Financial Policies are Changing the Business

By Steve Bergsman,
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When commercial real estate investors, brokers, and lending institutions in the United States lament the strong hand of government oversight on financial markets, they don't realize how rational it all is compared to Europe, where regulations are complex and perplexing – even to Europeans.

Take, for example, this story from Hans-Ulrich Berendes, SIOR, CRE, FRICS, a principal in Hamburg-based Berendes & Partner Consulting GmbH/CORFAC International. Recently, he met with the CEO of a big pension trust in Germany to discuss the acquisition of an office building with a yield of a miserly 2.5 percent. Berendes was a little confused by the pension fund's interest in the building, because the low yield made the deal a negative from the start.

"At the end of the day," he told the CEO, "it will be a business with a minus yield because of the costs of maintenance and management. The deal doesn't make much sense for you."

The CEO responded, "I have so much liquidity in my business and I'm legally forced to invest. I cannot hold liquidity in the balance. I have to invest it somewhere. Even if I get something with a 1 percent yield I would do it because I have to get rid of my liquidity."

And don't get Berendes started on multifamily housing. Europe is facing a crisis in affordable housing, but no one wants to build because residential markets in Germany and elsewhere in Europe are so tightly regulated. "The people who are renting a flat have a lot of rights, in fact they have more rights than owners," says Berendes. "Then there are rental caps imposed by municipalities, which means owners can't get market rents."

In the United States, the Federal Reserve has been slowly inching up interest rates. In March, the Fed raised the benchmark rate for the second time in three months, effectively moving to end its nine-year economic stimulus campaign.

Across the pond, the European Central Bank is in a bind. "Yields and inflation are coming closer so we have to hope there will not be a bubble," says Berendes. "We have to look at the ECB, which has capped the inter-banking rate at zero. If it would go to 0.5 percent or perhaps 1 percent within a year, a lot of owners and developers would go get into financial troubles because it would double interest rates."

The Fed is attempting to end its stimulus program just as some of the key reforms of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was passed in 2010, are kicking in. The roll-out of reforms will continue over the next couple of years with different regulations coming out at different times, observes Ann Hambly, SIOR associate member, founder and president of 1st Service Solutions in Grapevine, Texas.

Remember, the Dodd-Frank Act was designed to regulate the financial markets and protect consumers so extreme economic events, such as the financial crisis that began in 2008 and morphed into a severe recession, doesn't happen again.

Hambly maintains the new regulations will affect borrowers in numerous ways. First, will be an increased cost for borrowers.

"There is no question that the new regulations imposed by the Dodd-Frank Act will increase the overall cost of commercial real estate lending, and lenders have an incentive to pass these costs to borrowers," she says. "Based on some industry estimates, the cost of commercial real estate lending will increase by 10 to 50 bps (basis points)."

Secondly, underwriting standards will be tougher.

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Actually, underwriting standards are already tougher, but as Gabriel Silverstein, SIOR, a managing director at SVN/Angelic, New York City, and SVN Institutional Capital Markets Chair, points out, sometimes standards implementation are not always logical.

"This is not about underwriting standards as much as it is about penalizing the institution for making the loan," he says. "There is a fine line between tighter underwriting standards, which is a good thing, versus tougher regulations that are chiseled in concrete. Due to lesser flexibility, lenders can't do certain loans although they would like to make those loans. Before, they could adjust if they understood the deal."

He gives this example. His company was hired to do the refinancing on a regional mall in Minnesota that was outside of the major metropolitan areas. At first, and as expected, all the lender responses were negative. What took Silverstein by surprise, however, was the absoluteness of the answers, saying "I can't even contemplate this loan" or "I would never look at this deal."

As a blanket statement, the banks were saying they could not lend on a regional mall no matter how good the mall was performing. "It's kind of crazy, because there is no financial reason not to do it," says Silverstein." In fact, this is a good performing asset with reason to expect it will continue to be a good asset for a very long time."

The underlying problem is, Silverstein opines, "lenders that are regulated can't look at it because regulators hate malls so much. Regulators cut with a big machete and they would penalize the lender severely. All the regulating agencies — over banks and life insurers — do nothing but read bad headlines about the asset class. So, it doesn't make a difference how good the asset is, because the regulators say, if you make a loan on that I'm going to penalize you with huge loss reserves."

Silverstein suspects any lender who ends up doing this deal will be in the unregulated group. "Here's another reason why the debt fund universe has dramatically expanded, because they can evaluate based on merit," he exclaims.

Hambly cuts to a different consequence. In regard to underwriting standards, she lists two reasons for the change, and both involve commercial mortgage-backed securities:

Since some of the blame for the Great Recession was placed on the bond ratings given CMBS loan origination, the Dodd-Frank Act created an Office of Credit Ratings at the SEC to provide oversight on rating agencies. The OCR now requires agencies to disclose rating criteria and has the ability to impose sanctions and bring claims against any rating agency for material misstatements.

One of the biggest perceived game changers in CMBS was the implementation of the risk retention provision of the Dodd-Frank Act. Prior to that, CMBS loans were originated, pooled, and sold. Every party involved in the creation of the CMBS pool collected a fee and bondholders took all of the losses. Risk retention now requires the CMBS lender to hold onto 5 percent of the loans it issues.

Risk retention is generally considered one of the more astute changes caused by Dodd-Frank. In theory, it makes for better underwriting because a lender will make a better loan if it has to live with that loan for the life of it.

"If you are a commercial real estate owner and you have a property worth $10 million and you want to put $5 million of debt on it to be 50 percent leveraged, you will likely never feel this change. Any bank will do this loan," says Hambly. "It is when you get up into the more creative solutions and larger loans that you will feel the effect of the regulation. If you're in a tertiary market with CMBS debt and want to go to 80 percent, you are going to feel it."

"The risk retention change went into effect at the end of 2016 and there have been some good and not-so-good effects," says Silverstein. Calling it one of the few "unintended good consequences" of tighter regulations, CMBS pricing has improved. He notes, "The bond market seemingly has sent a message to Wall Street that it likes the idea that Wall Street is still on the hook for those loans, that it forces a level of discipline by the lender that previously didn't exist – and that is a good story for the bond buyer. Hence, pricing has gotten better."

The downside is the CMBS market is not expanding. Although pricing has gotten better, volume is flat compared to last year.

Regulations are one of those scale-of-balance kind of issues; new rules are intended to make things better but there are always unintended consequences somewhere down the line.

As Silverstein comments, “the single biggest impact that has come out of this cycle is that nine years into the up-side we have not seen loan-to-value ratios return to where they were 10 years ago. That may not be a bad thing. If you are a lender it is a good thing. If you are a private developer, it is a bad thing. Today, there are fewer buyers and fewer participants for out-of-the-ground development.”

Hambly agrees, “If you are an investor in debt instruments, it gets safer. If you are a borrower, it is going to be harder for you. The benefits of new regulations depend on where you play in the spectrum.” ▽

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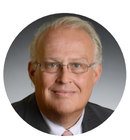

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