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Risk Retention and the Preserving Access to CRE Capital Act

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The final rules for implementing Section 941 of the Dodd-Frank Act as it relates to credit risk retention will become effective December 24 of this year. With the effective date quickly approaching, Congress has stepped in to clarify the risk retention rules and propose some modifications that would ease the new requirements on the CMBS market. On March 2, 2016, the House Financial Services Committee passed H.R. 4620, the Preserving Access to CRE Capital Act of 2016. This bill, introduced by Rep. J. French Hill (R-AR), was introduced "to amend the Securities Exchange Act of 1934 to exempt certain commercial real estate loans from risk retention requirements." The Preserving Access to CRE Capital Act clarifies the "B-piece option," creates an exemption for single asset/single borrower securitization and modifies the now existing exception for qualified commercial real estate loans.

Risk Retention Rules Today

Sponsors of both public and private securitizations are required to retain a minimum 5 percent interest in all CMBS issued in a particular transaction (calculated using GAAP) and can be taken as a vertical interest (that is, with the issuer holding 5 percent of each tranche) or as a horizontal, residual interest in the first-loss position (the residual interest). "Sponsor" is defined in the risk retention rules as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[1] If there are multiple sponsors in a securitization, one sponsor must step up and retain the required credit risk. CMBS in particular has the benefit of the B-piece option, where the sponsor can transfer the residual interest to up to two pari passu third-party purchasers (B-piece buyers), provided the B-piece buyers hold the residual interest, without financing it, for not less than five years.

The B-Piece Option and a Senior-Subordinate Structure

This new legislation proposes that instead of just one, third-party B-piece buyer alone or two B-piece buyers as pari passu investors purchasing the 5 percent residual interest, one or two B-piece buyers could now also hold the residual interest in a senior-subordinate structure. Though the maximum number of B-piece buyer participants would still be

1 12 C.F.R. 244.2 (2015).

capped at two, the ability to create senior-subordinate structures would give B-piece buyers flexibility to price those structured positions in more favorable ways and more creatively divide up the risk associated with the residual position.

An Exception for Single Asset/Single Borrower Transactions

As the risk retention rules currently stand, there are no special exceptions for single asset/single borrower securitizations. Those securitizations must comply with each of the same risk retention rules as a typical pool of unrelated and unaffiliated loans. However, the new legislation proposes a complete carveout for these kinds of transactions, explicitly stating that "a securitization 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 is exempt from the risk retention requirements." This exception, if passed into law, would completely alleviate the single asset/single borrower securitization market from the constraints of the new risk retention rules.

Qualified Commercial Real Estate Loans

The risk retention rules when promulgated included an exception for pools comprised entirely of qualified commercial real estate (QCRE) loans. Yet regulators set the bar for QCRE loans well above what the majority of the CMBS marketplace could provide. Among other requirements, the heightened underwriting requirements for any QCRE loan included confirming each loan had a minimum term of 10 years, a maximum amortization term of 25 years, a 60 percent or 65 percent maximum loan to value ratio (depending on the property type), no subordinate financing on the real estate collateral and a minimum debt service coverage ratio of 1.5 or 1.7 (depending on the property type).[2] With the proposed legislation, the regulations for defining a QCRE loan would be amended to provide for:

- Including requirements under which interest-only loans may have a path to becoming a QCRE loan (presumably if such loan has a low loan to value ratio).
- Not imposing any term requirements on the length of a QCRE loan in lieu of the minimum 10-year term currently required.
- If an amortization requirement is included, not imposing an amortization schedule of less than 30 years in lieu of the current 25-year required schedule.
- Not imposing separate loan to value ratio caps on QCRE loans that are documented with appraisals that utilize lower capitalization rates than other loans.

These modifications to the definition of a QCRE loan move the needle in the direction of more practical and attainable underwriting requirements.

Looking Forward

These proposed changes in the risk retention rules are the result of significant lobbying efforts by the CMBS industry. However, passage of this bill out of the House Financial Services Committee is just the first step, and the bill must continue through the House of Representatives and the Senate to the President's desk. Time will tell whether this bill can and will be signed into law this year as the U.S. faces a presidential election in November and, just 46 days after Election Day, the effective date of the CMBS risk retention rules.

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2 12 C.F.R. 244.17.

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