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The Real Estate Roundtable

CMSA
COMMERCIAL MORTGAGE SECURITIES ASSOCIATION

VIA E-MAIL

November 3, 2003

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Board of Governors of the Federal Reserve System
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Office of the Comptroller of the Currency
Public Information Room, Mailstop 1-5
250 E Street, S.W.
Washington, D.C. 20219
Attention: Docket No. 03-14
Fax: (202) 874-4448
Email: regs.comments@occ.treas.gov

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C., 20429
Fax: (202) 898-3838
Email: Comments@FDIC.gov

Regulation Comments, Attention: No. 2003-27
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attention: No. 2003-27.
Fax: (202) 906-6518
E-Mail: regs.comments@ots.treas.gov

Re: Risked-Based Capital Guidelines; Implementation of New Basel Accord

Dear Ladies and Gentlemen:

We appreciate the opportunity to comment to the Board of Governors of the Federal Reserve System (the Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (collectively, "the Agencies") on the advance notice of proposed rulemaking in relation to the implementation of the new Basel Capital Accord ("Basel II" or the "New Accord") in the United States.

The Real Estate Roundtable ("Roundtable") and The Commercial Mortgage Securities Association ("CMSA") are pleased to acknowledge their considerable respect and appreciation for the efforts of Federal Reserve Vice Chairman Roger Ferguson and his research staff, who have met with our members a number of times to discuss our concerns on the New Accord. We look forward to continuing this constructive dialogue on the New Accord as it moves toward ultimate implementation.

The Roundtable and its members lead an industry that generates more than one-third, or $2.9 trillion, of America's gross domestic product, employs more than 9 million people, represents capital investment of over $4.6 trillion, and produces 70 percent of the taxes raised by local governments for essential public services. Our members are senior real estate industry executives from the US's leading income-producing real property owners, managers and investors, as well as the key executives of the major financial services companies involved in financing, securitizing or investing in income-producing properties. The Roundtable membership includes the elected heads of America's leading real estate trade organizations, including CMSA. This comment letter represents a collaborative effort on behalf of the Roundtable and the CMSA.

The CMSA is an industry group formed in 1994 and dedicated to improving the liquidity of commercial real estate debt securities through access to the capital markets. The CMSA includes as its members the wide spectrum of companies involved in the business of creating, trading, monitoring and investing in CMBS --- banks originating loans and other commercial mortgage loan originators; banks investing in securities and other CMBS investors; mortgage servicing companies and securities trustees; rating agencies; as well as Bondholders investing in AAA-rated to Non-Rated CMBS classes. Further information about our association, including our Board of Governors and membership, is included in the Appendix as Attachment A.

We appreciate your consideration of the views of the Roundtable and CMSA on how the New Accord could affect the real estate industry. Residential and non-residential real estate have been pillars of the economy during this recent economic downturn. Yet reduced CRE lending, particularly as the economy continues to struggle, could be expected to further weaken property values and undermine overall market liquidity.

While substantial resources have been invested into developing the New Accord and preparing for its implementation, more remains to be done to determine the impact on affected industries. The Roundtable and CMSA welcome the Basel Committee's October 11th announcement that the treatment of securitization will be revised and the Supervisory Approach will be replaced with a less complex approach. We also support the Basel Committee's recent decision to postpone finalization of the New Accord until mid-2004. The Accord should benefit from further review of the important issues and industry concerns that remain to be resolved, and we are willing to assist in any analysis which would prove useful.

Commercial Mortgage Backed-Securities

Since the inception of the commercial mortgage backed-securities (CMBS) market in the mid 1980s, the market has grown to over $550 billion in CMBS backed by U.S. real estate mortgage loans. The CMBS capital markets are now nearly on par with commercial banks to be the leading source of commercial real estate debt (approximately 15% for each sector). For the first nine months of 2003, total new issue volume of CMBS amounted to $52.3 billion backed by U.S. real estate mortgage debt and $11.5 billion backed by international real estate mortgage debt. It is estimated that the annual secondary market trading (non-new issue) of CMBS is well over $400 billion.

U. S. CMBS Issuance Volume and Transaction, 1985 to 2002

	Issuance ($billion)	Number of Transactions		Issuance ($billion)	Number of Transactions
1985	2.7	1	**1994**	17.4	95
1986	1.1	1	**1995**	17.8	76
1987	0.9	9	**1996**	28.9	94
1988	1.2	15	**1997**	40.4	79
1989	1.7	23	**1998**	77.7	81
1990	4.8	20	**1999**	58.5	92
1991	8.2	31	**2000**	48.9	82
1992	14.0	51	**2001**	74.3	99
1993	17.2	111	**2002**	60.0	73
Source: Commercial Mortgage Alert					

As an industry, we are highly committed to the principles of sound risk management and equal capital for equal risk, and we are concerned that the Basel II Guidelines, as proposed, may be inadvertently biased against CMBS exposures, and will disadvantage non-investment grade CMBS investments as compared to non-investment grade Corporate Bond investments, to the detriment of liquidity in this important financing sector. We are also concerned that the rationale given for the disparate treatment between originating banks and investing banks does not accurately reflect the practices of the CMBS marketplace. We offer these comments to you in an effort to provide the Agencies further assistance in its work to establish a regulatory capital framework for CMBS within the Accord.

Our comments in the first attachment to this letter are divided into two categories that we would like the Agencies to address: 1) the disadvantaged and asymmetrical capital treatment of non-investment grade CMBS as compared to non-investment grade corporate bonds; and, 2) the inconsistent application of the RBA approach for banks originating loans, securitizing the loans and retaining a class of the securitization ("Originating Banks") versus those banks investing in third-party originated securitizations ("Investing Banks"). Within each category, we outline certain assumptions made in the Basel II Guidelines which we believe, upon further investigation, should be reconsidered by the Agencies. We also provide the Agencies with an overview of empirical data that supports our view. We conclude by explaining the mechanics of the CMBS market while giving the Agencies a guide to the information available in the CMBS marketplace which we hope is helpful in furthering the Agencies understanding of the sector.

Commercial Real Estate Lending

We also have concerns about the impact the New Accord could have on bank lending to the commercial and multifamily real estate sector. The Real Estate Roundtable believes that all commercial and multifamily real estate (including 1-4 family properties) should receive a single risk weight treatment based on the low asset correlation approach. The commercial banking industry, and the industries it serves, should not be penalized for risks not in evidence.

Commercial banks are the primary supplier of acquisition, development and construction (ADC) loans in the U.S., and an increase in capital charges could have profound market implications on the practice of bank lending, valuations and liquidity to the commercial and multifamily markets. Increasing the capital charges for ADC loans would result in substantial loan pricing increases to real estate borrowers that could negatively impact market liquidity and valuations.

Typically, construction loans have 36-month durations. While duration clearly adds risk to any transaction, there is no evidence to suggest that the capital assignment on a three-year high volatility commercial real estate ("HVCRE") transaction (at a .05 PD) should be twice that of a one-year loan. Unlike CRE exposures, ADC loans are typically structured with some type of recourse, additional collateral, or credit enhancement. Since 1993, two substantial reforms — FIRREA and FDICIA — were implemented to deal with property valuations, loan-to-value ratios, and borrower equity requirements. Without a thorough examination of how banks determine project values and deal structures today, their CRE portfolio performance would indicate that this is not as substantial an issue as it was pre-1993.

In addition to an increase in market transparency and available market performance data, commercial banks have made substantial improvements to the practice of commercial real estate (CRE) underwriting and lending since the late 1980s that has contributed to the low incidence of defaults and losses across current CRE portfolios. In fact, the lack of default and loss occurrences from major real estate banks suggests that assertions on asset loss correlations are based on speculative conclusions and not on actual data.

Conclusion

Many members of CMSA and of the Roundtable have made significant contributions to the research we include here. We would like to especially acknowledge the work of all three rating agencies — Standard and Poor's, Moody's Investors Service, and Fitch Ratings — in the primary research contained here; in addition, the real estate capital markets departments and research departments of several Wall Street firms have been very helpful — Morgan Stanley and Lehman Brothers.

If you have any further questions or comments on this matter, please do not hesitate to contact us or Clifton E. Rodgers, Jr. at (202) 639-8400 or by email at crodgers@rer.org or Eric M. Hillenbrand at (312) 732-7672 or by email at eric_hillenbrand@bankone.com. We will follow-up with your staffs to further discuss the research presented here.

Sincerely,

Jeffrey D. DeBoer
President and Chief Operating Officer
Real Estate Roundtable

Eric M. Hillenbrand
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Banc One Capital Corp.
Co-Chair CMSA Basel II Taskforce

James Croke, Esq.
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CC:

Bradford Case, Board of Governors of the Federal Reserve Bank
David Jones, Board of Governors of the Federal Reserve Bank

I. Non-Investment Grade CMBS versus Non-Investment Grade Corporates

CMBS Capital Charges: Are They Justified?

The capital charges for CMBS should reflect the risk and liquidity of pooled securities relative to single-asset exposures, such as rated corporate debt or CRE mortgage loans. From a risk perspective, pooled transactions possess certain favorable features over whole loans: diversification benefits, structural credit enhancement, detailed underwriting scrutiny from multiple parties, and standardized loan practices. From a liquidity perspective, securities from pooled transactions benefit from broad investor sponsorship and detailed loan-level and deal-level reporting standards. However, there are some drawbacks which are outlined in the Agencies' report. Most notably, the Agencies consider that "...compared with a corporate bond having a given level of stand-alone credit risk, a securitization tranche having the same level of stand-alone risk – but backed by a reasonably granular and diversified pool – will tend to exhibit more systematic risk."

Based primarily on this opinion, non investment-grade CMBS classes would require considerably greater risk-based capital under the proposed Basel II Guidelines than either corporate loans or CRE mortgage loans. While the assets from pooled securitizations have diminishing diversification benefits relative to individual corporate (or CRE) loans when combined in a bank's portfolio, we believe that the magnitude of the impact to capital charges unfairly penalizes non investment-grade CMBS assets. Furthermore, given considerable differences in historical bond performance, it seems inappropriate to apply common scaling factors to all securitized products. To support our view, we will provide empirical data that suggests pooled CMBS assets have performed favorably to similarly-rated corporate bonds and other ABS and MBS assets as well as an analysis of some of the favorable features of CMBS transactions.

Proposed RBA Risk Weights Seem Inconsistent With Expected Loss Approach

The Ratings-Based Approach (RBA) builds upon the widespread acceptance of external ratings by third-party investors as objective assessments of a securitization's stand-alone credit risk. Through rigorous research and analysis, and continual monitoring, the rating agencies forecast an expected loss rate for CRE loans in order to assign rating grades to CMBS classes. The rating agencies derive such loss rates for a total portfolio and then apply increasingly higher credit enhancement requirements in order to support their providing stronger ratings which reflect a decreased likelihood of default of the class of securities even when the underlying loans default. Expected losses for a particular rating grade in a CMBS transaction are intended to be directly comparable to a similarly-rated class of an ABS, MBS or a corporate bond.

Required regulatory capital should be assigned such that a bank maintains adequate capital reserves to cover expected losses on the assets. It is our contention that

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"Risk Based Capital Guidelines: Implementation of New Basel Capital Accord" published collectively by the Department of Treasury (offices of Comptroller of the Currency and Thrift Supervision), Federal Reserve System, and Federal Deposit Insurance Corporation, p 80.

required capital under the RBA is applied inconsistently with the expected loss approach. Given that the cushion between required capital and expected loss is considerably higher than in similarly-rated corporates, the RBA unfairly penalizes non investment-grade CMBS assets. As evidence, we have measured the "multiple" of required capital for ABS (including CMBS), as a class, and corporate bonds, as a class, relative to the expected loss of the class. In the case of a Ba2 rating, the risk capital that would be required with respect to a CMBS asset would cover losses up to 7.4x expected losses, while the risk capital that would be required with respect to a corporate bond would cover losses only up to 1.7x expected losses (see Figure 1 below).

While we recognize that these proposed capital charges are based upon an intelligent mathematical approach, it appears to us that the assumptions that underpin the analysis are flawed, and that the results are therefore also flawed. To date, empirical evidence suggests that rated CMBS classes have clearly performed better than inferred by these assumptions. Compared to corporate bonds, CMBS assets have proven to default less frequently and have considerably lower incidence of negative rating transitions, as described below (see Figure 2).

Figure 1. Proposed RBA Risk-Weights

	(A)		(B)	= B / A		(C)	= C / A
Rating	5yr Exp Loss[1]	ABS Scaling Factor (Base Case)	ABS Capital (%)	ABS Multiple	Corp Scaling Factor (Base Case)	Corp Capital (%)	Corp Multiple
Aaa	0.00%	12%	1.0%	600.0	20%	1.6%	1,000.0
Aa1	0.02%	15%	1.2%	70.4	20%	1.6%	93.8
Aa2	0.04%	15%	1.2%	32.1	20%	1.6%	42.8
Aa3	0.08%	15%	1.2%	15.4	20%	1.6%	20.5
A1	0.14%	20%	1.6%	11.1	50%	4.0%	27.9
A2	0.26%	20%	1.6%	6.2	50%	4.0%	15.6
A3	0.42%	20%	1.6%	3.9	50%	4.0%	9.6
Baa1	0.61%	50%	4.0%	6.6	100%	8.0%	13.2
Baa2	0.87%	75%	6.0%	6.9	100%	8.0%	9.2
Baa3	1.68%	100%	8.0%	4.8	100%	8.0%	4.8
Ba1	2.90%	250%	20.0%	6.9	100%	8.0%	2.8
Ba2	4.63%	425%	34.0%	7.4	100%	8.0%	1.7
Ba3	6.52%	650%	52.0%	8.0	100%	8.0%	1.2
B1	8.87%	Deduction	100.0%	11.3	150%	12.0%	1.4
B2	11.39%	Deduction	100.0%	8.8	150%	12.0%	1.1
B3	14.88%	Deduction	100.0%	6.7	150%	12.0%	0.8
Caa	26.81%	Deduction	100.0%	3.7		100.0%	3.7

[1] *Five-year expected losses from Moody's Investor Service*

Source: Department of the Treasury

CMBS vs. Corporates: (Rating) Actions Speak Louder Than Words

The rating assigned to a security conveys the rating agency's opinion of expected losses (and/or default probability) on the security. Ratings are intended to be comparable across asset types. For instance, in an expected loss framework, a CMBS security rated BBB has a similar loss expectation as a corporate security rated BBB. But the credit

profile of the security, and hence loss expectations, could change over time. Rating agencies try to capture these changes through periodic rating actions. While few securities actually default, many more securities experience rating changes. The momentum of rating actions is a strong indicator of credit performance for a particular asset class. What do rating actions tell us about the relative performance of CMBS and corporates?

To answer this question, we use the rating action statistics published by Moody's Investors Service in its January 2003 report titled "Structured Finance Rating Transitions: 1983-2002 Comparisons with Corporate Ratings and Across Sectors" as well as Standard & Poor's reports entitled "Rating Transitions 2002: Respectable Rating Performance of U. S. CMBS" and "Ratings Performance 2002: Defaults, Transitions, Recovery, and Spreads." In Figure 2, we compare annual downgrade and upgrade frequencies across various structured finance sectors with those in corporates. CMBS clearly has the best performance across all the sectors displayed in the figure. For example, while 88.7% of the CMBS securities, on average, maintain their rating over a period of a year, 1.6% get downgraded and 3.5% get upgraded. This translates into an upgrade/downgrade (U/D) ratio of 2.22 for CMBS. The comparable U/D ratio for corporates was a mere 0.44 (3.9% upgrades for 8.9% downgrades). CMBS securities also display greater ratings stability (88.7%) relative to corporates (81.5%).

Data from Fitch Ratings shows similar results and can be found in the Appendix as Attachment B under Rating Agency Research.

"Risk Based Capital Guidelines: Implementation of New Basel Capital Accord" published collectively by the Department of Treasury (offices of Comptroller of the Currency and Thrift Supervision), Federal Reserve System, and Federal Deposit Insurance Corporation, p 73.

Figure 2 Moody's Annual Downgrade, Upgrade and Rating Unchanged Frequencies in the Structured Finance Sectors (Broad-Rating Based)

Asset Class		Downgrade	Upgrade	Unchanged	Withdrawn	U/D Ratio
ABS	1991-2002	2.95%	1.27%	86.59%	9.19%	0.43
CDO	1991-2002	10.88%	0.57%	83.35%	5.20%	0.05
CMBS	1991-2002	1.57%	3.49%	88.72%	6.22%	2.22
RMBS	1991-2002	1.88%	3.61%	89.18%	5.34%	1.92
OTHERS	1991-2002	4.20%	2.78%	79.84%	13.18%	0.66
All structured	1983-2002	2.99%	2.52%	87.66%	6.84%	0.84
All corporates	1983-2002	8.88%	3.90%	81.49%	5.73%	0.44

Source: Moody's Investors Service

In Figures 3a and 3b, we take a more granular look. The figures show one-year rating transitions over a ten year period by rating category for CMBS and corporates. For every initial rating, Figures 3a and 3b show the distribution of the securities across the various rating categories after twelve months. For instance in figure 3b1, for all CMBS AA classes, 85.67% can be expected to remain AA and 5.11% can be expected to be upgraded in twelve months. The figure also shows U/D ratios. Once again, the evidence is loud and clear. For every rating category, CMBS assets have notched up superior U/D ratios relative to corporates. While most people would expect this for investment grade classes, it is also true for non-investment grade classes. For instance, BB and single-B CMBS securities have shown to have one-year U/D ratios of 1.40 and 1.07, respectively. The comparable numbers for corporates are 0.55 and 0.61.

Figure 3a1. Moodys Corporates: One-Year Rating Transition Matrix [1983-2002]

	Rating after 1 year								
Initial Rating	Aaa	Aa	A	Baa	Ba	B	Caa or below	WR	U/D Ratio
Aaa	86.09%	8.79%	0.96%	0.00%	0.00%	0.00%	0.00%	4.16%	9.75*
Aa	0.76%	86.18%	8.69%	0.36%	0.09%	0.02%	0.03%	3.87%	0.08
A	0.04%	2.43%	86.97%	5.54%	0.67%	0.21%	0.04%	4.10%	0.38
Baa	0.05%	0.27%	5.63%	82.40%	4.97%	1.06%	0.39%	5.24%	0.93
Ba	0.01%	0.03%	0.56%	5.02%	75.31%	8.22%	2.04%	8.81%	0.55
B	0.01%	0.05%	0.21%	0.56%	5.67%	74.40%	10.70%	8.40%	0.61
Caa or below	0.00%	0.00%	0.00%	0.91%	2.31%	5.87%	80.73%	10.18%	9.09**

Source: Moody's Investors Service

** % Downgraded*

*** % Upgraded*

Figure 3a2. Standard & Poor's Corporates: One-Year Rating Transition Matrix [1985-2002]

Rating at Beginning of Year	AAA	AA	A	BBB	BB	B	CCC	D
AAA	93.06%	6.29%	0.45%	0.14%	0.06%	0.00%	0.00%	0.00%
AA	0.59%	91.01%	7.57%	0.61%	0.06%	0.11%	0.02%	0.01%
A	0.05%	2.10%	91.48%	5.61%	0.47%	0.19%	0.04%	0.05%
BBB	0.03%	0.23%	4.38%	89.13%	4.64%	0.94%	0.27%	0.39%
BB	0.04%	0.08%	0.43%	5.97%	83.02%	7.76%	1.20%	1.50%
B	0.00%	0.08%	0.28%	0.40%	5.26%	82.24%	4.85%	6.88%

Source: Standard & Poor's Ratings

Figure 3b1. Moodys CMBS: One-Year Rating Transition Matrix [1988-2002]

	Rating after 1 year								
Initial Rating	Aaa	Aa	A	Baa	Ba	B	Caa or below	WR	U/D Ratio
Aaa	88.67%	1.43%	0.00%	0.00%	0.00%	0.00%	0.00%	9.90%	1.43%*
Aa	5.11%	85.67%	0.66%	0.16%	0.00%	0.16%	0.08%	8.15%	4.82%
A	1.36%	3.05%	88.52%	1.36%	0.00%	0.00%	0.00%	5.70%	3.24%
Baa	0.59%	1.19%	2.90%	89.06%	1.38%	0.26%	0.20%	4.41%	2.54%
Ba	0.00%	0.00%	0.57%	2.41%	90.77%	1.70%	0.43%	4.12%	1.40%
B	0.00%	0.00%	0.16%	0.63%	1.73%	91.81%	2.36%	3.31%	1.07%
Caa or below	0.00%	0.00%	0.00%	0.00%	0.00%	2.50%	90.00%	7.50%	2.50%**

Source: Moody's Investors Service

** % Downgraded*

*** % Upgraded*

Figure 3b2. Standard & Poor's CMBS: One-Year Rating Transition Matrix [1985-2002]

Rating at Beginning of Year	AAA	AA	A	BBB	BB	B	CCC	D
AAA	99.44%	0.50%	0.06%	0.00%	0.00%	0.00%	0.00%	0.00%
AA	3.81%	94.76%	0.98%	0.40%	0.00%	0.05%	0.00%	0.00%
A	0.81%	3.20%	93.55%	2.09%	0.18%	0.12%	0.06%	0.00%
BBB	0.23%	1.33%	1.97%	93.69%	2.20%	0.41%	0.18%	0.00%
BB	0.00%	0.08%	0.47%	2.53%	94.22%	1.18%	0.56%	0.87%
B	0.00%	0.00%	0.00%	0.21%	2.06%	93.51%	2.70%	1.52%

Source Standard & Poor's Ratings

CMBS vs. Corporates: CMBS Posts Lowest Incidence of Bond Defaults

We have already seen that rating actions have been substantially more favorable for CMBS than for corporates. One would expect to extract similar conclusions by looking at actual bond defaults, and this is in fact the case. In Figures 4a and 4b, we

highlight the percentage of bonds that default over twelve months for each rating category. For the purposes of this study, we have assumed a rating of Caa or less to be synonymous with default. (It should be noted here that Moody's rates a security to its loss severity, whereas Standard & Poor's rates to its probability of default. The actual default frequencies of various credit ratings are shown in the "D" column of the rating transition matrixes.) Once again, CMBS outshines the other sectors across all rating categories. To illustrate, Figure 4a shows that only 0.43% of the group of CMBS rated BB at any time tend to default over a period of twelve months. The comparable figure is almost five times higher for corporates (2.04%) and virtually off the charts for ABS and CDOs (in excess of 11%). In Figure 4b, Standard & Poor's one-year default rates for investment grade CMBS (AAA to BBB ratings) were consistently zero, where those for corporates ranged between zero for AAA to 0.39% for BBB.

Figure 4a. CMBS Bond Defaults Are Substantially More Modest Than Other Sectors

	Rating of Caa or below after 1 year					
Initial Rating	**ABS**	**CDO**	**CMBS**	**RMBS**	**Others**	**Corporates**
Aaa	0.07%	0.00%	0.00%	0.00%	0.00%	0.00%
Aa	0.22%	0.11%	0.08%	0.00%	0.00%	0.03%
A	0.09%	0.90%	0.00%	0.20%	0.25%	0.04%
Baa	0.68%	3.18%	0.20%	0.86%	2.14%	0.39%
Ba	11.10%	11.04%	0.43%	2.39%	2.38%	2.04%
B	21.71%	29.91%	2.36%	6.41%	2.33%	10.70%

**Note: for Corporates, the original rating of Caa or Below only includes Caa-C*

Source: Moody's Investors Service

Figure 4b. Standard & Poor's One-Year Bond Default Rates by Asset Type

Rating at Beginning of Year	**ABS**	**CDO**	**CMBS**	**RMBS**	**Corporates**
AAA	0.00%	0.00%	0.00%	0.00%	0.00%
AA	0.00%	0.00%	0.00%	0.00%	0.01%
A	0.32%	0.00%	0.00%	0.00%	0.05%
BBBa	0.37%	1.80%	0.00%	0.10%	0.39%
BB	1.63%	3.40%	0.87%	1.00%	1.50%
B	10.71%	6.30%	1.52%	2.00%	6.88%

Source: Standard & Poor's Ratings

All Securitized Product is Not Created Equal

Under the securitization framework, a securitization exposure is "any on- or off-balance sheet position created by aggregating and then tranching the risks of a pool of assets, commitments, or other instruments (underlying exposures) into multiple financial interests where, typically, the pooled risks are not shared pro-rata." In theory, the A-IRB approach is consistent across pooled transactions – it relies on an external rating assessment to determine the risk of the asset. In practice, however, the reliability of the external rating in measuring the potential risk of loss is more volatile as quality falls.

The Agencies acknowledge this when they refer to "highly subordinated securitization exposures" with risks that are "...difficult to evaluate" and where "...risk quantifications tend to be highly sensitive to modeling assumptions that are difficult to

evaluate objectively." In fact, they use it as justification for treating highly subordinated securitization exposures more conservatively, when they state:

> "For securitization exposures rated below BB-, the proposed A-IRB treatment – deduction from capital – would be somewhat more conservative than suggested by credit risk modeling analyses. However, the Agencies believe this more conservative treatment would be appropriate in light of modeling uncertainties and the tendency for securitization exposures in this range, at least in the inception of the securitization transaction, to be non-traded positions retained by an originator because they cannot be sold at a reasonable price."

Given greater uncertainty for lower-rated classes, we would also suggest that the Agencies use more discretion when applying scaling factors to securitized products. Under the current framework, there is virtually no distinction for securitized credit products, with CDOs, ABS, CMBS and residential MBS receiving equivalent treatment. However, there are clear distinctions in performance when we compare structured products derived from asset-backed/corporate debt to structured products derived from mortgage debt (either commercial or residential). First, from the perspective of bond defaults, CDOs and ABS have proven to have considerably greater risk than CMBS or MBS; as shown in Figure 4, BB-rated defaults have averaged over 11%, compared to CMBS and RMBS at 0.43% and 2.39%, respectively. Second, from the perspective of rating actions, ABS and CDOs have posted upgrade/downgrade ratios well below 0.5:1, while CMBS and RMBS post U/D ratios in the vicinity of 2:1. We ask that the Agencies consider a substantial reduction in scaling factors for non investment-grade CMBS and RMBS.

Pooling Enhances Diversification

Pooling loans into a single transaction helps to mitigate the variability of losses. The level of diversification of a pool depends upon several factors. Moody's, for example, looks at diversity in CMBS transactions in four ways: by property type, geographic location, economic diversity and loan by loan concentration. Quantitatively, diversity can be measured by the number of loans in the pool, loan sizes, and the correlations among the loans. Moody's utilizes the Herfindahl index to measure pool concentration. Notice that diversity does not affect the expected loss to the trust. Instead, diversity determines the volatility of the loss. A highly concentrated pool (like a whole loan) has very high loss volatility, in the sense that the loss will tend to be either very high or very low. In contrast, a pooled CMBS transaction would reduce the risk to more senior classes in the capital structure. The Agencies have argued that rated securities backed by a pool of loans will receive limited diversification benefits when combined in a bank portfolio. That is true, so long as a large number of loans contribute to the transaction (>500). Based on diversification measures (like the Herfindahl index),

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"IBID", p.80-81.

The Herfindahl-Hirschman Index is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in the market and then summing the resulting numbers. For example, for a market consisting of four firms with shares of thirty, thirty, twenty and twenty percent, the HHI is 2600 (302 + 302 + 202 + 202 = 2600). Moody's use of the Herfindahl Hirschman Index in rating CMBS is described in Attachment C in their document, "CMBS: Moody's Approach to Rating US Conduit Transactions".

securities backed by a relatively small number of loans (like CMBS) would still realize significant diversification benefits when combined in a bank portfolio.

II. Inconsistent Application of RBA Approach for Investing versus Originating Banks

All CMBS Ratings Subject to Market Discipline

We strongly recommend that the Agencies reconsider the distinction between Originating Banks and Investing Banks in the use of external ratings under the A-IRB approach Although we recognize your position in encouraging Originating Banks to "shed subordinate securitized risks" , we believe that significant differences exist between CMBS and other asset classes in which Banks may hold such risk. In the Guidelines, the Agencies cite the concern "that the market discipline underpinning an external credit rating may be less effective when the rating applies to a retained, non-traded securitization exposure and is sought by an originator solely for regulatory capital purposes" for the rationale behind not allowing the RBA approach for securitization exposure below KIRB for originating banks

We assert that this statement is unequivocally not true for the CMBS marketplace. Specifically, the underpinnings for an external rating are quite rigorous given the active Rating Agency process, the liquidity of the sector and the possibility of future sale of such classes. It is common practice for a CMBS transaction to obtain ratings across the entire capital structure (AAA through unrated) and distribute that risk to third-party investors. Unlike other ABS and MBS markets, a thriving new issue market exists for Below Investment Grade Classes of CMBS.

There are 10 active investors in securities with ratings of B+/B1 through non-rated. These investors represent capital from the life insurance and pension communities, as well as opportunity funds, finance companies and banks. Such investors have staff with extensive commercial real estate credit expertise and they act as another check of the CRE Mortgage Loan underwriting and the Rating Agency analyses. In 2003, these investors have actively and competitively bid on the approximately $3 billion of Below Investment Grade Classes of CMBS issued. With yields near historic lows and real estate performance displaying remarkable consistency, the non investment-grade buyer base has been one of the fastest growing sectors in CMBS.

An Originating Bank's decision to retain subordinate CMBS classes is not motivated by any lack of an external market for those exposures. In fact less than 5% of the transactions securitized in 2003 contained non-investment grade class sold to the originator. To the extent that the Agencies policy is influenced by an assumption of "a non-traded positions retained by an originator because they cannot be sold at a reasonable

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"Risk Based Capital Guidelines: Implementation of New Basel Capital Accord" published collectively by the Department of Treasury (offices of Comptroller of the Currency and Thrift Supervision), Federal Reserve System, and Federal Deposit Insurance Corporation, p 78.

"IBID", pg 78.

price" we encourage you to revisit this assumption as it relates to the evidence that we have provided on the CMBS marketplace.

Further we would surmise that the Agencies did not intend to create a bias against an originating bank holding the subordinate pieces of its own collaterization as opposed to buying the subordinate pieces of another bank's deal. Consider the following example: Bank X originates $1 billion of commercial mortgage loans which it subsequently securitizes as CMBS. Bank X retains the bonds rated BB+ and below. If we assume that KIRB is equal to 8% and the notional exposure of the bonds retained by the bank is equal to $55.0 million, Bank X would be required to maintain $55.0 million of capital against its retained bonds. If Bank X were to buy the same group of bonds as an investing bank, the capital required under the RBA approach would be $37.9 million.

Example Calculation

Scenario #1

Bank X originates $1 billion of commercial mortgage loans
Bank X retains the bonds rated BB+ and below (approximately 5.5% of transaction)
Capital required for Bank X's position = $55.0 million

Scenario #2

Bank X buys bonds rated BB+ and below from another originator

Rating	*Size ($mm)*	*Risk Weight (%)*	*Capital ($mm)*
BB+	12.4	250	2.48
BB	6.3	425	2.14
BB-	6.3	650	3.28
Single B to Unrated	30	Deduction	30
Total	**55**		**37.9**

As written, the guidelines suggest that an originating bank investing in its own subordinate securities is inherently riskier than buying another bank's subordinate securities. We disagree with this view.

III. CMBS Market Structure and Information Availability

In the following section we explain the mechanics of the CMBS marketplace and provide the Agencies with a guide to the multitude of information that is available to CMBS market participants. We hope the Agencies find these comments useful in understanding the dynamics of the CMBS marketplace and the vital role that it plays in commercial real estate finance.

Risk Based Capital Guidelines: Implementation of New Basel Capital Accord" published collectively by the Department of Treasury (offices of Comptroller of the Currency and Thrift Supervision), Federal Reserve System, and Federal Deposit Insurance Corporation, p 80-81.

The Securitization Process Promotes Lending Discipline

The independent review process, which is fundamental to the CMBS market has helped encourage more conservative lending practices among CMBS originators. The improved transparency between the capital markets and the property markets should serve to dampen some of the volatility of the commercial real estate markets going forward. In addition to our comments below, Moody's Investor Service further explores this topic in its paper, "CMBS: New Rules for An Old Asset Class", which is included in the Appendix as Attachment D.

Similar to whole loan lending, the lender (placement agent) in a commercial mortgage origination must get comfortable with the level of risk associated with the required debt. However, before a commercial mortgage loan is securitized in a CMBS transaction, it must also pass the scrutiny of two independent parties with either significant franchise risk or investment risk: the rating agencies' review and the first-loss investor's due diligence. These review and diligence processes are described below.

a) **Placement Agent Review.** The investment bank(s) functioning as securities underwriter and placement agent for the CMBS perform due diligence on the originator/seller of the CRE Mortgage Loans, review the CMBS transaction structure with expert outside counsel, and perform due diligence on the CRE Mortgage Loans. The placement agent will also coordinate the structuring of the CMBS in preparation for marketing the transaction. This review is necessary to support the new issue process as well as to prepare for the on-going monitoring of the transaction to support secondary market trading in which the investment bank will take principal risk post-new issue in the buying and selling of the CMBS securities.

b) **Rating Agency Review.** The determination of the expected credit risk of a portfolio of CRE Mortgage Loans backing a CMBS is assessed by independent third parties, the Rating Agencies. The Rating Agencies intensely review the underlying assets and employ the resources, both internal and external, to dissect the structure of the specific CMBS. (For example, the Rating Agencies employ counsel with extensive deal structuring experience to review the CMBS transaction and documents.) The Rating Agencies review all relevant underwriting information on the CRE Mortgage Loans and make site visits to the properties. These due diligence actions by the Ratings Agencies represent a significant departure from their review process of other Asset Backed Securities ("ABS"). Such securities are rated based on metrics such as "law of large numbers" or consumer credit scoring performed by the originator of the underlying asset. Further description of the Rating Agencies' Approach to Rating CMBS is included in the Appendix as Attachment C.

c) **First-Loss Investor Review.** The CRE Mortgage Loans backing a CMBS must also pass the review and evaluation of the so-called "First-Loss Class Investors". Such investors also perform significant due diligence on an asset-by-asset basis. The transaction documents identify the First Loss Class Investor as the Controlling Class of the Securitization. The Controlling Class is often purchased by investors that also perform the role of the Special Servicer (or have

the right to replace the Special Servicer for the Trust). We will discuss in more detail the Special Servicer's role later in our comments.

The securitization process has proven to promote lending discipline – and to reduce the volatility of CMBS asset pools as described above. Much credit is due to the dynamics of the First Loss market. First Loss buyers have been able to enforce certain loan standards (e.g., minimum credit enhancement, uniform loan terms, plain-vanilla asset types, etc.) and remove loans of questionable credit quality from transaction pools. Partnerships among First Loss buyers also helped to strengthen standards, and the involvement of real estate opportunity funds has increased the number of parties reviewing a transaction.

To date, the loss experience on CMBS transactions has been far better than anticipated. Across transactions originated from 1996-99, aggregate losses remain less than 50 bp. With such low incidence of losses, performance has been more highly levered to weaker asset classes, most notably hotels, health care and credit-tenant leases (CTLs) (see Figure 5). For example, 50% of historical bsses are tied to property types that account for only 10% of deal assets. As time has gone by, the First Loss buyers have had a hand in ferreting out weaker (and more volatile) asset types from CMBS transactions, reducing the probability of future losses. Since 1998, when hotel, health care and CTL loans accounted for 14% of deal originations, exposure to those more volatile asset types has fallen to approximately 2.5%. In addition to the loss data presented by Lehman Brothers, we also direct you to Attachment B in the Appendix for several loss studies from the Rating Agencies.

Figure 5. The Asset Mix is Less Volatile Now

	Credit Measures			Pct. Exposure in Deals Originated in...		
Property Type	Non-Perf. (%)	Losses (% Orig)	Credit Indicator	1998	2003	Pct. Chg.
Retail	1.18	0.28	0.27	29.02	41.72	12.70
Office	0.71	0.10	-0.28	19.20	28.78	9.58
Multifamily	0.91	0.11	-0.50	25.48	17.52	-7.97
Hotel	7.34	1.22	6.77	9.95	2.27	-7.68
Industrial	1.61	0.07	0.33	6.68	4.91	-1.77
Other	1.17	0.05	-0.22	5.44	4.71	-0.73
CTL	3.80	0.96	2.99	1.97	0.09	-1.87
HC	8.89	1.70	6.74	2.26	0.00	-2.26
Overall	**1.66**	**0.28**	**0.61**	**100.00**	**100.00**	**0.00**

Source: Lehman Brothers

Representations and Warranties from Loan Sellers Mitigate Credit Risk

The CRE Loans that underlie CMBS are acquired from one or more separate loan sellers (which are typically the originators of such CRE Loans). In connection with the

conveyance of the CRE Loans, the loan seller will deliver an extensive amount of representations and warranties relating to the general quality of the loans and the security underlying those loans. A representative list of those representations and warranties are included in Attachment E. These representations and warranties are primarily established by the rating agencies and may be somewhat varied in each CMBS transaction in a manner that appropriately addresses the related CRE Loans, or as may be negotiated by the related First Loss Class Investor. Any exceptions to these representations and warranties are required to be disclosed, and such exceptions are evaluated by the rating agencies and the investors in the CMBS.

If there is a material breach of any of these representations or warranties, the loan seller will be obligated under the related loan sale agreement to either cure the breach within a prescribed period of time (usually around 60 days, although this may be extended if such breach is in the process of being cured), or will be required to repurchase the loan based on its outstanding amount, as well as any costs related to holding such CRE Loan and re-conveying it to such loan seller – regardless if the value of the loan has declined as a result of any problems associated with such breach. Amounts received in connection with such a repurchase are used to prepay the outstanding CMBS.

This benefit of having such representations and warranties (along with the related remedies) is unique to CMBS, and protects CMBS investors against any "unforeseen" issues that might exist with particular "defective" loans that might sit in a mortgage pool – a benefit that does not exist for the holder of a typical CRE loan pool. The Representation and Warranties provided by the loan seller serve as a further credit quality check in the CMBS marketplace.

Trustees and Servicers Play Vital Roles

The Trustee on a CMBS transaction is bound by a Pooling and Servicing Agreement (PSA) that dictates the requirements of the parties in the transaction and details how to distribute cash to the bonds. The Trustee produces a Monthly Remittance Report for the life of the transaction. This report gives all bond performance details regarding principal, interest and any premium payments as well as any loss information. It also typically provides an overview of the collateral information. A representative Remittance Report is found in the Appendix as Attachment F.

The Servicing Function within the CMBS marketplace is usually divided between several parties. The Primary Servicer is typically the servicer responsible for day to day contact with the borrower. Their job is to collect payments and financial statement information. Each month they report on the status of the loan and all required information detailed in the standard CMSA Investor Reporting Package. The CMSA Investor Reporting Package (Version 3.0) is found in the Appendix as Attachment G, and it serves as the industry standard for the collection and dissemination of information to the CMBS marketplace. We discuss further the information provided for under the CMSA Investor Reporting Package in a later section. The Master Servicer collects all information from the various Primary Servicers in a transaction and consolidates the information into one package to be sent to the Trustee. The Master Servicer can also perform the role of Primary Servicer.

In addition to its collection and payment responsibilities, the Master Servicer alerts investors to potential credit issues with individual loans in a CMBS transaction through its monthly loan Watchlist. The CMSA has standardized the criteria for including loans on the Watchlist, and the criteria were selected based on their ability to provide investors with knowledge of potential credit issues prior to actual delinquency. The Watchlist criteria are organized under financial conditions, borrower issues, property condition issues, lease rollover, tenant issues and vacancy.

In addition to the Master Servicer, the Special Servicer (which is usually either the First Loss Investor or designated by the First Loss Investor) also plays a crucial role in loss mitigation. There are several criteria that determine whether a loan is transferred from the Master Servicer to the Special Servicer. The Special Servicer generally becomes involved in a loan if there is an "eminent default", the loan is 60 or more days delinquent, or there is a Special Servicing Transfer Event as defined in the deal documents. The Special Servicer has the responsibility to act in the best interest of all Certificate Holders on behalf of the Trust in resolving a delinquency or default. The Special Servicer typically attempts to restructure or "work out" the loan in conjunction with its right to ultimate foreclose on the loan in order to maximize the recovery to the Trust. The Special Servicer does not, however, initiate "new lending activity" to the borrower. In addition, in many transactions, the Special Servicer will have rights to evaluate and approve certain actions relating to the management of loans that are not in default (e.g. – review and approval of any change in the borrower or the borrower's ownership structure; any approvals relating to the incurrence of additional debt by the borrower). Recognizing the important role of the Master Servicers and Special Servicers in CMBS transactions, the Rating Agencies analyze these companies as part of the ratings process. Representative Rating Agency analysis of a Master Servicer and Special Servicers is included in the Appendix as Attachment H.

REMIC Laws and Encourage Loan Standardization

Most CMBS in the U.S. are issued as REMIC interests for the purpose of federal tax law to avoid taxation at the pool level. In order for CMBS to qualify under REMIC, the underlying CRE Loans must meet a number of requirements that are specified under the U.S. tax code. Those requirements include that each CRE Loan, at the time of the securitization, have, among other things, the following characteristics: the securitization's interest in the loan must require full payment by the related borrower (and not permit payment at a discount); the loan must provide for enforcement remedies, including foreclosure; the loan may not be converted into the equity of the borrower; a loan secured by a ground lease must mature sufficiently prior to the expiration of the lease (including automatic extensions) so that a significant real property interest remains at such maturity (tax rules do not state a minimum period, but ERISA rules require a minimum of 10 years); cross-collateralized loans with multiple properties must by their terms require partial prepayment of the loan in order to release a property; and all proceeds under a loan must have been disbursed and bear interest on the entire unpaid principal balance. Also, a CRE Loan should not be included in a REMIC if it is known that the loan is in default or is expected to go into default, as foreclosure property would not be a qualified asset for the REMIC. This provision also helps to ensure the credit quality of loans financed through CMBS transactions.

Information Available to CMBS Investors Rivals Any Sector of the US Capital Markets

Throughout the Guidelines on Securitization, the Agencies pose questions regarding the availability of information for Originating Banks as Compared to Investing Banks. The Agencies make the statement that, "Third-Party investors generally do not have access to detailed, on-going information about the credit quality of the underlying exposures in a securitization" . For CMBS that statement is emphatically not true. We assert that the information available to CMBS investors rivals any sector of the capital markets.

The information available to Originating Banks may be more, less or the same as that available to Investing Banks, depending on the rigor of the Originating Bank, and depending on which class of securities the Investing Bank is purchasing. The information available to an Investing Bank is an established standard determined by the Rating Agencies, by market convention, by the disclosure requirements of the SEC in public securities and private placements, and will vary somewhat if the Investing Bank is purchasing Investment Grade Public Securities (all information disclosed to all investors in the public prospectus) or Below Investment Grade Private Securities (more information available through the individual asset files and within the private placement offering). The individual CRE Mortgage Loans backing a CMBS are typically analyzed by at least two Rating Agencies as well as the First Loss Class Investors. These parties have access to nearly the same level of information as the originator of the CRE Mortgage Loan when it makes the decision to fund that loan. This information includes third-party due diligence reports (appraisal, environmental, structural reports), property operating statements and accounting reports. In addition, the Rating Agencies and Below Investment Grade Class Investors perform site inspections on individual properties and read market research reports.

Post-Securitization Information for CMBS investors is also robust. Trustees provide monthly reporting packages to investors to provide detail on the bonds as well as the individual mortgage loans and properties. The Master Servicer receives quarterly and annual operating statements and rent rolls from the borrowers of the individual mortgage loans backing the securities. In addition, property inspections are performed. Many securities underwriters closely monitor transactions they have underwritten and provide regular research reports updating investors on individual loans.

Significant work by associations such as the Commercial Mortgage Securities Association has led to standards for various aspects of the CMBS market, including the reporting packages. Companies such as Trepp, Intex, Conquest and Realpoint provide investors with the ability to monitor transactions through web-based databases and applications, as well as input their own assumptions to "stress" a transaction.

At the risk of being redundant we enumerate the myriad sources of information available to a CMBS investor all of which may be found in the Appendix as Attachment I.

Risk Based Capital Guidelines: Implementation of New Basel Capital Accord" published collectively by the Department of Treasury (offices of Comptroller of the Currency and Thrift Supervision), Federal Reserve System, and Federal Deposit Insurance Corporation, p 77.

1. Deal Prospectus
2. Rating Agency Pre-Sale Report
3. Monthly Trustee Remittance Report
4. CMSA Data Files
5. CMSA Supplemental Reports
    a) Servicer Watchlist / Portfolio Review Guidelines
    b) Delinquency Loan Status Report
    c) REO Status report
    d) Comparative Financial Status Report
    e) Operating Statement Analysis Report (OSAR)
    f) NOI Adjustment Worksheet
    g) Historical Loan Modification Report
    h) Historical Liquidation Report
    i) Loan Level Reserve/ Letter of Credit Report
    j) Reconciliation of Funds
6. Underwriter Research on Collateral Performance
7. Third Party Research
    a. Real Point Deal Review
    b. Trepp Deal Review

Summary

We greatly appreciate the opportunity to present our comments to the Agencies on their work to date for the Basel II Guidelines. We look forward to working with the Agencies to ensure that the systematic bias against non-investment grade CMBS exposures is removed from the final Guidelines so that Basel II does indeed represent "equal capital for equal risk".

Appendix

Attachment	Content	File Name
A	Commercial Mortgage Securities Association	CMSA
B	Rating Agency Research	
	Fitch Ratings	Fitch 2003 CMBS Loan Loss Study.pdf; Fitch 2003 Conduit Loan Default Study.pdf; Fitch 2003 Loss Study Property Type Trends.pdf; Fitch CMBS v Corporates 2000.pdf
	Moody's Investor Service	Moody's Structured Finance Rating Transitions.pdf
	Standard and Poor's	SP Rating Transition Study.pdf
C	Rating Agency Review Process	
	Fitch Ratings	Fitch CMBS Rating Guide.pdf
	Moody's Investor Service	Moody's Approach to Rating US Conduit.pdf
	Standard and Poor's	S&P Rating Criteria.pdf; SP Rating Methodology.pdf
D	CMBS: New Rules for An Old Asset Class", Moody's Investor Service, Sally Gordon, December 8, 2000.	CMBS New Rules for an Old Asset Class.pdf
E	Typical Representations and Warranties	Reps & Warranties.doc
F	Representative Remittance Report from CSFB 2003-C3	csfb03c3remit200310.pdf
G	CMSA Investor Reporting Package (Version 3.0)	CMSA_IRP_4.1_2003.pdf
H	Rating Agency Analysis of Servicers	
	Fitch Ratings	Fitch Servicer Criteria.pdf
	Standard and Poor's	S&P Servicer Evaluation.pdf

Attachment	Content	File Name
I	CMBS Investor Information (most information provided is for a representative conduit transaction CSFB 2003-C3)	
	Deal Prospectus	fb03c3.pdf
	Deal Data Tape	fb03c3.xls
	Rating Agency Pre Sale Reports	
	Fitch Ratings	Fitch Presale.pdf
	Moody's Investor Services	Moody's Presale.pdf
	Standard and Poor's	SP Presale.pdf
	Monthly Trustee Remittance Report	csfb03c3remit200310.pdf
	CMSA Files	CMSA IRP_1.xls; CMSA IRP_2.xls
	Representative Underwriter Research	
	Lehman Brothers	Lehman Research.pdf
	Morgan Stanley	MWD Research.pdf
	Third Party Research	
	RealPoint Deal Review	Realpoint_Report.pdf
	Trepp Deal Review	Trepp Research.pdf