NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

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HEARING BEFORE THE

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON ECONOMIC POLICY

ENTITLED

"RESTORING CREDIT TO MAIN STREET: PROPOSALS TO FIX SMALL BUSINESS BORROWING AND LENDING PROBLEMS"

WRITTEN STATEMENT OF

THE NATIONAL ASSOCIATION OF REALTORS®

MARCH 2, 2010

Introduction

The National Association of REALTORS® (NAR) is pleased to offer our views on "Restoring Credit to Main Street: Proposals to Fix Small Business Borrowing and Lending Problems." NAR represents more than 1.2 million REALTORS® who are involved in commercial and residential real estate as brokers, sales persons, property managers, appraisers, counselors, and others engaged in all aspects of the real estate industry. The overwhelming majority of REALTORS® are not employees of the realty offices with which they are affiliated. They are independent contractors, a legal small business entity separate from the real estate company itself. Real estate firms, the businesses with which these independent agents are affiliated, are likewise small firms which typically have fewer than five salaried employees.

Having a sound and well-functioning small business sector is critical to our nation's growth and recovery. In fact, small businesses have accounted for roughly one-third of job growth in the previous two economic expansions. Moreover, 45 % of the net job losses in the current recession have been from the small business sector.[1] According to the National Federation of Independent Businesses (NFIB), the percentage of small business owners holding a business loan or credit line fell almost 20 % in the last year. Additionally, NFIB reported "only 40 % of small business owners attempting to borrow in 2009 had all of their credit needs met." Significant drops in lending to small businesses continue to adversely affect our nation's economic recovery.

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. For example, REALTORS® rely on credit lines to help pay rent and other expenses, which are paid down over the course of the year, and repeated each year. Some of these businesses have been forced to close their doors because financial institutions failed to renew or greatly reduced their line of credit. For the past couple of years, every small business sector has been plagued by similar lending issues.

Improve Lending for Small Businesses Administration Loans

As banks continue to scale back small business lending, we believe that 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. Applications for SBA loans can be as much as 100 pages long and require documentation 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, agents, and property owners 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,

[1] Secretary of the Treasury Timothy F. Geithner and Small Business Administration Administrator Karen G. Mills, *Report to the President: Small Business Financing Forum*, at 18-20 (Dec. 3, 2009)

in fact, 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 believe that the increases are much needed, we are concerned that this will not alleviate the core issues of an arduous application process 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 is irrelevant which side of a transaction incurs 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. In addition to SBA loans, alternative forms of credit must also be strengthened.

Increasing the Cap on Credit Union Business Lending

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 small businesses have strong, long-lasting relationships with credit unions, 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 small business 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. However, credit unions cannot solve this problem alone.

Small Businesses and Retail/Office Space

Small businesses have also been directly impacted by the commercial real estate crisis. Above, we have identified the availability of small businesses to access credit as a vital component to the economic recovery, however, unappreciated is the fact that a significant portion of commercial real estate is owned, leased, and operated by small businesses.

Roughly 76% of small businesses either own or lease some type of commercial real estate.[2] Nearly half of these businesses own of portion of the structure and/or land where their business is located. Also, 67% of businesses with more than 20 employees own such property, according to NFIB. Furthermore, 55% of small businesses that own their premise have a mortgage on them.[3] In light of the current credit crisis, many small business property owners are experiencing difficulty in refinancing their mortgages that have matured or will in the next few years due to either cash flow and/or declining property values.

Unlike residential mortgages, commercial real estate loans are short-term loans, between 3 and 10 years, which are refinanced by the borrower when the loan matures. Additionally, many commercial real estate loans have terms related to cash flow levels, which affect the property's value and performance. In order for the loan to be performing, cash flow levels of the business cannot fall below a certain level. In other words, if cash flow decreases, even if the property is generating enough cash flow to service its debt, the property can be placed in technical default. As commercial property values continue to plummet, more small business property owners are underwater. This has increasingly made it hard for small business owners refinance as their loans come due, forcing some small businesses to close their doors.

While owning or leasing a commercial space is important for small businesses to conduct their services, commercial real estate investment plays a key role in the success of small employers across the country. In fact, almost 40% of small businesses own some type of investment property and two out of three small business property owners have at least one or more investment properties.[4] These investments are often used to support their business activities and expenses such as purchasing inventory or maintenance repairs. In some cases, the investment property is used as collateral to purchase other business assets. With decreased property values, small business owners are finding it harder to obtain the necessary credit to help maintain day-to-day expenses as well as expansion.

Small Business Access to Commercial Real Estate Funding

The problem of access to capital for small commercial real estate has its roots in the larger commercial market crisis. Just last month, Moody's reported that "[l]osses on commercial real estate loans could top $150 billion by the end of 2011." In fact, last month 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. commercial mortgages are now underwater, meaning the loan balance is more than the value of the underlying asset. Regulators are increasing capital requirements on banks holding these assets, which greatly reduces the money available for lending. To make matters worse, $1.4 trillion worth of commercial real estate loans will mature by 2014, with very limited capacity to refinance.

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[2] National Federation of Independent Business, *Small Business: Credit in a Deep Recession*, (February 2010) (online at http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-In-a-Deep-Recession-February-2010-NFIB.pdf) (hereinafter – NFIB Report).
[3] NFIB Report
[4] NFIB Report

Banks' exposure to commercial real estate loans and securities is well documented. The 20 largest banks (those with assets over $100 billion) are heavily concentrated in Commercial Mortgage-Backed Securities (CMBS), which are usually mortgage pools of varying types of commercial properties. As commercial properties experienced cash flow problems and property values declined, CMBS values have plummeted and investors fled to other markets, leaving the $700 billion CMBS market virtually frozen. These institutions hold an estimated 89.4% of total bank exposure to CMBS, according the COP Panel. CMBS exposure increases to 94.5% when banks over assets over $10 billion are included.[5] High exposure and depressed values of CMBS have forced large financial institutions to take steep write downs, leading to lower loan volumes.

In addition to large financial institutions' high exposure of CMBS, the current distribution of commercial whole loans in smaller regional and community banks is deeply concerning. According to the Congressional Oversight Panel (Oversight Panel) report issued last month, 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. 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. According to the Oversight Panel, large banks with the highest exposure to commercial real estate loans also account for nearly 40% of all small business loans.

The Oversight Panel report also identified the fact that 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. Additionally, we are concerned that lending will be further constrained as more banks continue to fail, are seized, or taken over by regulators. The Wall Street Journal reports "Since January 2008, 181 banks and savings institutions have been seized by regulators, including 16 so far this year." This is especially alarming for small communities across the country that oftentimes only have access to one community bank as a source for credit.

A "negative feedback loop[6]" starts when banks must retain capital due to risks associated with the commercial real estate crisis. This forces banks to reduce all forms of lending. Banks provide less capitol to small businesses, causing them to reduce their workforce or even fail, leading to less demand for commercial real estate, causing real estate prices to decline, devaluing the loans the banks hold on these properties. More pressure on commercial real estate prices leads to additional write downs by banks and result in further contraction of small business loans, suppressing economic recovery even further.

<u>Solutions to Increase Commercial Real Estate Lending to Small Businesses</u>

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[5] 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).
[6] Oversight Panel

In order to restore access to credit for small businesses, we first must fix the underlying problems with commercial mortgage markets. NAR believes that a number of solutions will be 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 five 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 Subcommittee to give these proposals strong consideration. The proposals are: increasing the cap on credit union business lending; incentives for increasing investment in properties; a mortgage insurance program for performing commercial loans; additional Federal Reserve and banking agency guidance especially relating to term extensions; and an extension to the Term Asset-Backed Securities Loan Facility (TALF).

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 impending commercial liquidity crisis, particularly as it affects performing loans that are underwater.

Increasing the Cap on Credit Union Commercial Lending

Just as consumers and businesses have relied on credit unions to fill in the gaps where banks could not serve their other lending needs, credit unions have been providing commercial real estate loans. But as was explained earlier, today those credit unions with the most experience dealing with commercial borrowers are hampered by the 12.25% business lending cap. For this reason, we believe that passage of 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, is an important step for Congress to take.

Mortgage Insurance Program for Performing Commercial Real Estate Loans

As mentioned above, commercial real estate loans are generally short-term – sometimes even less than five years. The problem commercial properties are having is that when they try 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. 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.

<u>Additional Guidance Relating to Term Extensions</u>

Another proposal for helping performing properties to 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.

<u>Extension to the Term Asset-Backed Securities Loan Facility (TALF)</u>

The CMBS market, which supports commercial and investment real estate lending, continues to remain tightly constrained. 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. CMBS delinquencies climbed to about 6.5% this month, 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 the 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 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 expect TALF to continue to jumpstart the private commercial mortgage markets by restoring investor confidence.

The extension of the TALF program through at least the end of 2010 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.

Without taking these steps to restore liquidity to commercial mortgage markets, lending to small businesses will continue to be restrained.

<u>Conclusion</u>

As Congress begins to lay out policies to help restore lending to small businesses across the country, improvements to SBA lending is critical to help jumpstart our economic recovery. Specifically, eliminating burdensome application processes and fees are key elements that will allow the SBA to better provide the credit that is so desperately needed by U.S. small businesses. Another avenue for credit availability is U.S. credit unions. These institutions are currently hampered by a lending cap, preventing them from providing assistance to small businesses. We urge Congress to pass H.R. 3380 to increase the credit union lending cap to 25% of total assets to provide greater liquidity to small businesses.

Additionally, we have demonstrated that small business success is directly related to a sound and well-functioning commercial real estate sector. This is true for 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 projects losses at banks ranging as high as $200-300 billion between now and 2011, something MUST be done.

We thank the Subcommittee 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.