Clients&FriendsAlert

Risk Retention for Commercial Mortgage-Backed Securities: Fact Sheet[1]

October 29, 2014

Introduction

On October 22, 2014, the federal regulatory agencies responsible for implementing regulations under Dodd-Frank finalized the risk retention rules for ABS transactions, including CMBS transactions. The final rules come more than three years after risk retention rules were originally proposed,[2] and more than a year after the rules were re-proposed.[3] The final rules contain a few clarifications and revisions to the re-proposed rules, but for the most part the final rules are substantially the same as the re-proposed rules.

The following is a summary of the risk retention provisions as they relate to CMBS. A summary of the revisions made to the re-proposed rules appears at page 8 and a summary of industry requested changes to the re-proposed rules that were not adopted in the final rules appears at page 9.

Effective Date

For CMBS, the risk retention requirements will become applicable two years after the final rules are published in the Federal Register.

Basic Requirement

The final rules retain the original 5% risk retention obligation for a CMBS sponsor (or a majority-owned affiliate of the sponsor[4]), but provide an exception for CMBS backed (in whole or in part) by "qualifying CRE loans," as discussed below.

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1 This Fact Sheet summarizes certain aspects of the final risk retention rules as they relate to commercial mortgage backed securities. Please refer to Cadwalader's forthcoming Clients & Friends memo for a more comprehensive summary and evaluation of the final rules.

2 http://www.sec.gov/rules/proposed/2011/34-64148.pdf

3 http://www.sec.gov/rules/proposed/2013/34-70277.pdf

4 A majority-owned affiliate is an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

Forms of Risk Retention

There are generally two structures for retaining risk:

- an "eligible vertical interest," in which the sponsor is required to retain 5% of the face value of each class of securities issued in the CMBS transaction (excluding the REMIC residual); or

- an "eligible horizontal interest," in which the sponsor is required to retain the most subordinate class or classes of securities issued in the CMBS transaction (excluding the REMIC residual) in an amount equal to 5% of the "fair value" of all of the CMBS issued (determined by using a "fair value" measurement framework under U.S. GAAP).

The B-piece buyer option, described below, is a form of horizontal retention.[5]

For sponsors satisfying their risk retention obligation through horizontal risk retention (including by means of the B-piece buyer option), the use of fair value will result in a higher retention obligation (by face amount) than the vertical risk retention obligation, and likely will increase the required retention amount well above the size of the B-piece in a typical CMBS conduit transaction.

The rules also permit a sponsor to satisfy its risk retention obligation by a combination of horizontal and vertical retention. This provision would allow CMBS sponsors to supplement the B-piece option by retaining, themselves or through an affiliate (or by causing contributing loan originators to retain), an additional eligible vertical interest to "top up" the amount by which the securities retained by the B-piece buyer falls short of 5% of fair value. The "vertical interest" required to be retained by the sponsor in a hybrid retention would represent an interest in each class of CMBS, including an interest in the class or classes retained by the B-piece buyer.

The rules also allow a sponsor to offset its risk retention requirement by the amount of eligible horizontal or eligible vertical interests retained by one or more loan originators (or a majority-owned affiliate of the applicable originator). However, no originator may retain more than its pro rata share (based upon collateral contributed) of the sponsor's risk retention obligation, nor may any originator retain less than 20% of the sponsor's risk retention obligation. Therefore, originators that contribute

[5] In lieu of the sponsor retaining an eligible horizontal interest or utilizing the B-piece buyer option, the sponsor may instead establish with the CMBS trustee a "horizontal cash reserve account" in the amount of the fair value of the eligible horizontal interest sold, which would be held in cash or cash equivalents and available to offset losses and other shortfalls on the transaction.

less than 20% of the collateral for a CMBS transaction cannot hold any of the required risk retention.[6]

Restriction on Hedging

During the period when risk retention is required, the sponsor (or originator, B-piece buyer or applicable majority-owned affiliate) is prohibited from hedging its exposure to the retained interests by purchasing any security or other financial instrument if (i) the payments on such security or instrument are materially related to the credit risk of the retained interest and (ii) such instrument in any way reduces or limits the financial exposure to the credit risk of the retained interest or any of the underlying assets.

Exceptions to this rule include (i) hedging interest rate or currency risk; and (ii) hedging via an index, as long as (x) any single security that the sponsor is required to retain does not account for 10% or more of such index and (y) all classes of securities issued in connection with any securitization in which the sponsor is required to retain a risk interest, do not collectively account for 20% or more of such index.

In addition, sponsors (and originators, B-piece buyers and their respective majority-owned affiliates) are prohibited from pledging any retained interest as collateral for any non-recourse financing.[7]

Restriction on Transfer; Holding Period

In general, a retaining sponsor, originator or B-piece buyer (or applicable majority-owned affiliate) may not sell or otherwise transfer any interest that it is required to retain to any person other than a majority-owned affiliate. However, the final rules allow the original B-piece buyer or the sponsor to sell its eligible horizontal residual interest to a qualifying B-piece buyer after five years, subject to the same restrictions and conditions that apply to an initial B-piece buyer. These conditions include the requirement that the subsequent B-piece buyer conduct an independent review of the credit risk of each securitized loan.

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[6] Although the rules and the accompanying release make it clear that there can be only one party that is acting as the "retaining sponsor" for purposes of the risk retention rules, nothing in the rules or the accompanying release seems to prevent a second sponsor that is also an "originator" from taking a portion of the required risk retention in its capacity as an originator.

[7] Although this restriction does not appear to expressly sunset, as is the case for transfer and hedging restrictions as discussed below, the restriction on nonrecourse financing applies to CMBS interests "required" to be retained. This suggests that if the CMBS interest can be transferred, it should be able to be financed with nonrecourse financing.

Sunset

The final rules include the previously proposed sunset provision, which allows the transfer (or hedging) of a retained interest upon the *latest* of:

- the reduction of the unpaid principal balance of the underlying loans to 33% of their unpaid principal balance as of the securitization cut-off date;

- the reduction of the unpaid principal balance of the issued CMBS to 33% of its principal balance as of the securitization closing date; and

- two years after the securitization closing date.

In addition, a B-piece buyer will not be restricted from hedging, transferring or financing its retained interest after all of loans in the pool have been defeased with cash or cash equivalents (which can include obligations backed by the full faith and credit of the United States).[8]

B-Piece Buyer Option

The final rules contain a CMBS-specific alternative to satisfy a sponsor's risk retention obligation, permitting the acquisition of a subordinate horizontal interest (i.e., the B-piece) in the CMBS transaction by a third-party purchaser (or a majority-owned affiliate of the third-party purchaser) that agrees to hold the horizontal interest subject to conditions similar to the requirements that would be applicable to the sponsor's retention of a horizontal interest.

B-Piece Buyer Requirements

The requirements of the B-piece buyer are as follows:

- a B-piece buyer must be unaffiliated with any party to the CMBS transaction except (a) the special servicer, (b) an originator of less than 10% of the securitized loans or (c) other investors in the CMBS transaction;

- at no time can there be more than two B-piece buyers, and if there are two B-piece buyers, their interests must be *pari passu*;[9]

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8 This provision appears in the context of the B-piece buyer's transfer restrictions (Section __.7(b)(8)(i)) and arguably does not apply to other risk retention parties. We are unaware of any reason to justify this distinction.

- each B-piece buyer must conduct an independent review of the credit risk of each securitized loan; and

- each B-piece buyer must pay for the B-piece in cash and may not obtain financing from any party to the CMBS transaction (other than another investor).

Operating Advisor

A CMBS transaction in which the sponsor is relying on the B-piece buyer option must feature an operating advisor that (i) is not affiliated with any other parties to the transaction, (ii) has no financial interest in the transaction (aside from fees), and (iii) has the following rights and responsibilities:

- the operating advisor is required to act in the best interest of, and for the benefit of, investors as a collective whole;

- the operating advisor must meet standards of experience, expertise and financial strength that are set forth in the transaction documents (although the final rules do not set forth any such standards, leaving the transaction parties to determine what standards should apply);

- after the B-piece is reduced below 25% of its initial principal balance (whether by payments, realized losses or appraisal reduction amounts), the special servicer must be required to consult with the operating advisor on material servicing decisions;

- the operating advisor must have adequate access to information (such as reports of the special servicer) and must report to investors periodically on whether the special servicer is operating in compliance with the standard set forth in the transaction documents; and

- the operating advisor must have the right to recommend replacement of the special servicer if the operating advisor (i) determines that the special servicer has failed to comply with the standard of conduct set forth in the transaction documents and (ii) believes that such replacement would be in the best interest of the investors as a collective whole. If the operating advisor makes such a recommendation, then the special servicer may be replaced upon the affirmative vote of a majority of the all CMBS holders voting on the matter. The required quorum for such vote (i) may not exceed 20% of the outstanding principal balance of CMBS and (ii) must require at least 3 investors that are not affiliated with each other.

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[9] Although not expressly stated in the final rules or the accompanying release, if a sponsor is retaining a vertical interest in a CMBS transaction (and as a result is retaining a portion of the most subordinate CMBS class or classes), the sponsor's retention should not prevent two separate B-piece buyers from holding the remaining portion of the horizontal risk retention.

Sponsor's Duty to Monitor

Reliance on the B-piece buyer option does not relieve a sponsor of its primary risk retention obligation and, therefore, the final rules require sponsors to "maintain and adhere to" policies and procedures to monitor B-piece buyers' compliance with the requirements of the rule (although the rules do not specify what such policies and procedures should be). In the event that the sponsor detects a failure a B-piece buyer to adhere to the requirements of the rule, it must promptly notify all holders of the CMBS.

Qualifying CRE Loans

The final rules provide that "qualifying CRE loans" attract a zero risk retention requirement. Despite the request of many industry participants, the standards for qualification as a QCRE loan are still extremely tight.

The final rules provide a benefit for including QCRE loans in a pool, even if they do not comprise 100% of the pool, by permitting the required risk retention percentage to be reduced proportionately (but not by more than 50%) by the percentage of QCRE loans in the pool. For example, if a CMBS pool contains 20% QCRE loans, the risk retention requirement would be reduced to 4%, instead of 5%.

The final rules contain numerous requirements for a loan to qualify as a QCRE loan, including the following:

- the loan must be secured by (i) a first lien on a multi-family or commercial property where the expected source of at least 50% of the funds for repayment is either sale or refinancing proceeds or rental income or (ii) a fee interest in land that is leased to a third-party that owns the improvements (consisting of a multi-family or commercial building) on such land. The definition excludes other types of land loans, construction loans and unsecured developer loans;

- the loan must have a term of at least 10 years;

- the loan must have (i) a fixed rate of interest, (ii) a floating rate that is swapped into a fixed rate or (iii) a floating rate and the borrower has obtained an interest rate cap contract for the term of the loan;

- the loan must provide for amortization, with no IO period, based on an amortization schedule of no greater than 25 years "level monthly payment" (or 30 years for qualifying multifamily loans, as described below);

- the loan must have no greater than a 65% LTV and a 70% CLTV (or 60% and 65%, respectively, if the appraisal utilizes a cap rate that is less than or equal to 10-year swaps plus 300);

- the loan must have a DSCR (based upon two years of actual historical performance and two years projected performance) no lower than:

➢ 1.5x for "qualifying leased CRE loans" (calculated net of any income derived from non-qualified tenants). These are loans secured by properties (other than multifamily, farm and hospitality properties) for which no more than 20% of the aggregate gross revenue of the property is payable by one or more tenants (a) with less than six months remaining on their lease terms or (b) who are not "qualified tenants." A "qualified tenant" is a tenant either under lease or with an expired lease and occupying month-to-month (but in occupancy for at least three years), who, in either case, has "satisfied all obligations with respect to the property in a timely manner";

➢ 1.25x for "qualifying multi-family loans." These are multi-family loans where at least 75% of the NOI is derived from rents and tenant amenities, and not from other commercial uses; and

➢ 1.7x for all other types of CRE loans.

If a sponsor is relying on inclusion of QCRE loans in a securitization to reduce its risk retention obligations, then it must certify that it has internal supervisory controls to determine that such QCRE loans meet all the QCRE requirements. In the event that it is determined, after securitization, that any such loan did not meet the requirements for a QCRE loan, then, if such failure is material, the sponsor must either cure such deficiency or repurchase the loan at a price equal to par plus accrued interest.

Required Disclosures

The final rules require that the sponsor provide potential investors and, upon request, the SEC and appropriate Federal banking agencies (if any) with written disclosures regarding the retained interests that includes the following:

Horizontal interest. With respect to any retained horizontal residual interest, a sponsor must disclose:

- Within a reasonable period of time prior to the sale of the CMBS, the fair value of the eligible interests that the sponsor expects to retain at the securitization closing, including the material terms of the horizontal interest, a description of the valuation methodology used to calculate the fair value and the key inputs and assumptions that were used in measuring the fair value (including all inputs and assumptions that could have a material impact on the fair value calculation);

- If specific prices, rates or sizes of each class of CMBS are not available, the sponsor must disclose a range of fair values for the horizontal interests that it expects to retain; and
- Within a reasonable period of time after the securitization closing, the fair value of the horizontal interests that were actually retained and any differences in the final valuation methodology from what was previously disclosed;

B-Piece Buyer. With respect to any horizontal risk that is retained by a third-party B-piece buyer, a sponsor must disclose within a reasonable period of time prior to the sale of CMBS, the name of the B-piece buyer, its experience in investing in CMBS, the fair value of the interest to be retained, the purchase price paid by the B-piece buyer, the material terms of the retained interest and the material terms of the transaction documents with respect to the operating advisor.

Vertical interest. With respect to any retained vertical interest, the sponsor must disclose:

- Within a reasonable period of time prior to the sale of CMBS the percentage that the sponsor is required to retain, the amount that the sponsor expects to retain at closing and the material terms of such vertical interest; and
- Within a reasonable period of time after the securitization closing, the amount of the vertical interest actually retained if that amount is materially different than what was previously disclosed.

Record Retention. Sponsors are required to retain all required disclosures for three years after all CMBS interests in the related securitization transaction are no longer outstanding.

Notable Revisions Made in Final Rules

- The controversial "projected cash flow rate test" feature of the re-proposed rules has been removed. This feature would have prevented the holder of a horizontal risk retention interest from receiving principal and interest at a rate that is faster than the rate at which the issued CMBS recover their principal.
- The B-piece buyer definition is expanded to include a "majority-owned affiliates," which opens up various structuring possibilities.
- Non-economic residual interests are excluded from the definition of "Asset Based Security" and therefore not included in any risk retention requirement.

- Maximum quorum that securitization documents can require for purposes of replacing the Special Servicer upon an operating advisor's recommendation was raised to 20% (proposal called for 5%), with such quorum requiring at least 3 investors that are not affiliated with each other. This provision makes it more difficult to replace the special servicer.

- The definition of Qualifying Commercial Real Estate Loan was modified to include (1) loans secured by a fee interest in a ground leased property, (2) floating rate loans that have the benefit of an interest rate cap and (3) loans with "level payments of principal and interest" as opposed to straight line amortization.

Notable Requested Revisions That Were Not Made

- No relief for single-borrower/single-asset securitizations.

- No relief granted to allow senior/sub structuring within the horizontal risk retention held by a B-piece buyer.

- No relief granted to allow for more than two *pari passu* B-piece buyers.

- No relief granted regarding disclosure of purchase price of B-piece.

- No relief granted regarding the use of subordinate or *pari passu* participation interests as an acceptable form of risk retention.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions regarding this Alert.

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