COLORADO REAL ESTATE JOURNAL

THE COMMUNICATION CHANNEL OF THE COMMERCIAL REAL ESTATE COMMUNITY

MARCH 16 – APRIL 5, 2016

Two new regulations' potential impact on the CMBS market

The recent box-office hit "The Big Short" makes the complexities of asset-backed securities and credit-default swaps accessible to the masses. Adam McKay brilliantly uses the game Jenga as a metaphor to explain how subprime loans brought down the U.S. housing market. As a result of the financial crisis of 2008, numerous government agencies have been working to improve transparency, fix underwriting pitfalls and restore confidence in the ABS markets.

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, two regulatory changes go into effect at the end of this year. Regulation AB II and Rule 15G of the Securities Exchange Act of 1934 are intended to improve transparency and encourage better underwriting standards. The new requirements apply to commercial mortgage-backed securities, a significant source of capital for commercial real estate and there is concern regarding the negative effect they might have on the commercial lending environment.

An asset-backed security is a financial security collateralized by assets like commercial mortgages, residential mortgages, credit card debt, auto loans and leases, etc. With an ABS issuance, there is one issuing company (sponsor) that bundles a number of loans backed by similar asset types and sells them as part of a public offering. The sponsor contributes anywhere from 100 percent to 0 percent of the loans included in the offering, with a handful of other loan originators selling loans into the securitization. The sponsor divides the issuance into different levels of repayment risk called tranches. In "The Big Short," Ryan Gosling's character compares residential mortgage-backed security tranches to different layers of a Jenga stack. The safest of the risk tranche is the AAA. This is at the top of the Jenga stack and represents the security holders paid first. The riskiest tranche is the B tranche, also known in the industry as the "B-Piece." B-Piece investors are the last to receive payment, not receiving it until all of the tranches above them have been paid. This is the very bottom row of Jenga blocks. Historically the B-Piece has made up 5 to 10 percent of a pool.

Significant losses by ABS holders during the 2008 financial crisis exposed concerns with transparency and oversight of the ABS securitization process. Regulation AB was originally created in 2004 to better address the needs of the ABS market. Prior to Reg AB, ABS issuances were solely governed by the Securities Act of 1933 and the Exchange Act of 1934. Reg AB II is the revision of Reg AB, and standardizes and improves asset-level data in ABS issuances. I won't dive into Reg AB II as it is mainly administrative and although it will be a huge pain for issuers, originators and servicers, it is not expected to

Dan Konecny
Vice president of loan production, Essex Financial Group, Denver

have as big an impact on the CMBS market as Rule 15G is. Rule 15G, also known as the Rules for Credit Risk Retention, requires sponsors of asset-backed securities to retain credit risk associated with the issuance of those securities. The belief is that requiring the sponsor to have skin in the game will incentivize the sponsor to monitor and control the underwriting and will help align the interest of the sponsor with that of the bond buyers. Regulation AB II goes into effect Nov. 23, 2016, and the risk retention requirements go into effect Dec. 23, 2016 ... happy holidays to everyone.

Rule 15G requires sponsors of ABS issuances to retain at least 5 percent of the credit risk associated with the assets underlying the securities. Sponsors are restricted from hedging any interest in the credit risk of the securitized assets or transferring the interest for five years, both of which were determined would undermine the intent of the risk retention requirement. A sponsor is allowed to allocate a portion of the risk to an originator that contributed at least 20 percent of the pool's underlying assets. The risk must be pari passu and relate to the entire pool and not just the assets the second originator originated. Sponsors can retain the risk vertically, horizontally or through a combination of vertically and horizontally. With the vertical retention, a sponsor must retain 5 percent of each class of ABS interests issued as part of the securitization transaction. With horizontal risk retention, the sponsor retains interest in the first loss position, or the riskiest 5 percent. In the event that the first loss position represents less than the required 5 percent, the sponsor would be required to hold securities in the tranche immediately above the first loss position. Finally, the sponsor

The belief is that requiring the sponsor to have skin in the game will incentivize the sponsor to monitor and control the underwriting and will help align the interest of the sponsor with that of the bond buyers.

can hold a combination of vertical and horizontal risk so long as it equates to 5 percent of the total securitization and the vertical exposure component has equal risk to every tranche.

Although the agencies' main goal with risk retention has been to promote good underwriting, they are concerned with potential disruption to liquidity in the CMBS market. The ability to sell off the B-Piece has been an important factor determining the liquidity of the market. With the dangers of potential market disruption in mind, Rule 15G allows the sponsor to sell off the 5 percent horizontal risk to a third-party purchaser. The difference with selling the B-Piece in the context of the new risk retention rules compared to how it's been done in the past is the third-party purchaser must follow the same rules the securitization sponsor would have been required to follow, including holding the securities for at least five years, as well as not hedging the risk. The agencies believe the new rules instead encourage improved due diligence by the B-Piece buyers, in turn incentivizing securitizers to better scrutinize the assets they include in the securitizations – without disrupting the market entirely.

The question is what premium will the B-Piece investor charge to hold the investment for five years? One CMBS originator with whom I spoke said his discussions with B-Piece investors indicated a premium of 5 to 10 percent. For every 1 percent increase in the B-Piece price, CMBS spreads increase 2 basis points, so using this math, borrowers can anticipate a 10 to 20 bps increase in rate. A different CMBS originator was not as confident in predicting the cost. To him the five-year hold requirement was very concerning as groups typically investing in the first loss position require liquidity and will be uncomfortable entering into trades they can't get out of for five years. In his mind, the number of B-Piece buyers will shrink, driving up pricing even more. One thing both originators agreed on was that vertical retention is unlikely. Issuers won't want to hold the securities on their balance sheet for an extended period of time, so selling the horizontal risk to a third-party purchaser is the likely scenario to satisfy the new requirements.

There is concern surrounding CMBS loans maturing in the second half of 2016 and beginning of 2017. Those borrowers might want to consider refinancing early or looking into alternative financing options. It is to be seen what effect the new regulations will have on the market; however, like the characters in "The Big Short," Wall Street will work diligently to figure out how to get through – or around – the new regulations. In the meantime, if you haven't seen or read "The Big Short," I highly recommend it. Seventy-seven pages into his book, Michael Lewis gives his readers a gold star for getting that far. If you're reading this