**Risk Retention in CMBS Lending – Reality or Illusion**

By Joseph Philip Forte

Faced with the prospect of refinancing nearly $1.4 trillion of U.S. commercial real estate debt in the next four years, real estate investors remain skeptical, despite the halting recovery of capital markets in recent months, whether commercial mortgage-backed securities can restart with sufficient volume to finance the recovery of the commercial property markets and avoid the consequences of a catastrophic shortfall in available financing.

Poorly underwritten, substandard loans have been blamed on securitizing lenders’ failure to retain any risk in the loans originated. Yet, the Federal Reserve published a report that concluded

“… simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the [Dodd-Frank] Act – namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans…”

But what is the most effective form of risk retention appropriate to the commercial real estate market?

Too much capital, persistent historically low interest rates, excessive leverage, unsustainable property values and ever declining cap rates have eventually led to the downturn of booming real estate markets in the past and the subsequent collapse of securitized lending was not in this respect an exception. The trouble was not and still is not with securitization itself, but rather with originators, issuers and investors’ incredible misperception and mispricing of risk. It is as though they collectively thought that somehow the securitization process had taken all of the risk out of real estate financing (or at least was someone else’s problem: a clearly erroneous conclusion.

From the inception of the CMBS market until two years before the current crisis began, the most cognizant assessor of risk was the buyer of the lowest tranche of CMBS certificates – the first-loss position (the “B-piece buyer”) – which paid cash and did its own due diligence on the loan collateral and securitization structure, intending to retain the risk for its own account. But since 2005, risk was no longer assessed for the term of the loan but solely at the point of origination.

The credo became: Make it and sell it. Although intermediaries always export risk by parceling it out to various end users with different risk appetites, this time the ultimate buyer did not fully appreciate the risk because the credit rating agencies failed to properly identify and consider, in issuing their ratings, the risk of new structured finance vehicles being used to package credit risk assets such as collateralized debt obligations.
Issuers viewed themselves as exporting risk – it was someone else’s risk after it was securitized – but the someone else didn’t quite appreciate the risk undertaken. But as we have seen, it does not always work out quite like that, as assets have a way of migrating back to an issuer’s balance sheet through the failure of an investment in an asset by an issuer’s subsidiary (e.g., structured investment vehicles or SIVs) or a defaulted financing of an asset sale. Thus were the seeds of the current turmoil planted over the last several years.

When a lender sells an asset, it does so to remove the asset from its balance sheet to free up capital and allow the institution to make a new loan as well as collect a new fee. Real estate lending went from being a portfolio business to a fee business — from a storage business to a moving business. Yet, by financing its purchaser in the sale of an asset, the loan seller is removing the asset from its balance sheet as owner, but clearly reacquiring the risk of the newly pledged asset as lender. Hence, the prospect of being able to remove assets from the seller’s portfolio (or its continuing pipeline) without retaining the risk of the assets on its balance sheet was a very appealing structure for asset sellers.

Wall Street, in an attempt to avoid retaining any risk whatsoever, now adapted new CDO technology used in other markets for use in the commercial real estate finance market. In stark contrast to the traditional warehouse or “repo” financing of financial assets, the CDO offered a long term fixed rate without mark-to-market requirements or margin call risk. The availability of CDO financing led to a further explosion of non-senior loan products, which, because of US tax law limitations could not otherwise be disposed of, by depositing B notes, mezzanine debt and B-pieces, into a CMBS trust. The mortgage loan origination community was more than willing to accommodate the ever-increasing capital markets investor appetite for subordinate debt products by increasing loan production as the lenders were able to serially clear their financed non-senior debt inventory — that otherwise would have been retained in portfolio — into a CDO. Thus, lending volume of non-senior mortgage components and mezzanine debt grew significantly, supported by the growth of the commercial real estate CDO, allowing CMBS issuance to reach record levels. We began to build financial capital stacks overleveraging property rather than creating physical building.

Although many investment-grade investors were relying almost entirely on letter ratings to assure themselves of their investments’ prudence, B-piece buyers before 2005 required full access to information about the borrower, the property, the leases and cash flow, the loan, all third-party and originator reports on borrower and guarantor credit and the collateral, as well as the lender’s underwriting to do their own due diligence and evaluation.

Because of the inherent risk of their first-loss position, the due diligence and reunderwriting that they undertook was far greater than that of a primary mortgage market lender — securitized or portfolio — but rather like the specialized real estate diligence of a disciplined junior mortgagee. This analysis should question the wisdom of vertical risk retention as a
A proposed solution because of the dilution and fragmentation of the first-loss risk to more senior CMBS bond buyers who in most cases lack the specialized realty discipline of the B-piece buyer.

Thus, the B-piece buyers, not the credit rating agencies, were the market’s real gatekeepers. As a condition of their buying the first-loss tranche, B-piece buyers routinely questioned and even rejected loans deemed substandard. The credit enhancement provided by their first-loss position to the senior certificate holders became a subordination cushion, as B-piece buyers focused on understanding and managing the credit risk associated with each asset in the trust.

Last year, the Congressional Oversight Panel in its “February Oversight Report – Commercial Real Estate Losses and the Risk to Financial Stability” predicted that regional and local banks alone, which supply substantially more capital to the commercial real estate markets than do insurance companies or CMBS lenders, would have losses of $200 - $300 billion in their commercial real estate loan portfolios beginning in 2011. Yet the banks’ retention of 100% of the credit risk in their portfolios did nothing to prevent “bad” underwriting and substandard loan origination for their own accounts. It is a clear cautionary tale about the illusory value of credit risk retention by loan originators.

The benefit of the risk retention by B-piece buyers is precisely that they are not the originators of the mortgage loans with their own competing motives of originator compensation, interlender competition, borrower relationships, property envy, industry league table standings, achieving CMBS deal size and frequency, and PR/marketing opportunities (that is, “bragging rights”) which color, influence or sometimes interfere with a lender’s clear assessment of a loan’s credit risk. A truly independent second review of each loan by a real estate specialist — not the credit rating agencies — is needed. If CMBS is to be restarted, we cannot revert to the post-2005 fully leveraged B-piece buyers who collect fees and quickly export their first-loss position risk to a CDO. As the debate over the efficacy of different forms of credit risk retention for different asset classes continues among regulators, a recent report by the Federal Reserve recommended different retention requirements for various types of securitized assets, recognizing “differences in market practices and conventions.”

To jump-start CMBS, the “skin in the game” conundrum must be resolved to the ultimate satisfaction of investors, both investment-grade and non-investment-grade. Based on the Dodd-Frank guidelines, recovery of CMBS will be best protected against poor underwriting being done and condoned, and substandard loans being made and deposited into CMBS, if the first-loss positions are sold for cash in arm’s-length negotiations by independent third parties. The third parties must have adequate financial resources to back losses and must conduct do due diligence of all the individual loans in the context of the whole pool before, not after, CMBS issuance.
Although a B-piece buyer may be permitted to finance a portion of its purchase with an “at-risk” loan (from other than the originator or issuer, or their sponsor), it must retain its first-loss position and not export the credit risk into a financial arrangement like a CDO or otherwise reallocate its credit risk to another, thereby dissipating its discipline as a risk buyer.

CMBS investors will be better able to rely on the buyer of a first-loss risk in a specific pool who analyzes and evaluates each individual loan to be deposited rather than rely on an originator and securitizer primarily interested in selling loans or CMBS certificates. The loan-by-loan analysis of the overall pool risk provides a more reliable assessment of credit risk for the certificate holders than the originator or depositor, who have not assembled the pool based on overall risk but by individual loans and for competing motives.

Yet, loan originators and CMBS securitizers must also be incorporated into any final CMBS risk retention regime adopted to further align the interests of originators, securitizers and investors. The Dodd-Frank Act recognizes that “skin in the game” can take many forms other than retaining a specified percentage of an asset’s credit risk. Although representations and warranties have been an integral structural component of the architecture of CMBS since the beginning, the Securities and Exchange Commission (“SEC”) has recently promulgated a new rule implementing Dodd-Frank’s contemplated menu of options to satisfy its requirement of risk retention. These alternatives include the development of baseline representations and warranties and more effective breach repurchase enforcement mechanisms as well as adequate underwriting standards and controls.

In an industry-wide effort to provide expertise in support of the SEC’s fulfillment of its mandate, the Commercial Real Estate Finance Council (“CREFC”) has developed a set of standard Model Representations and Warranties which it proposes will constitute another form of risk retention envisioned by Dodd-Frank by creating a benchmark against which specific deal variations will be measured. As in the past, such Representations and Warranties will be made by loan originators and securitizers at securitization to all prospective CMBS investors. But the current responses by originators and securitizers to existing repurchase requests has been less than satisfactory in the current downturn with the originators and securitizers challenging or denying the repurchase demands resulting in unnecessary costs and protracted delays occasioned by litigation to resolve such repurchase disputes. The new SEC rule is meant to strengthen it as a remedy for investors by imposing several rather strong measures on originators and securitizers who fail to abide by their contractual obligations. CREFC has also promulgated best practices for resolving breach claims with an expedited mandatory non-binding mediation procedure (before litigation may be commenced) to be included in all Pooling and Servicing Agreements and Mortgage Loan Purchase Agreements.

Under its new proposed rule, the SEC will now also require that securitizers disclose in significant detail all of the breach repurchase requests
they have received across all of their securitization trusts—both “fulfilled and unfulfilled”—for the last three years (phased in) and that credit rating agencies to include in any credit rating report a summary of representations and warranties as well as enforcement mechanisms in the trust and “how they differ from those contained in issuances of similar securities.” Obviously, these requirements are intended to identify originators and securitizers who have “clear underwriting deficiencies” in their origination and securitization of loans. Moreover, the SEC is proposing that the securitizers disclose all fulfilled and unfulfilled repurchase demands to investors quarterly to allow them to monitor such activities.

The restaging of CMBS market has to be a new generation of structures, not a fancy repackaging of the same old structures. First, structures need to be more transparent and not overly complex for investors. New originators and securitizers need to understand their mistakes and the problems facing servicers from the “old” origination/securitization environment. Second, CMBS cannot be seen as or be a moving business; and although not a “storage” business, it will require that there be real “skin in the game” to give investors confidence in the “new” origination process as well as future securitization structures.

Ultimately, bridging the current gap between originators/securitizers and investors will best be accomplished by returning the B-piece buyers to their original role as the gate keepers self-charged with maintaining discipline in the CMBS market and by the SEC requiring the identification of originators and securitizers with “clear underwriting deficiencies.” Only this can provide investors with the degree of predictability and stability that they seek when they can once more rely with some degree of confidence on the redundant loan-by-loan review by an “at-risk” first-lost holder and the SEC’s monitoring quality of originators/securitizers’ underwriting and controls to assure investors of better quality pool assets in the future.