



NEW YORK
CITY BAR

COMMITTEE ON STRUCTURED FINANCE

PATRICK DOLAN
CHAIR
1095 AVENUE OF THE AMERICAS
NEW YORK, NY 10036
Phone: (212) 698-3555
Fax: (212) 698-3599
patrick.dolan@dechert.com

June 15, 2016

KIRA BRERETON
SECRETARY
1095 AVENUE OF THE AMERICAS
NEW YORK, NY 10036
Phone: (212) 698-3574
Fax: (212) 698-0695
kira.brereton@dechert.com

Hon. Paul Ryan
Speaker
U.S. House of Representatives
H-232 The Capitol
Washington, DC 20515

Re: Support for H.R. 4620, the Preserving Access to CRE Capital Act of 2016

Dear Speaker Ryan:

The Committee on Structured Finance (the “Committee”) of the New York City Bar Association (the “Association”) is pleased to submit the following comments on H.R. 4620, the Preserving Access to CRE Capital Act of 2016 (the “Bill”), which was introduced by Rep. J. French Hill (R-AR) and passed by the U.S. House Financial Services Committee on March 2, 2016.¹

The Association is an organization of over 25,000 lawyers. Most of its members practice in the New York City area; however, Association membership spans nearly every state and over 60 countries. The Committee exists to address the unique set of legal, accounting, and regulatory issues critical to structured finance. The Committee appreciates the opportunity to comment on the Bill and stands ready to assist if further clarification is required on any of the points raised in this letter.

The Committee appreciates Rep. J. French Hill’s and the U.S. House Financial Services Committee’s considerable efforts to put forth the Bill. The Committee agrees with and endorses

¹ The comments in this letter express solely the views of the Committee as a whole, and do not necessarily reflect the views of any individual Member of the Committee. In addition, this letter does not represent the views of any of the law firms or companies with which the Members of the Committee are affiliated.

the goals of the bill generally and, believes the Bill will greatly help “preserve access to capital” at a critical point for the CMBS market. The Committee submits this letter to convey the Committee’s support for the Bill and the Committee’s views regarding certain of the details in the Bill.

The Committee cannot overstate how important swift passage of the Bill is to the health of the commercial real estate market and the national economy. With the CMBS risk retention compliance date of December 24, 2016 fast approaching, CMBS issuance has declined precipitously. U.S. CMBS first-half issuance is on track to reach \$31 billion, down about 43% compared to last year.² In April, only \$2.7 billion of deals priced compared to \$9.3 billion during the same period last year.³ According to a review by *Commercial Mortgage Alert*, just \$6.9 billion of transactions are in the pipeline for June and July – less than half of last year’s issuance during the same period.⁴ In addition, loan inventories at larger CMBS banks are down by as much as 75% from a year ago.⁵ Commercial property sales have slumped – only \$25.1 billion worth of office buildings, stores, apartment complexes and other commercial property were sold in February 2016, compared with \$47.3 billion in the same period a year earlier.⁶

Matters are further complicated by the impending “maturity cliff” within commercial real estate finance: An enormous volume of CMBS loans are scheduled to mature later this year and next.⁷ If CMBS lenders are not able to refinance these loans, it is not clear who will fill the vacuum. The effects of such a financing gap, were it to occur, on the commercial property market and the broader economy could be devastating. In the past, banks and life insurers were the main providers of funding to the commercial real estate market. However, over the past several decades, CMBS has emerged as an important tool and a very significant source of capital for this market. With a host of regulatory pressures on banks and other financial institutions, the banking industry may well be compelled to retreat further from its role as the primary source of funding for commercial real estate.⁸ The confluence of stresses on the banking industry, the issuance of risk-retention regulation of CMBS, and the upcoming maturity cliff threatens to cause critical shortfalls in capital for commercial real estate financings and refinancings across

² See *Commercial Mortgage Alert*, “Light CMBS Issuance Seen Through Summer,” May 13, 2016.

³ *Id.*

⁴ There are \$3.4 billion of U.S. CMBS deals in the pipeline for June, down from \$10.4 billion a year earlier. July has only about \$3.5 billion of potential deals, down from \$8.7 billion last July. See *id.*

⁵ See *Commercial Mortgage Alert*, “CMBS Pipeline Thin, But Loan Market Stirring,” April 1, 2016.

⁶ See *Wall Street Journal*, “U.S. Commercial-Property Sales Plunge,” Peter Grant, March 23, 2016

⁷ \$87.1 billion loans are scheduled to mature in 2016 and \$105.8 billion in loans are scheduled to mature in 2017. See Annex I (showing CMBS maturities scheduled by year).

⁸ Due to new Basel III capital requirement rules for commercial lending for banks there is a decreased motivation for banks to originate CRE loans; given the amount of refinancing expected in the 2015-2017 period, this factor may limit bank participation and require other lenders to enter the market. However, historically, neither life insurers nor originators have been capable of providing the amount of new financing and refinancing needed. See *The Journal of Portfolio Management*, Vol 41. No 6 at pp. 123, “The Post Crisis CMBS Market: Will Regulations Prevent Another Market Meltdown”, by Frank J. Fabozzi, Joe McBride and Manus Clancy.

the U.S., and to impose higher rates on those commercial real estate transactions for which funding is available.⁹

The Bill is a much-needed, timely and reasonable common sense compromise that will help address some of the shortcomings of the risk retention rules and provide immediate relief to the CMBS sector, as further discussed below.

B-PIECE BUYER OPTION

Generally, the risk retention rule requires the sponsor to retain an economic interest in the credit risk of an ABS transaction in the form of either an “eligible vertical interest” (i.e., 5% of each class of securities issued) or an “eligible horizontal interest” (i.e., the most subordinate securities in an amount equal to 5% of the fair value of the class of the ABS securities issued) or by a combination of horizontal and vertical retention. Given its distinct characteristic from other asset classes, a unique provision was carved out of the risk retention rules that applies only to CMBS: A sponsor may satisfy all or a portion of its risk retention requirement if an independent third party purchaser purchases and holds the eligible horizontal interest for its own account. Under this provision, the risk retention rule allows for up to 2 third-party purchasers (each, referred to in the industry as a “B-Piece Buyer”) to use the B-Piece Buyer option to satisfy the rule, but does not allow the B-Piece Buyers to hold their interests in a senior/subordinate structure.¹⁰ To satisfy the B-Piece Buyer option, the current risk retention rule allows up to two B-Piece Buyers in any single CMBS transaction to hold the eligible horizontal interests on a *pari passu* basis (i.e. each B-Piece Buyer will be paid at the same level in the payment structure). Allowing up to two B-Piece Buyers in any single transaction is helpful, but the “*pari passu*” requirement causes undue burdens on CMBS transactions.

To begin with, the typical CMBS structure provides certain consent and direction rights to the most subordinate first loss B-Piece Buyer in the deal. In conduit CMBS deals, generally the servicer must obtain the consent of the B-Piece Buyer in a transaction (that is the directing holder of such transaction), prior to taking certain actions with respect to the mortgage loans. Such rights include consenting to a foreclosure or modification of a mortgage loan, sales of defaulted loans, releases, requests to release certain funds from reserves, waivers, property management company changes, exercises of material remedies following a default and consents to the incurrence of additional debt. In general, the directing certificate holder has these consent rights until the outstanding principal balance of the applicable subordinate notes it holds is reduced to less than 25% (or more) of its original principal balance (taking into account realized losses and appraisal reduction amounts).

⁹ With low prevailing interest rates it may be possible for commercial real estate lenders to pass on higher funding costs to borrowers. However, such cost-sharing opportunities may diminish as interest rates rise. Note that from 2004 until June 29, 2006, the Federal Reserve raised the Federal Funds Rate to 5.25% after 17 consecutive interest rate hike meetings. Although it is generally expected that the Federal Reserve will raise rates slowly in the near future, any increase in rates will likely have a constraining effect on lending and available credit to an ailing commercial real estate market.

¹⁰ These investors are referred to in the industry as “B-Piece Buyers” because they purchase the most subordinate securities of the transaction.

Pursuant to the risk retention rules, the horizontal risk retention that a B-Piece Buyer may acquire is required to be measured on a “fair value” basis under U.S. GAAP. Since a horizontal interest is required to be the most subordinate tranche issued by a securitization trust (and represents the “first loss” tranche) they are almost always valued at less than their face value. Therefore, in order to acquire the appropriate amount of securities to satisfy the terms of the risk retention rule, a B-Piece Buyer would need to acquire more securities than they currently acquire, which would result in “moving up the stack” in order to acquire higher rated securities. Market participants claim that applying this to the 5% risk retention would result to almost double what the typical B-Piece Buyer purchases today. This poses a twofold dilemma: (1) issuers generally offer a lower return for these less risky securities (while a B-Piece Buyer and its investor base are generally designed to invest for the higher returns) and (2) the B-Piece Buyer will need to raise and invest more capital in each deal in order to acquire the 5% retained interest.

The Bill’s proposed changes would address these concerns by allowing B-Piece Buyers to hold their interests in a senior/subordinate structure and therefore allow B-Piece Buyers to attract capital at different risk profiles.

SINGLE ASSET CMBS

Currently, the risk retention rules cover all forms of CMBS, including single asset or single borrower CMBS transactions.¹¹ Single asset/single borrower CMBS transactions target investors that are looking for exposure to a specific asset. These deals generally involve disclosure that is highly detailed and relates to one or more related commercial real properties that represent the exposure of a single borrower and are evidenced by a single loan (or a cross-collateralized pool that functions as one loan), unlike a “conduit” transaction (or any other form of asset backed securities which are almost always backed by a diverse pool of assets) which requires disclosure and due diligence on commercial real properties related to possibly 100 or more loans exposed to the credit of 100 or more borrowers.¹²

The Bill would exempt single asset/borrower CMBS from the ambit of the risk retention regulations. This is appropriate given the distinguishable nature of single asset/borrower CMBS from other forms of CMBS and ABS. The Bill offers the single asset/borrower CMBS market much-needed immediate relief.

QCRE LOANS

The risk retention rules provide for an exemption from the risk retention requirements for a loan that qualifies as a qualified commercial real estate loans (a “QCRE Loan”). Industry participants have noted that the elements of a QCRE Loan were such that there were few types of

¹¹ Since for most single asset/borrower CMBS deals there has been no role for B-Piece Buyers the risk retention rules seem arbitrarily more burdensome and costly to the single asset/borrower CMBS market even though arguably they should be more relaxed due to the more transparent nature of those deals.

¹² Market participants have long claimed that single asset/single borrower CMBS transactions are distinguishable from other conduit CMBS deals since the deals generally only involve one loan and more often than not there has been no role for B-Piece Buyers in the single asset/borrower CMBS space.

loans in the market that could qualify.¹³ Thus, as currently drafted, this exemption from the risk retention rules provides minimal benefits for CMBS.

In addition, the QCRE Loan exemption also has the unintended consequence of excluding higher-quality assets from CMBS pools. For example, in the commercial property space historical loss performance for interest-only loans with a 50% loan-to-value ratio are actually better than 10-year loans¹⁴, and 5-year or 7-year loans have performed better than 10-year loans.¹⁵ However, interest-only loans do not qualify as QCRE Loans and QCRE Loans require a minimum 10-year loan term. The Bill would amend the regulations to provide requirements under which interest-only loans may be exempt from the risk retention requirements and remove the requirement that a QCRE Loan have a minimum term (as opposed to the minimum 10-year loan term requirement).

Currently, QCRE Loans require an amortization schedule that does not exceed 25 years (or 30 years in the case of a qualifying multifamily loan). This requirement may have the unintended consequence of eliminating the highest quality commercial real estate loans from the loan pool. For example, for amortizing loans a 30-year amortization schedule is the standard schedule for commercial real estate loans in CMBS pools.¹⁶ In addition, imposing this requirement will increase a borrower's payments, which could put pressure on the borrower's ability to repay the loan. The Bill would remove the requirement that QCRE Loans require an amortization schedule that does not exceed 25 years (or 30 years in the case of a qualifying multifamily loan).

Finally, the Bill would remove the provisions that require QCRE Loans with lower capitalization rate appraisals (at the time of origination) to be subject to lower loan-to-value ("LTV") caps. Currently, QCRE Loans are required to have an LTV that is not greater than 65%. However, if the property was appraised with a capitalization rate that was less than the sum of the 10-year Treasury swap rate plus 300 basis points (as of the date concurrent with the effective date of the appraisal), the QCRE Loan would be required to have an LTV that does not exceed 60%. However, industry participants generally believe that the safest loans on mature properties in the market are appraised with more conservative capitalization rates due in part to the stable nature of such properties.¹⁷ The concern here is that the higher-quality loans will be eliminated from the CMBS pools because better-quality loans with lower capitalization rates will be subject to more stringent LTV caps and not qualify for QCRE Loan status. The Bill would eliminate this concern.

¹³ See *Trepp Talk*, "[What Qualifies? Risk Retention](http://info.trepp.com/trepp-talk/topic/risk-retention)" in CMBS, by Joe McBride, posted January 28, 2014 at <http://info.trepp.com/trepp-talk/topic/risk-retention>.

¹⁴ See *Real Estate and Financial Services Organizations' Group Letter to Federal Agencies on Proposed Risk Retention Rule*, at [Appendix 7](#) and [Appendix 8](#), October 30, 2013.

¹⁵ See *id.*

¹⁶ Commercial real estate loans that have an amortization schedule typically use a 30-year amortization schedule. A simple internet search of the term "Commercial Real Estate Loan" on Investopedia only mentions a 30-year amortization schedule in the description. See <http://www.investopedia.com/terms/c/commercial-real-estate-loan.asp>.

¹⁷ See *Real Estate and Financial Services Organizations' Group Letter to Federal Agencies on Proposed Risk Retention Rule*, Page 20, October 30, 2013.

The Committee appreciates the opportunity to comment on the Bill. The Committee stands ready to assist with further information or other assistance regarding this important matter.

Very truly yours,



Patrick D. Dolan

Cc: Hon. J. French Hill
Hon. Kevin McCarthy
Hon. Nancy Pelosi

New York City Bar Association
Committee on Structured Finance
Patrick D. Dolan, Chair

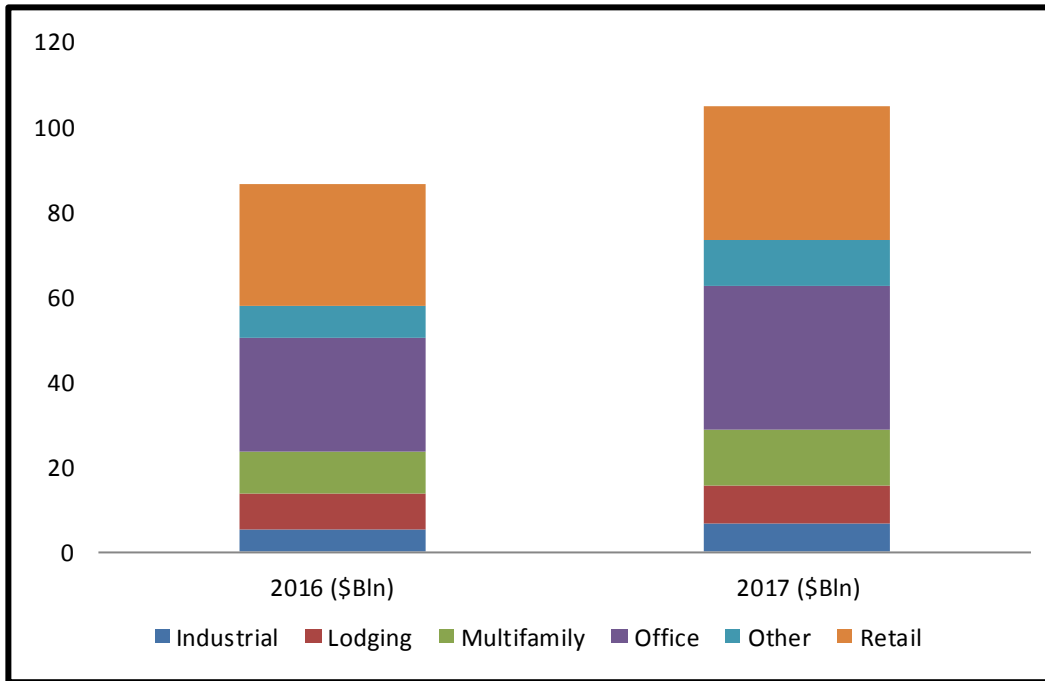
Mark Adelson
Robert Steven Anderson
Kira Brereton
Lewis Cohen
Christopher J. DiAngelo
Afsar Farman-Farmaian
Shuoqiu Gu
Greg Kahn
Jamie Kocis
Jason H. P. Kravitt
Steve Levitan
George P. Lindsay
Jerry R. Marlatt
Richard Mertl
David Nirenberg
Steve Plake
Richard J. Reilly*
Paul R. St. Lawrence
Craig Stein
Gregory D. Walker
Jordan Yarett

Howard Altarescu
Vincent Basulto
Grant E. Buerstetta
John M. Costello, Jr.
Patrick D. Dolan
Karen Fiorentino
Christopher Haas
Anastasia Kaup
Mark J. Kowal
Ritika Lakhani
Gregory T. Limoncelli
Alexander G. Malyshev
Lorraine Massaro
Dina J. Moskowitz
Christopher J. Papajohn
Lauris G.L. Rall
Y. Jeffrey Rotblat
Adam Singer*
Jeffrey Stern
Craig A. Wolson
Boris Ziser

* Primary draftsman of this letter of comments

ANNEX I

CMBS Maturities 2016-2017



Source: Trepp