

## MEMORANDUM

**TO:** File No. S7-14-11

**FROM:** Steven Gendron  
Analyst Fellow  
Office of Structured Finance  
Division of Corporation Finance  
U.S. Securities and Exchange Commission

**RE:** Meeting with various CMBS market participants.

**DATE:** April 19, 2012

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On March 28, 2012, Paula Dubberly, Katherine Hsu, Rolaine Bancroft, Jay Knight, Steven Gendron, Maxym Rummyantsev and David Beaning of the Division of Corporation Finance, Eric Emre Carr of the Division of Risk, Strategy, and Financial Innovation, and Mike Keehlwetter of the Office of the Chief Accountant participated in a meeting with the following persons:

- Justin Kennedy, LNR Property
- Nancy Mullerhand, Metlife
- William Moretti, Metlife
- Schecky Schechner, Barclays Capital
- Gary Horbacz, Prudential
- Sean Beggan, Prudential
- Spencer Haber, H2 Capital
- Barry Sternlicht, Starwood
- Boyd Fellows, Starwood

The following staff of other federal regulators also participated: Sebastian Astrada (Federal Reserve Board), Kathy Russo (FDIC), Michael Nixon (HUD), Joe Smith (OCC), Adam Ashcraft (FRBNY), Beth Mlynarczyk (Treasury), Philip Millman (FHFA).

The participants discussed topics related to the Commission's March 30, 2011 proposals regarding credit risk retention. Handouts are attached to this memorandum.



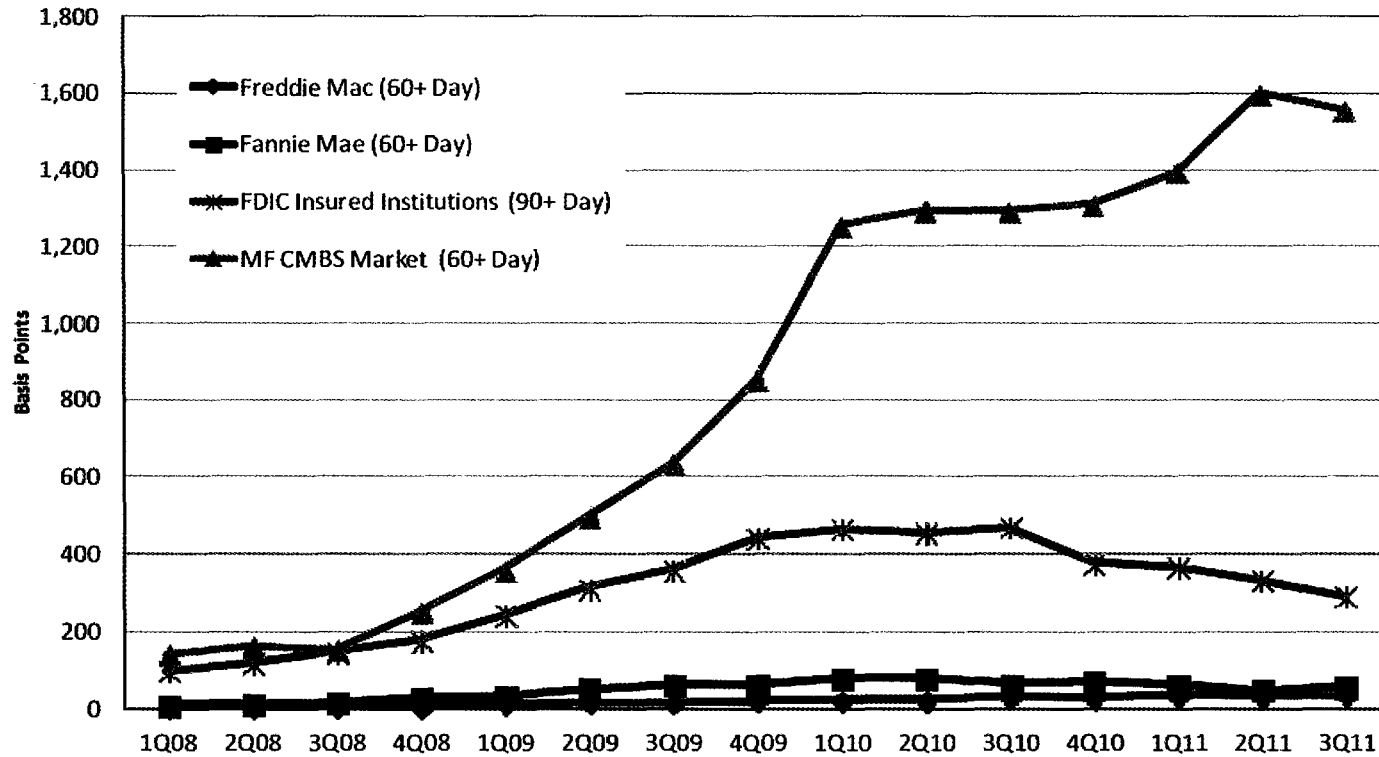
## **Dodd-Frank & Risk Retention**

**March 2012**

## Dodd-Frank/CMBS Originator Performance Overview

- Dodd-Frank regulation requires an issuer/originator risk retention program that seeks to level the playing field between balance sheet lenders and “shadow finance” arbitrage origination models by altering the manner in which securitizers earn profits
  - ~ Requiring securitizers to retain a piece of each loan/securitization changes; similar to a balance sheet lender earning NIM over the life of a loan
- This concept is strongly supported by loan performance data --- data across collateral types show statistically significant differences between the credit performance of these two models
- Possibly the most striking difference is the outperformance of Fannie Mae/Freddie Mac risk-sharing models vs. CMBS conduit/arbitrage origination multifamily performance
  - ~ 15+% delinquency on conduit MF vs. .20-.25% delinquency on Fannie Mae/Freddie Mac-issued transactions
- Performance relationships persist when comparing default rates across major property types

## Freddie Mac / Fannie Mae Historical Delinquency Data



**Sources:**

FDIC Insured Institutions: FDIC Quarterly Banking Profile – Loan Performance Data (Multifamily only).

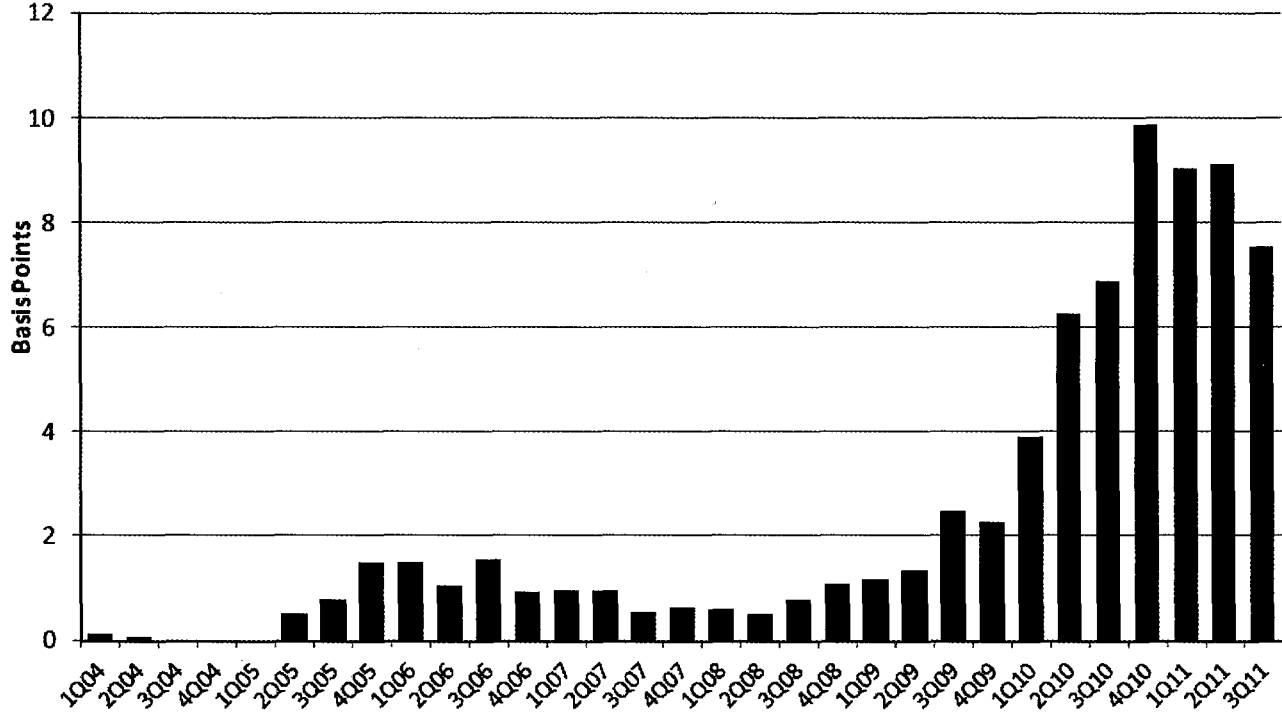
MF CMBS Market: TREPP. 60+ days, in foreclosure, REO, or non-performing balloons.

Fannie Mae: 3Q11 delinquency rate from Form 10-Q for the quarter ended September 30, 2011.

Freddie Mac: Multifamily delinquency performance is based on UPB of total Multifamily mortgage portfolio and includes mortgage loans that are two monthly payments or more past due or in the process of foreclosure as of period end.

# Freddie Mac Multifamily Portfolio Net Charge-Offs

**Freddie Mac Multifamily Portfolio Net Charge-offs <sup>1</sup>**  
*(rolling 12 months)*



1. Data point for each quarter reflects net charge-offs for a rolling twelve month period. For example, the 2Q11 value equals the sum of net charge-offs in 3Q10, 4Q10, 1Q11 and 2Q11 divided by the average balance of the multifamily loan and guarantee portfolios during 2Q11.

## CMBS Conduit Loan Losses

### Loss Severity is more severe than first glance

Date	Loss Severity - All Loans
2010 Average	45.20
2011 Q1	30.81
2011 Q2	43.57
2011 Q3	44.72
2011 Q4	50.73
2011 Average	42.80
12-Jan	39.54
<b>Total</b>	<b>43.50</b>

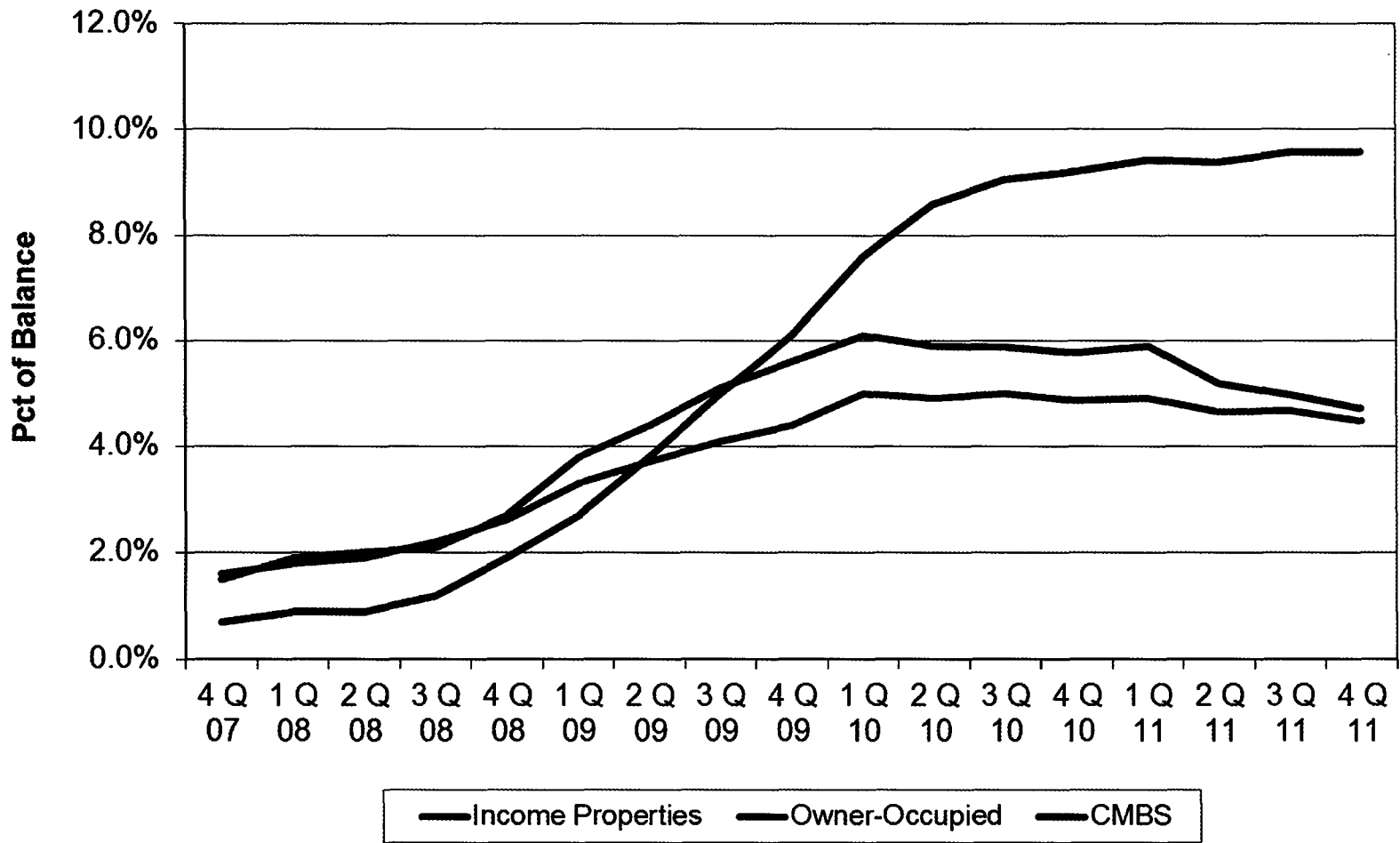
Date	Loss Severity - Stripping Out Losses < 2% of Balance*
2010 Average	59.64
2011 Q1	47.60
2011 Q2	50.78
2011 Q3	54.53
2011 Q4	55.77
2011 Average	52.54
12-Jan	53.23
<b>Total</b>	<b>55.07</b>

*\*Notes relating to adjusted loss severity*

- Over the course of the year, a number of large loans paid off, but the special servicer fees led to small losses
- Stripping out these loans shows both a jump in the average loss severity and a more consistent monthly observation

# CMBS and Commercial Mortgages Held By Banks Delinquency Rate

## Delinquency Rate (30+)





**Risk Retention In the U.S.**



## Risk Retention Amount and Measurement

### Required Risk Retention Amount

An appropriate measurement basis is critical in order to avoid sub optimal outcomes.

#### Regulatory Proposal – 5% of PAR

Potential issues:

- A. PAR amount  $\neq$  market value; issuer can shift value from retained class to classes that are sold
- B. PAR amount  $\neq$  face amount of loans  $\neq$  amount actually lent; risk retention amount will vary depending upon structure (over-collateralized, under-collateralized, parity)

#### Investor Proposal – 5% of Net Borrower Proceeds (Actual Amount Lent)

Advantages:

- A. Eliminates any benefit of manipulating the value of the retained class(es)
- B. Establishes a direct link to the amount lent; amount of risk retention is independent of capital structure

## Premium Capture Cash Reserve Account (PCCRA)

Goal of Risk Retention: Encourage Securitization Lenders to Act More Like Portfolio Lenders

- I. PCCRA forces securitization lenders to earn profits over time, similar to portfolio lenders
  - A. Current securitization model – issuers earn 100% of profit immediately, regardless of whether or not the loans subsequently default
  - B. The Crapo Amendment permits the B-piece buyer to relieve the issuer of its obligation to retain risk
  - C. As a result, CMBS issuers will have zero skin-in-the-game and may continue to aggressively underwrite loans
  - D. PCCRA forces the issuer to hold an IO strip that gets paid at the bottom of the waterfall on a monthly basis instead of selling that IO to the open market
  - E. PCCRA corrects this setback by forcing securitization lenders to earn profits evenly over the life of the loans
  - F. PCCRA aligns issuer profit with loan performance and should contribute to more conservative underwriting practices
  
- II. The PCCRA, contrary to issuer feedback, will not shut down the CMBS market
  - A. The PCCRA does prohibit monetizing excess spread at the time of securitization
  - B. However, the proposal permits the issuer to earn profits evenly over time as long as the loans perform
  - C. Many other structured product sectors function in a similar manner with no ill effects: autos (\$118 billion outstanding), credit cards (\$164 billion) and CLOs (\$225 billion)

## Premium Capture Cash Reserve Account (PCCRA), continued

### III. A modified PCCRA may encourage issuers to retain risk despite the Crapo Amendment

- A. Under the current proposal, the issuer probably won't retain risk and will instead delegate that responsibility to the B-piece buyer
- B. The issuer may continue to underwrite the most aggressive loans that can be sold to the market
- C. Even if the issuer did retain risk, there is no incentive to choose the strongest form (horizontal/first loss) over the weakest form (vertical) given the implied costs
- D. The provisions of the PCCRA can be relaxed to provide that incentive
- E. Issuers can be encouraged to retain horizontal risk by permitting immediate profit at the time of securitization equal to the market value of any horizontal risk retained
- F. If properly implemented, the PCCRA could transform the securitization model (profits up front, no risk retained) into a "quasi" portfolio lender model (profits over time, first loss risk retained)

# Premium Capture Cash Reserve Account – Portfolio Lender vs. Securitization Lender

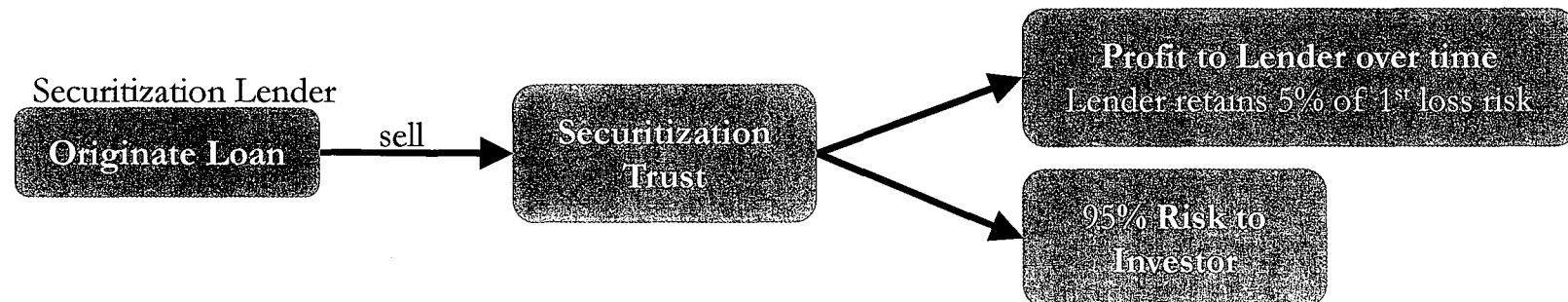
## Portfolio Lender Model



## Securitization Model without PCCRA



## Securitization Model with PCCRA





**Risk Retention Outside the U.S.**

## Article 122a of the Capital Requirements Directive

- *Recital 24: “It is important that the misalignment between the interest of firms that ‘re-package’ loans into tradable securities and other financial instruments (originators or sponsors) and firms that invest in these securities or instruments (investors) be removed. It is also important that the interests of the originator or sponsor and the interests of investors be aligned. To achieve this, the originator or sponsor should retain a significant interest in the underlying assets...”*
- Implementation Date of the Capital Requirements Directive (“CRD”) for EU members:  
**January 1, 2011**
- ~\$130 billion (USD equivalent) of securitizations have been completed under the risk retention requirements
- 5 CMBS transactions representing more than \$4 billion (USD equivalent) have been completed since implementation:

– CPUK Finance Ltd	- \$1.6 billion	- February 2012
– DECO 2012-MHILL	- \$228 million	- February 2012
– Tesco Property Finance 5	- \$705 million	- January 2012
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- We noticed that the majority of the CMBS transactions used the vertical slice option for risk retention

## European Securitization with Risk Retention (in millions USD equivalent)

Sector	Year		Grand Total
	2011	2012	
Auto	19,770	3,319	23,089
Cards	7,136	2,310	9,446
CDO	2,219		2,219
CMBS	1,596	2,532	4,129
Consumer	1,452		1,452
Leases	821		821
Other	1,871	75	1,946
RMBS	70,049	14,412	84,461
<b>Grand Total</b>	<b>104,914</b>	<b>22,648</b>	<b>127,562</b>

Source: JP Morgan ABS New Issuance

# Risk Retention Amount and Measurement

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## **Required Risk Retention Amount**

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Regulatory Proposal – 5% of PAR

Potential issues:

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*Autos and credit cards outstanding balance from SIFMA (1985 -2011 issuance ) as of 12/31/2011, CLO outstanding balance from Wells Fargo (1997-2011 issuance) as of 3/12/2012.*

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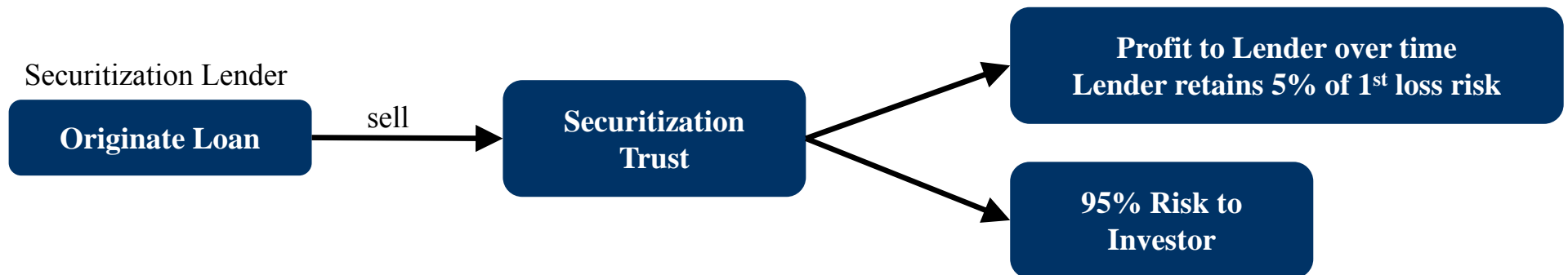
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