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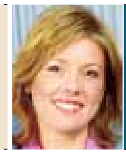

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Reform's Reach

Get to know financial reform's possible impact on commercial real estate

Since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act this past July, there has been much confusion and speculation about its possible impact on commercial real estate. This is likely because the more-than-2,300-page law makes little specific mention of commercial real estate but imposes monumental changes to the regulatory framework that governs a host of the sources from which the commercial real estate sector's capital is derived.

Amid the sea of questions regarding its effect on commercial real estate, it can be safely said that the act, viewed as the most sweeping reform of the U.S. financial system since the Great Depression, will have an important and enduring impact on commercial real estate.

Illustration: Dennis Wunsch

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It will likely take years before the broad regulatory framework the financial-reform act proposes is in place and its repercussions to the financial industry fully visible. It is not too early, however, to look at five big-ticket items that many real estate companies, associations, analysts and others are talking about and that all industry players, including mortgage brokers, should closely heed.

Risk retention

The Dodd-Frank Act mounts safeguards into the mortgage-backed-securities markets to try to thwart the extremes of the past. The law requires banks that issue commercial mortgage-backed securities (CMBS) to have 5-percent "skin in the game." This means lenders securitizing loans must retain ownership of 5 percent of each pool of the CMBS loans they create.

Certain carve-outs for commercial mortgages exist. One carve-out is that regulators can allow alternative risk-retention arrangements. Low-risk mortgages (e.g., those that are fully documented with fixed rates) are also exempt.

Regardless, little doubt exists that all implicated issuers must examine and scrutinize real estate loans more carefully and make sure the paperwork is accurate and complete. This is consistent with the Dodd-Frank Act's requirement that issuers analyze the quality of the underlying assets in the pools they create and meet disclosure requirements about those assets.

Some believe that the 5-percent risk-retention notion should necessitate higher-quality appraisals for commercial properties. These appraisals should have improved quality not only in terms of the process used, but also in terms of having adequate paperwork completed to back them up. The barebones appraisal reports of the past, which often were freely accepted without much scrutiny, should not cut it under this legislation.

With the act's provision for lenders' risk retention, many believe that the commercial real estate market, which has recently begun a hopeful recovery, will see tighter lending standards, more transparency and more accuracy in lending. As a direct result, many believe that there will be a decrease in speculative commercial financing.

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Capital reserves

The Dodd-Frank Act also requires that banks hold more capital reserves. Some believe that significant increases in capital reserves will occur given the amount and nature of recent default rates and loan delinquencies.

Although the exact amount of increased capital reserves that banks will carry is unknown, it is something that industry players should monitor. In fact, some speculate that there will be as much as 20-percent to 30-percent less lending per dollar from what were once called capital reserves.

Credit-rating agencies

The financial-reform act also will impact regulation of credit-rating agencies such as Moody's Investor Service, Standard & Poor's and Fitch Ratings, also known as nationally recognized statistical-rating organizations (NRSROs).

The provisions aimed at NRSROs are designed to improve transparency in the credit-rating process, reduce conflicts of interest, enhance regulation, and augment the Securities and Exchange Commission's enforcement powers.

For example, the law imposes expert liability on the NRSROs that consent to the inclusion of a credit rating in a security registration statement. The law also exposes NRSROs to the same liability as other experts — e.g., lawyers, accountants, engineers, or other professionals whose statements or reports are also used with registration statements.

The law further provides for a lower pleading requirement against NRSROs in government and private lawsuits. This could result in a host of lawsuits by investors against NRSROs and damage awards on levels to which they had not previously been exposed.

The act also mandates the use of standardized forms to publicize the NRSROs' methodologies used in the ratings process. The level of detail to be required is not spelled out, however. The provisions regarding NRSROs, which result in them bearing more risk and liability, are expected to have notable impact on debt-security issuers, underwriters and many others.

Trading and derivatives

Also important to commercial real estate are the financial-reform act's provisions to rein in banks' proprietary trading and limit their ability to own or sponsor hedge funds and private-equity funds — also known as the "Volcker Rule" provisions, named for former Federal Reserve Board chairman Paul Volcker.

This rule requires banks to avoid activity that is commonly viewed as being a big cause of the recent economic mess. Moving forward, banks, their affiliates, depository institutions and the like will be limited to providing debt financing for commercial real estate. This, along with the anticipated escalation of compliance costs, has resulted in some banks leaving the real estate investment and fund businesses altogether, with others considering that path.

The Dodd-Frank Act also imposes wide-ranging regulation of risky derivatives. This implicates commercial real estate because, in some areas, interest-rate swaps have been used for interest-rate stability and protection. Derivatives will not be eliminated, but the act's overarching goal is to make them more transparent and less risky.

Accordingly, costs associated with derivatives could increase and be passed on to borrowers — though perhaps only on a limited basis if competition for the instruments combats the increase.

What the future holds

In terms of positive forecasts for the commercial real estate industry, many signs point to more-conservative underwriting, real equity financing real estate transactions, containment of risk for those in the commercial real estate feeding chain and increased transparency in lending transactions on many levels.

Simply put, the financial-reform act's aim is to provide stability to the financial industry and boost confidence in banks. This should increase banks' ability and desire to lend money on commercial real estate transactions.

There are negative forecasts, however. Possible increased costs for borrowers in light of the act's comprehensive regulation, supervision and compliance is one. Another is the notable challenges to obtaining construction funding and credit generally, particularly from larger banks most impacted by the act and its regulatory scheme.

The tightening of capital requirements for banks and greater regulatory scrutiny may go hand in hand with more expensive credit. Another possibility is that banks will continue to sell off their real estate investment and real estate fund businesses because of the ongoing uncertainty regarding where the massive regulatory reform will go.

Whether these are short-term issues that will pass or longer-term issues that will live on remains to be seen. ●

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