House Financial Services Committee, Subcommittee on Capital Markets and Government Sponsored Enterprises
Hearing on:
"The Impact of the Dodd-Frank Act and Basel III on the Fixed Income Market and Securitizations"

February 24, 2016

Written Testimony of the
Commercial Real Estate Finance Council

Executive Summary

The Commercial Real Estate Finance Council ("CRE Finance Council" or "CREFC") appreciates this opportunity to provide the Subcommittee with testimony on the impact of Dodd-Frank and Basel III on securitizations and the fixed income market.

The CRE Finance Council is the collective voice of the entire $3.5 trillion commercial real estate finance market. Its members include all of the significant portfolio, multifamily, and commercial mortgage-backed securities ("CMBS") lenders; issuers of CMBS including banks, insurance companies, Government Sponsored Enterprises (GSEs), and private equity funds; loan and bond investors such as insurance companies, pension funds, specialty finance companies, Real Estate Investment Trusts ("REITs"), and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers. Our industry plays a critical role in the financing of office buildings, industrial complexes, multifamily housing, shopping centers, hotels, and other types of commercial real estate that help form the backbone of the American economy.

Our principal functions include setting market standards, facilitating the free and open flow of market information, and education at all levels. Securitization is one of the essential processes for the delivery of capital necessary for the health of commercial real estate markets

and broader macro-economic growth. One of our core missions is to foster the efficient, transparent and sustainable operation of CMBS. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to help optimize market standards and regulations.

CMBS is a form of financing whereby commercial mortgages are pooled in a trust and informed investors buy bonds based on the income stream of the mortgages. The bonds are tranched into different risk levels that match investor risk/return objectives. By providing access to the public capital markets, CMBS allows banks and other mortgage originators to free up their balance sheets so they can recycle their limited balance sheet capital into new loans. It is efficient and de-concentrates risk that could otherwise overweight the balance sheets of banks as we saw during the Great Recession.

CMBS is about 25% of all commercial real estate lending – about $100 billion per year. It expands the pool of available loan capital beyond what balance sheet lenders (banks and insurance companies) can contribute to meet borrow demand. There is $600 billion of outstanding CMBS debt, $200 billion of which will need to be re-financed in the next two years. Many of the borrowers are in secondary and tertiary markets. CMBS financing may be the only, or at least the most cost effective, financing they can get.

Since 2010, regulators have sought to implement the Dodd Frank mandate of reducing systemic risk in the financial services sector. Several regulatory agencies were tasked with working collaboratively on rules and reaching consensus. With such a daunting task, it is of no surprise that many aspects of the rules apply broadly across asset types and lack specific correlation to the varying characteristics of different asset types and industry sectors, i.e. CMBS. The problem is “One size does not fit all”.

To date, CMBS is subject to Regulation AB II, the Volcker Rule, Basel III (HVCRE, Liquidity Coverage Ratio and Risk-Based Capital), and, of course, the Dodd-Frank Risk Retention rule. The sheer number of new rules and their breadth is resulting in a significant retrenchment by banks and illiquidity in the markets. In many cases, the regulatory burden outweighs the prudential benefit.

Also, there is a growing concern that regulation is institutionalizing inefficiencies. Today, CMBS investors are demanding return premiums similar to corporate junk bonds yet property fundamentals are strong. Property owners face the prospect of higher rates on loans, tougher credit and diminished property values as debt issuance slows. Estimates for 2016 issuance have been downgraded from over $100 billion to $70 billion.

The market is becoming fragile – even before half of the planned regulations come into place. Illiquidity and volatility are becoming the norm.

Why is the CMBS market suffering dysfunction? There are many macro external factors disrupting the capital markets. But, it's clear regulation has a role too … and a big one.

Regulators broadly have concluded that securitized loans are more risky than loans kept on balance sheet -- regardless of the underwriting, credit or collateral. The regulatory cost of capital they impose is simply based on the lending platform. This is a flawed premise.

Because of this burden, CMBS is losing institutional capacity. Banks and mortgage originators are leaving, or substantially reducing, their commitment to the market. Once industry capacity is shut down, it takes a long time before this capacity can be re-generated.

Loss of capacity is problematic in the short run and dire in the long run. When we get to a point in the cycle where capital and credit gets scarce -- and we will -- then the loss of CMBS capacity will hit borrowers broad and hard. Additionally, CMBS bond investors typically are

pension funds and insurance companies. What hurts CMBS also hurts pensioners and life insurance beneficiaries.

A modest but important step Congress can take is the following:

Specifically, we urge Congress to provide modest relief from the Risk Retention rules for one sector of CMBS known as the Single Asset Single Borrower (SASB) market. SASB is a securitization of a single, large mortgage on one asset such as a mall, hotel or office building. Financing for these large, high cost assets is often beyond the scope of one lender. Therefore, it's more efficient to use CMBS financing i.e., the public capital markets.

Investors invest enthusiastically in SASB securitizations because the assets perform extremely well and are easy to analyze and underwrite. SASB is not a multi mortgage conduit transaction. The idea of risk retention was to protect investors buying conduit securitizations where you had dozens of asset in a pool and it was hard for investors to analyze what they were buying. Nevertheless, regulators, with a broad brush, applied risk retention to SASB. This lacks rationale and will do more harm than good.

Not only does this add cost to borrowers and reduce yield to investors, it is expected to hamper the competitiveness of SASB to the point that capacity leaves the sector.

Representative French Hill is promoting a bill that includes very modest changes to the risk retention rules, including an exemption for the single asset, single borrower CMBS. We fully support this legislation and urge the Committee to do so as well.

Introduction

The legislators and regulators had a daunting mission in restoring the health of the financial services sector following the financial crisis and the Great Recession. Eight years later, we have the benefit of empirical data and anecdotal experience about the very real costs of a

macro economic crisis and also, the costs of regulation. It is now also a generally held view that deceleration in growth is likely to be a longer term feature of the national and global economies.

It is within the context of this growth picture that we must revisit our regulatory regime, and specifically its deleveraging objectives, as well as the assumptions and the math behind them. It is critical to note that the Group of Twenty (G20) first added financial regulation to its agenda in 2009, broadening and enhancing the role that the international regulatory bodies played in determining home country requirements. At that time, goals for reducing leverage in the system were based on trends and observations ending with the deepest points of the mark-to-market losses. At the same time, there was little emphasis on the economic effects of regulation. It still remains a challenge to determine the collective effects and costs of the cumulative regulations aimed at the structured finance marketplace, because the rules are still being written.

While the regulators periodically revisit the deleveraging question in speeches and analyses, the U.S. regulators, in particular, seem unwilling to meaningfully investigate the role that regulation is playing in the fracturing of markets, fund flows and the global slowdown. This frustration was felt by CREFC during the rule writing process. We provided to regulators data supported recommendations for modest modifications to the proposed risk retention rules but found little receptivity. Now, CMBS is dislocating and the effects of regulation should be addressed.

While much of the volatility in the current market is the result of geopolitical and other forces, the strong contingent of CREFC's members believe that regulatory burden is responsible for reducing liquidity in and weakening the resilience of our market. Many believe that liquidity is the CMBS linchpin and that the regulations are causing permanent damage to it. Yet, even buy-and-hold investors, such as the pension fund universe (that is reportedly 6.99% invested in

real estate)[1] need market liquidity in order to be able to meet their own regulatory and fiduciary requirements.

CREFC and its members believe that thoughtful regulation can be a net positive and that some new requirements have improved the marketplace. Within the context of the global slowdown and the observable causality between certain regulatory impediments and market dislocations, CREFC believes deleveraging goals and the implementation of certain regulatory requirements should be reexamined.

A significant driver of this deterioration in the CMBS market is regulation. While the broad intent of the regulations is well-founded, the overwhelming burden of rules that lack tailoring to the characteristics of different asset classes provides little marginal prudential improvement, if at all. At the same time, these rules generate significant costs to the end users (i.e., borrowers and consumers) and to savers whose investments are devalued as a result. Consequently, there is a growing chorus of urgent concerns from all ends of the industry that regulation is institutionalizing inefficiencies and could even severely disable the CMBS market. Moreover, lenders and investors agree that a dislocation in CMBS will travel quickly throughout the commercial real estate ("CRE") debt and equity markets, impacting valuations and fundamentals and potentially inciting a negative feedback loop throughout the sector by depressing values and increasing defaults. Certain aspects of the marketplace are so fragile today -- even before half of the planned regulations come into place -- that CMBS is experiencing severe pricing volatility, a marked contraction in issuance and reduction in capacity. We are working on borrowed time to investigate the solution and to initiate remediation.

[1] According to a recent survey, U.S. institutional tax-exempt exposure to real estate debt and equity grew to $835 billion. One of the largest Asset Managers, TIAA-CREF, has $82 billion, or 9.4%, in exposure of a total of $866 billion in AUM as of 3/31/2015. http://www.pionline.com/article/20141027/PRINT/310279999/real-estate-managers-back-over-1-trillion-again

CMBS the Asset Class and Historical Performance

The securitization of commercial mortgages began out of the necessity to clean up the balance sheets of taxpayer-backed depository institutions in the late 80's and early 90's. A combination of excess development in the wake of strong commercial property demand, a subsequent economic downturn, tax reform, and loose credit from depository institutions led to a drastic overbuilding of office properties. By 1989, 534 depository institutions became insolvent due to imprudent loans. Congress created the Resolution Trust Corporation (RTC) in 1989 to dispose of the failed institutions' bad loans. The RTC pooled the mortgages and sold them off as diversified bonds, creating the first CMBS issuances. Since then, the market has become much more transparent and investor-centric.[2]

Credit retracted nationally across industries. Not only had the universe of lenders shrunk dramatically, but the few banks that could lend on property were reluctant to do so, prompting innovative financiers to bypass the banking system for the capital markets. They pooled commercial loans and sold bonds tied to those loans to sophisticated institutional investors from pension funds and insurance companies. By 1998, issuance topped $50 billion per year, and by 2007, issuance topped $200 billion per year.[3]

One of the attractive features of CMBS was that institutional investors (entities with monthly, quarterly or actuarially-driven cash flow obligations) could achieve greater diversification across geography and asset class than by purchasing or originating whole loans themselves. Instead of owning a $50 million loan on a *single* property, the investor could purchase $50 million worth of bonds equally diversified on a pro-rata basis across 40-100 loans

[2]Alan C. Garner, "Is Commercial Real Estate Reliving the 1980s and Early 1990s," https://www.kansascityfed.org/publicat/econrev/pdf/3q08garner.pdf (2008)
[3] Sam Chandan, "The Past, Present, and Future of CMBS," http://realestate.wharton.upenn.edu/research/papers/full/730.pdf (2012)

in 10-30 individual markets. And importantly, the investor could decide how much risk they wanted to take based on a bond's seniority in the capital structure and the duration of the security. The most secure bonds received cash flow payments first, while the riskiest bonds last. In the event of a distressed sale, bond holders are paid before the borrower who contributed the equity. Typically, these securities offer more yield, transparency and diversification than similarly-rated corporate bonds.

At the asset level, an investor, generally a business entity (a partnership or corporation) – seeks to purchase a commercial property and obtain debt financing on that property. Each commercial property can be thought of as a self-contained business with an income statement and balance sheet. The rents charged to use a property – including monthly apartment, office, or retail rents – serve as the "sales" or revenue for the business.

Similarly, a property has expenses in the form of third-party property management fees (landscaping, maintenance, etc.), property taxes, insurance, leasing expenses (as in the case of an apartment leasing manager, or a retail leasing agent, who go and find renters for the property), and non-capitalized annual repairs to the property. These expenses subtracted from total revenues represent the property's profit and loss, or "P&L". It is through this number that all applicable underwriting calculations, such as debt service coverage ratio ("DSCR"), whether from the investor or lender, are calculated.

The property owner's ability to pay off debt is not measured (since all CMBS loans are non-recourse) – but rather, the *property's*, or business's ability to service monthly payments is measured. A mid- to long-term holder of commercial property, regardless of property type, buys a building based on how much cash flow, or yield, the asset will generate each year, and considers hundreds of data points (ongoing surveillance of CMBS is reported on a monthly basis

via the CREFC Investor Reporting Package, or "IRP" which contains more than 800 data points as well as supplemental reports)[4], in addition to a business plan that includes market information ranging from demographics, supply and demand factors for the asset type, and relative positioning to comparable products.

Post-financial-crisis (also known as "CMBS 2.0"), there are two distinct CMBS markets: the conduit market and the single-asset single-borrower market.

The conduit market pools commercial mortgages ranging in size from $2 million to over $100 million (but generally not more than $100 to $300 million). These loans are stabilized, cash-flowing properties with three years of operating history and professional ownership. As thousands of small banks either closed their doors or were purchased by larger firms in the wake of the 2008 credit crisis, conduits remain a substantial source of debt for secondary and tertiary market real estate operators. Conduit financing provides capital for grocery-store shopping centers, strip malls, family owned hotels, shopping malls, and apartment buildings.

The other type of CMBS lending is single asset/single borrower SASB loans. These loans typically are over $250 million and are made on a single, large property or portfolio of properties owned by one borrower such as large, well-capitalized, public and private real estate companies. Last year, SASB made up over one-third of the total CMBS market, up from roughly 10% historically. Institutional investors enthusiastically invest in SASB bonds. The demand for this market came about as banks and insurance companies were unable or unwilling to offer their balance sheets to finance trophy buildings or portfolios of properties. The credit characteristics of these loans are highly desirable – often many times oversubscribed by investors. Due to the durable nature of commercial real estate's cash flow, and subsequently the

[4] For information on the IRP, please visit: http://www.crefc.org/irp or see Appendix A. This information anticipated by almost 20 years asset-level information now required by the SEC for other asset classes.

CMBS bonds, the asset class as a whole has performed extremely well. The all-time cumulative loss rate for SASB transactions is 0.25%, and 2.79% for conduit transactions.[5]

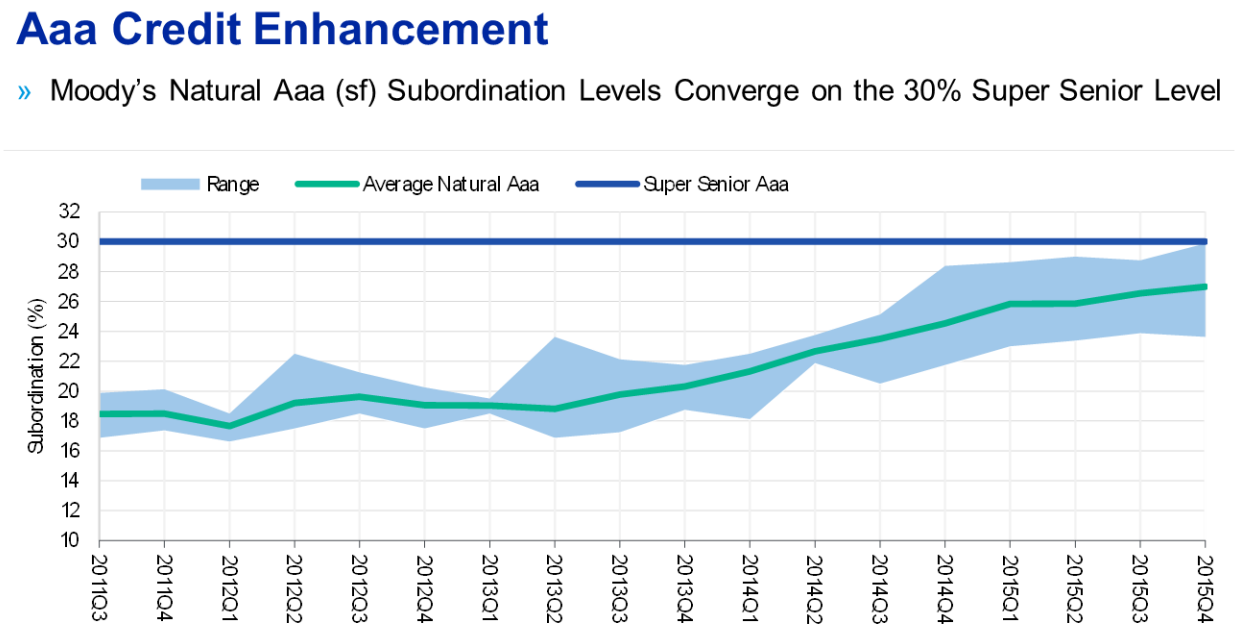
SASB transactions performed better in the depths of the crisis than most fixed income markets perform under *efficient* market conditions. Due to the structure and transparency of SASB deals, investors were (and still are) able to make informed decisions. Addressing the risk retention rule's treatment of SASB transactions is an important recommendation moving forward. The idea of risk retention was to protect investors buying conduit securitizations with as many as 300 assets in a pool. Nevertheless, regulators, with a broad brush, applied risk retention to SASB. This lacks rationale and will do more harm than good. CREFC discussed these issues at length with the Agencies responsible for crafting the risk retention, and our list of submissions to the regulators can be found in Appendix B.[6]

Difference between CMBS 1.0 and 2.0 / 3.0

The CMBS market has greatly evolved in several critical ways since the crisis: 1) pro-forma (aspirational) underwriting is fairly rare and is certainly no longer the norm; 2) CMBS deals include much greater levels of subordination, or cushion, to absorb potential losses (see Exhibit 1 below); 3) collateralized debt obligations (CDOs) backed by CMBS are no longer

[5] As of 08/31/2013, per CREFC's comment letter to regulators.
[6] See CREFC's Letter to various regulators on Risk Retention: http://docs.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Risk%20Retention%20Proposed%20Rule%20Comment%20Letter.pdf

issued; and, 4) even greater transparency and information is provided to investors.



Source: Moody's Investors Services

Even though the recent economic conditions were primed to result in a return of aggressive lending and funding in recent years, the levels of loan and deal level leverage remained much lower than in CMBS 1.0. Importantly, the double leverage that came with CDO funding, seems to be completely wrung out of the system.

Early regulatory and industry intervention at the beginning of the crisis was successful at weeding out the most ambitious lending and financing forms from the CMBS industry. The combination of accounting changes and additional requirements of the rating agencies as well as other rules helped to stabilize the CMBS market starting in 2010.

CREFC members also played a vital role in this stabilization, as our community contributed a critical new feature of the CMBS 2.0 marketplace - additional transparency

measures in the form of the Annex A, the deal package; and an Investor Reporting Package ("IRP"), a monthly report with over 800 data fields and supplemental reports providing insight into asset, loan, and bond level performance, as well as the final disposition of specially-serviced CMBS loans (See Appendix A for more details on CREFC IRP). CREFC and the CMBS industry have self-regulated over the years as investors demanded standardized deal documents and up-to-date performance data.[7]

In 2009, CMBS issuance had collapsed to almost $0 from a height of $231 billion in 2007. Issuance rebounded to roughly $100 billion in the private label market last year. Until recently, many bonds had excess bidders and the CMBS enjoyed inflows of capital correspondent with performance. It seemed that despite low interest rates, market participants generally agreed that CMBS was functioning well in the main.

As a result, CMBS 2.0 has continued to evolve. More stringent accounting and rating agency rules resulted in greatly reduced economic incentives in CDOs. Now that CMBS are not re-leveraged through CDOs, the dollar value of investable capital is lower today than it was when rates were higher. In addition, the rating agencies have all significantly revised their models and required much greater amounts of subordination. In other words, the bonds at the bottom of the stack that absorb losses have roughly doubled. Thirdly, better transparency in the form of Annex A and the IRP, now in its 8th version, has reinforced better underwriting standards and more extensive due diligence. While the market is constantly evolving, CREFC believes that these positive conditions are not temporary, but rather more permanent features of the CMBS 2.0 and 3.0 markets.

[7] A full list of these self-regulatory measures is available in CREFC's letter to the Federal Reserve System, the FDIC, Treasury, the SEC, and the OCC: http://docs.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Risk%20Retention%20Proposed%20Rule%20Comment%20Letter.pdf

Moving Past Equilibrium with the Regulatory Regime to Burden

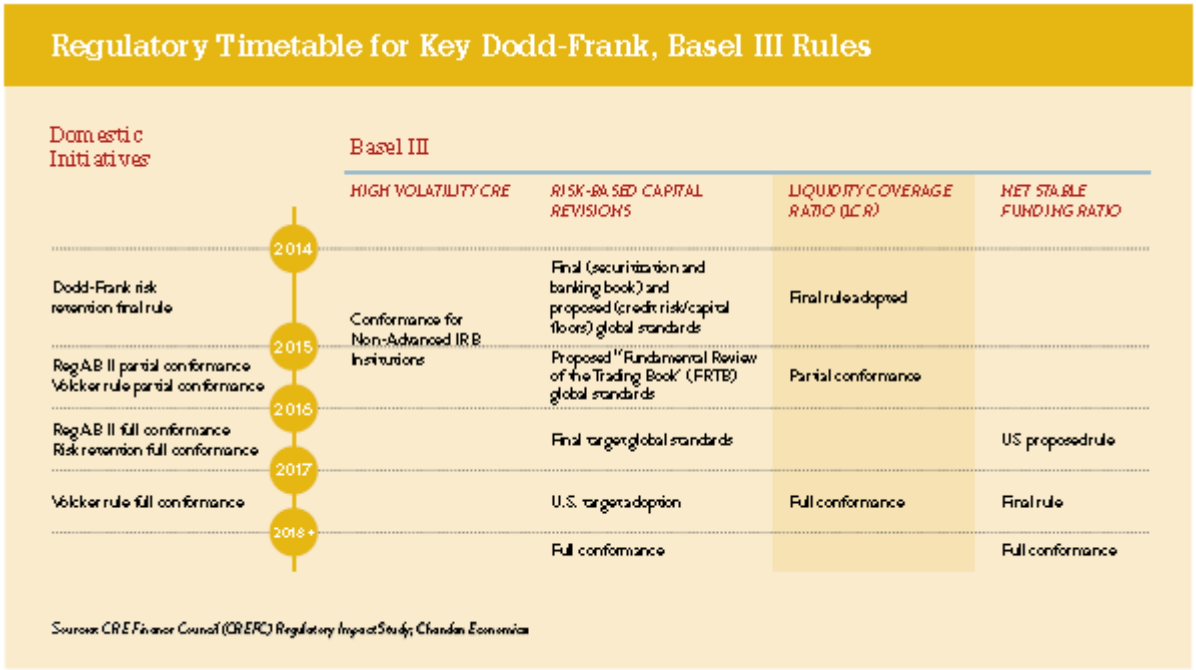
The CREFC community is generally supportive of prudent regulation that appropriately weighs the cost of the regulation with the corresponding prudential benefit it is expected to achieve. In our comments to the various regulators, including the Securities and Exchange Commission ("SEC"), we made this fact known and expressed a desire to work with them in identifying solutions that would enhance positive market practices, including those put in place by the CMBS market itself. Currently, the CMBS market is subject to an extraordinary amount of direct regulation. Further there are innumerable rules that indirectly impact the market by greatly changing the conditions under which the entire financial system operates. These rules then drive the conditions in which CMBS functions. Of the subset of these new rules that affect CMBS most directly, there are:

- the accounting changes FAS 166 / FAS 167;
- rating agency rules;
- Regulation AB II (a set of disclosure requirements);
- reporting requirements to the TRACE facility;
- the Volcker Rule (which sanctions CMBS market making but presents a set of very high hurdles for compliance);
- the Basel III leverage ratio (which affects how market making desks fund themselves with repurchase agreements);
- the liquidity coverage ratio and risk based capital; and
- the risk retention rule (which requires that issuers hold 5% of a securitization).

Last year, CREFC produced a study[8] of the regulatory impacts on the commercial real estate sector overall and found through interviews and quantitative analysis that taken together, regulation has done some good things for our sector, but it has also reconfigured the structure of the markets in such a way that makes it ultimately less resilient in times of stress and also generally runs counter to broader policy goals.

CMBS Liquidity and Market Resiliency

The universal concern of all industry participants is that the constant march of new regulatory requirements will create such a drag on margins that a critical mass of participants will exit. Many CREFC members have commented on this likely end game for CMBS now that they can envision a more complete regulatory timeline.



Starting with the risk retention rule, which goes into effect on December 24 of 2016, borrowers, issuers, and investors are keenly analyzing implementation at this time. CREFC

8 http://www.crefc.org/CREFC/Publications/Regulatory_Impact_Study/CREFC/Resources/Regulatory_Impact_Study.aspx?hkey=47af34d5-3cea-43e1-942f-309fd7508928

gathered estimates last year, and found that the regulation would likely add roughly 10% to the interest rate the borrower pays. This number was calculated assuming stable conditions and *before* CMBS participants started to consider the implementation challenges in earnest. Based on a sampling of issuers and investors more recently, CREFC found that on average, our members believe that much of the current spread widening is driven by regulatory burden, suggesting that the 10% of marginal costs originally estimated will prove to be lower than the actual costs incurred in a volatile trading environment such as the one prevailing for some time now. Given that risk retention is the next piece of regulation to move into effect for our sector, it can reasonably be credited as the greatest driver of costs to the borrower at this time and one of our industry's priorities.

CREFC and its members have consistently supported differentiated treatment for SASB bonds, because the asset class has performed better than most other fixed income sectors, and in some ways, is simply the best performing sector ever through a crisis. Yet, the six regulators that were obligated to promulgate rules related to asset-backed securities, chose to include SASB deals in the coverage universe, even though there was very little, if anything, more that regulation could accomplish with the sector. This rule that was written with conduit structures in mind, will be applied to the SASB universe, despite the fact that the requirements cannot be adopted without wholesale restructuring the SASB model and the market with it.

Additionally, it is important to note that risk based capital rules and the liquidity coverage ratio are steep for our sector, and, more importantly, they treat CMBS relatively poorly compared to other financial instruments. Additional rounds of Basel capital requirements will make CMBS even less viable. Based on a series of interviews conducted with market leaders since the beginning of 2016, the Fundamental Review of the Trading Book (FRTB), which

changes capital requirements for all inventories kept for market making purposes, has been cited as one of the most concerning pieces of regulation, if not the most. Even though the Basel Committee on Banking Supervision (BCBS), reduced the magnitude of the charges applied to CMBS in the final version of the FRTB published on January 14, of this year, these requirements place commercial real estate backed-deals on par with subprime residential mortgages. In turn, it will be even more challenging to allocate capital to CMBS businesses, and ensures continued reduction in secondary market liquidity below even today's levels.

The Liquidity Coverage Ratio (LCR), which is the first of two new liquidity requirements under Basel III, is also an example of regulatory extremism. Again, CMBS is treated the same as residential mortgage-backed securities, despite considerable differences in transparency levels, investor base, systemic risk profile, and many other features. The LCR delivers an unexpected punch to CMBS by requiring that issuing banks reserve liquid assets against the CRE loans they no longer own, considering that issuing banks in no way benefit from or are obligated to support these bonds.

Regulation and Liquidity

In short, these regulations are and will continue to have a significant impact on CMBS. The precipitous decline in CMBS liquidity, especially the prolonged spikes in bid-ask spreads, are particularly troubling and suggest that the market is trading inefficiently in anticipation of the next round of regulation. Moreover, certain trends suggest that the pattern may be sustained for some time, if not deepened:

1) Participants are quickly leaving the market:
    a. The number of market making platforms is declining rapidly, especially those that provide balance sheet and that can hold inventories. One member investor

speculated that there were ten true dealers with capacity to hold inventories and to make markets across a range of new issues last year; that number was halved by year-end 2015 and as of this writing, the number is now down to two or three. The results of the CREFC liquidity survey are aligned with this member's point of view.

b. As expected, the investors who relied on liquidity – those who care more about total returns than relative value – have exited *en masse* in lock step with the liquidity providers, leaving a distinct and troublesome gap at the lower end of the bond stack.

c. While there were roughly 40 conduit lenders last year, they too are starting to close their doors.

2) The features of the market have permanently shifted, and remain lower than during the recovery (2011):

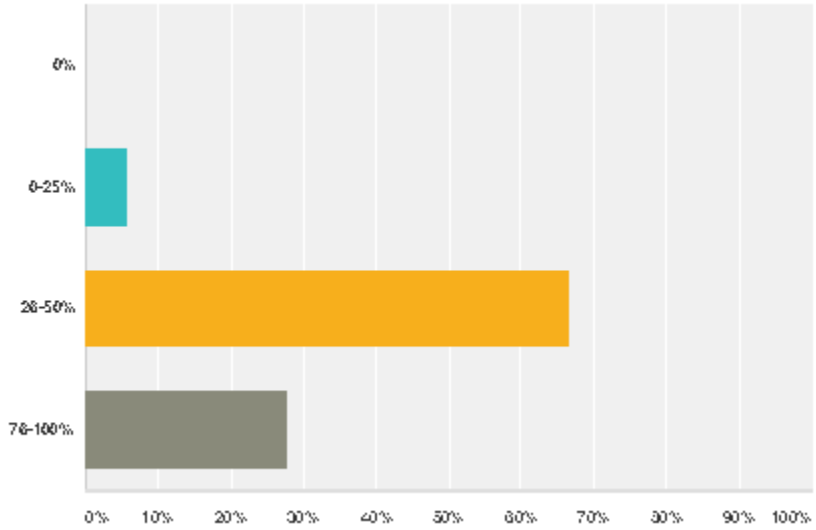
a. Inventories;

b. Turnover; and

c. Trade size.

Investor demand for liquidity relative to market supply is stark. A survey of issuers, traders, investors and other market participants conducted by CREFC in early February suggests that, market-making capacity was already undercapitalized by one quarter to one half. Since then, additional traders have lost their seats, draining further capacity from the system.

Exhibit 3: How Much More Balance Sheet Market Makers Need to Support Secondary Markets



Source: CREFC 2016 Survey on Liquidity

The contraction in secondary market liquidity has been so strong that it has worked its way backwards into the primary issuance market. At the beginning of the year, predictions of $100 billion in private label issuance or more were the norm. By the middle of February, some researchers had ratcheted their forecasts down by roughly one third to as low as $70 billion. This downshifting is extreme for such a short period of time and underlines the significance of the liquidity contraction.

Primary Sources of Overregulation

There are many sources of overregulation, but for the purposes of this document, CREFC will cite one: deleveraging targets. As noted above, the regulators keep track of bank and nonbank leverage in the system globally. Under the auspices of the G20 framework and the many international committees established to set requirements (see Appendix F), regulators are developing an ongoing stream of requirements that continue to address the highest goal, which is

reducing risk in the system. The most noticeable way they do this is to drive credit creation lower.

Despite global growth challenges, the regulatory community remains committed to reducing bank and nonbank leverage, and is especially interested in constraining the structured products sector, especially CMBS. The focus on CMBS has been expressed in multiple ways since the beginning of the crisis. Most importantly, the regulators are working to raise the costs of CMBS and other structured products relative to other asset classes through the risk-based capital and liquidity regimes that tax securitizations more than other products.

CREFC and other industry participants have repeatedly requested that regulators share information about their methodologies, and particularly, their calibration goals, though they keep this aspect of their work secret, generally. The differential in treatment between CMBS and other products is so great, that the regulators seem to be intentionally calibrating to a target that is more. As a result, the CMBS sector is at a greater risk of losing more capacity than any other asset class.

As a consequence, CMBS capacity will leave the market and borrowers will struggle to find credit. In the end, markets will be made unnecessarily inefficient and savers will see their investments devalued more than would have been the case without regulation.

Recommendations and Conclusions

Considering all of the perverse impacts of regulations – both individually and in the aggregate – our list of recommendations would be long, and mostly within the regulatory purview. As such, we began this process first by petitioning the regulatory community for correction and clarification. Regulators accepted some of our recommendations but also declined a good number. It is for this reason that we now seek Congressional intervention.

From the legislative perspective, we urge the Committee to favorably act on the discussion document proffered by Mr. Hill of Arkansas regarding risk retention. Though the ask is modest relative to the regulatory inefficiencies and perverse outcomes faced by CMBS - the recommendations are most meaningful.

Consider and Report Out of Committee Representative French Hill's Risk Retention Discussion Draft.

CREFC strongly supports the recommendations below, which restore the proper balance between protective measures and a healthy, functioning CMBS market for the borrowers and employers in every Congressional district. Specifically, the recommendations would: (1) exempt from the risk retention requirements the highly-sought SASB transactions; (2) set reasonable parameters for regulating and designating as "qualified" certain high-quality commercial loans under the risk retention rules; and (3) provide flexibility in structuring the retained interest to suit investors.

First, the recommendations would address the issues related to the transparent and high-performing SASB transactions by making them exempt from the risk retention requirements. As mentioned above, SASB transactions are marked by superior performance — the SASB segment booked a mere 0.25 basis points in cumulative losses between 1997 and 2013. This financing option is ideal for borrowers seeking to finance apartment complexes, hotels, office buildings, and, of course, gateway market "trophy" properties. Current regulations, which do not include an exemption for SASB transactions, threaten to raise borrowing costs, decrease borrower choice in this market, and induce them to seek other modes of financing that may be less transparent and low risk (e.g., corporate bond markets).

Second, the recommendations would put in place common-sense parameters for considering which CRE loans would be deemed "qualified" under the risk retention requirements. Currently, only a small percentage of CMBS loans would be considered as Qualifying Commercial Real Estate Loans, or QCRE Loans. As background, Dodd-Frank gave regulators the discretion to provide exemptions from the risk retention rules for conservatively underwritten loans, similar to the designation of the QRM standard for residential mortgages. These loans, which meet a set of parameters set by regulators, would be considered "qualifying" loans and exempt from the risk retention requirements. Regulators exercised that discretion in crafting the final rules. Surprisingly, private label residential mortgage-backed securities were given a generous set of qualifying requirements under the QRM standard; in fact, it is estimated that considerably more than 85% of today's RMBS loans would qualify for an exemption. Yet, conversely, in the CMBS space, the qualifying conditions are so onerous that only 3%-8% of all CMBS loans written since 1997 would qualify for an exemption. This has little sense of proportion or compelling rationale.

Mr. Hill's draft would moderately widen the underwriting requirements for QCRE, thus helping maintain credit quality in this space, along with stable pricing and availability of financing for a broad swath of business owners. Specifically, Mr. Hill's draft would allow pools of unrelated/unaffiliated, or "conduit" loans will be allowed to amortize over not more than 30 years (from the current 25-year standard); permit low-LTV interest-only loans to be treated as "qualified" where no authority was granted previously; and permit loans less than 10 years in term as qualifying for exemption under the QCRE rule.

Third, under the risk retention rules, there are special rules for CMBS that allow a third-party investor to purchase the B-piece (known under the rule as the eligible horizontal residual

interest, or "EHRI"). The risk retention rule allows up to two third-party investors to share the 5% retention burden, but requires them to hold their positions pari *passu* (i.e., horizontally). The proposed legislation supported by CREFC would allow third-party purchasers to share the retention obligation *pari passu* or in a senior-subordinate (i.e., vertical) structure. Congressman Hill's proposal does nothing at all to change the core retention requirement or any of the other requirements surrounding the B-piece investors. The core 5% retention requirement and all other general requirements (e.g., substantive due diligence, holding the interest for five years, etc.) would remain intact. The legislation allows for a reasonable amount of flexibility in how the B-piece is held internally by two purchasers. This flexibility will allow the B-piece buyer to match investor capital with the additional capital investment (the retained risk amount) that the rules require. For CMBS, the required amount of risk retained will be about two times that of what is currently invested by B-piece buyers in a typical CMBS deal. That is a massive amount of incremental capital B-piece buyers have to raise in order to be risk retention compliant. And that investment is essentially non-transferable – meaning that the funds raised will be "parked" in a single deal for at least five year. Obviously, this comes with an illiquidity premium that investors will seek – further increasing costs to borrowers. The senior-sub structure will be used to help align investors with this new retained risk requirement. It will not affect at all the amount of risk that must be retained, the underwriting due diligence required by the rules or the holding period requirements of the rules. It simply gives the industry flexibility to achieve the risk retention goals of the regulations.

Additional Recommendations

Additionally, CREFC recommends that Congress consider requiring additional oversight to the regulatory process. This will improve communications between regulators and the industry at all points in the cycle. In specific, CREFC recommends that Congress require:

1. Regulators to outline and operationalize a defined means to secure implementation interpretations of regulation and to formalize a process for filing petitions for "no action" letters from the Agencies when confusion on rule implementation impedes capital flows;
2. That the regulators secure Congressional approval for requirements developed through international forums (for example, FRTB was finalized by the BCBS and regulators should be very vigilant to discern the potential negative impacts such rules could have on market liquidity when undertaking the U.S. rule promulgation process); and
3. That the regulators establish a standing emergency outreach group as a forum in which market participants can air concerns about market functionality and potential dislocations outside of the supervisory silo and without triggering supervisory action.

Conclusion

CREFC would like to thank the members of this Subcommittee for providing the opportunity to submit this statement. CREFC asks that the Subcommittee give serious consideration to the negative consequences of the latest round of rulemaking – consequences far beyond the CMBS markets. More to the point: without a robust and competitive CMBS marketplace our members anticipate a liquidity-driven stress event that could potentially take years to rebalance as market participants leave the arena for other lines of business. This imbalance will have far-reaching and profound effects on communities in a very visible way, by

constricting the funding for commercial properties that we all come to rely on daily for our groceries, housing, workplaces, healthcare, education, and goods and services. In short, the $200 billion of maturing CMBS debt in the next two years will need to be financed regardless of the actions Congress takes. In the absence of intervention and continuity of a competitive CMBS marketplace, we fear that buildings currently funded could fall into foreclosure, resulting in blighted, perhaps empty structures and loss of principal for America's pension and other investors and retirees.

We remain optimistic that there is time to correct this looming liquidity crunch, and we are eager to work with members of the Committee, and with Congress, to ensure that the discretely tailored recommendations embodied in Mr. Hill's discussion draft become law.

Appendix A: CRE Finance Council Investor Reporting Package

The key items of interest included in the CRE Finance Council Investor Reporting Package (IRP) include the following data and supplemental reports that are filed monthly or on an as needed basis.

- Master Servicer Files
  - Loan Setup
  - Loan Periodic Update
  - Property Files
  - Financial Files
- Property Income Statements (Borrowers and Property)
- Special Servicer Loan File
- Special Servicer Property File
- Schedule AL File (Required by SEC)
- Trustee Data Files
  - Bond Level Summary
  - Collateral Summary
- Supplemental Data Reports to be filled out by Servicers
  - Servicer Watchlist/Portfolio Review Guidelines
  - Delinquent Loan Status Report
  - REO Status Report
  - Comparative Financial Status Report
  - Historical Loan Modification/Forbearance and Corrected Mortgage Loan Report
  - Loan Level Reserve/LOC Report
  - Total Loan Report
  - Advance Recovery Report
- Supplemental information to be supplied by Servicers:
  - Appraisal Reductions
  - Servicer Realized Losses
  - Reconciliation of Funds
  - Historical Liquidation Losses
  - Interest Shortfall Reconciliations
  - Significant Insurance Event Report
  - Loan Modifications
  - Loan Liquidations
  - REO Liquidations
  - 1099 A/C Tax Forms for Servicers

Appendix B: CREFC and Industry Background

Industry-led Reforms

Since the crisis, CMBS market participants have sought to address industry weaknesses. A broad variety of stakeholders have taken steps to promote greater levels of discipline in loan origination, structuring, monitoring, and disclosure.

As part of its core mission, CRE Finance Council works closely with its members, including the majority of CMBS issuers, B-piece buyers and servicers, as well as leading investors in the asset class, to establish best practices. In response to the crisis, CRE Finance Council members developed and enhanced several sets of documentation and practice standards, which materially add to market transparency, standardization and efficiency.

The below templates and standards were developed by working groups under the auspices of the CRE Finance Council and staffed by volunteers from the CRE lending, investing and servicing communities. These resources are reviewed and refreshed ongoing, so as to remain relevant and meaningful.

1. ***CREFC Investor Reporting Package (U.S. and EU Versions):*** Standardized and comprehensive package of bond, loan and property level information used extensively in the CMBS marketplace. This data is collected prior to issuance and throughout the life of the transaction.
    a. ***CREFC Special Servicing Disclosure Reports added to IRP™:*** New disclosure reports adopted December 2012 providing increased transparency surrounding special servicer activities, including information regarding affiliates, fees, loan modification decisions, and the final disposition of specially-serviced CMBS loans.
    b. ***Standardized Annex A:*** Provides a deep data dive on the largest loans within the transaction, including enhanced granularity regarding operating statements and additional data with respect to escrow accounts and reserves.
2. ***Pooling and Servicing Agreement (PSA):*** First offered to the public by CREFC's predecessor, Commercial Mortgage Securities Association. Since the crisis, numerous enhancements and modifications have been made, including more specific deal terms and conflict resolution standards for issues involving servicers.
3. ***Model Representations & Warranties:*** Standardized set of representations and warranties for inclusion in transaction documentation regarding the accuracy of loans in the pool, including more than 50 parameters. This is a critical feature of CMBS documentation as it enables investors to pursue loan repurchases in the event of material breaches; representations and warranties essentially function as a loan-level form of "skin-in-the-game" for the originators, issuers and sponsors.
4. ***Principles-Based CRE Loan Underwriting Framework:*** Set of principles establishing industry best practices in underwriting processes and characteristics, encouraging standardization and lower risk-taking in lending.

Appendix C: Links to CREFC Comment Letters and Submissions

Risk Retention

- June 19, 2014: Follow-up to Meeting at the Board of Governors of the Federal Reserve System
- February 28, 2014: Submission to the Agencies regarding risk retention and treatment of SASB & QCRE
- October 30, 2013: Joint Trade Association comment letter regarding the risk retention proposed rule
- October 30, 2013: CREFC comment letter regarding the risk retention proposed rule
- July 18, 2011: CREFC comment letter regarding the original risk retention proposed rule

Reg AB II

- March 28, 2014: CREFC comment letter regarding asset-backed securities
- October 4, 2011: CREFC comment letter regarding asset-backed securities
- August 2, 2010: CREFC comment letter regarding asset-backed securities

Basel Capital Requirements

- March 27, 2015: Joint trades comment letter regarding capital floors
- August 12, 2014: Joint trades comment letter regarding treatment of securirization
- July 25, 2014: CREFC response to BCBS – IOSCO survey on treatment of securitization
- March 24, 2014: Joint trades comment letter on securitization framework

Basel Liquidity Requirements

- March 13, 2014: CREFC comment letter regarding the liquidity coverage ratio

Volcker Rule

- February 13, 2012: CREFC comment letter regarding the Volcker Rule

Appendix D: Timetable for Regulatory Implementation

Rule	Impacted Sector	Concern	Effect	Secondary Effect	Regulator	Status	Fully Effective
Supplementary Leverage Ratio (SLR)	Banks	Risk weightings do not fully capture the risk of a bank	Banks less leveraged	Higher prices/spreads for repo	Fed, FDIC, OCC	Final rule released	January 1, 2018
Liquidity Coverage Ratio (LCR) / High Quality Liquid Assets (HQLA)	Banks, Shadow banking	Banks during the financial crisis did not have enough liquid assets to weather prolonged periods of stress	More difficult for banks to hold non-liquid assets	Higher spreads/less liquidity for RMBS, CMBS	Fed, FDIC, OCC	Final rule released	January 1, 2017
Net Stable Funding Ratio	Banks, Shadow banking	Mismatch between duration of assets and liabilities	Banks punished for liquidity mismatch	Reduction in repo funding	Fed	Not yet proposed	January, 2018 (est.)
CCAR	Banks	Banks and regulators did not have a prospective look at impact of adverse economic scenarios/banks overly aggressive with capital management	Conservative capital management; trapped capital	Reduced lending to marginal credits	Fed	Rule in force	March, 2011
Living Wills	Banks, Nonbank SIFIs	No orderly way to unwind large, interconnected firms	Firms required to plan liquidation	Regulators able to force shedding of business lines, products	Fed, FDIC	Rule in force	December 31, 2013
Intermediate Holding Company (IHC)	Banks	U.S. subsidiaries of foreign banks are undercapitalized for their potential risk, allowing for a regulatory arbitrage with U.S. banks	U.S. subsidiaries of foreign banks exiting U.S. market	Fewer counterparties with repo capacity; less liquidity	Fed	Final rule released	July 1, 2016
G-SIB Capital Surcharge	Banks	The largest banks are so large and systemically important on a global scale, they need another layer of capital	Largest banks forced to hold more capital, especially if they use short-term funding	Market share shift to regionals	Fed	Final rule released	January 1, 2019
Total Loss Absorbency Capital (TLAC)	Banks	Banks failed during the financial crisis because they could not raise capital	More longer-term debt issued by banks that can be converted to capital	Increased funding costs for G-SIFIs	Fed	Draft rule proposed	January 1, 2022 (proposed)
Margin Requirements for Short-Term Funding	Shadow banking	Too much risk is being taken in short-term wholesale funding	Increase in non-agency repo cost	Decreased liquidity	Fed	Not yet proposed	2018 (est.)
Volcker Rule	Banks, Insurers	Banks using proprietary information to trade against clients' best interests	Elimination of bank proprietary trading desks	Reduction in secondary liquidity could affect M2M	Fed, FDIC, OCC, SEC, CFTC	Rule in force	July 1, 2015
Risk Retention	CRE mREITs	Securitizers do not have enough 'skin in the game' and have not been an effective check on the system	Securitizers must hold share of risk	Higher yields in ABS market; reduced capital in B-piece market	Fed, FDIC, OCC	Final rule released	December 24, 2016
Nonbank SIFI designation	Insurers, asset managers	Certain nonbank financial firms do not have sufficient federal regulation	Designated firms may need to hold more capital	Uneven playing field vs. non-designated firms	FSOC, Fed	Authority effective, capital standards pending	May, 2012
Fundamental Review of the Trading Book	Banks, Shadow banking	VAR models do not accurately reflect risk in trading books	Overhaul of risk measurement	Could prompt selling non-agency inventory, negative M2M impact for mREITs	Basel	Proposed framework released	January, 2019 (targeted)
Guidance on Commercial Real Estate Lending	Banks, CRE mREITs	Possible asset bubble in CRE/are banks taking on too much risk	More scrutiny on banks making CRE loans	Banks less willing to make CRE loans, market shares shift to mREITs	Fed, FDIC, OCC	Document released	December, 2015
Guidance on Leveraged Loans	Banks	Banks taking on too much risk in the loans they provide for buyouts	More scrutiny on banks making leverage loans	Banks less willing to make leveraged loans, fewer leveraged buyouts	Fed, FDIC, OCC	Document released	March, 2013
Money Market Fund Reforms	Money market	Fixed NAV provides false assurance that funds will not 'break the buck'/concerns about runs when NAV falls below $1	Funds pushed to more liquid collateral	Funds could become repo counterparties	SEC	Final rule released	July, 2016
Liquidity Rules for Asset Managers	Asset Managers	Fund managers will not be able to meet redemptions if there are mass redemptions/reducing confidence in mutual funds/ETFs	Shift funds toward more liquid securities	Increased cost of capital for smaller companies; negative impact on bond fund ETFs	SEC	Draft rule proposed	2016-2017 (est.)
Derivative Rules for Asset Managers	Asset Managers	Fund managers taking on too much risk/juicing performance with over reliance of derivatives	Derivative limits for funds	Lower returns for funds; decrease in leveraged ETFs	SEC	Draft rule proposed	2016-2017 (est.)
Stress Tests for Asset Managers	Asset Managers	A failure of an asset manager would shake confidence among retirement savers	Potential higher capital standards and limitations on capital management for asset managers	Could lower returns for funds	SEC	Not yet proposed	2017 (est.)
Additional Rules for Asset Managers	Asset Managers	Current regulations of asset managers have not been updated to reflect their risks	Heightened scrutiny on asset managers, potentially limiting business activities	Could lower returns for funds	SEC	Not yet proposed	2018 (est.)
Fiduciary Standard Rule	Insurers, Asset managers	Investment advisors are not acting in the best interest of their clients	Move all brokers to 'best interest' standard	Lower profitability for broker/dealers and asset managers; limited buyers for certain assets	SEC	Not yet proposed	TBD
Block Trade TRACE Reporting	Banks/Bond trading, Insurers	More transparency is needed in bond market trading	Block trades must be disclosed within 15 minutes	Reduced liquidity and larger bid/ask spreads on FI products; could impact M2M	FINRA	Rule in force	January, 2015

Source: FBR Research

Appendix E: Relevant Regulations and Impacts

The below explanation of the regulatory regime has been excerpted from the CRE Finance Council regulatory impact study Regulatory Design, Real Outcomes that was published in November 2015.

- The Group of 20 (G20) added financial institution regulation to its agenda in 2009 and designated the Financial Stability Board (FSB) to oversee implementation of extensive remediation that regulators sought in response to the financial crisis.
- In the United States, much of the regulatory agenda is embodied by the Dodd-Frank Act, though policy makers are rolling out additional planks of the G20 agenda outside of Dodd-Frank.
- Much of this regulation applies to the CRE sector, including capital, liquidity, risk retention, Volcker, some asset management requirements, and various reporting and disclosure rules.
- Going forward, there are material changes to come for the CRE sector:
    - Basel III remains a work in progress.
    - Newer elements of the regulatory agenda, especially those extending to the asset management sector and to short-term financing, have not yet been exposed.
    - The question of how regulators will treat systemically important financial institutions (SIFIs) and how that regulation may impact the flow of funds to and within the CRE sector remains a key consideration for the industry.
- While major questions regarding regulatory intent remain to be answered, CRE market participants have observed that questions regarding unintended consequences often arise during the implementation phase. This means that even after a rule is published, the

industry requires a period of dialogue with the regulators to answer outstanding questions of interpretation.

- As the regulatory conformance schedule in the U.S. currently extends into 2019, it is likely that the industry will be absorbing major changes from new rulemaking and implementation into the next decade.

For the CRE bank lending sector, capital and liquidity requirements present the greatest financial challenges of the new rules. For the CMBS sector, the credit risk retention rule is the biggest game changer. As of this writing, Basel III capital and liquidity rules are still evolving, and the credit risk retention (CRR) rule will go into effect late in December 2016. Though the Volcker rule allows CMBS underwriting, it restricts secondary trading to market making. Other meaningful rules, such as Volcker, are in effect or going into effect shortly.

Going forward, the regulators are shifting their focus and plotting course on a number of nonbank fronts. Because much of the crisis can be traced to “liquidity transformation”, or the use of short-term debt to fund longer term assets, the regulators have aggressively addressed these activities within the banking sector already, but intend to extend requirements and oversight to bilateral repurchase agreements (i.e., those that occur outside of the banking system) and possibly to other types of short-term financing.

Collectively, the regulators are also in the beginning phases of articulating priorities around the asset management industry as a whole, though the SEC did finalize rules related to the money market mutual funds already in 2014. In addition, SEC commissioners have mentioned consideration of requirements relating broadly to portfolio composition, risk management and stress testing.

Finally, the agencies continue to work slowly through the questions of SIFI designation and treatment. As of this writing, the authorities have decided to pursue regulation of asset management activities instead of designations, though they hold out the possibility of also designating asset managers and subjecting them to prudential requirements. Because the systemically important insurers (SIIs), many of which have been designated already, and the potential asset manager SIFI designees are prominent CRE lenders and investors, the issue is an important one to the sector. Not only can new requirements influence business strategy at these firms, but they can influence activities across the sector indirectly.

SII capital and liquidity treatment has not been proposed here in the U.S. However, for these institutions, rating agency requirements have represented binding requirements, or the outer bound threshold. Until new regulatory rules have been rolled out in the US, it is not clear which regime will present the strictest set of requirements.

Perhaps the most prominent regulatory issue at this time is the matter of market making and liquidity. Many rules affect the willingness of bank dealers to support secondary market trading, including Volcker, risk based capital, the liquidity coverage ratio, the leverage ratio (which impacts the repo market), and others. Over the course of 2014 and 2015 public discourse on the nature of liquidity and the sources of its contraction has moved between regulators, Congress, business leaders, and the press. For CMBS, turnover volume remains lower than during the crisis, suggesting that the market is indeed structurally different since rulemaking. Market participants generally cite requirements around capital and repos as the primary drivers of the dealers' pullback on balance sheet allocation to the business.

What follows below is a brief set of explanations of rules and other regulatory activities:

Credit Risk Retention (CRR)

The CRR rule, which requires that all sponsors (or B-piece buyers) hold 5% of a transaction for at least five years, was adopted at the end of 2014 and becomes effective at the end of 2016. It is alternately called the “eat-your-own-cooking” rule and is intended to achieve better underwriting in CMBS pools. The requirement is expect to add costs of 10 bps to 50 bps under (2015) conditions.

Revisions to Basel III Risk-Based Capital

The Basel Committee on Banking Supervision (BCBS) is actively revising the foundational concepts underlying the risk-based capital framework and will likely produce final versions of several new standards late in 2015 and early in 2016.

Initiatives regarding capital floors, treatment of credit risk (portfolio lending) and securitizations will impact costs across CRE business lines at large- and medium-sized banks in the future. Based on some industry analysis produced in relation to the BCBS document, “Revisions to the securitisation framework”, we believe that for commercial asset classes with maturities of five years or more, higher capital requirements are expected for most tranches.

The BCBS is also finishing work on the “Fundamental review of the Trading Book” (FRTB), which applies to all assets held for market making purposes. As of this writing (4Q15), the FRTB work stream is possibly one of the most controversial aspects of rulemaking financial system-wide. On average, the requirements as proposed will more than double capital charges for senior and junior bonds, and will be particularly onerous for CMBS as compared to other asset classes. Based on an informal survey of the dealer community, there is a strong majority view that a material number of dealers would drop out of the market, and early estimates of bid-

ask spread widening range of hundreds of basis points. Importantly, the industry would have to conform to these requirements after other rules enter into effect.

Basel III Liquidity Ratios

Basel III mandates that large banks adhere to two liquidity ratios—the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR was adopted in 2014 and went into effect at the beginning of 2015. Meanwhile, US regulators are expected to propose the NFSR in (2016).

The LCR adds costs to whole loans that have drawdown features, such as construction loans. The rule also disadvantages private-label and some GSE-sponsored CMBS. Where banks had used CMBS to help manage their asset and liability (ALM) exposures (the difference in duration between their assets and their liabilities), the rule excludes the vast majority of CMBS from the High Quality Liquid Asset (HQLA) designation, which is becoming fairly synonymous with banks' ALM portfolios.

Based on the BCBS's final standards regarding the NSFR, it appears that this rule when adopted in the US will likely add operating costs to balance sheet loans.

Volcker Rule

The Volcker Rule is impacting the industry on many levels. While CMBS are generally allowed under the rule, and most CRE whole loans appear not to be subject to the trading restrictions, the Volcker rule will require the support of substantial infrastructure representing an ongoing cost of doing business.

Registration and Disclosure Rules

New shelf registration requirements and Regulation AB II and other reporting requirements will add costs to CMBS. The new shelf registration requirements will add an

estimated $20,000 per transaction, according to a senior partner at a law firm. FINRA reporting requirements are considered to contribute to reduced secondary trading liquidity.

Total Loss Absorbency Capital

The first international level proposal for Total Loss Absorbency Capital (TLAC) was published by the Financial Stability Board (FSB) at the November 2014 G20 Summit. TLAC essentially acts as a capital floor for large banks and would override risk-based capital at the holding company level, requiring that large banks hold 16% to 18% capital and high-quality debt, not including buffers. Based on analysis performed by The Clearing House, the FSB's proposal will require that banks establish a cushion that is 2.6x to 5.2x the historical need for capital in a crisis.

The Federal Reserve adopted a final rule relating to part of the TLAC, which established the capital base according to the leverage requirements (total assets to risk-based capital) at 2x the international standards for global systemically important banks (G-SIBs).

Appendix F: Overview of Regulatory Process – International and Domestic

American financial services policy makers often focus on what is historically considered a Eurocentric regulatory regime headed by the Basel Committee on Banking Supervision (BCBS). After the financial crisis, the banking industry and the media focused on the new capital and liquidity requirements the BCBS passed on to U.S. regulators through Basel III. Indeed, their influence has grown, but the international regulatory infrastructure is much more layered than is widely known and yet, it is also heavily influenced by U.S. policy-making goals.

Today, the BCBS and similar standard setting bodies answer to two supranational groups, the G20 and FSB, which often draw their leadership from the Federal Reserve System (FRS) and other U.S. agencies. Moreover, the other member nations generally view the U.S. as the nation that led the financial crisis, should be first among equals in adopting the regulations that are contributing to structural shifts in the capital markets.

Officials from the FRS, FDIC, OCC, SEC, and other regulatory bodies led the conversation in Basel and abroad and directly contributed to the increase in capital and liquidity standards contained in Basel III and other rules being adopted at home. Think of the G20 and FSB as an executive, decision-making arm that sets the international agenda, while the various Basel committees consult, research, and publish the rules that carry out these international regulatory goals. The entire regulatory architecture synergistically shares the same resources, staff, and officials - mainly those mentioned in the preceding paragraph.

What is the Systemic Risk Agenda? Who are the Macro Prudential Regulators?

In the post-financial crisis era, nations recognized and felt the impact and toxicity of excess financial leverage. Rightfully so, leaders called for a coordinated response effort, and more importantly, a framework to prevent similar crises in the future. The largest nations and

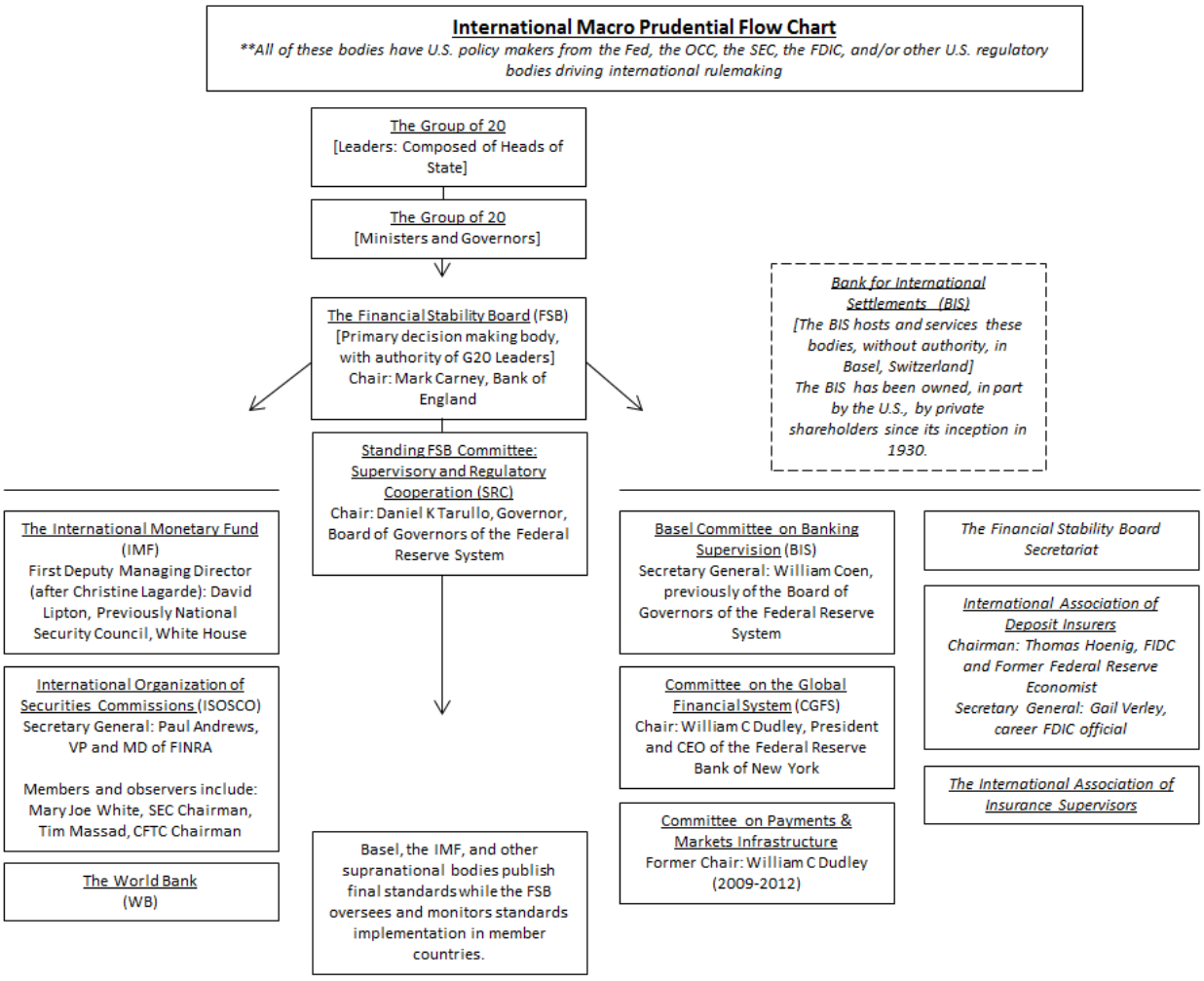
emerging market economies under the leadership of the newly created G20, met to expand existing supranational regulators as well as create new ones. Collectively, these nations set out to weed out systemic risk and promote economic growth and stability.

Since 2009, an aggregation of supranational bodies led by the FSB, with the distinct power granted by the leaders of the G20, leads the international regulatory rulemaking, implementation, and oversight process. Acronymic bodies including the BCBS, International Organization of Securities Commissions (ISOCO), Bank for International Settlements (BIS), Committee on the Global Financial System (CGFS), The World Bank (WB), and the IMF (IMF), all serve various decision-making, research, implementation, and oversight roles within, but underneath, the supervision of the G20 and the FSB.

No single nation is “in charge” and no single body exists to implement policy or regulations from the international level; individual jurisdictions are responsible for tailoring nada adopting requirements through their own legislative and / or rulemaking frameworks. Sovereign nations are responsible for implementing and monitoring their own capital, liquidity, and risk management rules across their banking and financial services industries. With each subsequent international financial crisis, supranational standard setting bodies have emerged with more influence and the ability to create “soft law” in the wake of financial turmoil. It is with this lens that the current international financial regulatory architecture may be viewed.

However, the United States, acting through the Federal Reserve, has considerable authority by way of conducting monetary policy, providing liquidity to central banks during crises, and by extension, commercial banks, abroad. It has the leadership role not just because of the size of its central bank balance sheet and ability to absorb risk, but also due to its supervisory role.

The Federal Reserve and the U.S. banking agencies have leadership posts or influence on every single supranational body this paper outlines – including the G20, the FSB, the Basel Committees, ISOCO, the IMF, and the World Bank.



The Group of 20 (G20)

The G20 is generally considered one of the preeminent organizations on international matters, especially international financial regulation. Self-appointed in 2009, the body expanded upon the G7 to include larger developing economies in order to better account for systemic risk, and includes the 19 member countries plus the European Union (EU). G20 member countries

account for 86% of global GDP, 90% of global banking assets, and 94% of the global bond market.

The G20 is split among two levels: 1) G20 Leaders, made up of heads of state; and 2) G20 Governors, made up of central bankers and treasury officials and their equivalents. The leaders meet on a near-annual basis to review work of the G20 Ministers and set the agenda for the ministers' future work, while ministers execute the Leaders' agenda on an ongoing basis.

Financial Stability Board (FSB)

The FSB is the primary global decision making body, and has been since the G20 created the FSB in 2009 to coordinate international financial regulation.

> "The FSB promotes international financial stability; it does so by coordinating national financial authorities and international standard setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies…the FSB, working through its members, seeks to strengthen financial systems and increase the stability of international financial markets. The policies developed in the pursuit of this agenda are implemented by jurisdictions and national authorities."

The FSB Charter derives its authority from the G20 Leaders' statement explaining that the FSB should be "given a broadened mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced capacity" including responsibilities such as reviewing, coordinating, and addressing gaps among the "international standard setting bodies" (i.e., Basel, etc.) and "oversee action needed" to address financial system vulnerabilities."

The FSB's previous iteration, the Financial Stability Forum, served a consultative function with international standard setting bodies. However, in 2009, the heads of state of the largest economies of the world improved the FSB's mandate to implement the overarching regulatory agenda and ensure implementation of the rules published by international standard setting bodies.

Note that the main influencing bodies of Basel – i.e., sovereign member nations – have not changed, however, the decision making process has. Instead of sovereign nations, mainly the United States, shaping supranational regulatory policy through the Basel Committee, they do so today through the G20 and FSB.

The FSB is chaired by Mark Carney, Governor of the Bank of England. Carney directs the Plenary, a committee of 69 members from FSB member countries, international financial institutions, and international standard setting bodies. Members of the Plenary include representatives from the G20 countries, the World Bank, the IMF, the BIS, the ECB, the European Commission, the BCBS, the IAIS, IOSCO, IASB, CGFS, and the OECD. In essence, the membership of the G20 is circular –its members, who help set the agenda, are also tasked with developing the rules they seek to create.

The Secretariat of the FSB is located in Basel, Switzerland, and is hosted by the Bank for International Settlements. The Secretariat has 33 members and supports the policy development and activities of the FSB. The Secretariat is noted here because of its proximity and closeness to the "Basel Process," explained in the next section. The proximity and location of the FSB in Basel further engenders the close thinking of the economists, central bankers, and regulators that work out of the various committees hosted by the Bank for International Settlements.

The Bank for International Settlements (BIS)

The Bank for International Settlements hosts a number of international standard setting bodies – notably the Basel Committee on Banking Supervision and the Committee on the Global Financial System – that are physically housed at the BIS facilities. In fact, all but IOSCO sit in the Basel location.

The best-known committee, the BCBS, was formed in 1974 by the Group of 10 (G10) in the wake of economic turmoil – the collapse of fixed exchange rates, rising oil prices, interest rate fluctuations, and bank failures. Prior to the creation of the BCBS, the BIS served as an international meeting place and information exchange for central bankers. It became the supranational regulatory body it is today in the early 90's after the Federal Reserve formally joined the Basel Process and the BIS.

BCBS membership includes central banks and regulatory authorities (in the U.S.: FRS, OCC and FDIC); and other international groups including the BIS, the IMF, the Basel Consultative Group (a liaison group to non-members), the European Banking Authority, and the European Commission. "The Basel Process is based on three key features: synergies of co-location, flexibility and openness in the exchange of information, and support of the BIS's expertise in economics, banking, and regulation."

BIS Ownership and Founding

The BIS is a private, for-profit firm. It was created principally as a bank – to take deposits and make loans, while providing trustee and agent services for its central bank clients. It formed in 1930 as a commercial bank with public shares, which were primarily offered to central banks. Eighty-six percent of BIS stock is owned by central banks while 14% is owned privately by public shareholders. Ownership entitles shareholders to dividend payments but only member central banks are entitled to sit on the BIS board or attend board meetings – which are notoriously secretive making its importance and banking services difficult to quantify.

Today, the U.S. sits on the board of BIS and has since 1994 when it quietly joined the organization. In 1930, the Federal Reserve was barred from owning shares or from formal BIS board participation, instead, shares were held in a trust by First National City Bank.

Importantly, the bank's charter and statutes explicitly state that the bank was set up to execute the monetary policy of its member banks. If a member bank disagrees with a financial transaction that the BIS plans to execute, member banks (who collectively own the BIS) have the ability to dissent and stop a transaction.

International Organisation of Securities Commissions (IOSCO)

The International Organisation of Securities Commissions, also known as IOSCO, is the international body that connects the world securities' regulators – in the U.S., the Securities and Exchange Commission. It was established in 1983 and operates out of Madrid, Spain – a notable departure from most of the standard-setting bodies based out of Basel.

The organization's stated purpose is to maintain fair and transparent markets while addressing systemic risks. It is governed by the ISOSCO board, comprised of 33 securities regulators, including Tim Massad, Chair of the CFTC, and Mary Jo White, Chair of the SEC.

The Role of the Federal Reserve during the Financial Crisis

The Federal Open Market Committee (FOMC), acting through the Federal Reserve Bank of New York (FRBNY), is able to conduct currency exchange or swaps. In 2007, the FOMC created temporary dollar liquidity swap lines with 14 central banks, recognizing that the EU, UK, and Swiss banking industries had over $8 trillion in USD exposure. In 2008, temporary swap lines peaked at $583 billion, equaling 25% of the Fed's balance sheet at that time and four times the total outstanding IMF credit (IMF intervention peaked in 2010).

The FRBNY publishes quarterly reports on its foreign exchange activities. Its most recent report, covering Q3 2015, stated that the Federal Reserve Open Market Account Holdings had $20 billion in foreign currency denominated assets, primarily in yen and euro. In October 2013, the central bank made six of those swap lines – the Bank of Canada, the Bank of England, the

Bank of Japan, the European Central Bank, and the Swiss National Bank – permanent, to foster financial stability.

The U.S. Treasury also has the ability to execute foreign exchange through its Exchange Stabilization Fund (ESF). As of December 31, 2015, it holds a total of $118 billion in reserve assets, mainly consisting of $49 billion in Special Drawing Rights (SDR), $11 billion in gold, and $17 billion in “other national central banks, BIS and IMF.”