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HEARING BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

ENTITLED

"COMMERCIAL REAL ESTATE: A CHICAGO PERSPECTIVE ON CURRENT MARKET CHALLENGES AND POSSIBLE RESPONSES"

WRITTEN STATEMENT OF

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ON BEHALF OF

THE NATIONAL ASSOCIATION OF REALTORS®

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Chairman Moore, Ranking Member Biggert, and members of the Subcommittee, on behalf of more than 1.1 million REALTORS® who are engaged in all aspects of the residential and commercial real estate industry, I am pleased to offer our views on "Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses."

My name is Joseph Cosenza. A REALTOR® for 42 years, I am Vice Chairman/Director and one of the four original principals of The Inland Real Estate Group, Inc., in Oak Brook, Illinois. Additionally, I have been President of Inland Real Estate Acquisitions, Inc. since November 1988. Since 1968, I have directly overseen the purchase of more than $32.8 billion of income-producing commercial real estate.

Having a sound and well-functioning commercial and multifamily real estate sector is critical to our country's economic growth and development, and to millions of U.S. businesses of all sizes that provide local communities with jobs and services. It is estimated that the commercial real estate sector supports more than 9 million jobs and generates billions of dollars in federal, state and local tax revenue. Nonetheless, the overall economic downturn and crisis in the broader financial markets is directly impacting not only the fundamentals of commercial real estate finance, but also the outlook for recovery. And while the commercial and multifamily real estate markets play a vital role in the economy, these markets are now experiencing the worst liquidity challenge since the early 1990s.

Many in the $6.5 trillion commercial real estate industry have been warning for some time that the liquidity crisis facing our industry has the potential to wreak havoc on the broader economy. In fact, an apt description for the situation is that commercial real estate is the "next shoe to drop". The collapse of the nation's housing market had and continues to have a huge impact on the entire global financial system. Likewise, it is important to recognize the economic ramifications of a widespread collapse in the commercial real estate markets.

This year, Moody's proposed that "[l]osses on commercial real estate loans could top $150 billion by the end of 2011." In fact, last January more than 6% of commercial mortgages in the U.S. were delinquent and the number continues to rise at an alarming rate, according to the Wall Street Journal. By year end, delinquency rates on loans for commercial properties could rise to between 9% and 14%, according to Jefferies & Co., as consumer spending and confidence continue to be low.

Furthermore, commercial property values have fallen 43% across the board from their peak in 2007, according to Moody's. Moody's also estimates that commercial property values could fall between 44% and 55% from 2007 prices. Billions of dollars in U.S. mortgages are now underwater, meaning the loan balance is higher than the value of the underlying asset. Falling real estate values have forced many banks to reduce their commercial real estate loan volumes, which are down 86.5% from 2007.[1]

A crisis is looming in the commercial real estate market due to a confluence of issues that include: (1) economic conditions, especially high unemployment; (2) weakening commercial property fundamentals; (3)

[1] Wei, Lingling. "Another CMBS Bright Spot – J.P. Morgan Expected to Sell $500 Million in Inland Western Debt." *Wall Street Journal* 2 Dec. 2009: C8.

declining commercial property sales volume and price; (4) slow commercial property lending; and (5) increasing commercial loan delinquencies. These circumstances, paired with $1.4 trillion of anticipated commercial mortgages' maturities through 2014, create a challenging commercial real estate finance environment.

Combating the Crisis

NAR believes that a number of solutions are needed to lessen this crisis. Since all properties are different, different approaches will be necessary. We see commercial properties as falling into one of three categories: properties that are simply not sustainable; properties that are performing, current, and can support their debt, but may have difficultly refinancing because their values are lower than their debt; and properties that are viable long-term but need immediate help with loan modifications or refinancing assistance. There are a number of solutions that we believe can start to solve the problems in two of these three categories. In the first category are properties that are not viable and cannot be saved. But properties that fall within the other two are viable long-term and can be saved with a variety of tools. It is critical that steps are taken now to prevent a total collapse of commercial markets and a corresponding downturn in our economy.

NAR presents six proposals to improve commercial real estate markets. While none of these can solve the crisis alone, together they can all contribute to a recovery. We urge the Committee to give these proposals strong consideration. The proposals are: incentives for increasing investment in properties; increasing the cap on credit union business lending; a mortgage insurance program for performing commercial loans; additional Federal Reserve and banking agency guidance especially relating to term extensions; an extension of TALF; and improve lending access for small businesses.

Incentives for Increasing Investment Property - Accelerated Depreciation

Improved cash flow for investors/owners of commercial real estate would help to fend off some of the challenges the market faces. The most effective means of improving the cash flow on real property is to provide more generous depreciation allowances. We believe that some combination of accelerated depreciation (or shorter recovery periods) and passive loss relief would be significant investor incentives. Proposals related to depreciation would have the most immediate and beneficial impact on investment incentives and carry great potential for improved cash flow. Improved cash flow can soften some of the coming commercial liquidity crisis, particularly as it affects performing loans that are underwater.

Increasing the Cap on Credit Union Business Lending

The biggest problem in commercial real estate and small business markets is a lack of liquidity. Commercial banks account for $1.5 trillion, or 45 %, of outstanding commercial real estate debt.[2] Due to the slumping economy and falling commercial real estate values, many commercial banks have tightened their credit

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[2] Congressional Oversight Panel, *February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability*, (February 10, 2010) (online at http://cop.senate.gov/documents/cop-021110-report.pdf) (hereinafter "Oversight Panel").

standards and reduced their loan volumes. For example, lending was down 7.82% among the ten largest U.S. banks in 2009. While large banks, with assets over $10 billion, hold over half of commercial banks' total commercial real estate whole loans, their actual exposure (total commercial real estate loans/total Tier 1 capital) is relatively low when compared with small and mid-sized financial institutions.[3] Tier 1 capital is the amount of money banks have on hand to cover any loan losses.

According to the Congressional Oversight Panel (Oversight Panel) report issued this year, banks with assets of $1 billion to $10 billion have the highest commercial real estate exposure, followed by those with assets of $100 million to $1 billion. These two asset groups have an average commercial real estate exposure of 347% and 345% more than their available Tier 1 capital reserves, respectively. Unlike large banking institutions, small and mid-size banks are more vulnerable to commercial real estate trends because they do not have credit card services or investment banking operations to offset significant commercial real estate losses.

The Oversight Panel report also identified smaller regional and community banks with "substantial" commercial real estate exposure account for almost half of the small business loans issued across the country. Of the 8,100 U.S. banks, 2,988 small institutions have "problematic" exposure to commercial real estate loans, according to the Wall Street Journal. In other words, their level of commercial real estate loans is at least 300% of total capital or their construction and land loans exceed 100% of total capital. This exposure amongst small regional and community banks has caused a significant decrease in credit available to the small business community, which has slowed down the national economic recovery. This decrease in small business loans also has the potential to elevate problems within the commercial real estate industry by further reducing cash flows and raising vacancy rates. Additionally, we are concerned that lending will be further constrained as more banks continue to fail, are seized, or taken over by regulators. According to the Federal Deposit Insurance Corporation (FDIC), since January 2008, 234 banks and savings institutions have been seized by regulators, including 68 so far this year.

During previous crises consumers and businesses have relied on credit unions to fill in the gaps where banks could not serve them. Credit unions have been providing business loans for more than 100 years. Today, however, credit unions are hampered by a business lending cap of 12.25% of total assets. Many commercial REALTORS® have reported having strong, long-lasting relationships with credit unions, which could help them refinance and sustain their properties, but find the lending cap presents an obstacle. More than half of the outstanding business loans held by credit unions have been extended by those approaching or at, the cap. That means that credit unions with experience in handling commercial loans are unable to continue to help get us out of this crisis. We are pleased to support H.R. 3380, introduced by Rep. Kanjorski (D-PA) and Rep. Royce (R-CA), which will increase the cap on credit union lending to 25% of total assets.

Mortgage Insurance Program for Performing Commercial Real Estate Loans

Commercial real estate loans are generally short-term - sometimes even less than five years. The problem commercial properties are having is that when they go to refinance an existing loan, there can be a significant difference between the current appraised value of the property and the debt currently serving the property.

[3] Oversight Panel

Even on performing properties, lenders will not refinance at the existing debt level and are instead demanding a new infusion of capital into the project—capital which simply isn't available.

One proposal is to develop a mortgage insurance program for commercial debt. This would not insure the entire value of the loan, but instead would offer insurance on the difference between the current value and the debt service. Such a proposal or even a government guarantee program could bolster commercial markets during this difficult time. The program could be structured to limit eligibility to performing properties that have been evaluated and are income producing, and expected to be viable in the long-term. Banks would pay a guarantee or insurance fee that would help fund the program. The insurance could be short-term and designed to cover the equity gap until the market rebounds.

Additional Guidance Relating to Term Extensions

Another proposal for helping performing properties overcome the equity gap is term extensions. For properties that can support their current debt, a simple loan extension makes perfect sense. As most commercial loans are short term, these loans refinance frequently. If instead of requiring a refinance at the end of a loan term (and having to deal with the equity gap), lenders could be encouraged to extend the term of the current loan.

Currently lenders are not offering extensions because they are wary of oversight and regulatory concerns. Federal guidance encouraging these types of extensions for appropriate properties could be a helpful tool.

Extension of TALF

The commercial mortgage backed securities (CMBS) market, which supports commercial and investment real estate lending, continues to remain tightly constrained. In 2007, the CMBS market provided approximately $240 billion in financing. In contrast, the CMBS market provided less than $13 billion in issuance in 2008, despite strong credit performance and huge demand from borrowers.

With an average of $300 billion in commercial real estate loans maturing each year for the next decade and an extremely limited capacity to refinance, the result could very well be widespread systemic damage. Deutsche Bank's Parkus estimates that more than 65% of loans packaged into CMBS won't qualify for refinancing when they come due. This lack of capacity threatens our economic recovery. This threat is exacerbated by the hundreds of billion in commercial mortgage loans coming due in the next several years. In fact, the inability to secure financing will result in increased loan defaults and foreclosures, and the forced sale of many properties at greatly depressed prices, creating a ripple effect of financial losses and more job layoffs. Last month, CMBS delinquencies climbed above 8%, an all-time high according to Trepp. Fitch Ratings estimates this number could reach 12% in 2012.

Last November, the first CMBS in over 18 months was sold with assistance from TALF. Additional loans are now in the program's pipeline. At the end of 2009, the Federal Reserve reported it had made $7 billion in TALF CMBS loans. The initial success of TALF helped drive two other CMBS refinancing deals that were completed in the fourth quarter of 2009, without help from the program. Nonetheless, these deals were conservative in nature, featuring extremely strict underwriting standards and greater safeguards to investors.

This year, up to $20 billion of commercial mortgage bond issuance is expected, according to Barclays Capital. However, due to the long-term nature and complexity of putting together CMBS deals – often taking between six months and two years to complete – potential investors have been or will be excluded from participation in the program as a result of the March 31, 2010, and June 30, 2010, sunset dates for legacy and newly issued CMBS, respectively. The Oversight Panel cautions "[t]he withdrawal of Federal Reserve liquidity programs such as TALF (a partially TARP funded program) may result in wider spreads, less readily available capital for commercial real estate, and more difficulty refinancing loans at maturity." Given additional time, we would expect TALF to continue to jumpstart the private commercial mortgage markets by restoring investor confidence.

While we believe an extension to TALF will help stimulate the struggling CMBS market, NAR also strongly urges lawmakers and the federal government to make program requirements less burdensome for potential investors. Some investors have failed to participate in this program because of onerous rules and regulations set forth by the Federal Reserve. Improving this process will allow TALF to maximize its effectiveness by enabling investors to help develop sufficient CMBS volume to address the massive credit shortfall in the commercial real estate sector.

The extension of the TALF program through at least the end of 2010 and loosening program requirement is the most effective way to immediately address the crisis in the commercial credit market with the least exposure to the taxpayer. TALF should be extended as soon as possible in order to continue to help restore capacity and address the enormous credit shortfall facing commercial real estate.

Improve Lending Access for Small Businesses

In addition to addressing the issues facing the commercial real estate market, improving access to capital for small businesses—widely acknowledged as a critical part of growing the American economy—is also greatly needed. According to recent reports, banks reduced the amount of money extended to small businesses by $15.7 billion between September 2008 and September 2009.[4] While there has been some improvement, we believe that the Small Business Administration (SBA) can be a more useful tool for facilitating access to the loans small businesses need.

Unfortunately, however, it seems many small businesses are still having trouble getting SBA loans to grow and improve their operations. Applications for SBA loans can be as much as 100 pages long; documentation is required that most small businesses don't keep; some lenders are uninformed on who is eligible for the loans; and even after these obstacles are surmounted, SBA lenders are often still reluctant to make the loans.

Like any small business, many real estate brokers and agents struggle to find capital for day-to-day operating expenses, debt service, capital expenditures, and funding for expansion. Unfortunately, our members report that SBA lenders continue to turn them away under the mistaken belief that real estate agents are ineligible for SBA loans despite the SBA's recent clarification that independent contractor sales agents are, in fact,

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[4] Appelbaum, Binyamin and Ylan Mui. "Lack of Customers, Assets Stunting Growth of Small Business." *The Washington Post* 23 February 2010: A12.

eligible. NAR appreciates the SBA's willingness to provide that clarification and is hopeful that SBA lenders will soon "get the message."

Recently, the President proposed increasing the limits of SBA loans. While we welcome the proposed increases, we are concerned that this will not get at the core issues of an arduous application processes and reticent lenders. NAR has made recommendations to SBA to improve the current situation. In particular, we have suggested in comment letters that the SBA should seek authority to eliminate SBA's 1/4 point guaranty fee for loans with maturities of 12 months or less where the total loan amount is no more than $150,000. A quarter percent on a $150,000 loan is $375 and, to the extent that a $375 fee might affect the SBA's decision to make a loan, the fee should be eliminated.

NAR has also proposed waiving lender fees, as permitted under the American Recovery and Reinvestment Act (ARRA). This would eliminate fees that impede loan applications and ultimately the loans themselves. Among the SBA's stated reasons for excluding this measure from recent efforts to stimulate lending are the prioritization of borrower relief and a need for appropriations to fund the measures. NAR believes that if the Administration wishes to increase small business lending, it should not matter on which side of a transaction fees occur if the fees continue to prevent loans from being made. We would also urge Congress to provide appropriations for these measures that will match small business demand.

Additionally, NAR would like Congress to consider raising loan limits for both SBA 7A and SBA 504 loans. Currently, SBA 7A loans are available up to $2 million and SBA 504 loans are available up to $4 million, depending on the purpose of the loan. Raising these loan limits will provide another lending vehicle for commercial property owners in a credit market that remains tightly constrained. Furthermore, permitting SBA 504 loans to be used for refinancing of performing commercial properties can be another useful tool to help address the liquidity crisis facing the commercial real estate industry.

Furthermore, NAR applauds the efforts of the Administration and Congress for introducing a proposal that would boost small business lending. In this two-part proposal, low-cost capital will be provided to community banks with assets less than $10 billion, if these institutions increase their small business lending portfolio. This plan also would provide much needed funding for state programs that pool default risk on small business loans, which is critical during a time of state budget shortfalls.

The availability of credit to small businesses has a strong impact on commercial properties. According to the Oversight Panel, small banks with the highest exposure to commercial real estate loans also account for nearly 40% of all small business loans. As small business credit becomes even less available, commercial markets will continue to suffer. Many small businesses take out short term loans to cover inventory or payroll expenses until sales or other revenue is generated. However, many of these borrowers have found themselves unable to obtain credit in the last year. According to the National Federation of Independent Businesses, the percentage of small business owners holding a business loan or credit line each fell almost 20% in the last year. This makes it harder for them to pay rent on their leased space, or causes them to abandon their business, creating high vacancy rates in commercial space, which can decrease the value of the properties, adding to the crisis.

Conclusion

Having a sound and well-functioning commercial and multifamily real estate sector is critical to millions of U.S. businesses of all sizes that provide local communities with jobs and services and, consequently, to our country's overall economic growth and stability.

NAR believes it is critical for Congress to act now. During the previous commercial market collapse in the 1980s, the Oversight Panel states that "roughly 2,300 lending institutions failed and the government was forced to expend $157.5 billion (approximately $280 billion in 2009 dollars) protecting depositors' funds and facilitating the closure or restructuring of these organizations." Given that the same report states projects that losses at banks could range as high as $200-300 billion between now and 2011, something MUST be done.

We thank the Committees for this chance to provide input on the important issues surrounding the commercial real estate crisis. The National Association of REALTORS® looks forward to additional opportunities to work with the Committees and find solutions to recreate healthy markets, communities and our economy.