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Clients&FriendsAlert

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

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Introduction

On August 28, 2013, the federal regulatory agencies responsible for implementing regulations under Dodd-Frank re-proposed rules for risk retention requirements in ABS transactions, including CMBS transactions. The re-proposal comes more than two years after the original proposed rules and, while retaining much of the basic architecture of the original proposal, differs from the original in a number of significant ways.

Public comments on the re-proposal are due October 30, 2013.

Effective Date

For CMBS, the risk retention requirements will become applicable two years after final rules are adopted.

Basic Requirement

The re-proposal retains the original 5% risk retention obligation for CMBS sponsors, other than for CMBS backed (in whole or in part) by "qualifying CRE loans," as discussed below.

Unlike the original proposal, however, the re-proposal measures the 5% risk retention based on "fair value" (determined in accordance with GAAP), rather than the initial principal balance of the retained interests.

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

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[1] This Fact Sheet summarizes certain high-level aspects of the re-proposed risk retention rules from the perspective of the commercial mortgage backed securities markets. Please refer to Cadwalader's forthcoming Clients & Friends memo for a more comprehensive summary and evaluation of the re-proposal.

No PCCRA

As a result of the increased risk retention obligation (i.e., the change to fair value measurement), the controversial "premium capture cash reserve account" feature of the original proposal has been removed. This "PCCRA" feature would have essentially required ABS sponsors to defer and subordinate any securitization profit until the maturity of the related ABS transaction.

Hybrid Retention Option

For all ABS classes, there are generally two structures for retaining risk: an "eligible vertical interest" or an "eligible horizontal interest." The B-piece buyer option is a type of horizontal retention.[2] The vertical retention option requires a sponsor to retain 5% of the fair value of every class issued in the CMBS transaction (including the REMIC residual). The re-proposed rules permit a sponsor's risk retention obligation to be satisfied by any combination of horizontal and vertical retention. [3]

Since the revised risk retention requirement will likely exceed the size of a traditional CMBS B piece, this flexibility would allow CMBS sponsors to supplement the B-piece option by retaining, themselves or through an affiliate (or possibly cause contributing loan originators to retain), an additional eligible vertical interest to "top up" the amount by which the B-piece falls short of 5% of the fair value.[4]

Restriction on Hedging

During the period when risk retention is required, the sponsor (or B-piece buyer, as described below) is prohibited from hedging its exposure to retained interests by purchasing any security or other financial instrument if the payments on such security or instrument are materially related to the credit risk of such a retained interest and if 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.

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2 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 invested in limited eligible investments and available to offset losses and other shortfalls on the transaction.

3 The re-proposed rules contain limitations on how quickly a sponsor holding a horizontal residual interest may recover "fair value" of the horizontal interest. Basically, the sponsor may not recover "fair value" of the residual interest at a rate that is faster than the rate at which the issued CMBS interests recover their principal. Using the terminology of the re-proposed rules, the "Closing Date Projected Cash Flow Rate" cannot exceed the "Closing Date Projected Principal Repayment Rate."

4 The re-proposed rules allow the sponsor to offset its risk retention requirements by the amount of eligible horizontal or eligible vertical interests retained by originators. 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. The combination of these restrictions effectively disallows risk retention by originators that contribute less than 20% of the collateral for a CMBS transaction. In addition, it is unclear whether the 20% restriction refers to the aggregate 5% sponsor obligation (which would mean that no originator could retain less than 1% of fair value) or if it refers to the net obligation of the sponsor after taking into account B-piece retention, if the B piece buyer acquires less than 5% of the fair value of the transaction.

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

In addition, sponsors (and B-piece buyers) are prohibited from pledging any retained interest as collateral for any non-recourse financing.

Sunset

Rather than the original proposal's requirement that risk be retained for the life of an ABS transaction, the re-proposal includes a sunset provision, which allows the transfer (or hedging) of retained risk 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 closing;
- the reduction of the unpaid principal balance of the issued ABS to 33% of its initial principal balance; and
- two years after the ABS closing date.

B-Piece Buyer Option

As in the original proposal, the re-proposal contains a CMBS-specific alternative to satisfy sponsors' risk retention obligations, permitting the acquisition of a subordinate horizontal interest (i.e., the B-piece) in the CMBS transaction by a third party investor who agrees to hold the B-piece subject to conditions similar to the requirements that would be applicable to the sponsor if it retained the horizontal risk directly. The details and requirements of the re-proposed B-piece buyer option are as follows:

Buyer Requirements

- 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;
- there can be either one or two B-piece buyers, but not more than two. If two, then their interests must be *pari passu*;
- 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).

Holding Period

Rather than requiring a B-piece buyer to retain the B-piece for the life of the transaction (as in the original proposal), the re-proposal allows the original B-piece buyer to sell its interest to another qualifying B-piece buyer after five years, subject to the same restrictions and conditions that applied to the 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.[5]

Operating Advisor

A CMBS transaction in which the sponsor is relying on the B-piece buyer option must feature an operating advisor who is not affiliated with any other parties to the transaction and has no financial interest in the transaction (aside from fees), with 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 re-proposed rule does 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, the special servicer must be required to consult with the operating advisor on enumerated major 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 transaction documents; and
- the operating advisor may recommend replacement of the special servicer if the operating advisor determines that the special servicer has failed to comply with the transaction documents and the operating advisor 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 (with a minimum of 5% of all CMBS holders constituting a quorum for such a vote).

Sponsor's Duty to Monitor

Reliance on the B-piece buyer option does not relieve a sponsor of its primary responsibility for risk

[5] Given this requirement, which is intended to ensure that the subsequent B-piece buyer exercises the same credit discipline as the initial B piece buyer (or as a retaining sponsor), it is unclear why the five-year hold period for the initial B piece buyer is justified.

retention and, therefore, the re-proposed 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 re-proposal does not specify what such policies and procedures should be). In the event that the sponsor detects a failure of a B-piece buyer to adhere to requirements, it must promptly notify all holders of the CMBS.

Qualifying CRE Loans

Like the original proposal, the re-proposal contains a concept of "qualifying CRE loans" which, if securitized, would attract a zero risk retention requirement. Although liberalized slightly, the standards for qualification as a QCRE loan are still extremely tight.

Unlike the original proposal, which gave no credit for originating QCRE loans unless the entire securitized pool was composed QCRE loans, the re-proposal affords a benefit for including some QCRE loans in a pool and permits the risk retention percentage to be reduced proportionately (but not less than 2.5%) 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 re-proposal contains approximately 10 pages of requirements for qualification as a QCRE loan. Highlights of the criteria are as follows:

- the loan must be secured by 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. The definition excludes land loans (including fee interests subject to ground leases), construction loans and unsecured developer loans;
- the loan must have a term of at least 10 years;
- the loan must be either fixed rate or the borrower must have swapped into a fixed rate (a cap contract does not satisfy this requirement);
- the loan must provide for amortization, with no IO period, based on an amortization schedule of no greater than 25 years (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 of greater than 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) occupied by tenants where no more

than 20% of the aggregate gross revenue of the property is payable by tenants (a) with less than six months left 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." The agency commentary on this point refers to "full-service gross" leases;

- 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 requirements of the re-proposed rules. In the event that it is determined, after securitization, that any such loan does 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.

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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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