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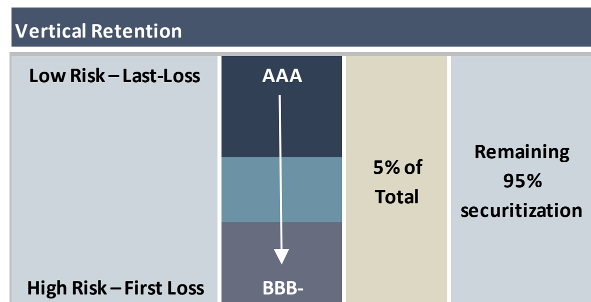
PCCP Market Commentary
More Volatility in a Volatile World: CMBS Risk Retention
Third Quarter 2016

As we write this quarterly newsletter, volatility in the world seems to be increasing. The Brexit vote is now in, and surprise: the bookies and the financial community were wrong. Market reaction was swift and severe, and most tellingly, global. A little bit of volatility can be a good thing. Sharpshooting investors can take advantage of price differentials and add value for their capital. A lot of a good thing can have suboptimal side effects, like paralysis.

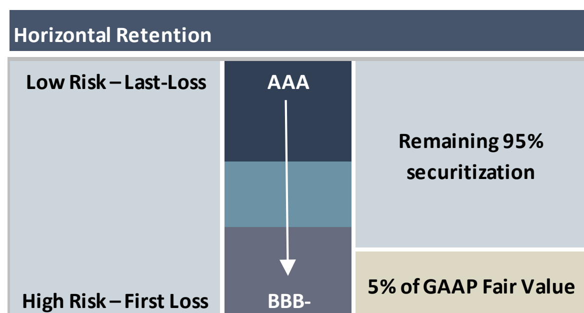
Even before the Brexit vote, we decided to devote our newsletter to an upcoming source of volatility in the real estate credit markets: the implementation in late 2016 of risk retention rules for commercial mortgage backed securities in the U.S. One thing seems to be certain. These new rules will increase the cost of capital for this important part of the U.S. real estate capital markets.

After the global financial crisis, U.S. legislators and regulators decided that people making loans should share some of the risk of repayment. This alignment of interest, presumably, would lead to better credit outcomes, and perhaps minimize the possibility of the next credit bubble. Starting in December of 2016, under Dodd-Frank (the name of the U.S. financial re-regulation laws passed in 2010), the "sponsor" of a loan securitization transaction (the group that actively participates in the origination and initiation of the underlying assets), must retain (or cause a qualified party to hold) a minimum 5% interest in the securitization for a minimum of five years or until all of the assets have been resolved. The sponsor may not hedge, finance, or transfer its position for the first five years. After five years, the sponsor may transfer its position to a qualified assignee.

There are three primary methods for a sponsor to meet risk retention: vertically, horizontally, or "L" retention, which is a combination of vertical and horizontal. Each of these structures is explained below.

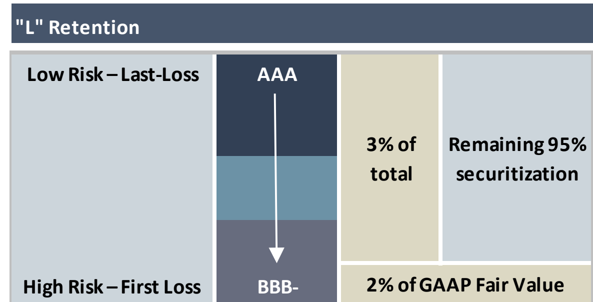


Vertical risk retention, depicted to the right, can be satisfied through a 5% pari passu investment in each of the bonds of the securitization, or a 5% interest in the full pool prior to securitization. Market watchers predict that the vertical retention strategy will be favored by banks and large financial institutions, for the following reasons: (i) this option requires no fair value disclosure and no regulatory testing, (ii) the sponsor holds the vertical interest directly, avoiding liability for the actions of another retention holder, (iii) a single vertical tranche may be relatively capital efficient for a bank holder; and (iv) a sponsor can more easily match loan origination volume to the budgeted capital available for risk retention.



Horizontal risk retention is depicted in the chart to the left and can be satisfied with a 5% interest in the GAAP fair value of the securities. The fair value calculations and assumptions (loan specific assumptions, loss projections, calculations, etc.) must be disclosed to the market. A horizontal risk retention position may be sold to third party B-note buyers. These B-note buyers must be "qualified institutional buyers" with more than $100 million in assets managed, as defined by the SEC. The position cannot be

sold to more than two B-note buyers and they must own the B-notes pari passu. The B-note buyers are subject to the same transfer, financing, and hedging restrictions as the sponsor, and the sponsor remains liable to ensure that the B-note buyers remain compliant. Market participants have indicated that the potential liability related to disclosures made regarding the fair value calculations, loss projections, and underlying assumptions could lead to significant rate increases for sponsors utilizing a horizontal retention strategy.



"L" Retention is, not surprisingly, a combination of the horizontal and vertical retention options. A sponsor using the "L" retention strategy would be required to make the fair value disclosures for the portion of the retention that is horizontal retention. The 5% interest would be comprised of any combination of the vertical retention and the fair value of the horizontal retention. An example of this would be the 2% fair value of the BBB- tranche plus a 3% share of the remainder of the securitized pool (or any combination of the two that equal 5%). The strategy is likely to be used only if a sponsor desires to sell the BBB- (or other low-end rated tranches) to a B-note buyer. However, the sponsor is not permitted to sell the vertical tranche and will be responsible for the disclosure and third party risk associated with the horizontal option while earning a lower return on the combined vertical and horizontal investment.

We have discussed risk retention with the experts we know in the business. No consensus has emerged from these discussions on what the actual outcome of the new rules will be. There seems to be a shared belief that spreads will increase in the range of 20 bps to 50 bps or more, starting relatively soon. The market seems to be consistent in the belief that larger, well-capitalized banks and financial institutions will benefit from their ability to utilize vertical retention and they will likely face less scrutiny in their underwriting during securitization. The 5% retention is expected to have an effect on the liquidity in the markets and may lower the overall volume of CMBS transactions, as well as raising the spread on the loans, specifically on horizontal retention securitizations.

The requirement for B-note buyers to hold the 5% interest pari passu is problematic as the buyers have historically purchased only the highest yielding 2% to 3% of a securitization. Requiring the B-note buyer to purchase a lower yielding portion of the securitization will either decrease yields to the B-note buyers, increase the overall cost of the loans in the pool, or some combination of the two. A proposed amendment is currently in discussion in the House of Representatives (H.R.4620) which would allow for the B-note to be held in a senior/subordinate structure by two parties with different yield requirements. No determination has been made on the amendment at this time, but market participants believe this would help to mitigate the rising cost of capital.

As an investor in our own funds and joint ventures that make loans, we welcome a market that has a level playing field. Private equity based lenders have long been required by the investor marketplace to step up for vertical retention. Delegated underwriters of agency loans have long been required to retain a horizontal retention. Balance sheet lenders have 100% retention. It should be no surprise that new capital put at risk needs a return, and thus spreads may widen. Real estate is a capital intensive business, and any increase in cost of capital may affect asset pricing. Like Brexit, we may have to wait and see how far this increased cost of capital reverberates.

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