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

FIELD HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

MAY 17, 2010

Printed for the use of the Committee on Financial Services

Serial No. 111–136

U.S. GOVERNMENT PRINTING OFFICE

58–046 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIÉRREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
CHARLES WILSON, Ohio
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
BILL FOSTER, Illinois
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
STEVE DRIEHAUS, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan
DAN MAFFEI, New York

SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas
CHRISTOPHER LEE, New York
ERIK PAULSEN, Minnesota
LEONARD LANCE, New Jersey

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

DENNIS MOORE, Kansas, *Chairman*

STEPHEN F. LYNCH, Massachusetts	JUDY BIGGERT, Illinois
RON KLEIN, Florida	PATRICK T. McHENRY, North Carolina
JACKIE SPEIER, California	RON PAUL, Texas
GWEN MOORE, Wisconsin	MICHELE BACHMANN, Minnesota
JOHN ADLER, New Jersey	CHRISTOPHER LEE, New York
MARY JO KILROY, Ohio	ERIK PAULSEN, Minnesota
STEVE DRIEHAUS, Ohio	
ALAN GRAYSON, Florida	

CONTENTS

WITNESSES

MONDAY, MAY 17, 2010

APPENDIX

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

Monday, May 17, 2010

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1 p.m., in room 2525, Dirksen Federal Courthouse, 219 South Dearborn Street, Chicago, Illinois, Hon. Dennis Moore [chairman of the subcommittee] presiding.

Members present: Representatives Moore and Biggert.

Also present: Representatives Bean, Foster, and Gutierrez.

Chairman MOORE OF KANSAS. Everybody is here so we're going to start a little bit early, just a couple of minutes early.

This field hearing of the Subcommittee on Oversight and Investigations of the House Financial Services Committee will come to order.

Our hearing today is entitled, "Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses." This is our 13th O&I hearing this Congress and our third field hearing.

Before we begin with opening statements, I want to take a moment of personal privilege to first thank Ranking Member Judy Biggert for asking that we come to Chicago to focus on this important issue of commercial real estate. Thank you very much, Judy.

Congress can learn more about the particular issues or challenges when we get out of Washington and hear directly from local business leaders, financial institutions, and regulators on the ground as we will today.

I also want to thank Ranking Member Biggert and Full Committee Ranking Member Spencer Bachus' staff, Nicole Austin and Jason Goggins, for their good efforts and for working closely with my staff, not only on this field hearing, but on all of the O&I hearings we have held to date.

And I want to thank the people of Chicago for welcoming us, especially Chief Judge James F. Holderman of the Northern District of Illinois for letting us borrow his courtroom this afternoon.

We will begin this hearing with members' opening statements, up to 10 minutes per side, and then we will hear testimony from our witnesses for each witness panel. Members will have up to 5 minutes to question our witnesses. The Chair advises our witnesses to please keep your opening statements to 3 minutes to keep things moving so we can get to members' questions. Also, any unanswered questions can always be followed up in writing for the record.

Without objection, all members' opening statements will be made a part of the record, and I want to recognize myself for an opening statement.

Commercial real estate continues to be an area of deep concern as we work to support a strong economic recovery, not only in Chicago, but throughout our country. The Congressional Oversight Panel's February report received a lot of attention as they wrote, "between 2010 and 2014, about $1.4 trillion in commercial real estate loans will reach the end of their terms. Nearly half are at present 'underwater.' Commercial property values have fallen more than 40 percent since the beginning of 2007. A significant wave of commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American."

We must look at this problem from all angles. Lending securitization, asset valuation, regulation, and so on, and so I look forward to the observations that our witnesses will share with us today.

I now recognize for 5 minutes the ranking member of the subcommittee, my colleague representing the 13th District of Illinois, Ranking Member Judy Biggert.

Mrs. BIGGERT. Chairman Moore, thank you, and welcome to Chicago. Last September, I asked Chairman Frank, our Financial Services Chairman to hold a hearing on commercial real estate.

Chairman Moore, thank you for scheduling this important hearing and for coming here to Chicago to chair it. And I thank my Illinois colleagues—Representatives Gutierrez, Bean, and Foster—for joining us. I also want to thank Chief Judge Holderman as well as his staff, for kindly allowing us to use this courtroom today. And I thank many of our local witnesses for sharing their expertise with us.

I'm very disappointed that the Department of the Treasury could not spare even one staff member to testify on such an important topic, but we'll move on. And we're here to address an increasingly problematic sector over our economy—that is the commercial real estate market or CRE market. Chicago is home to key leaders in all aspects of commercial real estate, including acquisitions, appraisals, mortgage lending, and securitization, to name a few.

In 2009, we lost more jobs here than in any other metropolitan region in the country. This March, unemployment in Illinois increased to 11.5, percent which is above the national average of 9.9 percent in April.

With businesses downsizing or shutting their doors, and workers being laid off, taxes increasing, and regulatory and market uncertainty on the rise, we can anticipate additional residential foreclosures, followed by commercial building vacancies.

During the first quarter of 2010, CRE mortgage delinquencies in Chicago exceeded the national average, rising to 6.7 percent. Illinois banks continue to fail; last Friday, it was Midwest Bank and Trust Company. Last month, seven banks went under, including our own State Treasurer's family bank. Excessive concentrations in certain types of risky commercial real estate loans and even loans to criminals played a role. Where were the regulators?

We must address the causes of the turmoil in the CRE market and remove barriers to market recovery. Will we need an Act of Congress? Regulatory action? What about ideas that voluntarily can be implemented by market participants? For example, can banks simply extend the terms of a loan until market prices recover? I think it will take an all-of-the-above approach, but our ultimate goal should be to keep out of the equation any additional taxpayers' bailouts.

Taxpayers backed the $700 billion TARP program and the bailouts of Fannie Mae and Freddie Mac to the tune of $145 billion as of last week. And if the FHA or FDIC insurance funds are depleted, taxpayers may be asked to front for those as well.

In my view, it's high time that the Federal Government permanently exit the "too-big-to-fail" bailout business, and instead enact effective financial reforms to reestablish market discipline and transparency. And instead of shipping new taxes from Illinois to Washington for bureaucrats to spend on a new agency or programs, we should hold regulators accountable for doing their job and allowing small business entrepreneurs to retain and invest more of their money in their own businesses.

We need to break down the barriers to recovery. For example, right away, Congress should infuse small businesses with capital and give them certainty for short- and long-term planning so that businesses can expand and create jobs. Congress should extend for more than 1 year the increased section 179 expensing limits; for 2010, the 5-year net operating loss carry back; and accelerated depreciation.

In addition, this week, the House should reject any bill that more than doubles the tax on carried interest. It would be a big mistake and devastating for Chicago if Congress increases taxes that would severely curtail investment in real estate. With more cash flow instead of tax flow, small businesses can and will expand, create jobs, and get our economy back on track.

Regulators could gain a sense of urgency and make a serious effort to fix the foundational accounting problems in the commercial real estate market before it's too late.

Since February 2009, I have been asking Federal Reserve Chairman Bernanke, as well as other regulators, to address issues like this. The response in Washington is that the issues are being addressed, but here in Chicago, in Illinois, that's not what our constituents are reporting. Regulators have issued guidance after guidance after guidance, but it's vague and meaningless without clear and consistent execution by the examiners on the ground.

Examiners should not force banks to devalue performing loans. That's so counterproductive. Just because, in the run-up to the crisis, they underreacted by failing to stem commercial real estate loan concentrations in some community banks, that should not mean that they now must overreact. Nor should examiners instill unfounded fear in our community bankers. This is having a ripple effect, worsening the credit crunch and forestalling economic recovery.

Today, it's critically important that we examine the trends here in Chicago, explore the causes behind the collapse, and find solutions—be they regulatory, statutory, or voluntary among industry participation—to restore the flow of credit so they can restore productivity to our commercial properties. We don't need stall tactics. We need solutions. Some banks will fail and some loans and securities will go bad, but I'm confident that many will succeed. By recognizing and breaking down existing barriers to stability in commercial real estate, we can put Chicago firmly back on the road to economic recovery and get unemployed Illinoisans back to work.

I look forward to working with my colleagues on solutions. I look forward to hearing from today's witnesses. And again, thank you, Chairman Moore, and I yield back.

Chairman MOORE OF KANSAS. My thanks to the ranking member for her statement. The Chair now recognizes for 3 minutes Congressman Luis Gutierrez, the chairman of the Financial Institutions Subcommittee, who represents the Fourth District of Illinois and chairs our Democratic Task Force on Commercial Real Estate. You are recognized for 3 minutes.

Mr. GUTIERREZ. Thank you so much. First of all, I have to say to everybody, you're going to miss Chairman Moore. We came together in 1993 to Congress, and I'm unhappy that you're leaving, and I'm saddened. Your shoes will be hard to fill; they're very large.

Judy Biggert, thank you so much for your concern and your effort and for working so closely with all of your colleagues. I would say more nice things about you, but I don't want them to be used against you in the coming election, so I'll share some things in private with you later on.

Yes, it's coming. And as Chairman Moore has indicated, they have asked me to head up a task force in the Subcommittee on Financial Institutions. We're getting ideas. And so the testimony today will be used as part of that task force information and putting legislative work before the Congress of the United States.

And why do I say it's a tsunami? Because here's what's going to happen. You have $3.4 trillion. That's what the commercial real estate market is worth, and $1.4 trillion of it comes due in the next 5 years. That means somebody has to get a new loan, refinance, restructure. If we're having such a hard time today getting banks to lend people money, what would make us think that in the next 5 years, commercial real estate, which is doing so poorly, is simply going to all get renegotiated?

I want to remind everybody how close this is and evidence about how real it is and something that maybe most people can understand here in Chicago. I had a hearing, and we had the owner of Mr. Beef, over on Orleans. If you haven't had one, you should. It's a Chicago institution and interesting and ironic, Midwest Bank which just closed last Friday, taken over by the FDIC, told Mr. Beef they were calling in his loan. Not that Mr. Beef isn't profitable, you can go there any day. They did it because they said they had to call in his loan because the amount of money that was extended to him on the real estate and the value of that real estate were not on par. That's just one example.

So the place that you go shop for your clothes, the place you go to eat, the place you go to buy books, the local business maybe where your kids get tutoring, all of those local businesses, even though they're thriving and doing as well as Mr. Beef is doing, that doesn't mean the bank isn't going to call in the loan and possibly then close down the business. And we all know that in Chicago, we have businesses with apartments on top of them.

Lastly, let me just say this just to show you what's going to happen. Twenty percent of the loans today in the Chicago area, land loans, are not performing, 20 percent today. That's stuff that really hasn't even been built or even opened up yet. Now take that into consideration when you think of the $1.4 trillion and you begin to see the scope of this.

So I thank Chairman Moore for calling this hearing and I thank Judy Biggert for encouraging the committee to come here to Chicago because I want to make sure that as we develop the legislation, and legislation will be developed to counteract this, that Chicago is taken into consideration.

Thank you very much, Mr. Chairman.

Chairman MOORE OF KANSAS. Thank you, sir. I next recognize for 3 minutes Congresswoman Melissa Bean, who represents Illinois' 8th District. She's the co-chair of the New Democratic Financial Services Task Force and brings 2 decades of business experience with her to Congress. Congresswoman Bean, please.

Ms. BEAN. Thank you, Mr. Chairman, and I would also like to thank Congresswoman Biggert, ranking member on the subcommittee, for holding this important hearing. And Mr. Chairman, thank you for traveling from Kansas, your District. It goes without saying that you're not in Kansas any more. You're here in the big city and we appreciate having a local hearing so we can get perspective from those who are in the industry and can bring a Chicago metropolitan perspective to these hearings.

I have long been concerned with the problems we're facing in commercial real estate. If left unaddressed, I fear our current economic recovery could be delayed or even reversed. While in the Wall Street reforms that we have already passed through the House and we're waiting to get back from the Senate, we did address mortgage reform on the residential side, and there is a risk retention component that applies to commercial lending as well, but we didn't really get as beat on the commercial side.

As other members have just stated, according to the Congressional Oversight Panel Report on CRE, $1.4 trillion of loans will come due in the next 4 years. Half of these are currently underwater. In Illinois, the delinquency rate for commercial mortgages is 6.8 percent, which is more than 1 percent higher than the national average.

Further troubling, the delinquency rate for local construction and land loans in the Chicago area is 25.7 percent. While economic indicators are improving, delinquency rates in the commercial real estate space continue to rise.

The problems in the commercial real estate market don't just impact the investors and developers of commercial real estate, but many of our community banks who hold these loans. As community banks write off losses in their commercial real estate portfolio, this limits the amount of new loans that they can make. As we have seen recently in Illinois, many community banks are overexposed to commercial real estate and have already been closed by the FDIC.

With hundreds of banks around the country on the FDIC's watch list, addressing this problem is of critical importance. The way I see it, there are several questions we need to answer.

First, how do we deal with the performing but underwater commercial real estate loans that are coming due at banks that are unable or unwilling refinance?

Second, how do we strike the proper balance of prudent regulation of banks and the risk they have on their balance sheets with an appropriate flexibility to address exacerbated market conditions?

Third, how do we restart the securitization market for commercial real estate loans and enable smaller institutions to take advantage of securitization, to add much needed liquidity in the market?

Finally, how do we make sure banks are able to offer loans to creditworthy borrowers who need a commercial real estate loan?

If the answer to these questions requires legislation, I believe the committee should seek to do so in a matter that effectively addresses the problems in the market while minimizing the risk and cost to taxpayers.

Thank you, and I yield back.

Chairman MOORE OF KANSAS. Thank you. Finally, the Chair will recognize for 3 minutes Congressman Bill Foster, who represents Illinois' 14th District, and has brought his scientific and business background to great use in the House Financial Services Committee.

Mr. FOSTER. I would like to thank my colleagues for arranging this hearing and to echo thanks to Chief Judge Holderman for allowing us to use this wonderful venue.

It strikes me that the keys to this problem to the extent that it can actually be solved are first to let the market separate those firms and projects which can actually be saved from those that cannot. There has been a certain amount of misallocation of capital in the last several years. When I look at shopping centers built out in the middle of developments which were not built, these will represent stranded investments for the next decade, and it is a mistake to struggle to try to keep these. They will be dark for the next decade and that's just the way it is.

On the other hand, there's a fraction of businesses that are viable, do have a good cash flow and viable business model, and these are the ones that we should concentrate on and save. We must provide incentives to bring private equity off of the sidelines and into the business to save this.

My office is working specifically on a proposal to incentivize mezzanine financing. There are a number of other proposals working their way through Congress and through the Administration and I will be very interested in seeing the reaction of our witnesses to these various proposals.

I think also where appropriate, we may want to consider methods of providing regulatory capital relief to small banks, heavily committed, heavily invested in commercial real estate. That is a very dangerous game to play and we could be in a situation where we're causing trouble downstream, but the fraction of their investment in commercial real estate that is really not at risk maybe should not be fully counted in the normal way that we count investments in commercial real estate in their capital requirements.

I look forward to hearing the reactions of all of our witnesses to these various proposals and I yield back the rest of my time.

Chairman MOORE OF KANSAS. Thank you, sir. I am pleased to introduce our first witness panel: Mr. Peter Borzak, principal, Pine Tree Commercial Realty, testifying on behalf of the International Council of Shopping Centers; Mr. Joseph "Cosenza," is that pronounced correctly, sir?

Mr. COSENZA. Yes.

Chairman MOORE OF KANSAS. —vice chairman and director of The Inland Real Estate Group, and president, Inland Real Estate Acquisitions, testifying on behalf of the National Association of Realtors and the Illinois Association of Realtors; Mr. William Askew, senior policy advisor, The Financial Services Roundtable; Mr. Thomas Hough, CEO and chairman, Carrollton Bank, testifying on behalf of the Illinois Bankers Association; Mr. Greg Ohlendorf, president and CEO, First Community Bank and Trust, testifying on behalf of the Independent Community Bankers of America, and the Community Bankers Association of Illinois.

Without objection, your written statements will be made a part of the record. You will each have 3 minutes to summarize your statements and touch on the key messages you would like to share with the panel up here.

Mr. Borzak, sir, you are recognized for 3 minutes.

STATEMENT OF PETER BORZAK, PRINCIPAL, PINE TREE COMMERCIAL REALTY, ON BEHALF OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. BORZAK. Thank you. I would like to thank you all for holding this hearing and considering these issues that are facing our industry. My name is Peter Borzak, and I'm representing the International Council of Shopping Centers, also known as ICSC, which is the dominant trade organization for the retail real estate industry. ICSC boats over 55,000 members in 92 countries worldwide.

My company, Pinetree Commercial Realty, is based in suburban Chicago. We have been in business since 1995 and have developed or acquired 56 shopping centers.

As you know, this cycle was not caused by the commercial real estate industry, but was rather caused by residential real estate lending and the mislabeling of securitized debt. However, the resulting financial market meltdown caused prices of commercial real estate to drop on average 30 to 40 percent which is now continuing to pose threats to the commercial real estate industry, the banking sector, and the economy in general.

Although there is capital coming into the commercial real estate industry, that capital right now is targeting only premium properties in a handful of the largest markets in the metropolitan United States.

Commercial real estate is a capital-intensive industry and there are a couple of things that Congress can do to try to keep commercial real estate from posing a greater threat to the economy.

Number one, please do not pass the increased tax on carried interest. This tax is not meant to target the commercial real estate industry and it is not meant to correct a problem in our industry. Rather than a scalpel, Congress is proposing using a bazooka to address the carried interest issue in the financial sector and it will cause devastating effects for local operators who provide jobs and the majority of the real estate across this country. Carried interest helps alignment and carried interest is subordinate, generally, to returns on cash investments. Enacting this legislation will drive commercial real estate prices down even further and cause further job loss.

Number two, from my experience, local regulators seem to be trying to work with local and regional banks to help them through this difficult period. However, Washington seems intent on forcing consolidation and putting more banks out of business. There seems to be a huge double standard in dealing with the money center banks that are considered "too-big-to-fail" and the local banks that are considered too small to matter. As these small banks are shuttered, so are the thousands of relationships with local real estate operators, retailers, and local business people.

Local and regional banks provide most of the real estate and small business loans in our country and losing those relationships will cost us in lost jobs, lost businesses, and greater consolidation. Both of these issues are truly "Main Street" issues that will have a direct impact on employment and economic recovery. There's obviously a lot more detail that can be provided on these issues when time is not a factor.

Thank you again for holding these hearings and considering the needs of the commercial real estate industry.

[The prepared statement of Mr. Borzak can be found on page 79 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Mr. Borzak.

Mr. Cosenza, you are recognized for 3 minutes.

STATEMENT OF G. JOSEPH COSENZA, VICE CHAIRMAN AND DIRECTOR OF THE INLAND REAL ESTATE GROUP, INC., AND PRESIDENT, INLAND REAL ESTATE ACQUISITIONS, INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS AND THE ILLINOIS ASSOCIATION OF REALTORS

Mr. COSENZA. Chairman Moore, Ranking Member Biggert, and Representatives Gutierrez, Bean, and Foster, thank you for inviting me to testify. My name is Joe Cosenza, and I have been a Realtor for 42 years. I am vice chairman and one of the four original school teachers who started and own the Inland Real Estate Group here in Oak Brook, Illinois, along with my partners Dan Goodwin, Bob Baum, and Bob Parks, who are all still working today.

Since 1968, I have directly overseen the purchase for Inland of over $32 billion of income-producing properties. We have 1,400 employees.

I am here today to testify on behalf of more than 1.1 million Realtors who are engaged in all aspects of the real estate transaction.

Today, I will present six proposals that we believe will improve the struggling commercial real estate industry which supports 9 million jobs in every sector of our economy. While none of these can solve the crisis alone, together, they can contribute to the recovery.

First, we believe the most effective means of improving the cash flow on property is to allow new investors to accelerate depreciation from 39 years down to 15 years. This is a proposal that my company, Inland, would certainly invest in because all new money goes to pay down existing debt and to improvements on the property.

Second, we support the increasing the cap on credit union business lending from the current 12 percent up to 25 percent of total assets. H.R. 3380, introduced by Representatives Kanjorski and Royce, would accomplish this goal and we urge the passage of this bill. This will put fresh money into the system at no cost to the Federal Government.

Third, we propose developing a short-term mortgage insurance program to cover the difference between today's current value and the debt until the market recovers. It would be limited to performing properties that are viable for the long term.

Fourth, Realtors recommend that the Federal Reserve Board provide term extensions for loans on properties that can support their current debt. This is a winning situation for banks and owners and requires no legislative action.

Fifth, we propose that Congress and the Federal Reserve extend the TALF program through the end of 2010 that addresses the massive shortfalls in the market. Requirements must be loosened so that more investors will participate.

Finally, sixth, we need to increase small business lending. Applications must be easier to complete. We also recommend the waiving of the fees and raising loan limits for both SBA 7A and 504 loans, and particularly 504 loans to be used for refinancing.

In conclusion, the National Association of Realtors believes it is critical for Congress and regulators to act now. We thank the subcommittee for this chance to provide input. I welcome any questions.

[The prepared statement of Mr. Cosenza can be found on page 97 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, sir.

Mr. Askew, you are recognized, sir, for 5 minutes.

STATEMENT OF WILLIAM E. ASKEW, SENIOR POLICY ADVISOR, THE FINANCIAL SERVICES ROUNDTABLE

Mr. ASKEW. Commercial real estate is a $5 trillion industry. Banks and commercial mortgage-backed securities are the largest sources of credit for CRE.

Revitalizing the CMBS market is critical; $1.4 trillion in U.S. real estate loans are maturing between 2010 and 2014, and without a liquid secondary market, these loans will have trouble refinancing, putting more pressure on already depressed real estate valuations.

The Roundtable formed a commercial real estate coalition to develop ideas to support the CRE industry. The coalition includes leading industry practitioners and other trade associations, many of them on your witness list.

The coalition set three goals to guide its deliberations: first, to restore confidence in the commercial real estate sector; second, to maintain regulatory compliance while balancing the need for additional lending; and third, to restart the commercial mortgage-backed securities market for long-term financing.

Last month in the Roundtable and Coalition, the Coalition published a White Paper entitled, "Recapitalizing Commercial Real Estate: A Roadmap to Recovery." We have 51 recommendations to meet these goals.

The recommendations represent a holistic approach, as there is no one silver bullet to solve the problems facing the market. I have submitted the full paper with my written testimony and I'll now highly just a couple of the key recommendations.

First, utilize securitization to restart the CMBS market for long-term financing. The restart of the securitizations will be key to the economic recovery. In the absence of a CMBS market or other viable secondary market solutions, there's a financing void for commercial mortgage loans. Left unfilled, this lack of financing will further exacerbate the downward pressure on the commercial real estate values.

We encourage policymakers to continue to consider the unique characteristics of asset classes when adopting risk retention proposals and avoid one-size-fits-all legislation which may hurt borrowers and investors alike. Additionally, we urge policymakers to avoid unintended consequences in creating new rules. For example, FAS 166 and 167 rules, combined with a risk retention mandate and changes in risk-based capital could virtually halt new securitizations.

Second, extend TALF to inject liquidity and confidence in the CMBS market. The CMBS TALF was developed to inject liquidity and confidence into the market by encouraging the securitization of privately originated loans in important asset classes to consumers and businesses. The program is set to expire and an extension is vital to the market.

TALF has been helpful in tightening spreads and encouraging certain new CMBS issuance. However, a crucial next step in market liquidity is the issuance of a new multi-borrower pooled "conduit" CMBS in order to provide the capacity necessary to satisfy the enormous volume of maturing loans and borrower demand.

We recommend that Treasury utilize the TALF program as a direct and temporary solution to address the absence of a private-sector hedging tool that the banks do not have available today.

Third, eliminate procyclical accounting policies and practices. The economic crisis highlighted the impact of procyclical accounting standards on financial markets including CRE. For example, the application of fair value accounting standards, which use near term exit pricing for asset valuation, proved to be both challenging and problematic during this period.

The Roundtable recommends that FASB evaluate procyclical accounting standards and report to Congress how such standards might be modified in the current economy. This would include evaluation of fair value accounting, loan loss reserves, non-performing short-term loans, gain-on-sale, treatment of covered bonds, and deferred tax assets.

Finally, the Roundtable encourages greater coordination between accounting policy and other regulatory and statutory changes to avoid market dislocation, and to provide markets with certainty and confidence.

Thank you for this opportunity to present the Financial Services Roundtable's view.

[The prepared statement of Mr. Askew can be found on page 56 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Mr. Askew.

Mr. Hough, you are recognized, sir, for 3 minutes.

STATEMENT OF THOMAS W. HOUGH, CEO AND CHAIRMAN, CARROLLTON BANK, ON BEHALF OF THE ILLINOIS BANKERS ASSOCIATION

Mr. HOUGH. Thank you, Chairman Moore, Ranking Member Biggert, and members of the subcommittee. My name is Thomas Hough, and I am the chairman and Ceo of Carrollton Bank and also chairman of the Illinois Bankers Association.

While Illinois bankers are working hard to meet the credit needs of our communities, we are facing unprecedented pressure from our regulators these days and we're very concerned about that.

My time here is brief, so I'll try to make just two points. First, we believe that there are major disconnects in assurances regulators are making to Congress in Washington, D.C., with respect to their impact on community bank lending and community bank closings. Our members talk nonstop about the stringent regulatory environment today and how the application of outdated accounting rules is undermining their ability to extend credit. Obviously, we're in turbulent economic times, which dictate a high level of caution when lending. But that alone does not explain the sometimes overly aggressive decisions and forced write-downs that our banks are experiencing in their field examinations today.

For example, commercial loans are being downgraded even when they are fully performing. Collateral-dependent loans are being classified based on atypically depressed property values, even when the collateral is producing expected revenues, there is no intent to sell it in this distressed market, and a loan is not only current, but has never been past due. And based on accounting rules that were written for another era, we are being told to write down loans based on the performance of completely unrelated loans in our portfolio and even based on loans in the portfolios of our competitors down the street, in some cases.

These examination mandates are being repeated every day throughout our State and they are needlessly depleting bank capital and in turn creating so much competition in capital markets that most banks' chances for raising new capital today range from slim to none.

This leaves many banks with few options. Many are shrinking their balance sheets, either by selling assets or by curtailing lending or not renewing loans. Unfortunately, for some banks the only option is no option at all and that's to be drawn into receivership.

Current Federal law provides virtually no discretion to the FDIC and the prudential regulators after the point when a bank's capital levels fall below certain levels, even when due to overly conservative write-downs based on ill-fitting accounting rules.

Since Congress enacted fiducia in 1991, the regulators had no choice at that point to trigger so-called prompt corrective action when a bank's cap drops below a certain level. And that's my second point.

There's a major disconnect between when our regulators do have the discretion in the examination stage at the banks in the field to avoid causing the unnecessary depletion of capital compared to when do not have that discretion, in the prompt, corrective action stage. They are not connecting the dots between cause and effect and they should be. There has not been enough discussion of these disconnects and there should be.

Most community banks will survive if given the time and leeway to work through this one-in-a-lifetime recession and more of them will lend more in their communities if they are not encumbered with unnecessary write-downs, needless cap recalls, and the chilling prospect of the prompt, corrective action.

Chairman MOORE OF KANSAS. The gentleman's time has expired. Can you wind up, sir?

Mr. HOUGH. Yes, thank you. We urge you to keep these concerns in mind as you go forward in your deliberations in Congress. Thank you very much.

[The prepared statement of Mr. Hough can be found on page 118 of the appendix.]

Chairman MOORE OF KANSAS. Thank you.

Mr. Ohlendorf, you are recognize, sir, for up to 3 minutes.

STATEMENT OF GREG M. OHLENDORF, PRESIDENT AND CEO, FIRST COMMUNITY BANK AND TRUST, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA AND THE COMMUNITY BANKERS ASSOCIATION OF ILLINOIS

Mr. OHLENDORF. Subcommittee Chairman Moore, Ranking Member Biggert, and members of the subcommittee, I am Greg M. Ohlendorf, president & CEO of First Community Bank and Trust, located in Beecher, Illinois. I have been in banking for 25 years,all of those years with my same institution, an $150 million community bank that was founded in 1916. I am pleased to address the subcommittee here today at this field hearing. I'm also privileged to represent ICBA and its 5,000 community bank members nationwide as well as CBAI in this important hearing.

First Community Bank and Trust, like almost all community banks, specializes in small business lending, including commercial real estate or CRE lending. Community banks support small business lending and support local economic activity not supported by Wall Street. Even during these challenging times, our Nation's nearly 8,000 community banks remain committed to serving their local small business and small business-lending customers. But my bank and all community banks face serious challenges that can hinder our ability to make small business and CRE loans.

Community banks now confront the toughest regulatory environment in more than 2 decades. The banking regulatory agencies have moved the pendulum too far in the direction of overregulation at the expense of lending. As a result, capital standards above those required by regulations, questionable loan valuations, loan loss reserve policies, and overly strict implementation of CRE concentration guidance, my bank and community banks all over the country are avoiding making small business and CRE loans that we would otherwise have made in the past.

While the tough regulatory environment is inhibiting new loans in many instances, loan demand from qualified borrowers is also down. Many of our best, small business and CRE customers cite their uncertainty about the economic recovery as their key reason for seeking additional credit. Our country needs to return to a more balanced regulatory environment that promotes lending and economic recovery as well as safety and soundness.

Specifically, we support a proposal to amortize loan losses over 10 years for regulatory capital purposes. This proposal will not distort or misrepresent a bank's GAAP financial statements and was successfully used during the agriculture crisis of the 1980's. So this proposal is not unprecedented.

The time has come to extend this reasonable lifeline to community banks. We support the Administration's proposed $30 billion small business lending fund. A properly designed program will encourage additional small business lending, fuel job creation, and help create economic stability. And we support a regulatory proposal to include the entire amount of the allowance for loan or lease losses as part of the banks' risk-based capital. This proposal would favorably impact 45 percent of Illinois banks and encourage all banks to reserve more.

In our written statement, we discuss these and other recommendations in great detail.

I would like to thank you for the opportunity to testify and I would be happy to answer any questions.

[The prepared statement of Mr. Ohlendorf can be found on page 158 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, sir. I thank all the witnesses for their testimony. I recognize myself for up to 5 minutes for questions.

Mr. Borzak and Mr. Cosenza, one idea your organizations both propose is accelerated depreciation to improve CRE investment incentives and improve cash flow, but something our government must do a better job on, in my estimation, as we emerge from the financial crisis is getting back to fiscal responsibility and a balanced budget. What would the impact be on Federal tax revenues with this accelerated depreciation proposal and what would the costs be?

Mr. Askew?

Mr. ASKEW. I don't have those numbers, but we could calculate that and get those back in a written statement.

Chairman MOORE OF KANSAS. I would like to have those, sir, and we will share those with the committee. I would appreciate that very much.

Mr. ASKEW. Yes, sir.

Chairman MOORE OF KANSAS. Mr. Borzak, any thoughts?

Mr. BORZAK. I also don't have those numbers here, but I can get them.

Chairman MOORE OF KANSAS. All right. Mr. Cosenza?

Mr. COSENZA. I don't have the numbers, but you do understand why we're behind this. It's because it allows new money to come into someone's existing property, much like Mr. Beef's situation where a new investor would own part of that existing person's deal. What are the incentives to do this? One of them is to have an accelerated depreciation for the income that you're going to make, and the second one is for the Federal Government, that it pays down the existing person's debt and furthermore improves the property. None of the money goes into the person's pocket.

Chairman MOORE OF KANSAS. I understand that, but I think our government has to be concerned about the debt our country has at the present time, which has increased over the past several years.

I was surprised to see how many of you call for the extension and even expansion of TALF to help with the CRE, the commercial real estate market.

Mr. Askew, will you explain this idea and why the Federal Reserve and Treasury should consider extending the program?

Mr. ASKEW. Yes, sir. What is needed in the market right now is a secondary financial market, a securitization market. There has only been one issue of TALF on the CMBS that has gone through the DDR deal and that helped narrow the spreads in the market, but that's just one deal. The market is still—we still have not had any other CMBS securitizations to speak of. So what we're proposing in the paper is that Treasury would create the warehouse for pooled conduit loans. Right now, there are a lot of loans across small banks and large banks that are good, performing commercial real estate loans and the idea is to securitize those loans so that the banks, as Mr. Gutierrez says, can make more loans for commercial real estate. But we have to be able to securitize them, pull them together, pool them together, and we're asking Treasury to do a warehousing function. It's similar to the PPIP that was defined or talked about by the Congressional Oversight Panel, and it was a very profitable program, what they did with PPIP, so this one would return money to the government, but we just—the program expires in June, the CMBS program. So we just think it would help if they kept that a little bit longer. And also, it would be a good possibility for the government to start the program.

Chairman MOORE OF KANSAS. Thank you, Mr. Askew. Do any other witnesses have a comment?

Mr. Cosenza?

Mr. COSENZA. I do, because the reason why an extension is needed is because it didn't have long enough of a time originally the first time to work out its quirks. The reason why there was only one that was done is because it was such a doggone tough program. One of the aspects of it which I don't think anybody realizes is that when a transaction is already done, let's say there are 40 or 50 properties in this one bond issue and an investor wants to buy into that bond issue, goes to the Federal Government, asks him for 85 percent of a non-recourse funds to allow him to buy that, so that the money can move in the marketplace, that's wonderful. The problem was that there were regulations within the Federal Government where they could say, we don't like one of the assets in this pool, and therefore, we're not going to give you, the investor, the money to invest in it. It was too late. The pool was already done. And whoever did it, whether it was J.P. Morgan or whatever bank it was, it was too late. They're stuck with the paper. That's one aspect of it.

Chairman MOORE OF KANSAS. Thank you. And I see my time has just about expired. I will recognize Ms. Biggert next, for up to 5 minutes for questions.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you all for being such excellent witnesses today. I wish that we had more time, and Mr. Askew, thank you for the Financial Services Roundtable paper. I think that puts so much together and obviously we could probably talk about the 51 issues well into the night. But since we don't have that time, I would just like to go over a couple of things and really talking mostly about the regulatory and statutory. For example, Mr. Hough, you said in your testimony that ill-fitting accounting rules are undermining the banks' ability to extend credit.

Mr. Askew, you said that the final interagency joint rule on FAS 166 and 167 should be reexamined. And Mr. Ohlendorf, you talked about despite the guidance on CRE loan workouts, community banks continue to report that they're forced to write down performing loans.

So briefly, have any of your financial institutions had discussions with FASB officials about these accounting rules? We'll just go right down the line.

Mr. COSENZA. Any of the accounting rules for banks? I'm going to let the banks speak.

Mr. ASKEW. We had all of the regulatory agents, we had OCC, the Fed, the Treasury, and FDIC at our meetings, Congresswoman Biggert, but we did not have FASB and in retrospect, I wish I had them at the table. I did not. But we do have meetings set up and we are going to visit FASB and talk to them about our suggestions.

Mrs. BIGGERT. Mr. Hough?

Mr. HOUGH. FASB has great power. They're very independent. They're the so-called five gnomes who sit in this office and make up these rules and it affects everybody and the whole economy, and it is very frustrating not to be able to have any access to these folks.

Mrs. BIGGERT. Mr. Ohlendorf?

Mr. OHLENDORF. One of the concerns that we have had with the whole FASB regulation is the cyclicality and countercyclicality of the loan loss reserve issue. We, in our industry, had some good times and banks made good profits and we can't complain about that. But we were prohibited from being able to reserve for a rainy day because FASB rules do not allow for that. We had to test our allowance. We have an 11-component evaluation now that's done every single quarter, and if I can't show that my portfolio has strength or weakness in it, then I can only reserve a certain dollar amount.

I wish in these times that my rainy day fund could have been a little deeper, because we had profits that we could have set aside that could have been used to help us through these troubling times. Now in this environment we come in and have to apply those same accounting rules, both from a regulatory perspective and an accounting perspective and those two people don't always come from the same perspective. And now they're coming in, downgrading loans, reclassifying assets, looking at very short-term windows.

We used to be able to look at a 3- to 5-year loss history. Now, regulators are coming in saying, your loss history needs to be looked at over 18 months, maybe 2 years at the most. We all know what has happened over those 2 years and you can understand very easily how much more money has to be set aside just at the time where capital is very, very dear and every dollar we set aside from our capital account and our allowance account limits small business lending.

Mrs. BIGGERT. We have been told that regulators have the flexibility to interpret FASB accounting rules and we have also heard that some regulators are more overzealous than others when it comes to the CRE valuations. Is there a particular regulator, the FDIC, the OCC, the OTS or the Fed whose examiners are requiring performing and current loans to be devalued?

Mr. OHLENDORF. We have heard anecdotal evidence from banks across the country and I think it just depends who your regulator is. If you're in a tough market, and Chicago is a challenging CRE market, I'm not sure it matters what regulator. We have heard anecdotal evidence that all have been pretty dominating on loan valuations.

Mrs. BIGGERT. Mr. Hough?

Mr. HOUGH. I don't think there's any objective evidence. I think most bankers would say the problems are more with the Federal regulators than the State regulators because we have all heard, you have talked about it too, Congresswoman, about hearing one thing from the regulators in Washington, but then when it gets down to the field level, Chicago and my examiner is out of Champaign and Springfield, Illinois, when it gets down to the field level and they're examining my bank or my members' banks, that it's a different type of a thing. And examiners have—they are risk averse. There's no incentive for them to be anything but conservative.

Mrs. BIGGERT. Just one other thing. From hearing everybody and the way that this is—I would love to host a roundtable with the regulators and the banks. Would your industry participate in a roundtable with FASB and Federal agencies on this issue?

Mr. HOUGH. Yes.

Mr. ASKEW. I think that is a great idea and I think that's what we should do. I think that's the only way we're going to address all the issues in commercial real estate.

Mrs. BIGGERT. Thank you. And I don't know if the Realtors and whomever wants to participate, but any stakeholders we would be happy to have. Is my time up?

Chairman MOORE OF KANSAS. Thank you. Your time has expired. I will next recognize Mr. Gutierrez for up to 5 minutes.

Mr. GUTIERREZ. Thank you so much. I guess we have—listening here today, I just want to quickly go to Mr. Hough and Mr. Ohlendorf. Is there a difference by the regulators? When the examiners come down to examine your books are they being unfair?

Mr. OHLENDORF. Congressman, anectdotally, from both my own situation as well as others that we represent, what is happening during the exam, a typical exam at a community bank may be a 2-week process.

Mr. GUTIERREZ. Let me ask you the process more succinctly since I only have 5 minutes. What we have heard here is that the regulators are telling the examiners to take other things under consideration other than the underlying value of the property. That is, is the loan performing? Are they telling you that performing loans no longer will be part of your portfolio? You have to bring in more capital if you want them on your books?

Mr. OHLENDORF. On certain loans, absolutely.

Mr. GUTIERREZ. Mr. Hough?

Mr. HOUGH. I have never experienced it at my bank, but members have told me that is the case.

Mr. GUTIERREZ. I understand, you don't want somebody hearing what you said and the big regulators send the examiners and say well—

Mr. HOUGH. Correct.

Mr. GUTIERREZ. We weren't following the rules. We'll have them come later on, but I think it's a critically important question, that is, here's what the Federal Government says it's going to do and the regulators say they're going to do, and guess what? As Mr. Cosenza said it doesn't cost any money, right? It doesn't cost any money. So in other words, there are things that we can do from a regulatory point of view, right? Just taking into consideration where we're at today that won't cost us any money, that will help us get through the tsunami that's coming. Because when I asked Mr. Bernanke what the greatest threat is to community banks, I said community banks, Mr. Askew, you're not the community banker, but community banks, he said CRE and the economy.

I just want to go back because I think we have a wonderful Chicago experience, not wonderful that it happened, but wonderful in how it enlightens us. Midwest Bank, one of the reasons—and just think about TARP money. TARP is the solution, right? TARP is part of the solution, right? But it isn't a solution because Midwest Bank got TARP money, got $80 million of it. And you know what they did once they got the TARP money, the regulators told them to stop lending money and shut down Mr. Beef. That's a true story. That happened. So I think we need to focus on that because that's very, very important.

I want to ask because I'm not sure which one of the agencies is implicated, but there is guidance on prudent CRE loan workouts from last fall, 2009.

And I think, Mr. Moore, it would be an important question if I and others move forward. We're going to have a hearing on this on my subcommittee in the coming weeks just what kind of legislation and regulatory evidence we have and regulatory issues that we should take into consideration because what I see is the guidance and what the examiners are doing. And I want to say look, there are going to be different things that are going to have to be done. Some are going to be the same for everybody in the industry because on the other hand you folks that have this commercial real estate, you really have to get together and have one message. Because if I hear from the roundtable that represents the JPMorgan's of the world, and the Citibanks of the world and the Bank of Americas of the world, all who got TARP money, that it's a bad idea to allow the small community bankers to amortize differently their money, then here's what we get. We get these financial institutions, the fact is, you're all important and we're not going to come here to beat up the big banks versus the small banks. You're all important. But 40 percent, 4 out of 10 loans on commercial real estate are issued by community banks, banks $10 billion and smaller and they didn't get many of those hundreds of billions of dollars in TARP money.

So I think what we're talking about in changing rule and because a rule doesn't benefit you, big bank or your particular situation, but benefits someone else within the whole circle, I would just encourage you not to simply look at your own self-interest and what is good for you and your industry, but what's good for America because that's what you're demanding that Chairman Moore and Ranking Member Biggert and I do, set aside Republicans and Democrats and set aside our difference and our own personal interests. I simply encourage you and ask you because we're here to help you. This is a big important thing. Those mom-and-pop shops are out there and we want to help them and if you make a lot of money, God bless you. But I just want to make sure that there are businesses out there that are thriving and are encouraged to move forward. Thank you so much. You're all very, very important to us and I hope you will work more collaboratively in the future. Thank you.

Chairman MOORE OF KANSAS. I thank the gentleman, and I now recognize the gentlelady from Illinois, Ms. Bean, for up to 5 minutes for questions.

Ms. BEAN. Thank you, Mr. Chairman. Mr. Ohlendorf, if you can give me a quick answer to this one, because I have a few other questions. In your testimony, you reference the benefit of the NOL carryback that we extended to 5 years in the stimulus that we did last February. Do you know what either your bank or those in your association, what were they able to do with those recouped taxes once they received them?

Mr. OHLENDORF. Congresswoman, it certainly helped our capital position and others' capital positions and the bottom line is if we don't have capital available to us and if we don't have capital that we can leverage, we can't lend. And so anything that we can do to bring those dollars back, it gave us money to be able to leverage again. Had we not been able to do that, those losses would have just sat out there forever. Capital would have been depleted and those lending opportunities wouldn't have been there.

Ms. BEAN. You also in your testimony expressed support for the Administration's proposal to take $30 billion of TARP money or other money and make that available to community banks. Many of the executive compensation provisions of what we had done in the broader TARP proposals didn't scale to small banks, so that really limited participation of our smaller banks. Can you explain the potential of that investment, particularly given the scenario that we're in?

Mr. OHLENDORF. Congresswoman, we have seen obviously a number of significant Illinois failures. Seven community banks, a couple of weeks ago. A lot of those banks with just a little bit of capital could have made it. We have seen estimates that in the low hundreds of billions of dollars, you could recapitalize every community bank in the country, when $2 trillion of capital was infused or loan guarantees or zero interest loans went to our big brethren. We understand they were important in the industry, but some of the creativity that was going on at that time to save the largest financial institutions, we would like to see at the community bank level some of that similar creativity, come up with ways that we can extend and give us some time.

We all have to believe we will come out of this recovery at some stage in the game. As Congressman Gutierrez said, the tsunami is coming, we just don't know how long that's going to last, but if we can just get through it and have some capital in the kitty, I think we can make it through and the industry is going to make jobs available and make loans available and it's going to make a difference.

Ms. BEAN. My final sort of comment and question for the whole panel is, many of you talked about countercyclical, and I know Congressman Foster and I worked on putting countercyclical mechanisms into the Wall Street reforms that we did. Essentially, when we see a bubble in the formation increasing capital requirements on the way up, easing them on the way down so the fallout isn't so deep and broad.

There wasn't a lot of call from industry participants on the way up for those increased capital requirements. Nobody wants to be the buzzkill. Even the regulators didn't step in when the party is on. And so it's interesting. We hear it, of course, after the fact when it improves one's balance sheet to treat mark to market a little differently in a downward scenario than when it was improving everyone's balance sheets. Again, there wasn't a lot of call for looking at more regulation then.

So what should we be doing in terms of as we did mortgage reform and the Wall Street reforms for residential, we really didn't address underwriting standards, loan to value ratios. So I would like some comments on that and specifically if you consider that at the peak to where we are in values right now, there has been about a 43 percent drop since 2007 so that's in the last 3 years. How much did it go up before that peak in the previous 3 to 5 years and shouldn't there have been some caution?

Mr. COSENZA. I'll give you an example of this, a very particular one because I buy a tremendous amount of real estate. And during the last 14 months, I bought about $2.7 billion worth. Of that real estate, the capper-rates, the returns I got on my investment were similar to what I was getting 7, 8, 9, and 10 years ago. During that time, much of that inflationary period wiped out. So therefore, let's assume for a minute that in 2001, 2002, and 2003, you were buying properties for somewhere around an 8 percent return, give or take. By the time it got to 2006, it was 6.5 percent. And all of us had to contend with that, otherwise sit back and don't buy anything.

Well now, similarly, all of the banks' rates came down. I still had the same spread, my same cash flow. The mistake we all made was we did 5-year loans. And so the mark-to-market, even though we do 50 percent loans, the mark-to-market killed us too because if the real estate was $100 million, our loan was $50 million, and all of a sudden, the real estate became only worth $70 million or $65 million, my loan had to get paid down.

Ms. BEAN. So if everyone had bought a little less when it seemed out of control, wouldn't that have been helpful?

Mr. COSENZA. It would have been. There's no question about it, but it's not as if you made more money. It's the whole economy just kept churning.

Ms. BEAN. Will others weigh in on the values of what they had been before the peak and how much it increased in that 3 to 5 years prior?

Mr. BORZAK. Yes. The spread has increased by and capper rates decreased. Prices went up by a significant amount between 2003 and 2007 when they peaked. However, it's a more complicated issue. Real estate pricing is much more supply and demand of capital. And over the last 26 years since I have been in the business, the commercial real estate industry has become much more institutional and much less entrepreneurial. There was a lot more private equity capital and other institutional and pension fund money that was finding its way into real estate in the mid part of this past decade. That forced prices to unprecedented levels, but there was a lot of talk about whether that was a permanent shift and whether they were permanently going to be more dollars allocated to commercial real estate, so it wasn't always apparent that it was a pricing bubble. On the residential side, it was a little bit more apparent. The kind of financial mechanisms that were being used to finance homes, maybe were suggesting that there was a bubble.

Ms. BEAN. So more specifically, there's limited time—

Chairman MOORE OF KANSAS. The gentlelady's time has expired.

Ms. BEAN. Okay. I'll follow up with you on that.

Mr. COSENZA. Thirty percent. The answer is 30 percent.

Ms. BEAN. Thank you.

Chairman MOORE OF KANSAS. Mr. Foster is recognized for up to 5 minutes, sir.

Mr. FOSTER. Yes. First, Mr. Ohlendorf and Mr. Hough, do you have any reaction to Mr. Cosenza's and the Realtors' proposal to raise the cap on credit union business lending?

Mr. OHLENDORF. I struggled with it from the standpoint of the financial situation between credit unions being nontaxed entities and the banks being taxed entities. It's just a significant difference. Credit unions were set up to deal with small business—not small business, but small consumer, small loans, small things. And it made a lot of sense in areas that were underserved and that's all well and good. I think you have to question the structure of those credit unions is such that the expertise is there. There are a lot of smart people in this business all around that made some terrible mistakes as far as what was going to happen in the business lending area. I think it's potentially very dangerous and I also struggle with just the level playing field isn't there.

Mr. FOSTER. Mr. Hough?

Mr. HOUGH. There's only a small handful of large credit unions that would make any significant difference here, but we felt was well with the fact that they don't pay income tax and we're talking about balanced budgets and things, it's troubling.

But on the other hand, clearly, it would help a little bit to provide more funding, but not very much to the CRE market.

Mr. FOSTER. Mr. Cosenza, do you have an estimate for how much additional support this might bring to the commercial real estate market?

Mr. COSENZA. I do not have that, but we will get it to you and every single dollar that goes into the economy that doesn't cost the government or the United States citizens any money is certainly a smart thing to do at this time.

Mr. FOSTER. Thank you. Let's see. I would like to talk a little bit more about procyclical accounting policies. We're going to be having at the American Enterprise Institute, actually, a workshop on a specific proposal having to do with changing the loan to value ratios during the upswing where you basically would not—let's see. The easy way to explain it is you would automatically turn up downpayments by the amount that the housing market has gone up in the last say 4 years.

And so what you're doing is it's a mechanism to automatically turn up the required downpayment or limiting the loan to value automatically by formula during the upswing.

I was wondering if you have any reaction to this because it's obviously politically almost impossible to pull away the punch bowl as the party is going. But on the other hand, it seems in retrospect to be absolutely necessary. I was wondering, are there mechanisms that you would support, specific mechanisms that would deal with the countercyclical problem on the upswing.

Mr. COSENZA. Speaking personally, I would not have a problem with those kinds of restrictions. But in this respect, I'm not speaking for the National Association of Realtors, or all of those little guys who can't possibly put down 50 percent or refinance to the tune of 50 percent when they had a loan which was 70 percent or 80 percent loan to value.

Mr. BORZAK. I think that's a difficult proposition. I think those prices are set by so many different dynamics and to try to regulate whether the increase in pricing is due to a bubble that's artificially induced because of financing techniques or because of real market fundamentals. Those increases in value may be sustainable and they may be permanent. And so to penalize certain areas based on certain arbitrary regulated pricing restrictions, that sounds like it could be overregulation.

Mr. FOSTER. No, this is not an attempt to change the long-term value of markets. This is simply—

Mr. BORZAK. Right, to change the amount of money—

Mr. FOSTER. —when they're rising rapidly to say wait, you can issue a mortgage with 90 percent loan to value on the value of the property 4 years ago, but not on the fraction of the appreciation that has happened in the last few years.

Mr. BORZAK. And my only point is that the appreciation that has happened in the last few years in certain markets may be permanent, sustainable increases in pricing and to apply those lending standards differently. There are too many dynamics that are affecting the values. If it's clear that there is a bubble, that there is an artificially-induced increased, then limiting the loan to value ratios might be healthy, but it's difficult to determine.

Mr. ASKEW. Congressman Foster, I would commend looks at countercyclical approaches. I don't know about the specifics of what you're talking about here. I would love to look into it and we would be glad to do that and give you our feedback, but anything that we could do on the countercyclical side when we get through this hole that we have ourselves in would be helpful because anything you talk about, whether it's the Resolution Fund right now, whether it's FDIC assessments, loan loss reserves, there are several areas that we could prevent this type of problem if we were very proactive on the other side. So we would be glad to participate and we would like to participate to help look at those countercyclical solutions.

Chairman MOORE OF KANSAS. The gentleman's time has expired. We do have some extra time, though, and with the consent of the members of the committee here, we'll go one more round for 2 minutes each this time, and I'll recognize first the ranking member for up to 2 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Borzak, have there been any assets that you have not been able to work out or get placed with a new lender and were all your workouts placed with your existing lender? Do you have additional debt maturing? And how do you expect to refinance?

Mr. BORZAK. We have been fortunate that we have been able to find resolutions to all of our debt issues. We have only in a couple of cases been able to find those resolutions with alternate financial institutions.

Generally, our resolutions were either with our existing bank, through equity paydowns and loan extensions or by financing the acquisition of that debt with 100 percent equity. So I know that it has been very difficult in the past 18 months to find alternative banking solutions or loan solutions to those workouts.

Mrs. BIGGERT. In your testimony, you talked a little bit about CMBS special servicers. Could you mention them?

Mr. BORZAK. Correct. The CMBS paper, the securitized paper is administered by a master servicer until there's a problem and when there's a problem, the special servicer steps in and because this is the first time since the CMBS concept really became so popular in the early 1990's, this is the first time that industry has faced the kind of distress that it's facing right now.

The special servicers in the entire industry are really just trying to get up to speed and trying to find their way right now. So it's very difficult at the moment to get ahold of special servicers, very difficult to get responses. It takes a while. And the solutions that the servicers are able to effectuate are more limited than with a bank that has a loan on their balance sheet and can do what they want inside of the capital constraints.

So we do have one situation with a special servicer right now and we're in dialogue, but it is a slow moving process.

Mrs. BIGGERT. Thank you. I yield back.

Chairman MOORE OF KANSAS. I thank the gentlelady, and next, the Chair will recognize for up to 2 minutes, Mr. Gutierrez, please?

Mr. GUTIERREZ. I just have one question. Okay, so Mr. Borzak and Mr. Cosenza, what's the peak, what year was the peak in real estate?

Mr. COSENZA. The peak was really toward the middle and end of 2006. That's when I saw the—

Mr. GUTIERREZ. The middle of 2006?

Mr. BORZAK. I think prices continued to go up into the middle of 2007. It was about July of 2007 that we kind of saw the peak.

Mr. GUTIERREZ. So by the end of 2006—

Mr. BORZAK. But Mr. Cosenza would know better than I would.

Mr. GUTIERREZ. By the end of 2006, middle of 2007, right? That's the peak of it. And that's where a lot of these loans, the tsunami that I'm talking about are going to come from because if prices went down after that, people who in 5 years, that's 2011, 2007, right, 2011, 2012, 2013, they're the ones who are going to have the big problem, right, of loan to value because they got their loan when real estate was way up here and it came down in 2008, 2009 and really hasn't substantially come up.

Okay, I just wanted to focus and target on those years, because I think from a legislative point of view, Mr. Moore, and Congresswoman Biggert, we should focus on where the problem is really going to be the worst. Thank you so much. Thank you, Mr. Moore.

Chairman MOORE OF KANSAS. Certainly. The Chair next recognizes Ms. Bean for up to 2 minutes.

Ms. BEAN. Thank you, Mr. Chairman. One of the questions I wanted to get back to was underwriting standards in general and do you think there should be a better look at underwriting standards, whether it's loan to value ratios, should we consider things like as we did credit rating agency liability for derivatives where we had AAA rated securities that should never have gotten them, we did that in our Wall Street reforms. Should there be, as I understand in some countries, appraiser liability? Just your thoughts on those kinds of things.

Mr. HOUGH. There were situations I saw in banking where a bank competitor would hire a certain appraiser and they might want to lend the full value of the property and the appraiser will appraise it for 120 percent. I don't know how they did it, but you do wonder sometimes of the qualifications of the appraiser.

Ms. BEAN. Any other comments?

Mr. ASKEW. Overall, the commercial real estate market, unlike what happened in the residential market where there were some gaps in regulation, there were unregulated loan originators in some of our States. To underwrite overall is good in the commercial real estate space and also the loan to value ratio. Most of the loans average somewhere around 70 percent, so even 65 percent. So it's a little bit different. But as far as values just falling right now, that's what has created the problem. Values could have fallen, but they have fallen so much that is where the gaps, the equity gap has been created.

Mr. COSENZA. In the commercial real estate business, I don't think I have really seen any abuse from the appraisal industry per se. I think though because just like mark-to-market, as the values start going up, they really have to go with the values because that's exactly what something will sell for. So they're caught in the same spiral going up as the banks got caught with the mark-to-market going down. And you could never balance it off.

Ms. BEAN. Would you say though there weren't loans ever written that were almost not justifiable based on even maximum occupancy rates and rents?

Mr. COSENZA. Some of the ones I have seen in The Wall Street Journal are absolutely stupid, including a large apartment complex that was in New York.

Chairman MOORE OF KANSAS. The gentlelady's time has expired. The Chair will next recognize Mr. Foster for up to 2 minutes.

Mr. FOSTER. Yes. Let's see, Mr. Cosenza's suggestion was extending the cap on SBA 504 loans and to allow them to be used for refinancing of commercial properties. Does anyone have any comments on that? What's the downside?

Mr. ASKEW. I agree with him. I think it's a good idea.

Mr. FOSTER. No objections at all?

Mr. ASKEW. None, whatsoever. But it has to be an easier process. Forty percent of the people can't fill out the forms. It's so tough in that industry, honestly.

Mr. FOSTER. Is there a way to do that without compromising underwriting standards?

Mr. ASKEW. Yes, there certainly is. If I gave a test to my students when I was a teacher and 40 percent of them failed and the other ones had to have help doing the test, either I taught wrong or I made the test wrong. It's me, it's not them.

Mr. OHLENDORF. And I think getting some of the other institutions involved. A lot of SBA lending is concentrated in a small number of institutions. And I think finding a way to get more institutions participating in those programs, they certainly have viability, but the underwriting and the application process is pretty rigorous.

Mr. FOSTER. There's a related suggestion to generate a new class of SBICs that are allowed to participate in commercial real estate, mezzanine finance and so on and is that something that you have discussed or heard about, have any comment on?

Mr. ASKEW. I have, and even though the SBA program from the Administration doesn't fit our industry because they made it for the smaller banks, we have still supported that all along and we have been meeting with them on all the meetings, trying to help that process along because we think at the heart of it, it's a good program. And the point about the complexity, we tried to make that clear and your point about the commercial real estate we have added those thoughts in for how we might expend the program.

Mr. FOSTER. One of my hopes is that if you concentrate on the mezzanine finance segment of the market, then you have a third set of eyes so you can reduce the paperwork because you have external validation that this is a viable project.

Mr. ASKEW. Right.

Mr. COSENZA. And the National Association of Realtors would love to help work with Congress on that issue.

Mr. OHLENDORF. As long as they can scale.

Chairman MOORE OF KANSAS. The gentleman's time has expired. I want to thank our first panel for your testimony. You're now excused. I'll invite the second panel of witnesses to please take your seats. We're going to have a 3-minute recess, so if anybody has any business to take care off, they can do that, and we will be back to start in about 3 minutes.

[recess]

Chairman MOORE OF KANSAS. This hearing will come back to order and I'm pleased to introduce our second witness panel. First will be Mr. Anthony Lowe, Regional Director, Division of Supervision and Consumer Protection, for the Chicago Regional Office of the FDIC. Second, Mr. Bert A. Otto, Deputy Comptroller, Central Office of the OCC. We're pleased to have you both testify again, as you did at our Michigan hearing on small business lending. And third, we'll hear from Mr. Daniel McKee, Regional Director, Central Region of the OTS. And Ms. Cathy "Lemieux"—is that pronounced correctly?

Ms. LEMIEUX. Yes.

Chairman MOORE OF KANSAS. —Senior Vice President, Supervision and Regulation, at the Federal Reserve Bank of Chicago.

Without objection, your written statements will be made a part of the record and you will have up to 3 minutes to summarize your statements.

Mr. Lowe, you are recognized, sir, for 3 minutes.

STATEMENT OF M. ANTHONY LOWE, REGIONAL DIRECTOR, DIVISION OF SUPERVISION AND CONSUMER PROTECTION, CHICAGO REGIONAL OFFICE, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. LOWE. Thank you. Chairman Moore, Ranking Member Biggert, and members of the subcommittee, I am Anthony Lowe, Chicago Regional Director for the FDIC. I appreciate the opportunity to testify on behalf of the agency on the state of commercial real estate and bank lending.

Adverse credit conditions brought on by an ailing economy and stressed balance sheets have created a difficult environment for both borrowers and lenders. Continued resolution of the current economic crisis will depend heavily on creditworthy borrowers having access to lending.

Nationwide, expenses for troubled loans continue to weigh heavily on insured depository institutions. And total loan and lease balances at FDIC-insured institutions declined by $129 million during the fourth quarter of 2009.

Illinois, like many States in the industrial Midwest, has been hard hit by the recent recession. Nearly 7 percent of the State's jobs have been lost since the fourth quarter of 2007. Average home prices are well below peak levels of early 2007 and commercial real estate markets have been strained by higher vacancy rates.

The financial condition of Illinois banks has deteriorated and remains weak. Illinois institutions' loan loss provisions have reached record levels. Loan delinquencies are above national levels and Illinois institutions reported negative loan growth rates for 2008 and 2009. These conditions have caused a number of bank failures. From October 2008 through April of 2010, 32 Illinois insured depository institutions failed.

I am going to briefly turn to bank examination and regulation in the current environment. FDIC bank examiners work out of duty stations in 85 communities across the country, including 5 here in

Illinois. FDIC examiners are not directly involved in bank credit decisions. We do not instruct banks to curtail prudently managed lending activities, restrict lending to strong borrowers, or deny a refinance request solely because of weakened collateral value. We would not require a reappraisal for a healthy, performing loan.

FDIC examiners focus on borrower case flow as the primary source of repayment during our credit reviews, not on collateral support which serves as a secondary source of repayment. The borrowers' willingness and ability to keep payments current is always the primary criteria for our loan reviews.

In February of this year, the regulators jointly issued an interagency statement on meeting the credit needs of creditworthy business borrowers to encourage prudent lending and emphasize that examiners will apply a balanced approach in evaluating small business loans. We believe this statement will help banks become more comfortable extending soundly written and structured small business loans.

While many challenges remain before us, I'm confident the banking industry as a whole is moving in the right direction, towards sounder lending practices, stronger balance sheets, and a greater capacity to meet the credit needs of their communities. I'll be happy to answer questions.

[The prepared statement of Mr. Lowe can be found on page 136 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Mr. Lowe.

Mr. Otto, you are recognized for up to 3 minutes, sir.

STATEMENT OF BERT A. OTTO, DEPUTY COMPTROLLER, CENTRAL DISTRICT, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. OTTO. Chairman Moore, Ranking Member Biggert, and members of the subcommittee, my name is Bert Otto and I am the Deputy Comptroller for the Central District of the Office of the Comptroller of the Currency. I have been a National Bank Examiner for almost 37 years and I have been involved in the direct supervision of community and mid-sized national banks for nearly my entire career. I appreciate the opportunity to be here today.

The OCC's core mission is to ensure that national banks remain safe and sound and meet the credit needs of their communities and customers. Part of an examiner's job is to determine if banks make loans on prudent terms based on sound analysis of the borrower's financial condition, recognize weaknesses and existing credits and work with borrowers to develop corrective plans whenever possible, maintain sufficient reserves and capital to buffer and absorb losses and actively reflect the condition of their loan portfolio and their financial statement. It is not the examiner's job to dictate loan terms, products, or borrowers. These are decisions that bank management must make.

The critical part of our job is determining when potential risk exposures or weaknesses require corrective action by bankers. Knowing when to make these calls requires judgment and a balanced supervised reproach. We strive to get this balance right through strong, thoughtful, and consistent supervision and clear, two-way communication with banks we supervise. Maintaining this balance is critical in supporting a sustainable economic recovery and restoring the health of the commercial real estate market.

Commercial real estate issues confronting the Chicago metropolitan market mirror what we have been seeing nationwide. Vacancy rates are still rising nationally and cash flows produced by CRE properties are continuing to decline.

While there is some evidence of a slight improvement in the CRE markets, we expect that many banks will experience further deterioration in their loan portfolios. These conditions have strained both CRE borrowers and the CRE loan portfolios of many banks. The OCC has been addressing the build-up of risk in this market for the past several years and my written statement includes details about targeted CRE examinations we have conducted at banks at risk due to the nature and scope of their CRE activities, guidance we have issued, and outreach to examiners and bankers we have conducted.

Last October, we and the other banking regulators issued additional guidance on CRE loan workouts to provide greater clarity and certainty on our policies and expectations. The guidance also promotes consistency across the agencies in our evaluation of CRE credits and stresses two of our long-standing policies that examiners will not classify a loan based solely on the decline and underlying collateral values, nor will they criticize prudent loan workout arrangements. Indeed, such workouts are often in the best interests of financial institutions and the borrower.

In summary, we are aware of the critical role that bank credit plays in the health of our Nation's economy. Our message to bankers is to make new loans to creditworthy borrowers using prudent underwriting standards, realistically recognize and address problem credits, and work constructively with troubled borrowers to the extent possible.

Thanks again for the opportunity to appear here today and I will be happy to answer your questions.

[The prepared statement of Mr. Otto can be found on page 172 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Mr. Otto.

The Chair next recognizes Mr. McKee. You are recognized, sir, for up to 3 minutes.

STATEMENT OF DANIEL T. McKEE, CENTRAL REGIONAL DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. MCKEE. Good afternoon, Chairman Moore, Ranking Member Biggert, and members of the subcommittee. Thank you for inviting me here today. My name is Daniel McKee and I'm the Regional Director of the OTS Central Region here in Chicago.

Our region provides day-to-day supervision of OTS-regulated thrifts in 10 Midwestern States, including Illinois. In the Chicago area, we supervise 27 savings associations with total assets of about $7.1 billion. Approximately 23 percent of those assets or approximately $1.6 billion consists of commercial real estate, known as CRE.

The nationwide contagion that began in the home mortgage market has reached CRE and although thrifts are limited in the amount of CRE lending they can do, some OTS-regulated thrifts, particularly the small community-oriented institutions, have suffered significant CRE losses. In some cases, those losses have contributed to thrift failures.

In light of elevated delinquency rates of all types of loans, thrifts and banks are understandably more careful in extending credit than they were during the height of the real estate boom a few years ago. This is generally a good thing. No one advocates returning to the kind of standards for loan underwriting that helped bring about the financial crisis. However, no one wants the pendulum to swing too far in the other direction and unduly restrict credit to creditworthy borrowers.

The key is achieving a balance between the safety and soundness of financial institutions and the proper flow of credit that is essential to a vibrant economy. The OTS takes the position that thrifts should never turn away good customers. We have conveyed those supervisory expectations to the thrift industry and have joined in interagency guidance that drives home the point.

The reality remains, however, that credit will continue to be somewhat constricted as long as the economy suffers from pressures such as high unemployment and the impact continues to show on the balance sheets of banks and thrifts in the form of delinquent loans.

Regarding recommendations for the future, the OTS has advocated easing restrictions on commercial lending and small business loans by thrifts. This proposal which passed the full House of Representatives twice in the past is fully consistent with the traditional focus of thrifts on consumer and community lending and it would make badly needed CRE credit more available in communities across America.

Thank you again, for having me here, Mr. Chairman, and I'm happy to answer any questions.

[The prepared statement of Mr. McKee can be found on page 153 of the appendix.]

Chairman MOORE OF KANSAS. Thank you very much, Mr. McKee.

And now, the Chair recognizes Ms. Lemieux for 3 minutes, please.

STATEMENT OF CATHY LEMIEUX, SENIOR VICE PRESIDENT, FEDERAL RESERVE BANK OF CHICAGO

Ms. LEMIEUX. Chairman Moore, Ranking Member Biggert, and members of the subcommittee, thank you for the opportunity to testify at this timely and important hearing. I should note that I'm testifying today in my role as Head of Bank Supervision at the Federal Reserve Bank of Chicago and what I say does not necessarily represent the views of the Board of Governors of the Federal Reserve System.

Conditions in commercial real estate markets pose a threat to the banking industry nationwide, and in the Chicago area, many local banks have heavy concentrations in commercial real estate lending. There are signs that CRE markets are firming, however, the time needed to fully recover might be measured in years, not months.

In my written testimony, I place this challenge in the context of overall financial and banking conditions and survey a wide range of Federal Reserve initiatives. However, I will focus my remaining comments on bank supervision.

Federal Reserve supervision has focused on CRE exposures for a number of years. Most recently, we have been working vigorously to implement the interagency guidance on prudent loan workouts issued last October. It's key messages are: (1) that prudent workouts are in the best interest of both banks and borrowers; (2) examiners should take a balanced and consistent approach in their view of banks' workout activities; and (3) restructured loans will not be adversely classified solely because the collateral has declined to an amount less than the loan balance.

Since the guidance was issued, the Federal Reserve has conducted extensive staff training and industry outreach to underscore the importance of sound lending practices. For example, at the Federal Reserve Bank of Chicago, we have devoted 2 days to training our 300 examiners to ensure they had a thorough and consistent understanding of this guidance. We have also hosted a number of forums where supervisors and bankers can exchange views on CRE lending and credit availability.

Current real estate market conditions are unlike any we have seen in some time. This has raised safety and soundness concerns at some banks. We are committed to working with our banks as they deal with these challenging conditions. A healthy banking system is a prerequisite for providing credit to sound borrowers.

I would be pleased to answer any of your questions.

[The prepared statement of Ms. Lemieux can be found on page 122 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Ms. Lemieux. I very much appreciate your testimony. I will start. I have 5 minutes for questions.

Ms. Lemieux, I was struck by how many of our witnesses on the first panel called for the extension of TALF to help stabilize the commercial real estate market. What's your reaction to that broad support for extending TAFL? Is that something the Federal Reserve should monitor and consider, especially with the expiration of the program to occur in the next month or so.

Ms. LEMIEUX. I did hear the comments and will certainly relay them to the policymakers in Washington. I'm focused on bank supervision, but I will say that we are pleased that the TALF program has spurred the beginning of issuance and our contacts in the industry tell us that the private market is beginning to work and there are plans for private issuance of TALF, but I can provide you with further comments from our policymakers.

Chairman MOORE OF KANSAS. Thank you. This next question is for all the witnesses. I appreciate very much the efforts of all of your agencies to provide more clarity and certainty on responsible small business lending and CRE loan workouts, but the message from D.C. doesn't seem to be making its way down to the officials doing the bank examinations.

We heard at our field hearing in Michigan last November and we have heard it today, so two questions: One, yes or no, do you acknowledge this is the case? And two, what steps is your agency taking internally to get that message all the way down to the frontline examiners.

Mr. Lowe, do you have thoughts, sir?

Mr. LOWE. Yes, sir. I do. First off, is it the case that there's a disconnect? Personally, I do not believe that there is. There may be some differences of opinion about the interpretation of how we're looking at loans and looking at credit and the factors that we take into determining how credits will be classified, but I don't believe there's any disconnect between our policy statements, the financial institution letters that we have issued jointly with the other agencies. And some of the things that we have done at the FDIC and I think the other regulatory agencies have also, we have issued internal memorandums. We have had nationwide conference calls with all of our examiners across the country to make sure everyone knows what the expectations are. And that expectation is that we're going to be looking at cash flow. We're going to be looking at performance in determining the quality of credits and determining if there should be some type of impairment that needs to be recognized.

Chairman MOORE OF KANSAS. Thank you. Mr. Otto, your thoughts?

Mr. OTTO. Yes, I would agree with Anthony's comments and then extend it a little bit further. I think we have done a lot of work in getting the message out to the examiners, but also bankers. We have held CEO roundtables. We have had chief credit officer roundtables where we really do ask for feedback on our policies. And if something is not clear, we would hope that we would have that two-way communication.

But something I don't think any of the agencies did a very good job of at the last downturn of the economy and we have kind of learned from that, that was a lessons learned and we're really trying to stress the importance of that two-way communication. We can't really deal with the issue unless we have bankers stepping up and talking to us about what their feeling is in their examinations.

Chairman MOORE OF KANSAS. Thank you, Mr. Otto. Mr. McKee, sir?

Mr. MCKEE. As Bert indicated, we have done the same at the OTS, and in the last couple of months, I have had 4 CEO outreach meetings where we invite between 15 to 25 CEOs together. I had one here in the Chicago office about a month, month and a half ago. And through that type of forum, we do get good feedback from the bankers, really what they're seeing, what problems they are having. And we ask them during that process, what can we do better, what can we do differently through our exam process?

I have a call with all of the examiners from the central region, the 10 States that I'm responsible for, later this month. And I'll be going through the results of that type of a discussion with the examiners at that point. And nationally, the OTS has reached out to all the examiners on a conference call to discuss these types of issues as well.

Chairman MOORE OF KANSAS. Very good. Ms. Lemieux, do you have any comments?

Ms. LEMIEUX. I certainly agree with my regulatory colleagues. At the Chicago Fed, we really have four lines of defense to make sure that the application of the guidance is consistent and effective. The first is examiner training, and I mentioned that in my opening statement. As the FDIC does, we have calls with the industry and calls with all our staff across the system to address questions that come up in the field as this guidance is applied.

The second is outreach to the banking industry. The Chicago Fed conducts a community banking symposium. We had one last November and it was co-sponsored by the individuals here at this table. We had over 200 bank CEOs and Governor Duke was our speaker who discussed, in depth, that guidance which at that time had just been issued.

Third, we have internal quality management programs that ensure that our guidance is supplied consistently. No one examiner gets to decide these things by themselves. There's a group of people, not only the exam team, but the officers and managers in the office as well as we consult with our specialists as well as our colleagues in Washington to make sure we get that answer right.

Fourth, as is the case with all agencies, bankers have the right to appeal examination decisions. And to date, the Chicago Fed hasn't had appeals on this issue from our bankers.

Chairman MOORE OF KANSAS. Thank you. My time has expired. The Chair will next recognize Ms. Biggert for questions for up to 5 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. I appreciate all of your testimony and the issue you have been talking about as far as the loan valuations. Would you all be willing to participate in a roundtable with the stakeholders to discuss this?

Mr. Lowe?

Mr. LOWE. Absolutely.

Mrs. BIGGERT. Mr. Otto?

Mr. OTTO. Yes.

Ms. LEMIEUX. I might offer that the Chicago Fed has hosted a number of hearings for different task forces and we would be happy to work with you on that.

Mrs. BIGGERT. Thank you. I appreciate that. Then Ms. Lemieux, on page 7 of your testimony, you mentioned that the Fed recognized in the 1980's and the 1990's the problems with the rising CRE concentrations and as a result you led an interagency effort to develop supervisory guidance on CRE concentration. When did you propose this guidance?

Ms. LEMIEUX. I'm a little confused with the reference.

Mrs. BIGGERT. It's on page seven.

Ms. LEMIEUX. Do you mean the 1990 guidance or the most recent guidance?

Mrs. BIGGERT. It was 2006.

Ms. LEMIEUX. Yes, we actually in the Chicago Fed began identifying this issue much earlier. In 2004, we worked with our colleagues throughout the system and our bankers to really fully understand the issue. The guidance was developed and went through an inter-agency process and was eventually issued.

Mrs. BIGGERT. It concerns me that for a decade and a half some banks continued to make these risky CRE loans and increased the concentration in their portfolio.

Ms. LEMIEUX. I guess I'm a little confused, because certainly a lesson learned from the 1990's was the impact commercial real estate can have on—and concentrations can have. And in terms of our focus on risk management at banks, we certainly viewed concentration as a risk and worked with our banks to make sure that they had the procedures and the internal controls and the audit to mitigate the results of those concentrations.

Mrs. BIGGERT. We looked at the Midwest Bank and Trust failure last Friday. It seems that was a concentration that wasn't—that the various regulators didn't really look at.

Ms. LEMIEUX. There is never just one reason a bank fails. And certainly Midwest Bank was subject, had invested heavily in commercial real estate and the management there tried valiantly to adjust their operations to overcome the dramatic change in real estate values. As someone mentioned before, preemptory action requires certain actions. It's just limited the time management had to make adjustments.

Mrs. BIGGERT. I was just summarizing a report that says the FDIC failed to supervise the bank and failed to take any action. There was a risky CRE loan concentration and essentially failed to do the job. And then finally, it is no secret that our State Treasurer's family bank, Broadway Bank, recently failed. And looking at that timeline, they issued more risky CRE loans over the course of several years and the press reports tell us that in 2007, 2008 the shareholders of the bank walked away, the family walked away with $70 million in dividends and in 2009, the Broadway Bank was told to raise $85 million by April and they didn't meet that and failed. And the cost to the FDIC Fund is reported to be about $400 million. And in addition, some say that the family could walk away with millions in tax write offs. And the jury is not out. Now we have another perhaps cost to the FDIC Fund of Corus Bank and any—we have to work for the MLRR report from the Treasury Inspector General on that. So we don't know what's going to happen there. And it could cost over $100 million. So there's something wrong with this picture. And the regulators did nothing to stop this wave of these loans and I see he's going to bang the gavel on me. Maybe I'll get another chance to come back to that.

Chairman MOORE OF KANSAS. You still have a minute or so, if you would like.

Mrs. BIGGERT. Okay, good. Can anybody tell me why, for so many years, nothing has been done while your agencies knew that there was a problem if you all had an interagency, I would call it a summit or a meeting, saying that there was a problem and why weren't these loans talked about and these unsafe and unsound practices of so many banks?

Would anybody care to talk about that?

Mr. LOWE. Yes, Congresswoman, I'll try to attempt to answer parts of that. Back through the early part of the decade and leading up to the real estate crisis, if you were to look at our examination reports from any of the agencies of pretty much any of these banks that did fail, we were consistently warning the banks about concentrations of credit, concentrations in commercial real estate and specifically ADC and that type of lending. We were usually also making recommendations for the banks to strengthen their underwriting, to hold additional capital and again to strengthen the oversight of that and measurement and monitoring of that particular facet of a bank's operations.

The majority of those institutions at that point in time before the real estate market crashed were continuing to make profits. The credits were continuing to perform at that time and I think this goes to what we have been talking about. If a credit is performing, if it is cash flowing, we're looking at the collateral as a secondary form of repayment. So those credits were performing at that point in time. The market was still performing, so that did factor into our staff decisions.

Chairman MOORE OF KANSAS. The gentlelady's time has expired, so if you would like to ask that the witnesses make written comments available to the entire panel, we can do that as well.

Mrs. BIGGERT. I appreciate that.

Chairman MOORE OF KANSAS. Certainly. The Chair will next recognize for up to 5 minutes, Ms. Bean, the gentlelady from Illinois.

Ms. BEAN. I actually may pick up where my colleague left off. Five years ago, before this problem in the real estate market, what was done to try to change the allocation of loans at community banks since there does appear to have been this overconcentration in commercial real estate?

Mr. OTTO. I'll make a couple of comments. I think that one of the things that we looked at, we do monitor concentrations and we will make sure that the Board, the Board of Directors have approved limits and if the limits get out of line, we will have discussions with them. Do they have the staff necessary to handle high concentrations? And quite honestly in some cases, we will ask the bank to add capital, raise capital in some of these. What we have found in this crisis, what has caused a lot of the banks' problems has been high concentrations of out-of-area lending and growth. Concentrations and growth over my career, those are the two things that get banks into trouble. And we ask management to make sure that they have the controls in place, the MIS to monitor that and when it gets too high that the Board of Directors understand where they're at.

A lot of banks did not really know the level of concentrations.

Ms. BEAN. I actually am going to take the rest in a written report as the chairman had recommended just so I can get to some other questions. The committee will be considering this week legislation similar to the President's proposal to provide up to $30 billion of investment in community banks for the purpose of increasing small business lending.

Not only what impact do you think that would have on small business lending in Illinois, but how will the supervision of the bank that receives that investment be altered? To whomever wants to address that.

Ms. LEMIEUX. There are two ways to interpret that, certainly, we don't supervise banks that have received TARP any differently or any other type program any differently than we do other banks. We want to be sure they operate in a safe and sound manner and serve the needs of their communities. Certainly, TARP banks have extra reporting requirements concerning lending, so that would be up to the designers of the program.

Ms. BEAN. Any other comments on that? Another question, you talked about sometimes banks appealing a decision. We hear, I think all of us have heard from community banks who have felt that regulators have been overly stringent. They hesitate to appeal because they're fearful about ramifications. So who knows when a bank appeals a decision and should they be?

Mr. LOWE. At the FDIC, we have made it clear, because we have also had several venues across the region where we have had director's colleges and meetings with bank directors and chief executive officers where we have clearly indicated to them this is the process, if you don't concur with our findings during the examination process or the processing of a report or before the rating is issued, there are clearly some steps that can be taken. We try to resolve our differences of opinion during the examination process. If that doesn't occur and the bank still wishes to appeal or to have us consider some additional information we can usually do that at the regional office level. So that process has been made public to all our institutions that there is a process for them to pursue and we have had several appeals here over the last couple of years and we go through the process. We have a fresh set of eyes to look at the findings, look at the conclusions, look at the recommendations, and come to a conclusion as to whether the findings were well supported.

Ms. BEAN. So you're saying no, they shouldn't be here on appeal?

Mr. LOWE. No banks should be afraid to appeal.

Mr. MCKEE. I just might add to that the CEO meeting that I referred to earlier, two of those meetings we had the ombudsman which is the person in our organization who would oversee any type of an appeal in attendance there to try to get the dialogue, for them to get comfortable that it's not a bad thing for them to appeal, that we will take an independent review of it and make a decision at that point.

Ms. BEAN. I appreciate that and if I have time, and I'm sure you'll gavel me if I don't, my last question is about some of the proposals to amortize real estate losses at community banks over a period of years instead of immediately.

From your perspective, what are the positives and/or concerns? It does kind of align with some of the countercyclical recommendations that we have talked a lot about, but some also say that's kicking the can down the road and making a problem fester. What are your thoughts?

Mr. LOWE. I'll tell you one of my concerns would be that you potentially have this gap between the regulatory capital of an institution and gap capital where if you have this forbearance potentially, the bank is showing that it has more capital to protect against losses than it actually does. I think that takes away the transparency in the financial process for investors, for bank customers, a lot of that transparency is eliminated in that type of a process.

Ms. BEAN. Other comments?

Mr. OTTO. We feel that it delays the problems. I think we have tried that in the past, and from our perspective, it hasn't worked well.

Mr. MCKEE. I believe it would delay really the true capital position reflecting that. The thrift industry back in the late 1980's had deferred loan losses, the same type of principle and I think it was a lesson we learned, that was maybe not a good thing to pursue.

Ms. BEAN. Thank you.

Ms. LEMIEUX. I agree with my colleagues. I think one point I would like to underline that Anthony emphasized is transparency to the market. So it's not only the ability of our examiners to understand the financial condition of the organization, but also the investors in that organization and market participants.

Ms. BEAN. Thank you. I yield back.

Chairman MOORE OF KANSAS. The gentlelady's time has expired. I now recognize Mr. Foster for 5 minutes.

Mr. FOSTER. Thank you. One thing that we have heard from several witnesses, I guess, is the statement that loans will not be reclassified solely on the basis of the drop in collateral value. And it sounds like that is crying out for some fine print and a little asterisk. So I was wondering, under what conditions will the value of the underlying collateral become relevant in the examination process and so on? If we could just march down the line.

Mr. LOWE. Basically, when we start looking at collateral we have come to a conclusion that the borrower does not have the wherewithal, either the willingness or the ability, to continue to amortize a loan as contracted. They either don't have the cash flow, the global cash flow or assets that can be liquidated, to continuing amortizing and at that point in time, we will start to look at the collateral since that is the secondary source of repayment.

Mr. FOSTER. Do you look at the overall—across the whole portfolio, the total amount of collateral compared to the loan size and so on in such a way that a bank would have an incentive to try to get rid of or not renew loans that were not well collateralized? If you understand my—what I'm trying to—whether you look at the total collateral position of a bank when you're evaluating its health, I guess—

Mr. LOWE. You mean for an individual credit?

Mr. FOSTER. No, not on a loan-by-loan basis, but overall.

Mr. LOWE. We generally will do our credit reviews on a loan-by-loan type of basis and not by looking at the—

Mr. FOSTER. So it's strictly only true how well collateralized it is after you have concluded that the thing has gone belly up and you're looking at liquidation as a possibility. Okay.

Mr. OTTO. Yes, if the primary source of repayment obviously is cash flow, if that is gone, then we look at the collateral that the collateral covers, but the primary source of repayment would have to be gone.

Mr. MCKEE. But if the primary source of repayment is still sufficient, the collateral may not be sufficient to collateralize the loan, but it doesn't mean it's a problem loan at that point. Again, we look at the primary source which in real estate is going to be your cash flow.

Mr. FOSTER. So a bank that has lots and lots of performing loans all of which are undercollateralized would not be a source of concern for you?

Mr. MCKEE. It potentially could be a source of concern. We would have to look at each loan on an individual basis.

Mr. FOSTER. If each were performing individually, you would say okay, that's fine, and that's really the way it works in reality. Okay.

Mr. MCKEE. Because some banks can make unsecured loans.

Mr. FOSTER. Okay. Let's see, I guess it strikes me that one of the fundamental questions that we have to face when we're talking about schemes to recapitalize banks as Melissa mentioned or just CRE market supports, whether we're going to establish programs and policies that effectively put the taxpayer on the hook if there's a double dip in commercial real estate prices. And from that point of view, the TARP program was a success. There wasn't a double dip in toxic asset valuations and the taxpayer got out, in fact, with a profit.

In the CRE, it's less clear. I was wondering if you have any words of wisdom on how well defended we should be against a double dip in commercial real estate and prices as we're thinking about these programs?

Ms. LEMIEUX. We can refer it to the policymakers in Washington.

Mr. FOSTER. It's a fundamental question. We can recapitalize a bunch of marginal banks and lose that whole investment if, in fact, there is a further drop. And so it's a fundamental question and I wonder who we should turn to for advice on the risks that we're putting out for the taxpayer?

Ms. LEMIEUX. It is a serious question and one of the criteria for TARP was that the money went to viable banks and that requirement was important to the market because they knew that was a requirement, so it was a signaling mechanism for others that might have the ability to invest in that bank. So that's just an observation.

Mr. FOSTER. Any words of wisdom you have would be very welcome because that's the fundamental question we're facing. Thanks. I yield back.

Chairman MOORE OF KANSAS. The gentleman yields back, and I think we do have a few extra minutes here, so with everybody's consent, we're going to do one 2-minute round of questions again, and then we'll start on our third and final panel.

Mr. Lowe, I would like to get your view on a couple of items with respect to bank failures given the FDIC's role in that. Knowing that more banks will likely fail and there will be some ongoing consolidation within the banking sector, what steps has the FDIC taken to make sure that any banks sold are sold to a wide variety of other firms and not just the largest banks? And what is your reaction to the suggestion that CRE assets from failed banks be securitized as they were following the S&L crisis?

Mr. LOWE. With regard to the sale of institutions, we're required under the law right now to make sure these transactions are done at the least cost to the Deposit Insurance Fund. When we go through the process of coming up with the bid list and actually when we put the bank out for bid, we do look at a lot of factors, the capital of the institution that's going to be acquiring it, the management expertise, the business plan, different factors, but when we make a final decision we do still have to make sure it is the least cost, regardless of the type of transaction that we do decide is the best that we need to be pursuing.

I'm sorry, what was the second part of the question?

Chairman MOORE OF KANSAS. What's your reaction to the suggestion that the CRE has from failed banks be securitized as they were following the S&L crisis?

Mr. LOWE. That's an issue I would like to consider for a follow-up response.

Chairman MOORE OF KANSAS. Ms. Biggert, you are recognized for 2 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. I still don't understand why it took 16 years for agencies to issue the guidance on CRE loan concentrations. I know John Dugan, the Comptroller of the Currency, in The American Banker, said we know that significant CRE concentrations and economic downturns can lead to an increase in problem banks, an increase in bank failures, loss of jobs, loss of income, loss to communities, loss to the Deposit Insurance Fund, and higher costs for all banks, even those that do not have CRE concentrations. I think it's just a shame that—particularly with the FDIC. I have a bank in my District that failed and the way that—when it came out, the Inspector General for the FDIC said it was—that the FDIC failed to do the job and it is costing us so much money with—to take over banks.

Is there going to have to be another special assessment to the banks for the FDIC? Is that in the works?

Mr. LOWE. At this point in time, I'm not aware that we're considering another special assessment. We continue to look at our pricing and our premiums. Just a couple of weeks ago—last month, actually, our Board of Directors did approve for notice of a proposal to look at—looking at the larger, more complex institutions and making sure they were appropriately pricing their deposit insurance coverage. But at this point in time, to my knowledge, there are no plans for an additional special assessment.

Mrs. BIGGERT. That's good news, because every special assessment then raises the capital which then lowers the ability of the banks to make the loans. Does anybody have anything additional to add to how this is going to change?

Mr. MCKEE. I just might mention on the concentration piece that the thrift industry, OTS, we have a statutory limitation of 400 percent and that's been in effect for many years, so we did not join the other regulatory agencies with their guidance because of the fact that we had the statute that already limited the CRE concentration.

Mrs. BIGGERT. I worry about this, but on the other hand, I worry about an overreaction too, so there's such regulation that it goes too far. Work on that, please. I yield back.

Chairman MOORE OF KANSAS. Thank you. Ms. Bean, you're recognized for 2 minutes.

Ms. BEAN. Thank you, Mr. Chairman. You can get back to me in the interest of time so we can get you the third panel, but I had asked the last panel about underwriting standards for commercial real estate loans. If you can give me a yes or no on whether you think further congressional action is necessary in that regard, that would be helpful. If we can go right down the line?

Mr. LOWE. No.

Mr. OTTO. We would have to look at it.

Mr. McKEE. Same here. We would have to study that.

Ms. LEMIEUX. I think that's in the realm of bank management. That's a decision that different managers of banks and boards make, depending on the risk appetite of their organization. But again, we can get back to you on that.

Ms. BEAN. I yield back.

Chairman MOORE OF KANSAS. Thank you. Mr. Foster, you are recognized, sir, for 2 minutes.

Mr. FOSTER. I was wondering if someone could explain briefly how the different classes of commercial real estate loans are handled in terms of capital requirements? And whether there are any changes in these requirements that could provide some capital relief without really changing the overall risk to the FDIC Fund, this sort of thing? Are there any specific proposals out there that would allow you to say that there is a certain class of real estate loans is not really a risk and you shouldn't hold as much capital against it as other classes? Is that already done to the extent possible? Are there further enhancements of that, which might provide some relief?

Mr. LOWE. The risk-based capital is, and I'm struggling with what the numbers are, the limits are, but there are different percentages of capital that's assigned, based on risk-based capital.

Mr. FOSTER. There are several of these different classes?

Ms. LEMIEUX. This is the FOSL 1 rules, so there are big buckets, residential real estate. So they're not very risk sensitive. That's how we determine our risk-based assets.

Mr. FOSTER. Is there a chance that you could better match the real risk to what's there?

Ms. LEMIEUX. Certainly, we're working with all the regulators internationally on risk-based capital standards. And while in the United States, we have elected to apply those only at the largest banks, there are ramifications and proposals being considered to adjust the FOSL 1 requirements in light of what we have learned, but they certainly won't be as individually tailored as they are for the largest banks.

Mr. FOSTER. Have there been any easy to explain systematic differences in the lending practices and the degree to which commercial real estate is a problem among the different chartered organizations? It's sort of an open-ended question. But if you just look, different banks. Maybe if you could respond in writing, I guess.

Ms. LEMIEUX. Okay.

Chairman MOORE OF KANSAS. I would ask the witnesses, if they would, please respond in writing, because the members certainly have the right to ask the questions. We're just out of time now.

I want to thank our second panel for your testimony. You're now excused. I'll invite the third and final panel of witnesses to please take your seats. Thanks again for coming today and for testifying.

I'm pleased to introduce our third and final panel: Ms. Paula Dubberly, Associate Director, Division of Corporation Finance, at the SEC: Mr. Kevin Stoklosa, Assistant Technical Director, Financial Accounting Standards Board; Mr. Leslie Sellers, president of the Appraisal Institute; Mr. Kent Born, senior managing director, PPM America, testifying on behalf of the CRE Finance Council;

and Mr. Bruce Cohen, CEO, Wrightwood Capital, testifying on behalf of the Real Estate Roundtable.

Without objection, the written statements of each of the witnesses will be made a part of the record, and you will each have 3 minutes to summarize your statements and touch on the key messages you would like to share.

Ms. Dubberly, you are recognized for 3 minutes.

PAULA DUBBERLY, ASSOCIATE DIRECTOR, DIVISION OF CORPORATION FINANCE, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. DUBBERLY. Chairman Moore, Ranking Member Biggert, and members of the subcommittee, I am Associate Director of the Division of Corporation Finance at the SEC and I'm pleased to testify on behalf of the Commission today on the topic of securitization. Securitizations may serve as a vehicle for financing commercial real estate, so my comments today will provide an overview of the Commission's work in the securitization area, specifically focusing on a recent proposed rulemaking that the Commission published for public comment on April 7th that proposes significant revisions to the rules governing offers, sales, and reporting with respect to asset-backed securities.

Securitization generally is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into instruments that are offered and sold in the capital markets as securities.

At its inception, securitization primarily served as a vehicle for residential mortgage financing, but since then has provided liquidity to nearly all major sectors of the economy, including the residential and commercial real estate industry, the automobile industry and the consumer credit industry.

Many of the problems giving rise to the financial crisis involved asset-backed securities, including residential mortgage-backed securities. As the crisis unfolded, investors increasingly became unwilling to purchase these securities. The absence of this financing option has negatively impacted the availability of credit.

The Commission's proposal is intended to provide investors with timely and sufficient information. Although these revisions are comprehensive and therefore would impose new burdens, if adopted, the Commission believes they would protect investors and promote efficient capital formation.

I will briefly summarize the proposal. The proposal would change the eligibility requirements for ABS offerings to qualify for expedited treatment. One of the current eligibility requirements for these expedited offerings is that the securities are rated investment grade by a nationally recognized statistical rating organization. Much has been written about the failure of ratings. The proposal would repeal the expedited offering criterion relying on ratings and establish new requirements for expedited ABS offerings. These proposed requirements are designed to provide for a certain quality and character for ABS securities that are eligible for expedited issuance.

Because many ABS investors expressed concerns that they did not have enough time to consider the disclosures about the potential investment, the proposal would require issuers doing an expedited offering to provide at least five business days for investors to consider a preliminary prospectus about the offering.

The proposal would require, in addition to aggregated pool data, disclosure of specified loan level data and machine-readable standardized format. The data points the Commission proposed to require for commercial mortgage-backed securities are primarily based on the definitions included in the CRE Finance Council's investor reporting package, current regulation AB requirements and staff's review of current disclosure.

The Commission also proposed to require the filing of a computer program of the contractual cash flow provisions of the securities. Significant concerns have been raised about investor protection in the private ABS market where a significant portion of securitization transactions take place.

The Commission proposed to require enhanced disclosure by ABS issuers who wish to take advantage of the safe harbor provisions for these privately-placed ABS. In addition, the Commission proposed amendments to require ABS issuers to file a public notice.

The comment period for the proposed rules expires on August 2nd. The Commission looks forward to reviewing and considering all comments.

Thank you again for the opportunity to testify.

[The prepared statement of Ms. Dubberly can be found on page 105 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Ms. Dubberly.

Mr. Stoklosa, you are recognized for 3 minutes, sir.

STATEMENT OF KEVIN STOKLOSA, ASSISTANT TECHNICAL DIRECTOR, FINANCIAL ACCOUNTING STANDARDS BOARD

Mr. STOKLOSA. Mr. Chairman and members of the subcommittee, my name is Kevin Stoklosa, Assistant Director of Technical Activities at the Financial Accounting Standards Board.

Thank you for inviting me today to participate in this important hearing.

Since 1973, the FASB has established standards of financial accounting and reporting for nongovernment entities including both businesses and not-for-profit organizations. Those standards are recognized as authoritative, generally accepted accounting principles. GAAP is essential to the efficient functioning of the U.S. economy because investors, creditors, donors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make resource allocation decisions.

Because the actions of the FASB affect so many organizations, the FASB carefully considers the views of all interested parties including users, auditors, regulators, and preparers of financial information in its decision-making process. Although the FASB and regulators have different objectives, because of their keen interest in GAAP financial statements as the starting point in their assessment of the safety and soundness of an entity's financial position, the FASB members and staff regularly meet with regulators to obtain their input and better our understanding of their views.

The subcommittee is examining the causes of the turmoil in the commercial real estate market, and the state of the market. I would like to focus my remarks on the FASB's accounting guidance that most significantly affects these companies.

From the perspective of entities that develop, purchase, or own commercial real estate, the accounting guidance requires those entities to measure the investment at historical cost. Under this accounting model, entities are required to capitalize certain costs incurred in the development or acquisition of commercial properties. GAAP provides prescriptive guidance on what costs should be capitalized and when capitalization of those costs should cease to continue. Testing properties for impairment during both the construction stage and once the property is available for occupancy is also required.

As a result of input from both preparers and users of financial statements, the FASB has recently added a project to its agenda to reconsider whether entities should be permitted to measure investment properties at fair value, instead of historical cost. International accounting standards currently permit investment properties to be measured at fair value.

From the perspective of entities that finance commercial real estate, the accounting guidance is based on whether the creditor holds the loans or whether the creditor transfers or securitizes the loans. Last year, the FASB issued Statements 166 and 167 which were needed improvements to the accounting and reporting for transfers of financial assets, including securitizations, and other involvements with special purpose entities. This guidance, which still allows for entities to obtain sale accounting, where appropriate, it should result in more assets involved in such transactions staying on the books of the sponsoring financial institutions, by significantly reducing the ability to get off-balance sheet treatment for securitizations and other similar arrangements where significant risk is retained by the entity. Although this guidance will better reflect financial institutions' exposure to risks, it may affect their ability to comply with the regulatory capital requirements and therefore affect the liquidity available to the CRE industry.

Mr. Chairman, that concludes my prepared remarks. I would like to thank you and the subcommittee for the opportunity to testify this afternoon.

[The prepared statement of Mr. Stoklosa can be found on page 193 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Mr. Stoklosa for your testimony.

Mr. Sellers, you are next recognized for 3 minutes, sir.

STATEMENT OF LESLIE SELLERS, PRESIDENT, APPRAISAL INSTITUTE

Mr. SELLERS. Being here at the site of the Great Chicago Fire of 1871 is reminiscent of mass destruction and rebuilding, not unlike the work that we face to rebuild our financial system today. Hundreds of banks are expected to fail in the next 2 years. Financing for commercial real estate is nearly nonexistent as trillions of dollars of commercial paper comes due.

Based on my discussions with government officials, investors, and borrowers throughout the world, there's a striking concern that we conduct real estate financing with a Wild West attitude. The United States has lost credibility as a financial leader of the world. Clearly, if we are going to retain and attract new investment, we must earn back the trust of investors.

We firmly believe that collateral risk assessment must be enforced. We cannot rely on credit risk alone. We must account for collateral risk. We need to promote quality and competency over speed and volume. We need to consistently enforce lending regulations and guidelines. We need to elevate risk management to be on par with loan production.

We believe there are specific actions that can help put out the fires and help in the rebuilding process. First, to help with the CRE workouts, lenders should engage competent appraisers to provide multi-value appraisals, providing as-is market value, liquidation value, and fair value. These represent the most likely, the most pessimistic, and the most optimistic measurements applied to risk.

Second, financial institutions should engage independent valuation experts in the periodic monitoring of CRE assets, much like pension funds and institutional investors do now.

Third, we need to strengthen the interagency appraisal guidelines to demand competency, quality, and accountability.

And finally, we need to strengthen the institutional capacity of collateral risk within the financial institutions and the bank regulatory agencies for better oversight and enforcement.

In closing, professional appraisers stand prepared to battle the fires confronting the commercial real estate market today. As we look to win back the confidence of investors worldwide, we believe enhanced collateral risk assessment is one of the building blocks necessary to chart that path.

Thank you, and I am happy to answer any questions.

[The prepared statement of Mr. Sellers can be found on page 184 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Mr. Sellers, for your testimony.

The Chair will next recognize Mr. Born. You are recognized, sir, for up to 3 minutes.

STATEMENT OF KENT BORN, SENIOR MANAGING DIRECTOR, PPM AMERICA, ON BEHALF OF THE CRE FINANCE COUNCIL

Mr. BORN. Thank you, Chairman Moore, Ranking Member Biggert, and members of the subcommittee.

My name is Kent Born. I manage a $6 billion commercial mortgage-backed securities portfolio for PPM America. I also am a past president of the CRE Finance Council which represents lenders, issuers, servicers, and investors of all kinds.

Today, I would like to focus on three points: first, the challenges facing commercial real estate finance; second, the unique structure of CMBS; and third, policies to support a lasting recovery.

As a lagging indicator, the $7 trillion commercial real estate market is now feeling the full impact of a prolonged recession. The contagion from the collapse of the subprime market spread quickly to CMBS even though loan defaults and ARM market remained less than one percent for more than a year after the subprime meltdown.

Today, a perfect storm exists in four interconnected challenges. First, there's virtually no lending in the CMBS market and this is down from nearly $250 billion of lending as recently as 2007.

Second, approximately, $1.4 trillion in commercial real estate loans mature over the next several years.

Third, at the risk of stating the obvious, we are in the midst of a recession.

And finally, a severe equity gap exists in commercial real estate. Commercial properties have lost anywhere from 30 to 50 percent of value since the fall of 2007, and this is arguably the biggest challenge that we face in the market today.

The centerpiece of the financial stability plan is restarting securitization to meet borrower demand. In order to do this, there are four key differences that need to be understood in any policy.

First, CMBS borrowers are sophisticated businesses that own income-producing properties. Second, the CMBS structure typically includes anywhere from 100 to 300 loans averaging $8 million in size. Third, we have the COE Finance Council Investor Reporting Package, a standardized database that is now being used as a model for the residential market. And finally, we're the only market with first loss investors who re-underwrite all of the loans in a pool prior to issuance.

There are four key areas that provide a framework for recovery. First of all, we need increased coordination in accounting and regulatory reforms and we support a House-passed study on these issues.

Second, we need reforms that are customized by asset class. In this regard, House and Senate-passed language to consider the best form of skin in the game for commercial mortgages is crucial.

Third, we need new capital sources for the commercial real estate market. TALF was extremely helpful in terms of bringing liquidity back to the secondary market, but we need to explore ways to address the equity gap issue such as RTC-like structures, guarantees for small loans and/or covered bond frameworks.

And finally, we need to provide investors with certainty. Investors need certainty in regulation and they need confidence in areas such as credit ratings and in underwriting and really the market as a whole.

So I thank you for the opportunity to testify and I look forward to taking your questions.

[The prepared statement of Mr. Born can be found on page 65 of the appendix.]

Chairman MOORE OF KANSAS. Thank you to all of our witnesses for your testimony. I recognize myself for up to 5 minutes for questions.

Mr. Born, you first, sir. Taking a step back from commercial real estate, I find that most Americans may not understand how securitization works from a fundamental level and how it impacts their everyday lives.

I'm sorry, excuse me. I apologize. Mr. Cohen, you're recognized. I apologize. I didn't mean to leave you out there. You have 3 minutes, sir.

STATEMENT OF BRUCE R. COHEN, CEO, WRIGHTWOOD CAPITAL, ON BEHALF OF THE REAL ESTATE ROUNDTABLE

Mr. COHEN. My name is Bruce Cohen, and I'm the chairman and chief executive officer of Wrightwood Capital. I appreciate the opportunity to testify today on behalf of the Real Estate Roundtable.

I commend you, Mr. Chairman, and the members of this committee for holding this hearing. The capital-related issues facing the commercial real estate industry are real and pose meaningful risks to the overall economy. We are grateful for your efforts to identify critical policy actions that can address this increasingly troublesome situation.

The bottom line is this: Despite some stabilization of the broader credit market since the fall of 2008, and modest improvements in credit availability for a small segment of commercial real estate markets, the current financial system in America simply can't meet the financing needs of the broader commercial real estate market.

Absent a significant change to the current landscape, the jeopardy to the overall economy is material. Some might ask, why should we care? Let me offer some reasons for concern.

First, we're in a time in which budgetary pressures on State and local governments are extraordinary. Many people are unaware that local governments on average receive 50 percent of their revenue from commercial real estate-related transactional activities. A sick commercial real estate market will naturally exacerbate the problems these communities face.

Second, the absence of capital translates to an inability to build new buildings or meet the construction-related needs of older ones. This will lead to a dramatic reduction in jobs, given the prominent role construction plays in our overall economy, as well as fewer opportunities for building owners to make their properties more energy efficient.

Beyond the effects on jobs and building needs themselves, most are unaware of the sizable economic stakes that citizens have in healthy commercial property markets. Estimates are that Americans have approximately $160 billion of retirement savings invested in commercial real estate. So as commercial real estate goes, so go local budgets that are already pinched, jobs which are already in short supply, and retirement accounts, pension plans, endowments, and foundations that have already been diminished.

We recognize and appreciate the steps taken so far by the Congress, the Federal Reserve, and the Treasury Department to try to address the vast liquidity crisis that's crippling the economy, destroying jobs, and causing a free fall in commercial property values, but much more needs to be done.

Our overall economy needs to see job growth, but estimates suggest that 50 to 60 percent of all job growth comes from companies with less than 100 employees. Simply put, additional measures must be taken to create credit capacity in the regional and community banks which in turn will stimulate the availability of capital for small and mid-market companies.

Moreover, even if traditional portfolio lenders to commercial real estate such as commercial banks and life insurance companies return to the market in force, these institutions simply do not have the capacity to satisfy the credit demand of this industry. Therefore, additional steps must be taken to restore asset-backed and commercial mortgage securitization markets.

In my written statement, I detail the policy mix the Real Estate Roundtable believes would be most helpful. First, the TALF program has compressed spreads and catalyzed some asset-backed and commercial mortgage-backed securitizations. The program has ended for legacy assets and will end in June for new CMBS. As this program has unwound, policymakers need to examine other measures that can help the securitization market.

As for small banks, one idea being considered in Congress involves a measure that will allow small and medium-sized banks to amortize their write-down and losses on commercial real estate loans on a quarterly straight-line basis over a 7-year period. Beyond the need to restore credit, the industry also faces a large equity gap. We think it's time to reform the laws applicable to foreign investment in U.S. real estate. Simple reforms to the current law, called FRPTA, could be made that would stimulate foreign capital flows. Lastly, we do not think it is the time to increase taxes on real estate, most specifically, the carried interest tax hike would discourage risk taking on the part of the real estate entrepreneur at a time in which we most need it.

Thank you for this opportunity. I would be happy to answer any questions the committee might have.

[The prepared statement of Mr. Cohen can be found on page 85 of the appendix.]

Chairman MOORE OF KANSAS. Thank you, Mr. Cohen, for your testimony. At this time, I recognize myself for up to 5 minutes for questions.

Mr. Born, taking a step back from commercial real estate, I find that most Americans may not understand how securitization works from a fundamental level and how it impacts their everyday life. Would you explain briefly how securitization can help expand credit availability for small businesses, loans, credit cards, student loans, things of that nature, please?

Mr. BORN. I think in general, securitization as a concept works quite well. There were obviously some abuses in the application of securitization which got us to the point where we are, generally speaking. It is a great way actually to, I think, to disperse capital throughout the system. Using the CMBS market as an example, you have banks who used to originate loans and warehouse loans. To the extent that they kept them on their balance sheet, at a certain point in time, they would be unable to continue to lend. By securitizing them and then selling the bonds to investors such as myself, you're able to basically take a pool of loans, tranche it into different areas of risk, sell it to the investors, different investors, who have an appetite for that risk, and then start lending money again, providing capital to the system which I think is for the most part a positive for the economy.

Chairman MOORE OF KANSAS. Thank you. During committee mark-up on financial regulatory reform in the House, I, along with

Representatives Walt Minnick, Melissa Bean, and others wanted to make sure the special nature of CMBS securitization was taken into account with respect to risk retention.

Ms. Dubberly, on securitization of risk retention, also known as "skin in the game" how would SEC's proposed rule affect commercial real estate securitization?

Ms. DUBBERLY. The SEC's risk retention piece only relates to what we call shelf offerings, which are expedited offerings, straightforward regular offerings where you file a registration statement. Those aren't impacted at all by the proposal. The proposal which has the risk retention piece in it is for expedited treatment. Currently, there is a requirement that the securities have to be investment grade. The Commission is trying to eliminate reliance on rating agencies, and so it tried to come up with another criteria for higher quality securities, so the 5 percent vertical slice risk-retention piece would apply there for any ABS issue. It's a 5 percent vertical slice. It's a piece of each tranche that's being sold.

Chairman MOORE OF KANSAS. Mr. Cohen, do you, and then Mr. Born, have any comments on that question?

Mr. COHEN. On the issue of risk retention?

Chairman MOORE OF KANSAS. Yes.

Mr. COHEN. Congresswoman Bean asked the question earlier about rating agency underwriting credit decisions. The best solution for credit decisions is the requirement to retain risk. So long as we have had a system where risk could be distributed, there wasn't anybody who had a responsibility for credit decisions in the system. So our view is, to the extent that there is credit discipline that's imposed, it will be imposed by people who have to bear the risk as opposed to any type of regulatory oversight.

Chairman MOORE OF KANSAS. Mr. Born, any additional thoughts?

Mr. BORN. I would say yes. Within the CMBS market, we originally tried to address this issue by virtue of these first loss investors as I described before who would literally re-underwrite every loan in the pool to get comfortable with that and then they would be buying essentially the equity piece and we're in the first line of defense, if you will. I think where that started to go astray was once they began to package up these securities and sell them off, they no longer had the vested interest that they had originally, so in terms of CMBS, I'm not opposed to retention, but I think something more along the lines of a requirement that these first loss investors, after they do all this diligence, have to hold on to these securities for some specified period of time, I think would address that issue.

Chairman MOORE OF KANSAS. My time is about to expire. I'm going to next recognize the ranking member, Ms. Biggert, please.

Mrs. BIGGERT. Thank you, Mr. Chairman. As we just learned during Panel 2, the regulators knew for quite a period of time, almost 2 decades, that there was high concentration of risky CRE loans and tried to issue some guidance about it. But the guidance didn't work and according to Panel 1, the guidance on valuation of performing loans also didn't seem to be working, so as I mentioned to the other panels, would you and your agency or association participate in a roundtable?

Mr. BORN. Sure.

Mr. COHEN. Absolutely.

Mrs. BIGGERT. Mr. Sellers?

Mr. SELLERS. Absolutely.

Mrs. BIGGERT. What are the real barriers to recovery in the CMBS market?

Mr. Born?

Mr. BORN. I'll take it. I think for us, it's really this equity gap. You have a lot of properties out there whose current cash flow can cover the existing debt service payment. But once they reach refinance, depending on when that date occurs, there could be a significant gap between what their property is now worth by virtue of the depreciation of property values, generally, and what the loan amount is. So that, to me, is critical.

The other issue that's been problematic in terms of generating new lending in CMBS is the warehouse risk. There was so much volatility in CMBS prices in 2008, particularly, the last part of 2008 that you couldn't really originate a new loan or pool of loans and know that you could ultimately sell the bonds at a profit.

One other point I would make, a number of people have talked about the importance of extending TALF for new issue CMBS. Candidly, I don't agree with that. I think TALF for legacy CMBS was enormously successful in terms of spurring secondary market liquidity, but TALF for new issue was never really designed to address the two problems I just referenced. It was incapable of doing that.

Mrs. BIGGERT. And you have talked about the 5 percent retention or "skin in the game." Will that work with the securities?

Mr. BORN. As outlined by Ms. Dubberly in terms of the 5 percent vertical slice, I'm not sure how well that works for us. I think there are a couple of things that we have been looking at, this notion of the first loss investor being required to hold that risk for a period of time. I think that would address it in CMBs.

And the other issue, Congresswoman Bean has been asking several people about the government getting involved in underwriting standards. I think something along the lines of a best practices for commercial mortgage underwriting that both the government and trade associations could work on would be good and then perhaps have the loan originators represent or warrant that they, in fact, did follow these best practices in originating the loans. If you did that in conjunction with the first loss investors having to keep the riskiest piece, I think that gets you there.

Mrs. BIGGERT. Thank you. Ms. Dubberly?

Ms. DUBBERLY. I think one of the biggest problems with the CMBS market is investors. Investors aren't ready to come back to the market and I think that hopefully the Commission's program will help them have restored confidence in the market, and have the tools to make informed investment decisions so they don't rely on the rating agencies.

The Commission has asked a lot of questions about the first loss approach, about whether that makes sense. One of the problems with taking the first loss is the first loss person usually is also the master servicer and they will have a potential conflict of interest with the other tranches, with the other investors, because they will want to hold on to the real estate longer than maybe the other investors would if there's a problem. But the Commission has asked a lot of questions about that.

Mrs. BIGGERT. So the SEC is really doing a lot to trying to spur the activity in this market?

Ms. DUBBERLY. The whole April 7th proposal, the Commission feels will really benefit the market by helping to restore investor confidence in the market, yes.

Mrs. BIGGERT. Mr. Sellers, did you have something you wanted to say?

Mr. SELLERS. In regards to the "skin in the game" I'm old enough to remember back in the 1970's when we had banks that made loans and held it for the whole length of the loan and they were extremely conservative in their lending practices. But we have gone from one extreme to the other in that we don't have any "skin in the game" to where you have gotten in a situation where we're just passing paper and passing risk.

I think the real answer is somewhere in between. In regards to the CMBS market, we have an issue where investors are expecting their money when the bond comes due. While we may not really want to be able to refinance that loan, we may have to force them to refinance the loan in order to pay that loan off. So we have a timing issue that's related.

The other problem is we have many investors that have cash in their properties, pension funds, and rents. They're not really worried, but they have some properties, 11, 12 percent we're told, that are underwater. That doesn't bother them. They can weather the storm. But when the other properties go under because the bonds are coming due and forcing these people to refinance under new underwriting guidelines, then we're going to be bringing down the other people who are able to hold their property values as well. So it's a very complex issue.

Mrs. BIGGERT. Thank you.

Chairman MOORE OF KANSAS. The gentlelady's time has expired. The Chair next recognizes Congresswoman Bean for 5 minutes.

Ms. BEAN. Thank you, Mr. Chairman, and thank you all for your testimony today.

Mr. Cohen, in your testimony, you highlighted that while the TALF program did not produce many CMBS deals, it did spur $3 billion in private sector deals.

Would you agree with Mr. Born that we should then allow that program to expire at this time?

Mr. COHEN. I think the position we're taking is that the program itself is not as critical as much as other steps necessary to spur the secondary market. We really need to do things that will spur the secondary market. That's the only way we can meet the proverbial tsunami of debt maturities that the Congressman was speaking about. That has to come from the secondary market.

Ms. BEAN. So would you support some of the things that Mr. Born had spoken about, covered bonds, additional loan guarantees. I know also in your testimony you talked about FRPTA to bring—if we could repeal FRPTA, which disincentivizes foreign capital to come back to the market, those would be things that you would support?

Mr. COHEN. That's correct. And just to amplify that for a second, to the extent that we have had a 40 percent deterioration in values, we now have a situation where lenders are coming back in at even lower financing levels than they had in the past. That's calling for an enormous amount of equity to be able to meet these refinancing gaps. So we have to do things necessary to spur equity aggregation, equity allocation, and equity flows to this market.

Ms. BEAN. My other question is that one of our colleagues, Mr. Minnick on the committee, has a proposal that would for a premium of 350 basis points provide a Treasury guarantee on new CMBS for CRE loans that are under $10 million each. The concept is to provide liquidity to community banks who issue sound, commercial real estate loans and bring investors back into the market. What's your opinion of what that would do in terms of providing a temporary guarantee and what residual effect do you think there would be?

Mr. COHEN. Again, I think our view is that you have to restore credit. You have to restore capital flows. Congressman Foster asked, how do you protect against further deterioration or additional declines in commercial real estate values? It is directly correlated to whether or not there's capital and credit availability.

So our view is anything that restores credit availability has to be for the secondary market and it has to be for the small and midsized banks. They, in particular, are the ones who are going to deliver credit to the market.

Ms. BEAN. My last question, if I have some time, is for Mr. Born. You talked about the risk retention and actually having some concerns about that, not being opposed to it, but not limiting that as a way to better understand. And you talk about customizing by asset class. Given the way securities have been done recently, those who created the securities, those who rated the securities, and those who invested in the securities, the vast majority had no idea what was in those securities. So how do you customize that when nobody knows what's going on?

Mr. BORN. I guess—some people know what's going on.

Ms. BEAN. If you read, "The Big Short," it was a really small number of people.

Mr. BORN. As I said in response to Chairman Moore's question about securitization. I think securitization is a good concept. There were obviously abuses in the system that got us to the point where we are.

Ms. BEAN. Not just abuses, but a real lack of understanding and risk management tools in place that were being used or practiced to really understand. It was mostly gross incompetence.

Mr. BORN. There were bad decisions made. There was a lack of oversight at steps along the road. I don't disagree with that. But I think we are on the road to recovery. It's early, but I think back to a year ago, looking at not only were there no new loans being made, but there were no bonds trading the secondary market in CMBS. Every bond you bought or sold was price discovery. It was an adventure. It took me from the last 2 months of 2008 when we were actually a pretty active buyer because we recognized the prices were so depressed it was a good investment.

It took me 6 weeks to buy the same amount of bonds I could have done in a couple of hours back in 2006. It was just a complete dearth of liquidity. We are now at a point where I can put bonds out to sell. I get 12 bids back. There's a fairly defined market in terms of what the price should be. I try to buy bonds, the same kind of thing.

So now the—and I'm a little off point here, but I think now the next step is this equity gap. Risk retention is extremely important. I don't disagree with that, but I'm hesitant to set something up that results in one of the parties to the transaction having to keep all of the loans essentially on their balance sheet. That's not going to get anybody to lend. That just fundamentally won't work. So we just need to recognize some of the differences in CMBS versus other structured asset classes and just craft something that will get better oversight, but at the same time not shut down the lending market.

Ms. BEAN. I know I'm out of time, but if I can request the Chair's permission for a second to suggest that if you could give us some further suggestions on exactly how you would do that, that would be greatly appreciated.

Mr. BORN. All right.

Chairman MOORE OF KANSAS. The gentlelady's time has expired. The Chair will next recognize Mr. Foster for up to 5 minutes.

Mr. FOSTER. Yes, Ms. Dubberly, I am fascinated by your April 7th proposal to get away from using credit rating agencies with computer-readable descriptions of the mortgaged-backed assets. And so let's see, as I understand it, what you do is provide underlying data in a machine-readable format and also an actual piece computer code that would allow you to look at what happens as different tranches degrade and so on. Is that a correct understanding?

Ms. DUBBERLY. Yes, that's correct. It's actually—I'm very excited about this because it's the first time the Commission would require the filing of a computer program. So the way the pools are put together and the way the securities are actually structured is through the use of a computer program, the analysts run different models to figure out—

Mr. FOSTER. I'm a former Python programmer.

Ms. DUBBERLY. Then you know, so—

Mr. FOSTER. There are all sorts of issues about changes in the compiler or the interpreter, actually, but you would have to make sure there's an agreed upon—this is going to be a legally binding version of the computer program.

Ms. DUBBERLY. Right now, they take the computer program, translate it into English and put it in the prospectus and so they already have that. And then if you're an investor, you have to translate it from the English back into—trying to put it in a program if you want to run your models yourself.

Mr. FOSTER. Right. So how many entities are there out there that could actually use that level of detailed information? Are there ten or a thousand?

Ms. DUBBERLY. Oh no. I think the way it's structured because the data points will be standardized and because it's in XM Owl and because Python is open source, I think most investors in ABS will utilize this. ABS investors aren't "ma and pa" investors.

They're institutional investors. I think it will be easy for third-party vendors to develop software that will make it very useful for investors.

Mr. FOSTER. I think that is potentially a great advance. I'm a little confused on how this might work in the commercial MBS realm. Because if you're just talking about normal mortgage-backed securities, you have your credit scores and your income and your Zip Codes and relatively small number of things can fairly well characterize the mortgages well enough to get an estimate of what it's worth. But in the case of commercial things, you're so dependent on the details of the business operations, of each one of these loans that I'm a little bit skeptical, frankly, that it's ever going to apply there. Or if people attempt to apply it, it will sort of be abusable in the sense that it will be easy to mischaracterize things with a simple set of numbers, what the true riskiness is.

Ms. DUBBERLY. We need you to comment on our rule proposal. We hope it will apply well to commercial mortgages. It's smaller pools, definitely, but it's standardized data and it will still be in a format that can be utilized. A lot of it does depend on who are actually on the rent rolls for any shopping center or who are on the rent rolls for whatever the commercial property is, but we still think it will be a valuable tool for CMBS.

Mr. FOSTER. So you have business interest on the commercial mortgage-backed security application of this?

Ms. DUBBERLY. I'm sorry?

Mr. FOSTER. I can usually understand a lot of enthusiasm. In fact, I know a couple of people who were based a couple of years ago, proposed this to me as something I might want to push. On the commercial—I'm sorry, on the residential MBS, but on commercial MBS, is there a real commercial interest in this? Do businesses want to use these tools for commercial MBS?

Ms. DUBBERLY. Yes, I think it will make the job of analyzing the pools just faster and easier for them to do. If it's not standardized, it will just take longer to do and this you'll be able to do it much quicker.

Mr. FOSTER. It could be a big help in trying to resurrect the whole securitization market.

Mr. Stoklosa, are there countercyclical accounting standards that are going to cause bigger rainy day funds on the upswing that are under discussion, as opposed to just having relief once the bubble has burst?

Mr. STOKLOSA. I don't know if accounting standards are countercyclical or not. I guess that is for other people to judge. I think our goal is to have the accounting standards reflect the economics to the best they can.

I know impairment was a big issue on one of the earlier panels and from an impairment perspective, we do have a proposal on the table to provide some new impairment guidance, to provide more flexibility, to provide more judgment for people and entities to better identify the risks that they have and the potential losses they may have. So we should be coming out with that proposed guidance in a couple of weeks.

Mr. FOSTER. Also, Mr. Sellers, this thing also gets into the appraisal principles. If you were—if the appraisal was based more on backward-looking historical value of the property, I think that would have a huge countercyclical element that you would simply treat skeptically the value of recently-appreciated assets and that principle to the extent that it got into our accounting standards and then appraisal standards, I think would be tremendously valuable in stabilizing our whole system.

I would appreciate your reaction to that.

Mr. SELLERS. I agree. The appraisal process is completely misunderstood. We do forecast the future. That is part of our proposal. You need to have competent appraisers who are using good, fundamental market analysis, not inferred, market analysis, but good and fundamental market analysis.

And if you do that, you have a reasonable opinion or value based on specific trends and specific anticipated movements in the marketplace. The market completely moves backwards and forwards, up and down. We, as appraisers, can give you values and give you opinions of values of different types for different time periods.

Chairman MOORE OF KANSAS. The gentleman's time has expired. But we will, I think—Ms. Biggert indicated she would like to have an additional 2 minutes, and the other members will have an opportunity for up to 2 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Stoklosa, we have been hearing some talk about the FASB or the FASB Chairman Herz, gave a speech recently that highlighted both the confusion about and the distinction between FASB's role to set accounting standards for disclosure purposes and the need for banking regulators to ensure the safety and soundness of financial institutions. So I don't know—there's kind of a who does what. Would—how much of a role have stakeholders or perhaps the SEC had—as overseers of FASB and therefore all accounting rules and how they take it into account FASB changes to the accounting standards that effect commercial real estate such as the adoption of the financial accounting standards 166 and 167?

Mr. STOKLOSA. Yes, I think the Statements 166 and 167, they're all about transparency of risk. And whomever has the risk will do the accounting. So if the entity that's setting up some sort of securitization, if they transfer the loans off their books, but if they retain a certain amount of risk, and if they retain enough risk such as first loss risk, have they really transferred anything? And therefore, that guidance will come up and say, if you haven't transferred the risk, then you retain the accounting. You retain the loans on your books. If you transfer the risk, you get to take it off.

Prior to 166 and 167, there were bright lines that allowed entities to even though they retained the risk were still able to get it off balance sheet. So we made those improvements.

In terms of the SEC's oversight, I leave it up to the SEC. I'm sure if that's your role to talk about the SEC oversight. But the SEC, they're involved in our process as are any other constituents. We have an open due process. We issue exposure drafts. We have roundtables where we invite all of our constituents to roundtables, that being auditors, preparers, users, regulators. So anyone who wants to participate in a roundtable to talk about the issues are free to do so.

Mrs. BIGGERT. Do you have public opinion for these?

Mr. STOKLOSA. Pardon me?

Mrs. BIGGERT. Do you solicit comments from the public?

Mr. STOKLOSA. Yes. Our exposure drafts go out, normally for about 90 days for public comment, and we get the comments back and we present all that information to the Board for their redeliberations of the issues.

Mrs. BIGGERT. Thank you.

Chairman MOORE OF KANSAS. The gentlelady's time has expired. The Chair next recognizes Ms. Bean for up to 2 minutes.

Ms. BEAN. Thank you, Mr. Chairman. Just two things. Thank you again for hosting the hearing and by doing it here, we didn't get interrupted and called to votes. So we were actually able to really hear the testimony which never happens in Washington.

My only other comment is to say I think Congressman Foster is arguably the only Member of Congress who has programmed in Python before. So that's all I have. Thank you.

Chairman MOORE OF KANSAS. Thank you, Ms. Bean. Mr. Foster, if you have any comments?

Mr. FOSTER. I was wondering if any of you are optimistic that covered bonds may be an important part of the way forward for commercial real estate. Any opinions, one way or the other on that?

Nothing. You're pretty much—

Mr. BORN. I don't know that it necessarily solves the problem, but it is one tool that can be explored. It's not a cure-all for what ails us.

Mr. FOSTER. So it's not being actively developed by any segment?

Mr. BORN. Not that I'm aware of.

Mr. FOSTER. Okay, and I guess one last question on what I mentioned about the waterfall programs and so on, is that being retroactively applied to some of the MBSs that are out there as a way to maybe reliquify some part of that market?

Ms. DUBBERLY. No. It would only be forward-looking. It would apply to new issuances after any rule was adopted. The problem would be the trusts are formed and they're sort of self-running. It would be hard to put a new requirement on them after they have been—

Mr. FOSTER. They might voluntarily do it to increase the—

Ms. DUBBERLY. That would be fine. We would obviously love that.

Mr. FOSTER. Thank you very much. I yield back.

Chairman MOORE OF KANSAS. Thank you. I ask unanimous consent that the following items be made a part of the record: Number one, Biggert 1, I call it, is a letter from the Kansas Realtors for this area. I remind you that this issue does not just affect Chicago or Illinois, but Kansas, the rest of the country.

Number two is a written statement with attachments from our friend and colleague, Representative Ken Calvert of California who has been active on this issue.

Exhibit Number Three is our reports on CRE by the Congressional Research Service.

And Exhibit Four is a Congressional Oversight Panel Report. If there are no objections, these will be received in the record. Thank you.

Again, I want to thank all of our witnesses for your testimony today. It has been very, very helpful. I thank this panel. I very much appreciate that.

Ranking Member Bean has a parting comment or something she would like to say—excuse me, I'm sorry.

Mrs. BIGGERT. If the gentlemen will yield?

Chairman MOORE OF KANSAS. I apologize. I do. She has not been advanced yet. This is the ranking member.

Mrs. BIGGERT. It's very confusing to him too—Congresswomen from Illinois whose names start with a "B."

I have always liked to be a "B," because usually you get to go first, but now she's "B-E" and I'm "B-I." Anyway, thank you.

I would like to thank all the witnesses for coming to this hearing. I think it has been very, very helpful to us and we really have had the time to sit and listen to all of you and that's so important for us as we move forward in this very complicated financial services reform, so we appreciate that.

And I do really thank again my colleagues for coming in and particularly the chairman who did come from Kansas and has spent the time with us and we are really going to miss him as he is retiring this year. It's going to be a big loss. I think we came in at the same time.

Chairman MOORE OF KANSAS. Thank you very much.

Mrs. BIGGERT. I didn't realize when you came in, but we were colleagues and have spent the time in Congress together, so I appreciate it.

Chairman MOORE OF KANSAS. That's right. Thank you. The Chair notes that some members may have additional questions for our witnesses which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to our witnesses and to place their responses in the record.

The hearing is adjourned. Thanks to all.

[Whereupon, the hearing was adjourned at 3:48 p.m.]

A P P E N D I X

May 17, 2010

THE FINANCIAL SERVICES ROUNDTABLE
Impacting Policy. Impacting People.

STATEMENT OF

WILLIAM E. ASKEW

ON BEHALF OF

THE FINANCIAL SERVICES ROUNDTABLE

ON

COMMERCIAL REAL ESTATE: A CHICAGO PERSECTIVE ON CURRENT MARKET

CHALLENGES AND POSSIBLE RESPONSES

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 17, 2010

Chairman Moore, Ranking Member Biggert, and Members of the Subcommittee, I am William E. Askew, the Anthony T. Cluff Senior Policy Advisor to The Financial Services Roundtable ("the Roundtable"), on whose behalf I am appearing today. The Roundtable is a national trade association that represents 100 of the nation's largest integrated financial services companies. Our member companies provide banking, insurance and investment products and services to millions of American consumers. Several of our members are based in Illinois and many more have branches in the Chicago area.

Thank you for the opportunity to address the challenges facing the commercial real estate ("CRE") market. Commercial real estate is a five trillion dollar industry supporting twelve million jobs. The collapse of the credit market has impacted the CRE market, $6.7 trillion market at its peak and with $3.5 trillion in debt. Banks and commercial mortgage backed securities ("CMBS") are the largest sources of credit. Bank balance sheets hold $1.5 trillion of CRE loans, but as the underlying property assets securing these loans may have declined in value by as much as 40%, banks have reduced lending and investment activity for CRE. Annual CMBS issuance volume from 2001-2007 was on average $127 billion with a peak of $230 billion in 2007. As credit markets froze in 2008, so did the CMBS market, issuing $12 billion in 2008 and $1 billion in 2009. In Q1 2010 $309 million of CMBS has been issued, through one deal. Revitalizing the CMBS market is critical as $1.4 trillion in U.S. real estate loans are maturing between 2010 and 2014, and without a liquid secondary market, these loans will have trouble refinancing, putting more pressure on already depressed real estate valuations.

Given the importance of this industry to the economy, the Roundtable formed the Commercial Real Estate Coalition ("the Coalition"). The Coalition includes leading industry practitioners, such as securities and loan investors, borrowers and lenders, and representatives from industry trade associations, including the Commercial Real Estate Finance Council, International Council of Shopping Centers, National Association of Home Builders, National Association of Real Estate Investment Trusts, and the Real Estate Roundtable. Additionally, representatives of the Federal banking agencies were invited to attend meetings of the Coalition. The Coalition devoted much time and resources over the last several months to develop ideas to support and rehabilitate the commercial real estate industry.

At the outset, the Coalition set goals to guide its deliberations. These goals were: (1) restore confidence in the commercial real estate sector; (2) maintain regulatory compliance while balancing the need for additional lending; and (3) restart the commercial mortgage-backed securities market for long-term financing. After a dozen meetings and hours of debate, last month the Roundtable and the Coalition published a white paper entitled "Recapitalizing Commercial Real Estate: A Roadmap to Recovery", with 51 recommendations to meet these goals. The recommendations put forward in the white paper represent a holistic approach to rehabilitating the commercial real estate market. There is no one silver bullet to the problems facing the market. Given the size of the industry and scope of the problems, multiple actions are required. The full white paper is attached to this testimony, and I now will highlight a few of the key recommendations the Roundtable makes in the white paper.

1) Utilize Securitization to Restart the CMBS Market for Long-Term Financing

A major issue facing the industry is reviving the commercial mortgage backed securities ("CMBS") market. The overall commercial real estate market requires long term credit to function properly. The re-start of securitization will be key to economic recovery. Over the past two decades, the main secondary market vehicle for financing commercial real estate has been the CMBS market. In the period between 2001 and 2007, CMBS supplied 50 percent of all debt capital to the market; yet the CMBS market was illiquid between July 2008 and May 2009 and has yet to fully recover.

Today, there are few new securitized transactions in the market. In the absence of a CMBS market or other viable secondary market solutions, there is a financing void for commercial mortgage loans. Left unfilled, this lack of financing will further exacerbate downward pressure on commercial real estate values.

The Federal regulators can play a role in helping to revitalize the market. The Roundtable supports efforts to use securitization markets to sell commercial real estate assets taken over by regulators. In the wake of the savings and loan crisis, the Resolution Trust Corporation and the FDIC successfully used securitization as an effective exit strategy for assets seized from failed financial institutions. These securitizations helped to start the private sector CMBS market during that period. We encourage Federal banking agencies to take similar steps with commercial real estate assets acquired from failed financial institutions in the current crisis.

We also encourage policymakers to consider the unique characteristics of asset classes when adopting risk retention proposals and avoid one-size-fits-all legislation which may hurt borrowers and investors alike.

Additionally, our paper urges policymakers and regulators to coordinate reform measures, to avoid unintended consequences of disparate new rules creating further volatility and obstacles to recovery. For example, FAS 166 and 167 rules combined with a risk retention mandate and changes in risk based capital could virtually halt new securitizations. The Roundtable believes that the final interagency joint rule on FAS 166 and 167 should be re-examined and regulatory capital requirements should be adjusted appropriately to separate artificial accounting treatment from real credit risk (e.g. consolidation of an entire loan or pool of loans onto balance sheets for disclosure purposes does not change credit risk exposure). New retention mandates must also be examined in this context.

2) Extend TALF to Inject Liquidity and Confidence in the CMBS Market

The CMBS Term Asset-Backed Securities Loan Facility ("TALF") was developed to inject liquidity and confidence into the market by encouraging the securitization of privately originated loans in important asset classes to consumers and businesses. This program is set to expire and an extension is vital to the market. The program completed its first and only CMBS transaction with strong demand by investors driven by the conservative underwriting of the underlying collateral and the enhanced structure. The expected investment returns of the AAA tranche were large enough that investors declined to leverage those bonds with TALF; however, approximately 22% of the deal was financed using TALF funds.

TALF has been helpful in tightening spreads and encouraging certain new CMBS issuance. However, a crucial next step in market liquidity is the issuance of new multi-borrower pooled "conduit" CMBS (i.e. a diversified pool with 50 or more loans of all sizes) in order to provide the capacity necessary to satisfy the enormous volume of maturing loans and borrower demand.

There is currently insufficient market predictability for legacy CMBS lenders and issuers to assume the balance-sheet risk of aggregating pools of commercial loans to smaller property owners and issue larger, well diversified multi-borrower CMBS transactions. Such an aggregation may take six months or more to aggregate necessary collateral. While some institutions are beginning to contemplate commercial real estate loan originations with a securitization exit strategy, lenders in general are hesitant to take the interest rate and hedging risks to aggregate a portfolio of commercial loans. This is particularly true given the limited hedging vehicles available to protect balance sheets from the effects of spread volatility during the aggregation period. With this concern in mind, we recommend that Treasury utilize the TALF program as a direct and temporary solution to address the absence of a private-sector hedging tool. This approach would be temporary and phased out once a critical mass of deals are priced and can be referenced in the construction of a private hedging tool.

The new-issue CMBS TALF program is set to expire on June 30, 2010. However, some market participants believe that an extension may be in order if policymakers expand their definition of eligible collateral under TALF to include direct commercial mortgage loans and loans originated prior to July 1, 2008. To date, TALF collateral has been limited to Nationally Recognized Statistical Rating Organization ("NRSRO")-rated or Committee on Uniform Securities Identification Procedures ("CUSIP") securities of certain vintages and has excluded direct mortgages secured by real property assets. We understand that this restriction was intended to limit the program's exposure to real estate risk. Treasury may be able to use new guidelines to limit the program to acceptable loan structures, underwriting standards, and NRSRO-recommended credit-support levels to create a program to include an up-to-five year fully-callable financing vehicle for commercial loans. The existence of such long-term financing for commercial mortgages would limit the downside risk of making loans intended for securitization, even if the timeframe or ultimate execution of a private securitization is uncertain.

TALF will cease making loans collateralized by newly issued CMBS on June 30, 2010, and loans collateralized by all other types of TALF-eligible newly issued and legacy assets as of March 31, 2010, while the Federal Reserve Board of Governors has indicated that it will reserve judgment and continue to examine the facility.

The Roundtable recommends that decisions related to TALF should be clarified and support a transition to a vibrant private market for "conduit" CMBS deals needed for a CRE recover. TALF has been helpful, and based on current market conditions, the future of the program should be structured to reinforce the market if needed. In the meantime, policymakers should consider utilizing TALF as described above (hedging tool, whole loans, etc) in order to facilitate the transition to a private market. The Roundtable and Coalition members will continue to provide feedback to Treasury and the New York Federal Reserve on the TALF program to support the number and variety of transactions accessing the capital markets.

3) Eliminate Pro-Cyclical Accounting Practices

The economic crisis highlighted the impact of accounting standards on financial markets including commercial real estate. For example, the application of fair value accounting standards, which use near term exit pricing for asset valuation, proved to be both challenging and problematic in that period. Indeed, near-term exit pricing can differ vastly from the expected value of long-term assets and such procyclical actions have contributed to the slow recovery of the economy.

The Roundtable has several recommendations related to accounting standards. First, the Roundtable recommends that FASB evaluate pro-cyclical accounting standards and report to Congress how such standards might be modified in the current economy. This would include evaluation of fair value accounting, loan loss reserves, non-performing short-term loans, gain-on-sale, treatment of covered bonds, and deferred tax assets.

Additionally, the Roundtable asks for increased transparency and participation in the FASB rule making process. FASB should be subject to a formal notice and comment period similar to the Administrative Procedures Act ("APA") that is used by other self-regulatory organization like the Financial Industry Regulatory Authority ("FINRA"). Like FINRA, applying an APA-like process to FASB would increase transparency in the rule making process by requiring FASB to consider public comments and explain the reasoning behind its decisions.

Finally, the Roundtable encourages greater coordination between accounting policy and other regulatory and statutory change to avoid market dislocation, and to provide markets with certainty and confidence.

Conclusion

Thank you for the opportunity to present the recommendations of The Financial Services Roundtable and the Commercial Real Estate Coalition. We appreciate the Subcommittee's attention and focus on the commercial real estate industry. We must act now to ensure that commercial real estate is not a deterrent to our economic recovery. The Roundtable and the Coalition look forward to working with you and the full Committee to assist and rehabilitate the industry.

TESTIMONY OF KENT BORN

ON BEHALF OF THE COMMERCIAL REAL ESTATE FINANCE COUNCIL

Before the

UNITED STATES HOUSE FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON
OVERSIGHT & INVESTIGATIONS

Hearing on "Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses"

May 17, 2010

My name is Kent Born. I am a Senior Managing Director for PPM America, a Chicago-based investment management firm affiliated with Jackson National Life Insurance Company (Jackson). Jackson is one of the leading writers of annuities and life insurance in the United States. My primary responsibility at PPM America is managing a portfolio of commercial mortgage-backed securities ("CMBS"), which currently totals approximately $6.0 billion. I also am a past President of the Commercial Real Estate Finance Council ("CRE Finance Council"), which until March was named the Commercial Mortgage Securities Association ("CMSA"), on whose behalf I am testifying today. The CRE Finance Council is grateful to Chairman Moore, Ranking Member Biggert, and the Members of the Subcommittee for giving the CRE Finance Council the opportunity to share its perspective on the state of commercial real estate and the markets that fuel its growth and overall viability.

Today, the $7 trillion commercial real estate ("CRE") market in the United States is facing serious duress, and there are significant hurdles to recovery in the near term. The challenges posed by the distressed CRE market will continue to have an impact on U.S. businesses that provide jobs and services, as well as on millions of Americans who live in multifamily housing. Our testimony will focus on three key areas: 1) the challenges facing the $3.5 trillion market for CRE finance; 2) the unique structure of the commercial market and the need to customize and coordinate reforms accordingly to support, and not undermine, our nation's economic recovery; and 3) suggested public policy measures that should be considered to help support a broad and lasting CRE recovery. These suggestions are designed to address the current state of the CRE market and must be undertaken in light of the unique structure of the CRE securitization markets.

The CRE Finance Council

The CRE Finance Council represents the full range of commercial real estate finance market participants, including investment and commercial banks; rating agencies; accounting firms; servicers; other service providers; and investors such as insurance companies, pension funds, and money managers. The CRE Finance Council is a leader in the development of standardized practices and in ensuring transparency in the commercial real estate capital market finance industry.

Because our membership consists of all constituencies across the entire market, the CRE Finance Council has been able to develop comprehensive responses to policy questions to promote increased market efficiency and investor confidence. For example, our members continue to work closely with policymakers in Congress, the Administration, and financial regulators, providing practical advice on measures designed to restore liquidity and facilitate lending in the commercial mortgage market, such as the Term Asset-Backed Securities Loan Facility ("TALF") and the Public-Private Investment Program ("PPIP"). The CRE Finance Council continues to participate actively in the public policy issues and proposals that impact commercial real estate finance.

THE CURRENT STATE OF THE MARKETS

The Current State of CRE Finance

CRE is a lagging indicator, and it now is feeling the impact of a prolonged recession. In fact, what began as a "housing-driven" recession due to turmoil in the residential/subprime markets (in which credit tightened severely), quickly turned into a "consumer-driven" recession, impacting businesses and the overall economy. It should come as no surprise that CRE would experience strain in light of the economic fundamentals today and over the last year, including poor consumer confidence and business performance, high unemployment and property depreciation. Unlike previous downturns, the stress placed on the CRE sector today is generated by a "perfect storm" of four interconnected challenges that compound each other and that, when taken together, will exacerbate the capital crisis and prolong a recovery:

- **Limited Liquidity/Lending with CMBS Dormant.** – Even in normal economic conditions, the primary banking sector lacked the capacity to meet CRE borrower demand. That gap has been filled over the course of the last two decades by securitization (specifically, CMBS) which utilizes sophisticated private investors – pension funds, mutual funds, and endowments, among others – who bring their own capital to the table and fuel lending. CMBS accounts for approximately 25% of all outstanding CRE debt, with as much 40% of outstanding debt at its peak, while readily identifiable properties funded by CMBS exist in every state and every congressional district. However, the volume of new CRE loan originations, and thus of new CMBS, has plummeted from $240 billion in 2007 (nearly half of all CRE lending) to $12 billion in 2008, and to approximately $2 billion in 2009. That said, and thanks in part to the success of the TALF program, the CMBS market is beginning to show new signs of life, as there were three "single-borrower" CMBS issuances in December and the first multi-borrower CMBS was issued just last month.

- **Significant Loan Maturities.** – At the same time, approximately $1 trillion in CRE loans mature over the next several years, but the capital necessary to refinance these loans is still relatively constrained and more significant, many loans require additional "equity" to refinance given the decline in CRE asset values.

- **Severe U.S. Recession.** – With a prolonged recession and unemployment at 9.9%, there is no greater impact on CRE than jobs and the economy, as commercial and multifamily occupancy rates, rental income and property values have subsequently been severely impacted and perpetuate the downturn. Those impacts persist even as the recession has abated.

- **"<u>Equity Gap</u>."** – The biggest challenge today is the reality that CRE assets have depreciated in value by 30% to 50% since 2007, creating an "equity gap" between the loan amount and the equity needed to extend or re-finance a loan, which impacts even "performing" properties that continue to support the payment of monthly principal and interest on the underlying loans.

Significantly, it is important to note several additional points with respect to the current state of CRE finance. First, the average CMBS securitized loan is $8 million, which makes CMBS a significant source of capital for lending to small businesses. Without a revival of the CMBS markets, loans for smaller businesses will continue to be significantly constrained, placing more pressure on small and regional banks, with troubling effects on local economies. Second, the dormant (or near dormant) CMBS market has virtually eliminated the key outlet for "take-out" financing particularly for small institutions – securitizing bank balance sheet construction loans after the projects are ready to come on line, for example. Third, more than 1,500 U.S. banks (mostly smaller community banks) have CRE exposure greater than 300% of their tier 1 capital, meaning that they are considered "at risk" under the metrics employed by the FDIC. This debt (construction loans, land loans, etc.) is not securitized.

As Richard Parkus, an independent research analyst with Deutsche Bank who has testified before both the Joint Economic Committee and the TARP Oversight Panel, has noted, while the overall CRE market will experience serious strain (driven by poor consumer confidence and business performance, high unemployment and property depreciation), it is this non-securitized debt on the books of small and regional banks that will be most problematic on a relative basis, as the projected default rates for such unsecuritized commercial debt have been, and are expected to continue to be, significantly higher than CMBS loan default rates.

For more than a year after the subprime crisis, default rates in the CMBS market, which were historically low (less than .50% for several years) still hovered around a mere 1.25%. Unfortunately, the economic recession that began as a crisis of liquidity in some sectors transformed into a crisis in confidence that affected all sectors, and it was only a matter of time before CMBS was affected. No matter the strength of our fundamentals and loan performance, once investors lost confidence and began to shy away from mortgaged-backed securities, CMBS could not avoid the contagion.

This unfortunate combination of circumstances left the broader CRE sector and the CMBS market with several overarching problems: 1) an initial liquidity gap, i.e., the difference between borrowers' demand for credit and the nearly non-existent supply of credit; 2) hesitancy of lenders and issuers to take the risk of trying to make or "aggregate" loans for securitization, given the uncertainty related to investor demand to buy such bond (this 3-6 month "pre-issuance" phase is known as the "aggregation" or "warehousing" period); and 3) most significant, a severe and current "equity gap" (again, the difference between the current market value of commercial properties and the debt owed on them, which will be extremely difficult to refinance as current loans mature) – all of which continue to perpetuate challenges in the credit markets and overall CRE market.

<u>Unique Characteristics of the CMBS Market</u>

Critical to this conversation is an understanding that the CMBS market does have important and inherent differences from other classes of Asset-Backed Securities. These differences relate not only to the structure of securities, but also to the underlying collateral, the type and sophistication of the borrowers, as well as to the level of transparency in CMBS deals.

Commercial Borrowers

Commercial borrowers are sophisticated businesses with "income-producing" properties that have cash flows based on business operations and/or tenants under leases. This characteristic stands in stark contrast to the residential market where, for example, loans were underwritten in the subprime category for borrowers who may not have been able to document their income, or who may not have understood the effects of factors like floating interest rates and balloon payments on their mortgage's affordability. As such, in CRE both the properties and other relevant information are more tangible to the various market participants.

Additionally, securitized commercial mortgages have different terms (generally 5-10 year "balloon" loans), and they are, in the vast majority of cases, non-recourse loans. This means that if the borrower defaults, the lender can seize the collateral, although it may not pursue a claim against the borrower for any deficiency in recovery.

Structure of CMBS

A CMBS pool is typically composed of 100-300 loans. This size is in contrast to consumer ABS classes (homes, autos, credit cards, etc.) that have pools with thousands of loans. This limited number of loans allows market participants (investors, rating agencies, etc.) to gather detailed information about income-producing properties and the integrity of their cash flows, the credit quality of tenants, and the experience and integrity of the borrower and its sponsors, and thus conduct independent and extensive due diligence on the underlying collateral supporting their CMBS investments.

First-loss Investor ("B-Piece Buyer") Re-Underwrites Risk

CMBS bond issuances typically include a first-loss, non-investment grade bond component. The third-party investors that purchase these lowest-rated securities (referred to as "B-piece" or "first-loss" investors) conduct their own extensive due diligence (usually including, for example, site visits to every property that collateralizes a loan in the loan pool) and essentially re-underwrite all of the loans in the proposed pool. Because of this, the B-piece buyers often negotiate the removal of any loans they consider to be unsatisfactory from a credit perspective, and specifically negotiate with bond sponsors or originators to purchase this non-investment-grade risk component of the bond offering. This third-party investor due diligence and negotiation occurs on every deal before the investment-grade bonds are issued.

Greater Transparency

A wealth of transparency currently is provided to CMBS market participants via the CRE Finance Council Investor Reporting Package® (CRE Finance Council IRP). The CRE Finance Council IRP provides access to loan, property and bond-level information at issuance and while securities are outstanding, including updated bond balances, amount of interest and principal received, and bond ratings, as well as loan-level and property-level information on an ongoing basis. The "IRP" is constantly reviewed by market participants to improve disclosure, and it has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market.

Current Efforts to Restore Liquidity

As a centerpiece of the Administration's Financial Stability Plan, policymakers hoped to restart the CMBS and other securitization markets through innovative initiatives like TALF. TALF did help provide liquidity to the CMBS markets by offering low-cost loans to CMBS bond investors. While it did not lead to an overnight increase in new lending for a variety reasons (e.g., "aggregation" challenges, the equity gap) the program was able to stimulate investor demand and free up the balance sheets of financial institutions, creating a "multiplier effect" to make new loans or buy bonds.

More specifically, TALF also helped produce the first private CMBS issuance in more than 18 months at the end of last year in the form of a conservative "single-borrower" deal (i.e. one large commercial mortgage to a single borrower, sold to investors, as opposed to more traditional "conduit" deals which commonly involve a diversified pool of 100-300 loans made to different borrowers). This first issuance led to a few more similar "single-borrower" deals at year end, and the first true multi-borrower deal in over two years which was issued just last month, all *without* government support.

The progress thus far has been welcome and positive, but it will be critical for the CMBS market to move toward more traditional "conduit" deals in order to provide the capacity necessary to address the enormous challenges discussed above. Likewise, as mentioned earlier, the conduit deals are necessary to reach more local/regional communities and smaller loans (e.g. $8 million loans, which is the average loan size in CMBS), but until the "conduit" market evolves further, we are likely to see more large loan single-borrower deals.

A FRAMEWORK FOR RECOVERY

Both the previous and current Administrations share Treasury Secretary Geithner's view that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small." The importance of restoring the securitization markets is recognized globally as well, with the International Monetary Fund noting in a Global Financial Stability Report last year that "restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions."[1] In part, this is because – as noted above – there is simply not enough capacity in the primary banking sector to meet the financing demands of borrowers, and additional liquidity is needed to help stabilize property values and alleviate the equity gap that exists in the massive wave of impending loan maturities.

As such, private investors who purchase CMBS, and thereby provide the capital that supports the origination of loans for CMBS, are absolutely critical to restarting commercial mortgage lending

---

[1] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (October 2009), at 33 ("Conclusions and Policy Recommendations" section) available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

in the capital markets that are critical to a CRE recovery. Accordingly, government initiatives and other reforms must support private investors – who bring their own capital to the table – in a way that gives them certainty and confidence to return to the capital markets. Although there is not a single "magic bullet" that can or will alleviate the entirety of the challenges currently posed by CRE and relevant to the CMBS market, the following suggestions together serve as a blueprint for public policy initiatives that could best support and sustain the requisite CRE recovery.

1. Increase Coordination of Regulatory & Accounting Reforms

Congress currently is moving toward finalizing a package of financial sector regulatory reforms that will change the nature of the securitized credit markets at the heart of recovery efforts. The securitization reform proposals appear to be prompted by some of the practices that were most typical in the subprime and residential securitization markets. At the outset, we must note the CRE Finance Council does not oppose efforts to address such issues, as we have long been an advocate within the industry for enhanced transparency and sound practices.

This is an extraordinarily difficult time to make significant changes, particularly in an uncoordinated manner. Yet, we are seeing a growing number of reforms that include unprecedented and retroactive accounting standards (FAS 166/167), risk-based capital changes, and "retention" (or "skin-in-the-game") proposals, among others. When taken together, these extensive changes create tremendous uncertainty and serve as an impediment to private lending and investing as the markets attempt to anticipate what impact these developments may have on capital and liquidity. The overall impact (and the very future of these markets) will remain unclear until the complete package of reforms is finalized.

As mentioned above, financial policymakers have gone to great lengths to provide liquidity and facilitate lending through the securitized credit markets, but some reforms undermine a recovery in these markets. For example, as a general matter, there is concern that a 5% risk "retention" mandate could greatly impair the ability to originate CMBS by significantly increasing the cost of securitization and reducing its utility, not to mention draining the much needed capital and liquidity to make loans or buy bonds. It is only logical that if "originators" and/or "securitizers" are required to retain a percentage of every loan made or bond issued, it could quickly restrict and limit balance sheet, liquidity, and overall lending capacity. In fact, depending on how it is structured, a 5% risk retention could change the CMBS structure altogether, impacting capital and liquidity in the CRE market, during a still nascent recovery for both the CMBS and CRE markets.

Of equal concern, under the new and retroactive accounting rules (FAS 166 and 167) mentioned above, some financial institutions could be required to account for 100% of securitized assets on balance sheet (i.e., "consolidation"), despite having retained only a small percentage of the securitized pool. As financial regulators have repeatedly noted, a retention mandate creates additional uncertainty under FAS 166 and 167 related to who would "consolidate" 100% of assets on balance sheet. Much worse, it would require some lenders (i.e., banks) to hold even more capital (beyond the retention) against a highly distorted and inflated accounting disclosure, despite no change in real credit risk. The result, as repeatedly outlined by market analysts, is an uncertain and slowed market recovery in which lenders and investors forgo deals in the short term, while in the long term the overall volume of lending transactions is reduced considerably. Put simply, it effectively limits access to credit and raises the cost of lending in an already troubled environment.

Concerns with inconsistent and uncoordinated policies were highlighted by Federal Reserve Board Member Elizabeth Duke, among other policymakers, who cautioned that:

> If the risk retention requirements, combined with accounting standards governing the treatment of off-balance-sheet entities, make it impossible for firms to reduce the balance sheet through securitization and if, at the same time, leverage ratios limit balance sheet growth, we could be faced with substantially less credit availability. I'm not arguing with the accounting standards or the regulatory direction. I am just saying they must be coordinated to avoid potentially limiting the free flow of credit.... As policymakers and others work to create a new framework for securitization, we need to be mindful of falling into the trap of letting either the accounting or regulatory capital drive us to the wrong model. This may mean we have to revisit the accounting or regulatory capital in order to achieve our objectives for a viable securitization market.[2]

To this end, the final regulatory reform package should include an important provision included in the House-passed bill that would require regulators to examine and report on the combined impact of the new securitization retention requirements and the new accounting rules on credit availability before any final rulemaking is done on the new retention requirements.

2. <u>Regulatory Reforms Should Account for Differences That Exist in the CRE Market.</u>

The 5% Retention

While "skin-in-the-game" can come in many forms, legislative proposals have fixated on mandating a 5% retention by "originators" and/or "securitizers" in all asset-backed markets (residential mortgages, commercial mortgages, student loans, auto loans, small business loans, etc), with little examination by asset or separation by actual 'root' causes of the economic crisis. As an example, a recent report of the TARP Congressional Oversight Panel highlighted that the most distressed CRE loans include non-securitized debt held by smaller institutions (which had 100% "retention" on these loans), which raises serious questions about the best way to strengthen lending for each type of loan and asset class.

It is critical that the most appropriate and direct form of "skin-in-the-game" (e.g., a percentage retention; underwriting standards and controls; stronger "representations and warranties," etc.) be considered by asset class and with limited negative complications. Most important, policymakers must ensure that any regulatory reforms are customized to address the specific needs of each securitization asset class and coordinated by all policymakers to provide the certainty and confidence necessary to promote private lending and investing, and a recovery for both CRE and the overall economy.

---

[2] "Regulatory Perspectives on the Changing Accounting Landscape," Speech by Governor Elizabeth A. Duke at the AICPA National Conference on Banks and Savings Institutions, Washington DC, September 14, 2009, available at http://www.federalreserve.gov/newsevents/speech/duke20090914a.htm.

As explained above, the CMBS structure has always had a third-party in the first-loss position that specifically negotiates to purchase this risk. Most significantly, these third-party investors are able to, and do, protect their own interests in the long-term performance of the bonds rather than relying merely on the underwriting and representations of securitizers or originators. First-loss buyers conduct their own extensive credit analysis on the loans, examining detailed information concerning every property – before buying the highest risk bonds in a CMBS securitization. As such, the holders of the first-loss bonds are intimately familiar with the loans, properties and bonds issued, and they are fully cognizant, through their own diligence, of the scope and magnitude of the risk being taken.

Because the CMBS market is structured differently than other securitization markets, policymakers' focus in this market should be on the proper transfer of risk (e.g., sufficient collateral disclosure, adequate due diligence and/or risk assessment procedures on the part of the risk purchaser), analogous to what takes place in CMBS transactions. Therefore, any regulatory reform law should ensure that regulators can permit CMBS securitizers to transfer risk to B-piece buyers who – in the CMBS context at least – act as "securitizers" to satisfy any retention obligation. This approach would be a "true" retention (and alignment of interests) by someone performing due diligence, purchasing and retaining a first-loss position. To not consider ways to maintain and strengthen this structure could needlessly and unnecessarily tie up valuable capital, which would halt the flow of credit at a critical time for CRE.

Regulators need both direction and discretion to determine the most direct and effective form of "skin-in-the-game" by asset class. This also would be consistent with the recent IMF admonition that:

> Proposals for retention requirements should not be imposed uniformly across the board, but tailored to the type of securitization and underlying assets to ensure that those forms of securitization that already benefit from skin in the game and operate well are not weakened. The effects induced by interaction with other regulations will require careful consideration.[3]

In this regard, the CRE Finance Council is very encouraged that the House-passed bill included a bipartisan and unanimously adopted amendment that would allow regulators to consider various ways to satisfy a retention requirement, including an "originator," a "securitizer," or "third party investor" who performs due diligence, purchases a first-loss position and *retains* this risk to ensure an alignment of interest. Likewise, the Senate bill requires that reforms be considered by asset class, while an important amendment was also unanimously approved to incorporate explicit language recognizing the "third party" retention model and other important forms of "skin-in-the-game" for commercial mortgages. These developments are very positive and would strengthen these markets, while also promoting an overall CRE recovery. And, given the impact on credit, a broad coalition of groups (including borrowers and realtors, among other associations) have written policymakers on this issue that is critical to the CRE market, which faces more than $1 trillion in loan maturities in the next few years.

Prohibition on Hedging of Retained Risk.

[3] IMF *Global Financial Stability Report* 2009, at 109.

In conjunction with the retained risk requirement, both the House and the Senate bills include provisions that would prohibit "securitizers" from hedging any retained credit risks. Rather than adopting an outright ban on hedging the retained risk, however, the legislation or the supporting conference reports should clarify that this prohibition is not intended to impose undue constraints on "protective" mechanisms that are legitimately used by securitizers to maintain their financial stability.

Several risks inherent in any mortgage or security exposure arise not from imprudent loan origination and underwriting practices, but from outside factors such as changes in interest rates, a sharp downturn in economic activity, or regional/geographic events such as a terrorist attack or weather-related disaster. Securitizers attempt to hedge against these market-oriented factors in keeping with current safety and soundness practices, and some examples in this category of hedges are interest rate hedges using Treasury securities, relative spread hedges (using generic interest-rate swaps), and macro-economic hedges (that, for example, are correlated with changes in GDP or other macro-economic factors). The hallmark of this category is that these hedges seek protection from factors the securitizer does not control, and the hedging has neither the purpose nor the effect of shielding the originators or sponsors from credit exposures on individual loans.

As such, hedges relate to generally uncontrollable market forces that cannot be controlled independently. There is no way to ensure that any such hedge protects 100% of an investment from loss – particularly as it pertains to a CMBS transaction that, for example, is secured by a diverse pool of loans with exposure to different geographic locations, industries and property types. Therefore, loan securitizers that must satisfy a retention requirement continue to carry significant credit risk exposure that reinforces the economic tie between the securitizer and the issued CMBS even in the absence of any hedging constraints.

For these reasons, securitization reform legislation should not seek to prohibit securitizers from using market-oriented hedging vehicles. Instead, if a limitation is to be placed on the ability to hedge, it should be made clear that it is intended to prohibit only the hedging of any *individual* credit risks within the pool of risks underlying the securitization. Because these types of vehicles effectively allow the originator or issuer to completely shift the risk of default with respect to a particular loan or security, their use could provide a disincentive to engage in prudent underwriting practices – the specific type of disincentive policymakers want to address.

Granting regulators the flexibility to customize retention requirements to each asset type and market should enable the regulators to utilize the most effective retention regime for each asset class, including – for CMBS – by creditor, securitizer or third-party investor that re-underwrites.

3. <u>Provide Investors with Certainty & Confidence.</u>

Private investors bring their own funds to the table and provide much needed capital that fuels overall lending. In addition to the issues discussed above, there are two areas where increased certainty is critical.

Credit Rating Agency Reform.

Both the House and the Senate regulatory reform bills include titles on credit rating agency reform. The CRE Finance Council and its members generally are supportive of any reforms that require CRAs to provide more information about individual ratings and their rating methodologies.

One aspect of the reforms currently being considered, however, is a previously rejected proposal to require credit ratings to be differentiated for certain types of structured financial products (requiring the use of "symbology," such as "AAA.SF"). Generally speaking, "differentiation" is an overly simplistic and broad proposal that provides little value or information about credit ratings. Thus, CRE Finance Council's members – and specifically the investors the symbology is geared to inform – continue to oppose any differentiation requirement, although we are strong supporters of more effective means of strengthening the credit ratings system in order to provide investors with the information they need to make sound investment decisions.

In fact, a broad coalition of market participants – including issuers, investors, and borrowers seeking access to credit – remain overwhelming opposed to differentiation because it will serve only to increase confusion and implementation costs, while decreasing confidence and certainty regarding ratings. Such effects would, in turn, create market volatility and undermine investor confidence and liquidity, which could exacerbate the current constraints on borrowers' access to capital, at a time when other policymakers are employing every reasonable means to get credit flowing again.

In this regard, it is worth noting that the concept of differentiation has been examined extensively and rejected in recent years by this Committee, as well as by the SEC[4], for most (if not all) of the foregoing reasons. Nothing has changed in the interim.

Accordingly, Congress should not include a differentiation requirement as part of any credit rating agency reform, but instead should include language consistent with that already passed in 2008 by this Committee in the Municipal Bond Fairness Act. That legislation would require CRAs to use ratings symbols that are consistent for all types of securities, recognizing the fact that a single and consistent ratings structure is critical to bond investors who want the ability to compare a multitude of investment options across asset classes. Ultimately, investors expect and demand a common rating structure to provide a meaningful foundation for our markets and ratings system. Such consistency will promote certainty and confidence among investors and all market participants.

In terms of credit ratings performance, the CRE Finance Council devoted significant resources over the last few years to affirmatively enhance transparency in credit ratings. Such enhancements will be far more effective in providing investors with the information they need to make the most informed decisions than a differentiated ratings structure. Instead of differentiated ratings, what CMBS investors have consistently sought is new, targeted transparency and disclosures about the ratings of structured products, to build on the already robust information CRAs provide in their published methodology, presale reports, and surveillance press releases.

In comments filed with the SEC in July 2008, the CRE Finance Council (filing under its former CMSA name) listed a number of recommendations for enhancements that would serve the

---

[4] We note that the CRAs have recently announced an intention to use differentiated ratings (after previously rejecting them), despite strong market opposition. In fact, in early 2008, the CRAs sought feedback on various differentiation proposals, which elicited overwhelming opposition from investors. For example, see the results of Moody's Request for Comment: "Should Moody's Consider Differentiating Structured Finance and Corporate Ratings?" (May 2008). Moody's received more than 200 responses, including ones from investors that together held in excess of $9 trillion in fixed income securities.

investor community, such as publication of more specific information regarding NRSRO policies and procedures related to CMBS valuations; adoption of a standard pre-sale report template with specified information regarding methodology and underwriting assumptions; and adoption of a standard surveillance press release with specified information regarding the ratings. Such information would allow investors to better understand the rating methodology and make their own investment determinations.

Fundamentally, the CRE Finance Council and its members believe that one of the keys to long term viability is market transparency. As noted above, transparency is one of the hallmarks of our market, as exemplified by the unqualified success of our Investor Reporting Package. As we endeavor to continually update our reporting package and provide additional standardized information to market participants, one of our most important proactive initiatives is the ongoing process of creating model offering documents and providing additional disclosure fields with regard to additional subordinate debt that may exist outside the CMBS trust.

REMIC Reform.

Real Estate Mortgage Investment Conduits – or "REMICs" – are the basic tax entity used to hold the pools of ABS loans. The basic IRS rule with respect to REMICs is that REMICs have to primarily be managed as passive loan holding companies. As deterioration occurs in the CRE market, there may be building pressure to consider government-induced modification programs. The CRE Finance Council has been opposed to loan modification proposals that would change the terms of contracts in ways that undermine investors settled expectations. Thus far, the IRS rightfully has only moved to reassert that there will not be tax consequences for modification of loans that are in imminent default, without changing the terms of the "pooling and serving agreement" (or "PSA" contract). If, however, the policy moves beyond this ruling to require modifications or to create such a government program for commercial mortgages, this could create significant uncertainty for the market and drive away investors that are critical to the lending market and an overall CRE recovery. Any future REMIC reforms must therefore provide investors certainty by preserving any underlying investor contractual rights while continuing to allow prudent decision making and the taking of appropriate action with respect to securitized loans that are in "imminent default."

4. <u>Programs Should Support Transition to Private Market.</u>

As noted above, the TALF and PPIP programs have helped facilitate liquidity in the CMBS markets by stimulating private investment. To date, TALF, for example, has helped to reduce rate spreads on CMBS secondary trading and to produce the first private-label CMBS issuance in more than 18 months. .

This progress is welcome and positive, but it will be critical for the CMBS market to move toward more multi-borrower "conduit" deals if it is to provide the capacity necessary to deal with the enormous challenges discussed above, including the need to provide capacity for smaller loans. . One challenge in reviving "conduit" deals has been the inability of institutions to bear the "balance sheet risk" during the "pre-securitization" phase (generally 3-6 months), which is the time between when the loan is made and when it is packaged and sold to investors (known as the "aggregation" or "warehousing" phase). In a vibrant market CMBS market with new issuance, the private sector is able to create an index of bonds that can be used as a hedging tool against aggregation/warehousing risk. Unfortunately, in the absence of significant CMBS issuance, it is very difficult for the private market to create a hedging tool to address the balance sheet risk of aggregating pools of commercial mortgages to smaller property owners and issue larger, well diversified multi-borrower CMBS.

This 'chicken and egg' conundrum has led many participants to suggest that the most efficient and effective use of TALF in the short term – since the program is being suspended next month – would be as a temporary hedging tool until a private sector vehicle can be established. At this point, however, the CRE Finance Council and its members believe that programs like TALF should not be viewed as catalysts, but only as a fallback or backstop should the markets falter in their ongoing re-emergence. Moreover, to the extent such programs continue to be employed, it is imperative that the goals and expectations of the programs going forward – as well as their benefits and limitations – are clearly communicated and understood.

5. **<u>Proactive Measures That Should Be Taken.</u>**

Significantly, the many challenges discussed earlier are interconnected and compound one another. Therefore, policymakers should approach policy initiatives with an acute understanding that the CRE problem has quickly shifted from a crisis of confidence and liquidity to shortage of equity, as there is high demand to service creditworthy borrowers. The equity gap remains the most significant and difficult challenge for financial institutions and commercial borrowers of all sizes. However, there remains heightened concern at the small and regional bank level, as it is expected that the FDIC will seize several hundred additional institutions with both performing and troubled loans (including large amounts of CRE debt that is *not* securitized) that will need to be re-sold and re-financed.

There are a myriad of potential options that could be deployed to bolster a CRE recovery, but it is worth highlighting two items. First, as the Resolution Trust Corporation (RTC) pioneered, the securitization of commercial mortgages can be used as an effective "exit strategy" for the government *after* an institution has failed and its assets (including CRE loans that were not securitized) are seized by the FDIC. Such a proven mechanism can minimize government and taxpayer exposure, while providing liquidity and capacity to the CRE market. Preliminary proposals to establish federal government guarantees for bonds collateralized by small business loans are the types of RTC-like solutions that could play an important role if properly structured. These proposals should be examined carefully and extensively to understand short terms needs and challenges, as well as long term consequences for the market.

Second, the CRE Finance Council supports the "covered bond" bill sponsored by Capital Markets Subcommittee Chairman Paul Kanjorski and Ranking Member Scott Garrett that would include high-quality CMBS as eligible collateral in their proposed framework to facilitate a covered bond market. Covered bonds originated in Europe, and are securities issued by a financial institution and backed by a specified pool of loans known as the "cover pool," to which bondholders have a preferential contractual claim in the event of the issuer's insolvency. In the United States, a typical covered bond transaction involves an insured depository institution ("IDI") selling mortgage bonds, secured by the cover pool, to a trust or similar entity (known as a "special purpose vehicle" or "SPV"). The pledged mortgages remain on the IDI's balance sheet securing the IDI's promise to make payments on the bond, and the SPV sells "covered bonds," secured by the mortgage bonds, to investors. In this fashion, the IDI generates more capital which can be used, in turn, to make more loans or provide financial institutions with a bigger cushion for their regulatory capitalization requirements. In sum, covered bonds are an elegant mechanism for generating more liquidity in the capital markets.

A problem arises, however, if the IDI becomes insolvent and the FDIC assumes control as a receiver or conservator. Once the FDIC takes over, there can be uncertainty about whether the FDIC would continue to pay on the bond obligation according to the bond's terms, or whether it will repudiate the transaction. If the IDI is also in default on the bond, there also can be uncertainty regarding the amount that investors would repaid, or at the very least, delay in allowing investors access to the bond collateral. The transactions can be hedged to alleviate some of these risks, but this increases transaction costs. In the face of such risks, investors were reluctant to invest in covered bonds to any significant degree; the FDIC reported in July 2008 that only two banks had issued covered bonds.

The FDIC recognized that covered bonds could be a "useful liquidity tool" for IDIs and the importance of "diversification of sources of liquidity."[5] Therefore, to provide a measure of certainty to encourage investment in covered bonds, the FDIC issued a Policy Statement in 2008 setting forth directives explaining how it would handle certain types of covered bond obligations where it has assumed control of an IDI. Unfortunately, the FDIC limited the scope of its Policy Statement to covered bonds secured by "eligible assets," and limited the definition of "eligible assets" to residential mortgages. As a result, a market for covered bonds in the CRE mortgage sector has not developed.

Significantly, however, commercial mortgages and CMBS are already permitted in covered bond pools in most European jurisdictions[6], which also accord the appropriate and necessary regulatory treatment, including capital requirements, with respect to covered bonds to facilitate the market and to better serve consumers and businesses seeking access to credit. It follows that in order to be globally competitive, any U.S. covered bond regime should include commercial mortgages and CMBS, and that the overall regulatory framework should be closely aligned with the approach used by our European counterparts. Such a framework will give U.S. consumers and businesses access to the same sources of credit availability, supporting our overall recovery.

While covered bonds should not and cannot replace CMBS as a capital source for the CRE mortgage market, facilitating a commercial covered bond market will be additive. Covered bonds can provide yet another source of liquidity for financial institutions to help raise much needed capital to fund CRE loans, and in turn, ease the current CRE credit crisis, which persists despite high borrower demand. Indeed, in the current environment, covered bonds could be a helpful means of raising capital relative to CMBS, particularly today as the cost of capital related to a covered bond deal could be less volatile than for CMBS. Such conditions also could assist financial institutions in

[5] Covered Bond Policy Statement, Final Statement of Policy, FDIC, 73 Fed. Reg. 43754, 43754 (July 28, 2008).

[6] Legislative frameworks for covered bonds in the following countries specifically permit the use of commercial mortgage loans as collateral: Austria, Bulgaria, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Latvia, Luxembourg, the Netherlands, Norway, Poland, Portugal, Romania, Spain, Sweden, the United Kingdom. In addition, all European jurisdictions that permit the use of residential mortgage-backed securities ("RMBS") in cover pools also permit the use of CMBS.

aggregating collateral for a covered bond issuance, in contrast with the aggregation difficulties now being experienced in the CMBS market. We therefore applaud Chairman Kanjorski and Ranking Member Garrett's inclusion of commercial loans and CMBS as permissible covered bond collateral in their legislation.

Conclusion

There are enormous challenges facing the CRE markets, driven by a multitude of factors listed above, including macroeconomic factors, such as business performance, unemployment, and depreciation of property values. The CMBS market is showing some positive signs with the re-emergence of "singe-borrower" deals and the successful offering of the first multi-borrower deal in two years, but it remains largely dormant (particularly for "conduit" deals). Such private lending and investing is critical to providing liquidity and facilitating overall lending, particularly in more regionally diverse areas (as opposed to just large loans in "single borrower" deals) that will support an efficient CRE recovery.

To resuscitate private lending and the investing that is essential to support that lending, the markets require certainty both in terms of: 1) recovery efforts aimed at lending and liquidity (i.e. TALF, PPIP, etc); and 2) regulatory (i.e. "retention") and accounting (FAS 166 and 167) reforms. Such efforts and reforms cannot be made in a vacuum, especially considering the expansive number of issues and the vast number of financial regulators (Fed, Treasury, FDIC, OCC, SEC, FASB, etc.) involved in these deliberations and determinations.

The oversight of CRE, a greater understanding of the challenges ahead, and potential ways to support a market recovery, should be examined carefully and regularly at the current time. In the legislative arena, there is nothing more significant that can be done in the short term than ensuring that financial reforms strengthen our markets and promote confidence without unnecessary or unintended negative consequences. In this regard, any risk retention mandate must be tailored by "asset class" (e.g. residential mortgages, commercial mortgages, student loans, auto loans, etc.), and considered in entirety with all other reforms (accounting, capital rule changes, etc.) or risk doing significant harm to capital, liquidity and credit availability in the CRE market at this challenging time.

Today, we are seeing conflicting policies, which creates uncertainty and serves as an impediment to a CRE recovery. Overall, any policies must be both customized by market and coordinated in order to provide the certainty and confidence that is necessary to promote private lending and investing, and an overall recovery in CRE and the broader economy.

International Council of Shopping Centers

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

COMMERCIAL REAL ESTATE: A CHICAGO PERSPECTIVE ON THE PROBLEMS AND SOLUTIONS

Everett McKinley Dirksen U.S. Courthouse
Chicago, IL

May 17, 2010

STATEMENT OF PETER BORZAK
PINE TREE COMMERCIAL REALTY
ON BEHALF OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Thank you for conducting today's hearing on commercial real estate (CRE). This is an important issue to every community across the country, but nowhere more than Chicago.

My name is Peter Borzak and I am the Principal for Pine Tree Commercial Realty. Founded in 1995, Pine Tree is located in Northbrook, Illinois and is a recognized leader in the development, acquisition, leasing and management of retail properties throughout the United States.

I am appearing today on behalf of the ICSC. Founded in 1957, ICSC is the premier global retail real estate trade association for the shopping center industry. Its more than 55,000 members in over 92 countries include shopping center owners, developers, managers, marketing specialists, investors, retailers and brokers, as well as academics and public officials. In 2009, shopping center related employment account for more than 500,000 jobs in the state of Illinois.

Thirty years ago real estate capital largely came from local private investors and bank relationships. Since then, the CRE industry has become more institutionalized. In the years leading up to the credit crisis, the supply of capital exceeded the supply of property and a relative valuation bubble was created. As the securitization market became heated, rating agencies neglected their responsibilities. The Commercial Mortgage Backed Securities model and the efficient delivery of credit is an important catalyst for economic recovery, but the problems with mislabeling risk need to be addressed.

Today, the CRE market is trying to find market stability and establish new valuations, but the lack of credit presents a significant obstacle. Assets need to be deleveraged and capital investment to attract new tenants needs to be obtained, but there is very little bank lending and only a glimmer of hope that CMBS lending will appreciably return soon.

For CRE, the credit crisis continues. The majority of ICSC's owner / developer members are private businessmen like me, many of whom are experiencing a difficult time trying to find credit while facing maturing loans and the potential of foreclosure. According to various sources, $1.4 trillion in commercial real estate loans will require refinancing from 2010 through 2014 and nearly half of these loans are "underwater", meaning the property is worth less than the existing loan amount. The amount of bank-held CRE debt coming due will peak in 2012, with large amounts of Commercial Mortgage Backed Securities coming due in 2015-2017.

Like many CRE owners, we have been faced with the dilemma of working out several maturing loans with very few if any viable credit options. During 2009, we were able to find resolutions to many of our bank loans, but in most cases, those resolutions included the investment of additional equity dollars to reduce the leverage level, or required us to finance the retirement of the loan entirely with equity funding. As an example, we had an asset facing a maturity default that was 85% leased and 100% of the fully leased loan-to-value ratio. The bank required $500,000 of additional equity and tenant improvements to increase the lease level to 95%. For this additional investment we were granted a 3 year extension with annual hurdles.

We were fortunate to be able to access the equity funding to facilitate this loan resolution. Many others in our industry have not been able to access those equity funds, and many have lost the equity that was held in their real estate portfolios because of the decrease in asset values and increase in vacancy that resulted from the recession.

In addition to our bank workouts, we are currently trying to work with special servicers regarding two maturing CMBS loans. In one case it looks as if we will not be able to reach a reasonable resolution and will have look elsewhere for a new loan, potentially with a mortgage fund. CMBS special servicers are much harder to access than a bank and have less flexibility in a work-out.

Over the last year and a half ICSC has been working to get to the root of the credit problems facing the retail real estate industry and has created a proposal to give the commercial real estate market tools to recover from the economic downturn. At this time, ICSC believes that the largest obstacle facing the restart of the CRE market is the equity gap between existing loan amounts and current values, as I described above.

Unlike residential real estate, CRE borrowers will put additional equity into their assets, if they can access the capital and it makes economic sense. In order to address this problem, ICSC is pushing forward with a temporary and targeted enhanced depreciation proposal that will provide 50% bonus depreciation for new investment in existing distressed commercial real estate. The new capital will be tied to paying down the debt on the asset, with a portion allowed for job creation and capital improvements in the property. The proposal enjoys the support of the Independent Community Bankers Association and the National Association of Realtors.

ICSC believes that deleveraging CRE debt, largely held by regional and community banks, with fresh capital and new underwriting standards will help local economies recover faster and keep hometown banks in our communities. In addition to helping the credit needs of our owner/developers, we are also hearing from our tenants that small business loans are hard to access. Community banks are the main source of small business lending to many mom-and-pop retailers, and this proposal will help community banks that are trying to unwind commercial real estate debt from their balance sheet and increase small business lending capabilities.

Access to capital and credit are truly the biggest problems facing our industry and while ICSC is putting forth this thoughtful proposal, the industry is also fighting against two major efforts to undercut capital creation in real estate; Increasing the tax on carried interest and one-size-fits-all risk retention standards for Commercial Mortgage Backed Securities.

Simply stated, I believe if a carried interest tax increase is enacted, it will severely inhibit local developers and operators and lead to job loss through less development and consolidation of local development by major national institutions. In addition, it will inhibit local developers and operators from making investments, as the current structure encourages them to align their interest with their investing partners and the success of the project rather than simply creating a structure that pays short term fees at the beginning of the project.

Furthermore, this tax will make investment in underserved markets far less feasible to developers because of the increased risk. The net result will be to cause harm to those communities that need development and revitalization the most. A lack of retail options leads to higher prices for basic commodities like milk and bread for those people who can least afford to pay.

Community leaders where we do business fully understand and appreciate the benefits our development brings to their citizens - - more consumer choices at lower cost; more job opportunities, both at the construction phase and thereafter; an increased tax base and an improved quality of life. In fact, the U.S. Conference of Mayors and the National Association of Counties have both passed resolutions in opposition to this tax increase on CRE.

As for risk retention standards for asset-backed securities, ICSC believes that "skin-in-the-game" is an important market protection to bring more safety and soundness to the market, leading to increased investor confidence. However, ICSC supports the Senate passed amendment and similar language passed in the House to allow regulators flexibility in determining the most appropriate form of risk retention for commercial real estate finance instead of a fixed 5% risk retention level, which will likely lead to reduced credit availability when paired with recent FASB accounting requirements.

At the end of the day, the issues discussed today are not about Wall Street but about Main Street. The CRE issue is a major systemic economic issue threatening job creation, economic development, and revitalization of communities across the country.

Thank you for holding today's hearing and for giving me the opportunity to testify. I look forward to working with you as you continue to examine this important area. I welcome any questions.

The Real Estate Roundtable

STATEMENT OF

BRUCE R. COHEN
CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
WRIGHTWOOD CAPITAL

ON BEHALF OF

THE REAL ESTATE ROUNDTABLE

UNITED STATES HOUSE OF REPRESENTATIVES

FINANCIAL SERVICES SUBCOMMITTEE ON

OVERSIGHT & INVESTIGATIONS

FIELD HEARING

ON

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

DIRKSEN FEDERAL COURTHOUSE
ROOM 2525, 219 S. DEARBORN ST.
CHICAGO, ILLINOIS

Monday, May 17, 2010

Market Square West • 801 Pennsylvania Ave., NW • Suite 720 • Washington, DC 20004 • Phone: 202-639-8400 • Fax: 202-639-8442 • www.rer.org

The Real Estate Roundtable

UNITED STATES HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES SUBCOMMITTEE ON
OVERSIGHT & INVESTIGATIONS

FIELD HEARING

ON

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

DIRKSEN FEDERAL COURTHOUSE
ROOM 2525, 219 S. DEARBORN ST.
CHICAGO, ILLINOIS

Monday, May 17, 2010

STATEMENT OF

BRUCE R. COHEN
CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
WRIGHTWOOD CAPITAL

ON BEHALF OF

THE REAL ESTATE ROUNDTABLE

INTRODUCTION

Thank you, Chairman Moore, Ranking Member Biggert and members of the Committee, for conducting today's hearing on the state of the economy with respect to commercial real estate.

I am Bruce Cohen, and I am the Chairman and Chief Executive Officer of Wrightwood Capital and a member of The Real Estate Roundtable, an organization that represents the leadership 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 testify today about the impact the economic downturn and credit market dislocation is having on commercial real estate and how that dislocation will negatively affect the overall economy and impede future economic growth.

By way of background, when I speak of the commercial real estate sector I am speaking of six principal property types – apartment, office, retail, industrial, health care and hotels. It is also important to realize that the commercial real estate market includes many diverse regional and local markets, as well as submarkets within markets, each with their own dynamics. A common attribute through all, however, is that they each depend on a healthy economy for occupancy and operating income, and on a liquid financing market to facilitate investment, development and sales of properties.

My message today is simple and straightforward. Despite some improvements in credit markets since the meltdown in 2008, the current credit system in America simply does not have the capacity to meet the legitimate demand for mainstream commercial real estate debt. As the demands for debt remain unmet, the stress to the financial services system overall, individual financial institutions, and those who have invested in real estate directly or indirectly will increase.

There are a number of "green shoots" in real estate capital markets. For example, things have improved dramatically over the past year in publicly traded markets, with substantial amounts of equity and unsecured debt raised. There has been a modest volume of commercial mortgage backed securities (CMBS) transactions, and we hear the pipelines are improving. Also, life insurance company lenders are in the market for conservatively underwritten, low leverage, high quality transactions. While encouraging, these developments relate to a very small segment of the overall market.

For most of the market, the lack of credit has stalled transaction volume, which has fallen by nearly 90 percent from its peak. Over the past two years, asset values are estimated to have fallen by approximately 35-40 percent, on average. Most of the private market continues to suffer from a lack of capital and excess leverage. Job losses continue to hurt property fundamentals. As a result, vacancies have been pushed to new highs and cash flows continue to weaken, leading to further erosion of commercial property values.

With very limited capacity to meet the ongoing demand for credit, there is increasing concern about a potential wave of defaults – from maturing loans - that will further exacerbate the current credit crisis. Needless to say, this has broad systemic consequences and will reverse the progress that has been made in healing the banking system and credit markets to date.

What does this mean for Main Street USA?

The commercial real estate sector of the economy is large, representing $6.7 trillion of value supported by $3.5 trillion in debt. Its health is vital to the economy (estimates show commercial real estate constitutes 13% of GDP by revenue) and our nation's financial system.

An estimated 9 million jobs are generated or supported by real estate — jobs in construction, planning, architecture, environmental consultation and remediation, engineering, building maintenance and security, management, leasing, brokerage, investment and mortgage lending, accounting and legal services, interior design, landscaping, cleaning services and more.

Rising defaults (resulting from a lack of refinancing options) and falling property values in commercial real estate will create a cascade of negative repercussions for the economy as a whole.

- **For millions of Americans whose pension funds invest directly or indirectly in approximately $160 billion of commercial real estate equity**, increased loan defaults and lower property values will mean a smaller retirement nest egg.
- **For millions of construction, hotel and retail workers**, the commercial real estate liquidity vacuum will translate into cancelled or delayed projects, layoff and pinched family budgets — exacerbating rising unemployment and declining consumer spending. This, in turn, will further hurt U.S. businesses and exacerbate falling demand for commercial real estate space.
- **For state and local governments**, erosion of property values will mean less revenue from commercial property assessments, recording fees and transaction taxes resulting in bigger budget shortfalls.
- **For the communities they serve**, it will mean cutbacks in essential public services such as education, road construction, law enforcement, and emergency planning.

I am here today to continue to sound the alarm bell. The policy actions to date have been helpful, but additional steps are called for to help transition the ownership and financing of commercial real estate from a period of higher than desirable leverage and weak loan underwriting to a time of systemically supportable leverage, sounder underwriting, and economic growth.

It is essential for policymakers to focus on policies that will nurture a fragile recovery into durable expansion – foster climate for job growth. To this end, The Real Estate Roundtable is now focused on the following areas –

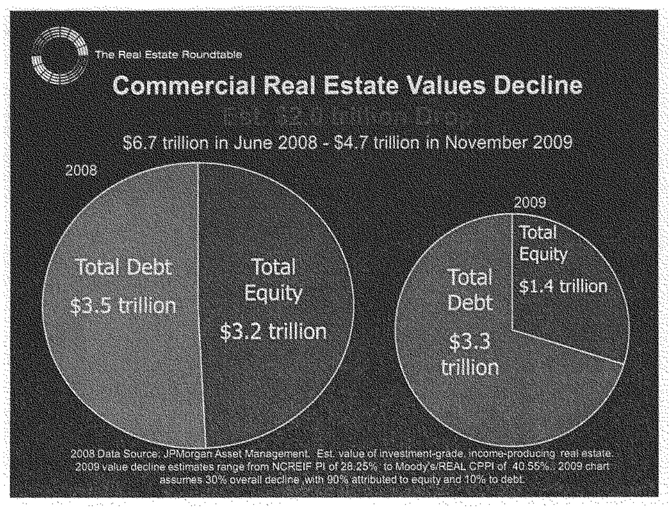
- **Jobs.** Lift the cloud of regulatory uncertainty; foster a climate for job growth, investment and economic expansion.
- **Equity.** Enact measures to encourage capital formation and rebalance markets by filling the massive equity gap. Encourage foreign investment in U.S. real estate by revising the Foreign Investment in Real Property Tax Act (FIRPTA) and incentivize U.S. investors. Reject new anti-real estate investment taxes, such as the proposed carried interest tax hike;
- **Troubled Assets.** Develop new measures to help dispose of troubled assets, restructure bank balance sheets.
- **Securitization.** Pursue additional measures to repair securitization markets, spur secondary market activity, and enhance credit capacity (e.g., resolve conduit aggregation risk challenges; develop a framework for U.S. covered bond market).

THE CURRENT PICTURE

The commercial real estate industry is in deep stress for two reasons. First, the macro economy has yet to shake off the impact of the "Great Recession": unemployment remains high; consumer spending has yet to rebound; and business and personal travel is down. All of which results in reduced operating income for property owners and lower property values.

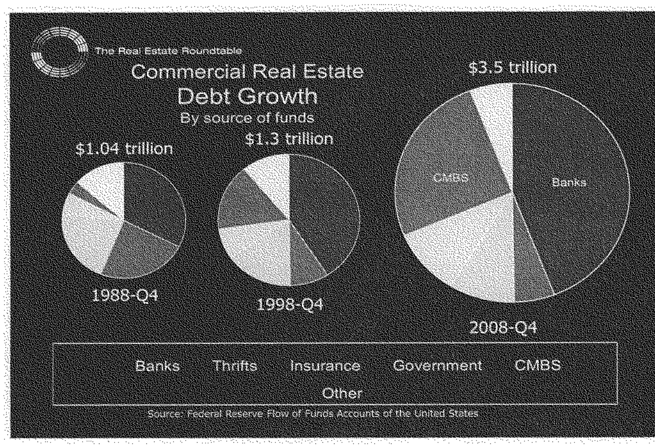
Second, and in many respects more importantly, except for a narrow segment of the market, the credit markets remain essentially closed to refinancing existing real estate debt or securing new debt to facilitate transactions. The continued lack of a functioning credit market puts further downward pressure on property values and is causing many commercial property owners to face "maturity defaults" on their loans. This will create a great deal of added stress on the banking system, as losses are absorbed, and on the overall economy.

The size of the problem is large today and if not addressed could become large enough to undermine the positive economic growth signs that are starting to appear. At its peak, commercial real estate in America was valued at approximately \$6.7 trillion. It is supported by about \$3.5 trillion of debt. However, with a lack of credit, and property fundamentals weakened by job losses, the estimated value of the equity in commercial real estate has diminished from approximately \$3.5 trillion, at the peak, to approximately \$1.4 trillion. With a decline in values, the market has become over leveraged.

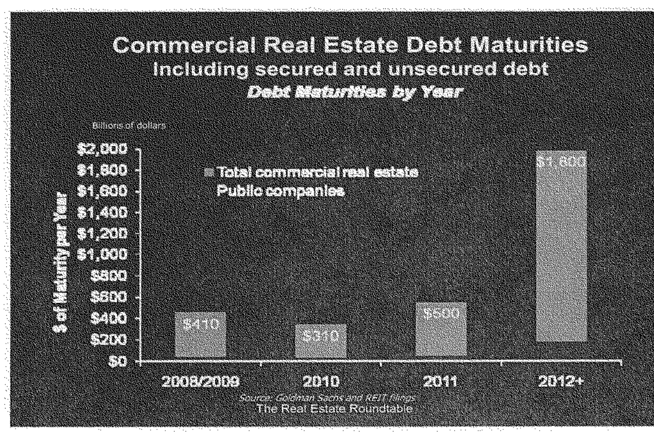


Most commercial real estate debt has loan terms of 10 years or less, and therefore a significant percentage of outstanding debt matures each year and needs to be refinanced. The three largest providers of credit to the sector are: 1) commercial banks, with \$1.5 trillion, or

43%; 2) commercial mortgage backed securities (CMBS) accounts for approximately $750 billion, or 22%; and 3) life insurance companies, with $315 billion or 9%. Additionally, some $330 billion is held by the government sponsored enterprises (GSEs), agencies or GSE-backed mortgage pools.

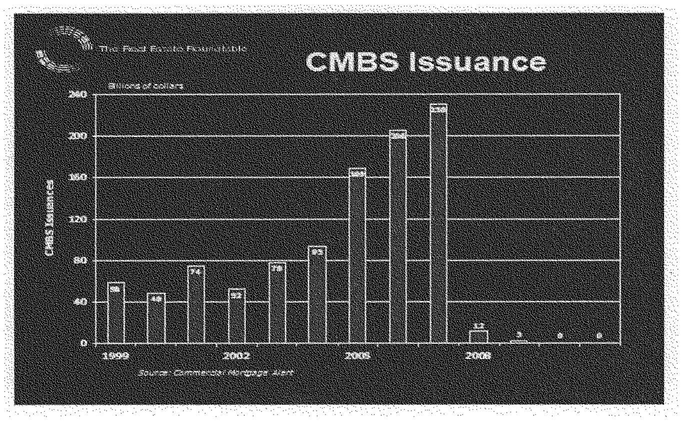


In 2010, the amount of maturing commercial real estate loans is estimated to be $300 billion. Maturing debt in this sector continues to expand. With an average $400 billion of commercial real estate debt maturities each year for the next decade, the credit market as it is currently structured does not have the capacity to absorb this demand.



During the last several years, banks and the commercial mortgage backed securities market provided about 83% of the growth in commercial real estate debt. Today, banks remain on the sidelines, and the CMBS market is only producing a small fraction of the credit it once provided to the marketplace.

The CMBS market is illustrative of the problem. CMBS issuance peaked in 2007 with $230 billion of bonds issued; this plunged to $12 billion in 2008 – a nearly 95% decline. In 2009, there was approximately $3 billion. Thus far this year, there has been only $309 million of new CMBS issuance.



The result is that the $6.7 trillion commercial real estate sector, a very large contributor to overall economic growth, continues to face a liquidity crisis of mammoth proportions. That being said, it is noteworthy that real estate investment trusts (REITs) and other publicly traded real estate companies have raised appreciable amounts of equity, as well as some debt. Since the beginning of 2009, REITs, which represent approximately ten percent of the overall commercial real estate market, have raised over $31 billion in the public equity markets and nearly $20 billion of unsecured debt. These capital raising activities alone do not mean that commercial real estate is out of the woods. The industry overall continues to face tremendous challenges to maintain sufficient liquidity in the face of the current credit crisis. But, it is definitely a positive sign that some capital has been made available through public securities markets to the publicly-traded segment of the commercial real estate business. Importantly, the government sponsored enterprises - Fannie Mae and Freddie Mac – have remained in the multifamily financing market. While improved, additional measures are needed in order to further reduce financial pressures for all owners and operators of commercial real estate.

The February Congressional Oversight Panel Report: *Commercial Real Estate Losses and the Risk to Financial Stability* makes several important points:

- Approximately $1.4 trillion in U.S. real estate loans on bank balance sheets will come due between 2010 and 2014, with nearly half of those loans currently "underwater;"
- The wave of commercial real estate loan losses over next four years could jeopardize stability of many banks;
- A "significant wave of commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American;" and
- Policymakers must address toxic assets and commercial real estate threats.

Treasury Secretary Geithner recently acknowledged that escalating losses from commercial real estate loans remains a concern but suggests the problem can be managed. However, FDIC Chair Sheila Bair has warned that commercial real estate loan losses will drive 2010 bank failures, which likely will top last year's 140 collapses. Over 700 banks are on the FDIC watch list.

Secretary Geithner is promoting $30 billion fund proposed by the White House to provide money to midsize and community banks that boost lending to small businesses. The program requires congressional approval and would use money repaid by banks to the TARP program. There is broad concern that this program is not of sufficient scale to have the necessary capacity to help small business create the jobs necessary to grow the economy.

The January Troubled Asset Relief Program (TARP) Special Inspector General Report to Congress concludes that, while the $700 billion TARP program helped stabilize the financial system, the program's original goals have not been met. It further states,

- "Lending continues to decrease, month after month;"
- Home foreclosures remain at record levels; and
- Unemployment remains at the highest level in generations.

In fact, last year U.S. banks posted their sharpest decline in lending since 1942, and small bank lending to small businesses has contracted by the largest decline on record. Small businesses are key drivers for job growth and depend on credit to grow. Policymakers need to explore additional measures to encourage the level of lending and investment required to grow jobs.

One idea being considered in the House of Representatives involves a measure that would allow small and medium size banks to amortize any losses or write-down losses on commercial real estate loans (or real estate owned) on a quarterly straight-line basis over the 7-year period beginning with the month in which such loss or write-down occurs. If enacted, this measure might help break the logjam in troubled commercial real estate assets on bank balance sheets.

Small Banks Need Asset-Backed Securitization Markets to Work

We appreciate the steps taken so far by the Congress, the Federal Reserve and the Treasury Department to try to address the vast liquidity crisis that is crippling the economy, destroying jobs and causing a free fall in commercial property values. But much more needs to be done. Additional measures must be taken to create credit capacity in the regional and community banks and that we can best support our industry by stimulating the availability of credit for small and mid-market companies.

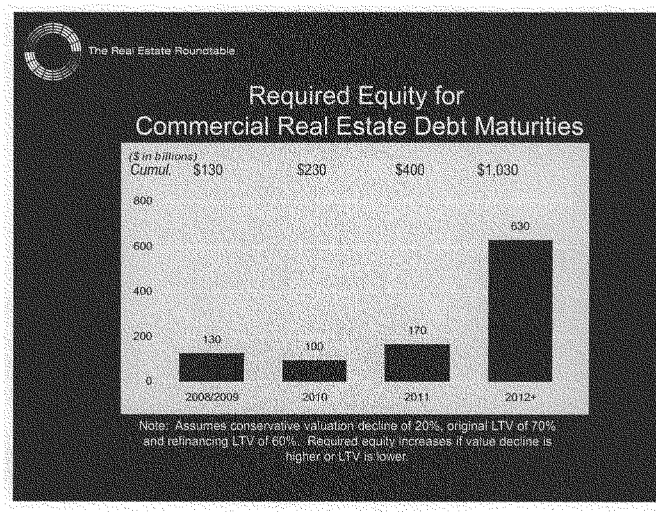
Even if commercial banks return to the market in force, these institutions simply do not have the capacity to satisfy demand. Therefore, steps must be taken to restore active asset-backed and commercial mortgage securitization markets.

- **The Term Asset Backed Loan Facility (TALF) has helped reduce spreads and stimulate securitization activity in asset backed and CMBS markets. Yet new middle-market CMBS issuance remains stalled.** Despite the relatively low volume - $30 million - of newly-issued commercial mortgage backed securities (CMBS) directly supported by the Fed's in 2009, the program paved the way for nearly $3 billion in private (non-TALF-supported) CMBS issuance last year. Yet, TALF for ABS and Legacy CMBS expired March 31, 2010; TALF for new issue CMBS expires June 30, 2010. Only $309 million of CMBS have been issued year to date.
- **The Public Private Investment Program (PPIP) has not achieved its stated goal of taking troubled assets off commercial bank balance sheets. As a result, the banking system remains unable to provide essential credit to the businesses that need it most. The PPIP had two components: the Legacy Loans Program and the Legacy Securities Program.** The Treasury's initial commitment to the program was $100 billion, but since then the program has been significantly scaled back. While the Legacy Loans Program never really got off the ground, the Legacy Securities Program was allocated $30 billion of taxpayer funds, with the Treasury committing $3 of capital for every private $1 ($1 of equity capital, $2 of debt capital). That is expected to translate into $40 billion of purchasing power if the program reaches full capacity. However, this is far short of what is needed to clean up the $1.5 trillion of commercial real estate loans on bank balance sheets.
- **Tax reforms could promote help from non-U.S. investors.** Finally, non-U.S. investors could provide significant new real estate lending originations if the Treasury and the Internal Revenue Service would issue a Notice (or other guidance) to confirm that real estate loan originations are encompassed by the proprietary securities trading safe harbor of section 864(b)(2) of the Tax Code and thus such actions do not constitute a U.S. trade or business. Clarifying this would expand real estate lending capacity in the country and enable non-U.S. investors to originate real estate debt just as they are now allowed under current tax law to invest in existing debt.

The Debt Crisis is Also an Equity Crisis

The commercial real estate "debt crisis" in many ways can also be seen as an equity crisis. Because of the significant value declines in commercial real estate - estimated by some to be

35% or more - for lending to resume, and transactions to go forward, there must be significant additional equity investment into the market place. Preliminary conservative estimates reveal a vast "equity gap" exceeding $1 trillion over the next several years. One potential source for this needed equity investment is foreign pension and other non-U.S. fund pools — but policy must facilitate this investment. Equity capital required to rebalance current leverage positions – fill equity gap. Policy action needed to spur non-U.S. equity investment into U.S. real estate



- In the best interest of the economy, the Congress should make a much needed policy change by modifying the Foreign Investment in Real Property Tax Act ("FIRPTA"). As you may know, under current U.S. tax law, gains realized from the sale of U.S. real estate by non-U.S. investors are subjected to U.S. taxation at full U.S. rates under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). Such taxation is completely at odds with the U.S. tax treatment of a large number of other types of foreign investments in the United States. With a few technical exceptions, FIRPTA is literally the only major provision of U.S. tax law which subjects non-U.S. investors to taxation on capital gains realized from investment in U.S. assets. By modifying FIRPTA, non-U.S. investors will be encouraged to inject much needed capital into the U.S. real estate markets.

- Over the years, FIRPTA has had an adverse effect on foreign investment in U.S. real estate. In fact, the obstacles that are imposed under FIRPTA have led many non-U.S. investors to invest in real estate elsewhere – to such countries as Brazil, China and India - shifting wealth and economic dynamism away from the U.S. market. The **laws relating to foreign investment in U.S. real estate should be reviewed by**

Congress and corrected in a responsible way to allow increased investment into US real estate, while still ensuring that the real estate is domestically controlled.

Now is not the time to pursue new anti-real estate investment taxes such as increasing the capital gains rate, or the proposed tax hike on partnership "carried interest." Both these ideas are anti-investment and should be set aside at least until the economy rights itself. And, all businesses should be made eligible for the five-year carry back of net operating loses

- **The "carried interest" proposal is sometimes discussed as a potential "revenue raiser" but would be a very negative policy change now.** It would significantly raise taxes on a broad range of commercial and multi-family real estate owners of all sizes and property types. The proposal frequently is portrayed simply as a tax increase on a few well-heeled "hedge fund" and private equity managers and as a move toward tax fairness. This could not be further from the truth.

- In fact, it would impose a huge tax increase on countless Americans who use partnership structures for all types and sizes of businesses. It would be especially bad for real estate businesses.

- An increase in this tax rate would be the first time that the sweat equity of an entrepreneur who is building a business would be taxed as ordinary income. The carried interest tax would dampen, if not stifle entrepreneurial activity. A higher tax on entrepreneurial risk taking will have a chilling effect on investment. It would discourage risk taking that drives job creation and economic growth. In short, it would have profound unintended consequences for Main Street America. Now is the time to create jobs, not destroy them.

- Enacting this proposal would be playing Russian roulette with an economy that is already weak in the knees. Taxing carried interest at ordinary income rates is not sound economic practice especially given the current economic crisis. Instead of encouraging equity investment, the proposal would encourage real estate owners to borrow more money to avoid taking on equity partners thereby delivering a huge blow to the 1.5 million workers directly employed in the real estate business and the nation's 800,000 construction workers. These are outcomes the Administration should be trying to avoid at this critical point in the recession.

- About 15 million Americans are partners in more than 2.5 million partnerships. They manage nearly $12 trillion in assets and generate roughly $400 billion in annual income. Virtually every real estate partnership, from the smallest apartment venture to the largest investment fund, has a carried interest component. Through these structures, entrepreneurs match their ideas, knowhow and effort with equity investors. Taxing all carried interests in partnerships as ordinary income would be a whopping 150% tax increase. As much as $20 billion in value annually could be driven from the economy.

- Further, 46% of all partnerships are engaged in real estate, and 60% of their income is capital gain income. Real estate general partners put "sweat equity" into their business, fund the predevelopment costs, guarantee the construction budget and financing, and expose themselves to potential litigation over countless possibilities. They risk much. Their gain is never guaranteed. It is appropriately taxed today as capital gain.

CONCLUSION

In summary, conditions in the nation's commercial real estate markets today are quite challenging. Property fundamentals declined due to weakness in the overall economy. Defaults and foreclosures are expected to increase due to the paralyzed credit markets. Together, the resulting value declines and debt dislocations threaten to undermine any nascent economic stabilization some believe is now underway.

The overriding concern lies in the credit markets. Here, it is important that government continue to explore appropriate steps to restore functionality to credit markets, bank lending and create an environment conducive for business and investors to invest and deploy capital. At the same time, it is important that unnecessary barriers to equity investment be lowered and that taxes on risk taking not be increased.

We encourage Congress and the Administration to pursue such measures or a combination of measures that could be rapidly implemented and help address this difficult situation. We stand ready to discuss and aid in the development and implementation of such measures.

Thank you for the opportunity to testify today.

NATIONAL ASSOCIATION OF REALTORS®

REALTOR®

The Voice For Real Estate®

500 New Jersey Avenue, N.W.

Washington, DC 20001-2020

Vicki Cox Golder
CRB
President

Dale A. Stinton
CAE, CPA, CMA, RCE
Chief Executive Officer

GOVERNMENT AFFAIRS DIVISION
Jerry Giovaniello, Senior Vice President
Gary Weaver, Vice President
Joe Ventrone, Vice President
Jamie Gregory, Deputy Chief Lobbyist

HEARING BEFORE THE

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

ENTITLED

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

WRITTEN STATEMENT OF

G. JOSEPH COSENZA

ON BEHALF OF

THE NATIONAL ASSOCIATION OF REALTORS®

MAY 17, 2010

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

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

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

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

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

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

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

---

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

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

Combating the Crisis

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

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

Incentives for Increasing Investment Property - Accelerated Depreciation

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

Increasing the Cap on Credit Union Business Lending

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

---

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

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

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

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

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

Mortgage Insurance Program for Performing Commercial Real Estate Loans

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

---

[3] Oversight Panel

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

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

Additional Guidance Relating to Term Extensions

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

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

Extension of TALF

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

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

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

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

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

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

Improve Lending Access for Small Businesses

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

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

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

---

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

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

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

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

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

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

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

Conclusion

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

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

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

Testimony Before the Subcommittee on Oversight and Investigations of the United States House of Representatives Committee on Financial Services

"Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses"
Monday, May 17, 2010

by Paula Dubberly
Associate Director, Division of Corporation Finance
U.S. Securities & Exchange Commission

I. Introduction

Chairman Moore, Ranking Member Biggert, and members of the subcommittee:

My name is Paula Dubberly, Associate Director of the Division of Corporation Finance at the Securities and Exchange Commission, and I am pleased to testify on behalf of the Commission today on the topic of securitization as it concerns commercial real estate. Securitizations can serve as a vehicle for financing commercial real estate, so my comments today will provide an overview of the Commission's work in the securitization area generally, specifically focusing on a recent proposed rulemaking that the Commission published for public comment on April 7, 2010 that proposes significant revisions to the rules governing offers, sales, and reporting with respect to asset-backed securities ("the April 7 proposal").[1]

II. Background

Securitization generally is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into instruments that are offered and sold in the capital markets as securities. This financing technique makes it easier for lenders to exchange payment streams coming from the loans for cash so that they can make additional loans or credit available to a wide range of borrowers and companies seeking financing.

---

1 The April 7 proposal is available on the SEC public Web site. See Asset-Backed Securities, Release No. 33-9117 (Apr. 7, 2010)[75 FR 23328] at http://www.sec.gov/rules/proposed.shtml.

At its inception, securitization primarily served as a vehicle for residential mortgage financing. Since then, asset-backed securities have played a significant role in both the U.S. and global economy. At the end of 2007, there were more than $7 trillion of both agency and non-agency[2] mortgage-backed securities and nearly $2.5 trillion of asset-backed securities outstanding.[3] Securitization can provide liquidity to nearly all major sectors of the economy including the residential and commercial real estate industry, the automobile industry, the consumer credit industry, the leasing industry, and the commercial lending and credit markets.[4]

Many of the problems giving rise to the financial crisis involved structured finance products, including residential mortgage-backed securities.[5] Many of these residential mortgage-backed securities were used to collateralize other debt obligations such as collateralized debt obligations and collateralized loan obligations (CDOs or CLOs), types of asset-backed securities that are sold in private placements.[6] As the default rate for subprime

---

2 Agency securities are securities issued by the government-sponsored enterprises, Ginnie Mae, Fannie Mae or Freddie Mac.

3 See American Securitization Forum, Study on the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets (June 17, 2009), at 16 (citing to statistics on outstanding residential mortgage-backed securities and outstanding U.S. ABS collected by the Securities Industry and Financial Markets Association), available at http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf.

4 See testimony of Micah Green, President of the Bond Market Association, Before the Senate Basel Committee on Banking Supervision, A Review of the New Basel Capital Accord, (June 13, 2003), available at http://banking.senate.gov/.

5 A report by the U.S. Government Accountability Office (GAO) notes that 75% of subprime loans were packaged into securities in 2006. See U.S. Government Accountability Office, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (Jan. 2009) at 26.

6 CDOs are typically sold as a private placement to an initial purchaser followed by resales of the securities to "qualified institutional buyers" pursuant to Rule 144A. Pools comprising the CDOs may consist of various types of underlying assets including subprime mortgage-backed securities and derivatives, such as credit default swaps referencing subprime mortgage-backed securities, and even tranches of other CDOs.

and other residential mortgages soared, such securities, including those with high credit ratings, lost much of their value.[7] CDOs were noted, in particular, to have contributed to the collapse in liquidity during the financial crisis.[8] As the crisis unfolded, investors increasingly became unwilling to purchase these securities, and today, this sentiment remains, as new issuances of asset-backed securities, except for government-sponsored issuances, have recently dramatically decreased.[9] The absence of this financing option has negatively impacted the availability of credit.[10]

III. The April 7 Proposal

The recent financial crisis highlighted that investors and other participants in the securitization market did not have the necessary tools to be able to fully understand the risk underlying those securities and did not value those securities properly or accurately. The severity of this lack of understanding and the extent to which it pervaded the market and

---

CLOs are similar to CDOs except that they hold corporate loans, loan participations or credit default swaps tied to corporate liabilities.

7 See, e.g., The President's Working Group on Financial Markets, Policy Statement on Financial Market Developments, March 2008 (the "PWG March 2008 Report") at 9 (discussing subprime mortgages and the write-down of AAA-rated and super-senior tranches of CDOs as contributing factors to the financial crisis).

8 See, e.g., The Report of the Counterparty Risk Management Policy Group III ("CRMPG III"), Containing Systemic Risk: The Road to Reform, August 6, 2008, at 53 (noting that lack of comprehension of CDO and related instruments resulted in the display of price depreciation and volatility far in excess of levels previously associated with comparably rated securities, causing both a collapse of confidence in a very broad range of structured product ratings and a collapse in liquidity for such products). Another type of asset-backed security that is privately offered is asset-backed commercial paper (ABCP), which was increasingly collateralized by CDOs and RMBS from 2004 through 2007. The ABCP market severely contracted during the crisis. See PWG March 2008 Report at 8.

9 See, e.g., David Adler, "A Flat Dow for 10 Years? Why it Could Happen," Barrons (Dec. 28, 2009) (noting that new securitization issuances, except those sponsored by the government, have largely come to a halt). In 2008 through the end of September, annualized issuance volumes for overall global securitized and structured credit issuance were approximately \$2.4 trillion less than in 2006. See Global Joint Initiative to Restore Confidence in the Securitization Market, Restoring Confidence in the Securitization Markets (Dec. 3, 2008) at 6.

10 Id. In the past 20 months, the Commission is aware of only one registered offerings of residential mortgage-backed securities backed by newly originated loans.

impacted the U.S. and worldwide economy calls into question the efficacy of several aspects of the Commission's regulation of asset-backed securities.

On April 7, the Commission proposed a number of changes to the offering process, disclosure, and reporting requirements for asset-backed securities, which are designed to enhance protection in this market. The April 7 proposal is designed to address issues that contributed to or arose from the financial crisis and to be forward-looking; some of the proposals are designed to improve areas that have the potential to raise issues similar to the ones highlighted in the financial crisis. The April 7 proposal is intended to provide investors with timely and sufficient information, including information in and about the private market for asset-backed securities, reduce the likelihood of undue reliance on credit ratings, and help restore investor confidence in the representations and warranties regarding the underlying assets. Although these revisions are comprehensive and therefore would impose new burdens, if adopted, we believe they would protect investors and promote efficient capital formation.

The April 7 proposal covers the following areas:

(1) revisions to the shelf offering process and criteria and prospectus delivery requirements;

(2) Securities Act and Exchange Act disclosure requirements, including new requirements to disclose standardized asset-level information or grouped account data and a computer program that gives effect to the cash flow provisions of the transaction agreement (often referred to as the "waterfall"); and

(3) changes to the Securities Act safe harbors for exempt offerings and exempt resales for asset-backed securities.

The April 7 proposal, if adopted, would apply to new issuances of asset-backed securities. Therefore, the proposed rules, if adopted, would not impose new requirements on outstanding asset-backed securities. The comment period for the proposed rules expires on August 2, 2010. The Commission looks forward to reviewing and considering all the comments.

The following is a summary of the proposed amendments in these three areas:

A. Revisions to Shelf Offering Process and Criteria

Securities Act shelf registration provides important timing and flexibility benefits to issuers. An issuer with an effective shelf registration statement can conduct delayed offerings "off the shelf" under Securities Act Rule 415 without further staff clearance. Under the Commission's current rules, asset-backed securities may be registered on a Form S-3 registration statement and later offered "off the shelf" if, in addition to meeting other specified criteria, the securities are rated investment grade by a nationally recognized statistical rating organization. Much has been written about the failures of ratings to measure accurately and describe the risks associated with certain of those products that were realized during the financial crisis.[11] The April 7 proposal would repeal the ABS shelf eligibility criterion relying on ratings and establish other criteria for shelf eligibility as well as revise the shelf registration procedure for issuances of asset-backed securities.

---

[11] See, e.g., The PWG March 2008 Report at 2, 8 (noting that the performance of credit rating agencies, particularly their ratings of mortgage-backed securities and other asset-backed securities, contributed significantly to the financial crisis).

The April 7 proposal would establish the following new requirements for ABS shelf eligibility criteria:

- A certification filed at the time of each offering off of a shelf registration statement, or takedown, by the chief executive officer of the depositor[12] that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows to service any payments due and payable on the securities as described in the prospectus;
- Retention by the sponsor of five percent of each tranche of the securitization,[13] net of the sponsor's hedging (also known as "risk retention" or "skin-in-the-game");
- A provision in the pooling and servicing agreement that requires the party obligated to repurchase the assets for breach of representations and warranties to periodically furnish an opinion of an independent third party regarding whether the obligated party acted consistently with the terms of the pooling and servicing agreement with respect to any loans that the trustee put back to the obligated party for violation of representations and warranties and which were not repurchased; and
- An undertaking by the issuer to file Exchange Act reports so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets.[14]

---

12 We use the term "depositor" to mean the depositor who receives or purchases and transfers or sells the pool assets to the issuing entity. For ABS transactions where there is not an intermediate transfer of the assets from the sponsor to the issuing entity, the term depositor refers to the sponsor. For ABS transactions where the person transferring or selling the pool assets is itself a trust, the depositor of the issuing entity is the depositor of that trust. See Item 1101(e) of Regulation AB.

13 We use the term "sponsor" to mean the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. See Item 1101(l) of Regulation AB.

The Commission also proposed to replace Forms S-1 and S-3 with new forms for registered ABS offerings -- proposed Forms SF-1 and SF-3 -- and to revise the shelf offering structure for those securities. Form SF-3 would be the form used for ABS shelf offerings.

In addition, investors have expressed concern regarding a lack of time to analyze securitization transactions and make investment decisions. While the Commission historically has not built minimum time periods into its registration process to deliberately slow down the market,[15] and instead has believed investors can insist on adequate time to analyze securities (and refuse to invest if not provided sufficient time), we have been told that this is not generally possible in this market, particularly in an active market. Given many ABS investors' stated desire for more time to consider the transaction and for more detailed information regarding the pool assets, the Commission proposed to revise the filing deadlines in shelf offerings to provide investors with additional time to analyze transaction-specific information prior to making an investment decision. These changes are designed to promote independent analysis of ABS by investors rather than reliance on credit ratings. Under the proposed ABS shelf procedures, an ABS issuer would be required to file a preliminary prospectus with the Commission for each takedown off of the proposed new shelf registration form for ABS (Form SF-3) at least five business days prior to the first sale

---

[14] Section 15(d) of the Exchange Act provides that for issuers that do not also have a class of securities registered under the Exchange Act, the duty to file ongoing reports is automatically suspended after the first year if the securities of each class to which the registration statement relates are held of record by less than three hundred persons. As a result, typically the reporting obligation of all asset-backed issuers, other than those with master trust structures, are suspended after they have filed one annual report on Form 10-K because the number of record holders falls below, often significantly below, the 300 record holder threshold.

[15] See, e.g., Section IV.A. of Securities Offering Reform, Release No. 33-8591 (Jul. 19, 2005) [70 FR 44722] (release adopting significant revisions to registration, communications and offering process under the Securities Act and stating that Rule 159 would not result in a speed bump or otherwise slow down the offering process).

in the offering.[16] Under the proposal, issuers would use one prospectus for each transaction and the current practice of using core or base prospectuses plus supplements would be eliminated for offerings of ABS.

B. Securities Act and Exchange Act Disclosure Requirements

In 2004, the Commission adopted a new set of rules prescribing the disclosure requirements for asset-backed issuers.[17] Many disclosure requirements of Regulation AB are principles-based. Regulation AB currently requires that material, aggregate information about the composition and characteristics of the asset pool be filed with the Commission and provided to investors. Market participants have expressed a desire for expanded disclosure relating to the assets underlying securitizations. The April 7 proposal includes additional, and in some cases, revised disclosure requirements for ABS offerings and ongoing reporting.

For each loan or asset in the asset pool, the Commission proposed to require disclosure of specified data relating to the terms of the asset, obligor characteristics, and underwriting of the asset. Such data would be provided in a machine-readable, standardized format so that it is most useful to investors and the markets. The April 7 proposal would require issuers to provide the asset-level data or grouped account data at the time of securitization, when new assets are added to the pool underlying the securities, and on an ongoing basis. The data points the Commission proposed to require for commercial mortgage

16 Pursuant to Exchange Act Rule 15c2-8(b) [17 CFR 240.15c2-8(b)], with respect to ABS, a broker-dealer is exempt from the requirement that a preliminary prospectus be delivered to prospective investors at least 48 hours prior to sending a confirmation of sale if the issuer of the securities has not previously been required to file reports pursuant to Sections 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m or15 U.S.C. 28o). The Commission also proposed to repeal this exception from Rule 15c2-8(b) such that a broker-dealer would be required to deliver a preliminary prospectus at least 48 hours prior to sending a confirmation of sale in connection with an issuance of ABS, including those issued by ABS issuers exempted from the requirement to file reports pursuant to Section 12(h) of the Exchange Act.

17 See the 2004 ABS Adopting Release.

backed securities are primarily based on the definitions included in the CRE Finance Council Investor Reporting Package, current Regulation AB requirements and staff review of current disclosure.

The Commission proposed to require the filing of a computer program (the "waterfall computer program," as defined in the proposed rule) of the contractual cash flow provisions of the securities in the form of downloadable source code in Python, a commonly used computer programming language that is open source and interpretive. The computer program would be tagged in XML and required to be filed with the Commission as an exhibit. Under the proposal, the filed source code for the computer program, when downloaded and run (by loading it into an open "Python" session on the investor's computer), would be required to allow the user to programmatically input information from the asset data file that we have described above. With the waterfall computer program and the asset data file, investors would be better able to conduct their own evaluations of ABS and may be less likely to be dependent on the opinions of credit rating agencies.

The Commission also proposed additional requirements to refine current disclosure requirements for asset-backed securities. Among other things, the Commission proposed to require:

- aggregated and loan-level data relating to the type and amount of assets that do not meet the underwriting criteria that is specified in the prospectus;
- for certain identified originators, information relating to the amount of the originator's publicly securitized assets that, in the last three years, has been the subject of a demand to repurchase or replace;

- for the sponsor, information relating to the amount of publicly securitized assets sold by the sponsor that, in the last three years, has been the subject of a demand to repurchase or replace;
- additional information regarding originators and sponsors;
- descriptions relating to static pool information, such as a description of the methodology used in determining or calculating the characteristics of the pool performance as well as any terms or abbreviations used;
- that static pool information for amortizing asset pools comply with specified (Item 1100(b)) requirements for the presentation of historical delinquency and loss information; and
- the filing of Form 8-K for a one percent or more change in any material pool characteristic from what is described in the prospectus (rather than for a five percent or more change, as currently required).

The Commission also proposed to limit some of the existing exceptions to the discrete pool requirement in the definition of an asset-backed security. This is intended to not only address recent concerns arising out of the financial crisis but also serves to protect against future practices of participants along the chain of securitization that could result in the addition of assets into a securitization pool without a clear understanding of their quality.

C. Privately-Issued Asset-Backed Securities

A significant portion of securities transactions, including the offer and sale of all CDOs and asset-backed commercial paper, is conducted in the exempt private placement market, which includes both offerings eligible for Rule 144A resales and other private placements.[18] CDOs are typically sold by the issuer in a private placement to one or more initial purchaser or purchasers in reliance upon the Section 4(2) private offering exemption in the Securities Act, which is available only to the issuer, followed by resales of the securities to "qualified institutional buyers" in reliance upon Rule 144A.[19] Subsequent resales may also be made in reliance upon Rule 144A. Rule 144A provides a safe harbor for resellers from being deemed an underwriter within the meaning of Sections 2(a)(11) and 4(1) of the Securities Act[20] for the sale of securities to qualified institutional buyers. If the conditions of the Rule 144A safe harbor are satisfied, sellers may rely on the exemption from Securities Act registration provided by Section 4(1) for transactions by persons other than issuers, underwriters or dealers.[21]

Some have concluded that the events of the financial crisis have demonstrated that a lack of understanding of CDOs and other privately offered structured finance products by investors, rating agencies and other market participants may have significant consequences to the entire financial system.[22] For example, the ratings of these products proved inaccurate,

---

18 CDOs often permit the active management of their pool assets, which could include engaging in activities the primary purpose of which is to protect or enhance the returns of their equity holders. Such CDOs typically would not meet the requirements of Rule 3a-7 under the Investment Company Act because that rule includes conditions that are intended to permit an issuer to engage only in limited activities that do not in any sense parallel typical 'management' of registered investment company portfolios. Accordingly, these CDOs usually rely on one of the private investment company exclusions, both of which condition the exclusion in part on the issuer not making a public offering.

19 In general, a qualified institutional buyer is any entity included within one of the categories of "accredited investor" defined in Rule 501 of Regulation D, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers not affiliated with the entity (or $10 million for a broker-dealer).

20 15 U.S.C. 77b(a)(11) and 15 U.S.C. 77d(1).

21 See Section II.A. of the Resale of Restricted Securities, Release No. 33-6862 (Apr. 30, 1990) [55 FR 17933].

22 See, e.g., The PWG March 2008 Report (noting that originators, underwriters, asset managers, credit rating agencies and investors failed to obtain sufficient information or conduct comprehensive risk assessments on instruments that were often quite complex and also noting that downgrades were even more frequent and

which significantly contributed to the financial crisis.[23] This lack of understanding by credit rating agencies, investors, and other market participants indicates that the offering processes and disclosure available in the public and private market were inadequate to provide appropriate investor protection. Further, these securities are issued by special purpose vehicles whose only purpose is holding financial assets, with numerous parties involved in the securitization process. As a result, information about those assets and the structure of the vehicle is critical to an informed investment decision.

The safe harbors of Rule 144A and Regulation D that provide the ability to rely on an exemption from registration do not impose specific requirements on the disclosures provided to investors if those investors meet certain size requirements. However, the financial crisis has called into question the ability of the Commission's rules, as they relate to the private market for asset-backed securities, to ensure that investors had access to, and had sufficient time and incentives to adequately consider, appropriate information regarding these securities.[24]

---

severe for CDOs of ABS with subprime mortgage loans as the underlying collateral). See also the Turner Review, at 20 (finding that "the financial innovations of structured credit resulted in the creation of products – e.g., the lower credit tranches of CDOs or even more so CDO-squareds – which had very high and imperfectly understood embedded leverage.").

23 See id.

24 An assessment of whether the protections of the Act are needed often focuses on whether the purchasers of securities can "fend for themselves." SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). Historically, whether this test is met turned on whether information necessary or appropriate to make informed decisions is realistically available to the purchasers. See id. The Supreme Court also noted that "We agree that some employee offerings may come within § 4(1), e.g., one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement." Id. at 125. See also Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978) (discussing the Supreme Court's observation in Ralston that an offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering' and the ruling that an essential requirement is access to the kind of information that registration would disclose).

In the April 7 proposal, the Commission proposed to require enhanced disclosure by asset-backed issuers who wish to take advantage of the safe harbor provisions for these privately-issued securities.[25] In addition, in order to provide additional transparency with respect to the private market for these securities, the Commission proposed amendments to Rule 144A to require a structured finance product issuer to file a public notice on EDGAR of the initial placement of structured finance products that are eligible for resale under Rule 144A.[26] As we believe that the Commission may benefit from the availability of more information about private placements of structured finance products, we proposed to require that in submitting such notice, the issuer undertake to provide offering materials to the Commission upon written request.

IV. Conclusion

The recent financial crisis highlighted the need for further consideration of the effectiveness of the Commission's regulations governing securitizations. We are committed to reinvigorating and reforming these and any other regulations needed to improve investor protections and promote more efficient markets, including the asset-backed markets.

Thank you again for the opportunity to speak with you about these important issues. I am happy to answer any questions you may have.

---

25 The Commission also proposed to make conforming changes to Regulation D, Form D and Rule 144.

26 "Structured finance products" for this purpose would be more broadly defined than the Regulation AB definition of "asset-backed security" in order to reflect the wide range of securitization products that are sold in the private markets.

TESTIMONY OF THOMAS W. HOUGH
CHAIRMAN, ILLINOIS BANKERS ASSOCIATION

HEARING BEFORE THE U.S. HOUSE SUBCOMMITTEE
ON OVERSIGHT AND INVESTIGATIONS

CHICAGO, ILLINOIS
MAY 17, 2010

Chairman Moore, Ranking Member Biggert, and members of the Subcommittee. My name is Thomas Hough. I am the Chairman and CEO of Carrollton Bank and also Chairman of the Illinois Bankers Association.

The Illinois Bankers Association represents nearly 700 commercial banks and savings institutions of all sizes in Illinois. Collectively, IBA members represent nearly 90% of the assets of the Illinois banking industry, which employs more than 100,000 men and women in more than 5,000 offices across our state.

Illinois bankers are working hard to meet the credit needs of our communities in this challenging economy. Yet we are feeling more pressures from our regulators than ever before, posing unprecedented obstacles to lending at a time when our communities need us to lend more than ever before.

Our members talk nonstop about how the stringent regulatory environment and ill-fitting accounting rules are undermining their ability to extend credit. Obviously, the large number of job losses, struggling businesses and declining real estate values dictate a high level of prudence and caution when lending. But that alone does not explain the increasingly overly aggressive and inexplicable decisions and forced write-downs that our banks are experiencing in their safety and soundness examinations today.

Commercial loans are being downgraded even when they are fully performing. Collateral-dependent loans are being classified based on atypically depressed property values, even when the collateral is producing expected revenues, there is no intent to sell it in this distressed market, and a loan is not only current, but has never been past due. And thanks to accounting rules that were written for another era – (for example, FASB 105 and FASB 114) – we are being told to write down loans based on the performance of completely unrelated loans in our portfolio – and even based on loans in the portfolios of our competitors down the street!

These and other examples of unnecessary write-downs are depleting our banks' capital, forcing many – and I want to emphasize <u>many</u> – banks to look for more capital. When so many banks are competing for new capital at the same time, the chances of success often range from slim to none. This leaves a bank with few options. While the majority of Illinois banks remain well-capitalized, many are doing so by shrinking their business – by selling assets, and by curtailing their lending in the very communities they are trying to serve.

Meanwhile, our industry is being crushed by new regulations, with no end in sight. In the past 16 months, the Federal Reserve Board alone has issued no less than 31 new or revised regulations. Each requires significant time and money and builds upon volumes of existing regulations. This is putting an enormous strain on our staffs, and for community banks it is becoming a nearly insurmountable burden. When you add to this more than two dozen proposals pending in Congress for a whole new class of regulations – mostly to be issued by what essentially will be yet another regulator – it is plain to see how difficult it can be to achieve the right balance between satisfying loan demands and regulatory demands.

We know there are no easy fixes. As with any economic downturn, let alone the worst recession since the 1930s, we need to give the economy time to recover, and when doing so, we need to be adaptable and sometimes even modify longstanding rules to accommodate the present situation. That applies to the economy generally, and it applies with equal force to the community banking industry.

Bank regulators are accustomed to looking at worst case scenarios. As Chairman Frank frequently notes, no examiner has ever been fired for being overly conservative. Meanwhile, the FASB accounting rules being applied to banks were written for a different time, and in some cases, for a different industry, yet current federal law provides little discretion to the FDIC and the prudential regulators when a bank's capital levels drop due to unduly conservative write-downs based on outdated or ill-fitting accounting rules.

So we would ask you, please remember that the banking industry truly is the engine of our economy. If you give it sufficient breathing room during this unique, once-in-a-lifetime period, we can and will better contribute to the nation's recovery. Most community banks will survive if given the time and leeway to work through this recession, and more of them will lend more in their communities if they are not encumbered with needless write-downs, unnecessary capital calls, and the endless prospect of more regulations. We urge you to keep these points in mind as you go forward in meetings with your constituents and your very important and transformational deliberations in Congress.

Thank you for your consideration of our concerns.

For release on delivery
1 p.m. CDT
May 17, 2010

Statement of

Cathy Lemieux

Senior Vice President

Federal Reserve Bank of Chicago

before the

Subcommittee on Oversight and Investigations

Committee on Financial Services

United States House of Representatives

May 17, 2010

Introduction

Chairman Moore, ranking member Biggert, and members of the committee, I appreciate the opportunity to appear before you today to discuss trends in the commercial real estate (CRE) sector and other issues related to the condition of the banking system. First, I will discuss the condition of financial markets generally and of the banking system. I will then describe current conditions in commercial real estate markets (and the Chicago area specifically). Next I will outline Federal Reserve activities to enhance liquidity and improve conditions in financial markets to support the flow of credit to households and businesses, including certain activities that have a direct impact on CRE markets. Finally, I will discuss the ongoing efforts of the Federal Reserve to promote credit availability and ensure a balanced approach is taken when reviewing banks' credit activities.

Background

The Federal Reserve has supervisory and regulatory authority for bank holding companies (BHCs), state-chartered banks that are members of the Federal Reserve System (state member banks), and certain other financial institutions and activities. We work with other federal and state supervisory authorities to ensure the safety and soundness of the banking industry, foster stability of the financial system, and provide for the fair and equitable treatment of consumers in financial transactions. While the Federal Reserve is not the primary federal supervisor for the majority of commercial banks, it is the consolidated supervisor of BHCs, including financial holding companies, and conducts inspections of those institutions.

Under existing law, the primary purpose of inspections is to ensure that the holding company and its nonbank subsidiaries do not pose a threat to the BHC's depository subsidiaries. In fulfilling this role, the Federal Reserve is required to rely to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the BHC's depository, securities, or insurance subsidiaries. The Federal Reserve is also the primary federal supervisor of state member banks, sharing supervisory responsibilities with state agencies. In this role, Federal Reserve supervisory staff regularly conduct on-site examinations and off-site monitoring to ensure the safety and soundness of supervised state member banks.

The Federal Reserve is involved in both regulation, establishing the rules within which banking organizations must operate, and supervision, ensuring that banking organizations abide by those rules and remain safe and sound. Because rules and regulations in many cases cannot reasonably prescribe the exact practices each individual bank should use for risk management, supervisors set out policies and guidance that expand upon requirements set in rules and regulations and establish expectations for the range of acceptable practices. Supervisors rely extensively on these policies and guidance as they conduct examinations and assign supervisory ratings.

Beginning in the summer of 2007, the U.S. and global economies entered a period of intense financial turmoil that has presented significant challenges for the financial services industry. These challenges intensified in the latter part of 2008 as the global economic environment weakened further. As a result, parts of the U.S. banking system have come under severe strain, with some banking institutions suffering sizable losses. The number of bank failures continues to rise, with some 140 banks having failed in 2009, and 67 more in the first four months of 2010.

Conditions in Financial Markets and the Economy

Supported by stimulative monetary and fiscal policies and the concerted efforts of policymakers to stabilize the financial system, a recovery in economic activity appears to have begun in the second half of last year. However, significant restraints on the pace of the recovery remain, including weakness in both residential and nonresidential construction and the poor fiscal condition of many state and local governments. In addition, the labor market has been particularly hard hit by the recession.

Financial markets have improved considerably in recent months. Conditions in short-term credit markets have continued to normalize, and spreads in bank funding markets and the commercial paper market have returned to near pre-crisis levels. However, recent developments in Europe have introduced a new element of uncertainty. In light of the many improvements noted, the Federal Reserve has largely wound down the extraordinary liquidity programs that it created to support financial markets during the crisis.

Despite stronger financial positions, banks' lending to both households and businesses has continued to fall. The decline in large part reflects sluggish loan demand and the fact that many potential borrowers no longer qualify for credit, both results of a weak economy. The high rate of write-downs has also reduced the quantity of loans on banks' books. Banks have also been conservative in their lending policies, imposing tough lending standards and terms; this caution reflects bankers' concerns about the economic outlook and uncertainty about their own future losses and capital positions.

Although bank credit remains tight, there are some positive signs. Economic activity has continued to strengthen. In addition, senior loan officers have indicated that, at least outside of CRE, they anticipate a modest reduction in their troubled loans over the coming year. As a result, bank attitudes toward lending may be shifting. In the Senior Loan Officer Opinion Survey conducted in April, most banks reported unchanged lending standards over the previous three months. For the first time since the crisis began in the summer of 2007, banks reported no net tightening of lending standards for small businesses.[1]

Performance of the Banking System

By some measures, the financial condition of banking firms has strengthened markedly during recent quarters. Last spring, the Federal Reserve and other banking regulators evaluated the nation's largest bank holding companies under the Supervisory Capital Assessment Program, popularly known as the stress test. The release of the stress test results significantly increased market confidence in the

[1] See Board of Governors of the Federal Reserve System (2010), April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/default.htm.

banking system. Greater investor confidence in turn allowed the banks to raise substantial amounts of new equity capital and, in most cases, to repay government capital.

On the other hand, loan quality has continued to deteriorate at banking institutions. For example, during the fourth quarter of 2009 (the most recent period for which data are available), nonperforming assets at the 50 largest U.S. bank holding companies continued to climb. This raised the ratio of nonperforming assets to 5.1 percent of loans and other real estate owned on bank balance sheets. The most rapid deterioration in asset quality occurred in first-lien mortgages due to higher loan modifications and a backlog in foreclosures. Small and mid-size banks are experiencing similar difficulties.

Credit losses at U.S. banking organizations also continue to rise, and banks face risks of sizable additional credit losses given the likelihood that employment will take some time to recover. In addition, while housing prices appear to have stabilized in recent months, foreclosures and mortgage loss severities are likely to remain elevated. Moreover, the values of both existing commercial properties and land have declined almost 40% on average but are showing some preliminary signs of stabilization. Thus, while the largest portion of the value decline may be behind us, it is not certain that values will begin to rise again sharply in the foreseeable future. CRE values tend to lag the overall economy on both the up and down sides.

In the aggregate, Illinois banks experienced net losses for most of 2009, even though declining interest margins stabilized in the second half. (Interest margins are particularly important for small and mid-size institutions, as they are an important source of retained earnings that add to a bank's capital and can be used to offset credit losses.) In recent quarters, nonperforming loans and loan-loss provision expenses rose rapidly at Illinois institutions. While Illinois banks did make significant additions to their loan-loss reserves, the gains were outpaced by the increase in nonperforming loans. Capital ratios have been declining for the past three years, due largely to continued net losses. Since the financial crisis began, 35 Illinois institutions have failed, accounting for nearly 14 percent of the U.S. total. At present, just over eight percent of U.S. commercial banks are located in Illinois. Most of the failed banks held much larger-than-average concentrations in CRE, which, when the economy slowed, had a quick and adverse impact on bank earnings and capital. Today, Illinois loan portfolios remain concentrated in CRE, with commercial and industrial lending a distant second.

Current Conditions in Commercial Real Estate Markets

Demand for commercial property in the U.S., which is sensitive to trends in the labor market, has declined significantly and vacancy rates have increased. Hit hard by the loss of businesses and employment, an increasing amount of retail, office, and industrial space is standing vacant. In addition, many businesses have cut expenses by renegotiating existing leases. The combination of reduced cash flows and higher rates of return required by investors has lowered valuations, and many existing buildings are selling at a loss. As a result, credit conditions in CRE markets are particularly strained and commercial mortgage delinquency rates have increased rapidly.

The higher vacancy levels and significant decline in the value of existing properties have placed particularly heavy pressure on construction and development projects that do not generate income until after completion. As a result, developers, which typically depend on the sales of completed projects to repay their outstanding loans, are finding their ability to service existing construction loans strained.

Sharp price declines and tighter underwriting standards have frustrated borrowers seeking to refinance the balloon payments on maturing commercial mortgages. As a result many lenders have either extended or re-structured maturing loans; the Federal Reserve has been working with banks to encourage this restructuring where feasible.

In Chicago, CRE conditions are largely dependent on employment trends. With the onset of the financial crisis, job losses in Chicago have been concentrated in professional and business services. As of fourth quarter 2009, metro Chicago's total employment declined 4.3% over the last 12 months, significantly worse than the national decline of 3.5%.[2] By most measures, Chicago's CRE markets have shown adverse trends and performed significantly worse than national averages. Chicago's multifamily market has been adversely affected by contracting employment and additions to supply. For example, during the 2007-09 time period, 30,560 rentable units were added, while net absorption during this period was only 4,978. As a result, the vacancy rate doubled, from 3.7 percent in 2006 to 7.4 percent in 2009. Unsold condominiums reverting to rentals are a particular concern, as Chicago has led the U.S. in condominium construction.

Chicago's hotel sector is also a concern, with significant new supply added at the same time as convention business has declined. From 2006 to 2009, Revenue per Available Room declined from $85.45 to $64.90, due in part to 6,622 rooms being added while demand fell sharply. Office, warehouse, and retail space have also experienced declining occupancy and rental rates. For example, from 2006 to 2009, the office vacancy rate rose from 15.4 percent to 18.4 percent (14.8 percent downtown and 23.0 percent suburban). Over the same time period, warehouse vacancy rates rose from 11.6 percent to 14.9 percent. Also over the same time period, retail vacancy rates rose from 8.4 percent to 13.7 percent and average rents fell from $19.91 to $15.36.

(It should be noted that the regulatory definition of CRE includes all construction loans, loans secured by nonfarm nonresidential properties, and loans secured by multifamily properties. Therefore it includes 1- to 4-family residential construction loans, which have been severely affected by the housing slump.)

Many community and smaller regional banking firms have built up unprecedented concentrations in CRE loans and will be particularly affected by conditions in real estate markets. For example, these loans make up more than 30 percent of community bank assets and have deteriorated sharply as fundamentals in property markets have weakened. Performance problems have been most striking in

---

[2] All Chicago market data are from CBRE Econometric Advisors, Spring 2010 reports covering Chicago CRE submarkets.

construction and development loans, especially for those that finance residential development, but have been significant in other loan segments as well. Problem CRE loans represent a significant proportion of total CRE loans and of capital at a number of smaller banking organizations.

The Federal Reserve has been focused on CRE exposures at supervised institutions for some time. In response to rising CRE concentrations (especially in some regional and community banking firms in the early part of this decade) and in light of the central role CRE loans played in the banking problems of the late 1980s and early 1990s, we led an interagency effort to develop supervisory guidance on CRE concentrations. The guidance was proposed and finalized in 2006 and published as final in the Federal Register in early December 2006.[3] In that guidance, we emphasized our concern that some institutions' strategic- and capital-planning processes did not adequately recognize the risks arising from their CRE concentrations. We also outlined our expectations that institutions with concentrations in CRE lending needed to perform ongoing assessments to identify and manage concentrations through stress testing and similar exercises to identify the impact of adverse market conditions on earnings and capital.

As weaker housing markets and deteriorating economic conditions have impaired the quality of CRE loans at supervised banking organizations, the Federal Reserve has devoted increasing resources to assessing the quality of CRE portfolios at regulated institutions. These efforts include monitoring the impact of declining cash flows and collateral values on CRE portfolios. Federal Reserve examiners in Districts most adversely affected have been particularly focused on evaluating exposures arising from CRE lending.

Federal Reserve examiners are reporting a sharp deterioration in the credit performance of loans in banks' portfolios and loans in commercial mortgage-backed securities (CMBS). Of the approximately $3.5 trillion of outstanding debt associated with CRE, including loans for multifamily housing developments, about $1.8 trillion was held on the books of banks and thrifts, and an additional $900

[3] See Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2007), "Interagency Guidance on Concentrations in Commercial Real Estate," Supervision and Regulation Letter SR 07-1 (January 4), www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.

billion represented collateral for CMBS, with other investors holding the remaining balance of $800 billion. Of note, more than $600 billion of CRE loans will mature each year over the next few years. In addition to losses caused by declining property cash flows and deteriorating conditions for construction loans, losses will also be boosted by the depreciating collateral values underlying those maturing loans, although supervisors, when assessing creditworthiness, are focusing on the cash-generating capacity of the properties and not just on collateral values. Nevertheless, these losses will place continued pressure on banks' earnings, especially those of smaller regional and community banks that have high concentrations of CRE loans.

Federal Reserve Activities to Help Revitalize Credit Markets

The Federal Reserve has taken a number of actions to strengthen the financial sector and to promote the availability of credit to businesses and households. In addition to aggressively lowering short-term interest rates, the Federal Reserve has established a number of facilities to improve liquidity in financial markets. One such program is the Term Asset-Backed Securities Loan Facility (TALF), a joint Federal Reserve – Treasury program that was begun in November 2008 to facilitate the extension of credit to households and small businesses.

Before the crisis, securitization markets were an important conduit of credit to the household and business sectors. Securitization markets (other than those for mortgages guaranteed by the government) essentially shut down in mid-2008, and the TALF was developed to promote renewed issuance. Under the TALF, eligible investors may borrow to finance purchases of the AAA-rated tranches of various classes of asset-backed securities. The program originally focused on credit for households and small businesses, including auto loans, credit card loans, student loans, and loans guaranteed by the Small Business Administration. The program was broadened to allow investors to use the TALF to purchase both existing and newly issued CMBS, which were included to help mitigate the refinancing problem in that sector.

The TALF has been successful in helping restart securitization markets. Issuance has resumed, and rate spreads for asset-backed securities have declined substantially, an indication that risk premiums are compressing. In addition, a substantial fraction of Asset Backed Securities (ABS) is now being purchased by investors that do not seek TALF financing, and ABS-issuers have begun to bring non-TALF-eligible deals to market.

The current fundamental weakness in CRE markets is exacerbated by the fact that the CMBS market, which previously had financed about 30 percent of originations and completed construction projects, completely shut down for more than a year. Until mid-November 2009, when the first CMBS issuance came to market with financing provided by the Federal Reserve's TALF, essentially no CMBS had been issued since mid-2008. Investor demand for the new issuance was high, in part because of the improved investor protections put in place so that securities would be eligible collateral for TALF loans. In the end, non-TALF investors purchased almost 80 percent of the TALF-eligible securities. Two additional CMBS deals without TALF support came to market shortly after the TALF-finance deal was issued. The first multi-borrower CMBS deal in a year and a half, which also did not apply for TALF financing, was issued in April. All three of these deals were very well received by investors, and several major banks have started warehousing CRE loans for future CMBS issuance, though volumes remain low. Irrespective of these positive developments, market participants anticipate that CMBS delinquency rates on legacy securities will climb higher in the near term and issuance of new securities will be minimal, driven not only by negative fundamentals but also by borrowers' difficulty in rolling over maturing debt.

The TALF program terminated on March 31, 2010, except for loans collateralized by newly issued CMBS, which are authorized until June 30, 2010.

Availability of Credit

In an effort to encourage prudent CRE loan workouts, the Federal Reserve led the development of interagency guidance issued in October 2009 regarding CRE loan restructurings and workouts.[4] This policy statement provides guidance for examiners and for financial institutions that are working with CRE borrowers who are experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties, particularly as the loans on those properties mature and need to be refinanced. The statement is especially relevant to small businesses because owner-occupied CRE often serves as collateral for many small business loans.

The Federal Reserve recognizes that prudent loan workouts are often in the best interest of both financial institutions and borrowers, particularly during difficult economic conditions. There has been a significant increase in the use of such loan modifications in non-bank CRE lenders, such as life insurance companies and servicers of CMBS pools. Accordingly, the policy statement details risk-management practices for loan workouts that support prudent and pragmatic credit and business decision-making within the framework of financial accuracy, transparency, and timely loss recognition.

Importantly, at the Federal Reserve we have complemented the guidance with training programs for examiners and outreach to the banking industry to underscore the importance of sound lending practices. From January to April 2010, Federal Reserve staff conducted a System-wide examiner training initiative that reached Federal Reserve and state examiners across the United States. Additionally, an interagency training program was conducted specifically for examiners reviewing CRE loans as part of the interagency Shared National Credit Program, which includes the largest commercial real estate loans in the nation.

We are working hard to track the progress and effectiveness of this guidance. Before issuing the guidance, Federal Reserve staff surveyed examiners to gain a better understanding of the banks' workout

[4] See Interagency Policy Statement on CRE Loan Restructurings and Workouts (November 2009), www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm.

practices. We also are asking examiners to capture, where possible, information on troubled debt restructurings and other types of loan workouts and dispositions as part of the ongoing examination process. In addition, we are exploring the feasibility of more formal statistical approaches for measuring and evaluating the effectiveness of the guidance. We continue to receive and evaluate comments and feedback from supervised banks, and we will consider the need for adjustments if feedback suggests they are needed.

Prudent real estate lending depends upon reliable and timely information on the market value of the real estate collateral. This has been a cornerstone of the regulatory requirements for real estate lending and is reflected in the agencies' appraisal regulations. In that regard, the Federal Reserve requires a regulated institution to have real estate appraisals that meet minimum appraisal standards, including the Uniform Standards of Professional Appraisal Practice, and contain sufficient information to support the institution's credit decision. Over the past several years, the Federal Reserve has issued several appraisal-related guidance documents to emphasize the importance of a bank's appraisal function and the need for independent and reliable appraisals. Most recently, the Federal Reserve and the other federal agencies issued a proposal to revise the Interagency Appraisal and Evaluation Guidelines, which is expected to be finalized in the coming months. These guidelines reinforce the importance of sound appraisal practices.

Given the lack of sales in many real estate markets and the predominant number of distressed sales in the current environment, regulated institutions face significant challenges today in assessing the value of real estate. We expect institutions to have policies and procedures for obtaining new or updated appraisals as part of their ongoing credit review. An institution should have appraisals or other market information that provide appropriate analysis of the market value of the real estate collateral and reflect relevant market conditions, the property's current "as is" condition, and reasonable assumptions and conclusions.

The Federal Reserve has directed examiners to be mindful of the effects of excessive credit tightening in the broader economy, and we have taken steps, including additional examiner training and industry outreach, to underscore these intentions. We are aware that bankers may become overly conservative in an attempt to ameliorate past weaknesses in lending practices, and we are working to emphasize that it is in all parties' best interests to continue making loans to creditworthy borrowers.

As part of our effort to help stimulate appropriate bank lending, the Federal Reserve and the other federal banking agencies issued regulatory guidance in November 2008 to encourage banks to meet the needs of creditworthy borrowers, including small businesses.[5] The guidance was issued to encourage bank lending in a manner consistent with safety and soundness -- specifically, by taking a balanced approach in assessing borrowers' abilities to repay and making realistic assessments of collateral valuations.

On February 5 of this year, the banking agencies issued guidance to examiners that reinforced the points that institutions should strive to meet the credit needs of creditworthy small business borrowers and that the supervisory agencies will not hinder those efforts.[6] For the reasons noted earlier, we recognize that the ongoing financial and economic stress has resulted in a decrease in credit availability, including loans to small businesses, and has prompted institutions to review their lending practices. Although current loss rates would indicate that a measure of tightening was appropriate and necessary, some institutions may have become overly cautious in their lending practices. Thus, while prudence must remain the watchword for both banks and their supervisors, we do not want our examiners to take an overly mechanistic approach to evaluating small business lending. So far, we have not seen evidence that this is a widespread problem among our examiners.

---

[5] See Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," joint press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

[6] See Board of Governors of the Federal Reserve System (2010), "Regulators Issue Statement on Lending to Creditworthy Small Businesses," press release, February 5, www.federalreserve.gov/newsevents/press/bcreg/20100205a.htm.

Conclusion

While financial market conditions have improved in the United States, the overall environment remains under stress, and some geographic areas (including Chicago) are experiencing more difficulty than others. The Federal Reserve, working with the other banking agencies, has taken strong action to ensure that the banking system remains safe and sound and is able to meet the credit needs of our economy. We also have aggressively pursued monetary policy actions and have provided liquidity to help restore stability to the financial system and support the flow of credit to households and businesses. In our supervisory efforts, we are mindful of the risk-management deficiencies at banking institutions revealed by the financial crisis and are ensuring that institutions develop appropriate corrective actions.

It will take some time for the banking industry to work through this current set of challenges and for the financial markets to fully recover. In order to promote credit availability, the Federal Reserve is encouraging banks to deploy capital and liquidity in a responsible way that avoids past mistakes and does not create new ones. The Federal Reserve is committed to working with other banking agencies and the Congress to promote the concurrent goals of fostering credit availability and a safe and sound banking system.

STATEMENT OF

M. ANTHONY LOWE
CHICAGO REGIONAL DIRECTOR
DIVISION OF SUPERVISION AND CONSUMER PROTECTION
FEDERAL DEPOSIT INSURANCE CORPORATION

on

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

before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
HOUSE FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

May 17, 2010

Chicago, Illinois

Chairman Moore, Ranking Member Biggert, and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the state of commercial real estate and business lending. As Regional Director for the FDIC's Chicago Region, I am responsible for overseeing bank supervision, regulation, safety and soundness examinations and consumer compliance examinations in six Midwestern states, including Illinois.

In my testimony, I will briefly discuss the FDIC's view of credit conditions and lending activity on a national level, the current banking environment in Illinois, the examiners' role in evaluating banks' commercial real estate portfolios, and the banking agencies' efforts to encourage financial institutions to make prudently-underwritten credit available in their markets.

Credit Quality and Lending Activity

As federal insurer for all banks and thrifts, and primary federal supervisor for just under 5,000 state chartered banks, the FDIC is very aware of the challenges faced by financial institutions and their customers during these difficult economic times. Among the greatest strengths of our economy is the diverse collection of nearly 8,000 FDIC-insured depository institutions that operate almost 100,000 offices across our nation. Bankers and examiners know that prudent, responsible lending is good business and benefits everyone.

Adverse credit conditions brought on by an ailing economy and stressed balance sheets, however, have created a difficult environment for both borrowers and lenders. The deterioration in the economy contributed to a decline in both the demand and the supply of credit. Continued improvement from the current economic crisis will depend heavily on creditworthy borrowers, both consumer and business, having access to lending.

Nationwide, expenses for troubled loans continue to weigh heavily on insured depository institutions. The industry earned less than $1 billion in the fourth quarter of 2009, essentially just breaking even. During the quarter, insured institutions added $61.1 billion in provisions for loan and lease losses to their reserves, although this was $10 billion less (-14.1 percent) than they set aside in the fourth quarter of 2008. Net charge-offs of loans and leases totaled $53 billion, an increase of $14.4 billion (37.2 percent) compared to a year earlier. The annualized net charge-off rate in the quarter was 2.89 percent, which is the highest rate in any quarter in the 26 years for which quarterly charge-off data are available. The amount of loans and leases remaining on banks' balance sheets that were noncurrent rose by $24.3 billion (6.6 percent) during the quarter.[1] At the end of December, 5.37 percent of all loans and leases were noncurrent, also a 26-year high. However, fourth quarter 2009 was the third consecutive quarter that the rate of increase in the volume of noncurrent loans slowed.

Major loan categories exhibited high levels of charge-offs and noncurrent loans. The highest net charge-off rates in the fourth quarter were for credit cards (9.16 percent annualized) and real estate construction and development loans (7.77 percent). The net charge-off rate for real estate construction and development loans represented a record high and the net charge-off rate for credit card loans is near the record high set the previous quarter. Construction and development loans also had the highest noncurrent rate at the end of December (15.95 percent), followed by 1-4 family residential mortgage loans (9.31 percent), both record high levels.

[1] Noncurrent loans are those that are 90 days or more past due or on nonaccrual status.

Larger institutions had higher charge-off and noncurrent rates than smaller institutions. The average net charge-off rate on all loans and leases for community banks (institutions with less than $1 billion in assets) was 1.70 percent in the quarter, compared to an average of 3.09 percent at larger institutions. The ratio of noncurrent loans and leases to total loans and leases for community banks as of December 31 was 3.43 percent, versus 5.68 percent for larger institutions. Some of the difference in credit quality performance reflects differences in the composition of loan portfolios at large and small banks. Large institutions have higher proportions of retail loans (residential mortgages and consumer loans) while community banks have larger relative shares of loans to commercial borrowers. Consequently, the negative impact of falling housing prices and rising unemployment and bankruptcies has been greater in the loan portfolios of large banks. Further deterioration in commercial real estate (CRE) markets would have a greater proportional impact on the performance of small and medium-sized institutions.

Tighter underwriting standards, deleveraging by institutions seeking to improve their capital ratios, and slack loan demand have all contributed to declines in loan balances at many institutions. Total loan and lease balances at FDIC-insured institutions declined by $128.8 billion (1.7 percent) during the fourth quarter. This is the sixth consecutive quarter that aggregate loan balances have fallen. For all of 2009, loan balances declined by $587.3 billion, or 7.5 percent, which was the largest percentage decline since 1942.

As shown in Table 1, much of the decline in loan balances occurred at larger institutions. Institutions with total assets greater than $100 billion as of December 31 reported an aggregate net decline in total loans and leases of $116.8 billion in the quarter, or over 90 percent of the total industry decline. On a merger-adjusted basis, at community banks that filed reports as of December 31, total loan and lease balances decreased $4.3 billion during the quarter. A majority of institutions (53.2 percent) reported declines in their total loan balances during the quarter.

Table 1. Loan Growth by Asset Size Groups, Fourth Quarter 2009
(Dollar amounts in billions)

Asset Size	Number of Institutions	Number Not Reporting Increase in Loans	Number Reporting Increase in Loans	Aggregate Net Change in Loans ($ Billions)	Percent Change
> $100 Billion*	48	40	8	(116.8)	-2.82%
$10 - $100 Bill.	77	55	22	9.6	0.74%
$1 - $10 Billion	554	372	182	(16.9)	-1.78%
< $1 Billion	7,333	3,794	3,539	(4.3)	-0.41%
All Insured Institutions	8,012	4,261	3,751	(128.4)	-1.73%

Note: Reflects changes in loan balances for institutions categorized by size group as of December 31, 2009. Changes in these groups are adjusted for mergers and acquisitions. The difference between the net decline on this table ($128.4 billion) and the industry aggregate net decline ($128.8 billion) reflects institutions that closed during the quarter but were not acquired by another institution.

Source: Call and Thrift Financial Reports.

*The > $100 billion asset size category includes insured depository institution affiliates that would otherwise fall in smaller size groups.

Credit Quality and Lending Activity in Illinois and the Chicago metropolitan area

Illinois, like many states in the Industrial Midwest, has been hard-hit by the recent recession. Nearly 7 percent of the state's jobs have been lost since fourth quarter 2007. Job losses in the manufacturing sector were especially severe, accounting for nearly one-third of those losses. As Illinois employers shed jobs, unemployment has more than doubled since the recession began and stands at 11.5 percent as of March 2010. Average home prices are well below peak levels of early 2007 and commercial real estate markets have been strained by higher vacancy rates.

Challenges facing the Chicago metropolitan area have affected the state's performance. The Chicago area accounts for three quarters of the state's workforce, and similar to the state as a whole, unemployment in the Chicago area has nearly doubled, increasing from just under six percent in first quarter 2008 to more than 11 percent as of first quarter 2010. Chicago's residential housing is also stressed. Single family home prices have fallen 26 percent from peak levels reached in early 2007.[2]

As a result of the state's severe economic downturn, the overall financial condition of insured depository institutions headquartered in Illinois have experienced deterioration. In 2009, the median pre-tax return on assets for insured depository institutions in Illinois was 0.30 percent, compared to a nationwide median of 0.50 percent. As Illinois institutions continued to experience growing loan delinquencies, their loan loss provisions reached record levels, weighing heavily on earnings. Loan delinquencies increased year-over-year and remained above national levels. The state's institutions also reported record-high net charge-off activity during the year. After posting near double-digit average loan growth rates during the mid to late 1990s, Illinois institutions reported negative loan growth rates for 2008 and 2009, led by sharp slowdowns among most major lending categories, particularly construction and development lending.

Financial conditions in Illinois are largely influenced by insured depository institutions located in the Chicago metro area, where over one-third (36 percent) of

---

[2] Case-Shiller home price index, seasonally adjusted, for Chicago, comparing peak level (1st Quarter 2007) to current level (February 2010).

Illinois institutions are headquartered. Additionally, depository institutions in the Chicago metro area held nearly three quarters (73 percent) of state-wide assets. In 2009, the median pre-tax return on assets for these institutions was negative 0.53 percent--in the bottom quartile of all metro areas throughout the nation. Record levels of loan loss provisions in 2009 significantly impaired earnings. Loan delinquencies for Chicago area institutions in fourth quarter 2009 were among some of the highest of all metropolitan areas in the nation, and these institutions reported record-high net charge-off activity during the year. These conditions have caused a number of bank failures. From October 2008 through April 2010, thirty two Illinois insured depository institutions were placed in receivership.

On a positive note, insured financial institutions in Chicago and across Illinois continue to repair their balance sheets. Banks and thrifts are actively working with their customers to restructure loans and charge off non-performing loans where appropriate. In addition, the rate of increase in the volume of noncurrent loans is slowing. As the economy gradually improves in 2010, institutions in Chicago and Illinois will become increasingly poised to respond to growing loan demand from businesses and consumers.

Factors Affecting Small Business Lending

Although the economy appears to be recovering, business conditions remain challenging for small businesses. Real GDP has posted three consecutive quarters of growth since the third quarter of 2009. Consumer spending also rose in each of the past three quarters. Even the housing sector has shown some signs of stabilization in sales and prices since the second half of 2009. However, the unemployment rate remains high -- 9.9 percent as of April 2010 -- and labor market weakness poses ongoing risks to the business outlook. Small business pessimism persisted in April, according to a survey by the National Federation of Independent Business (NFIB).[3]

This weakness in business conditions has had significant effects on both credit demand and supply. The demand for business credit tends to vary over the business cycle with the level of spending on new capital equipment and inventories. Small businesses reported that capital spending levels remained near record low levels in April 2010, as did the demand for credit to finance such projects.[4] Similarly, in the Federal Reserve's most recent *Senior Loan Officer Opinion Survey*, banks again noted weaker loan demand from business borrowers, especially from small businesses. At the same time, access to credit remains difficult, as lenders raise credit standards in response to higher loan losses. In April, banks reported little change in their lending standards for loans to small businesses, following a period of tightening standards that dates back to mid-2007. However, banks continued to tighten terms on loans extended to small businesses.[5]

Surveys of small businesses suggest that while small business loans have clearly become more difficult to obtain, weak business conditions have represented an even larger problem. In the NFIB's April 2010 survey, the percent of respondents who said that loans were "harder" to get in the last three months outnumbered those who said loans were "easier" to secure by 14 percentage points. But the same survey showed that 29 percent of respondents cited "poor sales" as their biggest business problem, compared to just four percent that cited "finance and interest rates." The percentage of respondents

---

[3] "NFIB Small Business Economic Trends," May 2010.
[4] "NFIB Small Business Economic Trends," May 2010.
[5] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, April 2010, http://www.federalreserve.gov/boarddocs/SnLoanSurvey/

who said that sales were "lower" in the last three months outnumbered those who said sales were "higher" by 15 percentage points.[6]

Ensuring that creditworthy small business borrowers have access to credit remains critical to sustaining the economic recovery. FDIC-insured institutions are a major source of financing for small businesses, supplying over 60 percent of the credit used by small businesses to run and grow their businesses. Community banks have a particularly important role in lending to small businesses. As of June 30, 2009 (the most recent data available), community banks accounted for 38 percent of small business and farm loans, even though these institutions represented only 11 percent of industry assets.

Recent initiatives and proposals to support small business financing will help to sustain local communities and community banks. For example, the American Recovery and Reinvestment Act (ARRA), signed into law in February 2009, temporarily raised the guarantee levels on Small Business Administration (SBA) 7(a) loans and eliminated upfront borrowing fees on SBA loans in the 7(a) and 504 programs. ARRA also provided a range of tax cuts and tax incentives for small businesses, helping them to cope with the unusually harsh economic environment. In addition, the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) was authorized to provide financing for SBA-backed loans. After these measures were implemented in early 2009, both the volume of SBA loan originations and the volume traded in the secondary market have increased above pre-crisis levels.[7]

---

[6] "NFIB Small Business Economic Trends," May 2010.

[7] U.S. Department of Treasury, "Treasury, SBA Host Small Business Financing Forum," November 18, 2009, http://www.treas.gov/press/releases/tg411.htm

The Role of Bank Supervision

The FDIC and its examiners understand that bank lending is critical to local and national economies. We share Congress' and the public's desire for making credit available on Main Street and for banks to work with borrowers that are experiencing difficulties.

The FDIC's bank examiners are based at duty stations located in 85 communities across the country, including five field offices and a regional office in Illinois. Our field examiners are both knowledgeable of local conditions and experienced in their profession, with over 11 years of tenure on average. Many have seen more than one previous economic down cycle, and all recognize the critical role that banks play in credit availability. Our examiners do their jobs with a keen understanding of the economic environment and real estate conditions where banks operate.

Concerns have been expressed by small businesses, trade groups, and members of Congress that the bank supervisors may be contributing to the lack of credit availability, and that examiners are discouraging banks from extending small business and commercial real estate mortgage loans. There have been assertions that examiners are instructing banks to curtail loan originations and renewals, and are criticizing sound performing loans where collateral values have declined. We also have heard criticisms that regulators are requiring widespread re-appraisals on performing commercial real estate mortgage loans, which then precipitate write-downs or a curtailment of credit commitments based on a downward revision to collateral values.

I would like to emphasize that FDIC examiners do not direct banks' credit decisions. Our examiners do not instruct banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or deny a refinance request solely because of weakened collateral value. We do encourage banks to be knowledgeable of local market conditions and closely review collateral valuations when a borrower's financial condition has materially deteriorated and a sale of the collateral may be necessary. We would not require a re-appraisal for a healthy performing loan. We leave the business of lending to those who know it best -- the community bankers who provide credit to small businesses and consumers on Main Street. The FDIC believes that bank supervision should avoid interfering with banks' day-to-day credit operations.

Encouraging Banks to Lend to Creditworthy Customers

To reiterate the importance of bank lending at this critical stage in the economic cycle, we have re-emphasized that bank examiners should encourage banks to originate and renew prudently underwritten commercial loans and work cooperatively with borrowers facing financial difficulties. Examiners will not criticize financial institutions for originating properly underwritten loans or for entering into prudently structured workout arrangements. These expectations are consistent with the FDIC's bank examination process and policy guidance that has been issued to the institutions we supervise.

The basis of many of the complaints about refinancing commercial loans seems to center on what is a performing loan. We hear that loans are considered to be in performing status by many borrowers because they are current on the interest payments. However, in some cases, the interest payments are being facilitated by loan proceeds -- often because the borrower is in a deteriorating financial condition. It is difficult for the bank, and the examiner, to not consider this situation a potential problem. In other cases, borrowers complain that examiners are telling banks that more equity is needed when the collateral goes down in value.

To be clear, FDIC examiners focus on borrower cash flow as the primary source of repayment during our credit reviews -- not on collateral support which serves a secondary or tertiary source of repayment. When reviewing loans during our examinations, we consider collateral documentation, but our primary and initial focus is on the borrower's financial strength, with secondary evaluation of other critical elements of credit support such as guarantor strength, business cash flow, and future prospects. The borrower's willingness and ability to keep payments current, especially when economic conditions are stressed, is always the primary evaluative criterion for our loan reviews.

From a banking policy perspective, the FDIC has issued several statements that encourage financial institutions to continue funding prudent CRE loans and working with borrowers that are experiencing difficulty. Most recently, on February 12, 2010, the regulators jointly issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* to encourage prudent lending and emphasize that examiners will apply a balanced approach in evaluating small business loans. We believe this statement will help banks become more comfortable extending soundly underwritten and structured small business loans. The Interagency Statement is included as an Appendix to this testimony.

Previously, the FDIC issued in March 2008, a Financial Institutions Letter on *Managing CRE Concentrations in a Challenging Environment* which reiterated supervisory guidelines for managing CRE portfolios, while encouraging banks to keep prudent CRE credit available in their markets. At the time, we recognized that credit for small business and commercial real estate had become relatively scarce, and our goal was to support banks' efforts to continue lending despite difficult market conditions.

In November 2008, the FDIC joined the other federal banking agencies in issuing the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* to encourage banks to continue making loans available to creditworthy borrowers and work with mortgage borrowers that are having trouble making payments. The banking agencies remain committed to this Statement, as it promotes lending to creditworthy customers, working with mortgage borrowers that need relief, and implementation of appropriately structured compensation programs.

More recently, in October 2009, we joined the other financial regulators in issuing the *Policy Statement on Prudent Commercial Real Estate Workout*s. This Policy Statement encourages banks to restructure commercial real estate loans, applying appropriate and long-standing supervisory principles in a manner that recognizes pragmatic actions by lenders and borrowers are necessary to weather this difficult economic period.

We will continue our dialogue on credit availability with the banking industry, members of Congress, and the public in the months ahead. As I stated earlier, bank lending is an essential aspect of economic growth and will be vital to facilitating a recovery. Our efforts to communicate supervisory expectations to the industry should help banks become more comfortable extending and restructuring loans, and in turn strengthen business conditions and hasten a much-awaited recovery.

Conclusion

FDIC-insured banks are uniquely equipped to meet the credit needs of their local markets, and have a proven tradition of doing so, through good times and bad. In concert with other agencies and departments of the federal government, the FDIC continues to employ a range of strategies designed to ensure that credit continues to flow on sound terms to creditworthy borrowers. Banks are being encouraged to work with borrowers that are experiencing difficulties during this difficult period whenever possible. While many challenges remain before us, I am confident that the banking industry as a whole is moving in the right direction -- toward sounder lending practices, stronger balance sheets, and a greater capacity to meet the credit needs of their communities.

APPENDIX

INTERAGENCY STATEMENT ON MEETING THE CREDIT NEEDS OF CREDITWORTHY SMALL BUSINESS BORROWERS
February 5, 2010

The federal financial institutions regulatory agencies[1] and the state supervisors[2] (collectively, the "regulators") are issuing this *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* (the "Statement") to restate and elaborate their supervisory views on prudent lending to creditworthy small business borrowers.[3] This Statement builds upon principles in existing guidance, including the November 2008 *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* and the October 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts*. The regulators note that while the October 2009 statement focused on commercial real estate, many principles articulated in that guidance are applicable to small business lending.

Some small businesses are experiencing difficulty in obtaining or renewing credit to support their operations.[4] Between June 30, 2008, and June 30, 2009, loans outstanding to small businesses and farms, as defined in the Consolidated Report of Condition (Call Report), declined 1.8 percent, by almost $14 billion.[5] Although this category of lending increased slightly at institutions with total assets of less than $1 billion, it declined over 4 percent at institutions with total assets greater than $100 billion during this timeframe. This decline is attributable to a number of factors, including weakness in the broader economy, decreasing loan demand, and higher levels of credit risk and delinquency. These factors have prompted institutions to review their lending practices, tighten their underwriting standards, and review their capacity to meet current and future credit demands. In addition, some financial institutions may have reduced lending due to a need to strengthen their own capital positions and balance sheets.

Supervisory Expectations

While the regulators believe that many of these responses by financial institutions are prudent in light of current economic conditions and the position of specific financial institutions, experience suggests that financial institutions may at times react to a significant economic downturn by becoming overly cautious with respect to small business lending. Regulators are mindful of the harmful economic effects of an excessive tightening of credit availability in a downturn and are working through outreach and communication with the industry and supervisory staff to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound small business borrowers. Financial institutions that engage in prudent small business lending after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for loans made on that basis.

Underwriting and Risk Management Considerations

An institution should understand the long-term viability of the borrower's business, and focus on the strength of a borrower's business plan, including its plan for the use and repayment of borrowed funds. The institution should have an understanding of the competition and local market conditions affecting the borrower's business and should not base lending decisions solely on national market trends when local conditions may be more favorable. Further, while the regulators expect institutions to effectively monitor and manage credit concentrations, institutions should not automatically refuse credit to sound borrowers because of a borrower's particular industry or geographic location. To the maximum extent possible, loan decisions should be made based on the creditworthiness of the individual borrower, consistent with prudent management of credit concentrations.

For most small business loans, the primary source of repayment is often the cash flow of the business, either through the conversion of current assets or ongoing business operations. An institution's cash flow analysis should cover current and expected cash flows, and reflect expectations for the borrower's performance over a reasonable range of future conditions, rather than overly optimistic or pessimistic cases. Many small business borrowers also rely on their personal wealth and resources to support loan requests. A borrower's credit history and financial strength, including credit score, are components of assessing willingness and ability to repay, and should be considered in conjunction with other judgmental factors, such as the strength of management. The loan structure should be appropriate for meeting the funding needs of the borrower given the type of credit and expected timing of the business' cash flow. Further, an institution should analyze the secondary sources of repayment, such as the strength of any guarantor or collateral support, and the ability of the borrower to provide additional capital. Institutions should not place excessive reliance on cyclical factors, such as appreciating or depreciating collateral values.

An institution should have robust risk management practices to identify, measure, monitor, and control credit risk in its lending activities. Further, institutions should promote a credit culture in which lenders develop and maintain prudent lending relationships and knowledge of borrowers. This culture should encourage lending staff to use sound judgment during the underwriting process. While institutions may use models to identify and manage concentration risk, portfolio management models that rely primarily on general inputs, such as geographic location and industry, should not be used as a substitute for the evaluation of an individual customer's repayment capacity.

Examination Reviews

Examiners will not discourage prudent small business lending by financial institutions, nor will they criticize institutions for working in a prudent and constructive manner with small business borrowers. Examiners will expect institutions to employ sound underwriting and risk management practices, maintain adequate loan loss reserves and capital, and take appropriate charge-offs when warranted. As with all lending, examiners are expected to take a balanced approach in assessing the adequacy of an institution's risk management practices in its small business lending activities. As a general principle, examiners will not adversely classify loans solely due to a decline in the collateral value below the loan balance, provided the borrower has the willingness and ability to repay the loan according to reasonable terms. In addition, examiners will not classify loans due solely to the borrower's association with a particular industry or geographic location that is experiencing financial difficulties.

[1] The federal financial institutions regulatory agencies consist of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the National Credit Union Administration (collectively, the "agencies").

[2] The state supervisors are represented through the Conference of State Bank Supervisors.

[3] Financial institutions should apply the principles of this Statement in accordance with their internal definitions of small business loans or as appropriate in their loan portfolios. Small business lending includes loans to small businesses and farms, such as working capital lines of credit, secured and unsecured term loans, as well as unsecured revolving credit.

[4] Responses to the Federal Reserve Board's Senior Loan Officer Opinion Survey indicate that the net fraction of banks that tightened credit standards and terms on C&I loans to small firms was very high in 2009, and exceeded its previous highs in the past twenty years.

[5] The data is for commercial banks, where small business loans, as reported in the Call Report FFIEC 031 and 041, schedule RC-C, part II are defined as loans with original amounts of $1 million or less that are secured by nonfarm nonresidential properties or commercial and industrial loans plus loans with original balances of $500,000 or less for agricultural production or secured by farmland.

Embargoed until presented on
May 17, 2010 at 1:00 p.m.

Statement of

Daniel T. McKee, Central Regional Director
Office of Thrift Supervision

concerning

Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses

before the

Financial Services Subcommittee on Oversight and Investigations
United States House of Representatives

May 17, 2010

Office of Thrift Supervision
Department of the Treasury

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on

Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses

Before the Financial Services Subcommittee on Oversight and Investigations
United States House of Representatives
May 17, 2010

Statement of Daniel T. McKee, Central Regional Director
Office of Thrift Supervision

I. Introduction

Good afternoon Chairman Moore, Ranking Member Biggert and members of the Subcommittee. I am Daniel McKee, Regional Director for the Central Region of the Office of Thrift Supervision (OTS). I appreciate the opportunity to testify on behalf of the OTS on the topic of Commercial Real Estate (CRE) in the Chicago area and throughout the nation.

I have been with the OTS since it was created in 1989. I currently serve as the Regional Director for 10 states in the Midwestern United States, including Illinois. Our regional headquarters office is located in Chicago. The region has many small community banks whose business models center on home mortgages, auto loans, agriculture and, to a lesser extent, CRE loans. OTS supervises 27 savings institutions with home offices in the Chicago metropolitan area that range in asset size from $3.6 million to $1.6 billion As of year-end 2009, these 27 institutions held total assets of $7.1 billion and approximately 23 percent of these assets – or $1.6 billion – consisted of CRE.

It is important to understand that OTS-regulated institutions (commonly called "thrifts") have limited participation in the CRE market. Thrifts primarily serve the financial services needs of their communities by extending credit for home mortgages and other consumer loans. There are statutory constraints on OTS-regulated institutions that limit their participation in CRE lending. The Home Owners' Loan Act (HOLA) caps the aggregate amount that thrifts can lend for commercial real estate loans at 400 percent of the thrift's total capital. In addition, HOLA restricts thrifts from investing more than 20 percent of their assets in commercial business loans. [1] Loans secured by residential properties, such as loans for multifamily housing and development of single family homes, are not subject to statutory limits.

---

[1] 12 USC 1464(c)(2)(A).

Today's testimony will present the views of the OTS on the condition of the CRE lending market and conditions currently creating obstacles to credit availability in the Chicago area and nationwide. It will also explain the actions the OTS has taken to encourage prudent extensions of CRE credit. Finally, it will recommend increasing the availability of CRE credit from OTS-regulated institutions by modifying statutory constraints that inhibit commercial lending.

II. Impediments to CRE Lending

The same factors that have tightened credit for home mortgages and small businesses also have constrained the extension of credit for CRE. The recession has constricted lending across the financial services industry from its peak before the crisis. This constriction is due in large part to the proliferation of loan defaults and losses in the commercial, mortgage and consumer lending sectors. These defaults and losses necessitate a heightened sensitivity to the risk that each institution is able to bear.

Defaults in CRE loans for OTS-regulated thrifts in the Chicago Metropolitan Statistical Area (MSA) increased steadily and dramatically over the past five years. From year-end 2005 to year-end 2009, CRE defaults jumped more than five percent from 1.8 percent to 7.0 percent. The Chicago MSA's default rate for CRE of 7.0 percent at year-end 2009 was above the national average of 5.8 percent.

In light of elevated delinquency rates for all types of loans, thrifts and banks are understandably more careful in extending credit than they were during the height of the real estate boom a few years ago. Sound underwriting is based on each borrower's ability to repay the loan and not primarily on the value of the collateral, which as we have seen, can drop precipitously, causing upheaval in the real estate market and the economy overall. There is a balance to be sought, and a point of appropriate equilibrium to be reached, by the financial industry as encouraged and overseen by the industry's regulators. As regulators, we must ensure that the trend toward restoring sound underwriting does not move too far and restrict credit for creditworthy borrowers. In the OTS Central Region, I have observed that federal savings institutions have a strong desire to make CRE loans to solid businesses whose recent financial statements and tax returns demonstrate good cash flows, good business plans and good collateral.

III. Actions to Expand CRE Lending

The OTS has always held the position that thrifts should never turn away a good customer. We have encouraged OTS-regulated institutions to make all types of loans allowed by statute, provided they are prudently underwritten to creditworthy borrowers. OTS emphasizes that thrift managers must find a proper balance between fulfilling the credit needs of their communities and ensuring safety-and-soundness of their institutions.

To support this position, the OTS and other federal banking agencies issued a "Policy Statement on Prudent Commercial Real Estate Loan Workouts" on October 29, 2009. This interagency statement was designed to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers. It states that examiners will take a balanced approach when reviewing an institution's CRE loans and workouts.

The OTS believes this statement sends a clear message to financial institutions that they will not be criticized for making prudent CRE loans or for working with existing CRE borrowers who need to refinance or restructure their loans, as long as they do so in a prudent manner.

Research by a California-based research-and-consulting firm[2] suggests that this message is being heard. The research shows that lenders have granted extensions on about 60 percent of the commercial real estate loans that have matured since the beginning of 2009. The firm estimates that in the Chicago area, commercial property loans totaling $22.2 billion will mature over the next three years. Prudently extending loan due dates, as the interagency statement urged, could reap benefits if borrowers can refinance a year or two later after the economy improves and property values continue to rise.

IV. Legislative Recommendations

As I mentioned earlier in this testimony, the OTS supports a legislative proposal that would further encourage thrift institutions to make more loans for CRE and small businesses. HOLA restricts the volume of CRE, commercial and small business loans that thrift institutions are allowed to make. Currently, HOLA caps the aggregate amount of credit thrifts can lend for commercial purposes at 20 percent of a savings institution's assets. Any commercial loans in excess of 10 percent of assets must be small business loans.[3] In addition, HOLA caps a thrift's level of CRE loans at 400 percent of the institution's capital. The proposal would remove the statutory limit for small business lending and increase the cap on other commercial lending from 10 to 20 percent of assets. Due to the current limits, some thrifts may be discouraged from entering this line of business altogether because they believe they will be unable to achieve sufficient economies of scale.

The existing ceiling on commercial lending limits the pool of credit available for CRE and limits the ability of thrifts to provide credit to serve the important commercial needs of their communities.

---

[2] Foresight Analytics LLC, Oakland, California
[3] 12 USC 1464(c)(2)(A).

A statutory change included in previous legislation and supported by the OTS, which passed the House Financial Services Committee in the 108th, 109th and 110th Congresses and passed the full House of Representatives twice, would have increased credit for CRE lending by increasing the cap on commercial lending from 10 percent to 20 percent of an institution's assets and by entirely lifting the limits on small business lending.

In a hearing on February 26, 2010, before the House Committee on Financial Services on the "Condition of Small Business and Commercial Real Estate Lending in Local Markets," Chairman Frank and Ranking Member Bachus agreed that lifting these caps is an important and desirable goal. We appreciate Chairman Frank's leadership in this effort and hope that this change will be included in future legislation.

V. Conclusion

I have tried to put the current broad credit issues in some perspective and to make suggestions to hasten the return of adequate credit to the CRE market. However, although the economy is starting to show some positive signs and pockets of recovery, full recovery and a full flow of credit through the economy will take more time.

I appreciate the opportunity to testify today on behalf of the OTS and would be happy to answer any questions you may have.

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

Greg M. Ohlendorf
President & CEO, First Community Bank and Trust

On behalf of the
Independent Community Bankers of America
&
The Community Bankers Association of Illinois

Before the

Congress of the United States
House of Representatives
Committee on Financial Services
Subcommittee on Oversight and Investigations

Field Hearing on
"Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses"

May 17, 2010
Chicago, IL

Chairman Moore, Ranking Member Biggert, and Members of the Subcommittee, I am Greg M. Ohlendorf, President & CEO of First Community Bank and Trust, located in Beecher, IL (a suburb in southeast Will County 37 miles south of Chicago). I have been in banking for 25 years, all of those years with First Community. We are a $150MM community bank with a focus on real estate lending and technology products and services. The bank was founded in 1916.

I graduated in 1985 with a BS degree in Business Administration from Illinois Wesleyan University, Bloomington, IL and in 1990 with an MBA from Governors' State University, University Park, IL.

I have served on a number of committees with the Independent Community Bankers of America (ICBA) and am currently the Chairman of their Policy Development Committee and an at-large Director on their Board. I also serve as a special guest on their Payments and Technology Committee. In addition to my experience with ICBA, I am also a member and past director of the Community Bankers Association of Illinois (CBAI) and taught at their community banking school for 10 years.

I am pleased to address the Subcommittee here today at this field hearing entitled "Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses." I am also privileged to represent ICBA and it 5,000 community bank members nationwide and the CBAI and its 430 members at this important hearing.

As you know, community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. Even during these challenging times, our nation's nearly 8,000 community banks remain committed to serving their local small business and commercial real estate customers, who are pivotal to our country's economic recovery.

The overwhelming majority of community banks are well capitalized and have good liquidity. But, many community banks face serious challenges that can hinder their ability to make loans. First, community banks confront the toughest regulatory environment in more than two decades. While Washington policymakers exhort community banks to lend to businesses and consumers, banking regulators, particularly field examiners and their field offices, place restrictions on banks well beyond what is required to protect bank safety and soundness. The banking agencies have moved the regulatory pendulum too far in the direction of overregulation at the expense of lending. We need to return to a more balanced approach that promotes lending and economic recovery in addition to bank safety and soundness.

While the tough regulatory environment is inhibiting new loans in many instances, community banks have also witnessed a decrease in demand for loans from qualified borrowers. Many of our best small business and real estate customers cite their uncertainty about the recovery as their key reason for not seeking additional credit.

Commercial real estate lending presents special challenges for the community banking sector. Many community banks rely on CRE loans as the "bread and butter" of their local banking market. Community bank CRE portfolios are under stress. The downturn in the economy affects the ability of CRE borrowers to service their loans. Regulatory overreaction adds further stress to community bank CRE portfolios. For example, field examiners continue to require community banks to classify and reserve capital for performing CRE loans solely because collateral is impaired, despite guidance from Washington to look beyond collateral values. Community banks all over the country, even those located in areas that have relatively healthy economies, are under regulatory pressure to decrease CRE concentrations.

Community banks are the key to economic recovery. It is vitally important that policymakers create an environment that promotes community bank lending to small businesses, rather than inhibiting lending. We have several recommendations to improve the commercial lending environment and address problems related to CRE.

- Our country needs a balanced regulatory environment that encourages lending. In a balanced environment, regulators do not exacerbate credit availability through pro-cyclical increases in bank capital requirements. And, bank examiners consider the total circumstances of loans and borrowers, and not just collateral values, when determining the value of loans in banks.
- The Term Asset Liquidity Facility (TALF) should be expanded to cover purchases of a wider range of Commercial Mortgage Backed Securities (CMBS). Extending TALF for a five-year period would help the debt refinancing of CRE, and help stabilize the CRE market.
- The American Recovery and Reinvestment Act (ARRA) contained several tax relief and SBA reform measures to help boost small businesses. Congress should adopt the Small Business Committee legislation to extend these beneficial measures.
- Extend Loan-Loss Amortization for Privately-Held Banks. Provide for extended loan-loss amortization for privately-held banks. Examiners are requiring banks to write down loans that are performing and whose collateral is likely to increase in the coming year. A similar policy in effect for agricultural lenders in the 1980s significantly mitigated the damage from the economic crisis of that era. Extended amortization would allow banks more leeway to work with struggling borrowers.
- The entire amount of the allowance for loan and lease losses (ALLL) should be included as part of risk-based capital. The risk-based capital rules should take into consideration the entire amount of ALLL and not just the amount up to 1.25% of a bank's risk-weighted assets. This would encourage banks to reserve more and recognize the loss-absorbing abilities of the entire amount of the ALLL.
- The FDIC Transaction Account Guaranty (TAG) Program has been an important tool for protecting and promoting the interests of small businesses by guaranteeing payroll accounts and providing community banks additional liquidity to make loans to creditworthy borrowers. Ending the program at the end of 2010 would be premature. The program should be made permanent or at least extended to 2013.
- SBA reforms should be enacted to meet the needs of community bank SBA lenders. For example, the SBA "low-doc" program should be revived to help smaller banks that do not have a dedicated SBA lending staff.

- As policymakers decide the status of Fannie Mae and Freddie Mac going forward, a reasonable value should be given to community banks for the preferred shares, which were rendered worthless by the government's takeover of the GSEs. Additionally, dividend payments should be resumed for preferred shares.
- ICBA applauds the recent expansion of the net operating loss (NOL) five-year carryback for 2008 or 2009. ICBA recommends extending this beneficial NOL reform through 2010. This would allow many more small businesses to preserve their cash flow and ride out this difficult business environment as the economy recovers.
- The law governing Subchapter S banks should be amended to permit IRA investments in Subchapter S banks without regard to timing and to permit Subchapter S banks to issue preferred shares. These reforms would give Subchapter S banks new sources of capital at this critical time.
- Congress should preserve the top marginal tax rate for Subchapter S income at 35 percent and maintain parity between corporate and individual tax rates to prevent costly shifts in business forms for Subchapter S businesses, including Subchapter S banks.

Administration's Small Business Lending Fund

In addition to these ideas, ICBA is strongly supportive of the proposal announced by the President and Treasury to further stimulate lending to the small business sector through community banks. ICBA believes the program could be successful, if structured properly. ICBA has made several recommendations for a successful program, including allowing community banks to participate in the new program without the restrictions associated with the TARP Capital Purchase Program (CPP). This would encourage broad participation. All of ICBA's recommendations for the new small business program are discussed more fully below.

Examination Environment Hinders Lending

Indeed, the mixed signals that appear to be coming out of the banking agencies have dampened the lending environment in many communities. On the one hand, a November 12, 2008, Interagency Statement on Meeting the Needs of Creditworthy Borrowers established a national policy for banks to extend credit to creditworthy borrowers as a means to help our nation get back on its economic feet. It stated that, "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers." Again, in November 2009, the banking agencies issued the Guidance on Prudent Commercial Real Estate Loan Workouts, which was intended to ensure that examiners look at factors other than just collateral values when evaluating commercial credits and to ensure that supervisory policies do not inadvertently curtail credit to sound borrowers. Two weeks ago the regulators repeated some of these same messages in the context of small business lending generally in another interagency statement.

Field Examiners Second Guessing Washington

However, these messages seem to be lost on examiners, particularly in parts of the nation most severely affected by the recession. In Illinois, the tough regulatory environment is forcing my bank and most other banks to avoid making good loans that we would have made in the past.

As a result of capital standards above those required by regulations, questionable loan valuation and loan loss reserve policies, and overly strict implementation of CRE concentration guidance, my bank's loan portfolio has remained stagnant in 2009 and YTD 2010 after experiencing a 21% increase from year-end 2007 to year-end 2008.

But Illinois banks are not the only banks to feel these regulatory pressures. In a recent informal survey conducted by ICBA, 52 percent of respondents said they have curtailed commercial and small business lending as a result of their recent safety and soundness examinations. Also, 82.5 percent of respondents answered that the Federal banking agencies' guidance on CRE loan workouts has not improved the examination environment for CRE loans.

Higher Regulatory Capital Standards

Bank examiners are raising required capital levels well above the capital standards established by statutes and regulations. As a result, community banks with sufficient capital to be considered "well-capitalized" are being classified as only "adequately capitalized." Although banks may meet the higher standard imposed by the examiners, they have done so at the cost of reduced lending.

Being downgraded to "adequately-capitalized" impacts a bank's liquidity, and its ability to make loans and raise new capital from investors. "Adequately capitalized" institutions may not accept brokered deposits or pay above market interest rates on deposits without a waiver from the FDIC. The FDIC is being very tough on granting brokered deposit waivers causing further liquidity problems for banks. The interest rate restrictions limit many banks' ability to attract good local deposits. These deposits will likely migrate out of the community to other financial firms not subject to this restriction. In addition, to meet the higher capital standards, banks decrease the number of loans on their books and are forced to turn away quality borrowers. As noted above, lending at our bank has not increased over the past 15 months. The higher examiner-imposed capital standard is a major reason for the decrease.

The examiner-imposed capital standards may force my bank to seek additional outside capital. Raising unnecessary capital dilutes the interest of existing shareholders, which erodes wealth that could be deployed by the shareholders to support other economic activities in the local economy.

Furthermore, the prospect that regulators might increase capital requirements in the future makes raising capital difficult as potential new investors consider whether their investment in the bank might be diluted in the future.

Aggressive Writedowns of Loans; High Loan Loss Reserves

While the banking regulators in Washington have been very willing to discuss their safety and soundness examination policies with the ICBA and have reassured us that they are taking measures to ensure their examiners are being reasonable and consistent with recent guidance, ICBA continues to hear from community bankers that their examinations are unreasonably tough.

For example, despite the guidance on CRE loan workouts, community banks continue to report that they are forced to write down performing CRE loans based solely on appraisals and absorption rates (lots sold). In those cases, examiners are ignoring the borrower's ability to repay its loan, the borrower's history of repaying other loans with the lender, favorable loan-to-value ratios and guarantors. When a recent appraisal is unavailable, examiners often substitute their own judgment to determine collateral value.

Further, commercial credits that show adequate cash flow to support loan payments are being downgraded because of collateral values, or because the examiner believes the cash flow will diminish in the future. Other bankers complain that otherwise solid loans are being downgraded simply because they are located in a state with a high mortgage foreclosure rate. This form of stereotyping is tantamount to statewide redlining that ignores any differences among markets within a state.

Many community banks report that examiners are not only requiring an aggressive write down of commercial assets, they are also requiring banks to establish reserves at historically high levels. Banks, which were rated CAMELS 1 or 2 on prior examinations and had loan loss reserves of 1 to 1.5 percent of total loans, report that they are being required to more than double their loan loss reserves. Aggressive write-downs of commercial assets and large loan loss reserves have a serious negative impact on bank earnings and capital and the ability of community banks to meet the credit needs of small businesses.

Banks May Avoid Good Loans to Satisfy Regulators

Examiner practices not only undermine the fundamental goal of the interagency policies, they are costing community banks money, leading to a contraction of credit, and forcing many of them to rethink their credit policies. Under this climate, community bankers may avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital.

Moreover, the examination environment is driving down the amount banks are willing to lend on a project, when they do decide to provide financing. Two years ago, a bank such as mine would have been willing to finance 75 to 80 percent of the cost of a project, but under today's circumstances, my bank could only finance about 60 to 70 percent of a project, at most, out of concern about future downgrades of the loan.

Demand for Credit Down

Community banks are willing to lend, that's how banks generate a return and survive.
The tough regulatory environment is inhibiting community banks from making new commercial real estate and small business loans in many instances. But, community banks have also witnessed a decrease in demand for loans from qualified borrowers as a result of the current recession. It is a fact that the demand for credit overall is down as businesses suffered lower sales, reduced their inventories, cut capital spending, shed workers and cut debt. Small business loan demand is down as well. In a recent National Federation of Independent Business (NFIB) survey, respondents identified weak sales as the biggest problem they face. Only eight percent of respondents said access to credit was a hurdle. In a recent ICBA survey, 37 percent of banks responding said lack of loan demand was constraining small business lending.

The FDIC Quarterly Banking Profile showed a $129 billion decline in outstanding loan balances in the fourth quarter 2009 after a record $210.4 billion quarterly decline the previous quarter. Net loans and leases declined across all asset size groups on a quarterly basis in the second half of 2009.

All community banks want to lend more. Less lending hurts profits and income. Many community bank business customers cite the key reason for not seeking credit is their uncertainty about the economic climate and cost of doing business going forward. Until their confidence in the economic outlook improves, businesses will be unlikely to seek more loans.

Commercial Real Estate
One issue of increasing concern in the community banking sector is that of commercial real estate and the potential for overexposure. Many community banks rely on commercial real estate (CRE) as the "bread and butter" of their local markets. The degree of borrowers' ability to service their CRE loans is closely tied to the performance of the overall economy, employment and income. Notably, retail sales declined 0.3% in the important December 2009 figure and unemployment remains near a 26-year high. So the sales at stores and businesses occupying commercial space is under stress and rents are suffering, putting increased pressure on paying loan and lease commitments. Until individual spending (which makes up 70% of GDP) and employment numbers improve, CRE loans set for renewal are likely to see continuing rising defaults.

This adds stress to the community banking sector as they rely on commercial real estate as a significant portion of their overall portfolio. However, bank regulators have much more aggressively examined community banks for CRE concentration dating back to 2006. For example, an institution whose total amount of reported construction, land development, and other land loans represents, approaches, or exceeds 100% or more of the institution's total capital will be subject to greater regulatory pressure and oversight. An institution whose total CRE loans represent, approach, or exceed 300% or more of the institution's total capital and whose outstanding balance of CRE loans has increased by 50% or more during the prior 36 months will also come under even greater regulatory scrutiny.

It is not uncommon to have community banks exceed the 100/300% of regulatory capital threshold, but few have seen very rapid growth in CRE exceeding 50% in the past 3 years. Many community banks survived the CRE stress in the 1980s and 1990s, and have much better controls over their CRE concentration. Community bankers report today's CRE troubles are nowhere near the magnitude of the late 1980s and 1990s. CRE credit in the economy has already shrunk by about $45 billion from its 2007 peak. However, CRE exposure will be a significant reason banks will remain under stress in 2010 and is a key reason 702 banks are on the FDIC problem bank list.

That said, community banks report they underwrite and manage these commercial real estate loans in a conservative manner, requiring higher down payments or other steps that offset credit risks and concentrations. Community banks believe they do a better job monitoring CRE loans than do large nationwide lenders because they are more likely to work one-on-one with the customer, and they have a better understanding of the economic conditions in their communities.

The vast majority of community banks have the capital to ride out the depressed CRE market. However, community banks all over the country, even those located in areas with relatively healthy economies, are under regulatory pressure to decrease CRE concentrations.

Should real estate prices stabilize with economic growth, the CRE concerns will abate. Many community banks report that CRE loan payments are regularly being made (so the loans are performing) but their underlying collateral value has declined. Therefore, as CRE loans are due for renewal; borrowers as well as banks are often forced to put up increased capital to be able to renew the loan and prevent default.

ICBA's Recommendations

Community banks are the key to economic recovery. Despite a 4th Quarter 2009 decline of net loans and leases at 8.2% compared to the previous year among all banks, community banks with less than $1 billion in assets showed only a narrow year-over-year decline in net loans and leases of 1.4% after being the only group to post increases in each of the previous three quarters. Our nation's biggest banks cut back on lending the most. Institutions with more than $100 billion in assets showed an 8.3% decrease while $10-100 billion-asset-banks had net loans and leases decline at 11.4% compared to the previous year. Policymakers need to create an environment that promotes community bank lending to small businesses, rather than inhibiting lending. We have several recommendations to improve the commercial lending environment and address problems related to CRE.

Regulatory Relief is Top Priority

Community bankers' top concern is that bank regulators have swung the pendulum too far toward regulatory overkill, inhibiting new small business lending and making the small business and CRE problems worse rather than helping resolve the problem. The bank regulators are forcing write-downs on performing commercial loans and treating all loans in many hard hit states the same regardless of a loan's performance. Also the FDIC practice of dumping properties at "fire sale" prices onto a market can trigger a counterproductive downward spiral in real estate values and further bank write-downs. Banking regulatory staffs in the field and field offices are ignoring the policies established in Washington put in place to promote lending. Field examiners and their respective field offices are imposing arbitrary capital standards on community banks, requiring those banks to shrink their assets rather than increase lending.

If community banks are to increase small business lending, the regulatory environment needs to change. Our country needs a balanced regulatory environment that encourages lending and economic recovery, in addition to bank safety and soundness. In a balanced environment, regulators do not exacerbate credit availability through pro-cyclical increases in bank capital requirements. And, bank examiners consider the total circumstances of loans and borrowers, and not just collateral values, when determining the value of loans in banks.

Extend and Expand TALF Program
The TALF program was designed to keep the secondary markets open and vibrant for a variety of loan and investment products. Secondary markets for commercial debt must be robust so CRE debt refinancing can take place at reasonable borrowing rates. Like residential real estate, commercial real estate loans were bundled into securities, pooled and sold. Specifically, the market for CMBS has not fully recovered. Expanding the TALF to cover purchase of a wider range of CMBS and extending TALF for a five-year period would help the debt refinancing of CRE, and help stabilize the CRE market. Notably, community banks can sell very few of their whole CRE loans; more likely they are engaged in loan participations, so policies should focus on stabilization of CRE valuations.

Extend Small Business Changes in the ARRA
The severe economic recession justified a sizable economic stimulus, including tax relief measures for individuals and small businesses. ICBA was pleased the American Recovery and Reinvestment Act (ARRA) enacted last February contained several tax relief and SBA reform measures to help boost small businesses. Specifically, the major SBA loan program enhancements enacted are all helping many small businesses ride out this deep recession. We also support the extension of the key incentives for SBA 7(a) and 504 lending programs.

ICBA also applauds the Small Business Committee's legislation to extend the beneficial SBA enhancements included in ARRA. Specifically:

- Extending the SBA fee reductions through fiscal year 2011;
- Extending the higher guarantee levels through fiscal year 2011;
- Making permanent the SBA secondary market facility authority.

If enacted, these measures would all help community banks expand their SBA lending to small businesses and would stimulate much-needed economic activity and job creation.

SBA Reforms
ICBA supports additional measures to enhance SBA lending. The key to meeting small business capital needs is to have diversity in SBA lending options. The SBA should be able to meet the needs of both large and small SBA loan program users. This was our objection to the SBA's elimination of the successful "LowDoc" program. It was used most often by banks that did a small number of loans and did not have the dedicated SBA loan staff.

Because there are more than 8,000 community banks nationwide they can support a large number of SBA loans if community banks are more easily able to use the SBA. In other words, we do not want an SBA with a one-size-fits all cookie cutter approach that only the biggest-volume SBA lenders can fully use. Before this financial crisis hit, nearly 60% of all SBA loans were concentrated in just ten banks. If we are concerned with supplying small businesses with a steady source of capital, the SBA needs to do a better job of embracing the more than 8,000 banks nationwide so all lenders can easily participate.

Enhancements to Community Bank Capital
Of course community banks and small businesses rely on raising capital in this difficult capital market. Therefore, we would like to recommend several reforms that can help community banks and small businesses preserve and raise capital.

Restore Reasonable Value to Fannie Mae and Freddie Mac Preferred Stock
Community banks were encouraged by their bank regulators to hold Fannie Mae and Freddie Mac preferred stock as part of their Tier 1 capital and were severely injured when the U.S. Treasury placed these entities into conservatorship in September 2008. Some $36 billion in Fannie Mae and Freddie Mac capital held in banks, including many community banks, was largely destroyed by Treasury's action. As policymakers decide the status of Fannie Mae and Freddie Mac going forward, at a minimum, a reasonable value should be given to the preferred shares. Dividend payments should be resumed for these preferred shares. Importantly, this will help restore capital needed for additional small business lending. For each dollar of value restored some eight to ten dollars in new lending can occur.

Extend the 5-Year NOL Carryback Through 2010
ICBA applauds the recent expansion of the NOL five-year carryback for 2008 or 2009 that President Obama signed into law on November 6th. The FDIC reports that 30 percent of banks had a net loss for 2009. ICBA recommends extending this beneficial NOL reform through 2010. This would allow many more small businesses to preserve their cash flow and ride out this difficult business environment as the economy recovers.

Specifically, ICBA recommends allowing community banks and small businesses with $10 billion in assets or less to spread out their current losses with a five-year carryback allowed through tax year 2010, including TARP- CPP programs participants to increase small business lending. It makes little sense for Congress to encourage community banks to lend more to small businesses by participating in the TARP program and then to punish them by not allowing the potential use of the NOL five-year carryback tax reform. Allowing all interested small businesses with $10 billion or less in assets to use an expanded NOL through 2010 will help free up small business resources now to help support investment and employment at a time when capital is needed most. Expanding the NOL five-year carryback to include tax year 2010 and allowing TARP participant banks with $10 billion in assets or less simply allows these businesses to accelerate the use of allowable NOL deductions that can be claimed in future years under current law. However, by accelerating the use of NOLs it will free up much needed cash flow now when businesses need it most.

A recent report by the Congressional Research Service helps support the net operating loss tax relief. The May 27 CRS report notes most economists agree that U.S. companies would benefit from a longer net operating loss carryback than the current two years period. The CRS report says the carryback period should last through the typical business cycle (six years) to help smooth the peaks and valleys in income.

Extend Loan-Loss Amortization for Privately-Held Banks
Provide for extended loan-loss amortization for privately-held banks. Examiners are requiring banks to write down loans that are performing and whose collateral is likely to increase in the coming year. A similar policy in effect for agricultural lenders in the 1980s significantly mitigated the damage from the economic crisis of that era. Extended amortization would allow banks more leeway to work with struggling borrowers.

The Entire Amount of the ALLL Should be Included as Part of Risk-Based Capital
Under the current risk-based capital rules, a bank is allowed to include in Tier 2 capital its allowance for loan and lease losses (ALLL) up to 1.25% of risk-weighted assets (net of certain deductions). Consequently, some community banks are now being downgraded based on capital inadequacy even though they have excess amounts of ALLL. The risk-based capital rules should take into consideration the entire amount of ALLL and not just the amount up to 1.25% of a bank's risk-weighted assets. This would encourage banks to reserve more and recognize the loss-absorbing abilities of the entire amount of the ALLL.

Extending the FDIC TAG Program One Additional Year
The FDIC Transaction Account Guaranty (TAG) Program, which guarantees noninterest bearing transaction accounts, certain NOW accounts and IOLTA accounts, has been an important tool for protecting and promoting the interests of small businesses by guaranteeing payroll accounts and providing community banks additional liquidity to make loans to creditworthy borrowers. Banks pay a separate fee to the FDIC for this additional coverage. Accounts guaranteed under the TAG are not considered in determining the deficit in the FDIC's Deposit Insurance Fund, so continuing the TAG would not increase the deficit in the DIF or affect the FDIC's regular insurance premiums. We are concerned that an expiration date of December 31, 2010, would not provide enough time to restore and maintain liquidity and customer confidence in the banking system. Particularly in those areas of the country like Georgia, Florida, California and the Southwest, it is very important that this program continue an additional 12 months to allow additional time for those areas to stabilize. The TAG program ensures that community banks are not at a competitive disadvantage in this fragile economy. The safety of transaction accounts continues to be one of the most important concerns for customers. The public perceives that too-big-to-fail institutions can provide unlimited protection because these banks will ultimately be bailed out if they become financially unstable. Community banks should be afforded the same opportunity to guarantee their customers' transaction accounts.

Allow New IRAs as Eligible S Corporation Shareholders
The challenging economic and credit markets make it difficult for many community banks to raise additional capital to support small business lending. Unfortunately, Subchapter S community banks are disadvantaged in raising additional capital by onerous shareholder restrictions. Current law restricts the types of individuals or entities that may own S corporation stock.[i] S corporation community banks seeking to raise capital may not allow new IRA shareholders. Traditional and Roth IRA stockholders are permitted only to the extent that that IRA stock was held on or before October 22, 2004.

Therefore, Subchapter S community banks are put at a disadvantage relative to other less restrictive business forms in their ability to attract capital due to the rigid IRA shareholder restriction.

ICBA recommends that new IRA investments in a Subchapter S bank be allowed regardless of timing. We believe this reform will grant more community banks the needed flexibility in attracting IRA shareholder capital, especially from existing shareholders.

Allow Community Bank S Corporations to Issue Certain Preferred Stock
Another obstacle preventing S Corp. banks from raising capital is the restriction on the type of stock they can offer. Current law only allows S corporations to have one class of stock outstanding.[ii] C corporations that want to make the S corporation election must eliminate any second class of stock prior to the effective date of the S corporation election. Likewise, issuing a second stock class by an S corporation terminates its S corporation status. Community banks must maintain certain minimum capital ratios to be considered a well-capitalized institution for regulatory purposes. As a community bank grows in size, its earnings alone may not provide sufficient capital to fund its growth. Banks needing more capital can raise additional capital by issuing common stock, preferred stock, or, in some cases, trust-preferred securities.

Many community banks avoid issuing additional common stock to fund growth so that they can protect their status as an independent community bank and serve their local community lending needs. Instead, they frequently use preferred stock to fund growth and retain control. However, S corporation banks are not allowed to issue commonly used preferred stock because preferred stock is considered a second class of stock. This prevents small community banks from having access to an important source of capital vital to the economic health and stability of the bank and the community it serves.

ICBA recommends exempting convertible or "plain vanilla" preferred stock from the "second class of stock" definition used for S corporation purposes. This would help more community banks become eligible to make the S corporation election as well as help those that currently are S corporations seeking to raise additional capital. Allowing community bank S corporations to issue preferred stock would allow them to reduce the burden of double taxation like other pass-through entities and, at the same time, fund future growth.

Preserve 35% Top Marginal Tax Rate on Subchapter S Income
Small businesses are facing difficult economic times. A troubled credit market combined with a slowdown in U.S. economic growth, high energy prices, and sharp inflationary costs across-the-board for inputs are crimping small business profits and viability. Maintaining cash flow is vital to the ongoing survival of any small business and taxes are typically the second highest expense for a business after labor costs. As pass-through tax entities, Subchapter S taxes are paid at the individual income tax level. Marginal income tax rates do play a critical role in a small business' viability, entrepreneurial activity, and choice of business form. Today more than half of all business income earned in the United States is earned by pass-through entities such as S corporations and limited liability corporations.

The top corporate income tax rate and individual income tax rate are currently set at 35%. Much discussion has been given to addressing the corporate tax rate for international competitiveness concerns and raising the individual income tax rate. Significant shifts in the existing marginal tax rates and parity between corporate and individual tax rate can trigger unwanted and costly shifts in business forms. It is important to consider maintaining parity between the top corporate and individual income tax rates in the Code. Additionally, during this difficult economic period, at a minimum, the current top tax rate of 35% should be preserved on both small business Subchapter S income and C corporation income, not increased.

Administration's Small Business Lending Fund

ICBA is strongly supportive of the proposal announced by the President and Treasury to further stimulate lending to the small business sector through community banks. ICBA believes the program could be successful, if structured properly. ICBA has made several recommendations to the Administration for a successful program:

- The new program should impose no TARP-like restrictions on community banks that participate in the program. For example, the program should not require stock warrants, restrict compensation or bank dividends, or limit access to tax benefits like the NOL carryback.
- The government should not have the right to change the contract to impose unilaterally new conditions and requirements.
- Bank dividend payments to the government should be suspended for one year until the small business loans can be underwritten and put in place.
- Community banks should be able to repay the government's investment without penalty and should be able to retain the government's investment for at least five years or more to support long term small business loans.
- The broadest number of community banks should be eligible to participate. We recommend that CAMELS-rated 3 banks be automatically eligible and that 4-rated banks be allowed to participate on a case-by-case basis. When considering applications to participate in the program, a bank's post investment capital position should be used to determine eligibility.
- Special consideration should be given to minority banks given their role promoting the economic viability of minority communities.
- Treasury should have the ability to make the final capital injection decision after consultation with the banking regulators.
- The eligibility criteria and approval process must be well defined and transparent so bank access to the program will be fair and transparent.
- All forms of banks, including Subchapter S and mutual banks and mutual bank holding companies, should be included in the program.
- Existing TARP CPP participants should be able to transfer to the new program and be relieved of the TARP restrictions.
- All participants should be allowed to treat the investment as Tier 1 capital.
- Agricultural loans should be included within the program.
- Reporting of small business lending should be made simple.
- Finally, credit unions should not be allowed to participate in the programs because credit unions commercial lending is restricted, in the first place, and secondly, because credit union lending is already subsidized through a broad tax exemption

Conclusion

Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. Community banks form the building blocks of our communities and support small businesses around the country. The community banking industry is poised to serve as an economic catalyst to lead our nation's economic recovery. They are ready, willing and able to meet the credit needs of small businesses and the communities that they represent. But, we need to move away from an overly restrictive, pro-cyclical regulatory environment to one that actually promotes small business and CRE lending in community banks. In addition, we believe that our other recommendations, if adopted, would go a long way to strengthen the community banking sector and increase small business lending. We look forward to working with Congress and the Administration on these and other initiatives to support small business and CRE lending by community banks.

[i] Internal Revenue Code §1361(b)(1).
[ii] Internal Revenue Code §1361(b)(1)(D).

For Release Upon Delivery
1:00 p.m., May 17, 2010

TESTIMONY OF

BERT A. OTTO

DEPUTY COMPTROLLER, CENTRAL DISTRICT

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

of the

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

May 17, 2010

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Chairman Moore, Ranking Member Biggert and members of the Subcommittee, my name is Bert Otto and I am the Deputy Comptroller for the Office of the Comptroller of the Currency's Central District. I appreciate the opportunity to appear before the Subcommittee to discuss commercial real estate (CRE) lending in Illinois and other parts of the country.

I have been a National Bank Examiner with the OCC for almost thirty-seven years and have served in a variety of positions in the field and in our Washington, D.C. headquarters. For almost my entire career, I have been involved in the direct supervision of community and midsize national banks. In my present capacity, I am responsible for the oversight of nationally chartered community banks in ten states in the Midwest, including Illinois.

To put the OCC's regulatory role in Illinois in perspective, we supervise approximately 20 percent of the banks headquartered in the state, representing about 38 percent of the bank and thrift assets. The 128 nationally chartered community banks headquartered in Illinois hold aggregate assets of roughly $91 billion. In addition, several large national banks supervised by OCC do a significant volume of business in Illinois, but are headquartered in other states.

The OCC's core mission is to ensure that national banks remain safe and sound and meet the credit needs of their communities and customers. In carrying out our mission, we strive to ensure that banks have the systems and capital in place to support their lending activities. A critical part of our job is determining when potential risk exposures or weaknesses in risk management practices require corrective action by bankers. Knowing when to make these calls requires judgment and a balanced supervisory approach. Moving too quickly or too strongly when problems begin to arise can impede economic growth and access to credit, while waiting too long or not requiring appropriate controls can lead to excessive risks that will ultimately impair a bank's overall financial condition – and its ability to lend. The OCC strives to get this balance right through strong, thoughtful and consistent supervision, and clear two-way communication with the banks we supervise. It is especially important in today's economic environment to ensure that our actions do not discourage national banks from making loans to creditworthy borrowers.

II. Overview of Commercial Real Estate Conditions

To put my remarks into context for today's hearing, it is helpful to look first at the general economic and commercial real estate conditions in Illinois and Chicago. Like much of the United States, Illinois is currently facing serious economic challenges. The recession hit the Chicago metropolitan area and the state of Illinois harder than many other areas of the county. While job losses have decelerated since the beginning of 2010, they have not ended, and unemployment in both the Chicago metropolitan area and Illinois as a whole is well above the national average. We are seeing signs of improvement in some sectors of the state's economy, but exports, which are concentrated in two industries agriculture and manufacturing, continue to suffer. The state's agricultural exports are down 45 percent from their peak value compared to 38 percent nationally, and manufacturing exports are down 26 percent from the summer 2008 peak compared to a similar 24 percent decline nationally.

Local economic performance and the general drag of the national and global downturns are having a significant effect on CRE in the metropolitan area. All types of commercial real estate are experiencing vacancy rates well above historical averages, and some are at record levels. Without job growth, this trend is likely to continue. For example, Grubb & Ellis reported that office demand in the Chicago metropolitan area declined by 1.4 million square feet in the first quarter of the year. This same source reports that more than two dozen recently completed industrial buildings of 200,000 square feet or more are vacant or nearly vacant. This competitive supply will continue to put pressure on the level of operating cash flows that such projects can generate. These cash flows have a direct impact on the value of the project and the amount of debt it can support.

Issues confronting the Chicago market mirror what we are seeing on a nationwide basis. For example, vacancy rates are still rising nationally, albeit at a slower rate than in past quarters, and cash flows produced by CRE properties are projected to decline well into 2011. Nationally, the CRE markets still face significant headwinds, and we expect that many banks will experience further deterioration in their CRE loan portfolios. Vacancy rates are nearing their expected peaks for the cycle but stand at or near record-high levels which is continuing to place downward pressure on rents. Cash flows produced by CRE properties are projected to decline well into 2011. There are, however, some signals of a slight improvement in the CRE capital markets and according to Moody's/Real Commercial Property Index, property values rose three of the last four months (through February). Thus after dropping 44 percent between the peak in October 2007 and October 2009, commercial property values now stand 42 percent lower than their peak. Lower prices and historically attractive yields are encouraging new investment. CRE sales activity inched higher in each quarter of 2009, and sales volume in the first quarter of 2010 was up 16 percent from average quarterly activity last year. Well-leased assets in larger markets in particular have garnered relatively strong interest from investors. Additional signs of stabilization include tightening CMBS spreads and rising REIT share prices. REITs also raised $24 billion in equity in 2009, and the first quarter of 2010 was the first time in almost two years that they purchased more property than they sold. Despite these positives, we expect CRE losses to remain elevated for an extended period, much as we saw in the early 1990s downturn.

These conditions and market forces have strained both CRE borrowers, and the CRE loan portfolios at many banks, and we expect these trends may continue for some time. The OCC fully recognizes the important engine that CRE plays in the overall health and vitality of Illinois and the United States economy. We have taken steps to help ensure that bankers do not become unduly conservative and that they continue to make loans to creditworthy borrowers, including CRE borrowers. For example, through the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* issued in November of 2008, the federal regulatory agencies reiterated how important it is for banking organizations to meet the needs of creditworthy borrowers.[1] OCC management and examiners are reinforcing this message in outreach meetings and in industry and interagency forums with bank directors, chief executive officers, and senior credit officers.

---

[1] *See:* "Interagency Statement on Meeting the Needs of Creditworthy Borrowers" at: http://www.occ.gov/ftp/release/2008-131.htm.

III. Commercial Real Estate Lending

Notwithstanding these efforts, a number of bankers, including those in Illinois, have expressed concern that examiners have become overly conservative and are constraining CRE lending as a result. Before addressing some of the specific concerns that we are hearing, let me first provide a brief overview of our supervisory approach in this area.

We have been addressing the build up of risk in the CRE market through our examination and supervisory activities for a number of years. We know from experience that CRE concentrations can become a significant strain on banks' performance when the economy slows down. Indeed, 99 percent of national banks designated as problem banks, including those that have failed, have significant concentrations of credit, most often in CRE. Our goal in focusing on CRE exposures early in this credit cycle has been to ensure that bank management recognizes and addresses potential problems at the earliest stage possible, when risk mitigation actions are likely to be most successful.

Specifically, over the past six years, we have been conducting a series of targeted examinations at banks that we believe are at significant risk due to the nature and scope of their CRE activities. Findings from these initial examinations, and the weaknesses we discovered in various risk management practices, helped to formulate the guidance that we and the other federal banking agencies issued in 2006 on sound risk management practices for concentrations in CRE lending.

In 2005, to assist bankers in identifying and assessing potential CRE vulnerabilities, we developed and made widely available via our National BankNet Web site, a CRE stress test tool for bankers. Although BankNet is only open to national banks, we make our CRE tools available to state banks upon request. Currently, we have two tools available on BankNet. The Acquisition & Development (A&D) Stress-Testing Worksheet is an Excel-based tool that allows bankers to perform comprehensive sensitivity analysis on an A&D project quickly and easily. The tool helps to identify potential changes in project value based on changes in market and project conditions. The Commercial Real Estate Stress Testing Worksheet is another Excel-based tool that requires only some basic loan underwriting criteria to provide a concise analysis of the potential credit quality deterioration posed by the embedded risks. The worksheet shows the progression of the potential impact to debt service coverage and loan-to-value from individual changes in the capitalization rate, interest rate, and vacancy rate. We also provide examiners with access to various market databases that allow them to monitor and analyze CRE trends by major geographies and product type.

Throughout this credit cycle we have stressed to our examiners the need to take a balanced and consistent approach in examinations, to clearly communicate and explain their actions and recommendations, and to provide bank management reasonable timeframes to implement any needed corrective action. To ensure that we were applying a consistent approach in our examinations, in April 2008, we issued internal supervisory guidance to our examiners to reiterate and clarify our policies on CRE lending. That same month we held a nationwide teleconference with our examiners to discuss the guidance. During that call we reiterated the need for examiners to take a balanced approach in their supervision and to maintain open communications with bankers during examinations. Given the increases in troubled CRE loans that examiners were seeing, in April 2009, we issued supervisory guidance to examiners on factors that they should consider when evaluating banks' workout programs and risk ratings for problem CRE loans.

In October 2009, we and the other banking regulators issued guidance on CRE loan workouts to provide greater clarity and certainty to the industry and examiners on the agencies' policies and expectations, and to promote greater consistency across the agencies in our evaluations of these credits.[2] Many of the principles discussed in this guidance build upon the principles that our examiners already were applying based on the earlier, internal guidance we had provided, including our longstanding policy that examiners will not criticize prudent loan workout arrangements. The guidance also stresses that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower, and examiners should not criticize banks for engaging in an effective workout program even if the restructured loan has a weakness that results in an adverse credit classification. The statement also reiterates our policy that a loan should not be classified simply because the underlying collateral value has declined to an amount that is less than the current loan balance. Instead, classifications must be based on an analysis of the borrower's ability and capacity to repay.

For many CRE projects, however, the value of the collateral and the repayment of the loan are both dependent on the cash flows that the underlying project is expected to generate. Because of this linkage, current collateral values can be an important indicator of the project's viability and can signal changes that will adversely affect the cash flow available to service or repay the loan. In such cases, classification will generally be appropriate.

---

[2] *See*: "Policy Statement on Commercial Real Estate Loan Workouts," at: http://www.occ.treas.gov/ftp/release/2009-128a.pdf.

Given the concerns and questions we were hearing about how examiners differentiate between performing and non-performing loans, the guidance includes a series of examples with various fact patterns and describes the appropriate classification, accrual, and accounting treatment for each different scenario. The varying examples underscore that every loan must be evaluated on its specific facts and circumstances. Drilling down into these specifics is a basic tenet of our loan review processes. The simple fact is that loans or borrowers that initially appear to be similarly situated often have significant differences that will affect their ability to perform as structured.

We and the other agencies conducted a nationwide teleconference with the industry to explain the guidance and to walk through the various examples. We have also followed up with our examination staff on the guidance through internal supervisory guidance and conference calls. We also worked with the other federal banking agencies to develop an interagency training program for examiners who are reviewing CRE credits in the agencies' shared national credit program. The objective of the training was to ensure that examiners apply the October guidance in a consistent manner. We and the other federal banking agencies also have agreed to collect feedback from bankers on the effectiveness of our guidance and areas where further clarifications may be needed as part of our upcoming on-site examinations.

I want to address a couple of specific concerns that we are hearing about how examiners are evaluating CRE loans.

Some bankers have contended that examiners are barring loans to certain borrowers or industries, or are criticizing loans simply because they are located in a state with a high mortgage foreclosure rate or to an industry experiencing problems. Deciding which borrowers or businesses a bank should lend money to is not part of our examination process, provided the business is lawful and the bank is meeting the credit needs of its communities. We do expect banks to have robust credit underwriting and risk management processes, which among other things, monitor and control the bank's overall exposure to a particular borrower and industry segment. We also expect bankers to assess how borrowers and industries may perform in stressed economic environments to ensure that they will continue to have the capacity to perform under the terms of their loan obligations. However, examiners do not criticize loans simply because a borrower is located in a certain geographic region or operates in a certain industry. Each loan must be evaluated based on its own structure, terms, and the borrower's willingness and ability to repay the loan under reasonable terms. Market conditions, however, can influence a borrower's repayment prospects and the cash flow potential of the business operations or underlying collateral, and these are factors that we expect bank management to consider when evaluating a loan.

We have also received questions about whether examiners are classifying loans to borrowers that are current and can meet their debt obligation – what has sometimes been referred to as "performing non-performing" loans. The OCC does not direct banks to classify borrowers that have the demonstrated ability to service their debts under reasonable payment schedules. There are instances, however, where liberal underwriting structures can mask credit weaknesses that jeopardize repayment of the loan. A common example in today's environment is bank-funded interest reserves on CRE projects where expected leases or sales have not occurred as projected and property values have declined. In these cases, examiners will not just accept that the loan is good quality because it is current; instead, they will also evaluate the borrower's ability to make future payments required by the terms of the loan. As previously noted, the agencies' October 2009 policy statement on CRE loan workouts addresses these situations and provides examples of when classification is and is not appropriate.

Finally, we also hear concerns that examiners prohibit bankers from extending additional credit when the loan has been classified. To clarify – our examiners do not dictate loan terms, and we do not prohibit bankers from extending additional credit to classified borrowers. We recognize that within the context of a prudent, well-defined workout plan, extending credit may be the best course of action. However, if the extension of additional credit merely prolongs the inevitable and the borrower has no reasonable chance of repaying the debt, then the lender is just increasing the ultimate probable loss of the loan. Examiners will and should be critical of this latter practice. This is why we expect certain conditions to be met before renewals, modifications, or extensions are made to a borrower whose loans are criticized or classified. These conditions include: a majority of the bank's board or a designated committee must approve the credit in writing and find that it is necessary to promote the best interests of the bank; the bank must perform a written credit and collateral analysis of the borrower and credit; and the board's formal plan to collect or strengthen the credit will not be compromised by the new loan.

IV. Conclusion

The OCC is acutely aware of the pivotal role that bank credit plays in the health of our nation's economy, and we are encouraging bankers to lend to creditworthy borrowers.

Our messages to bankers have been, and continue to be, the following:

- Make new loans to creditworthy borrowers, using prudent underwriting standards;
- Work constructively with borrowers, using prudent underwriting standards; and
- Realistically recognize and address problem credits by maintaining appropriate reserves and taking appropriate charge-offs when repayment is unlikely. Recognizing and classifying a problem credit does not mean that a banker can no longer work with, or extend credit to, the borrower. We expect bankers to work with troubled borrowers.

Our direction to examiners and the policies they apply have also remained consistent.

The examiner's role is to determine that banks:

- Make loans on prudent terms, based on sound analysis of a borrower's financial and collateral information and ability to repay;
- Recognize weaknesses in existing credits and work with those borrowers to develop reasonable workout plans wherever possible;
- Have adequate risk management systems to identify and control risk taking;
- Maintain sufficient reserves and capital to buffer and absorb actual and potential losses; and
- Accurately reflect the condition of their loan portfolio in their financial statements.

While there are a variety of forces that have made businesses, consumers, and bankers more cautious and that have contributed to a slowdown in lending, many of these are beyond the direct control or influence of bank supervisors. It is incumbent upon us to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers. We are committed to do just that.

Testimony presented on behalf of the

Appraisal Institute

American Society of Appraisers

American Society of Farm Managers and Rural Appraisers

National Association of Independent Fee Appraisers

Before the

House Committee on Financial Services'

Subcommittee on Oversight and Investigations

On

"Commercial Real Estate:

A Chicago Perspective on Current Market Challenges and Possible Responses."

Presented by

Leslie Sellers, MAI, SRA

President

Appraisal Institute

May 17, 2010

Chairman Moore and Ranking Member Biggert, and members of the Subcommittee, thank you for the opportunity to share the real estate appraisal profession's concerns regarding challenges and possible responses to today's market. My name is Leslie Sellers, MAI, SRA, and I am the 2010 president of the Appraisal Institute, an international association of real estate appraisers, the largest in the United States, headquartered here in Chicago. I am here today on behalf of the four largest professional organizations of appraisers, including the American Society of Appraisers, the American Society of Farm Managers and Rural Appraisers, and the National Association of Independent Fee Appraisers.

Today's commercial real estate market is facing severe and potentially crippling challenges. Underlying economic conditions are troubling, with high unemployment, minimal job creation and limited investment taking place. Private equity for investment is limited, and equity positions have been severely impaired and in some cases eliminated as a result of overall market declines. Hundreds of bank failures loom, vacancy rates remain high, and many commercial real estate loans are delinquent or facing foreclosure. By some estimates, there is several trillion dollars of commercial paper due to be refinanced in the coming years, with significant concerns relative to who will finance these maturing loans. Without debt capital, many of these loans will go into foreclosure, causing further economic hardship.

However, there is some good news. There are initial signs of bottoming in the market. If economic conditions stabilize and begin to improve, investors may return to the table. The concern, however, is that the next few years are vital and that demand for most commercial property uses now is anemic. We are here today to explain how professional real estate appraisers can assist in the economic recovery, and how we can avoid such situations in the future.

In speaking with our members in the Chicago real estate market, the biggest challenge today is the lack of available financing. While there is demand for new loans, a typical commercial real estate loan requires 40 percent equity, is likely a short-term loan and carries very high fees. As a result, financing is scarce. Within the market itself, many subsectors in Chicago have vacancy rates well above historical averages, and with unemployment remaining high, this trend is not likely to change in the short term. Chicago, it seems, is like many real estate markets today.

Role of CRE Appraisals

As background, investing in commercial real estate carries a great deal of risk, as it represents an illiquid asset and for the most part takes several years to develop a property. These risks can be mitigated by sound due diligence and risk management procedures conducted by financial institutions. Real estate appraisals are a central part of these procedures, helping financial institutions make safe and sound loan decisions through fundamental market analysis.

Traditional lending theory centers on the "Three C's" – Credit, Capacity to repay and Collateral. Lender underwriters confirm that the borrower is creditworthy and has the capacity to repay the loan, and then hire professional real estate appraisers to provide professional opinions of value to understand the collateral risk offered for the mortgage. The same is generally true for the secondary commercial real estate markets, but unfortunately this analysis is all too often conducted in portfolio or in aggregate and not on a property specific basis.

Commercial real estate appraisals also are an important component to real estate portfolio monitoring. Like all investments, commercial real estate is subject to market fluctuations. It is critical that financial institutions monitor these fluctuations to guard against risk. Real estate appraisals also are used in asset management, loss mitigation or property disposition, which are common situations in today's market. Here, lenders are facing a potential loss due to delinquency and foreclosure and use appraisal services to test collateral for loan workouts. Upon foreclosure, appraisals also can be used for accounting procedures and to help dispose of assets in an orderly fashion.

At this point, I would like to address both industry and professional appraisal concerns, and provide strategic industry, regulatory and legislative recommendations.

Industry Concerns

We would like to dispel several myths about real estate appraisals that have surfaced in Congressional testimony and in the media.

Myth 1. *Real estate appraisals are backwards looking.*

Some have tried to argue that appraisals only look at historic comparable sales, and because of this, do not reflect the current market. This belief fails to recognize that real estate appraisers typically employ three approaches to value, plus trained real estate appraisers interview active market participants. While the sale comparison approach is important, other approaches may be more applicable, including the income capitalization approach and the cost approach. For income-producing properties, the income capitalization approach is typically the most applicable approach, relying on current market information obtained directly from the marketplace. This approach to value is based on the premise of future benefits accruing to the owner and therefore is better measured of anticipated future benefits. Simply put, the appraisal process requires an appraiser to view the property and the market from three perspectives – a look back to understand trends and behaviors of investors/users, a present view to understand supply and demand and the situation that investors/users face, and a forward view to measure the potential benefits of ownership.

Myth 2. *CRE properties are too hard to value.*

Some have also tried to argue that many properties are simply too hard to value. This argument leaves a false impression of real estate appraisals. While there are many hard-to-value properties, especially in today's market where few sales are taking, the task is performed frequently by trained competent appraisers. In fact, highly trained real estate appraisers employ residual valuation techniques when necessary.

Myth 3. *There are not enough qualified appraisers to handle the distressed CRE workload.*

Members of our respective professional appraisal organizations have met rigorous education, experience, testing and peer review requirements. Our organizations offer training to tens of thousands of appraisers on valuing complex properties such as subdivisions, land and distressed commercial real estate. Combined, our organizations represent more than 35,000 professional appraisers, resulting in an ample supply of valuation expertise in virtually every market in the United States.

Professional Appraisal Concerns

Our organizations have concerns with regard to current federal regulations, guidelines and practices within the regulatory sphere involving collateral valuation:

1. *Securitization processes:* While securitization plays a critical role in providing liquidity to the marketplace, we believe greater due diligence, particularly in the area of collateral analysis, is long overdue. Unfortunately, the structures of the secondary market and the relatively long period of success it had in recent decades lulled many into believing that secondary market risks in commercial real estate were non-existent or unlikely. Here, as with any investment decision, due diligence and risk management – The Three C's – should be areas of primary importance.

   In my capacity as President of the Appraisal Institute, I have had opportunity to travel internationally and discuss commercial real estate issues with government officials, investors and borrowers throughout the world. What I have learned from these conversations is that much of the world looks to the United States for guidance in establishing procedures of their own in mortgage lending and real estate finance. For instance, new emerging market economies in Eastern Europe, such as Ukraine, modeled much of their real estate valuation regulatory structure after ours here in the United States. The same is true for many other countries.

   What has been striking in some of my recent conversations is the extent of concern that many foreign observers have with how the United States conducts due diligence in both the primary and secondary real estate markets. Many have expressed severe concern with the "wild west" attitude found in many quarters of the real estate industry. As a result, many foreign investors are reconsidering their investments in the United States.

   For us, it is clear that if we are going to retain and attract new investment, we must earn back the trust of investors worldwide. Put another way: we have an opportunity today to embark on a path that builds confidence in our financing systems, winning back investors and promoting economic growth. We firmly believe that enhanced due diligence that more closely examines collateral valuation is part of that effort to rebuild investor confidence.

   While the secondary market may obtain appraisals and environmental site assessments as part of due diligence requirements, we believe that enhancements of these processes are essential. Appraisals should give full consideration to fundamental market considerations.

   The U.S. financial system has operated under an unlevel playing field – banks are required to comply with the sweeping changes of Title XI of FIRREA, but the securitized industry has not. This resulted in an unfair playing field for many financial institutions, and some may argue a weakening of the appraisal product produced for securitized products.

   With participation loan packages, where a large number of properties are marketed to large number of banks, the complexity of the package may be beyond the capacity of the participant to analyze adequately. Our members report that detailed information on appraisals may be limited and the timeframe to make a loan decision may be short, hence comprehensive analysis may not be feasible. This may result in participation based on reputation of "lead" financial institutions, and that likely does not adequately assess collateral risk.

   Another problem is that requests for proposals (RFPs) for appraisal services are often premised on who offers the lowest bid. Emphasizing pricing over competency can result in lower quality appraisal services that do not adequately capture the complexity of the real property assignment. This can be compounded with appraisal reviews that are also based on similar low-bid arrangements.

In the end, we believe there are a number of areas that can be strengthened in collateral valuation in the secondary market. Appropriate guidelines and enforcement of those rules and regulations can enhance the confidence of investors. While lenders prefer portfolio analysis over appraisals of individual collateral property, both are needed; individual valuations provide a check on, and help build and strengthen overall portfolio analysis.

2. *Inconsistent and inadequate regulatory agency oversight and enforcement:* We believe oversight of financial institutions due diligence procedures is limited. Currently the federal agencies do not have sufficient qualified real property analysts to properly monitor and adequately enforce existing regulatory policies. Auditing teams typically do not contain licensed or certified real estate appraisers, yet having trained professionals would be a best practice in adequately assessing real estate collateral policies.

   A recent review conducted by the Appraisal Institute indicates that two-thirds of failed banks from 2009 were previously cited for appraisal administration problems by federal bank regulators and that many of these issues remained unresolved at the time of the bank failure[1]. In other words, many financial institutions are not conducting sound collateral risk management, and while regulators are often citing the institutions, little action has actually occurred to resolve the issues found in the citation. This problem illustrated very well by a recent Material Loss Report of IndyMac Bank, where that institution had been cited for appraisal administration shortcomings numerous times over a seven-year period leading up to the bank failure[2].

   The concerns identified in the Material Loss Reports are consistent with concerns expressed by our members, who have reported a clear lack of consistency among bank examiners on real estate appraisal issues. This highlights a significant challenge – building appraisal capacity within the financial institutions themselves and within the federal bank regulatory agencies and the bank examiner community.

3. *Vague and confusing guidelines:* The bank regulators often have been cited for issuing guidelines that are NOT generally understood by financial institutions and the real estate community at large. This problem is extremely acute with regard to commercial real estate and real estate valuation issues, where there remain many questions unresolved from guidelines issued in the early 1990s. For example, when the Interagency Appraisal and Evaluation Guidelines were issued in 1994, they explained when appraisals are required in federally related transactions. They also permitted extensive exemptions from professional appraisal requirements. One exemption allows for an "evaluation" rather than an appraisal in loan renewal, refinancing and workout situations under certain conditions, including where no new monies are advanced and when there are "no material changes in market conditions." The understanding of many appraisers and financial institutions is that where material changes in market conditions have occurred a new appraisal is required in a loan renewal or workout situation. However, that term has not been defined within the guidelines themselves leading

---

[1] Available at http://www.appraisalinstitute.org/ano/archive.aspx?volume=11&numbr=3/4#9472

[2] Available at http://www.ustreas.gov/inspector-general/audit-reports/2009/oig09032.pdf

to varying degrees of debate over what constitutes a material change. Further, the responsibility for determining when a material change has occurred is not addressed at all.

Another example: the recent guidance issued on Prudent Commercial Real Estate Loan Workouts has not been understood by many financial institutions and industry participants. We have heard reports from our members that the guidelines are well-intended but not adequately descriptive, and as a result were not generally understood. Further, the new guidelines reference accounting standards that have been recently updated and changed, which themselves take time to study, understand and implement. Moving forward, we believe all facets of the commercial real estate industry must be involved in the development and implementation of clear guidelines that are essential to prudent decision making.

4. *Loan Production Objectives Over Risk Management:* Appraisal organizations have had a long-standing concern with how loan funding decisions are made within many financial institutions, in particular the propensity to place the interests of loan production ahead of appropriate due diligence and risk management. There are myriad reasons for this concern, but the most common is that many parties within an institution are incentivized to make almost any deals. Loan officers may be paid on commission. A key underlying fact is that financial institutions cannot make money unless they are making loans. Federal regulatory agencies and financial institution reserves are funded out of bank assessments. S some therefore argue that even bank regulators themselves have an interest in loan production.

   Regardless of the potential incentives or conflicts of interest, we believe more emphasis must be placed on making safe and sound loans, rather than making lending decisions focused on achieving volume alone. As loan officers are incentivized to close loans because financial institution profits are indirectly generated by loan production, the temptation to make loans of marginal or dubious quality is great. Further, many loan committees are presented with very limited information about the underlying collateral and the appraisal report. In many cases, loan committees advised whether the appraisal was prepared in accordance with uniform appraisal standards, in addition to the loan-to-value information. In other words, the only information the committee has is the number provided on the front page of the appraisal report. Within the appraisal report, the appraiser could have advised that the property was in a highly volatile market, or it could have indicated a possible range of values. By not relying on the collateral as an essential form of security for loan repayment, many loan committees too often make their loan decisions today by looking at the revenue of the property and the creditworthiness of the commercial loan applicant, with not nearly enough attention to the underlying collateral.

   We share similar concerns in the area of loan monitoring, which in many institutions is conducted by loan officers with limited training and expertise on valuation issues. Current regulatory bulletins advise loan officers to review loan performance on a regular basis, but this is typically done by simply reviewing cash flow and property information and often does not involve the appraisal department or those with professional valuation experience and training. However, if the security of the loan is based exclusively or mainly on the credit and the borrower defaults, the institution with only has the underlying real estate, to make it whole. Here again, due diligence must be emphasized and play a more integral role.

5. *Disincentives for obtaining a credible appraisal:* There exist many disincentives to obtaining credible appraisals in loan origination, loan monitoring and property disposition. As previously discussed, loan

production forces often outweigh risk management, and place a great deal of pressure to close the deal. However, such disincentives exist in loan monitoring as well. A current example of this: a bank president was found guilty of bank fraud for concealing the existence of several appraisals recently conducted by the bank in advance of an examination[3]. The appraisals did not report a pretty picture – significant declines in market value of the underlying assets held as security for several commercial real estate loans. The bank president apparently advised staff to make sure that the appraisals "did not see the light of day."

According to press accounts, when examiners arrived, they conducted a thorough review and were about to give the bank a clean bill of health, when a staff person, or whistleblower, advised that the president had not been truthful with the examiners. Examiners were directed to look underneath a desk and in a box where they would find updated appraisals that had been concealed for the examination.

Of course, the effort undertaken by that bank president is extreme, but it does illustrate a common concern in many institutions today. Banks do not want to obtain updated appraisals because they may result in their having to increase their capital reserves. Many borrowers do not want updated appraisals because they may result in an "equity call." These concerns can be compounded by the examination process itself, which can operate on a "don't ask – don't tell" arrangement. Our members report that access to the audit team is often restricted by senior bank management and is diligently monitored and scrutinized. Examinations can also be restricted by the size of the audit team as well as the time allocated to the audit. Further, during the examination, auditors typically only review a sampling of files in an effort to look for discrepancies. We are not promoting write downs and equity calls. We believe that having adequate, timely information provides the opportunity for better solutions.

In our view, the function of the real estate appraisal is to provide parties with credible, timely and, most importantly, independent information to help with business decisions and to protect the public trust. However, the appraiser's role must be protected, respected, and enhanced for it to be successful, as the various interests that exist can often overwhelm our role.

6. *Appraisal Competency:* Federal guidelines presently require residential loans higher than $250,000 and commercial loans over $ 1 million, are required to have a licensed or certified real estate appraiser (with complex commercial properties and those over $1 million requiring a certified general appraiser). The licensing regulations were enacted to establish the "minimum" level for competency, and do not outline a hierarchy for experience and competency requirements for increased complexity of the real estate collateral.

   Further, the federal agency guidelines do not require financial institutions to maintain an internal appraisal department to order or review the valuation of the collateral. Additionally, if an internal appraisal staff is maintained, reporting is often to loan production via the chief credit risk officer. While this is not commonplace in some of the larger lending institutions, it is known to occur in regional and smaller banking environments, where insufficient safeguards to protect appraiser independence may not been clearly instituted. The commercial loan officer representing the loan applicant is often the only representative present at the decision-making committee.

[3] Available at http://blog.oregonlive.com/frontporch/2010/02/former_bank_of_clark_county_ex.html

Recommendations

We propose several recommendations to this Committee to address the concerns expressed above. For ease of understanding, we have divided these into two categories – 1) those to restore confidence in today's real estate market and 2) legislative suggestions.

Restoring Confidence in the Market

1. *Conduct Multi-Value Appraisals for Troubled CRE Assets*: In accordance with the recently released guidance on prudent CRE loan workouts, we recommend financial institutions engage appraisers to prepare three value estimates Fair value, Market value and Liquidation value) These values can be used in loan monitoring and reserve loss establishment in accordance with ALLL and proposed guidelines released by the Financial Accounting Standards Board.

2. *Implement Consistent and Robust CRE Monitoring Procedures*: Recently, the CFA Institute, an internationally respected association of finance officials, adopted an updated version of the Global Investment Performance Standards, which are recognized globally for investment management, including commercial real estate investment[4]. GIPS 2010 recommends an increase in the frequency of external valuations conducted by qualified real estate appraisers from once every three years to annually. We believe such policies are sound and have applicability in other forms of commercial real estate lending, including that overseen by the federal bank regulators. Further, we are confident that we can develop scopes of work that will allow periodic valuations to be delivered in a timely and cost efficient manner.

3. *Strengthen Interagency Appraisal and Evaluation Guidelines:* The federal bank regulatory agencies have released proposed Interagency Appraisal and Evaluation Guidelines that are expected to be finalized this year. The agencies should revise the proposed guidelines, strengthening the importance of professional appraisals and appraiser competency (as opposed to reliance on highly unreliable valuation products), and providing specific definition to key terms such as "complex" appraisals and "material change in market conditions." Further, the Guidelines should reinforce a recent Federal Reserve Board staff interpretation clarifying that commercial broker price opinions do not satisfy the definition of an "evaluation," meaning more sophisticated valuation skills and due diligence are required than simply utilizing a commercial BPO where an evaluation is allowed.

4. *Promote Appraisal Independence:* Require an internal collateral risk assessment/real estate appraisal department reporting directly to compliance (to maintain independence) staffed with qualified real estate appraisers who have obtained the appropriate experience and competency to review appraisals for compliancy. Further, appraisal reviews on the collateral should be reported independently by the appraisal department directly to the commercial loan committee.

5. *Increase Appraisal Capacity:* Increase staffing within the federal agencies to include individuals with the appropriate qualifications, experience, and competency (i.e., real property analysts or real estate appraisers) to perform an adequate analysis of the appraisal policies and procedures as well as the

[4] Available at http://www.gipsstandards.org/standards/current/2010_edition_gips.html

collateral within the loan portfolio. Additionally, we repeat our recommendation, made previously, that each federal banking agency establish the office of Chief Appraiser, who would report only to the most senior management of the banking agencies

Legislative Suggestions

1. *Enact the appraisal reform provisions found in H.R. 4173, the House version of the financial regulatory reform debate*: This legislation enhances appraiser oversight and enforcement and clarifies certain provisions to enhance commercial real estate collateral analysis.

2. *Support Financing to Small Business*: Specifically, support the Administration's request for an expanded SBA authorization for small business commercial real estate and working capital programs.[5] The plan proposes legislation to temporarily allow small businesses to refinance existing, qualified, owner-occupied small business commercial mortgages into SBA's 504 program, which provides guarantees supporting loans for the development of real estate and other fixed assets. Currently, 504 loans must be used for new development or construction — and can only include a limited amount of refinancing when businesses are expanding. The program promotes sound underwriting, including current market value real estate appraisals.

3. *Oppose increasing the appraisal threshold for Small Business Administration commercial real estate loans.* H.R. 3854, the Small Business Financing and Investment Act of 2009, introduced by Rep. Kurt Schrader (D-Ore.), passed the House of Representatives on October 29, 2009, and is currently pending in the Senate. Among other things, the bill raises the threshold for appraisals for commercial real estate backed by the Small Business Administration (SBA) loans from $250,000 to $400,000. In the last two years, the number of SBA loans that are more than 60 days past due, delinquent, or in liquidation has nearly doubled from 10 percent to 18 percent. Startlingly, more than 12 percent of SBA loans today stand in liquidation, *up from 6 percent in 2007. It is surprising that in today's financial climate, where bankruptcies are* facing some of the biggest SBA lenders in the country, Congress would even consider loosening basic risk management and underwriting requirements.

Closing Remarks

Our organizations stand committed to working with Congress, federal agencies, and our real estate industry groups and clients to address problems and concerns in the commercial real estate market. Our profession represents a relatively small component in commercial real estate finance, but it is one that carries a great deal of importance. We look forward to working with the Committee and others moving forward.

Thank you for the opportunity to appear before you today, and I am happy to answer any questions you may have.

---

[5] Available at
http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf

Statement of

Kevin Stoklosa

Assistant Technical Director

Financial Accounting Standards Board

Before the House Financial Services Oversight & Investigations Subcommittee

"Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses"

Chicago, Illinois

May 17, 2010

Good afternoon. Mr. Chairman and members of the Subcommittee, my name is Kevin Stoklosa, Assistant Director of Technical Activities at the Financial Accounting Standards Board ("FASB"). Thank you for inviting me to participate in today's important hearing. I have brief prepared remarks and would respectfully request that the full text of my testimony be entered into the public record.

Since 1973, the FASB has established standards of financial accounting and reporting for nongovernmental entities, including both businesses (public and private) and not-for-profit organizations. Those standards are recognized as authoritative Generally Accepted Accounting Principles (GAAP). GAAP is essential to the efficient functioning of the U.S. economy because investors, creditors, donors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make resource allocation decisions.

Because the actions of the FASB affect so many organizations, the FASB carefully considers the views of all interested parties, including users, auditors, regulators, and preparers of financial information in its decision-making process. Although the FASB and regulators have different objectives, because of their keen interest in GAAP financial statements as a starting point in their assessment of the safety and soundness of an entity's financial position, the FASB members and staff regularly meet with regulators to obtain their input and better our understanding of their views.

The Subcommittee is examining the causes of the turmoil in the commercial real estate (CRE) market, and the state of the market. I would like to focus my remarks on the FASB's accounting guidance that most significantly affects these companies.

From the perspective of entities that develop, purchase, or own commercial real estate, the accounting guidance requires those entities to measure the investment at historical cost. Under this accounting model entities are required to capitalize certain costs incurred in the development or acquisition of commercial properties. GAAP provides prescriptive guidance on what costs should be capitalized and when capitalization of those costs should cease to continue. Testing properties for impairment during both the construction stage and once the property is available for occupancy is also required.

As a result of input from both preparers and users of financial statements, the FASB has recently added a project to its agenda to reconsider whether entities should be permitted (or required) to measure investment properties at fair value, instead of historical cost. International accounting standards currently permit investment properties to be measured at fair value.

From the perspective of entities that finance commercial real estate, the accounting guidance is based on whether the creditor holds the loans or whether the creditor transfers or securitizes the loans. Last year, the FASB issued Statements 166 and 167 which were needed improvements to the accounting and reporting for transfers of financial assets, including securitizations, and other involvements with special purpose entities. This guidance, which still allows for entities to obtain sale accounting (and thus gain on sales) should result in more assets involved in such transactions staying on the books of the sponsoring financial institutions, by significantly reducing the ability to get off-balance sheet treatment for securitizations and similar arrangements where significant risk is retained by the entity. Although this guidance will better reflect financial institutions exposure to risks, it may affect their ability to comply with the regulatory capital requirements and therefore affect the liquidity available to the CRE industry.

Mr. Chairman that concludes my prepared remarks. I would like to thank you and the Subcommittee for the opportunity to testify this afternoon. I would be happy to answer any questions.

FOLLOW-UP Questions from the May 17, 2010, Subcommittee on Oversight and Investigation field hearing entitled, "Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses" directed to Ms. Cathy Lemieux, Executive Vice President, Supervision and Regulation, Federal Reserve Bank of Chicago

1) Should TALF be extended to help stabilize the CRE market? (page 79, line 1687)

The TALF program supported the issuance of asset-backed securities and commercial mortgage-backed securities (CMBS) by providing funding to investors in those securities. The TALF was authorized using the emergency authority of the Federal Reserve to lend to institutions other than depository institutions in unusual and exigent circumstances. As financial market conditions normalized, the Board of Governors closed the TALF program on June 30, 2010. The CRE market is not currently being restrained by a lack of funding for CMBS or illiquidity of CMBS. Instead, there are substantial obstacles to the origination of new commercial mortgages or the refinancing of existing commercial mortgages. Consequently, TALF financing for investment in CMBS would be unlikely to help stabilize the market.

2) If the Fed recognized in the 1980s and 1990s the problems with the rising CRE concentrations, why did it take until 2006 to issue guidance? (page 87, line 1887)

The Federal Reserve and the other banking regulators responded promptly to CRE's role in the earlier banking crisis. For example, following passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the banking agencies adopted regulations in August 1990 on the performance and use of appraisals by federally regulated financial institutions. Since that time, the banking agencies have issued extensive related guidance emphasizing the importance of independent appraisal and evaluation functions. Another example is the uniform regulations prescribing standards for real estate lending adopted by the banking agencies in December 1992 following passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). These regulations require institutions to adopt real estate lending policies that are consistent with safety and soundness and appropriate to the size and complexity of the institution. They also incorporate specific loan-to-value limits for different categories of real estate loans. These regulations and other initiatives have strengthened supervision of banks' CRE lending in the intervening years.

The Fed and the other banking agencies also took prompt actions in response to the rapid rise in CRE concentrations that occurred in the early part of the 2000s. They intensified their supervision of banks' CRE lending in a number of ways, including conducting "horizontal" reviews of this activity across a number of banks, developing better analytical tools for examiners to use, and expanding their use of real estate market data. These efforts culminated in the issuance of final supervisory guidance in 2006.

3) Five years ago, what did the regulators do to try to change the allocation of loans at community banks to reduce CRE concentrations? (page 88, line 1917)

The Federal Reserve and the other banking supervisors generally do not attempt to allocate credit – that is, to determine how much an individual bank (or the banking system as a whole) should lend to particular types of borrowers. Instead, supervisors expect bank management to identify, measure, monitor, and control any loan concentrations in their portfolios. Banks should have adequate management information systems to identify loan concentrations. They should also have effective policies, systems, and internal controls to monitor and manage risks of loan concentrations. Banks that need to reduce concentrations are normally expected to develop a plan that is realistic, prudent, and achievable in view of their particular circumstances and market conditions. Such a plan could include holding more capital in lieu of reducing lending.

The banking agencies applied these principles to rising CRE concentrations in recent years. The final supervisory guidance issued in 2006 reinforced and enhanced long-standing regulations and guidelines for safe and sound real estate lending. Since what is a manageable level of concentration risk depends on portfolio risk characteristics, the quality of risk management, and the level of capital, the guidance does not establish concentration limits that apply to all institutions. Instead, it guides banks in developing risk management practices and levels of capital that are commensurate with the level and nature of their CRE concentrations.

4) Would legislation on CRE underwriting standards be helpful? (page 99, line 2174)

In 1993, the regulatory agencies adopted real estate lending standards pursuant to implementing Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The final rule requires every depository institution to establish and maintain comprehensive, written real estate lending policies that are consistent with safe and sound banking practices and appropriate to the size of the institution and the nature and scope of its operations. The institution's board of directors must review and approve at least annually its real estate lending policies. The lending policies must establish:

- loan portfolio diversification standards;
- prudent underwriting standards, including loan-to-value limits, that are clear and measurable;
- loan administration procedures for the bank's real estate portfolio; and
- documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policies.

Federal Reserve supervisory officials and examiners monitor lending standards and practices in connection with ongoing supervisory activities and the conduct of on-site examinations. One of the principal objectives of an on-site examination is to evaluate loan underwriting practices and the quality of bank loan portfolios. As part of the routine procedures for evaluating bank loan portfolios, examiners ascertain whether credit terms and standards have eased since prior examinations, and if so, whether the bank's lending activities remain within the bounds of prudent underwriting practice.

After each examination, the exit interview includes a general discussion of the bank's lending policies and practices. As part of this discussion, an effort is made to determine management's views on the bank's current lending terms and standards, as well as on market practices more generally. Where applicable, management and directors are reminded of the necessity to take into account the potential effects of changing economic conditions when evaluating the adequacy of loan loss reserves and capital, assigning internal loan risk ratings, and interpreting management reports.

5) Have there been any easy-to-explain systematic differences between bank charter types in lending practices and CRE problems? (page 100, line 2213)

Prices of existing commercial properties are estimated to have declined 35 to 40 percent since their peak in 2007, and market participants expect further declines. Demand for commercial property has declined as job losses have accelerated, and vacancy rates have increased. The higher vacancy levels and significant decline in the value of existing properties have placed particularly heavy pressure on construction and development projects that generate no income until completion. Developers typically depend on the sales of completed projects to repay their outstanding loans, and with the volume of property sales at especially low levels and with prices depressed, the ability to service existing construction loans has been severely impaired.

Almost $500 billion of CRE loans will mature each year over the next few years. In addition to losses caused by declining property cash flows and deteriorating conditions for construction loans, losses will also be boosted by the depreciating collateral value underlying those maturing loans. These losses will place continued pressure on banks' earnings, especially those of smaller regional and community banks that have high concentrations of CRE loans.

○