Issue Area: Commercial Finance
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ISSUE: 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.

NAR POSITION: The NATIONAL ASSOCIATION OF REALTORS® believes that the ability to securitize and trade loans in a secondary market, by definition, creates liquidity. Securities are, by design, a more liquid form of investment than direct investment in real estate. Moreover, the more liquid the assets held by a financial system, the more stable, secure and flexible that system will be.

OPPOSING VIEWS:

IMPACT ON REALTORS®: What will a broad-based commercial secondary market provide to the economy, to the institutional lenders and to the real estate industry? In the long-term, commercial real estate lenders will have improved balance sheets and will have increased flexibility in their asset selections. The capacity to easily buy and sell ownership interests will enable financial institutions to manage portfolio assets and not property. Securitization of commercial loan portfolios will significantly reduce institutional exposure to real estate risks. Additionally, cash infusions from the sale of these assets will stimulate and expedite the recirculation of capital throughout the marketplace, allowing commercial banks to originate new consumer and business loans instead of worrying about portfolio overload. A salutary by-product of commercial mortgage securitization will be a healthy and flexible commercial finance industry and dependable local economies.

STATUS/OUTLOOK: On September 23, 1994, President Clinton signed into law the Riegle Community Development and Regulatory Improvement Act of 1994. A portion of this legislation removes certain legal impediments to the securitization of commercial mortgages. These securitization provisions were lifted in concept from the Commercial Mortgage Capital Availability Act, a bill introduced last year in the Senate by Senators Richard Bryan (D-NV) and Peter Domenici (R-NM), and in the House of Representatives by Congressmen Barney Frank (D-VA), Jim Leach (R-IA) and Jim Moran (D-VA). Specifically, the new Act will reduce the cost of issuing commercial mortgage securities by including "commercial mortgages" in the benefits granted by the Secondary Mortgage Market Enhancement Act (SMMEA). For example, this legislation will override state restrictions on the purchase of high-grade commercial mortgage backed securities (CMBS) by banks , thrifts, and insurer, and also streamline the issuance process by exempting these securities from state registration requirements. This legislation will also ensure that the amount of reserves a lending institution must hold against a security will more accurately reflect the true risk imposed by issuing the security.

On December, 21, 1995 the Office of the Comptroller of the Currency (OCC) issued regulations for the implementation of the Riegle Community Development and Regulatory Improvement Act of 1994. The regulations require that a single borrower comprise no more than five percent of a CMBS issue. This provision raises several concerns. First, a single borrower may have more than a single asset in a securitization. Consequently, a pool of 100 properties with a dozen owners has greater diversification than is recognized by the regulations. Second, this diversification rule does not take into account borrower credit ratings. Finally, the larger "mega" deals would have difficulty meeting the diversification test because of the small number of high priced assets that sometimes comprise these types of deals.

NAR has worked closely with the other two members of the Capital Consortium, the Mortgage Bankers Association of America and the National Realty Committee, to draft a Comment Letter to the OCC. The letter was submitted to the OCC on February 20, 1996. The Comment Letter opposed the limitation of a single obligor comprising no more than 5 percent of the securitization. In addition the Comment Letter opposed the requirement that the underlying loans of a securitization be homogeneous. Because CMBS issues often feature different property types that each require specialized provisions in the loan documents, it is unreasonable to require all loans to be homogenous. The OCC has indicated that the 5 percent diversification test will be dropped in the final regulations. The final regulations will be issued no later than the end of 1996. The Consortium supports efforts of the OCC to allow banks to purchase CMBS. However, the Consortium opposed the provision of the proposed rules that mandates a 5 percent diversification test for bank purchases of CMBS issues. In addition, required CMBS to feature "homogenous pools" of property. The Consortium opposed this provision because it would interfere with the asset class diversification of a CMBS pool. On February 20, 1996, the Capital Consortium sent a comment letter to the OCC that detailed these concerns.

On December 2, 1996, the Office of the Comptroller of the Currency issued some final regulations that were favorable to commercial real estate. The regulations create greater flexibility for bank purchases of commercial mortgage-backed securities (CMBS). Previously national banks could only purchase CMBS that were rated in the two highest rating categories (AAA, AA). The regulations will allow banks to purchase commercial mortgage-backed securities on an unlimited basis for AAA, and AA securities that have "numerous" obligors (the regulations and OCC officials declined to provide a definition for numerous obligors). For AAA, AA without numerous obligors and A, BBB securities, banks can purchase them subject to concentration limitations of 10 percent of capital stock actually paid in and unimpaired and 10 percent of it unimpaired surplus fund.

The new regulations represent a significant step forward in the evolution of the CMBS market because banks will be allowed to purchase A and BBB securities. The final regulations deleted the 5 percent diversification test and "homogeneous pool" requirement that were opposed by the Capital Consortium.

On a separate track, NAR, in conjunction with the Capital Consortium, has submitted an application to the Department of Labor (DOL) requesting an exemption from the "parties in interest clause" contained in the Employee Retirement Income Security Act (ERISA) in March 1995. DOL reviewed the submission and required clarification on a number of issues. The consortium sent a letter responding to the DOL questions and revised application in March 1996. If approved, such an exemption would encourage pension fund investment in commercial securities. On September 12, 1996, the Capital Consortium sent to the DOL a package that was intended to address concerns that were raised during the July 1, 1996 teleconference. On December 9, 1996, the DOL responded to the Capital Consortium's application with a request for additional information. On March 1998, the DOL sent a letter to the Capital Consortium that indicated that insufficient evidence had been provided that would allow a class exemption to be granted. Historically, the Bond Market Association has been more successful in obtaining a class exemption with the DOL. Consequently, at the April 19, 1998 meeting of the Capital Consortium it was decided that the Consortium would suspend its application efforts and join the Bond Market Association effort. The Bond Market Association has submitted an outline of its proposal to the Department of Labor for comment in July 1998. After receiving comments a submittal will be drafted.

On July 25, 1996, the Capital Consortium launched the Capital Markets Initiatives. The Capital Markets Initiatives are a set of tools that are intended to facilitate the development of the primary and secondary CMBS markets. The Capital Markets Initiatives consists of four elements: (1) Capital Markets Mortgage; (2) Due Diligence Checklist; (3) Data Element Guidelines; and (4) the National Public Policy and Initiatives Update. The Capital Markets Mortgage is a recommended template for commercial loans that are intended to be securitized. The Due Diligence Checklist is intended to provide an inventory of the items contained in the loan documentation. The Data Elements Guidelines are suggested reporting information from borrower to lender. The National Public Policy and Initiatives is a listing of the legislative and regulatory barriers to the development of the CMBS market that the Capital Consortium was sought to eliminate. Copies of the Capital Markets Initiatives are available for $15.00 and can be ordered by calling John Krukoff at (312) 329-8292. A revised Capital Markets Mortgage is anticipated to be made available in late summer 1998.

On August 18, 1997, the Federal Reserve revealed proposed guidelines for at-risk capital. The joint notice for proposed rule making was issued to revise their at-risk based capital standards to address the regulatory capital treatment of recourse obligations and direct credit substitutes. The proposed multilevel ratings-based approach would use credit ratings from a nationally recognized statistical rating organization to determine an institution's relative credit risk and its associated capital requirement. The proposed capital requirements are as follows:

- Securities with a credit rating of AAA, the highest rating category, would be assigned to the 20 percent risk category.
- Positions with a credit rating of BBB to AA, that with the AAA category comprise the investment-grade securities category, would be assigned to the 100 percent category or, "modified grossed up" and assigned to the 50 percent risk category.
- Positions that are not rated at least BBB would be "grossed-up" and assigned to the 100 percent risk category, subject to low-level recourse capital rule.

Under "grossed-up" treatment, a position is combined with all positions that are more senior positions in the transaction. For example, a BBB position would be combined with A, AA, and AAA positions for risk-weighted capital purposes. The "low level" recourse rule limits the capital requirements for recourse obligations to the institution's maximum contractual obligation. The proposed regulations will lower the level of reserves required for the AAA CMBS, which will bring greater stability to the commercial finance markets. However, the "gross-up" approach will cause a dramatic increase in reserve requirements. Consequently, February 2, 1998, the Capital Consortium submitted a Comment Letter supporting lower reserve requirements for AAA and strongly opposed the "gross-up" approach. As of July 1998, no action has been taken by the agencies.

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