Testimony of David W. Turnbull
to the
Committee on Financial Services
&
Committee on Small Business
U.S. House of Representatives
Washington, D.C.
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Mr. Chairman and Members of the Committee:

I appreciate the invitation and opportunity to testify before you today.

I am the president and owner of a diversified real estate development and investment firm headquartered in Boise, Idaho. In addition to our business activities in Idaho we have projects in Colorado, Minnesota, Wisconsin and Utah. Our real estate development activities span residential land development, home building, and commercial development including retail, office and industrial properties.

I have been asked to address a number of topics, but first I would like to make a couple of observations. Given the nature of my business, I have been a ground-zero witness to a series of economic events that has brought the economy of the United States and the world to its knees. I watched as a residential real estate bubble inflated seemingly overnight by cheap credit, loose and in some cases fraudulent underwriting practices, and certainly inadequate regulation. Much of it was not supported by the underlying economic fundamentals and a correction was inevitable. What was avoidable, with proper policy response, was the depth of the correction and the associated collateral damage.

I watched as prominent government officials and economists opined that the residential real estate calamity was "contained" and would not likely spill over into the general economy. I shook my head in wonder. Perhaps I was too immersed, too close to the residential real estate market and gave undue weight to its significance to the overall economy. But everything I saw in our local economy was deeply impacted by the health of housing.

Few could have forecast the scope of the housing crash we've experienced over the last 4 years. In spite of my cautious outlook at the time, my worst case scenario for our market was a 50-60 percent correction in housing starts, a forecast met with skepticism by many of my colleagues. But I was too optimistic. Housing starts in our markets have fallen 80 – 85 percent. To us, this is not a recession; it's a depression.

It is now widely acknowledged that the economic impact of the housing market downturn was not "contained" and that it is the primary cause of the current recession – the worst recession in most of our lifetimes.

Although one of the topics of today's hearing is the state of commercial real estate lending in local markets, I think it's important to draw attention to the fact that this all started with the residential markets. Even though there are some parallels between the residential and commercial real estate markets, our experience is that commercial real estate lending markets were not out of line with underlying fundamentals. I can assure you that each of our loans was meticulously and conservatively underwritten, but I am sure there are other loans, particularly in the larger metropolitan areas, that were underwritten with less conservative criteria, such as pro-forma rents instead of actual rents.

I'll refer to a few data points to illustrate my assertion. The first office lease I did in 1990 was at $13.50 per sq. ft. 1990 was not a particularly good year for commercial real estate. In 2008 – 18 years later and at the height of the market - I was leasing office space in superior buildings for $18.50 per sq. ft., a compounded annual rate of increase of just 1.77%. These are not the kind of numbers that suggest a bubble in commercial real estate in our market, yet we are still being devastated by the global lack of credit for commercial real estate, which I'll illustrate with another personal example. An office building that I sold in 2002 for $2,700,000 recently failed to sell in a foreclosure auction for the creditor's minimum bid price of $1,000,000. The replacement cost of the building, even with today's lower construction costs, is in excess of $2,200,000. This is not an isolated example and it is indicative of what can happen to the value of commercial real estate when it becomes a cash market. Values can drop 30 to 50 percent below replacement cost. The markets have clearly ceased to function and normality won't be restored until we have reconstituted credit markets, primarily in the form of the securitization model.

Now I would like to address some of the questions put to me in the invitation to testify before you today.

The President has announced a new proposal to provide capital to small banks designed to increase small business lending. Please discuss your views on this proposal, including the effect you expect it would have on the financial condition of small banks and how it will be helpful in increasing lending to small businesses.

We have several prospective businesses that would like to further invest in their companies, including purchase buildings from us, but they are having difficulty obtaining the credit to do so, even in the SBA loan program. Since small business is the primary source of new jobs in our economy I think it is very important to provide the credit and liquidity to them to make it all possible. The perception on Main Street is that nearly everything done to-date has benefitted Wall Street and the big companies and very little of that has directly benefitted small business. I believe that perception has some merit.

What general challenges do small and mid-sized businesses face in obtaining commercial real estate credit? In your view, are depository institutions contributing or in a position to help turn around the local economy? Why or why not?

It is my observation that the liberal monetary policy available to depository institutions via the Fed and the Treasury has alleviated the most severe credit dislocations, including the markets for credit cards, auto and other consumer loans, but the benefits are not fully filtering down to the end users of credit. Many banks have instituted interest rate floors and other provisions that were not prevalent a few years ago, thus increasing their net interest margin and making credit to borrowers more expensive. Major financial institutions are said to be engaged in the mother of all carry trades, wherein they obtain funds through the discount window or from deposits at near zero interest rates and invest the funds in safe and secure Treasury instruments for a generous yield. This carry trade, financed by the Fed and the US Treasury, is not exactly what the taxpayer or perhaps Congress had in mind when it approved the TARP and TALF programs. The incentive for banks to take risk is exceedingly low and thus, while the most credit-worthy customers can still obtain financing, albeit at a greater cost, most businesses are being shut out of the credit markets.

Of course, many depository institutions are in a position to provide additional credit to small and mid-sized businesses, both for commercial real estate credit and for ordinary operations. But there are many banks that are not. The expeditious consolidation of banks that have severely compromised capital positions is important. We do not want to repeat the Japanese experience. At the same time, I know of well capitalized banks that are under extraordinary regulatory pressure to curtail lending and reclassify loans seemingly in contradiction to stated policy guidance and representations from agency directors.

Discuss your views about the liquidity being provided by the secondary commercial real estate markets, particularly the commercial mortgage-backed securities (CMBS) markets. Please also discuss your views about whether the Term Asset-Backed Securities Loan Facility, administered by the Federal Reserve, is providing support to the commercial mortgage-backed securities markets?

The disintegration of the CMBS market is one of the two most serious issues facing commercial real estate markets, the other being the general economic environment. While the TALF program has been effective for reconstituting the ABS market for credit card, auto and other consumer loans, in my view it is ill-suited to resurrect the secondary credit markets for commercial real estate. The TALF requirements are so complex that it is realistically available only to the very sophisticated and elite borrowers.

Securitization, in my view, is the most critical component of the secondary or term loan market. <u>It provides for the democratization of credit</u>. Properly structured, securitization should reduce risk and thus provide credit at the most reasonable cost possible. A reconstituted CMBS market must have at least four characteristics that were not required under the now defunct system:

1. Bond issuers, those that are responsible for the underwriting and issue the debt, must retain a significant level of risk to ensure proper underwriting procedures.

While an up front fee may be appropriate, the issuer's compensation should be based on performance of the asset over time.

2. Rating agencies must be accountable for the ratings they issue and should be compensated by the purchaser, not the issuer of the security.
3. Servicers must be authorized and given the tools to effectively deal with troubled assets within the security pool.
4. Initially, federal guarantees will be required to stimulate the formation of a functional CMBS markets. Those guarantees can be phased out over time as the private sector gains confidence in the system and replaces the need for federal participation.

Too much time has passed without adequate action to resolve this problem. The President, Congress, and regulatory agencies should move expeditiously to pass the necessary legislation and/or regulation needed to reconstitute the CMBS markets. Failure to do so will result in further unnecessary devaluation of commercial real estate assets and the associated damage to the economy.

What legislative, regulatory or other impediments are hindering the ability of banks to increase the availability of small business and commercial real estate credit? What more can be done on either a regulatory or legislative basis to help increase credit availability for commercial real estate generally?

The primary obstacle to banks providing needed credit to legitimate borrowers is the legacy assets that encumber their balance sheets with no good conduit to dispose of them. The best solution, in my estimation, is for the government to provide a securitization model to move new originations off the balance sheet, with the following provisions:

1. The government could use existing GSE's by expanding their charter to include commercial real estate. For example, Fannie Mae already underwrites commercial real estate in the form of multifamily housing. It has the structure in place to expand that program to include office, industrial and retail properties.
2. The GSE would set forth underwriting standards and loan criteria.
3. The banks would be allowed to earn a reasonable origination fee up front.
4. The interest spread would be earned over time based on the performance of the asset, thus instituting a pay-for-performance model with the proper incentives.
5. Existing loans that meet the criteria could also qualify within the standards established.

Consider this: Without the existence of FNMA (Fannie Mae), FHLMC (Freddie Mac), and FHA, we wouldn't have a housing market today and we would be in a full-blown depression. The only equivalent we have today for these conduits in the CRE market is TALF – the equivalent of the Fed creating a super-jumbo market for residential real estate while leaving the entry level to median priced home buyers dangling with no viable options. It will not solve the problem.

Is there a scarcity of demand for small business or commercial real estate borrowers? If so, is that because credit standards have become more stringent, potential borrowers are more financially constrained, or some combination of both.

In my opinion, loan demand has decreased due to the state of the economy and the general need of businesses to deleverage. However, there is not a scarcity of demand for credit and the demand that does exist is too often going unfulfilled because of tighter credit standards and the general state of the economy placing severe pressure on the balance sheets of even the best businesses.

The financial regulators of the Federal Financial Institutions Examination Council issued a policy statement entitled *Prudent Commercial Real Estate Loan Workouts* on October 30, 2009. Does this statement and other statements of the FFIEC relating to commercial lending provide sufficient guidance regarding the need to increase credit availability while maintaining prudent lending standards? Has such guidance been helpful? Has bank supervision been consistent with the guidance?

I believe that the October 30, 2009 policy statement has provided excellent guidance to banks and regulators in dealing with a variety of complex and sometimes difficult loan scenarios. In my discussion with several bank CEO's about this matter, it seems that the policy is not being uniformly implemented by the regulators. Some banks' experiences have been satisfactory and some have not.

There is considerable anecdotal evidence, particularly in the commercial real estate and small business sectors, and in other businesses generally, that long standing customers of banks with existing lines of credit are having that credit pulled altogether, or significantly reduced on roll-over, even for projects or businesses in which substantial capital investments have been made. Please discuss.

My experience is that banks have generally acted responsibly in dealing with their customers but I'm sure there are plenty of anecdotes that would suggest otherwise, sometimes fairly and sometimes not. We are in a deleveraging process and it is not always pretty, not always fair, and oftentimes painful.

I thank the committee for its consideration.