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

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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 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. 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 –

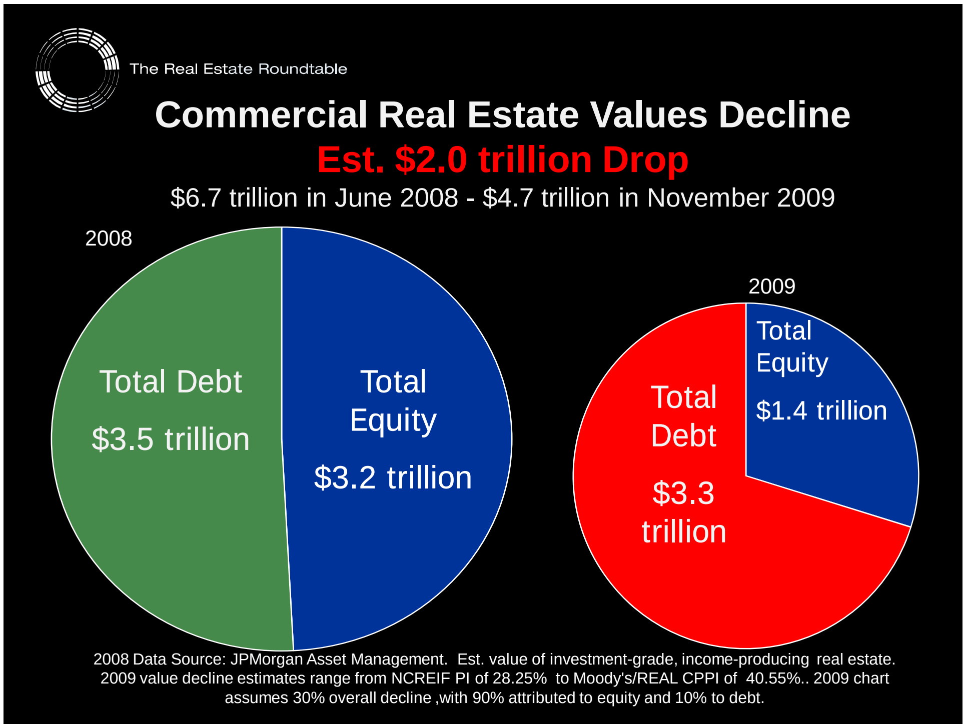
- **Jobs.** Lift the cloud of regulatory uncertainty; foster a climate for job growth, investment and economic expansion.
- **Equity.** Enact measures to encourage capital formation and rebalance markets by filling the massive equity gap. Encourage foreign investment in U.S. real estate by revising the 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.

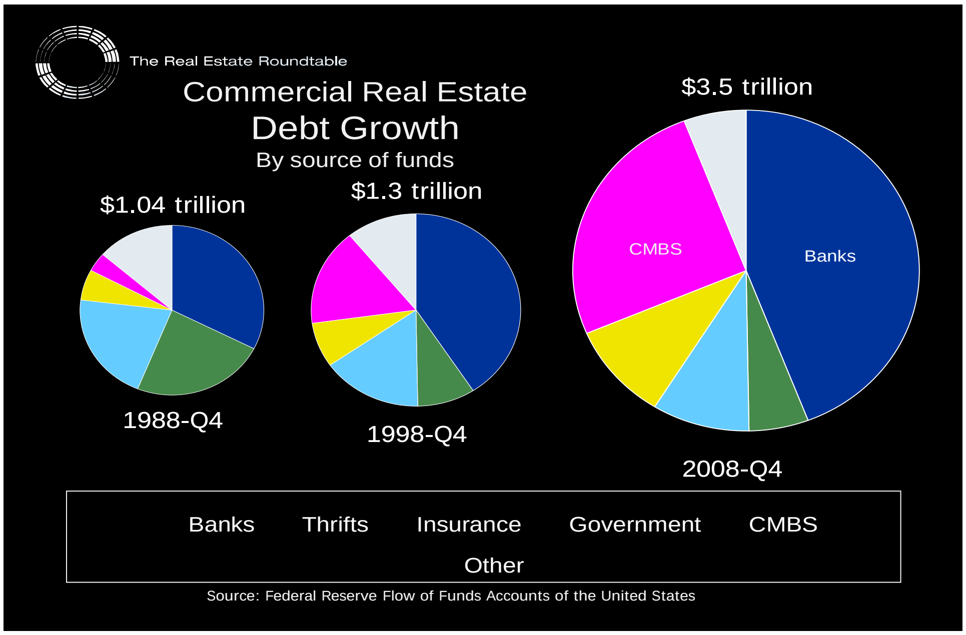
Second, and in many respects more importantly, except for a narrow segment of the market, the credit markets remain essentially closed to refinancing existing real estate debt or securing new debt to facilitate transactions. The continued lack of a functioning credit market puts further downward pressure 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.

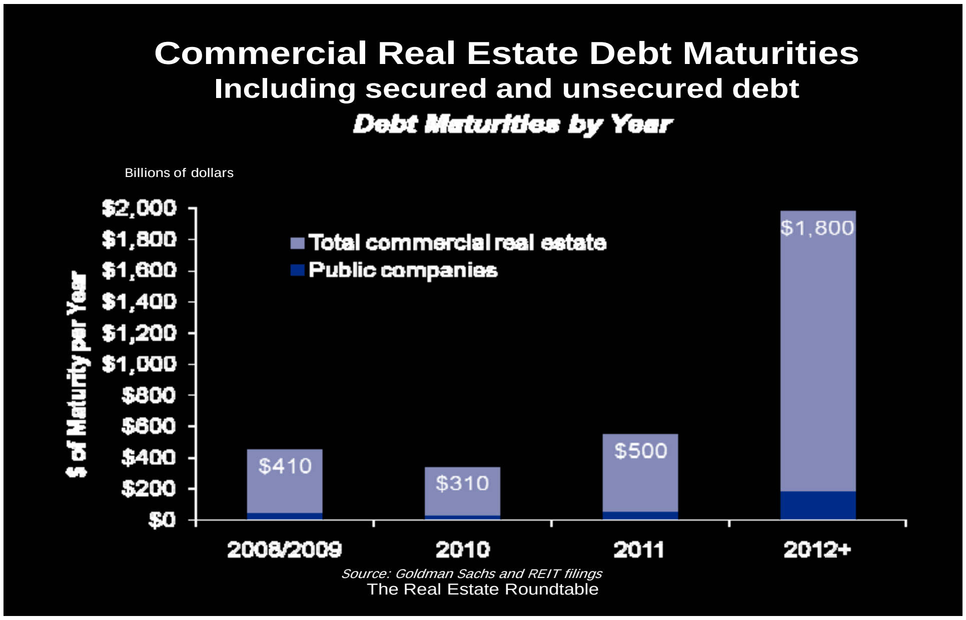


Most commercial real estate debt has loan terms of 10 years or less, and therefore a significant percentage of outstanding debt matures each year and needs to be refinanced. The three largest providers of credit to the sector are: 1) commercial banks, with $1.5 trillion, or

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.

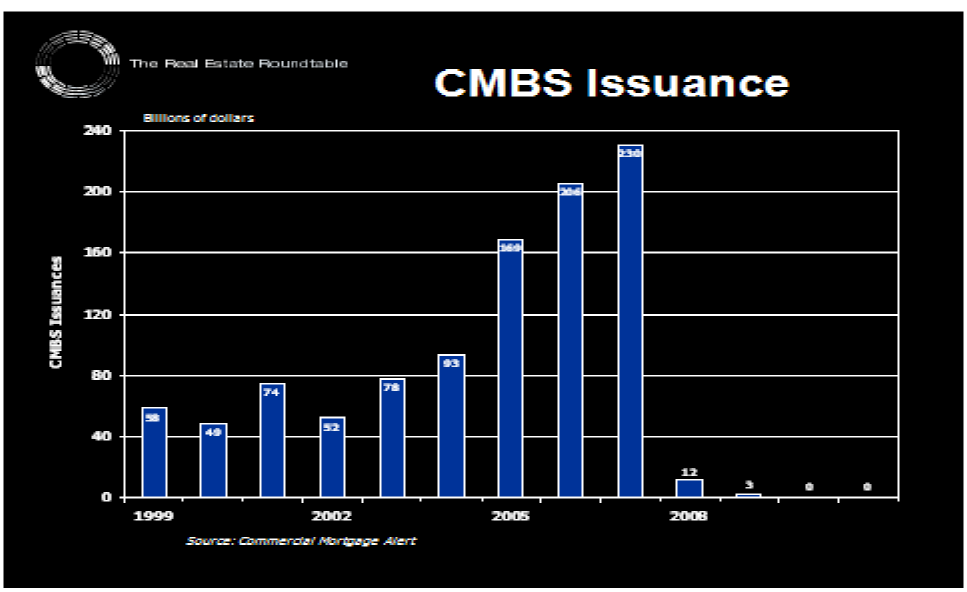


In 2010, the amount of maturing commercial real estate loans is estimated to be $300 billion. Maturing debt in this sector continues to expand. With an average $400 billion of commercial real estate debt maturities each year for the next decade, the credit market as it is currently structured does not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

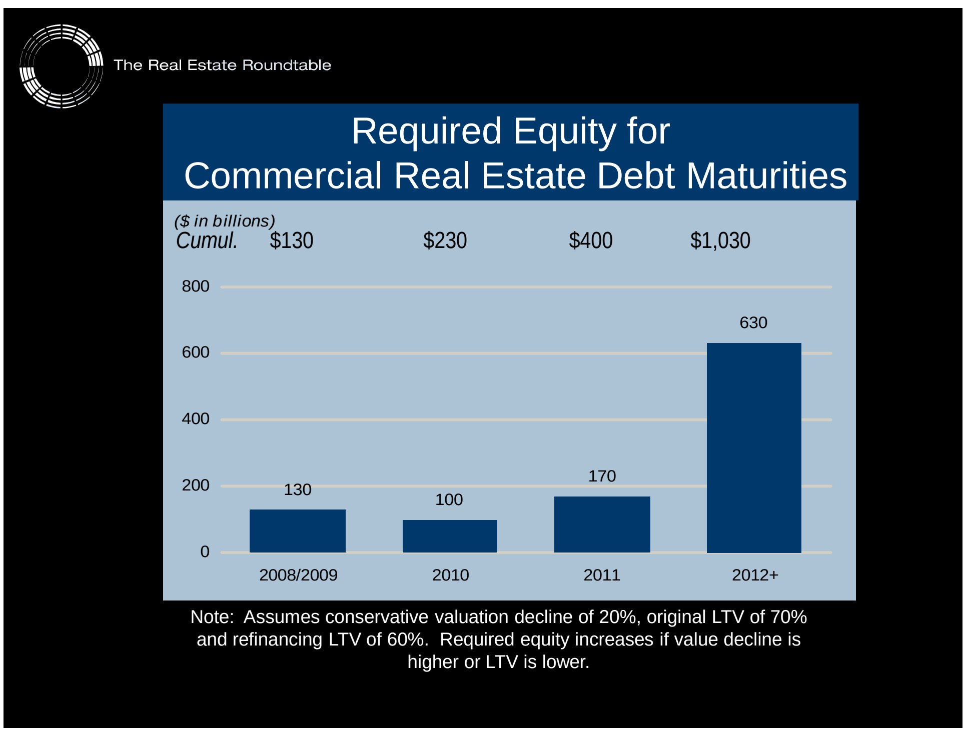
Even if commercial banks return to the market in force, these institutions simply do not have the capacity to satisfy demand. Therefore, steps must be taken to restore active asset-backed and commercial mortgage securitization markets.

- **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 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.