

Implications of Financial Reforms For Commercial Real Estate

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The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) poses many questions for the commercial real estate (CRE) industry. Since Dodd-Frank overhauls the regulatory framework governing many of the sources feeding CRE's thirst for capital, the impact of this sweeping law on CRE is likely to be significant and lasting. But since CRE itself is hardly mentioned in this massive statute, we are left to speculate how Dodd-Frank will impact the commercial real estate industry.

It will take years before the financial industry has a clear picture of the regulatory framework created by Dodd-Frank. So, too, the full ramifications of this law for the financing of both new and existing CRE properties will not be known for years to come. But it is not too early to see the contours of the changes that will be coming to CRE and to provide initial answers to some of the questions that people are asking.

1. Will Dodd-Frank Limit Bank Lending to CRE?

The picture here is mixed. On a macro level, Dodd-Frank will stabilize the financial system and bolster confidence in banks which should expand their willingness to lend. On the other hand, the tightening of capital requirements for banks, particularly large banks, and the greater scrutiny by the regulators will likely reduce the amount of credit to CRE and increase the costs of that credit, as compared to the peak years of 2006-2007.

2. Will Dodd-Frank Revive CMBS?

Even before the passage of Dodd-Frank, the CMBS market was starting to show some signs of reawakening. But, unlike portions of the TARP program that are now winding down, Dodd-Frank is not intended

to directly resurrect the CMBS market. Dodd-Frank is intended to install safeguards into the mortgage-backed securities markets to prevent the excesses of the past decade. In particular, Dodd-Frank requires issuers of CMBS to have "skin in the game" and to retain at least a 5% interest in the asset-backed debt they create. In addition, issuers are required to analyze the quality of the underlying assets in the "pool" and to disclose more information about those assets.

A further safeguard enacted by Dodd-Frank is an enhanced regulatory regime for the credit rating industry. This regime will require the rating agencies to dig deeper in their analysis, disclose more of their methodologies, and be more alert to conflicts of interests. Dodd-Frank also imposes greater liability on the rating agencies for their ratings. In recent days several ratings agencies have withdrawn their ratings on some bond issuances out of concern for the potential liability they now face.

The combined effect of these safeguards will undoubtedly reshape the securitization markets going forward. Until the issuers and the rating agencies adjust to these new rules, the issuance of new CMBS may slow or even come to a halt for a period of time. But eventually the markets will adapt to the new rules and CMBS should gain greater investor confidence prompting a resurgence of the CMBS markets. Importantly, however, the safeguards required by Dodd-Frank may drive up the costs of CMBS issuance.

3. Will the Volcker Rule Limit Investment in CRE?

The Volcker Rule, in essence, is intended to restrict proprietary trading by banks and their affiliates and to

prohibit banks from investing in hedge funds and private equity funds. This practice was viewed as a major factor contributing to the recent financial meltdown. The Volcker Rule will prevent banks and large financial organizations from making the massive equity investments in CRE that Lehman and others undertook in the past decade. In the future these institutions will, for the most part, be limited to providing debt financing for CRE. There are reports that some banks are contemplating divestiture of existing real estate funds because of the implications of Dodd-Frank.

A related question is whether the Volcker Rule will apply to the purchase of New Market Tax Credits and Low Income Housing Tax Credits. Clarification will be required on this issue. It is possible that the purchase of tax credits will be excluded from the definition of proprietary trading. Or the Treasury may need to provide rule-making guidance on this point. It is clear, however, that the governmental tax credit programs did not lead to the types of abuses that the Volcker Rule is designed to prevent.

4. How will Dodd-Frank affect interest rate swaps and other risk management instruments?

In recent years, many segments of CRE and their lenders have come to rely on interest rate swaps and other hedging instruments for interest rate protection. As has been well publicized, Dodd-Frank is instituting a comprehensive regime for regulating derivatives. For CRE, there are two questions. First, will interest rate swaps be available under this new regime? The clear answer is yes. The new clearing and trading rules will not eliminate derivatives but will make them safer and more transparent. The second question is what will the cost of these instruments be under the new system? It is likely that the new rules will add compliance and trading costs that will be passed on to the borrowers. On the other hand, the transparency of the new system will promote competition for these instruments that could bring costs down. The jury is still out on this question.

5. Does Dodd-Frank address the future of Fannie Mae and Freddie Mac?

Dodd-Frank does not address the future of Fannie Mae and Freddie Mac, leaving uncertainty looming over the residential and multi-family finance markets. However, in response to a recent request for public comment on reform of the housing finance system, Treasury and HUD received several hundred comments addressing the future of secondary market housing finance, including comments on multi-family finance from the Center for American Progress, in which Goulston & Storrs partner, David Abromowitz, played a lead role.

We will continue to monitor the implementation of Dodd-Frank, as well as emerging recommendations for reform of the housing finance system, and will advise you as new questions affecting CRE arise and as the answers to the questions discussed above become clearer.

For further guidance regarding Dodd-Frank and its impact on CRE, please contact your regular Goulston & Storrs attorney or any one of the attorneys listed below.

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