

THE VIRUS, RISK, AND COMMERCIAL MORTGAGE-BACKED SECURITIES: EXAMINING DODD-FRANK’S IMPACT IN THE MIDST OF A PANDEMIC

*Owen Haney**

ABSTRACT

When lawmakers sought to reshape the financial industry through the passage of the Dodd-Frank Act in 2010, they specifically attacked the “moral hazard” in the asset-backed securities market that they believed was partly responsible for the collapse of global financial markets. Congress identified several practices in asset-backed securitizations that posed a risk to the world economy. In particular, regulators believed that the “originate-to-distribute” model, whereby loan originators—those parties armed with the best knowledge regarding the quality of the loans in the transaction and who consequently set underwriting standards—could sell off the loans without bearing any risk should those borrowers (homeowners in the residential mortgage-backed securities space, and businesses in the commercial mortgage-backed securities space) go into default.

With the adoption of risk-retention rules, lawmakers hoped that originators would be incentivized to provide accurate information to investors about the risk of securitized loans because they would now be required to hold a swatch of the securities themselves. In addition to requiring loan originators to keep some “skin in the game,” Dodd-Frank-era reforms increased disclosure requirements and altered the weighting of mortgage-backed securities for the purposes of risk-based capital rules so as to make them more expensive to investors.

In early March 2020, nearly ten years after the passage of Dodd-Frank, the stock market plunged to historic lows once more. Over the course of four days, the Dow Jones Industrial Average fell 26%.

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National unemployment suddenly rose to over 20%. Covid-19 had arrived in the United States, and the national financial immune system went into shock. Economic distress, unemployment, and stay-at-home orders heavily damaged American businesses, particularly brick-and-mortars. Commercial mortgages experienced rapid default because underlying businesses could not afford to make payments.

The corresponding commercial mortgage-backed securities industry went into a tailspin, and observers were left with this unsettling question: did Dodd-Frank do enough to eliminate the moral hazard and dangerous practices that led to the last financial meltdown, or would this exogenous viral shock expose wrongdoing capable of once again systemically crippling the world economy?

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PART I: BACKGROUND

Since the first reported case of Covid-19 in the United States on January 22, 2020,¹ over 31 million people in the United States have been infected by the virus, and over 559,000 individuals have died as a result of the disease.² In addition to the virus's devastating impact on human health, the economic consequences of the virus have been similarly grim. Stay-at-home orders and other government restrictions shuttered "non-essential" businesses.³ Stock prices fell precipitously in March.⁴ In April, unemployment in the country peaked at 14.7%.⁵ The United States is experiencing its second recession of the 21st century.⁶

The focus of this note is the impact of coronavirus on commercial mortgage-backed securities ("CMBS") and whether the virus has exposed systemic risk within the CMBS market. Moreover, this note explores whether the regulation of CMBS following the reforms of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or simply "the Act")⁷ have positioned the country to withstand systemic risk embedded in the CMBS market, if it exists.

1. See Jennifer Harcourt et al., *Severe Acute Respiratory Syndrome Coronavirus 2 From Patient With Coronavirus Disease, United States*, 26 EMERGING INFECTIOUS DISEASES 1266, 1266, 1268 (2020).

2. These are the statistics in the United States as of April 9, 2021, according to the New York Times. See Jordan Allen et al., *Coronavirus in the U.S.: Latest Map and Case Count*, N.Y. TIMES (Apr. 9, 2021, 7:41 AM), <https://www.nytimes.com/interactive/2020/us/coronavirus-us-cases.html> [<https://perma.cc/G2ME-WGTH>].

3. See, e.g., *Governor orders all non-essential workers in NY to stay home*, WHAM (Mar. 20, 2020), <https://13wham.com/news/local/governor-orders-all-non-essential-workers-in-ny-to-stay-home> [<https://perma.cc/S5J9-4P3G>].

4. See, e.g., *Coronavirus: U.S. Stocks See Worst Fall Since 1987*, BBC NEWS (Mar. 17, 2020), <https://www.bbc.com/news/business-51903195> [<https://perma.cc/M6XH-E26H>].

5. Paul Fronstin & Stephen A. Woodbury, *How Many Americans Have Lost Jobs With Employer Health Coverage During the Pandemic?*, COMMONWEALTH FUND (Oct. 3, 2020), <https://www.commonwealthfund.org/publications/issue-briefs/2020/oct/how-many-lost-jobs-employer-coverage-pandemic> [<https://perma.cc/8M4H-4WTJ>].

6. Neil Irwin, *The Pandemic Depression Is Over. The Pandemic Recession Has Just Begun.*, N.Y. TIMES (Oct. 7, 2020), <https://www.nytimes.com/2020/10/03/upshot/pandemic-economy-recession.html> [<https://perma.cc/FH5P-8VZG>].

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

A. COMMERCIAL-MORTGAGE BACKED SECURITIES

A commercial mortgage-backed security is a debt instrument made up of commercial mortgage loans that are secured by the first lien in the underlying real estate.⁸ Unlike residential mortgage-backed securities (“RMBS”), the underlying real estate in CMBS is income-producing and managed for a business purpose.⁹ CMBS offers an alternative financing vehicle—distinct from an ordinary commercial real estate loan—for commercial properties such as hotels, malls, office buildings, and apartment buildings.¹⁰

The first entity to securitize commercial mortgages in a structure that resembled modern CMBS was the government sponsored Resolution Trust Corporation in the early 1990s.¹¹ Private CMBS sprouted soon after, and issuance continued to grow until the market collapsed in 2007.¹² The CMBS market recovered after the crash in 2007, but new issuance in 2019 was still less than half of the \$250 billion in new issuance in 2007.¹³ Since the risk-retention rule¹⁴ went into effect in 2016, new issuance of CMBS has slowed once more.¹⁵

In an ordinary CMBS transaction, a loan originator places the commercial loan into a trust—a bankruptcy-remote vehicle—which in turn issues different classes of bonds, also known as tranches, which are

8. See Patrick Corcoran, *A Property Market Framework for Bond Investors*, in THE HANDBOOK OF COMMERCIAL MORTGAGE-BACKED SECURITIES 1, 1 (Frank J. Fabozzi & David P. Jacob eds., 1997).

9. See Alice A. Lustig, *The Commercial Mortgage-Backed Securities Market*, in THE HANDBOOK OF COMMERCIAL MORTGAGE-BACKED SECURITIES 75, 75 (Frank J. Fabozzi & David P. Jacob eds., 1997).

10. See Maegan E. O’Rourke, *The New Normal: How the Dodd-Frank Risk Retention Rules Affect the Future of CMBS*, 51 SUFFOLK UNIV. L. REV. 77, 81–82 (2018).

11. See *id.* at 81.

12. See *id.*

13. See Jamie Woodwell & Reggie Booker, *CMBS Spreads & Issuance*, MORTG. BANKERS ASS’N: COM./MULTIFAMILY MKT. INTEL. BLOG (Jan. 24, 2020), <https://www.mba.org/news-research-and-resources/research-and-economics/commercial/-multifamily-research/blog/blog-posts/current-blog-posts/cmbs-spreads-and-issuance> [<https://perma.cc/YHG3-NC6X>].

14. See *infra* Part II.

15. See O’Rourke, *supra* note 10, at 89.

backed by the interest and principle of the underlying mortgages.¹⁶ Banks participate in CMBS as originators, as investors, and as service providers.¹⁷ CMBS are structured so that the highest class of bondholders, such as the AAA-rated class, receives any return of principle first, while bondholders of the BBB-rated tranche will be the last to receive a return of principal.¹⁸ Despite the risk of the lowest rated tranche, the “B-Piece” bondholder often contracts for special protections and is often a sophisticated investor.¹⁹ When a CMBS becomes delinquent, meaning that a loan becomes more than 60 days past due, a special servicer is engaged to either extend the loan, make loan modifications, restructure the loan, or foreclose and sell the property.²⁰

Certain features of CMBS require special attention when considering the risks posed by CMBS to investors. Generally, CMBS deals consist of fewer loans than their RMBS counterparts.²¹ Thus, when a loan in the pool of loans underlying the securities goes into default, it may pose a greater risk of delinquency of the entire CMBS structure.²² Moreover, CMBS deals often entail balloon loans, which require a substantial principal payment at loan maturity.²³ If a deal calls for full payment of principal at maturity, delay results in balloon default.²⁴ As a result, modern CMBS deals incorporate “external tail” provisions, which set the maturity date of the CMBS issue after the maturity date for the underlying loans.²⁵ This allows the servicer time to arrange refinancing and to advance interest and scheduled principal payments to bondholders in the event of a loan default.²⁶

16. See John N. Dunlevy, *Structural Considerations Impacting CMBS*, in *THE HANDBOOK OF COMMERCIAL MORTGAGE-BACKED SECURITIES* 123, 123 (Frank J. Fabozzi & David P. Jacob eds., 1997).

17. 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, 71 (2016).

18. See Dunlevy, *supra* note 16, at 126.

19. O’Rourke, *supra* note 10, at 85.

20. See Dunlevy, *supra* note 16, at 129.

21. See O’Rourke, *supra* note 10, at 82.

22. See *id.*

23. See Dunlevy, *supra* note 16, at 126.

24. See *id.*

25. See *id.* at 127.

26. See *id.*

B. CMBS AND THE CORONAVIRUS

The coronavirus pandemic has had a profound effect on the CMBS market in the United States. Commercial properties have suffered as a result of the recession.²⁷ Businesses have largely transitioned to remote work,²⁸ and social-distancing mandates²⁹ and stay-at-home orders have reduced human interaction.³⁰ The cumulative effect of these changes has been the failure of over \$5.5 billion in commercial mortgage loans between the months of May and June 2020, or a surge of 792% for the same period last year.³¹

Loan-level failures have traveled up the securitization pipeline leading to concerning levels of delinquencies in the CMBS market. In June 2020, the overall delinquency rate³² of loans comprised in CMBS was 10.32%, just two basis points off the peak delinquency rate for CMBS in 2012.³³

The current crisis has produced a much swifter rise in CMBS delinquencies than the last financial crisis (the “2007–08 Financial

27. See Irwin, *supra* note 6, at 6.

28. See Forbes Real Est. Council, *14 Big Factors Driving Commercial Real Estate Trends This Year*, FORBES (Sept. 8, 2020, 8:10 AM), <https://www.forbes.com/sites/forbesrealestatecouncil/2020/09/08/14-big-factors-driving-commercial-real-estate-trends-this-year/?sh=75b6e63d7ee8> [https://perma.cc/468J-C36M].

29. See generally Koren Miklós & Rita Pető, *Business Disruptions From Social Distancing*, 15 PLOS ONE 1 (2020), <https://doi.org/10.1371/journal.pone.0239113> [https://perma.cc/3AHE-TMLM].

30. See Sumit Agarwal et al., *Pandemic Risk Factors and the Role of Government Intervention: Evidence From COVID-19 and CMBS Mortgage Performance* (forthcoming 2021) (manuscript at 2), <https://ssrn.com/abstract=3674960> [https://perma.cc/Q5EN-R59B].

31. See Dorothy Neufeld, *Commercial Mortgage Delinquencies Near Record Levels*, VISUAL CAPITALIST (July 16, 2020), <https://www.visualcapitalist.com/mortgage-delinquencies> [https://perma.cc/JZ4W-NDFU].

32. “The delinquency rate is defined as the percentage of commercial real estate loans that were 30 or more days past due or in foreclosure. The higher the delinquency rate, the more likely investors in these transactions will absorb credit losses.” NAIC Cap. Mkts. Bureau, *CMBS Market Showing Signs of Life Despite High Delinquency Rate*, NAT’L ASS’N INS. COMM’RS (2018), https://www.naic.org/capital_markets_archive/110307.htm [https://perma.cc/S9B3-3ARS].

33. *CMBS Delinquency Rate Continues Retreat From Near All-Time High*, TREPP (Sept. 1, 2020), <https://info.trepp.com/hubfs/Trepp%20August%202020%20CMBS%20Delinquency%20Report.pdf> [https://perma.cc/CPS6-8J7P].

Crisis” or “Financial Crisis”). As of June 2020, the pandemic’s devastation in the CMBS market has equaled the disruption of the last recession, doing so four years and eight months sooner.

Though the overall delinquency rate in CMBS has dropped from its June 2020 peak,³⁴ certain sectors of the CMBS market continue to decay. CMBS backed by lodging reached a new high of 17.53% delinquency in October, while CMBS backed by retail hit 11.33% delinquency for the same month.³⁵ Regional malls have been particularly devastated; during October they experienced a delinquency rate of 21.06%.³⁶ As coronavirus cases increased through the United States in the “second wave” of the pandemic during the end of 2020,³⁷ the CMBS market may continue to deteriorate.³⁸

C. SYSTEMIC RISK AND CMBS

The CMBS market is approaching a notable and dour benchmark: delinquencies reached 10.32% in June 2020, just below the all-time high-water mark of 10.34% set in July 2012.³⁹ Despite the similarity of these figures, the source of the crises vastly differ. The current crisis is linked to the coronavirus: apartment owners, restaurants, and hotels are unable to pay rent as a result of the virus, leaving insufficient cash flows to cover mortgage payments and other debts.⁴⁰ The last crisis, however,

34. New delinquencies were at 4.85% for the month of October 2020. See *U.S. CMBS Delinquencies Resume Increase in October*, FITCH RATINGS (Nov. 6, 2020), <https://www.fitchratings.com/research/structured-finance/us-cmbs-delinquencies-resume-increase-in-october-06-11-2020> [<https://perma.cc/BV2H-4NKN>].

35. See *id.*

36. *Id.*

37. See Lisa Lockerd Maragakis, *Coronavirus Second Wave? Why Cases Increase*, JOHNS HOPKINS MED. (Nov. 17, 2020), <https://www.hopkinsmedicine.org/health/conditions-and-diseases/coronavirus/first-and-second-waves-of-coronavirus> [<https://perma.cc/DZY4-Y3LX>].

38. Fitch still predicts the overall delinquency rate to be less than its projection of 8.25% and 8.75% for the end of 2020. See *U.S. CMBS Delinquencies Resume Increase in October*, *supra* note 34.

39. See Paul Bubny, *CMBS Delinquencies Spike in June; Near 2012 Peak* (July 6, 2020) <https://www.connectcre.com/stories/cmbs-delinquencies-spike-in-june-near-2012-peak> [<https://perma.cc/3H2H-25K8>].

40. See Peter J. Irwin et al., *CMBS Loan Workouts During COVID-19: A Borrower’s Perspective*, DEBEVOISE & PLIMPTON (May 14, 2020), <https://www.debevoise.com/-/media/files/insights/publications/2020/05/20200514-cmbs-loan-workouts-during-covid-19.pdf> [<https://perma.cc/296R-T55P>].

began with a steep decline in value in the housing market, which sent shockwaves through the rest of the economy.⁴¹ Though different sources of disruption, they may both be primers for systemic risk.

Systemic risk might be quickly defined as the risk that disruption in the financial system will cause the collapse of the real economy.⁴² As an example of systemic risk in action, the 2007–08 Financial Crisis was ultimately the product of erroneous market expectations.⁴³ Investors, rating agencies, and borrowers misapprehended the ability of homeowners to maintain mortgage payments, and firms and lenders found themselves overleveraged at both the institutional and loan level when the housing market deteriorated in 2007.⁴⁴ As residential mortgages, particularly sub-prime mortgages, began to default, firms that were heavily invested in RMBS began to incur steep losses.⁴⁵ Out of panic or uncertainty, the public and other firms retreated from institutions associated with asset-backed securities, and soon, firm liquidity and public credit evaporated.⁴⁶ The recession swept in, and the failure of market expectations precipitated the failure of the real economy.

In the wake of the 2007–08 Financial Crisis, a wealth of literature has spread discussing the role of banks,⁴⁷ insurance companies,⁴⁸ and the

41. See Ingrid Gould Ellen & Samuel Dastrup, *Housing and the Great Recession*, FURMAN CTR. (Oct. 2012), <https://furmancenter.org/files/publications/HousingandtheGreatRecession.pdf> [<https://perma.cc/V22L-3R33>].

42. See Steven L. Schwarcz, *Systematic Regulation of Systemic Risk*, 2019 WIS. L. REV. 1, 2–3 (2019).

43. See Howell E. Jackson & Steven L. Schwarcz, *Pandemics and Systemic Financial Risk* 5 (Apr. 19, 2020) (unpublished manuscript), <https://ssrn.com/abstract=3580425> [<https://perma.cc/R6YK-3BDQ>].

44. See *id.*

45. *Id.*

46. *Id.*

47. See, e.g., Rebecca Keats, *U.S. Banks Played a Pivotal Role in the 2008 Financial Crisis*, MKT. REALIST (Jan. 2016), <https://marketrealist.com/2015/11/us-banks-played-pivotal-role-2008-financial-crisis> [<https://perma.cc/MPK8-NSML>].

48. See, e.g., *Prudential Is Freed From “Too Big to Fail” Label and the Tough Oversight That Came With It*, L.A. TIMES (Oct. 17, 2018), <https://www.latimes.com/business/la-fi-prudential-too-big-to-fail-20181017-story.html> [<https://perma.cc/NKL5-UDB9>].

interdependence of markets in the creation of systemic risk.⁴⁹ While the literature generally agrees that systemic risk arises from any disturbance that works itself through the economic system to an extent that compromises the public's confidence in the financial system and its stability as a whole, scholars offer numerous methods of quantifying, measuring, and insuring against systemic risk.⁵⁰ These methods deserve a student's note worth of discussion all their own.

In short, systemic risk is tied to size. If a financial institution is large enough, and if a financial market is massive enough, then the failure of the institution or the market will result in the collapse of all related institutions or markets.⁵¹ Though the securitization of sub-prime residential mortgages is among the most commonly cited reasons behind the 2007–08 Financial Crisis,⁵² Congress sought to eliminate other issues in the CMBS markets which it perceived to have played a role in the economy's collapse.⁵³ While Congress sought to curb these behaviors, there is still no certainty whether the CMBS market, on its own, contributes to systemic risk.⁵⁴

During the period between 1998 and 2007, the CMBS market rapidly expanded and CMBS became the dominant financing vehicle for the commercial real estate industry.⁵⁵ As the popularity of CMBS grew, so too did its investor pool. Where B-Piece investors were once the same pool of sophisticated risk-savvy investors,⁵⁶ the subordinated tranche of CMBS increasingly became the eye for investors in CDOs, or collateralized debt obligations.⁵⁷ These investors profited by purchasing, packaging, and re-securitizing the first-loss B-Piece to its own pool of investors.⁵⁸ This “originate to securitize” model eliminated risk to

49. See, e.g., Caroline Bradley, *Breaking Up Is Hard to Do: The Interconnection Problem in Financial Markets and Financial Regulation, a European (Banking) Union Perspective*, 49 TEX. INT'L L.J. 271, 272 (2014).

50. See generally Cristina Georgiana Zeldea, *Systemic Risk: An Overview*, 2019 FIN. STUD. 35, 38–43 (2019).

51. See Joseph Haubrich & Charlotte DeKoning, *Sizing Up Systemic Risk*, 13 ECON. COMMENT. 1, 1 (2017).

52. See Adam J. Levitin & Susan M. Wachter, *The Commercial Real Estate Bubble*, 3 HARV. BUS. L. REV. 83, 84 (2013).

53. See *infra* Part II.

54. See Levitin & Wachter, *supra* note 52, at 108.

55. See *id.* at 97.

56. *Id.* at 98.

57. See *id.* at 102.

58. *Id.*

originators, while exposing a less sophisticated market participant to the most risk-laden investment in CMBS.

As competition for subordinated and other classes of CMBS securities increased, underwriting standards deteriorated.⁵⁹ Debt-service-coverage ratios (“DSCRs”) declined during this period, meaning that mortgage cash flows were increasingly unable to cover the underlying commercial collateral’s debt obligations.⁶⁰ Studies of commercial real estate associate a decline of DSCR ratio with defaults in mortgage loans.⁶¹

Meanwhile, rating agencies, facing a fierce level of competition among one another, were quick to give risky CMBS investments higher grades.⁶² Thus, originators became less scrupulous regarding the health of the underlying collateral, just as rating agencies became more likely to overlook the signs of a risky investment in order to win more business. These perverse incentives lead to a CMBS market rife with misinformation between lenders and originators, resulting in dangerous consequences for investors. When the CMBS market collapsed in 2007, Congress and market-watchers took note of the rampant moral hazard and focused their regulatory efforts on eliminating these issues.

D. DODD-FRANK AND CMBS

In response to the 2007–08 Financial Crisis, lawmakers enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act.⁶³ The single largest piece of modern financial legislation targeted changes in multiple areas of financial markets, which included numerous provisions aimed at asset-backed securities (“ABS”).⁶⁴ The Act empowered the Securities and Exchange Commission and other

59. *See id.* at 104.

60. *See id.*

61. J. Zachary Monsma & Janet G. Price, *A Property Market Framework for Bond Investors*, in *THE HANDBOOK OF COMMERCIAL MORTGAGE-BACKED SECURITIES* 237, 240–41 (Frank J. Fabozzi & David P. Jacob eds., 1997).

62. *See* Levitin & Wachter, *supra* note 52, at 108.

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

64. DODD-FRANK: WHAT IT DOES AND WHY IT’S FLAWED 11, 103–04 (Hester Peirce & James Broughel eds., 2012).

agencies with broad rulemaking powers pursuant to regulating markets.⁶⁵

As a result of these agency delegations, numerous regulations that affect CMBS have gone into effect over the last decade, including risk-retention requirements for ABS sponsors, increased disclosure requirements, the Volcker Rule, and enhanced capitalization requirements for banks.⁶⁶

Each of these changes will be discussed in detail in Part II. In Part III, the paper will focus on how these regulations have bolstered the CMBS market against systemic risk incident to the coronavirus.

PART II: REGULATION OF CMBS POST-FINANCIAL CRISIS

Following the challenges faced by the mortgage-backed securities industry during the last recession, Congress and federal agencies enacted several important laws and regulations that affected CMBS.

A. THE VOLCKER RULE

Perceived by some commentators as the most controversial legal change in response to the 2007–08 Financial Crisis,⁶⁷ Section 619 of the Dodd-Frank Act (widely known as the “Volcker Rule,” or herein, “the Rule”)⁶⁸ prohibits banking entities from engaging in proprietary trading and from sponsoring or investing in a hedge or private equity fund.⁶⁹ Among the various policy justifications behind the Volcker Rule, the

65. CURTIS W. COPELAND, CONG. RSCH. SERV., RULEMAKING REQUIREMENTS AND AUTHORITIES IN THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 2 (2010).

66. See, e.g., 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); SEC Asset-Backed Securities Disclosure and Registration, 17 C.F.R. § 229 (2014); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–21 (2010) (codified at 12 U.S.C. § 1851 (2012)); John Walter, *U.S. Bank Capital Regulation: History and Changes Since the Financial Crisis*, 105 ECON. Q. 1, 2 (2019).

67. Ryan Bubb & Marcel Kahan, *Regulating Motivation: A New Perspective on the Volcker Rule*, 96 TEX. L. REV. 1019, 1020 (2018).

68. The Rule inherits its name from its proponent, former Chairman of the Federal Reserve Paul Volcker. Jordan Schiff, *The Volcker Rule in Practice: Its Impact, Reception, and Evolving Profile*, 2020 COLUM. BUS. L. REV. 744, 745 (2020).

69. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–21 (2010) (codified at 12 U.S.C. § 1851 (2012)).

most salient is that banks, because of their importance to the stability of the economy, should not trade on their own account, and should not invest in funds on its own account, because of the risk of the bank's failure, or the bank's failure or loss in liquidity by virtue of its exposure to a failed fund.⁷⁰

Proponents of the Volcker Rule point to the conflicts of interest that existed before the Rule's existence—banks exploiting client information to make trades on their own account, or even selling financial products to clients which were designed to fail.⁷¹ These banking abuses, however, are not associated with the collapse of the economy in 2008, or with systemic risk in general.⁷² For example, the Volcker Rule does not prevent banks from originating, selling, or investing in subprime mortgages—practices that are associated with the 2007–08 Financial Crisis. Indeed, the efficacy of the Volcker Rule as a macroprudential device has been in question since before its enactment.⁷³

Though the Rule permits banks to engage in “market-making,”⁷⁴ lawmakers and commentators at the time of the Rule's enactment recognized the challenge faced by regulators who would have to distinguish between illegal proprietary trading and legal market-making activity.⁷⁵ In response to fear of running afoul of the Volcker Rule,

70. See Jeff Merkley & Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. LEGIS. 515, 533 (2011).

71. *Id.* at 523.

72. See Kim Dixon & Karey Wutkowski, *Volcker: Proprietary Trading Not Central to Crisis*, REUTERS (Mar. 30, 2010), <http://www.reuters.com/article/GCA-Economy2010/idUSTRE62T56420100330> [<https://perma.cc/A5FE-HW4V>].

73. Letter from Spencer Bachus, Ranking Member, United States House of Representatives to Members of the United States Dep't of the Treasury, Fin. Servs. Oversight Council (Nov. 3, 2010) (on file with author).

74. Lee Meyerson & Keith Noreika, *Finalized Changes to Volcker Rule*, HARV. L. SCH. F. ON CORP. GOV. (Sept. 12, 2019), <https://corpgov.law.harvard.edu/2019/09/12/finalized-changes-to-volcker-rule> [<https://perma.cc/M8PM-VCBJ>].

75. See *Implications of the “Volcker Rules” for Financial Stability*, *supra* note 73, at 1312 (statement of Sen. Christopher Dodd, Chairman of the S. Banking, Hous. & Urb. Affs. Comm.) (stating that an individual in the banking industry told him that he “can find a way to say that virtually any trade we make is somehow related to serving one of our clients. They can go ahead and impose the rule on Friday, and I can assure you that by Monday we will find a way around it.”).

commentators have posited that banks have contracted their market-making functions.⁷⁶

According to the Mortgage Bankers Association of America, one of the largest lobbying firms in CMBS,⁷⁷ the Rule has “hindered both market making functions necessary to ensure a healthy level of market liquidity and hedging necessary to mitigate risk.”⁷⁸ In May 2018, the Chairman of the Consumer Real Estate Finance Council stated that the Council would work with regulators and members on changes to the current compliance regime to restore liquidity in CMBS to a “level that has been lacking post the enactment of the Volcker Rule.”⁷⁹ In October 2019, a collection of federal agencies⁸⁰ amended the Volcker Rule to exclude privately offered credit funds from “covered funds” under the Volcker Rule.⁸¹ The agencies acknowledged that the original rule “‘inhibited’ the ability of banking entities to originate loans and extend credit, in contravention of the intent of the Volcker Rule.”⁸²

Whether the recent amendment to the Volcker Rule will increase liquidity in the CMBS marketplace and stave off the commercial mortgage crisis remains to be seen.⁸³ As of May 2021, the delinquency

76. Simon Nixon, *Why Liquidity-Starved Markets Fear the Worst*, WALL ST. J. (May 20, 2015), <https://www.wsj.com/articles/why-liquidity-starved-markets-fear-the-worst-1432153849> [<https://perma.cc/37A9-5ZZW>] (“Banks have become so reluctant to make markets that it has become hard to execute large trades even in the vast foreign-exchange and government-bond markets without moving prices, raising fears investors will take unexpectedly large losses when they try to sell.”).

77. *Client Profile: Mortgage Bankers Ass’n of America*, OPENSECRETS.ORG, <https://www.opensecrets.org/federal-lobbying/clients/summary?cycle=2003&id=D000000309> [<https://perma.cc/UM3V-4BCT>] (last visited Aug. 20, 2021) (illustrating that the Mortgage Bankers Association employed 24 lobbyists in 2020).

78. Erika Morphy, *The Volcker Rule’s Proposed Revision Could Add Liquidity to CMBS*, GLOBEST.COM (May 31, 2018, 7:31 AM), <https://www.globest.com/2018/05/31/the-volcker-rules-proposed-revision-could-add-liquidity-to-cmbs> [<https://perma.cc/QVW9-UHMX>].

79. *Id.*

80. *Volcker Rule 2.0: Some Helpful Upgrades and Bug Fixes—Update Your Volcker Policies and Procedures Now*, CLIFFORD CHANCE (Oct. 2019), <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2019/10/volcker-rule-2-0-some-helpful-upgrades-and-bug-fixes-update.pdf> [<https://perma.cc/Y332-GMZN>].

81. SEC Covered Funds Activities and Investments, 17 C.F.R. § 255.10 (2014).

82. *Id.*

83. *See Newly Adopted Volcker Rule Amendments Expand Opportunities for Banks to Sponsor and Invest in Private Credit Funds*, CLIFFORD CHANCE (July 2020), <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/07/Newly->

rate in the CMBS marketplace was 4.12%.⁸⁴ If the amendment does counteract the deterioration of CMBS then it is notable that deregulation of the CMBS industry, and not increased regulation, has had a positive effect.

B. REGULATION AB II

In 2014, the SEC deployed amendments to Regulation AB and other disclosure-based regulations to require increased disclosure regarding asset-backed security offerings, including commercial mortgage-backed securities.⁸⁵ These regulatory changes, collectively termed “Regulation AB II,” were a response to “concerns about the operation of [the SEC’s] rules in the securitization market.”⁸⁶ In its summary of the changes to the rules, the SEC remarked that “the financial crisis highlighted that investors and other participants in the securitization market did not have the necessary information and time to be able to fully assess the risks underlying asset-backed securities and did not value asset-backed securities properly or accurately.”⁸⁷

Specifically, the SEC attributed “the failure[s] of credit ratings” and “the collapse of ‘investment-grade rated securities’” to the economic devastation wrought by the 2007–08 Financial Crisis.⁸⁸ Thus, Regulation AB II seeks to provide ABS investors with “improved pricing accuracy,” unfiltered by credit rating agencies, in the form of mandated asset-level data disclosures.⁸⁹ For CMBS issuers, “[t]he asset-level data required will, in general, include information about the credit quality of the obligor, the collateral related to each asset, the cash flows related to a particular asset, such as the terms, expected payment amounts, indices

Adopted-Volcker-Rule-Amendments-Expand-Opportunities-for-Banks-to-Sponsor-and-Invest-in-Private-Credit-Funds.pdf [https://perma.cc/C6QZ-FK6G].

84. U.S. CMBS Delinquencies Tick Up in April for First Time since October 2020, FITCH RATINGS (May 7, 2021), <https://www.fitchratings.com/research/structured-finance/us-cmbs-delinquencies-tick-up-in-april-for-first-time-since-october-2020-07-05-2021> [https://perma.cc/8Z5K-LW4P].

85. Charles A. Sweet, *The SEC Finally Adopts Regulation AB II*, 20 J. STRUCTURED FIN. 22, 22 (2015).

86. SEC Asset-Backed Securities Disclosure and Registration, 17 C.F.R. § 229 (2014).

87. *Id.* at 10.

88. *Id.* at 12.

89. *Id.* at 41.

and whether and how payment terms change over time and the performance of each asset over the life of a security.”⁹⁰

In addition to asset-level data disclosures, Regulation AB II increased required disclosures from minority originators,⁹¹ required issuers to provide prospectuses to investors five days before sale,⁹² and mandated the appointment of an “assets representations reviewer.”⁹³

Notably, Regulation AB II also requires that the Chief Executive Officer in charge of the securitization certify that, inter alia, she has reviewed, and is familiar with the pool assets, the structure of the securitization, and all material transaction documents; that the prospectus does not contain any untrue statements; and that the prospectus and registration fairly present the risks of ownership of the proposed ABS.⁹⁴ The CEO certification requirement makes senior officers liable under Section 11 of the Securities Exchange Act for material misstatements or omissions.⁹⁵ According to the SEC, prior to Regulation AB II, it had “been difficult to hold senior officers of ABS issuers accountable for the failure to provide accurate information.”⁹⁶

Thus, Regulation AB II broadly focuses on correcting investor over-reliance on credit agencies, on the pre-recession challenge of punishing CEOs, and to regulate more parties involved in ABS transactions. Despite the overhaul of ABS disclosures, a recent ProPublica report suggests that rampant fraud and material misstatements continue to plague the CMBS sector.⁹⁷ Furthermore, it remains unclear how increased disclosure requirements can reduce systemic risk in CMBS.

90. *Id.* at 72.

91. *See Sweet, supra* note 86, at 24.

92. 17 C.F.R. § 229.

93. *Sweet, supra* note 86, at 26.

94. 17 C.F.R. § 229.

95. *Id.*

96. *Id.* at 332.

97. *See* Heather Vogell, *Whistleblower: Wall Street Has Engaged in Widespread Manipulation of Mortgage Funds*, PROPUBLICA (May 15, 2020), <https://www.propublica.org/article/whistleblower-wall-street-has-engaged-in-widespread-manipulation-of-mortgage-funds> [<https://perma.cc/DU29-VS6J>].

C. CAPITALIZATION REQUIREMENTS

Every federally insured depository institution in the United States is required by law to maintain adequate levels of capital.⁹⁸ Without a capitalization requirement, United States regulators believe banks would tend to retain less capital and make riskier investments because they know “governments and deposit insurers [will] end up holding the bag” if their investments go sour.⁹⁹

Following the 2007–08 Financial Crisis, Dodd-Frank enacted changes to United States capital requirements, which affected the CMBS market.¹⁰⁰ Under the current scheme, banks that participate in “plain vanilla banking activities” need only be “adequately capitalized,” while banks that engage in CMBS trading need to be “well capitalized.”¹⁰¹

Notably, risk-based capital requirements also apply to insurance companies.¹⁰² At the end of 2019, \$173.5 billion worth of life-insurance CMBS holdings were included in risk-based capital computations.¹⁰³

According to CMBS insiders, the risk-weighting of CMBS under these regulations has negatively impacted private-label CMBS and made CMBS more expensive under risk-based capital rules.¹⁰⁴ During the peak of the CMBS market in 2007, outstanding debt exceeded \$800 billion.¹⁰⁵ In March 2020, outstanding debt for the CMBS market had

98. See John Walter, *U.S. Bank Capital Regulation: History and Changes Since the Financial Crisis*, 105 *ECON. Q.* 1, 2 (2019).

99. *Id.* at 1 (quoting Sheila Bair).

100. See generally Letter from Com. Real Est. Fin. Council et. al, to Hon. Janet Yellen (Dec. 2, 2016) [hereinafter C.R.E. Letter] (on file with the National Multifamily Housing Council), https://www.nmhc.org/uploadedFiles/Advocacy/CRE%20Associations%20B-IV%20Letter_120216%20Final.pdf [https://perma.cc/PKN3-DAUK].

101. *Dodd-Frank: Minimum Capital Requirements*, MOODY'S ANALYTICS (Mar. 1, 2011), <https://www.moodyanalytics.com/-/media/article/2011/11-01-03-dodd-frank-act-regulations-minimum-capital-requirements.pdf> [https://perma.cc/MES2-63CS].

102. *Risk-Based Capital*, NAT'L ASS'N INS. COMM'RS (June 24, 2020), https://content.naic.org/cipr_topics/topic_riskbased_capital.htm [https://perma.cc/7SXV-2YCD].

103. Louie Woodall, *U.S. Life Insurers Exposed to \$130bn of CMBS*, RISK QUANTUM (Apr. 7, 2020), <https://www.risk.net/risk-quantum/7522206/us-life-insurers-exposed-to-130bn-of-cmbs> [https://perma.cc/JX44-XDVP].

104. See C.R.E. Letter, *supra* note 101.

105. Cristopher LaBianca et. al, *Role of CMBS in the Financing of Commercial and Multifamily Real Estate in America*, MORTG. BANKERS ASS'N (Oct. 2019),

fallen to \$490 billion.¹⁰⁶ In comparison, outstanding RMBS debt reached \$2.2 trillion in 2007.¹⁰⁷

Prior to the 2007–08 Financial Crisis, however, favorable risk-weighting of CMBS led to a higher demand and larger market for private-label CMBS.¹⁰⁸ Authors Stanton and Wallace suggest that between 2002 and 2008, regulatorily mandated capital savings were responsible for significant distortions in prices that institutional investors were willing to pay for CMBS when compared to similarly rated RMBS and corporate bonds.¹⁰⁹ Furthermore, Opp, Opp, and Harris argue that regulatory capital shifts prior to the 2007–08 Financial Crisis reduced the incentive of rating agencies to acquire information about underlying assets, leading to inaccurate bond ratings.¹¹⁰

These studies illustrate the influence that capital requirements had over CMBS prior to the financial crisis. Though the size of the market and the complexity of CMBS products have changed since the financial crisis,¹¹¹ the major players in CMBS have remained stable, with hedge funds, capital management firms, and life insurance companies retaining large portions of the sector.¹¹² Given the stability and similar sophistication of CMBS investors over time, alterations in capital requirements may continue to influence buyer-choice in CMBS.

<https://www.mba.org/Documents/CMBS%20White%20Paper.pdf>
[<https://perma.cc/G6NM-DKUZ>].

106. Jennifer Johnson, *Lodging Exposure in U.S. Insurer Commercial Mortgage-Backed Securities (CMBS) Investments, Year-End 2019*, NAT'L ASS'N INS. COMM'RS (2019), <https://content.naic.org/sites/default/files/capital-markets-special-report-lodging-exposure-cmbs-investments.pdf> [<https://perma.cc/KY8Y-P2KA>].

107. *Part 1 of 2: Mortgage Loan and MBS Trends and Relative Instance Industry Exposure—Residential*, NAT'L ASS'N INS. COMM'RS (2019), https://www.naic.org/capital_markets_archive/120809.htm [<https://perma.cc/22AL-ZE8J>].

108. Richard Stanton & Nancy Wallace, *CMBS Subordination, Ratings Inflation and Regulatory-Capital Arbitrage*, 2018 FIN. MGMT. 175, 177 (2018).

109. *Id.* at 179.

110. *Id.* at 176 (citing Christian C. Opp, Marcus M. Opp & Milton Harris, *Rating Agencies in the Face of Regulation*, 108 J. FIN. ECON. 46, 46–47 (2013)).

111. *See supra* Part I.

112. *See Institutional Holders of CMBS*, HOLDINGS CHANNEL (last visited Mar. 31, 2021) <https://www.holdingschannel.com/institutional/holders-of-cmbs> [<https://perma.cc/32M4-GFEQ>]; Hailey Ross & Jason Woleben, *U.S. life insurers' growing commercial mortgage portfolios may face virus pressure*, S&P GLOB. (April 2, 2021) <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-life-insurers-growing-commercial-mortgage-portfolios-may-face-virus-pressure-57760836> [<https://perma.cc/7RX4-U95N>].

In the aftermath of the 2007–08 Financial Crisis, the Financial Stability Oversight Council (“FSOC”) designated numerous institutions as “systemically important financial institutions” (“SIFIs”).¹¹³ Most of these firms were banks, while three of these companies were insurance companies: Prudential, AIG, and MetLife.¹¹⁴ During the course of the Trump administration, regulators either removed these designations or the companies successfully sued to have the designations removed.¹¹⁵

Regardless of their SIFI designation, commentators and lawmakers alike recognize the importance of these institutions to the world economy and may recall the controversial bailout of AIG during the 2007–08 Financial Crisis.¹¹⁶ With exposure to CMBS approximating \$130 billion in April 2020,¹¹⁷ regulators may be wise to deploy risk-based capital rules to forestall yet larger catastrophes due to CMBS positions now and in the future.

D. RISK-RETENTION

According to Barney Frank, the architect behind Dodd-Frank, the “single most important part of the bill”¹¹⁸ was the requirement that regulatory agencies draft a rule mandating that the sponsor of a securitization retain not less than 5% of the credit risk of any asset conveyed to a third party.¹¹⁹ Prior to the 2007–08 Financial Crisis,

113. See Jim Zarroli, *GE Capital Wants Off the List of Too-Big-To-Fail Institutions*, NPR (Mar. 31, 2016, 12:33 PM), <https://www.npr.org/sections/thetwo-way/2016/03/31/472535899/ge-capital-wants-off-the-list-of-too-big-to-fail-institutions> [<https://perma.cc/7WDG-GMGV>]; see also John Heltman, *Prudential, the last nonbank SIFI, sheds the label*, AM. BANKER (Oct. 17, 2018, 9:08 AM), <https://www.americanbanker.com/news/prudential-the-last-nonbank-sifi-sheds-the-label> [<https://perma.cc/H8FS-W7Y3>].

114. See Renae Merle, *AIG Is No Longer ‘Too Big to Fail,’ Regulators Say*, WASH. POST (Sept. 29, 2017, 7:47 PM), <https://www.washingtonpost.com/news/business/wp/2017/09/29/aig-is-no-longer-too-big-to-fail-regulators-say> [<https://perma.cc/C6D2-V273>].

115. See *id.*

116. See *id.*

117. See Woodall, *supra* note 104.

118. 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> [<https://perma.cc/NS4F-X576>].

119. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941, 124 Stat. 1376, 1891–92 (2010).

lenders increasingly profited by originating loans and then off-loading their risk by selling them into securitization pools.¹²⁰ This process increased bank liquidity and made credit more widely available, but disincentivized banks to engage in adequate underwriting.¹²¹ This “originate-to-distribute” model is associated with widespread deterioration in asset-backed securities during the Financial Crisis.¹²²

In 2014, then-SEC Commissioner Luis Aguilar remarked that “risk retention rules are intended to align the incentives of sponsors and ABS investors by requiring sponsors to retain a financial interest and maintain skin in the game.”¹²³

Four years after the passage of Dodd-Frank, and two years after the passage of the final rule, the 5% risk-retention requirement took effect in late 2016 for new issuance of CMBS.¹²⁴

Sponsors of CMBS may comply with the 5% risk-retention requirement in one of three ways: by retaining an eligible horizontal residual interest, an eligible vertical interest, or an “L-shaped” slice—some combination equaling at least 5% of the fair market value of the security.¹²⁵

Retaining an eligible vertical interest translates into holding an equal portion of each tranche of the security equaling 5% of the total risk of the security.¹²⁶ Sponsors may also retain a 5% horizontal share of the most subordinated class of the security, the so-called B-Piece.¹²⁷ Because of the first-loss nature of the B-Piece buyer, investors in this position are considered more sophisticated, and hence, need not take on additional interest in the security.¹²⁸ The “L-shaped” interest may be captured by combining some vertical or horizontal interests in the

120. See Public Statement, Luis A. Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, *Skin in the Game: Aligning the Interests of Sponsors and Investors* (Oct. 22, 2014), <https://www.sec.gov/news/public-statement/2014-spch102214laa> [https://perma.cc/MVA5-CNC6].

121. See *id.*

122. See *id.*

123. *Id.*

124. 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) (“Compliance with the rule with regard to [CMBS] is required beginning December 24, 2016.”).

125. See *id.* at 77604, 77644.

126. See *id.* at 77607.

127. See *id.*

128. See *id.* at 77724.

security, so long as they equate to no less than 5% of the aggregate risk of the security.¹²⁹

Initial responses from the CMBS market to the risk-retention rules were grim: Some experts declared that the minimum 5% vertical interest to be too expensive for most sponsors,¹³⁰ while others insisted that the opacity of the rules would slow the market to a crawl.¹³¹ Despite these initial concerns, new issuance in CMBS has climbed in every year since the Financial Crisis.¹³²

In addition to failing to slow the issuance of CMBS, Sean J. Flynn Jr. and his colleagues suggest that risk-retention rules serve to reduce asymmetrical information between buyer and seller.¹³³ In addition to ensuring that sponsors retain some “skin in the game,” a driving force behind risk-retention was addressing information asymmetry between issuers and investors.¹³⁴ This asymmetry, according to the SEC, gave rise to the moral hazard of sponsors incurring risks when they knew they would not be exposed to the losses.¹³⁵

Under Flynn, Ghent & Tchistyi’s analysis, the choice of risk-retention structure (i.e., horizontal residual interest, vertical interest, etc.) influences bond pricing.¹³⁶ The study reveals that bond issuers are able to sell bonds for higher prices when the loan sponsor retains

129. See *id.* at 77607.

130. See Allison Bisbey, *Why Risk Retention Rules May Give Big Banks the Edge in CMBS*, AM. BANKER (Aug. 19, 2016), <https://www.americanbanker.com/news/why-risk-retention-rules-may-give-big-banks-the-edge-in-cmbs> [https://perma.cc/QE4Y-8VH].

131. *Risk Retention Clarity Is Key to CMBS Future*, SUMMER ST. ADVISORS (July 12, 2016), <https://summerstreetre.com/risk-retention-clarity-is-key-to-cmbs-future> [https://perma.cc/9XHF-9MY3].

132. Orest Mandzy, *CMBS Issuance Hit \$96.7B in 2019: Who Were the Most Active Bookrunners?*, TREPP (Jan. 8, 2020), <https://info.trepp.com/trepp-talk/cmbs-issuance-hits-96-7-billion-in-2019-who-are-the-most-active-bookrunners> [https://perma.cc/E23G-FL2C].

133. Sean J. Flynn Jr. et al., *Informational Efficiency in Securitization After Dodd-Frank*, 33 REV. FIN. STUD. 5131, 5132 (2020).

134. See Credit Risk Retention, 79 Fed. Reg. at 77706.

135. *Id.* at 77705 (“The informational asymmetries in securitization markets generated between the borrower and the investors in the asset-backed securities, who are the ultimate providers of credit, give rise to the moral hazard problem of loan originators or securitization sponsors incurring risks in the underwriting or securitization process for which they did not bear the consequence.”).

136. See Flynn Jr. et al., *supra* note 134, at 5149–50.

a horizontal residual structure of the most subordinated class.¹³⁷ In effect, issuers can signal to buyers that the collateral supporting the security is of satisfactory quality by taking on the riskiest portion of the transaction.¹³⁸ If risk-based capital rules are the blunt swords that massively influence the cost of capital in CMBS investments, risk-retention rules are the fine blades that issuers deploy to signal to buyers that the underlying transaction is a strong one.

PART III: DODD-FRANK'S LEGACY AND THE CORONAVIRUS

Despite the wide-sweeping nature of Dodd-Frank's reforms, it has failed to calibrate the CMBS market to withstand exogenous shocks, such as those resulting from a pandemic. Despite a strong 2019, the CMBS market deteriorated in the fall of 2020.¹³⁹ Meanwhile, the CMBS market is smaller¹⁴⁰ and has fewer unique participants¹⁴¹ in 2020 than it did in 2007. Dodd-Frank may be partly responsible for these observations. Given the contraction of the CMBS market, and the fact that the public and other banks are not retreating from CMBS participants, the deterioration of CMBS may not pose a systemic risk to the economy.

A. DODD-FRANK'S EFFECT ON MODERN CMBS

The current CMBS market is a fraction of the size of its peak in 2007.¹⁴² This may in part be the result of Dodd-Frank regulation. The Dodd-Frank risk-retention requirement has made CMBS more expensive to both borrowers and issuers. Since the implementation of risk-retention, borrowers pay higher interest rates to obtain less

137. See *id.* at 5153.

138. *Id.* at 5135–36.

139. Jake Mooney & Chris Hudgins, *Coronavirus Jolts CMBS Pricing and 2020 Issuance Expectations*, S&P GLOB. MKT. INTEL. (Apr. 9, 2020), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/coronavirus-jolts-cmbs-pricing-and-2020-issuance-expectations-57965361> [<https://perma.cc/6GU2-L89H>].

140. See LABIANCA ET AL., *supra* note 106, at 10.

141. See DIANA KNYAZEVA ET AL., *ISSUANCE ACTIVITY AND INTERCONNECTEDNESS IN THE CMBS MARKET* 37 (2016).

142. See CATHERINE LIU, TREPP, *NEARLY \$100 BILLION OF CMBS LOANS COME DUE THROUGH 2020* 1 (2019), <https://info.trepp.com/hubfs/Maturities%20Due%20Through%202020%20-%20January%202019.pdf> [<https://perma.cc/3D6T-L93J>].

favorable loan terms while issuers retain more risk than they did before risk retention.¹⁴³ While this has the effect of making CMBS safer to investors,¹⁴⁴ the market has contracted since the implementation of risk-retention rules.¹⁴⁵

Additionally, investors now use risk-retention structure as a signal for collateral quality.¹⁴⁶ Where investors once evaluated the amount of risk that an issuer retained for themselves a signal for collateral quality, all issuers must now retain 5% of the credit risk.¹⁴⁷ Since issuers do not retain more than 5%, investors now look to an issuer's choice of risk-retention structure to determine the security's quality.¹⁴⁸ At the present moment, it is unclear whether retention-structure is a more efficient signal than pre-Dodd-Frank volume-of-risk signaling.¹⁴⁹ As a result, risk-retention rules have made CMBS more expensive to issuers, and possibly less efficient to investors.

As detailed in Part II, capitalization requirements have made the CMBS market a challenging entry point for smaller banks who lack the capital reserves to support significant CMBS holdings.¹⁵⁰ In effect, the participants in the CMBS market are increasingly large banks.¹⁵¹ In the first quarter of 2020, the eight largest loan contributors to CMBS were Citibank, Goldman Sachs, Morgan Stanley, Deutsche Bank, JPMorgan Chase, Wells Fargo, and Bank of America.¹⁵² These eight institutions all fall within the top twenty largest banks by asset size in the United

143. Craig Furfine, *The Impact of Risk Retention Regulation on the Underwriting of Securitized Mortgages*, 58 J. FIN. SERVS. RSCH. 91, 93 (2020).

144. *Id.*

145. *See* LIU, *supra* note 143, at 1.

146. SEAN J. FLYNN JR. ET AL., RISK RETENTION AND INFORMATION IN THE FACE OF REGULATION 4-5 (2019).

147. *Id.* at 3, 6.

148. *Id.* at 3.

149. *See* Furfine, *supra* note 144, at 92, 100 (finding that commercial mortgages securitized in deals after risk-retention rules went into effect were subject to higher interest rates, lower loan-to-value ratios, and higher risk-debt-service ratios; thus, CMBS has become more expensive to borrowers in the wake of risk retention).

150. *See supra* Part II.

151. *Data Rankings Top CMBS Loan Contributor*, COM. REAL EST. DIRECT, <https://crenews.com/data-rankings-top-cbms-loan-contributor> [https://perma.cc/D2MS-M7W8] (last visited Dec. 24, 2020).

152. *Id.*

States.¹⁵³ Their combined market share for all new issuance of CMBS in Q1 2020 was just over 69%.¹⁵⁴ This top-8 concentration among loan contributors resembles the top-8 market share of loan contributors before the 2007–08 Financial Crisis.¹⁵⁵

Prior to the Great Recession, industry regulators warned that a high concentration of commercial real estate holdings would make institutions vulnerable to “cyclical commercial real estate markets.”¹⁵⁶ Additionally, with a high concentration among top loan contributors the market is more vulnerable to shocks.¹⁵⁷

Similarly, industry commentators allege that the Volcker Rule has diminished the capacity of banks to function as market-makers, making CMBS more challenging to trade.¹⁵⁸ Though the Rule has a carve-out for market-making, banks may be reticent to trade CMBS if they doubt regulator’s capacity to distinguish between market-making and illegitimate transactions.

This is not to suggest that Dodd-Frank has made CMBS a safer market space for investors. Indeed, Dodd-Frank intended to eliminate information asymmetry and align incentives between banks and investors, but the predominant observation following the Dodd-Frank reforms has been the decline of new issuance in CMBS.¹⁵⁹

153. See *Biggest U.S. Banks By Asset Size (2021)*, MX TECHS. INC. (Jun. 9, 2020), <https://www.mx.com/moneysummit/biggest-banks-by-asset-size-united-states> [https://perma.cc/2NTL-H7CD].

154. See *id.*

155. See KNYAZEVA ET AL., *supra* note 142, at 23–24.

156. Sam Chandan, *The Past, Present, and Future of CMBS*, WHARTON REAL EST. REV. (Spring 2012) at *2, <https://realestate.wharton.upenn.edu/wp-content/uploads/2017/03/730.pdf> [https://perma.cc/9W XF-BV2K].

157. Thorsten Beck, Olivier De Jonghe & Klass Mulier, *Bank Sectoral Concentration and Risk: Evidence from a Worldwide Sample of Banks*, (July 18, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2959273 [https://perma.cc/V62Y-9QR4].

158. *MBA Advocates Volcker Rule Changes to Improve CMBS Market Making*, MORTG. BANKERS ASS’N (Sept. 28, 2017), <https://newslink.mba.org/cmf-newslinks/2017/september/mba-cmf-newslink-9-28-17/mba-advocates-volcker-rule-changes-to-improve-cmbs-market-making> [https://perma.cc/6GCM-L7XG].

159. Origination of CMBS loans reached \$230.5 billion in 2007 but has not increased beyond \$95.5 billion in 2019. STATISTA RSCH. DEP’T, VOLUME OF COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS) ORIGINATIONS IN THE UNITED STATES FROM 2000 TO 2020 (Nov. 26, 2020), <https://www.statista.com/statistics/942195/volume-cmbs-originations-usa> [https://perma.cc/79LR-LWMS].

B. THE CORONAVIRUS FALLOUT IN CMBS

Despite the recent downturn in the CMBS market due to the coronavirus pandemic, the real economy is insulated from the disturbances in the CMBS landscape. As discussed in Part I, market size is a factor that economists commonly consider relevant in systemic risk analysis.¹⁶⁰

As discussed in Part II, total outstanding debt in the CMBS market in March 2020 was \$480 billion.¹⁶¹ At the peak of the CMBS market in 2007, there was \$800 billion in total outstanding debt.¹⁶² Since the 2007–08 Financial Crisis and the implementation of Dodd-Frank, the CMBS market has markedly contracted. The CMBS market is now about half the size of the CMBS market before the last recession.¹⁶³ Some commentators are uncertain whether CMBS contributed to systemic risk even at the height of dysfunction in the CMBS market in 2007.¹⁶⁴ Since the market is now half its peak size, it follows that the CMBS market poses even less systemic risk than its mid-2000s predecessor.

Though the market remains concentrated at the top, with the same major participants as 2007,¹⁶⁵ Dodd-Frank has unwittingly neutralized the market's potential to pose systemic risk. Where Congress sought to root out the moral hazard that it believed contributed to the 2007–08 Financial Crisis, the Dodd-Frank reforms instead succeeded in minimizing the market's potential to contribute to global economic instability. However, instead of eliminating the behaviors it saw as risk-making, the reforms only made those behaviors less profitable.¹⁶⁶

160. See Haubrich & DeKoning, *supra* note 51, at 1.

161. See *Risk-Based Capital*, *supra* note 103.

162. *Id.*

163. *Id.*

164. See Catherine Liu, *The Great Financial Crisis vs. Covid-19: The Impact on Commercial Real Estate & CMBS*, TREPP (Oct. 29, 2020), <https://www.trepp.com/trepp-talk/great-financial-crisis-vs-coronavirus-market-disruption-impact-on-cre-cmbs> [<https://perma.cc/8W65-LT94>] (noting that the deterioration of the CMBS market took longer to play out and did not coincide with the height of the Great Financial Crisis).

165. See KNYAZEVA ET AL., *supra* note 142, at 22, 41.

166. See Vogell, *supra* note 98.

Risk retention rules made CMBS more expensive to smaller investors and also made signaling less efficient.¹⁶⁷ The Volcker Rule made market-making more challenging for banks.¹⁶⁸ Risk-based capital rules made CMBS holdings more expensive for banks.¹⁶⁹ These measures, as narrowly intentioned as they might have been, resulted in broad and sweeping effects. Dodd-Frank and the disasters of RMBS halted all growth in CMBS. Therefore, even as Covid-19 shutters hotels, businesses, and more commercial real estate across the United States, the damage to CMBS is unlikely to cause yet greater damage to the economy. The CMBS market is sufficiently insulated so that a mass-delinquency event in CMBS, such as the United States experienced in 2020, will not trigger a global financial meltdown.

CONCLUSION

The deadly virus which has changed so many aspects of daily life will not harm the world economy through any systemic risk posed by CMBS. Though the virus has wreaked havoc and caused delinquencies to reach near-unprecedented levels in CMBS, the Dodd-Frank reforms have caused the CMBS market to contract to such an extent that further CMBS deterioration will not pose systemic risk to the economy.

167. *See supra* Part II.

168. *Id.*

169. *Id.*