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SMALL BUSINESS ACCESS TO CAPITAL: CHALLENGES PRESENTED BY COMMERCIAL REAL ESTATE

ROUNDTABLE

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

NOVEMBER 17, 2010

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SMALL BUSINESS ACCESS TO CAPITAL: CHALLENGES PRESENTED BY COMMERCIAL REAL ESTATE

WEDNESDAY, NOVEMBER 17, 2010

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS
AND ENTREPRENEURSHIP,
Washington, DC.

The Committee met, pursuant to notice, at 10:19 a.m., in Room SD–428A, Russell Senate Office Building, Hon. Mary L. Landrieu, Chair of the Committee, presiding.

Present: Senators Landrieu and Hagan.

Staff present: David Gillers, Chris Lucas, and Jelena McWilliams.

OPENING STATEMENT OF HON. MARY L. LANDRIEU, CHAIR, AND A U.S. SENATOR FROM LOUISIANA

Chair LANDRIEU. Good morning and welcome all of you to the Small Business Access to Capital: Challenges Presented by Commercial Real Estate market and other issues that may come up at our roundtable. This is about our 12th roundtable that we have conducted since I have been chair of the Committee and I find them to be extremely helpful in flushing out some important ideas, emerging issues, and potentially emerging solutions that can be crafted either by this Committee in legislation or other Committees of the Congress that have jurisdiction over aspects of these topics. I am very appreciative of you all taking the time to come and share your thoughts about it.

Let me give a brief opening statement in a more informal fashion, and then I would like each of you to introduce yourself as we begin. I am going to be with you until about 11:00. There are three votes that have been called, and the staff will conduct the final 30 minutes or so of the roundtable themselves.

Right before the election, we passed a groundbreaking small business jobs bill last year that addressed some of the credit concerns facing small businesses. I am proud to have had a leading role in that effort, and hopefully many aspects of that bill, as it is put into place, will become clear to the country on how effective and important it is.

However, there are several issues that remain unsolved, and one of them is the commercial real estate market, loans associated with it, and evaluation of commercial property.

Every small business has to be housed somewhere. Some small businesses are in garages. Some small businesses are in kitchens. Some small businesses operate out of automobiles, but many of them have some commercial connection. They either own the building they are in or they are leasing the building they are in; and so small businesses all over America, and there are 27 million of them, have a real interest on how this issue is going to get resolved and work out.

We are very honored to have Congressman Minnick with us who is a leading expert from the House and has his own legislation. He has been gracious to join us this morning to give us some of his thoughts.

As some of you may be aware, the commercial real estate problem has been looming in the background since 2008. During discussions on Wall Street reform and the financial crisis, many suggested that an impending crisis in commercial real estate was around the corner.

With more pressing aspects of the economy requiring our immediate attention, the commercial real estate issue has been largely left untouched. Approximately $1.4 trillion of commercial real estate debt is coming due in 2013. To give you context, that is about half of all outstanding commercial real estate which, according to the Federal Reserve, is $3.2 trillion.

We have a chart that shows this. If you will hold it up so people can actually see it, it is basically a tsunami of maturing commercial real estate debt and virtually no way out there to refinance.

Even more pressing according to the Federal Reserve, about $338 billion is on the books of our community banks. This Committee is keeping a very close eye on our community banks not as regulators or oversight which we do not have jurisdiction in this Committee but we think of our community banks as partners for small business lending.

Community banks like yours, Stephen, out in the New Roads area in Louisiana that know your customers and know your clients and are in a position to really help get credit out there and capital to small businesses that need to grow and expand.

So we are very concerned, the Small Business Committee. We have already started work on this issue. In our small business jobs bill which the President signed into law six weeks ago, we tried to get at this problem by allowing refinancing of owner-occupied commercial real estate debt through the SBA 405 loan program.

However, it is limited in its size and scope. It is capped at $7.5 billion, while we have just established that small banks are holding $338 billion coming due in 2013. So while it is a step, it is a very small step in this direction. We were happy to take it but much more needs to be done.

While I strongly believe the refinancing program is critical and necessary, I do not believe it will solve the entire problem. Because the financial melt down of 2008 required our full and immediate attention, the problem with commercial real estate debt has largely been ignored.

Now that we have passed the Wall Street reform bill, it is time to turn to assessing and identifying commercial real estate problems. How is commercial real estate connected to small business lending? I have gone over that.

I hosted a Small Business Jobs Summit in Louisiana last month. Over 400 small businesses attended with the same message. Many of them still were looking for loans, some were looking for opportunities to finance out some of the important debt they were carrying.

Small businesses across America, as I said, either rent or own their own small business space. There seems to be very limited financing available for new construction and development loans. Approximately 7 percent of American jobs, that is nine million jobs, are tied directly to the commercial real estate market. This includes small construction companies, janitorial services, heating and cooling companies, landscaping companies, leasing companies to name a few, and might I say, many of them are small businesses.

That is why this Committee is interested and we are going to continue to promote and advocate for small business everywhere for their expansion, identifying rules and regulations that limit their growth, and identifying Federal policies that might be counterproductive in trying to work our way to a better atmosphere for small businesses in America.

I have said over and over again this recession is ending. There is a recovery underway, but the recovery needs to be connected to jobs and it is going to be small businesses of America that create those jobs. This Committee wants to plow through and clear some paths for that to happen.

I am aware of the small business bank failures or community bank failures that are taking place so we have got to be careful. There are over 800 banks on the FDIC watch list out of a total of 7,800 nationally.

As of yesterday there have already been 146 bank failures alone this year with more expected. Last year there were 140 total in the whole year so we are already at 146 into the third quarter, I guess, or last quarter of this year.

Finally, because thousands of community banks know that in the next three years their borrowers will not be able to refinance their commercial real estate loans, they want to understandably protect themselves from the possibility of failure.

As a result they are growing even more risk-averse about lending. We are already seeing some banks hold back even more from making loans.

Now I know many of you want to jump straight into discussing how to solve the problem. But first things first. Let us go to introductions, and then we will open up for questions and opportunities.

William, we will start with you.

Mr. ASKEW. Senator Landrieu, I am Bill Askew, a senior policy advisor from the Financial Services Roundtable. It is an trade organization supporting the hundred largest financial institutions in America, and I commend you for having this meeting today and for your focus on the commercial real estate sector. It is a very important process.

Chair LANDRIEU. Thank you, Bill.

Mr. ARBURY. Madam, I am Jim Arbury, senior vice president of government affairs for the National Multi Housing Council and National Apartment Association. The National Multi Housing Council represents the larger principal officers of multi-family properties and the National Apartment Association's number of State affiliates. All told we represent about 6 million apartment units around the country. I really want to commend you also for all of the work that you have done on Katrina, and post-Katrina, and all of those problems. It has been phenomenal. Thank you very much.

Chair LANDRIEU. Thank you. It is still a work in progress.

Dan.

Mr. SIGHT. Chairwoman Landrieu, thank you for inviting me here today. My name is Dan Sight. I am the vice president of Reece Commercial in Kansas City, Missouri, and I like to call myself a street broker. I have been active in selling and leasing commercial real estate my entire career. I am here presenting the National Association Realtors. I am the 2011 chair of the Commercial Committee for NAR. I want to commend you for your insight into the situation that we are facing as commercial real estate investors, brokers, and owners around the country. And we are here to try to help you with the National Association of Realtors to come up with solutions that will help our members and help your members as well.

Chair LANDRIEU. Thank you, Dan. We so appreciate you all holding your annual meeting in New Orleans. I hope everybody had a good time. I was unable to attend the festivities myself, but I know that you all were there and we really appreciate it.

Mr. SIGHT. You are welcome.

Chair LANDRIEU. Jeff.

Mr. DE BOER. Senator, thank you. Jeff De Boer. I am president of The Real Estate Roundtable here in Washington, D.C. The roundtable, as you know, represents the CEOs and chair people of the top 130 publicly-held and privately-owned real estate entities across the country. We collectively represent about 5 billion square feet of developed property that is valued around a trillion dollars. We have about one and a half million apartment units and about one and a half million hotel spaces. I look forward to the discussion. I do want to congratulate you on the bill that was done this fall on small business lending. I acknowledge and agree with what you said that it is a small step but it is a good step and a positive step. And congratulations on beginning the process here. Thank you.

Chair LANDRIEU. Thank you.

Frank.

Mr. INNAURATO. First I want to say I am Frank Innaurato, managing director of CMBS analytical services and surveillance at Realpoint which is an NRSRO out of Horsham, Pennsylvania. We are one of the relatively new NRSROs to the business, having been designated in the few last years. But since roughly 2000, 2001 we have been doing research and surveillance on all of the commercial mortgage-backed securities out there and active in the market.

So we very much have a pulse and finger on the market and how things have changed very dramatically over the last few years within commercial real estate, and ironically in looking at the tsunami of maturity and the refinancing problems, we are very much concerned with where things will be coming in the next few years especially into the next year 2011 relative to not only the CMBS market but the markets overall as a whole.

To just kind of give you an idea if you are not familiar with what we do, we have roughly 225 institutional clients that use our services primarily for research, surveillance, and rating products.

I want to thank you for the opportunity to be a part of such a panel here. While we are not a direct kind of piece to the puzzle as many of you might be, we feel we are very much an indirect piece to understanding what is going on in the market. So I thank you, Madam Chairman.

Chair LANDRIEU. And you yourself are a small business, right, Frank?

Mr. INNAURATO. Yes, we are. Yes, we are.

Chair LANDRIEU. How many people do you have working?

Mr. INNAURATO. We are only a 35- to 45-person shop out of Horsham, Pennsylvania, doing surveillance on roughly 700 CMBS securities on a monthly basis so we are doing a lot with a little.

Chair LANDRIEU. Good job.

Stephen.

Mr. DAVID. My name is Stephen David. I am president/CEO of People's Bank in New Roads, Louisiana, a small $150 million bank, about 35 miles northwest of Baton Rouge. I appreciate the invitation. I am glad to be here. Also I want to note because I do not know if it will come in in the discussion but the SBA program and reduction in fees, and increase in the guarantee has made a big difference in allowing us to continue to make loans that otherwise we would not have been able to make.

Chair LANDRIEU. Thank you, Stephen.

Ron.

Mr. PAUL. Thank you, Chairwoman. I am Ron Paul. I have only daughters, no sons.

Chair LANDRIEU. Good. Just kidding.

Mr. PAUL. I am chairman of Eagle Bank, a $2 billion bank in the Washington metropolitan area that specializes in small businesses. We have a significant concentration in real estate but a very well-positioned, well-capitalized profitable bank.

Chair LANDRIEU. Thank you.

Congressman.

Representative MINNICK. I am Walt Minnick, Congressman from Idaho and member of the House Financial Services Committee.

Chair LANDRIEU. Thank you. I would like to begin now, if we could, with Congressman Minnick and allow each of you to expand on maybe three minutes, four minutes each about one or two points that you really want us to understand relative to this commercial market and the tsunami that is likely to occur and potential actions that Congress could take either, of course, through this Committee or the Banking Committee or other Committees that potentially have jurisdiction over some pieces of this.

From those of you who could speak at it from a perspective of either a small business that you are yourself or from a perspective of small business would actually really help us to bring some of these issues more clearly into focus.

Walt Minnick has been probably the leading voice in Congress on trying to find a solution to this particular problem. He served with distinction for many years in the House and has developed quite an expertise on this subject. I am happy to have invited him and very appreciative that he would give us some time this morning to come and share with us some of the outcomes of his work.

Congressman, we will begin with you.

Representative MINNICK. Thank you, Madam Chair.

In 2007 the value of all commercial real estate in the United States was $5 trillion. Today it is approximately $3 trillion. There is roughly $3.32 trillion as illustrated in that chart in debt against these assets, much of it held by the Nation's commercial banks.

This 40 percent decline in value has been caused by the ongoing financial crisis, a deep recession, and sharply restricted sources of credit for commercial real estate investments. Unfortunately the Nation's 8,000 community banks are much more exposed to commercial real estate than larger financial institutions whose business is much more diversified.

Small business which, as you know, creates most of the new jobs in America relies primarily on local community banks for credit. If the capital of these banks becomes impaired because of losses from commercial real estate, small business cannot expand and the recession becomes deeper and longer.

Worse yet as commercial real estate values continue to spiral downward and bad loans are written down or foreclosed, as many as 2,000 smaller banks could fail over the next several years. This could cost the FDIC, and indirectly the taxpayers, in excess of half a trillion dollars by some estimates, more than the net cost of TARP and the savings and loan bailout combined.

Without available credit, transactions in some markets currently reflect declines of up to 60 to 80 percent from 2007 valuation levels, and as the bottom feeders rush in, there is more trouble on the horizon. As investors buy up troubled assets at steep discounts, they immediately reduce rents to eliminate vacancy and create cash flows.

While this strategy works for the new investors and distressed assets, it creates major problems for current real estate investors as they battle tenant relocation and a much higher cost structure than their new competitors. This leads ultimately to more distressed real estate and a new round of forced closures.

The losses from commercial real estate have been slow materializing because of the long-term nature of commercial real estate leases. But make no mistake, these losses are coming. If commercial real estate credit markets are not stabilized, the losses could potentially be greater than the total capitalization of the U.S. banking system.

This could trigger both an avalanche of bank failures and the much talked about second dip in the recession with renewed economic hardship for small businesses and all Americans.

So what do we do about this looming real estate crisis? Like you, I do not believe in subsidies or bailouts for banks or commercial real estate investors. I do believe the Treasury and the Federal Reserve should provide a backstop program that assures market credit is available for all well underwritten commercial real estate loans.

Instead of being the lender of first choice because of low subsidized interest rates and easier or reduced underwriting standards, the Federal Government could and should facilitate credit for well underwritten loans. In doing so, the taxpayer would be fairly compensated with substantial profits.

I have introduced bipartisan legislation in the House of Representatives to deal with this in a way that will save many of our smaller banks and make, not cost, the taxpayer money. Essentially what my bill would do is create an analog for commercial real estate that is similar to what Fannie and Freddie do for residential real estate.

It would allow large financial institutions to aggregate at current value existing commercial real estate loans and then to package them and to get a third-party guarantee, excuse me, get a rating from a rating agency which rating agencies can now be sued for negligence so it will be a good rating as investment grade and then to package these into a security and wrap them with a government loan and sell them into the market.

The government loan guarantee would be available only at a hefty fee and the CBO has estimated that this program would not only provide credit to the market and a floor under commercial real estate values but also yield the taxpayer a net profit over the life of the program in excess of $1 billion.

So it stabilizes the market. It provides credit to the market, and it makes the taxpayers money. This is a well needed analog which I am hopeful will be considered by you and your colleagues in the Senate, Madam Chairman.

Chair LANDRIEU. Thank you, Congressman.

I really appreciate the time and effort put into that innovative proposal, and I would like to get at sometime in the next hour some comments from various folks here about the pros and cons of an approach like that. We need to play the devil's advocate as well because the minute you say like create something like Fannie Mae and Freddie Mac I think the antennas go up. People are very concerned about the track record of those organizations and their difficulties, although there are outstanding benefits that they have also provided for our Nation. That is food for thought. We will come back to that.

Thank you for your presentation.

Ron.

Mr. PAUL. Thank you, Chairwoman Landrieu. As I mentioned earlier, I am chairman and chief executive officer of Eagle Bank, a well capitalized, very profitable $2 billion community bank, headquartered in nearby Bethesda, Maryland, specializing in loans to small businesses.

While many other banks of various sizes have hunkered down, we have increased our loan portfolio. Loans are up 16 percent from a year ago. The Washington Business Journal recently recognized us as having made the greatest increase in overall loans in the Washington D.C. market. The Journal stated that Eagle Bank had the greatest increase in commercial real estate loans and the greatest increase in business loans over the same period.

And we have not made the loans by sacrificing credit quality. Our ratio for nonperforming assets is 1.46. We are very proud of the fact that over the last 12 years we have funded $23.5 billion in commercial real estate loans and have written off less than $2 million.

I have also been a real estate investor in office buildings and multifamily apartment buildings in metropolitan Washington, D.C., and around the country for the last three decades. As such, I have a unique perspective on the challenges facing the commercial real estate market today as both a lender and an investor.

This Committee is well aware, as mentioned earlier, that there is approximately $3.2 trillion of commercial real estate debt in existence in the United States. Forty percent of that, or $1.4 trillion, is estimated to become due in the next three years. Of the $3.22 trillion in outstanding loans, half is held by banks and another 25 percent held by the CMBS market.

One of the major issues we will all grapple with both with respect to loans held in portfolios as well as those loans maturing is the decline in value of real estate. We recognize that determining value is subjective and varies from appraiser to appraiser. It is not a mathematical calculation.

Consider an office building that has a dozen tenants with leases at market rates and maturities spread over time, that is, picture a stabilized office building, its cash flow has been and is projected to continue to be more than sufficient to cover the debt service and operating expenses. That conclusion is the result of a mathematical computation.

If I am the lender on that project, and I assure you that many loans in our portfolio match this description, I consider this a good loan. But also imagine that as a result of the CMBS markets evaporating and based on current regulatory standards, banks are not in a position to extend additional credit and buildings down the street are being foreclosed upon or handed back. An appraiser will use the value of one of those buildings now and it becomes a comparable sale for the building we just talked about. The appraised value on the stabilized project based on the loan to value ratio subjectively determined just went down by the appraiser's perspective significantly.

But remember the building's cash flow is still more than sufficient to keep the current debt. The project is not in fault.

I believe that Congress needs to address this issue to ensure that that performing loan continues to be treated as a performing loan. Projects that have a reasonable projection of continuing sufficient debt service coverage, that is, the borrower is projected to make each month's payment, should not be classified credit unworthy.

The question presented is whether loan to value ratio should be the basis for a loan becoming classified if the debt service coverage test is met. The issue needs to be examined with respect to both during the life of a loan and as the bank considers renewing it during this time of significant demand for extensions and issuance of new debt.

This all assumes that the banks are in a position to make loans. Even if Congress solves the issue of keeping loans in performing status, for those of us in stronger markets, and Washington, D.C., is certainly one of those markets, and hopefully shortly there will be many more, the issue is different.

It is one of liquidity. We need to have the cash to make the loans. As you know, once a bank has capital, it can leverage that capital tenfold so $50 million in capital means you can lend $500 million.

But, and it is a big "but", you need to have the other $450 million in funds available. This issue was quantified by the loan to deposit ratio. Eagle Bank's loan to deposit ratio is 97 percent. For every hundred dollars we have in funding, $97 is out the door already, excluding loans we have already committed but not yet funded.

The American bankers published a list in September of the top banks nationally in terms of loan to deposit ratio. Eagle Bank, which recognizes its responsibility to lend, is proudly on it. It is going to be the strong markets and the strong banks that start pulling the country out of this economy and strong banks need liquidity to make new loans to small businesses along with commercial real estate.

When a small business, say, a hardware store or a restaurant, comes to Eagle Bank and asks to increase its loans due to inventory or volume of business increasing, which is a good thing, the bank does not want to be in a position of have to say, sorry, we do not have the funds available even though your business underwrites.

We need to come up with ways to increase liquidity for strong banks. Obviously increasing our deposits is the best way. The many alternatives for depositors to place the liquidity in markets other than banks such as credit unions hurts our ability to attract these core deposits.

Additionally, the current cap with FDIC insurance coverage of $250,000 hurts community banks' ability to bring in larger deposits. The cap inhibits individuals and entities from putting more of their cash into banks due to risk, and I mean real banks, not financial service companies like Goldman Sachs or AIG. They do not turn around and lend money to Main Street America. Community banks do.

We must also examine and explore new ways to facilitating alternative means of funding for well capitalized, well managed banks. Our regulators annually rate banks. Congress should look at allowing highly rated banks to have access to alternative funding means such as borrowing programs at the Federal Reserve Banks or the Federal Home Loan Bank.

I also might add, as Stephen mentioned, that we also request a waiver of SBA fees to be extended at the end of the year since we are just beginning to see a pickup in SBA lending.

On behalf of Eagle Bank and community banks across the country, I thank you for the interest that this Committee has shown in the small businesses and commercial real estate and I thank you for allowing me to appear before you. I look forward to continuing this conversation with you this morning and in the future as you wish. Thank you.

Chair LANDRIEU. Thank you. We are going to pause just for a minute, Stephen, before we get to you. I would like to take a couple of comments about the two or three or four speakers because in their statement there were about four kinds of new big ideas that were thrown out.

Any comments or questions that any of you have about some of the suggestions either made by the Congressman, I am sure some of you have reviewed his bill and his proposals prior to coming here. Some of your organizations might have already put out a statement or comment about the advantages or disadvantages of such a proposal.

We are joined by Senator Hagan. Thank you so much, Senator. You have been an outstanding advocate for small businesses, and we really appreciate your being here. We just started and we are going around the room and we will come back to you. What is your time frame because we could acknowledge you now.

Go right ahead.

Senator HAGAN. We have votes coming up at 11:00 so I thank the Chairman for holding this hearing and I am extremely interested in it. North Carolina, it is all about jobs, jobs, jobs, access to capital to be sure that industry can stay in business and I am very interested to listen to what you all have to share with us today. Thank you.

Chair LANDRIEU. Thank you. I think you will be very interested, and we both have to leave in about 20 minutes or so but to really hear some of the new emerging ideas that are coming forward, Senator Hagan, about trying to stabilize this commercial estate market which, as you know, our Committee does not have direct jurisdiction. But as it affects small business, we are taking a very aggressive posture because the outcome or the way that the country decides to move forward hopefully as opposed to just standing still and running around in a circle I am hoping we will move forward in some direction, will have a direct impact on the 27 million small businesses out there.

All of them need office or either own office space or are affected by the values of the commercial buildings next door. It really is just a corner stone of this market and a corner stone of our potential. I see that fragile recovery under way. As you and I know, it is not as strong as we would like.

We had two presentations by the Congressman and Mr. Paul. I would really like comments. Jeffrey, would you start us off, and when you all want to speak, just set your name card up like this so I can recognize you or just give me a signal. Thank you.

Mr. DE BOER. Thank you for this hearing, and I guess I would say that these two opening statements really crystallize three of the most important issues here, one being the CMBS market. We have got to figure out a way to get that going again. It is showing some sort of nascent signs of life.

It is going to run about $12- to 15 billion this year. That is off a peak of around $230 billion in 2007. We do not necessarily need to get back to 230 but we need to get greater than the 12 or 15 we are going to do here. The Congressman put forward some ideas. There are other things out there but certainly that is number one.

This issue about value is a very troubling issue because it is almost like you are asking people to describe a color that they have never seen, and I say that because you want value to be determined out there but yet there are no transactions.

Typically values are determined when there is a willing buyer and a willing seller. There are distressed sellers and there are opportunistic buyers. So we do not have a color that we can really see to describe.

So this whole issue about what is value is really an odd component out there, and I think it is very important what Mr. Paul brought up about that.

Finally, just the other very important thing is this issue of banks liquidity. I think, you know, the point about you can lend ten times your capital. Most small banks or regional banks, I would suggest, are ill-liquid because they have already lent in many cases, now there are exceptions, but they have already lent up to their ability to lead.

Then you say, well, how do they create more liquidity? Well, they create liquidity by selling assets. But if they sell assets, they are going to sell assets at a loss. So for every dollar of loss that they sell they correspondingly will have to reduce capital. So it is a Catch-22 that is going where banks want to become more liquid. In fact, they are becoming less able to lend.

And the final point that I would say that obviously, I mean, these banks are embedded with commercial real estate loans, traditional commercial real estate loans. But they are also embedded with small businesses who use their real estate as collateral to make the loans.

These asset values are down 25 to 35 to 50 percent in some markets. Now, in some places they are coming back, and the big public REITs are accessing capital and the big private owners in gateway cities are getting a little more liquid, but Main Street is not at all.

So you go and you want to get a loan and your collateral value is down substantially. The bank is already embedded with all of this stuff. The regulators will come in and say do not make any more loans on this type of asset plus the banks themselves will be fearful of making these loans.

So these are very complex, inter-related. We have got some ideas in addition to what Mr. Minnick suggested. These are the key things. How do we get the CMBS market? How do we increase bank liquidity? How do we have a better sense of value to make sure that the metrics work?

You talk about the SBA system working because it has the flexibility out there now that local bankers used to have but do not have today. I will stop with that. I think I have gone on enough.

Chair LANDRIEU. Excellent crystallization of these points, and we really appreciate it. That is what these roundtables are, you know, the format is meant to do.

Jim, did you have a comment?

Mr. ARBURY. Yes. I would like to, first of all, echo what Jeff said but also what the congressman said. Multi-family, we have the great benefit of having GSE available, GSE lending available to us. We have had a great track record, unlike the single-family, I mean, we have not cost the taxpayer a dime.

And properly underwritten with, you know, good money in the game. You know, we have done very well, and the taxpayer is not at risk. But that going forward, even though all the demographics are in our favor, we have got about a hundred to a hundred fifty billion of maturing debt coming due in the next year or so, more than that in the next couple of years.

We have $872 billion total debt outstanding of which about a third is owned by the GSEs. The big uncertainty and the big risk going forward is if the government pulls the plug on the GSEs suddenly or way too early, there will be, we will be right in here in the whole mix with the rest of the commercial in terms of problems with foreclosures and what will happen going forward.

Chair LANDRIEU. Bill.

Mr. ASKEW. I will not repeat what Jeff said on CMBS but I do agree that restarting the CMBS is one of the key issues here. I want to reference your chart up there because I think your chart is the most important chart in this room and it says everything we can say about commercial real estate.

Chair LANDRIEU. Compliments to whoever. Did you all present this? The Real Estate Roundtable. We have to give credit where credit is due.

Mr. ASKEW. The size of the role of maturities is clearly the issue in CRE, and it is the issue we have got to face down and we have to do something about.

The CMBS market has shown signs of life as Jeff says but it is not back, and we need it back. And so I think the issue is more of existing debt and how we are going to refinance that debt as it matures. That is the issue we have to face and that is the issue we have to deal with.

And another thing that you said, Ron, about performing loans going to non-performers. There needs to be some changes and some consistency in the way that the local examiners are interpreting interagency guidance.

The guidance came out in October. It actually helped it seemed for a while but now there is too much in differences in the way that guidance is being interpreted. So I think those are two of the key issues.

And I just throw in the third issue as accounting policy right now that has thrown all of this into confusion, FASB 166, 167, and then Dodd-Frank had set some clear guidelines on risk retention which, if we can follow through on how the bill was set up, I think we could get clarity and this will work.

But the FDIC has come out right now with safe harbor explanation and then SEC has got some guidance, reg A and B, that throws some confusion; and so the market is confused right now and it could slow down what was starting to be a restart of CMBS. So we need clarity.

Chair LANDRIEU. Hopefully it will not be that difficult to clarify this interim guidance. Several people have suggested that, and I think that is important. It may be easier said than done but we will see.

Let us go now to you, Stephen David, and we would love to have your opening statement.

Mr. DAVID. Thank you, Senator.

I almost want to say it is verbatim what Ron had to say so I will just sort of try to expand on that.

The appraisal market right now is that we have appraisers who are in fear of their own shadow. That has been a large problem for us and it brings us to problems with regulators because when they do an appraisal, we are finding that they are not realistic values.

We recently had a sheriff's sale; and that is, in Louisiana on a foreclosure, the method of getting back the property. It goes to an open bid process. The property has to be appraised by someone appointed by the sheriff and we also have it appraised.

In this particular example, the property appraised for $224,000. We knew the property, thought it had a substantially larger value on it. We took it back, we bought it back at the sale, had it reappraised by a different appraiser who appraised it for $226,000. Within three days I had three offers over $300,000 for the property and sold it for $327,000.

So the realistic part of what has happened with appraisal is they have always been, in my opinion, subjective. They are becoming more and more subjective. That plays into what issues we have now from a regulatory standpoint is we have loans that are coming up for renewal and are being pushed to get new appraisals.

We know what happens if we get a new appraisal. We are immediately going to be underwater and then we will be facing a substandard classification.

Or we have someone who wants to build something, commercial real estate. It could be spec houses or strip centers, things that we deal with in smaller towns and cities. And the appraisal is going to come in at less than what it is going to cost to do the project, cash flows no longer being the driving factor but market value being the driving factor.

So that is a problem from a regulatory standpoint as well as the position it puts us in with the appraisals.

Additionally, capital is an issue. Particularly in smaller community banks, to use that word. As we look and see which banks are being closed, it is very clear they are all community-bank size, banks that are being closed. So there is what we call the three C's of lending now. It is capital, compliance, and cost.

We do not have a definition of what is enough capital. They will tell you only it is sufficient or it is not sufficient but never a number. Well, the more capital has put a burden on banks of what is available to lend. The cost and compliance cost, they are also, as you said, it is ten times what we can lend. In my small bank $150 million. In the last three years our compliance costs went from just over $10,000 a year to over $250,000 a year. Our cost of FDIC insurance premiums went from $17,000 a year to $220,000 a year this year. So we are talking about in excess of $500,000 which multiplied times ten is $5 million.

That is a large number for a bank our size and those are the dilemmas that we are facing in trying. We are a high loan to deposit. We are a loan-driven bank, have always been and hope to remain a loan-driven bank.

I will tell you that our loan to deposit ratio has decreased from 120 percent to 100 percent in the last 12 to 18 months, and not so much from inability to find loans; it is inability to make loans that otherwise we would have made. Thank you.

Chair LANDRIEU. Thank you, and I really appreciate it.

Mr. David and I had many conversations as the Banking Committee was doing its work. He was very instrumental in giving me some information that I tried to pass on to the Banking Committee about the effects of raising some of these fees on the small banks out there.

I mean, if you are a billion dollar bank, those fees are pocket change. But if you are a $150 million bank, and I do not know how many banks, Senator Hagan, in the country that are, you know, small but they are in small places and they are doing good work in those places on Main Streets far away from this beltway that need our attention and need out support.

So I am going to be looking at this fee issue. Stephen shared those numbers with me before so I have heard them before. That is why I am not shocked this morning. But it is just in my view unconscionable. I will just say that.

It is just unconscionable for fees to be raised that much on that kind of institution. I am going to do everything I can to eliminate them or reduce them.

Go ahead, Frank.

Mr. INNAURATO. Thank you again, Chairwoman. I want to really thank everyone for the opportunity today to participate in this hearing.

Just to give you a little bit more background on Realpoint, obviously being the only NRSRO or Nationally Recognized Statistical Rating Organization in the room, we specialize in the structured finance market and specifically doing a lot of conversation about this CMBS market. We have earned our bread and butter and expertise focusing on commercial mortgage backed securities.

Currently more than roughly 225 institutional investment firms subscribe to Realpoint, and we pride ourselves on our trusted ratings analysis of approximately $788 billion of outstanding CMBS which not only includes domestic CMBS but some of the agency portfolios, Canadian portfolios and the like.

At Realpoint on a monthly basis we closely monitor all current commercial mortgage-backed security transactions in the United States which is close to 700 transactions on a monthly basis. This consists of in-depth monthly ratings reports of these securities, analytical performance studies, watch list reports, alerts, and other information about all the rated securities or underlying collateral for that security such as the property level reports.

In terms of general market direction, we can report that, while commercial real estate loan defaults have slowed recently, they have not stopped altogether; and we really feel that the market will continue to show signs of distress going into the 2011 potentially bottoming out in 2011 and show signs of recovery in 2012.

I do have some statics that I really wanted to share with everyone in the room relative to what we are seeing through the end of the third quarter within CMBS.

Through September 2010, the delinquent unpaid balance for CMBS continue to exhibit moderate monthly growth, having increased by an additional $800 million in one month up to $62.2 billion.

So I note through many of the charts that we are seeing just the size and the volume of loans that we are being concerned about not only through distress on your own balance sheets but within CMBS specifically. If I had a chart or a graph it is almost a straight line of continued growth.

In the last few months you have seen some tempering off and some slowdown. But some of that has really been fueled by increased liquidations. Due to the decrease in value of some many properties, loans that are being worked out and liquidated in this market are experiencing average loss severities anywhere from 50 to 60 percent on their original loan balance.

For the last few months of this year, just to give you an idea, from January through June 2010 average growth per month of new delinquent loans within CMBS was averaging $3 billion a month. So a substantial growth in the early part of the year has moderately tapered off a little bit in the last few months.

Despite ongoing loan liquidations reporting on a monthly basis, modifications or resolutions of distressed loans, the 90-day delinquent foreclosure or RAO within CMBS as a whole continue to grow on a monthly basis. They grew by another $1.2 billion from the previous month after falling for the first time in almost three years from July to August 2010.

So again not only new delinquencies but the level of delinquencies is being reached in CMBS loans going from 30 days to 60 days to 90 days. And in cases where they have been unable to negotiate some type of a workout or related scenario with the asset manager or specialist within special servicing to work out these loans, borrowers have been left in many cases just simply to default on their loan and hope that some kind of modification or resolution can be reached.

Overall putting some more percentages and fuel on the fire, the delinquent unpaid balance for CMBS alone was up over 96 percent from September 2010 through, excuse me, in one year from 2009 through 2010. So nearly 100 percent growth from the only $32 billion of delinquent unpaid balance that was reported back in 2009.

Overall this reflects 28 times the low point for CMBS delinquency. Back in March of 2007 when the markets were still performing and the growth of aggressive lending, underwriting, and new issuance within CMBS delinquency was as low as $2.2 billion.

So when I present numbers that are as high as $62 plus billion you can see the magnitude within CMBS and how voracious the growth has been in such a short time.

Chair LANDRIEU. You used the word "growth" you mean "increase."

Mr. INNAURATO. Increase.

Chair LANDRIEU. Growth is a positive word. This is not positive.

Mr. INNAURATO. Yes. In this case it is increase, very much so. I am glad you clarified that. Yes.

Chair LANDRIEU. An increase in delinquencies is not a good thing.

Mr. INNAURATO. No, not at all. In many cases the increase in delinquency that you are seeing as well is fueled by loans that initially claimed imminent default where on the small commercial banking side, borrowers pick up the phone and place a call and say, is there something we can do, is there something we can work out so that I do not default on my loan.

Within the commercial mortgage-backed securities world that is imminent default. So the lenders, the masters servicers and special servicers are left with an otherwise performing loan but a borrower who now realizes due to decline in values and decline in the performance of their underlying market, they are raising their hand and saying, can I get a modification, can I get a re-work because my property values are down anywhere from 30 to 50 percent in a given market. My cash flow is not where I hoped it to be. So I might need a modification. So they threaten imminent default, and immediately a loan is transferred to an asset manager.

In that realm of managers, special servicing, putting some more numbers on it just to give you an idea, this is considered special servicing within CMBS. The number of loans with special servicing was 4700 and close to $92 billion of loans that were requesting some form of workout status of which only $62 billion was delinquent.

So that left another $30 plus billion of loans that were still current in payment but looking for some kind of modification, maturity extension, new interest rate, new terms, based on the problems they were foreseeing.

We have talked a lot about the impact of value declines and the like, and I thought one of the numbers that I would share with you is that year-to-date through September 2010 within the CMBS market, $5.5 billion of loans have been worked out within CMBS but at an average loss severity of over 50 percent, meaning that loans that were originated at a higher value and a higher, low LTV, higher valuation, higher UPB are losing nearly half of their dollar amount in today's workout scenario.

$5.5 billion loan workouts just in the first nine months within CMBS is the highest that has ever been realized in the history of CMBS. This is legacy CMBS. These are deals that were originated mostly during the peak of the market, from 2005 through 2008, mid year, and most of the delinquency and the problems that we are seeing in the market today are coming from the aggressive underwriting and lending that went on during that time.

In addition to all these loans, though, however Realpoint through its surveillance efforts continues to monitor daily many watchlisted loans, loans that remain current in payments but have been transferred to special servicing. I have highlighted a lot of that.

But in our opinion many of these loans may ultimately default again, not just loans that have already asked debt relief but loans that we have not seen default yet.

An interesting point to kind of add something to some of the previous conversations is with CMBS most of the traditional loans and deals, much higher balance in unpaid, is for the individual loans.

Whereas if you were a $3 to 5 million loan, you would not refinance into a new deal especially if the conduit markets were dead. You are just not going to get into that type of universe right now. The deals that are being produced and the new CMBS deals that are coming to market, very well underwritten, highly scrutinized, but you are seeing higher balance loans still within these transactions, not to the extent of the 2007 or 2008 deals but traditionally when loans got to a smaller level they would refinance through a community bank. This is a big problem within CMBS right now.

A large portion of what you are seeing by way of the maturity risk that is coming due is because many of these loans that have amortized down, many of these loans that have done nothing that Mr. Paul said performed from the day one until now. They have paid their debt service. They have consistently had a good DSCR, debt service covered ratio, maintain a high level of occupancy, but there is no one willing to lend.

So they are left to either ask the CMBS world for an extension, a modification, or default and turned over the keys after doing nothing for five to ten years but pay on their loan.

Chair LANDRIEU. That will make people very angry, and we are going to try to avoid that because they are angry enough. So we are looking for some solutions and if you wrap up in 30 seconds so we can call on the others and throw out maybe one solution that you might see or do you think that anything Mr. Minnick or Mr. Paul or Mr. David said might work in your view?

Mr. INNAURATO. Definitely. 2010 we have seen the re-emergence of the secondary or conduit market, not to the levels that we hoped to see in volume and size. But as of mid November there had been six conduit deals placed or in the process of being placed which is very very good.

Really our suggestion is we feel at Realpoint that we were not part of the problem. We want to be part of the solution. Being relatively new to the rating of new issuance CMBS, I think we very much agree that with quality on the writing and with the right packaging of these loans that this CMBS market can be revitalized.

However, there has to be a willingness to lend. There has to be the availability of capital. There has to be quality underwriting but there also has to be investors willing to purchase the CMBS in the secondary market.

So it is one thing, two pieces of the pie really need to come together for it all to work.

Chair LANDRIEU. We hope your experience will be valuable to us in crafting a solution.

Jeffrey, we will do this real quick.

Mr. DE BOER. I guess I sort of said the key points earlier. But just if you wanted to get a couple of solutions on the table in addition to what Mr. Minnick has put forward, some people talk about this liquidity and the losses the banks have. Maybe a solution here would be to allow or an idea would be to allow banks to amortize the losses on the sale of these assets over a seven- or 10-year period rather than recognize them immediately. That might encourage some of these assets to move.

The key thing, you have to clear the bank balance sheet of toxic assets. You have to create more equity into the system, both for the lenders and for the borrowers. And, you know, you have to encourage risk taking.

The bottom line here is, you know, all of this, look, we went into this problem with commercial real estate relatively in balance. Okay. Supply and demand was relatively in balance meaning, you know, there was not huge vacancy rates for office, not large vacancy rates for retail or multifamily or anything else.

Why is there a problem now? Because the demand has fallen off. Why has the demand fallen off? It is not a secret. There are no jobs. And so the key to this whole thing—really we can talk about a lot of esoteric things. But as you well know, jobs. We need a solid program to encourage jobs.

And like I said, on the equity side, look, lenders need more equity. There are a lot of people sitting on the sidelines that want to put equity in. Some of these happened to be configured in private equity funds.

Now, I understand private equity is a negative word up here for some reason and with the regulators, but the fact of the matter is they have got capital. They would like to invest in institutions, and there are regulations that inhibit their ability to do that.

On the borrowers' side of things, look, these people, many of these borrowers are out of equity because they originally bought an asset for $100. They put $70 of debt on it. The asset is now worth $60. Their equity is gone. They have been hanging on because the interest rate environment is low; and so even though their vacancy rates have increased, they have been able to perform under the loan.

They are running out of juice. So they need equity investment either from the private world here in the United States, domestic people, or also from foreign investors. We have talked about how we could reduce the tariff for global capital to come into the U.S. real estate markets under this FIRPTA thing. And Senator Hatch and Senator Menendez and others are looking at that.

One final thing. Any time I am up here, you know, the main thing is, boy, do not do anything that would encourage risk taking or further put a boot on real estate as it is trying to recover here, and institutions trying to recover.

That gets into this carried interest debate that we do not need to talk much about it. But the bottom line there is this would be a severe impediment to a lot of very small real estate partnerships that are struggling to hang onto their properties and suddenly their tax laws are going to be changed many times retroactively.

So I just say let us find the way to increase liquidity. Let us find a way to bring in some equity and let us not, for god sakes, make things worse for struggling partnerships across the country.

Chair LANDRIEU. Excellent points. Any comments? I will have to turn it over to David. I have five minutes left in the vote and it takes me about five minutes to walk to where I have to vote. So I am going to leave in just a minute. And I will turn this over to David.

Bill.

Mr. ASKEW. If I could just add a comment to Stephen's and Jeffrey's.

Chair LANDRIEU. Go ahead.

Mr. ASKEW. On the fee issue, it is not just small banks. It is not just community banks. Fees are impacting all of the banking system. And if you look at the FDIC, just take that one item for a minute, if you look at the assessment last year, they added $15 billion to the industry. It took out all of the industry's profit, the entire financial industry's profit last year just going back to that fund.

So those fees. And then you add on the burden of the regulatory reform that we are going to have to follow, those fees are significant in this process so I just want to second that point.

Chair LANDRIEU. Thank you for clarifying that.

I am going to turn it over to David. He is going to conduct this for another 10 or 15 minutes. This has been extremely helpful. Obviously we are not going to find the solution this morning.

But I would like, Congressman, for you to add a few points as we close because I think that there have been several good suggestions and solutions put forward, and we are going to continue to work on this issue and present our findings not only to the staff here but to staffs on other committees as well because there is some urgency about this and we need to push this issue very hard through the lame duck, through the beginning of the next Congress so we can get something together and out there that would be helpful and supportive.

I turn it over to David. And thank you all.

Mr. GILLER. Thank you, Senator.

One crucial point, and perhaps, Mr. Paul, Mr. David, Mr. Askew can speak to, is to clarify why this issue, why the challenge of commercial real estate affects banks across the board. So even healthy, profitable, strong banks such as yourselves are dealing with this issue as well. I think it is an important issue to clarify. Commercial real estate is not an issue for everyone but it is not limited to, let us say, weaker banks. I would just like to clarify why this is such an issue even for the strong, healthy banks such as yourselves.

Mr. PAUL. Thank you, David.

I think the position that Eagle Bank and I think most community banks would have is that most banks in today's world are substantially concentrated in real estate. Certainly in the Washington metropolitan area real estate is not a very popular word.

The fact of the matter is if I could sit with a piece of real estate that has a first trust that nobody could take away from me, that is a whole lot more security than receivables or other inventory that could disappear very easily.

The real question in my mind comes down to how we resolve this loan to value side so it is not forcing banks to write down a very subjective evaluation. I still, as I mentioned in my testimony, am a firm believer that for an interim period, consideration should be given as to valuations being focused on debt service coverage, as Stephen mentioned, as opposed to a very subjective loan to value.

The issue as it is relates to banks, how it affects banks is that clearly a well capitalized bank, if they are forced to write down that phantom loss which is again that subjective loss, now all of a sudden takes a very well capitalized bank and puts them into a potentially much weaker capitalized bank.

That also, obviously, prohibits the future lending. And as the economy gets stronger, it is the community banks that are going to get us out of this. With all due respect to a lot of people around this table, we are at $2 billion. I define community banks at really $10 billion and under. I think those are the banks that are going to jumpstart this economy because it is all about jobs.

And when the restaurant needs that loan, it is going to be a community bank that makes that loan to be able to support their employee growth.

So I do believe that the 8000 community banks that we have are in serious jeopardy even if they are extremely well capitalized if we do not focus on this loan value issue. Thank you.

Mr. GILLER. Mr. Askew.

Mr. ASKEW. David, I will add to that. I agree with his point but I will add to that. If you look at the market right now, it is a trifurcated market in commercial real estate. There are the larger assets that price is actually improving on a little bit right now, albeit a little bit.

Then there is the distressed market which continues to fall. Those prices continue to fall. And then you have those assets in the small owner-occupied businesses that are just flat, and they are holding steady.

If you look at the large banks, to your question, to your point, we have been through those stress tests. We have taken those hits. We are in the state of recovery so to speak from the commercial real estate side.

But the issue is jobs. This whole issue with commercial real estate is 12 million jobs. I think it is more than that. This is just what we have identified. There is indirect support of jobs in the commercial real estate sector. If we do not get the jobs back, then we are going to go through this recession slower than we should. Those jobs impact all of us. I do not care which bank you are in. I do not care how big you are or how small you are, you cannot recover, you cannot get stronger unless the job market comes back.

Mr. GILLER. Dan.

Mr. SIGHT. Thank you, David.

Again I am here representing the National Association of Realtors. Most of our realtors are small business oriented and 54 percent of our transactions are a half million dollars are less. So we have got two extremes of the market. We have the CMBS and then we have what the commercial realtors are doing with NAR.

Our sales are down 80 percent from 2007, and as a result, 43 percent of our commercial realtors have not completed a single sales transaction this year.

According to our research at NAR, commercial real estate prices have plummeted as much as 45 percent from their peak. Let me take us back to Main Street as the Senator said.

I have a project in Kansas City. It is a small office warehouse project. Around $900,000 project, multi-tenant, seven tenants. The thing was going great. Did a 20-year amortization, five-year balloon. Went through the five-year balloon. We are looking great. We are starting on a short amortization schedule.

Two years ago crisis hit. So what am I doing as an investor? Just as I tell my clients, make a deal. My rents have come down. My job as an owner, as a broker as well, put somebody in there. So my rents have gone down, my vacancy has gone up. The cap rates that the appraisers are coming up with have gone up as well.

That property has gone down in value, hopefully not as much as the 45 percent but arguably somewhere in that range.

I come back to Mr. Paul or Stephen in two years when my note comes due. What are they going to do with me? I have made my payments, never missed a payment. My partners and myself are well capitalized. What kind of push are you going to be on to renew that note. You are going to look at it and go, well, the value is down. How do we refinance that, which is a real issue.

There are a lot of these projects like this all around America. A couple of things that NAR has proposed are term extensions so that these bankers are not penalized for me extending this loan.

Let us let the market take care of itself. Let us create some jobs. Let us fill up our vacancies. Let us get our rents back up but let us renew that note. Let us not take it into my REO property. Let us keep it going. So we are a real advocate for term extensions that will not penalize our lenders.

Another thing that we talked about is mortgage insurance for loans that are performing. There is an equity gap maybe between what they are valued at, what the loan is. Maybe we should look at some private mortgage insurance that could be paid for by the bank. It could be paid for by the borrower, mostly by the borrower. But to ensure that that money is there to keep the market moving and going.

Something else we talked about, jobs. Lawrence Yun, our economist, did a presentation for us in May this year. 2007 everything was pretty rosy in commercial real estate. Sales were good. Market was good. We were just rolling along. Then when he started overlaying our job losses, it became really clear to me as a simple person what happened to the commercial real estate market. We lost jobs, do not have as much demand for office, do not have as much demand for retail, do not have as much demand for industrial. We really need something in this country to get people back to work that will help fill up our spaces and will help stabilize the values of commercial real estate.

Mr. GILLER. Before we move on to the next question, does anyone else want to clarify? I think it is an important to clarify why the commercial real estate issue is not just a problem for underperforming banks, it affects all banks nationwide even strong, profitable performing banks.

Mr. ARBURY. I think what we really have gotten into is sort of a valuation nightmare. I mean we went from a period prior to the bursting of the bubble where the big financial institutions refused to recognize that values have dropped and now we have gone the other way and now we have got values, whatever appraised values, based on the few sales that exist being way under what the discounted cash flow value is of a property.

And so that leads to liquidity and you will never get jobs back, you will never get construction back, for example, multifamily. We have got a huge demand looming out there and we will never be able to meet it unless we get liquidity back. Valuation is a big problem.

Mr. GILLER. In a minute I want to turn it over to my Republican counterparts to ask a few questions but I realize the two of you have not had an opportunity to present your opening statements. Would you like to do so now?

Mr. ARBURY. I will do one minute.

Having been a former Senate staffer, I know not to go too long here. The news from multifamily is pretty good. I mean I can see growth, the growth being that occupancy is up. The demographics are out there.

But I think that a number of financial institutions have gone from being risk managers to be risk-averse, and being risk-averse means you probably have to turn down just about every loan that comes to you, either forced on you by the regulators or by whatever financial position you are in at the time.

Multifamily is the ultimate small business. 55 percent of apartment properties are owned by individuals. So there is great competition. But without liquidity, and we have got to get through this financial crisis, but without more financial liquidity we would just not be able to meet the demand going forward that is there because the demographics have definitely changed. And multifamily gives workers much more flexibility in terms of being able to move around the country to find a job as opposed to being stuck where they own something.

I will stop right there.

Mr. GILLER. I want for a moment to check back in with the Honorable Congressman Minnick to see whether you have any observations or comments on what has been discussed.

Representative MINNICK. Well, the problems that affect banks of all sizes but are particularly acute for our smaller banks all involve capital liquidity or concentration or some interconnection of those three. And the problem of capital adequacy is exacerbated by declining asset values and that is the big problem when you have commercial real estate that is, was at one time worth $5 trillion and now is approaching less than $3 trillion.

It seems to me the solutions on the capital side, there have been a lot of good ones that have come out in this forum, include term extensions for performing loans without an intermediate write-down even if the asset values are questionable. Acceptance of an MPV-based assets as opposed to, valuation as opposed to last distressed sale comps makes a lot of sense.

The suggestions slightly more controversial in my mind that you allow the amortization of recognized losses certainly has merit particularly when it is coincident with a period to raise capital. It is easier to raise capital if you do not have to take an immediate write-down.

I think one of the things we have not hit on as hard as we might is the problem of pro-cyclical regulation. We have the FDIC. Chairman Frank and I sent a letter to the regulators earlier this year, saying let us not use belt and suspenders regulation. Let us enforce. Just because you have had bad experience that does not mean you should pile on the pro-cyclical regulation.

So all of those things affect capital adequacy, and in combination, can deal with the shortfall and make it possible to raise capital and save half of these 2- or 3000 banks that will be at risk.

The other questions of the liquidity and concentration are addressed by jumpstarting the CMBS market, and several comments have been made that the CMBS market is coming back. But let us recognizes it is barely coming back. We are talking about $8 to 10 billion this year as opposed to $207 billion before the crash, and the properties involved are mostly large trophy properties. They are not Main Street properties.

The problem is, I think everybody on this panel has remarked, is Main Street creates jobs. And small business relies on the Main Street banks for their capital. So if you want the smaller banks to have the liquidity, particularly if the regulators says they are over concentrated, you need something other than a distressed market to provide a way to sell property that they have their loan against whether it is performing or nonperforming.

The bill that I have sponsored would jumpstart the CMBS market for the smaller properties, hopefully get back to that $2- or 300 billion worth of capacity that we need to refinance this onslaught and do it in a way where the banks can sell it at fair value, not distressed value.

And with respect to concentration, if the FDIC says you should be one to one and you are three to one or four to one, this gives you a way to reduce your concentration without having to stop, with impairing your capital and without having to cease making new loans.

You can sell off the loans to get the proper concentration that the regulator specifies and then you can sell somewhere in order to get the liquidity to make the next loan. It seems to me in combination with all of these things we can, this is a catastrophe that is going to happen but it is entirely preventible if we take the right regulatory and legislative steps to do so.

And I think the ideas coming out of this forum really provide the list of things that needs to be done by both regulators and the Congress over the next six to eight months.

I would like to see it between now and the end of the year.

Mr. GILLER. Just to follow up on one of those issues, the pro-cyclical nature of regulatory action and Mr. Askew mentioned this issue of the October 2009 guidance that all the regulators came out with, the prudent commercial loan workout guidance. And before your Committee, Chairman Bernanke said, yes, our examiners should be following this guidance. They should focus on values or cash flows and not values of the collateral. But we are hearing that every examiner in the field is sponsoring this.

I know that you and Chairman Frank have requested a GAO study on that issue. If you could just talk a bit more about what has motivated that request for GAO study and what you are hearing about the regulators in the field.

Representative MINNICK. No examiner ever got fired by being too tough on a financial institution. They only get a black mark on their job evaluation if an institution that they have accessed subsequently fails.

So there is a natural human interest, when times are tough and examiners had a bad experience, to ensure that it does not happen on my watch again. So even though the regulators who come before congressional committees, both in person and in hearings, and say, yes, we are following these regulations. It is not pro-cyclical. We have not gotten tougher. That is not the experience that our bankers see the next time the examiners show up.

So I am from Missouri with respect to whether or not this guidance is in fact. It sounds good when you hear it but on the ground the experience is very different. I think that goes through to the ability of senior managers and regulators to enforce the idea that it is okay to take a few risks as an examiner because you do not want to cause ten banks to fail because of your regulatory assessment when, if you had more sensible regulation, one or none would fail. And that is the experience and the problem we have on the ground. It is ground truthing what we are told in testimony.

Mr. DAVID. Just to comment, I think Jeffrey made a comment about a possible suggestion being writing things down over a period of time. We are dealing with capital appraisals, all of a subjective nature, and it appears time is an enemy. And with using things such as giving it time to write things down, use time as an ally because the values were here, they are here, they will go back up in time. So the more time that we are allowed to write down a property, the better the outcome will be because the economy will come back. How much time it will take or when that will be is certainly uncertain.

If we are able to create more jobs, it will come back quicker. When that is done, then the total losses get cut substantially. So I think we need to find solutions where time is an ally, not an enemy.

Mr. DE BOER. Just a couple quick points. You had asked, David, about why should healthy banks be concerned about this as opposed to a bank that is heavily laden with real estate losses or something like that.

It reminds me of a time I sat next to a banker at a dinner and asked him how, I said you must be under stress. This was around early 2008. He said, oh, no. Life is good. We did not make any subprime loans.

They quickly were under problems a short time later. So it is sort of a contagion. If your building next door is exactly the same as the building that you are in but it loses tenants and it loses value, you are going to lose value as well even if you are well-tenanted. It is a very contagious type of situation.

As far as why are small banks more affected than larger banks, we talked about the stress test and so forth, smaller banks, this is the life blood for jobs in small business in local communities.

The banks used to have the flexibility to work with local businesses to make sure that they had the credit to grow and create their businesses. A lot of these loans were not what might be called extensions, just strict extension of credit.

I think these gentlemen would say they are an investment in the business plan of that borrower and they believe in that person. These business plans, because of what is happening in the macro economy, because of the loss of jobs and so forth, these business plans have now been put on hold. But that is all they have been put on in many cases. They have been put on hold.

What has been suggested here is once you get the economy going and you get time, and time is an ally, these business plans will come back. I think it was suggested here in an example where, you know, you were going to do something and you put it on hold for a while.

This stuff will come back if you have time to allow it to do so. So I think some of this flexibility is very very important. It is a systemic problem that has been mentioned.

I guess I would make one other point about the CMBS market. I am a big proponent of the CMBS market. I think it is a very important source of capital for commercial real estate and for the economy.

I also do not believe that a lot of the small business loans are necessarily securitizeable or securitized loans. These are loans that, small business loans are more made on transitional assets. Again you are starting your business. You are starting to grow. You have not tenanted up your building yet and you need financing to get through.

The securitized loans by and large are made on stabilized assets. They are made by the money center banks. They are made by life companies, the securitized lenders. They have a very important role to play but it is not this role. I think that is an important thing to just note for you, David.

Mr. GILLER. I appreciate that. Just one quick one before you go on.

For the purposes of this conversation, I think it is important to highlight the crucial role that the CMBS market does play for providing liquidity to the commercial real estate market. In general but again from our perspective for the Small Business Committee, for small business lending, yes, peripherally small business lending is affected by the CMBS market but really we are primarily focusing on the non-securitizeable loans, a couple hundred thousand dollars, a couple million dollars, 10, 15 million which, to your point, are not directly affected by the CMBS market.

Mr. SIGHT. A couple of other things I wanted to mention. Yesterday I was at a lunch at a regional bank in Kansas City. They had their economist there and I met a gentleman who had a small manufacturing, not so small, 300 employees, growing the business. They make decals and all sorts of fun bumper stickers and things like that.

I mentioned to him that I was coming up here. I said, how is your business? He goes it is good, and I go, well, are you hiring anybody? He goes, no. I said, do you plan to? He said not until I know what the playing field is.

So I talked to him. I talked to other business owners. What are my health care costs going to be? Do not know what they are going to be. So I am worried about that. I am worried about government regulation. I do not know what the playing field is. I am not going to make business decisions on growing my company until I know where it is.

That is one thing I wanted to make you all aware of. The other thing I wanted to mention is something that is very disturbing to myself and the National Association of Realtors of the change in FASB laws on lease accounting.

I am sure you have looked at it and researched it. We cannot really find anything that is going to be very helpful to commercial real estate in that proposal. I know that is not something that the Senate can regulate or do a whole lot about. But I am really concerned about that issue about putting leases on balance sheets.

For my banker that I talk to about that he said that is great. We are going to put it on there as a liability. The lease then becomes an asset but in reality is it an asset? They are going to discount that asset. So it is going to muck up, if you will, a business owner's financial statement. It is not good for commercial real estate in an already down situation.

Mr. LUCAS. Thank you very much. Unfortunately Senator Snowe cannot make it today due to another commitment, but she is very engaged on the issue, extremely concerned, and thanks all of you for coming.

One thing that really stuck in my head was something that Mr. David said when he talked about appraisers and how they are scared of their own shadow. I think we have a situation, and Congressman Minnick touched on it a little bit, where we have an issue with regulation and maybe over regulation.

Is there something we can do to steel their spines when it comes to appraisals to prevent this sort of thing from occurring? Is that part of the solution you see to the problem in commercial real estate?

Mr. PAUL. I am a firm believer for an interim period of time appraisers, if in fact that is going to be the gold standard, that the appraiser should be required to work off of the debt service coverage and not true valuation.

What we are consistently hearing around this table is that the property that was valued at a million dollars and the cash flow is the exact same today as it was five years ago, there is no reason that an appraiser because there was a problem with the building next door should all of a sudden discount that the $600,000.

It goes back to David's earlier comment that when it goes from a million to 600,000, and that bank has to write off that 400,000, clearly that has an impact on what it is going to be able to do in the future in terms of additional lending.

So by far, the debt service coverage should be the governing rule for a certain period of time, as Stephen says, to give us the opportunity of time to get through this crisis. Thank you.

Ms. MCWILLIAMS. Would you recommend this be done only for performing loans that so far the debt to service coverage would be sufficient to cover the monthly loan payments?

Mr. PAUL. Yes. I believe that if you can look at a performing building and accept the fact that there is no expected dramatic change in that cash flow so in other words you do not have a major tenant coming up for renewal in three months that if it can be demonstrated that that cash flow is projected to continue in the foreseeable future or certainly during this moratorium period that it be considered a performing asset and that would go, even current loans that are in the nonperforming standard should be reevaluated to be able to move to a performing standard.

Mr. DAVID. I think another issue, and we just finished a safety and soundness exam, and what I am seeing in the field and hearing from other bankers also is, and one of the things that Dan alluded to, is when you try to reschedule the loan if it had been on a 15-year pay out, because income or rents are down, that you may want to go to a 20-year. Or if you allowed him to pay an interest-only payment, what we are seeing from the examiners is that has immediately become a substandard loan whether the values are there or not.

And so that is an issue that I just went through. I mean we literally finished a week ago with an FDIC safety and soundness exam. So that is an issue that needs to be addressed.

Ms. MCWILLIAMS. If I can follow up on the question of bank examiners and the Federal regulations. From most parties that we spoke with, we heard that the 2009 guidance was actually very helpful and useful in this process, but the issue is that examiners on the ground are not following the guidance to a "T" for a number of reasons, as Representative Minnick outlined.

Apparently what we are hearing is that the appraisals are playing a huge role in the inability of banks to refinance these loans, followed by the strict bank examining procedures on an ongoing basis. If the bank examiners were to follow the guidance to a "T", what portion or percentage of the problem would be eliminated?

Mr. PAUL. A major, major, major part of the problem. We stress test our real estate portfolios by, on a quarterly basis, increasing our interest rates by 200 basis points and decreasing our rental income by 10 percent. And with that stress test, 90 percent of our portfolio continues to perform as negotiated in the loan documents.

I wish that the regulators focused on that stress test as opposed to requiring appraisals to be done on a regular basis. The stress test in my mind is indicative of where the project is going in the future and, therefore, I should not be required to write down a loan if, in fact, the debt service coverage is being maintained and that stress test confirms that it will continue to be maintained.

Mr. GILLER. Just on that issue I feel like we would be remiss if we did not quote Chairman Bernanke, who, in front of the House Financial Services Committee, the semi-annual monetary policy address to Congress, February 24th of this year, he stated, "We have issued guidance in commercial real estate which gives a number of ways of helping, for example, instructing banks to try to restructure troubled commercial real estate loans and making the point that commercial real estate loans should not be marked down because the collateral value has declined."

And this is the key line here.

Quote, "It depends on the income from the property, not the collateral value."

This is precisely the issues you were talking about. It is precisely the issue that Chairman Bernanke refers to in the October 30th, 2009 guidance. And for whatever reason, as Congressman Minnick has suggested, there is no consistent implementation of this guidance.

Is anyone hearing that there is consistent implementation of this guidance on the ground?

[Pause.]

Okay. That is a fairly universally accepted truth.

Mr. ASKEW. David, you may expand that to say, is there any consistent interpretation of the guidance, and that is what is lacking. They interpret it different ways. That is the problem.

Mr. DE BOER. Bill, that is an interesting point in the sense of what this group might able to be assisting here is to underscore the thoughts and give more flesh, if you will, to the guidance so that the examiners feel a more compelling case in what they are supposed to really do. It is a little murky. Although we think that language is clear, I think they have room for interpretation, and perhaps some underscoring or sharpening of that, polishing might be useful.

Mr. PAUL. I think we all discussed the regulatory side of this and how the regulators are not following the quote that you just gave. But I believe going back to your point earlier, David, is that we really need to drill down to the small businesses and understand exactly what impact the current banking issue is with regard to small businesses.

There is a chart that I hope everybody could read that looks at the loan to deposit ratio. On a national basis, we are at an 85 percent loan to deposit ratio. And for those bankers that have been around for a long time, that was pretty much the norm 20 years ago. That is where you wanted to be.

If you look at the strong markets, you will see that Washington, D.C., as an example is 96 percent. So when the markets come back in the other areas, we are going to get back to that 96 percent area.

In my opinion, from a regulatory perspective, that is not the place that anybody wants to be. I think it is not anecdotal that what Jim was talking about earlier that the strongest market is multifamily, and multifamily is as strong as it is because there is a place currently to be able to place that debt. If that disappears, that is going to be a major, major problem on the multifamily side. And I think what we are talking about is how do we find that same opportunity to create liquidity within the smaller size of loans, not only in the real estate side but on the overall business side.

Mr. GILLER. Just to follow up on that and to steer it really back to this issue of small business lending, there are some numbers on the bank concentrations that I would just like to read.

This issue does have a kind of disproportionate effect on the small banks and on small businesses. Dennis Lockhart, president of the Atlanta Fed, has spoken about this. You have got roughly 4000 banks between a $100 million in assets to $10 billion. This community bank, not including under $100 million, and again this is out of about 7800 banks nationally.

So on average these 4000 banks are considered by the regulators as being commercial real estate concentrated, which means that their commercial real estate holdings are about 300 percent, as you know, of tier one capital.

Unfortunately for the small businesses, these 4000 or so banks with the high real estate concentrations also provide proportionally higher amounts of small business lending, so about 40 percent of small business lending in the country is through these smaller banks, the community banks.

So just to focus the issue and kind of highlight why this is such a big issue, what happens to small business lending if these 4000 community banks suffer in the next three years? I would like to get your sense of what the worst-case scenario is, best case scenario is, how many bank failures we are talking about, will this lead theoretically to a double dip recession, is it not that severe?

Just get your take generally in context, putting this in the context of greater kind of the financial crisis, how serious this issue is specifically for the small business owners.

[Pause.]

Mr. PAUL. I guess I win by default.

I think the answer to that is that if, as we all sit around this table, is that it is clearly the small businesses that are going to jumpstart the economy and supply the funds to be able to build employment and growth.

The concern that I have is whether it is a liquidity issue or it is a write down of capital because of the commercial real estate valuation side. It will impair the opportunities for us to make those loans to the restaurant or the manufacturer or whatever the case might be to when the economy comes back.

I believe what will happen is that you are effectively tying both hands behind the economy's back because if you do believe that it is the community banks that will provide that source of funding to allow the economy to grow but at the same time you are hitting the capital side, not providing the liquidity, how do you expect, in fact, that liquidity to go back into the small businesses.

So I think it is a very dicey, risky position that we are in right now if we do not address my two biggest concerns being liquidity and valuations.

Mr. GILLER. Thank you. I want to turn to Mr. Askew to get the Financial Services Roundtable perspective specifically on this issue of liquidity, scope of this problem, and what your folks are thinking about the issue.

Mr. ASKEW. Okay. Clearly commercial real estate is a bigger issue in the smaller banks. That is a true statement. I want to go back to something that Jeffrey said about this CMBS that I want to kind of caution everybody about.

Remember where the majority of your small business loans are still made. They are made in the larger banks. And remember where half of your commercial real estate is in those larger banks, or maybe a little bit higher.

But the fact is when a CMBS, the way a commercial real estate property works, back to the idea of your property is performing and you have got your rents paying the cash flow, the property is cash-flowing, if the property across town or in the same area or even close goes dark, what happens is it is a downward spiral because what they wind up doing is opening that up at half the rates of the other property.

And so you wind up with bringing down, the leases move out of one property and they move into another, and it is a process where we all have to be in this together.

We have to get this entire commercial real estate market well. I do not care which property type because we are in those same markets that the community, our community banks are in those markets. They are a third or a fourth or higher of that market so they are part of those local markets too.

But the point about the economy, I do not think it is going to cause a double dip recession. I think Ben Bernanke and Tim Geithner and our people who are leading that have said they are not going to have special commercial real estate policy. They are too smart that they are going to allow this to double dip this economy. They know a lot more than I do about it.

But I do believe it is going to be a drag on the economy. I do believe that chart you had put up there shows what a drag it is going to be. If you let interest rates go up, right now interest rates are an all-time low. That is what is keeping, that is why the commercial real estate market is doing as well as it is and that is why you saw some improvement in prices earlier in the year. It is because of interest rates.

But if those interest rates were to go up dramatically, then you would have a different story. It is going to be a drag on the economy but most important it is going to be a drag on jobs, David.

And I am talking about jobs, not just jobs to fix the CRE. I am talking about jobs related to the CRE, jobs related to servicing commercial properties, jobs related to apartment buildings, jobs related to hotels. Those are the 12 million jobs I am talking about.

So if that begins to answer your question. I think it is an issue for all of us to deal with.

Mr. GILLER. I would love to assume that the Small Business Committee and the Senate have jurisdiction over monetary policy but no one in Congress does. Thank you.

Mr. LUCAS. I do think that is a great point and it is very sad and tragic that we do not have jurisdiction over that but it helps inform us in terms of the policies we look to craft.

So I just wanted to ask, Mr. Innaurato, as you are looking at rating the CMBS market generally speaking, are you looking at that as something that is a concern? If it does occur, which it looks like it might, what sort of damage could that do? And if anybody else generally wants to speak on that.

Mr. INNAURATO. One of the problems that we see very easily, you have a performing loan. Let us say it has a debt service coverage ratio above 1.2, occupancy 85–90 percent. It has been cash flowing. Loses one of its tenants. Finds out that the tenant is gone because, as was described, the tenant went around the corner to a vacant property and got half the rent.

The next thing you know there are co-tenancy clauses within the structure of the leasing, and more of the property goes downhill, and now within a six-month time frame, you had a property that was performing for the last five years is now underperforming.

And because it originated in a lower cap rate environment, from a valuation standpoint based on even stabilized income, you had concerns about the value. Now you have substantial concerns about the value.

I think overall from our perspective we have a delicate balance in trying to be conservative but not overly conservative because we are seeing transactions occur not only for distressed properties but willingness for your more savvy investors to step in and say we see the upside in this particular property, in this particular market and do not believe in the valuations that are being published for these properties today.

Because of that, you are seeing what you would think would be unheard of cap rates being reported on some of the transactions. Properties changing hands as low as 3 to 4 percent on today's income which is distressed but with the upside of growing in a more stabilized market.

So from a ratings perspective, we are trying to say, for lack of a better term, stabilized, how we are approaching the nonperforming assets versus the assets that are really kind of on the edge because, in theory, anything that was originated from 2001 to 2008 at a 6 percent cap rate even performing today, if I value it at an 8 or 9 percent cap rate, you go from a 70 percent loan to value to over 100.

So, in theory, if you were doing it just for book purposes you have a loss on every property that was originated during the peak of the market.

I am speaking in generalities. One of the pieces of my testimony that I did not get a chance really to focus on I think that affects all the banks, whether of large scale or small scale, is the warehousing risk for a bank.

Many of the small community banks that were available to do refinancing for loans that were coming out of CMBS or loans that had amortized over time or through relationship lending, granting an easy extension, the fear today is that, from a warehousing perspective, if I grant these terms today and something in my market a week later, a month later, causes an appraiser to come in and now say, well, you valued the asset here. We are now hitting at another 10 to 20 percent. None of the banks want to take on that risk.

That is slowing down the resurgence in the CMBS market because of the warehousing risk of originating loans and not having the ability to immediately put them into a new securitization.

Many of the deals that we have even looked at this year from a new issuance standpoint, that has been an issue. The investment banks do not want to sit and hold these loans for a long period of time because historically they have been used to originating them, putting them together, putting them into a CMBS. Move on to the next transaction.

And I think for the community banks where more of that relationship lending went on, I think the fear is that we want to do more business but what is the impact a month from now, six months from now if, in this market, I do not have the liquidity I need to support your loan or I do not have the flexibility based on the limitations that are being presented to me to do so.

So I kind of talked in a little bit of a circle to try and address all of them. From a pure ratings perspective on new issuance CMBS for us it really comes down to quality of underwriting.

The aggressive lending that was prevalent during the peak of the market and the aggressive underwriting per se on what was termed pro forma loans, loans that you hoped would generate levels of cash flow through new tenancy there is no existence of that today.

So unless you are bringing loans to the markets that are very stable and have shown low leverage, high tenancy, it is very hard to securitize today's market.

We are hoping that as we go into next year that the momentum that is starting to build will continue to grow and we will see more traditional conduits.

Ms. MCWILLIAMS. If I can just follow up on something you said and you repeated it from an earlier statement—that a number of these loans were based on very aggressive underwriting standards. Some of them should not have been made.

The underwriting on commercial real estate loans is not as bad as on residential real estate and subprime, and we recognize that, but do you have any indication or data to support a statement that a certain percentage of these loans should be allowed to fail or default because they were not properly underwritten?

Mr. INNAURATO. I do not have statistics to back up that statement per se. Oftentimes even our investor clients have been unable to identify throughout the legacy CMBS deal which loans were considered pro forma underwriting versus traditional underwriting.

What we have tried to do in house is look at the loans that, say, for a period of time, say from 2004 to 2006, if this level of cash flow was consistent, and this level of performance was consistent, why, as part of the underwriting, did you expect it to go up 20 percent, and then why did you lend at that time, at 20 percent higher level expecting the growth?

When the markets collapsed, as I alluded to a little bit, those 70 percent loan to value immediately, almost overnight, became 100 percent loan to value loans. So in this market, in my opinion, if more stabilization was presented to community banks and to larger banks and larger institutions to not be fearful that loans that are generating enough cash flow to cover their in-place debt service and in-place interest rates, especially with the support of a lower interest rate environment, if there was not that fear that they may be taking on a loan that could be requesting a modification or debt relief in the near-term, you would see more lending, you would see more securitization because if you attend any of the industry conferences that we are a part of, there is a lot of money still sitting on the sidelines from an investment standpoint that wants the CMBS market to return, maybe not to the levels we saw during the peak because we might not have to get to that level if the community banks can pick up the slack on the refinancing that is due to come.

Ms. MCWILLIAMS. If I can just ask you one more question, what would represent a healthy CMBS market in your view?

Mr. INNAURATO. A healthy CMBS market would probably be closer to what we saw from, say, 2001, pre 9/11 2001 through, say, 2003 and 2004. They were averaging probably $50 to $75 billion issuance per year.

It really was not until we got into 2005 through mid 2008 that you saw the lending get to such an aggressive standpoint that every month even for my business as it was, at the time again focusing on small business, we were a 35, 40 person shop and every day a new CMBS transaction was coming to market, that our investor clients were coming to us and saying, break down the real estate, tell me what is going on.

But for a large period of time because the markets were good not everyone was concerned about the underlying real estate and the performance. As the market turned and more loans got into distress, a typical conduit loan or conduit deal of 150 to 200 loans, anywhere from $3 to $5 billion, if you start saying that 40 to 50 percent of that transaction is now in distress, the volume of work definitely picked up.

I think that from a stabilized standpoint, our hope is to optimistically get to the level that we saw in the early 2000s.

Mr. PAUL. One additional comment I want to make on that is many of the CMBS loans that were made were also made at incredibly low interest rates. So at some point at the peak of the market in 2006, 2007, it was not unusual to be able to get a 10-year CMBS loan at 80, 90 basis point over 10-year treasuries.

I do not think anybody sitting around this table would make that type of a loan at the interest rate at this point. So should rates go up as somebody was mentioning earlier, when that loan does become up for renewal, there is a significant sensitivity that we have to look at because of the difference in the current interest rate environment versus what it was underwritten at.

Ms. MCWILLIAMS. Would you say then that an improvement in the CMBS market would help even the community banks that keep the loans in their portfolio?

Mr. PAUL. I could speak to Eagle Bank. Eagle Bank has an average commercial real estate loan of $1,312,000. That average loan is obviously not going to be a CMBS participant. So I go back to the two points.

Obviously as we have grown, the loan requests that we had have gotten larger but I do not think that it is going to be those trophy-type projects that are going to be brought to a community bank. They are not going to be the type of projects that, Dan, you mentioned earlier. It is a warehouse, we have some issues, can you help me, those are the type of projects that are going to be brought to a community bank. It is not the trophy projects that will go to the CMBS side.

Mr. INNAURATO. Just for clarification, the majority of CMBS loans are under $10 million that are on the books today, and so not to confuse that all CMBS loans are large or huge loans. They are under $10 million, so just for clarity.

Mr. DAVID. I think it is important to remember from a community banking standpoint, we are talking about CRE, by definition CRE, things that qualify. But I think it is real estate in general. A lot of the loans that the banking industry makes to its businesses are not CRE loans.

When we talk about regulation and we talk about appraisals and all of those things and we talk about job creation, those are the issues that I face. Buying loan portfolios secured by real estate is probably close to 90 percent but maybe 40 percent of it is true commercial real estate. The other ones maybe a loan to a local grocer. That building and the property is the collateral but it is not a commercial real estate loan from a regulatory standpoint.

I think it is important that we keep in mind that it is all real estate. For a lot of them it is their home that they may own, and that is what I will use as collateral to do the business. That is where the job creation comes from. It is not just commercial real estate but real estate in general.

Mr. GILLER. And we are hearing that there is some confusion from a regulatory perspective on specifically those types of loans,

loans secured by commercial real estate but really it is a working capital loan.

So it is not a real CRE loan but there is some confusion among the regulators who are classifying this as CRE.

Mr. DAVID. That is happening because they gleaned their numbers straight from the call reports that are filed with the FDIC. They are looking and saying everything on that line item is commercial real estate so they are doing their formulas accordingly as that divided by the capital. If you are exceeding 300 percent or not, but not everything that is listed on that line is, by definition, commercial real estate. It is real estate to a commercial borrower.

Mr. GILLER. Thank you. Just to wrap it up, we understand we have been discussing several issues. The main issue seems to be this valuation nightmare. There is downward pressure from the regulatory environment, downward pressure also from appraisers.

Related to it or even a separate issue, there is this issue of liquidity for the smaller banks. That ties into the CMBS market. I guess an open question is for the smaller banks how directly they are impacted by the CMBS market, and if folks have final thoughts that you would like to leave us with, we can go around, and also we are going to be leaving the record open for about a week. If there are additional written statements or pieces of information or data that you would like to submit, it will be left open for another week.

If there are folks who would like to leave us with some parting words of wisdom that we should bear in mind as we tried to address this.

Mr. DE BOER. David, there were a lot of terrific points and this is a great discussion to have. It is very circular, is it not? I mean, it is jobs, values, credit, growth, jobs, and instead of focusing on any one of those, you have to focus on all of them.

We have talked about the need to get jobs all across the economy, not just for community banks or for small businesses but for the macro economy. It is all interrelated.

Your question about, you know, does the CMBS market directly benefit smaller banks? Maybe it does not but just like a healthy building is infected by an unhealthy building next door so to speak, if we can create more credit for the overall commercial real estate marketplace even with those assets that are CMBS quality but may not be of the size that Mr. Paul is doing, that will help the whole system.

It is that whole circle that I think you need to think in terms of. How do we expand credit availability across the board and encourage entrepreneurship? How do we encourage jobs across the board? How do we work on this value issue across the board?

Value is an interesting thing. We are talking about depressed values in this conversation but the reality is, as Frank mentioned, in parts of the marketplace there are almost irrational high values because there is a shortage of quality assets that are coming onto the marketplace in strong gateway type cities that are well leased.

When those assets come on the marketplace, you have got this tremendous amount of capital waiting to play, and so they bid up the price, bid down to cap rate, and so we have this bifurcation that is going on that we talked a little bit back there.

Again there are no conclusions but I think this is a really good forum to get a discussion and maybe you have come up with some ideas that will help all of us.

Mr. ASKEW. David, if I could just add that with that circular idea in mind which I agree with 100 percent, I will submit our white paper paperwork which I have given to you for the record because we did spend the last year with the trade organizations focused on commercial real estate builders and investors and banks and insurance companies and we did come up with 51 recommendations. This circle is going to take a lot of issues. I think we have covered, and I do not mean to sound like we have the answer to everything, but we did cover most of the issues that were discussed in this room today. So I will submit that for your gleaning and looking at, consideration.

Mr. PAUL. Just as a last comment also, I truly appreciate the opportunity to do this. I think there has been a lot of great discussions.

Bill, I hope that we can all get copies of that white paper because I think it would be very interesting.

Just as a final comment, obviously I am a huge proponent of community banking and believe in the tremendous need of community banking. And my biggest concern right now is that if we do not react very quickly to the points that have been made today, I see a tremendous amount of transfer of wealth going from the community organizations, the strong community people that support the community and being shifted back into Wall Street.

And I see if foreclosures continue with the huge 96 percent that you mentioned on the increase of the delinquencies and requests for the structuring of the CMBS market, if there is something that is not dramatically done, you will have a transfer of wealth back to Wall Street which is, I think, exactly where we started from which we are desperately trying to avoid reoccurring.

I say that we have a limited period of time in order to address these issues and hopefully the community banking world can participate in helping that but not under the current circumstances.

And again I thank you for the opportunity.

Mr. ARBURY. I think if we stay in a risk-averse mode for much longer which I understand why we are there because of not being reasonable risk managers going into the bubble and through the bubble, it will be a long time coming out of this and what Ron just said will probably occur. But we have got to get back to reasonable risk management and away from being totally risk-averse which are two totally different things.

Mr. SIGHT. Just to finish up, I think from a lender's standpoint, from a borrower's standpoint, from a realtor's standpoint, from tenants' standpoints, business standpoints, what would really help all of us is confidence from the government, confidence that the U.S. is still working, the world is still spinning, this is still a fantastic country to be in and to start a business, and we need that confidence from our leaders so that people are willing to go out and risk and to start new companies, to grow their companies, and that would, I think, really help all of us in this country.

So thank you.

Mr. GILLER. Thank you all for participating. I know it is a weekday and so thank you so much for your time.

We look forward to continuing to work with all of you and to continuing this conversation as new ideas or other thoughts come to you. We would like to talk about next steps on how now do we get around this problem.

Thank you very much.

[Whereupon, at 12:19 p.m., the roundtable was adjourned.]

APPENDIX MATERIAL SUBMITTED

STATEMENT
"SMALL BUSINESS ACCESS TO CAPITAL: CHALLENGES PRESENTED BY COMMERCIAL REAL ESTATE"
SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP
Ranking Member Olympia J. Snowe
November 15, 2010 v1

Thank you, Chair Landrieu, for holding today's roundtable on a critical problem currently facing small businesses and the economy at large, the impending capital crisis in the commercial real estate market. This problem is *not* just localized to high foreclosure markets such as California, Nevada, Arizona, or Florida. It appears to be a threat to communities across the nation and, in fact, just three weeks ago in my home state of Maine, I heard from realtors about the devastating effects that a lack of capital is having on their business.

I thank all of our panelists for taking the time to join us today to discuss this issue, which is a lynch-pin for our economic recovery. Chair Landrieu and I worked to help address this issue in the *Recovery Act* by including language that would allow borrowers to refinance into the 504 program for the *purpose of expanding their projects*. This provision was later expanded in *Small Business Job Creation and Access to Credit* to allow *all* commercial real estate borrowers to refinance into the 504 program and receive a lower interest rate. The SBA has estimated that once this provision is implemented, it will help to refinance an estimated $20 billion a year in commercial real estate assets.

In addition, increasing the maximum loan size of the 504 program from $2 million to $5 million, which I proposed in my "*Next Steps*" bill, and was included in the Small Business Jobs bill, will increase the availability of the 504 program for larger commercial real estate properties. These steps are positive progress for the commercial real estate market and I thank Chair Landrieu for her bi-partisan work with me on these key issues facing investors in Maine and across America.

Today's roundtable moves beyond the SBA and the *Small Business Jobs Act* to address the astonishing estimated $1.4 trillion in commercial real estate loans maturing in the next three years. These loans represent a wide variety of businesses from corner stores to mega malls. Without the ability to access capital there will be, according to a report issued by the Congressional Oversight Panel Chaired by Elizabeth Warren, "...significant bankruptcies among developers and significant failures among community banks." It is vital that Congress work together to find solutions to this problem so that this disaster does not come to pass.

One area that I am particularly concerned about is performing non-performing commercial real estate loans. A performing non-performing property is one where a borrower continues to make payments on the real estate loan, but the underwriting standards that were used to originate the loans – the tenants on that property for example – are no longer paying the borrower. The end result is that a bank will call the loan depriving the borrower of essential capital and forcing a viable business into bankruptcy.

This Committee addressed a similar problem, technical default, in a hearing held on March 19, 2009. A technical default occurs when a borrower continues to make loan payments, but their revenue or profit projections have dropped to a level where their banks can cut their line of credit or call their loan. During this hearing we heard from small business owners who owned viable businesses but were being forced into default through situations beyond their control. The problems raised by performing non-performing real estate are similar and we must be vigilant to ensure that a similar crisis does not take place.

Chair Landrieu, I look forward to hearing from today's witnesses on financing commercial real estate and I thank you again for holding a roundtable on such an essential topic.

NMHC National Multi Housing Council®
Apartments: Smart Communities, Smarter Living

NAA National Apartment Association

STATEMENT BY
JAMES ARBURY
SENIOR VICE PRESIDENT OF GOVERNMENT AFFAIRS
ON BEHALF OF THE
NATIONAL MULTI HOUSING COUNCIL
AND THE
NATIONAL APARTMENT ASSOCIATION
BEFORE THE
SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP
"Small Business Access to Capital: Challenges Presented by Commercial Real Estate"

NOVEMBER 17, 2010

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Chairman Landrieu, I am James Arbury, Senior Vice President of Government Affairs of the National Multi Housing Council and National Apartment Association Joint Legislative Program.

NMHC and NAA represent the nation's leading apartment firms. Our combined memberships are engaged in all aspects of the industry, including ownership, development, management and finance. NMHC represents the principal officers of the industry's largest and most prominent firms. NAA is the largest national federation of state and local apartment associations with 170 state and local affiliates comprised of more than 50,000 members. Together they represent just under 6 million apartment homes.

We applaud your efforts to focus attention on the issue of availability of credit for commercial real estate. One-third of American households rent, and over 14 percent of households—16.7 million households—live in a rental apartment (buildings with five or more units). Our industry's ability to meet the nation's rental housing needs depends on reliable and sufficient sources of capital.

Multifamily Capital Markets and Industry Performance

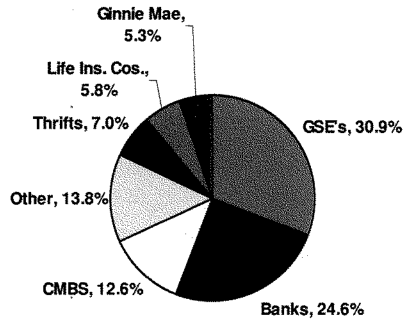
Since the onset of the financial meltdown, virtually all private mortgage lenders left the housing finance market, and the apartment industry has relied heavily on credit either insured or guaranteed by the federal government. Fully 8 out of 10 apartment loans issued in the first six months of 2010 had some form of government credit behind them, namely FHA, Fannie Mae or Freddie Mac. The FHA and Government Sponsored Enterprises (GSEs) are expected to account for 80-90 percent of the $50-$60 billion in credit provided to the apartment sector this year.

Historically, however, the apartment industry has enjoyed access to mortgage credit from a variety of capital sources. In addition to the FHA and GSEs, banks and thrifts, life insurance companies, pension funds and the commercial mortgage-backed securities market have all provided significant amounts of mortgage capital to the apartment industry. Prior to the financial crisis, these capital sources provided our sector with $100-$150 billion annually, reaching as high as $225 billion, to develop, refinance, purchase, renovate and preserve apartment properties.

These market sources have proven to be reliable and durable, with the exception of unique financial situations, such as the current economic crisis and the 1997-1998 Russian financial crisis.

As of the first quarter of 2010, there was approximately $872 billion in outstanding multifamily mortgage debt (see Table 1). In recent years, the industry has shifted from relying on whole loans from banks and life insurance companies to securitized loans. Currently, just under half (49 percent) of outstanding multifamily capital is held in the secondary market (31 percent by the GSEs, 13 percent in CMBS and 5 percent in Ginnie Mae). Nevertheless, banks remain an important capital source, providing nearly one-quarter of the industry's mortgage capital.

Table 1
Multifamily Mortgage Debt Outstanding 2010 Q1

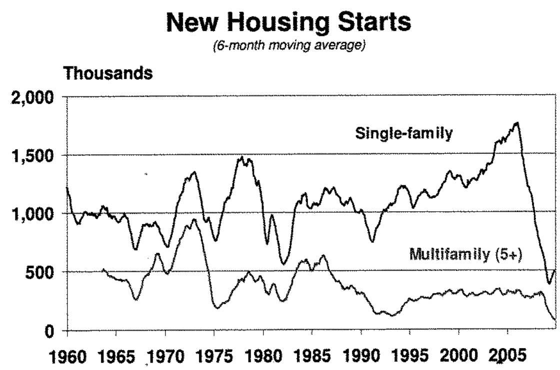


Source: Federal Reserve Outstanding Mortgage Debt 2010

As policymakers consider the causes of, and solutions to, the single-family meltdown, it is important to distinguish between performance in the single-family sector and the multifamily sector. The multifamily industry did not overbuild in the housing boom.

The New Housing Starts table below shows the stark contrast between the single-family housing production/bubble and resulting housing crisis and the relatively constant level of new production in the multifamily housing sector during the same period. Since the mid-1990s, the multifamily industry has started approximately 350,000-375,000 new units annually. During the same period, the single-family market almost doubled its production from around 1 million to 1.75 million units.

Table 2



Source: Census Bureau.

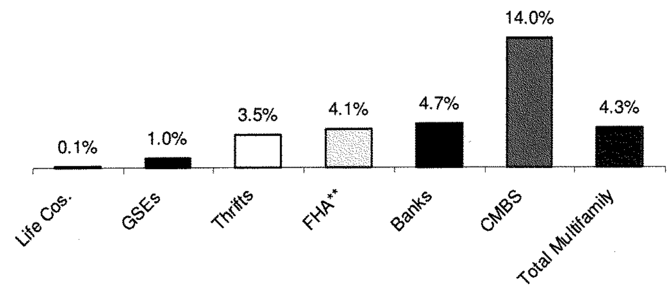
The discipline shown by the apartment industry has translated into stronger portfolio performance as well. Overall loan performance in the $853 billion multifamily sector remains relatively healthy, with delinquencies and default rates only a fraction of those seen in single-family. The 90 day delinquency rate of multifamily loans is estimated to be 4.3 percent or $31 billion. Compared to the single-family residential mortgage market where the mortgage debt outstanding is reported at $10.7 trillion as of March 30, 2010 and a 90-day delinquency rate of 9.2 percent or $984.4 billion.

There has been some stress recorded in bank loans and CMBS, particularly those originated between 2006 and 2008 when more aggressive underwriting and higher leverage was employed. However, that stress is largely a result of the overall economy and the worst job market in 40 years and not due to oversupply.

Many of those problematic loans were taken out to renovate and reposition existing properties. When property values plummeted and unemployment soared, those projects stalled and borrowers lost most of their equity. The problem is especially acute in some markets such as the boroughs of New York City and other major employment centers that have large concentrations of apartment properties.

Nevertheless, many of these distressed loans will be resolved, and most apartment residents will not be affected by loan delinquencies or even defaults, as such situations generally result in a smooth transition to a new operating entity with sufficient capital to maintain the property.

Table 3
Delinquency Rates of Multifamily Credit Sources



Seriously delinquent loans are defined as at least 90 days past due and defaulted FHA multifamily Section 221(d)(4) loans.

Sources: Federal Reserve Outstanding Multifamily Mortgage Debt, 2010 Q1, Fannie Mae, Freddie Mac 10K/10Q SEC Filing Statements, and HUD.

** Data provided for the Federal Housing Administration multifamily portfolio is restricted to market rate Section 221(d)(4) defaulted loans as of July 2010, that total $505 million in defaulted loans. It does not include the full portfolio of multifamily insured loans including hospitals and nursing homes.

The current housing finance system has worked extremely well in providing liquidity to the apartment sector in all economic climates. Here in the U.S. the GSEs, Fannie Mae and Freddie Mac, have remained a critical liquidity source in the domestic multifamily finance field. They have served this role during other capital market dislocations, including the Russian economic collapse in the late 1990s, which caused a collapse of the U.S. commercial mortgage conduit market, and during the 2001-2003 recession.

Maintaining Credit Capacity for the Apartment Market

The bursting of the housing bubble exposed serious flaws in our housing finance system. As policymakers undertake housing finance reform—including creating a framework for a U.S. covered bonds market—we urge you to ensure that any actions taken are not done so at the expense of the much smaller and less understood, but vital, multifamily sector.

Apartments are a critical component of the nation's housing market, and our industry depends on a reliable, reasonably priced and readily available supply of credit to meet the nation's growing demand for rental housing.

The U.S. is on the cusp of fundamental changes in our housing dynamics. Changing demographics are causing a surge in rental demand that will continue long after the economic recovery. This includes 78 million echo boomers entering the housing market, baby boomers downsizing and a dramatic decrease in the number of married couples with children to less than 22 percent of households.

Between 2008 and 2015, nearly two-thirds of new households formed will be renters. That's 6 million new renter households. University of Utah Professor Arthur C. Nelson predicts that half of all new homes built between 2005 and 2030 will have to be rental units. The Harvard University Joint Center for Housing Studies estimates that we already have a shortage of some three million units of affordable rental housing.

Our industry cannot meet the nation's current or future housing needs—or refinance the approximately $200 billion in mortgage debt coming due over the next two years—without a fully functioning secondary mortgage market.

For these reasons it is critically important to maintain the existing level of liquidity for the multifamily market, in good times and bad. The strong performance of the sector, thanks in large part to the robust capital markets supporting it, has attracted an enormous amount of private investment. These investors have supported the expansion of the industry and a marked improvement in its professionalism. It has made the production of millions of units of workforce and market-rate housing possible.

For the past 50 years, the U.S. housing system has been the envy of the world in attracting private capital to meet our nation's housing needs. As lawmakers look for added mortgage credit sources and redesign the secondary mortgage market, we urge them to retain the successful elements of our present system, specifically those which contributed to the strength of the multifamily market, and understand the inherent limitations of new capital sources.

A government-supported secondary market is absolutely critical to the multifamily sector and our industry's ability to continue to meet the nation's demand for affordable and workforce housing. Multifamily may only represent 10 percent on average of the GSEs' mortgage debt, but they currently provide nearly 90 percent of multifamily mortgage capital.

Since 1996, the GSEs have provided more than $535 billion in multifamily mortgage debt. Having this reliable source of capital—in good markets and bad—has provided financing for more than 11 million apartments in that time. This most recent financial crisis underscores the importance of the GSEs to multifamily. Over the past two years, they have provided $94 billion in mortgage debt to our industry at a time when virtually every other capital source left the market.

A Government-Supported Secondary Mortgage Market for Multifamily Housing is Critical

While our industry relies on other sources of capital, including thrifts, banks and life insurance companies, these are not sufficient to provide the capital necessary to keep the apartment sector functioning. Banks are limited by capital requirements. Life insurance companies have always been less than 10 percent of the market, lend primarily only to newer, luxury high-end properties and enter and leave the multifamily market based on economic and capital market conditions. The private-label CMBS market is unlikely to return to the volume and market share it reached a few years ago, and the FHA has exceeded its capacity to meet the sector's capital demands.

The following outlines why it is important to retain a government-supported secondary mortgage market for multifamily in any reform effort.

1. Providing Affordable and Workforce Housing

Fannie Mae and Freddie Mac make immeasurable contributions to housing affordability through their multifamily programs. Between 1999 and 2007 they provided $104 billion in multifamily mortgage financing for apartments affordable to families at or below 80 percent of the area median income (AMI). That's 3.2 million units—half of all units financed during this period. Additionally, half of their mortgages financed during this period were in underserved targeted areas. **The GSEs' multifamily programs have always met and exceeded their special affordable multifamily goals.**

They have been and can continue to be the single largest provider of credit enhancement for multifamily housing bonds used to finance affordable housing.[1]

But their contributions to workforce housing go beyond their affordable housing goals. Few people realize that fully 90 percent of the apartment units financed by Fannie Mae and Freddie Mac over the past 15 years—more than 10 million units—were affordable to working families at or below their communities' AMI. This includes an overwhelming number of market-rate apartment properties with no federal subsidies.

The message here is that nearly ALL of the GSEs' multifamily activities help create affordable and workforce housing, not just the capital they provide to properties designated as affordable.

The vast majority of non-subsidized apartments provide housing to people at or below area median income. That is because multifamily housing is inherently affordable. The median household income of all renters in 2007 was $25,500, well below the national median income of $47,000. The median income of renters in non-subsidized market-rate apartments was $30,000.

The conventional apartment industry's ability to serve renters at or below area median income is a result of the liquidity the sector has had access to for the past 20 years, and that liquidity is the result of a government-supported secondary multifamily mortgage market that has lowered the cost of capital to affordable AND market rate apartment providers. Without that government support, interest rates and debt service costs will rise, rents will have to increase to cover these costs and our market-rate industry will be less able to serve people at or below AMI.

Not only does the presence of a government-supported secondary multifamily mortgage market lower the cost of capital, it is important to understand that it also works to leverage private capital to support affordable housing.

Without a government guarantee of multifamily mortgages or mortgage-backed securities, rents will go up and the supply of affordable housing will go down because other capital sources cannot and will not fill the gap.

- Even if the life insurance companies expand their role in multifamily finance, they have no mandate to take on the additional risk of affordable housing. Their mortgage programs are based on maximizing profits for their investors and policyholders.

[1] They continue to provide credit enhancement, but only for fixed-rate bonds as the variable-rate bond market is unstable and their regulator has prohibited them from taking the variable rate-bond market's liquidity risk.

They will also not step in to fill the financing needs of older properties, properties with subsidy, properties in weaker markets or properties with physical needs.

- A resumption of bank lending will also not fill the gap because stricter portfolio and accounting standards limit their ability to provide development and debt capital. Banks have never been a source of long-term financing (longer than three to five years).
- It is unclear when and to what extent the commercial mortgage-backed securities (CMBS) markets will be able to meet the multifamily sector's capital needs both in the short and long term. Private label CMBS provided 12 percent of net financing capital, or $1 billion a year, in the 10-year period from 1985 to 1994. It grew to 18 percent, or $6.3 billion per year, in the next 10-year period from 1995 through 2004 before peaking at 23 percent, or $17 billion a year, in the housing bubble years of 2005 through 2007. Since the bubble burst in 2007, private-label CMBS have had net flows of -$7.5 billion per annum (-22.3% of net multifamily financing flows) as the market shut down completely.
- The Federal Housing Authority (FHA) is likewise not a replacement, as it has exceeded its capacity to serve a material share of the market. It would take a substantial commitment from the government to fund significant changes to FHA's resources, systems and delivery process for FHA to meet the financing gap. Currently, FHA is changing its multifamily underwriting criteria to reduce, not expand, the number of loans it funds as a result of weakening portfolio performance.

2. Preserving Critical Housing Stock

Another important, and often overlooked, function of the GSEs has been to provide the capital necessary to preserve older apartment properties. Typically, institutional investors overlook "Class B" and "Class C" properties. These are older buildings with fewer amenities, in weaker markets and/or in need of improvements, and they are crucial to meeting the housing needs of millions of Americans seeking affordable decent and safe housing.

Capital for these properties has historically been provided by local banks (now extremely limited), CMBS (now absent), FHA (at or near capacity) and the GSEs through the Low-Income Housing Tax Credit (LIHTC) and other investment funds. Without a strong secondary multifamily mortgage market, there will be insufficient capital to preserve affordable multifamily housing. More rental units will leave the market or be converted/upgraded and the nation will lose more than the 132,000 apartment units it already loses each year to obsolescence.[2]

3. Supporting Industry Standardization

The GSEs have created extensive standardization in the legal, financial underwriting, physical assessment and environmental hazard management (e.g., lead-based paint, asbestos, operations and management protocols, etc.) of multifamily real estate. The banks and insur-

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[2] Based on HUD's Components of Inventory Change (CINCH) data set. Over the last decade, losses to the stock have averaged 0.71 percent annually. This figure is applied to our estimated apartment stock of 17 million. Based on a total multifamily housing stock of approximately 17 million units, a loss rate of 0.5% would equal 85,000 units lost annually; a loss rate of 0.8% would equal 136,000 units lost annually.

ance companies also base their work on the GSEs' loan requirements and uniform mortgage documents.

This standardization has made multifamily financing more efficient, has helped lower the cost of capital, and has strengthened general underwriting in the apartment sector. The GSEs have been a leader in attracting worldwide capital sources to the housing industry.

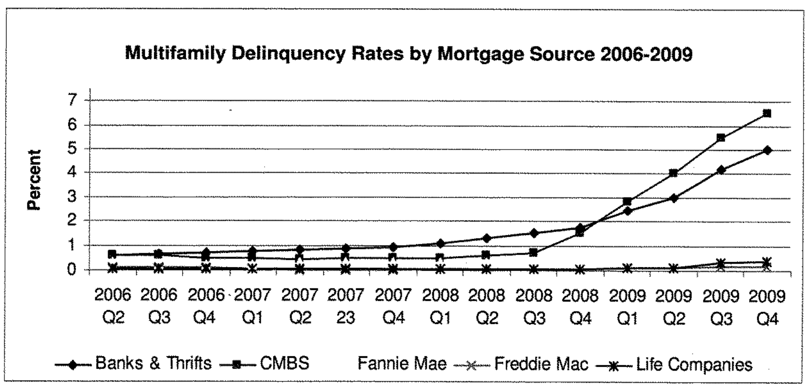
4. Providing Liquidity with Strong Historical Performance

The U.S. housing finance system, with the GSEs playing a central role as the system developed and evolved over the last 60 years, worked extremely well. It allowed the U.S. to enjoy the highest homeownership rate in the world and helped create the broadest and best housing stock on earth. It was the envy of the world.

The secondary market created by the GSEs has repeatedly shown its value as a liquidity source to ensure that the apartment sector had working capital in all market conditions. When credit markets have been impaired for reasons that have nothing to do with multifamily property operating performance, the GSEs have ensured the continued flow of capital to apartments. This was the case during the savings and loan crisis, the 1999 Russian economic crisis, and is the case today. This invaluable system has enabled our sector to continue to meet the nation's housing needs in good times and in bad, an important public policy goal.

Moreover, they have done it with strong historical portfolio performance. Over the past 20 years, their multifamily loan delinquency and defaults have been minimal—less than one fifth of one percent. At the end of 2009, the GSEs' delinquency rates were at or below one-half of one percent (45 bps). This is 14 times less than the CMBS market (6.5 percent) and 11 times less than commercial banks (5 percent). Even the government's FHA multifamily loan insurance program is experiencing higher levels of distress (1.2 percent) than the GSEs.

Table 4



Note: Delinquency is defined as follows: Banks & Thrifts = 90+ days; CMBS = 90+ days; Life Insurance Companies = 90+ days; Fannie Mae = 60+ days; and Freddie Mac = 90+ day.

Sources: Realpoint Research, Fannie Mae, Freddie Mac, Mortgage Bankers Association, U.S. Department of Housing and Urban Development.

There are many reasons for the GSEs' strong performance, including, but not limited to:

- sound and effective credit policy;
- prudent underwriting and loan terms and mortgage requirements;
- effective third-party assessment procedures (as part of the loan underwriting and due diligence process);
- strong contractual agreements with their origination and servicing partners;
- risk-sharing with and risk-retention by origination and servicing partners;
- effective loan portfolio management and oversight;
- standard mortgage documentation; and
- geographic and loan product diversification.

In addition, multifamily loans are generally considered to be less risky than and are expected to outperform other commercial real estate loans. The Congressional Oversight Panel's February 2010 report of commercial real estate noted that overall mortgage defaults in multifamily were less than half of commercial real estate—3.58 percent for multifamily among banks compared to 8.74 percent for all commercial mortgages.

To be sure, the prolonged economic weakness continues to affect apartment firms, and the GSEs are expected to experience an increase in problem loans, delinquencies, defaults and even foreclosures. However, these losses will be quite small compared to their single-family losses, and they will be within manageable levels.

It is important to point out that the GSEs reserved against these losses. Unfortunately, those reserves were used to pay off single-family losses; otherwise, there would be no impact to the taxpayer for the GSEs' multifamily losses. Also important to note is that the multifamily finance business lines of Fannie Mae and Freddie Mac have provided steady and significant profits to the GSEs. **If they, or whatever replaces them, continue to manage their multifamily business as the GSEs have for the past 20 years, and continue to benefit from greater oversight, the risk to the taxpayer will be minimal.**

The Multifamily Apartment Industry is Small Business

More than one-half of multifamily apartment communities (5 or more units) are individually owned. Bureau of the Census data shows that 299,262 multifamily apartment properties are owned by individuals. This represents 55 percent of the nation's 544,621 multifamily properties.

The top fifty owners of multifamily apartment units represent only 16 percent of the nation's 17,453,000 multifamily apartment units:

Table 5

Apartment Ownership Concentration by Units

	Units owned (000)	
Top 10 owners	1,260	7%
Top 25 owners	2,064	12%
Top 50 owners	2,847	16%
All apartments	17,453	100%

Source: NMHC's survey of the top 50 apartment owners and managers: 2010.

Tomorrow's Housing Policy: New Principles

I would also like to take a moment to address our national housing policy more broadly as I feel that it underscores the importance of explicitly considering the multifamily component in a restructured secondary mortgage market.

For decades, the federal government has pursued a "homeownership at any cost" housing policy, ignoring the growing disconnect between the country's housing needs and its housing policy. In the process, many people were enticed into houses they could not afford, which in turn helped fuel a housing bubble that ultimately burst and caused a global economic crisis.

The nation is now paying the price for that misguided policy and learning firsthand that there is such a thing as too much homeownership; that aggressively pushing homeownership was not only disastrous for the hardworking families lured into unsustainable homeownership, but also for our local communities and our national economy.

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. Housing our diverse nation means having a vibrant rental market along with a functioning ownership market. It's time we adopt a balanced housing policy that doesn't measure success solely by how much homeownership there is.

For many of America's most pressing challenges, from suburban sprawl to affordable housing, apartments are a much better solution. Apartments help create stronger and healthier communities by offering enough housing for the workers that businesses need, by reducing the cost of providing public services like water, sewer and roads and by creating vibrant live/work/play neighborhoods.

They will help us house our booming population without giving up all our green space and adding to pollution and traffic congestion. And they will help us reduce our greenhouse gas emissions by creating more compact communities that enable us to spend less time in our cars.

Elements of a Balanced Housing Policy

NMHC and NAA have joined together to advocate for a more balanced housing policy, one that respects the rights of individuals to choose housing that best meets their financial and lifestyle needs. We urge policymakers at all levels of government to work with the apartment industry to craft a smarter housing policy that:

- Assures that everyone has access to decent and affordable housing, regardless of his or her housing choice;
- 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;
- Promotes healthy and livable communities by encouraging responsible land use and promoting the production of all types of housing;
- Recognizes that all decent housing, including apartments, and all citizens, including renters, make positive economic, political and social contributions to their communities; and
- Balances the expected benefits of regulations with their costs to minimize the impact on housing affordability.

I thank you for the opportunity to address the Committee.

The Real Estate Roundtable

STATEMENT OF

JEFFREY D. DEBOER

ON BEHALF OF

THE REAL ESTATE ROUNDTABLE

UNITED STATES SENATE
COMMTTEE ON SMALL BUSINESS & ENTREPRENEURSHIP

HEARING

ON

"SMALL BUSINESS ACCESS TO CAPITAL: CHALLENGES PRESENTED BY COMMERCIAL REAL ESTATE"

RUSSELL SENATE OFFICE BUILDING

ROOM 428A

WASHINGTON, DC

WEDNESDAY, NOVEMBER 17, 2010

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STATEMENT OF

JEFFREY D. DEBOER

ON BEHALF OF

THE REAL ESTATE ROUNDTABLE

INTRODUCTION

Thank you, Chairman Landrieu, Ranking Member Snowe, members of the Committee, for conducting today's hearing regarding small business lending and commercial real estate.

I am Jeffrey DeBoer, and I am the President and Chief Executive Officer of The Real Estate Roundtable. The Roundtable represents the CEOs, Chairs and Presidents of the nation's top 130 privately owned and publicly-held real estate ownership, development, lending and management firms, as well as the elected leaders of the 16 major national real estate industry trade associations. Collectively, Roundtable members hold portfolios containing over 5 billion square feet of developed property valued at over $1 trillion; over 1.5 million apartment units, and in excess of 1.3 million hotel rooms. Participating Roundtable trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business.

Thank you for the opportunity to share my perspective today.

As I understand the desired focus of today's discussion, you are particularly interested in exploring how stress in the nation's commercial real estate marketplace may be negatively affecting the ability of smaller community and regional banks to extend credit to small businesses.

The bottom line is this: aside from the money center banks, the banking system in America remains frozen - particularly for small business lending.

We believe there are four primary reasons for this situation.

1. Most small banks do not have significant excess liquidity to make new loans.

2. Most small banks are in the process of deleveraging.

3. Quality loan demand is considered weak. Small businesses are not, by and large, seeking growth capital because the macro-economy is uncertain. And frequently banks do not consider lending to a small business to make payroll to be a "quality loan".

4. Many small banks are already heavily exposed to commercial real estate and small business loans secured by business real estate. Some of these loans were careless from the beginning, but the vast majority was sound when made. In either case, as the original loan comes due, the potential for defaults and foreclosures is high due to the impact rising unemployment and greatly reduced availability of credit have had on overall values. Losses from these types of loans (or fear of losses from these types of loans) cause lenders to be reluctant to lend which further reduces access to credit for job growth and value stabilization, accelerating a negative economic cycle.

Hopefully, the discussion today can help lay a foundation for multi-Congressional Committee policy actions that are much needed to address this very troublesome situation.

The Situation

Commercial real estate, like much of the economy, continues to face many challenges — not the least of which are that 15 million Americans are unemployed, businesses remain resistant to investment and hiring because of unpredictable future scenarios, and one in four homes is underwater.

As your meeting here today suggests . . . public policy must put job creation and credit availability at the top of its agenda – particularly for small businesses.

Small businesses employ half of all Americans and account for about 60 percent of job creation. Federal data indicate that lending to such companies fell approximately 6 percent, to below $670 billion in the first quarter of this year from more than $710 billion in the second quarter of 2008.

In addition, companies less than two years old accounted for roughly 25 percent of gross job creation over the last 20 years, even though they employed less than 10 percent of the work force during that time.

Clearly, policy actions to enhance credit availability for small businesses must focus on job growth.

Where does commercial real estate fit into this?

Employment is the economic metric which most profoundly impacts the underlying fundamentals of the real estate market. This is why policy is so critical and is worthy of close scrutiny.

For example, if someone has lost a job, or fears they may lose a job, they won't move out of mom and dad's home to set up their own household, they don't move from a smaller rental apartment to a larger one, they won't move from a rental unit to buy an apartment or a single family residence, or have extra money to go to the mall and purchase goods. Also, companies that are letting people go, will not lease additional office space, they want less office space. In order for real estate fundamentals to tangibly recover we need substantial job growth.

Net operating incomes on all types of commercial real estate have seriously declined due to substantial economy-wide job losses. Severe income declines, in conjunction with the overall collapse of the financing world, have caused commercial real property values to plunge nationwide. Most estimate the across the board drop in commercial real estate values between 35% and 40% from their 2007 levels.

As I will comment later, in some parts of the commercial real estate marketplace, values appear to have come back somewhat, but the fact remains: the number of distressed commercial properties in the nation has more than doubled this past year and is expected to continue to rise.

From a positive point of view, the capital climate has improved somewhat for many publicly traded real estate companies – REITs – with substantial amounts of equity and unsecured debt raised to rebalance portfolios. On the private ownership side, owners and investors of high quality assets located in top "gateway" markets also are now able to more readily access capital and credit at appropriate leverage levels.

It is also a positive sign that the commercial mortgage backed securities (CMBS) market, once the second largest source of credit for commercial real estate, is slowly starting to show signs of improvement. We now expect approximately $12 to $15 billion of CMBS to be issued in 2010. While not close to the record $230 billion in 2007, this is a positive turnaround from the past two years when the new issue CMBS marketplace was essentially dead in the water.

Bringing back a robust CMBS market is essential for commercial real estate. It is also essential to strengthening financial institution balance sheets across the board. Without a viable secondary market, financial institutions must keep more of their loans in portfolio, creating the need to maintain higher capital levels to cushion against potential losses. This need for higher capital constricts lending to all types of borrowers. Except for government-sponsored enterprises, such as Fannie Mae and Freddie Mac, the secondary market has not yet fully returned as a viable source for funding new credit.

Also, life insurance company lenders are in the commercial real estate market for conservatively underwritten, low leverage, high quality transactions.

While these are encouraging signs, it is important to note that these developments relate to a very small segment of the overall market.

This top-end liquidity has not found its way to mainstream U.S. commercial real estate markets, as weak job growth and tight credit continues to plague the industry and small business job creators. In this sense, the commercial real estate market is largely bifurcated.

Some might ask, "why should we care?" Let me offer other reasons for concern.

From a systemic perspective, nearly 3,000 community banks nationwide are classified as having material "commercial real estate (CRE) concentrations." According to the Congressional Oversight Panel Report, approximately $1.4 trillion in U.S. real estate loans will come due between 2010 and 2014, with nearly half of those loans currently "underwater". The Report warns that losses on commercial real estate loans could reach $300 billion, potentially wiping out "hundreds more community and midsize banks" and drying up the credit needed to restore the economy to health.

In many cases, developers will need to refinance or make balloon payments that exceed the value of the underlying properties. This is because the original loans were 3 to 10 years in duration and typically were non-amortizing. Therefore, as values have dropped while the original loan amount stayed steady, the loan is now underwater. Deutsche Bank estimates that more than 65% of commercial real estate loans might not qualify for refinancing because banks have tightened underwriting standards, reduced available loan to value ratios, and property values have collapsed.

Smaller banks, which provide the bulk of the credit to small businesses, are facing the brunt of commercial real estate losses.

While insurance companies and securitized lenders such as larger banks financed stabilized properties, smaller commercial banks typically provided short term loans for new construction or projects that were otherwise going through a transition, during which their borrower was generally executing a value creation strategy. This would entail making improvements to a property that would theoretically lead to increased occupancy or income. Such financing provided by smaller commercial banks was more than the extension of credit. It was an investment in a business plan.

However, during the Great Recession, as unemployment increased; demand for space evaporated, consumer spending declined and business plans were put on hold.

We contend that these strategies in many cases have been delayed, not necessarily invalidated.

As job growth and consumer spending ultimately resumes, it inevitably translates to a need for space. Similarly, people need a place to live and while they will double up or live at home for some period, ultimately they want to be in their own place. In an economy as massive as the U.S., demand for space will grow while there will be virtually no new properties built. We already see in markets where, despite a slow recovery, leasing activity is picking up and space is getting leased, albeit at lower rents. As a result, the values of previously underperforming assets are modestly improving through increased occupancies and growing net operating income.

Many small businesses that borrowed against the equity in their buildings, or homes - or with net worth's bolstered by those assets - are struggling to show the same creditworthiness.

Small banks historically could make credit judgments but today they are inhibited because of a general lack of capital, and because of an overly strict reliance on the metrics of loan to value examiner scrutiny.

Most of these institutions have no liquidity. They are loaded with commercial real estate that have embedded losses. If immediately recognized, the losses would further serve to impair bank capital. So the catch 22 is that if they try to create liquidity by selling assets, it constrains their ability to lend.

These institutions are typically levered by approximately ten times their equity. So, the problem is that a dollar of loss immediately hits their capital and correspondingly requires them to shrink by $10 if they're fully leveraged. That's the reality of where most banks are.

So, selling assets at a loss just requires them to shrink, as they need to restore capital before they can lend again. The issue for most of them is they simply don't have enough capital to bear the losses in their portfolios, and the regulators respond by telling them to cease and desist lending until they can raise more capital. This points most into the proverbial death cycle, or in the very least a state of paralysis.

As for the metrics of strict loan-to-value lending in today's world, only the Small Business Administration lending programs are sufficiently flexible to accommodate credit demands based on the value of real estate.

One policy approach to consider to help ease this liquidity trap might be to allow banks to amortize losses attributable to commercial real estate lending over a 7-10 year period. This would allow the banks to use earnings over time to restore their capital base, while selling assets to create the liquidity necessary to resume lending.

Another approach may be to encourage greater private equity investments in many of these institutions – to turn around and recapitalize struggling banks. Federal financial regulators appear to be concerned that private-equity investments in banks might put depositors' money at risk. Last year for example the FDIC toughened rules on private-equity firms buying failed banks by requiring higher capital ratios and prohibiting sales of banks for at least three years. Yet, one might think that a compromise could be found to bring much-needed equity into the banking system.

Alternatively, we are requesting The Treasury Department to provide a series of safe harbors that would enable certain non-U.S. investors to increase their participation in the U.S. credit markets without risk of adverse U.S. tax consequences.

As way of background, the proposed guidance we are requesting has been on the IRS-Treasury business plan since August 2006 and several private sector groups have requested, without success, that guidance be published. The proposed guidance would enhance overall credit availability for commercial real estate by revising the effectively connected income (ECI) rules under section 864 pertaining to certain investment activities in the U.S. by non-U.S. persons. Non-U.S. investors have substantial capital that could be made available to ease the credit shortage within the U.S. by purchasing financial assets held by U.S. banks and the FDIC. However, these investors are unable to do so, in large measure because of the tax uncertainty created by the absence of definitive guidance on when certain investment activities in the U.S. by a non-U.S. person will be treated as the conduct of a trade or business under section 864.

On the other side of the equation, borrowers also need additional equity to refinance and rebalance loans held by commercial banks. However, a hurdle faced by those seeking new equity to refinance their outstanding loans is the US tax code--the Foreign Investment in Real Property Tax Act (FIRPTA) -- a 30-year-old law that heavily taxes foreign equity investments in U.S. real estate interests. The intent of the law is to make sure the government can tax the gains when a foreign entity sells a property or shares in real estate companies. But the law effectively blocks the flow of more foreign capital into commercial real estate markets.

While total economic growth is not dependent upon foreign real estate investment, the real estate market would be enhanced significantly by the elimination or modification to the FIRPTA laws. This new equity investment by foreign investors would aid financial institutions in refinancing a large amount of debt that they would otherwise need to write off at losses. Further, allowing the financial institutions to execute new loans, which in turn, would create new economic activity and, hopefully, new jobs. Also, the injection of additional equity would generate activity by the real estate owner who would be able to continue its real estate project because of the new equity, thereby allowing more economic activity, e.g., allowing the real estate owner to invest in tenant improvements, thus creating jobs and new tenants which in turn would increase the value of the property.

Further complicating matters is a new accounting proposal from the Financial Accounting Standards Board (FASB) would extend the mark-to-market requirements that currently cover complex securities would also apply to loans on banks' books. Banks were hit hard by earlier mark-to-market accounting rules (FAS 157) that forced them to take steep write-downs on some assets, especially MBS and CMBS. We are concerned that the proposal would strain overall credit capacity — particularly for commercial real estate — since banks would be required to value loans at current prices. Even if performing perfectly, many long-term loans would likely be marked down on the day a loan is made. Federal Reserve Chairman Bernanke raised concerns about this proposal in a Feb. 24, 2010 hearing before the House Financial Services Committee, stating, "...commercial real estate loans should not be marked down because the collateral value has declined. It depends on the income from the property, not the collateral value."

Another FASB issue – FAS 166-167 – could jeopardize the return of the asset-backed securitization market – particularly CMBS. Under the new Dodd-Frank rules, CMBS issuers would be required to keep 5 percent of the securities issued on their balance sheets. However, the accounting rules could force issuers to reconsolidate the other 95 percent back on their balance sheets because they retain "control" of 5 percent. This would negate the economic benefits of securitization and is seen as an impediment for a more robust CMBS market.

There are also concerns about the impact Basel III could have on the U.S. banking system. While the goal of the new regime is laudable, requiring banks to hold far more capital to prevent financial disaster could further exacerbate credit challenges for real estate and broader credit capacity.

Most important now are policies that will facilitate equity investment in real estate, help banks to clear their balance sheets of toxic assets and encourage lending.

Clearly, an improving economy would solve many problems in commercial real estate and small business, so would lifting the cloud of regulatory uncertainty and creating a positive climate for job growth and investment.

We continue to urge policymakers to take action that encourages stable valuations, enhanced transparency and sensible underwriting, and support efforts to establish appropriate systemic safeguards—all key factors for the return of a reliable credit system.

Thank you very much. I am happy to answer any questions.

Associated Builders and Contractors, Inc.

November 16, 2010

The Honorable Mary Landrieu
Chair
Senate Small Business &
Entrepreneurship Committee
United States Senate
Washington, DC 20510

The Honorable Olympia Snowe
Ranking Member
Senate Small Business &
Entrepreneurship Committee
United States Senate
Washington, DC 20510

Dear Chairwoman Landrieu and Ranking Member Snowe:

On behalf of Associated Builders and Contractors (ABC), a national association with 77 chapters representing 25,000 merit shop construction and construction-related firms with 2 million employees, I am writing in regard to the full committee hearing on, "Small Business Access to Capital: Challenges Presented By Commercial Real Estate."

Access to capital is a major concern within the construction industry, which has been severely impacted by the economic downturn. With a construction industry unemployment rate of 17.3 percent and a loss of 998,000 jobs in 2009, our industry simply cannot continue to endure the limited access to capital in this economy.

ABC urges Congress to immediately address the near freeze on lending for private sector construction projects. The long delay in lending or outright refusal by financial institutions to fund private sector projects has had an extremely detrimental impact on the construction industry. Many ABC members have viable low-risk projects and/or contracts that simply need funding in order for work to commence. As the construction industry works toward economic recovery, it is critical that small businesses have access to much-needed funds.

Small businesses are the backbone of the U.S. economy and give Americans a sense of pride and accomplishment. Within the construction industry, they provide valuable jobs and play an integral role in building communities. We look forward to working with you as you develop initiatives to promote small business lending.

Sincerely,

Brewster B. Bevis

Brewster B. Bevis
Senior Director, Legislative Affairs