J.P.Morgan

Bianca A. Russo
Managing Director &
Associate General Counsel
Legal Department

April 23, 2012

Jay Knight
Attorney - Division of Corporate Finance
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington, DC 20549
VIA Electronic Mail

Re: Supplemental Materials on Risk Retention and Premium Capture

Dear Jay,

Thank you for meeting with us on February 29th to discuss our comments on the Risk Retention rule proposal, and particularly the premium capture cash reserve account ("PCCRA") provisions. At your request, we are providing some supplemental materials with more analysis on how we arrived at the estimates of increased borrowing costs that were in our original comment letter and more analysis on the economic and capital impact of the PCCRA. Attached is the presentation we originally provided with the added supplemental information (see in particular slides 11 and 12 for RMBS and slides 14-17 and 23-24 for CMBS). We also inserted an introductory slide with a summary of our key points, which are generally as follows:

- We believe the proposal's flexible approach to allowable forms of Risk Retention should be retained.
- Risk Retention should be subject to a sunset provision of 3 years which would adequately cover underwriting risk, and not subject a sponsor to additional risk from an economic cycle.
- We believe PCCRA is broader than necessary to achieve its purpose and should be eliminated or significantly modified.
- **PCCRA Impacts on RMBS**:
  - Vertical Risk Retention, in and of itself, should be sufficient; it cannot be "gamed" as any structural changes in one class of securities will be exactly offset by structural changes in other classes of securities with a sponsor retaining an equivalent percentage of each.
    - We believe that a 5% Vertical Risk Retention will not drastically increase interest rates for borrowers.
  - If PCCRA is not eliminated, we would recommend the following changes:
    - For Vertical Risk Retention, the formula should either a) be the same as the Representative Sample option utilizing 100% of Par or b) use Market Value in the place of Par.
    - Representative Sample by itself will be difficult to implement with an "equivalent risk" and therefore should allow for an unstructured pass-through, a "Retention Class," to be held instead.
  - A suggestion has been made that to avoid PCCRA the sponsor can hold more than 5%. However, current guidance indicates that Risk Retention of more than 5% of a first loss tranche

would put stress on the consolidation analysis, potentially leading to transactions accounted for on balance sheet. It is also more than that required by Dodd-Frank.

- "Net Closing Costs" needs to be defined to include additional expenses such as GAAP origination costs, REMIC tax and hedging costs, as well as an allowance for loans purchased and/or originated at a premium.
  - Borrowers would be directly impacted if hedging costs are not included as originators may be unwilling to provide rate locks. An originator would establish a hedge to remain economically neutral; if the loans increase in value and the hedge decreases in value the additional premium may be trapped in the PCCRA and the originator would need to cover a hedge loss out-of-pocket.
  - Borrowers would be directly impacted if loan premiums were not deductible. Many originators offer higher interest rates to borrowers to cover closing costs; if premiums are trapped in the PCCRA, then originators would have a disincentive to cover borrower closing costs which would ultimately remove availability and liquidity for these loans.
  - When loans trade in the whole-loan market, a buyer may also purchase the servicing rights ("MSR") with the intent to sell or transfer the servicing to either an affiliate or a third party who can best service the loans. The cost of the MSR should therefore also be included in "Net Closing Costs."

- **PCCRA Impacts on CMBS**:
  - Dodd Frank legislation acknowledges the role of the third party B-piece buyer as a risk retention surrogate.
    - The "conduit" CMBS market serves smaller regional markets under-served by portfolio lenders.
    - The CMBS market is currently functioning with both GSEs and bank-originated CMBS B-piece sales.
    - Any additional retention should work with and not disrupt this functioning private market.
  - PCCRA attempts to change the CMBS business model of selling discount B-pieces and call-protected excess interest strips.
  - PCCRA will force out banks as originators if banks cannot recover costs and compensate for the risks incurred; that will produce higher CRE mortgage rates for borrowers due to increased capital costs of unregulated entities who will originate.
  - We propose alternatives to PCCRA for CMBS (see slide 22 in the presentation).
    - For example, additional retention by the sponsor in addition to that held by the third party B Piece buyer.
  - Special consideration should be given to single-borrower and other investment grade issues.

If you would like to discuss these supplemental materials or have any further questions, please let me know. In particular, if it would be helpful we would welcome the opportunity to work through our economic analyses with you. For example, we can walk you through the modeling of a representative sample so you can appreciate the challenges to build and can see how our proposed "retention class" compares to a vertical slice.

Very truly yours

Bianca A. Russo

RISK RETENTION

April 2012

J.P.Morgan

This presentation is for discussion purposes only and is incomplete without reference to, and should be viewed solely in conjunction with, the oral briefing provided by J.P. Morgan.

The information in this presentation reflects prevailing conditions and our views as of this date, all of which are accordingly subject to change. J.P. Morgan's opinions and estimates constitute J.P. Morgan's judgment and should be regarded as indicative, preliminary and for illustrative purposes only. In preparing this presentation, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources or which was otherwise reviewed by us.

J.P. Morgan is a marketing name for investment banking businesses of JPMorgan Chase & Co. and its subsidiaries worldwide.

Risk Retention impacts on RMBS & CMBS

Risk Retention impacts on RMBS

- For RMBS we believe the proposals flexible approach to allowable forms of risk retention should be retained
  - The 5% risk retention requirement, in and of itself, is not expected to drastically increase interest rates for borrowers
  - Vertical risk retention cannot be “gamed” as it holds an equivalent percentage of each class of securities
  - The representative sample technique, when designed to require an unstructured pass-through participation class or “retention class”, cannot be used to avoid risk retention
  - The final rules should allow for the termination of the risk retention requirements after three years
- Risk retention in excess of 5% would put stress on the consolidation analysis and could cause firms to consolidate entities where there entities would otherwise not be deemed significant
- We believe the premium capture provisions are broader than necessary to achieve their purpose and as a result will adversely affect the availability of mortgage products nationwide and will result in higher rates for borrowers
  - Additionally, PCCRA could negatively impact the ability to re-establish a private label securitization
    - Bank portfolios would be under increased capital pressure via consolidation
    - Many loans would end up with non-bank entities and be financed via “shadow banking” entities
    - Ultimately this will negatively impact the availability of credit and home prices

Risk Retention impacts on CMBS

- Dodd Frank legislation acknowledges the role of the third party B-piece buyer as a risk retention surrogate
  - The B-piece exemption in Dodd Frank removes the burden of risk retention on the seller
  - The CMBS market is currently functioning with both GSEs and bank originated CMBS B-piece sales
  - Any additional retention should work with and not disrupt this functioning private market
- PCCRA attempts to change the CMBS business model of selling discount B-pieces and call-protected excess interest strips
- PCCRA will force out banks as originators and produce higher CRE mortgage rates for borrowers due to increased capital costs of unregulated entities who will originate

Agenda

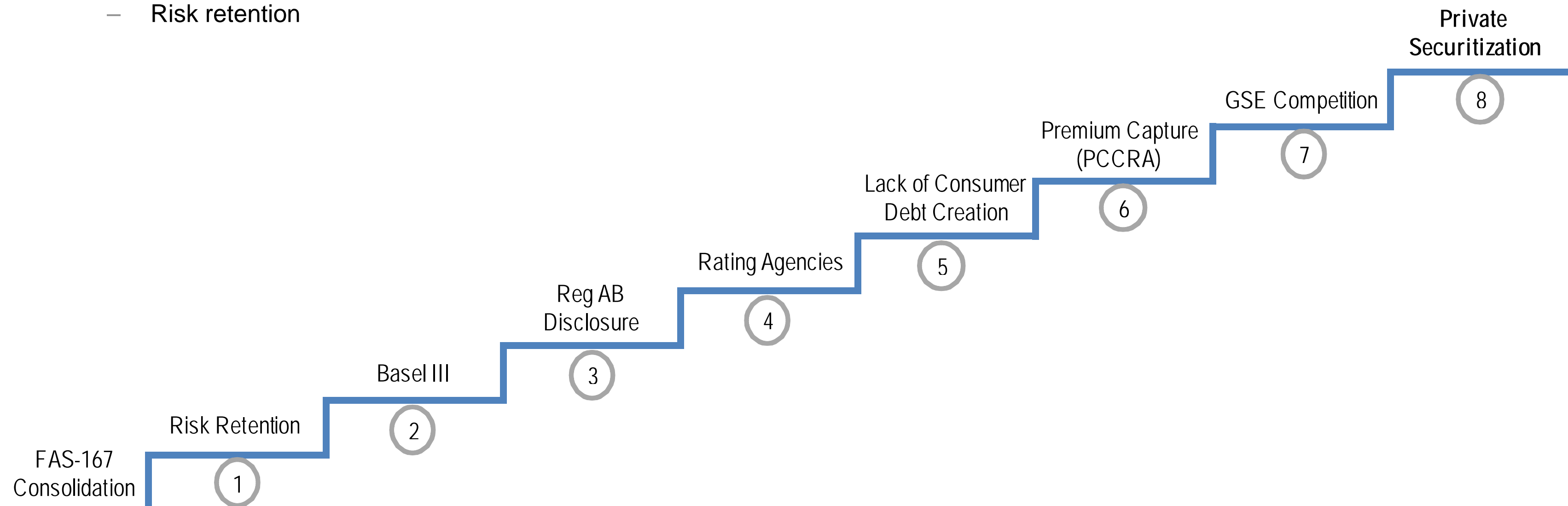
	Page
Premium Capture Considerations for RMBS	**2**
Premium Capture Considerations for CMBS	13

J.P.Morgan

Challenges to re-establishing the RMBS market

GSE competition and premium capture are main hurdles, others are surmountable

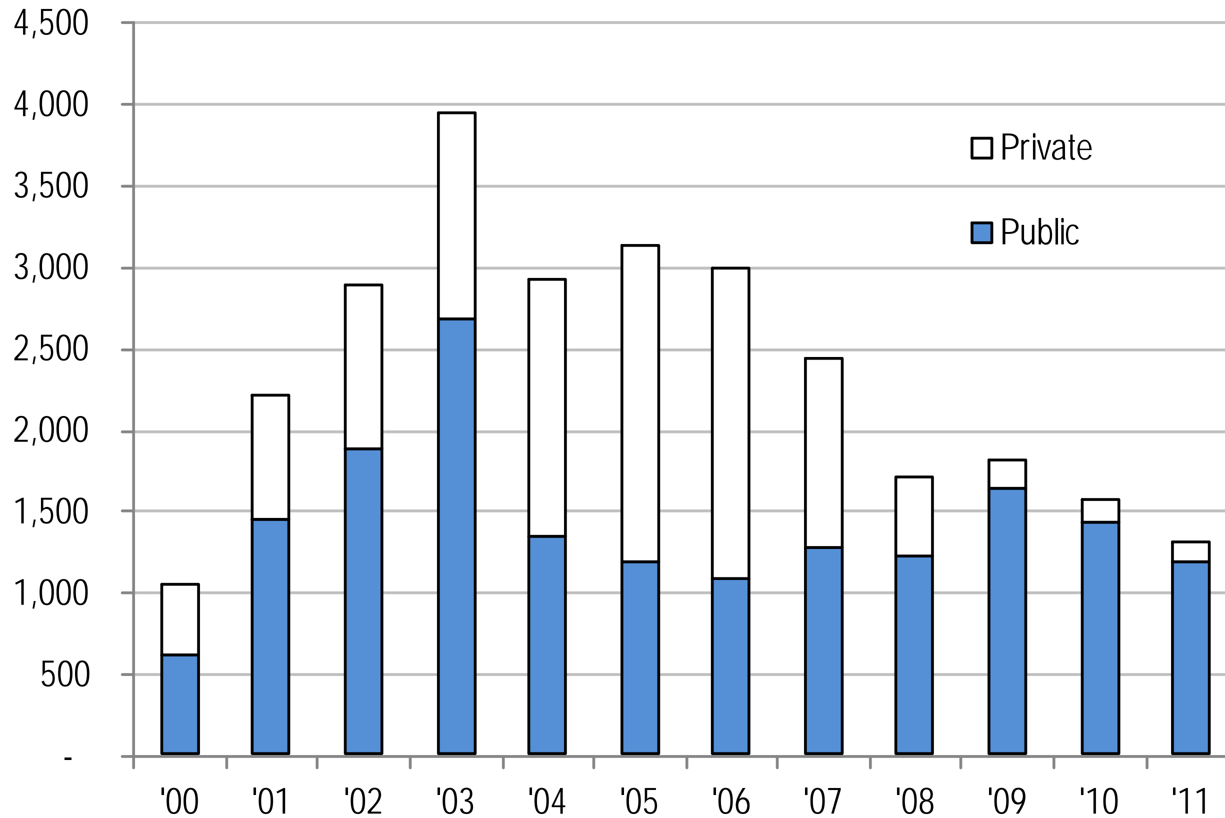
- **There are several steps to be completed prior to the return of the private label securitization market**
  - Market participants have been reviewing and preparing for additional data & reporting requirements
    - ASF Project Restart
  - Future capital & accounting treatment will be of critical importance and impacted by
    - Servicing affiliation
    - Risk retention



Source: J.P. Morgan

GSE lending dominates the market with over 90% of new loans

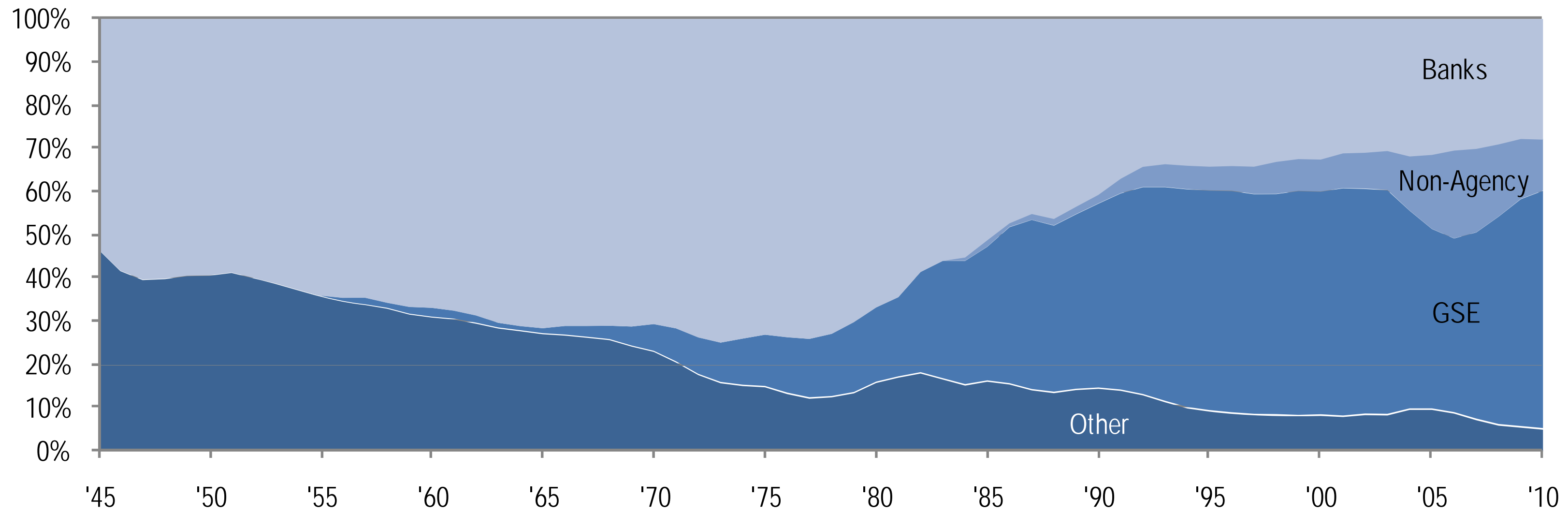
Total market originations by product ($bn)



Source: Inside Mortgage Finance, J.P. Morgan

GSE financing accounts for over half of mortgages outstanding

Market share of mortgage debt (%), including both first and second liens



- GSEs finance 55% of all current mortgage debt outstanding
- Why have GSEs dominated?
  - Liquidity advantage
  - Lower capital requirements / mispricing of insurance risk
- GSE reform will require a new mortgage finance model

Source: Federal Reserve. "Other" represents insurance companies, financial companies, the Federal Government, and non-farm non-financial corporate businesses

Risk Retention can be achieved without PCCRA

- **The premium cash capture reserve account provision (PCCRA) in the proposal is broader than necessary to ensure that structuring is not used to circumvent the risk retention requirements.**
- **The proposed PCCRA framework will:**
  - Significantly increase interest rates for borrowers and adversely impact the struggling mortgage market in particular; and
  - Impact borrower affordability
- **We propose changes to PCCRA to preserve its intended function. Our changes would ensure that:**
  - Sponsor's retained interests are meaningful
  - Interests of the sponsor and the holders of the securities are aligned
  - Structuring choices do not undermine risk retention economics
  - Risk retention requirements are not circular
  - Identical economic interests are treated similarly
  - Sponsors continue to achieve sale accounting treatment for securitizations, and
  - Borrowers are protected from significant interest rate increases

Why PCCRA as proposed may be harmful to the mortgage market

- **The PCCRA requirement alone will significantly increase mortgage rates and negatively impact the housing market's recovery by significantly decreasing credit availability and home ownership opportunities**
  - To match current securitization economics, originators will have to raise mortgage interest rates by approximately 2 percentage points, and more for lower-credit borrowers.
  - This would be in addition to other cost increases associated with risk retention in general under the risk retention proposal, particularly if the final risk retention rules do not provide for a sunset provision
- **Adverse impact on financial institutions**
  - Sponsors may increase the retained interests within a securitization to avoid triggering PCCRA, thereby risking consolidation under GAAP and leading to significantly higher capital costs for sponsors and higher mortgage rates for borrowers
  - To offset consolidation impacts, lender-sponsors would be required to increase mortgage rates by approximately 300 basis points under today's regulatory capital requirements (which are subject to increase in the future)
- **Any increase in borrowing cost would ultimately be borne by the consumer and would negatively impact affordability and as a result, housing prices**
  - As discussed herein, we believe PCCRA would result in an increase in mortgage rates, potentially up to or even in excess of 200 basis points
  - To illustrate, the table below shows the impact of a 2% rate increase on a hypothetical borrower of a 30-year fixed mortgage today
    - In order to maintain the same level of affordability (as measured by DTI) with the higher mortgage rate, the property value must be reduced by approximately 20%

	Current loan amount	Premium capture effect	Breakeven loan amount
Loan amount	$500,000	$500,000 →	**$400,000**
Property value	$625,000	$625,000	$500,000
Loan-to-value	80%	80%	80%
Rate	4.500%	6.500%	6.500%
Monthly income	$9,046	$9,046	$9,046
Monthly payment	$2,533 →	**$3,160**	$2,528
DTI	28%	35%	28%

How to preserve meaningful risk retention without the distortions created by PCCRA

- **PCCRA is unnecessary for vertical risk retention**
  - Sponsors cannot avoid vertical risk retention by re-structuring. Structural changes in one class of securities will be exactly offset by structural changes in other classes of securities, and vertical risk retention holds an equivalent percentage of each
  - If PCCRA is retained for vertical retention, the capture amount should exclude cash reserve account amounts from gross proceeds so that the calculation is not circular, and use the same multiplier of 100 percent for vertical retention as for its economic equivalent, the representative sample method
- **For example, suppose that a securitization can be structured one of two ways:**
  - "Structure A" is a sequential structure whereby excess spread is only released to the residual holder after all other securities are retired. In this structure, if the excess spread was sufficient to cover all losses over the life of the deal, the residual holder will receive the remaining cash after all other securities have been paid in full, and if the excess spread was insufficient to cover all losses over the life of the deal, the residual holder will receive nothing.
  - "Structure B" allocates all excess spread each month to a senior interest-only ("IO") class and, as a result, its subordinate class (Class B) has less credit enhancement and lower market value, and the senior IO in Structure B has a commensurately higher market value than that of the residual in Structure A.
  - The table below shows the impact of changing the structure on vertical risk retention as compared with horizontal risk retention
    - As this example illustrates, changing the structure has no impact on vertical risk retention

Structure A (Sequential Pay): Vertical vs. Horizontal Retention

		Market Value		Vertical Retention		Horizontal Retention	
Class	Balance	(%)	($)	(%)	($)	(%)	($)
A	95.00	100	95.00	5	4.75	0	0.00
B	5.00	80	4.00	5	0.20	100	4.00
Residual	n/a	3	3.00	5	0.15	100	3.00
Gross Execution			102.00	Total Retained	5.10	Total Retained	7.00
Costs			1.00				
Net Execution			**101.00**	**As a % of Net**	**5.05%**	**As a % of Net**	**6.93%**

Structure B (Senior Interest-Only Strip): Vertical vs. Horizontal Retention

		Market Value		Vertical Retention		Horizontal Retention	
Class	Balance	(%)	($)	(%)	($)	(%)	($)
A	95.00	100	95.00	5	4.75	0	0.00
A-IO	n/a	4	4.00	5	0.20	0	0.00
B	5.00	60	3.00	5	0.15	100	3.00
Gross Execution			102.00	Total Retained	5.10	Total Retained	3.00
Costs			1.00				
Net Execution			**101.00**	**As a % of Net**	**5.05%**	**As a % of Net**	**2.97%**

How to preserve meaningful risk retention without the distortions created by PCCRA

- **PCCRA is unnecessary for the representative sample method if this retention method is properly redesigned**
  - As proposed, the representative sample method is unusable but - if modified appropriately - will offer sponsors a valuable risk retention tool that cannot be used to circumvent risk retention
  - Two problems are presented by the proposed representative sample method
    - First, sponsors will not use it because the definition of "equivalent risk" is so vague
    - Second, in order to pick a sample of equivalent risk, a sponsor could be required to pick the random sample several times, each of which it could be argued, undermines the level of "randomness" reflected in the sample selection
  - The solution is to modify this method to require a "retention class" and then sponsors cannot avoid risk retention
    - Require sponsors to retain an unstructured pass-through participation class (a "retention class"), which represents a 5% economic interest in all loans included within the transaction and receives 5% of all cash flows from the loans in the securitization
    - The Retention Class would be subject to the same credit, prepayment, and other risks that impact the entire collateral pool, and would have the same economic profile as a representative sample, without having any specific tranches that are subject to time tranching, credit tranching or coupon stripping
- **PCCRA treats identical economic interests differently**
  - The proposed premium capture provisions treat vertical retention, which provides a perfect economic representation of the ABS interests, differently from representative sample retention, which provides an approximate economic representation of the ABS interests
- **PCCRA will ultimately result in significantly higher mortgage rates for borrowers due to increased capital costs**
  - Sponsors may increase the retained interests within a securitization to avoid triggering PCCRA, thereby risking consolidation under GAAP and leading to significantly higher capital costs for sponsors and higher mortgage rates for borrowers
  - Many sponsors also originate mortgages for servicing by an affiliate. If the sponsor increases the retained interest to avoid PCCRA, consolidation under GAAP would occur for transactions that would otherwise have been accounted for as a sale, regardless of what form of risk retention the sponsor chose.
  - Consolidation will severely and negatively impact the sponsor's balance sheet, income statement and regulatory capital treatment – thereby lowering the amount of capital available for mortgage lending and affecting the liquidity of mortgage loan trading

How to preserve meaningful risk retention without the distortions created by PCCRA

- **PCCRA would raise hedging costs significantly, also leading to higher mortgage rates**
  - The premium capture provisions would substantially raise hedging costs due to the asymmetrical impact that the premium capture provisions would have in response to interest rate changes. Market interest rates and mortgage loan prices generally move in opposite directions.
  - To hedge the asymmetrical impact of the premium capture provisions on value due to fluctuations in interest rates (timing differences in the recognition and recapture of losses or gains for tax purposes), the sponsor would need to use hedging instruments which are significantly more expensive (and less precise) than those currently used. We estimate that the increased hedging costs, which would ultimately be transferred to the borrower, could raise mortgage rates by approximately 25-50 basis points.
- **PCCRA's effects on liquidity would undermine federal monetary policy decisions**
  - Market interest rates and mortgage loan prices generally move in opposite directions. As a result, the proposed premium capture provisions, which would lower the liquidity of premium loans, would reduce the capital available for lending when a policy decision to lower rates results in the creation of premium loans.
  - This would be counter to the effect that is generally intended by such policy decisions. Thus, the premium capture provisions would dilute the impact of the U.S. Government's federal interest rate policy decisions by reducing the capital available for mortgage loans when interest rates are lowered and by increasing the capital available for mortgage loans when interest rates are raised.
- **Provide for a thoughtful definition of "net closing costs"**
  - Any measure of realized net income should properly reflect all costs related to the transaction and to the origination or sale of its assets
  - Proper accounting for costs is essential to achieving the purpose of PCCRA without significantly raising mortgage rates and further depressing housing prices

Securitization Example for 30 Year Mortgage Loans

Fixed Rate 30 Year Mortgage

- The following example illustrates securitization economics for a Jumbo loan transaction
  - This example utilizes a 5.00% loan rate and is prior to the implementation of PCCRA

Rating	Balance	%	Initial Coupon	Price	Weighted Average Life	Yield	Credit Enhancement
AAA	462,500,000	92.50%	3.700%	100.00	7.2	3.7	7.50%
AA	14,250,000	2.85%	4.375%	90.00	12.5	5.6	4.65%
A	6,500,000	1.30%	4.375%	85.00	12.5	6.3	3.35%
BBB	5,750,000	1.15%	4.375%	80.00	12.5	7.0	2.20%
BB	4,750,000	0.95%	4.375%	70.00	12.5	8.8	1.25%
NR	6,250,000	1.25%	4.375%	60.00	12.5	10.9	
IO	500,000,000	Notional	1.000%	4.00		~13	
Total	**500,000,000**			**102.50**			

Economic Analysis	Price
Gross Proceeds	102.50
Less: Par for Loans	-100.00
Less: Origination Costs	-1.00
Less: Hedging Costs	-0.50
Less: Transaction Costs	-0.50
Economic Benefit	**0.50**

Execution Analysis & Assumptions

- Currently, we believe this transaction would result in a $1.875 PCCRA as follows: (PCCRA = Gross Proceeds – 95 of Par – Transaction Costs):
  - PCCRA = $1.875 = $97.375 – $95.00 - $0.50
- An issuer will not receive $0.50 at close in this example as a 5% Risk Retention will result in a $5.125 retained vertical economic interest prior to calculation of the PCCRA requirements
  - The net proceeds for an Issuer prior to PCCRA is $97.375 ($102.50 * 95%) on their investment of $102.00 (- $5.125 net proceeds), with the implementation of PCCRA an Issuer would receive $95.50 (or -$7.00 net proceeds) on their investment of $102.00
- Transaction costs would include Rating Agencies, loan level file review, legal costs for documentation, accountants review & comforting, SEC registration fee's, etc.
- Pricing speed is assumed to be10 CPR prepayment speed with a 0.25% servicing fee

Consolidation will have a significant impact on Risk Weighted Assets

Balance Sheet Considerations

- The following tables provide estimates of Capital Charges and the impact on Risk Weighted Assets ("RWA") for a 5% Vertical Retention and for an on Balance Sheet Consolidation
  - Current accounting guidance indicates a 1st loss in excess of 5% may result in consolidation
- Additional Issuer level considerations will include impacts on the Income Statement regarding the timing of income & losses, off-setting interest rate hedges, Rating Agency considerations & Leverage ratios
- The following is a simplified example that utilizes a 9.50% Capital Requirement
  - The impact of full consolidation vs. a 5% vertical risk retention approximates an additional $48 million of RWA
  - Issuers will apply capital charges based upon their internal ROE targets for any incremental capital required
  - Based upon the following example, loan rates may be impacted by approximately 2.40%
    - Borrower impact = ($48 million * 25% capital charge [1]) / $500 million loan pool

Risk Retention – 5% Vertical

Rating	Balance	%	Initial Coupon	Price	Market Value	5% of Market Value	Basel II Capital Charge	Risk Weighted Assets
AAA	$ 462,500,000	92.50%	3.700%	100	$ 462,500,000	$ 23,125,000	7%	$ 153,781
AA	$ 14,250,000	2.85%	4.375%	90	$ 12,825,000	$ 641,250	15%	$ 9,138
A	$ 6,500,000	1.30%	4.375%	85	$ 5,525,000	$ 276,250	20%	$ 5,249
BBB	$ 5,750,000	1.15%	4.375%	80	$ 4,600,000	$ 230,000	75%	$ 16,388
BB	$ 4,750,000	0.95%	4.375%	70	$ 3,325,000	$ 166,250	425%	$ 67,123
NR	$ 6,250,000	1.25%	4.375%	60	$ 3,750,000	$ 187,500	1250%	$ 222,656
IO	$ 500,000,000	Notional	1.000%	4.00	$ 20,000,000	$ 1,000,000	12%	$ 11,400
BONDS				102.50	$ 512,525,000	$ 25,626,250		$ 485,735
MSR	$ 500,000,000	Notional	0.250%	1.00	$ 5,000,000	N/A	250%	$ 1,187,500
BONDS & MSR				103.50	$ 517,525,000			$ 1,673,235

Risk Retention – Full Consolidation

Rating	Balance	%	Price	Market Value	5% of Market Value	Basel II Capital Charge	Risk Weighted Assets
N/A	$ 500,000,000	100%	103.50	$ 517,500,000	N/A	100%	$ 49,162,500

(1) 25% pre-tax capital charge provides a 15% post-tax return utilizing a 40% tax rate

Agenda

	Page
Premium Capture Considerations for RMBS	2
Premium Capture Considerations for CMBS	**13**

CMBS conduits provide needed products to more markets than bank portfolios

Conduit lenders serve:

- Smaller markets which are ignored by portfolio lenders; such as Newark, NJ, Troy, MI, Modesto, CA, Baltimore, MD, Burlington, VT, Jackson, MS, etc.
- Non-institutional borrowers who don't have clout with portfolio lenders
- Smaller loans that cannot find long term fixed rate debt at banks and bigger loans that are more leveraged than life companies prefer

Conduit securitization connects:

- Loans with mutual funds and private funds who don't have origination staff but buy bonds
- Investors with fixed income capital to borrowers with long term fixed rate capital needs
- Brokers, lawyers, bankers, rating agencies, trustees and servicers together in a complex, time consuming manufacturing process

Banks don't need to lend on CMBS financed assets

- Portfolio loans are directed toward the best assets and the best client relationships and have finite limits
- The largest banks, like J.P. Morgan, don't have enough balance sheet availability to serve secondary and tertiary property markets

Conduit lending risks

Conduit lenders take many risks during the process of manufacturing

- Risk of spread movements in credit markets
- Risk of liquidity remaining at time of sale
- Risk of aggregating a complete pool over time
- Risk of rating agency and pool ratings and policy changes
- Risk of borrower performing its duties
- Risk of tenant default/bankruptcy
- Risk B-piece investor opinion on loans is different than underwriter
- Risk of local real estate and job markets performing
- Risk of regulatory capital changes

Additional factors

- Lender's incentive to price in all these is motivated by extracting an immediate profit to pay for infrastructure and reward shareholders
- Profit is constrained by competition for loans by other participants

Costs incurred by lenders

Conduit lenders must pay for personnel and bank capital during the manufacturing process

- Profit targets are 2-3% including costs
- Some loans make money; some loans lose money but the average must sell profitably
- Costs are all front loaded; therefore if banks stop making loans, we don't need the people

Banks need to pay salaries and benefits for:

- Originators finding and competing for the loans
- Underwriters analyzing the loans
- Traders pricing the loans
- Legal personnel documenting and closing the loans
- Sales personnel selling the bonds

Conduits will move to unregulated firms

If banks can't recoup the costs of infrastructure they will not originate loans for sale

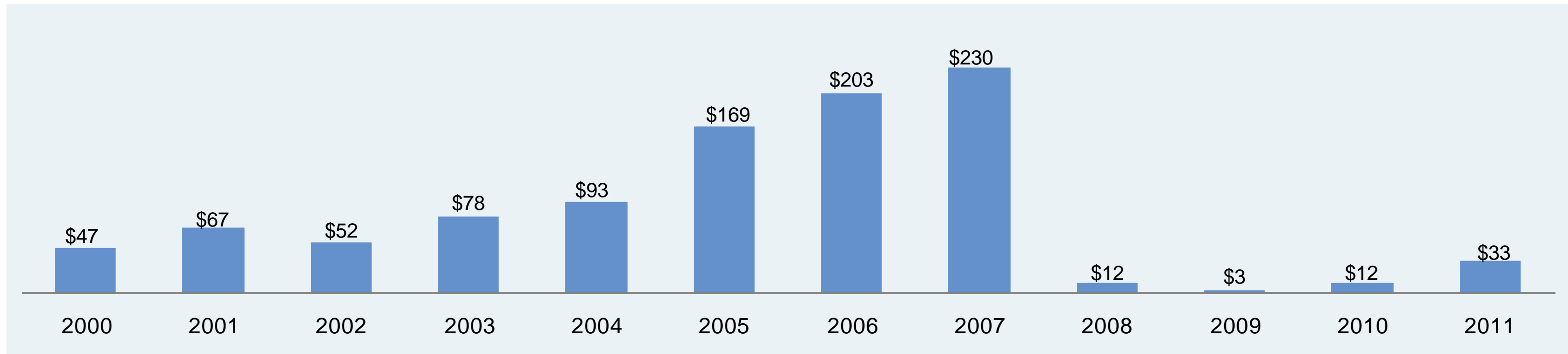
- Large borrowers will hire banks as agents for a fee and take the risk themselves
- Small borrowers will go to unregulated lenders who will aggregate loans:
  - Hedge funds
  - REITs
  - Debt funds
  - Finance companies
  - Life companies

Unregulated lenders will charge more because of:

- Higher cost of capital on warehouse lines from banks
  - The amount of balance sheet required is large
- Banks will charge fees to securitize
  - Broker dealers will still price and distribute CMBS
- Permanent capital in unregulated firms costs more

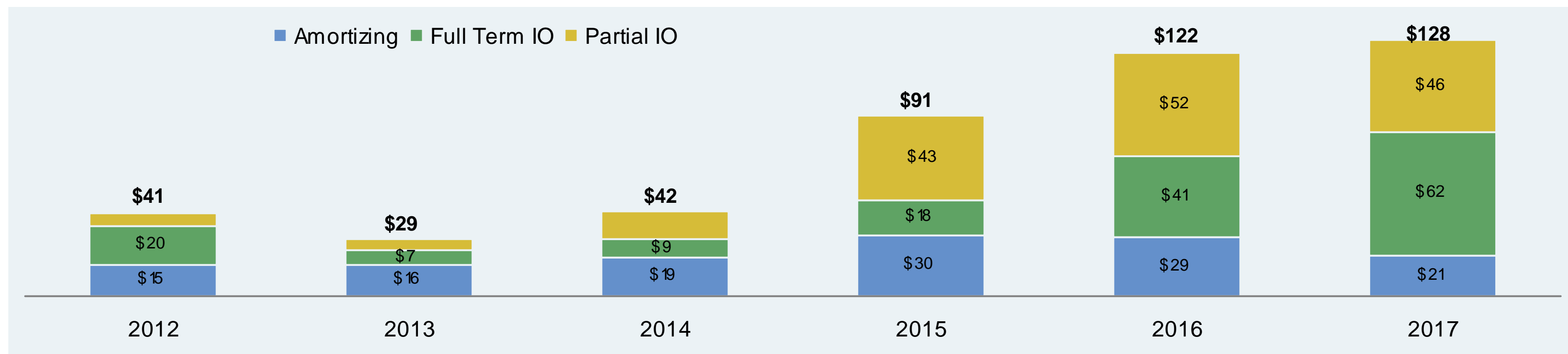
Historical CMBS issuance and future financing needs

Historical CMBS issuance volumes ($bn)



Source: Commercial Mortgage Alert, JPM CMBS Research

Fixed rate conduit CMBS loan maturities ($bn)



Source: JPM CMBS Research

PREMIUM CAPTURE CONSIDERATIONS FOR CMBS

2011 conduit CMBS new issuance

2011 conduit CMBS origination

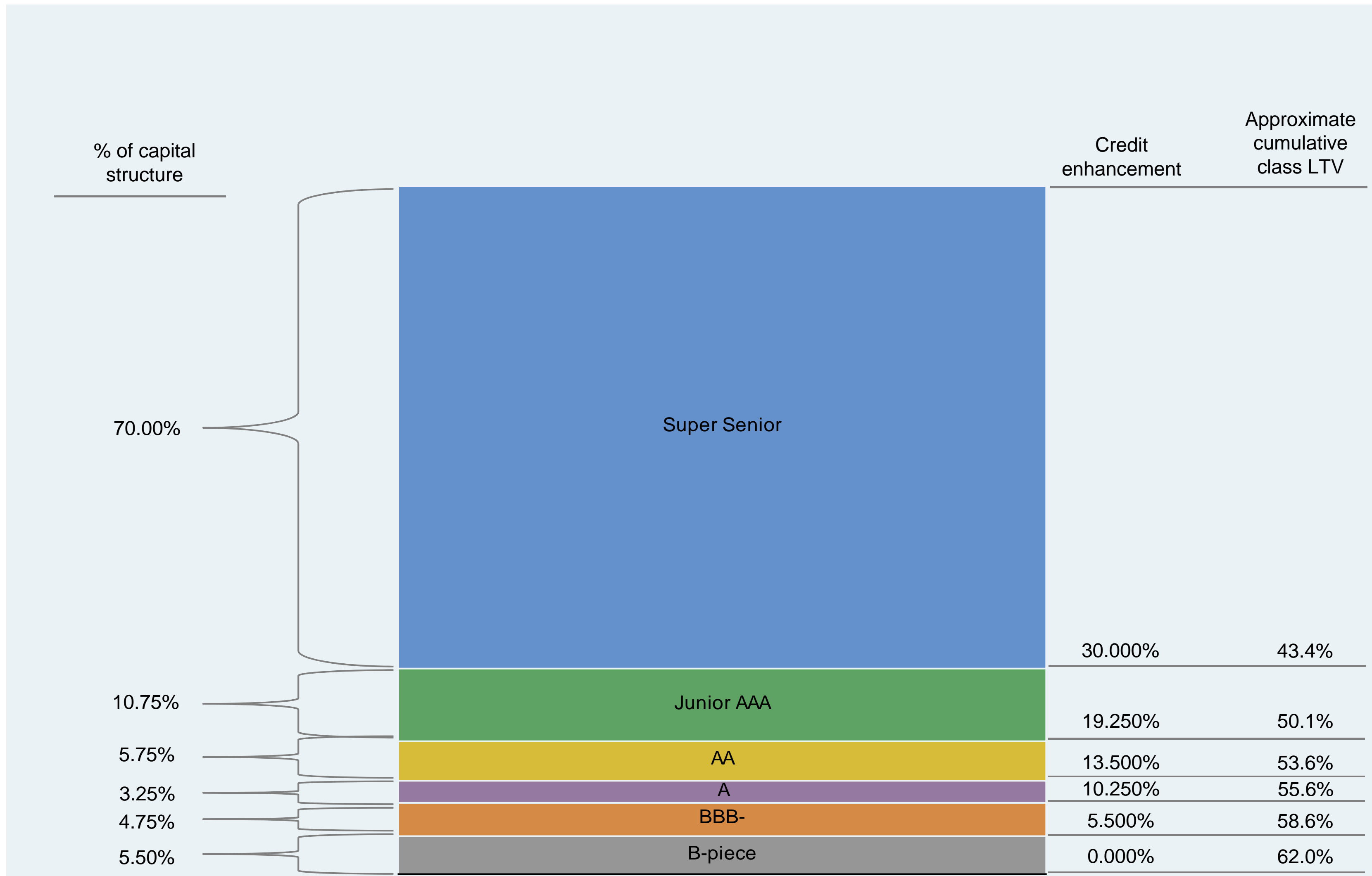
Type of CMBS transaction	Initial pooled balance ($MM)	Number of transactions	% of total
Private label CMBS	$24,487.9	18	65.3%
FREMF K Series	$12,985.8	11	34.7
Total	**$37,473.8**	**29**	**100.0%**

2011 private label CMBS conduit loan contributors

#	Loan contributor	Loan balance ($MM)	% of total
1	J.P. Morgan	$3,969.7	16.2%
2	Morgan Stanley	2,924.3	11.9
3	UBS	2,724.0	11.1
4	Wells Fargo	2,452.6	10.0
5	Deutsche Bank	2,374.9	9.7
6	RBS	2,091.4	8.5
7	Goldman, Sachs & Co.	1,840.2	7.5
8	Cantor Commercial Real Estate	1,408.6	5.8
9	Bank of America	1,330.1	5.4
10	Citigroup	1,251.2	5.1
	Others	2,121.1	8.7
	Total	**$24,487.9**	**100.0%**

Source: J.P. Morgan

Generic conduit CMBS capital structure



CMBS market has additional PCCRA complications due to the B-piece exemption afforded by Dodd Frank

- **Dodd Frank legislation acknowledges the role of the third party B-piece buyer as a risk retention surrogate**
  - The B-piece exemption in Dodd Frank removes the burden of risk retention on the seller
  - The CMBS market is currently functioning with both GSEs and private label CMBS B-piece sales
    - FHLMC issued 11 CMBS deal totaling $13.0bn in 2011 with third party B-piece sales and no retention
    - J.P. Morgan and other private label issuers sold $24.5bn in 18 conduit CMBS deals with B-piece and no retention
  - Any additional retention would have to work with and not disrupt this functioning private market
- **PCCRA attempts to change the CMBS business model of selling discount B-pieces and call protected excess interest**
  - The purchase of a first loss B-piece at a steep discount to par is mandated by the B-piece buyer's yield
  - When a sponsor monetizes the excess spread, it does not diminish the risk to the B-piece buyer
  - PCCRA acts as an additional layer of first loss protection and imposes a substantial burden on sponsors
- **PCCRA will ultimately result in significantly higher CRE mortgage rates for borrowers due to increased capital costs:**
  - Sponsors may increase the retained interests within a securitization to avoid triggering PCCRA, thereby risking consolidation under GAAP and leading to significantly higher capital costs for sponsors and higher mortgage rates for borrowers
  - Many sponsors also originate mortgages for servicing by an affiliate. If the sponsor increases the retained interest to avoid PCCRA, consolidation under GAAP would occur for transactions that would otherwise have been accounted for as a sale, regardless of what form of risk retention the sponsor chose.
  - Consolidation will severely and negatively impact the sponsor's balance sheet, income statement and regulatory capital treatment – thereby lowering the amount of capital available for mortgage lending and affecting the liquidity of mortgage loan trading
  - To offset consolidation impacts, lender-sponsors would be required to increase mortgage rates by approximately 50 basis points under today's regulatory capital requirements (which are subject to increase in the future)

Recommended Alternatives to PCCRA for CMBS

JPMorgan Chase recognizes the Agencies' concern that risk retention could be "gamed" by sponsors issuing bonds at substantial premiums, or that B-piece Buyers would not have sufficient "skin in the game" given their purchase of the B-pieces at a deep discount to par.

JPMorgan Chase recommends that PCCRA be eliminated in the final rules, but that potential manipulation of the price of the B-piece can be prevented through a requirement that the B-piece have a coupon equal to the lesser of (i) 10-year Treasuries plus 1.0% or (ii) the net weighted average coupon ("WAC") of the loan pool. Currently, investors are buying conduit CMBS B-pieces with coupons that are approximately equal to 10-year Treasuries plus 50 basis points, which is slightly below the WAC of the loan pools.

Another viable alternative to a PCCRA would be that, ***in addition to the base 5% risk retention (based on par) held by the B-piece Buyer, the CMBS sponsor would retain the greater of 5% of the market value (net of closing costs) or par value of the securitization, in each case after taking into account the proceeds of the sale of the B-piece to the B-piece Buyer***. This would be accomplished by the additional retention by the CMBS sponsor of a pari passu loan participation or pass-through interest in the entire pool of loans in an amount equal to the greater of:

- 5% of the par value of all of the principal-paying classes issued in the CMBS transaction minus the proceeds of the sale of the B-pieces sold to a B-piece Buyer; and
- 5% of the market value (i.e., gross proceeds of sale) of all of the classes issued in the CMBS transaction, less the net closing costs permitted to be deducted under GAAP (e.g., taxes, hedging costs, rating fees, legal and accounting fees) minus the proceeds of the sale of the B-pieces sold to a B-piece Buyer

This additional retention ensures that even if the sponsor issues bonds at a substantial premium, the combined retention by both the sponsor and the B-piece Buyer accomplishes the goal of meaningful risk retention that complies with the intent of Dodd Frank, but permits the sponsor to realize value from the securitization of the loans up front, as opposed to waiting until the maturity of the transaction in the form of a PCCRA.

We should note, however, that this additional retention by the sponsor will cause ***origination spreads to increase by as much as 50 basis points and will ultimately make commercial mortgage borrowing more expensive for the borrower***.

Typical conduit loan is 10-year fixed rate coupon

15 bps of spread equals 1 point of profit for a 10-year loan

An unregulated lender has extra costs that will be passed on to the borrower

- More expensive equity capital at 20%+ return
- More expensive warehouse funding at L+ 200-400
- Distribution fees .50 – 1.00% like corporate bonds
- Scarcity premium since fewer firms will compete for loans

Origination costs

- 6 months aggregation requires approximately 3 months of average hold
  - 3 months of warehouse charge premium is 30 bps over bank cost
- Banks will charge 50 bps to do rating and approximately 10 bps for distribution
- Hedging costs are approximately 5 bps

New conduit lenders will charge at least 50 bps more than banks to compensate for these additional costs

PCCRA effect

If PCCRA was mandated, banks could mathematically attempt this PCCRA structure. J.P. Morgan could not see us utilizing this structure, but this is an illustrative example of how it would work.

Without PCCRA

Class	Notional	Price	Value
AAA	$390	$101	$394
IO	$500	$8	$38
Mezz	$78	$88	$68
B-piece	$33	$30	$10
PCCRA	$0	$0	$0
Total	**$500**	**$102**	**$510**

Cost of Collateral	$500
Total Profit	$10
Total Profit (%)	2.0%
Loan Coupon	4.6%

With PCCRA

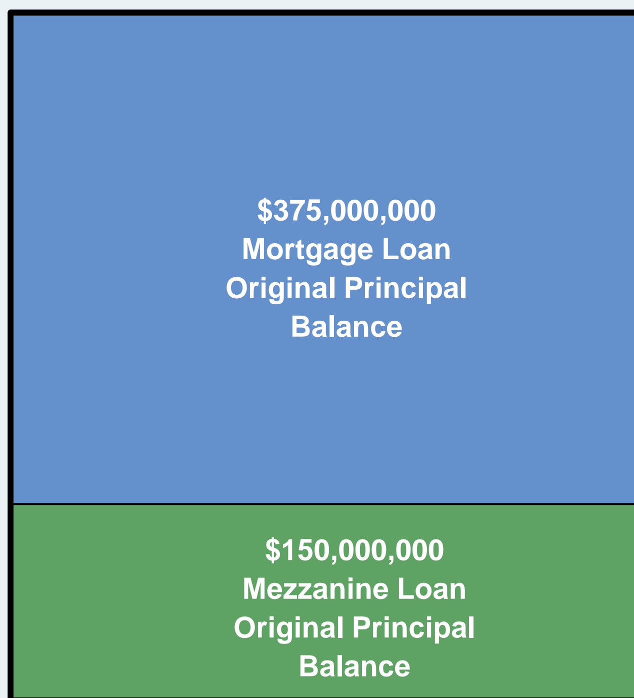
Class	Notional	Price	Value
AAA	$390	$101	$394
IO	$500	$12	$59
Mezz	$50	$93	$47
B-piece	$0	$0	$0
PCCRA	$60	$0	$0
Total	**$500**	**$100**	**$500**

Cost of Collateral	$500
Total Profit	$0
Loan Coupon	5.0%
Incremental Cost of Borrowing	**0.45%**

- With PCCRA as first loss, no B-piece needs to be sold and special servicer control can be in the hands of an investment grade bondholder voting regime
  - 2 points of profit ($10MM) today has a future value of $12.5MM when the PCCRA is released in 10 years
  - A PCCRA notional amount of $60MM is structured as a first-loss PO bond, and is sized to ensure that 12.5MM will be investment grade rated and will not be loss-impaired on the PCCRA release date
  - A higher recovery on the PCCRA class will result in a deferred profit windfall to the issuing bank
  - Retaining a 60mm first loss PO will result in 45bp higher borrowing costs
- A bank's motivation to take the origination risks is diminished and will remove them from lending conduit CMBS loans
  - Banks will use capital to become agents for the unregulated who will charge more
- Analysis ignores hedging and the effect of interest rates on fixed rate bond coupons as premium or discount prices

Single Borrower CMBS Example

JPMCC 2011-PLSD – single borrower transaction from 4Q2011



Basis PSF[1]	LTV[2]	UW NOI Debt Yield[3]	UW NCF DSCR[4]
$193	44.1%	12.8%	1.76x
$271	61.7%	9.2%	1.17x

Source: J.P. Morgan

[1] Based on collateral square footage of 1,939,082

[2] Based on the Cut-off Date principal balances and the appraised value of $850.0 million

[3] UW NOI Debt Yield based on UW NOI of $48.1 million and Cut-off Date principal balances

[4] UW NCF DSCR based on UW NCF of $45.8 million and debt service consisting of Mortgage Loan debt service, which is calculated based on a constant payment with an approximately 5.658% coupon and a 30-year amortization schedule and Mezzanine Loan debt service, which is interest-only and is calculated based on an 8.500% coupon and actual/360 accrual.

Risk Retention and PCCRA in Investment Grade Issues

CMBS risk retention by a B-piece Buyer generally would only apply to "conduit" CMBS of 10-100 loans for securitization

- The B-piece Buyer concept is not directly applicable to single borrower CMBS
- Backed by a single mortgage loan or related mortgage loans made to a single borrower
- 50-65% LTV ratios that are made in conjunction with mezzanine loans, and do not issue below investment grade classes
- The LTV of the CMBS issue would typically be 40-60% while the combined LTV of the CMBS issue and the mezzanine loans would be 75-80%

The mezzanine debt is secured by the ownership interests in the mortgage loan borrower

- There are multiple mezzanine loans and related borrowers
- Mezzanine loans are priced at par and are often sold at the same time as the related CMBS loans
- Mezzanine loan buyers perform the same due diligence on the loan collateral as B-piece Buyers do

The loss record on Single Borrower and floating rate CMBS transactions is superior to conduit CMBS

- That most losses have been absorbed by the mezzanine loan holders and almost no losses have been borne by the CMBS holders
- Mezzanine loans are effectively acting on a reverse sequential basis as the first loss pieces

These facts strongly argue for allowing mezzanine loans in Single Borrower and floating rate CMBS transactions to satisfy the risk retention requirement via the B-piece exemption in Dodd Frank and to satisfy the any PCCRA requirement since this first loss protection is already being provided ***on a par purchase*** price basis by the mezzanine lenders.