



Risk Retention Proposed Rule Summary of General and CMBS Provisions

I. Dodd-Frank Act Risk Retention Provisions and Definitions

Provisions Specific ally Applicable to CMBS

- The Dodd-Frank Act requires 5% retained risk on all CMBS transactions, but permits the regulators to reduce this 5% based on the following:
 - Retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the CMBS and meets the same standards for risk retention required of the securitizer,
 - A determination by the regulators that the underwriting standards and controls for the asset are adequate, and
 - provision of adequate representations and warranties and related enforcement mechanisms.

2. Definition of Originator, Securitizer and CRE Loan

- Because the proposed rule refers often to “the originator” and “the securitizer,” the definitions of these terms in the Dodd-Frank Act are cited below for reference purposes.
 - “**Securitizer**” = 1. An issuer of an asset-backed security (ABS), or 2. a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.
 - “**Originator**” = a person who: A. through the extension of credit or otherwise, creates a financial asset that collateralizes an ABS; and B. sells an asset directly or indirectly to a securitizer.
 - **Definition of a Commercial Real Estate (CRE) Loan:** For purposes of the proposed rules, a CRE loan is defined as “a loan secured by a property with five or more single-family units, or by non-farm, non-residential real property, the primary source (50% or more) of repayment for which is expected to be derived from: a. the proceeds of the sale, refinancing, or permanent financing of the property, or b. rental income associated with the property other than rental income that is derived from any affiliate of the borrower.” Under the proposal, a CRE loan does not include a

land development and construction loan, loans on raw or unimproved land, a loan to a REIT, or an unsecured loan.

II. General Risk Retention Requirements

1. Scope of Application

- *Sponsor.* The proposed rules generally require that a securitization “sponsor,” or one of its consolidated affiliates, hold the required risk retention. Practically speaking, of all the various parties involved in a typical securitization transaction, the “sponsor” is the true decision-maker behind the securitization transaction and determines what assets will be securitized. In light of this, the proposed rule provides that a sponsor of an ABS transaction is the party required to retain the risk under the rule. The proposed rule defines the term “sponsor” in a manner consistent with the definition of that term in the SEC’s Regulation AB.
- *Originator.* For originators that contributed 20 percent or more of the securitization’s underlying assets, the proposed rule would permit a securitization sponsor to allocate a proportional share of the risk retention obligation to the originator(s). This would have to be voluntary on the originator’s part, however, through a contractual agreement with the sponsor.
- The proposed rule defines “originator” as the person that “creates” a loan or other receivable. This only covers the original creditor—and not a subsequent purchaser or transferee. Mortgage bankers that do not fund loans or are not part of the lending decision would not be considered an originator under the proposed rule, based on our interpretation of the regulators’ clarification at our meetings.

2. Acceptable Forms of Risk Retention.

- Consistent with the statute, the proposed rule generally would require a sponsor to retain an economic interest equal to at least 5% of the aggregate credit risk of the assets collateralizing an issuance of ABS (the “base” risk retention requirement). The regulatory agencies have sought to structure the proposed risk retention requirements in a flexible manner that will allow the securitization markets for non-qualified assets to function in a manner that both facilitates the flow of credit to consumers and businesses on economically viable terms and is consistent with the protection of investors. The proposed rule provides several options for the form in which a securitization sponsor may retain risk. These include:
 - A 5% “vertical” slice of the ABS interests, whereby the sponsor or other entity retains a specified *pro rata* piece of each class of interests issued in the transaction (that is, the sponsor must hold 5% of each tranche);
 - A 5% “horizontal” first-loss position, whereby the sponsor or other entity retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests;
 - The rule also provides that Fannie Mae and Freddie Mac will be able to satisfy the risk retention requirement through their guarantees (which cover 100% of principal and interest) as long as they continue to operate under the conservatorship or

- receivership of the FHFA and with direct government support through the Treasury Department's Senior Preferred Stock Purchase Agreement.
- An "L-shaped interest" interest whereby the sponsor holds at least half of the 5% retained interest in the form of a vertical slice and half in the form of a horizontal first-loss position;
 - A "seller's interest" in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor or other entity holds a 5% separate interest that participates in revenues and losses on the same basis as the investors' interest in the pool of receivables (unless and until the occurrence of an early amortization event);
 - A representative sample, whereby the sponsor retains a 5% representative sample of the assets to be securitized, thereby exposing the sponsor to credit risk that is equivalent to that of the securitized assets; or
 - For certain "eligible" single-seller or multi-seller asset-backed commercial paper conduits collateralized by loans and receivables and covered by a 100% liquidity guarantee from a regulated bank or holding company, a 5% residual interest retained by the receivables' originator-seller. This option would not be available to ABCP programs that operate as SIVs or securities arbitrage programs.

3. Premium Capture Cash Reserve Account

- In addition to the base credit risk retention requirement, the proposed rule would prohibit sponsors from receiving compensation in advance for excess spread income to be generated by securitized assets over time. The proposed rules accomplish this by imposing a "premium capture" mechanism designed to prevent a securitizer from structuring an ABS transaction in a manner that would allow the securitizer to take an up-front profit on a securitization that would pay the sponsor more up front than the cost of the risk retention interest it is required to retain.
- For issuer retained risk retention, the amount placed in the premium capture cash reserve account would be calculated by subtracting from the gross proceeds received by the issuing entity from the sale of the ABS interest in the issuing entity to persons other than the sponsor (net of closing costs paid by the sponsor or the issuing entity to unaffiliated parties) an amount equivalent to 95 percent of the par value of all ABS interests in the issuing entity issued as part of the transaction. The 95 percent par value is designed to take into consideration the five percent interest that the sponsor is required to retain in the issuing entity.*
- In the case of a third-party purchaser of the CMBS horizontal risk retention slice, the amount placed in the premium capture cash reserve account would be calculated by subtracting from the gross proceeds received by the issuing entity from the sale of ABS interest in the issuing entity to persons other than the sponsor (net of closing costs paid by the sponsor or the issuing entity to unaffiliated parties) an amount equivalent to 100 percent of the par value of all ABS interests in the issuing entity issued as part of the transaction. The proposed rule uses 100 percent par for the ABS interests issued because the relevant menu options do not require the sponsor to retain any of the ABS interests issued in the transaction when a third-party purchases the horizontal risk retention slice of a CMBS.

The issuer must retain the entire amount of the premium capture cash reserve account. Since this account will be used to pay for first losses, it effectively becomes a “super junior” position that the issuer assumes that would have a lower payment priority than the 5.0 percent horizontal risk retention slice that the B-piece buyer is allowed to purchase.

*Please note that MBA has requested clarification from the regulators of the exact calculation of the amounts in these 2 scenarios and will be providing an update once we have heard back from the regulators.

4. Hedging

- As a general matter, the proposed rule prohibits a securitizer from hedging its required retained interest or transferring it, unless to a consolidated affiliate.
- The rule would permit hedging of interest rate or foreign exchange risk; pledging of the required retained interest on a full recourse basis; and hedging based on an index of instruments that includes the asset-backed securities, subject to limitations on the portion of the index represented by the specific securitization transaction or applicable issuing entities.

III. Standards for Qualifying Commercial Real Estate Loans

Sections III and IV describe the conditions under the Crapo Amendment of the Dodd-Frank Act that would eliminate the 5% risk retention requirement for issuers.

1. General Provisions: The securitization transaction must be collateralized solely (excluding cash and cash equivalents) by one or more commercial real estate (CRE) loans that meet all of the following requirements:
2. Underwriting, Product and Other Standards
 - the CRE must be secured by a first lien on the property;
 - Prior to origination of the loan, the originator must have:
 - Verified and documented the current financial condition of the borrower;
 - Obtained a written appraisal of the real property by an appropriately state-certified or state-licensed appraiser securing the loan that: i. was performed not more than 6 months from the origination date of the loan; ii. conforms to generally accepted appraisal standards as substantiated by the USPAP and the appraisal requirements of the Federal banking agencies; and iii. provides an “as is” opinion of the market value of the real property which includes an income valuation approach that uses a discounted cash flow analysis;
 - Qualified the borrower for the CRE loan based on a monthly payment amount derived from a straight-line amortization of principal and interest over the term of the loan, not to exceed 20 years;

- Conducted an environmental risk assessment to gain environmental information about the property and took appropriate steps to mitigate any environmental liability determined to exist based on this assessment;
- Conducted an analysis of the borrower's ability to service its overall debt obligations during the next 2 years, based on reasonable projections;
- Determined that, based on the previous two-years' actual performance and based on two years of projections which include the new debt obligations, the borrower had :
 1. a debt service coverage ratio (DSCR) of 1.5 or greater, if the loan is a qualifying leased CRE loan, net of any income derived from a tenant who is not a qualified tenant(s);
 2. A DSCR of 1.5 or greater, if the loan is a qualifying multifamily property loan, or
 3. A DSCR of 1.7 or greater, if the loan is any other type of CRE loan.

NOTE: To qualify for the lower DSCR, the CRE loan must be secured by a multifamily property, where at least 75% of the CRE property's net operating income (NOI) is derived from rents and tenant amenities, e.g. gym membership, parking fees, etc., or commercial nonfarm real property that is occupied by and derives at least 80% of its aggregate gross revenue from one or more "qualified tenants." A "qualified tenant" is defined as a tenant that: 1. Is subject to a triple net lease that is current and performing with respect to the CRE property, or 2. Was subject to a triple net lease that has expired, currently is leasing the property on a month-to-month basis, has occupied the property for at least 3 years prior to closing and is current and performing with respect to all obligations associated with the CRE property. All outstanding triple net leases must have a remaining maturity of at least 6 months, unless the tenant leases the property on a month-to-month basis as described above.

- The loan documentation for the CRE loan includes covenants that:
 - Require the borrower to provide to the originator and any subsequent debt holder of the commercial loan, and the servicer, the borrower's financial statements and supporting schedules on at least a quarterly basis, including information on existing, maturing and new leasing or rent-roll activity for the property securing the loan, as appropriate; and
 - Impose prohibitions on: 1. the creation or existence of any other security interest with respect to any collateral for the CRE loan; 2. The transfer of any collateral pledged to support the CRE loan; and 3. Any change to the name, location or organizational structure of the borrower, or any other party that pledges collateral for the loan;
 - Require the borrower and any other party that pledges collateral for the loan to:
 1. Maintain insurance that protects against loss on any collateral for the CRE loan, at least up to the amount of the loan, and names the originator or any subsequent holder of the loan as an additional insured or loss payee;
 2. Pay taxes, charges, fees, and claims, where non-payment might give rise to a lien on any collateral for the CRE loan;
 3. Take any action required to perfect or protect

the security interest of the originator or any subsequent holder of the loan in the collateral for the CRE loan and to defend the collateral against adverse claims; 4. Permit the originator or any subsequent holder of the loan and the servicer to inspect the collateral for the CRE loan and the books and records of the borrower or other party relating to the collateral for the CRE loan; 5. Maintain the physical condition of the collateral for the CRE loan; 6. Comply with all environmental, zoning, building code, licensing and other laws, regulations, agreements, covenants, use restrictions and proffers applicable to the collateral; 7. Comply with leases, franchise agreements, condominium declarations, and other documents and agreements relating to the operation of the collateral, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator or any subsequent holder of the loan or the servicer; and 8. Not materially alter the collateral for the CRE loan without the consent of the originator or any subsequent holder of the loan, or the servicer.

- The loan documentation for the CRE loan prohibits the borrower from obtaining a loan secured by a junior lien on any property that serves as collateral for the CRE loan, unless the loan finances the purchase of machinery and equipment and the borrower pledges such machinery and equipment as additional collateral for the CRE loan.
- The loan to value ratio (LTV) for the loan is: a. less than or equal to 65% or b. less than or equal to 60%, if the cap rate used in an appraisal meeting the requirements of the rule is less than or equal to the sum of: i. the 10 year swap rate, as reported in the Federal Reserve Board H.15 Report as of the date concurrent with the effective date of a qualified appraisal, and ii. 300 basis points.
- All loan payments required to be made under the loan agreement are: a. based on straight-line amortization of principal and interest over a term that does not exceed 20 years; and b. to be made no less frequently than monthly over a term of at least 10 years.
- Under the terms of the loan agreement: a. any maturity of the note occurs no earlier than 10 years following the date of origination; b. the borrower is not permitted to defer repayment of principal or payment of interest, and c. the interest rate on the loan is: i. a fixed interest rate, or ii. An adjustable interest rate and the borrower, prior to or concurrently with origination of the CRE loan, obtained a derivative that effectively results in a fixed interest rate.
- The originator does not establish an interest reserve at origination to fund all or part of a payment on the loan.

- At the closing of the securitization transaction, all payments due on the loan are contractually current.
- The depositor of the CMBS certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the CMBS meet all of the underwriting, product and other requirements and has concluded that its internal supervisory controls are effective and the evaluation of the effectiveness of the depositor's internal supervisory controls shall be performed, for each issuance of a CMBS, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such CMBS; and the sponsor provides, or causes to be provided, a copy of the depositor's certification to potential investors within a reasonable period of time prior to the sale of CMBS in the issuing entity, and upon request, to its appropriate federal banking agency, if any.

Buy-back Requirement

A sponsor that has relied on the qualified commercial real estate exception with respect to a securitization transaction will not lose this exception if, after the closing of the securitization transaction, it is determined that one or more of the CRE loans collateralizing the CMBS did not meet all of the underwriting product and other standards requirements provided that: 1. The depositor has complied with the depositor certification requirement, 2. The sponsor repurchases the loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) no later than 90 days after the determination that the loans do not satisfy all of the underwriting, product and other standards requirements, and 3. The sponsor promptly notifies, or causes to be notified, the holders of the CMBS issued in the securitization transaction of any loan(s) included in such securitization transaction that is required to be repurchased by the sponsor, including the principal amount of such repurchased loan(s) and the cause for such repurchase.

IV. B-Piece Buyers in CMBS transactions

- As contemplated by section 15G, the agencies propose to permit a reduction in the 5% retained risk, for certain securitizations of commercial mortgage-backed securities (CMBS), a form of horizontal risk retention in which the horizontal first-loss position initially is held by a third-party purchaser (known as a "B-piece buyer") that specifically negotiates for the purchase of the first-loss position and conducts its own credit analysis of each commercial loan backing the CMBS.
- The third-party purchaser acquires an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as the sponsor would have been required to retain under the horizontal risk retention option and certain additional conditions are met. The conditions include:
 - An Independent Operating Advisor (Advisor) is required if the control rights of the B-piece buyer are not collectively shared by all investors in the securitization. These control rights include but are not limited to the appointment of the servicer and

- special servicer. The Advisor would have the ability to replace the servicer and or special servicer that is affiliated with the B-piece buyer unless a majority of each class of certificate holders votes to retain the servicer and or special servicer:
- B-Piece buyer pays for the B-piece in cash;
 - B-piece purchaser performs a review of the credit risk of each asset in the CMBS pool;
 - B-piece buyer is under same hedging, transfer and other restriction as a sponsor that held a horizon tal risk retention position and the sponsor is responsible for monitoring the B-piece buyer's compliance with the preceding restrictions. Sponsors would have to disclose to investors the B-piece buyer's percent of the securitization and amount paid as well as the representations and warranties in the securitization.

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