Silly Season and Multifamily Policy

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When celebrity icon Donald Trump’s tweet about former Hewlett-Packard CEO Carly Fiorina’s appearance is the top national news of the day, it is safe to say the silly season is upon us. Given the quality of the discussion involving the presidential race, ignoring the news for the next year or so might improve one’s sanity.

However, the multifamily industry does not have that luxury. The combination of the proposed reform of the government-sponsored enterprises (GSEs), banking regulations that were conceived in the wake of the credit crisis that are only now on the verge of implementation, and legislation on issues such as taxes and energy policy means that what happens in Washington could have a big impact on the long-term health of the industry. Consequently, ignoring the political realm is not an option, no matter where one stands on the ideological spectrum.

Fundamentally, the outlook for the multifamily market remains positive. Speaking at the National Multi-Housing Council’s executive committee meeting in Washington, D.C., on Sept. 16, NMHC chief economist Mark Obrinsky said the next 12 months are likely to look like the last 12 months: increasing payrolls, GDP growing at long-term averages, improving consumer spending, low inflation, falling homeownership and rising household formations. All of those elements paint “a bright picture for our industry,” Obrinsky said.

Kim Betancourt, director of economics and multifamily research at Fannie Mae, concurred with the rosy outlook. Betancourt pointed to the record low multifamily vacancy rate of 4.75% nationally, the growth in the young adult renter cohort that extends into the middle of the next decade and the ongoing tepid supply increases as reasons for optimism about multifamily fundamentals. What’s more, she noted that solid performance was broad-based and not limited to core markets such as New York and San Francisco or trendy markets such as Denver and Portland. Cincinnati, Columbus, Nashville and Phoenix were among the metros cited by Betancourt that are adding jobs and population and whose multifamily markets are currently thriving.

With fundamentals humming along, near-term disruption to the industry may be more likely to stem from a regulatory or legislative misstep than the economy. While it isn’t possible to fully discuss all of the many issues of importance to the industry, the following is a snapshot of some of the major ones:

**GSE Reform**

Probably the issue with the biggest long-term effect on the sector is GSE reform. Fannie Mae and Freddie Mac supply roughly 35-40% of the mortgages on apartment buildings in any given year so they are crucial to the health of the industry. Fannie and Freddie started the year with $30 billion allotments, which were quickly used up. They subsequently were given another $15 billion, and have focused much of that on financing properties with affordable components.
Shrinking the agencies and decreasing public risk in the event of market disruptions has been in the works since the credit crisis, but solutions have been elusive, in large part because Democrats and Republicans disagree on the solution and neither side has the votes to pass its own plan.

Proposed solutions introduced to date include requiring Fannie and Freddie – which guarantee the first loss on multifamily mortgages – to share risk with private investors, creating a new government agency to explicitly guarantee losses, and fully privatizing the agencies, which is favored by some Republicans. Questions include whether there is enough private capital to fill the role provided by Fannie and Freddie if they are shrunken or eliminated, and what would happen to housing finance during recessions if the GSEs were not there to provide liquidity.

Because of the depth of the ideological disagreement, the 2016 election will prove to be a key to the next development. If a Democrat wins the White House, expect some type of solution that would gradually shrink the agencies’ role, while a Republican with the blessing of a GOP-led Congress would be more likely to implement a more drastic change. Either way, legislators and regulators must be aware that multifamily financing is vastly different from single-family, so solutions must be crafted to ensure the health of both sectors.

Taxes

Pressure to enact some type of encompassing tax reform to make the tax code simpler has been building for years, although it is another issue on which the parties are so polarized that there is no hope of passing any reform until after the next election. Even then, the makeup of the next Congress and which party occupies the White House will determine what type of compromise — if any — is possible.

There are a whole host of issues that would potentially impact commercial real estate. One is “like-kind” exchanges, also known as 1031 Exchanges, which allow investors to defer taxes on profits made when selling properties if the investor uses the capital to buy a similar type of asset. Proposals to eliminate the break have come from both sides of the aisle, although it’s not clear whether they have any significant momentum. A broad coalition of real estate groups, including the NMHC and National Apartment Association, released the results of a study this summer that found that the 1031 rule has many benefits, including encouraging investment, creating jobs and increasing federal tax revenue.

Other issues that are front and center to the industry include maintaining the Low-Income Housing Tax Credit, which helps to subsidize privately operated affordable housing; maintaining the current treatment of carried interest; protecting the partners in “flow-through” entities commonly used in real estate from higher taxes; retaining the deduction for business interest; and blocking proposals to extend depreciation of multifamily buildings to 43 years from 27.5 years and to increase the depreciation recapture tax. These proposals would reduce multifamily development and investment at a time when more housing is needed.

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Capital Markets

Real estate financing is navigating a blizzard of new regulations, including the Bank for International Settlements (Basel III) regime and Dodd-Frank. The changes are having an impact on how commercial properties are financed and the cost of capital.

In January, the Federal Reserve, Comptroller of the Currency and FDIC implemented new capital requirements for banks involving “high-volatility CRE” loans, which encompasses acquisition, development and construction loans. The regulations require banks to hold an extra 50% of capital for such loans that are more than 80% levered or have borrower equity of less than 15%. The result is a significant increase in banks’ cost of capital, which is likely to be passed on to the cost of borrowing for development.

Proposed changes to capital charges stemming from Basel III involves a complicated series of options, which pretty much all serve to increase the cost of capital for banks. One proposal would require banks to implement a minimum 100% risk-weighting for all commercial loans, and a 120% risk-weighting for loans in which the borrowers are special-purpose entities. In the U.S., virtually all commercial properties are owned by special-purpose entities. For non-special-purpose entity loans, banks would have options for risk-weighting that would produce a sliding scale between 50 and 300% risk-weighting. Basel III regulations are in a comment period.

Dodd-Frank’s provisions include increased stress tests for banks. Stress tests were limited to money-center banks but have been expanded to banks with $10 billion of assets or more. Banks are required to gauge the ability of mortgages (among other investments) to withstand a range of economic scenarios. Complying with these rules forces banks to increase staff to deal with the requirements.

Another Dodd-Frank provision requires issuers of securitized bonds — including CMBS — to retain a 5% strip of the pools. The idea is to force issuers to “eat their own cooking” and prevent the sale of pools of bad loans, as happened in the last crisis. Regulators are allowing CMBS issuers to sell their 5% strip to qualified investors (known as B-piece buyers), but those investors must hold the bonds for five years, which reduces liquidity and erodes value to some extent.

The Commercial Real Estate Finance Council, a Washington, D.C.-based trade group, has studied the bank regulations and concluded that, all things being equal, they could reduce leverage and liquidity, increase costs, impose uneven regulatory requirements across capital sources and have an ambiguous impact on the goal of improving loan quality. The regulations will serve to make non-regulated lenders more competitive relative to regulated entities and make borrowing more expensive, according to CREFC. The group estimates that the combined impact of the various regulations will reduce economic output by $209 billion over 10 years, although the estimate ranges from $168 billion to $936 billion, depending on the economic scenario.
**Foreign Investment**

Issues related to foreign capital in the U.S. include the Foreign Investment in Real Property Tax Act (FIRPTA) and EB-5 Investor Visa Program.

FIRPTA is a 1980 law that imposes an income tax of as much as 54% on foreign investors disposing of U.S. real estate and infrastructure. Foreign investors pay a higher tax on real estate than on investments such as stocks and bonds. The law also penalizes foreign investors that own more than 5% of a listed company. Legislation has been proposed that would reduce the tax rate to make it in line with other investments and to increase the amount a foreign investor could own in a listed company to 10% before penalties kick in. While foreign pension funds from Canada, Norway, China, Singapore, Abu Dhabi and elsewhere have devoted a lot of capital to U.S. commercial real estate in recent years, the tax treatment is an impediment to many other institutions. FIRPTA is set to expire at the end of September, and is likely to do so. However, the expectation is that it will be extended at the end of the year as part of a tax extenders package that will renew some 50 tax provisions that expired during the year.

Another issue related to foreign capital is the EB-5 program, which provides visas to foreign investors in exchange for investments of $500,000 or more in U.S. real estate projects. EB-5 funds tend to finance construction of small- and medium-size properties, although a handful of large assets have used this type of funding. According to the NMHC, the program attracted $68 million from China alone for apartment projects in 2014. The program has grown in recent years, with the State Department issuing fewer than 2,000 EB-5 visas in 2010 and more than 10,000 in 2014. EB-5 has been under attack in some quarters of Congress, which is considering making changes.

**Environment**

The Clean Water Act gives the Environmental Protection Agency control over “navigable waters,” which as defined greatly increases the number of waterways under federal jurisdiction. The real estate industry is concerned that the new rules will add a layer of bureaucracy to the development process and make development more difficult, costly and time consuming. Commercial buildings are also facing increased regulation related to energy efficiency. The NMHC supports the use of tax incentives to implement energy-efficient equipment, but is trying to limit the use of mandates and building codes.

**Conclusion**

There are a whole host of other policy issues that will have an impact on commercial real estate in areas such as sustainability, housing policy, immigration policy and the Census Bureau’s American community survey. While economic fundamentals remain the most important factor in the performance of the industry, the regulatory and tax environment is an essential component that industry players can’t afford to ignore, either individually or collectively.