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THE PROBLEM WITH REGULATORY REFORMS

IRVINE, CA—It's not the concerns that led to the reforms themselves, but the way the reforms are being implemented that's putting a damper on CRE deals, Cox Castle's Adam Weissburg tells GlobeSt.com in this EXCLUSIVE interview.

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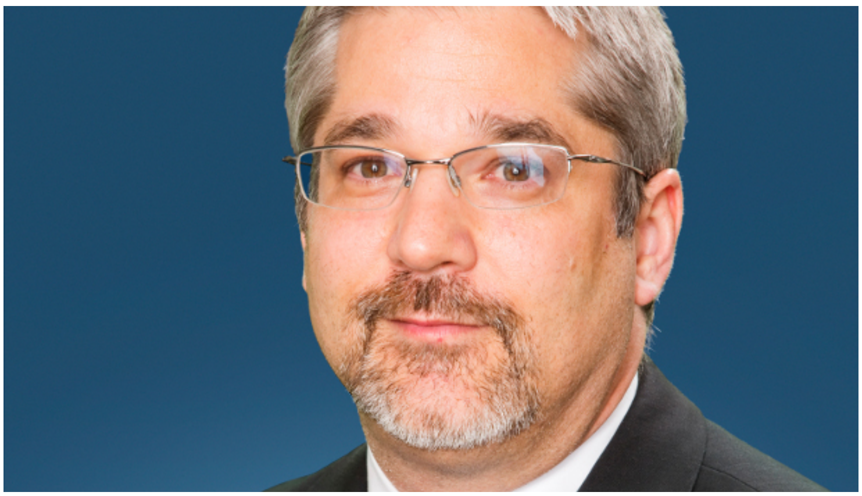

Weissburg: "I think the lack of certainty means that any time you're doing something out of the ordinary, it really causes a damper in transactional speed and correlation on cost."

IRVINE, CA—It's not the concerns that led to regulatory reforms themselves, but the way the reforms are being implemented that's putting a damper on **commercial real estate** deals, **Cox, Castle & Nicholson** partner **Adam Weissburg** tells GlobeSt.com. He says the impact of **Dodd-Frank** and **Basel III** on the **financial** interests of **developers** cannot be overstated, and he argues that perhaps regulatory reforms have gone too far and are conflicting with the interest in making sufficient credit available to generate **economic** activity.

We spoke exclusively with Weissburg, a 30-year veteran in representing borrowers and lenders in all facets of real estate finance, about why he believes regulatory reforms may have gone too far and how he believes they should be handled.

GlobeSt.com: Why do you believe that regulatory reforms may have gone too far?

Weissburg: I don't think it's really that regulatory reform has gone too far, but that the regulatory concerns and the regulations themselves seem to be at odds. If you go back to Dodd Frank and Basel III, you hear, "Too big to fail; make sure the banks have adequate capital and make sure underwriting decisions are good." In one instance, regulatory reforms leave out of the equation the **equity** that comes from **EB5** lenders. It's a good goal to have EB5 investment, but here you have passive investors that have a closed-end-fund approach to **investment**, so they won't necessarily write checks if things go bad. Classically, these are people who spend X amount to come to the US; they are not funds who will continue to support a project that may be delayed or whose demographics have slightly changed.

It’s also clear that a lot of the EB5 activity is not necessarily going to be taken by people who understand investment in real estate. I don’t want to criticize the approach, but it’s more that if the goal is to get people who understand real estate and who are willing to step up if there is a problem who are not going to fish and cut bait, on the one hand pushing this EB5 proposition has opened the door for a lot of people who don’t necessarily fit that approach.

I find it striking that when you have **mezzanine** and **debt** in this, based on current **capital structures** today, third-party is a tier higher than bank, and you have a lot of Wall Street structure to it. Why is that treated so disproportionately poorly? I completely agree that preferred equity should count, but valuing preferred equity over mezzanine seems not to get to the goal. If a construction loan goes bad because of the developer, why would any bank not be willing to trade a fund with several-hundred-million dollars of assets for the developer? And isn’t this actually better than EB5 equity where the investor may not have resources or experience? So I think that it’s really counterintuitive regulations.

A lot of people are kind of scratching their heads about the implementation of the regulations, not the regulations themselves. Because of these things as a whole, you see two and three tiers of various structure to fit in the box, and it’s inordinately expensive in terms of lawyer time to grapple with competing agendas. Some banks are charging higher money because they don’t know where they stand. It creates a lot of uncertainty, which is damaging to credit and costs.

GlobeSt.com: With reforms as they are now, how much are they conflicting with the interest in making sufficient credit available to generate economic activity?

Weissburg: It depends on whether or not you think things should be damped or not. Regulators will say it’s not damping it because we’re weeding out the more speculative deals and forcing good-deal exemption, which means you get better deals. But I would say the good deals rise to the top, and big banks will get them because they have the lowest costs, but it pushes the more challenging deals down with the riskiest deals ending up with the smallest banks (including smaller community banks). The people not passing are people who feel that they can afford the risk because they’re not doing nearly the volume, and this pushes the pricing up because if you have less competition, the banks can charge more; at the same time, default risk is actually up.

If you look at banks that have failed during the **recession** even though some big ones failed, a lot weathered the storm, have been held to a more exacting standard and should be able to weather the next storm. For those who didn’t do well, it’s not because of **capital** allocation, but because they invested in transactions where they didn’t have back of the house to do it the right way. When you push down that ladder of first to second to third tier, and you find banks less willing to use outside counsel because it’s expensive and they want to become competitive, there is a risk they’re playing in a pool they don’t understand. They don’t have the opportunity to do better deals, so they’re more willing to risk. I agree that there is a significant issue with banks having proper risk allocation, particularly on certain **construction** loans. In particular, full loan-development loans have risk. But rather than regulations focusing on having appropriate staffing, modeling and understanding of the risk, the regulators have taken the arbitrary line that this deal is bad and less bad if you put capital in. It also really doesn't get to the issue of whether the right bank is doing the right deal for its size, staffing and experience, and you have to wonder if there is a risk as riskier deals get pushed down will smaller banks again face a disproportionate default risk.

GlobeSt.com: What impact does this have on the commercial real estate industry?

Weissburg: What you're seeing is the bigger banks, the super-regionals and construction-specialty banks are all being very careful. As competition becomes more guarded, you have a natural increase in pricing. The Feds would say that's a good thing; we're weeding things out. Debt funds and other providers are coming in to fill in the gap, and they have a higher cost because they have a different leverage structure. They're more expensive. I think that the structure, which is favoring two if not three players, becomes more expensive. I think the lack of certainty means that any time you're doing something out of the ordinary, it really causes a damper in transactional speed and correlation on cost. Worse than uncertainty, that's not ideal. It's driving up the cost. There's a universal accord among people who do what I do; they say transactions cost more and take longer.

GlobeSt.com: How do you think reforms should be handled to prevent this problem?

Weissburg: In Hillary Clinton's speech to **Goldman Sachs**, she said she's getting taken to task with saying that people on the inside should be part of the regulations. I actually agree with that. In recognizing that there's a level of letting the fox into the henhouse, I also think there's something to be said for letting people who have to deal with these regulations on a day-to-day level be in there. There's a fine balance between letting people be unchecked and having rational regulations.

I am not against the regulatory environment. I certainly remember in the last recession there were times when every lawyer looked and said things are too frothy. There's always that potential, and universally the frothiness came from lack of adhering to **underwriting** guidelines that people six months prior would have adhered to; there's a natural pressure to overlook. There has to be some overarching structure that says we are not going to let that happen again. That makes sense, but coming up with arbitrary form-over-substance conversations and not letting the people dealing with them be in the room to me doesn't make as much sense.

If this is our goal, let's look at all these things. There's been a broad-brush criticism of the banking industry. It's been much maligned over the last eight years. I don't think that is productive and would rather see more conversations about what makes sense in a commercial context; remember, much of the problems in the Great Recession were actually driven by residential banking not commercial. And the outcry of "Breaking up big banks" isn't in my opinion a good idea; there are lots of reasons why big banks are beneficial—more liquidity to withstand a problem and it seems to me more capital means more affordability. So let's have a conversation for rational regulations. It's not that there aren't really smart people out there who can fix those things, and it's not that these are not legitimate concerns, but decisions are made sometimes more toward getting a good sound bite than what the regulations should be. We live in a global **economic** time where our financial markets are implicated by things regional, national and international, and there needs to be an appropriate level of thoughtfulness on a largely bipartisan basis to sit there and say, “How are we going to fix this?” There should be lots of people at the table, and I think right now that really hasn’t happened.