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**What CRE Finance Will Look Like in 2017**
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The commercial real estate financing market is facing numerous obstacles this year, ranging from the potential impact of newly implemented regulations to a likely shift in federal monetary policy to shifting solid fundamentals—and whether or not those changes will decrease demand for debt. There is also the rise of nontraditional, nonbank lenders in the marketplace to consider, as well as an incoming presidential administration that many believe will bring about policies beneficial to the overall economy but whose specific agenda remains notoriously hard to predict.

Yet, most observers remain bullish on the overall state of the nationwide commercial real estate market in 2017 and anticipate further growth across many asset classes. That, in turn, is expected to continue to drive demand on the financing side.

"I think we're ending 2016 with a lot of momentum that's going to be carried into 2017," Jamie Woodwell, the vice president of research and economics for the Mortgage Bankers Association, told Commercial Observer at the end of last month. "On the fundamentals side, you've got strong property markets, continued increases in property values and active transaction markets. On the supply side, all of the major capital sources continue to have strong appetites for commercial and multifamily mortgages."

Of course, there is much talk of the potential impact of an expected rising interest rate environment moving forward after the Federal Reserve raised its benchmark short-term rate at the end of last year and Fed officials predicting three additional increases over the course of 2017. While it remains to be seen whether the central bank follows through on that projection, most anticipate a costlier borrowing environment in the near future—particularly as it relates to a 10-year Treasury rate that has risen considerably since the presidential election in November.

After dropping to a new low of 1.37 percent in early July, the 10-year Treasury rate climbed to 2.6 percent on Dec. 16, 2016, while the Fed also raised its short-term funds target rate 25 basis points two days earlier to 0.75 percent from 0.5 percent.

"We definitely expect higher interest rates [in 2017]," said Ari Hirt, a managing director of debt and equity finance at Mission Capital Advisors, citing increases in both the Fed's short-term funds target rate and the 10-year Treasury. "We expect those rates will rise, meaning less coverage on properties and less projected income on properties under construction."

But with interest rates only increasing now, after dipping to record lows in the years following the Great Recession, many believe the current real estate investment environment is more than resilient enough to cope with such changing conditions.

"Although rates have risen modestly recently, if you look at the historical cost of debt on commercial property, the fact that you can borrow [at interest rates] in the high-4s, mid-5s is very low historically," said

Mark Jarrell, a corporate executive vice president and the head of portfolio lending and commercial mortgage-backed securities at Greystone. "I don't think higher interest rates will be an impediment to the market, because while rates might be higher today than they were six months ago, they're still very near historic lows."

Higher borrowing costs would also be more than manageable in a stimulated, growing economy—and that is exactly what many, on both the borrowing and lending sides, are expecting under President-elect Donald Trump's incoming administration.

"In general, our view [for the economy next year] is really rosy," Jarrell said. "No matter how you feel about the election and how it turned out, it's pretty clear that sentiment is good about the state of the U.S. economy and near-term future of the U.S. economy."

Market participants are anticipating supply side-friendly policies during a Trump presidency, such as sizable corporate and capital gains tax breaks, as a likely boon for investors on a national scale.

"If you're talking about a pretty quick tax bill cutting corporate tax rates and a possible rollback of [financial] regulations, everyone would have to think 2017 will be a good year for the economy," said Ronald Dickerman, the founder and president of real estate private equity firm Madison International Realty.

By all accounts, that optimism has pervaded throughout the real estate industry and is expected to drive greater activity—and more borrowing—this year.

"Everybody that I talk to feels like [Trump administration economic policies] will throw gas on the fire in a good way," said Boyd Fellows, a managing partner at ACORE Capital. "It's psychological. People feel a lot better about investing now than before Trump was elected."

With a Republican-controlled Congress capable of pushing through large swaths of the Trump administration's domestic agenda, most observers appear confident that business-friendly tax cuts will be a cornerstone of the incoming president's fiscal policy. What's less certain is the extent to which policymakers will be able to alter or even rollback financial regulations that have had a considerable impact on how commercial real estate lenders and borrowers do business—both presently and in the near future.

Risk retention rules, introduced as part of the Dodd-Frank Wall Street Consumer and Protection Act and having officially taken effect on Dec. 24, 2016, now require CMBS originators to retain a 5 percent interest in transactions they originate. In 2016, CMBS issuances experienced a sizable drop in transaction volume to roughly $70 billion from north of $100 billion in 2015. While this was largely a result of the macroeconomic volatility witnessed in the first quarter 2016, concerns persist that risk retention may further compound the conduit market's struggles going forward.

Morningstar Credit Ratings issued a "flat" forecast for the CMBS sector heading into 2017, but risk retention and interest rate volatility still "are not supportive for the market at all," according to Lea Overby, the managing director of structured finance research at Morningstar.

"Banks had a lot of difficulty issuing deals [in 2016]," she said. "The conduit market improved toward the end of [2016], no doubt, but it will be interesting to see how it changes [this] year."

Among those changes could be banks issuing smaller deals, as a result of risk retention requirements, in order to reduce their own exposure. "That may be a trend that we see in the coming year," Overby noted. "We may have more deals, but if each of them is 10 to 20 percent smaller, then we'll be down volume-wise [in 2017]."

Research firm Trepp also forecasted CMBS issuances to be roughly flat, at around $70 billion, in 2017. Trepp Senior Managing Director Manus Clancy said that he is "cautiously optimistic" that risk retention "won't have as big of an impact as people think"—though, like other conduit market observers, he noted that lenders will "ask for more returns in order to take the commitment, and that will raise the cost of borrowing."

According to CBRE research, risk retention requirements could see CMBS loan pricing jump 15 to 25 basis points in 2017, while some market watchdogs anticipate an even greater increase.

"Lenders are really adept at passing on costs, so they'll find a way," said David Blatt, the chief executive officer of boutique investment bank CapStack Partners. "Bringing in an element of ownership and responsibility into the product isn't going to cease origination by any means. Wall Street will do what it always does, which is adapt and find a way to make a return in a new reality. Ultimately, I don't think we're going to have a precipitous drop in terms of origination, because there's an appetite for this product."

As for whether risk retention could eventually fall victim to a rollback of financial regulations spearheaded by the White House and likeminded allies on Capitol Hill, there is widespread skepticism within the market that any such initiative would take particularly high priority on the Trump administration's to-do list—or that such a reversal could take effect in the immediate to near future.

"I think that the President-elect comes in with a short list of things that are high priorities, and I don't think rolling back risk retention is on that short list," Clancy said. "While, as a commercial developer, he probably understands acutely the benefit of lower cost of funds—and it may become a priority at some point—it doesn't strike me as a priority for the first 100 days."

Whether the cause is heightened regulation, including recently implemented Basel III rules governing high volatility commercial real estate (HVCRE) loans, or simply traditional bank lenders proving themselves more selective over the course of this current cycle, another financing trend that's expected to continue in 2017 is the rise of nontraditional, nonbank lenders.

Debt funds, mortgage real estate investment trusts and even other real estate investment and development firms have played an increasing role in the market—particularly in helping borrowers finance shorter-term deals with riskier profiles, such as construction loans.

"We have an optimistic view on the opportunity for us as a nonbank lender," Dennis Schuh, the chief originations officer of Starwood Property Trust, said of his company's role in the commercial real estate financing market. "The bank market has pulled back, as far as their credit and risk appetite. They're the largest financing segment of commercial real estate, so if they pull back a little, that creates a big opportunity for other financing sectors."

The nonbank, noninsurance, non-CMBS sector of the market has usually accounted for around 20 percent of total lending volume in recent times, according to CBRE research, and is only expected to play a bigger part moving forward as traditional lenders face capital constraints. These challenges have hit the construction financing market, in particular, with bank and nontraditional lenders increasingly teaming up to provide developers with the capital required for projects.

Wells Fargo, for example, partnered with Natixis Real Estate Capital last summer to seal a $197 million construction loan for developer Toby Moskovits' ambitious spec office project at 25 Kent Avenue in Williamsburg, Brooklyn. The San Francisco-based banking giant also worked with mezzanine lender Winter Properties last year to provide Slate Property Group and Meadow Partners with $110 million in financing for a new Downtown Brooklyn rental tower.

"I'd say construction loans of over $100 million are a challenge to get done with a single bank now," Hirt said. "There are new lenders who see this as an opportunity to go into the construction loan space."

But even lenders who don't specialize in construction financing have reaped the benefits of this new dynamic. "I think the [nonbank] sector has grown in share, and given the regulatory practices, it will continue to grow in 2017 and beyond," said Greystone's Jarrell, whose company works primarily within the CMBS and multifamily financing sectors.

"Under new regulations, banks have gotten to be more cautious, and they're slower to react, and I think nonbanks have the ability to react to clients' needs more quickly because they're not subject to the same level of oversight," he added. "It's not only that pricing now differentiates them but the processes."

Of course, banks still make up a significant portion of the industry's financing market—around 40 percent of lending volume in recent quarters, per CBRE. That number fell to 31 percent in the third quarter of last year, however, as banks were usurped by life insurance companies, which accounted for 35 percent of the lending market in that period.

But bank lenders are still widely expected to play a critical role when it comes to funding mid-sized transactions located away from the core, trophy markets that attract insurance companies, sovereign wealth funds and non-traditional lenders.

And as far as regulations perceived to be a hindrance to their commercial real estate lending capabilities, observers also note that the banking sector has undoubtedly learned lessons from the recent past and, in many cases, have made the decision to pull away from riskier propositions by themselves.

"Some of this is due to regulations, but I think lenders have cut back on construction lending due to their own view of exposure and market dynamics," said Steven Kohn, the president of equity, debt and structured finance at Cushman & Wakefield.

“Debt funds tend to lend a higher level of proceeds, and on a nonrecourse basis, and that’s very important to many owner-operators. They’ll also move quickly and they’ll take more risks,” Kohn said. “But if you’re a conservative, established borrower, bank debt is still readily available. You’ve got many choices now—banks, life insurance companies, mortgage REITs, pension funds and debt funds—which is great for a competitive process.”