



## Returning Liquidity to The Commercial Mortgage Market

### Executive Summary

As explained in greater detail below, we recommend that the following critical steps should be taken in order to help enhance liquidity and facilitate lending in the private commercial mortgage market:

**1. The Investor Incentive Issue Must Be Resolved – Extend TALF To CMBS With A 5-Year Term.**

CMSA believes that extending TALF to CMBS (as envisioned by Treasury and the Federal Reserve) should help bring investors back into the market. *We strongly believe, however, that the financing term should be at a minimum 5 years (with a possible extension), that the financing be non-recourse and free of mark-to-market provisions.*

**2. The Lender “Legacy Assets” Issue Must Be Resolved.**

Lenders are saddled with “legacy assets” that were intended for securitization, taken as security for the extension of credit or otherwise retained on book. Such legacy assets now constrain lenders’ capacity to provide new financing, as they clog their balance sheets and inflict unprecedented levels of valuation volatility. Before lending can restart, lenders need to liquidate these legacy assets. *We recommend doing so through two mechanisms:*

a. ***Extend TALF To Encompass Outstanding Legacy CMBS.*** The volatility of existing CMBS can be somewhat alleviated by including outstanding CMBS as “eligible assets” under TALF provided that the ratings of outstanding CMBS have been affirmed after January 1, 2009 to be eligible.

b. ***Create A Public-Private Investment Fund To Offer An Outlet For Other Existing Legacy Assets.***

Overall, having a sound and well-functioning commercial and multifamily real estate sector is critical to our country’s economic growth and development, and to millions of U.S. businesses of all sizes that provide local communities with jobs and services.

Many of the Country’s banks and insurance companies have substantial exposures to commercial real estate, and are facing increased capital pressures as the sector struggles amid the current credit crisis. These recommendations are intended to restore this private market sector in the most effective and efficient manner.

## **Background**

While the commercial and multifamily real estate industry plays a vital role in the economy, it now faces its worst liquidity challenge since the Great Depression. It is estimated that the commercial real estate (CRE) sector supports more than 9 million jobs and generates hundreds of millions of dollars in federal, regional and local tax revenue.

Over the past year, the broader credit crisis has permeated the world's capital markets and has severely curtailed commercial lending activity. This is particularly true for the \$6 trillion commercial real estate market, which is financed in part through more than \$3 trillion of debt. Currently, banks, life insurance companies and the CMBS market represent 75% of all outstanding commercial real estate loans.

Banks and insurers, however, have tightened their credit standards and reduced loan volume in reaction to pressure to increase reserve levels and decrease commercial real estate exposure. The CMBS market has ceased to function with respect to new issuance, and the market valuations of existing bonds are extremely volatile making them very unappealing for investors. As evidence of that, the CMBS market provided approximately \$240 billion in financing in 2007 (nearly 50% of all commercial lending), but provided less than \$13 billion in issuance in 2008, despite enormous demand from borrowers.

Hundreds of billions of dollars of commercial real estate loans from a variety of sources are expected to mature in 2009 and over \$1 trillion in the next few years. Under current conditions, however, there is insufficient credit capacity to refinance this wave of loan maturities. With no liquidity and credit frozen, banks, insurance companies and the CMBS market will experience a dramatic increase in defaults and losses, which will further depress commercial real estate values. Such an outcome would place additional pressure on the already-strained credit markets, prompting additional need for government intervention and financial assistance.

## **Recommendations**

### **1. Solving The Investor Incentive Problem – TALF**

The expansion of TALF to CMBS (as discussed by both Treasury and the Federal Reserve in their recent announcements) would stimulate investor demand if –

- The permissible term of TALF loans to finance the purchase of CMBS is at minimum 5 years (with possible extension) instead of the 3 year term allowed for other ABS classes (to address the longer term nature of CRE lending and to allow newly originated loans to perform throughout the current real estate market cycle) with permissible extensions (as allowed for the other ABS classes) and

- The financing rates are set at the same rate as for the other ABS classes (L +100) with appropriate haircuts.

Such financing, by replacing private financing that has historically been available for CMBS investments, would expand the investor base for lower LTV (implied AAA-rated) CMBS as it would attract sidelined private equity funds with yield targets in excess of 12%.

## **2. Solving The Legacy Asset Problem – More TALF (for Legacy CMBS) and the Public-Private Investor Fund (for other Legacy Assets)**

- Legacy assets on bank and insurer balance sheets (including CMBS, whole loans, B-Notes, mezzanine loans, bridge loans, etc.) represent a significant obstacle to new lending because banks and insurers are unwilling/unable to commit new capital when they have not addressed the balance sheet drag of the outstanding assets.

- Financial institutions have been unable to shed legacy assets for a number of reasons, including:

- The unprecedented price volatility in the market for outstanding CMBS;

- An inability to sell large floating rate loans that were originated for securitization or syndication. Buyers of this product have been hesitant to buy because there is no financing market available for their purchases, which in part causes the underlying asset values to be extremely volatile;

- The dearth of debt capital available for financing potential purchases of whole loans, securities or other structured finance products;

- The ripple effects that a few deeply discounted asset sales by a bank or insurer would have on the balance of the institution's portfolio, regardless of the underlying credit quality of the sold or remaining assets; and

- Unlike residential mortgages, most loans backing seasoned CMBS issues are fixed-rate, long-term loans subject to onerous call provisions and thus are not easily refinaneable.

The lender legacy asset problem can be alleviated through the utilization of two separate Mechanisms – one for legacy CMBS and the other for other legacy assets.

### **a. Legacy CMBS – Extend TALF**

The easiest, most straight-forward mechanism to partially address the legacy CMBS issue is simply to expand TALF eligibility to encompass existing CMBS in addition to new issuances. The current outstanding universe of CMBS, totaling approximately \$900 billion, needs to tighten, and volatility needs to decrease in order for any new loan program to succeed; extending TALF in this manner should address this need.

To ensure that the TALF remains limited to properly rated AAA bonds, the ratings of outstanding CMBS could be required to have been affirmed after January 1, 2009 to be eligible for TALF financing.

### **b. Other Legacy Assets – The Public-Private Investment Fund**

The Financial Stability Plan's "Public-Private Investment Fund" could be employed to purchase other legacy assets. The fund should be made available to private equity funds, money managers, banks, pension funds, insurance companies and private investors. Qualified assets would include both rated and unrated securities, whole loans and other structured finance instruments.

A public-private investment fund could be structured in several ways:

- Investments in legacy assets could be structured in a manner similar to private equity transactions, where private financial sponsors would provide 20-30% equity as a general partner, and the government would provide the balance of the capital as a limited partner. The limited partner would receive a preferred return (at an appropriate spread over the federal cost of funds) after which the general partner would be permitted to receive some level of promoted return, with any upside beyond that shared between public limited partner and private general partner. By making its investment in the form of equity without a required current return, the government would facilitate the liquidation of a wide variety of illiquid assets, including land and development loans.

- Alternatively, the government could provide long-term, non-recourse, non mark-to-market financing at a conservative advance rate and at a spread to its cost of funds (arguably lower than the preferred return hurdle described above). In order to be effective for most commercial assets, the financing should have a term of 3 to 7 years with extension(s) and be fully prepayable at par.

The two approaches are not mutually exclusive. The government could provide both debt and equity options to potential private-side partners, so that the capital structure can be tailored to best fit the investment opportunity.

Utilizing both the TALF to resolve the legacy CMBS issue and a public-private investment fund to address other legacy assets should have the benefit of (a) encouraging private capital to make investments in existing assets, (b) increasing the “market price” of legacy assets, which enhances bank balance sheets and minimizes mark-to-market consequences, and (c) potentially providing current and/or long term returns to taxpayers for their side-by-side investments in financial assets.

## **Conclusion**

Market participants support decisions by the Treasury and Federal Reserve to address the commercial real estate sector in the recent Financial Stability Plan. The creation of mechanisms to encourage both new mortgage origination and investment in commercial mortgage securities is critical to establishing stability in the capital markets. By enhancing liquidity in both new issue and legacy CMBS assets, the government will allow lenders and investors to take calculated risks on commercial real estate assets, without undue concerns about volatility or broader market disruption.

In order for this plan to work and to encourage lenders to underwrite new loans, however, we must also allow financial institutions to shed their non-CMBS legacy assets, in addition to their CMBS assets, so that they have the necessary capital and balance sheet capacity to warehouse loans for ultimate disposition in the capital markets. The current supply of loans, including large floating rate loans, development loans, land and commercial real estate business loans, thus must be cleared from the books of life insurance companies, banks and investment banks.

The Financial Stability Plan broadly provides programs to achieve both of these objectives, and we are happy to offer these suggestions for the successful implementation of that plan.