Dismantling Dodd-Frank:

Trump takes aim at financial services regulation

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In the weeks since Donald Trump was elected the 45th president, we have started to learn more about the policies he plans to enact and, in some cases, reverse. It appears one piece of legislation falling into the latter category is the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Within days of the election, Trump's team began releasing details about his position on financial services, posting a lengthy statement on his website.

"Bureaucratic red tape and Washington mandates are not the answer," the statement reads. "The Financial Services Policy Implementation team will be working to dismantle the Dodd-Frank Act and replace it with new policies to encourage economic growth and job creation."

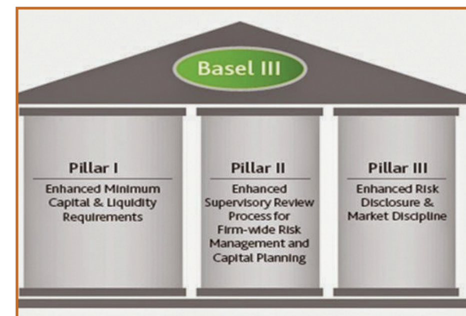
"Regulation tends to overplay"

To fully understand Dodd-Frank, its purpose and its challenges, we must venture back in time nearly a decade.

"The banks got overly aggressive relative to lending against the capital that they had on their balance sheets," says Trey Morsbach, senior managing director at HFF's Dallas office. "They were highly leveraged, so they were making risky and riskier loans with less capital than in an ideal situation."

We are all too familiar with the fallout that followed: the housing bubble burst and Great Recession.

As a result, Congress rushed to fill the holes it saw in financial services legislation. Then-Sen. Chris Dodd and then-Rep. Barney Frank, both Democrats, helped write the 2,300-page Dodd-Frank law, passing it with only four Republican votes total in the House and Senate.



From the beginning, Republicans worried the legislation added too many layers of regulations on the banking industry.

"Regulation tends to overplay, so it tends to overcompensate," Morsbach says.

Congress approved Dodd-Frank in 2010, while the international banking community was tackling very similar issues. The Basel III Accord, agreed upon by the members of the Basel Committee on Banking Supervision, went into effect in January 2015.

"Basel III, in concert with Dodd-Frank, are really the two pieces of both domestic and international governance and regulation that have meaningfully affected the way banks are lending," says Morsbach.

"It's causing banks to be much more conservative"

Dodd-Frank, in its effort to prevent another scenario like the one that led to the Great Recession, enacted several major agency changes, including two that affect the commercial lending industry.

The Volcker Rule prohibits affected banks from proprietary trading for their own accounts and from investing in private equity funds or hedge funds. The result is a lack of liquidity for commercial real estate markets, raising costs and slowing growth.

Another part of the bill tackles risk retention with securitization. It requires that lenders retain 5 percent of all loans, which sometimes results in a higher cost of lending and difficulty in finding a lender for higher-risk borrowers.

"There's a handful of things that they can no longer do, and so it's causing banks to be much more conservative," Morsbach says.

"The most-talked-about acronym in CRE"

On the international side, Basel III is also having a very real impact due to its creation of a concept called High Volatility Commercial Real Estate, or HVCRE.

"It's undoubtedly the most-talked-about acronym in the commercial real estate," says Morsbach.

The regulation mandates that borrowers who originate a commercial acquisition, development and construction loan must meet a 15 percent equity requirement. Additionally, the leverage on the loan cannot exceed 80 percent of the estimated completed value of the project. If the borrower isn't able to meet those conditions, the loan is then subject to a 150 percent risk weight requirement.

"It's very specific in terms of what would trigger an HVCRE classification, but if you are HVCRE, you need 150 percent more capital against that loan than you did yesterday," Morsbach explains. "It's a 50% increase in capital, which is real. That's a significant move on banks' balance sheets, which has a myriad of effects."

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The most obvious effect is pricing. Because capital is more expensive than debt, lenders are reporting increased costs, which some are passing along to borrowers.

"I would tell you that I think there are some aspects of Basel III and the Dodd-Frank legislation that aren't necessarily rational," Morsbach says. "Over time they may get amended."

"Much more bank-friendly and much less borrower-friendly"

The combined impact of Basel III and Dodd-Frank has been measurable, according to Morsbach. He cites a recent poll of all banks, large and small, conducted by the Federal Reserve and Morgan Stanley.

"The question was simple: by property type, are your credit underwriting standards tightening, staying the same or loosening?" he says. "Thirty percent, a third of all banks, said they're tightening."

Morsbach calls this the "exact opposite" of where banks were in 2007, when most banks weren't tightening credit standards.

"It's having the appropriate impact because it's designed to make loans and banks more disciplined. Banks are so fearful to have an HVCRE-qualified loan that they're not offering loans that they offered yesterday," he says. "We're seeing banks with probably the best real estate portfolios, from a credit perspective. I can't recall another time that they've been as healthy as they are now."

> "In 23 years, I've not seen the construction lending market as challenged as it is today. There is liquidity, and there is construction lending happening, but it's becoming much more difficult to attain" - Trey Morsbach

That positive outcome for banks, though, is balanced by new challenges for borrowers.

"The structures and credit in the individual loans are much more bank-friendly and much less borrower-friendly," Morsbach says. "In 23 years, I've not seen the construction lending market as challenged as it is today. There is liquidity, and there is construction lending happening, but it's becoming much more difficult to attain."

"People need us more"

As those loans become more of a challenge to procure, Morsbach and his team at HFF have become even more valuable.

"We, and organizations like ourselves, become more important. With uncertainty in the market and with some difficulty getting loans, people need us more. Our construction lending audience is up," he

says. “Construction lending at the industry level is decreasing, but construction lending assignments for firms like us are increasing.”

New numbers from CBRE back up Morsbach’s statement. In its first-ever annual report on the financial services industry, the company examined the impact of heightened regulations. It found the industry is turning to “active” markets, such as Dallas/Fort Worth.

“This growth is due to the robust talent available in the Dallas/Fort Worth market as well as the low cost of doing business in the area,” says Kristin Sexton, CBRE’s managing director of labor analytics.

“Dallas is a city with a very deep labor pool that can allow financial services companies to expand rapidly,” says Josh White, executive vice president in CBRE’s Dallas office. “In addition, Dallas is becoming a mature, metropolitan city that can now compete with established markets in terms of access to the arts, culture and urban living opportunities, all of which make it a very appealing option for companies that are looking to relocate.”

In addition to Dallas/ Fort Worth, San Antonio also made the list of cities that offer the “best mix of labor availability and cost for shared services jobs, which include back-office roles such as accounting, human resources, legal and finance,” according to CBRE.

While the financial services industry booms, Morsbach offers up two pieces of advice for developers. First, adapt.

“That may mean you have to be prepared to come with more equity, you may have to be prepared to provide better guarantees, or you may have to be prepared for a higher cost of capital,” he says. “There are implications that the better developers are able to navigate because they're either well-capitalized or they've got better balance sheets.”

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Morsbach says the other action a developer can take to help in the lending process is develop what he calls a “holistic” relationship with the bank.

“Banks are, I would say, probably biased against expanding their construction lending and exposures. They typically reserve the construction lending dollars for their better customers,” he explains. “Developers who have depository relationships, account relationships and treasure and management services are more likely to get construction financing.”

“If you want to read the tea leaves …”

Despite some of the challenges his clients face in this new era of financial regulation, Morsbach calls the changes a “net positive” for the industry.

"If conditions remain the same, the result will be a landlord market in roughly two years," says Trey Morsbach.

“If you really want to pull the string a little bit and think about the future, I can paint a picture where we're already not oversupplied from a new supply/new construction perspective as an industry,” he says. “If you look at the statistics, we're still below historic averages in terms of new supply. That was coming into 2016. This year, we've actually seen a pullback in supply largely because the construction lending environment is not allowing it.”

“That's a bit of prognostication,” Morsbach admits, “but if you want to read the tea leaves, it's a possibility based upon a general pullback and construction lending and availability that is causing some difficulty to get projects done.”

Many factors will come into play and determine whether Morsbach’s prediction becomes reality, including president-elect Trump’s changes to Dodd-Frank. Though he hasn’t released specific details of his plan, his site dictates “Federal policy should focus on free enterprise, while protecting consumers by policing markets for force and fraud. Both Wall Street and Washington should be held accountable.”

We should learn early in 2017 what that means for America’s commercial real estate industry. ●