

Commercial MBS Risk Retention

MBA continues to monitor the impacts of risk retention on CMBS markets.

BACKGROUND

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required federal agencies (the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), the Department of Housing and Urban Development (HUD) and the Federal Housing Finance Agency (FHFA)) to jointly prescribe rules for the retention of credit risk for asset-backed securities, including commercial mortgage-backed securities (CMBS).

Consistent with that requirement, those federal agencies issued a Proposed Rule in April 2011, a re-proposal in 2013, and a final the rule on December 24, 2014 (final rule). The final rule's risk retention requirements addressing CMBS took effect on December 24, 2016. MBA believes that additional changes and clarifications are necessary to the rule.

RISK RETENTION FINAL RULE

As described below, the final rule made important changes that were responsive to many of the issues and concerns raised by MBA. Importantly, the highly problematic proposed Premium Capture Cash Reserve Account and subsequently proposed cash flow restrictions were not included from the final rule.

Flexible Approach to Risk Retention

The rule provides flexibility for CMBS, including the ability to divide the horizontal residual interest between up to two purchasers and the ability to reduce the amount of risk retention based upon the percentage of "qualified" commercial and multifamily loans comprising the CMBS. It also specifies that a single sponsor for ABS with multiple sponsors can retain the vertical risk retention interest.

Risk Retention Hold Period and Hedging of Credit Risk

The rule calls for a five-year hold period for retaining the horizontal risk retention interest. In contrast, the proposed holding period would have covered the life of the securitization.

Financing of Risk Retention Interests

The rule specifies that the sponsor can finance its risk retention position, provided the financing is subject to full recourse. Third-party horizontal residual interest purchasers are permitted to finance their purchase, provided they do not obtain financing from a party with any direct or indirect interest in the securitization transaction.

Operating Advisors

The rule specifies that the special servicer must consult with the Operating Advisor on any material decision in connection with its servicing of the securitized assets when the eligible horizontal residual interest has been reduced to 25 percent of its initial principal balance or less, as a result of principal payments, realized losses, and appraisal reduction amounts.

Vote to Replace the Special Servicer

The rule provides the Operating Advisor with authority to recommend replacing the special servicer. If the Operating Advisor recommends replacing the special servicer, the special servicer is replaced upon the affirmative vote of a majority of the outstanding principal balance of all ABS interests voting on the matter, with a minimum of a quorum of ABS interests voting on the matter. The transaction documents must specify the quorum and may not specify a quorum of more than the holders of 20 percent of the outstanding principal balance of all ABS interests in the issuing entity, with the quorum including at least three ABS interest holders that are not affiliated with each other.

Disclosures Regarding Third-Party Purchasers

The rule requires third-party purchasers to disclose the fair value of their eligible horizontal residual interest, as well as the purchase price.

GSE Multifamily

The rule specifies that a sponsor satisfies its risk retention requirement if the sponsor fully guarantees the timely payment of principal and interest on all ABS interests, provided that Fannie Mae and Freddie Mac are operating under the conservatorship or receivership of the Federal Housing Finance Agency.

In addition, any limited-life regulated entity succeeding Fannie Mae and Freddie Mac would be exempted from risk retention, provided that it is operating with capital support from the federal government.

Recommended Risk Retention Clarifications and Modifications

Although the final rule was responsive to many of MBA's concerns and provided for additional risk retention flexibility, there are areas of the final rule where additional clarification and modification may be appropriate.

Areas of the risk retention final rule that would benefit from modification to be more workable within the existing CMBS market framework include:

- Single Asset Single Borrower CMBS. This category of CMBS should fall under the "qualified commercial real estate loan" classification and as such should be exempt from risk retention.
- Horizontal Risk Retention Holders. While the final rule permits the horizontal residual interest to be held by up to two purchasers provided that it is held on a *pari passu* basis, flexibility would be enhanced by also permitting a senior/subordinate structure for purchasers of the horizontal residual interest.
- Underwriting Standards for Zero Risk Retention. MBA remains concerned that the underwriting metrics for zero risk retention for commercial and multifamily loans specified in the final rule remain unduly restrictive. We recommend enhanced flexibility of underwriting parameters for a "qualified commercial real estate loan" for multi-property CMBS.