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Risk Retention in CMBS: A Look Back and a Look Forward

Industry participants looked forward to 2016 with a great deal of anticipation considering both the implementation of the risk retention rules, and the expected wall of maturities. By mid-year the first commercial mortgage-backed securities (CMBS) deal intended to be compliant with the risk retention rules had hit the market. It was the first of a handful of CMBS deals intended to explore approaches to risk retention ahead of the December 24, 2016 implementation date. This advisory recaps 2016 and examines how the year measured up to the market's expectations. It also looks ahead at 2017 and makes note of a few of the many potential causes for further uncertainty in the CMBS markets, including the newly elected president and Congress and possible legislative and/or regulatory changes, in particular with respect to the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as Dodd-Frank (H.R. 4173 — 111th Congress: Dodd-Frank Wall Street Reform and Consumer Protection Act, available [here](#)).

Background

The FDIC approved the joint final credit risk retention regulations for asset-backed securities on October 21, 2014 (which regulations implement the requirements of section 15G of the Securities Exchange Act of 1934 pursuant to Dodd-Frank, such regulations will be referred to herein as the "risk retention rules"). The regulations apply to new-issue CMBS beginning on the December 24, 2016 implementation date.

By itself, implementation of the risk retention rules would command the industry's full attention. However, the large volume of CMBS loans reaching maturity in 2016 served to complicate projections for origination volumes, and further added to the anticipation on the part of industry participants and observers.

The risk retention rules require that at least one sponsor of a securitization (or its majority owned affiliate) retain a 5 percent interest in the credit risk of the securitized assets. The requirement can be satisfied by holding a) a 5 percent interest in each class of the securitization (an "Eligible Vertical Interest," or "EVI"); b) 5 percent of the fair value of the securitization in a first loss, subordinate tranche (an "Eligible Horizontal Residual Interest," or "EHRI"); or c) any combination of an EVI and an EHRI such that the sum of the fair value of the EHRI and the percentage of the EVI are equal to at least 5 percent (sometimes referred to as an "L-shaped" retention interest) per section 941 of Dodd-Frank (*Final Rule Implementing Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Credit Risk Retention)* (Oct. 21, 2014), available [here](#)).

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Market Expectations for 2016¹

Some posited that risk retention would have a chilling effect on CMBS as bank lenders are required to reserve capital against EVIs, which creates inherent limitations on how many EVIs a particular bank can hold. At the same time, EHRIs are required to equal a minimum of a 5 percent interest in the proceeds of the transaction, while the typical b-piece sold out of a CMBS securitization is an approximately 2.5 percent interest. It was therefore expected that spreads would widen (and therefore the cost of CMBS funds would increase, potentially prohibitively) in order to incentivize b-piece buyers both for the increased size of a typical investment, and also for increased durational risk as holders of EHRI cannot trade out of their position for at least five years (while b-pieces currently have no such durational limitations). Accordingly, either approach to compliance with the risk retention rules may therefore be expected to increase the cost of CMBS borrowing relative to other commercial real estate financing avenues.

Meanwhile, according to Trepp, the CMBS sector faced the maturities of nearly \$90 billion in CMBS in 2016 (on loans made in 2006). Based on the combination of the anticipated increased costs of CMBS funds that could result from risk retention and the large number of loans maturing (and therefore ripe for refinancing) in 2016, many predicted increased CMBS issuance throughout 2016 as lenders were expected to clear their books ahead of the implementation date.

First Half 2016²

Despite expectations of robust issuance in 2016, the first half of the year saw a frothy market and issuance well off of 2015's pace (which itself was below expectations). Market uncertainty was blamed for wider spreads, while slower-than-anticipated originations encouraged heightened selectivity on the part of commercial real estate lenders of all types. In large part borrowers looked to other commercial mortgage lenders, including insurance companies, banks writing portfolio loans and other alternative funding arrangements. The first quarter of 2016 saw a roughly 38 percent drop in lending against commercial properties, at decreased leverage and with nearly every major lender reducing its origination volume.

The unexpected "leave" result in the June 23 referendum on the United Kingdom leaving the European Union (Brexit) further added to market uncertainty across the capital markets, with equity, commodity and debt markets all seeing selloffs in the aftermath. Pricing concerns, broader market conditions and uncertainty related to the Brexit vote helped to make the second quarter of 2016 the slowest for CMBS issuance since 2012.

Second Half 2016³

Heading into the implementation date, countervailing forces weighed on the CMBS market. Observers expected increased issuance ahead of the new rules, as lenders were expected to clear their balance sheets of loans that were originated under diligence and underwriting standards that did not take risk retention into account. At the same time, presidential election years in particular tend to elicit a wait and see approach, and this year's election was no exception—in addition to the usual uncertainty around elections, the candidates' tax proposals included potential changes to taxes that could have impacts for investors in real estate and asset backed securities.

The volume of CMBS issuance in the third quarter of 2016 inched up slightly over the second quarter but remained behind expectations and annual issuances continues to lag well behind the 2015 pace. There was an uptick in volume in the fourth quarter—with \$18.7 billion issued in October and November, as well as a steady volume of issuance so far in December (as compared to a monthly average of \$5.5 billion in the first three quarters of the year), which is consistent with the expectation that lenders would "clear the decks" ahead of risk retention.

¹ For further reading in connection with this section, see: *Less Than a Year Away CMBS Market Braces for Risk Retention*, Trepp., available [here](#); *More Risk-Compliant CMBS Deals in the Works*, Commercial Mortgage Alert 9/16/16; and *Risk Retention Puts CMBS Lenders on Edge; Dearth of Maturities Looms*, Trepp., available [here](#).

² For further reading in connection with this section, see: *Market Monitor*, Commercial Mortgage Alert October 14, 2016; *A Tale of Two Markets*, Trepp., available [here](#); *CMBS Lending Business Opens Back Up*, Trepp., available [here](#); and *CMBS Market Has Slowest Quarter in Four Years*, Trepp., available [here](#); *What Does the Upcoming Election Mean for CRE?* Trepp., available [here](#); *Where do the 2016 Presidential Candidates Stand on CRE Issues?* Trepp., available [here](#).

³ For further reading in connection with this section, see: *Lenders Preparing to Price in Risk Premium*, Commercial Mortgage Alert 9/30/16; *CMBS Volume to Pick Up in Fourth Quarter*, Commercial Mortgage Alert 10/7/16; *Mitsubishi Closing MC-Five Mile Venture*, Commercial Mortgage Alert 10/21/16; *Walker & Dunlop Quitting the CMBS Market*, Commercial Mortgage Alert 11/4/16 and *Interest Shortfalls Loom for CMBS*, Commercial Mortgage Alert, 10/21/16.

While the rush to clear the decks ahead of the implementation date has been positive for issuance in the second half of 2016, the expectations of increased costs of lending and administrative hurdles in taking on risk retention also may lead to a reshuffling of the participants in the CMBS deal space. Over the past several months a handful of CMBS originators have closed their CMBS lending operations. At the same time, a number of nontraditional CMBS lenders have reportedly begun to explore arranging their own deals and holding the related b-pieces in order to comply with the risk retention rules—with a few having already set up shelf entities.

One additional point of concern for CMBS is a recent report from Kroll projecting significant interest shortfalls on “re-performing” CMBS loans maturing over the next year related to the workout fees due on such loans. Kroll projects the related losses could reach investment-grade classes of the deals in which they are currently securitized.

Completed and Pending Risk Retention Deals⁴

While the risk retention rules took effect on December 24, 2016, a number of lenders indicated that they began pricing a premium into newly originated loans as early as late October 2016. According to reports from *Commercial Mortgage Alert*, among other reasons, risk retention deals were issued ahead of the implementation date in order to provide proof of concept (and an opportunity to iron out deal documentation with less pressure), to gauge regulatory treatment of EVIs for bank issuers and for the potential to be seen as industry leaders with respect to particular deal structures.

The first risk retention compliant CMBS transaction, Wells Fargo Commercial Mortgage Trust 2016-BNK1 (“WFCM 2016-BNK1”), was issued August 18, 2016. The deal was sponsored by Wells Fargo Bank, National Association, Bank of America, National Association and Morgan Stanley Mortgage Capital Holdings LLC, and rated by Fitch Ratings, Inc., Kroll Bond Rating Agency, Inc., Moody’s Investors Service, Inc. and S&P Global Ratings. Each sponsor retained an EVI in an amount roughly *pro rata* to its share of the collateral. WFCM 2016-BNK1 was well received by the market, with spreads tighter than any conduit CMBS deal in more than a year.

A second risk retention compliant CMBS deal, COMM Mortgage Trust, 2016-667M (“COMM 2016-667M”), was reportedly issued on October 26, 2016. COMM 2016-667M was both the first risk retention compliant single borrower CMBS issuance and the first risk retention compliant CMBS transaction to make use of an EHRI. It was reported that the Class E certificates would be slightly more than 5 percent of the proceeds of the transaction and comprised an EHRI and also that the purchaser thereof committed to hold such EHRI for the life of the deal.

In addition to the deals discussed above that are expressly intended to comply with the Risk Retention Rules, COMM Mortgage Trust, 2016-COR1 (“COMM 2016-COR1”) was issued on October 20, 2016, in which it is reported that one of the sponsors agreed to retain the most junior classes (equal to approximately three percent (3 percent) of the proceeds of the transaction), and which observers point to as a potential template for future risk retention issuance utilizing an EHRI, but without the inherent complexity of selling the EHRI to a b-piece buyer.

In the conduit CMBS space, it has been reported that additional deals intended to comply with the risk retention rules are in the works, which intend to utilize EVIs. However, the market has been slower to issue a conduit transaction intended to be risk retention compliant and that plans to utilize an EHRI. One such transaction was reportedly in the works, though many details, including transaction timing, and the exact EHRI formulation were unclear. Though some industry participants believe the EHRI formulation results in a lower cost of funds, there are potential pitfalls in crafting the first such deal.

Some of the unanswered questions relate to risk allocation between sponsors and b-piece buyers, for example, since sponsors would face liability for noncompliance with the risk retention rules, including the durational requirement, the creditworthiness of b-piece buyers is of critical importance to sponsors, as is allocation of risk relating to other potential non-compliance –

⁴ For further reading in connection with this section, see: Prospectus: Wells Fargo Commercial Mortgage Trust 2016-BNK1, via SEC’s EDGAR, available [here](#); Deutsche, *Citi Testing Risk-Retention Rules*, Commercial Mortgage Alert 10/7/16; *First Conduit Issue with Risk Retention Structure Prices Impressively Tight*, Trepp., available [here](#); *A Closer Look at the First CMBS Deal Compliant With Risk Retention*, Trepp., available [here](#); Deutsche, *Citi Testing Risk-Retention Rules*, Commercial Mortgage Alert 10/7/16; *Initial Pricings*, Commercial Mortgage Alert 10/14/16; *Jeffries LoanCore’s B-Piece Plan Advancing*, Commercial Mortgage Alert 9/23/16; *Dealers Try to Hold Line on Spreads*, Commercial Mortgage Alert 10/7/16; *CMBS Spreads Fall as Issuers Flood Market*, Commercial Mortgage Alert 11/4/16; *Talks Stalled on ‘Horizontal’ Risk-Retention*, Commercial Mortgage Alert 10/14/16; *Legal Advice in Connection with Risk Retention in Securitizations: A Preliminary View*, In Our Opinion, Volume 15—Number 3, Spring 2016, available [here](#); and Citi, *Deutsche Mapping ‘Vertical Option’ Deal*, Commercial Mortgage Alert 10/28/16.

accordingly *Commercial Mortgage Alert* reports that details regarding b-piece buyer net worth standards and the terms of indemnification by b-piece buyers of sponsors are among the significant questions that remain open at this time.

The American Bar Association published guidance in its spring 2016 newsletter stating that “the issuance of third-party legal opinions in the context of a nascent area of the law is often problematic for all concerned,” and also “third-party legal opinions would not be appropriate with respect to risk retention,” complicating a reported issuer request that b-piece buyer counsel opine as to compliance with risk retention rules by risk retention investment vehicles.

Potential Legislative Changes

Further compounding uncertainty with respect to the implementation of the risk retention rules are a couple pending pieces of legislation, the Preserving Access to CRE Capital Act of 2016 (Preserving Access to CRE Capital Act, H.R. 4620, available [here](#)) and the Financial CHOICE Act (Financial CHOICE (Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs) Act, H.R. 5983, available [here](#)). The Preserving Access to CRE Capital Act proposes to make a few significant modifications to the risk retention rules, namely exempting single asset and single borrower securitizations from risk retention, allowing senior/subordinate structures to hold EHRIs in order to broaden the scope of potential third-party purchasers, and broadening the criteria for “Qualified Commercial Real Estate Loans” in order to allow more commercial real estate mortgages to be exempted from risk retention. The Financial CHOICE Act covers a broad range of bank regulations, but for the purposes of this discussion the most significant is the repeal of risk retention rules for all but residential mortgage backed securities. Looking ahead to a Republican Congress and president, Kroll has speculated that a modified version of the Financial CHOICE Act may have some likelihood of success in 2017. President-elect Donald Trump has floated the idea of the repeal or rollback of much of Dodd-Frank during his campaign, so further or different changes could be in store.

Items of Interest for 2017⁵

While there remains a great deal of uncertainty with respect to how the market will digest risk retention, issuance ahead of the implementation date fleshed out some details. It includes the issuance of horizontal-strip, conduit deals, beginning with WFCM 2016-BNK1, demonstrating the EVI formulation; and potential templates for the retention of an EHRI held by a sponsor in COMM 2016-COR1 and by a third-party buyer in COMM 2016-667M. However, significant questions remain. Among them: a) what, if any, arrangements b-piece buyers and sponsors will settle on in order to facilitate b-piece buyers acting as the third-party holders of EHRI in a conduit setting; b) what impact risk retention will have on commercial mortgage loan pricing (and the related impact on origination and issuance volume going forward); c) whether there will be additional changes in applicable law and regulations in the aftermath of the election; and d) the degree to which industry participants will reorganize their respective roles in the CMBS marketplace to work within the evolving regulatory framework. The foregoing questions have led industry observers to anticipate slower issuance while the market absorbs the changes related to risk retention and the questions noted above are resolved. At the same time, others note that the risk retention pricing premium has been lower than expected and point to that, among other reasons, for optimism.

⁵ For further reading in connection with this section, see: *Risk Retention Loan Premium Not as Big as Feared*, Trepp., available [here](#).

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