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# THE REAL ESTATE MARKET: BUILDING A STRONG ECONOMY

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

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# THE REAL ESTATE MARKET: BUILDING A STRONG ECONOMY

**THURSDAY, FEBRUARY 28, 2008**

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:17 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Kerry, Stabenow, Salazar, Grassley, Snowe, Smith, and Sununu.

## OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

A Chinese proverb says that even good swimmers drown and good riders get thrown. Today, much of the housing market is under water. Last year, 1.3 million homes went through foreclosure. Today, more than 1 in 10 homeowners owes more on their homes than their homes are worth. A wave of declining home values washed over the market. The national average home price is down almost 9 percent from last year, and in many neighborhoods and regions that decline has been 20 percent, or even 30 percent.

For most Americans, their home is their biggest asset. Homes represent about a third of household net worth. Americans borrow against their homes. We take out home equity lines of credit to buy everything from cars to college. When the value of that home deteriorates, so does the ability to make those purchases.

At first, the choppy waters swamped just a part of the housing market. It started with exotic mortgages, and now it is affecting homeowners throughout the country. It is affecting families who have spent a lifetime building a clean credit record. These families are also seeing the value of their homes decline. Even good swimmers are finding their heads under water.

Today, we will discuss the effect that the housing market is having on the economy and we will discuss options that this committee can pursue to prevent the credit crunch from doing further damage. There are signs that what started as subprime losses is spilling over into other areas of the economy. Car debt, credit card debt, and student loan debt are all in jeopardy of suffering from the same credit crunch. Each of these debts is securitized and sold on the secondary market. Just as investors are refusing to purchase subprime securities, they are also leery now of auto, student loan, and credit card debt.

And today we will also examine the spillover of the credit crunch into the commercial real estate market. Residential and commercial real estate markets are tied together: often residential and commercial mortgages are pooled together in securities, often they are sold as a package on the market.

The same investors who have suffered losses on residential-backed securities have also been the traditional buyers of commercial-backed securities. With risks so great, investor capital for the real estate market is drying up and those investors who are willing to purchase commercial-backed securities are demanding higher interest rates in return.

When the cost of capital increases, developers spend more and build less, borrowers have to put up more equity, and borrowers get smaller loan proceeds. Companies re-think transactions. Fewer properties change hands.

In the final 3 months of the last year, nationwide office property sales fell by 42 percent. That is the biggest drop since 9/11. In the first 3 quarters of last year, $100 billion in property changed hands; in the 4th quarter of last year, just $5 billion.

Commercial real estate prices are falling at an annual rate of 11 percent, and, even though the Federal Reserve has cut interest rates to the lowest point since 2003, the interest rates for borrowing for apartment buildings, offices, retail properties, and hotels have climbed 125 basis points in January.

Well, the waves have swamped the residential market and engulfed the commercial market. Today we will hear from witnesses who have decades of experience. They are strong swimmers among economist and business executives, and I hope that they can help us learn how to cut through the waves. I hope they can help us guide the economy through rough waters, and I hope that they can suggest policies that will help more Americans keep their heads above water.

Senator Grassley has another hearing. He is in the Judiciary Committee right now, actually on a bill that he is sponsoring. He will be here shortly.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Our first witness is Dr. Lawrence Lindsey, president and CEO of the Lindsey Group, a global economic advisory firm. Dr. Lindsey has worked in the administrations of President Reagan, George H.W. Bush, and President George W. Bush. Dr. Lindsey has also served as a member of the Board of Governors of the Federal Reserve System from 1991 to 1997.

Dr. David Seiders is the chief economist and senior staff vice president at the National Association of Home Builders. Dr. Seiders has also served as senior economist at the Federal Reserve Board in Washington.

The third witness is Mr. Timothy Callahan. Mr. Callahan is the chief executive officer of Callahan Capital Partners, a real estate private equity firm that focuses on U.S. office property.

We will then turn to Mr. Schwartz, another witness before us today. I guess Senator Salazar is going to introduce Mr. Schwartz.

Thank you very much. Now I turn to Senator Salazar to introduce our final witness.

## OPENING STATEMENT OF HON. KEN SALAZAR, A U.S. SENATOR FROM COLORADO

Senator SALAZAR. Thank you very much, Chairman Baucus. It is my honor to have Jeff Schwartz here presenting testimony to our Finance Committee today with respect to commercial real estate. Jeff Schwartz is the chairman and CEO of ProLogis, a major real estate company that has focused in on distribution facilities. They have 510 million square feet of distribution space under management in 105 global markets. We are proud to have them as a corporate citizen in our State of Colorado, headquartered right off Pena Boulevard, in between Denver International Airport and downtown Denver.

I want to say just two things about Jeff and many of his cohorts here. They are great contributors to our economy, providing high-quality jobs to our State, to our country, and indeed to our world. Second, I have been tremendously impressed, Mr. Chairman, on what they have done with respect to embracing the green energy future of America.

ProLogis actually was the first LEED certified building at their headquarters in Colorado, the first LEED certified building in the entire State of Colorado, so I'm very proud of the work that they have done in that area. Mr. Schwartz, I welcome you here.

I will say just a word also about Mr. Callahan. I know you are based in Denver and have a host of real estate activities also in Denver, CO, so we are proud to have you here as well.

The CHAIRMAN. Thank you, Senator.

We will begin, first, with you, Dr. Lindsey. As you all know, we have a 5-minute rule here for your testimony, but your printed remarks will automatically be included in the record.

Dr. Lindsey?

## STATEMENT OF DR. LAWRENCE LINDSEY, PRESIDENT AND CEO, THE LINDSEY GROUP, WASHINGTON, DC

Dr. LINDSEY. Thank you very much, Mr. Chairman. It is a pleasure to be here to discuss what I think is the most important economic problem facing the country, and that is the condition of the mortgage market.

As you said, sir, housing is much more than a place to live. It is also collateral for other spending, and I think, even more importantly, a key step on the ladder to our ownership society.

I would like to stress three points today. First, as severe as our current problems are, neither problems nor the search for creative solutions is anything new in the American mortgage market. In my written testimony I cite a number of examples of the collapse of different mortgage models and creations of new ones, and, each time a new approach was developed, it worked based on the failures of the previous model. We have had at least four of those in the last 100 years.

Today's problems are no different. The root cause of this cycle of creativity and collapse is the constant need to find low-cost means of providing liquidity for what is essentially an illiquid product: housing.

Second, we have to recognize that this is not a subprime crisis, as some call it, but a problem faced by every homeowner. Over 75

million American homeowners face the prospect of historically unprecedented declines in the value of their most important asset. The consequences of this will make housing an even less liquid asset. It will not only curtail spending, but it will have knock-on effects in our National labor market as worker mobility becomes impaired.

I point out that this actually happened in Japan during the 1990s after the collapse of their housing market. So, solutions that focus on the subprime problems like foreclosures but make the mortgage market even less attractive for new money are counterproductive, both for lower-end borrowers and for the broader public.

Third, at this stage in the cycle, the most important thing public policy can do is allow, and possibly promote, the development of creative solutions in private mortgage markets and avoid one-size-fits-all approaches. This is politically quite a courageous thing to do, as the clamor for short-term fixes, protections of those who face losses, and a search for scapegoats is quite naturally and understandably the focus of media and public attention.

But misplaced emphasis on these issues will likely lead to mistakes and will sow the seeds for future failures in the mortgage market, to the detriment of our economy, tens of millions of homeowners, and ultimately the beneficiaries of politically based solutions.

These points lead me to conclude that the next step in the evolution of our mortgage system must be to assure ample liquidity to those involved in the mortgage process. This will involve helping homeowners with cash flow and assuring lenders that they are investing in secure products.

They must not be taken by surprise by rapid changes in the credit-worthiness of the securities they underwrite. I recommend a Federal Board of Certification, composed of senior government officials, that could administer standards for mortgages that are packaged in mortgage-backed securities and certify, for a fee, that the mortgages represented in that security meet those standards.

This does not involve a Federal guarantee of the security, even an implicit one, nor does it involve a guarantee of the mortgage portfolio. All the Certification Board would do is assure investors that the mortgages of a security meet the standards they claim to meet with regard to such features as documentation, loan-to-value ratios, debt service-to-income ratios, and borrower credit standards.

The current rating system is broken. The Federal Government can provide assurance about the quality of the products of the security market. Obviously a variety of such standards could exist and investors could pick the standard and implied level of risk they want, knowing that the mortgages in the security actually conform to that standard. Nor does this preclude other institutions from offering mortgage-backed securities without government certification if they can find a market for them, nor should we expect that all mortgages should be securitized. Borrowers who do not meet certifiable standards but who lenders deem credit-worthy nonetheless should be able to borrow.

This committee should also consider two temporary tax measures to improve the cash flow of those who own homes. This is a tar-

geted way of stabilizing home prices by subsidizing those who hold housing on their balance sheet. First, mortgage interest might become an above-the-line deduction, available to non-itemizers as well as itemizers, on a temporary basis.

Half of all homeowners do not itemize on their tax returns. These are disproportionately moderate-income individuals who might be bearing a disproportionate amount of the strains of the deteriorating housing market. On the other end of the housing scale, individuals who are either trying to obtain jumbo mortgages or who are forced to carry two mortgages because they have had to buy a home without being able to sell their old home, are coming against the cap on the size of the mortgage interest deduction.

A temporary lifting of that cap—and I stress temporary—might be a worthy change to consider in this environment. Providing a mechanism to reassure purchases of mortgage-backed securities and improving homeowner cash flow seem like the two most prudent steps the Congress could take at this time to preserve home values during this difficult period.

Thank you, sir.

The CHAIRMAN. Thank you, Doctor.

[The prepared statement of Dr. Lindsey appears in the appendix.]

The CHAIRMAN. Dr. Seiders?

**STATEMENT OF DR. DAVID SEIDERS, CHIEF ECONOMIST AND SENIOR STAFF VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC**

Dr. SEIDERS. Mr. Chairman and other members of the committee, my name is David Seiders. I am chief economist at the National Association of Home Builders. I would like to testify today on the current condition of the housing market and on some policy options to strengthen the economy through the housing sector.

I think it is worth saying that the U.S. housing market now is in the most pronounced downswing since the Great Depression, and the bottom is not yet in sight. New home sales and single-family housing starts already are down by more than 50 percent from their recent peaks, and the supply of new homes for sale is up to nearly 10 months, with serious down-side implications for future housing production.

The dramatic housing contraction obviously has exacted a heavy toll on economic growth and employment during the past 2 years and has pushed the economy to the brink of recession. In addition to the sharp declines in home sales and housing production, we are also seeing falling home prices and serious declines in mortgage credit quality. These factors have taken a toll on household wealth and provoked a surge in mortgage foreclosures, as well as a substantial decline in home ownership and serious damage to financial institutions holding mortgage assets.

The pronounced decline in mortgage credit quality first became evident in the subprime mortgage sector last year and resulted in serious damage to major components of U.S. mortgage securities markets. Furthermore, bank lending standards for all types of home mortgage loans have tightened substantially since last sum-

mer. These forces have combined to create a bona fide credit crunch in the housing sector.

The Federal Reserve has been easing monetary policy aggressively since last fall, and probably will do more in the near future. These actions definitely have improved the functioning of short-term money markets. However, it is important to note that rate cuts by the Fed do not necessarily translate into lower mortgage rates.

Long-term rates include an inflation premium, and, if market expectations of inflation rise as the Fed eases monetary policy, then little or no benefit will be transmitted to mortgage rates. I think this problem highlights the importance of congressional action with respect to fiscal policy in the current environment.

The recently enacted Economic Stimulus Act of 2008 may keep the economy out of recession this year, or at least limit the severity of recession, and NAHB applauds the work of the Congress on this bill. However, this short-term stimulus package does not address the deep problems posed by the housing contraction that is at the root of today's economic and financial market problems.

Some argue that the best way to bring the housing market back into balance is simply to permit housing prices to fall quickly over a short period of time. However, this would most likely cause further substantial damage to the economy, to financial markets, and to America's homeowners. A second round of fiscal stimulus, directed squarely at the housing sector, is a far better path to take.

With respect to stimulus options for housing, NAHB has the following tax policy recommendations for the committee. First, create a tax credit for the purchase of a home. Consumer interest in home buying appears to be perking up a bit, although home sales still are deteriorating. A temporary tax credit for home buyers could quickly energize the markets, reduce the heavy overhang of vacant housing units, help stabilize house prices, and halt the destructive decline in mortgage credit quality. There are several options for such a credit, which are summarized in some detail in my written statement.

Our second recommendation is to expand the Mortgage Revenue Bond program. This program offers a method of increasing housing demand and responding to foreclosure concerns. A special allocation of bonds to be used for either purchase or refinancing would be beneficial for housing and the economy.

Expanding the reach of the MRB program would be particularly helpful for communities facing waves of foreclosures or heavy inventory conditions. The committee adopted this proposal during its work on the first economic stimulus bill, and we urge that it be included in any future package.

The second stage of economic stimulus should also lengthen the time-frame for businesses to carry back net operating losses as deductions against previously paid taxes, from 2 to 5 years. In the case of home builders, the immediate boost of financial resources would lessen the need for high-cost financing or for accelerated sales of land and housing inventory onto glutted markets. Again, we appreciate the committee's efforts in moving this provision as part of the first stimulus package.

Finally, we recommend that housing be designated as an eligible investment for tax-preferred retirement accounts. The down-payment remains the single largest hurdle for most first-time home buyers, particularly considering today's much tighter lending standards, at least compared to previous years. Congress could increase capital available for down-payments by allowing these down-payments to qualify as eligible investments for tax-favored retirement accounts.

NAHB looks forward to working with the committee and the Congress on these and other options for addressing the crisis in housing. Thank you for the opportunity to testify today, and I am happy to answer any questions you may have.

The CHAIRMAN. Thank you, Dr. Seiders.

[The prepared statement of Dr. Seiders appears in the appendix.]

The CHAIRMAN. Mr. Callahan?

**STATEMENT OF TIMOTHY CALLAHAN, CHIEF EXECUTIVE OFFICER, CALLAHAN CAPITAL PARTNERS, DENVER, CO**

Mr. CALLAHAN. Thank you, Chairman Baucus and Ranking Member Grassley, for conducting today's hearing on the real estate markets and the economy. It is certainly timely.

As mentioned, Callahan Capital Partners is primarily focused on office properties throughout the United States. My previous experience as CEO of Trizec Properties and Equity Office Properties, two of the largest public U.S. office REITs, certainly gives me some perspective on the markets generally across the United States.

As you may know, real estate in the U.S. generates economic activity to about 20 percent of GDP, creates some 9 million jobs, and certainly significant tax revenue at all governmental levels. Commercial markets depend on a healthy economy for occupancy and a liquid financing market for new investment. Both are challenged today, but perhaps the latter much more.

The role of Congress in responding to this turmoil is certainly important. However, the dramatic headlines of housing and financial market crisis we see every day are important not to overreact to. Excessive tax breaks and government spending may serve to only increase supply in the wake of weakening demand. Overtaxation could encourage further hamstringing of borrowers and weaken the resilience of investors. Aggressive regulation of lenders risks tying the hands of institutions involved in finding solutions to the problems of today.

The last decade has certainly been robust for the real estate markets. Wall Street created new pipelines and conduits to inject large global capital pools into U.S. real estate markets, creating solid economic bases that did not previously exist, but it has also tied us very tightly to global capital markets, events, and flows.

Currently, fundamentals are solid, occupancy rates are strong, price depreciation has been impacted, but probably more for those who in fact need debt right now than on a general basis because of lack of transactions. Unlike previous cycles, this is not characterized by the lack of equity capital available. There is an abundance of that. There is not an imbalance between supply and demand; however, without equilibrium in the credit markets, we face daunting problems.

The uncertainty in the economy is a strong contributing factor to these problems. Consumer confidence is evaporating and business confidence may follow. The economy certainly needs the support of both, but in particular today the support of business spending.

After such a robust period of growth, it is not surprising, and probably was inevitable, that there would be a slow-down. But what was surprising, totally unexpected, was the dramatic retrenching in the debt markets. What started out as a subprime crisis rapidly spread into other structured credit products, such as Commercial Mortgage-Backed Securities, as investors began to question valuations across a broad spectrum of securitized loans.

In June, what started as tremors quickly became crisis in July and August, with more investors fleeing the markets. Massive losses recorded by several financial institutions drove more investors to the sidelines. Some of those investors saw pricing opportunities in late October, but were quickly proved wrong. More write-offs followed, and the downward spiral continued.

Lenders, at this point unable to move product off their books, were not able to regenerate capacity for new loans, effectively gridlocking the system. The CMBS market alone, about $750 billion in 2007, or 20 to 30 percent of commercial lending capacity, has been in large measure removed from the system. This has created an investor confidence crisis that threatens to get worse before it gets better. Some balance-sheet lenders, like life insurance companies, are filling a small part of this, but they do not have the capacity to fill the capital withdrawn from the market.

You will not see evidence of this in default statistics at this point, but, with the passage of time and the slowing economy, especially heavily leveraged borrowers from 2006 and 2007 will come under increasing pressure and then, unfortunately, many prudent investors, with the unfortunate timing of debt coming due in the near term, could be impacted as well. This downturn will create opportunities, but for those with capital, they need the debt markets to function to invest.

Ironically, this should be the best of time for real estate, but, without the combination of debt and equity available, the heart of our business will slow dramatically. Considering the size and scope of the real estate business globally, that is no small matter. So that brings us to the question of, when does this downward cycle of debt end? I think that is the question right now that I think is on most people's minds.

For the government's role in answering these questions we certainly support the actions taken on the stimulus package and by the Fed on rates recently, but in conclusion we believe it is important that government take appropriate steps to shore up investor confidence and consumer confidence, create a conducive environment for business investment, and implement appropriate monetary policy. With respect to commercial real estate, we do not believe new stimulative tax or spending policies are needed.

However, we would urge the committee to add clarity to real estate tax policy by reauthorizing the expired tax extenders, notably leasehold depreciation of brown field clean-up. It is a very stressful time in the markets, but these markets need to solve some of these problems themselves. We do urge Congress to refrain from impos-

ing a burden of new taxes, such as carried interest, on the industry. It is an unnecessary stress at this point in time for entrepreneurs and investors of all sizes and it favors emphasizing debt in a time when the debt crisis is really at its height.

Thank you very much for the opportunity to come before you and present our views.

The CHAIRMAN. Thank you, Mr. Callahan.

[The prepared statement of Mr. Callahan appears in the appendix.]

The CHAIRMAN. Mr. Schwartz?

**STATEMENT OF JEFFREY SCHWARTZ, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, PROLOGIS, DENVER, CO**

Mr. SCHWARTZ. Thank you, Chairman Baucus, Ranking Member Grassley, and members of the Senate Finance Committee. Again, thank you for holding this important hearing on the state of the real estate market and the vital role commercial real estate has in the global and national economy.

While our company provides infrastructure for the supply chain of large manufacturers, large retailers, and major companies of all sizes throughout the U.S. and North America, I am here today also representing NAREIT, or the National Association of Real Estate Investment Trusts, the representative voice of U.S. REITs and publicly traded real estate companies.

Mr. Chairman, I appreciate the opportunity today to provide an overview of the health of the commercial real estate market.

As you and other members of the committee are well aware, commercial real estate contributes approximately 6 percent of the total GDP in the United States today, and publicly traded real estate represents between 10 and 20 percent of that total. That includes companies like ProLogis and other Real Estate Investment Trusts, as well as all public real estate companies today.

Additionally, much of the commercial real estate owned by institutions is held through private REITs. When it comes to building and maintaining a strong economy, the role of commercial real estate should not be overlooked, nor underestimated.

My written statement provides many charts and data points concerning the health of the commercial real estate sector. In brief, the fundamentals as far as vacancy rates, net operating income, and the balance between supply and demand generally appear to be fairly healthy. However, credit markets have tightened appreciably, and many commercial property owners and developers are having difficulty accessing capital to operate their businesses.

This credit crunch has severely cut back on the amount of Commercial-Backed Mortgage Security issuances, formerly a leading source of liquidity, and it has caused reduced bank lending and significantly more difficult terms. This has appreciably slowed down the number of commercial real estate transactions and has initiated the decline in commercial property values, even while fundamentals throughout the country remain strong.

Further, the health of the commercial real estate sector is closely tied to the broader economy. When economic activity slows down, demand for office space also contracts. Similarly, decreases in retail

spending over time will affect demand for retail leasing. Commercial real estate fundamentals have so far weathered the significant capital market dislocations, but, without renewed liquidity in the real estate and financial sectors, the situation, as well as the entire economy, could deteriorate rapidly. Mr. Chairman, we thank the committee for holding this hearing at this critical time when economic storm clouds are developing on the horizon.

As to what actions the committee should consider taking, our overriding recommendation would be, first, as Tim said, to do no harm. To the extent that legislative steps regarding tax policy are taken, we caution you to move in a careful, deliberative manner so that upheaval in the financial markets is not accelerated and so that harmful unintended consequences do not mar the coming years.

Instead, measured steps may provide a path to ensuring that real estate markets remain liquid and healthy. We do believe that several provisions contained in legislation now before this committee, S. 2002, introduced last year by Senators Salazar and Hatch, are part of the solution, as they will increase transaction volume and, consequently, liquidity within the REIT and commercial real estate markets.

Mr. Chairman, we commend Senator Salazar, my Senator from Colorado, Senator Hatch, as well as the other five members of this committee who are co-sponsoring S. 2002 for their foresight in sponsoring legislation that would help facilitate healthy activity in the commercial real estate market at a time when it is needed.

NAREIT applauds you for holding this hearing and thanks you for the invitation to provide the insight we have on the state of the commercial real estate market in the United States. We stand ready to assist this committee and the Congress to achieve the overall goal of building a strong economy.

I would be happy to respond to any questions later, but then again, thank you.

[The prepared statement of Mr. Schwartz appears in the appendix.]

The CHAIRMAN. Thank you, all of you.

I am going to ask each of you to just give a very brief response as to what you think the most responsible action is that Congress can take. The Fed is taking its action on the rates, but what is the most responsible action that Congress could take, recognizing that there is a real problem, a lot of people thrown out of their homes, foreclosures, the credit crunch? Yet we do not want a moral hazard here. We want to be responsible. Maybe some of this is going to develop in ways we do not yet foresee, both plus and minus.

Do you have some recommendations? I know the Federal board certificates, a tax credit for new home buyers. The question is, is that just for investors, is that just for owner-occupied purchasers, and so forth? So I am just going to start with you, Mr. Schwartz. I do not have a lot of time here, and neither do you, more importantly. [Laughter.] Just, the bottom line: what is the right thing to do? If you do not have a precise prescription, if you might point us in the direction you think makes more sense.

Mr. SCHWARTZ. Clearly, the biggest issue is the illiquidity in capital markets and the lack of counter-party trust in financial institutions. I realize that is not the direct province of this committee.

The CHAIRMAN. I am asking you whatever you think the answer is, irrespective of committee jurisdiction.

Mr. SCHWARTZ. You need to fix the banking problems. Nobody has trust in the banking system. Other banks do not trust their counterparts. They are not trading with each other. There has been a complete breakdown. There is no trust in the CMBS markets. There is actually no liquidity at all. BBB rates on CMBS have gone from 150 basis points above Treasuries, to 800 to 1,000 basis points.

The CHAIRMAN. Do you think that will help deal with the foreclosure problems and the housing problems?

Mr. SCHWARTZ. I think a healthier economy clearly will. You will have less chance of a recession, and if you do have a recession it will be a shorter, shallower one.

The CHAIRMAN. Mr. Callahan?

Mr. CALLAHAN. I think it is important to give some degree of confidence to consumer and business investors. I think right now people see turmoil in the marketplace. It is a very complicated problem. I was in banking for 14 years before getting into real estate on the principal side.

I think right now the lack of solutions is somewhat driven by the fact that people are baffled by what has happened, and what has happened so quickly. So I do think there is the potential for the law of unintended consequences by acting too quickly, but at the same time looking at the problems and consulting—I would agree with Jeff—with the banks to determine how we in effect free up the lending side.

The CHAIRMAN. So what would you do? Let us say the President would call you and say, Mr. Callahan, you have carte blanche here. You solve this for us. And you have power. You are the czar. What would you do?

Mr. CALLAHAN. Well, I think certainly on the housing side, that started this crisis, and I think there needs to be stability on the housing side. I do believe that there is capital out there, and if you can find a way to encourage that capital to invest in the housing side, primarily, I think that that brings stabilization to that and I think would bring some stabilization——

The CHAIRMAN. But do we take any action? Does Congress do anything now, or wait?

Mr. CALLAHAN. I would be cautious to take action at this point in time without understanding the problem. As I said, I feel that there are some experts who have been in these debt markets for a considerable period of time, even with all the complications of recent years that have developed. I think that people are still looking to understand the basic cause of what started this, and I think to try to react at this point in time prematurely could, in fact, be damaging.

The CHAIRMAN. Dr. Seiders, you are the czar.

Dr. SEIDERS. I am the czar. I think a short-term stimulus policy is what the economy and housing really need right now. We really need to stop house prices from falling, if at all possible. That is the

factor that is taking a heavy toll in the financial markets, not just the mortgage markets, but global capital markets and so forth. So I think a tax credit for home buyers, whether it is for buyers of new homes that are currently in inventory or for first-time buyers.

You asked about, should it be for investors? I think limiting it to primary residences would make perfect sense to get the supply/demand condition in the housing market improved quickly. We do see what looks like a growing interest, or a percolating interest, among potential home buyers. Nobody really wants to buy yet, it appears from the numbers. But a window of opportunity for a tax credit to buy a home, I think, would be reasonable at this time.

The CHAIRMAN. What is more important to you, the Net Operating Loss change or a tax credit proposal?

Dr. SEIDERS. I think they are both important, but I would say the tax credit most likely would be first.

The CHAIRMAN. All right.

Dr. Lindsey, you are now czar. There are a lot of czars here, but you are now the czar.

Dr. LINDSEY. We are competing czars.

The CHAIRMAN. Yes.

Dr. LINDSEY. I think Mr. Schwartz pointed out what the big problem is, which is illiquity and the lack of counter-party trust. I agree with that. When I was a Governor at the Fed, I had the housing portfolio back in 1991 to 1997. We had a housing crisis back then. This town and the financial markets settled on securitization as the best way around the last housing finance collapse, which was the S&Ls, which had their own problems. What we found in the last few months is that we have had a lack of trust in the securitization process.

So I recommend the certification as a way of reestablishing that trust. We do not really have an alternative in the near term toward using mortgage-backed securities as the primary way of getting money to savers. But the providers of money do not trust the securities they are buying, and reestablishing that trust is key.

When I was a Governor, I was also chairman of the Neighborhood Reinvestment Corporation, and that was to encourage investment in low- and moderate-income areas. Actually, we had such a board back then, Neighborhood Housing Services of America. It raised money, and that money was then used by the local neighborhood reinvestment outfits to put money into those neighborhoods.

It provided basically a "Good Housekeeping Seal of Approval" so the people could invest with confidence. I think that the best thing the government can do now is not put money in, but restore confidence by certifying and taking up the job that the rating agencies have let everyone down on.

The CHAIRMAN. Thank you very much.

Senator Grassley?

Senator GRASSLEY. Larry, you indicated that solutions which focus on subprime problems would make the mortgage market even less effective for new money. So my question is 2-fold. One, would this hold true for tax legislation as well? If so, what type of tax relief, in your opinion, could have a negative impact on the mortgage market?

Dr. LINDSEY. Senator, the great advantage of this committee is that it has the minimum possibilities of doing harm that exist in other committees, so I agree with you that most of the tax ideas discussed here would not be in that area. What I would be concerned with is things like changes in the bankruptcy law, which would basically erode the value of collateral. I am very concerned that Congress should move in that direction.

Just to quantify it, the mortgage bankers, whom I agree might not be the most disinterested party, estimate that that bankruptcy provision would cost 150 basis points to borrowers. I think that is high. But if you suppose it is only a fifth or a sixth as much, if you think about it, all of Fannie and Freddie's benefits amount to just 30 basis points, so doing just a little bit of harm involves wiping out all the benefits from institutions like Fannie and Freddie just like that. So you have heard, do not do things that cause unintended consequences. I would second that. On tax measures, what I would be careful of is setting in place things which can be gamed.

I am sorry, I have to disagree with you on the home buyer credit. One thing we could all do is sell houses to our neighbors, just swap houses. That involves the purchase of a house. What we do not need, necessarily, is more turnover. What we need is more willingness to hold housing, because we have too much housing out there. So I would not focus on the transaction in tax legislation, I would focus on encouraging people to hold more real estate in their portfolio than they otherwise would.

Senator GRASSLEY. Well then, when it comes to that, putting a floor on the housing market, what tax solutions would you provide in that area? For example, some have recommended increasing the cap on Mortgage Revenue Bonds or providing a home buyer credit for distressed properties. How would you react to those, or any other suggestions you might have from a tax standpoint?

Dr. LINDSEY. Neither of those is a bad idea. They do have their drawbacks. One of the challenges with Mortgage Revenue Bonds is their administration, often by local communities. We have been through this before where we tried essentially politically based solutions and it ends up with a lot of squabbling, it ends up with stories in the newspapers, it ends up with a little bit of a taint of corruption sometimes. We have to solve the problem, and maybe that is the price of putting up with it. But I would prefer as least targeted a piece of tax legislation as could possibly be arranged, because the more targeted the solution is, inevitably the more it looks like a fish that has been hanging around too long.

Senator GRASSLEY. Mr. Callahan, you cautioned us not to do things in the tax area that would bring about over-supply. Are there any tax measures, specific tax measures, that you think should be pursued that would stimulate supply?

Mr. CALLAHAN. Well, I think that to the extent that incentives are given to solve problems that in fact cause problems for others, I think that that would be detrimental. As I said, unintended consequences. So the problem in these markets is that everything is linked. We used to have very dedicated investors that were very specific to their investment.

I think the housing and the business investment credit markets are very much tied today, so I think that my concern is that at this

point in time the solution, in part, is freeing up credit in a way that allows people to have normal refinancing, whether it be homes or whether it be situations with regards to the commercial property. I think that part of the challenge right now is people cannot find the floor.

So, when I talk about the banks, I think part of the problem for the banks is that we need to find a way to give them the latitude not to be driven to mark to market—an interesting term in today's world, when I think it is very hard to find the market, and those downturns and the spiral have created problems, I think, in terms of finding value.

So I think, rather than look for a tax solution, I think it is, in fact, a systematic solution on the credit side that would give you the ability to then examine what tax alternatives would give you the best alternative at that point in time and be most effective. Until the credit side is solved, I think it is difficult to know the effect of those tax impacts.

The CHAIRMAN. Senator Sununu?

Senator SUNUNU. Thank you, Mr. Chairman.

Dr. Lindsey, in your written testimony you included a pretty thorough overview of a lot of the historical situations the country has faced before dealing with credit, with real estate, some of these financial issues. I think that was very helpful to have, especially if you are a younger member of the Senate and were not necessarily in public service in the 1980s and the 1990s through the S&L crisis, and other challenges the country has had to deal with.

Could you make some comparisons to real estate crises and credit crises in the 1930s, the 1980s, and the 1990s? In particular, talk about the government-sponsored funds that were established to address those problems. One of the proposals that has been made by the chairman of the Banking Committee is to resurrect the Home Owners' Loan Corporation, which was a real estate fund created in the 1930s to buy, hold, and sell residential real estate.

We had the S&L crisis and the Resolution Trust Corporation that dealt with insolvent institutions, and an instrument called FADA in the 1980s that had a similar responsibility. Talk about those government-sponsored funds, which obviously involve a government commitment of some sort, how they differed, and whether or not such a fund would be an appropriate response to the current situation.

Dr. LINDSEY. Thank you. It is amazing to see the same problems crop up again and again. I think the proposal that Senator Dodd is talking about, and I know some of my friends at the American Enterprise Institute and Alan Blinder have advocated, hearkens back to what was done in the 1930s. I think the 1930s is a different time than what we have. I think the proposal bears most close resemblance to what you mentioned, which was FADA, the Federal Asset Disposition Agency. There are lots of brain cells that have died in my head, and that was one of them. I was reminded of it when I saw the proposal.

Unfortunately, that was a brain cell that I wish just stayed dead. FADA was an effort by us to basically do what that proposal would do, which is to use money, Federal money, to buy homes that were in distress and sell them. Now, we could do that during the 1930s,

frankly, because we had a less transparent government than we have now.

But in the 1980s, when we created FADA, we quickly got into problems where special interests, lobbyists, what have you, got involved, and Congress ended up dissolving it 18 months after it started because it was just such a mess. I mentioned the rotting fish earlier. I am afraid that the practical implication of that idea—it may be a well-intended idea—is that it does not work because government works on a deal-by-deal basis when you do that kind of thing, and deal-by-deal bases often involve special interests.

I think the RTC, which we all remember, was also a painful memory, but because they were dealing with the disposition of whole institutions, it was painful, but we got it over quickly. I think if we did the house-by-house process we would end up causing a lot of problems and a lot of distress.

Senator SUNUNU. How much money—taxpayer money, Federal money—was put at risk in dealing with the RTC, and how much taxpayer funding potentially would be put at risk with a residential real estate trust that took ownership of tens of thousands of mortgages?

Dr. LINDSEY. Well, the total RTC disposition, I think the budgetary cost was about $150 billion before it was all over. The size of the current toll, part of the problem is, it is all going to depend on how far down housing prices go. But let us talk about some numbers. We started with $21, $22 trillion in residential real estate. Some estimates are that that could decline by 20 percent in value. I think it is a little high, but it is a good place to start because it is an easy number to work with. That is a $4-trillion loss that someone is going to have to hold.

Now, the more money that the government gets involved in trying to guarantee that $4-trillion hole, the more that is going to be eaten by the taxpayer. I do not think anybody here wants to think about a number like $4 trillion. So that is the potential size of the loss. Even if the government just took 10 percent of that and had a very effective program, you are talking about ultimately a $400 billion loss.

Senator SUNUNU. One final question, because my time is expiring. There are vacancies on the Board of Governors right now.

Dr. LINDSEY. Yes.

Senator SUNUNU. My question is, does that have any effect on this situation? Does it limit their ability to react if things deteriorate further, if we have an additional crisis? What limitation does that place on the board?

Dr. LINDSEY. Absolutely. There is a provision in the Federal Reserve Act, letter A, that would allow the Federal Reserve to lend money in emergency situations to non-member banks. That requires 5 board members for approval. Right now, there are two vacancies that have been awaiting confirmation since last July, I believe. There is one more person who has been renominated for a term that expired at the end of last month. If any one of the current 5 members gets the flu, the Fed would not be able to use its powers in an emergency. I think it is very dangerous, and I would urge the Senate to speedily ratify the President's nominees who

have been sitting there already for 8 months waiting for confirmation.

Senator SUNUNU. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman.

This is an incredibly important subject. It starts with families. Most families save through the equity in their home. That is how they become a part of the great American middle class. But I am hearing the same thing we all are in terms of how this has moved from subprime, to the prime market, to the larger capital markets.

Frankly, I hear, in talking to folks who have nothing to do directly with housing who are involved in the investment community, the financial community, great, great concern, as I know all of you have expressed. The overwhelming comments I am hearing relate to creating certainty in the marketplace and how that happened.

I would like to ask a question, though, specifically to mortgages, because Allen Blinder was mentioned a few moments ago. One of the things he has said is, no one understands how mortgages are sliced and diced and tranched in the complex derivative instruments. One of the problems right now is, nobody knows who holds their mortgage, or may not know who holds the mortgage securities. It is incredibly complicated. It is not surprising that people are not renegotiating their mortgages if they do not know whom to go talk to.

We know that many people avoid talking to the banker, the lender. But I am wondering if you might speak to the whole question of the complexity involved in millions of mortgages that have been repacked and resold and what we might do related to that.

Then also related to that, Professor Blinder, as has been said, recommended as part of getting at that and the confidence in the banking institutions and certainty, that we temporarily look at the Home Owners' Loan Corporation from back years ago in the 1930s. That was set up for 7 years and then it went away. It was to purchase mortgages, to get them off the books, to be able to create some certainty in the marketplace.

So I would appreciate if any of you would like to speak to issues of the complexity as it relates to what is happening for people, and also if any of our other witnesses besides Dr. Lindsey would want to respond in any different way to the notion of a Home Owners' Loan Corporation set up temporarily.

Dr. SEIDERS. Maybe a few words. The homeowner obviously deals with the servicer of the loan, not the investors, who are spread all over the globe, perhaps.

Senator STABENOW. Right. Right.

Dr. SEIDERS. And, for example, the Hope Now program, the administration-sponsored program, is a proactive approach to get homeowners who are in trouble, or think they might be, to contact their loan servicer. So I think that the complexities of the mortgage securities market spread the ownership of the mortgages all over the place, diffused the risk, and so forth, hid the risk. Nobody quite understood what kind of risks were in these structures.

I think somebody has already mentioned, the rating agency had no ability to truly assess the prospective quality of the various

tranches of mortgage-backed securities that were marketed, particularly during the boom period. What is really needed there—I guess Larry talked about this—is true transparency in the markets.

The rating agencies need to get up to speed on how to properly assess and rate securities in an environment where house prices are falling, or can fall. The models they were using prior to the break in the markets really were not recognizing the possibility of price declines, working mainly off of credit scores and that kind of thing.

So I think there is a lot to be done in terms of the transparency in the markets, the ability to rate the securities properly. In terms of dealing with the consumers, it really is the servicers. I think that some of the actions, the proactive steps to get contact made between the homeowner and the loan servicer, are critical.

Senator STABENOW. Dr. Seiders, before my time is up, let me just ask one more thing, since you are speaking, specifically on the NOL provisions that many of us have worked on and I am pleased are in the package on the floor. But I am hearing concerns from homebuilders because their expected losses are through 2009 and the provisions that we have right now go through 2008. I am being asked, and others are being asked, to look at extending that a year. I wonder if you would like to explain what the concern is there.

Dr. SEIDERS. Yes, we definitely support that, moving that out to 2009 with a 5-year carry-back. Some, particularly the big builders, tell us that this really will be important to their operation and their planning. Obviously, some are looking toward 2009 being a pretty tough year on the profit front, as well as recent years and 2008.

Senator STABENOW. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Stabenow.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus.

Let me first say that I think it is a very timely matter for this committee to be trying to address, the housing issue, one, because it is on the floor, two, because it is a reality that is facing the people of my State and the people of our country.

Our own estimates in Colorado indicate that we will have somewhere in the neighborhood of 50,000 homes that will go into foreclosure in 2007 and 2008. Economists also are telling us that, when you look at what the impact of that will be in terms of other homes in Colorado, approximately 700,000 homes will go into a declining state of value during that same time period.

So you are right, Dr. Lindsey, when you say that this was a problem in the housing market that extends beyond those who are going into foreclosure, and really is a problem that affects all of home ownership in our State of Colorado, as well as all across America.

So one of the things that I would be very interested in hearing from you, to the extent that you have studied it, is whether or not the 2008 Mortgage Foreclosure Prevention Act, which we currently have on the floor of the Senate, which I think we may start considering later this afternoon or tomorrow, will be helpful to us in ad-

dressing this housing crisis that we face. That is a general question that I hope, before we end the hearing, I can hear from all of you.

Before doing that, I also just want to address the commercial real estate world that both Mr. Schwartz and Mr. Callahan have testified about. I understand your testimony has said that the fundamentals are still good, but that there are additional things that we might be able to do to provide some needed steps to make sure that we maintain a robust commercial real estate market here in this country.

In that regard, I want to first talk about the bill that Senator Hatch and I introduced, which, with the help of Senator Baucus and committee staff, has been hopefully something that we can move forward with. It includes the co-sponsorship of Senator Kerry, Senator Smith, Senator Bunning, and Senator Crapo, a good bipartisan coalition. The legislation is designed to modernize the tax laws governing Real Estate Investment Trusts. We all know that REITs play a major role in the commercial real estate industry and are responsible for significant investments in hotels, apartments, shopping centers, and office properties.

Our legislation would go a long way towards stimulating investment in, and activity by, this very important industry by making a number of small, but important, changes to the rules that dictate what kinds of entities REITs can buy and sell and how long they must hold their assets before they sell them. These changes would have a meaningful stimulative impact on an informed player in the industry, and I hope the committee can work to enact them.

I would ask Mr. Schwartz and Mr. Callahan to simply summarize what benefit that legislation would bring to the commercial real estate world.

Mr. Schwartz?

Mr. SCHWARTZ. Yes. Thank you, Senator Salazar. S. 2002 would have the impact of increasing transaction volume in commercial real estate. It would lessen the restrictions on REITs, or Real Estate Investment Trusts, on selling assets. As my friend Mr. Callahan mentioned, in mark to market issues, particularly in CMBS and in all valuation, it is an issue today within the financial sector.

So, increasing the transaction volume in the commercial real estate market will create standards that appraisers and the market can work from, and with that, increase liquidity, which will increase transparency throughout the market. It also allows REITs to use a measurement of either book value, which is the current standard, or alternatively fair market value, in setting the threshold of what they can sell each year. Obviously, the fair market value is significantly higher than book value. Book value has depreciation and looks at historical values. This helps, again, increase transaction volume.

S. 2002 is really a clean-up bill. The bill will make slight modifications in the REIT rules that are necessary after REITs have evolved over the last 48 years, clean up some items, and also allow us to do things within Taxable REIT Subsidiaries, which are full taxpaying entities. This last change will also increase transactions and increase liquidity within the market. So, although this bill is a part of the solution, it is not the solution by itself but represents a step in the right direction. I see no negative consequences to it

whatsoever, just positive consequences, such as increasing liquidity and transparency in the markets.

Senator SALAZAR. So it is one of those measured steps that you believe we should take.

Mr. Callahan?

Mr. CALLAHAN. Well, I am currently here today testifying on behalf of the Real Estate Round Table, and I am currently on the private side. But from my past experience with regards to being CEO of two public companies, I think that it just a continuation of addressing the modernization of REITs and the impact that they have generally on the economy. This has become a growing part of the real estate business from somewhat a standing start in the early 1990s. So, I think it is very productive in that way.

I think, as Jeff mentioned, the fact that these entities, as well as those that are not overly leveraged, are those that will really for the most part be able to make transactions happen, that will give us the data, that will allow the market to clear.

I think the clearing of the market, the establishing of those data points, are the most critical elements now for banks so that the true mark to market can be determined and we just do not have the continued downward spiral on fear as opposed to the reality of what pricing may be in the marketplace. So, I would say it is positive in that respect for that question.

Senator SALAZAR. I appreciate that very much. Just in closing, my fear is we have a problem in terms of housing and liquidity there, that we do not have that cancer, if you will, that we now are trying to deal with, spread over to other areas of the real estate industry. My hope is that S. 2002 will help us do that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Next is Senator Smith.

Senator SMITH. Thank you, Mr. Chairman.

Dr. Lindsey, Dr. Seiders, one of you, in your testimony, indicated there is a school of thought out there that we should just let this market work and hit bottom, and I believe the point would be that that would allow the market to work itself out faster, and that anything we do would just simply delay where it inevitably will go anyway.

Dr. SEIDERS. I think that was certainly the implication of my remarks. I think if you look at what is happening, one of the hallmarks, if not the key, of this astounding housing down-swing is falling house prices. We have never seen anything like this before, except perhaps in the Great Depression. I presume it was there. We do not really have the documentation for that peiod.

This really is the biggest problem in the financial markets, because, the more that house prices erode, the more the quality of the mortgage debt out there goes down and the more fearful financial market participants become in general about, where is all that stuff? We talk about the slicing, dicing, and the tranching, and so forth. It is in the Collateralized Debt Obligations, it is in the Structured Investment Vehicles, it is in hedge funds, and so forth. The reason the markets have frozen up is because nobody knows exactly what they have or what the prospective quality is.

I think to just allow the prices to go down fast is the wrong path to take. By the way, in the fourth quarter of last year the rate of decline in house price depreciation accelerated dramatically. Toward the end of the year, the annualized rate of decline in house values was about 20 percent. This is a frightening development. I think if there is any way to slow that down and let the adjustment process work its way out over a longer period of time, I think that is highly advisable in this environment.

Senator SMITH. By the way, I do agree with you, but I think what I am asking is, is this not really just at its most basic economic root a supply and demand problem?

Dr. SEIDERS. It certainly is gross over-supply.

Senator SMITH. Yes.

Dr. SEIDERS. There are a number of reasons for that, back in the housing boom. Yes.

Senator SMITH. Well, I, for one, do support doing something. In fact, Senator Kerry and I introduced in the stimulus package a provision—an amendment that I think was a gross oversight in not being included in the final package—allowing temporary expansion of Mortgage Revenue Bonds to include some of these distressed or at-risk subprime mortgages so people can work out instead of looking for a bail out. But I do think we need to do that much. I guess I am trying to get a handle on what we ought to be doing that would be helpful but will not disrupt the immutable cycles of supply and demand.

Dr. SEIDERS. Well, first of all, I really do think that a temporary home buyer tax credit is a good idea—and I think some of the potential problems that Larry Lindsey pointed out are easily avoided in the structure of the credit. To get some of the excess supply off the market quickly will really be a key factor in helping to stabilize house prices. I think that is the absolute key to the evolution of the economy and the financial markets generally, not just in the mortgage area.

Senator SMITH. And is that going to restore the trust that you all indicate is lacking in financial markets?

Dr. SEIDERS. You stop those house prices from falling right away, you remove some of the fear.

Senator SMITH. All right.

Dr. Lindsey?

Dr. LINDSEY. I support market mechanisms, but sometimes there are feedback loops within markets. That is where our problem is now. The lack of trust that was mentioned in the mortgage market started this process. When you cannot get a mortgage, a tax credit is not going to do you any good. You have to get the mortgage funding flowing again. I think the key there is, again, to build some kind of confidence in the way the mortgage bonds, the mortgage securities are evaluated.

So while we certainly would want markets to adjust, the reason the house prices are falling is the lack of mortgage money. That is the market that is broken, and that is the market that you should look to repair.

Dr. SEIDERS. We are not excluding, by the way, policies on the mortgage market. We just did not bring them up here because this is a tax committee. We are talking about expansion of the FHA

program, expansion of what the GSEs will be doing, Fannie Mae and Freddie Mac. These are both either full faith and credit or a strongly implied Federal guarantee.

Those securities, both the Ginnie Mae securities and the mortgage-backed securities of Fannie Mae and Freddie Mac, are working. Spreads have widened out to some degree on the GSE side, but those markets are working, and will work unless the government forsakes Fannie and Freddie, and they are certainly not going to do that.

Senator SMITH. Well, I just would make the closing comment, Mr. Chairman, that I am not in the housing business, but I have been in the food business. When we over-plant peas one year and all of our competitors do and there is a glut on the market, the price really falls. The next year it is really hard to get credit to plant the same amount the next year. I think those fundamentals are still in play.

But having said that, markets are forces that we cannot ultimately control by government unless we are willing to take over a market, and I am not. I am willing, though, to help to try to underpin this in ways that are responsible, these loops of information you talk about, Dr. Lindsey. I am prepared to do something, but I do not think we should lose sight of the fact that this is a free market, and it is working right now because there is a glut and over-supply.

The CHAIRMAN. Thank you, Senator.

Senator Kerry?

Senator KERRY. Thank you, Mr. Chairman.

Gentlemen, thanks for being here. I agree with Senator Smith, that obviously you do not want to take over a market. The market is usually best left to its own devices. But as we all know, government plays a critical role with respect to the impact on the market and the judgment that it makes, whether it is through Fed rates—that is government. The government decides to set the Fed rate and that has an impact. Regulatory oversight has an impact. All kinds of things have an impact.

It seems to me pretty clear that when you have a major move, as we have had in the market the way we have seen this decline in prices and the foreclosure crisis growing—there is an article in the Boston newspapers today that the mayor of Boston is super concerned.

I have been talking with mayors all over our State, meeting with them: 400 foreclosures in the city of Brockton, 400 more coming, 600 in Boston. This is big stuff. It rips apart the community. Your 7–11 and convenience store gets hurt. Your gas station gets hurt. Your tax base disappears. You have to lay off police, fire fighters. Then it goes spiraling downwards. So it seems to me clear that government has the capacity here to be able to change the mood as well as to provide some incentives that make a difference.

Now, a number of questions. One, on this Mortgage Revenue Bond that Senator Smith and I are advocating, it seems to me that it makes sense, if you have somebody who can afford a fixed rate at 5 percent but they cannot afford when the ARM starts kicking in and it goes up and suddenly they are going to face a foreclosure,

we are better off keeping that person in their home, are we not, and negotiating a fixed rate? Do you want to comment on that?

Dr. LINDSEY. I would certainly agree with that.

Senator KERRY. So, if that is true, you have to have the ability to do that, which means increasing the availability of the Mortgage Revenue Bond so that—I know Dr. Lindsey commented that perhaps there had been some fraud at the local and State government level.

I want to make it clear, I do not think in that program—that is an empowerment of the local community to say, here we have increased capacity to renegotiate with you on your home, avoid having you thrown out, and put a stop measure in place on these foreclosures. That makes sense, does it not?

Dr. SEIDERS. It does to me.

Senator KERRY. What would the impact be in terms of stimulus?

Dr. SEIDERS. Well, I think you are talking about just one of the factors that can help to limit the foreclosures, but also to stimulate buying by first-time home buyers, primarily. That is what the Mortgage Revenue Bond program is for. Again, it is a way to help to whittle down the excess inventories and to help to stabilize the price side.

Senator KERRY. To what degree—and I would like each of you to comment on this—is this market readjustment, the depreciation in the value of homes, a reflection of perhaps an over-valuation that came about as a consequences of a balloon, in effect, as a result of these subprimes being put out at a market that was not realistic? I mean, not unlike other bubbles we have had in technology and elsewhere where there is an irrational exuberance, is it fair to say there might have been irrational exuberance in the real estate market and we are now adjusting the way we ought to be?

Dr. SEIDERS. There definitely was a run-up in house prices, both nominal and real, that really did get out of bounds. I think the massive deterioration of mortgage lending standards, not just in subprime, but we now know in other parts of the mortgage market as well, fueled the demand that pushed the prices up. The price appreciation pulled in hordes of investors and speculators on top of everything else and pushed the boom even further. So we know that we had an unsustainable housing boom in 2003, 2004, and 2005, both in volume terms, and particularly in price terms.

Senator KERRY. I was hearing stories of people, as I travel around the country, down in Florida and elsewhere, folks who have never been in the real estate industry were flipping apartments, buying them and taking on mortgages. It became almost sort of an investment game. So some of this adjustment, I assume, is good. Obviously foreclosing on people who want to stay in their homes is not, but some of it is appropriate to the market, is it not?

Dr. SEIDERS. No question about that. Over the longer term, we will be moving toward a more sensible, defensible system and so forth on the mortgage side. The problem is the immediate timeframe and the big risk to the economy and to the financial markets of further damage from further large declines in house prices.

I mean, more and more analysts are viewing the house price decline as just an uncontrollable, bottomless pit. The investment community gets wind of that, what do you really want to buy? Is there

any mortgage paper in this investment I am thinking about? So it freezes the system up.

Senator KERRY. Well, Dr. Lindsey, you may want to comment on this also. While the Fed rate and interest have gone down, the discount window has not changed. Is that not accurate? And does that not contribute somewhat to the illiquidity issue?

Dr. LINDSEY. Well, the Fed has lowered the discount rate in concert with its reduction in the Fed funds rate, and they have instituted this new term, "auction facility," as a supplement. I think the Fed is doing a good job. I had the privilege of working with you back in 1992 when we had some problems in the last S&L crisis in Massachusetts.

Senator KERRY. Right.

Dr. LINDSEY. I think, with regard to Mortgage Revenue Bonds, I think that they can be viewed as a partial solution. But given the magnitude of what is involved, I think the better focus is on opening up the mortgage market to new suppliers of credit and reestablishing new suppliers of credit. Unless we do that, we are not going to be able to stabilize house prices.

Senator KERRY. Well, that is interesting. I do not disagree completely. How would we do that, though? Obviously we ought to take whatever measures are available, in my judgment, and it ought to be cumulative. But when you say opening it up to other entities, shape that a little bit.

Dr. LINDSEY. The biggest problem that we have is that no one trusts the securitization process any more.

Senator KERRY. Right.

Dr. LINDSEY. And one thing that I suggested was that the Federal Government could certify a mortgage-backed security, not that it would not default, not that any one mortgage in it was bad, but that at least the mortgages within the security met the standards that were advertised. This is not a rating of it. It just says everyone in there put 10 percent down, everyone in there has a loan-to-value ratio of X, et cetera. That is what is lacking right now. I think that would be a big step toward encouraging people around the world to buy our mortgage paper, to step up and buy it.

Senator KERRY. I think that is accurate. I have heard from a lot of people in financial services that there is a lot of paper out there now people are trying to push, and one of the things that is creating this uncertainty is that a lot of people are holding paper and they do not know what is in it. A lot of portfolios people are not sure whether it is at risk or not at risk because people do not really know what it is.

The CHAIRMAN. Can I ask a question along that same line here? So much of this is lack of trust among banks, securitization, rating agencies, and so forth. Just, how do we get at solving that? In the old days, I am told, in the Asian financial crisis, Chairman Greenspan and Secretary Summers—I do not know who was then the head of the Fed in New York—could just get together, get the bankers in the room and make telephone calls around the world and kind of put confidence back together again and get things sort of stabilized. At least, that is the myth. I remember that photograph on the cover of *Time* magazine. There was Greenspan, Summers and Rubin, the big saviors.

What I hear today is, the world has changed so much. There are just so many different players. It is globalization with pension funds and private equity. There is just so much out there, you cannot get everybody in the same room. They say, all right, disclose, guys, what is on your balance sheets. Where are you? How do we work this out with these rating agencies? How do we find the capital to give you a little confidence with your bank, et cetera. So how do you get confidence back in securitization? How do you get confidence back among the banks? How do we do that?

Dr. SEIDERS. Mr. Chairman, if I might, I think the breakdown of the securities markets, mortgage and others, really are of the fully private markets. There was tremendous development there during the boom periods. I believe there is trust in government-related securities and in housing.

The CHAIRMAN. That is government-related.

Dr. SEIDERS. Well, yes, but they are already there. We are talking about the FHA and VA programs, securitized through Ginnie Mae, full faith and credit, gilt-edged. We are talking about Fannie Mae and Freddie Mac buying mortgages, packaging them up, selling them into the securities market. These are all still very well regarded.

The CHAIRMAN. The other securitization is falling apart.

Dr. SEIDERS. That is correct. Because of that, we are going to be seeing more out of Fannie Mae, Freddie Mac, and FHA, and also more lending back to the depositories.

The CHAIRMAN. How do you get the banks to trust? How do you loosen up credit here?

Dr. SEIDERS. One of the things on the bank side, by the way, which is going gangbusters, is the third housing GSE, the Federal Home Bank System, which has been lending billions and billions of dollars to the depositories, the member banks, and thrifts, which can then be used for lending into the market—primarily into housing, since the loans or the advances from the Federal Home Loan Banks have to be collateralized by certain things, and mortgages are key.

The CHAIRMAN. Dr. Lindsey, your view?

Dr. LINDSEY. Yes. Two thoughts on that, Senator. The first, with regard to, could you just call the people into the room, I think the real reason we cannot do that today is transparency. The problem is, the TV cameras would probably have to be in the room as well. You cannot have a transparent society and have three people make all the calls and fix the banking problem.

The CHAIRMAN. We will all just get on a conference call. [Laughter.]

Dr. LINDSEY. And make sure there are no leaks. I mean, what we have moved to, and I think it is not a perfect change, but I do think we have a more transparent world, and I think we have to live with that world. That is one reason why it cannot be fixed the way it was in the past.

The CHAIRMAN. But how do we fix it?

Dr. LINDSEY. Well, again, I think the government does have a role. My second point was, on Fannie and Freddie, the main thing that Fannie and Freddie do is provide a certification that all the mortgages in the pools that they are putting out meet certain

standards. Fannie and Freddie require that you put 20 percent down on the house. They require a check of the loan-to-value ratio, of the debt-to-income ratio.

Now, I think we need a greater variety of standards than what Fannie and Freddie offer, and that is why I am suggesting that we trust the private marketplace. But the government has to say that the standards are being met in the private marketplace. No one is going to trust the letters AAA any more, but they will trust someone who says, yes, we have audited this mortgage-backed security and they all have a certain amount of——

The CHAIRMAN. Maybe I am wrong. I am hearing you saying, basically pay less attention to the big banks, the Citigroups and all that, let them work that out, but focus more on Fannie, Freddie, and so forth. Is that correct?

Dr. LINDSEY. Yes. And we need not to put too much burden on the existing institutions. We need to create more institutions. We need as many credit channels in this society as we can get because a lot of them are getting clogged. Senator Stabenow, when she was here, mentioned the problem with auto finance. We have the same problem there as well. The auto companies could raise money through industrial loan corporations, but they have been blocked at the FDIC for various political reasons.

Again, you have every major source of consumer credit gradually being choked off, and what you have to do is, the Congress should move to open as many as possible and provide transparent assurances to the investors that the securities they are buying are actually what they are advertised to be.

The CHAIRMAN. Senator Salazar?

Senator SALAZAR. Dr. Seiders, you described in your testimony and in front of this committee that this is the worst set of conditions you have seen for housing since the Great Depression. You say there are actions that we ought to take to try to address those issues. Now, your organization, and through your testimony, you support some of the ideas that have come out of this committee, including the increase in Mortgage Revenue Bonds, which I support. Senator Kerry and Senator Smith are carrying that. Net operating loss carry-back provisions, which Senator Conrad and I have tried to push through and were supposed to be part of the stimulus package, we included those in this 2008 Foreclosure Prevention Act, which will go to the floor hopefully later today or tomorrow.

In addition, there are other things that are included. We are including $200 million for mortgage counseling. There is other money included in there for community development block grants for communities that are particularly affected. When you look at that legislation that we have brought to the floor, which is essentially the framework around which we will work to try to address the housing crisis, is that legislation that you support?

Dr. SEIDERS. I would say that we support probably everything in it except the bankruptcy provision.

Senator SALAZAR. So you would support everything that is in there except for the bankruptcy provision. Let me ask you on the bankruptcy provision——

Dr. SEIDERS. Well, the provision that we have a problem with is allowing the bankruptcy judges to adjust the terms of the mort-

gages, change the interest rates, write down the principal, and so forth. As Larry Lindsey suggested, I do not think that the securities markets need another massive uncertainty dropped on them.

I think that the efforts that are currently under way, like the Hope Now program, should be given a chance to work. These proactive attempts to try to go out there and work out a lot of these potential problem mortgages, to head off foreclosures, and so forth and so on, are a process that seems to have momentum.

Senator SALAZAR. Let me ask you this. I appreciate the fact that we are trying to deal with a complex issue to deal with, as you called it, the greatest pain since the Great Depression in housing. It seems to me that on the bankruptcy issue, at least in the conversations that we have been having, that we put some tight rails around those bankruptcy provisions so that you require the showing of need before you have the bankruptcy relief, and you also limit it to only a certain group of homeowners, those homeowners already in foreclosure. We are going to try to limit it, in a way, so it does not have the kind of impact or parade of horribles that I think some have been trotting out.

My question, I guess, is whether or not you think that we could put the kinds of limitations around access to the bankruptcy courts for homeowners who are in their foreclosure that would actually make that work. My thought has been that, if bankruptcy is in fact an option, that you might be able to induce, incentivize homeowners, as well as the lending institutions, to get together and to reach agreements on the modifications of loans, which is essentially much of what we are trying to do with other aspects of the legislation.

Dr. SEIDERS. Well, I am sure we could go back and re-look at some of the details with some of these points that you have made.

Senator SALAZAR. And Dr. Lindsey, do you have a comment overall in terms of what we have included in this legislation? Obviously there will be a number of different amendments that we will forward, but what is your view of the legislation? Is it the pill that we need to cure the sickness here?

Dr. LINDSEY. Senator, if you are trying to encourage new money to flow into the mortgage market, you do not want to establish a precedent where you change the terms retroactively on deals that have already been made. Is it theoretically possible that you could wall things off? I am sure it is. But you will be sending the signal to every major investor around the world, sovereign wealth funds, pension funds, insurance companies that buy mortgage securities, that the Congress of the United States can change the contract that you have just signed, and will because of political reasons.

When other countries do that to our firms, we get upset. We do not invest in Venezuela, for example, when they do things like that. For us to do the same thing here just is not a positive step forward. So I would urge you not to have that provision in the bill. You are sending the signal——

Senator SALAZAR. Let me ask you just one question on that, Dr. Lindsey. And I am not an expert on the bankruptcy code or the bankruptcy law here, but it seems to me if I have a vacation home or I have a yacht, I could access the bankruptcy court to discharge

the debt with respect to those homes. We put limitations on accessing the bankruptcy court with respect to our primary residences.

Now, it just strikes me, looking at it from a layperson's perspective here, that there is an inequity there that somehow we might address in the context of dealing with this issue, if we could put some rails around it so it is not something that is going to be taken advantage of by people who simply want to walk away from their debt.

Dr. LINDSEY. Well, what happens, most bankruptcy law is state-based law. Usually there is a difference between recourse states and non-recourse states. Basically you can either go after the collateral or you can go after the person. That is kind of the way it works. What you would be doing is, you would be breaking that—in general, nobody goes after the person. All that is left is the collateral. I think you would be making a change with regard to housing bankruptcy provisions that would not be sending a helpful signal.

Senator SALAZAR. Let me just make a concluding comment on that. That is that this is going to be the housing deal that we are going to try to move forward with in this Senate. Obviously it will be improved with significant amendments that I am talking about, and some of my colleagues are talking about as well. This issue on the bankruptcy provision. If you all have some thoughts on how we can deal with that in a way that does not create the kinds of consequences you are talking about, I would like to hear more about that.

Mr. Chairman, I really want to thank you for holding this hearing, because it is not only about housing, it is also about the real estate market and what is happening in the commercial real estate world. So, thank you very much.

The CHAIRMAN. Thank you, Senator.

Following on a bit, what is the genesis of that provision in the bankruptcy code that prevents a bankruptcy judge from discharging or modifying the terms of the debt in your home, mortgage in your home, as opposed to yachts and other loans and so forth? What is the origin, what is the genesis, what is the rationale? Does anybody know?

Dr. LINDSEY. I do not. I imagine it goes back to the original idea of—I am sure, in order to encourage money to flow into housing at some point along the way, Congress thought that was the best way to do it. It goes to the principle that everyone here has talked about, and it is the principle of unintended consequences. I think foreclosure is a terrible thing to have happen. I understand the human and political element involved, but that is why——

The CHAIRMAN. That raises another question that probably comes to the mind of some. We have a lot of incentives in American law to promote housing. I mean, mortgage interest deduction, the exclusion of the sale of a home, property deduction, State and local tax deductions, plus this, perhaps. How far do we go here? Some are suggesting, as you are, Dr. Seiders, still another. You have suggested some more, Dr. Lindsey, to draw the lines on the proposed standard deduction. I mean, when one takes standard deduction, I know some of you think those should be temporary, but temporary is a fleeting concept around here. What do you think?

Dr. SEIDERS. It is very easy to make a home buyer tax credit very temporary, and we would not recommend that as an enduring policy.

The CHAIRMAN. Well, it can be enacted temporarily, but you know about our so-called extenders. I mean, they want to be extended. People pressure to extend them, that kind of thing.

Well, this has been very helpful. Thank you very much for your contributions. I mean it, it has been very helpful.

The hearing is adjourned.

[Whereupon, at 11:42 a.m., the hearing was concluded.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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**UNITED STATES SENATE**

**COMMITTEE ON FINANCE**

**"THE REAL ESTATE MARKET: BUILDING A STRONG ECONOMY"**

**215 DIRKSEN BUILDING**

**FEBRUARY 28, 2008**

**STATEMENT OF TIMOTHY H. CALLAHAN**

**ON BEHALF OF**

**THE REAL ESTATE ROUNDTABLE[1]**

Thank you, Chairman Baucus and Ranking Member Grassley, for conducting today's hearing on the real estate markets and the economy.

**Introduction**

I am Timothy H. Callahan, CEO of Callahan Capital Partners, a real estate firm formed in late 2006 focused on creating value in real estate by investing in high-quality office properties. My testimony today is on behalf of the Real Estate Roundtable. My firm, which employs 15 people, is primarily invested in Denver Colorado properties, but our longer term plan is to create a

[1] The Real Estate Roundtable brings together leaders of the nation's top publicly-held and privately owned real estate ownership, development, lending and management firms with the leaders of the industry's sixteen national real estate trade associations to jointly address key national policy issues relating to real estate and the overall economy. Collectively, Roundtable members' portfolios contain over 5 billion square feet of office, retail and industrial properties valued at more than $700 billion; over 1.5 million apartment units; and in excess of 300,000 hotel rooms. Participating trade association members represent more than 1 million people involved in virtually every aspect of real estate.

premier, national real estate platform with geographic diversification. I am also the former Chief Executive Officer of Trizec Properties, Inc. and Equity Office Properties Trust, formerly two of the largest public U.S. office REITs.

Thank you for the opportunity to testify today about the state of the commercial real estate markets and the current credit and capital markets. Real estate directly and indirectly generates economic activity equivalent to about 20 percent of GDP. It encompasses an estimated $20 trillion in owner-occupied housing and approximately $5 trillion in income-producing commercial property. It creates some 9 million jobs and generates millions of dollars in federal, regional and local tax revenue. Local governments, especially, depend on this revenue (approximately 70 cents of every local budget dollar) to pay for public services such as education, road construction, law enforcement and emergency planning and response.

These are very uncertain times for real estate markets, and I commend Chairman Baucus and Ranking Member Grassley for their foresight in holding this hearing. The current disruption in the economy resulting from the housing meltdown is serious and well-documented. Along with the many individual homeowners facing substantial hardship, many financial institutions and bond holders have recognized significant losses due to both borrower foreclosure and the revaluation of existing securities backed by subprime residential mortgage bonds. This has led to a lack of mortgage market liquidity and a substantial decline in residential real estate market values.

**State of the Commercial Real Estate Markets Generally**

The commercial real estate markets do not have a broad, subprime lending problem like the housing market does with respect to market fundamentals. Fundamentals in most major markets are generally favorable. Nevertheless, the housing and financial market problems and their effect on the economy are being felt by commercial markets. All business is linked to a global

credit market that reacts to events and moves capital accordingly. As a result of this and other factors, the commercial markets also are experiencing a serious credit crunch of their own.

Commercial real estate is comprised of five principal property types – apartment, office, retail, industrial and hotels. It includes many diverse regional, markets each with their own dynamics. Commercial markets depend on a healthy economy for occupancy and on a liquid financing market for investment. While they remain in relative equilibrium, the ability to finance residential and commercial real estate of almost any size has reached a crisis stage. The loss in confidence in the financial markets has created a situation that prevents adequate funding for the residential and commercial mortgage loan markets to function in a normal manner.

The role of Congress in responding to this economic turmoil is important. Proper policy actions could forestall a full blown recession or shorten one should it occur. We supported the recently enacted economic stimulus package. Coupled with the recent rate cuts by the Federal Reserve, it should serve to coax much needed consumer and business spending. It also provides additional assistance to homeowners seeking to refinance mortgages. The consumer, who led the economic expansion, is key to restoring health to the economy. The stimulus package recognizes this and the importance of supporting homeowners and homebuyers since the strength of home values is so closely tied to consumer confidence.

For the most part, the dislocation in the economy will self-correct -- albeit not without pain and over a period longer than any of us would like. As daunting and dramatic as headlines are about the housing/financial markets crisis, it is important not to overreact to them. Congress should navigate carefully any additional policy actions it takes. Excessive tax breaks and government spending may serve to only increase supply in the face of weakening demand.

Conversely, over taxation could stifle entrepreneurs, hamstring borrowers and weaken the resilience of investors. Overly aggressive regulation of lenders, risks tying the hands of the

institutions best equipped to provide financing to credit worthy borrowers. We urge a cautious and thoughtful approach on all fronts.

**Fundamentals**

Commercial real estate has experienced a vigorous market for the last decade. Fundamental to this has been an ample supply of equity capital and affordable credit. Real estate investment trusts (REITs) and the rise of mortgage backed securities aided this, particularly early on. Wall Street investment bankers and a wave of equity funds created new pipelines and conduits to inject large global capital pools into real estate markets.

This largely has been positive, and the commercial markets reflect that in their overall soundness and stability. As stated, fundamentals are generally favorable in the commercial markets. Some softening is occurring, however, particularly outside of major markets. Vacancy rates have advanced, but are not spiking. Absorption rates are slowing, but relative to a recent very healthy pace. Price appreciation has slowed, but we are not currently seeing a precipitous decline in values. However, there may be some significant correction in values for those who may have mismatched a long term investment need with short term debt because replacing that debt today is at best uncertain.

Also, unlike prior real estate down cycles, this one is not characterized by a lack of equity capital. While credit concerns abound and REIT stock prices have declined, equity capital appears to be poised to take advantage of potential market opportunities. Furthermore, this downturn is not marked by a serious imbalance between supply and demand. There is reasonable equilibrium. However, if the credit markets do not return to equilibrium soon, commercial markets could face daunting problems.

So, much depends upon what happens with the economy. There's a substantial amount of uncertainty. Some big questions loom: To what extent will the residential crisis affect consumer

confidence? If consumer confidence evaporates, business confidence may follow. Consumers used home equity loans to finance residential renovations, pay for college, buy new cars and take vacations. Household debt has increased to 136 percent of disposable income.

On the corporate front, how deep will job losses be? The driver of our business is jobs as employee growth is the key to space demand. If borrowing is limited it inherently restricts the ability of businesses to grow. If you add in the concern over the future of the economy, business owners, at the very least feel compelled to delay expansion of their employee base. With multifamily, hospitality and retail properties in particular feeling the strain of being tied closely to the consumer, the fate of the business owner, particularly the small to mid-size firms who have been generating the most jobs, will determine whether the current economic drivers will continue to support the office and industrial sectors.

**Tightening Debt Markets**

In the midst of this economic uncertainty, commercial borrowing has become more difficult and expensive. The decade long run of inexpensive debt led to a high volume of lending to real estate. Robust transaction levels bid up property values to record levels. Some prices reflected bullish outlooks about future price appreciation more than underlying fundamentals. That phase has crested, however, and the market is in an expected slowdown phase. Capitalization rates are increasing, meaning that prices are declining as valuations adjust to a level more in line with property fundamentals.

The inevitability of a slowdown was to be expected. What wasn't expected was the sudden and dramatic retrenching of the debt markets. What started as a sub-prime crisis rapidly spread into other structured credit products such as commercial mortgage backed securities (CMBS) and collateralized debt obligations (CDO) securities, as investors began to question valuations across a broad spectrum of securitized loans.

In June, what started as tremors in the debt markets, had become a crisis by July and August as investors fled certain markets when valuations became difficult to determine. The massive losses recorded by several financial institutions in the Fall drove more investors to the sidelines, either because of the pain they were incurring directly or the perception that greater bargains lay ahead.

Those that saw pricing opportunities in October were quickly proven wrong and more doubts on valuation arose, which led to more write-offs, and the downward spiral continued. With so much capital sitting on the sidelines, the ability of lenders to move loans off their books was seriously compromised. The regeneration of that capital for new loans, the basic premise of today's capital markets, was effectively gridlocked.

The CMBS market alone, $741 billion in 2007, and between 20-30% of the commercial lending capacity, has been almost completely removed from the system and not replaced in any great measure. This is a crisis of investor confidence in the credit markets broadly, not just for real estate, and it could get worse before it gets better.

In this market, only those real estate transactions that have strong underwriting and are conservatively structured are able to close. Lenders, such as life insurance companies, that keep loans on their books and do not securitize them are filling some of the void left by the CMBS lenders. Nevertheless, these portfolio lenders do not have sufficient capacity to replace the capital that has been withdrawn from the market due to the CMBS market shutdown.

The full impact of this seizing up of the debt markets is not yet indicated statistically. Historical delinquency rates on commercial mortgage bonds are 2%, yet in January actual delinquencies were just 0.27%, a record low. Additionally, many heavily levered 2006-2007 buyers will come under increasing pressure with the passage of time and the inability to refinance. A slowing economy will magnify the impact. However, there are also other prudent investors who did not

overleverage or mismatch maturities of their investments, yet their misfortune is debt coming due shortly in the normal course of events in perhaps the worst debt market in a decade or more.

**Future Opportunity**

The downtrend will create opportunities, however. Since debt is more expensive and less available, cash is king. Investors with cash and low leverage investors, particularly insurance companies, pension funds and REITs, are well-positioned to take advantage of attractive prices and cushion property values. Foreign investors are increasingly attracted to U.S. markets by the investment return they get from the weak dollar. Investment banks and private equity funds, while working through the effects from leveraged investment strategies, still have substantial equity capital to deploy and take advantage of buying opportunities. Like the portfolio lenders, though, these capital providers need the debt markets to function to invest, and they simply are not.

Ironically, with fundamentals solid, subject to the emergence of recession, and more equity available for real estate now than we could have imagined even a few years ago, this should be the best of times. Yet the combination of debt and equity is our life blood, so the heart of our business is dramatically slowed without a stabilized debt market. With the significant role of commercial real estate in our economy and the global markets, it is no small matter if our business is stalled in the grips of the debt crisis.

**Summary**

In summary, commercial real estate fundamentals appear reasonably sound and at or close to equilibrium. Demand may ease, but development is in check in most sectors. Chastened lenders have pulled back and high leveraged, speculative investing is over. While some cash buyers and well capitalized investment funds stand ready to invest, they cannot do so without the credit

markets functioning. The ability of the credit markets to price risk is the key to loosening the credit gridlock. The current conditions have no end in sight. With credit tight, valuations are being depressed, leading to an even tighter credit environment. We are in the midst of a serious downward cycle. What breaks this cycle and when are questions to which everyone is awaiting answers.

For a more detailed market discussion, please see the attached document entitled "Leading the Enterprise 2008" -- a survey of leading real estate executives on the economic outlook, challenges and opportunities they see in 2008. The survey was done in November of 2007 and the world has continued to change, but the comments of the respondents are still largely relevant.

**Government's Role**

What is the role of government relative to economic policy from commercial real estate's perspective? As stated, we support the recently passed stimulus package and the Federal Reserve's aggressive movement on interest rates. It is important that government take appropriate steps to shore up consumer confidence, create a conducive environment for business and investors to invest and deploy capital, and implement appropriate monetary policy.

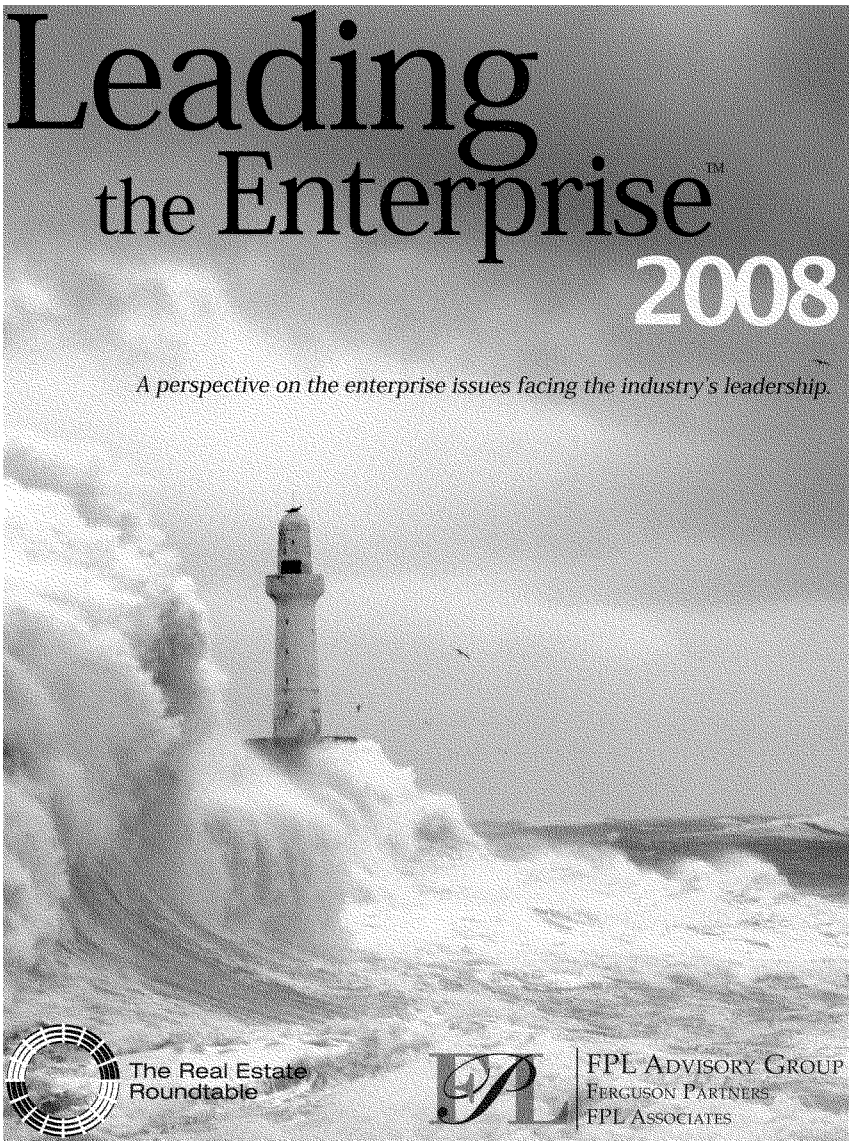
With respect to commercial real estate specifically, we don't believe now is the time to enact stimulative tax or spending policies. Some certainty with respect to real estate tax policy would help and we urge the Committee to re-authorize the expired tax extenders -- notably leasehold depreciation and brownfield clean up expense deductibility.

We are experiencing a crisis of the credit markets and, for the most part, the markets will have to work themselves out. We do urge that Congress refrain from imposing burdensome new taxes on the industry, such as the carried interest tax. Such a tax surely will exacerbate an already difficult environment for entrepreneurs and investors. Not only would it impose a heavy tax on

entrepreneurs of all sizes, it favors emphasizing debt in a time when our debt markets are in crisis.

Similarly, we caution Congress from over-stimulating the real estate markets. As mentioned, this down cycle is not a product of insufficient capital. There is plenty of equity capital. Demand is softening so we do not believe it would be prudent to stimulate supply.

Thank you for this opportunity to testify.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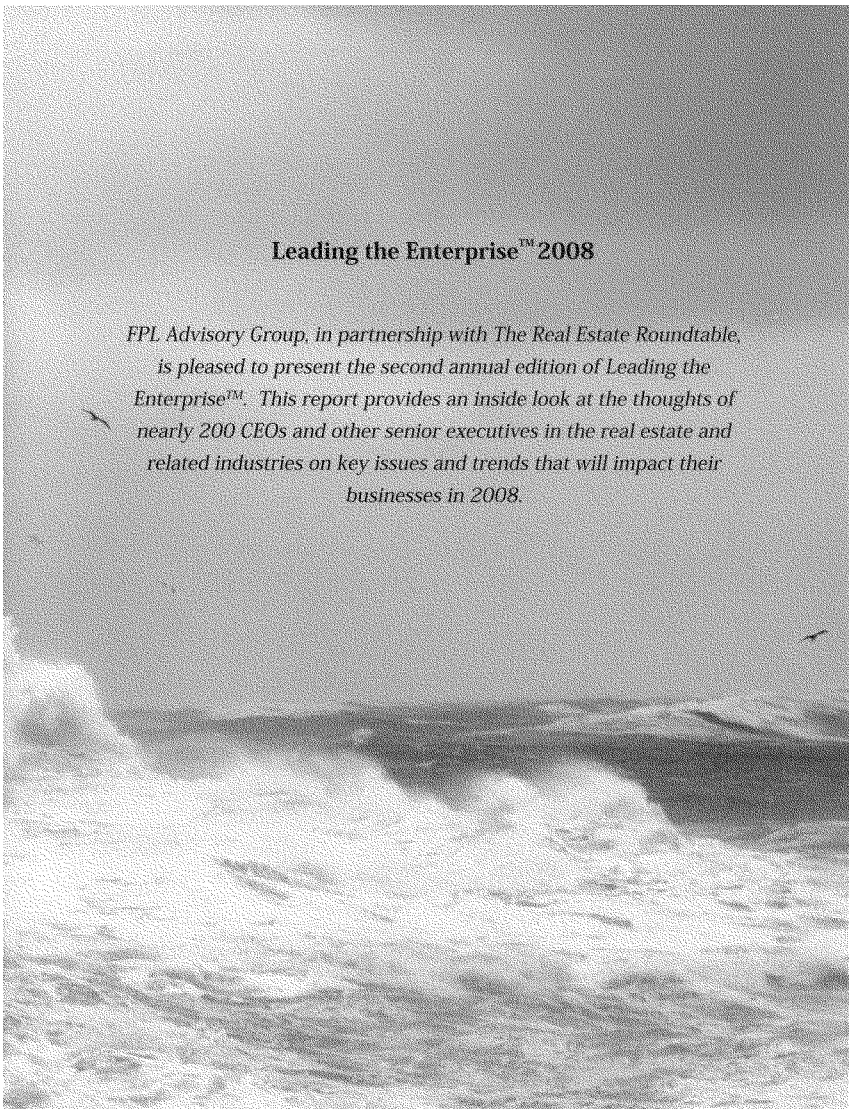

**Leading the Enterprise™ 2008**

*FPL Advisory Group, in partnership with The Real Estate Roundtable, is pleased to present the second annual edition of Leading the Enterprise™. This report provides an inside look at the thoughts of nearly 200 CEOs and other senior executives in the real estate and related industries on key issues and trends that will impact their businesses in 2008.*

# Leading the Enterprise™ 2008

*A perspective on the enterprise issues facing the industry's leadership.*

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## Preface

FPL Advisory Group, in partnership with The Real Estate Roundtable, is pleased to present *Leading the Enterprise™ 2008*. Based on surveys of and interviews with senior executives in the real estate and related industries, this unique report addresses the outlook for the coming year. The report looks at the challenges and opportunities that will affect companies in this space and offers an inside look at how executives and board members foresee the business environment in 2008.

Quotes used in this report are excerpted from many hours of interviews with senior executives. They provide a look at the multifaceted (and sometimes contradictory) views of the industry's leaders on the state of the overall economy and the real estate industry going into 2008, as well as the challenges, opportunities, and drivers of change they see as most important to their businesses.

Our sincere thanks goes to all participants. Their generous contribution of their time and insight made the creation of this report possible.

Respondents include CEOs, presidents, board members, and other senior executives from a broad list of industry sectors. Survey responses were gathered from the following sectors:

74% **Owners & asset managers** (REITs, investment managers, private equity funds, pension funds, homebuilders, public & private developers, corporate real estate firms)

19% **Financial services providers** (commercial & residential mortgage lenders, CMBS firms, hedge funds, investment banks, commercial banks, investment companies)

7% **Operators & service providers** (real estate operating companies, seniors housing companies, hospitality companies, commercial services & brokerage firms, associations, universities)

A partial list of participants is included at the back of this report.

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# Executive Summary

How quickly things change! The unbridled optimism which characterized the industry at this time last year has indeed been tempered — and the major drivers of this change are (not surprisingly) uncertainty over the health of the economy and concerns about how the ongoing contraction in the financial markets will impact the availability of capital. Despite these worries, however, it seems that most executives across the industry don't believe that the sky is falling.

Perhaps even more revealing than the survey numbers are the insights gathered through hundreds of written comments from and interviews with industry leaders. Respondents are concerned about raising capital and achieving growth in a more difficult market.

However, many believe that the slowdown most likely won't lead to a full-blown recession. Many expect to benefit from difficulties faced by their competitors. Several believe that a downturn will be an opportunity to snap up "A-player talent." The continued growth in overseas markets is in many ways mitigating the pain some are feeling in the U.S. It seems that everyone we interviewed is trying to figure out where the market will go. As one executive said, "Right now it's hard to predict anything. Much depends upon where the economy is going. The only thing you can really do is throw a dart."

Since the survey was completed in late 2007, the world has continued to change. The significant fall in housing and the resulting credit pullback has led to many of the traditional effects of a slowdown: deteriorating consumer credit, decreasing consumer spending, and potentially higher unemployment (particularly in the financial services sector). What's now over $100 billion in writedowns among financial institutions has created an even greater risk of continued financial pressure both here in the U.S. and abroad. On the brighter side, it seems likely that we'll see involvement from the U.S. government in the form of lowered interest rates, tax relief, and continued liquidity from foreign governments through sovereign wealth funds. Concerns that the commercial real estate space will feel a greater impact from the homebuilding crisis are on the rise.

As one *Leading the Enterprise™ 2008* participant said to us just before we went to press, "This could get messy." Time will tell just how accurate this prediction turns out to be.

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## Economic Outlook

- While optimism has declined markedly since the same time last year, more than two-thirds of respondents are either confident or neutral about the strength of the U.S. economy, and 84% are confident or neutral about the strength of their respective sectors.

- Despite a high degree of uncertainty about the strength of the economy, the majority of respondents feel that industry fundamentals are solid and that overseas growth will mitigate the softening of the domestic market.

## Challenges

- When it comes to their top operational challenges, only 5% of respondents cite cost management and just 3% cite downsizing their organizations. Rather than hunkering down to wait out the storm, many executives remain focused on finding appropriate investments (33%).

- On a personal level, leaders cite the achievement of growth as their top challenge. Leadership development dropped to second place from its position as the number one personal challenge cited by executives in 2007, likely due to a slightly greater focus on achieving growth in a more volatile market.

## Opportunities

- The majority of respondents still expect their opportunities for growth to outweigh the effects of a shaky economy and numerous challenges. 69% of respondents believe their company's 2008 revenues will surpass 2007 levels, and 71% believe profitability will improve.

- Most frequently cited are the opportunities to build global platforms and to capture market share away from struggling competitors.

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# Economic Outlook

It's no surprise that most executives' views of the world are less optimistic now than they were heading into 2007. It seems that it's anyone's guess as to how major economic indicators will change and what the impact will be on the capital markets. Certainly, there's been a departure from the jubilant atmosphere of the past few years.

At the same time, many feel that the correction will mean a return to reality for the market. In the words of one respondent, "Though debt will be constrained, it will end financial engineering and return investor focus to operating fundamentals." Many believe that this will give their companies an advantage over their competition. As one respondent wryly stated, "As the saying goes, in the midst of chaos or disruption comes opportunity."

The result is a mixed bag when it comes to the outlook for 2008. Those with a glass-half-full mentality might be encouraged to know that fully two-thirds of respondents are positive or neutral about the prospects for the economy in the year ahead, and a handful are still "strongly positive." On the other hand, their less optimistic colleagues might counter that the trend is quite negative compared with 2007 results.

Last year, 63% of respondents reported a positive outlook on the overall economy, with 9% expressing that they felt "strongly positive." This year, concerns about the health of the economy and the possibility of a recession have tempered optimism: just 38% indicate a positive forecast for 2008 (and less than 3% checked the "strongly positive" box). The number of respondents in the "neutral" camp is up from 25% to 29%. The biggest change is in the number of respondents who say they're "not very confident:" 32% versus only 12% last year.

When it comes to predicting the strength of their own sectors, executives are generally more optimistic than they are for the overall economy, but are still less enthusiastic than they were at the same time last year.

**Exhibit 1-1. Confidence Level by Sector**

| Most Confident | Least Confident |
|---|---|
| Equity REITs | Homebuilders |
| Investment Managers | Investment Banks |
| Private Equity Firms | Developers |


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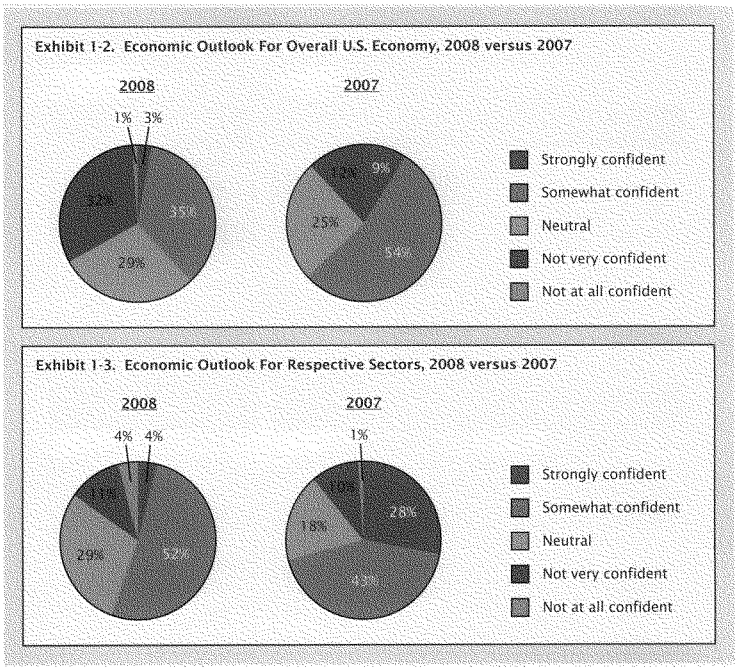


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While there's no clear consensus when it comes to predicting the direction and impact of various economic factors, here are a few highlights on what the majority think will happen and what the impact will be:

- 73% predict a continued drop in consumer confidence. 70% believe their businesses will be negatively affected by this drop.
- 63% predict a decline in job growth, with nearly as many expecting negative effects for their businesses.
- 83% expect construction spending to fall, and 40% believe this will be a net negative.
- The good news? Almost half expect interest rates to fall, and another quarter predicts they'll hold steady. Nearly 40% expect positive impacts from interest rate changes.

**Exhibit 1-4. Economic Factors Impacting the Industry**

| Interest Rates | |
|---|---|
| *In 2008, will:* | |
| Increase | 28% |
| No Change | 26% |
| Decrease | 46% |
| *Impact:* | |
| Negative | 20% |
| Neutral | 43% |
| Positive | 37% |

| Inflation | |
|---|---|
| *In 2008, will:* | |
| Increase | 53% |
| No Change | 36% |
| Decrease | 11% |
| *Impact:* | |
| Negative | 34% |
| Neutral | 51% |
| Positive | 15% |

| Strength of U.S. Dollar | |
|---|---|
| *In 2008, will:* | |
| Increase | 17% |
| No Change | 23% |
| Decrease | 60% |
| *Impact:* | |
| Negative | 29% |
| Neutral | 45% |
| Positive | 26% |

| Consumer Confidence | |
|---|---|
| *In 2008, will:* | |
| Increase | 6% |
| No Change | 21% |
| Decrease | 73% |
| *Impact:* | |
| Negative | 70% |
| Neutral | 23% |
| Positive | 7% |

| Job Growth | |
|---|---|
| *In 2008, will:* | |
| Increase | 14% |
| No Change | 23% |
| Decrease | 63% |
| *Impact:* | |
| Negative | 62% |
| Neutral | 22% |
| Positive | 16% |

| Construction Spending | |
|---|---|
| *In 2008, will:* | |
| Increase | 3% |
| No Change | 14% |
| Decrease | 83% |
| *Impact:* | |
| Negative | 40% |
| Neutral | 32% |
| Positive | 28% |


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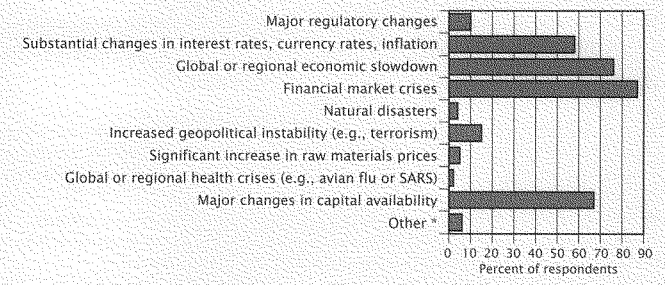
Interviews revealed a few key themes. While many believe that the fundamentals of the real estate business are still good, much depends upon what happens with the economy. There's a substantial amount of uncertainty on that topic. "Some big questions loom out there. Will the residential crisis affect consumer confidence and have a negative impact on the economy? Will the international capital markets close? Will the global perspective of many U.S. businesses neutralize the impact of negative consumer sentiment?" Many feel that at least the first half of 2008 will be characterized by an economic slowdown, but there doesn't seem to be widespread concern that the slowdown will be severe or long-lasting.

Most feel that fundamentals are still strong and that we won't see a precipitous decline in the commercial real estate space. In fact, many believe that the current softening in the real estate space is actually a healthy readjustment: "We're not sliding into an economic downturn. We're undergoing a necessary capital correction." Said another: "In short, the sloppiness is a good thing . . . the frenzy has largely subsided. Long term, this is great for our industry, because we were simply getting overheated."

When it comes to potential threats to the business, financial market crises rose from the third most important concern in 2007 to the number one concern in 2008. Worries over economic slowdowns and substantial changes in macroeconomic factors round out the top three areas of interest for the year, consistent with last year's report.

**Exhibit 1-5. Risk Management: Most Important Issues**




* Responses include increased tax rates; new supply; energy and insurance costs; excessive price volatility; and prolonged reduction in consumer spending.

*Note: Respondents could select up to three answers.*

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IN THEIR WORDS:

# Economic Outlook

## On the economy:

- "There is clearly a lot of noise in the market and a variety of mixed messages. I don't think we are heading into a recession, but we will probably move into some type of economic slowdown at least through the middle of 2008."
- "One of the big questions is the economy. There's still plenty of equity out there, but many people are sitting on the sidelines because pricing is virtually unknown."
- "From an economic perspective, the Fed will continue to help by lowering interest rates. The global picture seems to be pretty good, and most U.S. businesses are active around the world. The jobs picture shows this. And pension funds will take a long-term look and stay committed to investors who have done well by them."
- "There is probably a 10-20% probability of a recession in 2008. And this could jump to 30-40% depending upon what happens in the residential market and how this affects consumer confidence. GDP growth will be reasonably modest at 2% and nonetheless, employment growth seems reasonably robust."
- "From my perspective, the macro economy is slowing down. It will inevitably hit real estate in the form of job losses as well as weaker consumer confidence. Performance will probably be down in 2008. Nonetheless, institutional investors will not abandon the asset class by any stretch."
- "We view the market over the next three to six months to be in a pause, much like what happened in 1998 and 1999. We expect activity to pick up in the first quarter, or at the latest, the second quarter of 2008."

## On the industry's fundamentals:

- "The fundamentals of the real estate business are still strong, so our thought is that they'll give back what leverage took away. Even though many buyers are on the sideline today given the unsettled pricing environment, better prices will ultimately evolve, and we'll be able to compete much more effectively."
- "Right now, the fundamentals are OK but we're watching them closely. We see some softening, particularly in retail, but we don't envision a disastrous downturn. Regarding the capital markets, only those deals which are perfectly underwritten and structured are getting done today."
- "For the foreseeable future, I do think that demand will outstrip supply in the real estate industry, and hence things should remain reasonably stable."


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"Right now it's hard to predict anything. Much depends upon where the economy is going. The only thing you can really do is throw a dart."

- "While it's sloppy today, I don't see this as a seminal time in our industry. I don't believe that the economy is going to slam our business. Remember that the CMBS world is still a reasonably small part of the domestic real estate equity and debt universe. And furthermore, the operating side is still strong. Our performance numbers might slip a bit, but I don't see occupancies weakening significantly."

- "At this point in the cycle, the U.S. real estate market is in a mature stage in many geographies and property types. The phenomenal returns that the industry has achieved for the past five years for most investment vehicles (core, value-added, and opportunistic) will not be replicated . . . However, this is inevitable when you consider that core (minimal leverage) returns for the past three years have been 17%-plus — which is not sustainable in the long run. This is not to say that real estate is entering into dire territory . . . but returns will moderate."

### On the capital markets:

- "Even with the credit crisis, it is extraordinary how robust the stock market is today. It's hard to figure out. It seems like any good news drives anything up."

- "Wall Street clearly needs to clear its CMBS inventory, and it probably won't happen until early 2008 when investors have sufficient cash to buy again. It's the old question of supply and demand. There is also a lot of capital coming in from other parts of the world which mitigates some of the concerns about a domestic capital crisis. However, our guess is that the debt markets won't turn around until early 2008."

### On the housing crisis:

- "The homebuilding crisis will be a problem. The homebuilders will be hit hard, since they did a number of transactions off balance sheet. However, I don't think it will morph into a crisis for the commercial real estate business. Furthermore, I think the risk will be regionalized."

- "I don't believe that the homebuilding crisis will taint the commercial real estate sector but time will tell. Clearly if the economy weakens, and there are job layoffs, the office building market will be hit, including New York. And the condominium market will be troubled in many locations ranging from Florida to Chicago, Arizona, and Las Vegas."

- "Consumer confidence will clearly be shaken by the residential problems. If there are job losses, and communities stop growing, that will not portend well for our sector. Given the consumer confidence issue, retail is the asset class with probably the most exposure."

- "We have a falling savings rate in the U.S., and consumers will reduce consumption in order to increase savings. This is especially true as they have seen the equity value in their homes decline. It may take as long as a year or two to reset."

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# Challenges

In the face of uncertain economic conditions and volatility in the capital markets, many are trying to weather the storm while keeping an eye out for growth opportunities: "[We're trying] to not be blinded by all of the dust kicked up by the sub-prime/CDO/banking hysteria, and to identify the opportunities that are sure to present themselves during these tumultuous times." We asked executives to name the single biggest operational challenge they expect to face in 2008. Among a list of ten options, the following stand out as most important. Notably, these were the same top choices as in 2007.

- **Finding appropriate investments (33%).** With the capital markets in turmoil and pricing still high, respondents are most focused on finding deals and obtaining financing. Respondents describe "finding good long-term investment opportunities that are reasonably priced" and "access to capital" — particularly "capital that's long-term and focused on stable returns" — as a key focus in the coming year. "Diversification of capital sources" will be important. "There's a whole new set of economics today," notes one respondent, "and we need new partners for growth."

- **Finding, hiring, and retaining qualified employees (17%).** Echoing the views of many, one CEO stated, "We need to recruit, inspire, and train the best and brightest." Some worry that this might be particularly difficult in a down market: "A slowdown and lack of clear market direction may lead to significant personnel issues." Demographics further complicate the picture: "Baby Boomers are beginning to retire and 'Gen Y' has a very different view about work than past generations. Keeping them motivated and engaged will be a challenge. They are not driven by the same goals that organizations have been set up to meet." Overall, there's a clear focus on leadership because "if we can retain our core group of talent, we can do anything." Top of mind is "finding top talent overseas, particularly in Asia." Several companies expanding overseas cite the importance "maintaining a successful culture as we grow."

- **Maintaining growth of existing business (16%).** A big hurdle in 2008 will be "achieving growth in what will be a more challenging environment." Factors such as "substantive competitive development" and "shrinking business volumes" make this particularly difficult. As a result, diversification into "new property types," "new relationships and new markets," and "new products" will be critical. Equally important will be "management discipline" and "successful execution."

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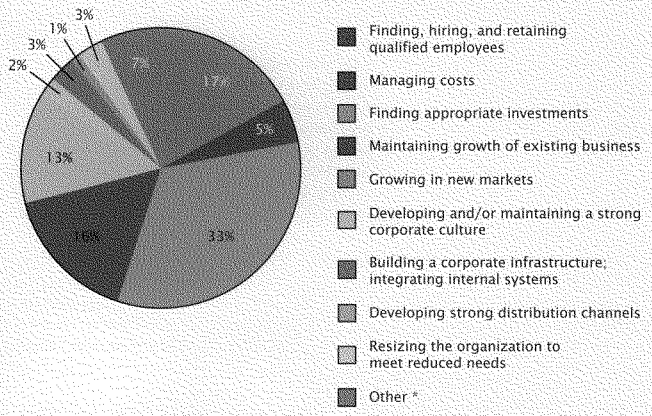
**Exhibit 2-1. Biggest Operational Challenge for 2008**




* Responses include adapting to continued changes in market and competitive climate; addressing economic uncertainty; dealing with impact of continued downturn in housing, especially instability of mortgage markets; and accessing capital/growing capital sources.

*Note: Respondents could select up to three answers.*

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On a personal level, leaders cite the same challenges as their top three, but in reverse order. Interestingly, development of leadership dropped from its position as the number one personal challenge cited by executives in 2007, most likely due to a slightly greater focus on achieving growth in a more difficult market.

- **Achieving growth (28%).** "Our biggest challenge in '08 is to achieve growth in what will be a more challenging environment," explained one senior executive. Specifically, others listed "substantive competitive development," "shrinking business volumes," and "the stalemate in the CMBS market" as obstacles to growth in 2008. Some are refocusing on growing their core businesses and believe strong execution will be key: "We need continued strict adherence to, and crisp execution of, our long-term strategic plan" and "we're focusing on developing the internal discipline to execute on a timely basis." Others believe the path to growth leads overseas, which will come with its own unique set of challenges: "we need to figure out how to manage the complexity that comes with global growth." As more firms build their global platforms, there's "increasing competition" and concerns about how to "expand globally on a basis that will provide our investors with a product comparable to that which we provide in the U.S. — while doing so profitably for our company."

- **Developing leaders within the organization (20%).** "If we can retain our core group of talent, we can do anything," proclaimed one CEO. Another said, "One of my biggest concerns is the retirement of senior executives who have made a tremendous amount of money and decide to do something different. The question is how do you prevent that, and if it occurs, how do you support the rest of the team?" "Skill sets and brains will make the difference as it relates to consummating deals." Simply put, "Focus on leadership," advised one CEO.

- **Finding opportunities for capital deployment (17%).** In an unpredictable market, "It's tough to deploy capital." The large amount of equity capital seeking investment opportunities makes this even more challenging. Lamented one executive, "Too much capital is looking to be invested in too few assets. Too much of this capital is fee-based with those controlling investing the dollars not having enough of their own skin and dollars at risk. This historically has been an invitation for disaster."


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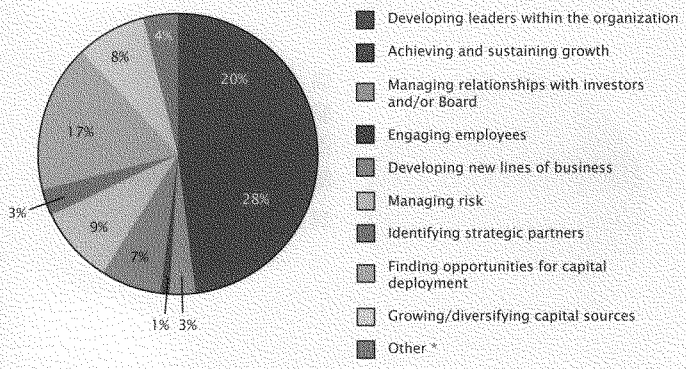
**Exhibit 2-2. Biggest Personal Challenge for 2008**




* Responses include executing against dramatic expansion; getting enough sleep/balancing stress; staying motivated despite weak company leadership; accelerating enhancements to product quality to meet changing customer requirements; adjusting to deteriorating market conditions; and making money.

*Note: Respondents could select up to three answers.*

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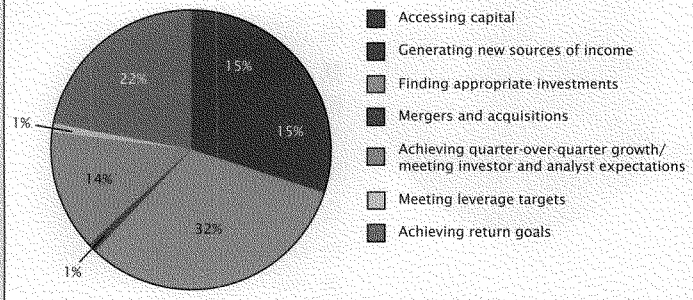
Many of our conversations with executives focused on how they'll weather the ongoing storms in the capital markets. "The financial crisis and resulting lack of liquidity reduces our business dramatically," remarked one respondent. "We could see a massive disruption of the capital markets," worried another. Not surprisingly, responses regarding the most significant financial challenges reflect these concerns. The responses differ from last year in that there's a less singular focus on finding investments and an increased level of interest in achieving returns and accessing capital.

- **Finding appropriate investments (32%).** "Our biggest challenge will be finding do-able deals. There's too much capital chasing overpriced deals," lamented one CEO. "We're struggling to find the proper risk/return ratio in a volatile environment." Says another, "The uncertainty around expected future returns makes it very difficult to establish current value." Yet another explained, "It's difficult to find opportunities that meet our underwriting standards in a weakening market."

**Exhibit 2-3. Biggest Financial Challenge for 2008**




*Note: Respondents could select up to three answers.*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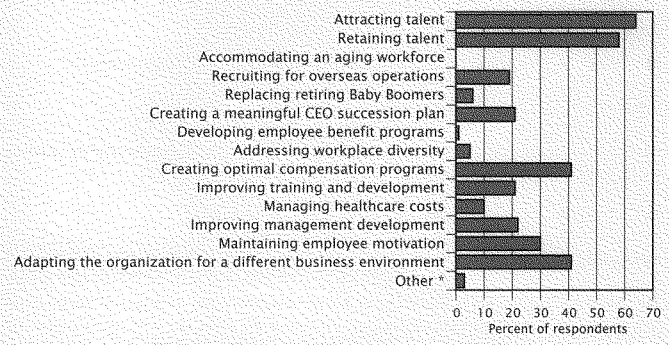
- **Achieving return goals (22%).** "Rising construction costs and interest rates," "potential tax increases (is anyone currently running for office saying they'll cut taxes?)," "too many legal/regulatory hurdles in the business," "rising development costs," "ever-steeper competition" — all these will combine to make the achievement of returns a challenge.

- **Accessing capital (15%).** "Capital availability to finance growth," "shortage of capital," "finding the last 35% of the capital stack from 65% to 100%," "obtaining capital that is priced right" — across all sectors, capital availability is clearly a concern.

- **Generating new sources of revenue (15%).** Many are seeking new revenue streams: "we need to come up with new products," and "we're developing new lines of business."

As in 2007, attracting and retaining talent are the top human capital challenges for industry leaders, followed by the creation of optimal compensation programs. There appears to be a slightly stronger focus this year on recruiting talent overseas as well as on CEO succession planning.

**Exhibit 2-4. Biggest Human Capital Challenge for 2008**




* Responses include building/implementing technology tools; managing cost of human capital to enhance deal flow; and dealing with immigration reform.

*Note: Respondents could select up to three answers.*

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IN THEIR WORDS:

# Challenges

### On the capital markets:

- "The upheaval in the financial markets should take some of the frothiness out of the system as mortgage lenders apply more realistic underwriting standards. This will remove the highly leveraged buyers from the market who were more oriented to the financial engineering of the product than to the underlying aspects of the real estate."

- "I worry about a number of things catching up with us. About 5% of sub-prime loans are now in default. If that number reaches 30%, we will have a social problem. There will be lawsuits facing many entities such as homebuilders and lenders. It will be a return of the 'Enron Era.' If this happens, the capital markets will unquestionably pull back."

- "I'm concerned about the rating agencies melting down. After all, they're the ones who rated these mortgage pools. Other resources are quite limited. Right now, we are keeping everything on our balance sheet except for what we can sell at par. If we have to sell mortgage pools at huge discounts, we will move from a liquidity crisis to a true credit crunch, which is problematic for everyone involved."

- "Any sustained dislocation or downturn in the real estate capital markets would clearly have a negative impact on transaction volume, adversely impacting various elements of the CRE finance industry and the commercial real estate brokerage business."

- "Financial market turmoil has decreased credit capacity for even the strongest borrowers."

### On finding appropriate investments:

- "The obstacles to success relate to identifying attractive investments that can be acquired at pricing that does not strictly benefit the seller."

- "Our biggest obstacle is a limited universe of quality product."

### On accessing capital:

- "The big question is what ratings will be applied to commercial paper. Until some of this gets washed through the system, a number of big financial institutions will not be able to do much business, and if in fact they 'hit the wall,' real estate fundamentals will be impacted."

- "My biggest concern is that our owners are not reinvesting in their assets, but are pocketing the rewards generated by their business success. This is disconcerting to us, because in order to be successful in our business, one needs scale and properties attractive to our customers, because there is plenty of competition."

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"The current 'Gen Y' has a very different view about work than past generations . . . They are not driven by the same goals that organizations have been set up to meet."

- "We need access to capital that is focused on long-term, stable returns."
- "We have developed a strategy of multiple funds/programs and ventures. Each one requires a distinct capital raise. This is going to be a big challenge!"
- "The challenge in the hospitality business today is for our development partners to find financing so that they can build properties."
- "Consummating any transaction today depends upon one's ability to obtain financing. A lot of assets are being re-priced. I don't think we will see increased liquidity in the credit markets until early 2008. We don't see a lot of the commercial banks or other portfolio lenders coming into the void."
- "For the first time, the willingness of European Central Bank to accommodate the flow of capital will be critically important. Expect LIBOR to decrease in the second half of 2008."
- "A key challenge will be attracting investors, getting them to accept lower returns, and keeping them interested in real estate over the long term."

On human capital:

- "There are rumors that [a major investment bank] may be downsizing. There may be finally opportunities for us, among others, to let B players go and attract A players. Before, we had to pay a premium just to hold on to our B players."
- "An important strategic challenge is paying people and retaining them. We have opted to pay up for quality people and not run the risk of compromising our organization."
- "A huge issue is the industry's inability to develop its talent relative to succession. From 1992 through 2002, the industry wasn't doing much to attract young, highly talented people. [Some firms have] done a better job of that, recruiting both from within and outside the real estate industry. They've established mentorship programs and moved people across functions. While many of these people are young, they're being pushed to take on more responsible roles simply because there's no other choice."
- "Unfortunately, our industry is horrible at planning for stress. And the easiest way to prepare is to make sure that your people are well trained to deal with asset restructurings and workouts. Unfortunately, the last time that this happened was in the late '80s and early '90s, so most of the people in the business who are 45 years old and younger have no idea how to respond."
- "Given the increasing diversity in this country, we're going out of our way to recruit and develop women and minorities."

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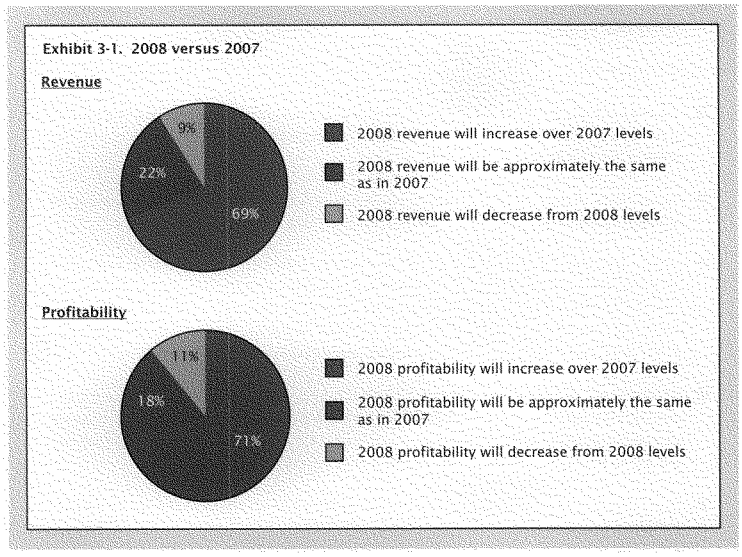
# Opportunities

So how does all this translate into the outlook for revenues and profitability? Despite their concerns about the economy, most executives expect 2008 to be an improvement over 2007. 69% forecast increases in revenues, and 71% expect their profitability to increase. Declines in revenue and profitability are predicted by only 9% and 11%, respectively. While positive, these projections are significantly more conservative than last year, when 85% of respondents predicted increased revenue and 80% predicted improved profitability.

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Here's what respondents told us about the most exciting opportunities they see for their businesses in 2008:

- **Globalization.** A majority of participating executives cite "continued overseas growth, particularly in Asia" as a major opportunity. Many are devoting untold resources to "building a global platform" and "expanding product lines and distribution to clients in new geographies." "Remember that the United States represents only a third of the global market, and 75% of the institutional capital to date has been invested in the United States. Investors simply want to go global." And the capital is flowing in from abroad as well. "There's a lot of European and Middle Eastern capital that will come into the U.S. due to the weakness of the dollar."

- **The silver lining.** An overwhelming number noted that the current uncertainty in the market will prove to be advantageous for their companies, providing opportunities as "the cream rises to the top." As those companies which are hardest hit by the retraction of the debt markets are forced to downsize, others in strong positions to steal market share are "ready to pounce." Industry consolidation is expected to continue.

- **Work environments and technological advances.** With globalization and contracting margins comes an increased focus on technology as a way to reach new markets and improve operating efficiency. Companies are using technology and product innovation to improve efficiencies and increase market share by better meeting customer needs. One executive noted that technological improvements necessitate more thoughtful use of workspace: "Technology is a tremendous tool toward productivity, but has hindered the personal relationships fostered through face-to-face meetings. A volley of terse emails and endless conference calls wastes time through miscommunication. I foresee increased demand for office space and wiser use of technology to foster better communication and productivity."

- **Diversification.** Companies are rapidly expanding into new markets and new property types, and they're highly focused on building new relationships to accomplish this. "A while ago, we focused on strictly apartments, but now we're doing other property types such as industrial, office, and retail." Another sees "real opportunity in bringing real estate investment products to multiple channels: institutional investors, high net worth investors, foreign investors."

- **Growth in existing markets.** Not all growth will come from the foray into new markets. Many are refocusing on their core businesses as the most important area for growth. "We are focused on our current portfolio, and protecting our downside." Said one lender, "In the small loan space, we have an excellent process and can churn out big time volume, and hence we can make 20 basis points. Ours is a Toyota business, among lenders who prefer the big deals (Ferraris), and that's just fine with us." Said another, "We're driving growth in our core business on a focused basis."

- **Green building.** The trend towards sustainable practices is providing opportunities for forward-thinking developers. "Sustainability of real estate development: the new mainstream movement in real estate!" declared one. "The continued shift towards high performance sustainable (aka 'green') real estate development and operations will create tremendous opportunities for early adopters/leaders not only because this is where the industry is moving towards but also because such a fundamental change will reduce cost, increase efficiency and profitability, and mitigate risk."

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IN THEIR WORDS:

# Opportunities

### On taking advantage of the current environment:

- "We're keeping our powder dry, hoping there will be opportunities."
- "From my perspective, it's back to reasonableness and lending as we did it before. Financing 85% of a transaction, irrespective of price, is simply ridiculous. Lenders were doing anything to get a transaction done."
- "The good thing that's happened in the market today is that leverage is no longer king, but cash is king. You've got to put 30% equity into deals, whereas before, 15% was acceptable. We were losing a lot of transactions to these highly leveraged investors. And these were the value-added transactions, in which our firm was particularly interested given the return opportunities."
- "If the business gets tough, those firms that have been in business for awhile will fare much better. The more recent startups will have no track record of success, and their recent investments will probably not fare all that well given the prices that were paid. In fact, some investment managers may ask other firms, like ours, to take over a startup investor which has a troubled portfolio. These startups jumped into the momentum game, and may not survive."
- "We're buying distressed development deals at a discount."
- "After a five year bull market in real estate, the next several years will finally be more balanced, which should lead to real value opportunities for contrarian investors."
- "We'll grow our market share while our competitors are downsizing."
- "This downturn is better for us. We understand the real estate and come at it from an asset management perspective. Many of the other firms in the finance business are much less competent, and will flush out on some basis."
- "We feel that the credit crisis was a welcome relief. We felt the last eighteen months were unsustainable, and now it's back to the fundamentals for the business. We were on the edge of too much financing driving deals that weren't making that much sense. And now we feel that there are good opportunities for growth."
- "We still have access to debt and equity capital while our competition seems to have trouble with this."
- "We're finding public-to-private arbitrage opportunities."

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"We have chosen not to 'chase the rabbit down the hole.' In short, the frenzy in the industry should slow down, and this is a good thing."

**On globalization:**

- "The opportunity today is global diversification, because that is what investors demand."
- "Today, as we look to fund-raising efforts, it's easier to raise a global fund, and then utilize our own discretion in investing around the world versus betting on one market which could become troubled pretty quickly."
- "Interestingly, South America is reasonably robust."
- "Globalization is here to stay, and that's influencing their business significantly. The GDP growth in some of the secondary markets around the world is quite extraordinary at 6% to 12%. The weak dollar is also helping the export picture. So industrial real estate firms that have the capacity to go global should be aligned to perform well in the future."
- "I do think that the [seniors housing] industry will continue to globalize in order to grow."

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# Conclusion

With the industry in a constant state of flux, it's impossible to predict what the business environment will look like even a few months from now, let alone what *Leading the Enterprise™ 2009* will reveal. What we do know is that the industry's leadership expects the majority of change to be driven by a few major forces:

- **Economic Factors.** "What's keeping me awake at night? Interest rates, debt margins, cap rates, employment, income growth, construction costs, inflation, housing values — the list of economic drivers that are keeping executives awake at night is a long one," said one executive. "As with any industry, supply and demand drive change. Real estate is no exception," said another.

- **Globalization.** "The biggest driver of change in the real estate business is the impact of global markets, both in the sense of exploring foreign markets for investing and attracting capital to the U.S. (which is currently on sale for foreign buyers due to the weak dollar)," explained one. Another said simply, "Globalization, globalization, and globalization."

- **Capital Flows/Availability.** "The cost of capital always drives real estate," and capital flows are a major concern. Many worry that "changes in the credit markets and the economy will dampen capital flows," and some believe "the abundance of new, inexperienced, capital entering the space will have dilutive impacts."

- **Changing Investor Climate.** "Private equity investment appetite" is growing as real estate "emerges as a mainstay of the broader capital markets." Real estate is now "a valid asset class even in this economic climate of uncertainty and chaos on Wall Street, and [we expect that] pension funds and other institutional investors continue to increase their allocation to real assets."

- **Demographics.** Trends such as the "aging of the world population," and the impact of "Boomers, echo-Boomers, and Gen-Xers who are spending more time and money on lifestyle and leisure pursuits" are driving demand and changing the profile of the labor pool.

Amidst so much uncertainty, one thing is clear: it's going to be a very interesting year.

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The Real Estate Roundtable provides a forum for top U.S. real estate and political leaders to discuss major policy issues and their implications for real estate and the economy. The Roundtable works with Washington lawmakers and regulators to produce meaningful results in the tax, capital and credit, environmental and energy, and homeland security policy areas. By identifying, analyzing and coordinating policy positions, The Real Estate Roundtable's business and trade association leaders seek to ensure a cohesive industry voice is heard by government officials and the public about real estate and its important role in the global economy.

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## Leading the Enterprise™ 2008

Based on surveys of and interviews with nearly 200 senior executives in real estate-related industries, *Leading the Enterprise™ 2008* is a unique report that addresses the outlook for the coming year based on the experiences and observations of industry leaders. The report looks at the challenges and opportunities that will affect companies in this space, and offers an inside look at how executives and board members foresee the 2008 business environment.

*Leading the Enterprise™ 2008* is produced by FPL Advisory Group in partnership with The Real Estate Roundtable.

The Real Estate Roundtable

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**Senate Finance Committee**
**Real Estate: Building a Strong Economy**
**February 28, 2008**
**Questions for Timothy Callahan**

**Questions from Chairman Baucus**

We have seen credit problems in the residential real estate market spread, causing a liquidity crisis and falling home prices.

1. Do you think the commercial real estate sector is subject to the same problems?

*[Mr. Chairman, I am pleased to have the opportunity to answer the Committee's follow up questions for the record. I would like to state up front that the real estate credit markets are very fluid and are deteriorating rapidly. My answers will reflect the best assessment I can provide at this time but such assessment may have a very short shelf life as events unfold in the markets.]*

*Yes, but for somewhat different reasons. All credit markets are experiencing a credit crisis. It is not limited to subprime or housing or real estate in general. All types of lending are being affected.*

*The commercial real estate markets do not have a broad, subprime lending problem like the housing market does with respect to market fundamentals. Most commercial lending has been reasonably underwritten (there are always exceptions) and commercial loans are performing (they meet their debt service obligations). Default rates are actually below historical averages. What wasn't expected was the sudden and dramatic retrenching of the debt markets. What started as a sub-prime crisis rapidly spread into other structured credit products such as commercial mortgage backed securities (CMBS) and collateralized debt obligations (CDO) securities, as investors began to question valuations across a broad spectrum of securitized loans.*

*I am not in the housing business so I cannot speak with the authority others, such as Dr. Seiders, can about it. Qualified commentators have noted that the housing subprime crisis was spurred by short term mortgage loans being made to borrowers who could not afford to re-pay the loans, particularly when the interest rate on the mortgage re-set at a higher rate and the properties did not appreciate in value as predicted. Subprime loans were not made with the proper due diligence to determine whether the borrower could meet the debt service. There were overly optimistic assumptions of home values and their projected increase. There were also assumptions that subprime borrowers would be able to re-finance short-term mortgages at the same low rates. When those rates rose sharply, borrowers began to default from even interest only payments. A decline in home values followed the defaults. Homeowners under stress from the subprime crisis were forced or decided to sell their homes at the same time that overbuilding in the housing sector was going on. This led to a serious supply demand imbalance for homes and a huge overhang of supply exists.*

*Fundamentals in most major commercial markets are generally favorable. Demand for space has been strong in recent years due to a growing economy. Supply is in relative equilibrium with demand, although some markets are encountering some imbalance. Vacancy rates are rising but not steeply. Debt to equity ratios are more favorable in commercial markets than in the housing markets where a record number of homeowners with mortgages now have negative equity (their mortgage balance exceeds the value of their home).*

*Nevertheless, the housing and financial market problems and their effect on the economy are being felt by commercial markets. All business is linked to a global credit market that reacts to events and moves capital accordingly. As a result of this and other factors, the commercial markets also are experiencing a serious credit crunch of their own. Most of the write-downs by lenders of commercial mortgages are to the values of commercial mortgage backed securities. The borrowers are not in default on their commercial loans. Home mortgage lenders, by contrast, are suffering losses because of defaults by borrowers.*

*However, some commentators are predicting commercial real estate values could fall 20 percent or more. They predict that home prices, which peaked in 2005 and have declined substantially, could fall another 25-40 percent, depending on the specific market. If the credit crisis continues and the economy slides into a deep recession neither forecast is unrealistic.*

2. How likely is it that this market unravels as did the residential real estate sector?

*The inability to secure liquidity from lenders is at a crisis level. Lenders over the last six to eight years injected a large amount of debt into the real estate markets generally. Therefore, their exposure on real estate debt is fairly high. These financial institutions are being hurt badly by the housing fallout and are taking huge write downs on their loan portfolios as home values collateralizing these mortgages plummet and defaults rise.*

*As their balance sheets deteriorate, lenders are in a worse and worse capital position to make further loans – commercial or residential. Underwriting standards have tightened, collateral requirements have increased and cost of borrowing has risen sharply.*

*Compounding this problem is the fact that these financial institutions are unable to sell their loans to the secondary mortgage backed securities markets as investors in those securities have sustained steep losses. These investors are not able to price the risk in new securities offerings because the value of the underlying real estate cannot be determined without a viable active market. That can't exist without debt being available on reasonable terms and sufficient quantity.*

*As commercial real estate is starved for liquidity, the value of commercial debt and, ultimately the value of the properties themselves, get pushed down as much by fear as economic fundamentals. The longer they are starved for liquidity, the more downward pressure this puts on values across the board. The uncertainty of values is keeping investors in mortgaged backed securities on the sidelines.*

*That securities market provides approximately 30-35 percent of commercial lending capacity. In 2007, the CMBS market was over $230 billion and most of that was lent in the first three quarters of the year. This loss of capacity cannot be made up by portfolio lenders – such as life insurance companies – who keep loans they originate on their balance sheets. This year alone, $44 billion of existing CMBS loans will come due and need to be re-financed.*

*In addition, consumer spending is weakening as home ownership woes mount, employment levels drop and commodity prices (fuel and food) soar. As a result of the beating to the consumer, business confidence is waning. Real estate will suffer as businesses pull back on their space needs.*

3. Is there anything in this Committee's jurisdiction that can be done to prevent degradation in the commercial real estate sector?

*As stated in the written testimony, it is most important that the Committee seek to maintain consumer confidence through policies, like those in the stimulus package, that increase cash into the economy, provide stabilization to the housing sector and support homeowners' ability to restructure distressed mortgages.*

*The commercial real estate sector does not need stimulus through the Tax Code. Neither, however, can it sustain new tax burdens such as taxing carried interest at ordinary income rates. Equity capital is available it just cannot be invested in real estate if the credit markets are dysfunctional. Commercial real estate requires normal functioning credit markets and they do not exist.*

**Questions from Ranking Member Grassley**

Mr. Callahan, in your written testimony, you make the following two points about taxes:

(1) Excessive tax breaks may serve to only increase supply in the face of weakening demand; and

(2) You urge Congress "to refrain from imposing burdensome new taxes on the industry, such as the carried interest tax."

Some have argued before this Committee that carried interest is essentially labor income, and taxing fund managers at lower rates than those in other occupations causes market distortions. Given your concern about the effect of excessive tax breaks on the economy, what is your reaction to that argument?

*The Roundtable, and 14 national real estate trade organizations representing all property types, opposes the carried interest tax. It would be a huge tax increase on countless Americans who use partnerships in businesses of all types and sizes. It would be especially bad for real estate partnerships through which $1.3 trillion dollars of*

*capital is invested. The public REIT markets, which are quite important to the industry and the economy broadly, account for only $315 billion of investment by contrast.*

*Real estate partnerships of all sizes have used the carried interest structure for the last several decades. It isn't a tax loophole and it isn't limited to Wall Street. It's the way real estate investment is made and the way real estate entrepreneurs are given a piece of the equity upside if they make the investment successful. In the real estate business, success is defined as capital appreciation in the property. This capital appreciation is long-term capital gain for all partners under current law.*

*The carried interest is not compensation for services. General partners receive fees for routine services, like leasing and property management. The carried interest is granted for the value the general partner adds to the venture beyond routine services. It is for the general partner's business acumen, experience and relationships. Knowing when to buy, how much to pay, whether to expand or renovate, when to sell and to whom. It also is in recognition of the risk the general partner takes with respect to the partnership's general liabilities. In conjunction with cash invested, this is the "capital" the general partner invests in the partnership.*

*The carried interest tax would significantly limit the utility of the partnership model to create business enterprise. Those striving to create a business but who lack the capital to back their ideas, energy and know-how, would no longer benefit from the capital gains tax preference. Only those with the disposable cash to invest would benefit from the preference. This will discourage risk taking that drives job creation and economic growth.*

*Furthermore, it will encourage entrepreneurs to take on more debt to avoid having to use equity investors. This is not good policy generally but is particularly bad given the current credit crisis. The last thing non-functioning debt markets need is a greater demand for debt.*

*Economic analysis of the carried interest tax proposal provided last year to the Committee makes the following conclusions:*

- *There are over 2.5 million partnerships, managing $13.6 trillion dollars in assets, and generating income of roughly $450 billion.*

- *Real estate accounts for 46 percent of these partnerships and roughly $1.3 trillion in equity investment. By contrast, the public REIT market accounts for about $315 billion of equity real estate investment.*

- *There are over 1.2 million real estate partnerships made up of 6.6 million partners.*

- *Changing the tax treatment of carried interests would result in a tax increase of $13 billion annually, and $5 billion in real estate alone. This analysis differs from the actual revenue estimate of the Joint Committee on Taxation of $1.3 billion. We do not have access to the JCT modeling but believe the full scope of the impact of carried interest on real estate is underestimated.*

- *The economy-wide lost economic income from distorting taxes on real estate partnership capital would be $15 to $20 billion annually, and as much as 10 to 25 times greater once the detrimental impact on entrepreneurial talent is incorporated.*

- *Workers would bear the impact of higher taxes in the form of reduced jobs in real estate and lower earnings overall.*

**Questions from Senator Hatch**

Mr. Callahan, you described the problems of the commercial credit markets that are not allowing them to function as they should. As I understand your view, it is that there is not a lot that Congress can do about that situation, but the one thing we can do to help is not adding new tax burdens to real estate entrepreneurs. One such new tax burden would be the carried interest proposal from last year. What effect would the carried interest tax proposal have right now on the commercial real estate market if it were enacted?

*Please see the answer to Senator Grassley's question above. Right now, few transactions are moving to closing due to the credit crisis. If Congress had enacted on top of this difficult market a proposal that raises taxes on entrepreneurs over 130 percent, it would have certainly reduced that activity further resulting in greater job loss, more pressure on property values and increased stress on local budgets that rely on property tax revenues.*

Mr. Callahan, you cautioned against Congress over-stimulating the real estate markets. What would be examples of the right kind and the wrong kind of stimulation provisions at this time?

*An example of an over stimulating tax policy would be to provide excessively, short term depreciation for buildings, e.g. 10-20 years or of course full expensing. This could cause capital to gravitate to real estate more for the tax benefits and not the underlying economics of the investment. Currently, there is an adequate supply of equity capital available to real estate. The stimulation of more investment through the Tax Code is not needed and, in fact, could be counter-productive by forcing excess supply to the markets assuming the credit markets rebound to a normal functioning range. As stated in earlier answers, existing equity capital can't be effectively invested because the credit markets, which go hand in hand with the capital equity markets in real estate investment, are not functioning.*

*Prior to the passive loss rules of 1986, overly generous depreciation created tax sheltering opportunities. Such depreciation created tax losses, especially in the early investment years when properties were being leased up and costs (plus tax depreciation) typically exceeded income. This led to over building and many of the problems the industry faced in the late 80s and 90s.*

*While the passive loss rules prevent many tax sheltering opportunities (few exist anyway with 39 year depreciation), tax depreciation that is faster than economic depreciation still doesn't make sense. We believe that tax depreciation and economic depreciation for structures should align. Economic studies we have conducted show that the economic life of buildings (assuming no capital improvements are ever made to it after it is placed in service) is around 23-25 years. This factors in actual wear and tear and market and technological obsolescence.*

*The kinds of tax provisions needed are those that align the tax treatment of an investment with the economics of the transaction. The best example of such tax policy currently before the Committee is the extension of 15 year depreciation for leasehold improvements. As you know, prior to this law being enacted in 2006, leasehold improvements were depreciation as part of the building over 39 years, straight line.*

*However, leasehold improvements typically don't last longer than 15 years before they are replaced. Their economic life, in most cases, is less than 15 years. They are financed as a separate asset from the building. Therefore, it makes sense that they are classified as an asset separate from the building and depreciated using a shorter depreciable life. Leasehold improvement replacement occurs when a lease turns over or is renewed. Average lease terms for retail properties are between 3-5 years. Lease terms in the office sector are about 5-10 years.*

*Fifteen year leasehold depreciation expired at the end of 2007 along with the other expired business tax extenders. Extending 15-year leasehold depreciation beyond 2007 will provide much needed certainty for investment in improvements that foster productive economic growth. Almost $250 billion is invested in commercial real estate improvements annually -- with $22 billion of that amount going to leasehold improvement construction.*

*All of the industries that supply goods and services to the construction industry increase their production in order to supply the construction industry with its required additional inputs. The $22 billion of direct leasehold improvement outlays generates $75 billion in direct and indirect goods and services. This ripple effect has positive and significant impact on the output, employment and payrolls of direct and indirect suppliers across the country. It supports 626,000 new jobs and $23 billion in new earnings.*

*A second example is another expired business extender which allows costs incurred to clean up environmentally contaminated sites to be deducted in the year they are incurred as opposed to being capitalized to the land's basis. Capitalization means there is no deduction for these expenses until the building is sold. Since this could be several years, this increases the overall tax burden of the redevelopment project. This higher tax burden hinders clean up and redevelopment efforts — particularly in areas that need them most.*

*Clean up and re-development of brownfield sites would help restore many blighted areas, create jobs where unemployment is high and ease pressure to develop beyond the fringes of communities. Small, urban centered businesses often benefit most directly by this redevelopment. Many brownfields properties are located in inner cities -- precisely where many businesses want to be. The economics are often right. Critical infrastructure, including transportation, is already in place and the workforce is in close proximity.*

*Finally, the Committee heard from Mr. Jeffrey Schwartz testifying on behalf of NAREIT about S. 2002, legislation to modify the REIT operational rules. This legislation would facilitate more efficient operation and management of REITs. We support S. 2002 and urge the Committee to act on it favorably and expeditiously.*

**Questions from Senator Snowe**

**Purpose:** **Retail Depreciation**

**Lead-in:** Mr. Callahan, I noticed in your testimony that the Real Estate Roundtable does not believe that now is the time for Congress to pass stimulative tax or spending proposals dealing with commercial real estate. That said, the Real Estate Roundtable does recommend that Congress reauthorize 15-year depreciation for leasehold improvements, which expired at the end of 2007.

**Question:** **Mr. Callahan, I agree that Congress must reauthorize accelerated depreciation for leasehold improvements. That said, I believe that this provision must be expanded so that retail space owned, as opposed to leased, by the retailer can take advantage of this beneficial incentive. Last year, Senators Lincoln and Kerry joined me to introduce legislation (S. 271) to make this provision law. Would you agree that enacting this provision as part of extenders legislation could help improve real estate devoted to retail space?**

*Senator Snowe, I would take this opportunity to point out that, for the reasons given in my answer to Senator Hatch's question, 15 year depreciation for leasehold improvements is not accelerated depreciation. In fact, it is slower than actual depreciation.*

*I am really not in position to comment on the tax depreciation of owner occupied retail space as my business is in leased office space. The economics and tax treatment of leased versus owned real estate are not identical. In the leased office space market specifically, the market dictates to owners the amount and timing of leasehold improvements that must be made to attract tenants. There is not the same market force in owner occupied space. Improvements can be postponed until the owner is ready to make them.*

*However, in the case of retail space, whether it is owned or leased, the retailer is competing for the same customers off the street. Therefore, one would assume they both have similar market pressure to make improvements to store space in order to attract these customers.*

*I am not in a position to comment on whether this policy is appropriate for the extenders legislation.*

**Questions from Senator Roberts**

**Mr. Callahan:** In your written testimony, you say that "we are experiencing a crisis of the credit markets, and for the most part, the markets will have to work themselves out." Yet, Congress is spending a good deal of time debating what role we can or should play in response to the downturn in the housing market. Do you believe Congress needs to intervene in some fashion, and if so, how do we do it with exacerbating current problems or creating new ones?

*Yes. Please see the attached letter sent to Senator Dodd, Chairman of the Banking Committee, on expanding the role of the Federal Reserve in addressing the credit crisis.*

**Mr. Callahan:** You raise the concern that I think many of us have about proposals to tax carried interest. During a hearing last July, we heard from Adam Ifshin who testified on behalf of the International Council of Shopping Centers. Mr. Ifshin testified that because of the investments made by his company, hundreds of jobs have been created and communities have been revitalized. I'm concerned that during the debate on the tax treatment of carried interest, some have characterized this as a "Wall Street issue" when it is really a "Main Street" issue that affects communities across the country. At a time when commercial real estate investment is (down), what would be the effect of imposing such a tax? What would it mean for investment, economic development and job creation for communities across the country?

*Please see my answer to Senator Grassley's and Senator Hatch's questions on carried interest.*

**For any witness:** Dr. Seiders, in your testimony, you indicate your support for legislation introduced by Senator Isakson that would provide a one-time tax credit of up to $15,000 over three years for the purchase of single-family principal residence that is a newly constructed home, or a home that is in default or foreclosure. Would you, or the any of the witnesses, care to comment on whether you think this legislation would help address the downturn in the housing market and be a sufficient incentive to encourage home buying?

*Given that my business is in the office sector, I am not in a position to comment on this proposal.*

*United States Senate*
*Committee on Finance*

*Sen. Chuck Grassley · Iowa*
*Ranking Member*

Opening Statement of Sen. Chuck Grassley
Hearing, "The Real Estate Market: Building a Strong Economy"
Thursday, Feb. 28, 2008

We start this year in an environment of declining house prices, financial turmoil, and rising oil prices. Economists are at odds about whether this country is heading for a recession. However, economists share the view that economic growth could be sluggish.

Congress acted swiftly to address this concern with passage of the Economic Stimulus Act of 2008. This was a short term band aid for the economy and did not focus on long term, sustained growth. This targeted tax relief should not become the trend, but rather the exception.

Some have suggested that the housing market is the root of the problem. The American home has long been the bedrock investment for many families. After the dot-com bubble burst, even more Americans looked toward their home as a safe investment. This attitude spread into the investment community as the booming real estate market made mortgage-backed securities even more appealing than before. Financial innovation by the mortgage industry made homes affordable to people who didn't have adequate income or reliable credit. Although, these so-called "subprime" borrowers actually represent a small fraction of all homeowners in America, the housing decline has had an impact throughout the nation. Due to the excess of irresponsible lending to these risky borrowers, housing prices were artificially inflated.

Now that the housing market bubble has burst, it seems that some price correction is inevitable. In fact, in many markets this will lead to recognition of more excess inventory and more price corrections. To a large extent, this problem will simply need to work itself out. However, at the same time, we need to be mindful of the harsh impact this could have on consumer confidence and economic growth.

Today we will explore what else, if anything, this committee can do to help boost the economy. Some would advocate a tax credit to incentivize people to purchase homes. This has some appeal and there is precedent for such a credit in the 1970s. However, this particular carrot, as well as any targeted tax relief, needs to be carefully reviewed. Such a credit is likely to cost in excess of $14 billion.

We should carefully balance any relief targeted to address the housing downturn to ensure that it helps ease the problem and doesn't simply create new problems. We also have to remember that

any relief benefits one sector of the public at the expense of another sector. The other sector is the taxpaying population that was careful in their family budgeting, especially as it related to housing costs. Mr. Chairman, taxpayers bear the burden of a bailout of these risky mortgages that went south. So, we need a compassionate view that recognizes taxpayers pay the ultimate tab.

It is clear that our country is going through a difficult time as homeowners struggle to keep their homes. What is less clear is what else should be done to help taxpayers weather the housing market storm. We appreciate your coming here today to discuss this important issue and look forward to exploring possible opportunities to alleviate the problem.

**Fixing the Mortgage Market**

Lawrence B. Lindsey

February 28, 2008

It is my pleasure to be here today to discuss one of the most important economic problems facing our country: the collapse of the home mortgage market and its effect on real estate values and the overall economy. Of course, in America, housing is much more than a place to live. It is a key step on the ladder of our ownership society in which ordinary people, through their own hard work and saving, get to own and participate in the greatest economic story in history: the United States of America.

There are three points to stress. First, as severe as our current problems are, neither problems nor the search for creative solutions is anything new in the American mortgage market. We have seen the development and subsequent collapse of a number of different housing mortgage models in the past 100 years. Each time a new approach was developed which worked for a while and then failed. Today's problems are no different. The root cause of this cycle of creativity and collapse is the constant need to find low cost and liquid means of financing a product – housing – that is inherently illiquid.

Second, we must recognize that this is not a "subprime" crisis as some call it, but a problem faced by every homeowner. Over 75 million American homeowners face the prospect of historically unprecedented declines in the value of their most important asset, their homes. The consequences of this will make housing an even less liquid asset. This will not only curtail spending, but it will also have knock-on effects in our national labor market as worker mobility will become impaired. This happened in Japan during the 1990s. Solutions that focus on "subprime" problems like foreclosure but make the mortgage market even less attractive for new money are counterproductive both for lower end borrowers and for the broader public.

Third, at this stage in the cycle the most important thing public policy can do is to allow and possibly promote the development of creative solutions in the private mortgage market and avoid one-size-fits-all approaches that are so typical in political and bureaucratic approaches. This is politically quite a courageous thing to do as the clamor for short term fixes, protection of those who face losses, and a search for scapegoats is

quite naturally and understandably the focus of media and public attention. But misplaced emphasis on these issues will likely lead to mistakes that will sow the seeds for future failures in the mortgage market to the detriment of our economy, tens of millions of homeowners, and ultimately the beneficiaries of politically based solutions.

There are things that the Congress can do to help liquefy the mortgage market and begin to put a floor under home prices. But understanding what these are requires some background on how we got where we are. Consider a brief review of the various cycles in housing finance that we have tried.

History's Lessons on Housing Finance

We have not always had mortgages in America. They were in fact an innovation in the late 19th century. It has been changes in how we view our homes that have led to innovations in finance. It is actually quite logical once you realize that the basic problem any banker or other lender must ask: HOW AM I GOING TO GET PAID BACK? That is a simple question, but sometimes forgetting the basics leads to trouble, as it has today.

Prior to the 1890s or so, bankers wouldn't make mortgages because they didn't know how they'd get paid back. Loans were made for farms that included farm houses, but the house was incidental to the farm and the way the lender expected to get paid back was from the income that the farm generated. Urban housing was another matter. The Savings and Loan industry developed in New England along a basic premise related to a new type of house: the Triple Decker. If you are in an old New England mill town like Manchester New Hampshire or towns that surround Boston like Somerville, or in similar cities in the Midwest like Chicago or Minneapolis, you can still see these structures.

The idea behind the Triple Decker was simple. The owner takes one apartment and rents out the other two. Those rents paid the mortgage and the property taxes and the owner theoretically lived "free." Actually, he didn't live free at all. Generally there was a high down payment that paid for most of his "third" of the property and the owner also was responsible for maintenance. Still, mortgages became available to ordinary people to buy not only their own home, but an investment property as well. The days of the all rental tenement being the only option were gone.

Banks learned from this and after World War I a new invention, the automobile, greatly expanded the possible places where people could live and families wanted to move out of the densely packed Triple Decker areas into single family homes. The innovative answer to the question HOW DO I GET PAID BACK in a single family home took the realization that the homeowner didn't have to pay rent anymore and that money that would have gone to pay rent could service the mortgage. This was still viewed as somewhat risky and large down payments were needed to cover the risk. Moreover, banks didn't want to make a long term commitment so the mortgage was typically a Five Year Balloon. In this mortgage the borrower paid interest every month and could pay what principal he could afford, but at the end of five years, the whole principal came due. Often times banks would rollover the mortgage into a second five year balloon for borrowers who had paid back a good portion of their principal. But, the borrower was potentially liable to lose the house at the end of five years if he couldn't pay the mortgage back.

The problem with this scheme became apparent in the Great Depression. Not only did many borrowers see their incomes decline, but the banks often did not have the spare funds to rollover a mortgage into another five year balloon. They were shrinking their balance sheets and the repayment of the old balloon mortgages allowed them to do that. The result was a catastrophe for homeowners. At one point in the 1930s about half of mortgage holders in America were in default on their mortgages.[1] Even homeowners who had steady incomes could not repay a five year balloon mortgage all at once. Government created innovations like the FHA were supposed to help, but only did so at the margin during the 1930s.

After World War II the nation had to find a new mortgage system. Returning GIs wanted to settle down, and new developments in home construction involved assembly line procedures that made houses more affordable, if financing could be found. The problem was finding a way to guarantee banks a source of long term funding so that they could make the long term mortgage loan and not have to issue Five Year Balloons. As

[1] Pollock, Alex J. "Crisis Intervention in Housing Finance: The Home Owners' Loan Corporation," AEI Financial Services Outlook, December 2007.

mentioned in my introduction, the house is a fairly illiquid asset that must be funded in a much more liquid financial market.

The solution was the 30-year fixed rate mortgage and the parallel creation of an industry: the Savings and Loan industry. The Savings and Loan industry existed to find a stable source of funding for long term mortgage finance. At the time, interest rates were regulated on deposits, and checking accounts could not pay interest. Savings banks and other savings and loans offered an incentive to lock up your money with them. S&Ls were allowed to pay a quarter point more on savings deposits, thus reducing competition and the possibility that depositors would leave the bank and make it hard to continue to finance the mortgages that were issued. Other features such as not paying interest unless the money was in the bank for a full quarter were included to make sure the deposit base was secure. The depositor was automatically given FDIC Insurance to further reduce the chance of a run on the bank that would deprive it of the funds needed to finance mortgages. The S&L model was simple: pay depositors 3 or 4 percent and make home loans at 5 ½ to 6 percent. The difference more than covered the cost of running the bank.

That system worked well until the inflation of the 1970s. A 4 percent return on your money at the savings bank just didn't make sense when inflation was 7 percent or more. So a gradual run on the savings banks started as more sophisticated depositors put their money into T-bills or other savings instruments. The bank was stuck with a bunch of long term mortgages but was losing the deposits that funded them. There were two problems. New money for mortgages became scarce and the Savings and Loan industry was essentially bankrupt by the end of the 1970s.

A partial solution to both problems was the development of the Adjustable Rate Mortgage or ARM. ARMs transferred the risk of inflation-induced rises in interest rates from the lender to the homeowner. This made mortgages more available and more affordable since an inflation risk premium had to be attached to the prevailing cost of funds to make a fixed rate mortgage. If the risk were transferred to the borrower, the need for the risk premium disappeared. Moreover, the borrower was the owner of an asset – the house – that went up with inflation. To a large extent he or she was compensated for the higher interest rate with home price appreciation. Today ARMs are sometimes

criticized as finance mechanisms. But when they were introduced they had the full blessing of the Congress and the regulatory community as a solution.

However, the insolvent position of the Savings and Loan industry continued due to its inability to profitably cover the cost of funding older long term fixed rate loans. Again, a legislative and regulatory solution to a previous housing finance problem in turn sowed the seeds to the destruction of the new model. In the 1980s the Congress tried some partial attempts at solving this problem, such as Garn-St.Germain, but by the end of the 1980s the entire system collapsed and we had the famous S&L bailout. Real estate depressions in Southern California, Texas, and New England followed.

The solution to the problem was to find some way of funding mortgages without relying on particular banks and Congress, the regulatory community, and the financial industry came up with the idea of securitization. All of those jumbles of letters we now see on the financial pages today: ABS (Asset Backed Security), CDO (Collateralized Debt Obligation) and the like were outgrowths of the securitization process that seemed like the solution to the problem in the early 1990s. Securitization meant that the firm that originated the mortgage could sell it into the financial market place at large and not hold it on its own books. This solved the problem that the S&L industry faced: holding long term mortgages on its books that had to be funded out of short term borrowing. However, securitization created two other problems, one that became obvious fairly quickly, the other that has become obvious only more recently.

Securitization by its nature required a standardization of mortgage products. This created a need for lending rules such as minimum down payment requirements and careful scoring of the creditworthiness of borrowers. In the early 1990s this led to a particular dearth of access to credit to low and moderate income individuals who lacked both the available saving and the credit histories needed to meet those standards. The regulatory community was placed under intense political pressure to come up with ways of providing access to credit for those populations, and did so, most notably with new rules under the Community Reinvestment Act. I was involved in that process and am proud of what was accomplished. In fact, most of those individuals could be and did turn out to be responsible borrowers and homeowners. But there can also be little doubt that in hindsight the new regulations did contribute to some of the excessive expansion in

credit that has occurred. I note this mainly to provide a cautionary tale. Even very well intentioned and largely successful regulations can have unintended consequences. That does not mean that such actions were wrong, but that we should be very careful in how we use legislation and regulation in "solving" current problems.

The far bigger problem we have with securitization is that those who made the loans – the originators – and those who packaged the loans and sold them – the securitizers – have very little at stake in what happens to the mortgage. While the Savings and Loan had every incentive to make sure that the borrower was creditworthy and therefore knew the answer to the question – HOW DO I GET PAID BACK – this was no longer the case for those who originated mortgages in our new securitized world.

The big risk from all this is that the people who bought the mortgage securities, the ultimate providers of money for the mortgages that fund America's housing industry, were handed securities that they will no longer be able to trust. Unless their trust and confidence is restored, the future for America's mortgage industry and for the long term value of our homes is in jeopardy.

There are, of course, lots of other details in these problems, but a look at history shows that three things stand out. First, financial innovation has always been a part of the mortgage industry. Second, each innovation solved the problems that came before, but ultimately created new problems. Third, each time the so-called solution had the full blessing of the political and regulatory community of the day.

Those of us who are and have been involved in this process – and I would count myself among them – really should be quite cautious about our willingness to point the finger at others as having caused the current distress. Congress and the regulatory community were always actively involved in setting up systems for making sure credit flowed into the housing industry at as low a rate as possible. Moreover, many political figures have actively lobbied for ever more affordable access to housing finance over the years, with the inevitable albeit unintended effect of lowering the average credit quality of the borrowers in the mortgage pool. This latter development, carried to excess by the inevitable profit seeking behavior of both borrowers and lenders, pushed housing prices above a sustainable level. An examination of the consequences of that follows.

The Broader Problem

Media attention has naturally turned to individuals who are in danger of losing their homes to foreclosure. A family losing its home is a painful process and one that can easily stir the emotions of any thoughtful and sensitive person. Most of those now in immediate danger of foreclosure fall in a group of borrowers called "subprime" because of their relatively low credit quality, high loan to value ratios, and mortgage features that make repayment difficult.

But these relatively recent homeowners with subprime adjustable rate mortgages represent less than 5 percent of the homeowners in America. There are more than 75 million other homeowners who also are seeing the value of their most important financial asset, as well as the place in which they live, decline in value during the recent housing downturn. These homeowners generally had much better credit ratings, made larger down payments, and had better servicing ability than the group on which others are now focused. Some of these people are losing their homes as well due to job losses or other events. A far larger group are seeing their down payments and much of their life saving disappear as home prices plummet in value.

Some economists have been talking about a 20 percent drop in national home prices. My personal view is that is probably slightly on the high side, but perfectly plausible. If that were to happen, more than $4.5 trillion of household wealth would be wiped out. That amounts to $15,000 for every man, woman and child in America, $60,000 for a four person family. Think about it – a median priced home in America that once sold for around $220,000 is in danger of dropping to $176,000. That is hard earned money intended for retirement, paying for children's education, or to permit a few luxuries in life.

For many of these homeowners who did not take out subprime mortgages or take a variable interest rate, this would wipe out more than all of the equity they have in their house. The economic consequences of this would be far reaching. Families could afford to spend less on every day items as they struggled to stay in their homes. Possibly equally important, these families might find it difficult to relocate should a new job or job transfer occur because they could not profitably sell there house and acquire a down-payment on a new home. Nor could they afford to carry two mortgages. In our highly

mobile society, a freezing of the liquidity of the housing market has potential far reaching implication for other markets as well, particularly the labor market.

So I believe the real challenge for America in the current home mortgage mess is to find a way of preserving home values over the long run. This broader focus in no way ignores the problems faced by those who took out subprime variable rate loans. In a very real sense, they have the same problem as the rest of us. If their houses go down, and stay down, in value, they too will be wiped out. A temporary fix that allows them to meet their current mortgage payment is just that, a temporary fix. If in five years their adjustable rate mortgage is no longer frozen and they are living in a house that has gone down 20 percent in value, they will find themselves in an even worse situation than they are in today.

In normal markets home prices do rise over the long term. They rise as incomes rises and with it, the ability to afford a home rises. These are not normal times. The problem is that incomes by themselves do not buy homes. People need access to mortgages to buy homes and our credit markets have shut down.

Establishing a secure and viable mortgage industry that has access to credit over the long term *is the only way* to give Americans the confidence that the value of their homes will be secure in the long run. None of the plans now being suggested, either by the current President or by those to be his successor have this as the focus. In fact, to some extent some of these plans work in the opposite direction. By proposing sweeping changes in the terms of existing mortgages by freezing interest rates involuntarily and retroactively changing foreclosure options and allowing bankruptcy judges a new and unilateral ability to change mortgage terms, the confidence of those who might commit new money to mortgage finance is being undermined. These plans might actually weaken the long term viability of the mortgage industry, by hurting access to credit for buyers, and thereby drive home prices down further.

The fact is that our current record level of homeownership is the product of more than a century of constant innovation. At each step along the way we made improvements that fixed the flaws in the system that came before it. We are now in one of those periods where we are going to have to innovate and possibly redesign our mortgage system to fix the flaws that have become apparent in the one that led us into

this mess. The real solution to the housing problem is to find a new and sustainable housing finance system, and to do that, we must first recall the lessons of the past as to how we got where we are today.

Transitioning to the Next Mortgage System

The underpinnings of the next step in the evolution of our mortgage system must be to assure ample liquidity to those involved in the mortgage process. This will involve helping homeowners with cash flow and assuring lenders that they are investing in secure products. They must not be taken by surprise by rapid changes in the creditworthiness of the securities they underwrite. A triple-A mortgage security cannot be allowed to drop to 70 cents on the dollar overnight. They must also face some kind of reassurance that they will not have their principal seized when the political tenor of the times demands it.

First, let's consider what is needed to do this in the case of new mortgages. While our Government Sponsored Enterprises, Fannie Mae and Freddie Mac have their flaws, they do offer one very important assurance to investors: rules on the creditworthiness of borrowers that lets them have some comfort that they will not involve a wave of defaults. Both the flaws and this latter strength offer a clue to how we might proceed.

It is an understatement to say that Fannie and Freddie have not been using their position as constructively as they might have. They have engaged in dubious accounting practices, run a substantial hedge-fund like book that implicitly made bets on the direction of interest rates in an effort to increase shareholder returns, and used lobbying and campaign contributions to expand the scope of their activities. I can understand the attraction of allowing them more ample scope of operation, particularly to higher end borrowers. But, given their capital constraints and their lack of forthrightness about their past financing, the extension of their mortgage business to higher-end mortgages came at the direct expense of mortgage affordability to the moderate end borrower for whom they were created.

While Fannie and Freddie should certainly be allowed to continue what they were doing in the past, the best way to move forward is to build on the model of securitization standards that was the real strength of their franchise. A new set of standards needs to be

established so that other potential securitizers, ones that do not rely on a government backstop, can become involved.

I am proposing that we create a Federal Board of Certification composed of the Comptroller of the Currency, a Governor of the Federal Reserve designated by the Chairman, the Secretary of Housing and Urban Development and the Under Secretary of Treasury for Domestic Finance to administer standards for mortgages that are packaged in mortgage backed securities and to certify – for a fee – that the mortgages represented in that security meet those standards.

This does not involve a federal guarantee of the security, even an implicit one. Nor does it involve a guarantee of the mortgage portfolio. All the Certification Board would do is assure investors that the mortgages in the security meet the standard they claim to meet with regard to such features as documentation, loan to value ratios, debt service to income ratios, and borrower credit standards. Obviously a variety of such standards could exist and investors could pick the standard and implied level of risk they want knowing that the mortgages in the security actually conform to that standard.

Nor does this preclude other institutions from offering mortgage backed securities without government certification. If the market has investors willing to buy such securities, so much the better. At the moment it does not at a reasonable price.

Most important, we should not expect that all mortgages would be securitized. Borrowers who do not meet certifiable standards but who lenders deem creditworthy should be able to borrow, but with the lender holding that mortgage on its own balance sheet.

Note that the existing rating agencies could choose to continue to perform their functions if there were a market demand for their services. Under current conditions, the trust in their performance is sadly lacking. The government can provide a similar type of product through this certification process. I can think of no single action by government that could do more to restore confidence in the mortgage lending process.

Similar creativity should be, and by and large is being, applied to current homeowners who are having problems making payments. Homeowners anticipating problems should contact their mortgage servicer as soon as possible. Servicers have little incentive to foreclose if the mortgagee has some capacity to make payments. More

generally, creative approaches are being developed by new entrants to the industry. One example that is particularly interesting is the shared appreciation mortgage which allows lenders to lower the principal amount owed by the borrower, and in the process lower the borrower's monthly payment, but in return the lender keeps a share in the value of the house (equal to the proportionate loan reduction amount) which is collected when the house is sold. By lowering the monthly payment this process offers the homeowner every incentive to stay in the house, an attractive piece of the interest rate freeze plans. But it also fully compensates the lender when house prices recover. Government should not pick a single approach but should facilitate those good-faith approaches that are out there by making changes in tax and securities rules that might accommodate these approaches.

Finally, there is a role for this Committee to consider in its main area of jurisdiction: taxation. Like most economists, I would conclude that in the grand scheme of things, home ownership gets quite generous tax treatment, particularly through the housing mortgage interest deduction. In an ideal world this would not be considered an economically efficient program, although there are benefits to society in encouraging home ownership that should be considered. But this is not an ideal world, and whatever one may think of the tax treatment of housing generally, the economic risks to further home price declines are large and should be avoided.

In this environment of declining mortgage availability and home price declines, tax favored treatment of mortgage interest does provide a reason for people to hold on to more housing than they otherwise might while also easing the cash flow problems associated with homeownership. In the near term this should be considered an economically stabilizing action by government.

Two changes in the tax deductibility of mortgage interest should be considered as temporary measures. First, mortgage interest might become an "above the line deduction" available to non-itemizers as well as itemizers. Half of all homeowners do not itemize their tax returns. These are disproportionately moderate income individuals who might be bearing a disproportionate amount of the strains from the deteriorating housing market. On the other end of the housing scale, individuals who are either trying to obtain Jumbo mortgages or who are forced to carry two mortgages because they have had to buy

a new home without being able to sell their old one are coming up against the $1 million limit on the size of a mortgage, the interest on which is tax deductible. A temporary lifting of that cap might be a worthy change to consider in this environment.

I would stress the advantages of having these measures be temporary. A lifting of the cap, for example, would be most effective for a period of two to three years while mortgage conditions stabilize. The above-the-line deduction should probably be in place longer, but with a phase-down period.

Certifying the standards of securitized mortgage pools, facilitating the search for creative solutions in the market place and a modest and temporary improvement in mortgagee cash flow through tax changes combine to offer the best way of easing the transition to the next model in housing mortgage finance.

**Senate Finance Committee Hearing**
**The Real Estate Market: Building a Strong Economy**
**February 28, 2008**
**Questions for Dr. Lawrence Lindsey**

**Questions from Senator Hatch**

Dr. Lindsey, thank you for your very interesting testimony. You mentioned that solutions to the mortgage crisis that focus on subprime problems like foreclosure but make the mortgage market even less attractive for new money are counterproductive both for lower end borrowers and for the broader public. Could you elaborate on this point generally, and specifically indicate whether ideas such as giving bankruptcy judges the power to modify the terms of mortgages are in this category?

You indicated in your review of the history of mortgages that financial innovation has always been present in this industry, and that each innovation solved the earlier problems but created new ones. Do you have any thoughts on what the next innovation might be, how it will solve our present problems and what problems it might bring with it?

I found your ideas of temporarily changing the tax treatment of mortgage interest expense to be very interesting. One concern that comes to mind is that there is a danger that such temporary measures could become part of the long and growing list of expiring tax provisions that get routinely extended and become de facto permanent provisions. Do you have any thoughts on this, and also, what is your view on the idea of a tax credit for the purchase of a new or unoccupied house?

**Answers from Larry Lindsey**

1) The central problem we have in housing is a shortage of demand given how high prices rose, so there will be some downward adjustment in housing prices. But as this happens, mortgages inherently become riskier, since people are lending against a depreciating asset instead of one that they assumed would rise in value. Given that, we want to do everything possible to encourage people to stay in the mortgage market as lenders and nothing to discourage them further.

   Giving bankruptcy judges the power to modify the terms of existing mortgages would do this. Basically the Congress would be changing the rules of the game, implicitly rewriting contracts. Lenders would justifiably ask themselves questions about the possibility of other ex post changes in American law and thereby view any contract or any loan as riskier than previously since one is adding "legal risk" to the whole host of other risks. In this case Congress would only be engaging in a small "taking" of the value of the contract. But what would stop Congress from larger takings, such as forced reductions in principal, interest rate freezes, or bans on foreclosure. All such proposals are also in the political domain now.

2) I wish I knew what the next successful innovation in the mortgage market might be. It would make me a wealthy man. In practice we are likely to try many experiments over the next few years. Some will work and prove durable, most will not. Again, the best thing the Congress could do is to facilitate, or at least not inhibit, this process of innovation.

3) You are of course right about the tendency for temporary tax measures to become permanent. One way of minimizing this risk is to have a pre-ordained gradual phase out so that the year-to-year tax shock is relatively small. For example, one could allow 100 percent "above the line" for two years, and then reduce it by 10 percent for each of the next ten years. Or, you could temporarily raise the mortgage deduction cap to 5 million, and then reduce it by one million in each of the following four years.

   A tax credit for the purchase of a new or unoccupied home creates lots of possibilities to "game" the system. It would also encourage new construction, that while good for the construction industry, would be bad for the overall housing market. The challenge we face is getting people to hold onto the existing amount of housing, and finance the existing amount of housing, and will be lucky when the problem evolves into one of encouraging new construction.

**Questions from Senator Roberts**

**Dr. Lindsey:** In your testimony, you discuss a proposal that may be considered in the Senate later this week to allow bankruptcy judges to rewrite mortgage terms. You say that "by . . . allowing bankruptcy judges a new and unilateral ability to change mortgage terms, the confidence of those who might commit new money to mortgage finance is being undermined." So, if Congress were to allow cramdowns, not only this new capital for financing likely to be hard to get, but won't the cost of a mortgage rise for borrowers as lenders price for the additional risk of a potential cramdown? What will this mean for potential homebuyers?

**For any witness:** Dr. Seiders, in your testimony, you indicate your support for legislation introduced by Senator Isakson that would provide a one-time tax credit of up to $15,000 over three years for the purchase of single-family principal residence that is a newly constructed home, or a home that is in default or foreclosure. Would you, or the any of the witnesses, care to comment on whether you think this legislation would help address the downturn in the housing market and be a sufficient incentive to encourage home buying?

**Answers from Larry Lindsey**

1) My sentiments regarding involuntary cramdowns are exactly the same as retroactive changes in contract law, only more so. They would discourage new financing thereby making home

   purchases even harder, drive house prices down more, and therefore exacerbate the existing downward spiral in housing prices and credit availability.

2) A tax credit for the purchase of a new or unoccupied home creates lots of possibilities to "game" the system. It would also encourage new construction, that while good for the construction industry, would be bad for the overall housing market. The challenge we face is getting people to hold onto the existing amount of housing, and finance the existing amount of housing, and will be lucky when the problem evolves into one of encouraging new construction.

**Senate Finance Committee**
**Statement for the Record From Senator Roberts**
**The Real Estate Market: Building a Strong Economy**
**February 28, 2008**

Mr. Chairman:

After years of rapidly appreciating home prices and generous mortgage financing terms, we are now seeing corrections in the housing sector. For many families, this has meant a decline in the value of their homes, tighter mortgage lending standards, and for some homeowners, the prospect of higher mortgage payments as those with ARMs are beginning to see their mortgage rates adjust upwards.

While there is no single response that will solve the problems in the housing market, voluntary actions taken by mortgage lenders to reach out to homeowners in distress is a good first step. It is important that the market and homeowners take the lead and work together to address the housing situation.

Although there are many suggestions as to what action, if any, Congress could take to mitigate the housing downturn, several of our witnesses today stress any effort must first "do no harm." I couldn't agree more. Too often, Congress, in, it's haste to pass legislation, does just that. It is critical that we proceed cautiously, take a hard look at any proposal that is offered to address the housing market, and be certain that any action we take does not create unintended consequences for the housing market down the road.

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

**Statement of**

**Jeffrey H. Schwartz**

**Chairman and Chief Executive Officer**

**ProLogis**

**and**

**First Vice-Chair**

**National Association of Real Estate Investment Trusts®**

**Before the**

**Senate Finance Committee**

**Hearing on**

**"The Real Estate Market: Building a Strong Economy"**

**February 28, 2008**

♦ ♦ ♦

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*Statement submitted before a hearing of the Senate Finance Committee entitled "The Real Estate Market: Building a Strong Economy" on February 28, 2008*

My name is Jeffrey H. Schwartz, and I am Chairman and Chief Executive Officer of ProLogis and First Vice-Chair of the National Association of Real Estate Investment Trusts®. ProLogis, headquartered in Denver, Co, is the world's largest owner, manager and developer of distribution facilities with more than one-half billion square feet of industrial space in 118 markets across North America, Asia and Europe. I am here today, testifying on behalf of NAREIT, the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. property and capital markets. I appreciate the opportunity today to provide an overview of the health of the commercial real estate market, but also the risks presently threatening that health.

As members of the Committee are well aware, commercial real estate contributes approximately six percent to the U.S. Gross Domestic Product. When it comes to building and maintaining a strong economy, the commercial real estate sector plays a constructive, creative and important role.

As an integral part of the commercial real estate economy, real estate investment trusts (REITs) are publicly traded companies that own and, in most cases, manage portfolios of investment-grade, income-producing commercial real estate, including office buildings, warehouse and distribution facilities, retail centers, apartment communities, health care facilities and hotels.[1] REITs operate like other publicly traded companies, including familiar names like Microsoft, Verizon or Citigroup. However, unlike Microsoft (which designs and provides software), Verizon (which builds and provides telecommunications services) or Citigroup (which manages and provides financial services), REITs own, operate, develop and lease commercial real estate as well as provide their tenants other real estate services.

Today, there are approximately 150 publicly traded REITs with a combined equity market capitalization exceeding $300 billion. Together, they own a combined real estate portfolio of more than $600 billion of commercial properties or approximately 10-15 percent of all institutional-grade, income-producing real estate nationwide.

In assessing the state of today's real estate economy, it may be helpful to separate its two primary components: the commercial property markets and the capital markets which provide debt and equity financing to the property sector. The reason it is important to examine property and capital markets separately is that it may come as a surprise to some that the past several years are best described as a period of reasonably healthy and strong commercial property markets. The "boom and bust" cycle that has appeared from time to time in the real estate economy has been primarily the tale of capital markets, not the tale of property markets. While capital markets today are in considerable difficulty, the financial distress attending those markets has not yet spilled over into real property

[1] Some REITs also provide financing for commercial real estate.

business fundamentals. However, property markets could lose their fundamental strength rapidly if the difficulties in capital markets are not overcome relatively soon, and what may be viewed currently only as modest weakness in the broader economy could turn quickly into a hard landing.

**Commercial Property Market Fundamentals**

The most important metric with which to gauge the health of income-producing property markets is *net operating income*, or NOI, which equals the revenues generated by leasing space in a commercial property minus the expenses associated with operating and maintaining that property. Exhibit 1 summarizes from 2000 through 2007 median growth in "same-store" net operating income – that is, NOI growth for the same portfolio of properties – among 30 of the largest real estate investment trusts nationwide. Except for a three-year period of negative or weak growth (2002-2004), net operating income has grown by three percent to five percent in every other year from 2000 through 2007.

The two factors contributing most to net operating income are effective *rents* and *occupancy rates*, that is, the percentage of leasable space in a given building that is actually generating income. Exhibit 2 summarizes average occupancy rates in office, retail, industrial/warehouse and apartment buildings from 1987 through 2007. As revealed in the exhibit, the deceleration in 2002-2004 of net operating income growth coincided with a downturn in occupancy rates from about 94 percent to about 89 percent. Occupancy rates since then have recovered to about 92 percent – their approximate long-term average – and have propelled NOI annual median growth back to five percent in 2006 and 2007.

Market participants also assess property market fundamentals by analyzing property markets in terms of *vacancy rates,* which are shown in Exhibit 3 for the same period. Vacancies surged to about 11 percent during 2003 and 2004, but then declined to less than eight percent – again, the approximate long-term average – through the end of 2007.

The fundamental strength of commercial property markets over the past several years owes primarily to the growth of demand for space. As the economy expands, the demand for additional space grows likewise. For example, Exhibits 4 and 5 illustrate, respectively, two drivers of such demand growth: the level of external trade (imports plus exports) from 1995 through 2007 and the level of retail sales activity from 1998 through January of 2008. External trade, which drives much of the demand for industrial and warehousing space, has grown steadily, with only the slightest hesitation in 2001 and 2002. Similarly, retail sales have grown even more consistently and drive much of the demand for space in retail properties.

The second main factor in maintaining the fundamental health of income-producing property markets over the past several years was a substantial increase in construction costs. Developers generally respond to strong real estate fundamentals both by constructing new commercial space and by renovating existing properties. If construction costs are relatively low, then the response of developers can be swift. In

some cases, developers may respond too aggressively by building too much new commercial space. When excessive construction occurs, net operating income inevitably suffers as competition between owners of new and existing properties drives down both occupancy rates and effective rents.

Exhibit 6 illustrates year-over-year growth in construction costs in the U.S. from late 1997 through 2006. As the exhibit reveals, construction costs surged between 6 percent and 10 percent during the period 2004-2005, just when commercial real estate property fundamentals were improving following the comparative weakness of 2002-2004. This growth in construction costs made it more costly for developers to build new commercial properties and dampened what otherwise might have been an over-response to strong real estate fundamentals.

Owing to a combination of the factors I have noted, construction activity has been strong, but not so strong as to lead to the type of over-building that has undermined net operating income during previous commercial property cycles. Using data from the Bureau of Labor Statistics, Exhibit 7 summarizes the number of square feet of new non-residential construction put in place from January 2002 through December 2007. As the U.S. economy expanded throughout that period, we witnessed only a steady increase in the construction of new commercial space rather than a surge in new construction that could have undermined property fundamentals.

In summary, income-producing property markets today are fundamentally sound and have been sound for several years. The persistent strength in commercial property fundamentals can be attributed to a healthy growth in demand for commercial space – including such demand drivers as office-related employment, retail activity, and external trade – as well as only a moderate level of new construction activity in response to those strong fundamentals.

**Commercial Property Capital Markets**

I now will turn to the financial side of the U.S. real estate economy, which presents a very different picture. While commercial property market fundamentals have remained relatively strong, current credit market conditions for commercial real estate are in extreme distress.

Reflecting this distress, share prices for publicly traded real estate equity securities have declined approximately 26 percent from their peak levels of a year ago. The recent sell-off in share prices is revealed in Exhibit 8, which tracks the FTSE NAREIT total return index for equity REITs – companies that own, develop, operate and lease commercial property. Likewise, sources of private equity capital, though more difficult to measure, also have pulled back. However, the decline in equity valuations primarily reflects current conditions and uncertainty plaguing credit markets.

Conditions in the commercial real estate credit market run the risk, if allowed to worsen, to add to the woes currently plaguing the home mortgage markets. Not unlike

developments in the market for single-family mortgage credit, available data suggest that an excess supply of capital prompted lenders to relax commercial mortgage lending standards and to reduce commercial mortgage interest rates. This then led investors to bid up property prices beyond levels consistent with property fundamentals.

As revealed in Exhibit 9, the tendency toward an excess supply of credit first became evident in 2002. The Federal Reserve Board's Senior Loan Officer Opinion Survey on Banking Lending Practices conducted during the second quarter of 2002 revealed a marked decline from previous surveys in the net percentage of loan officers reporting a tightening of credit standards on commercial real estate loans. In the fourth quarter of 2003, the survey suggested that, on net, lenders were no longer tightening standards at all for commercial real estate loans, and during each of the next eight quarters, the survey indicated that lenders continued to relax commercial real estate lending standards.

The steady erosion of lending standards had the effect of making more and more financing available to prospective borrowers. As we have seen, the easy availability of credit did not prompt a surge in new commercial construction; rather, the surplus of financing supported acquisitions of existing properties at higher and higher prices relative to their net operating income.

A corollary to the increasing availability of commercial real estate credit has been the dramatic growth in issuance of commercial mortgage-backed securities or CMBS. CMBS represent a mechanism for improving the efficient allocation of capital. Through CMBS, investors transfer funds to lenders, who use the proceeds of CMBS sales to originate new loans. Exhibit 10 illustrates growth in issuance of CMBS from 1999 through 2007. As the exhibit indicates, the importance of commercial mortgage-backed securities as a critical component of capital markets grew rapidly in 2005, 2006 and the first part of 2007, when average quarterly issuance exceeded $50 billion.

Reflecting the increased availability and lower cost of mortgage credit, Exhibit 11 summarizes the increase in transaction prices from the end of 1999 through the end of 2007 for commercial properties as reported by the MIT Center for Real Estate. During the first part of the period, commercial property values increased at about 8.5 percent per year on average. However, beginning in the third quarter of 2003, commercial property values increased at an unsustainable pace, averaging almost 22.5 percent per year through mid-2007, coincident with the relaxation of commercial real estate lending standards and the surging issuance of CMBS.

As problems surfaced in the residential sub-prime mortgage market, banks in the second half of 2006 began tightening their lending standards and raising their credit spreads for commercial mortgage credit (Exhibit 9). In the most recent survey of bank lending officers, just over 80 percent of lending officers reported a further tightening of lending standards, the highest level reported since the Federal Reserve initiated the survey in 1990. Today, bank credit is available, but only to a very narrow cohort of borrowers with the strongest credit prospects, placing great pressure on many borrowers, including those seeking only to refinance outstanding debt.

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In recent months, CMBS issuance also has plummeted, and the credit market for securitized commercial real estate debt is, for all intents and purposes, closed (Exhibit 10). In January 2008, for example, CMBS issuance was zero, an astonishing turn of events. Sharply wider credit spreads in the market for CMBS reveal the heightened level of investor uncertainty with respect to credit quality, indicative of the illiquidity that has frozen the market. As illustrated in Exhibit 12, credit spreads for AAA-rated CMBS have more than doubled in the past 12 months, whereas spreads for investment-grade securities have increased a thousand percent.

Absent the availability of credit financing, property transactions have slowed to a crawl. Exhibit 13 reveals that the number of property transactions has declined to a level not seen since the beginning of the decade. Without an adequate level of liquidity in property markets, the ordinary price discovery mechanism will not work. Investors are unable to determine appropriate price levels consistent with current property fundamentals and conditions in capital markets. Thus, markets are seized and will not function properly until liquidity is restored in credit markets.

Evidence of the far tighter credit market conditions and the absence of liquidity in property markets is the decline in property valuations reported in the third and fourth quarters of 2007 (Exhibit 11). Even though property fundamentals have remained strong, prices are beginning to weaken.

As valuations decline, cap rates, of course, have begun to increase. The cap rate for an income-producing property represents the implied return that investors expect to receive on the purchase of a property and equals the expected net operating income generated by the property as a percentage of the property's value. The cap rate is analogous to the earnings-to-price ratio for a company in the stock market. Exhibit 14 illustrates cap rates for office, retail, industrial, and apartment properties owned by pension funds and other fiduciaries. If both capital costs and expectations regarding future growth of NOI are constant, then the cap rate should be constant as well. If property values increased without any corresponding increase in future expected NOI – thereby driving down the cap rate – then investors would redeploy funds to alternative investments with returns that had not declined.

Cap rates on commercial properties have largely trended downward since 1993. During most of that period, however, the expected return on alternative investments – represented by the yield on long-term U.S. Treasury bonds – also was trending downward. As a result, the cap rate spread – the difference between cap rates and long-term Treasury yields – remained fairly constant at about 1.75 percent. Beginning in 2002, however, cap rates continued to decline even though long-term Treasury yields had steadied at about five percent. From 2002 through 2007, the cap rate spread narrowed until the second quarter of 2006, at which time there was no longer any spread between cap rates and Treasury yields. During most of 2007, reported cap rates were actually less than Treasury yields.

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**The Current Situation and Outlook**

Where do we stand now, following this period of rapid growth in commercial property values, moderate growth in net operating income, and declining cap rates? Quite simply, access to capital has become severely constrained – if available at all – property transactions have declined to a fraction of their previous level, and property values have started to decline as a result.

Bank lending officers have reported increasingly tighter lending standards in response to each Federal Reserve survey since the first quarter of 2006, and CMBS issuance has plummeted from its peak in the second quarter of 2007. Although not shown in the exhibit, no commercial mortgage-backed securities of any kind were issued during January 2008, the first month since CMBS gained prominence that no issues came to the market.

This sudden constriction in the availability of commercial real estate credit has been felt rapidly both in the level of commercial property transactions and in the level of property values. After peaking at nearly 1,900 transactions in May 2007, transaction volume plummeted to fewer than 250 transactions in January of this year. As with CMBS, property transaction activity is necessary to maintain an effective market for price discovery and to allocate available capital resources efficiently, as properties are typically transferred to owners who believe that they can improve the performance of the assets.

A more ominous result of the constriction of capital availability has been the nascent decline in property values. Commercial property values started to fall in the third quarter of 2007, and the decline in the two most recent quarters has been rapid, at an average annual pace exceeding 11 percent. Investors in publicly traded equity REITs have already seen even more of a correction in their share prices.

In light of the current situation, the commercial real estate economy as well as the overall economy is at appreciable risk. Real estate fundamentals have remained relatively healthy even as credit availability has tightened, REIT share prices have declined and property values have started to fall. However, the strength in real estate fundamentals has persisted because of growing demand for commercial space as well as because new construction has continued to grow at only a moderate pace.

It seems exceedingly unlikely that the current balance in commercial real estate markets will be upset by any surge in new construction. The possibility of slackening demand for commercial space, however, presents a much greater risk. For example, any significant decline in office-related employment would reduce the demand for office space, affecting both effective rents and occupancy levels in the office property market. Likewise, any significant decline in consumer spending would reduce the demand for retail space, while any significant decline in trade activity would reduce the demand for industrial and warehouse space.

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**Conclusion**

In conclusion, the primary basis for our present outlook with respect to the commercial real estate economy is the risk that illiquidity and credit restraint in the capital markets could bring about a significant economic downturn. Commercial real estate fundamentals have so far weathered the significant capital market dislocations. But, without renewed liquidity in the financial sector, the situation could deteriorate rapidly.

With respect to actions the Committee may consider taking, our overriding recommendation would be: First, do no harm. To the extent that legislative steps are taken, we caution you to move in a careful, deliberative manner so that upheaval in the financial markets is not accelerated and so that harmful, unintended consequences are not seen years hence. As an example, we do not believe that initiatives that would disproportionately raise taxes on the real estate industry are appropriate, especially at this time. Instead, and second, appropriate steps should be taken to ensure that real estate markets remain liquid and healthy. We do believe that several provisions contained in legislation now before this Committee, S. 2002, introduced last year by Senators Salazar and Hatch, are a part of the solution.

One of these provisions would authorize REITs to manage acquisitions and sales of their property portfolios more effectively and efficiently, consistent with their business goals as long-term holders of real estate. Allowing REITs to more readily access and recycle capital through the acquisition and disposition process would serve to enhance the property marketplace, much like removing the "lock-in" effect when capital gain rates have been lowered. REITs, which are largely well-capitalized and conservatively leveraged, would then be in a better position to inject desirable equity from the public markets into the commercial real estate marketplace, providing ballast to this sector at a potentially difficult time. In addition, under another provision contained in the Salazar-Hatch proposal, REITs engaged in taxable entrepreneurial, real estate activities that are ancillary to their primary real estate business, would be able to expand the range of these activities and infuse additional capital into the broader real estate economy.

We commend Senators Salazar and Hatch, as well as the other four members of this Committee who are co-sponsoring S. 2002, for their foresight in sponsoring legislation that would help facilitate healthy activity in the commercial real estate market at a time when it may be needed. To its credit, this Committee is desirous to build a strong national economy with a stable real estate base, and it is NAREIT's strong opinion that one of the ways to help achieve this goal is adoption of these types of provisions.

NAREIT applauds you for holding this hearing and thanks you for the invitation to provide the insight we have on the state of commercial real estate in the United States today. We stand ready to assist this Committee and the Congress to achieve the overall goal of building a strong economy. I would be happy to respond to any questions that you or the other members of the Committee might have.

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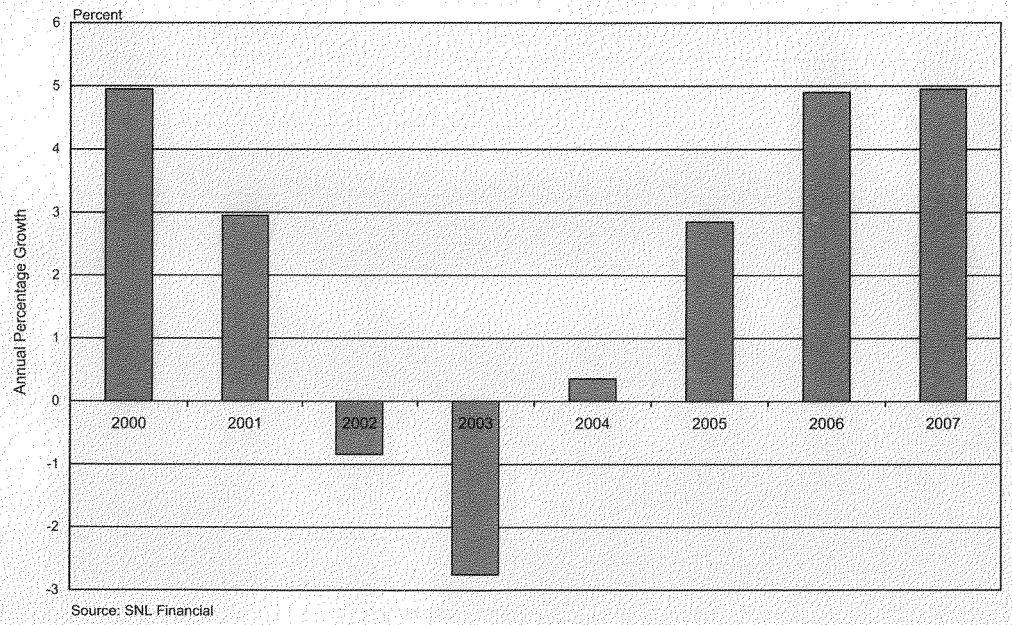
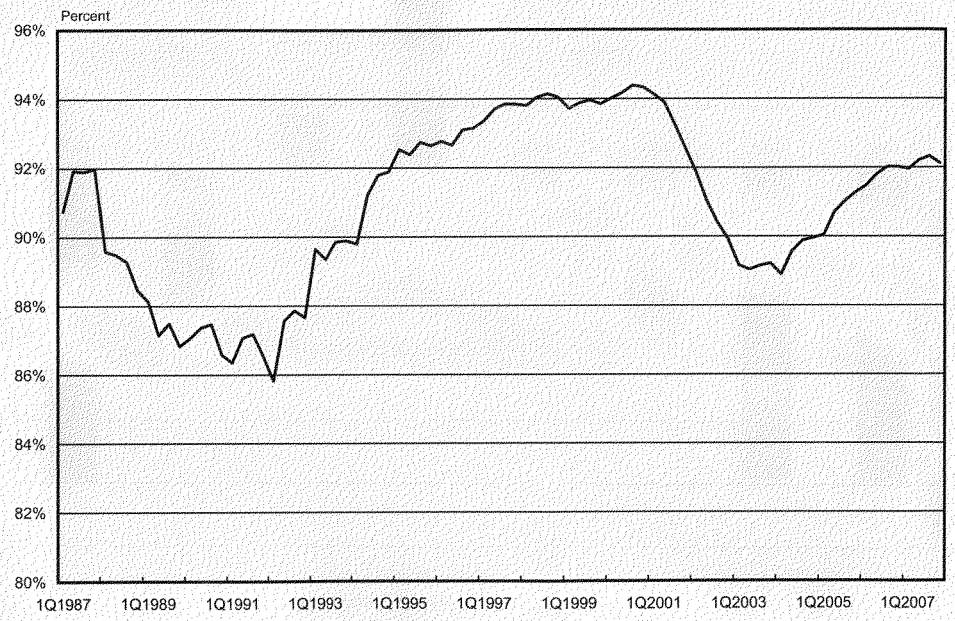
**Exhibit 1**
**Annual Median Growth in Same-Store Net Operating Income**
30 Large U.S. REITs, 2000 - 2007



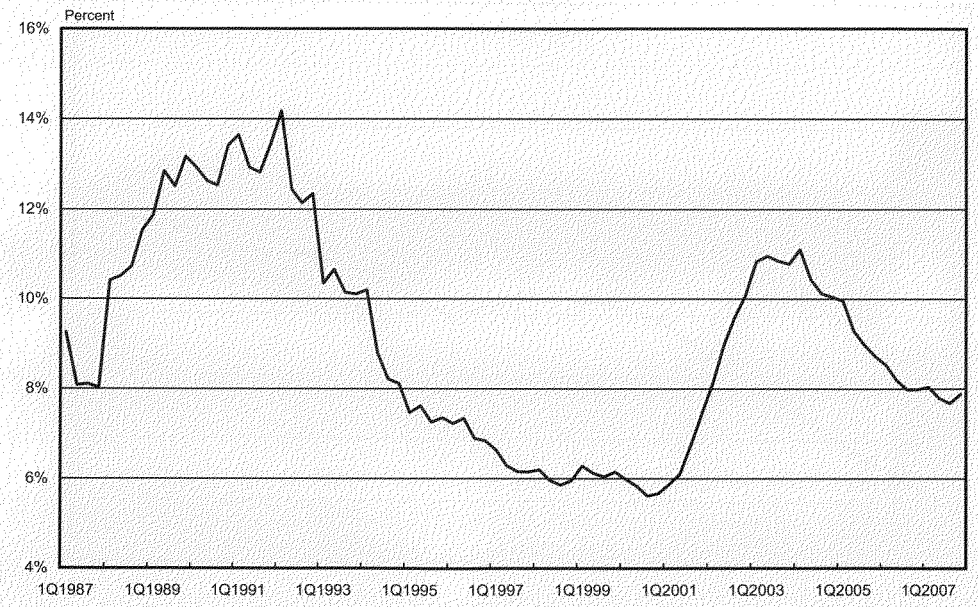

Source: SNL Financial

**Exhibit 2**
**Average Occupancy Rates**
1987-2007




Source: National Council of Real Estate Investment Fiduciaries

**Exhibit 3**
**Average Vacancy Rates**
1987-2007




Source: National Council of Real Estate Investment Fiduciaries

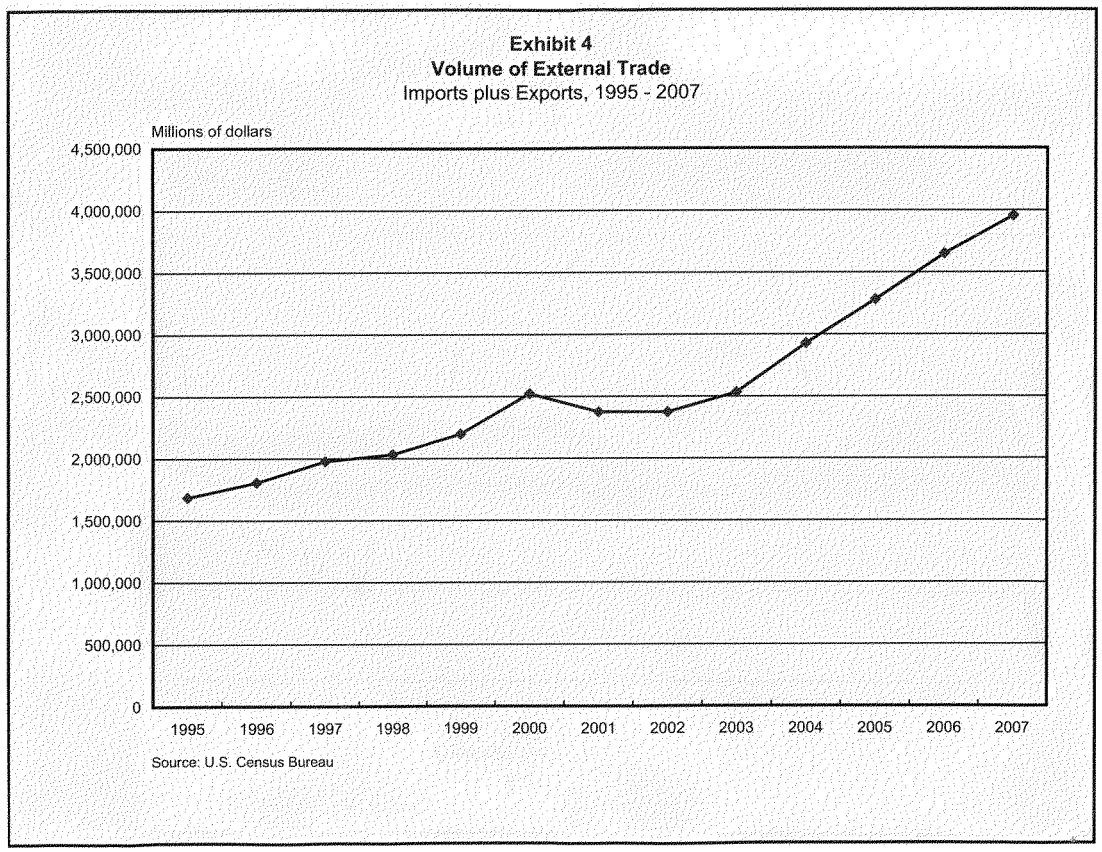


Exhibit 4
Volume of External Trade
Imports plus Exports, 1995 - 2007
Millions of dollars
4,500,000
4,000,000
3,500,000
3,000,000
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
Source: U.S. Census Bureau

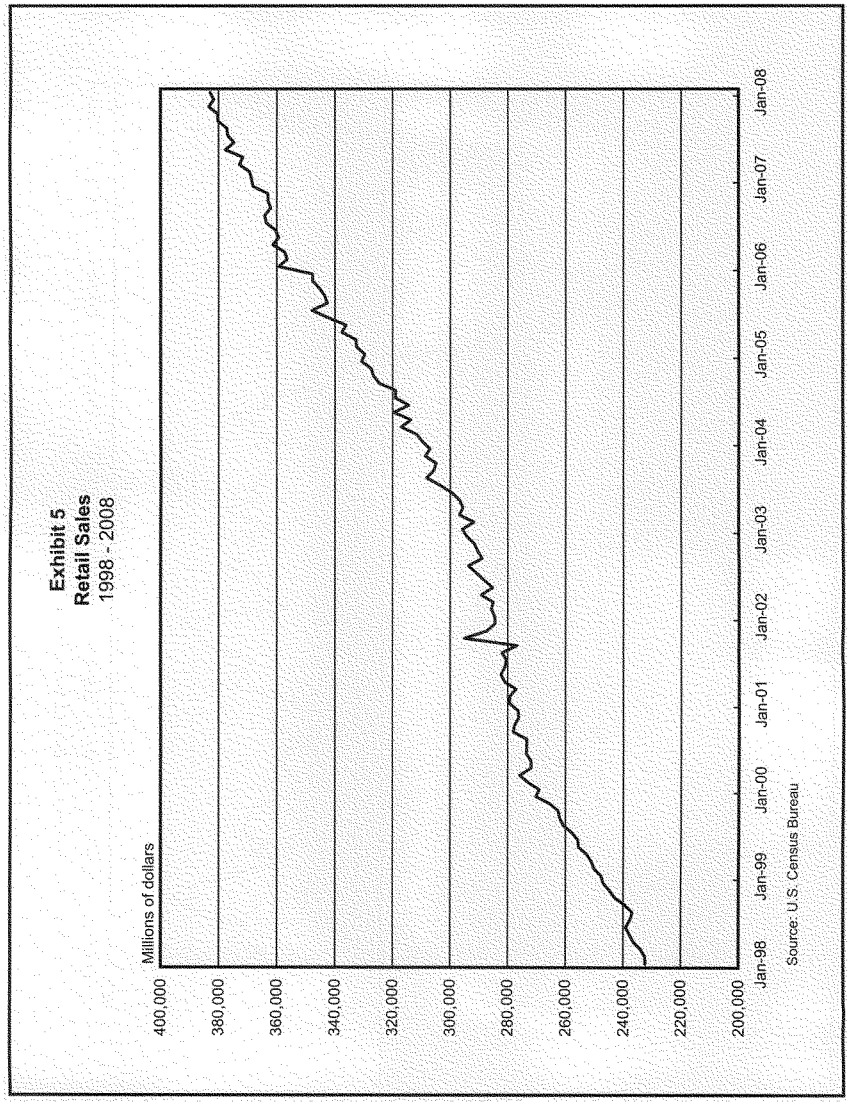
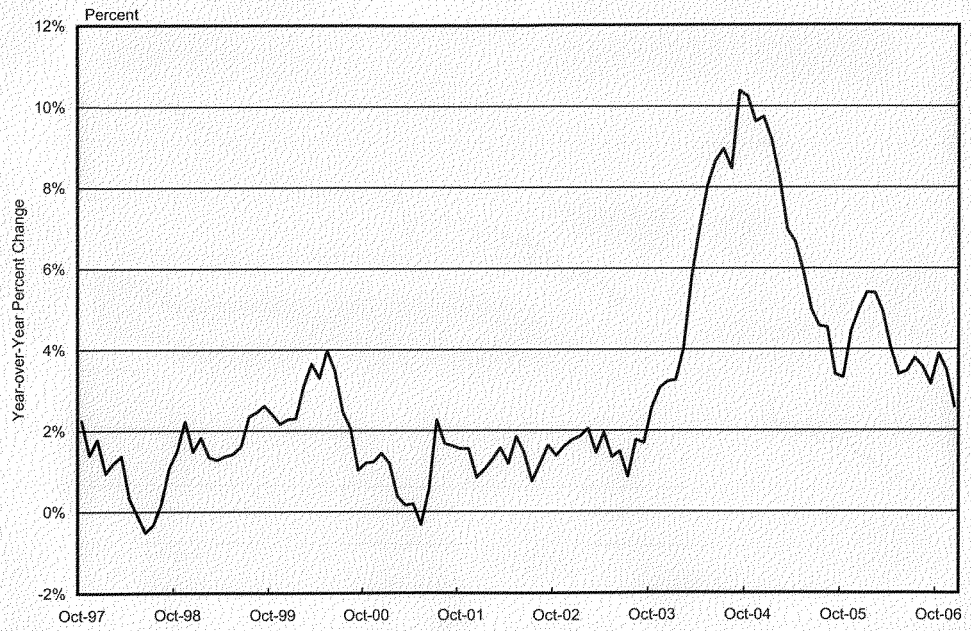


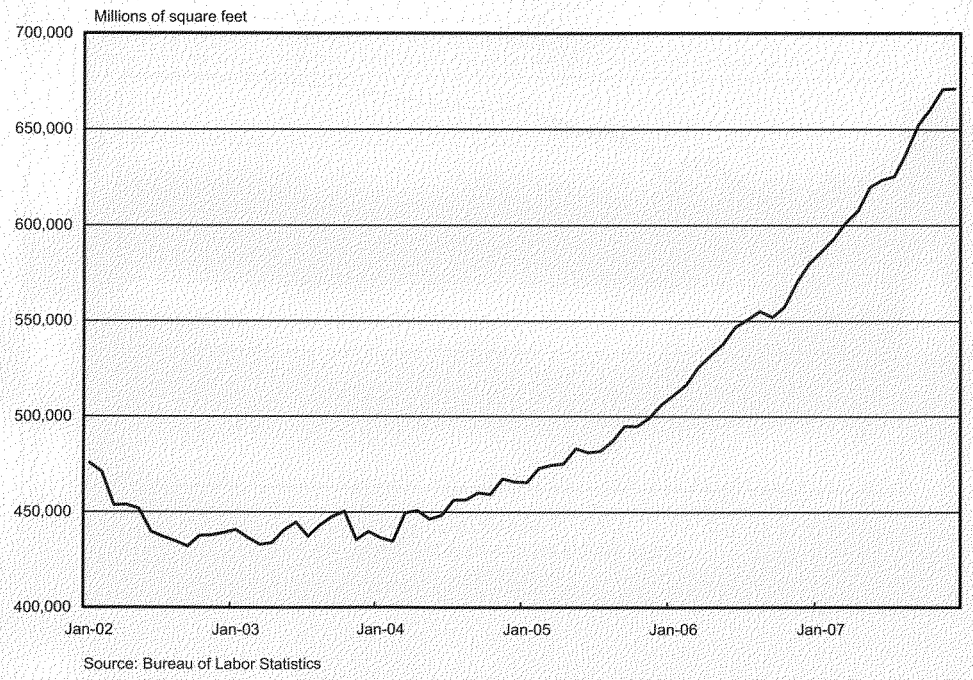
Exhibit 5
Retail Sales
1998 - 2008
Millions of dollars
400,000
380,000
360,000
340,000
320,000
300,000
280,000
260,000
240,000
220,000
200,000
Jan-98
Jan-99
Jan-00
Jan-01
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08
Source: U.S. Census Bureau

**Exhibit 6**
**Growth in Construction Costs**
1997-2006



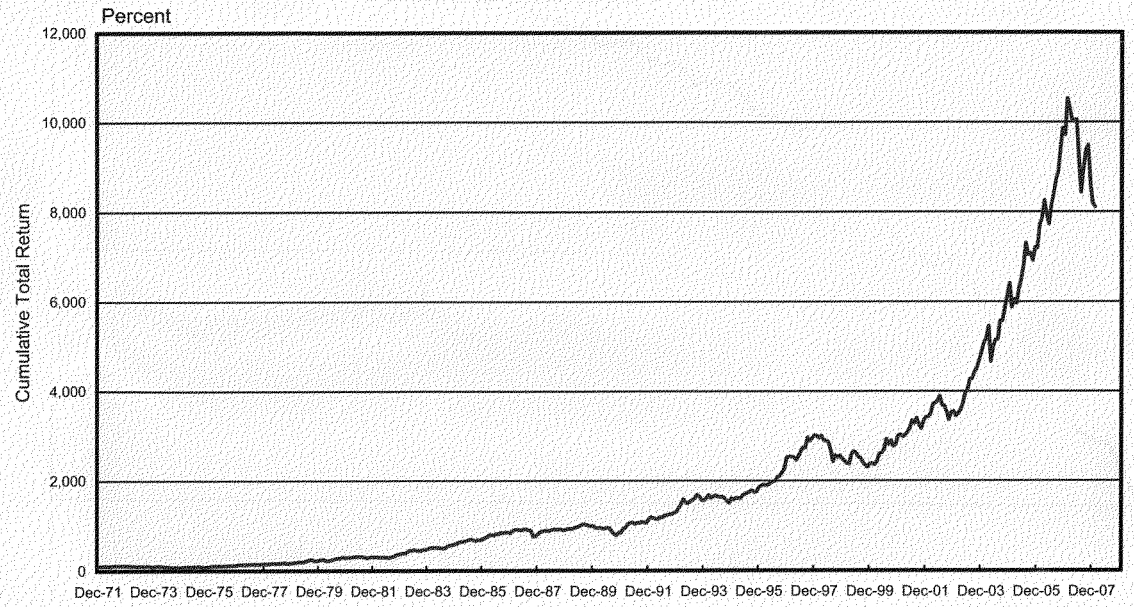

Source: Organization for Economic Cooperation and Development

**Exhibit 7**
**New Construction Put in Place**
2002-2007




Source: Bureau of Labor Statistics

**Exhibit 8**
**Cumulative Total Return for Equity REITs**
1972-2008




Source: National Association of Real Estate Investment Trusts®

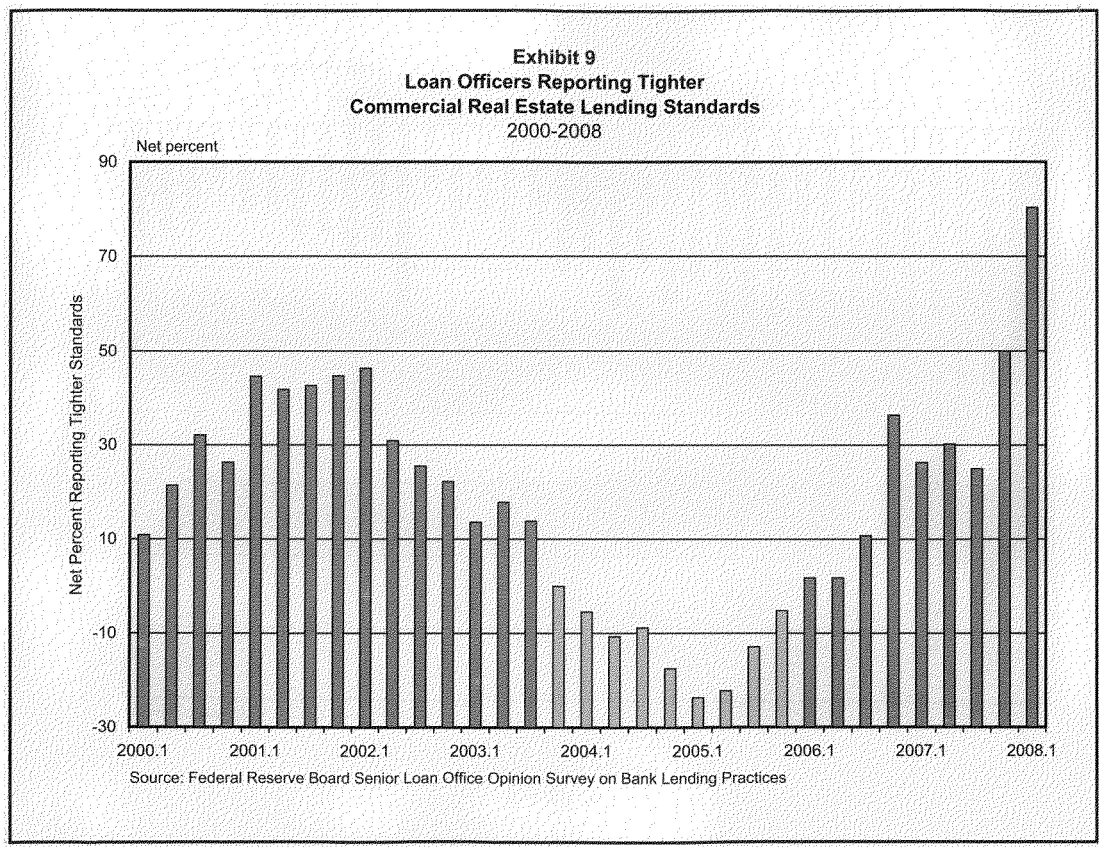
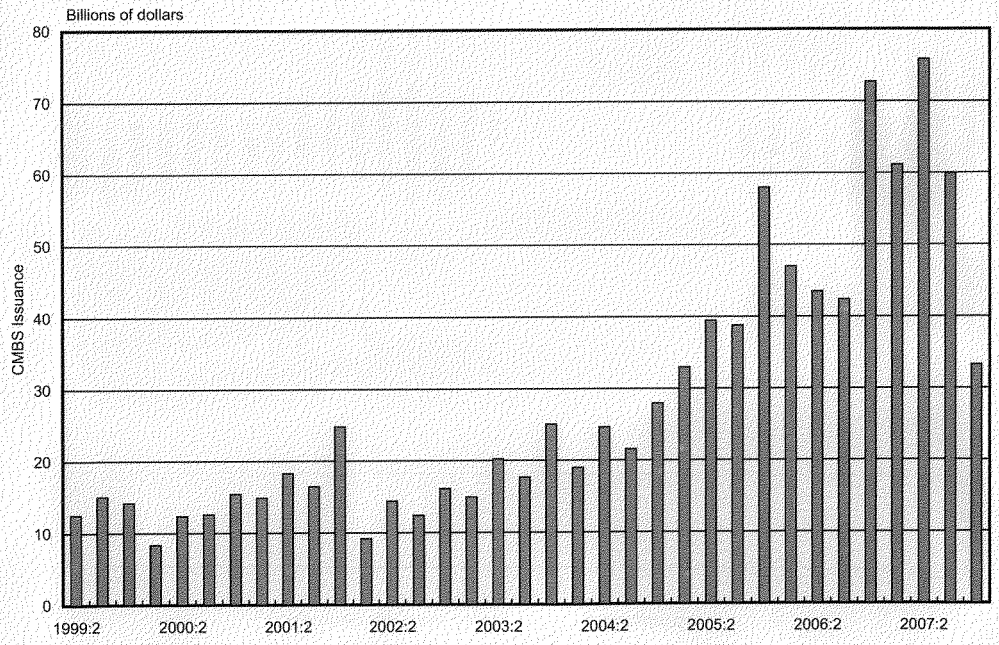


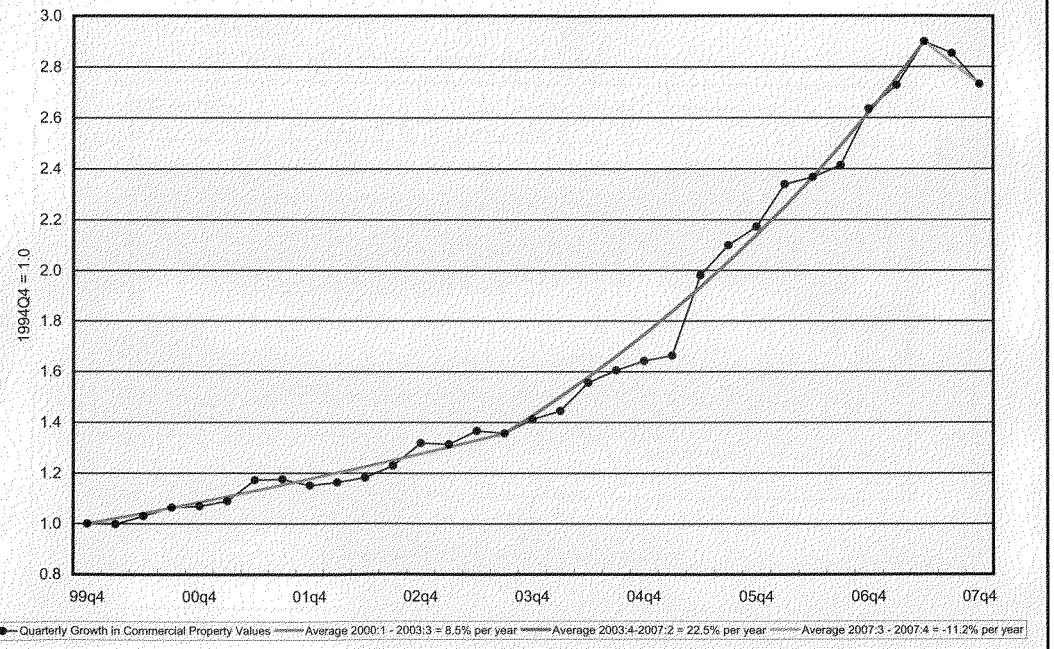
Exhibit 9
Loan Officers Reporting Tighter
Commercial Real Estate Lending Standards
2000-2008
Net percent
Net Percent Reporting Tighter Standards
90
70
50
30
10
-10
-30
2000.1
2001.1
2002.1
2003.1
2004.1
2005.1
2006.1
2007.1
2008.1
Source: Federal Reserve Board Senior Loan Office Opinion Survey on Bank Lending Practices

**Exhibit 10**
**New CMBS Issuances**
1999-2007



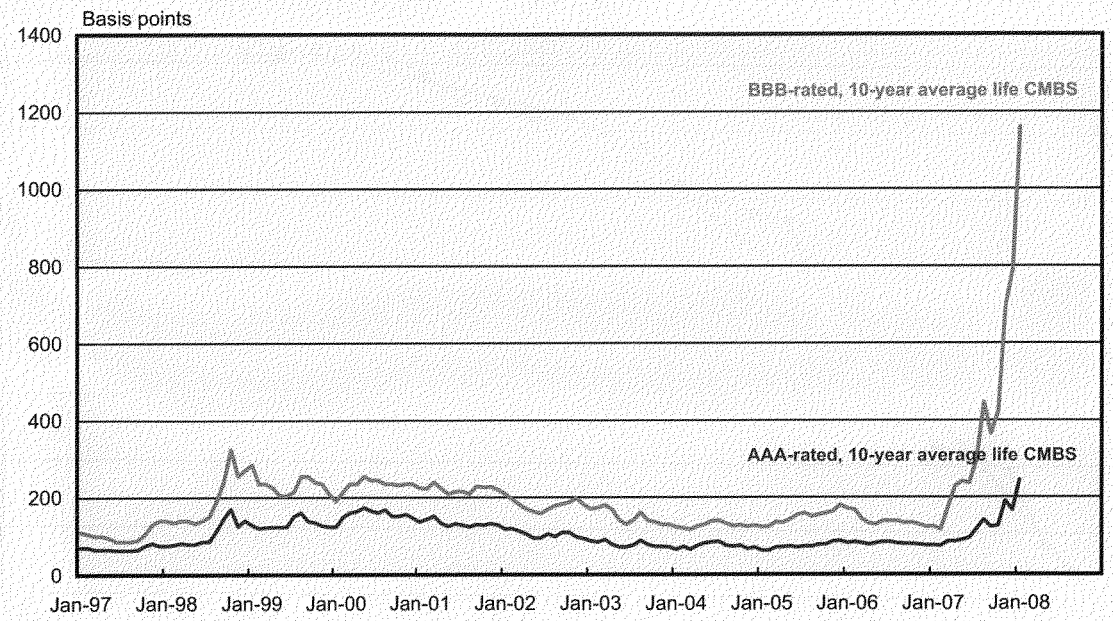

Source: Commercial Mortgage Alert

**Exhibit 11**
**Growth in Commercial Property Values**
2000-2007



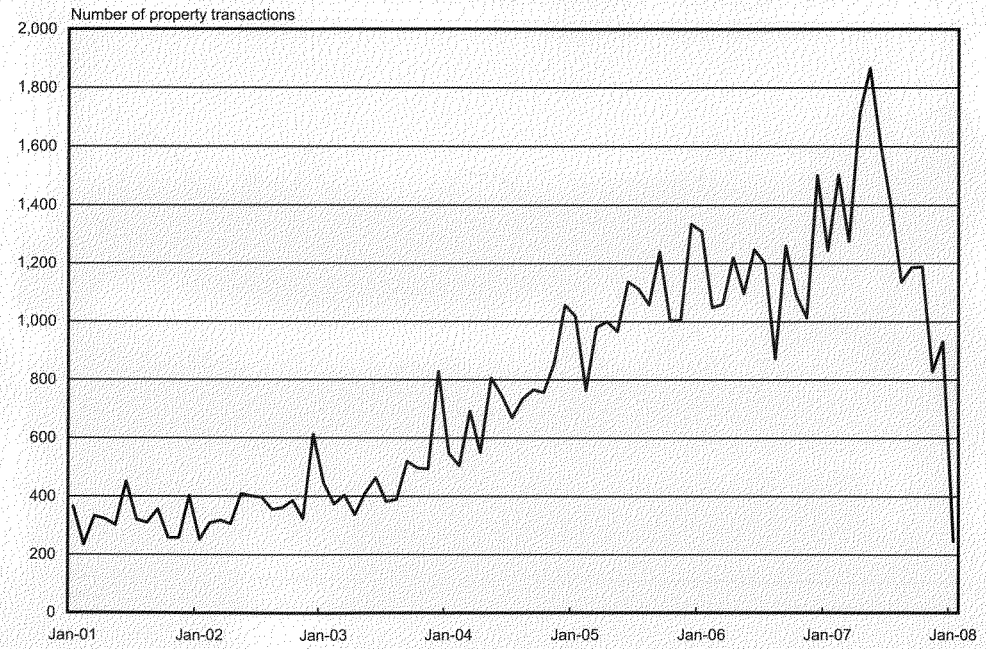

Source: MIT Center for Real Estate

**Exhibit 12**
**CMBS Yield Spreads to U.S. Treasuries**
1997-2008




Source: Morgan Stanley

**Exhibit 13**
**Commercial Property Transactions**
2001-2008




Source: Real Capital Analytics

**Exhibit 14**
**Cap Rates on Commercial Properties**
1993-2007

Source: National Council of Real Estate Fiduciaries

**Senate Finance Committee**
**"Real Estate: Building a Strong Economy"**
**February 28, 2008**
**Questions for Jeffrey Schwartz**

**Questions from Chairman Baucus**

**Liquidity Spillover Questions**

We have seen credit problems in the residential real estate market spread, causing a liquidity crisis and falling home prices.

1. **Do you think the commercial real estate sector is subject to the same problems?**

The economics of the commercial real estate sector are different from those of the residential sector. Unlike single family housing, commercial real estate is an income producing investment. Currently, the economic fundamentals that produce a healthy income flow are relatively solid. However, today's credit market crisis poses real risk for the commercial real estate sector, as well as all other sectors of the economy, in spite of its solid fundamentals. A serious recession would greatly increase that risk.

One way to think of the commercial real estate market is as the residence that houses our economy. The growth of our economy in this decade has increased the demand for this. That increased demand has contributed to relatively high occupancy rates, which have provided property owners throughout most of the decade with rental growth commensurate with the rising cost of property maintenance. With the exception of the years 2002 through 2004 , a period of weak economic growth accompanied with a decline in occupancy rates to about 89 percent, occupancy rates in this decade – including last year – have averaged around 92 percent, approximately their long-term average.

As a result, net operating income, which equals the revenues generated by leasing space, minus the expenses associated with operating and maintaining a property, has shown growth throughout most of this decade. Other than the period 2002 through 2004, net operating income for the 30 largest REITs increased by 3 percent to 5 percent each year, including 2007.

While steady demand for and limited new supply of commercial space so far has kept the commercial real estate industry's fundamentals strong, the state of the capital markets shows a very different picture. Most sectors of bond and equity markets have experienced appreciable declines in recent months. In particular, driven largely by investor concerns about the state of the credit markets, heightened uncertainty with respect to future investment returns, including real estate investment returns, and fears of recession, REIT share prices declined more than 21 percent in calendar year 2007 and another 2 percent this year through March 18.

Bank credit today is available only to a narrow group of borrowers with the strongest credit, and the Commercial Mortgage Backed Securities (CMBS) market, which was a critical element in fueling the industry's growth, has essentially shut down as buyers for these bonds have shunned these as well as nearly all other fixed income investments in recent months.

With such limited credit availability, purchases and sales of commercial property have plummeted to their lowest levels since 2001. Without a properly functioning market for commercial real estate transactions to make orderly price discovery possible, commercial property values are falling. MIT's Transaction Based Index, a barometer of the value of commercial real estate owned by large pension funds, fell 5 percent in the fourth quarter of 2007, on top of approximately a 2.5 percent decline in the third quarter of last year, making 2007 the worst year for the index's performance since 1992. Many analysts expect commercial property values to ultimately decline as much as 15-20 percent.

In summary, the commercial real estate marketplace today faces a paradox. In spite of the fact that occupancy rates are still solid and rents remain favorable, the severe credit constraints on the industry have made the market essentially dysfunctional. As a result, high quality values have declined only slightly. The real risk remains in the future if the credit markets do not stabilize.

2. **How likely is it that this market unravels as did the residential real estate sector?**

It is unlikely that the commercial real estate market will unravel in the way that the residential real estate market has. Nonetheless, the commercial market is under extreme pressure and facing serious risk.

It is important to note that some of the key factors that triggered and fueled the meltdown in the residential market do not have direct parallels in the commercial market. For example, the mortgage application process in the subprime residential market was characterized by extremely poor underwriting and, unfortunately, a good deal of outright fraud. As a result, default rates for these mortgages have exceeded 25 percent. Folding these mortgage loans into various types of structured investment instruments essentially equipped these products with ticking time bombs. This clearly has not been the case in the commercial real estate industry.

Additionally, the commercial real estate industry was not overbuilt as the residential real estate market was. In a column published in the Financial Times on March 17 this year, former Federal Reserve Board Chairman Alan Greenspan estimated that overbuilding by homebuilders put approximately 200,000 vacant homes on the market. He estimated that another 600,000 empty homes were put on the market as a result of foreclosures and unfortunate timing by investors who had intended to "flip" the properties.

In contrast, high construction costs for commercial property throughout much of this decade helped prevent overbuilding in the commercial market. The amount of commercial space on the market has grown basically in tandem with economic growth, resulting in the relatively stable occupancy rates referred to earlier. The phenomenon of thousands of empty units overhanging the market does not exist in the commercial real estate space as it does in the residential market.

The commercial real estate market, however, does face risk. Much of this risk comes from the dramatic constriction of credit combined with the leverage some commercial real estate owners assumed during the years of low-cost credit.

While the U.S. equity REIT industry has remained conservatively leveraged (the industry's average leverage ratio of debt divided by total market capitalization is today less than 40 percent) some investors in commercial real estate took on much higher leverage over the past several years. For example, many private equity real estate funds carry leverage as high as 80 to 90 percent. As loans supporting this type of leverage come due, replacement financing may be impossible to find in the current credit environment, resulting in the defaults of these funds. This situation is exacerbated by a decline in the value of the fund's assets caused by declining property values.

Finally, as noted earlier, the commercial real estate market can be thought of as the residence that houses our economy. Steady, measured economic growth has produced steady, balanced demand for commercial real estate space – a situation that has characterized our marketplace for most of this decade. A serious recession would change this dynamic dramatically, destroying the solid occupancy and rent fundamentals that currently support the commercial real estate market.

3. **Is there anything in this Committee's jurisdiction that can be done to prevent degradation in the commercial real estate sector?**

In the current environment, our most important recommendation to the Committee is that any actions taken be done in a careful, deliberative manner that minimizes the possibility of upsetting the industry's current balance. For example, we do not believe that initiatives that would disproportionately raise taxes on the industry would be appropriate.

The key challenge the industry faces is the need to restore liquidity to the market. The Committee does have one means of currently helping to address this need through some of the provisions of S. 2002, which was introduced by Senators Salazar and Hatch and currently is co-sponsored by four other members of the Committee.

S. 2002 contains provisions that would allow REITs to manage their property portfolios more effectively and efficiently. Removing barriers to REITs' ability to acquire and dispose of properties would better position them to use their conservative leverage to inject liquidity into the real estate market. Another provision in the bill would allow REITs to expand their entrepreneurial activities related to their core real estate businesses

– again, better positioning them to inject capital into the broader real estate economy. S. 2002 should be a piece of the solution.

**International Questions**

1. **I see from your testimony that your company operates internationally, and so I would expect you must have broad experience with other markets. How would you characterize the current state of the U.S. real estate market compared to markets in Asia and Europe?**

Real estate markets around the world vary, importantly, based on their degree of development. The Asian and eastern European markets, for example are generally high-growth, developing economies. An important part of that development is the creation of a commercial real estate infrastructure to house the growing office and industrial elements of those economies, as well as the retail and multi-family residential elements to serve the needs of populations that are becoming increasingly affluent. Similarly, Latin America is a developing region with a young, growing population that requires multi-family housing and a growing middle class that is demanding a retail infrastructure.

It remains my belief that, due to the credit crisis and economic slow down in the U.S., there is more potential danger inherent domestically.

2. **Since your company operates distribution facilities your operations must be impacted by international trade, as well as the current state of domestic markets. Based on what you see going on within your distribution facilities, how would you characterize current international trade flows, and what do you see for the future of the domestic economy?**

Our customers comprise a tenant base with expanding global operations. Through their businesses, we have a view of an expanding, more integrated and ever more competitive global economy. Such growth, integration and competition also are leading to higher volumes of international trade and cross border capital flows. A growing volume of trade drives much of the demand for industrial and warehousing space in our industry, while, at the same time, greater cross border capital flows help to finance the property development that ultimately satisfies that growing demand.

However, growing volumes of trade and cross border capital flows help lubricate the growth of our entire economy. They also provide economic opportunities, albeit it fiercely challenging and competitive opportunities, for nearly all sectors of our economy. What we have learned through our international business is that the future holds much promise for the domestic economy, but a promise that will be realized only by positioning our country to remain competitive with respect to an educated workforce and a competitive business environment, as well as stable fiscal and monetary policies.

**Questions from Ranking Member Grassley**

One of the provisions of the proposal introduced by Senators Hatch and Salazar provides that stock in a listed non-U.S. REIT would be considered real estate for purposes of the U.S. REIT tests, provided that REITS are held to the same standard under the laws of another country as they are here.

a. **Do you think as a general matter it is a good idea to have U.S. tax consequences depend on foreign tax treatment? If so, why. If not, why should this be an exception?**

As business globalization and cross-border investment continues to increase, it can be necessary and appropriate for U.S. tax consequences to depend, to some extent, on foreign tax rules, provided that the U.S. Treasury Department retains regulatory authority to monitor the U.S. tax consequences of such foreign tax rules.

The success of REITs in the United States as a convenient way for the regular investor to own institutional grade real estate has not been ignored around the world. More than 20 of the leading industrialized countries have adopted REIT rules very similar to the U.S. rules. Just last year, Germany, Italy and the United Kingdom enacted REIT laws, and Canada codified its long-standing trust rules to adopt U.S.-like REIT tests. Many other countries such as India, Indonesia, the People's Republic of China, the Philippines and South Africa are actively discussing the possibility of enacting REIT legislation.

As of June 2006, the global market capitalization of REITs was $608 billion. Investment in real estate more generally, and REITs in particular, is growing rapidly. The equity market capitalization of global REITs and listed real estate equities increased over the period from 2002 to 2006 at a compound annualized growth rate of 23%.

REITs offer investors both strong returns and significant diversification benefits. The diversification benefits of REITs are further enhanced with international investment. Indeed, real estate investment, with exposure to both domestic and international property, has become an integral component in a balanced investment portfolio for individual and institutional investors, and real estate investment through REITs allows individual investors in particular to participate in the growth potential of large-scale real estate projects. For the period from 1990 to 2005, the compounded annual return on global REIT investments was 8.95%. Over the same period, the compounded annual return on North American REIT investments (consisting largely of U.S. REITs, which is the longest-standing REIT market) was 15.17%. These returns are higher than the returns on many other traditional investment classes.

With the adoption of REIT regimes around the world, cross-border investment by REITs will continue to become more and more important. This cross-border investment can take the form of a domestic REIT's investment directly in real property in other countries

and a domestic REIT's investment in interests in REITs organized in other countries. Expansion into real property investments located in other countries provides diversification benefits for the REIT and its investors. Allowing this diversification by domestic REITs provides domestic investors with the option of achieving geographic diversification in two different ways. A domestic investor may choose to add to his portfolio investments in one or more foreign REITs. Alternatively, a domestic investor may choose to invest in a domestic REIT, with which the investor may be more familiar, that undertakes this geographic diversification for its investors.

In order to provide flexibility for investors, it is important to consider how the tax obstacles to cross-border investment by REITs can be reduced. For this reason, S. 2002 provides the Treasury Department with flexibility to determine whether equity interests in a foreign REIT-like entity is sufficiently similar to a U.S. REIT, based on certain guidelines, to justify treatment as a real estate asset when held by a U.S. REIT.

This proposal in S. 2002 is modeled in part on the entity classification regulations of Treas. Reg. §§ 301.7701-1 through 3 (also known as the "check the box" or CTB regulations). When issued in 1996, the CTB regulations dramatically modified the rules concerning entity classification both for foreign and domestic entities. In general, the CTB regulations provide that certain types of domestic and foreign entities are "per se" corporations, while other types are eligible for corporate or pass-through status at the choice of the taxpayer.

Most importantly, we want U.S. domiciled companies to become "global champions", increasing the overall strength of the United States. This provision helps to empower that opportunity in the real estate industry.

**b. How do you propose we confirm that the rules of foreign countries conform to the rules in the U.S. and monitor changes to those rules?**

To begin with, under S. 2002, no foreign entity may be considered a REIT-eligible asset until the Treasury Department determines that such entity meets the requirements in S. 2002. One such requirement is that the foreign entity be publicly listed. Thus, there should be reasonable transparency as to the foreign rules under which such entity operates. Just as the Treasury Department is able to monitor the creation of new foreign entities with respect to which guidance as to their entity classification may be required, the Treasury Department would monitor changes in laws concerning foreign REITs. Note that in the case of the CTB regulations, when appropriate the Treasury Department has issued guidance, including regulations, updating the original regulations to reflect changes in foreign entities. *See, e.g.,* Notice 2004-68, 2004-43 I.R.B. 706 (concerning new regulations treating a new business entity the European public limited liability company (Societas Europaea or SE) as a "per se" corporation for federal tax purposes).

I note that foreign REITs are now overwhelmingly owned by non-U.S. investors who have no nexus with the United States and therefore pay no U.S. taxes. Since U.S. REITs are very predominately owned by U.S. investors, allowing U.S. REITs to own substantial

interests in foreign REITs would have the effect of making significant new streams of revenues taxable in the United States, while increasing our global competitiveness.

**c. What happens if the stock of a non-U.S. REIT qualifies as an investment based on this standard, but the rules of that country change so that the REIT is no longer considered a real estate asset?**

In this case, appropriate transition rules should apply that would require the REIT to remedy any REIT qualification test requirement within a reasonable period of time after the Treasury Department issues revised guidance reflecting the change of entity classification (either by disposing of the asset or otherwise bringing itself into compliance with the REIT qualification tests). The Treasury Department can model any guidance on the existing REIT asset test rules, which allow a REIT 30 days after the end of a calendar quarter to resolve any asset test failure due to the acquisition of a new asset. In cases when a 30 day period might be insufficient to resolve any test violation, the Treasury Department could look to the "REIT Savings" rules enacted in 2004 that permit a REIT 6 months to cure asset test violations

**Questions from Senator Hatch**

**Mr. Schwartz, as you indicated, Senator Salazar and I have introduced S. 2002, the REIT Investment Diversification and Empowerment Act. I know it is a quite technical bill, but would you outline how its enactment would help the real estate market right now?**

S. 2002, introduced last August by Senators Hatch and Salazar, and now co-sponsored by six additional members of the Senate Finance Committee, would have the almost immediate impact of increasing transaction volume in the commercial real estate industry. Since REITs are real estate companies that earn income from rental and investment activities rather than "dealer" trading activities; the tax laws provide a "safe harbor" under which a REIT is not considered a dealer if it satisfies a number of tests. S. 2002 would update the safe harbor in two ways, effective for transactions following the date of enactment. First, the current holding period required before a REIT sells an asset would be halved from four years to two years. Second, under the safe harbor a REIT may not sell more than 10% of its assets in a year, and that 10% amount is now measured solely by tax basis. S. 2002 would allow a REIT to measure the 10% limit by fair market value (whichever method produces greater sales and future acquisitions). The volume of transactions created as a result of enacting these two provisions would create standards and establish data points within the market from which appraisers and rating agencies can work to establish property values, thus creating much-needed liquidity and increasing transparency in the market.

In essence, S. 2002 would update the REIT rules by making slight modifications in the original rules to make them more compatible with recent changes in the commercial real estate marketplace. And, enactment of these provisions in the near term would have the added benefit of stimulating commercial real estate activity and facilitating investment

within this vital sector of the U.S. economy. I believe S. 2002 is part of the solution to address the current credit crisis, not the only solution, but a definite step in the right direction that would lead to many positive results.

**Mr. Schwartz, you mentioned that Congress should first do no harm in attempting to improve the real estate markets. What specifically would be the worst thing we might consider that would be harmful?**

I believe the worst thing that the Congress could do at this point to improve the real estate markets would be to adopt a policy that has not been carefully reviewed or thoroughly detailed. In other words, what we don't need is for Congress to react in a "knee jerk" fashion that accelerates the current upheaval in the financial markets and results in greater harm and unintended consequences that are only apparent years down the road. For example, one of these potentially harmful initiatives that I have heard discussed would be any effort that would disproportionately raise taxes on the real estate industry, especially now. Instead, appropriate steps should be pursued that ensure the real estate markets remain liquid and healthy, such as several of the provisions contained in S. 2002 now before the Senate Finance Committee. Further, Congress should not enact legislation that would unilaterally abrogate contract rights, such as some of the bankruptcy reforms under consideration. This I believe would have significant long-term repercussions.

## Questions from Senator Roberts

**For any witness:** Dr. Seiders, in your testimony, you indicate your support for legislation introduced by Senator Isakson that would provide a one-time tax credit of up to $15,000 over three years for the purchase of single-family principal residence that is a newly constructed home, or a home that is in default or foreclosure. Would you, or the any of the witnesses, care to comment on whether you think this legislation would help address the downturn in the housing market and be a sufficient incentive to encourage home buying?

Testimony of
David Seiders
Chief Economist
National Association of Home Builders

United States Senate
Committee on Finance

**The Real Estate Market: Building a Strong Economy**

Thursday, February 28, 2008

**Written Statement**

**I. Overview**

On behalf of the approximately 250,000 members of the National Association of Home Builders (NAHB), thank you for the opportunity to submit testimony for the hearing entitled, *The Real Estate Market: Building a Strong Economy*. This statement is divided into two sections. First, it provides background on the key factors involved in the current housing crisis and, second, makes several policy recommendations for addressing this crisis and restoring housing as an engine of the economy.

The U.S. housing market now is in the contraction phase of the most pronounced housing cycle since the Great Depression. Single-family housing starts already are down by 60 percent from their peak at the beginning of 2006, and the bottom is not yet in sight. This dramatic contraction has exacted a heavy toll on economic growth and employment during the past two years, and now has pushed the U.S. economy to the brink of recession.

The adverse economic impacts of the housing contraction involve not only sharp declines in home sales and housing production, but also depressing effects of falling home prices on household wealth and mortgage credit quality. These events have provoked an alarming surge in mortgage foreclosures that have cut into the homeownership rate. Further, events have seriously damaged financial institutions holding mortgage assets, as well as companies that provide mortgage credit enhancement.

The pronounced decline in mortgage credit quality first became evident in the subprime mortgage sector last year, and that debacle triggered a stampede toward credit quality in national and global credit markets. This process has essentially shut down or seriously damaged a wide range of securities markets, including major components of the mortgage securities markets in the U.S. As these markets seized up, credit demands shifted back toward depository institutions here and abroad. But lending standards at commercial banks have tightened substantially since last summer, including standards for all types of conventional home mortgage loans, as banks have sought to control loan volume and loan quality and to conserve scarce capital.

With private securities markets in disarray and banks retrenching, a bona fide credit crunch is underway. This credit crunch actually appears to be worsening despite the concerted efforts of central banks here and abroad. The Federal Reserve has been easing monetary policy aggressively since last fall, and our central bank probably will do more in the near future. These actions have improved the functioning of short-term money markets, including the interbank markets, but the Fed has not been able to relieve strains in longer-term credit markets; indeed, long-term Treasury yields have shifted up recently.

The recently enacted *Economic Stimulus Act of 2008* may keep the economy out of recession this year, or at least limit the severity of recession, and NAHB applauds Congress for passing this important legislation. By its nature, this stimulus package is short-lived and does not address the deep problems posed by the housing contraction that are at the root of today's economic and financial market problems. Congress can, and should, do more.

Some have argued that the best way to bring the housing market into balance is to permit housing prices to fall in an uncontrolled fashion over a short period of time. However, this path of adjustment would most likely cause substantial collateral damage to the economy, to financial markets and to America's homeowners. Policymakers should not take that risk. A second round of economic stimulus is urgently needed as a complement to monetary policy adjustments. This time, stimulus

measures should be directed squarely at the housing sector--the sector that is at the root of the challenges facing the economy and the financial markets.

It is worth noting that the commercial real estate market typically follows the housing cycle with about a one-year lag, and serious signs of trouble now are cropping up on the commercial side. The commercial mortgage-backed securities market was inactive in January, prices of outstanding commercial mortgage securities have been in retreat, and new contracts for commercial projects have been falling for about six months. Policies to stabilize the housing market could pay dividends by helping to limit the commercial real estate downswing.

**II. The Housing Crisis**

*The Big Picture and Housing's Role*

Growth of U.S. economic output (real Gross Domestic Product) slowed to a meager 0.6 percent annual rate in the final quarter of 2007, according to the "advance" estimate released by the Commerce Department on January 30, and data received since then do not point toward upward revisions (the "preliminary" fourth-quarter estimate will be released on February 28). The weakest parts of the economy in the fourth quarter were sectors affected directly or indirectly by the housing downswing. Residential fixed investment fell at an annual rate of 23.9 percent, the steepest decline yet in the 2-year downslide, and growth of personal consumption expenditures slowed to a 2 percent annual pace--presumably weighed down by loss of housing equity and by concerns about the course of house prices in many areas.

Available information for the early part of 2008 point toward further weakness in GDP growth for the first quarter of this year (NAHB is currently estimating 0.3 percent), and negative growth is a distinct possibility for this period. A very sobering signal was delivered on February 5 when the Institute for Supply Management (ISM) released its index of activity in the nonmanufacturing sector for January--covering construction and private services (including finance). The index plummeted to a recession-like level (compared with 2001) and, although an upward revision is possible, fundamental weakness at the beginning of 2008 undoubtedly is being conveyed by the ISM measure

The labor market also shows serious recent signs of weakness, largely because of job losses in residential construction and related areas (including housing finance). Total payroll employment actually fell slightly (17,000) in January as private payrolls were essentially flat while government payrolls declined. Furthermore, average weekly hours worked in the private sector contracted a bit, and aggregate hours worked in the nonfarm business sector contracted significantly--with negative implications for GDP growth in the first quarter.

The recent weakness of GDP, the labor market and the nonmanufacturing sector, along with systematic declines in the Conference Board's index of leading economic indicators since last fall, have stoked recession worries among financial market participants and policymakers in Washington. NAHB's baseline (most probable) forecast still says that the U.S. economy will avoid recession in 2008, although we believe there is a nearly-even chance of slipping into the red zone during the first half of the year. If so, the setback may be brief and shallow, due largely to the double-barreled dose of monetary and fiscal stimulus being applied to the economy, although a post-stimulus setback is a distinct possibility early next year.

By all rights, a pronounced slowdown in economic growth should relieve inflationary pressures in the economy, allowing long-term interest rates to recede as the Federal Reserve drops the short end of the yield structure. Unfortunately, inflationary impulses are coming from commodity markets (primarily food and energy), and "core" inflation measures also have moved up recently. The Consumer Price Index for January displayed such patterns and caused an upshift in bond and mortgage rates.

Upward pressure on long rates is the last thing that housing and the economy need at this time, and our central bank cannot ignore documented upward pressures on inflation. NAHB expects the slow pace of economic activity to relieve inflation during the months ahead and allow long-term rates to recede, although this outcome no longer feels certain.

*Current State of the Housing Market*

Housing data received during the past month have yet to signal near-term stabilization of the housing market. Sales of existing homes fell by 2.2 percent in December, reflecting declines in both single-family and condo markets, and eroded further in January. In the new-home market, sales were down by 4.7 percent in December, falling to a 15-year low. Unsold inventories are at near-record levels in the markets for both new and existing homes, as are inventory/sales ratios. Furthermore, the Commerce Department's quarterly measure of vacant year-round housing units for sale (whether new or existing) was at a record level at the end of last year, as was the measure of vacant units for rent.

The downtrend in housing starts through the end of last year naturally translated into further declines in measures of construction spending. Single-family construction (in nominal terms) fell by 5.4 percent in December and was down by 31 percent on a year-over-year basis. Multifamily construction also has been falling systematically, contracting by 1.9 percent in December and 20.6 percent on a year-over-year basis. Spending on improvements to residential structures (additions and alterations) was essentially flat during 2007 and accounted for a lofty 37 percent of total residential construction at the end of the year.

With respect to early indications for 2008, single-family starts and permits were down substantially in January while gross and net sales in NAHB's proprietary survey of large builders slid further in January. NAHB's single-family Housing Market Index edged up only slightly in January and February from the record low in December. All of these indicators point to a still-unsettled housing market and uncertainty for the future.

*Key Indicator – Home Prices*

Housing wealth is the primary source of savings for most households and a key driver of consumer spending. If housing prices fall, homeowners' wealth decreases and consumer spending is negatively affected. As a result, households may decrease current consumption to offset the lost wealth. For these reasons, home prices are an important indicator of the state of the housing market and the potential direction of the overall economy. And, according to two different reputable independent measures, house prices have been weakening considerably in recent times.

The S&P/Case-Shiller National Home Price Index for the fourth quarter of 2007 was down by 9.8% (seasonally adjusted) from its peak in the second quarter of 2006, and the annualized rate of decline in the fourth quarter equaled 19.3%. Furthermore, all major metro markets in the S&P/C-S Composite 20 measure have been showing declines recently, and particularly large negatives are being recorded in markets that got seriously overheated during the earlier boom period and in parts of the industrial

Midwest suffering from chronically weak economic conditions--including Las Vegas, Phoenix and Detroit.

The House Price Index produced by the Office of Federal Housing Enterprise Oversight (OFHEO), the government regulator for Fannie Mae and Freddie Mac, also has been weakening recently. The national purchase-only measure for the fourth quarter of 2007 was down by 1.6% from its peak in the second quarter of last year and the annualized rate of decline in the fourth quarter came to 5.2%--the largest declines in the history of the series. The relatively small decline in the OFHEO price index, compared with the S&P/C-S index, largely reflects the greater stability in the prime, conforming mortgage market served by Fannie Mae and Freddie Mac.

*Financial Market Stresses and Tightening Lending Standards*

The financial market turmoil that erupted last summer still is a major problem for the U.S. economy. The severe liquidity problems in short-term funding markets have eased to some degree since late 2007, due partly to the Fed's new auctions of discount-window credit. The commercial paper market has improved in the process, particularly the battered asset-backed market, although this market still is not functioning normally.

Despite some easing of short-term liquidity issues, the stock market is being battered and the markets for longer-term credit remain under considerable strain. Quality spreads in corporate bond and mortgage markets still are quite elevated, and some components of the private securities markets are essentially shut down (including the subprime, Alt-A and jumbo mortgage securities markets). Only the markets with explicit or strongly implied federal government backing are functioning well, although even the spreads between yields on mortgages saleable to the secondary-market Government Sponsored Enterprises (Fannie Mae and Freddie Mac) and yields on comparable-maturity Treasuries have widened out a good bit since last summer.

It is clear that investors here and abroad have been traumatized by the realization of risks embedded in many of the securitized vehicles they hold, particularly those with U.S. subprime mortgage exposure, and they have turned extremely risk-averse--forcing down risk-free (government) interest rates but widening out quality spreads dramatically in private markets and shutting some down entirely. It will take considerable time for Wall Street to develop (and rate) transparent securitized investments that investors will accept. In the meantime, the banking system will have to take up a good bit of the slack in the credit creation process.

Mortgage interest rates are quite low at this time, at least on prime conventional conforming loans and FHA/VA mortgages. However, the Federal Reserve reports that bank lending standards are tightening considerably in all major components of the conventional home mortgage market--prime, subprime and "nontraditional" (including interest-only, payment-option, and Alt-A adjustable-rate loans). The Fed's January Senior Loan Officer Opinion Survey on Bank Lending Practices shows that standards have been tightening substantially for nearly a year on subprime and "nontraditional" mortgages, and standards started to tighten last fall on prime mortgages as well. Indeed, a net 41 percent of banks said they had tightened standards for prime loans in the quarterly report released last October, and that proportion was up to 53 percent in the January survey.

Credit conditions for home builders also have been tightening considerably. The Federal Reserve's January survey of bank lending officers showed that about 80 percent of banks had tightened lending standards on commercial real estate loans, including residential construction and land development

loans, during the previous three months. NAHB's builder surveys also document serious tightening of credit conditions for construction and development loans since last fall, as banks have reduced allowable loan-to-value ratios and maximum loan sizes. Many banks also have required builders to pay down portions of outstanding land loans as appraisals have been reduced.

*Action by the Fed and Congress*

On January 22, the Federal Reserve announced 75 basis point cuts to both the federal funds rate and the discount rate. These definitely were "emergency" cuts, enacted just eight days prior to the next regularly scheduled meeting of the Federal Open Market Committee (FOMC). Indeed, this was the first inter-meeting cut since September 2001 (in the wake of 9/11/01) and the single largest rate cut in 24 years.

The January 22 FOMC statement cited weakening of the economic outlook (including deepening of the housing contraction) and deterioration of financial market conditions (other than short-term funding markets), and noted that appreciable downside risks to growth remained--even after the emergency rate cut. The statement also moved earlier inflation concerns well off to the sidelines.

The Fed cut short-term rates by an additional 50 basis points at the regularly scheduled FOMC meeting on January 30, bringing the cumulative reduction in the funds rate so far this year to a whopping 125 basis points. The FOMC statement once again cited considerable stress in financial markets, deepening of the housing contraction and softening in labor markets. Further, on February 14, Fed Chairman Bernanke testified on "The Economy and Financial Markets" before the Senate Banking Committee. Bernanke made it clear that the Fed has become increasingly concerned about mounting stresses in the financial system as well as increased downside risks to growth--stemming largely from ongoing deterioration in the housing market.

It is important to note that Federal Reserve interest rate cuts do not always translate into lower mortgage interest rates. Mortgage interest rates also include an inflation component, and if the markets believe that inflation will increase due to Federal Reserve policy changes, then mortgage interest rates will not decrease as a result of Fed action. This highlights the importance of Congressional action with respect to fiscal policy. Indeed, Chairman Bernanke has indicated that fiscal policy can serve as an important complement to Federal Reserve monetary policy.

On February 13, the President signed into law the *Economic Stimulus Act of 2008*. The centerpiece of this short-term stimulus package is $117 billion in rebates of personal income taxes, to be distributed starting in May and an acceleration of $51 billion of investment tax incentives. The bill also temporarily raised loan-sized limits for both the FHA mortgage insurance program and for conventional loans eligible for purchase by the secondary-market GSEs (Fannie Mae and Freddie Mac).

The personal income tax rebates and the business investment incentives figure to provide a bit of support to GDP growth in the second quarter and solid support in the second half of this year, most likely pushing growth a bit above trend in the third quarter. These effects naturally will dissipate early next year, making the economy vulnerable to relapse into a slow-growth or recessionary mode.

The temporary increases in loan-size limits for FHA and the GSEs (up to a maximum of about $730 thousand) are bound to help the housing market in high-priced areas (like California) to some degree. The increase for FHA affects virtually every place in the United States and will increase the number of

homes eligible for an FHA mortgage by more than 10 million. It will take some time for the higher limits to be operational, of course, and it remains to be seen how much additional home buying will be simulated over the balance of the year. Further, the expiration of the higher loan limits at the end of the year will be a serious problem in the likely event that the private secondary market for jumbo loans is still not functioning properly.

*What now for housing?*

Key data on gross and net home sales, housing starts, building permits, residential construction activity and inventory overhang still paint a downbeat picture of the U.S. housing market. However, a few recent indicators contain glimmers of hope, at least with respect to the interest of prospective home buyers. Falling mortgage rates (at least in the prime market), falling house prices (at least in some places) and growing income (in most places) have combined to boost standard measures of housing affordability in recent months, including NAHB's Housing Opportunity Index. Furthermore, surveys of consumer sentiment conducted by the University of Michigan show that growing numbers of households believe that buying conditions have improved in recent months, because of lower mortgage rates and lower house prices.

The buyer traffic component of NAHB's monthly Housing Market Index (HMI) apparently hit a cyclical low last December. The traffic component edged up in January and moved up further in February--presumably reflecting the improvements in affordability and the brightening of consumer sentiment toward homebuying. The HMI components for current sales and sales expectations have yet to stage meaningful improvements, but perhaps the pickup in buyer traffic at least signals more positive "leanings" among prospective home buyers.

Despite recent glimmers of hope regarding the interest of prospective home buyers, it is obvious that the housing contraction still has substantial downward momentum and the housing market still poses major downside risks to the economic outlook. This situation cries out for a second stage of temporary economic stimulus, directed squarely at the sector that is at the root of the daunting problems facing the U.S. economy and the financial system.

**II. The Need for Economic Stimulus Targeted at Housing: Recommendations**

The case for housing stimulus is strong at this time. The record volume of vacant homes on the for-sale market inevitably will put persistent downward pressure on home prices for some time. If housing prices fall significantly, as many economists expect, then households spend less because they feel (and are) less wealthy. One key reason for reduced consumer spending is that housing wealth is the primary source of savings for most households. If housing prices fall, then homeowners' wealth decreases. As a result, households may decrease current consumption to offset the lost wealth.

According to a January 2007 report from the Congressional Budget Office (CBO), a 10 percent decline in housing prices from peak to trough – a conservative estimate of what many economists expect – would reduce consumption and ultimately subtract 0.4 to 2.2 percentage points from Gross Domestic Product (GDP) growth. Given that many economists expect meager growth in GDP this quarter, the CBO estimates indicate that falling housing prices can easily push the economy into recession. In dollar terms, the CBO report estimates that a 10 percent housing price decline would subtract $55 to $316 billion from GDP.

Continued downward pressure on home prices also further saps the quality of outstanding mortgage credit, making it even more difficult to refinance or restructure adjustable-rate mortgages that have encountered or are facing payment resets. These effects, in turn, will worsen the alarming upsurge in mortgage foreclosures; move even more homes onto the for-sale market, put even more downward pressure on house prices and mortgage quality; and stretch out the contraction in new housing production even further. This represents quite a feedback loop, with ominous potential consequences for the U.S. economy and the financial markets.

The contraction in the housing market also is having heavy direct effects on the national economy. In the fourth quarter of 2007, residential fixed investment (home building) subtracted 1.2 percentage points from real GDP growth. In January, when the entire economy lost 17,000 jobs, home building lost more than 28,000. Total homebuilding employment is down by 375,000 since the peak in February 2006, a decline of 10.9 percent, and further declines are inevitable during the months ahead. Furthermore, many home builders are now reporting substantial financial losses when only a few years ago they were generating jobs, providing local development and paying taxes.

With the above in mind, NAHB recommends the following tax policy changes for the consideration of the Finance Committee[1]:

**1. Create a Tax Credit for the Purchase of a Home**

House prices and inventories obviously are central to the outlook for the economy and the financial markets. Policies that stimulate home purchases in the immediate future can pay huge dividends. The biggest bang for the buck most likely would be provided by a temporary homebuyer tax credit. Indeed, the recent revival of interest among prospective buyers suggests that temporary credits could stimulate a wave of home buying that could quickly reduce excess supply in housing markets and halt the dangerous erosion of house prices and mortgage credit quality.

Tax credits for the purchase of a home would be very effective economic stimulus tool. They are a means of eliminating excess inventory, relieving some of the pressure on falling housing prices, and ending the waiting-on-the-sideline strategy some potential buyers have adopted in response to overly negative media stories concerning the future of the housing market. As Alan Greenspan noted in November of 2007, reducing inventory is critical for the health of the economy, and a tax credit would be the easiest and most cost-effective way to achieve this goal.

There are many models to which Congress can look when designing home buyer tax credits. The District of Columbia, for example, offers a $5,000 tax credit to first-time home buyers for the purchase of a new or existing home. A national first-time home buyer tax credit would stimulate buyer demand for households who do not have a home to sell, who are waiting on the sidelines until prices stabilize, and who now face greater housing affordability than a year ago. A temporary credit would be just the spark needed to move them into action. Furthermore, those who sell their existing homes to a first-time buyer will in turn purchase another home and spur additional economic activity.

Alternatively, in 1975, as a temporary stimulus measure related to excess housing inventory, the Congress established a tax credit for the purchase of a newly-constructed home.[2] The credit was well crafted in that it only applied to homes constructed by a certain date, thereby incentivizing sales of a

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[1] NAHB has other recommendations in this area that within the jurisdiction of other Senate Committees.
[2] Section 208 of the Tax Reduction Act of 1975. P.L. 94-12.

defined number of homes on the market. In other words, the credit was a pure demand-side subsidy. At the time, the credit was equal to the lesser amount of 5 percent of the home price or $2,000, which, considering today's housing prices, is equal to $10,000. The credit was effective policy and well-targeted. According to the Census, new home sales totaled only 519,000 in 1974. In 1975, sales increased to 549,000, despite no significant change in interest rates. By 1976 health had been restored to the housing market as new home sales totaled 646,000. Housing starts double from 1975 to 1978.

There are many other possible policies for providing a tax credit for the purchase of a home beyond those described above. Several have already been introduced in the 110th Congress and NAHB applauds the efforts of the lead sponsors of these bills. For example, Senator Debbie Stabenow (D-MI) has introduced S.1988, legislation that provides for a temporary, a one-time refundable tax credit for first-time homebuyers of ten percent of the purchase price of a principal residence. Additionally, Senator Johnny Isakson (R-GA) introduced S.2566, a bill creating a one-time $15,000 tax credit for purchasers of a single-family principal residence that is a newly constructed home or a home in default or foreclosure purchased within a one year time period.

What is common among these tax credits for the purchase of a home is that they represent policies that increase housing demand, thereby enabling home purchases for families and fight falling housing prices, which threatens the economy as a whole. We recommend a targeted homebuyer tax incentive in order to maximize induced purchases. Attached to this statement is a chart that summarizes the Stabenow and Isakson credit proposals as well as the DC and 1975 credit models.

**2. Expand the Mortgage Revenue Bond Program**

The existing Mortgage Revenue Bond (MRB) program also offers a method of increasing housing demand. A special allocation of bonds to be used for either purchase or refinancing would be beneficial for housing. The MRB program allows state and local governments to issue tax-exempt debt that may be used to finance mortgages at below-market interest rates. Certain technical restrictions concerning the MRB program also could be made more flexible to enhance its use as an economic stimulus tool. These include the house price limits and the first-time home buyer requirement. Expanding the reach of the MRB program would allow it to have the largest effect, particularly for communities experiencing the possibility of a wave of foreclosures or an extreme excess of inventory. NAHB thanks the Senate Finance Committee for including this provision in its first economic stimulus package crafted just a few weeks ago. We especially appreciate the work of Senators Schumer, Kerry and Smith in this effort.

**3. Expand the Net Operating Loss Deduction Carryback**

Many home builders are now reporting financial losses when a few years ago they were generating jobs, providing local development and paying taxes. For home builders large and small the importance of the ability to claim and carry back net operating losses (NOL) deductions to years when significant taxes were paid cannot be overstated. The inability to do so will result in the need to either increase high-cost borrowing or further liquidate land and homes, which will only compound the existing inventory problem. The additional supply of homes and land on market for sale, of course, will put even more downward pressure on prices and further add to the housing crisis. Ultimately, the result of this will be more layoffs of workers and reduced development of communities.

Current law allows for a two-year carryback of NOLs, however, home builder losses began in 2006. Expanding the carryback of NOLs to five years when significant taxes were paid provides financial

resources to the home building sector as well as all businesses to weather the economic downturn. Further, this will help businesses facing difficult economic decisions concerning employment and community development. Finally, an expansion of the NOL carryback simply allows businesses to accelerate their claim of NOL deductions that under present law would be claimed in the future. The need for these deductions today is critical. NAHB thanks the Senate Finance Committee for including this provision in its first economic stimulus package crafted just a few weeks ago. We especially appreciate the work of Senators Conrad and Smith in this effort.

**4. Designate Housing an Eligible Investment for Tax-preferred Retirement Accounts**

Existing rules for 401(k), IRA, and other retirement programs allow for alternative investments and allow emergency withdrawals, but withdrawals typically involve tax consequences and other penalties. A down payment remains the single largest hurdle for most first time homebuyers. Congress could increase capital available for a downpayment for the purchase of a home by allowing a downpayment to qualify as an eligible investment from tax-favored retirement accounts. Providing an investment opportunity to parents' or grandparents' tax-favored retirement accounts would open up a new source of funds for the first-time home purchaser. Housing wealth is the most important source of savings for most families, and the ability to move wealth from one asset (tax-favored retirement) to another (a home) should be an important part of any stimulus package.

**Conclusion**

NAHB appreciates the efforts of the Congress to pass economic stimulus legislation. Further, we applaud the Senate Finance Committee for focusing so closely on the crisis in the housing market during the first stimulus debate and continuing with this hearing. We urge the Senate and the Congress as a whole to refocus their attention on addressing both the weakness in the housing sector and stabilizing the nation's home builders, large and small, who keep this critical economic engine running. We believe the above recommendations are an excellent start. The nation's home builders will continue to work with Congress in the coming weeks and months to enact these recommendations that create additional, much-needed economic stimulus.

**Attachment 1**

| Comparing Home Buyer Tax Credits | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Bill/Law** | **Sponsor** | **Proposal** | **Credit amount** | **Sunset** | **Income Phaseout** | **Inflation Index** | **Analysis** |
| S. 1988 | Senator Stabenow | Refundable first-time home buyer tax credit | $3000/$6000 (single/married) | No | Begins at 25% - $63,700 for married taxpayers | Yes | Must be principal residence. 35% to 40% of buyers are first time, meaning perhaps 1.75 million homebuyers qualify in 2008. Geographically dispersed impact. |
| S. 2566 | Senator Isakson | Nonrefundable newly-constructed home buyer tax credit | $7,500/$15,000 (single/married) | Purchase from March 2008 to march 2009 - construction begins before Sept 2007 | None | No | New home sales for 2008 expected to be less than 700,000. Concentrated impact for high inventory areas. |
| | | Nonrefundable tax credit for purchase of home with mortgage in default or foreclosure completed | $7,500/$15,000 (single/married) | Purchase from March 2008 to march 2009 - mortgage default before March 1, 2008 | None | No | Concentrated impact for high invetory areas. |
| Sec. 1400C | NA | Nonrefundable first-time home buyer tax credit for the District of Columbia | Purchase price (maximum $5000) | Expired at end of 2007 | Phaseout begins at $70,000$110,000 for single/married taxpayers. | No | Used by about 3000 to 4000 buyers a year in DC. |
| 1975 Credit Home Buyer | NA | Tax credit for purchase of newly constructed home | 5% of purchase price: $2000 maximum ($10,000 in today's housing prices) | Purchase from March 1975 to end of year | None | No | 519,000 new home sales in 1974. 549,000 in 1975 and 646,000 in 1976. Builder production doubled from 1975 to 1978 as market rebounded. |

**Senate Finance Committee**
**Real Estate: Building a Strong Economy**
**February 28, 2008**
**Follow-up Questions for Dr. Dave Seiders**

**Senator Grassley**

*1. Your testimony calls for a second stage of temporary relief, including a home buyer tax credit of $10,000. This arguably will increase the demand of homes. How long should this credit be available?*

**Answer:** NAHB believes a temporary homebuyer tax credit would be the most effective fiscal policy tool to spur demand and stabilize the housing market. While there are no hard and fast rules, a tax credit that is available for a short period (e.g., one year) should be quite effective. A temporary buyer credit will increase demand, reduce the inventory overhang, support house prices and support mortgage credit quality -- thereby easing pressures on the financial sector and improving the conditions for struggling homeowners to refinance troubled mortgages. A temporary credit may very well create a "tipping point" in the current environment, encouraging many prospective buyers on the sidelines to enter or re-enter the for-sale market (the homeownership rate has fallen from a seasonally-adjusted high of 69.3% in the second quarter of 2004 to 67.7% in the fourth quarter of 2007).

*2. What would happen once this credit expires?*

**Answer:** Beneficial effects of this credit will be felt after expiration. The reduction in inventory and the support to home prices generated by the temporary credit will contribute to a healthier supply-demand balance in housing markets after expiration, and the beneficial impacts on mortgage credit quality will generate lasting effects in financial markets as well. These effects include a better environment for refinancing by homeowners under stress, preventing foreclosures and holding down the flow of foreclosed homes into inventory. In 1975, the country faced similar inventory conditions and when a temporary (nine months) $2,000 new-home credit was adopted it reduced the supply of new homes on the market from 9.9 months to 5.8 months by the end of the year. Today, we face a 9.9 months' supply of new homes on the market and a 10.3 months' supply of existing homes.

*3. Wouldn't we be in the same position as today with excess inventory building up?*

**Answer:** No. The buildup in inventories was the result of two major events that will not be repeated. First, mortgage lending standards deteriorated substantially during the earlier housing boom. Second, unprecedented numbers of investors and speculators bought into the housing market during the boom, encouraged by lax lending standards and the lure of rapid price appreciation. Lending standards have tightened substantially during the past year and investors/speculators have now exited the market--these pendulums will not be swinging back in the foreseeable future. In this regard, NAHB supports homebuyer tax credits that apply only to principal residences, in order to avoid stimulating the investor market. NAHB also calls for prompt Congressional action on

legislation to modernize the Federal Housing Administration and to reform supervision of the GSEs (Fannie Mae and Freddie Mac). These government-related sources of credit are critical to development of a housing recovery since fully-private components of mortgage and mortgage-backed securities markets are essentially shut down.

**Senator Hatch**

*1. Dr. Seiders, you mentioned that a few recent economic indicators contain some glimmers of hope for the housing industry. What conditions will signal the beginning of a turnaround in the housing market? Once prospective buyers get the sense that prices have reached the bottom, won't that indicate that it is time to buy?*

**Answer:** I was referring to recent improvements in standard measures of housing affordability, to recent increases in numbers of consumers saying that homebuying conditions have improved, and to recent increases in traffic of prospective buyers through model homes of builders. Unfortunately, these glimmers of hope have not yet translated into higher home sales, largely because of tightening mortgage credit conditions but also because many prospective buyers apparently expect home prices to decline further.

These conditions suggest that a temporary tax credit for home buyers could unleash a good bit of pent-up demand, thereby reducing inventories, supporting prices and encouraging homebuying even after the temporary tax credit expires. On the other hand, an unfettered decline in house prices (in the absence of policies to support prices) most likely would extend the dangerous downward spiral of mortgage credit quality, the tightening of mortgage lending standards and the decline in house prices -- a feedback loop that most likely would depress home buying for quite a while.

*2. Dr. Seiders, does the NAHB track the inventory of unsold new homes? If so, how much higher is this inventory now than normal?*

**Answer:** NAHB tracks the inventory of both new and previously owned homes on the market. The inventories are at near-record levels in both components of the market, and the new-home inventories are seriously understated since the government's estimates exclude homes handed back to builders through sales cancellations. Despite this deficiency, the months' supply of new homes on the market is at a record high (9.9 months at the end of January), more than double the normal inventory situation, and the months' supply of previously owned homes (10.3) is similarly excessive.

*3. Dr. Seiders, obviously some local housing markets are worse off than others. Are there markets in the U.S. that are doing fine or is the outlook gloomy everywhere in the nation? Should tax policy changes designed to bolster the industry be targeted to the most troubled markets?*

**Answer:** Geographic targeting is an interesting possibility since conventionally built housing inventories, by their nature, can't be shifted from relatively weak to relatively strong markets. Furthermore, it's fair to say that the seriousness of the housing

contraction, including the degree of inventory overhang and the downward pressure on house prices, differs substantially across areas of the country. In this regard, the greatest weakness is concentrated in previously overheated markets (such as California, Florida, Arizona and Nevada) and in markets burdened by structurally weak economies (such as Michigan and Ohio). But it's also fair to say that the geographic scope of this housing contraction has been spreading as the national contraction has lengthened and deepened.

A tax credit targeted to new homes in inventory or to homes in the foreclosure process would be well-crafted for areas that need it the most. On the other hand, credits targeted to first-time buyers of new or existing homes would provide broad-based support to the housing market, stimulating not only the entry-level market across the country but also the trade-up market--including the new-home market in areas with excessive inventory overhang.

**Senator Roberts**

*1. Dr. Seiders, in your testimony, you indicate your support for legislation introduced by Senator Isakson that would provide a one-time tax credit of up to $15,000 over three years for the purchase of single-family principal residence that is a newly constructed home, or a home that is in default or foreclosure. Would you, or the any of the witnesses, care to comment on whether you think this legislation would help address the downturn in the housing market and be a sufficient incentive to encourage home buying?*

**Answer:** NAHB supports the establishment of a temporary tax credit for home buyers, and we look forward to working with the Committee in designing the appropriate form that that credit should take. In 1975, the country faced similar conditions. The $2,000 new home credit adopted during this period (9 month credit period) reduced the months' supply of new homes on the market from 9.9 months to 5.8 months by the end of the year. Today, we face a 9.9 months' supply of new homes on the market and a 10.3 months' supply of existing homes. Clearly, the 1975 credit stimulated housing demand, and we believe that doing so is even more critical for the health of the economy at this time, in view of the sizeable downward pressure on home prices and the destructive deterioration of mortgage credit quality.

*2. Several witnesses today have said that market forces will come together to alleviate the problems surrounding the housing situation. The private sector, after all, has a great stake in ensuring that credit markets improve. I've heard pleas for the government to do no harm that would exacerbate the current situation in the real estate market, and I agree with that. We should be cautious of targeting large government responses which could result in longer-reaching, unintended consequences for the housing market down the road.*

*However, it is important to make sure the problem doesn't threaten more segments of the economy. Many lenders have stepped up to voluntarily work with homeowners to help them keep their homes.*

*Estimates are that more than 800,000 homeowners have been helped by their lenders, either through the initiation of a repayment plan or through a loan modification in the second half of 2007. This is an important step for lenders to take, and it gives homeowners valuable time to make necessary financial decisions, while not leaving a permanent federal government mark. Just as the stimulus package is intended to be a short-term, targeted response, housing proposals should not come with permanent fixes to problems that are not going to last forever.*

*Mr. Seiders, in your opinion, what is the best way to assist folks in this current situation by working with the private sector and allowing market forces to react without leaving a lasting impact on the housing market?*

**Answer:** NAHB firmly believes that private market forces generally can be relied upon to meet the majority of America's housing needs. However, the public sector has the responsibility to react to breakdowns of private markets, such as the recent breakdown of large parts of the housing finance system, and to provide support to Americans victimized by market breakdowns, such as homeowners now facing mortgage foreclosure.

The home-buyer tax credit that NAHB is recommending is a temporary measure designed to release pent-up demand, reduce excessive inventories, support faltering house prices, support mortgage credit quality and restore better balance between supply and demand in housing markets. The support to house prices provided by this temporary measure will enhance refinancing opportunities for homeowners facing the risk of foreclosure and limit the tightening of lending standards currently underway in the primary mortgage market.

Our recommendations on FHA and the GSEs (Fannie Mae and Freddie Mac) are designed to improve the cost and availability of mortgage credit in the current financial crisis and to promote a stronger and more flexible housing finance system over the longer term.

**THE HONORABLE GORDON H. SMITH**
**Senate Finance Committee Hearing Statement**
**February 28, 2008**

Mr. Chairman, I want to thank you for holding this important hearing.

Several months ago Senator Kerry and I began working on a bill to help stop the spread of foreclosures by giving people with the ability to pay the option to obtain safe, fair mortgages.

Our bill would do this by temporarily expanding the use of mortgage revenue bonds to allow the proceeds of the bonds to be used to refinance subprime loans.

It would also provide a $15 billion increase to the volume cap, which would be available for 3 years beginning in 2008.

The increased bond ceiling provided in our bill would also help first-time homebuyers who are finding that they have few to no financing options. This should reduce the inventory of vacant homes.

Last month, this committee overwhelming approved an amendment we offered during the markup of the stimulus package that would provide this new refinance authority and increase the volume cap for mortgage revenue bonds.

Unfortunately, our amendment was not included in the final package that was signed into law.

While our bill will not cure all that ails the real estate market, it will have a very real and direct impact on working families who are very worried right now about whether they will be able to hold on to their home.

And it will do so in manner that is fiscally responsible.

I know that Senator Kerry and I are united in our commitment to get this bill passed.

Across the country, families are facing ballooning interest rates and plummeting home values that threaten to drive them from their homes and swallow their life savings.

While much attention has been focused on the problems in the subprime market, what we are seeing today is that the problem is really much broader.

There is a lot of pressure out there to get something done to "fix" the problem, but I think that we need to be very careful in how we approach this.

If not done properly, we could respond in a way that has very negative repercussions on the larger economy and the very people we are trying to help.

I think that we need be creative in how we do this and resist any heavy handed action that would send capital out the market and worsen the current credit crunch.

I want to thank our witnesses for being here today. I look forward to hearing their opinions on how we navigate through the current downturn.

Thank you, Mr. Chairman.

COMMUNICATION

**Statement for the Record**
**On Behalf of the**
**National Multi Housing Council**
**and**
**National Apartment Association**

"The Real Estate Market: Building a Strong Economy"

Senate Committee on Finance
**Thursday, February 28, 2008**

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## Lessons Learned from the Foreclosure Crisis

The current situation in the for-sale housing market is an extremely unfortunate turn of events that is made even more unfortunate by the fact that it was completely foreseeable and preventable. For decades the government has pursued a "homeownership at any cost" housing policy. Like other participants in the housing sector, it mistakenly assumed that prices would always go up. People were enticed into houses they could not afford, and the rarely spoken truth that there is such a thing as too much homeownership was forgotten.

Now we are seeing the consequences of that misguided policy. People are losing their homes, local communities are struggling with blight and crime, and our national economy is at great risk as we face the danger of a full-blown credit crisis.

For years, we have been warning policymakers that pushing homeownership so aggressively could be disastrous not only for the hardworking Americans lured into unsustainable homeownership, but also for our local communities and our national economy. We were not alone in doing this. Here are just a few of the warnings that were issued:

- March 2004: NMHC President **Doug Bibby** testified before the House Committee on Financial Services Subcommittee on Housing and Opportunity that "low- and no-downpayment loans in particular are putting households at higher risk for default and may do more harm than good to local communities."

- December 2004: **William Apgar Jr.**, Ph.D., former Assistant Secretary of Housing at the Department of Housing and Urban Development (HUD) and long-time homeownership advocate, published a paper for Harvard University saying too many low-wealth and low-income families are being "pushed into homeownership" when it is not a good choice for them. Dr. Apgar recommended that instead of excessively promoting homeownership, America should focus on ways to use low-cost rental housing as a "pathway to social and economic opportunity."

- January 2005: The **Consumer Federation of America,** the **National Urban League** and 10 other organizations hold a briefing for more than 100 congressional staffers and reporters to explain that too many low-income families are being hurt by the rhetoric from HUD and elsewhere that they must become homeowners.

- January 2005: The **Center for Economic and Policy Research** issues a paper concluding that government homeownership incentives like subsidized downpayments primarily benefit real estate agents, mortgage brokers and other intermediaries—not necessarily the families the incentives are designed to help. "Even with federal subsidies," the CEPR says, "many low-income families would find themselves better off if they remain as renters instead of becoming homeowners."

- May 2005: **Dr. William Apgar Jr.** publishes a research report concluding that the nationwide municipal cost of foreclosures could easily top the $1 billion mark.

- June 2005: **NMHC/NAA** began running ads in *Roll Call* newspaper warning policymakers that homeownership is not a panacea.

- March 2007: **David Frum**, former speechwriter for President Bush, says "the fact that almost 70 percent of American adults now own their own home is hailed as a great social achievement. But the achievement came at a price...Loose (lending) standards now threaten the whole American financial system, but they also do harm to low-income borrowers."

***Learning a Lesson: New Solutions***

The mortgage market meltdown represents a failure of oversight and regulation. But it also reflects a colossal failure by financial instrument investors to conduct proper due diligence.

We certainly understand the great concern to help people remain in their homes -- even though many are now trapped in mortgages that are under water with no short-term prospect for a quick remedy to this crisis. But as Congress considers the various "solutions" being proposed, we urge lawmakers to act deliberately and cautiously in order to avoid unintended consequences. The primary objective at this point should be to avoid causing a deeper credit crisis.

Lawmakers should also abandon their unqualified support of all homeownership incentives. One example is the pending FHA reform measure (H.R. 1852, S. 2338). Among other provisions, the House bill would create a federally insured zero-downpayment mortgage program, while the Senate bill lowers the FHA's existing three percent downpayment requirement to 1.5 percent.

The marketplace has made it clear that zero-downpayment mortgages are extremely risky. Faced with mounting losses due to the foreclosure crisis, one of the largest private mortgage insurance ("PMI") firms, PMI Group, Inc., announced that it will no longer insure loans with downpayments of less than three percent. Earlier, MGIC Investment Corporation discontinued insuring loans with downpayments of loans of less than five percent in 30 markets around the country.

Offering an insight into the possible losses to the Federal Treasury if a federally insured zero-downpayment program is enacted, MGIC last week reported $1.47 billion in fourth-quarter losses. Another large PMI firm, Radian, disclosed $618 million in losses for the quarter.

If there is a silver lining in this situation, it is the opportunity we now have to learn from our mistakes and rethink our housing policy. That means finally acknowledging that homeownership isn't the right housing choice for all households at all points in their lives. Housing our diverse nation well means having a vibrant rental market along with a functioning ownership market. To do that, we need a more balanced housing policy that explicitly values rental housing and takes steps to ensure there is an adequate supply of it.

**A SMARTER HOUSING POLICY SATISFIES THESE PRINCIPLES:**

- It ensures that everyone has access to decent and affordable housing, regardless of whether they rent or own.
- It respects the rights of individuals to choose the housing that best meets their financial and lifestyle needs without disadvantaging, financially or otherwise, those who choose apartment living.
- It promotes healthy and livable communities by encouraging responsible land use and promoting the production of all types of housing.
- It recognizes that all decent housing, including apartments, and all citizens, including renters, make positive economic, political and social contributions to their communities.
- It balances the expected benefits of regulations with their costs to minimize the impact on housing affordability.

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NMHC and NAA operate a Joint Legislative Program and represent the nation's leading firms participating in the multifamily rental housing industry. NMHC/NAA's combined memberships are engaged in all aspects of the development and operation of apartment communities, including ownership, construction, finance and management. Together, the organizations operate a federal legislative program and provide a unified voice for the private apartment industry. Nearly one-third of Americans rent their housing, and over 14 percent of all U.S. households live in an apartment home. For more information, contact NMHC at 202/974-2300, e-mail the Council at info@nmhc.org, or visit NMHC's web site at www.nmhc.org.

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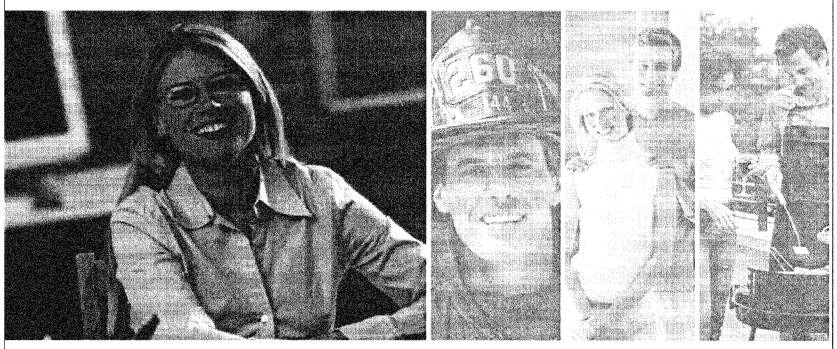
As Seen In
ROLL CALL
June 30, 2005

Owning a house shouldn't put dreams on hold.



America may be an "ownership society," but for many families, homeownership has become a trap rather than a step toward the American Dream. Enticed into buying a house by easy credit and pro-ownership policies, many now find themselves locked into spiraling cycles of debt as they struggle to manage their mortgage, maintenance and all the hidden costs of ownership.

Today, with foreclosures at record levels, it's time to reconsider the wisdom of a "homeownership at any cost" housing policy. For many families, renting makes more sense. A strong rental market can help keep hard-working families — and their neighborhoods — solvent and stable.

More than we realize, many Americans are choosing apartment living for convenience, financial flexibility and amenities. Find out how apartments can help create stronger and healthier communities.

Visit www.nmhc.org to find out more. It's a sound investment.

**Because not every home is a house.**

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