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WRITTEN STATEMENT OF

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ON BEHALF OF

THE MORTGAGE BANKERS ASSOCIATION OF AMERICA

NATIONAL ASSOCIATION OF REALTORS®

THE NATIONAL REALTY COMMITTEE

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GROWTH AND CREDIT FORMATION

OF THE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

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I. INTRODUCTION

Mr. Chairman, my name is Donald B. Susswein. I am a partner with the law firm of Thacher, Proffitt & Wood. On behalf of the MORTGAGE BANKERS ASSOCIAT1ON OF AMERICA (MBA), the NATIONAL ASSOCIATION OF REALTORS® (NAR) and the NATIONAL REALTY COMMITTEE (NRC), I wish to thank you and the members of the Subcommittee for your commitment to promoting capital availability for our nation's commercial sector by addressing the problems of affordable credit and access to the capital markets, and for this opportunity to provide input into the current discussion on developing broad-based securitization techniques for commercial loans.

The NAR, the NRC and the MBA represent real estate professionals engaged in all aspects of the real estate business, including the enhancing, ownership and management of commercial, industrial, agricultural, and resort real estate.

II. NEED FOR A COMMERCIAL SECONDARY MORTGAGE MARKET

The three national real estate organizations on whose behalf I am here today, wish to express their support of your efforts to encourage asset securitization and establish a secondary market for business, commercial and community development debt and equity investments. We are supportive of the basic tenor and underlying rationale of the Business, Commercial and Community Development Secondary Market Development Act (H.R. 2600). As described more fully below, however, we strongly encourage you to expand the scope of your efforts to more directly reduce impediments to the development of a secondary market for commercial real estate and other assets.

Strengthening the secondary market in commercial real estate loans will foster economic growth, create jobs and add to the financial stability of our lending institutions by increasing the flow of funds through capital markets and fostering liquidity. Securitization will not stimulate unnecessary new development activity. Indeed, it will contribute to the recovery of our commercial sector and help assure that the financial crisis experienced over the past several years will not be repeated.

Although real estate markets in selected parts of the country have begun to exhibit signs of a possible recovery, instability and deeply depressed market values are the norm in most areas. The weakness in the commercial real estate sector has triggered devastating events that extend far beyond the development site. Thousands of businesses related to the real estate industry have failed, tens of thousands of workers have lost their jobs, and numerous financial institutions have failed.

Many local economies have suffered considerably due to eroding tax bases caused by the fall of commercial real estate values. Communities have been forced to make up the difference in a variety of ways, including higher tax rates, layoffs and reduced services. In short, the deterioration of commercial property values has cut deeply into revenues that could otherwise have been used to build new schools, repair bridges, hire police and firemen, or provide other important community services.

One of the most serious problems that has impeded the stabilization and recovery of real estate markets is the lack of liquidity that has plagued the industry for more than three years. The crackdown by federal financial institution examiners on commercial real estate lending has caused a sharp reduction in the willingness of lenders to make new real estate loans or hold existing loans in their portfolios. In many instances, lenders have disregarded their customers' creditworthiness and put an across-the-board stop on commercial real estate credit. This has forced some borrowers to declare bankruptcy and has contributed to the deterioration of real estate markets and decline in property values.

Recent efforts by federal bank regulators to expand credit availability have had limited impact in the field. Banks remain skittish about making commercial real estate loans and are unlikely to resume a significant role in this type of lending in the near future. With more than $300 billion in existing commercial real estate loans expected to come due by the end of 1994, it is critical that measures be taken to assure the ability of the financial system to address constructively these outstanding obligations. An opportunity, therefore, exists to restructure these loans with the goal of absorbing these instruments into the securities markets.

III. LIQUIDITY AND RISK REDUCTION IS THE ANSWER

In the residential sector, mortgage securitization has significantly reduced the risk associated with prepayment and default of home loans. As a result, more institutional investors have been willing to invest in mortgage-backed securities. The resulting infusion and recirculation of capital has resulted in many benefits, not the least important of which has been to make more home mortgage funds available.

Securitization of commercial mortgage loans has not been a common occurrence, however, due in part to legislative and regulatory constraints.

A broad based secondary market for commercial mortgages will:

1) Provide liquidity for commercial real estate markets;

2) Reduce lenders' exposure to real estate losses and free up funds for non-real estate investments;

3) Help standardize commercial mortgage terminology and underwriting criteria;

4) Provide safer investments through information disclosure and risk-sharing;

5) Create new sources of capital investment unavailable from traditional lenders;

6) Provide credit to help assure orderly disposition of REO assets acquired by the FDIC and the RTC;

7) Make the commercial mortgage market more efficient by providing credit at reduced costs; and

8) Even out flows of funds throughout all phases of the economic cycle.

The evolution of a broad-based commercial mortgage securities market is also essential to any economic recovery and will significantly reduce the likelihood of another credit crunch. A secondary market will impose discipline in the primary market through pricing, which will reduce the likelihood of future over-building. Financial institutions will be able to more actively manage their portfolios, borrowers will not suffer periods of illiquidity in the market, and taxpayers will reap the rewards of a healthy, balanced economy.

IV. IMPEDIMENTS TO CREATION OF SECONDARY MARKET

1. Heterogeneity Of Loan Types

Numerous impediments must be removed before an active secondary commercial mortgage market can be established. For example, commercial mortgages are relatively heterogeneous in nature. They differ according to type, tenant mix, lease terms and maturities. This lack of standardization makes it difficult to evaluate and predict their performance.

Diversity of borrowers' creditworthiness and of localized economic characteristics can seriously affect loan risk. This problem complicates the task of performing due diligence on loan pools and calculating their overall quality. For example, a pool of securitized consumer loans typically consists of a large number of small loans, made on similar terms, to borrowers who have all met or exceeded pre-established and time-tested credit standards. Statistical assessments of loss expectation can therefore be calculated with respect to these loans with a reasonably high degree of accuracy. Although such consistency and accountability does not yet exist with respect to commercial loans, these characteristics are rapidly developing for commercial real estate.

2. Lack of Adequate Data

Another significant impediment to the creation of a vital secondary market for commercial mortgage-backed securities is the lack of a consistent database on the performance of commercial real estate mortgages. Some data are currently collected by the Federal Deposit Insurance Corporation, the Federal Reserve, the American Council of life Insurance and the Mortgage Bankers Association. However, definitions are often not consistently used or applied and information is not always gathered in a form most useful to analysts and investors. Better data collection and organization will facilitate the creation of pricing models for commercial mortgage-backed securities.

3. Standardization and the Development of a Central Marketplace

There is a growing movement among many parties anxious to see commercial mortgage securitization become more efficient. The Mortgage Bankers Association of America, the National Association of Realtors® and the National Realty Committee have established a consortium of top commercial banks, investment banks, pension funds, mortgage bankers, life insurance companies and borrowers to address these technical impediments. One purpose of the consortium is to gather commercial mortgage performance data necessary to create models which will accurately assess the risk of commercial mortgage securities. The consortium will also bring together the necessary expertise to create an industry consensus on standardization of underwriting and documentation. Members of the consortium maintain that a broad-based market for commercial mortgage-backed securities will not emerge until mortgages become standardized and underwritten with capital market execution in mind.

4. Legislative and Regulatory Barriers

Many experts conclude that changes to risk-based capital rules, the Secondary Mortgage Market Enhancement Act and the Employee Retirement Income Securities Act are essential in order to develop a broad-based commercial secondary mortgage market.

V. RECOMMENDATIONS

1. General

The development of a broad-based secondary market for commercial mortgages can be enhanced, in large part, through the elimination of legislative and regulatory barriers. We believe adoption of the following three changes are necessary before a broad-based commercial secondary mortgage market can be established:

broadening the Secondary Mortgage Market Enhancement Act (SMMEA) to apply to commercial mortgage securities;

amending the Employment Retirement Income Security Act (ERISA) to include a class exemption for commercial mortgage securities from being considered prohibited transactions; and changing the regulatory treatment (risk-based capital requirement) for subordinated pieces of commercial securities to avoid over-reserving.

We also believe the proposed legislation can be modified to eliminate an unnecessary regulatory burden on the Department of the Treasury by applying the proposed law to asset classes on a general, rather than on a selective basis. H.R. 2600 directs the Department of Labor to grant charters to organizations wishing to engage in secondary market operations. These "Secondary Market Facilitating Organizations (SMFOs)" would be certified by the Secretary of the Treasury in accordance with minimum eligibility requirements.

H.R. 2600 would further empower Treasury to work with other agencies to grant necessary exemptions from existing laws and regulations to facilitate an SMFO's securitization activities. Treasury would also establish regulatory and examination rules for these SMFOs.

We believe that constructive efforts to reduce or eliminate existing legislative and regulatory barriers are fundamental to the establishment of a broad-based commercial secondary mortgage market. We are concerned, however, that without additional guidance, the proposal to establish SMFO's may unduly add to the regulatory and examination responsibilities of the federal government. It may also provide financial benefits to individuals and organizations on an exclusive and restricted basis when a variety of asset classes could be better served with broad-based treatment.

2. **Risk-Based Capital Rules/Subordination**

Changes in the treatment of subordinated pieces of commercial securities under the risk-based capital guidelines, in order to negate over-reserving, are necessary to facilitate a secondary commercial mortgage market. Additionally, allowing those subordinated pieces to be traded is a necessary component of developing a liquid secondary market for commercial securities.

Unlike the residential mortgage markets, the commercial mortgage markets do not benefit from direct or implicit federal credit enhancement. There is no VA, FHA or FmHA for commercial mortgages, and no GNMA, FNMA or FHLMC to guarantee securities backed by commercial properties. The three organizations are not seeking or recommending new government credit guaranties. Some form of private credit enhancement is needed to facilitate the securitization of commercial mortgages. The residential market dealt with this situation for conventional, non-conforming (jumbo loans) with an internal form of credit enhancement known as subordination.

Subordination involves the division of a loan or a loan pool into two classes of ownership interests. One class, the subordinated piece, is the first to bear any losses arising from defaults or delinquencies. The senior piece benefits from having losses allocated first to the subordinated class.

Subordination, however, has been hampered by restrictive regulatory treatment of holders of subordinated interests and inordinate capital requirements for senior interests. Under current risk-based capital rules, a bank holding $100 million in commercial loans, for example, would be required to maintain $8 million in capital reserves. If the bank sells a 90 percent (S90 million) senior interest in the loans and retains 10 percent, it would still be required to hold $8 million in reserve, even though it only retained a $10 million investment. The current capital requirement is excessive and should be changed.

3. Secondary Mortgage Market Enhancement Act (SMMEA)

The Federal government enacted the Secondary Mortgage Market Enhancement Act (SMMEA) in 1984 to facilitate housing finance by enhancing liquidity in the secondary mortgage market for institutional investors. Enhancing the secondary market allows mortgage lenders to securitize their mortgage loans more easily and obtain fresh capital for new mortgage loans, while permitting investors to enjoy liquidity comparable to many U.S. Treasuries through the purchase of mortgage-related securities (MRS).

SMMEA includes a number of provisions designed to broaden the investor base for mortgage-related securities. Its enactment unlocked a large pool of potential demand for residential mortgage-related securities. Participants in this market were able to market these securities broadly without having to review the investment statutes of fifty states. The additional pool of demand increased liquidity and supported rapid growth in the mortgage-related securities market.

SMMEA's definition of mortgage-related securities excludes securities backed by commercial mortgages. In 1984, the Senate version, of SMMEA included commercial mortgage-backed securities. The House version which ultimately prevailed omitted commercial mortgages. At the time, there was no market for commercial mortgage securities since the first such transaction occurred that year. Since then, there have been significant strides made in commercial mortgage securitization. In addition, the REMIC provision, passed as a part of the Tax Reform Act of 1986, paved the way for issuance of multiple-class mortgage-backed securities in both equity and debt structures. The REMIC rules also draw no distinction between residential and commercial loans.

A commercial counterpart to SMMEA would decrease the cost of registering these securities, and open up investment by pension funds. The current market for commercial mortgage securities is characterized by private placement of tranches to investors. Private placements do not require extensive merit review which is conducted at the state level for public transactions. Unlike commercial transactions, public residential mortgage transactions are exempted from state merit reviews by SMMEA, simplifying the public issuance of residential mortgage securities. This treatment is not available for commercial mortgage securities.

SMMEA also significantly expanded the potential role of the private sector in the residential securities market by pre-empting state investment laws and regulations that limit investments in certain types of mortgage-backed securities. The federal pre-emption reduces issuing costs for residential pass-throughs and broadens the ability of state-regulated institutions and pension funds to be investors. Other SMMEA benefits that could be accorded to commercial mortgage securities include preferential capital treatment (e.g., 20 percent risk weighting) and eligibility for "shelf" registration procedures under the securities laws.

4. Employment Retirement Income Security Act (ERISA)

A class exemption for commercial securities under ERISA similar to the one for residential mortgage securities would encourage pension fund investment in these securities. Currently, the parties-in-interest problem makes these transactions prohibitive for pension funds. The term "parties of interest" includes any plan sponsor, employer, trustee, investment advisor, or service provider, and any 10% or more ownership parent or 50% or more ownership subsidiary of any such person.

Because the commercial real estate industry is characterized by many varied inter-relationships, mortgage pool sponsors could be prohibited from selling, exchanging,or transferring interest in mortgage pools or whole mortgages they own to funds with which they (or their affiliates) have ongoing relationships. Moreover, given the scope of the party-in-interest definition, and the possibility that indirect relationships can be picked up by ERISA's prohibited transaction rules, structuring acceptable transactions and performing the required due diligence could be very difficult, if not impossible.

In recognition of the foregoing, the Department of Labor created an exemption from ERISA's prohibited transaction and party of interest limitations for certain residential mortgage pool participations. Prohibited Transaction Class Exemption 817, as modified, and Prohibited Transaction Class Exemption 831, provides the relief necessary for pension funds and their advisors to actively trade residential mortgage-backed securities without concern about related ERISA violations, adding significantly to the liquidity and volume of the market. Exemptions 817 and 831 need to be amended to provide the same consideration for commercial mortgage pools and securities.

VI. CONCLUSION

Overcoming the legal and regulatory barriers to a commercial mortgage securities market will even out the flows of capital for commercial real estate, and to provide needed capital in other investments. The evolution of a broad-based secondary market for commercial mortgages will provide greater dispersement of information on real estate and on the entities that buy sell and manage it. This will provide greater standardization in underwriting of commercial real estate. This will result in the reduction of risk associated with such loans, thus providing greater protection to lenders and investors. The legislative and regulatory changes to SMMEA, ERISA and Risk-Based Capital Rules outlined here today would provide much needed relief to the commercial real estate industry and, consequently, to the U.S. economy.

We strongly believe that resolving the problems in the commercial real estate sector will extend to the nation's small communities and the overall economy, unable to fully recover, in large part, because of the difficulties experienced in the commercial real estate industry.

The Mortgage Bankers Association of America, the NATIONAL ASSOCIATION OF REALTORS® and the National Realty Committee would strongly support a bill that would lead to a broad-based commercial secondary mortgage market. We look forward to working with you and your colleagues towards accomplishing that objective.