The Long and Winding Road: A Short Tour of the Dodd-Frank Act and Its Impact on Real Estate

You thought this piece would begin with a Beatles quote. That is not to be. Rather, we are reminded of the famous Will Rogers quip: "Be thankful we are not getting all the government we are paying for."[1] But that is about to change with the passage on July 21, 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act"). Dodd-Frank contains over 2,300 pages of new legislation that will thrust the government into a much larger role in regulating banks, hedge funds, corporations, consumers and many others. Among other things, it is a mini-stimulus act for lawyers and accountants.

Right after the Act passed, Gail Edwards asked George to author an article for Pipeline that would include the impact of the Act on real estate – particularly commercial real estate. The answer to this question is not self evident from the Act itself and, so, George decided to enlist Shel Weisel in the effort to decipher the meaning of this massive law for real estate.

This article presents our thoughts about this topic as well as the thoughts we have gleaned from others who have written about this law. At best, this is a preliminary assessment since it will take years before the financial industry has a clear picture of how it will affect that industry and so, too, the full impact on real estate will not be known for many years.

Dodd-Frank is the first step on a long and winding journey. The intended destination is clear — a stable financial system and the elimination of the abuses that led to the financial meltdown in 2008. The vehicle to reach this destination is also clear — a revamped regulatory system with greater oversight, rulemaking and studies. Dodd-Frank requires more than 2 dozen rulemakings and more than 60 studies. The SEC alone will be required to issue more than 90 rules and 15 studies.[2] Undoubtedly, there will be bumps along the road and until the new rules are known, uncertainty will be pervasive in the financial industry and, by extension, in the industries that rely on capital infusions from Wall Street.

Over the long haul, Dodd-Frank is likely to be beneficial for both Wall Street and for real estate. The new regulatory scheme will promote transparency and will curb many excesses of the past. But in the short-term — the next year or two — it is not likely to advance the real estate recovery. To help you understand what Dodd-Frank will mean for real estate as we start down this long and winding road, we have organized this article as a short tour of what we think are the key areas of interest for our real estate brethren.

The first stop on our tour is **Consumer Protection.** Although this area may have the least impact on many DCBIA members because of the nature of its constituency, consumer protections are a major focus of the Act. A key provision is the creation of the Consumer Financial Protection Bureau with wide-ranging powers.

Two real estate areas significantly affected by the Act are mortgage lending practices and residential brokers. Dodd-Frank intends to eliminate predatory lending with a number of new requirements, including changes to RESPA and rules for the selection and compensation of residential appraisers.[3] The Act also will need to be scrutinized carefully by residential real estate brokers. There was active lobbying by the National Association of Realtors to make the Act more manageable for the broker community.[4] Thus, real estate professionals performing traditional real estate activities will be exempted from the ambit of the new Consumer Financial Protection Bureau, other than with respect to RESPA. The Act will also permit a broker to conduct three seller-financed transactions in a 12-month period without being subject to the new rules.

It appears that, in many parts of the country, single-family residential sales were artificially propped up by the $8,000 tax credit which expired this April. The residential industry is again depressed and the Act will certainly not increase sales. However, Dodd-Frank will provide badly needed protections for many consumers who might otherwise be fleeced by mortgage products they do not understand and can ill afford.

Our tour stops next at **Bank Lending** which currently is a shadow if its former self. In reality, this part of the tour should take place at the Federal Reserve since the Fed is charged with the task of establishing revised risk-based capital requirements for banks and non-bank financial companies by January 2012. Until the new regulatory standards are established, the current slowdown in bank lending for commercial real estate is likely to continue.

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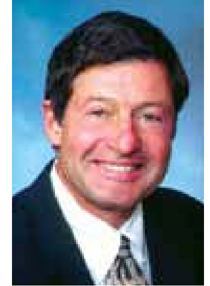

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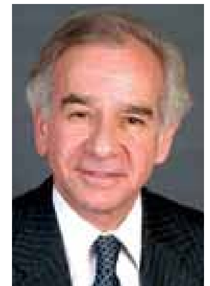

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1 With thanks to George's colleagues, Rick Baltz and Laura Badian, who first used the Will Rogers' quote in the Arnold & Porter Client Advisory entitled "The Corporate Governance and Executive Compensation Provisions in the Dodd-Frank Act — What To Do Now" (July 2010).

2 Two immediate positive byproducts of Dodd-Frank are the decision by the Securities and Exchange Commission to sign a 10-year lease for 900,000 square feet at Constitution Center, 400 Seventh Street, NW, DC, and to hire an additional 800 new employees in this area.

3 A good explanation of these requirements may be found in the DLA Piper publication, "Dodd-Frank Alert: Regulators Take Center Stage."

4 Please refer to the National Association of Realtors webpage (www.realtors.org) and its article President Signs Wall Street Reform and Consumer Protection Act (July 21, 2010).

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Once the new rules are put into place, lending for real estate should increase but it will be on a more conservative underwriting basis than we had seen before the meltdown. Whether there will be sufficient debt capital available to real estate to refinance the huge amounts of CMBS loans that will be coming due over the next three years is a source of major concern for commercial real estate owners. To some extent this concern may be mitigated if Wall Street is able to revive the securitization markets in a significant way.

The third stop on our tour is the wonderful world of **securitized mortgage-backed lending**. The financial meltdown brought securitized lending to a virtual halt and with good reason. In the past year, the securitized markets for residential mortgages and consumer loans have been revived by the massive intervention of the Federal Reserve and the Treasury Department. But that is not the case for commercial real estate. The commercial mortgage-backed securities (CMBS) have been very slow to recover because of the loss of investor confidence.

Dodd-Frank attempts to curb the excesses of the past decade in two important ways. First, lenders who issue CMBS must have at least a 5% stake in the debt — this is referred to as "skin in the game." In addition, issuers are required to disclose more information about the underlying assets and to analyze the quality of the assets in the mortgage "pool."

A second safeguard enacted by Dodd-Frank is the introduction of a much more comprehensive regulatory regime for the credit rating agencies. This is long overdue. Their lax underwriting standards played a key role in both the ascent and the collapse of the CMBS market. The regulation appears to be well thought out with annual SEC examinations and public disclosure. The regime will require the rating agencies to dig deeper in their analysis, disclose more information about their methods, and to be more attentive to conflicts of interest. Most importantly, Dodd-Frank imposes a private right of action against a rating agency for knowing or reckless conduct. This latter feature is already having an impact. In recent days, some ratings agencies have withdrawn ratings from some bond issuances out of concern for potential liability.

The combined effect of these safeguards will undoubtedly reshape the securitization markets going forward. Many of the new rules will not be issued until late July 2011. Until the rules are promulgated and the issuers and the rating agencies adjust to the 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. However, the safeguards required by Dodd-Frank may drive up the costs of CMBS issuance.

If you are still aboard, our journey, now by rail, explores **Hedge and Real Estate Funds**. There are three issues of significance for our industry. First, large real estate funds and their advisors will be subject to regulation by the SEC. Previously, these firms were not subject to the Investment Advisory Act because of the "private advisor" exemption. In the short-term, this new regulatory requirement may deflect

the focus of real estate funds from deal activity to regulatory compliance. Second, the so-called Volcker Rule will prevent banks and other large financial institutions from making and retaining large investments in commercial real estate as was done by Lehman Brothers and others over the last ten years. The impact of the Volcker Rule can already be seen. In March, Citigroup sold its real estate arm to Apollo and it is understood that ING and Morgan Stanley are contemplating the sales of their real estate funds. Third, the Act authorizes the SEC to pay whistleblowers bounties of up to 10% to 30% of funds collected in SEC enforcement actions that result in significant monetary sanctions. This incentive will invite disgruntled fund employees and losing bidders to lodge claims with the SEC.

The next stop on our tour brings us to the opaque subject of **Derivatives**, which are basically financial instruments designed to mitigate risks. This part of the financial system has been operating for years completely outside the scrutiny of the regulators and Dodd-Frank will require the CFTC and SEC to institute a comprehensive program to regulate derivatives and to provide transparency to this market. For real estate, there are two questions. First, will commercial real estate borrowers still be able to purchase interest rate swaps as a means of hedging interest rate risk under floating rate mortgages. The clear answer is yes. The new rules instituted by Dodd-Frank are not designed to eliminate these types of derivatives, only make them safer and more transparent. The second question is whether the costs of interest rate swaps will rise under the new system. Usually, greater regulation produces higher compliance costs. On the other hand, greater transparency may foster more competition and that would drive costs down. Like so many other parts of Dodd-Frank, we will not know how this will play out for some time.

Our stop here is more of a speed bump than a full stop and addresses the impact of the Act on **Real Estate Syndications**. The Act requires the SEC to change the net worth test for an "accredited investor." Under this test, the investor (individually or with his or her spouse) must have more than $1M of net worth at the time of purchasing an investment. The value of the investor's principal residence is now excluded from the calculation of net worth. This will require changes in the terms of private placement and offering materials, including subscription agreements and investor questionnaires. It will narrow the pool of potential investors, but in general, it should not impede a real estate recovery.

The next stop on the tour brings us back to Wall Street and the public outcry over **Executive Compensation and Corporate Governance**. These issues do not directly impact real estate but they are relevant to the public REIT industry. In a nutshell, Dodd-Frank mandates greater disclosure by public companies of compensation arrangements. It also gives shareholders the right to a non-binding vote on executive pay and golden parachutes.

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It is worth noting that, as a group, REITs have fared better during this downturn than many other sectors of the real estate industry. While excesses involving executive compensation have not been a problem for most REITs, the enhanced transparency and shareholder rights introduced by Dodd-Frank should only serve to make REITs an even more attractive investment for investors in the future.

Our final stop is **Multi-Family Housing**. In this arena, the Act singles out affordable housing but, in a glaring omission, it does not cover Fannie Mae and Freddie Mac. There are several provisions designed to bolster HUD programs for multi-family housing.[5] But the failure of Dodd-Frank to address the future of Freddie Mac and Fannie Mae creates a great deal of uncertainty in the multi-family housing market. This market has been a bright spot in 2010 as Freddie and Fannie have made attractively-priced loans available for quality product at substantially higher leverage than in other segments of the commercial real estate market. Treasury and HUD have sought and received hundreds of comments addressing the future of secondary market housing finance and, hopefully, a clearer picture of the future roles of these agencies will emerge soon.[6]

5 A good explanation of the impact of Dodd-Frank on affordable housing is contained in the Nixon Peabody LLP Affordable Housing Alert (July 28, 2010).

6 With thanks to Shel's colleagues, Peter Corbett and Bruce Meyerson, who collaborated with Shel, on a Goulston & Storrs Advisory, "Implications of Financial Reforms for Commercial Real Estate."

As we bring this tour to a close, we offer a few concluding observations. One could legitimately argue that over the past six months the commercial real estate market was beginning to self-correct, as it did following the real estate bubble and collapse in the early 1990's. Lenders were cautiously re-entering the market and using rigorous underwriting, conservative assumptions, and requiring substantially more equity from their borrowers. The passage of Dodd-Frank will now force bank lenders to pause and reconsider their willingness and ability to expand their commercial real estate loan portfolios. The Act will also slow the re-emergence of the CMBS market. Thus, over the short-term, Dodd-Frank will likely operate as a brake on the recovery of the commercial real estate market.

Our view of the long-term impact of Dodd-Frank is more optimistic. The protections that will be afforded to consumers in the real estate arena under the Act will be a major improvement. The enhanced regulatory regimes that will eventually be applied to banks, large financial institutions, credit rating agencies and the CMBS market will restore confidence in our economy and will help steer us away from a repetition of the abuses that led to the meltdown on Wall Street and the downturn in the real estate markets. But it will be a long and winding road until these benefits are realized. ▲