PRESENTED AT

50th Annual William W. Gibson, Jr. Mortgage Lending Institute

September 29-30, 2016
AT&T Conference Center, Austin, TX
October 20-21, 2016
Cityplace Conference Center, Dallas, TX

The Dawn of CMBS 4.0: Changes and Challenges in a New Regulatory Regime

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October 3, 2016

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Commercial real estate has been financed in the U.S. capital markets through creation of commercial mortgage-backed securities (CMBS) since the early 1990s, peaking at $240 billion in 2007 and representing about 25% of all commercial real estate financing. The premise is straightforward: loan originators pool mortgage loans secured by a variety of property types located in diversified geographic locations meeting minimum underwriting criteria into a trust, and then that trust issues certificates of beneficial ownership in the pool allocating payments of principal and interest to investors in sequential priority by class (or tranche) based on their desired levels of risk, return and tenor. [See Appendix]. The senior/subordinate structure delivers lower risk and lower yield to the senior certificate holders, and higher risk with higher yield to junior certificate holders generating the profits for sponsors and originators that drive the deal. [See Appendix – CMBS Profit Structure].

Prior to the Great Recession, the CMBS market was not subject to substantial regulation, other than securities laws generally and Regulation AB in particular. But in 2009 structured finance was blamed for the economic collapse, and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") brought a surge of rule-making that has participants scrambling to manage the cost and administrative burden of compliance.

It has been a bumpy recovery, but after bottoming out in 2009, CMBS has gradually returned to a respectable critical mass as it adapts to piece-meal regulatory creep and anticipates what comes next. The long awaited "Risk Retention Rule" becomes effective for CMBS on December 24, 2016[1], one of many regulatory and structural changes that have shaped CMBS structure from pre-crisis (CMBS 1.0), to now (CMBS 4.0):

A. Risk Retention.

The essence of the Risk Retention Rule is to require sponsors to retain 5% of the credit risk of the transaction with a goal of better aligning the interests of sponsors with those of investors, i.e., being willing to "eat your own cooking." For CMBS, an exception was allowed in the Dodd-Frank Act to permit the "B-Piece Buyer," the investor that purchases the riskiest part of the transaction, to meet the sponsor retention requirement, a structure fundamental to CMBS transactions. The rationale for the exception is that B-Piece Buyers are

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1 Credit Risk Retention, joint final rule implementing Section 941 of the Dodd-Frank Act, codified in Section 15G of the Securities Exchange Act of 1934, Federal Register Vol. 79, No. 247 at 77602 (Dec. 24, 2014) approved jointly by the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (the Fed), 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).

sophisticated investors who perform extensive due diligence on the assets and acquire the below investment grade securities specifically to pursue the related higher yields with a complete and informed understanding of the related risks. The legislative feat of this exception was viewed positively by the industry, but as the details of proposed regulations emerged, it became clear that it was far from the panacea participants expected. With the final rule, there are still suboptimal conditions and requirements, but industry participants have moved forward to adapt.

The options under Risk Retention are:

a. **Sponsor retains a 5% vertical interest.**

b. **Sponsor retains a 5% horizontal interest of the most subordinate securities, determined at "fair value," which will result in an interest approximating the bottom 8-10% of the stack (by par amount).**

c. **Sponsor retains an L-shaped interest, combining a vertical interest and horizontal interest which, in the aggregate, equals 5% of fair value.**

d. **Sponsor sells a horizontal interest to a Third Party Purchaser ("TPP", that is, the B-Piece Buyer). The law permits two TPPs acquiring the Risk Retention Interest together, but only on a pari passu, or equal, basis and not senior/subordinate between them.**

Option d. (using a TPP to meet risk retention) presents a number of hurdles in order to achieve compliance, both legal and practical, including:

i. **5 year hold, after which the TPP may only sell to another qualifying TPP. Participants have concerns that it will be difficult to sell after the initial period, and thus become effectively a 10-year hold.**

ii. **TPP must commit more capital per deal: 5% of fair value is expected to be 8-10% of the stack, requiring significantly more capital per deal than in pre-Risk Retention deals. Moreover, the horizontal interest likely will include investment grade certificates, which are not an economic or desirable instrument for B-Piece Buyers to acquire and hold. What new capital sources will be required for the TPP and are they accessible?**

iii. **TPP compliance with the holding period and other requirements of the rule and assuring the issuer/sponsor of its ability to do so for the term of the deal. Since the issuer/sponsor is responsible for TPP compliance, there will be liability and indemnity issues to be addressed once its threshold comfort level with this delegation is achieved. Unfortunately, the rule does not provide guidance regarding liability or compliance failure issues.**

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2016 Mortgage Lending eConference

First appeared as part of the conference materials for the
50th Annual William W. Gibson, Jr. Mortgage Lending Institute session
"The Dawn of CMBS 4.0: Changes and Challenges in a New Regulatory Regime"