S. HRG. 112–2

COMMERCIAL REAL ESTATE'S IMPACT ON BANK STABILITY

HEARING

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

FEBRUARY 4, 2011

Printed for the use of the Congressional Oversight Panel

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CONGRESSIONAL OVERSIGHT PANEL

PANEL MEMBERS

THE HONORABLE TED KAUFMAN, *Chair*

KENNETH TROSKE

J. MARK MCWATTERS

RICHARD H. NEIMAN

DAMON SILVERS

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HEARING ON COMMERCIAL REAL ESTATE'S IMPACT ON BANK STABILITY

FRIDAY, FEBRUARY 4, 2011

U.S. CONGRESS,
CONGRESSIONAL OVERSIGHT PANEL,
Washington, DC.

The panel met, pursuant to notice, at 10 a.m. in Room D 538, Dirksen Senate Office Building, Senator Ted Kaufman, chairman of the panel, presiding.

Present: Senator Ted Kaufman [presiding], Richard H. Neiman, Damon Silvers, J. Mark McWatters, and Kenneth R. Troske.

OPENING STATEMENT OF HON. TED KAUFMAN, U.S. SENATOR FROM DELAWARE

The Chairman. Good morning. I'm Ted Kaufman, the chairman of the Congressional Oversight Panel for the Trouble Asset Relief Program.

And we're here this morning—and I'm—welcome our witnesses and visitors—at a pivotal moment in the Nation's economic recovery. The financial panic that plagued our country is over. The Dow Jones industrial average has exceeded its year-end peak from 2007, only a few percentage points below its all-time high. Housing prices have begun to recover. Private companies are very slowly hiring again, beginning to put our millions of unemployed friends and neighbors back to work, although we have a long way to go, as everyone knows.

It's only fitting that, at a crisis past, a government should set aside its crisis authorities. And so, Treasury's most extraordinary authority, to stabilize our financial system, the Troubled Asset Relief Program, has ended. However, threats to the banking system and the broader economy remain.

Our hearing this morning will explore one of those threats in detail: the troubled market for commercial real estate loans.

Commercial mortgages are exactly what they sound like, the loans taken out by developers to buy, build, and maintain commercial properties. Almost everyone who lives in an apartment, works in an office building, or shops in a mall has spent time in a building that owes its existence to a commercial mortgage.

Most commercial mortgages have terms of 3 to 10 years, but the monthly payments are too low and—to fully repay the loan in that period. At the end of the term, the entire remaining balance comes due, and the borrower must take out a new loan to finance its continued ownership of that property. Put another way, a commercial borrower must reapply for credit every few years. In today's market, where banks remain hesitant to lend and the values of commercial properties have fallen by a third, many borrowers will be turned down.

The loans at greatest risk are those made at the peak of the real estate bubble, obviously; loans that will come due for refinancing in 2011, 2012, and 2013, and beyond. In essence, the term of a commercial loan creates a lag between the moment the market collapses and the moment that the economic impact is felt. The fuse has been lit, but no one knows how much damage will occur when it finally burns down.

The Congress Oversight Panel has been closely monitoring the commercial real estate market since its first hearing on the subject, in May have 2009. The panel issued a comprehensive report in February 2010. Even after almost 2 years, the panel remains deeply concerned.

In fact, just last month, the missed payment rate for commercial mortgage-backed securities reached an all time high of over 9.3 percent. The commercial real estate market encompasses $3.4 trillion in debt. If borrowers default in large numbers, commercial properties could face a wave of foreclosures. Customers, businesses, and renters in those properties could face uncertainty, and even eviction. Small banks, in particular, could face insolvency, as nearly 1,300 banks nationwide are considered by regulators to have concentrations in commercial real estate.

Concerns about commercial real estate also illuminate a broader theme of our oversight work, that even in a crisis, while authorities must deal with the short-term dangers, they must also be vigilant to the longer-term threats. If a small bank survived the financial crisis, thanks to the TARP, but collapses next year, due to commercial real estate losses, then TARP support will have served only to postpone the inevitable.

Further, more than 500 small banks continue to hold TARP money. And the greater the degree of these banks' exposure to commercial real estate, the lower is the likelihood that taxpayers recover all of our money.

We are grateful this morning—and I truly mean grateful—to be joined by two panels of expert witnesses, who will help us to explore these concerns, including government regulators and bank analysts. We appreciate your presence and look forward to your testimony.

Let me now turn to Mr. McWatters for his opening remarks.

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Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Ted Kaufman

Congressional Oversight Panel Hearing on Commercial Real Estate

February 4, 2011

Good morning. I am Ted Kaufman, the chairman of the Congressional Oversight Panel for the Troubled Asset Relief Program.

We are here this morning at a pivotal moment in the nation's economic recovery. The financial panic that plagued our country is over. The Dow Jones Industrial Average is nearing its year-end peak from 2007. Housing prices have begun to recover. Private companies are, very slowly, hiring again, beginning to put our millions of unemployed friends and neighbors back to work.

It is only fitting that, as a crisis passes, a government should set aside its crisis authorities, and so Treasury's most extraordinary authority to stabilize our financial system – the Troubled Asset Relief Program – has ended. However, threats to the banking system and the broader economy remain. Our hearing this morning will explore one of those threats in detail: the troubled market for commercial real estate loans.

Commercial mortgages are exactly what they sound like: the loans taken out by developers to buy, build, and maintain commercial properties. Almost everyone who lives in an apartment, works in an office building, or shops at a mall has spent time in a building that owes its existence to a commercial mortgage.

Most commercial mortgages have terms of three to 10 years, but the monthly payments are too low to fully repay the loan in that period. At the end of the term, the entire remaining balance comes due, and the borrower must take out a new loan to finance its continued ownership of the property.

Put another way, a commercial borrower must reapply for credit every few years – and in today's market, where banks remain hesitant to lend and the values of commercial properties have fallen by a third, many borrowers will be turned down. The loans at greatest risk are those made at the peak of the real estate bubble – loans that will come due for refinancing in 2011, 2012, 2013, and beyond. In essence, the term of a commercial loan creates a lag between the moment that the market collapses and the moment that the economic impact is felt. The fuse has been lit, but no one yet knows how much damage will occur when it finally burns down.

Congressional Oversight Panel

The Congressional Oversight Panel has been closely monitoring the commercial real estate market since its first hearing on the subject in May 2009, and the Panel issued a comprehensive report in February 2010. Even after almost two years, the Panel remains deeply concerned. In fact, just last month the missed-payment rate for commercial mortgage-backed securities reached an all-time high of over 9.3 percent.

The commercial real estate market encompasses $3.4 trillion in debt. If borrowers default in large numbers, commercial properties could face a wave of foreclosures. Customers, businesses, and renters in those properties could face uncertainty and even eviction. Small banks in particular could face insolvency, as nearly 1,300 banks nationwide are considered by regulators to have concentrations in commercial real estate.

Concerns about commercial real estate also illuminate a broader theme of our oversight work: that even in a crisis, while authorities must deal with short-term dangers, they must also be vigilant about longer-term threats. If a small bank survived the financial crisis thanks to the TARP but collapses next year due to commercial real estate losses, then TARP support will have served only to postpone the inevitable. Further, more than 500 small banks continue to hold TARP money, and the greater the degree of these banks' exposure to commercial real estate, the lower is the likelihood that taxpayers will recover all of our money.

We are grateful this morning to be joined by two panels of expert witnesses who will help us to explore these concerns, including government regulators and bank analysts. We appreciate your presence and look forward to your testimony.

Let me turn now to Mr. McWatters for his opening remarks.

STATEMENT OF J. MARK McWATTERS, ATTORNEY AND CERTIFIED PUBLIC ACCOUNTANT

Mr. McWATTERS. Thank you, Senator Kaufman.

And welcome to our distinguished witnesses.

There is little doubt that much uncertainty continues to exist within the commercial real estate, or CRE, market. In order to suggest a solution to the challenges facing the CRE market, it is critical that we thoughtfully identify the sources of the underlying difficulties. Without a proper diagnosis, it is unlikely that we may craft an inappropriately targeted remedy with adverse unintended consequences.

Broadly speaking, it appears that today the CRE industry is faced with both an oversupply of overleveraged CRE facilities and an undersupply of respective tenants and purchasers. In my view, there has been a remarkable decline in demand for CRE property over the past 2 years, and many potential tenants and purchasers have withdrawn from the CRE market, not simply because rental rates and purchase prices are too high due to the excess debt load carried by many CRE properties, but because their business operations do not presently require additional CRE facilities.

Over the past few years, while CRE developers have constructed new office buildings, hotels, multifamily housing, retail facilities, and industrial properties with an excess of cheap, short-term credit, the end users of such facilities have suffered the worst economic downturn in several generations. Any positive solution to the CRE focus—problem that focuses only on the oversupply of overleveraged CRE facilities, to the exclusion of the economic difficulties facing the end users of such facilities, appears less than likely to succeed.

The challenges confronting the CRE market are not entirely unique to the industry, but instead are indicative of the systemic uncertainties manifest throughout the entire economy. In order to address the oversupply of overleveraged CRE facilities, developers and their creditors are currently struggling to restructure and refinance their portfolio loans. In some instances, creditors are acknowledging economic reality and writing the loans down to market value, with perhaps the retention of an equity kicker right. In other cases, lenders and borrowers are merely kicking the can down the road by refinancing problematic credits on a short-term basis at favorable rates so as to avoid loss recognition and capital impairment for lenders and adverse tax consequences for the borrowers.

While each approach may offer assistance in specifically tailored instances, neither addresses the underlying reality of too few tenants and purchasers of CRE facilities. Until small and large businesses regain the confidence to hire new employees and expand their business operations, it is doubtful that the CRE market will sustain a meaningful recovery. As long as business persons are faced with the challenges of rising taxes and increasing regulatory burdens, it is less than likely that they will enthusiastically assume the entrepreneurial risk necessary for protracted economic expansion and a robust recovery of the CRE market.

It is fundamental to acknowledge that the American economy grows one job and one consumer purchase at a time, and that the

CRE market will recover one lease, one sale, and one financing at a time. With the expanding array of less-than-friendly rules, regulations, and taxes facing business persons and consumers, we should not be surprised that businesses remain reluctant to hire new employees, consumers remain cautious about spending, and the CRE market continues to struggle.

The problems presented by today's CRE market would be easier to address if they were solely based on the oversupply of overleveraged CRE facilities in certain well-delineated markets. In such an event, a combination of thoughtful, yet no doubt painful, restructurings, refinancings, and foreclosures would result in the material deleveraging and repricing of troubled CRE properties. Unfortunately, even though CRE properties that are appropriately leveraged and priced must also assimilate a drop in demand from prospective tenants and purchasers who have suffered a reversal in their business operations and prospects.

Although some progress has been made, the Administration could further assist the recovery of the CRE market, as well as the broader U.S. economy, by sending an unambiguous message to the private sector that it will not directly or indirectly raise the taxes or increase the regulatory burden of CRE participants and other business enterprises. Without such action, the recovery of the CRE market will quite possibly proceed at a sluggish and costly pace, with further adverse consequences for those financial institutions and investors that hold CRE loans and commercial mortgage-backed securities.

Thank you, and I look forward to our discussion.

The CHAIRMAN. Thank you. Damon Silvers.

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Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of J. Mark McWatters

Congressional Oversight Panel Hearing on Commercial Real Estate

February 4, 2011

Thank you Senator Kaufman and welcome to our distinguished witnesses.

There is little doubt that much uncertainty continues to exist within the commercial real estate, or CRE, market. In order to suggest a solution to the challenges facing the CRE market it is critical that we thoughtfully identify the sources of the underlying difficulties. Without a proper diagnosis it is likely that we may craft an inappropriately targeted remedy with adverse unintended consequences.

Broadly speaking, it appears that today's CRE industry is faced with both an oversupply of over-leveraged CRE facilities *and* an undersupply of prospective tenants and purchasers. In my view, there has been a remarkable decline in demand for CRE property over the past two years and many potential tenants and purchasers have withdrawn from the CRE market not simply because rental rates and purchase prices are too high due to the excess debt loads carried by many CRE properties, but because their business operations do not presently require additional CRE facilities. Over the past few years while CRE developers have constructed new office buildings, hotels, multi-family housing, retail facilities and industrial properties with an excess of cheap, short-term credit, the end users of such facilities have suffered the worst economic downturn in several generations. Any posited solution to the CRE problem that focuses only on the oversupply of over-leveraged CRE facilities to the exclusion of the economic difficulties facing the end users of such facilities appears less than likely to succeed. The challenges confronting the CRE market are not entirely unique to that industry, but, instead, are indicative of the systemic uncertainties manifest throughout the larger economy.

In order to address the oversupply of over-leveraged CRE facilities, developers and their creditors are currently struggling to restructure and refinance their portfolio loans. In some instances creditors are acknowledging economic reality and writing their loans down to market value with, perhaps, the retention of an equity participation right. In other cases lenders and borrowers are merely "kicking the can down the road" by refinancing problematic credits on a short-term basis at favorable terms so as to avoid loss recognition and capital impairment for the lenders and adverse tax consequences for the borrowers. While each approach may offer assistance in specifically tailored instances, neither addresses the underlying reality of too few tenants and purchasers of CRE facilities.

Until small and large businesses regain the confidence to hire new employees and expand their business operations it is doubtful that the CRE market will sustain a meaningful recovery. As long as businesspersons are faced with the challenges of rising taxes and increasing regulatory burdens, it is less than likely that they will enthusiastically assume the entrepreneurial risk necessary for protracted economic expansion and a robust recovery of the CRE market. It is fundamental to acknowledge that the American economy grows one-job and one-consumer purchase at a time, and that the CRE market will recover one-lease, one-sale and one-financing at a time. With the expanding array of less than friendly rules, regulations and taxes facing businesspersons and consumers we should not be surprised if businesses remain reluctant to hire new employees, consumers remain cautious about spending, and the CRE market continues to struggle.

The problems presented by today's CRE market would be easier to address if they were solely based upon the oversupply of over-leveraged CRE facilities in certain well delineated markets. In such an event, a combination of thoughtful—yet no doubt painful—restructurings, refinancings and foreclosures would result in the material de-leveraging and re-pricing of troubled CRE properties. Unfortunately, even those CRE properties that are appropriately leveraged and priced must also assimilate a drop in demand from prospective tenants and purchasers who have suffered a reversal in their business operations and prospects.

Although some progress has been made, the Administration could further assist the recovery of the CRE market—as well as the broader U.S. economy—by sending an unambiguous message to the private sector that it will not directly or indirectly raise the taxes or increase the regulatory burden of CRE market participants and other business enterprises. Without such action, the recovery of the CRE market will quite possibly proceed at a sluggish and costly pace with further adverse consequences for those financial institutions and investors that hold CRE loans and commercial mortgage-backed securities.

Thank you for joining us today and I look forward to our discussion.

STATEMENT OF DAMON SILVERS, DIRECTOR OF POLICY AND SPECIAL COUNSEL, AFL–CIO

Mr. SILVERS. Thank you, Mr. Chairman.

Good morning. This is the third hearing this panel has conducted on the interaction of the commercial real estate market with the Troubled Asset Relief Program.

Our earlier hearings looked at this issue through the experience of the New York and the Atlanta metropolitan areas. And so, this is really the first hearing that is focused on the national picture and on the viewpoint and efforts of the bank regulators in relation to issues raised by the commercial real estate market.

In our February 2010 report, as my fellow panelists have noted, this panel urged the Treasury Department and the bank regulators to closely monitor commercial real estate market, out of concern that the rapid decline of this market could lead to problems for financial institutions with significant exposure to commercial real estate loans, and, in particular, could affect the small banking sector. We noted that, due to the shorter term of most commercial real estate loans compared to conventional residential mortgages, the banking system would face rollover problems for more than $2 trillion worth of commercial real estate loans between 2011 and 2017, loans whose collateral seems likely to have fallen in value dramatically when the loans become due.

Today's hearing is an opportunity for us to revisit the question of what is going to happen to smaller banks as commercial real estate loans become due, and what impact these developments will have on efforts to revive commercial lending, and on the degree of concentration in our banking system. We do this against the backdrop of smaller TARP recipient banks having significant concentrations in commercial real estate even when compared to non-TARP recipients of the same size, and against the backdrop, that we—as we have noted in other reports, of the challenges that the Treasury Department faces, in terms of constructing an exit from TARP for these smaller recipients of TARP assistance.

But, this hearing is also an opportunity for us to look more broadly at the implications of the commercial real estate market for oversight of TARP as a whole. Several of our witnesses today have pointed out, in their written testimony, that commercial real estate loans are concentrated in smaller banks, and are not a problem, by and large, that threatens the stability of systemically significant institutions. We also have a substantial body of testimony today that discusses the capacity of banks and other commercial real estate lenders to restructure commercial real estate loans, and the difference that that capacity and flexibility has made, in terms of mitigating the impact of the dramatic fall of commercial real estate values.

Now, neither proposition is a great comfort to me, nor, I think, would either proposition be a great comfort to the American public if the public understood the implications of these statements.

Every week, the FDIC resolves more failed small banks. Those banks are shut down; their stockholders, wiped out; in many cases, their employees, laid off; the communities which they served, left without important institutions in some cases; in other cases, they continue under new names and new ownership.

All the—all those harmed by these actions, unavoidable as they certainly are, know that, if they had just been systemically significant, they might be well on their way to enjoying the fruits of the recent miniboom in finance. And then, consider any one of the more than 200,000 American families facing the loss of their home each month due to residential real estate foreclosures, in substantial part because of the lack of flexibility in the approach the bank have taken to residential real estate.

Now, today, rather than dwell too long on these injustices that appear, at this point, to be profoundly lodged at the heart of our financial policy landscape, I would hope we could learn something practical from this hearing as to, one, whether we still have cause to be concerned about rollover risk in commercial real estate, the risk that this panel has raised in prior reports; and, two, What can we learn from the commercial real estate experience that might help us in dealing with the profoundly troubled residential real estate market?

So, I look forward to hearing from our witnesses, and extend my thanks to all of you for helping us today.

The CHAIRMAN. Thank you, Mr. Silvers.

Dr. Troske.

SEN. TED KAUFMAN, CHAIRMAN
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS
KENNETH R. TROSKE

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CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Damon Silvers

Congressional Oversight Panel Hearing on Commercial Real Estate

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In our February, 2010 report, this panel urged the Treasury Department and bank regulators to closely monitor the commercial real estate market out of concern that the rapid decline of this market could lead to problems for financial institutions with significant exposure to commercial real estate, and in particular could affect the small banking sector. We noted that due to the shorter term of most commercial real estate loans compared to conventional residential mortgages, the banking system would face rollover problems for more than $2 trillion worth of real estate loans between 2011 and 2017—loans whose collateral seems likely to have fallen in value dramatically when the loans become due.

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But this hearing is also an opportunity for us to look more broadly at the implications of the commercial real estate market for oversight of TARP as a whole. Several of our witnesses today have pointed out in their written testimony that commercial real estate loans are concentrated in smaller banks, and are not a problem by and large that threatens the stability of systemically significant institutions. We also have a substantial body of testimony today that discusses the capacity of banks to restructure commercial real estate loans and the difference that has made in terms of mitigating the impact of the dramatic fall of commercial real estate values.

Neither proposition is a great comfort to me, nor I think would they be to the American public if the public understood the implications of these statements. Every week the FDIC resolves more failed small banks. They are shut down, their stockholders wiped out, in many cases their employees laid off—all knowing that if they just had been systemically significant they might be well on their way to enjoying the fruits of the recent mini-boom in finance. And consider any one of the more than two hundred thousand American families facing the loss of their home in substantial part because of the lack of flexibility in the approach the banks have taken to residential real estate.

Rather than dwell too long on these injustices that appear at this point to be profoundly lodged at the heart of our financial policy landscape, I would hope we could learn from this hearing (1) whether we still have cause to be concerned about rollover risk in commercial real estate, and (2) what we can learn from the commercial real estate experience for the profoundly troubled residential real estate market.

I look forward to hearing from our witnesses.

STATEMENT OF KENNETH TROSKE, WILLIAM B. STURGILL PROFESSOR OF ECONOMICS, UNIVERSITY OF KENTUCKY

Dr. TROSKE. Thank you, Senator Kaufman.

I would like to start by thanking the witnesses for appearing before the panel today. I appreciate you coming here to help us with our oversight responsibilities.

In my opening comments today, I want to touch on a topic that, while not the primary subject of today's hearing, is certainly related. That is the role of regulation and regulatory oversight in the recent financial crisis.

One common theme in the aftermath of our—the recent crisis has been that the crisis could have been prevented by more regulation. Of course, in our economic system, there are two sources of regulation, that imposed by the market and that imposed by the government. Both forms of regulation have their strengths and weakness. In my opinion, however, many of the calls for increased government regulation fail to recognize some of the inherent weaknesses in this type of regulation.

It is important to start off by recognizing that regulators are human beings, not superheroes, and they respond to incentives, just like all other normal human beings. Government regulators with no skin in the game have little incentive to closely monitor the behavior of companies to ensure that they protect investors and the economy. In contrast, in a well-functioning market, shareholders and creditors have a great deal of incentive to monitor firm behavior, since they do have skin in the game.

Some government regulators certainly do an exemplary job, but there are others, whose efforts will focus on merely implementing rules in a way to maintain their positions, and it is hardly—hard to know which is which before problems arise. As far as I know, no government regulator lost his or her job because the firm they regulated failed or received a bailout. In fact, many of the regulatory agencies that have received the most blame for the financial crisis received additional regulatory authority in the recent Dodd-Frank legislation. It seems clear that regulators have little financial incentive to develop and apply the kind of regulatory procedures that will yield maximum benefit, so we are forced to rely on regulators' personal motivation for doing the right thing. Hardly a sound basis for effective regulation.

We must also recognize that government regulators operate in a political process. When regulators try to regulate large companies, the shareholders and executives of these companies complain to their elected representatives about the undue burden of regulation, and these legislators try to limit the efficacy of regulators. We have seen this process play out time and time again in a variety of settings. When companies are making large profits, as often occurs in a price bubble, it is unreasonable to expect government regulators to have the political will to defy Members of the Congress and pop the bubble. I am not saying that the way the political process works is inappropriate, just that this dynamic must be kept in mind when thinking about the likely effectiveness of new regulation.

Finally, we need to recognize how executives, shareholders, and creditors of financial firms will respond to regulation. All businesses, including financial firms, aim to provide the products their customers demand. Customers demanded, and continue to demand, many of the financial products that they're—at the heart of the financial crisis, such as collateralized debt obligations and other complicated derivatives. Given new government—new government regulation will likely push firms to develop more complicated and difficult-to-regulate financial products, and move these products into an even more shadowy part of the banking sector.

In addition, with an increase in government—an increase in government regulation will decrease shareholders' and creditors' efforts at monitoring managers, and allow their oversight to be supplanted by government regulation. Given that regulation pushes companies to hide risky investments and reduces the incentives for shareholders and creditors to monitor the behavior of executives, government regulation likely leads to a world where there are fewer crises, but those crises that do occur will be much harder to spot and much larger and more destabilizing. Is this a tradeoff we want to make?

Of course the government's guarantee that systemically important financial firms will not be allowed to fail has effectively removed any incentive creditors have to monitor the behavior of executives and shareholders. It seems to me that a much simpler and more efficient solution would simply—would be to simply eliminate the government's guarantee, which would again provide creditors with the incentives to monitor the behavior of firms.

Claims that government—claims that the lack of regulation led to the recent financial crisis are akin to claims that someone got sick because they didn't take enough medication. Obviously, some medicine can kill you, some may prevent you from getting sick, but the correct medication is a complex function of the patient's overall health prior to becoming ill, his behavior, and the disease he ultimately encounters. So, it is virtually impossible to design a regime of medication that will prevent someone from ever getting sick. Instead, doctors advise us to follow a few basic rules—eat a balanced diet, exercise on a regular basis, don't smoke, avoid drinking to excess—that are designed to help build resistance to most common diseases and minimize the effects if we do become ill. However, even following these rules, people still get sick.

Good regulation would follow a similar course. Establish a set of basic rules, to enhance the ability of the natural regulators, shareholders, and creditors to oversee the behavior of managers. However, even the best government regulation will not prevent the occurrence of future financial crises. The best it can do is to reduce their frequency, minimize the effects when crises occur, and make people aware of the risks so they can prepare.

Responsibility for a firm's failure does not reside with government regulators, but instead rests with the managers and owners who made poor decisions. We need to keep this in mind when trying to design optimal regulation and planning for future crises.

Hopefully, the testimony we hear today will help us better understand remaining problems in the market so that political leaders can continue to work towards better, more efficient regulation to ensure the stability of the financial sector.

The CHAIRMAN. Thank you, Dr. Troske.

Mr. Neiman.

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CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Kenneth Troske

Congressional Oversight Panel Hearing on Commercial Real Estate

February 4, 2011

Thank you Senator Kaufman.

I would like to start by thanking the witnesses for appearing before the panel today. I recognize that all of you are very busy people with a number of other responsibilities, so I appreciate you taking time to come here and help us with our oversight responsibilities.

One common theme in the aftermath of the recent financial crisis has been that the crisis could have been prevented by more regulation. Of course in our economic system there are two sources of "regulation," that imposed by the market and that imposed by government. Both forms of regulation have their strengths and weaknesses. In my opinion, many of the calls for increased government regulation fail to recognize some of the inherent weaknesses in this type of regulation.

To begin with, it is important to recognize that regulators are human beings, not superheroes, and they respond to incentives just like all other normal human beings. And while we can argue about whether executives, shareholders, and creditors of failed companies suffered sufficiently large losses, there is no question that they lost more money in the crisis than government regulators as a direct result of firm failure. Government regulators with no "skin in the game" have little incentive to closely monitor the behavior of companies to ensure that they protect investors and the economy. In contrast, in a well-functioning market shareholders and creditors have a great deal of incentive to monitor firm behavior since they do have skin in the game. There are of course some government regulators who do an exemplary job, but there are others whose efforts will focus on merely implementing rules in a way to maintain their positions, and it is hard to know which is which before problems arise. And while it may have occurred, I know of no government regulator who lost his or her job because the firm they regulated failed or received a bailout. In fact, as a glance at the Dodd-Frank financial reform legislation reveals, many of the regulatory agencies that received the most blame for the financial crisis received additional regulatory authority in this legislation. In the end, it seems clear that regulators have little financial incentives to develop and apply the kinds of regulatory procedures that will yield maximum benefit, so we are forced to rely on regulators personal motivation for doing the right thing—hardly a sound basis for effective regulation.

We must also recognize that government regulators operate in a political process, so politics affects the outcome. When regulators try to regulate large companies, the shareholders and executives of these companies complain to their elected representatives about the undue burden of regulation, and in turn, these legislators try to limit the efficacy of regulators. We have seen this process play out time and time again in the enforcement of environmental regulation, occupational health and safety standards, and financial regulation. When companies are making large profits—as often occurs in a price bubble—it is unreasonable to expect government regulators to have the political will to defy members of Congress and pop the bubble. Note, I am not saying that the way the political process works is inappropriate. Rather I simply note that this dynamic must be kept in mind when thinking about the likely effectiveness of new regulation.

Finally, we need to recognize how executives, shareholders and creditors of financial firms will respond to regulation. All businesses, including financial firms, aim to provide the products their customers demand. It is clear that customers demanded many of the financial products that are at the heart of the financial crisis, such as collateralized debt obligations and other complicated derivatives, and customers continue to demand these products. Given this demand, one primary effect of new government regulation will be that firms will develop even more complicated and difficult to regulate financial products and work to move these products into an even more shadowy part of the banking sector where they will be even more difficult to monitor.

In addition, with an increase in governmental regulation, shareholders and creditors, who in a market economy are the strongest and most effective regulators of firms, will decrease their efforts and allow their oversight to be supplanted by the government's regulation. Given that regulation pushes companies to hide risky investments and reduces the incentives for shareholders and creditors to monitor the behavior of executives, even ideal government regulation will likely lead to a world where there are fewer crises, but those crisis that do occur will be much harder to spot, and much larger and more destabilizing. We need to ask ourselves whether this is a trade-off we want to make.

Of course the government's guarantee that systemically important financial firms will not be allowed to fail has effectively removed any incentive creditors have to monitor the behavior of executives and shareholders. Much of the new regulations appear to be attempts to fix the problems created by the existence of too big to fail firms. It seems to me that a much simpler and more efficient solution would be to simply eliminate the government's guarantee which would again provide creditors with the incentive to monitor the behavior of the firms.

Claims that the lack of regulation led to the recent financial crisis are akin to claims that someone got sick because they didn't take enough medication. As we all know, some medicine can kill you, some may prevent you from getting sick, but the correct medication is a complex function of the patient's overall health prior to becoming ill, his behavior, and the disease that he ultimately encounters. Given the complexity and uncertainty surrounding this problem, it is virtually impossible to design a regime of medication that will prevent someone from ever getting sick. Instead doctors advise us to follow a few basic rules—eat a balanced diet, exercise on a regular basis, don't smoke, avoid drinking to excess—that are designed to help build resistance to most common diseases and minimize the effects if we do become ill. However, even following these rules people still get sick. Good regulation would follow a similar course: establish a set of basic rules to enhance the ability of the natural regulators—shareholders and creditors—to oversee the behavior of managers. However, even the best government regulation will not prevent the occurrence of future financial crises; the best it can do is reduce their frequency, minimize the effects when crises occur, and make people aware of the risk so they can prepare. Responsibility for a firm's failure does not reside with government regulators, but instead rests with the managers and owners who made poor decisions. We need to keep this in mind when trying designing optimal regulation and planning for future crises. Hopefully, the testimony we hear today will help us better understand remaining problems in the market so that political leaders can continue to work toward better, more effective regulation.

STATEMENT OF RICHARD NEIMAN, SUPERINTENDENT OF BANKS, NEW YORK STATE BANKING DEPARTMENT

Mr. NEIMAN. Thank you.

Good morning. I want to thank our witnesses, particularly our senior Federal regulators who are appearing today at our Hearing of the Congressional Oversight Panel on Commercial Real Estate Lending.

The panel first explored these issues around commercial real estate in our field hearings in New York City in 2009 and in Atlanta in January of last year. In the time since then, there is reason to remain concerned about mounting pressure in the commercial real estate sector. Financial stability overall has been returning, but this nascent recovery is still vulnerable to shocks. The concern is that the credit risk, and particularly the maturity risk embedded in commercial real estate loans, could provide such a trigger in the near term.

It is estimated that hundreds of billions of dollars in commercial real estate debt will be maturing through 2014. The prospects for refinancing this debt are uncertain, as the recession and high levels of unemployment continue to put downward pressure on property values and reduce rent rolls. This could even jeopardize the viability of loans that were properly underwritten. These difficulties may weigh heavily on midsized and community banks, which are, comparatively, more concentrated in commercial real estate than larger institutions.

But, the future of commercial real estate lending matters to more than just a subset of lenders and borrowers. Commercial real estate impacts every community, on multiple levels, so understanding this sector is an important aspect of stabilizing our national economy. We are talking about the office buildings, shopping malls, and hotels that shelter jobs. Mortgages that help businesses remain open are critical to economic recovery.

Commercial real estate also includes multifamily and affordable housing units. For apartment buildings, in particular, there is a concern that the properties' condition will deteriorate as the owner's cashflow is diverted to making debt payments. Further, tenants who pay their rent on time can find themselves homeless because their landlord defaulted on the underlying commercial mortgage. Workouts for distressed loans on multifamily properties should be restructured with community preservation goals in mind.

So, in my questions this morning, I will be exploring this connection between the well-being of our society and financial stability. There are many open issues, such as: What steps are being taken at the national level to protect members, renters, and multifamily properties during a foreclosure? Are tightened underwriting standards being set at the right level to ensure prudent loans, or is credit being artificially restricted? And are banks adequately prepared for additional loan losses that may be coming?

I look forward to the witnesses' response on these issues, and to hearing your innovative ideas on stabilizing commercial real estate. So, thank you, again, for joining us.

The CHAIRMAN. Thank you all.

I'm pleased to welcome our first witness panel, which consists of Federal bank regulators. We're joined by Sandra Thompson, director of the Division of Supervision and Consumer Protection for the FDIC; Patrick Parkinson, director of the Division of Banking Supervision and Regulation for the Federal Reserve; and David Wilson, deputy comptroller for Credit and Market Risk for the OCC.

Thank you for coming this morning.

We ask that you keep your oral testimony to 5 minutes so we can have adequate time for questions. Your complete written record will be printed in the official record of the hearing.

And please proceed with your testimony. We'll start with Ms. Thompson.

SEN. TED KAUFMAN, CHAIRMAN
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK McWATTERS
KENNETH R. TROSKE

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Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Richard Neiman

Congressional Oversight Panel Hearing on Commercial Real Estate

February 4, 2011

Good morning, and thank you to our witnesses for appearing today at this hearing of the Congressional Oversight Panel on commercial real estate lending. The Panel first explored issues around commercial real estate at our field hearings in New York City in 2009 and Atlanta in January of last year.

In the time since then, there is reason to remain concerned about mounting pressure in the commercial real estate sector. Financial stability overall has been returning, but this nascent recovery is still vulnerable to shocks. The concern is that the credit risk, and particularly the maturity risk, embedded in commercial real estate loans could provide just such a trigger in the near-term.

It is estimated that hundreds of billions of dollars in commercial real estate debt will be maturing through 2014. The prospects for refinancing this debt are uncertain, as the recession and high levels of unemployment continue to put downward pressure on property values and reduce rent rolls. This could even jeopardize the viability of loans that were properly underwritten. These difficulties may weigh heavily on mid-size and community banks, which are comparatively more concentrated in commercial real estate than larger institutions.

But the future of commercial real estate lending matters to more than just a subset of lenders and borrowers. Commercial real estate impacts every community on multiple levels, so understanding this sector is an important aspect of stabilizing our national economy. We are talking about the office buildings, shopping malls and hotels that shelter jobs. Mortgages that help businesses remain open are critical to economic recovery.

Commercial real estate also includes multifamily and affordable housing units. For apartment buildings in particular, there is a concern that the property's condition will deteriorate as owners' cash flow is diverted to making debt payments. Further, tenants who pay their rent on time can find themselves homeless, because their landlord defaulted on the underlying commercial mortgage. Workouts for distressed loans on multifamily properties should be structured with community preservation goals in mind.

So in my questions this morning, I will be exploring this connection between the well-being of our society and financial stability. There are many open issues, such as-

- What steps are being taken at the national level to protect renters in multifamily properties during a foreclosure?
- Are tightened underwriting standards being set at the right level to ensure prudent loans, or is credit being artificially restricted?
- And are banks adequately prepared for additional loan losses that may be coming?

I look forward to the witnesses' responses on these issues and to hearing your innovative ideas on stabilizing commercial real estate.

STATEMENT OF SANDRA THOMPSON, DIRECTOR, DIVISION OF SUPERVISION AND CONSUMER PROTECTION, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. THOMPSON. Good morning. Chairman Kaufman and members of the panel, I appreciate the opportunity to testify on behalf of the FDIC regarding the condition of the commercial real estate market and its relationship to the overall stability of the financial system.

The events surrounding the recent financial crisis have taken a heavy toll on economic activity across our Nation. The past 3 years have been difficult for many institutions that focused on CRE lending, especially in home construction.

In 2009, there were 140 bank failures. Last year, 157 banks failed. And many of those failures were caused by losses on construction loans that were made during the boom years before the crisis.

Some community banks with CRE concentrations continue to experience elevated losses. Distressed CRE loan exposures take time to work out and, in some cases, require restructuring to establish more realistic and sustainable repayment programs. Some loans may not be able to be modified and must be written off. This process of prompt loss recognition and restructuring, painful as it may be, is needed to lay the foundation for recovery in the CRE market.

At the same time, it must be recognized that many institutions with CRE concentrations have weathered the financial crisis. As of the end of the year in 2008, there were over 2200 institutions that had CRE concentrations. Many of these institutions continue to operate in a safe and sound manner and serve the credit needs of their communities.

It is important to note that capital levels at insured institutions are relatively strong. Of the almost 8,000 insured depository institutions reporting as of the end of last September, some 96 percent are in the well-capitalized categories. For banks with CRE concentrations, 87 percent are well-capitalized.

The FDIC and the other Federal banking regulatory agencies have taken a number of steps to better understand the nature and extent of CRE concentrations. The FDIC has expanded the use of supervisory visitations at institutions with CRE concentrations. We've broadened our offsite surveillance programs to better capture CRE outliers. We receive more detailed information on a quarterly basis on owner-occupied CRE exposures so that we can better delineate a bank's CRE portfolio.

The FDIC has also joined with the other Federal bank regulators in encouraging lenders to continue making prudent loans and working with borrowers who are experiencing financial difficulties.

Although a number of financial institutions have reported poor results for the past several years, there are emerging signs of stabilization. Year-over-year earnings have improved for five consecutive quarters through September 30th, and loan-loss provisions have declined. Additionally, noncurrent loan balances have declined, with the largest decline occurring in the construction and development lending sector.

There are other signs pointing to a slow stabilization in the residential and commercial property sectors, with improvement in prices and vacancy rates. Nonetheless, while there are signs of stabilization, the CRE market is distressed and it will take some time to work through these issues.

All banks, community banks in particular, play a critical role in helping local businesses fuel economic growth. And we support their efforts to make good loans in this challenging environment.

Thank you. And I'll be pleased to answer any questions from the panel.

[The prepared statement of Ms. Thompson follows:]

Statement of

Sandra Thompson
Director
Division of Supervision and Consumer Protection
Federal Deposit Insurance Corporation

On

The Current State of Commercial Real Estate Finance and Its Relationship to the Overall Stability of the Financial System

Before the

Congressional Oversight Panel
Washington, DC

February 4, 2011

Chairman Kaufman and members of the panel, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning the condition of the commercial real estate (CRE) market and its relationship to the overall stability of the financial system. My testimony will describe the FDIC's observations about commercial real estate lending and how this sector has affected the condition of insured depository institutions. I will also draw a distinction between the types of CRE loans originated by banks to explain how the more risky elements, such as acquisition, development, and construction (ADC) lending, has experienced much higher loss rates than categories such as owner-occupied loans to small businesses. I will close with a summary of the FDIC's supervisory activities related to CRE lending and current market trends.

As the Panel well knows, the events surrounding the financial crisis of late 2008 have taken a heavy toll on real economic activity across our nation. The effects of the dislocations in real estate finance that triggered the crisis are still with us in the form of depressed real-estate prices, high levels of foreclosures and credit distress, and elevated levels of unemployment.

In response to these challenging economic circumstances, banks are clearly taking more care in evaluating applications for credit. While this more conservative approach to underwriting may mean that some borrowers who received credit in past years will have more difficulty receiving credit going forward, it should not mean that creditworthy borrowers are denied loans.

In retrospect, it is clear that the bank regulatory agencies could have been more aggressive in their approach to institutions with the riskiest CRE exposures, especially in real estate development lending. As outlined later in my testimony, the FDIC has taken steps to address our supervisory approach while at the same time recognizing that we, as bank supervisors, have a responsibility to encourage institutions, regularly and clearly, to continue to make soundly structured and underwritten loans. There is a balance that must be met. 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 promote the availability of credit as the economy recovers.

The Boom Years

The early and middle years of the last decade were marked by strong housing market activity and rising home prices. In addition, residential construction lending was a rapidly growing part of insured institutions' lending activity, especially among community banks. The annual number of single-family housing starts averaged 1.4 million between 2001 and 2007, well above the average of 1.1 million starts between 1980 and 2000. At the same time, home prices were growing faster than disposable personal incomes. Average U.S. home prices as measured by the S&P/Case-Schiller National Home Price Index rose by 89 percent between 2000 and 2006, while total disposable personal income rose by 35 percent. During 2005, the total number of housing units grew at a rate two-thirds faster than the population, while the homeownership rate stood just below the all-time high of 69 percent reached in 2004.

As housing boomed, ADC loans also grew rapidly. Construction of single-family housing also tends to spur demand for new commercial developments to serve growing communities. The total volume of outstanding ADC loans held by FDIC-insured institutions increased from $360 billion as of the first quarter of 2005 to a peak of $630 billion as of the first quarter of 2008, an increase of 75 percent in just three years. Along with this rapid growth in total holdings came increases in the magnitude of bank portfolio concentrations of ADC loans. The banking industry average concentration of ADC loans to total capital rose from 26 percent in 2000 to a peak of 50 percent in third quarter 2007. Similarly, the percentage of insured depository institutions with ADC concentrations exceeding total capital rose from 8 percent to 28 percent between 2000 and 2008.

All of these measures of housing market and construction activity reflected a boom that could not last. Home prices peaked in early 2006 and then fell by 31 percent – the largest nationwide decline in home prices since at least the 1930s – before stabilizing in mid-2009. Meanwhile, annual housing starts have declined by more than 70 percent from peak levels, and the homeownership rate declined to 66.7 percent by the third quarter of 2010. The record levels of mortgage credit distress that triggered the wider financial crisis began in subprime and nontraditional loans, but spread to prime loan portfolios. FDIC calculations based on the First American Corelogic database of privately-securitized mortgages shows that more than half of subprime loans originated in

2006 and 2007 had defaulted by November 2010. Further, more than 40 percent of Alt-A loans and more than 15 percent of prime loans made in those same years had defaulted in the same time period. This mortgage credit distress has led to record levels of loans entering foreclosures. FDIC estimates based on data from the Mortgage Bankers Association show that foreclosures reached 2.8 million in 2009 and appear to have exceeded 2 million again in 2010.

Impact of Housing Declines on CRE Loan Portfolios in the Banking Sector

Severe mortgage and housing market distress has adversely affected the credit performance of construction and other commercial real estate loan portfolios, both directly and indirectly. The most direct effect involves the decline in collateral values for residential properties and undeveloped land that serve as collateral for residential ADC loans. As these values declined in the last half of the decade, sales proceeds were insufficient to retire debt as planned and the percentage of problem residential ADC loans soared.

I would like to make a distinction between the risk management challenges posed by ADC loans, and loans collateralized by income-producing properties that are past the construction phase or are owner-occupied. While both of these are subcategories of what is commonly referred to as "commercial real estate lending," they differ a great deal in their cash flow characteristics and the losses they generate in periods of real estate market distress. What we observed in an earlier banking crisis, between 1989 and 1992, and what we are experiencing now, is that the largest percentage losses are incurred in ADC portfolios, and that these losses tend to occur earlier in a real estate market downturn. By contrast, losses on other CRE loans tend to be more modest, but also tend to take more time to be fully realized during economic downturns.

Noncurrent residential construction loans held by FDIC-insured institutions rose from 1.45 percent of outstanding balances in the first quarter of 2007 to 25.7 percent at the end of 2009, before falling slightly in 2010.[1] In addition, the wider economic effects of the real estate market bust and the financial market crisis of 2008 have included a marked deterioration in the cash flow characteristics and collateral values of commercial real estate construction and development projects.

As conditions worsened in residential and commercial real estate markets in the latter years of the decade, the level of total problem ADC loans – including both residential and commercial projects – also rose rapidly. The ratio of total noncurrent ADC loans held by FDIC-insured institutions rose from a cyclical low of 0.4 percent at the end of 2005 to a peak of 16.9 percent in first quarter 2010 before declining slightly by September 2010. Net charge-off rates for total ADC loans followed a similar pattern. After falling to a cyclical low of 0.01 percent in the second quarter of 2005, the annualized net charge-off rate for ADC loans held by FDIC-insured institutions rose steadily to a peak level of 8.08 percent by the fourth quarter of 2009, before declining modestly in the first three quarters of 2010. As institutions worked through the unprecedented decline in residential construction and home values, construction

[1] Noncurrent loans include loans 90 or more days past due or on nonaccrual status.

financing as a percentage of CRE lending declined from 32 percent in the fourth quarter of 2007 to 20 percent as of September 30, 2010.

The historic real estate market downturn we have recently experienced is contributing to acute credit distress in portfolios of ADC loans as well as other commercial real estate loans, which the banking industry is addressing. Since the end of 2007, FDIC-insured institutions have charged off almost $64 billion in ADC loans, while the outstanding balances of these loans have fallen by 44 percent. Over the same period, charge-offs in the somewhat larger nonfarm nonresidential portfolios have totaled $21 billion.

Commercial Mortgage Backed Securitizations

An important non-bank source of CRE financing during the last decade was commercial mortgage-backed securitizations. Issuance of commercial mortgage-backed securities, or CMBS, peaked in 2007 at $230 billion, having more than doubled from a total of less than $100 billion in 2004.[2] These securitizations focus almost exclusively on large, fully-leased investor properties. It is important to note that the CMBS market does not typically include ADC credits, or owner-occupied (small business) loans which represent a significant portion of community bank CRE lending. At the peak, CMBS accounted for almost 28 percent of all CRE financing. However, with the deterioration in CRE market fundamentals that occurred thereafter, combined with heightened risk aversion by investors in general that was centered on mortgage-backed securities, CMBS

[2] Source: Commercial Real Estate Finance Council, www.crefc.org.

issuance ground to a complete halt in late 2008 and early 2009. The CRE Finance Council estimates that total CMBS issuance was just $3 billion in 2009 and $12.3 billion in 2010, while Moody's projects that total CMBS issuance will rise to $37 billion in 2011. Disruption in the CMBS market has had a significant impact on market liquidity and has contributed to lower CRE valuations since 2007. A return of CMBS financing is likely to be slow, improving gradually over time with the recovery in CRE market fundamentals. In the interim, CRE valuations will likely remain under pressure, and the sector will continue to be highly dependent on depository institutions for new credit.

Effect of Declining CRE Values on Bank and Thrift Performance

The FDIC directly supervises nearly 5,000 community banks, many of which have some level of credit concentration in CRE. From a supervisory standpoint, the past three years have been difficult for many institutions that focus on CRE lending, especially in home construction. A large number of institutions have failed, and as of September 2010, some 860 banks were designated as "problem institutions." Many of these troubled institutions entered the financial crisis with high concentrations in ADC and non-owner occupied CRE loans.

Distressed CRE loan exposures take time to work out, and in some cases, require restructuring and/or charge-offs to establish a more realistic and sustainable repayment program given cash flow deterioration. A number of community banks supervised by the FDIC are still contending with these CRE lending problems. They are striving to overcome an environment of high credit-related costs (charge-offs, other real estate holding costs, loan workout expenses), lower interest income and weak loan demand.

The combination of high concentrations in ADC lending and the sharp deterioration in credit performance has made ADC lending an important factor in bank and thrift failures that have taken place since the start of 2008. FDIC analysis shows that institutions that failed during this period had concentrations of ADC loans to total assets that were roughly three times the average concentrations of non-failed institutions. Of the 322 insured institutions that failed during this period, more than 86 percent exceeded the CRE concentration levels that were defined in the December 12, 2006, Joint Guidance on CRE Lending.[3] This is more than twice the proportion of banks with elevated CRE concentrations observed in the industry as a whole. At the same time, it must be recognized that many institutions with CRE concentrations have weathered the financial crisis. As of December 31, 2008, there were over 2,200 institutions that had CRE concentrations according to the 2006 Joint CRE guidance and many of those institutions continue to operate in a safe and sound manner and serve the credit needs of their communities.

Largely driven by trends in CRE and ADC lending, the number of failed institutions has increased in each of the past four years, reaching 157 in 2010 – the highest annual total since 1992. While the number of failures is expected to remain elevated in 2011, we expect that 2010 represented the peak year for failures in this cycle.

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[3] See: FIL 104-2006, http://www.fdic.gov/news/news/press/2006/pr06114.html. The concentration levels are construction and development loans greater than 100 percent of total capital or total commercial real estate loans to total capital greater than 300 percent.

It is important to note that capital levels at insured institutions are relatively strong. Of the 7,770 insured depository institutions reporting as of September 30, 2010, some 96 percent are in the "well-capitalized" category according to the calculation used for Prompt Corrective Action. We expect that these capital levels will help most financial institutions absorb potential future losses on CRE loans.

Although a number of financial institutions have reported poor results for the past several years, there are emerging signs of stabilization. Year-over year earnings have improved for five consecutive quarters through September 30, 2010, and loan-loss provisions have declined. In dollar terms, noncurrent loan balances have declined, with the largest decline occurring in the construction and development lending sector which saw a $5.7 billion drop in noncurrent loans in the third quarter of 2010. Thus far, improved performance has been most evident among larger institutions, with performance still lagging somewhat at community banks considered as a group, especially those with elevated CRE concentrations. While the rate of noncurrent loans in the nonfarm nonresidential CRE category rose to 4.36 percent in the third quarter of 2010 from 3.41 percent the previous year, we expect credit performance in these portfolios will begin to improve as the economic recovery strengthens.

FDIC and Federal Bank Supervisory Agency Action on CRE Issues

The FDIC has taken a number of steps to better understand the nature and extent of CRE concentrations, and address banks' outsized credit exposures in a timelier manner. For example, we now have more detailed quarterly Call Report data reported by insured depository institutions on owner-occupied CRE exposures so that we can more readily differentiate among potentially more or less risky elements of banks' portfolios. The FDIC also has expanded the use of supervisory visitations at institutions with CRE concentrations and has broadened our off-site surveillance programs of institutions' data to better capture CRE outliers.

Moreover, we are beginning to ask bankers at each examination for their views on credit availability and to gauge how the regulatory process might positively influence banks' interest in originating new loans. The FDIC's supervisory process continues to evolve based on the lessons learned from this crisis, and we will continue to use our bank examination procedures to identify prospective risks that could affect an institution's safety and soundness. At the same time, the FDIC will continue to encourage banks to make prudent loans in their markets.

The FDIC monitors changes in a bank's condition between examinations by following-up on significant issues and analyzing financial reports. ADC loans and other CRE loans are necessarily a significant focus of our examinations and have been for some time. However, the FDIC provides banks we supervise with considerable flexibility in dealing with customer relationships and managing loan portfolios. We do not require banks to recognize losses on loans solely because of collateral depreciation or require appraisals on performing loans unless an advance of new funds is being contemplated or is otherwise clearly warranted. Write-downs on assets to "fire-sale" or liquidation values would be counterproductive for the economy and contrary to regulatory guidance.

The FDIC understands that businesses rely on banks to provide credit for their operations, and that extensions of credit from banking institutions will be essential in supporting economic growth. Accordingly, we have not instructed 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. To the contrary, through the 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts*[4] (CRE Workout Guidance), the FDIC has encouraged prudent and pragmatic CRE workouts within the framework of financial accuracy, transparency, and timely loss recognition. The FDIC expects that banks will work with commercial borrowers who remain creditworthy despite some deterioration in their financial condition. This interagency guidance has helped banks become more comfortable extending and restructuring loans, which will help businesses and expedite economic recovery. At the same time, we recognize that the economic environment for real estate continues to be stressed, and we expect that banks will continue to accurately recognize losses in a timely manner in accordance with accounting and financial reporting standards. We conducted follow-up surveys of institutions which restructured or renewed loans in accordance with

[4] http://www.fdic.gov/news/news/financial/2009/fil09061.html

the guidance. The results of our survey were positive as approximately 97 percent of respondents said that the guidance was helpful. Nearly 88 percent of respondents said there were not any specific regulatory policies that were impeding their ability to work constructively with CRE borrowers.

The FDIC has also been a strong supporter for new, sound lending. Since the onset of the crisis, we have actively encouraged banks to make good loans to consumers and businesses that are seeking credit. Accordingly, on November 12, 2008, the FDIC joined the other federal banking agencies in issuing the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*,[5] which encourages banks to continue making loans available to creditworthy borrowers and to work with mortgage borrowers that have trouble making payments. On February 12, 2010, the FDIC joined the other agencies again in issuing the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers*,[6] which reminded banks of the harmful economic effects of an excessive tightening of credit availability for small businesses, and stated that institutions engaging in prudent small business lending will not be subject to criticism as long as a comprehensive review of a borrower's financial condition is conducted. We believe that these efforts have helped banks become more comfortable originating credit in this difficult environment.

More recently, the FDIC hosted a Small Business Forum on January 13, 2011, with industry and government leaders to identify obstacles to small business lending.

[5] http://www.fdic.gov/news/news/financial/2008/fil08128.html
[6] http://www.fdic.gov/news/news/financial/2010/fil10005.html

The Forum covered a range of issues, including the impediments that are constraining the availability of credit for small businesses, and articulated ideas for overcoming these obstacles. Small businesses rely heavily on commercial real estate to collateralize borrowings for working capital and other needs. Community banks fulfill critical small business lending needs for cities and towns across the country. The FDIC will continue its support for small business credit availability, and in particular, credit availability needs for borrowers with commercial real estate.

Current Trends

Recent signs point to a tentative stabilization of the residential and commercial property sector, with improvement in price and vacancy rates. After weakening slightly in recent months, the S&P/Case-Shiller National Housing Index shows just a 2 percent year-over-year decline in residential real estate prices through September 2010. Similarly, the Moody's/REAL Commercial Property Price Index rose by almost 3 percent in the year ending in November 2010. But while vacancy rates appear to have leveled off for most major commercial property types, rental rates – typically a lagging indicator of market conditions – do not yet show clear signs of a broad-based stabilization. Through the fourth quarter of 2010, gross asking rents for office properties had declined for three consecutive quarters.[7] By contrast, average apartment rents increased in both the second and third quarters of 2010, while full- and limited-service hotels reported an increase of over 9 percent in revenue per available room during 2010.[8] As CRE cash flow

[7] **Source: CBRE Econometrics.**
[8] **Source: CBRE Econometrics.**

fundamentals slowly recover, so will the ability of CRE borrowers to service their debt out of current income.

Just as in the case of residential property markets, declines in commercial real estate prices that have taken place during the past few years will pose a longer term problem for commercial real estate lenders. Declines in CRE prices are leaving some borrowers with insufficient collateral to refinance their current loans when they come due, and are also inhibiting the ability of commercial borrowers to access new credit backed by the real estate they own. Concerns over collateral shortfalls for existing loans have been expressed by a number of analysts as property prices and market fundamentals have deteriorated. However, it is difficult to precisely measure the volume of CRE loans that will come due in any given year, or how many will experience collateral shortfalls. In any event, supervisory measures undertaken by the federal banking agencies to promote the responsible restructuring of CRE loans will help to ensure that the resulting credit distress is minimized.

Conclusion

The FDIC understands the significant challenges faced by banks and their borrowers in the commercial real estate market as the economy and financial sector recover from the dislocations that precipitated the crisis. Accordingly, the FDIC has enhanced its regulatory program and joined with other federal financial institution regulators in encouraging lenders to continue making prudent loans and working with borrowers experiencing financial difficulties. Community banks play a critical role in helping local businesses fuel economic growth, and we support their efforts to make good loans in this challenging environment.

Thank you. I am pleased to answer any questions from members of the Panel.

The CHAIRMAN. Thank you very much.
Dr. Parkinson.

STATEMENT OF PATRICK PARKINSON, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE

Dr. PARKINSON. Chairman Kaufman, members of the panel, thank you for your invitation to discuss the current state of commercial real estate and its relationship to the overall stability of the financial system.

Over the past year, the rate of deterioration for CRE market and credit conditions has leveled off, and there are some early signs of price stabilization in a number of key markets. However, weakness in real estate markets, both commercial and residential, continues to be a drag on overall growth in the economy.

CRE-related issues also present ongoing problems for the banking industry, particularly for community and regional banking organizations. Losses associated with CRE, particularly residential construction and land development lending, have been the dominant reason for the high number of bank failures since the beginning of 2008. Credit losses for bank CRE loans typically continue well past the trough of recessions, and we expect this pattern to continue in this cycle.

Working through the large volume of troubled CRE loans will take time as banks go through the difficult process of loan workouts and loan restructurings. However, if done prudently and effectively, loan restructuring can reduce the ultimate losses to the banking system. In addition, proper restructuring can reduce the damage done to businesses and the economy by limiting the forced liquidation of properties that would further depress prices.

While we expect significant ongoing CRE-related problems, it appears that worst-case scenarios are becoming increasingly unlikely. During 2010, delinquency rates on construction and development loans began to improve slightly, falling 1 percent. Still, even if CRE delinquency metrics continue improving, there remains a sufficiently large overhang of distressed CRE at commercial banks that loss rates for this portfolio will likely stay high for some time to come.

Approximately one-third of all CRE loans are scheduled to mature over the next 2 years. This circumstance represents substantial refinancing risk, as CRE loans typically have large balloon payments due at maturity. Since the passage of the October 2009 supervisory guidance on prudent loan workouts, banks have significantly increased the level of restructuring of CRE loans. Economic incentives to restructure or refinance existing loans are aided by the current low interest rate environments. Some banks with properties in healthier markets are also beginning to see a pickup in demand for high-quality properties with strong tenants.

Since the beginning of 2008 through the third quarter of 2010, commercial banks have incurred almost $80 billion of losses related to CRE exposure, equating to a little over 5 percent of the average exposure outstanding during that period. Given past historical experience and the recent improvement witnessed in the broader economy, it is estimated that banks have taken roughly 40 to 50 percent of the CRE losses that they will realize over this cycle.

While we can project potential losses facing banks, losses ultimately realized in this cycle will depend on macroeconomic and financial factors, especially unemployment rates and interest rates. Sensitivity of losses to those factors are why—is why we continue to emphasize the importance of stress testing as a critical element of managing risks associated with CRE concentrations.

Progress on working through the overhang of distressed CRE will take time and it will depend on banks taking strong steps to ensure that losses are recognized in a timely manner, that loan-loss reserves and capital appropriately reflect risk, that loans are modified in a safe and sound manner, and that loans continue to be made available to creditworthy borrowers. To this end, the Federal Reserve will continue to work with lenders to ensure that bank management and supervisors take a balanced approach to ensuring safety and soundness in serving the credit needs of the community.

Thank you. And I look forward to your questions.

[The prepared statement of Mr. Parkinson follows:]

For release on delivery
10:00 a.m. EST
February 4, 2011

Statement by

Patrick M. Parkinson

Director

Division of Banking Supervision and Regulation

Board of Governors of the Federal Reserve System

before the

Congressional Oversight Panel

Washington, D.C.

February 4, 2011

Chairman Kaufman, members of the Congressional Oversight Panel, thank you for your invitation to discuss the current state of commercial real estate (CRE) finance and its relationship to the overall stability of the financial system. Since the panel published its report, *Commercial Real Estate Losses and the Risk to Financial Stability*, one year ago, the rate of deterioration in market and credit conditions has leveled off, and there are some early signs of price stabilization in a number of key markets. Nonetheless, CRE delinquencies and losses are expected to remain elevated for some time.

Weakness in real estate markets, both commercial and residential, continues to be a drag on overall growth in the economy. Construction of nonresidential structures continues to lag because of weak fundamentals in the sector, including high vacancy rates and low property values, factors that are unlikely to change in the near term. Similarly, new home construction is likely to be constrained by the continuing overhang of distressed and vacant homes.

CRE-related issues also present ongoing problems for the banking industry, particularly for community and regional banking organizations. Losses associated with CRE, particularly residential construction and land development lending, were the dominant reason for the high number of bank failures since the beginning of 2008, and further CRE-related bank failures are expected over the next few years.

Credit losses for bank CRE loans typically continue well past the trough of recessions, and we expect this pattern to continue in this cycle. Working through the large volume of troubled CRE loans will take time as banks go through the difficult process of loan workouts and loan restructurings. If done prudently and effectively, including allocating appropriate levels of reserves and capital, loan restructuring can reduce the ultimate losses to the banking system. In addition, proper restructuring can reduce the damage done to businesses and the economy by limiting the forced liquidation of commercial properties that would further depress prices.

While we expect significant ongoing CRE-related problems, it appears that worst-case scenarios are becoming increasingly unlikely. CRE portfolio loan concentrations are not a significant risk factor for systemically important financial institutions. Some systemically important financial institutions have substantial exposures to commercial mortgage-backed securities (CMBS) and to derivatives securities such as CRE collateralized debt obligations. However, risks in these areas have been reduced, as significant mark downs have already been taken on these securities. In addition, conditions in the CMBS market have been improving, with spreads tightening and some new deals coming to market. However, we see losses in CRE to be an ongoing negative factor in bank portfolios that will need to be worked through over the next several years.

Current Conditions in the Commercial Real Estate Market

As housing market conditions deteriorated sharply throughout 2007, CRE markets began to experience weakness. Broad CRE market conditions remained relatively healthy until the second half of 2008, when CRE performance metrics turned down rapidly as a result of severe financial market disruptions and accelerating job losses. Vacancy rates increased sharply, rental rates plummeted, and property sales and values declined substantially. The higher vacancy rates and declines in the values of existing properties placed particularly heavy pressure on construction and development projects, which depend on market conditions at the time of completion for absorption and thus repayment.

Underlying market fundamentals of CRE remain a significant concern, but they have shown some signs of stabilizing. For instance, vacancy rates on office, industrial, and retail properties have stopped increasing, although they remained at elevated levels at the end of 2010, ranging between 13 percent and more than 16 percent, depending upon the property type and location. These levels are, on average, 5 to 6 percentage points above levels experienced in 2007. The rate of decline in rental rates has also slowed. At the beginning of 2010, office and industrial rental rates were between 10 and 12 percent lower than a year earlier, on average, but declines had slowed to between 5 and 7 percent at an annual rate at the end of the year. Sales volume of CRE properties improved each quarter during 2010, accumulating to almost $135 billion for the year as a whole. [1] This total is double the CRE property sales volume for all of 2009.

Recent readings from CRE price indexes indicate that the rate of price declines has slowed substantially. The NCREIF Transactions Based Index fell more than 36 percent from its peak in the second quarter of 2007 to the first quarter of 2010. In contrast, the index indicated that prices as of the third quarter of 2010 were only 0.2 percent lower than they were at the beginning of the year. However, the degree of price stabilization across different types of properties and locations is uneven. In particular, demand has been rebounding for well-occupied properties in top-tier markets, while less desirable properties in less favorable markets are still struggling from a lack of demand.

Concentrations of CRE Exposure on Bank Balance Sheets

At the end of the third quarter of 2010, approximately $3.2 trillion of outstanding debt was associated with CRE, including loans for multifamily properties. Of this amount, about one-half, or $1.6 trillion, was held on the balance sheets of commercial banks and thrifts. An additional $700 billion represented collateral for CMBS, and the remaining balance of $900 billion was held by a variety of investors, including pension funds, mutual funds, and life

[1] Real Capital Analytics

insurance companies. Outstanding CRE debt has contracted 6 percent from its peak in 2008, while outstanding CRE loans at banks have contracted by almost 12 percent. The majority of the decrease in bank loans was associated with reductions in construction and development loan balances, which were largely the result of foreclosures and charge-offs.

Despite the decline in aggregate CRE loans at commercial banks, many banks still have CRE loan concentrations, as defined in the 2007 "Interagency Guidance on Concentrations in Commercial Real Estate."[2] Banks are considered to have a CRE concentration when loans for construction, land development, and other land exceed 100 percent of risk-based capital or total CRE is greater than 300 percent of risk-based capital.[3] By this definition, almost 1,200 commercial banks, or 18 percent of all banks, had CRE concentrations at the end of the third quarter of 2010. CRE concentrations have been the dominant factor in bank failures. Of the more than 300 commercial banks and thrifts that have failed since the beginning of 2008, more than three-fourths had CRE concentrations at year-end 2007.

Notably, CRE concentrations are not a significant issue at the largest banks. Among banks with total assets of $10 billion or more, 10 percent had CRE concentrations. In contrast, one-third of all banks with assets between $1 billion and $10 billion had CRE concentrations. For banks with less than $1 billion in assets, approximately 17 percent had CRE concentrations.

Credit Quality of Commercial Real Estate in Bank Portfolios

At the end of the third quarter of 2010, almost 10 percent of CRE loans in bank portfolios were considered delinquent, a three-fold increase since the end of 2007.[4] Not surprisingly, loan performance problems have been most striking for construction and development loans,

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[2] 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.

[3] Owner-occupied CRE loans are not included in the CRE concentration definition.

[4] Delinquent CRE loans are defined as those that are 30 days or more past due.

especially for those that finance residential development. Almost 19 percent of all construction and development loans were considered delinquent at the end of the third quarter of last year.

During 2010, delinquency rates on construction and development loans began to improve slightly, falling 1 percent in the first three quarters of 2010. Additionally, delinquency rates on loans backed by existing nonfarm, nonresidential properties leveled off in 2010. Still, even if CRE delinquency metrics continue improving, there remains a sufficiently large overhang of distressed CRE at commercial banks such that loss rates for this portfolio will likely stay high for some time and many banks with CRE concentrations will remain under stress.

Approximately one-third of all CRE loans (both bank and non-bank), totaling more than $1 trillion, are scheduled to mature over the next two years. This circumstance represents substantial refinancing risk as CRE loans typically have large balloon payments due at maturity. Banks have been dealing with maturing loans in a variety of ways, including providing extensions of performing assets, troubled debt restructurings, equity injections, collateral sales, and, in some cases, pursuing foreclosures. Since the issuance of the October 2009 supervisory guidance on prudent loan workouts, banks have significantly increased the level of restructuring of CRE loans.[5] Economic incentives to restructure or refinance existing loans are aided by the current low interest rate environment. Some banks with properties in healthier markets are also beginning to see a pick-up in investor demand for high-quality properties with strong tenants.

Since the beginning of 2008 through the third quarter of 2010, commercial banks have incurred almost $80 billion of losses related to CRE exposure, equating to a little over 5 percent of the average exposure outstanding during this time. In past cycles, CRE credit and market fundamentals generally lagged the larger economy by a year or more. Given this historical

[5] Board of Governors of the Federal Reserve System (2009), "Federal Reserve Adopts Policy Statement Supporting Prudent Commercial Real Estate (CRE) Loan Workouts," press release, October 30, www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm.

experience and the recent improvement witnessed in the broader economy, it is estimated that banks have taken roughly 40 to 50 percent of the CRE losses that they will realize over this cycle. Using past cycles as a guide, we expect that the remaining losses will likely be incurred over the next few years.

While we can project potential losses facing banks, losses ultimately realized through this cycle will depend on the pace of improvement in the labor market, overall credit availability, and other macroeconomic and financial factors, especially unemployment rates and interest rates. Those factors are why we continue to emphasize the importance of stress testing as a critical element of managing risks associated with CRE concentrations.

Federal Reserve Supervisory Approach to Commercial Real Estate Concentrations

As noted in our previous statement to the panel on CRE conditions, the Federal Reserve led an interagency effort to develop supervisory guidance on CRE concentrations that was finalized in 2006 and published in the *Federal Register* in early 2007.[6] In that guidance, we outlined our expectations that institutions with concentrations in CRE lending need 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.

Since the quality of CRE loans at supervised banking organizations began to weaken, the Federal Reserve has devoted significant additional resources to assessing the quality of CRE portfolios. These efforts include monitoring the impact of changing cash flows and collateral values, as well as assessing the extent to which banks have been complying with our CRE guidance. Examiners have taken a balanced approach to ensuring that banks are recognizing losses in a timely manner, maintaining sufficient loan loss reserves, and monitoring collateral

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[6] See Jon D. Greenlee (2010), "Commercial Real Estate," statement before the Congressional Oversight Panel Field Hearing, Atlanta, Ga., January 27, www.federalreserve.gov/newsevents/testimony/greenlee20100127a.htm; also see Board of Governors, "Interagency Guidance," in note 3.

values while being mindful not to discourage healthy banks from making loans available to creditworthy borrowers.

Additionally, in an effort to encourage prudent CRE loan workouts, especially among maturing loans, the Federal Reserve led the development of interagency guidance issued in October 2009 regarding CRE loan restructurings and workouts.[7] To better understand the effectiveness of this guidance, the agencies conducted a survey of financial institutions during their examinations. The survey was completed in the third quarter of 2010.

The survey was designed to gain an understanding of the current trends in the institution's CRE portfolios and an estimation of the volume of loan restructurings that are likely to occur within the next year. The majority of respondents described the quality of their CRE portfolios as relatively stable but expressed concern regarding borrowers' deteriorating repayment abilities and declining collateral values, which were of particular concern where maturing loans no longer met the institution's underwriting standards. Approximately two-thirds of the respondents were engaged in workout activity. Of note, respondents reported that almost three-fourths of loan modifications were performing according to their modified terms. The survey also noted that the volume of future CRE workouts was estimated to increase by approximately 60 percent during 2011. In contrast, banks have only restructured approximately 5 percent of all outstanding CRE portfolios to date.

Given the level of restructured loans to date and the estimated volume of future restructurings, the Federal Reserve will continue to review institutions' restructuring policies to ensure that modifications are pursued in a prudent manner. Moreover, examiners will also monitor banks' internal reporting systems to determine if restructured loans are performing in accordance with modified terms.

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[7] See Board of Governors, "Federal Reserve Adopts Policy Statement," in note 5.

Regulated institutions continue to face significant challenges in determining the value of real estate in the current environment. For this reason, the Federal Reserve and the other federal banking agencies issued revisions to the *Interagency Appraisal and Evaluation Guidelines* in December 2010.[8] The Federal Reserve expects institutions to have policies and procedures for obtaining new or updated appraisals as part of their ongoing credit reviews. 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.

Changes to Supervision at the Federal Reserve

To improve both the Federal Reserve's consolidated supervision and our ability to identify potential risks to the financial system, we have made substantial changes to our supervisory framework. We have augmented our traditional supervisory approach, which focuses on examinations of individual firms, with greater use of horizontal reviews, which simultaneously examine portfolios across a group of firms, to identify common sources of risks and best practices for managing those risks. To supplement information from examiners in the field, we have enhanced our quantitative surveillance program to use data analysis and formal modeling to help identify vulnerabilities at both the firm level and for the financial sector as a whole. This analysis is supported by the collection of more timely, detailed, and consistent data from regulated firms. Many of these changes draw on the 2009 Supervisory Capital Assessment Program, or SCAP.

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[8] Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration (2010), "Agencies Issue Final Appraisal and Evaluation Guidelines," joint press release, December 2, www.federalreserve.gov/newsevents/press/bcreg/20101202a.htm.

Regarding CRE exposures specifically, we are working with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation on the collection of loan-level CRE data from a number of national and regional banks. The data collected will provide critical information on the credit quality and performance of these loan portfolios. These data will aid in the development of more forward-looking loan loss projections that will provide a useful benchmark for the broader CRE market that can be used for all institutions. They will also be used to develop more accurate stress test parameters for CRE portfolios of banks that the Federal Reserve supervises. In addition, the agencies have made adjustments to the Consolidated Reports of Condition and Income, or the Call Report, filed quarterly by banks, to obtain more detailed information with respect to their CRE restructurings.

Conclusion

Over the past year, CRE market and credit conditions have shown signs of stabilization and, in some areas, modest signs of improvement. We are also seeing signs of price stabilization in a number of CRE markets. Nevertheless, while some directional metrics are improving, the CRE market is still distressed and the strength and pace of improvements remains uneven.

We expect that banks will continue to incur substantial additional CRE losses over the next two years and that many banks with CRE concentrations will continue to be under stress. While problems in the CRE market will be an ongoing concern for a number of banking organizations and a negative factor for economic growth and lending, we do not see CRE losses as a threat to systemically important financial institutions.

Progress on working through the overhang of distressed CRE will take time and will depend on banks taking strong steps to ensure that losses are recognized in a timely manner, that loan loss reserves and capital appropriately reflect risk, that loans are modified in a safe and sound manner, and that loans continue to be made available to creditworthy borrowers. To this end, the Federal Reserve will continue to work with lenders to ensure that bank management and supervisors take a balanced approach to ensuring safety and soundness and serving the credit needs of the community.

The CHAIRMAN. Thank you, Dr. Parkinson.
Mr. Wilson.

STATEMENT OF DAVID WILSON, DEPUTY COMPTROLLER FOR CREDIT AND MARKET RISK, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. WILSON. Chairman Kaufman and members of the panel, I appreciate the opportunity to discuss the OCC's observations about the commercial real estate market and its impact on national banks.

The OCC supervises about 1415 national banks, representing about 18 percent of all insured depository institutions, and approximately 63 percent of all IDI assets.

Commercial real estate lending is a prominent business line for many national banks and is a sector that the OCC monitors very closely. National banks hold approximately 735 billion in outstanding CRE loans, which is about 16 and a half percent of their aggregate loan balances.

While there are signs that the commercial real estate markets are beginning to stabilize, we are a long way from full recovery.

Vacancy rates across major property types are starting to recover, but remain high by historical standards. We expect vacancy rates to remain elevated for at least the next 12 months.

Capitalization rates, the rate of return demanded by investors, have also shown recent signs of stabilization. Cap rates fell substantially from 2002 to 2007, to a point where they often did not fully reflect the risks associated with the properties being financed. Then they increased markedly in 2008 and 2009, as investors became more risk-averse. Recently, cap rates appear to have stabilized, particularly for high-quality assets, but the spreads being demanded by investors relative to treasuries remains wide.

A key driver for property values and CRE loan performance is the net operating income or cash flows generated by the underlying properties. Overall, NOI has continued to decline due to soft rental rates. While we expect the rate of decline to lessen, only apartments are expected to show meaningful NOI growth this year, with other major market segments expected to turn positive in 2012.

Property prices have also shown recent signs of stabilization. The Moody's All Property Index recorded an increase of 0.6 percent in November 2010, which was the third consecutive month of national price gains. While this trend is encouraging, we expect the prices to be volatile until underwriting market fundamentals improve consistently.

The trends and performance of CRE loans within national banks mirror those in the broader CRE market. While there are some signs of stabilization in charge-off rates, nonperforming loan levels remain elevated and continue to require significant attention by bank management and supervisors.

The effect of distressed commercial real estate on individual national banks varies by size, location, type of CRE loan. Because the charge-off rates for construction loans led performance problems in the sector, banks with heavier concentrations in this segment tended to experience losses at an earlier stage. Performance in this segment is expected to improve more rapidly as the pool of potentially distressed construction loans has diminished. Conversely, banks whose lending is more focused on income-producing commercial mortgages are continuing to experience increased charge-off rates.

Another factor for many community and midsized banks is their CRE concentrations. Although CRE concentrations as a percentage of capital has declined recently, they are still significant for many midsized and community banks. CRE concentrations and problem-loan workouts continue to be areas of emphasis and OCC examination activities, and our objectives are threefold: ensuring that the banks accurately risk-rate their loans, that they work constructively with troubled borrowers, and that they maintain adequate loan-loss reserves and capital, taking appropriate charge-offs when needed.

We are also emphasizing the importance of stress testing—and are assessing whether additional supervisory policies or guidance may be needed for examiners and institutions, to more effectively deal with the risks that CRE concentrations can pose to the industry and the viability of individual financial institutions.

In summary, there are modest signs of improvement, but the CRE markets still face significant headwinds. Ultimately, stabilization of the CRE markets will require restoring equilibrium between supply and demand, and will hinge on recovery of the overall economy. This process is not painless, and we expect CRE portfolios will continue to be a drag on some bank's performance for at least the next 12 to 18 months. During this period of adjustment, the OCC will continue to take a balanced and measured approach in its supervision.

[The prepared statement of Mr. Wilson follows:]

For Release Upon Delivery
10:00 a.m., February 4, 2011

TESTIMONY OF

DAVE WILSON

DEPUTY COMPTROLLER, CREDIT AND MARKET RISK
OFFICE OF THE COMPTROLLER OF THE CURRENCY

before the

CONGRESSIONAL OVERSIGHT PANEL
FEBRUARY 4, 2011

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 Kaufman and members of the Congressional Oversight Panel, my name is Dave Wilson and I am the Deputy Comptroller for Credit and Market Risk at the Office of the Comptroller of the Currency (OCC). I appreciate the opportunity to present the OCC's observations about the commercial real estate (CRE) market and its impact on national banks. The OCC supervises approximately 1,415 insured national banks, which comprise about 18 percent of the 7,760 FDIC-insured depository institutions (IDIs) in the United States, holding approximately 63 percent of all IDI assets. In terms of size, national banks constitute 13 of the 19 banks with assets over $100 billion, including the six largest banks in the United States; 42 percent of mid-size banks, with assets ranging from $5 billion to $100 billion; and 22 percent of community banks, with assets of less than $5 billion.[1]

Commercial real estate lending is a prominent business line for many national banks, and many have been adversely affected by the sharp and protracted downturn in the commercial real estate markets. The vast majority of national banks have and will continue to be able to manage through their troubled CRE exposures. For these banks, our supervisory message has been consistent and clear: work constructively with borrowers who are facing difficulties, but also recognize and address problem credits by maintaining appropriate loan loss reserves and taking appropriate charge-offs when repayment is unlikely. There will, however, be national banks whose CRE exposures and related losses are such that the bank will no longer be viable. In these cases, our supervisory objective is for early and least cost resolution strategies.

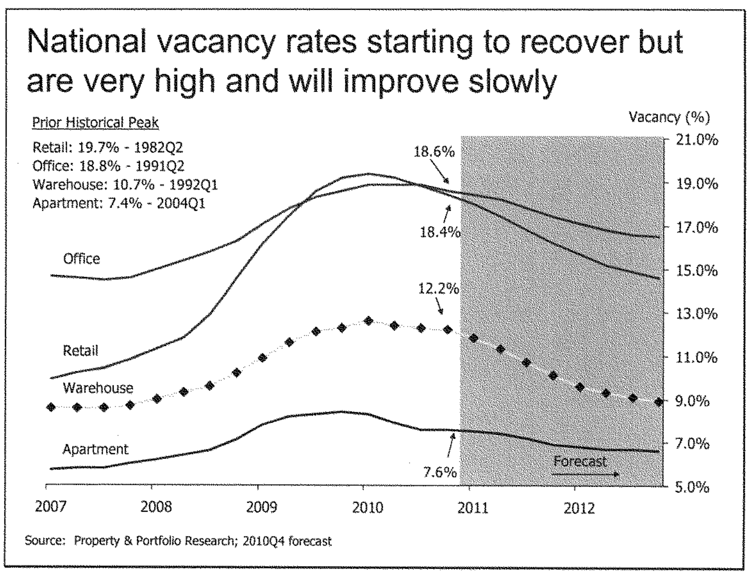
[1] Figures are based on 9/30/2010 data and include all FDIC-insured institutions, but do not include federally insured credit unions.

Pursuant to the Panel's request letter, the first part of my testimony discusses the OCC's current assessment of the CRE markets and the status of national banks' CRE lending portfolios. I then address the OCC's supervisory approach and actions for dealing with banks with high CRE concentrations.

II. Current CRE Market Conditions and National Banks' CRE Portfolios

Commercial property markets across the United States have begun to show signs of stabilization, as the economy slowly regains momentum. As shown in Chart 1 below, national vacancy rates across property types have started to recover, but remain high by historical standards. Based on projections by Property & Portfolio Research, elevated vacancy rates are likely to continue well into 2012.

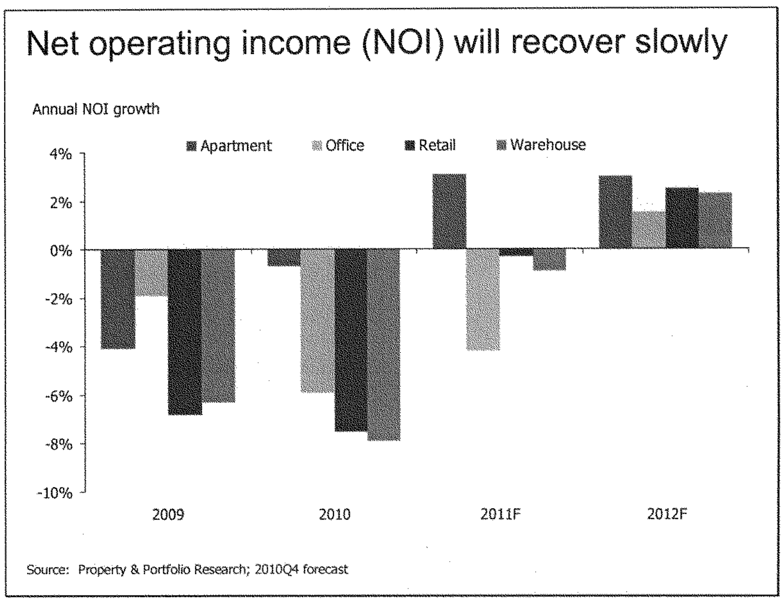
Chart 1



Notwithstanding the modest improvement in vacancy rates, net operating income – a key driver for CRE property values and the primary source for loan repayment –

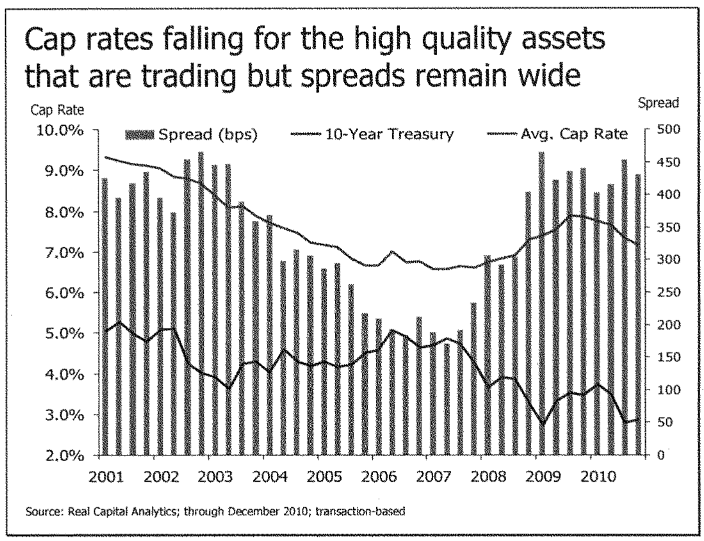
continues to decline across most CRE sectors. This is because leasing rates remain soft. Chart 2 below shows the recent and projected annual percentage changes in net operating income (NOI). As can be seen from the chart, while NOI is expected to stabilize for apartments this year, other property types are expected to experience further declines. Additionally, growth in 2012 is projected to be relatively modest.

Chart 2



A third factor affecting commercial property values is the capitalization rate, or rate of return, demanded by investors. This rate of return reflects, in part, investors' outlook on risk. The higher the required return, the lower the price investors are willing to pay (all other factors held constant). As occurred in other sectors, capitalization rates and risk premiums in relation to Treasury securities fell substantially for much of the past decade as investors and lenders competed for deals, relaxed their underwriting and investment standards, and accepted lower rates of return. We believe those capitalization rates were unsustainable as they often did not fully reflect the risks associated with the properties being financed. As investors became more selective, capitalization rates increased rather markedly in 2008 and 2009. As shown in Chart 3, cap rates appear to have stabilized and indeed have fallen somewhat, particularly for high quality assets, but the spreads being demanded by investors, relative to Treasuries, remains wide.

Chart 3



These trends in vacancies, NOI, and cap rates are reflected in overall property prices. In aggregate, commercial property prices fell roughly 40 percent from their peak in 2007, but prices have begun to show signs of stabilization. The Moody's/REAL All Property Type Aggregate Index[2] recorded an increase of 0.6 percent in November 2010, the third consecutive month of national price gains. While this is an encouraging trend,

[2] The Moody's/REAL Commercial Property Index measures the change in actual transaction prices for commercial real estate assets based on the repeat sales of the same assets at different points in time. Moody's Investors Service: Moody's/Real Commercial Property Price Indices, August 2010, page 3.

we expect that property values may remain volatile until underlying market fundamentals improve consistently. Within the aggregate Moody's index, only apartments are experiencing a meaningful recovery. As a further sign of the continued softness in the market, the Moody's report indicates that about 24 percent of the November transactions involved sales of properties that had notices of default, were in foreclosure, or had an owner in bankruptcy.[3] As measured by this index and illustrated in Chart 4, commercial property prices, while up 2.8 percent from a year ago, are still well below the 2007 peak.

Our expectation is that property values will slowly rise, but remain substantially below their 2006/2007 peaks (see Chart 5). While the pace and range of recovery will vary by geography, in general we expect office markets will face the longest road to recovery. Many retail markets will continue to be adversely affected by weak consumer spending and the overbuilding that occurred in this market segment. Within the CRE market, there is substantial bifurcation, with aggressive pricing reserved for quality assets in major urban markets such as Los Angeles, San Francisco, Chicago, Boston, New York, and the District of Columbia.

[3] Bloomberg/Business Week, "U.S. Commercial Property Prices Rise for Third Month," January 24, 2011.

Chart 4

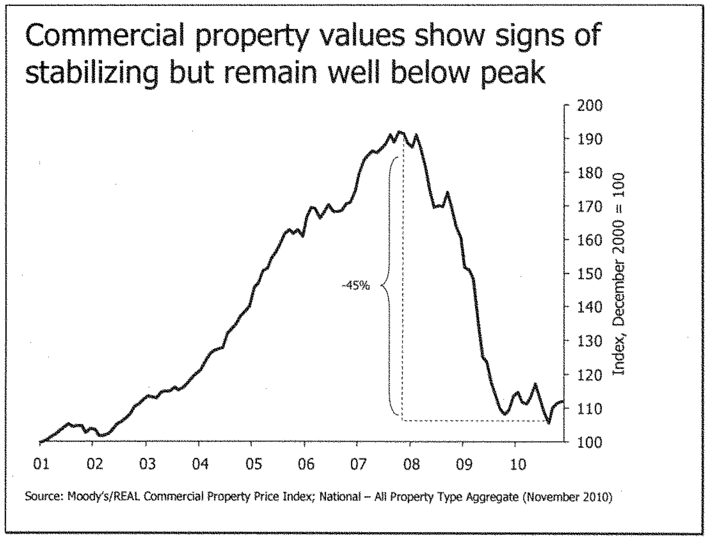
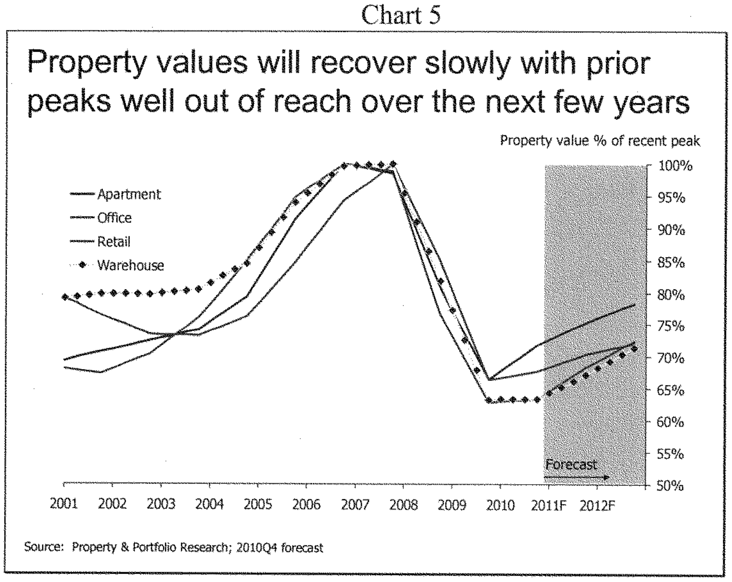


Chart 5



There also are some early signs of improvement in the CRE capital markets, but here again, activity is substantially below past peak levels. Issuance of commercial mortgage backed-securities in the U.S. totaled approximately $11.6 billion in 2010, up from $2.7 billion in 2009, but well-off the record level of $230.2 billion in 2007.[4] Similarly, sales transactions of CRE properties nearly doubled from 2009 to 2010, but at $120 billion, sales activity in 2010 was just a fraction of the $514 billion of properties traded in 2007.[5]

As shown in Chart 6, the rate of increase in CMBS delinquencies appeared to have moderated in the latter part of 2010, but trends remain uneven. By any measure, delinquency rates are exceedingly high and will continue to be a drag on this market.

Chart 6

Increases in CMBS delinquency have moderated; but level remains exceedingly high

CMBS Delinquency Rate

	Dec-10	Nov-10	Sep-10	Dec-09
Aggregate	8.8%	8.6%	8.2%	4.9%
Industrial	6.5%	6.4%	6.3%	3.4%
Multifamily	14.4%	13.9%	13.4%	8.1%
Office	6.7%	6.7%	6.4%	3.2%
Retail	7.4%	7.1%	6.6%	4.5%
Hotel	16.4%	16.4%	15.9%	9.1%

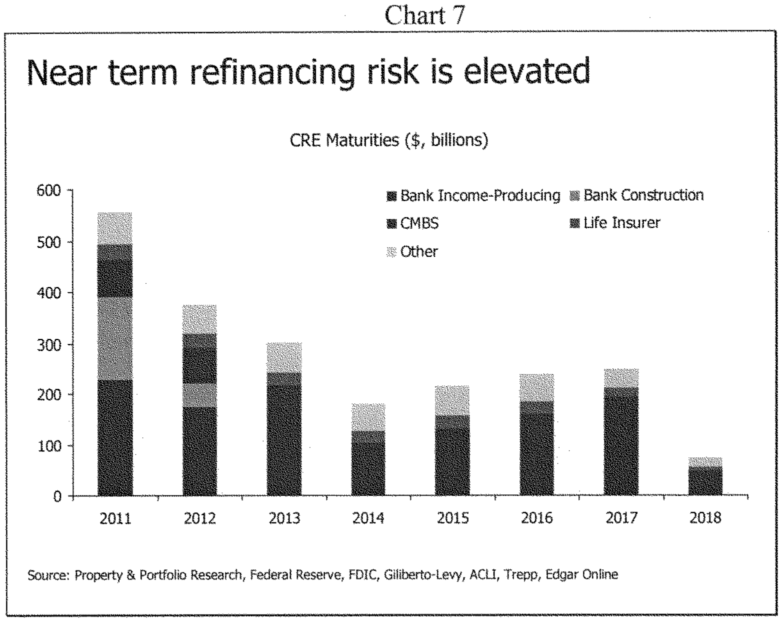
Source: Moody's CMBS Delinquency Tracker; January 2011

Given the continued weakness of CRE capital markets, the overhang of commercial mortgages that mature in the next few years represents one of the greatest risks to CRE loan performance. As shown in Chart 7, approximately $2.2 trillion of CRE

[4] Source: Commercial Mortgage Alert, January 2011.
[5] Source: Real Capital Markets Analytics, data through December 2010 for sales of $5 million or more.

loans are scheduled to mature from 2011 to 2018, with CRE loans from banks representing more than 60 percent of all maturities over the next few years. Additionally, a substantial portion of CRE debt that was expected to mature in 2010 may have been extended into 2011 or later. Permanent or rollover refinancing of these loans may be difficult due to lower property values coupled with lenders' and investors' greater reliance on in-place cash flow and more stringent loan-to-value requirements. One mitigating factor is the current low interest rate environment, which allows for some projects to cash flow since debt service requirements are low. If interest rates increase without a corresponding improvement in the economy, CRE refinancing difficulties would be exacerbated. This is a situation that we are continuing to monitor.

Chart 7



Consistent with the trends in the CRE markets, there are signs that CRE lending and loan portfolio performance have begun to stabilize within the banking sector. As measured by the Federal Reserve Board's Quarterly Senior Loan Officer Opinion Survey and summarized in Chart 8, fewer bankers are tightening underwriting standards and loan demand is starting to improve. These trends are consistent with what we are hearing from our examiners in the field. Despite these improving trends, new loan originations remain tepid (see Chart 9). As previously noted, we expect significant new activity in the CRE market to remain sluggish until underlying fundamentals, such as vacancies, NOIs, cap rates, and overall economic demand, show consistent and marked improvement.

Chart 8

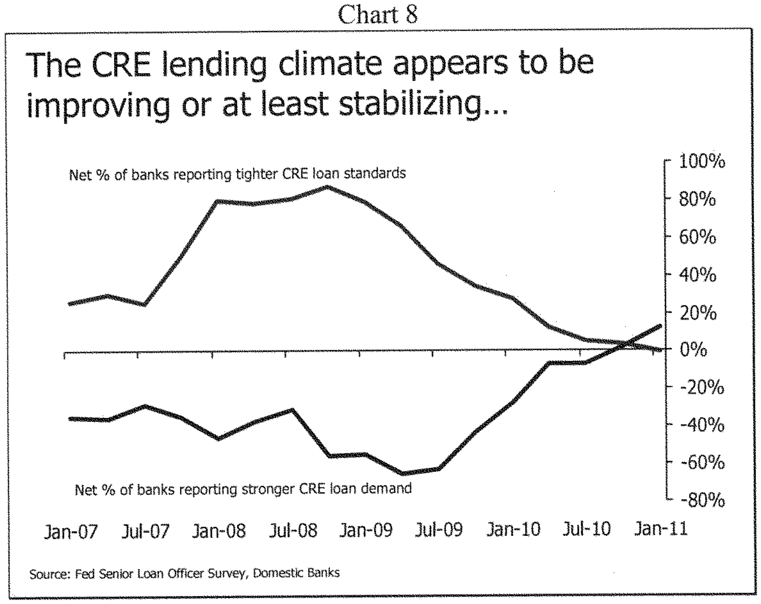
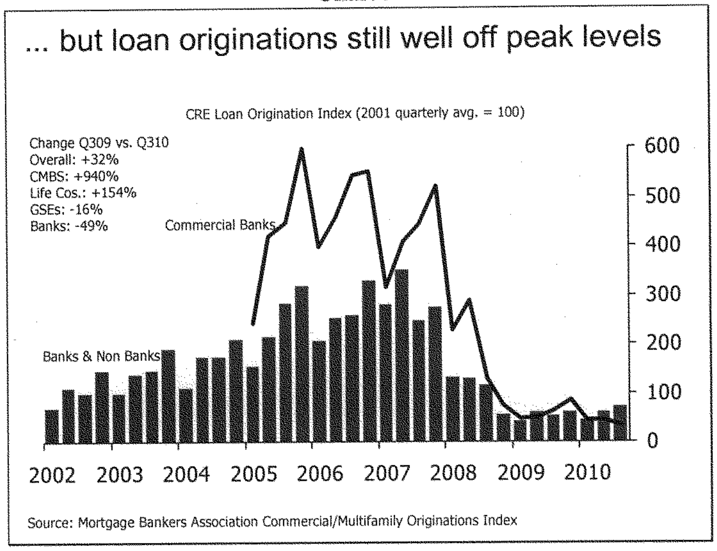


Chart 9



High vacancy rates and declining NOIs continued to adversely affect national banks' CRE portfolio performance throughout 2010 as nonperforming loan levels and loss rates remained well above long-term averages. Within the national bank population, there appears to be some stabilization in the level of non-performing CRE loans.[6] After increasing for every quarter since the third quarter of 2006, non-performing levels relative to total CRE loans declined slightly in the second and third quarters of 2010 to 8.41 percent (see Chart 10). However, through the third quarter of 2010, income-producing commercial mortgage charge-off rates continued to trend upward while charge-off rates for construction loans remained elevated (see Chart 11).

[6] Non-performing loans include loans that are on nonaccrual plus any other loans that are 90 days or more past due.

Chart 10

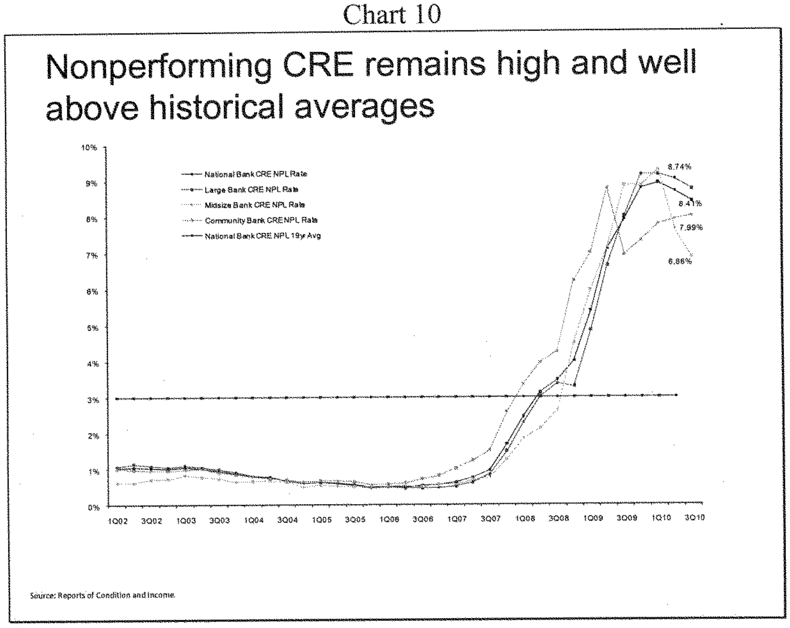
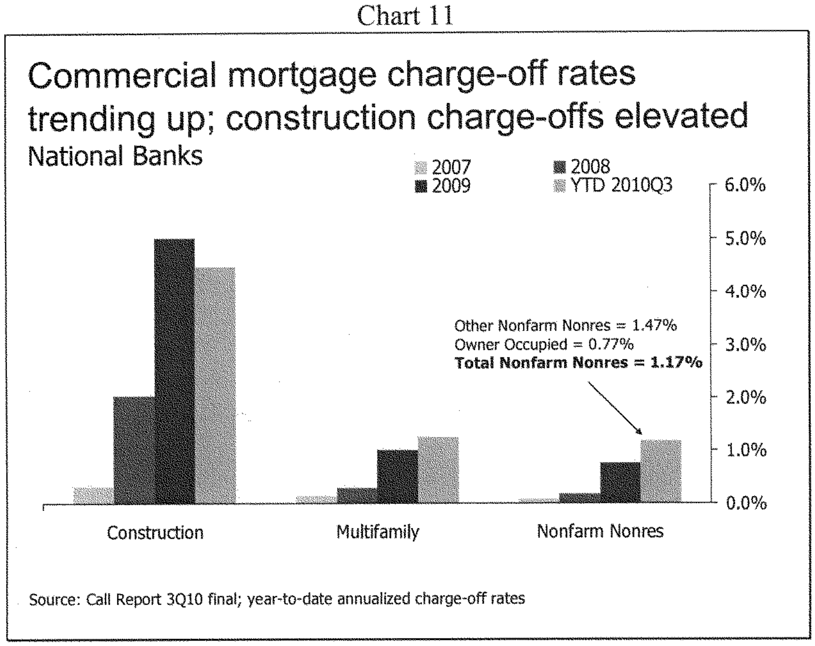


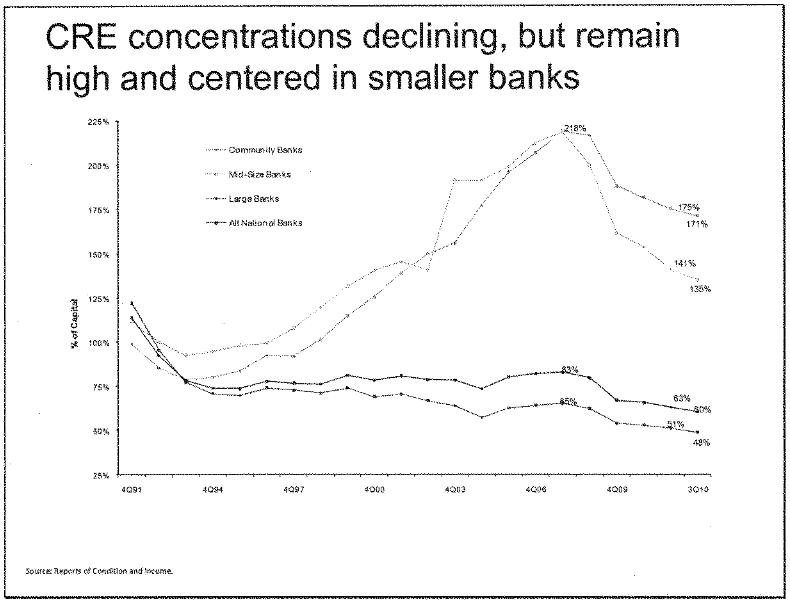
Chart 11



As part of our on-going supervision, the OCC uses a variety of tools to stress test possible CRE losses under a range of possible economic scenarios. Our current baseline analysis suggests that the two-year charge-off rate for CRE in total will remain near recent levels, with a peak in 2011, followed by a slight decline in 2012. In this scenario, commercial mortgage charge-offs increase due to another year of declining NOI in 2011 across most property types. Under a slower growth economic scenario, CRE charge-offs would rise higher, as demand for space falls, property values decline, and CRE credit markets tighten. This scenario would result in faster income-producing commercial mortgage deterioration and a slower improvement in construction loans compared to our baseline scenario.

The timing and effect of the distressed CRE market on national banks' overall financial condition varies by the size, location, and type of CRE exposure of the bank. As noted in Chart 11, charge-off rates for construction loans have led performance problems in the CRE sector and thus banks with heavier concentrations in this segment tended to experience losses at an earlier stage. Performance in this segment is expected to improve more rapidly as the pool of potentially distressed construction loans has diminished. Conversely, banks whose lending is more focused on income-producing commercial mortgages, including many smaller community banks, are continuing to experience increased charge-off rates. Compounding this problem for many community and mid-size banks is their significant CRE concentrations. As shown in Chart 12, although CRE concentrations as a percentage of capital have trended downward for all national banks, they are still significant for many mid-size and community banks. High CRE concentrations centered in construction and development loans have been a significant factor in the sharp uptick in bank failures over the past two years. In the vast majority of cases, failed banks had CRE concentrations of 300 percent or more of their capital two years before their eventual failure.

Chart 12



III. OCC Supervisory Approach to CRE Concentrations

The OCC has been raising and addressing concerns about the CRE market, and in particular, the concentrated exposures that many community banks have to this market, since early 2004 when we initiated the first of a series of targeted examinations at banks that we believed were at significant risk due to the nature and scope of their CRE activities. These supervisory efforts have continued with various targeted examinations and reviews at national banks with significant CRE concentrations. For example, in each of the last three years, we have conducted annual targeted examinations in all of our mid-size national banks that have significant CRE exposures. Similarly, our district offices have established action plans for ongoing monitoring and assessment of community banks with elevated CRE exposures. As part of these reviews, examiners evaluate the adequacy of the bank's internal loan risk rating and classification systems and determine whether bank management is recognizing problem loans and developing realistic workout plans, and maintaining adequate loan loss reserves.

We have also been directing national banks with significant CRE concentrations to develop more rigorous stress testing capabilities. For example, we have instructed banks that their stress testing of CRE transactions should consider the effect of multiple variables (e.g., changes in interest rates, vacancy rates, and capitalization rates), and that such stress tests should be performed periodically throughout the life of the loan.

To assist bankers in identifying and assessing potential CRE vulnerabilities, we developed, and have made available via our National BankNet Web site, a CRE stress testing tool that bankers can use. Although BankNet is a system designed for national banks, we make available our CRE tools 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 CRE Stress Testing Worksheet is an Excel-based tool that only requires an input of some basic loan underwriting criteria, yet it provides a concise output of the potential credit quality deterioration posed by the embedded risks. The worksheet shows the progression of the potential impact to debt service coverage (DSC) and loan-to-value (LTV) 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.

We elected to start targeted exams at selected banks early in the credit cycle – before problems were manifested in borrower performance – so that we could give bankers an opportunity to correct and address weaknesses. 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.[7]

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 stressed the need for examiners to take a balanced approach in their supervision and to maintain open and effective communications with bankers during their examinations. Given the issues that examiners were identifying in CRE loans, in April 2009 we issued follow-up supervisory guidance to examiners on factors that they should consider when evaluating banks' workout programs and risk ratings for problem CRE loans. Much of this guidance was subsequently incorporated into the agencies' October 2009 guidance on CRE loan workouts.[8]

The October 2009 guidance includes specific, real world examples to provide greater clarity and certainty for bankers in how examiners review and assess certain CRE loan structures. Given the concerns and questions we were hearing about how examiners

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[7] OCC Bulletin 2006-46, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices: Interagency Guidance on CRE Concentration Risk Management."
[8] OCC Bulletin 2009-32, "Commercial Real Estate (CRE) Loans: Guidance on CRE Loan Workouts."

differentiate between performing and non-performing loans, each example provides various fact patterns and describes the appropriate classification, accrual, and accounting treatment for each different set of circumstances. Drilling down into these specifics is a basic tenet of our loan review processes. The simple fact is that two loans or borrowers that initially appear to be similarly situated often have significant differences that will affect their ability to perform as structured.

To help assess the effectiveness of the October 2009 guidance, the federal banking agencies and Conference of State Bank Supervisors asked institutions to complete a CRE Questionnaire included in their pre-examination packages from May 31, 2010 through July 9, 2010. The agencies collectively received 370 responses, consisting of 325 institutions with total assets of less than $1 billion and 45 institutions with total assets of $1 billion or more. Approximately 97 percent of the survey respondents indicated that the guidance has been helpful, and nearly 88 percent indicated there were not any specific regulatory policies that were impeding their ability to work constructively with troubled CRE borrowers.

As previously noted, CRE concentrations, risk exposures, and problem loan workouts continue to be areas of emphasis in our current examination activities. We have conducted quality control testing in our banks to ensure that examiners are consistent in the risk rating of CRE loans and in the examination of banks with CRE concentrations. Key objectives of our CRE examinations are to ensure that bank management recognizes and addresses potential problems at the earliest stage possible—when workout efforts are likely to be most successful—and that previously identified deficiencies and shortcomings in risk management practices have been addressed. For example, last year we conducted a CRE horizontal review across 12 mid-size national banks with significant CRE exposures. Our review focused on a wide range of CRE portfolio management issues, with a particular emphasis on stress testing, concentration management, and compliance with the October 2009 guidance on prudent CRE workouts.

As noted in the agencies' October 2009 guidance, prudent CRE loan workouts are often in the best interest of the financial institution and the borrower. It has been our longstanding policy that examiners will not criticize prudent loan workout arrangements. Similarly, we have encouraged, and continue to encourage, bankers to extend credit to creditworthy borrowers. This does not mean, however, that examiners will allow bankers to ignore loans with structural weaknesses or insufficient cash flows to support repayment. While we encourage bankers to work with troubled borrowers, we also insist that banks maintain the integrity of their financial books and records by maintaining appropriate loan loss reserves and capital, and when warranted, taking appropriate charge-offs. Forestalling the recognition of problems in the hope that market conditions might improve is not an effective regulatory strategy, nor does it promote a return to more sustainable market conditions.

I want to stress that 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 of 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. In making loan classification or write-down decisions, examiners first focus on the adequacy of cash flow available to service the debt, including cash flow from the operation of the collateral, support from financially responsible guarantors, or other bona fide repayment sources. However, if these sources do not exist, and the only likely repayment source is sale of the collateral, then, consistent with generally accepted accounting principles (GAAP), examiners will direct the bank to write down the loan balances to the value of the collateral, less costs to sell.

In addition to our ongoing supervision of individual banks, in light of the significant number of bank failures that have occurred over the last 18 months – most of which had significant CRE concentrations — we also are assessing whether additional supervisory policies or guidance may be needed for examiners and bankers to more effectively deal with the risks that CRE concentrations can pose to the industry and the viability of individual financial institutions. Some of our efforts – such as working with accounting standard setters to develop a more forward looking loan loss model – would extend beyond CRE loans. But we are also evaluating the need to develop more clear and explicit expectations that as concentrations increase, so must the level and robustness of risk management systems, stress testing, capital planning, and capital levels. While this work is still in the very early stages, we believe it is one of the critical lessons learned from the recent financial crisis.

IV. Conclusion

In summary, while there are modest signs of improvement and stabilization, the CRE markets still face significant headwinds. Ultimately, stabilization of these markets will require restoring equilibrium between the underlying supply and demand factors within this market and will hinge on recovery in the overall economy. As we have seen, this process is not painless, and we expect CRE portfolios will continue to be a drag on national banks' performance for at least the next 12 to 18 months. During this period of adjustment, the OCC will continue to take a balanced and measured approach in its supervision: encouraging bankers to make prudent loans and to work effectively with troubled borrowers, but to also maintain appropriate loan loss reserves and capital levels, and recognize losses.

The CHAIRMAN. Thank you, Mr. Wilson.

We have some questions.

I'd like to start out talking about—primarily about small banks. And I'd like each witness to comment on how much you think—you've all talked about the distressed commercial real estate market—how much you think that overhang on small banks is affecting their recovery.

And we'll start with Ms. Thompson.

Ms. THOMPSON. I think the overhang is impacting their recovery. But, when we issued the guidance on CRE loan workouts, we started to see a lot of restructurings. And for the banks that are in our portfolio, they have a close and good relationship with their borrowers. We have about 4,700 institutions where we are the primary Federal regulator, and our employees are located and live in the communities. The bankers that service the commercial real estate loans and their portfolio have a high touch with their borrowers, and they are familiar with the markets, and it would be a win-win for them to work out and restructure these loans. We've been encouraging them to do so. We've also been encouraging them to acknowledge when they can't work these loans out, so that they can take the losses right away.

The CHAIRMAN. Dr. Parkinson.

Dr. PARKINSON. I think it is affecting the recovery. As I think all of us have been saying, we've really been emphasizing the importance of prudent and effective workouts, and certainly monitoring what the banks are doing in that area.

But, even with prudent and effective workouts, many of them have large volumes of assets that are extremely troubled, and, in the course of working them out, further losses are going to be recognized. And, in some cases, that's going to jeopardize their ability to pay the economic role that they need to play. And I don't think, at this stage, there's much we can do about that, other than make sure that they follow the workout guidance to mitigate and limit whatever damage their troubled condition would otherwise produce.

The CHAIRMAN. Mr. Wilson.

Mr. WILSON. Yes. I have similar comments. There are a number of severely distressed community banks that probably won't make it. And, there is no real silver bullet. But, the best we can do is make sure that we're fair and consistent with our workout guidance, because, in many cases, that's the best for the bank, that's the best for the customer, and, as was mentioned before, it's also best for the community.

The CHAIRMAN. Many times, when you talk to borrowers,—I think it's—many, many borrowers, you have good relationships with the banks—the borrowers say the banks tell them they can't lend them the money, they can't extend the loan, they can't work it out because of the regulators. I've heard this, time and time and time again.

And so, Ms. Thompson, do you have some comments you can address to this complaint? Because it is—I mean, the person that these borrowers are blaming are not the banks that won't lend them the money, it's the—they blame it on the regulators.

Ms. THOMPSON. You're absolutely correct. We hear that all the time.

And we really, as regulators, try to take a balanced approach to supervision. We want banks to make good, prudent loans. We don't want them to create further problems by "kicking the can down the road." We think it's important that there are good underwriting standards. And as long as a bank is making good loans, we are encouraging that practice, both for small business lending and for residential CRE. The regulators are trying to work with institutions so that we can have a safe and sound banking system with good loans, because we all know what happens when a bad loan is made.

The CHAIRMAN. Dr. Parkinson.

Dr. PARKINSON. Consistent with that, we're certainly aware of these reports, and we've been taking a very careful look at what our examiners are doing to try to ensure that they follow the guidance that we've set out and take an objective and balanced approach.

We try to continue to enforce that through guidance to examiners and through training. We're very carefully looking and monitoring the examination process, which includes local management vettings of exam findings, and reviewing a sample of exam reports to see if there are any inconsistencies with the guidance.

Our monitoring, to date, suggests that by and large, the examiners are appropriately considering the guidance. And if we've made it clear that if a banking organization is concerned about supervisory structures imposed by our examiners, they should incur contact either the Reserve Bank or contact us, in Washington, to discuss and identify the problems.

The CHAIRMAN. Mr. Wilson.

Mr. WILSON. I agree with that. We do hear that a lot. We are very sensitive to it. When we try to solicit specific examples of a situation, where we can follow up, as Pat says, many times when we do get specific situations, we do believe our examiners are working appropriately. But, lots of times it's more general, that we can't really track it down.

The CHAIRMAN. I don't have anymore time for questions, because—I will not ask—the question I want to ask is, How many times do you think the bankers are blaming you for the fact that they don't want to make the loan, anyway? But, I won't ask that question.

Mr. McWatters.

Mr. MCWATTERS. Thank you, Senator.

Let me start at a 30,000-foot altitude and ask a basic question.

Back at—the last time we had a severe real estate depression was '89 through '94, and the answer was the Resolution Trust Authority—or Corporation. RTC purchased lots of loans, sold them at very cheap prices, although it may not have been favorable for the taxpayers, but it did lead to immediate price discovery, as to what was a fair market value of those assets.

Given where we are today, is there a need for an RTC?

Ms. Thompson.

Ms. THOMPSON. Well, I worked at the RTC, and I think the industry and the regulators can work through this issue. We are seeing signs of stabilization. The CMBS market is coming back; it's not where it once was, but we saw a lot of transactions in the fourth-quarter last year. Vacancy rates are declining. And it seems like the workout process just needs time to work itself through.

I'm not sure that an RTC-type entity is necessary at this point.

Mr. MCWATTERS. Okay. Thank you.

Dr. Parkinson.

Dr. PARKINSON. Just to make an observation that the RTC was created to dispose of the assets of failed banks after they had failed and come into the FDIC's portfolio.

Mr. MCWATTERS. Right.

Dr. PARKINSON. If the concern today is about this overhang of troubled assets at the banks, until they fail, there really wouldn't be a purpose for RTC.

And, if the notion was that we create a government entity to buy troubled assets from commercial banks that were still sound, you'd face the same issues they did in trying to get the original conception of the TARP program off the ground?. And how do you do that in such a way that you aren't creating a government subsidy, on the one hand, or not giving a fair price to the troubled institution, on the other?

Mr. MCWATTERS. Oh, okay. Well, let me ask you this question. Is there any need for a quasi-TARP structure? I've read about government-sponsored REITs, quasi-REITs, where the government purchases mortgage, purchases property, holds them in this REIT-type entity—it's not a technical REIT, under the Internal Revenue Code—holds it, sells interest in it to the public, and then ultimately, as the properties recover, disposes of the properties, probably with the public investors granting back some sort of an equity participation right to the government, so the government walks out whole. Is there any need for something like that?

Dr. PARKINSON. I haven't given that specific proposal any careful thought. But, again, I think the challenges would be many. Again, what price would the REIT purchase the assets from the institutions? Where within the government would we have the capacity to manage a REIT? But, I haven't heard that proposal, and therefore——

Mr. MCWATTERS. Yeah.

Dr. PARKINSON [continuing]. I probably can't give you a fully satisfactory answer.

Mr. MCWATTERS. Yeah. What I'm looking for is not necessarily mechanics, but whether or not governmental intervention, taxpayer funds, are needed to solve this problem, or if this is a problem that can simply be solved by the market over the next 2 or 3 years.

Dr. PARKINSON. Well, I think funds have been flowing back into real estate REITs, of late. And also, another point I think all of us made was that, ultimately, the fate of these commercial real estate properties is very much going to be driven by developments in the broader economy, whether it's the path of interest rates, unemployment.

So, maybe the best thing we can do is try to support the recovery through prudent and appropriate monetary and fiscal policies. And that may be the single most effective thing to support the value of those CRE assets.

Mr. MCWATTERS. Okay.

Mr. Wilson.

Mr. WILSON. I agree. I think there is a lot of money out there. There's private investor money. They're just looking for the right price. There is price discovery on some of the most distressed assets. But, I think there are many cases where it makes more sense for the bank to hang on and work with the borrower, if there is a viable source of repayment that can eventually pay the loan. So, I think that we probably can work through the process, as painful as it would be.

Mr. MCWATTERS. Okay.

Ms. Thompson, did you have something else to add?

Ms. THOMPSON. Mr. McWatters, I think you're referring to an equity trust transaction. This was a type of transaction that was used at the Resolution Trust Corporation. Again, that was for failed assets, where the assets were sold into a trust—there were nonperforming and some performing—and the government took a percentage share of both the downside and the upside. That seems to work well for assets from failed institutions.

I'm not sure that that is necessary right now, because the market is starting to open up. Some of the problem banks are starting to raise capital. And we are seeing slow signs of asset sales. And, as I mentioned earlier, the CMBS market is slowly coming back. And, especially in the CMBS market, the special services have a lot more flexibility to work out the loans, as do banks that have commercial real estate in their portfolio.

The transaction itself has been done before, and I think that it's a good mechanism, but I'm not sure it's necessary for——

Mr. MCWATTERS. Okay.

Ms. THOMPSON [continuing]. An open market.

Mr. MCWATTERS. Okay. Fair enough. My time's up.

But, my takeaway from this is that, from the FDIC, Fed, and OCC's perspective, there is not the need—clear need, today, for direct governmental intervention of taxpayer funds to solve this problem.

Thank you.

The CHAIRMAN. Thank you, Mr. McWatters.

Mr. Silvers.

Mr. SILVERS. Thank you, Mr. Chairman.

I—before I begin my questioning, I just want to observe that, in one of the—our work, as a panel, is coming to an end. This probably is our second-to-last hearing. And one of the great pleasures of having served on this panel is to be able to learn from such dedicated public servants as yourselves. And I think, particularly when we discuss motivations of folks, it's always apparent to me that people such as yourselves have many opportunities to make lots of money elsewhere. And I just suspect, just from what I know of each of you, that you've spent long careers serving the public for far less than you can make in the private sector. And the motivations involved in that are clearly, perhaps, not dreamed of in economist philosophies.

Now, from that high level to the more mundane. Mr.—Dr. Parkinson, in your testimony, you—in your written testimony, you observed that the commercial banks have charged off about $80 billion of commercial real estate assets. Do I take from your testimony that—and this is all—to all three of you, but particularly to Dr. Parkinson—that these charge-offs have largely been, essentially, driven by—not by refinancing failures, but by the failure of the borrowers to be able to make the payments? Is that fair? Do I read that right?

Dr. PARKINSON. I think it would be difficult to parse. They can't meet the terms of the original loan, or it's in trouble. Whether that's because they don't have sufficient cashflow to service the debt, outside of an event where the balloon payment comes due, or how much that was an inability to make the balloon payments, I don't know. I'm guessing that there's some of both. And certainly, in many cases, the fundamental problem is the lack of cashflow——

Mr. SILVERS. Right.

Dr. PARKINSON [continuing]. And that, in turn, would make it very difficult for them to make the balloon payments——

Mr. SILVERS. But, the reason why the chargeoff has occurred—Mr. Wilson, you're nodding your head—it seems likely, given just the timing of the refinancing issues and the balloon payments, that the reason why these 80 billion charge-offs have occurred is more likely to be in the routine cashflows rather than in the balloon payment. Is that——

Mr. WILSON. Yes, I would agree with that, because commercial banks, insurance companies, and really even special services and CMBS, you know, have a fair amount of ability to work with customers. And if there is cashflow there and the loan is matured, that's an issue. But, lots of times they can work through those issues if there's a fundamental source for repayment still with the loan.

Mr. SILVERS. Ms. Thompson, do you have anything to add to this?

Ms. THOMPSON. Yeah. I think much of the chargeoffs have taken place in the ADC space.

Mr. SILVERS. Yes, I was getting to that.

Ms. THOMPSON. Oh.

Mr. SILVERS. Please continue.

Ms. THOMPSON. I was just going to say—because there's a distinction between the charge-off numbers for ADCs and the charge-offs for owner-occupied commercial real estate. And you'd notice significant differences in them both, and significant——

Mr. SILVERS. What portion of the——

Ms. THOMPSON [continuing]. Differences in the——

Mr. SILVERS [continuing]. 80 billion in commercial bank charge-offs do you think are ADC—meaning the development loans and the like?

Ms. THOMPSON. For commercial banks and savings institutions, about $64 billion, or 70 percent of all CRE charge-offs since year-end 2007, were attributable to ADC.

Mr. SILVERS. All right. Now, in—you know, this hearing has sort of already ranged widely, but it seems to me that our fundamental concern here, for starters, is that we've got about 34 billion in TARP assets in banks through CPP, mostly—almost entirely smaller banks. They're exposed to the commercial real estate market disproportionately. The question is, What happens when the balloon payments come due? The—it seems as though—do you—tell me if you disagree, but it seems though that question really—we haven't really gotten to that question yet, that the charge-offs we have seen are predominantly due to cash flow issues and disproportionately in development loans, not in, sort of, occupied properties. Is that a fair summary of where we sit——

Ms. THOMPSON. I think——

Mr. SILVERS [continuing]. Today?

Ms. THOMPSON. I think that's fair.

Mr. SILVERS. All right.

So, our panel's concern, I think—and this is the—like, the third hearing and we've done a couple of reports—is, What happens when the balloon payments hit?

Mr. WILSON, you say that there's a lot of flexibility here. So, let me ask you this. If I'm a C—if I'm a TARP-recipient bank, holding some of the public's money, and I come to one or all or more of you, in a year's time, with a bunch of loans that have come due, and, they—and the borrowers can't make the balloon payments, and they have problems refinancing, because the price of property has fallen 40 percent, which is the typical—which is what Moody says the market's fallen—so, I'm the—I'm a bank, and I come to you and I say, "I'd like, essentially, forbearance. I'd like to be able to rollover this loan or redo it, even though the value of the property is now—can't—the collateral can't support the loan, under normal underwriting standards," what do you guys say?

Ms. THOMPSON. We're telling our examiners not to have banks classify loans just because the collateral value has declined. We look at the borrower's ability to repay. So, to the extent you have a borrower, and they can make a repayment, I think that is the fundamental issue.

Mr. SILVERS. But, I'm asking when the—I mean, this is a situation where the borrower literally can't make a payment. There's a balloon payment due, they can't make it. They—you know.

Ms. THOMPSON. They may not be able to make that payment, but there is a payment that——

Mr. SILVERS. They're making their ongoing payments.

Ms. THOMPSON. If they're making their ongoing payments, there are flexibilities that the banks are allowed. The CRE workout guidance provides some specific examples of those types of transactions. They can modify the loan; they can extend the loan. We would focus specifically on the borrower's ability to repay. We would encourage a modification.

Mr. WILSON. Yeah, speaking broadly, for construction and development loans, if it was a failed project, you really have no cashflow; it's a liquidation-type situation. Most of the commercial mortgage, income-producing loans, have tenants and they have cashflow. It may not be enough cashflow, but there's an opportunity to resize the loan, bring additional equity to the table. If there is no additional equity, there's the ability for the bank to charge it down, but not off, and restructure the loan. And so, the loss content's not as high, in commercial mortgage, which we see is the bigger issue, going forward.

Mr. SILVERS. My time is expired.

Thank you.

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you.

I'd like to continue this line of questioning that Mr. Silvers has started, because I think it's a very important one. And I guess I want to sort of more generally—it seems like—this is a fairly complicated problem, knowing when you write a property down, in a dynamic economy in which prices obviously are fluctuating, and that affects the value of the underlying property, and things like that. So, I mean, is there—are there general rules, that you can sort of provide us with, when you think it's appropriate for a bank to write down a property and when it's—you leave it on the books as is? And what's the cost and benefits from taking either action?

I'll start with you, Ms. Thompson. Could you?

Ms. THOMPSON. Well, I think that a borrower's ability to repay is a big factor in the consideration of whether you modify a loan, or not. And, certainly foreclosures need to take place and write-downs need to take place. If banks take a really hard look at the borrower's capacity, as opposed to collateral value, then they could likely restructure and modify a loan that would work for both the borrower and the bank.

I do think that most institutions, especially the smaller institutions, hold these loans in portfolio, and they are very much aware of the appraisals and values that are in their specific communities. These bankers have a really good understanding of what they're supposed to do and when they're supposed to do it. We try not to be too prescriptive, but our view is, look at the borrower's ability to repay and try to restructure the loan. If you can't, then write it off as soon as you possibly can.

Dr. TROSKE. Okay, thank you.

Dr. Parkinson, do you have any thoughts?

Dr. PARKINSON. Yes, I generally agree. Well, number one, I think you're right, that it is a difficult question. I think Sandra is right, that the local bank probably has the best information to make a sensible judgment about that difficult question, and that the borrower's ability to service even a restructured loan is really the critical thing. Or perhaps the bank has to ask themself, "I have two alternatives. I foreclose, then I essentially manage the property and try to maximize the value. Or, do I leave it in the hands of the original borrower? And really, the answer to that question's going to depend on my assessment of the borrower and his capacity to really manage that property and to maximize its value, whether they can do that better than I can."

Dr. TROSKE. Go ahead, Mr. Wilson.

Mr. WILSON. Fundamentally, when we evaluate a loan, we look first to cashflow sources to repay the loan such as the NOI from the property, bona fide guarantors that have the ability, or other viable sources. And, as long as that's still intact, the value of the property is less important. Where the value of the property becomes important is when that primary source or those sources of cashflow are not there, or they're insufficient, then we have to look to the value of the property and that's sort of our benchmark for what you charge the loan down to. But, we would not do that if there's a source of cashflow to pay the loan. The collateral is only a secondary source of repayment.

Dr. TROSKE. Dr. Parkinson, I want to turn to—sort of expand on something that you sort of hinted at that's, I guess, sort of a related issue. I mean, one of the things that we have noted, as a panel, is the concentration of these—of CRE loans in small- and medium-sized banks. Do you have sense of why? Do they have a—what is their comparative advantage in making these loans? I'm assuming that that's why they're all there. And there's also—often been questions about whether it should—whether these loans should be with—you know, concentrated in these small- and medium-sized banks. I guess the alternative is that they would be made by larger banks.

Give me an overall sense of how we got to this situation, where these are the banks holding their loans? And what's their advantage in doing this? And, maybe, what's the cost of doing it?

Dr. PARKINSON. Well, just stepping back as an economist, I think these loans are ones where information asymmetries are particularly important. And if I'm a borrower from outside the local area, I'm not going to have the knowledge of the particular area and the project that the local bank does. And that's probably what gives the local bank their competitive advantage, compared to other potential lenders of these kinds of loans.

Over the years, one of the reasons smaller institutions have become concentrated in CRE is that other kinds of loans that they historically made, because of technological changes, development of securitization, et cetera, they no longer were the most efficient or effective lender, when it came to those kinds of products. So, in some sense, their concentration in CRE is a result of an adverse selection, where the other things that they used to be able to fund, they no longer can do so competitively.

So, it's understandable why they've ended up where they are. It does pose risk. Although one of the things that Sandra emphasized in her testimony that I think is worth emphasizing is that, while lots of banks with CRE concentrations are in deep trouble, there are also lots of banks with CRE concentrations that are managing those concentrations quite well so that—you know, that comes down to the importance, not simply of what the percentage of their portfolio is in CRE, but their capabilities for managing that portfolio. And that's why I think a lot of our guidance has not been specified, in terms of, for example, putting arbitrary limit on the concentration, but trying to encourage the institutions to manage those concentrations effectively.

Dr. TROSKE. Okay, thank you.

My time's up.

The CHAIRMAN. Thank you.

Mr. Neiman.

Mr. NEIMAN. Dr. Troske, in his opening statement, opened the door for discussion on the role of government, and particularly financial regulators. And I think CRE is, maybe, a good example of assessing the role of bank regulators, because, you know, regulators typically do review banks at a point in time—as well as looking back over bank practices over a prior period—assessing the bank's asset quality at a point in time, as well as its capital ratios.

There's a growing consensus that, in addition to this type of static assessment, that there should be a forward-looking approach to supervision, as well. And I think all of you, in your written testimonies, focused on issues around stress testing, not only by the regulator, but also in what you're expecting from the banks. And when you look at the Dodd-Frank reforms, there are additional assessments, going forward, with a forward-looking approach, whether it be living wills or the role of the FSSA.

Can you talk about your views on the lessons learned here, and how regulatory supervision has changed? And is this a concept that is being grasped by regulators?

Ms. THOMPSON. Yes. At the FDIC, we do have a forward-looking supervision program, where we have taken all the lessons learned from the bank failures and applied them to our supervision process. We looked at institutions that had high concentrations of commercial real estate that had volatile funding sources, and we have put together a training program, for all of our examiners that focuses on, not just the financial condition of the institution, but the practices of that institution. And we are increasing our offsite surveillance for all institutions, so that we know—especially for those that have CRE concentrations—what their financial condition is at any particular point in time.

We're very concerned about interest rates. This is a low-interest-rate environment, and we want our institutions to conduct stress testing so that bank management and the FDIC can see where the bank will be if an adverse situation takes place. We're very concerned about the health and safety and soundness of the financial sector, and we have had a good response from our bankers with regard to this forward-looking-supervision approach.

Mr. NEIMAN. Dr. Parkinson, can you comment on in the CRE context as to what is expected of institutions in assessing portfolios and risk under different economic scenarios, as well as utilizing, statistical modeling for loss-reserving?

Dr. PARKINSON. All right. Well, I think that's, again, a very important emphasis in the CRE guidance that we put out in 2006. That's all been reinforced by Dodd-Frank, with respect to the larger institution that requires the board to conduct annual stress tests and also requires banks to conduct their own stress tests on the smaller ones, on a semiannual basis; 10 to 50 billion, on an annual basis, and to actually publish reports on that. And obviously, where they have CRE concentrations, the stress testing of the CRE portfolios will have to be an important part of that.

Also an important initiative that I think I mentioned is the CRE data-collection project that the agencies have embarked upon, where we're collecting loan-level data on CRE loans; initially, from the very largest CRE lenders, and that's being expanded somewhat. But, I think that loan-level data will give us a better insight into asset class, to understand how the values of the loans are being driven by the underlying economic variables—vacancy rate, rental rates, et cetera—and, from that, to be able to figure out better how to stress test their existing portfolios. So, I think that is an important recent cooperative supervisory initiative among the three agencies.

Mr. NEIMAN. Thank you.

So, the issues around data collection, we've talked often about data—better performance data on the residential side; it sounds like it's just as important on the commercial side.

Mr. Wilson, would you like to comment about the expectations? What you would like to see in institutions to address some of the risks, going forward, on the CRE, as well as any changes in examination approach?

Mr. WILSON. Stress testing is obviously an area of focus at all levels of banks. We would size our expectations to the size of the bank. And we would also size our expectations to the level of concentrations that those banks have. So, if you're a community bank without a concentration, don't have a lot of hot money, things like that, we would expect a lower level.

But, we are in the early stages of putting together additional guidance. We're working with the Fed and the FDIC on that. We do have tools out there now, but we're talking about some additional tools that, especially, our community banks can use.

Mr. NEIMAN. Thank you.

The CHAIRMAN. Thank you.

And followup on a point raised by Dr. Troske, about the concentration of commercial real estate in the smaller banks. What impact do you think that's having on the ability of these banks—since they have this overhang in commercial real estate, the ability to carry out the other things that the bank does? Is this—do you think this is limiting their ability to make other loans and be—stimulate the economy in other ways?

And let's start with Mr. Wilson.

Mr. WILSON. I think, for a small subset of banks, the ones that are on the FDIC problem-loan list, for example, that's a true concern, because they're focused on working out of commercial real estate. But, we have a large number of banks, at all sizes, where they're open for business for commercial real estate lending as well as other lending. And, you know, I think they pull back, we think rightfully so, on some of the underwriting standards that, in retrospect, got too liberal. And so, it's a little bit of a new world for borrowers. But, we believe, there's plenty of credit available for borrowers of creditworthy quality.

The CHAIRMAN. Dr. Parkinson.

Dr. PARKINSON. I'm going to build on his points. I think, where a lender or bank has a CRE concentration, and that is a concentration of loans that weren't very well underwritten and that are suffering a lot of losses, which is impairing their condition, those banks when you look at loan growth, by the CAMEL ratings for the banks, the banks with the lowest CAMEL ratings are contracting loans at a must more rapid pace, and are recovering more slowly, in terms of their lending activity, than the stronger rated banks. So, to the extent that the commercial real estate concentration is not managed well and the bank gets into trouble, that clearly does have an adverse effect on people who rely upon that bank for credit.

The CHAIRMAN. Ms. Thompson.

Ms. THOMPSON. I agree with my colleagues. And I've mentioned that, during the crisis, the levels of lending for the larger institutions decreased, while the levels of lending for the smaller community banks, that do have the significant concentrations, did increase.

The CHAIRMAN. Ms. Thompson, if the Open Market Committee were to prove an increase in the Fed funds rates, would that have a result—be a significant shock on the commercial real estate market—or do you know where the commercial real estate going to—market's going to be?

Ms. THOMPSON. I'll defer that an answer to that to my colleague at the Federal Reserve.

The CHAIRMAN. Well, he can give us the best estimate of whether it'll happen or not——

[Laughter.]

The CHAIRMAN [continuing]. Which he will not do. And I'm more interested in, if it does happen, for the banks you're looking at, would this be a significant problem to those banks?

Ms. THOMPSON. I hate to——

The CHAIRMAN. Let me put it this way. Without the open market—if interest rates start going up, do you——

Ms. THOMPSON. This is a really good environment for restructuring. It's a really good environment for refinancing, modifications, and sales. I think that it might cause an issue or two.

The CHAIRMAN. Dr. Parkinson.

Dr. PARKINSON. I think it would depend on why interest rates were rising. And the reason interest rates would be rising was that the economy was recovering, unemployment was coming down, and the Fed was feeling comfortable raising its target rate. And I'd be willing to accept the risk and the adverse effect of the rising interest rates in that context, where it's in the context of economic growth, recovering smartly.

The CHAIRMAN. Got it.

Mr. Wilson.

Mr. WILSON. I agree totally with that. I think the disaster would be if rates went up and the economy doesn't improve concurrent with that. But, you know, generally when rates go up, it means the economy's getting better. And, hopefully then there's more capacity in commercial real estate borrowers.

The CHAIRMAN. Mr. Wilson, you mentioned stress tests; in fact, a number of you mentioned stress tests—all of you did, in fact—stress tests. Do you think when you do the—when stress tests come along, they should concentrate—or, what role do you think commercial real estate should play in determining stress tests on a financial institution right now?

Mr. WILSON. Well, I think that the lessons that we just went through, and the lessons of the late '80s, early '90s, should be applied to commercial real estate portfolios. It has been pointed out by my colleagues, that some banks do come through even severe downturns and come out the other side, even though they have large concentrations. But, what we need to do is understand better and size those. For example, it seems like construction and development—we may need to pay a lot more attention to those than, maybe, the permanent commercial mortgage. But, even then, at some level, a concentration is just too much. And I think, if you have a good stress test, you can show that.

The CHAIRMAN. Dr. Parkinson.

Dr. PARKINSON. We talked about the importance of stress testing. I think Dave also observed that, to the extent you have a concentration in CRE, it's obviously really important that you stress test your CRE portfolio. So, that has to be a critical part of it, if that is the profile of your institution.

The Chairman. Ms. Thompson.

Ms. THOMPSON. I do think stress testing is important, especially for commercial real estate. I also believe that the good underwriting underneath the loans is probably the most critical.

The CHAIRMAN. Thank you.

Thank you.

Mr. McWatters.

Mr. MCWATTERS. Thank you.

You know, I don't know of a real estate downturn that has not ultimately turned around. There's always a point where things were overvalued, there were not enough buyers, there were not enough tenants. But, you look forward 5 years, and things are a lot different.

Today, we have the added benefit of very low interest rates. Why not just kick the can down the road? Why not refinance, short-term basis, assuming interest rates are going to be down? Keep that going for 3 or 4 years. Wake up. Realize the market has recovered, prices are back up, borrowers are willing to pay more for—I mean, purchasers are willing to pay more for the property; tenants are willing to pay more in rental rates. And you're through this mess without the banks recognizing losses, without the banks having impaired capital, and without the borrowers representing—recognizing cancellation of indebtedness income.

What's the problem with that?

Ms. Thompson.

Ms. THOMPSON. I just don't think we could ignore the problems that exist today. That would be a huge prediction on an uncertain outcome. It's important to recognize and have some transparency for the financial sector so that people know that they have good loans, or they don't. And, it's important to take immediate action, whether it's modifying loans or writing the loans off, it's either one or the other. "Kicking the can down the road" just doesn't seem like it's an acceptable outcome.

Mr. MCWATTERS. Dr. Parkinson.

Dr. PARKINSON. I guess, I'd just observe that that strategy of kicking it down the road doesn't uniformly deliver success, historically. And I think the better approach, again, is to look at it loan by loan, borrower by borrower, and make an assessment as to whether they really have the capacity to service the debt. I think, if you're just kicking it down the road, there's a real possibility if the property is in the wrong hands, its value is just going to deteriorate, perhaps even if there is an economic recovery. So, I guess I would agree that we can't count on kicking it down the road producing the desired outcome.

Mr. MCWATTERS. Okay, but that is not being done? I mean, that's being done some, but, as a whole, that is not being done?

Dr. PARKINSON. Well, in the sense it's simply deferring the problem, we hope it's not being done at all. But, in some cases a loan may be restructured because that is in the best interest of both the bank and the borrower. But, our guidance tries to make clear that just doing that automatically or routinely, to defer recognition of losses, is not a good strategy.

Mr. MCWATTERS. Okay.

Mr. Wilson.

Mr. WILSON. I would just add that our guidance is also very clear that, if you choose to work with your borrower, number one, it has to improve the prospects for ultimate repayment; and, number two, you need to account for that loan properly. So, if there's risk in that loan, there needs to be appropriate reserves, there needs to be appropriate accrual on the loan, chargeoff, as necessary. For the bank, it's not kicking the can down the road, it's that the ultimate repayment is impaired.

Mr. MCWATTERS. So, the best approach is to recognize economic reality, write it down, recognize losses, take the hit to capital, and, in effect, have price discovery based upon that. Is that a fair assessment?

Ms. THOMPSON. Yes.

Mr. MCWATTERS. Okay.

And that ties back to my first question, about RTC-type structures, bailout-type structures—is that that might not be the answer if the financial institutions that were holding the CRE were in such perilous shape they could not absorb the losses, they could have not absorbed the hits to capital, and that the borrowers could not absorb the tax hits. Is that a fair statement?

Ms. THOMPSON. I think so.

Mr. MCWATTERS. Okay.

That's it.

The CHAIRMAN. Thank you.

Mr. Silvers.

Mr. SILVERS. Just to pick up where I left off in the last round. So, we have a whole bunch of small banks that still have TARP money, in the form of CPP, disproportionally exposed to commercial real estate—to the commercial real estate sector. Do any of you have thoughts on what is—if our policy goal—and it certainly—it would be, if I was the policymaker—is to avoid further concentration in our banking sector—if that's our policy goal, which means that we would like a robust small bank sector, any particular advice to Treasury, in terms of the management of TARP's investments in small banks over this period when these refinancings are coming due in commercial real estate?

Ms. THOMPSON. Many of the smaller institutions that have TARP CPP funds are managing their portfolios adequately. The Treasury has a provision, to the extent that TARP recipients miss dividends, that the Treasury can add someone to oversee the bank's board of directors. So, I think the measures are there. There are several institutions that have concentrations, and they're working their way through the crisis adequately.

Mr. SILVERS. Any more—any further thoughts on this subject?

Mr. Wilson.

Mr. WILSON. No.

Mr. SILVERS. Or——

Mr. WILSON. Yeah, I'm not real close to the TARP program. But, I would say that pursuant to our 2009 guidance, we have laid out how we would like to see these problem loans managed. And I think that applies whether the bank has TARP or not. If the bank needs to be resolved, I think it still needs to be resolved.

Mr. SILVERS. My—I don't know, it seems sort of intuitive to me, and I wonder if you all agree, that, if our goal is to try to keep the small bank sector healthy, that—during this period when small banks that have CRE exposure are going to have to manage through the rollover of these loans, that it might not be a good idea to try to compel them to pay back the—to pay the Treasury's money back during that period. But, I'm—this is not an ideological observation, it's a practical one. Is that right? Or would it be better to try to get them, during that period, to have—be subjected to the discipline of raising that capital privately?

Dr. PARKINSON. Well, I don't think we've been trying to force them to repay the TARP——

Mr. SILVERS. No, I'm——

Dr. PARKINSON. We have——

Mr. SILVERS [continuing]. Wasn't suggesting——

Dr. PARKINSON [continuing]. We have——

Mr. SILVERS [continuing]. You had been.

Dr. PARKINSON [continuing]. Lots of institutions that want to repay their TARP, but absent a substantial raise of private capital, we don't think that they wouldn't be safe and sound, having done that. I think that really is the issue. We look at each one of these TARP repayments, one by one, and want to satisfy ourselves that, either given the amount of capital they currently have or the amount of capital they can raise in the market post-TARP repayment, they will still have adequate capital to bear the risks that are present in their portfolio, including any risks that may be as a result of troubled CRE assets. But, at least the banks themselves feel that the sooner they can repay their TARP, the better. So, they're quite anxious to repay.

Mr. SILVERS. I see. That's very helpful.

If part of our mandate is to sort of look at these very practical aspects of TARP that I've just been asking about, if the other part of our mandate, I believe, is to—is that Congress wanted this rather extraordinary intervention in the financial markets; that is, TARP to be done fairly. This may be asking too much of the three of you, but I would ask you to comment on, What do we say to the executive or the employee or the investor in a small bank that is being resolved by the FDIC, against the backdrop of what we did, you know, in terms of forbearance to institutions, like Citigroup and Bank of America—how do we justify—how, in any respect, is that fair? And what do we say to the person who's on the losing end of the unfairness?

[No response.]

Mr. SILVERS. I guess we say nothing. Is that really so? It's kind of sad.

[No response.]

Mr. SILVERS. Well, perhaps it's unfair to——

Dr. PARKINSON. I'll just say two things. One, obviously the reason for the extraordinary interventions was a belief that, if the banks had failed in a disorderly manner, that the economy, the financial system might have been much more worse off, including those small institutions that didn't benefit directly from that assistance.

I think also the too-big-too-fail problem is a very real problem. The Dodd-Frank Act has various provisions designed to address that. I think we're still working through the implementation of those. So, ultimately, how effective they will be, the jury is still out, but we're working very hard to ensure that, particularly, the so-called systemically important institutions are held to much tougher standards than other institutions.

And, very importantly in terms of the market discipline side, with the new orderly resolution authority there's no longer any authority to do open bank assistance, so there's not going to be any benefit to the shareholders. I think all the agencies agree that any holder of a capital instrument should not benefit in any way from extraordinary assistance. And even the FDIC has proposed that holders of longer-term debt, that assistance payments for that class of creditors will be ruled out, in which case, I think all of those should do quite a bit to reinvigorate market discipline.

Ms. THOMPSON. I think you're right. What took place really helped everyone in the economy. And I think the Dodd-Frank Act did a lot to level the playing field between larger and smaller institutions. It took away some of the competitive inequities between the largest and the very smallest institutions. And, most importantly, it did remove "too big to fail." So, I think that the steps that were taken were necessary. And the steps that we're taking now, in terms of the orderly liquidation authority and implementation of other provisions of the Dodd-Frank Act, will go a long way toward having that conversation.

Mr. SILVERS. Well, my time is long expired.

Thank you.

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you.

I guess I want to—one comment I'll make about my opening statement. I was hoping to get the point across, that I think regulators were far too much blamed for the financial crisis than was warranted. I think it was primarily a result of the managers and owners of firms.

Dr. Parkinson, I wanted to start with you, because I wanted to ask a question sort of specific about the Fed. I was looking at the data yesterday, and I believe the levels of bank reserves at the Fed have grown back to $1.1 trillion, after dropping below 1.1 trillion for a while. We could discuss why that is. But, there seems to be—and most of that is excess reserves. So, banks seem to have a ample supply of capital sitting, certainly, at the Federal Reserve. Is that—does that give you some comfort, when thinking about the CRE situation? Do you have a sense of how much of this capital and excess reserves held at the Fed are held by these small- and medium-sized banks, thereby giving them a cushion if there are any additional problems in this market?

Dr. PARKINSON. I don't know the answer to that question. But, I would have approached it a different way, if the concern is about the availability of lendable funds to meet the needs of creditworthy borrowers. The fact that the banking system as a whole, is holding so much in excess reserves at the Fed that pays so very little, I think they have ample motive to go out and find creditworthy borrowers that they can make loans to, to make much higher returns than they're making on those excess reserves. And I think we are starting to see some signs that the tightening of credit conditions, that's been going on since the crisis emerged, is coming to an end, and that they are looking very actively for creditworthy borrowers to put that money to work.

Dr. TROSKE. And——

Dr. PARKINSON. But, I don't know the answer to your specific question. I suspect that a disproportionate amount is at the large institutions, but I don't know the facts.

Dr. TROSKE. I suspect the same. And I did ask our staff to find out, yesterday, and they were unsuccessful, as well. So—I wasn't surprised they were unsuccessful, since I suspected they weren't going to be.

I want to build on that last statement that you made, or the statements that you made, about just overall lending, and ask, I guess, the three of you. It is clear that lending is down by most banks. And there's a question—and I'm not sure we're going to resolve it today—about whether that reflects a lack of demand or a lack of supply. From your regulatory standpoint, can you give me a sense of whether you think—what it—it's a lack of demand or supply?

And we'll start with you, Ms. Thompson.

Ms. THOMPSON. I think it's both. Actually, I think there's three things. I think there's a lack of demand. I believe that there are borrowers that lack confidence. I think that there's a lack of supply. I think bank capital is concentrated. And, the biggest issue is the collateral values, because they've declined so precipitously.

I think that there is plenty of capital in the system. People have to start showing confidence in the financial institutions, and that is a slow process. I think there's a tentative rebuilding. We're working our way towards whatever this new norm is. And when people get comfortable, they'll go to institutions, apply for loans, and receive credit. But, I think there is a tentative nature out there right now. People are cautiously optimistic, because we're not out of the woods yet.

Dr. TROSKE. Okay.

Dr. Parkinson.

Dr. PARKINSON. Well, I think it is elements of both demand and supply. On the demand side when you talk to the banks, where they have binding lending commitments outstanding, the utilization rates of those lines is, sort of, at historic lows. And I think that's a pretty good indicator, at least for those borrowers, they just don't have the demand.

On the supply side, I think there are signs that for stronger borrowers, there's ample credit out there. But, obviously there's been a real change since the crisis, in terms of the access to credit by weaker borrowers. Now, we don't want to go back to the availability of credit that we had in 2006 and 2007. We want to go to some new normal, where there are more prudent underwriting standards. But, that does mean that lots of people that could get credit formerly probably are not going to be able to get it on the same terms today. And that must be constraining their spending.

But, again, we have ask, "What's the alternative?"

Dr. TROSKE. Mr. Wilson, do you have anything to add?

Mr. WILSON. I agree with that.

I guess I would also point out, on both the demand and the supply side, the Federal Reserves' quarterly survey shows that banks are saying that they're not tightening standards beyond what they were. And also, they're seeing loan demand starting to pick up.

But, in our conversations with banks, they said, "Yeah, we don't like the rate that the Federal Reserve pays on the reserves, and we would like to lend the money." So, I think there is a willingness, on the part of our banks, to put those out—back into good quality loans.

Dr. TROSKE. Thank you.

The CHAIRMAN. Thank you.

Superintendent Neiman.

Mr. NEIMAN. Yeah. I'd like to follow up on the issues around supply and demand, and really focus on underwriting criteria. Ms. Thompson mentioned that underwriting criteria is so critical.

The reference to the Federal Reserve senior loan officer survey does show that standards remain largely unchanged in the fourth quarter. Certainly, they are higher than the average level over the last decade. And the majority of respondents indicated that lending standards, would not expect to return to long-run norms until after 2012, and, as a result, will remain tighter, for the foreseeable future.

Is this a good thing? Were underwriting standards too lax, or is this some evidence of an overreaction?

Ms. Thompson.

Ms. THOMPSON. Well, I think underwriting standards were lax. And, the return to the basic fundamentals of lending is critical: making sure the borrowers have the ability to repay, not focusing on collateral values as the primary source of repayment, and looking at other ways to generate income to repay the loans. I think that's critical.

Mr. NEIMAN. Where regulators are sometimes criticized for extending—going too far to one extreme, have banks, in tightening and correcting those lax standards, gone too far? Is there any evidence of that in your reviews?

Ms. THOMPSON. Regulators are criticized, generally. In looking at the crisis, there were things that we could have done more quickly. And I do believe that there were some steps that we could have taken to help deal with this issue. I think that the lending and underwriting standards that we have worked collectively on through our guidance is good guidance, it's prudent, and it certainly will be sustainable in good times as well as bad.

Mr. NEIMAN. Dr. Parkinson, what are you seeing in your assessment of the underwriting standards being used by lenders?

Dr. PARKINSON. Well, again, I think you had it right, that there was a long period of tightening. But, that proceeded from a base period, where standards were too lax. And now, we see some signs that that's abating.

But almost more important than the specific standards, when you're assessing whether someone's a creditworthy borrower, that depends, in part, on your economic outlook, and how supportive you think the economic environment will be.

And I think confidence, both by the borrowers and by the lenders, has been slow to recover. I guess there are hopeful signs that the economy, in the last couple of months, has been picking up steam. And I think, once people are convinced that that higher path of growth is sustainable and is the most likely path, you'll get a rebound in confidence. And that's probably the most important thing, both to work on increasing the demand and increasing the supply of credit.

Mr. NEIMAN. Great.

Mr. Wilson, you mentioned taking supply and demand into consideration has an impact on lending levels. And you indicated that it has a varying degree, depending on the size of the institution or the type of the asset. Can you elaborate so we can get a better sense of loan levels, whether they be from big or small banks or a variety of type of loans?

Mr. WILSON. Well, I think that, for example, in the community banks that do have big concentrations of commercial real estate, what we're going through right now, brought to bear the risks, and they're more sensitive of those risks. So, they probably are tighter than they would have normally been if they didn't have the concentration.

Yeah, underwriting standards in almost any asset class in 2006, early 2007, were too liberal. The pendulum usually swings too far the other way as banks try to recover from problem loans. But, we're seeing evidence that, you know, they're coming back into balance pretty quickly, especially in certain markets, like leveraged loans. There are stories out there that the recap deals, number one, are very prevalent these days. Pricing is getting tighter. And, even in commercial real estate, pricing has tightened dramatically in the last couple of months. So, we do feel like those supply/demand factors are coming back into balance.

Mr. NEIMAN. And taking into consideration, in addition to the tightening of underwriting standards, how much is preservation of capital playing into that same issue of supply?

Mr. WILSON. And obviously that's a big problem with community banks that are under stress. It's, to some extent, an issue for all banks, because of the Basel 3 initiatives. But, Basel 3 was very sensitive to that. And that's why the committee has a phase-in that goes out through 2018, to be sensitive to that issue, to not constrain lending because of capital requirements.

Mr. NEIMAN. Thank you.

The CHAIRMAN. Thank you, Superintendent Neiman.

And thank the board. First, I want to thank you for being here today. But, even longer, I want to thank you for your public service. I continue to be incredibly impressed with the overall quality, intelligence, and competence of the people that serve in the Federal Government. And I think anyone here watching you today would be proud of the fact that you are representing all Americans near here, and doing a competent, thorough, and intelligent job at everything you do. So, I really want to thank you especially for that.

Thank you.

And if the second panel would come forward—the second panel, come forward.

Mr. Silvers is going to have to leave. It's nothing personal. [Laughter.]

But, he has to be somewhere else. He's necessarily absent.

[Pause.]

The CHAIRMAN. Welcome. Thank you for being here. Thank you for helping us work through these rather thorny complicated issues.

I'm really pleased to welcome our panel: Matthew Anderson, managing director at Foresight Analytics, a division of Trepp; Richard Parkus, executive director at Morgan Stanley Research; and Jamie Woodwell, vice president, commercial real estate research at the Mortgage Bankers Association.

And thank you for coming. Please keep your testimony to 5 minutes so we'll have time for questions. Your complete written statement will be printed in the record.

And we will begin with Mr. Anderson.

STATEMENT OF MATTHEW ANDERSON, MANAGING DIRECTOR, FORESIGHT ANALYTICS, A DIVISION OF TREPP

Mr. ANDERSON. Chairman Kaufman and members of the Congressional Oversight Panel, thank you for the opportunity to discuss commercial real estate and bank stability.

My testimony today will include a discussion of real estate value declines, the growth in the size of the debt market and resulting mortgage maturities, bank commercial real estate exposure and distress, and finally, some aspects of our outlook for the economy, real estate, and commercial real estate debt market, in particular.

I should add, the views expressed today are my own and not necessarily those of my employer, Trepp LLC.

One of the most important features of the current real estate cycle is the dramatic decline in property values. The most recent figures indicate that commercial property values have fallen by approximately 42 percent since speaking in late 2007. That's larger than the decline in the earlier 1990s, when commercial real estate values fell by nearly one-third, and on par with our estimates of the decline during the Depression.

A rise in volume of mortgage—maturing mortgages has put pressure on the commercial real estate debt market, and will continue to do so for several years. By our estimates, annual maturities reached $200 billion in 2006, and surpassed $300 billion in 2009. We further estimate that commercial real estate debt maturities will climb to approximately $350 billion per year between 2011 and 2013.

The combination of lower property values and rising volumes of maturing mortgages has resulted in a large amount of maturing loans that are underwater. We estimate that as much as half of the loans maturing in 2011 to 2015 are currently underwater, and that $251 billion is underwater by 20 percent or more.

Many banks entered the financial crisis with substantial exposures to commercial real estate. As of the first quarter of 2007, more than 2700 banks and thrifts, or 32 percent of the total bank count, had a commercial real estate, or CRE, concentration. The greatest concentrations were among banks with $1 to $10 billion in assets and banks with $100 million to $1 billion in assets, where 56 percent and 43 percent of banks in those groups, respectively, had CRE concentrations.

The number and proportion of banks with commercial real estate concentrations has fallen significantly since 2007. As of the third quarter of 2010, just under 1300 banks and thrifts had a CRE concentration, a decline of more than 1400 from the first quarter of 2007. Part of this reduction is the result of reduced amounts of debt outstanding. Approximately $300 billion of CRE loan exposure has been trimmed from banks' balance sheets over the last 2 years.

Banks that received CPP funds from TARP are more likely to have commercial real estate concentrations than non-CPP recipients. We've tabulated commercial real estate concentration figures for bank and thrift subsidiaries of firms that received CPP investments, including banks that have repaid the CPP funds, with the result that, as of the third quarter of 2010, 32 percent of the CPP-recipient subsidiaries had CRE concentrations, compared with 15 percent for non-CPP recipients.

Delinquency rates for construction loans and commercial mortgages have been declining, but remain high relative to the pre-crisis levels. Our early estimates for the fourth quarter of 2010 indicate that construction delinquency rates stand at 18 percent and commercial mortgage delinquencies at 5.3 percent, compared with 1-percent delinquency rates prior to the onset of the downturn.

We maintain a watch list of banks that appear to be at elevated risk of failure. This list has proven quite accurate, capturing 96 percent of failed banks since the beginning of the current cycle in 2007. Nonperforming commercial real estate loans have been the largest problem loan type for banks on this watch list. For more than 80 percent of the banks on our watch list, nonperforming commercial real estate loans are the main problem loan type.

Economic and real estate market conditions are improving, albeit slowly. The job market is gradually turning around. And in the commercial real estate market, occupancy rates and rents are stabilizing, but net operating income has been reduced by 15 percent, or more, from pre-recession levels.

Liquidity has also been returning to the commercial real estate market. This has been most notable in the CMBS segment, where $11.6 billion of new issuance occurred in 2010. Our parent company, Trepp LLC, expects this trend to continue, with $50 billion of new issuance during 2011.

We believe the recovery will be a prolonged one, with slow improvement in the broader economy translating into gradually increasing demand for commercial real estate. Delinquency rates will improve, as well, as lenders continue to reduce nonperforming loan balances, but this process looks likely to last several more quarters. We remain concerned about the volume of underwater mortgages that will mature over the next several years, and the broader issue of mortgage maturities overall.

Continued high demand for refinancing for loans originated during the commercial real estate debt boom of the 2000s will constrain real or inflation-adjusted growth in the commercial mortgage market over the next decade. We believe growth in the market will more closely resemble the 1990s, when annual growth was 0.8 percent in real terms, rather than 2000 to 2008, when annual real growth was 9.4 percent.

Mr. CHAIRMAN, I thank you and the other members of the panel. This statement constitutes my formal testimony. And I look forward to any questions you might have.

[The prepared statement of Mr. Anderson follows:]

Statement of
Matthew J. Anderson
Managing Director
Foresight Analytics, a division of Trepp, LLC
before the
Congressional Oversight Panel
Hearing on Commercial Real Estate's Impact on Bank Stability

Washington, DC
February 4, 2011

Chairman Kaufman and members of the Congressional Oversight Panel, thank you for the opportunity to discuss commercial real estate and bank stability. My testimony today will include a discussion of real estate value declines, the growth in the size of the debt market and resulting mortgage maturities, bank commercial real estate exposure and distress, and finally some aspects of our outlook for the economy, real estate and commercial real estate debt market in particular.

Commercial Real Estate Values

• One of the most important features of the current real estate cycle is the dramatic decline in property values. The most recent figures indicate that commercial property values have fallen by approximately 42% since peaking in late 2007. That is larger than the decline in the early 1990s, when commercial real estate values fell by nearly one-third, and on par with our estimates of the decline during the Depression.

Commercial Real Estate Debt Maturities

• A rising volume of maturing mortgages has put pressure on the commercial real estate debt market, and will continue to do so for several years. By Foresight Analytics' estimates, annual maturities reached $200 billion in 2006 and surpassed $300 billion in 2009.

• We further estimate that commercial real estate debt maturities will climb to approximately $350 billion per year between 2011 and 2013.

• The combination of lower property values and rising volumes of maturing mortgages has resulted in a large amount of maturing loans that are "underwater". We estimate that as much as half of the loans maturing in 2011 to 2015 are currently underwater, and that as much as $251 billion is underwater by 20% or more.

Commercial Real Estate Debt Exposure

• Many banks entered the financial crisis with substantial exposures to commercial real estate. As of the first quarter of 2007, more than 2,700 banks and thrifts (32% of the total bank count) had a commercial real estate (CRE) concentration. The greatest concentrations were among banks with $1 to $10 billion in assets and banks with $100 million to $1 billion in assets, where 56% and 43% of banks in those groups respectively had CRE concentrations.

• The number and proportion of banks with commercial real estate concentrations has fallen significantly since 2007. As of the third quarter of 2010, just under 1,300 banks and thrifts had a CRE concentration, a decline of more than 1,400 from the first quarter of 2007.

• Part of this reduction is the result of reduced amounts of debt outstanding. Approximately $300 billion of CRE loan exposure has been trimmed from banks' balance sheets over the last two years.

• Banks that received CPP funds from TARP are more likely to have commercial real estate concentrations than non-CPP recipients. We have tabulated commercial real estate concentration figures for bank and thrift subsidiaries of firms that received CPP investments — including banks that have repaid the CPP funds — with the result that as of 3Q 2010, 32% of the CPP recipients' subsidiaries had CRE concentrations, compared with 15% for non-CPP recipients' subsidiaries.

CRE Loan Performance

• Delinquency rates for construction loans and commercial mortgages have been declining, but remain high relative to pre-crisis levels. Our early estimates for 4Q 2010 indicate that construction delinquency rates stand at 18% and commercial mortgage delinquencies at 5.3%, compared with 1% delinquency rates prior to the onset of the downturn.

• Commercial real estate has accounted for an estimated $97 billion of bank charge-offs during the 2007 to 2010 period. For banks under $10 billion in assets, the proportion that commercial real estate comprises has been above average, amounting to more than 50% of all charge-offs for these banks.

Bank Distress

• We maintain a "Watch List" of banks that appear to be at elevated risk of failure. This list has proven quite accurate, capturing 96% of failed banks since the beginning of the current cycle in 2007.

• Nonperforming commercial real estate loans have been the largest problem loan type for banks on this Watch List. For more than 80% of the banks on our Watch List, nonperforming commercial real estate loans are the main problem loan type.

Market Conditions and Outlook

• Economic and real estate market conditions are improving, albeit slowly. The job market is gradually turning around. And in the commercial real estate market, occupancy rates and rents are stabilizing, but net operating income has been reduced by 15% or more from pre-recession levels.

• Liquidity has also been returning to the commercial real estate market. This has been most notable in the CMBS segment, where $11.6 billion of new issuance occurred in 2010. Our parent, Trepp, LLC expects this trend to continue, with $50 billion of issuance during 2011.

• We believe the recovery will be a prolonged one, with slow improvement in the broader economy translating into gradually increasing demand for commercial real estate.

  • Delinquency rates will improve as well, as lenders continue to reduce nonperforming loan balances but this process looks likely to last several more quarters.

  • We remain concerned about the volume of underwater mortgages that will mature over the next several years, and the broader issue of mortgage maturities overall.

  • Continued high demand for refinancing from loans originated during the commercial real estate debt boom of the 2000s will constrain real – or inflation-adjusted – growth in the commercial mortgage market over the next decade. We believe growth in the market will more closely resemble the 1990s, when annual growth was 0.8% in real terms, rather than 2000 to 2008, when annual real growth was 9.4%.

Mr. Chairman, I thank you and the other members of the Panel. This statement constitutes my formal testimony and I look forward to any questions you might have.

Introduction

Commercial real estate has been at the forefront of issues confronting banks in the current cycle, a result of both bank exposure and poor loan performance. In the following, we examine several topics pertaining to commercial real estate, bank exposure and bank distress, namely:

- Commercial real estate values,
- Commercial real estate debt maturities,
- Commercial real estate exposure,
- Loan performance and charge-offs,
- Bank distress, and
- Market conditions and outlook.

Commercial Real Estate Bear Markets

Major Value Decline – Prospect is a Long Recovery

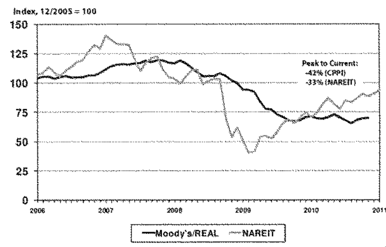
Period	Decline	Duration	Time to Recover
1929 to 1933	-44%	4 years	8 years
1941 to 1943	-42%	2 years	2 years
1989 to 1993	-32%	4 years	10 years
1999 to 2002	-4%	3 years	2 years
2007 to Present	REITs: -33% Direct: -42%	3 years	?

Sources: Foresight Analytics, Moody's, NCREIF, Bureau of Economic Analysis

Commercial Real Estate Values

- One of the most important features of the current real estate cycle is the dramatic decline in property values. The most recent figures indicate that commercial property values have fallen by approximately 42% since peaking in late 2007. That is larger than the decline in the early 1990s, when commercial real estate values fell by nearly one-third from 1988 to 1993, and on par with our estimates of the decline during the Depression.
- Recent trends in the Moody's Commercial Property Price Index (CPPI) indicate that prices stopped sliding in late-2009 and have fluctuated somewhat since then. The bottom in the CPPI was reached in August 2010, and has risen by 6.4% through November 2010.
- Prices for shares of publicly traded real estate investment trusts (REITs) have recovered significantly since reaching a cyclical bottom in February 2009, more than doubling in that period. Even with the increase, REIT share prices are approximately 33% below their peak levels in early 2007.
- The rise in REIT share prices and recent positive trends for the CPPI likely indicate that prices will rise further. Still, the decline from previous peaks is substantial and recovery will likely stretch over a protracted period. Our analysis indicates that it took 8 years for prices to recover from the Depression and 10 years to recover from the early 1990s downturn.

Commercial Real Estate Values
Moody's/REAL CPPI vs. NAREIT Price Index

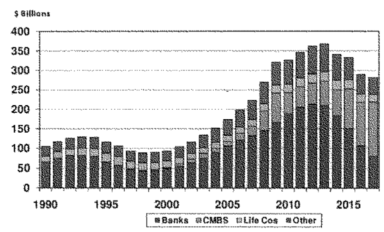


Sources: Moody's/MIT, NAREIT, Foresight Analytics

Commercial Real Estate Debt Maturities

- A rising volume of maturing mortgages has put pressure on the commercial real estate debt market, and will continue to do so for several years. By Foresight Analytics estimates, annual maturities reached $200 billion in 2006 and surpassed $300 billion in 2009.
- We further estimate that commercial real estate debt maturities will climb to approximately $350 billion per year between 2011 and 2013. Maturing amounts will

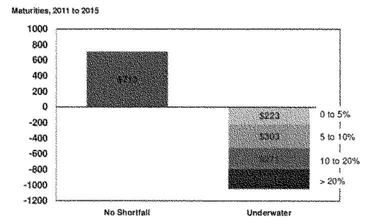
Commercial Real Estate Debt Maturities
Annual Maturities by Lender Type



Sources: Federal Reserve, Foresight Analytics decline thereafter, but will stay elevated for some time, exceeding $250 billion annually through 2017.

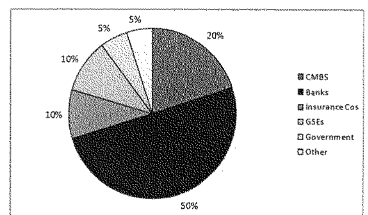
- The rising amount of commercial real estate (CRE) debt maturing is the result of tremendous growth in the market. Commercial real estate debt increased by $1.8 trillion between 2000 and 2007, more than doubling in size.
- The most rapid growth occurred in 2005, 2006 and 2007, with more than $300 billion of net growth in each year. The peak growth was reached in 2007, with $379 billion of net growth.
- We estimate significant refinancing demand from the 2006 and 2007 "boom years" cohorts during the next several years. We are particularly concerned about the ability of these properties to qualify for refinancing, in an environment with lower valuations and lower loan-to-value ratios.
- The combination of lower property values and rising volumes of maturing mortgages has resulted in a large amount of maturing loans that are "underwater"—where the outstanding balance on the loan is more than the value of the property. We estimated that as much as half of the loans maturing in 2011 to 2015 are currently underwater. Of the roughly $1 trillion of CRE debt that we put in this category, an estimated $271 billion is underwater by 10% to 20%, and a further $251 billion is underwater by more than 20%.

Underwater Mortgages
Maturing in 2011 to 2015 by Severity of Value Shortfall



Source: Foresight Analytics

CRE Debt Sources
As of 3Q 2010



Total: $3.2 trillion

Source: Federal Reserve

Commercial Real Estate Debt Exposure

- As of 3Q 2010, banks held nearly $1.7 trillion of commercial real estate debt on their balance sheets — $1.3 trillion in the form of commercial mortgages (on non-residential and multifamily properties) and $400 billion in construction & land loans and unsecured loans to finance commercial real estate, such as loans to REITs.
- While large banks — over $100 billion in assets — hold $553 billion (one-third) of this debt, smaller banks have a more pronounced reliance on commercial real estate loans. Approximately two-thirds of CRE debt is held by banks with less than $100 billion in total assets.
- Many banks entered the financial crisis with substantial exposures to commercial real estate[1]. As of 1Q 2007, 2,740 banks and thrifts (31.6% of the total bank

CRE Exposure by Size
Banks & Thrifts, as of 3Q 2010

Size Group, Total Assets	Bank Count	CRE vs. Total Capital	Total ($ Bn)	Commercial Mortgage*	Construction & Land	Unsecured CRE
>= $100 Bn	19	70%	$552.9	$393.4	$125.1	$34.4
$10 Bn to $100 Bn	91	116%	$353.0	$275.7	$68.3	$9.0
$1 Bn to $10 Bn	562	264%	$386.8	$304.8	$77.9	$4.1
$100 Mn to $1 Bn	4,415	273%	$375.8	$295.3	$77.7	$2.8
$0 to $100 Mn	2,682	141%	$26.0	$20.8	$4.9	$0.3
Total	7,769	121%	$1,694.4	$1,289.9	$353.9	$50.6

* Includes Owner-Occupied Real Estate and Multifamily Loans.

Sources: FDIC, FFIEC, Foresight Analytics

[1] A bank is deemed to have a CRE concentration if either a) construction & land loans outstanding are equal to or greater than 100% of the bank's total capital, or b) all CRE loans outstanding — construction & land loans, commercial mortgages (excluding owner-occupied properties), multifamily mortgages and unsecured CRE loans — are equal to or greater than 300% of the bank's total capital.

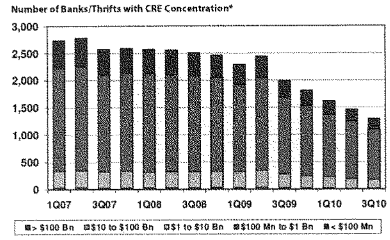
count) had a commercial real estate concentration. The greatest concentrations were among banks with $1 to $10 billion in assets (303 banks or 56% of the size category) and banks with $100 million to $1 billion in assets (1,888 banks or 43% of the size category).

- While their exposure remains substantial, banks have reduced their concentrations in commercial real estate, especially beginning in the second half of 2009. Part of this reduction is the result of rising bank equity capital (from fresh equity issuance and retained earnings) and part is the result of reduced amounts of debt outstanding.
  - Construction & land loans outstanding peaked in 1Q 2008 at $633 billion, falling to $354 billion as of 3Q 2010, a $279 billion decline.
  - Commercial mortgages outstanding (including multifamily) peaked in 2Q 2009 at $1.31 trillion, falling to $1.29 trillion as of 3Q 2010, an $18 billion decline.
  - Unsecured CRE loans have contracted by $20 billion since peaking at $70 billion in 4Q 2008.
- The number and proportion of banks with CRE concentrations has fallen significantly since 2007. As of 3Q 2010, 1,296 banks and thrifts (17% of the total) had a CRE concentration, a decline of 1,444 from 1Q 2007. CRE Concentrations have fallen for all size groups, but remain highest among banks in the $1 to $10 billion assets (161 banks, 29% of the total for the size group) and $100 million to $1 billion (926 banks, 21% of the total for the size group) total asset size ranges.
- Banks that received CPP funds from TARP are more likely to have commercial real estate concentrations than non-CPP recipients. We have tabulated CRE concentration figures for bank and thrift subsidiaries of firms that received CPP investments — including banks that have repaid the CPP funds — with the result that as of 3Q 2010, 32% of the CPP recipients' subsidiaries had CRE concentrations, compared with 15% for non-CPP recipients' subsidiaries. For banks in the $1 billion to $10 billion and $100 million to $1 billion asset size ranges, the CPP recipients' ratios were 36% and 35%, respectively, compared to 24% and 19%, respectively, for non-CPP recipients.

CRE Loan Performance

- Delinquency rates on commercial real estate have surged during the downturn in commercial real estate.
- Construction and Land Loans have been the worst performing CRE segment - with delinquency rates reaching 19.7% in 1Q 2010, up from lows in the 1% range during 2004 to 2006. The peak delinquency rate

CRE Concentrations
By Bank Size



* CRE Loans (excluding Owner-Occupied Mortgages).

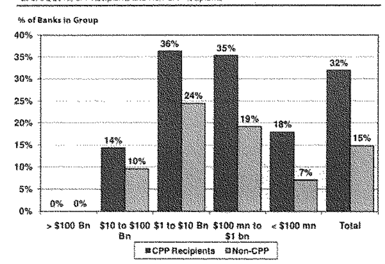
Sources: Call Reports, FDIC, Foresight Analytics

CRE Concentrations
Banks & Thrifts, 1Q 2007 and 3Q 2010

	1Q 2007		3Q 2010		Change	
Size Group, Total Assets	Number of Banks	% of Size Group	Number of Banks	% of Size Group	Number of Banks	% of Size Group
>= $100 Bn	4	29%	-	0%	(4)	-29%
$10 Bn to $100 Bn	28	27%	11	12%	(17)	-15%
$1 Bn to $10 Bn	303	56%	161	29%	(142)	-27%
$100 Mn to $1 Bn	1,888	43%	926	21%	(962)	-22%
$0 to $100 Mn	517	14%	198	7%	(319)	-7%
Total	2,740	32%	1,296	17%	(1,444)	-15%

Sources: FDIC, FFIEC, Foresight Analytics

CRE Concentrations
as of 3Q 2010, CPP Recipients and Non-CPP Recipients



Sources: FinancialStability.gov, FDIC, Federal Reserve, Foresight Analytics of 19.7% surpasses the previous peak rate of 18.3% (estimated) in 1991, during the height of the early 1990s commercial real estate downturn.

- Our estimates indicate that residential construction has performed the worst within the construction segment, with single family construction delinquencies reaching nearly 30% and condominium construction reaching nearly 45%.
- Commercial real estate construction delinquencies have also risen, per our estimates, to the 12% to 15% range during the first half of 2010.
- Construction delinquency rates have declined since 1Q 2010, as banks have worked through problem loans.

• Delinquency rates on commercial mortgages — both non-residential and multifamily — have risen substantially during the current cycle, reaching 5.5% and 5.7%, respectively, as of 3Q 2010. These delinquency rates were approximately 1% as of 4Q 2006, prior to the onset of the commercial real estate downturn.

• Our early estimates for 4Q 2010 indicate a further slight decline in the commercial mortgage delinquency rates, though a substantial recovery will likely require stronger economic growth and rising demand for space.

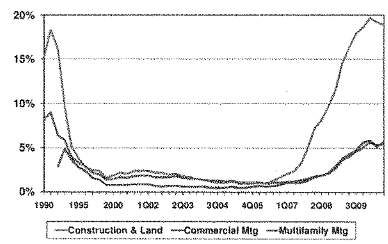
• Commercial real estate has accounted for an estimated $97 billion of bank charge-offs during the 2007 to 2010 period. We estimate $35.9 billion in CRE charge-offs for banks during 2010 (full-year figures will be available in late February), down slightly from $37.9 billion in 2009.

- For banks of all sizes, CRE charge-offs accounted for approximately 19% of all charge-offs during 2007 to 2010.
- For banks under $10 billion in assets, the proportion that CRE comprised was greater, amounting to 53% and 51%, respectively, for banks in the $1 to $10 billion and $100 million to $1 billion total asset size ranges.
- Charge-offs on construction and land loans accounted for approximately two-thirds of CRE charge-offs, across most bank size groups.

• Income yields on CRE loans have fallen since 2006 and 2007.

- We estimate that yields on construction and land loans have fallen to slightly below 3% as of 3Q 2010, down from recent highs in the upper-8% range in the first half of 2007. These loans are typically floating rate and falling short-term yield benchmarks have resulted in declining yields on these loans.
- We estimate that yields on commercial mortgages have fallen, though not as precipitously. Within the commercial mortgage segment there is a greater blend of fixed rate and floating rate debt. On a blended

Commercial Real Estate Delinquencies*
Percent of Amount Outstanding



* Loans 30+ Days Past Due.

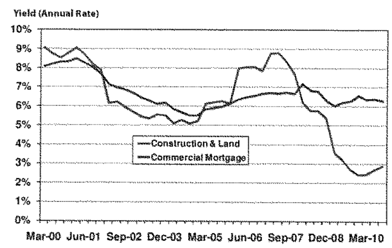
Sources: FDIC, Federal Reserve, Foresight Analytics

CRE Charge-Offs by Bank Size
Commercial Banks

Size Group, Total Assets	2007	2008	2009	2010e	Share of Total Charge-Offs, 2007 to 2010e: CRE Total	Construction	Commercial Mortgage
>= $100 Bn	$0.4	$3.8	$11.1	$13.3	9.2%	6.1%	3.1%
$10 to $100 Bn	$1.1	$7.1	$10.3	$9.2	21.4%	15.0%	6.4%
$1 to $10 Bn	$1.1	$5.4	$10.3	$8.5	52.7%	37.2%	15.5%
$100 Mn to $1 Bn	$0.8	$3.2	$5.8	$4.6	51.1%	35.2%	16.0%
$0 to $100 Mn	$0.1	$0.2	$0.4	$0.3	44.4%	24.2%	20.3%
Total	$3.5	$19.7	$37.9	$35.9	18.8%	12.9%	5.9%

Sources: FDIC, Foresight Analytics

CRE Loan Yields
By Loan Type



Source: Call Reports/TFRs, Foresight Analytics

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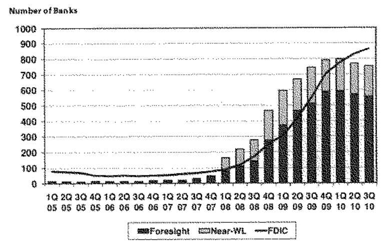
basis, our estimates indicate these yields have fallen to the low 6% range, down from the 7%+ range reached in 2007.

Bank Distress

- With the economic and real estate downturn, bank distress has increased. As of 3Q 2010, 860 banks were on the FDIC's Problem List, up from a cyclical low of 47 in 3Q 2006. By comparison, the number of banks on the Foresight Analytics combined Watch List and Near-Watch List was 753 as of 3Q 2010.
- Nonperforming CRE loans have been the largest problem loan type for banks on the Foresight Analytics Watch List.
- For 81% of the banks on our Watch List, CRE loans account for most of the banks' nonperforming (or defaulted) loans.
- For 262 (47%) of the Watch List banks, construction and land loans were the largest source of nonperforming loans. While construction and land loans remain the single largest problem loan type, the proportion for Watch List banks has been declining during the last several quarters.
- Nonperforming commercial mortgages were the largest problem loan type for 190 (34%) of the banks on our Watch List. This figure has been rising in both absolute terms and as a proportion of the Watch List for the last two years.
- Bank failures rose to 157 in 2010, up from 140 in 2009 and 25 in 2008.
- The pace of closures seems to have moderated recently. In 4Q 2010, there were 30 closures, a noticeable reduction from the 40 to 50 per quarter during the previous five quarters. In the first month of 2011, 11 banks were closed.
- The number of distressed banks remains high, however, and we expect more bank failures during 2011.

Bank Distress
FDIC Problem Institutions vs. Foresight Watch List



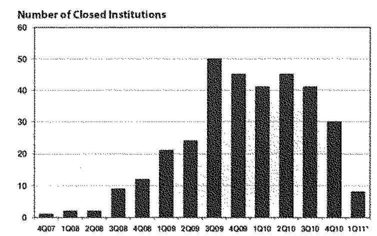
Sources: FDIC, Foresight Analytics

Sources of Distress
Top Source of Nonperforming Loans for Watch List

Loan Type	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10
Construction & Land	229	278	303	327	311	271	262
Commercial Mortgage*	64	88	117	146	164	179	190
Residential Mortgage	65	75	76	95	84	93	77
Other	13	25	16	26	31	27	27
Total	371	466	512	594	590	570	556
Shares:							
Construction & Land	62%	60%	59%	55%	53%	48%	47%
Commercial Mortgage*	17%	19%	23%	25%	28%	31%	34%
Residential Mortgage	18%	16%	15%	16%	14%	16%	14%
Other	4%	5%	3%	4%	5%	5%	5%

* Includes Multifamily. Source: Foresight Analytics

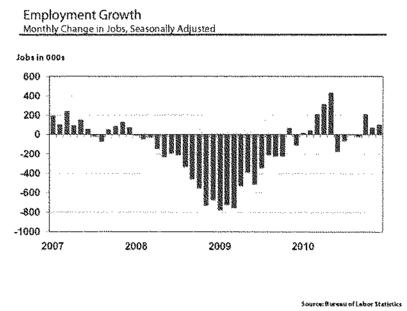
Bank Distress
Bank Failures per Quarter — Current Cycle

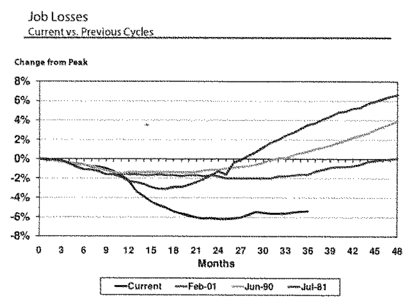


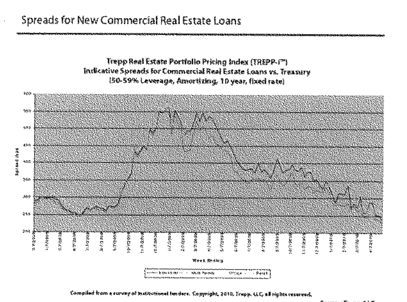
* Through 1/28/11 Source: FDIC

Market Conditions and Outlook

- Economic and real estate market conditions are improving, albeit slowly.
  - Office vacancy rates stabilized during 2010 — in the mid-teens for CBD office markets and high teens for suburban markets, after having risen approximately 5 percentage points from recent lows in 2007. Rents have also stabilized at levels approximately 10% lower than 2007 levels. The combined impact of higher vacancy rates and lower rents has been a drop in net operating income of 15%. Other commercial real estate sectors have been hit by similar downturns in occupancy and rents, with the lodging sector experiencing the greatest volatility.
  - Job growth turned positive in 2010, with 1.1 million jobs added for the year. While this is a welcome trend, the magnitude of job losses remains great, at 7.4 million jobs lost since December 2007. Moreover, the pattern of job growth has been uneven, with slower growth following the surge in jobs in early 2010.
  - We estimate that 333,000 office sector jobs were created during 2010. This follows the loss of 2.2 million office jobs during 2007 to 2009, with the result that office jobs have declined a net 1.9 million since 2007.
- Liquidity has also been returning to the commercial real estate market. This has been most notable in the CMBS segment, where $11.6 billion of new issuance occurred in 2010. Trepp, LLC expects this trend to continue, with a forecasted $50 billion of issuance during 2011.
- Spreads on new originations of commercial mortgages have recovered substantially since the worst of the crisis in late-2008 and early-2009. According to the TREPP-i pricing index, spreads on new commercial mortgages have fallen from 550+ basis points at the worst part of the crisis, to current spreads in the 225 to 250 basis point range. Underwriting remains conservative, however, with these spreads available for loans with moderate leverage in the 50% to 59% loan-to-value range.
- Our outlook for the commercial real estate market includes:
  - A prolonged recovery. An improving economy will lead to stronger supply and demand fundamentals for real estate, but the pace of recovery is expected to remain slow.
  - Gradual improvement in loan delinquency rates. Lenders will continue to reduce nonperforming loan balances — through note sales and workouts on the one hand, and improving market conditions on the other — but this process looks likely to last







several more quarters.

- Unless real estate values rebound substantially, distress will continue to materialize over the next several years, despite an overall improvement in delinquencies and defaults. Depressed values will weigh on the market as underwater loans mature and fail to qualify for fresh financing. We expect this volume to decline over time, as values increase, but the significant dollar amount of underwater maturities we estimate leads us to believe that problem loans will continue to emerge for several years to come.
- Continued high demand for refinancing from loans originated during the commercial real estate debt boom of the 2000s. As a result, the commercial real estate debt market will post modest real — inflation-adjusted — growth over the next decade. Growth in the market will more closely resemble the 1990s, when annual growth was 0.8% in real terms, rather than 2000 to 2008, when annual real growth was 9.4%.

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About Foresight

Foresight Analytics is a division of Trepp that provides analysis and forecasting for the real estate and banking industries. The company focuses on commercial and residential real estate market fundamentals and bank lending. Clients are mainly institutional investors, lenders and developers.

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Disclaimer

The CHAIRMAN. Thank you very much.
Mr. Parkus.

STATEMENT OF RICHARD PARKUS, EXECUTIVE DIRECTOR, MORGAN STANLEY RESEARCH

Mr. PARKUS. Chairman Kaufman and members of the Congressional Oversight Panel, my name is Richard Parkus, and I'm head of commercial real estate debt research at Morgan Stanley, and chair of the research committee at the Commercial Real Estate Finance Council.

I would like to thank the panel for taking—for giving me the opportunity to discuss the current state of commercial real estate financing markets and their potential impact on banks.

I would like to emphasize that the opinions I share today are strictly my own and do not represent those of Morgan Stanley or the Commercial Real Estate Finance Council.

The question of whether commercial real estate will be the next shoe to drop is often heard. In my view, this shoe dropped 2 years ago. Since late 2008, commercial real estate has gone through the most severe downturn since the early 1990s. In many respects, the downturn has been even more severe than the early 1990s. Vacancy rates have soared to greater heights. Rents have experienced larger declines. And the drop in property prices has been much larger than during the previous episode.

With respect to commercial real estate loans, most analysts expect that the loss rates for CMBS loans, originated during the bubbled years of 2005 through 2008, will exceed the 9- to 10-percent losses experienced in the early 1990s, possibly by as much as 4 to 5 percent.

The credit crisis had a particularly severe impact on commercial real estate financing markets. During the depths of the crisis, financing for large, high quality properties, so-called trophy properties, virtually disappeared. The availability of financing was severely impacted for small properties, as well, although it never completely dried up. Some regional and community banks continued to lend, albeit at reduced levels.

As TARP brought calm to financial markets in mid 2009, the flow of capital began to return quickly to the trophy property segment. The trickle of new capital has since grown into a flood, and today financing markets for trophy assets has fully recovered. Financing is widely available, and at very favorable rates.

Unfortunately, this story is not as positive in the financing markets for smaller properties. Here the market remains highly dislocated and has seen little improvement since the depth of the crisis. The vast amount of capital that has targeted the trophy property segment has not made its way into the market for smaller properties.

In summary, there's a growing bifurcation in the recovery of financing markets for trophy assets and smaller nontrophy assets, on the other hand. This is reflected in the large difference in property price appreciation between the two segments. Trophy property prices declined 39 percent between the 2007 market peak and the 2009 market trough, but have increased 17 percent since that trough. For the market as a whole, and smaller properties in particular, prices were down 44 percent, peak to trough, and have been effectively unchanged since that time.

Improving the availability of financing is a critical step in the price recovery process for smaller properties. One of the main sources of financing for this segment is banks, both regional and community, many of which continue to struggle with problem commercial real estate loan portfolios. Taking steps to improve the availability of financing for small properties would undoubtedly improve the ability of these banks to work through their problem loan books.

To date, core commercial real estate loans and bank portfolios are exhibiting delinquency rates in the 5-and-a-half-percent range, significantly below the 9-plus-percent delinquency rates for loans in CMBS. At least part of the reason for this differential relates to the fact that a significant portion of bank loans are floating-rate. As short-term interest rates plunged from 5 and a half percent in 2007 to a quarter of a percent in 2009, required monthly mortgage payments on floating-rate loans declined by as much as 60 to 70 percent, or more.

Without such enormous debt relief, we believe that delinquency rates on bank commercial real estate loans would be far higher, comparable at least to those of fixed-rate loans in CMBS, which did not receive the benefit of debt payment relief. However, this sword cuts both ways. If short-term interest rates rise significantly over the next several years, this could have a significantly negative impact on the performance of floating-rate loans and commercial real estate loans in bank portfolios. Not only would higher interest rates raise required mortgage payments, they could also lead to declining property prices, exacerbating the already significant maturity—maturing debt problem that lies ahead.

Without question, the biggest uncertainty and potential problem facing commercial real estate debt markets today is the wall of near-term maturing debt. We estimate that approximately a trillion dollars of core commercial real estate debt will mature through the end of 2013, more than 600 billion of that coming from banks. Adding to this the $375 billion of construction loans in bank portfolios that mature over the same period brings the total to almost 1.4 trillion over the next 3 years.

Many maturing CMBS loans are already receiving maturity extensions. And we speculate that the same is true in banks. Nevertheless, simply extending problem loans does not represent a comprehensive solution to the problem as a whole. While maturity extensions will undoubtedly help some borrowers, many loans are far too underwater—are too far underwater to be saved by this approach.

A critical ingredient for managing smoothly through the mountain of commercial real estate debt maturities that lie ahead is a well-functioning financing market. This is particularly important for smaller properties, since they make up the bulk of the maturities. In my view, a reformed and revitalizes CMBS market, one that is quickly reemerging now, has the potential to play a key role in helping to improve the availability of financing, particularly to smaller properties; and thus, to reduce the degree of stress as we work our way though this massive deleveraging process.

I thank you for the opportunity to share my views on these important issues and would be happy to answer any questions you may have.

[The prepared statement of Mr. Parkus follows:]

Morgan Stanley

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December 6, 2010

Global

CMBS Strategy

CMBS Market Insights

CRE Debt Markets: Challenges and Opportunities

A promising new foundation for the CMBS market is emerging. We believe that a revitalized CMBS market will be critical in dealing with the nearly $1.4 trillion of commercial real estate loans maturing over the next three years, and the $2.8 trillion maturing through 2020. The decade of deleveraging has begun. Opportunities abound.

Financing markets: Commercial real estate financing markets have effectively recovered for large, institutional-quality real estate assets, but remain highly dislocated for smaller properties. Significant improvement in the latter will likely take several more years.

Credit performance: In our view, and contrary to that of many market participants, the credit performance of legacy CMBS loans is not yet improving. Much of the *apparent* improvement simply reflects the effects of the significant increases in both liquidations and loan modifications. We expect new defaults to remain highly elevated for at least another 12-18 months, and possibly longer.

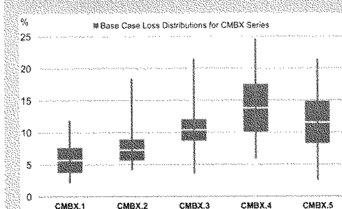
Fundamentals: The deterioration in fundamentals across the major property segments (office, industrial and retail) has slowed significantly, and we believe that it is likely to stabilize over the next 12-18 months. However, we think that robust NOI growth is several years away.

Morgan Stanley CMBS credit models: Loss projections from our newly developed loan-level credit models, which incorporate loan modifications, are previewed. Our Base Case loss projections are higher than those of the NAIC, while our Bull Case loss projections are slightly lower.

Trade Ideas:

- Buy the AM.3 and AM.5 indices
- Buy AJ.1 and AJ.2 reference cash bonds
- Buy 2005 and early 2006 AA cash bonds selectively
- Buy new issue credit bonds over 2007 senior bonds

Morgan Stanley CMBS Strategy Projected Base Case Loss Distributions



Source: Morgan Stanley Research

Comparison with NAIC Loss Projections

Scenario	CMBX.1	CMBX.2	CMBX.3	CMBX.4	CMBX.5
NAIC	**6.7**	**7.2**	**10.3**	**12.0**	**9.8**
MS Bear Case	7.6	9.6	12.7	16.5	13.2
MS Base Case	6.3	8.2	11.0	14.5	11.6
MS Bull Case	5.1	5.7	8.0	10.6	8.3

Source: NAIC, Morgan Stanley Research

CMBS Market Insights

CRE Debt Markets: Challenges and Opportunities

Richard Parkus (212) 761-1444
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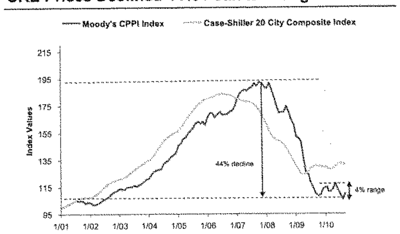
US commercial real estate debt markets are now approximately 24 months into what is unequivocally the worst downturn since the early 1990s, and possibly longer.[1] During this period, commercial real estate prices fell 30-60%, rents plummeted and vacancy rates ballooned, in many cases surpassing previous highs set in the early 1990s.[2] As fundamentals weakened dramatically and financing markets all but shut down, the performance of commercial real estate debt deteriorated at a pace far exceeding even that experienced during the early 1990s.

Exhibit 1

CRE Prices Declined 44% Peak to Trough



Source: Moody's, Standard and Poor's, Morgan Stanley Research

With the deterioration in fundamentals likely to stabilize in 2011, in our view, at least for the most part, and financing markets exhibiting significant improvement, particularly for institutional-quality assets, commercial real estate is set to enter the recovery phase. Nevertheless, a vast swath of the commercial real estate market must undergo significant deleveraging, and this process has only just begun. The deleveraging process is likely to be slow, requiring several years, and painful, given the enormous amount of excess leverage and the likely slow pace of improvement in fundamentals.

[1] Here, the start of the downturn in CRE debt markets is informally identified with the initial onset of severe deterioration in CMBS loan performance in September 2008.

[2] According to the MIT's TBI (Transactions-Based Index), commercial real estate prices, in aggregate, declined by approximately 25% peak to trough during the early 1990s, far less than the current price declines.

On the other hand, given that we are nearing the bottom of one of the worst cycles in commercial real estate history, we believe that this is a particularly opportune time for new investment ideas, both debt and equity, distressed and non-distressed. For commercial real estate debt, in particular, loans originated at the bottom of cycles have consistently experienced lower losses than loans originated at other parts, typically by significant margins.

We believe that the recovery is likely to be propelled, in part, by a revitalized CMBS market, which is now emerging. While CMBS new issue volume was only about $10 billion in 2010 (compared to $223 billion in 2007), it is likely to see significant growth in 2011 and beyond. Moreover, experimentation is already underway in new CMBS deals to modify structures to address aspects of legacy loans and deals that are proving to be highly problematic in the current environment.

With Morgan Stanley re-launching coverage of CMBS, this report sets out, in some detail, our views on the most important issues facing the sector. The following is a synopsis of our views:

- Commercial real estate financing markets have effectively recovered for large, institutional-quality real estate assets, but remain highly dislocated for smaller properties. Significant improvement in the latter will likely take several more years.
- Contrary to the view of many market participants, the credit performance of legacy CMBS loans has shown little or no improvement to date. Much of the apparent improvement simply reflects the large increases in both loan liquidations and modifications. Moreover, we expect the default rate to remain highly elevated for another 12-18 months, and possibly longer.
- As the resolution of problem loans enters a new and accelerated phase, clear patterns are beginning to emerge about special servicers' decisions regarding modification and liquidation. Special servicers display a strong preference for modifying larger loans (> $15 million), even those exhibiting DSCRs below 1.0x. Smaller loans with DSCRs below 1.0x tend to be liquidated, often through note sales, while those with DSCRs above 1.1x have a better chance of being modified.

- In most modifications to date, borrowers appear to be committing some amount of new equity. However, in some cases, the new equity comes with such preferential treatment that the benefits to the lenders appear to be quite modest at best.
- With the exception of apartment and hotel, which are experiencing significant improvements, the deterioration in fundamentals across the major property segments – office, industrial and retail – has slowed significantly, and will likely stabilize over the next 12-18 months. However, improvements in property NOIs will, in many cases, be painfully slow due to long-term leases.
- The maturity wall remains largely intact in CMBS and will present challenges over the next three years as some of the most over-levered and poorly underwritten loans mature.
- We expect that CMBS new issue volumes will increase significantly in 2011 to approximately $35-$45 billion. Much of the source for new lending will be maturing CMBS loans that are capable of refinancing and defaulted CMBS loans that are liquidated.
- We preview our newly developed CMBS credit models, which we will unveil in detail in the near future. Loss projections in our base case scenario run from 6.3% for the CMBX.1 to 14.5% for the CMBX.4. The recently released NAIC loss projections are roughly in line with those of our credit models under our bull case scenario.
- While the market has rallied relentlessly during much of 2010, there remain many attractive opportunities in CMBS, both in cash and synthetics, in our view. For outright synthetic longs, we like AM.3 and AM.5 relative to AM.4. In cash, we like the reference bonds corresponding to the AJ.1 and AJ.2 indices. Further down in credit, we think that select 2005 and early 2006 cash AAs are particularly attractive. Overall, we prefer cash bonds to the synthetic indices, as the synthetic-cash bases remain far wider than can be justified on fundamental grounds. We prefer seasoned AJs from high-quality 2005 and 2006 deals to average-quality AMs from 2007 deals. Lower-rated classes from new issue deals offer significant value relative to highly rated classes from 2006 and 2007 deals.

CRE Financing Markets: A Bifurcated Recovery

Commercial real estate financing markets are recovering from the extraordinary degree of paralysis during the depths of the crisis. However, the recovery is proving to be highly bifurcated, with some segments showing dramatic improvement, and others exhibiting little progress and remaining seriously dislocated. Meanwhile, high-profile transactions are luring many into the misconception that financing markets are normalizing and property prices are on the mend. In our view, this is a very incomplete picture.

During the initial phase of the downturn, mid-2008 through mid-2009, financing virtually disappeared for larger assets as lending activity by securitization programs, life companies and even bank syndicated loan desks ground to a halt. Financing for smaller loans (less than $20 million), however, fared somewhat better; while the pullback of securitization lending did create a sizeable dislocation, approximately 60-70% of smaller maturing loans were ultimately able to secure financing, largely via regional and community banks.[3]

By 3Q09, with financial markets thawing and the economy close to a bottom, interest in financing new, conservatively underwritten commercial real estate loans began to re-emerge. Life companies and large foreign banks, many of them new entrants to the space (e.g., Bank of China and Industrial and Commercial Bank of China), led the way. Securitization programs, mortgage REITs, opportunity funds and specialty finance companies soon joined them.

The focus for all of these lenders was, and remains, almost exclusively on large, institutional-quality real estate assets. Thus, the availability of financing for this segment of the commercial real estate market soared. The demand for financing, on the other hand, has remained anemic, due to the large percentage of maturing loans that are significantly over-levered and do not qualify for refinancing without additional equity. The confluence of the two effects has created a significant demand-supply imbalance in financing markets for institutional-quality real estate. The extraordinarily fierce competition for lending opportunities on high-quality assets is a sign of this imbalance.

Lending volumes are a poor indicator of credit availability in the current environment. While they remain extremely low, even for institutional-quality properties, this reflects the lack of lending opportunities rather than a lack of willingness on the part of lenders.

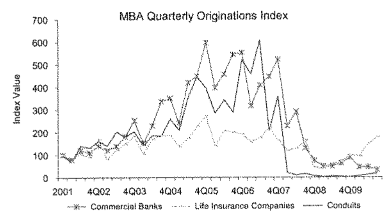
The situation in financing markets for smaller commercial real estate assets is very different. Here, the traditional sources of financing are regional and community banks (as opposed to the global banks) and securitization programs. Many regional and community banks, however, have seen their loan portfolios severely impacted by commercial real estate-related loan losses. Indeed, regional and community banks have been negatively affected to a far greater degree than the global banks due to their vastly higher exposures –

[3] Most fixed-rate loans that matured during this period had been originated during 1999-2002, and were likely to have experienced significant price appreciation prior to the recent downturn. Thus, the difficulty these loans experienced in refinancing predominantly reflected market dislocation rather than inability to qualify.

five to ten times higher for core commercial real estate loans, and five to seven times higher for construction loans. Unfortunately, the problem of commercial real estate loan losses for regional and community banks is likely to worsen before it improves, as many banks are simply delaying the deleveraging problems via widespread term extensions. We think it is likely that the extension of new credit to commercial real estate from smaller regional and community banks will remain well below its normalized level until these institutions begin to deal with their problem loans in a meaningful way, which could be several years (see Exhibit 2). This is likely to hamper the recovery of smaller real estate assets.

Exhibit 2

CRE Originations Have Rebounded Quickly at Life Companies Since the Beginning of 2010, but Continue to Decline at Banks



Source: Mortgage Bankers Association

With respect to securitization programs, as already noted, the current focus remains predominantly on larger loans. There are two reasons. First, there is strong investor preference for higher quality, and thus larger, assets. Second, accumulating a sufficient amount of smaller loans requires more time, given how thinly staffed most securitization lending programs are at the moment. This increases the warehousing timeline and thus risk at a time when hedging warehousing risk is especially problematic, given the dormant state of the total return swap (TRS) market.

In our view, the recovery of financing markets for smaller commercial real estate properties depends to a much greater extent on the speed with which the conduit CMBS market returns. We have begun to see the re-emergence of traditional conduit loans in the most recent new issue CMBS deals, and we expect that this trend will continue, but the pace is likely to be slow.

CMBS remittance data clearly reflect the difficulty borrowers continue to experience in refinancing at maturity. Exhibit 3 shows the percentage of CMBS loans maturing in 2010 that have been unable to refinance.[4] The results are broken out by loan vintage.

Exhibit 3

Recent Vintage Loans Maturing in 2010 Continued to Experience Difficulty Refinancing

	Total Loans		Maturity Defaults		Default Rate	
Vintage	#	Balance ($mm)	#	Balance ($mm)	#	Balance
1998	26	160	6	31	23%	20%
1999	12	100	2	6	17%	6%
2000	929	4,750	234	1,221	25%	26%
2001	128	503	27	111	21%	22%
2002	24	96	3	17	13%	18%
2003	88	1,120	27	592	31%	53%
2004	22	486	10	411	45%	84%
2005	467	11,368	199	5,502	43%	48%
2006	15	669	7	322	47%	48%
2007	29	87	4	42	14%	48%
Total	1,740	19,339	519	8,254	30%	43%

Source: Intex, Trepp, Morgan Stanley Research

Approximately 43% (by balance) of loans maturing between January and August 2010 had still not been able to refinance as of September. As would be expected, loans from older vintages experienced less difficulty than loans from more recent vintage.[5] Interestingly, large loans (>$50 million) encountered even more difficulty refinancing during this period than smaller loans (<$10 million). This leads to an important point: while there is intense competition to finance larger, high-quality properties, many of these loans are unable to refinance because they do not qualify, typically because of excessive leverage.

Of loans scheduled to mature in 2009, 22% of pre-2005 vintage loans remained outstanding as of September 2010, while 54% of 2005-07 vintage loans have not paid off.

Exhibit 4 presents an alternative perspective of the refinancing data.[6] For each month, the blue line indicates the percentage of loans scheduled to mature in that month that did not paid off by their maturity dates, e.g., technically, maturity defaults. Similarly, the yellow line provides the percentage of loans scheduled to mature in the given month that had still not paid off six months after their maturity date. The chart indicates that approximately 50% of maturing loans do not pay off on time, and 25% have still not paid off six months after their maturity date.

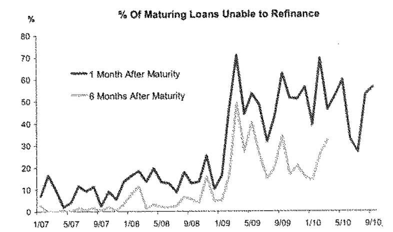
[4] The figures are calculated as follows: First, we take the set of all outstanding non-defeased conduit loans as of December 2009. From this, we take the total balance of all loans scheduled to mature between January 2010 and August 2010 as the denominator. The numerator is the total balance of loans scheduled to mature between January and August that had not paid off as of September. Note, for example, that of the 22 loans ($486 million) from the 2004 vintage that were scheduled to mature during the January to August period, 10 loans ($411 million) had still not been able to refinance as of September.

[5] Highly seasoned loans experienced much greater property price appreciation prior to the crisis and subsequent price declines.

[6] The results in Exhibit 4 are constructed as follows: For each month, we first calculate the set of loans scheduled to mature in that month that are still outstanding and non-defeased as of 12 months before that date. We then calculate the proportion of these loans that remain outstanding on the maturity date and six months after the maturity date.

Exhibit 4

Only about 50% of Loans Maturing Each Month Since the Onset of the Crisis Have Been Able to Refinance on Time



Source: Intex, Trepp, Morgan Stanley Research

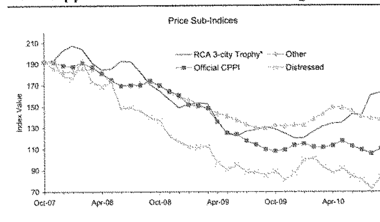
Perhaps the most striking aspect of Exhibit 4, however, is the suddenness with which financing markets seized up following the events of October 2008.

Despite the dramatic improvement in financing markets for institutional-quality properties, refinancing for legacy loans is likely to become increasingly problematic during 2011-13, as the amount of maturing loans from the 2005-08 bubble vintages grows significantly, particularly the five-year IO loans.

While financing market conditions do not directly affect commercial real estate fundamentals, they do directly impact valuations, and the bifurcated recovery in financing markets has had a highly differentiated effect on property valuations. The Moody's/REAL CPPI suggests that property prices declined by 44% between their 2007 peak and 2009 trough, and have increased by 2% since that point. On the other hand, a sub-index of CPPI composed of trophy properties located in New York, Washington DC and San Francisco declined by 38% peak to 2009 trough, but have appreciated by 36% since that time, leaving them only 15% below their 2007 peak values. Finally, there are distressed properties whose prices declined by 58% peak to 2009 trough, and have appreciated by 3% since then, leaving prices down 56% peak-to-current.

Exhibit 5

Trophy Properties Experiencing Much Greater Price Appreciation than All Other Categories



Source: Geltner Associates LLC, based on data from Real Capital Analytics Inc, & methodology licensed to Real Estate Analytics LLC (REAL), Moody's, Morgan Stanley Research

Exhibit 6

Significant Differences in Price Changes Since the 2009 Bottom for Different Property Categories

Price Changes	10/07 - '09 Bottom	Since '09 Bottom	Since 10/07
CPPI	-44%	2%	-43%
3-City Trophy	-38%	36%	-15%
Distressed	-58%	3%	-56%
Other	-32%	6%	-28%

Source: Geltner Associates LLC, based on data from Real Capital Analytics Inc, & methodology licensed to Real Estate Analytics LLC (REAL), Moody's, Morgan Stanley Research

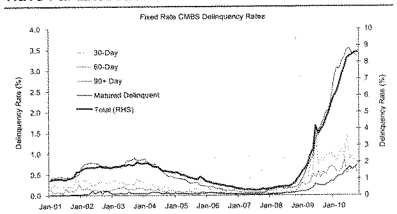
Loan Performance: No Improvements Yet, and None Expected

The speed of deterioration in CMBS loan performance during the current downturn has been breathtaking, even in comparison to the early 1990s. For commercial mortgages held by life insurance companies, the 60+ day delinquency rate peaked in June 1992 at 7.53%.[7] The 60+ day delinquency rate for conduit loans, which reached 7.82% in October, has already surpassed this level. More significantly, it has done so over a far shorter period. The CMBS 60+ day delinquency rate increased by approximately 740bp in just two years, while it took insurance company loans approximately four years to see that degree of deterioration.

[7] See *ACLI Mortgage Loan Portfolio Profile*, June 30, 2010.

Exhibit 7

The Degree and Speed of Deterioration in CMBS Have Far Exceeded Previous CRE Crashes



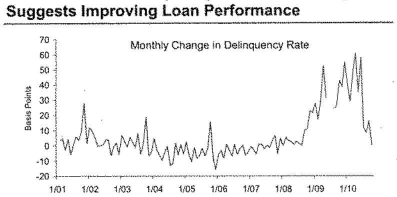
Source: Intex, Trepp, Morgan Stanley Research

The fact that delinquency rates have risen so high over such a short period reflects, in part, the slow pace at which delinquent loans have been resolved during the crisis. The slow pace of resolutions is itself the result of the severe dislocation in financing markets. With the availability of credit highly constrained, the sales of REO properties and distressed loans have been problematic.

Since the onset of the crisis, the aggregate delinquency rate has grown at a staggering 30-50bp per month, which dwarfs anything seen previously in either CMBS or life company portfolios. In July, however, the monthly increase began to slow substantially, and in October it was effectively zero. This has led to a growing belief in the market that the credit performance of legacy loans is improving markedly.

Exhibit 8

The Dramatic Decline in Monthly Increases in the Conduit CMBS Delinquency Rate Misleadingly Suggests Improving Loan Performance



Source: Intex, Trepp, Morgan Stanley Research

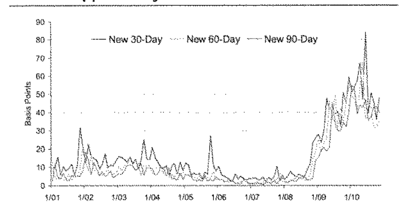
In fact, much of the apparent improvement in loan performance is the result of a dramatic pick-up since July 2010 in property liquidations, loan sales and modifications, which are net outflows from the pool of delinquent loans. When liquidations and modifications become large relative to the rate of new delinquencies, simple delinquency rates become a highly misleading indicator of credit trends. In fact, as the pace of loan liquidations and modifications is likely to continue to increase, delinquency rates may well be at or near their peak for this cycle.

To examine credit trends in fixed-rate CMBS loans, we look instead at the rate at which loans are becoming delinquent *that had never been delinquent previously*. For example, the 'new 30-day' delinquency rate for a given month reflects only those loans that became 30-days delinquent in that month that had never been 30-days delinquent prior to that time. The new 30-day delinquency rate represents the new addition to the overall delinquency category each month.[8] We define the 'new 60-day' and 'new 90-day' rates analogously. Effectively, they measure the rate at which loans are going 'bad' and, therefore, more accurately reflect credit trends.

Exhibit 9 presents the three series for the fixed-rate conduit CMBS sector. While all three series are volatile on a monthly basis, there is little evidence to suggest that loan performance is improving. Rather, the trend rate of flow of new loans into 30-day, 60-day and 90-day categories appears to have been fairly range-bound since March 2009. While there were several months – March, April and June – with unusually large inflows (to the 30-day bucket), these months are probably best thought of as outliers. Recent monthly flows into the new 30-day and new 60-day buckets are of approximately the same size as the average monthly flows since April 2009, calculated after excluding these three months. This suggests there has been little improvement to date in the credit performance of legacy loans.

Exhibit 9

The Rate at Which Loans Are Going Bad Has Not Slowed Appreciably



Source: Intex, Trepp, Morgan Stanley Research

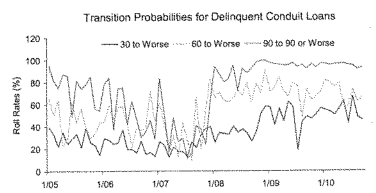
If loan performance were, in fact, improving one would also expect to see evidence in the one-month delinquency

[8] That is, any previously current loan moving into the delinquent category must first pass through the 30-day delinquency bucket, and thus will be reflected in the new 30-day bucket.

transition rates.[9] In particular, the '30-to-worse', '60-to-worse' and '90-to-90-or-worse' transition rates would be expected to be trending downward. These one-month transition rates are presented in Exhibit 10 and again show no sign of improvement.

Exhibit 10

Delinquency Transition Rates for Conduit CMBS Loans Show Little Sign of Improvement



Source: Intex, Trepp, Morgan Stanley Research

In a typical downturn, defaults tend to peak two to three years after the recession has ended, and we expect this pattern to repeat in the current cycle. Moreover, one does not have to look too far to identify prime candidates for future defaults: approximately 15.9% ($94 billion) of loans from the 2000-08 vintages have reported DSCRs below 1.0x based on 2009 or 2010 financials. Of these, only 18.2% are currently delinquent.

Exhibit 11

16% of Conduit Loans Exhibit DSCR < 1.0x, of Which Only 18.2% Are Delinquent, Which Bodes Ill for Future Defaults

	Universe		DSCR < 1.0x		DSCR < 1.0x as % of	Delinquent as % of DSCR <
Vintage	Count	Bal ($Bn)	Count	Bal ($Bn)	Universe	1.0x
2000	673	3.2	171	0.8	23.3	37.9
2001	2,515	13.9	458	2.3	16.6	16.5
2002	2,764	18.5	398	2.1	11.6	17.0
2003	4,139	31.6	478	3.5	11.2	17.7
2004	5,301	49.4	722	5.6	11.3	13.3
2005	9,299	115.2	1,340	14.5	12.6	18.2
2006	11,743	155.4	2,057	24.2	15.6	16.0
2007	11,594	188.6	2,111	39.0	20.7	19.6
2008	804	10.5	166	1.5	14.5	31.2
Total	**48,832**	**586**	**7,901**	**94**	**15.9**	**18.2**

Source: Intex, Trepp, Morgan Stanley Research

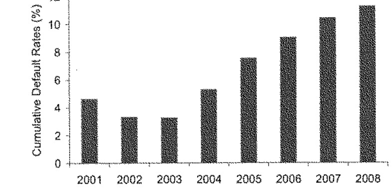
[9] The '30-to-worse' transition rate reflects the proportion of 30-day delinquent loans that move to being 60-days delinquent or worse in the following month. The '60-to-worse' and '90-to-90-or-worse' are defined analogously.

The $77 billion of non-delinquent loans with DSCRs below 1.0x are being supported by some combination of borrower equity infusions and reserves. We expect that a significant proportion of them will ultimately default, as borrowers' hopes of being rescued by a quick recovery fade.

Cumulative term defaults to date since the beginning of the crisis (September 2008 to present) are in excess of 10% for the 2007 and 2008 vintages.[10] We expect that ultimately they will approach, and possibly exceed, the 20% level.[11]

Exhibit 12

Cumulative Term Default Rates for the 2007 and 2008 Vintages Already Exceed 10% and May Ultimately Approach 20%



Source: Intex, Trepp, Morgan Stanley Research

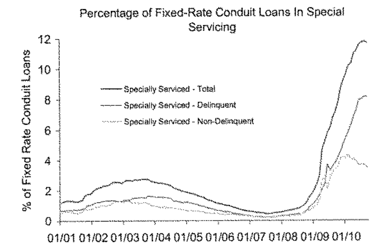
The growth rate of specially serviced loans has begun to slow over the past few months. While some of this reflects the significant increase in the rate of loan liquidations and modifications (discussed in detail in the next section), there has also been a slowdown in the rate of loans being transferred to special servicing. Upon closer inspection, however, most of the slowdown has been concentrated in non-delinquent loans being transferred. The rate at which delinquent loans are being transferred has exhibited little change.

[10] Rates were calculated with respect to original loan balances.

[11] In comparison, in "Commercial Mortgage Defaults: An Update," Real Estate Finance, Spring 1999, Esaki, L'Heureux and Snyderman estimate that the worst performing vintage of life company loans (the 1986 vintage) experienced cumulative defaults and losses of approximately 36% and 10%, respectively, during the early 1990s. Notice, however, that above cumulative term defaults statistics for CMBS do not include maturity defaults and losses. When these are included, our total loss estimates for the 2006 and 2007 vintages do indeed exceed that of 1986.

Exhibit 13

The Rate of Specially Serviced Loans Has Stabilized, but This Mainly Reflects a Decline in the Number of Non-Delinquent Loans Being Transferred



Source: Intex, Trepp, Morgan Stanley Research

The rate of non-delinquent specially serviced loans peaked at 4.32% ($28.5 billion) in February 2010 and has since declined to 3.53% ($21.7 billion). We expect that the growth of non-delinquent specially serviced loans will accelerate again in the near future. The majority of these loans were transferred at the borrower's request in order to negotiate a loan modification. There are currently $68.7 billion of non-defeased fixed-rate loans originated during the bubble period of 2005-08 and originally scheduled to mature during 2011-13. We estimate that approximately 65% of these loans will not qualify to refinance at maturity, along with many other loans. Many will be transferred to the special servicer for restructuring or liquidation.

Resolution of Problem Loans: The Time Has Come

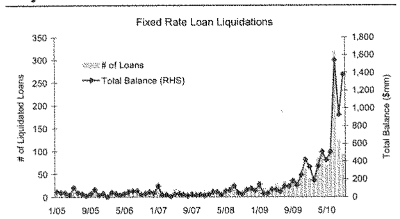
Between September 2008 and June 2010, problem fixed-rate loans poured into special servicers at a remarkable average rate of 200 ($3.2 billion) per month. As of September 2010, there were 4,379 fixed-rate conduit loans ($71.7 billion) alone at special servicers, 11.7% of the fixed-rate universe.

The dislocation in financing markets in combination with the speed with which loans were being transferred to special servicers made it effectively impossible to make significant progress on resolving problem loans. However, the recent improvement in financing markets, at least for higher-quality assets, as well as the slowdown in the rate of loans being transferred, is now allowing the resolution process to move forward.

Loan liquidations (including foreclosure sales, REO property sales, note sales and discounted payoffs) have accelerated sharply since June. For fixed-rate conduit loans, there were, on average, 70 loans ($383 million) liquidated per month during 1H10. By July this was up to 319 loans ($1,542 million), with August and September coming in at 125 ($922 million) and 94 ($1,377 million), respectively.[12]

Exhibit 14

Loan Liquidations Have Risen Significantly Since July



Source: Intex, Trepp, Morgan Stanley Research

The average amount of time required to liquidate defaulted loans is a critical factor in determining the value of many highly distressed securities, particularly those trading as credit IOs. To examine this issue, we first take the subset of liquidated loans that had been delinquent prior to liquidation. These loans are classified according to their type of liquidation: foreclosure sales, REO sales and 'other', the majority of which are note sales.[13]

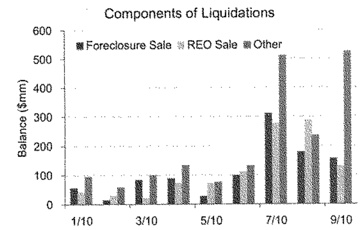
Exhibit 15 presents the total monthly balance of each type of liquidation since January 2010. While all categories have risen significantly since July, the 'other' category has increased disproportionately. We attribute this to the increase in note sales, as special servicers are embracing the strategy of auctioning off portfolios of smaller loans as a way of making progress on resolving their massive portfolios of problem loans. Given the time and cost of the foreclosure route, not to mention the fact that courts in judicial foreclosure states are overflowing with foreclosure cases, commercial and residential, we expect that note sales will grow over time, possibly by a significant amount. This, in turn, should drive liquidation volumes higher over time.

[12] Because of the reporting lag, liquidations in a given month typically are not known precisely for several months.

[13] In a foreclosure sale, the property is sold at the foreclosure auction. An REO sale occurs when the special servicer credit bids at the foreclosure auction to buy the property and take it REO. The property is then sold at some later point.

Exhibit 15

Liquidations Have Increased Significantly Since July 2010, Particularly the 'Other' Category, Which Includes Note Sales

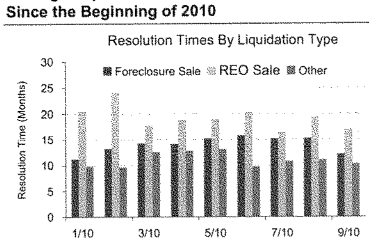


Source: Intex, Trepp, Morgan Stanley Research

Exhibit 16 presents (balance-weighted) average liquidation times by month and liquidation type.[14] Liquidation times appear to have been experiencing a very modest downward trend since mid-year, possibly a reflection of improving financing markets. Average liquidation times are approximately 15-20 months for REO sales, 12-15 months for foreclosure sales and 10 months for note sales.

Exhibit 16

Average Liquidation Times Are Down Slightly Since the Beginning of 2010

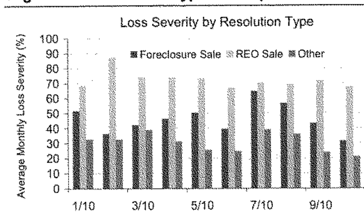


Source: Intex, Trepp, Morgan Stanley Research

[14] Liquidation time is defined as the time between the date of the loan's last payment and the liquidation date.

Exhibit 17

Loss Severity Rates for REO Sales Are Much Higher than for Other Types of Liquidation

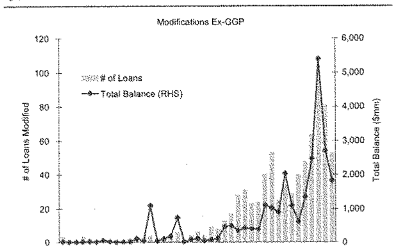


Source: Intex, Trepp, Morgan Stanley Research

Loan modifications have also increased significantly during 2010, up from an average of 21 loans ($411 million total balance) per month in 2009 to 53 loans ($1,955 million) per month in 2010, and 77 loans ($2,911 million) since June 2010 (see Exhibit 18).[15]

Exhibit 18

$23.5 Billion of Modifications ex GGP to Date



Source: Intex, Trepp, Morgan Stanley Research

The analysis below examines differences between loans that special servicers chose to modify and loans they chose to liquidate. Understanding the approach special servicers are taking in determining whether a given loan should be liquidated or modified is a crucial component of valuing legacy bonds.

Before proceeding, we note that the information relating to modified loans provided by special servicers is, in our view, inadequate. The precise details for any loan modification should be provided in a timely manner. This includes the

[15] Exhibit 18 includes modifications from all CMBS sectors, including those modifications still under investigation for modification type.

exact terms for any equity infusion by the borrower or any other outside investor, including any fees paid to the special servicer. As it currently stands, hundreds of modified loans remain 'under investigation', as market participants search for even basic details about the structure of the modification. We hope that this important deficiency is addressed as the return of the CMBS market proceeds.

To date, there have been 912 CMBS loan modifications with a total balance of $36.6 billion. Exhibit 19 breaks these down between the fixed-rate conduit and large loan sectors. The analysis excludes GGP loans because these modifications were effectively dictated by the bankruptcy court, and thus do not necessarily reflect special servicers' approach to loan modification decision-making. This leaves 813 loans with a balance of $27.3 billion.

Exhibit 19

$27.3 Billion of CMBS Loans Have Been Modified to Date, Excluding GGP Loans

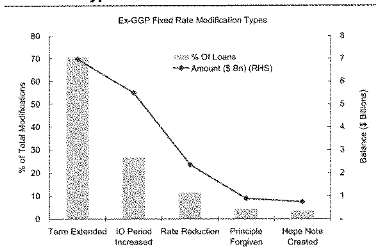
	Total Modifications		Ex-GGP Mods	
	# of Loans	($ Bn)	# of Loans	($ Bn)
Conduit-Fusion	784	$23.0	687	$13.8
Large Loan	126	$12.2	124	$12.0
Other	2	$1.4	2	$1.4
Total	912	$36.6	813	$27.3

Source: Intex, Trepp, Morgan Stanley Research

Narrowing the focus to modifications of fixed-rate conduit loans only, Exhibit 20 indicates that approximately 70% of conduit loan modifications to date have included a maturity extension, while 25% have included an extension of the IO period (for partial IO loans), and only 11% have included an interest rate cut.[16]

Exhibit 20

Term Extension Represents by Far the Most Common Type of Modification



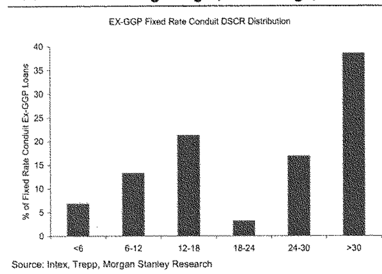
Source: Intex, Trepp, Morgan Stanley Research

[16] Exhibit 19 includes only modified fixed rate loans, excluding both GGP loan and modified loans that are under investigation. Note also that many loans include several characteristics, e.g., extension and rate cut, and loans often appear in multiple categories. Thus, the sum of the percentages does not necessarily sum to one.

For the subset of conduit loans whose modifications included a maturity extension, 16% were extended for one year or less, while 43% were extended for two-and-a-half years or more. We suspect that the shorter-term extensions correspond either to loans where the borrower was deemed likely to secure financing given additional time, or to loans where the borrower has been unwilling (or unable) to contribute additional equity.

Exhibit 21

Lengths of Maturity Extensions Vary Widely, but Have Been Growing Longer, on Average, over Time



Source: Intex, Trepp, Morgan Stanley Research

We now restrict the analysis to modifications and liquidations of fixed-rate conduit loans that occurred during 2010 in order better isolate special servicer trends.

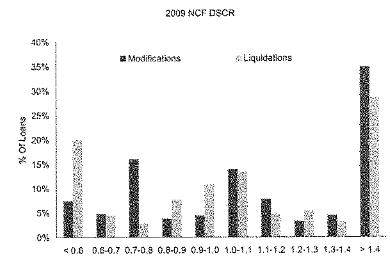
Our a priori assumption is that special servicers would be more likely to modify better-performing loans that have a higher probability of ultimately paying off, and liquidate worse-performing loans that have lower probability of a successful resolution. In our view, modifying loans that do not have a high likelihood of being able to pay off within several years is a highly risky and generally poor strategy. To the extent that borrowers believe they are likely to lose the property in the end, they will not contribute the needed capital expenditures and reserves, making the ultimate losses likely to be much higher. Thus, one would expect modified loans to have higher DSCRs relative to liquidated loans. One would also expect that below DSCRs of 1.0x, there would be a significantly higher incidence of liquidations.

To explore this issue, we further restrict our set of 2010 modified and liquidated loans to those that have reported 2009 updated financials. Exhibit 22 provides separate DSCR distributions for modified loans and liquidated loans based on 2009 financials. The results indicate that while this relationship may be true, it is far weaker than what would be expected. Approximately 64% of modified loans had 2009 DSCRs greater than 1.0x, compared to 55% for liquidated loans. However, many liquidated loans had DSCRs well above 1.0x and many modified loans had DSCRs well below 1.0x.

It is quite surprising that 36% of modified loans in 2010 had 2009 DSCRs below 1.0x, and 28% below 0.8x. One might conjecture that a large percentage of the below 1.0x loans that were modified were either apartment or hotel, as these two sectors are currently showing a strong recovery and thus the loans may have a reasonable prospect of turning around. Exhibit 23 provides a breakdown of these two distributions by property type. Apartment and hotel do indeed have the highest shares on a loan count basis.

Exhibit 22

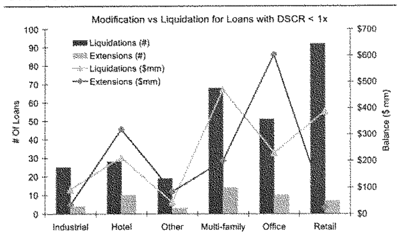
64% of Loans Modified in 2010 Had 2009 DSCRs above 1.0X, 55% for Liquidated Loans



Source: Intex, Trepp, Morgan Stanley Research

Exhibit 23

The Apartment and Hotel Sectors, the Only Sectors with Recovering Fundamentals, Have the Largest Shares of Modifications



Source: Intex, Trepp, Morgan Stanley Research

However, something even more interesting is evident in Exhibit 23. Looking at hotel, for example, the number of modifications is only 36% of the number of liquidations. Yet the balance of modified hotel loans is 50% greater than that of liquidated loans. This suggests that the loans being modified are, on average, much larger than those being liquidated. This is confirmed in Exhibit 24. For every property type, the average loan size of modified loans is much larger than that for liquidated loans. The same is true for virtually all property sectors for loans with DSCRs below 1.0x.

Exhibit 24

Modified Loans Have Much Higher Balances than Liquidated Loans

	Average Loan Size ($mm) for Properties with DSCR < 1.0x					
	Hotel	Industrial	Multi-family	Office	Retail	Aggregate
Extension	$31.8	$8.5	$14.1	$47.9	$3.3	$23.9
Liquidation	$9.5	$4.3	$7.5	$5.3	$4.8	$5.9

Source: Intex, Trepp, Morgan Stanley Research

When loan size and DSCR are examined simultaneously, an interesting picture emerges. Since different special servicers may be following different strategies, the analysis is most useful if performed on subsets of loans from a single special servicer.

Exhibit 25 provides a series of three scatter plots. Each scatter plot graphs 2009 DSCR versus loan size for two subsets of loans, those that were modified (blue) and those that were liquidated (tan). All loans in a given scatter plot had the same special servicer. The first scatter plot represents loans specially serviced by LNR, the second loans specially serviced by CW Capital and the third by Midland.

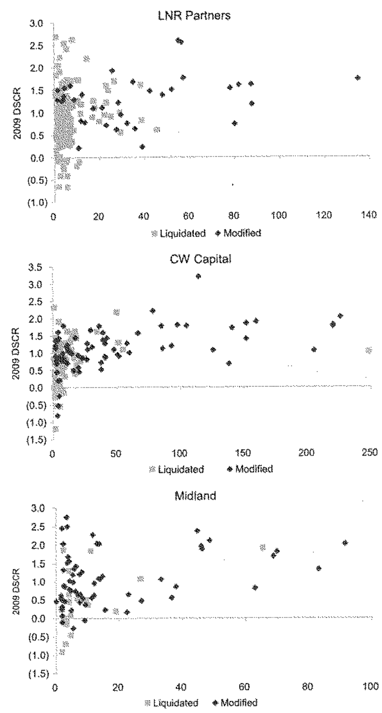
All three exhibits suggest that size is by far the most important factor in the modified/liquidation decision. In particular, most loans over $20 million are modified, independent of their 2009 DSCR. For loans below $20 million, LNR appears to liquidate those with DSCRs below 1.0x, while CW Capital and Midland appear to have modified a reasonably high percentage.

We suspect that in most cases in which loans with DSCRs below 1.0x were modified, borrowers contributed additional equity. Verifying this, however, is time-consuming, as information on borrower equity infusions for modified loans is not widely reported.

Morgan Stanley

Exhibit 25

Loan Size Appears to Be the Most Dominant Factor in the Modification/Liquidation Decision, Followed by DSCR



Source: Intex, Trepp, Morgan Stanley Research

While liquidations and modifications have increased to the $1.0-1.5 billion and $2.0-$3 billion monthly ranges, respectively, there is approximately $85 billion of CMBS loans (all sectors) currently at special servicers, and billions more transferring in each month. Clearly, unless special servicers increase the pace of resolutions, they will become inundated. We expect that the growth in resolutions will come disproportionately from sales of portfolios of smaller loans and modifications of larger loans.

The impact on loss timing will likely be somewhat bar-belled – losses on smaller loans will come in earlier than they otherwise would have, while losses on larger loans will tend to be pushed out into the future. Thus, we expect to see realized losses flowing in at an accelerating rate. This should speed up the demise of many of the lowest-rated credit IO bonds.

While loan modifications do help to clear the delinquent and specially serviced loan pipelines, we regard them as risky and believe that in many cases they simply push the de-leveraging problem off into the future. An even more significant problem, however, is that in cases where extensions are unlikely to be successful (i.e., borrowers ultimately lose the property), borrowers have little incentive to make adequate capital expenditures to keep the property from deteriorating, or fund T&I and LC reserves. Office properties, for example, require large upfront cash outlays for tenant build-outs and leasing commissions for brokers, among other things. Without adequate reserves for these expenses, it will be difficult to re-lease space as it rolls. The result is likely to be an even larger loss in the future.

To prevent such incentive problems, special servicers attempt to get borrowers seeking a loan modification to contribute additional equity, typically by paying down part of the loan or funding upfront reserves for property-related expenses. Unfortunately, detailed data are not easily available on loan modifications, so their degree of success, particularly for modifications of smaller loans, is not easy to determine. Moreover, in many of the cases where borrowers agree to make significant equity infusions in exchange for modifications, the positive benefits to the trusts are often severely diminished by the rights granted to the new equity. A good example of this is the modification of the Columbia Center loan in MSC 2007 HQ12.

Case Study: The Columbia Center Loan Modification

Columbia Center is a 76-story, 1.5 million square foot, Class A, trophy office property in Seattle owned by Beacon Capital Partners. At loan origination, the property was appraised at $648 million.

The original loan was a $480 million 5y IO with a 74% LTV and a scheduled maturity date of May 2012. The loan was split into four components: two pari passu A-notes, A1 ($300 million) and A2 ($80 million) and two pari passu B-notes, B1 ($80 million) and B2 ($20 million). The A1 and A2 are held in the securitization trust and the B1 and B2 were sold to investors outside the trust.

The loan, which exhibited a full-year 2009 NOI DSCR of 0.89x, was transferred to the special servicer in February 2010. A new appraisal in March 2010 resulted in an appraisal reduction of $92 million and interest shortfalls thereafter (property appraised at $330 million). The borrower stopped paying on the loan in April 2010.

The loan was modified as of 9/2/10. The A1 and A2 maturities were extended for 36 months (from May 2012 to May 2015) with two additional one-year extension options, bringing the total extension to five years. The A1 will continue to accrue interest at the same rate (5.62%) and the borrower will make A1 current, while the A2 will defer interest until maturity, which will lead to ongoing interest shortfalls in the deal. The B2 (outside the trust) will also defer interest until maturity. The A2 and B2 are, effectively, 'hope notes'.

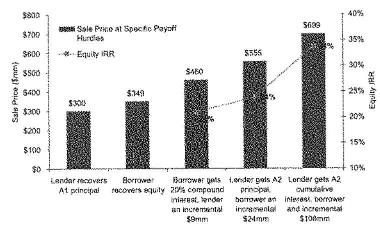
The borrower will make an initial contribution of $30 million of new equity to a reserve fund and subsequent contributions of $19.2 million via four equal payments, six months apart, beginning in January 2013. *In terms of payoff at the extended maturity date, the borrower's new equity contribution is junior to the A1 note, but senior to the A2 (and its deferred interest). Additionally, the borrower is entitled to earn 20% compound interest on its equity plus additional cash before the A2 principal is recovered as a result of the deal's modified waterfall structure.*

The Columbia Center loan restructuring is a good example of recent large fixed-rate loan modifications. Borrowers, in many cases, are being provided with extraordinary incentives to remain in properties. These incentives typically take the form of giving contributed equity priority over the hope notes (e.g., the A2 and B2 notes in the Columbia Center example) both in terms of repayment in a future payoff scenario and, potentially, ongoing cash flow above some hurdle level. They have the effect of reducing the likelihood that the hope notes will ultimately be repaid or receive their full deferred interest. Since the hope notes are typically cut somewhere in the range of 100% LTV, to the extent that they receive no principal payment at payoff, the trust may well have been better off liquidating.

In the case of Columbia Center, assuming that the loan is liquidated at the extended maturity date, and that the equity receives no cash flows prior to that point, we calculate the amount the property would have to sell for in order to pay principle and interest to various classes. We present the results in Exhibit 26.

Exhibit 26

If the Trust Is Ultimately Made Whole, the Borrower Will Earn a 35% IRR, on its Equity Investment



Source: Intex, Trepp, Morgan Stanley Research

In order to pay off the A1 note, the value at maturity would have to be at least $300 million, which is approximately the estimated current value. If the value is $349 million then, in addition, the borrower gets its equity back. At $460 million, the borrower receives not only its equity, but also 20% compound interest on it. In addition, $9 million of cash is paid to the trust. At $555 million, the A2 note is completely paid off, while the borrower receives another $24 million (in addition to its equity investment plus the 20% compound interest). Finally, in the event that the property is worth $699 million, the A2 also receives all of its deferred interest and the borrower receives an incremental $108 million.

Thus, for the trust to come out whole, the property would have to sell for $380 million today or $699 million, $51 million more than its 2007 value, in 2017. To put this in perspective, such value growth, at an assumed cap rate of 7.5%, would require an NOI CAGR of 15% for 2010-17 – an unlikely outcome, in our view, particularly given the highly distressed nature of the Seattle office market.

Exhibit 27

Sale Price Necessary for A2 Principle to Be Fully Recovered Is Not Very Plausible

Plausability Test ($mm)	
Sales Price in 2017	$699
Assumed cap rate	7.5%
Implied 2017 NOI	$52
2009 NOI	$19
Implied 2009-2017 NOI CAGR	15%

Not a high probability eventuality!

Source: Intex, Trepp, Morgan Stanley Research

In our view, it is difficult to see how this modification could be perceived as being particularly positive from the perspective of the trust. Assuming that the property value today is approximately $300 million, if the value of the property appreciates by 50% by 2017, the loss to the trust declines only from 21% to 17.5%.

We are concerned that in many cases the positive benefits to the trust from loan modifications with additional contributed equity are being eroded by the generosity of the investment terms to the new equity. Given the extreme dearth of high-quality assets and the availability of relatively cheap financing, we see this as a particularly favorable time to liquidate high-quality assets, at least relative to 2012-13, when a much larger number of properties will likely be available and financing terms may not be so favorable.

CRE Fundamentals: Nearing a Bottom, but Recovery for Core Sectors to Be Slow

The deterioration in commercial real estate fundamentals has begun to abate across the major property sectors. For most, vacancy rates have already breached previous records set during 1991-93: retail vacancy stands at 13.1% versus a previous peak of 11.4%, industrial is 14.1% versus 10.9% and apartment is 8.1% versus 6.5%. Lodging suffered its worst downturn on record, surpassing even the post 9-11 devastation. Only the office sector did not record a new vacancy high, although the current rate (16.9%) is approaching the previous peak (18.9%).

While fundamentals are stabilizing, we expect rents to decline further in many office, industrial and retail markets over the next 12-24 months, albeit by modest amounts.

In our view, a quick recovery is unlikely. The recent recession was far deeper than past recessions, and was accompanied by a global financial crisis. Not surprisingly, perhaps, the recovery has been extremely weak by historical standards, and, in the view of many economists, is likely to remain so over the next few years. The critical ingredient to recovery in commercial real estate markets is job growth, which has remained elusive during this recovery.

While the recovery is likely to be fairly protracted for most core property sectors, several – apartment and hotel – are already showing significant signs of improvement. Given the short lease terms in both sectors, improvements in rents and vacancies are likely to flow through relatively quickly into improvements in property NOIs.

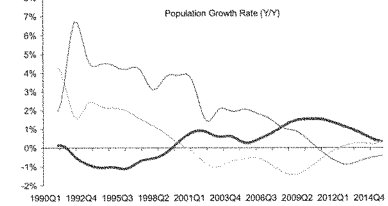
The apartment sector, whose performance in CMBS has been very poor (14.7% current delinquency rate), is experiencing the beginning of a surprisingly strong rebound. Absorption has been sharply positive in the last two quarters, which has brought down the vacancy rate by a dramatic 1.45% (from 7.38% to 5.98%) in just two quarters – one of the quickest declines on record. In addition, many apartment markets are now beginning to experience robust rent growth.

The improvement reflects a combination of increasing household formations as the economy slowly recovers, spillover effects from ongoing problems in housing and the moderate additions to the apartment stock over the past few years. CBRE Econometric Advisors is forecasting a cumulative apartment supply growth of only 1.8% in 2011-13.

The near-term outlook for the apartment sector is further improved by the favorable demographics through 2013, as the 20-34-year-old age cohort for the US population, the age cohort with the highest percentage of renters, experiences 15% growth over this period.

Exhibit 28

Apartment Sector Facing Favorable Demographics, as 20-34 Age Cohort Will Experience Strong Growth over the Coming Years

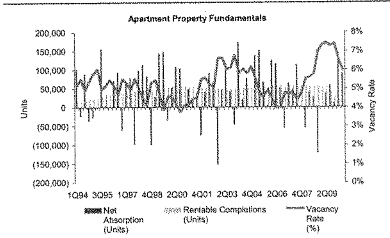


Source: Bureau of Census, Moody's, Morgan Stanley Research

Hotel was by far the hardest-hit property sector during the recent downturn, with RevPAR down as much as 33%Y for the luxury and 19%Y for the economy segments during the depths of the crisis. This implies NOI declines of 40-50% or more. Not surprisingly, this led to far worse default incidence than was experienced in the post 9/11 period, with current delinquency rates reaching as high as 17.2% in October.

Exhibit 29

Apartment Fundamentals Have Improved Quickly, with Historically Large Recent Vacancy Declines



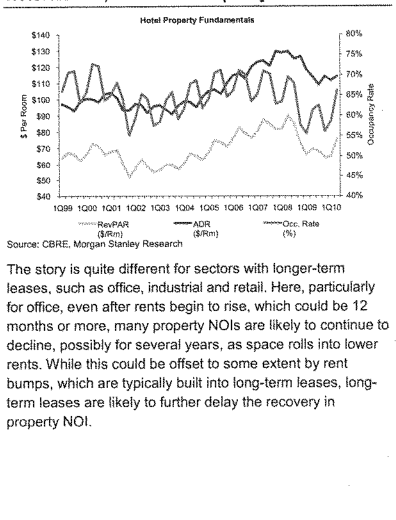
Source: CBRE, Morgan Stanley Research

However, hotel has been staging an impressive recovery over the past few quarters, with RevPAR increasing by 10-15% across segments. The improvement in fundamentals has yet to translate into improved loan performance.

We expect that further improvement in the hotel sector will be driven by improvements in the economic environment, and job growth in particular.

Exhibit 30

Hotel RevPar, ADR and Occupancy on the Rise



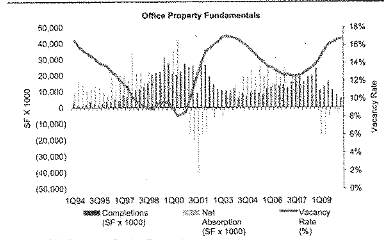
Source: CBRE, Morgan Stanley Research

The story is quite different for sectors with longer-term leases, such as office, industrial and retail. Here, particularly for office, even after rents begin to rise, which could be 12 months or more, many property NOIs are likely to continue to decline, possibly for several years, as space rolls into lower rents. While this could be offset to some extent by rent bumps, which are typically built into long-term leases, long-term leases are likely to further delay the recovery in property NOI.

The office market, in particular, continues to struggle and is likely to do so for several years. Indeed, the long-term leases that buffered many properties from much of the initial impact of dramatic rent declines should help to ensure the recovery is relatively drawn out. While the negative absorption has largely dissipated, suggesting that office vacancies are close to a peak, rents are likely to continue to be under near-term pressure.

Exhibit 31

Office Sector's Long Lease Terms Help to Insulate Against NOI Declines in Market Declines, but Can Slow Recovery on the Way Up



Source: CBRE, Morgan Stanley Research

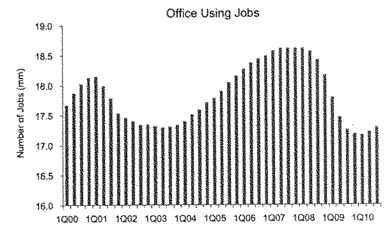
Moderate improvements in office NOIs should come with improvements in occupancy, but more robust increases will likely require significant rent growth.[17] With the vacancy rate approaching 17%, however, there is a great deal of space that needs to be absorbed before robust rent grown can be expected. Moreover, many major office tenants are focusing on increasing the efficiency of their office space usage, i.e., reducing space per employee, as a means of reducing costs. This trend tends to slow vacancy improvements.

Vacancy improvements, like rent growth, are dependent on office job growth, and the picture on this front is not overly encouraging, as the prevailing view is that job growth is likely to lag significantly in this recovery. Indeed, early signs of growth in office jobs have dissipated in recent quarters, reinforcing the view that the degree of job growth necessary to bring improvements to commercial real estate fundamentals is faltering. This is also the message from the Fed's pursuit of a second round of quantitative easing.

[17] Increasing occupancy increases variable costs, which moderates the increase in NOI, while rent growth flows straight through to NOI growth.

Exhibit 32

Office Using Jobs Are Experiencing a Particularly Slow Recovery



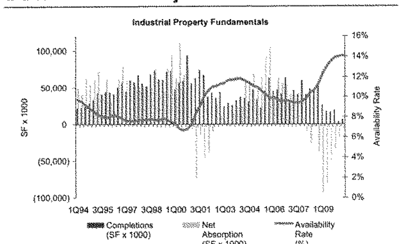
Source: CBRE

While the negative absorption in office, during the recent downturn, was smaller in magnitude than the decline following the tech bust of the late 1990s, this was not the case in industrial. Industrial vacancy rates surged to a record high of 14%, and while negative absorption appears to be tailing off, rents continue to show downward momentum.

With industrial production slowly improving, and a weaker dollar likely to spur imports, we expect that the industrial sector will stabilize in 2011. However, like office, there is a great deal of excess space to be absorbed before robust improvements in property NOIs can be expected.

Exhibit 33

Industrial Sector Likely to Stabilize in 2011



Source: CBRE, Morgan Stanley Research

Like office and industrial sectors, retail is also experiencing record vacancy rates and rent declines. In fact, according to CBRE Econometric Advisors, the current episode is the first time on record that the retail sector has experienced negative absorption on an annualized basis. While negative absorption is abating, retail rents are likely to remain under pressure for several years, suggesting a slow climb out of the current hole.

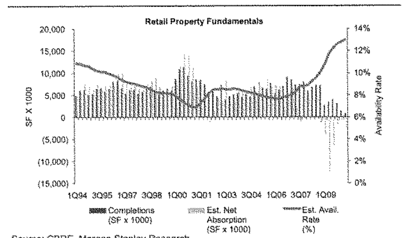
Retail sales, ex-auto, have been in recovery mode, but the improvements have slowed recently. The backdrop is a weak consumer focused on paying down debt, particularly revolving debt, and an increasing savings rate – savings have climbed back into the 6% range, after hovering at approximately 2% for much of the past decade.

The Morgan Stanley REIT Strategy group believes that retail faces a tough road for next several years. Occupancy gains are likely to be a major challenge for malls, as new lease deals are likely to be offset by store closings and downsizings upon lease renewals.

The group sees the gulf between strong and weak malls widening significantly, with weak malls becoming increasingly challenged. This, in particular, is not good news for CMBS, which likely has significant exposure to weaker malls.

Exhibit 34

Retail Fundamentals to Remain Challenging for Several Years



Source: CBRE, Morgan Stanley Research

Apart from apartment and hotel, improvements in commercial real estate values largely reflect improvements in financing markets (and mainly for large loans), not commercial real estate fundamentals.

However, the very low near-term supply pipelines for most property sectors and the fact that construction financing is effectively non-existent are clearly positive factors for the commercial real estate recovery. This notwithstanding, we believe that the recovery will be slow for the core property types of office, retail and industrial.

Hitting the Maturity Wall in 2011

Historically high origination volumes of debt with weak underwriting and/or covenants during the bubble years of 2005-07 have given rise to imposing volumes of near-term maturities for a variety of debt markets, much of it still over-leveraged. Some sectors, such as the leveraged loan market, have been successful in reducing near-term maturities. As of mid-2009, almost $300 billion of leveraged loans were scheduled to mature through 2013. That amount has been reduced to approximately $130 billion, mainly via bond-for-loan takeouts, loans refinanced with new loans, equity issuance and maturity extensions.[18]

The CMBS market, on the other hand, has seen little progress in this regard. On the surface, the near-term maturity problem may appear to be of only moderate scale, as the main maturity bulge occurs in 2015-17, with $373.4 billion scheduled to mature during that period. Nevertheless, scheduled maturities do increase substantially in the near term, rising from an average level of $12.4 per year during 2009-10 to $46.0 during 2011-13.

Moreover, CMBS is only about 25% of the commercial real estate debt market. When considering the maturity issues for commercial real estate debt, it is important to take account of the other major sectors as well, banks and life companies in particular. When this is done, the near-term maturity profile looks considerably more problematic.[19]

Exhibit 35

Approximately $1.4 Trillion in Commercial Real Estate Debt Set to Mature Through 2013, and $2.8 Trillion Through 2020

	Banks			CMBS				
Maturity Year	Core CRE	Multi-Family	Const. / Lands	Conduit	Floater	Life Cos.	Other	Total
2011	167.4	35.4	376.7	38.9	15.3	18.0	58.4	**710.0**
2012	172.7	36.5		56.7	19.2	19.5	63.3	**367.9**
2013	165.9	35.1		42.5	1.1	20.3	63.1	**328.0**
2014	139.5	29.5		53.7	0.5	19.3	60.1	**302.6**
2015	113.4	24.0		101.3	1.3	18.2	51.6	**309.7**
2016	77.8	16.5		135.8	0.1	17.7	45.7	**293.6**
2017	60.1	12.7		136.3		16.9	39.0	**265.1**
2018	42.9	9.1		7.1		14.9	33.5	**107.5**
2019	30.7	6.5		4.0		12.4	24.2	**77.8**
2020	22.4	4.7		3.1		9.7	15.8	**55.8**
Total	**992.8**	**209.9**	**376.7**	**579.3**	**37.5**	**167.0**	**454.7**	**2,817.9**

Source: Foresight Analytics, SNL, Intex, Trepp, Morgan Stanley

We estimate that approximately $710 billion of commercial real estate loans currently on bank balance sheets will have matured by end-2011, including effectively all construction loans, and well in excess of $300 billion more will mature each year for the next five years. In total, we see $2.8 trillion maturing through 2020 in banks, CMBS and life companies.

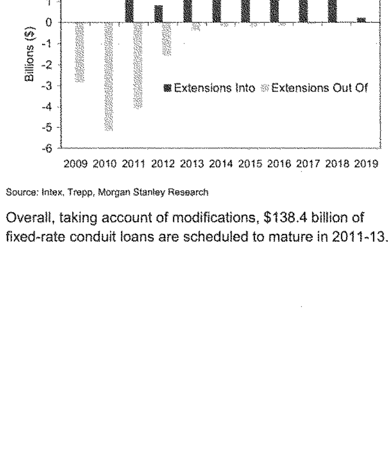
We think the market continues to underestimate significantly the scope of problems in bank commercial real estate portfolios. A large percentage of banks' commercial real estate loans – core, multifamily and construction – that were scheduled to mature over the past two years have likely been extended, or restructured in some way, and this approach will continue to be used extensively for several more years. This, however, does not eliminate the ultimate need to refinance these loans.

It is risky to extrapolate into the future the ease with which financing markets are currently able to absorb financing demand because this demand is small relative to what is coming down the road. Unprecedented amounts of commercial real estate debt will require financing in the next few years. While future financing issues are unlikely to derail commercial real estate markets, we believe that they will be a part of the landscape for years to come.

With respect to the CMBS sector, the impact of modifications to date on the maturity profile of fixed-rate conduit loans has been modest, at best. While some near-term maturities have been pushed out in time, the magnitude has been very small.

Exhibit 36

Modifications Have Pushed Maturities from the 2009-11 Range Out to 2013-17



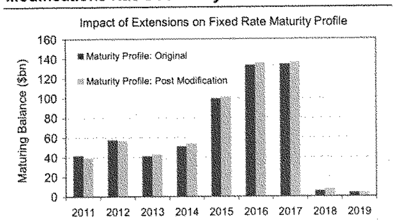
Source: Intex, Trepp, Morgan Stanley Research

Overall, taking account of modifications, $138.4 billion of fixed-rate conduit loans are scheduled to mature in 2011-13.

[18] See "Modifying the Loan Wall", *Leveraged Finance Insights*, August 18, 2010.

[19] We assume that the maturity time profile for bank multifamily loans is proportional to Foresight Analytics' estimated maturity time profile for bank core CRE loans. We also assume that 100% of construction loans have now passed their maturity dates. Finally, the CMBS statistics exclude defeased loans.

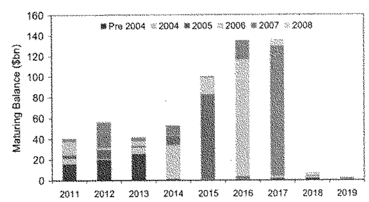
Exhibit 37
However, to Date, the Overall Impact of Modifications Has Been Very Small



Source: Intex, Trepp, Morgan Stanley Research

Of the $138.4 billion of loans maturing in 2011-13, $64.4 billion (46%) are from the 2005-08 loan vintages, and we expect them to experience significant problems refinancing.

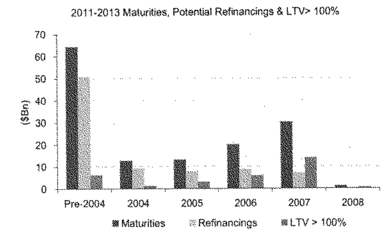
Exhibit 38
Significant Amounts of 2006 and 2007 Vintage Loan Maturities in 2011 and 2012



Source: Intex, Trepp, Morgan Stanley Research

Using our newly developed Morgan Stanley CMBS Strategy credit models, which are discussed in a later section, we estimate that in excess of 40% of the $138.4 billion will not qualify to refinance at maturity without additional equity.[20] For the subset of 2005-08 vintage loans, more than 65% will fail to qualify. From the 2007 vintage, we estimate that less than 25% will qualify for refinancing, while approximately 33% have greater than 100% LTV.

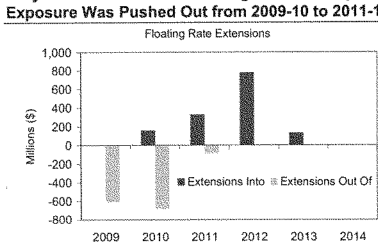
Exhibit 39
Large Percentages of 2006 and 2007 Vintage Loans to Face Difficulty Refinancing During 2011-13



Source: Intex, Trepp, Morgan Stanley Research

For the floating-rate sector, we present the corresponding results in Exhibits 40 and 41. Only $1.4 billion has been formally extended at this point. Exposure was moved out of 2009-10 and into 2011-13.

Exhibit 40
Only a Small Amount of Floating-Rate Maturity Exposure Was Pushed Out from 2009-10 to 2011-13



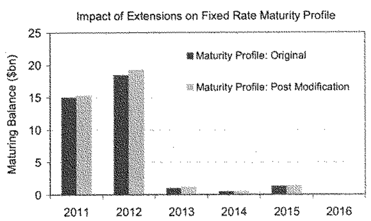
Source: Intex, Trepp, Morgan Stanley Research

Taking account of modifications, there are $15.3 billion of loans scheduled to mature in 2011 and $19.2 billion in 2012. We expect that a relatively small portion of this will be able to refinance on time and the remainder will receive term extensions.

[20] Our credit models do not necessarily default loans that are unable to refinance at maturity. Instead, loans that "qualify" for a modification could receive a maturity extension and/or rate cut.

Exhibit 41

Majority of $35 Billion in Floaters Maturing in 2011 and 2012 Are Unlikely to Qualify for Refinancing



Source: Intex, Trepp, Morgan Stanley Research

New Issue CMBS Market to See Robust Growth in 2011

The CMBS market sputtered back to life in 2010. Issuers have managed to bring 12 new issue deals to the market ($10.2 billion) to date in 2010. We expect more substantial new issue volumes in 2011, as well as more normalized collateral.

We see two main sources for CMBS new issuance in 2011. The first consists of loans scheduled to mature in 2011 that qualify to refinance. The second is CMBS loans that are foreclosed and liquidated and thus require new financing.

We do not expect CMBS to benefit to any significant extent by taking market share from banks. Nor do we think that CMBS will be able to snare many life company borrowers. Indeed, given the intense competition for lending assignments on large, institutional-quality loans, CMBS originators are likely to have greater success refinancing maturing conduit loans.

As noted, taking account of maturity extensions, there are approximately $40 billion of scheduled loan maturities in the conduit sector in 2011. Based on our credit models, we estimate that around $24.5 billion of loans will qualify for refinancing at maturity. Of the approximately $15.5 billion of loans that do not, we expect that about $6bn will be extended. We expect the remainder, around $9.5 billion, to be resolved, either through foreclosure and liquidation or note sales. Loan liquidations have recently been running at $1 billion per month, or more.

To the extent that CMBS is able to capture 100% of maturing CMBS loans that qualify for refinancing and 100% of the financing of liquidated loans, the amount of loans available for CMBS financing, and thus new issue in 2011, should be approximately $35 billion. If CMBS is only able to capture 75%, that figure falls to $25 billion. Adding another $10 billion for loans coming from outside of CMBS, as was the case in 2010, gives a likely range for 2011 new issuance of $35-45 billion.

Morgan Stanley CMBS Strategy Loss Projections

This section previews loss projections from the newly developed Morgan Stanley CMBS Strategy credit models, which will be unveiled in detail in the near future.

The new models are loan-level and are based on rent and vacancy projections from a major third-party data provider. Revenue projections are modeled to reflect the fact that rent and vacancy changes have different impacts on revenue, particularly with regard to timing. For property types with longer lease structures, rent changes are passed through into revenue only as space rolls, taking the typical structure of rent bumps into consideration. The modeled relationship between revenue change and NOI change is the result of a statistical analysis based on the actual performance over time of properties underlying conduit CMBS loans. Finally, we have spent a great deal of time modeling both borrower and special servicer behavior regarding both liquidations and modifications. Our models employ assumptions consistent with the stylized facts laid out in the previous section on loan resolution.

We provide loss projections under bull, bear and base case scenarios. Each is based on a different set of rent and vacancy projections, cap rate assumptions, borrower default decision logic and servicer behavioral liquidation/modification logic. The results are presented in Exhibit 43. For each scenario, we calculate expected losses in two ways. The first employs our modification/liquidation assumptions, while the second assumes no modifications. This is done in order to explore the impact of our loan modification assumptions on losses and valuations.

The modification logic used in this version of the models allows term extensions only for loans maturing prior to 2014. Maturing loans greater than $15 million which do not qualify for refinancing are extended at maturity if they have an LTV (at maturity) of between 80% and 120% *and* a DSCR above 0.9x. For LTVs above 120%, we assume that the loan is liquidated. For LTVs below 80%, the loan pays off without a loss. For loans less than $15 million, we require the same LTV range, but a DSCR above 1.0x.

Loans that qualify for modification receive a term extension of four years. However, modified loans that qualify for refinancing prior to their extended maturity date are assumed to do so.

The impact of loan modifications on projected losses clearly depends significantly on the characteristics of the rent and vacancy projections employed; strong rent and vacancy assumptions will translate into positive implications of modifications, and vice versa. While their absolute impact is self-determinant, flexing these fundamental variables gives one a sense for the range of impact modifications can have. We believe that this is an important lever to be aware of, given its ultimate impact on valuation.

Our base case loss projections rise from 6.26% for the CMBX.1 to 14.46% for CMBX.4. Comparing the two sets of loss projections, it is clear that our specification for modifications has a relatively modest impact on total losses. Moreover, the impact, as would be expected, is most significant for the CMBX.3, CMBX.4 and CMBX.5 series. CMBX.1 losses are largely unaffected.

Interestingly, while the impact of loan modifications on expected losses is modest in our framework, the impact on bond valuation can be enormous, particularly for lower-rated bonds where losses are effectively pushed off into the future, allowing the bondholders to receive years of additional coupon.

Exhibit 42

Morgan Stanley CMBS Strategy Loss Projections

	Losses With Loan Modifications (%)				
Scenario	CMBX.1	CMBX.2	CMBX.3	CMBX.4	CMBX.5
MS Bear Case	7.6	9.6	12.7	16.5	13.2
MS Base Case	6.3	8.2	11.0	14.5	11.6
MS Bull Case	5.1	5.7	8.0	10.6	8.3

	Losses Without Loan Modifications (%)				
Scenario	CMBX.1	CMBX.2	CMBX.3	CMBX.4	CMBX.5
MS Bear Case	7.6	9.8	13.2	17.2	13.7
MS Base Case	6.6	8.5	11.5	14.9	12.1
MS Bull Case	5.1	6.0	8.5	11.2	8.8

Source: Morgan Stanley Research

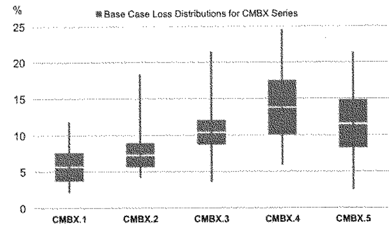
The CMBX indices are effectively synthetic CDOs and, as such, it is not only the average loss rate for each series that matters for valuation, but also the entire distribution of losses. These loss distributions are presented graphically in Exhibit 43, where the blue boxes represent the inter-quartile ranges and the white bars in the center of the boxes the medians. The lines at either end of the boxes identify the outliers, both high and low.

The projected loss distributions for CMBX.4 and CMBX.5 are much more widely dispersed that the others – the interquartile range is approximately 8% wide versus 3-4% for CMBX.1, CMBX.2 and CMBX.3.

This implies that the higher-rated classes are more vulnerable to losses and the lower-rated classes are less vulnerable relative to cumulative loss probability distributions that have less dispersion.

Exhibit 43

Morgan Stanley CMBS Strategy Projected Base Case Loss Distributions



Source: Morgan Stanley Research

Recently, the National Association of Insurance Commissioners (NAIC) introduced a new methodology for determining regulatory capital requirements for CMBS securities. The methodology is based on bond-level expected losses determined by models developed by BlackRock Advisors. The NAIC loss estimates are presented in Exhibit 44 along with the Morgan Stanley estimates.

Exhibit 44

NAIC versus Morgan Stanley Loss Projections

	Comparison with NAIC Loss Projections				
Scenario	CMBX.1	CMBX.2	CMBX.3	CMBX.4	CMBX.5
NAIC	**6.7**	**7.2**	**10.3**	**12.0**	**9.8**
MS Bear Case	7.6	9.6	12.7	16.5	13.2
MS Base Case	6.3	8.2	11.0	14.5	11.6
MS Bull Case	5.1	5.7	8.0	10.6	8.3

Source: NAIC, Morgan Stanley Research

For the most part, the NAIC estimates lie between our base and bull case scenarios. A more meaningful comparison would require the distribution of losses for each of the CMBX series and, better still, CUSIP-level loss estimates.

CMBS Relative Value

The CMBS market witnessed the combination of two extraordinary events in 2010: the worst credit performance in recent history and a dramatic rally in legacy CMBS securities and the synthetic indices that resulted in almost complete price recovery in what was just twelve months earlier a decimated sector with an uncertain future. That these two events occurred simultaneously gives some indication of the massive size of the technical bid for credit that has inundated all credit sectors.

Much of this technical factor is the result of the historically low interest rate environment that has pushed investors into ever-riskier debt in search of sufficient yield. Given the Fed's determination to hold rates low for the near term via QE2, this positive technical does not look to be going away any time soon.

Another positive factor is the ever-dwindling supply of structured finance securities (CLO, CMBS and Non-Agency RMBS). With little new issuance in any of the structured finance sectors in 2009 and 2010, and only marginally improved issuance expected in 2011 (on an absolute basis), the combination of loan payoffs, amortization and defaults is reducing the available supply of securities.

The PPIP bid also continues to provide a positive technical backdrop for CMBS and RMBS specifically, especially for AMs and AJs. Of the approximately $30bn PPIP funds initially available, about $10.8bn of capacity remains. To date, the market value of RMBS and CMBS held by PPIP funds is $15.9bn and $3.4bn, respectively.

Recently, however, these positive factors have been overshadowed by the return of the sovereign debt crisis. While Ireland and Greece have been dealt with, the contagion is quickly spreading to Spain and Portugal, and may ultimately impact Italy. These problems may take some time to resolve, particularly given the large size of Spain relative to both Greece and Ireland. This is likely to keep markets volatile in the near term, and prevent a sustained rally into year-end.

The CMBS market will likely have trouble returning to the previous steady grind tighter until fears surrounding the sovereign debt crisis subside. Once this happens, however, we expect the positive technicals outlined above to return to the forefront and drive continued appreciation.

Trade Ideas

For investors particularly concerned about ongoing macro volatility, staying in the top of the capital stack, at the AM level and above, should provide a reasonable buffer.

While nothing in CMBS has quite as compelling a risk/return profile as the LCF AAA classes in non-agency RMBS, or AAA CLO bonds, there are nevertheless a variety of attractive opportunities.

We view the top of the CMBS capital structure, super senior AAAs and AMs, as very low risk in terms of principal loss, though some super senior AAAs, and many AMs, may have significant downgrade risk.

Buy the AM.3 and AM.5 Indices

In our view, the AM.3 and AM.5 indices represent attractive low risk opportunities in the CMBX space. We expect the CMBX.3 and CMBX.5 credit curves to flatten between the AAA and AM tranches as the market begins to accept that the difference in credit risk does not warrant such a high spread differential. Our credit models project zero losses for both AM.3 and AM.5 under our Base Case scenario, and minimal losses under the Bear Case scenario. AM.4, on the other hand, experiences significant losses under our Bear Case scenario. Currently, AM.5 trades 146bp over AAA.5 and AM.3 trades 186bp over AAA.3. The corresponding differential for CMBX.1 and CMBX.2 are 125bp and 81bp, respectively. However, we also expect the spread differential between all of the AAA indices to converge, most likely to AAA.1, in recognition of the fact that they are all risk remote. This could significantly increase the amount that AM.3 and AM.5 ultimately tighten, even if AAA.1 does not tighten any further.

Buy AJ.1 and AJ.2 Reference Cash Bonds

An even more compelling trade in our view entails moving down the capital structure to the AJ indices. While the AJ.3, AJ.4 and AJ.5 experience non-trivial losses under our Base Case scenario, AJ.1 and AJ.2 experience zero losses under our Base Case and only miniscule losses under our Bear Case scenario. Instead of buying the AJ.1 and AJ.2 indices, however, we recommend instead buying the corresponding reference cash bonds. Most of these bonds trade cheap relative to the index, with spread differentials that can be as wide as several hundred basis points. Moreover, the implied basis between the index and the exact reference portfolio cannot be justified on fundamental grounds. Given the very low risk of principal loss in the reference bonds, we believe that their spreads, which are typically in the +450bp to +600bp range, have significant room to tighten.

Referring back to the first trade recommendation (referencing CMBX AMs), buying the AM.3 and AM.5 reference cash bonds instead of the indices is also reasonable. However, in cash bonds we prefer the earlier vintage AJ.1 and AJ.2 reference bonds. More generally, we think that 2005 and 2006 cash AJs (on a selective basis) offer greater value than 2007 AMs. Our credit models project lower losses, under both our Base Case and Bear Case scenarios, for the 2005 and 2006 AJs than for the 2007 AMs. Moreover, the former typically trade at wider spreads than the latter.

In general, we prefer cash bonds relative to the synthetic indices, abstracting from liquidity concerns, as the synthetic-cash bases remain exceptionally wide by historical standards. As repo rates have compressed and haircuts declined, the sizes of the current bases cannot be justified on fundamental grounds.

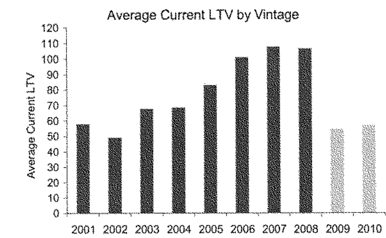
For CMBX.3, CMBX.4 and CMBX.5, we think that below the AM tranches, relative value declines quickly as one moves progressively lower. We expect that for these three series, the credit curves below the AM level, and particularly below the AJ level, will steepen over time as losses become more certain.

Buy 2005 and 2006 AA Cash Bonds Selectively
Further down in credit, we view the 2005 and *early* 2006 AA cash bonds as very attractive. For the 2005 AAs, using the AA.1 reference bonds as an example, we see effectively zero losses under our Base Case scenario, and minimal losses under our Bear Case scenario. These bonds currently trade approximately in a +600bp to +800bp context, and thus look quite appealing. For the 2006 AJs, using the AA.2 bonds, as an example, we do see modest losses (two bonds have losses) under the Base Case scenario. Under the Bear Case scenario, four bonds experience losses. These bonds, however, trade in the +800bp to1,000bp range. Clearly, some selectiveness is important for the 2005-2006 AAs, but the reward more than justifies the risk, in our view.

Basis-Types Trades
Putting on an exact basis trade (i.e., shorting one of the indices and going long each of the underlying reference bonds) in order to take advantage of the wide basis is very challenging. A better approach is to go long one (or several) higher quality cash bonds and short the appropriate index. In fact, the most appealing version is to choose one of the most overvalued indices to short and then identify a set of high quality bonds to go long. Here, it is possible to "win" on both legs. There are many appealing trades of this type available in today's dislocated market, from AMs down to As. It is sometimes possible to identify high quality bonds that trade hundreds of basis points wide to the index. One particularly attractive aspect of such trades is that they are, to some degree, hedged, and thus less susceptible to market volatility in a difficult macro environment.

Buy New Issue Credit Bonds Over 2007 AMs
In our view, 2010 new issue deals look to offer significant value relative to high quality legacy bonds on a risk-adjusted basis. Under our Base Case scenario, estimated average LTV's are 107% for 2007 vintage CMBS deals, 101% for 2006 deals and 83% for 2005 deals.

Exhibit 45
Average LTV's as of 2011 by Vintage Under Our Base Case Scenario



Source: CMA, Morgan Stanley Research
Note: 2009-2010 LTV's are initial, 2001-2008 come from our credit models

For 2007 AMs, this translates to an LTV of approximately 86% at the attachment point and 75% at the detachment point. Average quality 2007 AMs currently trade at a spread of about +450bp.

The 2010 new issue deals were fairly heterogeneous, but most exhibited deal-level initial LTV's below 60-65%. Assume, conservatively, that the BBB- class has a 60% initial LTV. The BBB- priced in the new issue market in the +425bp range. Thus, relative to 2007 AMs, new issue BBB-s offer about the same spread at a 15-20% lower LTV. The B-pieces on these deals also look to offer significant relative value, offering returns in the mid to high teens with LTV's of 60-65%, or less.

While we agree that property quality in recent 2010 deals has, in many cases, been worse than that of the larger loans in legacy deals, and that the collateral of the new deals is not as diversified, we think that the conservative leverage more than makes up for these shortcomings.

Key Risks to Trades

If interest rates rise sooner than expected, the large technical bid that has pushed investors into higher-yielding securities such as CMBS could diminish. However, Morgan Stanley economists do not expect the Fed to raise rates until the first quarter of 2012 (from 0.13% to 0.5%). Though they do project an increase in ten-year Treasuries from 2.25% in 2Q11, to 3.75% by 4Q11, we do not expect this level of rate change to push yield-seeking CMBS investors out of the market.

Unexpected regulatory changes, though low probability events, do have "fat tails". For instance, if the final Dodd-Frank rules do not allow the 5% risk retention requirement to be satisfied by third party 1st loss, B-piece buyers or other work-arounds, the impact on CMBS markets could be substantially deleterious. We believe this would curtail new issuance and likely cause severe volatility in cash and synthetic prices.

Conclusion

Commercial real estate markets will soon be entering the recovery phase. The phase, however, will be a long and painful one as fundamentals will likely take more time to rebound than they have in past downturns and much of the required deleveraging still needs to take place.

Nevertheless, the CMBS market is emerging from the ashes, and we expect significant growth in new issue over the coming year as both lending volumes and collateral types begin to normalize.

The most significant risk we see to commercial real estate debt markets is the combination of a large increase in interest rates and cap rates (200bp or more). Such an eventuality, which we view as reasonably likely over the medium term, has the potential to exacerbate greatly the future deleveraging process. However, we would not expect moderate increases to derail the trades outlined in the preceding section.

We acknowledge the significant contribution of Suneet Joshi to this report.

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Not-Rated/Hold	**119**	**4%**	**26**	**3%**	**22%**
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Total	**2,807**		**958**		

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The CHAIRMAN. Thank you very much.

Mr. Woodwell.

STATEMENT OF JAMIE WOODWELL, VICE PRESIDENT OF COMMERCIAL REAL ESTATE RESEARCH, MORTGAGE BANKERS ASSOCIATION

Mr. WOODWELL. Thank you for the opportunity to discuss the Mortgage Bankers Association's research on conditions and trends in commercial real estate and commercial real estate finance.

In my testimony, I'd like to cover three general areas. The first is to correct some myths that have taken hold in discussions about commercial real estate. The second is to highlight current conditions and trends in commercial real estate markets. And the third is to note some key factors that will affect commercial real estate markets, going forward.

An important point of clarification is to ensure that we're speaking of the same thing when we say "commercial real estate." When industry professionals speak about commercial real estate and commercial mortgages, they're speaking about office buildings, apartment buildings, shopping malls, warehouses, and other properties that lease out space in exchange for rental payments.

This income-producing property market is generally distinct from two other markets that are sometimes folded into conversations, particularly in discussing bank lending: owner-occupied commercial real estate and construction loans. Neither owner-occupied commercial properties nor single-family construction lending are closely tied to the core commercial real estate markets. The many recent discussions and conclusions have grouped them. These distinctions are a key reason for some of the confusion about commercial real estate and how commercial mortgages have been forming in recent quarters.

Before discussing the state of commercial real estate markets, I think it's important to clear up a few myths that have taken hold in discussions about commercial real estate. The first is that banks are being excessively weighed down by their commercial mortgages or their mortgages on commercial and multifamily properties. The second is that there's been a looming wave of loan maturities threatening the system.

As of the third quarter, bank and thrift delinquency rates for commercial and multifamily mortgages remained lower than the average for their overall books of business. And commercial and multifamily mortgages continued to have the lowest chargeoff rates among any major loan type.

To put these numbers in context: Since 2006, banks and thrifts have charged off $132 billion of single-family mortgages, $127 billion of credit card loans, $72 billion of commercial and industrial loans, $66 billion of construction loans, and $53 billion of other loans to individuals, but just $27 billion of commercial and multifamily mortgages.

A second myth I'd like to address is that there's been a looming wave of commercial and multifamily loan maturities weighing on the market. On Monday, MBA will release its third annual study detailing the scheduled loan maturities of $1.4 trillion of commercial and multifamily mortgages held by nonbank lenders. What these studies have shown is that, with a typical loan term of 10 years, most investor groups' commercial and multifamily mortgage maturities are spread over a relatively long period. This is in direct contrast to other forms of credit, such as credit card debt, in which the entire outstanding balance rolls every month, and commercial paper, in which nearly the entire market matures every 80 days or less.

Let me now turn briefly to current commercial real estate conditions and trends which continue to exhibit the influences of the broader economy. During the third quarter, the economy began to show modest growth, and the absorption of commercial space picked up in the face of little new space coming online. The impact has been marginal declines in vacancy rates and a firming of asking rents. Property sales and origination volumes have picked up, but have not been high enough to keep up with the mortgage debt that investors have seen paying off and paying down.

Looking ahead, the most significant factor in the performance of commercial real estate markets will be the performance of the broader economy. Vacancy rates at commercial properties rose as jobs were lost, as consumers pulled back in spending, and as household growth contracted. Economic growth is needed to reverse this trend.

Commercial real estate finance markets will be driven by property incomes, values, and interest rates, and where the markets are when loans come due, relative to where they were when loans were made. To the degree future incomes, values, and rates support refinancing existing debt, loans will mature and roll over. To the degree they do not, the existing equity, mezzanine debt, and, as a last resort, first-lien mortgages, will be resized to fit the future capital stack.

The Great Recession has strained commercial real estate markets, as it's strained nearly every part of the U.S. economy. The long-term nature of the market, in the form of relatively long leases and borrowing terms, however, has helped moderate the recession's impact.

Thank you for the opportunity to discuss these issues with you today.

[The prepared statement of Mr. Woodwell follows:]

Testimony of Jamie Woodwell

Vice President, Commercial Real Estate Research

Mortgage Bankers Association

Before the

Congressional Oversight Panel

Hearing on

Commercial Real Estate Finance

February 4, 2011

Chair Kaufman, and members Neiman, Silvers, McWatters and Troske, thank you for the opportunity to appear before you today to discuss the Mortgage Bankers Association's (MBA)[1] research and analysis of conditions and trends in commercial real estate and commercial real estate finance.

In my testimony I would like to cover three general areas. The first is to correct some myths that have taken hold in discussions about commercial real estate. The second is to highlight current conditions and trends in commercial real estate markets. The third is to note some key factors that will affect commercial real estate markets going forward.

DEFINING COMMERCIAL REAL ESTATE

An important point of clarification is to ensure that we are speaking of the same thing when we say "commercial real estate." When industry professionals speak about commercial real estate and commercial mortgages, they are speaking about office buildings, apartment buildings, shopping malls, warehouses and other properties that lease out space in exchange for rental payments. These are income producing properties and are at the heart of the market financed by commercial mortgage-backed securities (CMBS), life insurance companies, Fannie Mae, Freddie Mac, FHA and other lenders. This is also the market in which Real Estate Investment Trusts and other institutional investors operate. This income-producing property market is generally distinct from two other markets that are sometimes folded into conversations, particularly in discussing bank lending – owner-occupied commercial real estate and construction loans.[2]

Owner-occupied commercial real estate consists of buildings owned by a business that operates within it. These businesses often take out business loans – underwritten based on the occupying-business' cash flows, and collateralized by the business' assets, but with the property pledged as additional collateral out

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

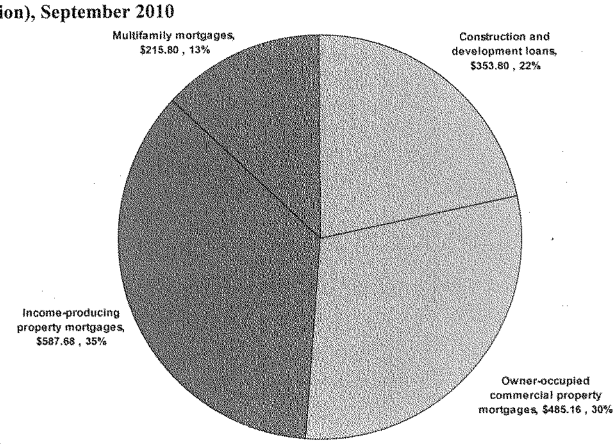
[2] In their guidance on commercial real estate concentrations at banks and thrifts, regulators addressed their rules to commercial and multifamily mortgages and construction and development loans, as well as other real-estate related loans. They purposefully excluded loans to which an owner-occupied property had been pledged as additional collateral. They also established distinct thresholds for construction and development loans. None-the-less, a broad definition of "commercial real estate" as including the full range of loans has taken hold in some quarters. See http://www.fdic.gov/regulations/laws/federal/2006/06notice1212.html.

of an abundance of caution. The performance of these loans has much less to do with commercial property markets and much more to do with the success of the occupying business itself.

Construction loans are likewise quite different from income-producing property loans, and are driven by a different set of risks and rewards. Furthermore, a significant share of construction loans, particularly in recent periods, has been tied to acquisition, development and construction in the single-family housing market, not the commercial real estate markets.

As of the third quarter, commercial banks and thrifts held $353.8 billion in construction and development loans and $485.2 billion in loans collateralized by owner-occupied commercial properties. In contrast, banks held $587.7 billion of mortgages backed by income-producing commercial (nonresidential) properties and $215.8 billion of mortgages backed by multifamily properties.[3]

Figure 1. Bank and Thrift Balances of Income-producing Commercial Mortgages, Owner-occupied Commercial Mortgages, Multifamily Mortgages and Construction and Development Loans ($billion), September 2010



SOURCE: MBA and FDIC

[3] These numbers are calculated from the FDIC's Quarterly Banking Profiles. The break-out between owner-occupied and income-producing properties is available for banks (which represent $1,055 billion of the total nonresidential commercial mortgages), but not thrifts (which represent $67 billion). For the presentation here, the owner-occupied/income-producing split seen in the $1,055 billion of bank loans was applied to the $67 billion of thrift loans.

Neither owner-occupied commercial properties nor single-family construction lending are closely tied to the core commercial real estate markets, but many recent discussions and conclusions have grouped them. These distinctions are a key reason for some of the confusion about commercial real estate and how commercial mortgages have been performing in recent quarters.

MYTHS

Before discussing the state of commercial real estate markets, I think it is important to clear up a few myths that have taken hold in discussions about commercial real estate markets. The first is that banks are being excessively weighed down by their mortgages on commercial and multifamily properties, and the second is that there has been a looming wave of loan maturities threatening the system.

Commercial Mortgage Performance

One current myth I'd like to address is that the banking sector is being excessively weighed down by its mortgages on commercial and multifamily properties.

MBA observed back in 2009 that commercial and multifamily mortgages had among the lowest delinquency rates of major loan types at banks and thrifts and that the charge-off rates for commercial and multifamily mortgages were the lowest of any major loan.[4] Based on third quarter numbers from the FDIC, the basic trends of that March 2009 Data Note still hold. As of September 30, 2010, 4.36 percent of bank and thrift balances of commercial mortgages were 90 days or more delinquent or in nonaccrual, as were 4.67 percent of their balance of multifamily mortgages. This compares to 5.12 percent of bank/thrift overall loans and leases that were 90 days past due or in nonaccrual.[5]

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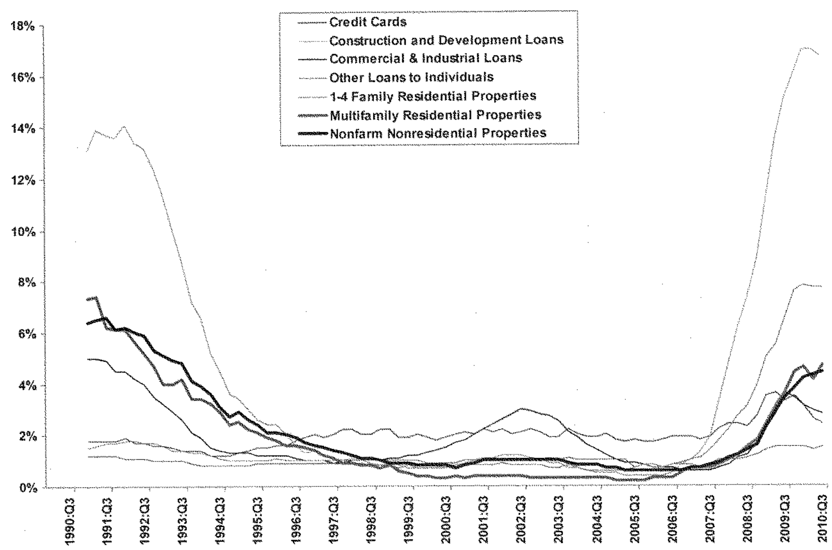
[4] MBA Research DataNote, *Performance of Commercial and Multifamily Mortgages Remains Stronger than Overall Bank / Thrift Loan Portfolios*, March 2010.
[5] FDIC, *Quarterly Banking Profile*, Third Quarter 2010.

Figure 2. Percent of Loan Balance 90+days Delinquent or in Nonaccrual at Banks and Thrifts



Source: FDIC

In terms of charge-off rates, through the first three quarters of 2010, banks and thrifts charged-off 1.17 percent of their commercial mortgage balances and 1.14 percent of their multifamily balances. Commercial and multifamily mortgages have the lowest charge-off rates among any major loan type and less than half the 2.59 percent overall charge-off rate for banks and thrifts.[6]

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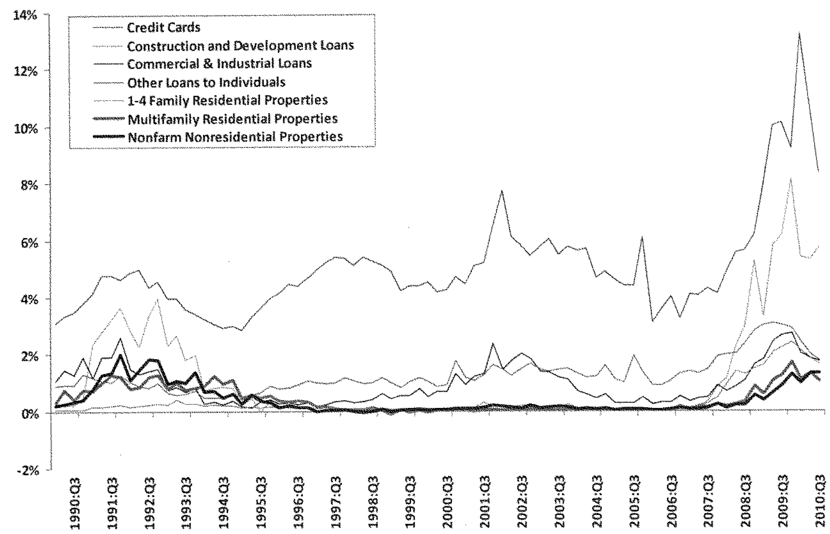
[6] Ibid.

Figure 3. Annualized Charge-off Rates of Loans at Banks and Thrifts



Source: FDIC

To put these numbers in context, since 2006, banks and thrifts have charged off $132 billion of single-family mortgages, $127 billion of credit card loans, $72 billion of commercial and industrial loans, $66 billion of construction loans and $53 billion of other loans to individuals, but just $27 billion of commercial and multifamily mortgages.[7]

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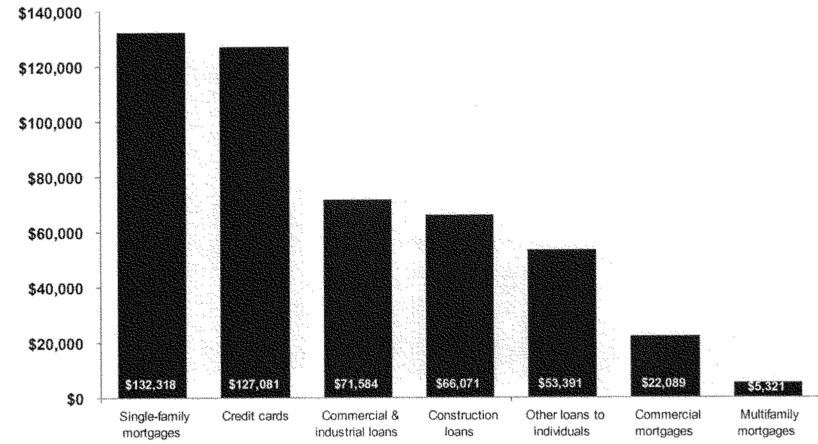
[7] Ibid.

Figure 4. Aggregate Bank and Thrift Net Charge-offs, 2007 through Q3 2010 ($millions)



Source: MBA and FDIC

Even when a property defaults on a mortgage, it is often generating cash flow that can be used to meet the required interest or principal payments or to defray losses to a lender. In addition, the marketability of commercial properties often makes them more liquid than many other collateral types.

The key takeaway here is that rather than commercial and multifamily mortgages saddling banks and thrifts, these mortgages have been among the better performing assets for depositories through the credit crunch and recession.

Wave of Loan Maturities

A second myth I'd like to address is that there has been a looming wave of commercial and multifamily loan maturities weighing over the market.

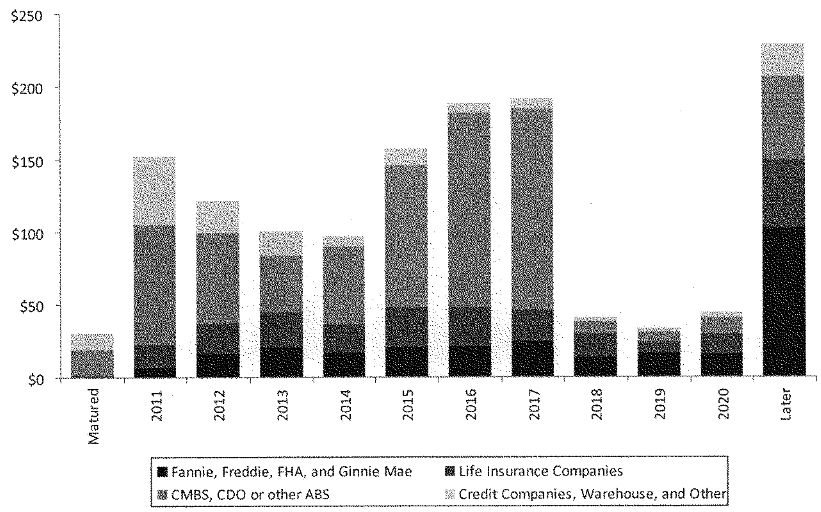
In February 2009, MBA released a study detailing the scheduled loan maturities of more than $1.5 trillion of commercial and multifamily mortgages held by non-bank lenders.[8] The study was updated in February

[8] Mortgage Bankers Association, *Commercial/Multifamily Survey of Loan Maturity Volumes as of December 31, 2009.*

2010[9] and we will be releasing the most recent numbers – as of December 31, 2010 – on Monday at our Commercial/Multifamily Real Estate Finance Convention in San Diego.

What all these studies have shown is that for most investor groups, commercial/multifamily mortgage maturities are spread over a relatively long period, and that the surge of property sales and mortgage origination activity that took place in 2005, 2006 and 2007 mean that recent and coming years actually face lower volumes of loan maturities than do out years of 2015, 2016 and 2017.

Figure 5. Non-Bank UPB of Outstanding Commercial/ Multifamily Mortgages, by Year of Maturity, as of Dec. 31, 2010 ($billions)



Source: Mortgage Bankers Association

Commercial real estate is a relatively long-term asset. The typical office lease may run three, five, ten or more years and the typical commercial mortgage has a ten-year term. Contrast this with other forms of credit such as credit card debt, in which the entire outstanding balance rolls every month and commercial paper, in which nearly the entire market matures every 80-days and less.[10]

[9] Mortgage Bankers Association, *Commercial/Multifamily Survey of Loan Maturity Volumes as of December 31, 2010.*
[10] Federal Reserve Board, *Maturity Distribution of Outstanding Commercial Paper*, as of January 25, 2011.

Let me qualify our findings by noting that they cover $1.4 trillion of commercial and multifamily mortgages outstanding in the institutional markets – including CMBS, life insurance companies, pension funds, credit companies, Fannie Mae, Freddie Mac, FHA and other investors. They do not capture a large share of the commercial bank and thrift market, particularly those that make smaller loans in smaller markets. Because of the shorter term nature of these institutions' liabilities, they tend to focus more on shorter-term assets as well, and will likely have a higher share of their loans maturing in the next few years than the market as whole. As noted earlier, many analysts attribute $1.6 trillion of outstanding loans and upcoming maturities to the bank/thrift sector. However, of that figure, only $800 billion is related to the income-producing property market.[11]

For those bank/thrift loans that are maturing, as well as loans held by life companies, pension funds, the GSEs and even the CMBS market, loan servicers have a great deal of discretion in working with loans that meet their maturity dates and are facing one or more challenges in finding refinancing. This includes everything from built-in loan extension options to other loan extensions, loan modifications, loan sales and a host of other alternatives.

In addition, it should be remembered that for each dollar of loan "demand" generated by a maturing mortgage there is a complementary dollar of loan "supply" in the form of dollars the lender must now re-deploy.

The key takeaway here is that the longer-term nature of commercial real estate has meant that relatively fewer – not more – commercial and multifamily mortgages have been maturing during the throes of the credit crunch and recession compared to other credit types. These maturities are relatively spread out and will be increasing starting in 2015 as the 2005, 2006 and 2007 cohorts come due.

CURRENT MARKET CONDITIONS AND TRENDS

Let me now turn to current commercial real estate conditions and trends, which continue to exhibit the influences of the broader economy.

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[11] The $1.6 trillion figure comes from the Federal Reserve Boards *Flow of Funds Account of the United States*, the remaining figures are based on the FDIC's Quarterly Banking Profile. All figures are for the third quarter 2010.

During the third quarter, the economy began to show (modest) growth and the absorption of commercial space picked up in the face of little new space coming on line. The impact has been marginal declines in vacancy rates and a firming of asking rents. Property sales and originations volumes have picked up, but have not been high enough to keep up with the mortgage debt that investors have seen paying off and paying down. The weak economy has also continued to exert pressure on the performance of properties and the mortgages they back. Mortgage delinquencies were mixed in the fourth quarter, with CMBS and banks/thrifts experiencing continued growth in delinquency rates (albeit at far slower rates of growth) and delinquencies at life companies, Fannie Mae and Freddie Mac remaining at low levels.

Economy

The economy grew at a seasonally-adjusted annual rate of 2.6 percent in the third quarter, up from 1.7 percent in the second quarter and marking the fifth straight quarter of positive growth.[12]

Job growth turned slightly negative during the quarter, following positive growth during the first half of the year. On a seasonally adjusted annual rate, the U.S. economy lost 91,000 jobs between the end of June and the end of September, after gaining 261,000 jobs in the first quarter and 570,000 jobs in the second quarter. Some of the Q2 gains and Q3 losses are attributable to the winding up and down of hiring for the decennial Census. In the months since, modest job growth has returned – with additions of 172,000 jobs in October and 39,000 jobs in November.[13]

Household growth has also picked up, with growth of 261,000 households in the second quarter and 247,000 households in the third quarter. Recent declines in the homeownership rate have meant that demand stemming from household growth has largely accrued to the renter-occupied market rather than the owner-occupied market. Over the past year, demand among renter households has increased by more than one million units, while demand among owner households has declined by 315,000 households. The shift in tenure choice is having a far larger impact on multifamily markets than is household growth in general.[14]

The recession's shadow continues to hang over new construction activity. Multifamily building permits in November fell to 94,000 on a seasonally adjusted annual rate, the lowest level in the past 12 months.

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[12] Department of Commerce. Bureau of Economic Analysis.
[13] Department of Labor, Bureau of Labor Statistics.
[14] MBA calculations based on the Department of Commerce, Census Bureau's Housing Vacancy Survey.

Starts fell to 72,000 and completions fell to a rate of 73,000. The lack of new construction is a clear – and expected – response to the stress the recession has brought to the market.[15]

Real Estate Fundamentals

Modest economic growth, coupled with a steep fall-off of construction activity, brought net absorption of space back above net completions for all the major property types for the first time since 2006. As a result, vacancy rates also fell for all the major property types, again for the first time since 2006. Despite the decline, vacancy rates remain at elevated levels – apartment vacancy rates in the third quarter averaged 7.7 percent, compared to 5.8 percent in Q3 2007; industrial vacancy rates averaged 13.1 percent, compared to 8.6 percent in Q3 2007; retail averaged 18.8 percent, compared to 10.4 percent in Q3 2007; and office vacancies averaged 18.8, compared to 14.5 percent in Q3 2007.[16]

Asking rents declined for most property types in the third quarter, but the rate of decline slowed appreciably. Asking rents for apartments were unchanged from the level a year earlier, while office and retail asking rents declined four percent each and industrial asking rents declined six percent.[17]

Differences in the terms of commercial real estate leases have meant that the recession has affected different property types in different ways. Property types with shorter term leases (hotels with a typical lease term of one night, self-storage properties with a typical lease term of one month and multifamily rental properties with a typical lease term of one year) experienced immediate and dramatic impacts from the recession – as nearly all of their leases rolled and were re-priced to recession-level asking rents. Longer term lease properties, on the other hand, were protected from some of the impacts of the recession as only a portion of their leases were re-priced during the period, and those that were re-priced were coming off of rates that may have been five, ten or more years old. As the economy grows, shorter-term lease properties are expected to feel the most immediate positive impacts, while longer-term lease properties will feel more muted positive impacts, just as they felt more muted negatives.

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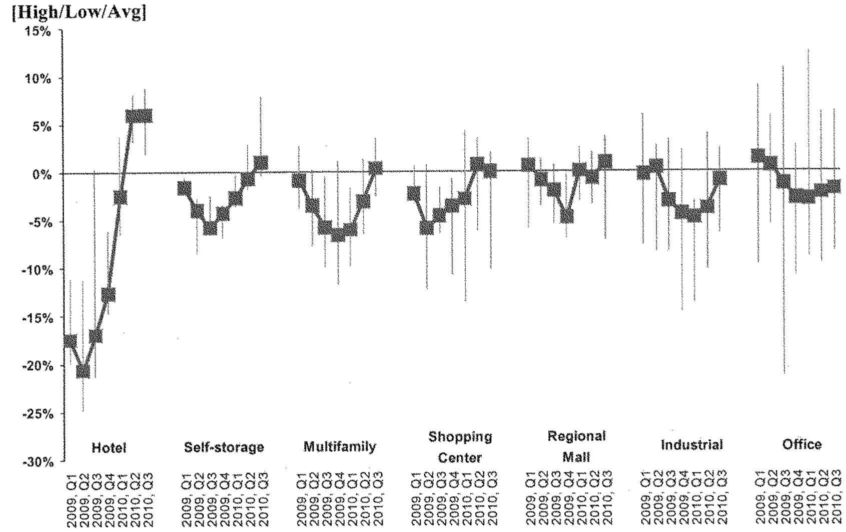
[15] Department of Commerce, Census Bureau.
[16] Data from Property and Portfolio Research and presented in MBA's Q3 2010 *Commercial/Multifamily Quarterly Data Book*.
[17] Ibid.

Figure 6. Year-over-Year Change in REIT "Same Store" NOIs (Q1 2009 – Q3 2010) [High/Low/Avg]



Source: MBA and SNL Financial

Property Sales

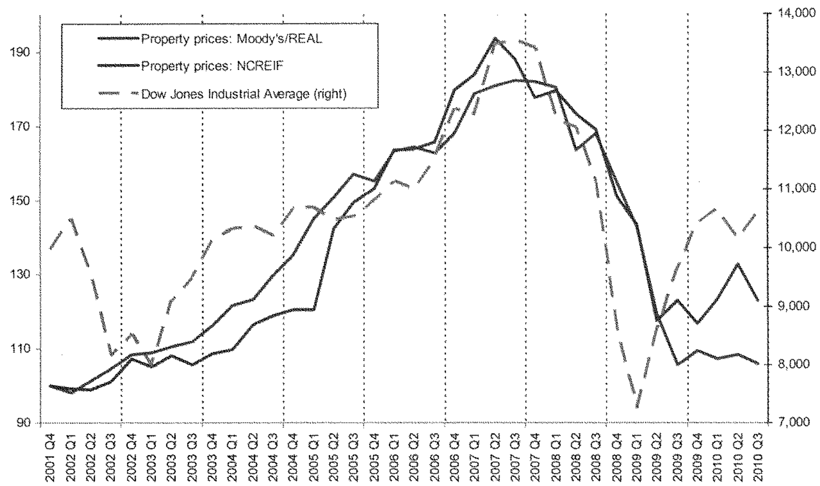
The volume of commercial and multifamily property sales transactions picked up during the quarter, leading Q3 year-to-date volumes – of $60 billion – 82 percent higher than a year before, but still considerably below levels seen in previous years. Year-to-date sales volumes of retail properties were up 48 percent; industrial property sales were up 59 percent; apartments up 97 percent; and office property sales were up 122 percent. Recorded prices per square foot were up and cap rates were down. Cap rates for industrial properties fell to 8.4 percent, from 8.6 percent a year earlier; retail cap rates fell to 7.8 percent, from 8.1 percent; for office properties they fell to 7.3 percent, from 8.2 percent a year earlier; and for apartments they fell to 6.7 percent from 7.1 percent a year earlier.[18]

The indices tracking commercial real estate prices continue to tell a mixed story, likely driven in large part by the low property sales volumes and the types of properties changing hands. The Moody's/REAL CPPI fell 2.3 percent over the quarter, while the NCREIF TBI fell 7.3 percent. The Moody's index ended

[18] Data from Real Capital Analytics and presented in MBA's Q3 2010 *Commercial/Multifamily Quarterly Data Book*.

the quarter at 57 percent of its peak (2007) value. The NCREIF value ended the quarter at 64 percent of its peak value. An alternative index from Green Street Advisors shows prices currently at 82 percent of their peak value. It is important to note that the decline in commercial real estate prices has been generally in-line with – although lagged from – declines in broader equity markets.[19]

Figure 7. Index of Commercial/Multifamily Property Prices (2001 Q4 = 100) and the Dow Jones Industrial Average



Source: MBA and Moody's/REAL, MIT, Wall Street Journal

<u>Mortgage Originations</u>

Like property sales, commercial/multifamily mortgage originations have picked up but remained low compared to pre-recession levels. On Monday we will be releasing the results of our fourth quarter survey of mortgage bankers originations, which show that fourth quarter 2010 originations were 88 percent higher than during the same period in 2009, and were 63 percent higher than during the third quarter of 2010.[20]

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[19] Data from Moody's Investor Services, National Council of Real Estate Investment Fiduciaries and MIT and presented in MBA's Q3 2010 *Commercial/Multifamily Quarterly Data Book.*

[20] Mortgage Bankers Association, *Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations, Q4 2010* (forthcoming).

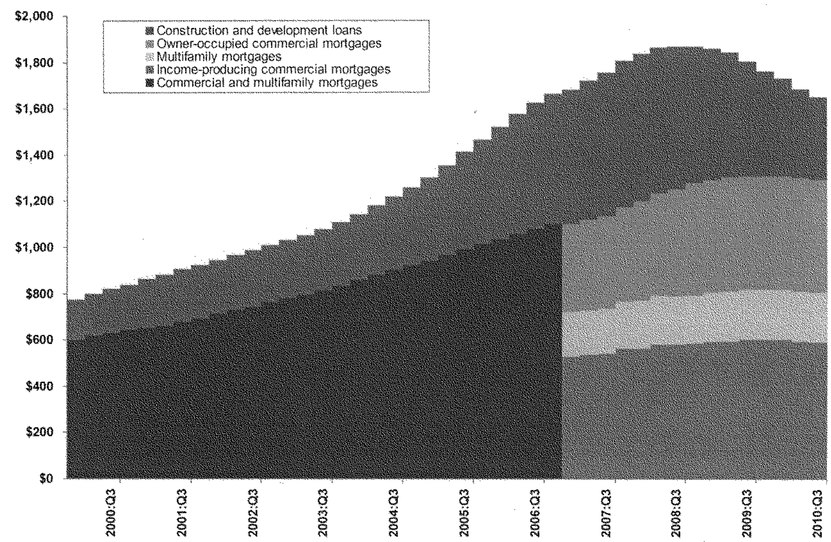
Outstanding Mortgages

The pick-up in origination activity wasn't enough to stem declines in the level of mortgage debt outstanding, as loans continued to pay-off and pay-down more quickly than new loans were taken out. Commercial and multifamily mortgage debt outstanding declined by $42 billion during the quarter, driven by declines in loans held by banks (down $30 billion) and in CMBS (down $12 billion). The decline in the balance of commercial and multifamily mortgage debt held by commercial banks was driven by declines in the banks' construction loans, including those for single-family construction, which the Federal Reserve includes in its totals. A full $22.5 billion of the drop in banks' holdings was construction loans, compared to a $7.5 billion decline in loans backed by existing commercial and multifamily properties.[21]

Since their peaks, the overall balance of loans and leases held by banks and thrifts has fallen by 7.6 percent and the balance of construction loans has fallen by 44 percent, while the balance of income-producing property mortgages has declined by only 2.4 percent and the balance of multifamily mortgages has declined by 0.2 percent. There has been far greater stability in the amount of commercial and multifamily mortgage credit than there has been of credit more broadly.[22]

[21] Mortgage Bankers Association, *Commercial/Multifamily Mortgage Debt Outstanding, Q3 2010.*
[22] FDIC, *Quarterly Banking Profile*, September 2010.

Figure 8. Balance of Bank/Thrift Commercial and Multifamily Mortgages and Construction and Development Loans ($billions)

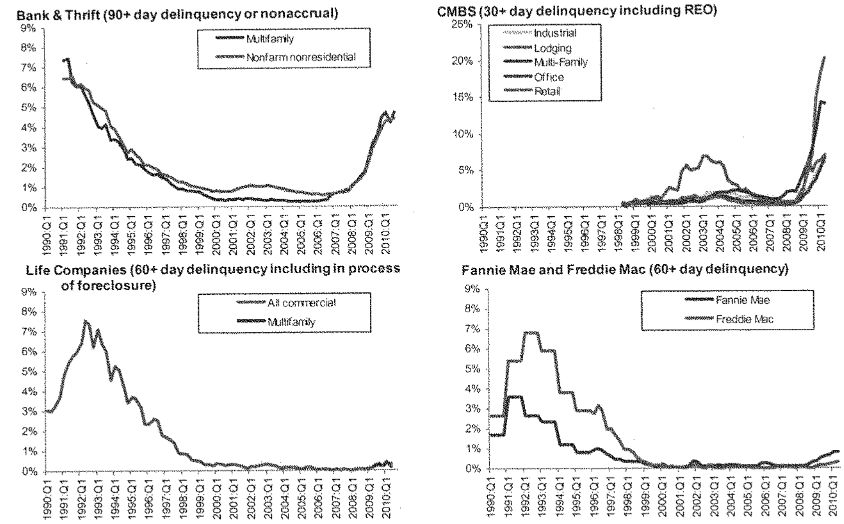


Source: MBA and FDIC

The performance of commercial/multifamily mortgages was mixed in the quarter – clearly differentiated by investor group. The 30+ day (including REO) delinquency rate on loans held in CMBS continued to increase during the third quarter, hitting 8.58 percent, a new high for the series. The 90+ delinquency rate for commercial and multifamily mortgages held by banks and thrifts (and excluding the construction loans mentioned and included above in the mortgage debt outstanding numbers) rose slightly to 4.41 percent, a high for this recession but lower than the levels seen in the early-1990s. Life companies, Fannie Mae and Freddie Mac continue to see low 60+ day delinquency rates – 0.22 percent, 0.65 percent and 0.35 percent respectively – all well below levels seen during the early-1990s.[23]

[23] Mortgage Bankers Association, *Commercial/Multifamily Mortgage Delinquency Rates, Q3 2010.*

Figure 9. Multifamily and Other Commercial Mortgage Delinquency Rates among Major Investor Groups



Sources: MBA, FDIC, Trepp, ACLI, Fannie Mae and Freddie Mac

KEY FACTORS AFFECTING COMMERCIAL REAL ESTATE FINANCE

As MBA looks at the commercial real estate finance markets, we see four key factors that will drive the market in coming quarters; the performance of the broader economy, and property incomes, property values and interest rates and how they differ from those when properties were last financed.

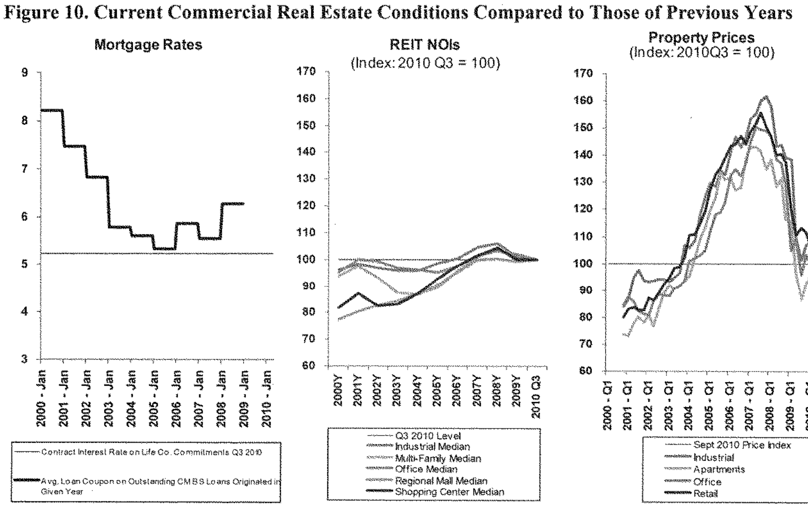
The Broader Economy

The most significant factor in the performance of commercial real estate markets during the recent downturn – and in coming quarters – has been and will be the performance of the broader economy. Vacancy rates at commercial properties rose as jobs were lost, consumers pulled back in spending and household growth contracted. Likewise, capitalization rates on commercial properties rose (and prices declined) as investor yields across a range of investment options grew. A key determinant of future commercial real estate performance will be future economic growth. Stronger job growth – particularly in the services sector – would translate directly into greater demand for office space, contractions in vacancy rates and increases in asking rents. Greater consumer spending would drive more demand for retail space. Conversely, greater strength in the U.S. housing market could bring with it a slower recovery for multifamily rental housing, which has been buoyed by renter demand generated by the drop in the homeownership rate.

Interest Rates, Property Incomes and Values and How They Differ from When the Properties Were Last Financed

Commercial real estate finance in coming years will also be driven by the similarities and differences between future conditions and those during which loans were last financed. Even with the recent rise in the 10-year Treasury, low current interest rates mean that for most properties, today's mortgage rates are below the rates currently in-place on any debt the property backs. This is particularly true for 10-years loans that were made in the early-2000s. The average mortgage coupon on an outstanding CMBS loan that was made in 2001, for example, is 7.46 percent,[24] compared to an average coupon offered by life insurance companies during the third quarter of 2010 of 5.23 percent.[25] This difference, for however long it persists, means that a new loan taken out today will generally be less expensive than what might be in place.

Figure 10. Current Commercial Real Estate Conditions Compared to Those of Previous Years



Source: JP Morgan, ACLI, MIT, SNL Financial

[24] JPMorgan Securities, *Fixed-Rate Conduit CMBS Monitor*, December 2010.
[25] American Council of Life Insurers, *Commercial Mortgage Commitments, Third Quarter 2010.*

The same is generally true of property incomes. Property markets experienced strong growth in their fundamentals during the mid-2000s. Even with the recession, median net operating incomes (NOI) for REITs were higher during the third quarter of 2010 than they had been in 2000, 2001, 2002, 2003, 2004, 2005 or 2006. Properties that were last financed during any of these years are likely to have more income today than they did when last financed, and are therefore likely – from an income perspective – to be able to support the mortgage payments of a refinance. The amount of income growth diminishes as the year of financing gets closer to the present, and for most property types the median REIT NOIs in 2007, 2008 and 2009 were higher than they are today, meaning many properties with financing originated in those years currently have incomes below what was used to support their most recent financing. Depending on the size of the decline – and the particulars of the property – many of these loans may require income-related re-sizing when they come due.

The most significant factor at play in today's market is property values. The number of property sales has fallen dramatically in recent years, which makes any determination of market value difficult to gauge. Based on the Moody's/REAL Commercial Property Price Index (CPPI)[26], average prices for all property types ended the third quarter 2010 above the levels they had been up until 2004 – meaning the average 10-year loan maturing in 2011 has seen an increase in value in the underlying collateral. However, average property prices today are – for most property types – below the levels they were at in subsequent years. From a loan-to-value ratio perspective, many of these properties would likely not support the same size loan if refinanced today. This is particularly true of loans from 2006 and 2007.

The order of magnitude of the differences between the income and value challenges is also instructive. Office property prices, as measured by the CPPI, were 30 percent below their peak at the end of the third quarter, while median REIT NOIs for office properties were just three percent below their peak. As of the third quarter, the challenge related to property values was clearly far greater than any challenges related to either interest rates or incomes.

The current dearth of new development activity should help the markets as they rebalance, giving property owners power in increasing rents and decreasing vacancies, which in turn should support both property incomes and values. The challenges for the market going forward will be the degree to which property incomes, values and interest rates rise and where the markets are – relative to where they were

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[26] Moody's/REAL Commercial Property Price Index (CPPI)

when the loans were made – when the real boom of maturities occurs in 2015, 2016 and 2017. To the degree future incomes and values support refinancing the existing debt, loans will mature and roll-over. To the degree they do not, the existing equity, mezzanine debt and, as a last resort, first lien mortgages will be resized to fit the future capital stack.

CONCLUSION

The Great Recession has strained commercial real estate markets, as it has strained nearly every part of the US economy. The long-term nature of the market, in the form of relatively long leases and borrowing terms, however, has helped moderate the recession's impact.

Thank you for the opportunity to discuss these issues with you today.

The CHAIRMAN. Can you—I'd like to start my first question to all three of you, starting with Mr. Anderson. Has the commercial real estate market, do you think, hit bottom?

Mr. ANDERSON. From a value standpoint, yeah, I think so. I think the value indicators would—or price indicators would seem to indicate that we've hit bottom, we've bounced along bottom for roughly a year, for the broad market. As Mr. Parkus mentioned, for trophy properties, prices have picked up, and that's gained a lot of attention. So, I think we have, more or less, hit bottom. But we also haven't seen very much in the way of very strong price growth, at least for the broader market.

The CHAIRMAN. Mr. Parkus.

Mr. PARKUS. I also do believe that the commercial real estate market—in terms of fundamentals, we have to be careful about what we're talking here about. In terms of the rents and vacancies, those dramatic declines that we've seen in the performance of actual properties, I believe is approaching a bottom. And we will probably be at a bottom sometime in 2011 or 2012 for most property sectors. So, yes, I do believe that that has—we are at a bottom.

I think the bigger question is, "How long do we bump along the bottom?" as Mr. Anderson was saying.

In terms of price improvements, we have seen dramatic improvements for a relatively small proportion of the commercial real estate universe which focuses really on trophy assets and higher-quality institutional-quality assets, and relatively little improvement for smaller assets.

The CHAIRMAN. Mr. Woodwell.

Mr. WOODWELL. Echoing some comments that were made, I think there are many aspects to the commercial real estate markets. One can look at prices, one can look at the property performance, one can look at a whole range of different things. And they move in relation to one another, but not necessarily——

The CHAIRMAN. Right.

Mr. WOODWELL [continuing]. In lockstep.

Prices probably are the leading indicator. They were one of the leading indicators of the decline, and now they're probably one of the leading indicators of a return. We have seen some greater strength there in the last quarter or so.

I think it also is interesting to look at the different types of markets. So, a primary market, with more institutional investors, is probably more driven by investor yields and what competitive investor yields are. Whereas, the tertiary markets are probably more driven by the fundamental economics of what's happening in that market, the job growth, and how those are supporting individual commercial properties.

The CHAIRMAN. Great.

And back to your question, Mr. Parkus. How long can we bump along the bottom?

Mr. PARKUS. Well, you know, the—it's a difficult question. But, our best estimate is that it will take several years for individual properties—the cashflow, the net operating income at individual properties to begin to improve substantially.

We think that vacancy rates will begin to come down gradually, probably sometime in 2000—late 2011 or 2012. But, those improvements will tend to be offset by the sort of delay or lagged impact of declining rents. Declining rents don't flow through into property revenues until space changes. And, as space changes, it will change those rents in the properties. Even as rents are rising—begin to rise, space will be rolling, in many cases, into lower and lower rents. So, that will drag the recovery out several years, we believe.

So, property-level improvements are probably a late 2012 or maybe even 2013 phenomena. I should say, robust, very significant improvements, which we do believe will ultimately come.

The CHAIRMAN. Mr. Anderson.

Mr. ANDERSON. I would generally agree.

I think you have to look sector by sector. And, really, in the multifamily sector there's already some improvement. The lodging sector has shown some improvement, as well. Lodging tends to be very volatile and very correlated—highly correlated with the economy. So, with an improving economy, the lodging sector is one of the early beneficiaries. The office sector is probably one that we're the most concerned about. Office jobs are off by almost 2 million jobs from the peak in 2007. And it'll really take quite a while to build those jobs back up again. So, I think we're looking at a multiyear impact in the office market.

The CHAIRMAN. Mr. Woodwell.

Mr. WOODWELL. Echoing that last point, I think by sector is very important. If you look at the different lease terms, of different types of commercial properties, you can think of a hotel having, essentially, a nightly lease; self-storage having a monthly lease; apartment buildings, generally, a year-long lease. The longer the lease term, the more muted the impact of the downturn in the recession, but also, then, the more muted the impact in the upturn. So, as a result, hotels and multifamily, which saw the impacts most immediately, are also seeing the positive impacts most immediately.

The CHAIRMAN. Thank you.

Mr. McWatters.

Mr. MCWATTERS. Thank you, Senator.

Following up on Senator Kaufman's comments, it doesn't sound like any of you see a double dip—a serious double dip in CRE within the next few years.

Mr. Anderson.

Mr. ANDERSON. No, that's not a big feature of our outlook. It's always possible.

Mr. MCWATTERS. Okay.

Mr. ANDERSON. And, you know, external events can drive the economy back into recession, as we've seen with the debt crisis in Europe. But, that's not a major part of our outlook.

Mr. MCWATTERS. Okay.

Mr. Parkus.

Mr. PARKUS. No, I don't see anything like that. It would have to be driven, again, by some extraordinary surprise on the downside, which is economywide.

Mr. MCWATTERS. Okay.

Mr. Woodwell.

Mr. WOODWELL. And, again, I think the market's being driven very much, now, by the economy. Where the economy goes, so will the return of the commercial real estate markets.

Mr. MCWATTERS. Okay.

What about a spike in interest rates over the next year or so? How would that affect your outlook?

Mr. ANDERSON. An outright spike would definitely have an impact on real estate, especially bank lending in real estate. There's a large amount of floating-rate debt. On the construction side, it's pretty much all floating-rate. So, the low interest rates have definitely benefited borrowers and lenders, from the standpoint of avoiding some of the distress that could crop up in that segment. And also, in the broader commercial mortgage market, I think. For banks, about half is floating-rate and half is fixed-rate; it depends on the bank. But, those are probably pretty good rough figures. So, a surge in interest rates could have a negative impact on borrowers' ability to pay.

Mr. MCWATTERS. Okay. Okay.

Mr. Parkus.

Mr. PARKUS. I agree with Mr. Anderson. I think that rising interest rates do pose a nontrivial threat to commercial real estate, especially if the rate increases are significant.

I'd also say that it depends on what drives the interest-rate increase. As someone on the previous panel made the very good point, if rate increases largely reflect a buoyant economic condition, where the Fed is trying to sort of rein in, you know, surging economic activity, that would be one scenario. And I think the—that type of rising interest rate would be less problematic. On the other hand, today there's a lot of concern about future inflation through commodity price inflation. And I think that fear can get embedded as—in interest rates, as well, as it—we—it appears to be in long-term interest rates, already.

So, it really depends on whether the interest rates are—at the short end or the long end are rising, and what the source of the push upward is.

Mr. MCWATTERS. Okay, fair enough.

Mr. Woodwell.

Mr. WOODWELL. One additional point is, it sort of is relative to the interest rates that are in place. So, if you think of the different cohorts of loans, loans that were made in the—2001/2002 that might be coming due now, they were made at points with relatively higher interest rates than we're experiencing right now. So, they've got a bit of a cushion. As you get to 2004, say, the interest-rate environment there was much lower. So, loans that'll be maturing—10-year loans maturing from 2004, say, in 2014, they'll have much less of a cushion for current interest rates, and, as a result, future higher rates would have more of an impact on them.

Mr. MCWATTERS. Okay. So, it sounds like the three of you anticipate a slow recovery of the CRE market over the next few years. May I assume from that, that you do not see the basis, the need for a TARP–2, an RC—RTT—RTC-type structure or any other government source funds to bail out these financial institutions or CMBS holders?

Mr. Anderson.

Mr. ANDERSON. I don't know about the outright need. It would certainly have an impact. If there were—if there was an RTC established all over again, it would help clear the market of troubled debt that much more rapidly. But, it would also have a cost and an impact.

You know, part of the corollary would be a significant increase in the rate of bank closures; whereas, what we've been seeing is a high rate, but a—really a process of working through problem banks. And so, I—it would have an impact on the market. You'd have a sharp drop in prices, and it would come at a great cost. But, you would have—what we had in the early '90s was a market that cleared and then, actually, rapid growth after that, in the later half of the 1990s.

So, absent an RTC, our outlook is for pretty much more of the same as what we've been experiencing for the last couple of years, just really stretched out over quite a long period.

Mr. MCWATTERS. Okay.

My time's up. I will continue with this next time.

The CHAIRMAN. Thank you.

Superintendent Neiman.

Mr. NEIMAN. Thank you.

During my opening remarks, I referenced the multifamily housing as a category of CRE; the impact that properties may deteriorate as rental income is diverted from maintenance to debt service, with the impact of renters possibly losing their homes. How do you all assess the impact of the CRE situation on multifamily housing?

Mr. ANDERSON. Well, I'm—for us, we focus on bank loan performance very closely. And, probably simply put, the delinquency rates on bank multifamily loans have been highly correlated with the delinquencies on commercial mortgages. So, if the question is, "Do we see multifamily as a commercial real estate type?" I'd say, yes. The correlation is very high there.

Mr. NEIMAN. Mr. Woodwell.

Mr. WOODWELL. It's interesting, if you look at what's been happening with the homeownership rate, every percentage-point drop in the homeownership rate means, essentially, a 3-percent increase in demand for rental housing. So, with the drop in the homeownership rate, we've actually seen a large surge, essentially, in demand for rental housing. A lot of that is for single-family housing—rental housing, but also a fair amount going into the apartment sector, as well.

So, notwithstanding the fact that the apartments do have those annual leases that turn, and turned over the course of the recession, the multifamily sector, the apartment sector, has been among the better-performing of the different commercial real estate sectors, in terms of fundamentals. And that has sort of rolled over to generally good performance in many of the different investor groups that lend money for multifamily mortgages. The one exception there is, in the CMBS market, the multifamily mortgages do have a delinquency rate that's well above many of the other property types.

Mr. NEIMAN. Well, as a result, and with increased demand for rentals due to the mortgage crisis, do we face a shortfall in available rental properties?

Mr. WOODWELL. A lot of folks have studied that. We've looked into some of those numbers, as well. It does appear that, with— the vacancy rates are still at relatively high levels. So, even with that demand, the vacancy rates remain high. We'll see, as those start to get burned through, how much of a demand is there.

Mr. NEIMAN. Are there ways that bankers and borrowers are working together, possibly with local or state housing finance authorities, to ensure that tenants and living conditions are not negatively impacted by the CRE crisis?

Mr. WOODWELL. I guess I would just put out there that the servicer and the lender, themselves, often have some of the greatest stake in making sure that that property maintains its ongoing operations and value. So, they're working very closely, in those situations, to keep those properties operating well.

Mr. NEIMAN. Mr. Parkus, are there any unique issues that should be highlighted in distinguishing multifamily properties from other CRE?

Mr. PARKUS. Well, I think there are. You know, our outlook for multifamily is dramatically better than for other sectors, in the near term. As some of my colleagues have mentioned here, the state—the restricted state of credit for the single-family housing sector has redirected much of the new family formation process to multifamily. And we've seen dramatic improvements in vacancy rents—vacancy rates, dramatic improvements in rents, over the last just 3 to 6 months. We think that that will continue, that the medium-term demographics look very good.

In terms of the very stressed operating environment that we've just come through, and the impact on residents in these properties, I would also very much agree that the absolute most important objective of special servicers is to make sure the properties do not deteriorate, to the extent that they have any control over that. And they do, generally. Keeping enough cashflow to keep up maintenance and other property expenditures is very, very high; otherwise, the value of the property deteriorates.

Mr. NEIMAN. So, your confidence in servicers of commercial property mortgages, as opposed to residential mortgages, you——

Mr. PARKUS. I'm not familiar——

Mr. NEIMAN [continuing]. Think—oh. But, you did indicate a level of confidence, with respect——

Mr. PARKUS. I do believe——

Mr. NEIMAN [continuing]. To the ability——

Mr. PARKUS [continuing]. That that is a very high priority, yeah.

Mr. NEIMAN. Okay. Appreciate it.

The CHAIRMAN. Thank you.

Dr. Troske.

Dr. TROSKE. Thank you.

I guess I want to sort of look back and ask some—a somewhat more philosophical question about price movements and what occurred in the commercial real estate market over the early part of the decade. You know, it's often been characterized that there was a bubble in the commercial real estate market. As many economists, I sort of struggle to know what that means, because—something that I can look back and name is not a particularly useful concept. I like to be able to know what it is before it occurs.

Recently, economist Casey Mulligan, in his New York Times column, has presented data suggesting that, relative to 2000, investing in commercial real estate actually fell, in real terms, which is not what you'd expect in a bubble, and then much of the price increase was being driven by sort of a competition for resources that were flowing into residential markets and driving up the price of land and the price of labor and the price of other inputs into—in the production.

I'd like the three of you to comment. I mean, do you—would you characterize it as a bubble? Is it—was it—were changes in prices reflecting what was going on in the housing market? Or was there just some overly optimistic investors in commercial real estate that's—that were driving all of this?

And we'll start with—actually, we're going to start with Mr. Woodwell, since—you know, we'll start at the other end——

[Laughter.]

Dr. TROSKE [continuing]. Just to be fair.

Mr. WOODWELL. It's a great question. And trying to understand that, I think, is really important to trying to understand what the commercial real estate markets and other markets have been going through.

If—one thing—the—we include in our written testimony is looking at commercial real estate prices, relative to the Dow-Jones industrial average. And the same type of increase. If you look, during that period, you saw increases in a whole variety of different investment forms and a variety of different commodities, et cetera, during that runup period. Absolutely, construction costs were high during that period, and rising.

When one looks at the property performance, property performance was very strong. When one looks at the mortgage performance, the mortgage performance was very strong in that preceding period. So, I think that it did lead to a lot of optimism that folks probably wish that they could rewind a little bit right now.

Dr. TROSKE. Mr. Parkus.

Mr. PARKUS. I would say that there was a bubble. And I would say—you know, I can't define a bubble, or I can't do it here—but I would say that there was—you know, what we saw in the early part of this decade—and let's not forget, commercial real estate went through a sort of mini downturn in 2001/2002, and really didn't come out of that until sometime in 2000—late 2003 or 2004. And, because of that, we saw relatively little overbuilding in this time around. Now, overbuilding was beginning to show its sort of ugly face in 2006 and 2007, but was cut off very quickly in 2008. So, we owe the previous downturn, you know, a just drove of thanks to keeping the overbuilding away this time.

However, what we did have, in coming out of the last downturn, was extraordinarily low interest rates, as we have right now. And extraordinary low interest rates drove many investors to demand into riskier and riskier products. We also had a tremendous increase in the size of the—of pools of so-called "hot money" in international financial markets, seeking yields wherever.

All of that—and all of those conditions, I think, came together to create bubble-like conditions, not only in commercial real estate, but across the spectrum, in terms of leveraged loans, in terms of—

across all credit products, in terms of corporate bonds. We saw a loosening of lending standards, driven by a loosening—really driven by a loosening in what investors would accept. The demand for yield was dramatic and was driving—really drove the decline in lending standards. In normal conditions, investors don't put up with that. But, in those in kinds of condition, with extraordinarily low interest rates, investors were amenable to almost anything.

Dr. TROSKE. Mr. Anderson.

Mr. ANDERSON. Yeah, that—although—quite a few comments.

I think it was a bubble. In terms of a definition of a "bubble," it's probably—maybe one definition would be a rapid rise that's really unsustainable. Now, whether you would know that it was unsustainable at the time, or not, may be something else. But, certainly one feature of the price increase that occurred during that period was that it was almost all based on pricing, as opposed to income. The way real estate is generally—real estate prices are generally thought of is—in terms of an income stream that's capitalized. That has—and capitalization rates came way down during that period, and that drove almost all of the increase. So, really, net operating income grew a little bit, but not really that much. And it was almost all from declining capitalization rates, or cap rates.

How did the cap rates come down? Well, a big part of it was the availability of financing. So, very liquid debt markets very much contributed to declining cap rates. If you had to pay all cash for a property, you'd have a very different standard for what sort of price you would pay. Whereas, if you can borrow ever greater amounts, which borrowers could heading into the boom, you know, you can pay ever higher prices and still hit a return, as long as you can add more debt.

And, you know, one other feature factoring into the availability of debt was that—it was sort of self-perpetuating, but the great liquidity in the market and good cashflow performance helped keep delinquency rates very low. So, it appeared—from a lender standpoint, it appeared to be a very safe, you know, low-risk area to be lending in. And so, I think those factors really played together.

One item I was going to add is, I remember vividly, in 2006, seeing an investor presentation, a very credible argument for why cap rates could be 5 percent, or even lower, and that that was very—that was sustainable. And I went in as a disbeliever, and came out not exactly being a believer, but having been impressed, anyhow, by the argument. So, in hindsight, certainly we know that it was a bubble. At the time, there were some very credible players that had good arguments as to why pricing could remain where it was at.

Dr. TROSKE. Thank you.

The CHAIRMAN. Thank you.

I'd like each of you to comment on when you expect to see the majority of losses from defaults.

Mr. Woodwell? In the commercial real estate market.

Mr. WOODWELL. We don't have any models that would predict that. I do think, based on the loan maturity survey that we're——

The CHAIRMAN. Right, that's what I was——

Mr. WOODWELL [continuing]. Looking at there, as folks have discussed, there is, sort of, the income perspective on things, and then the maturity perspective, and which will be driving those. The different investor groups have very different maturity profiles so that, if there is a maturity issue facing mortgages, different investor groups will see them at different times. The multifamily investors, some of those loans—FHA, for instance, have a 40-year maturity. You work back, life insurance companies, 10-year, typically; CMBS, 5, 7, 10; and then, credit companies, banks would have a shorter term.

So, to the degree one's focused on maturity, one would look at those——

The CHAIRMAN. Right.

Mr. WOODWELL [continuing]. Those schedules. To the degree one's focused then on income-driven, then we're probably back to the discussions of different property types having very different situations, where, for instance, hotel and multifamily—those are shorter-lease terms—have probably seen the bulk to the hit to their NOI and are starting to see a rebuilding of those. Whereas, the longer-lease-term properties weren't as dramatically hit by the downturn, in terms of their bottom lines, but then, likewise, won't see quite as quick of a rebound.

The CHAIRMAN. Mr. Parkus.

Mr. PARKUS. I think it depends on the location or the investor base. In CMBS, we are beginning to see losses ramp up very quickly now. It depends on the investor base, because it depends, really, on whether—the extent to which problem loans are pushed out, extended, and how long that process lasts. In CMBS, there will be a combination of loan extensions and foreclosure and liquidations. Losses are already ramping up very quickly now. We expect losses to remain high for this year and through next year. The difference is, is that the sources of losses in the nearer term are from term defaults—what we refer to as term defaults, where properties simply can't make the mortgage payments and are foreclosed and liquidated. And sometime in 2012/2013, that will come more from maturity-related defaults.

On the bank side, it really is a question about, I believe, when banks seriously begin to deal with the problem loan portfolios. It's——

The CHAIRMAN. And, when——

Mr. PARKUS [continuing]. Hard to say.

The CHAIRMAN [continuing]. Do you think that will be? Yes. I mean, no one knows. I'm——

Mr. PARKUS. I think, within a couple of years. I think that the regulators that we heard from today are right, that as soon as banks have the wherewithal—individual banks have the financial wherewithal to deal with these problems, they are being forced to deal with them. But, it will also be dragged out, because many banks do not have that wherewithal today.

The CHAIRMAN. Mr. Anderson.

Mr. ANDERSON. Actually, yeah, we do model it for banks. And we've done quite a few calculations, ourselves, to try to estimate what the ultimate losses will be for banks, and how far along they are through the charge-off process. By our estimates, banks, in aggregate, including large and small banks, are through 50 to 60 percent of the charge-offs on commercial real estate loans—on defaulted commercial real estate loans. So, you know, we're past the halfway point, but there's still quite a bit more to come, we think.

The earlier panel noted that banks have been provisioning less over the last few quarters. You can kind of take that as a—two different ways. You could take it—the glass-half-full interpretation would be that banks see the light at the end of the tunnel and feel less of a need to add to loss allowances. The converse would be that—and I do think there is something to that—but, the converse would also be that, I think, there's intense pressure in the—among—in the bank sector, to maintain capital. And so, the—to the extent that you can stretch your losses out, you certainly boost your capital in the near term. And I think that's another feature of what's going on.

So, there's certainly an incentive to work through the problems, but banks have been doing it for the last 2 or 3 years, and, you know, and given that they're past the halfway point, I think, we'll be at it for at least another couple of years, probably.

The CHAIRMAN. Thank you very much.

Mr. McWatters.

Mr. MCWATTERS. Thank you.

Let's continue with the TARP-type structure, TARP–2. Mr. Parkus, do you think it would be critical that Congress provide more money to bail out financial institutions, due to their CRE loans?

Mr. PARKUS. That gets to an area, really, outside of my domain. I guess I don't feel that I have—you know, that I should be speaking to a question about—sort of really addressing how to deal with banks. My expertise is in commercial real estate. If I understand your question.

Mr. MCWATTERS. Okay. Fair enough.

Mr. Woodwell.

Mr. WOODWELL. And, I apologize, I don't think I have the adequate knowledge to address that adequately.

Mr. MCWATTERS. Okay. Well, I mean, my question is, Can these banks work through CRE problems by themselves, or do they need assistance—the small banks and the large banks, both?

It sounds like, when I heard the answer to your first questions, is that, you know, given a few years, things will turn out okay. It's going to be rocky for a while, but it's going to turn out okay. And that would lead me to believe, as the regulators said, there's really not a need for an RTC, a TARP–2, or something along those lines.

Mr. WOODWELL. I——

Mr. MCWATTERS. Does that help?

Mr. WOODWELL. I guess I—I think I do understand what you're getting at. I think that an RTC, traditionally, is for the liquidation of loans out of banks, in receivership.

Mr. MCWATTERS. Yes.

Mr. WOODWELL. Now, does it make sense for regulators, the FDIC, to consider an RTC solution for the large number of loans that they are taking in from failed banks? They should certainly consider it. It's another form of securitization. And, quite frankly, that is what gave rise to the CMBS market in the first place, in the early 1990s.

On the other hand, you simply have to look at the cost-benefit analysis, according to how much they can get by liquidating loans in the way that they are currently doing. And, I—it's difficult for me to know—to make that cost-benefit analysis. I would certainly think that it's—it is a potential outlet. Whether or not it is more cost-effective than the current disposal methods, I don't know.

Mr. MCWATTERS. Okay. Okay.

Help me understand, since you—all three of you think the market will turn around in the next few years, taking the approach of simply extending loans, today, at favorable rates—we have low interest rates, on a short-term basis—and rolling those, versus a full-tilt restructuring, refinancing, writedown, impairment of capital, recognition of tax cancellation indebtedness income, and the like. When is that appropriate to use one of those approaches, and when is it appropriate to use the other approach?

Mr. Anderson.

Mr. ANDERSON. Well, I—in one sense, I think you have to look at it loan by loan, borrower by borrower, property by property.

You know, for the lender, the ultimate metric probably has to be what sort of loss they expect to take. So, whether it would be better to—if they need to take a loss now versus potentially taking a loss down the line. And, you know, if lenders are of the general view that the markets are gradually improving, then, at least in cases where they think that the borrower ultimately will get right-side-up again and be able to, ultimately—or keep current on payments and ultimately repay the loan, then that's a sound strategy, as long as it works out.

In cases where the bank doesn't really think that that's too likely, then it wouldn't really be appropriate, and especially if they think that there's, for whatever reason, the likelihood that the value recovered a year or 2 or 3 from now would be lower than it might be now, then certainly it makes more sense to put the pressure on now and try to deal with the loan—deal with that problem sooner.

In terms of modifications and charge-offs, again, that has to do with whether or not the bank, after their analysis, deems that to be a better outcome than outright foreclosure or rolling the loan over. I should add also that, you know, per the guidance in 2009, banks can't just roll over a loan if it's not otherwise performing. So——

Mr. MCWATTERS. Right.

Mr. ANDERSON [continuing]. So the borrower does have to be current in order to even quality for that.

Mr. MCWATTERS. Right. And there could be some incentive to do that, not so much because that loan, in 2 or 3 years, is going to be in the money, but that the institution itself may be stronger in 2 or 3 years, and able to absorb a loss in 2 or 3 years.

So, Mr. Parkus.

Mr. PARKUS. Well, you know, I basically agree with that. I would add that, you know, if you have a borrower, with a loan that is, let's say, an 85 LTV in the market—in order to refinance, the current market is a 70 or 75 LTV sort of maximum LTV—that certainly makes sense, as long as you believe the borrower is—has good intentions, as long as the property is liked—likely to improve, as opposed to deteriorate. There are many cases where we think extensions make a lot of sense.

But, there are many cases where we think that extensions clearly do not make a lot of sense. There are many loans out there that are not 85 LTV in today's environment; they're 120 or 130 LTV. These loans will not be viable in the future under any reasonable scenario. And there are many out there like that, many that were overlevered to that degree. When you—that's what happens when you have a 40- or 50-percent price decline and the original LTV on the loan was not 70, but was 90 or 95, you get into those situations. So, in those cases, we think that that is not a good approach.

Mr. MCWATTERS. Okay. That's helpful.

I'm way over my time. Sorry.

The CHAIRMAN. Superintendent Neiman.

Mr. NEIMAN. Thank you.

I find interesting, and hopefully constructive, to make some comparisons between the CRE crisis, as well to the residential mortgage crisis. And when you hear about the factors that contributed to it—investors seeking higher yield, weak underwriting, low equity, over-leveraging, too much focus on collateral—lots of similarities, until you get down to the comparison, that on the residential side, a high evidence of borrowers who clearly did not understand the product they were getting into, less sophisticated in efforts by either brokers or lenders to take advantage of those borrowers. This, I don't see on the commercial real estate side. We have some of the most sophisticated developers in the country.

Can you speak to this issue and are there lessons to be learned in making comparisons or contrasting differences?

Mr. PARKUS. Well, yeah. I would say that, for the most part, on the commercial real estate side, apart from really small loans—say, owner-occupied loans, in bank portfolios—certainly what we see in CMBS, we deal with borrowers, for the most part, that are fairly sophisticated.

And the transparency. One of the huge differences, I think, between residential and commercial, is the—simply the degree of fraud that was out there. There was a lot of opacity in the residential side, and there was a lot of outright fraud. I would say, in CMBS, it was not a case of outright fraud, for the most part. There's—you'll always be able to find, you know, a small number of loans that had questionable this or that. But, we are not here because borrowers did not understand—or, I should say, investors did not understand the nature of the loans that were being made. I think we were all guilty, in the sense that very bad loans, clearly that should not have been made, were made.

Mr. NEIMAN. So, is the same euphoria, that real estate prices, whether residential or commercial property, will always go up——

Mr. PARKUS. Yes. Yes, certainly that was that case. I think it had been so long since we had seen—I think the idea that rising prices just validates—rising price—the idea that prices will always rise just gets built into a mentality. And when you need—when you're—when you have—as an investor, you need to reach certain debt hurdles, you're willing to cut corners, you're willing to believe that, “Well, I—maybe this will perform, maybe this clearly inadequate loan”—and then the next time, “Maybe this even worse-quality loan will perform.” And it’s sort of a—you get swept away along those lines.

Mr. NEIMAN. Mr. Woodwell, your organization sees this from both the commercial and the residential side.

Mr. WOODWELL. I might draw a greater distinction between the motivations for purchasing a home and for investing in an income-producing property, that an investor, someone purchasing an office building, a shopping center, is looking for that—looking at that as an investment, as something that’s going to both throw off income and, essentially, get dividends through those income payments in the degree to which the income exceeds any mortgage payments; and then also is looking for a capital gain. And the degree to which an investor is driven more by a capital gain and, sort of, heightened expectations there, versus the income of the property, that can lead to those prices exceeding the growth of the incomes, which is probably something that we saw during the ’05, ’06, ’07 period.

But, that being said, I do think that one needs to be careful that there are very different motivations between those who are purchasing homes and those who are purchasing commercial real estate.

Mr. NEIMAN. Mr. Anderson——

Mr. ANDERSON. Yeah, I got a couple comments that—I’d agree, I don’t think there was a subprime element of—in the commercial real estate market. And, as you pointed out, they are generally sophisticated borrowers that understand, you know, the terms of what they’re agreeing to.

Mr. NEIMAN. Are they so sophisticated that they took advantage of the system with little equity?

Mr. ANDERSON. There might have been some of that going on, sure. You know, if you’re looking at it, thinking, “Gosh, I can squeeze some more dollars out of this by adding more leverage,” you can understand how people might get into that. The irony is that, with ever higher prices, the sense of risk was diminished. So, the pricing of risk went way down, and yet, actually, that was when risk was the highest. So, the higher the prices went, the greater the real risk, but the lower risk pricing actually went.

Mr. NEIMAN. Well, thank you.

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you.

A number of you have made a distinction between sectors of the commercial real estate market, in a number of your comments. And I guess I wanted to explore that a little more.

I’ll start with you, Mr. Parkus. You made a big distinction between financing trophy properties and other smaller properties, or the difference in performance of financing, going back into commercial properties. And, I guess, what are some of the—you know, what are the differences that are producing this—in these two types of markets, that are producing these different performances?

Mr. PARKUS. Well, I think the big difference is in the price performance. We’re seeing trophy properties and institutional-quality properties appreciate at a much more significant rate than smaller properties. And I think that that is, you know, largely the result of, you know, institutional investors. When institutional investors come in and look for higher-quality properties.

There's been a tremendous interest, from institutional investors all over the world, in the U.S.—high-quality U.S. commercial real estate properties. Smaller properties are typically outside of their purview. They don't invest in small multifamily—for the most part, small multifamily properties, in Dallas, say. They invest in large office properties in gateway cities.

So, there is—what my point was, is that there is a very significant bifurcation going on between the haves, the very best, and, kind of, the have-nots, which is more the—a very large portion of the commercial real estate sector is.

Dr. TROSKE. And listening to your comment, it does seem like you indicated that the difference was reflecting the fact that these trophy properties were seeing a greater appreciation in price. So, there should—a reason for why they have an easier time getting financing, not just some dream of owning a office building in Manhattan.

Mr. PARKUS. They have an easier time getting financing, because there is, intrinsically, greater demand for those types of assets, from large, well-capitalized investors. If there is—if you have an asset for which there is a lot of interest, lenders will be very interested, as well.

Dr. TROSKE. Mr. Anderson, you've sort of commented on that, as well.

Mr. ANDERSON. Yeah. Well, I'd pick up on the demand-for-trophy-properties argument. I think that's true. What you tend to see in a market downturn with lower rents is occupants—occupiers of space being able to move up the quality of space at roughly the same rent that they were paying. So, they may move from what's called B space in the—B-quality space in the office sector, up to A space, with little or no increase in rent. So, they take advantage of those price declines—or rent declines.

The way that works—and so, how that benefits the trophy properties is that they tend to remain full; whereas, the B properties and then C properties experience even greater vacancies as people move out of those spaces and into higher-quality properties.

Dr. TROSKE. Mr. Woodwell—and you focused primarily on the difference between, sort of like, commercial properties and development—construction. And so, give me a little—I mean, and that seems to be much of the difference between your point—your view of the market and some of the other views we've heard. And so, can you, sort of, maybe, expand on that a little?

Mr. WOODWELL. Sure. And I think the—first, it sounds like everyone is peeling off the construction activity, particularly that that had to do with single-family construction activity that's driving a lot of the numbers that we've seen, in terms of chargeoff rates, delinquencies, in that broader CRE category.

In terms of, then, the distinction between, sort of, primary, secondary, tertiary market, I think what you have there sort of makes sense. If you think about it as primary markets, you'll have hundred-million-dollar investments; tertiary markets, you'll have $500,000 investments. And that the large institutional investors who are drawn to those hundred—hundred-million-dollar investments, it would take a whole lot of tertiary market investments to get to one of those major market investments. So, that there—there is a natural break, with more local investors playing in those smaller primary—or secondary and tertiary markets; more of the large international institutional players playing in those primary markets.

I think also, if you think about the course of the credit crunch in the recession, the credit crunch probably had more of an impact—which came first—probably had more of an impact on those large international institutional investors. And then the recession probably had much more of an impact on those local. So, slightly different impact, slightly different forces at play amongst those different players.

Dr. TROSKE. You wanted to——

Mr. PARKUS. There's one additional factor, I think, that we could mention here. And that is the—sort of, emphasize the demand from lenders. The ultimate lenders, in many cases, are not the banks, but investors in CMBS. And investors in CMBS have a strong preference for high-quality assets, when you can get them. So, that tends to drive—you ask, "Why would lending focus on trophy assets versus smaller assets?" I think that that is—and large banks, as well.

Dr. TROSKE. Thank you.

The CHAIRMAN. Well, that concludes our meeting.

I want to thank you for your—for being here today and for your excellent testimony and dealing with our questions.

Also want to take a moment to thank a member of our professional staff. We've had 27 hearings, and every one of them has been organized by Patrick McGreevy, including nine field hearings.

Patrick, we appreciate all your terrific work, on behalf of the panel. And I want to thank you, for the panel, for your good work.

We'll leave that hearing record open for 1 week, in case there are any questions. This is not our last hearing. So, until the next time, which will be our last hearing, this hearing is adjourned.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]