Who is Afraid of Vertical Risk Retention?

By **Toby Cobb**

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We as nationwide commercial real estate lending professionals at 3650 REIT have discussed on numerous occasions that "skin in the game," or retention of risk, matters—but that is not enough. How *much* skin in the game is what matters most. Risk retention is a blunt tool, but it is most effective when the amount of risk being retained is meaningful. Skin in the game delivers proper incentives to protect bondholders, and when absent, fees become the motivating factor instead of maximizing the return for the benefit of the bondholders.

In today's challenging market environment, the absence of adequate skin in the game will likely result in the misalignments and bad behavior that occurred during the Great Financial Crisis of 2008-2009. What's more, it might be even more difficult to remove special servicers due to losses and class migration in today's pooling and servicing agreements.

When we reflect on the last 10 months, of the 37 CMBS conduit-type issuances, only five utilized horizontal risk retention (HRR), which represents real skin in the game, while the other 32 employed vertical risk retention (VRR or "skinny Ls," L-shaped risk retention). If we continue to peel back the curtain, we discover that of these 32 VRR deals, only six transactions had a subordinate buyer with greater than 7.5 percent of the capital stack. Moreover, 12 transactions were below 5 percent credit enhancement.

Nine of these latest 37 securitizations have VRR and do not disclose yields. VRR has the issuer holding 5 percent vertical. If we assume the bottom 7.5 percent of the deal is the only portion exposed to risk, the issuer is holding 5 percent vertical, of which only 7.5 percent has real exposure. The issuer is then keeping 37.5 bps of risk in a deal where they are likely targeting 200 bps of arbitrage. They can simply write off the 37.5 bps and book 162.5 bps of profit. Let's dispel with any notion that VRR represents skin in the game.

Now, if we assume the B-piece buyer sells the BB tranche, which they often do because the entire B-piece of a VRR deal is fully tradable, then the B-piece buyer would be holding only the B and non-rated (NR) pieces of the securitization. Further, assume the B and NR pieces' market value are roughly 25-30 cents on the dollar. If that is the case, then in many of these VRR and skinny L deals, the controlling class at the bottom of the deal represents as little as 2 percent of the value of the loan pool. This is not true skin in the game. With 7 percent of all commercial real estate loans in special servicing following the COVID-19 pandemic, a 2 percent value holder will likely start looking at fee income opportunities versus recovery of principle for the benefit of the bondholders.

Take for example, a sponsor whose B-piece buyer is holding the bottom 5 percent of the loan, or in many cases less. Now assume the B-piece buyer owns the subordinate tranche at a market value of 30 cents on the dollar, which would result in only a 1.5 percent retained interest in the pool ($0.30 x 5 percent credit support level). Therefore, VRR and skinny-L issuances do not represent skin in the game at all.

The form and thickness of risk retention matters, because skin in the game matters. We believe credit rating agencies should rate bonds accordingly, but we implore bond buyers to invest with this in mind. ■

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