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TO: Interested Parties
FROM: Herb Miller, Third Way Trustee; and Jim Kessler, VP for Policy
RE: Commercial Real Estate—Forestalling the Next Foreclosure Crisis

The Obama Administration has acted aggressively to stem the residential housing crisis, and even if foreclosures continue to rise, the government is well-prepared to lessen their impact on the economy.

But there is another real estate crisis pending that policymakers have yet to tackle and cannot ignore—this time in the commercial sector.

Commercial real estate is headed toward a crisis point similar to the one that faced the residential real estate market last fall. Like housing, there is vast overcapacity throughout the country. For example, the amount of large retail space in America, measured by square footage per capita, doubled between 1990 and 2005—at a time when the internet blossomed and billions in retail sales moved online.¹ And like housing, there has been massive borrowing to finance the development of these structures—borrowing that has been leveraged many times over through complicated securitization instruments similar to the residential mortgage market.

Nevertheless, there are also many thousands of solid properties that are sound investments and that employ many hundreds of thousands of Americans across the country. These properties could well serve as the front line against the collapse of the commercial real estate sector—provided that they are insulated from the coming shocks in the rest of the commercial sector. Without proactive federal intervention, the looming collapse of commercial real estate could not only shatter hopes of an economic recovery this year but send the financial system back into a downward spiral.

This memo offers a three-step solution to forestall the potential crisis while benefitting Main Street over Wall Street: first, separate truly toxic assets from those that are sound; second, offer temporary federal loan guarantees to protect solid performers from the ongoing credit crunch that threatens their survival; and third, ensure that taxpayers share in the profits.

Commercial Real Estate: Caught Between a Bubble and a Crunch

Like the housing bubble, commercial buildings that were constructed, renovated, and financed over the previous five years were severely overvalued. In addition, many mature, income producing assets were refinanced at unsustainable debt levels. Banks have tremendous exposure in commercial real estate.

- Between 2009 and 2011, \$814 billion in commercial real estate loans are expected to mature, according to the research firm Foresight Analytics.² One-half were originated between 2004 and 2008.³
- In the fourth quarter of last year, delinquency rates on construction loans for commercial real estate were 11.4%, compared to 2.7% in the commercial mortgage market.⁴
- Foresight Analytics estimates that banks have about \$1.8 trillion in commercial real estate loans on their books today. That is roughly half of the total commercial real estate debt of about \$3.5 trillion. (By contrast, the entire residential real estate market in the U.S. is roughly \$11 billion.)⁵

At the same time, long-term financing is also simply not available.

- According to a recent report by Deutsche Bank, 80% of commercial loans made in 2007, financed by mortgage-backed securities (CMBS), and due to mature will not qualify for long term financing.⁶ “When those loans come due, borrowers likely will find fewer sources of debt financing. Many borrowers will end up defaulting as investors will not pay more than what the property is worth,” according to Deutsche Bank.⁷
- Deutsche Bank conservatively estimates that maturity default-related losses will be “at least 4.6% of the CMBS loans securitized in 2005; 5.8% for those in 2006, and a whopping 12.5% of those securitized in 2007.”⁸

And to the extent that credit is available, commercial borrowers are receiving only temporary one-year extensions on maturing mortgages. This is helping to forestall an immediate crisis, but these short-term extensions are just that—short term. And it is adding to the volume of financing that will be needed in 2010, just as a new wave of maturing loans hit.⁹ “We are particularly concerned about the ‘boom year’ vintages ... maturing in 2011, setting that year up as a likely pivotal year,” according to Foresight Analytics. They expect maturing loans to completely “crowd out” demand for new lending making it difficult to get financing for new construction and renovations. Maturing mortgages are expected to represent 80% of total commercial mortgage originations over the coming years, compared to 35% between 2000 and 2007.¹⁰

Why Save Commercial Real Estate?

In the absence of a healthy credit market, a small number of financiers with capital are buying up commercial real estate properties from desperate owners unable to obtain financing—but at a steep, steep discount. Rather than a normal rate of return that a bank would seek for a commercial loan—these financiers generally seek a 20% rate of return or better. Thus, a property that may generate \$7 million a year from leases—a property that should be able to qualify for a long term loan of about \$65 million during normal times—is sold to a financial group at a fraction of its value, roughly \$35 million.

The original bank gets paid off for part of the short term construction loan but eats much of the rest. Multiplied by thousands of loans, this threatens our financial

system and puts taxpayers on the hook for more bank bailouts. The original owner takes a loss and may have to liquidate other properties and assets to pay off all or part of the original short term loan—further driving asset values down. Finally, the new owners control the property, but they are often looking to flip it a few years later. Like foreclosed-upon homes, these properties generally are not maintained, rented, marketed and managed with the care of an experienced property owner, thereby further reducing the asset value of the property.

Some of these commercial structures will never be worth even half the value at which they were initially appraised and financed. But a large number of overvalued assets do perform well. They have a predictable and lucrative revenue stream. They are not toxic assets; they are overvalued assets. However, just as these performing assets were once overvalued, they are in danger of being packaged and sold well below their value because they are caught in the undertow of the frozen credit markets.

The ramifications of these properties being severely undervalued could be devastating for the economy and for taxpayers. Plummeting commercial real estate assets could:

- Threaten banks and financial institutions that have to swallow huge losses
- Have a debilitating effect on the value of surrounding assets in the community
- Deplete local property tax bases vital for city and county services
- Start a cycle of depreciation that is difficult to contain
- Put taxpayers on the hook

The Solution: Separate Toxic Assets from Solid Performers and Provide Targeted Loan Guarantees.

To forestall a looming crisis, government must step in to ensure that it does not have to bail out financial institutions and local government from major future losses in the commercial real estate sector. We suggest the outline of a plan to:

1. Separate so-called toxic commercial assets from those that are over-valued but able to perform.
2. Guarantee commercial real estate loans for a portion of the worth of these performing assets, based on the actual and/or expected revenue the property will generate. This guarantee would encourage lending by banks and other financial institutions and the continuation of operations by the current owners of the properties.
3. Allow taxpayers to share in the profits from the performance of these assets through the pay-back of their loan and sunset the program once the credit crisis ends.

This approach reduces risk to the Treasury.

Treasury is organizing a financing program (PPIC) to provide 85% debt and 7.5%

equity to Wall Street investment funds to acquire Toxic Assets at deep discounts. Although this is a worthy objective, some believe that it is risky to provide any fund 92.5% of all capital needs.

The Treasury Department program needs a balanced Main Street/Wall Street approach that reduces the debt risk to the Federal government while stabilizing commercial real estate values. If the Federal government through FHA or Fannie Mae guaranteed only 75% of current appraised value and guaranteed long-term self-amortizing loans to responsible property owners, a large percentage of commercial real estate would be stabilized with only the distressed properties being sold into PPIC. For example, if the Federal government guaranteed a 20-year self-amortizing loan on a successful income producing property, it could charge an interest rate of 9% to 10% for its guarantee, netting the tax payer 7% to 8% annual profit above the Fed's cost of money for its guarantee. Translating that amount to guarantees for \$1.25 trillion dollars of loans, taxpayers would receive an annual profit of around \$100 Billion per year, or \$2 trillion over the entire loan term, enough to materially reduce our Federal deficit.

Property owners have invested their resources into their properties, knowing how to lease, manage, promote and asset manage them successfully. Just as homeowners are being respected by our government and given assistance to forestall foreclosures to avoid a proven major reduction in home values, assisting commercial property owners to obtain reasonable self-amortizing loan-term loans is both good business for the federal government and a smart investment. By stabilizing the commercial real estate market, the federal government will forestall a wholesale collapse of trillions of dollars of real estate and the damage it causes to both the financial community and the local tax structure.

This approach is fiscally sound.

This Main Street approach will provide the federal government significant revenue with very limited risk. Currently there is virtually no real estate debt market over approximately \$30 million, the debt of which is being provided by smaller regional banks. The federal government could receive a 700 to 800 basis point annual spread above Treasuries for its guarantee of 75% self-amortizing twenty-year loans. Given that the new federally-guaranteed commercial loans would be based on today's lower property values, the risk to the Federal government should be even lower than that of historical failure rates for similar loans.

Conclusion

A balanced Main Street/Wall Street approach to the multi-trillion dollar commercial real estate challenge will produce excellent fiscal results for the federal government while ensuring that the federal government does not have to bail out financial institutions and local governments in the future. Saving the commercial real estate market from collapse will not only preserve the fragile recovery that may now be under way—it's also good business for taxpayers.

Endnotes

¹ Stacy Mitchell, "Sharp Rise in Shopping Center Vacancies," *Main Street News*, July 2008.

² Neil Irwin, "Fed Widens Effort to Back Commercial Real Estate Loans," *Washington Post*, May 20, 2009.

³ Matthew Anderson and Susan Persin, "Commercial Mortgage Outlook: Growing Pains in Mortgage Maturities," *Foresight Analytics*, March 17, 2009.

⁴ Matthew Anderson, "Nightly Business Report," Transcript from interview: "Reviving the Economy: Real Estate," April 16, 2009.

⁵ Matthew Anderson, "Nightly Business Report," Transcript from interview: "Reviving the Economy: Real Estate," April 16, 2009.

⁶ Ilaina Jones, Reuters, "U.S. Commercial Property Faces Default Decade: Report," May 7, 2009.

⁷ *Ibid.*

⁸ *Ibid.*

⁹ Anderson and Persin, March 17, 2009.

¹⁰ *Ibid.*