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Capital Market Intitiatives Executive Summary

In the early 1990s, the commercial real estate industry faced a credit crunch. Many commercial real estate property owners experienced difficulties in obtaining reasonable financing, including the refinancing of existing properties. This capital dirth resulted in a drop in property values, dampened investment returns, increased delinquencies and foreclosures, as well as industry layoffs. In turn, this resulted in an erosion in state and local tax bases, which adversely impacted community services. The Capital Consortium was formed during the years of the most recent credit crunch to facilitate the flow of capital to commercial real estate properties, including multifamily housing. The Capital Consortium is comprised of the National Association of Realtors, the Mortgage Bankers Association of America, and the National Realty Committee

Recognizing that a vibrant secondary market had furnished liquidity for residential mortgages in the United States for many years, the Consortium identified several reasons why the commercial secondary market lagged behind that of its residential counterpart, including:

(1) the lack of standard document templates;
(2) inconsistency in data reporting;
(3) and unfavorable regulatory/legislative treatment.

The Consortium undertook a series of initiatives specifically to facilitate the expansion of the secondary market for commercial mortgages. Although capital availability for commercial properties has increased substantially in recent years, the commercial real estate market has traditionally experienced wide fluctuations in capital availability based upon the relative position of commercial real estate within the overall real estate cycle. Therefore, the Consortium's Capital Markets Initiatives remain important because they should help to:

(1) stabilize property values during commercial real estate downturns;
(2) broaden access to capital and enhance liquidity in a responsible fashion;
(3) and furnish more affordable financing to borrowers.

The Capital Consortium's final work product, Capital Markets Initiatives, was launched on June 25, 1995. The Capital Markets Initiatives are comprised of the Capital Markets Mortgage, the Due Diligence Checklist, the Data Elements Guidelines and the National Public Policy and Initiatives Update-- a set of complementary endeavors to assist the expansion of a secondary market for commercial securitization, including multifamily housing.

While each of these initiatives could stand alone, they are presented as a collective package. Therefore, the Capital Consortium has furnished these Capital Markets Initiatives which are summarized below, as tools to be utilized in the marketplace recognizing that the evolving commercial secondary market will dictate their eventual form.

The Capital Markets Mortgage

The Capital Markets Mortgage is designed to serve as a template for commercial mortgages that can be readily and predictably rated, to facilitate the pooling of multiple mortgages for secondary market transactions. It is not intended for use in complex commercial real estate loan transactions or in cases where one or several loans would dominate the mortgage pool. Although the language may vary from mortgage to mortgage, the Capital Markets Mortgage is geared toward promoting structural consistency in capital markets mortgage transactions. The Capital Markets Mortgage attempts to address the lack of document uniformity by organizing mortgage documents in a more standard structure, thus facilitating document review by interested parties seeking information on key provisions. The Capital Markets Mortgage attempts to achieve five primary purposes:

(1) standardize the location of provisions so that users can readily review and locate relevant sections;
(2) outline material aspects of mortgage loans for users when they initially prepare the documents;
(3) establish certain basic universal concepts that include a covenant to pay debt, a grant of security interest in the collateral, certain representations and warranties, standard legal issues, mechanical aspects, such as method of payment and other customary provisions utilized in market transactions;
(4) identify certain standard clauses for deletion if inappropriate to the transaction at hand;
(5) provide space for state-specific clauses.

The Due Diligence Checklist

The Due Diligence Checklist is intended as an easy reference to identify whether specific information is located within a loan document file. The Checklist itemizes information ranging from borrower-related documents, such as the partnership agreement, to third party reports, such as a Phase I environmental report, to evidence of other existing debt on the secured property, etc. The Capital Consortium does not intend for this listing to serve as a due diligence standard or requirement to be met by loan originators or servicers, nor does it validate the accuracy of the information contained within the file, such as tenant sales histories. Rather, the checklist should assist interested parties when pooling loans to simply record whether or not items are included in the loan file. In this way, it should ease review of loan document files, thereby expediting transaction execution.

Data Elements Guidelines

The Data Elements Guidelines aim at providing a comprehensive, uniform data framework for issuers, investment bankers, loan servicers and investors to better manage information at the security, class, pool, loan, property and tenant levels. They outline the data field type and size, the timing of updates and the existing data source(s). In drafting the data elements, the Consortium adopted an inclusive approach, with contributing representatives from all aspects of the industry, including four rating agencies. In addition, the Consortium welcomed participation from other industry trade associations, including the Commercial Secondary Market and Securitization Association (CSSA), the Public Securities Association (PSA) and the Multifamily Housing Institute (MHI) to avoid duplication of efforts. The Data Elements Guidelines attempt to:

(1) enhance market liquidity and efficiency through reporting of more consistent and reliable industry data;
(2) balance the first loss investor's need to obtain information to permit adequate monitoring of the investment's ongoing performance with information that could reasonably be obtained from the borrower;
(3) address the broad needs of the industry which do not constrain the model to existing technology or vendor capabilities that may change over time; reflect the ongoing need to update the data base model, given the dynamic nature of data needs over time;
(4) and acknowledge that the elements are extensive and that the various users of the model may opt to revise these elements upon their implementation.

National Public Policy and Initiatives Update

The Consortium's National Public Policy and Initiatives Update aim at reducing legislative and regulatory barriers to the development of a more efficient commercial secondary mortgage market, while safeguarding prudent investment. At the outset, The Capital Consortium identified the following needed legislative and regulatory reforms:

(1) amendment of the "five or fewer" rule of the U.S. Tax Code governing real estate investment trusts (REITs) to enhance domestic pension fund investment in commercial real estate;
(2) Federal preemption of state securities laws with regard to limitations on investment in commercial mortgage-backed securities (CMBS);
(3) change in the regulatory treatment by federal banking agencies of CMBS or portions of loan portfolios sold to other institutions to avoid over-reserving;
(4) and creation of a class exemption for investment grade CMBS to the Employee Retirement Income Security Act's (ERISA's) prohibited transactions and parties in interest provisions.

Throughout the Capital Consortium's tenure, tremendous progress was made in accomplishing these goals. The Omnibus Budget Reconciliation Act of 1993 removed the bias against domestic pension funds' capital investment in REITs.

The Riegle Community Development and Regulatory Improvement Act of 1994 authorized federal preemption of state securities laws, subject to promulgation of regulations by the Office of the Comptroller of the Currency and amended the risk-based capital treatment of CMBS to avoid over-reserving. The Consortium submitted an initial application for exemptive relief under ERISA for investment grade CMBS in March 1995 which was subsequently updated.

Conclusion

The CMBS market has emerged as an attractive and stable source of commercial real estate finance that has served as a counterweight to market instability. The Capital Markets Initiatives have fostered greater efficiency in the primary and secondary CMBS markets, which will ultimately provide greater stability to the commercial real estate market. However, the ever changing regulatory and legislative environment will require constant vigil to ensure that a healthy CMBS market continues to develop. A revised Capital Markets Mortgage is anticipated to be available in late summer 1998.