North Carolina
Banking Institute

Volume 23 | Issue 1 Article 17

3-1-2019

Not All Securitizations Are Equal: Risk Retention for Commercial Mortgage-Backed Securitization in an Era of Deregulation

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NOT ALL SECURITIZATIONS ARE EQUAL: RISK RETENTION FOR COMMERCIAL MORTGAGE-BACKED SECURITIZATION IN AN ERA OF DEREGULATION

I. INTRODUCTION

Commercial real estate ("CRE")[1] projects may be funded through a variety of financing avenues[2]: one of the most significant of which is commercial mortgage-backed securitization ("CMBS").[3] Similar to other forms of securitization,[4] CMBS opens capital markets[5] as an alternative financing resource for CRE, thereby increasing access to capital.[6] Since the inception of CMBS transactions in the early 1990s,[7] and until the financial crisis of 2008, the CMBS industry was strong and

1. Commercial real estate ("CRE") refers to " 'income-producing properties that are managed for economic profit,' such as apartments, shopping centers, hotels, restaurants, warehouses, and offices." Alan Kronovet, Note, *An Overview of Commercial Mortgage Backed Securitization: The Devil is in the Details*, 1 N.C. BANKING INST. 288, 288 (1997) [hereinafter *Overview of CMBS*] (quoting David P. Jacob & Kimbell R. Duncan, *Commercial Mortgage-Backed Securities*, *in* THE HANDBOOK OF MORTGAGE BACKED SECURITIES 491, 491 (Frank J. Fabozzi ed., 4th ed. 1995) (footnote omitted)).

2. For example, CRE may be financed through traditional lending, where the lender views the loan transaction as a long-term investment and holds the mortgage through maturity. *Id.* at 297. Alternatively, CRE may be financed through commercial mortgage-backed securitization, where the lender sells the mortgage shortly after its origination. *Id.*

3. *See infra* Part II. Throughout this note, "CMBS" is used to refer to both commercial mortgage-backed *securitization* (in both the singular and plural forms) and commercial mortgage-backed *securities*, depending on the surrounding context. The former refers to the securitization process, while the latter refers to the transferable securities themselves. *See infra* Part II.A–B.

4. *See infra* Part II.

5. A "capital market" is "[a] securities market in which stocks and bonds with long-term maturities are traded." *Capital Market*, BLACK'S LAW DICTIONARY (10th ed. 2014).

6. *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Hearing Before the Subcomm. on Hous. & Cmty. Opportunity and the Subcomm. on Fin. Insts. & Consumer Credit*, 108th Cong., at 6 (2003) (statement of Cameron L. Cowan, Partner, Orrick, Herrington & Sutcliffe, LLP, on behalf of the Am. Securitization Forum) [hereinafter Am. Securitization Forum], http://archives-financialservices.house.gov/media/pdf/110503cc.pdf.

7. Patrick C. Sargent & Michael D. Jewesson, *The Dawn of CMBS 4.0: Changes and Challenges in a New Regulatory Regime*, ALSTON & BIRD 1 (Oct. 3, 2016), https://www.alston.com/-/media/files/insights/publications/2016/10/the-dawn-of-cmbs-40-changes-and-challenges-in-a-ne/files/thedawnofcmbs40/fileattachment/thedawnofcmbs40.pdf; *Overview of CMBS*, *supra* note 1, at 296.

experienced steady growth.[8] In fact, by 2007, approximately one-third of all CRE financing was obtained through CMBS.[9] However, the prosperous run for CMBS came to a screeching halt when disaster struck in the financial crisis of 2008,[10] and the entire securitization industry and its lack of significant regulation[11] came into the spotlight.[12]

In response to the 2008 financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"),[13] which, among other things, introduced a number of new regulations that affect CMBS and other asset-backed securitization ("ABS")[14] transactions.[15] These new regulations include increased disclosure requirements,[16] credit rating agency reform,[17] capital

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8. *See* Alan Kronovet & Chris van Heerden, *Chapter 2 in the History of CMBS: Coming to Terms with the New Rules*, 20 N.C. BANKING INST. 67, 70–71 (2016) (providing chart ("Exhibit 2: CMBS Issuance Reached $94.6 billion in 2015") depicting a relatively constant increase in issuance of CMBS between 1993 and 2007, substantial decline in 2008 and 2009, but subsequent steady increase).

9. *Id.* at 68–69.

10. *See id.* at 68–69 (stating that the "long run of continued growth" that the CMBS industry experienced "came to an end with the 2008 financial crisis"); *see also* THOMAS LEE HAZEN, JERRY W. MARKHAM & JOHN F. COYLE, CORPORATIONS AND OTHER BUSINESS ENTERPRISES: CASES AND MATERIALS 673 n.7 (West Acad., 4th ed. 2016) ("The United States faced one of the gravest economic crises in history in 2008 after a slump in the real estate market caused massive losses to many of the nation's largest financial institutions.").

11. Sargent & Jewesson, *supra* note 7, at 1.

12. *See* Robert A. Brown, *Financial Reform and the Subsidization of Sophisticated Investors' Ignorance in Securitization Markets*, 7 N.Y.U. J.L. & BUS. 105, 113–15, 124–25 (2010) (stating that the mortgage-backed security "success story ended . . . with the unexpected 2007 failure of a Bear Stearns-managed hedge fund comprised of subprime RMBS"); Sargent & Jewesson, *supra* note 7, at 1 (stating that structured finance was blamed for the 2008 financial crisis); Kronovet & van Heerden, *supra* note 8, at 77 ("The financial crisis emanated from subprime mortgages but called into question CMBS valuation and market practices.").

13. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

14. *See infra* Part III (defining ABS).

15. *See, e.g.*, Dodd-Frank, tit. IX, subtit. D, 124 Stat. at 1890–98 ("Subtitle D—Improvements to the [ABS] Process").

16. *See* Dodd-Frank § 942(b), 15 U.S.C. § 77g(c) (requiring "detailed periodic asset-level disclosures" (quoting Kronovet & van Heerden, *supra* note 8, at 87)); § 945, 12 U.S.C. § 77g(d) (requiring "disclosure detailing an issuer's pre-securitization asset review process" (quoting Kronovet & van Heerden, *supra* note 8, at 87)); § 943, 15 U.S.C. § 78o-7 (requiring "disclosure of loan repurchase requests" and "a summary to be provided by the rating agencies describing how the representations, warranties, and enforcement mechanisms in a particular deal differ from other similar issuances" (quoting Kronovet & van Heerden, *supra* note 8, at 87)).

17. *See, e.g.*, Dodd-Frank tit. IX, subtit. C, 124 Stat. at 1872–90 ("Subtitle C—Improvements to the Regulation of Credit Rating Agencies"); Dodd-Frank § 943, 15 U.S.C. § 78o-7 (requiring rating agencies to include report of the "representations, warranties, and enforcement mechanisms available to investors[] and . . . how they differ from the representations,

requirements,[18] and a 5% credit risk-retention requirement.[19] The latter of these regulations—the risk-retention requirement—is perhaps the most impactful Dodd-Frank regulation.[20]

Although Dodd-Frank brought widespread reform across the entire U.S. financial system, it nevertheless "focused on securitization as the target of legislative and regulatory attention."[21] The new securitization regulations under Dodd-Frank were specifically intended to serve as "improvements to the [ABS] process"[22] in order to ensure the "continued viability of the [ABS] markets."[23] However, Dodd-Frank immediately faced criticism, as it was "astonishingly vague,"[24] yet gave expansive authority to regulatory agencies to enact new rules.[25] Specifically, with regard to securitization, Dodd-Frank's ABS regulations have been criticized[26] because they broadly applied to ABS, in general, without

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warranties, and enforcement mechanisms in issuances of similar securities . . ." which is to accompany any credit rating of ABS).

18. Dodd-Frank § 171(b)(7)(B)(i), 124 Stat. at 1438; *see also* Steven L. Schwarcz, *Securitization and Post-Crisis Financial Regulation*, 101 CORNELL L. REV. 115, 118–20 (2016) (examining the regulatory responses of the United States and Europe after 2008 financial crisis, noting that the United States responded with increasing disclosure and risk retention requirements, rating agency reform, and imposing capital requirements).

19. Dodd-Frank § 941, 15 U.S.C. § 78c(b).

20. *See* Kronovet & van Heerden, *supra* note 8, at 86 (stating that Dodd-Frank's risk-retention requirement is the "most significant securitization reform"); *see also* Floyd Norris, *Mortgages Without Risk, at Least for the Banks*, N.Y. TIMES (Nov. 28, 2013), https://www.nytimes.com/2013/11/29/business/mortgages-without-risk-at-least-for-the-banks.html?_r=0 (stating that Barney Frank, Dodd-Frank co-author, considers the risk-retention requirement to be "the single most important part" of Dodd-Frank).

21. Kronovet & van Heerden, *supra* note 8, at 86.

22. Dodd-Frank tit. IX, subtit. D, 124 Stat. at 1890–98 ("Subtitle D—Improvements to the [ABS] Process").

23. Dodd-Frank § 941(c)(2), 124 Stat. at 1896.

24. Richard A. Epstein, *Government by Waiver*, 7 NAT'L AFF. 39 (2011), https://www.nationalaffairs.com/publications/detail/government-by-waiver ("The 848-page law creates a host of new regulatory agencies and powers to oversee the financial industry. Addressed to a sector of the economy in which clear and predictable rules are especially important, the law is astonishingly vague and broad, leaving regulators—including new agencies with no experience or track record—with unprecedented freedom to draw up the rules.").

25. *Id.* This is problematic because, as Justice Powell once explained, "[t]he rulemaking power granted to an administrative agency charged with the administration of the federal statute is not the power to make law. Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213–14, 96 S. Ct. 1375, 1391 (1976) (internal quotation marks omitted). However, if Congress enacts a statute—such as Dodd-Frank—which essentially writes administrative agencies a blank check for determining the scope of their authority, unnecessary and overly-expansive regulations should be expected to follow.

26. *See, e.g.*, Brown, *supra* note 12, at 116 (stating that there is a lack of differentiation between the different mortgage asset classes in academic legal literature and in Dodd-Frank and arguing that "the causes of the RMBS market's failure are not applicable to the CMBS

acknowledging key distinctions between the different types of securitization transactions.[27] Such broad application necessarily assumes uniformity among the various forms of securitization transactions that fall under the umbrella of Dodd-Frank's definition of ABS.[28] But not all securitization transactions are equal.[29]

While there is no doubt that ABS played a significant role in the 2008 financial crisis, it is evident that CMBS were far less to blame than other ABS,[30] such as collateralized debt obligations ("CDO")[31] and residential mortgage-backed securities ("RMBS").[32] Additionally, there were dozens of other contributing factors that also played significant roles in the 2008 financial crisis, such as the failure of the rating agencies,[33]

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market"); Tyler R. Morgan, *The Refinancing Crisis in Commercial Real Estate: Dodd-Frank Threatens to Curtail CMBS Lending*, 13 TENN. J. BUS. L. 361, 364 (2012) ("Dodd-Frank itself fails to adequately differentiate between the residential mortgage-backed securities ("RMBS") and CMBS markets.").

27. Brown, *supra* note 12, at 114, 116; *accord* Morgan, *supra* note 26, at 364; *see, e.g.*, Dodd-Frank tit. IX, subtit. D, 124 Stat. at 1890–98 ("Subtitle D—Improvements to the [ABS] Process").

28. *See* Brown, *supra* note 12, at 133 (stating that the differences between CMBS and RMBS have provided CMBS investors with more protections); *see also* Morgan, *supra* note 26, at 364 ("[T]he policy concerns behind the risk retention and mandatory disclosure requirements under Dodd-Frank do not exist in the CMBS market because the product structure of CMBS currently provides sufficient investor protections."); *supra* Part III (providing Dodd-Frank's definition of ABS).

29. Brown, *supra* note 12, at 133; *accord* Morgan, *supra* note 26, at 364; *see also infra* Part IV (discussing distinctions between CMBS and other forms of securitization).

30. Morgan, *supra* note 26, at 364; *accord* Brown, *supra* note 12, at 114.

31. A collateralized debt obligation ("CDO") "is a structured financial product that pools together cash flow-generating assets and repackages this asset pool into discrete tranches that can be sold to investors." *Collateralized Debt Obligation – CDO*, INVESTOPEDIA [hereinafter INVESTOPEDIA], https://www.investopedia.com/terms/c/cdo.asp (last visited Sept. 16, 2018). For more information about CDOs, see *infra* notes 232–37 and accompanying text.

32. *See* Morgan, *supra* note 26, at 364 (noting Dodd-Frank's failure to sufficiently distinguish CMBS from other ABS); *accord* Brown, *supra* note 12, at 114. In contrast to CMBS, which are solely comprised of commercial mortgages, RMBS are solely comprised of residential mortgages, but are nevertheless another form of ABS.

33. *See* Richard Stanton & Nancy Wallace, *CMBS Subordination, Ratings Inflation, and Regulatory-Capital Arbitrage*, 47 FIN. MGMT. 175, 175, 194–96 (2018), https://onlinelibrary.wiley.com/doi/epdf/10.1111/fima.12183 (concluding that little to nothing changed in CMBS markets—including quality of individual CMBS structures—in the years leading up to the 2008 financial crisis other than the "rating agencies' persistent reductions in subordination levels"). The major credit rating agencies are referred to as the "Big Three," which includes Moody's Investors Service ("Moody's"), Standard & Poor's Global Ratings ("S&P"), and Fitch Ratings ("Fitch"). Shankar Ramakrishnan & Philip Scipio, *Big Three Credit Ratings Still Dominate Business*, REUTERS (May 4, 2016, 2:50 PM), https://www.reuters.com/article/uscorpbonds-ratings-idUSL2N17U1L4. These credit rating agencies, which provide credit ratings, research, and risk analysis for the financial markets, MOODY'S INVESTORS SERVICE, https://www.moodys.com/Pages/atc.aspx (last visited Jan 3, 2019), are

which have also seen heightened regulation under Dodd-Frank, as well as predatory and fraudulent lending practices in the residential mortgage market.[34] These factors, among many others, undermine the logic of leaving CMBS subject to current regulatory scheme promulgated under Dodd-Frank.[35]

Over ten years have passed since the heart of the 2008 financial crisis,[36] approximately eight years since the passage of Dodd-Frank,[37] and approximately two years since Dodd-Frank's risk-retention requirement went into full effect for CMBS.[38] In conjunction with the lapse in time since the 2008 financial crisis and Dodd-Frank's controversial nature,[39] the election of President Donald J. Trump with partisan control of Congress birthed an era of deregulation.[40]

On February 3, 2017, President Trump signed Executive Order 13772, setting forth core principles with which financial regulations

said to "play a critical 'gatekeeper' role in the debt market." Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 931(2), 15 U.S.C. § 78o-7 (2012).

34. Brown, *supra* note 12, at 116; *see also* Stanton & Wallace, *supra* note 33, at 175 (noting lack of evidence of "dishonesty on the part of borrowers and lenders" in the CMBS market, unlike RMBS market).

35. *See* Sargent & Jewesson, *supra* note 7, at 10 ("Commentators to the proposed banking regulations do not question the need for some degree of regulation, rather they raise concerns about its growing complexity, redundancy, and negative impact on the availability of capital and liquidity. . . .").

36. *See* Joel Haveman, *The Financial Crisis of 2008*, ENCYCLOPEDIA BRITANNICA (Feb. 2, 2009), https://www.britannica.com/topic/Financial-Crisis-of-2008-The-1484264 (discussing timeline of surrounding circumstances leading up to 2008 financial crisis).

37. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

38. Credit Risk Retention, 79 Fed. Reg. 77602 (Dec. 24, 2014) (codified at 12 C.F.R. pts. 43, 244, 373 & 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267) (stating risk-retention requirement became effective on December 24, 2015 for ABS collateralized by residential mortgages (i.e., RMBS), and December 24, 2016 for all other ABS (e.g., CMBS)).

39. *See* U.S. DEP'T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS 91, 101 (Oct. 2017) [hereinafter TREASURY REPORT], https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf ("The imposition of securitizer or sponsor risk retention requirements has generated substantial controversy among market participants."); *see, e.g.*, Milton Ezrati, *Dodd-Frank Desperately Needs More Reform*, FORBES (Aug. 21 2018, 3:15 PM), https://www.forbes.com/sites/miltonezrati/2018/08/21/dodd-frank-desperately-needs-more-reform/?source=299loomberg#4f6379c18c6e (stating Dodd-Frank, at best, has created as many problems as it has solved, thereby leaving the U.S. susceptible to another financial crisis, and while reform efforts are taking place, they only scratch the surface of what needs to be done); *see also* Alan Rappeport & Emily Flitter, *Congress Approves First Big Dodd-Frank Rollback*, N.Y. TIMES (May 22, 2018), https://www.nytimes.com/2018/05/22/business/congress-passes-dodd-frank-rollback-for-smaller-banks.html (highlighting partisan polarization as to whether Dodd-Frank's regulations are necessary).

40. *See, e.g.*, Rappeport & Flitter, *supra* note 39 (stating that President Trump "promised to 'do a big number on Dodd-Frank' ").

should be consistent, including "mak[ing] regulation[s] efficient, effective, and appropriately tailored."[41] In accordance with Executive Order 13772, the U.S. Department of the Treasury ("the Treasury") conducted a study and issued a subsequent report, which indicated the current regulatory regime that largely stemmed from Dodd-Frank is overly expansive and damaging to the securitization markets.[42] On May 24, 2018, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act—the first major rollbacks of Dodd-Frank[43]—which President Trump unsurprisingly signed into law.[44] Even with the recent shift away from a Republican supermajority in Congress,[45] deregulation efforts will likely remain constant,[46] and additional Dodd-Frank rollbacks are almost certainly inevitable.[47] Therefore, as discussions about Dodd-Frank modifications and rollbacks continue, focus should turn to the risk-retention requirement and the lack of exemptions for deserving CMBS transactions.[48]

Proceeding in seven parts, this Note examines distinctions between CMBS and other ABS, highlights the Treasury's findings that Dodd-Frank's securitization reform damages CMBS and the securitization industry as a whole, and thus argues that CMBS should not remain subject to the current risk-retention rules that were imposed under Dodd-

41. Exec. Order No. 13772: Core Principles for Regulating the United States Financial System, 82 Fed. Reg. 9965, 9965–66 (Feb. 3, 2017).

42. *See* TREASURY REPORT, *supra* note 39, at 91–105, 97 ("As defined currently, these rules add unnecessary cost and complexity to the securitization market and apply broadly across securitized product classes, irrespective of their differences and performance history.").

43. *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296, 1296 (2018) ("An act to promote economic growth, provide tailored regulatory relief, and enhance consumer protections, and for other purposes.").

44. *Id.*; Sylvan Lane, *Trump Signs Dodd-Frank Rollback*, THE HILL (May 24, 2018, 12:32 PM), https://thehill.com/policy/finance/389212-trump-signs-dodd-frank-rollback ("Trump had pledged to 'dismantle' Dodd-Frank, a law long targeted by Republicans, and touted the bill he signed as the first step in that process.").

45. *See* Catie Edmondson & Jasmine C. Lee, *Meet the New Freshmen in Congress*, N.Y. TIMES (Jan. 3, 2019), https://www.nytimes.com/interactive/2018/11/28/us/politics/congress-freshman-class.html (discussing political demographics of the 116th Congress).

46. *See* Rappeport & Flitter, *supra* note 39 (noting that at least one of the Dodd-Frank rollbacks was a "demonstration of bipartisanship").

47. *See* DECHERT, LLP, FINANCIAL REGULATION REFORM TRACKER: ROLLBACK OF DODD-FRANK (Mar. 8, 2018), https://www.dechert.com/knowledge/hot-topic/financial-regulation-reform-tracker/rollback-of-dodd-frank.html (noting recent congressional and regulatory actions relating to Dodd-Frank that directly impact securitization transactions, including expansion of current risk-retention exemptions and whether five-year holding period for third-party purchasers and sponsors should be decreased).

48. *See infra* Part IV.

Frank. Part II provides a brief background on securitization and CMBS.[49] Part III discusses Dodd-Frank and the regulations subsequently promulgated thereunder that affect securitization transactions, particularly CMBS.[50] Part IV highlights key differentiations between CMBS and other ABS transactions, as well as their respective roles in the 2008 financial crisis.[51] Part V discusses Executive Order 13772 and the Treasury's subsequent report concerning Dodd-Frank's effect on securitization.[52] Part VI suggests that the Dodd-Frank reform efforts should turn to the deregulation of CMBS and recommends alternatives to the current risk-retention requirement for CMBS.[53] Part VII concludes by reiterating the importance of securitization and why CMBS should see deregulation.[54]

II. BACKGROUND ON SECURITIZATION AND CMBS

Securitization,[55] which allows the owner of a cash-producing asset to immediately realize the asset's value, first arose in the early 1970s and quickly became a major part of the modern financial industry.[56] Since its inception, the securitization market has continually increased "its importance as a financing vehicle for a variety of asset classes,"[57] including commercial mortgages[58] beginning in the early 1990s.[59] Securitization, particularly CMBS, remains an essential part of the financial

49. *See infra* Part II.

50. *See infra* Part III.

51. *See infra* Part IV.

52. *See infra* Part V.

53. *See infra* Part VI.

54. *See infra* Part VII.

55. Securitization is also known as "structured finance." *Structured Financing Techniques*, 50 BUS. LAW. 528, 531–32 (1995) [hereinafter *Structured Financing Techniques*] ("The process of issuing securities backed by assets in structured financing is sometimes called 'securitization' because assets are, in a sense, turned into securities—they are monetized, not through traditional secured borrowings or factoring, but through the issuance of asset-backed securities.").

56. Am. Securitization Forum, *supra* note 6, at 1; TREASURY REPORT, *supra* note 39, at 91. However, "[t]he practice of securitizing cash flows through the issuance of associated debt obligations has existed as a successful financing tool for centuries." TREASURY REPORT, *supra* note 39, at 91.

57. Kronovet & van Heerden, *supra* note 8, at 67.

58. Kronovet & van Heerden, *supra* note 8, at 67.

59. Kronovet & van Heerden, *supra* note 8, at 68; Am. Securitization Forum, *supra* note 6, at 1.

industry of the twenty-first century, even in the wake of the 2008 financial crisis.[60]

A. Defining Securitization

Although there is no universally accepted definition of securitization, and even some disagreement about what necessarily must be included to constitute an acceptable definition,[61] securitization can be understood as the process of converting assets into negotiable securities, transferable on a secondary market,[62] that generate cash flow for investors.[63] Although some assets are more commonly securitized than others[64] (such as residential and commercial mortgages, business loans,

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60. *See infra* Part IV; *see, e.g.*, ROBERT H. SITKOFF & JESSE DUKEMINIER, WILLS, TRUSTS, AND ESTATES 399–400 (Wolters Kluwer et al. eds., 15th ed. 2017) (stating that ABS industry was worth greater than $1 trillion in 2016); *cf.* Kronovet & van Heerden, *supra* note 8, at 68–69 (stating that roughly one-third of the outstanding commercial mortgages were financed through CMBS in 2007 and still approximately one fifth in 2015).

61. *See, e.g.*, Steven L. Schwarcz, *What Is Securitization? And For What Purpose?*, 85 S. CAL. L. REV. 1283 (2012) (analyzing the necessary components of a "workable" definition of securitization, and providing a proposed definition with those components, while critiquing past attempts at defining securitization).

62. A "secondary market" is a "securities market in which previously issued securities are traded among investors." *Secondary Market*, BLACK'S LAW DICTIONARY (10th ed. 2014). Thus, a "secondary mortgage market" is a securities market in which mortgage-backed securities are traded between investors who are neither the issuers of those securities nor the initial investors who purchased the securities directly from the issuer. *See Overview of CMBS*, *supra* note 1, at 288 n.7 (discussing secondary markets).

63. *Compare Securitize*, BLACK'S LAW DICTIONARY (10th ed. 2014) ("To convert (assets) into negotiable securities for resale in the financial market, allowing the issuing financial institution to remove assets from its books, and thereby improve its capital ratio and liquidity, and to make new loans with the security proceeds if it so chooses."), *and* LYNN M. LOPUCKI, ELIZABETH WARREN & ROBERT M. LAWLESS, SECURED TRANSACTIONS: A SYSTEMS APPROACH 32 (Erwin Chemerinsky et al. eds., Wolters Kluwer 8th ed. 2016) ("To 'securitize' an asset is to divide ownership of its value into large numbers of identical shares."), *with* Am. Securitization Forum, *supra* note 6, at 1 ("Securitization is the creation and issuance of debt securities, or bonds, whose payments of principal and interest derive from cash flows generated by separate pools of assets."), *and Overview of CMBS*, *supra* note 1, at 288–89 ("Securitization is the process by which financial assets that generate cash flow, such as home mortgages, automobile loans, credit card receivables, tax liens, or [CRE] loans, are converted into securities in order to gain access to the capital markets. Securitization takes illiquid assets and transforms them into marketable securities." (footnotes omitted)).

64. *See* LOPUCKI, WARREN & LAWLESS, *supra* note 63, at 32 (stating that mortgages and accounts are the most commonly securitized assets).

automobile loans, credit card receivables, and tax liens),[65] it is worth noting that "any kind of asset can be securitized."[66]

There are numerous forms of securitization transactions, most of which (if not all), fall into the broad category of ABS.[67] For example, among the different forms of securitization transactions that are considered ABS, there are collateralized loan obligations ("CLO"),[68] CMBS, RMBS, and CDOs.[69] Regardless of the form of a particular securitization transaction, these core aspects remain relatively constant.

B. The Structure and Mechanics of CMBS and Other Securitization Transactions

As is the case with any securitization transaction, there are numerous players involved in CMBS transactions,[70] which often include the (a) borrowers, (b) originator[71] (lender), (c) depositor,[72] (d) issuer[73]

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65. *See Overview of CMBS*, *supra* note 1, at 288 (listing "home mortgages, automobile loans, credit card receivables, tax liens, [and] commercial real estate loans" as assets that can be securitized).

66. LoPucki, Warren & Lawless, *supra* note 63, at 32.

67. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 941, 15 U.S.C. § 78c(a) (2012) (defining ABS expansively); *see also infra* Part III.

68. *See Collateralized Loan Obligation – CLO*, Investopedia, https://www.investopedia.com/terms/c/clo.asp (last visited Oct. 6, 2018) ("A collateralized loan obligation . . . is a security backed by a pool of debt, often low-rated corporate loans.").

69. *See, e.g.*, Dodd-Frank § 941(a), 15 U.S.C. § 78c(a) (defining ABS).

70. Treasury Report, *supra* note 39, at 91.

71. An "originator" is "a person who: (1) [t]hrough an extension of credit or otherwise, creates an asset that collateralizes an [ABS]; and (2) [s]ells the asset directly or indirectly to a securitizer or issuing entity. 12 C.F.R. § 244.2 (2018).

72. In a securitization transaction, a "depositor" is:

> (1) [t]he person that receives or purchases and transfers or sells the securitized assets to the issuing entity; (2) [t]he sponsor, in the case of a securitization transaction where there is not an intermediate transfer of assets from the sponsor to the issuing entity; or (3) [t]he person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust.

Id.

73. An "issuer" or "issuing entity" is, "with respect to a securitization transaction, the trust or other entity: (1) [t]hat owns or holds the pool of assets to be securitized; and (2) [i]n whose name the [ABS] are issued." *Id.* An "issuer" may also be referred to as a "securitizer." Dodd-Frank § 941(b), 15 U.S.C. § 78o-11; *see also infra* note 77 (defining securitizer).

(special purpose vehicle ("SPV")),[74] (e) underwriters,[75] and (f) investors.[76] Although some of these parties can—and frequently do—take on multiple roles in the securitization process, the process is more easily broken down when each party is viewed as only playing one role. Nevertheless, it is worth noting that the "securitizer"[77] (generally the "sponsor"),[78] which is perhaps the most heavily regulated player under Dodd-Frank's ABS regulations,[79] may be the originator, depositor, and, through a SPV, the issuer.

The CMBS process may proceed in the following chronological order.[80] First, borrowers (who are either owners or purchasers of CRE) take out mortgages secured by the CRE itself.[81] Next, the originator conveys the mortgage notes that are to be securitized to a depositor, where the mortgages are pooled together.[82] Then, the depositor sells the pool(s) of mortgages to a SPV.[83] When the depositor sells the pool(s) of mortgages to the SPV, it is important that the transfer of these mortgages constitutes a "true sale,"[84] as opposed to a mere transfer of a security

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74. A special purpose vehicle ("SPV"), sometimes also referred to as a special purpose entity ("SPE"), is a legal entity (often a trust) created for the purpose of the securitization transaction, which is entirely separate from the originator and capable of providing limited liability. LOPUCKI, WARREN & LAWLESS, *supra* note 63, at 32.

75. Underwriters, which are generally investment banks, serve as intermediaries between the SPV, as issuer of the securities, and the investors. Am. Securitization Forum, *supra* note 6, at 5.

76. *See* Sargent & Jewesson, *supra* note 7, at app. 1 ("CMBS Structure").

77. The term "securitizer" can refer to "either: (1) [t]he depositor of the [ABS] (if the depositor is not the sponsor); or (2) [t]he sponsor of the [ABS]." 12 C.F.R. § 244.2; *see also infra* note 78 (defining sponsor).

78. A "sponsor" is "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." § 244.2.

79. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 941(b), 15 U.S.C. § 78O-11 (2012) (stating risk-retention requirement applies to securitizers (which includes sponsors) and originators).

80. *See* Sargent & Jewesson, *supra* note 7, at app. 1 ("CMBS Structure").

81. *See* Sargent & Jewesson, *supra* note 7, at app. 1 ("CMBS Structure").

82. *See* Sargent & Jewesson, *supra* note 7, at app. 1 ("CMBS Structure").

83. *See* Sargent & Jewesson, *supra* note 7, at app. 1 ("CMBS Structure").

84. A "true sale" legally separates the assets that are sold from the originator (seller). Am. Securitization Forum, *supra* note 6, at 4 ("The proceeds of the securities are remitted to the originator as the purchase price for the assets. If the asset transfer is not a 'true sale,' the investors are vulnerable to claims against the originator of the assets.").

interest.[85] Then, the SPV divides the pool(s) into different tranches,[86] which are based on the underlying loan quality and priority level.[87] Next, from the tranches, the SPV issues certificates (securities) to the depositor, which subsequently sells the certificates to underwriters and/or initial purchasers.[88] The underwriters and/or initial purchasers pay the depositor for the certificates directly, and the depositor pays the originator the purchase price for the mortgage loans.[89] Finally, the underwriters and/or initial purchasers may sell the certificates to investors,[90] at which point the CMBS have entered into the secondary mortgage market.[91]

C. The Importance of CMBS in CRE Financing

Whenever a CRE project is in need of obtaining financing, the CRE borrower will want to "consider[] whether [or not] to borrow from a lender who will securitize the [CRE] loan."[92] In making its decision,

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85. *Overview of CMBS*, *supra* note 1, at 311–12; *accord Structured Financing Techniques*, *supra* note 55, at 533.

86. "Tranche" stems from the French word "slice." *Tranche*, BLACK'S LAW DICTIONARY (10th ed. 2014). In securities law, a tranche refers to "[a] bond issue derived from pooling of similar debt obligations." *Id.*

87. LOPUCKI, WARREN & LAWLESS, *supra* note 63, at 32 ("A tranche is a priority level. If the account debtors' payments are insufficient to pay all of the certificates, the SPV pays them to the first tranche, pro rata in proportion to their shares, until the first tranche certificates are paid in full. The SPV pays the excess, if any, to the second tranche in the same manner. The SPV repeats the process for each successive tranche, until the money is exhausted."). Furthermore, tranches are generally

> divided into senior, mezzanine, and junior classes. Senior and mezzanine classes typically carry an investment-grade rating by a nationally recognized statistical rating organization (NRSRO), with the senior bond often carrying a AAA rating. The junior, or subordinate, class is typically unrated. Principal and interest payments from the underlying collateral 'waterfall' down the capital structure of the SPV's balance sheet, while losses associated with the default of the underlying assets are absorbed beginning with the most junior, or first-loss, classes. More senior classes typically do not bear credit-related cash shortfalls until the credit enhancement from subordinate classes is exhausted.

TREASURY REPORT, *supra* note 39, at 92.

88. *See* Sargent & Jewesson, *supra* note 7, at app. 1 ("CMBS Structure").

89. *See* Sargent & Jewesson, *supra* note 7, at app. 1 ("CMBS Structure").

90. *See* Sargent & Jewesson, *supra* note 7, at app. 1 ("CMBS Structure").

91. *Overview of CMBS*, *supra* note 1, at 288 n.7.

92. *Overview of CMBS*, *supra* note 1, at 297.

the CRE "borrower must weigh the relative benefits of this type of borrowing against more traditional [CRE] financing."[93]

Securitization provides various benefits to the parties involved, regardless of whether a party's role is large or small.[94] For borrowers, securitization lowers borrowing costs[95] and provides greater access to investment capital[96] and financing[97] through the U.S. capital markets, which may otherwise be unavailable.[98] For this reason, CMBS is particularly important in smaller, more rural communities.[99] Without securitization, the availability of financing to CRE borrowers in these communities would be limited by the local institutions' available capital, which in turn would increase borrowing costs.[100] Additionally, most CRE loans are nonrecourse,[101] which is substantially beneficial to CRE borrowers in the event of default.[102]

Securitization also enables loan originators to immediately realize the value of their loans, thereby increasing available capital for new loans, which in turn, increases their overall return on investment.[103] It also provides the issuers of the CMBS with flexibility "by allowing the inclusion of assets that have different cash flow and maturity characteristics."[104]

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93. *Overview of CMBS*, *supra* note 1, at 297.

94. *See, e.g.*, Michael Madison, *The Real Properties of Contract Law*, 82 B.U. L. REV. 405, 464 (2002) ("Securitization has . . . revolutionized the way in which real estate is . . . acquired and financed. . . .").

95. Am. Securitization Forum, *supra* note 6, at 4.

96. *Overview of CMBS*, *supra* note 1, at 289, 297.

97. Am. Securitization Forum, *supra* note 6, at 4.

98. Am. Securitization Forum, *supra* note 6, at 6.

99. Am. Securitization Forum, *supra* note 6, at 6.

100. *See* Am. Securitization Forum, *supra* note 6, at 7 ("Securitization . . . aids in the geographic dispersion of capital to areas that may otherwise be deprived of credit options. Traditionally, depository institutions have provided credit in the areas where they accepted deposits. By securitizing loans, however, the lender generates capital for new loans that may come from a different location. This linkage to the capital markets broadens the range of regions where depository institutions obtain capital to provide credit.").

101. Adam J. Levitin & Susan M. Wachter, *The Commercial Real Estate Bubble*, 3 HARV. BUS. L. REV. 83, 89 (2013). A "nonrecourse loan" is "[a] secured loan that allows the lender to attach only the collateral, not the borrower's personal assets," if the borrower defaults. *Nonrecourse Loan*, BLACK'S LAW DICTIONARY (10th ed. 2014).

102. *Overview of CMBS*, *supra* note 1, at 297 n.96. *But cf.* Treas. Reg. § 1.1001-2(a)(i), (b) (2018) (discussing income taxation liability for discharged debt obligations stemming from nonrecourse loans).

103. Am. Securitization Forum, *supra* note 6, at 6–7; *Overview of CMBS*, *supra* note 1, at 289.

104. *Overview of CMBS*, *supra* note 1, at 289.

In addition to the more lucrative benefits, securitization also lowers some of the risk that is inherent in any lending transaction.[105] By providing access to financing through capital markets, securitization allows geographical diversification among the securitized assets, as well as diversification among property types.[106] For example, if a disaster (such as a hurricane) strikes a particular geographical region and causes numerous borrowers—whose loans are part of a particular CMBS conduit—to default, such disaster would not be entirely detrimental to the CMBS conduit if it were also made up of loans secured by CRE in geographical areas immune to that particular disaster.[107] Likewise, diversification among property type would protect investors and originators in the event that a particular industry or property type, such as grocery stores or hotels, experienced oversaturation and a subsequent rise in defaults.[108]

Furthermore, through segregation of the securitized assets from the originating entity, securitization reduces the level of investor risk in the event the loan originator files bankruptcy.[109] This is because the originator's assets will not include the loans that were sold to the SPV in a true sale and subsequently securitized.[110] Similarly, because CMBS are made up of CRE loans, CMBS will often provide for decreased bankruptcy risk of the borrower as well.[111] This is because a CRE borrower is often a single-purpose entity[112] (as is sometimes required to obtain a CRE loan), formed for the sole purpose of borrowing money from the lender, whose sole asset is the CRE that secures the loan and whose sole creditor is the lender.[113] This "bankruptcy remoteness"[114] benefits originators, issuers, and investors alike.[115]

105. *See* Brown, *supra* note 12, at 138 (discussing benefits of diversification among property types and geographical locations).

106. Brown, *supra* note 12, at 138. This diversification lessens the risks inherently associated with real estate lending. Brown, *supra* note 12, at 138.

107. Brown, *supra* note 12, at 138.

108. Brown, *supra* note 12, at 138.

109. *Overview of CMBS*, *supra* note 1, at 311.

110. *Overview of CMBS*, *supra* note 1, at 311.

111. *Overview of CMBS*, *supra* note 1, at 298; Levitin & Wachter, *supra* note 101, at 89.

112. Levitin & Wachter, *supra* note 101, at 89. A "single-purpose entity" can be any entity, capable of providing limited liability, which "holds title to real property and owes money to a lender as a result of a mortgage on the property, but which has no other assets or liabilities." *Single-Purpose Entity*, FREE DICTIONARY, https://financial-dictionary.thefreedictionary.com/single-purpose+entity (last visited Feb. 9, 2019).

113. *Overview of CMBS*, *supra* note 1, at 298.

114. *See Overview of CMBS*, *supra* note 1, at 289 (discussing importance of "bankruptcy remoteness" in securitization transactions).

115. Am. Securitization Forum, *supra* note 6, at 7.

III. THE NEW REGULATIONS: RISK RETENTION

In 2010, when Congress passed Dodd-Frank in response to the 2008 financial crisis,[116] it created a new, extraordinarily powerful regulatory framework.[117] Dodd-Frank included a number of new regulations directly affecting CMBS and other securitization transactions, including increased disclosure requirements,[118] a 5% credit risk-retention requirement,[119] rating agency reform,[120] and capital requirements.[121] The risk-retention requirement became effective for CMBS as of December 24, 2016.[122]

In its attempt to "improve[] . . . the [ABS] process,"[123] Dodd-Frank failed to make adequate differentiations between the various securitization transactions.[124] Instead of making the necessary distinctions, Dodd-Frank broadly defined "ABS"—those securitization transactions to which the new regulations apply—as follows:

> [An asset-backed security ("ABS") is] a fixed income or other security collateralized by any type of self-

116. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010) ("To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.").

117. *See* Epstein, *supra* note 24, at 39 (discussing Dodd-Frank's breadth).

118. *See* Dodd-Frank § 942(b), 15 U.S.C. § 77g(c) (requiring "detailed periodic asset-level disclosures" (quoting Kronovet & van Heerden, *supra* note 8, at 87)); § 945, 12 U.S.C. § 77g(d) (requiring "disclosure detailing an issuer's pre-securitization asset review process" (quoting Kronovet & van Heerden, *supra* note 8, 87)); § 943, 15 U.S.C. § 78o-7 (requiring "disclosure of loan repurchase requests" and "a summary to be provided by the rating agencies describing how the representations, warranties, and enforcement mechanisms in a particular deal differ from other similar issuances" (quoting Kronovet & van Heerden, *supra* note 8, at 87)).

119. Dodd-Frank § 941, 15 U.S.C. § 78c(b).

120. *See, e.g.*, Dodd-Frank tit. IX, subtit. D, 124 Stat. 1872–90 ("Subtitle C—Improvements to the Regulation of Credit Rating Agencies"); Dodd-Frank § 943, 15 U.S.C. § 78o-7 (2012) (requiring rating agencies to include report of the "representations, warranties, and enforcement mechanisms available to investors; and how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities . . ." which is to accompany any credit rating of ABS).

121. Dodd-Frank § 171(b)(7)(B)(i), 124 Stat. at 1438.

122. Credit Risk Retention, 79 Fed. Reg. 77602, 77602 (Dec. 24, 2014) (codified at 12 C.F.R. pts. 43, 244, 373 & 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267).

123. Dodd-Frank tit. IX, subtit. D, 124 Stat. at 1890–98 ("Subtitle D—Improvements to the [ABS] Process").

124. Brown, *supra* note 12, at 114; *accord* Morgan, *supra* note 26, at 364; *see also supra* note 26 (discussing Dodd-Frank's failure to distinguish between various ABS).

> liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including[:] (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the [Securities and Exchange] Commission [("SEC")], by rule, determines to be an asset-backed security for purposes of this section. . . .[125]

The breadth of this definition captures every imaginable ABS transaction: as it was likely intended to do. However, such definition placed all ABS into the same category for purposes of regulation, and, absent an exemption,[126] left CMBS vulnerable to overly-expansive and unnecessary regulation[127]—such as those regulations currently in place, which were enacted under the umbrella of authority created by Dodd-Frank.[128]

A. *The Risk-Retention Requirement*[129]

While Dodd-Frank's regulatory grasp extends to vast areas of the modern U.S. financial system, one of its main targets was securitization transactions,[130] particularly those backed by home mortgages.[131] Of all

125. Dodd-Frank § 941(a), 15 U.S.C. § 78c(a).

126. Dodd-Frank permits the SEC and the "Federal banking agencies" to adopt "exemptions, exceptions, or adjustments" to the Dodd-Frank regulations, including those that would apply to the risk-retention requirement. Dodd-Frank § 941(b), 15 U.S.C. § 78o-11(e) (internal quotation marks omitted).

127. *See* Epstein, *supra* note 24, at 39 (alluding to the likelihood of exponential expansion of regulations following passage of Dodd-Frank because of overly-broad rulemaking power it disseminates to regulatory agencies).

128. *See infra* Part V.

129. While each of these new regulations (i.e., the disclosure requirements, capital requirements, rating agency reforms, and risk-retention requirement) are extremely significant in that they impact the CMBS industry, and each should receive similar scrutiny in the spirit of potential deregulation, this Note focuses primarily on the risk-retention requirement.

130. *See* Kronovet & van Heerden, *supra* note 8, at 86 ("While sweeping in scope, Dodd-Frank focused on securitization as the target of legislative and regulatory attention.").

131. *See* Morgan, *supra* note 26, at 364 ("The securitization of residential mortgage-backed assets is generally cited as the catalyst of the subprime mortgage crisis and the subsequent collapse of the financial markets.").

the Dodd-Frank regulations that affect securitization transactions, the most significant piece of securitization reform is unquestionably the risk-retention (i.e., "skin-in-the-game")[132] requirement,[133] which Barney Frank, co-author of the Dodd-Frank legislation, called "the single most important part of the bill."[134] Indeed, six regulatory agencies are involved with the risk-retention requirement.[135]

The primary purpose of the risk-retention requirement is to ensure alignment of the various interests in ABS transactions, many of which are inherently competitive with one another under the traditional *securitization* practice, "originate-to-sell."[136] In contrast to the traditional *lending* practice of "originate-to-hold," where the loan originator keeps the loans on its books throughout the entire amortization period of the loan,[137] under the originate-to-sell model, the underlying loans are originated for the sole purpose of selling the loans to a securitization vehicle, without any originator or issuer recourse in the event the underlying loans experience default.[138] In essence, the risk-retention requirement has reinserted an element of the originate-to-hold model back into the originate-to-sell

132. Credit Risk Retention, 79 Fed. Reg. 77602, 77719 (Dec. 24, 2014) (codified at 12 C.F.R. pts. 43, 244, 373 & 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267).

133. Kronovet & van Heerden, *supra* note 8, at 86 ("The risk retention component, or 'skin in the game' provisions, of Dodd-Frank make up the law's most significant securitization reform.").

134. Norris, *supra* note 20 (" 'To me,' said Barney Frank, the former chairman of the House Financial Services Committee and co-author of the law, 'the single most important part of the [Dodd-Frank] bill was risk retention.' ").

135. Kronovet & van Heerden, *supra* note 8, at 86–87; *see, e.g.*, Credit Risk Retention, 79 Fed. Reg. at 77602 (stating that the Office of the Comptroller of the Currency, Treasury ("OCC"), Board of Governors of the Federal Reserve System ("Board"), Federal Deposit Insurance Corporation ("FDIC"), U.S. Securities and Exchange Commission ("SEC"), Federal Housing Finance Agency ("FHFA"), and Department of Housing and Urban Development ("HUD") jointly adopted the final rule for credit risk retention).

136. Kronovet & van Heerden, *supra* note 8, at 87; Schwarcz, *supra* note 18, at 118–19 (stating that a "moral hazard" resulted from the securitization practice of "originate-to-distribute").

137. Prior to the introduction of securitization, lenders would hold mortgage notes throughout their entire amortization periods (e.g., thirty years for a thirty-year mortgage, or fifteen years for a fifteen-year mortgage). Am. Securitization Forum, *supra* note 6, at 7–8. This can be referred to as the "originate-to-hold" model. Ann Hambly, *CMBS Risk Retention 101*, COM. OBSERVER (Jan. 4, 2017, 1:45 PM), https://www.commercialobserver.com/2017/01/cmbs-risk-retention-101/#.W5LoT1j70Gk.email.

138. *See* Sargent & Jewesson, *supra* note 7, at 1 (noting that securitization transactions were not heavily regulated prior to the passage of Dodd-Frank after the 2008 financial crisis).

model[139] by requiring sponsors to retain 5% of the total credit risk[140] of the underlying mortgages in a CMBS.[141]

B. *The Risk-Retention Options Available for CMBS*

In accordance with Dodd-Frank,[142] the administrative agencies tasked with enacting new ABS regulations have made different risk-retention methods available for sponsors of securitization transactions.[143]

1. The Three Standard Risk Retention Structures

In general, there are three risk-retention structures from which sponsors may choose to satisfy the risk-retention requirement: (1) a vertical slice, (2) a horizontal slice, or (3) a combination of a vertical and horizontal slice—known as an "L-shaped" slice.[144] Each of these methods are available to all ABS.

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139. *See* Hambly, *supra* note 137 ("[Traditionally, an owner of CRE] went to the local bank and got a loan. Back then, banks funded loans through the traditional 'originate to hold' concept, meaning if there was loss on the loan, the bank would suffer the loss. . . . In this model, banks had incentive to originate high-quality loans.").

140. "Credit risk" is defined as

> (1) [t]he risk of loss that could result from the failure of the borrower in the case of a securitized asset, or the issuing entity in the case of an ABS interest in the issuing entity, to make required payments of principal or interest on the asset or ABS interest on a timely basis; (2) [t]he risk of loss that could result from bankruptcy, insolvency, or a similar proceeding with respect to the borrower or issuing entity, as appropriate; or (3) [t]he effect that significant changes in the underlying credit quality of the asset or ABS interest may have on the market value of the asset or ABS interest.

12 C.F.R. § 244.2 (2018).

141. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 941(b), 15 U.S.C. § 78o-11(c)(E) (2012) (requiring securitizers to retain 5% of credit risk in ABS transactions).

142. *See id.* (permitting the six regulatory agencies, authorized to do so under Dodd-Frank, to establish alternatives to general 5% risk-retention requirement).

143. *See* 12 C.F.R. § 244.4(a) (providing that sponsors of securitization transaction can accomplish risk-retention requirement through retaining an "eligible vertical interest," an "eligible horizontal residual interest," or "combination thereof"—referred to as an L-shaped interest).

144. *Id.*

In the vertical structure, the sponsor retains an "eligible vertical interest,"[145] or, in other words, an interest in each tranche in the transaction, which amounts to 5% of the aggregate risk in the CMBS.[146] Vertical risk retention offers perhaps the cheapest method for sponsors to meet the risk-retention requirement.[147] Additionally, this method best ensures the sponsor's interests are aligned with those of investors since the sponsor has skin in the game (i.e., risk exposure) in each tranche of the transaction.[148]

In the horizontal structure, the sponsor retains an "eligible horizontal residual interest,"[149] i.e., an interest in the lowest tranche (or tranches) in the transaction, which amounts to 5% of the aggregate risk in the CMBS.[150] Horizontal risk retention, because it requires the sponsor to retain an interest in the riskiest part of the transaction, burdens the sponsor with more credit exposure than the other two risk-retention methods; however, it does provide some benefits, such as the possibility of earning a higher rate of return than any other tranche.[151] Additionally,

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145. *Id.* "Eligible vertical interest" refers to "a single vertical security or an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same proportion of each such class." *Id.* § 244.2.

146. Sargent & Jewesson, *supra* note 7, at 2; Catherine Liu & Katrina Estrella, *2018: Year of Transition for CMBS Industry*, REBUSINESS ONLINE (Feb. 27, 2018), http://rebusinessonline.com/2018-year-of-transition-for-cmbs-industry/.

147. Credit Risk Retention, 79 Fed. Reg. 77602, 77720 (Dec. 24, 2014) (codified at 12 C.F.R. pts. 43, 244, 373 & 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267).

148. *Id.*

149. 12 C.F.R. § 244.4. "Eligible horizontal residual interest" refers to

> an ABS interest in the issuing entity: (1) That is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition; (2) [w]ith respect to which, on any payment date or allocation date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the eligible horizontal residual interest prior to any reduction in the amounts payable to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) [t]hat, with the exception of any non-economic [real estate mortgage investment conduit ("REMIC")] residual interest, has the most subordinated claim to payments of both principal and interest by the issuing entity.

Id. § 244.2.

150. *See id.* (defining eligible horizontal residual interest); *accord* Sargent & Jewesson, *supra* note 7, at 2; Liu & Estrella, *supra* note 146.

151. Credit Risk Retention, 79 Fed. Reg. at 77719–20.

under the horizontal approach, the sponsor can choose to satisfy the risk-retention requirement by "establish[ing] and fund[ing], in cash, an eligible horizontal cash reserve account in the amount equal to the fair value of such eligible horizontal residual interest or part thereof, provided that the account meets [certain] . . . conditions[,]" in lieu of retaining an actual horizontal interest in the CMBS.[152]

The L-shaped (hybrid) structure allows the sponsor to meet the risk-retention requirement by combining the horizontal and vertical structures.[153] Under this approach, the sponsor may elect to retain whatever percentage of risk the sponsor prefers in a vertical and horizontal interest—so long as the risk retained equals 5% of the aggregate risk in the CMBS.[154] Under the current regulations, the L-shaped structure is perhaps the most attractive risk-retention option because its flexibility allows sponsors to tailor their risk-retention method to fit their specific needs.[155]

2. Allocation of Risk Retention to the Originator

In choosing to satisfy the risk-retention requirement through the vertical, horizontal (including the cash reserve account alternative), or L-shaped structures, a sponsor may further elect to offset the required risk-retention percentage by allocating some of the burden to the originator.[156] The method in which this risk allocation to the originator is accomplished is subject to a number of requirements, including that (a) the originator's retained interest is retained and held "in the same manner and proportion (as between horizontal and vertical interests) as the sponsor,"[157] (b) the originator's retained interest does not exceed a certain amount,[158] (c) the originator's retained interest is at least 20% of the aggregate risk amount otherwise required to be retained by the sponsor,[159] and (d) the amount for which the originator purchases the eligible interests from the sponsor "is equal, on a dollar-for-dollar basis, to the amount by which the

152. 12 C.F.R. § 244.4(b).
153. Credit Risk Retention, 79 Fed. Reg. at 77720. For example, under the L-shaped approach, a sponsor could retain 2% in a vertical interest and 3% in a horizontal interest to satisfy the risk-retention requirement. *Id.*
154. *Id.*; *accord* § 244.4; Sargent & Jewesson, *supra* note 7, at 2.
155. Credit Risk Retention, 79 Fed. Reg. at 77720–21.
156. § 244.11(a).
157. *Id.* § 244.11(a)(1)(i).
158. *Id.* § 244.11(a)(1)(ii).
159. *Id.* § 244.11(a)(1)(iii).

sponsor's required risk retention is reduced."[160] However, the burden remains on the sponsor to provide any required disclosures to necessary parties,[161] as well as to ensure that the originator complies and remains in compliance with all relevant regulations and requirements,[162] including the hedging and transfer restrictions that the sponsor itself is subject to.[163]

3. CMBS Option: Utilization of the "B-Piece" Construct

For CMBS, there is yet another method in which the sponsor can satisfy the risk-retention requirement under the current regulations: the utilization of "B-piece" buyers[164] as third-party purchasers ("TPP") of the horizontal residual interest.[165] This approach follows a risk-shifting practice, which was already in existence and utilized throughout the CMBS industry prior to Dodd-Frank,[166] as a means of satisfying the sponsor's risk-retention obligation.[167] B-piece buyers are generally highly experienced real estate investors who specialize in high-risk/high-reward real estate investments.[168] Unlike other ABS investors, B-piece investors use their vast, specialized knowledge about real estate markets and the underlying mortgages in any given CMBS, "to conduct extensive due diligence."[169] Indeed, B-piece investors may insist on removal of some of the riskiest mortgages before consummation of the deal.[170] As a result,

160. *Id.* § 244.11(a)(1)(iv).
161. *Id.* § 244.11(a)(2).
162. *Id.* § 244.11(b).
163. *Id.* § 244.11(a)(3).
164. "B-piece" refers to "below-investment grade CMBS tranches." Kronovet & van Heerden, *supra* note 8, at 87. B-piece buyers are investors in the CMBS industry who "buy the lowest, riskiest tranches in each CMBS transaction with commiserate risk-based yields and are awarded with some control over the disposition of the defaulted loans." Kronovet & van Heerden, *supra* note 8, at 87 n.15. Additionally, B-piece buyers often remove loans from CMBS pools during the due diligence period if they find them to be objectionable to the pool. Kronovet & van Heerden, *supra* note 8, at 87 n.15. A B-piece buyer's insistence on the removal of a loan during due diligence (called a "kickout") is very expensive for CMBS sponsors because in such a case, the sponsor is stuck holding that loan itself. Levitin & Wachter, *supra* note 101, at 98–99. Since B-piece buyers are investors, this Note uses the terms "B-piece buyer" and "B-piece investor" interchangeably.
165. Credit Risk Retention, 79 Fed. Reg. 77602, 77723 (Dec. 24, 2014) (codified at 12 C.F.R. pts. 43, 244, 373 & 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267).
166. *Id.* at 77724; Kronovet & van Heerden, *supra* note 8, at 87.
167. 12 C.F.R. § 244.7(b); Sargent & Jewesson, *supra* note 7, at 2; Kronovet & van Heerden, *supra* note 8, at 87; Liu & Estrella, *supra* note 146.
168. Credit Risk Retention, 79 Fed. Reg. at 77724.
169. *Id.*
170. *Id.*

B-piece investors are frequently more knowledgeable about the underlying mortgages than the other parties in CMBS transactions.[171]

Under this approach, the sponsor can sell its horizontal interest to one or two B-piece buyers as TPPs;[172] but there cannot be more than two TPPs at any given time,[173] and if there are two TPPs, the TPPs' respective interests must be *pari passu*[174] with one another.[175] The horizontal interest (or combined interests if there are two TPPs) represents the eligible horizontal residual interest that the sponsor would have otherwise been required to retain.[176] Although the sponsor is able to satisfy the risk-retention requirement through the utilization of the B-piece construct, the sponsor remains responsible for TPP compliance throughout the life of the CMBS, including through later transfers to subsequent TPPs.[177] Thus, the risk retention relief this approach provides the sponsor is minimal.

The B-piece construct also places limitations on TPPs. Once a TPP purchases a horizontal residual interest from a sponsor, it is required to hold that B-piece interest for a five-year term.[178] Throughout the entire term of the TPP's ownership of the B-piece interest (whether it is for five years or longer), the TPP is subject to compliance with the requirements that the sponsor would have been subject to had it retained the interest, such as the hedging and transferring restrictions.[179] However, once the five years are up, the initial TPP is free to sell its B-piece interest to another qualified TPP (if it so chooses), but must notify the sponsor and provide the sponsor with the certain information regarding the acquiring TPP.[180] The subsequent TPP is not required to hold the B-piece interest for any particular term, and thus may sell its interest to a different

171. *Id.*; *accord* Morgan, *supra* note 26, at 379–80.

172. 12 C.F.R. § 244.7(b); *accord* Sargent & Jewesson, *supra* note 7, at 2.

173. 12 C.F.R. § 244.7(b)(1). The reasoning behind limiting the number of TPPs permitted to share the sponsor's eligible horizontal residual interest to two was based on the fear that too many TPPs would "dilute incentives generated by the risk retention requirement." Credit Risk Retention, 79 Fed. Reg. at 77725.

174. *Pari passu* is Latin for "by equal step," i.e., "[p]roportionally . . . equal . . . without preference." *Pari Passu*, BLACK'S LAW DICTIONARY (10th ed. 2014).

175. 12 C.F.R. § 244.7(b)(1).

176. *Id.* § 244.7(b).

177. *Id.* § 244.7(c); *accord* Robin Bouchard et al., *What Can Be Expected in Structured Finance and Securitization for 2018?*, 110 Banking Rep. (BNA) No. 6, at 200, 201 (Feb. 5, 2018).

178. § 244.7(b)(8)(ii)(A).

179. *Id.*

180. *Id.*

qualified TPP at any time.[181] But similar to the initial TPP, the subsequent transferring TPP must also provide the sponsor with the necessary information regarding the successor TPP.[182]

In addition, under the CMBS B-piece construct, the current regulations further require that the underlying securitization transaction documents provide for the appointment of an independent operating advisor,[183] who monitors the special servicer,[184] as well as provides investors with periodic independent reports of its opinion on the special servicer's performance and compliance regarding its duties.[185] Additionally, the independent operating advisor, "among other obligations, has the authority to recommend and call a vote for removal of the special servicer under certain conditions."[186] The independent operating advisor does not have any financial interest in a CMBS transaction over which it monitors, "other than [the] fees from its role as operating advisor,"[187] and is charged with looking out for the interests and benefits "of investors as a collective whole."[188] In addition to the other regulations enacted under Dodd-Frank, this requirement further increases the cost of CMBS transactions.[189]

IV. DIFFERENTIATING CMBS FROM OTHER FORMS OF SECURITIZATION

Dodd-Frank has consistently faced criticism for its failure to properly separate the problematic ABS transactions from the other

181. *Id.* § 244.7(b)(8)(ii)(C).
182. *Id.* § 244.7(b)(8)(ii)(B).
183. *Id.* § 244.7(b)(6)(v).
184. A "servicer" is defined as "any person responsible for the management or collection of the securitized assets or making allocations or distributions to holders of the ABS interests. . . ." *Id.* § 244.2. A "special servicer" is, "with respect to any securitization of [CRE] loans, any servicer that, upon the occurrence of one or more specified conditions in the servicing agreement, has the right to service one or more assets in the transaction. *Id.* § 244.7(a). "Servicing assets" refers to "rights or other assets designed to assure the servicing or timely distribution of proceeds to ABS interest holders and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets." *Id.* § 244.2.
185. *Id.* § 244.7(b)(6)(v)(D).
186. Credit Risk Retention, 79 Fed. Reg. 77602, 77724 (Dec. 24, 2014) (codified at 12 C.F.R. pts. 43, 244, 373 & 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267); *accord* 12 C.F.R. §§ 244.7(b)(6), 244.7(b)(6)(vi)(A).
187. 12 C.F.R. § 244.7(b)(6)(i)(B).
188. *Id.* § 244.7(b)(6)(i)(C).
189. Credit Risk Retention, 79 Fed. Reg. at 77724.

securitization transactions.[190] Indeed, there are a number of differences between RMBS and CMBS, as well as CDOs and CMBS, that are not accounted for in Dodd-Frank.[191] Although some of the regulations subsequently promulgated under Dodd-Frank have made some distinctions between certain securitization transactions, these distinctions similarly fail to provide adequate exemptions for CMBS.[192]

A. Comparing RMBS and CMBS: The Underlying Mortgages

While the list of differences between RMBS and CMBS, and CDOs and CMBS, discussed below is by no means exhaustive, it serves as illustrative to the fact that not all ABS transactions are the same. The differences described below suggest that CMBS presents less structural risks to investors than RMBS, and thus do not warrant the same level of regulation as RMBS.[193]

1. Loan-to-Value Ratios

One significant difference between CMBS and RMBS can be seen by the loan-to-value ("LTV") ratios of the underlying mortgages: the average LTV ratio is significantly higher in RMBS than in CMBS. The net benefit of the lower LTV ratios in CMBS is twofold. First, because the borrowers have more skin in the game, they are much less likely to default. Second, because a lower LTV ratio provides a greater equity cushion, the value of the property must decline a significant amount before there is a risk to investors.[194]

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190. *See, e.g.*, Brown, *supra* note 12, at 115–16 (stating that the failures of RMBS led the legislators and the general public to believe such failures were present among all ABS, and the successes of CMBS were overlooked as a result); *accord* Morgan, *supra* note 26, at 364 ("Dodd-Frank itself fails to adequately differentiate between the [RMBS] and CMBS markets."); *see also supra* notes 26–27 (discussing Dodd-Frank's failure to adequately distinguish CMBS from other ABS).

191. *See, e.g.*, Brown, *supra* note 12, at 116 ("[C]ontrary to the majority view in the legal commentary, the causes of the RMBS market's failure are not applicable to the CMBS market . . . . [Because] the product structure of CMBS transactions provides greater investor protections than RMBS.").

192. TREASURY REPORT, *supra* note 39, at 91, 95; *see also infra* Part V.

193. Brown, *supra* note 12, at 16.

194. This equity cushion is referred to as the "subordination level," which "is the maximum amount of principal loss on the underlying mortgage that can occur without a given security suffering any loss." Stanton & Wallace, *supra* note 33, at 177 n.9.

The difference in the underlying LTV ratios for RMBS and CMBS can be explained, at least in part, by the fact that there are strong governmental incentives in helping Americans achieve their dream of owning a home.[195] For example, Federal Housing Administration ("FHA") loans are mortgages insured by the FHA and allow individuals to obtain a mortgage with a down payment of only 3.5%, which results in an LTV ratio of 96.5%.[196] Additionally, veterans have access to Veteran Administration ("VA") loans, which have an LTV ratio of 100%.[197] In VA loans, the federal government guarantees lenders payment of at least some of the loss that would be incurred in the event of borrower default.[198] Nevertheless, the ideal LTV ratio for residential mortgages is generally eighty percent and below, at which point the borrower is not required to purchase private mortgage insurance ("PMI").[199] Unlike RMBS, the average LTV ratio for the underlying mortgages in CMBS is generally less than 70%, and this was true even during the years leading up to the 2008 financial crisis.[200]

While these efforts are notable, lowering the lending standards bar for residential mortgages can result in an increase in sub-prime lending,[201] which opens the door for higher default rates.[202] Given that future real estate prices can be extraordinarily unpredictable, the true risk of

195. *See* U.S. DEP'T OF HOUS. & URBAN DEV., BLUEPRINT FOR THE AMERICAN DREAM (2002), https://archives.hud.gov/initiatives/blueprint/blueprint.pdf (last visited Jan. 3, 2019) (stating that "homeownership" is synonymous with "The American Dream").

196. ZILLOW, *What is an FHA Loan? – The Complete Consumer Guide*, https://www.zillow.com/mortgage-learning/fha-loan/ (last visited Jan. 3, 2019); Justin Pritchard, *What is a Loan to Value Ratio and How to Calculate It*, THE BALANCE (Jan. 3, 2019), https://www.thebalance.com/loan-to-value-ratio-315629; *see also Overview of CMBS*, *supra* note 1, at 292 (discussing how VA and FHA loans are guaranteed by the federal government).

197. *See, e.g.*, VETERANS UNITED HOME LOANS, https://www.veteransunited.com/va-loans/ (last visited Jan. 3, 2019) (advertising that qualified veterans can secure a home mortgage without a down payment); *see also* VETERANS UNITED HOME LOANS, [hereinafter *Why VA Loans Don't Require Down Payment*], https://www.veteransunited.com/realestate/why-va-loans-dont-require-a-down-payment/ (last visited Jan. 3, 2019) (stating that VA loans do not require a down payment or private mortgage insurance ("PMI")).

198. *Why VA Loans Don't Require Down Payment*, *supra* note 197.

199. Pritchard, *supra* note 196. Private mortgage insurance ("PMI") protects the lender against borrower default, the risk for which decreases as the borrower pays down the loan and builds equity. Pritchard, *supra* note 196.

200. Stanton & Wallace, *supra* note 33, at 187.

201. "Sub-prime lending" refers to loans made that are below the typical lending standards. Brown, *supra* note 12, at 111 n.23.

202. Brown, *supra* note 12, at 111 ("Market participants and practitioners have generally concluded that years of lax lending standards in subprime residential mortgage loan origination led to increasingly poor loan quality, widespread downgrades of the highest rated classes of [RMBS], and substantial losses in the lowest rated classes." (footnotes omitted)).

high LTV ratios is a decline in property value because even a relatively small decline could place a borrower "underwater"[203] on a loan. In contrast, if a borrower paid a 20% down payment (which would result in an LTV ratio of 80%), then the value of the property would have to decline 20% before the borrower would be underwater and have no incentive to continue paying on the mortgage.[204]

Unlike residential mortgage lending, which usually permits higher LTV ratios,[205] commercial mortgage lending generally requires lower LTV ratios, which frequently causes the loan to be overcollateralized[206] by the CRE that secures the loan. Overcollateralization of the loan serves as an additional equity cushion—which may be nonexistent in loans with high LTV ratios—for the lender, should the borrower default.[207]

The lower LTV ratios that are required for commercial mortgages make CMBS inherently less susceptible than RMBS to default.[208] Because heightened LTV ratio requirements (i.e., lower LTV ratios) result in a significant amount of equity being tied up in the mortgaged CRE, the CRE borrower has a strong incentive to avoid default.[209] Additionally, such equity may even permit the borrower to leverage the equity by taking out an additional loan to help remain current on the securitized loan. Furthermore, even if the borrower does default, there is much less risk that the CMBS will experience a loss from the securitized mortgage since the underlying commercial mortgage was overcollateralized. In other words, the value of the property will be sufficient to cover the outstanding loan, even if the property experienced a slight decrease in value after the mortgage loan was made.

203. Levitin & Wachter, *supra* note 101, at 89. If a borrower's LTV ratio is greater than 100%, the borrower is said to be "underwater" or "upside down" on the loan. Levitin & Wachter, *supra* note 101, at 89. In other words, if more debt is owed on the real estate that secures the property than the property is worth the real estate (or borrower) is underwater. Levitin & Wachter, *supra* note 101, at 89.

204. Levitin & Wachter, *supra* note 101, at 89.

205. From the perspective of the lender (originator), and generally an investor structured financial products, lower LTV ratios are preferred.

206. *See* *Overcollateralization*, INVESTOPEDIA, https://www.investopedia.com/terms/o/overcollateralization.asp (last visited Jan. 3, 2019) ("Overcollateralization . . . is the process of posting more collateral than is needed to obtain or secure financing. Overcollateralization is often used as a method of credit enhancement by lowering the creditor's exposure to default risk.").

207. *Id.*

208. Brown, *supra* note 12, at 128.

209. Brown, *supra* note 12, at 128.

2. Limitations on Prepayment: Prepayment Prohibitions and Prepayment Penalties

Another difference between the underlying mortgages in CMBS and RMBS relates to prepayment limitations in commercial mortgages, such as prepayment prohibitions and prepayment penalties.[210] Although there is a presumption that a lender is under no duty to accept a prepayment (absent a contrary term in the lending agreement),[211] prepayment penalties in residential mortgage loans have been banned in many states after the 2008 financial crisis.[212] Unlike their residential counterparts, most of the underlying mortgages in CMBS have limitations on prepayment of the loan, through either a complete prepayment prohibition, or at least a prepayment penalty.[213]

These limits on prepayment of the underlying commercial mortgages benefit the integrity of CMBS in a number of ways.[214] Most importantly, they help ensure a steady and reliable stream of cash flow from the underlying mortgages at the agreed upon interest rate.[215] When prepayment is not completely prohibited, prepayment penalties encourage the borrower to hold the property until loan maturity.[216] Even in the case of a prepayment, a prepayment penalty lessens the damage to the CMBS from the loss of that mortgage's future payments.[217] Additionally, "[t]he borrower, in acting to protect its equity investment from the reach of the prepayment penalty, has an incentive to finance only properties with a stable income flow—precisely those that are less likely to default."[218] Similarly, "the lender has an incentive to offer financing only to

210. Brown, *supra* note 12, at 126–27.

211. Brown, *supra* note 12, at 126 n.108 ("American law has presumed that in the absence of a clause permitting prepayment, the lender is under no obligation to accept it.").

212. Brown, *supra* note 12, at 129. Whether or not there is an associated penalty, when a borrower is permitted to make prepayments, the lender loses a portion of its expected return from future payments towards interest. This may be especially problematic if interest rates are going down and the lender is forced to reinvest at a lower market rate of interest. However, CMBS are able to protect against potential loss from prepayments by way of prepayment penalties and prepayment prohibitions in the underlying mortgage agreements. Brown, *supra* note 12, at 126–28.

213. Brown, *supra* note 12, at 126–27.

214. Brown, *supra* note 12, at 126–27.

215. Brown, *supra* note 12, at 126–27.

216. Brown, *supra* note 12, at 127.

217. Brown, *supra* note 12, at 126–27.

218. Brown, *supra* note 12, at 128.

properties that will not default and can generate enough rents to meet the debt service of the loan."[219]

3. The Number and Size of the Underlying Mortgages

Another important difference between RMBS and CMBS is the size and number of the underlying mortgages in any given pool.[220] The individual underlying commercial mortgages in CMBS are generally much larger in size than those in RMBS.[221] For example, in a CMBS transaction, the average loan size is well over $1,000,000,[222] compared to the average loan size in a RMBS transaction, where the typical loan would be around $200,000.[223] Additionally, unlike RMBS, which often hold thousands of residential mortgages,[224] CMBS generally contain only around 300 mortgages.[225] The smaller number of loans in any given CMBS transaction makes it relatively easy for investors to perform due diligence on the underlying assets; thus, the CMBS structure is generally more risk-averse.[226]

B. Comparing RMBS and CMBS and Their Respective Roles in the 2008 Financial Crisis

Despite "significant downgrades to the mortgage-backed securities sector"[227] following the 2008 financial crisis, "CMBS pricing . . . [remained] resilient."[228] Indeed, between 2007 and 2009, "the performance of CMBS was relatively strong compared to RMBS and other [ABS]."[229] Furthermore, during the 2008 financial crisis, commercial mortgage loans did not experience a significant increase in rates of default; in fact,

219. Brown, *supra* note 12, at 128.
220. Brown, *supra* note 12, at 133.
221. Brown, *supra* note 12, at 133.
222. Brown, *supra* note 12, at 137.
223. Levitin & Wachter, *supra* note 101, at 98.
224. Levitin & Wachter, *supra* note 101, at 98.
225. Brown, *supra* note 12, at 140.
226. Brown, *supra* note 12, at 140; *accord* Morgan, *supra* note 26, at 376. *But see* Levitin & Wachter, *supra* note 101, at 98 (suggesting that RMBS are better geographically diversified than CMBS because of the vast number of loans contained in the former).
227. Brown, *supra* note 12, at 108–09 n.9.
228. Brown, *supra* note 12, at 108–09 n.9.
229. Morgan, *supra* note 26, at 376.

"realized defaults were in line with levels observed"[230] during the majority of the preceding forty years.[231] Similarly, CMBS did not experience a decrease in average LTV ratio, during and leading up to the 2008 financial crisis, despite the rating agencies' increasingly lax standards during that time.[232]

C. Comparing CMBS and CDOs

There are also numerous differences between CMBS and CDOs despite the fact that Dodd-Frank placed both into the category of ABS for regulatory purposes.[233] One obvious difference is that the underlying assets in CMBS—the commercial mortgages—are always secured by tangible, real property.[234] Conversely, CDOs may be made up of a variety of assets, tangible and intangible, such as automobile loans, credit card receivables, student loan debt, as well as other forms of ABS, including RMBS and CMBS.[235] For instance, prior to the 2008 financial crisis, CDOs sometimes purchased lower-rated bonds from CMBS and other securitizations.[236] Furthermore, unlike CMBS and RMBS, CDOs are not necessarily backed by the cash flow of assets.[237] Some CDOs, called synthetic CDOs, instead of being backed by cash flows of assets, "are

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230. Stanton & Wallace, *supra* note 33, at 195 ("[D]uring the [2008 financial] crisis, expected cumulative default rates were in line with levels observed over almost the whole of the 40-year period before the crisis, excluding the most recent few years. [B]oth before and during the crisis, the primary shift in the market was the reduction in allowable subordination levels by the rating agencies.").

231. Stanton & Wallace, *supra* note 33, at 195.

232. Stanton & Wallace, *supra* note 33, at 194–95.

233. *See supra* Part III (defining ABS).

234. *See* Brown, *supra* note 12, at 109 (stating that commercial mortgage loans are the underlying assets of CMBS).

235. *See* INVESTOPEDIA, *supra* note 31 ("A [CDO] is a structured financial product that pools together cash flow-generating assets and repackages this asset pool into discrete tranches that can be sold to investors."). CDOs can be separated into two categories: synthetic CDOs and cash CDOs. *Collateralized Debt Obligations (CDOS)*, FINCAD, [hereinafter FINCAD], https://www.fincad.com/resources/resource-library/wiki/collateralized-debt-obligations-cdos (last visited Sept. 14, 2018) ("A cash CDO is backed by 'true' assets, such as bonds or loans. . . . Synthetic CDOs are not backed by cash flows of assets. Instead, they are linked to their reference entities by credit derivatives, such as [credit default swaps]. . . .").

236. Kronovet & van Heerden, *supra* note 8, at 77–78 ("CDOs . . . assembled and re-securitized lower-rated junior CMBS bonds, credit default swaps, mezzanine debt, and miscellaneous assets.").

237. *See* FINCAD, *supra* note 235.

linked to their reference entities by credit derivatives,[238] such as credit default swaps."[239] CDOs, both synthetic CDOs and cash CDOs, were significant contributors to the 2008 financial crisis.[240]

V. EXECUTIVE ORDER 13772 AND THE TREASURY'S FINDINGS FOR THE NECESSITY OF DODD-FRANK REFORM CONCERNING SECURITIZATION

On February 3, 2017, President Trump issued Executive Order 13772, "Core Principles for Regulating the United States Financial System."[241] Specifically, Executive Order 13772 set out to regulate the financial industry in a manner consistent with the "Core Principles" of regulation, which include: (a) preventing bailouts funded by taxpayers, (b) "foster[ing] economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazards and information asymmetry,"[242] (c) enabling American companies to become competitive with foreign companies in both foreign and domestic markets, (d) "mak[ing] regulation efficient, effective, and appropriately tailored,"[243] and (e) to "restore

238. *See* *Credit Derivative*, INVESTOPEDIA, https://www.investopedia.com/terms/c/creditderivative.asp (last visited Oct. 9, 2018) ("Credit derivatives transfer credit risk related to an underlying entity from one party to another without transferring the actual underlying entity. . . . There are two main types of derivatives: puts [(an option to buy)] and calls [(an option to sell)]."); *see also Credit Default Swap*, INVESTOPEDIA, https://www.investopedia.com/terms/c/creditdefaultswap.asp (last visited Oct. 9, 2018) ("A credit default swap is a particular type of swap designed to transfer the credit exposure of fixed income products between two or more parties. In a credit default swap, the buyer of the swap makes payments to the swap's seller up until the maturity date of a contract. In return, the seller agrees that, in the event that the debt issuer defaults or experiences another credit event, the seller will pay the buyer the security's premium as well as all interest payments that would have been paid between that time and the security's maturity date. A credit default swap is the most common form of credit derivative and may involve municipal bonds, emerging market bonds, mortgage-backed securities or corporate bonds."). Although credit derivatives are beyond the scope of this Note, they are nevertheless worth mentioning because their existence in CDOs is another illustration of the differences between CDOs and CMBS.

239. FINCAD, *supra* note 235.

240. *See* Levitin & Wachter, *supra* note 101, at 107, 108 ("With CMBS, as with RMBS, we believe the supply glut resulted in an increase in MBS volume even as risk premia declined was caused first and foremost by the emergence of CDOs as major buyers of MBS. . . . [And, f]or RMBS, the CDO enabled the expansion of the [private loan securitization] market, while for CMBS, the CDO undermined the traditional underwriting discipline from the B-piece market.").

241. Exec. Order No. 13772: Core Principles for Regulating the United States Financial System, 82 Fed. Reg. 9965, 9965–66 (Feb. 3, 2017).

242. *Id.* at 9965.

243. *Id.*

public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework."[244]

Executive Order 13772 further instructed the Secretary of the Treasury to conduct a study on the current regulatory state and provide a subsequent report "identify[ing] any laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other Governmental policies that inhibit Federal regulation of the United States financial system in a manner consistent with the Core Principles."[245]

In accordance with Executive Order 13772, the Treasury subsequently issued a formal report, which included findings that the post-2008 financial crisis regulatory "reforms have gone too far toward penalizing securitiz[ation transactions]."[246] Specifically, with regard to all forms of securitization, the Treasury report first stated that "[t]he current regulatory regime discourages securitization as a funding vehicle;"[247] instead, it "encourag[es] lenders to fund loans through more traditional methods such as bank deposits."[248] Secondly, the current "[r]egulatory bank capital requirements treat investment in non-agency securitized instruments punitively relative to investments in the disaggregated underlying collateral."[249] Third, the "[r]egulatory liquidity standards unfairly discriminate against high-quality securitized product classes compared to other asset classes with a similar risk profile."[250] Fourth, the Treasury found that the risk-retention requirement imposed on sponsors "adds unnecessary costs to securitization as a funding source, thereby inhibiting the prudent expansion of credit through securitized products."[251] Finally, the report stated that the "[e]xpanded disclosure requirements, while an important post-crisis reform, are unnecessarily burdensome and could be more appropriately tailored."[252] Additionally, with respect to CMBS in particular, the Treasury found the transfer requirements for TPPs to be unnecessary and discriminatory toward CMBS.[253]

244. *Id.*
245. *Id.* at 9965–66.
246. TREASURY REPORT, *supra* note 39, at 91, 95.
247. TREASURY REPORT, *supra* note 39, at 91, 95.
248. TREASURY REPORT, *supra* note 39, at 91, 95.
249. TREASURY REPORT, *supra* note 39, at 91, 95.
250. TREASURY REPORT, *supra* note 39, at 91, 95.
251. TREASURY REPORT, *supra* note 39, at 91, 95.
252. TREASURY REPORT, *supra* note 39, at 96.
253. TREASURY REPORT, *supra* note 39, at 102.

In line with its findings, the Treasury provided recommendations for regulatory reform that would lessen the negative effects Dodd-Frank and its regulatory progeny have had on securitization transactions. Some of the most significant of these recommendations relate to risk retention, which the Treasury referred to as "an imprecise mechanism by which to encourage alignment of interest[s]."[254] Nevertheless, the Treasury recognized the benefits of requiring sponsors to have skin-in-the-game.[255] Thus, "[i]nstead of recommending an across-the-board repeal of the [risk-retention] requirement, [the] Treasury recommend[ed] that federal banking regulators expand [the current] qualifying risk retention exemptions across eligible asset classes based on the unique characteristics of each securitized asset class, through notice-and-comment rulemaking."[256] The Treasury suggested that the existence of asset-specific disclosure requirements ought to be sufficient to merit an exemption where the underlying assets are considered to be "qualified."[257]

The Treasury also recommended that the five-year holding period for TPPs and sponsors in CMBS transactions should be reviewed.[258] More specifically, the Treasury suggested that the holding period should be shortened to whatever regulators determine to be the length of the "emergence period" (i.e., the period where the bad loans have either defaulted or their presence is at least evident).[259]

Finally, instead of continuing to allow six regulatory agencies to possess rulemaking authority with regard to the risk-retention requirement, the Treasury recommended that "Congress . . . designate a lead agency . . . to be responsible for future actions related to the rulemaking."[260]

VI. RECOMMENDATIONS FOR REFORM OF DODD-FRANK: CMBS DEREGULATION

Dodd-Frank permitted the regulatory agencies tasked with implementing the new regulations to utilize their rule-making authority to "adopt or issue exemptions, exceptions, or adjustments . . . relating to the

254. TREASURY REPORT, *supra* note 39, at 103.
255. TREASURY REPORT, *supra* note 39, at 103.
256. TREASURY REPORT, *supra* note 39, at 103.
257. TREASURY REPORT, *supra* note 39, at 103.
258. TREASURY REPORT, *supra* note 39, at 103.
259. TREASURY REPORT, *supra* note 39, at 103.
260. TREASURY REPORT, *supra* note 39, at 103.

risk retention requirement and the prohibition on hedging."[261] However, there has yet to be a sufficient exemption for CMBS, despite the fact that clear and distinct differences exist between CMBS and other forms of securitization transactions.[262] Although regulations promulgated under Dodd-Frank did grant CMBS a slight exception to the risk-retention requirement by permitting the utilization of TPPs,[263] such an exception does not, by any means, constitute an *exemption*, partial or total, from the risk-retention requirement. Similarly, although the current regulations also provide CMBS with the possibility of a complete exemption from the risk-retention requirement if certain underwriting standards are met for "qualifying" CRE loans,[264] the underwriting standards are set so unreasonably high that the effort necessary to meet those standards is impractical, which thereby defeats the purpose of having the exemption to begin with.[265] Therefore, given the importance of CMBS in CRE lending, and because it is evident that CMBS fall outside the group of securitization transactions that were the true troublemakers leading up to the 2008 financial crisis,[266] CMBS should be released from the burdensome grip of the current regulatory regime.

One possible avenue that the Dodd-Frank reform efforts might seek is an across-the-board exemption for CMBS to the risk-retention requirement altogether. Indeed, there is strong support for the argument that what necessitated the risk-retention requirement in the first place—largely the "moral-hazard"[267] that came along with the originate-to-sell practice—was not an issue for CMBS given the heightened borrower

261. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 941(b), 15 U.S.C. § 78o-11 (2012) (giving SEC and Federal banking agencies authority to provide risk-retention exemptions); *accord* 12 C.F.R. § 244.21 (2018) ("The federal agencies with [the necessary] rulewriting authority . . . with respect to the types of assets involved may jointly provide a total or partial exemption of any securitization transaction as such agencies determine may be appropriate in the public interest and for the protection of investors.").

262. *See* TREASURY REPORT, *supra* note 39, at 102 (stating that the current risk retention exemptions available to CMBS are insufficient); *see also supra* Part IV.

263. *See* Sargent & Jewesson, *supra* note 7, at 2 (stating that Dodd-Frank allowed an exception to the risk-retention requirement for CMBS, which allows the sponsor to meet the requirement through the use of a "B-piece buyer," also known as a TPP).

264. 12 C.F.R. § 244.15.

265. TREASURY REPORT, *supra* note 39, at 102.

266. *See supra* Part IV.

267. *See* Credit Risk Retention, 79 Fed. Reg. 77602, 77719 (Dec. 24, 2014) (codified at 12 C.F.R. pts. 43, 244, 373 & 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267) (stating that a primary goal of the risk-retention requirement was to fix the "moral hazard" problem); Schwarcz, *supra* note 18, at 118–19 (stating that the "moral hazard" problem resulted from the securitization practice of "originate-to-distribute").

requirements, as well as the preexisting, extensive nature of CMBS B-piece buyer due diligence.[268] Unlike CDOs, CMBS only contain one type of asset: commercial mortgages. Consequently, CMBS are much less complex, thereby making such extensive due diligence feasible.[269] Additionally, largely because of the level of due diligence by B-piece investors, CMBS—unlike RMBS—did not experience problems with underlying loans stemming from widespread predatory/fraudulent lending practices.[270]

Furthermore, under the assumption that the current Dodd-Frank disclosure requirements remain in place, or that the investors remain capable of obtaining asset-level disclosures, such investors should know exactly what they are purchasing—including the uncertainty that comes along with any investment. Indeed, the ancient maxim of *caveat emptor*[271] remains deeply embedded in American jurisprudence: so, why enact regulations protecting a sophisticated buyer who remains unaware of the inherent risk and uncertainty of an investment—particularly after full disclosure?

A different, more risk-averse avenue that CMBS risk-retention reform might take could focus on the B-piece investors and the current five-year holding requirement. As the Treasury report indicated, it is unlikely that the mandatory holding period actually needs to be five years to accomplish its intended purpose, and should therefore be shortened.[272] Although the Treasury suggested that the period be shortened to whatever amount of time that is determined necessary for the bad loans to default, a mandatory holding period, of any length greater than one or two years may nevertheless be unwarranted with respect to CMBS.[273] While the Treasury's recommendation would allow for a relaxed mandatory holding period for CMBS, the likely result would be that the regulatory

268. Brown, *supra* note 12, at 133; *accord* Morgan, *supra* note 26, at 365; *see also* parenthetical information for sources cited *supra* note 28 (discussing risk-averse structure of CMBS).

269. *See* Levitin & Wachter, *supra* note 101, at 95 ("CMBS are one of the simplest securitization structures. . . ."); *see also supra* Part IV.

270. Brown, *supra* note 12, at 115–16; *accord* Morgan, *supra* note 26, at 365; Stanton & Wallace, *supra* note 33, at 177 ("[U]nlike the RMBS market, all agents in the CMBS market can reasonably be viewed as sophisticated, informed investors. . . .").

271. *Caveat emptor* is Latin for "let the buyer beware." *Caveat Emptor*, BLACK'S LAW DICTIONARY (10th ed. 2014). Although often limited in modern law, *caveat emptor* is "[a] doctrine holding that a purchaser buys at his or her own risk." *Id.*

272. TREASURY REPORT, *supra* note 39, at 103.

273. TREASURY REPORT, *supra* note 39, at 103.

agencies would choose to err on the side of caution and require a longer holding period than may truly be necessary.

Another avenue the CMBS deregulation efforts might pursue could be in the form of a partial exemption from the risk-retention requirement limited to certain CMBS that meet the requisite specified standards. This could be accomplished in a number of different ways, such as through an expansion of the current exemptions for qualified CRE loans, as was recommended by the Treasury in its report.[274] For example, whether a CMBS transaction qualifies for a total or partial exemption could be based on the average credit rating of the underlying mortgages in the CMBS. Alternatively, whether a CMBS qualifies for an exemption could be based on the average credit rating of the CMBS combined with an additional requirement that no tranche within the CMBS is below a certain rating. While there are myriads of additional requirements and conditions that could theoretically flow from the structure of this approach, an overly-logistical interpretation and implementation of this recommendation would probably fail to provide the CMBS industry with enough relief to foster meaningful growth, which would ultimately defeat the purpose the purported exemption. Therefore, under this recommendation—and all recommendations for CMBS regulation for that matter—simplicity is key.[275]

No single route to CMBS deregulation can necessarily guarantee to be the best option for preserving the viability of the CMBS industry, fostering future growth, and protecting the economy from a future financial crisis until it has been implemented and put to the test. However, one thing is clear: the CMBS industry did not need to be heavily regulated prior to the 2008 financial crisis; nor does it now under Dodd-Frank's current regulatory regime.

VII. CONCLUSION

Securitization is an essential part of the modern financial world.[276] Although critics can easily place securitization transactions as

274. TREASURY REPORT, *supra* note 39, at 103.

275. Schwarcz, *supra* note 18, at 131 (discussing how the complexity in securitization transactions was a significant contributor to the 2008 financial crisis); *cf.* Brown, *supra* note 12, at 121 ("The dominant underlying themes that 'investors took risks that they didn't understand' and 'risk was mispriced' have shaped the legislative debate around securitization reform." (footnote omitted)).

276. *See supra* Part II.

significant contributors to the 2008 financial crisis,[277] there were many other contributing factors, such as the credit rating agencies and predatory and even fraudulent lending practices in the residential mortgage lending sector.[278] Additionally, securitization should neither be overgeneralized, nor should the various securitization transactions be placed in the same category for regulatory purposes.[279] Each and every regulation must be appropriately tailored[280] to neatly fit each form of securitization it affects.

While there is no doubt that Dodd-Frank's purpose was to overhaul numerous portions of the American financial system,[281] it did not set out to dismantle it through unnecessary regulation. Despite the gravamen of the Treasury's findings and the general acquiescence that Dodd-Frank's regulatory burdens have negatively impacted CMBS, some nevertheless continue to praise Dodd-Frank's CMBS regulations in their current form, and argue against abolition.[282] However, it does not follow that the current regulations, as they are—which burden the CMBS industry—should remain in full-force simply because some degree of regulation is necessary. In fact, such an argument is necessarily illogical. For example, Dodd-Frank's provisions regarding "improvements to the [ABS] process"[283] acknowledged concerns about damaging the ABS markets.[284] However, notwithstanding the availability of satisfying the risk-retention requirement through the B-piece construct, no meaningful exemptions have been established for CMBS. Consequently, by leaving

277. Brown, *supra* note 12, at 113–15.

278. Stanton & Wallace, *supra* note 33, at 175, 194–96; *see also supra* Part I, notes 30–35 and accompanying text.

279. *See supra* Part IV.

280. Exec. Order No. 13772: Core Principles for Regulating the United States Financial System, 82 Fed. Reg. 9965, 9965 (Feb. 3, 2017).

281. *See supra* note 116 (quoting Dodd-Frank's stated purpose).

282. *See, e.g.*, Maegan E. O'Rourke, Note, *The New Normal: How the Dodd-Frank Risk Retention Rules Affect the Future of CMBS*, 51 SUFFOLK U. L. REV. 77, 90–92 (2018) (arguing that current regulations pertaining to Dodd-Frank's risk-retention requirement should remain unmolested because of "optimism that the rules will not prevent continued CMBS issuance").

283. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, tit. IX, subtit. D, 124 Stat. 1890, 1890 (2010) ("Subtitle D—Improvements to the [ABS] Process").

284. *See* Dodd-Frank § 941(c), 124 Stat. at 1896 (requiring agencies to conduct a study on effects of risk-retention requirement on securitization transactions and to subsequently submit a report that includes "recommendations for eliminating any negative impacts on the continued viability of the [ABS] markets . . . .").

CMBS subject to the current regulatory scheme promulgated under Dodd-Frank, Dodd-Frank seemingly defeats its very purpose.[285]

As the Dodd-Frank debate continues, and as further repeal or modification looms in this era of deregulation, attention should be directed toward CMBS.[286] While Dodd-Frank initially provided certain exemptions to its regulatory provisions for some ABS,[287] and regulations enacted thereunder have since provided additional exemptions, it is evident that the current exemptions do not go far enough for CMBS—particularly in the case of risk retention. Similarly, although there have been recent Dodd-Frank rollbacks that loosened some of its regulatory pressure,[288] there has yet to be any notable legislative efforts that would benefit CMBS, specifically. Consequently, the Dodd-Frank reform efforts should turn their attention to CMBS, and seek a new or expanded CMBS exemption from the risk-retention requirement.

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285. *See* TREASURY REPORT, *supra* note 39, at 91, 95–96 (stating current regulations under Dodd-Frank damage securitization industry).

286. *See* TREASURY REPORT, *supra* note 39, at 91, 95–96 (stating Dodd-Frank reform is necessary for ABS and providing recommendations).

287. *See, e.g.*, Dodd-Frank § 941(e), 15 U.S.C. § 78o-11 (providing that certain institutions and programs are exempt from the risk-retention requirement).

288. *See, e.g.*, Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296, 1296 (2018) (May 2018 Dodd-Frank rollbacks); *see also* Rappeport & Flitter, *supra* note 39 (discussing recent Dodd-Frank rollbacks).

*I would like to thank all of my wonderful family and friends for their constant support and understanding throughout the process of developing this Note. I am extraordinarily grateful to Professor Lissa L. Broome, Joanne Wu, Rebecca D. Floyd, and the staff members of the North Carolina Banking Institute Journal for their thoughtful edits and comments which guided me to the final stages of the publication process. I would like to especially thank Professor Lissa L. Broome for her dedication to this journal and the University of North Carolina School of Law.