STEIN'S LAW

An Unwanted Christmas Gift for CMBS

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As President-elect Trump prepares to take office, he said he wants to repeal much of President's Obama's signature legislation. That would include the Dodd–Frank Wall Street Reform and Consumer Protection Act. Politicians and pundits debate whether this might actually happen. Most say it won't.

The commercial mortgage-backed securities industry would gladly say goodbye to Dodd-Frank, thus avoiding another impending headache. This time the headache will consist of the so-called "risk retention" rules set to take effect on Dec. 24—a Christmas gift the industry definitely did not want.

The "risk retention" rules try to force a CMBS sponsor to hold at least 5 percent of the risk (a 5 percent "slice") of the transaction. This way, in theory, the sponsor won't sell garbage to the market, because the sponsor has "skin in the game." A sponsor's retained slice can take three possible forms.

First, it can be "vertical." Here, the sponsor keeps 5 percent of the face value of each class of securities issued in the transaction. They must hold their slice until two-thirds of the loans have paid off, two-thirds of the bonds have paid off and at least two years has passed since the transaction closed.

Second, the retained slice can be "horizontal." Here, the sponsor keeps the most subordinate class of securities representing 5 percent of the fair value—not face value—of all the CMBS in the offering. Alternatively, the sponsor can bring in a third party buyer to play this role and retain this slice of risk. Whoever buys a "horizontal" slice for risk-retention purposes must hold it for at least five years. After that, they may be able to sell to a third party that meets a complicated set of requirements.

Third, the sponsor can mix and match. The sponsor can keep less than 5 percent of the most subordinate class of bonds but bring its total retained slice to 5 percent by keeping a suitably sized vertical interest in all other classes.

A CMBS sponsor can sometimes lay off part of the required risk retention on the institutions that actually originated the loans in the pool. Only if an originator contributed at least 20 percent of the face amount of those loans, it can retain a corresponding share of the risk that the sponsor would otherwise have had to keep. This reduces the sponsor's retention accordingly. But it doesn't work with originators that contributed less than 20 percent of the pool.

A multitude of federal agencies promulgated the risk-retention rule in 2014. Ever since, the CMBS industry has struggled to decide how to deal with the new rules.

In August, sponsors sold a "test case" conduit transaction constructed to meet the new requirements, even though not yet effective. Three bank sponsors kept their 5 percent retained slice in a separate class. The deal had high quality collateral. The industry was ready for it after a slow spell. It priced favorably.

A second transaction backed by a single Manhattan skyscraper followed in October. A third party bought the subordinate slice, agreeing to hold it for the required five years. It was another conservative deal with low-leverage, high-quality collateral and strong historical occupancy. It too was warmly received.

A second test conduit transaction, this time structured with a vertical slice, hit the market in early November.

Many questions remain. For horizontal slice deals, banks must determine whether they can hold their 5 percent slice on their balance sheets or must rely on third party buyers—who turn out to be expensive. For example, they can't finance their purchase with financing from certain other participants in the CMBS transaction, so they may need to use their own cash, which typically costs them more.

Rick Jones of Dechert LLP, who runs a popular and very readable industry blog, crunchedcredit.com, recently collected a long list of uncertainties on risk retention. For example, how can sponsors and third party buyers allocate liability between themselves? What happens if they can't agree on pricing?

We also note that the few transactions with risk retention closed to date have been relatively conservative in collateral quality and leverage. What will happen when this changes? Will the Christmas Eve effective date paralyze the market as everyone struggles to decide what the new rules require? Aside from the test transactions, no clear guidance yet exists on how to move forward.

Finally, with the Trump election and Republican-controlled Congress, will the rules change in 2017? In a post-election blog post, Jones said he doubts that. Others in the industry feel likewise, given that Trump's base doesn't love the financial industry. Considering how slowly Washington works, any real change is probably many years away. The CMBS industry will just have to figure out how to live with its Christmas present.

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DAN WITH A PLAN

CMBS Will Change but Not for the Reasons You Think

"Only when the tide goes out do you discover who's been swimming naked."—Warren Buffet

There is a plethora of consternation in the real estate capital markets about the new risk-retention rates, and how this could roil the commercial mortgage-backed securities markets. Beginning in 2017, all CMBS lenders will now be required to retain either a vertical or horizontal (first loss) tranche of a CMBS security which will subsequently raise the cost of the security to the borrower since the issuers will have to hold reserves on their balance sheet. So, simply add 10 to 20 basis points to the spread and it will be business as usual? Maybe. However, there are clearly other factors in play. CMBS shops have used this pause to relook at their entire business in an attempt to determine where they fit in the marketplace.

The largest players are generally the issuers, the behemoths that both securitize their own loans and take in loans from "contributors." J.P. Morgan Chase leads a cast that includes Deutsche Bank, Bank of America, Wells Fargo and CCRE. These five groups will likely be the big winners as they have the large balance sheets in which holding a slice of a CMBS loan is merely a rounding error. As issuers, they can cajole a B-piece holder more effectively since they can use pay-for-play leverage if a B-piece buyer tries to kick out a particular loan. They can also originate some loans at break-even to simply add to the size of the securitization, effectively undercut their competitors, mainly contributors. Contributors need the issuers to take in their loans to ultimately be part of the issuers' securitization, so these contributors need to add a small buffer to insure that their loans are not kicked out of the pool. As smaller shops, they cannot afford to either pay the roughly 100 basis point retention fee (about $100,000 on $10 million) or to have multiple pieces of loans sit on their balance sheet, the cost of which would exceed the profit on the deal.

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Some contributors have left the business, namely MC-Five Mile and Walker & Dunlop, and many of the three dozen or so in the marketplace will follow. The survivors will be those lenders nimble enough to have figured out a way to absorb the risk. Bancorp is one such firm since, as a bank, they can afford to buy the vertical slice along with the competitive advantage of having arguably the smartest guys in real estate, Jonathan Kohan and Ron Wechsler, leading their CMBS efforts. Phil Miller and Macquarie Group were insightful enough to join forces with Principal Financial and the legendary Rob Dirks, who together will be a strong force. For those originators not blessed with such rainmakers, a bleak future may be in store as there will no doubt be fewer players in the market later this year.

As always, the CMBS market, however, is ruled by the B-piece buyers. They have proven fickle throughout the year with the only constant being their group disdain for Class B malls. Andrew Farkas' C-III Capital has become a dominant force among B-piece buyers. For example, they purchased the entire junior tranche of Morgan Stanley's 2016-BNK-2 issuance in November. This pool had a heavy concentration in New York and California (40 percent), which likely gave them comfort. While it was also overweight in retail (41 percent), it was of high quality with the largest asset being a $68 million tranche to the Gotham Organization in Harlem. Rialto Capital also continues to be the other large buyer of B-pieces as they took the whole of CSAIL's 2016-C7 securitization, which consisted mainly of Credit Suisse and Benefit Street. Again, retail (40 percent) was the dominant product, but the two largest loans were trophy malls of Simon Property, so risk of default is extremely low. By the way, both of the preceding loans had risk-retention rules attached to them. And the world did not end.

While the various players are wringing their hands over the effects of risk retention, they should instead be ruminating about how $137 billion of CMBS (Source: Trepp) will be refinanced in 2017 as interest rates spike. An 85 basis point increase in the 10-year Treasury Bond since Labor Day (50 basis points since Election Day alone) is not much on an absolute basis, but it clearly is "bigly" on a percentage basis. For property owners that have cash reserves, they will be well positioned if interest rates continue to climb or if deleveraging becomes a theme for 2017.

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