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Feds Lay Foundation for Regulatory Reform Plan

Congress to write legislation for financial system oversight while real estate industry waits for impact on lending

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Commercial real estate and banking professionals agree that the regulatory changes proposed by President Barack Obama's administration for the U.S. financial system are just the foundation of legislation that will be built up by Congress.

Components of the new regulatory structure may include increased capital reserve requirements for financial institutions and new oversight for securitized markets and advisors for hedge funds and private equity groups. Whatever form the rules take later this year, commercial real estate debt likely is to be more expensive and less plentiful than in recent years.

Obama announced five major categories of regulatory reform on June 17:

1. promoting robust supervision and regulation of financial firms,
2. establishing comprehensive supervision of financial markets,
3. protecting consumers and investors from financial abuse,
4. providing the government with tools it needs to manage a financial crisis, and
5. raising international regulatory standards and improving international cooperation.

The first category addresses financial institutions that are critical to market functioning. The Obama Administration wants to create a Financial Services Oversight Council to identify emerging systemic risks and grant new authority to the Federal Reserve to supervise institutions that pose a risk to financial stability.

Additionally, financial firms would be subject to stronger capital and prudential standards, a new National Bank Supervisor would supervise all federally chartered banks, the Office of Thrift Supervision and the federal

thrift charter would be eliminated, and advisors of hedge funds and other private capital pools would have to register with the Securities and Exchange Commission.

"We can't afford to let our financial system operate under a regulatory system that is inadequate and in many ways risky in and of itself," a senior administration official said in a conference call with reporters on June 16.

He said the Obama Administration and leaders in the House of Representatives and the Senate do not think the country can afford to wait for financial markets to stabilize before the regulatory system is reformed. Administration officials are working with congressional committees that could push forward legislation this year.

Michael Singh, West Coast managing director for the real estate investment banking team at Jones Lang LaSalle, said lenders and borrowers generally see the regulatory proposals as a starting point for a discussion.

"The financial services industry believes it is critical to our nation's economy that we work with policymakers in Washington to enact comprehensive reform this year to improve the accountability, transparency, investor protection and oversight of financial markets," said Timothy Ryan, president and chief executive officer of the Securities Industry and Financial Markets Association, in a statement on June 16.

"We have a once-in-a-generation opportunity to rebuild our regulatory structure so that our financial system is more stable, more resilient and better underpins a dynamic U.S. economy," Ryan said.

Regulating Securities

The Obama Administration's regulatory proposals address the securities markets in the second category of reforms that relates to comprehensive supervision, with a goal of

making sure that major financial markets are strong enough to withstand systemwide stress and the failure of one or more large institutions.

Proposals for the securities industry include more transparency, stronger regulation of credit rating agencies, and a requirement that originators of debt retain a 5 percent financial interest in loans packaged and sold as securities.

The SEC would be empowered to increase transparency and standardization for securitized markets and would be encouraged to increase regulation of credit rating agencies, including better disclosures about conflicts of interest and the creation of new rating systems that differentiate between securitized and other investments.

In a white paper from the U.S. Department of the Treasury about the proposed regulatory reforms, the Treasury said that in securitization, loan originators didn't require sufficient documentation of income and ability to pay, securitizers didn't set high standards for the loans they were willing to buy, investors relied too much on rating agencies and credit ratings often failed to accurately portray the risks of securitized investments.

Singh said the idea of requiring originators to keep a piece of the debt they originate has been discussed for a while now because loan issuers sold all the risk, so they were less cautious about underwriting.

"My guess is there will be more cost involved in banks keeping some of the risk on their balance sheets," he said. "We will see higher [interest] rates overall."

Andrew Raines, senior partner at Raines Law Group LLP in Beverly Hills, said it is probably a good idea to require financial institutions that originate debt with the intention of packaging loans together and selling them in commercial mortgage-backed securities to hold a portion of the risk on their balance sheets.

"If that was the case before, there would probably have been a little bit better underwriting and less risk involved in some of these CMBS deals," Raines said.

Mark Zytko, co-founder and co-chief executive officer of Los Angeles-based Mesa West Capital, said the most meaningful part of the proposed regulatory reforms is the requirement that originators of debt hold a portion of the risk in loans that they sell in the CMBS market.

"It keeps people more in line with their investors," Zytko said. "Originators sort of

stopped caring about the risk level because they were selling 100 percent of the risk."

Instead of requiring originators to keep some "skin in the game," he said regulators could put absolute limits on the market, such as a credit limit, risk level or credit rating requirement for loans sold into CMBS, but eventually market participants would find ways around such rules.

Gary Mozer, principal and managing director at Los Angeles-based George Smith Partners, said the Fannie Mae-delegated underwriting and servicing program is proof that better loans are made when originators hold on to some of the debt when loans are sold.

"The DUS underwriter has to take the first loss piece and as a result they're more conservative," Mozer said. "But you have to have a lot of capital for that first loss piece."

While the Fannie Mae policy aligns the interests of loan originators and investors buying multifamily paper, the originators have to have a lot of cash on their balance sheets to carry their small pieces of those loans and protect against related losses. However, Mozer said that makes it easier for institutional lenders to participate in the DUS program and harder for smaller entrepreneurial firms to do that kind of lending.

Greg Rickard, managing director of El Segundo-based lender and investor advisory firm Equassure, said the idea of requiring originators to keep some interest in loans that are sold to investors also is already in practice with loans backed by the U.S. Small Business Administration.

"I think it's a good thing to make sure whoever's originating the loan keeps some skin in the game," Rickard said. "It does require capital though. To hold a deal on your books, you have to back it with capital."

Wide-Sweeping

Harold P. Reichwald, partner in the Los Angeles office of Manatt Phelps & Phillips LLP, said the Obama administration's regulatory proposals were both general in tone and content and fairly wide-sweeping, setting the stage for tough negotiations with Congress.

Reichwald said the items that will impact lending the most are the higher capital reserve requirements for financial institutions and the regulation of securitized investments.

"Every time you come to a conclusion that says prudential capital was too low to absorb risks, that says the ability to leverage a balance sheet will be restricted to a greater extent than

before," he said. "There will probably be less lending and a shift to fee-based activities."

Raines agreed that higher requirements for capital reserves among the nation's financial institutions will most likely restrict the amount of money available for lending activity.

"The capital requirement will cause the lenders to be more selective in terms of the loans that they make," he said.

Dan Seiver, visiting professor in the finance department at San Diego State University's College of Business Administration, said the requirement for financial institutions to hold more cash in reserve to cover loan losses will limit the amount of cash available for lending to a degree, but the idea is to keep banks from going overboard again.

"We want them to loan prudently, because a bunch of loans that were made should never have been made," Seiver said. "It's not surgically precise and there will be good loans that won't get made, but some of the insane lending may be reined in."

Kevin Petrasic, an associate in Washington, D.C., at Paul, Hastings, Janofsky & Walker LLP, worked in several different capacities for the Office of Thrift Supervision until last year, when he left his job as special counsel to the regulator.

Since the OTS was created in 1989, Petrasic said the need for a separate charter and regulator for thrifts - savings associations that focus largely on home mortgages - always was questioned and there was always an assumption that bank and thrift supervision would eventually be merged.

He said the combination of a new regulator for banks and thrifts, a new consumer finance protection agency and higher capital requirements for the largest banks have the potential to limit lending through the creation of additional regulatory burdens from separate agencies that may have conflicting rules.

"By all accounts, the pendulum has swung very dramatically one way and we have seen the legislative response in the other direction," Petrasic said. "We need legislation that can deal with the issues today in a difficult time but also two years from now when things are starting to recover."

Jennifer Tullius, a litigator at the Raines Law Group, said she expects banks to push back hard against proposals for a consumer finance protection agency. Such an agency has the potential to impact lending, depending on the guidelines that it imposes for consumer and investment products.

"We will see a really dramatic drop in lending if something like that goes through, so that lenders can get a handle on the new requirements," Tullius said.

Similarly, Raines said the requirement for hedge fund and private equity fund advisors to register with the SEC could limit the amount of private equity and debt available for commercial real estate, at least temporarily while those entities figure out how to comply with new reporting requirements and regulations.

Reichwald said members of Congress have indicated publicly that they would like to pass legislation reforming the financial system before the end of the year. "We're living with an extraordinarily difficult political problem," he said. "The public views the way banking has been done as harmful for the overall economy. The public would very much support a variety of changes to rein in those practices. At the same time, the cost of that is often lost on the average person."