisely a securitization of a "leveraged loans", a particular type of corporate loan. CLOs are generally actively managed, rated, closed-end, structured investment funds. The term "CLO" refers to both the fund and to the securities it issues. CLOs tend to be actively managed, meaning that the CLO manager may buy and sell assets within preset investment parameters and guidelines.[20] CLO's securities are generally rated by credit rating agencies. CLOs have limited lifetimes (usually less than 10 years, more typically 7-9 years) and a single funding period, so they are closed-end funds. What distinguishes CLOs from other types of investment funds is a CLO invests primarily or exclusively in corporate loans and that

[18] For direct securitizations, such as of most US mortgages, car loans, and student loans, the issuing entity holds the loans directly. For other asset classes, such as equipment lease securitizations, floor plan loan securitizations, and credit card receivable securitizations and some UK RMBS, there is an intermediate securitization, and the ultimate issuer holds the collateral certificates or special units of beneficial interest issued by the intermediate securitization entity, such as a master trust, issuance trust, or collateral trust.

[19] 12 C.F.R. § 248.10(c)(8)(iii).

[20] Loan Syndications and Trading Association, Comment Letter on Credit Risk Retention, Oct. 30, 2013, *at* http://www.lsta.org/WorkArea/showcontent.aspx?id=17146 at 27 ("CLOs are actively managed, and CLO managers can continue to monitor asset quality, and respond appropriately through asset dispositions, through much of the life of the CLO.").

the interests in the CLO are structured (meaning tranched) so that credit and interest rate risks are not allocated pro rata among investors.[21]

The key point to see here is that ***there is no clear difference between a CLO and either a CDO or a hedge fund.*** A CLO is indistinguishable from a rated, structured hedge fund that invests primarily in corporate loans.[22] Not surprisingly, none of the major credit rating agencies have separate ratings criteria for CLOs. Instead, CLOs and collateralized bond obligation are both treated as flavors of collateralized debt obligations (CDOs) by the rating agencies. Likewise, in the UK, CLO is used as the generic term to refer to all CDOs.

Given that there is no substantial difference between CLOs and CDOs, one would expect CLOs to be treated the same as CDOs and hedge funds by Reg VV. In fact, they are not, to the extent that a CLO holds only loans as assets, Reg VV treats it as akin to a passively managed securitization, like those that exist for residential mortgages. This disparate treatment of similar funds is apparently necessitated by a provision in the Volcker Rule that provides that, "Nothing in this section shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law."[23] Thus, Reg VV distinguishes between CLOs with loan-only assets, and all other CLOs, which might also have securities or prohibited derivatives as assets. This provision is a comfort provision for community banks that regulators have incorrectly interpreted as a super-exemption to benefit the too-big-to-fail banks' CLO business.

It also bears emphasis that CLOs are *not* financing small businesses. CLOs invest primarily in the "leveraged loan" market—the highly liquid market in large, syndicated, high-yield corporate loans. The leveraged loan market is the loan equivalent of the high-yield or "junk" bond market. Leveraged loans are heavily traded, tracked on indices, and even receive credit ratings, just like bonds. Leveraged loans are used extensively as financing for takeovers and leveraged buyouts (LBOs), rather than for providing operating capital to Main Street businesses. CLOs provide only part of the market for leveraged loans.

2. CLO Assets: Syndicated Leveraged Loans, but Sometimes More

While CLOs invest primarily in syndicated leveraged loans, some CLOs hold some corporate bonds as well, and more CLOs are at least authorized to purchase corporate bonds. We do not know this because CLO deal documents are not publicly available. Because CLOs are actively managed, those CLOs that are authorized to purchase corporate bonds may do so in the future; the CLO manager is not required to take into account the Volcker Rule effect on CLO investors in its investment decisions. Thus, any CLOs that either hold or are authorized to purchase corporate bonds or derivatives would potentially be "covered funds."

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[21] Indeed, UK terminology uses CLO to refer to genus of structure financial products known in the US as a CDO.

[22] Cf. Davis Polk, Client NewsFlash, *Who Knew CLOs Were Hedge Funds?* Feb. 10, 2014 (assuming that CLOs are obviously different from hedge funds—themselves a poorly defined category of investment fund—but never explaining why).

[23] 12 U.S.C. § 1851(g)(2).

Significantly, we do not know how many CLOs in fact have authority to purchase corporate bonds, much less hold them. There has been some speculation in news media,[24] but there is no data available on this because CLO deal documents are not publicly available. Likely the CLO world separates into three "buckets": a group of CLOs that have no bond or prohibited derivate holdings; a group of CLOs that have a single high-quality bond that can easily be swapped out; and a group of CLOs that have more extensive non-loan holdings. Without knowing the relative sizes of these buckets, it is very difficult to say anything about the effect of the Volcker Rule on existing CLOs. As discussed below, this lack of data point underscores the problems that exist in regulating the CLO market and structured financial products in general given the extensive use of private placements of structured products.

3. CLO Ownership Interests: "For Cause" Removal, Evasion, and Implicit Guarantees

As Reg VV currently stands, banks will be prohibited from holding "ownership interests" in CLOs that are "covered funds." Not all bank investments in CLOs are "ownership interests," however. Reg VV defines "Ownership interest" as "any equity, partnership, or other similar interest,"[25] as well as includes an interest that:

> [h]as the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).[26]

CLOs typically permit investors to remove the CLO manager upon an event of default (as defined in the CLO agreement). Some CLOs also give investors the right to replace the CLO manager "for cause," such as fraud, criminal activity, or material breach of the CLO manager's contract, which might not constitute an "event of default" under the CLO agreement.

Such "for cause" removal rights raise potentially thorny Volcker Rule evasion issues. On their face, "for cause" removal rights are creditor protections, but they can also be used as leverage to exert control over the CLO manager by threatening removal unless the manager accedes to the demands of the investor. Moreover, "for cause" can be defined in ways that link removal rights to fund performance. For example, a failure to hit particular return hurdles could be defined as a material breach of the CLO manager's contract. As with CLO investment authority and actual investment patterns, we do not know how widespread such "for cause" removal provisions are among CLO contracts, much less exactly what they cover. Accordingly, legislating to protect "for cause" removal potentially opens the door to a serious Volcker Rule evasion problem.

The ultimate concern regarding "for cause" removal is not Volcker Rule evasion per se, but that exercise of "ownership rights" will result an implicit guarantee of uninsured investment funds by insured depositories. If bank investments in CLOs have the indicia of ownership of the CLOs, banks might feel under pressure for reputational

[24] Davis Pollk, *supra* note 22.
[25] 12 C.F.R. § 248.10(d)(6)(A).
[26] 12 C.F.R. § 248.10(d)(6)(B).

reasons to bail out their affiliated CLOs should the CLOs get in trouble, even though there is no legal obligation to do so. This type of implicit guarantee can result in the deposit insurance safety net leaking out beyond depositories and effectively insuring speculative investments—without payment of any insurance premia for the risk.

This leakage of deposit insurance beyond insured depositories to speculative investment funds is exactly what the Volcker Rule is designed to prevent. Allowing "for cause" removal rights or any other indicia of fund ownership raises the specter of banks bailing out legally separate funds. This is not a speculative concern. We have seen it happen repeatedly with credit card securitizations, as banks routinely rescue their credit card securitization vehicles from impending "defaults".[27] We also saw this occur in 2007, when many banks took their sponsored Structured Investment Vehicles (SIVs) back on balance sheet[28] and when Bear Stearns bailed out two nominally independent, external hedge funds.[29] In the case of SIVs and the Bear Stearns funds, the implicit guarantee was based around sponsorship and provision of liquidity puts, rather than control in the form of removal rights. All the more so would sponsorship and removal rights be likely to create an implicit guarantee. Accordingly, any sort of ownership indicia, including "for cause" removal rights, might engender the type of implicit guarantee the Volcker Rule is meant to prevent.

4. CLO Ownership Interests: More Than Just "For Cause" Removal

Reg VV's definition of "ownership interest" extends beyond equity interests and "for cause" removal rights. It also includes a set of provisions that effectively make a CLO interest an "ownership interest" if the investor's returns depend on the CLO's performance—indicia that the interest is more like equity than debt. Thus, Reg VV defines "ownership interest to include an interest that:

> (D) Has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);
>
> (E) Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

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[27] *See* Adam J. Levitin, *Skin-in-the-Game: Risk Retention Lessons from Credit Card Securitization*, 81 GEO. WASH. L. REV. 813, 840-41, 847-48 (2013); Joseph R. Mason et al., *Asset Sales, Recourse, and Investor Reactions to Initial Securitizations: Evidence Why Off-Balance Sheet Accounting Treatment Does Not Remove On-Balance Sheet Financial Risk*, May 22, 2009, *available at* http://ssrn.com/abstract=1107074 (sponsors intervened for credit card securitization trusts 17 times between 1991 and 2001). Technically, the issue for credit card securitizations is not a "default," but an early amortization event that will result in the termination of the securitization vehicle as a funding mechanism for future credit card lending.

[28] William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. Cal. L. Rev. 783, 842 (2013)

[29] *Id.* at 841-42.

> (F) Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund;[30]

Many CLO interests will qualify as an "ownership interest" on the basis of these tests, irrespective of "for cause" removal rights. In particular, nearly all CLOs have overcollateralization (O/C) and interest coverage (I/C) tests as standard creditor protections.[31] If these tests are not met, then cashflows are diverted from junior tranches to pay down senior tranches and deleverage the CLO. The effect of O/C and I/C tests is to ensure that "the amounts payable by the covered fund with respect to the interest could be reduced on based on losses arising from the underlying assets of the covered fund". Accordingly, legislating changes to protect "for cause" removal rights may not have much effect on the application of the Volcker Rule to CLOs. Bank investments in CLOs may still be "ownership interests" on separate, independent bases than "for cause" removal rights.

5. Legacy CLO Issues: Uncertain Scope, Limited Concern, and Surgical Fixes Possible

Recall that Reg VV would require a bank to divest from a CLO only if both (1) the CLO has an investment in corporate bonds or prohibited derivatives and (2) the bank's interest in the CLO would give it the right to remove management absent an event of default (or an equity interest). No one knows the universe of CLOs for which these two conditions both apply, and it is specious to suggest that concern over this issue is somehow chilling the CLO issuance market. At most, the Volcker Rule is a problem for some bank investments in legacy CLOs. The Volcker Rule is *not* a problem for the CLO market going forward.

For some unknown number of legacy CLOs, banks will potentially have to divest if the CLOs hold bonds and if the bank's investment qualifies as ownership interest for any reason, not just "for cause" removal, but also sharing in upside benefits or downside risk. We should not assume, however, that banks are helpless in regard to the investments of CLOs.

Because too-big-to-fail banks are major sponsors and buyers of CLOs, too-big-to-fail banks have a great deal of market power that they can exert on CLO managers. (Community banks are unlikely to have significant holdings of CLOs.) A CLO manager that wants to get future business from too-big-to-fail banks is likely to agree to remove isolated bond holdings from a CLO's portfolio. Banks' market power alone is likely to result in many of the CLOs that currently qualify as "covered funds" to cease to meet that definition by the divestment date in Reg VV.

To the extent that divestment is required, it is not particularly problematic. Banks have until July 21, 2015 to divest from ownership interests in covered funds,[32] and

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[30] 12 C.F.R. § 248.10(d)(6)(D)-(F).

[31] *See, e.g.*, Babson Capital White Paper, *What are CLOs and how do they work?* July 2009, at http://www.babsoncapital.com/BabsonCapital/http/bcstaticfiles/Research/file/CLO%20White%20Paper_CLOWP4309_Jun09.pdf.

[32] *See* Board Order Approving Extension of Conformance Period, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

individual banks may receive a two-year extension for the divestment period.[33] Additionally, the Federal Reserve Board has authority to extend the conformance period for all banks for up to two additional years.[34] The CLO market is reasonably liquid,[35] so there is little reason to think that such divestments with a period of up to three years would result in fire sale prices and losses for too-big-to-fail banks (provided that banks have been keeping their CLO interests on their trading books and marking them to market, rather than keeping them at book value as hold-to-maturity assets). Indeed, banks will not need to divest at all from many ownership interests in covered funds because the funds will have paid off before the end of the divestment period.

Concerns about divestment prices are not unique to CLOs. This is an issue that applies to all other sorts of proprietary investments of banks that are prohibited under the Volcker Rule. There is nothing special about CLOs in regard to the Volcker Rule. While one might reasonably criticize Reg VV for imposing an artificial distinction between bonds and loans (particularly between bonds and syndicated loans), this is a distinction that has long existed in securities regulation, and there are still important differences between bonds and loans (as a general matter): bonds tend to have fewer and weaker covenants and tend to be unsecured, whereas loans tend to have more covenants and are secured. Accordingly, it might make sense to treat an investment in a fund containing solely loans as less speculative than an investment in a fund containing both loans and bonds.

If Congress thinks it is appropriate to reopen the legal distinction between loans and bonds, it is important to recognize the implications. If we were to treat bonds and loans identically for regulatory purposes, we could either ratchet down and deregulate the bond market...or we could ratchet up and subject the syndicated loan market to securities regulation, which is the last thing that market wants. I express no position here as to which would be the proper course. Instead, I only make this observation to underscore that disregarding the loan-bond distinction has implications that reach beyond the CLO market.

To the extent that Congress is worried about banks having to divest from legacy CLOs, there are a number of discrete, surgical fixes possible, and most do not require legislation. First, regulators could be persuaded to clarify Reg VV to create a *de minimis* bond holding exception for existing CLOs or to create an exception for "for cause" removal rights in CLOs. Another solution would be for regulators to announce a policy of forbearance for banks that waive their "for cause" removal rights. Yet another would be a longer divestment period. Most CLOs have a life of 10 years or less, so the longer the divestment period, the greater the run-off of existing CLOs and the less divestment necessary. Moreover, banks often hold the senior tranches of CLOs, which might have faster paydowns than the junior tranches, so the maturity of bank investments in CLOs might be less than CLO lifespans.

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[33] 12 C.F.R. § 248.12(e).

[34] See 12 U.S.C. 1851(c)(2) (the Board has already granted one additional year of conformance time, so only two additional years can be granted now).

[35] *See* Andreas A. Jobst, *Collateralised Loan Obligations (CLOs); A Primer*, http://www.securitization.net/pdf/fmg_clo_100102.pdf.

6. The CLO Market Going Forward: Market Solutions

What is clear is that the Volcker Rule's application to CLOs should not affect the availability of capital to business borrowers. Divestment from existing CLOs does not affect capital availability, as these CLOs, and the loan they have invested in, are already funded. Although some critics of the Volcker Rule have attributed a recent drop in CLO issuance to the Volcker Rule, they have neither identified why the Volcker Rule would cause such a drop in issuance, nor have they explained why CLO issuance is now up for the first three weeks of February 2014 to $4.4 billion over its 17-month low of $2.55 billion in January 2014.[36]

Going forward, the Volcker Rule should not be a problem for the CLO market. If CLO sponsors want to attract banks to the investment class—which they surely will—they will structure CLOs to either (1) restrict investments solely to loans, (2) remain outside of the definition of covered fund by using the Rule 3-a7 exemption from the definition of "investment company," or (3) provide for CLO interests without removal rights, potentially as a separate class of CLO interests.

Already, some new CLOs have loan-only investment restrictions.[37] Similarly, some new CLOs are being structured to qualify for the Rule 3-a7 exemption from the definition of "investment company," which is the starting point for the definition of a "covered fund."[38] Finally, the issuance of separate classes of securities to satisfy regulatory requirements is already widely done to ensure that securities are available for purchase by insurance companies or pension plans. NAIC rules require that insurers invest in securities from domestic issuers. Thus, CLOs and CDOs, which use Cayman Islands entities as their primary issuers, will also have a Delaware entity co-issuer for a class of securities for sale to insurance companies. Similarly, pension plans are required to purchase only ERISA-qualified securities, and many ABS deals will have a special ERISA-qualified class or classes to satisfy this market. In short, I do not see the Reg VV treatment of CLOs as a particular concern, and I do not it as a basis for a broader reconsideration of the Volcker Rule.

III. REPRESENTATIONS AND WARRANTIES

One of the biggest lessons for ABS markets from the financial crisis was the importance of representations and warranties and their enforcement mechanisms. ABS investors are investing in a discrete pool of assets, and their investment pricing is based on the quality of those securitized assets. If the assets are not of the quality promised, then the entire basis for the investment decision is undermined. This was particularly a problem for private-label mortgage securitizations, but the issue is of concern to ABS

[36] *The Impact of the Volcker Rule on Job Creators: Hearing Before the H. Fin. Serv. Comm.*, 113th Cong., (2014) (statement of Elliot Ganz, Executive Vice President and General Counsel of the Loans Syndications and Trading Association); *See also* Kristen Haunss, *CLO Issuance Jumps as U.S. Managers Bet on Volcker Rule Verdict*, BLOOMBERG (Feb. 19, 2014), http://www.bloomberg.com/news/2014-02-19/clo-issuance-jumps-as-u-s-managers-bet-on-volcker-rule-verdict.html.

[37] Carol J. Clouse, *Another Volcker Workaround for CLOs*, ASSET SECURITIZATION REPORT, Feb. 18, 2014.

[38] *Id.*

investors generally. ABS investors need to have confidence that the representations and warranties that accompany their investments will be correct and, to the extent they are breached, that they will be enforced. To the extent that ABS investors do not think that the representations and warranties on their investments will be honored, they will be reluctant to invest, particularly in the more junior tranches that bear the majority of the credit risk.

Section 943 of the Dodd-Frank Act is an attempt to help create better market discipline for ABS by forcing disclosure of information about representations and warranties and loan repurchase requests. Section 943 requires the SEC to promulgate regulations requiring credit rating agencies to include in their ABS ratings reports a description of the deal's representations and warranties and enforcement mechanisms and their difference from similar deals.[39] Section 943 also requires the regulations to require securitizers to disclose the fulfilled and unfulfilled repurchase requests for all of its trusts "so that investors may identify asset originators with clear underwriting deficiencies." The SEC fulfilled its rulemaking requirement in early 2011.[40]

The information required by section 943 is not particularly burdensome to compile, and it is potentially very valuable for improving the efficiency of ABS markets, as the data allows ABS investors to identify problematic originators (and sponsors) and thus avoid their future deals. In theory, this should enable better market discipline. Originators and sponsors should be incentivized to securitize loans that conform to the representations and warranties made on them, so that they will be able to sell future deals.

I have doubts about whether such disclosures are likely to be effective. First, originators can easily avoid reputational sanctions by operating under multiple (and changing) names. And second, the information produced may not be timely. Putting aside early payment defaults, the indications of high repurchase requests are unlikely to occur for a few years, by which point it may be too late; it only takes a few years for an asset bubble to form. To wit, the housing bubble was only from 2003-2006. Nonetheless, section 943 is a step forward toward a more transparent ABS market.

It is worthwhile noting that section 943 and the rules thereunder require only disclosure. They do not mandate the use of any particular representations and warranties. While there is some purchase to the idea of a mandatory or at least a default set of representations and warranties for different ABS classes—something that Chairman Garrett has proposed in both PATH Act[41] and the Private Mortgage Market Investment Act[42]—section 943 does not go so far as mandating contract terms for sophisticated private parties.

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[39] *Id.* § 943 (codified at 15 U.S.C. § 78o-7 note).

[40] 76 Fed. Reg. 4511, Jan. 26, 2011, *codified at* 17 C.F.R. §§ 229.1104, 229.1121, 240.15Ga-1(a), 240.17g-7.

[41] Protecting American Taxpayers and Homeowners Act, Title III, *available at* http://financialservices.house.gov/uploadedfiles/bills-113hr-pih-pathdd-ss.pdf (directing a privately owned mortgage securitization utility to develop "best practices" for representations and warranties and remedies).

[42] Private Mortgage Market Investment Act, Title II, *available at* http://financialservices.house.gov/uploadedfiles/pmmia_bill.pdf.

IV. Credit Risk Retention

Section 941 of the Dodd-Frank Act requires securitization sponsors and issuers to retain at least 5% of the credit risk in any non-exempted securitization. Statutory exemptions exist for securitizations backed by "qualified residential mortgages" (QRM) and for securitizations meeting certain underwriting standards, which are to be defined in a joint rulemaking by the SEC, Federal Reserve Board, FDIC, OCC, FHFA, and HUD.[43] These agencies issued an initial notice of proposed rulemaking under section 941 on March 28, 2011.[44] The agencies have subsequently re-proposed a revised rule on August 26, 2013.[45]

A. Qualified Residential Mortgage Definition

There are serious deficiencies with the re-proposed rule, particularly related to the treatment of residential mortgage securitizations. Most significantly, in the re-proposed rule, QRM is defined in the broadest possible way permitted by statute,[46] namely as any mortgage that meets the regulatory definition of a Qualified Mortgage (QM), which is used to provide a safe harbor for the Dodd-Frank Act's ability-to-repay requirement.[47] QM is variously defined for different types of mortgages by the CFPB,[48] HUD,[49] the VA, the Department of Agriculture, and the Rural Housing service.[50]

The breadth of this definition is surprising because the CFPB's QM rulemaking was a consumer protection rulemaking, rather than a systemic stability rulemaking. Thus, some commentators have (wrongly) criticized the QM rulemaking for not accounting for loan-to-value ratios,[51] but loan-to-value ratios do not affect *ability* to repay a mortgage, and the CFPB correctly adhered to its statutory mandate. Loan-to-value ratios do, however, affect the probability of default and loss-given-default, both of which matter from a systemic stability standpoint.

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[43] 12 U.S.C. § 78o-11(c)(1)(B).

[44] Credit Risk Retention, 76 Fed. Reg. 24090, 24167 (Apr. 29, 2011) (original proposed QRM rule). Federal Register publication lags behind agency approval of proposals.

[45] Credit Risk Retention, 78 Fed. Reg. 57928-01 (Sept. 20, 2013) (reproposed QRM rule). Federal Register publication lags behind agency approval of proposals.

[46] Credit Risk Retention, 78 Fed. Reg. 57928-01 (Sept. 20, 2013) (the reproposed rule making has some other minor requirements, such as the loans be performing loans, that they not include any resecuritizations, and that the securitizer certify certain internal controls).

[47] 15 U.S.C. § 1639C.

[48] 12 C.F.R. §1026.43.

[49] Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages, 78 Fed. Reg. 75215-38, (Dec. 11, 2013), *codified at* 24 C.F.R. §§ 201.7 (property improvement and manufactured housing loans), 203.19 (single family), 1005.120 (Indian housing), 1007.80 (Native Hawaiian housing).

[50] 15 U.S.C. § 1639C(b)(3)(B)(ii).

[51] *See, e.g.*, Edward J. Pinto, Peter J. Wallison, *New Qualified Mortgage Rule Setting us up for Another Meltdown*, WASHINGTON TIMES (Mar. 3, 2013), http://www.washingtontimes.com/news/2013/mar/3/wallison-and-pinto-new-qualified-mortgage-rule-set/?page=all.

The original credit risk retention proposal defined QRM to include reference to loan-to-value ratios,[52] as well as downpayment and appraisal requirements,[53] and more restrictive debt-to-income ratios than permitted under the CFPB's and HUD's QM rulemakings.[54] The absence of loan-to-value ratios or of other features designed to discourage pro-cyclical lending means that QRM is not doing any work that is not already done by QM. The absence of loan-to-value requirements for residential mortgages in the section 941 rulemaking is particularly striking because there is a loan-to-value requirement for commercial mortgage securitizations to be excused from credit risk retention.[55] Skin-in-the-game is meant to be a systemic stability regulation, but it has instead been pegged to a consumer protection regulation.

The section 941 credit risk retention reproposal also provides that for *commercial* mortgage securitizations to be exempted from credit risk retention the securitizations had to employ independent, unconflicted operating advisors.[56] An independent operating advisor will help reduce some of the conflicts of interest in commercial mortgage securitizations. It is puzzling why a similar intervention was not required for the QRM exemption for *residential* mortgages given the serious conflicts of interest that have plagued residential mortgage securitizations due to the affiliations between servicers, sponsors, and depositors, and the lack of incentives for trustees to monitor performance of the loans or representations and warranty compliance.

Indeed, the operating advisor requirement for CMBS underscores a significant change in the QRM reproposal from the original proposal. The original credit risk retention proposal also included a requirement as part of the QRM definition that a securitization's deal documents must require loss mitigation with a goal of maximizing net present value of the loan, without reference to the interests of any individual tranche of MBS investors.[57] This requirement was eliminated—without any comment by the agencies—from the reproposed rulemaking. The elimination of loss mitigation is not in reaction to CFPB regulations, as the CFPB's Reg X servicing rules do not require such loss mitigation; instead Reg X requires that if loss mitigation is offered, it must comply with certain regulatory features.[58] The QRM reproposal should include a net present value positive loss mitigation requirement and provisions mandating an equivalent of an independent operating advisor to ensure representation and warranty compliance in MBS, which is an important step toward creating a stable and sustainable private-label MBS market.

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[52] Credit Risk Retention, 76 Fed. Reg. 24090, 24167 (Apr. 29, 2011) (proposed QRM rule).

[53] *Id.*

[54] *Id.* at 24166.

[55] Credit Risk Retention, 78 Fed. Reg. 57928-01 (Sept. 20, 2013), proposed rule §§ _.17(5) (LTV and CLTV requirements for commercial mortgages), _.15 (no credit risk retention required if underwriting standards are met); _.14 (definitions of LTV and CLTV.

[56] Credit Risk Retention, 78 Fed. Reg. 57928-01 (Sept. 20, 2013), proposed rule § _.7(b)(6) (requirements for CMBS exemptions from credit risk retention).

[57] Credit Risk Retention, 76 Fed. Reg. 24090, 24167 (Apr. 29, 2011) (proposed QRM rule).

[58] Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696, 10823 (Feb. 14, 2013), *codified at* 12 C.F.R. Pt. 1024 ("the Bureau has clarified in response to inquiries raised by commenters that servicers are not required by the Bureau's rules to offer any particular loss mitigation option to any particular borrower.").

B. Impact of Credit Risk Retention on ABS Markets

It is hard to say what the ultimate impact of the credit risk retention rules, if adopted, will be on ABS markets. The rulemaking estimates an impact of between zero and 30 basis points for the cost of credit, depending on whether the retained credit risk is funded through equity issuance, term debt, or bi-lateral repo.[59] I have no reason to gainsay this estimate.

The impact of credit risk retention is likely to vary by market. For some markets, like credit card ABS, it should not matter, as there is already credit risk retention mandated by deals, namely that the seller keep an untranched "vertical" seller's interest of a specified percentage (often at least 4%, if not 7%).[60] Moreover, many ABS markets are really funding markets, rather than risk transfer markets. For operating companies that rely on securitization as a steady funding source—credit card issuers, auto finance companies—credit risk retention should not particularly matter because these issuers are already strongly incentivized to engage in good underwriting in order to retain future access to capital markets. For these companies, credit risk retention might result in a small increase in the cost of funding, which would have to be done through other means—deposits and general corporate debt. Credit risk retention only really matters for mortgage securitization markets where the securitizers are not the operating companies and securitization is about credit risk transfer as well as funding.

C. Credit Risk Retention Will Not Work Unless Too-Big-to-Fail Is Addressed

Irrespective of the details of the section 941 rulemaking, I am skeptical whether credit risk retention can be effective so long as the too-big-to-fail (TBTF) problem remains unaddressed. The conceit behind credit risk retention is that if securitizers have to "eat their own cooking," they will take care that it is not toxic—credit risk retention should ensure better underwriting of securitizations. Credit risk retention may not work, however, when dealing with TBTF financial institutions. If a TBTF bank believes that it will be bailed out at taxpayer expense, credit risk retention will not incentivize it to ensure better underwriting of securitizations. In a TBTF world, securitizers gain all of the upside of undertaking more securitizations, while the downside risk from the credit risk retention is borne by the taxpayers. We saw a version of this in the 2008 financial crisis. Some of the firms that blew up were the ones that retained the most risk, such as Citibank (retained tranches of CDOs), Countrywide (payment option ARMs kept on balance sheet), and Washington Mutual (various non-prime mortgages kept on balance sheet). Even worse, the section 941 credit risk retention requirement could have a lulling effect on other investors, who wrongly assume that the structured financial products are safe for investment because the securitizers are also investing in them. As long as we are living with TBTF, we should be encouraging credit risk retention only for financial institutions that can actually fail. TBTF needs to be addressed for structured finance reforms to be effective.

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[59] Credit Risk Retention, 78 Fed. Reg. 57928-01, 58020 ("Our range of reasonable estimates of the cost of risk retention is between zero and 30 basis points.").

[60] Levitin, *supra* note 27, at 816, 831.

CONCLUSION

A great deal of uncertainty still hangs over the ABS and CLO markets as the shape of both regulatory reform and market reform are not yet complete. The largest ABS markets are based around the financing of mortgage loans, and as long as the GSE question remains unresolved, it seems unlikely that we will see a major rebirth of private-label mortgage securitization. Yet other ABS markets have been rebounding and hopefully will continue to do so. The best regulatory approach at present is to allow Dodd-Frank Act rulemakings to go into effect and continue to monitor the market's recovery rather than to try and correct course prematurely.

Statement of the U.S. Chamber of Commerce

ON: The Dodd-Frank Act's Impact on Asset-Backed Securities

TO: The Subcommittee on Capital Markets and Government Sponsored Enterprises

BY: Tom Quaadman, Vice President of the Center for Capital Markets Competitiveness

DATE: Wednesday, February 26, 2014

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises. My name is Tom Quaadman, and I am Vice President of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber"). The Chamber is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and is dedicated to promoting, protecting, and defending America's free enterprise system. I appreciate the opportunity to testify before the Subcommittee today on behalf of the businesses the Chamber represents.

I would like to thank Chairman Garrett, Ranking Member Maloney and the members of the Capital Markets and Government Sponsored Enterprises for holding this important hearing, *The Dodd-Frank Act's Impact on Asset-Backed Securities.*

The American economy has the most innovative and diverse financing system in the world.[1] Efficiency is one of the key drivers of this system. The more efficient our financial system is, the greater its capacity to support business growth and economic expansion. If our financial system is efficient there are a number of resulting benefits: it is easier for businesses to obtain the resources needed to grow and operate; more new companies are launched; more companies can go public; businesses can manage risk more affordably; and there is greater availability of consumer credit (which is an important source of initial financing to many entrepreneurs). In other words, a diverse, well-developed, and efficient system of capital formation is necessary for robust economic growth and increased employment.

Our financial system has been one of the most innovative sectors of our economy. While many western industrialized economies have lumbered forward

[1] In testimony given before the Subcommittee on Capital Markets and Government Sponsored Enterprises for the October 24, 2013 hearing entitled: *Legislation to Further Reduce Impediments to Capital Formation*, the Chamber included, as appendix A, a 2011 study released by the Chamber authored by Professor Anjan Thakor of Washington University entitled, *Sources of Capital and Economic Growth: Interconnected and Diverse Markets Driving U.S. Competitiveness* ("Thakor Study"). The Thakor Study found that a key factor for small business success and resulting growth and job creation is their ability to access financing. The Thakor Study had five key conclusions:

1. A robust, efficient and diverse financial system facilitates economic growth;
2. In terms of their financing choices individual entrepreneurs are largely limited to debt financing for raising capital;
3. As businesses grow they can access both debt and equity financing and the mix of these two, called the "capital structure" decision, is an important choice every business makes;
4. A rich diversity of financing sources is provided by the U.S. financial system; and
5. The U.S. financial system is highly connected and what happens to one financing source causes spillover effects in other parts of the system. So for example, if excessive regulation restricts access to, or the operation of, the IPO and secondary markets for publicly traded companies, the resulting loss of liquidity will act as a disincentive to private equity and venture capital activity as well.

wedded to traditional, static financial sectors, American entrepreneurs and the financing systems that support them have proven adept at finding new ways to finance American business. For instance, this has taken the form of non-traditional use of financing, such as home equity loans for small business owners, or the use of new technologies such as securitizations.

Securitization has been used for decades, and while it is most closely associated in the public eye with home mortgage financing, it has in recent decades come into widespread use as a form of business financing. Securitizations allowed for robust financing that, when used judiciously, permitted the safe dispersion of risk and eventually grew to encompass a large segment of the debt markets.

We are all aware of the problems with mortgage backed securities comprised of poorly-underwritten sub-prime mortgages and their role in the financial crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") attempted to address these problems through the risk retention provisions contained in Section 941 of the Act. The Chamber initially supported the concept of risk retention. However, as I will explain in greater detail, this has unintentionally targeted forms of business financing that performed well during the financial crisis.

Securitization has become a vital component of our system of finance over the past two decades and now provides a critical source of funding alongside more traditional balance sheet lending. It is important to note that not all securitized products are the same – there are different classes of underlying assets, different structures, and contrasting credit risk profiles. It is also important to note that other securitization asset classes did not experience the wholesale meltdown experienced by subprime RMBS. Uniform application of the rules to different products would heighten the risk that the rules could adversely affect credit availability.

The regulations implementing Section 619 of the Dodd Frank Wall Street Reform and Consumer Protection Act prohibiting proprietary trading by financial institutions (the "Volcker Rule") is having an immediate impact upon certain forms of capital formation used by businesses to obtain the resources to grow and create jobs. The Chamber repeatedly wrote to, and met with, regulators urging them to consider the impacts of the Volcker Rule upon the ability of non-financial businesses to raise capital.[2] As the Volcker Rule will not become fully operational until the end of the conformance period in July, 2015, the problems I will discuss today will only be the first of many problems that will impact non-financial businesses. These impediments

[2] *See* comment letters of October 11, 2011, November 17, 2011, December 15, 2011, January 17, 2012, February 13, 2012, February 14, 2012, April 16, 2012, November 16, 2012, September 25, 2013, November 7, 2013 and November 25, 2013 from the U.S. Chamber of Commerce to the regulators and FSOC.

to capital formation are not only confined to the Volcker Rule, but to other portions of the Dodd-Frank Act as well.

The best current example of such impediments is how Collateralized Loan Obligations ("CLOs") are adversely impacted by both the Volcker Rule and Risk Retention regulations.

CLOs are a form of a securitization, but more like a hybrid combined with a portfolio loan. Having grown over the course of time, CLOs provide business financing to companies in 47 states and the District of Columbia that collectively employ over five million Americans. CLOs are primarily used as a non-investment grade vehicle and give small-, midsize-, or challenged-businesses a stream of capital formation. A broad swath of corporate America participates in this market, including companies from the health care, energy, retail, entertainment, and telecommunications sectors, to name just a few.

Because CLO portfolios are managed and comprised almost exclusively of senior, secured non-real estate corporate loans, they performed well during the financial crisis. The CLO market performed largely as expected during the financial crisis. Unlike structured products based on subprime mortgages, many of which experienced considerable losses in recent years, investment grade CLO tranches experienced very few aggregate losses.[3] In the past 16 years combined, CLOs have experienced a cumulative *impairment* rate of approximately 1.5%, and the actual *loss* rate was even lower, which is well in line with investor expectations. The Federal Reserve Board acknowledged a low default rate for CLO collateral in its Report to Congress on Risk Retention in October 2010, citing the aligned incentive mechanisms inherent in CLO structures.[4]

The Chamber expressed serious concerns that the regulators had failed to take into account the impact of the Volcker Rule upon the capital formation of Main Street businesses. An economic analysis, as required under the Riegle Act, may have been able to identify harmful impacts upon Main Street businesses, but no such study was undertaken with the Volcker Rule. While it appears that the regulators tried to address some of these concerns, the issue regarding Collateralized Loan Obligations shows that the financial regulators may have missed the mark, and this failure has real-life consequences that are harmful to the overall economy.

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[3] In fact, most CLO debt downgraded during the crisis has been subsequently upgraded with most originally rated AAA tranches still rated at least Aa- or better, even under new stronger requirements from the agencies. CLO mezzanine debt, originally rated below investment grade, will not take any losses and CLO equity outperformed original pre-crisis expectations.

[4] *See* Board of Governors of the Federal Reserve, Report to Congress on Risk Retention, October 2010.

CLOs provide over $300 billion in financing to thousands of businesses. One surprising, and troubling, development in the final rulemaking on the Volcker Rule is the excessively broad definition of "ownership interest." This definition is used to determine whether a bank owns an interest in a covered fund, like a hedge fund, that must be divested under Volcker. The regulators far exceeded the requirements of the statute, and their definition of "ownership interest" includes not only equity in such a fund, but also the "right to participate in the election or removal" of the investment manager. In so doing, regulators swept certain bank bond portfolios into a prohibition directed at hedge fund ownership.

As a result many banks are being forced to sell off debt like CLOs and may not participate in offering such notes in the future. CLO notes are clearly debt, not equity, and have a long track record of stable and steady performance – the historic default rate of CLOs is under 1.5%, and the loss given default much lower than that. These are assets that withstood the stress of the financial crisis, and continue to trade at or close to par.

Why would banks be forced to divest a safe debt instrument under a provision of law intended to cover hedge funds? Because the highest rated class of CLO debt carries with it the right to participate in the selection of a new investment manager if, and only if, the CLO equity owners remove a poorly performing manager for cause, prior to an actual default. This right is a prudential creditor protection—it permits senior creditors to have a voice in actions taken to avert disaster. In a sense, this is the same type of power that we want our prudential regulators employing with respect to a troubled financial institution.

U.S. banks currently own about $70 billion worth of CLO debt. Foreign banks whose operations are subject to Volcker own about $60 billion in addition to this. Any effort to restructure this amount of debt would be overwhelming. As a result, we are likely to see banks begin to sell off these performing assets, which would put downward pressure on prices and start a rush to liquidate. Ironically, this would benefit hedge funds and others who can purchase strong, performing assets at steep discounts, but it would remove significant capital from the banking system. Equally important, this will remove a major source of liquidity from the CLO market, and make it harder for business that need the CLO market for loans to find the financing that they need to operate grow, and create jobs.

These concerns are also no longer theoretical. Bloomberg has recently reported that CLO issuances in the United States were down by 60% in January and that some forms of CLO activities are now migrating to Europe.

Accordingly, the Chamber supports the discussion draft introduced by Representative Barr. The Barr discussion draft corrects the defect of the Volcker Rule by aligning the definition of ownership interests to CLOs that exist as of December 31, 2013. This would prevent the fire sale of existing CLOs that harm the institutions that hold them and depress the existing markets harming new CLO issuances. Passage of the Barr discussion draft would also allow the regulators the time to fix the potential adverse impacts of the Volcker Rule upon Main Street businesses. The Chamber also believes that the Barr discussion draft should include a requirement that a comprehensive study of Dodd-Frank rules be conducted to better understand the interaction of various regulatory initiatives and their impacts upon Main Street businesses.

The Chamber has repeatedly called for a comprehensive study of the cumulative impacts of Dodd-Frank and Basel III upon the capital formation capabilities for Main Street businesses. As an example, the failure to have a clear derivatives end-user exemption could hamper the ability of a company to mitigate risk; the Volcker Rule may impede the ability of businesses to raise capital in the debt and equity markets; Basel III could harm business lending through negative risk weights for commercial lines of credit; while looming money market fund regulations may hurt the ability of businesses to access the commercial paper markets and use effective cash management techniques.

The one place these initiatives converge is with the business trying to raise capital. If the business cannot raise capital, or only do so in a less liquid and more expensive environment, then businesses cannot grow, create jobs, or may even have to shutter their doors. For these reasons, the Chamber last year issued a study *How Main Street Businesses Use Financial Services* [5] to show how businesses use financial services. A comprehensive study of the cumulative impacts of these regulatory initiatives upon this diverse mosaic of capital formation is needed before Basel III and certain Dodd-Frank Act provisions, such as the Volcker Rule, are implemented.

This may only be the first wave of capital formation problems that may crop up as a result of the Volcker Rule. Accordingly, the Chamber supports the introduction and passage of the Barr discussion draft to correct the ownership interest definition for CLO's and preserves an important and necessary form of financing for Main Street businesses.

[5] The study can be found at: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/CCMC-Main-Street-Businesses-Survey_summit1000pdf.pdf

CLOs are also not solely impacted by the Volcker Rule. The proposed risk retention rules also restrict the ability of Main Street businesses to use CLOs. It should be noted that the Qualified Residential Mortgage rules carve out the mortgaged back securities that contributed to the financial crisis, but that business financing such as CLOs, which were not a cause of and performed well during the financial crisis, are still subject to the proposed risk retention rules.

CLOs are not the type of originate-to-distribute securitizations that the risk retention rules were designed to address. CLO managers already have "skin in the game" by virtue of a number of unique characteristics embedded within the CLO structure, including the fact that managers receive a majority of their fees only after investors get paid. Notwithstanding the aligned interests between managers and investors, the proposed rule requires that CLOs provide that the "sponsor" must retain 5% of the fair value of a new CLO. This would mean more onerous requirements for CLOs than for other asset classes, as the proposed "5% of fair value of the CLO" retention requirement exceeds the requirement applicable to other asset classes. Under the proposed rule, the CLO sponsor remuneration is restricted until the CLO notes begin to amortize. Since CLO notes do not begin to amortize until the end of the reinvestment period, which occurs years into the future, this restriction on cash flows would render the economics of such an arrangement unworkable.

In conclusion, I would like to note that this Committee is to be commended for the leadership it has demonstrated curtailing the problems associated with Volcker Rule implementation. Again, the Chamber believes that a comprehensive review of the impact of Dodd Frank and other regulatory initiatives undertaken in the wake of the financial crisis are warranted to prospectively identify other impediments to capital formation for business.

Testimony of Paul Vanderslice on behalf of the Commercial Real Estate Finance Council
House Financial Services Committee, Subcommittee on Capital Markets and Government Sponsored Enterprises
Hearing on "The Dodd-Frank Act's Impact on Asset-Backed Securities"
February 26, 2014

Thank you Chairman Garrett, Vice Chairman Hurt, and Ranking Member Maloney for the opportunity to testify today. I am the co-head of the U.S. CMBS Group and the head of the Commercial Mortgage distribution efforts for Citigroup Global Markets. However, I am testifying today on behalf of the Commercial Real Estate Finance Council, or ("CREFC"), where I most recently served as Chair. My comments will focus on the recently re-proposed risk retention rules and CMBS.

CREFC is the collective voice of the entire $3.1 trillion commercial real estate finance market. Its members include balance sheet, Agency and CMBS lenders as well as loan and bond investors and servicing firms of all types. Our industry plays a critical role in the financing of all types of income producing properties – commercial and multifamily.

My testimony today will focus only on the CMBS side of commercial real estate finance as CMBS is the sector subject to the risk retention rules and Regulation AB. To give you a better sense of the significance of this industry, Mr. Chairman and Ranking Member Maloney, in the combined New York MSA, there are thousands of properties with outstanding CMBS loans totaling over $66 billion. Mr. Vice Chairman, in the Commonwealth there are over 2,100 properties with outstanding CMBS loans with a value of over $26.2 billion.

CMBS is an integral component of CRE lending because it expands the pool of available loan capital beyond what balance sheet lenders (banks and insurance companies) can contribute.

In 2013, CMBS provided almost 25 percent of all CRE financing – over $80 billion.[1] CMBS also provided 34 percent of all CRE loans to tertiary markets and 24 percent to secondary markets.[2] No other lender source comes close to serving these markets to that extent.

The proposed CMBS retention rules impose a cost on borrowers that is projected to be between 40 to 50 basis points. This translates into an increased cost burden on commercial property owners of 8 to 10 percent at current market borrowing rates of approximately 5 percent. CRE values are highly correlated to the cost of financing.

A strong consensus across all CREFC constituencies was reached on a set of recommendations to the risk retention rules re-proposed this past August. These recommendations are discussed in detail in CREFC's written comments.

In promulgating the rules, the Agencies stated that their goal is "to minimize the potential for the proposed rule to negatively affect the availability and costs of credit to consumers and businesses."[3] For CMBS, the Agencies also made it clear that they are trying "to balance two overriding goals: (1) not disrupting the existing CMBS third-party purchaser structure, and (2) ensuring that risk retention promotes good underwriting."[4]

CREFC and its members are supportive of the goal of risk retention in the proposed rules. However, we believe strongly that the rules should provide optionality and flexibility for achieving this goal. Simply put, there is more than one means to an end. Allowing our industry this optionality and flexibility will allow risk retention to be achieved fully but with the least possible amount of marketplace disruption.

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[1] Real Capital Analytics.
[2] Real Capital Analytics.
[3] *See* Proposed Rule, Credit Risk Retention, 78 Fed. Reg. 57928, 57934 (Sept. 20, 2013).
[4] *Id.* at 57958.

Today, I will address our core recommendations we submitted to regulators.

Cash Flow Test for the Eligible Horizontal Retained Interest

First, regulators are concerned about a misalignment of interest between issuers and investors if cash flow rates allow an issuer to get cashed out of its investment before investors. Therefore, they proposed a cash flow test designed to align payouts to issuers and investors, respectively. However, the test is fatally flawed when applied to CMBS issuances. All CMBS transactions would fail the test because of the inherent structure of CMBS deals. The Agencies recognized the flaw and asked us to provide a better test method which we have done. That proposed solution is unanimously supported by all CREFC constituencies, including investors.

B-Piece Structure Issues

Second, for CMBS only, the proposed rules allow a third-party purchaser that buys the first-loss position to bear the retention obligation. These so-called B-Piece investors are a bedrock component of CMBS deal structures and both the statute itself and the regulators recognize their importance and the discipline they bring to the underwriting process. The re-proposed regulations, however, have two significant flaws which must be corrected:

1. The actual amount of retention required under the re-proposed rules is quite significant – effectively 5 percent of the cash proceeds (or "fair value") of the bond sales – which is about double the capital investment made by B-piece buyers in current deals. This means that the B-piece buyer will have to buy not only the non-rated tranche and some of the low B to BB rated bonds (current practice), but also BBB and even A class bonds. Typical buyers of these mezzanine bonds are insurance companies, money managers and mortgage REITs. B-piece buyers are not capitalized to buy these higher rated bonds.

To mitigate this investment capital burden, the regulations allow two B-Piece investors to jointly share the retention obligation. However, the proposed risk retention rule requires that they must hold their positions side by side on a *pari passu* basis. This arrangement doesn't help the B-piece investor buy further up the capital stack as is required to fulfill its risk retention obligation. Instead of investing *pari passu*, the B-piece buyer and another investor should be allowed to stack their respective investments on top of one another to achieve the 5 percent requirement.

This would enable the marketplace to divide the 5 percent tranche into two slices – the rated bond portion which would be purchased by a mezzanine investor and the non-investment grade portion which would be bought by the B-piece investor. Both investors would have to conduct due diligence of the pool and hold the investment for 5 years. The result is 5 percent risk retention with the least disruption to the marketplace.

Without this senior-subordinate structure, additional cost will be passed through to borrowers hindering the CRE market recovery.

2. As part of their investment, B-Piece buyers have the right to appoint the "special servicer" who is charged with overseeing and working out distressed loans included in the CMBS loan pool. This is because the initial risk of loss from those distressed loans falls on the B-Piece Buyer as the first loss investor. The proposed risk retention rule allows an Operating Advisor to recommend that a special servicer be replaced if it believes it is in the best interest of investors. The rule also requires that this recommendation must be approved by a majority vote of a mere 5-percent quorum of all investors. Current practice quorums are typically 50 percent.

There was a strong consensus among the CREFC members that this threshold should increase to a quorum requirement of at least 20 percent, with a minimum of at least three investors participating in the vote.

QCRE Parameters

Fourth, the proposed rules would exempt "Qualified Commercial Real Estate" or QCRE loans from the retention regime if specified parameters are satisfied. The QCRE goal is to reward conservative underwriting. There was a broad consensus among CREFC members – including among the investment grade ("IG") investors – that the QCRE parameters should be modified by making four changes to the proposed QCRE loan parameters. Based on historical data from all CMBS deals since 1997, our recommendations would expand the universe of QCRE-eligible loans from 3.6 percent of CMBS loans to 15.6 percent but – using the same data – the cumulative loss percentage for those qualifying loans would fall from to 0.74 percent to 0.57 percent.[5] This is in contrast to other qualifying asset exemptions, under which a vast majority of assets would qualify.

Single Borrower Single Credit Transactions

Fifth, there also was a strong consensus across all CREFC constituencies to completely exempt Single Borrower/Single Credit ("SBSC") deals from the retention regime. SBSC deals involve only one loan (or a pool of cross-collateralized loans that essentially function as one loan). Historically, there has been no role for B-Piece Investors in SBSC transactions; SBSC transparency is extremely high because granular loan details are reported to potential investors; and SBSC loss experience has been exceedingly low.

Furthermore, because these transactions effectively contain only one loan, it is much easier for institutional investors to evaluate the credit of the transaction before investing and they have broader access to data because the deals typically are done in the private "144A" market.

[5] *See* CRE Finance Council Comment Letter Appendix 6 (showing the number of loans to be considered QCRE under the Proposed Rule and the CRE Finance Council recommendations).

In response to regulator concerns that there is no *mandatory* disclosure for 144A deals, CREFC developed a mandatory SBSC disclosure regime that would have to be satisfied to qualify for the retention exemption. There is a strong consensus among all CREFC members – including a majority consensus among the IG Investors whom the retention rules are designed to protect – that these SBSC deals should be completely exempt from the retention rules. A one-size-fits-all approach lumping these transactions in with others would not benefit CMBS investors.

Regulation AB

Finally, with respect to Reg AB, I would like to highlight just two issues from our comment letter to the SEC. First, CREFC conceptually has no objection to the type of oversight functions that are contemplated to be performed by the credit risk manager in the Re-Proposed Rules. However, we do not believe that it is necessary or efficient to require that an additional deal party provide these functions in the CMBS market. We believe that these functions are already being performed in most cases by the servicer, special servicer and the Operating Advisor.

Second, CREFC urged the Commission not to require a chief executive officer's certification in connection with shelf registration eligibility because the requirement is duplicative of other rules and regulations with respect to CMBS already in place. These rules already contain robust accountability and oversight mechanisms. The cost of implementing an additional certification would significantly outweigh any incremental benefit to CMBS investors.

Conclusion

Mr. Chairman, we want to make risk retention work, not eliminate it, and we believe that the recommendations I have outlined today and that CREFC has advanced in its comment letters would help accomplish that objective. I am happy to answer any questions you may have.

CRE Finance Council, Written Testimony Exhibit A
HFS Capital Markets Subcommittee, February 26, 2014

CRE Finance Council

October 4, 2011

VIA ELECTRONIC FILING – rule-comments@sec.gov
Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment, Release Nos. 33-9244; 34-64968; File No. S7-08-10

Dear Ms. Murphy:

The Commercial Real Estate ("CRE") Finance Council® appreciates the opportunity to respond to the request of the Securities and Exchange Commission (the "Commission") for comments on the release (the "Release")[1] of re-proposed rules (the "Re-Proposed Rules") with respect to Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment relating to asset-backed securities ("ABS").

There are a number of parts of the Re-Proposed Rules which the CRE Finance Council supports. We wish to note that our comments focus on areas of the Re-Proposed Rules and the questions with respect to which we believe comment is necessary and appropriate for participants in the commercial mortgage-backed securities ("CMBS") market. We further wish to note that our comments in this letter are in addition to those we previously submitted, which we respectfully re-affirm.[2]

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.

[1] SEC Release Nos. 33-9244; 34-64968; File No. S7-08-10.

[2] *See* CRE Finance Council Comments re: Asset Backed Securities, Release Nos. 33-9117; 34061858; File No. S7-08-10, available at http://cmbs.informz.net/cmbs/data/images/crefc_final_comments_to_sec.pdf

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Our principal functions include setting market standards, facilitating the free and open flow of market information, and education at all levels, particularly related to securitization. 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 efficient and practical regulatory structures. We look forward to continuing to work with policymakers on this effort. We also continue our ongoing work with all market constituencies to develop industry standards 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")™ for ongoing disclosures and surveillance by investors.

I. Overview

We recognize and appreciate the fact that the Commission has considered concerns expressed by the industry in our previous comment letters, particularly those pertaining to the criteria for shelf eligibility and those pertaining to our desire to better align the interests of issuers and investors without impairing the efficient operation of the CMBS market.

As such, we would like to focus our observations on the need for certain clarifications and modifications regarding the new Re-Proposed Rules, including:

- the proposed requirement that the chief executive officer or executive officer in charge of securitization of the depositor file a certification concerning the disclosure contained in the prospectus and the design of the securitization as a condition to shelf eligibility;
- the proposed requirement that an annual evaluation be filed with respect to compliance with registration requirements as a condition to shelf eligibility;
- the proposed requirement that the underlying transaction documents contain provisions requiring the appointment of a credit risk manager to review assets upon the occurrence of certain trigger events as a condition to shelf eligibility;
- the proposed requirement that the underlying transaction documents contain provisions requiring repurchase request dispute resolution as a condition to shelf eligibility;
- the proposed requirement that certain investor communication provisions be included in the underlying transaction documents as a condition to shelf eligibility;
- the proposed requirement that underlying transaction documents, in substantially final form, be filed by the date the preliminary prospectus is required to be filed under Rule 424(h); and
- certain of the questions concerning additional asset level data disclosure.

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Certification of Chief Executive Officer or Executive Officer in Charge of Securitization: The requirement of a certification is duplicative of other rules and regulations that apply to CMBS and is therefore unnecessary. CMBS transactions and structures already (i) contain robust disclosure in the prospectus supplement (including disclosure with respect to the transaction structure and the underlying assets), (ii) pursuant to Section 945 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Reform Act"), will be required to contain disclosure with respect to the diligence performed on the underlying assets in the prospectus supplement, and (iii) require the signature of the chief executive officer on the registration statement, for which the chief executive officer incurs personal securities law liability (including liability with respect to the disclosure in the prospectus supplement) pursuant to Section 11(a) of the Securities Act of 1933.

However, if the Commission believes that a certification of the chief executive officer of the depositor or the executive officer in charge of securitization will provide significant value, we believe that while the re-proposed language addresses a number of the concerns we had with the original version of the certification, additional enhancements should be adopted to further clarify the Commission's proposed language.

Annual Compliance Certification: Our members appreciate the Commission's efforts to address the commercial real estate industry's concerns with respect to the annual compliance certification. We appreciate the change from a quarterly to an annual compliance certification, as an annual certification is aligned with CMBS market practices. We also appreciate the revisions permitting the issuer to cure non-compliance. We do, however, request that the issuer be permitted to re-obtain shelf eligibility 30 days post-cure rather than the 90 day period set forth in the Re-Proposed Rules. Once certification compliance is cured a further delay in shelf eligibility is merely punitive and serves no purpose in providing investors with information.

Credit Risk Manager: Our members firmly believe securitization structures are enhanced by the use of a professional to provide oversight. The CMBS structures in use in 2011 already incorporate the most critical elements of such oversight function through the duties of the servicer, special servicer and operating advisor. Requiring an additional party to be inserted into these structures with its attendant costs and decision making inefficiencies provides no real value to investors. With respect to CMBS transactions, it would be more cost effective and efficient to allow the servicer, special servicer and the operating advisor to perform the functions of a credit risk manager. In addition, certain of the provisions of the Re-Proposed Rules with respect to the credit risk manager should be modified with respect to CMBS transactions to take into account the unique aspects of the CMBS market.

Repurchase Request Dispute Resolution: Including in deal documents a dispute resolution mechanism with respect to repurchase requests for breaches of asset level representations and warranties may improve sector performance, but our members recommend that the Commission allow the transaction parties to determine the method of dispute resolution rather than including a specific method in the rules.

Investor Communication: Many 2010-2011 CMBS securitizations have included features to facilitate investor communications which may be important for members to

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effectively enforce certain rights under the transaction documents. Our members appreciate the Commission's attempt to address investor concerns with respect to their ability to organize with other investors to effectively enforce their rights under the transaction documents. We believe, however, that the Commission should require that the underlying transaction documents provide reasonable methods of investor communications instead of requiring one or two particular methods. Our members, including investors, have concerns about the delay and inconvenience if investor communications are required to be made through the 10-D filings and have additional concerns about privacy issues if communications are required to be filed. Some investors also desire anonymity and public disclosure of their identity could have an adverse effect on the marketability of the securities.

Filing of Substantially Final Underlying Transaction Documents: Our members have no objections to the requirement that underlying transaction documents, in substantially final form, be filed at the same time as the prospectus supplement is required to be filed pursuant to Rule 424(h). We request that the Commission clarify that the underlying transaction documents required to be filed be limited to those that are required to be exhibits to the registration statement. In addition, we request that the Commission specify that the issuer will not be required to wait an additional 5 business days prior to selling the first certificate due solely to a changes to the underlying transaction documents after the Rule 424(h) filing.

Additional Asset Level Data Disclosure Questions: Our members have reviewed the questions with respect to additional asset level data disclosure set forth in the Release and appreciate the opportunity to comment on those we feel will impact the CMBS market. In general, we ask the Commission to take into account the robust package of asset level information already provided by the CMBS industry pursuant to the IRP and Annex A to the offering document, the form of which has been revised by the CRE Finance Council to improve disclosure.

Our specific comments regarding the Re-Proposed Release are below.

II. Certification of Chief Executive Officer or Executive Officer in Charge of Securitization

The Re-Proposed Rules would require that the chief executive officer of the depositor or the executive officer in charge of securitization file a certification concerning the disclosure contained in the prospectus and the design of the securitization in connection with any shelf offering. In our comments on the initial proposal, the CRE Finance Council urged the Commission not to require a chief executive officer's certification in connection with shelf registration eligibility because the requirement is duplicative of other rules and regulations with respect to CMBS already in place or to be put in place, including Section 11(a) of the 1933 Act (which imposes personal securities law liability for material misstatements or omissions on any officer who signs the registration statement), Item 601(b)(31) of Regulation S-K (which, in general, requires either the senior officer in charge of securitization of the depositor or the servicer to certify that the exchange act periodic reports are not misleading), Item 1123 of Regulation AB (which requires a servicing compliance statement signed by a senior officer), and Section 945 of the Reform Act (which requires disclosure with respect to the diligence performed on the underlying assets in the prospectus supplement). Considering the

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aforementioned certifications that the CMBS industry is already required to provide, we believe that the laws and regulations governing the industry already contain robust accountability and oversight mechanisms. Therefore we believe that the cost of implementing an additional certification significantly outweighs any incremental benefit to CMBS investors.

If the Commission does decide to require a certification, however, we suggest the re-proposed certification language be modified as follows:

I, [identify the certifying individual,] certify as of [the date of the final prospectus under Securities Act Rule 424 (17 CFR §239.424)] that:

1. I have reviewed the prospectus relating to [title of all securities, the offer and sale of which are registered] (the "Securities") and am familiar with the structure of the securitization described therein, ~~including without limitation~~ the material characteristics of the securitized assets underlying the offering (the "Assets"), the material terms of any internal credit enhancements and the material terms of all material contracts and other arrangements entered in to ~~the~~ effect the securitization;

2. Based on my knowledge, the prospectus does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading;

3. Based on my knowledge, the prospectus and other information included in the registration statement of which it is a part, ~~fairly present~~ disclose in all material respects the characteristics of the ~~securitized a~~Assets ~~underlying the offering described therein~~ and the risks of ownership of the ~~asset-backed s~~Securities, ~~described therein, including~~ all credit enhancements and all risks ~~factors~~ relating to the ~~securitized a~~Assets ~~underlying the offering~~ that would materially and adversely affect the cash flows ~~sufficient~~ available to service payments on the ~~asset-backed s~~Securities in accordance with their terms as described in the prospectus; and

4. Based on my knowledge, taking into account the material characteristics of the ~~securitized a~~Assets ~~underlying the offering~~, the structure of the securitization, ~~including~~ the material terms of any internal credit enhancements, and any other material features of the transaction, in each instance, as described in the prospectus, the securitization is structured in a manner that is expected~~designed~~ to produce, but is not guaranteed by this certification to produce, cash flows at times and in amounts sufficient to service ~~expected~~ payments on the ~~asset backed s~~ Securities in accordance with their terms as described in the prospectus; provided that the timing and sufficiency of such cash flows may be materially and adversely affected by the risks and uncertainties described in the prospectus relating to the Assets and the ownership of the Securities.~~offered and sold pursuant to the registration statement~~.

The foregoing statement is a forward-looking statement within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements speak only as of the date they are made, and the undersigned undertakes no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made. No person should place undue reliance on any forward-looking statement and should consider the risks and uncertainties described herein and in the prospectus.

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In addition, we ask that the Commission confirm that any party signing the certification is entitled to the due diligence defense under Section 11(b) of the Securities Act of 1933 and is entitled to rely on information provided by third party originators, third party report providers and other transaction parties.

Finally, although we appreciate the Commission's willingness to consider allowing an independent evaluator to provide the certification on behalf of the issuer, we believe that few, if any; third parties would agree to provide this service. Attorneys and accountants involved in the securitization and issuance of securities are likely prohibited from providing this certification and other parties are not likely to provide any meaningful disclosure. Further, the expense involved in retaining a third party would most likely be prohibitive for the issuer. Therefore, we do not believe that this alternative is necessary.

Recommendation: We firmly believe that no real value will be added by requiring an additional certification as contemplated by the Re-Proposed Rules. However, if the Commission believes that a certification of the chief executive officer or executive officer in charge of securitization of the depositor concerning the disclosure contained in the prospectus and the design of the securitization is necessary considering the robust accountability and oversight already applicable to the CMBS industry, the CRE Finance Council recommends that the re-proposed certification language be revised as set forth above.

III. Annual Compliance Certification

The Re-Proposed Rules would require that an issuer perform an annual evaluation of compliance with shelf registration requirements as of 90 days after the end of its fiscal year in order to conduct a takedown off an effective shelf registration statement. The depositor or issuer can cure any failure to meet shelf registration requirements by subsequently filing the required information and, 90 days after such subsequent filing, will be permitted to continue to use the shelf registration.

We appreciate the Commission's decision to require an annual instead of a quarterly evaluation, as it aligns the rule more closely to market practices. We also appreciate the addition of a cure mechanism for non-compliance with shelf registration requirements, as the ability of an issuer to complete a takedown off its shelf registration statement promptly as needed is critical to the successful functioning of the CMBS market. We believe, however, that a 90-day waiting period after filing of all necessary information is excessive and will cause unnecessary punitive delays in CMBS issuance.

Recommendation: For the reasons mentioned above, the CRE Finance Council recommends that a depositor or issuing entity be allowed to continue to use its shelf registration after a waiting period of 30 days following any corrective subsequent filing.

IV. Credit Risk Manager

The Re-Proposed Rules would require, as a condition to shelf eligibility, that the underlying transaction documents contain provisions requiring the appointment of a credit risk manager to review assets upon the occurrence of certain trigger events. These provisions are in

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lieu of the requirement contained in the initial proposed rules that any party obligated to repurchase assets for breaches of representations and warranties furnish an independent third party opinion regarding whether the obligated party acted consistently with the terms of the pooling and servicing agreement and any other relevant transaction documents with respect to any assets that were not repurchased after a request by the trustee. Although we understand the Commission's desire to provide an alternative mechanism for investigating and resolving breaches of representations and warranties and we appreciate the removal of the independent third party opinion condition from the Re-Proposed Rules, we do not believe that this aspect of the Re-Proposed Rules, as drafted, is the best way to achieve the Commission's goals with respect to CMBS transactions.

Appointment of Credit Risk Manager

The Re-Proposed Rules would require that a credit risk manager be appointed by the trustee, which credit risk manager may not be affiliated with any sponsor, depositor or servicer in the transaction. The CRE Finance Council recognizes that other trade associations in the securitization industry have endorsed the concept of a credit risk manager in their comments to the previous proposal, but they did so with a focus on residential mortgage backed securitization [3] and with the caveat that the credit risk manager concept might not be necessary for all asset types.[4] It should be noted that, with respect to residential mortgage backed securitizations, the issuer generally retains the servicing duties and there is no independent third party reviewing the assets and the servicing decisions. This is not the case in CMBS.

The Commission indicated in the Release that the purpose of requiring the appointment of an independent credit risk manager is to facilitate enforcement of representations and warranties and the resolution of disputes regarding breaches of representations and warranties. The credit risk manager would be required to review the underlying transaction assets for compliance with the representations and warranties upon the occurrence of certain trigger events which must be, at a minimum, (i) the failure to meet certain credit enhancement requirements specified in the underlying transaction documents, such as required reserve account amounts or overcollateralization percentages and (ii) the direction of investors pursuant to a process set forth in the underlying transaction documents and disclosed in the prospectus.

Although our members conceptually have no objection to the type of oversight functions that are contemplated to be performed by the credit risk manager in the Re-Proposed Rules, we do not believe that it is necessary or efficient to require that an additional deal party provide these functions in the CMBS market. We believe that these functions are already being performed in most cases by the servicer, special servicer and the operating advisor.

In CMBS transactions, the special servicer performs a review and provides an asset status report with respect to any asset that is transferred to special servicing. In connection with such review, the special servicer is given access to the entire servicing and mortgage file with respect

[3] See letter from ASF, Aug. 2, 2010, comments at 24.

[4] See letter from SIFMA, Aug. 2, 2010, comments at 18, n.27.

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to the asset. An asset is transferred to special servicing upon the occurrence of any one or more of a number of events, including a monetary event of default, a material non-monetary event of default beyond certain grace periods and a bankruptcy or insolvency event with respect to an obligor. These trigger events have been developed over time by the participants in CMBS transactions and are meant to encompass events that would cause a lender to question the status of an asset or the obligor in respect of the asset.

Servicers and special servicers in CMBS transactions are often independent of the depositor and the loan sellers, and are required pursuant to the transaction documents to act in the best interests of the certificateholders, as a collective whole. In addition, many CMBS transactions now include and, pursuant to the risk retention rules currently proposed by the Reform Act, will be required under certain circumstances to include, an operating advisor appointed at the transaction's inception to ensure that the special servicer's overall performance complies with its contractual responsibilities. The operating advisor must be an independent third party, unaffiliated with the special servicer, or according to a modification proposed by the CRE Finance Council in its comments on the risk retention proposal, must undertake measures to mitigate any potential conflict of interest if there is any affiliation with a transaction party.[5] Therefore, although special servicers in CMBS transactions, unlike transactions with respect to other asset classes, are generally not affiliated with parties responsible for repurchases due to breaches of asset level representations and warranties, to the extent there is a perceived conflict with respect to the special servicer, the presence of the operating advisor in addition to the special servicer's contractual obligations to act in the interests of all certificateholders, should alleviate the concerns about perceived conflict. In addition, CMBS transactions contain provisions pursuant to which the servicer, special servicer and the operating advisor may be removed and replaced upon the occurrence of an event of default or by a certain class or percentage of certificateholders. Therefore, unlike other asset classes, CMBS transaction documents already include measures to provide transaction parties with access to all information and the duty to act in the best interest of all certificateholders and CMBS transaction documents contain checks and balances to ensure that such parties act in accordance with the requirements of the transaction documents.

We believe that the inclusion of another party in the deal structure for CMBS transactions is unnecessary given the roles of the current transactions parties. The servicer, special servicer and operating advisor should be allowed to perform the functions of a credit risk manager with respect to CMBS transactions. In addition, requiring another transaction party would greatly increase the transaction costs of CMBS without providing any material corresponding benefits to investors. Allowing the servicer, special servicer and operating advisor to perform these functions would be much more cost efficient, as such parties' compensation is already factored into CMBS transaction costs.

Functions of Credit Risk Manager

Although our members generally do not object to the oversight functions described with respect to the credit risk manager in the Re-Proposed Rules, we have certain concerns with

[5] CRE Finance Council risk retention comments at 31.

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respect to these functions as contemplated in the Release. In particular, we would like to comment on (i) the proposed trigger events for asset review by the party performing the functions of the credit risk manager, (ii) the proposed disclosure of reports with respect to potential breaches of representations and warranties in public filings, (iii) the question of whether the party performing the functions of the credit risk manager should be allowed to file a breach claim on behalf of the securitization trust and (iv) the question of whether parties with repurchase obligations should be required to file annual certificates stating all required repurchases were made or explaining why a repurchase request was refused.

Trigger Events. We do not believe the trigger event with respect to the failure to meet certain credit enhancement requirements specified in the underlying transaction documents is appropriate for CMBS transactions, as CMBS transactions do not contain such credit enhancement requirements. Rather, the sequential pay feature of CMBS structurally allocates risk to the lower bonds in lieu of using triggers. Thus, each investor knows up front his/her priority in the waterfall, and triggers are not necessary. Moreover, as mentioned above, CMBS transaction documents contain provisions requiring that an asset be transferred to special servicing upon certain events and that the special servicer perform a review of any asset transferred to special servicing. These special servicing transfer events have been negotiated among industry participants and reflect events CMBS investors consider materially adverse and worthy of review. As such, these events should be deemed triggers for CMBS for purposes of the proposed rule. Likewise, we believe that the trigger event for representation and warranty breach review for CMBS transactions, like special servicing transfer events, should be negotiated by the transaction parties to reflect matters material to our asset class and set forth in the underlying transaction documents instead of being dictated by the rules. We note that the special servicer is contractually obligated to represent the best interests of all certificateholders in accordance with the industry standard of care.

Finally, we note that our proposal for CMBS servicers, special servicers and operating advisors to perform the credit risk manager role is consistent with the Commission's proposal for review upon investor-direction. The operating advisor construct, as proposed by the CRE Finance Council in its risk retention comments, provides for operating advisor review upon investor request as prescribed in the transaction documents. Thus, this framework addresses concerns that investors have a means to pursue remedies when a breach of representations and warranties is suspected.

Public Filing of Breach Reports. We do not believe that a report concerning potential breaches should be filed as an exhibit to the Form 10-D filing or on a Form 8-K. In many instances when a breach claim is being pursued in our industry, a workout is also being negotiated with the related obligor. Our members, including investors, believe that it could be detrimental to the transaction parties if detailed information about potential breaches and workouts is required to be publicly filed prior to the resolution of such matters. There is concern among a broad spectrum of transaction parties, including investors, that the availability of too much detailed information to the public with respect to breaches and potential workouts could jeopardize a successful resolution of the asset, including, for example, revealing resolution strategies or otherwise informing defaulted borrowers in a way that would give them an inappropriate negotiating advantage. Our investor members have indicated that they do not need

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a full report with respect to potential breaches but instead would like to be apprised that a breach claim has been made, and subsequently provided with summary information describing the general status and resolution of the claim.

In addition, our investor members have indicated that they would prefer to be apprised of potential breaches through an information source they already rely on, rather than being required to consult yet another source. The information should also be made available in a manner that will be useful to investors while not jeopardizing the potential for successful workouts as described above. Our investor members therefore recommend that the existing IRP be used to provide such information and that this information be such that it can be added in the existing data fields in the IRP. For example, the "Special Servicer Comments" field could very briefly describe whether a breach claim has been made, and what the general status or disposition of the claim is. To avoid overwhelming investors with information that they would need to process and overwhelming issuers with reporting obligations, the IRP fields would only include this information when a special servicer or operating advisor is reviewing a loan pursuant to the terms of the transaction documents.

Claims for Breach by Reviewing Party. Our members do not see any benefit to requiring that the underlying transaction documents give the party providing the breach review the discretion to assert a claim for breach on behalf of the securitization trust, as this function is already delegated to the special servicer pursuant to CMBS transaction documents. Therefore, this requirement would provide no real value to investors.

Annual Certification of Repurchase Status. Our members do not see any benefit to requiring that each party with a repurchase obligation provide an annual certificate to the trustee and noteholders certifying that all loans required to be repurchased under the transactions documents have been repurchased or why any loans identified as breaching a representation or warranty were not repurchased. We believe that the requirements of Form 15G are sufficient with respect to repurchase requests and their status and that requiring an additional certificate would be onerous and add expense without providing any material value.

Recommendation: For the reasons stated above the CRE Finance Council recommends that, with respect to CMBS transactions, (i) the servicer, special servicer and operating advisor be permitted to perform the duties of the credit risk manager set forth in the Re-Proposed Rules, as negotiated in the underlying transaction documents for each transaction, (ii) the trigger events for a review with respect to a possible breach of a representation and warranty be left to the negotiated agreement of the transaction parties and set forth in the underlying transaction documents for each transaction, (iii) public filing of the reports of the reviewing party should not be required and instead limited information with respect to breach claims should be included in the existing IRP reports, (iv) the party performing the breach review should not have the ability to bring a claim on behalf of the securitization trust, rather, it should be left as currently structured to the special servicer tasked with that responsibility, and (v) an annual statement with respect to the status of repurchases by the obligated parties is duplicative and unnecessary and should not be required.

V. Repurchase Request Dispute Resolutions

The Re-Proposed Rules would require that the underlying transaction documents include a provision that states that, if an asset subject to a repurchase request is not repurchased by the end of the 180-day period beginning when notice of the repurchase request is received, then the party submitting such repurchase request shall have the right to refer the matter, at its discretion, to either mediation or third-party arbitration, and the party obligated to repurchase must agree to the selected resolution method.

Our members support the idea of alternative dispute resolution mechanisms with respect to repurchase claims for breaches of representations and warranties, and members of the CMBS industry have had numerous discussions concerning possible ways of providing alternative dispute resolution mechanisms. The CRE Finance Council incorporated mediation as a mechanism in its model representations and warranties in response to the concerns of our members.[6] Requiring utilization of specific mechanisms for such dispute resolution would not be appropriate, however. The CMBS market is unique and needs the flexibility to incorporate appropriate mechanisms for each transaction based on the specific factors with respect to such transaction. We support a requirement that the underlying transaction documents provide some form of alternative dispute mechanism, but that final determination of such mechanism should be left to the discretion of the transactions parties.

Recommendation: For the reasons stated above, the CRE Finance Council recommends that, with respect to CMBS transactions, the rules mandate that a form of alternative dispute resolution must be set forth in the underlying transaction documents, but that the specific form of dispute resolution not be specified in the rules.

VI. Investor Communication

The Re-Proposed Rules would require, as a condition to shelf eligibility, that the underlying transaction documents include a provision requiring that the party responsible for making periodic filings on Form 10-D include in the Form 10-D any request from an investor to communicate with other investors related to such investor's rights under the terms of the securitization, provided that such request is made during the reporting period and received by the reporting party on or before the end date of the reporting period. The Release proposes that the disclosure on Form 10-D be required to include the name of the investor making the request, the date the request was received and a description of the method by which investors may contact the requesting investor.

We understand that the Commission is seeking to address investor concerns over their ability to organize with other investors and effectively enforce their rights under the transaction documents. We do not object to a requirement that transaction documents provide a reasonable

[6] See CRE Finance Counsel model representations and warranties and model dispute resolution, available at www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/CMBS_20/CREFC_Model_Reps.pdf and www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/CMBS_20/CREFC_Remediation.pdf, respectively. See also the related submittal letters to federal regulators dated January 19, 2011 and March 23, 2011.

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method for investors to communicate. In order to retain the flexibility to develop the best methods of communication, however, we do not believe that the method of communication should be specified in the rules.

Our investor members have indicated that they would prefer to use existing communication channels developed by the industry to communicate with each other instead of communicating through the Form 10-D filings for several reasons. The requirement that communications be made through the Form 10-D filing would delay communications between investors. Because the Form 10-D is filed with the Commission within 15 days of the distribution date, the filing would be made 16 to 60 days after the request was made. In addition, because the From 10-D filing is available to the public, a number of our investor members have voiced privacy concerns and stated that in certain situations they may want to contact other investors without doing so publicly. Finally, our investor members would prefer to receive information and communications through existing channels they already regularly monitor instead of incurring the additional monitoring costs and inconvenience of regularly reviewing the Form 10-D filings.

The CMBS market regularly responds to changing investor concerns with respect to the provision of information to investors and communications among investors and transaction parties. The industry currently provides a number of methods of communication with investors including distribution date statements, the comprehensive IRP developed by the CRE Finance Council and transaction level websites, which provide investors with real time forums to communicate and receive information. We believe that allowing transaction parties and investors to use one of these existing methods of communication or to craft a new method of communication meeting their unique requirements would better facilitate meaningful communication.

Likewise, the CMBS industry already has proven requirements and processes in place for investors to gain access to certain reports and transaction websites. Our members believe that the rules should not specify any maximum, minimum or specific requirements for verifying if a party making a communication request is an investor, but should instead allow the transaction parties to determine the best method of verification. Should the Commission decide to include rules with respect to investor verification requirements, it should be noted that the record holder listed with respect to a majority of CMBS certificates is the Depository Trust Company and, in such instances, the communication request should be coming from the beneficial owner and not the record holder. Although the trustee can request a list of beneficial owners from the Depository Trust Company, the process is costly and can take days or weeks to complete. In addition, a custodian, and not the true beneficial owner is often the party named on the Depository Trust Company's holder report.

Recommendation: For the reasons mentioned above, the CRE Finance Council recommends that, with respect to CMBS transactions, the Commission require that the underlying transaction documents provide a reasonable method for investors to communicate, but not specify such method or specify the method by which the transaction parties may verify an investor's identity.

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VII. Filing of Substantially Final Underlying Transaction Documents

The Re-Proposed Rules would require issuers to file copies of the underlying transaction agreements, in substantially final form, at the time the preliminary prospectus under proposed Rule 424(h). The Release also included a question as to whether issuers should be required to file, as an exhibit to the prospectus supplement, a copy of the representations, warranties, remedies and exceptions with respect to the transaction assets, marked to show how they compare to industry developed model provisions.

Our members do not object to the requirement concerning the filing of substantially final forms of the underlying transaction documents at the time the preliminary prospectus is filed under proposed Rule 424(h). We ask, however, that the Commission specify in the final rule that the underlying transaction documents required to be so filed are limited to those currently required to be filed as exhibits to the registration statement. In addition, we ask that the Commission include a statement in the final rule indicating that any changes made to the underlying transaction documents after the initial Rule 424(h) filing would not require a subsequent Rule 424(h) filing. Any changes to the underlying transaction documents that would be material to investors would be reflected in the prospectus supplement and, therefore, the requirement for a new Rule 424(h) filing with respect to material changes in the prospectus supplement should be sufficient. The underlying transaction documents for CMBS transactions include numerous parties and are often revised up to the moment of the transaction closing. Requiring a new Rule 424(h) filing due to changes in the underlying transaction documents would be unduly burdensome and would unnecessarily delay the closing of CMBS transactions.

Although our members generally do not object to the proposed filing requirement with respect to the underlying transaction documents and understand the Commission's reasons for proposing the requirement, we do not believe that issuers should be required to similarly file, as an exhibit to the prospectus supplement, a copy of the representations, warranties, remedies and exceptions with respect to the transaction assets, marked to show how they compare to industry developed model provisions, as one commentator suggested. Rule 17g-7 of the Reform Act already requires rating agencies to provide this information in their pre-sale reports. In addition, the representations and warranties, remedies and exceptions will be set forth in the substantially final mortgage loan purchase agreement filed at the time of the Rule 424(h) filing. This will provide investors with sufficient time to compare the provisions to any standard or industry developed model they choose.

Recommendation: For the reasons mentioned above, the CRE Finance Council recommends that, with respect to CMBS transactions, (i) a clarifying statement be added to the rule specifying that the underlying transaction documents required to be filed are only those currently required to be filed as exhibits to the registration statement, (ii) a subsequent Rule 424(h) filing not be required due solely to changes to the underlying transaction documents previously filed and (iii) issuers not be required to file the representations, warranties, remedies and exceptions with respect to the transaction assets, marked to show how they compare to industry developed model provisions.

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VIII. Additional Asset Level Data Disclosure Questions

Our members have reviewed the Commission's questions concerning additional asset level data disclosure set forth in the Release. Certain of the questions posed in the Release have little or no relevance to CMBS and are, therefore, not addressed in this letter. For instance, Questions 92 through 97 relate to reporting when assets are added to the pool after issuance and should, therefore, be inapplicable to CMBS transactions, which have static asset pools. Our thoughts with respect to those questions we believe are relevant to the CMBS market are set forth below.

Question 68: Question with respect to the implementation of Section 7(c) by the proposed rules:

As stated in our previous response letter, our members agree with the Commission that robust information is necessary to give investors the ability to make informed investment decisions, as evidenced by the CMBS industry's longstanding use of the IRP, which already includes the vast majority of the Commission's proposed general and CMBS-specific data items. The CRE Finance Council, including investor members, feels strongly that the addition of new fields that are not of significance to CMBS or the inclusion of fields that are not in exact alignment with how those fields may be reported in the current IRP would cause significant, costly and undue programming burdens without any material benefit to investors. To that end, the CRE Finance Council recommends that the SEC tailor Schedule L-D to take into consideration the data points as already presented in the IRP. We have re-attached, as Exhibit A, our suggested modifications to each proposed Item on Schedule L-D and, as Exhibit B, a sample of the form of Schedule L-D for CMBS that gives effect to such suggested modifications. We would like to work with the Commission to create a schedule that will meet the goals of providing robust data while allowing CMBS transaction participants and data users to provide a subset of data as it is presented in the current IRP.

In addition, the CRE Finance council believes that distribution of data through SEC filings does not add much value in the CMBS context but would add costs to the transactions. As set forth in our prior response letter, the CMBS market has been a leader in ongoing reporting as is evidenced by the IRP. The IRP is either distributed directly to investors or made easily accessible to investors electronically much sooner than proposed filings, thereby making such filings unnecessary and of little value to investors. Our investor members have indicated that they would prefer to be provided information pursuant to a distribution source they already rely on, rather than being required to consult yet another source. We therefore urge the Commission to consider allowing the CMBS market to distribute any required ongoing reporting through means already in place, such as the IRP.

Question 69: Question with respect to the proposed required XML format:

The CMBS industry has an existing mechanism for standardizing and comparing data across similar securities through the IRP. In addition, as set forth in our prior response letter, based on a survey of investor members, we are not aware of any investor who converts IRP data from Excel to XML. Therefore, we firmly believe that it would be a significant, costly burden to convert to a new technology and could potentially cause additional data quality risks as the

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conversion is implemented. Our members believe that XML is an adequate standard for the format of data, and are in fact working to develop a roadmap for establishing a new IRP to accommodate XML delivery. However, we do not believe that requiring the CMBS industry to convert to an XML format is appropriate or worth the cost.

Questions 70-76: Questions relating to loan brokers and originators:

As opposed to certain other asset classes, loans originated for CMBS are originated in a competitive rate environment with multiple lenders competing for commercial borrowers' loans. The identity of the originator is already disclosed in the transactions documents and, therefore, numbers are not necessary. In addition, additional disclosure on tax identification numbers and other identifying information could potentially be used to facilitate financial fraud and create potential privacy and security issues. Our members do not see any benefit to providing such information in the context of CMBS and, therefore, do not believe it is worth the risks involved.

Questions 77-78: Questions regarding whether risk retention figures should be allocated and reported on a loan level basis:

Our members do not believe this would add any value in the CMBS industry and therefore do not support the addition of this disclosure.

Question 79: Question with respect to disclosing net present value on loss mitigation v. foreclosure:

It is our interpretation that this questions regarding disclosure of net present value analysis is relative to RMBS only. Such disclosure for CMBS, given the numerous alternatives, numerous variables associated with varying property types and income generating properties and numerous legal paths to asset recovery, would be inadvisable, unduly burdensome and would not provide a comprehensive picture to investors. With respect to CMBS, detailed standards are already in place within the transaction documents setting forth the manner in which a special servicer is to determine and execute the best recovery method for an asset. These existing standards set forth in the transaction documents should be sufficient for the CMBS market.

Question 80: Question with respect to fee disclosure:

We do not believe that any additional disclosure with respect to fees received by transaction parties is required in the CMBS market. Fees earned by servicers, trustees and other parties are already disclosed on a monthly basis and in a manner familiar to CMBS investors pursuant to the IRP. Requiring additional duplicative disclosure would add cost to the transactions without providing any real additional value.

IX. Private Transactions

The CRE Finance Council notes that the Re-Proposed Rules continue to discuss the concept of requiring CMBS issuers in privately offered transactions to provide information to investors, upon request, that they would have been required to provide if the transaction had been publicly offered. Our members would like to reiterate to the Commission that applying this rule to CMBS issuers would be detrimental to a significant sector of the CMBS market and ask that

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the Commission re-evaluate our discussion with respect to this matter in our response letter to the initial proposed rules.

X. Conclusion

The CRE Finance Council appreciates the Commission's consideration of our comments regarding the Re-Proposed Rules. We stand ready to provide any additional assistance that may be helpful.

Respectfully submitted,

Stephen M. Renna
Chief Executive Officer
CRE Finance Council

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CRE Finance Council, Written Testimony Exhibit B
HFS Capital Markets Subcommittee, February 26, 2014

CRE Finance Council®
The Voice of Commercial Real Estate Finance

October 30, 2013

The Honorable Ben S. Bernanke
Chairman, Board of Governors
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Mary Jo White
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable Thomas J. Curry
Comptroller of the Currency
U.S. Department of the Treasury
250 E Street, SW
Washington, DC 20219

The Honorable Jacob J. Lew
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. 2013-0010; 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" or "CREFC") appreciates the opportunity to comment on the proposed rule for credit risk retention for asset-backed securities,[1] which was jointly published by your respective agencies (collectively, the "Agencies")

[1] Proposed Rule, Credit Risk Retention, 78 Fed. Reg. 57928 (Sept. 20, 2013) (hereafter, "NPR" or "Proposed Rule").

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pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] This proposed rule follows the prior proposed rule of 2011.[3]

The CRE Finance Council is the collective voice of the entire $3.1 trillion commercial real estate finance market. Its members include all of the significant portfolio, multifamily, and commercial mortgage-backed securities ("CMBS") lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds, specialty finance companies, REITs and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers.[4] Our industry plays a critical role in the financing of office buildings, industrial complexes, multifamily housing, retail facilities, hotels, and other types of commercial real estate that help form the backbone of the American economy.

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 help optimize market standards and regulations.

Considering the important role that commercial real estate plays in the economy and the critical function that securitization serves in commercial real estate, we must emphasize at the outset that the stakes in this rulemaking process are very high. Indeed, the CMBS market suffered a traumatic disruption due to the financial crisis in 2007-2009. Volume fell from an all-time high of $229 billion in 2007 to a low of just $3 billion in 2009. The recent recovery in new CMBS issuance and trading values for vintage CMBS is not the result of investor amnesia or apathy, but the product of an industry-wide process of self-assessment, restructuring and implementation of materially enhanced standards.

A few examples as a result: Loan-to-Value ratios have dropped from 2005-2007 levels; credit support across all bond classes from AAA down to BBB- has risen materially; and appraisal reductions are now accounted for in determining controlling class rights. As discussed in more detail below and in Appendix 1, the CRE Finance Council spearheaded industry efforts to bolster underwriting, disclosure, accountability and transparency for investors, resulting in greater confidence and increased demand for CMBS.

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[2] 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)).

[3] Proposed Rule, Credit Risk Retention, 76 Fed. Reg. 24090 (Apr. 29, 2011) (hereafter, "Prior NPR" or "Prior Proposed Rule").

[4] A complete CRE Finance Council Membership list is attached at Appendix 12.

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An important feature of the domestic CRE market is its diversity of financing sources. Representing roughly 20 percent of outstanding CRE financings as of September 30, 2013,[5] non-Agency CMBS provides liquidity to a comprehensive range of property sizes, types and geographies. Conduits fund stabilized properties in tier I markets, but they also fill gaps by lending in other markets, as well. Within the Single Asset Single Borrower segment, CMBS can access a wide investor base capable of financing transactions that can be too large for balance sheet lenders. CMBS is a significant source of financing, a competitive lender and one that fills certain gaps.

CMBS is an integral component of CRE lending – and therefore supports the overall health of the economy as a whole – by adding access to capital and diversification to the lender and investor base beyond what portfolio – or balance sheet – lending can contribute on its own to the sector. CMBS accomplishes this in part by allowing for the efficient tailoring of investment risk and yield requirements to the specific goals and desires of the entire range of potential institutional investors. If the regulatory regime results in limiting a vibrant CMBS market, the liquidity of insured depositories and other regulated institutions would be reduced unnecessarily and, in all likelihood and at the same time, real estate risk would shift from the capital markets and become more concentrated on bank and life insurance company balance sheets. Failure to achieve a balanced and workable set of risk retention rules thus could be counterproductive and could 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, may be a drag on the economy and job growth.

We also urge the Agencies to bear in mind that these 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

[5] *See* http://www.sifma.org/research/statistics.aspx.

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sections of the Act might more efficiently address the same objectives as credit risk retention requirements.[6]

The CRE Finance Council and its members believe that the basic retention regime outlined in the Proposed Rule can be the basis for a viable set of retention rules within the overall regulatory framework. We recognize that extraordinary thought and work went into the development of the Proposed Rule, and we particularly appreciate the Agencies' efforts to craft provisions that seek to address the unique characteristics of the CMBS market and that incorporate many of the suggestions made in the comment letter we submitted on the initial proposal on July 18, 2011 ("Prior Comment Letter.").

In promulgating the Proposed Rule, the Agencies made clear that they are attempting "to minimize the potential for the proposed rule to negatively affect the availability and costs of credit to consumers and businesses."[7] The CMBS retention rules – as currently proposed – appear to impose a cost on borrowers that is projected to be from 40 to 50 basis points for conduit transactions,[8] if issuers and sponsors apply rigorous risk-based pricing to the retained interests. This marginal cost translates into an increased cost burden on commercial property owners of 8 to 10 percent at current market borrowing rates of approximately 5-percent.

In the CMBS space, the Agencies also made clear that they are endeavoring "to balance two overriding goals: (1) not disrupting the existing CMBS third-party purchaser structure, and (2) ensuring that risk retention promotes good underwriting."[9] The comments set forth below are intended to build on and improve the Proposed Rule to ensure that it does achieve the appropriate balance in the CMBS space by minimizing unnecessary borrower costs and by better preserving existing CMBS third-party purchaser structures without undermining the underwriting integrity risk retention it is intended to promote.

[6] 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).

[7] 78 Fed. Reg. at 57934.

[8] If a bank issuer/sponsor uses its own regulatory capital returns as the basis for pricing the Eligible Horizontal Residual Interest ("EHRI"), it is likely that the institution would start with a minimum return requirement of 12.5 percent (the simple average of tier 1 common capital ratios reported by the six largest US banks at the corporate level in 2012). This equates to a minimum hurdle of approximately 37.5 basis points. The issuer would need to receive an additional margin on top of this corporate-wide return measure, especially given the nature of the credit and liquidity risks inherent in the EHRI. If assuming a 13-15 percent return is required of the EHRI, then the marginal cost to the borrower of risk retention is estimated to be approximately 40-50 basis points.

[9] 78 Fed. Reg. at 57958.

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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.[10] 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 finance marketplace. We look forward to continuing to work with the Agencies during the rulemaking process.

INTRODUCTION & EXECUTIVE SUMMARY

The CRE Finance Council shares the Agencies' goals of promoting sound underwriting while at the same time preserving the basic CMBS market structure that has been successful and resilient over time, and to do so in a way that minimizes the negative impact on the cost and the availability of credit. During the legislative debates and when the CRE Finance Council first had the opportunity to comment on the Prior Proposed Rule in 2011, we embraced the core risk retention construct and our efforts were focused on ensuring that the details of the proposed risk retention rules worked for CMBS structures.

Since the crisis, CMBS market participants also have sought to improve industry practices outside of the formal regulatory rulemaking process. As part of its core mission, the CRE Finance Council works closely with its members, including the largest principal CMBS issuers, B-Piece Buyers and servicers, and the leading investors in CMBS and portfolio CRE loans, to establish best practices. In response to the crisis, CRE Finance Council members developed and enhanced several sets of documentation and best practices standards, which materially add to market transparency, standardization and efficiency including:

(1) Model Representations and Warranties;
(2) Underwriting Principles;
(3) Refinements of Annex A;
(4) New Loan Modification, and Loan and REO Liquidation Reports; and
(4) Version 7.0 of the CREFC Investor Reporting Package ("IRP")™ for ongoing disclosures and surveillance by investors

all of which we previously have shared with the Agencies and the Department of the Treasury. The CRE Finance Council also has 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 transparency enhancement. We intend to modify the model PSAs to incorporate the Proposed Rule requirements when they are finalized to the extent that is

[10] *See* The Act at §941(b), 124 Stat. at 1896.

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appropriate.[11] We believe that increased transparency, standardization and efficiency also should collectively improve underwriting integrity and these improvements thus are designed to advance investor interests and implement one of the core objectives of the Act.

Similarly, the CRE Finance Council worked with its members to build a broad consensus on the changes we collectively believe are necessary to ensure that the Proposed Rule achieves the Agencies' objectives – interest balancing, risk mitigation and minimizing market impact. The CRE Finance Council operates member forums that are organized around each of our core market constituencies: Investment-Grade Investors; B-Piece Investors; Issuers; Servicers; High Yield Investors; and Portfolio Lenders. Each forum engaged in an extended set of discussions to gather feedback and to propose modifications to the Proposed Rule. The discussions were supplemented by a set of targeted surveys that were sent only to the members of the Investment-Grade Investor forum because its membership is large, diffuse, and purchases the largest segment of CMBS new issue bonds.[12] That process was overseen and moderated by the CRE Finance Council's Policy Committee, which is comprised of the leaders of each of the forums and certain members of CRE Finance Council's Executive Committee.

What emerged from these discussions was a strong consensus across all CRE Finance Council constituencies in support of the suggested modifications to the Proposed Rule outlined below. These modifications are all designed to support (rather than displace) the proposed risk retention framework in the CMBS space, and to better ensure that this framework more fully satisfies both the Agencies' and the Act's objectives. Given our broad and diverse membership, unanimity is rarely achievable. Nonetheless, all of the suggested modifications have, at a minimum, the majority support of each of CREFC's member constituencies. In some cases, the support is unanimous. In instances in which there was a range of opinions above a threshold majority, we have defined the range of recommended modifications. The CRE Finance Council's recommendations seek to provide practical solutions for the CMBS marketplace while meeting the goals of the proposed risk retention structure.

The following summary of our core suggestions also serves as a table of contents of our Rule Analysis & Proposed Recommendations; all **bolded and underlined** titles and letter section references

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[11] A more detailed summary of these efforts is attached as Appendix 1.

[12] The CREFC surveys were conducted throughout October 2013 as part of CREFC's Proposed Rule deliberations. CREFC staff and the leadership of the IG Investor Forum crafted and approved background information and each question. All surveys were sent to the entire CREFC IG Investor Forum (which formally is called the CREFC "IG Bondholders Forum") and to any other CREFC members who were identified as "IG Investors" in CREFC's member database. Respondents include investors from large life companies, banks, mutual funds, pension funds and private investors, among others. There are 61 company members of the Forum; we show response rates in conjunction with the different survey results referenced below. A copy of the survey and tabulated results also is included as Appendix 11.

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below and throughout the letter also function as hyperlinks if you are viewing these materials electronically:

- **<u>A Meaningful Closing Date Cash Flow Test</u> (Part A.2; Page 12):** As currently proposed, CMBS B-piece retention investments always will fail the requisite Closing Date Projected Cash Flow Rate/Projected Principal Repayment Rate test for two reasons:

  (1) The vast majority of the loans included in CMBS pools (and of all commercial real estate loans whether securitized or not) have no- or low-amortization, prepayment lockout, yield maintenance and/or defeasance structures that result in very low principal repayment rates prior to maturity; and

  (2) B-Piece Buyers obtain their bond positions at a significant discount from par value (because they are in the horizontal first-loss position). As such, the Closing Date Projected Cash Flow Rate (which is based upon the fair value of the "Eligible Horizontal Residual Interest" ("EHRI")) will de facto always be higher than the Closing Date Projected Principal Repayment Rate starting on Day 1.

  For the calculation to work in the CMBS context, it should be rewritten to ensure that (1) the B-Piece Buyer's cash flow as a percentage of the B-Piece Buyer's notional Unpaid Principal Balance ("UPB") will not exceed (2) the cash flow received by the remaining ABS interests as a percentage of their notional UPB. This formulation is consistent with the objective of ensuring that the EHRI does not receive more than its pro rata share of total cash flows from the securitization trust. All CRE Finance Council constituencies unanimously support this recommendation; if the calculation is not modified at least for CMBS/B-Piece Buyer retention, it will completely undermine the viability of CMBS B-Piece retention.

- **<u>Single Borrower/Single Credit Exemption</u>[13] (Part B.1; Page 13):** Single borrower/single credit ("SBSC") deals involve only one loan (or a pool of cross-collateralized loans that essentially function as one loan). Historically, there has been no role for B-Piece Buyers in SBSC transactions; transparency is extremely high because granular loan details are reported to potential investors; and their loss

[13] Re-named from the Proposed Rule's term, "single asset single borrower". The CRE Finance Council definition is intended to exclude an extremely small subset of slightly riskier transactions that technically involve more than one borrower. Also, this definition is intended to include pools of multiple loans only when all loans are cross collateralized.

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experience has been exceedingly low – well below that of conduit CMBS and other asset classes – and has been more on par with non-securitized corporate bonds. Furthermore, because these transactions effectively contain only one loan, it is much easier for investors to evaluate the credit of the transaction before investing. There is a strong consensus among all CRE Finance Council members – including a majority consensus among the Investment-Grade Investors ("IG Investors") whom the retention rules are designed to protect – that these SBSC deals do not present the issues that the Proposed Rule is intended to address and therefore should be completely exempt from the risk retention rules.

- **Modified Definition and Parameters for QCRE (Part B.2; Page 16):** To ensure that the qualified commercial loan exemption is an effective mechanism that can be used in the CMBS market, there is broad consensus among CRE Finance Council members – including IG Investors – that the QCRE loan requirements be modified to:

  (a) remove maturity term restrictions (in place of the minimum 10-year term requirement);

  (b) allow for 30-year instead of 25-year amortization schedules;

  (c) allow interest-only loans with a loan-to-value ("LTV") ratio of 50 percent or less to qualify as QCRE loans;

  (d) remove the lower LTV cap for loans that were appraised utilizing a lower capitalization rate.

  The historical loss performance for 5 and 7-year loans and interest-only loans actually is better than for 10-year loans and we can identify no rational basis for excluding the shorter-term or interest-only loans. Similarly, we can identify no supportable basis for requiring a 25-year amortization schedule for most QCRE loans. Importantly, both the shorter QCRE loan restrictions and an expedited amortization schedule will have the unintended result of driving the highest quality CMBS loans out of the CMBS market, thereby effectively weakening the overall CMBS loan pool and unnecessarily raising borrowing costs for all CMBS borrowers. The cumulative loss data bears this out historically because – in the aggregate – the cumulative loss experience for loans that satisfy the proposed CREFC QCRE loan parameters is lower than the cumulative loss experience under the parameters as proposed by the Agencies.

  This same logic also applies to loans that would be excluded by the lower LTV cap restriction when a property is appraised with a lower capitalization rate. Extensive

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industry analysis bears out the concern that this will result in the exclusion of loans secured by the best properties from CMBS pools because it is those properties that qualify for the lower cap rate treatment.

- **Senior/Subordinate Structure for B-Piece Retention (Part C.1; Page 21):** The Proposed Rule allows a third-party purchaser (or B-Piece Investor or B-Piece Buyer) to own the EHRI as the requisite CMBS retention and it allows that EHRI investment to be purchased by one or two such third-party buyers. If there are two buyers, however, the Proposed Rule requires that they must hold their positions on a *pari passu* basis. Basing the retention obligation on 5-percent of the fair value of a deal rather than 5-percent of the credit risk of the deal almost doubles the amount of retention for CMBS and the "thickness" of the traditional B-Piece investment and, in many cases, will require retention of investment-grade securities. Allowing two buyers to share the retention obligation is helpful, but the *pari passu* requirement seems to create unintended roadblocks for investors, especially in light of the increased retention obligation. In particular, the requirement of *pari passu* sharing of retention obligations (i) reduces flexibility in that CMBS cannot structure a product that meets B-Piece Investor needs; (ii) dampens the market for B-Piece Buyers who want to target their investment to a particular level of the debt stack, e.g. second loss piece vs. first loss piece; (iii) raises the challenge of assigning control between two unrelated B-Piece Buyers who would consequently have joint control if they are *pari passu* (rather than having tranched control commensurate with their investment as has historically been the case), and may not be able to agree on various control issues that arise throughout the deal causing decision making deadlocks and delay in the servicing of the loans and an impediment to borrowers desiring to obtain various consents; and (iv) needlessly restricts the potential liquidity of these positions even after the mandatory 5- year hold period has expired due to the lack of flexibility.

  To attract B-Piece Investors with sufficient capital and the appropriate capabilities, the EHRI also should be allowed to be held in a senior/subordinate structure, provided that both the senior and subordinate holders satisfy all of the obligations and requirements imposed on B-Piece Buyers to satisfy the CMBS retention requirements and provided further that the subordinate horizontal first-loss position must bear at least one-half of the requisite overall EHRI investment (2.5-percent of the fair value of the deal). Without this flexibility, IG Investors, many of which are unable to own non-investment grade bonds, have expressed concern that they will be locked out of part of their traditional market share. In addition, B-Piece Buyers recognize that their value proposition will be challenged by the need to purchase credits that fall higher in the credit stack. Finally, the senior portion of this proposed senior/subordinate B-Piece structure will be an attractive investment to experienced CRE debt investors whose

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investment return thresholds are lower than for traditional B-piece investors, which can reduce the overall weighted cost of capital of a CMBS transaction and generate lower borrowing costs to commercial property owners. In sum, the *pari passu* requirement reduces both IG and B-Piece Investors' ability to acquire bonds that are consistent with their respective mandates and restrictions (a fundamental benefit of securitization), frustrates formerly obvious lines of control, and creates perverse structuring consequences. For these reasons, CRE Finance Council members overwhelmingly support this recommendation.

- **Appraisal Reduction Amount Calculation for Operating Advisor Consultation Rights (Part C.2; Page 24):** The Proposed Rule requires that Operating Advisor consultation rights attach when the EHRI has a principal balance of 25 percent or less of its initial principal balance. In that regard, CREFC's IG Investors Forum unanimously has proposed that this calculation be based on the formal Appraisal Reduction Amount, i.e. that the Operating Advisor consultation rights attach when the EHRI has an outstanding principal balance, as notionally reduced by any appraisal reductions then allocable to the class or classes (or portions thereof) that constitute the EHRI, that is equal to or less than 25 percent of its initial principal balance. This is current market practice and the CRE Finance Council's members support this recommendation unanimously.

- **Increase in the Voting Quorum to Replace the Special Servicer (Part C.3; Page 24):** CRE Finance Council members agree that the 5-percent quorum required for a vote to replace the special servicer based on an Operating Advisor recommendation is too low. There is strong consensus that this threshold should increase to a quorum requirement of at least 20 percent, with a minimum of at least three investors participating in the vote. In addition, a significant portion of the CREFC membership (not only special servicers) believes that the quorum requirement should be materially higher, closer to two-thirds of total investors. Imposition of this quorum requirement would still be a significant decrease from current market practices. Currently, deal documentation generally specifies that special servicers can be replaced only if a very high percentage of all bondholders (60-75 percent) affirmatively vote for replacement while the B-Piece Buyer remains in control. In the event the B-Piece Buyer is no longer in control, voting thresholds for replacement currently average roughly 50 percent or more of all bondholders.

- **B-Piece Buyer Affiliations (Part C.4; Page 26):** The Proposed Rule prohibits a third-party purchaser of the EHRI from being affiliated with a lender that contributes more than 10 percent of the loans to that deal. Several prominent CMBS B-Piece Buyers have originator affiliates and the prevailing belief among CRE Finance Council

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members is that the strongest deals from an underwriting perspective are those to which a B-Piece Buyer affiliate has contributed a large pool of loans. B-Piece Buyer incentives are perfectly aligned with those of the other investors to those deals. There is no compelling support for precluding B-Piece Buyers from investing in a deal to which its affiliate has contributed more than 10 percent of the loans, especially given the fact that such investments are wholly aligned with the fundamental objectives underlying the risk retention regime.

- **Additional Operating Advisor Disclosure (Part C.5, Page 26):** The Proposed Rule requires disclosure of certain information related to the transaction, including details surrounding the Operating Advisor's qualifications. Additionally, the Proposed Rule sets out the goal of Operating Advisor independence. CRE Finance Council members support these provisions, and there is consensus, especially amongst the IG Investors, to require additional disclosures related to the Operating Advisor's material conflict of interest or potential conflict of interest, and related to Operating Advisor compensation.

- **Technical Recommendations (Part D; Page 28):** We also have included several recommendations that are more technical in nature but that we believe are necessary to ensure that the Proposed Rules operate as intended.

Where appropriate and as indicated below, the recommendations are supported by formal data analyses. We are happy to provide additional detail on the data analyses that were done and to discuss the analyses to the extent either or both would be helpful to the Agencies.

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PROPOSED RULE ANALYSIS and RECOMMENDATIONS

A. Basic Retention Issues

1. Retention Flexibility & The Elimination of the Premium Cash Capture Reserve Account ("PCCRA")

At the outset, the CRE Finance Council is very supportive of all of the structural flexibility embedded in the Proposed Rule, including clarifying that L-shaped retention can be shared between a sponsor and a third-party purchaser and that the allocation of retention can be executed in any way the bearers of the retained interests choose as long as they collectively satisfy the 5-percent fair value retention obligation. As part of this flexibility, the CRE Finance Council agrees with the Agencies' decision to eliminate the PCCRA. In our prior comment letter, we discussed at length the ineffectiveness of the proposed PCCRA as applied to the CMBS market, and we were pleased to read that the Agencies have removed the requirement from the Proposed Rule.[14]

2. The Payment Date Cash Flow/Principal Repayment Test Must Be Modified

The CRE Finance Council agrees that a cash flow test should be an integral part of the risk retention process. We also support the Agencies' efforts to impose a test that will not seek to disrupt the CMBS market, while, at the same time, being applied to various markets. Most, if not all, CMBS transactions would, however, fail the test as currently proposed.[15]

As illustrated in the spreadsheet attached as Appendix 2, the current proposal is not viable for the CMBS market. As a general matter, in the CMBS market, the EHRI will not receive a disproportionate amount of cash flow relative to its pro rata share of unpaid principal balance ("UPB"). The Proposed Rule's use of fair value in the calculation – as opposed to face value – would prevent B-Piece Buyers from being able to buy the B-Piece at a discount. It is this discount, however, that is essential to holding the EHRI position in the CMBS marketplace; B-Piece Buyers assume that they will absorb some losses. The higher yield the B-Piece Buyers are able to realize is, however, based on this very willingness to absorb losses; this goes to the essence of risk/reward investing in the CMBS marketplace, without which no investor – including no B-Piece Investor – would be willing to accept the greater risk. Additionally, the discount on the subordinate bonds does not prevent the IG Investors from receiving their proportionate share of the cash flows. In order to achieve these objectives, an "apples-to-apples" comparison of cash flows to notional UPB is required.

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[14] *See* 78 Fed. Reg. at 57934.

[15] Proposed Rule § __.4(a), 78 Fed. Reg. at 58026.

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Because all fair-valuation calculations must be disclosed, investors will be informed of the amount the B-Piece Buyer paid for its position; the revised calculation will not disable a typical CMBS B-Piece investment unless there are other streams of investment payments not included in the typical coupon payments and that should be in line with the Agencies' objective in requiring use of the calculation.[16] Failure to modify the formula – or imposition of the requirement that CMBS B-Piece Buyers must comply with the Alternative EHRI Proposal outlined in the rules[17] – would constitute a significant change to the economics of CMBS B-Piece investments, and would therefore jeopardize the viability of the CMBS/B-Piece model completely. This would be counter to the Agencies' expressed intent to adhere to current CMBS market practices as much as possible.[18] The CRE Finance Council's member constituencies unanimously support the recommended formula modifications.

CRE Finance Council Recommendation: The Proposed Rule should adjust the language to reflect that, on any distribution date, the amount of cumulative cash flow received by the EHRI holder as a percentage of face value (determined as of the date of issuance) of the EHRI will not exceed the cumulative amount of cash flow received by the rest of the ABS classes measured as a percentage of the face value (determined as of the date of issuance).

B. QCRE Issues

1. Exempt Single Borrower/Single Credit Deals

By design, the Proposed Rule includes only a very narrow exemption from risk retention for loans that will qualify as "Qualifying Commercial Real Estate" ("QCRE") loans. In the discussion, the Agencies explained that they did not believe that "non-conduit" CMBS transactions warranted any special treatment under the QCRE loan rules or otherwise should qualify for any special exemption;

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[16] The Agencies assert that "the purpose of the restriction is to prevent sponsors from structuring a transaction in which the eligible horizontal residual interest is projected to receive such a disproportionate amount of money that the sponsor's interests are no longer aligned with investors' interests." 78 Fed. Reg. at 57939. As long as the B-Piece Investor does not receive more money than its bond ownership – based on par value – would allow, the B-Piece Investor's interests remain aligned with those of other investors in the deal. And – perhaps equally important – the B-Piece deal proceeds are consistent with market expectations of what they should be given the nature of their position in the deal.

[17] *See* 78 Fed. Reg. at 57941.

[18] *See, e.g.,* 78 Fed. Reg. at 58013 (the Agencies "understand[] that the current market practice regarding risk retention in the CMBS market is largely in line with the agencies' proposed rules. The proposed rules allow for the continuation of current risk retention market practice for CMBS in the form of the B-Piece retention with additional modifications to the current practice."); *id.* at 58014 ("To the extent that the proposed rule allows the current market practice to continue with minor change in the size of the horizontal piece, and most market participants follow it, both costs and benefits of the proposed rule are expected to be minimal with the exception of the requirement of the appointment of the independent operating advisor discussed above.")

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although the Agencies acknowledged that "these transactions allow fuller asset-level disclosure in offering documents and could allow prospective investors the opportunity to review each loan in the pool, the agencies do not believe that this fact alone is sufficient grounds to satisfy the exemption standards of section 15G of the Exchange Act."[19]

Single borrower/single credit CMBS ("SBSC") are a specialized sub-set of the "non-conduit" CMBS market and the underlying loans are unique both within the "non-conduit" CMBS space as well as in the broader CMBS market. Over the next 7 years, more than $25 billion of previously issued SBSC bonds are scheduled to mature.[20] SBSC transactions are highly transparent relative to conduit pools. They involve only a single loan to a single borrower or a pool of loans (that may be to several affiliated borrowers) that are all cross-collateralized with one another such that – functionally – they operate as a single loan or "credit." As such, they should qualify for special treatment for several reasons.

First, SBSC deals have proven to be extremely low-risk as they have performed exceptionally well over time by all standards. Over the last sixteen years, cumulative losses across the entire spectrum of SBSC deals have been just 25 basis points or .25 percent.[21] SBSC deals thus have been much safer than the overall conduit CMBS market in which losses have been 2.79 percent over that same period,[22] and than the CMBS loans that would have satisfied the proposed QCRE loan criteria which experienced an aggregate cumulative loss rate of .74 percent over that same period.[23] In comparison, the cumulative loss rate for non-agency Residential Mortgage-Backed Securities loans that would have satisfied the proposed Qualified Mortgage retention exemption provisions over the same period was 6.41 percent.[24]

SBSC performance also compares favorably to corporate debt securities. SBSC transactions performed comparably well in stress periods to corporate bonds over a 31-year period in terms of

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[19] 78 Fed. Reg. at 57976.

[20] See Appendix 3 (showing SBSC and other large loan maturation schedule by year).

[21] *See* Appendix 4 (illustrating same).

[22] *See id.*

[23] *See* Appendix 6 (showing the number of loans to be considered QCRE under the Proposed Rule and the CRE Finance Council recommendations).

[24] JP Morgan provided this calculation.

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ratings transitions.[25] When evaluating loss severity, SBSC deals significantly outperformed even the highest caliber corporate debt segment – first lien loans.[26]

Second, SBSC deals are highly transparent and truly target investors that are looking for exposure to a specific asset. An investment in an SBSC deal generally involves extensive due diligence on one or more related commercial real estate properties that directly or indirectly represent the credit of a single sponsor and are evidenced by a single loan or a group of cross collateralized loans, as compared to a conduit transaction that requires due diligence on commercial real properties that secure as many as 100 or more mortgage loans representing the credit of 100 or more sponsors. Furthermore, SBSC transactions generally are offered only in the private placement market and only to "Qualified Institutional Buyers" under Rule 144A[27] and to "Institutional Accredited Investors" under Section 4(a)(2) of the Securities Act of 1933,[28] which also greatly expands the type and granularity of the data available to prospective investors.[29] This is because an investor in a single exposure necessarily requires extensive diligence and access to information. Accordingly, the level of disclosure included in offering documents and on investor information websites with respect to a SBSC transaction is highly detailed, with much disclosure provided regarding third-party reports, underwriting, reserves, cash management, cash flow analysis, major leases, asset specific risk factors, specifics on all material loan documents, etc. All of these factors mean that investors are in a position to fully evaluate the underwriting of an SBSC transaction and rely far less on the origination and underwriting of the transaction sponsor in making their investment decision.[30]

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[25] *See* Appendix 5 (comparing the SBSC and corporate debt rating transitions).

[26] *See* Appendix 4 (comparing SBSC and corporate debt cumulative loss rates); *compare also* Tad Philipp, et al., "US CMBS: Single-Asset/Single-Borrower Mid-Term Report Card Meets Expectations," Moody's Investors Service, Special Comment (Oct. 21, 2013), *at* https://www.moodys.com/research/US-CMBS-Single-AssetSingle-Borrower-Mid-Term-Report-Card-Meets--PBS_SF345417 (by subscription only); Sharon Ou, et al., "Annual Default Study: Corporate Default and Recovery Rates, 1920-2012," Moody's Investors Service, Special Comment (Feb. 28, 2013), *at* https://www.moodys.com/Pages/GuideToDefaultResearch.aspx (by subscription only).

[27] *See* 17 CFR 230.144A.

[28] *See* Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(2).

[29] In a publicly offered transaction, if any loan-level data is provided to any investor by either the issuer or underwriter, the information will be a free-writing prospectus and generally will need to be filed in accordance with Rule 433 issued under the Securities Act of 1933. *See* 17 C.F.R. § 230.43. Because the filing requirement could conflict directly with privacy law restrictions against public disclosure of borrower personal financial information, and because there also may be confidentiality provisions in the loan documents that prevent public filing of such information, much more limited information is provided to investors in public classes. Loan-level data can, however, be given to prospective investors in privately offered classes and such information need not be filed as a free-writing prospectus.

[30] On this point, one of the only SBSC transactions that incurred losses was the Extended Stay Hotels SBSC transaction of 2007. Reportedly, only a small proportion of the bonds sold and mostly at a steep discount, because

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Third, imposing a retention obligation on SBSC deals is likely to impose an additional cost of credit on potential borrowers. In this very competitive space, this is likely either to cause potential borrowers to flee the market completely[31] or to act as their own issuance sponsor so that they themselves can bear the "retention" obligation directly. Neither of these results is optimal. From a regulatory perspective, borrowing activity will move to a relatively less transparent sector (assuming that risk retention and Regulation AB requirements will be enforced). From the investor perspective, they will either lose quality loans in which to invest or they will lose the integrity that a traditional SBSC bond issuance has evidenced.

It is for these reasons that the CRE Finance Council IG Investor community expressed a strong consensus supporting the blanket exemption for SBSC transactions, with 77.4 percent of the 31 IG Investors responding to the CRE Finance Council survey affirmatively favoring the exemption and another 6.5 percent affirmatively expressing no opinion on exemption; the rest of the impacted CREFC member constituencies – Issuers, B-Piece Buyers, Servicers – unanimously support the exemption.

CRE Finance Council Recommendation: Exempt single borrower/single credit issuances from the risk retention rules. An exempt "Single Borrower/Single Credit" transaction should be defined as "A securitization of a single commercial real estate loan or a group of cross-collateralized commercial real estate loans that represent(s) the obligation of one or more related borrowers, and that is secured, or collectively secured as the case may be, by one or more commercial properties that are directly or indirectly under common ownership or control."

2. The Parameters for QCRE Loans Should Be Modified

As currently drafted, the parameters of the QCRE loan retention exemption are exceedingly restrictive. Since 2003, only 7.71 percent of the CMBS CRE loans would have qualified as QCRE loans under the parameters included in the Proposed Rule and those loans constituted only 3.12 percent of the CMBS loan principal balance over that same time frame.[32] Some CMBS market participants

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investors were able to identify the weaknesses of the deal. *See* Al Yoon & Nancy Leinfuss, "Extended Stay seeks to break up $4.1 billion CMBS," Reuters (June 16, 2009), *at http://www.reuters.com/article/2009/06/16/us-extendedstay-debt-sb-idUSTRE55F72I20090616.*

[31] There is evidence that the CMBS market already is losing some SBSC deals to corporate debt issuances. Harrah's recently refinanced a large loan in the corporate bond market and Hilton is in the process of doing the same. *See, e.g.*, Tim Cross, "Leveraged Loan Issuance Takes Breather As Market Digests Dell, Hilton," Forbes, *at* http://www.forbes.com/sites/spleverage/2013/09/27/leveraged-loan-issuance-takes-breather-as-market-digests-dell-hilton/ (Sept. 27, 2013); Beth Jinks, "Harrah's to Extend $5.5 Billion CMBS Maturities," Bloomberg (March 8, 2010), *at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=adHk3v2GAvgc.

[32] *See* Appendix 6 (showing the number of loans to be considered QCRE under the Proposed Rule and the CRE Finance Council recommendations).

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fear that imposing such restrictive conditions on retention exemptions for CMBS ultimately will result in weaker CMBS loan pools as the higher quality loans gravitate to other markets (which may not have sufficient capacity) because of the higher cost of borrowing that is expected to result from the imposition of the retention obligations. As noted at the outset, CMBS market participants have estimated that the retention obligations ultimately will cost borrowers from 40-50 additional basis points to access CMBS credit. In today's market, this would constitute increased costs of borrowing that ranges from 8 to 10 percent.

In addition to the SBSC exemption supported by all CREFC constituencies, there also is a strong consensus among CREFC members that the following four QCRE loan requirements should be modified:

(1) There should be no QCRE minimum loan term requirement (rather than the 10-year term required under the current proposal);

(2) The requisite amortization schedule should be allowed to be 30 years for all QCRE loans;

(3) Interest-only loans with Loan-to-Value ("LTV") ratios of 50 percent or less should be eligible for the QCRE loan retention exemption; and

(4) The lower allowable LTV ratio cap for loans that were appraised with capitalization ("cap") rates lower than 300 basis points more than current Treasury swap rates should be eliminated.

Each of these parameters is discussed, in turn, below. As a general matter, there is a broad consensus among all of the CRE Finance Council member constituencies in support of these changes to the QCRE loan parameters. This is in part because the cumulative loss percentage for loans that satisfy the CREFC proposed QCRE loan parameters is 0.57 percent compared to a cumulative loss ratio for loans that satisfy the currently proposed QCRE parameters that is almost 50 percent higher or 0.74 percent.[33] Some of CREFC's AAA IG Investors, however, generally oppose any liberalization of the QCRE loan parameters, primarily based on the concern that lenders will underwrite to the parameters to avoid or greatly minimize the required amount of retention.

At the same time, many members – including CREFC's Issuer, B-Piece Buyer and Servicer members, as well as some in the IG Investor community – believe that these recommendations do not go far enough and that the proposed debt service coverage ratio ("DSCR") and the LTV/CLTV ratio

[33] *See id.*

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caps exceed an optimal level. These constituencies argue that a very small percentage of CMBS loans will satisfy these requirements; that the level of these caps does not correlate with loan safety/soundness; and that this all is in stark contrast to the very liberal Qualified Residential Mortgage retention exemption under which the vast majority of residential mortgages will qualify. Although some IG Investors support liberalizing these QCRE loan requirements, others would prefer to further evaluate the appropriate level for these requirements at a later date, if at all.

(a) Loan Terms

The Proposed Rule acknowledges that "many commenters objected to the minimum length and amortization of QCRE loans" in the Prior Proposed Rule.[34] Despite the objections, the Proposed Rule includes a 10-year minimum maturity term for QCRE loans, under the belief that any shorter terms "may create improper underwriting incentives and not create the low-risk CRE loans intended to qualify for the exemption."[35] The Agencies, however, provide no data to support this assumption, and instead rely on the assumption that "an originator may focus only on a short timeframe in evaluating the stability of the CRE underlying the loan in an industry that might be at or near the peak of its business cycle."[36]

A review of the available data makes clear, however, that – historically – loans with 5-year or 7-year maturity terms have, as a class, been safer and better loans than 10-year term loans because losses on those loans have been less severe. Over a 16-year period from 1997 through July, 2013, for example, the cumulative loss rate for 5-year CMBS loans was 2.61 percent; for 7-year CMBS loans was 2.07 percent; and for 10-year CMBS loans was 2.87 percent.[37] For that reason, there was broad consensus across all CREFC constituent groups – including B-Piece Buyers, Issuers IG Investors (75 percent of the IG Investors responding to CREFC's IG Investor survey on this question voted in support) – to exclude a minimum maturity term for the QCRE loan requirements.

CRE Finance Council Recommendation: The definition of QCRE in the Proposed Rule should be modified to remove any minimum maturity term for QCRE loans.

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[34] 78 Fed. Reg. at 57981.

[35] *Id.* at 57982.

[36] *Id.*

[37] *See* Appendix 7 (showing loan performance by term).

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(b) Amortization Schedule

The Proposed Rule had modified the amortization schedule required for QCRE loans from the Prior Proposed Rule by allowing for loans that amortize based on a 30-year amortization schedule for multifamily residential and a 25-year amortization schedule for all other loans. The Agencies maintain that this is an appropriate balance because "a longer amortization period reduces the amount of principal paid on the CRE loan before maturity, which can increase risks related to having to refinance a larger principal amount than would be the case for a CRE loan with a shorter amortization."[38]

A 30-year amortization schedule is the standard amortization schedule for CRE loans in both the securitized and the portfolio markets. Although we appreciate the increase in the allowable amortization period from 20 to 25 years, CRE Finance Council members – across all constituencies, including IG Investors, B-Piece Buyers and Issuers – are concerned that requiring the extra amortization will drive the highest quality borrowers out of the CMBS market, which will weaken CMBS loan pools. In addition, the expedited amortization will have only a negligible impact on the outstanding balance at the end of a 10-year term.

For example, on a $1 million loan at a 4-percent interest rate, the expedited amortization schedule will result in a higher payment of $500 per month, which will result in an overall reduction of the outstanding principal balance at the end of the loan term of only $60,000. CREFC members simply do not believe that the imposition of this requirement will result in better underwriting, but instead will result in a loss of the highest quality loans to other markets. For that reason, there was broad consensus across all CREFC constituent groups – including Issuers, B-Piece Buyers, and IG Investors (with 75 percent of the IG Investors responding to CREFC's IG Investor survey on this question voting in support) – to raise the minimum amortization schedule for non-interest-only loans to a 30-year amortization schedule which is consistent with current market practices.

CRE Finance Council Recommendation: The definition of QCRE in the Proposed Rule should be modified to allow for up to 30-year amortization schedules.

(c) Interest-Only Loans

The Proposed Rule bars interest-only loans from qualifying as QCRE loans. The Agencies state that "interest only loans or interest-only periods are associated with higher credit risk. If a borrower is not required to make any form of principal payment, even with a 25-year amortization

[38] 78 Fed. Reg. at 57981.

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period, it raises questions as to the riskiness of the loan, and would be inappropriate for qualifying CRE loan treatment."[39] The Agencies, however, do not provide any data to support this claim.

Interest-only loans that have a 50 percent or lower LTV ratio should be eligible for QCRE loan status provided that they satisfy the other QCRE loan requirements. A 65 percent LTV amortizing loan should have an LTV at the end of a 10-year term of approximately 55 percent. Allowing interest-only loans that satisfy that lower LTV ratio requirement at the outset should be viewed as the equivalent of an amortizing loan that starts with a higher LTV. From a risk perspective, interest-only CRE loans that had an LTV of 50 percent or less have experienced cumulative losses over the last 16 years of 2.59 percent compared to the cumulative losses of 10-year loans of 2.82 percent.[40] For these reasons, CRE Finance Council's member constituencies, including 73.9 percent of the 23 IG Investors that responded to the CREFC IG Investor survey on this question, all strongly support permitting interest-only loans with an LTV ratio of 50 percent or less to qualify as QCRE loans.

CRE Finance Council Recommendation: The parameters of the QCRE loan requirements in the Proposed Rule should be modified to allow interest-only loans with an LTV ratio of 50 percent or less to qualify.

(d) Capitalization Rate

The Proposed Rule requires that the maximum LTV and CLTV ratios be lowered by 5-percent if the CRE property collateral was appraised with a low capitalization (or "cap") rate that is less than the prevailing 10-year Treasury swap rate plus 300 basis points.[41] In support of this additional limitation, the Agencies assert that "[g]enerally, a low cap rate will inflate the appraised value of the CRE property and thus increase the amount that can be borrowed given a fixed LTV or CLTV."[42] Market experience runs counter to the Agencies' cap rate assumptions as generally the safest loans on the most mature properties in premier markets are appraised with the lower capitalization rates in part in recognition of the stability of those properties.[43] Again, the market concern here is that if the safest CRE loans will be subject to more aggressive LTV and CLTV ratio caps, the result will be the loss of such loans from CMBS loan pools and further erosion in the quality of loan included in CMBS loan pools. For these reasons, there is a strong consensus across all CREFC constituency groups to

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[39] 78 Fed. Reg. at 57982.

[40] *See* Appendix 7 (CMBS 10-year data) and Appendix 8 (interest-only data).

[41] Proposed Rule § __.17(a)(5)(ii), 78 Fed Reg. at 58041.

[42] 78 Fed. Reg. at 57982.

[43] *See, e.g.,* Appendix 9 (demonstrating peak performance of CMBS loan classes).

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eliminate the lower LTV/CLTV ratio caps on loans documented with appraisals that utilize lower cap rates.

CRE Finance Council Recommendation: Eliminate the lower LTV/CLTV ratio caps for loans documented with appraisals that utilize lower cap rates.

C. B-Piece/Operating Advisor Issues

Section __.7 of the Proposed Rule outlines the rules that apply when a third-party purchaser – or "B-Piece Buyer" in our parlance – bears the retention obligation. These rules require an Operating Advisor to have a formalized role in any CMBS deal that utilizes the B-Piece retention option. In our Prior Comment Letter, we generally expressed our support for these rules and we suggested a number of modifications designed to make the proposed retention scheme operate efficiently and be less disruptive of current CMBS market practices. We believe the Agencies' constructive approach to these issues in the Proposed Rule is a step forward, and we thank the Agencies for adopting several of the CRE Finance Council's recommendations for improving the B-Piece retention rules and for recasting the Operating Advisor role to be more in line with current marketplace practices and investor demands.

In that spirit, we have four additional suggestions that CREFC's members collectively believe are vital to fostering an efficient CMBS marketplace while not sacrificing investor protection in any way. If the Agencies are sincere in their interest in "increase[ing] the likelihood that third-party purchasers will assume risk retention obligations,"[44] it is imperative that these four recommendations be incorporated into the final rules.

1. Where two B-Piece Buyers hold the EHRI, a senior-subordinate structure should be allowed in addition to *pari passu*

Under the proposed rule, two third-party purchasers – B-Piece Buyers – can be used to satisfy the overall 5-percent of fair value risk retention requirements by purchasing the EHRI, provided that each of the purchasers' interests are held *pari passu*. According to the Proposed Rule, the reason for the *pari passu* requirement is so that "neither third-party purchaser's losses are subordinate to the other's losses."[45] The structure in the Proposed Rule is different from the Prior Proposed Rule, as the Agencies felt it was "appropriate" to provide for "additional flexibility" for retention in this space.[46]

[44] 78 Fed. Reg. at 57953.

[45] *Id.*

[46] *Id.*

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The challenge posed by the new Proposed Rule is one of capacity in the marketplace. Today, the B-Piece investor community typically purchases 6 or 7-percent of the par value of a deal at a discount that translates into a typical investment of 2.5 to 3-percent of the fair value of the deal proceeds. Under the proposal, B-Piece Investors will need to raise the capital to consume the expanded 5-percent fair value retention requirement. That level of retention will mean that bonds higher in the waterfall – bonds historically rated BBB-, BBB, and potentially even A- – will be swept into the EHRI retention position.

Presumably, the capital the B-Piece Buyer will need to raise is capital from investors that currently are buying lower-rated investment grade bonds. Appendix 10 illustrates the take-up rate that would have been necessary for each bond class tranche for several recent deals when the EHRI is based on a 5-percent fair value calculation. The mixing of capital sources that have different risk-return profiles presents significant logistical impediments that will yield market inefficiencies, cost and ineffectiveness.

Allowing the sharing of the retention obligation across two investors should at least partially address the potential capital shortfalls. Requiring the two investors to hold their positions in *pari passu*, however, only will create considerable pricing and structuring challenges. As noted above, the B-Piece Buyers will have to absorb positions that cross over from investment grade to non-investment grade bond classes, which presumes that the investor base will be willing and able to buy across the capital stack. Given legal, operational and fiduciary constraints, IG Investors essentially are never able to invest in the non-rated bond classes.

Institutional IG investors that seek the higher yield of the lower-rated bond tranches could potentially fill the gap, but they often are constrained by law or by fiduciary limitations. Because of their restrictions on investing in non-IG or unrated bonds, however, they will be unable to participate in a *pari passu* EHRI investment. As a result, the *pari passu* structure will reduce the overall amount of available CMBS capital and investors' ability to target their investments by risk. It also will reduce the ability to efficiently price each layer in the capital structure, thereby raising the weighted average cost of capital, and exposing the parties in the transaction to additional transactional costs.

A senior/subordinate structure is better aligned with current marketplace practice; would be a much more efficient structure overall;[47] and would adhere to the fundamental principle of risk-targeting that the CMBS market serves. It would allow institutional investors seeking the additional yield that the lower-rated bond classes provide to participate in the retention regime by investing in the rated component of the EHRI. Allowing a senior/subordinate risk retention sharing regime thus could preserve the basic capital structures that currently drive CMBS.

[47] Another 14 percent of the Investment-Grade Investors responding were neutral on this question and only 14 percent of those responding were opposed.

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In addition, providing for *pari passu* B-Piece ownership creates potential issues regarding the exercise of control over servicing decisions, the direction of certain matters regarding specially serviced loans, and the appointment and replacement of the special servicer. It is long-standing CMBS practice that the first-loss entity that owns the most subordinate class of certificates that, in general, has an outstanding principal balance equal to 25 percent or more of its original principal balance (as notionally reduced by appraisal reductions), has the right to appoint a controlling class representative who has such certain consent and direction rights. Tranching of the B-Piece classes has historically been commensurate with tranching of control. The requirement that B-Piece Buyers can only hold *pari passu* interests raises the challenge of assigning control between two unrelated B-Piece Buyers who, when given joint control, may not be able to agree on various consent issues that arise throughout the deal, thereby potentially causing decision making deadlocks and delays in the servicing of the loans and an impediment to borrowers desiring to obtain various consents in an efficient manner. Joint control by two investors has historically raised significant problems when drafting provisions in servicing agreements regarding the resolution of borrower requests in an efficient manner.

There is no evidence to suggest that allowing the holders of the retained EHRI to hold those positions either in *pari passu* or in a senior/subordinate structure would create additional risk for investors or to the CMBS marketplace in general. CRE Finance Council member constituencies are in overwhelming agreement that the senior/subordinate retention structure should be permissible provided that the initial senior EHRI holder also must satisfy all of the obligations and requirements imposed on the subordinated interest holder to make that a permissible retention alternative. After the five-year hold period, however, the senior EHRI position should be fully tradable without restriction to avoid the imposition of unnecessary liquidity restrictions on the marketplace. In addition, the subordinated EHRI holder – who would be the traditional B-Piece Investor in the standard CMBS structure – must retain at least half of the overall retention obligation, or 2.5-percent of the fair value of the deal. It is for these reasons that 67.7 percent of the 31 IG Investors responding to the CREFC survey voted in favor of allowing the senior/subordinate retention structure outlined above[48] and that there is unanimous support for these recommendations among the rest of the CREFC member constituencies.[49]

CRE Finance Council Recommendation: In addition to *pari passu* ownership, the Agencies should modify the Proposed Rule to allow for up to two EHRI investors also to hold their retention positions in a senior/subordinate structure provided that the junior EHRI investor must retain at least half of the requisite EHRI (or 2.5-percent of the fair value of the deal) and

[48] Another 12.9 percent of the responding IG Investors voted a neutral position on this question.

[49] CREFC's B-Piece Buyer and Servicer forums support shorter mandatory retention periods for the senior EHRI investor and relaxed application of the independent review of the credit risk of each securitized asset requirements but there was no consensus supporting these additional changes, especially among CREFC's Investment Grade Investor community.

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provided further that both initial EHRI investors must each independently satisfy all of the requirements and obligations imposed on a third-party purchaser bearing the retention obligation under Section __.7.

2. Operating Advisor consultation rights should be calculated using the Appraisal Reduction Amount

The CRE Finance Council appreciates that the Agencies have responded to the request in our Prior Comment Letter to limit the Operating Advisor consultation rights to when the B-Piece first loss position has deteriorated and has been reduced in value to a level that no longer meets a reasonable "skin in the game" standard. Accordingly, under the Proposed Rule, "the consultation requirement only applies to special servicers and only takes effect once the eligible horizontal residual interest held by third-party purchasers in the transaction has a principal balance of 25 percent or less of its initial principal balance."[50]

The current market practice for evaluating principal reductions is to require use of an appraisal. While it does not appear that the Proposed Rule would prohibit the use of an appraisal to evaluate the magnitude of any principal reduction, the rule does not specify the appropriate mechanism for determining the outstanding principal balance. All of CREFC's member constituencies unanimously support specifying use of appraisals to value outstanding principal balances.

CRE Finance Council Recommendation: The Agencies should clarify that the Appraisal Reduction Amount must be used to calculate principal reduction value to evaluate when the Operating Advisor consultation rights attach.

3. The voting quorum to replace special servicers should be raised

As stated above, the CRE Finance Council strongly supports the Agencies' efforts to protect investors from unnecessary risk while attempting to preserve current marketplace standards. In that regard, the Agencies have proposed that a special servicer could be removed based on an Operating Advisor recommendation by an "affirmative vote of a majority of the outstanding principal balance of all ABS interests voting on the matter, and require a quorum of 5-percent of the outstanding principal balance of all ABS interests."[51] In support of this requirement, the Agencies have simply said that the "removal of the special servicer should be independent of whether the third-party purchaser is the controlling class in the securitization transaction or similar considerations[,]" and that "[t]he proposed

[50] 78 Fed. Reg. at 57956; *see also* Proposed Rule §__.7(b)(6)(iv) (requiring same), 78 Fed. Reg. at 58032.

[51] 78 Fed. Reg. at 57956; *see also* Proposed Rule §__.7(b)(6)(vi)(B) (requiring same), 78 Fed. Reg. at 58032.

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affirmative majority vote and quorum requirements are designed to provide additional protections to investors in this regard."[52]

The CRE Finance Council Issuer, B-Piece Buyer and Servicer forums all unanimously favor increasing the quorum requirements to be more in line with current market practices. They would, therefore, recommend a tiered-system under which the requisite quorum for a replacement vote would be two-thirds of all of those eligible to vote before the B-Piece Investor had been appraised down below 25 percent and one-third after. Even this would be a significant downward departure from current market practices under which special servicer replacement while the B-Piece Buyer remains in control either is not subject to a bondholder vote or requires a very high percentage of all bondholders (60-75 percent) to affirmatively vote for replacement. After the B-Piece Buyer no longer is in control, generally replacement is required only if at least 50 percent of all bondholders affirmatively vote in favor. Part of the B-Piece Investor and Servicer rationale for the higher thresholds is that the B-Piece Investors have special servicing rights that would be threatened by low voting thresholds at a point in time when the primary beneficiary of effective special servicing is the B-Piece Investor itself because it remains in the first-loss position.

CREFC's IG Investors do not support quorum requirements at that high a level. There is, however, concern – even among the most conservative CMBS IG Investors – that the 5-percent quorum threshold is simply too low; would open the market to manipulation; could result in unnecessary replacement of a special servicer; and could lead to the highjacking of the process by a single well-placed, but disgruntled, investor. At the other end of the spectrum, many investors are concerned that a quorum threshold that is set too high will be unachievable because of the frequent difficulty in identifying and locating many bond investors. The CREFC consensus position reconciling these two concerns is that the quorum threshold should be raised to a minimum of 20 percent with at least three separate investors participating in the vote. In a survey of CREFC's IG Investors, over 92 percent of those responding believed that the quorum rule should include a requirement that at least three separate investors must participate in the vote; and 50 percent of the responding investors opined that the appropriate quorum threshold should be 20 percent. All CRE Finance Council member constituencies thus support raising the quorum requirements to at least 20 percent (with at least 3 independent investors participating in the vote).

CRE Finance Council Recommendation: The removal of the special servicer should be subject to a majority vote of the outstanding principal balance of all ABS interests voting on the matter, but the minimum quorum requirement should be raised to 20 percent with at least three independent investors participating in the vote.

[52] 78 Fed. Reg. at 57956-7.

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4. **The Prohibition on B-Piece Buyers being affiliated with originators that contribute more than 10 percent of the loans to a CMBS loan pool should be eliminated**

The Proposed Rule would bar a third-party purchaser of the EHRI retention position generally from being "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,"[53] but allows for an exception for "[o]ne or more originators of the securitized assets, as long as the assets originated by the affiliated originator or originator[s] collectively comprises less than 10 percent of the principal balance of the securitized assets included in the securitization transaction at closing of the securitization transaction."[54]

While the Proposed Rule is silent on the rationale for this restriction and associated exception, the Prior Proposed Rule makes the argument that it "intended to address the potential conflicts of interest that can arise when a third-party purchaser serves as the 'controlling class' of a CMBS transaction."[55] A B-Piece Buyer in a CMBS transaction typically does, however, serve as the "controlling class" as long as the principal balance of its investment in the deal is at least 25 percent of its initial principal balance. There is no compelling reason to preclude the affiliate of an originator from purchasing the EHRI position. Indeed, two prominent institutions that represent a material percentage of B-Piece capital have affiliates heavily engaged in originating CMBS loans, and the imposition of this affiliation prohibition may jeopardize a significant amount of potential third-party purchaser capital and forestall the development of underwriting that has more integrity because of the ultimate bearing of the first-loss position by a corporate affiliate.

CRE Finance Council Recommendation: The Agencies should eliminate any prohibition on the affiliation between a third-party purchaser bearing the EHRI retention obligation and an originator of loans for that transaction. This recommendation is unanimously supported across all CREFC constituencies.

5. **Additional Operating Advisor Related Disclosures**

The Proposed Rule requires various CMBS-specific transaction document required disclosures, including required disclosures of Operating Advisor related information.[56] The required Operating

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[53] Proposed Rule §__.7(b)(5)(i), 78 Fed. Reg. at 58031.

[54] Proposed Rule §__.7(b)(5)(ii)(B), 78 Fed. Reg. at 58031.

[55] 76 Fed. Reg. at 24110.

[56] *See* Proposed Rule § __.7(b)(7)(vii), 78 Fed. Reg. at 58031; *see also* discussion at 78 Fed. Reg. at 57957.

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Advisor disclosures currently include the name and form of organization of the Operating Advisor; a description of how the Operating Advisor meets the standards in the Proposed Rule (including the Operating Advisor's "experience, expertise and financial strength to fulfill its duties");[57] and the terms of the Operating Advisor's compensation.[58] Additionally, the Agencies discuss the need for the Operating Advisor to be independent to others as part of the securitization transaction, and state that "an independent Operating Advisor is a key factor in providing a check on third-party purchasers and special servicers, thereby protecting investors' interests."[59] The Proposed Rule then states that the securitization transaction documents shall provide for the fact that the Operating Advisor is not affiliated with other parties to the transaction, does not either directly or indirectly have any financial interest in the transaction (other than fees as part of its role as Operating Advisor), and will act in the best interest of investors.[60]

CREFC's IG Investors have suggested that two additional disclosures be required in order to fully ensure the independence of the Operating Advisor and there is strong support across all of the CRE Finance Council's members in support of the additional disclosure. First, any material conflict of interest or potential material conflict of interest that the Operating Advisor may have should be reported as an additional disclosure to the securitization transaction. This will allow the parties, including IG Investors, to closely scrutinize the Operating Advisor to ensure that it will truly act independently. Second, some IG Investors believe that just compensation will both attract high quality Operating Advisors and help guarantee a conflict of interest-free environment. Even though the terms of the Operating Advisor's compensation need to be disclosed,[61] additional information regarding the formula for calculating such compensation should be disclosed. By mandating disclosure of these additional points, all parties to the securitization transaction can make educated decisions. Further, it will allow the marketplace to help determine how best to make the Operating Advisor independent.

CRE Finance Council Recommendation: The Agencies should require additional disclosures related to (i) any material conflict of interests or potential conflict of interests that the Operating Advisor may have, and (ii) the formula behind the Operating Advisors compensation. Both of these disclosures will serve the goals of transaction transparency and independence of the Operating Advisor.

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[57] Proposed Rule §__.7(b)(6)(ii), 78 Fed. Reg. at 58031.

[58] Proposed Rule §__.7(b)(7)(vii)(A) – (C), 78 Fed. Reg. at 58031.

[59] 78 Fed. Reg. at 57955.

[60] Proposed Rule §__.7(b)(6)(i)(A) – (C), 78 Fed. Reg. at 58031.

[61] *See* §__.7(b)(6)(iii), 78 Fed. Reg. at 58032.

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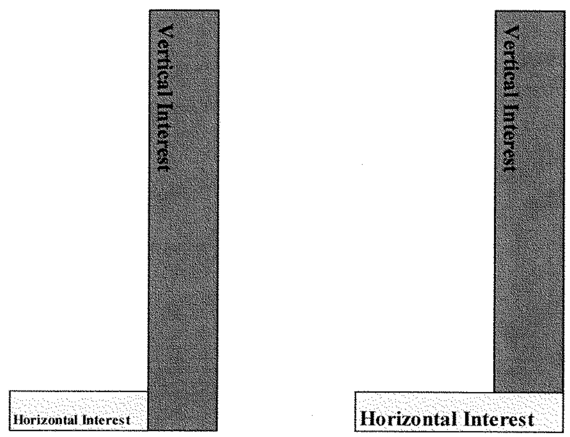
D. TECHNICAL RECOMMENDATIONS

The following technical recommendations have the unanimous support of each of CREFC's constituent forum leaders. We believe that incorporation of these suggestions will ensure that the details of the proposed retention regime will be clearer and more operable in the marketplace.

1. Basic CMBS Retention – L-Shaped CMBS Retention

The Proposed Rule allows CMBS securitization sponsors to share the 5-percent fair value retention obligation with a B-Piece Investor that purchases the EHRI and the Proposed Rule further allows the retention obligations to be allocated between the two in this structure in essentially any way to which the sponsor and the B-Piece Investor agree provided that the total retained amount satisfies the core 5-percent fair value retention obligation. The question has arisen whether the sponsor's vertical retention must include a portion of the EHRI in a structure in which a B-Piece Investor will be sharing the retention obligations through its retention of the EHRI. The two graphs below illustrate the two potential L-shaped retention structures:



Alternative #1 **Alternative #2**

CMBS Sponsors have a strong preference for not requiring that their vertical retention include a share of the EHRI in this scenario because it avoids numerous accounting and securitization control

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problems. Given that the Proposed Rule permits a B-Piece Buyer to retain the entire 5-percent fair value retention obligation, it seems consistent with the philosophy of the Proposed Rule not to require the Sponsor to retain a portion of the EHRI in connection with L-Shaped retention. We also note that in the Prior Proposed Rule, the L-shaped risk retention proposed rule provided that the vertical portion of the retained risk was not to be calculated with respect to the ABS interests that were part of the horizontal portion of the retained risk.[62] A similar clarification should be made to the Proposed Rule.

2. Basic CMBS Retention – REMIC Residual Interests Should Be Excluded From The Retention Regime

Almost all CMBS transactions are done through a tax vehicle called a Real Estate Mortgage Investment Conduit ("REMIC"). The interests in a REMIC include one or more classes of "regular interests," which are entitled to principal and/or interest payments, and a single class of "residual interests," which generally do not receive principal or interest payments. As explained below, the sole purpose of the "residual interest" is to require the holder of that interest to be responsible for any REMIC net income tax obligation. Because the holder of that interest does not share any of the credit risk in the underlying transaction, the REMIC "residual interest" should not be subject to any of the retention requirements.

The principal benefit of the REMIC structure is that it is not taxed at the entity level.[63] Congress, however, wanted to ensure that to the extent the REMIC itself generates net income, tax would be paid on that income. Congress therefore required that the tax on any net income earned by the REMIC be paid by the holders of the "residual interest."[64] There is no requirement that a residual interest be entitled to any principal or interest. In fact, in the overwhelming majority of securitizations in the market, the holder of the residual interest is not entitled to any principal or interest.[65] The residual interest does not represent an economic interest in the securitization but is nevertheless responsible to pay the REMIC's taxes.[66]

[62] *See* Prior Proposed Rule, 76 Fed. Reg. at 24103 (discussing same).

[63] § 860A(a) of the Internal Revenue Code of 1986, as amended (the "IRC").

[64] IRC § 860C.

[65] Although it is structurally possible that a residual interest could receive proceeds from the sale of foreclosed property that exceed the amounts owed to regular interest holders, it would be rare that such amounts are in fact ever received. Such amounts received, if any, would also be substantially less than the total tax liability generated by the residual interest.

[66] Because the residual interest represents income without any corresponding cash, it is often referred to as being "non-economic." Buyers of residual interests are paid upfront to bear the future liability of the securitization.

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Because a non-economic residual interest represents a tax liability, Congress was concerned that it not be held by persons who were unlikely to pay tax, such as certain tax-exempt entities (including "disqualified organizations") or non-U.S. persons.[67] Special rules exist to ensure that the taxable income of a REMIC is collected and that transfers to disqualified organizations are disregarded.[68] All pooling and servicing agreements contain restrictions against the transfer of a residual interest to an even broader category of "non-permitted" persons. While many sponsors, such as U.S. banks, would not be subject to these restrictions, other sponsors, such as funds, may be. Even sponsors that would be permitted to hold residual interests often find it less expensive or less burdensome to pay someone else to hold the residual interest and bear the future taxes. Any rule subjecting the "residual interest" to the risk retention requirements would upset the normal course of securitization formation without generating any off-setting benefit for the retention regime.

3. Basic CMBS Retention – Treatment of *Pari Passu* and Subordinated Notes and Participation Interests as Retention

In many smaller loan pool deals – floater deals or "large loan" deals with ten or fewer loans for example[69] – each loan included in the deal often has a companion *pari passu* note or participation interest or a subordinated note or participation interest (collectively, "Retained Interests") that is not included in the CMBS loan pool. The Retained Interests are in all ways relevant to risk retention and alignment of interests identical to any other ABS interest issued by the securitization vehicle. Only the form differs (since the Retained Interests are not technically issued by the securitization vehicle). The loans subject to Retained Interests are serviced under the related CMBS transaction documents; cashflow and losses are allocated to Retained Interests similarly to comparable ABS interests; and the owners of Retained Interests are in every way exposed to the performance of the related commercial mortgage loans in the same ways as the holders of ABS interests.

The retention of Retained Interests by a sponsor, originator or B-piece Buyer, in compliance with all other requirements for risk retention applicable to retention of ABS interests, should be a permissible form of risk retention. So long as the Retained Interests related to a CMBS transaction have an aggregate fair value of at least 5-percent of the total fair value of all ABS interests and related Retained Interests, then retention of the Retained Interests will satisfy the purposes of the retention requirements because the Retained Interests constitute "skin in the game" equivalent to holding a

[67] A "disqualified organization" includes the United States, any state or any political subdivision thereof, an organization that is exempt from tax (except certain farmers' cooperatives and tax-exempt organizations subject to the tax on "unrelated business income") and rural telephone and electricity cooperatives. IRC § 860E(e)(5).

[68] IRC § 860E(e).

[69] This logic applies equally to SBSC transactions, although the CRE Finance Counsel believes strongly that such transactions should be exempt from risk retention for the reasons explained elsewhere in this comment letter.

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retention in ABS interests issued by the CMBS vehicle. The added structural flexibility permitted by Retained Interests would allow retention in a more efficient form for certain investors (e.g., investors that for various regulatory or other reasons prefer to own "whole loan" interests rather than interests in the form of securities issued by a securitization vehicle). At the same time, the retention of Retained Interests does not compromise in any way the purposes served by risk retention.

4. QCRE – Certain Provisions of Section __.17 Should be Modified to Limit the Scope of the Requisite "Security Interest" and More Generally To Take Into Account *Pari Passu* and Junior Liens Loans

Pari passu notes are a common feature of the CRE loan market. Large commercial mortgage loans originated by a syndicate of investment banks on a *pari passu* basis (and/or with associated junior lien loans), for example, are extremely common in the current market, given that sponsors are often desirous of maximizing their exposure to a diversity of banks, and multiple banks are often bidding for and awarded the origination on a joint and several basis. The *pari passu* loans tend to be of the highest underwriting quality because of the marquis properties to which they are often attached and because of the additional hurdles to which such loans are subject (issuer retention of one of the notes or multiple securitizations, for example). A *pari passu* note should not be ineligible for QCRE loan treatment if it otherwise satisfies the applicable requirements (including the CLTV limitations). Where several major banks are involved in the origination process in such a large pari passu origination, there is generally a higher level of underwriting, due diligence and credit review, as multiple banks are involved in the diligence.

To satisfy the QCRE loan requirements, certain provisions of Section __.17 would need to be modified to account for QCRE loans that have associated *pari passu* loans and/or junior lien loans (which are expressly mentioned but not correctly accounted for) that are held outside the subject securitization trust.

For example, the following clarifications would need to be made:

(i) Section __.17(a)(1)(ii) which deals with assignment of leases and other property interests – insert after (ii) but prior to (A): "requires (together with any *pari passu* lien loans and/or junior lien loans on the subject mortgaged property, as their interests may appear)."[70]

(ii) Section __.17(a)(1)(iii)(A) requires the originator to obtain a security interest in "all interests of the borrower and any applicable operating affiliate" in the collateral that secures the loan."[71] Imposition of this requirement is consistent with marketplace and other legal requirements but

[70] Proposed Rule § __.17(a)(1)(ii), 78 Fed. Reg. at 58040.

[71] Proposed Rule § __.17(a)(1)(iii), 78 Fed. Reg. at 58040.

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only to the extent necessary to perfect the lender's interest in the property. Generally, the security interest is limited to the outstanding balance on the loan and the borrower (or other lien holders) are entitled to any overage. Two provisions would need to be amended to address these concerns. First, to address the *pari passu*/junior lien holder issue, insert after "A security interest" at the beginning of (iii) the words "Together with any pari passu lien loans and/or junior lien loans on the subject mortgaged property as their interests may appear". Second, at the end of (A) and (B) to deal with ensuring that the protection is properly sized, insert the words "to the extent necessary to perfect the bondholders' interest in the property".

(iii) The definitions of "DSC" and "CLTV" would need to be revised to recognize the *pari passu* interests by inserting "(together with any *pari passu* line loans but without regard to any junior lien loans)" at the very end of the DSC definition as the last clause in (2)(ii)[72] and by inserting "(together with any *pari passu* first lien mortgage loans)" in the CLTV definition after the words "first lien mortgage loan".[73]

We believe that the foregoing clarifications are necessary to ensure that the QCRE loan provisions are viable and consistent with reasonable market practice and other legal requirements. Accommodating *pari passu* lien loans is crucial in order to afford borrowers the ability to obtain large loan financing, and to permit multiple banks to participate in the origination of large commercial loans. There is no additional risk as the income from the property is simply divided on a *pari passu* basis among the senior lenders. There is no supportable reason that *pari passu* notes should not be eligible for QCRE loan treatment if they otherwise satisfy the applicable requirements (including the DSC and CLTV limitations). In addition, the security interest requirements also need to be reformed to ensure that that interest is not required to be more than necessary to protect the lenders' interests.

5. QCRE – Appraisals

Section __.17(a)(2)(ii) requires the originator to obtain a written appraisal. Written appraisals are a standard requirement for CMBS loans. Two details in the Proposed Rule requirement, however, warrant modification.

First, subsection (A) requires that the appraisal be done "by an appropriately State-certified or State licensed appraiser."[74] The standard market requirement is that the appraisal must satisfy Uniform Standards of Professional Appraisal Practice ("USPAP") requirements as adopted by the Appraisal

[72] *See* Proposed Rule §_.14 ("DSC" Definition), 78 Fed. Reg. at 58037.

[73] *See* Proposed Rule §_.14 ("CLTV" Definition), 78 Fed. Reg. at 58037.

[74] Proposed Rule § __.17(a)(2)(ii)(A), 78 Fed. Reg. at 58040.

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Standards Board of the Appraisal foundation. Many commercial appraisers meet the USPAP requirements but are not state certified or licensed as the certifications and licensure generally have more resonance in the residential real estate space

Second, subsection (C) requires 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."[75] The requirement that the opinion be based on a DCF approach may not be appropriate for a stabilized property like a mature multifamily property. Therefore, we recommend that the valuation approach could use a DCF or a direct cap rate analysis.

6. QCRE – Insurance Requirements

Section __.17(a)(3)(iii) – require each borrower and each operating affiliate to "[m]aintain insurance that protects against loss on collateral for the CRE loan . . . at least up to the amount of the loan . . . "[76] Generally, the standard insurance requirement is based on the lower of the loan balance or the replacement cost. If the replacement cost is lower than the loan amount, the borrower should not be required to maintain a higher level of insurance than is necessary to rebuild.

7. QCRE – Prior "Borrower" Performance

The QCRE loan underwriting requirements require that "based on the previous two years' actual performance, the *borrower* had" satisfied certain minimum Debt-Service Coverage ("DSC") ratios.[77] Commercial mortgage loans originated for CMBS often require the related real estate owners to transfer subject properties into newly formed special purpose borrowing entities. As such, the "borrower" for most such loans will not have existed for two years (or for any substantial period) prior to the origination of the loan and therefore the "borrower" cannot have had any particular DSC ratio, because that "borrower" did not exist and the financing upon which the DSC calculation is based also did not exist.

We interpret this requirement to mean that, based upon the financial performance of the subject property in the last two fiscal years ending prior to loan origination, the new loan (and the new borrower/property owner) would have had a DSC ratio (based upon the principal balance and interest rate of the new loan) that meets the specified requirements. A clarification that this interpretation is correct would be helpful.

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[75] Proposed Rule § __.17(a)(2)(ii)(C), 78 Fed. Reg. at 58040.

[76] Proposed Rule § __.17(a)(3)(iii), 78 Fed. Reg. at 58041.

[77] Proposed Rule § __.17(a)(2)(vi) (*emphasis* added), 78 Fed. Reg. at 58040.

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8. **Floating Rate Mortgage Loans & Interest Rate Cap Contracts**

The Proposed Rule excludes variable rate mortgage loans from the definition of QCRE loan, unless the borrower "obtained a derivative that effectively results in a fixed interest rate."[78] While we understand the Agencies' concern that exposure to rising interest rates may not be consistent with QCRE status, it is common for floating rate commercial mortgage loans originated for securitization to require the borrower to acquire and pledge an interest rate cap contract (rather than a swap agreement) from a credit-worthy counterparty as additional collateral for the loan. The use of a cap contract rather than a swap has two significant benefits. First, cap contracts provide for "one-way" payments: the counterparty is required to pay the borrower in the event that interest rates rise, however, the borrower benefits in a low or declining interest rate environment, since it is not required to make payments to the cap counterparty. A borrower subject to an interest rate swap agreement derives no benefit from low interest rate environments, because the "two-way" nature of the payments under a swap contract requires the borrower to pay the swap counterparty to the extent that interest rates decline below the "strike rate" under the swap contract.

Second, because swap contracts require the borrower to make payments to the swap counterparty in declining interest rate environments, the swap counterparty becomes a creditor of the borrower. Because CMBS borrowers typically are "special purpose entities" having only one creditor (i.e., the lender under the mortgage loan), the imposition of a second creditor makes such loans less secure than typical CMBS loans. Interest rate cap providers are not, under any circumstances, entitled to receive payments from the borrower (other than an up-front payment made at loan origination) and, therefore, can never be creditors of the borrower.

The Agencies should therefore allow floating rate commercial mortgage loans to qualify as QCRE loans, provided that such loans satisfy all other QCRE criteria; and, provided further that the related borrower pledges an interest rate cap contract from a credit-worthy counterparty with a strike rate that effectively sets a maximum interest exposure for the borrower which, when employed in a DSCR calculation, results in a DSCR for such mortgage loan that is consistent with QCRE status.

9. **Exemption Process**

As the Agencies expressly have noted:

> [S]ection 15G(e)(1) permits the agencies jointly to adopt or issue additional exemptions, exceptions, or adjustments to the risk retention requirements of the rules, including exemptions, exceptions, or

[78] Proposed Rule § __.17(a)(7)(iii)(B), 78 Fed. Reg. at 58041.

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> adjustments for classes of institutions or assets, if the exemption, exception, or adjustment would: (A) Help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.[79]

To ensure that Section 15G(e)(1) is implemented in a way that provides a meaningful opportunity to request an exemption, exception, or adjustment to the risk retention requirements, it is imperative that the Agencies circumscribe a formal 15G(e)(1) process in the final rules. The Agencies previously have indicated that they intend to jointly issue all guidance related to the risk retention rules;[80] while that is a laudable objective, it does create logistical challenges for those endeavoring to abide by a complicated set of rules that will require additional interpretation (and correction) as we move forward. Promulgating a formal set of rules for those seeking such assistance and redress would be a welcome development for marketplace participants.

CONCLUSION

The CRE Finance Council again recognizes that an extraordinary amount of thought and work went into the development of the Proposed Rule and we appreciate the extent to which the Agencies responded to and incorporated the concerns and suggestions of the CMBS market in re-crafting the Proposed Rule. Our members continue to 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

[79] 78 Fed. Reg. at 57969-70.

[80] 78 Fed. Reg. at 57933.

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take the necessary time to get this right, and the CRE Finance Council looks forward to working further with the Agencies on this endeavor.

Sincerely,

Stephen M. Renna
President & CEO
CRE Finance Council

cc: The Honorable Shaun Donovan
Secretary
United States Department of Housing and Urban Development
451 7th Street SW
Washington, DC 20410-0500

Mr. Edward DeMarco
Acting Director
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APPENDIX 1: CREFC and Industry Background

Industry-led Reforms

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

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

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

1. ***CREFC Investor Reporting Package (U.S. and EU Versions):*** Standardized and comprehensive package of bond, loan and property level information used extensively in the CMBS marketplace. This data is collected prior to issuance and throughout the life of the transaction.
    a. ***CREFC Special Servicing Disclosure Reports added to IRP™:*** New disclosure reports adopted December 2012 providing increased transparency surrounding special servicer activities, including information regarding affiliates, fees, loan modification decisions, and the final disposition of specially-serviced CMBS loans.
    b. ***Standardized Annex A:*** Provides a deep data dive on the largest loans within the transaction, including enhanced granularity regarding operating statements and additional data with respect to escrow accounts and reserves.

2. ***Pooling and Servicing Agreement (PSA):*** First offered to the public by CREFC's predecessor, Commercial Mortgage Securities Association. Since the crisis, numerous enhancements and modifications have been made, including more specific deal terms and conflict resolution standards for issues involving servicers.

3. ***Model Representations & Warranties:*** Standardized set of representations and warranties for inclusion in transaction documentation regarding the accuracy of loans in the pool, including more than 50 parameters. This is a critical feature of CMBS documentation as it enables investors to pursue loan repurchases in the event of material

APPENDIX 1: CREFC and Industry Background

breaches; representations and warranties essentially function as a loan-level form of "skin-in-the-game" for the originators, issuers and sponsors.

4. ***Principles-Based CRE Loan Underwriting Framework:*** Set of principles establishing industry best practices in underwriting processes and characteristics, encouraging standardization and lower risk-taking in lending.

APPENDIX 2: Closing Date Cash Flow v. Principal Repayment Test

Risk Retention - Alternative Test

Conclusion: It is imperative that par, not fair value, be used as the valuation treatment CMBS in order for the Alternative regulatory test to apply within in the context of current economics and market practices. If fair valuation is maintained as part of the requirement, most, if not all, CMBS deals will fail the test until maturity.

Note: For the purposes of simplicity, the below assumes no losses to the pool. Losses would further challenge the deal, making it increasingly difficult to pass the Alternative test, especially if treated under fair value. This bolsters the case that the Alternative test is viable only in a par valuation environment.

Pool Balance	$1,250,000,000
WAC	5.25%
WAM	10
WARA	30
Discount Rate on Pool	4.75%
Fair Value of Pool	$1,295,526,185
Fair Value % Principal	103.6%
Ex Post CDR Assumption	0.00%
Severity Assumption	45.0%
Note: Assumes no liquidation lag	
Total Losses	0.0%
FV of HRI	$64,776,309
Discount Rate on HRI	14.00%
Current Yield on HRI	6.40%
HRI WAL	10
HRI Implied Principal	$159,973,803
HRI Purchase Price	$0.405
HRI Implied Coupon Rate	**2.59%**
HRI Principal Percentage of Total Pool	**12.8%**
Loss-Adjusted IRR	14.0%

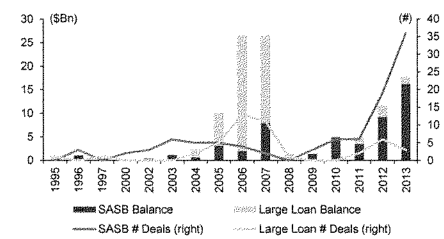
	Loss-Adjusted Pool Amounts								HRI Loss-Adjusted Cash Flows					CREFC Test		
Year	Defaults	Liquidations	Losses	PPMTs	IPMTs	EB	CF	TOT. PRIN PMTs	IPMTs	Losses	PPMTs	EB	CF	HRI % of CF as % of UPB	Rest of Pool % of CF as % of UPB	HRI % < Rest of Pool %?
0						$1,250,000,000						$159,973,803	($64,776,309)			
1	$0	$0	$0	$18,021,167	$65,625,000	$1,231,978,833	$83,646,167	$18,021,167	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	7.4%	OK
2	$0	$0	$0	$18,967,278	$64,678,889	$1,213,011,555	$83,646,167	$18,967,278	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	7.5%	OK
3	$0	$0	$0	$19,963,060	$63,683,107	$1,193,048,495	$83,646,167	$19,963,060	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	7.7%	OK
4	$0	$0	$0	$21,011,121	$62,635,046	$1,172,037,374	$83,646,167	$21,011,121	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	7.9%	OK
5	$0	$0	$0	$22,114,205	$61,531,962	$1,149,923,169	$83,646,167	$22,114,205	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	8.0%	OK
6	$0	$0	$0	$23,275,201	$60,370,966	$1,126,647,968	$83,646,167	$23,275,201	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	8.2%	OK
7	$0	$0	$0	$24,497,149	$59,149,018	$1,102,150,820	$83,646,167	$24,497,149	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	8.4%	OK
8	$0	$0	$0	$25,783,249	$57,862,918	$1,076,367,571	$83,646,167	$25,783,249	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	8.7%	OK
9	$0	$0	$0	$27,136,869	$56,509,297	$1,049,230,702	$83,646,167	$27,136,869	$4,145,684	$0	$0	$159,973,803	$4,145,684	2.6%	8.9%	OK
10	$0	$0	$0	$1,049,230,702	$55,084,612	$0	$1,104,315,313	$1,049,230,702	$4,145,684	$0	$159,973,803	$0	$164,119,487			
11	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
12	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
13	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
14	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
15	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
16	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
17	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
18	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
19	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
20	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
21	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
22	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
23	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
24	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
25	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
26	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
27	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
28	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
29	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			
30	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0			

APPENDIX 3: Loan Issuance and Maturation

Deal Balance By Issuance Year

Year	Balance ($) SASB	Balance ($) Large Loan	Number of Deals SASB	Number of Deals Large Loan
1995	0	967,185,797	0	1
1996	1,072,448,928	0	3	0
1997	0	977,099,000	0	1
2000	236,967,406	0	2	0
2002	361,964,000	0	3	0
2003	1,147,659,000	0	6	0
2004	644,200,000	1,834,015,102	5	2
2005	3,108,700,000	6,944,884,010	5	5
2006	1,981,273,330	24,573,697,961	4	13
2007	7,957,901,391	18,623,193,266	2	11
2008	0	1,438,411,000	0	1
2009	1,360,000,000	0	3	0
2010	4,947,990,100	0	6	0
2011	3,509,601,594	1,403,042,765	6	2
2012	9,128,506,326	2,478,912,811	19	6
2013	16,193,193,878	1,514,949,000	36	3

Source: Trepp, Morgan Stanley Research

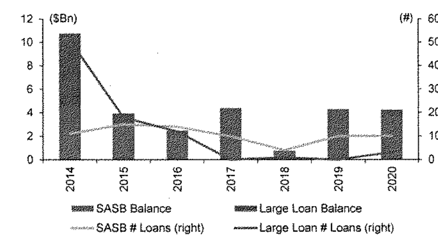


APPENDIX 3: Loan Issuance and Maturation

Loan Balance By Maturity

Year	Balance ($) SASB	Balance ($) Large Loan	Number of Loans SASB	Number of Loans Large Loan
2014	4,540,654,166	6,210,789,865	11	51
2015	3,124,473,609	791,406,231	15	18
2016	2,091,398,327	380,400,000	14	12
2017	4,375,735,012		10	0
2018	732,530,275	11,355,284	4	1
2019	4,277,838,655		10	0
2020	3,664,851,429	552,912,000	10	3

Source: Bloomberg, Trepp, Morgan Stanley Research
Note: Includes loans that have optional extensions



APPENDIX 4: Cumulative Loss Rates and Loss Severities

	Cumulative Loss Rate				
	All Time	2013 YTD (201309)	2012	2011	2010
SASB	0.25%	0.00%	0.00%	0.00%	0.53%
Conduit	2.79%	0.86%	1.18%	1.12%	0.73%

Source: Trepp and JPMorgan Chase & Co.

	Average Corporate Debt Recovery Rates Measured by Post-Default Trading Prices					
	Issuer-weighted			Volume-weighted		
Lien Position	**2012**	**2011**	**1982-2012**	**2012**	**2011**	**1982-2012**
1st Lien Bank Loan	67.0%	70.9%	66.0%	66.8%	77.8%	59.9%
2nd Lien Bank Loan*	17.4%	68.3%	29.8%	15.3%	67.5%	28.2%
Sr. Unsecured Bank Loan*	n.a.	23.1%	47.1%	n.a.	43.0%	40.2%
Sr. Secured Bond	51.2%	63.4%	51.6%	28.4%	57.7%	49.8%
Sr. Unsecured Bond	43.4%	39.7%	37.0%	40.2%	55.2%	37.8%
Sr. Subordinated Bond	29.7%	36.7%	30.9%	35.5%	31.5%	25.7%
Subordinated Bond	35.4%	35.4%	31.5%	30.9%	35.2%	25.3%
Jr. Subordinated Bond	n.a.	n.a.	24.7%	n.a.	n.a.	17.1%

* The recovery rates for 2011's and 2012's second lien and unsecured bank loans were based on no more than three observations, respectively
Source: Moody's Investors Service

APPENDIX 4: Cumulative Loss Rates and Loss Severities

Single Asset/Borrower Deals			
Vintage	Total Sec. Bal.	Loss Amount	Cum. Loss %
1997	953,691,691	-	0.00%
1998	1,005,000,000	-	0.00%
1999	1,707,187,444	3,627	0.00%
2000	3,236,375,546	3,580,285	0.11%
2001	4,759,636,946	272,536	0.01%
2002	2,508,823,945	3,812	0.00%
2003	2,227,159,000	-	0.00%
2004	4,247,025,000	-	0.00%
2005	12,083,629,700	-	0.00%
2006	10,146,778,330	930,513	0.01%
2007	13,807,901,391	243,885,592	1.77%
2009	1,360,000,000	-	0.00%
2010	12,747,896,207	-	0.00%
2011	3,509,601,594	-	0.00%
2012	9,293,506,326	-	0.00%
2013	16,078,193,878	-	0.00%
Grand Total	99,672,406,998	248,676,364	0.25%

	Cumulative Loss Rate				
	All Time	2013 YTD (201309)	2012	2011	2010
SASB	0.25%	0.00%	0.00%	0.00%	0.53%
Conduit	2.79%	0.86%	1.18%	1.12%	0.73%

SASB Deals							
Deal	Property Name	Property Type	Closing Date	Vintage	Orig Bal	Total Loss	Loss %
stein971	Steiner Properties, LLC	Various	19970327	1997	60,416,691	-	0.00%
sctsdale	Scottsdale Fashion Squa	RT	19970812	1997	156,000,000	-	0.00%
uswfb1a	Kansas Gas & Electric #4	Various	19970930	1997	177,275,000	-	0.00%
13gengro	13 Affiliates of General (	RT	19971125	1997	560,000,000	-	0.00%
fairfax	Fair Oaks Mall	RT	19980303	1998	140,000,000	-	0.00%
ltt981	Library Tower	OF	19980311	1998	200,000,000	-	0.00%
aventura	Aventura Mall	RT	19980406	1998	200,000,000	-	0.00%
ge981	Various	Various	19980925	1998	465,000,000	-	0.00%
cr99zc1	Various	Various	19990225	1999	140,000,000	-	0.00%
star99c1	Starwood Portfolio	LO	19990316	1999	541,328,908	-	0.00%
1251xl	1211 Avenue of the Ame	OF	19990412	1999	450,000,000	-	0.00%
ms991nyp	One New York Plaza	OF	19990608	1999	245,858,536	-	0.00%
mcmt99c1	Sheraton Fisherman's W	LO	19990830	1999	330,000,000	3,627	0.00%
vfc00vno	Various	RT	20000301	2000	500,000,000	128	0.00%
smp001	SDG Macerich 13 Proper	RT	20000412	2000	138,500,000	-	0.00%
bc2000a	Various	Various	20000419	2000	109,690,006	542,299	0.49%
fts004ts	Various	Various	20000504	2000	430,000,000	2,893,450	0.67%
fb1211aa	1211 Avenue of the Ame	OF	20000512	2000	300,000,000	135,510	0.05%
1345aoa	1345 Avenue of the Ame	OF	20000928	2000	450,000,000	-	0.00%
gs00dw1	Various	IN	20001017	2000	264,555,825	1,072	0.00%
ppglp0c1	The Providence Place M	RT	20001102	2000	127,277,400	-	0.00%
hilton00	Hilton Hotels Portfolio	LO	20001109	2000	499,580,782	7,826	0.00%
pruhtgc1	Various	RT	20001130	2000	243,885,659	-	0.00%
cr00zc2	Various	Various	20001213	2000	172,885,874	-	0.00%

APPENDIX 4: Cumulative Loss Rates and Loss Severities

msxl280	280 Park Avenue	OF	20010207	2001	269,805,327	66,811	0.02%
bs01epr	Various	OT	20010214	2001	125,000,000	-	0.00%
gs01lib	One Liberty Plaza	OF	20010223	2001	432,000,000	-	0.00%
bacm01fm	The Florida Mall	RT	20010223	2001	269,715,565	-	0.00%
ml01hrpt	Office Portfolio Trust	OF	20010228	2001	259,828,148	-	0.00%
chase245	245 Park Avenue	OF	20010313	2001	500,000,000	194,956	0.04%
pgmt01xl	Potomac/Gurnee Mills	RT	20010501	2001	354,807,985	-	0.00%
ms01sgm	Sawgrass Mills	RT	20010731	2001	300,000,000	-	0.00%
lbubswm	Various	RT	20010809	2001	800,000,000	-	0.00%
gsms1285	1285 Avenue of the Ame	MU	20010816	2001	372,250,000	6,858	0.00%
ms01frm	Freehold Raceway Mall	RT	20010926	2001	177,776,741	3,911	0.00%
cr01zc1	Various	Various	20011127	2001	103,341,595	-	0.00%
jpm01kp	Kings Plaza	RT	20011130	2001	172,051,784	-	0.00%
lb01c7a	299 Park Avenue	OF	20011206	2001	44,000,000	-	0.00%
fb01lcca	Portfolio	HC	20011213	2001	449,059,801	-	0.00%
ball1wbm	Waikiki beach Marriott F	LO	20011227	2001	130,000,000	-	0.00%
gs02calw	Various	IN	20020226	2002	950,000,000	-	0.00%
ms02wm	Woodfield Shopping Cer	RT	20020326	2002	43,000,000	417	0.00%
fvmmt02c	Fashion Valley Mall	RT	20020327	2002	29,123,704	-	0.00%
gmacn2fl	Fort Lewis Army Base	MF	20020401	2002	150,000,000	-	0.00%
gmac02md	Fort Meade Military Hou	MF	20020523	2002	325,000,000	-	0.00%
gmacn02a	Various	Various	20020816	2002	64,600,000	-	0.00%
vfmmt2c4	Westfield Shoppingtown	RT	20020906	2002	49,736,241	3,395	0.01%
1166aoa	1166 Avenue of the Ame	OF	20021008	2002	147,364,000	-	0.00%
calst2c6	Various	MU	20021205	2002	750,000,000	-	0.00%
ept03epr	Various	Various	20030227	2003	155,500,000	-	0.00%
basn03rt	Renaissance Tower	OF	20030415	2003	20,000,000	-	0.00%
gmac03ea	Laurelwood	OT	20030501	2003	21,959,000	-	0.00%
gmac03kl	Kirtland Housing	MF	20030508	2003	74,000,000	-	0.00%
calw031	Various	IN	20030625	2003	460,000,000	-	0.00%
gmac03fd	Ford Island Housing	MF	20030715	2003	114,000,000	-	0.00%
gmac03fb	Fort Bragg Housing	MF	20030801	2003	296,000,000	-	0.00%
ms03kids	Various	Various	20030811	2003	300,000,000	-	0.00%
ms03bnb	Various	Various	20030930	2003	30,000,000	-	0.00%
gmac03pr	Presidio of Monterey/Na	MF	20031015	2003	355,200,000	-	0.00%
gmac03st	Stewart/Hunter Army Ai	MF	20031112	2003	246,500,000	-	0.00%
gmac03ca	Various	Various	20031201	2003	154,000,000	-	0.00%
cdc04cm	California Market Cente	RT	20040116	2004	16,000,000	-	0.00%
ms04gst1	Various	Various	20040205	2004	418,000,000	-	0.00%
olcm04c3	One Lincoln Street	OF	20040527	2004	311,000,000	-	0.00%
gmac04fl	Fort Lewis Project	MF	20040610	2004	75,000,000	-	0.00%
bs04esa	Various	LO	20040629	2004	2,050,000,000	-	0.00%
gmac04de	Fort Detrick and WRAM(	MF	20040809	2004	83,200,000	-	0.00%
gmac04fp	Fort Polk Project	MF	20040910	2004	165,000,000	-	0.00%
fb04cbn1	Various	Various	20041022	2004	5,000,000	-	0.00%
tower042	Various	Various	20041207	2004	293,825,000	-	0.00%

APPENDIX 4: Cumulative Loss Rates and Loss Severities

fb04hc1	Various	HC	20041215	2004	820,000,000	-	0.00%
gmacn4pn	Camp Pendleton Project	MF	20041230	2004	10,000,000	-	0.00%
gmacn5hc	Hickam Air Force Base P	MF	20050301	2005	212,000,000	-	0.00%
nlf051	Various	Various	20050304	2005	275,000,000	-	0.00%
bal5boca	Boca Portfolio	MU	20050317	2005	700,000,000	-	0.00%
ml05ggp1	GGP 13 Affiliates	RT	20050321	2005	417,400,000	-	0.00%
gs05rock	Rockefeller Center	OF	20050526	2005	1,685,000,000	-	0.00%
ml05gn1	Battery Park - Gateway I	MF	20050531	2005	94,229,700	-	0.00%
cci051	Tower Sites	Various	20050608	2005	1,900,000,000	-	0.00%
bs05afr1	Various	MU	20050615	2005	304,000,000	-	0.00%
fb20051	1345 Avenue of the Ame	OF	20050825	2005	981,000,000	-	0.00%
ball5esh	Various	Various	20051005	2005	2,520,000,000	-	0.00%
balleshd	Various	Various	20051005	2005	2,520,000,000	-	0.00%
116605c6	1166 Avenue of the Ame	OF	20051102	2005	475,000,000	-	0.00%
twhotel	Various	LO	20060104	2006	425,000,000	930,513	0.22%
cs06oma	mezzanine loan	OF	20060210	2006	415,150,330	-	0.00%
ball6277	Mezzanine loan	OF	20060215	2006	200,000,000	-	0.00%
bal06esh	#N/A	#N/A	20060224	2006	180,500,000	-	0.00%
com6cni2	CNL Hotel & Resorts, Inc	LO	20060227	2006	1,000,000,000	-	0.00%
tower061	Various	Various	20060228	2006	1,550,000,000	-	0.00%
ball6laq	La Quinta	Various	20060420	2006	2,260,000,000	-	0.00%
cs06hc1	Various	HC	20060427	2006	1,200,000,000	-	0.00%
tstar061	The Timberlands	OT	20061030	2006	800,000,000	-	0.00%
cci061	Tower Sites	Various	20061129	2006	1,550,005,000	-	0.00%
ftst64ts	Four Times Square (The	Various	20061219	2006	566,123,000	-	0.00%
amt071	Tower Sites	Various	20070504	2007	1,750,000,000	-	0.00%
gtp071	Tower Sites	Various	20070525	2007	550,250,000	-	0.00%
gs07eop	EOP Portfolio	MU	20070619	2007	7,407,651,391	-	0.00%
wb07esh	Extended StayAmerica	LO	20070828	2007	4,100,000,000	243,885,592	5.95%
ddr09dd1	Note A Component	RT	20091125	2009	400,000,000	-	0.00%
ball9fdg	FLAGLER DEVELOPMENT	MU	20091215	2009	460,000,000	-	0.00%
jpm09iw	iWEST Portfolio	RT	20091223	2009	500,000,000	-	0.00%
obp10obp	Bank of America Tower a	OF	20100708	2010	650,000,000	-	0.00%
vornado1	VNO Portfolio-A2FX	RT	20100818	2010	660,000,000	-	0.00%
jp10cntr	Centro Portfolio	RT	20100913	2010	484,625,882	-	0.00%
jp10cntm	Centro Portfolio Mezz	RT	20100913	2010	89,000,000	-	0.00%
ballhltn	Hilton Loan	LO	20101105	2010	8,264,270,325	-	0.00%
esa10esh	ESH Portfolio	LO	20101123	2010	2,000,000,000	-	0.00%
acr10art	ART Portfolio-A1	WH	20101215	2010	600,000,000	-	0.00%
gs11alf	Sunrise Assisted Living P	HC	20110317	2011	325,000,000	-	0.00%
ballfshn	Fashion Centre at Penta	RT	20110714	2011	410,000,000	-	0.00%
com11thl	Various	LO	20110728	2011	975,000,000	-	0.00%
jpm11cch	City Center Hotel Portfol	LO	20110808	2011	425,000,000	-	0.00%
wf11bxr	Mortgage Loan	RT	20110818	2011	1,000,000,000	-	0.00%
jpm11pls	Palisades Center	RT	20111221	2011	374,601,594	-	0.00%
com12w57	9 West 57th Street	OF	20120301	2012	625,000,000	-	0.00%

APPENDIX 4: Cumulative Loss Rates and Loss Severities

bal12osi	Various	Various	20120327	2012	324,800,000	-	0.00%
jp127wtc	7 World Trade Center	OF	20120405	2012	125,000,000	-	0.00%
fmbt12fb	Fontainebleau Miami Be	LO	20120416	2012	412,000,000	-	0.00%
gs12aloh	Ala Moana	RT	20120514	2012	1,400,000,000	-	0.00%
jp12wldn	Walden Galleria	RT	20120530	2012	270,000,000	-	0.00%
jp12hsbc	HSBC Tower - 452 Fifth /	OF	20120725	2012	300,000,000	-	0.00%
gs12shop	The Grand Canal Shoppe	RT	20120806	2012	625,000,000	-	0.00%
ms12star	North Star Mall	RT	20120816	2012	340,000,000	-	0.00%
bal12cmz	Clarion Portfolio	LO	20120912	2012	165,000,000	-	0.00%
bal12clr	Clarion Portfolio	LO	20120925	2012	335,000,000	-	0.00%
comm12lt	Westroads Mall	RT	20121004	2012	259,000,000	-	0.00%
motel6	MOTEL 6	LO	20121113	2012	1,050,000,000	-	0.00%
bb12show	Fashion Show Mall	RT	20121114	2012	835,000,000	-	0.00%
vn126ave	1290 Avenue of the Ame	OF	20121129	2012	950,000,000	-	0.00%
jpm12phh	Palmer House Hilton	LO	20121211	2012	175,000,000	-	0.00%
bamlpark	101 Park Avenue	OF	20121213	2012	300,000,000	-	0.00%
gs12tmsq	One Time Square	RT	20121219	2012	208,000,000	-	0.00%
com12mvp	MVP Portfolio	LO	20121220	2012	294,706,326	-	0.00%
gs12bwtr	Bridgewater Commons	RT	20121221	2012	300,000,000	-	0.00%
qc13qc	Queens Center	RT	20130129	2013	600,000,000	-	0.00%
esa13efl	ESH 2013-ESA - Series FL	LO	20130212	2013	350,000,000	-	0.00%
esa13es5	ESH 5Yr Fixed	LO	20130212	2013	350,000,000	-	0.00%
esa13es7	ESH 7Yr Fixed	LO	20130212	2013	1,820,000,000	-	0.00%
esa13esm	ESH Mezz A Non-Free Pr	LO	20130212	2013	500,000,000	-	0.00%
gs13kyo	Non-PK A	LO	20130215	2013	1,100,000,000	-	0.00%
rbs13smv	The Shops at Mission Vie	RT	20130221	2013	295,000,000	-	0.00%
gs13king	Kings Plaza	RT	20130225	2013	498,503,359	-	0.00%
ms13wlsr	Wilshire Courtyard	OF	20130227	2013	193,000,000	-	0.00%
slg13bwa	1515 Broadway	MU	20130306	2013	900,000,000	-	0.00%
ms13altm	Altamonte Mall	RT	20130314	2013	160,000,000	-	0.00%
cgc13smp	Santa Monica Place	RT	20130320	2013	239,147,293	-	0.00%
lcc13gcp	Grand Central Plaza	OF	20130321	2013	275,000,000	-	0.00%
com13gam	Green Acres Mall	RT	20130321	2013	324,420,483	-	0.00%
wf13120b	120 Broadway	OF	20130328	2013	310,000,000	-	0.00%
cg13vno	666 Fifth Avenue	RT	20130328	2013	390,000,000	-	0.00%
gs13nyc5	Manhattan Collection	LO	20130328	2013	410,000,000	-	0.00%
com13wwp	Worldwide Plaza	OF	20130328	2013	710,000,000	-	0.00%
del13hdc	Hotel del Coronado	LO	20130411	2013	285,000,000	-	0.00%
del13hdm	Hotel del Coronado Mez	LO	20130411	2013	115,000,000	-	0.00%
com13sfs	Scottsdale Fashion Squa	RT	20130411	2013	525,000,000	-	0.00%
ballwbrk	Willowbrook Mall	RT	20130418	2013	360,000,000	-	0.00%
gs13pemb	Pembroke Lakes Mall	RT	20130423	2013	260,000,000	-	0.00%
wf13btc	Bergen Town Center	RT	20130425	2013	300,000,000	-	0.00%
cgc13375	375 Park Avenue	OF	20130529	2013	782,750,000	-	0.00%
jp13jwrz	Grande Lakes Desert Rid	LO	20130529	2013	510,000,000	-	0.00%
jp13jwmz	Grande Lakes Desert Rid	LO	20130529	2013	294,497,467	-	0.00%

APPENDIX 4: Cumulative Loss Rates and Loss Severities

com13thi	Tharaldson Portfolio A2	LO	20130627	2013	775,000,000	-	0.00%
jp13acmz	Americold Cold Storage	IN	20130725	2013	70,000,000	-	0.00%
cg13breh	BRE Select Hotels Corp F	LO	20130725	2013	600,000,000	-	0.00%
stw13fv1	Red Roof Inn Hotel Portf	LO	20130808	2013	199,040,632	-	0.00%
jpm13wt	Willis Tower (A-3-A-2-B)	OF	20130808	2013	91,834,644	-	0.00%
jpm13alc	ALC Portfolio	HC	20130821	2013	250,000,000	-	0.00%
com13300	300 Park Avenue	OF	20130827	2013	485,000,000	-	0.00%
bb13tysn	Tysons Galleria Mall	RT	20130829	2013	325,000,000	-	0.00%
bhp13bo	Boca Hotel Portfolio	LO	20130926	2013	425,000,000	-	0.00%

Source: Trepp

APPENDIX 5: SBSC and Corporate Debt Rating Transition Comparison

CMBS Single Asset/Single Borrower Lifetime Transition Matrices										
	Current Rating									
Orig Rating	Aaa (sf)	Aa (sf)	A (sf)	Baa (sf)	Ba (sf)	B (sf)	Caa (sf) / below	Total	Count	Wtd Avg Duration (Yrs)
Aaa (sf)	95%	3%	1%	0%	1%	0%	0%	100%	271	4.7
Aa (sf)	36%	53%	4%	3%	1%	2%	1%	100%	174	4.9
A (sf)	24%	14%	53%	2%	4%	1%	2%	100%	169	5.0
Baa (sf)	18%	5%	13%	56%	5%	2%	2%	100%	189	4.3

Source: Moody's Investors Service. Data as of February 2013

Total Global Corporate Debt Ratings Transitions -- Average Five-Year Letter Rating Migration Rates, 1970-2012*

From/To	Aaa	Aa	A	Baa	Ba	B	Caa	Ca-C	WR	Default
Aaa	52.027%	23.121%	5.208%	0.353%	0.307%	0.037%	0.037%	0.000%	18.817%	0.093%
Aa	2.881%	46.071%	20.953%	3.663%	0.681%	0.209%	0.057%	0.016%	25.172%	0.296%
A	0.195%	7.685%	50.245%	14.327%	2.618%	0.825%	0.171%	0.006%	23.250%	0.678%
Baa	0.180%	1.061%	12.145%	46.836%	8.641%	2.752%	0.534%	0.073%	26.159%	1.620%
Ba	0.041%	0.165%	2.040%	11.680%	26.464%	10.896%	1.395%	0.110%	39.219%	7.991%
B	0.032%	0.046%	0.265%	1.665%	6.531%	21.995%	5.079%	0.635%	44.552%	19.199%
Caa	0.000%	0.000%	0.022%	0.579%	1.685%	7.411%	9.226%	1.049%	43.724%	36.305%
Ca-C	0.000%	0.000%	0.000%	0.000%	0.000%	2.156%	1.848%	2.640%	41.663%	51.694%

*Last Cohort formed on 1/1/2008
Source: Moody's Investors Service

APPENDIX 6: QCRE Loan Analysis - Proposed Rule vs. CREFC Proposal

Trepp Public Conduit Universe

Reproposal Parameters: MF amort. 30y All other amort. 25y. 65 LTV. 1.5 DSCR (1.25 MF, 1.7 hospitality), 10+ yr Loan Term, No IO

							All				Qualified			
Vintage	Total Count	Total Sec. Bal.	Qualified Count	% By Count	Qualified Sec. Bal.	% By Balance	Ever 90+	Ever 90+ %	Loss Amount	Cum. Loss %	Ever 90+	Ever 90+ %	Cum. Loss	Cum. Loss %
1997	2,996	17,109,211,368	293	9.78%	1,109,357,933	6.48%	2,522,504,977	14.74%	565,545,998	3.31%	147,318,677	13.28%	21,928,085	1.98%
1998	8,435	46,206,359,955	880	10.43%	3,961,926,191	8.57%	4,896,008,145	10.60%	1,235,322,981	2.67%	152,952,107	3.86%	37,008,821	0.93%
1999	6,898	35,253,064,849	678	9.83%	2,609,046,966	7.40%	4,933,655,004	13.99%	1,114,021,272	3.16%	106,135,350	4.07%	17,015,561	0.65%
2000	3,865	22,241,634,274	401	10.38%	1,608,700,981	7.23%	4,160,180,740	18.70%	1,021,550,677	4.59%	107,085,633	6.66%	15,402,380	0.96%
2001	4,326	30,478,177,066	435	10.06%	2,037,174,211	6.68%	5,705,600,954	18.72%	1,352,776,368	4.44%	116,187,944	5.70%	25,702,275	1.26%
2002	4,100	33,091,693,298	443	10.80%	2,347,035,811	7.09%	4,581,375,638	13.84%	1,003,954,484	3.03%	114,795,023	4.89%	6,567,663	0.28%
2003	5,885	55,843,173,315	751	12.76%	3,703,460,954	6.63%	6,335,107,926	11.34%	939,448,184	1.68%	165,224,202	4.46%	27,665,123	0.75%
2004	6,694	79,389,101,101	564	8.43%	2,938,183,491	3.70%	9,483,808,177	11.95%	1,508,610,940	1.90%	82,167,203	2.80%	18,005,523	0.61%
2005	10,695	143,562,326,568	796	7.44%	4,321,088,482	3.01%	23,820,749,182	16.59%	4,019,031,941	2.80%	174,390,700	4.04%	57,288,855	1.33%
2006	11,921	162,824,533,258	525	4.40%	2,838,353,605	1.74%	33,475,622,956	20.56%	6,259,882,627	3.84%	78,216,664	2.76%	14,757,286	0.52%
2007	11,876	191,791,869,757	267	2.25%	1,449,046,164	0.76%	50,974,521,156	26.58%	6,269,466,456	3.27%	66,573,184	4.59%	6,959,651	0.48%
2008	819	10,707,465,072	13	1.59%	45,033,361	0.42%	2,313,358,236	21.61%	572,372,282	5.35%	5,356,623	11.89%	-	0.00%
2010	219	5,384,767,165	14	6.39%	567,113,511	10.53%	-	0.00%	-	0.00%	-	0.00%	-	0.00%
2011	980	24,747,173,352	40	4.08%	302,502,681	1.22%	28,707,602	0.12%	-	0.00%	-	0.00%	-	0.00%
2012	1,735	32,164,603,817	153	8.82%	1,682,818,203	5.23%	2,435,549	0.01%	-	0.00%	-	0.00%	-	0.00%
2013	2,041	37,633,927,633	187	9.16%	2,044,021,128	5.43%	-	0.00%	-	0.00%	-	0.00%	-	0.00%
Grand Total	83,485	928,429,081,848	6,440	7.71%	33,564,863,674	3.62%	153,233,636,243	16.50%	25,861,984,209	2.79%	1,316,403,310	3.92%	248,301,223	0.74%

Trepp Public Conduit Universe

CRE Finance Council Proposal : 30 yr AM; no maturity term; 1.5 DSCR (1.25 for multifamily; 1.7 for hospitality); 65 LTV (IO Loans LTV <=50)

							All				Qualified			
Vintage	Total Count	Total Sec. Bal.	Qualified Count	% By Count	Qualified Sec. Bal.	% By Balance	Ever 90+	Ever 90+ %	Loss Amount	Cum. Loss %	Ever 90+	Ever 90+ %	Loss Amount	Cum. Loss %
1997	2,996	17,109,211,368	365	12.18%	1,728,875,121	10.10%	2,522,504,977	14.74%	565,545,998	3.31%	169,207,804	9.79%	23,752,913	1.37%
1998	8,435	46,206,359,955	1,141	13.53%	7,320,245,854	15.84%	4,896,008,145	10.60%	1,235,322,981	2.67%	247,654,618	3.38%	53,005,898	0.72%
1999	6,898	35,253,064,849	970	14.06%	4,746,470,321	13.46%	4,933,655,004	13.99%	1,114,021,272	3.16%	225,528,160	4.75%	31,462,425	0.66%
2000	3,865	22,241,634,274	623	16.12%	3,594,660,183	16.16%	4,160,180,740	18.70%	1,021,550,677	4.59%	208,876,525	5.81%	39,326,987	1.09%
2001	4,326	30,478,177,066	712	16.46%	6,075,803,458	19.93%	5,705,600,954	18.72%	1,352,776,368	4.44%	398,431,455	6.56%	45,860,010	0.75%
2002	4,100	33,091,693,298	773	18.85%	7,085,994,969	21.41%	4,581,375,638	13.84%	1,003,954,484	3.03%	630,894,684	8.90%	186,357,139	2.63%
2003	5,885	55,843,173,315	1,356	23.04%	15,674,888,916	28.07%	6,335,107,926	11.34%	939,448,184	1.68%	847,871,956	5.41%	91,447,599	0.58%
2004	6,694	79,389,101,101	1,244	18.58%	17,927,783,610	22.58%	9,483,808,177	11.95%	1,508,610,940	1.90%	1,336,861,882	7.46%	88,227,083	0.49%
2005	10,695	143,562,326,568	1,694	15.84%	22,000,462,723	15.32%	23,820,749,182	16.59%	4,019,031,941	2.80%	1,249,188,794	5.68%	96,681,192	0.44%
2006	11,921	162,824,533,258	1,384	11.61%	18,317,383,907	11.25%	33,475,622,956	20.56%	6,259,882,627	3.84%	1,038,413,275	5.67%	83,173,445	0.45%
2007	11,876	191,791,869,757	1,040	8.76%	13,412,659,019	6.99%	50,974,521,156	26.58%	6,269,466,456	3.27%	806,297,590	6.01%	50,324,606	0.38%
2008	819	10,707,465,072	57	6.96%	413,581,522	3.86%	2,313,358,236	21.61%	572,372,282	5.35%	156,041,190	37.73%	29,807,123	7.21%
2010	219	5,384,767,165	94	42.92%	2,901,375,590	53.88%	-	0.00%	-	0.00%	-	0.00%	-	0.00%
2011	980	24,747,173,352	254	25.92%	6,710,276,224	27.12%	28,707,602	0.12%	-	0.00%	-	0.00%	-	0.00%
2012	1,735	32,164,603,817	456	26.28%	6,760,476,941	21.02%	2,435,549	0.01%	-	0.00%	-	0.00%	-	0.00%
2013	2,041	37,633,927,633	586	28.71%	9,934,609,113	26.40%	-	0.00%	-	0.00%	-	0.00%	-	0.00%
Grand Total	83,485	928,429,081,848	12,749	15.27%	144,605,547,471	15.58%	153,233,636,243	16.50%	25,861,984,209	2.79%	7,315,267,934	5.06%	819,426,419	0.57%

APPENDIX 7: Loan Performance by Term

Trepp Public Conduit Universe: All Loan Performance by Loan Term			
Vintage	5 - yr. Cum. Loss %	7 - yr. Cum. Loss %	10+ - yr. Cum. Loss %
1997	0.66%	1.72%	3.52%
1998	4.80%	1.59%	2.70%
1999	2.51%	1.92%	3.23%
2000	1.96%	1.93%	4.75%
2001	0.32%	0.94%	4.80%
2002	0.77%	1.19%	3.32%
2003	1.24%	1.12%	1.83%
2004	1.32%	2.04%	1.99%
2005	2.65%	2.60%	2.86%
2006	4.52%	3.06%	3.79%
2007	3.95%	2.16%	3.22%
2008	1.20%	6.09%	5.78%
2010	0.00%	0.00%	0.00%
2011	0.00%	0.00%	0.00%
2012	0.00%	0.00%	0.00%
2013	0.00%	0.00%	0.00%
Grand Total	**2.61%**	**2.07%**	**2.87%**

APPENDIX 8: Interest-Only Loan Performance

	Trepp Public Conduit Universe: All IO Loans		
Vintage	Total Count	Total Sec. Bal.	Cum. Loss %
1997	46	534,329,092	0.74%
1998	112	2,884,794,990	0.83%
1999	122	2,553,497,312	1.97%
2000	133	1,761,049,270	1.14%
2001	216	3,164,922,998	2.32%
2002	220	3,278,040,729	1.18%
2003	615	14,386,572,012	1.03%
2004	1,468	37,022,087,464	0.94%
2005	4,481	94,986,573,794	2.45%
2006	6,389	122,776,731,711	3.47%
2007	7,858	166,019,657,689	3.04%
2008	518	8,640,371,879	5.28%
2010	32	713,433,633	0.00%
2011	163	6,085,919,572	0.00%
2012	320	10,988,969,236	0.00%
2013	494	17,985,875,618	0.00%
Grand Total	23,187	493,782,827,000	2.59%

Morgan Stanley & Moody's / RCA

APPENDIX 9:
Performance of Major vs. All Markets

Index	Peak to Trough	Peak to Current	Percentage Peak-to-Trough Loss Recovered	Peak Month	Trough Month
Apartment - Major	-23.6%	11.8%	150.2%	Dec-07	Dec-09
Apartment	-38.9%	-0.5%	98.8%	Dec-07	Dec-09
Office CBD - Major	-46.9%	-4.9%	89.5%	Dec-07	Sep-09
Office CBD	-49.6%	-6.6%	86.8%	Dec-07	Sep-09
Major Markets (All-Property)	-38.1%	-5.7%	85.1%	Dec-07	Nov-09
Apartment - Non-Major	-47.3%	-8.8%	81.5%	Sep-07	Dec-09
National All-Property	-40.2%	-14.9%	62.8%	Dec-07	Dec-09
Office	-46.0%	-18.1%	60.7%	Dec-07	Nov-09
Retail - Major	-38.3%	-15.7%	59.1%	Sep-07	Jun-10
Core Commercial	-40.6%	-19.9%	51.0%	Nov-07	Dec-09
Office CBD - Non-Major	-50.4%	-25.9%	48.6%	Dec-07	Sep-09
Non-Major Markets (All-Property)	-42.1%	-22.5%	46.6%	Oct-07	Dec-09
Office Suburban - Major	-46.4%	-25.7%	44.6%	Dec-07	Jun-10
Retail	-42.4%	-23.5%	44.6%	Aug-07	Sep-10
Industrial - Major	-34.1%	-20.3%	40.4%	Dec-07	Mar-10
Retail - Non-Major	-43.9%	-29.5%	32.9%	Sep-07	Sep-10
Office Suburban	-44.7%	-30.4%	32.1%	Oct-07	Jul-10
Industrial	-33.1%	-25.9%	21.6%	Jan-08	Jan-10
Office Suburban - Non-Major	-43.5%	-36.0%	17.2%	Dec-07	Dec-09
Industrial - Non-Major	-33.8%	-32.1%	5.0%	Mar-08	Dec-10

APPENDIX 10: Senior-Subordinate Structure Analysis

Risk Retention - Senior-Subordinate Structure Analysis

Conclusion: The challenge posed by the new Proposed Rule is one of capacity in the marketplace. Today, the B-Piece investor community typically purchases 6 or 7-percent of the par value of a deal at a discount that translates into a typical investment of 2.5 to 3-percent of the fair value of the deal proceeds. Under the proposal, B-Piece Investors will need to raise the capital to consume the expanded 5-percent fair value retention requirement. That level of retention will mean that bonds higher in the waterfall – bonds historically rated BBB-, BBB, and potentially even A- – will be swept into the EHRI retention position.

	Scenario 1	Scenario 2	Scenario 3
Description	Approximate levels based on recently executed transactions	Credit bonds subject to RR price at B-Piece Yield	Credit bonds subject to RR price at 50% B-Piece Spread
Par	$100.0	$100.0	$100.0
Gross Profit	3.00%	3.00%	3.00%
Market Value	$103.0	$103.0	$103.0
Req. Risk Retention	$5.2	$5.2	$5.2
B-Piece Size	$6.656	$6.656	$6.656
BBB- Size	$5.188	$5.188	$5.188
A Size	$3.687	$3.687	$3.687
AA Size	$6.438	$6.438	$6.438
10-year Swap	2.75	2.75	2.75
B-Piece (bond equivalent yield)	18.000%	18.000%	18.000%
BBB- Spread	425	1,525	650
A Spread	275	475	275
AA Spread	185	185	185
B-Piece Coupon (%)	4.360	4.360	4.360
BBB- Coupon (%)	4.811	4.811	4.811
A Coupon (%)	4.811	4.811	4.811
AA Coupon (%)	4.811	4.811	4.811
B-Piece Px	$0.385	$0.385	$0.385
BBB- Px	$0.849	$0.406	$0.720
A Px	$0.952	$0.819	$0.952
AA Px	$1.020	$1.020	$1.020
B-Piece Fair Value	$2.6	$2.6	$2.6
BBB- Fair Value	$4.4	$2.1	$3.7
A Fair Value	$3.5	$3.0	$3.5
AA Fair Value	$6.6	$6.6	$6.6
Total Fair Value	$17.0	$14.3	$16.4
% B-Piece Purchased	100.0%	100.0%	100.0%
% BBB- Purchased	58.8%	100.0%	69.3%
% A Purchased	0.0%	16.0%	0.0%
% AA Purchased	0.0%	0.0%	0.0%
Total Thickness Purchased	**9.7%**	**12.4%**	**10.3%**
AAA Thickness	78.031	78.031	78.031
AAA Px	$1.000	$1.000	$1.000
Implied IO Price	$0.079	$0.107	$0.086
Assumed IO BEY	5.000%	5.000%	5.000%
Incremental Coupon		0.354%	0.085%

APPENDIX 11: CREFC IG INVESTOR SURVEY RESULTS

CREFC IG Investor Survey Results
October 2013

Survey Introduction: The below CREFC surveys were conducted throughout October 2013. CREFC staff and the leadership of the CREFC IG Bondholders Forum crafted and approved background information and each question. All surveys were sent to CREFC IG Bondholders Forum Members and all CREFC members who were tagged as "IG Investors" in CREFC's database. Respondents include investors from large life insurance companies, banks, mutual funds, pension funds, and private investors, among others.

Question #	CREFC Survey #1 on SASB, Senior / Sub Structure, and OA-SS Removal Quorum - October 1, 2013	Number of Answers	Yes %	No %	Neutral %	
1	Single Borrower Single Asset Deals Question **Question: Are you supportive of CMBS Single Borrower Single Asset deals being exempt from the risk retention rule?**	31	77.4%	16.1%	6.5%	
2	Pari-Passu Structure Required when Two B-Piece Buyers Hold Horizontal Risk **Question: Are you supportive of additional flexibility so that two B-Piece Buyers have the option of using a senior/sub structure in addition to the pari-passu structure when they are holding the horizontal risk retention piece?**	31	67.7%	19.4%	12.9%	
3A	5% Voting Quorum to Replace Special Servicer Under the proposed rule, the Operating Advisor has the ability to recommend the replacement of the Special Servicer if it concludes both: (1) that the Special has failed to comply with any standard required of it, and (2) that removal would be in the best interest of the investors as a collective whole. Once the recommendation is made, bondholders are entitled to a vote. For the vote to count, there is a 5% quorum requirement. If that quorum requirement is satisfied, then, to replace the Special Servicer a majority of those voting (based on outstanding principal balance of all ABS interests) must vote for replacement. Here is a step-by-step explanation: 1) OA recommends replacement of the Special Servicer 2) Deal documents are expected to require notice of a vote to be provided to all bondholders for their participation in the vote 3) At least 5% of the outstanding principal balance of all ABS interests are needed to vote 4) A majority of the those voting is needed to approve the replacement of the Special Servicer **Question: Do you think 5% is the right voting quorum threshold?**	30	16.7%	56.7%	26.7%	
		Number of Answers	Quorum of 10%	Quorum of 15%	Quorum of 20%	Any quorum threshold over 10% as long as a minimum of three investors voting?
3B	**Question: If NO in Question #3, do you support any of the following?:**	20	15.0%	20.0%	45.0%	30.0%

Question #	CREFC Survey #2 on OA-SS Removal Quorum and OA Issues - October 16, 2013	Number of Answers	Yes %		No %
1A	**Question: Do you agree that a quorum vote must include a minimum of three investors?**	27	92.6%		7.4%
		Number of Answers	10%	15%	20%
1B	**Question: If YES to Question #1 and assuming at least three investors are voting, which do you think is the appropriate quorum threshold percentage?**	26	26.9%	23.1%	50.0%
		Number of Answers	Yes %		No %
2	Potential Conflicts. The re-proposal requires the OA to be independent with respect to the transaction parties. However, Operating Advisor firms often have affiliates or subsidiaries that serve as underwriters to issuers, diligence providers to B-Piece buyers, and consultants to loan borrowers. Engaging in these other businesses on an ongoing basis naturally creates conflicts of interest for the OA role. **Question: In order to avoid potential ongoing conflicts of interest with transaction parties, should the OA be prohibited from have any business services beyond the OA responsibilities with transaction parties on other deals? In other words, do IG bondholders believe the OA should be a fully independent party in the CMBS business?**	27	66.7%		33.3%
3	Compensation. It is widely accepted that the OA is undercompensated and the current fixed strip leaves even less compensation for the OA when their role becomes most critical. **Quetion: Should CREFC make a general comment in its response that the OA compensation should be in alignment with the financial interests and incentives of the OA and the certificate holders?**	27	59.3%		40.7%
4	OA Liability. Some OA's have commented that the indemnification from liability for their role needs strengthening to ensure their efficacy. **Question: Should CREFC advocate in its response for strengthened liability protections for OAs?**	27	63.0%		37.0%

Question #	CREFC Survey #3 on QCRE Parameters - October 22, 2013	Number of Answers	Yes %	No %
1	**Question: Do you think the QCRE definition should be changed from that defined in the re-proposal? In other words, do you think the share of loans that qualify for QCRE exemption should be allowed to rise from proposed level?**	29	69.0%	31.0%
2	**Question: If you believe that the share of CMBS loans that qualify for a QCRE loan exemption should be allow to rise from proposed levels, please tell us if you agree with following methods of allowing more loans to reach the exemption. Do you think that the QCRE loan definition should be changed to include those loans with 30 year amortization instead of limiting it to loans with 25 year amortization schedules?**	24	66.7%	33.3%
3	**Question: Do you think that the QCRE loan definition should be changed to allow loans of all maturity terms qualify for exemption instead of limiting the exemption to loans of 10 year loan terms or longer?**	24	75.0%	25.0%
4	**Question: Do you think that interest only loans of any maturity term but with LTV ratios of 50% or less should be exempt from risk retention?**	23	73.9%	26.1%

APPENDIX 12: Member List

CRE Finance Council

CRE Finance Council Member Companies

Level 1

AIG Investments
Alston & Bird LLP
Banc of America Securities
Barclays Capital Real Estate Inc
Berkadia Commercial Mortgage LLC
Berkeley Point Capital
BlackRock
Bloomberg L.P.
Bryan Cave LLP
C-III Capital Partners
Cadwalader, Wickersham & Taft LLP
CBRE Capital Markets, Inc.
CIBC World Markets Corp.
Citigroup Global Markets
Cleary, Gottlieb, Steen & Hamilton LLP
Clifford Chance US LLP
Cornerstone Real Estate Advisers LLC
Credit Suisse
CWCapital
DBRS, Inc.
Dechert LLP
Deloitte & Touche LLP
Dentons US LLP
Deutsche Bank Securities Inc.
DLA Piper LLP (US)
Eastdil Secured
Ernst & Young LLP
Fannie Mae
Fidelity Management & Research Co.
Fitch Ratings
Freddie Mac
GE Real Estate
GEMSA Loan Services, LP
Goldman, Sachs & Co.
J.P. Morgan
John Hancock Financial Services
Jones Lang LaSalle
Kaye Scholer LLP
KeyBank Real Estate Capital
Kilpatrick Townsend & Stockton LLP
LNR Property Corporation
Macquarie Bank Ltd.
Meridian Capital Group LLC
Metropolitan Life Insurance Co.
Moody's Investors Service
Morgan Stanley
Morningstar Credit Ratings, LLC
New York Life Investment Management
Nomura Securities International, Inc.
ORIX USA Corporation
Pacific Life Insurance Company
PNC Real Estate
PPM America, Inc.
PricewaterhouseCoopers LLP
Principal Global Investors
Proskauer Rose, LLP
Prudential Mortgage Capital Company
Royal Bank of Scotland
Schulte Roth & Zabel LLP
Seyfarth Shaw LLP
Sidley Austin LLP
Situs
Standard & Poor's Ratings Services
Starwood Capital Group
Teachers Insurance and Annuity Association
Trepp, LLC
U.S. Bank, NA
UBS Investment Bank
Venable LLP
Walker & Dunlop
Wells Fargo

Level 2

AEGON USA Investment Management, LLC
Allstate Insurance Company
Amherst Securities Group LP
Anderson, McCoy & Orta, P.C.
Andrews Kurth LLP
Arbor Commercial Mortgage, LLC
Auction.com
Ballard Spahr LLP
Barnes & Thornburg LLP
Bilzin Sumberg Baena Price & Axelrod, LLP
Brookfield Real Estate Financial Partners LLC
CCRE
DebtX
Duane Morris LLP
Genworth Financial
H/2 Capital Partners
Hunt Realty Investments, Inc.
Huntington National Bank
ING Investment Management
Intex Solutions, Inc.
IStar Financial
Kelley Drye & Warren, LLP
Kroll Bond Ratings
MBIA Insurance Corporation
McKenna Long & Aldridge, LLP
McKinley, Inc.
Morrison & Foerster LLP
Natixis Real Estate Capital
NCB, FSB/ A National Cooperative Bank Company
NorthStar Realty Finance Corp.
Oaktree Capital Management, L.P.
Polsinelli PC
Real Capital Analytics
Regions Financial Corp
Rockport
RR Donnelley
Shearman & Sterling LLP
Stinson Morrison Hecker LLP
Trimont Real Estate Advisors, Inc.
White and Williams LLP
Willkie Farr & Gallagher
Winstead PC

Level 3

1st Service Solutions
Aareal Capital Corp.
Accenture

APPENDIX 12: Member List

CRE Finance Council

CRE Finance Council Member Companies

Akin Gump Strauss Hauer & Feld LLP
Allen & Overy LLP
AllianceBernstein L.P.
Alvarez & Marsal Real Estate Advisory Services, LLC
American Capital Strategies, Ltd.
Andrascik & Tita LLC
Annaly Commercial Real Estate Group
Apollo Global Management
ARC Realty Finance Trust, Inc.
AREA Property Partners
Ares Management LLC
Assured Lender Services Inc.
Baker Donelson Bearman Caldwell & Berkowitz, P.C.
Bedrock Capital Associates LLC
Beech Street Capital, LLC
Beekman Advisors
Belgravia Capital
The Birdsey Group, LLC
The Blackstone Group
Brean Capital LLC
Brickman
Buchalter Nemer
Canopy Investment Advisors
CapitalSource
Carlton Fields
Cassin & Cassin LLP
Centerline Capital Group
CMBS.com
Cobb Partners
Cohen Financial
Cole Real Estate Investments
Colony Financial, Inc.
Cooper-Horowitz Inc.
CoStar - PPR
CPPIB Credit Investments Inc.
Craighead Law LLC
Crowell & Moring LLP
David L. Bonuccelli & Associates, Inc.
Duval & Stachenfeld LLP
Edwards Wildman Palmer LLP
Eightfold Real Estate Capital, L.P.
Ellington Management
Elliott Management Corporation
Exceder Real Estate Advisors, LLC
First Financial Network, Inc
Fox Rothschild LLP
FPL Advisory Group Co.
Frandzel Robins Bloom & Csato, LC
FTI Consulting
Goff Capital Partners
Greystone & Co.
GRS Group
Guggenheim Partners
Harbor Group Ltd
Haynes and Boone, LLP
Heitman, LLC
Hudson Realty Capital LLC
Hunneman Capital Group
Impact Community Capital LLC
Interactive Data
Invesco Real Estate
Investcorp International Inc.
Jefferies & Co.
JER Partners
Johnson Capital
K&L Gates LLP
Kasowitz, Benson, Torres, Friedman, LLP
Katten Muchin Rosenman LLP
Korn/Ferry International
KPMG LLP
KSL Capital Partners
Ladder Capital Finance
LEM Mezzanine, LLC
LoanCore Capital
Loeb & Loeb LLP
Lone Star, LLC
Lormax Stern Development Company, LLC
Lowenstein Sandler PC
Mayer Brown LLP
Mayersohn Law Group P.A.
MC Five Mile Capital Partners
McCarter & English, LLP
McCracken Financial Solutions Corp.
Mesa West Capital
Miller, Canfield, Paddock and Stone, P.L.C.
MKP Capital Management, L.L.C.
Morris, Manning & Martin, LLP
Newmark Grubb Knight Frank
Nixon Peabody LLP
O'Connor Cochran LLP
One William Street Capital Management, L.P.
Onyx Equities, LLC
Park Bridge Financial LLC
Paul Hastings LLP
PCCP
Pearlmark Real Estate Partners
Pentalpha Capital Group
Perkins Coie LLP
Pillar Financial, LLC
Pine River Capital
Prima Capital Advisors LLC
Prime Finance Partners
Promontory Interfinancial Network, Bank Assetpoint
Prudential Real Estate Investors
Putnam Investments
R.J. Finlay & Co.
RAIT Financial Trust
Raith Capital Partners
Redwood Trust, Inc.
Related Companies, LP
Resource Real Estate, Inc.
Rialto Capital Management
RLJ Lodging Trust
Rubin, Ehrlich & Buckley, P.C.
Sabal Financial Group LP
Seer Capital Management LP
Shorenstein Properties LLC
Sills Cummis & Gross PC
Spring Hill Capital Partners, LLC
Square Mile Capital Management, LLC
Stabilis Capital Management LP
Standish Mellon Asset Management

APPENDIX 12: Member List

CRE Finance Council

CRE Finance Council Member Companies

Stifel Nicolaus
StormHarbour Securities
Strategic Property Associates LLC
Summer Street Advisors, LLC
Sutherland, Asbill & Brennan LLP
T. Rowe Price Associates, Inc
Talmage, LLC
Thompson & Knight LLP
Thompson Hine LLP
Torchlight Investors
Townhouse Partners
TRIGILD
TriLyn LLC
Voit Real Estate Services
Walton Street Capital
Washington Holdings
Waterstone Asset Management
The Weitzman Group, Inc.
White Mountains Advisors LLC
Winston & Strawn LLP

CRE Finance Council, Written Testimony Exhibit C
HFS Capital Markets Subcommittee, February 26, 2014

CRE Finance Council®
The Voice of Commercial Real Estate Finance

February 6, 2014

The Honorable Janet L. Yellen
Chairman, Board of Governors
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Mary Jo White
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable Thomas J. Curry
Comptroller of the Currency
U.S. Department of the Treasury
250 E Street, SW
Washington, DC 20219

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

Re: Single Borrower Single Credit Disclosure Framework
Proposed Rule, Credit Risk Retention
OCC Docket No. 2013-0010; Federal Reserve Docket No. R-1411; FDIC RIN 3064-AD74; SEC File No. S7-14-11; FHFA RIN 2590-AA43

Ladies and Gentlemen:

On October 30, 2013, the Commercial Real Estate Finance Council ("CRE Finance Council" or "CREFC") submitted its comments on the proposed rule for credit risk retention for asset-backed securities,[1] which was jointly published by your respective agencies (collectively, the "Agencies") pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2]

[1] Proposed Rule, Credit Risk Retention, 78 Fed. Reg. 57928 (Sept. 20, 2013) (hereafter, "NPR" or "Proposed Rule").

[2] 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)).

As part of those comments, we advocated for an exemption for Single Borrower/Single Credit ("SBSC") transactions,[3] and in our conversations with the Agencies, we agreed to provide a disclosure regime to ensure these transactions are transparent and to recommend a minimum deal size to which the exemption could attach. With respect to the minimum deal size, there is a strong consensus across both the issuers and the investors that $200 million is an appropriate threshold for the exemption. With respect to the requisite disclosure, there also is a strong consensus supporting the disclosure framework summarized in the attachments; we also developed proposed draft regulatory language that would implement that regime which is attached, as well. The process we used to develop these consensuses and the underlying logic for the proposals are discussed below.

The CRE Finance Council is the collective voice of the entire $3.1 trillion commercial real estate finance market. Its members include all of the significant portfolio, multifamily, and commercial mortgage-backed securities ("CMBS") lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds, specialty finance companies, REITs and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers.[4] Our industry plays a critical role in the financing of office buildings, industrial complexes, multifamily housing, retail facilities, hotels, and other types of commercial real estate that help form the backbone of the American economy.

One topic of discussion with Agencies' staff related to our comments surrounding SBSC transactions, in which we advocated for an exemption for such deals. Given that these transactions only involve one loan, and that historically, there has been no role for B-Piece Buyers, the CRE Finance Council believed that they should be treated differently that those transactions requiring risk retention. Additionally, for SBSC transactions, transparency is extremely high because granular loan details are reported to potential investors; and their loss experience has been exceedingly low – well below that of conduit CMBS and other asset classes – and has been more on par with non-securitized corporate bonds. There was a strong consensus among all CRE Finance Council members – including a majority consensus among the Investment-Grade Investors ("IG Investors") whom the retention rules are designed to protect – that these SBSC deals do not present the issues that the Proposed Rule is intended to address and therefore should be completely exempt from the risk retention rules.

In order to ensure such transparency that inherently creates low risk transactions, we are providing the attached regulatory language that constructs a disclosure regime for SBSC transactions. As with our original comments, the CRE Finance Council developed this language in consultation and with the input of various constituencies.[5] The result is a proposed disclosure

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[3] *See* Letter from CREFC to the Agencies (Oct. 30, 2013), at Part B.1, Page 13 (on file with the Agencies) ("Comment Letter").

[4] A complete CRE Finance Council Membership list is attached to the CREFC Comment Letter at Appendix 12.

[5] As explained in the Comment Letter, the CRE Finance Council operates member forums that are organized around each of our core market constituencies: IG Investors; B-Piece Investors; Issuers; Servicers; High Yield Investors; and Portfolio Lenders. The process of soliciting input from these forums is overseen and moderated

regime that has the support of the entire CMBS industry, including the investors that would be party to these SBSC transactions.

The regime was developed to address the concern that while there is disclosure in the 144A market, there should be a mandatory disclosure regime in place in order for SBSC transactions to be exempt from the risk retention rules. There are three pillars to this proposed disclosure regime. First, the disclosure requirements of a public CMBS offering shall be met, and the offering document must provide various disclosures, including:

(i) A summary of the material terms of the loan documents;
(ii) A description of the property or properties;
(iii) A description of the borrower, the borrower sponsorship and guarantors, and related ownership structure;
(iv) A summary of any material property management agreement, franchise agreement, and ground lease;
(v) A description of any material mezzanine, other subordinate debt, or preferred equity; and
(vi) An identification of material risk factors related to the loan or loans and the property or properties.

Second, the qualified investor will be entitled, upon request, to receive various additional information, including:

(i) Third party reports (i.e. appraisals, environmental reports, and engineering/building condition reports);
(ii) All loan documents, including the loan agreement, promissory note, cash management agreement, mortgage/security agreement, and property management agreement; and
(iii) Copies of financial statements.

Third, the proposed regime provides for a system of ongoing reporting, which would include the monthly CREFC Investor Reporting Package ("IRP") applicable to the transaction. As can be seen in the attachments, the IRP is a comprehensive document consisting of historical and current data, specific informational reports, and loan files.

Finally, in response to staff concern that very small SBSC deals could be used as a way to elude the applicability of the core retention regime, the CRE Finance Council is proposing a $200 million minimum deal size to qualify for the exemption in order to alleviate that concern.

The CRE Finance Council appreciates the amount of effort and work the Agencies have put forth in the development of the Proposed Rule, and in preparation of conversations about our Comment Letter. We have always valued the opportunity to work with the Agencies to further explain our ideas and to alleviate any concerns the Agencies may have with those ideas. The

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by the CRE Finance Council's Policy Committee, which is comprised of the leaders of each of the forums and certain members of CRE Finance Council's Executive Committee.

attached SBSC transaction disclosure regime should alleviate any concerns with exempting these deals from the risk retention framework, and we are happy to discuss at your convenience.

Sincerely,

Stephen M. Renna
President & CEO
CRE Finance Council

cc: The Honorable Shaun Donovan
Secretary
United States Department of Housing and Urban Development
451 7th Street SW
Washington, DC 20410-0500

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
400 7th Street SW
Washington, DC 20024

SINGLE BORROWER/SINGLE CREDIT EXCEPTION

To be inserted within:

§ .14 Definitions applicable to qualifying commercial loans, qualifying commercial real estate loans, and qualifying automobile loans.

Offering Document means the offering circular or memorandum made available to investors in connection with the offering of CMBS as part of a Single Borrower/Single Credit transaction.

Single Borrower/Single Credit transaction means a securitization of a single commercial real estate loan or a group of cross-collateralized or cross-defaulted commercial real estate loans that represent the obligation of one or more related borrowers secured by one or more commercial properties under direct or indirect common ownership or control, and satisfying the requirements set forth in §___.15(d).

To be inserted within:

§ .15 Qualifying commercial loans, commercial real estate loans, and automobile loans

(d) Exception for Single Borrower/Single Credit transaction. Single Borrower/Single Credit transactions shall be subject to a 0 percent risk retention requirement under subpart B, provided that:

(1) Offering Document Disclosures. The Offering Document shall:

(i) Generally satisfy the applicable disclosure requirements set forth in 17 C.F.R. § 229.1100, *et seq.*, except for the requirements in § 229.1112 insofar as it relates to the borrower or borrowers or the property of properties;

(ii) Contain:

(A) A summary of the material terms of the loan documents for the loan or loans underlying the Single Borrower/Single Credit transaction, including material terms of cash management arrangements;

(B) A description of the related property or properties, including the following information regarding the property or properties underlying the Single Borrower/Single Credit transaction for the preceding three years (or shorter period for which such information is reasonably available to the securitizer):

(1) Historical operating financial information; and

(2) Underwritten cash flow information for disclosed revenue and expense items;

(C) A description of the borrower, the borrower sponsorship and guarantors, and related ownership structure;

(D) A summary of any material property management agreement;

(E) A summary of any material franchise agreement;

(F) A summary of any material ground lease;

(G) If there is any material mezzanine debt, subordinated debt or preferred equity related to the property or properties, a description thereof and a summary of the material terms of any related intercreditor agreement; and

(H) Identification of material risk factors related to the loan or loans underlying the Single Borrower/Single Credit transaction, the related property or properties, and the related borrower or borrowers.

(iii) Disclose that the Single Borrower/Single Credit transaction is exempt from risk retention obligations in reliance on the Single Borrower/Single Credit transaction exception in §__.15(d).

(2) Additional Disclosures. In addition to the Offering Document satisfying the requirements set forth in §__.15(d)(1), the following additional information shall be made available in connection with the CMBS offering related to the Single Borrower/Single Credit transaction to prospective investors, upon their request, subject to clause (iii) of this paragraph (2):

(i) Copies of third party reports related to the property or properties underlying the Single Borrower/Single Credit transaction, including the:

(A) Appraisal(s);

(B) Environmental report(s); and

(C) Engineering/building condition report(s); and

(ii) Copies of material loan documents (except for the portions thereof subject to confidentiality obligations in favor of the related borrower or borrowers) for the loan or loans underlying the Single

Borrower/Single Credit transaction, including, to the extent applicable, the:

(A) Loan agreement;

(B) Promissory note;

(C) Cash management agreement;

(D) Mortgage and security agreement;

(E) Any material property management agreement;

(F) Agreements governing any mezzanine debt or subordinate debt preferred equity related to the property or properties underlying the Single Borrower/Single Credit transaction, including any related intercreditor agreement; and

(G) Material documents or information used by the originating lender in its underwriting of the loan, including but not limited to property tax bills and independent real estate tax analysis.

(iii) Notwithstanding the foregoing, the making available of the information set forth in clauses (i) and (ii) of this paragraph (2) may be conditioned on the prospective investor entering into a commercially reasonable confidentiality agreement.

(3) Ongoing Reporting. The agreement setting forth the requirements for ongoing reporting to CMBS investors in connection with the Single Borrower/Single Credit transaction shall require that the following information shall be made available to investors and prospective investors via the certificate administrator's or trustee's website (upon making applicable certifications) on an ongoing basis:

(i) Monthly distribution date statements prepared by the trustee or certificate administrator;

(ii) Monthly Commercial Real Estate Finance Council Investor Reporting Packages applicable to the transaction;

(iii) Notices of amendments to the loan documents for the loan or loans underlying the Single Borrower/Single Credit transaction, requests for termination of the related special servicer, and other material items of the type required under Form 10-D, pursuant 17 C.F.R. § 240.13a-17, for the Single Borrower/Single Credit transaction, except for the requirements in 17 C.F.R. § 229.1112 insofar as it relates to the borrower or borrowers;

(iv) Periodic financial information furnished by the borrower or borrowers pursuant to the loan agreement;

(v) Annual assessments of compliance with servicing criteria and related public accounting firm attestation reports for entities performing a servicing function as contemplated by 17 C.F.R. § 229.1122 and servicer compliance statements as contemplated by 17 C.F.R. § 229.1123; and

(vi) Any updates to the reports listed in subparagraph (2)(i) of this paragraph, if required to be obtained pursuant to the servicing agreement for the Single Borrower/Single Credit transaction.

To be inserted within:

§ __.17 Underwriting standards for qualifying CRE loans.

(c) Exception. The provisions of this section shall not apply to Single Borrower/Single Credit transactions.

CREFC REQUESTED EXEMPTION FOR SINGLE BORROWER DEALS

CREFC requests that Single Borrower/Single Credit transactions be exempted from the credit risk retention rules (the "Single Borrower/Single Credit Exemption").

A "Single Borrower/Single Credit" ("SBSC") transaction would be defined as "A securitization of a single commercial real estate loan or a group of cross-collateralized commercial real estate loans that represent(s) the obligation of one or more related borrowers secured by one or more commercial properties under direct or indirect common ownership or control, and satisfying the following Disclosure Requirements in connection with the related securities offering."

SBSC transactions are substantially similar to, and compete directly with, the whole loan lending activities of portfolio lenders with the further refinement that SBSC transactions allow capital markets investors to purchase higher risk and correspondingly higher yielding, subordinate interests in such loan(s). Current disclosure requirements for these transactions offer 144A investors robust disclosure measures. If SBSC transactions are to be exempted from risk retention under Dodd-Frank, the disclosure requirements for SBSC transactions ought to mirror the disclosure requirements generally required by portfolio lenders. This will ensure investors continue to be provided with material information to assess the concentrated credit risks within SBSC transactions.

DISCLOSURE REQUIREMENTS:

I. Offering circular or memorandum (the "Offering Document") will generally satisfy the disclosure requirements of a public CMBS offering:

   A. All Regulation AB requirements for CMBS transactions (to the extent applicable) will be satisfied, except for the requirement for Regulation S-X financial statements required under Item 1112 of Regulation AB.

   B. The Offering Document will disclose historical operating financial information for the property or properties for the preceding 3 years (or such shorter period for which such information is reasonably available), together with underwritten cash flow information for disclosed revenue and expense items.

   C. Securitization due diligence/disclosure obligations under Rule 193 (implementing Section 945 of Dodd-Frank Act) will be satisfied.

   D. The Offering Document will provide the following disclosures regarding the loan or loans and the property or properties due to asset/credit concentration:

      - A summary of the material terms of the loan documents, including material terms of cash management arrangements

      - A description of the property or properties

- A description of the borrower, the borrower sponsorship and guarantors, and related ownership structure
- A summary of any material property management agreement
- A summary of any material franchise agreement
- A summary of any material ground lease
- If there is material mezzanine, other subordinate debt, or preferred equity, a description thereof and a summary of the material terms of any related intercreditor agreement
- Identification of material risk factors related to the loan or loans and the property or properties

II. After entering into an industry standard confidentiality agreement, any otherwise qualified investor will be entitled, upon request, to receive the following additional information:

A. Copies of third party reports:

1. Appraisal
2. Environmental Report
3. Engineering/Building Condition Report

B. Copies of all relevant loan documents (except for portions thereof subject to confidentiality obligations), including but not limited to the following:

1. Loan Agreement
2. Promissory Note
3. Cash Management Agreement
4. Mortgage/Security Agreements
5. Property Management Agreements
6. Documents and Agreements governing material mezzanine or other subordinate debt
7. Other material employed in the underwriting of the loan, including but not limited to property tax bills, independent real estate tax analysis, etc.

C. Copies of financial statements and rent rolls, to the extent required to be provided by the borrower to the loan seller.

III. The Offering Document would disclose that the transaction is exempt from risk retention obligations in reliance on the Single Borrower/Single Credit Exemption.

IV. Ongoing Reporting.

The following regular reporting and ad hoc information would be made available to investors and prospective investors (upon delivery of applicable certifications):

A. Monthly Distribution Date Statements

B. Monthly CREFC Investor Reporting Package (IRP) applicable to the transaction, which is required per the CMBS loan documents (See Appendix 1 for detailed reporting and information provided by IRP)

C. Notices of amendments to the mortgage loan documents, requests for termination of special servicer, and other material items of the type required under Form 10-D

D. Annual Assessments of Compliance with Servicing Criteria and related Public Accounting Firm Attestation Reports

E. Periodic financial information furnished by the borrower that is required under the loan agreement

F. If required to be obtained pursuant to the applicable servicing agreement, updated appraisal reports and environmental assessments

Structured Finance Industry Group

Testimony of Neil J. Weidner

On Behalf of the Structured Finance Industry Group (SFIG)

Before the United States House of Representatives

Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on

The Dodd-Frank Act's Impact on Asset-Backed Securities

February 26, 2014

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February 26, 2014

Introduction

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises: I want to thank you for holding this afternoon's hearing entitled "The Dodd-Frank Act's Impact on Asset-Backed Securities."

My name is Neil J. Weidner and I am here to testify on behalf of the Structured Finance Industry Group (SFIG).

Founded in March 2013, SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. With approximately 240 institutional members, SFIG's membership represents all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers and trustees.

SFIG membership believes that securitization is an essential source of funding for the real economy. It connects investors with desired investments and provides consumers and businesses with access to funding and capital. Securitization provides economic benefits that can increase the availability, and lower the cost, of credit to households and businesses.

Like any powerful tool, however, securitization must be used carefully, and thoughtful regulation is an important part of that. Yet if regulation is taken too far, it could render large portions of the securitization market either operationally or economically non-viable, leading to a reduction of available credit and/or increases in borrowing costs.

Ultimately, the level of regulation will determine the affordability of credit for Main Street, including commercial loans for manufacturers and other businesses, student loans for college and graduate students, and credit cards, mortgages and auto loans for consumers.

SFIG wants to ensure that all types of securitization transactions, irrespective of asset class, are both well-regulated and liquid. We continue to work with Congress and the federal agencies to address our concerns as they relate to Dodd-Frank rulemakings, including (but not limited to) risk retention, Regulation AB and the Volcker Rule.

While SFIG respectfully acknowledges that the goal of this hearing is to discuss Dodd-Frank's impact on asset-backed securities, we also highlight that the impact from regulation currently felt by the securitization market is by no means limited to Dodd-Frank. Other current rulemaking initiatives—such as shadow banking reform and proposals for implementing Basel III (including liquidity coverage and net stable funding ratios), also contribute to the high degree of uncertainty that exists in the securitization market today.

As we assess these regulatory initiatives, each of which has merit in its own right, we are concerned about the combined, long-term impact they could have on the ability of Main Street America—a primary beneficiary of securitization—to use the markets for affordable credit.

Our concern about this combined impact is also borne of the recognition that any single regulatory initiative, in isolation, can potentially have an outsized negative impact on the securitization market. One of the clearest examples of this is the effect of the Volcker Rule on collateralized loan obligations (or "CLOs") and, relatedly, the commercial loan market that relies on CLOs to provide affordable financing to U.S. borrowers. Another such example is the impact felt by the CLO marketplace from the proposed credit risk retention rules. My testimony today will focus on both examples and proposed solutions to counteract these negative effects.

If we do not foster a healthy and stable CLO market for all participants, then companies that create jobs, make capital investments to grow their businesses and provide goods and services will suffer. Companies such as:

- Berry Plastics of Evansville, Indiana, which manufactures packaging and bottles for food, soap, medicine and other consumer goods; or
- Pinnacle Food Group, LLC of Parsippany, New Jersey, which produces food products that reach more than 85 percent of U.S. households; or
- HCR ManorCare of Toledo, Ohio, which employs over 57,000 people in 32 states and provides post-hospital and long-term care; or
- SeaWorld Parks and Entertainment of Orlando, Florida, which operates 11 theme parks that hosted more than 24 million guests in 2012.

Importantly, CLO issuance in January, 2014, was down approximately $7.0 billion compared to January, 2013,[1] and some analysts have already reduced their full-year estimates for CLO issuance in 2014 by $10 billion or more.[2]

However, the CLO market has seen a slight upturn in February, and many in the market believe this positive result is due to the bi-partisan work of the Committee and the commitment by the federal agencies to resolve the unintended consequences of the Volcker Rule

Yet, SFIG is concerned that without an expedient resolution for CLOs, the market will quickly contract.

It is just as important to note that the long-term viability of the CLO market will not be solely determined by the implementation of the Volcker Rule. The pending credit-risk retention rulemaking is also of critical importance. If implemented as re-proposed, market forecasters

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[1] http://research1.ml.com/C?q=wezDxGw7YSk.
[2] Id.

predict that CLO issuance and the amount of credit provided to businesses could be reduced by 75 percent or more.

We appreciate the bi-partisan work of the Committee and the federal agencies to work toward both a short-term solution for the Volcker Rule and a long-term solution for risk retention., Without significant changes to these regulatory initiatives, we are deeply concerned about the sustainability of the CLO industry.

Therefore, it is imperative that the momentum that this Committee has provided - on both sides of the aisle – is maintained. Thank you for your work on these important issues.

Overview of CLOs

What are CLOs?

CLOs are investment funds that invest in commercial loans—that is, senior secured loans (including middle market loans) made to U.S. companies. Companies may use these loans to finance expansion projects, such as building new utility plants and energy pipelines, to support working capital and general operations, such as paying employee salaries and supplier invoices, and for refinancing existing debt. Commercial loans are therefore a critical source of credit for U.S. businesses - credit that is necessary for job creation and economic growth. The credit provided by CLOs to the commercial loan market generally serves to stabilize and lower interest rates for businesses that might not otherwise have access to capital markets financing. In fact, CLOs represent the largest non-bank segment of the commercial loan market, having invested in approximately $280 billion of loans made to U.S. companies.

The companies that access the funding provided by CLOs can be found in every state of the Union and operate across all kinds of industries, including: restaurants, utilities, healthcare providers, rental car companies, communications and broadcasting companies, manufacturers, and supermarkets and food services companies. It is no exaggeration to say that the access to credit provided by CLOs affects nearly everyone in your Congressional districts who is working hard to create jobs and spur the U.S. economy.

As a technical matter, CLOs are structured as securitizations. They issue securities that are dependent upon repayment from portfolios of financial assets.[3] It is important to note that the CLO structure and associated markets have a proven track record, having demonstrated their stability and resiliency before, during and after the recent financial crisis. This strength is largely driven by five differentiating features:

1. Diversification. A CLO portfolio is primarily comprised of senior secured commercial loans, usually a minimum of 90 percent, and those loans are well-diversified across different industry sectors. Consequently, CLOs are not reliant on the performance of any particular company or industry.

2. Active Management. CLOs are actively managed by SEC-registered investment advisers who perform credit analysis on the commercial loans in which the CLO invests and, within certain limitations, buy and sell assets in response to changing market conditions. CLO managers are charged with managing the portfolios of CLOs with portfolio risk guidelines while minimizing realized losses. Their expertise significantly contributed to CLOs' strong credit performance during the financial crisis.

3. Alignment of Interests. The interests of CLO managers are strongly aligned with the interests of CLO investors. In other words, CLO managers have "skin in the game." They do not profit from the sale of assets to the CLOs they manage at the time of sale; they receive the bulk of their compensation only when and if the CLO performs well over time; and if they breach their legal duties as set out in the CLO transaction documents, they can be removed as manager by the investors.

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[3] CLOs usually issue multiple classes of secured debt and a single class of unsecured equity, with the most senior class of secured debt (which bears the least risk of loss) at the top of the CLO capital structure and the most subordinated equity class (which bears the most risk of loss) at the bottom of the CLO capital structure. By issuing their securities in multiple classes or "tranches," CLOs are able to attract investors with varying risk/reward appetites.

4. Self-Correcting Mechanisms. CLOs are designed to "self-correct" for any material deterioration in the credit quality of the portfolio of commercial loans. These mechanisms include tests that, if not satisfied, require that investors in the CLO's senior debt securities be repaid before the CLO manager receives most of its fees or any investors in the CLO's junior equity securities receive further payment, until compliance with the tests is restored.

5. Transparency. CLOs purchase commercial loans from third-party sellers in an active, transparent secondary market. The loans are issued by companies that are audited by reputable accounting firms; report financial performance information to loan investors on a regular basis; frequently are required to file regular financial reports with the SEC; and typically have assigned, monitored ratings from one or more of the principal credit rating agencies.

State of the CLO Industry

Historical Performance

CLOs performed very well before, during and since the financial crisis. As a result of the strong historical performance of the underlying leveraged loans, 5 year cumulative impairments on investment grade CLO debt securities since 1993 have been less than 0.8%.[4] Consequently, no CLO debt security initially rated higher than "A" by one of the primary credit rating agencies has suffered a principal loss. For debt securities initially rated "BBB" or higher the 5-year cumulative principal loss rate for securities issued between 1993 and 2012 is just 0.2%.[5] These loss rates compare favorably with certain fixed income securities such as corporate bonds, which have seen principal loss rates of approximately 0.7% during the period from 1992 to 2012.[6]

CLOs have also provided strong returns to investors compared to other fixed income

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[4] Moody's Investors Service, *Default & Loss Rates of Structured Finance Securities: 1993-2012*, November 27, 2013.
[5] Moody's Investors Service, *Default & Loss Rates of Structured Finance Securities: 1993-2012*, November 27, 2013.
[6] Id.

securities, as CLO debt securities with an average rating of "A" returned an average of 3.9% in 2013, compared to an average loss of 2.2% for all other fixed income securities during the same time period.[7]

Current State of the CLO Marketplace

Issuance Compared to Historical

While CLO issuance has rebounded considerably from financial crisis levels, the uncertainty surrounding interpretation of the Volcker Rule appears to have contributed to putting a damper on recent CLO issuance activity. CLO issuance in January 2014 was down approximately $7.0 billion compared to January 2013.[8] Based on this, some analysts have already reduced their full-year estimates for CLO issuance in 2014 by $10 billion or more.[9] It has been further estimated that if the risk retention rules proposed under the Dodd-Frank Act were enacted in their current form, CLO issuance and the amount of credit they provide to businesses could be reduced by 75 percent or more over the long term.

We note that issuance this month increased after seeing a 17-month low in January. This recent uptick has been attributed to the market's reaction to this Committee's bi-partisan support for a regulatory fix to the Volcker Rule.

Therefore, we appreciate the bi-partisan efforts of this Committee to address these issues, and we appreciate the continued momentum that this hearing has provided. Without the efforts of both Congress and the agencies, the market may quickly decline, and forecasters' downward predictions for both the near- and long-term CLO market will prove accurate.

How Declines in CLO Issuance Affect Main Street

As noted earlier, CLOs are currently invested in approximately $280 billion of senior,

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[7] http://research1.ml.com/C?q=BVkyYbIBgLg.
[8] http://research1.ml.com/C?q=wezDxGw7YSk.
[9] Id.

secured commercial and industrial loans made to U.S. companies. This $280 billion represents approximately 45 percent of the credit available to non-investment grade U.S. companies that borrow in the commercial loan market. These borrowers include companies in a wide variety of geographic areas and important sectors of the U.S. economy. They are growing, job-creating companies that affect the everyday lives of U.S. workers and consumers. On the whole, the businesses that use CLO financing are currently estimated to employ approximately 7.5 million people.[10]

As CLO issuance declines, the ability of these companies to obtain important financing at reasonable rates diminishes. And if CLO issuance declines by the 75 percent or more that is estimated, as a result of the proposed risk retention rule being implemented in its current form, then it is expected that a "refinancing wall" will occur between 2017 and 2020. Specifically, this means that there would be more loans that need to be refinanced than the commercial loan market, as currently composed, would be able to support.[11]

CLOs also allow global investors, who lack the access to directly lend to U.S. companies, a method of providing this credit with the assistance of a U.S.-based asset manager and at the risk level they are most comfortable. Without CLOs available as a means of funding commercial and industrial loans, there is no certainty that the other current participants in the commercial lending market, such as banks and mutual funds, would be able to provide all of the additional funding necessary to support the refinancing wall that would hit U.S. borrowers. At the very least, even if alternate funding sources become available, then they will be more expensive than CLOs and will increase the costs of borrowing for the companies, making it harder for companies to meet payroll or grow without sacrificing jobs.

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[10] This figure is derived from SFIG's analysis of FY2012 data consisting of public company information, private company information and third-party research. At the request of the committee, SFIG will be pleased to share its methodology.

[11] See *The CLO Salmagundi: Risk Retention Consequences*, Wells Fargo Research (Dave Preston and Jason McNeilis), September 20, 2013. See also *CLO Weekly: Loan Performance Solid*, Bank of America Merrill Lynch Securitized Products Research (Chris Flanagan, Ryan Asato, Justin Borst and Collin Chan), October 18, 2013, p. 7.

Reasons for the Current State of the CLO Marketplace

Volcker Rule

Even though CLOs are "long-only" funds that invest primarily in loans to U.S. companies through a robust, transparent structure with a buy-and-hold strategy that does not contribute to mark-to-market volatility, most CLOs are effectively treated as hedge funds under the Final Rule[12]. The Final Rule defines "covered fund" in a way that includes securitization issuers, such as CLOs, that rely on the exemption provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Although the Final Rule excludes from the definition of covered fund "loan securitizations," or securitization issuers that hold only loans and certain servicing assets, risk-mitigating assets and cash equivalents[13], most CLOs in existence today do not qualify for the loan securitization exclusion, even though typically 90 percent or more of their portfolios are devoted to commercial loans.[14]

One of the primary consequences of a CLO being treated as a covered fund under the Volcker Rule is that banks are not permitted to acquire or hold an "ownership interest" in that CLO, absent certain limited exceptions. The problem for the CLO market, and for the banks that invest in it, is that the Final Rule defines "ownership interest" in a way that includes not only the junior-most "equity" class of securities issued by a CLO (in other words, the class of securities that economically "owns" the CLO), but also the highly rated, senior secured classes of debt securities issued by a CLO and commonly purchased by banks of all sizes. As a result, over the next 17 months U.S. banks may have to divest up to $70–80 billion of senior CLO debt securities. In addition to disrupting the CLO market (and consequently, the market for commercial loans on which so many U.S. businesses depend for financing) and creating

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[12] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013) ("Final Rule").

[13] Section __.10(c)(8)(i) of the Final Rule.

[14] CLOs that have already issued their securities and commenced operations are commonly referred to as "legacy CLOs." Legacy CLOs typically permit a small portion (usually in the 7.5% to 10% range) of their portfolios to consist of bonds, for the purposes of diversity and realizing extra income. Bonds and other securities, however, generally are not permitted under the loan securitization exclusion.

downward pressure on the market values of CLO debt securities generally, this forced selling could very well cause banks to unnecessarily incur substantial losses on otherwise well-performing, high quality assets.[15]

The Volcker Rule's Effect on Bank CLO Investments: A Case Study

The well-underwritten commercial loans held by CLOs, the various structural features of CLOs that provide significant protections to investors, the strong historical performance of CLOs (before, during and since the recent financial crisis) and the excellent risk-adjusted returns of CLOs, among other factors, have attracted a variety of institutional investors to CLOs.

In particular, a wide range of U.S. banks, including large, mid-size and community banks, have invested in CLOs—specifically, in the interest-bearing, secured note classes issued by CLOs that are rated "AAA" or "AA" by one or more rating agencies.[16] As mentioned, the amount of senior CLO debt securities currently held by U.S. banks is between $70 and $80 billion.

For example, First Federal Savings Bank, an over 90-year-old community bank in Elizabethtown, Kentucky, with approximately $850 million in assets, is one such U.S. bank that invests in CLOs. In a February 4th, 2014 letter to the federal agencies responsible for implementing the Volcker Rule[17], the Chief Financial Officer of First Federal Savings Bank describes CLO debt securities as "well structured, variable rate, diversified credit assets that

[15] In addition to the $70–80 billion held by U.S. banks, it is estimated that approximately $60 billion of senior CLO debt securities are currently held by non-U.S. banks. Non-U.S. banks that have branches or agency offices in the U.S. are subject to the Volcker Rule and are prohibited, in the same manner as U.S. banks, from holding an ownership interest in a covered fund that is open to U.S. investors. As a result, such non-U.S. banks face the same issue as U.S. banks regarding whether, in the absence of clarification or guidance from the agencies or action by Congress, they will need to sell their CLO debt securities or attempt a restructuring of the CLOs that issued those securities. The absence of such non-U.S. banks from participation in the CLO market would further diminish the funding capacity that CLOs provide to U.S. businesses.

[16] Such notes typically comprise the senior-most (commonly referred to as the "controlling class") or next senior-most classes of CLO debt securities and represent a majority of a CLO's capital structure.

[17] The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

provide banks of all sizes with an opportunity for an attractive risk-adjusted return." The CFO noted that First Federal Savings Bank has invested $36.5 million in senior CLO debt securities, an investment that represents 14 percent of a "carefully managed investment portfolio," which First Federal Savings Bank views as "a conservative and much less risky component of [its] balance sheet."[18]

However, if there is no clarification to the Volcker Rule, then First Federal Savings Bank would be forced to divest its CLO assets by July 21, 2015. At the same time, all other U.S. banks subject to the Volcker Rule would have to similarly divest their CLO debt securities, thus creating a buyer's market and depressing asset prices. As the bank stated in its letter to the agencies, "A 20% decline in market value of these CLOs as a result of forced liquidation would equate to a $7.4 million charge to earnings. A loss of this magnitude would erode tangible common equity by more than 30%." The bank further stated, "We should not be forced to divest and take losses on safe investments that were on our balance sheet prior to the finalization of the Final Rule."

We highlight First Federal Savings Bank as a text book example of a community bank's equity being needlessly eroded though impairing its ability to lend to local businesses. If taken on National scale, clearly the consequences for the U.S. economy would be significant.

The Rulemaking Issue

The Final Rule effectively transforms the senior CLO debt securities held by banks into the equivalent of equity securities. It does this by re-characterizing as "equity-like" certain common features of CLO debt securities that are designed solely to safeguard the rights of those security holders as secured creditors of the CLOs in which they have invested. The Final Rule essentially says to banks, "You may have thought you were ***lending*** to CLOs, but you really ***own*** those CLOs." This was news to both banks and the actual owners of the CLOs.

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[18] First Federal Savings Bank Letter (Feb. 4, 2014), available at https://fdic.gov/regulations/laws/federal/2014/2014-collateralized-debt-obligations-ae11-c_03.pdf.

The definition of "ownership interest" in the Final Rule contains specific language that is intended to capture securities and other interests that, while in the form of debt, exhibit substantially the same characteristics as equity. Most of this language describes features relating to economic control of the issuing entity or the right to receive a share of the entity's profits and losses. However, the definition also treats as "ownership interests" those interests that, on a current, future or contingent basis, have "the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)."[19]

As discussed in the Overview, there are a number of structural features that contribute to the robustness of CLOs. Among these are important creditors' rights given to holders of CLO debt securities that reflect their effective status as senior ***lenders*** to, rather than ***owners*** of, a CLO. Although most of these creditors' rights are vested in the senior-most outstanding or "controlling class" of debt securities, because CLO debt securities are paid in order of seniority, any class of CLO debt securities can become the controlling class after all classes senior to it have been paid in full.

One such important creditors' right is the ability to remove a CLO manager "for cause" and participate in the selection of its replacement. In typical CLO transaction documents, the events that could trigger the right to remove a CLO manager "for cause" include, among others, a willful breach by the CLO manager of its obligations under the transaction documents, the dissolution or insolvency of the CLO manager or fraud or criminal activity by the CLO manager in connection with its investment management business.[20] By their very nature, "for cause" events ultimately threaten the ability of a CLO to make promised payments of principal and interest to the holders of its debt securities.[21] Another important creditors' right is to vote on the

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[19] See Section __.10(d)(6)(i)(A) of the Final Rule.

[20] In the event of a CLO manager's removal, the controlling class typically shares with the equity class of securities the right to propose a replacement. If specified percentages of the two classes are unable to agree on a replacement, a court can be petitioned to appoint a successor.

[21] In CLO transaction documents, the equity class of securities issued by a CLO receives no such promise of repayment in respect of amounts invested by its holders. Rather, CLO equity is entitled only to receive excess interest and principal collections that are not needed to pay amounts due to holders of CLO debt securities or certain

replacement for a CLO manager that resigns. The resignation of a CLO manager is effectively a change-of-control event for the CLO, a circumstance under which traditional bank lenders often receive consent rights or the right to be repaid.

In almost all CLOs, a specified percentage of the controlling class has the right to remove the CLO manager "for cause" and the right to nominate or approve the replacement of a CLO manager who has been so removed or has resigned. Consequently, CLO debt securities are, under a literal reading of the Final Rule, interests that have "the right to participate in the selection or removal" of an investment manager of a covered fund—in other words, "ownership interests" in which banks may not invest. Incongruously, because these rights are structured to help ***prevent*** an event of default under the CLO transaction documents, the carve-out in the Final Rule's language for "rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event" does not appear to apply.

Restructuring as an Alternative to Bank Divestiture

As an alternative to divesting their CLO debt securities, banks theoretically could attempt to orchestrate the restructuring of the legacy CLOs that issued those securities so that the CLOs qualify for the loan securitization exclusion from the definition of "covered fund". For at least two reasons, however, restructurings of legacy CLOs on a widespread basis is unrealistic. *First*, CLO managers would need to sell existing holdings of bonds and other securities that are not permitted under the loan securitization exclusion. They may not be willing to do so, however, if the CLO would incur a loss. Moreover, CLO managers have fiduciary responsibilities to ***all*** of the investors in the CLOs that they manage. Sales of non-loan assets, while beneficial for banks as a means of qualifying for the loan securitization exclusion, might be economically disadvantageous to other, non-bank CLO investors. *Second*, even after such sales, CLO managers would need to promise not to make any new purchases of impermissible securities. Banks that have invested in CLOs likely would not be comfortable with any such promise unless it was formally memorialized in an amendment to the CLO's transaction documents. However,

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service providers to the CLO, such as the CLO manager and trustee.

it can be very difficult to amend CLOs transaction documents because amendments frequently require the consent of a majority of each class of securities issued by the CLO and the cooperation of security holders whose interests are not always aligned.

One Immediate Effect of the Rulemaking Issue

Although banks have until at least July 21, 2015 to bring any existing activities and investments into compliance with the Volcker Rule, they may face a problem ***today*** under current accounting rules. If the CLO debt securities held by banks are impermissible "ownership interests" in covered funds, then those banks no longer will be able to treat their senior CLO debt securities as long-term investments. Consequently, if the current market values of those securities are lower than the prices paid by banks to acquire them, banks may need to recognize immediate charges against earnings. The irony is that banks face the prospect of reduced capital levels as the result of holding secure and performing investments, solely because the Final Rule re-characterizes as "equity-like" certain features of those investments that are designed to protect banks in the first place.

Risk Retention

Pursuant to Section 941 of the Dodd-Frank Act, six governmental agencies were tasked with developing rules to require securitizers to retain a portion of the risk of the assets they securitize. The agencies have released proposed rules which, if enacted "as-is," would permit a CLO to satisfy the agencies' risk retention requirements either by retaining a specific type of interest in the CLO by the CLO investment manager or by structuring CLOs to consist solely of "CLO-eligible loan tranches" and related servicing assets. In either case, these options for risk retention are unworkable for most of the current participants in the CLO market and, if they are the only options available, are expected to significantly decrease the number of participants in the CLO market, the amount of CLO issuance and, consequently, the availability of financing to U.S. companies. I will address the problems with each of these options in turn.

CLO Manager Retention

The current risk retention proposal will require CLO investment managers to retain an interest equal to 5 percent of the fair value of all CLO securities issued in each new CLO it manages unless the transaction is structured to consist solely of "CLO-eligible loan tranches" and related servicing assets. In addition, to the extent that the retained interest represents a horizontal interest in the CLO, the interest is required to be structured in way to prevent the retention holder from receiving cash at a faster rate than that at which principal is paid to investors in all other CLO securities, as based on projected cash flows.

CLO managers are similar to (and in fact, often also are) mutual fund managers and generally do not profit from selling assets to an investment vehicle, but instead rely on fees received for active management in connection with the performance of the vehicle. As a result, many of the managers in the CLO market are not capitalized in a manner that would permit them to hold interests in CLOs that they manage at the level that the agencies are proposing. The agencies expressed understanding in their re-proposal that requiring collateral managers to be the sole sponsors of CLOs and to satisfy risk retention would reduce the number of CLO issuances and competition among CLO managers.

Also, the requirement to restrict payments received by the holder of a retention interest is unnecessary as CLO equity tranches are already fully subordinated to payments to CLO debt securities. Since CLOs distribute interest and principal received on the underlying loans separately, principal proceeds on the underlying loans are never paid to a CLO equity tranche before all of the CLO debt securities have been paid in full. Furthermore, CLOs typically provide that interest payments will be diverted to pay principal of CLO debt securities when certain overcollateralization or interest coverage tests are not met. As a result of these features, losses fall on CLO equity tranches before affecting any CLO debt security.

Perhaps even more importantly, restricting cash flows paid to the holders of CLO equity tranches will make them less attractive to investors. As almost of all of the credit risk of a CLO is found in the bottom 20 percent of the capital structure and CLO equity tranches represent roughly half of that bottom 20 percent, investors expect to receive a higher return in exchange for taking on the risk of potential losses. All of that higher return comes in the form of excess interest generated by the underlying loans. If interest cash flows are withheld, investors in CLO equity tranches may not be appropriately compensated for bearing the credit risk of the transaction and may be unwilling to invest in CLOs going forward. A reduction in the number of CLO equity investors in the market would further reduce CLO issuance and shrink the availability of credit available to U.S. companies.

CLO-eligible Loan Tranches

Alternatively, the agencies proposed that a CLO manager would not have to retain an interest in a CLO it manages if the CLO consisted solely of "CLO-eligible loan tranches" acquired in the open market and related servicing assets. "CLO-eligible loan tranches" were defined by the agencies as loans where the lead arranger for the loan agrees to hold 5 percent of the loan purchased by the CLO for the life of the loan without the ability to hedge its exposure. Unfortunately, 10 banks are the lead arrangers for nearly 85 percent of all syndications of broadly syndicated loans, with 3 banks acting as lead arranger for nearly 49 percent of all syndications.[22] With such a small universe of lead arrangers, requiring the lead arrangers to retain 5 percent of every tranche of a loan syndication that a CLO wanted to have qualified as a "CLO-eligible loan tranche" would potentially require an enormous increase in those banks' risk-based capital. In addition, retaining these loan tranches would require the banks holding them to pay a higher premium for depository insurance. These additional costs, if not prohibitive to the banks, would be passed along to borrowers, further increasing the costs of borrowing and negatively affecting the ability of U.S. companies to finance growth. Additionally, the requirement that the banks hold a portion of these loan tranches until maturity without being permitted to hedge is a credit strategy opposed by both bank regulators and common prudential risk management practices. Given all of these concerns, banks have indicated that they are unlikely to originate a substantial amount of loans that would satisfy the proposed requirements of a "CLO-eligible loan tranche".

SFIG's Recommendations

SFIG believes there are simple, straightforward solutions for restoring regulatory clarity

[22] Dealogic (October 25, 2013)

to the participants in the CLO marketplace and keeping affordable credit flowing to U.S. businesses of all kinds. SFIG further believes that these solutions can be achieved expediently and in ways that are consistent with the intent of Congress when it passed the Dodd-Frank Act.

Solutions for the Volcker Rule

SFIG has requested that the agencies confirm, in a FAQ or other appropriate interpretive guidance, that the term "ownership interest" as defined in Section__.10(d)(6) of the Final Rule does not include the debt securities of CLO issuers that are covered funds, where those CLO debt securities give holders only a contingent right to remove a CLO manager "for cause," or to nominate or vote on a nominated replacement for a CLO manager following its removal for cause or resignation, but do not contain any of the other indicia of ownership listed in the Final Rule. SFIG believes that such confirmation would clarify for banks that their holdings of senior CLO debt securities are not impermissible holdings of "ownership interests" of covered funds under the Volcker Rule, thus protecting both CLO market participants and the U.S. companies that rely on the commercial loan market for financing from the adverse consequences of divestiture described previously.

In the event that the agencies decline to provide this guidance, SFIG has asked that, alternatively, the agencies provide guidance that debt securities of CLOs in existence as of a certain date of determination (to be identified by the agencies), which afford their holders the creditor's right to remove a CLO manager "for cause" or to participate in the selection of its replacement upon removal or resignation, but which do not have any of the other indicia of ownership listed in the Final Rule, not be deemed to be "ownership interests" under the Final Rule. In light of the significant difficulties involved in restructuring legacy CLOs, SFIG believes that the grandfathering of existing CLO debt securities is a practical solution for mitigating the Volcker Rule's disruptive effect on the commercial loan market.

SFIG further notes that some banks that hold senior CLO debt securities have considered the effect of unilaterally waiving their creditor's right to remove a CLO manager "for cause" or to participate in the selection of its replacement upon removal or resignation. There is, however, no existing guidance from regulators as to whether such action by banks would be effective to cause their investments in CLO debt securities to not be deemed to be "ownership interests" under the Final Rule. SFIG believes that banks would welcome, in the absence of other regulatory clarification or guidance and as an alternative to widespread divestiture of bank holdings of CLO debt securities, interpretive guidance from the agencies that any such unilateral waiver would be so effective.

Solutions for Risk Retention

As demonstrated earlier, the currently proposed options for asset-backed securities risk retention are unworkable for CLOs and are expected to greatly reduce CLO issuance and its beneficial effect on the commercial loan market. In its comment letter to the agencies, SFIG has proposed certain additional solutions to make risk retention more workable for the CLO market while also satisfying the policy concerns that led to the adoption of the Dodd-Frank Act.

Moreover, in a second comment letter developed with the LSTA and SIFMA, SFIG has explored alternative solutions, suggesting that the agencies consider adopting the concept of a "Qualified CLO" as a means of satisfying the purposes of Section 941 of the Dodd-Frank Act.[23] Below are detailed descriptions of these suggested solutions for CLO risk retention:

Third Party Retention

SFIG's members believe that the agencies should adopt a third-party retention holder option as a way for broadly syndicated CLOs to meet their risk retention obligation. We note that the agencies have indicated that, in some cases, an entity that is a third party to a transaction may be an appropriate entity to satisfy a securitization's risk retention, such as the proposed lead arranger for a CLO-eligible loan tranche. In CLOs, investors actively negotiate the quality and parameters of the securitization's asset pool through negotiation of the portfolio constraints of the managed CLO asset pools. As a result, we believe that CLOs would be an appropriate asset class for a third-party retention holder option. We further propose that a third-party retention

[23] See LSTA, SFIG and SIFMA Letter Comment, Jan. 10, 2014.

option for CLOs contain the following characteristics:

1. Third Party Retention Holders and Eligible Retention Interests. SFIG has proposed that the CLO third-party purchaser retention option permit up to two third-party purchasers to jointly satisfy some or all of a CLO's risk retention requirements. We think that it is appropriate to permit multiple parties to be able to jointly satisfy such CLO's risk retention requirements due to the nature of the market for CLO securities and the active involvement of investors in the structuring of such CLOs.

2. Asset Pool Composition and Third Party Review. In order for an open market CLO to be eligible to utilize the third-party purchaser retention option, such CLO's asset pool would be required to be comprised primarily of commercial loans and servicing assets. The agencies have asserted that risk retention should be held by collateral managers when no other party is the sponsor of the CLO as the agencies consider the collateral managers to be the parties that determine the credit risk profile of the securitized assets in a CLO. Although CLO managers do select the specific assets to be included in a CLO asset pool, they do so in accordance with set parameters laid out in the transaction documents for each CLO. Due to the revolving nature of a CLO asset pool and the number assets in the typical CLO asset pool, it is not practical, nor commercially desirable by other CLO investors, for a third-party retention holder to approve each asset selected by the CLO manager before it is acquired by a CLO issuer. However, we believe that it is possible for a third-party retention holder to materially influence the selection of the assets in an open market CLO in a manner that will satisfy the agencies' goal of improving the quality of the assets in securitization asset pools without reviewing and approving each asset. As a proxy for reviewing each asset, each third-party retention holder would be required to conduct a review of, and approve certain key terms (the "Transaction Portfolio Terms") governing the quality of the assets the CLO will be permitted to purchase and the composition of the CLO's portfolio. Once the Transaction Portfolio Terms have been approved, the CLO manager will be permitted to trade portfolio assets without additional

approvals from the third-party retention providers so long as trades are made in accordance with the Transaction Portfolio Terms. After the third-party retention holders have approved the initial Transaction Portfolio Terms, no material change to any of the Transaction Portfolio Terms may be effected without the prior written consent of each third-party retention provider. Additionally, to satisfy our proposed third-party retention holder option, the CLO issuer will be required to have acquired or entered into binding commitments to acquire by the CLO's closing date at least 50 percent of the initial target par amount CLO portfolio assets. This will help ensure that the third-party retention holders are able to gauge the CLO manager's ability to comply with the Transaction Portfolio Terms prior to the closing of the CLO.

3. CLO Managers. SFIG proposes that any broadly syndicated CLO relying on the third-party retention holder option be required to be managed by a CLO manager that is a registered investment adviser under the Investment Advisers Act of 1940.

4. Retention Period. SFIG believes that a shorter holding period than proposed by the agencies would be appropriate for third-party retention holders, after which the eligible horizontal residual interest (or "EHRI") or eligible vertical interest (or "EVI") would be freely transferable. Additionally, we also propose that during such holding period third-party retention holders be subject to the restrictions on hedging and transfer applicable to a sponsor holding an EHRI or EVI in order to ensure that such third-party retention holder is fully exposed to the credit risk of such broadly syndicated CLO.

Expand the Definition for Qualified Commercial Loans

SFIG's members believe that a viable definition of a "qualified commercial loan" would contribute significantly to the workability of subjecting CLOs to required risk retention. SFIG members find the re-proposal's definition unduly restrictive and believe that it effectively excludes other well-underwritten commercial loans that should be included. Unfortunately, due to the truncated period for comments on the re-proposal, SFIG's members have not had sufficient opportunity to formulate and propose an alternative, but are interested in a discussion with the agencies regarding such an alternative.

SFIG's members also believe that CLOs of qualified commercial loans should not be static pools, but afforded the same active management as other CLOs.

"Qualified CLOs"

As was laid out in our joint letter with the LSTA and SIFMA to the agencies on January 10, 2014, for a CLO to be a "Qualified CLO," it would be required to be structured to meet certain minimum requirements for asset quality, portfolio composition, structural features, alignment of interests of CLO managers and investors, regulatory oversight and transparency and disclosure.[24] Among other things, these include:

1. Asset Quality Protections. In order to ensure the quality of the collateral in a "Qualified CLO", each "Qualified CLO" would be required to, among other things, hold at least 90 percent of its assets in senior secured loans and cash equivalents, not own ABS interests or derivatives (other than for hedging purposes), not purchase defaulted assets, margin stock or equity convertible securities, acquire loans held or acquired by at least three other investors or lenders not affiliated with the CLO manager and own loans whose borrowers are subject to an annual audit from an independent accredited accounting firm.[25].

2. Portfolio Protections. In order to ensure that CLO investors are not unduly exposed to loan pools that are concentrated in riskier areas of the global economy or certain specific borrowers, each "Qualified CLO" would be required to limit its investments such that no more than 3.5 percent of its assets relate to a single borrower, no more than 15 percent of its assets relate to a single industry and no more than 20 percent of its assets may relate to non-U.S. borrowers (and no more

[24] Id. at 6.
[25] Id. at 6-7.

than 10% may relate to borrowers outside the U.S. and Canada).[26]

3. Structural Features. In order to ensure that the CLO debt securities are adequately protected by means of structural features, a "Qualified CLO" would be required to have an equity tranche equal to at least 8 percent of the CLO's assets, as well as overcollateralization and interest coverage tests that, if failed, will require interest and principal proceeds to be used to repay CLO debt securities.[27]

4. Alignment of Interests of CLO managers and Investors. A "Qualified CLO" would be required to be structured to acquire assets in the open market rather than from the balance sheet of the CLO manager or an affiliate, make a majority of the CLO manager's fees be subordinated to payments due on rated CLO debt securities, limit the ability of the CLO manager to sell assets on a discretionary basis, require the CLO manager and/or certain of its affiliates and/or employees to hold a 5% unhedged interest in the CLO's equity tranche and to limit distributions on the retention interest for the first two years of the CLO.[28]

5. Regulatory Oversight. A "Qualified CLO" must have a manager that is a registered investment adviser under the Investment Adviser Act of 1940.[29]

6. Transparency and Disclosure. Each "Qualified CLO" will be required to provide certain monthly reporting to all CLO security holders.[30]

We believe that our proposal for a "Qualified CLO" could be an alternative solution for the problems described earlier. Perhaps most notably, this proposed retention interest would appropriately align the interests of the CLO manager with those of investors and more correctly size the risk retention interest to more closely correspond with 5 percent of the credit risk of the

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[26] Id. at 7.
[27] Id. at 7-8.
[28] Id. at 8.
[29] Id. at 9.
[30] Id. at 9.

CLO.

We also note that the proposed asset quality protections will help ensure the quality of CLO collateral and the safety of CLO debt securities as an investment for banks and help protect the soundness of our banking system.

Congressional Request

Given the importance of the CLO market in financing U.S. businesses and the need to ensure that CLO issuance does not meaningfully decline as a result of the agencies' rule making under Section 941 of Dodd-Frank, we respectfully request that the Financial Services Committee review our recommended solutions to the problems presented by the currently proposed rules.

Comments on Proposed Legislative Fix

SFIG appreciates the bi-partisan efforts this Subcommittee has shown to find solutions for the CLO marketplace it relates to the Volcker Rule. Chairman Garrett, today's hearing along with the two previously held hearings in the full Committee have helped elevate the prioritization of a solution for CLOs. Ranking Member Maloney, the letter that you and Ms. Waters wrote to the agencies—along with signatures by 15 other Democrats—has been instrumental in helping both the agencies and the industry work towards a solution.

As such, SFIG believes the discussion draft the Committee has offered is a natural extension of the bi-partisan work you all have continued to pursue. We believe it not only encapsulates the intent of lawmakers through the Dodd-Frank Act itself, but also the intent recently expressed by lawmakers of both parties on this Committee.

SFIG will continue to work with the agencies through the rulemaking process to find expedient solutions. And this discussion draft is yet another helpful tool for all of us to work together to create a well-regulated and liquid CLO marketplace.

As such, we have attached in Appendix A a list technical issues that will need to be addressed by the agencies in order for a CLO solution to Volcker to become operational. At the same time, we would not recommend that they become part of any legislative fix, as they are technical in nature.

Conclusion

Securitization continues to be an essential source of funding for the economy, and SFIG believes in both a well-regulated and liquid securitization marketplace for all asset classes.

The financial crisis taught us that securitization must be carefully structured, and thoughtful regulation through Dodd-Frank Act implementation is an important part of that structuring process.

However, if regulation is taken too far, it will render large portions of the securitization market either operationally or economically unworkable.

Our regulatory concerns focus on the combined effects of current regulatory proposals, which encompass much more than Dodd-Frank, such as shadow banking reform and proposals for implementing Basel III (including liquidity coverage and net stable funding ratios).

At the same time, any single regulatory initiative, while having merits in its own right, can also have a severe and negative impact on the securitization market if not crafted appropriately. The most immediate example of such a negative impact is the effect felt throughout the CLO marketplace by the Volcker Rule and proposed risk retention rules. Without changes to the proposed regulatory framework, companies providing up to 7.5 million jobs could be negatively affected, as CLO issuance is expected to decline by 75 percent or more.

We thank the Chairman, Ranking Member, Congressman Barr and the Members of this Committee for the bi-partisan work with the agencies to resolve the unintended consequences of the Volcker Rule. The CLO market has seen a slight upturn in February. However, SFIG is concerned that without an expedient resolution for CLOs, the market will quickly contract.

If we do not find solutions that work for both the regulators and the marketplace, then companies who create jobs, make capital investments to grow their businesses and provide goods and services will suffer—businesses such as Berry Plastics, Pinnacle Foods, HCR ManorCare and SeaWorld.

As such, SFIG will continue to work with both the federal agencies and this Committee to find bi-partisan solutions to create both a well-regulated and liquid CLO marketplace.

Thank you, and I look forward to your questions.

Appendix

SFIG appreciates the substantial effort and consideration that both Congress and the federal agencies have put into understanding the implications of the Volcker Rule on the CLO market and searching for solutions that would ensure both a well regulated and liquid industry.

As legislators and regulators continue to move forward on this path, SFIG would like to raise the following points that should be addressed if a grandfathering framework for legacy CLOs is either considered or developed:

1. Since legacy CLOs are not all exclusively backed by loans, grandfathering must account for diverse types of portfolios, such as those with bond buckets, structured finance buckets and non-senior-secured loan buckets.

2. Bucket sizes used within the definition of a CLO should be measured relative to the original portfolio size, rather than current portfolio balances. As a CLO de-levers, its portfolio composition changes as the bucket sizes of remaining collateral tend to increase. This natural amortization should not make a CLO fall out of the definition used for grandfathering.

3. Several factors need to be considered regarding the cutoff date, including:

    a. Would a grandfathering date apply only to a bank's holdings purchased prior to the cutoff date, or would it apply to any deals issued prior to the cutoff date? This distinction would affect whether or not a bank is allowed to make new purchases of old, seasoned CLOs, or if they would merely be able to retain their existing holdings. It could also significantly affect market liquidity for pre-Volcker CLOs.

    b. A cut-off date should specify the date by which a CLO should be "traded," not "issued." Otherwise, if a CLO was traded prior to the cutoff date (which could include the pricing of new issue CLOs), but the trade settled (or the new transaction closed) after the cutoff date, it would not benefit from the grandfathering.

c. There may also be some ambiguity as to whether the grandfathering date applies to the entire CLO transaction or to a specific tranche issued by the CLO. CLOs often allow for "additional issuances" of notes from the existing structure, effectively allowing the CLO to upsize later in life. Separately, CLOs typically allow existing tranches to be refinanced or re-priced after the end of a prescribed "non-call period." Any grandfathering rule should consider whether additional issuances or refinanced or re-priced tranches from grandfathered CLOs would likewise benefit from grandfathered status.

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February 25, 2014

Chairman Scott Garrett
2232 Rayburn House Office Building
Washington, DC 20515

Ranking Member Carolyn Maloney
2308 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Maloney:

On behalf of the 1 million members of the National Association of REALTORS® (NAR), who are involved in all types of real estate transactions, thank you for holding tomorrow's hearing entitled "The Dodd-Frank Act's Impact on Asset-Backed Securities." Section 941 of the Dodd-Frank Act adds a new section 15G to the Securities Exchange Act of 1934 that requires securitizers to retain 5% of the credit risk of a residential mortgage asset that it sells to a third party. Section 15G(e)(4) requires the regulators to define and exempt a Qualified Residential Mortgage (QRM). As Congress begins to examine recently proposed and finalized mortgage lending rules, we believe it is critical for lawmakers to urge regulators to construct a QRM rule that mirrors the newly implemented Qualified Mortgage (QM) rule.

The Dodd-Frank Wall Street Reform Act established the QM rule as the primary means for mortgage lenders to satisfy its "ability to repay" requirements. NAR has been generally supportive of the Consumer Financial Protection Bureau's (CFPB) efforts to craft a QM rule that is not unduly restrictive and provides a safe harbor for lenders making QM loans. Last year, the six federal regulators published a revised proposed rule that would equate QRM with the newly implemented QM standard issued by the CFPB.

In synchronizing both definitions, the revised rule encourages safe and financially prudent mortgage financing while also ensuring creditworthy homebuyers have access to safe mortgage financing with lower risk of default. In addition, consistency between both standards reduces regulatory burden and gives mortgage professionals much-needed clarity and consistency in the application of the important mortgage standards required pursuant to Dodd-Frank.

We are already in a tight credit environment. The QM and other rules effectively ban the types of products and processes that led to the mortgage crisis. Congress should support, and regulators should establish, a QRM that mirrors the QM. This will ensure that consumers who have the ability to repay their loans will have the access to affordable credit they deserve.

NAR thanks the Subcommittee members for their attention to this issue. We look forward to working with Congress and the Administration on efforts to address the challenges still facing the nation's housing markets.

Sincerely,

Steve Brown
2014 President, National Association of REALTORS®

cc: Members of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises

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February 25, 2014

Congressman Andy Barr
1432 Longworth House Office Building
Washington, DC 20515

Dear Congressman Barr:

I am the Chief Financial Officer for First Financial Service Corporation (NASDAQ: FFKY) and its subsidiary First Federal Savings Bank (FFSB) in Elizabethtown, KY. FFSB, a community bank with approximately $850,000 in assets and has been serving its community for over 90 years.

I am writing to express my strong support for your proposed legislation that is seeking interpretive guidance on the Volcker Rule's definition of an "ownership interest" as it relates to collateral loan obligations (CLOs) as well as the proposal to grandfather any CLO investments that were made prior to December 31, 2013.

I recently expressed my personal concern in a letter dated February 4, 2014 to the Honorable Janet L. Yellen, Honorable Mary Jo White, Honorable Mark P. Wetjen, Honorable Martin J. Gruenberg, and Honorable Thomas J. Curry. I also had the opportunity to listen to the webcast of the hearing that took place on February 5, 2014 entitled "The Impact of the Volcker Rule on Job Creators, Part II." I was very pleased to hear you read selection's from that letter during the hearing as it is a very important issue to me, FFSB, our customers, our shareholders, and the community that we have been serving for over 90 years.

Like many other banks, we were surprised to learn that previously admissible investments such as CLOs would become inadmissible due to the changes in the Final Rule and a forced liquidation of these investments would materialize during the conformance period. Based on my interpretation as well as many others in the industry, CLO debt securities in no way have an ownership interest in the CLO but are rather simply creditors and that is why I support your proposal to seek the interpretive guidance on the definition of an "ownership interest."

In my letter to the regulators I noted the potential impact that the implementation of this rule as it stands could have on FFSB. A forced liquidation of these investments could be viewed as a fire sale by the market resulting in deep discounts and material losses to our bank. Losses related to our CLO portfolio as a result of this rule could potentially translate to hiring freezes and/or layoffs for our employees and higher rates and fees to our customers in an effort to overcome these losses. These losses would be related to investments that were previously viewed as admissible investments, but may now be inadmissible due to a rule that lacks clarity and appears to be open for interpretation. FFSB has already experienced this interpretation issue with our primary regulator.

It is hard to understand, as a management team that was able to take a financial institution through the darkest days of the financial crisis, why we should be presented with another existential threat based solely on an arbitrary and expansive interpretation of the Volcker Rule.

Again, please accept my sincere appreciation in your continued efforts to finding the right solution to this important issue. I stand ready to help in any way that I can.

Sincerely,

Frank Perez
Chief Financial Officer
First Federal Savings Bank

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
VICE PRESIDENT

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April 18, 2014

The Honorable Dennis Ross
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Ross:

The U.S. Chamber of Commerce ("Chamber"), the world's largest business federation representing the interests of more than three million businesses and organizations of every size, sector and region, as well as state and local chambers and industry associations, and dedicated to promoting, protecting and defending America's free enterprise system. It was a pleasure to testify on the Chamber's behalf at the February 26, 2014 hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises entitled "The Dodd-Frank Acts Impact on Asset Backed Securities". My answers to your questions for the record ("QFRs") are listed below.

Question 1:

Most of you have testified that CLOs performed well during the crisis. Why do you believe they didn't follow the same performance as CDOs and mortgage-backed securities? Is there something inherent in the asset class or the structure that led to this performance?

Answer:

The stellar performance of Collateralized Loan Obligations ("CLO") during the worst financial crisis since the Great Depression is attributable to both the structure of CLOs and the type of assets they hold. Unlike asset classes that performed poorly in the crisis – namely subprime RMBS and CDOs comprised primarily of those assets – CLOs are not a structure used by a loan originator to move assets off its books in exchange for a fee. CLOs invest in a relatively small number of senior secured commercial loans (my understanding is that usually a CLO owns between 100 and 200 loans). The CLO manager, who is a professional investment advisor, selects the loans for the loan portfolio and actively manages this portfolio. The manager is independent of the loan originators, and buys the loans in arms-length transactions. The manager continues to buy and sell loans as loan performance and market conditions dictate. The manager's compensation is in large part determined by the performance of the CLO. The bulk of a CLO manager's compensation is deferred until the CLO note holders are paid. The manager's independence and the deferred compensation ensure that the interests of investors and manager are aligned, without recourse to risk retention. The compensation is, in fact, the managers "skin in the game."

Another reason for the excellent performance of the asset class is because of the assets that a CLO typically holds. Typically 90%-plus of CLO assets are senior secured commercial loans. Because these loans are secured with high quality collateral, the recovery in a case of default tends to be in the range of 80% or more. So, even in those instances where a loan defaults, the overwhelming majority of the loan value will be recovered.

It is the structure and collateral that has contributed to the outstanding performance of this asset class – a cumulative default rate of less than 1.5%, with realized losses being much lower than that.

Question 1a:

Does the re-proposed risk retention rule appropriately acknowledge these differences?

Answer:

The Proposed Rule on Credit Risk Retention[1] does not acknowledge these differences, thereby harming the ability of America's businesses to use CLOs as a means of accessing capital.

CLOs are not originate-to-distribute securitizations and do not need risk retention rules, while CLO managers are not sponsors of the transactions and should not be subject to risk retention rules. CLO managers already have "skin in the game" by

[1] The joint Chamber-Private Equity Growth Capital Council October 28, 2013 comment letter is attached with this letter and we respectfully request that it be made a part of the record.

virtue of a number of unique characteristics embedded within the CLO structure, including the fact that managers receive a majority of their fees only after investors get paid. Notwithstanding the aligned interests between managers and investors, the Proposed Rule requires that CLOs provide that the "sponsor" must retain 5% of the fair value of a new CLO. This will mean more onerous requirements for CLOs than for other asset classes, as the proposed "5% of fair value of the CLO" retention requirement exceeds the requirement applicable to other asset classes. Under the Proposed Rule the CLO sponsor may not receive cash flows until the securitization begins to amortize, which is inconsistent with how CLO cash flows work because the notes issued by the CLO do not amortize until the end of the reinvestment period.

Question 2:

The Dodd-Frank Act established the Financial Stability Oversight Council ("FSOC") and tasked it with comprehensively monitoring the stability of our nation's financial system. Once the various Dodd-Frank reforms and other regulatory initiatives that are the focus of this hearing are fully implemented, there is a risk that the asset-backed securities market will be far less liquid and less stable. Is this something FSOC should be monitoring? Is anyone aware of an effort to do so?

Answer:

The imposition of the Volcker Rule and the Credit Risk Retention will imperil the ability of businesses to access capital through CLOs. This will inhibit capital formation and incentivize riskier behavior that may harm the stability of the financial system.[2] We believe that FSOC should understand the impact of these initiatives upon the stability of the American financial system, as well as the impact of the various regulatory initiatives and how they interact with one another. However, this highlights the fact that regulatory gaps were not addressed by the Dodd-Frank Wall Street Reform and Consumer Protection Act and that appropriate analysis of rules before they are finalized has still not occurred. The imposition of the Volcker Rule and the Credit Risk Retention will imperil the ability of businesses to access capital

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[2] *See* attached letter of February 25, 2014 from the U.S. Chamber to the U.S. banking regulators on the need to fufill statutory requirements for economic analysis under the Riegle Act.

through CLOs. This in turn will incentivize riskier behavior that could cause the financial system to become less stable.

***

Thank you again for the opportunity to answer the QFRs and please let me know if you would like to discuss these answers and the subjects of the hearing in greater detail.

Sincerely,

Tom Quaadman

CC: Chairman Scott Garrett
Ranking Member Carolyn Maloney

CENTER FOR CAPITAL MARKETS COMPETITIVENESS

PRIVATE EQUITY GROWTH CAPITAL COUNCIL

October 28, 2013

Mr. Robert deV. Frierson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Mr. Robert Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
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Legislative & Regulatory Activities
Division
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

Regulations Division
Office of the General Counsel
Department of Housing and Urban
Development
451 7th Street, SW
Washington, DC 20410

Re: Joint Proposed Rule on Credit Risk Retention OCC RIN 1557-AD40; FRB RIN 7100-AD70; FDIC RIN 3064-AD74; SEC RIN 3235-AK96; FHFA RIN 2590-AA431 HUD RIN 2501-AD53

Dear Mr. deV. Frierson, Mr. Pollard, Mr. Feldman, Ms. Murphy and To Whom It May Concern:

Our organizations represent all sectors of the economy and speak on behalf of businesses that employ tens of millions of workers domestically and internationally. Our members need access to a variety of different forms of capital to provide the resources for operations, expansion and job creation. We support strong risk

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management practices and the appropriate level of controls needed to insure responsible and sustainable business lending. As such, we appreciate the opportunity to provide comment on the Joint Proposed Rule on Credit Risk Retention ("Proposed Rule") issued by the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve (Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC"), the Securities and Exchange Commission ("SEC"), the Federal Housing Finance Agency ("FHFA"), and the Department of Housing and Urban Development ("HUD") (also collectively known as "the Agencies").

While we agree that unreasonable risk-taking should be mitigated to the extent possible, we firmly believe that reasonable risk-taking is a necessary ingredient for the free enterprise system to work. We have serious concerns that the Proposed Rule will adversely restrict an important form of financing for businesses, Collateralized Loan Obligations ("CLOs"), which were not a cause of the 2007-2008 financial crisis. If the Proposed Rule were to be adopted, businesses would have fewer funding options, higher borrowing costs and reduced credit availability. Accordingly, we respectfully request that the risk retention rules exempt CLOs, or in the alternative that the rules be tailored in such a manner that CLOs will continue to be an efficient form of financing available to businesses.

As you know, section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires the Agencies to prescribe rules that require securitizers to retain an economic interest in a material portion of the credit risk of the underlying securitized assets. We support the goals of section 941(b) of improving the alignment of interests among borrowers, issuers, and investors within the securitization chain. Credit risk retention is one mechanism that could help align such interests, but it is a policy approach that comes with inherent costs. We would suggest that in the case of CLOs the costs of risk retention far outweigh the benefits.

Fully functioning credit markets are necessary for economic growth and job creation. We have specific concerns with certain aspects of the Proposed Rule and their potential impact on the American consumer, American businesses and the American economy. An appropriate resolution of these issues can assist in restoring credit flows to the market place and maintain the balance between effective regulation of the market place and appropriate risk taking.

Securitization has become a vital component of our system of finance over the past two decades and now provides a critical source of funding alongside more traditional balance sheet lending. It is important to note that not all securitized products are the same—there are different classes of underlying assets, different structures and contrasting credit risk profiles. Uniform application of the rules to different products would heighten the risk that the rules could adversely affect credit availability. Therefore, it is important that the Agencies adopt rules that are closely tailored to the characteristics, risks, and benefits associated with each asset class.

Simply put, a one size fits all approach will make it difficult for the Agencies to effectively regulate the marketplace, while hampering the ability of businesses and investors to appropriately use the right securitization products.

For all American businesses, access to capital and the ability to borrow at reasonable rates is critical to growth and success. CLOs are a vital funding mechanism and source of credit, especially for companies that cannot access the corporate bond market. According to a report conducted by the Federal Reserve, the FDIC, and the OCC, in 2010 there were approximately $250 billion in syndicated commercial loans made to U.S. companies through CLOs.[1] This constitutes 25% of all term loans outstanding in the United States. A broad swath of corporate America participates in this market, including companies from the health care, energy, retail, entertainment, and telecommunications sectors, to name just a few.

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[1] "Credit Quality of the Shared National Credit Portfolio Improved in 2010," *Shared National Credit Review* (Sept. 28, 2010), available at http://www.federalreserve.gov/newsevents/press/bcreg/20100928a.htm

CLOs are not originate-to-distribute securitizations and do not need risk retention rules. Furthermore, CLO managers are not sponsors of the transactions and should not be subject to risk retention rules. CLO managers already have "skin in the game" by virtue of a number of unique characteristics embedded within the CLO structure, including the fact that managers receive a majority of their fees only after investors get paid. Notwithstanding the aligned interests between managers and investors, the Proposed Rule requires that CLOs provide that the "sponsor" must retain 5% of the fair value of a new CLO. This would mean more onerous requirements for CLOs than for other asset classes, as the proposed "5% of fair value of the CLO" retention requirement exceeds the requirement applicable to other asset classes that the securitizer retain "not less than 5% of the credit risk of the assets." Under the Proposed Rule the CLO sponsor may not receive cash flows on the equity slice until the CLO notes begin to amortize and then only on a pro rata basis. This payment structure is inconsistent with how CLO cash flows work because the notes issued by the CLO do not amortize until the end of the reinvestment period, which may be years into the future. This restriction on cash flows would render the economics of such an arrangement unworkable.

Furthermore, the proposed alternative arranger option described in the Proposed Rule for CLOs is unworkable. The Proposed Rule requires that loan arrangers can satisfy risk retention via a "CLO-eligible" loan tranche. The loan arranger would have to retain 5% of the loan tranche purchased by CLOs for the life of the loan (or until default) which is contrary to prudent risk management principles. The loan arranger must take an initial allocation of at least 20% of the entire credit facility. The Proposed Rule would therefore require loan arrangers to hold significantly increased amounts of loans on their books, which would require those banks to have increase regulatory capital requirements and would impair their ability to engage in prudential risk management.

The CLO market performed largely as expected during the financial crisis. Unlike structured products based on subprime mortgages, many of which experienced considerable losses in recent years, investment grade CLO tranches experienced very

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few aggregate losses.[2] In the past 16 years combined, CLOs have experienced a cumulative *impairment* rate of approximately 1.5%, and the actual *loss* rate was even lower, which is well in line with investor expectations. The Fed acknowledged a low default rate for CLO collateral in its Report to Congress on Risk Retention in October 2010, citing the aligned incentive mechanisms inherent in CLO structures.[3] This fact should be considered as the Agencies work to finalize the Proposed Rule.

Businesses that rely upon the CLO market are essential components of the American economy. The CLO market enables these companies to create and preserve millions of American jobs. This is an obvious source of capital that simply cannot be impaired. Given the critical role that CLOs play as a source of funding for American businesses, it is essential that the Agencies modify the Proposed Rule so that CLOs are not subject to overly broad credit retention requirements.

While we believe CLOs should be exempt, if the Agencies do not exempt CLOs then the Agencies should tailor the proposed rule in such a manner to allow CLOs to continue to be an efficient form of capital formation for businesses.

In conclusion, we urge the Agencies to strike the appropriate balance between enhancing regulatory oversight and ensuring vibrant and liquid credit markets where borrowers can access loans at affordable rates. As currently drafted, the proposed rules would have adverse consequences upon the CLO market and the businesses that use CLOs to access almost $300 billion in capital. By constraining the ability of businesses to access the financing provided by CLOs, borrowing costs will increase, risk will be transferred to less stable financing vehicles and economic growth and job creation will suffer.

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[2] In fact, most CLO debt downgraded during the crisis has been subsequently upgraded with most originally rated AAA tranches still rated at least Aa- or better, even under new stronger requirements from the Agencies. CLO mezzanine debt, originally rated below investment grade, will not take any losses and CLO equity outperformed original pre-crisis expectations.

[3] *See* Board of Governors of the Federal Reserve, Report to Congress on Risk Retention, October 2010.

Accordingly, we respectfully request that these concerns be taken into account and that the Agencies exempt CLOs from the risk retention rules, or construct the rules so that businesses will be able to use CLOs as an appropriate financing mechanism to grow and create jobs. A failure to do so will create harmful and long-term unintended adverse impacts to our businesses, capital markets and economy.

Sincerely,

David Hirschmann
President
Center for Capital Markets Competitiveness
U.S. Chamber of Commerce

Steve Judge
President and CEO
Private Equity Growth Capital Council

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
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February 25, 2014

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Mr. Alfred M. Pollard
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Federal Housing Finance Agency
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Re: Joint Proposed Rule on Credit Risk Retention OCC RIN 1557-AD40; FRB RIN 7100-AD70; FDIC RIN 3064-AD74; SEC RIN 3235-AK96; FHFA RIN 2590-AA431 HUD RIN 2501-AD53

Dear Mr. deV. Frierson, Mr. Pollard, Mr. Feldman, Ms. Murphy, and To Whom It May Concern:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation, representing over three million companies of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and efficient regulatory structure for capital markets to fully function in the 21st Century economy.

Mr. Robert deV. Frierson
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Ms. Elizabeth M. Murphy
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The CCMC previously submitted comments on *Joint Proposed Rule on Credit Risk Retention* ("proposed risk retention rules") as proposed by the Board of Governors of the Federal Reserve ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC"), Securities and Exchange Commission ("SEC"), the Office of the Comptroller of the Currency ("OCC"), the Department of Housing and Urban Development ("HUD") and the Federal Housing Finance Agency ("FHFA") (also collectively "the regulators").[1]

Along with our many substantive concerns, the CCMC comments on the proposed risk retention rules expressed concern about the process associated with these proposals. Specifically, we noted that the proposed risk retention rules could have wide ranging economic impacts and that the proposals failed to provide a cost-benefit analysis. Without a cost-benefit analysis, the proposed risk retention rules do not allow commenters to understand the economic impacts of the rules and standards under consideration. These procedural irregularities impaired the ability of commenters to provide the regulators with informed comments on the proposed risk retention rules. We write today to further explain these procedural concerns associated with the absence of a cost-benefit analysis in these proposed rules.

The absence of cost-benefit analysis for the proposed risk retention rules is inconsistent with the obligations of the Federal Reserve, FDIC, and OCC under the Riegle Community Development and Regulatory Improvement Act (Riegle Act, 12 U.S.C. §4802(a)). This law applies to all "Federal banking agencies" defined by cross-reference in Section 4801 of the Riegle Act (12 U.S.C. §1813) to include the OCC, FDIC, and Federal Reserve. The Riegle Act mandates that "[i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest (1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations." [2]

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[1] *See* CCMC and coalition comment letters of August 2, 2011, September 26, 2013 and October 28, 2013.
[2] 12 U.S.C. §4802(a) (emphasis added).

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The Federal banking agencies covered by the Riegle Act must meet these commitments whether or not they are raised by commenters in the course of a rulemaking because they are statutory requirements for their exercise of rulemaking authority by the relevant agencies that impose "additional reporting, disclosure, or other requirements on insured depository institutions." There can be no question that the proposed risk retention rules impose such additional obligations on insured depository institutions for purposes of the Riegle Act. As an organization representing both depository institutions and their customers, the CCMC has an interest in ensuring that regulators honor their obligations under the Riegle Act. We note that these requirements also apply to many of other regulations associated with implementation of the Dodd-Frank Act by the Federal Reserve and other Federal banking agencies, and not just the proposed rule cited in this letter. To date, however, we have not seen the required cost-benefit analysis for the proposed risk retention rules.

We welcome the opportunity to discuss the cost-benefit analysis obligations of the Federal Reserve and other Federal banking agencies under the Riegle Act in relation to the proposed risk retention rules and other pending and recently completed rulemakings by Federal banking agencies.

Sincerely,

Tom Quaadman

Congressman Dennis Ross

Question: The Dodd-Frank Act established the Financial Stability Oversight Council ("FSOC") and tasked it with comprehensively monitoring the stability of our nation's financial system. Once the various Dodd-Frank reforms and other regulatory initiatives that are the focus of this hearing are fully implemented, there is a risk that the asset-backed securities market will be far less liquid and less stable. Is this something FSOC should be monitoring? Is anyone aware of an effort to do so?

CREFC Answer: *The majority of Commercial Real Estate Finance Council members believe that risk retention will have a significant impact on Commercial Mortgage Backed Securities (CMBS), and thus, on broad commercial real estate (CRE) market liquidity. This is especially true in light of several other material reforms (e.g., Basel III Liquidity Coverage Ratio, potential changes to Basel III risk-based capital treatment of securitizations, and SEC's Regulation AB) being implemented during the same timeframe; many reforms and rising rates are likely to impact CMBS liquidity in the next couple of years. CMBS is critical to the marketplace because it services not only top tier borrowers and properties, but also provides funding to secondary and tertiary markets. In turn, CMBS serves a unique component of the CRE sector and the real economy.*

At this time, we are not aware of any analysis being conducted in the U.S. to estimate the impact of risk retention on the economy, though there are considerable such efforts emerging in Europe conducted by the Bank of England, the European Central Bank to support securitization markets in light of their importance to the real economy.

Congressman Mick Mulvaney

Question 1. The commercial real estate market has been hit particularly hard during the recession. Economic conditions and regulatory uncertainty – including risk retention rules – continue to hinder the resurgence in the credit markets that are needed to fuel an economic recovery in commercial real estate. I am concerned about a "one-size-fits-all" risk retention rule and the impact such a rule has on commercial real estate. Section 941 of Dodd-Frank added a new section to the Securities Exchange Act to specifically address commercial real estate. This language mandates that there are options for and alternatives to a percentage risk retention, to strengthen the commercial real estate market and support recovery. Such options and alternatives include: adequate underwriting standards and controls; adequate representations and warranties with related enforcement mechanisms; and a percent of the total credit risk held by the securitizer, originator or a third party investor. However, the language of the law and these alternatives to a percentage risk retention have been largely ignored.

a. **Question:** Can you speculate as to why this specific language in Dodd-Frank is being ignored?

CREFC Answer: *To the regulators' credit, they are trying to meet several rule-writing goals, including simplicity, rigor and equitable application. They seem, however, to hold these principals in higher regard than the market structure, borrower cost and credit history data that we have presented in support of a differentiated, tailored approach. In our view this reflects an unfortunate favoring of form over function.*

Congress may well want to ask that question of the regulators directly. In our frequent meetings with regulators, they have said that they prefer a quantitative approach, since the stature called for a minimum 5% retention requirement, as opposed to a more flexible qualitative framework to your question.

b. **Question:** What do you think is the impact of the failure to recognize and utilize the alternative risk retention options on the commercial real estate market?

CREEFC Answer: *In the worst case, borrower costs will rise, the best credits will depart CMBS for alternative forms of financing, including on-balance-sheet bank and insurance company financing or other lesser regulated lending forms. Practically speaking, this would mean that the flow of credit would likely contract for the borrowers with the greatest need, as CMBS funds secondary and tertiary markets, or that a portion of that lending would migrate to 100% on-balance-sheet risk at other institutions. It is critical to recognize that risk retention conformance is being targeted in a period of rising rates and will overlap with the implementation of other significant regulatory changes, all of which will drive borrowing costs higher.*

Repeating a sentiment voiced often during the hours of deliberation over CRE Finance Council's position on risk retention, a majority of the investment grade (IG) Investors view underwriting criteria, the disclosure regime and time allowable for due diligence to be most critical. Risk retention is often couched as a poor policy alternative to strong underwriting guidelines. At the same time, the underwriting parameters embedded in the risk retention rule are not useful targets for the CMBS sector. Only 3% to

8% – depending on the methodology – of CMBS loans originated between 1997 and August of 2013 would be eligible for the Qualifying Commercial Real Estate (QCRE) loan designation under the risk retention rule as re-proposed.

The CRE Finance Council spoke to this in its comment letter of October 30, 2013 and recommended several key changes to the rule. However, in follow up discussions with the regulators, they indicated a resistance to our third-party data supplied in support of these refinements. The best example of this was the recommendation that interest-only loans with low loan-to-values (LTV) as well as loans with shorter-terms be made eligible, given their strong credit performance. We asked about loans with LTVs at or below 50%, which is, ironically, less than typical 5-year notes' ending LTV ratio (on a 30-year amortization schedule).

Please bear in mind that the IG Investor contingent voted in favor of these recommendations, in light of the fact that they would like to see the pools continue to contain a large proportion of these high quality assets, and are concerned that increased borrowing costs will induce adverse selection in future CMBS. We fear the market will see the good credits seek funding outside of CMBS, thereby leaving only the riskier credits, with higher volatility naturally resulting.

Question 2. I understand that the organization you are testifying on behalf of, the Commercial Real Estate Finance Council, is advocating for a tailored Qualified Commercial Real Estate ("QCRE") rule for the Single Borrower, Single Credit ("SBSC" or "single loan") market. What are the risks and rewards of the approach you are advocating? What would the QCRE regime look like to you? And conversely, if the regulators choose not to tailor QCRE to the SBSC market, what would be the outcome or consequences for borrowers and issuers?

CREFC Answer: *The SBSC market is very different than the conduit market. SBSC are generally backed by one loan on a single property, though some transactions are backed by multiple loans on several similar properties originated to the same borrower. Also, SBSC deals are placed in the private market (so-called "144A deals"), which allows for greater transparency (in both the primary and the secondary markets) once the potential investor has signed a confidentiality agreement. As opposed to conduit CMBS, where the transactions are backed by a diversified pool of loans (usually 65-75 loans) and the deals are placed publically, the investors have relatively more insight into the credit quality of SBSC securities. It is this greater transparency that investors cite consistently as being the critical differentiator of this marketplace. In short, the investors know which deals they want to invest in and which ones to avoid.*

As a result, the issuers have historically been successful in packaging sound deals, even through two downturns. Cumulative losses since 1997 are 20 basis points (or, one-fifth of one percent). This compares well with even corporate bonds. If asked, most IG Investors will say that they believe that this segment of the CMBS market is functioning and will continue to function well. Said another way, applying risk retention to this market place will cause borrower costs to rise and for the market to contract.

CRE Finance Council proposed in consultation with several regulatory agencies a set of recommendations for the SBSC market on February 28, 2014 centering on revised QCRE eligibility requirements (linked at http://bit.ly/1kTLm8g). This is a highly-functioning and sensitive market, and the CRE Finance Council *proposal represents a good option for balancing market participants' concerns, strong through-the-cycle-credit trends and regulatory goals.*

Chairman Scott Garrett:

Question: Mr. Vanderslice: Within the risk retention re-proposal, there is a new regulatory test that is applied to the Eligible Horizontal Retained Interest (EHRI). We understand that revitalizes many of the elements of PCCRA which was seen as being a fatal flaw for the CMBS industry and others. Then-Chairman Bachus and I expressed in a letter to the agencies dated March 26, 2012 we believe that PCCRA would be detrimental to financing activities in the consumer, corporate and commercial real estate markets and would harm job creation.

Does CREFC believe there is any way to modify the test so that it would be workable for your markets, yet still achieve the regulatory intent?

CREFC Answer: *Yes, we do. As we recommended in our comment letter of October 30, 2013, we believe that it is critical to recognize certain aspects of all bond markets in this particular instance (linked at http://bit.ly/1kTM8C9). The principle in question here is the simple fact that bond buyers purchasing lower credit instruments exact a larger discount to account for future credit losses.*

This essential principal of all bond markets is also important to the B-piece buyer in CMBS transactions. They, as investors, price their bonds according to the perceived risk. Market participants and regulators should want to preserve this pillar of the marketplace.

Through this EHRI test, the regulators would have the B-piece buyers pay well in excess of market expectations for their slice in order to prevent any subversion of risk retention through excessive B-piece discounting. However, there is no such subversion as the IG investors are aware of the price at which the B-piece buyer is taking its first-loss risk. The market functions well, given this symmetry of information.

As recommended in our comment letter, we propose that the regulators reformulate the test to be based on notional, not market, value. This will accomplish the regulators' hope of preventing gaming of the rule and will allow the CMBS market to continue to function inside of the boundaries of normal and essential market practices.