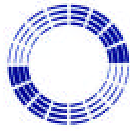

The Real Estate Roundtable

STATEMENT OF

JEFFREY D. DEBOER

ON BEHALF OF

THE REAL ESTATE ROUNDTABLE

UNITED STATES CONGRESS

JOINT ECONOMIC COMMITTEE

HEARING

ON

COMMERCIAL REAL ESTATE: DO RISING DEFAULTS POSE A SYSTEMIC THREAT?

RAYBURN HOUSE OFFICE BUILDING
ROOM 2226
WASHINGTON, DC

Thursday, July 9, 2009

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INTRODUCTION

Thank you, Chairman Maloney, Vice Chairman Schumer, Ranking Members Brady and Brownback, members of the Committee, for conducting today's hearing on the state of the economy with respect to commercial real estate.

I am Jeffrey DeBoer, and I am the President and Chief Executive Officer 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. 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.

The lack of credit has stalled transaction volume, which has fallen by nearly 80 percent. Asset values are estimated to have fallen from their peak by approximately 35 percent on average, and capitalization rates are presumed to have increased by approximately 250 basis points, while rents have declined up to 20 percent depending on the property type. Yet, with a scarcity of property transactions, there is no effective price discovery, and this further exacerbates the real estate credit market crisis – where loan-to-value is a critical metric used in the lending process. This is a market failure of catastrophic proportions.

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.

As detailed below, we recommend that the following policy actions should be enacted as soon as possible:

1. Extend the Term Asset-Backed Securities Loan Facility (TALF) beyond its current December 31, 2009 sunset date, through the end of 2010.

2. Establish a federally-backed credit facility, possibly created from the PPIP structure or a privately funded guarantee program, for originating new commercial real estate loans.

3. Encourage foreign capital investment in U.S. real estate by amending or repealing the outdated Foreign Investment in Real Property Tax Act (FIRPTA).

4. Encourage banks and loan servicers to extend performing loans, based on cash flow analysis; and, temporarily amend real estate mortgage investment conduit (REMIC) regulations to facilitate early review and possible modification to the terms of commercial mortgage loans that have been securitized in CMBS.

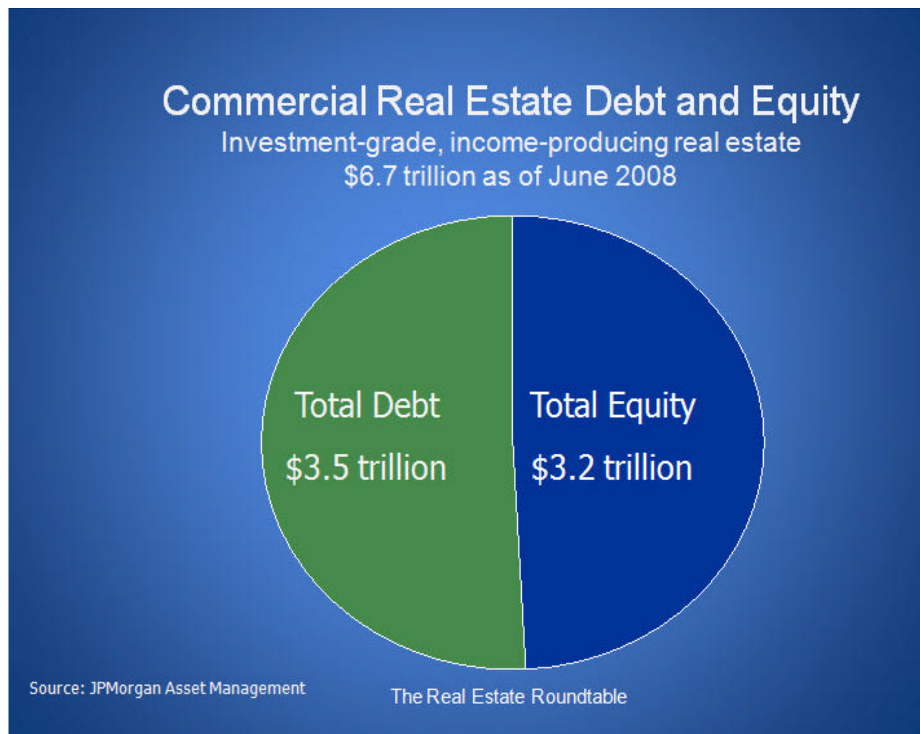
5. Reject new anti-real estate investment taxes, such as the carried interest proposal; and, provide a five year carry back for the net operating losses of all businesses.

THE CURRENT PICTURE

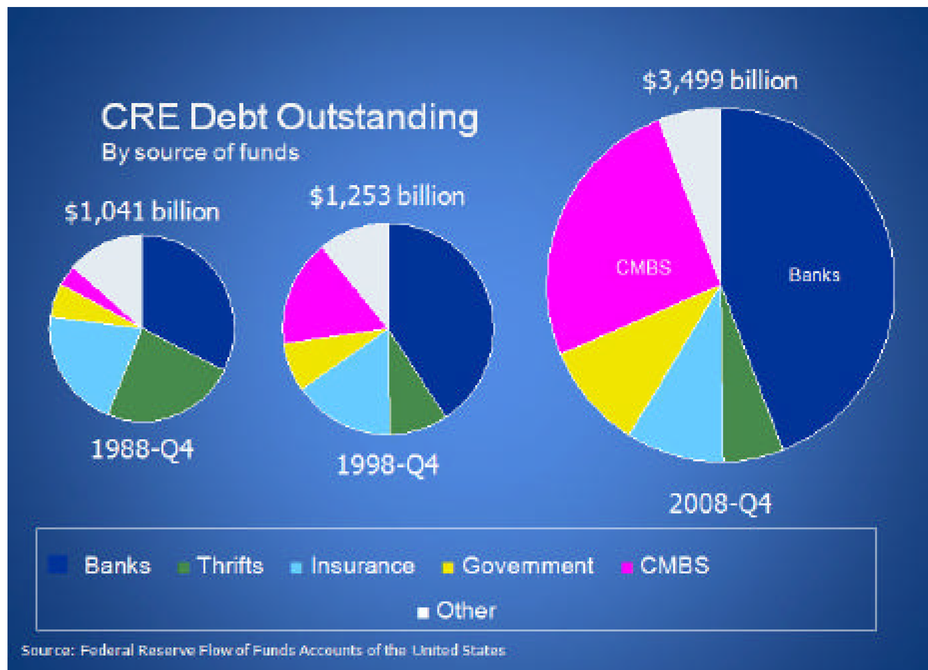
The commercial real estate industry is in deep stress for two reasons. First, the macro economy is caught in a "Great Recession": unemployment is high and likely going higher; consumer spending is down substantially; and business and personal travel is down. All of which results in reduced operating income for property owners and lower property values.

Second, and in many respects more importantly, the credit markets are essentially closed to refinancing existing real estate debt or securing new debt to facilitate transactions. The lack of a functioning credit market is putting 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.

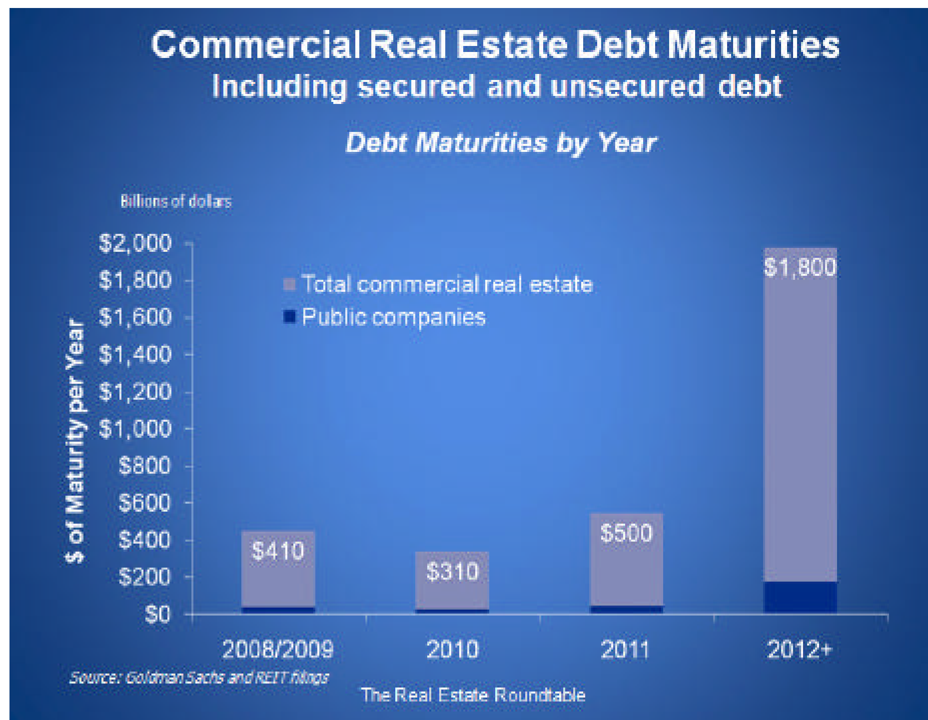
The size of the problem is large today and if not addressed could become large enough to undermine the positive economic growth signs that are starting to appear. Commercial real estate in America is valued at approximately $6.7 trillion. It is supported by about $3.5 trillion of debt.



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.

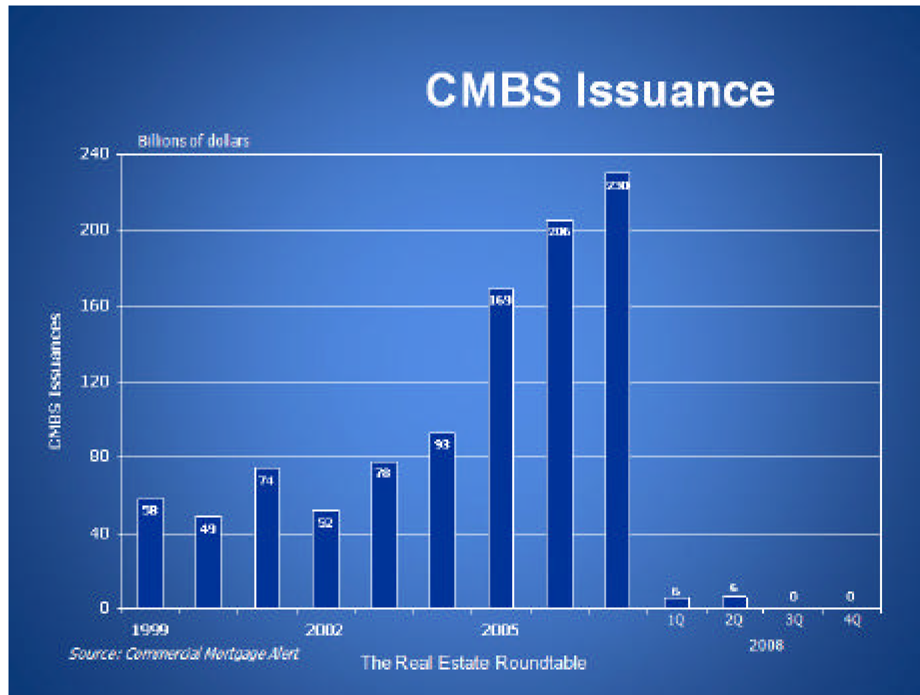


In 2009, the amount of maturing commercial real estate loans is estimated to be between $300 and $500 billion. Maturing debt in this sector continues to expand. With an average $400 billion of commercial real estate debt maturities each year for the next decade, the credit market as it is currently structured 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 both of these large sources of commercial real estate credit are virtually shut down.

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. Thus far this year, there has been no new CMBS issuance.



The result is that the $6.7 trillion commercial real estate sector, a very large contributor to overall economic growth, now faces a liquidity crisis of mammoth proportions - where even performing loans, on strong assets in good markets, face extreme difficulty in refinancing their debt.

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, so far in 2009 as investors have sought opportunities to deploy capital in the more liquid and transparent sectors of the market. Since the beginning of the year, REITs, which represent approximately ten percent of the overall commercial real estate market, have raised nearly $16.3 billion in the public equity markets and approximately $2.4 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. The only other sources of credit available to the sector are the government sponsored enterprises - Fannie Mae and Freddie Mac - but these sources are limited

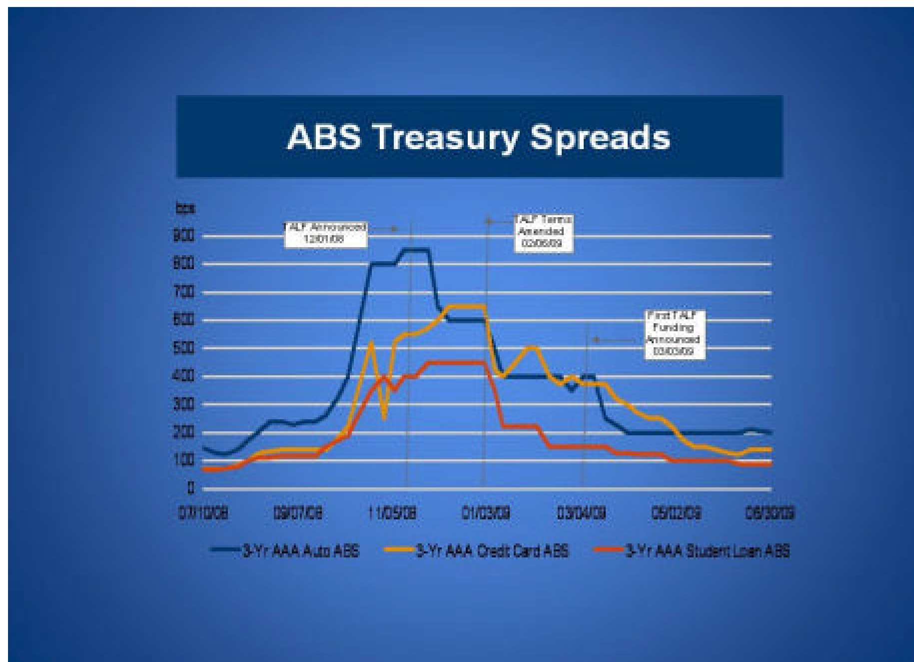
to the multifamily market. So, additional measures are imperative on the credit front in order to further reduce financial pressures for all owners and operators of commercial real estate.

POLICY ACTIONS ARE NEEDED

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. We suggest policymakers focus on the following principle areas.

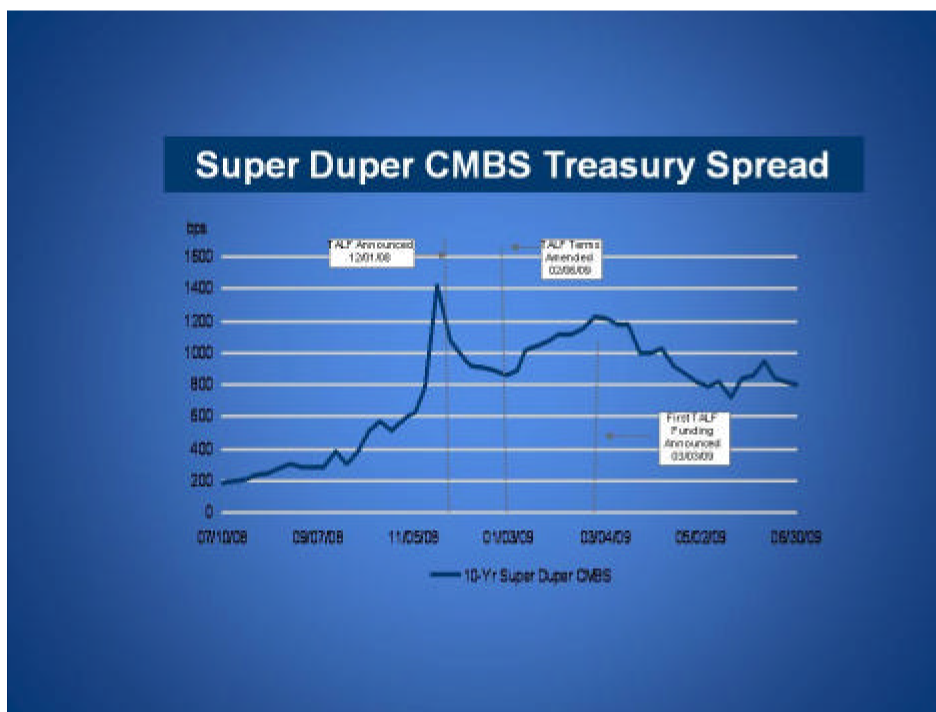
1. **Even if portfolio lenders – such as commercial banks and life companies – returned to the market in force, these institutions simply do not have the capacity to satisfy demand. Therefore, steps must be taken to restore an active commercial mortgage securitization market.**

    - **We are encouraged by the creation of the Term Asset Backed Loan Facility (TALF), which will provide attractive financing to investors who purchase newly issued AAA-rated securities backed by commercial real estate loans**. Newly issued AAA-rated commercial mortgage backed securities (CMBS) became eligible for TALF financing in late June, as will legacy AAA CMBS later in July. This program is intended to help reconnect the loan originators with the secondary markets. This program already has been very helpful in addressing the liquidity problem in consumer debt - such as auto loans and credit card debt and has led to the issuance of nearly $51 billion of financing. For example, newly issued AAA-rated asset backed securities (ABS) were recently priced through TALF at a spread of 155 basis points over LIBOR. That's 100 basis points less than where the market would have priced it, and approximately 400 basis points better than where similar securities were trading at the end of 2008.



- **We believe that, once it is fully functioning for real estate later in the summer, this program will be helpful to commercial real estate as well.** The Federal Reserve Board's recent announcement regarding the much anticipated expansion of the TALF program to legacy CMBS assets brought an even stronger market reaction than when the announcement of the new issue parameters came out. The extension of eligible TALF collateral to include legacy CMBS is intended to promote price discovery and liquidity for legacy CMBS. However, there are concerns that a recent watch listing by Standard & Poor's of many of the potentially qualified legacy securities could limit the eligibility of most potential legacy CMBS bonds for TALF funding.

- For example, since the TALF announcement, risk premiums on the top-rated AAA portions of securities with recent loans as collateral have tightened by 650 basis points over Treasuries from a high of 1350 basis points in November of 2008. The resulting improvement in legacy CMBS markets should ultimately facilitate the issuance of newly issued CMBS, thereby helping borrowers finance new purchases of commercial properties or refinance existing commercial mortgages on better terms.



- **We support the Federal Reserve's recent move to expand the list of acceptable credit rating agency firms from three to five.** This should introduce more competition among the firms and provide investors with a better view of the performance of existing CMBS. Moreover, we have long supported reform of the credit rating agencies. Along those lines, the SEC took long overdue steps recently to increase the transparency of the credit rating agencies' rating methodologies, strengthen their disclosure, prohibit them from engaging in practices that create conflicts of interest, and enhance their' recordkeeping and reporting obligations. This

action should provide increased confidence to the investor community regarding the strength of underlying securities.

- **However, due to the long lead time necessary to assemble TALF-eligible CMBS transactions, the program's remaining term does not permit adequate time to develop sufficient volume to address the massive credit shortfall to the sector.** For this reason, we strongly recommend that the Federal Reserve extend the TALF beyond its current December 31, 2009 deadline, through the end of 2010. If not, only a very limited number of CMBS securitizations will take place under TALF, and the program will end before it has had the desired effect on price discovery and a return of an active securitization market.

- **While the TALF is intended to help restart a segment of the CMBS securitization market, it is no panacea.** While the leverage the TALF provides to investors in the AAA-rated securities is attractively priced, it is cost-prohibitive to add debt over the AAA-rated piece due to the frozen credit markets. As a result, the program effectively gives the market 35-45 percent loan-to-value financing. Historically, conservatively underwritten loans were in the 60 percent loan-to-value range. More typically, loans were extended to 75 percent loan-to-value levels. With a drop in collateral asset values of, say, 35 percent, this makes loan-to-value a critical concern. So, only a very narrow segment of the market will be eligible for TALF-based commercial real estate loans. TALF will not be a significant help to the vast bulk of maturing CMBS loans that need to be refinanced, and it will not solve the over-leverage issues affecting the major segment of the market.

- **The TALF's reliance on the credit rating agencies to assess valuation is a concern**. Due to a scarcity of sale transactions, there is no true "market" for property level commercial real estate assets. As a result, values are extremely difficult to ascertain. In an environment where these agencies are struggling to regain their credibility with investors, the credit rating agencies will likely be compelled to value the collateral at a relatively low level, compared to historic norms. The resulting AAA-rated piece will likely be a relatively small portion of the overall financing available to borrowers. The result of this is that TALF will not be able to meet the current demand from maturing commercial real estate loans.

- **We also support the Public Private Investment Program (PPIP) announced by the Treasury and other regulators.** This program will also provide attractive financing to private investors to purchase legacy or toxic assets held by financial institutions. Removing these assets should help to enable banks to return to the business of making sound loans to commercial real estate. While we are concerned about the postponement of the Legacy Loans Program by the Federal Deposit Insurance Corporation (FDIC), we are encouraged by reports that the Treasury will soon be announcing their selection of asset management firms to participate in the program. The PPIP will use matching federal money and funds raised by the selected companies from private investors to buy distressed mortgage-backed securities and other troubled assets from U.S. banks. The purchases are intended to establish market prices for the assets, clean up bank balance sheets, and revitalize lending.

2. **Additional steps must be taken to facilitate "new" real estate loan originations:**

   - We have been studying the creation of a federally chartered, privately funded loan guarantee program for commercial real estate securities. After an initial period of support from TARP and the Federal Reserve (similar to the TALF program), such a program would be self-funded by a fee charged to the issuers of securities – in much the same way the Federal Deposit Insurance Corporation insures bank deposits. Such an entity would create an insurance pool to stand behind these securities and help restore investor confidence and restart securitization markets. While our interest is in focusing such an entity on the CMBS market, it could be used for a variety of asset classes. By creating a loan guarantee facility for newly issued mortgage backed securities, banks and loan originators will have a stable secondary market into which they can sell newly originated, solidly underwritten loans.

   - Another option we have been pursuing would involve the adaptation of the PPIP's public-private investment structure under the stalled Legacy Loans Program (LLP). Under this structure, Public Private Investment Funds (PPIFs) would be created, utilizing private capital with leverage from the federal government. However, instead of using the program for so-called legacy – or troubled – loans, the PPIFs would be used to fund a pipeline of solidly underwritten, *newly originated* commercial real estate loans. Instead of acquiring legacy loans, the program would shift to new loans and provide an important source of liquidity to the industry at the whole loan level. It would also help solve the warehousing problems afflicting potential TALF-eligible CMBS loan originators.

   - 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.

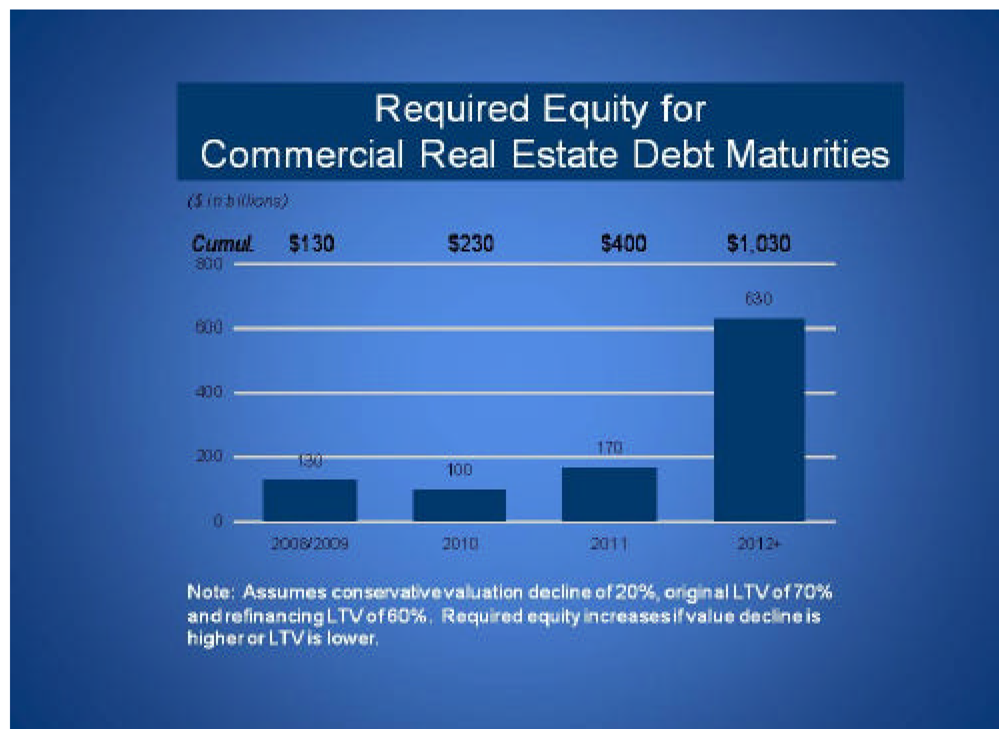
3. **Given the lack of liquidity, regulators must give lenders and mortgage servicers more flexibility to restructure loans and make modifications when a positive outcome can be generated. It is also important for bank regulators to establish policies – possibly in the form of guidance - that would temporarily encourage banks to extend existing loans that are current – where there is adequate debt service coverage to service debt payments.**

   - As part of this effort, it is important to **amend the real estate mortgage investment conduit (REMIC) rules to facilitate reasonable modifications to the terms of commercial mortgage loans that have been securitized in CMBS**. The current administrative tax rules applicable to REMICs and investment trusts exacerbate the problem by imposing limitations that significantly impede the ability to negotiate and

implement a restructuring package on a timely basis. To that end, The Real Estate Roundtable has requested that the Treasury Department issue guidance that would temporarily suspend the current administrative tax rules that, in normal economic conditions; serve to restrict the ability to restructure securitized mortgage loans. We are hopeful that Treasury will act soon in this important area.

- In the banking sector, since long-term value is hard to determine in the current environment, bank regulations should temporarily encourage banks to extend existing loans where there is adequate debt service to cover payments. Such guidance would also encourage banks to focus on cash flow and debt service coverage and minimize dependence on loan-to-value measurements. This could help minimize costly foreclosures and help alleviate the pressure on banks to reduce their commercial real estate exposure.

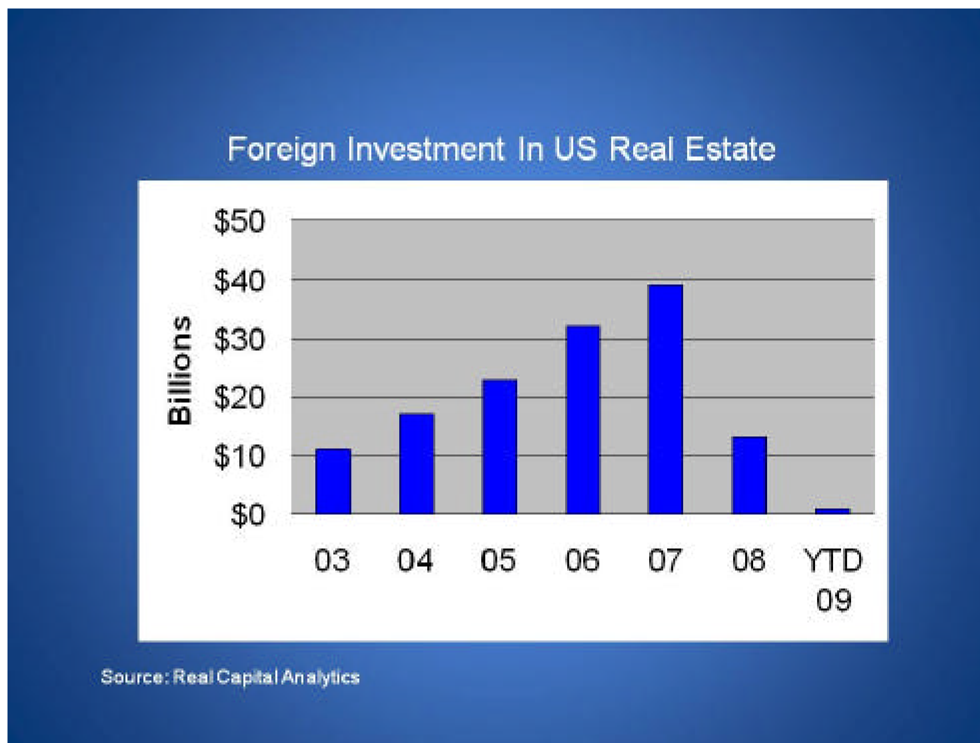
4. **Because of the significant value declines in commercial real estate - estimated by some to be 35% or more - for lending to resume, and transactions to go forward, there must be significant additional equity investment into the market place. Preliminary conservative estimates reveal an "equity gap" 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.**



- 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.



5. **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.

- **Regarding net operating loss (NOL) carry-back,** the NOL provision is one of the strongest tools Congress can provide to help companies in a broad cross-section of industries weather the current economic conditions. Faced with limited access to

capital, the ability to transform a future tax benefit into cash today is critical to maintain otherwise viable businesses. As you are aware, Congress provided a five-year carry-back for 2001 and 2002 NOLs and AMT NOL relief to companies of all sizes in the *Job Creation and Worker Assistance Act of 2002* enacted following the September 11 terrorist attacks.

- Currently, the NOL provision that was enacted into law by the *American Recovery and Reinvestment Act* provided a 5 year carry-back for 2008 NOLs, but arbitrarily limited the relief to small companies with annual gross receipts of $15 million or less. As a proven economic stimulus tool, the NOL provision should be expanded to mid to large size companies, which currently are limited to a 2 year allowance for tax years beginning or ending in 2008 and 2009. For many in the commercial real estate industry, the five-year NOL carry-back could provide the capital they need to bridge the gap until the other previously mentioned stimulative measures have an opportunity to work.

CONCLUSION

In summary, conditions in the nation's commercial real estate markets today are quite challenging. Property fundamentals are sliding 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 take appropriate steps, along the lines of the TALF and PPIP, to restore functionality to credit markets 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 catastrophic situation. We stand ready to discuss and aid in the development and implementation of such measures.

Thank you for the opportunity to testify today.