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HEARING BEFORE

THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE OF FINANCIAL SERVICES

ENTITLED

"ALTERNATIVES FOR PROMOTING LIQUIDITY IN THE COMMERCIAL REAL ESTATE MARKETS, SUPPORTING SMALL BUSINESSES AND INCREASING JOB GROWTH"

WRITTEN TESTIMONY OF

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2010 TREASURER, NATIONAL ASSOCIATION OF REALTORS®

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Chairman Frank, Ranking Member Bachus, and Members of the U.S. House Financial Services Committee, thank you for inviting me to testify today on "Alternatives for Promoting Liquidity in the Commercial Real Estate Markets, Supporting Small Businesses and Increasing Job Growth." My name is Jim Helsel and I am the President of Helsel, Incorporated, Realtors® in Camp Hill, Pennsylvania. I have been involved in real estate for 35 years and currently serve as the 2010 Treasurer of the National Association of REALTORS® (NAR).

I am here to testify on behalf of more than 1.1 million REALTORS® who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors, and others engaged in all aspects of the real estate industry. Members belong to one or more of 1,400 local associations/boards and 54 state and territory associations of REALTORS®.

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 1990's.

Many of us 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.

Moody's has proposed that "Losses on commercial real estate loans could top $150 billion by the end of 2011." In fact, as of the first quarter of this year, delinquency rates in the CMBS market were up to 7.24%. 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 continues to be low. Furthermore, commercial property values have fallen 43% across the board from their peak in 2007, and more than 33% from 2008, according to Moody's. Moody's also estimates that commercial property values could fall between 44% and 55% from 2007 prices. A June survey of our commercial members revealed that more than 46% of them had not completed a single commercial sales transaction in the first quarter of 2010. NAR's economic research suggests that vacancy rates in commercial sectors will not stabilize until early 2011. Billions of dollars in U.S. mortgages are now underwater, meaning the loan balance is higher than the value of the underlying asset. In fact, half of all commercial real estate mortgages will be underwater by the end of 2010, according to Elizabeth Warren, chairwoman of the Congressional Oversight Panel.[1] Furthermore, loan originations are down 87.2% in the first quarter of 2010, compared with the peak in 2007.[2]

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) declining commercial property sales volume and price; (4) slowing commercial property lending; and, (5) increasing commercial loan delinquencies. These challenges, 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 will be needed to lessen this crisis. Since all properties are different, we believe different approaches will be necessary. When looking at this problem, we think of commercial properties as following into three categories: (1) properties that are simply not sustainable; (2) properties that are performing, current, and can support their debt – but may have difficultly refinancing because their value is lower than their debt; and (3) properties that are viable long-term but need immediate help with loan modifications or refinancing assistance. There are some properties that simply cannot be saved, as described in category one. However, the other two property types – which are viable long-term, can be saved with a variety of tools. It is critical these steps are taken to prevent a total collapse of commercial markets and a corresponding downturn in our economy.

The Commercial Real Estate Stabilization Act

NAR applauds the intended goals of the "Commercial Real Estate Stabilization Act of 2010" (H.R. 5816), introduced by Representative Minnick (D-ID). As the current commercial real estate liquidity crisis is exacerbated by the current economic downturn, Congress should consider legislation aimed at stabilizing our nation's fragile financial and commercial real estate sectors. We strongly support the objectives to stabilize commercial mortgage markets and help to clear the inventory of troubled properties.

Representative Minnick's proposal to create a temporary program to guarantee commercial loans could jump-start lending and help to rebuild a private commercial mortgage market. As delinquencies continue to climb, and owners find no avenues to refinance, such a proposal could help limit further defaults, which are currently dragging down our economy. We look forward to working with Representative Minnick and the Committee to further review this proposal and the impacts it will have on our fragile markets.

[1] CNBC.com, "Half of Commercial Mortgage to Be Underwater: Warren", March 29, 2010.

[2] Mortgage Bankers Association "Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations – 2010.Q1.

Other Legislative and Regulatory Proposals

While NAR supports a variety of proposals to improve commercial real estate markets, there are specific proposals that have been discussed a length by Congress, and could have an immediate impact if enacted. These proposals include: (1) increasing the cap on credit union member business lending (MBL), (2) passage of the Small Business Lending Fund Act, and (3) changes to the Small Business Administration's (SBA) loans. Moreover, we believe there are additional solutions that could help mitigate the commercial credit crisis, which include term extensions for performing commercial mortgages and accelerated depreciation.

Credit Unions

The biggest problem in commercial real estate and small business markets is lack of available capital. Two members of this Committee have introduced legislation that will take steps to address this problem. H.R. 3380, introduced by Rep. Kanjorski (D-PA) and Royce (R-CA) will increase the cap on credit union lending to 25%.

Commercial banks account for $1.5 trillion or 45 % of outstanding commercial real estate debt.[3] Due to the slumping economy and falling commercial real estate values, many commercial banks have tightened their credit standards and reduced their loan volumes. For example, lending was down 7.82% among the ten largest U.S. banks in 2009. While these 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-size financial institutions.[4] 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 last February, 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 midsize 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 roughly 8,100 U.S. banks, some 2,988 small institutions have "problematic" exposure to commercial real estate loans. In other words, their level of commercial real estate loans

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[3] 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").

[4] Oversight Panel

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.

A decrease in small business loans could also 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 and seized or taken over by regulators. Since January 2008, 269 banks and savings institutions have been seized by regulators, including 104 so far this year, according to the Federal Deposit Insurance Corporation (FDIC).

During previous crisis' consumers and businesses have relied on credit unions to fill in the gaps where banks cannot serve them. Credit unions have been providing business loans for more than 100 years. But today they are hampered by a member business lending (MBL) 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 simply cannot due to the lending cap. This cap was instituted in 1998 for no discernable rationale. There is certainly reason today to raise it. 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 these loans are unable to continue to help get us out of this crisis. Additionally, the Credit Union National Association (CUNA) estimates that, if H.R. 3380 were signed into law, credit unions could extend up to $10 billion in additional business loans to their members, helping them create 108,000 jobs.

H.R. 3380 now has the expressed support of 124 Members of the House of Representatives. This legislation will increase liquidity without costing the federal government a dime or risking taxpayer resources. We urge this Committee to move this bill before the end of the 111th Congress.

Furthermore, we also support the Administration's proposal to increase the cap on credit union MBL lending. Unlike H.R. 3380, the Administration's proposal would raise the current 12.25% business lending cap to 27.5% for well-capitalized credit unions. We do, however, oppose the Administration's proposal to require credit unions to have at least 5 years of MBL experience in order to qualify for the higher limit. This would unfairly prevent credit unions that have proven to be well-capitalized and ready to lend to the small business community from participation.

While raising the arbitrary credit union MBL cap is not the "silver bullet" solution to the commercial real estate industry's financial woes, it would be an important step in restoring the flow of credit to the commercial real estate industry and subsequently help our nation's economic recovery.

Small Business Lending Fund Act

NAR applauds the leadership of Chairman Frank (D-MA) in passing H.R. 5297, the "Small Business Lending Fund Act of 2010." This bill would authorize the U.S. Treasury to lend up to $30 billion to interested community banks, in order to expand access to credit for small businesses. According to the Independent Community Bankers of America (ICBA), the $30 billion in capital provided in this legislation could help community banks provide as much as $300 billion in additional small business lending.

Under the program's mandates, loans issued to participating banks would be required to be repaid, with interest, over a 10-year period. More notably, the bill contains lending provisions that help ensure community banks have both the incentive and capacity to increase total loans to small businesses by decreasing the dividend or interest rate cost on the capital investment as lending grows. Specifically, this performance-based program would adjust the initial 5 percent interest rate for voluntarily participating lenders relative to the amount of their small business lending activity. For example, banks that increase such lending by 10 percent or more would pay an interest of 1 percent.

Conversely, lending institutions that do not increase their small business lending within the first two years of the program would be required to pay a 7 percent interest rate thereafter. As an added safeguard to ensure that participating banks will use the loans received from the federal government to leverage new loans to small businesses and repay those loans to the federal government in a timely manner, at the end of 4.5 year term, the annual interest rate for all borrowers would be fixed at 9 percent.

We also support the efforts of Representative Minnick (D-ID), who successfully added an amendment to that bill, which would broaden eligibility for the program by including non-owner occupied commercial real estate in addition to owner-occupied commercial real estate loans. More than $1.4 trillion in commercial real estate loans will come due by 2014, and roughly 65% of these deals will have trouble getting financing. Depressed conditions in the small business community continue to negatively affect the commercial real estate industry, which threatens our nation's economic recovery.

Additionally, we applaud the efforts of Representatives Miller (D-NC) and Perlmutter (D-CO), who helped pass amendments that would provide additional credit to the commercial real estate industry. Representative Miller's amendment further expands the program's definition of small business lending to include loans made to small businesses for the purpose of acquiring, constructing, or improving industrial, commercial, residential, or farm buildings. Representative Perlmutter's amendment allows small banks to amortize commercial real estate loan losses or write-downs over 10 years, freeing up more capital for these institutions to lend to small businesses.

As the Senate considers this bill, we support the inclusion of provisions to raise the cap on credit union MBL. We also support several new tax provisions that they are currently debating. REALTORS® are generally self-employed individuals who are also investors in real estate and/or advisors to those who invest in real estate. Two tax provisions, bonus depreciation and new expensing rules, would enhance the real estate business and provide fairness.

Bonus Depreciation

The existing rule allowing the expensing of otherwise depreciable assets would be, for the first time, expanded to include the category of real estate assets known as "leasehold improvements." Allowing small businesses to expense these improvements will create jobs and improve property values. The provision is a substantial incentive for small investors who wish to upgrade their real estate properties.

Expensing Rules

A second valuable tax provision would put the self-employed on a level playing field with other businesses. Under current law, an employer may deduct from both its income tax base and its payroll tax base the cost of health insurance premiums made on behalf of employees. By contrast, self-employed individuals may deduct health insurance premiums for themselves and their families for income tax purposes, but not for payroll tax purposes. The new provision provides a temporary rule that will permit the self-employed to deduct health insurance premiums when calculating self-employment taxes. This new provision creates equity between employers and the self-employed.

Small Business Administration (SBA) Loan Changes

Improving access to capital for small businesses is widely acknowledged as a critical part of growing the American economy. According to recent reports, banks reduced the amount of money extended to small businesses by $15.7 billion between September 2008 and September 2009.[5] As banks continue to pare back small business lending, the Small Business Administration (SBA) can be a useful tool for facilitating access to the loans small businesses need.

Unfortunately, however, it seems many small businesses are having trouble getting SBA loans to grow and improve their operations. REALTORS®, who are independent contractors and entrepreneurs, are a part of this group. Many brokers and agents are small businesses that struggle to find capital for day to day operating expenses, debt service, capital expenditures, and funding for expansion. Agents specializing in commercial real estate could see particular benefits from improved SBA lending, as small businesses use these loans to purchase and lease commercial properties.

NAR commends the SBA's decision to include real estate professionals as eligible candidates for SBA loans, but across the country, REALTORS® have reported problems getting access to SBA loans. Applications can be 100 pages long; documentation is required that most small businesses don't keep; some lenders are uninformed on who is eligible for the loans. Even after these obstacles are surmounted, SBA lenders are often still reluctant to make the loans.

Like everyone else, real estate practitioners have been feeling the credit pinch. In response, the SBA has temporarily eliminated fees that impede loan applications and ultimately the loans themselves as well as increased guarantees up to 90% on some loans. While this is an important step in restoring liquidity to the small business sector, raising loan limits for both SBA 7(a) and 504 loans will provide further relief. Currently, SBA 7(a) 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

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

performing commercial properties can be another useful tool to help address the liquidity crisis facing the commercial real estate industry. We urge Congress to consider these important modifications to SBA loans. We also support the inclusion of these provisions in the Small Business Lending Fund legislation currently being considered by the U.S. Senate. Finally, we urge Congress to provide appropriations for these measures that will match small business demand.

The availability of credit to small businesses has a strong impact on commercial properties. According to the Oversight Report, large banks with the highest exposure to commercial real estate loans 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 find 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 percent 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.

Additional Solutions

NAR believes a number of additional steps could be taken to prevent a collapse of the commercial mortgage market.

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.

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.

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. During the previous commercial market collapse in the 1980s, the Oversight Report 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 the same report states projects that losses at banks could range as high as $200-300 billion between now and 2011, something <u>must</u> be done.

As always, NAR is at the call of Congress, the financial regulators, and the Administration, to help in the ongoing effort to find solutions to stabilize and ensure recovery of the commercial real estate markets. Such an effort is particularly important given that the commercial real estate sector is a key component to job creation and economic revitalization for the nation as a whole.

Again, we appreciate the Committee holding this hearing and we stand ready to assist in any way in your efforts going forward.