MEMORANDUM

TO: File No. S7-14-11

FROM: Jay Knight
Special Counsel
Office of Structured Finance
Division of Corporation Finance
U.S. Securities and Exchange Commission

RE: Meeting with Representatives of JPMorgan Chase & Co.

DATE: March 15, 2012

On February 29, 2012, Paula Dubberly, Katherine Hsu, Jay Knight, David Beaning, Steven Gendron, and Max Rumyanstev of the Division of Corporation Finance, Emre Carr of the Division of Risk, Strategy, and Financial Innovation, and Michael Keehlwetter of the Office of the Chief Accountant participated in a meeting with the following representatives of JPMorgan Chase & Co.:

- Bianca Russo
- Paul White
- Liam Sargent
- Ramon Gomez
- Stephanie Mudick
- Jonathan Strain
- Thomas Koonce

The following staff of other federal regulators also participated: Beth Mlynarczyk (Treasury), Mike Nixon (HUD), Phil Sloan (FDIC), and Adam Ashcraft (FRBNY).

The participants discussed topics related to the Commission's March 30, 2011 proposals regarding credit risk retention and the comment letter submitted by JPMorgan Chase with respect to that proposal. A handout is attached to this memorandum.

Attachment

RISK RETENTION

February 2012

STRICTLY PRIVATE AND CONFIDENTIAL

J.P.Morgan

This presentation is for discussion purposes only and is incomplete without reference to, and should be viewed solely in conjunction with, the oral briefing provided by J.P. Morgan.

The information in this presentation reflects prevailing conditions and our views as of this date, all of which are accordingly subject to change. J.P. Morgan's opinions and estimates constitute J.P. Morgan's judgment and should be regarded as indicative, preliminary and for illustrative purposes only. In preparing this presentation, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources or which was otherwise reviewed by us.

J.P. Morgan is a marketing name for investment banking businesses of JPMorgan Chase & Co. and its subsidiaries worldwide.

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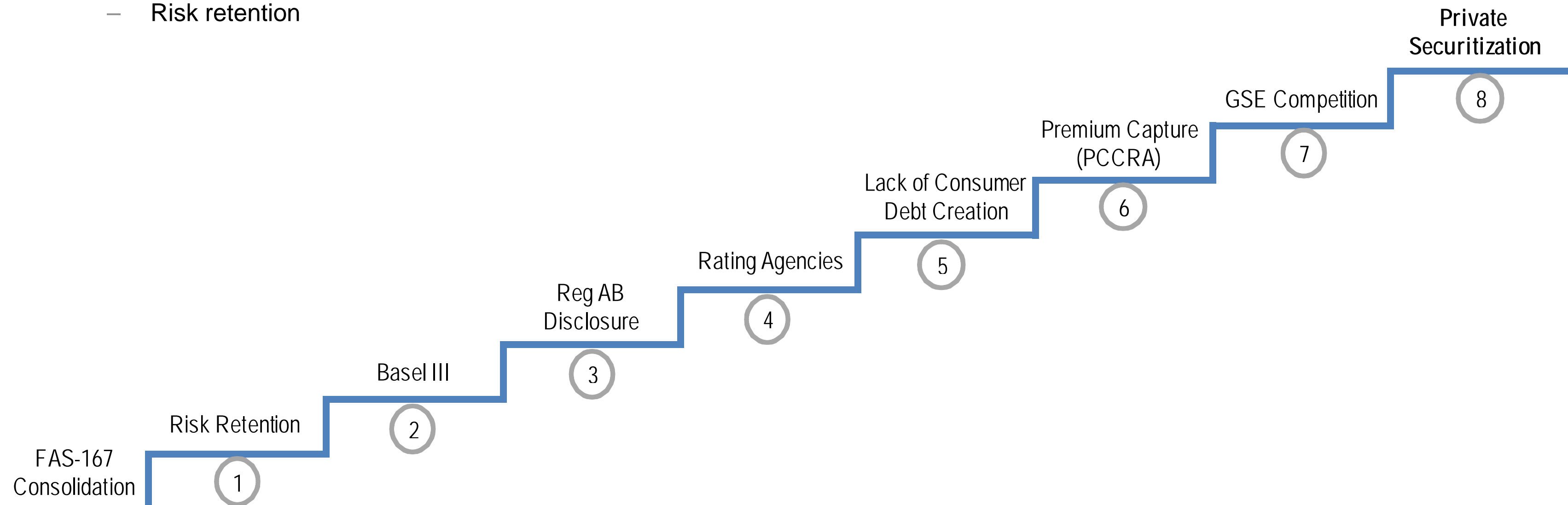
Challenges to re-establishing the RMBS market

GSE competition and premium capture are main hurdles, others are surmountable

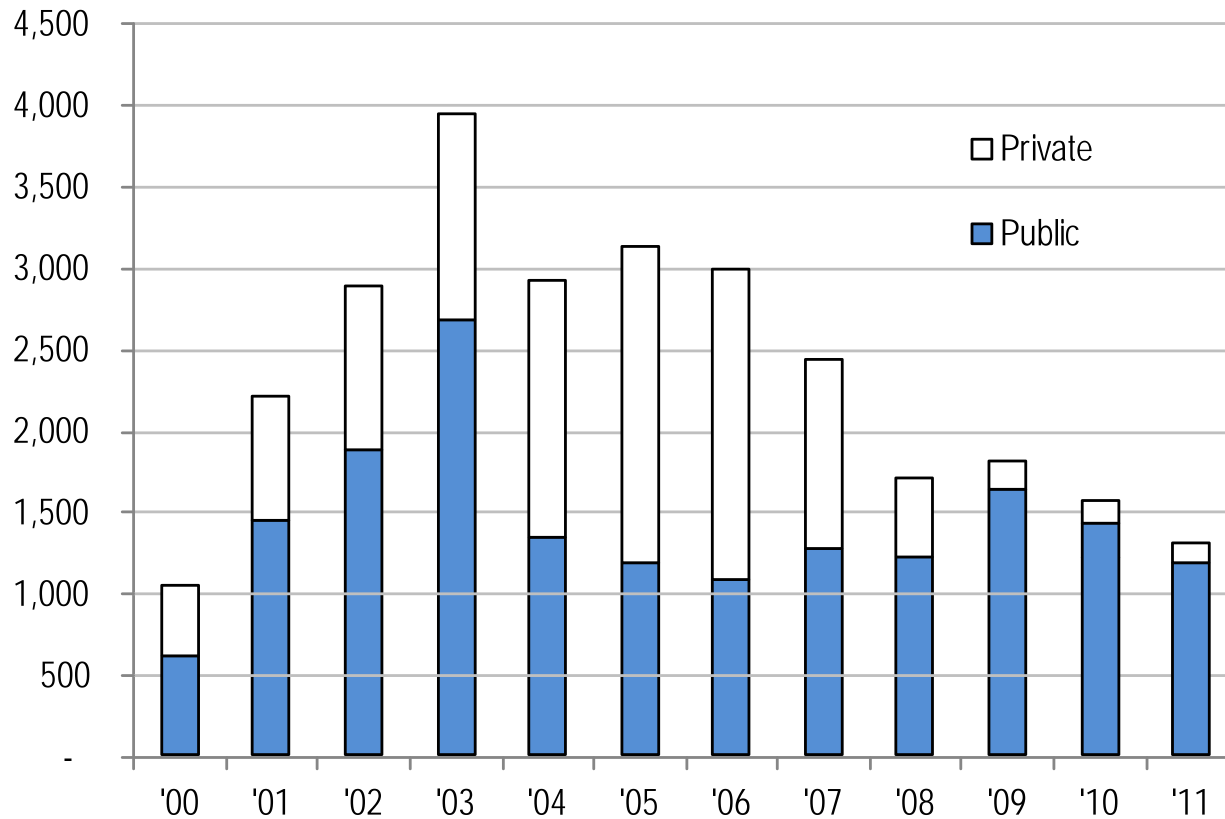
- **There are several steps to be completed prior to the return of the private label securitization market**
  - Market participants have been reviewing and preparing for additional data & reporting requirements
    - ASF Project Restart
  - Future capital & accounting treatment will be of critical importance and impacted by
    - Servicing affiliation
    - Risk retention



Source: J.P. Morgan

GSE lending dominates the market with over 90% of new loans

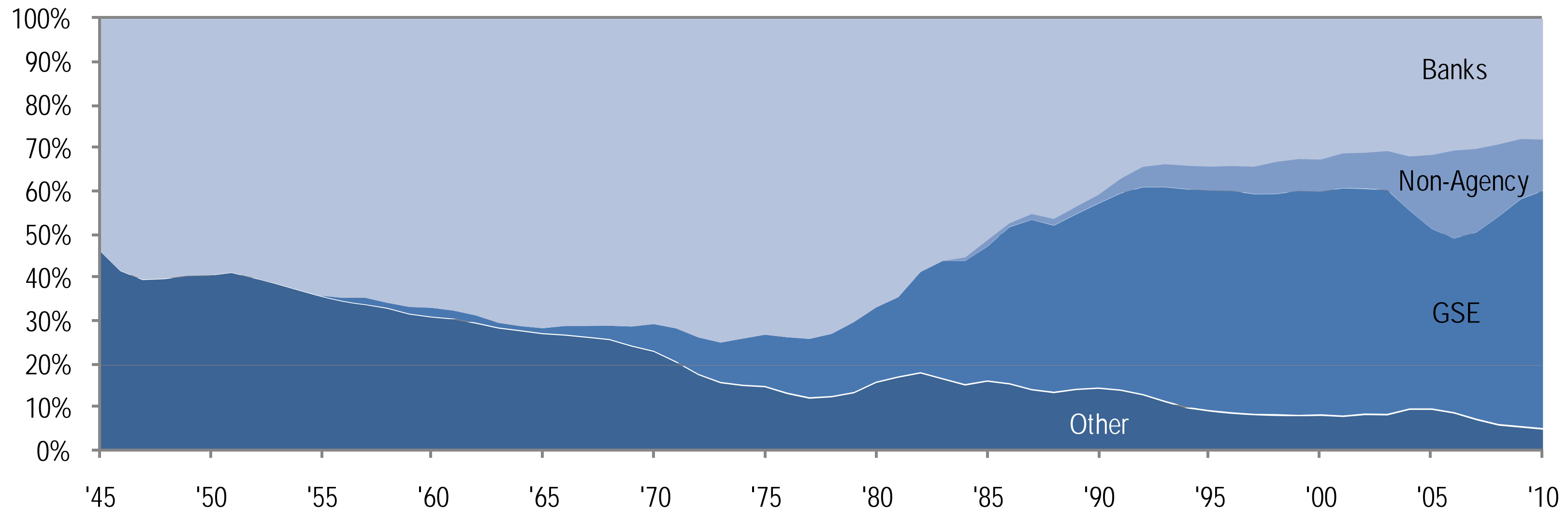
Total market originations by product ($bn)



Source: Inside Mortgage Finance, J.P. Morgan

GSE financing accounts for over half of mortgages outstanding

Market share of mortgage debt (%), including both first and second liens



- GSEs finance 55% of all current mortgage debt outstanding
- Why have GSEs dominated?
  - Liquidity advantage
  - Lower capital requirements / mispricing of insurance risk
- GSE reform will require a new mortgage finance model

Source: Federal Reserve. "Other" represents insurance companies, financial companies, the Federal Government, and non-farm non-financial corporate businesses

Risk Retention can be achieved without PCCRA

- **The premium capture cash reserve account provision (PCCRA) in the proposal is broader than necessary to ensure that structuring is not used to circumvent the risk retention requirements.**
- **The proposed PCCRA framework will:**
  - Significantly increase interest rates for borrowers and adversely impact the struggling mortgage market in particular; and
  - Impact borrower affordability
- **We propose changes to PCCRA to preserve its intended function. Our changes would ensure that:**
  - Sponsor's retained interests are meaningful
  - Interests of the sponsor and the holders of the securities are aligned
  - Structuring choices do not undermine risk retention economics
  - Risk retention requirements are not circular
  - Identical economic interests are treated similarly
  - Sponsors continue to achieve sale accounting treatment for securitizations, and
  - Borrowers are protected from significant interest rate increases

Why PCCRA as proposed may be harmful to the mortgage market

- **The PCCRA requirement alone will significantly increase mortgage rates and negatively impact the housing market's recovery by significantly decreasing credit availability and home ownership opportunities**
  - To match current securitization economics, originators will have to raise mortgage interest rates by approximately 2 percentage points, and more for lower-credit borrowers.
  - This would be in addition to other cost increases associated with risk retention in general under the risk retention proposal, particularly if the final risk retention rules do not provide for a sunset provision
- **Adverse impact on financial institutions**
  - Sponsors may increase the retained interests within a securitization to avoid triggering PCCRA, thereby risking consolidation under GAAP and leading to significantly higher capital costs for sponsors and higher mortgage rates for borrowers
  - To offset consolidation impacts, lender-sponsors would be required to increase mortgage rates by approximately 300 basis points under today's regulatory capital requirements (which are subject to increase in the future)
- **Any increase in borrowing cost would ultimately be borne by the consumer and would negativelyim pact affordability and as a result, housing prices**
  - As discussed herein, we believe PCCRA would result in an increase in mortgage rates, potentially up to or even in excess of 200 basis points
  - To illustrate, the table below shows the impact of a 2% rate increase on a hypothetical borrower of a 30-year fixed mortgage today
    - In order to maintain the same level of affordability (as measured by DTI) with the higher mortgage rate, the property value must be reduced by approximately 20%

	Current loan amount		Premium capture effect		Breakeven loan amount
Loan amount	$500,000		$500,000	→	**$400,000**
Property value	$625,000		$625,000		$500,000
Loan-to-value	80%		80%		80%
Rate	4.500%		6.500%		6.500%
Monthly income	$9,046		$9,046		$9,046
Monthly payment	$2,533	→	**$3,160**		$2,528
DTI	28%		35%		28%

How to preserve meaningful risk retention without the distortions created by PCCRA

- **PCCRA is unnecessary for vertical risk retention**
  - Sponsors cannot avoid vertical risk retention by re-structuring. Structural changes in one class of securities will be exactly offset by structural changes in other classes of securities, and vertical risk retention holds an equivalent percentage of each
  - If PCCRA is retained for vertical retention, the capture amount should exclude cash reserve account amounts from gross proceeds so that the calculation is not circular, and use the same multiplier of 100 percent for vertical retention as for its economic equivalent, the representative sample method
- **For example, suppose that a securitization can be structured one of two ways:**
  - "Structure A" is a sequential structure whereby excess spread is only released to the residual holder after all other securities are retired. In this structure, if the excess spread was sufficient to cover all losses over the life of the deal, the residual holder will receive the remaining cash after all other securities have been paid in full, and if the excess spread was insufficient to cover all losses over the life of the deal, the residual holder will receive nothing.
  - "Structure B" allocates all excess spread each month to a senior interest-only ("IO") class and, as a result, its subordinate class (Class B) has less credit enhancement and lower market value, and the senior IO in Structure B has a commensurately higher market value than that of the residual in Structure A.
  - The table below shows the impact of changing the structure on vertical risk retention as compared with horizontal risk retention
    - As this example illustrates, changing the structure has no impact on vertical risk retention

Structure A (Sequential Pay): Vertical vs. Horizontal Retention

		Market Value		Vertical Retention		Horizontal Retention	
Class	Balance	(%)	($)	(%)	($)	(%)	($)
A	95.00	100	95.00	5	4.75	0	0.00
B	5.00	80	4.00	5	0.20	100	4.00
Residual	n/a	3	3.00	5	0.15	100	3.00
Gross Execution			102.00	Total Retained	5.10	Total Retained	7.00
Costs			1.00				
Net Execution			**101.00**	**As a %of Net**	**5.05%**	**As a %of Net**	**6.93%**

Structure B (Senior Interest-Only Strip): Vertical vs. Horizontal Retention

		Market Value		Vertical Retention		Horizontal Retention	
Class	Balance	(%)	($)	(%)	($)	(%)	($)
A	95.00	100	95.00	5	4.75	0	0.00
A-IO	n/a	4	4.00	5	0.20	0	0.00
B	5.00	60	3.00	5	0.15	100	3.00
Gross Execution			102.00	Total Retained	5.10	Total Retained	3.00
Costs			1.00				
Net Execution			**101.00**	**As a %of Net**	**5.05%**	**As a %of Net**	**2.97%**

How to preserve meaningful risk retention without the distortions created by PCCRA

- **PCCRA is unnecessary for the representative sample method if this retention method is properly redesigned**
  - As proposed, the representative sample method is unusable but - if modified appropriately - will offer sponsors a valuable risk retention tool that cannot be used to circumvent risk retention
  - Two problems are presented by the proposed representative sample method
    - First, sponsors will not use it because the definition of "equivalent risk" is so vague
    - Second, in order to pick a sample of equivalent risk, a sponsor could be required to pick the random sample several times, each of which it could be argued, undermines the level of "randomness" reflected in the sample selection
  - The solution is to modify this method to require a "retention class" and then sponsors cannot avoid risk retention
    - Require sponsors to retain an unstructured pass-through participation class (a "retention class"), which represents a 5% economic interest in all loans included within the transaction and receives 5% of all cash flows from the loans in the securitization
    - The Retention Class would be subject to the same credit, prepayment, and other risks that impact the entire collateral pool, and would have the same economic profile as a representative sample, without having any specific tranches that are subject to time tranching, credit tranching or coupon stripping
- **PCCRA treats identical economic interests differently**
  - The proposed premium capture provisions treat vertical retention, which provides a perfect economic representation of the ABS interests, differently from representative sample retention, which provides an approximate economic representation of the ABS interests
- **PCCRA will ultimately result in significantly higher mortgage rates for borrowers due to increased capital costs**
  - Sponsors may increase the retained interests within a securitization to avoid triggering PCCRA, thereby risking consolidation under GAAP and leading to significantly higher capital costs for sponsors and higher mortgage rates for borrowers
  - Many sponsors also originate mortgages for servicing by an affiliate. If the sponsor increases the retained interest to avoid PCCRA, consolidation under GAAP would occur for transactions that would otherwise have been accounted for as a sale, regardless of what form of risk retention the sponsor chose.
  - Consolidation will severely and negatively impact the sponsor's balance sheet, income statement and regulatory capital treatment – thereby lowering the amount of capital available for mortgage lending and affecting the liquidity of mortgage loan trading

How to preserve meaningful risk retention without the distortions created by PCCRA

- **PCCRA would raise hedging costs significantly, also leading to higher mortgage rates**
  - The premium capture provisions would substantially raise hedging costs due to the asymmetrical impact that the premium capture provisions would have in response to interest rate changes. Market interest rates and mortgage loan prices generally move in opposite directions.
  - To hedge the asymmetrical impact of the premium capture provisions on value due to fluctuations in interest rates (timing differences in the recognition and recapture of losses or gains for tax purposes), the sponsor would need to use hedging instruments which are significantly more expensive (and less precise) than those currently used. We estimate that the increased hedging costs, which would ultimately be transferred to the borrower, could raise mortgage rates by approximately 25-50 basis points.
- **PCCRA's effects on liquidity would undermine federal monetary policy decisions**
  - Market interest rates and mortgage loan prices generally move in opposite directions. As a result, the proposed premium capture provisions, which would lower the liquidity of premium loans, would reduce the capital available for lending when a policy decision to lower rates results in the creation of premium loans.
  - This would be counter to the effect that is generally intended by such policy decisions. Thus, the premium capture provisions would dilute the impact of the U.S. Government's federal interest rate policy decisions by reducing the capital available for mortgage loans when interest rates are lowered and by increasing the capital available for mortgage loans when interest rates are raised.
- **Provide for a thoughtful definition of "net closing costs"**
  - Any measure of realized net income should properly reflect all costs related to the transaction and to the origination or sale of its assets
  - Proper accounting for costs is essential to achieving the purpose of PCCRA without significantly raising mortgage rates and further depressing housing prices

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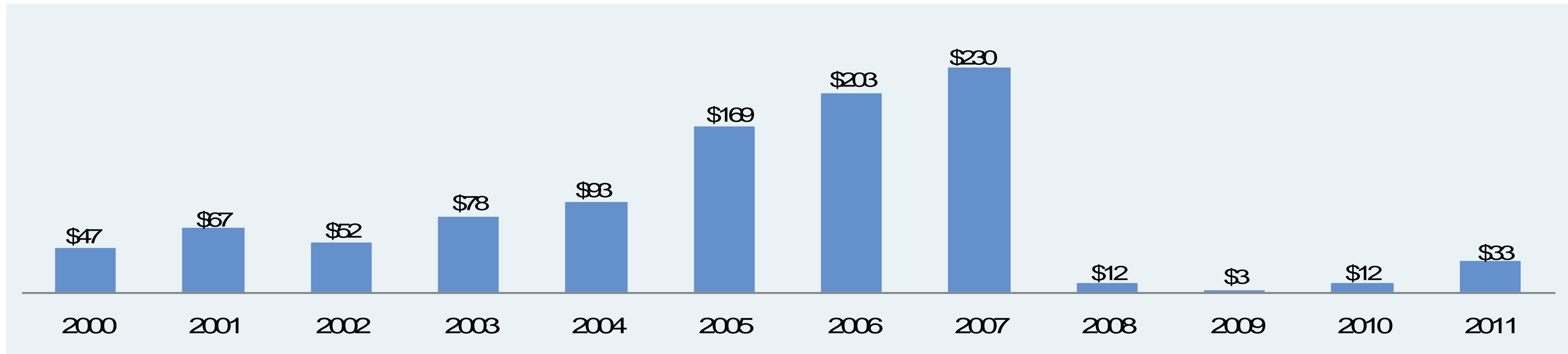
CMBS market has additional PCCRA complications due to the B-piece exemption afforded by Dodd Frank

- **Dodd Frank legislation acknowledges the role of the third party B-piece buyer as a risk retention surrogate**
  - The B-piece exemption in Dodd Frank removes the burden of risk retention on the seller
  - The CMBS market is currently functioning with both GSEs and private label CMBS B-piece sales
    - FHLMC issued 11 CMBS deal totaling $13.0bn in 2011 with third party B-piece sales and no retention
    - J.P. Morgan and other private label issuers sold $24.5bn in 18 conduit CMBS deals with B-piece and no retention
  - Any additional retention would have to work with and not disrupt this functioning private market
- **PCCRA attempts to change the CMBS business model of selling discount B-pieces and call protected excess interest**
  - The purchase of a first loss B-piece at a steep discount to par is mandated by the B-piece buyer's yield
  - When a sponsor monetizes the excess spread, it does not diminish the risk to the B-piece buyer
  - PCCRA acts as an additional layer of first loss protection and imposes a substantial burden on sponsors
- **PCCRA will ultimately result in significantly higher CRE mortgage rates for borrowers due to increased capital costs:**
  - Sponsors may increase the retained interests within a securitization to avoid triggering PCCRA, thereby risking consolidation under GAAP and leading to significantly higher capital costs for sponsors and higher mortgage rates for borrowers
  - Many sponsors also originate mortgages for servicing by an affiliate. If the sponsor increases the retained interest to avoid PCCRA, consolidation under GAAP would occur for transactions that would otherwise have been accounted for as a sale, regardless of what form of risk retention the sponsor chose.
  - Consolidation will severely and negatively impact the sponsor's balance sheet, income statement and regulatory capital treatment – thereby lowering the amount of capital available for mortgage lending and affecting the liquidity of mortgage loan trading
  - To offset consolidation impacts, lender-sponsors would be required to increase mortgage rates by approximately 50 basis points under today's regulatory capital requirements (which are subject to increase in the future)

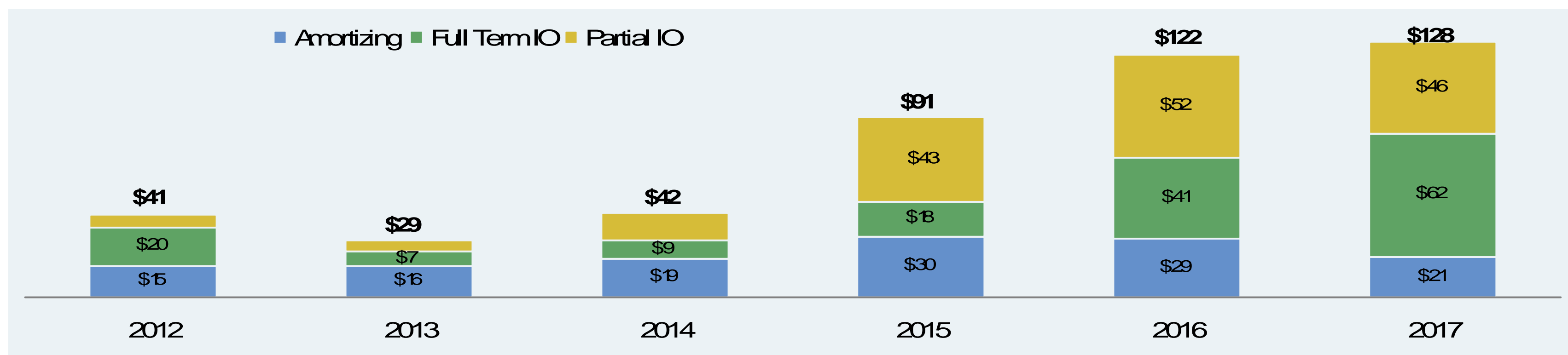
Historical CMBS issuance and future financing needs

Historical CMBS issuance volumes ($bn)



Source: Commercial Mortgage Alert, JPM CMBS Research

Fixed rate conduit CMBS loan maturities ($bn)



Source: JPM CMBS Research

2011 conduit CMBS new issuance

2011 conduit CMBS origination

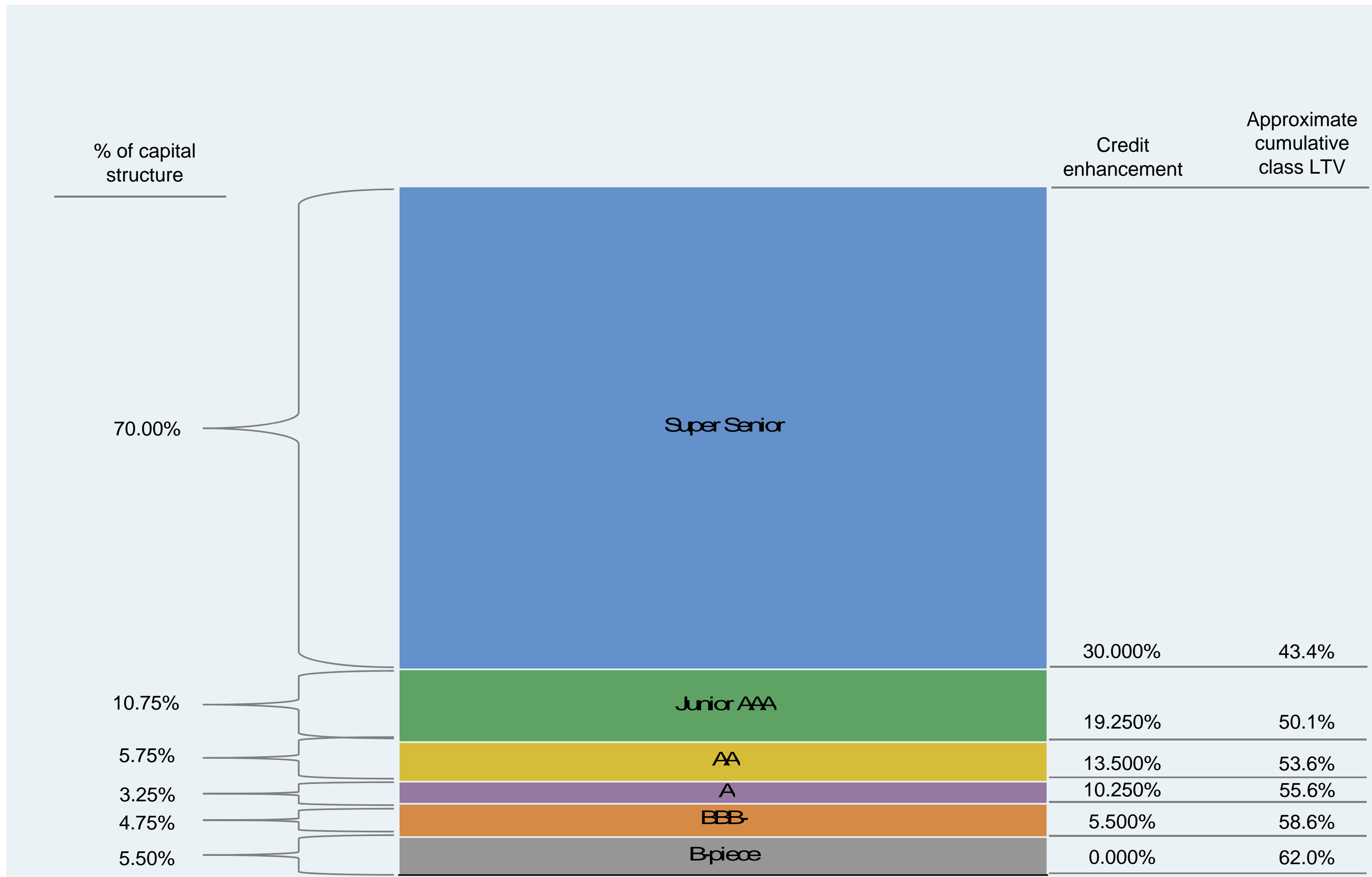
Type of CMBS transaction	Initial pooled balance ($MM)	Number of transactions	% of total
Private label CMBS	$24,487.9	18	65.3%
FREMF K Series	$12,985.8	11	34.7
Total	**$37,473.8**	**29**	**100.0%**

2011 private label CMBS conduit loan contributors

#	Loan contributor	Loan balance ($MM)	% of total
1	J.P. Morgan	$3,969.7	16.2%
2	Morgan Stanley	2,924.3	11.9
3	UBS	2,724.0	11.1
4	Wells Fargo	2,452.6	10.0
5	Deutsche Bank	2,374.9	9.7
6	RBS	2,091.4	8.5
7	Goldman, Sachs & Co.	1,840.2	7.5
8	Cantor Commercial Real Estate	1,408.6	5.8
9	Bank of America	1,330.1	5.4
10	Citigroup	1,251.2	5.1
	Others	2,121.1	8.7
	Total	**$24,487.9**	**100.0%**

Source: J.P. Morgan

Generic conduit CMBS capital structure



Recommended Alternatives to PCCRA for CMBS

JPMorgan Chase recognizes the Agencies' concern that risk retention could be "gamed" by sponsors issuing bonds at substantial premiums, or that B-piece Buyers would not have sufficient "skin in the game" given their purchase of the B-pieces at a deep discount to par.

JPMorgan Chase recommends that PCCRA be eliminated in the final rules, but that potential manipulation of the price of the B-piece can be prevented through a requirement that the B-piece have a coupon equal to the lesser of (i) 10-year Treasuries plus 1.0% or (ii) the net weighted average coupon ("WAC") of the loan pool. Currently, investors are buying conduit CMBS B-pieces with coupons that are approximately equal to 10-year Treasuries plus 50 basis points, which is slightly below the WAC of the loan pools.

Another viable alternative to a PCCRA would be that, ***in addition to the base 5% risk retention (based on par) held by the B-piece Buyer, the CMBS sponsor would retain the greater of 5% of the market value (net of closing costs) or par value of the securitization, in each case after taking into account the proceeds of the sale of the B-piece to the B-piece Buyer***. This would be accomplished by the additional retention by the CMBS sponsor of a pari passu loan participation or pass-through interest in the entire pool of loans in an amount equal to the greater of:

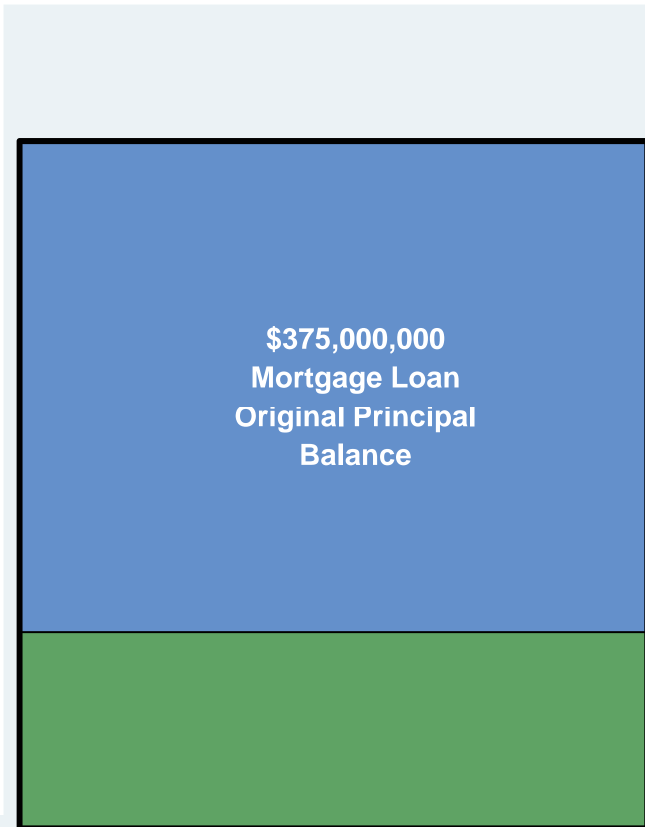
- 5% of the par value of all of the principal-paying classes issued in the CMBS transaction minus the proceeds of the sale of the B-pieces sold to a B-piece Buyer; and
- 5% of the market value (i.e., gross proceeds of sale) of all of the classes issued in the CMBS transaction, less the net closing costs permitted to be deducted under GAAP (e.g., taxes, hedging costs, rating fees, legal and accounting fees) minus the proceeds of the sale of the B-pieces sold to a B-piece Buyer

This additional retention ensures that even if the sponsor issues bonds at a substantial premium, the combined retention by both the sponsor and the B-piece Buyer accomplishes the goal of meaningful risk retention that complies with the intent of Dodd Frank, but permits the sponsor to realize value from the securitization of the loans up front, as opposed to waiting until the maturity of the transaction in the form of a PCCRA.

We should note, however, that this additional retention by the sponsor will cause ***origination spreads to increase by as much as 50 basis points and will ultimately make commercial mortgage borrowing more expensive for the borrower***.

Single Borrower CMBS Example

JPMCC 2011-PLSD – single borrower transaction from 4Q2011



Basis PSF[1]	LTV[2]	UW NOI Debt Yield[3]	UW NCF DSCR[4]
$193	44.1%	12.8%	1.76x
$271	61.7%	9.2%	1.17x

Source: J.P. Morgan
[1] Based on collateral square footage of 1,939,082
[2] Based on the Cut-off Date principal balances and the appraised value of $850.0 million
[3] UW NOI Debt Yield based on UW NOI of $48.1 million and Cut-off Date principal balances
[4] UW NCF DSCR based on UW NCF of $45.8 million and debt service consisting of Mortgage Loan debt service, which is calculated based on a constant payment with an approximately 5.658% coupon and a 30-year amortization schedule and Mezzanine Loan debt service, which is interest-only and is calculated based on an 8.500% coupon and actual/360 accrual.

Risk Retention and PCCRA in Investment Grade Issues

CMBS risk retention by a B-piece Buyer generally would only apply to "conduit" CMBS of 10-100 loans for securitization

- The B-piece Buyer concept is not directly applicable to single borrower CMBS
- Backed by a single mortgage loan or related mortgage loans made to a single borrower
- 50-65% LTV ratios that are made in conjunction with mezzanine loans, and do not issue below investment grade classes
- The LTV of the CMBS issue would typically be 40-60% while the combined LTV of the CMBS issue and the mezzanine loans would be 75-80%

The mezzanine debt is secured by the ownership interests in the mortgage loan borrower

- There are multiple mezzanine loans and related borrowers
- Mezzanine loans are priced at par and are often sold at the same time as the related CMBS loans
- Mezzanine loan buyers perform the same due diligence on the loan collateral as B-piece Buyers do

The loss record on Single Borrower and floating rate CMBS transactions is superior to conduit CMBS

- That most losses have been absorbed by the mezzanine loan holders and almost no losses have been borne by the CMBS holders
- Mezzanine loans are effectively acting on a reverse sequential basis as the first loss pieces

These facts strongly argue for allowing mezzanine loans in Single Borrower and floating rate CMBS transactions to satisfy the risk retention requirement via the B-piece exemption in Dodd Frank and to satisfy the any PCCRA requirement since this first loss protection is already being provided ***on a par purchase*** price basis by the mezzanine lenders.