NYU STERN

Center for Real Estate Finance Research

Fifth Annual Fall Symposium

How Will the Elections Shape the Real Estate Industry?

October 19, 2016

How Will the Elections Shape the Real Estate Industry?

Our fifth annual Fall Symposium focused on how the upcoming elections will shape the real estate industry. The morning was dedicated to answering two important questions in residential real estate and was prefaced by a residential market update. The first panel focused on the lower-income segment of the mortgage market and discussed recent activity in the non-prime space, private-label securitization, origination by non-banks, and its interaction with government policy. The second panel was focused on the middle market tier and discussed the prospects for reform of Fannie Mae and Freddie Mac. After a networking lunch, we turned to an exciting panel on real estate tax. Donald Trump's tax returns have been front-page news and have prompted a new debate on the tax treatment of commercial real estate. Our panel of experts debated potential tax reforms and how they could potentially affect the real estate industry. The last panel discussed infrastructure spending, an important complement to real estate investing. This is one area of policy agreement among the presidential candidates. What are the prospects for a meaningful infrastructure spending bill in 2017, what form would it take, and how will it be funded?

Market Update: National Residential RE Market

Summary by Anna Yao, NYU Student

Sam Khater

On Thursday, Oct. 19th, 2016 Deputy Chief Economist **Sam Khater** kicked off NYU Stern's fifth annual Fall Symposium with a brief update of the current national residential real estate market. Khater focused on the growth in home price and rental growth in the inner city and suburbs, stressing that high prices in the immediate Manhattan market is largely driven by a very low inventory and an urban, back-to-the-city rebound. Home prices have maintained a steady five to six percent growth, the lowest volatility in 40 years. Furthermore, price growth in lower-end real estate has out-appreciated the higher-end by approximately 33% due to a lack of new lower-end production.

In addition, Khater analyzed the prevailing average credit scores of homebuyers. Although mortgage underwriting has tightened since the economic recession in 2001, average leverage on homes has risen to a level even higher than that during the 2008 housing boom.

Even so, according to data from 2015, homeowners have on average higher credit scores than in 2005, which Khater attributed to a lack of consumer confidence among low credit borrowers.

To conclude the market update, Khater noted the sharp decline in LLC cash sales throughout New York City following the induction of a new treasury LLC disclosure law, which requires title companies to disclose owner identities behind anonymous sales of luxury real estate.

Panel 1: How to get the Private-label RMBS Market Going Again?

Summary by Jon Van Gorp, Panel Moderator

From Left to Right: Matt Nichols, Jon Van Gorp, Monique Rollins, Jason Kravitt, Roger Ashworth and Stijn Van Nieuwerburgh

The first panel of the day debated the reasons why the private-label mortgage securitization market has not restarted after the credit crisis. **Jon Van Gorp** of Mayer Brown moderated the panel and was joined by **Matt Nichols,** CEO of Deephaven Mortgage, **Roger Ashworth**, a mortgage analyst and RMBS at Citibank, **Monique Rollins**, Deputy Assistant Secretary for Capital Markets with the U.S. Treasury, and **Jason Kravitt**, a senior partner also of Mayer Brown.

Roger kicked off the discussion by sharing several market–based indices demonstrating that the government–sponsored enterprises, or GSEs, dominate the capital markets funding transactions supported by newly originated mortgage loans. Currently, the GSEs are responsible for in excess of 90% of the RMBS capital markets activities. Matt Nichols explained that this result is not surprising given the regulatory environment and the government's housing policy. According to him, there are currently four types of residential mortgage loans originated by mortgage loan originators. The first type is conforming mortgage loans that are originated according to a GSE's specifications to be funded by their RMBS program. The second type is jumbo mortgage loans, which are conforming mortgage loans but having larger–than–conforming principal balances. These loans, once popular collateral for securitization programs, are now held and funded on a balance sheet by the banks that originate them. The third category is so–called "alternative A" or "Alt-A" mortgage loans that are generally conforming mortgage loans but for the borrower documenting its income pursuant to GSE guidelines during the underwriting process. Alt-A borrowers are usually self-employed and unable to provide the documentation needed to verify the income needed for a conforming loan. The fourth category is the traditional subprime mortgage loans made to borrowers who cannot meet the credit threshold for a conforming loan.

The panel's discussion focused on the second two categories of mortgage loans. The underlying thesis is that the origination market for these categories of loans is challenged, rather than the securitization market being broken. Several economic and legal factors contribute to this result. New post-credit crisis compensation rules limit the compensation that can be paid to originators who originate these hard-to-originate loans. Similarly, post-credit crisis regulations that create assignee liability for originator defects has halted the secondary purchase and financing market for these loans, and as a result has made it difficult for originators of these products to establish predictable takeouts and financing alternatives for these loans.

At the same time, GSEs are expending their programs to capture more funding of these products. The expansion of the FHA/VA programs, for example, has allowed lower credit borrowers to be funded by the Ginnie Mae RMBS. This kind of government expansion presents the dilemma debated by the panel. Using the GSEs to provide mortgage credit to underserved portions of the market is consistent with their mandate and generally viewed as good for housing. But these expanded programs do increase pressure on balance sheets of the GSEs, and in turn the government who is more or less obligated to support them.

Credit risk transfer transactions demanded by the Federal Housing Finance Agency, known as FHFA, have shown the potential to transfer credit risk created by the GSEs to the private market, but it is early days for these programs. The panel eventually envisions a market where private investor involvement in the mortgage credit market is driven by these risk transfer transactions. That support however may still leave products such as the Alt-A loans underdeveloped and dependent on the rebirth of the traditional private-label mortgage market to grow.

Regardless of the outcome of the 2016 Presidential election, all panelists agree that the GSEs in their current form will dominate the mortgage credit markets for the immediate future. Increased interest rates could impact the growth of the private-label mortgage market, but some of the post-credit crisis regulatory changes will have a long–lasting effect on the origination market for some mortgage loans traditionally funded by the private markets. In other words, to answer the question posed to panelists at the beginning of the panel, the private-label mortgage securitization market did not disappear, but instead the products disappeared and therefor the private-label securitization market that used to fund them also disappeared.

Panel 2: GSE Reform: Will it Happen and What Form Will it Take?

Summary by Stijn Van Nieuwerburgh, panel moderator

From Left to Right: Stijn Van Nieuwerburgh, Andrew Davidson, Phillip Swagel, Ed DeMarco, and Patricia Mosser

The government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac collapsed almost 8 years ago and have been in the government's conservatorship ever since. Despite recent attempts, the body politic has been unable to reach consensus on how to reform them. Yet new initiatives, like the credit risk transfer programs, have brought back private capital bearing credit risk. The second panel of the day discussed four leading proposals for reform and assessed prospects for reform in 2017 under a Clinton or Trump administration. Prof. **Stijn Van Nieuwerburgh** moderated the panel.

Prof. Philip Swagel (University of Maryland and Milken Institute) was Assistant Secretary of the Treasury from December 2006 until January 2009, advising Secretary Hank Paulson on all aspects of economic policy. He started by reminding the audience about the lead up to the housing crisis and the role of Fannie and Freddie in it.

Edward DeMarco (Milken Institute) served as Acting Director of the Federal Housing Finance Agency (FHFA), the conservator for Fannie Mae and Freddie Mac and regulator of those companies and the Federal Home Loan Banks from September 2009 to January 2014. He explained how prior to the crisis all interest and prepayment risk on mortgages was laid off to the market while all credit risk was borne by Fannie and Freddie.

One key innovation in the U.S. housing finance market has been the introduction of the structured credit risk transfer programs. Starting in summer 2013, Fannie and Freddie began to lay off increasing amounts of credit risk on the mortgages they guarantee back to the private market. **Andrew Davidson** (Andrew Davidson & Co) explained how these credit risk transfer (CRT) programs work and have fared.

The main part of the discussion consisted of a detailed discussion of four recent proposals for GSE reform. These proposals are available on the CREFR web site on our GSE Reform page. Prof. **Patricia Mosser** (Columbia University), discussed her utility model proposal. What is interesting is that all four proposals are fairly close to one another and provide a realistic blueprint for reform. They all keep the separation of interest rate and credit risk investor clienteles. They all envision the continuation of the guarantee function and a scaling up of the CRT programs to the point where all non-catastrophic risk is laid off to the private market. They all envision additional private capital backing the successor(s) of the GSEs.

Despite the near-consensus, the panelists feared that housing finance reform was not very high on either presidential candidate's reform agenda.

Finally, the panel discussed the potential roll-off of the agency RMBS portfolios accumulated on the Fed's balance sheet as part of the Quantitative Easing programs. **Patricia Mosser** argued that the roll-off would be gradual and would have only modest implications for mortgage interest rates and house prices.

Panel 3: Commercial Real Estate Tax Reform

Summary by Gary Friedland, Panel Moderator

From Left to Right: Stijn Van Nieuwerburgh, Gary Friedland, Ryan McCormick, Adam Feuerstein, and Steven Rosenthal

Gary Friedland, a Scholar-in-Residence at NYU Stern, moderated a panel exploring how the election results might impact income tax treatment of commercial real estate. The release of one page of Mr. Trump's 1995 personal tax return by the NY Times casts a spotlight on the favorable tax treatment accorded to developers of rental and income-producing properties. Even though the Presidential candidates' plans do not address many of these issues and no Congressional proposals have gained traction, the attention drawn to these matters by the publicity surrounding the Trump return raises the potential for a reexamination of the rationale for the current tax treatment. This might lead to changes to the Federal tax code that had not been seriously explored before the campaign.

The panel focused on potential changes in the tax treatment of carried interest (the "promote" in the commercial real estate world); depreciation; 1031 like-kind exchanges; passive activity loss; and net operating loss. The favorable tax law treatment is generally not available to condominium projects.

Adam Feuerstein, PWC's National Real Estate Tax Technical Leader, set the stage by explaining each concept and its current tax law treatment.

Steve Rosenthal, a Senior Fellow at the Urban-Brookings Tax Policy Center, has been extensively quoted as a tax expert in the series of articles published in the NY Times, focusing on the Trump tax return.

Ryan McCormick is Senior Vice President and Counsel at the Real Estate Roundtable, a member organization which addresses key national policy issues to reflect the views of the nation's largest real estate companies.

The panel featured a spirited debate between Mr. Rosenthal and Mr. McCormick. Addressing each provision separately, they expressed their divergent views as to whether the current treatment should be maintained or changed, and the rationale supporting their position. They explored Congressional proposals that have surfaced in recent years, the Clinton and Trump plans (to the extent they have articulated a position on a particular item), and other alternatives.

Some of the provisions – 1031 and carried interest – have generated controversy in recent years, and been the subject of frequent legislative efforts to change the law. Some of the other provisions have been overlooked, such as the passive activity loss exception for real estate professionals (including developers), but are likely to be reexamined in light of the "Trump effect."

Mr. Feuerstein led a discussion of the U.S. taxation of foreign investors in U.S. real estate, one area where real estate is discriminated against, in contrast to the other provisions debated at this session. He described the significant FIRPTA reforms enacted in 2015 that are expected to boost foreign investment in U.S. real estate and infrastructure projects.

The panel concluded by Messrs. Rosenthal and McCormick, both former high level staff members of Congressional tax-writing committees, leading a discussion of the possible legislative course of action for tax reform during 2017, depending on the outcome of the Presidential and Congressional elections. The consensus was that if any tax reform will be passed in 2017 it is more likely to be comprehensive tax reform, rather than

piecemeal. However, it remains to be seen whether, even if Hillary Clinton becomes President, the Trump effect will linger or fade.

Panel 4: Infrastructure Spending

Summary by Sam Oke, NYU Stern MBA Student

From Left to Right: Stijn Van Nieuwerburgh, James Burgoyne, Benjamin Page, Barry Blattman, and Ingo Walter

The fourth and last panel discussed the nature of infrastructure spending in the broader context of the upcoming presidential election. The panel began by recognizing the widespread positive externalities of infrastructure spending such as economic stimulus and increased labor productivity. The challenge inherent with investing in critical infrastructure assets with such positive externalities is capturing the value to ultimately monetize.

Barry Blattman, Vice Chairman & Senior Managing Partner at Brookfield Asset Management, began the panel response by highlighting the growth of infrastructure as an asset class and the relative attractiveness of infrastructure investments in a low interest rate environment. He put forth the idea of infrastructure investments as an alternative to fixed-income securities as investors consider the threat of rising interest rates eroding investment value. In the long term, he predicts the proportion of infrastructure assets in the Brookfield portfolio will exceed that of real estate assets.

James Burgoyne, Managing Director of Oil & Gas Infrastructure at GE Energy Financial Services, pointed to another attractive characteristic of investment in infrastructure assets – longevity. Infrastructure, as a long-lived asset class, aligns well with the long-lived liability obligations of many corporations. One challenge with infrastructure investing is navigating the potential changes in the regulatory environment given the 40-50 year lifecycles of the assets. The political risk of changing regulations that come with a new administration must be carefully considered when investing. He articulated regulatory transparency as the key to creating an environment conducive for infrastructure investing.

Ben Page, Senior Fellow at the Urban Institute, enumerated what he sees as the two primary benefits of infrastructure spending – Keynesian stimulus and increasing productivity. Government investment in infrastructure projects could be utilized as a mechanism to combat unemployment both on a national and local level. Adequate transportations systems including airports in addition to roadway networks reduce transportation inefficiency thus increasing labor productivity. As a caveat to the impact of infrastructure spending on the overall economy, Page highlighted that with the long timeline for the approval and construction of infrastructure investments, the realization of returns is not immediate but prolonged.

Ingo Walter, Professor Emeritus of Finance at NYU Stern, moderated the panel. Using NYU Stern as a model, he drew attention to the growing recognition of infrastructure as its own distinct specialization apart from real estate. At the university level, NYU Stern is in the process of developing a specialization within the MBA and undergraduate programs focused on infrastructure finance and development

In response to several insightful questions from attendees, the panelists concurred with the notion that politics has a significant impact on the infrastructure space. Congress' influence on federal dollar allocation to infrastructure-related projects makes the likelihood of political influence abating difficult to conceive.