CONGRESSIONAL OVERSIGHT PANEL

FEBRUARY OVERSIGHT REPORT *

COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY

FEBRUARY 10, 2010.—Ordered to be printed

* Submitted under Section 125(b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343

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CONGRESSIONAL OVERSIGHT PANEL

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EXECUTIVE SUMMARY *

Over the next few years, a wave of commercial real estate loan failures could threaten America's already-weakened financial system. The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation's mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy.

Commercial real estate loans are taken out by developers to purchase, build, and maintain properties such as shopping centers, offices, hotels, and apartments. These loans have terms of three to ten years, but the monthly payments are not scheduled to repay the loan in that period. At the end of the initial term, the entire remaining balance of the loan comes due, and the borrower must take out a new loan to finance its continued ownership of the property. Banks and other commercial property lenders bear two primary risks: (1) a borrower may not be able to pay interest and principal during the loan's term, and (2) a borrower may not be able to get refinancing when the loan term ends. In either case, the loan will default and the property will face foreclosure.

The problems facing commercial real estate have no single cause. The loans most likely to fail were made at the height of the real estate bubble when commercial real estate values had been driven above sustainable levels and loans; many were made carelessly in a rush for profit. Other loans were potentially sound when made but the severe recession has translated into fewer retail customers, less frequent vacations, decreased demand for office space, and a weaker apartment market, all increasing the likelihood of default on commercial real estate loans. Even borrowers who own profit-

* The Panel adopted this report with a 5–0 vote on February 10, 2010.

able properties may be unable to refinance their loans as they face tightened underwriting standards, increased demands for additional investment by borrowers, and restricted credit.

Between 2010 and 2014, about $1.4 trillion in commercial real estate loans will reach the end of their terms. Nearly half are at present "underwater"—that is, the borrower owes more than the underlying property is currently worth. Commercial property values have fallen more than 40 percent since the beginning of 2007. Increased vacancy rates, which now range from eight percent for multifamily housing to 18 percent for office buildings, and falling rents, which have declined 40 percent for office space and 33 percent for retail space, have exerted a powerful downward pressure on the value of commercial properties.

The largest commercial real estate loan losses are projected for 2011 and beyond; losses at banks alone could range as high as $200–$300 billion. The stress tests conducted last year for 19 major financial institutions examined their capital reserves only through the end of 2010. Even more significantly, small and mid-sized banks were never subjected to any exercise comparable to the stress tests, despite the fact that small and mid-sized banks are proportionately even more exposed than their larger counterparts to commercial real estate loan losses.

A significant wave of commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American. Empty office complexes, hotels, and retail stores could lead directly to lost jobs. Foreclosures on apartment complexes could push families out of their residences, even if they had never missed a rent payment. Banks that suffer, or are afraid of suffering, commercial mortgage losses could grow even more reluctant to lend, which could in turn further reduce access to credit for more businesses and families and accelerate a negative economic cycle.

It is difficult to predict either the number of foreclosures to come or who will be most immediately affected. In the worst case scenario, hundreds more community and mid-sized banks could face insolvency. Because these banks play a critical role in financing the small businesses that could help the American economy create new jobs, their widespread failure could disrupt local communities, undermine the economic recovery, and extend an already painful recession.

There are no easy solutions to these problems. Although it endorses no specific proposals, the Panel identifies a number of possible interventions to contain the problem until the commercial real estate market can return to health. The Panel is clear that government cannot and should not keep every bank afloat. But neither should it turn a blind eye to the dangers of unnecessary bank failures and their impact on communities.

The Panel believes that Treasury and bank supervisors must address forthrightly and transparently the threats facing the commercial real estate markets. The coming trouble in commercial real estate could pose painful problems for the communities, small businesses, and American families already struggling to make ends meet in today's exceptionally difficult economy.

* * * * *

This month's report also includes a brief summary of the status of the disposition of the warrants that Treasury has acquired in conjunction with its TARP investments in financial institutions. The Panel had conducted its own review of the initial results of Treasury's repurchases of warrants in its July Report (*TARP Repayments, Including the Repurchase of Stock Warrants*) and called for greater disclosure concerning Treasury's warrant disposition process and valuation methodology. In January, Treasury published its first report on the warrants. Treasury's warrant sales receipts up to this time total just over $4 billion, which is slightly more than Treasury's own internal model estimates their value, but slightly below (92 percent) the Panel's best estimate. The Panel now projects receipts from the sale or auction of TARP warrants—both those sold or auctioned to date and those yet to be disposed of—will total $9.3 billion.

SECTION ONE: FEBRUARY REPORT

A. Introduction

Treasury is winding down the Troubled Asset Relief Program (TARP), although the Program has been extended until October 3, 2010. The TARP financial assistance programs for banks and bank holding companies (BHCs) have ended, and all but six of the nation's largest BHCs have repaid the assistance they received;[1] in total, 59 of the 708 institutions that participated in the financial assistance program have repaid fully.[2] Simultaneously, however, federal financial supervisors and private analysts are expressing strong concern about the commercial real estate markets. Secretary Geithner's letter to Congressional leaders certifying his decision to extend the TARP cited as one of the reasons for the extension that "[c]ommercial real estate losses also weigh heavily on many small banks, impairing their ability to extend new loans."[3]

The financing of commercial real estate is not identical to that of residential real estate, nor is the way in which potential defaults can be avoided. Nonetheless, the two markets share core elements. Securitization of mortgage-backed loans is a major factor in both; securitization of loans is concentrated in large banks, while small banks generally hold whole loans on their books. The difficulties residential real estate has encountered and the difficulties commercial real estate has started to experience are a combination of the real estate bubble, the credit contraction, and the state of the economy. And of course, both types of loans play an essential role in financial institutions' operations, balance sheets, and capital adequacy.

But the timing of the two sets of difficulties is different. Home mortgages started to default at unprecedented rates as the real estate bubble burst in 2007. Commercial real estate defaults are rising, but the consensus is that the full force of the problems in that sector and their impact on the nation's financial institutions will be felt over the next three years and beyond, after the TARP has expired.

The relationship between the commercial real estate markets and the TARP has been a concern of the Panel for some time. The Panel began to study the issue in detail in May 2009 at a field hearing in New York City.[4] Its August 2009 report on "The Continued Risk of Troubled Assets"[5] contained a specific discussion of commercial real estate, and its June 2009 report on "Stress Testing and Shoring Up Bank Capital"[6] noted the role of commercial real

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[1] Subject to the stress tests conducted by the federal bank supervisors in the first half of 2009.

[2] Although Citigroup repaid funds it had received under two TARP programs, Treasury owns $24.4 billion in common shares and therefore Citigroup is still participating in the CPP.

[3] Letter from Timothy F. Geithner, Secretary of the Treasury, to Nancy Pelosi, Speaker of the U.S. House of Representatives (Dec. 9, 2009) (online at www.ustreas.gov/press/releases/reports/pelosi%20letter.pdf).

[4] Congressional Oversight Panel, *Field Hearing in New York City on Corporate and Commercial Real Estate Lending* (May 28, 2009) (online at cop.senate.gov/hearings/library/hearing-052809-newyork.cfm).

[5] Congressional Oversight Panel, *August Oversight Report: The Continued Risk of Troubled Assets,* at 54–57 (Aug. 11, 2009) (online at cop.senate.gov/documents/cop-081109-report.pdf) (hereinafter "COP August Oversight Report").

[6] Congressional Oversight Panel, *June Oversight Report: Stress Testing and Shoring Up Bank Capital,* at 26, 41–43 (June 9, 2009) (online at cop.senate.gov/documents/cop-060909-report.pdf) (hereinafter "COP June Oversight Report").

estate loss projections in the stress test computations. The Panel held its second field hearing on commercial real estate on January 27, 2010 in Atlanta, one of the nation's most depressed commercial real estate markets; this report reflects the testimony at that hearing.

The nation's bank supervisors expressed serious concern in 2006 about the potential effect of the commercial real estate markets on the condition of the nation's banks. Congress specifically authorized Treasury to deal with commercial mortgages as part of the Emergency Economic Stabilization Act (EESA). But the direct attention paid to that subject by Treasury in its use, or planned use, of TARP funds has been relatively small.

The most serious wave of commercial real estate difficulties is just now beginning; experts believe that the volume of bank write-downs and potential loan defaults may swell in the coming years, in the absence of a strong immediate improvement in the economy. This report examines the nature and potential impact of a second wave of property-based stress on the financial system—this time based on commercial rather than residential real estate. To do so, it begins by outlining the way commercial real estate is financed, explores the relationship between the state of commercial real estate today and the property bubble of 2005–2007, and highlights the all-important impact of economic recovery on commercial real estate values and the health of commercial real estate loans. The report then details the nature, timing, and potential impact of the risks involved in commercial real estate and the ways banks and lenders can work to cushion the effect of temporary dislocations pending an economic recovery. It also briefly suggests ways in which the broader risks might be mitigated by a combination of government and private sector actions.

These are not theoretical questions. The report examines the way these risks can directly affect ordinary citizens and businesses. A wave of foreclosures affecting multifamily housing, for example, can displace families or reduce the conditions in which they live. Mortgages on multifamily housing make up 26.5 percent of the nation's total stock of commercial real estate mortgages.[7]

Commercial real estate issues—most likely serious ones—have been identified for several years, and the nation experienced a previous commercial real estate crisis during the 1980s. How the financial system and the government deal now with a second wave of property-induced stress on the financial system will indicate what Treasury, the bank supervisors, and the private sector have learned from the last two years.

B. What is Commercial Real Estate?

Although "commercial real estate" has a variety of definitions in academic and business literature, there are two general ways of thinking about it. Relevant guidance from the federal financial supervisors takes a straight-forward approach, defining commercial real estate as "multifamily" property, and "nonfarm nonresidential"

[7] Board of Governors of the Federal Reserve System, Z.1 *Flow of Funds Account of the United States* (December 10, 2009) (online at www.federalreserve.gov/releases/Z1/Current/z1.pdf) (hereinafter "Federal Reserve Statistical Release Z.1").

property.[8] This formulation reflects the division of the non-farm[9] real estate markets into a single-family residential market (generally one to four family structures) and a largely separate commercial market, which includes practically all other property types.[10]

That leads to the second defining characteristic, which goes to the core of any discussion of commercial real estate loans and financing. Commercial properties are generally income-producing assets, generating rental or other income and having a potential for capital appreciation.[11] Unlike a residential property, the value of a commercial property depends largely on the amount of income that can be expected from the property.[12]

1. Types of Commercial Real Estate

The characteristics of different categories of commercial real estate are important when considering their respective value and ability to support bank and other loans.

a. Retail Properties

Retail properties range in size from regional malls, free-standing "big-box" retailers, and strip malls to single, large or small buildings housing local businesses. To generate the cash flow necessary to service their loans, all retail properties depend, directly or indirectly, on the success of the businesses that occupy the property (which in turn depends on its own combination of financial, economic, and competitive factors). For this reason, retail properties (as well as hotel and tourist properties) are more directly affected by the health of the economy than most other property types. Retail is also the property type most sensitive to location.

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[8] See Board of Governors of the Federal Reserve System, *Mortgage Debt Outstanding* (Dec. 2009) (online at www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm).

[9] *Id.* As of the 3rd quarter of 2009, the total universe of real estate debt consisted of $10.85 trillion of residential mortgages, $3.43 trillion of commercial mortgages (including multifamily), and $132.28 billion of farm mortgages.

[10] *See* John P. Wiedemer, *Real Estate Finance, Seventh Edition,* at 244 (1995) (hereinafter "Real Estate Finance, Seventh Edition"). Following industry conventions, this report considers the "residential" category to consist of single family homes and two- to four-unit multifamily properties. Although larger multifamily properties are considered by some definitions (and by the IRS) to be residential, they are more commonly included in the commercial category because of characteristics these properties share with other types of commercial property.

[11] *Id.,* at 244–245. Some property types that do not produce traditional rental income are classified as commercial real estate. In the case of a property owned by the tenant ("corporate real estate"), such as a factory, the notional income generated by the structure is subsumed within the results of the broader enterprise. Institutional properties (e.g. museums, hospitals, schools, government buildings) are considered commercial property due to their many similarities to more traditional commercial property types, the fact that most of these properties produce cash flow of some type, and because the properties are financed in the commercial mortgage market. Land for development is a precursor for an income producing property. Land is also often held for appreciation as an investment. Conversely, some residential assets are income producing, such as single family houses that are rented, or small two- to four- unit apartment properties. Due to the methods of finance and other characteristics, these properties are rarely considered to be commercial real estate.

[12] There are four common methods of valuing a commercial property: capitalization rate, discounted cash flow, comparable sales, and replacement cost. The first two methods are purely functions of property income. The comparable sales method is implicitly based on property income, since comparable property sale prices depend on other buyers' assessments of value based on income. Replacement cost does not depend on income, but is mainly used as a check on the other methods.

b. Hotel and Tourist Properties

Hotel and tourist properties include resort, convention, airport, extended stay, and boutique hotels, as well as motels.[13] The hotel sector is cyclical and volatile, in large part because the "lease term" for a hotel is usually a few days at most. Hotel income depends directly on the level of occupancy and the daily rate charged; those rental rates are sensitive to additional supply in the market and can change daily. These factors, plus changing trends in both tourism and business travel based on the economy or local conditions, make future hotel income difficult to predict. Hotels also tend to be highly leveraged, further increasing investment risk.[14]

c. Office Buildings

The office sector is a diverse grouping that includes all properties in which office occupancy is the dominant use.[15] Office buildings are designated by class, from A to C, in descending order of quality and cost.[16] Because office leases are relatively long term, usually for three to ten years, office properties can be more stable in their financial performance than other classes of commercial real estate, at least during the lease terms and assuming no defaults. Office space tends to have significant costs during re-leasing, including brokerage charges, downtime, and the considerable amount of fit-out work that needs to be done to accommodate new tenants.

d. Industrial Properties

Industrial real estate traditionally consists of warehouse, manufacturing, light industry and related, e.g., research and development or laboratory, properties.[17] Office and industrial properties are sometimes combined into a single "office/industrial" category because some industrial properties contain a significant amount of office space. Light industrial and warehouse properties can often easily be converted from one use to another; a heavy industrial property, such as a mill, will be less amenable to conversion to other uses.[18] Industrial properties tend to have more stable returns than office, hotel, or retail properties.[19]

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[13] *See* William B. Brueggeman and Jeffery D. Fisher, *Real Estate Finance and Investments,* at 211 (2001) (hereinafter "Brueggeman and Fisher").

[14] Precept Corporation, *The Handbook of First Mortgage Lending: A Standardized Method for the Commercial Real Estate Industry,* at 253 (2002).

[15] Again, some of the space is owner-occupied, *e.g.,* by small services businesses.

[16] Urban Land Institute, *Office Development Handbook, 2nd Edition* (Dec. 1998) "Class A space can be characterized as buildings that have excellent location and access, attract high quality tenants, and are managed professionally. Building materials are high quality and rents are competitive with other new buildings. Class B buildings have good locations, management, and construction, and tenant standards are high. Buildings should have very little functional obsolescence and deterioration. Class C buildings are typically 15 to 25 years old but are maintaining steady occupancy. Tenants filter from Class B to Class A and from Class C to Class B."

Other classification systems may set square footage standards for the classes, and may include an "unclassified" category for space below the standards of Class C or unusual property types that may be difficult to lease.

[17] Johannson L. Yap and Rene M. Circ, *Guide to Classifying Industrial Property, Second Edition,* Urban Land Institute, at viii (2003) (hereinafter "Guide to Classifying Industrial Property").

[18] See Brueggeman and Fisher, *supra* note 13, at 211.

[19] Guide to Classifying Industrial Property, *supra* note 17, at vi.

e. Multifamily Housing and Apartment Units

Multifamily housing consists of buildings with multiple dwelling units for rent. Unlike most residential properties, multifamily properties are income generating, and generally use the commercial mortgage market for financing. The basic subtypes of multifamily are high rise, low rise, and garden apartments.[20] A number of other types of properties are sometimes converted into apartments (such as loft units in converted industrial properties) and would then fall into this category.[21]

Multifamily properties usually have a greater number of tenants and shorter leases (six months to two years) than retail, office, and industrial spaces. Again, cash flow is relatively stable over the terms of any lease. Multifamily properties, however, are susceptible to competition, because the barriers to entry into the market are low.[22]

Unlike other commercial property types, a significant percentage of the multifamily sector is subsidized in some form through government programs such as the Section 8 Housing Choice Voucher Program or Low Income Housing Tax Credits (LIHTC). These units are often referred to as "affordable" or "assisted" housing, as opposed to unsubsidized "market rate" housing.

As of 2007 there were more than 17 million apartment units in the United States, most of which have one or two bedrooms. As can be seen in Figure 1, the South contained the largest number of apartment units followed by the West, the Northeast, and the Midwest.[23] The highest median rents, however, were seen in the West, followed by the Northeast, the South, and the Midwest.[24] Rents in certain markets, especially major metropolitan areas such as New York, are significantly more than the median.

FIGURE 1: MULTIFAMILY UNITS AND MEDIAN RENTS BY REGION

Region	Number of Units	Percent of Total Units	Median Monthly Rent	Multifamily Property Size by Number of Units in Each Category				
				5–9 Units	10–24 Units	25–49 Units	50–99 Units	100+ Units
Northeast	3,950	23%	$714	871	1,062	679	577	762
Midwest	3,556	20%	550	1,110	1,299	404	357	386
South	5,577	32%	640	1,840	2,510	435	260	532
West	4,305	25%	800	1,317	1,603	586	373	427
Total U.S.	**17,389**	**100%**	**675**	**5,138**	**6,473**	**2,104**	**1,567**	**2,107**

The median household income of renters, as of 2007, was $25,500, well below the national median of $47,000. The median income of renters of unsubsidized market rate units was higher, at $30,000. The median age of renters was 39. Nearly half of apart-

[20] Brueggeman and Fisher, *supra* note 13, at 211.

[21] Condominium and assisted living properties share many characteristics with multifamily rental properties, but are not considered part of the multifamily category, although they do use the commercial finance market. *See* Real Estate Finance, Seventh Edition, *supra* note 10, at 199–200.

[22] Joseph F. DeMichele and William J. Adams, "*Introduction to Commercial Mortgage Backed Securities,*" in The Handbook of Non-Agency Mortgage-Backed Securities, at 335–336 (1997) (hereinafter "DeMichele and Adams").

[23] National Multi Housing Council, *Quick Facts: Apartment Stock* (2009) (online at www.nmhc.org/Content/ServeContent.cfm?ContentItemID=141).

[24] *Id.*

ments are occupied by only one person. Of renter households, 22 percent have at least one child.[25]

f. Homebuilders

The development of residential properties is considered a commercial real estate activity, and loans to businesses that develop residential properties are also considered commercial real estate loans.

2. How Commercial Real Estate Is Financed

The financing of commercial real estate reflects the prime characteristics of commercial property, namely that (1) they are built to generate income, (2) income is used to service the loans obtained by the property developer or operator, and (3) the value of the property depends largely on the amount of that income.

The commercial and residential real estate industries share many similarities in basic structure and terminology. Location is a well-known factor influencing the property values of both categories. Both types of property experienced bubbles in the past decade. Loan underwriting and equity requirements were loosened for both types of real estate, although the commercial real estate bubble was smaller and less extreme; moreover, as discussed throughout the report, the full force of the commercial real estate bubble has yet to be felt.

The bubble in residential property also did much to fuel directly the bubble in commercial property. Companies related to residential real estate, construction, and home furnishing grew rapidly as a result of the residential bubble and expanded the demand for office and industrial space. Many new retail properties were also built to serve new residential development; the force of the credit-driven consumer economy was even greater.

Commercial and residential real estate finance, however, have significant differences. Unlike most residential borrowers, commercial borrowers tend to be real estate professionals. Commercial borrowers are also expected to pay debt service from property income rather than from personal income, unlike homeowners. Consequently, some of the loan structures that are used in the residential mortgage market, such as stated income loans or low introductory interest rates, are not available in the commercial market. In addition, the different tax treatment of commercial and residential properties (especially the allowance of depreciation of commercial properties) creates incentives for different types of ownership and financing structures.

The two main categories of commercial real estate mortgages are discussed below.

a. Construction and Development Financing

Construction loans—often called “ADC,” for “acquisition, development, and construction” or “C&D” for “construction and development”—allow the developer to do just what the name implies, that is, to obtain funds to build on the property. ADC financing is usu-

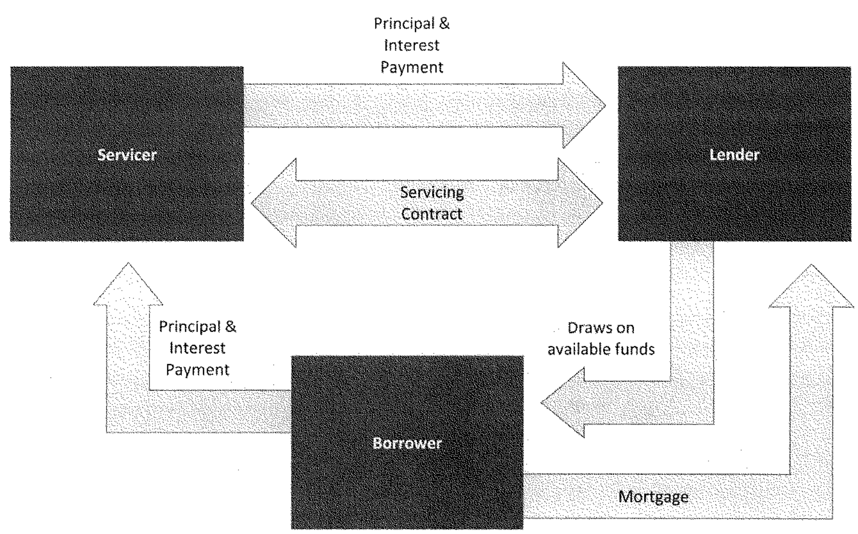
[25] *Id.*

ally short-term and almost always supplied by a depository institution.

These loans usually have an adjustable rate, priced at a spread over the prime rate or another benchmark.[26] The bank typically plays an active role in monitoring these loans and approving "draws" as funds are needed for construction.[27] Since a property under construction does not generate rental income to cover debt service, a construction loan more often than not includes an interest reserve which holds back enough of the loan proceeds to cover the interest payments due during the term of the loan. (Thus, the developer borrows the money to pay the interest on the construction loan, because the property, by definition, cannot generate cash flow to do so.) Underwriting a construction loan requires forecasting the time it will take the developer to lease up the property to a sufficient extent to enable the loan to be converted into permanent financing.

Unlike later stages of financing, construction loans are usually recourse loans, that is, the lender has a right to recover directly from any available general assets of the developer if the loan is not repaid (a right that is meaningful only to the extent that the developer has those assets in the necessary amount).

FIGURE 2: CONSTRUCTION LOAN FLOWCHART [28]



[26] Brueggeman and Fisher, *supra* note 13, at 445.
[27] Brueggeman and Fisher, *supra* note 13, at 481–485.
[28] In smaller and some other non-securitized loans, the relationship runs directly between the borrower and the lender, without the use of a servicer.

b. Permanent Financing

After construction is completed and the building leased, the developer takes out a commercial mortgage as permanent financing and uses the proceeds to repay the construction loan; the need for permanent financing is built into the financing and economics of the project from the outset.

The terms of the permanent financing and the attractiveness of the property to lenders depend, again, on the income the property is expected to generate, based on its initial leasing rate, general economic conditions, and demand for properties of that type. Translation of that income into a projected value for the property sets the loan-to-value (LTV) ratio (the principal balance divided by the property's value) backing the debt and also affects the loan's interest rate.

Commercial mortgages may have a fixed or an adjustable rate and may also be interest-only and negative-amortization loans.[29] The loan-to-value ratio is typically lower for commercial mortgages than for single-family residential mortgages, ranging from 50 to 80 percent. The remaining amount is usually equity supplied by the borrower (either singly or through a group of investors). The term for commercial mortgages is fairly short, usually three to ten years. The amortization schedule is often longer than the term of the loan, usually 30 years, with a balloon payment of the remaining outstanding principal due at loan maturity.

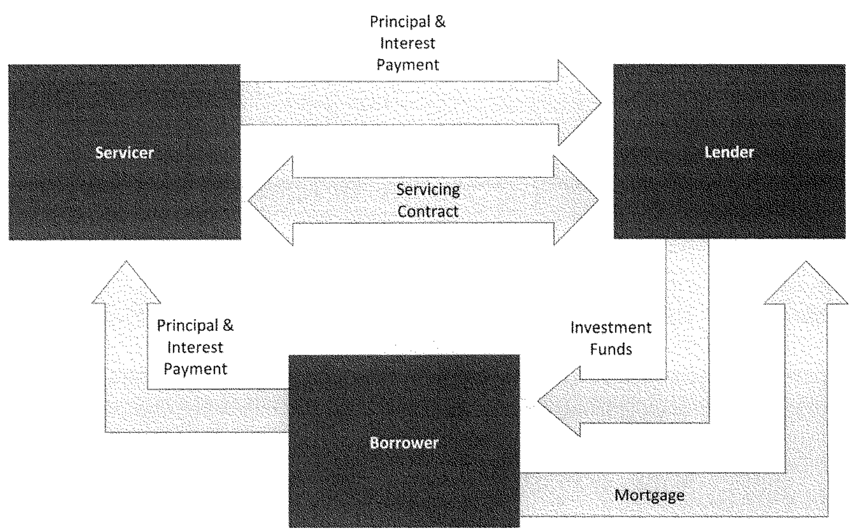
Commercial borrowers usually refinance their properties at the end of the loan term. During refinancing, the lender (often a different lender than the original one) reevaluates the property and bases the new loan terms on the current state of the property and prevailing market conditions. Similarly, many non-traditional or subprime residential loans were made with the assumption that the loan would need to be refinanced at the end of the introductory period when the rate reset. However, unlike the commercial sector in which refinancings were necessary three to ten years later, many non-traditional or subprime loans required refinancing in only one to three years. Thus, loose underwriting or other factors contributing to the inability to refinance loans arose much more quickly in the residential real estate sector than the commercial real estate sector.

There are a number of other reasons why the commercial real estate cycle tends to lag the residential cycle. The multi-year leases common in commercial real estate lock in rental income for the duration of the lease, even if the tenant's actual space needs have decreased. In addition, it takes some time for either economic growth or contraction to work its way through the economy to the point where it influences commercial space demand. For example, a retail store may have poor sales for months or years before it closes and causes a loss of income to the property owner. Unemployment, itself a lagging indicator, greatly influences commercial real estate demand, since each lost job means an empty office or factory work station, as well as lower retail and hotel spending.

[29] In a negative amortization loan, the monthly payment is less than the interest due. The unpaid interest is added to the principal balance, which increases over the term of the loan, and both must be paid in a balloon at maturity.

Unlike construction loans, commercial mortgages are generally non-recourse loans; the borrower stands to lose only its own investment if the property is foreclosed.[30] The lender may look only to the property itself to recover its funds if the borrower defaults, generally through a sale to a third party who wishes to take over the property. The nonrecourse nature of the financing, again, makes careful underwriting crucial.[31]

FIGURE 3: PERMANENT MORTGAGE FLOWCHART[32]



[30] *See* Brueggeman and Fisher, *supra* note 13, at 447.

[31] Commercial mortgages may have prepayment penalties to discourage refinancing before the maturity date. Most securitized mortgages incorporate a prepayment "lock out" that forbids prepayment altogether unless there is "defeasance," where the prepaying mortgage is replaced in the pool with an equal amount of Treasury bonds.

[32] Again, in smaller and some other, non-securitized, loans, the relationship runs directly between the borrower and the lender, without the use of a servicer.

In a way, the term "permanent financing" is a misnomer. Commercial mortgages generally have a short term, and they require refinancing at the end of their original term, such as seven years. At that point, the income experience of the property, which largely sets its value, is re-examined, and the new loan is originated based on that re-examination (often by a lender different than the original one) plus then-prevailing interest rates; such a refinancing may benefit the borrower or the lender. Future refinancing is assumed during underwriting of the original loan because the underwriting computations assume a period far longer than the term of the loan; thus, a drop in the value of the property as an income-producing asset stiffens the loan terms and increases the economic costs to the borrower. Those costs may make further operation of the property by the developer untenable, transferring the loss of value to the lender.

As discussed below, a number of different classes of financial institutions provide permanent financing and refinancing for commercial real estate projects. Depository institutions, especially in smaller communities, are likely to finance local projects and hold the loans on their books as whole loans. Pension funds and insurance companies are major whole loan investors, although they tend to originate their loans through a contracted mortgage bank or mortgage brokerage firm. And a large number of permanent loans are funded through the issuance of commercial mortgage-backed securities (CMBS), described below in Section E.2.

In order to fund a large whole loan mortgage, a group of investors will often form a syndicate to invest in a project jointly and thereby spread risks or allow larger amounts to be funded. Smaller banks will often syndicate a large mortgage among a group of banks with similar investment needs.

Real estate syndications are particularly common among equity investors, although permanent mortgages, construction loans, and various combinations of investment types are syndicated as well. A syndicator, often the general partner of a limited partnership, acts as the sponsor and organizer of the syndication. The syndicator usually does not invest much of its own capital; instead, it earns a fee for its management role.

Aside from limited partnerships, real estate investors use numerous other types of syndication structures. These include "blind pools," in which the syndicator has great discretion over the properties or types of investments to be funded, and public syndicates, which are structured to allow the interests to be sold to investors in different states.[33]

The patterns of commercial real estate financing—and loan administration through a network of servicers—are discussed in Section E.

3. Kinds of Difficulties Commercial Real Estate Can Encounter—An Introduction

There are two types of difficulties that commercial real estate financing arrangements encounter most frequently. The first is credit risk, where the property produces insufficient cash flow to serv-

[33] *See generally* Brueggeman and Fisher, *supra* note 13, at 368–386.

ice the mortgage. The second is term risk, which involves difficulty refinancing the current mortgage on the property at the end of the loan term. Term risk itself has two parts. The first involves difficulties faced by owners of relatively healthy properties, who cannot refinance because a credit contraction or severe economic downturn either limits the capital available or tightens underwriting standards. The second type of term risk involves difficulties faced by owners of projects that were originally financed based on faulty underwriting at a time when commercial real estate values were inflated. The problems posed by both credit risk and term risk are discussed in Section F.2.

C. History of Commercial Real Estate Concerns

Commercial real estate concerns are not new. The nation experienced a major commercial real estate crisis during the 1980s that resulted in the failure of several thousand banks and cost the taxpayers $157 billion (nominal dollars). More than half a decade ago, the banking supervisors began to express worries about a new overconcentration in commercial real estate lending, especially at the smaller institutions, as discussed below, and in Section H.1.

1. Commercial Real Estate Crises of the 1980s and 1990s

Commercial real estate crises have happened, and challenged the regulatory apparatus, before. Historically, the commercial real estate market has been cyclical, and some oscillation between booms and busts is natural.[34] The last significant U.S. real estate-related financial crisis before the 1980s occurred in the late 1920s and early 1930s. The boom and bust that occurred during the 1980s was characterized by commercial property values that fell between 30 and 50 percent in a two-year period—at the time the largest drop in property values in the United States since the Great Depression.[35]

The initial boom was so great that between 1980 and 1990 the total value of commercial real estate loans issued by U.S. banks tripled, representing an increase from 6.9 percent to 12.0 percent of banks' total assets.[36] Savings and loan institutions (S&Ls) also increased their commercial real estate loan portfolios as the proportion of their portfolios in residential mortgage lending declined.[37]

From the late 1980s, however, the value of commercial real estate properties rapidly declined, and by 1991 a large proportion of banks' commercial real estate loans were either non-performing or foreclosed.[38] Residential property values also fell nine percent from

[34] *See* C. Alan Garner, *Is Commercial Real Estate Reliving the 1980s and Early 1990s?,* Federal Reserve Bank of Kansas City—Economic Review, at 91 (Fall 2008) (online at www.frbkc.org/Publicat/ECONREV/PDF/3q08Garner.pdf) (hereinafter "Garner Economic Review Article").

[35] Jim Clayton, *Cap Rates & Real Estate Cycles: A Historical Perspective with a Look to the Future,* Cornerstone Real Estate Advisors (June 2009) (online at www.cornerstoneadvisers.com/research/CREACapRates.pdf). A more detailed description of the causes of the 1980s crisis appears in Annex I, *infra.*

[36] This does not include the quantities being loaned by credit unions or thrift institutions. *See* Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future,* at 152 (Dec. 1997) (online at www.fdic.gov/bank/historical/history/137__165.pdf) (hereinafter "History of the Eighties").

[37] *Id.,* at 26.

[38] *Id.,* at 153.

1980 to 1985.[39] Due to the more localized nature of banking during this period—the result of public policies at both the federal and state levels that discouraged or even prohibited interstate banking and branching—states such as Texas and Florida were affected more severely than other areas.[40] Unable to recoup their losses, roughly 2,300 lending institutions failed, and the government was forced to expend $157.5 billion (approximately $280 billion in 2009 dollars)[41] protecting depositors' funds and facilitating the closure or restructuring of these organizations.

Between 1986 and 1994, 1,043 thrift institutions and 1,248 banks failed, with total assets of approximately $726 billion (approximately $1.19 trillion in 2009 dollars).[42] Although the commercial real estate market was not the only market suffering a downturn at this time and therefore cannot be labeled as the only cause of these failures, an analysis of bank assets indicates that those institutions that had invested heavily in commercial real estate during the preceding decade were substantially more likely to fail than those that had not.[43]

Congress responded to the banking and thrift crisis of the 1980s by passing the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989. This Act consolidated the major federal deposit insurance programs under the authority of the Federal Deposit Insurance Corporation (FDIC) and created the Resolution Trust Corporation (RTC), which was tasked with liquidating the assets of insolvent thrift institutions and using the revenue to recoup the government's outlays. The RTC is generally considered to have been a successful program.[44]

One consequence of the thrift and banking crisis of the late 1980s and early 1990s was the sharp decline in the number of banks and thrifts: in 1980, there were 14,222 banks, but only 10,313 by 1994. The thrift industry contracted from 3,234 savings and loans in 1986 to 1,645 institutions in 1995. The banking sector also had become more concentrated over this period, with the 25 largest institutions holding 29.3 percent of insured banking deposits in 1980, growing to 42.9 percent in 1994.[45]

From 1990 onward, the commercial real estate market gradually recovered, and by the end of the decade it was once again a popular

[39] Robert Shiller, *Irrational Exuberance* (online at www.econ.yale.edu/¢shiller/data/Fig2-1.xls) (accessed Jan. 27, 2010). Percentage change is inflation adjusted.

[40] See Frederic J. Mishkin, *The Economics of Money, Banking, and Financial Markets* (Addison-Wesley, 2003). *See also* Lawrence J. White, *The S&L Debate: Public Policy Lessons for Bank and Thrift Regulation* (Oxford University Press, 1991).

[41] Inflation-adjusted figures are calculated using the U.S. Bureau of Labor Statistics' Consumer Price Index Inflation Calculator. U.S. Bureau of Labor Statistics, *CPI Inflation Calculator* (online at data.bls.gov/cgi-bin/cpicalc.pl) (accessed Feb. 8, 2010).

[42] $519 billion of these assets belonged to failed thrift institutions, and $207 billion to failed banks ($851.91 billion and $339.78 billion in 2009 dollars, respectively). *See* Timothy Curry and Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences,* FDIC Banking Review, at 26 (Dec. 2000) (online at www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf). *See also* Federal Deposit Insurance Corporation, *Number and Deposits of BIF-Insured Banks Closed Because of Financial Difficulties, 1934 through 1998* (online at www.fdic.gov/about/strategic/report/98Annual/119.html) (accessed at Jan. 15, 2010).

[43] See Rebel A. Cole and George W. Fenn, *The Role of Commercial Real Estate Investments in the Banking Crisis of 1985–92,* at 13 (Nov. 1, 2008) (online at ssrn.com/abstract=1293473) (hereinafter "Cole and Fenn").

[44] COP August Oversight Report, *supra* note 5, at 40; Congressional Oversight Panel, *April Oversight Report: Assessing Treasury's Strategy: Six Months of TARP,* at 49–50 (Apr. 7, 2009) (online at cop.senate.gov/documents/cop-040709-report.pdf).

[45] *See* Stephen Rhoades, *Bank Mergers and Industrywide Structure,* 1980–1994, at 25 (Jan. 1996) (online at www.federalreserve.gov/pubs/StaffStudies/1990-99/ss169.pdf).

investment option.[46] There were three broad reasons. First, the basic factors necessary for market recovery were present: the economy was in a sustained upswing, which meant that the demand for office and retail space was still growing, and the monetary and regulatory problems that had allowed the market to run out of control had been resolved.[47]

Second, the collapse prompted a restructuring of how the commercial real estate market operated, which in turn brought new investments. Many commercial property owners viewed going public—moving from private ownership to the public real estate investment trust (REIT) model (rarely used before 1990)—as a way to recapitalize their holdings and operations, and thereby avoid bankruptcy. These proved remarkably popular, and between 1992 and 1997, approximately 150 REITs were organized, with aggregate equity value escalating from $10 billion to over $175 billion during that period.[48] At the same time, Wall Street banks—hitherto largely uninvolved in commercial real estate—saw the defaulted loans the RTC was selling as a good opportunity to move into the real estate market for a low entry cost.[49] These banks also came up with a proposal for how the RTC could dispose of the billions of dollars in thrift loans that were not in default: create commercial mortgage-backed securities. These proved to be popular, too, and attracted considerable investment.[50]

In addition to the need for the government to dispose of these financial assets, the Tax Reform Act of 1986, which created the Real Estate Mortgage Investment Conduit (REMIC), facilitated the issuance of mortgage securitizations, including CMBS.

Finally, although the bursting of the technology bubble of 2001 had negative repercussions across all markets, it caused investors to become wary of new industries and move back toward more traditional investment opportunities like commercial real estate. It helped that most REITs were continuing to report double-digit rates of return.[51] This extra investment shored up the commercial real estate market in a time when most other markets were suffering.[52]

2. Recognition of Commercial Real Estate Problems Before the Crisis Broke

During the boom in residential real estate in the early to mid–2000s, larger institutions and less regulated players came to dominate most credit offerings to individual consumers, such as home mortgages and credit cards.[53] In response to this increased com-

[46] Roger Thompson, *Rebuilding Commercial Real Estate,* HBS Alumni Bulletin (Jan. 9, 2006) (online at hbswk.hbs.edu/item/5156.html) (hereinafter "Rebuilding Commercial Real Estate").

[47] *See* HighBeam Business, *Operators of Nonresidential Buildings Market Report* (online at business.highbeam.com/industry-reports/finance/operators-of-nonresidential-buildings) (hereinafter "Nonresidential Buildings Market Report") (accessed Jan. 19, 2010).

[48] *See* Rebuilding Commercial Real Estate, *supra* note 46.

[49] *See* Rebuilding Commercial Real Estate, *supra* note 46.

[50] *See* Rebuilding Commercial Real Estate, *supra* note 46.

[51] *See* Rebuilding Commercial Real Estate, *supra* note 46.

[52] *See* Nonresidential Buildings Market Report, *supra* note 47 (accessed Jan. 19, 2010); *see also* Rebuilding Commercial Real Estate, *supra* note 46.

[53] Federal Deposit Insurance Corporation, *The Future of Banking in America: Community Banks: Their Recent Past, Current Performance, and Future Prospects* (Jan. 2005) (online at www.fdic.gov/bank/analytical/banking/2005jan/article1.html); Senate Committee on Banking, Housing, and Urban Affairs, Testimony of John Dugan, Comptroller of the Currency, *The State of the Banking Industry,* 110th Cong. (Mar. 4, 2008) (online at banking.senate.gov/public/

petition in other areas, smaller and community banks increased their focus on commercial real estate lending.[54] Commercial real estate lending, which typically requires greater investigation into individual loans and borrowers, also caters to the strengths of smaller and community financial institutions.[55] As a result, these smaller institutions could generate superior returns in commercial real estate, and many institutions grew to have high commercial real estate concentrations on their balance sheets.

At the same time, commercial real estate secured by large properties with steady income streams, the highest quality borrowers in the space, gravitated towards origination by larger institutions with subsequent distribution to the CMBS market.[56] These properties typically require larger loans than smaller and community banks can provide, and the greater resources of larger institutions and the secondary market can better satisfy these needs.[57] The CMBS market therefore captured many of the most secure commercial real estate investments.

In combination, these two trends meant that, even absent a commercial real estate bubble or weak economic conditions, smaller and community banks would have greater exposure to a riskier set of commercial real estate loans. Alongside substantial asset price corrections and deteriorating market fundamentals, these conditions put smaller and community banks at much greater risk than the collapse in residential real estate did.

By early 2006, bank supervisors had reason to be concerned about the state of the commercial real estate sector. As was happening in the residential market, a confluence of low interest rates, high liquidity in the credit markets, a drop in underwriting standards, and rapidly rising "bubble" values produced a boom in "bubble-induced" construction and real estate sales based on a combination of unrealistic projections and relaxed underwriting standards.[58] In 2005 and 2006, a survey of the 73 largest national banks found that their loan standards were weakening, as Figure 4 shows.[59] The banks' commercial real estate lending portfolios were

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index.cfm?FuseAction=Files.View&FileStore__id=44b0e0bc-10ee-447b-a1e8-8211ea4c70dc) (hereinafter "Dugan Testimony, March 4, 2008 Senate Banking Hearing").

[54] Dugan Testimony, Dugan Testimony, March 4, 2008 Senate Banking Hearing, *supra* note 53. *See also* Board of Governors of the Federal Reserve System, *Speech of Chairman Ben S. Bernanke to the Independent Community Bankers of America National Convention and Techworld* (Mar. 8, 2006) (online at www.federalreserve.gov/newsevents/speech/Bernanke20060308a.htm) (hereinafter "Bernanke Community Bankers Speech") (discussing the evolution of unsecured personal lending from a relationship lending paradigm to a highly quantitative paradigm more suitable for larger financial institutions).

[55] Bernanke Community Bankers Speech, *supra* note 54. *See also* Dugan Testimony, Dugan Testimony, March 4, 2008 Senate Banking Hearing, *supra* note 53.

[56] Dugan Testimony, Dugan Testimony, March 4, 2008 Senate Banking Hearing, *supra* note 53; Richard Parkus, *The Outlook for Commercial Real Estate and Its Impact on Banks,* at 17 (Jul. 30, 2009) (online at www.cre.db.com/sites/default/files/docs/research/cre__20090730.pdf). The CMBS market is discussed below, in Section E.2.

[57] Dugan Testimony, Dugan Testimony, March 4, 2008 Senate Banking Hearing, *supra* note 53.

[58] Federal Deposit Insurance Corporation, *Financial Institution Letters: Managing Commercial Real Estate Concentrations in a Challenging Environment* (March 17, 2008) (online at www.fdic.gov/news/news/financial/2008/fil08022.html) (hereinafter "Financial Institution Letters").

[59] Office of the Comptroller of the Currency, *Survey of Credit Underwriting Practices 2006,* at 25–27 (Oct. 2006) (online at www.occ.treas.gov/2006Underwriting/2006UnderwritingSurvey.pdf) (hereinafter "Survey of Credit Underwriting Practices").

also becoming riskier, as shown in Figure 5, and the outlook over the next 12 months was for the risks to continue to grow.[60]

FIGURE 4: CHANGES IN UNDERWRITING STANDARDS FOR NON-CONSTRUCTION COMMERCIAL REAL ESTATE LOANS [61]

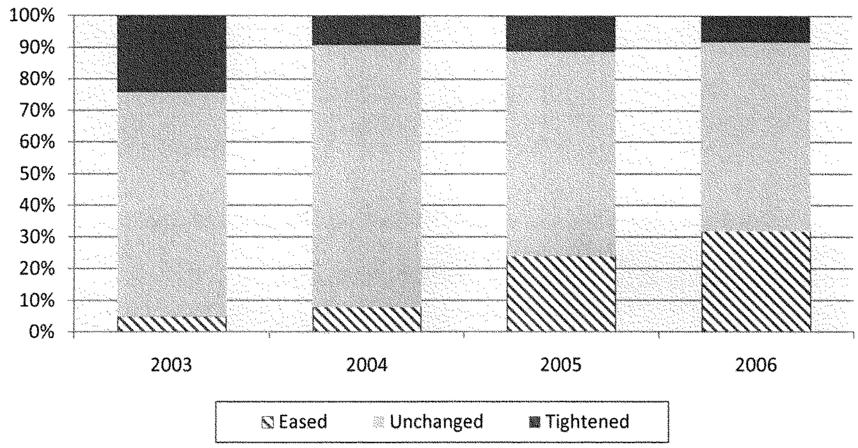
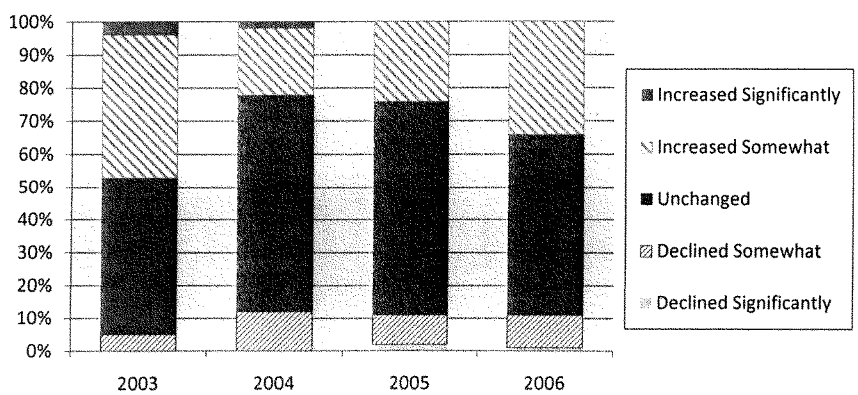


FIGURE 5: CHANGES IN THE LEVEL OF CREDIT RISK IN BANK PORTFOLIOS FOR NON-CONSTRUCTION COMMERCIAL REAL ESTATE LOANS [62]

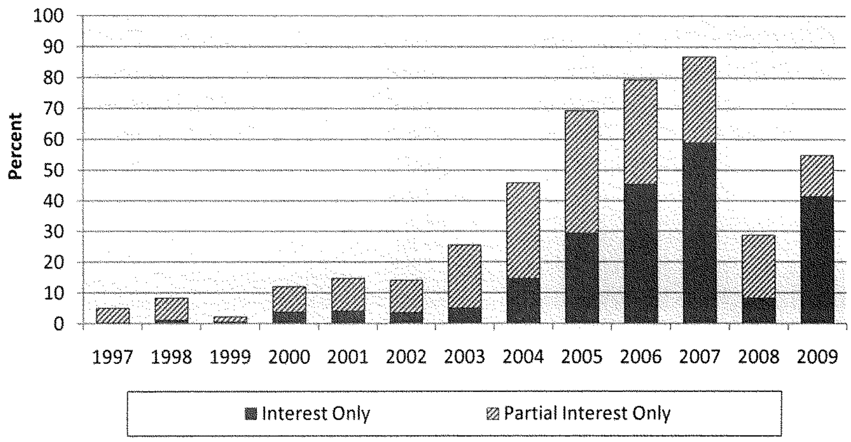


Lax underwriting was also evident in CMBS deals from 2005 to 2007. In the late 1990s, only six to nine percent of the loans in CMBS transactions were interest-only loans, during the term of which the borrower was not responsible for paying down principal, as Figure 6 shows. By 2005, that figure had climbed to 48 percent, and by 2006, it was 59 percent.[63] The Government Accountability

[60] *Id.,* at 25–27.
[61] *Id.,* at 25–27.
[62] *Id.,* at 25–27.
[63] Bloomberg data (accessed Jan. 12, 2010).

Office (GAO) found in a report this month that CMBS underwriting standards were at their worst in 2006–2007.[64]

FIGURE 6: PERCENTAGE OF CMBS THAT WERE INTEREST-ONLY AND PARTIAL INTEREST-ONLY AT ORIGINATION, BY YEAR [65]



But weakened underwriting was not the only reason for supervisors to be concerned. In fact, beginning in 2003, the Office of the Comptroller of the Currency (OCC) conducted an examination of commercial real estate lending across multiple institutions and found increasing policy exceptions, lengthening maturities, and a lack of quality control and independence in the appraisal process.[66] At the same time that loans were growing riskier, many banks' portfolios were becoming less diversified generally and more concentrated in commercial real estate lending. In 2003, banks with assets of $100 million to $1 billion had commercial real estate portfolios equal to 156 percent of their total risk-based capital. That figure had risen to 318 percent by the third quarter of 2006.[67] The concentrations were particularly worrisome in the West and the Southeast. By June 2005, in the FDIC's San Francisco region, which covers 11 states including California, Arizona, and Nevada, commercial real estate lending at 60 percent of banks amounted to

[64] Government Accountability Office, *Troubled Asset Relief Program: Treasury Needs to Strengthen its Decision-Making Process on the Term Asset-Backed Securities Liquidity Facility* at 29 (Feb. 2010) (online at www.gao.gov/new.items/d1025.pdf) (hereinafter "GAO TALF Report") (also noting that commercial real estate prices have been falling since early 2008, and CMBS delinquencies have been rising, and stating: "The Federal Reserve and Treasury have continued to note their ongoing concerns about this segment of the market").

[65] Bloomberg data (accessed Jan. 12, 2010). "Interest only" refers to the original percentage of the loans comprising the collateral that are fully interest only, meaning that they do not amortize. "Partial interest only" refers to the original percentage of the loans comprising the collateral that are partially interest only, meaning that they do not amortize over part of the term.

[66] Office of the Comptroller of the Currency, *Remarks by John C. Dugan, Comptroller of the Currency, Before the New York Bankers Association, New York, New York* (Apr. 6, 2006) (online at www.occ.treas.gov/ftp/release/2006-45a.pdf) (hereinafter "Dugan Remarks Before the New York Bankers Association").

[67] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, *Concentrations in Commercial Real Estate, Sound Risk Management Practices* (Jan. 9, 2006) (online at www.occ.treas.gov/ftp/release/2006-2a.pdf) (hereinafter "Agencies Proposed Guidance").

more than three times their capital levels.[68] The picture was only slightly less worrisome in the Atlanta region, which covers seven states; the percentage of banks in the region that exceeded the 300 percent threshold was 48 percent.[69] The broader market environment exacerbated the problem because when mortgage markets froze, builders could not find buyers, and the need for developed lots decreased dramatically, causing many developers to leave behind unfinished projects with loans that could not be serviced.[70]

3. During the Late 2000s

Revelations about deteriorating loan performance in subprime residential mortgages and resulting declines in the value of residential mortgage backed securities (RMBS), collateralized debt obligations (CDOs), and other instruments began in the spring of 2007.[71] The problems continued to worsen through the summer of 2007.[72] As the extent of this crisis became apparent, analysts began warning of a potential follow-on crisis in commercial real estate.

In November 2007, a Moody's report and a Citigroup analyst's note both predicted falling asset prices and trouble for commercial real estate similar to the crisis in the residential real estate market.[73] Other experts sounded an alarm about commercial real estate as part of a broader alarm about the worsening of the financial crisis. In testimony before the House Financial Services Committee, Professor Nouriel Roubini predicted that "the commercial real estate loan market will soon enter into a meltdown similar to the subprime one." [74]

This view was by no means unanimous. During late 2007 and early 2008, a number of commentators challenged the assertion

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[68] Federal Deposit Insurance Program, Office of the Inspector General, *FDIC's Consideration of Commercial Real Estate Concentration Risk in FDIC-Supervised Institutions,* at 2 (Feb. 2008) (Audit Report No. 08–005) (online at www.fdicig.gov/reports08/08-005.pdf) (hereinafter "FDIC's Audit Report").

[69] *Id.,* at 2.

[70] Congressional Oversight Panel, Testimony of Chris Burnett, chief executive officer, Cornerstone Bank, *Atlanta Field Hearing on Commercial Real Estate* (Jan. 27, 2009) (online at cop.senate.gov/hearings/library/hearing-012710-atlanta.cfm) (hereinafter "COP Field Hearing in Atlanta Testimony of Chris Burnett").

[71] *See, e.g.,* Senate Committee on Banking, Housing & Urban Affairs, Subcommittee on Securities, Insurance and Investment, Written Testimony of Warren Kornfeld, Managing Director, Moody's Investors Service, *Subprime Mortgage Market Turmoil: Examining the Role of Securitization,* 110th Cong., at 14 (Apr. 17, 2007) (online at banking.senate.gov/public/index.cfm?FuseAction=Hearings.List&Month=0&Year=2007) ("Pools of securitized 2006 mortgages have experienced rising delinquencies and loans in foreclosure, but due to the typically long time to foreclose and liquidate the underlying property, actual losses are only now beginning to be realized"); New Century Financial Corporation, *New Century Financial Corporation Files for Chapter 11; Announces Agreement to Sell Servicing Operations* (Apr. 2, 2007) (online at www.prnewswire.com/news-releases/new-century-financial-corporation-files-for-chapter-11-announces-agreement-to-sell-servicing-operations-57759932.html).

[72] G.M. Filisko, *Subprime Lending Fallout,* National Real Estate Investor (July 1, 2007) (online at nreionline.com/finance/reit/real_estate_subprime_lending_fallout/).

[73] See, e.g., John Glover and Jody Shen, *Deadbeat Developers Signaled by Property Derivatives,* Bloomberg (Nov. 28, 2007) (online at www.bloomberg.com/apps/news?pid=newsarchive&sid=au2XBiCyWeME); Peter Grant, *Commercial Property Now Under Pressure,* Wall Street Journal (Nov. 19, 2007); Moody's Investor Service, *Moody's/REAL Commercial Property Price Indices, November 2007,* at 1 (Nov. 16, 2007) (online at www.realindices.com/pdf/CPPI_1107.pdf).

[74] *See, e.g.,* House Committee on Financial Services, Written Testimony of Nouriel Roubini, Professor of Economics, New York University Stern School of Business, *Monetary Policy and the State of the Economy,* 110th Cong. (Feb. 26, 2008) (online at financialservices.house.gov/hearing110/roubini022608.pdf).

that the commercial real estate market was in crisis, and anticipated no collapse.[75]

FDIC senior management also identified commercial real estate as a potential problem during early 2008. Chairman Sheila Bair testified before the Senate Banking Committee in March and June 2008, both times emphasizing smaller banks' concentrated holdings of problematic commercial real estate investments.[76] This position represented a shift in emphasis from her position in December 2007, when she distinguished the current market difficulties from the S&L crisis because of the earlier crisis' roots in commercial real estate problems.[77]

In June 2008, the FDIC indicated that its examiners were aware of the potential for a crisis and continued to press banks that were not in compliance with 2006 interagency guidance on concentrations in commercial real estate.[78] However, the FDIC Inspector General's Material Loss Review found cases in which examiners did not call for action by the FDIC in resolving the troubled bank involved soon enough.[79]

The OCC and the Federal Reserve Board (Federal Reserve), like the FDIC, also noted that many of their regulatory charges were potentially overexposed in commercial real estate.[80] Similarly, both

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[75] While these analysts noted the downturn in commercial real estate, they expressed the opinion that market fundamentals were sound. *See, e.g.,* Mortgage Bankers Association, *Commercial Real Estate/Multifamily Finance Quarterly Data Book: Q4 2007,* at 55 (Mar. 26, 2008) (online at www.mortgagebankers.org/files/Research/DataBooks/2007fourthquarterdatabook.pdf); Keefe, Bruyette & Woods, *KRX Monthly: Is Commercial Real Estate Next?,* at 1 (Mar. 4, 2008) (online at www2.snl.com/InteractiveX/ResearchRpts/ResearchReportDetails.aspx?KF=5701364&persp=rr&KD=7424418); Lew Sichelman, *Major Fall in CRE Deals Since End of Summer,* National Mortgage News (Nov. 5, 2007) (online at nationalmortgagenews.com/premium/archive/?id=157677).

[76] Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Sheila Bair, Chair, Federal Deposit Insurance Corporation, *The State of the Banking Industry: Part II,* 110th Cong., at 4–5 (June 5, 2008) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9708bf58-20ac-4aa9-9240-f0d772a1be25) (hereinafter "June 5, 2008 Written Testimony of Sheila Bair"); Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Sheila Bair, Chair, Federal Deposit Insurance Corporation, *The State of the Banking Industry,* 110th Cong., at 11-12 (Mar. 4, 2008) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=093111d0-c4fe-47f30-a87a-b103f0513f7a) (hereinafter "March 4, 2008 Written Testimony of Sheila Bair").

In responding to comments received on their proposed guidance on commercial real estate lending in 2006, the supervisors noted the concerns that smaller institutions expressed about the fact that real estate lending had become their "bread and butter" business in part because other lending opportunities for these smaller banks have dwindled over time. Many observers have noted that small and medium sized banks have lost market share in credit card lending and mortgage financing, for example, leaving them less diversified and with portfolios concentrated on riskier loans such as commercial real estate. This, in turn, reflects the larger trends in financial intermediation, particularly the growth in securitization of mortgages and consumer and credit card loans as well as the economies of scale that allow the largest banks to originate such loans in large volumes either for their own portfolios or for inclusion in asset backed or mortgage backed securities. *See* Agencies Proposed Guidance, *supra* note 67. *See, e.g.,* Timothy Clark et al., *The Role of Retail Banking in the U.S. Banking Industry: Risk, Return, and Industry Structure,* FRBNY Economic Policy Review, at 39, 45–46 (Dec. 2007) (online at www.newyorkfed.org/research/epr/07v13n3/0712hirt.pdf); Joseph Nichols, *How Has the Growth of the CMBS Market Impacted Commercial Real Estate Lending at Banks?,* CMBS World, at 18, 19–20 (Summer 2007) (online at www.cmsaglobal.org/cmbsworld/cmbsworld_toc.aspx?folderid=1386).

[77] House Committee on Financial Services, Testimony of Sheila Bair, Chairman, Federal Deposit Insurance Corporation, *Hearing on Foreclosure Prevention,* at 37, 110th Cong. (Dec. 6, 2007) (online at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:40435.pdf).

[78] *See, e.g.,* June 5, 2008 Written Testimony of Sheila Bair, *supra* note 76, at 13.

[79] Federal Deposit Insurance Corporation, Office of Inspector General, *Semiannual Report to the Congress,* at 13 (Oct. 30, 2009) (online at www.fdicoig.gov/semi-reports/SAROCT09/OIGSemi_FDIC_09-9-09.pdf). *See* Section H.1, below.

[80] Senate Committee on Banking, Housing, and Urban Affairs, Written Testimony of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System, *The State of the*

Continued

agencies focused on ensuring that their examiners who supervised smaller and community banks with large commercial real estate exposures acted within the boundaries of the 2006 interagency guidance.[81]

In contrast to the FDIC, Federal Reserve, and OCC, Treasury's public statements and initiatives during late 2007 and early 2008 concentrated mostly on the residential real estate sector. To the extent that Treasury discussed commercial real estate, it did so in the context of a broader real estate market contraction or in the context of write-downs on CMBS.[82]

In the months leading up to the financial crisis and the panic atmosphere that surrounded the consideration of EESA, the Act giving the Treasury Secretary the authority to establish the TARP, both private analysts and bank supervisors began noticing warning signs that a commercial real estate collapse could endanger the health of the financial system. But, again, these warnings typically took place alongside more dire warnings about the crisis in the residential real estate market.[83]

4. Emergency Economic Stabilization Act and the TARP

During consideration of EESA, concerns about the commercial real estate market occasionally surfaced as part of the floor debate in both houses of Congress, especially in the context of critiquing the bill for not doing more to protect the interests of commercial real estate borrowers and lenders. For example, Representative Steven LaTourette criticized the practice of bank examiners insisting that banks write down commercial real estate assets that had declined in value, resulting in decreased credit capacity for community needs like additional commercial real estate development.[84] Senator Orrin Hatch similarly highlighted the need to preserve commercial real estate expansion and construction as part of broader economic needs not addressed in EESA.[85]

Banking Industry, 110th Cong. (Mar. 4, 2008) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5496f28d-b49b-4a58-befa-8bb3708de3cb) (hereinafter "Written Testimony of Donald Kohn"); Dugan Testimony, March 4, 2008 Senate Banking Hearing, *supra* note 53.

[81] Written Testimony of Donald Kohn, *supra* note 80.

[82] Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Henry M. Paulson, Jr., Secretary of the Treasury, *Recent Developments in U.S. Financial Markets and Regulatory Responses to Them,* 110th Cong. (July 15, 2008) (online at banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=8f6a9350-3d39-43a0-bbfb-953403ab19cc).

[83] John McCune, *First-half 2008: far from a pretty picture,* ABA Banking Journal, at 7 (Sept. 1, 2008) ("The impact of the [residential real estate] collapse also appeared to be percolating down into the commercial real estate lending segment. . . . It remains to be seen if this is the start of a larger trend, but is certainly something worth paying attention to"); Mark Vitner, Senior Economist, Wachovia, and Anika R. Khan, Economist, Wachovia, *Could housing tremors shake commercial real estate?,* ABA Banking Journal, at 56 (May 1, 2008) ("The abrupt collapse of the subprime mortgage market and severe correction in home construction and prices has raised concerns the same thing could happen to commercial real estate").

[84] Statement of Congressman Steven LaTourette, Congressional Record, H10386-87 (Sept. 29, 2008) ("[I]f you are a bank and you have a million dollar building in your portfolio but because the real estate market isn't doing so well, the bank examiners have come in and they have said your building is only worth $400,000 today. You haven't sold it. Nothing has happened to it. You are still collecting rent on it, but you have taken a $600,000 hit on your balance sheet. That has a double-edged effect in that now that you have a reduced balance sheet, you have to squirrel more cash so you can't make loans to people wanting to engage in business, people wanting to buy homes").

[85] Statement of Senator Orrin Hatch, Congressional Record, S10263 (Oct. 1, 2008) ("The rest of the economy is in urgent need of attention too. . . . We need to keep business fixed investment in new plant and equipment and commercial construction moving forward. That would

This legislative concern about commercial real estate assets translated into specific authority in the final legislation to address commercial real estate problems. EESA signals that troubled commercial real estate assets, like residential assets, are important to financial stability. The statute itself identifies commercial mortgages, as well as securities based on, or derivatives of, commercial mortgages, as troubled assets, that Treasury may purchase without a written determination that such a purchase is necessary for financial stability.[86] In contrast, other financial instruments require that Treasury deliver such a written determination to Congress prior to making a purchase.[87]

Given congressional concerns regarding commercial real estate, the Panel has conducted previous work on the potential problems in the commercial real estate market. The Panel held a field hearing in New York about commercial real estate credit, hearing from analysts, market participants, and supervisors.[88] In its June Report, the Panel addressed the failure to capture the risk posed by commercial real estate loans as a major shortcoming of the stress tests conducted under the Supervisory Capital Assistance Program in May 2009.[89] The Panel further addressed the risks posed by commercial real estate assets in its August Report on the continuing presence of troubled assets on bank balance sheets.[90] This report, as well as its January 27, 2010 field hearing in Atlanta, followed and amplified these efforts.

D. Present Condition of Commercial Real Estate

The commercial real estate market is currently experiencing considerable difficulty for two distinct reasons. First, the current economic downturn has resulted in a dramatic deterioration of commercial real estate fundamentals. Increasing vacancy rates and falling rental prices present problems for all commercial real estate loans. Decreased cash flows will affect the ability of borrowers to make required loan payments. Falling commercial property values result in higher LTV ratios, making it harder for borrowers to refinance under current terms regardless of the soundness of the original financing, the quality of the property, and whether the loan is performing.

Second, the development of the commercial real estate bubble, as discussed above, resulted in the origination of a significant amount of commercial real estate loans based on dramatically weakened underwriting standards. These loans were based on overly aggressive rental or cash flow projections (or projections that were only sustainable under bubble conditions), had higher levels of allowable leverage, and were not soundly underwritten. Loans of this sort (somewhat analogous to "Alt-A" residential loans) will encounter

help keep employment, productivity, and wages growing, and keep the rest of the economy healthy").

[86] The mortgage must have been originated, or the security or derivative must have been issued, prior to March 14, 2008. Residential mortgages, securities, or derivatives also fall into this category of Treasury's purchasing authority. 12 U.S.C. § 5202(9)(A).

[87] 12 U.S.C. § 5202(9)(B).

[88] Congressional Oversight Panel, *The Impact of Economic Recovery Efforts on Corporate and Commercial Real Estate Lending* (May 28, 2009) (online at cop.senate.gov/documents/transcript-052809-newyork.pdf).

[89] COP June Oversight Report, *supra* note 6.

[90] COP August Oversight Report, *supra* note 5.

far greater difficulty as projections fail to materialize on already excessively leveraged commercial properties.

In both cases, inherently risky construction loans and the non-recourse nature of permanent commercial real estate financing increase the pressures that both lenders and borrowers face. Construction loans are experiencing the biggest problems with vacancy or cash flow issues, have the highest likelihood of default, and have higher loss severity rates than other commercial real estate loans. (For example, the 25 institutions from the Atlanta area that failed since 2008 reported weighted average ADC loans of 384 percent of total capital a year before their failure.[91] Because a lender's recovery is typically limited to the value of the underlying property, commercial real estate investments are increasingly at risk as LTV ratios rise or the value of the collateral is no longer sufficient to cover the outstanding loan amount.

The following three sections further analyze the current state of the commercial real estate market and the risks posed to financial institutions by commercial real estate loans. This section, Section D, discusses the overall condition of the economy and how negative economic growth, rising unemployment rates, and decreased consumer spending have impacted commercial real estate fundamentals. Section E discusses the current landscape of the commercial real estate market, including current levels of commercial real estate whole loans and CMBS by holding institution, property type, and geographic region. Section F discusses the risks posed by the current state of the commercial real estate market, such as credit risk (the risk that loans will default prior to maturity), term risk (the risk that loans will default at maturity or will be unable to refinance), the risk that borrowers will be unable to obtain financing for commercial real estate purchases or developments, and interest rate risk (the risk that rising interest rates will make it harder for borrowers to finance or refinance loans).

Again, no single factor is as important to the state of the commercial real estate markets as a steady, and indeed swift, economic recovery. It is questionable whether loans financing properties on the basis of unrealistic projections, inflated values, and faulty underwriting during 2005–2007 can survive in any event, as discussed more fully below. But it is more important to recognize that the continuing deep recession that the economy is experiencing is putting at risk many sound commercial real estate investments that were soundly conceived and reasonably underwritten.

Economic growth and low unemployment rates lead to greater demand for, and occupancy of, commercial office space, more retail tenants and retail sales, and greater utilization of travel and hospitality space.[92] Without more people in stores, more people at hotels, more people able to afford new or larger apartments, and more businesses seeking new or larger office space and other commercial

[91] Congressional Oversight Panel, Written Testimony of Doreen Eberley, acting regional director, Atlanta Regional Office of the Federal Deposit Insurance Corporation, *Atlanta Field Hearing on Commercial Real Estate,* at 4, (Jan. 27, 2010) (online at cop.senate.gov/documents/testimony-012710-eberley.pdf) (hereinafter "Written Testimony of Doreen Eberley").

[92] See Congressional Oversight Panel, Written Testimony of Chris Burnett, chief executive officer, Cornerstone Bank, *Atlanta Field Hearing on Commercial Real Estate*, at 3–6 (Jan. 27, 2010) (online atcop.senate.gov/documents/testimony-012710-burnett.pdf) (hereinafter "Written Testimony of Chris Burnett").

property, the markets cannot recover and the credit and term risk created by commercial real estate loans cannot abate without the potential imposition of substantial costs on lenders. Each of these factors has its own impact on the broader commercial real estate problem. Thus, retail and hotel-tourist property problems likely reflect reduced cash flows not only from unemployment but also from household deleveraging, i.e., higher family savings rates. Perhaps even more important, the problem property owners and lenders face derives both from an undersupply of tenants and purchasers, and economic pressures that reduce incentives for the flow of new sources of equity into the commercial real estate markets.

1. Economic Conditions and Deteriorating Market Fundamentals

The health of the commercial real estate market depends on the health of the overall economy. Consequently, the market fundamentals will likely stay weak for the foreseeable future.[93] This means that even soundly financed projects will encounter difficulties. Those projects that were not soundly underwritten will likely encounter far greater difficulty as aggressive rental growth or cash flow projections fail to materialize, property values drop, and LTV ratios rise on already excessively leveraged properties. New and partially constructed properties are experiencing the biggest problems with vacancy and cash flow issues (leading to a higher number of loan defaults and higher loss severity rates than other commercial property loans).[94] Falling commercial property prices are increasing debt-to-equity ratios, decreasing the amount of equity the borrower holds in the property (putting pressure on the borrowers) and removing the cushion that lenders built into non- recourse loans to protect their original investments (putting pressure on the lenders).

Since the summer of 2007, the ongoing economic crisis has spread from credit markets, through the financial sector, and into the broader economy. Economic indicators are sending mixed signals as to whether the worst is over or whether the nation should expect further weakening in the economy. Economic growth has only recently returned after several quarters of decline, suggesting that a recovery is beginning. However, despite recent positive Gross Domestic Product (GDP) numbers, unemployment has risen to levels not seen in decades. Figures 7 and 8 illustrate the evolution of the current economic downturn.

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[93] See, e.g., Congressional Oversight Panel, Written Testimony of Jon D. Greenlee, associate director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System, *Atlanta Field Hearing on Commercial Real Estate,* at 5–6 (Jan. 27, 2010) (online at cop.senate.gov/documents/testimony-012710-greenlee.pdf) (hereinafter "Written Testimony of Jon Greenlee").

[94] *Id.,* at 7 ("As job losses continue, demand for commercial property has declined, vacancy rates increased, and property values fallen. The higher vacancy levels and significant decline in the value of existing properties have placed particularly heavy pressure on construction and development projects that do not generate income until after completion").

FIGURE 7: SEASONALLY ADJUSTED ANNUAL GDP GROWTH RATES [95]

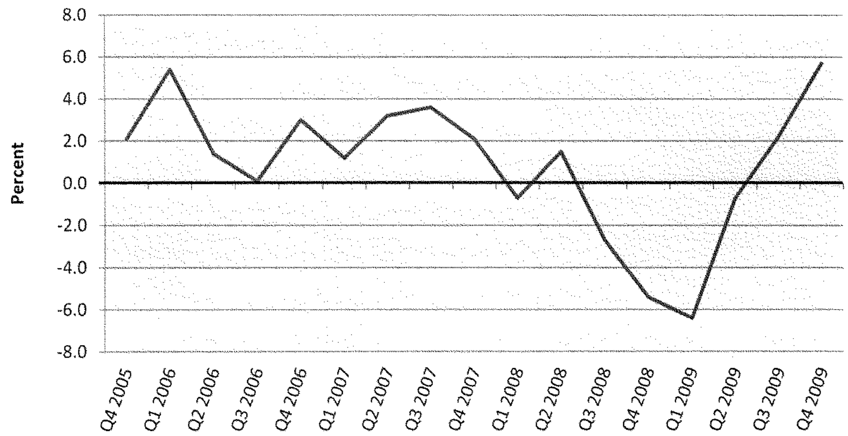
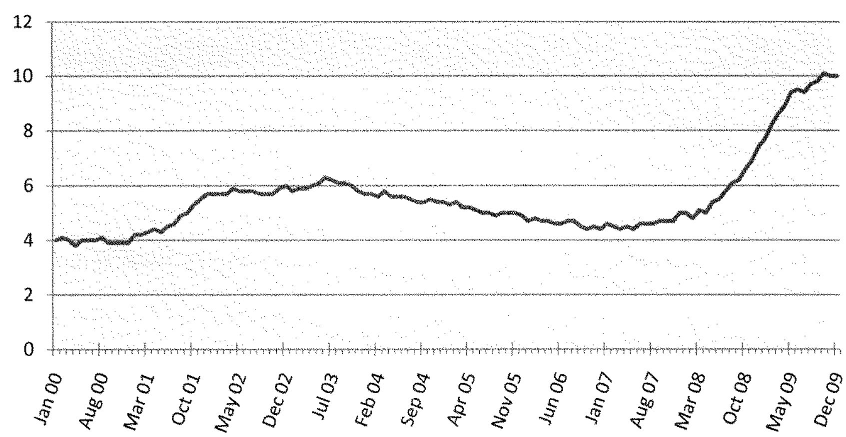


FIGURE 8: UNEMPLOYMENT RATES SINCE 2000 [96]



[95] U.S. Department of Commerce, Bureau of Economic Analysis, *Gross Domestic Product: Third Quarter* 2009 (Dec. 22, 2009) (online at www.bea.gov/ newsreleases/ national/gdp/2009/xls/ gdp3q09__3rd.xls). The Bureau of Economic Analysis provides that the acceleration in real GDP growth in Q4 2009, based on their advance estimate, primarily reflected an acceleration in private inventory replenishment (adding 3.4 percentage points to the fourth quarter change of 5.7 percent), a deceleration in imports (increasing 10.5 percent in Q4, as compared to a 21.3 percent increase in Q3), and an upturn in nonresidential fixed investment (increasing 2.9 percent in Q4, as compared to a 5.9 percent decrease in Q3) that was partly offset by decelerations in federal government spending (increasing 0.1 percent in Q4, as compared to an 8.0 percent increase in Q3) and in personal consumption expenditures (increasing 2.0 percent in Q4, as compared to a 2.8 percent increase in Q3). U.S. Department of Commerce, Bureau of Economic Analysis, *Gross Domestic Product: Fourth Quarter 2009 (Advance Estimate)*, at 1–2 (Jan. 29, 2010) (online at www.bea.gov/ newsrelease/national/gdp/ gdpnewsrelease.htm) (hereinafter "BEA Fourth Quarter GDP Estimate"). It is yet to be seen whether this growth, driven in part by inventory replenishment, is sustainable. Sustainability of economic growth will depend, to some extent, on how (or whether) inventory replenishment translates into final sales to domestic purchasers.

[96] Bureau of Labor Statistics, *Employment Status of the Civilian Noninstitutional Population 16 Years and Over, 1970 to Date* (online at ftp.bls.gov/pub/suppl/empsit.cpseea1.txt) (accessed Feb. 9, 2010). Underemployment, an alternative measure of the status of employment, includes a larger percentage of the population and directly follows the trend of unemployment. Both measures illustrate the continuing deterioration of employment conditions since January 2008.

Other economic indicators that are vital to the health of commercial real estate, such as consumer spending, have experienced overall declines from pre-recession levels but do not provide a clear message of recovery. For example, personal consumption has declined from its peak in the fourth quarter of 2007, but quarterly changes have oscillated between positive and negative.[97] The extent and timing of the economic recovery is important in assessing the magnitude of the commercial real estate problem because, as a general rule, commercial real estate metrics tend to lag overall economic performance,[98] and commercial real estate market fundamentals have already deteriorated significantly.

For the last several quarters, average vacancy rates have been rising and average rental prices have been falling for all major commercial property types.[99] The following charts present these changes in average vacancy rates and average rental prices from 2003 to 2009.

As of December 2009, underemployment was 17.3 percent and unemployment was 10 percent. Underemployment, as measured by the Bureau of Labor Statistics, is comprised of the total number of unemployed as well as marginally attached workers, discouraged workers, and individuals employed part-time due to economic factors who would otherwise seek full-time work. For further discussion of the measure, *see* Bureau of Labor Statistics, *Alternative Measures of Labor Utilization* (Dec. 2009) (online at www.bls.gov/ news.release/ empsit.t12.htm). In January 2010, unemployment rates decreased from 10.0 to 9.7 percent and underemployment decreased from 17.3 to 16.5 percent. Bureau of Labor Statistics, *Employment Situation Summary* (Feb. 5, 2010) (online at bls.gov/ news.release/ empsit.nr0.htm); Bureau of Labor Statistics, *Alternative Measures of Labor Utilization* (Jan. 2010) (online at www.bls.gov/ news.release/ empsit.t15.htm). However, for the week ending January 30, 2010, the advance figure for initial jobless claims for unemployment insurance rose to 480,000, an increase of 8,000 from the previous week's revised figure. This was the fourth rise in initial jobless claims in the last five weeks. *See* U.S. Department of Labor, *Unemployment Insurance Weekly Claims Reports,* Feb. 4, 2010 (increase of 8,000), Jan. 28, 2010 (decrease of 8,000), Jan. 21, 2010 (increase of 36,000), Jan. 14, 2010 (increase of 11,000), and Jan. 7, 2010 (increase of 1,000).

[97] U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts Table* (Table 2.3.3: Real Personal Consumption Expenditures by Major Type of Product, Quantity Indexes) (aggregate numbers, indexed to 2005) (online at www.bea.gov/ National/ nipaweb/ TableView.asp? SelectedTable=63&ViewSeries= NO&Java=no&Request3 Place=N&3Place=N&FromView= YES&Freq= Qtr&FirstYear=2007&LastYear= 2009&3Place=N&AllYearsChk= YES&Update=Update &JavaBox=no#Mid) (accessed Feb. 8, 2010) (showing increases in Q2 2008, Q1 2009, and Q3 2009).

[98] Written Testimony of Doreen Eberley, *supra* note 91, at 7–8 ("Performance of loans that have commercial real estate properties as collateral typically lags behind economic cycles. Going into an economic downturn, property owners may have cash reserves available to continue making loan payments as the market slows, and tenants may be locked into leases that provide continuing cash flow well into a recession. However, toward the end of an economic downturn, vacant space may be slow to fill, and concessionary rental rates may lead to reduced cash flow for some time after economic recovery begins"). For example, although the economic recession in the early 2000s officially lasted only from March 2001 to November 2001, commercial real estate vacancies did not peak until September 2003 and did not begin to decline until March 2004. See National Bureau of Economic Research, *Business Cycle Expansions and Contractions* (online at www.nber.org/cycles.html) (accessed Feb. 8, 2010); Mortgage Bankers Association, *Commercial Real Estate/Multifamily Finance Quarterly Data Book: Q3 2009*, at 26–27 (Nov. 2009) (hereinafter "MBA Data Book: Q3 2009").

Commercial real estate fundamentals tend to track unemployment rates, another lagging economic indicator, more closely than GDP growth. The current economic crisis has so far followed this trend, with vacancy rates continuing to rise even after the return of positive economic growth. Similar to unemployment rates, vacancy rates began to fall in 2003, began rising in 2007, and are still rising.

[99] MBA Data Book: Q3 2009, *supra* note 98, at 26–27.

FIGURE 9: COMMERCIAL REAL ESTATE AVERAGE VACANCY RATES BY PROPERTY TYPE [100]

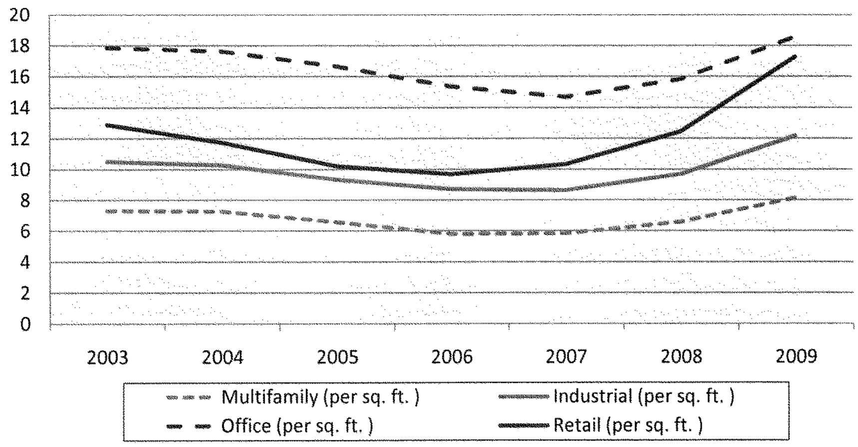
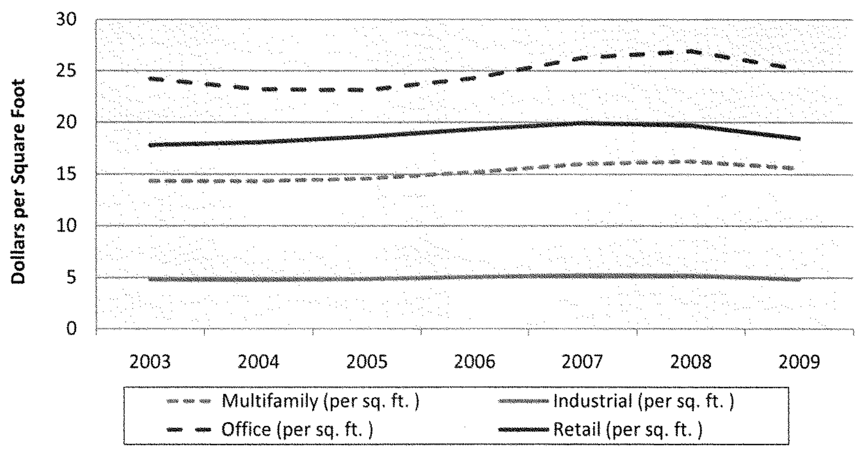


FIGURE 10: COMMERCIAL REAL ESTATE AVERAGE RENTAL PRICES BY PROPERTY TYPE [101]



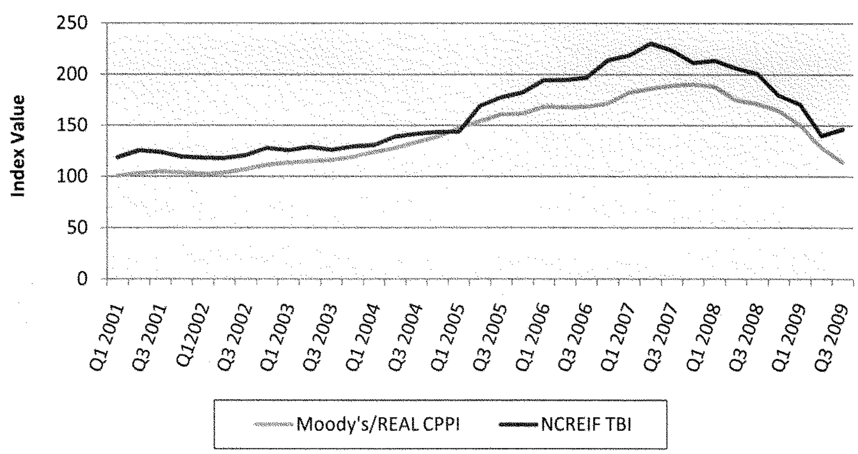
[100] MBA Data Book: Q3 2009, *supra* note 98, at 27. Although average vacancy rates are commensurate with 2003 levels, it should be noted that the levels in 2003 were also the result of recessionary conditions of the early 2000s, vacancy rates have been buffered by the presence of long-term leases on some commercial properties, and the increase in available commercial space has translated into an increasing number of properties with vacancy issues.

[101] MBA Data Book: Q3 2009, *supra* note 98, at 27. *See also* Written Testimony of Doreen Eberley, *supra* note 91, at 4–5 ("As of third quarter 2009, quarterly rent growth has been negative across all major commercial real estate property types nationally for at least the last four quarters. Asking rents for all major commercial real estate property types nationally were lower on both a year-over-year and quarter-over quarter basis").

Current average vacancy rates and rental prices have been buffered by the long-term leases held by many commercial properties (e.g., office and industrial).[102] The combination of negative net absorption rates[103] and additional space that will become available from projects started during the boom years[104] will cause vacancy rates to remain high, and will continue putting downward pressure on rental prices for all major commercial property types. Taken together, this falling demand and already excessive supply of commercial property will cause many projects to be viable no longer, as properties lose, or are unable to obtain, tenants and as cash flows (actual or projected) fall.

In addition to deteriorating market fundamentals, the price of commercial property has plummeted. As seen in the following chart, commercial property values have fallen over 40 percent since the beginning of 2007.[105]

FIGURE 11: COMMERCIAL REAL ESTATE PROPERTY PRICE INDICES[106]



[102] *See* Richard Parkus and Harris Trifon, *The Outlook for Commercial Real Estate and its Implications for Banks*, at 10 (Dec. 2009) (hereinafter "Parkus and Trifon"). See additional discussion of commercial properties at Section B.1.

[103] Net absorption rates are a measure of the change in occupancy levels or vacancy rates. Negative net absorption occurs when the amount of available commercial space (e.g., through lease terminations and new construction) *exceeds* the amount of *space being taken* off the market (e.g., through new leases and renewals).

[104] MBA Data Book: Q3 2009, *supra* note 98, at 28–29 (as shown by the number of net completions).

[105] Moody's Investors Service, *Moody's/REAL Commercial Property Price Indices, December 2009*, at 1 (Dec. 21, 2009) (hereinafter "Dec. 2009 Moody's/REAL Commercial Property Price Indices") ("The peak in prices was reached two years ago in October 2007, and prices have since fallen 43.7%"). However, it should be noted that there was a small uptick in commercial property prices in November. *See* Moody's Investors Service, *Moody's/REAL Commercial Property Price Indices, January 2010*, at 1 (Jan. 15, 2010) ("After 13 consecutive months of declining property values, the Moody's/REAL Commercial Property Price Index (CPPI) measured a 1.0% increase in prices in November. . . . The 1.0% growth in prices seen in November is a small bright spot for the commercial real estate sector, which has seen values fall over 43% from the peak").

[106] *See* Massachusetts Institute of Technology Center for Real Estate, Commercial RE Data Laboratory, *Transactions-Based Index (TBI)* (accessed February 9, 2010) (measuring price movements and total returns based on transaction prices of commercial properties (apartment, industrial, office, and retail) sold from the National Council of Real Estate Investment Fiduciaries (NCREIF) Index database); Dec. 2009 Dec. 2009 Moody's/REAL Commercial Property Price Indi-

Continued

The decline in property value is largely driven by declining cash flows that have resulted from increased vacancy rates and decreased rental income.[107] Contracting cash flows (actual and projected) result in lower net present value calculations. Tightened underwriting standards also decrease the ability of borrowers to qualify for commercial real estate loans, thus decreasing the demand for commercial property.[108] Sharp decreases in the number of sales of commercial and multifamily properties reflect such a decrease in demand.[109]

It should be noted that pricing is in a state of adjustment due to the decrease in the number of sales transactions. In the absence of market comparables, it is difficult to establish property values with any certainty. The few transactions that are occurring are generally focused on distressed borrowers or troubled loans[110] and are being underwritten with higher cap rates, lower initial rents, declining rent growth or cash flow projections, and higher required internal rates of return.[111] When fundamentals stabilize and lending resumes, the number of sales transactions should increase, thereby decreasing the spread between mortgage interest rates and the rate on comparable Treasury securities.[112]

Overall, the general economic downturn, uncertainty about the pace of any recovery, and low expectations for improving commercial real estate market fundamentals mean that prospects for a commercial real estate recovery in the near future are dim.

E. Scope of the Commercial Real Estate Markets

Commercial real estate markets currently absorb $3.4 trillion in debt, which represents 6.5 percent of total outstanding credit market debt.[113] The commercial real estate market grew exponentially

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ces, *supra* note 105, at 1, 3 (measuring "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"). *See* also Massachusetts Institute of Technology Center for Real Estate, Commercial RE Data Laboratory, *Moody's/REAL Commercial Property Price Index (CPPI)* (accessed February 9, 2010) (discussing the difference in Moody's/REAL CPPI and NCREIF TBI); MBA Data Book: Q3 2009, *supra* note 98, at 34–35.

[107] *See*, e.g., Written Testimony of Doreen Eberley, *supra* note 91, at 4; Parkus and Trifon, *supra* note 102, at 32.

[108] Parkus and Trifon, *supra* note 102, at 32; *see also* Written Testimony of Doreen Eberley, *supra* note 91, at 6–97 (providing that tightened underwriting standards and a more risk-averse posture on the part of lenders has resulted in reduced credit availability and that reduced credit availability "reduces the pool of possible buyers, increases the amount of equity that buyers must bring to transactions, and causes downward pressure on values").

[109] *See* MBA Data Book: Q3 2009, *supra* note 98, at 30–31; *see also* Congressional Oversight Panel, Written Testimony of Mark Elliott, partner and head, Office and Industrial Real Estate Group, Troutman Sanders, *Atlanta Field Hearing on Commercial Real Estate*, at 1 (Jan. 27, 2010) (online at cop.senate.gov/documents/testimony-012710-elliott.pdf) (hereinafter "Written Testimony of Mark Elliott") ("The distress [in commercial loan markets in Atlanta] arises out of the nearly complete shut down of new loans into the market, and a corresponding and nearly as dramatic shut down of the replacement of existing loans on commercial properties. . . . This shutdown of the finance side has had an equally dramatic effect on the buy-side of commercial real estate assets; without the means to finance an acquisition, almost nothing is being bought or sold").

[110] Written Testimony of Jon Greenlee, *supra* note 93, at 11 ("Given the lack of sales in many real estate markets and the predominant number of distressed sales in the current environment, regulated institutions face significant challenges today in assessing the value of real estate").

[111] *See* Written Testimony of Doreen Eberley, *supra* note 91, at 5 (providing that in the current environment, investors are demanding higher required rates of return on their investments, as reflected in higher property capitalization rates and explaining that rising capitalization rates cause property values to fall); RREEF Research, *Global Commercial Real Estate Debt: Deleveraging into Distress*, at 3 (June 2009) (hereinafter "Deleveraging into Distress").

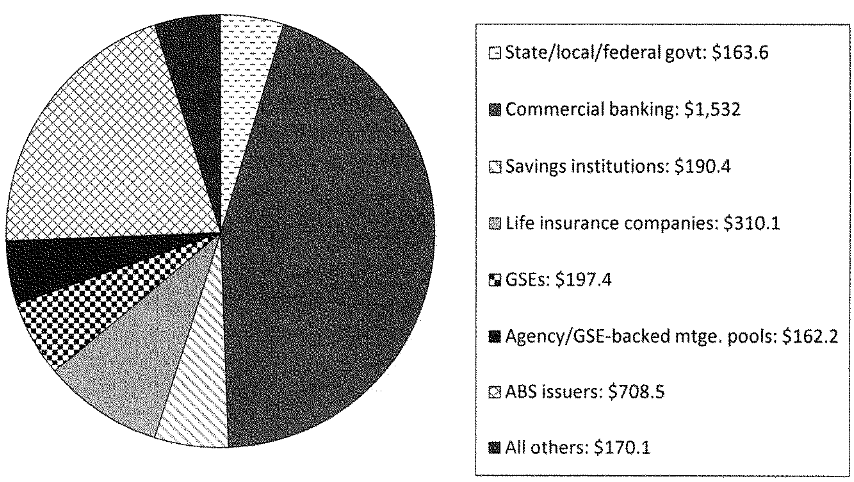
[112] Deleveraging into Distress, *supra* note 111, at 3.

[113] Federal Reserve Statistical Release Z.1, *supra* note 7.

from 2004 to its peak in Q4 2008, with a 52 percent growth in debt; however, commercial real estate debt growth appears to be winding back, decreasing 1.3 percent from its peak 2008 levels to Q4 2009.[114] Although peak commercial real estate debt outstanding was only one-third that of residential mortgage debt at its peak in Q1 2008,[115] the size of the commercial real estate market means that its disruption could also have ripple effects throughout the broader economy, prolonging the financial crisis.

For financial institutions, the ultimate impact of the commercial real estate whole loan problem will fall disproportionately on smaller regional and community banks that have higher concentrations of, and exposure to, such loans than larger national or money center banks. The impact of commercial real estate problems on the various holders of CMBS and other participants in the CMBS markets is more difficult to predict. The experience of the last two years, however, indicates that both risks can be serious threats to the institutions and borrowers involved.

FIGURE 12: CRE DEBT OUTSTANDING BY FINANCIAL SECTORS *(billions of dollars)* [116]



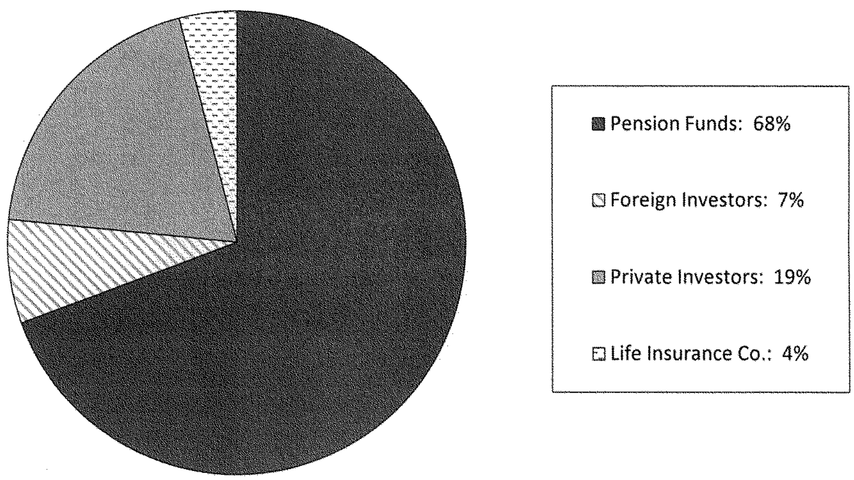
As the figure above shows, commercial banks hold $1.5 trillion in commercial real estate debt outstanding, which is the largest share of the market at 45 percent.[117] The next largest commercial real estate debt holders are asset-backed security (ABS) issuers with 21 percent of the total market.[118] The remaining holders of commercial real estate debt share a fairly equal slice of the pie, ranging from four to nine percent. The total commercial real estate

[114] Federal Reserve Statistical Release Z.1, *supra* note 7.
[115] Federal Reserve Statistical Release Z.1, *supra* note 7.
[116] Federal Reserve Statistical Release Z.1, *supra* note 7.
[117] Federal Reserve Statistical Release Z.1, *supra* note 7.
[118] While the Federal Reserve uses the classification "ABS issuers" when disaggregating credit market debt by sector, for the purposes of this report, ABS issuers are equivalent to CMBS issuers.

debt outstanding includes both commercial real estate whole loans and related securities (i.e., CMBS).

Banks are generally much more exposed to commercial real estate than CMBS investors because of the quality of the properties serving as collateral. Unlike the residential real estate market where banks generally kept the best residential mortgages and securitized the riskier loans into RMBS, CMBS loans were generally made to higher quality, stable properties with more reliable cash flow streams (e.g., a fully leased office building).[119] The CMBS market was able to siphon off the highest quality commercial properties through lower interest rates and more allowable leverage.[120] Banks, particularly mid-size and small banks, were left lending to transitional properties or construction projects with more uncertain cash flows or to less sought-after properties in secondary or tertiary markets.[121] CMBS losses will potentially trigger capital consequences, as discussed in greater detail in Section G.

FIGURE 13: COMMERCIAL REAL ESTATE PRIVATE EQUITY [122]



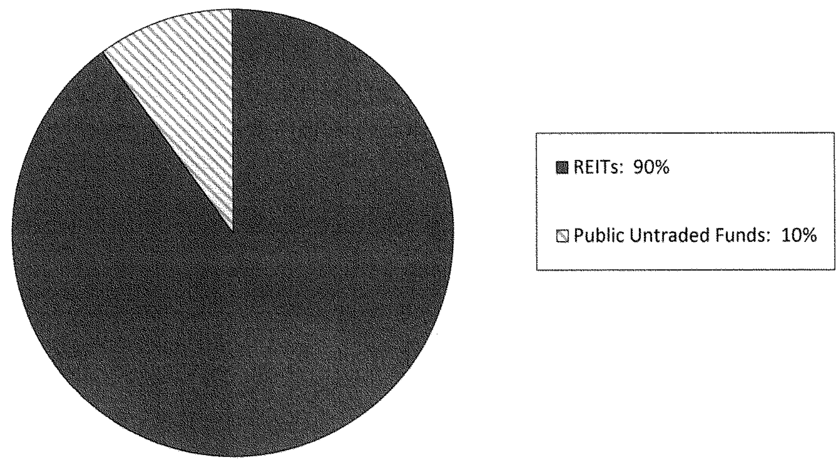
[119] *See* Parkus and Trifon, *supra* note 102, at 36.

[120] *See* Parkus and Trifon, *supra* note 102, at 36; *see also* Richard Parkus and Jing An, *The Future Refinancing Crisis in Commercial Real Estate Part II: Extensions and Refinements*, at 25 (July 15, 2009) (hereinafter "The Future Refinancing Crisis, Part II") ("[T]he CMBS market grew dramatically over the past few years, from $93 billion in issuance in 2004, to $169 billion in 2005, to $207 billion in 2006 to $230 billion in 2007. Much of the growth in market share came at the expense of banks, as CMBS siphoned off many of the desirable loans on stabilized properties with extremely competitive rates. Banks, funding themselves at L–5bp simply couldn't compete on price terms given the execution that was available in CMBS at the time. This forced banks, particularly regional and community banks, into riskier lines of commercial real estate lending").

[121] Parkus and Trifon, *supra* note 102, at 26 ("Because of their liability structure, bank commercial lending has always tended to focus more on shorter term lending on properties with some transitional aspect to them—properties with a business plan. Such transitional properties typically suffer more in a downturn as the projected cash flow growth fails to materialize"). These loans typically have three to five year terms, are expected to mature at the trough of the downturn (2011–2012), and have consistently had significantly higher delinquency rates than CMBS loans. *See also* Richard Parkus and Harris Trifon, *The Outlook for Commercial Real Estate and Its Implications for Banks*, at 48 (Dec. 2009).

[122] Gail Lee, *U.S. CRE Debt Markets: What's Next?,* PREA Quarterly, at 68–70 (Fall 2009) (hereinafter "US CRE Debt Markets"). Data excludes corporate, nonprofit, and government equity real estate holdings as well as single-family and owner-occupied residences.

FIGURE 14: COMMERCIAL REAL ESTATE PUBLIC EQUITY [123]



[123] U.S. CRE Debt Markets, *supra* note 122. Data excludes corporate, nonprofit, and government equity real estate holdings as well as single-family and owner-occupied residences.

FIGURE 15: BANK EXPOSURE TO COMMERCIAL REAL ESTATE, CMBS, AND CDS (AS OF 9/30/09) [124]

[Dollars in millions]

Commercial Banks (classified by asset size)	Total Assets	Total CRE Whole Loan Exposure	Total CMBS Exposure	Notional Amount of Credit Derivatives	Notional Amount of Credit Derivatives (Guarantor)	Tier 1 Risk-based Capital	CRE Whole Loans/ Tier 1 Capital	CMBS/ Tier 1 Capital	CDS/ Tier 1 Capital
> $10 billion (85 banks)	$9,460,306	$842,794	$47,304	$12,985,697	$6,273,213	$749,303	112.5%	6.3%	1733.0%
$1 billion to $10 billion (440 banks)	1,158,908	364,533	1,943	60	31	104,897	347.5%	1.9%	0.1%
$100 million to $1 billion (3,798 banks)	1,104,244	353,651	708	132	24	102,542	344.9%	0.7%	0.1%
< $100 million[125] (2,588 banks)	142,938	26,955	58	0	0	16,315	165.2%	0.4%	0.1%

[124] Federal Deposit Insurance Corporation, *Statistics on Depository Institutions* (online at www2.fdic.gov/sdi/main.asp) (hereinafter ''Statistics on Depository Institutions'') (accessed Jan. 22, 2010). Notional amount of credit derivatives is total credit derivative exposure of which credit default swaps for CMBS are a portion.

[125] Per SNL Financial, the weighted average of commercial real estate to tier 1 risk-based capital is 276 percent for banks with less than $25 million in total assets.

Commercial real estate whole loans are spread among the four commercial bank asset categories, with the mid-size banks' commercial real estate to Tier 1 capital ratios reaching the range considered "CRE concentrated" and the largest and smallest banks' ratios being one-third of that.[126] Tier 1 capital is the supervisors' preferred measurement of capital adequacy. Although banks with over $10 billion in assets hold over half of commercial banks' total commercial real estate whole loans, the mid-size and smaller banks face the greatest exposure. Thus, mid-size and smaller banks are less well-capitalized against the risks of substantial commercial real estate loan write-downs. In terms of securitized and structured products, however, the largest banks dominate in market share. CMBS exposure to Tier 1 capital is six percent at the largest banks, two percent at mid-size banks, and negligible at the smaller banks. Credit derivatives are virtually nonexistent on all other banks' books but those of larger commercial banks.[127]

The current distribution of commercial real estate loans may be particularly problematic for the small business community because smaller regional and community banks with substantial commercial real estate exposure account for almost half of small business loans. For example, smaller banks with the highest exposure—commercial real estate loans in excess of three times Tier 1 capital—provide around 40 percent of all small business loans.[128]

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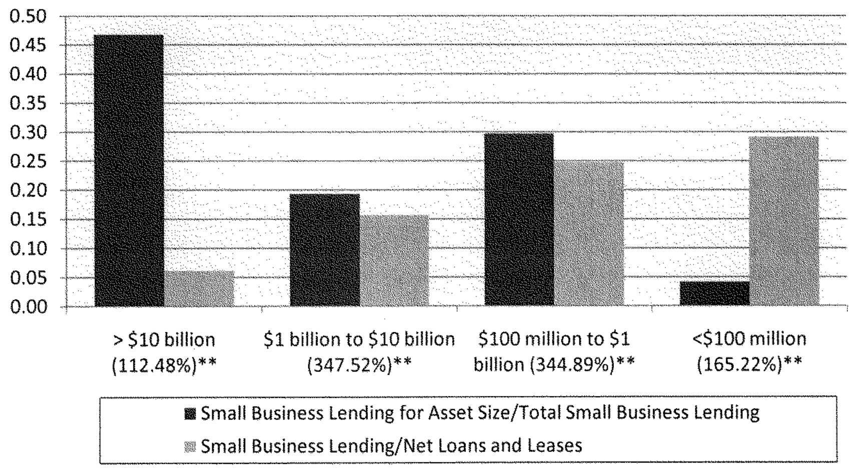
[126] Per the Final Guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* published by the OCC, the Federal Reserve, and the FDIC, a bank is considered to be "CRE concentrated" if loans for construction, land development, and other land and loans secured by multifamily and nonfarm, nonresidential property (excluding loans secured by owner-occupied properties) are 300 percent or more of total capital or if construction and land loans are more than 100 percent of total capital.

[127] Statistics on Depository Institutions, *supra* note 124 (accessed Jan. 22, 2010).

[128] Dennis P. Lockhart, *Economic Recovery, Small Businesses, and the Challenge of Commercial Real Estate*, Federal Reserve Bank of Atlanta Speech (Nov. 10, 2009) (hereinafter "Lockhart Speech before the Atlanta Fed").

FIGURE 16: CRE WHOLE LOAN EXPOSURE AND SMALL BUSINESS LENDING BY INSTITUTION SIZE[129]



*** Percentage reflects CRE exposure (total CRE loans/total Tier 1 Risk-Based Capital)*

The withdrawal of small business loans because of a disproportionate exposure to commercial real estate capital creates a "negative feedback loop" that suppresses economic recovery: fewer loans to small businesses hamper employment growth, which could prolong commercial real estate problems by contributing to higher vacancy rates and lower cash flows. This loop has a considerable impact on the overall economy considering that small businesses have accounted for around 45 percent of net job losses in this recession (through 2008) and have contributed to around one-third of net job growth in the past two economic expansions.[130] Federal Reserve Chairman Ben Bernanke and Treasury Secretary Timothy Geithner have noted the particular problems that small businesses are facing in the current, challenging credit environment.[131] In his January 27, 2010 State of the Union address, President Obama announced a proposal to take "$30 billion of the money Wall Street banks have repaid and use it to help community banks give small businesses the credit they need to stay afloat."[132] For further discussion of President Obama's proposal and its TARP ramifications, see Section I.4.

In addition to the impact on the small business community, the geographic areas serviced by the more exposed regional and com-

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[129] Statistics on Depository Institutions, *supra* note 124 (accessed Jan. 22, 2010).

[130] Lockhart Speech before the Atlanta Fed, *supra* note 128. *See also* Secretary of the Treasury Timothy F. Geithner and Small Business Administration Administrator Karen G. Mills, *Report to the President: Small Business Financing Forum*, at 18–20 (Dec. 3, 2009) (hereinafter "Small Business Financing Forum").

[131] *See* Economic Club of Washington, D.C., *Statement of Federal Reserve Chairman Ben S. Bernanke* (Dec. 7, 2009); Small Business Financing Forum, *supra* note 130, at 18–19.

[132] *See* Remarks by the President in State of the Union Address, *The White House Office of the Press Secretary* (Jan. 27, 2010) (online at www.whitehouse.gov/the-press-office/remarks-president-state-union-address) (hereinafter "State of the Union Remarks"). As discussed in Section I.4 below, the Administration's proposal involves transferring the necessary amount from the TARP to a separate fund.

munity banks may suffer as a result of tightened credit terms, a contraction in bank lending, and possibly bank failures. To the extent that smaller communities have fewer options for available credit, these developments could have severe short-term consequences. As far as individual commercial properties or borrowers are concerned, the impact will depend on the type of commercial property involved and local developments related to commercial real estate fundamentals as well as the overall economy. For example, apartment buildings in the South are greatly underperforming the national statistics, while apartment buildings in the East continue to perform better.[133] On the other hand, the Southern retail sector has greatly outperformed the nation while the Eastern retail sector was the worst performer nationally.[134]

1. Whole Loans

A whole loan is simply the original mortgage loan made by a lender for a series of principal and interest payments over time. As indicated in Figures 12 and 15 above, 46 percent of outstanding commercial real estate debt exists in the form of whole loans, as it is the original source of funding.[135] Through whole loans, investors provide capital to the commercial mortgage market in exchange for the undiluted risks and income associated with those loans. The securitization of commercial real estate through CMBS began in the 1990s and entered a stage of innovation in the 2000s; so, structured commercial real estate products are relatively young.[136] As noted in Figure 15 above, commercial real estate loans outstanding are split fairly evenly between larger banks and mid-size banks. For the two mid-size classes of banks (i.e., assets from $100 million to $10 billion), however, the total commercial real estate loans outstanding is between 347 and 345 percent of Tier 1 capital, compared to only 112 percent of Tier 1 capital at commercial banks with over $10 billion in assets.[137]

Foresight Analytics, a California-based firm specializing in real estate market research and analysis, calculates banks' exposure to commercial real estate to be even higher than that estimated by the Federal Reserve. Drawing on bank regulatory filings, including call reports and thrift financial reports, Foresight estimates that the total commercial real estate loan exposure of commercial banks is $1.9 trillion compared to the $1.5 trillion Federal Reserve estimate. The 20 largest banks, those with assets greater than $100 billion, hold $600.5 billion in commercial real estate loans.[138] The

[133] *See* Dec. 2009 Dec. 2009 Moody's/REAL Commercial Property Price Indices, *supra* note 105, at 7–8 (providing that the eastern apartment index has fallen 13.2 percent, the national apartment index has fallen nearly 40 percent, and the broader southern apartment index has fallen 51.8 percent in the past year).

[134] *See* Dec. 2009 Dec. 2009 Moody's/REAL Commercial Property Price Indices, *supra* note 105 (providing that eastern retail prices fell 31.9 percent, national retail prices fell 19.4 percent, and southern retail prices fell 8 percent in the past year).

[135] The calculation is based upon the "Total CRE Whole Loan Exposure" column of $1.587 trillion (Figure 15) divided by $3.434 trillion of "Total CRE Debt Exposure By Financial Sector" (totaling all sectors) (Figure 12).

[136] James R. Woodwell, *The Perfect Calm*, Mortgage Banking (Jan. 2007) (online at www.mbaa.org/files/Research/IndustryArticles/Woodwell.pdf).

[137] Statistics on Depository Institutions, *supra* note 124 (accessed Jan. 22, 2010).

[138] Foresight Analytics, LLC, *Commercial Real Estate Exposure by Size of Bank as of 3Q 2009* (Jan. 13, 2009) (provided at the request of the Congressional Oversight Panel) (hereinafter "CRE Exposure by Size of Bank"). The FDIC does not disaggregate data in public form beyond the

Continued

following table shows the breakdown of commercial real estate loans across banks by type.

FIGURE 17: COMMERCIAL REAL ESTATE LOANS BY TYPE (BANKS AND THRIFTS AS OF Q3 2009) [139]

Institution Size by Total Assets	Bank Count	Total CRE Loans	Commercial Mortgages	Multifamily Mortgages	Construction and Land	Unsecured CRE
> $100 Bn	20	600.5	318.3	79.7	160.5	42.0
$10 Bn to $100 Bn	92	373.4	209.6	57.0	93.8	13.0
$1 Bn to $10 Bn	584	447.8	272.9	45.9	123.3	5.7
$100 Mn to $1 Bn	4,499	412.5	269.0	32.0	108.0	3.5
$0 to $100 Mn	2,913	29.7	20.7	1.9	6.7	0.4
Total	**8,108**	**1,864.0**	**1,090.6**	**216.5**	**492.3**	**64.6**

139 *Id.*

The OCC, the Federal Reserve, and the FDIC have published a Final Guidance on Concentrations in *Commercial Real Estate Lending, Sound Risk Management Practices.*[140] Although the Guidance does not place any explicit limits on the ratio of commercial real estate loans to total assets, it states that "if loans for construction, land development, and other land and loans secured by multifamily and nonfarm, nonresidential property (excluding loans secured by owner-occupied properties) were 300 percent or more of total capital, the institution would also be considered to have a [commercial real estate] concentration and should employ heightened risk management practices."[141] The supervisors also classify a bank as having a "CRE Concentration" if construction and land loans are more than 100 percent of total capital.[142]

total assets "greater than $10 billion" category. The use of Foresight Analytics data allows for a further disaggregation of FDIC categories, although the number of banks reporting, and thus total exposure across banks, are slightly different.

140 *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, 71 Fed. Reg. 74580 (Dec. 12, 2006). This guidance is discussed in more detail at pages 108–113 below.

141 Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 74580, 74581 (Dec. 12, 2006).

142 *Id.*

FIGURE 18: COMMERCIAL REAL ESTATE EXPOSURE VS. RISK-BASED CAPITAL [143]

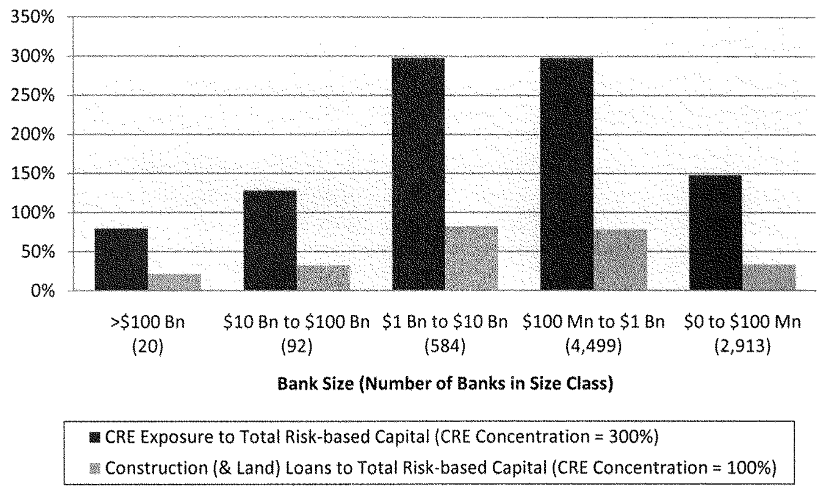


FIGURE 19: BANKS CATEGORIZED AS HAVING "CRE CONCENTRATIONS" [144]

Size Group	Bank Count		
	Total	CRE Concentrations	Banks with CRE Concentrations/Total Banks within Asset Class
> $100 Bn	20	1	5%
$10 Bn to $100 Bn	92	27	29%
$1 Bn to $10 Bn	584	358	61%
$100 Mn to $1 Bn	4,499	2,115	47%
$0 to $100 Mn	2,913	487	17%
Total	**8,108**	**2,988**	

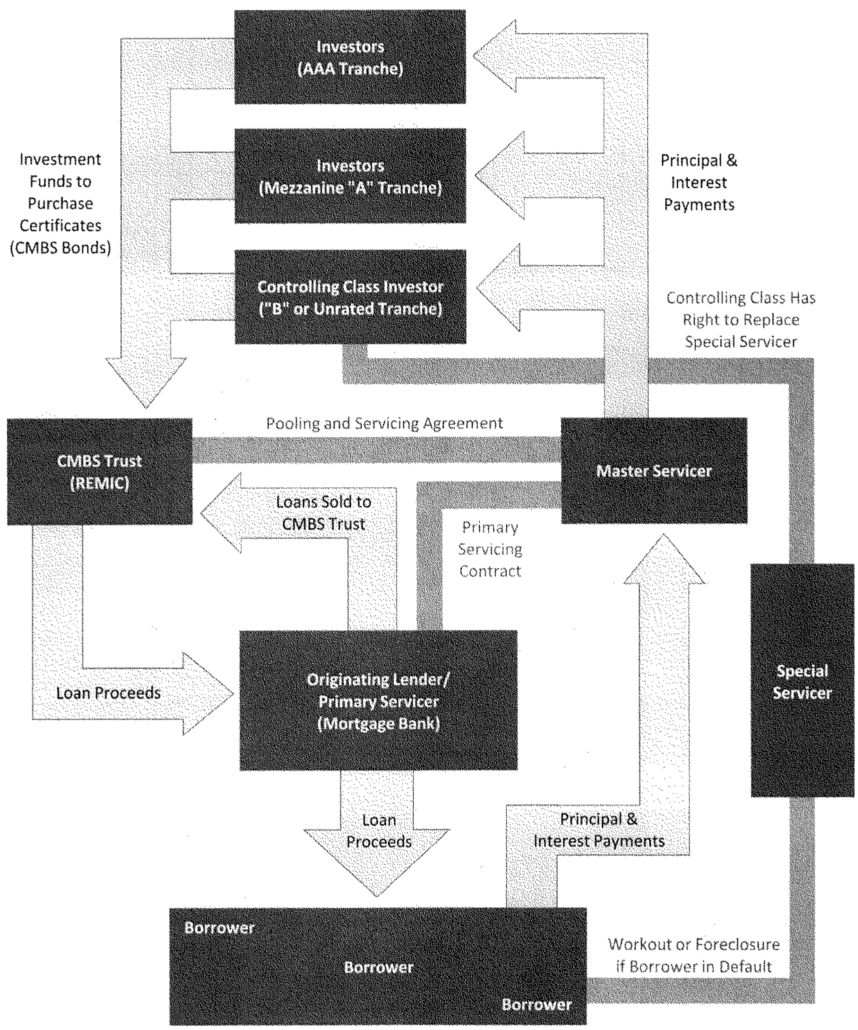
[144] CRE Exposure by Size of Bank, *supra* note 138.

As seen in the Foresight Analytics data above, the mid-size and smaller institutions have the largest percentage of "CRE Concentration" banks compared to total banks within their respective asset class. This percentage is especially high in banks with $1 billion to $10 billion in assets. The table above emphasizes the heightened commercial real estate exposure compared to total capital in banks with $100 million to $10 billion in assets. Equally troubling, at least six of the nineteen stress-tested bank-holding companies have whole loan exposures in excess of 100 percent of Tier 1 risk-based capital. See additional discussion of banks that have received TARP assistance in Section H.

[143] CRE Exposure by Size of Bank, *supra* note 138.

2. Commercial Mortgage Backed Securities (CMBS)

FIGURE 20: CMBS FLOWCHART



CMBS are asset-backed bonds based on a group, or pool, of commercial real estate permanent mortgages. A single CMBS issue usually represents several hundred commercial mortgages, and the pool is diversified in many cases by including different types of properties. For example, a given CMBS may pool 50 office buildings, 50 retail properties, 50 hotels, and 50 multifamily housing developments. (In residential mortgage markets, loan terms are more standardized, and the overall impact of an individual loan in the performance of the MBS is minimal. In commercial mortgage markets, however, the individual commercial real estate loan can significantly impact the performance of the CMBS).[145]

As can be seen in Figure 21 below, the use of CMBS to finance commercial real estate has grown very rapidly in recent years, peaking near the height of the commercial real estate bubble.

FIGURE 21: TOTAL COMMERCIAL REAL ESTATE SECURITIZED [146]

Year	Percent Securitized
1970	.1
1980	1.5
1990	3.8
2000	18.9
2007—3rd Q (peak of securitization)	27.9
2009—3rd Q	25.4

[146] Commercial Mortgage Securities Association, *Compendium of Statistics: Exhibit 19: Holders of Commercial & Multifamily Mortgage Loans* (Dec. 10, 2009) (online at www.cmsaglobal.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf) (hereinafter "Commercial Real Estate Securities Association, Exhibit 19") (updated Jan. 12, 2010). Exhibit 21, Mortgage Securitization Levels.

Both original permanent and refinanced loans may be securitized. The current lack of investor appetite for CMBS greatly constrains the ability of commercial property owners to obtain permanent loans to pay off construction loans or to refinance existing permanent loans. And without the ability to do so, outstanding commercial real estate loans have a reduced chance of repayment, unless the original lender provides funds for refinancing.

A CMBS pool is usually set up to be eligible for tax treatment as a REMIC to allow taxation of income and capital gains only at the investor level. This structure makes the tax treatment of ownership of any particular tranche of a CMBS comparable to the ownership of whole loans, which are only taxed at the investor level.[147] This issue is discussed further in Section G.3.

CMBS structures stratify a pool of commercial real estate mortgages into tranches (classes).[148] This both enhances and complicates the structure in comparison to typical single-class residential MBS. The creation of tranches allows investors to choose from varying risk/reward ratios. Most CMBS use a senior/subordinate structure, sometimes referred to as a "waterfall." In this arrangement, interest and principal due to the most senior tranche is paid first, in full, from the cash flow coming from the underlying mortgages. If the pool has cash left over, the next tranche is paid. This process continues down to the most junior or subordinate "first loss" tranche.[149] If there is insufficient cash to pay all tranches, the most subordinate tranche is not paid. Further losses then flow up the subordination chain. Each class, therefore, receives protection from the class below it, while at the same time providing protection for the class directly above it. These relationships are illustrated in Figure 20, above.

[145] Commercial Mortgage Securities Association, *Chapter Four: Issuing CMBS,* CMSA E-Primer (www.cmsaglobal.org/assetlibrary/E0B68548-4965-488A-8154-30691CB0F880/8be06679b07c4a5d93777548733482534.pdf).
[147] *See* Brueggeman and Fisher, *supra* note 13, at 558–559.
[148] Commercial Mortgage Securities Association, *Chapter One: An Overview of CMBS,* CMSA E-Primer (www.cmsaglobal.org/assetlibrary/CDACA8B2-5348-497A-A5AC-13A85661BF2E/6baf4dcc38f14cefa99d85803fd283905.pdf).
[149] DeMichele and Adams, *supra* note 22, at 329–330.

Senior tranches earn a better credit rating and yield a lower interest rate than more subordinate tranches due to their lower risk. Tranches are often referred to as either “investment grade” or “B-piece.” Investment grade tranches have credit ratings from AAA to BBB- (to use S&P ratings) and are bought by the more safety-conscious investors. The investment grade category can be further divided into the AAA rated senior tranche and lower rated “mezzanine” tranches. B-pieces, which are rated BB and below or are unrated, are risky and are purchased by specialized investors who thoroughly scrutinize the deal and the underlying properties.[150] Thus, the stratification creates a CMBS structure in which risk is theoretically concentrated in the lower-rated tranches, so the credit enhancement of a tranche is provided through the subordination of other tranches.[151]

The B-piece buyer assumes a greater level of risk by taking the most junior class yet receives in return a potentially higher yield. CMBS structures often make the B-piece buyer the “controlling class,” which has special rights to monitor the performance of each loan.[152]

A typical CMBS structure—and the risks that come with it—can be illustrated by reviewing a specific CMBS deal and tracing it from loan origination to securitization. For Trust ML–CFC, Series 2007–5, Merrill Lynch served as depositor and joined Countrywide, Keybank, and IXIS Real Estate Capital as sponsors of a CMBS issue consisting of a pool of 333 commercial, multifamily, and manufactured housing community mortgage loans with an aggregate initial mortgage balance of $4.4 billion.[153] The largest loan backing the CMBS pool is an $800 million Peter Cooper Village and Stuyvesant Town loan (PCV/ST), which represents 18 percent of the pool.[154] Tishman Speyer Properties, LP and BlackRock Realty acquired the New York-based PCV/ST 56 building apartment complex through a $3 billion interest-only loan in 2006 and recently stopped scheduled debt payment, triggering default.[155] Trust ML–CFC, Series 2007–5 securitizes an $800 million piece of the total PCV/ST loan, while other CMBS trusts securitize the remaining balance. The loan’s LTV ratio at origination was 55.6 percent.[156]

As of November 2009, the loan was transferred to special servicing (see explanation below) to facilitate debt restructuring due to financial challenges from failed attempts to deregulate rent-stabilized units and insufficient cash flow to cover the debt service. While the PCV/ST loan is certainly the most stressed loan within the pool, specially serviced loans comprise 21 percent of the pool,

[150] DeMichele and Adams, *supra* note 22, at 329–330.

[151] Nomura Fixed Income Research, *Synthetic CMBS Primer,* at 6 (Sept. 5, 2006) (online at www.securitization.net/pdf/Nomura/SyntheticCMBS_5Sept06.pdf).

[152] Commercial Mortgage Securities Association and Mortgage Bankers Association, *Borrower’s Guide to CMBS,* at 6 (2004) (online at www.cmsaglobal.org/CMSA_Resources/Borrowers_Page/Borrower_s_Page/) (hereinafter “Borrower’s Guide to CMBS”).

[153] SEC EDGAR Free Writing Prospectus, *ML–CFC Commercial Mortgage Trust 2007–5* (Feb. 26, 2007) (online at www.secinfo.com/dsvrn.u13t.htm) (hereinafter “ML–CFC Commercial Mortgage Trust 2007–5”).

[154] Fitch Ratings, *ML–CFC Commercial Mortgage Trust Series 2007–5–U.S. CMBS Focus Performance Report* (Dec. 7, 2009) (online at www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=490406) (hereinafter “CMBS Focus Performance Report”).

[155] ML–CFC Commercial Mortgage Trust 2007–5, *supra* note 153. *See also* Dawn Wotapka, *Tishman, Blackrock Default on Stuyvesant Town,* WSJ (Jan. 8, 2010) (online at online.wsj.com/article/SB10001424052748703535104574646611615302076.html).

[156] ML–CFC Commercial Mortgage Trust 2007–5, *supra* note 153.

and an additional 48 loans are classified by Fitch Ratings as "loans of concern."[157] Furthermore, approximately 46.9 percent of the pool had a weighted average debt service coverage ratio less than 1.20 as of year-end 2008.[158]

As with most CMBS, the securities issued by the sponsors were organized into tranches. Fitch downgraded seven of these tranches and maintained a negative rating outlook on 15 of the 24 rated tranches within the ML–CFC, 2006–1 trust pool on October 30, 2009, driven by the projected losses and current foreclosures and delinquencies on underlying loans.[159] The losses for this CMBS deal are higher than the Fitch-modeled average recognized and have potential losses of 6.9 and 9.7 percent, respectively, for all CMBS 2007 vintages.[160] As losses increase, the relative loss protection from the upper tranches decreases.

a. Servicing

After a commercial mortgage is originated, the borrower's main contact with creditors is through the loan servicer. Loan servicing consists of collecting and processing mortgage payments; remitting funds either to the whole loan owner or the CMBS trustee; monitoring the property; handling delinquencies, workouts, and foreclosures; and performing other duties related to loan administration.[161] Servicers earn a servicing fee (usually from 1 to 25 basis points) based on the outstanding principal balance of the loan. Whole loans, which are held on a bank's balance sheet, are typically serviced by the originating lender.

For CMBS pools, a Pooling and Servicing Agreement (PSA) sets out the duties of the servicer and includes a "servicing standard" that describes the roles of each servicer and specific instructions for dealing with delinquencies, defaults, and other eventualities.[162] A CMBS structure provides for a master and special servicers, and may or may not include primary servicers as well.

The master servicer is responsible for servicing all performing loans in the pool through maturity. It also decides when loans that are delinquent or in default are transferred to the special servicer. For a delinquent loan where the late payments are considered recoverable by the master servicer, the latter will advance the missing principal and interest payments to pay the CMBS bondholders. When the funds are recovered, the master servicer will be refunded first, ahead of payments to the senior tranche. If the master servicer deems the loan to be unrecoverable, it will stop these advances.

In many cases, the master servicer handles all contact with the borrower, including collecting payments, correspondence, and site visits. However, in some cases, these contact duties are subcon-

[157] CMBS Focus Performance Report, *supra* note 154.

[158] CMBS Focus Performance Report, *supra* note 154. The debt service coverage ratio (DSCR) is the ratio between the annual debt service and the annual net operating income of the property. This ratio is a key underwriting criterion for lenders, as it refers to a property's ability to pay debt service after paying other regular expenses. A debt service coverage ratio of 1.1 to 1.0 means that the property's cash flow exceeds debt service for a given period of 10 percent. Typically, lenders require a ratio greater than 1.0.

[159] CMBS Focus Performance Report, *supra* note 154.

[160] CMBS Focus Performance Report, *supra* note 154.

[161] *See* Real Estate Finance, Seventh Edition, *supra* note 10, at 303.

[162] Borrower's Guide to CMBS, *supra* note 152, at 3.

tracted to one or more primary servicers.[163] In these cases, the primary servicer has responsibility for contact with the borrower, leaving the master servicer to handle higher-level administrative duties. The primary servicer will often be the firm that originated the mortgage. This arrangement can be advantageous because the primary servicer maintains its personal relationship with the borrower, and the CMBS investors gain the services of a person or firm very familiar with the loan and property.[164]

The third class of servicer is the "special servicer," which is responsible for dealing with defaulted or other seriously troubled loans. The master servicer, following the servicing provisions in the PSA, transfers servicing for these loans to the special servicer. This usually occurs after the loan is 60 days delinquent.[165] The special servicer then determines the appropriate course of action to take in keeping with the servicing standard in the PSA. The controlling class of the CMBS, usually the buyer of the first loss position, often has the right to appoint a special servicer and direct its course of action.[166] The special servicer typically earns a management fee of 25 to 50 basis points on the outstanding principal balance of a loan in default as well as 75 basis points to one percent of the net recovery of funds at the end of the process.

FIGURE 22: TOP 10 COMMERCIAL MORTGAGE MASTER SERVICERS [167]

[Dollars in millions]

Rank	Servicing Company	Parent Company/Ownership	TARP Recipient	Amount	Number of Loans	Average Loan Size
1	Wells Fargo N.A./Wachovia Bank N.A.	Wells Fargo	X	$476,209	42,829	$11.1
2	PNC Real Estate/Midland Loan Services.	The PNC Financial Services Group, Inc.	X	308,483	32,087	9.6
3	Capmark Finance Inc	Berkshire Hathaway, Inc./Leucadia National Corp.	[168]	248,739	32,357	7.7
4	KeyBank Real Estate Capital.	Keycorp	X	133,138	12,501	10.7
5	Bank of America N.A	Bank of America	X	132,152	9,953	13.3
6	GEMSA Loan Services LP.	GE Capital/CB Richard Ellis	....	104,755	7,144	14.7
7	Deutsche Bank	Deutsche Bank Group	....	63,812	2,446	26.1
8	Prudential Asset Resources.	Prudential Financial	....	62,826	6,004	10.5
9	JP Morgan Chase Bank	JPMorgan Chase & Co	X	50,410	42,914	1.2
10	NorthMarq Capital	NorthMarq Capital	....	37,903	5,387	7.0

[167] Mortgage Bankers Association, *Survey of Commercial/Multifamily Mortgage Servicing Volumes, Mid Year 09* (2009). This table includes multifamily properties of 2–4 units.
[168] Capmark was formerly a subsidiary of GMAC, a TARP recipient. It was sold in September 2009 to Berkadia III, LLC, a joint venture between Berkshire Hathaway, Inc. and Leucadia National Corporation. Neither of these firms are TARP recipients.

b. Underlying Property and Location

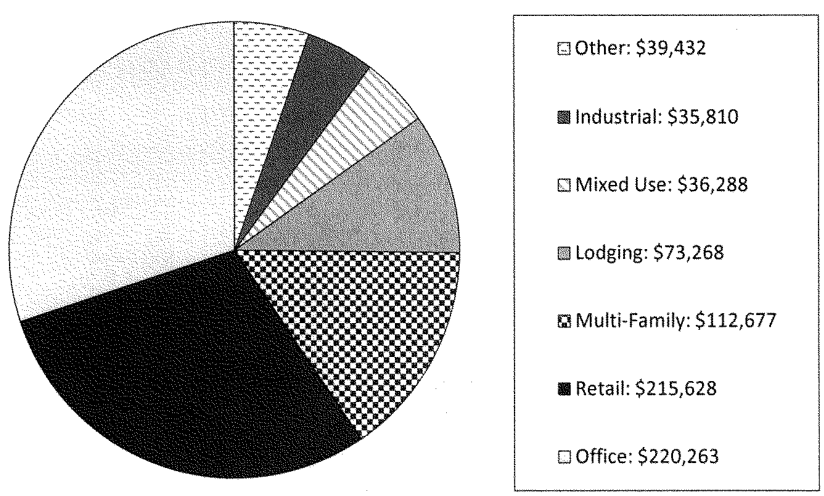
The current outstanding CMBS market is valued at $709 billion. The CMBS market was virtually frozen from July 2008 to May 2009, with no CMBS issued during this period, but $2.329 billion

[163] Borrower's Guide to CMBS, *supra* note 152, at 5.
[164] Borrower's Guide to CMBS, *supra* note 152, at 3.
[165] John N. Dunlevy, *Structural Considerations Impacting CMBS,* in The Handbook of Non-Agency Mortgage-Backed Securities, at 398 (1997).
[166] Borrower's Guide to CMBS, *supra* note 152, at 6.

in issuances have occurred since June 2009.[169] The freeze in the CMBS market was primarily due to problems in the broader mortgage security market. Decreased AAA-rated CMBS yield spreads over 5- and 10-year Treasury yields and the Federal Reserve's May 19, 2009 announcement of extending TALF to high-quality legacy CMBS provided the cushion of credit needed to begin the CMBS market thaw.[170] Slowly, the securitized commercial real estate market is coming to life again. Using the data provided in Figure 15 [CRE, CMBS, CDS] and the Commercial Mortgage Securities Association (CMSA) statistic of $709 billion in CMBS outstanding, commercial banks hold a mere seven percent of the CMBS market.[171]

Whereas commercial real estate whole loan exposure is spread across the four size categories of banks, CMBS exposure is concentrated in large commercial banks. According to Foresight Analytics, the 20 largest banks (those with assets over $100 billion) hold approximately 89.4 percent of total bank exposure to CMBS.[172] The FDIC data further confirms this, as banks in the "greater than $10 billion" asset class hold 94.5 percent of total bank exposure to CMBS. CMBS is a negligible percentage of Tier 1 capital across commercial banks compared to the same ratio for whole loans, as seen earlier in Table 15.[173]

FIGURE 23: CMBS OUTSTANDING BY PROPERTY TYPE *(millions of dollars)* [174]



Office and retail commercial property comprise 59 percent of all CMBS underlying loans. Multifamily and lodging (hotel) properties, though a more moderate property presence, comprise 15 and 10

[169] Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146 (updated Jan. 12, 2010).
[170] Federal Reserve Bank of Atlanta, *Financial Highlights* (July 22, 2009) (online at www.frbatlanta.org/filelegacydocs/FH_072209.pdf).
[171] Statistics on Depository Institutions, *supra* note 124 (accessed Jan. 22, 2010).
[172] CRE Exposure by Size of Bank, *supra* note 138.
[173] Statistics on Depository Institutions, *supra* note 124 (accessed Jan. 22, 2010).
[174] Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146.

percent, respectively. The remaining 16 percent of CMBS property types are industrial, mixed use, and other.[175]

FIGURE 24: CMBS BY PROPERTY LOCATION[176]

[Dollars in millions]

State	Current Balance	Allocation Percent
California	$104,965	16.9
New York	95,824	15.4
Texas	49,840	8.0
Florida	42,400	6.8
Illinois	24,740	4.0
Pennsylvania	19,910	3.2
Georgia	19,838	3.2
New Jersey	19,691	3.2
Maryland	18,585	3.0
All Other States (less than 3.0% of total each)	$231,000	36

[176] Commercial Mortgage Securities Association, *Compendium of Statistics, at Exhibit 10: CMBS by Regions—Detail* (Aug. 2008).

The loans securing CMBS deals are generally concentrated in more populated states and do not include less sought after properties in secondary or tertiary markets (or properties associated with less populated areas).[177] California and New York commercial real estate loans represent nearly one-third of all securitized loans. CMBS exposure to loans originated in Texas, Florida, and Illinois is notable to a smaller degree, and the remaining geographic CMBS loan exposure is spread among all other states.[178] As foreclosure rates vary widely across states, knowing the state of origination for loans bundled in a CMBS structure provides greater insight into potential CMBS valuation issues.[179]

The following chart, Figure 25, provides information on CMBS delinquency rates for the top 10 metropolitan statistical areas.

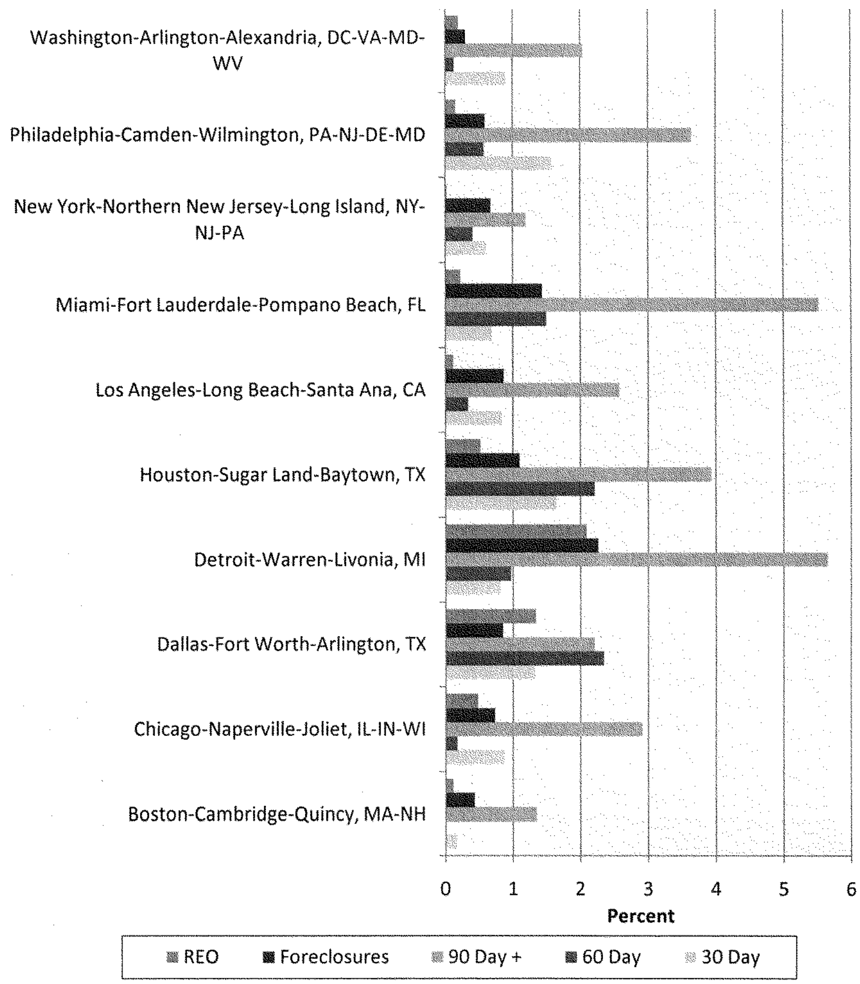
[175] Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146.

[177] *Id.* For example, the ten states with the smallest CMBS market share in December 2009 (from smallest to largest) were Wyoming, Montana, South Dakota, North Dakota, Vermont, Alaska, West Virginia, Idaho, Maine, and Rhode Island, with a combined total of 0.99 percent. *See U.S. CMBS: Moody's CMBS Delinquency Tracker, January 2010,* at 16 (Jan. 15, 2010) (hereinafter "CMBS Delinquency Tracker"). These states were among the 13 least populated states according to U.S. Census Bureau rankings. *See* U.S. Census Bureau, *The 2010 Statistical Abstract: State Rankings, Resident Population, July 2008* (available online at www.census.gov/compendia/statab/2010/ranks/rank01.html) (last accessed Jan. 22, 2010). The four most populated states (California, Texas, New York, and Florida) also had the largest CMBS market share in 2009, with a combined total of 40 percent.

[178] Commercial Mortgage Securities Association, *Compendium of Statistics, at Exhibit 10: CMBS by Regions—Detail* (Aug. 2008); *see also* CMBS Delinquency Tracker, *supra* note 177, at 16.

[179] The potential impact of commercial real estate problems on CMBS is magnified by so-called "synthetic CMBS." Based on available transaction data, DTTC reported 2,065 derivative contracts referencing CMBS with a gross notional value of $24 billion as of January 8, 2010. A synthetic product is simply a derivative instrument designed to mimic the cash flows of a reference entity or asset. Synthetic CMBS allow an investor to gain exposure to either a specific CMBS pool or a CMBS index without actually taking ownership of the assets. The synthetic CMBS market lacks transparency; thus, determination of its scope relative to the commercial real estate market is difficult. The Depository Trust and Clearing Corporation, *Trade Information Data Warehouse (Section I),* at Table 3 (online at www.dtcc.com/products/derivserv/data__table__i.php?id=table3__current) (hereinafter "Trade Information Data Warehouse") (accessed Jan. 12, 2010).

FIGURE 25: CMBS DELINQUENCY RATES BY TOP 10 METROPOLITAN STATISTICAL AREAS [180]



This chart illustrates the variation in problems that more populated areas are experiencing with commercial real estate loans collateralizing CMBS deals.

3. CMBS Credit Default Swaps

Credit defaults swaps (CDS) are over-the-counter (OTC) derivative [181] instruments predicated on a contract between two counterparties: a protection buyer and a protection seller. CDS contracts

[180] Bloomberg data (accessed Jan. 12, 2010).

[181] The Financial Accounting Standards Board defines a derivative as an instrument that has one or more underlying assets and one or more notional amounts or payment provisions which determine settlement, requires no initial net investment, and whose terms permit net settlement.

function in a similar manner to insurance contracts. A protection buyer pays a periodic or up-front fee to a protection seller, who must then pay the protection buyer a fee in the occurrence of a "credit event" (e.g., bankruptcy or credit rating downgrade), effectively transferring credit risk from the buyer to the seller.[182] An added layer of the CDS structure is its inherent "risk circularity," replacing credit risk with counterparty risk.[183] By safeguarding against the risk of credit default through a CDS, the protection buyer faces the risk that its counterparty will default on the contract, leaving it exposed to the original credit risk. This risk circularity was at the crux of American International Group's (AIG) "too big to fail" status and ultimate government bailout and payment to its CDS counterparties.[184]

The intent of a credit default swap is generally either to hedge or to speculate. An institution can hedge the credit risk of assets by acquiring CDS protection on those assets and can hedge the risk of counterparty default by acquiring CDS exposure to another institution.[185] For example, if an investor held the CMBS pool MLCFC, Series 2007–5, he could hedge exposure through CMBX.3, which references this CMBS pool. CDS also allow an institution to gain exposure without any possession of the underlying referenced entities or assets through trading or speculative activities. An institution can acquire long exposure to the credit assets by selling CDS protection or acquire short exposure to the credit assets by buying CDS protection.[186] Either way, the investor is speculating on the likelihood of a future credit event in regards to the reference entity or assets in which the investor possesses only exposure without actual ownership. Speculative trading is commonly referred to as a "naked" swap, since the investor has no cash position in the reference entity or assets.[187]

The meltdown in the residential mortgage market and sub-prime loan-backed RMBS caused a massive capital drain on the major sellers of RMBS CDS in 2008 and heightened the counterparty risk exposure of buyers. The gross notional seller exposure to CDS backed by RMBS was $135.9 billion as of January 8, 2010, compared to CDS backed by CMBS exposure of $24.1 billion.[188] However, net notional exposure for CMBS is $5.0 billion, compared to

[182] David Mengle, *Credit Derivatives: An Overview,* Federal Reserve Bank of Atlanta Economic Review (Fourth Quarter 2007) (online at www.frbatlanta.org/filelegacydocs/erq407__mengle.pdf).

[183] European Central Bank, *Credit Default Swaps and Counterparty Risk* (Aug. 2009) (online at www.ecb.int/pub/pdf/other/creditdefaultswapsandcounterpartyrisk2009en.pdf) (hereinafter "European Central Bank CDS Report").

[184] Dean Baker, *The AIG Saga: A Brief Primer,* The Center for Economic and Policy Research (Mar. 2009) (online at www.cepr.net/documents/publications/AIG-2009-03.pdf) (hereinafter "The AIG Saga: A Brief Primer").

[185] European Central Bank CDS Report, *supra* note 183.

[186] European Central Bank CDS Report, *supra* note 183. Long exposure is speculation on the future upside potential and short exposure is speculation on the future downside potential, meaning a seller with long exposure is speculating on the unlikelihood of default and a buyer with short exposure is speculating on the reverse.

[187] European Central Bank CDS Report, supra note 183. Congressional Oversight Panel, *Special Report on Regulatory Reform,* at 13–15 (Jan. 2009) (online at cop.senate.gov/reports/library/report-012909-cop.cfm). As noted, a swap is a form of insurance, but the holder of a "naked" swap owns nothing to insure. A common state insurance rule bars purchasing insurance in the absence of an insurable interest, e.g., in the purchaser's home or car, or for members of the purchaser's family, precisely because buying insurance without such an interest is a form of speculation. As noted in the Panel's Special Report on Regulatory Reform, however, Congress prohibited the regulation of most derivatives in 2000. That action barred, for example, attempts to apply state insurance rules to "naked swaps."

[188] Trade Information Data Warehouse, *supra* note 179, at Table 3.

only $67.7 million for RMBS. (Net notional exposure provides a more accurate view of actual exposure as it represents the maximum amount of credit exposure or payout in a credit default event.)[189] Furthermore, this exposure is concentrated in 2,067 CDS contracts, while the RMBS exposure is spread throughout 27,908 contracts.[190] Thus, the maximum credit exposure for CMBS-backed CDS is not only bigger than that of RMBS-backed CDS, but it is concentrated in a smaller number of contracts. As noted in the European Central Bank's report on Credit Default Swaps and Counterparty Risk, "[i]n practice, the transfer of risk through CDS trades has proven to be limited, as the major players in the CDS market trade among themselves and increasingly guarantee risks for financial reference entities."[191] The fact that RMBS credit default exposure played a significant role in the 2008 collapse and that the concentration of CMBS-backed CDS appears to be greater than that in RMBS CDS must be carefully considered in assessing the impact such swaps could have if the volume, nature, and pace of foreclosures of securitized properties continue to increase. Any attempt to gauge the potential impact—as was the case of RMBS swaps and swaps written on other securities—is difficult if not impossible owing to the opacity of the credit default swaps' market. (Although that issue is generally beyond the scope of this report, it should be noted that the Panel's Reform Report called direct attention to the need for transparency in the CDS markets.)[192]

The impact of commercial real estate losses on CMBS and CMBS CDS markets ultimately affects the institutions that invest in them. The extent of the impact is largely dependent on the institution's size. As noted in section E.2(b), CMBS exposure is concentrated in the 20 largest financial institutions with assets over $100 billion.[193] According to discussions with market experts, the largest banks issued higher quality commercial real estate loans for the purpose of securitizing, packaging, and distributing them, which left mid-size and smaller banks to do the remaining lending for construction and local commercial real estate loans.[194] Thus, in terms of risk and exposure relative to assets and Tier 1 capital, the larger financial institutions are exposed to CMBS, and the smaller and mid-size financial institutions are more exposed to the whole loans. Given the size of notional CMBS holdings, that risk and exposure require extremely careful attention, in light of the experience of the last three years.

4. Financing of Multifamily Housing

Multifamily housing is a subsection of commercial real estate that overlaps the commercial and residential mortgage markets in terms of structure and use. Although income-producing and bearing

[189] Trade Information Data Warehouse, *supra* note 179, at Table 3.
[190] The Depository Trust and Clearing Corporation, *Trade Information Warehouse,* at Table 6 (online at www.dtcc.com/products/derivserv/data__table—i.php?id=table6__current) (accessed Jan. 12, 2010).
[191] European Central Bank CDS Report, *supra* note 183.
[192] Congressional Oversight Panel, *Special Report on Regulatory Reform,* at 13–15 (Jan. 2009) (online at cop.senate.gov/reports/library/report-012909-cop.cfm).
[193] Commercial Mortgage Securities Association, *Investors of CMBS in 2008* (online at www.cmsaglobal.org/uploadedFiles/CMSAlSitelHome/IndustrylResources/Research/IndustrylStatistics/Investors.pdf) (accessed Jan. 20, 2010).
[194] Staff conversation with The Real Estate Roundtable (Jan. 6, 2010).

commercial loan characteristics, multifamily housing also serves as a residence for tenants. Before delving deeper into the ramifications of commercial real estate losses on communities and tenants, it is important to understand the scope of multifamily housing. Multifamily mortgage debt outstanding has shown steady growth for several years, except for a $1.2 billion decrease from Q3 to Q4 2009, ending the year at $912 billion. In comparison, both residential mortgage and all other commercial mortgage debt outstanding peaked in 2008 and has steadily decreased since.[195] Multifamily mortgage originations decreased 40 percent from Q3 2008 to Q3 2009, compared to an overall decrease of 54 percent for all commercial property over the same time period.[196] Thus, while the market for residential and other commercial mortgages experienced a "boom and bust," multifamily has exhibited a steadier growth over time with less substantial decrease in recent quarters.

Government sponsored entities Fannie Mae and Freddie Mac (the GSEs) hold the largest amount of multifamily mortgage debt outstanding—39 percent. Commercial banks and CMBS/ABS issuers follow in stair-step succession with 24 and 12 percent, respectively, of total multifamily mortgage debt outstanding. The remaining 25 percent is divided fairly evenly among governments, savings institutions, life insurance companies, and financing institutions.[197] Only in recent years have the GSEs come to hold such a large share of multifamily mortgage debt, as private sources of funding supplied the market in the past.[198] As the CMBS market supports only 12 percent of the $912 billion of multifamily debt outstanding, the bulk of multifamily financing remains in whole loans.[199]

According to the National Multi Housing Council, nearly one-third of American households rent and over 14 percent live in multifamily apartment complexes.[200] Multifamily rental housing provides an alternative to home ownership for people in recent geographic transition, in search of convenience, or in need of a lower cost option. It also provides a more economic option than single family structures in terms of social services delivery, such as assisted living and physical infrastructure.[201] When looking at the default possibilities of mortgages, the discussion often centers on the exposure to the borrower, lender, and investors. Devaluations of and defaults in multifamily mortgage loans indeed impact these individuals through lower cash flows, difficulty in refinancing, and potential loss of property. But this impact also extends to the residents of multifamily housing who potentially face deteriorating buildings, neglected maintenance, and increased rent.

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[195] Federal Reserve Flow of Funds Z.1, Dec. 10, 2009.

[196] MBA Data Book: Q3 2009, *supra* note 98.

[197] MBA Data Book: Q3 2009, *supra* note 98.

[198] Donald S. Bradley, Frank E. Nothaft, and James L. Freund, *Financing Multifamily Properties: A Play with New Actors and New Lines,* Cityscape: A Journal of Policy Development and Research (Vol. 4, Num. 1, 1998) (online at www.huduser.org/Periodicals/CITYSCPE/VOL4NUM1/article1.pdf).

[199] Federal Reserve Flow of Funds Z.1, Dec. 10, 2009.

[200] National Multi Housing Council, *About NMHC* (online at www.nmhc.org/Content/ServeContent.cfm?ContentItemID=4493) (accessed Jan. 21, 2010).

[201] Harvard University Joint Center for Housing Studies, *Meeting Multifamily Housing Finance Needs During and After the Credit Crisis: A Policy Brief* (Jan. 2009) (online at www.jchs.harvard.edu/publications/finance/multifamily_housing_finance_needs.pdf) (hereinafter "Meeting Multifamily Housing Finance Needs").

Both the total commercial mortgage and multifamily mortgage default rates have increased in recent quarters to 8.74 and 3.58 percent, respectively.[202] Although multifamily loan performance has remained strong compared to the overall commercial mortgage market, as evidenced in the significantly lower default rate, tightened credit, and broader challenges for commercial real estate mortgages could hinder apartment owners' ability to refinance and thus could cause increased defaults.[203] If financing is tight and capital costs increase, owners may neglect property improvements or may attempt to pass along costs to tenants through increased rent and fees. Neglected property impacts the surrounding neighborhood's condition and, ultimately, value.[204]

Currently, 79 percent of multifamily renters in the lowest income quartile and 45 percent in the lower-middle income quartile spend over half of their income on housing.[205] Affordable, government-subsidized, multifamily units play a key role in the multifamily mortgage market, as they answer the low-income barrier to entry of home ownership. Low-income housing tax credits and tax-exempt multifamily bonds buttress the affordable housing market, but the credit crisis has undermined their ability to do so. Tax credit prices have fallen from 90 to 70 cents on the dollar, so more credits are now required to deliver the same amount of equity. Tax-exempt multifamily bond issuances have sharply decreased, cutting off another equity source for development and rehabilitation.[206] Renters in need of affordable housing cannot move to a new complex in the face of increased rent or deteriorating maintenance as easily as other renters can, so the need for viable and prolific equity options is especially relevant in this subsector of the commercial mortgage market.

While the multifamily mortgage market default rates are lower than those of the commercial mortgage market as a whole, multifamily default rates are still increasing. Furthermore, vacancy rates as of Q3 2009 were 13.1 percent, up from 11 percent in Q3 2008. Some multifamily lenders used aggressive estimates in their underwriting practices that have heightened refinancing hurdles for those loans in the current market.[207] Thus, the risks associated with property devaluation and tightened credit are the same for multifamily as they are for other commercial properties, but unlike other types of commercial real estate, those risks have the potential to translate into destabilized families and loss of affordable housing.

F. Risks

In the years preceding the current crisis, a series of trends pushed smaller and community banks toward greater concentration

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[202] Federal Reserve Statistical Release, *Charge-off and Delinquency Rates* (online at www.federalreserve.gov/Releases/ChargeOff/delallsa.htm) (accessed Jan. 20, 2010). Sibley Fleming, *Bank Default Rates on CRE Loans Projected to Hit 4% in Fourth Quarter,* National Real Estate Investor (online at nreionline.com/news/CRE__bank__default__rates).

[203] Meeting Multifamily Housing Finance Needs, *supra* note 201.

[204] Meeting Multifamily Housing Finance Needs, *supra* note 201.

[205] Meeting Multifamily Housing Finance Needs, *supra* note 201.

[206] Meeting Multifamily Housing Finance Needs, *supra* note 201.

[207] Department of Housing and Urban Development, *Eye on Multifamily Housing Finance* (online at www.huduser.org/portal/periodicals/ushmc/fall09/ch1.pdf).

of their lending activities in commercial real estate. Simultaneously, higher quality commercial real estate projects tended to secure their financing in the CMBS market. As a result, if and when a crisis in commercial real estate develops, smaller and community banks will have greater exposure to lower quality investments, making them uniquely vulnerable.[208]

As discussed above, the combination of deteriorating market conditions and looser underwriting standards, especially for loans originating in the bubble years of 2005–2007, has presented financial institutions holding commercial real estate loans and CMBS with significant risks.[209] These institutions face large, potentially devastating losses as a result of loans that become non-performing or go into default.[210] The values of the underlying collateral for these loans have plummeted, cash flows and operating income have fallen, and the number of sales transactions has been drastically reduced.[211] One measure of the risks associated with CMBS is the fact that the Federal Reserve Bank of New York requires the largest haircuts (15 per cent) for CMBS financings compared to other asset classes in the Term Asset-Backed Securities Liquidity Program (TALF), as the GAO report noted in a report issued this month.[212]

As loan delinquency rates rise, many commercial real estate loans are expected to default prior to maturity.[213] For loans that reach maturity, borrowers may face difficulty refinancing either because credit markets are too tight or because the loans do not qualify under new, stricter underwriting standards.[214] If the borrowers cannot refinance, financial institutions may face the unenviable task of determining how best to recover their investments or minimize their losses: restructuring or extending the term of existing

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[208] See additional discussion of smaller regional and community bank exposure in Section E.

[209] *See generally* Parkus and Trifon, *supra* note 102; COP August Oversight Report, *supra* note 5, at 54–57. GAO TALF Report, *supra* note 64, at 13 (showing that private investors must provide a 15 percent "haircut," or equity contribution, on government-backed loans for CMBS, compared with 5–10 percent for credit card loans, and 5–9 percent for equipment loans).

In addition, other factors could affect leasing incentives. For example, the Financial Accounting Standards Board has a current project on its agenda which could affect lease accounting for all public and private companies who lease property (the lessee). Currently lessees who recognize their lease payments as an expense may be required under certain circumstances to recognize their entire lease obligation as a liability on their balance sheet. If adopted, lessess may not renew their lease or terminate their lease obligation early. As a result, this could further provide additional lending risks in the real estate sector, since a borrower's cash flw could significantly cecrease due to empty tenant space which could result in further delinquencies or defaults in commercial real estate loans.

[210] *See* Richard Parkus and Harris Trifon, Q4 2009 *Commercial Real Estate Outlook: Searching for a Bottom,* at 3, 65–67 (Dec. 1, 2009) (hereinafter "Parkus and Trifon: Searching for a Bottom").

[211] *See generally* MBA Data Book: Q3 2009, *supra* note 98. For example, values of commercial real estate fell around 40 percent from Q3 2007 to Q3 2009. *See id.* at 34. In Q3 2009, for all major property types, average vacancy rates increased (to 8.4 percent for apartments, 13 percent for industrial, 19.4 percent for office, and 18.6 percent for retail) and average rental rates decreased (by 6 percent for apartments, 9 percent for industrial, 9 percent for office, and 8 percent for retail) causing cash flows and operating income to fall. *Id.* at 9. Sales transactions were 72 percent lower year-to date Q3 in 2009 than in 2008, which were 66 percent lower than 2007. *Id.* Note that none of these numbers include construction or ADC loans. For an additional discussion of commercial real estate fundamentals, see Section B of this report.

[212] GAO TALF Report, *supra* note 64, at 13.

[213] *See* The Future Refinancing Crisis, Part II, *supra* note 120, at 4, 11; *see also* Goldman Sachs, *U.S. Commercial Real Estate Take III: Reconstructing Estimates for Losses, Timing,* at 16–20 (Sept. 29, 2009) (hereinafter "Commercial Real Estate Take III").

[214] *See* Richard Parkus and Jing An, *The Future Refinancing Crisis in Commercial Real Estate,* at 3 (Apr. 23, 2009) (hereinafter "The Future Refinancing Crisis in CRE").

loans or foreclosure or liquidation.[215] On the other hand, borrowers may decide to walk away from projects or properties if they are unwilling to accept terms that are unfavorable or fear the properties will not generate sufficient cash flows or operating income either to service new debt or to generate a future profit.[216] Finally, financing may not be available for new loans because of a scarcity of credit, rising interest rates, or the withdrawal of special Federal Reserve liquidity programs. This section will provide a more detailed analysis of each of these problems and then turn to broader social and economic consequences and the consequences for financial institutions.

1. Loans Become Delinquent

The problem begins when commercial real estate loans become delinquent (or past due) and worsens as new (or total) delinquent loans increase and delinquent balances continue to age.[217]

Although many analysts and Treasury officials believe that the commercial real estate problem is one that the economy can manage through, and analysts believe that the current condition of commercial real estate, in isolation, does not pose a systemic risk to the banking system, rising delinquency rates foreshadow continuing deterioration in the commercial real estate market.[218] For the last several quarters, delinquency rates have been rising significantly.

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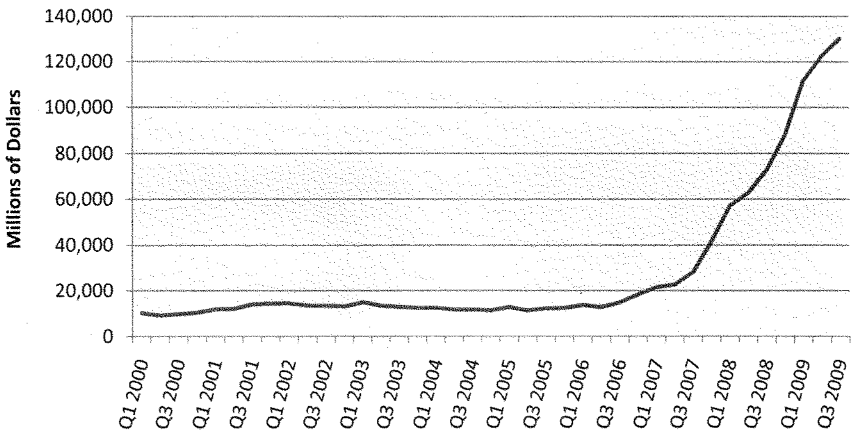
[215] *See* Parkus and Trifon: Searching for a Bottom, *supra* note 210, at 3. For further discussion of the alternatives available, see Section G of this report.

[216] *See, e.g.,* Realpoint Research, *Monthly Delinquency Report—Commentary, December 2009,* at 5–6 (Dec. 30, 2009) (hereinafter "Realpoint Report—December 2009"); Commercial Real Estate Take III, supra note 213, at 18–20.

[217] *See, e.g.,* Parkus and Trifon Searching for a Bottom, *supra* note 210, at 3, 67.

[218] *See, e.g.,* Parkus and Trifon Searching for a Bottom, *supra* note 210, at 67; U.S. Department of the Treasury, *Statement of Secretary of the Treasury Timothy F. Geithner to the Economic Club of Chicago,* at 7 (Oct. 29, 2009) (providing that the commercial real estate problem is "a problem the economy can manage through, even though it's going to be still exceptionally difficult"); *see also* Written Testimony of Jon Greenlee, *supra* note 93, at 4, 9 (explaining that banks face significant challenges and significant further deterioration in their commercial real estate loans but that the stability of the banking system has improved in the past year).

FIGURE 26: COMMERCIAL REAL ESTATE DELINQUENCIES FOR ALL DOMESTIC COMMERCIAL BANKS [219]



The extent of ultimate commercial real estate losses is yet to be determined; however, large loan losses and the failure of some small and regional banks appear to some experienced analysts to be inevitable.[220] New 30-day delinquency rates across commercial property types continue to rise, suggesting that commercial real estate loan performance will continue to deteriorate.[221] However, there is some indication that the rate of growth, or pace of deterioration, is slowing.[222] Unsurprisingly, the increase in delinquency rates has translated into rapidly rising default rates.[223]

2. Loans Go Into Default or Become Non-Performing

A loan will technically be in default when a borrower first fails to fulfill a loan obligation or promise, such as failure to make timely loan payments or violation of a debt covenant (for example, the requirement to maintain certain levels of capital or financial ratios).[224] However, for the purposes of this report, a loan will be con-

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[219] Board of Governors of the Federal Reserve System, *Data Download Program: Charge-off and Delinquency Rates (Instrument: Delinquencies/ All banks)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=CHGDEL) (accessed Feb. 9, 2010). The Federal Reserve defines delinquent loans as those loans that are past due thirty days or more and still accruing interest as well as those in nonaccrual status. *See also* Citibank, *CMBS Collateral Update: CMBS Delinquencies as of December 31, 2009,* at 4–7 (Jan. 4, 2010) (providing analysis on CMBS delinquency by property type, origination year, region, and state); Realpoint Report—December 2009, *supra* note 216, at 1 (providing that "the overall delinquent unpaid balance is up an astounding 440% from one-year ago . . . and is now over 17 times the low point . . . in March 2007"); MBA Data Book: Q3 2009, *supra* note 98, at 63–65 (providing that between the second and third quarters of 2009, the 30+ day delinquency rate on loans held in CMBS increased 0.17 percentage points to 4.06 percent and the 90+ day delinquency rate on loans held by FDIC insured banks and thrifts increased 0.51 percentage points to 3.43 percent); Parkus and Trifon, *supra* note 102, at 5–21; GAO TALF Report, *supra* note 64, at 29.

[220] *See, e.g.,* Parkus and Trifon: Searching for a Bottom, *supra* note 210, at 3, 67.

[221] *See generally* Parkus and Trifon, *supra* note 102, at 12 (hotel, increasing), 15 (industrial, increasing), 17 (multifamily, increasing), 19 (office, stable but expected to increase), 20–21 (retail, high but stable) (Dec. 2009).

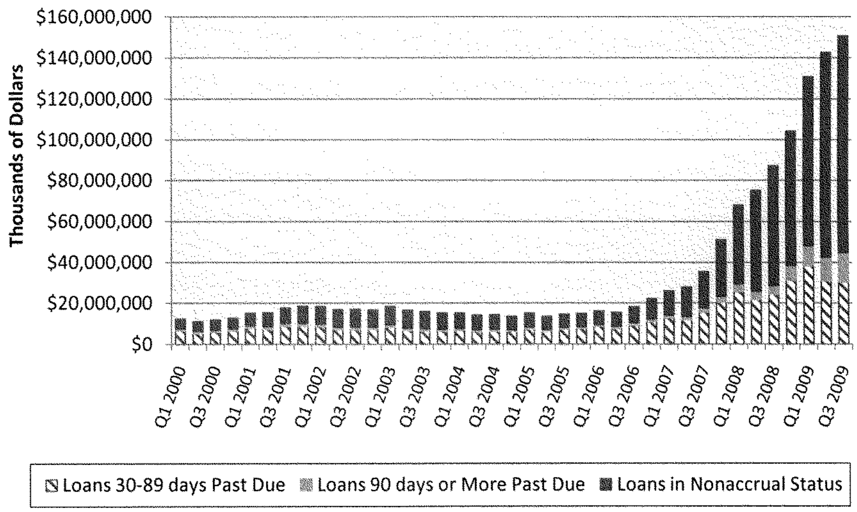
[222] *See* Federal Deposit Insurance Corporation, *Quarterly Banking Profile Third Quarter 2009,* at 1–2 (Sept. 2009) (online at www2.fdic.gov/qbp/2009sep/qbp.pdf) (providing that the amount of noncurrent loans continued to increase but that the increase "was the smallest in the past four quarters, as the rate of growth in noncurrent loans slowed for the second quarter in a row"); Parkus and Trifon, *supra* note 102, at 9.

[223] *See, e.g.,* Parkus and Trifon: Searching for a Bottom, *supra* note 210, at 27–30.

[224] *See* Barron's Real Estate Handbook, Sixth Edition at 228 (2005).

sidered in default when it becomes over 90 days delinquent. Thus, default rates will reflect the number of new loans that are over 90 days delinquent.[225] If a loan is over 90 days delinquent, or is in nonaccrual status because of deterioration in the financial condition of the borrower or because the lender can no longer expect the loan to be repaid in full,[226] the loan will become non-performing[227] or noncurrent.[228] The increasing number of loans that are delinquent by 90 days or less, in default or delinquent by over 90 days, and in nonaccrual status, shown in Figure 27, indicates problems with the collectability of outstanding amounts and draws into question the proper valuation of these assets on financial institution balance sheets.[229]

FIGURE 27: DELINQUENT, DEFAULTED, AND NON-PERFORMING COMMERCIAL REAL ESTATE LOANS FOR ALL DOMESTIC COMMERCIAL BANKS[230]



[225] *See* The Future Refinancing Crisis, Part II, *supra* note 120, at 15.

[226] A loan is to be reported to the FDIC as being in nonaccrual status if "(1) it is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) payment in full of principal or interest is not expected, or (3) principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection." *See* Federal Deposit Insurance Corporation, *Schedule RC–N—Past Due and Nonaccrual Loans, Leases, and Other Assets: Definitions* (online at www.fdic.gov/regulations/resources/call/crinst/897rc-n.pdf) (accessed Feb. 9, 2010).

[227] A loan is non-performing when it is not earning income, cannot be expected to be repaid in full, has payments of interest or principal over 90 days late, or was not repaid after its maturity date. *See* Barron's Real Estate Handbook, Sixth Edition, at 388 (2005).

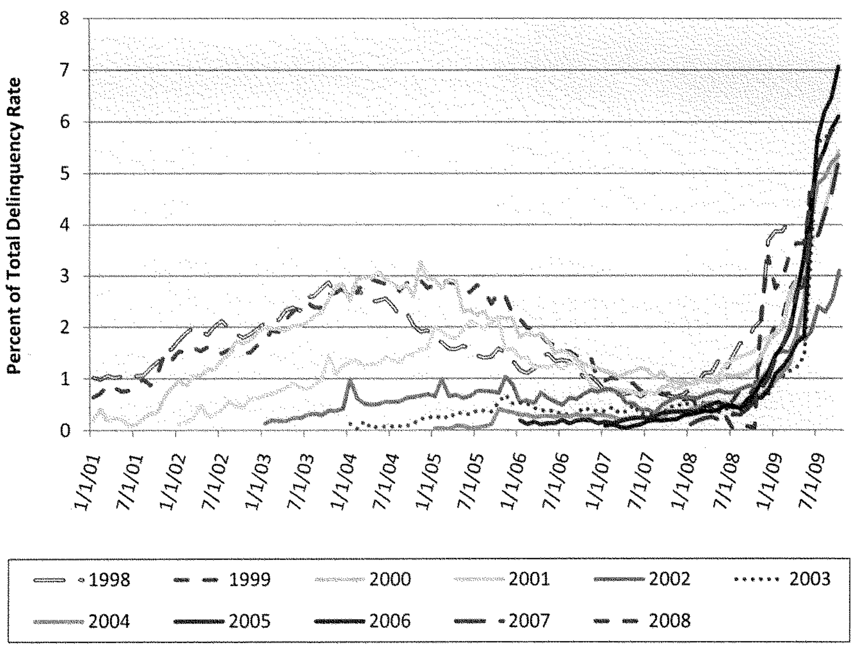
[228] *See* Written Testimony of Doreen Eberley, *supra* note 91, at 4 fn. 6.

[229] Valuation issues will be discussed further in Section G.2.

[230] Statistics on Depository Institutions, *supra* note 124.

The increasing number of delinquent, defaulted, and non-performing commercial real estate loans also reflects increasing levels of loan risks. Loan risks for borrowers and lenders fall into two categories: credit risk and term risk.[231] Credit risk can lead to loan defaults prior to maturity; such defaults generally occur when a loan has negative equity and cash flows from the property are insufficient to service the debt, as measured by the debt service coverage ratio (DSCR).[232] If the DSCR falls below one, and stays below one for a sufficiently long period of time, the borrower may decide to default rather than continue to invest time, money, or energy in the property. The borrower will have little incentive to keep a property that is without equity and is not generating enough income to service the debt, especially if he does not expect the cash flow situation to improve because of increasing vacancy rates and falling rental prices.[233] The number of term defaults, and accompanying losses, has been steadily increasing for the last several quarters, as exemplified by the following chart on CMBS loan default rates.

FIGURE 28: CMBS TERM DEFAULT RATES BY VINTAGE[234]



[231] See additional discussion of these risks in Section B.3.

[232] The Debt Service Coverage Ratio (DSCR) is the metric for determining when a property is earning sufficient income to meet its debt obligations. DSCR is calculated by taking net operating income (cash flows from the property) divided by debt service (required debt payments). A DSCR of less than one indicates that the property is not earning sufficient income to make debt payments. *See* Brueggeman and Fisher, *supra* note 13, at 344–45.

[233] *See generally* The Future Refinancing Crisis, Part II, *supra* note 120, at 11. See additional discussion of credit risk in Section B.3.

[234] Data provided by Richard Parkus, Head of Commercial Real Estate Debt Research, Deutsche Bank.

The level of credit risk is also reflected in the price of commercial property (as a measure of the present value of future cash flows) and the LTV ratio (as a measure of equity or negative equity). As commercial property prices continue to fall and LTV ratios continue to rise, the risk that additional commercial real estate loans will default prior to maturity is increasing.[235] For example, most of the commercial real estate loans from the 2002–2008 vintages are three-year to ten-year loans with LTVs well over 100 percent.[236] When combined with further deterioration in commercial real estate fundamentals, these loans are experiencing increasing credit risk and are providing continued exposure to term defaults.[237]

Term risk, on the other hand, reflects the borrower's ability to repay commercial real estate loans at maturity, and will depend more on the borrower's ability to refinance. As indicated above, term risk can be experienced even by performing properties.[238]

3. Loans Are Not Refinanced

Holders of commercial real estate loans and related securities are already experiencing significant problems with maturing loans that are unable to refinance. As seen by the following charts, the number of loans that are unable to refinance at maturity is increasing steadily.[239]

[235] *See* Written Testimony of Jon Greenlee, *supra* note 93, at 4–5 (providing that "the value of both existing commercial properties and land has continued to decline sharply, suggesting that banks face significant further deterioration in their CRE loans"); Dec. 2009 Dec. 2009 Moody's/REAL Commercial Property Price Indices, *supra* note 105, at 4; *see also* Commercial Real Estate Take III, *supra* note 213, at 3, 18–19; Brueggeman and Fisher, *supra* note 13, at 344–45.

[236] For example, Foresight Analytics LLC estimates that $770 billion (or 53 percent) of mortgages maturing from 2010 to 2014 have current LTVs in excess of 100 percent. Foresight further provides that over 60 percent of mortgages maturing in 2012 and 2013 will have LTVs over 100 percent.

[237] Dec. 2009 Moody's/REAL Commercial Property Price Indices, *supra* note 105, at 4.

[238] *See* Realpoint Report—December 2009, *supra* note 216, at 5 (providing that "balloon default risk is growing rapidly from highly seasoned CMBS transactions for both performing and non-performing loans coming due as loans are unable to pay off as scheduled").

[239] *See* Parkus and Trifon, *supra* note 102, at 26–31 (providing that the low level of loans paying off each month reflects the "current scarcity of financing," "the increasing number of loans that do not qualify to refinance," and "the unwillingness of borrowers to refinance at high mortgage rates," and that the number of maturity defaults and extensions also reflects "the combination of scarce financing options and increased number of loans that do not qualify to refinance").

FIGURE 29: CMBS LOAN PAYOFFS[240]

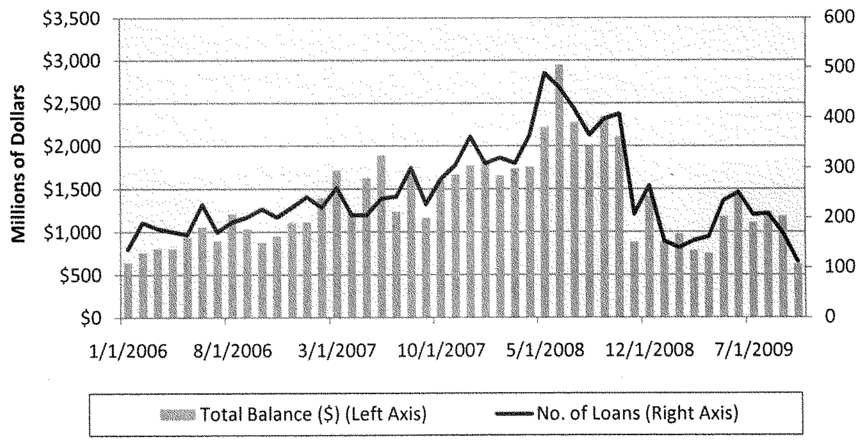
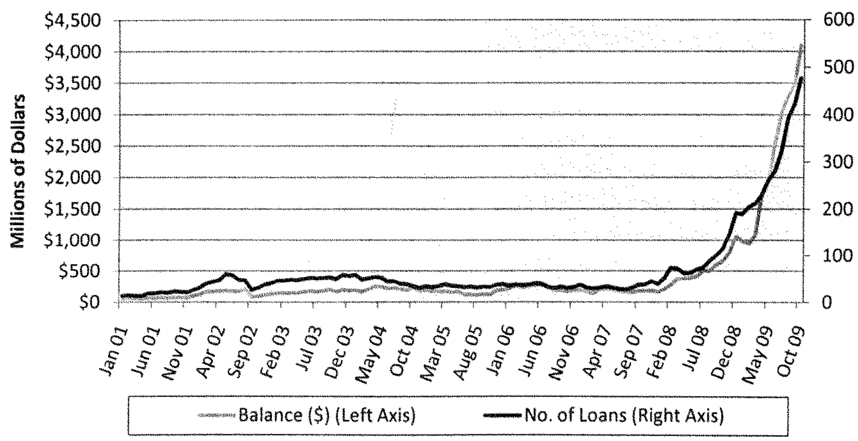


FIGURE 30: NUMBER OF CMBS MATURITY DEFAULTS/EXTENSIONS



These problems with refinancing are expected to intensify. Hundreds of billions of dollars of commercial real estate loans are scheduled to mature in the next decade, setting the stage for potentially continuing high levels of maturity defaults.[241] The following charts show projected maturity or refinancing schedules for all commercial mortgages by lender type, CMBS loans by vintage, and commercial real estate loans held by banks by origination year.

[240] Data provided by Richard Parkus, Head of Commercial Real Estate Debt Research, Deutsche Bank.

[241] *See* Parkus and Trifon, *supra* note 102, at 32–33; The Future Refinancing Crisis in CRE, *supra* note 214, at 3. See additional discussion of term risk in Section B.3.

FIGURE 31: COMMERCIAL MORTGAGE MATURITIES BY LENDER TYPE [242]

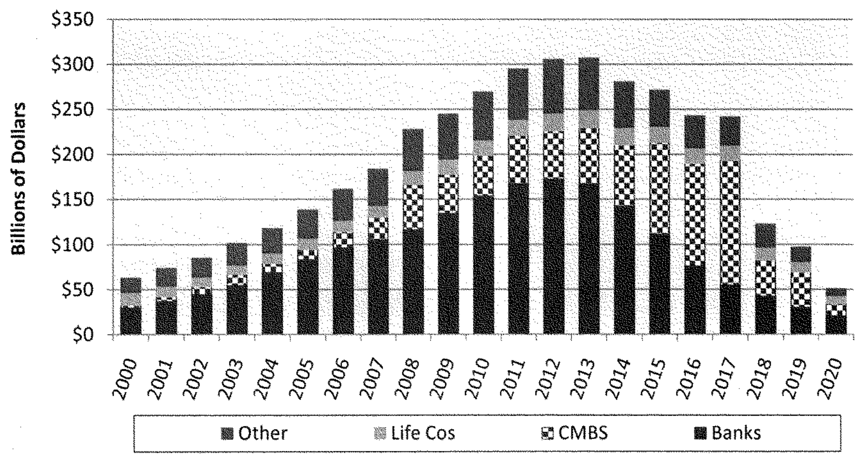
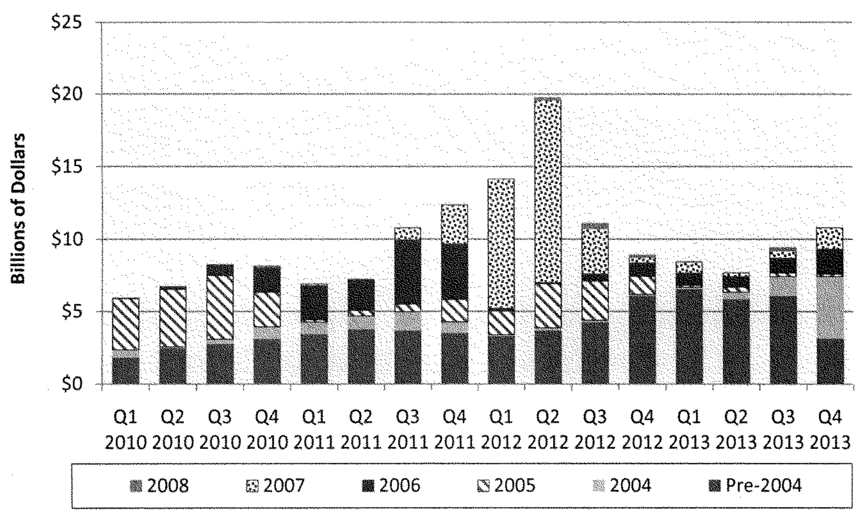


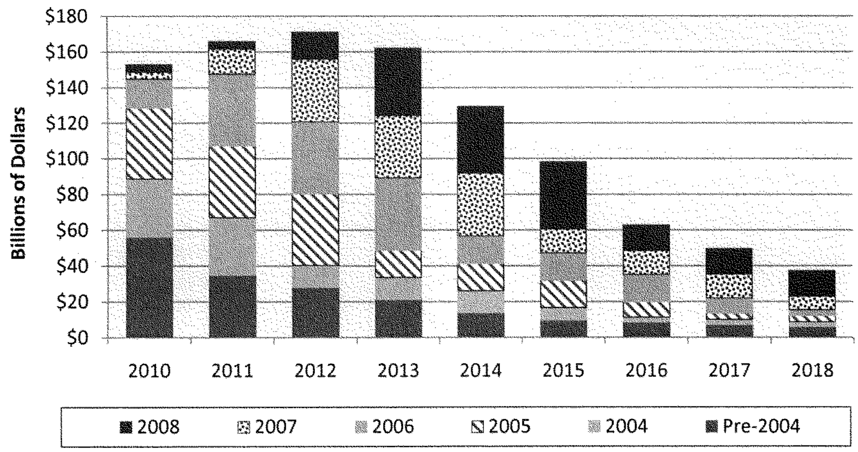
FIGURE 32: CMBS MATURITY SCHEDULE BY VINTAGE [243]



[242] Data provided by Foresight Analytics LLP. Foresight estimated gross originations for commercial and multifamily mortgages based on Federal Reserve Flow of Funds data. Then, Foresight applied a distribution of loan maturities to the origination year to project future mortgage maturity dates.

[243] Data provided by Richard Parkus, Head of Commercial Real Estate Debt Research, Deutsche Bank.

FIGURE 33: MATURITY SCHEDULE FOR COMMERCIAL REAL ESTATE LOANS HELD BY BANKS BY ORIGINATION YEAR [244]



According to the Real Estate Roundtable, the total rolling maturities for vulnerable commercial real estate loans for CMBS, insurance companies, and banks and thrifts are $1.3 trillion through 2013 and $2.4 trillion through 2018.[245] The refinancing risk is particularly significant from 2010 to 2013.[246] As a result, expected losses from term defaults and maturity defaults are concentrated in the next few years when many expect continued weakness or deterioration in the commercial real estate market.[247]

The inclusion of construction loan losses changes the magnitude and timing of commercial real estate losses. Construction loan losses have accelerated the commercial real estate credit cycle because construction credit quality has deteriorated faster than non-construction loan quality and construction loans generally have

[244] Data provided by Foresight Analytics LLP. Foresight estimated gross originations for commercial and multifamily mortgages based on Federal Reserve Flow of Funds data. Then, Foresight applied a distribution of loan maturities to the origination year (cross-tabulating estimates with figures reported in the Call Reports) to project future maturity dates for commercial real estate loans held by banks.

[245] The Real Estate Roundtable, *Restoring Liquidity to Commercial Real Estate Markets,* at 4–5 (Sept. 2009) (online at www.rer.org/ContentDetails.aspx?id=3045) (hereinafter "Real Estate Roundtable White Paper"). The Real Estate Roundtable is a trade association comprised of leaders of the nation's top public and privately-held real estate ownership, development, lending and management firms and leaders of sixteen national real estate trade associations. The Roundtable addresses key national policy issues and promotes policy initiatives relating to real estate and the overall economy.

[246] *See, e.g.,* Written Testimony of Jon Greenlee, *supra* note 93, at 7–8 (providing that "more than $500 billion of CRE loans will mature each year over the next few years"); Financial Crisis Inquiry Commission, Written Testimony of Dr. Kenneth T. Rosen, chair, Fisher Center for Real Estate and Urban Economics, University of California—Berkeley's Haas School of Business, *The Current State of the Housing, Mortgage, and Commercial Real Estate Markets: Some Policy Proposals to Deal with the Current Crisis and Reform Proposals to the Real Estate Finance System,* at 3 (Jan. 13, 2010) (online at www.fcic.gov/hearings/01-13-2010.php) (providing that the number of commercial mortgage maturities is expected to increase each year through 2013).

[247] *See* The Future Refinancing Crisis, *supra* note 213, at 7, 14–16, 23–26; *see also* Tom Joyce, Toby Cobb, Francis Kelly, and Stefan Auer, *A Return to Normalcy in 2010?,* at 20 (Jan. 2010) (hereinafter "Joyce, Cobb, Kelly and Auer"); Parkus and Trifon, *supra* note 102, at 30–33, 48; US CRE Debt Markets, *supra* note 122, at 68–70.

shorter terms.[248] In addition, construction loans have higher loss severity rates leading to higher peak losses.[249]

The commercial real estate loans at issue—namely, construction loans, mini-perm loans,[250] short-term fixed rate whole and CMBS loans, and short-term floating rate whole and CMBS loans—are largely structured as interest only, partial interest only, or partial amortization loans.[251] This means that the loans typically do not amortize the full principal, leaving a large balloon payment at the end of the term. In order to make these balloon payments, borrowers typically attempt to refinance or apply for new loans with sufficient proceeds to pay off the existing loans. Borrowers unable to refinance these loans at maturity will have to locate additional funds for the balloon payment, sell the property, work out an alternative arrangement with the lender, or default.[252]

To qualify for refinancing, under current conditions, the borrower must generally satisfy three criteria: (1) the new loan balance must be greater than or equal to the existing loan balance, (2) the LTV ratio must be no greater than 70 (current maximum LTVs are between 60 and 65), and (3) the DSCR (assuming a 10-year, fixed rate loan with a 25-year amortization schedule and an 8 percent interest rate), must be no less than 1.3.[253]

a. Qualifying Loans Face Scarcity of Credit

Many commercial real estate loans from earlier vintages, such as 1999 and 2000, that occurred before the dramatic weakening in underwriting quality of the bubble years, have experienced price appreciation and would normally qualify for refinancing, even under the new, stricter underwriting standards.[254] However, as these loans are maturing, they are having difficulty refinancing because most credit markets are operating at dramatically reduced levels.[255] For example, the CMBS market was essentially frozen from July 2008 to May 2009 (with no CMBS issued during this time) and is only now starting to thaw.[256] Weak demand for credit, tight-

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[248] Commercial Real Estate Take III, *supra* note 213, at 11–14.

[249] See Commercial Real Estate Take III, *supra* note 213, at 11–14; The Future Refinancing Crisis, Part II, *supra* note 120, at 23–27; see also Parkus and Trifon, *supra* note 102, at 40, 44–45.

[250] A mini-perm loan is a short-term bank loan, similar to a bridge loan, that is typically offered at the maturity of a construction loan so that the borrower can establish an operating history, in preparation for obtaining a term loan. *See* Brueggeman and Fisher, *supra* note 13, at 437–38, 444.

[251] *See, e.g.,* Parkus and Trifon: Searching for a Bottom, *supra* note 210, at 24–26, 45. See additional discussion of the structure of commercial real estate loans in Section E.

[252] See The Future Refinancing Crisis in CRE, *supra* note 214, at 11; Parkus and Trifon: Searching for a Bottom, *supra* note 210, at 33. See additional discussion of the options for borrowers and lenders in Section G.3.

[253] *See* The Future Refinancing Crisis in CRE, *supra* note 214, at 11; Parkus and Trifon: Searching for a Bottom, *supra* note 210, at 33.

[254] The Future Refinancing Crisis in CRE, *supra* note 214, at 3.

[255] *See* COP Field Hearing in Atlanta, *supra* note 70, at 6–7 (Testimony of Doreen R. Eberley); Congressional Oversight Panel, Written Testimony of Timothy F. Geithner, Secretary of the Treasury, *COP Hearing with Treasury Secretary Timothy Geithner*, at 3, 7–8 (Dec. 10, 2009) (online at cop.senate.gov/hearings/library/hearing–121009–geithner.cfm) (hereinafter "COP Hearing with Secretary Geithner") ("Lending standards are tight and bank lending continues to contract overall, although the pace of contraction has moderated"); The Future Refinancing Crisis in CRE, *supra* note 214, at 3.

[256] *See* Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146 (updated Jan. 12, 2010); COP Hearing with Secretary Geithner, *supra* note 255, at 3 ("[A]lthough securitization markets have improved, parts of those markets are still impaired, especially for

Continued

ened lending standards, and potentially large commercial mortgage losses have contributed to a contraction in bank lending.[257] Further, many banks have expressed a desire to decrease their commercial real estate exposure rather than refinance existing loans.[258]

b. Loans that Fail to Qualify for Refinancing

Although capital contraction has posed a problem, the significant number of loans—especially those originated during the peak years of 2005 to 2007—that will not qualify for refinancing at maturity pose a far greater problem. As noted above, two general types of non-qualifying loans reflect different levels of seriousness. The first type includes loans that are performing at maturity but are unable to refinance due to the collateral effects of wider economic problems, such as increases in unemployment and decreases in consumer spending leading to less demand for commercial space and higher vacancy rates. These loans, while reasonable at their inception, fell victim to an unexpected deterioration in commercial market fundamentals. Loans that are performing at maturity but have difficulty refinancing during a declining real estate market because they have an "equity gap" provide a good example of the first kind of non-qualifying loans.

As seen by the following table, if the market value of a property has fallen significantly, the LTV ratio will rise, since the loan-to-value ratio is the loan balance divided by the value. Assuming the borrower has a lender who is willing to refinance the mortgage, the borrower will need to come up with additional equity in order to stay under the lender's LTV ratio limit.

FIGURE 34: EXAMPLE OF EQUITY GAP

2005 (Property Financed with 5–year Mortgage)	
Property Value	$1,000,000
Outstanding Principal Balance	$750,000
Equity	$250,000
LTV	75%
2010 (Mortgage Matures—Borrower Must Refinance)	
Property Value	$750,000
Outstanding Principal Balance	$700,000
Equity	$50,000
LTV	93%
Available Loan for 75% LTV (75% of $750,000)	$562,500
Total Equity Needed ($700,000-$562,500)	$187,500

securities backed by commercial mortgages"). *See also* discussion of the CMBS market in Section E.2.

[257] *See* COP Hearing with Secretary Geithner, *supra* note 255, at 3, 8 ("The contraction in many categories of bank lending reflects a combination of persistent weak demand for credit and tight lending standards at the banks, amidst mounting bank failures and commercial mortgage losses"); Board of Governors of the Federal Reserve System, *National Summary of the October 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices*, at 2 (Nov. 2, 2009) (online at www.federalreserve.gov/boarddocs/snloansurvey/200911/fullreport.pdf) (providing that reduced risk tolerance, a less favorable or more uncertain economic outlook, and a worsening of industry-specific problem contributed to tightened credit standards for C&I loans); *see also* Real Estate Roundtable White Paper, *supra* note 245, at 4 (accessed Feb. 9, 2010).

[258] *See* U.S. Department of the Treasury, *Monthly Lending and Intermediation Snapshot* (Dec. 14, 2009) (online at www.financialstability.gov/impact/monthlyLendingandIntermediationSnapshot.htm) (hereinafter "Treasury Snapshot, Dec. 14 2009"). *See also* discussion of capital contraction in Section G.1.

FIGURE 34: EXAMPLE OF EQUITY GAP—Continued

Subtract $50,000 in Existing Equity	
Equity Gap at 75% LTV	$137,500
Available Loan for 65% LTV (65% of $750,000)	$487,500
Total Equity Needed ($700,000-$487,500)	$212,500
Subtract $50,000 in Existing Equity	
Equity Gap at 65% LTV	$162,500

In order to refinance, the borrower in this example needs to come up with nearly $140,000 to refinance because of declining property values, even though there is equity remaining in the property. Increased underwriting standards will exacerbate the equity shortfall in this example, requiring an additional $25,000 to refinance based upon a more conservative 65 percent LTV limit. Underwater borrowers with negative equity will be in an even worse situation. Bear in mind that the borrowers in this situation may own a property that is fully leased and generating more than enough rental income to cover debt service. Simply due to the recent decline in property values, thousands of otherwise healthy properties could now face default and foreclosure because of this problem. The Real Estate Roundtable estimates that the total equity gap for commercial real estate could be over $1 trillion.[259]

The second type of non-qualifying commercial real estate loans includes loans, performing or non-performing, that were excessively speculative or based on inadequate credit checks or underwriting standards. These loans do not qualify for refinancing for reasons beyond the unexpected economic downturn. Construction loans represent by far the riskiest loans and provide a good example of the second type of non-qualifying loans.

Currently, the markets are heavily penalizing properties with vacancy issues, which translate into cash flow issues. Newly or partially constructed commercial properties are experiencing the biggest vacancy problems.[260] Lenders are also requiring much lower LTVs (or significantly less leverage), and the values of newly constructed properties have fallen dramatically. Construction loans originating from 2005 to 2008, or those based on aggressive rental and cash flow projections, have a high likelihood of default and high loss severity rates.[261] The total delinquency rate of construction loans is already 16 percent,[262] but this percentage does not necessarily portray the severity of the construction loan problem, especially for the smaller and regional banks with the highest exposure. Construction loans are generally structured as short-term floating rate loans with upfront interest reserves that are used to satisfy interest payments until the project is completed. Because of historically low interest rates, interest reserves are lasting longer, allowing many construction loans to remain performing, even

[259] The Real Estate Roundtable, *Challenges Facing Commercial Real Estate*, at 6 (2009).
[260] Parkus and Trifon, *supra* note 102, at 40.
[261] Parkus and Trifon, *supra* note 102, at 40.
[262] Parkus and Trifon, *supra* note 102, at 44; *see also* Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, *Statement of Daniel K. Tarullo, member, Board of Governors of the Federal Reserve System: Examining the State of the Banking Industry*, at 7–9 (Oct. 14, 2009) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c123f6a9-0b8d-4b22-ba68-fa900a712d86) (hereinafter "Testimony of Daniel K. Tarullo").

though the underlying properties may be excessively leveraged or have little profit potential. Thus, as interest rate reserves are exhausted, delinquency rates and losses will likely increase dramatically.[263]

A number of construction projects have been delayed or abandoned providing physical proof of problems with construction loans. Stalled projects, ranging from high-profile to smaller-scale developments, span the country. Higher profile examples include a shopping district in Atlanta (Streets of Buckhead), redevelopment of a retail store in Boston (Filene's Basement), a mixed-use building in Phoenix, a large casino-hotel in Las Vegas (Fontainebleau), and a retail project in the New Jersey Meadowlands (Xanadu).[264] From a community standpoint, half-finished buildings or new commercial properties that are vacant or largely vacant can be thought of as merely irritating eyesores. But, they can also be symbolic of greater problems or misfortunes resulting from the current economic downturn (and its general effect on individuals, businesses, unemployment, and spending), deterioration in the commercial real estate market, and general capital contraction.

4. New Loans Fail To Get Financing

The problems which persist for existing loans will also contribute to an inability for new loans to get financing.[265] High vacancy rates and weak demand for additional commercial property will not only imperil the ability of current loans to perform and current borrowers to refinance but also discourage additional development and consequently the need for new loans. Substantial absorption will have to take place before new developments, and the accompanying loans, become attractive.[266] Sharp decreases in commercial and multifamily mortgage loan originations, loans for conduits for CMBS, and sales of commercial property reflect the existence of tight credit conditions and low demand for new commercial real estate loans.[267]

Further, banks facing large potential commercial real estate losses may be unable to extend new loans.[268] In an effort to increase loan loss reserves and shore up additional capital, banks

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[263] Parkus and Trifon, *supra* note 102, at 40–45.

[264] *See* Alexandra Berzon, *Icahn Is Winning Bidder for Casino*, Wall Street Journal (Jan, 21. 2010); Carrick Mollenkamp and Lingling Wei, *Unfinished Projects Weigh on Banks*, Wall Street Journal (Jan. 20, 2010).

[265] See additional discussion of scarcity of credit in Section C.2.

[266] *See* Written Testimony of Mark Elliott, *supra* note 109, at 7 ("Because of too much speculative development and the diminished economy, there is a fundamental over-supply of real estate in every product class and of every type"); COP Field Hearing in Atlanta, *supra* note 70, at 1 (Testimony of Chris Burnett); Treasury Snapshot, Dec. 14 2009, *supra* note 258 ("Demand for new commercial real estate loans remains low due to the lack of new construction activity. Real estate developers are reluctant to begin new projects or purchase existing projects under current poor economic conditions, which include a surplus of office space as firms downsize and vacancies rise"); Commercial Real Estate Take III, *supra* note 213, at 6–8. See also the discussion of capital contraction above in Section G.1.

[267] MBA Data Book: Q3 2009, *supra* note 98, at 30, 39–43; *see also* Matthew Anderson and Susan Persin, *Commercial Mortgage Outlook: Growing Pains in Mortgage Maturities*, at 1, 3 (Mar. 17, 2009) ("[W]e expect the commercial real estate debt market to show minimal net growth during the next decade. The high volume of loans maturing in the multifamily and commercial mortgage markets will absorb most of the origination volume for several years. . . . [W]e estimate that refinancing of maturing mortgages comprised about 80% of total originations in 2008, as compared to 35% during the 2000 to 2007 period").

[268] *See, e.g.*, COP Hearing with Secretary Geithner, *supra* note 255, at 3 ("Commercial real estate losses weigh heavily on many small banks, impairing their ability to extend new loans").

will have less capital available to make new loans.[269] However, even assuming available capital, banks with significant commercial real estate exposure may shy away from additional commercial real estate loans, regardless of the quality of such loans, opting instead to reduce their current exposure because commercial real estate market fundamentals are weak and not expected to improve in the near term.[270] Banks may also be unwilling to take originally loans onto their balance sheet that will ultimately be securitized because of warehousing and arbitrage risk, hindering recovery in the CMBS market.[271]

In addition, rising interest rates and the withdrawal of Federal Reserve liquidity programs may exacerbate the problem.[272] A significant amount of commercial real estate loans are floating rate loans. Historically low interest rates are helping these loans perform in the face of decreased operating income or cash flows by reducing interest payments or the level of debt service. However, if interest rates begin to rise, the values of commercial property would fall further and cash flows and interest rate reserves would be exhausted sooner, leading to an accompanying rise in loan defaults.

Rising interest rates would also impair refinancing for properties that are not aggressively leveraged because of the combination of an increasing cost of capital and diminished operating income or cash flows. As the DSCR continues to fall, the level of risk increases, causing lenders to charge even higher rates of interest to compensate for additional risk.[273] The withdrawal of Federal Reserve liquidity programs, such as TALF (a partially TARP funded program), may result in wider spreads, less readily available capital for commercial real estate, and more difficulty refinancing loans at maturity.[274]

From the banks' perspectives, rising interest rates will typically reduce profitability as funding costs increase more rapidly than the yield on banks' loans and investments. Such reduced profitability

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[269] *See* COP Field Hearing in Atlanta, *supra* note 70, at 8–9 (Testimony of Chris Burnett).

[270] *See* Treasury Snapshot, Dec. 14 2009, *supra* note 258 ("Finally, nearly all respondents indicated that they are actively reducing their exposure to commercial real estate loans, as banks expect commercial real estate loan delinquencies to persist and forecasters expect weakness in the commercial real estate market to continue").

[271] *See* Joyce, Cobb, Kelly and Auer, *supra* note 247, at 21.

[272] These included five programs, the Money Market Investor Funding Facility, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Primary Dealer Credit Facility, the Term Securities Lending Facility, and the Term Asset-Backed Securities Loan Facility (TALF), designed to expand the range and terms of the Board's provision of funds to support financial institutions. The Term Auction Facility, which allows depository institutions, upon provision of adequate collateral to obtain short-term loans from the Board at interest rates determined by auction, remains in operation as of the date of this report. Bank supervisors have already begun advising the institutions they regulate to adopt plans for addressing rising interest rates and illiquidity. *See, e.g.*, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision (OTS), and Federal Financial Institutions Examination Council State Liaison Committee, *Advisory on Interest Rate Risk Management* (Jan. 6, 2010) (online at www.fdic.gov/news/news/press/2010/pr1002.pdf).

[273] *See* Board of Governors of the Federal Reserve System, *Speech by Governor Elizabeth A. Duke at the Economic Forecast*, at 9 (Jan. 4, 2010) (online at www.federalreserve.gov/newsevents/speech/duke20100104a.htm) (discussing unfavorable outlook for commercial real estate and higher rates of return required by investors).

[274] *See, e.g.*, COP Field Hearing in Atlanta, *supra* note 70, at 8 (Testimony of Jon Greenlee) (providing that TALF has been successful in helping restart securitization markets and narrowing rate spreads for asset-backed securities). See additional discussion of the TALF at Section I.1.

will put further stress upon banks already struggling with sizable exposures of delinquent or non-performing commercial real estate loans in their portfolios and thereby hasten the need for these banks to resolve the status of such loans regardless of the accounting treatment of such loans.

5. Broader Social and Economic Consequences

Declining collateral values, delinquent and defaulting loans, and inability to secure refinancing in order to make a balloon payment can all result in financial institutions having to write-down asset values. These write-downs have already caused financial institutions to fail, and if commercial real estate losses continue to mount, the write-downs and failures will only increase. But, it is important to realize that these conditions will have a far broader impact.

Commercial real estate problems exacerbate rising unemployment rates and declining consumer spending. Approximately nine million jobs are generated or supported by commercial real estate including jobs in construction, architecture, interior design, engineering, building maintenance and security, landscaping, cleaning services, management, leasing, investment and mortgage lending, and accounting and legal services.[275] Projects that are being stalled or cancelled and properties with vacancy issues are leading to layoffs. Lower commercial property values and rising defaults are causing erosion in retirement savings, as institutional investors, such as pension plans, suffer further losses. Decreasing values also reduce the amount of tax revenue and fees to state and local governments, which in turn impacts the amount of funding for public services such as education and law enforcement. Finally, problems in the commercial real estate market can further reduce confidence in the financial system and the economy as a whole.[276]

To make matters worse, the credit contraction that has resulted from the overexposure of financial institutions to commercial real estate loans, particularly for smaller regional and community banks, will result in a "negative feedback loop" that suppresses economic recovery and the return of capital to the commercial real estate market. The fewer loans that are available for businesses, particularly small businesses, will hamper employment growth, which could contribute to higher vacancy rates and further problems in the commercial real estate market.[277]

The cascading effects of a financial crisis on the economy was the justification for the use of public funds under EESA, and future problems in the commercial real estate markets may create similar conditions or causes for concern.

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[275] Real Estate Roundtable White Paper, *supra* note 245, at 1–2 (accessed Feb. 9, 2010); *see also* COP Field Hearing in Atlanta, *supra* note 70, at 4.

[276] Real Estate Roundtable White Paper, *supra* note 245, at 1–2 (accessed Feb. 9, 2010).

[277] *See* Lockhart Speech before the Atlanta Fed, *supra* note 128; *see also* COP Field Hearing in Atlanta, supra note 70, at 10, 12 (Testimony of Doreen Eberley) (providing that small businesses and trade groups are having difficulty obtaining credit and renewing existing lines of credit and that extending credit to businesses will be essential in stimulating economic growth). Consumers or households are experiencing similar problems obtaining access to credit, resulting in reduced consumer spending. *See* COP Field Hearing in Atlanta, *supra* note 70, at 4 (Testimony of Jon Greenlee).

G. Bank Capital; Financial and Regulatory Accounting Issues; Counterparty Issues; and Workouts

Some of the risks of commercial real estate loans can produce a direct impact on bank capital, some trigger related financial market consequences, and still others can be eased or resolved by private negotiations short of any immediate impact. This section discusses (1) the bank capital rules that set the terms on which loan failures can affect bank strength, (2) a general summary of the accounting policies involved, (3) the risk of collateral financial market consequences, and (4) the way in which workouts and loan modifications can reduce or eliminate, at least for a time, such adverse impacts.

1. Commercial Real Estate and Bank Capital [278]

Troubled loans have a significant negative effect on the capital of the banks that hold them; the two operate jointly. Although bank capital computations are often very technical and complicated,[279] the core of the rules can be stated simply. A bank's capital strength is generally measured as the ratio of specified capital elements on the firm's consolidated balance sheet (e.g., the amount of paid-in capital and retained earnings) to its total assets.[280] Decreases in the value of assets on a bank's balance sheet change the ratio by requiring that amounts be withdrawn from capital to make up for the losses. Losses in asset value that are carried directly to an institution's capital accounts without being treated as items of income or loss have the same effect.[281]

During the financial crisis, all of these steps accelerated dramatically. A plunge in the value of a bank's loan portfolio that has a significant impact on the value of the bank's assets—as it usually will—triggers a response by the bank's supervisor, one that usually requires the institution to raise additional capital or even push it into receivership. Otherwise, the bank's assets simply cannot support its liabilities and it is insolvent. The TARP attempted to re-

[278] This discussion is taken from the Panel's August report. *See* COP August Oversight Report, *supra* note 5, at 18–19.

[279] Capital adequacy is measured by two risk-based ratios, Tier 1 and Total Capital (Tier 1 Capital plus Tier 2 Capital (Supplementary capital). Tier 2 capital may not exceed Tier 1 capital. Tier 1 capital is considered core capital while Total Capital also includes other items such as subordinated debt and loan loss reserves. Both measures of capital are stated as a percentage of risk-weighted assets. A financial institution is also subject to the Leverage Ratio requirement, a non-risk-based asset ratio, which is defined as Tier 1 Capital as a percentage of adjusted average assets. *See* Office of Thrift Supervision, *Examination Handbook,* Capital, at 120.3 (Dec. 2003) (online at files.ots.treas.gov/422319.pdf); *see also* Federal Deposit Insurance Corporation, Risk Management Manual of Examination Policies, Section 2.1 Capital (April 2005) (online at www.fdic.gov/regulations/safety/manual/section2-1.html#capital); Office of the Comptroller of the Currency, Comptroller's Handbook (Section 303), Capital Accounts and Dividends, (May 2004) (online at www.occ.treas.gov/handbook/Capital1.pdf). In addition, the risk-based capital standards identify "concentration of credit risk, risks of nontraditional activities, and interest rate risk as qualitative factors to be considered in the [supervisory] assessments of an institution's overall capital adequacy." *See* Accounting Research Manager, Chapter 1: Industry Overview—Banks and Savings Institutions, at 1.31 (online at www.accountingresearchmanager.com/wk/rm.nsf/0/ 6EE8C13C9815FB4186256E6D00546497? OpenDocument&rnm= 673577&Highlight=2, BANKS,SAVINGS,INSTITUTIONS).

[280] The value of the assets is generally "risk-weighted," that is, determined based on the risk accorded the asset.

[281] Although these losses are carried directly to the capital account, they have no effect on regulatory capital calculations when recorded in the other-comprehensive-income account.

store the balance during the crisis by shoring up bank capital directly.[282]

The problem of unresolved bank balance sheets is intertwined with the problem of lending, as the Panel has observed before.[283] Uncertainty about risks to bank balance sheets, including the uncertainty attributable to bank holdings of the troubled assets, caused banks to protect themselves against possible losses by building up their capital reserves, including devoting TARP assistance to that end. One consequence was a reduction in funds for lending and a hesitation to lend even to borrowers who were formerly regarded as credit-worthy.

2. Accounting Rules [284]

Under applicable accounting standards, financial institutions in general value their assets according to "fair value" accounting.[285] Since the beginning of the financial crisis, concerns about how financial institutions reflect their true financial condition without "marking their assets to market" have surfaced.

Under the basic "fair value" standard, the manner in which debt and equity securities and loans are valued depends on whether those assets are held on the books of a financial institution in its (1) trading account (an account that holds debt and equity securities that the institution intends to sell in the near term), (2) available-for-sale account (an account that holds debt and equity securities that the institution does not necessarily intend to sell, certainly in the near term), or (3) held-to-maturity account (an account, as the name states, for debt securities that the institution intends to hold until they are paid off).

The bank designates assets that are readily tradable in the near future by classifying these assets in a trading account. Many of these assets are bought and sold regularly in a liquid market, such as the New York Stock Exchange or the various exchanges on which derivatives and options are bought and sold, which sets fair market values for these assets.[286] There is no debate about market

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[282] Congressional Oversight Panel, Testimony of Assistant U.S. Treasury Secretary for Financial Stability Herbert Allison, at 27 (June 24, 2009) (online at cop.senate.gov/documents/transcript-062409-allison.pdf) (Treasury seeks to enable banks "to sell marketable securities back into [the] market and free up balance sheets, and at the same time [to make] available, in case it's needed, additional capital to these banks which are so important to [the] economy"); *See also id.* at 28 ("Treasury . . . is providing a source of capital for the banks and capital is essential for them in order that they be able to lend and support the assets on their balance sheet and there has been . . . there was an erosion of capital in a number of those banks").

[283] *See, e.g.,* COP June Oversight Report, *supra* note 6, at 6, 11–12.

[284] For a more complete discussion of "fair value accounting" *see* COP August Oversight Report, *supra* note 5, at 18–19.

[285] Financial Accounting Standard 157, adopted in 2006, was meant to provide a clear definition of fair value based on the types of metrics utilized to measure fair value (market prices and internal valuation models based on either observable inputs from markets, such as current economic conditions, or unobservable inputs, such as internal default rate calculations).

[286] *See* Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157: *Fair Value Measurements* (SFAS 157) (September 2006). If assets are not traded in an active market, SFAS 157 describes the steps to be taken in the valuation of these assets. In this regard, SFAS 157 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the entity's market assumptions. SFAS 157 requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value of assets. These two types of inputs have created a three fair value hierarchy: Level 1 Assets (mark-to-market), Level 2 Assets (mark-to-matrix), and Level 3 Assets (mark-to-model).

Level 1—Liquid assets with publicly traded quotes. The financial institution has no discretion in valuing these assets. An example is common stock traded on the NYSE.

value. In the trading account, the value must be adjusted to reflect changes in prices. The adjustments affect earnings directly.

Assets in an available-for-sale account are carried at their "fair value." In this case, any changes in value that are not realized through a sale do not affect earnings but directly affect equity on the balance sheet (reported as unrealized gains or losses through an equity account called "Other Comprehensive Income"). However, unrealized gains and losses on available-for-sale assets do not affect regulatory capital. Assets that are regarded as held-until-maturity are valued at cost minus repaid amounts (i.e., an "amortized basis").

The treatment of these assets held in either an available-for-sale or a held-to-maturity account changes when these assets become permanently impaired.[287] In this case the permanent impairment is reported as a realized loss through earnings and regulatory capital.

When mortgage defaults rose in 2007 and 2008, the value of underlying assets, such as mortgage loans, dropped significantly, causing banks to write-down both whole loans and mortgage-related securities on their balance sheets. As discussed in the August report, financial institutions are worried that reflecting on their balance sheets the amounts they would receive through forced sales of assets will distort their financial positions—to say nothing of threatening their capital—although they are not in fact selling the assets in question and in fact might well recover more than the fire sale write-down price.[288]

In April 2009, the Financial Accounting Standards Board again adjusted the accounting rules to loosen the use of immediate fair value accounting. One of the new rules suspends the need to apply mark-to-market principles for securities classified under trading or available-for-sale if current market prices are either not available or are based on a distressed market.[289] The rationale for this

Level 2—Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. The frequency of transactions, the size of the bid-ask spread and the amount of adjustment necessary when comparing similar transactions are all factors in determining the liquidity of markets and the relevance of observed prices in those markets.

Level 3—Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. If quoted market prices are not available, fair value should be based upon internally developed valuation techniques that use, where possible, current market-based or independently sourced market parameters, such as interest rates and currency rates.

See also footnote 289, which discusses how to determine if there is an active market.

[287] Credit impairment is assessed using a cash flow model that estimates cash flows on the underlying mortgages, using the security-specific collateral and transaction structure. The model estimates cash flows from the underlying mortgage loans and distributes those cash flows to various tranches of securities, considering the transaction structure and any subordination and credit enhancements that exist in the structure. It incorporates actual cash flows on the mortgage-backed securities through the current period and then projects the remaining cash flows using a number of assumptions, including default rates, prepayment rates, and recovery rates (on foreclosed properties). If cash flow projections indicate that the entity does not expect to recover its amortized cost basis, the entity recognizes the estimated credit loss in earnings.

[288] John Heaton, Deborah Lucas, and Robert McDonald, *Is Mark to Market Destabilizing Analysis and Implications for Policy,* University of Chicago and Northwestern University (May 11, 2009).

[289] Financial Accounting Standards Board, FASB Staff Position: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP FAS 157–4) (Apr. 9, 2009). FSP 157–4 relates to determining fair values when there is no active market or where the price inputs

Continued

amendment is that security investments held by an entity can distort earnings in an adverse market climate by reducing those earnings more than will be required if the loans are held to maturity.

A second new rule, also adopted on April 9, 2009, applies to permanently impaired debt securities classified as available-for-sale or held-to-maturity, upon which the holder does not intend to sell or believes it will not be forced to sell before they mature.[290] Under the new rule, the part of the permanent impairment that is attributable to market forces does not reduce earnings and does not reduce regulatory capital, but other impairment changes, such as volatility of the security or changes due to the rating agency, will reduce earnings and regulatory capital. The old rule did not distinguish how the impairment was derived. All permanent impairments, whether related to market forces or other conditions, reduced earnings and reduced regulatory capital. (The changes in these accounting rules are the subject of a continuing debate on which, as in the August report, the Panel takes no position.)

As described below, effective in 2010, two new accounting standards, SFAS 166 [291] and SFAS 167,[292] will have a special impact on

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being used represent distressed sales. For this the FSP establishes the following eight factors for determining whether a market is not active enough to require mark-to-market accounting:

1. There are few recent transactions.
2. Price quotations are not based on current information.
3. Price quotations vary substantially either over time or among market makers.
4. Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
5. There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.
6. There is a wide bid-ask spread or significant increase in the bid-ask spread.
7. There is a significant decline or absence of a market for new issuances for the asset or liability or similar assets or liabilities.
8. Little information is released publicly.

[290] Financial Accounting Standards Board, *FASB Staff Position: Recognition and Presentation of Other-Than-Temporary Impairments* (FSP No. FAS 115–2 and FAS 124–2). This FASB Staff Position (FSP) amends the recognition guidance for the other-than-temporary impairment (OTTI) model for debt securities and expands the financial statement disclosures for OTTI on debt securities. Under the FSP, an entity must distinguish debt securities the entity intends to sell or is more likely than not required to sell the debt security before the expected recovery of its amortized cost basis. The credit loss component recognized through earnings is identified as the amount of cash flows not expected to be received over the remainder term of the security as projected based on the investor's projected cash flow projections using its base assumptions. Part of the entity's required expansion in disclosure includes detailed explanation on the methodology utilized to distinguish securities to be sold or not sold and to separate the impairment between credit and market losses. For debt securities an entity intends to sell before maturity or is more likely than not required to sell prior to maturity, the entire loss must be recognized through earnings. FSP FAS 115–2 does not change the recognition of other-than-temporary impairment for equity securities.

[291] Statement of Financial Accounting Standard (SFAS) No. 166, "Accounting for Transfers of Financial Assets an amendment of Statement No. 140" (SFAS 166). SFAS 166 revises existing sale accounting criteria for transfers of financial assets. Prior to 2010, financial institutions that transferred mortgage loans, credit card receivables, and other financial instruments to special purpose entities (SPEs) that met the definition of a qualifying special purpose entity (QSPE) were not currently subject to consolidation by the transferor. Among other things, SFAS 166 eliminates the concept of a QSPE. As a result, existing QSPEs generally will be subject to consolidation in accordance with the guidance provided in SFAS 167. See footnote 292 for a discussion of SFAS 167. *See* Financial Accounting Standards Board, Statement of Accounting Standard No.166, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No.140 (June 2009) (online at www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819183786&blobheader=application%2Fpdf).

[292] SFAS No. 167, "Amendments to FASB Interpretation No. 46(R)." SFAS 167 significantly changes the criteria by which a financial institution determines whether it must consolidate a variable interest entity (VIE). A VIE is an entity, typically an SPE, which has insufficient equity at risk or which is not controlled through voting rights held by equity investors. Currently, a VIE is consolidated by the financial institution that will absorb a majority of the expected losses or expected residual returns created by the assets of the VIE. SFAS 167 requires that a VIE

institutions' reflection of CMBS that they originated, packaged, or both. Prior to 2010, those investments in CMBS were generally placed in special purpose vehicles (so-called "SPVs") that financial institutions were permitted not to record as part of their balance sheet assets. As a result, those assets were not reflected in the institution's financial statements.[293]

SFAS 166 and SFAS 167 generally require that those investments in CMBS and other assets that a financial institution held in an SPV be restored to a financial institution's balance sheet. As a result, it is estimated that approximately $900 billion in assets will be brought back on financial institutions' balance sheets.[294] Of this amount, the four largest stress-tested banks will recognize approximately $454 billion. As disclosed in their public filings, Citigroup, Bank of America, JPMorgan Chase, and Wells Fargo will

be consolidated by the enterprise that has both the power to direct the activities that most significantly impact the VIE's economic performance and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. SFAS 167 also requires that an enterprise continually reassess, based on current facts and circumstances, whether it should consolidate the VIEs with which it is involved. *See* Financial Accounting Standards Board, Statement of Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R) (June 2009) (online at www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819183863&blobheader=application%2Fpdf).

[293] In addition, if a financial institution declares bankruptcy, the assets in a SPV are generally protected ("sometimes referred to as "bankruptcy remote"") from creditors' claims against the institution. However, when General Growth Properties, Inc. (GGP) filed for bankruptcy in April 2009, it included its affiliates that were SPVs. Those affiliates challenged their inclusion since they were considered bankruptcy remote. However, given the "unprecedented collapse of the real estate markets" and "serious uncertainty" about when and if refinancing would be available, the United States Bankruptcy Court for the Southern District of New York Court concluded that GGP's management had little choice other than to reorganize the entirety of GGP's enterprise capital structure through a bankruptcy filing. Further, the court rebuked the commonly held misperception that a "bankruptcy remote" structure is "bankruptcy proof." The future impact of this opinion, and its relationship to the change in accounting standards, is unclear at best. *See* United States Bankruptcy Court Southern District of New York, In re: General Growth Properties, Inc. et al., Debtors, Case No. 09–11977 (August 2009) (online at www.nysb.uscourts.gov/opinions/alg/178734—1284—opinion.pdf). For a summary of the case, *see* Sutherland, Legal Alert, Bankruptcy Court Denies CMBS Lenders Request to Dismiss Bankruptcy Petitions of SPE Affiliates of General Growth Properties, Inc. (Aug. 2009) (online at www.sutherland.com/files/News/c5bb2175090baa=0943310995b609 a8c6459ab057/=Presentation/NewsAttachment/f5d5b364=09c8b1094283–af7f-ae99c0b083f3/=RE%20Alert%208.19.09.pdf).

[294] *See* COP August Oversight Report, *supra* note 5, at 13 (footnote 26).

recognize additional assets of approximately $154 billion,[295] $100 billion,[296] $110 billion,[297] and $48 billion,[298] respectively.[299]

When these assets are put back on the balance sheet, the accounting standards require that these assets reflect the amounts (i.e., carrying value) that would have been reflected on an institution's balance sheet. Because these assets were not previously reflected on the institution's balance sheet, the institution was not required to recognize any losses incurred from holding them. As a result, the recognition of these new assets on an institution's balance sheet may result in an increase to loan loss reserves (allowance for loan losses) as well as additional losses from the write-down in values of investments in CMBS. The addition of these assets coupled with the decline in value of commercial and commercial real estate whole loans (commercial whole loans) could also significantly affect the capital of a financial institution.

For a financial institution, the allowance for loan losses is the dollar amount needed to absorb expected loan losses.[300] It is in-

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[295] Citigroup disclosed in its 10–Q for the quarter ended September 30, 2009 that the proforma effect of the adoption of these new accounting standards will increase assets by approximately $154 billion. Of the total amount, $84 billion is related to credit cards, $40 billion is related to commercial paper conduits, and $14 billion is related to student loans. The disclosure did not quantify investments in CMBS. Citigroup also disclosed that there will be an estimated aggregate after-tax charge to *Retained earnings* of approximately $7.8 billion, reflecting the net effect of an overall pretax charge to *Retained earnings* (primarily relating to the establishment of loan loss reserves and the reversal of residual interests held) of approximately $12.5 billion less the recognition of related deferred tax assets amounting to approximately $4.7 billion. Further, Citigroup disclosed that Tier I capital and Total capital ratios will be decreased by 151 and 154 basis points. *See* U.S. Securities and Exchange Commission, *Citigroup Inc. Form 10–Q for the quarter ended September 30, 2009*, at 97 (Nov. 6, 2009) (online at sec.gov/Archives/edgar/data/831001/000104746909009754/a2195256z10–q.htm).

[296] In its fourth quarter earnings release, Bank of America disclosed that of the $100 billion of added loans, $72 billion includes securitized credit cards and home equity receivables. The disclosure did not quantify investments in CMBS. In addition, regulatory capital will be reduced by $10 billion including deferred tax asset limitations. Further, it estimates that Tier I Capital will decrease between 70 to 75 basis points and Tier I Common Ratio will decrease between 65 to 70 basis points. On December 31, 2009, Tier I capital and Tier 1 Common Ratio was 10.4 percent and 7.8 percent, respectively. *See* U.S. Securities and Exchange Commission, *Bank of America Form 8–K*, Exhibit 99.2 (Jan. 20, 2010) (online at sec.gov/Archives/edgar/data/70858/000119312510008505/dex992.htm).

[297] JPMorgan Chase did not disclose the category of assets that would be added to the balance sheet. In addition, JPMorgan Chase further disclosed that the "[r]esulting decrease in the Tier I capital ratio could be approximately 40 basis points. *See* U.S. Securities and Exchange Commission, *JP Morgan Chase & Co. Form 10–Q for the quarter ended September 30, 2009*, at 97 (Nov. 6, 2009) (online at sec.gov/Archives/edgar/data/70858/000119312509227720/d10q.htm).

[298] Wells Fargo did not disclose the category of assets that would be added to the balance sheet. *See* U.S. Securities and Exchange Commission, *Wells Fargo and Company Form 10–Q for the quarter ended September 30, 2009*, at 13 (Nov. 6, 2009) (online at sec.gov/Archives/edgar/data/72971/000095012309059235/f53317e10vq.htm).

[299] The supervisors recognized that the adoption of SFAS 166 and SFAS 167 could significantly affect the risk-based capital requirements of financial institutions and in December 2009 adopted a regulatory capital rule that would give a financial institution the option to recognize the effects of these new accounting standards over a four-quarter period. Citigroup disclosed that upon the adoption of these new accounting standards, its risk-based capital ratio would decrease by approximately 151 basis points. Similarly, Bank of America and JP Morgan disclosed that its risk based capital ratio would decrease by approximately 75 basis points and 40 basis points, respectively.

Upon adoption of the regulatory capital rule, FDIC Chairman Shelia Bair stated that "[t]he capital relief we are offering banks for the transition period should ease the impact of this accounting change on banks' regulatory capital requirements, and enable banks to maintain consumer lending and credit availability as they adjust their business practices to the new accounting rules." However, only time will tell how financial institutions will adjust their business practices to the new accounting rules and how their capital levels will be affected.

[300] The allowance for loan loss is a balance sheet account. Under generally accounting principles (GAAP) in the review of the adequacy of loan loss allowance, loans that have common characteristics such as consumer and credit cards loans are reviewed by a financial institution on a group basis. Commercial real estate loans and certain commercial loans are required to be reviewed on an individual basis.

Further under GAAP, the recognition of loan losses is provided by SFAS No. 5, *Accounting for Contingencies* and No. 114, *Accounting by Creditors for Impairment of a Loan* (SFAS No.

creased by management's estimates of future loan losses and by recoveries of loans previously recorded as a loss (charged-off) and reduced by loan losses incurred when the borrower does not have the ability to repay the loan balance. There is no "check the box" formula for determining the appropriate level of loan losses. Rather, it is based upon a high degree of judgment by management.[301] Because this account is based upon management's judgment, there is a high degree of risk that a financial institution's allowance for loan losses may be insufficient, especially in regard to the additional assets that will be recognized upon the adoption of these new accounting standards.

The new accounting standards will force more accuracy in an institution's financial statements, but the increased accuracy will mean that the parlous state of commercial whole loans will be even clearer.

3. Commercial Real Estate Workouts

a. Options for Resolving Defaulting or Non-Performing Loans

When a permanent commercial mortgage borrower defaults, the borrower and the lender or special servicer have a number of options available to them to resolve the situation and recover as much of their respective interests as possible: (1) the lender or servicer can foreclose, (2) the parties can engage in a "workout" and modify the loan by lowering the principal, the interest rate, or both, and (3) the lender can extend the borrower's loan on the same terms for an additional period. Each of these actions may be the best choice in appropriate situations.

114). An estimated loss from a loss contingency, such as the collectability of receivables, should be accrued when, based on information available prior to the issuance of the financial statements, it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. SFAS No. 114 provides more specific guidance on measurement of loan impairment and related disclosures but does not change the fundamental recognition criteria for loan losses provided by SFAS No. 5. Additional guidance on the recognition, measurement, and disclosure of loan losses is provided by Emerging Issues Task Force (EITF) Topic No. D–80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (EITF Topic D–80), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FIN 14), and the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions*. Further guidance for SEC registrants is provided by Financial Reporting Release No. 28, Accounting for Loan Losses by Registrants Engaged in Lending Activities (Dec. 1, 1986). *See* SEC Staff Accounting Bulletin No.102—Selected Loan Loss Allowance Methodology and Documentation Issues, 1. Accounting for Loan Losses—General, at 4 (July 6, 2001) (online at sec.gov/interps/account/sab102.htm).

[301] *See* Financial Reporting Release No. 28 (FRR 28), Accounting for Loan Losses by Registrants Engaged in Lending Activities, Securities Act Release No. 6679,1986 WL 1177276 (Dec. 1, 1986). *See also* FRR 28A, Amendment of Interpretation Regarding Substantive Repossession of Collateral, Securities Release No. 7060, 56 SEC Docket 1731, 1994 WL 186824 (May 12,1994).

In order to determine the dollar amount needed to absorb expected future loan losses, management reviews the credit quality of all loans that comprise a financial institution's loan portfolio (i.e., consumer, credit cards, and commercial and commercial real estate loans). The accounting guidelines require that management's assessment "incorporate [its] current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process." For example, management's assessments of the credit quality of the loan portfolio should include the following characteristics: past loan loss experience, known and inherent loss risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, current economic conditions, in addition to any pertinent characteristics of the loan. *See* SEC Staff Accounting Bulletin (SAB) No.102—Selected Loan Loss Allowance Methodology and Documentation Issues, Question. 1 at 5 (July 6, 2001) (online at sec.gov/interps/account/sab102.htm). Question 1 further states that" [a] systematic methodology that is properly designed and implemented should result in [an entity's] best estimate of its allowance for loan losses."

In some cases, after analyzing the property, the servicer may determine that foreclosure is the best option. Properties with very poor operating fundamentals, such as high vacancy, may be unlikely to recover under any probable scenario. In these cases it may be best for the lender to resolve the situation promptly by taking the property and booking the loss. In order to avoid foreclosure costs and delays, commercial real estate lenders may be willing to agree to an alternative to a traditional hostile foreclosure, such as a deed in lieu of foreclosure, a voluntary "friendly foreclosure" (where the borrower does not fight the foreclosure process), or a short sale.

If possible, commercial lenders will often arrange for a new borrower to step in after foreclosure to purchase the property and replace the defaulted borrower. In January 2010, Tishman Speyer Properties and BlackRock defaulted on $4.4 billion in debt from its 2006 purchase of Stuyvesant Town and Peter Cooper Village in Manhattan. In defaulting, they turned the property over to the lenders. Within several weeks, lenders were in serious discussions with potential purchasers and property managers.[302] Also, in December 2009, Morgan Stanley and its lenders performed an "orderly transfer" of five downtown San Francisco office buildings that it had purchased in 2007.[303]

These alternative strategies are more common in commercial real estate than in residential. With residential properties, more typically after a default or foreclosure, a property will sit vacant for weeks or months before the lender is able to sell the home. Commercial defaults are also significantly less disruptive to communities and families, as the lenders are usually able to manage properties as productive assets. Residential foreclosures, on the other hand, force families out of their homes and burden neighborhoods with vacant and sometimes derelict properties. However, newly built commercial properties, especially those built "on spec" with no pre-leased tenants, often do remain empty for some time.

Loans on properties with viable fundamentals and income which cannot support the current payment, but which could support a slightly lower payment, may benefit from a loan modification such as a rate or principal reduction. In these cases, the lender must weigh the present value cost of the modification with the costs of foreclosure, which may be substantial.

As with the residential market, commercial borrowers with negative equity ("underwater") have an incentive to default in order to avoid an almost certain loss.[304] Workouts that do not address the incentives inherent in negative equity situations run the risk of simply delaying an inevitable redefault and foreclosure, which can

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[302] Oshrat Carmiel and Sharon L. Lynch, *Wilbur Ross May Go All the Way,' Buy Stuyvesant Town*, Bloomberg (Jan. 26, 2010) (online at www.bloomberg.com/apps/news?pid=newsarchive&sid=aMe55gpowv2g).

[303] Dan Levy, *Morgan Stanley to Give Up 5 San Francisco Towers Bought at Peak*, Bloomberg (Dec. 17, 2009) (online at www.bloomberg.com/apps/news?pid=20601110&sid=aLYZhnfoXOSk).

[304] Jun Chen and Yongheng Deng, *Commercial Mortgage Workout Strategy and Conditional Default Probability: Evidence from Special Serviced CMBS Loans*, Real Estate Research Institute Working Paper (Feb. 2004) (online at www.reri.org/research/article_pdf/wp120.pdf) (hereinafter "Chen and Deng: Commercial Mortgage Workout Strategy"). The GAO made a similar observation in a report about the risks associated with TALF, the government lending facility: "A number of scenarios could result in a borrower walking away from a loan. For example, the collateral could lose value so that the loan amount exceeded the value of the collateral." GAO TALF Report, *supra* note 64, at 18.

be costly for both lender and borrower. Even borrowers in negative equity that continue to service their debt may make significant cuts in property maintenance and other discretionary expenses in an attempt to limit their potential losses.

Principal reductions, or write-downs, have the advantage of removing the incentive for these borrowers to default, since the new principal balance will usually be less than the sale proceeds from the property. The borrower will no longer have to come up with cash to pay off the loan when they sell the property. On the other hand, principal reductions are not favored by many lenders because they are costly, and because they force the recognition of a loss on what may already be a weak balance sheet. In the case of a bank, this may cause it to run afoul of its supervisors over capital requirements.

Borrowers facing foreclosure may choose to declare bankruptcy in order to halt temporarily foreclosure proceedings. Unlike the situation in residential real estate, bankruptcy courts can order a write-down of a commercial real estate loan balance under certain circumstances.[305] Borrowers may be able to use this possibility as a negotiating tactic with the lender. The usefulness of this option can be influenced by the use of a SPV to hold each property.[306]

An interest rate reduction reduces the monthly payment and may prevent a marginal borrower from defaulting. Lenders may also prefer this option to a principal reduction because it does not force them to book a large loss. But rate reductions do not remove the incentive for underwater borrowers to default. And, the low-yielding loan that results from such a workout will drop sharply in value if interest rates rise; the fact that current interest rates are near record lows makes this potential for a dramatic drop in value a serious concern.

Perhaps the most palatable workout option for the lender is a term extension. It does not force a recognized loss, nor does it saddle the lender with a low yielding investment sensitive to interest rate risks. Unfortunately, there are only certain situations where extensions make sense.

Borrowers that cannot pay their debt service or are marginal have little to gain from a term extension. Additional time will not enable them to pay their debt service if they cannot do so already.[307] There are a few exceptions, such as a case in which a delinquent borrower expects a major increase in revenue due, for example, to a large new tenant whose lease begins in a few months. In such a case, the borrower may be sustained by the extension long enough for the new tenant to begin paying rent that will allow the borrower to continue paying its debt service. This is an unlikely scenario in the current market. In general, extensions will not help

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[305] *See* Brueggeman and Fisher, *supra* note 13, at 39–41.

[306] Proskauer Rose, LLP, *Real Estate Bankruptcy Cramdowns: Fact or Fiction* (Mar. 16, 2009) (online at www.mondaq.in/unitedstates/article.asp?articleid=76162). But see footnote 293 regarding the bankruptcy of GGP. When GGP filed for bankruptcy it included its affiliates that were SPVs. Those affiliates challenged their inclusion since they were considered bankruptcy remote. However, the bankruptcy court held that SPVs may be bankruptcy remote but are not bankruptcy proof.

[307] In residential mortgage workouts, term extensions may extend the amortization schedule as well, and thereby reduce the monthly payment. Commercial real estate loans tend to have an amortization schedule that is longer than the loan term. Extending the term (while not changing amortization) will not reduce the mortgage payment, since the monthly principal payment will remain unchanged.

properties that have low income due to bad business fundamentals, and continued loans to failing projects that are simply recycled to meet debt service requirements recall some of the worst abuses of the last commercial real estate crisis and cannot be recreated.

The most promising use for term extensions is to help healthy borrowers that have sufficient property income but cannot refinance due to market difficulties. Most of these borrowers will have also suffered losses in property value and may be in a negative equity situation, further complicating refinancing. In these cases, an extension may make sense if the lender and borrower both believe that the property value will recover enough over the term of the extension to put the borrower back into positive equity.

However, there is an inherent tension between the economic benefits to lenders of modifying loan terms and restructuring financing arrangements, on the one hand, and the risk that doing so only delays ultimate—some commentators would say inevitable—write-downs, foreclosures, and losses.[308] Performing loans will likely require long extensions at below-market rates that will result in large real losses, even assuming an absence of principal loss.[309] The underwriting standards of the bubble years were so aggressive that improving economic conditions are unlikely to be enough to save the loans made during this time. Accelerated amortization of loan balances over a moderate time period is unlikely to address sizeable equity deficiencies. And, the likelihood of significant price appreciation is remote given tightened financing terms and the billions of dollars of distressed loans and commercial property that are accumulating due to maturity extensions.[310] Balancing all of these considerations—and distinguishing those loans that will continue to perform until conditions readjust—and those for which delay in accepting a less than full recovery of value—with the requirement of accompanying write-downs—is at the core of a bank's and investor's judgment about loan strength and responsible credit and capital management.

Even under more forgiving standards, many loans will not warrant workouts, extensions, or modifications because the borrowers cannot show creditworthiness, the problems extend beyond a decrease in collateral value, or lenders cannot expect to collect the loan in full. Lenders must recognize the losses from these poor quality loans when incurred. However, as the statistics in Section H.3 suggest, the loss recognition, net write-down, and net charge-off process has only just begun.

Another issue associated with workouts is their impact on investor trust and expectations, especially for CMBS. Changing the terms of loan contracts from what was originally agreed, especially for troubled, but not defaulted or imminently defaulting borrowers, can reduce investor trust in the certainty of contracts and cause them to rethink their risk expectations in this type of investment.[311] This loss of confidence by investors could impede the re-

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[308] *See, e.g.,* Mortgage Bankers Association, *Commercial Real Estate/Multifamily Finance Quarterly Data Book Q3 2009*, at 22 (Nov. 2009); The Future Refinancing Crisis in CRE, *supra* note 214, at 21; The Future Refinancing Crisis, Part II, supra note 120, at 27.

[309] Parkus and Trifon: Searching for a Bottom, *supra* note 210, at 67.

[310] *See* The Future Refinancing Crisis in CRE, *supra* note 214, at 21.

[311] Commercial Mortgage Securities Association, *Concerns with REMIC Proposals to Authorize Loan Modifications and Restructure Contracts* (July 13, 2009).

covery of the commercial real estate secondary market, which is a necessary part of a commercial real estate recovery. This consideration, as well as other moral hazard concerns must, be balanced against the benefits that can be achieved by workouts.

Successful workouts often depend on access to sufficient equity capital. The "equity gap" problem borrowers experience in a falling market was discussed in section F.3 (b). So far in this downturn, there has been very little new equity investment in commercial real estate. Foreign investors such as sovereign wealth funds, as well as other types of opportunistic investors, may prove to be a major source of equity investment in the future, whether as purchasers of distressed properties or as investors in properties that need equity in order to refinance. One prominent expert has estimated that more than $100 billion in equity capital from foreign investors and other sources is currently waiting on the sidelines for the right market conditions. So far, most commercial property owners have been reluctant to sell property or accept equity investment at the deeply discounted terms these investors are seeking. This standoff between property owners and investors has been described as "a game of chicken."[312] As the prospects of commercial real estate become clearer over the next few years, it is likely that one side or the other will capitulate. This may lead to a mass of equity transactions at discounted, but ultimately stabilized, prices as this enormous pool of capital competes for available properties. The discounted prices will in turn generate substantial bank write-downs and capital losses. (Prudently managed banks build some assessment of default risk into the pricing and terms of the commercial real estate (and other) loans they make. But, as noted elsewhere in this report, that may well have less effect now, both because a number of the loans at issue were not prudently made in the first place, and even prudently managed banks could not foresee the as yet unknown depth of the financial crisis and economic downturn that has marked the last two years.)

Defaulted construction loans are more difficult to resolve successfully than are permanent mortgages. Construction lending is lending at the margin, and despite careful underwriting and provisions such as interest reserves, it is an inherently risky activity. While a completed and leased property may be able to ride out a recession, new development depends on the marginal demand for commercial space, which is likely to collapse quickly in a recession. Even in safer build-to-suit construction, pre-leased tenants may back out or go under in hard times, causing a chain reaction ending in foreclosure.

In a weak real estate market, the developer has significant incentives to default, due to the additional expense needed to complete construction, and because of the slim chances of successfully leasing the property upon completion. Another risk is that the developer goes bankrupt before completion, leaving the lender with no borrower and an incomplete property.

Construction loans carry their own type of term risk. In most cases, the construction lender and developer count on a permanent

[312] David Geltner, *The U.S. Property Market in 2010: The Great Game of Chicken*, PREA Quarterly (Winter 2010) (hereinafter "Geltner PREA Report").

lender to take out, or pay off, the construction loan upon completion of the property. The construction lender usually requires that the developer obtain a commitment for this takeout before closing on the construction loan.[313] In a credit crunch and real estate crash, however, permanent lenders may renege on their prior loan commitments, or may have simply gone out of business by the time the property is completed. Under these economic circumstances, it is hard to find a replacement lender. Without a takeout, the construction lender will probably end up with the property, and with a number of problems that this entails.

Lender real estate owned foreclosures (REOs) obtained from construction loans present a particular burden to lenders, since they (1) generate no income, (2) are probably unfinished, requiring additional investment before they can be leased, (3) are difficult to sell in a depressed market, since there is likely to be oversupply of similar properties already, (4) are prone to vandalism and theft of materials and fixtures, and (5) may present a public relations problem for the lender, since surrounding property owners and residents will be unhappy at having a half-finished, derelict property nearby.

Workout options for construction loans are generally similar to those used for permanent mortgages but require more careful attention and creativity in structuring the workout. Term extensions, principal write-offs, rate reductions, changes to the amortization schedule, conversion to a different type of loan (e.g., amortizing to interest-only), participation stakes, and bringing in new investors are all possible options, and depend on what can be negotiated considering the unique circumstances of the development project. As is the case with permanent loans, construction loan workouts often involve a degree of hope that the market will turn around in relatively short order. In some cases, however, the market may have changed to such an extent that the property is simply not viable in the foreseeable future, and no reasonable workout can be arranged.

The FDIC's October 30, 2009 policy statement on workouts, discussed in Section H.3, directly addresses construction and land loan workout strategies, as well as provides some illustrative examples with explanations of how they would be treated from a regulatory point of view.[314] It is interesting to note that the FDIC statement devotes as much space to discussing construction loans as it does to permanent mortgages, despite the much smaller pool of construction loans, underscoring the concern they appear to have about this category of assets.

Considering that U.S. banks own $481 billion in construction and land loans, this concern is well founded.[315] The approximately 50 percent recovery rate of invested capital from defaulted construction loans in 2009, shown in Figure 36 below, suggests that the ultimate losses from these loans could be enormous.[316]

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[313] Brueggeman and Fisher, *supra* note 13, at 439–445.

[314] Federal Deposit Insurance Corporation, *Policy Statement on Prudent Commercial Real Estate Loan Workouts* (Oct. 30, 2009) (online at www.fdic.gov/news/news/financial/2009/fil09061a1.pdf) (hereinafter "Policy Statement on CRE Workouts").

[315] SNL Financial (accessed on Jan. 13, 2010).

[316] Real Capital Analytics, *Q4 Update: Recovery Rates on Defaulted Mortgages* (2010) (hereinafter "Q4 Update: Recovery Rates on Defaulted Mortgages").

b. Can different structural models and servicing arrangements allow private markets to function more effectively than was true for residential real estate?

Financial institutions and federal supervisors appear to be inclined to extend prudent, performing loans that are unable to refinance at maturity. Lenders have an incentive to work with borrowers, where possible, to delay, minimize, or avoid writing down the value of loans and assets or recognizing losses. Workout strategies such as modifications and extensions may help lenders avoid the significant costs and discounted or distressed sales prices associated with foreclosures and liquidations. The hope is that the economy will improve or that commercial real estate loans will not be as problematic as expected. This may be the case if the economy rebounds during the extension period, vacancy rates decrease (or absorption rates increase), cash flows strengthen, or commercial property values rise. Current historically low interest rates help both lenders and borrowers of floating rate loans by significantly lowering the debt service so that cash flows and interest rate reserves carry loans longer.

As is the case in the residential real estate market, a falling commercial real estate market poses risks to all property owners, even supposedly healthy ones. If the commercial real estate market does not recover as quickly as the lender anticipates in structuring the workout, the property is likely to go into default again. The large number of loans that for various reasons cannot be refinanced, combined with loans in default due to poor property income, puts additional downward pressure on property values and discourages lending. Since falling values make loans harder to refinance, a falling market has the tendency to create a vicious circle of defaults of weak properties leading to defaults of stronger properties.

A number of factors make the consequences of default less damaging and somewhat more acceptable to commercial borrowers than for residential borrowers. Commercial real estate investors often hold their properties in limited partnership or limited liability company structures, often with only one property in each business entity. This provides a degree of protection in default and bankruptcy. REITs organize their holdings into single-property limited partnerships, partly for this reason. Residential borrowers are unprotected by any corporate or liability limiting structure, although the nonrecourse clause in residential mortgages does limit losses in default to the property itself.

There is some evidence that commercial borrowers may also have a more lenient or at least pragmatic attitude toward default than most residential borrowers. At least in theory, commercial borrowers make default decisions based on profit and loss considerations, rather than emotional desires or a sense of moral obligation. They may opt for a “strategic default,” and preemptively declare bankruptcy (as discussed in Section H.3), in cases where they stand to lose a great deal from continuing to pay their debt service.

The options available to commercial mortgage servicers in dealing with delinquencies and defaults are generally similar to the options available to residential servicers. One of the significant advantages that commercial mortgage servicers have over their residential counterparts is that they service fewer, larger loans, and can therefore give each loan more individual attention. A typical CMBS deal may be backed by a pool of a hundred or so loans, while a residential mortgage backed security deal may contain many hundreds or thousands of loans.

This is a major advantage in dealing with defaults, since a successful workout requires that the servicer become intimately familiar with the property and its income sources. Office and retail leases in particular are often quite complicated and include various reimbursements, cost sharing arrangements, and other negotiated terms. These leases require thorough study in order to model properly the cash flows that can be expected from the property. The commercial real estate servicer or special servicer is also more likely to be dealing with a borrower that is knowledgeable about real estate. This may make it easier to arrange a workout or other strategy, because the borrower is well prepared to discuss and evaluate the options.

c. Are workouts actually happening? If not, why not?

Unfortunately, publicly available information on commercial real estate workouts is extremely limited, and lacks enough detail about the type of workout strategy to draw many conclusions about what is currently occurring in the commercial real estate market. This is largely due to the fragmented nature of workout reporting. Individual servicers, whether for CMBS or whole loans, normally report workout information only to their lender client or investors. Banks report information on loan losses, but typically provide little detail on the strategies that were used to resolve defaulted loans.

Figure 35 below, adapted from research by Real Capital Analytics, shows current "troubled" (delinquent or defaulted) commercial mortgage assets in the United States and their status. The terms used in Figure 35 are defined directly below the table.

FIGURE 35: TROUBLED COMMERCIAL MORTGAGE U.S. ASSETS AS OF DECEMBER 2009 [317]

Assets	Number of Properties	Volume in Millions of Dollars
Troubled	6,425	$139,500.6
Restructured/Modified	725	17,109.4
Lender Real Estate Owned (REO)	1,411	21,992.1
Total Current Distressed	8,651	178,602.1
Resolved	1,314	24,508
Total	**9,875**	**$203,110.4**

[317] Real Capital Analytics, *Troubled Assets Radar: United States Troubled Assets* (online at www.rcanalytics.com/commercial-troubled-assets-search.aspx) (accessed Jan. 25, 2010).

- Troubled: Properties in the process of being foreclosed, in bankruptcy, or undergoing workouts.
- Restructured/Modified: Properties where the lender has implemented a workout strategy, including loan extensions of less than two years.
- Lender REO: Properties that lenders have taken back through foreclosure.
- Resolved: Properties that have moved out of distress via refinancing or through a sale to a financially stable third party.

It is clear from Figure 35 that relatively few properties have completed workouts, only 725 out of a total of 9,875. This does not necessarily indicate reluctance by lenders and servicers to deal with troubled assets. Dealing with defaulted properties, whether by foreclosure, workout, or another strategy, is a lengthy process. It is possible that many of these troubled loans are early in the process of resolution due to the rapid increase in defaults during 2009.

Due to the lack of detailed information on workouts, the Panel consulted with numerous commercial mortgage lenders, servicers, trade organizations, and other knowledgeable commercial real estate professionals about their assessments of the number and types of workouts currently occurring. Their comments were quite consistent, but unfortunately, lacking in much useful detail. The consensus is that workout activity has increased significantly since the decline in commercial property values began, but no quantification is available. According to industry experts, commercial real estate servicers are actively pursuing workouts where they believe it is reasonable. As was mentioned earlier, the large dollar amount of the individual loans, combined with the sophistication of the commercial real estate borrowers (as compared to residential) encourages lenders to attempt workouts where they make sense for both parties.

Anecdotal evidence suggests that whole loans are more likely to undergo a workout than securitized loans. It is not clear whether this is because of the lower quality collateral that is held by whole loan investors, a greater eagerness on their part to work out problem loans, or because of issues related to CMBS servicing arrangements and standards. Some PSAs require the consent of most or all investors in order to modify the terms of a loan, making any changes difficult.

Bank supervisors have sought to deal with these issues in an updated policy statement on commercial real estate loan workouts (the Policy Statement). That statement is discussed in Section H.3.

An ominous indicator of the future losses that may be expected from defaulted commercial real estate debt is the declining recovery rate, or the amount of the loan balance that the lender ultimately recoups after either foreclosing on or working out a defaulted loan. Recovery rates from defaulted mortgages fell significantly in the 4Q 2009, as lenders dealt with an increasing number of non-performing loans. As with residential real estate, foreclosures of commercial real estate put additional downward pressures on property values, reducing the ultimate recovery rate for all lenders. The provider of this data, Real Capital Analytics, uses different terminology for the basic categories of real estate debt than has been used thus far in this report. Its acquisition/refinancing category corresponds to what has been termed permanent mortgages, and its development/redevelopment category corresponds to construction and development loans.

Mean recovery rates for development/redevelopment loans declined from 57 percent during the first three quarters of 2009 to 52 percent. Mean recovery rates from acquisition/refinancing loans similarly declined from 69 percent to 63 percent over the same time period. On a weighted average basis, the decline in acquisition/refinancing loan is even more severe, with a drop of 14 percent, as can be seen in Figure 36 below. The authors of this report interpret the falling recovery rates as being the result of lower market pricing as well as an increasing willingness on the part of lenders to deal seriously and realistically with the large number of non-performing loans, even if it means incurring additional losses.[318]

FIGURE 36: RECOVERY RATES ON DEFAULTED MORTGAGES [319]

Loan Type	Q1–Q3 2009		Q4 2009		2009 Total	
	Mean *(Percent)*	Weighted Average *(Percent)*	Mean *(Percent)*	Weighted Average *(Percent)*	Mean *(Percent)*	Weighted Average *(Percent)*
Development/Redevelopment	57	49	52	50	56	49
Acquisition/Refinancing	69	69	63	55	67	66
Overall	65	61	59	52	63	59

[319] Q4 Update: Recovery Rates on Defaulted Mortgages, *supra* note 316.

All property types had declining recovery rates in the fourth quarter of 2009, with the exception of industrial properties. For the entire year of 2009, the lowest recovery rates were for bare land and properties under development, with mean recovery rates of 46 percent and 50 percent respectively, as shown in Figure 37 below. A more unexpected finding was that the highest recovery rate was among retail sector mortgages, at 73 percent.[320]

FIGURE 37: MEAN RECOVERY RATES BY PROPERTY TYPE (2009) [321]

[Dollars in millions]

Property Type	Outstanding Balance	Number of Defaulted Mortgages	Mean Recovery Rate *(Percent)*
Office	$1,746.7	47	64
Industrial	153.7	29	72
Retail	568.3	26	73
Hotel	360.2	25	67
Multifamily	1,913.4	130	63
Development Sites	404.6	13	46
Land	471.0	24	50
Total	**$5,617.8**	**294**	**63**

[321] Recovery Rates by Property Type, *supra* note 320.

The lowest recovery rates by location were in the areas hardest hit by the recession—Michigan, Florida, and Arizona.[322] When looked at by lender type, insurance companies had the highest recovery rates overall, recouping 79 percent of their invested capital on acquisition/refinancing loans. Although the exact reasons for this are not apparent, it is worth noting that life insurance companies are very conservative lenders (for example, they often require recourse clauses in their loans), because of the long-term nature of their own obligations to their policy holders. Interestingly, CMBS performed the poorest at recovering losses from acquisition/refinancing loans of all lender types, returning only 62 percent of invested capital. On the whole, banks recovered more of their capital, with the smaller regional or local banks slightly outperforming

[318] Q4 Update: Recovery Rates on Defaulted Mortgages, *supra* note 316.
[320] Real Capital Analytics, *Recovery Rates by Property Type* (2010) (hereinafter "Recovery Rates by Property Type").
[322] Real Capital Analytics, *Recovery Rates by Location* (2010).

their larger national and international counterparts in both the development and acquisition/refinancing categories.[323]

d. Potential Impediments to Successful Workouts

Several tax issues complicate workouts and new investment in commercial real estate. Although investors have been willing to put in additional equity, and although banks and servicers have engaged in workouts and other modifications, these issues make resolution of problematic commercial real estate loans without provoking a financial crisis more difficult.

i. REMIC

Although CMBS can be designed in a number of ways, many are structured as REMICs.[324] REMICs are pass-through entities; they are not taxed on their income, but rather pass it directly through to investors.[325] Without the REMIC status, the CMBS's income could be taxed at the corporate level and then again at the investor level.[326] To maintain the REMIC status, the entity must follow strict rules.[327]

One of these rules is that if a REMIC makes a "significant modification" to a loan, the IRS can impose severe penalties.[328] These penalties can be up to 100 percent of any gain that the REMIC receives from modifying the loan.[329] The REMIC could also lose its status as a pass-through entity.[330] The rules provide an exception for loans that are either in default, or for which default is "reasonably foreseeable."[331]

To enable REMICs to modify loans more freely, the IRS published guidance and new regulations in September 2009.[332] These expanded the types of modifications that a REMIC was permitted to undertake and provided a safe harbor for certain modifications. The safe harbor applies if there is "a significant risk of default . . .

[323] Real Capital Analytics, *Recovery Rates by Lender Type* (2010).

[324] A REMIC is a tax entity, not a legal form of an organization.

[325] 26 U.S.C. § 860A.

[326] Prior to the 1986 law that created the REMIC status, an MBS with only a single type of ownership interest could maintain pass-through status. An MBS with multiple tranches or both equity and residual interests could be seen by the IRS as requiring more active management than a pass-through vehicle could allow. The REMIC status allows a pass-through entity to have multiple tranches and interests. Brueggeman and Fisher, *supra* note 13, at 558.

[327] Rev. Proc. 2009–45, Section 3.

[328] A significant modification will cause the mortgage to no longer be treated as a qualified mortgage. It will be considered to be a prohibited transaction under 26 U.S.C. § 860F. 26 CFR § 1.860G–2(b). The purpose behind this is that the REMIC should be a passive vehicle, and cannot engage in active business activities.

A "modification" is defined as "any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise." 26 CFR § 1.1001–3(c)(1)(i). In general, "a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." 26 CFR § 1.1001–3(e)(1).

[329] 26 U.S.C. § 860F(a).

[330] A significant modification can cause a mortgage to no longer be a qualified mortgage. A REMIC can lose its pass-through status if one or more significant modifications of its loans cause less than substantially all of the entity's assets to be qualified mortgages. Rev. Proc. 2009–45 Section 3.09.

[331] 26 CFR § 1.860G–2(b)(3)(i).

[332] Rev. Proc. 2009–45; 74 FR 47436. The new regulations were initially issued for comment in 2007, so they were not necessarily in response to issues in the current commercial real estate market.

upon maturity of the loan or at an earlier date" and if the modification "presents a substantially reduced risk of default." [333]

Though this guidance provides REMICs with more flexibility, it is not a panacea. First, some believe that the guidance is vague, and because of the steep penalties, are still wary of modifying loans. Second, the PSAs were written under the previous rules, and many have language that tracks the earlier rules, making modifications either very complicated or barred for servicers. At the Panel's Atlanta hearing, Brian Olasov, a real estate professional who specializes in securitizations, described the REMIC guidance as a "complete non-event," saying that the REMIC rules did not "tie the hands" of the special servicers in "seeking the highest NPV resolution." [334]

ii. Taxation of Foreign Investors in U.S. Real Estate

Outside investors are a possible solution to the equity crunch that might hit the commercial real estate sector over the next few years. Although many believe that billions of dollars in non-U.S. equity are waiting to be invested in U.S. commercial real estate, there can be negative tax consequences for non-U.S. purchasers of or investors in U.S. real estate. Non-U.S. investors can be hit with double or even triple taxation on their investments in U.S. real estate.

Generally, nonresident aliens are not subject to capital gains taxes on U.S. investments.[335] Nonresident aliens are generally only subject to U.S. capital gains tax if the income is "effectively connected to a U.S. trade or business." [336] The Foreign Investment Real Property Tax Act (FIRPTA), however, makes an exception for real estate, and imposes the U.S. tax on real estate holdings.[337] It does so by deeming gains or losses from the disposition of real estate "as if such gain or loss were effectively connected with such trade or business." [338] Therefore, a nonresident alien seeking to invest in the United States will have a financial incentive to choose stocks or bonds over real estate.

If the non-U.S. investor is a corporation, it can be subject to two additional layers of tax. The branch profits tax, a dividend equivalent tax, subjects a foreign corporation's U.S. connected income to a 30 percent tax.[339] The corporation could then also be subject to the standard U.S. corporate income tax.

Some have called for congressional or IRS action to alleviate this tax burden on nonresident alien investments in U.S. real estate.[340]

e. Loss Recognition

The problem of commercial real estate reflects three related timelines. The first is the timeline for recovery of the economy to a sufficient point that borrowers' cash flows return to normal and loan values increase. The second is the timeline of loan extensions

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[333] Rev. Proc. 2009–45, Sections 5.03, 5.04.
[334] COP Field Hearing in Atlanta, *supra* note 70 (Testimony of Brian Olasov).
[335] 26 U.S.C. § 871(a)(2).
[336] 26 U.S.C. § 871(a)(2).
[337] 26 U.S.C. §§ 897, 882. This tax can be capital gain or ordinary income, depending on the character of the asset. 26 U.S.C. §§ 897, 1221.
[338] 26 U.S.C. § 897(a)(1).
[339] 26 U.S.C. § 884.
[340] Real Estate Roundtable White Paper, *supra* note 245 (accessed on Jan. 25, 2010).

and restructurings. The third is the timeline along which commercial real estate credit markets reopen for sound projects. If these timelines do not cross within an acceptable period, and there is not a dramatic turnaround and quick recovery in commercial real estate prices, many commercial real estate loans will produce unavoidable losses that in the end must be borne by the borrower, the lender, or the taxpayer.

When prudently managed banks evaluate the strength of commercial real estate loans in their portfolios today, they try to determine the prospect of each project, against their judgment of the path of the three timelines. This means projecting, among other things, the income that can be produced by the property, the borrower's record in servicing the debt, and the present ratio of the property's value to the amount of the loan. On that basis, the lender must decide whether the loan can be repaid and whether changing the terms of the loan increases that possibility. The same judgments are involved in setting the terms for a refinancing.

These judgments are decisions about potential losses. If the lender decides that the loan will not be repaid—either because the borrower has stopped making payments for a sufficiently lengthy period, or because refinancing is impossible on terms the lender can accept—it faces the prospect of foreclosing and recognizing some degree of loss on the loan. If it modifies the loan to accept a lesser amount on repayment, it must write-down the difference between the original and renewed loan amount. If it decides that the borrower and the project have the potential strength, and that economic conditions are sufficiently unsettled, it may reach an agreement with the borrower to provide an additional period before final action is required. The lender hopes, of course, that by doing so it will avoid losses as the loan strengthens. The extent to which banks should write off their loan in whole or in part now or should be encouraged to provide the lender with an extended period of time through one of the arrangements described in the report is perhaps the major point of contention in the commercial real estate markets today.[341]

The extent to which banks recognize commercial real estate losses and how and when they choose to do so can have a direct impact on the future viability of many banks. The details of workouts, loan extensions, modifications, or refinancings and foreclosures can also have collateral consequences for healthy institutions as they understandably take steps to protect themselves. In particular, it is likely that these banks will reduce their lending because, or in anticipation, of loan losses, as discussed elsewhere in the report.

The precipitous drop in commercial property values since 2007 ultimately means that banks may have to take losses in the range of \$200 billion–\$300 billion.[342] The timing of the loss recognition is

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[341] Those who fear that the modifying loan terms will make banks appear stronger than they really are (because banks are unrealistically extending loans) and provide an artificial floor for commercial real estate prices (postponing accurate market pricing) refer to it as "kicking the can down the road" or "extend and pretend."

[342] *See* Parkus and Trifon: Searching for a Bottom, *supra* note 210 at 65. This estimate appears to be generally consistent with another recent estimate by Moody's Investors Service. Moody's projects \$77 billion in commercial real estate losses between Q4 2009 and the end of

Continued

critical, but there is no single way to time those losses. In many cases, loans that were sound when they were made may end up producing little or no loss, because economic conditions recover, new investors are found to close the equity gap (especially as property values rise), or some combination of the two. In other cases, a clear-sighted analysis will show that loss from a loan is likely, and banks whose loan portfolios contain those loans in amounts large enough to threaten their capital should in many cases be placed into receivership now.

Any attempt to evaluate these consequences, however, is complicated because many loans have yet to mature and many borrowers continue to make required payments under their existing loans. The problems looming in commercial real estate will fully emerge over the next seven to nine years during the waves of refinancing expected in 2011–2013 and then in 2016–2017.[343] A huge number of the affected properties are now under water—that is, they have a value less than the loan amount—but the rate of economic recovery and its effect on loans that continue to perform are difficult to predict.[344] This does not mean that there is no looming crisis.[345] Banks are already experiencing significant losses on construction loans, which have shorter terms of three to four years but in many cases financed projects from the bubble years of 2005–2007, and in others are coming due as values have fallen, and incomes have dropped, significantly. The warnings about commercial real estate loans are extremely serious, and the condition of construction loans now gives these predictions substantial credence.

In dealing with potential commercial real estate losses, not all banks should be treated in the same way. Banks whose portfolios are weak across the board ("C" banks) should be forced to recognize all losses, whatever the consequences. "A" banks, those that have operated on the most prudent terms and have financed only the strongest projects, and "B" banks, those with commercial real estate portfolios that have weakened but are largely still based on performing loans, should be dealt with more carefully.[346]

There are three reasons not to force all potential losses to be recognized immediately. First, doing so could create a self-fulfilling prophecy, as selling commercial real estate at fire-sale prices could depress values of even relatively strong properties. In this way, real estate prices would be driven below actual long-term values, pushing the commercial real estate sector into what has been termed a negative bubble, not only forcing more banks in a particular region into perhaps unnecessary insolvency, but having rip-

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2011 at the banks it rates. This number would be higher were it not for the fact that the banks Moody's rates hold only about 50 percent of the total bank exposure to commercial real estate. The Moody's report also does not include losses incurred in 2012 and beyond. Joseph Pucella et al., Moody's Investors Service, U.S. Bank Ratings Incorporate Continued High Commercial Real Estate Losses (Feb. 6, 2010).

[343] *See* Real Estate Roundtable, *Continuing the Effort to Restore Liquidity in Commercial Real Estate Markets* at 5 (online at www.rer.org/uploadedFiles/RER/Policy__Issues/Credit__Crisis/2009__09__Restoring__Liquidity__in__CRE.pdf?n=8270) (accessed on Feb. 6, 2010); *see also* The Future Refinancing Crisis in CRE, *supra* note 214, at 3.

[344] *See* Footnote 242 Foresight Analytics LLC estimates that $770 billion (or 53 percent) of mortgages maturing from 2010 to 2014 have current LTVs in excess of 100 percent. Foresight further provides that over 60 percent of mortgages maturing in 2012 and 2013 will have LTVs over 100 percent, *supra*.

[345] See section F.3(b), *supra*.

[346] The "A", "B", and "C" classification used in this discussion is not meant to reflect any regulatory classification but is only used for ease of reference.

ple effects across the broader markets for commercial real estate.[347]

Second, real estate prices have already fallen far from their peak, and some analysts believe prices are now in line with historical trends.[348] Write-downs do not cause sales, but a drop in values based on the data generated by unnecessary write-downs may indirectly threaten banks, by allowing new investors to buy at unrealistically low prices. (As noted above, investors holding a great deal of money, much of it currently overseas, are waiting for the right time to invest in U.S. commercial real estate.)[349]

Third, loan write-downs are as much about the allocation of profits as losses. Purchasers of property at depressed values obtain the gain potential inherent in that property. That is wholly appropriate when a fire-sale discount is required by economic realities. But forcing write-downs can also operate unfairly—and be economically inefficient—by unnecessarily transferring the profit potential from the banks whose strength would increase as the economy—and property values—recover to investors pushing to depress prices before that happens.

In this situation, the job of policy makers, bankers, and CMBS master servicers is to determine when and how to evaluate honestly the components of the crisis and try to moderate them. This does not mean allowing banks that are not viable because of the quality of the commercial real estate loans they hold, to continue to operate; but neither does it mean forcing banks that engaged in relatively prudent lending, but were undercut by the depth of the recession, into the same position.

Again, it is important to recognize that some of the economic factors that will determine which side of the argument is correct lie outside of the commercial real estate sector. Assessing the likelihood and pace of the operation of those factors is beyond the scope of this report; nonetheless, they provide a picture of the complex economic forces at work here.

H. Regulatory Guidance, the Stress Tests, and EESA

As Treasury and federal financial supervisors brace for the expected wave of problems in the commercial real estate sector, they should consider their decisions in the context of the actions already taken by the banking supervisors. In terms of commercial real estate, the most important regulatory steps during the recent economic cycle have been the following: (1) The issuance of regulatory guidance in 2006 about the growing risks associated with the concentration of commercial real estate loans in banks; (2) the supervisors' administration of the stress tests in the first half of 2009 for the nation's 19 largest BHCs; (3) the issuance of expanded regulatory guidance on loan workouts in 2009; and (4) decisions made by supervisors with respect to banks' exit from the TARP. In this section the report explores those steps.

[347] Geltner PREA Report, *supra* note 312.
[348] Geltner PREA Report, *supra* note 312.
[349] Geltner PREA Report, *supra* note 312.

1. Supervisors' Role Before Mid-2008

As the credit bubble grew, the supervisors reminded banks of commercial real estate risks. In March 2004, FDIC Chairman Donald Powell noted, in a speech to members of the Independent Community Bankers Association:

> The real question in all this is—and the thing you should think about on the plane ride home—what happens when interest rates rise significantly from these historic lows? . . . The performance of commercial real estate loans has remained historically strong during the past three years even though market fundamentals have been poor. *Low interest rates have bailed out many projects that would have sunk if the environment had been different. When the tide of low interest rates and heavy fiscal stimulus recedes, we'll see some vulnerabilities exposed that are currently hidden from view. It is hard to predict how serious these are because we've never seen a cycle quite like this before.*[350]

The concern actually predated the Powell speech. In 2003, a year before the Powell speech, the supervisors began working on a more formal regulatory statement about commercial real estate lending concentrations, especially those accumulating at small and mid-sized banks.[351] In January 2006, the supervisors issued proposed guidance for public comment.[352] (Regulatory guidance is a statement of standards that banks should observe, rather than a set of legal requirements. Nonetheless, such guidance can serve as part of the basis for regulatory action against a particular institution.)

The January proposal noted that commercial real estate markets are cyclical and stated that some banks were not setting aside adequate capital or taking other steps necessary to manage the risks associated with these loans. The interagency proposal included two numerical thresholds for determining whether heightened risk-management practices were warranted at a particular bank. First, bank examiners were to look at whether the bank's outstanding portfolio of construction and development loans exceeded its total capital. Second, examiners were to determine whether the bank's outstanding portfolio of commercial real estate loans exceeded 300 percent of its total capital.[353] The proposal also included guidance that banks were to use to manage their risks and to ensure that they were holding enough capital to protect against future losses.[354]

The proposed guidance drew more than 4,400 comment letters, most of which came from financial institutions and their trade groups and strongly opposed the proposal. Many letters argued that existing regulations and guidance were adequate to address

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[350] Federal Deposit Insurance Corporation, *Remarks by Chairman Donald Powell Before the Independent Community Bankers Association, San Diego, Calif.* (Mar. 16, 2004) (emphasis added) (online at www.fdic.gov/news/news/press/2004/pr2204.html).

[351] The situation that sparked the supervisors' concern is outlined above, in Section E.

[352] Agencies Proposed Guidance, *supra* note 67.

[353] Agencies Proposed Guidance, *supra* note 67.

[354] Agencies Proposed Guidance, *supra* note 67. The proposed guidance noted that "institutions with CRE concentrations . . . should hold capital higher than regulatory minimums and commensurate with the level of risk in their CRE lending portfolios."

the risks associated with lending concentrations in commercial real estate.[355] In addition, several comment letters asserted that banks' underwriting practices were stronger than they had been in the late 1980s and early 1990s, when banks suffered losses on their commercial real estate loans, because banks had learned lessons from those times.[356]

During the comment period, the supervisors gave the banking community a nuanced view of their meaning. In an April 2006 speech that Comptroller of the Currency John Dugan gave to the New York Bankers Association, Mr. Dugan made the following statement:

> Concentrations in commercial real estate lending—or in any other type of loan for that matter—do raise safety and soundness concerns. . . . Our message is not, 'Cut back on commercial real estate loans.' Instead it is this: 'You can have concentrations in commercial real estate loans, but only if you have the risk management and capital you need to address the increased risk.' And in terms of 'the risk management and capital you need,' we're not talking about expertise or capital levels that are out of reach or impractical for community and mid-size bankers—because many of you already have both.[357]

In June 2005, then-Federal Reserve Governor Susan Bies noted her concerns about the rising concentration of commercial real estate loans at some banks, particularly in light of the sector's historical volatility. She also said that underwriting standards might be under downward pressure but offered the assurance that they remained at much higher levels than they had been in the periods preceding earlier crises.[358]

In congressional testimony in September 2006, the new FDIC Chairman Sheila Bair also expressed concern about lending concentrations in commercial real estate, in measured tones:

> While the rapid price appreciation seen in recent years in several locations is certainly not sustainable over the long-term, we do not anticipate a wide-spread decline in prices. Overall, market fundamentals are generally sound and FDIC economists do not foresee a crisis on the horizon.[359]

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[355] U.S. Department of the Treasury, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Dec. 12, 2006) (online at www.fdic.gov/regulations/laws/federal/2006/06notice1212.html) (hereinafter "Concentrations in CRE Lending").

[356] Concentrations in CRE Lending, *supra* note 355.

[357] Dugan Remarks Before the New York Bankers Association, *supra* note 66.

[358] Board of Governors of the Federal Reserve System, Remarks of Governor Susan Schmidt Bies at the North Carolina Bankers Association's 109th Annual Convention, Kiawah Island, South Carolina (June 14, 2005) (online at www.federalreserve.gov/boarddocs/speeches/2005/20050614/default.htm). One key to the commercial real estate crisis of the 1980s was similar shoddy underwriting, as the report discusses elsewhere. *See* Annex I.

[359] House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Statement on Interagency Proposals Regarding the Basel Capital Accord and Commercial Real Estate Lending Concentration*, 109th Cong., at 14 (Sept. 14, 2006) (online at financialservices.house.gov/media/pdf/091406scb.pdf).

The final guidance, issued in mid-December 2006,[360] reflected changes in response to the comments the proposal had generated. (Despite the change, the Office of Thrift Supervision did not join in the final statement, choosing instead to issue its own guidance.)[361]

In the final guidance, the proposed 300 percent threshold was changed so that banks with total commercial real estate loans representing at least 300 percent of their total capital would be identified for further analysis only in cases where their commercial real estate portfolios had increased by 50 percent or more in the previous three years.[362] New language was added to state that the numerical thresholds were not limits, but rather a "monitoring tool,"[363] subject to the discretion of individual examiners. Text accompanying the final guidance contained a related warning that "some institutions have relaxed their underwriting standards as a result of strong competition for business."[364] (The manner in which the guidance has been used in individual bank examinations is not known, because the results of each examination are confidential unless it results in a public supervisory action.)

After the 2006 guidance was issued, the cause for concern about the commercial real estate sector continued to grow. In 2007, warning signs emerged in the housing sector, which had key parallels with the commercial real estate market, including, most notably, the formation of an asset bubble fed by poor underwriting standards.[365] But starting in early 2008, federal bank supervisors also began warning about bank exposure to potentially toxic commercial real estate assets. Noting that small and community banks often had especially high levels of such exposure, these supervisors began acknowledging the potential for a financial crisis resulting from a commercial real estate downturn and the resulting disproportionate effect on the balance sheets of smaller and community banks.

In February 2008, the FDIC Office of Inspector General released a report on commercial real estate that concluded: "commercial real estate concentrations have been rising in FDIC-supervised institutions and have reached record levels that could create safety and soundness concerns in the event of a significant economic downturn."[366] The Inspector General's report found that the rising con-

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[360] Concentrations in CRE Lending, *supra* note 355.

[361] John Reich, director of the OTS, explained the decision to issue separate guidance by saying: "I thought the guidance was too prescriptive, that the numbers would be interpreted by bank examiners across the country as ceilings, not screens or thresholds for further examination." Barbara A. Rehm, Steven Sloan, Stacy Kaper, and Joe Adler, *OTS Breaks from Pack on Commercial Real Estate Loan Guidelines*, American Banker (Dec. 7, 2006) (online with subscription at www.americanbanker.com/issues/171__239/__297668-1.html).

[362] Concentrations in CRE Lending, *supra* note 355.

[363] Concentrations in CRE Lending, *supra* note 355. The final guidance stated that "[a]n institution with inadequate capital to serve as a buffer against unexpected losses from a CRE concentration should develop a plan for reducing its CRE concentrations or for maintaining capital appropriate to the level and nature of its CRE concentration risk."

[364] Jon D. Greenlee, associate director of the Federal Reserve Board's Division of Bank Supervision and Regulation, summarized the reasons for the changes from the proposed to the final guidance at the Panel's recent field hearing in Atlanta. He explained that the supervisors were seeking to allow banks to pursue their business plans, and to avoid overly stringent requirements. COP Field Hearing in Atlanta, *supra* note 70, at 41.

[365] *See* Congressional Oversight Panel, *December Oversight Report: Taking Stock: What Has The Troubled Asset Relief Program Achieved?* at 8–9 (Dec. 9, 2009) (online at cop.senate.gov/documents/cop-120909-report.pdf) (hereinafter "COP December Oversight Report").

[366] Federal Deposit Insurance Corporation, Office of Inspector General, *FDIC's Consideration of Commercial real estate Concentration Risk in FDIC-Supervised Institutions,* at 2 (Feb. 2008)

centrations were in part a reflection of demand for credit, as well as banks' searches for loans that would yield higher profits. The report expressed particular concern about the increasing reliance on commercial real estate loans at small and mid-sized banks.[367] The report also found that examiners underutilized tools at their disposal to uncover and address excessive concentration in commercial real estate assets.[368] In particular, examiners were often not adhering to 2006 regulatory guidance issued jointly by the FDIC and other federal bank supervisors.[369]

The FDIC responded to the 2008 Inspector General report by issuing a Financial Institutions Letter about the risks associated with loan concentrations in commercial real estate to state banks that it regulates.[370] The letter recommended that banks with significant commercial real estate concentrations ensure appropriately strong loan loss allowances and bolster their loan workout infrastructures and risk management procedures, among other precautions.[371] The FDIC's March 2008 letter was more strongly worded than the 2006 interagency guidance had been. It stated that the agency was "increasingly concerned" about commercial real estate concentrations; it also "strongly recommended" that banks with commercial real estate concentrations increase their capital to protect against unexpected losses.[372]

Around the time that the FDIC sent its letter, the commercial real estate market began to slow considerably. Lending standards rose in early 2008,[373] and spending on commercial construction projects slowed.[374] In March 2008, FDIC Chairman Sheila Bair testified before a congressional committee that liquidity in commercial real estate capital markets was sharply curtailed, and that loans were showing signs of deterioration at a time when loan concentration levels were at or near record highs.[375] At the same hearing, Federal Reserve Vice Chairman Donald Kohn testified that the agency had recently surveyed its bank examiners in an effort to evaluate the implementation of the 2006 guidance. This survey found that while many banks had taken prudent steps to manage

(online at www.fdicoig.gov/reports08/08–005.pdf) (hereinafter "FDIC's Consideration of CRE Risk").

[367] FDIC's Consideration of CRE Risk, *supra* note 366, at 2.

[368] FDIC's Consideration of CRE Risk, *supra* note 366, at 8.

[369] State banking regulatory organizations had also been active in implementing the 2006 Federal regulatory guidance. *See* Neil Milner, President and CEO of the Council of State Bank Supervisors, *Iowa Day with the Superintendent* (Apr. 12, 2007) (online at www.idob.state.ia.us/bank/docs/ppslides/DWS07/CSBSPresentation.ppt). The guidance materials called for further scrutiny of banks with at least 300 percent of total capital in commercial real estate loans and where commercial real estate portfolios had increased 50 percent or more in the past three years. 71 Fed. Reg. 74580, 74584.

[370] Financial Institution Letters, *supra* note 58. As far back as 2003, the FDIC Inspector General found that its examiners were not properly estimating risks associated with commercial real estate loans. Federal Deposit Insurance Program, Office of the Inspector General, *Examiner Assessment of Commercial Real Estate Loans* (Jan. 3, 2003) (Audit Report No. 03–008) (online at www.fdicoig.gov/reports03/03–008–Report.pdf).

[371] Federal Deposit Insurance Corporation, *Press Release: Federal Deposit Insurance Corporation Stresses Importance of Managing Commercial Real Estate Concentrations* (Mar. 17, 2008) (online at www.fdic.gov/news/news/press/2008/pr08024.html).

[372] Financial Institution Letters, *supra* note 58.

[373] Board of Governors of the Federal Reserve System, *Minutes of the Federal Open Market Committee* (Jan. 29–30, 2008) (online at www.federalreserve.gov/monetarypolicy/fomcminutes20080130.htm).

[374] Board of Governors of the Federal Reserve System, *Minutes of the Federal Open Market Committee* (Apr. 29–30, 2008) (online at www.federalreserve.gov/monetarypolicy/fomcminutes20080430.htm).

[375] March 4, 2008 Written Testimony of Sheila Bair, *supra* note 76.

their commercial real estate lending concentrations, other banks had used interest reserves and maturity extensions to mask their credit problems, or had failed to update appraisals despite substantial changes in local real-estate values.[376]

By late summer 2008, the securitization markets for commercial real estate had shut down, a milestone followed by the market panic of September 2008 and the enactment of EESA.

2. Supervisors' Role in the Stress Tests

In February 2009, the Obama Administration announced that bank supervisors would subject the nation's 19 largest BHCs to stress tests to determine their ability to weather future economic distress. The stress tests began with the determination of three variable assumptions: unemployment, housing prices, and GDP. The assumptions were used to test the banks' portfolios over 2009 and 2010 under two scenarios: a "baseline" scenario and a "more adverse" scenario. Banks were required to hold a capital buffer adequate to protect them against the more adverse downturn.

For specific loan categories, including commercial real estate, the supervisors established "indicative loss rates," which they described as useful indicators of industry-wide loss rates, and from which banks could diverge if they provided evidence that their own estimated ranges were appropriate.[377] These indicative loss rates were estimated expected loss rates if the economy followed either the baseline or more adverse scenarios. The supervisors explained that they derived the indicative loss rates "using a variety of methods for predicting loan losses, including analysis of historical loss experience at large BHCs and quantitative models relating the performance of individual loans and groups of loans to macroeconomic variables."[378]

The indicative loss rates for commercial real estate loans were broken into loss rates for construction, multifamily, and non-farm/non-residential; they are shown in Figure 38.

FIGURE 38: STRESS TEST INDICATIVE LOSS RATES FOR COMMERCIAL REAL ESTATE (CUMULATIVE 2009–2010, IN PERCENTAGES)[379]

	Baseline	More Adverse
All commercial real estate	5–7.5	9–12
Construction	8–12	15–18
Multifamily	3.5–6.5	10–11
Non-farm, Non-residential	4–5	7–9

[379] SCAP Overview of Results, *supra* note 377.

In May 2009, the results of the stress tests were released, providing a window into the potential losses that large financial institutions faced in seven different lending markets, including commer-

[376] Written Testimony of Donald Kohn, *supra* note 80.

[377] The supervisors described these indicative loss rates as "useful indicators of industry loss rates and [could] serve as a general guide." Banks could vary from these loss rates if they provided evidence that their own estimated ranges were appropriate. Federal Reserve Board of Governors, *The Supervisory Capital Assessment Program: Overview of Results* at 5 (May 7, 2009) (online at www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf) (hereinafter "SCAP Overview of Results").

[378] Federal Reserve Board of Governors, *The Supervisory Capital Assessment Program: Design and Implementation* at 8 (Apr. 24, 2009) (online at www.federalreserve.gov/newsevents/press/bcreg/bcreg20090424a1.pdf).

cial real estate. The results showed that most of the stress-tested 19 institutions hovered around or well below a median loss rate of 10.6 percent for commercial real estate loans. Three institutions had significantly higher loss rates: GMAC at 33.3 percent, Morgan Stanley at 45.2 percent, and State Street at 35.5 percent. While useful, the details of the results that the supervisors released publicly are limited. For example, although the indicative loan loss rates for commercial real estate are broken into three buckets, the institution-specific results did not provide this level of detail, only showing estimated commercial real estate losses. Also, the results did not break down estimated losses by year, showing instead total estimated losses for 2009 and 2010.[380] In addition, at its September 10, 2009 hearing and in a follow-up letter, the Panel questioned Secretary Geithner on the inputs for and results of the stress tests. Secretary Geithner stated that he would provide further information, but after two request letters and three months, he provided no additional data. Instead he referred the Panel back to the bank supervisors, who have not yet provided any data.[381]

The results of these tests are of very limited value in evaluating commercial real estate losses in the tested BHCs. First, the testing measured only losses through the end of 2010.[382] As discussed, commercial real estate losses are expected to continue and possibly even accelerate in 2012 or beyond.[383] Thus, the degree to which the capital buffers required through 2010 will be sufficient for later periods is unclear.

More important, of course, as the Panel has noted several times before, no effort has been made by the Federal Reserve Board and the other supervisors to extend the regulatory stress testing regime in an appropriate way to other banks. (The 2006 guidance did suggest that banks conduct their own stress testing if their concentrations of commercial real estate lending were significantly high.)

Second, since February 2009, the economic indicators used in the stress testing have been moving in unanticipated directions. The most recent figures for those three metrics show that GDP increased at an annual rate of 5.7 percent from the third to the fourth quarter of 2009,[384] a 9.3 percent annual unemployment rate as of December 2009,[385] and a 4.5 annual percent decrease in hous-

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[380] For further discussion of the limits of the stress tests, see the Panel's June report. COP June Oversight Report, *supra* note 6, at 30, 39–49. In the June Report, the Panel recommended, among other things, that "more information should be released with respect to the results of the stress tests. More granular information on estimated losses by sub-categories (e.g., the 12 loan categories that were administered versus the eight that were released) should be disclosed." COP June Oversight Report, *supra* note 6, at 49 .

[381] Letter from Chair Elizabeth Warren, Congressional Oversight Panel, to Secretary Timothy F. Geithner (Sept. 15, 2009) (online at cop.senate.gov/documents/letter–091509–geithner.pdf); Letter from Chair Elizabeth Warren, Congressional Oversight Panel, to Secretary Timothy F. Geithner (Nov. 25, 2009) (cop.senate.gov/documents/letter–112509–geithner.pdf); Letter from Secretary Timothy F. Geithner to Chair Elizabeth Warren, Congressional Oversight Panel, at 188 (Dec. 10, 2009) (cop.senate.gov/documents/cop–011410–report.pdf). The Panel requested inputs and formulae for the stress tests, more information about estimates for indicative loss rates, actual loss rates two quarters after the implementation of the stress tests, and the impact of unemployment metrics.

[382] With the exception of loan losses, for which institutions would be required to reserve in 2010 for 2011 loan losses.

[383] COP June Oversight Report, *supra* note 6, at 41–42.

[384] BEA Fourth Quarter GDP Estimate, *supra* note 95. *See* section D,1 *supra*, for a discussion of economists' views of the 5.7 percent GDP growth.

[385] This represents an average of the monthly unemployment rate for the previous 12 months. Bureau of Labor Statistics: Labor Force Statistics from the Current Population Survey (Jan. 24,

Continued

ing prices as of the end of November 2009.[386] Real GDP decreased by 2.4 percent from 2008 to 2009.[387] Under the more adverse predictions for 2009, GDP fell by 3.5 percent, housing fell by 22 percent, and unemployment was at 8.9 percent. For the entire year, while the housing price indicator is performing significantly better than expected, unemployment is higher, and the change in GDP is approaching its range in the more adverse scenario. As discussed in the Panel's June Report, the Federal Reserve would not disclose to the Panel the model used for the stress tests, making a complete evaluation of the process impossible.[388] The Panel cannot, therefore, determine how different variables were weighted in the tests, and their interactive effects.

Figure 39 shows, for each of the 19 stress test institutions, the commercial real estate loans outstanding, and the stress test loan loss rates for commercial real estate. These institutions have not publicly disclosed their actual commercial real estate losses, so it is difficult to evaluate the accuracy of the stress test loss rates.

FIGURE 39: COMMERCIAL REAL ESTATE EXPOSURE OF STRESS TEST INSTITUTIONS (AS OF Q3 2009) [389]

	Total Assets	**CRE Loans Outstanding** *(thousands of dollars)*	**CMBS Holdings** *(thousands of dollars)*	**CRE/ Risk Based Capital** *(Percent)*
Bank of America Corporation	$2,251,043,000	$91,031,681	$7,931,055	49.3
JPMorgan Chase & Co	2,041,009,000	66,281,865	6,010,000	43.5
Citigroup Inc	1,888,599,000	16,904,864	2,119,000	12.7
Wells Fargo & Company	1,228,625,000	96,424,887	11,163,000	79.4
Goldman Sachs Group, Inc.	882,185,000	219,000	—	1.0
Morgan Stanley	769,503,000	1,106,000	—	14.0
MetLife	535,192,209	30,495,694	15,534,957	99.1
PNC Financial Services Group, Inc	271,407,000	14,290,871	6,825,278	97.8
U.S. Bancorp	265,058,000	28,988,774	161,982	110.4
Bank of New York Mellon Corporation	212,007,000	1,523,042	2,895,000	10.5
GMAC Inc	178,254,000	1,473	—	0.0
SunTrust Banks, Inc	172,717,747	16,448,434	—	99.5
Capital One Financial Corporation	168,463,532	17,625,230	—	100.5
BB&T Corporation	165,328,000	27,450,854	51,842	173.7
State Street Corporation	163,277,000	592,344	3,903,374	5.2
Regions Financial Corporation	139,986,000	24,639,026	20,993	165.6
American Express Company	120,445,000	9,614	—	0.2
Fifth Third Bancorp	110,740,000	13,435,515	139,901	85.3
KeyCorp	96,989,000	15,340,865	45,607	131.1

[389] SNL Financial (accessed on Jan. 13, 2010). MetLife was not a TARP participant.

The stress tests were a central element of Treasury's Financial Stability Plan, intended to "clean up and strengthen the nation's banks."[390] The markets and the public have placed a great deal of confidence in the results, and yet serious questions remain about the timeframe, variables, and model, especially with regard to commercial real estate losses. As much of the statement of economic recovery is based on the stress test results, the Panel renews its call

2010) (online at data.bls.gov/PDQ/servlet/SurveyOutputServlet?data__tool=latest__numbers&series__id=LNS14000000).

[386] *Id.*

[387] BEA Fourth Quarter GDP Estimate, *supra* note 95.

[388] COP June Oversight Report, *supra* note 6.

[390] U.S. Department of the Treasury, *Secretary Geithner Introduces Financial Stability Plan* (Feb. 10, 2008) (online at www.financialstability.gov/latest/tg18.html).

to the supervisors to provide more transparency in the process and possibly to rerun the tests with a longer time horizon, in order to capture more accurately commercial real estate losses.

3. Supervisors' Role Regarding Loan Workouts

As 2009 continued, the outlook for commercial real estate loans continued to worsen. At the end of the second quarter, nine percent of the commercial real estate debt held by banks was delinquent, almost double the level of a year earlier. Prospects were particularly bad for construction and development loans, more than 16 percent of which were delinquent.[391] By October 2009, commercial property values had fallen 35 to 40 percent from their peaks in 2007.[392] And there were signs of more trouble ahead. Comptroller of the Currency John Dugan told a congressional committee in October 2009 that construction and development loans for housing, which, as noted above, are classified as commercial real estate loans, were by far the largest factor in commercial bank failures over the previous two years. He stated that the health of the broader commercial real estate sector was dependent on the overall performance of the economy.[393] FDIC Chairman Sheila Bair voiced additional concerns about the risk that commercial real estate posed to community banks. She said that commercial real estate comprised more than 43 percent of the portfolios of community banks. In addition, she noted that the average ratio of commercial real estate loans to total capital at these banks was above 280 percent—or close to one of the thresholds established in the 2006 regulatory guidance.[394]

The supervisors took their first major step to address these problems on October 30, 2009, releasing a policy statement that takes a generally positive view of workouts for commercial real estate loans.[395] The policy statement came amid concerns from banks that supervisors too often look askance at workouts, which allow lenders to protect themselves against defaults, because the supervisors worry that workouts allow lenders to delay acknowledging the bad loans on their books. The 33-page document, titled "Policy Statement on Prudent Commercial Real Estate Loan Workouts," states the following:

> The regulators have found that prudent commercial real estate loan workouts are often in the best interest of the financial institution and the borrower. Examiners are expected to take a balanced approach in assessing the ade-

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[391] Testimony of Daniel K. Tarullo, *supra* note 262.

[392] Testimony of Daniel K. Tarullo, *supra* note 262, at 7–9.

[393] Senate Committee on Banking, Housing & Urban Affairs, Subcommittee on Financial Institutions, Written Testimony of John C. Dugan, Comptroller of the Currency: *Examining the State of the Banking Industry,* 111th Cong. (Oct. 14, 2009) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=a2046ce1-1c34-4533-91ef-d6d6311760a7) (hereinafter "Testimony of John Dugan").

[394] Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, Statement of Sheila C. Bair, chairman, Federal Deposit Insurance Corporation: *Examining the State of the Banking Industry*, 111th Cong. (Oct. 14, 2009) (online at banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=6277ecd6-1d5c-4d07-a1ff-5c4b72201577).

[395] The regulatory agencies that released the statement were the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, and the Federal Financial Institutions Examination Council State Liaison Committee. Policy Statement on CRE Workouts, *supra* note 314.

> quacy of an institution's risk management practices for loan workout activity. Financial institutions that implement prudent commercial real estate loan workout arrangements will not be subject to criticism for engaging in these efforts even if the restructured loans have weaknesses that result in adverse credit classification. In addition, renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

Elsewhere, the document states that "loans to sound borrowers that are renewed or restructured in accordance with prudent underwriting standards should not be adversely classified or criticized unless well-defined weaknesses jeopardize repayment. Further, loans should not be adversely classified solely because the borrower is associated with a particular industry that is experiencing financial difficulties."[396] But the document also makes clear that writedowns are still necessary in some cases. For example, it states that if an underwater borrower is solely dependent on the sale of the property to repay the loan, and has no other reliable source of repayment, the examiner should classify the difference between the amount owed and the property value as a loss.[397] It also states that performing loans should be adversely classified when they have "well-defined weaknesses" that will "jeopardize repayment."[398]

While the policy statement does not establish many bright lines for what qualifies as a prudent workout, it does provide guidance in the form of hypothetical examples. One such example involved a $10 million loan for the construction of a shopping mall. The original loan was premised on the idea that the borrower would obtain long-term financing after construction was completed, but with a weak economy and a 55 percent occupancy rate at the mall, such financing was no longer feasible. In these circumstances, the lender split the loan in two—a $7.2 million loan that would have enough cash flow to allow the borrower to make payments, and a $2.8 million loan that the lender charged off, reflecting the loss on its books. For the lender, creating a good loan and a bad loan, as opposed to keeping one bad loan on its books, provided certain accounting benefits, and the regulator did not object to the debt restructuring.[399]

A second hypothetical example of a workout deemed acceptable by the supervisors involved a $15 million loan on an office building, under which the borrower was required to make a $13.6 million balloon payment at the end of the third year. Over those three years, the property's appraised value had fallen from $20 million to $13.1 million, meaning that the outstanding value of the loan now exceeded the property's value. Two factors suggested that the

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[396] Policy Statement on CRE Workouts, *supra* note 314, at 7.
[397] Policy Statement on CRE Workouts, *supra* note 314, at 9.
[398] Policy Statement on CRE Workouts, *supra* note 314, at 7.
[399] The description here is a condensed version of a scenario described in the supervisors' policy statement. It is meant to provide only a general understanding of the kinds of loan workouts that supervisors deem prudent. *See* Policy Statement on CRE Workouts, *supra* note 314, at 18–19.

loan could be paid off if it were restructured, even though the property was valued at less than the remaining amount owed under the loan: (1) the borrower had been making timely payments; and (2) the office building was generating more revenue than the borrower owed each month. Under these circumstances, the lender was not penalized for restructuring the loan in such a way that the outstanding $13.6 million was amortized over the next 17 years.[400]

The key point that industry participants have taken from the policy statement is that under certain circumstances an underwater loan will not have to be written down as long as the borrower is able to make monthly payments on the restructured debt. Indeed, the document states: "The primary focus of an examiner's review of a commercial loan, including binding commitments, is an assessment of the borrower's ability to repay the loan."[401] Focusing on the borrower's ability to service the loan, even when the borrower owes more than the value of the loan, of course carries the risk of underestimating the impact that negative equity has on rates of default and, consequently, on losses for lenders.[402]

At the Panel's January 27 field hearing on commercial real estate, Doreen Eberley, acting regional director in the FDIC's Atlanta Regional Office, argued that loans should not be written down solely because the property value has fallen. She noted that the primary source of repayment for a loan is the borrower's ability to pay, while the collateral is the secondary source. There is no reason to write down a loan, she argued, when a borrower has the wherewithal and the demonstrated willingness to repay it. And she said that requiring banks to mark all of their loans to their fair market value would lead to a lot of volatility on bank balance sheets.[403] Jon Greenlee, associate director of the Federal Reserve's Division of Bank Supervision and Regulation, said that the upcoming wave of expected refinancings is one reason why loan workouts are necessary. If a borrower can continue to make payments at a certain level, Mr. Greenlee argued, that is a better outcome than fore-

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[400] The description here is a condensed version of a scenario described in the supervisors' policy statement. It is meant to provide only a general understanding of the kinds of loan workouts that supervisors deem prudent. *See* Policy Statement on CRE Workouts, *supra* note 314, at 14–0915.

[401] Policy Statement on CRE Workouts, *supra* note 314, at 3. *See* David E. Rabin and David H. Jones, *New Policy on Commercial Real Estate Loan Workouts—Providing Welcomed Flexibility,* K&L Gates Distressed Real Estate Alert (Nov. 10, 2009) (online at www.klgates.com/newsstand/detail.aspx?publication=6010) (hereinafter "Rabin and Jones").

[402] A 2004 research paper found that CMBS borrowers are likely to decide whether to make payments based not only on their cash flow, but also on their equity position in the mortgage. Chen and Deng: Commercial Mortgage Workout Strategy, *supra* note 304. This greater willingness to walk away from a property that is underwater has also been observed in residential real estate. A July study found that 26 percent of underwater borrowers decided to walk away even when they can afford to pay their mortgage. Luigi Guiso, Paola Sapienza, and Luigi Zingales, *Moral and Social Constraints to Strategic Default on Mortgages,* Financial Trust Index (July, 2009) (online at www.financialtrustindex.org/images/Guiso_Sapienza_Zingales_StrategicDefault.pdf). Another complicating factor involves whether the loan is recourse, in which case the lender can recover from other assets of the borrower, or non-recourse. There are instances of both types of loan in the residential sector; in the commercial real estate sector, as discussed in *infra*, most construction loans are recourse, while most permanent loans are non-recourse. It is unclear whether the phenomenon's effects are larger, similar in size, or smaller in the commercial sector. On one hand, real estate developers are less likely than homeowners to worry about the stigma associated with walking away from a loan. In addition, people need a place to live, and consequently residential borrowers are often more tethered to their properties than commercial borrowers are. On the other hand, commercial properties produce income, which is usually not true of residential properties. Rental income may be large enough to change the commercial borrower's calculus, so that the borrower decides to continue making payments even when the loan is worth more than the property.

[403] Written Testimony of Doreen Eberley, *supra* note 91, at 57, 61–62.

closure for both the bank and the borrower.[404] Chris Burnett, chief executive officer of Cornerstone Bank, an Atlanta-based community bank, offered a different rationale in favor of the regulatory policy statement on loan workouts. He stated that if banks were required to mark their loan portfolios to their fair market value, it is unclear how deep the holes in their capital bases would be.[405]

The impact of the policy statement is subject to debate, in three broad areas.

The first involves the statement's immediate effect on loan write-downs. As noted above, there is no single write-down formula that applies to all loans. Too few write-downs can allow banks that have acted imprudently or even recklessly in managing their loan portfolios to survive unjustifiably. But in other cases forcing write-downs can create self-fulfilling prophecies. For every "extend and pretend," there can also be an "extend and soundly lend."

Second, the policy statement has the potential to affect banks' capital. If it leads to fewer write-downs, that may mean that banks will be required to set aside less capital; banks often seek to avoid larger capital reserves, because they reduce the bank's ability to earn profits. It is important to note, however, that the policy statement does not change the accounting rules that apply to the effects of loan write-downs on bank balance sheets, and that banks will still have to take write-downs when their auditors instruct them to do so.

Third, the policy statement may have an impact on bank lending. Banks with overvalued loans on their books may hoard capital and reduce sound lending. But if instead banks were being forced prematurely to write down possible losses, that could lead them to curtail lending.

Again, as discussed above, there is no one solution that fits all banks or all loans and properties; that is why the crisis requires forcing losses where necessary to protect the deposit insurance system, but not forcing banks into insolvency or depressing the value of projects that have a substantial chance of regaining value as the economy recovers, or as changes in real estate prices draw investors back into the market to close the equity gap. Often, a partial write-down may be appropriate as part of a refinancing package.

It is also important to note that the 2009 policy statement is not entirely new. It closely resembles another policy statement that federal banking supervisors issued in 1991, during that earlier wave of problems in the commercial real estate sector. In 1991 supervisors published a document that instructed examiners to review commercial real estate loans "in a consistent, prudent, and balanced fashion" and to ensure that regulatory policies and actions not inadvertently curtail the flow of credit to sound borrowers.[406] The 1991 statement also stated that evaluation of real estate loans "is not based solely on the value of the collateral" but on a review of the property's income-producing capacity and of the

[404] Written Testimony of Jon Greenlee, *supra* note 93, at 59.
[405] Written Testimony of Chris Burnett, *supra* note 92, at 126.
[406] House Financial Services Committee, Written Testimony of Elizabeth Duke, Federal Reserve Governor, *Credit Availability and Prudent Lending Standards,* 111th Cong. (Mar. 25, 2009) (online at www.federalreserve.gov/newsevents/testimony/duke20090325a.htm).

borrower's willingness and capacity to repay.[407] The issuance of a similar document in 2009 highlights the subjective nature of bank examinations; indeed, bank examiners must apply the rules, along with their own judgment and discretion, to the specific facts they encounter. The new policy statement provides a reminder of the criteria that are to be applied, and therefore may have an impact in situations where the question of whether to write-down the loan's value is not clear cut. It is unclear how much impact the 2009 policy statement is having at the field level, but especially in light of bankers' concerns that supervisors tend to become overly cautious in depressed markets,[408] the actual impact could be smaller than banks would like it to be.[409]

The policy statement has evoked a range of reactions among industry participants. Lenders obviously like it because it allows them to avoid writing down problematic loans. On the other hand, investors who would like to buy those distressed loans at a discount have a less favorable view.[410] The likely net effect is to make the downturn in commercial real estate at least somewhat less severe in the short term while also extending the period of uncertainty by pushing some losses further into the future. It is critical that bank supervisors fully recognize and are publicly clear about the potential for a commercial real estate crisis and are quick to force loss recognition where necessary before the commercial real estate sector can return to health.

4. Supervisors' Role in Banks' Exit from the TARP

Bank supervisors play a key role in determining when TARP-recipient banks may leave the program, and their judgments about commercial real estate loans continue to impact that success. A bank may not repurchase its preferred stock without the approval of its primary federal regulator.[411] If a bank has significant commercial real estate holdings, it might be told by its regulator that it will benefit from continuing to hold TARP funds, although it could also reach the same judgment by itself. Some banks might have capital levels that appear safe and stable, but are choosing not to repay because of the possibility of future commercial real estate losses. For example, as of the 3Q 2009, Marshall & Ilsley

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[407] Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision, *Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans* (Nov. 7, 1991) (online at files.ots.treas.gov/86028.pdf).

[408] *See, e.g.,* House Financial Services Committee, Subcommittee on Oversight and Investigations, Written Testimony of Michael Kus, Legal Counsel, Michigan Association of Community Bankers, *Field Hearing on Improving Responsible Lending to Small Businesses,* 111th Cong. (Nov. 30, 2009) (online at www.house.gov/apps/list/hearing/financialsvcs—dem/kus—testimony.pdf) ("[I]nstead of working with community banks to help both banks and their customers overcome current economic stress, some federal examiners have become extremely harsh in their assessment of the value of commercial real estate loans and their collateral. This extreme examination environment is adding to the commercial real estate contraction for small businesses. Community banks are effectively being forced to avoid making good loans out of fear of examination criticism, forced write-downs and the resulting loss of income and capital").

[409] *See, e.g.,* Written Testimony of Mark Elliott, *supra* note 109 (stating that "the guidance given is still open to interpretation and, in this environment, that interpretation will trend toward the cautious . . .").

[410] Rabin and Jones, *supra* note 401 ("lenders now have new breathing room and may be permitted to retain billions of dollars of undersecured commercial real estate loans without having to write-down these assets. The investors who have been waiting on the sidelines thinking that this recession might present a new opportunity to pluck out investments for pennies on the dollar . . . will have to keep waiting").

[411] 12 U.S.C. 5221(g).

Corp., a Wisconsin bank, had a tier 1 capital ratio of 9.61 percent,[412] but in its 3Q 10–Q has disclosed that it had $6.3 billion in construction and development loans, of which $984.5 million is non-performing.[413] M&I's CFO explained that "[f]rom our perspective, it's still good to have that incremental capital. As we get through the economic cycle and return to profitability, I think we then start considering what our TARP repayment strategies are going to be."[414] Other banks have been allowed to repay, even though they hold significant commercial real estate assets. For example, Sun Bancorp, Bank of Marin Bancorp, Old Line Bancshares, and Bank Rhode Island have all repurchased their Capital Purchase Program (CPP) preferred stock, and have commercial real estate loans to total loans of 42.3, 41.2, 36.0, and 23.2 percent, respectively.[415] This shows that commercial real estate concentrations are high even in some institutions that are considered well capitalized.

Among the large banks, BB&T, for which commercial real estate makes up a larger proportion of its assets than other large banks, has commercial real estate holdings (loans and CMBS) constituting 24.47 percent of its total assets. Wells Fargo, which also holds larger proportions of commercial real estate holdings, has a commercial real estate to total assets ratio of 11.63 percent. Figure 40 shows the commercial real estate holdings of the top 10 institutions that have redeemed their TARP funds, as well as an aggregated number for the remaining institutions that have redeemed. The top 10 institutions have a commercial real estate to total assets ratio of 5.35 percent, while the institutions outside of the top 10 have a ratio of 16.17 percent.

FIGURE 40: PERCENTAGE OF CRE LOANS TO TOTAL LOANS OF REDEEMED CPP PARTICIPANTS (AS OF 3Q 2009) [416]

	Total Assets	CRE Loans Outstanding *(thousands of dollars)*	CMBS Holdings *(thousands of dollars)*	CRE/Risk Based Capital *(Percent)*
Bank of America Corporation	$2,251,043,000	$91,031,681	$7,931,055	49.3
JPMorgan Chase & Co.	2,041,009,000	66,281,865	6,010,000	43.5
Wells Fargo & Company	1,228,625,000	96,424,887	11,163,000	79.4
Goldman Sachs Group, Inc.	882,185,000	219,000		1.0
Morgan Stanley	769,503,000	1,106,000		14.0
U.S. Bancorp	265,058,000	28,988,774	161,982	110.4
Bank of New York Mellon Corporation	212,007,000	1,523,042	2,895,000	10.5
Capital One Financial Corporation	168,463,532	17,625,230		100.5
BB&T Corporation	165,328,000	27,450,854	51,842	173.7

[412] Marshall & Ilsley Corp., *Form 10–Q for the quarter ended September 30, 2009,* at 44 (Nov. 9, 2009) (online at www.sec.gov/Archives/edgar/data/1399315/000139931509000034/micorp10q—09–2009.htm) (hereinafter "Marshall & Ilsley Form 10–Q").

[413] Marshall & Ilsley Form 10–Q, supra note 412.

[414] Marshall & Ilsley Corp, *Remarks by Gregory A. Smith, Senior Vice President and Chief Financial Officer at the Merrill Lynch 2009 Banking and Financial Services Conference* (Nov. 11, 2009) (online at phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzU4ODEzfENoaWxkSUQ9MzUxMzEzfFR5cGU9MQ=&t=1). In its 3Q 2009 10–Q, Marshall & Ilsley explained: "Notwithstanding the current national capital market impact on the cost and availability of liquidity, management believes that it has adequate liquidity to ensure that funds are available to the Corporation and each of its banks to satisfy their cash flow requirements. However, if capital markets deteriorate more than management currently expects, the Corporation could experience stress on its liquidity position." Marshall & Ilsley Form 10–Q, *supra* note 412, at 74.

[415] SNL Financial (accessed on Jan. 13, 2010).

FIGURE 40: PERCENTAGE OF CRE LOANS TO TOTAL LOANS OF REDEEMED CPP PARTICIPANTS (AS OF 3Q 2009)[416]—Continued

	Total Assets	CRE Loans Outstanding *(thousands of dollars)*	CMBS Holdings *(thousands of dollars)*	CRE/Risk Based Capital *(Percent)*
State Street Corporation	163,277,000	592,344	3,903,374	5.2
Top 10 Total	8,146,498,532	331,243,677	32,116,253	57.8
All Others Total	521,017,638	55,639,492	145,666	136.8
Total	**$8,667,516,170**	**$386,883,169**	**$32,261,919**	**63.0**

[416] This figure is based on guidance established by federal supervisors in December 2006. The numerator, total commercial real estate loans, is comprised of items 1a, 1d, 1e, and Memorandum Item 3 in the Call Report FFIEC 031 and 041 schedule RC-C. The denominator, total risk-based capital, is comprised of line 21 in the Call Report FFIEC 031 and 041 schedule RC-R-Regulatory Capital. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (Dec. 12, 2006) (online at frwebgate1.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=661175176921+0+2+0&WAISaction=retrieve).

There are two other issues involving commercial real estate that may have an impact on financial institutions' exit from the TARP. First, although many banks have already taken write-downs on their CMBS portfolios, there may be more write-downs to come. For banks that have already repaid their TARP funds, these write-downs could affect their capital levels. For those that still hold TARP funds, write-downs could keep them in the program longer than expected. At the Panel's field hearing in Atlanta, Doreen Eberley, the acting Atlanta regional director of the FDIC, testified that "capital is the most significant concern facing [Atlanta area] financial institutions" and that these institutions are "facing capital pressures now."[417]

Figure 41 shows commercial real estate loans and CMBS as a percentage of all assets for the top 20 institutions that are still participating in the CPP, as well as aggregated numbers for the remaining participating institutions. The top 20 institutions have a commercial real estate to all assets percentage of 4.84 percent; the remaining institutions' percentage is 38.03 percent.

FIGURE 41: PERCENTAGE OF CRE LOANS TO TOTAL LOANS OF CURRENT CPP PARTICIPANTS (AS OF 3Q 2009)[418]

	Total Assets	CRE Loans Outstanding *(thousands of dollars)*	CMBS Holdings *(thousands of dollars)*	CRE/Risk-Based Capital *(Percent)*
Citigroup Inc.	$1,888,599,000	16,904,864	2,119,000	12.7
American International Group, Inc.	844,344,000			
Hartford Financial Services Group, Inc.	316,720,000			
PNC Financial Services Group, Inc.	271,407,000	14,290,871	6,825,278	97.8
Lincoln National Corporation	181,489,200			
GMAC Inc.	178,254,000	1,473	....	0.0
SunTrust Banks, Inc.	172,717,747	16,448,434	....	99.5
Fifth Third Bancorp	110,740,000	13,435,515	139,901	85.3
KeyCorp	96,989,000	15,340,865	45,607	131.1
Comerica Incorporated	59,590,000	9,292,959	....	110.7
Marshall & Ilsley Corporation	58,545,323	14,792,400	....	245.5
Zions Bancorporation	53,298,150	15,246,020	....	242.9
Huntington Bancshares Incorporated	52,512,659	10,528,342	....	203.8
Discover Financial Services	42,698,290			
Popular, Inc.	35,637,804	5,888,803	....	184.5

[417] Written Testimony of Doreen Eberley, *supra* note 91.

FIGURE 41: PERCENTAGE OF CRE LOANS TO TOTAL LOANS OF CURRENT CPP PARTICIPANTS (AS OF 3Q 2009)[418]—Continued

	Total Assets	CRE Loans Outstanding *(thousands of dollars)*	CMBS Holdings *(thousands of dollars)*	CRE/Risk-Based Capital *(Percent)*
Synovus Financial Corp.	34,610,480	12,353,093	1,566	362.6
First Horizon National Corporation	26,465,852	2,677,495		59.1
Associated Banc-Corp	22,881,527	4,198,449		204.5
First BanCorp.	20,081,185	3,795,482		201.9
City National Corporation	18,400,604	2,648,255	19,629	146.7
Top 20 Total	4,485,981,821	157,843,320	9,150,981	63.4
Total of All Others	709,674,170	175,437,021	937,419	273.2
Total	**$5,195,655,991**	**$333,280,341**	**$10,088,400**	**106.4**

[418] This figure is based on guidance established by federal supervisors in December, 2006. The numerator, total commercial real estate loans, is comprised of items 1a, 1d, 1e, and Memorandum Item 3 in the Call Report FFIEC 031 and 041 schedule RC–C. The denominator, total risk-based capital, is comprised of line 21 in the Call Report FFIEC 031 and 041 schedule RC—R—Regulatory Capital. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (Dec. 12, 2006) (online at frwebgate1.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=661175176921+0+2+0&WAISaction=retrieve).

A similar issue arises with regard to the effect of SFAS 167. Banks large and small will be required to bring off balance sheet vehicles back onto their balance sheets. Bringing these assets onto the balance sheets of institutions that still hold TARP funds could require them to remain in the program for longer than they would have without the new accounting rule.

5. Summary

The effect of the 2006 guidance on banks and examiners and the impact it might have had if it had been proposed earlier, or in more binding form, are impossible to gauge. The stress tests provided greater clarity about the impact of troubled assets on balance sheets, but only for the nation's largest banks.[419] Furthermore, their usefulness beyond 2010, when a large wave of commercial real estate loans comes due, is less clear.

The moderating effect of the 2009 policy statement on loan workouts depends on the clarity and clear-sightedness with which both banks and examiners apply its terms. The Panel is concerned about the possibility that the supervisors, by allowing banks to extend certain underwater loans rather than requiring them to recognize losses, will inadvertently delay a rebound in bank lending. But the opposite scenario—in which bank write-downs themselves cause other banks to restrain lending, as prices fall and a negative bubble starts to grow—is also worrisome.

In assessing the supervisors' actions and attempts to balance the considerations involved in the face of uncertain economic timelines, the Panel notes that it is neither desirable nor possible to prevent every bank failure. The greatest difficulty is determining the point at which the number and velocity of failures can create a broader risk to the financial sector, the citizens who rely on smaller banks, and the people and communities whose lives are affected by property foreclosures. As noted throughout the report, stabilization of the commercial real estate market is dependent on a broad eco-

[419] *See* COP June Oversight Report, *supra* note 6.

nomic recovery;[420] likewise, a long downturn in the commercial real estate sector has the potential to stifle a recovery.

I. The TARP

Since the passage of EESA, Treasury has periodically taken steps to address specific risk and potential losses in the commercial real estate market. For example, in November 2008, Treasury, the FDIC, the Federal Reserve, and Citigroup agreed on a pool of ring-fenced Citigroup assets the three agencies would guarantee as part of the Asset Guarantee Program (AGP).[421] The asset pool included certain commercial real estate investments,[422] though neither the value of the commercial real estate assets in the pool, nor the ratio of commercial real estate assets to other assets, is clear. But Treasury exhibited enough concern about the risk posed by some of Citigroup's commercial real estate investments in November 2009 to provide a guarantee of these assets in order to stabilize the bank.

In this section the report describes the accomplishments and limitations of the TARP with respect to commercial real estate, and also explores what other support Treasury might consider providing under the TARP. It should be noted at the outset that there is no indication that Treasury has treated commercial real estate as a separate category of problem faced by one or more classes of financial institutions.

1. The Term Asset-Backed Securities Loan Facility (TALF)

The TALF was established by the Federal Reserve Bank of New York (FRBNY) and Treasury in November 2008, with the goal of restarting lending for asset-backed securities, a class of securities that includes consumer-sector loans for credit cards and auto purchases.[423] Under the TALF, the government extends loans to securities investors, and the assets that comprise the securities serve as collateral aimed at protecting the government against losses. Interest rates on TALF loans are below the prevailing market rates.[424] Thus, the TALF is both a way to provide liquidity to impaired markets, as well as a subsidy that reduces the price investors otherwise would have to pay for the securities they are buying.

In February 2009, Treasury announced its intention to expand the TALF to commercial mortgage-backed securities as part of its

[420] *See* Written Testimony of Doreen Eberley, *supra* note 91, at 51; *see also* Written Testimony of Jon Greenlee, *supra* note 93.

[421] U.S. Department of the Treasury, *Summary of Terms: Eligible Asset Guarantee* (Nov. 23, 2008) (online at www.ustreas.gov/press/releases/reports/cititermsheet__112308.pdf).

[422] Board of Governors of the Federal Reserve System, *Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Authorization to Provide Residual Financing to Citigroup, Inc. for a Designated Asset Pool,* at 3 (Nov. 23, 2009) (online at www.federalreserve.gov/monetarypolicy/files/129citigroup.pdf).

[423] For a broader discussion of TALF's implementation and impact, see the Panel's May and December reports. Congressional Oversight Panel, *May Oversight Report: Reviving Lending to Small Businesses and Families and the Impact of the TALF* (May 7, 2009) (online at cop.senate.gov/documents/cop-050709-report.pdf); COP December Oversight Report, *supra* note 365.

[424] Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: Frequently Asked Questions* (Jan. 15, 2010) (online at www.newyorkfed.org//markets/talf__faq.html#12) ("The interest rates on TALF loans are set with a view to providing borrowers an incentive to purchase eligible ABS at yield spreads higher than in more normal market conditions but lower than in the highly illiquid market conditions that have prevailed during the recent credit market turmoil").

comprehensive Financial Stability Plan.[425] In May 2009, the Federal Reserve followed through by expanding eligible TALF collateral to include new CMBS issuance (i.e., CMBS issued in 2009 and beyond) and legacy CMBS (i.e., CMBS issued in 2008 or earlier).[426] Newly issued CMBS includes not only new mortgages, but also loans that provide refinancing of existing commercial mortgages.

In order to qualify for TALF financing, newly issued CMBS must meet specific criteria, which are designed to protect the government against losses; for example, the underlying commercial mortgage loans must be fixed-rate, they cannot be interest-only loans, and the borrowers must be current on their payments at the time the loans are securitized. Similarly, legacy CMBS must meet various criteria in order to qualify for the TALF. For example, legacy securities must hold the most senior claim on the underlying pool of loans; consequently, only the senior-most piece of the CMBS, which generally carries an AAA rating, is eligible for government financing.[427]

Treasury has committed up to $20 billion in TARP funds to the TALF. Those dollars are in a first-loss position, meaning that if the TALF loses money, the TARP would pay for the first $20 billion in losses.[428]

There are different ways to assess the TALF's impact on the commercial real estate market. One measure is the volume of commercial mortgages that have been securitized since the program was unveiled. Prior to the time CMBS was made eligible under TALF, the market for commercial mortgage-backed securities was frozen. At the market's peak in 2006 and 2007, $65 billion to $70 billion in commercial mortgage-backed securities were being issued each quarter; but between July 2008 and May 2009, not a single CMBS was issued in the United States.[429] That changed following the announcement that CMBS would become eligible under the TALF. Between June and December 2009, a total of $2.33 billion of U.S. CMBS was issued.[430] While this figure represents a small fraction of the commercial mortgage securitization volume at the market's peak, that peak was in part the result of an asset bubble. Given the current upheaval in the commercial real estate market—with property values plummeting, rents falling and vacancy rates rising—it is not clear what a healthy level of commercial mortgage

[425] U.S. Department of the Treasury, *Fact Sheet: Financial Stability Plan,* at 4 (Feb. 10, 2009) (online at www.financialstability.gov/docs/fact-sheet.pdf).

[426] Board of Governors of the Federal Reserve System, *Press Release* (May 19, 2009) (online at www.federalreserve.gov/monetarypolicy/20090519b.htm); Board of Governors of the Federal Reserve System, *Press Release* (May 1, 2009) (online at www.federalreserve.gov/newsevents/press/monetary/20090501a.htm).

[427] Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: Terms and Conditions* (Nov. 13, 2009) (online at www.newyorkfed.org/markets/talf_terms.html).

[428] Board of Governors of the Federal Reserve System, Term Asset-Backed Securities Liquidity Facility (TALF) Terms and Conditions (online at www.federalreserve.gov/newsevents/press/monetary/monetary20081125a1.pdf). Treasury projects that it will actually make money from the TALF. The GAO, however, projects that the CMBS portion of the TALF could lose as much as $500 million under what GAO deemed a worst-case scenario for commercial real estate prices. Some of those losses would likely be offset, though, by interest payments on other TALF loans; in addition, Treasury disputes GAO's methodology, and says that commercial real estate prices would have to decline by 65 percent for the CMBS portion of TALF to incur losses. GAO TALF Report, *supra* note 64.

[429] Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146 (accessed Jan. 12, 2010).

[430] Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146 (accessed Jan. 12, 2010).

securitization would be. It is also not clear how much of the partial return of this previously moribund market is attributable to the TALF. Of the $2.33 billion in CMBS issued in 2009, $72.25 million, or about three percent of the total, was financed through the TALF.[431]

The TALF has financed a larger volume of sales of commercial real estate securities in the secondary market. Between July and December 2009, $9.22 billion was requested through the TALF for legacy CMBS.[432] As was described above, these TALF loans are not providing new financing for the commercial real estate market, but they do offer a channel to finance the resale of existing real estate debt. As such, they provide a government-subsidized channel for the removal of troubled commercial real estate assets from bank balance sheets. It is important to note, though, that the $9.22 billion in TALF funds requested for legacy CMBS represents only about 1 percent of the approximately $900 billion CMBS market.[433] In comparison to the entire commercial real estate debt market, which is valued at over $3 trillion,[434] the program's impact is even smaller. Figure 42 shows the total value of TALF CMBS loans requested by month, including both legacy and newly issued CMBS.

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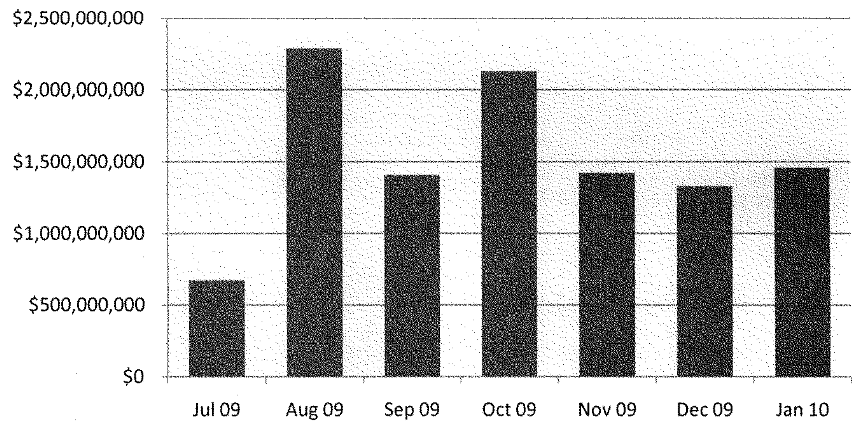
[431] Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: CMBS* (online at www.newyorkfed.org/markets/CMBS_recent_operations.html) (hereinafter "Term Asset-Backed Securities Loan Facility: CMBS") (accessed Jan. 22, 2010).

[432] *See* Term Asset-Backed Securities Loan Facility: CMBS, *supra* note 431 (accessed Jan. 22, 2010).

[433] Joint Economic Committee, Testimony of Jon D. Greenlee, Associate Director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System, *Commercial Real Estate* (July 9, 2009) (online at www.federalreserve.gov/newsevents/testimony/greenlee20090709a.htm).

[434] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States: Flows and Outstandings, Third Quarter 2009,* at 96–97 (Dec. 10, 2009) (online at www.federalreserve.gov/Releases/z1/Current/z1r-1.pdf).

FIGURE 42: TALF CMBS LOANS REQUESTED BY MONTH[435]



Another way to evaluate the TALF's impact is by assessing how the program has affected the market's view of the risk associated with real-estate bonds. In particular, the spread between the interest rate paid on Treasury notes and the rate paid on the highest-rated pieces of CMBS shows the market's view of the riskiness of those investments. Prior to the credit crunch that began in 2007, these spreads were generally at or below 200 basis points. What this means is that if Treasury notes were paying four percent interest, the top-rated pieces of CMBS generally paid interest of six percent or less. Spreads on these bonds rose in 2007 and skyrocketed in 2008, reflecting the rise in perceived risk. At their peak, the spreads were above 1,000 basis points, meaning that these bonds were paying interest rates more than 10 percentage points above the Treasury rate.[436] Needless to say, in such an environment it was difficult, if not impossible, to find reasonably priced financing for commercial real estate. Spreads began to fall around the time that the TALF was introduced in May 2009. By the summer of 2009, spreads were back in the range of 400–500 basis points—still elevated by historical standards, but reflecting a healthier real-estate finance market.[437] Market observers attribute the fall in spreads to the announcement that CMBS would become eligible under the TALF,[438] and market data support that hypothesis.[439]

[435] Requested funds do not all result in actual loans; the requested figure is used because the FRBNY did not report the amount of actual "settled" loans until October 2009. Term Asset-Backed Securities Loan Facility: CMBS, *supra* note 431 (accessed Jan. 22, 2010).

[436] Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146 (accessed Jan. 12, 2010).

[437] Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146 (accessed Jan. 12, 2010).

[438] *See, e.g.,* Bank of America Merrill Lynch, *CMBS Year Ahead: 2010 Year Ahead: Better, but not Out of the Woods Yet* (Jan. 8, 2010) (hereinafter "CMBS Year Ahead: 2010") ("Of the changes that occurred in 2009, we think the introduction of TALF to CMBS was one of the biggest drivers of spreads throughout the year. We believe that CMBS spreads would have tightened even absent TALF, but to a far lesser degree. We think this is true despite the fact that both the new issue and the legacy portions have been used less than most people anticipated").

[439] In the spring and summer of 2009, spreads on lower-rated commercial real-estate bonds, which are not eligible for financing under the TALF, did not fall substantially the way that spreads on TALF-eligible bonds did. Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146 (accessed Jan. 12, 2010).

Still, the TALF's impact on the pricing of credit in the commercial real estate market should not be exaggerated. Spreads on lower-rated CMBS bonds, which are not eligible under the TALF, remain remarkably high—in the range of 3,000–7,000 basis points as of August 2009.[440] Spreads on new CMBS deals will be lower, because the underlying loans are less risky than loans in older CMBS; still, these data help to explain the constrained market for new CMBS deals.

In general, though, private actors have been making commercial real estate loans on more favorable terms since the introduction of the TALF.[441] And while it is impossible to untangle the impact of the TALF from the effect of improved economic conditions, it is fair to conclude that when all else is equal, a market with a liquidity facility like the TALF will almost certainly have narrower spreads and more readily available credit than a market that does not have such a facility.[442] The TALF is scheduled to expire this year—the last subscriptions secured by legacy CMBS are to be offered in March, and the last subscriptions secured by newly issued CMBS are to be offered in June.[443] Many analysts anticipate that the program's withdrawal will exacerbate the difficulties associated with refinancing commercial real estate loans.[444] Some analysts doubt that credit markets will have sufficient capacity to refinance the loans coming due in the next few years without additional government liquidity.[445] If credit is available only on less favorable terms, or if the market simply contains insufficient credit to accommodate maturing commercial real estate loans, then more loans will default at maturity, forcing banks to take losses, resulting in greater strain on the financial system. On the other hand, Treasury states that liquidity has re-entered the commercial real estate sector;[446] three CMBS deals closed late in 2009, including two that did not rely on TALF financing.[447]

The Federal Reserve has previously extended the TALF out of a concern that the securitization markets lacked sufficient liquidity

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[440] *See* Commercial Real Estate Securities Association, Exhibit 19, *supra* note 146 (accessed Jan. 12, 2010).

[441] *See, e.g.,* David Lynn, *Signs of Life Emerge in Commercial Real Estate Lending Market*, National Real Estate Investor (Dec. 7, 2009) (online at nreionline.com/finance/news/signs__of__life__emerg__1207/).

[442] *See, e.g.*, U.S. Department of the Treasury, *The Consumer and Business Lending Initiative: A Note on Efforts to Address Securitization Markets and Increase Lending*, at 3 (Mar. 3, 2009) (online at www.ustreas.gov/press/releases/reports/talf__white__paper.pdf).

[443] Board of Governors of the Federal Reserve System, *Press Release* (Aug. 17, 2009) (online at www.federalreserve.gov/monetarypolicy/20090817a.htm) (hereinafter "TALF Extension Press Release").

[444] *See, e.g.*, Standard & Poor's, *Report From ABS East 2009: Securitization Begins To Move Past The Fear*, at 10 (Nov. 6, 2009) (online at www.securitization.net/pdf/sp/ABS-East__6Nov09.pdf); New Oak Capital, *TALF for CMBS: A Bridge to Better Days or a Bridge to Nowhere?* (Feb. 26, 2009) (online at www.newoakcapital.com/market-outlook/?p=67).

[445] CCIM Institute, *December 2009 Legislative Bulletin*, at 1–2 (Dec. 2009) (online at www.ccim.com/system/files/2009-12-legislative-bulletin.pdf) (hereinafter "CCIM Institute Bulletin").

[446] Treasury conversations with Panel staff (Feb. 2, 2010).

[447] Strong investor demand surrounded the recent issuance of a new CMBS issuance in November 2009, only a portion of which was TALF-eligible, contributing to narrower than expected spreads. Two non-TALF new CMBS issuances followed in December. Anusha Shrivastava, *Investors Welcome Commercial Mortgage Deal Without TALF*, Dow Jones Newswires (Nov. 18, 2009) (online at www.nasdaq.com/aspx/company-news-story.aspx?storyid=200911181112dowjonesdjonline000478); CCIM Institute Bulletin, *supra* note 445, at 1.

to function properly on their own, and it could do so again.[448] If the Federal Reserve decides to end the TALF for CMBS in the first half of 2010,[449] the decision will likely reflect a judgment that the markets have become healthier or a judgment that the TALF is not a solution to those problems that continue to plague the commercial real estate markets.

2. The Public Private Investment Program (PPIP)

Treasury announced the PPIP in March 2009. The idea behind this program is to combine TARP funds with private investment in an effort to spur demand for the troubled assets that have been weighing down bank balance sheets. Like the TALF, by providing a subsidy to investors, the PPIP is designed to increase liquidity in the marketplace. Assets that are eligible for purchase under the PPIP include both residential and commercial real estate loans. If these assets increase in value, the government shares the profits with private investors. If the assets lose value, the two parties share the losses. The PPIP has two components: a program for buying troubled securities, which is now under way; and a program for buying troubled whole loans, which has yet to launch on a large scale.

The program for buying troubled securities is known as the Legacy Securities PPIP. Treasury has committed $30 billion in TARP funds to the program, comprised of $10 billion in equity and up to $20 billion in debt. The taxpayer dollars are being split between eight separate funds, which are under private-sector management, and which will also hold private-sector investments totaling $10 billion.[450] The investment funds may only buy certain types of securities—specifically, commercial and residential mortgage-backed securities that were issued prior to 2009 and originally had AAA ratings.[451] As such, the program overlaps with the TALF, providing support to the secondary market for commercial mortgage-backed securities, but only for the highest-rated bonds. So far, the program's impact on the CMBS market appears to be quite limited.[452] This is in part because the program only recently became operational; eight investment funds were established between late Sep-

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[448] The Federal Reserve could also extend the new issue CMBS portion of TALF, while terminating the legacy securities portion, or vice versa. TALF Extension Press Release, *supra* note 443.

[449] One large bank, Bank of America, believes the legacy CMBS portion is unlikely to be extended, but assigns a higher probability to the extension of the newly issued CMBS portion. CMBS Year Ahead: 2010, *supra* note 438.

[450] Originally, the $30 billion was to be split between nine funds, but Treasury is dissolving one of the funds, the UST/TCW Senior Mortgage Securities Fund, under a contractual provision that allowed for its dissolution upon the departure of key personnel. The eight remaining funds are the Invesco Legacy Securities Master Fund; Wellington Management Legacy Securities PPIF Master Fund; AllianceBernstein Legacy Securities Master Fund; Blackrock PPIF; AG GECC PPIF Master Fund; RLJ Western Asset Public/Private Master Fund; Marathon Legacy Securities Public-Private Investment Partnership; and Oaktree PPIP Fund. Treasury conversations with Panel staff (Jan. 5, 2010); U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf) (hereinafter "Treasury Transaction Report").

[451] For the complete eligibility rules, see U.S. Department of the Treasury, *Legacy Securities Public-Private Investment Funds, Summary of Proposed Terms* (Apr. 6, 2009) (online at www.treas.gov/press/releases/reports/legacy__securities__terms.pdf).

[452] CMBS Year Ahead: 2010, *supra* note 438 (stating that the PPIP's arrival led to CMBS purchases by non-PPIP investment managers, and that the PPIP has helped to keep CMBS spreads in check, but also that the activity of PPIP funds within CMBS has been "rather muted").

tember and mid-December 2009, and as of Dec. 31, 2009, they had invested only $3.4 billion. Just $440 million, or 13 percent of the total, was spent buying CMBS.[453] Even in the long term, the program appears unlikely to have a large impact on the $900 billion CMBS market because the investment funds will only be able to spend a maximum of $40 billion, and they will likely spend the large majority of that money on residential mortgage bonds.

The second program, known as the Legacy Loans Program, was also announced in March 2009. It has since been indefinitely postponed,[454] although the FDIC says that it continues to work on ways to refine the program.[455] The Legacy Loans Program was meant to purchase whole loans from banks, using a combination of public and private equity capital and debt guaranteed by the FDIC.[456] The program would have benefitted smaller banks that hold whole loans, as opposed to securities. At this stage, though, it has not had any impact on the commercial real estate market. According to Treasury, the program's key problem was that banks that held commercial real estate loans were unwilling to sell them at prices investors were willing to pay.[457]

Both the legacy securities and legacy loan programs, moreover, raise two more general points. Unless the CMBS and whole loans are bought at or close to par, the purchases will not prevent write-downs that can reduce bank capital.[458] At the same time, buying the assets at inflated prices causes its own problems, by exposing the government to future losses.[459]

3. The CPP

A third, albeit indirect way that Treasury has addressed the looming problems in commercial real estate is by injecting capital into banks. To date, 708 financial institutions have received capital injections from the government under the TARP's CPP. Providing assistance to commercial real estate lenders was never a stated goal of the CPP, but it was one effect of the program. Before the CPP expired at the end of 2009, Treasury used the program to provide nearly $205 billion to financial institutions, generally by purchasing preferred stock in those institutions. The banks that received CPP funds put them to a variety of uses, but one fairly common use was for the maintenance of an adequate capital cushion

[453] Of the $440 million total, the PPIP funds spent $182 million on super-senior tranches of CMBS at a median price of 81.1 percent of their par value. They spent $169 million on AM tranches, which were below the super-senior tranches but still initially rated AAA, at a median price of 72.1 percent of par. And they spent $89 million on AJ tranches, which were the lowest-rated AAA tranches, at a median price of 64.7 percent of par. U.S. Department of the Treasury, *Legacy Securities Public-Private Investment Program: Program Update—Quarter Ended December 31, 2009* at 4, 6 (Jan. 29, 2010) (online at financialstability.gov/docs/External Report—12–09 FINAL.pdf).

[454] Following a test run in the summer of 2009, which involved assets from failed banks, the FDIC has been unable to resolve two major problems with the program: (1) how to protect the FDIC from losses if the purchased assets lose value; and (2) how to devise a pricing mechanism that determines the loans' long-term value and that results in sale prices that selling banks would accept. FDIC conversations with Panel staff (Jan. 11, 2010); Federal Deposit Insurance Corporation, *Legacy Loans Program—Winning Bidder Announced in Pilot Sale* (Sept. 16, 2009) (online at www.fdic.gov/news/news/press/2009/pr09172.html) (describing results of pilot sale).

[455] COP Field Hearing in Atlanta, *supra* note 70 (Testimony of Doreen Eberley).

[456] Federal Deposit Insurance Corporation, *Legacy Loans Program—Program Description and Request for Comments* (Apr. 15, 2009) (online at www.fdic.gov/llp/progdesc.html).

[457] Treasury conversations with Panel staff (Feb. 2, 2010).

[458] COP August Oversight Report, *supra* note 5, at 45–46.

[459] COP August Oversight Report, *supra* note 5, at 45–46.

so that the bank could absorb losses on its portfolios,[460] including commercial real estate loans.

The CPP, which was meant to restore stability to the financial system, was, perhaps not surprisingly, a blunt instrument for remedying the problems related to commercial real estate. First, while some banks that received CPP funds held large concentrations of commercial real estate loans, a large majority of the funds went to big banks,[461] which, as noted earlier, tend to be much less dependent on commercial real estate lending than their smaller counterparts.[462] Treasury argues that it could not force small banks to participate in the CPP.[463] But there are also stories of small banks that made great efforts to get these funds but were denied them,[464] although it is difficult from the outside to assess whether a particular bank met the program's criteria. Second, because Treasury did not attach strings to the money it provided to CPP recipients—Treasury could have required the banks to submit regular lending plans, for example—the flow of credit to commercial real estate borrowers, and particularly those borrowers who rely on small banks, remained more constricted than it might have if the program had been designed differently. Third, Treasury closed the CPP at the end of 2009.

Thus, until now, to the extent that the TARP has had any impact on the commercial real estate sector, that impact has been centered around the CMBS market; the TALF focuses on securitizations, and the PPIP is designed to buy legacy securities—that is, already-issued mortgage-backed instruments. In light of the fact that large banks tend to have more exposure to securitized commercial real estate loans than smaller banks do, and smaller banks tend to have more relative exposure to whole loans,[465] the TARP's assistance in the commercial real estate market has been confined mostly to the large financial institutions. While Treasury notes that the TALF and the PPIP have had a positive impact on the cost of financing throughout the commercial real estate sector,[466] the fact

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[460] Office of the Special Inspector General for the Troubled Asset Relief Program, *SIGTARP Survey Demonstrates That Banks Can Provide Meaningful Information On Their Use of TARP Funds*, at 9 (July 20, 2009) (online at www.sigtarp.gov/reports/audit/2009/SIGTARP_Survey_Demonstrates_That_Banks_Can_Provide_Meaningfu_Information_On_Their_Use_Of_TARP_Funds.pdf) ("[M]ore than 40 percent of banks reported using some TARP funds to generate capital reserves to help the institution remain well-capitalized from a regulatory capital perspective").

[461] Roughly $163.5 billion of the CPP funds disbursed, or nearly 80 percent, went to 17 large financial institutions. The 18 institutions were Citigroup, Bank of America, JPMorgan Chase, Goldman Sachs, Morgan Stanley, Wells Fargo, The Bank of New York Mellon, State Street, SunTrust, BB&T, Regions Financial, Capital One, KeyCorp, U.S. Bancorp, PNC, Fifth Third Bancorp, and American Express. Treasury Transaction Report, *supra* note 450.

[462] As of June 2009, large national banks held commercial real estate loans valued at 56 percent of their capital, while the same percentage for mid-size banks and community banks was 191 percent. Testimony of John Dugan, *supra* note 393, at 25.

[463] Treasury conversations with Panel staff (Feb. 2, 2010).

[464] *See, e.g.,* Written Testimony of Chris Burnett, *supra* note 92 ("The application process was perhaps the most frustrating regulatory experience in my 30 years in this business. Our bank applied in 2008 as soon as the program was announced. We were finally told to withdraw our application in October, 2009, almost a year after the program began. Early in the process, we had new capital lined up to invest alongside TARP, but after ten months of waiting for an answer, those capital sources had dried up").

[465] The 20 largest banks have 89.4 percent of the total bank exposure to CMBS, as noted in Section E.2, even though they hold only 57 percent of assets in the banking system. But those same 20 large banks have an average commercial real estate exposure equal to 79 percent of their total risk-based capital—far lower than for banks with assets under $10 billion, where the average commercial real estate exposure equals 288 percent of total risk-based capital. COP staff calculations based on CRE Exposure by Size of Bank, *supra* note 138.

[466] Treasury conversations with Panel staff (Feb. 2, 2010).

remains that Treasury has not used the TARP to provide direct targeted help to smaller banks with commercial real estate problems.

This disparity creates a tension with EESA, which contains provisions aimed at ensuring that small banks are able to benefit from the TARP. The statute directs the Secretary, in exercising his authority, to consider "ensuring that all financial institutions are eligible to participate in the program, without discrimination based on size, geography, form of organization, or the size, type, and number of assets eligible for purchase under this Act . . ..''[467] The law also directs the Secretary to consider providing assistance under certain circumstances to financial institutions with assets of less than $1 billion.[468]

4. Small Banks, Small Business, and Commercial Real Estate

In October 2009, the Administration announced another TARP initiative that held the potential to have an impact on the commercial real estate sector, and specifically on small banks and the whole loans they tend to hold. The program was to look much like the CPP—it would have provided low-cost capital to financial institutions—but with modifications aimed at remedying some of the CPP's previously mentioned shortcomings. First, only small financial institutions—specifically, community banks and community development financial institutions (CDFIs)—were to be eligible to participate.[469] Second, in order to qualify, the institutions were to submit small business lending plans, and the TARP funds would have to be used to make qualifying small business loans.[470]

Even though commercial real estate was not mentioned in the press release announcing this new program, Treasury has noted that the problems of commercial real estate and the restricted flow of credit to small business are related.[471] When the inability of small businesses to borrow causes them to close their doors, vacancy rates increase, which then drag down commercial real estate values.[472] In a recent speech, Dennis Lockhart, president of the Federal Reserve Bank of Atlanta, expanded on this theme. He spoke about "the potential of a self-reinforcing negative feedback loop" involving bank lending, small business employment, and commercial real estate values.[473] Lockhart noted that small businesses

[467] 12 U.S.C. § 5213.

[468] Specifically, the law refers to financial institutions with assets of less than $1 billion that had been adequately capitalized or well capitalized but experienced a drop of at least one capital level as a result of the 2008 devaluation of Fannie Mae and Freddie Mac preferred stock. *See* 12 U.S.C. 5213.

[469] The proposal stated that participating community banks would have access to capital at a dividend rate of 3 percent, compared with the 5 percent rate under the CPP. Community development financial institutions, which are lenders that serve low-income or underserved populations, would be able to borrow at 2 percent. White House, *President Obama Announces New Efforts to Improve Access to Credit for Small Businesses* (Oct. 21, 2009) (online at www.whitehouse.gov/assets/documents/small_business_final.pdf) (hereinafter "President's Small Business Announcement").

[470] President's Small Business Announcement, *supra* note 469.

[471] Treasury conversations with Panel staff (Nov. 4, 2009).

[472] Treasury conversations with Panel staff (Nov. 4, 2009).

[473] Federal Reserve Bank of Atlanta, *Speech by President and Chief Executive Officer Dennis P. Lockhart to the Urban Land Institute's Emerging Trends in Real Estate Conference: Economy Recovery, Small Business, and the Challenge of Commercial Real Estate* (Nov. 10, 2009) (online at www.frbatlanta.org/news/speeches/lockhart_111009.cfm) (hereinafter "Lockhart Speech at the Urban Land Institute").

tend to rely heavily on smaller financial banks as a source of credit. He further noted that smaller financial institutions tend to have a larger-than-average concentration in commercial real estate lending.[474] Lastly, he noted that banks with the highest levels of exposure to commercial real estate loans account for almost 40 percent of all small business loans.[475] What this means is that a small bank that does not make many loans—perhaps because it is hoarding capital to offset future losses in the value of its commercial real estate portfolio—can feed a vicious cycle that does additional damage to the bank itself. The lack of lending may mean that small businesses that rely on the bank as a source of credit will be forced to shut their doors. This drives up vacancy rates on commercial real estate in the local region, which puts more downward pressure on real estate prices, and those falling prices can lead to additional write-downs in the bank's commercial real estate portfolio.

It is therefore possible that a program aimed at improving access to credit for small businesses could also have beneficial effects on the commercial real estate sector. However, the program announced in October 2009 never got off the ground. At a Panel hearing in December, Secretary Geithner said that banks are reluctant to accept TARP funding and participate in the program because they fear being stigmatized, and they are concerned about restrictions that the program would impose; he said that dealing with those concerns would require action by Congress.[476] Some small banks told Treasury that they were not interested in participating—in part because of the stigma associated with the TARP, and in part because of the TARP's restrictions, including its limits on executive compensation.[477] So in February 2010, Treasury announced that it was splitting the small business lending initiative into two parts. One part would remain with the TARP, while the other much larger part would not.

Within the TARP, Treasury proposes to provide up to $1 billion in low cost capital to CDFIs (lending institutions that provide more than 60 percent of their small business lending and other economic development activities to underserved communities).[478] The plan would allow CDFIs to apply for funds up to five percent of their risk-weighted assets. They would pay a two percent dividend, well under the CPP's five percent dividend rate. CDFIs that already participate in the CPP would be allowed to transfer into this new program. If the CDFI's regulator determines that it is not eligible to participate, it would be allowed to take part in a matching program. Under the matching program, Treasury would match private

[474] Banks with total assets of less than $10 billion accounted for only 20 percent of commercial banking assets in the United States, but they accounted for almost half of all commercial real estate loans. Small banks also accounted for almost half of all small business loans. Lockhart Speech at the Urban Land Institute, *supra* note 473.

[475] Lockhart Speech at the Urban Land Institute, *supra* note 473.

[476] Congressional Oversight Panel, Testimony of Treasury Secretary Timothy Geithner, at 24 (Dec. 10, 2009).

[477] Even though small bank employees generally do not earn as much as their counterparts at the largest banks, they are not exempt from certain executive compensation restrictions under the TARP. For example, restrictions on bonuses and golden parachutes apply to the highest paid employees of a TARP-recipient financial institution, regardless of the employees' salaries. Treasury conversations with Panel staff (Feb. 2, 2010).

[478] U.S. Department of the Treasury, *Obama Administration Announces Enhancements for TARP Initiative for Community Development Financial Institutions* (Feb. 3, 2010) (online at www.financialstability.gov/latest/pr__02032010.html) (hereinafter "Community Development Announcement").

funds raised on a dollar-for-dollar basis, as long as the institution would be viable after the new capital has been raised.[479] As announced, the CDFI program does not include any requirement that the participating financial institutions increase their small business lending. Treasury says that CDFIs, by virtue of their mission of lending in underserved areas, are already fulfilling the Administration's lending objectives.[480]

President Obama announced the second part of the small business lending initiative during his recent State of the Union Address.[481] It would require legislation, and would establish a new $30 billion Small Business Lending Fund outside of the TARP. The program would be aimed at midsized and community banks, those with assets under $10 billion, which have less than 20 percent of all bank assets but account for more than 50 percent of small business lending.[482] Because the funds would not be provided through the TARP, participating banks would not be subject to the TARP's restrictions, including those on executive compensation.[483] The Fund would provide capital to those banks with incentives for them to increase their small business lending. The dividend rate paid by participating banks would be five percent, but it would decrease by one percent for every two and a half percent increase in incremental small business lending over a two-year period, down to a minimum dividend rate of one percent.[484] Consequently, banks that increase their small business lending by at least two and a half percent would get the money on more favorable terms than were available under the CPP. Banks could borrow up to between three and five percent of risk weighted assets, depending on the size of the institution.[485] As with the CDFI program, financial institutions that currently participate in the CPP would be able to convert their capital into the new program.[486]

Banks received another signal aimed at spurring small business lending—this time from their supervisors—in a February 5, 2010 interagency statement. The document cautions that financial institutions may sometimes become overly cautious in small business lending during an economic downturn, and states that bank examiners will not discourage prudent small business lending.[487]

At this stage it is unclear whether the Small Business Lending Fund will have a significant impact on small business lending and, by extension, commercial real estate. The first hurdle the program

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[479] Treasury will not provide capital until the CDFI has raised the private funds, and Treasury's contribution will be senior to the private investment. Community Development Announcement, *supra* note 478; Treasury conversations with Panel staff (Feb. 2, 2010).

[480] Treasury conversations with Panel staff (Feb. 2, 2010).

[481] State of the Union Remarks, *supra* note 132.

[482] White House, *Administration Announces New $30 Billion Small Business Lending Fund* (Feb. 2, 2010) (online at www.whitehouse.gov/sites/default/files/FACT-SHEET-Small-Business-Lending-Fund.pdf) (hereinafter "Administration Announces Small Business Lending Fund").

[483] *Id.*

[484] The baseline for the bank's small business lending would be 2009. *Id.*

[485] Banks with less than $1 billion in assets would be eligible to receive capital equal to as much as five percent of their risk-weighted assets, while banks with between $1 billion and $10 billion in assets could receive capital equal to as much as three percent of their risk-weighted assets. *Id.*

[486] *Id.*

[487] Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Office of Thrift Supervision, National Credit Union Administration, Conference of State Bank Supervisors, *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* (Feb. 5, 2010) (online at www.federalreserve.gov/newsevents/press/bcreg/bcreg20100205.pdf).

faces is getting congressional authorization.[488] Even if that happens, it remains an open question whether a sufficiently large number of banks will choose to participate. And even if many banks do participate, it is unclear whether it will result in a large increase in small business lending. Unlike the Administration's initial plan, the new program encourages banks to increase their small business lending, but does not require them to submit quarterly reports detailing those lending activities.[489]

5. What Approach to Take?

This report has outlined the risks posed by the current and projected condition of commercial real estate. A second wave of real-estate driven bank difficulties, even if not as large as the first, can have an outsize effect on a banking sector weakened by both the current crisis and by the economy remaining in a severe recession. In the same way, even if smaller absolute numbers are involved, a second wave of bank losses and defaults can have a serious effect on public access to banking facilities in smaller communities, lending to small business, and more importantly, on confidence in the financial system. The system, as noted above, cannot, and should not, keep every bank afloat. But neither should it turn a blind eye to the impact of unnecessary bank consolidation. And the failure of mid-size and small banks because of commercial real estate might even require a significant recapitalization of the FDIC with taxpayer funds.

As the report has pointed out, the risks are not limited to banks and real estate developers. A wave of foreclosures can affect the lives of employees of retail stores, hotels, and office buildings, and residents of multifamily buildings. It can reduce the strength of the economic recovery, especially the small business recovery. And it can change the character of neighborhoods that contain foreclosed buildings whose condition is deteriorating.

Moreover, worries about the problems facing commercial real estate may already be adding to the very credit crunch that, by limiting economic growth, makes those risks more likely to mature. In the words of Martin Feldstein, professor of economics at Harvard University and a former chair of the Council of Economic Advisors:

> Looking further ahead, it will be difficult to have a robust recovery as long as the residential and commercial real estate markets are depressed and the local banks

[488] In addition to the Administration's proposal, members of Congress have made proposals to increase small business lending. For example, in late 2009, Senator Mark Warner (D–VA) and 32 other senators proposed the creation of a loan pool, using $40 billion of TARP funds and an additional $5 billion–$10 billion contributed by participating banks. Participating banks would make small business loans from this pool, and the funds would remain off the banks' balance sheets, so that they could not be used to bolster capital levels rather than to make loans. Senator Mark Warner, Press Release, *Warner Urges Action to Revive Lending to Small Businesses* (Oct. 21, 2009) (online at warner.senate.gov/public/index.cfm?p=PressReleases&ContentRecord__id=7dd28f00-d69f-44e4-a6b9-8826c1106a88&ContentType__id=0956c5f0-ef7c-478d-95e7-f339e775babf&MonthDisplay=10&YearDisplay=2009). Senator Cardin has also proposed that Treasury and the Small Business Administration jointly establish a small business lending fund, using $30 billion from the TARP. Under this proposal, loans would "have the same terms and conditions as, and may be used for any purpose authorized for, a direct loan under section 7(a) of the Small Business Act." Boosting Entrepreneurship and New Jobs Act, Section 5, S. 2967 (Jan. 28, 2010).

[489] President's Small Business Announcement, *supra* note 469.

> around the country restrict their lending because of their concern about possible defaults on real estate loans.[490]

The risks on the horizon could open a way to undoing what the TARP has accomplished, but any crisis triggered by problems in commercial real estate will reach fruition after the Secretary's TARP authority expires at the beginning of October 2010. Loans generated during the bubble period are likely to go bad in substantial numbers; LTVs, and even loan servicing, for other properties have dropped despite what may have been careful underwriting of the initial loans. It is unlikely, however, that the actual extent of the projected difficulties can be determined until the onset of the refinancing cycles that begin in 2011–13 and beyond (that may themselves be subject to extensions or workouts).

Supervisors, industry, Congress, and the public could consider one, or a combination of the approaches discussed below. The Panel takes no position on which are preferable, other than to note that any continued subsidization with taxpayer funds creates substantial additional problems. Continued subsidization is not an essential element of any solution.

a. Mid-Size and Small Banks

According to witnesses at the Panel's field hearing, adding capital to banks whose commercial real estate exposure exceeds a certain level, is composed of a higher proportion of low quality properties, or both, could provide a cushion against potential commercial real estate losses.[491] Capital additions could be supplemented by attempts to remove especially risky assets from bank balance sheets altogether through a public or private purchase program (perhaps a structure that is a variant of the never-used legacy loans program). Either way it will be essential to manage potential bank exposures carefully in light of economic conditions. This means forcing immediate write-downs where necessary to reflect the true condition of an institution holding a high percentage of the weakest commercial mortgages, in order to protect both bank creditors and the FDIC. But it also means recognizing that managing risk involves difficult judgments about the level LTVs will ultimately reach at the time refinancing is required and working with borrowers to prevent foreclosure when new equity and improved economic conditions can make loans viable.

Capital enhancement and removal of troubled assets from balance sheets could be the subject of a revised government effort under the TARP (or thereafter). Stronger banks could be induced to offer packages of those loans for purchase by investment vehicles combining TARP and private capital, at manageable discounts (perhaps also reflecting Treasury guarantees). Treasury could use its EESA authority to create a guarantee fund for loans held by banks below a certain size, upon payment of regular premiums, to support commercial real estate loans that meet defined standards, preventing write-offs and aiding in refinancing. The agencies could revive and expand the PPIP legacy loans program and create a fund,

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[490] Martin Feldstein, *U.S. Growth in the Decade Ahead,* American Economics Association (online at www.aeaweb.org/aea/conference/program/retrieve.php?pdfid=449).

[491] COP Field Hearing in Atlanta, *supra* note 70.

through either the FDIC or the Federal Reserve System, that can support the purchase of legacy loans after October 3, 2010. And the TALF could be extended for both legacy and new CMBS, either to complement other actions or to keep the securitization markets liquid.[492]

But there are also arguments for another approach, based on a conclusion that the problem of commercial real estate can only be worked through by a combination of private market and regulatory action. Any government capital support program can create as much moral hazard for small banks as for large financial institutions, and government interference in the marketplace could result in bailing out the imprudent, upsetting the credit allocation function of the capital markets, or protecting developers and investors from the consequences of their decisions.

"Awareness" on the part of both the private and public sectors would be the hallmark of the second approach. The supervisors would manage their supervisory responsibilities for the safety and soundness of the banking system and individual institutions to allow failures where necessary and apply guidance to give more soundly capitalized banks breathing room for economic recovery. Banks that should fail on the basis of an objective assessment of their record and prospects would be allowed to fail. Commercial real estate lenders and borrowers (who are business professionals) would understand that the government would not automatically come to their rescue and that taking on new equity, taking losses, admitting true positions and balance sheets, were all necessary. They would know that if they agreed to refinancing based on faulty underwriting or unrealistic expectations of economic growth, traffic in particular retail establishments or the prospects of changing the occupancy rates and rents in multifamily buildings, they were doing so at their own risk.

b. Large Banks

The situation of the large banks is more complicated. Although it is impossible to predict whether CMBS exposure poses a risk of reigniting a financial crisis on the order of 2008, there are disquieting similarities between the state of the RMBS markets then and the CMBS markets now. To be sure, there are some important differences; asset quality is reportedly higher, pools are smaller, and the supervisors have at least promised more extensive moni-

[492] If the potential crisis that the report identifies comes to pass, stronger action could prove necessary to prevent unwarranted bank failures. As the Panel discussed in its April and January Reports, at pages 39 and 23 respectively, the Emergency Banking Act of 1933 authorized the Reconstruction Finance Corporation to make preferred stock investments in financial institutions and instituted procedures for reopening sound banks and resolving insolvent banks. As part of the effort to restore confidence in the banking system, only banks liquid enough to do business were to be reopened when President Roosevelt's nation-wide banking holiday was lifted. As part of the process, banks were separated into three categories, based on an independent valuation of assets conducted by teams of bank examiners from the RFC, Federal Reserve Banks, Treasury, and the Comptroller of the Currency. The categories comprised: (1) banks whose capital structures were unimpaired, which received licenses and reopened when the holiday was lifted; (2) banks with impaired capital but with assets valuable enough to repay depositors, which remained closed until they could receive assistance from the RFC; and (3) banks whose assets were incapable of a full return to depositors and creditors, which were placed in the hands of conservators who could either reorganize them with RFC assistance or liquidate them. *See* James S. Olson, *Saving Capitalism: The Reconstruction Finance Corporation and the New Deal, 1933–1940,* at 64 (1988).

toring.[493] But if the economy does not recover in time, a high default rate remains a possibility (or, in the view of some observers, more than a possibility).[494] No one agrees on the point at which default levels can cause a severe break in CMBS values, but a break could trigger the same round of capital-threatening write-downs and counterparty liability that marked the financial crisis of mid-2007. Again, more flexible extension and workout terms can buy time until the economy recovers and values strengthen sufficiently to permit the return of the markets to normal parameters. But without a willingness to require loss recognition on appropriate terms, postponement will be just that.

Given the stress tests and promises of greater regulatory and market vigilance, it may be that the large institution sector can be left without additional assistance. But for that to be a safe approach, supervisors must monitor risk and not hesitate to increase capital to offset prospective losses in place of the capital that came from Treasury during the TARP. Without stronger supervision, the risks of commercial real estate even for large institutions are not negligible. The willingness of supervisors to engage in such supervision before the fact is the most important factor in preventing those risks from occurring.

J. Conclusion

There is a commercial real estate crisis on the horizon, and there are no easy solutions to the risks commercial real estate may pose to the financial system and the public. An extended severe recession and continuing high levels of unemployment can drive up the LTVs, and add to the difficulties of refinancing for even solidly underwritten properties. But delaying write-downs in advance of a hoped-for recovery in mid- and longer-term property valuations also runs the risk of postponing recognition of the costs that must ultimately be absorbed by the financial system to eliminate the commercial real estate overhang.

It should be understood that not all banks are the same. There are "A" banks, those who have operated on the most prudent terms and have financed only the strongest projects. There are "B" banks, whose commercial real estate portfolios have weakened but are largely still based on performing loans. There are "C" banks, whose portfolios are weak across the board. The key to managing the crisis is to eliminate the C banks, manage the risks of the B banks, and to avoid unnecessary actions that force banks into lower categories.

Any approach to the problem raises issues previously identified by the Panel: the creation of moral hazard, subsidization of financial institutions, and providing a floor under otherwise seriously undercapitalized institutions. That should be balanced against the importance of the banks involved to local communities, the fact that smaller banks were not the recipients of substantial attention during the administration of the TARP, and the desire that any shake-out of the community banking sector should proceed in a

[493] The degree to which that monitoring is in fact occurring and is matched by appropriately strong regulatory action is outside the scope of this report, as is the degree to which bank auditing is sufficiently strict to prevent financial reporting distortions.

[494] COP Field Hearing in Atlanta, *supra* note 70, at 50 (Testimony of Doreen Eberley).

way that does not repeat the pattern of the 1980s. The alternative, illustrated by recent actions of the FDIC, is to accept bank failures, and, when write-downs are no longer a consideration, sell the assets at a discount, and either create a partnership with the buyers to realize future value (as was done in the Corus Bank situation) or absorb the losses.

There appears to be a consensus, strongly supported by current data, that commercial real estate markets will suffer substantial difficulties for a number of years. Those difficulties can weigh heavily on depository institutions, particularly mid-size and community banks that hold a greater amount of commercial real estate mortgages relative to total size than larger institutions, and have—especially in the case of community banks—far less margin for error. But some aspects of the structure of the commercial real estate markets, including the heavy reliance on CMBS (themselves backed in some cases by CDS) and the fact that at least one of the nation's largest financial institutions holds a substantial portfolio of problem loans, mean that the potential for a larger impact is also present.

There is no way to predict with assurance whether an economic recovery of sufficient strength will occur to reduce these risks before the large-scale need for commercial mortgage refinancing that is expected to begin in 2011–2013. The supervisors bear a critical responsibility to determine whether current regulatory policies that attempt to ease the way for workouts and lease modifications will hold the system in place until cash flows improve, or whether the supervisors must take more affirmative action quickly, as they attempted to do in 2006, even if such action requires write-downs (with whatever consequences they bring for particular institutions). And, of course, they must be especially firm with individual institutions that have large portfolios of loans for projects that should never have been underwritten.

The stated purpose of the TARP, and the purpose of financial regulation, is to assure financial stability and promote jobs and economic growth. The breakdown of the residential real estate markets triggered economic consequences throughout the country. Treasury has used its authority under the TARP, and the supervisors have taken related measures in ways they believe will protect financial stability, revive economic growth, and expand credit for the broader economy.

The Panel is concerned that until Treasury and bank supervisors take coordinated action to address forthrightly and transparently the state of the commercial real estate markets—and the potential impact that a breakdown in those markets could have on local communities, small businesses, and individuals—the financial crisis will not end.

Annex I: The Commercial Real Estate Boom and Bust of the 1980s

As indicated in the main text,[495] the initial boom of the 1980s was so great that between 1980 and 1990 the total value of commercial real estate loans issued by U.S. banks tripled, representing an increase from 5.8 percent to 11.0 percent of banks' total assets.[496] Several factors converged to cause the real estate crash of the late 1980s: growth in demand, economic conditions, tax incentives, a descent into faulty practices, and lax regulatory policies.

Although the commercial real estate market was not the only market suffering a downturn at this time, and therefore cannot be labeled as the only cause of these failures, an analysis of bank assets indicates that those institutions which had invested heavily in commercial real estate during the preceding decade were substantially more likely to fail than those which had not.

The majority of lending institutions that failed were from specific geographic regions: ones which had been economically prosperous in the early 1980s and had therefore attracted the greatest levels of investment and generated the most inflated real estate prices. The failing banks and thrifts also tended to be small, regional institutions. These, unlike their national counterparts, could not hedge their bets by lending in multiple regions; their loans were made in a more concentrated and inflated property market. Furthermore, in the interest of economic stability, the federal banking and savings and loan deposit insurance agencies, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board, seemed willing to extend protections to large banks that it would not offer to local thrifts. For example, they agreed to extend coverage to the uninsured depositors of certain large banks but would not offer similar treatment to regional savings and loans.[497] This is not to say that the large institutions were unharmed; the large banks and thrifts had thrown themselves into commercial real estate lending with greater vigor than the smaller ones and had allowed these loans to account for a far greater proportion of their assets. As a result, and in spite of their advantages, many large banks came to the brink of collapse as well.

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[495] *See* Section B.

[496] This does not include the quantities being loaned by credit unions or thrift institutions. *See* History of the Eighties, *supra* note 36, at 153.

[497] *See* History of the Eighties, *supra* note 36, at 151 (Dec. 1997).

FIGURE 43: TOTAL VALUE OF COMMERCIAL REAL ESTATE LOANS BY U.S. COMMERCIAL BANKS[498]

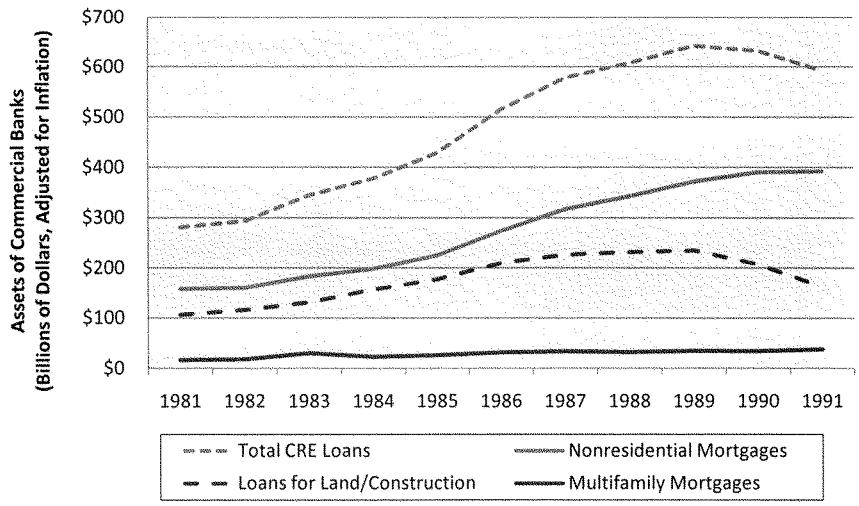
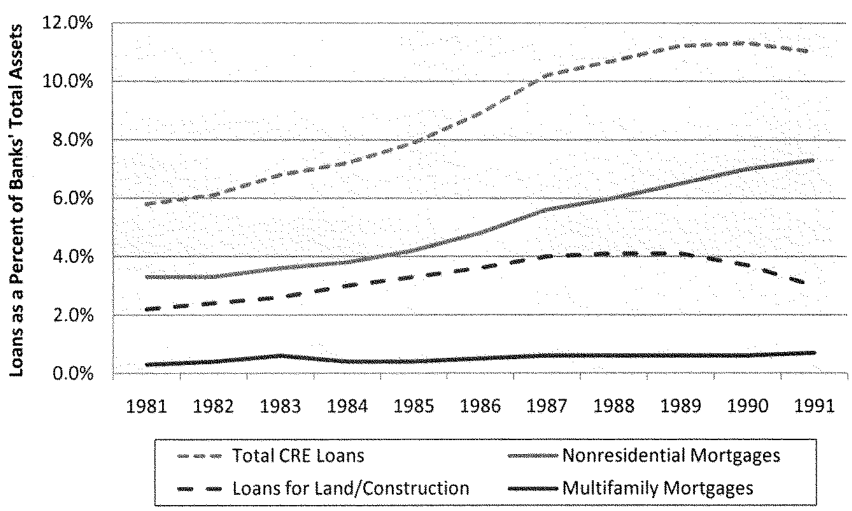


FIGURE 44: TOTAL VALUE OF COMMERCIAL REAL ESTATE LOANS BY U.S. COMMERCIAL BANKS[499]



[498] *See* Cole and Fenn, *supra* note 43, at 21. A comparable chart for current values of commercial real estate loans by U.S. banks is provided in Section E on page 46.
[499] *See* Cole and Fenn, *supra* note 43, at 21.

1. Demand for Office Space and Regional Impact

During the 1970s, increasing rates of inflation made real estate a popular investment.[500] Furthermore, with the United States shifting away from manufacturing toward a more services-based economy, there was a growing demand for additional office space. From the late 1970s until the end of the 1980s (with the exception of 1982), the number of people working in offices grew by more than four percent every year.[501] Existing office space was fully absorbed, and by 1980, the office vacancy rate had fallen to 3.8 percent.[502] There was, therefore, significant demand for the construction of new workspace in most major U.S. markets.[503]

Despite this high demand, the increase in supply that was forthcoming proved to be excessive. All sectors of commercial real estate experienced a boom in the early 1980s, but investments in office space were the ones yielding the highest returns, and the majority of new construction loans were for the building of office space.[504] Office construction increased by 221 percent between 1977 and 1984,[505] meaning that in spite of steadily increasing demand, office vacancy rates rose rapidly.[506] Although investment began to level off in 1986, office vacancy rates reached 16.5 percent and then began climbing toward 20 percent during the credit crunch of the early 1990s.

Demand for office space was a driving factor for the boom and is one of the reasons why the majority of lending institution failures are centered on specific regions. Although most of the country saw fluctuations in commercial real estate values and the whole country suffered from the fallout of the crisis, the most significant swings in property values occurred in states or regions which had comparatively prosperous economies in the early 1980s, such as Arizona, Arkansas, California, Florida, Kansas, Oklahoma, Texas, and the Northeast.[507] These areas' strong economies had more growing businesses and investors, which heightened their demand for office space, and therefore increased both the amount of overbuilding and the amount of real estate investment that occurred there during the 1980s.[508]

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[500] *See* Lynn E. Browne and Karl E. Case, "How the Commercial Real Estate Boom Undid the Banks," in *Real Estate and the Commercial Real Estate Crunch,* at 61 (1992) (online at www.wellesley.edu/Economics/case/PDFs/banks.pdf) (hereinafter "Browne and Case Article").
[501] *See* History of the Eighties, *supra* note 36, at 92.
[502] *See* History of the Eighties, *supra* note 36, at 93.
[503] *See* Garner Economic Review Article, *supra* note 34, at 93–94.
[504] *See* History of the Eighties, *supra* note 36, at 141, 145.
[505] *See* History of the Eighties, *supra* note 36, at 143.
[506] *See* Garner Economic Review Article, *supra* note 34, at 93.
[507] *See* History of the Eighties, *supra* note 36, at 13–26.
[508] *See* History of the Eighties, *supra* note 36, at 13–26.
[509] *See* Garner Economic Review Article, *supra* note 34, at 93.

FIGURE 45: OFFICE VACANCY RATE FROM 1979–1990 [509]

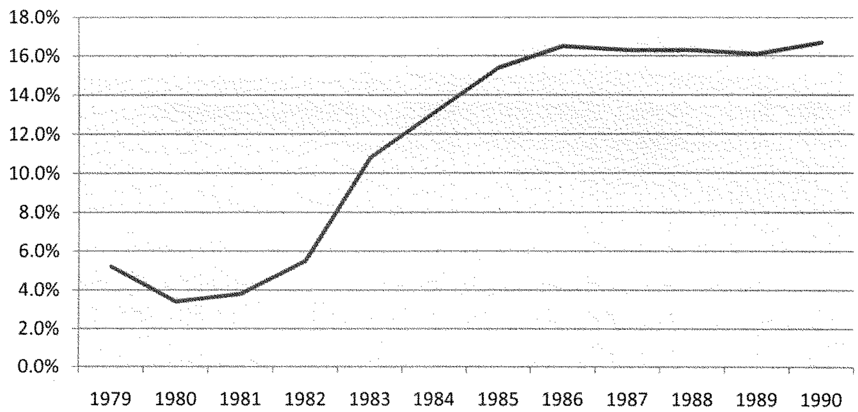
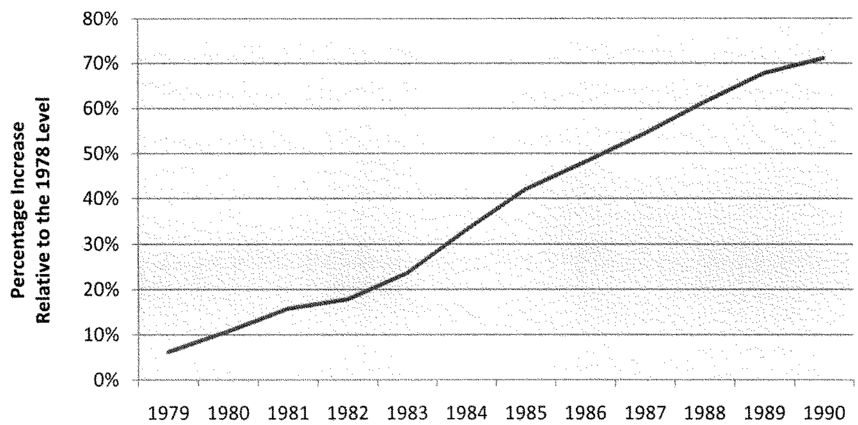


FIGURE 46: INCREASE IN OFFICE EMPLOYMENT FROM 1979–1990 [510]



[509] *See* Garner Economic Review Article, *supra* note 34, at 93.
[510] *See* History of the Eighties, *supra* note 36, at 146.

2. Tax Law Changes

The Economic Recovery Tax Act of 1981 (ERTA) incentivized investment in commercial real estate by introducing an Accelerated Cost Recovery System (ACRS) which dramatically improved the rate of return on commercial properties.[511] During the 1970s, the high rate of inflation had reduced the value of depreciation tax deductions on commercial buildings.[512] The ACRS resolved this by shortening building lives from 40 years to 15 and by allowing investors to use a 175 percent declining-balance method of depreciation rather than simple straight-line depreciation.[513] These measures increased the tax deductions which were available in the early years of a property's holding period. The ACRS also made commercial real estate investments a useful tax shelter for high-income individuals. A commercial property could be financed largely by debt (which conferred additional tax advantages), depreciated at an accelerated rate, and then sold for a capital gain to others who wished to repeat the process.[514] Furthermore, the passive losses which an investor suffered prior to the resale could be deducted from ordinary income for tax purposes.[515] Not surprisingly, the period after 1981 saw a sharp increase in investments in commercial real estate.[516]

The Tax Reform Act of 1986 eliminated many of the advantages which ERTA had created for commercial real estate investors.[517] The ACRS was removed, and losses from passive activities, such as real estate investment could no longer be deducted from active sources of income. These developments limited the profitability of commercial real estate development, curtailing investor interest and prompting a general softening of property prices.[518]

3. Inflation, Interest Rates, and the Deregulation of Thrift Institutions

During the late 1970s, the unexpected doubling of oil prices helped drive inflation into the double digits.[519] The Federal Reserve moved under Chairman Paul Volcker to break the inflation cycle by dramatically increasing the federal funds rate in 1979, which in turn caused a sharp increase in interest rates in gen-

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[511] *See* Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981,* at 68–69 (Dec. 19, 1981) (online at www.archive.org/stream/generalexplanati00jcs7181#page/n1/mode/2up) (hereinafter "Economic Recovery Tax Act of 1981").

[512] *See* Browne and Case Article, *supra* note 500, at 63.

[513] *See* Economic Recovery Tax Act of 1981, *supra* note 511, at 68–69.

[514] *See* James R. Hines, "The Tax Treatment of Structures," in *The Effects of Taxation on Capital Accumulation* (1987).

[515] *See* Browne and Case Article, *supra* note 500, at 64.

[516] *See* Garner Economic Review Article, *supra* note 34, at 93.

[517] *See* Andrew A. Samwick, "Tax Shelters and Passive Losses after the Tax Reform Act of 1986," in *Empirical Foundations of Household Taxation,* at 193–223 (1996).

[518] *See* Garner Economic Review Article, *supra* note 34, at 93.

[519] There is now general agreement that the surge in inflation in the late 1970s resulted from both excessive fiscal stimulus (fiscal deficits over this period were −2.7 percent in 1977 and 1978, 1.6 percent in 1979, and 2.7 percent in 1980) and loose monetary policy. The budget deficits in the 1970s were the largest since the end of World War II. Congressional Budget Office, *A 125 Year Picture of the Federal Government's Share of the Economy, 1950 to 2075* (online at www.cbo.gov/doc.cfm?index=3521&type=0) (accessed Feb. 9, 2010). *See also* Congressional *Budget Office, Budget and Economic Outlook: Historical Budget Data, January 2010* (online at www.cbo.gov/ftpdocs/108xx/doc10871/historicaltables.pdf) (accessed Feb. 9, 2010).

eral.[520] The funding liabilities of lending institutions (the amount of interest they had to pay on their short-term loans) increased sharply as well. This put thrifts in a bind because they specialized in residential mortgages, which meant that their main source of income was the repayments on long-term mortgages with low, fixed interest rates.[521] With the revenue from these low-interest loans now being surpassed by their losses on high-interest borrowing, many thrifts faced an unsustainable asset-liability gap that put them on the path to insolvency.[522] The situation was exacerbated when Regulation Q—which had placed ceilings on the interest rates which saving institutions could offer to depositors—was phased out between 1980 and 1982.[523] In order to remain competitive, thrifts therefore had to start offering interest rates to savers which matched or bettered inflation, which increased their funding liabilities even further.[524] This higher interest rate environment was also highly detrimental to the ability of borrowers, such as real estate investors, to refinance their loans, further exacerbating the economic contraction that was then underway.

Rather than allow the thrifts to fail, Congress decided to loosen the regulations on these institutions' lending practices so that they would be able to experiment with new methods of generating revenue. The Depository Institutions Deregulation and Monetary Control Act of 1980, followed by the Garn-St Germain Depository Institutions Act of 1982, significantly reduced the amount of capital which thrifts had to keep in their mandatory reserve accounts at Federal Reserve Banks and increased the proportions of their total assets which could be used for consumer and commercial loans. They also increased the amounts which the FDIC would guarantee from $40,000 per account to $100,000, meaning that even if a thrift's financial future was uncertain, the average saver would not feel he were taking as much risk by maintaining an account there. Further, the thrift industry's regulator, the Federal Home Loan Bank Board, set regulatory standards that allowed savings and loans broad latitude in the resources that could be counted as capital. Thrifts now had the opportunity to engage in riskier lending and investing with the hope of achieving increased profitability in new and uncertain markets, with the added confidence of knowing that they would not lose depositors by doing so.

4. Competition Among Lending Institutions and Lax Lending Practices

Thrifts were not the only lending institutions which felt pushed to take greater risks. The 1980s had brought challenges to banks' profitability. The high interest rates and elimination of Regulation Q had affected banks as well as thrifts, increasing their costs of doing business. Simultaneously, the number of lenders was on the rise; in addition to the thrifts moving into new markets, approxi-

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[520] *See* Federal Reserve Bank of St. Louis, *The Reform of October 1979: How It Happened and Why, remarks by D.E. Lindsey, A. Orphanides, and R.H. Rasche at the Conference on Reflections on Monetary Policy 25 Years after October 1979* (Oct. 2004) (online at research.stlouisfed.org/conferences/smallconf/lindsey.pdf).

[521] *See* Rob Jameson, *Case Study / US Savings & Loan Crisis* (Aug. 2002) (online at erisk.com/learning/casestudies/ussavingsloancrisis.asp) (hereinafter "Jameson Case Study").

[522] *See* Jameson Case Study, *supra* note 521.

[523] *See* Jameson Case Study, *supra* note 521.

[524] *See* Jameson Case Study, *supra* note 521.

mately 2,800 new banking charters were granted in the 1980s, and the rapid growth of the commercial paper market had taken a sizeable proportion of banks' commercial and industrial lending business.[525] In the face of this increased competition, banks became more willing to take risky investments on the principle that "if we don't make the loan, the institution across the street will."[526]

In this difficult lending environment, commercial real estate loans were an attractive revenue earner. The booming commercial real estate market made nonperformance seem unlikely, and commercial real estate lending involved large, up-front fees.[527] For struggling institutions—both banks and thrifts—this sort of immediate income could be essential.

Competition for commercial real estate loans rapidly intensified. In order to secure the largest possible share of this booming market, lending institutions started to engage in risky business practices. Many lowered their maximum LTV ratios, decreasing the amount of borrowers' equity at risk and increasing the potential loss to the lender.[528] Some became less rigorous in enforcing principal payment schedules, and would allow principal payments to be renewed repeatedly or unpaid interest simply to be added to the unpaid principal (practices which were uncommon prior to the 1980s).[529] Perhaps most significantly, underwriting standards in some cases became laxer. Traditionally, the decision to extend a loan collateralized by commercial real estate was made by evaluating whether the project in which the borrower wished to invest was likely to generate sufficient earnings to cover the debt payments. As a backup measure, lenders would evaluate the value of the collateralized investment property and whether it would cover the value of the loan if the borrower defaulted. From the late 1970s onward, lenders started to place increasing emphasis on the backup criterion and less on whether the project was likely to succeed.[530] This might not have been dangerous were it not for the fact that property valuations were being increasingly inflated as well. Once the market began to decline in the late 1980s, lenders found not only that their borrowers were defaulting but that the sale of foreclosed properties would not recoup their loan principal.

5. Faulty Appraisals

Before committing funds to a real estate loan, federally insured deposit institutions are required to hire an outside appraiser to deliver an independent opinion on the collateral value of the property in question. This is to ensure that an informed but impartial individual is present who can assess the project's viability and hopefully steer the lender away from risky loans.[531] However, prior to 1987, federal bank examiners had very few guidelines for how to assess an appraiser's credibility, and state licensing standards for

[525] *See* History of the Eighties, *supra* note 36, at 154.
[526] *See* History of the Eighties, *supra* note 36, at 154.
[527] *See* Garner Economic Review Article, *supra* note 34, at 93.
[528] *See* History of the Eighties, *supra* note 36, at 155.
[529] *See* History of the Eighties, *supra* note 36, at 155.
[530] *See* History of the Eighties, *supra* note 36, at 155.
[531] *See* History of the Eighties, *supra* note 36, at 156.

appraisers were practically non-existent.[532] A federal review of appraisal practices in the mid-1980s revealed that many appraisers had embraced the flawed belief that the real estate boom was sustainable and had tended to over-value properties as a result.[533] Since there were no mechanisms by which appraisers could be held accountable for faulty appraisals, they had never had sufficient motivation to analyze whether their assumptions were accurate.[534] Furthermore, the commercial real estate market was growing so rapidly in the early 1980s that many appraisal offices had to hire new and inexperienced appraisers, who were less likely to question the prevailing wisdom that commercial property values would continue to increase.[535] For all these reasons, appraisals failed to provide a reliable check on risky lending in the early 1980s and helped contribute to the severity of the bust which followed.

It should be noted that the economic recession of 1990–1991 affected the multifamily sector in a similar fashion. Overbuilding in this sector ultimately led to a collapse in values, which in turn led to tighter underwriting standards. Fortunately, with inflation under control and with the fall in interest rates during the 1980s, borrowers took advantage of the opportunity to refinance, and the multifamily market began to loosen substantially by 1992.[536]

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[532] *See* History of the Eighties, *supra* note 36, at 157.
[533] *See* History of the Eighties, *supra* note 36, at 157.
[534] *See* History of the Eighties, *supra* note 36, at 157.
[535] *See* History of the Eighties, *supra* note 36, at 157.
[536] Rent Guidelines Board, *1996 Mortgage Survey Report* (online at tenant.net/Oversight/RGBsum96/msurv/96msurv.html) (accessed Feb. 7, 2010).

SECTION TWO: UPDATE ON WARRANTS

On Tuesday, January 19, 2010, the Office of Financial Stability (OFS) issued a Warrant Disposition Report detailing the Department of the Treasury's approach to warrant dispositions related to TARP CPP investments.[537] The Panel has performed its own analysis of Treasury's warrant disposition process using an internally created model, beginning with its July report. Based upon 11 initial warrant sales of relatively small institutions, Treasury received only 66 percent of the Panel's estimated value of warrants sold.[538] Subsequently, Treasury's return on warrant sales has improved to 92 percent of Panel estimates.[539] In its July report, the Panel recommended that Treasury be more forthcoming on the details of its disposition process and valuation methodology. The July report also recommended that Treasury provide periodic written reports on its warrant fair market value determinations and subsequent disposition rationale.[540]

Upon repayment of Treasury's CPP investment, a financial institution has the right to repurchase its warrants at an agreed-upon fair market value.[541] The repurchase process follows a set timeline that includes bid submission(s), Treasury bid evaluation, and a final appraisal option.[542] This Warrant Disposition Report provides Treasury's first comprehensive and systematic public explanation of its internal procedures and specific details for each warrant sale.

Treasury utilizes three sources in its determination of the fair market value of warrants and subsequent evaluation of an institution's bid to repurchase its warrants: market quotes; independent, third-party valuations; and internal model valuations.[543]

- Market quotes: Though warrants are similar in structure to options, there is little market data for long-dated options that is comparable in length and terms to those of the warrants held by Treasury. Accordingly, Treasury collects what market pricing information is available from various market participants who are active in the options and/or convertible securities markets and uses this data to estimate warrant valuations. In the future, Treasury plans to use the market values from the trading of recently auctioned CPP warrants as some indication of the market's expectations for long-term volatility (in addition to continuing to collect valuation estimates from market participants).

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[537] Warrant Disposition Report, *United States Department of the Treasury—Office of Financial Stability* (online at www.financialstability.gov/docs/TARP%20Warrant%20Disposition%20Report%20v4.pdf) (hereinafter "Warrant Disposition Report").

[538] *See* COP August Oversight Report, *supra* note 5, at 54–57.

[539] *See* Warrant table at Figure 47.

[540] Warrant Disposition Report, *supra* note 537.

[541] Warrant Disposition Report, *supra* note 537.

[542] Under the repurchase through bid process, financial institutions have 15 days from CPP preferred repayment to submit an initial bid. Then, Treasury has 10 days to accept or reject the bid. Additional bids may be submitted at any time, even if an agreement on fair market value is not reached within the 25-day timeframe.

Under the repurchase through appraisal process, Treasury or the repaying financial institution may invoke an appraisal procedure within 30 days following Treasury's response to the institution's first bid if no agreement on fair market value has been reached. In this scenario, both parties select independent appraisers who conduct their own valuations and work toward fair market value agreement. If both appraisers are in agreement, that valuation becomes the repurchase basis. If they are not in agreement, a third appraiser creates a composite valuation of the three appraisals to establish the fair market value (subject to some limitations). However, this process has yet to be used to date.

[543] Warrant Disposition Report, *supra* note 537.

• Independent valuation: Outside consultants and external asset managers provide estimated valuation and a range of values to Treasury for use as a third-party valuation source.

• Internal modeling: Treasury uses a binomial option model adjusted for American-style options as its primary internal valuation model.[544] Treasury uses the 20-trading day trailing average stock price of a company in its valuations and updates this data if negotiations continue over an extended period of time. A binomial option pricing model values a warrant based on how the price of its underlying shares may change over the warrant's term. The binomial model allows for changes to input assumptions (e.g., volatility) over time.[545]

The OFS Warrant Committee, comprised of Treasury officials within OFS, makes a recommendation to the Assistant Secretary for Financial Stability regarding acceptance or rejection of a bank's bid based on these three valuation sources. In the event that there is no fair market value agreement between parties and no invocation of the appraisal process, Treasury seeks to sell the warrants to third parties "as quickly as practicable" and, when possible, through public auction.[546] Treasury has conducted the three warrant auctions to date as public modified "Dutch" auctions registered under the Securities Act of 1933 and administered by Deutsche Bank.[547] In a "Dutch" auction, bidders submit one or more independent bids at different price-quantity combinations and have no additional information on others' bids. Bids must be greater than the minimum price set by Treasury. The warrants are then sold at a uniform price that clears the auction.[548]

By comparison, the Panel's warrant valuation methodology employs a Black-Scholes model modified to account for the warrants' dilutive effects on common stock and the dividend yield of the stock. A Black-Scholes model and binomial model share similar underlying assumptions but differ in the variability of those assumptions. In its use of Black-Scholes, the Panel assumed that the risk-free rate, the dividend yield, and the stock price volatility of each financial institution would be constant over time.[549] The binomial model, on the other hand, includes inherent variability in assumptions at various time intervals. This model is generally more complex and time-intensive, whereas Black-Scholes is, by comparison, more transparent and reproducible.

[544] Dr. Robert Jarrow, an options expert and professor at Cornell University, reviewed Treasury's internal valuation model and concluded that it is consistent with industry best practice and the "highest academic standards."

[545] Congressional Oversight Panel, *July Oversight Report: TARP Repayments, Including the Repurchase of Stock Warrants* (July 10, 2009) (online at cop.senate.gov/documents/cop-071009-report.pdf).

[546] Warrant Disposition Report, *supra* note 537.

[547] As auction agent, Deutsche Bank Securities Inc. has received fees equal to approximately 1.5 percent of gross proceeds ($16.6M). This is a haircut to the typical average secondary equity offering fees of 3.5 to 4.5 percent.

[548] Warrant Disposition Report, *supra* note 537. It is generally accepted that, compared to discriminating price auctions in which a bidder pays what he bids, uniform price auctions increase how aggressively participants bid in an auction, thus increasing the amount of proceeds from the auction. This occurs because uniform price auctions decrease the so called "winner's curse," which is a bidder's fear that an auction win means he overpaid. A uniform price auction is the same type of auction used to sell Treasury debt.

[549] Congressional Oversight Panel, *July Oversight Report: TARP Repayments, Including the Repurchase of Stock Warrants* (July 10, 2009) (online at cop.senate.gov/documents/cop-071009-report.pdf).

Congress has addressed the receipt and disposition of TARP warrants in three separate legislative actions: EESA, American Recovery and Reinvestment Act of 2009 (ARRA), and Helping Families Save Their Homes Act of 2009 (HFSA). EESA was authorized on October 3, 2008, and provided that, in exchange for the purchase or commitment to purchase a troubled asset: (1) in the case of a financial institution whose securities are traded on a national securities exchange, Treasury is to receive a warrant giving the right to receive nonvoting common stock or preferred stock, or (2) in the case of all other financial institutions, Treasury is to receive a warrant for common or preferred stock or a senior debt instrument.[550]

This legislation was followed by ARRA, enacted on February 17, 2009, which stated that when TARP assistance is repaid by a financial institution, "the Secretary of the Treasury shall liquidate warrants associated with such assistance at the current market price."[551] On May 20, 2009, HFSA amended section 7001(g) of ARRA by striking "shall liquidate warrants associated with such assistance at the current market price" and inserting "at the market price, may liquidate warrants associated with such assistance."[552] This effectively reversed the limitations on the Secretary's discretion to dispose of TARP warrants as set forth in ARRA. Given the timing, the "shall liquidate" language may have created a greater sense of urgency in Treasury's initial warrant dispositions and may have ultimately influenced the lower bid prices received in those warrant repurchases.

The following table includes both data previously published by the Panel and new data provided by Treasury in its January 19th Warrant Disposition Report. In prior reports, the Panel has provided a table detailing warrant repurchases by financial institutions to date, repurchase/sale proceeds, the Panel's best estimate of warrant fair market value,[553] and the internal rate of return for each institution's CPP repayment, which is also a Panel staff calculation.[554] To allow for comparison between Panel estimates and the data Treasury has utilized in its disposition decisions, this table has been expanded to include the best estimates of warrant market value from Treasury's three valuation methods discussed above (noted in columns headed "Market Quotes Estimate," "Third-Party Estimate," and "Treasury Model Valuation"). The "Price/Estimate Ratio" column displays the number of cents on the dollar that Treasury has received for warrant dispositions compared to the Panel's best estimate of warrant value.

[550] Warrant Disposition Report, *supra* note 537.
[551] Warrant Disposition Report, *supra* note 537.
[552] Warrant Disposition Report, *supra* note 537.
[553] The Panel's modified Black-Scholes model produces a low estimate, high estimate, and "best" estimate of warrant value.
[554] The Internal Rate of Return (IRR) is effectively the interest rate received for an investment (i.e., Treasury's TARP CPP investment) consisting of payment(s) (i.e., Treasury's initial investment in the financial institution) and income (i.e., dividends, TARP CPP preferred repayment, warrant redemption) at discrete points in time. For Treasury's TARP investments in a financial institution, the IRR is calculated from the initial capital investment and subsequent dividends and warrant repayments/sale proceeds over time.

FIGURE 47: WARRANT DISPOSITIONS FOR FINANCIAL INSTITUTIONS WHICH HAVE FULLY REPAID CPP FUNDS AS OF FEBRUARY 2, 2010 [555]

Institution	Investment Date	QEO	Warrant Repurchase Date	Market Quotes Estimate	Third Party Estimate	Treasury Model Valuation	Warrant Repurchase/Sale Amount	Panel's Best Valuation Estimate at Repurchase Date	Price/Estimate Ratio	IRR *(Percent)*
Old National Bancorp	12/12/2008	No	5/8/2009	$1,353,000	$3,054,000	$1,326,000	$1,200,000	$2,150,000	0.5581	9.30
Iberiabank Corporation	12/5/2008	Yes	5/20/2009	1,566,000	2,334,000	1,421,000	1,200,000	2,010,000	0.5970	9.40
Firstmerit Corporation	1/9/2009	No	5/27/2009	4,918,000	6,485,000	5,400,000	5,025,000	4,260,000	1.1796	20.30
Sun Bancorp, Inc	1/9/2009	No	5/27/2009	2,096,000	4,028,000	2,252,000	2,100,000	5,580,000	0.3763	15.30
Independent Bank Corp.	1/9/2009	No	5/27/2009	2,104,000	2,885,000	2,345,000	2,200,000	3,870,000	0.5685	15.60
Alliance Financial Corporation	12/19/2008	No	6/17/2009	762,000	990,000	818,000	900,000	1,580,000	0.5696	13.80
First Niagara Financial Group	11/21/2008	Yes	6/24/2009	1,646,000	4,221,000	2,807,000	2,700,000	3,050,000	0.8852	8.00
Berkshire Hills Bancorp, Inc.	12/19/2008	No	6/24/2009	611,000	1,494,000	971,000	1,040,000	1,620,000	0.6420	11.30
Somerset Hills Bancorp	1/16/2009	No	6/24/2009	266,000	447,000	276,000	275,000	580,000	0.4741	16.60
SCBT Financial Corporation	1/16/2009	No	6/24/2009	1,159,000	2,888,000	1,281,000	1,400,000	2,290,000	0.6114	11.70
HF Financial Corp.	11/21/2008	No	6/30/2009	424,000	753,000	563,000	650,000	1,240,000	0.5242	10.10
State Street	10/28/2008	Yes	7/8/2009	33,000,000	55,000,000	57,000,000	60,000,000	54,200,000	1.1070	9.90
U.S. Bancorp	11/14/2008	No	7/15/2009	127,000,000	144,000,000	140,000,000	139,000,000	135,100,000	1.0289	8.70
The Goldman Sachs Group, Inc.	10/28/2008	No	7/22/2009	826,000,000	993,000,000	902,000,000	1,100,000,000	1,128,400,000	0.9748	22.80
BB&T Corp.	11/14/2008	No	7/22/2009	36,000,000	62,000,000	67,000,000	67,010,402	68,200,000	0.9826	8.70
American Express Company	1/9/2009	No	7/29/2009	219,000,000	309,000,000	285,000,000	340,000,000	391,200,000	0.8691	29.50
Bank of New York Mellon Corp.	10/28/2008	No	8/5/2009	94,000,000	136,000,000	135,000,000	136,000,000	155,700,000	0.8735	12.30
Morgan Stanley	10/28/2008	No	8/12/2009	731,000,000	900,000,000	855,000,000	950,000,000	1,039,800,000	0.9136	20.20
Northern Trust Corporation	11/14/2008	No	8/26/2009	69,000,000	86,000,000	84,000,000	87,000,000	89,800,000	0.9688	14.50
Old Line Bancshares Inc.	12/5/2008	No	9/2/2009	102,000	254,000	214,000	225,000	500,000	0.4500	10.40
Bancorp Rhode Island, Inc.	11/21/2008	No	9/30/2009	1,166,000	1,476,000	1,423,000	1,400,000	1,400,000	1.0000	12.60
CVB Financial Corp.	12/5/2008	Yes	10/28/2009	917,000	1,110,000	1,349,000	1,307,000	1,230,279	1.0624	−26.30
Centerstate Banks of Florida Inc.	11/21/2008	No	10/28/2009	125,000	236,000	206,000	212,000	220,000	0.9636	5.90

Manhattan Bancorp	12/5/2008	No	10/14/2009	34,000	50,000	56,000	63,364	140,000	0.4526	9.80
Bank of the Ozarks	12/12/2008	No	11/24/2009	2,210,000	2,480,000	2,509,000	2,650,000	3,500,000	0.7571	9.00
Capital One Financial ..	11/14/2008	No	12/3/2009	30,000,000	124,000,000	108,000,000	148,731,030	232,000,000	0.6411	12.00
JP Morgan Chase & Co.	10/28/2008	No	12/10/2009	658,000,000	1,063,000,000	998,000,000	950,318,243	1,006,587,697	0.9441	10.90
TCF Financial Corp.	1/16/2009	No	12/16/2009	15,900,000	16,200,000	14,300,000	9,599,964	11,825,830	0.8118	11.00
LSB Corporation	12/12/2008	No	12/16/2009	446,000	605,000	569,000	560,000	535,202	1.0463	9.00
Wainwright Bank & Trust Company	12/19/2008	No	12/16/2009	532,000	632,000	541,000	568,700	1,071,494	0.5308	7.80
Wesbanco Bank, Inc. ...	12/5/2008	No	12/23/2009	577,000	643,000	851,000	950,000	2,387,617	0.3979	6.70
Union Bankshares Corporation	12/19/2008	Yes	12/23/2009	448,000	424,000	410,000	450,000	1,130,418	0.3981	5.80
Trustmark Corporation	11/21/2008	No	12/30/2009	7,601,000	9,014,000	9,704,000	10,000,000	11,573,699	0.8640	9.40
Flushing Financial Corporation	12/19/2008	Yes	12/30/2009	742,000	1,007,000	850,000	900,000	2,861,919	0.3145	6.50
Total	....	....	....	**$2,870,705,000**	**$3,935,710,000**	**$3,683,442,000**	**$4,025,635,703**	**$4,367,594,154**	**0.9217**	**14.40**

555 "Market Quotes Estimate," "Third party Estimate," and "Treasury Model Valuation" are from the OFS Warrant Disposition Report. "Panel's Best Valuation Estimate at Repurchase Date" is from the Panel's internal valuation model.

In sum, warrant repurchases and auction sales have generated proceeds of $2.9 billion and $1.1 billion, respectively. Treasury notes that these warrant dispositions have produced an absolute return—the ratio of actual proceeds to the CPP preferred investment amount—of 3.1 percent from dividends and 5.7 percent from sale of warrants for total absolute return of 8.8 percent.[556] The Panel agrees with this simple calculation but prefers to use an internal rate of return (IRR) calculation, which is an annualized measure and therefore allows for comparison with other investment alternatives in the economy. The Panel's latest IRR for the TARP CPP, based on all warrant sales and repurchases to date, is 14.4 percent.[557]

The proceeds from warrant sales/repurchases of larger financial institutions were from 86 to over 100 percent of the Panel's best estimate, with the only significant outlier being Capital One Financial, whose auction results reflected only 64 percent of the Panel's best estimate. This result may have been due to several factors, including: (1) market uncertainty surrounding Treasury's warrant auctions, as Capital One's warrants were the first to go to auction; (2) the significant portion of Capital One's earnings derived from its credit card business, which given recent regulatory changes may be viewed as a less desirable investment option; and (3) the decline in implied volatility of Capital One's stock price in the months preceding the auction (a higher volatility suggests the potential for greater returns in the future, leading to higher valuations of the associated stock's warrants).

For smaller institutions, the ratio of actual proceeds received to the Panel's best estimates tended to be lower than that for larger institutions, possibly reflecting the fact that the market for trading of the underlying stock of these smaller institutions is less liquid.

Some trends in estimates versus actual sales prices emerge when reviewing the pattern of warrant repurchases over time. The first five repurchase bids came in below Treasury's internal model "best estimate" and well below the third-party valuation "best estimate." Treasury attributed this to the warrant liquidation language in ARRA, as discussed above, and to the fact that Treasury initially relied on financial modeling consultants for third-party input as opposed to external asset managers.[558] The remaining accepted warrant repurchase bids came in above or just below Treasury's internal model "best estimate," well above most of the market quote valuations, and close to the third-party valuations. Overall, the gross proceeds of $2.9 billion from warrant repurchases to date—although only 94 percent of the Panel's best estimated value for these warrants of $3.1 billion—were greater than Treasury's internal model valuation of these warrants of $2.6 billion.

[556] Warrant Disposition Report, *supra* note 537.

[557] Warrant Disposition Report, *supra* note 537. The "QEO" column in the table above notes whether a financial institution completed a qualified equity offering before December 31, 2009, in which case, according to the terms of CPP contracts, the institution was allowed to reduce by half the number of warrants owned by Treasury and available for its disposition. A QEO is an offering of securities that qualifies as Tier 1 capital.

[558] Warrant Disposition Report, *supra* note 537.

FIGURE 48: VALUATION OF OUTSTANDING WARRANTS AS OF FEBRUARY 2, 2010

[Dollars in millions]

Stress Test Financial Institutions with Warrants Outstanding	Warrant Valuation		
	Low Estimate	High Estimate	Best Estimate
Wells Fargo	$354.41	$1,836.20	$817.62
Bank of America Corporation	578.94	2,581.34	965.46
Citigroup, Inc.	10.04	921.63	175.81
The PNC Financial Services Group Inc.	99.66	540.64	251.21
SunTrust Banks, Inc.	14.85	238.42	110.90
Regions Financial Corporation	7.36	185.20	90.87
Fifth Third Bancorp	87.22	359.91	201.68
Hartford Financial Services Group, Inc.	510.11	863.18	619.91
KeyCorp	16.77	151.28	78.41
All Other Banks	751.70	2,890.27	1,921.43
Total	**$2,431.06**	**$10,568.07**	**$5,233.30**

As the above table shows, the Panel's best estimate of Treasury's outstanding warrants is $5.2 billion, with a minimum valuation estimate of $2.4 billion and a maximum estimate of $10.6 billion. Bank of America and Wells Fargo, both of whom repaid their CPP investment in December 2009, will likely be the next high-valued warrants to be auctioned.[559] Combining the best estimate of warrants outstanding with the warrant redemption receipts received so far shows that the Panel's best estimate of the total amount Treasury will receive from the sale of TARP warrants now stands at $9.3 billion.

[559] Treasury Transaction Report, *supra* note 450.

SECTION THREE: ADDITIONAL VIEWS

A. J. Mark McWatters and Paul S. Atkins

We concur with the issuance of the February report and offer the additional observations below. We appreciate the spirit with which the Panel and the staff approached this complex issue and incorporated suggestions offered during the drafting process.

There is little doubt that much uncertainty exists within the present commercial real estate, or CRE, market. Broad based recognition of CRE related losses has yet to occur, and significant problems are expected within the next two years. The bottom line is that CRE losses need to be recognized—hiding losses on balance sheets is not good for financial institutions, for investors, or for the economy. Just as in the residential real estate market, the CRE market needs freedom to engage in price discovery in order for investors to have confidence and transparency to resume investing risk capital in CRE.

In order to suggest any "solution" to the challenges currently facing the CRE market, it is critical that market participants and policymakers thoughtfully identify the sources of the underlying difficulties. Without a proper diagnosis, it is likely that an inappropriately targeted remedy with adverse unintended consequences will result.

Broadly speaking, it appears that today's CRE industry is faced with both an oversupply of CRE facilities and an undersupply of prospective tenants and purchasers. In addition to the excess CRE inventory created during the 2005–2007 bubble period, it appears that there has been an unprecedented collapse in demand for CRE property. Many potential tenants and purchasers have withdrawn from the CRE market not simply because rental rates or purchase prices are too high, but because their business operations do not presently require additional CRE facilities. Over the past few years while CRE developers have constructed a surplus of new office buildings, hotels, multi-family housing, retail and shopping centers, and manufacturing and industrial parks, a significant number of 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 CRE facilities to the exclusion of the economic difficulties facing the end users of such facilities appears unlikely to succeed. The challenges confronting the CRE market are not unique to that industry, but, instead, are generally indicative of the systemic uncertainties manifest throughout the larger economy.

In order to address the oversupply of CRE facilities, developers and their creditors are currently struggling to restructure and refinance their CRE portfolio loans. In some instances creditors with sufficient regulatory capital 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 are merely "kicking the can down the road" by refinancing problematic credits on favorable terms at or near par so as to avoid the recognition of book losses and the attendant reductions in regulatory capital. With respect to the most problematic credits, lenders are foreclosing on their CRE collateral interests and are either attempting to manage the properties in a depressed market or disposing of the facilities at significant discounts. While these approaches may offer assistance in specifically tailored instances, none directly addresses the challenge 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 remains doubtful that the CRE market will sustain a meaningful recovery. As long as businesses are faced with the multiple challenges of rising taxes, increasing regulatory burdens, and enhanced political risk associated with unpredictable governmental interventions in the private sector (including government actions that will affect health care and energy costs), it is unlikely that they will enthusiastically assume the entrepreneurial risk necessary for protracted business expansion at the microeconomic level and thus a recovery of the CRE market at the macroeconomic level. 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 ever-expanding array of less-than-friendly rules, regulations and taxes facing businesses 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.

It is indeed ironic that while Treasury is contemplating a plan to fund another round of TARP-sourced allocations for "small" financial institutions (including targeting funds to certain favored groups, including CDFIs), the Administration is also developing a plan to raise the taxes and increase the regulatory burden of many financial institutions and other CRE market participants. The Administration seems reluctant to acknowledge that such actions may raise the cost of capital to such financial institutions and decrease their ability to extend credit to qualified CRE and other borrowers. More significantly, the Administration appears indifferent to the dramatic level of uncertainty that such actions have injected into an already unsettled marketplace.

It is also troublesome that Treasury would contemplate another round of bailouts to rescue financial institutions that placed risky bets on the CRE market. Over the years many of these institutions have profited handsomely by extending credit to CRE developers, and it is disconcerting that these same institutions and their CRE borrowers would approach the taxpayers for a bailout. We should also note that during the bubble era, these institutions and the CRE developers were almost assuredly managed by financial and real estate experts and advised by competent counsel and other professionals who were thoroughly versed in the risks associated with CRE lending and development.[560]

Although some financial institutions may struggle or even fail as a result of their ill-advised underwriting decisions and the result-

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[560] Sophisticated securities products, including CDSs, also were developed to provide for hedging and risk management for CRE and CMBS exposure, among other things. Some have mistakenly likened these products to "insurance," because some market participants viewed them in that sort of role. It is a facile comparison, because they differ in significant ways from "insurance." Thus, they properly are not treated as such.

ing overdevelopment of the CRE market, any taxpayer-funded bailouts of these institutions will inject unwarranted moral hazard risk into the market and all but establish the United States government as the implicit guarantor of any future losses arising from distressed CRE loans.[561] Such actions will also encourage private sector participants to engage in less-than-prudent economic behavior, confident in the expectation—if not an emerging sense of entitlement—that the taxpayers will yet again offer a bailout if their CRE portfolios materially underperform. Since CRE market participants reaped the benefits from the run-up to the CRE bubble, they should equally shoulder the burdens from the bursting of the bubble. The Administration—through TARP, a program similar to the Resolution Trust Corporation (RTC),[562] or otherwise—should not force the taxpayers to subsidize these losses and underwrite the poor management decisions and analysis of such CRE lenders and developers. A market economy by necessity must cull or marginalize the products and services of the weakest participants so that those who have developed innovative and competitive ideas may prosper on a level playing field. Any attempt by the Administration to prop up the financial institutions and developers who contributed to the oversupply of CRE property is not in the best interests of the more prescient and creative market participants or the taxpayers. The opportunity for entrepreneurs to succeed or fail based upon their own acumen and judgment must survive the current recession and the implementation of the TARP program.

In addition, as the Report notes, Treasury has realized that financial institutions increasingly consider TARP to be a stigma of weakness. This perception is inevitable after almost a year and a half of TARP and is a healthy development. In fact, banks that accept TARP funds at this point of the economic cycle should be branded as weaker institutions. A question for policymakers is whether they should be allowed to fail rather than be propped up further at taxpayer expense.

Finally, as Treasury considers its actions in using TARP funds in the context of CRE or other areas, it must be mindful not only of political realities, but also funding realities. As the Report indicates, there are substantial "uncommitted" funds available to Treasury under the TARP. Some of these funds have never been allocated out of Congress's original authorization of $700 billion under EESA. However, if Treasury exceeds the original $700 billion in total allocations under the TARP, it then would rely on its interpretation that EESA allows "recycling" of TARP funds; that is,

[561] The results of any additional "stress tests" conducted by the applicable banking supervisors should not be used by Treasury as an excuse for the allocation of additional TARP funds to capital-deficient financial institutions. Instead, such financial institutions should seek capital from the private markets or be liquidated or sold through the typical FDIC resolution process.

[562] The RTC responded to the failure of a significant number of financial institutions within specific geographic areas. Without the RTC, some have argued that the affected areas would have been "materially under-banked." It is not apparent that the same situation manifests itself today as a result of distressed CRE loans or otherwise. Some banks will fail (and will be liquidated or sold through the typical FDIC resolution process), but a substantial majority should survive and will be better off by not having to compete with their mismanaged former peers. Because these banks are not systemically significant financial institutions, the failure of which might materially impair the U.S. economy, Treasury's potential use of the TARP program to recapitalize them stretches the intent of EESA and would create risks of moral hazard and implicit government guarantees. In addition, an RTC-type approach raises the potential for unintended enrichment of some participants at the taxpayer's expense.

amounts returned to the Treasury create more "headroom" for Treasury to use TARP funds up to a maximum outstanding at any time of $700 billion. We find Treasury's legal analysis regarding this interpretation of EESA unconvincing and disagree with Treasury's assertion that these returned amounts become "uncommitted" funds again, which may be re-committed.

SECTION FOUR: CORRESPONDENCE WITH TREASURY UPDATE

Secretary of the Treasury Timothy Geithner sent a letter to Chair Elizabeth Warren on January 13, 2010,[563] in response to a letter from the Chair regarding the assistance provided to CIT Group, Inc. under the Capital Purchase Program.

[563] *See* Appendix I of this report, *infra*.

SECTION FIVE: TARP UPDATES SINCE LAST REPORT

A. TARP Repayments

No additional banks have repaid their TARP investments under the CPP since the Panel's most recent oversight report. A total of 59 banks have repaid their preferred stock TARP investments provided under the CPP to date. Treasury has also liquidated the warrants it holds in 40 of these 59 banks.

B. CPP Monthly Lending Report

Treasury releases a monthly lending report showing loans outstanding at the top 22 CPP recipient banks. The most recent report, issued on January 15, 2010, includes data through the end of November 2009. Treasury reported that the overall outstanding loan balance of the top CPP recipients declined by 0.2 percent between the end of October 2009 and the end of November 2009. The total amount of originations at the end of November 2009 was five percent below what it was when EESA was enacted.

C. CPP Warrant Disposition Report

As part of its investment in senior preferred stock of certain banks under the CPP, Treasury received warrants to purchase shares of common stock or other securities in those institutions. At the end of 2009, Treasury held warrants in 248 public companies as part of the CPP. In December 2009, Treasury began the public sale of warrants to third parties, in addition to original issuers, through a standardized process that, according to Treasury, is designed to ensure that taxpayers receive fair market value whether the warrants are purchased by the issuer or a third party.

On January 20, 2010, the Treasury released a report showing that as of December 31, 2009, the government had received $4 billion in gross proceeds on the disposition of warrants in 34 banks. These proceeds consisted of $2.9 billion from repurchases by the issuers and $1.1 billion from auctions. See Section Two for a detailed discussion of the report.

D. TARP Initiative to Support Lending to Small Businesses

On February 3, 2010, Treasury announced the final terms of a TARP initiative to invest capital in CDFIs that lend to small businesses. Under the program, eligible CDFIs will have access to capital at a two percent rate, compared with a five percent rate under the CPP. CDFIs that are already participating in TARP will be able to transfer those investments into this program. Further, CDFIs will not be required to issue warrants to take part in the initiative.

E. Term Asset-Backed Securities Loan Facility (TALF)

At the January 20, 2010 facility, investors requested $1.5 billion in loans for legacy CMBS. Investors did not request any loans for new CMBS. By way of comparison, investors requested $1.3 billion in loans for legacy CMBS at the December facility and $1.4 billion at the November facility. Investors did not request any loans for new CMBS at the December facility but did request $72.2 million in loans for new CMBS at the November facility. These have been the only loans requested for new CMBS during TALF's operations.

At the February 5, 2010 facility, investors requested $987 million in loans to support the issuance of ABS collateralized by loans in the auto, credit card, equipment, floor plan, servicing advances, small business, and student loan sectors. No loans were requested in the premium financing sector. By way of comparison, at the January 7, 2010 facility, investors requested $1.1 billion in loans collateralized by the issuance of ABS in the credit card, floor plan, and small business sectors.

F. Legacy Securities Public-Private Investment Program (PPIP)

On January 29, 2010, Treasury released its initial quarterly report on PPIP for the quarter ending December 31, 2009. The report indicates that PPIP, which Treasury intends to support market functioning and facilitate price discovery in the mortgage-backed securities markets through the purchase of eligible assets, has created $24 billion in purchasing power for public-private investment funds. As of the end of the quarter, these funds had drawn down $4.3 billion in total capital which was invested in eligible assets or cash equivalents pending investment.

G. Home Affordable Modifications Program (HAMP) Updated Requirements

On January 28, 2010, Treasury and the Department of Housing and Urban Development (HUD) released guidance regarding documentation requirements and procedures for servicers participating in the HAMP. Under these new terms, all modifications with an effective date on or after June 1, 2010, will require an initial standard package of three documents before evaluation. Treasury and HUD also clarified procedures by which borrowers may be converted from trial modifications to permanent modifications.

H. Metrics

Each month, the Panel's report highlights a number of metrics that the Panel and others, including Treasury, the Government Accountability Office (GAO), Special Inspector General for the Troubled Asset Relief Program (SIGTARP), and the Financial Stability Oversight Board, consider useful in assessing the effectiveness of the Administration's efforts to restore financial stability and accomplish the goals of EESA. This section discusses changes that have occurred in several indicators since the release of the Panel's January report.

- Interest Rate Spreads. Interest rate spreads have continued to contract since the Panel's January report, further reflecting signs of economic stability. The mortgage rate spread, which measures the difference between the conventional 30-year mortgage rate and 10-year Treasury bills, was 1.3 percent at the end of January.[564]

[564] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: Conventional Mortgages, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly_Thursday_/

This represents a 45 percent decrease since the enactment of EESA.

FIGURE 49: INTEREST RATE SPREADS

Indicator	Current Spread (as of 1/29/10)	Percent Change Since Last Report (12/31/09) *(Percent)*
TED spread [565] (in basis points)	17	−10.5
Conventional mortgage rate spread [566]	1.32	0.76
Corporate AAA bond spread [567]	1.62	3.8
Corporate BAA bond spread [568]	2.57	−3.4
Overnight AA asset-backed commercial paper interest rate spread [569]	0.13	−0.25
Overnight A2/P2 nonfinancial commercial paper interest rate spread [570]	0.13	−0.16

[565] *TED Spread,* SNL Financial.
[566] Federal Reserve Release H.15, *supra* note 564 (accessed Jan. 27, 2010); Federal Reserve Release H.15, supra note 564 (accessed Jan. 27, 2010).
[567] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: Corporate Bonds/Moody's Seasoned AAA, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly_Friday_/H15_AAA_NA.txt) (accessed Jan. 27, 2010); Federal Reserve Release H.15, *supra* note 564 (accessed Jan. 27, 2010).
[568] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: Corporate Bonds/Moody's Seasoned BAA, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly_Friday_/H15_BAA_NA.txt) (accessed Jan. 27, 2010); Federal Reserve Release H.15, *supra* note 564 (accessed Jan. 27, 2010).
[569] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Asset-Backed Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (hereinafter "Federal Reserve Release: Commercial Paper") (accessed Jan. 27, 2009); Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Nonfinancial Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed Jan. 27, 2010). In order to provide a more complete comparison, this metric utilizes a five-day average of the interest rate spread for the last five days of the month.
[570] Federal Reserve Release: Commercial Paper, supra note 569 (accessed Jan. 27, 2010). In order to provide a more complete comparison, this metric utilizes a five day average of the interest rate spread for the last five days of the month.

- Commercial Paper Outstanding. Commercial paper outstanding, a rough measure of short-term business debt, is an indicator of the availability of credit for enterprises. The amount of asset-backed commercial paper outstanding decreased by 11 percent in January. Financial and non-financial commercial paper outstanding both increased in January by 4 and 11 percent, respectively.[571] Total commercial paper outstanding has continued to decrease since the enactment of EESA. Asset-backed commercial paper outstanding has declined nearly 40 percent and nonfinancial commercial paper outstanding has decreased by 43 percent since October 2008.[572]

FIGURE 50: COMMERCIAL PAPER OUTSTANDING

[Dollars in billions]

Indicator	Current Level (as of 1/27/10)	Percent Change Since Last Report (12/31/09) *(Percent)*
Asset-backed commercial paper outstanding (seasonally adjusted) [573]	$431	−11.3
Financial commercial paper outstanding (seasonally adjusted) [574]	601	4.03
Nonfinancial commercial paper outstanding (seasonally adjusted) [575]	115	11.2

[573] Federal Reserve Release: Commercial Paper, *supra* note 569 (accessed Jan. 27, 2010).
[574] Federal Reserve Release: Commercial Paper, *supra* note 569 (accessed Jan. 27, 2010).
[575] Federal Reserve Release: Commercial Paper, *supra* note 569 (accessed Jan. 27, 2010).

H15_MORTG_NA.txt) (hereinafter "Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data") (accessed Jan. 27, 2010); Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: U.S. Government Securities/Treasury Constant Maturities/Nominal 10-Year, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly_Friday_/H15_TCMNOM_Y10.txt) (hereinafter "Federal Reserve Release H.15") (accessed Jan. 27, 2010).
[571] Federal Reserve Release: Commercial Paper, *supra* note 569 (accessed Jan. 27, 2010).
[572] Federal Reserve Release: Commercial Paper, *supra* note 569 (accessed Jan. 27, 2010).

• Lending by the Largest TARP-recipient Banks. Treasury's Monthly Lending and Intermediation Snapshot tracks loan originations and average loan balances for the 22 largest recipients of CPP funds across a variety of categories, ranging from mortgage loans to commercial real estate to credit card lines. The data below exclude lending by two large CPP-recipient banks, PNC Bank and Wells Fargo, because significant acquisitions by those banks since October 2008 make comparisons difficult.[576] In November, these 20 institutions originated $186.5 billion in loans, a decrease of 14 percent compared to October 2008.[577] The total average loan balance for these institutions decreased by 2.5 percent to $3.3 trillion in November.[578]

FIGURE 51: LENDING BY THE LARGEST TARP-RECIPIENT BANKS (WITHOUT PNC AND WELLS FARGO) [579]

[Dollars in millions]

Indicator	Most Recent Data (November 2009)	Percent Change Since October 2009 *(Percent)*	Percent Change Since October 2008 *(Percent)*
Total loan originations	$186,556	−0.25	−14.5
Total mortgage originations	55,227	1.07	24.7
Small Business Originations	4,586	−15	[580] −10.3
Mortgage refinancing	32,519	6.9	73.3
HELOC originations (new lines & line increases)	1,954	−12.2	−58.9
C&I renewal of existing accounts	49,614	4.1	−13.6
Total Equity Underwriting	30,600	4.8	58.3
Total Debt Underwriting	262,719	−13	−27

[579] Treasury Snapshot for November 2009, *supra* note 577.
[580] Treasury only began reporting data regarding small business originations in its April Lending Survey, this number reflects the percent change since April 2009. Treasury Snapshot for November 2009, *supra* note 577.

• Housing Indicators. Foreclosure filings increased by fourteen percent from October to November, and are 25 percent above the October 2008 level. Housing prices, as illustrated by both the S&P/Case-Shiller Composite 20 Index and the FHFA House Price Index, increased slightly in November.

FIGURE 52: HOUSING INDICATORS

Indicator	Most Recent Monthly Data	Percent Change From Data Available at Time of Last Report *(Percent)*	Percent Change Since October 2008 *(Percent)*
Monthly foreclosure filings [581]	349,519	14	25

[576] PNC Financial and Wells Fargo purchased large banks at the end of 2008. PNC Financial purchased National City on October 24, 2008 and Wells Fargo completed its merger with Wachovia Corporation on January 1, 2009. The assets of National City and Wachovia are included as part of PNC and Wells Fargo, respectively, in Treasury's January lending report but are not differentiated from the existing assets or the acquiring banks. As such, there were dramatic increases in the total average loan balances of PNC and Wells Fargo in January 2009. For example, PNC's outstanding total average loan balance increased from $75.3 billion in December 2008 to $177.7 billion in January 2009. The same effect can be seen in Wells Fargo's total average loan balance of $407.2 billion in December 2008 which increased to $813.8 billion in January 2009. The Panel excludes PNC and Wells Fargo in order to have a more consistent basis of comparison across all institutions and lending categories.
[577] U.S. Department of the Treasury, Treasury Department Monthly Lending and Intermediation Snapshot: *Summary Analysis for November 2009* (Jan. 27, 2010) (online at www.financialstability.gov/docs/surveys/Snapshot_Data_November_2009.xls) (hereinafter "Treasury Snapshot for November 2009").
[578] Treasury Snapshot for November 2009, *supra* note 577.

FIGURE 52: HOUSING INDICATORS—Continued

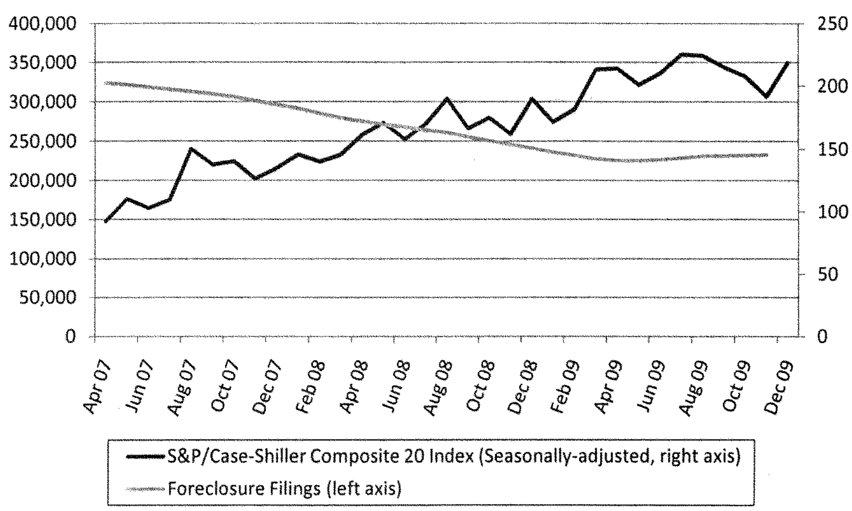
Indicator	Most Recent Monthly Data	Percent Change From Data Available at Time of Last Report *(Percent)*	Percent Change Since October 2008 *(Percent)*
Housing prices—S&P/Case-Shiller Composite 20 Index[582]	145.5	0.24	−7.1
FHFA Housing Price Index[583]	200.4	0.07	−1.3

[581] RealtyTrac, *Foreclosure Activity Press Releases* (online at www.realtytrac.com//ContentManagement/PressRelease.aspx) (hereinafter " Foreclosure Activity Press Releases") (accessed Jan. 27, 2010). Most recent data available for December 2009.

[582] Standard & Poor's, *S&P/Case-Shiller Home Price Indices* (Instrument: Seasonally Adjusted Composite 20 Index) (online at www.standardandpoors.com/prot/servlet/BlobServer?blobheadername3=MDT-Type&blobcol =urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DSA_ CSHomePrice_History_012659.xls&blobheadername2= Content-Disposition&blobheadervalue1=application%2Fexcel&blobkey =id&blobheadername1=content-type&blobwhere=1243643617751 &blobheadervalue3=UTF-8) (hereinafter "S&P/Case-Shiller Home Price Indices") (accessed Jan. 27, 2010). Most recent data available for November 2009.

[583] Federal Housing Finance Agency, *U.S. and Census Division Monthly Purchase Only Index* (Instrument: USA, Seasonally Adjusted) (online at www.fhfa.gov/webfiles/15368/MonthlyIndex_ Jan1991_to_Latest.xls) (accessed Jan. 27, 2010). Most recent data available for November 2009.

FIGURE 53: FORECLOSURE FILINGS AS COMPARED TO THE CASE-SHILLER 20 CITY HOME PRICE INDEX (AS OF NOVEMBER 2009)[584]



• Small Business Lending. On February 5, 2010, federal and state financial agencies, including the Federal Reserve and FDIC, issued a statement highlighting the importance of prudent and productive small business lending. This statement urged institutions to focus their decision on a small business owner's business plan rather than basing the decision solely on economic and portfolio manager models. Furthermore, it stated that regulators will not adversely classify loans solely due to a borrower's specific industry or geographic location.[585] As figure 54 illustrates, new small busi-

[584] Foreclosure Activity Press Releases, *supra* note 581 (accessed Jan. 27, 2010); S&P/Case-Shiller Home Price Indices, *supra* note 582 (accessed Jan. 27, 2010). Most recent data available for November 2009.

[585] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, Conference of State Bank Supervisors, *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* (Feb. 5, 2010) (online at www.fdic.gov/news/news/press/2010/pr10029a.pdf) ("As a general principle, examiners will not adversely classify loans solely due to a decline in the collateral value below the loan balance, provided the bor-

Continued

ness lending by the largest TARP participants has decreased more than 10 percent since Treasury began tracking this metric in April 2009.

FIGURE 54: SMALL BUSINESS LENDING BY LARGEST TARP-RECIPIENT BANKS (WITHOUT PNC AND WELLS FARGO)[586]

[Dollars in millions]

Indicator	Most Recent Monthly Data (November 2009)	Percent Change from Data Available at Time of Last Report *(Percent)*	Percent Change Since April 2009 *(Percent)*
Small Business Lending Origination	$4,586	−15	−10.3
Small Business Lending Average Loan Balance	179,131	−0.4	−4.1

586 Treasury Snapshot for November 2009, *supra* note 577.

I. Financial Update

Each month, the Panel summarizes the resources that the federal government has committed to economic stabilization. The following financial update provides: (1) an updated accounting of the TARP, including a tally of dividend income, repayments and warrant dispositions that the program has received as of February 1, 2010; and (2) an updated accounting of the full federal resource commitment as of December 31, 2009.

1. TARP

a. Costs: Expenditures and Commitments

Treasury has committed or is currently committed to spend $519.5 billion of TARP funds through an array of programs used to purchase preferred shares in financial institutions, offer loans to small businesses and automotive companies, and leverage Federal Reserve loans for facilities designed to restart secondary securitization markets.[587] Of this total, $298.3 billion is currently outstanding under the $698.7 billion limit for TARP expenditures set by EESA, leaving $403.3 billion available for fulfillment of anticipated funding levels of existing programs and for funding new programs and initiatives. The $298.3 billion includes purchases of preferred and common shares, warrants and/or debt obligations under the CPP, AIGIP/SSFI Program, PPIP, and AIFP; and a $20 billion loan to TALF LLC, the SPV used to guarantee Federal Reserve TALF loans.[588] Additionally, Treasury has allocated $36.9 billion to the Home Affordable Modification Program, out of a projected total program level of $50 billion.

rower has the willingness and ability to repay the loan according to reasonable terms. In addition, examiners will not classify loans due solely to the borrower's association with a particular industry or geographic location that is experiencing financial difficulties").

587 EESA, as amended by the Helping Families Save Their Homes Act of 2009, limits Treasury to $698.7 billion in purchasing authority outstanding at any one time as calculated by the sum of the purchase prices of all troubled assets held by Treasury. Pub. L. No. 110–343, § 115(a)–(b); Helping Families Save Their Homes Act of 2009, Pub. L. No. 111–22, § 402(f) (reducing by $1.26 billion the authority for the TARP originally set under EESA at $700 billion).

588 Treasury Transaction Report, *supra* note 450.

b. Income: Dividends, Interest Payments, and CPP Repayments

As of February 1, 2009, a total of 59 institutions have completely repurchased their CPP preferred shares. Of these institutions, 37 have repurchased their warrants for common shares that Treasury received in conjunction with its preferred stock investments (including six institutions for whom warrants were exercised at the time of the initial Treasury investment); Treasury sold the warrants for common shares for three other institutions at auction.[589] For further discussion of Treasury's disposition of these warrants, see Section Two of this report. In January, Treasury received partial repayments from two institutions, totaling $57.2 million.[590] In addition, Treasury receives dividend payments on the preferred shares that it holds, usually five percent per annum for the first five years and nine percent per annum thereafter.[591] In total, Treasury has received approximately $189.5 billion in income from repayments, warrant repurchases, dividends, payments for terminated guarantees, and interest payments deriving from TARP investments,[592] and another $1.2 billion in participation fees from its Guarantee Program for Money Market Funds.[593]

c. TARP Accounting

Figure 55: TARP ACCOUNTING (AS OF FEBRUARY 1, 2010) [594]

[Dollars in billions]

TARP Initiative	Anticipated Funding	Actual Funding	Total Repayments/Reduced Exposure	Funding Outstanding	Funding Available
Capital Purchase Program (CPP) [595]	$204.9	$204.9	$122	$82.9	$0
Targeted Investment Program (TIP) [596]	40.0	40.0	40	0	0
AIG Investment Program (AIGIP)/Systemically Significant Failing Institutions Program (SSFI)	69.8	[597] 46.9	0	46.9	22.9
Automobile Industry Financing Program (AIFP)	81.3	81.3	3.2	78.1	0
Asset Guarantee Program (AGP) [598]	5.0	5.0	[599] 5.0	0	0
Capital Assistance Program (CAP) [600].					
Term Asset-Backed Securities Lending Facility (TALF)	20.0	20.0	0	20.0	0
Public-Private Investment Partnership (PPIP) [601]	30.0	30.0	0	30.0	0
Supplier Support Program (SSP)	[602] 3.5	3.5	0	3.5	0
Unlocking SBA Lending	15.0	0	N/A	0	15.0
Home Affordable Modification Program (HAMP)	50.0	[603] 36.9	0	35.5	14.5
Community Development Financial Institutions Initiative [604].					
Total Committed	519.5	468.5	–	298.3	51
Total Uncommitted	179.2	N/A	170.2	N/A	[605] 349.4

[589] Treasury Transaction Report, *supra* note 450.
[590] Treasury Transaction Report, *supra* note 450.
[591] *See, e.g.,* U.S. Department of the Treasury, *Securities Purchase Agreement: Standard Terms* (online at www.financialstability.gov/docs/CPP/spa.pdf) (accessed Jan. 4, 2010).
[592] *See* U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of December 31, 2009* (Jan. 20, 2010) (online at www.financialstability.gov/docs/dividends-interest-reports/December%202009%20Dividends%20and%20Interest%20Report.pdf) (hereinafter "Treasury Dividends and Interest Report"); Treasury Transaction Report, *supra* note 450.
[593] U.S. Department of the Treasury, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 18, 2009) (online at www.treasury.gov/press/releases/tg293.htm).

Figure 55: TARP ACCOUNTING (AS OF FEBRUARY 1, 2010) [594]—Continued

[Dollars in billions]

TARP Initiative	Anticipated Funding	Actual Funding	Total Repayments/Reduced Exposure	Funding Outstanding	Funding Available
Total	**$698.7**	**$468.5**	**$170.2**	**$298.3**	**$400.4**

[594] Treasury Transaction Report, *supra* note 450.
[595] As of December 31, 2009, the CPP was closed. U.S. Department of the Treasury, *FAQ on Capital Purchase Program Deadline* (online at www.financialstability.gov/docs/FAQ%20on%20Capital%20Purchase%20Program%20Deadline.pdf).
[596] Both Bank of America and Citigroup repaid the $20 billion in assistance each institution received under the TIP on December 9 and December 23, 2009, respectively. Therefore the Panel accounts for these funds as repaid and uncommitted. U.S. Department of the Treasury, *Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup* (Dec. 22, 2009) (online at www.treas.gov/press/releases/20091229716198713.htm) (hereinafter ''Treasury Receives $45 Billion from Wells Fargo and Citigroup'').
[597] In information provided by Treasury in response to a Panel request, AIG has completely utilized the $40 billion made available on November 25, 2008 and drawn down $5.3 billion of the $29.8 billion made available on April 17, 2009. This figure also reflects $1.6 billion in accumulated but unpaid dividends owed by AIG to Treasury due to the restructuring of Treasury's investment from cumulative preferred shares to non-cumulative shares. Treasury Transaction Report, *supra* note 450.
[598] Treasury, the Federal Reserve, and the Federal Deposit Insurance Company terminated the asset guarantee with Citigroup on December 23, 2009. The agreement was terminated with no losses to Treasury's $5 billion second-loss portion of the guarantee. Citigroup did not repay any funds directly, but instead terminated Treasury's outstanding exposure on its $5 billion second-loss position. As a result, the $5 billion is now accounted for as available. Treasury Receives $45 Billion from Wells Fargo and Citigroup, *supra* note 596.
[599] Although this $5 billion is no longer exposed as part of the AGP and is accounted for as available, Treasury did not receive a repayment in the same sense as with other investments.
[600] On November 9, 2009, Treasury announced the closing of this program and that only one institution, GMAC, was in need of further capital from Treasury. GMAC received an additional $3.8 billion in capital through the AIFP on December 30, 2009. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg__11092009.html); Treasury Transaction Report, *supra* note 450.
[601] On January 29, 2010, Treasury released its first quarterly report on the Legacy Securities Public-Private Investment Program. As of that date, the total value of assets held by the PPIP managers was $3.4 billion. Of this total, 87 percent as non-agency Residential Mortgage-Backed Securities and the remaining 13 percent was Commercial Mortgage-Backed Securities. U.S. Department of the Treasury, *Legacy Securities Public-Private Investment Program* (Jan. 29, 2010) (online at www.financialstability.gov/docs/External%20Report%20-%2012-09%20FINAL.pdf).
[602] On July 8, 2009, Treasury lowered the total commitment amount for the program from $5 billion to $3.5 billion. This action reduced GM's portion from $3.5 billion to $2.5 billion and Chrysler's portion from $1.5 billion to $1 billion. On November 11, 2009, there was a partial repayment of $140 million made by GM Supplier Receivables LLC, the special purpose vehicle created to administer this program for GM suppliers. This was a partial repayment of funds that were drawn down and did not lessen Treasury's $3.5 billion in total exposure to the ASSP. Treasury Transaction Report, *supra* note 450.
[603] This figure reflects the total of all the caps set on payments to each mortgage servicer and not the disbursed amount of funds for successful modifications. In response to a Panel inquiry, Treasury disclosed that, as of Jan 10, 2010, $32 million in funds had been disbursed under the HAMP. Treasury Transaction Report, *supra* note 450.
[604] On February 3, 2010, the Administration announced a new initiative under TARP to provide low-cost financing for Community Development Financial Institutions (CDFIs). Under this program, CDFIs are eligible for capital investments at a 2 percent dividend rate as compared to the 5 percent dividend rate under the CPP. Currently, the total amount of funds Treasury plans on investing has not been announced.
[605] This figure is the sum of the uncommitted funds remaining under the $698.7 billion cap ($179.2 billion) and the repayments ($170.2 billion).

FIGURE 56: TARP REPAYMENTS AND INCOME

[Dollars in billions]

TARP Initiative	Repayments/ Reduced Exposure (as of 2/1/10)	Dividends [606] (as of 12/31/09)	Interest [607] (as of 12/31/09)	Warrant Repurchases (as of 2/1/10)	Other Proceeds (as of 2/1/10)	Total
Total	$170.1	$12.5	$0.38	$4.03	$2.51	$189.5
CPP	121.9	8.3	0.02	4.03	—	134.3
TIP	40	3	N/A	0	—	43
AIFP	3.2	0.94	0.34	N/A	—	4.48
ASSP	N/A	N/A	0.01	N/A	—	0.01
AGP	[608] 5	0.28	N/A	0	[609] 2.23	7.5
PPIP	N/A	N/A	.002	N/A	—	0.002
Bank of America Guarantee	—	—	—	—	[610] 0.28	.28

[606] Treasury Dividends and Interest Report, *supra* note 592.
[607] Treasury Dividends and Interest Report, *supra* note 592.
[608] Although Treasury, the Federal Reserve, the FDIC, and Citigroup have terminated the AGP, and although Treasury's $5 billion second-loss position no longer counts against the $698.7 TARP ceiling, Treasury did not receive any repayment income.
[609] As a fee for taking a second-loss position up to $5 billion on a $301 billion pool of ring-fenced Citigroup assets as part of the AGP, Treasury received $4.03 billion in Citigroup preferred stock and warrants; Treasury exchanged these preferred stocks and warrants for trust preferred securities in June 2009. Following the early termination of the guarantee, Treasury cancelled $1.8 billion of the trust preferred securities, leaving Treasury with a $2.23 billion investment in Citigroup trust preferred securities in exchange for the guarantee. Treasury Transaction Report, *supra* note 450.
[610] Although Treasury, the Federal Reserve, and the FDIC negotiated with Bank of America regarding a similar guarantee, the parties never reached an agreement. In September 2009, Bank of America agreed to pay each of the prospective guarantors a fee as though the guarantee had been in place during the negotiations. This agreement resulted in payments of $276 million to Treasury, $57 million to the Federal Reserve, and $92 million to the FDIC. U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Bank of America Corporation, *Termination Agreement*, at 1–2 (Sept. 21, 2009) (online at www.financialstability.gov/docs/AGP/BofA%20-%20Termination%20Agreement%20-%20executed.pdf).

2. Other Financial Stability Efforts

a. Federal Reserve, FDIC, and Other Programs

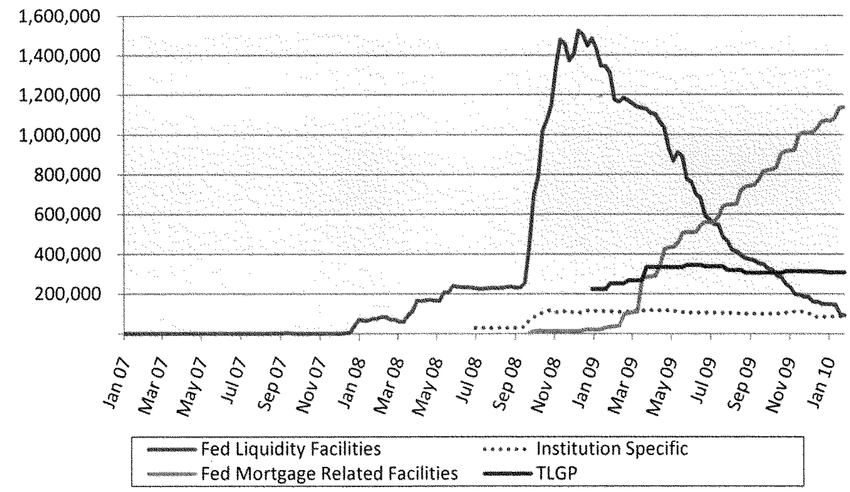
In addition to the direct expenditures Treasury has undertaken through TARP, the federal government has engaged in a much broader program directed at stabilizing the U.S. financial system. Many of these initiatives explicitly augment funds allocated by Treasury under specific TARP initiatives, such as FDIC and Federal Reserve asset guarantees for Citigroup, or operate in tandem with Treasury programs, such as the interaction between PPIP and TALF. Other programs, like the Federal Reserve's extension of credit through its section 13(3) facilities and SPVs and the FDIC's Temporary Liquidity Guarantee Program, operate independently of TARP.

Figure 57 below reflects the changing mix of Federal Reserve investments. On February 1, 2010, four temporary Federal Reserve programs aimed at increasing liquidity in the financial system expired: the Primary Dealer Credit Facility (PDCF), the Term Securities Lending Facility (TSLF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), and the Commercial Paper Funding Facility (CPFF). As the liquidity facilities established to face the crisis have been wound down, the Federal Reserve has expanded its facilities for purchasing mortgage-related securities. The Federal Reserve announced that it intends to purchase $175 billion of federal agency debt securities and $1.25 trillion of agency mortgage-backed securities.[611] As of January 28, 2010, $162 billion of federal agency (government-sponsored enterprise) debt securities and $973 billion of agency mortgage-backed securities have been purchased. The Federal Reserve has announced that these purchases will be completed by April 2010.[612]

[611] Board of Governors of the Federal Reserve System, *Minutes of the Federal Open Market Committee,* at 10 (Dec. 15–16, 2009) (online at www.federalreserve.gov/newsevents/press/monetary/fomcminutes20091216.pdf) ("[T]he Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt").

[612] Board of Governors of the Federal Reserve System, *FOMC Statement* (Dec. 16, 2009) (online at www.federalreserve.gov/newsevents/press/monetary/20091216a.htm) ("In order to promote a smooth transition in markets, the Committee is gradually slowing the pace of these purchases, and it anticipates that these transactions will be executed by the end of the first quarter of 2010"); Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances* (Feb. 4, 2010) (online at www.federalreserve.gov/Releases/H41/Current/).

FIGURE 57: FEDERAL RESERVE AND FDIC FINANCIAL STABILITY EFFORTS [613]



3. Total Financial Stability Resources (as of December 31, 2009)

Beginning in its April report, the Panel broadly classified the resources that the federal government has devoted to stabilizing the economy through myriad new programs and initiatives as outlays, loans, or guarantees. Although the Panel calculates the total value of these resources at nearly $3 trillion, this would translate into the ultimate "cost" of the stabilization effort only if: (1) assets do not appreciate; (2) no dividends are received, no warrants are exercised, and no TARP funds are repaid; (3) all loans default and are written off; and (4) all guarantees are exercised and subsequently written off.

With respect to the FDIC and Federal Reserve programs, the risk of loss varies significantly across the programs considered here, as do the mechanisms providing protection for the taxpayer against such risk. As discussed in the Panel's November report, the FDIC assesses a premium of up to 100 basis points on TLGP debt

[613] Federal Reserve Liquidity Facilities include: Primary credit, Secondary credit, Central Bank Liquidity Swaps, Primary dealer and other broker-dealer credit, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, Term Asset-Backed Securities Loan Facility. Federal Reserve Mortgage Related Facilities Include: Federal agency debt securities and Mortgage-backed securities held by the Federal Reserve. Institution Specific Facilities include: Credit extended to American International Group, Inc., and the net portfolio holdings of Maiden Lanes I, II, and III. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances* (H.4.1) (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed Feb. 4, 2010). For related presentations of Federal Reserve data, *see* Board of Governors of the Federal Reserve System, *Credit and Liquidity Programs and the Balance Sheet,* at 2 (Nov. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf). The TLGP figure reflects the monthly amount of debt outstanding under the program. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program* (Dec. 2008–Dec. 2009) (online at www.fdic.gov/regulations/resources/TLGP/reports.html).

guarantees.[614] In contrast, the Federal Reserve's liquidity programs are generally available only to borrowers with good credit, and the loans are over-collateralized and with recourse to other assets of the borrower. If the assets securing a Federal Reserve loan realize a decline in value greater than the "haircut," the Federal Reserve is able to demand more collateral from the borrower. Similarly, should a borrower default on a recourse loan, the Federal Reserve can turn to the borrower's other assets to make the Federal Reserve whole. In this way, the risk to the taxpayer on recourse loans only materializes if the borrower enters bankruptcy. The only loan currently "underwater"—where the outstanding principal amount exceeds the current market value of the collateral—is the loan to Maiden Lane LLC, which was formed to purchase certain Bear Stearns assets.

FIGURE 58: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF DECEMBER 31, 2009)

[Dollars in billions]

Program	Treasury (TARP)	Federal Reserve	FDIC	Total
Total	**$698.7**	**$1,518.6**	**$646.4**	**$2,863.7**
Outlays [i]	286.8	1,136.1	69.4	1,492.3
Loans	42.7	382.6	0	425.3
Guarantees [ii]	20	0	577	597
Uncommitted TARP Funds	349.2	0	0	349.2
AIG	**69.8**	**68.2**	**0**	**138.5**
Outlays	[iii] 69.8	0	0	69.8
Loans	0	[iv] 68.2	0	68.7
Guarantees	0	0	0	0
Bank of America	**0**	**0**	**0**	**0**
Outlays	[v] 0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	0	0
Citigroup	**25**	**0**	**0**	**25**
Outlays	[vi] 25	0	0	25
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Purchase Program (Other)	**58**	**0**	**0**	**58**
Outlays	[vii] 58	0	0	58
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Assistance Program	**N/A**	**0**	**0**	[viii] **N/A**
TALF	**20**	**180**	**0**	**200**
Outlays	0	0	0	0
Loans	0	[x] 180	0	180
Guarantees	[ix] 20	0	0	20
PPIP (Loans) [xi]	**0**	**0**	**0**	**0**
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	0	0
PPIP (Securities)	[xii] **30**	**0**	**0**	**30**
Outlays	10	0	0	10
Loans	20	0	0	20
Guarantees	0	0	0	0
Home Affordable Modification Program	**50**	**0**	**0**	[xiv] 50
Outlays	[xiii] 50	0	0	50
Loans	0	0	0	0
Guarantees	0	0	0	0
Automotive Industry Financing Program	[xv] **78.2**	**0**	**0**	**78.2**

[614] Congressional Oversight Panel, *Guarantees and Contingent Payments in TARP and Related Programs,* at 36 (Nov. 11, 2009) (online at cop.senate.gov/documents/cop-110609-report.pdf).

FIGURE 58: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF DECEMBER 31, 2009)—Continued

[Dollars in billions]

Program	Treasury (TARP)	Federal Reserve	FDIC	Total
Outlays	59	0	0	59
Loans	19.2	0	0	19.2
Guarantees	0	0	0	0
Auto Supplier Support Program	**3.5**	0	0	3.5
Outlays	0	0	0	0
Loans	[xvi] 3.5	0	0	3.5
Guarantees	0	0	0	0
Unlocking SBA Lending	[xvii] **15**	**0**	**0**	**15**
Outlays	15	0	0	15
Loans	0	0	0	0
Guarantees	0	0	0	0
Temporary Liquidity Guarantee Program	**0**	**0**	**577**	**577**
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	[xviii] 577	577
Deposit Insurance Fund	**0**	**0**	**69.4**	**69.4**
Outlays	0	0	[xix] 69.4	69.4
Loans	0	0	0	0
Guarantees	0	0	0	0
Other Federal Reserve Credit Expansion	**0**	**1,270.4**	**0**	**1,270.4**
Outlays	0	[xx] 1,136	0	1,136.1
Loans	0	[xxi] 134.4	0	134.4
Guarantees	0	0	0	0
Uncommitted TARP Funds	**349.2**	**0**	**0**	**349.2**

[i] The term "outlays" is used here to describe the use of Treasury funds under the TARP, which are broadly classifiable as purchases of debt or equity securities (e.g., debentures, preferred stock, exercised warrants, etc.). The outlays figures are based on: (1) Treasury's actual reported expenditures; and (2) Treasury's anticipated funding levels as estimated by a variety of sources, including Treasury pronouncements and GAO estimates. Anticipated funding levels are set at Treasury's discretion, have changed from initial announcements, and are subject to further change. Outlays used here represent investment and asset purchases and commitments to make investments and asset purchases and are not the same as budget outlays, which under section 123 of EESA are recorded on a "credit reform" basis.

[ii] Although many of the guarantees may never be exercised or exercised only partially, the guarantee figures included here represent the federal government's greatest possible financial exposure.

[iii] This number includes investments under the AIGIP/SSFI Program: a $40 billion investment made on November 25, 2008, and a $30 billion investment committed on April 17, 2009 (less a reduction of $165 million representing bonuses paid to AIG Financial Products employees). As of January 5, 2010, AIG had utilized $45.3 billion of the available $69.8 billion under the AIGIP/SSFI and owed $1.6 billion in unpaid dividends. This information was provided by Treasury in response to a Panel inquiry.

[iv] This number represents the full $35 billion that is available to AIG through its revolving credit facility with the Federal Reserve ($24.4 billion had been drawn down as of January 28, 2010) and the outstanding principal of the loans extended to the Maiden Lane II and III SPVs to buy AIG assets (as of December 31, 2009, $15.5 billion and $17.7 billion respectively). Income from the purchased assets is used to pay down the loans to the SPVs, reducing the taxpayers' exposure to losses over time. Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet,* at 17 (Oct. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200910.pdf). On December 1, 2009, AIG entered into an agreement with FRBNY to reduce the debt AIG owes the FRBNY by $25 billion. In exchange, FRBNY received preferred equity interests in two AIG subsidiaries. This also reduced the debt ceiling on the loan facility from $60 billion to $35 billion. American International Group, *AIG Closes Two Transactions That Reduce Debt AIG Owes Federal Reserve Bank of New York by $25 billion* (Dec. 1, 2009) (online at phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MjE4OD18Q2hpbGRJRD0tMXxUeXB1PTM=&t=1).

[v] Bank of America repaid the $45 billion in assistance it had received through TARP programs on December 9, 2009. U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf).

[vi] As of February 4, 2009, the U.S. Treasury held $25 billion of Citigroup common stock. U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf).

[vii] This figure represents the $204.9 billion Treasury has disbursed under the CPP, minus the $25 billion investment in Citigroup ($25 billion) identified above, and the $121.9 billion in repayments that are reflected as available TARP funds. This figure does not account for future repayments of CPP investments, nor does it account for dividend payments from CPP investments. U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf).

[viii] On November 9, 2009, Treasury announced the closing of the CAP and that only one institution, GMAC, was in need of further capital from Treasury. GMAC, however, received further funding through the AIFP, therefore the Panel considers CAP unused and closed. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg__11092009.html).

[ix] This figure represents a $20 billion allocation to the TALF SPV on March 3, 2009. However, as of January 28, 2010, TALF LLC had drawn only $103 million of the available $20 billion. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (Jan. 28, 2010) (online at www.federalreserve.gov/Releases/H41/Current/); U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf). As of January 28, 2010, investors had requested a total of $65.7 billion in TALF loans ($10.7 billion in CMBS and $55 billion in non-CMBS) and $64 billion in TALF loans had been settled ($10 billion in CMBS and $54 billion in non-CMBS). Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: CMBS* (accessed Feb. 4, 2010) (online at www.newyorkfed.org/markets/CMBS__recent__operations.html); Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: non-CMBS* (accessed Feb. 4, 2010) (online at www.newyorkfed.org/markets/talf__operations.html).

[x] This number is derived from the unofficial 1:10 ratio of the value of Treasury loan guarantees to the value of Federal Reserve loans under the TALF. U.S. Department of the Treasury, *Fact Sheet: Financial Stability Plan* (Feb.10, 2009) (online at www.financialstability.gov/docs/fact-sheet.pdf) (describing the initial $20 billion Treasury contribution tied to $200 billion in Federal Reserve loans and announcing potential expansion to a $100 billion Treasury contribution tied to $1 trillion in Federal Reserve loans). Because Treasury is responsible for reimbursing the Federal Reserve Board for $20 billion of losses on its $200 billion in loans, the Federal Reserve Board's maximum potential exposure under the TALF is $180 billion.

[xi] It is unlikely that resources will be expended under the PPIP Legacy Loans Program in its original design as a joint Treasury-FDIC program to purchase troubled assets from solvent banks. See also Federal Deposit Insurance Corporation, *FDIC Statement on the Status of the Legacy Loans Program* (June 3, 2009) (online at www.fdic.gov/news/news/press/2009/pr09084.html) and Federal Deposit Insurance Corporation, *Legacy Loans Program—Test of Funding Mechanism* (July 31, 2009) (online at www.fdic.gov/news/news/press/2009/pr09131.html). The sales described in these statements do not involve any Treasury participation, and FDIC activity is accounted for here as a component of the FDIC's Deposit Insurance Fund outlays.

[xii] As of February 4, 2010, Treasury reported commitments of $19.9 billion in loans and $9.9 billion in membership interest associated with the program. U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf).

[xiii] U.S. Government Accountability Office, *Troubled Asset Relief Program: June 2009 Status of Efforts to Address Transparency and Accountability Issues,* at 2 (June 17, 2009) (GAO09/658) (online at www.gao.gov/new.items/d09658.pdf). Of the $50 billion in announced TARP funding for this program, $36.9 billion has been allocated as of February 4, 2010. However, as of January 10, 2010, only $32 million in non-GSE payments have been disbursed under HAMP. Disbursement information provided in response to Panel inquiry on February 4, 2010; U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf).

[xiv] Fannie Mae and Freddie Mac, government-sponsored entities (GSEs) that were placed in conservatorship of the Federal Housing Finance Agency on September 7, 2009, will also contribute up to $25 billion to the Making Home Affordable Program, of which the HAMP is a key component. U.S. Department of the Treasury, *Making Home Affordable: Updated Detailed Program Description* (Mar. 4, 2009) (online at www.treas.gov/press/releases/reports/housing_fact_sheet.pdf).

[xv] *See* U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf). A substantial portion of the total $81 billion in loans extended under the AIFP have since been converted to common equity and preferred shares in restructured companies. $19.2 billion has been retained as first lien debt (with $6.7 billion committed to GM, $12.5 billion to Chrysler). This figure ($78.2 billion) represents Treasury's current obligation under the AIFP after repayments.

[xvi] *See* U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Report for Period Ending February 1, 2010* (Feb. 2, 2010) (online at www.financialstability.gov/docs/transaction-reports/2-3-10%20Transactions%20Report%20as%20of%202-1-10.pdf).

[xvii] U.S. Department of the Treasury, *Fact Sheet: Unlocking Credit for Small Businesses* (Oct. 19, 2009) (online at www.financialstability.gov/roadtostability/unlockingCreditforSmallBusinesses.html) (''*Jumpstart Credit Markets For Small Businesses By Purchasing Up to $15 Billion in Securities*'').

[xviii] This figure represents the current maximum aggregate debt guarantees that could be made under the program, which, in turn, is a function of the number and size of individual financial institutions participating. $309 billion of debt subject to the guarantee has been issued to date, which represents about 54 percent of the current cap. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program: Debt Issuance Under Guarantee Program* (Dec. 31, 2009) (online at www.fdic.gov/regulations/resources/tlgp/total_issuance12-09.html) (updated Feb. 4, 2010). The FDIC has collected $10.5 billion in fees and surcharges from this program since its inception in the fourth quarter of 2008. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program* (Nov. 30, 2009) (online at www.fdic.gov/regulations/resources/TLGP/fees.html) (updated Feb. 4, 2010).

[xix] This figure represents the FDIC's provision for losses to its deposit insurance fund attributable to bank failures in the third and fourth quarters of 2008 and the first, second and third quarters of 2009. Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Fourth Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_4qtr_08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (First Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_1stqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Second Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_2ndqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_09/income.html).• This figure includes the FDIC's estimates of its future losses under loss-sharing agreements that it has entered into with banks acquiring assets of insolvent banks during these four quarters. Under a loss-sharing agreement, as a condition of an acquiring bank's agreement to purchase the assets of an insolvent bank, the FDIC typically agrees to cover 80 percent of an acquiring bank's future losses on an initial portion of these assets and 95 percent of losses of another portion of assets.• See, for example Federal Deposit Insurance Corporation, *Purchase and Assumption Agreement Among FDIC, Receiver of Guaranty Bank, Austin, Texas, FDIC and Compass Bank* at 65–66 (Aug. 21, 2009) (online at www.fdic.gov/bank/individual/failed/guaranty-tx_p_and_a_w_addendum.pdf). In information provided to Panel staff, the FDIC disclosed that there were approximately $132 billion in assets covered under loss-sharing agreements as of December 18, 2009. Furthermore, the FDIC estimates the total cost of a payout under these agreements to be $59.3 billion. Since there is a published loss estimate for these agreements, the Panel continues to reflect them as outlays rather than as guarantees.

[xx] Outlays are comprised of the Federal Reserve Mortgage Related Facilities. The Federal Reserve balance sheet accounts for these facilities under Federal agency debt securities and mortgage-backed securities held by the Federal Reserve. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed Feb. 4, 2010). Although the Federal Reserve does not employ the outlays, loans and guarantees classification, its accounting clearly separates its mortgage-related purchasing programs from its liquidity programs. *See* Board of Governors of the Federal Reserve, *Credit and Liquidity Programs and the Balance Sheet November 2009,* at 2 (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf) (accessed Dec. 7, 2009).

[xxi] Federal Reserve Liquidity Facilities classified in this table as loans include: Primary credit, Secondary credit, Central bank liquidity swaps, Primary dealer and other broker-dealer credit, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, Term Asset-Backed Securities Loan Facility, and loans outstanding to Bear Stearns (Maiden Lane I LLC). Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed Feb. 4, 2010); *see id*.

SECTION SIX: OVERSIGHT ACTIVITIES

The Congressional Oversight Panel was established as part of EESA and formed on November 26, 2008. Since then, the Panel has produced 14 oversight reports, as well as a special report on regulatory reform, issued on January 29, 2009, and a special report on farm credit, issued on July 21, 2009. Since the release of the Panel's January oversight report, which assessed Treasury's exit strategy for the TARP, the following developments pertaining to the Panel's oversight of the TARP took place:

- The Panel held a field hearing in Atlanta, Georgia on January 27, 2010, discussing the state of commercial real estate lending, the potential effect of commercial real estate problems on the banking system, and the role and impact of the TARP in addressing that effect. The Panel heard testimony from regulators at the FDIC and the Federal Reserve as well as from a number of participants in the commercial real estate industry. An audio recording of the hearing, the written testimony from the hearing witnesses, and Panel members' opening statements all can be found online at http://cop.senate.gov/hearings.

Upcoming Reports and Hearings

The Panel will release its next oversight report in March. The report will address the assistance provided to GMAC under a wide array of TARP initiatives as well as the approach taken by GMAC's new management to return the company to profitability and, ultimately, return the taxpayers' investment.

The Panel is planning a hearing in Washington on February 25, 2010 to discuss the topic of the March report. The Panel is hoping to ask Treasury officials to explain their approach to and reasons for providing assistance to GMAC and to hear details from GMAC executives about their plans for the future of the company.

SECTION SEVEN: ABOUT THE CONGRESSIONAL OVERSIGHT PANEL

In response to the escalating financial crisis, on October 3, 2008, Congress provided Treasury with the authority to spend $700 billion to stabilize the U.S. economy, preserve home ownership, and promote economic growth. Congress created the Office of Financial Stability (OFS) within Treasury to implement the Troubled Asset Relief Program. At the same time, Congress created the Congressional Oversight Panel to "review the current state of financial markets and the regulatory system." The Panel is empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy. Through regular reports, the Panel must oversee Treasury's actions, assess the impact of spending to stabilize the economy, evaluate market transparency, ensure effective foreclosure mitigation efforts, and guarantee that Treasury's actions are in the best interests of the American people. In addition, Congress instructed the Panel to produce a special report on regulatory reform that analyzes "the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers." The Panel issued this report in January 2009. Congress subsequently expanded the Panel's mandate by directing it to produce a special report on the availability of credit in the agricultural sector. The report was issued on July 21, 2009.

On November 14, 2008, Senate Majority Leader Harry Reid and the Speaker of the House Nancy Pelosi appointed Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Director of Policy and Special Counsel of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School, to the Panel. With the appointment on November 19, 2008, of Congressman Jeb Hensarling to the Panel by House Minority Leader John Boehner, the Panel had a quorum and met for the first time on November 26, 2008, electing Professor Warren as its chair. On December 16, 2008, Senate Minority Leader Mitch McConnell named Senator John E. Sununu to the Panel. Effective August 10, 2009, Senator Sununu resigned from the Panel, and on August 20, 2009, Senator McConnell announced the appointment of Paul Atkins, former Commissioner of the U.S. Securities and Exchange Commission, to fill the vacant seat. Effective December 9, 2009, Congressman Jeb Hensarling resigned from the Panel and House Minority Leader John Boehner announced the appointment of J. Mark McWatters to fill the vacant seat.

ACKNOWLEDGEMENTS

The Panel wishes to acknowledge Richard Parkus, head of Commercial Real Estate Debt Research, and Harris Trifon, analyst, Deutsche Bank; Gail Lee, managing director at Credit Suisse; Matthew Anderson, partner, Foresight Analytics LLC; Nick Levidy, managing director, Moody's Investor Services; Robert White, president, Real Capital Analytics, Inc.; Jeffrey DeBoer, president and chief executive officer, The Real Estate Roundtable; and David Geltner, director of research, Massachusetts Institute of Technology

Center for Real Estate for the contributions each has made to this report.

APPENDIX I: LETTER FROM SECRETARY TIMOTHY GEITHNER TO CHAIR ELIZABETH WARREN, RE: PANEL QUESTIONS FOR CIT GROUP UNDER CPP, DATED JANUARY 13, 2010

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

January 13, 2010

Ms. Elizabeth Warren
Chair
Congressional Oversight Panel
732 North Capitol Street, NW
Washington, D.C. 20401

Dear Chair Warren:

Thank you for your letter of November 25, 2009, which raises many important questions regarding Treasury's assistance to CIT Group, Inc. (CIT). Detailed responses to each of those questions are attached. I appreciate your follow-up letter for January 11, 2010, and please accept my sincere apology for the delayed response.

In late 2008 and early 2009, our nation faced one of the most severe financial crises of the past century, and with a rapidly contracting economy, our financial system was in danger of even further deterioration or collapse. The actions taken by the U.S. Government at the onset of the financial crisis, including the creation of the Capital Purchase Program (CPP), and the comprehensive, forceful, and sustained commitment to fiscal stimulus and financial stability made under the Obama Administration, enabled us to contain the crisis.

As part of that response in December 2008, under CPP, Treasury invested in CIT at the bank holding company level. Treasury's practice in all CPP investments was to rely on the recommendation of the primary federal banking regulator. This particular investment was made following the Federal Reserve's approval of CIT's application to become a bank holding company and the Federal Reserve's decision to recommend the application for funding. Generally, among the factors federal banking regulators examine in making their decisions about whether to recommend CPP applications include ratings of the quality of a bank's financial condition, risk profile, and overall performance. Federal banking regulators also provide a statement of viability of the CPP applicant without Emergency Economic Stabilization Act (EESA) investment.

The overriding objective of EESA was to stabilize the financial system and to do so with as little cost to the taxpayer as possible. It was impossible to guarantee that every investment made under the Troubled Asset Relief Program (TARP) would be successful – including those investments that were critical to breaking the back of the financial panic.

As detailed in the attached responses, Treasury expects to lose its entire investment in CIT. Nonetheless, over two thirds of the $241 billion invested in over 700 banks under EESA has already been repaid. Even with the loss on CIT, Treasury expects to earn a positive return for U.S. taxpayers on those investments overall. I strongly believe that EESA has met its objective of stabilizing the financial system while limiting the cost borne by taxpayers.

Thank you again for your attention to this important matter, and we look forward to working with your office as we continue our efforts to stabilize the financial system. If you have any further questions or concerns, please do not hesitate to contact me or my staff.

Sincerely,

Timothy F. Geithner

Enclosure

1. **How much does the U.S. taxpayer stand to lose due to CIT's bankruptcy, including, separately, the value of all preferred stock, warrants, and projected dividends?**

   The bankruptcy court confirmed CIT's pre-packaged plan of reorganization on December 8, 2009. Under that plan, following CIT's emergence from reorganization, which occurred on December 10, 2009, Treasury received a contingent value right in exchange for its $2.33 billion investment under the CPP (which is $2.396 billion including accumulated and unpaid dividends); this right is unlikely to have any value. No additional consideration was paid for the warrants, and therefore there is no further loss associated with them. Treasury and its outside advisors have taken steps to maximize any potential recovery of the investment. However, as a preferred shareholder, Treasury's position is junior to that of all CIT's creditors. In this bankruptcy as in similar ones in which debtors are required to take significant haircuts on the value of their debt, the Bankruptcy Code operates to restrict repayments of preferred shareholders prior to full recovery by the creditors. As a result, under the plan of reorganization, the U.S. taxpayer will likely lose its entire investment in CIT.

2. **How much, separated into the same categories, has the taxpayer lost due to the failures of other CPP-recipient financial institutions?**

   To date, other than CIT, only two other direct recipients of CPP funds have filed for bankruptcy. These include Treasury UCBH Holdings, Inc (CPP investment of $298.74 million) and Pacific Coast National Bancorp (CPP investment of $4.12 million). At this time, we believe these investments will also be largely or entirely lost.

3. **Treasury has stated that "participation [in CPP] is reserved for healthy, viable institutions," noting that "[h]ealthy banks, not weak banks, lend to their communities, and the CPP is a program for healthy banks." Did Treasury consider CIT to be a healthy bank at the time when CPP assistance was first provided? If so, on what basis did Treasury make this determination? If not, for what reasons did Treasury consider CIT to be eligible for CPP funding? Please provide any due diligence memoranda or other documentation explaining Treasury's decision.**

   Treasury has a strict application process for approval of all CPP investments which it has consistently followed. Under this process, financial institutions submit applications to their primary federal banking regulator, who in turn reviews the application and provides Treasury with a recommendation. Treasury relies on the expertise of the financial regulators, and gives considerable weight to their recommendations. Upon receipt of the regulator's recommendation, Treasury staff reviews it along with the bank's application and presents them to the Office of Financial Stability's ("OFS") Investment Committee for review. The Investment Committee in turn makes a funding recommendation to the Assistant Secretary for Financial Stability. In this case, CIT underwent this application process, was recommended for funding by its primary federal banking regulator, and such recommendation was affirmed by the OFS Investment Committee.

4. **Treasury has explicitly stated that CPP is not a bailout and that it was "designed to generate a positive return over time to the taxpayer." In the case of CIT, however, it appears clear that taxpayers will face significant losses. Regulators have closed United Commerical Bank and Pacific Coast National Bank as well, which also received CPP assistance. Did Treasury's expectation of "a positive return over time" incorporate the possibility of the failure of these or other financial institutions? If so, how has Treasury accounted for these loss projections in estimating the long-term cost or benefit to taxpayers of CPP?**

   In the financial statements for OFS, which were released on December 9, 2009, Treasury assumed that the funds invested in CIT would not be repaid, and United Commercial Bank and Pacific Coast National Bank would repay only a small fraction of the amount of the investments made by OFS. With this assumption, Treasury continues to estimate that the proceeds of its CPP investments will exceed the amount that was invested under the program. We invested in over 700 institutions as part of CPP. As noted above, the bulk of the funding decisions for CPP had to be made during a period of extreme economic uncertainty. Given the program was designed to contribute to the stability of our financial system, we cannot rule out the possibility that not all of the individual investments will earn profits for taxpayers. Treasury continues to work to minimize these losses and maximize recovery to the taxpayer.

5. **How many more failures does Treasury expect among CPP-recipient financial institutions, and what is the estimated cost to taxpayers of these failures? Please provide any memoranda projecting such losses. How is Treasury acting to protect the taxpayers' investments in those institutions?**

   The OFS financial statements, which were released on December 9, 2009, provide the estimated overall net cost/gain information for the CPP. OFS' equity model does not project losses in terms of specific number of institutions; rather, OFS' equity model takes a composite of all CPP institutions and projects the per quarter probability that such institutions will continue to perform, will repurchase, or will fail. The dollar amounts are then summed by event to generate performing, prepay, and default cash flows. As of September 30, 2009, using discount rates that capture market risks, the model projects $11 billion in defaults during the life of the CPP with those losses more than offset by cash inflows, including dividend payments. Once your staff has had an opportunity to review the OFS financial statements, my staff is available to answer any questions. We will work with recipients of EESA funds and their supervisors to accelerate repayment where appropriate.

6. **In particular, how many institutions in the CPP program are now on the list of problem banks maintained by the Federal Deposit Insurance Corporation? What steps [are] Treasury taking to protect the taxpayers' investment in those institutions?**

   Treasury actively monitors all of its investments made under the Troubled Asset Relief Program, including its investments in CPP recipients. In instances in which a CPP recipient appears to be having difficulty, Treasury engages directly with the institution—and on occasion, the primary regulator—to discuss the actions that can be taken to stabilize the institution and preserve the value of Treasury's recovery as a preferred stock holder. However, please note that Treasury does not have access to confidential supervisory information on an ongoing basis.

7. **What is Treasury's projection of the final benefit or cost to taxpayers of the overall CPP program?**

   The OFS financial statements, which were released December 9, 2009, provide the current estimated overall net gain information for the CPP. For the period ending September 30, 2009, Treasury-OFS reported net income of approximately $15 billion for CPP.

8. **Treasury has provided exceptional assistance outside of CPP to several firms that it considers "systemically significant," including Bank of America, Citigroup, and AIG. Did Treasury consider whether CIT's significance to the financial system warranted similar assistance? If Treasury determined that CIT was not systemically significant, on what basis was this determination made? Please provide any memoranda regarding this determination.**

   Even during periods of financial stress, there is a very high threshold for exceptional government assistance to individual companies, and the strong presumption is that private companies should seek private sector solutions. As we have stated previously, Treasury evaluated the potential of providing additional assistance to CIT. Treasury determined that, in this instance, such exceptional assistance was not warranted. This determination was made on the basis of a number of factors, including, among other things: CIT's role in the financial system; the availability of alternative sources of liquidity to CIT; the likelihood that CIT would continue as a going concern in the absence of exceptional assistance; the existence of alternative credit channels for CIT's customers; the condition of the financial system at the time of the determination; and CIT's size and funding structure. It should be noted that less than a week after CIT announced that discussions with Government agencies had ceased, it was able to secure an additional $3 billion loan facility from private sources. Between July 2009 and its bankruptcy filing, CIT was able to raise a total of $8.5 billion in financing from private sources. CIT emerged from bankruptcy on December 10, 2009 as a recapitalized going concern.

Requests for Documents

With respect to your request for documents set forth in this letter, please note that we are in the process of collecting and evaluating materials that may be responsive to your request, and will make any relevant documents available to your staff consistent with our Protocols for the Protection of Potentially Protected Documents.