



November 5, 2010

VIA ELECTRONIC FILING – www.regulations.gov

The Honorable Timothy Geithner
Secretary, U.S. Department of the Treasury and
Chairman, Financial Stability Oversight Council
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Notice and Request for Information, Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds, Docket No. FSC-2010-0002

Dear Secretary Geithner:

The Commercial Real Estate (CRE) Finance Council appreciates the opportunity to respond to the Financial Stability Oversight Council (FSOC)'s request for comments regarding implementation of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which adopts prohibitions on proprietary trading by banking entities and certain relationships with hedge funds and private equity funds, also known as the "Volcker Rule."¹

The CRE Finance Council represents the collective interests of the \$3.5 trillion commercial real estate finance market, including issuers; investors such as insurance companies, pension funds, and money managers; portfolio and commercial mortgage-backed securities (CMBS) lenders; commercial and investment banks; rating agencies; accounting firms; servicers; and other service providers. Our principal missions include setting market standards, facilitating market information, and providing education at all levels, particularly related to securitization, which has been a crucial and necessary tool for growth and success in commercial real estate

¹ Notice and Request for Information, Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds, 75 Fed. Reg. 61758 (Oct. 6, 2010) ("Request for Information").

finance. To this end, we have been, and will continue, to work closely with policymakers to ensure that legislative and regulatory actions do not negate or contradict economic recovery efforts in the CRE market, which has been greatly impacted by the recent downturn in the economy – including high unemployment, low consumer confidence and falling property values.

Our comments will focus on the aspect of the Volcker Rule that limits proprietary trading by banking entities and nonbank financial entities that are supervised by the Federal Reserve Board. More specifically, we wish to emphasize the importance of adhering to the rule of construction in Dodd-Frank which directs that the Volcker Rule should not be construed to limit or restrict lawful securitizations sponsored or participated in by banks and regulated nonbank financial entities.² The securitization markets play an important role in making all types of credit, including commercial mortgages, available to American businesses. Given this fact, and the fact that securitization is conceptually different from the types of activities the Volcker Rule seeks to address, Congress expressly excluded securitization from the scope of activities prohibited by the Volcker rule. This purposeful exclusion should be kept in mind as the FSOC studies implementation issues in connection with the Volcker Rule, and the FSOC's recommendations should caution regulators not to adopt proprietary trading rules that inadvertently or effectively have an adverse impact on the ability of covered entities to sponsor or participate in securitizations.

Background: Importance and Current Status of the Structured Finance Market

As you know, the \$9 trillion structured finance market is critical to supporting lending and overall credit availability for millions of Americans, including consumers looking to purchase or refinance a home, receive a student loan, or buy a car, and businesses that need capital to create jobs, invest in real property and fuel economic growth. The securitized credit markets have helped provide liquidity using private investors, such as pension funds, mutual funds, and endowments, who make their own capital available to support the credit markets. These investors have made available approximately 40% of the credit in the United States over the last 15 years. Indeed, the importance of these markets was acknowledged in your observation, at the height of the credit crisis, that “[b]ecause this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small.”³

Today, the securitized credit markets (which include residential and commercial mortgage loans, student loans, auto loans, credit card, small business and corporate loans, among

² See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619 (adding Section 13(g)(2) to the Banking Holding Company Act of 1956).

³ Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009), available at <http://www.ustreas.gov/press/releases/tg18.htm>.

others) face a multitude of challenges that, when taken together, will undoubtedly continue to impact the capital and liquidity needed to support credit availability:

- First, credit capacity remains constrained despite enormous borrower demand and significant loan maturities (e.g., \$1 trillion in commercial mortgage loans in the next few years), while asset values continue to decline (i.e., there is an “equity gap” between loan amount and asset value). This combination of difficulties is most keenly affecting the commercial and residential mortgage sectors.
- Second, recent securitization accounting changes (known as Financial Accounting Standard (FAS) 166 and 167) have been finalized, and combined with new regulatory capital guidelines, could significantly limit the capacity and the overall amount of capital that can be directed toward such lending and investing. These accounting changes are being implemented at the same time that the securitization markets are attempting to recover from a historic decline and regulators are drafting new rules intended to govern the industry.
- Third, implementation of regulatory changes in an uncoordinated manner has a short term chilling effect on the credit markets. In addition to the accounting changes, we are seeing a growing number of reforms that include risk-based capital changes, and risk retention (i.e., “skin-in-the-game”) proposals from various regulatory agencies including the Securities and Exchange Commission and the Federal Deposit Insurance Corporation, in addition to those adopted in Dodd-Frank.

With more than \$1 trillion in commercial mortgages maturing in the next several years, many of which face an “equity gap” between property value and loan amount, we have a particular interest in facilitating a revival of the CMBS market, which presently represents approximately 25% of all outstanding CRE debt and accounted for as much as 50% of all new CRE lending in 2007.

Today, uncertainty related to regulatory changes and their interaction with accounting rules remains a major impediment to private lending and investing that is critical to a CRE recovery. There are serious questions about the viability of the CMBS market when considering the combined impact of reforms on the market and concerns about whether implementing regulators will coordinate reforms and customize risk retention requirements for inherently different asset classes, as directed by Dodd-Frank.

While it has been correctly asserted that some asset classes, such as residential mortgage-backed securities, remain dormant, we believe it is important to note that the CMBS market is showing signs of revitalized activity, which makes deliberate and coordinated policy and implementation by asset class even more crucial at this critical time. In fact, there have been seven CMBS deals completed this year with a total issuance of \$4.5 billion through the third quarter. Further, industry analysts predict that CMBS issuance for the fourth quarter 2010 alone will range from an additional \$4 billion to \$8 billion, and as much as \$35 billion of CMBS issuance in 2011, depending on a number of factors, including regulatory certainty. These figures are small compared to the \$238 billion in issuance in 2007, but the progress is timely

given the number of CRE loan maturities in the next few years, and is encouraging considering that private issuance ceased for six quarters until the first non-TALF deal was issued in December 2009.

We believe it also is worth noting that the CMBS transactions that have recently taken place have been structured with low-leveraged and well-underwritten loans, and feature even greater transparency, which further amplifies the differences between CMBS and other asset classes and highlights the need to carefully consider rules by asset class, as directed by Dodd-Frank.

Likewise, during debate on the Volcker Rule in Congress, many questions were raised about how the restrictions contemplated by the rule might affect securitization. These questions were prompted by the fact that asset-backed securities (ABS) issuers (almost all of which are now owned by bank holding companies) purchase or originate loans to place in pools and then sell the pools through bond issuances. There was concern that the Volcker Rule's prohibition on proprietary "investing" by banks was drafted so broadly that it could be interpreted as including the acquisition and origination of loans for the purpose of pooling the loans for securitization.

Congress recognized, however, that such acquisition and origination activities are distinguishable from ones in which the bank itself is an investor acquiring assets for its own separate portfolio – investments which should be relatively low-risk under the Volcker Rule's rationale. In contrast, in the case of securitization, the loans are being acquired or originated so they can be packaged and sold to other investors. Indeed, securitization is now a core banking activity and banks use it as a mechanism to manage their credit exposure. Significantly, securitization also allows banks to make more loans by freeing up their balance sheet capacity, and brings more private capital into the credit system. For all of these reasons Dodd-Frank Section 619 includes the direction that the Volcker Rule is not to be construed to limit or restrict lawful securitizations. The clarification is especially important given the current state of the CRE market, discussed above, because at this juncture, securitization is vital to the CRE market's recovery. It is against this backdrop that we provide our comments regarding implementation of the Volcker Rule.

Recommendations Concerning Implementation of the Volcker Rule

As directed by the Request for Information, the questions to which we are replying are noted at the beginning of each response:

1. In what ways can the implementation of the Volcker Rule best serve to: (i) promote and enhance the safety and soundness of banking entities?

Implementation of the Volcker rule can help promote safety and soundness by adhering to the Congressional intent to avoid adopting rules that restrict the ability to engage in lawful securitization. As mentioned, securitization is now a core banking activity. Through securitization, institutions are able to free up more balance sheet capacity for lending, which facilitates earning of revenues from lending operations, in addition to revenues earned as sponsors of securitizations. Securitization also helps banks reduce credit exposure by allowing

risk to be spread among knowledgeable investors who are willing and able to accept the risk. Securitization is, therefore, relevant to both the safety and soundness of these institutions. Any inadvertent restriction would have an immediate and palpable impact on institutions' ability to lend and to securitize, which can only have an adverse impact on their safety and soundness.

2. What are the key factors and considerations that should be taken into account in making recommendations on implementing the proprietary trading provisions of the Volcker Rule?

As discussed, Congress exempted securitization from the Volcker rule both in recognition of securitization's importance to the economy and in recognition that securitization is conceptually different from the types of conflicts of interest and high-risk activities the Volcker Rule seeks to address. Equally important, Congress understood that certain activities are less likely to raise these types of concerns, such as risk-mitigating hedging activities, and market-making activities.⁴ Furthermore, Dodd-Frank specifies that entities may continue to engage in these "Permitted Activities" without running afoul of the Volcker Rule.

Accordingly, it is critical that the FSOC's recommendations remind regulators that they should not adopt implementing regulations that, nevertheless, inhibit or restrict the ability of institutions to securitize assets or participate in securitizations.

4. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should inform decisions on the definitions of:

(xi) "risk mitigating hedging activities."

"Risk-mitigating hedging activities" are among those on the "Permitted List" under the Volcker Rule, and also are specifically excluded from the definition of transactions creating a conflict of interest under Section 621 of Dodd-Frank, which prohibits material conflicts of interest between underwriters, placement agents, initial purchasers or sponsors of securitizations vis-à-vis any investor in the transaction.

The exception recognizes that risk-mitigating hedging activities are necessary "market protective" mechanisms that are legitimately used by securitizers to maintain their financial stability. Accordingly, the statute seeks to strike a balance between fulfilling the legislation's objective of proscribing conflicts of interest while avoiding the imposition of undue constraints on the ability to appropriately manage risk.

In the CRE sector, risk-mitigating hedging is necessary because several risks inherent in any commercial mortgage or security exposure arise not from imprudent loan origination or underwriting but from outside factors such as changes in interest rates, a sharp downturn in economic activity, or regional/geographic events such as a terrorist attack or weather-related disaster. CMBS securitizers attempt to hedge against these market-oriented factors in keeping

⁴ See Dodd-Frank § 619 (adding Section 13 (d) to the Bank Holding Company Act).

with current safety and soundness practices, and some examples in this category of hedges are interest rate hedges using Treasury securities, relative spread hedges (using generic interest-rate swaps), and macro-economic hedges (that, for example, are correlated with changes in GDP or other macro-economic factors).

The hallmark of this category is that these hedges seek protection from factors the securitizer does not control (e.g. interest rate risk), and the hedging has neither the purpose nor the effect of shielding the originators or sponsors from credit exposures on individual loans, nor the imprudent selection the loans underlying the securities. As such, hedges are used to mitigate risks that relate to generally uncontrollable market forces. There is no way to ensure that any such hedge protects 100% of an investment from loss – particularly as it pertains to a CMBS transaction that, for example, is secured by a diverse pool of loans with exposure to different geographic locations, industries and property types. Therefore, loan securitizers that must satisfy a retention requirement, as may be required by Dodd-Frank, continue to carry significant credit risk exposure that reinforces the economic tie between the securitizer and the issued CMBS even in the absence of any hedging constraints.

For these reasons, the term “risk-mitigating hedging” should not be defined in a way that would prohibit securitizers from using market-oriented hedging vehicles for protection from factors for which it would be imprudent not to mitigate risk (e.g. market risk or interest-rate risk), and should therefore be defined in a broad enough manner to allow hedging to be used for global credit risk management.

Conclusion

We appreciate the opportunity to offer our insights concerning the implementation of the Volcker Rule, and urge the FSOC to provide clear, unequivocal recommendations to regulators concerning the need to ensure that these regulations do not inadvertently hinder or constrain lawful securitization transactions by banks and regulated nonbank financial companies. We stand ready to provide any additional assistance that may be helpful.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "John D'Amico". The signature is fluid and cursive, with a large initial "J" and "D".

John D'Amico
Chief Executive Officer
CRE Finance Council