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Why the next real estate downturn might have less distressed opportunities than the 2008 and 1986 downturns - by Michael Zysman

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The real estate crash that occurred in 2008 marked the end of a real estate super-cycle that began 22 years prior, in the aftermath of the 1986 real estate crash. Both the 2008 and 1986 real estate crashes were primarily caused by instability in the banking sector that occurred when undercapitalized banks failed, and the high yield bond markets burst. The next real estate downturn will likely be different due to the passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), technological innovations that give banks and regulators access to real time data on the financial system, the adoption of Basel III banking regulations, and trillions of dollars of private equity sitting on the side-lines waiting for distressed investing opportunities.

Dodd-Frank has numerous provisions which deter banks and bond issuers from taking many of the excessive risks that led to the 2008 and 1986 real estate crashes. To help improve credit standards in the Commercial Mortgage Backed Securities (CMBS) market, Dodd-Frank has risk retention guidelines that require issuers of CMBS to hold at least 5% of risk in any securitization for a minimum of five years. Before Dodd-Frank, issuers of CMBS were not required to hold risk once the loans were sold. This new provision helps curb excessive risk taking.

Another significant part of the Dodd-Frank bill that affects commercial real estate is the dissolutions of the Office of Thrift Supervision (OTS), and the reassignment of the majority of its responsibilities to Office of the Comptroller of the Currency (OCC). The OTS was established in 1989 to regulate the U.S. savings and loan industry and to help protect against the savings and loan failures that occurred in the 1986 banking crisis from occurring again. Previously, the OCC primarily regulated commercial banks. Institutions regulated by the OTS had more relaxed regulatory requirements, allowing them to make riskier loans. These relaxed regulatory requirements were part of the reason why many savings and loan institutions failed during the 2008 financial crisis. Now that both savings and loan institutions and commercial banks are regulated by the same bodies, the federal government can actively monitor and regulate the U.S. banking system in a more uniform manner.

Dodd-Frank also created the Financial Stability Oversight Council (FSOC) which effectively consolidates all financial oversite by the federal government. The creation of the FSOC is significant, as it allows for the government to act more efficiently to protect against financial instability. There are 10 voting members who represent the heads of the following regulatory agencies: The Federal Reserve, OCC, FDIC, SEC, CFPB, CTC, FHFA, NCUA, and an independent insurance expert. They can electronically obtain and/or request information from both banks and non-bank financial companies considered significant to the financial system, to actively monitor data and identify threats to the US Financial System through the newly created Office of the Financial Research (OFR). Once a threat is identified, the FSOC can work quickly to formulate a plan with its regulatory bodies and other branches of Government to neutralize that threat.

To help prevent another banking crisis on an international level, most developed countries have adopted Basel III banking standards, which require banks to increase their reserves on loans based on their risk levels. Dodd-Frank implemented Basel III standards on the U.S. Banking System. This has affected real estate lending since Basel III requires loans backed by non-income producing land, construction and/or substantial renovation of real property to be designated as High Volatility Commercial Real Estate (HVCRE) and hold substantial reserves against these loans. This has led to banks making conservative loans on HVCRE assets.

According to the *Financial Times*, private equity firms have an estimated $2.5 trillion of uninvested capital waiting to be deployed as of June 27, 2019. This level of uninvested private equity creates an additional backstop to the U.S. and international banking system, since private equity investment will recapitalize banks, provide liquidity to borrowers that have loans coming due, and purchase distressed assets if the aforementioned regulations fail to prevent a future banking crisis. Private equity has also provided liquidity to areas of the economy where banks have a limited ability to lend due to new banking regulations.

Dodd-Frank and its subsequent amendments have done a good job keeping the U.S. banking system stable. Regulation over banks has been centralized, communication between regulatory bodies has been streamlined, financial information on the economy and banking system can be quickly analyzed, and trust between foreign banks has been strengthen through Basel III. There is no perfect formula for bank regulation which is why there have been numerous amendments to Dodd-Frank. As long as the federal government and international regulators continue to act quickly to neutralize financial threats and remove inefficiencies in the financial system, we can expect to see limited distress in the banking system.

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