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Potential Relief for CMBS Risk Retention Sent to the U.S. House of Representatives

Authored by Stewart McQueen, Richard D. Jones and Jonathan Gaynor

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Summary

The "Preserving Access to CRE Capital Act of 2016" (the "**Act**")[1], sponsored by Representative French Hill (R-AR), was reported favorably to the House of Representatives on March 2, 2016 by the House Committee on Financial Services by a bi-partisan vote of 39-18. The Act would modify certain aspects of Section 15G of the Securities Exchange Act of 1934 ("**Section 15G**")[2] as it relates to commercial mortgage-backed securities ("**CMBS**") transactions. Specifically, if passed into law, the Act would modify the credit risk retention rules applicable to CMBS transactions in three important ways:

- exempting single asset/single borrower securitization transactions from the requirements of the credit risk retention rules;
- allowing up to two third-party purchasers of an eligible horizontal residual interest to hold such interest in a senior/subordinate structure; and
- modifying the criteria for the qualifying commercial real estate loan exemption to allow more commercial real estate loans to qualify under such exemption.

If passed into law, the Act would require the Agencies[3] to promulgate new risk retention regulations implementing such changes.[4]

Overview of the Risk Retention Requirements for CMBS

On October 22, 2014, the Agencies promulgated the final U.S. risk-retention rules (the "**Rule**") for asset-backed securities to implement the risk retention requirements of Section 15G.[5] The Rule will become effective for CMBS transactions on December 24, 2016. The Rule generally requires that the sponsor of a securitization transaction acquires a 5% risk retention interest (the "**Required Retention Interest**") in the securitization transaction and refrains from transferring, selling or conveying the Required Retention Interest to any person other than its majority-owned

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[1] H.R. 4620, 114th Cong. §2(1) (2016).

[2] 15 U.S.C. § 78o-11 (2016).

[3] The Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, the Department of Housing and Urban Development, the Federal Housing Finance Agency, the Federal Depositors Insurance Corporation and the Office of the Comptroller of the Currency (collectively, the "**Agencies**").

[4] It is unclear whether the Agencies would need to enact any specific regulation implementing the single asset/single borrower exemption discussed herein. *See* H.R. 4620, §2(2) (each such single asset/single borrower securitization "*is exempt* from the risk retention requirements of [Section 15G]" (emphasis added)). The other changes in the Act would require the Agencies to promulgate new regulations (in the case of the exemption allowing two third-party purchasers to hold an eligible horizontal residual interest in a senior/subordinate structure) or to "jointly maintain rules" (in the case of the qualifying commercial real estate loan exemption). *See* H.R. 4620, §2(2).

[5] *See* Credit Risk Retention; Rule, 79 Fed. Reg. 77,602 (2016).

affiliates.[6] The sponsor is also prohibited from directly hedging or financing its Required Retention Interest with non-recourse debt.[7] The sponsor has the option of holding the Required Retention Interest as an eligible vertical interest ("**EVI**") in an amount equal to 5% of the face value of each tranche of securities issued in connection with the securitization, as an eligible horizontal residual interest ("**EHRI**") in amount equal to 5% of the fair value of all securities issued in connection with the securitization, or in any combination of an EVI and an EHRI (i.e., an L-Shaped Interest).[8]

With respect to CMBS transactions, the Rule offers a sponsor the option to satisfy its risk retention obligations by selling an EHRI to up to two eligible third-party purchasers (so-called "**B-piece Buyers**"), subject to the satisfaction of certain conditions and restrictions.[9] Under the Rule, if there are two B-piece Buyers, each of their interests in the EHRI must be held on a *pari passu* basis.[10] The Rule also contains an exemption for securitizations of qualifying commercial real estate ("**QCRE**") loans which meet certain restrictive criteria.[11] The sponsor's Required Retention Interest in a securitization is reduced by the proportion of the unpaid principal balance of the QCRE loans to the total unpaid principal balance of the pool of assets.[12]

The Act

The Act would exempt single asset/single borrower commercial real estate loan securitizations ("**SASB Securitizations**") from the requirements of Section 15G.[13] The Act refers to SASB Securitizations as securitizations of a single commercial real estate loan or a group of cross-collateralized or cross-defaulted commercial real estate loans that represent the obligation of one or more related borrowers secured by one or more commercial properties under direct or indirect common ownership or control. SASB Securitizations are generally comprised of high quality loans with low loan-to-value ratios and often issue only investment grade securities. Currently, the Rule does not have any exemption for SASB Securitizations.[14]

Further, the Act would amend the third-party purchaser option so that B-piece Buyers would be able to hold the Required Retention Interest in a senior/subordinate structure.[15] This change is important because it would allow a sponsor to attract different pools of investment capital with different risk tolerances and yield requirements to satisfy the third-party purchaser option. As this business is currently constituted, B-piece Buyers buy the below-investment grade and non-rated securities, which often represent between 2% to 3% of the fair value of the securities issued in connection with the related securitization. Under the Rule, the EHRI is required to constitute 5% of the fair value of all securities issued in connection with the securitization; as a result, the EHRI is likely to include investment grade securities earning a lower yield, which is not appealing to the typical B-piece buyer. The Act would allow a traditional B-piece Buyer and

[6] *See* 12 C.F.R §§ 244.3(a), 244.4(a) (2016).

[7] 12 C.F.R. § 244.12(e).

[8] 12 C.F.R. § 244.4(a).

[9] *See generally,* 12 C.F.R. § 244.7.

[10] 12 C.F.R. § 244.7(b)(1).

[11] *See* 12 C.F.R. §§ 244.15, 244.17.

[12] 12 C.F.R. § 244.17(b).

[13] H.R. 4620, §2(1).

[14] *See* 79 Fed. Reg. at 77,680.

[15] H.R. 4620, §2(1).

another buyer, content to acquire the senior portion of the Required Retention Interest, to collectively acquire the Required Retention Interest.

Finally, the Act would loosen the Rule's criteria for QCRE loans.[16] The Rule's current QCRE criteria are quite restrictive and the general industry consensus is that less than 10% of all securitized commercial real estate loans would have qualified as QCRE loans under the Rule. The Act would require the Agencies to engage in additional rulemaking with respect to the QCRE loan criteria:

- to allow certain interest-only loans to qualify for the exemption;[17]
- to eliminate any term requirements;
- to allow loans with amortization schedules of 30 years or greater; and
- to eliminate separate loan-to-value caps on QCRE loans that are documented with appraisals utilizing lower capitalization rates than other loans.[18]

Conclusion

The Act represents important changes to the risk retention requirements that could have a huge impact on the health of the capital markets—but it is not a panacea. The Act would: (i) exempt SASB Securitizations from the requirements of the credit risk retention rules; (ii) allow up to two B-piece Buyers of an EHRI to hold such interests either on a *pari passu* basis or in a senior/subordinate structure; and (iii) modify the criteria for the QCRE loan exemption to allow more commercial real estate loans to qualify under the exemption.[19] However, the Act itself does not address many other problems with the Rules. For example, the viability of the third-party purchaser option for CMBS is likely still in doubt, both because of the required holding period of the EHRI and because of sponsors' continued exposure to liability for B-Piece Buyer compliance. There is still a lot of wood to chop in figuring out a path forward. The Act does, however, give us more options to consider.

While the Act received bi-partisan support in committee, its chance of passage is unclear given the divisive political environment, especially during an election year. Even if the Act does pass this year, joint Agency action to implement parts of the Act prior to the effective date of the Rule seems highly unlikely. We will continue to monitor the progress of the Act as it makes its journey through Congress and provide updates along the way.

We encourage you to contact us with any questions you may have and we would be delighted to discuss in greater detail how risk retention requirements or the Act may impact your organization.

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[16] *See* H.R. 4620, §2(2). The text of the Act speaks of "qualified commercial real estate loans" (*see* H.R. 4620, §2(2)), but the Final Rule speaks of "qualifying commercial real estate loans" (*see* 12 C.F.R. § 244.15) and "qualifying CRE loans" (*see* 12 C.F.R. § 244.17).

[17] Specifically, the Act would require the Agencies to develop requirements for allowing certain interest-only loans to meet the exemption. The Act is silent on what these requirements should be.

[18] H.R. 4620, §2(2). The Rule currently provides for lower loan-to-value ratio caps on QCRE loans where the direct capitalization rate utilized in the appraisal is less than or equal to the 10-year swap rate plus 300 basis points. *See* 12 C.F.R. §§ 244.17(a)(5)(i), (ii).

[19] If more loans meet the QCRE loan criteria, the size of the Required Retention Interest for sponsors would decrease, which could help reduce the economic burden imposed by Section 15G.

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