SummerStreetAdvisors

Under Regulatory Scrutiny, Banks Rein in Risk

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When the Dodd-Frank financial reforms were announced several years ago, some people said they went too far in restraining banks' activities, while others believed they didn't go far enough. Now that the legislation has gone into effect, however, it seems to be doing its job: motivating banks to make prudent loans and conduct proper due diligence, without causing a credit crunch. While it's impossible to know what the future holds, there are signs that the limits placed on real estate lending will help smooth out the boom-bust cycle we've seen for decades.

In the past year, we've seen the pace of commercial mortgage-backed securities (CMBS) issuance and construction lending cool down in a controlled manner. In the past, lenders' reaction to overheated markets has been to hurry up and do more deals before the market crashes and the window of opportunity slams shut. What's different this time? Stiff penalties and even personal liability for those who fail to manage risk.

One of the major impacts of Dodd-Frank is to increase banks' capital reserves on highly volatile commercial real estate (HVCRE) loans, which includes construction loans. The need to retain more capital for each deal limits the number of loans banks can hold on their books. As a result, banks have become somewhat more selective about which development deals they want to fund. Construction lending hasn't stopped--experienced developers willing to put their own money at risk can get loans with full recourse. But it's a different story for merchant developers looking for non-recourse loans on projects they expect to flip to investors upon completion.

So developments that meet occupier needs are moving forward, while those that only serve to feed investors' insatiable appetite can't get financing. In essence, good deals get done and bad deals don't. If this is the new normal, it's better than the "old normal" cycle of overheated lending followed by a painful credit crunch.

Greater Scrutiny of Third-party Loans

The Federal Reserve and other banking authorities have also cautioned FDIC-insured institutions that they must perform due diligence on loans originated by others as if they were the

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Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

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initial underwriter. Due diligence should be performed not only on the property involved but also on partners in the deal, to ensure they have the wherewithal to meet their obligations. At a time when banks are forming syndication deals to finance large deals that pose too much risk for any one lender, this requirement helps to ensure that banks know what they're funding, rather than relying on partners.

In a similar vein, there are new rules governing CMBS loans which affect banks and other portfolio lenders. A couple of years ago, the CMBS market was firing on all cylinders, and lenders were starting to loosen their underwriting criteria to get more deals. There was no reason to worry about property cash flows to repay the debt, since the lender could make a profit by selling the loan at a profit to the CMBS market within 30 days of closing. CMBS investors had no practical way to determine whether the underwriting was solid. But then investors got nervous about their level of risk, and demand for CMBS product failed to keep up with supply. When banks had to hold the permanent loans they underwrote for the CMBS market, it prevented them from making better loans intended for their balance sheet.

CMBS volume in the first half of 2016 was about half of what it had been in 2015. In part this was because investors feared an overheated market and the possibility of an economic slowdown. But the biggest reason seemed to be the new risk retention rules that will take effect in December. Going forward, CMBS issuers must retain 5 percent of their deals for the duration of the loans (typically 10 years). Issuers must also name a senior executive personally accountable for the accuracy of reporting at the risk of facing fraud charges. As CMBS players figure out how to make the new rules work, the market has come back in recent months, albeit at higher spreads to cover the additional due diligence costs.

Just as tighter construction lending standards are chasing merchant developers out of the market, the risk retention requirement is causing some opportunistic underwriters to close their doors. Banks in the CMBS business may actually like the new rule, because it eliminates fly-by-night competition and because yields on CMBS first-loss positions are relatively high. CMBS deals aren't quite as sweet for borrowers as they used to be, but bringing risk and yield into better alignment will help to keep the market stable.

Stress Tests Show Resiliency

Another important element of Dodd-Frank is the establishment of "stress tests" to determine how well banks would hold up in the event of adverse market conditions. The key measure is the aggregate common equity capital ratio—the extent to which banks can cover their losses in the event of a recession. In June, the Federal Reserve released results of its supervisory stress test on the 33 largest U.S. banks, and the outlook is good. In an ordinary recession, banks would see their common equity capital fall from an average of 12.3 percent, where it was in the fourth quarter of 2015, to about 10.5 percent. In a deep global recession like the one in 2008, the aggregate equity ratio would fall to about 8.4 percent. So if nothing else, the new rules should prevent the need for another bank bailout.

Capital ratios, actual 2015:Q4 and projected 2016:Q1–2018:Q1

Percent

Regulatory ratio	Actual 2015:Q4	Stressed capital ratios[1]	
		Ending	Minimum
Common equity tier 1 capital ratio	12.3	10.5	10.5
Tier 1 capital ratio	13.5	11.8	11.8
Total capital ratio	16.2	14.0	14.0
Tier 1 leverage ratio	9.2	8.0	8.0

Note: In accordance with the regulatory capital framework, all risk-based capital ratios are now calculated using standardized RWAs, which became effective on January 1, 2015. The transition had a one-time effect of reducing risk-based capital ratios in first quarter 2015. However, the aggregate common equity capital ratio of the 33 firms increased by 70 basis points between the first quarter of 2015 and the fourth quarter of 2015.

[1] The capital ratios are calculated using capital action assumptions provided within the Dodd-Frank Act stress testing rule. See 12 CFR 252.56(b). These projections represent hypothetical estimates that involve an economic outcome that is more adverse than expected. The minimum capital ratio presented is for the period 2016:Q1 to 2018:Q1.

This cushion of safety comes at a price. Even with low interest rates, debt markets are not as favorable to borrowers as they were a couple of years ago. Loan-to-value ratios are lower across the board, and non-recourse financing is hard, if not impossible to find. Properties with potential cash-flow issues, such as anchor tenants with imminent lease expirations, have fewer options for refinancing, even at a higher cost. With deals harder to finance and new development harder to justify, a lot of investment capital is sitting on the sidelines. This is all bad news for real estate players who make their money on the boom-bust cycle. But it's good news for anyone who wants to see a stable, sustainable market.