

STEPTOE & JOHNSON^{LLP}

ATTORNEYS AT LAW

Scott A. Sinder
202.429.6289
ssinder@steptoe.com

1330 Connecticut Avenue, NW
Washington, DC 20036-1795
Tel 202.429.3000
Fax 202.429.3902
steptoe.com

February 22, 2010

TO: CMSA

FROM: Scott A. Sinder
Rhonda M. Bolton

RE: Summary and Analysis of Congressional Oversight Panel Report on Commercial Real Estate and Risk to Financial Stability

You have asked us to provide a summary and analysis of the Congressional Oversight Panel Report on “Commercial Real Estate and Risk to Financial Stability,” which was released on February 10, 2010. Generally, the Panel suggests that Treasury has not paid enough attention to the looming commercial real estate (CRE) crisis, concentrating instead on dealing with the problems in the residential market. Much of the report is devoted to a description of the structure and current status of the CRE finance market, and to making the case that a major CRE crisis is indeed on the horizon, and that it threatens to slow or halt the nation’s economic recovery.

The Panel states in the report 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.” (p. 138). Separately, the Panel’s Chair, Elizabeth Warren, has told the news media that the goal of the report is, essentially, to sound the alarm about the CRE crisis, get policymakers to focus on it, and get them to do something about it (e.g., Sewell Chan, “Concern Aired Over Banks’ Real Estate Loans,” New York Times (Feb. 11, 2010).

The focus of the 189-page report is the effect of the CRE crisis on banks. However, the Panel echoes all of the concerns CMSA has repeatedly expressed regarding the difficulties facing the CRE market, including declining fundamentals, the effect of the overall economic downturn, the impending wave of loan maturities that will need to be financed in an environment of tight credit, and the equity gap. The report also emphasizes the potential negative effect of the CRE crisis on the economy as a whole, as has CMSA. Notably, the report mentions other issues of

particular interest to CMSA, including the new accounting rules (although the Panel does not appear to fully comprehend their adverse impact), REMIC reform, and the future of the Term Asset-Backed Securities Loan Facility (TALF).

The Panel does not make many concrete recommendations for supporting a CRE recovery, but one of the suggestions it does make is the extension of TALF for CMBS, and the expansion of the Public-Private Investment Program (PPIP) for legacy securities and revitalization of PPIP for legacy loans, at least to the extent necessary to assist mid-sized and smaller banks with getting troubled CRE loans off their books.

Following is a summary and analysis of the Panel's report, in the form of bullet points, with a particular focus on matters in the report related to the commercial mortgage-backed securities (CMBS) market. Each bullet is followed by a citation to the relevant pages in the Panel's report.

I. Observations About the Status of the CRE Market

- The Panel is most concerned about the effect of CRE problems on small and mid-sized community banks because of their greater exposure to the riskiest types of CRE loans, e.g., construction and development loans. The Panel believes that defaults on loans owned by such banks can spread distress to other sectors of the economy because smaller banks tend to do more small business lending, and small businesses in turn, tend to generate a significant proportion of jobs for the economy. Less lending to small businesses will create a negative feedback loop that will prolong, or exacerbate, the current recession. (p. 3, 42). The Panel has asked Treasury to stress test the small and mid-sized banks in light of the CRE exposure, but so far, Treasury has responded that such an effort would be impractical given the number of institutions involved. (see Feb. 11, 2010 New York Times article)
- The Panel states that the effect of the CRE crisis on CMBS investors and other participants is “more difficult to predict,” but the experience over the last two years indicates that there can be serious risks to the institutions and borrowers involved both with CMBS and whole loans (p. 36)
- The Panel states that the CMBS market siphoned off loans made on the highest quality commercial properties; but reports that CMBS losses “will potentially trigger capital consequences.” (p. 37)
- The Panel acknowledges and describes all of the difficulties facing the CRE market that have been repeatedly discussed by CMSA, including declining fundamentals, the effect of the overall economic downturn, the impending wave of loan maturities that will need to be financed in an environment of tight credit, and the equity gap. (p 35)
- Given the overall state of the economy, the uncertain pace of any recovery, and low expectations for any improvement in CRE fundamentals, the Panel predicts that prospects for a CRE recovery in the near future are “dim.” (p. 35)

- The Panel appears to take a skeptical view of Treasury Secretary Geithner’s statement in October 2009 that the commercial real estate problem is one “the economy can manage through,” and opinions of analysts that commercial real estate, in isolation, does not present a systemic risk to the banking system. The Panel counters such statements with the opinion that “rising delinquency rates foreshadow continuing deterioration in the commercial real estate market.” (p. 63) In this regard, the most favorable finding in the report is that there is some indication that the pace of deterioration is “slowing.” (p. 64)
- The report suggests that whatever difficulties are faced by the CRE market, they will be exacerbated by withdrawal of Federal Reserve liquidity programs such as TALF: “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.” (p. 78)
- The report goes on to describe the broader social and economic consequences of a collapse of the CRE market, citing not only failure of financial institutions, but rising unemployment rates, decreased consumer spending, erosion of retirement savings as institutional investors suffer losses, and declining tax revenues for state and local governments, which lead to a decline in social services. The result would be a suppression of the economic recovery, which could create a vicious cycle that makes recovery of the CRE market even more difficult. The report notes that these types of cascading effects on the economy were the justification for use of public funds under the EESA, and “future problems in the commercial real estate markets may create similar conditions or causes for concern.” (pp. 78-80)
- The Panel suggests that it may not be possible for loans underwritten in the 2005-07 timeframe to survive, since it identifies that period as the one in which underwriting was most problematic. Instead, the Panel suggests that it is more important to recognize that the recession is putting even sound CRE loans/investments at risk, and that steps need to be taken to deal with this latter difficulty. (p. 21, 28)
- The Panel discusses the impact of changes in accounting rules on bank capital, including fair value and other-than-temporary impairment accounting rules, and FAS 166/167. Unfortunately, the Panel’s understanding of the effect of the rules appears to be superficial: the report describes the revised fair value accounting rules as “loosen[ing] the use of immediate fair value accounting” and does not address concerns that the revised rule is unworkable from a practical perspective. Rather, the report states that the changes in the accounting rules are “the subject of a continuing debate” on which the Panel takes no position. The report accurately describes some effects of FAS 166/167 on bank balance sheets: the recognition of consolidated assets on a bank’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.” Yet, the report does not take the next step of recognizing that these changes can result in

reduced capital and liquidity in the financial system as a whole, choosing instead to focus on a conclusion that “[t]he 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.”) (pp. 81-87)

- The report discusses various strategies that lenders can take to resolve defaulting or non-performing loans – foreclosure, workouts, and extensions, and acknowledges that the suitability of any of these options depends on the particular circumstances. The report also acknowledges the complexity of the task of trying balancing considerations such as future loan performance, borrower incentive to default, the effects of having to take a write-down, and workout costs, in trying to determine the best course in each situation. Significantly, the report acknowledges the problem that workouts create for CMBS, by changing the terms of loan contracts and reducing investor trust and certainty, citing CMSA’s July 13, 2009 paper entitled “Concerns with REMIC Proposals to Authorize Loan Modifications and Restructure Contracts.” The Panel acknowledges that “loss of confidence by investors could impede the recovery 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.” (pp. 87-91)
- The report describes some facts and trends related to workouts. Among these, it observes that “[f]inancial institutions and federal supervisors appear to be inclined to extend prudent, performing loans that are unable to refinance at maturity.” It also posits a number of reasons why it may be easier for servicers to do workouts of commercial loans, for example, the fact that there are fewer loans in commercial pools than in residential ones. The Panel attempted to assess whether workouts were actually occurring and found that there was little public data on workouts. In discussions with industry experts, the Panel found a general consensus that workout activity had increased since the decline in commercial property values began, but there is no quantifiable evidence. The Panel reports anecdotal evidence that whole loans are more likely to undergo a workout than securitized loans, although the reasons for this are unclear. It does cite CMBS standards and servicing arrangements as a possible cause. (pp. 94-96)
- The panel examined impediments to successful workouts, including, most relevantly, REMIC rules. The Panel notes the September 2009 rule revision to expand the types of modifications allowed by REMICs, but observes that this change is “not a panacea.” The report quotes observers who complained that the new IRS guidance is too vague, that the penalties are still so large that REMICS remain wary of modifications and that PSAs written under the earlier version of the rules may make modifications too complicated or may still bar them. (pp. 96-99)
- The Panel also recognized that tax rules, including the possibility of double- or triple taxation of investment income, would probably discourage the degree of foreign investment in U.S. real estate that could help ease the equity crunch. The Panel noted that there have been some calls for congressional or IRS action to alleviate such

burdens to encourage foreign investment in U.S. real estate, but the Panel does not endorse such a plan itself (p.99-100)

- The report examines recovery rates and finds that they are declining, which it describes as an “ominous indicator of future losses that may be expected from defaulted commercial real estate debt.” Recovery rates are examined based on geographic location and by lender type, among other parameters. The Panel found that CMBS performed the poorest of all lender types at recovering losses from acquisition/refinancing loans, returning only 62 percent of invested capital. Insurance companies had the highest recovery rates at 79 percent. Banks appear to be somewhere in between these figures.
- The Panel recognizes that questions about whether, and when, to recognize loan losses, are “major points of contention” in the commercial real estate industry. It notes that the extent and timing of loss recognition will have a direct impact on the future viability of many banks. It reports that 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,” but there is no one way to time these losses, and timing is complicated by the fact that it is impossible to predict the pace of the economy’s recovery.
- The Panel states that 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. But it warns that just because many of these loans have yet to reach maturity, it does not mean the crisis is not already here, citing the significant losses already being experienced on construction loans. The Panel concludes: “The warnings about commercial real estate loans are extremely serious, and the condition of construction loans now gives these predictions substantial credence.” (pp. 101-102)

II. CMBS-Specific Discussion in the Report

The Report is divided into sections that provide facts and fundamental information about the whole loan market and the CMBS market. The information related concerning CMBS will be summarized here.

- Factual details about the CMBS market describe how CMBS deals are structured, CMBS share of the CRE finance market, distribution of CMBS by geographic location and property type, distribution of delinquencies based on a number of parameters (e.g., location, property type). CMSA materials are cited for some of the factual information in the report. (p. 47-52)
- Factual details about CMBS-backed credit default swaps (CDS) are also provided. The Panel reports that the maximum credit exposure for CMBS-backed CDS is not only larger than that of RMBS-backed CDS, it is concentrated in smaller number of contracts. The Panel expresses concern that given the role that RMBS-backed CDS played in the meltdown of the collapse of the residential market, and the fact that the

concentration of CMBS-backed CDS is greater than that in RMBS-backed CDS, CDS must be carefully considered in assessing the impact of an increased volume, nature, or pace of foreclosures on securitized commercial properties. The Panel advises that it is not possible to gauge the potential impact because of the opacity of the CDS market and reiterated an earlier call for more transparency in the CDS market. The report concludes that the impact of CRE losses on CMBS and CMBS-CDS markets is a function of the size of the institution that invests in them, and that CMBS exposure is concentrated in the 20 largest financial institutions with assets over \$100 billion. The Panel recommends that “[g]iven the size of notional CMBS holdings, that risk and exposure require extremely careful attention, in light of the experience of the last three years.” (pp. 58-59)

III. TALF

- The report notes that one measure of the particular risks associated with CMBS at present is the fact that the TALF program requires the largest haircuts for CMBS financings compared with other asset classes. (p.62)
- The report cites figures regarding the volume of commercial mortgage securitizations at the market’s peak in 2006-07, and at the low point when the market froze between July 2008 and May 2009. It observes that the market 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 securitization would be. It is also not clear how much of the partial return of this previously moribund market is attributable to the TALF.” (p. 123)
- The report recognizes that although these TALF loans are not providing new financing for the commercial real estate market, 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. In comparison to the entire commercial real estate debt market, which is valued at over \$3 trillion, the program’s impact is even smaller.” But another way to look at TALF’s impact is its effect on the market’s view as expressed by spreads, and by the time TALF was introduced in the spring/summer of 2009, spreads were still elevated by historical standards, but reflecting a healthier real-estate finance market.” (p. 124)
- The report notes that generally, private actors have been making commercial real estate loans on more favorable terms since the introduction of the TALF, and concludes that “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.” (p. 125)

- The Panel notes that Treasury states that liquidity has re-entered the commercial real estate sector; three CMBS deals closed late in 2009, including two that did not rely on TALF financing. The Panel then opines that “[t]he Federal Reserve has previously extended the TALF out of a concern that the securitization markets lacked sufficient liquidity to function properly on their own, and it could do so again. If the Federal Reserve decides to end the TALF for CMBS in the first half of 2010, 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.” (p. 126)

IV. Legacy Securities Public-Private Investment Program (PPIP)

- The Panel provides a report on the status of the PPIP and its affect on the CMBS market, finding that “[s]o far, the program’s impact on the CMBS market appears to be quite limited. This is in part because the program only recently became operational; eight investment funds were established between late September 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. 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 report notes that the PPIP program for legacy loans never got off the ground because of banks’ unwillingness to offer their loans for sale at the prices investors wanted to pay. The report notes further than both the PPIP for legacy securities and for legacy loans have a problem in terms of asset pricing: “[u]nless the CMBS and whole loans are bought at or close to par, the purchases will not prevent write-downs that can reduce bank capital. At the same time, buying the assets at inflated prices causes its own problems, by exposing the government to future losses.” (pp. 126-28)
- Overall, the Panel appears critical of Treasury’s use of TARP funds for TALF and PPIP in a way that did not provide “direct targeted help to smaller banks with commercial real estate problems,” and suggests that this approach is inconsistent with EESA, which had provisions aimed at ensuring that small banks benefited from TARP as well. (p. 129) The Panel notes that since October 2009 the Administration announced two initiatives designed to help smaller banks, the one to provide low-cost capital to community banks and financial institutions using TARP funds, and an initiative to encourage lending to small businesses, which will not use TARP funds. The Panel observes that it is unclear what impact, if any, these initiatives will have on small banks facing problems with CRE loans. (pp. 130-33)

V. Suggested Interventions

The Panel offers some suggested interventions that can be made by the government and the private sector, but says it is not endorsing any specific solution, and that policymakers could adopt one, or a combination, of the Panel’s suggestions. (p. 133-38)

- For mid-size and small banks, the Panel suggests a program of capital enhancement combined with removal of troubled assets from their balance sheets. Significantly, an extension of TALF is suggested as part of this plan. More specifically, the Panel suggests: “[s]tronger 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, 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.” (p. 135)
- A second approach for mid-size and small banks would not provide a safety net. Instead, “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.” (pp. 135-36)
- For large banks, the Panel expressed concern about their level of CMBS exposure, and that the current state of the CMBS market is disquietingly similar to that of the RMBS market just before the latter collapsed. The Panel posits that loan extensions could buy large banks more time to wait out the recession, and that given that they have been stress tested, and that regulators have promised enhanced vigilance, large banks may be able to get by without additional government assistance for the present. But the Panel emphasizes that for such an approach to work, “supervisors must monitor risk and not hesitate to increase capital to offset perspective losses in place of the capital that came from Treasury during the TARP.” (p. 136)
- In terms of loss recognition by banks, the Panel divides banks into three categories: “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.” In no

event should banks be forced to recognize all potential losses immediately because of the prospect of driving prices down even further. (p. 102)

- The Panel recognized further that it would be undesirable and inefficient to force write-downs that would “unnecessarily transfer 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.” (p. 103)
- The Panel also cautioned that as Treasury and bank supervisors ready themselves to deal with the expected problems in the CRE market, they should consider their decisions in the context of certain key actions already taken by bank supervisors in this area: (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.” (p. 103)

With respect to the stress tests, the Panel complains that Treasury has failed to provide the Panel with detailed information about the inputs and the results, despite repeated requests. The Panel urges that the stress tests measure losses beyond 2010 given that the CRE crisis is expected to be at its height after that time, and that stress tests be conducted on smaller banks that have a higher exposure to CRE loans than large banks. As for the 2009 guidance encouraging banks to do more workouts on commercial loans, the Panel urged bank supervisors to keep in mind that the net effect of this guidance may make the downturn in commercial real estate appear less severe in the short term, while extending the period of uncertainty, and urged them not to hesitate to force loss recognition where necessary before the CRE sector can return to good health. (pp. 103-117)

* * *