Welcome fellow Real Estate Professionals …

MYLESTITLE'S 1ST QUARTER 2015

ADVISORY COUNCIL BREAKFAST & SEMINAR

Solutions to Maryland Real Estate Issues:
THE "NEW" REAL ESTATE PARADIGM …
KEY ISSUES FOR 2015 AND BEYOND

Major Changes Ahead for Developers, Borrowers & Lenders in the $3 Trillion Commercial Real Estate (CRE) Debt Market: *On Deck -- Basel III*

So, what is Basel III? Likely Unintended Consequences & Potential Problems. Alternative Solutions & New Debt Sources for CRE Borrowers in 2015.

MICHAEL D. PEDUZZI
Senior Vice President & Chief Financial Officer
PeoplesBank,
A Codorus Valley Company

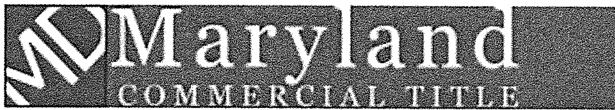
LOUIS S. WEEKS III
Managing Director & Managing Partner
ColumbiaNational Real Estate Financing

In association with and sponsored by:
MYLES L. LICHTENBERG, ESQ. &
MYLESTITLE | MARYLAND COMMERCIAL TITLE

Hayfields Country Club
February 12, 2015 | 7:30am to 9am

Visit us online at:
MarylandCommercialTitle.com & MylesTitle.com

Contact us, directly at:
410.458.8975, *Anytime*
Myles@MylesTitle.com



Phone: 410-458-8975 | Tell a Friend

Large firm quality, local expertise: Maryland commercial title insurance practice, since 1980

READ OUR BLOG ...
News | Analysis | Insights
Critical "Real Estate" Stuff
Below the Radar!

Advisory Council
Seminar Archives

Home | About Us | Services | Contact Us | Blog

MAJOR CRE FUNDING CHANGES AFOOT: Basel III

By: Myles, October 14th, 2014

BIG BANKING CHANGES ARE IN THE WORKS FOR COMMERCIAL REAL ESTATE BORROWERS & LENDERS. Yes, Basel is seemingly a bit in the finance and banking weeds, but – as it turns out – it's quite significant. More specifically, note that Basel is a global, voluntary regulatory standard on bank capital adequacy, stress testing and market liquidity risk. After a lengthy comment period, the federal banking agencies released the **US Basel –III Final Rule** on July 2, 2013, published in the Federal Register on April 14, 2014.

> ***So why does this matter? Because there is a huge potential impact of the new regulatory capital rules on the commercial real estate industry, specifically for the borrowers of commercial mortgages who build, own and operate multifamily and commercial properties such as rental apartments, offices, shopping centers, hotels and warehouses.***
>
> **The Scope of What's At Stake: According to the Federal Reserve,the banking sector has provided about half of the approximately $3 trillion of outstanding commercial real estate debt.**

- The US Basel III final rule will replace the existing general risk-based capital rules under Basel I and the advanced approaches rules under Basel II, affecting more than 8,000 US banking organizations.
- *These rules revise regulatory capital requirements for all banks, savings associations, US bank holding companies with greater than $500 million in assets, and all savings and loan holdings companies. The rules implement the majority of the revisions of the global Basel III capital reforms, as well as relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, in an effort to strengthen the quantity and quality of regulatory capital.*
- *The Essence of It All:* The new capital rules require banking organizations to maintain higher capital levels and enhance the definition of what can be included in the calculation of capital. The rules will have wide-reaching impacts on the banking industry, potentially altering the profitability and

investment strategies for banking organizations and reassessing the allocation of capital.

In sum, the final rule increases bank capital requirements while tightening the definition of what can be included in the calculation of capital and revising the methodology of calculating risk-weighted assets, making them more risk sensitive. Given the significance of this source of capital to the industry, the regulatory capital changes within the final rule could impact commercial real estate in numerous ways, including:

1. Availability of capital to commercial real estate (What's Changed & Impact):

- The final rule requires banks to maintain higher capital levels overall, while also contributing to higher capital levels for real estate assets due to changes in the risk weightings for these assets.
- These changes may influence banks' willingness to finance commercial real estate loans due to lower returns on capital and decreased profitability.
- If banks decide to reallocate capital away from commercial real estate to asset classes with more favorable treatment and a superior return on capital, there may be less liquidity for all types of real estate loans. This in turn may exacerbate the market's observed imbalance between the capital demanded by the industry to refinance existing properties and build new properties and the availability of capital in the banking system and other sources to supply those funds.
- To date, the commercial mortgage backed securities (CMBS) market and life insurance companies, while increasing production, have not provided sufficient capital to the market to close that gap.

2. Higher cost of commercial mortgages (What's Changed & Impact):

- Rather than reallocating away from commercial real estate, banks may instead choose to continue to lend to the sector but at a higher cost to retain profitability.
- Borrowing costs may also increase due to higher mortgage servicer fees resulting from less favorable capital treatment of retained mortgage servicing rights when selling or securitizing originated loans and higher overall capital charges resulting from increased risk weights for commercial mortgages.
- While mitigated in the short term by historically low interest rates, long-term higher borrowing costs will ultimately put upward pressure on capitalization rates, thereby causing property values to fall.
- Depending on supply and demand for space in each market, owners may be able to pass higher financing costs on to tenants through increased rents.

3. Further shift away from relationship lending(What's Changed & Impact):

- The final rule redefines how capital is calculated, placing specific constraints on mortgage servicing rights.
- These constraints not only impact capital but may deter banks from future involvement in the servicing industry.
- As a result, banks may be economically motivated to sell the servicing of,a loan to a third party, and borrowers will have to deal with non- relationship servicers for requests during the term of the debt.

4. Other Criticisms – Pro & Con – of Basel III:

- Think-tanks such as the World Pensions Council (WPC) have argued that Basel III merely builds on and further expands the existing Basel II regulatory base, without questioning fundamentally its core tenets, notably the ever-growing reliance on standardized assessments of "credit risk" marketed by two

private sector agencies- Moody's and S&P, thus using public policy to strengthen anti-competitive duopolistic practices.

- Basel III has also been criticized by banks, organized in the Institute of International Finance in Washington D.C. (an international association of global banks) with the argument that it would hurt them and economic growth. OECD estimated that implementation of Basel III would decrease annual GDP growth by 0.05–0.15%, blaming regulation as responsible for slow recovery from the late-2000s financial crisis.
- Basel III was also criticized as negatively affecting the stability of the financial system by increasing incentives of banks to game the regulatory framework.
- The American Banker's Association, community banks organized in the Independent Community Bankers of America, and some of the most liberal Democrats in the U.S. Congress, including the entire Maryland congressional delegation with Democratic Sens. Cardin and Mikulski and Reps. Van Hollen and Cummings, voiced opposition to Basel III in their comments submitted to FDIC, saying that the Basel III proposals, if implemented, would hurt small banks by increasing "their capital holdings dramatically on mortgage and small business loans."
- Others have argued that Basel III did not go far enough to regulate banks, as inadequate regulation was a cause of the financial crisis. On 6 January 2013 the global banking sector won a significant easing of Basel III Rules, when the Basel Committee on Banking Supervision extended not only the implementation schedule to 2019, but broadened the definition of liquid assets.

Conclusion/Potential Solutions

- Through both up and down cycles, banks have been the greatest source of debt capital to the commercial real estate sector – provided the marketplace with about half of the approximately $3 trillion of outstanding commercial real estate debt.The new regulatory capital rules under Basel III will increase the capital that banks must hold against their commercial mortgage exposures.
- The result will either be more expensive mortgage rates or less capital allocated to commercial real estate or a shift to commercial mortgage backed securities (CMBS) market and life insurance companies.
- Less favorable treatment of mortgage servicing rights may make retaining servicing less attractive, impeding the desired relationship between lender and borrower.
- In aggregate, the changes may have the unintended consequence of moving more commercial mortgage lending out of the banking system to the commercial mortgage backed securities market or to a nonregulated environment with non-bank lenders. While these capital sources can be very efficient, they provide less reliable long-term liquidity.
- The recent downturn demonstrated the need for banks to hold more capital against credits in all economic sectors. The new rules reflect the need to better differentiate risk among types of commercial mortgages.
- Such differentiation and the resulting higher capital requirements are intended to enable banks to absorb losses in times of economic stress and to help prevent future systemic banking catastrophes. However, these changes may negatively impact the availability and cost of debt capital in the commercial real estate sector, making the business of developing and owning real estate less profitable and curtailing development and real estate transaction.

Posted in Basel III, Commercial Real Estate, Debt, Mortgage Baced Securities, Regulation | No Comments