S. HRG. 111–320

COMMERCIAL REAL ESTATE

FIELD HEARING

CONGRESSIONAL OVERSIGHT PANEL

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

HEARING HELD IN ATLANTA, GEORGIA, JANUARY 27, 2010

Printed for the use of the Congressional Oversight Panel

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CONGRESSIONAL OVERSIGHT PANEL

PANEL MEMBERS

ELIZABETH WARREN, *Chair*

RICHARD H. NEIMAN

PAUL ATKINS

DAMON SILVERS

J. MARK MCWATTERS

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ATLANTA FIELD HEARING ON COMMERCIAL REAL ESTATE

WEDNESDAY, JANUARY 27, 2010

U.S. CONGRESS,
CONGRESSIONAL OVERSIGHT PANEL,
Atlanta, GA

The Panel met, pursuant to notice, at 10:04 a.m. in room 132, Georgia Institute of Technology, 85 Fifth Street, NW, Atlanta, Georgia 30308, Elizabeth Warren, Chair of the Panel, presiding.

Present: Elizabeth Warren [presiding], Damon Silvers, Richard Neiman, Paul Atkins, and Mark McWatters.

Index: Elizabeth Warren, Damon Silvers, Richard Neiman, Paul Atkins, and Mark McWatters.

OPENING STATEMENT OF ELIZABETH WARREN, CHAIR, CONGRESSIONAL OVERSIGHT PANEL

Chair WARREN. This hearing of the Congressional Oversight Panel will now come to order. My name is Elizabeth Warren. I'm the Chair of the Congressional Oversight Panel. I'd like to start this morning by thanking Georgia Tech for the use of the facilities, and I also want to thank the staff of Congressman John Lewis for working with us and with our staff in helping to plan this hearing.

I am joined this morning by the rest of our panel. The Deputy Chair, Damon Silvers of the AFL–CIO, and then further down on my left is Superintendent of Banking for the State of New York, Richard Neiman. On my right is Paul Atkins, who a former Commissioner of the Securities and Exchange Commission, and on my far right is Mark McWatters an attorney and certified public accountant. This is the full Congressional Oversight Panel. We are glad that we can all be with you today to learn about commercial real estate.

And I would like to start by recognizing the Mayor of Atlanta. We are honored to have you here, Mr. Mayor, and hope that you can give us some remarks to help us get started on this hearing. Mr. Mayor.

STATEMENT OF KASIM REED, MAYOR OF ATLANTA

Mr. REED. Madam Chair, distinguished members of the Panel, welcome to Atlanta.

Good morning. It's a pleasure to welcome you to our city and to one of the nation's premier institutions of higher learning, Georgia Tech. I believe that Georgia Tech is an ideal environment for this important panel to conduct its work. Problem solving is indeed etched into its culture. Known for educational excellence and academic rigor, the solution to many, many tough problems have been conceived on this historic campus. It is my sincere hope that this tradition will continue as some of our country's greatest tests face us right now.

As a newly elected mayor, I am especially grateful that the Congressional Oversight Panel has chosen our city as the site for these crucial discussions on the condition of the commercial real estate market. Atlanta is a city whose fiscal ebb and flow is closely tied to the fortunes of this sector of the local and national economy.

It is not news to anyone certainly in this room that our city has been one of the hardest hit commercial real estate markets in the United States. Commercial property values have seen sharp declines. Applications for new construction permits have fallen off to the most alarming levels that I have seen in 50 years, and we have had more than 30 banks fail in Georgia in the last two years. The current rate of decline is untenable. I use the word untenable after much consideration because a declining commercial real estate market has a compounding impact on our city's tax base, our employment levels, and the availability of affordable housing for our families, and this threat to the vitality of our city, our nation, and our state must be met with action.

That said, I do want members of this panel to know that the scope of the challenges that Atlanta faces are substantial, but we are willing to work as partners. Our citizens are uniquely aware of the existing realities and the burdens to be born in order to turn around our local, regional, and national economy, but we are also very optimistic in our hope that there is an impending recovery. And we know that your work is an important part of the recovery. We hope that the solutions developed from today's discussion will play a role in the reversal of fortune within the commercial real estate market and, by extension, the larger economy.

Please know that in our city you have a partner who is willing to work with experts from the public and private sector to stabilize the various markets within our economy. Thank you for the opportunity to speak with you today, and may your hearings be just as productive as they are necessary. Thank you, and welcome to Atlanta.

Chair WARREN. Thank you very much, Mr. Mayor. We appreciate it. We are going to start with some opening statements from the panelists and then we'll call our first panel of witnesses. So thank you, Mr. Mayor, for being with us.

Mr. REED. Thank you.

Chair WARREN. The Congressional Oversight Panel was established in October of 2008 to oversee the expenditure of the $700 billion dollar Troubled Asset Relief Program, or TARP, as it is commonly known. We issue reports every month on different topics, mostly trying to evaluate the Treasury Department's administration of this program and their efforts to stabilize our economy. As part of our work, we travel from area to area to try to go to the places that have been hard hit by various aspects of the financial crisis. This morning we have come to Atlanta to learn more about the wave of foreclosures and vacancies sweeping through your commercial real estate markets.

To prepare for this hearing we did some research and what we discovered was deeply disturbing. We learned that vacancy rates for Atlanta retail and office space grew throughout 2009, eventually topping 20 percent. Commercial property values have declined across the board and the price per square foot of office space has fallen by 50 percent. These declines have severely threatened bank balance sheets, contributing to the failure of 30 Georgia banks since August of 2008, more than any other state in the nation.

Many experts believe that Atlanta's experience could foreshadow a problem that could echo across the country. Such a crisis could cause damage far beyond the borrowers and lenders who participate in any one transaction. More empty storefronts means more lost jobs, more lost productivity, and prolonged pain for middle-class families. Commercial loan defaults could lead to deep losses for banks and potentially raise the specter of more taxpayer-funded bailouts.

Foreclosures in apartment complexes and multifamily housing developments could push families out of their residences even if they have never missed a rent payment. And because the modern financial industry is so deeply interconnected, a downturn in the commercial credit markets could spread to the rest of our financial system.

Against this backdrop, the Panel is holding today's hearing to explore the troubles in commercial real estate. We hope that by learning from Atlanta's experiences, we may better advance our oversight responsibilities and public understanding of this important problem. No one can predict the course that commercial real estate will take. The problems appear at a time when banks are already weakened by massive losses. So we need to closely examine the stability of our banks.

For example, the stress test conducted last year examined financial institutions only through 2010. We ask the question how these institutions will cope with a commercial real estate crisis that may produce losses in 2011, 2012, and 2013. Whether or not Treasury and Federal Reserve have fully examined this question and made appropriate provisions will be a part of our oversight question. And given that TARP itself is due to expire in October of this year, we raise a question about how much TARP can do to address these challenges.

We also note that commercial real estate poses particular threats to small and midsize banks, which are often the key sources of loans for commercial projects in their communities. Given these smaller banks have never faced stress tests, how likely are smaller financial institutions to survive a significant shock in commercial real estate? How can the Treasury's programs, which until now have focused on supporting the very largest financial institutions, provide adequate support to smaller banks? What are the implications for the FDIC if the rate of bank failures, already high, starts to rise at a steeper rate?

These are hard questions, and we are grateful to be joined by experts who can begin to find the answers, including government experts representing the Federal Reserve, the FDIC, as well as local bankers and investors. We thank you all for your willingness to share your perspectives and we look forward to your testimony.

The Chair calls on Mr. Atkins, if you'd like to make some opening remarks.

[The prepared statement of Chair Warren follows:]

ELIZABETH WARREN, CHAIR
PAUL S. ATKINS
RICHARD H. NEIMAN
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Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Elizabeth Warren

Congressional Oversight Panel Field Hearing on Commercial Real Estate

Atlanta, Georgia
January 27, 2010

Good morning. My name is Elizabeth Warren, and I am the Chair of the Congressional Oversight Panel. I would like to begin by extending our sincere thanks to the City of Atlanta and to Georgia Tech for hosting us and for helping to plan today's hearing.

Congress established our Panel in October of 2008 to oversee the expenditure of funds from the $700 billion Troubled Asset Relief Program, commonly referred to as the TARP. We issue monthly oversight reports that analyze and evaluate the Treasury Department's administration of this program and their efforts to stabilize our economy.

As part of our work, we travel from time to time to areas of the country that have been especially hard-hit by aspects of the financial crisis. This morning, our work has brought us to Atlanta to learn more about the wave of foreclosures and vacancies sweeping through your commercial real estate markets.

To prepare for this hearing, we did some research—and what we discovered was deeply disturbing. We learned that vacancy rates for Atlanta retail and office space grew throughout 2009, eventually topping 20 percent. Commercial property values have declined across the board, and the price-per-square-foot of office space has fallen by 50 percent. These declines have severely threatened bank balance sheets, contributing to the failures of 30 Georgia banks since August of 2008—more than in any other state in the nation.

Many experts believe that Atlanta's experience could foreshadow a problem that could echo across the country. Such a crisis could cause damage far beyond the borrowers and lenders who participate in any one transaction. More empty storefronts could translate into more lost jobs, more lost productivity, and prolonged pain for middle-class families. Commercial loan defaults could lead to deep losses for banks and, potentially, to raise the specter of more taxpayer-funded bailouts. Foreclosures of apartment complexes and multi-family housing developments could push families out of their residences—even if they have never missed a rent payment. And because the modern financial industry is so deeply interconnected, a downturn in the commercial credit markets could spread to the rest of our financial system.

Against this backdrop, the Panel is holding today's hearing to explore the troubles in commercial real estate. We hope that, by learning from Atlanta's experiences, we may better advance our oversight responsibilities and public understanding of this important problem.

Congressional Oversight Panel

Although no one can predict the course that the commercial real estate markets will take, the problems appear at a time when banks have already experienced massive losses. We should closely examine their stability. For example, the stress tests conducted of America's largest banks examined their financial standing only through 2010. How will these institutions cope if a commercial real estate crisis causes severe losses in 2011, 2012, and 2013? Have Treasury and the Federal Reserve fully examined this question? And, given that TARP itself is due to expire in October of this year, how much can TARP do to address these challenges?

Commercial real estate also poses particular threats to small- and mid-sized banks, which are often the key sources of loans for commercial projects in their communities. Given that these smaller banks have never faced stress tests, how likely are small financial institutions to survive a significant shock in commercial real estate? How can Treasury's programs, which until now have focused on supporting the very largest financial institutions, provide support to smaller banks? What are the implications for the FDIC if the rate of bank failures, already high, starts to rise at a steeper rate?

These are hard questions, and we are grateful to be joined by experts who can begin to find answers, including government experts representing the Federal Reserve and the Federal Deposit Insurance Corporation, as well as local bankers and investors. We thank you for your willingness to share your perspectives, and we look forward to your testimony.

STATEMENT OF PAUL ATKINS, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Mr. ATKINS. Thank you, Madam Chair, and thank you all for coming today. And thank you, Mr. Mayor for your kind remarks and welcome to the city. And thank you very much to the witnesses who have come to appear before us today and share their insights. I very much look forward to hearing from you today.

There is no question that commercial real estate in the U.S. experienced a boom in the last ten years just like in the residential housing market. Business confidence was high. Risk capital was available aplenty. The cost of money was low, even by historical standards. So even what might have been marginal deals seemed to have gotten done anyway. So too much money was chasing too few deals.

I want to leave as much time as possible for the witnesses to talk, so I don't want to talk myself today. But the things that I really am interested in hearing about from the witnesses, of course, is the current state of the commercial real estate market here in Atlanta and also in the United States as a whole. And the two aspects of that that are really crucial to me are, obviously, we have a clear oversupply of commercial real estate space. But is our problem just a supply side one? What about the demand side? Obviously, we have been and are still going through economic issues on the national level and even on the global level. And so some of those economic problems, obviously, are affecting the demand for commercial real estate space. People are reluctant to invest or take on obligations of new loans or take on risk because of uncertainty in the future. That has to do with microeconomic and macroeconomic regulatory and legislative issues, taxation, fiscal issues, all those sorts of things, and I'd love to hear your perspective on how those compare here in Atlanta and also the United States as a whole.

So thank you very much, and I yield the balance of my time.

Chair WARREN. Thank you. Mr. Silvers.

STATEMENT OF DAMON SILVERS, DEPUTY CHAIR, CONGRESSIONAL OVERSIGHT PANEL

Mr. SILVERS. Thank you, Madam Chair. Good morning. Like my fellow panelists, I'm very pleased to be here in Atlanta and grateful for the help and the presence here today of Atlanta's mayor, Kasim Reed. I also want to extend my appreciation again for the assistance of the office of Congressman John Lewis, one of the people in public life whom I admire most.

The Emergency Economic Stabilization Act of 2008, which gave rise to TARP, sought to address both the immediate and acute crisis that ripped world markets in October of 2008 and the deeper causes of that crisis in the epidemic of residential foreclosures. The purpose of the Act was not to stabilize the financial system for its own sake, but to do so in order that the financial system could play its proper role of providing credit to Main Street. Since this panel began its work a little more than a year ago, we have continued to ask three questions. First, is TARP working effectively to stabilize the financial system? Secondly, is that same financial system, as a result of TARP, doing its job of providing credit to Main

Street, and, three, is TARP functioning in a way that is fair to the American people?

Today's hearing on the impact of difficulties in the commercial real estate market is really about all three of these questions. There is three-and-a-half trillion dollars in U.S. commercial real estate debt. Five hundred billion of that debt will mature in the next few years. There was clearly a bubble in the commercial real estate values prior to 2008. We've heard already a fair amount about that. But it is not clear the extent of the bubble. Meaning it's not clear how much of those—of those values were unsustainable and how much was real. As a result, the return of commercial real estate prices to levels that are supported by real estate fundamentals is a potential source of systemic risk.

For example, recently Bank of America was allowed to repay TARP funds in a manner that weakened its Tier 1 Capital ratios. Meanwhile, here in Atlanta, Bank of America is dealing with large commercial real estate problem loans in properties like Streets of Buckhead, and it's quite unclear what the outcome in those circumstances is going to be.

In addition, it is unclear whether the financial system as a whole is healthy enough to provide financing for properties even when they are properly priced, let alone financing for new development.

Finally, there is the question of the impact of the decline on commercial real estate values on smaller banks. This goes to the fairness point part of our mission. In Georgia there have been 30 bank failures since August of 2008. These banks have gone through the FDIC resolution process resulting, insofar as I know, their disappearance as independent entities.

The contrast between the impact of the financial crisis on small banks and on very large failing financial institutions, that received both extraordinary TARP assistance and assistance from the Federal Reserve System, appears to raise fundamental issues of fairness.

I hope in this hearing we will address these questions, and, in the process, help the Panel to advise the Treasury Department and Congress as to what steps, if any, need to be taken in the area of commercial real estate. I do not believe it is either desirable or possible to prevent commercial real estate prices from returning to sustainable levels. The goals here should be to ensure that the collapse of the bubble in commercial real estate has little, if any, systemic impact, that financing remains available for both existing property and new construction that is rationally priced, and that the federal government conducts itself in this area in a manner that is fair to both small and big financial institutions and to communities where commercial real estate financing is vital to maintaining community vitality and jobs.

In reviewing the materials our staff helpfully provided for this hearing and the testimony of our witnesses, I cannot help but be struck by the contrast between the bonuses being announced this week by the institutions the public rescued on Wall Street and the unabated tide here in Atlanta and across this country of unemployment, residential and commercial foreclosures, and jobs that, not only are lost, but not being created.

President Obama has rightly asked the big banks to help pay for TARP, but more needs to be done to restore fairness to our economy and financial system. I hope that this hearing can provide concrete ideas we can bring back to the Treasury and Congress for how TARP can be managed to be part of the solution the Mayor referred to earlier for communities like Atlanta. Solutions that lead the financial system to play in its proper role as a creator and not a destroyer of jobs and communities. Thank you.

[The prepared statement of Mr. Silvers follows:]

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Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Damon Silvers

Congressional Oversight Panel Field Hearing on Commercial Real Estate

Atlanta, Georgia
January 27, 2010

Good morning. Like my fellow panelists, I am very pleased to be here in Atlanta, and grateful for the help and presence here today of Atlanta's mayor, Kasim Reed. I would also like to express my thanks to all our witnesses, and in particular to the FDIC and the Federal Reserve Bank of Atlanta for the work both institutions have done analyzing the state of commercial real estate in the Southeast.

The Emergency Economic Stabilization Act of 2008, which gave rise to TARP, sought to address both the immediate acute crisis that gripped world markets in October, 2008, and the deeper causes of that crisis in the epidemic of residential foreclosures. The purpose of the Act was not to stabilize the financial system for its own sake, but to do so in order that the financial system could play its proper role of providing credit to Main Street.

Since this Panel began its work a little more than a year ago, we have continued to ask three questions—(1) Is TARP working to stabilize the financial system; (2) Is the financial system doing its job of providing credit to Main Street; and (3) is TARP functioning in a way that is fair to the American people.

Today's hearing on the impact of difficulties in the commercial real estate market is really about all three of these questions. There is $3.5 trillion in U.S. commercial real estate debt. $500 billion of that debt will mature in the next few years. There was clearly a bubble in commercial real estate values prior to 2008, though it is not clear the extent of the bubble. As a result, the return of commercial real estate prices to levels that are supported by real estate fundamentals is a potential source of systemic risk. For example, recently Bank of America was allowed to repay TARP funds in a manner that weakened its Tier 1 Capital ratios. Meanwhile, here in Atlanta Bank of America is dealing with large commercial real estate problem loans in properties like Streets of Buckhead.

In addition, it is unclear whether the financial system is healthy enough to provide financing for properties even when they are properly priced, let alone financing for new development.

Finally, there is the question of the impact of the decline of commercial real estate values on smaller banks. Here in Georgia there have been thirty bank failures since August of 2008. These banks have gone through the FDIC resolution process resulting in their disappearance as independent entities. The contrast between the impact of the financial crisis on small banks and on very large failing financial institutions that received both extraordinary TARP assistance and assistance from the Federal Reserve System appears to raise fundamental issues of fairness.

I hope this hearing will address these questions, and in the process help the Panel to advise the Treasury Department and the Congress as to what steps if any need to be taken in the area of commercial real estate. I do not believe it is either desirable or possible to prevent commercial real estate prices from returning to sustainable levels. The goals here should be to ensure that the collapse of the bubble in commercial real estate has little if any systemic impact, that financing remains available for both existing property and new construction that is rationally priced, and that the federal government conducts itself in this area in a manner that is fair to both small and big financial institutions, and to communities where commercial real estate financing is vital to maintaining community vitality and jobs.

In reviewing the materials our staff helpfully provided for this hearing, I cannot help but be struck by the contrast between the bonuses being announced this week by the institutions the public rescued on Wall Street, and the unabated tide here in Atlanta and across this country of unemployment, residential and commercial foreclosures. President Obama has rightly asked the big banks to help pay for TARP. But more needs to be done to restore fairness to our economy and our financial system. I hope that this hearing can provide concrete ideas that we can bring back to the Treasury Department and the Congress for how TARP can be managed to be part of the solution for communities like Atlanta—solutions that lead to the financial system playing its proper role as a creator, and not a destroyer of jobs and communities.

Chair WARREN. Thank you, Mr. Silvers. Mr. McWatters.

STATEMENT OF J. MARK McWATTERS, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Mr. MCWATTERS. Thank you, Professor Warren. I very much appreciate the attendance of the distinguished witnesses that we have today, and I look forward to hearing your views. In order to suggest a solution to the challenges currently facing the commercial real estate or CRE market, it is critical that we thoughtfully identify the sources of the underlying difficulties. Without a proper diagnosis, it is likely that we may craft an inappropriately targeted remedy with adverse, unintended consequences. Broadly speaking, it appears that today's CRE market is faced with both an oversupply of CRE facilities and an undersupply in prospective tenants and purchasers.

In my view, there has been an unprecedented collapse of demand for CRE property, and many potential tenants and purchasers have withdrawn from the CRE market, not simply because rental rates and purchase prices are too high, but because the business operations do not presently require additional CRE facilities.

Over the past few years, while CRE developers have constructed new facilities, the end users of such facilities have suffered the worst economic downturn in several generations. Any posited solution to the CRE problem that focuses only on the oversupply of 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 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 portfolio loans. In some instances, creditors are acknowledging economic reality and writing their loans down to the market 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 losses and the attendant reductions in regulatory capital.

While each approach may offer assistance in specifically tailored instances, neither addresses the underlying economic reality of too few tenants and purchasers for CRE properties. Until small and large businesses regain the confidence to hire new employees and expand their business operations, it is doubtful the CRE market will sustain a meaningful recovery. As long as business persons are faced with the multiple challenges of rising taxes, increasing regulatory burdens, enhanced political risks associated with unpredictable governmental interventions in the private sector, as well as uncertain healthcare and energy costs, it is unlikely that they will enthusiastically assume the entrepreneurial risk necessary for protracted economic expansion and a recovery of the CRE market.

It is fundamental to acknowledge that the American economy grows one job and one consumer purchase at a time, and that the CRE market will recover one lease, one sale, and one financing at a time. With the ever expanding array of less than friendly rules, regulations, and taxes facing business persons and consumers, we should not be surprised that businesses remain reluctant to hire new employees, consumers remain cautious about spending, and the CRE market continues to struggle.

The problems presented by today's CRE market would be far easier to address if they were solely based upon the mere oversupply of CRE facilities in certain well-delineated markets. In such event, a combination of restructurings, refinancings, and foreclosures would most likely address the underlying difficulties. Unfortunately, the CRE market must also assimilate a remarkable drop in demand from prospective tenants and purchasers with CRE properties who are suffering a reversal in their business operations and prospects.

In my view, the Administration could promptly jumpstart the CRE market as well as the overall economy by sending an unambiguous message to the private sector that it will not directly or indirectly raise taxes or increase the regulatory burden of CRE participants and other business enterprises. Without such express action, the recovery in the CRE market will most likely proceed at a sluggish and costly pace that may foreshadow the Secretary's allocation of additional TARP funds to financial institutions that hold CRE loans and commercial mortgage-backed securities.

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

[The prepared statement of Mr. McWatters follows:]

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Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of J. Mark McWatters

Congressional Oversight Panel Field Hearing on Commercial Real Estate

Atlanta, Georgia
January 27, 2010

Thank you Professor Warren.

I very much appreciate the attendance of the distinguished witnesses that we have today. I look forward to hearing their views.

There is little doubt that much uncertainty exists within the present commercial real estate, or CRE, market. According to the Real Estate Roundtable[1]:

i. CRE values have declined by approximately $2 trillion since June 2008;

ii. Approximately $3.3 trillion of CRE debt remains outstanding;

iii. Approximately $300 billion of CRE debt matures annually, yet existing financial institutions cannot meet the refinancing demand;

iv. Banks hold over $500 billion of construction and land development loans and exposure is far higher for regional and community banks than for money center institutions;

v. Banks and commercial mortgage-backed securities, or CMBS, provide approximately 80 percent of the CRE debt financing, yet both sources remain substantially shut down to new lending;

vi. Distressed loans in special servicing are growing at a rate of $2-3 billion per month; and

vii. Broad based recognition of CRE related losses has yet to occur and significant problems are expected in 2010-2012.

In order to suggest a solution to the challenges currently facing the CRE market it is critical that we thoughtfully identify the sources of the underlying difficulties. Without a proper diagnosis it is likely that we may craft an inappropriately targeted remedy with adverse unintended consequences.

Broadly speaking, it appears that today's CRE industry is faced with both an oversupply of CRE facilities *and* an undersupply of prospective tenants and purchasers. In my view, there has been an unprecedented collapse in demand for CRE property and that 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

[1] See www.rer.org.

business operations do not presently require additional CRE facilities. Over the past few years while CRE developers have constructed new office buildings, hotels, multi-family housing, retail and shopping centers and manufacturing and industrial parks, the end users of such facilities have suffered the worst economic downturn in several generations. Any posited solution to the CRE problem that focuses only on the oversupply of 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 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 portfolio loans. In some instances creditors are acknowledging economic reality and writing their loans down to market value with, perhaps, the retention of an equity participation right. In other cases lenders 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 losses and the attendant reductions in regulatory capital. While each approach may offer assistance in specifically tailored instances, neither addresses the underlying economic reality of too few tenants and purchasers of CRE facilities.

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

The problems presented by today's CRE market would be far easier to address if they were solely based upon the mere oversupply of CRE facilities in certain well delineated markets. In such event, a combination of restructurings, refinancings and foreclosures would most likely address the underlying difficulties. Unfortunately, the CRE market must also assimilate a remarkable drop in demand from prospective tenants and purchasers of CRE properties who are suffering a reversal in their business operations and prospects.

In my view, the Administration could jump start the prompt and robust recovery of the CRE market--as well as the overall U.S. economy--by sending an unambiguous message to the private sector that it will not directly or indirectly raise the taxes or increase the regulatory burden of CRE market participants and other business enterprises. Without such express action, the recovery of the CRE market will most likely proceed at a sluggish and costly pace that may foreshadow the Secretary's allocation of additional TARP funds to financial institutions that hold CRE loans and commercial mortgage-backed securities.

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

Chair WARREN. Thank you, Mr. McWatters. Superintendent Neiman.

STATEMENT OF RICHARD NEIMAN, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Mr. NEIMAN. Thank you. I am very pleased to be here in Atlanta. Atlanta has a special meaning to me. I went to law school here at Emory. I even started my career in bank regulation here in Atlanta as an intern for the regional office of the control of the currency.

This hearing continues the Panel's commitment to issues around it, credit availability, community banking, and commercial real estate. It's been six months since our first hearing on these issues, which was held in New York City, and it is the right time to revisit them.

New York has a unique concentration of commercial real estate properties. But, as the recession has lingered, regional business hubs, such as Atlanta, are under increasing pressure as well. Atlanta, in particular, experienced a surge in commercial real estate development during the boom years. And from my days here in Atlanta, I vividly recall—in fact, I even worked at the Hyatt Regency in the sky bar that went around the restaurant, around and around. You could see the entire city, and now you're looking probably at the thirtieth floor of the building next to you.

Now high vacancy rates for office space here are compounding as a fallout from the financial crisis. Reevaluating the growing risks in this sector is a top priority, and that is why commercial real estate is the subject of the Panel's first hearing in the New Year. Commercial real estate is not a boutique lending niche of importance only to a subset of lenders and borrowers. Commercial real estate impacts every community on multiple levels, so understanding this sector is an important aspect of stabilizing our national economy.

When people think of commercial real estate they often just think of properties, such as office buildings, shopping malls, and hotels, but commercial real estate also includes multifamily and affordable housing units, from rental apartment complexes to condos. This is the financing that provides accommodation for jobs, for conducting business, and for living.

I know that we will hear a lot today about the risk that troubled commercial real estate loans present for bank balance sheets, and that is certainly a critical consideration, particularly for me, as a bank regulator. But financial stability begins and ends with the well-being of our neighborhoods, and our families, and our national economy. It is the health of our communities that is our ultimate concern.

For multiple family buildings in particular, there is a concern that the property's condition will deteriorate as the owner's cash flow is diverted to making debt payments. Further, tenants who pay their rent on time can find themselves homeless because their landlord defaulted on the underlying commercial mortgage.

In New York we are developing progressive solutions that can serve as models for stabilizing multifamily housing units nationwide. Foremost is Governor Patterson's 2009 mortgage reform legislation, which provides new protections for renters when their landlord is in foreclosure. Our state housing finance agency is also developing a pilot program to convert unused luxury units to affordable housing.

There is still another way in which commercial real estate intersects with people's daily lives, and that is the impact of community banks. Community banks not only provide a proportionately large share of commercial real estate financing, they also are key sources of credit to small businesses, an engine of growth for job creation. We have seen growing numbers of smaller banks fail recently and anticipate that this trend will continue. These small bank failures, which could be increasingly driven by commercial real estate defaults, creates holes in our communities. Where there was once a flourishing center for responsible hometown lending, there can be a vacuum. This means less credit may be available for small businesses as well as for consumer lending.

The meltdown in residential subprime mortgages caught many by surprise. But with commercial real estate we have more advance warning of the scope and the magnitude of the developing problem. It is my hope and intent that today's hearing will not only assess the magnitude of the problem, but will also explore potential market-based and public policy solutions. I look forward to your testimony and to your innovative ideas. Thank you.

[The prepared statement of Mr. Neiman follows:]

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Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Richard Neiman

Congressional Oversight Panel Field Hearing on Commercial Real Estate

Atlanta, Georgia
January 27, 2010

Good morning. I am pleased to be here in Atlanta to continue the Panel's commitment to issues around commercial real estate. It has been six months since our first hearing on this area, which was held in New York City, and it is the right time to revisit these critical issues.

New York has a unique concentration of commercial properties, but as the recession has lingered, regional business hubs such as Atlanta are under increasing pressure as well. Atlanta in particular experienced a surge in commercial real estate development during the boom years. Now, high vacancy rates for office space here are compounding the fallout from the financial crisis.

Reevaluating the growing risks in this sector is a top priority, and that is why commercial real estate is the subject of the Panel's first hearing in the New Year. Commercial real estate is not a boutique lending niche, of importance only to a subset of lenders and borrowers. Commercial real estate impacts every community on multiple levels, so understanding this sector is an important aspect of stabilizing our national economy.

When people think of commercial real estate, they often just think of properties such as office buildings, shopping malls, and hotels. But commercial real estate also includes multifamily and affordable housing units, from rental apartment complexes to condos. This is the financing that provides accommodation for jobs, for conducting business, and for living.

I know that we will hear a lot today about the risks that troubled commercial real estate loans present for bank balance sheets, and that is certainly a critical consideration, particularly for me as a bank regulator. But financial stability begins and ends with the well-being of our neighborhoods and families and national economy. It is the health of our communities that is our ultimate concern.

For multifamily buildings in particular, there is a concern that the property's condition will deteriorate as owners' cash flow is diverted to making debt payments. Further, tenants who pay their rent on time can find themselves homeless, because their landlord defaulted on the underlying commercial mortgage.

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Congressional Oversight Panel

There is still another way in which commercial real estate intersects with people's daily lives, and that is in the impact on community banks. Community banks not only provide a proportionately large share of commercial real estate financing, they also are key sources of credit to small businesses, an engine of growth for job creation.

We have seen growing numbers of smaller banks fail recently, and anticipate this trend will continue. These small bank failures, which could be increasingly driven by commercial real estate defaults, create holes in our communities. Where there once was a flourishing center for responsible hometown lending, there can be a vacuum. This means less credit may be available for small businesses, as well as for consumer lending.

The meltdown in residential subprime mortgages caught many by surprise. But with commercial real estate, we have more advance warning of the scope of the developing problem.

It is my hope and intent that today's hearing will not only assess the magnitude of the problem, but will also explore potential market-based and public policy solutions.

I look forward to your testimony this morning, and to your innovative ideas.

Chair WARREN. Thank you Superintendent Neiman. We call our first panel now. Our first panel, while they are taking their places, I will go ahead and introduce them. Our first panel of witnesses today will consist of government banking regulators from the Federal Reserve and the Atlanta office of the FDIC. And I'm pleased to welcome Jon Greenlee, who is the Associate Director of the Division of Banking and Supervision for the Board of Governors of the Federal Reserve System. Thank you, Mr. Greenlee. And Doreen Eberley, the Acting Director of the Atlanta Regional Office of the FDIC.

I am going to ask each of you if you would limit your oral remarks to five minutes, but we have read your testimony and it will become part of the written record of this hearing. So with that, I would like to present you Mr. Greenlee for five minutes.

STATEMENT OF JON GREENLEE, ASSOCIATE DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE

Mr. GREENLEE. Thank you, Chair Warren, and members Neiman, Silvers, Atkins and McWatters. I appreciate the opportunity to appear before you today to discuss trends in the commercial real estate sector and other issues related to the condition of the banking system. Although conditions in the financial markets continue to show improvement, significant stress remains and borrowing by business and households sectors remain weak. The condition of the banking system remains far from robust, loan quality continues to deteriorate across many asset classes because of the economic downturn, increases in unemployment, and weaknesses in real estate markets. As a result, many banking organizations have experienced significant losses and are challenged by poor earnings and concerns about capital adequacy.

In Georgia, the performance of banking organizations has also deteriorated. Like their counterparts nationally, banks in Georgia have seen a steady rise in non-current loans and provisions for loan losses, which have weighed on bank earnings and capital, and 30 banks have failed in the state since the turmoil in financial markets first emerged.

Substantial financial challenges remain, and, in particular, for those banking organizations that have built up unprecedented concentrations in commercial real estate loans, given the current strains in the real estate markets.

From a supervisory perspective, the Federal Reserve has been focused on CRE exposures for some time. In 2006 we led the development of interagency guidance on CRE concentrations to highlight the importance of strong risk management over these types of exposures.

On October 30th of last year the federal and state banking agencies, including my colleagues at the FDIC, issued guidance on CRE loan restructuring and workouts. This guidance is designed to address concerns that examiners may not always take a balanced approach to the assessment of CRE loans. One of the key messages in the guidance was that for renewed or restructured loans in which borrowers who have the ability to repay their debt according to reasonably modified terms, will not be subject to examiner criticism.

Consistent with our longstanding policies, this guidance supports balanced and prudent decision-making with respect to loan restructuring and timely recognition of losses. At the same time, our examiners have observed incidents where banks have been slow to acknowledge declines in commercial real estate cash flows and collateral values in their assessment of potential loan repayment.

As noted in the guidance, the expectation is that the bank should restructure CRE loans in a prudent manner and not simply renew a loan to avoid a loss recognition.

Immediately after the release of this guidance, the Federal Reserve developed an enhanced examiner training program and we have engaged in outreach with the industry to underscore the importance of the principles laid out in that guidance.

Finally, in late November, the Federal Reserve's TALF program financed the first issuance of CMBS since mid-2008. Investor demand was high. And in the end, non-TALF investors purchased almost 80 percent of the TALF eligible securities. Shortly thereafter, two additional CMBS deals without TALF support came to market and were positively received by investors. Irrespective of these positive developments, market participants anticipate that CMBS delinquency rates will continue to increase in the near term.

In summary, it will take some time for the banking industry to work through this current set of challenges and for the financial markets to fully recover. The Federal Reserve is committed to working with Congress and the other banking agencies to promote the concurrent goals of fostering credit availability and a safe and sound banking system. Accordingly, we thank you for holding this important hearing, and I look forward to your questions. Thank you.

[The prepared statement of Mr. Greenlee follows:]

For release on delivery
10 a.m. EST
January 27, 2010

Statement of

Jon D. Greenlee

Associate Director

Division of Bank Supervision and Regulation

Board of Governors of the Federal Reserve System

before the

Congressional Oversight Panel

Field Hearing

Atlanta, Georgia

January 27, 2010

Chair Warren, and members Neiman, Silvers, Atkins and McWatters, I appreciate the opportunity to appear before you today to discuss trends in the commercial real estate (CRE) sector and other issues related to the condition of the banking system. First, I will discuss overall credit conditions and bank underwriting standards, and I will briefly address conditions in Georgia. I will then describe current conditions in commercial real estate markets and outline Federal Reserve activities to enhance liquidity and improve conditions in financial markets to support the flow of credit to households and businesses, including certain activities that have a direct impact on CRE markets. Finally, I will discuss the ongoing efforts of the Federal Reserve to ensure the overall safety and soundness of the banking system, as well as actions taken to promote credit availability.

Background

The Federal Reserve has supervisory and regulatory authority for bank holding companies (BHCs), state-chartered banks that are members of the Federal Reserve System (state member banks), and certain other financial institutions and activities. We work with other federal and state supervisory authorities to ensure the safety and soundness of the banking industry, foster stability of the financial system, and provide for the fair and equitable treatment of consumers in financial transactions. While the Federal Reserve is not the primary federal supervisor for the majority of commercial banks, it is the consolidated supervisor of BHCs, including financial holding companies, and conducts inspections of those institutions.

Under existing law, the primary purpose of inspections is to ensure that the holding company and its nonbank subsidiaries do not pose a threat to the BHC's depository subsidiaries. In fulfilling this role, the Federal Reserve is required to rely to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the BHC's depository, securities, or insurance subsidiaries. The Federal Reserve is also the primary federal supervisor of state member banks, sharing supervisory responsibilities with state agencies. In this role, Federal Reserve supervisory staff regularly conduct on-site examinations and off-site monitoring to ensure the safety and soundness of supervised state member banks.

The Federal Reserve is involved in both regulation, establishing the rules within which banking organizations must operate, and supervision, ensuring that banking organizations abide by those rules and remain safe and sound. Because rules and regulations in many cases cannot reasonably prescribe the exact practices each individual bank should use for risk management, supervisors set out policies and guidance that expand upon requirements set in rules and regulations and establish expectations for the range of acceptable practices. Supervisors rely extensively on these policies and guidance as they conduct examinations and assign supervisory ratings.

Beginning in the summer of 2007, the U.S. and global economies entered a period of intense financial turmoil that has presented significant challenges for the financial services industry. These challenges intensified in the latter part of 2008 as the global economic environment weakened further. As a result, parts of the U.S. banking system have come under severe strain, with some banking institutions suffering sizable losses. The number of bank failures continues to rise, with some 140 banks having failed in 2009.

Conditions in Financial Markets and the Economy

Although the nationwide unemployment rate remains very high and real estate markets remain weak, conditions in financial markets have improved in recent months. In particular, the functioning of interbank and other short-term funding markets has improved considerably, interest rate spreads on corporate bonds have narrowed significantly, prices of syndicated loans have increased, and some securitization markets have resumed operation. In addition, equity prices have increased sharply, on net, since their low in early 2009.

Borrowing by households and businesses, however, has remained weak. Residential mortgage and consumer debt outstanding fell sharply in the first three quarters of last year, and the available data suggest that the decline continued in the fourth quarter. Nonfinancial business debt likely decreased again in the fourth quarter as decreases in commercial paper, commercial mortgages, and bank loans more than offset a solid pace of corporate bond issuance.

Some of this reduction in debt represents reduced demand for credit from borrowers who would like to deleverage. However, access to credit also remains difficult, especially for households and small businesses that depend significantly on banks for financing. Indeed, the most recent results from the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices indicate that both the availability and demand for bank loans are well below pre-crisis levels. In October, more banks reported tightening their lending standards on consumer and business loans than reported easing, although the degree of net tightening continues to decline from peaks reached in the latter part of 2008. The survey also suggests that demand for consumer and business loans remains weak. Of note, decreased loan demand from creditworthy borrowers was the most common explanation given by respondents for the contraction of business loans this past year.

Loan quality continued to deteriorate for both large and small banking institutions during the third quarter of 2009, the most recent period for which data are available. At the largest 50 bank holding companies, nonperforming assets continued to climb, raising the ratio of nonperforming assets to 4.8 percent of loans and other real estate owned on bank balance sheets. Most of the deterioration was concentrated in residential mortgages and CRE, but commercial loans also experienced rising delinquencies. Results of the banking agencies' Shared National Credits review, released in September, also document significant deterioration in the performance of large syndicated loans.[1] Similar trends are apparent at community and small regional banks: nonperforming assets increased to 4.6 percent of loans at the end of the third quarter of 2009, more than seven times the level for this ratio at year-end 2006, before the financial crisis began. Home mortgages and CRE loans accounted for most of the increase, but commercial loans have also shown marked deterioration during recent quarters.

Credit losses at banking organizations continue to rise, and banks face risks of sizable additional credit losses given the likelihood that employment will take some time to recover. In addition, while housing prices appear to have stabilized in recent months, foreclosures and mortgage loss severities are likely to remain elevated. Moreover, 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. In sum, banking organizations continue to face significant challenges, and credit conditions remain tight.

Performance of the Banking System

Despite these challenges, the stability of the banking system has improved over the past year. Importantly, the rigorous Supervisory Capital Assessment Program (SCAP) stress test, a program that was led by the Federal Reserve helped to increase public confidence in the banking system during a period of high stress. In the months since, and with the strong encouragement of the federal banking supervisors, many of these largest institutions have raised billions of dollars in new capital, improving their ability to withstand possible future losses and to extend loans as demand for credit recovers. Depositors' concerns about the safety of their funds during the

[1] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2009), "Credit Quality Declines in Annual Shared National Credits Review," joint press release, September 24.

immediate crisis in the fall of 2008 have also largely abated. As a result, financial institutions have seen their access to core deposit funding improve.

However, two years into a substantial economic downturn, loan quality continues to deteriorate across a number of asset classes, and, as noted earlier, has declined further as weakness in housing markets affects performance of residential mortgages and construction loans. Demand for commercial property, which is sensitive to trends in the labor market, has declined significantly and vacancy rates have increased. Hit hard by the loss of businesses and employment, an increasing amount of retail, office, and industrial space is standing vacant. In addition, many businesses have cut expenses by renegotiating existing leases. The combination of reduced cash flows and higher rates of return required by investors has lowered valuations, and many existing buildings are selling at a loss. As a result, credit conditions in CRE markets are particularly strained and commercial mortgage delinquency rates have increased rapidly. It is expected that all property types will continue to experience declining values and weak demand through the remainder of this year.

In Georgia, the performance of banking organizations has deteriorated significantly over the past several quarters as the region's real estate expansion reversed course. Like their counterparts nationally, Georgia banks have seen a steady rise in non-current loans and provisions for loan losses, which have weighed on bank earnings and capital. Since the turmoil in financial markets emerged more than two years ago, 26 banks in Georgia have failed. Notably, almost all of the banks that have failed in Georgia thus far were located in the metro-Atlanta market and had a high percentage of total loans in land acquisition, development, and construction. Most of the lending activity at these failed banks was related to the region's housing boom in the first half of this decade. Also of note, many of the failed banks relied heavily on brokered deposit funding, rather than core deposits, to support what had been very strong asset growth. By the end of 2007, the average ratio of brokered deposit funds was 13 percent at banks in Georgia, compared to just 7 percent at the national level.

In Atlanta, CRE conditions are largely dependent on employment trends and job losses have continued to rise as unemployment has risen above 10 percent in the region. Job losses are resulting in negative absorption rates for office, retail and warehouse space, with rents continuing to decline for all CRE property types. Business bankruptcies, a leading indicator for retail CRE performance, have risen 35 percent from a year ago. In addition, the rate of Home Price Appreciation (HPA) continues to erode in Atlanta while it appears to have stabilized in a number of major metropolitan areas.

Current Conditions in Commercial Real Estate Markets

All across the country, and in this region in particular, it is clear that significant financial challenges remain. Indeed, some large regional and community banking firms that have built up unprecedented concentrations in CRE loans will be particularly affected by conditions in real estate markets.

The Federal Reserve has been focused on CRE exposures at supervised institutions for some time. In response to rising CRE concentrations, especially in some large regional and community banking firms in the early part of this decade, and the central role of CRE loans in the banking problems of the late 1980s and early 1990s, we led an interagency effort to develop supervisory guidance on CRE concentrations. The guidance was finalized in 2006 and published in the Federal Register in early 2007.[2] In that guidance, we emphasized our concern that some

[2] See Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2007), "Interagency Guidance on Concentrations in Commercial Real Estate," Supervision and Regulation Letter SR 07-1 (January 4), www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.

institutions' strategic- and capital-planning processes did not adequately recognize the risks arising from their CRE concentrations. We also outlined our expectations that institutions with concentrations in CRE lending needed to perform ongoing assessments to identify and manage concentrations through stress testing and similar exercises to identify the impact of adverse market conditions on earnings and capital.

As weaker housing markets and deteriorating economic conditions have impaired the quality of CRE loans at supervised banking organizations, the Federal Reserve has devoted increasing resources to assessing the quality of CRE portfolios at regulated institutions. These efforts include monitoring the impact of declining cash flows and collateral values on CRE portfolios. Federal Reserve Banks that are located in more adversely affected geographic areas have been particularly focused on evaluating exposures arising from CRE lending.

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. As a result, developers, which typically depend on the sales of completed projects to repay their outstanding loans, are finding their ability to service existing construction loans strained.

Federal Reserve examiners are reporting a sharp deterioration in the credit performance of loans in banks' portfolios and loans in commercial mortgage-backed securities (CMBS). Of the approximately $3.5 trillion of outstanding debt associated with CRE, including loans for multifamily housing developments, about $1.7 trillion was held on the books of banks and thrifts, and an additional $900 billion represented collateral for CMBS, with other investors holding the remaining balance of $900 billion. Of note, more than $500 billion of CRE loans will mature each year over the next few years. In addition to losses caused by declining property cash flows and deteriorating conditions for construction loans, losses will also be boosted by the depreciating collateral value underlying those maturing loans. These losses will place continued pressure on banks' earnings, especially those of smaller regional and community banks that have high concentrations of CRE loans.

Federal Reserve Activities to Help Revitalize Credit Markets

The Federal Reserve has taken a number of actions to strengthen the financial sector and to promote the availability of credit to businesses and households. In addition to aggressively lowering short-term interest rates, the Federal Reserve has established a number of facilities to improve liquidity in financial markets. One such program is the Term Asset-Backed Securities Loan Facility (TALF), a joint Federal Reserve – Treasury program that was begun in November 2008 to facilitate the extension of credit to households and small businesses.

Before the crisis, securitization markets were an important conduit of credit to the household and business sectors. Securitization markets (other than those for mortgages guaranteed by the government) essentially shut down in mid-2008, and the TALF was developed to promote renewed issuance. Under the TALF, eligible investors may borrow to finance purchases of the AAA-rated tranches of various classes of asset-backed securities. The program originally focused on credit for households and small businesses, including auto loans, credit card loans, student loans, and loans guaranteed by the Small Business Administration. The program was broadened to allow investors to use the TALF to purchase both existing and newly issued CMBS, which were included to help mitigate the refinancing problem in that sector.

The TALF has been successful in helping restart securitization markets. Issuance has resumed and rate spreads for asset-backed securities have declined substantially, an indication that risk premiums are compressing. The TALF program has helped finance 2.6 million auto loans, 876,000 student loans, more than 100 million credit card accounts, 480,000 loans to small businesses, and 100,000 loans to larger businesses. Included among those business loans are 4,900 loans to auto dealers to help finance their inventories. Perhaps even more encouraging, a substantial fraction of Asset Backed Securities (ABS) is now being purchased by investors that do not seek TALF financing, and ABS-issuers have begun to bring non-TALF-eligible deals to market. By improving credit market functioning and adding liquidity to the system, the TALF and other Fed programs have provided critical support to the financial system and the economy.

The current fundamental weakness in CRE markets is exacerbated by the fact that the CMBS market, which previously had financed about 30 percent of originations and completed construction projects, completely shut down for more than a year. Until mid-November 2009, when the first CMBS issuance came to market with financing provided by the Federal Reserve's TALF, essentially no CMBS had been issued since mid-2008. Investor demand for the new issuance was high, in part because of the improved investor protections put in place so that securities would be eligible collateral for TALF loans. In the end, non-TALF investors purchased almost 80 percent of the TALF-eligible securities. Shortly after this deal, two additional CMBS deals without TALF support came to market and were positively received by investors. Irrespective of these positive developments, market participants anticipate that CMBS delinquency rates will climb higher in the near term, driven not only by negative fundamentals but also by borrowers' difficulty in rolling over maturing debt.

Availability of Credit

In an effort to encourage prudent CRE loan workouts, the Federal Reserve led the development of interagency guidance issued in October 2009 regarding CRE loan restructurings and workouts.[3] This policy statement provides guidance for examiners and for financial institutions that are working with CRE borrowers who are experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties, particularly as the loans on those properties mature and need to be refinanced. The statement is especially relevant to small businesses because owner-occupied CRE often serves as collateral for many small business loans.

The Federal Reserve recognizes that prudent loan workouts are often in the best interest of both financial institutions and borrowers, particularly during difficult economic conditions. Accordingly, the policy statement details risk-management practices for loan workouts that support prudent and pragmatic credit and business decision-making within the framework of financial accuracy, transparency, and timely loss recognition.

Immediately after the release of this guidance, the Federal Reserve conducted a System-wide teleconference with examiners to underscore the importance of this new guidance. In addition, on November 20 of 2009, we participated in an industry outreach teleconference to discuss the guidance. Examiner training and industry outreach will be ongoing. This month, a comprehensive, System-wide training initiative was launched to further underscore our expectations.

Prudent real estate lending depends upon reliable and timely information on the market value of the real estate collateral. This has been a cornerstone of the regulatory requirements for real estate lending and is reflected in the agencies' appraisal regulations. In that regard, the Federal Reserve requires a regulated institution to have real estate appraisals that meet minimum appraisal standards, including the Uniform Standards of Professional Appraisal Practice, and

[3] Interagency Policy Statement on CRE loan Restructurings and Workouts (November 2009); http://www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm

contain sufficient information to support the institution's credit decision. Over the past several years, the Federal Reserve has issued several appraisal-related guidance to emphasize the importance of a bank's appraisal function and the need for independent and reliable appraisals. More recently, the Federal Reserve and the other federal agencies issued a proposal to revise the Interagency Appraisal and Evaluation Guidelines, which is expected to be finalized in the coming months. These guidelines reinforce the importance of sound appraisal practices.

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. We expect institutions to have policies and procedures for obtaining new or updated appraisals as part of their ongoing credit review. An institution should have appraisals or other market information that provide appropriate analysis of the market value of the real estate collateral and reflect relevant market conditions, the property's current "as is" condition, and reasonable assumptions and conclusions.

The Federal Reserve has directed examiners to be mindful of the effects of excessive credit tightening in the broader economy, and we have taken steps, including additional examiner training and industry outreach, to underscore these intentions. We are aware that bankers may become overly conservative in an attempt to ameliorate past weaknesses in lending practices, and we are working to emphasize that it is in all parties' best interests to continue making loans to creditworthy borrowers.

As part of our effort to help stimulate appropriate bank lending, the Federal Reserve and the other federal banking agencies issued regulatory guidance in November 2008 to encourage banks to meet the needs of creditworthy borrowers, including small businesses.[4] The guidance was issued to encourage bank lending in a manner consistent with safety and soundness; specifically, by taking a balanced approach in assessing borrowers' abilities to repay and making realistic assessments of collateral valuations. This guidance has been reviewed and discussed with examination staff within the Federal Reserve System and ongoing training continues.

Conclusion

While financial market conditions have improved in the United States, the overall environment remains under stress, and some geographic areas are experiencing more difficulty than others, as is the case in Georgia. The Federal Reserve, working with the other banking agencies, has taken strong action to ensure that the banking system remains safe and sound and is able to meet the credit needs of our economy. We also have aggressively pursued monetary policy actions and have provided liquidity to help restore stability to the financial system and support the flow of credit to households and businesses. In our supervisory efforts, we are mindful of the risk-management deficiencies at banking institutions revealed by the financial crisis and are ensuring that institutions develop appropriate corrective actions.

It will take some time for the banking industry to work through this current set of challenges and for the financial markets to fully recover. In order to promote credit availability, the Federal Reserve is encouraging banks to deploy capital and liquidity in a responsible way that avoids past mistakes and does not create new ones. The Federal Reserve is committed to working with other banking agencies and the Congress to promote the concurrent goals of fostering credit availability and a safe and sound banking system.

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[4] See Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," joint press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

Thank you again for your invitation to discuss these important issues at today's hearing. I would be happy to answer any questions that you may have.

Chair WARREN. Thank you, Mr. Greenlee. Ms. Eberley.

STATEMENT OF DOREEN EBERLEY, ACTING ATLANTA REGIONAL DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. EBERLEY. Good morning Chair Warren and members of the panel. I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation concerning the condition of the commercial real estate market in Atlanta and its impact on insured institutions' lending.

As you noted in your invitation letter, the real estate market in the Atlanta metropolitan area has been hard hit. My testimony will describe the factors that led to the difficulties in the Atlanta housing market and the manner in which those difficulties have translated to high levels of loan losses and bank failures. I will discuss weaknesses we have started to see in the Atlanta area market for other types of real estate, such as office, retail, hotel, and industrial properties. And, finally, I'll describe the supervisory actions regulators are taking to address these risks.

The Atlanta area was ranked first in the nation in single-family home construction each year from 1998 to 2005. In response to an increased demand for housing stock, residential development activity increased and many FDIC-insured institutions headquartered in the Atlanta area exhibited rapid growth in their acquisition, development, and construction or ADC portfolios. This growth resulted in significant concentrations in ADC loans. The FDIC monitored the growth of ADC loans in the Atlanta area as it occurred and attributed the growth to local institutions meeting the housing needs of an increasing population. What was not really apparent, however, was the increasing volume of subprime and nontraditional mortgage originations in the market. The increased availability of these types of mortgages turned out to be a significant factor driving housing demand.

Demand for vacant developed lots in the Atlanta market collapsed shortly after subprime and nontraditional mortgage originations were sharply curtailed in 2007. The resulting imbalance between supply and demand has led to deterioration in the performance of residential development loans, which comprised the bulk of the ADC portfolios of Atlanta area financial institutions. The impact of this deterioration has been magnified by the disproportionately high concentration of ADC loan lending. At year end 2007, Atlanta-based institutions reported a weighted average ADC concentration that was nearly three times higher than that reported by similar institutions in other metropolitan areas. Losses experienced by Atlanta banks on ADC portfolios have also been higher than the national average, and poorly performing portfolios of ADC loans have been a significant factor in recent bank failures. The 25 institutions from the Atlanta area that have failed since the beginning of 2008 reported a weighted average ADC concentration a year before failure of 384 percent of total capital.

While Atlanta's residential development market remains strained with reports of a ten-year supply of vacant developed lots, weaknesses are now emerging in the Atlanta area market for other categories of real estate, such as office, retail, hotel and industrial properties. Atlanta ranks among the top ten markets, in terms of vacancy rates across these categories. As a result, performance of these loans has started to deteriorate.

Contrary, to what we've seen in ADC portfolios, loss rates and non-performing rates experienced by Atlanta institutions for the largest category of commercial real estate loans—those that have non-farm, non-residential property as collateral—are comparable to national averages. It's not greater. Also, Atlanta area financial institutions are proportionately less exposed to this segment of the market than it appears in other metropolitan areas.

In response to the risks in the Atlanta and other commercial real estate markets, the FDIC has maintained a balanced supervisory approach. We identify problems and seek corrections when there are weaknesses, while remaining sensitive to the economic and real estate market conditions and the efforts of bank management. Through industry guidance we have encouraged banks to continue making loans available to credit-worthy borrowers and to work with mortgage borrowers that have trouble making payments; we have required banks to have policies and practices in place to ensure prudent commercial real estate lending; and we have encouraged prudent and pragmatic commercial real estate workouts within the framework of financial accuracy, transparency, and timely loss recognition.

Finally, we believe that financial reform proposals currently under consideration can play a role in mitigating the types of risks that have led to significant losses in the Atlanta market. For example, the FDIC believes that consideration of a borrower's ability to repay is a fundamental consumer protection that should be enforced across the lending industry. Establishment of such a standard at the federal level should eliminate regulatory gaps between insured depository institutions and non-bank providers of financial products and services by establishing strong, consistent consumer protection standards across the board.

In addition, we support the creation of a process to oversee systemic risk issues, develop new prudential policies, and mitigate developing systemic risks. With the benefit of hindsight, it's fair to say that during the years leading up to the crisis, systemic risks were not identified and addressed before they were realized as widespread industry losses. The experience in Atlanta is illustrative. During the years of rapid ADC loan growth local financial institutions and their supervisors did not fully appreciate the growing risks posed by the availability of subprime and nontraditional mortgage products. Examples such as this underscore the benefit of monitoring systemic risks to assess emerging risks using a system-wide prospective.

[The prepared statement of Ms. Eberley follows:]

STATEMENT OF

DOREEN R. EBERLEY
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on

THE COMMERCIAL REAL ESTATE MARKET

before the

CONGRESSIONAL OVERSIGHT PANEL

January 27, 2010
Tech Square Research Building
Georgia Institute of Technology
Atlanta, Georgia

Chair Warren and members of the Panel, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning the condition of the commercial real estate (CRE) market in Atlanta and its impact on insured depository institutions and lending.

As you noted in your invitation letter, the real estate market in the Atlanta metropolitan area[1] has been hard hit. To date, the FDIC-insured institutions in this area have experienced their greatest losses on acquisition, development, and construction (ADC) loans, most acutely on loans for residential land development. These loans deteriorated rapidly as certain types of higher-risk mortgages became less available, housing inventory built up, and home prices began to fall. Recently, we have also started to see weakness in the Atlanta area market for other types of real estate such as office, retail, hotel, and industrial.

My testimony, will describe the factors that led to high concentrations of ADC loans in the Atlanta market, and the manner in which the subsequent decline in home prices were then closely followed by high levels of loan losses and bank failures in this market. I will also discuss how CRE properties are valued and what the risks are to banks associated with these properties. Finally, I will describe the supervisory actions regulators are taking to address these risks.

[1] Unless otherwise noted, for purposes of this testimony, the Atlanta area is defined as the Atlanta-Sandy Springs-Marietta Core Based Statistical Area (CBSA), which currently includes these 28 Georgia counties: Barrow, Bartow, Butts, Carroll, Cherokee, Clayton, Cobb, Coweta, Dawson, DeKalb, Douglas, Fayette, Forsyth, Fulton, Gwinnett, Haralson, Heard, Henry, Jasper, Lamar, Meriwether, Newton, Paulding, Pickens, Pike, Rockdale, Spalding, and Walton. Bank data for the area include the all institutions headquartered in the CBSA with total assets of less than $6 billion. There were 104 institutions meeting this definition as of September 30, 2009, which is the most current financial data available. We exclude larger institutions because we assume these would have a high percentage of loans outside the CBSA.

ADC Loan Concentrations in Atlanta

The Atlanta area was ranked first in the nation in single-family home construction each year from 1998 to 2005.[2] According to the Census Bureau, Atlanta's total population increased 25.6 percent from 2000 to 2008, making Atlanta one of the fastest growing metropolitan areas in the nation.

Another factor contributing to the increase in housing stock was the increased availability of credit for housing – especially subprime and nontraditional mortgages, which significantly expanded the pool of potential homeowners. From 2002 to 2007, the aggregate balance of privately-securitized subprime mortgages in the Atlanta area grew from $4.6 billion to $15.4 billion, and the balance of privately-securitized Alt-A loans (which includes nontraditional mortgages) grew from $1.8 billion to $16.6 billion.[3]

As a result of population growth and expanded credit availability, there was increased demand for housing stock. In response, development activity increased and many FDIC-insured institutions headquartered in the Atlanta area exhibited rapid growth in their ADC portfolios. From 2002 to 2007, the share of total assets represented by ADC loans at Atlanta-based institutions increased from 11 percent to 32 percent. At similarly-sized institutions in other metropolitan areas, the share of total assets represented by ADC loans grew from 5 percent to 12 percent. The FDIC monitored this growth of ADC loans in the Atlanta area as it occurred, and in other markets in the

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[2] Mark Vitner and Yasmine Kamaruddin, Wells Fargo Securities, "Georgia Economic Outlook: October 2009."
[3] FDIC analysis of LoanPerformance Securities Database.

southeastern United States. We attributed the growth in ADC loans to a similar increase in the population and demand for housing stock. What was not readily apparent, however, was the increasing volume of subprime and nontraditional mortgage originations in these markets. These types of mortgages turned out to be a significant factor driving the construction market.

Falling home prices, and a retreat by lenders from weak lending practices that prevailed during the long expansion that preceded the crisis, have led to an oversupply of available residential lots for which there is little demand. As was the case in other markets, the Atlanta housing market began to decline in the second half of 2007, at about the same time that subprime and nontraditional mortgage originations were sharply curtailed. Subprime mortgage originations in the Atlanta area declined 82 percent from 2006 to 2007.[4] Home prices, as measured by the Case-Shiller index, have fallen over 20 percent from peak to trough. Housing starts in the market have fallen 93 percent, and single-family home sales have fallen 54 percent. Recently, both indicators posted very small gains, but it is too soon to declare that the bottom has been reached. The *Atlanta Journal-Constitution* reported last August that there were 150,000 vacant developed lots, which represented a 10-year supply at current absorption rates.[5]

The deterioration in the housing market has been reflected in the performance of ADC loans at Atlanta-area financial institutions. At the end of September, 2009, over 22 percent of ADC loans at institutions headquartered in Atlanta were noncurrent, compared

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[4] FDIC analysis of LoanPerformance Securities Database.
[5] "Volume of 'subdivision' vacant lots overwhelms banks," Atlanta Journal-Constitution, August 8, 2009.

to 15 percent nationwide.[6] The weighted average annualized net charge-off rate for ADC loans was 10.8 percent at Atlanta-area institutions, compared to 6.0 percent nationwide. Most importantly, it is obvious that ADC concentrations have been a significant factor in recent bank failures. At the 25 institutions from the Atlanta area that have failed since the beginning of 2008,[7] the weighted average ADC concentration a year before failure was 384 percent of total capital. Only one of the failed institutions during this time period had ADC loans that were less than 100 percent of capital a year before failure.

Eroding credit quality of other CRE loans is an emerging risk

The downturn in other CRE prices, such as office, retail, hotel and industrial, began after the fall in home values was well underway. By some measures, however, CRE prices have suffered a sharper decline than home prices. Nationally, prices for CRE properties, as measured by the Moody's/REAL Commercial Property Price Index, have fallen over 40 percent from their peak in October 2007.

There are three main factors that influence CRE values. The first factor is the trend in property fundamentals that influence cash flow, such as rental income and vacancy rates. Lower rental rates or higher vacancies result in reduced cash flow available for debt repayment.

As of third quarter 2009, quarterly rent growth has been negative across all major CRE property types nationally for at least the last four quarters. Asking rents for all

[6] Noncurrent loans are those that are 90 or more days past due or have been placed on nonaccrual status.
[7] A total of 30 FDIC-insured institutions headquartered in Georgia have failed since the beginning of 1998. Of these, 25 were headquartered in the Atlanta metropolitan area.

major CRE property types nationally were lower on both a year-over-year and quarter-to-quarter basis. Trends in rental prices in the Atlanta area appear to have mirrored national trends, though to a lesser extent.[8]

Vacancies in rental properties are significantly higher than the national average across all major CRE property types in the Atlanta area. Retail and office vacancy rates were both 31 percent higher than the national average, industrial vacancy rates were 40 percent higher than the national average, and apartment vacancy rates were 58 percent higher than the national average. The hotel occupancy rate was 9 percent below the national average. Net absorption – or the net change in occupied space or units – has turned negative in the Atlanta market for apartments (last four quarters), hotel (last twelve quarters), industrial (last four quarters), office (last four quarters), and retail (last five quarters).[9]

The second factor influencing price is investors' required rate of return on investment. In the current environment, investors are demanding higher returns. The higher expected returns are reflected in properties' capitalization rates, or "cap rates." The cap rate is the ratio of net operating income to property value. Therefore, there is an inverse relationship between cap rates and property values; property values decline as cap rates rise. Property values could fall sharply even if there is no adverse change in cash flow. Nationally, cap rates fell through 2007, but they have since risen sharply. For example, from 1990 through 2004, the average cap rate for office properties nationwide

[8] Property and Portfolio Research
[9] Property and Portfolio Research

was 8.3 percent. However, the national average fell to 6.1 percent in 2007 and since has rebounded to 8.1 percent.[10] In the Atlanta market, office property cap rates have increased from their 2007 cyclical low of 6.5 percent to 8.8 percent, retail cap rates increased from 6.6 percent to 9.1 percent, industrial cap rates increased from 6.3 percent to 8.5 percent, and multi-family housing cap rates increased from 5.4 percent to 7.7 percent.[11]

The third factor driving CRE values is credit availability. When credit availability is reduced, that in turn reduces the pool of possible buyers, increases the amount of equity that buyers must bring to transactions, and causes downward pressure on values. During the boom years, commercial mortgage-backed securities (CMBS) grew in importance as a source of CRE financing, although FDIC-insured banks and thrifts still held the largest share of commercial mortgage debt. According to the Federal Reserve's Flow of Funds report, commercial banks and savings institutions hold just over half of commercial and multi-family mortgage loans, while CMBS issuers account for one-fourth of the total. However, CMBS issuance was virtually shut down in the last half of 2008 and all of 2009 and, at the same time, bank credit is also more difficult to get. The Federal Reserve's senior loan officer survey has reported a net percentage of respondents tightening CRE credit standards for 16 consecutive quarters.[12]

[10] Property and Portfolio Research. Represents average of 54 largest markets.
[11] Property and Portfolio Research
[12] Board of Governors of the Federal Reserve System, "October 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices."

As a result of these tightening standards and a more risk-averse posture on the part of lenders, the availability of CRE credit has been declining since the beginning of 2008. The FDIC recognizes that credit may not be readily available for CRE borrowers and we have joined the other banking agencies in issuing a statement to the industry on making loans available to creditworthy borrowers in 2008, and policy guidance on prudent CRE workouts in 2009. I will discuss these initiatives later in my testimony.

Atlanta ranks in the top ten markets across all major CRE categories, ranked by available space, and FDIC-insured institutions headquartered in Atlanta have lent a considerable sum of money against CRE properties. As of September 30, 2009, Atlanta-area institutions had total CRE loans[13] (excluding ADC) of $9.3 billion, nearly one-quarter of their total assets. Their weighted average concentration of CRE loans, including ADC, to total capital was 320 percent, versus a weighted average of 311 percent for all comparably sized institutions headquartered in metropolitan areas nationwide.

Performance of loans that have CRE 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

[13] Includes loans secured by nonfarm, nonresidential properties; loans secured by multifamily (5 or more) properties; and loans to finance CRE, but not secured by CRE.

concessionary rental rates may lead to reduced cash flow for some time after economic recovery begins.

Performance of these loans has started to deteriorate. In Atlanta banks, for the largest category of CRE loans – those with nonfarm, nonresidential properties as collateral – the aggregate noncurrent rate was 3.58 percent as of September 30, 2009, and the annualized charge-off rate was 0.52 percent. These are comparable to the aggregate noncurrent and charge-off rates for all institutions nationwide, which are 3.58 percent and 0.62 percent, respectively.

FDIC Response to Risks in the CRE Markets

The FDIC has maintained a balanced supervisory approach that identifies problems and seeks corrections when there are weaknesses, while remaining sensitive to the economic and real estate market conditions and the efforts of bank managements. As federal supervisor for more than 5,000 community banks, the FDIC is well aware that bank lending is critical to our economy, and we share Congress' and the public's concern for making credit available on Main Street and working with borrowers experiencing difficulties. In response, on November 12, 2008, the FDIC joined the other federal banking agencies in issuing the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, which encourages banks to continue making loans available to creditworthy borrowers and to work with mortgage borrowers that have trouble making payments.

Our examiners, who are part of their local communities, are especially aware of the economic conditions and of the important role of bank lending. Bank examiners have an important responsibility to perform a thorough, yet balanced asset review during our examinations, with a particular focus on concentrations of credit risk. Our efforts have focused on evaluating the effectiveness of banks' commercial real estate (CRE) loan underwriting, credit administration, portfolio management and stress testing, proper accounting, and the appropriate use of interest reserves. We expect that banks will have policies and practices in place to ensure these fundament aspects of prudent CRE lending are employed. The FDIC issued a Financial Institutions Letter in March 2008 titled *Managing CRE Concentrations in a Challenging Environment* that emphasized the importance of these tenets. This Letter followed up on the December 2006 joint *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, which reminded institutions that strong risk management practices and appropriate levels of capital were essential elements of a sound commercial real estate lending program.

The FDIC also monitors changes in a bank's condition between examinations by following-up on significant issues and analyzing financial reports. ADC loans and other CRE loans are necessarily a significant focus of our examinations and have been for some time.

At the same time, the FDIC provides banks we supervise with considerable flexibility in dealing with customer relationships and managing loan portfolios. We do not instruct banks to recognize losses on loans solely because of collateral depreciation or require appraisals on performing loans unless an advance of new funds is being contemplated or is otherwise clearly warranted for a safety and soundness reason. Write-downs on assets to "fire-sale" or liquidation values would generally be contrary to regulatory guidance.

The FDIC has heard from a number of small businesses and trade groups about difficulties they are having obtaining credit or renewing loans for existing credit relationships. The FDIC also has heard concerns that bank examiners are instructing banks to curtail lending or criticizing loan relationships where collateral values have declined, making it more difficult for consumers and businesses to obtain credit or roll over otherwise performing loans. This is not the case. FDIC examiners focus on borrowers' repayment sources, particularly their cash flow, as the means of paying off loans. Collateral is a secondary source of repayment and should not be the primary determinant in extending or refinancing loans.

The FDIC understands that businesses rely on banks to provide credit for their operations, and those extensions of credit will be essential in stimulating economic growth both in Georgia and across the country. Accordingly, we have not instructed banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or deny a refinance request solely because of weakened collateral value. To the contrary, through the 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* (CRE Workout Guidance), FDIC has encouraged prudent and pragmatic CRE workouts within the framework of financial accuracy, transparency, and timely loss recognition. The FDIC expects banks to work with commercial borrowers who remain creditworthy despite some deterioration in their financial condition. This interagency guidance should help banks in Georgia and across the county become more comfortable extending and restructuring loans, which will help businesses and expedite a much-awaited economic recovery. At the same time, we recognize that the economic environment for real estate continues to be stressed, and we expect that banks will continue to accurately recognize losses in a timely manner in accordance with generally accepted accounting and financial reporting standards.

Finally, we believe that financial reform proposals currently under consideration could play a role in mitigating the types of risk that have led to significant losses in the Atlanta market. For example, the increased availability of subprime and nontraditional mortgages inflated the demand for housing and fueled unsustainable increases in residential development activity in the Atlanta area. Mortgage credit was offered by lenders without strong underwriting based on an ability to repay, and without strong rules against abusive lending practices and a meaningful examination and enforcement presence. Mortgage loans were underwritten in a manner that stripped individual and family wealth and undermined the foundation of the economy.

The FDIC believes that consideration of a borrower's ability to repay is a fundamental consumer protection that should be enforced across the lending industry. Establishment of such a standard at the Federal level should eliminate regulatory gaps between insured depository institutions and non-bank providers of financial products and services by establishing strong, consistent consumer protection standards across the board.

In addition, we support the creation of a process to oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. With the benefit of hindsight, it is fair to say that during the years leading up to the crisis, systemic risks were not identified and addressed before they were realized as widespread industry losses. The experience in Atlanta provides an example. During the years of rapid ADC loan growth, local financial institutions and their supervisors did not fully appreciate the growing risks posed by subprime and nontraditional mortgage originations. Examples such as this underscore the benefit of monitoring systemic risk to assess emerging risks using a system-wide perspective.

Conclusion

We understand the significant challenges faced by banks and their borrowers in the Atlanta real estate market. Accordingly, the FDIC has joined with other federal financial institution regulators in encouraging lenders to continue making prudent loans and working with borrowers experiencing financial difficulties both in Atlanta and across the country. Community banks in Georgia will play a critical role in helping local businesses fuel economic growth, and we support their efforts to make good loans in this challenging environment.

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

Chair WARREN. Ms. Eberley, that's all for now.
Ms. EBERLEY. Thank you.
Chair WARREN. Okay. Thank you very much.
So we're going to see if we can go through a round of questions here. What I'd like to start with, since we have two people who supervise the regulators in front of us, is I'd like to talk a little and ask them a bit about the role of the regulators in the run up to this crisis. The rules governing lending, obviously, are going to be critical in understanding the problem and trying to shape some kind of solution.
Now, as I understand it, 2005, 2006 there was a significant deterioration in bank underwriting standards. In 2006, there was an interagency guidance concerning risks to banks having large concentrations of commercial real estate, and the banks complained about this guidance because it would have restricted the amount of concentration that they could have had in lending, and, as a result, the guidance was changed. The regulations were, in fact, weakened so that there was less regulatory oversight.
So what I'd like to start with is a question about the role that the regulators played in the run-up to this crisis and maybe a grade for how the regulators did. Mr. Greenlee.
Mr. GREENLEE. Thank you for that question. From our perspective, commercial real estate in particular, is an area that we've been focused on for quite some time. We did identify building concentrations in the earlier part of the decade, and we got together with the other agencies to try to find a way to make sure that as banks were continuing to expand in that area and that they were managing the risk associated with commercial real estate appropriately. And we issued the guidance in 2006 that you are referencing.
Chair WARREN. But the guidance, that was weakened when the banks complained.
Mr. GREENLEE. We were trying to balance our guidance, in terms of not, you know, overlaying too stringent of requirements on banks, but allowing them to pursue their business plans.
Chair WARREN. So in 20/20 hindsight——
Mr. GREENLEE. At the same time make sure——
Chair WARREN [continuing]. How has that worked out for us?
Mr. GREENLEE. I think in 20/20 hindsight, you look back, and, as we have mentioned in both our testimonies, the commercial real estate concentrations have become a significant problem.
Chair WARREN. What I'm asking about though is the role of the regulators in those concentrations. The regulators had the power to make sure that this didn't happen. What went wrong?
Mr. GREENLEE. Our guidance was really aimed at trying to get the banks to manage those concentrations in a more effective way. Particularly through the use of stress testing to gain a broader understanding of what potential difficulties in the marketplace could mean to overall bank solvency, and to have the banks take the responsibility for managing that risk in a prudent and effective way.
Chair WARREN. Let me switch then. Let me go to the current context, since we're going to be pressed on time. To what extent did the banks, the current banks, recognize their commercial losses? Are the losses now acknowledged on the books of the banks? Are

the books of the banks reliable on the question of commercial real estate losses, Mr. Greenlee?

Mr. GREENLEE. One of the purposes of the guidance that we issued last October, as I mentioned in my statement, was that we had come across incidents where banks were slow to recognize losses. In some instances, banks had renewed and restructured loans in ways that may not have increased the ability of that borrower to repay the loan in full. So, in part, we were trying to send a message to the industry too that they need to recognize their losses in a timely manner. Our——

Chair WARREN. My question is how much confidence do you have that they've done that?

Mr. GREENLEE. For our examiners that is a main focus of their onsite examination process. There are a few outliers, our supervisors are addressing them and making sure that the banks are taking losses as appropriate.

Chair WARREN. I don't think I'm hearing an answer though. Are you confident that that has now been accomplished, that the books accurately reflect the commercial real estate losses?

Mr. GREENLEE. As commercial real estate markets continue to be under pressure, I think there could be more losses. Our examination process is designed to——

Chair WARREN. But you feel confident that they're at least current today?

Mr. GREENLEE. I think in terms of individual, specific banks there may be some question. As such, we continue our supervisory efforts to make sure they are recognizing their losses. It's a very hard question to kind of answer in a broad way, because it is very institution-specific as to whether or not the banks have good risk management and loss recognition practices.

Chair WARREN. Ms. Eberley, I'm sorry, I didn't mean to ignore you during this.

Ms. EBERLEY. That's okay.

Chair WARREN. We have such short periods of time. Would you like to add to either one of those questions about the role of the regulators or where we stand?

Ms. EBERLEY. Yes, I will. To the second question, I think that the point that Mr. Greenlee is making is an appropriate one, that this is an ongoing process for financial institutions. They're required to take a look at their loans on a regular basis as they do their call reports to the federal regulators. Their financial statements every quarter have to be an accurate reflection of their financial condition.

Chair WARREN. So you're confident in the books now?

Ms. EBERLEY. I wouldn't say that the losses are over, if that's your question.

Chair WARREN. That's not my question. My question is whether or not the books currently reflect appropriately the risks that these banks face?

Ms. EBERLEY. I think, yes, generally they do. There are outliers, but generally they do.

Chair WARREN. Thank you. Mr. Atkins.

Mr. ATKINS. Okay. Thank you very much. Let's circle back around to that. I think that was a good question with respect to the guidance back in the middle part of this decade. When it came out, and I guess I am on more of a security side than a banking side, but I assume that basically the purpose of the guidance was to call attention to and to impact management to make sure that they were looking for and taking into account various types of disaster scenarios and things like that. So, just to follow up on the question, when that guidance was revised, in what way was it revised? And did it have any impact with respect to how banks were treating their loans or undertaking new transactions?

Mr. GREENLEE. When we issued the guidance, we did put it out for public comment, and, as you noted, we got a lot of comments back from the industry and other participants. And, as we do with everything we put out for public comment, we tried to take those responses into account as we worked toward the final issuance of the guidance. One chief concern that many people expressed at that time was, again, concern that their business plans and the lending that they were primarily engaged in, commercial real estate. There were also concerns about effects on local economies and profitability of the institution as a whole. As regulators, we try to strike a balance to make sure that the banks understand what the downside scenarios are, that they have thought about that, in terms of their capital planning, and conducted proper stress testing so that the banks understand the capital impact. We also tried to ensure that they understand the need to have effective processes in place to manage the risks that they're taking on in their institutions.

Mr. ATKINS. Ultimately, it was their decision and not the regulators' decision, and we have had sort of a hundred or a thousand-year type of storm. But looking forward at current types of activity in the marketplace, obviously, it's very far down. And one of the issues that gets raised over and over is how bank examiners might be dampening the ability or willingness of bankers to undertake new loans. And so I salute the the guidance, the training, and the other things that you have been doing, because, as I know from personal experience from the early 1990s when we went through a similar thing, the regulators are not always as responsive. But it sounds like you are trying.

So I was wondering do you have any assessment of how effective that's being, because, obviously, we don't want to have the dreaded "F" word of forbearance. Do you perceive that examiner scrutiny is depressing the willingness of bankers to be active in this marketplace?

Ms. EBERLEY. I don't believe so. I think the greater constraints are capital constraints that financial institutions are operating under because of the volume of troubled assets that they have on their books, and, additionally, liquidity concerns. I think those are the two greatest constraints to institutions being able to lend.

Mr. ATKINS. With respect to demand then—well the liquidity constraints and that sort of thing—but also the demand from business folks who are looking to take out loans. What we're seeing, of course is a depression of the demand. I guess we'll hear more about that later. But are you seeing that nationwide as a whole or is it regionally focused?

Mr. GREENLEE. From what we're hearing and observing, the demand for credit is down considerably. Loans to businesses and consumers alike have been dropping in the banking system. We have done a lot of work and we continue to try to better understand, the supply and demand effects of credit. We hear stories just like you do that the examiners perhaps are impeding credit being made available to borrowers. We follow up on those things. And we have issued supervisory statements, such as the November 2008 statement encouraging banks to make prudent loans. And in the CRE guidance, it is especially important in terms of the effect it has on small businesses, because a lot of small business loans are secured by the real estate that the business owner owns or the business owns. So we were trying to think about that as well.

Mr. ATKINS. Well, my time is up, so thank you.

Chair WARREN. Thank you. Mr. Silvers.

Mr. SILVERS. Thank you. I'll try to continue the thread here. We are looking at this ultimately from the perspective of our responsibilities and the relationship to TARP. What actions, if any, should or might be taken with TARP funds or with the powers that the bill passed by Congress in the crisis gives the Treasury to address commercial real estate? And, in order to begin to do that, we need to begin by asking, "What's the problem here?" You mentioned—I think each of you mentioned—liquidity as a potential issue and you mentioned capital, the capital constraints in financial institutions. Those seem to be two possible diagnoses of, I think, what your testimony and the testimony of our witnesses that will follow you suggest is an absence of commercial real estate finance in this market and, to a significant degree, nationwide.

So can you comment on the relevant importance of those two issues to start off?

Mr. GREENLEE. In terms of looking at the banks that we supervise and particularly the local community banks that specialize and have concentrations in commercial real estate, I agree with my colleague that the capital constraints, the liquidity concerns that they have, are a significant factor in their willingness and ability to continue to make commercial real estate loans or loans in general. We also try to think about the broader marketplace, and the CMBS market is an important provider of commercial real estate financing. And, as you know, we expanded the TALF program for CMBS to provide some stability to that market and try to bring some investors back in. That has actually worked. We had one recent CMBS issuance of TALF, and then following that, two more were issued without TALF financing. So the broader CRE liquidity in the marketplace is an important consideration. And it also gets to investors' willingness to take on this risk, and how they're pricing it, and how they see the future for real estate prices.

Mr. SILVERS. Ms. Eberley.

Ms. EBERLEY. I would say that capital is the most significant concern facing financial institutions here in the Atlanta area, with liquidity as the second.

Mr. SILVERS. Let's focus on capital for a moment. I must say, I am inherently suspicious of complaints about liquidity, the reason being that my liquidity crisis is your belief that I am deluding myself, as to the value of the asset I'm trying to sell. So I want to focus on capital.

If that's the major problem, that our financial institutions are undercapitalized, that would suggest that perhaps—Ms. Eberley, you raised the issue of trying to get assets off the books. Is that a plausible solution, meaning if assets are moved off of bank books at fair—at rational prices today, would that solve a liquidity crisis, or, I mean, solve the capital crisis or would it exacerbate it?

Ms. EBERLEY. I would say it would exacerbate it. The institutions need the capital to be able to sell loans at prices that the market will pay. What they are doing now is they are recognizing market value declines as they occur, typically on a quarterly basis, since they file their financial statements with the regulators, and—and it erodes capital over time.

Mr. SILVERS. And so now——

Ms. EBERLEY. And economic recovery would also help.

Mr. SILVERS. Yes. And I share the comments, the views of my colleagues, that all these things are driven by larger economic forces. But can you all comment on the relative capital strength as you perceive in this marketplace as between community banks, larger regional institutions, and national players? Is there a capital problem across the board or is this limited to one or more segments of the banking industry?

Ms. EBERLEY. I'll speak to the community banks. They came into this crisis with very strong capital levels compared to historic norms, very strong capital, which has been fortunate.

Mr. SILVERS. So you would say that, in fact, community banks are not where the capital problem resides.

Ms. EBERLEY. No. I said they came into the crisis with very strong capital. It's——

Mr. SILVERS. Finish the thought then.

Ms. EBERLEY. Yes. They definitely are facing capital pressures now. It would have been far worse had they not come in with the strong capital levels that they did at the beginning of the crisis.

Mr. SILVERS. And then can you comment—I know that you don't regulate the larger institutions directly, but—but you certainly pay attention to them, given the fact that you insure them. Can you comment on the other segments?

Ms. EBERLEY. I'd like to defer to Mr. Greenlee to talk about capital——

Mr. SILVERS. That's fine.

Ms. EBERLEY [continuing]. With the larger institutions.

Chair WARREN. We're going to have to be short. We're over time.

Mr. GREENLEE. I would just quickly say that part of the supervisory stress test we conducted last Spring, the Supervisory Capital Assessment Program (SCAP), was designed to ensure that the largest institutions had an adequate capital base to weather an adverse economic scenario. And they have been able to raise significant amounts of capital since that time.

Mr. SILVERS. So they are lending freely right now in this market?

Mr. GREENLEE. They are making loans, but the loan balances overall are declining.

Chair WARREN. Mr. McWatters.

Mr. MCWATTERS. Thank you. You know, I've heard a lot of problems. We have a lot of problems. But if you had to summarize in a one-page memo to your immediate supervisor, who asked you, how do I orchestrate a soft landing of the CRE market, what would you say and why would you say it?

Mr. GREENLEE. I think that's an interesting question. I would say the one thing that we do know is that the broader economic environment, the recession and increases in unemployment have been a significant factor in commercial real estate prices falling, and vacancies rising. In terms of trying to get prices to stabilize or potentially recover, the economic environment is going to be a key factor.

Ms. EBERLEY. I think what the regulators have already done is the most important step that we can make, which is to encourage institutions to engage in reasonable workouts of loans with borrowers that have the ability to pay. Perhaps not make the same payment they were making before, but the ability to continue making payments to the institution at a reduced basis. Loans can be reworked, restructured, partially charged down, and the inter-agency guidance addresses all of the options and specifically says that regulators will not criticize bank management for engaging in that sort of activity.

Mr. MCWATTERS. So it's a bit of a kick the can down the road with the expectation or, with the hope, that prices will recover, and that prices will recover when more tenants are competing for the properties, more purchasers are competing for the properties. And that will only happen when their underlying businesses become stronger.

Ms. EBERLEY. I wouldn't call it a kick the can down the road. I would call it a recognizing the economic reality of today. Loans are going to have to be written down. There will have to be some partial write downs, and reworking, and restructuring, but it doesn't have to be a complete loss. There are ways to move forward.

Mr. MCWATTERS. Okay. Do you see a lot of simple refinancing at existing prices with the expectation that prices will recover for the property?

Ms. EBERLEY. Do you mean just rolling over a loan and——

Mr. MCWATTERS. Rolling it without writing down and impairing regulatory capital. Taking losses in the light which effects share value and so forth.

Ms. EBERLEY. We do occasionally. And there's two ways that that happens. One way is with a borrower that has the ability to continue servicing debt, and making payments, and amortizing a credit. Another way is—is where an institution would just refinance the loan, set a payment date in the future, and say you'll pay us then, and that's not acceptable.

Mr. MCWATTERS. Okay. Okay. How about an update on TALF and PPIP? Where is that going and what's the future?

Mr. GREENLEE. I can speak to TALF. My understanding is that the last Federal Open Markets Committee (FOMC) indicated that the TALF programs will be winding down on their scheduled dates. But the FOMC also reserved the right to modify that schedule if conditions warrant it is deemed appropriate.

Ms. EBERLEY. In terms of PPIP, there haven't been any Treasury or taxpayer funds used to support a PFIF-type partnership. There have been for the partnerships form basis supported by FDIC funds or guarantees. And we continue to work on ways to refine the program.

Mr. MCWATTERS. I guess one more question. Every time I speak with someone who wants to refinance or wants to borrow money, they say they can't refinance or they can't borrow. But what I hear from a lot of regulators and a lot of other people is, "Yeah, it's happening." A lot of banks are refinancing. Where is the disconnect? And what's happening in the marketplace? If I have an underwater property that I want to refinance, how difficult is it? I mean is it actually being done?

Mr. GREENLEE. In my discussions with bankers, I hear that it is being done when they can do it in a prudent and effective way, when a borrower has the willingness and ability to make payments on a restructured basis.

Ms. EBERLEY. My discussions with examiners would indicate the same, that it is being done.

Mr. MCWATTERS. Okay. That's all.

Chair WARREN. Commissioner Neiman.

Mr. NEIMAN. I'd like to follow up on the CRE guidance and regulatory accounting, because I think there is a lack of full understanding by the public and the media, as to the purpose and the objectives of the CRE guidance. You know, sometimes people refer that it provides the ability for institutions to extend and pretend, because it does not automatically consider an underwater loan to be impaired, requiring that it be written down, if there is an expectation of repayment.

Could you elaborate on why regulators put first priority on loan performance and the expectation of being repaid according to contract terms compared to with collateral? I think it would be helpful just to go into that in a little more detail.

Ms. EBERLEY. Certainly. I think that first and foremost, when examiners are looking at loans and financial institutions, the very first focus is on a borrower's ability to repay the debt. We look to the borrower. We expect financial institutions to look to the borrower, not to look to the sale of collateral. Ability to repay is the fundamental tenet of lending that we expect in community institutions.

Mr. NEIMAN. And would you agree that loans that were paying, the fact that the loan is being held to maturity, if they were required to mark these loans based on collateral, you would have a great deal of volatility in those balance sheets without really referencing the true credit risk of that loan?

Ms. EBERLEY. So you're saying, if a fair market value were adopted on a wholesale basis for loan portfolios?

Mr. NEIMAN. That's right.

Ms. EBERLEY. Yes. It would. It would inject a lot of volatility.

Mr. NEIMAN. Would you like to comment on issues around calls to impose a full fair market accounting on loan portfolios held by banks?

Mr. GREENLEE. I think that you have highlighted one of the key considerations since a lot of the issues we were dealing with concern how to value the assets. We have gone through a period where valuations have been challenged, particularly with some of the mortgage-backed securities. I think the question you raise is really a question of at what value do you have a buyer. While a buyer would buy at distressed level, which would be a valuation of a different kind than just looking at the collateral values.

Mr. NEIMAN. I want to come back to these differences, and we're going to hear a lot, I assume, from the second panel, on the difference between credit risk and term risk. There are really two categories of commercial borrowers who are going to be facing default. One group that faces a credit risk due to fundamentals like increasing vacancies and decreasing rent rolls or an inability to make those payments. And another group who are paying on time and have sufficient cash flow on projects that are performing, but the value of the collateral has declined so much that in any refinancing they would have to come up with sufficient equity to refinance that project and have an inability to do that and thus face default or foreclosure.

Can you elaborate on what are the key drivers? Where do you see those falling out and impacting banks, which are the key drivers to foreclosures in commercial real estate?

Mr. GREENLEE. I'll comment first. I think we have seen a lot of construction projects, for example, come to completion or be running into difficulties in the last few years in particular. That is why the whole focus on the borrower's ability to repay, to sell the property, or to find a permanent investor, is such an important issue and that is where we have tried to focus.

Some of our thinking behind this guidance that we issued last October was to try to address the other point you were making about the huge amount of refinancing risk that we see on the horizon and we know the property values have declined. Even if the borrower does have the ability and willingness to pay, the terms and conditions, and what the values are going to be, potentially are very different than when the original loan was made. And so our thought was that we need to find a way to restructure these loans. We need to find a way to enable these people that have an ability and willingness to repay, to stay in that property. We believe that is better for the bank and for everyone involved.

Mr. NEIMAN. Do you want to comment?

Ms. EBERLEY. I have nothing to add. I agree completely.

Chair WARREN. Thank you. I'm actually just going to pick up on the same theme in a short question. We are talking about the importance of capital, and that you need more capital, private capital injected in these banks, not more government money in them. But capital investments depend on confidence, and that confidence is based on an accurate assessment of what this bank is worth, and that depends on how these assets are valued. And, frankly, the regulators don't give us a lot of confidence, based on their most recent history. I'm concerned about the shifts in accounting standards. I understand the point that Superintendent Neiman has raised and that Mr. Atkins raised. But I want to go back to this October 2009 change. As I understand it—we all understand—that any loan that has a loan-to-value ratio that's low, that has a lot of equity in the deal, is a loan that's most likely to be repaid. And so as I understand this change in accounting, it says that, hey, if you're in negative territory, if there's not only no equity, but that you're actually below water on this loan, you don't have to reflect that in your books. You soften how to reflect that in your books. And what concerns me is how this helps improve the confidence in the banks that—that the books accurately reflect where the banks stand financially so that investors say it's good to invest in banks?

Every time I see this softening, I'm really troubled by it, and I just want to understand it better. Ms. Eberley.

Ms. EBERLEY. I wouldn't call it a softening, but the guidance I think is much more structured to say you need to recognize the reality of the economic situation for the borrower and find a way to move forward. That may require a partial charge down in the loan balance. So the bank would—would reflect a loss and restructure a loan at a lower balance that the borrower can then move forward with. That can be a better deal, as Mr. Greenlee said, in the long run for the financial institution——

Chair WARREN. That one I totally understand.

Ms. EBERLEY. Okay.

Chair WARREN. That's not my concern. You've written it down and it now accurately reflects what the properties were and the likelihood that it's going to be repaid. But where I am concerned is the part that I'm reading that says, in effect, if you've gone from a loan that had a positive equity on it to a loan that has a negative equity on it, you don't have to change your books so long as you can continue to collect monthly payments. You don't have to change in your books the value of that loan. Now, if I'm not understanding this correctly, that's fine, but I want to understand it.

Ms. EBERLEY. No, that's correct. And if the borrower has the financial wherewithal to repay the loan and you're looking at the borrower's obligations on a global basis, and they have the capability and demonstrated willingness to repay the loan, there's no reason to write down that loan.

Chair WARREN. You are saying there's no reason to write down a loan. We should treat loans exactly the same whether they have positive equity or negative equity? I don't know any banker on earth who has done that prior to this time, and, yet, this is what the regulators are saying we should do? We should treat those as if they were the same value?

Ms. EBERLEY. Bankers are making loans based on the borrower's ability to repay. The collateral is the secondary source of repayment, not the primary.

Chair WARREN. I'll stop. Mr. Atkins.

Mr. ATKINS. Thank you. I just wanted to pick up on your discussion earlier about guidance with respect to market accounting and FASB 157. Of course this comes up and when I was at the SEC in the summer of 2008, we were hearing a lot of stories about how accountants were forcing complete write-offs of some of these securities based on there being no trades or looking at the indexes and things that were indicating that the values were very low. The SEC, finally, in September of 2008, when FASB came out with guidance with respect to 157 to clarify the orderly market aspect of that, which I think was overdue and finally helpful, relieved some chaos in the market. So I was wondering, do you view that guidance now as being sufficient? Does there need to be additional guidance, with respect to mark-to-market accounting, or how do you perceive that in your activities?

Mr. GREENLEE. I think that it was helpful to get clarification. What I believe raises the most questions are the Level 3 assets and how those ultimately get valued. As we've gone through the valuation process, the banks, our examiners, and the broader marketplace improved their ability to evaluate those assets. Confidence increased that the right factors were the focus. It is also important not to be based solely on an index or something that tended to maybe overshoot on the way down. Certainly, when you encounter illiquid markets, valuation does get to be a challenge, and there is also a lot of modeled risk that has to be managed. Fortunately, we have seen improvement since we went into this financial crisis.

Mr. ATKINS. The pressure from the outside accountants has abated because of that, so I assume that management now can point to this guidance and that's proven helpful?

Mr. GREENLEE. I believe it's helpful. But I also believe that a lot of those assets that were in question at the time were written down quite a lot. So I am not sure there are going to be further significant write-downs on those particular assets. Valuation practices, at least in some of the larger firms, have improved.

Mr. ATKINS. Okay. All right. Thanks.

Chair WARREN. Mr. Silvers.

Mr. SILVERS. Yes, thank you. This may not seem like it follows the thread of the conversation, but I'm going to come back around to it. Some of the testimony we have for today suggests strongly that in this area, in the Atlanta metropolitan area, real estate development, residential real estate development, and all of the ancillary activities associated with it, is a very large portion of the economy in this area. Do you all have a sense of roughly what that appears to have been? Meaning how much economic activity have we lost as a result of the deflating of the bubble in this area?

Ms. EBERLEY. I can't give you a quantification of that. We can go back to our research staff and give you an answer in writing.

Mr. SILVERS. Do you have a sense that it's big?

Ms. EBERLEY. It is big. It is big. The Atlanta economy has been driven by construction for many, many years. This goes back to the early 1980s that it's been a trend. It certainly has become more pronounced in the last decade.

Mr. SILVERS. Mr. Greenlee, any thoughts about this?

Mr. GREENLEE. Well, I don't live here, but my impression and my understanding is exactly what Ms. Eberley described. Construction and real estate development was a big driver of the economy here. In terms of answering your question, I can speak to the Federal Reserve Bank of Atlanta staff and see if we can get you additional information.

Mr. SILVERS. It would be interesting to have some data on that. Not just the direct development activity, but, as one of our other witnesses put it, everything that flowed from it, architecture, furniture sales—secondary, tertiary. I would go for that. The reason I want to put that on the record is because it seems to me that the conversation we've just been having about mark-to-market, about capital requirements and the like, appears to—tell me if you disagree—but it appears to suggest a strategy of attempting to kind of hold on as much as possible to a set of values and arrangements based on that economy that is no longer with us, in the hopes that we will somehow return to it. I think this conversation about trying to focus on rent, on cash flow, as opposed to property values, to collateral value, it has that feel to it. And that would appear to run the risk that, if we're not going to be able to return to that type of economy, we are essentially locking in the financial system in a way that will make it unable to shift to finance activity that could actually lead to renewed growth. Can you comment on your views of whether or not I'm identifying a reasonable matter of concern?

Ms. EBERLEY. Well, let me make a distinction that might help address some of the concern that Chair Warren expressed, as well. When a loan at an institution is considered collateral-dependent and when the borrower's ability to repay is clearly nonexistent or not sufficient, the institution is required to look to the collateral value and write the loan down to the collateral values. But that's where the borrower's ability to repay is no longer apparent or evidenced and more certainly if payment is not happening.

Mr. SILVERS. Well, if your primary measure of value deteriorates then——

Ms. EBERLEY. Right.

Mr. SILVERS [continuing]. You look to your secondary collateral. Is it good enough?

Ms. EBERLEY. Right. And the accounting rules require that the balances be written down.

Mr. SILVERS. Thank you.

Ms. WARREN. Thank you. Mr. McWatters.

Mr. MCWATTERS. Just a quick question. Would you support the investment of additional TARP funds in Atlanta regional financial institutions because of the CRE problem? Is it that bad or will it recover in due course?

Ms. EBERLEY. Additional capital in Atlanta financial institutions would be most helpful, and economic recovery would certainly make a difference in Atlanta, as well.

Mr. GREENLEE. I would echo that. Improved capital would be helpful to the banks.

Mr. MCWATTERS. So additional TARP funds?

Mr. GREENLEE. You would have to look at the details of the program and go through the process that we have been going through with the banks that applied for TARP. Generally, improved capital positions would be helpful.

Mr. MCWATTERS. Okay. Thank you.

Chair WARREN. Superintendent Neiman.

Mr. NEIMAN. Thank you. Three questions that I hope to get in.

Chair WARREN. Talk fast.

Mr. NEIMAN. They are critical to our February report. Do you see CRE as posing a systemic risk to recovery and financial stability or does it not rise to the level of residential and subprime and can be contained?

Mr. GREENLEE. From our perspective, it is an important exposure that the banks we supervise have. We have a lot of banks with significant concentrations and they are under stress because of the weakness in the CRE markets. And so it is something we do focus a lot on and spend a lot of time working on.

Ms. EBERLEY. I would say that commercial real estate values have declined more than they did in the last commercial real estate crisis in the late 'eighties, but there are important protections, from a regulatory standpoint, that have been put in place since that time, including enhanced appraisal regulations, regulatory guidelines about loan-to-value limitations, and enhanced underwriting practices and institutions. So I think there's some mitigation there.

Mr. NEIMAN. Stress tests. Do you think that stress tests should be rerun for an expanded class of institutions beyond the SCAP approach or with the new assumptions?

Mr. GREENLEE. What we are focused on right now at the Federal Reserve is really trying to get improved stress testing practices in the banks that we supervise improved. We think that is an improvement that the banks we need to better manage their business.

Mr. NEIMAN. Stress tests done by the bank?

Mr. GREENLEE. Yes. That is what we would like to see.

Mr. NEIMAN. Or the FDIC on an isolated basis. I know we used a stress test in particular institutions where we think it may present a problem.

Ms. EBERLEY. We absolutely do. And I think that stress testing by financial institutions on their own balance sheets, on their own economic circumstances, and their locality are very important.

Mr. NEIMAN. And then the third question. Are there any changes in public policy that you would find helpful, particularly in dealing with commercial real estate? It's kind of a follow-up to Mark's question. Either in the TARP program itself or outside of TARP that would help address this from either a Treasury or a regulatory perspective? Are there tools that would be helpful to you in dealing with CRE?

Mr. GREENLEE. I can only comment that we did what we thought we could with the TALF, in terms of trying to help support the CMBS market and provide financing there.

Mr. NEIMAN. From the FDIC's perspective, are there any changes needed to the public policy or tools?

Ms. EBERLEY. I think the best tool that we have is to work with the institutions and get them to work with borrowers.

Mr. NEIMAN. Great. Do you think that CRE guidance is fully understood by institutions, or is there still work to be done in getting institutions to really understand their responsibilities with respect to modification?

Ms. EBERLEY. Yes. I think it's an ongoing process.

Mr. GREENLEE. Yeah. We've done some initial outreach, but we recognize we need to do more.

Chair WARREN. Thank you very much. This panel is excused. I would like to call the second panel. I am pleased to welcome Brian Olasov, who is the managing director of the Atlanta office of the law firm McKenna, Long, and Aldridge. David Stockert is the CEO of Post Properties, an Atlanta-based firm that develops and operates apartment buildings. Chris Burnett, the CEO of Cornerstone Bank, a community bank in the Atlanta region. Hal Barry, chairman of Barry Real Estate Companies, an Atlanta-based developer of commercial property. And Mark Elliott who is a partner at the

Atlanta office of the law firm of Troutman Sanders and the head of the Office and Industrial Properties practice. I appreciate you all being with us today. I'm going to ask you, as I did with our first witnesses, if you would hold your oral remarks to five minutes or even less so that we'll have more time for questions, but your written testimony will be part of the public record. Thank you very much. If I could start with you, Mr. Olasov.

STATEMENT OF BRIAN OLASOV, MANAGING DIRECTOR, ATLANTA, McKENNA, LONG, AND ALDRIDGE

Mr. OLASOV. Madam Chair and distinguished members of the Panel, I'm very enthusiastic to be testifying before you today. In fact, I'm chomping at the bit after that first panel to discuss some of these issues.

Chair WARREN. We thought you might be.

Mr. OLASOV. As the Panel described in selecting the site for today's discussion, it's entirely appropriate that the hearing be held in Georgia, whose banking system has suffered disproportionately. Over the past couple of weeks I've had the opportunity to discuss my views with staff members of the Oversight Panel, and I'd like to reiterate some of these opinions today.

By way of background, I have worked in commercial banking, investment banking, a bank regulatory research environment, academia, and I'm currently at a national law firm where I've had the opportunity to assist in large, complex real estate workouts, both in commercial and residential transactions shared between portfolio lenders, banks that we're going to discuss in greater detail today, and in the area of structured finance, MBS and CMBS. I have worked extensively as an expert witness in litigation involving residential and CMBS.

During the previous downturn, I collaborated on building a historical market to market model for the thrift industry and testing, and frequently refuting various theories of conventional wisdom concerning what happened to the thrift industry, what were the factors that actually collapsed the thrift industry.

My written statement can be brief, as I have also submitted two recent editorials, along with a draft white paper that reflects my views on a policy prescription to deal with the continuing unresolved problem of toxic assets in banking. That reflects very much the thoughts of COP's August report. And I applaud the August report and some of their conclusions reached.

Let me summarize my opinions and observations. In my view, there is a logical and inevitable sequence that follows from an inability or unwillingness to move problem assets from banks. The inability or unwillingness of banks to remove these assets stems from the overwhelming and justified desire to preserve regulatory capital. As long as banks sit on material levels of problem loans, given the volatile nature of the value and cash flow attributes of these loans, available cash will migrate to excess reserves of the Fed or low-risk securities include Treasuries and agency mortgage banks.

When regulatory enforcement is perceived by bank management as either unfairly severe or capricious, and I think that's applicable to the earlier discussion on policy guidance that came out in October, this accelerates the movement towards more restrictive lending policies, and this is dramatic and demonstrable. This results in a constriction of available credit.

Since the architectural intent of financial stability in all its guises, obviously including TARP, is to bridge the economy until private sector demand reengages, the absence of a healthy, functioning credit allocation system, primarily a banking system, prolongs the need for this bridge to exist. This comes at a terrible price to the real economy and to the American taxpayer that must support this skein in subsidies.

Conventional wisdom holds that distress in residential markets has bottomed out. I happen to disagree with that. And that the commercial real estate mortgage market is the next shoe to drop. My own informal research indicates a lag of approximately six quarters between residential and commercial mortgage markets. If this relationship persists, and in the presence of delinquency and default numbers that are still rising in residential mortgage markets, commercial markets are at least 18 months, and I would argue considerably longer, from touching bottom.

The deteriorating performance of the CMBS market gives us a predictor of increasing problems in bank portfolios, as can be seen in the graph. And for those of you who have a copy of this, CMBS, I think, is instructive because it doesn't suffer the same accounting confusions that the earlier panel touched on.

Until we design a mechanism that promotes the movement of problem assets off banks' balance sheets, banks will be less inclined to meet reasonable, prudent borrower requests. This problem will become increasingly acute as 1.4 trillion dollars of commercial real estate loans balloon over the next three years. At a national level where banks hold 1.8 trillion of CRE loans, or 13.5 percent of all bank assets, a deterioration of CRE portfolios will jeopardize some already weakened banks. And I would add that those are likely to be in those same areas that are currently suffering residential problems, making it much more difficult for those regional banks in that regional system to recover.

In Georgia, where 23——

Chair WARREN. Mr. Olasov, I'm sorry, sir. We're at five minutes. I'm going to ask you to finish up, please.

Mr. OLASOV. All right. Thank you. I'll end on a positive note, which is to say that in supporting CMBS and indirectly commercial mortgage lending, TALF has contributed to a dramatic reduction of spreads on senior bonds. TALF funding has been extraordinarily limited, but it's still been extremely helpful including promoting new CMBS issuance in the fourth quarter.

[The prepared statement of Mr. Olasov follows:]

Testimony of Brian Olasov[1]

Managing Director, McKenna Long & Aldridge LLP

Congressional Oversight Panel

Atlanta Field Hearing

January 27, 2010

It's an honor to appear before the panel today to discuss the state of commercial real estate and its impact on banking. As the panel described in selecting the site for today's discussion, it's entirely appropriate that this hearing be held in Georgia whose banking system has suffered disproportionately during this downturn. Over the past couple of weeks, I've had the opportunity to discuss my views with staff members of the Oversight Panel and I'd like to reiterate some of these opinions today.

By way of background, I have worked in commercial banking, investment banking, a bank regulatory research environment, academia and a national law firm where I've had the opportunity to assist in large, complex real estate workouts both in commercial and residential transactions among portfolio lenders and in the area of structured finance. I have worked extensively as an expert witness in litigation involving residential and commercial mortgage-backed securities. During the previous downturn, I collaborated on building a historical market value model for the thrift industry and testing, and refuting, various theories of conventional wisdom concerning the collapse of the thrift industry.

My written statement can be brief as I have also submitted two recent editorials along with a draft white paper that reflects my views on a policy prescription to deal with the continuing unresolved problem of toxic assets in banking.

Let me summarize my opinions and observations:

1. In my view, there is a logical and inevitable sequence that follows from an inability or unwillingness to move problem assets from banks.
2. The inability or unwillingness of banks to remove these assets stems from the overwhelming (and justified) desire to preserve regulatory capital.
3. As long as banks sit on material levels of problem loans, given the volatile nature of the value and cash flow attributes of these loans, available cash will migrate to excess reserves or low-risk securities including Treasurys and agency MBS.
4. When regulatory enforcement is perceived by bank management as either unfairly severe or capricious, this accelerates a movement towards more restrictive lending policies.
5. This results in a constriction of available credit.

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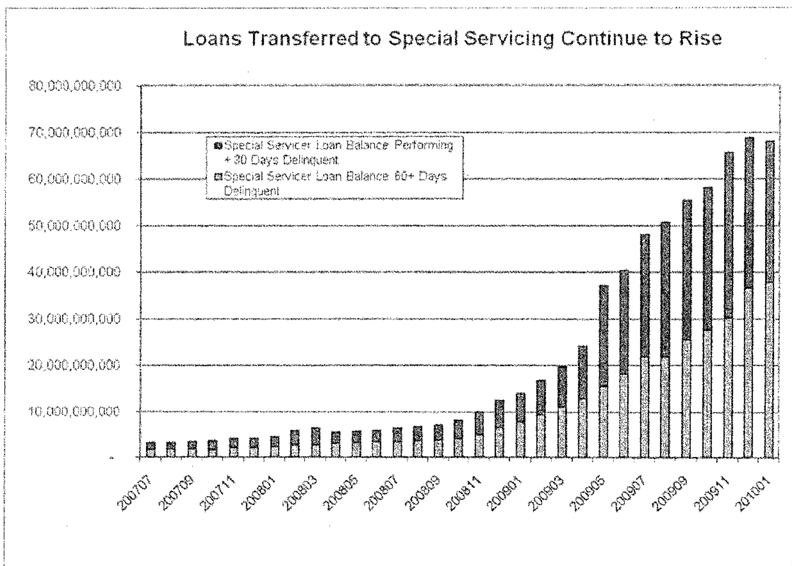
[1] The opinions expressed herein are mine and do not necessarily reflect the opinions of McKenna Long & Aldridge.

6. Since the architectural intent of Financial Stability in all its guises is to "bridge" the economy until private sector demand reengages, the absence of a healthy, functioning credit allocation system, primarily through our banks, prolongs the need for this bridge to exist.
7. This comes at a terrible price to the real economy and to the American taxpayer that must support this skein of subsidies.
8. Conventional wisdom holds that distress in residential markets has bottomed out and that the commercial real estate mortgage market is "the next shoe to drop".
9. My own informal research indicates a lag of approximately six quarters between residential and commercial markets. If this relationship persists and since delinquency and default numbers on residential mortgages continue to escalate, commercial markets are at least eighteen months from touching bottom.
10. The deteriorating performance of the CMBS market gives us a predictor of increasing problems in bank portfolios as can be seen in the graph below[2]:



[2] Trepp data using January 2010 remittance reports.

11. Until we design a mechanism that promotes the movement of problem assets off banks' balance sheets, banks will be less inclined to meet reasonable, prudent borrower requests.
12. This problem will become increasingly acute as $1.4 trillion of commercial real estate loans balloon over the next three years.
13. At a national level where banks hold $1.8 trillion of commercial real estate loans[3] or 13.5% of total bank assets, a deterioration of CRE portfolios will jeopardize some already weakened banks. In Georgia where 23.5%[4] of total banking assets reside in commercial real estate loan portfolios, weakening values and cash flows may have more severe consequences.
14. TARP's failure to deal with problem real estate loans puts additional pressure on the FDIC to resolve more banks through disruptive liquidations.
15. In the absence of mechanisms to cleanse bank portfolios or provide adequate matching funds to deserving community and regional banks, fresh capital has been sidelined awaiting FDIC bargains. The failure to deal with these problems and, on selective occasions, provide some form of bank assistance creates high direct and indirect costs to communities, the FDIC and the broader economy.
16. In supporting CMBS and, indirectly, commercial mortgage lending, TALF has contributed to a dramatic reduction of spreads on senior-most bonds since Treasury Secretary Geithner expanded vintage CMBS as eligible collateral. Although requests for TAL F funding have been limited (January applications were $1.5 billion, up from $1.3 billion in December)[5], the support has helped at the margins and encouraged at least one of the three new CMBS deals to hit the market in QIV 2009. Spread compression can be seen in this data compiled by Alan Todd at JP Morgan[6]:

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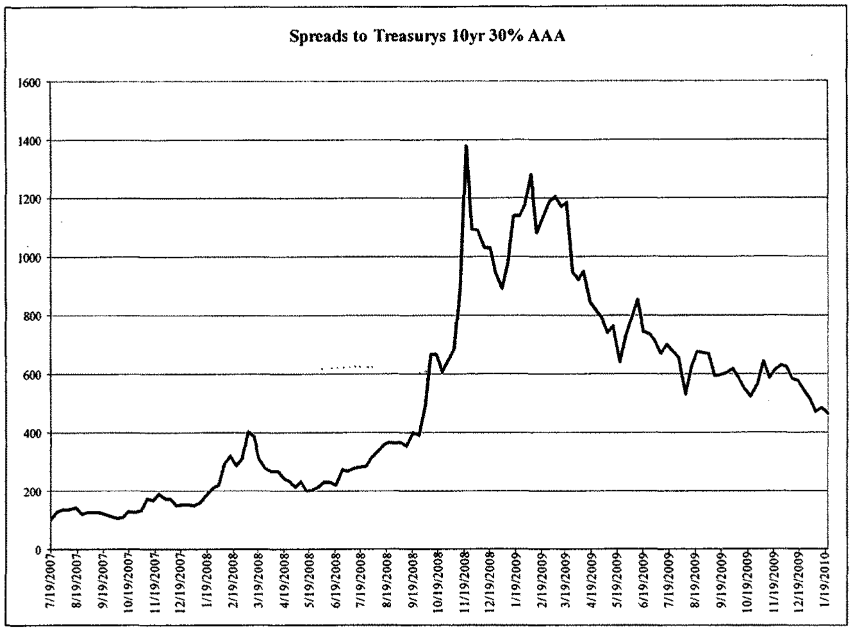
[3] Bank regulators include construction and land development, multifamily and core commercial real estate in their definition of commercial real estate loans.

[4] FDIC Statistics on Depository Institutions Report as of 9/30/09.

[5] Commercial Mortgage Alert, January 22, 2010, http://www.cmalert.com/headlines.php?exact=1&hid=67690&s=TALF

[6] JP Morgan CMBS Weekly Report, January 22, 2010.



I welcome your questions and comments.

Chair WARREN. Thank you very much. Mr. Stockert.

STATEMENT OF DAVID STOCKERT, CHIEF EXECUTIVE OFFICER, POST PROPERTIES

Mr. STOCKERT. Thank you, Madam Chair, distinguished members of the Congressional Oversight Panel. I am David Stockert, the president and CEO of Post Properties. We are a REIT that owns and operates nearly 20 thousand apartments in 55 communities. Our total market capitalization is roughly two billion dollars. I am testifying for the National Multi Housing Council and the National Apartment Association and have been asked to discuss the state of the apartment market.

2009 was one of the most challenging years in memory for our industry. The vacancy rate for investment grade apartments hit eight percent in fourth quarter, an almost 30-year high. 2009's 2.3 percent drop in rents nationally was the largest in 30 years. With more than four-and-a-half million vacant rental units, absorption rates for newly completed apartments had dropped to the lowest levels since 1989. Property values have declined by more than 30 percent, and transaction volume has plummeted from $100 billion to around $14 billion in just two years.

Because of the capital shortage, new apartment development has come to a virtual standstill. New apartment starts set a post World War II record low of 84 thousand units down 67 percent from a year ago. This comes as the foreclosure crisis and the echo boomers entering the housing market have modestly increased demand for rental housing. Analysts project the growing demand will create a shortage of apartments beginning as early as late 2011.

In addition to these challenging conditions, our industry faces an estimated 50 to 60 billion dollars in loans maturing in 2010 and 2011 that will need to be refinanced. Now, many believe that 2010 will likely mark the bottom fundamentally of the market, but the headwinds are still very strong. GDP may recover in 2010, but significant job growth is not expected until 2011 or later, and employment is the primary driver of demand in our business. The loss of over eight million jobs is a severe blow to the industry. In addition, we think the recovery will likely be one based on a flight to quality. Public companies like ours will have greater access and do have greater access to low-cost debt and other forms of capital. Other nonpublic companies in our industry are not nearly as fortunate.

Older properties with weaker sponsorship and properties in secondary markets will continue to find it difficult to access capital.

Looking at the capital markets, the multifamily sector has benefited from the presence of the GSEs, Fannie Mae and Freddie Mac, and the FHA multifamily mortgage insurance program, which has served as a partial replacement for the construction financing. These two capital sources accounted for 90 to 95 percent of all the multifamily debt issued in 2009.

While the multifamily sector has enjoyed more liquidity through the GSEs than the rest of commercial real estate, industry has not been all good news. All debt sources have tightened their requirements, meaning firms must provide additional equity, refinance debt, purchase property, or start a new development. With most equity sources on the sidelines, this has exacerbated the capital shortage in the apartment sector.

The GSEs are very necessary, but they're not wholly sufficient. Reestablishing a viable CMBS market is also critical. This will require reforming the regulatory oversight in Wall Street and improving transparency and rating agency performance. In addition, we are urging the Treasury Department to extend the TALF program through 2010.

I also want to address the widespread media coverage of multifamily CMBS defaults. These reports have left the impression that all multifamily mortgages are experiencing high default rates. This is untrue. CMBS represents just 12 percent of the more than 900 billion of outstanding multifamily loans. The vast majority of multifamily mortgages are held by commercial banks, insurance companies, and the GSEs. When those loans are examined, multifamily default rates are quite low. Delinquencies for loans issued by insurance companies and GSEs remain well below one percent, and the GSEs are underwriting new multifamily loans with good coverage ratios and relatively moderate loan to value levels.

Given the importance of the GSEs to the apartment sector, we are closely watching reform efforts, which are just getting underway. In the short term, we are reassured by the Treasury's December 24th announcement confirming its unlimited support for the GSEs through 2012. In the long term, however, it is critical that policy makers understand the unique needs of the multifamily housing sector and not restrict the supply of multifamily capital as they reform the single family financing process.

Among other things, the reformed GSEs must continue their vital role as a source of permanent debt to refinance construction loans. They should also continue to provide capital for affordable housing projects with greater risk profiles.

Chair Warren. Mr. Stockert——

Mr. STOCKERT. I'm going to stop there, and thank you very much for listening.

[The prepared statement of Mr. Stockert follows:]

NMHC National Multi Housing Council
Apartments: Smart Communities, Smarter Living

STATEMENT BY

DAVID STOCKERT

PRESIDENT AND CHIEF EXECUTIVE OFFICER

POST PROPERTIES

ON BEHALF OF THE

NATIONAL MULTI HOUSING COUNCIL

AND THE

NATIONAL APARTMENT ASSOCIATION

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL

ATLANTA, GA

JANUARY 27, 2010

1850 M Street, NW, Suite 540 ▪ Washington, DC 20036 ▪ 202.974.2300 ▪ FAX 202.775.0112 ▪ www.nmhc.org ▪ info@nmhc.org

Chairman Warren and distinguished Members of the Oversight Panel, I am David Stockert, the President and Chief Executive Officer of Post Properties. With a total market capitalization of roughly two billion dollars, Post Properties operates as a real estate investment trust whose primary business is developing and managing apartment communities.

We were founded nearly 40 years ago, and we are one of the largest developers and operators of multifamily communities in the United States. Post Properties is headquartered in Atlanta, Georgia and has operations in nine markets across the country. We currently own and operate approximately 20,000 apartment units in 55 communities.

I am a witness today on behalf of the National Multi Housing Council (NMHC) and the National Apartment Association (NAA).

NMHC and NAA represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of state and local apartment associations. NAA is a federation of 170 state and local affiliates comprised of more than 50,000 multifamily housing companies representing more than 5.9 million apartment homes. One-third of Americans rent their housing, and over 14 percent of all U.S. households live in a rental apartment.

Your interest in the current economic circumstances and liquidity issues affecting the commercial real estate industry is prudent and appropriate. As a developer and owner of income properties, I can share with you our experience and offer you suggestions regarding strengthening the financial system and improving the business climate for commercial real estate.

Post Properties and the entire membership of NMHC/NAA feel acutely the stress on the multifamily housing sector resulting from our nation's economic situation. We fully support federal efforts to help preserve the nation's supply of safe, decent and affordable housing and to provide liquidity to the apartment sector. While there is a perception that the apartment sector has not suffered to the same degree as the single-family sector, we are nonetheless collaterally impacted by the bursting of the housing bubble and the ensuing economic and financial meltdown.

Because of the nearly complete freeze in the capital markets, much of the new development activity in our sector has come to a standstill. The real estate value of our communities has been substantially diminished. Net operating income has declined. In addition, our industry faces an estimated $50-60 billion in loans that are maturing in 2010-2011 and will need to be refinanced.

Because of the frozen capital markets, sales of apartment properties have plummeted. Construction financing has all but disappeared, and with it, much of our sector's capacity to develop new apartments once market conditions improve. This comes at a time when the single-family foreclosure crisis has increased the demand for affordable rental housing. Without a fully functioning capital market to support the development of new rental housing, the nation will face a shortage of apartments beginning as early as 2011.

We are optimistic that, by the end of 2010, much of the decline will be behind us, but recognize that we are likely facing a slow return to a stabilized or growth environment.

The State of the Multifamily Industry

Job growth is one of the most important drivers of demand for apartments. Due to the dramatic loss of jobs in the U.S., 2009 was one of the most challenging years in memory for the apartment industry. U.S. apartment vacancy hit eight percent in the fourth quarter, an almost 30-year high. There are more than 4.5 million vacant rental units; as much as 1.5 million more than in a normal market. 2009's 2.3% drop in rents nationally was the largest in at least 30 years.

Without a fully functioning credit market, transaction volume plummeted; falling from $100 billion to around $14 billion in just two years.

Many in our industry believe that 2010 will likely mark the bottom in terms of declining occupancies and net operating income in most markets. While there may be some sub-markets that will continue to weaken, overall the industry expects it will begin to see a modest recovery commence by the end of 2010.

Despite this generally more optimistic consensus, the headwinds are still very strong. Most of 2010 is expected to be a challenging year for the apartment sector. Even though GDP is expected to recover in 2010, there won't be significant job growth until 2011. Employment growth is essential for apartment demand, and the loss of over eight million jobs during the recession is a severe blow to our industry.

In addition, a "flight to quality" will create a greater separation between different markets and different classes of properties. Class A properties in primary markets will benefit, while older properties with weaker sponsorship and secondary markets will continue to find it difficult to access capital, even as investors return to the market.

Post Properties is known for the quality of our communities and a high level of customer service. Although we focus on "luxury" apartments, the truth is that we provide affordable housing alternatives for residents who wish to live near major employment centers but could not afford similarly located single-family housing. While fewer of our customers leave to buy houses or condominiums today, many more are moving in with friends, roommates or family as a result of job loss.

Rents today at many of our communities are less than they were ten years ago; expenses, however, continued to escalate over that time period at roughly the rate of inflation.

A. Multifamily Vacancy

The U.S. Census Bureau vacancy rate for all rental apartments (in buildings with 5 or more units) rose to 13.1 percent, the highest figure since the inception of the series in 1968. The MPF Research national vacancy rate for investment-grade apartments declined slightly to 7.9 percent from last quarter but is still 1.7 percent higher than a year ago. The vacancy rate remained the same in the Midwest (7.8 percent) and the South (a record high of 9.2 percent), but edged down 10 bps in the Northeast (to 5.9 percent). The vacancy rate fell 50 bps in the West, to 7.1 percent.

Table 1
U.S. Multifamily Vacancy Rate Information

Multifamily % Vacant	**3Q 09**	2Q 09	Change Last Qtr	3Q 08	Change Yr Ago
U.S. – Census	**13.1**	12.1	1.0	10.7	2.4
U.S. – MPF	**7.9**	8.1	-0.2	6.2	1.7

B. Multifamily Construction Activity

According to NMHC analysis, multifamily permits and starts continued their steep downturn; completions also declined this quarter.

Permits (5+ units in structure) decreased sharply to a seasonally adjusted annual rate (SAAR) of 94,700, down 8.4 percent from last quarter and a large 65.6 percent drop from a year earlier. This is the lowest level on record (since 1959).

Starts dropped even more precipitously to a SAAR of 84,000, down 19.7 percent from last quarter and 67 percent from a year ago. This is also the lowest level on record.

Completions decreased to a SAAR of 247,000, down 15.6 percent from the previous quarter and 10 percent from a year ago. The declines in starts and permits will mean larger drops in completions in the coming quarters.

Table 2
New Construction Permit Activity

Permits (2+ units, unadjusted)	**3Q 09**	2Q 09	Change Last Qtr	3Q 08	Change Year Ago
Northeast	4,600	4,700	-100	9,100	-4,500
Midwest	6,500	4,500	2,000	13,900	-7,400
South	12,500	16,600	-4,100	42,700	-30,200
West	6,500	6,000	500	17,500	-11,000
U.S.	30,100	31,800	-1,700	83,200	-53,100

C. Rents and Transaction Activity

Apartment rents measured by public and private data sources diverged. Same store rents for professionally managed apartments tracked by MPF Research declined 4.6 percent this quarter, surpassing last quarter's record decline of 3.4 percent. Rents continued to decline in all four regions for a fourth straight quarter. The West had the largest decline at -7.7 percent, while the Northeast (-2.6 percent), the Midwest (-2.8 percent) and the South (-3.3 percent) experienced smaller declines. Regional rent growth declines set records, except in the Northeast.

By contrast, the CPI rent index, which covers all rental housing, rose 2.0 percent, still positive but the lowest rate of annual growth since 1968. With overall inflation negative, real rent grew by a larger amount, namely 3.6 percent.

Table 3
Same Store Rent Change

MPF "same store" rent (annual change %)	3Q 09	2Q 09	1Q 09	4Q 08	3Q 08
Northeast	**-2.6**	-2.1	-1.3	-5.4	2.3
Midwest	**-2.8**	-1.8	-0.7	1.6	2.4
South	**-3.3**	-2.0	-0.6	-0.7	1.6
West	**-7.7**	-6.5	-3.8	-1.7	1.3
U.S.	**-4.6**	-3.4	-1.7	-1.7	1.7

Looking at apartment transactions, volume rose slightly in the third quarter to $3.6 billion, up 12.1 percent from the prior quarter but still down an exceptional 64.2 percent from last year's level, and still far below mid-decade levels. Apartment prices fell further. The average price for properties sold in the third quarter of 2009 was $78,709 per unit, down 9.7 percent from the previous quarter and down more than 30 percent from 2008. This was the fifth straight quarter of decline and the lowest average price since the second quarter of 2004. The market value of investment-grade apartments in the National Council of Real Estate Investment Fiduciaries' (NCREIF) database also continued to decline in the third quarter, falling 4.3 percent from the previous quarter and 27.0 percent from last year. The capitalization rate increased to 7.1 percent.

D. New Apartment Absorption

Absorption rates for newly completed apartments have dropped to the lowest levels since data started being collected in 1989. Census Bureau data show that looking at the trailing 12-month average, using not seasonally adjusted data, only 50 percent of 2009Q1 new apartments were leased, the same as the previous quarter and a record low. The historical average for the series is a 67 percent lease-up rate.

Similarly, the 6-month absorption rate (also on a trailing 12-month average basis) was 68 percent, also a record low and well below the series average of 84 percent. After fairly steady absorption rates in the 1990s, lease-up rates have fallen for most of the decade, interrupted only by a partial rebound from 2003-05.

Debt Financing and Liquidity

The commercial real estate markets have had great difficulty accessing capital since 2007's collapse of the commercial mortgage-backed securities (CMBS) markets. Institutional investors such as pension funds, insurance and other equity sources exited the commercial and multifamily real estate markets and did not participate in the private real estate markets in 2009.

Historically, multifamily has typically enjoyed good access to debt for decades, even during difficult economic periods and weak market conditions. When one supplier of credit to apartment properties or multifamily developers was under stress, another would step in to take its place.

For example, when the savings and loans crisis occurred in the late 1980s, commercial banks expanded their market shares. When the FHA temporarily exited the market in the wake of the failure of the co-insurance program, the GSEs, banks, and others helped to ensure a flow of credit. When Freddie Mac's portfolio of multifamily mortgages was under stress in the late 1980s from loans written in distressed markets, Fannie Mae and other lenders gained share.

In this economic crisis, the GSEs have stepped in to fill the gap, and the FHA multifamily mortgage insurance program has served as a partial replacement for construction financing. These two capital sources—the GSEs' multifamily loan purchase programs and the FHA/Ginnie Mae multifamily insurance program—accounted for 90-95 percent of all the multifamily debt issued in 2009.

Table 4
Outstanding Mortgage Debt by Source

	2000 Second Qtr.		2008 Fourth Qtr.		Change '00-'08	
Institution	**Billions**	**Percent**	**Billions**	**Percent**	**Billions**	**Percent**
Commercial Banks	$78	19%	$217	24%	$139	179%
Savings Institutions	$61	15%	$64	7%	$3	5%
Life Insurance Companies	$34	8%	$50	6%	$16	49%
Farmers Home	$12	3%	$11	1%	-$1	-6%
FHA/GNMA	$21	5%	$45	5%	$24	113%
Fannie Mae & Freddie Mac	**$72**	**18%**	**$318**	**35%**	**$246**	**343%**
Conduits	$47	12%	$110	12%	$63	135%
Individuals/Others*	$79	20%	$96	11%	$17	22%
Total	**$404**	**100%**	**$911**	**100%**	**$507**	**126%**

Table Notes:
- * *The Individuals/Others category includes REITs, insured pension funds, non-insured pension funds, mortgage companies, state and local credit agencies, state and local pension funds, credit companies and finance companies.*
- *Source: Federal Reserve Board Statistical Supplement, Report 1.54 - Outstanding Mortgage Debt, 2001 and 2008 fourth quarter reports.*
- *Data includes outstanding balance on issued and insured mortgage securities.*

But it has not been all good news for the multifamily sector of commercial real estate. As fundamentals weakened, debt providers significantly tightened their underwriting requirements. This has meant that apartment firms had to provide additional equity to finance a purchase transaction, refinance a maturing loan or renovate or develop new rental housing. FHA has also indicated that it will tighten its underwriting and loan requirements. With most equity sources on the sidelines, this has meant a capital crisis for the apartment sector even with the backstop provided by the GSEs and FHA. In other words, the GSEs are necessary, but not sufficient to meet the industry's capital needs.

Multifamily Loan Performance

There has been widespread media coverage of a March 3, 2009 report by Deutsche Bank declaring that multifamily CMBS are experiencing the worst deterioration of all the CMBS thus far, and that the deterioration is worsening. While the multifamily CMBS market is indeed suffering, it is important to keep this in perspective. Many observers have misunderstood the Deutsche Bank report to mean that ALL multifamily mortgages are experiencing high default rates.

This is untrue. The CMBS multifamily rates, while high, are only a portion of the debt outstanding. CMBS represents just 12 percent of the more than $900 billion of multifamily loans outstanding. The vast majority of multifamily mortgages are held by commercial banks (24%) and the GSEs Fannie Mae and Freddie Mac (35%). Banks and Thrifts account for just under a third of multifamily mortgage debt outstanding (31%), life insurance companies (6%) and FHA/Ginnie Mae (5%).

When loans held by those entities are examined, it is clear that multifamily default rates remain, in fact, quite low and much lower than in the single-family sector. Delinquencies for loans issued by insurance companies and the GSEs remain well below one percent, and the GSEs are underwriting new multifamily loans with good coverage ratios and relatively moderate loan-to-value levels.

Nonetheless, the agencies are anticipating increased loan defaults both in their portfolios of multifamily mortgage loans and guaranteed mortgage securities. Reports indicate that Fannie Mae will increase its loan loss reserve capital by $1 billion; Freddie Mac is also expected to increase its capital reserves to compensate for potential losses in its multifamily mortgages.

Secondary Market Concerns and Future

As you know, Congress is beginning to develop plans to restructure Fannie Mae and Freddie Mac. What that new structure will look like and how we transition to it will be debated for months, and maybe years, to come.

In the short term, the industry is reassured by the December 24 announcement by the Treasury Department confirming its unlimited support for Fannie Mae and Freddie Mac through 2012 and easing the portfolio limits on the mortgage giants. Before the announcement, the retained portfolio of each firm was capped at $800 billion and each was required to reduce their portfolios by 10 percent a year beginning in 2010. Now, the portfolio reduction requirement applies to the portfolio caps ($900 billion) and not the actual size of the portfolio at the end of 2009 ($771.5 billion for Fannie Mae and $761.8 billion for Freddie Mac).

This means the companies will not have to take immediate steps to reduce their portfolios and could even expand them. In addition, Treasury announced that it was committed to providing the GSEs with unlimited financial support through 2012, removing a prior limit of $200 billion per company.

The announcement makes it clear that the federal government intends to back the GSEs in whatever capacity is necessary to maintain their housing finance activities.

In the long term, however, the multifamily industry is greatly concerned about the future of the GSEs, given their critical role as a liquidity backstop. As the Administration and Congress begin the process of establishing a new secondary mortgage market system and regulatory oversight for the GSEs, lawmakers should understand the unique needs of the multifamily sector and take steps to ensure that they do not restrict the supply of multifamily capital as they reform the single-family financing process.

Among other things, the GSEs must:

- Continue to serve the entire multifamily market to provide liquidity. This will allow banks and other construction capital sources to have a steady and reliable source for permanent debt. It also provides for needed loan diversity to support loans for affordable and workforce housing that have greater credit risk profiles due to the need for higher loan proceeds and limited income stream to support debt coverage.

- Continue to be available to the market regardless of market conditions. Fannie Mae and Freddie Mac serve not only as a mortgage capital source, but serve as a standard in multifamily lending in all markets, both large and small, and in urban and rural areas.
- Continue to create and support opportunities for mixed-income and mixed-use development that improves economic development and accessibility to jobs.

Commercial Mortgage-Backed Securities (CMBS)

Reestablishing a viable commercial mortgage-backed securities market is also critical to meet the variety of financing needs. Reforming the regulatory oversight of Wall Street and improving transparency and rating agency performance are important to bringing back the CMBS market. Reform measures and efforts by the Federal Reserve and Treasury through the Term Asset-Backed Loan Facility (TALF) program are important. As such, the government should not terminate its efforts, and should continue to extend the TALF program, at a minimum through 2010. This is important to build additional confidence among investors. With greater investment anticipated during 2010, programs such as TALF are important to stimulate the markets.

Troubled Asset Relief Program (TARP)

I have been asked to address the use of TARP funds to support our sector. Last year, legislation was introduced that would have recycled TARP funds to support distressed multifamily properties. While we are not actively seeking such funds, should they be made available, we would recommend that they not be used to transfer properties to new owners, but rather that they support existing owners and lenders.

We would support two key uses of TARP funds:

1. Provide insurance to lenders who extend current loans for periods of 24-36 months.
2. Provide gap financing on newly refinanced loans through subordinated debt, cash-flow mortgages or, when appropriate, grants.

Any TARP program should not create uncertainty in the capital markets about potential future government intervention in the contractual and legal chain of ownership, and should carefully define when such funds are used.

National Policy Change to Meet Our Housing Needs

For decades, the federal government has pursued a "homeownership at any cost" housing policy, ignoring the growing disconnect between the country's housing needs and its housing policy. In the process, many people were enticed into houses they could not afford, which in turn helped fuel a housing bubble that ultimately burst, catalyzing a global economic crisis.

The nation is now paying the price for that misguided policy and learning firsthand that there is such a thing as too much homeownership; that aggressively pushing homeownership was not only disastrous for the hardworking families lured into unsustainable homeownership, but also for our local communities and our national economy.

If there is a silver lining in this situation, it is the opportunity we now have to learn from our mistakes and rethink our housing policy. Housing our diverse nation means having a vibrant rental market along with a functioning ownership market. It's time we adopt a balanced housing policy that doesn't measure success solely by the level of homeownership.

For many of America's most pressing challenges, from suburban sprawl to affordable housing, apartments are the preferred solution. Apartments help create stronger and healthier communities by offering enough well-located housing for the workers that businesses need, by reducing the cost of providing public services like water, sewer and roads, leveraging existing infrastructure, and by creating vibrant live/work/play neighborhoods.

Apartments offer a flexible and convenient lifestyle and will help us house our booming population without giving up all our green space and adding to pollution and traffic congestion. And they will help us reduce our greenhouse gas emissions by creating more compact communities that enable us to spend less time in our cars.

Elements of a Balanced Housing Policy

NMHC and NAA have joined together to advocate for a more balanced housing policy, one that respects the rights of individuals to choose housing that best meets their financial and lifestyle needs. We urge policymakers at all levels of government to work with the apartment industry to craft a smarter housing policy that:

- Assures that everyone has access to decent and affordable housing, regardless of his or her housing choice;
- Respects the rights of individuals to choose the housing that best meets their financial and lifestyle needs without disadvantaging, financially or otherwise, those who choose apartment living;
- Promotes healthy and livable communities by encouraging responsible land use and promoting the production of all types of housing;
- Recognizes that all decent housing, including apartments, and all citizens, including renters, make positive economic, political and social contributions to their communities; and
- Balances the expected benefits of regulations with their costs to minimize the impact on housing affordability.

Attachments:

NMHC Research Notes Series 2009
NMHC Market Trends Series 2009

NMHC

Research NOTES

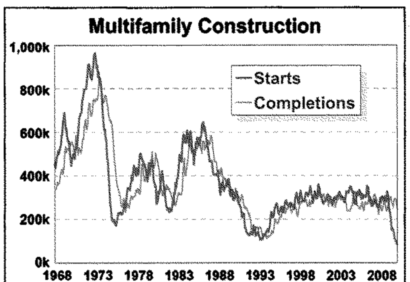
October 30, 2009

IS A SUPPLY SHORTAGE LOOMING?

The apartment industry is facing arguably the most difficult operating environment in the postwar era. Renter vacancy rates are at record levels whether measured across all apartments (5+ units) or only investment-grade, and whether the data comes from government sources or private data providers. Yet there is a broad consensus that as early as 2011 today's insufficient demand will be replaced by a supply shortage. Construction of market-rate apartments has all but shut down because of scarce construction financing and the current oversupply. Once job growth returns, demographic and household formation trends will kick in. But is the existing oversupply too large for demographic demand to work off quickly? This issue of *Research Notes* looks at current supply conditions to help gauge whether we might see a shortage in the coming years.

New Construction Trends

The data on apartment construction underscore the decline in new supply; starts have dropped dramatically. Although multifamily completions (5+) have thus far remained close to the 1990s levels, they typically lag the starts data by about nine months and are expected to drop in the near future.



Source: Census Bureau; NMHC.

For the most recent month, starts have fallen to a seasonally adjusted annual rate of only 84,000. (Note: This is measured as a 3-month moving average to offset the fact that multifamily construction varies greatly from month to month for reasons that may have nothing to do with underlying trends.)

We need to net condos out of these figures, however. The condo share of construction has decreased considerably—from a high of 47 percent at the height of the boom in mid-2005 to around 15 percent in the first half of 2009. Taking account of condos and a small number of other non-apartment units, we're currently on an annual pace to produce fewer than 90,000 apartments, including tax credit/subsidized units. Unfortunately, there are no current data on the share of subsidized construction, but anecdotal reports suggest it might be a bit higher than in the last year or so—perhaps one-third. That takes market-rate construction to an annual rate of about 60,000.

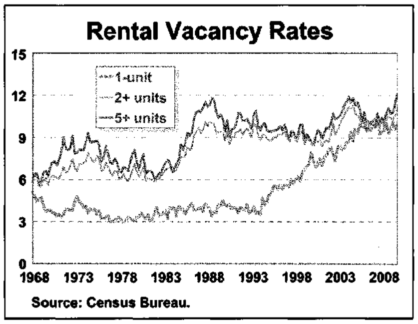
That is a little less than replacement need. Applying an estimated annual loss rate of 0.7 percent (the average for the last 10 years) to a conservatively estimated 10 million (likely more) market-rate apartments shows annual losses to the stock of 70,000. So at current production levels, the number of market-rate apartments in the U.S. is actually declining.

The Current Oversupply

As a result of the steepest drop in employment of the postwar era plus the spillover of bubble-induced excess construction in the for-sale market, the Census Bureau reported that the number of for-rent vacant residences of all types reached a record 4.4 million in the second quarter. Of these, 1.4 million were vacant single-family units for rent. We estimate 800,000 were in buildings with 2-4 units, and 2.2 million were in 5+ multifamily buildings.

Of course, some vacancies are normal and necessary; only the number of units over and above the normal level should be considered excess inventory. Using the 1990s average vacancy rate of 7.7 percent as the norm suggests that the rental oversupply (of all types of units) is currently 1.3 million units overall, also a record. (Note that if we used a lower vacancy rate as the norm, the estimated oversupply would be larger.)

Gauging how many excess vacant units are apartments rather than single-family or small multifamily is somewhat more difficult. In particular, it is hard to know what the normal vacancy rate should be for the single-family rental sector. For 25 years, the single-family vacancy rate was far more stable than the multifamily (measured as either the 2+ or 5+ sector) rate, and about half as large. But beginning in 1994, there has been a steady rise in the former rate until it essentially converged with the multifamily vacancy rates in the middle of the current decade.



So is the former 3-5 percent single-family vacancy range the norm or is the current 9-10 percent range? For present purposes, we'll assume the recent range is the more likely one. If we assume that in the future the vacancy rate on rental units should be the same regardless of structure, then the excess supply would shake out as shown in the table below.

Excess For-Rent Inventory		
	Total Vacant	*Excess Vacant*
Single-family	1,428,000	410,000
2-4 units	800,000	230,000
5+ units	2,179,000	856,000
Total	4,407,000	1,266,000
Source: Census Bureau; NMHC.		

This estimate is sensitive to a number of assumptions. In particular, if the normal vacancy rate for single-family rentals is actually more like its 1990s average of around 5 percent, then the number of normal vacancies in the single-family sector would be smaller. In turn, this implies that a higher share, and number, of the single-family vacant units represent excess inventory. Since the estimate for the total excess for-rent inventory is fixed, that would mean that the number (and share) of apartment units that represent excess inventory is actually smaller.

Working in the other direction, some vacant units in the rental universe have been excluded, such as units that have been rented but not yet occupied and units that are being held off the market for various reasons. It is not clear whether or not these categories should be included. In any case, the Census Bureau does not provide any information on how many such units should be part of the for-rent, vs. for-sale, housing stock, so there is no practical way to include them.

How Fast Can the Excess Inventory Be Used Up?

The past may not offer much insight into how rapidly this excess can be worked off. In four decades of data, the steepest one-year decline in vacant, for-rent units was only 320,000, and that was for the entire rental stock, including single-family and small multifamily buildings. However, production of new, for-rent residences over the same time frame has never been as low as it is today.

By contrast, the greatest one-year net absorption (net increase in the number of renters overall) was 1.5 million. If repeated over the next 12 months, that might eliminate the entire excess rental stock. (This assumes that the rental units in the categories mentioned above, for which we don't have enough information to include, such as units held off the market, do not flood back into the market.) Although this record occurred recently (2007), throughout the 1970s and 1980s, the two-year increase in renters averaged 1.1 million and was frequently above 2.0 million. It is encouraging that the demographics now are similar in many ways to the era when the baby boomers moved into the housing market. Unfortunately, the Census data do not break down the change in renters by type of rental unit, so we can't examine the impact on apartments separate from other rental units.

It seems likely that the excess inventory could be worked off quickly: economic recovery, demographic trends and the lack of new supply will combine to reverse the current supply-demand imbalance. But the timing is hard to gauge. If the recovery is slow and halting, it is likely to postpone—but not cancel—the positive demographics. A subpar recovery is not likely to cause a supply surge, however, so demand is still likely to outstrip supply at some point in the next few years.

Questions or comments on Research Notes should be directed to Mark Obrinsky, NMHC's Vice President of Research and Chief Economist, at mobrinsky@nmhc.org or 202/974-2329.

NMHC

Research
NOTES

July 2009

WHO'S MOVING INTO APARTMENTS?

The U.S. has always been a country on the move. On average, one in six households lived somewhere else a year ago. While the economic downturn has postponed many planned relocations, they are likely to rebound when the economy begins to improve.

It is well known that renters move more often than homeowners. Less well known is the fact that there is considerable tenure switching—from owner-to-renter or renter-to-owner. Even less well known is that more tenure-switching movers are owners becoming renters than vice versa.

This issue of *Research Notes* examines which households are most likely to move from owners to renters and which households are most likely to move into apartments specifically. It finds that younger households have a high net switch rate into apartments. But there is one age group that is even more likely to switch to apartments: seniors.

Among household types, singles are the most likely to switch into apartments; single parents also have a decided net switch rate to apartments.

Households on the Move

In 2007 (the latest year for which we have data), 16 percent of households had moved within the previous 12 months. There has been little variation in this figure since 1997—the high was 17.8 percent during the peak of the housing boom in 2005, while the low was 15.6 percent in the recession year 2001.

Of those households who moved, 52 percent had been and remained renters—virtually the same as the average of 51 percent since 1997. Another 18 percent had been and remained homeowners. That means 30 percent of movers switched tenure.

In 2007, more owners became renters (17 percent) than renters became owners (13 percent). To a smaller degree, this has been true over the last decade as well. The 10-year average shows 16 percent of movers switched from owner to renter, and 15 percent made the renter-to-owner switch.

Note the data source, the American Housing Survey (AHS), only has the prior tenure information for 93 percent of households who moved. The other 7 percent either split off from previously existing households (e.g., children leaving their parents' homes or a roommate leaving to get married), were recent immigrants to the U.S., or did not answer the question. So, although more movers switched from owner to renter than from renter to owner, the homeownership rate didn't necessarily decline.

Even so, the fact that a large number of owners become renters every year is not widely known, so it merits some investigation. To do this, we need to analyze the data in the "recent mover" file.

Recent Movers

Recent movers are defined as households who have moved within the prior two years (rather than just last year). The AHS captures key demographic, housing, and income data about them. Below are tenure data about recent movers by age group.

Tenure of Recent Movers by Age Group

	Used to rent	*Currently rent*
All movers	61%	63%
Under 30	71%	76%
30-44	63%	58%
45-64	50%	53%
65 and over	36%	52%

Source: NMHC tabulations of the American Housing Survey recent movers, 2007.

Among all households who moved in the previous two years, 61 percent had been renters, but 63 percent are now renters. Not surprisingly, youngest households were the most likely to be renters—both before (71 percent), and after (76 percent), the move. Households in the 30-44 year age group were the only group less likely to rent after the move than before—many probably became first-time homeowners.

What may be a surprise is that the age group that increased its rentership the most is the oldest age group. Fully 52 percent of recent movers who are 65 or more years old are now renters, though only 36 percent had been renters before moving—a net increase of 16 percentage points. The economic recovery might lower this figure somewhat, although it will likely remain high. While seniors move the least, they are nonetheless expected to be the fastest-growing age group over the next 15 years, making this potentially a very important market for the apartment industry.

The types of households most likely to rent—singles, single parents, and "others" (i.e., not a married couple,but also neither a single-person nor single-parent household)—are also the households that increase their rentership the most when moving. Among single-person household movers, 61 percent rented before moving, while 73 percent rent after moving. Among single-parent households, rentership increases from 69 percent before the move to 76 percent after. "Other" households changed less—from 70 percent renters before moving to 74 percent after.

By contrast, married couples were considerably less likely to rent after moving than before; among those without children, 49 percent were renters before moving but only 40 percent after; for those with children rentership fell from 54 percent to 42 percent.

There is a similar story when we look at whether movers live in single-family or multifamily (rental or for sale) housing. (Note that due to data limitations, the term "multifamily" in these analyses means units in buildings with at least two—not five—units in them.)

Housing Type of Recent Movers by Age Group

	Formerly Multifamily	***Currently Multifamily***
All movers	36%	43%
Under 30	43%	56%
30-44	37%	37%
45-64	29%	35%
65 and over	23%	42%

Source: NMHC tabulations of the American Housing Survey recent movers, 2007.

Recent movers are more likely to live in multifamily housing (whether for-sale or rental) after moving than they were before. Interestingly, this is true of all age groups (except among 30-44 year-olds, who are equally likely to be in multifamily housing after the move as before). But younger (under 30) and older (65 and over) households are the most likely to switch into multifamily housing.

Singles were also the household type most likely to switch into multifamily housing. Before moving, 39 percent of single-person households lived in multifamily residences; after moving, the figure was 61 percent. Single parents also chose multifamily more often after moving (47 percent) than before (38 percent). Among "other" households, 41 percent lived in multifamily buildings before moving, but 48 percent did after moving. Only 20 percent of married couples with children live in multifamily properties after moving, the smallest figure for any type of household.

We can combine these analyses and examine which households are most likely to switch into apartments.

Recent Movers Switching to Apartments

	Former Apt Resident	***Current Apt Resident***
All movers	35%	40%
Under 30	43%	53%
30-44	35%	34%
45-64	28%	32%
65 and over	21%	37%
Singles	37%	57%
Single parents	37%	46%
Married with kids	31%	25%
Married, no kids	27%	19%
Other	40%	45%

Source: NMHC tabulations of the American Housing Survey recent movers, 2007.

Care must be taken here, as the cross tabulations run into the limits of the sample size. Still, a number of points stand out. Among households who move, seniors and singles show the biggest increase in apartment residence among all households. Younger (under 30) households and single parents also substantially increase their likelihood of renting an apartment when they move. Even households headed by a 45-64 year-old mover increase their likelihood of living in an apartment. That means only 30-44 year-olds—along with married couples—as less likely to be in an apartment.

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Research NOTES

April 29, 2009

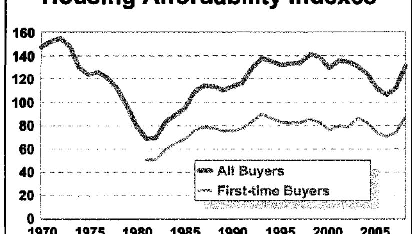
MORE COMPETITION FROM HOMEOWNERSHIP?

The sharp drop in house prices over the last two to three years has helped cause a surge in popular measures of homeownership affordability. The implications of that increase are unclear however. Will buyers start to return to the single-family and condo markets? Will this mean increased competition from the for-sale market, with apartment renters moving out in greater numbers again? While this trend bears watching, the view here is that the housing downturn still has a way to go. And that the economy is still a far greater problem for apartment owners than homeownership.

Measuring Affordability

The most widely cited measure of affordability is the National Association of Realtors' Housing Affordability Index (HAI). It is calculated as the ratio of median family income to the principal and interest (P&I) payment on a median-priced house—with a downpayment of 20 percent and a maximum of 25 percent of income devoted to the P&I payment.

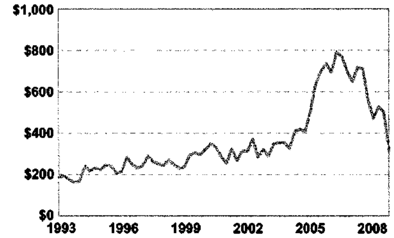
Housing Affordability Indexes



Source: NAR.

In the first two months of this year, the HAI for all buyers reached an all-time high of 173. Clearly, by this measure, affordability has improved greatly. But it is not at all clear what, if anything, that implies for apartment owners. After all, the big run-up in homeownership rates took place from 1995-2005. Yet over that period, the HAI—for both first-time buyers and for all buyers—was flat or falling. The limitations of the HAI are that it leaves the mortgage market out of the picture; it assumes no change in would-be buyers' ability to make a downpayment; and it ignores the cost of the other tenure choice, namely renting.

Buy vs. Rent Premium



Source: M/PF Yieldstar; Federal Reserve; NAR; NMHC.

The latter drawback can be remedied simply enough. The buy vs. rent premium is the amount by which the monthly payment on a median-priced house nationally (including property taxes and insurance) exceeds the median national rent for professionally managed apartments.

The trend in this chart is somewhat similar to the first: the sharp run-up of recent years has been largely unwound, with the premium now down to the 2001 level. Nevertheless, it still cost, on average, $313 more to buy than rent in the fourth quarter of 2008, well above the $271 average for 1995-2000 when the for-rent *and* for-sale markets were doing well.

It is more difficult to determine how changes in mortgage underwriting are affecting the for-sale market. Looser credit requirements had a lot to do with the housing boom, and the return to more traditional underwriting should reduce mortgage borrowing (for a given affordability level or buy-rent premium). We also know that downpayment requirements were greatly loosened during the housing bubble, but that they are back. To gauge how much that affects home buyer demand we need to know a great deal about the overall wealth (both assets and liabilities) of potential buyers. While there is no time series with such data, the Census Bureau produces periodic analyses estimating overall affordability that takes into account the buyer's ability to make a downpayment.

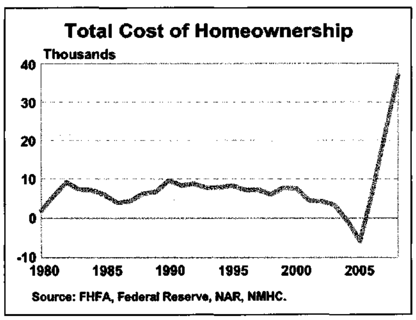
The conclusion of the most recent report (covering 2002) is that the ability to make the monthly payments plays a very small part in affordability. Only 19 percent of those who could not afford a median-priced house had sufficient funds for downpayment, but not enough income for the monthly payments.

By contrast, 23 percent could afford the monthly payments, but either lacked a downpayment or had too much debt. The majority (58 percent) of would-be buyers priced out of the market had more than one problem—that is, they could not afford the monthly payment and had either too much debt or insufficient cash for a downpayment.

The figures are even starker for renters: only two percent were unable to afford to buy solely because they could not afford the monthly payments. In other words, measures of home buying affordability that only look at the monthly payments are missing the main problem, and consequently provide only limited information.

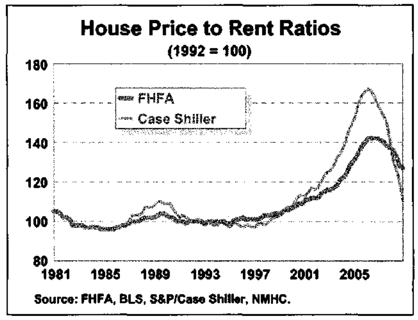
The House Price Effect

House prices also affect the cost of owning, mainly through future appreciation. If house prices are rising, the cost of owning is lower; if they are falling, the cost of owning goes up. Since we don't know actual appreciation in advance we must estimate it, for example, by using either the most recent year's appreciation rate or the long-run average (around four percent).



The chart above offers a comprehensive measure that includes the cost of debt and equity, as well as property taxes, maintenance and depreciation, house (or, really, land) price appreciation and tax savings. (Economists refer to this as the "user cost" of ownership. For more on this concept, see the March 14, 2003 *Research Notes*.) Using the assumption that this year's appreciation will equal last year's, the user cost clearly fell below the bottom of its usual range and was actually negative in 2004 and 2005. That surely helps explain the continued surge in demand despite the increasing cost, at least as shown by some affordability measures.

This also helps explain the stunning drop in current homeownership demand: although prospective monthly payments have fallen, as has the premium over renting, the user cost has shot up to unheard-of levels because of negative appreciation. Indeed, the 2008 figure of $36,976 is almost four times as high as the pre-2005 peak ($9,628).



If would-be home buyers continue to expect the near future to resemble the recent past, the user cost of homeownership may remain elevated for a while. The house price-to-rent ratio is a simple gauge of how prices compare to rents. Both measures shown above—based on the more volatile Case Shiller, and the more stable FHFA (formerly OFHEO) home price indexes—suggest that prices are still too high relative to rents, by anywhere from 10-27 percent. But prices could fall more than that. Not only is it possible they will "overshoot," but also with rents falling, the equilibrium price is a (downward-) moving target.

Put differently, as long as prospective home buyers expect house prices to continue to fall—or even remain flat—they will rightly see the homeownership cost as historically high, and probably further delay buying.

Questions or comments on *Research Notes* should be directed to Mark Obrinsky, NMHC's Vice President of Research and Chief Economist, at mobrinsky@nmhc.org or 202/974-2329.

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Research NOTES

February 3, 2009

THE GSEs' ROLE IN MULTIFAMILY FINANCE

The credit crisis that began in August 2007 and the ensuing financial sector collapse have affected virtually all industries. For the apartment sector, it has meant a near halt in construction lending and more expensive and more restrictive acquisition finance. But our industry has one big advantage over the other commercial real estate sectors: Fannie Mae and Freddie Mac. Barred by charter from the commercial mortgage market, the firms have served as a critical liquidity backstop for the apartment market.

It is unclear, however, whether they will be able to supply the same degree of liquidity next year because of regulatory mandates that they begin to reduce the size of their portfolios in 2010. This issue of *Research Notes* looks back at the role they have played in multifamily finance.

Background

Fannie Mae was established as a federal agency in 1938 and then privatized in 1968 to become a government-sponsored enterprise (GSE) with private shareholders but a public purpose and responsibilities. Freddie Mac was chartered two years later. Although conventional wisdom holds that the GSEs were created to make homeownership more affordable, that is not actually listed in their charters. Their primary purpose has always been to provide liquidity to the mortgage markets—in fact, three of the four purposes listed in their charters concern liquidity.

Both firms began buying multifamily mortgages essentially since the beginning, but in contrast to their single-family mortgages, which were largely securitized, both tended to hold the majority of their multifamily mortgages in their retained portfolios.

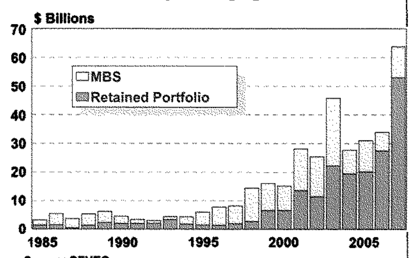
For Fannie Mae, the multifamily share of their portfolio has risen and fallen in long cycles, never going below 5 percent, and reaching a high of 28 percent in the third quarter of 2008 (latest data available). Freddie Mac's multifamily portfolio has also cycled higher and lower over the years. Currently, more than two-thirds of Freddie's mortgage portfolio is in multifamily.

Both companies do securitize some of their multifamily mortgages; however, the multifamily share of their mortgage-backed securities (MBS) is much smaller than the multifamily share of their portfolios. Currently, only 4 percent of Fannie's MBS outstanding are multifamily, while for Freddie the share is less than one percent.

Thus, for Fannie Mae, 53 percent of their multifamily total is held in their portfolio; for Freddie Mac, 86 percent of their multifamily total is retained mortgages.

Combined, 62 percent of the GSEs' multifamily business is retained in their portfolio (vs. 38 percent securitized). By contrast, only 7 percent of single-family loans are in portfolio (93 percent are securitized).

GSE Multifamily Mortgage Purchases



Source: OFHEO.

The chart above shows annual combined multifamily mortgage purchases by Freddie Mac and Fannie Mae through 2007. Clearly, GSE activity slowed in the middle of the current decade, even as transaction activity reached new highs and the CMBS market boomed. Arguably, that is just what policymakers would want: the firms step up when needed, but step back when not.

The GSEs and Liquidity

It is worth looking closer to see whether the GSEs have provided liquidity when it was needed most. Unfortunately, there is no reliable data series on multifamily loan originations, so it is not possible to measure lender shares against the GSE share. The Federal Reserve data on mortgage debt outstanding (MDO) does, however, fill the gap and it confirms the important liquidity role of Fannie and Freddie.

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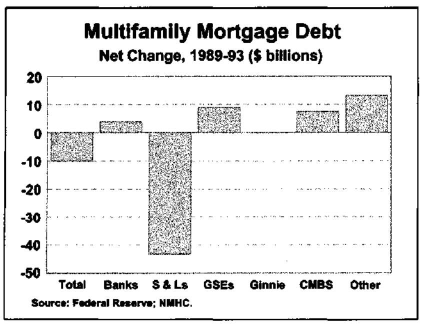
There are a number of examples that illustrate this point, but two will suffice for present purposes. The first example is the "credit crunch" of two decades ago, brought on by a combination of overbuilding, revised tax laws, the resolution of the savings and loan crisis, tightened regulation of banks and a moderate recession.

Over the five years from 1989 through 1993, net multifamily mortgage debt actually declined by $10 billion. As the chart below shows, this was mainly due to the net disinvestment from thrifts (-$43 billion). Some of those loans went into the portfolios of banks who took over S&Ls and some were packaged into securities by the Resolution Trust Corporation (RTC).

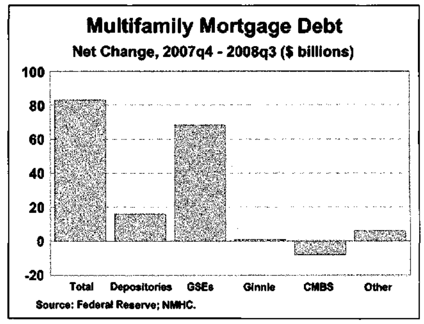
In order to dispose of the assets of failed S&Ls, the RTC packaged commercial mortgages into mortgage-backed securities, thus becoming an important pioneer in the CMBS market and accounting for the $7.4 billion figure for CMBS shown below. Ginnie Mae MBS volume was essentially flat, while life insurance companies added about $3 billion (lumped into the "Other" category below).

Fannie Mae and Freddie Mac, meanwhile, provided a net multifamily investment of $9 billion, making them essential players in this market. In other words, when the multifamily mortgage market was under great stress, the GSEs increased their multifamily activity just as they were designed to do.



The second example of how the GSEs provided crucial liquidity to the apartment industry is the current one. This time the implosion of the single-family mortgage market—brought on by the combination of a bursting housing bubble and lax (at best) underwriting—combined with a highly leveraged global economy has brought the financial system to a state of near-collapse.

For the multifamily mortgage market, this has meant the drying up of almost all sources of debt finance, with the exception of Fannie and Freddie. In this respect, the apartment industry has a big advantage over the other commercial real estate asset types, as participants in these markets will readily admit.



The chart above makes the point rather starkly. In the 12 months from October 2007 through September 2008, multifamily mortgage debt outstanding grew by $83 billion. Of that amount, a staggering $68 billion (82 percent) was provided by the GSEs.

Ginnie Mae provided less than $1 billion, the life insurance companies less than $4 billion (again included in "Other"), and the CMBS market went into reverse, as multifamily CMBS outstanding fell by $8 billion. Clearly, without Fannie and Freddie, the apartment industry would have been virtually unable to obtain acquisition financing or to refinance existing debt.

Unfortunately, the Fed data do not break out construction financing from permanent financing. As a result, the GSEs' role may be even greater than shown in the chart. Depository institutions provided just under $16 billion in funding over this time frame, but this is widely believed to be primarily construction finance. If it were entirely construction lending, it would mean the GSEs were responsible for **all** permanent financing. If only half of depository lending consisted of construction loans, the GSEs' share of permanent lending would be 91 percent.

This is exactly what the market needed, and exactly what Fannie and Freddie were created to do: provide a liquidity backstop when the private market either cannot or will not. While there may well be other ways to accomplish this, surely the starting point for any rethinking of the GSEs' role ought to be: first, do no harm.

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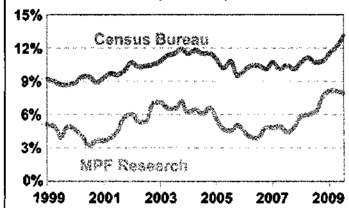
NMHC

MARKET TRENDS

November 2009

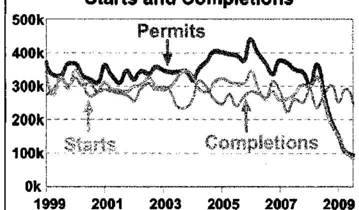
Apartment vacancy rates diverged this third quarter. The U.S. Census Bureau vacancy rate for all rental apartments (in buildings with 5 or more units) rose to 13.1 percent, the highest figure since the inception of the series in 1968. The MPF Research national vacancy rate for investment-grade apartments declined slightly to 7.9 percent from last quarter but is still 1.7 percent higher than a year ago. The vacancy rate remained the same in the Midwest (7.8 percent) and South (a record high of 9.2 percent), but edged down 10 bps in the Northeast (to 5.9 percent). The vacancy rate fell 50 bps in the West, to 7.1 percent, a considerable decline from the recent high of 8.1 percent in 2008Q4.

Multifamily % Vacant	3Q 09	2Q 09	Change Last Qtr	3Q 08	Change Yr Ago
U.S. – Census	13.1	12.1	1.0	10.7	2.4
U.S. – MPF	7.9	8.1	-0.2	6.2	1.7



U.S. Rental Apartment Vacancy Rate (5+ Units)

Multifamily permits and **starts continued their steep downturn; completions also declined** this quarter. **Permits** (5+ units in structure) decreased sharply to a seasonally adjusted annual rate (SAAR) of 94,700, down 8.4 percent from last quarter and a large 65.6 percent drop from a year earlier. This is the lowest level on record (since 1959). **Starts** dropped even more precipitously to a SAAR of 84,000, down 19.7 percent from last quarter and 67.0 percent from a year ago. This is also the lowest level on record. And **completions** decreased to a SAAR of 247,000, down 15.6 percent from the previous quarter and 10 percent from a year ago. The declines in starts and permits will likely mean larger drops in completions in the coming quarters.

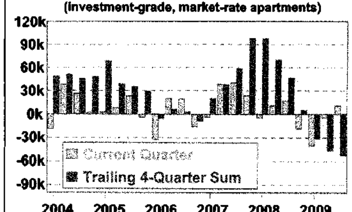


U.S. Multifamily Permit Issuance, Starts and Completions

Source: Census Bureau.

Permits (2+ units, unadj.)	3Q 09	2Q 09	Change Last Qtr	3Q 08	Change Year Ago
Northeast	4,600	4,700	-100	9,100	-4,500
Midwest	6,500	4,500	2,000	13,900	-7,400
South	12,500	16,600	-4,100	42,700	-30,200
West	6,500	6,000	500	17,500	-11,000
U.S.	30,100	31,800	-1,700	83,200	-53,100

Multifamily net absorptions of investment-grade apartments tracked by Reis were 10,397 units, up 14,767 from the previous quarter, but down 6,054 from a year ago. This is the first positive level of absorptions in four quarters. Still, the four-quarter trailing net absorptions figure of -52,257 is at its lowest level since the second quarter of 2002.



Net Absorptions

(investment-grade, market-rate apartments)

Source: Reis.

Multifamily completions in the investment-grade market also declined to 21,122 units, down 5,987 from last quarter and 5,984 from a year ago. For now, completions remain much higher than absorptions, which is reflected in higher vacancy rates.

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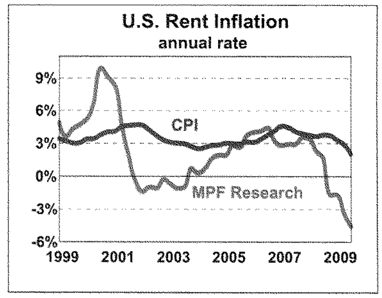
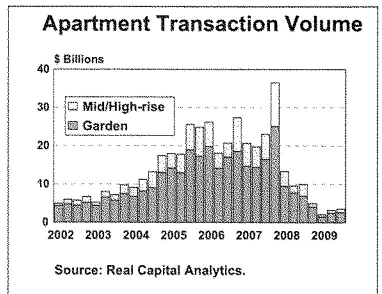
Apartment rents measured by public and private data sources diverged. Same store rents for professionally managed apartments tracked by MPF Research declined 4.6 percent this quarter, surpassing last quarter's record decline of 3.4 percent. Rents continued to decline in all four regions for a fourth straight quarter. The West had the largest decline at -7 percent, while the Northeast (-2.6 percent), the Midwest (-2.8 percent) and the South (-3.3 percent) experienced smaller declines. Regional rent growth declines set records except in the Northeast. By contrast, the CPI rent index, which covers all rental housing, rose 2.0 percent, still positive but the lowest rate of annual growth since 1968. With overall inflation negative, real rent grew by a larger amount, namely 3.6 percent.

MPF "same store" rent (ann. chg., %)	3Q 09	2Q 09	1Q 09	4Q 08	3Q 08
Northeast	-2.6	-2.1	-1.3	-5.4	2.3
Midwest	-2.8	-1.8	-0.7	1.6	2.4
South	-3.3	-2.0	-0.6	-0.7	1.6
West	-7.7	-6.5	-3.8	-1.7	1.3
U.S.	-4.6	-3.4	-1.7	-1.7	1.7



In the apartment transaction market, **volume rose slightly** in the third quarter to $3.6 billion, up 12.1 percent from the prior quarter but still down 64.2 percent from last year's level, and still far below mid-decade levels. **Apartment prices fell further.** The average price for properties sold in the third quarter of 2009 (tracked by Real Capital Analytics) was **$78,709 per unit**, down 9.7 percent from the previous quarter and a striking 30.5 percent drop from last year. This was the fifth straight quarter of decline and the lowest average price since the second quarter of 2004. The market value of investment-grade apartments in the National Council of Real Estate Investment Fiduciaries' (NCREIF) database also continued to decline in the third quarter, falling 4.3 percent from the previous quarter and 27.0 percent from last year. The **cap rate** increased to 7.1 percent.

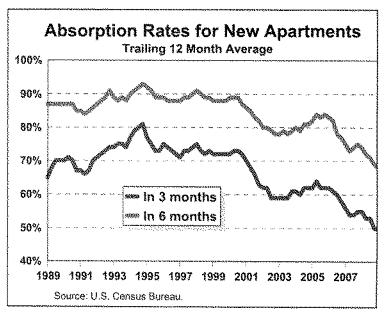


Source: Real Capital Analytics.

New Apartment Absorptions

Absorption rates for newly completed apartments have dropped to the lowest levels since data started being collected in 1989. Census Bureau data show that in the first quarter of 2009 (latest data available), only 52 percent of newly completed apartments were leased up. Although this was an improvement from the 45 percent figure of the previous quarter, the series is generally too volatile to read much into quarter-to-quarter changes.

For that reason, it's helpful to look at the trailing 12-month average (using not seasonally adjusted data). By that measure, 50 percent of 2009Q1 new apartments were leased, the same as the previous quarter and a record low. The historical average for the series is a 67 percent lease-up rate. Similarly, the 6-month absorption rate (also on a trailing 12-month average basis) was 68 percent, also a record low and well below the series average of 84 percent. The Absorption chart shows just how challenging the current decade has been for new apartment lease-ups. After fairly steady absorption rates in the 1990s, lease-up rates have fallen for most of the decade, interrupted only by a partial rebound from 2003-05.



Source: U.S. Census Bureau.

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NMHC

MARKET TRENDS

August 2009

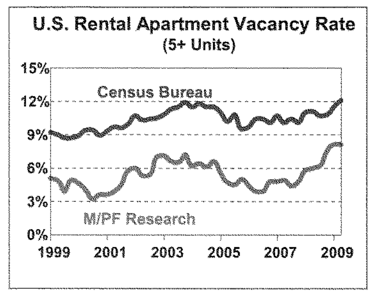
Apartment vacancy rates were at record levels in the second quarter. The U.S. Census Bureau vacancy rate for all rental apartments (in buildings with 5 or more units) rose to 12.2 percent, the highest on record (going back to 1968). The M/PF Research national vacancy rate for investment-grade apartments was 8.1 percent, the same as the revised first quarter figure and also an all-time high (though this series only goes back to 1993). The vacancy rose slightly in the South to 9.2 percent, remained steady in the West at 7.7 percent, and declined slightly in the Northeast to 6.0 percent and in the Midwest to 7.8 percent. The figure for the South was a record; it was also the 10th straight quarter in which the highest regional vacancy rate was in the South.

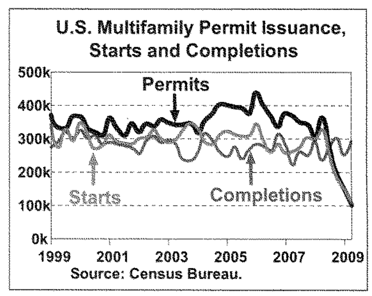
Multifamily % Vacant	2Q 09	1Q 09	Change Last Qtr	2Q 08	Change Yr Ago
U.S. – Census	**12.2**	11.5	0.7	11.7	0.5
U.S. – M/PF	**8.1**	8.1	0.0	6.0	2.1

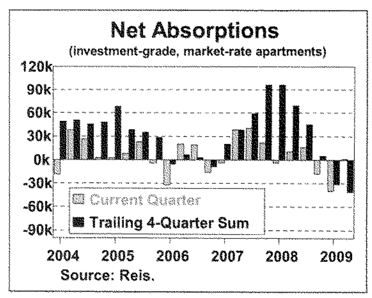
Multifamily **permits** and **starts continued their steep decline** while **completions increased** this quarter. **Permits** (5+ units in structure) decreased sharply to a seasonally adjusted annual rate (SAAR) of 101,700, down by 32.1 percent from last quarter and by 72.1 percent from a year earlier. Having dropped for nine consecutive quarters, this is the lowest level of permitting on record (since 1959). **Starts** declined nearly as dramatically to a SAAR of 108,000, down by 28.2 percent from last quarter and by 67.1 percent from a year ago. This was the second lowest figure on record. In contrast, **completions** increased to a SAAR of 293,000, up by 16.0 percent from the previous quarter and 24 percent from a year ago. Completions have yet to reflect the downturn in permits and starts.

Permits (2+ units, unadj.)	2Q 09	1Q 09	Change Last Qtr	2Q 08	Change Year Ago
Northeast	4,700	4,500	200	35,600	-30,900
Midwest	4,500	5,100	-600	12,100	-7,600
South	16,400	18,700	-2,300	37,500	-21,100
West	5,600	9,600	-4,000	24,500	-18,900
U.S.	31,200	37,900	-6,700	109,700	-78,500

Multifamily net absorptions of investment-grade apartments tracked by Reis were 888, up 40,786 from the previous quarter, but down by 9,959 from a year ago. Since the bulk of new leasing activity occurs during the second and third quarters, such a slim net absorption is a sign of real weakness in apartment demand. The four-quarter trailing net absorptions figure of 41,118 is at its lowest level since the 3rd quarter of 2002. **Multifamily completions** in the investment-grade market also declined slightly to 22,696, down 1,973 from last quarter and 5,858 from a year ago. However, completions have not declined nearly as rapidly as net absorptions.

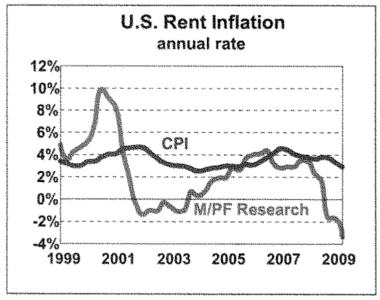




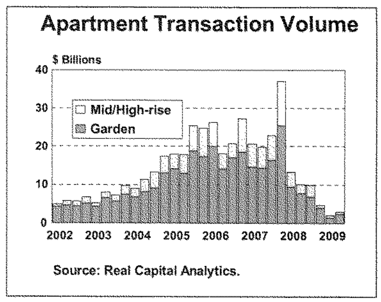


Apartment rents measured by public and private data sources continued to diverge widely. Same store rents for professionally managed apartments tracked by M/PF Research declined by 3.4 percent, the biggest decline on record. Rents continued to decline in all four regions for a second straight quarter. (Note that since overall inflation was negative in the quarter, the "real" rent decline was smaller at -2.2 percent.) The West had by far the largest decline at -6.5 percent, while smaller declines were posted in the Northeast (-2.1 percent), the Midwest (-1.8 percent), and the South (-2.0 percent). In contrast, the CPI rent index, which covers all rental housing, not just apartments, rose by 2.9 percent in the second quarter. This was the lowest such increase in over four years. Coupled with the negative inflation of the quarter, however, "real" rent actually rose by a startling 4.1 percent, the highest in 55 years.

M/PF "same store" rent (ann. chg., %)	**2Q 09**	1Q 09	4Q 08	3Q 08	2Q 08
Northeast	**-2.1**	-1.3	-5.4	2.3	2.3
Midwest	**-1.8**	-0.7	1.6	2.4	2.1
South	**-2.0**	-0.6	-0.7	1.6	2.1
West	**-6.5**	-3.8	-1.7	1.3	2.7
U.S.	**-3.4**	-1.7	-1.7	1.7	2.3

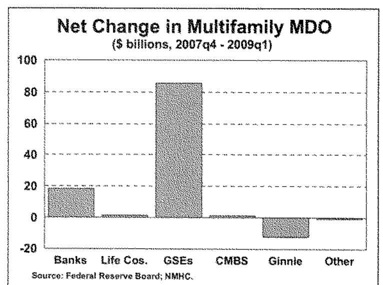


In the apartment market, **transaction volume rose slightly** in the second quarter to $2.8 billion, up by 42.5 percent from the prior quarter but still down 71.9 percent from a year ago and near the record low. **Apartment prices fell further.** The average price for properties sold in the second quarter of 2009 (tracked by Real Capital Analytics) was **$85,407 per apartment unit,** down by 3.1 percent from the previous quarter and by 8.2 percent from last year. This was the fifth straight quarter of decline and the lowest average price since the 2nd quarter of 2004. The market value of investment-grade apartments in the National Council of Real Estate Investment Fiduciaries' (NCREIF) database continued to decline in the second quarter, falling by 6.4 percent from the previous quarter and by 24.8 percent from last year. The **cap rate** remained at 6.8 percent.



Multifamily Mortgage Debt

Multifamily mortgage debt grew by only $6.1 billion in the first quarter of 2009, a drop of almost 60 percent from the year-earlier level and the lowest such figure in more than 11 years. Over the most recent four quarters, mortgage credit increased by $46.4 billion, a moderation after the run-up to an all-time record of $98.9 billion just five quarters ago. While the decline mainly reflects the sharp drop in transactions activity, the changed landscape of mortgage lending has also played a role. In particular, the CMBS market remains dormant, and portfolio lenders are generally providing limited credit. As a result, Fannie Mae and Freddie Mac—which have continued to lend—have become the key pillars in multifamily mortgage credit. From the fourth quarter of 2007 through the first quarter of this year (latest data available), the GSEs were responsible for 92 percent of the net increase in mortgage credit to the apartment industry. (Note: On the accompanying chart, "banks" refers to thrifts as well as commercial banks.)



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NMHC

MARKET TRENDS

May 2009

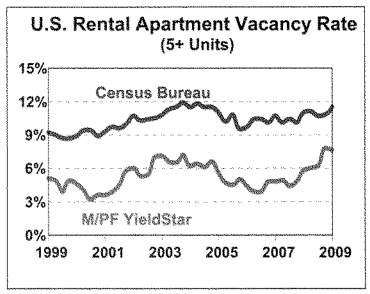
In the first quarter of 2009, **apartment vacancy rates did not trend consistently.** The U.S. Census Bureau vacancy rate for all rental apartments (in buildings with 5 or more units) rose to 11.5 percent, the highest vacancy rate since the 4th quarter of 2004. The M/PF YieldStar national vacancy rate for investment-grade apartments decreased slightly this quarter to 7.6 percent. While the vacancy rates rose in the South to 9.1 percent, the highest in nearly a decade, and in the West to 7.7 percent, these increases were more than offset by declines in the Midwest (to 7.9 percent) and the Northeast (to 5.0 percent).

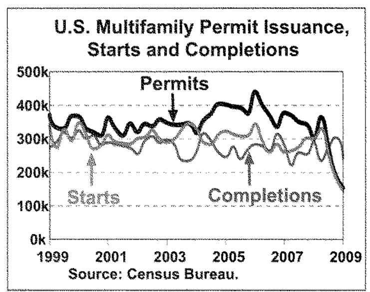
Multifamily % Vacant	1Q 09	4Q 08	Change Last Qtr	1Q 08	Change Yr Ago
U.S. – Census	11.5	10.8	0.7	11.0	0.5
U.S. – M/PF	7.6	7.8	-0.2	5.8	1.8

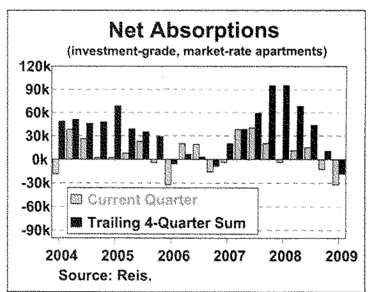
Multifamily **permits, starts,** and **completions** all declined this quarter. **Permits** (5+ units in structure) decreased to a seasonally adjusted annual rate (SAAR) of 153,700, down by 20.1 percent from last quarter and by 48.9 percent from last year. This is the lowest level since the second quarter of 1993, and reflects declining activity in all regions of the country. **Starts** declined for a third straight quarter to a SAAR of 145,700, down by 21.5 percent from last quarter and by an even larger 51.7 percent from a year ago. **Completions** declined to a SAAR of 241,700, down 20.4 percent from the previous quarter and 17.1 percent from a year ago. Since completions lag starts by several quarters, they have not yet shown the steep drop seen in permits and starts, but surely will do so soon.

Permits (2+ units, unadj.)	1Q 09	4Q 08	Change Last Qtr	1Q 08	Change Year Ago
Northeast	4,500	6,200	-1,700	10,100	-5,600
Midwest	5,100	8,300	-3,200	9,200	-4,100
South	18,700	23,100	-4,400	39,600	-20,900
West	9,600	14,200	-4,600	19,200	-9,600
U.S.	37,900	51,800	-13,900	78,100	-40,200

Multifamily net absorptions of investment-grade apartments tracked by Reis were -32,095 in the first quarter, a further erosion of 19,558 from the previous quarter, and a drop of 28,700 from a year ago. This is the lowest level of net absorptions in three years. The trailing four-quarter sum showed net absorptions of -18,270, the lowest figure since the third quarter of 2002. **Multifamily completions** in the investment-grade market also declined to 22,833, down 7,938 from last quarter but just 122 lower than a year ago. The trailing four-quarter sum was essentially unchanged from last quarter and does not yet reflect the slowdown in new construction permits and starts.







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Apartment rents measured by public and private data sources diverged widely. Same store rents for professionally managed apartments tracked by M/PF YieldStar declined by 2.8 percent, the biggest decline in at least 15 years. For the first time since the third quarter of 2003, rents declined in all four regions. The Northeast and West had the largest declines (-6.1 percent and -3.8 percent, respectively), while declines in the Midwest and South were more modest (-0.7 percent and -0.6 percent, respectively). In contrast, the CPI rent index, which covers all rental housing, not just apartments, increased in the fourth quarter by 3.3 percent, the lowest in three years.

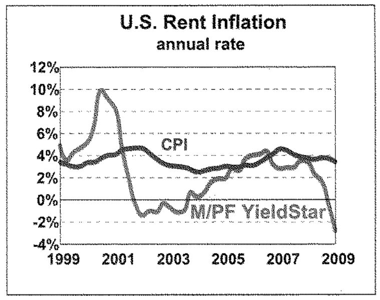
M/PF "same store" rent (ann. chg., %)	1Q 09	4Q 08	3Q 08	2Q 08	1Q 08
Northeast	-6.1	-0.1	2.3	2.3	4.1
Midwest	-0.7	1.1	2.4	2.1	3.3
South	-0.6	0.2	1.6	2.1	2.5
West	-3.8	-1.7	1.3	2.7	4.4
U.S.	-2.8	-0.3	1.7	2.3	3.4

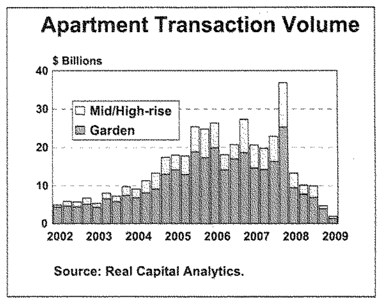
In the apartment market, **transaction volume continued to plummet** in the first quarter to an anemic $1.8 billion, down 61 percent from the prior quarter and 86 percent from a year ago. This is the lowest level of transaction volume since at least 2001. **Apartment prices rose slightly but remain below last year's levels.** The average price for properties sold in the first quarter 2009 (tracked by Real Capital Analytics) was $89,250 **per apartment unit,** up 2.1 percent from the previous quarter but down 8.9 percent from a year ago. The market value of investment-grade apartments in the National Council of Real Estate Investment Fiduciaries' (NCREIF) database continued to decline in the first quarter, falling 9.9 percent from the previous quarter and 11.4 percent from last year. These were each record-setting declines. The **cap rate** remained at 6.8 percent.

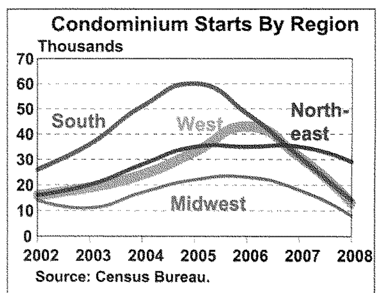
Condo Construction

In 2008, multifamily (2+) condo starts and completions both continued their decline. Nationwide, starts were down 43 percent from 2007 and 57 percent from their peak in 2006. The West, Midwest and South all recorded more than 50 percent drops. The Northeast led the regions with 29,000 units started; the Midwest recorded the lowest level at 8,000 units.

Completions, on the other hand, were down just 13 percent from 2007 totals, but at 101,000 units they were not notably lower than their five-year average of 103,000 units. Having recorded a high level of starts earlier in the decade, the South led the other regions in 2008 annual completions at 36,000. However, that was a 38 percent drop from its 2006 peak. The West overtook the Northeast in condo completions for the second year in a row, while completions in the Midwest remained slightly above their five-year average at 17,000 units.







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NMHC

MARKET TRENDS

February 2009

In the fourth quarter of 2008, **apartment vacancy rates increased.** The U.S. Census Bureau vacancy rate for all rental apartments (in buildings with 5 or more units) rose to 10.8 percent. This is also the average vacancy rate for the year and the highest average vacancy rate since 2004. The M/PF YieldStar national vacancy rate for investment-grade apartments increased sharply to 7.8 percent, the second highest vacancy rate since 1993. Mirroring the national vacancy rate, the M/PF YieldStar regional vacancy rates rose too. The highest vacancy rate was in the South (8.5 percent), followed by the Midwest (8.0 percent), the West (7.3 percent), and the Northeast (6.2 percent).

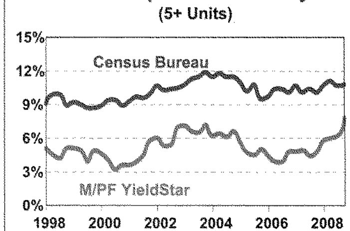
Multifamily % Vacant	4Q 08	3Q 08	Change Last Qtr	4Q 07	Change Yr Ago
U.S. – Census	**10.8**	10.7	0.1	10.1	0.7
U.S. – M/PF	**7.8**	6.2	1.6	4.8	3.0

Continuing the previous quarter's trend, **multifamily permits and starts decreased while multifamily completions increased in the fourth quarter. Permits** (5+ units in structure) decreased to a seasonally adjusted annual rate (SAAR) of 192,300, the lowest quarterly permitting level in nearly 16 years. For 2008, permits totaled 290,300, the lowest since 1996. **Starts** declined sharply for a second straight quarter to a SAAR of 180,300, down by 29.6 percent from last quarter. For the year, starts slipped to their smallest level since 1995. **Completions** increased to a SAAR of 299,700, up by 9.8 percent from the previous quarter. This is the first quarter since 1991 that the level of completions has exceeded that of starts and permits. For the year, completions reached 275,000, an 8.3 percent increase over 2007, but just under the average for the past 10 years.

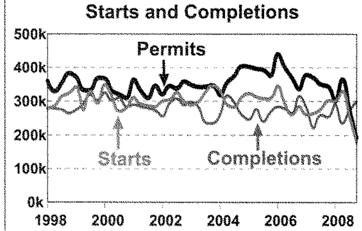
Permits (2+ units, unadj.)	4Q 08	3Q 08	Change Last Qtr	4Q 07	Change Year Ago
Northeast	**6,200**	9,300	-3,100	16,200	-10,000
Midwest	**8,300**	12,900	-4,600	12,700	-4,400
South	**23,100**	39,200	-16,100	40,800	-17,700
West	**14,200**	17,000	-2,800	25,400	-11,200
U.S.	**51,800**	78,400	-26,600	95,100	-43,300

Multifamily net absorptions of investment-grade apartments tracked by Reis were -13,160 in the fourth quarter, a further sign that the sharp drop in employment in the late fall and winter has begun reverberating throughout the apartment industry. That brought absorptions for the year down to 7,011; although positive, this was well below the previous year's figure of 98,203. **Multifamily completions** in the investment-grade market rose slightly to 24,226; that's up 1,583 from the previous quarter but down 6,480 from a year ago. For the year, completions reached 96,796, not much changed from the level of the prior four years.

U.S. Rental Apartment Vacancy Rate
(5+ Units)

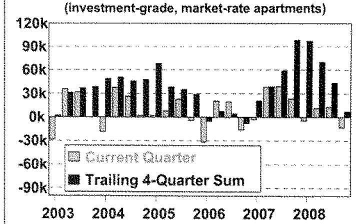


U.S. Multifamily Permit Issuance, Starts and Completions



Source: Census Bureau.

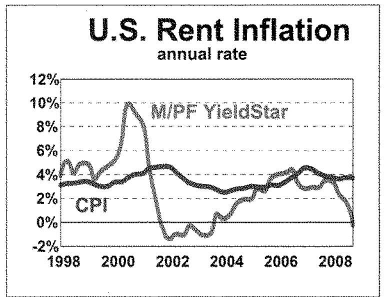
Net Absorptions
(investment-grade, market-rate apartments)



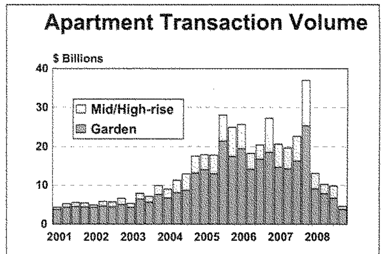
Source: Reis.

Apartment rents measured by both public and private data sources did not trend consistently. Same store rents for professionally managed apartments tracked by M/PF YieldStar declined by -0.3 percent, the first decline since the third quarter of 2003. This slight national decline reflected the effect of negative rent growth in the West (-1.7 percent) and Northeast (-0.1 percent), while rents increased in the Midwest (1.1 percent) and South (0.2 percent). Still, inflation-adjusted rent growth was negative in all four regions. The CPI rent index, which covers all rental housing, not just apartments, increased in the fourth quarter by 3.7 percent.

M/PF "same store" rent (ann. Chg., %)	4Q 08	3Q 08	2Q 08	1Q 08	4Q 07
Northeast	**-0.1**	2.3	2.3	4.1	3.4
Midwest	**1.1**	2.4	2.1	3.3	2.8
South	**0.2**	1.6	2.1	2.5	2.6
West	**-1.7**	1.3	2.7	4.4	4.9
U.S.	**-0.3**	1.7	2.3	3.4	3.5



In the apartment market, **transaction volume continued to decline** in the fourth quarter to $4.6 billion, down by 53.3 percent from the third quarter. For the year, total volume decreased to $37.6 billion, off by 61.7 percent from 2007 and the lowest since 2004. **Apartment prices fell for the third straight quarter.** The market value of investment-grade apartments in the National Council of Real Estate Investment Fiduciaries' (NCREIF) database declined in the fourth quarter by 9.5 percent from the previous quarter and by 11.4 percent from last year. These were each record-setting declines. Among apartment transactions monitored by Real Capital Analytics, the average price for properties sold in the fourth quarter 2008 was **$87,164 per apartment unit,** down 23 percent for the quarter and 13.8 percent from last year. At 6.8 percent, the average **cap rate** rose by 30 basis points from the previous quarter to the highest level since 2004.

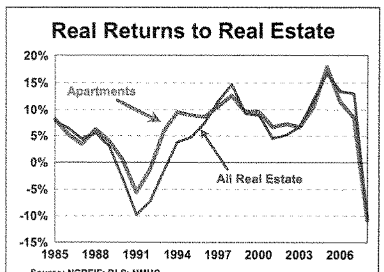


Source: Real Capital Analytics.

Apartment Investment Returns

Not surprisingly, the economic downturn has taken a toll on apartment investment returns. According to the National Council of Real Estate Investment Fiduciaries, total unlevered returns on privately held apartments were -7.0 percent in 2008, the worst performance in the 20-year history of the NCREIF apartment index. Adjusted for inflation, the total return to apartments was -10.8 percent, also the worst on record. Returns to all real estate asset types were not much better at -6.5 percent. No asset type registered positive returns: hotels turned in the worst performance at -9.4 percent, while retail performed the best at -4.1 percent.

In the public markets, however, apartment REITs outperformed the other REIT asset classes. Last year, the total return to apartment REITs was -25 percent, compared to -41 percent for office REITs, -48 percent for retail REITs, -60 percent for lodging REITs and -67 percent for industrial REITs. Apartments were the only real estate asset class to outperform the overall stock market: as measured by the S&P 500, the total return to stocks was -38 percent.



Source: NCREIF; BLS; NMHC.

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Chair WARREN. Thank you very much. I appreciate it.
Mr. Burnett.

STATEMENT OF CHRIS BURNETT, CHIEF EXECUTIVE OFFICER, CORNERSTONE BANK

Mr. BURNETT. Thank you. Good morning. I am Chris Burnett. I am the chief executive officer of Cornerstone Bank headquartered here in Atlanta. Cornerstone is one of Georgia's 25 largest community banks with assets of 550 million dollars with one-third of our loans in housing, one-third of our loans in small business financing, and a third in commercial real estate loans. We do have a balanced portfolio and a balanced perspective on the problems facing our economy today.

Commercial real estate is certainly a challenging area, but you cannot talk about this category without stressing the impact that has been had from the housing industry. As we all know, new home construction and residential lot development was the first issue to hit the economic downturn. When the mortgage market seized up, builders could not find buyers for their homes, and the need for developed lots virtually went to zero, causing many developers to fail and leaving hundreds of projects in suspension.

The effectors, the effect on our lenders was devastating. In Georgia, we've already seen 30 community banks fail, all of which had heavy concentrations in residential development and construction loans.

We've also seen the problems in the job market. We're acutely familiar with the devastation in our residential housing and its impact on the economy, as thousands of jobs have been lost in Georgia in that industry and many more workers leaving our state.

Regarding commercial real estate, for most community banks like ours the typical client is a business owner with financial substance, substance that has been—or has had the wherewithal to move from rental space into owner-occupied buildings. Unless those owner-occupants were involved in the real estate industry or retailing, most borrowers continue to make their payments on time, and the performance of most owner-occupied commercial loan portfolios remain satisfactory through 2009. But the difficult economy has taken its toll, draining earnings and liquidity from once strong borrowers. The aftershocks of the recession continue to abate a recovery and consumer confidence, thus restricting spending. As a result, we are now seeing a rise in borrower and tenant distress. Tenants are asking for rental concessions, which are often granted, but this reduces the cash flow available to meet debt service. This issue is systemic at all levels. Even the larger banks, the insurance companies, and the pension funds that lend on the much larger commercial projects are also reporting similar stresses. As we have talked about, vacancy rates for these projects in the metro Atlanta area are now over 20 percent, and that sort of rate is not sustainable with the level of debt that most owners incur to bring those projects to market.

On the retail front in particular, where the greatest deterioration is occurring, as long as unemployment remains high and the economic news is negative, consumer spending will be tight. As a result, more retailers, especially nonfranchised, small businesses are closing. The same is true for service businesses that occupy office space. As these companies contract or close all together, vacancy rates climb and cash flows available for debt service decline. The banks are then often confronted with a dilemma. They must either foreclose on the properties or restructure the mortgages, allowing them to convert to interest-only payment terms and often times lowering their interest rates. These loans then become known as troubled debt restructures, meaning that they must be classified as substandard assets. New appraisals are mandated by regulatory rules, and if the new values do not support those loan balances, specific reserves must be established further eroding bank capital.

There is no question that it's more unlikely today for borrowers to obtain credit. Borrower's financial conditions have deteriorated making loan decisions more difficult to make. Strong pressure by regulators to reserve for projected loan losses and to reduce real estate lending concentrations further impairs a borrower's ability to obtain credit. In many cases throughout Georgia, regulatory orders directed at troubled institutions mandate no growth and asset shrinkage policies, therefore making it impossible for those banks to extend credit. And all of this goes on while private capital sits on the sidelines still apprehensive to invest in Georgia's banks.

Let me be clear. We want to make good loans to help businesses in our communities grow. That is what we do and that is what our industry is all about. That is what Main Street banking is all about. But it can be frustrating to borrowers and bankers when we are told lend more and be as flexible as possible with workouts, but also apply the hard lessons learned related to sound underwriting. With these conflicting messages, lending more money right now is a very delicate balance.

And finally asking—I'm going to speak briefly on the TARP issue. Twenty-six banks in Georgia have received TARP investments. My bank is not one of those. The TARP application process was perhaps the most frustrating regulatory experience in my 30 years in this industry. Our bank applied in 2008 as soon as the program was announced. We were finally told to withdraw our application in October of 2009, almost a year after the program began. Early in the process we had new capital lined up alongside with TARP, because the receipt of TARP was viewed as a confirmation of viability, but after ten months of waiting for an answer, those capital sources had dried up.

In my opinion, the measure of TARP's effectiveness can be assessed in two ways. If the intent is to help banks clean up their balance sheets and rid them of troubled assets, then it has been effective to a degree in Georgia. Those banks that did receive TARP investments have been able to rid their books of some distressed assets, although at extremely low values. However, if the intent was to stimulate more lending, the jury is still out on TARP's effectiveness.

Banks have burned through enormous amounts of capital for both actual and projected losses with only about 40 percent of Georgia's banks currently profitable. Banks cannot increase retained earnings. They cannot shore up their capital positions until they return to profitability.

Chair WARREN. Mr. Burnett, I'm going to have to stop you on time there. But thank you very much. We wanted to hear this about TARP. Thank you.

[The prepared statement of Mr. Burnett follows:]

TARP Congressional Oversight Panel Field Hearing

Atlanta, Georgia, Jan. 27, 2010

Written Testimony of Chris Burnett

Chief Executive Officer, Cornerstone Bank, Atlanta

Good morning. I am Chris Burnett, Chief Executive Officer of Cornerstone Bank headquartered here in Atlanta. Cornerstone is one of Georgia's 25 largest community banks with assets of $550 million. With one-third of our loans in housing, one-third in small business financing and one-third in commercial real estate loans, we have a balanced portfolio and a balanced perspective on the problems facing our economy today.

You have asked me to testify today about three things; commercial real estate lending, commercial real estate problems and the effects of TARP on the commercial real estate marketplace.

I'll first describe what composes Real Estate Lending, including commercial real estate, for Georgia's banks and briefly describe the current state of each of those segments. Then I'll discuss particular problems in the appropriate segments. I'll finish with my views of the effects of TARP investments on our marketplace.

Bank Real Estate Lending

There are five components of bank real estate lending: 1) acquisition development and construction, 2) 1-4 family residential, 3) multifamily residential real estate, 4) farmland and 5) commercial real estate. Each bank reports quarterly to FDIC how much of their portfolio is in each component, and this is available for the public to view.

In general, lending to the **Acquisition Development and Construction lending**, sector is minimal at this time. High foreclosures, high unemployment, low in-migration and the need to steeply reduce available inventory of homes means that loans for new developments and housing would represent significant additional risk for both borrowers and lenders.

Closely related to this is the **1-4 Family Residential** sector, which was similarly affected by the downturn and the evaporation of the mortgage market.

The third important category is **Multifamily lending.** This is primarily lending for apartments. This is an area of stress in the marketplace, especially in the more mature multifamily communities and buildings.

A fourth category is **Farmland**, and metro-Atlanta bankers are simply not involved in that financing.

A fifth category is **Commercial and Industrial lending**, which at our bank included loans to owner-occupied buildings as well as retail shopping centers and hotel lending.

Right now, most owner-occupied properties are holding their values relatively well compared to other property types. At my bank, we do not have any past due loans of this type at this time, so this is the sector in which we're seeing the least stress.

Outside of loans to borrowers heavily dependent on the residential real-estate industry, here's why these loans are holding up better than others. In general, businesses that own their own buildings as well as rent out other portions of those facilities have two things going for them. First, they generally tend to be more financially stable and have better cash reserves. Second, because they have other tenants, they are more likely to continue to have some monthly cash flow that helps them cover the debt service for their real estate loans.

However, reasonable concern is warranted, especially related to real estate loans to businesses associated directly with the residential construction sector, as well as those to owners and developers of retail centers.

I'll describe the more specific problems and concerns with each of these areas below.

Commercial Real Estate Problems

Residential AD&C Problems

The residential Acquisition Development and Construction segment has been the hardest hit in Georgia. This sector makes up the bulk of commercial real estate related lending for Georgia banks.

You simply can't talk about commercial real estate in Georgia without a discussion of residential development real estate. This has been the area of most distress, primarily as a result of the devastating and rapid real-estate market downturn.

Construction and land development loans were the first to be hit by the economic downturn. When the mortgage market seized up, the developers could not find buyers for their homes causing many of those developers to fail leaving hundreds of projects in suspension. The effect on their lenders was just as devastating. In Georgia, we have already seen 30 community banks fail, all of which had heavy concentrations in construction and land development lending. Those banks closed were all community banks, which shouldn't be a surprise as we have more community banks in Georgia than any other state in the Southeast.

The second component, one-four family residential, was similarly affected by the downturn and the evaporation of the mortgage market. The completed new home inventory the lenders ended up with has been less affected than partially completed homes. Atlanta has been fortunate in that we did not experience some of the huge home price increases some markets experienced. The fact that we have been known for being an affordable housing market is now paying off. That inventory of new construction, foreclosed homes is coming down.

At this point, the disastrous effects of the economy and credit crisis on these sectors are all too apparent and have already manifested themselves on our banks in the form of rising delinquencies, defaults and foreclosures on these undeveloped, partially built or even completed but unsold homes. We're now well into the cleanup phase of dealing with these problems, but even FDIC is predicting more failures as the residential real estate construction market is still troubled.

Multifamily Problems

The effects of the residential real estate collapse are also being felt in multifamily portfolios. For example, Georgia has lost about 300,000 jobs during this recession. A large percentage of those jobs are directly related to the construction industry. This massive loss of jobs associated with one sector has caused people to leave the region to seek employment elsewhere, driving up vacancies. This is especially apparent in multifamily properties that are older and on the lower end of the rent scale.

With the high numbers of foreclosures in Georgia, we expected that many of those families would move into vacant multifamily units. However, what has happened is that investors have been buying foreclosed homes at steep discounts and have been moving those homes into the rental market. We understand that in many cases, the cost to buy foreclosed single family homes is below what it would cost a developer to build a new multifamily rental unit. So, families forced to vacate their homes due to foreclosure or job loss are renting these single-family properties in greater numbers rather than predicted leaving multifamily units at the lower price point with higher vacancy rates.

This has a secondary effect directly on the value of single family homes in the area. Higher numbers of single family homes that are rental properties serve to lower property values in an area.

On the positive side of the multifamily equation is that long-term demographics appear to be in our favor. In three-to-four years, we feel like demand will be high for multifamily units. One example of why is that this year's freshman college class is expected to be the largest in history. Within the next three to four years, these young adults will move into the market for housing and most expect that will be in multifamily housing.

Commercial and Industrial (C&I) Problems

As I noted earlier, owner occupied facilities closely associated with the residential construction sector are the most stressed – businesses such as engineering firms, architects, industrial and interior design firms, real-estate attorneys and others.

With fewer homes being built, bought and sold, these businesses have held on as long as they can. These are the primary C&I defaults and losses for Georgia Banks. For example, our one C&I loan foreclosure was to a furniture business that simply could not keep the doors open any longer.

Perhaps the greatest area of concern in the C&I portfolio is for loans to retail shopping developments. Stress on these loans is directly related to the depth and length of the recession, high unemployment and a tightening of consumer purchasing.

As consumers have less money to spend as well as less willingness to spend the money they have, consumer-dependent businesses in these properties are more at risk. The longer we have high unemployment, lower than average consumer confidence and continued economic weakness, the more stress we'll see on these portfolios.

Borrowers with loans for these developments are more at risk for several reasons. First, they are dependent on the tenants being in business and paying their rents. Second, they have less reserves or net worth in the first place to weather downturns in their business. Faced with rising vacancies, declining rents and less demand from new tenants, these loans are the most at risk.

A second factor adding stress to both the owner-occupied and retail property portfolios is that those borrowers that are able to continue making payments are being challenged by declining property values and requests for significant rent concessions from tenants. The larger banks, insurance companies and pension funds that lend to much larger commercial projects than a bank our size would do are reporting similar stresses. Vacancy rates for these projects in metro-Atlanta are over 20 percent, a rate that is simply not sustainable with the level of debt most owners have incurred to bring their projects online.

Many of the borrowers are forced to make such rent reductions because having some rental income from tenants is simply better than having no rental income from tenants forced to go out of business because they can't pay the rent.

Banks are then confronted with a dilemma. They must either foreclose on the properties or restructure the mortgages, allowing them to convert to interest-only payment terms at lower interest rates. These loans then become known as "Troubled Debt Restructures," meaning that they must be classified as "Substandard" assets. A TDR triggers the need for a new property appraisal on the loan. In the current economy and marketplace, it is likely that appraisal will show a decline in property value, sometimes a very significant decline. This is preferable to an outright default and potential foreclosure, but there are downside effects on a bank's capital as well as the overall market. Here is a simple example of the capital effect that has on the bank.

In this example, the loan is based on an original appraisal of $10 million. If the new appraisal comes back at $9 million, the borrower has to pay down the loan or produce additional collateral. Otherwise the bank has to allocate the $1 million difference directly from our actual capital to our loan loss reserve. That's capital that we essentially can't recover from our reserves, even if the property value increases over time. The federal banking regulators announced new guidance on this in late October that was intended to help this exact situation. It is simply too early to tell if this guidance will produce positive results.

A secondary effect on the marketplace of significantly reduced rents is that it reduces the investment value of the property. Potential purchasers of that property base the investment value on rental income, or monthly cash flow. As that cash flow, and in-turn, value declines, those investors are demanding more return on their investment because of the higher risk. This makes the properties harder to market and sell to potential investors.

The long and deep recession has also taken a toll on loans to hotel developers and other businesses related to travel, hospitality and tourism.

For example, we have one loan on a hotel property near a major trade facility. This borrower reports that occupancy is running between 60-70% of its average during better economic times. This is directly related to reduced traffic from vendors and buyers attending various market events at the facility. And with less traffic at this facility, business is significantly off for local hotels, restaurants, catering and other service businesses that are reliant on a brisk business from the facility's merchants and customers.

Effects of TARP, Availability of Capital for Banks and Credit Availability

You asked me to discuss the effects of TARP on the commercial real estate market. I will do that in the context that the other significant factor affecting banks' ability to lend more is the availability of capital.

Twenty-six of the 306 Georgia-based banks have received Capital Purchase Program investments, totaling about $6.2 billion. It appears that has been a good investment, to date. Those institutions have paid the U.S. Government $239.7 million in dividends through mid-November as a return on its investment.

My bank is not among those institutions. 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.

The measure of TARP's effectiveness can basically be boiled down in two ways, in my opinion.

If the intent was to help banks clean up their balance sheets and rid themselves of troubled assets, it has been effective to a degree, here in Georgia. With the capital protection provided by TARP, those banks that received investments have been able to rid their books of distressed loans at valuations that are extremely low.

However, if the intent was to stimulate more lending, the jury is still out on its effectiveness... I am sure this has been helpful to those recipients, but there are other factors affecting the difficulty Cornerstone and other banks are having in extending more credit to businesses.

Business loan demand is down, and bank capital to support lending remains under extreme pressure. Also, sources of new capital are limited, sitting on the sidelines or looking elsewhere to invest.

Business loan demand and prudent caution

As I mentioned earlier, consumer spending remains muted and business loan demand is off. With more people saving more to pay off debt, companies have put off expansions or additions to inventories.

Also, banks are carefully balancing the need to lend more and avoid making more loans that might not be paid back because of the economy. In a recent national survey of lenders, more than 70 percent cited the poor economy as the number-one reason for conservative underwriting.

In Georgia, that shows up primarily in unemployment, which stands above 10 percent. Other factors are that business bankruptcies and loan delinquencies also continue to rise.

For example, through September there were 23,245 Chapter 7 bankruptcy filings in North Georgia. As of November, that number was 12.5 percent higher than full-year 2008 figures and 56 percent higher than the similar nine-month reporting period in 2008, according to data released by the U.S. Bankruptcy Court, Northern District of Georgia. I have not seen a recent update of this data.

So, the ongoing challenge in this environment for both a borrower and a bank is to be as certain as possible that a person or business can repay a loan, and that just takes a lot of I-dotting and T-crossing in this economy.

It may not seem like it sometimes, especially if you are a borrower, but the reality is a loan decision starts from the point of view that the bank wants to ensure that a borrower isn't taking on more risk than his or her family or business can reasonably support. That's protection for the borrower and good underwriting for the bank.

New Capital Scarce

So, there is a desire out there for banks to raise and deploy more capital to support new loans. That remains extremely difficult in this environment.

In relation to TARP, investors with available capital generally have taken a hands-off approach to most banks that did not receive investments or that were told to withdraw their applications. In our case, we had investors who voiced their sincere interest in matching any TARP funding we would have received. However, due to the delay in considering our application, their interest evaporated.

A second factor limiting new investment capital is the FDIC's approach to resolving failed banks. Because of the FDIC's trend toward entering loss-share agreements with acquirers of failed banks and in being more willing to grant shelf charters, non-bank investors have told me personally they'd rather sit back and be opportunistic about investing after a bank fails through those processes, rather than taking more risk by investing now.

A third factor inhibiting new capital investment is the uncertainty that comes from the current regulatory and political environment. As the Administration, Congress and regulators propose, debate and state their views on a wide variety of regulatory reform ideas, investors remain extremely cautious about investing in the banking sector. They are seriously concerned about the risk involved with investing before any of these reforms are finalized. The severe tone and unprecedented scope many of these proposals would have on potential returns for these investors is keeping them firmly on the sidelines and looking to invest their capital in other businesses.

Other Capital Constraints

Alongside the broad economic and policy constraints affecting credit availability and new capital, many of our state's banks simply are struggling to maintain adequate regulatory capital levels because of ongoing and rising numbers of troubled loans that are a direct result of the poor economy.

Regulators rightly require banks to maintain strong capital levels to cushion the blow of losses from bad loans. However, to keep those capital levels high, banks often can't deploy that capital to provide funding for additional credit to small business and other borrowers as they must use that capital to account for current and projected future loan losses.

And, unfortunately, the economy has also led to an estimated one-third of Georgia banks being subject to regulatory enforcement orders.

In addition, these regulatory orders also have the result of restricting lending in other ways, too. It seems the rule, rather than the exception in these orders, for regulators to require higher minimum levels of tier-1 and total risk-based capital than the standard definitions used for banks that are considered well capitalized.

Also, based on federal guidelines, a bank under a regulatory enforcement order is often told to reduce its concentration of real estate related loans. As I noted before, this is problematic because many of the small businesses community banks have traditionally provided credit to are directly related to the real estate development and building sector. And because new capital is tough to come by for many banks and overall loan demand is down across all sectors, especially community banks, their only option is to shrink portfolios to get their ratios in line.

While I understand the concern with over-concentration in any one sector, it is extremely difficult to rapidly change that mix of loans in a troubled economy.

And because bank's lending limits are based on how much capital they have, declining capital levels translate into fewer loans, in general.

There is no question it is more difficult today for borrowers to obtain credit. The combination of the poor economy, actual losses, aggressive pressure by regulators to reserve for predicted loan losses, regulatory orders directed at troubled borrowers and reducing real estate concentrations while private capital is sitting on the sidelines all lead to a difficult credit market.

Let me be clear: we want to make good loans to help businesses and communities grow. That's what we do, and that's what makes our Main Street banks – many of which are basically small businesses themselves – profitable and healthy. Here's why it is difficult right now, and it is the root cause of frustration from borrowers as well as bankers. We have been told the following from all fronts: "Lend more and be as flexible as possible with workouts, but also apply the hard lessons learned related to underwriting." So, to lend more money right now requires a delicate balancing act.

Based on the increased regulatory scrutiny and the protracted economic malaise, it is harder and harder each day to determine what IS a good loan and what IS and WILL BE a viable business to lend to in this economy. That's especially acute here in Georgia where residential and commercial real estate has been a dominant driver of economic growth.

Conclusion

In conclusion, the real estate lending market in Georgia is under stress, with problems being more severe in some categories than others. Any loans for actual properties or business directly related to residential development or construction remain under severe stress. The multi-family real estate sector is also experiencing difficulty, with some long-term positive signs based on demographics. Retail-based real estate is a cause for considerable concern with unemployment remaining high and consumer spending under pressure. Owner-occupied real estate, while under pressure, is holding its own for now.

The overall success of TARP is mixed, with extremes depending on whether a bank was or was not a recipient.

Georgia's banks continue to struggle to raise new capital or retain capital that could be used to support new lending and stimulate the economy. The causes of the ongoing stress are the ongoing poor economy, certain regulatory policies and general uncertainty about the long-term structure of the banking sector.

Many of our banks need more capital. I understand that the Treasury Department has effectively closed the Capital Purchase Program and the Capital Assistance Program. Based on these factors, I encourage the I encourage your panel to recommend that policymakers examine new ways to make uncommitted TARP funds or repaid TARP funds available to more community banks in Georgia and across America. These investments could stabilize more communities and the banks that serve them, keep more banks open and free up more capital that could be deployed in support of new loans.

I also encourage you to evaluate the current regulatory structure to determine if shelf charters, loss-share agreements, mandatory suspensions of credit and large-scale bank closures are really the best ways to stabilize our industry and our nation.

Bipartisan cooperation between policymakers, regulators and bankers is the best way to get America's economy and financial system back on track. I certainly hope that we can move in that direction, and I sincerely appreciate your efforts to make that happen.

Chair WARREN. Mr. Elliott.

STATEMENT OF MARK ELLIOTT, PARTNER AND HEAD OF THE OFFICE AND INDUSTRIAL REAL ESTATE GROUP, TROUTMAN SANDERS

Mr. ELLIOTT. Thank you, Professor Warren and members of the Panel. My name is Mark Elliott, and I'm the head of the office and industrial real estate group at Troutman Sanders. As Mayor Reed said, Atlanta is a real estate town. I have seen more distress in the market here in the last year than in my 30 years of practice. And before I get into specifics, let me just share something with you anecdotally on the numbers. Just to kind of illustrate the point: deal volume for transactions, that's purchases and sales in 2007 compared to 2009 in our business has gone down to roughly one-sixteenth. It's roughly in 2009 six percent of what it was in 2007. And we, as a country and the press, decried and panic when retail sales nationwide drop by seven percent. We dropped by 95 percent, and that distress is remarkable, and it's having catastrophic effects on the service providers in the industry.

And I think there are two reasons for this. It relates from problems on the supply side and problems on the demand side. And, Mr. Atkins, you had asked for some comments on the demand side. And I'm very happy to address that now.

Basically, for a real estate developer or an owner to borrow money, they basically need to make sure that they are going to have a return on that money and a profit that covers the cost of the capital plus the cost of borrowing, plus some profit to the owner. And I think for three specific reasons, you're not going to see borrowing of any kind of rigor for quite some time. The first of which is, and people have addressed it here today, it's the tremendous loss of jobs in our economy, and I know you used an eight million figure. I think it's 6.1 million jobs lost in calendar year 2009. And, Mr. McWatters, as you said, we'll build this back one job at a time, but the crash in the real estate industry has occurred one job loss at a time. And every loss of those jobs represents an empty office somewhere and—or at least there's some very strong correlation. So eight million jobs lost is a lot of empty offices.

The second point is a tremendous loss of confidence in the business sector coupled by a loss in market cap on the tenants of this space. Just like builders build buildings on the come, so do tenants lease on the come, and when you're a business unit owner, and you're leasing space in the future, you're making business expectations and you're making business judgments on the basis of your business growing or at least that's been the hope. There is complete loss of confidence on the business growth aspect. And I would say the tenant base is much more worried about what they can do to shrink or get out of their lease five years from now than they are on what they can do to grow that lease.

And the third one is the whole mandate on the corporate America to cut costs and to cut costs aggressively. Typically, you'll see that the second greatest cost that business unit owners faced after employment is real estate costs, and people are cutting their space and they're cutting the cost of their space, and they are very, very aggressively renegotiating lease rates. And, Mr. Neiman, you made the point about looking out at the Hyatt Regency 25 years ago and being able to see a nice view of Atlanta. Even though there are buildings in the way now, because of the empty offices they have in the upper levels of those buildings you can just look right through the windows and enjoy those views again. And that is having a very, very dramatic affect on the value of businesses.

I guess I'll summarize in this last minute. I think the commercial office market, if you look at the life of an office building, it's almost like an aircraft carrier. You can't brake it on a second's notice, and you can't accelerate it on a second's notice. And what you're going to continue to see as leases roll over the next three, six, nine, 12, 15 months that you're not seeing now is empty offices where tenants are still paying coupon rate and contract rate because that's their obligation, are going to continue to shrink because that represents their actual need for the space. They are going to continue to aggressively renegotiate their lease rates to reflect current value, not what they agreed to pay in 2001, when they entered into that lease. And so, I think you're going to continue to see on the demand side an incredible reticence to engage in any kind of borrowing. And I'll stop there.

[The prepared statement of Mr. Elliott follows:]

COMMENTS ON THE MORTGAGE AND SALE MARKETS

FOR COMMERCIAL REAL ESTATE

MARK L. ELLIOTT

TROUTMAN SANDERS LLP

My name is Mark Elliott, and I am a partner in the real estate group of Troutman Sanders LLP, and head of our Office and Industrial Real Estate Group nationwide. I have practiced real estate law in Atlanta for nearly 30 years, with a focus on the commercial office sector.

Let me start by saying that Atlanta is a real-estate town; we love our sparkling, tall, new buildings. There is an enormous amount of distress in the commercial loan markets in Atlanta; certainly more than I have witnessed in my 30 years of practice. The distress 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 in the market. This shut down of the finance side has had an equally dramatic effect on the buy-sell side of commercial real estate assets; without the means to finance an acquisition, almost nothing is being bought or sold, and assets that would normally, in due course, have been moved from less productive to more productive owners, are staying in the hands of those who would wish them gone.

Some numbers, for context and to better illustrate how far this market has fallen, would be in order here. Deal volume for transactions (purchases and sales) by dollars on a national basis (for commercial real estate asset sales), when comparing calendar years 2009 to 2007, ran at roughly 6%. Stated another way, deal volume was for 2009 1/16th of what it was in 2007. We as a country reacted with dismay when over-all retail sales dropped, on a year to year basis, by roughly 7%. In the commercial transaction market, we are talking about having experienced a 94% drop in sales volume; for those who rely on real estate sales for their profession, it is a catastrophe.

I think the root causes of this shut-down in the finance and sale markets for commercial office buildings, on a fundamental level, are 2 fold; there is a problem on the demand side with borrowers and owners and there is a problem on the supply side, with lenders and banks. I will break down the components of the problems on the demand side and on the supply side, as each has several reasons.

Demand Side:

On the demand side, very few commercial property owners currently desire to take on new debt obligations, and commercial Lenders continue to report upon and express frustration at poor revenues arising from "weak borrower demand". This reluctance by borrowers would exist even if there was cash being dropped from helicopters, if picking up that cash today meant that it would have to be paid back, eventually. This reluctance to take on additional debt arises for 3 specific reasons.

(i) The tremendous loss of jobs evidenced by our current unemployment rate of 10.2% has completely undercut the need for office space. Quite simply, we have lost 6.1 million jobs since the beginning of 2009, and each one of those lost jobs represents an unoccupied office, somewhere. Here in the State of Georgia, we are suffering the highest unemployment rate in the history of the state. That translates into empty offices and office buildings here in Atlanta.

(ii) The loss of confidence by the leadership in the business sector, coupled with the losses in market capitalizations, has undercut the willingness of companies to take on obligations for space needs that they do not know they can fill, especially as they sit on an inventory of empty office space brought on by their staff reductions over the last year. Long-term planning would normally include projecting business growth, leading to hiring growth, leading to increased space needs. Capitalism has always carried with it a sense of optimism, but that optimism is difficult to find in the business community, today. The long-term planning that we see now for our business leaders does not include projecting business growth.

(iii) The mandates to cut costs in corporate America in all conceivable ways has led financial officers to focus on one of their higher costs; their real estate. Cutting real estate costs by reducing space needs has been an easy and dramatic way to react to profit pressures imposed by eroding sales. Reducing space costs can come from 2 distinct directions: leasing less space, and demanding lower payment obligations for the space that is leased, and both are achievable in the current market. Each of those actions has a dramatic and negative effect on commercial building values.

Supply Side:

On the supply side, the banks have been very reluctant to lend money secured by commercial office buildings, for several reasons, and very difficult in renewing existing debt. Those reasons are as follows, and center into 4 primary categories:

(i) More stringent underwriting standards by the banks, arising out of the (quite appropriate) caution from the lessons learned by this recent real estate crash, have caused banks to create a financing box that very few owner and developers of real estate can fit into. For example, a building with a $100,000,000.00 value in 2006 might very well attract financing with an 80% loan to value 1st priority loan (of $80,000,000.00) and a 10-15% loan to value subordinate, or mezzanine loan, leaving the owner to come up with 5 to 10 million dollars in equity. That same building today, with the same tenant mix, might be valued at $70,000,000.00; and might attract a first priority loan with a 60% loan to value ratio (or a $42,000,000.00 loan). That means in a 3 year period the amount of first priority debt that the same commercial office building could support and obtain has roughly been cut in half, of what it once was.

(ii) The tenant base in buildings, which owners and lenders rely upon to pay their agreed upon rents to service the debt and pay expenses, has undergone a dramatic change in credit-worthiness and stability, reflecting the general upheaval of corporate credit ratings throughout the country. The recent run-ups in the stock market have mitigated this problem to some extent, but the underlying unease remains. That unease manifests itself in 2 primary ways: how can this tenant with a much lower market capitalization and diminished credit rating continue to pay rents established and agreed upon when there was a much more vibrant and rich real estate market, and how willing will the tenant be to continue to pay full rent on all of its leased space, when, because of cutbacks, that company only occupies 70% of the space that it occupied 2 years ago, and the "market rate" for that rent, were it adjusted today, would be 20% less than the coupon rate? The effect of this unease is a discount being taken off of projected income streams from buildings, further diminishing asset values, and further diminishing the amount of borrowing available for that owner and that building.

(iii) The regulatory environment which banks face has become increasingly more difficult, increasingly harsh and critical to their performance and increasingly more stringent. Banks' overall loan portfolios are being increasingly criticized, and because of this, to the extent credit is available from banks, it is available only to the best borrowers. Banks have become much more reluctant to make new loans, for fear of regulatory penalties. 2 years ago, a project that was 35% pre-leased (before the start of construction) could get financing, on the basis that the lease-up of the unleased space would continue in the ordinary course. That same loan, if made today, would draw harsh regulatory criticism as being too speculative. The regulatory pendulum has swung from being too forgiving and lax, to too stringent and unforgiving, and a comfortable median that allows more credit to flow needs to be found. Indeed, loan portfolios that 2 years ago passed muster are today drawing criticism from the regulatory authorities, even though nothing in the portfolio has changed, except the external market conditions.

2 months ago, guidance was given at the federal level to the regulatory authorities, suggesting less stringent treatment and more lee-way provided for certain existing loans and loan portfolios, that attempted to address some of these concerns. However, the guidance given is still open to interpretation and, in this environment, that interpretation will trend toward the cautious, and this guidance did not address at all the views on or relief for new lending, which views remain very critical, and not favorable at all.

(iv) Perhaps appropriately, there is virtually no new commercial real estate development under way and thus, no commercial real estate development loans being made. 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. While some of this imbalance might be addressed with functional obsolescence of certain real estate, we would be well served if very few new shovels go in the ground for commercial real estate in calendar year 2010.

I next want to address the commercial mortgage backed securities market, and why there is such substantial dysfunction in that market. The CMBS market, at its peak in calendar year 2007, contributed nearly sixteen billion dollars of debt capital for the commercial real estate market. Because of the terrible troubles associated with the securities sold with this market, that market is essentially gone right now; it would be extraordinarily difficult today to find buyers for these sorts of securities. No funding sources exist or have arisen that could come close to replacing that CMBS market.

But the problems with the CMBS market go much further than the fact that the market for new CMBS loans has disappeared; we still have what was already done with CMBS loans in that market. The complexity and tortured structures that developed around this business worked very well when it came to slicing up and selling the various level and tranches of debt. The structures have not worked well at all in the environment we now find ourselves in; plunging real estate values that have put the real estate assets value at less than the entire debt, and somewhere in the middle, but probably near the top, of the various debt interests. Where do you go with $100 million of debt which is into 6 levels, when the underlying asset is only worth $70 million, today? Who has the power to sort through and resolve potentially conflicting interests?

What has made this very vexing is how control for negotiating the debt instruments and the debt itself has been allocated, under the service agreements which dictate the identity, selection and role of the servicers of the debt, who are responsible for "dealing with" the loan and the troubled borrowers. Very typically, the holder of the most junior (last in line for payment) debt piece in the sliced up debt stack gets to select the loan servicer. That level of debt is the least likely to make some principal accommodation to a troubled borrower, on a troubled asset, because the first dollars written off in a debt reduction scenario come 100% from the most junior loan piece.

Functionally, all the holder of the most junior loan piece in a CMBS structure wants is time; time that will allow the poorly valued asset to increase in value, because of economic recovery (jobs); generally higher real estate values, across the board (inflation) or some other, unforeseen cause and rescue. A resolution (such as a foreclosure or a deed in lieu to the most senior debt piece) today wipes out the junior holder's piece of the debt. Because of that desire for time, stalling and deferring is the preferred course of action.

However, that very action of deferral causes 2 distinct problems. First, it is contrary to the desires of the more senior debt, who could get paid 100 cents on the dollar for their portion, even if the debt as a whole is not paid in full. The senior debt could then turn around and re-lend the borrowed proceeds (somewhere, maybe), to a more promising project.

Second, for the troubled real estate asset and the real estate community, waiting is not necessarily the best answer on a macro-economic sense. The best answer for the troubled asset might very well be to move it into more productive or creative hands, to find a better or even a different use. That movement will not happen, under the current conditions and circumstances, and with current lock-up of the CMBS Market.

There have been efforts to invigorate and provide capital and liquidity for the private mortgage and securitization market through government interaction and help. So far, while those efforts have been thoughtful and sincere in their intent, they have not produced anywhere near their desired effect.

On March 23, 2009, the Treasury Department, the Federal Reserve, and the FDIC announced details of a Public-Private Investment Program designed to (i) remove toxic real estate loans and securities from the balance sheets of U.S. depositary institutions, which include banks and thrifts (**Participant Banks**), (ii) rejuvenate real estate credit markets and (iii) restart the real estate loan securitization market. The Public-Private Investment Program was divided into two programs, (a) the Legacy Loans Program dealing with residential and commercial real estate loans held by Participant Banks and (b) the Legacy Securities Program dealing with commercial mortgage backed securities (**CMBS**) and residential mortgage backed securities (**RMBS**).

Legacy Loans Program

The initial announcement of the Legacy Loans Program gave a basic framework of how the program would work. The FDIC would oversee the program. Private investors were to invest equity equally with the Treasury to purchase portfolios of troubled whole loans. This equity was to be paired with purchase money debt (of up to a 6:1 debt to equity ratio) guaranteed by the FDIC to finance the loan purchases. The loan portfolios were to be purchased through an auction process conducted by a financial advisor authorized by the FDIC.

Following the initial announcement of details regarding the Legacy Loans Program, the FDIC held multiple conference calls in which industry participants (e.g. law firms, mortgage brokers, bankers) were invited to submit questions and deliver comments to help structure the Legacy Loans

Program. A public question and comment period closed on April 10, 2009, by which time industry participants were asked to submit written questions and comments regarding the structure of the program that are posted on the FDIC's website. Hundreds of comments and questions were delivered to the FDIC ranging from brief expressions of outrage from individuals over the use of taxpayer dollars to detailed memoranda from large financial institutions and law firms aimed at providing input on the structuring of the program. These comments and questions are available to the public at http://www.fdic.gov/llp/LLPcomments.html.

Following the close of the public comment period and the initial anticipation regarding the Legacy Loans Program there was a lull in discussion regarding the program. On May 28, 2009, a Wall Street Journal article reported that the Legacy Loans Program was stalling and may be put on permanent hold. On June 3, 2009, the FDIC acknowledged the issues with the Legacy Loans Program when it issued a press release announcing the postponement of "a previously planned pilot sale of assets." After these acknowledgements of the issues with the program, it is not unfair to say that the initial public fervor for the Legacy Loans Program waned significantly.

Since the summer of 2009, their have been intermittent announcements regarding the status of the Legacy Loans Program. On September 16, 2009 the FDIC issued a press release stating that the FDIC had signed a bid confirmation letter for a pilot sale of receivership assets that the FDIC was conducting to test the funding mechanism for the Legacy Loans Program. In November 2009 Sheila Bair, Chairman of the FDIC, commented that the FDIC was continuing to develop the Legacy Loans Program and showed optimism in hoping to launch to program in the first quarter of 2010.

The FDIC put a positive spin on the delay in launching the Legacy Loans Program by stating that the delays occurred because "banks have been able to raise capital without having to sell bad assets through the Legacy Loans Program, which reflects renewed investor confidence in our banking system." However, skeptics may attribute the delays to various other factors. The abundance of questions and comments presented during the public comment period showed that many complex structural questions needed to be addressed before the program could be implemented. Numerous concerns were also raised regarding private investors' ability to exploit the program or "game the system" for their benefit at the expense of taxpayer dollars. These concerns are all set forth at length in the questions and comments submitted during the FDIC's public comment period.

A key accounting rule change made by the Financial Accounting Standards Board (**FASB**) in April 2009 giving banks more leeway to estimate the value of the loans on their books should also be considered in its effect on the Legacy Loans Program. FASB suspended it fair-value, or mark-to-market accounting rule, that required banks to mark assets each quarter to reflect market prices. The fair-value accounting rule forced banks to show tremendous losses in the distressed mortgage market. Once this rule was suspended it permitted the banks to immediately reduce writedowns and boost net income, easing pressures on banks to unload troubled assets through the Legacy Loans Program.

Circumstances other than the questions regarding the structure of the program and the effect of the FASB accounting rule change may also have been involved in the slowdown of the Legacy Loans Program. Political pressures may have played a part in influencing the FDIC. Numerous commentators expressed outrage over the government's subsidy of banks' prior poor underwriting practices. One non-profit government investigatory group, Project on Government Oversight (POGO), even questioned whether the FDIC was overstepping its authority and placing billions of taxpayer dollars at risk without congressional approval.

The FDIC's much-augmented role in addressing other more immediate economic problems should not be underestimated in the part it also may have played in interfering with the implementation of the program. Handling its primary role of overseeing the nation's depositary institutions, the FDIC handled over 140 bank failures in 2009 alone. The resources that the FDIC had to dedicate to managing this unprecedented number of bank failures probably also contributed to taking the FDIC's focus away from moving the Legacy Loans Program forward.

While we may not be able to determine how much each of the aforementioned factors played in stalling the implementation of the Legacy Loans Program, what we do know is that this once has highly-publicized program lost a great deal of momentum and has been largely quiet since its unveiling last spring.

Legacy Securities Program

The other component of the Public-Private Investment Program, known as the Legacy Securities Program, has met with more success than the Legacy Loans Program. In the Legacy Securities Program private sector fund managers and private investors partner with the Treasury to form Public-Private Investment Funds, or PPIF's, that purchase eligible securities backed directly by mortgages that span the residential credit spectrum (e.g., prime, Alt-A, subprime mortgages) as well as the commercial mortgage market from eligible sellers such as banks, insurance companies, mutual funds and pension funds. The equity capital raised from private investors by the fund managers is matched by Treasury. Treasury also provides debt financing up to 100% of the total equity of each PPIF. Furthermore, Treasury allows the PPIFs to obtain additional financing, up to certain limits, including from the Federal Reserve's Term Asset-Backed Securities Loan Facility (**TALF**) program for those assets that are eligible for TALF financing (currently restricted to CMBS only).

On July 8, 2009 Treasury selected the following nine fund managers to manage the PPIF's and to commence raising equity capital from private sector investors to purchase legacy securities: AllianceBernstein, LP, Angelo, Gordon & Co., LP and General Electric Capital Corporation Partnership, BlackRock, Invesco Ltd., Marathon Asset Management, LP, Oaktree Capital Management, LP, TCW Asset Management, Wellington Management Company, LLP, Western Asset Management Company. These fund managers were selected based on numerous criteria, namely (1) demonstrating capacity to raise at least $500 million of private capital,

(2) demonstrating experience and a track record in dealing with eligible CMBS and RMBS assets, (3) a minimum of $10 billion in eligible CMBS and RMBS assets under management, (4) demonstrating operational capacity to manage PPIF's in accordance with Treasury's objectives, and (5) having headquarters in the United States.

Since the selection of the nine fund managers, six rounds of initial closings have been conducted under the Legacy Securities Program. As of December 18, 2009, all nine fund managers had completed an initial closing, and the PPIF's had completed initial and subsequent closings on approximately $6.0 billion of private sector equity capital which has been matched 100 percent by Treasury, representing $12.0 billion of total equity capital. Treasury has also provided $12.0 billion of debt capital.

I thank you for your time and attention today, and I will be happy to answer any questions you have or clarify any points I have made.

Anthony Greene assisted me in the preparation of this presentation.

Chair WARREN. Thank you very much, Mr. Elliott. Mr. Barry.

STATEMENT OF HAL BARRY, CHAIRMAN, BARRY REAL ESTATE COMPANIES

Mr. BARRY. Thank you very much for having me, and I really appreciate the opportunity to be here. A lot to think about. You all said a lot of things that made me do more thinking. Let me begin with a quick introduction of who I am. I am president of Barry Real Estate Companies. I am an Iowa native, but have been in Atlanta and involved in commercial real estate since 1966 and as a developer since 1975. Mr. Neiman, you may remember John Portman. I was partnered up with John Portman on a development in the suburbs as Portman-Barry, and in the 1980s, we were the guys that built the big, spec buildings and hoped they would lease as office buildings. And we proved that didn't work. And in 1995 we formed Barry Real Estate Companies. And, hey, as opposed to big, and spec, and empty, our approach was take the supply and demand that you referred to earlier out of the equation, but build to lease properties, so a little different equation. You have to learn how to meet the demand of that prospect and how to show him how you can deliver a building whether it be a year later, or two years later, or even longer, but how to develop, design, and finance a property. Give him the lowest possible rent structure, but also create the lifestyle for that tenant.

Well, we've had a hell of a run at it. It's been good, about four million feet. We're a small entrepreneurial Atlanta-based company that has been able to develop on a user-basis throughout the country. And so it was rolling really good until, as you know, this started happening about two years ago. And let me talk about some of our problems with our existing portfolio and then—and then the pipeline, as I see it today.

On the existing issues, in downtown Atlanta we are developing a project not too far from here and when you go out, as you go down the expressway, you'll see this. You'll see part of it. You'll see a building that's leased to Ernst & Young and other tenants, a preleased building, and across the street you'll see the Southern Company building, two buildings. We went into an area that the last new building that had been built in downtown Atlanta was probably 15, 20 years ago, and we saw this movement to midtown, and we saw the exodus to the suburbs, and I was part of that, but we saw a real opportunity downtown. And so we felt we could make a deal that moved the headquarters of Southern Company down there. It worked. So we bought the next site and built the Ernst & Young building. You will see our W Hotel is there as well. But in the process of that, we said, look, this is the urban center of Atlanta. This is where it should happen. This is where—we talk about commuting, and we all know Atlanta created the colossal traffic jam 24 hours a day. You know, it is awful. And so we said there's a better way. There's a better way than public transportation. That better way is walking to work, that is live, work, play communities. And so what we did over the last four years, five years, in red, and I can submit you copies of this, is a total of nine blocks that we assembled. Some of which we have under contract, part of which we owned with Mr. Stockert and Post Properties to build residential on it, but a total of nine blocks. A focus on urban living—a live, work, play, walking community—Atlanta is beginning to figure it out. There's a better way than sitting in the automobile. And so we we're headed toward the most exciting thing I've ever done.

But guess what? With this recession, it hit us really hard. So about a week ago or two weeks ago, it hit the press. We have a lender, a bank who has a loan on the best site we've got, the one where that big building's planned. We designed that building out for various users. We're not going to start a spec building at that size. In fact, back to our user-driven philosophy, we don't start spec buildings. You don't have a tenant; you don't build. Take the supply and demand risk out of it.

Chair WARREN. Mr. Barry, we're out of time here.

Mr. BARRY. Are we out of time?

Chair WARREN. Do you want to give us a sentence on how the story comes out?

Mr. BARRY. Well, I want to move onto one other thing. That is, very quickly, we tried to finance. We were lucky. Our user-driven business signed leases with the U.S. government to build four GSA facilities in St. Louis, Minneapolis, Cincinnati, and Portland, Oregon. Finding a bank—a U.S. bank to finance government-leased buildings in today's market—Mr. Silvers, you're laughing. You know where I'm coming from. It's been a real chore.

Chair WARREN. Thank you, Mr. Barry.

So I'd like to start with my questions with the reason we do field hearings. I read a lot of different speculation about where we are in this commercial real estate downturn. And here we are in Atlanta with five people who have clearly got dirt under their fingernails and are trying to live through it. And I would just like your assessments. And where we can, give a little bit to back it up. Where are we in this? You know, is it that we've gone down and we've hit bottom, we're near bottom? Mr. Elliott, you gave us some startling numbers about how far we've gone down, but you're talking about continuing to shrink. Can you give us some sense of what it feels like and what kind of data you can point to on where you think we are in this? Mr. Stockert, you look like you'd like to jump in first.

Mr. STOCKERT. Well, I'll just—I can speak for the multi-family——

Chair WARREN. Please.

Mr. STOCKERT [continuing]. Housing market. I think that we are nearing the bottom of fundamentals in our business. And I think many of us in the business feel like we are starting to at least see some glimmers in the way of some modest upturns in GDP that we might reasonably assume are going to lead to some job growth during the course of the next couple of years. The better fundamental factor for us is that the supply of housing of all kinds is coming to a near standstill. So, if you look at Atlanta at the peak, we were permitting 70 thousand housing units, and that wasn't just because people were nutty in development. There were 150 thousand people moving into the metro every year. We were trying to meet that demand for housing. And of course we overdid it.

But today we are on pace to do six thousand permits, seven thousand permits in this market. So I get excited, as an owner of multifamily and one who's got a reasonable balance sheet, because I think that we will come to a point where we will be undersupplied in housing.

Chair WARREN. So you think, at least in residential multifamily, you look like you're near the bottom just because of a supply and demand——

Mr. STOCKERT. Well, yes, on the fundamentals. We're going to have a terrible year in cash flow because the rents that we banked in last year are going to run through to the next year too, so cash flows are going to be down.

Chair WARREN. I hear you.

Mr. STOCKERT. But, we can see some light.

Chair WARREN. Mr. Burnett.

Mr. BURNETT. Yes. I'll address the residential single family, which I do believe we are at the bottom of that marketplace. And particularly in the last several months we have seen an improvement in home sales, particularly in our foreclosed inventory, and we are down significantly on the number of homes in foreclosure. I think that's being driven by two primary factors. First of all, we know that interest rates are poised to increase, and, so, if people want to buy a home they need to strike now while rates are still low. And second, I think the first-time home buyer credit has been effective here in Atlanta, which is an affordable housing market.

But, surprisingly, we are now seeing a pickup in lot sales for the first time because, as Dave said, we had about six thousand building permits issued this past year. And that's about two years consecutively that we've built virtually no products. So finally lots are beginning to sell.

Chair WARREN. And can I just ask, you don't think you have a shadow inventory problem that as things pick up you've got a lot of banks and others that didn't foreclose, and therefore, more property is going to gush back onto the market and push it back down.

Mr. BURNETT. I think from the banking perspective we are in a better position there because we have new product versus competing with a mortgage lender who has foreclosed on an existing home. When you're selling a brand new product that's never been lived in, it simply is more appealing.

Chair WARREN. Okay. But that doesn't mean that the whole market is at bottom. It only means the new market is at bottom and starting to turn out. The sale of previously owned homes——

Mr. BURNETT. Correct. And I think that the new market will lead us out of this. Existing home sales will continue to be much more sluggish.

Chair WARREN. Thank you. Mr. Elliott, can I ask you?

Mr. ELLIOTT. Thank you. You used a great term, which is shadow inventory. And I'm afraid that on the office side, unlike hotels which have their tenant base walk in every night and apartments, which have their tenant base walk out or not every 12 months, office leases are signed for ten or 15-year periods. And when someone quotes a 15 or 20 percent vacancy rate, they are not factoring in unused office space, shadow inventory that, when leases continue to roll in their natural course as they will every year over time, that you're going to continue to see large users giving back ten, 20, 25 percent of their space. So no, I don't think we've hit bottom, because I don't think we've accurately reflected what, on the user's side of the commercial office sector, the real use is.

Chair WARREN. Thank you. That's very helpful. Mr. Barry.

Mr. BARRY. Well, just maybe on a positive note. In 1995, we began to see the markets come back, and we started doing user-driven type office buildings. We're seeing some of the same thing today. As far as multi-tenant buildings, it's a disaster. But if there are users that have specific needs that may want to do build-to-suit buildings, in our focus that's around the Southeast, we're seeing some of that now.

Chair WARREN. If the panel will indulge me, I'd like Mr. Olasov to give us his thoughts on this too.

Mr. OLASOV. Yes, just very briefly. I would say that what we are seeing in commercial real estate, we are into the second wave of weakness. The first wave I would characterize as structural, which is that there is just too much leverage on commercial property markets. The debt got too complicated. That raises all sorts of governance issues. If you take a look at the Moody's research showing peak to trough, where peak was October 2007 and where we are right now, all commercial property, all property types, all regions are down 43 percent. A big chunk of that's attributable to leverage problems and what I would call debt, debt structure, and capital stack problems. Now we are starting to see the second wave, and I would echo what Mark has to say. Different collateral types have different life cycles largely dependent on the duration of the leases. So if you take a look at the property types that are most demonstrably the weakest, you start with the shortest possible duration lease. That's a hotel. That's a one-night lease. And we're seeing delinquencies in CMBS pushing 20 percent in hotels.

Multifamily is the next shorter duration. Office, at the other end of the spectrum, tends to be longer term, more stable tenants, but, as you start seeing lease rollover, this is going to move from the capital problems to fundamental problems in operating income. And we haven't even begun to see that play out yet.

Chair WARREN. Thank you very much. Mr. Atkins.

Mr. ATKINS. Thank you. I'm just going to follow up with that too. So actually that was perfect. I wanted to explore a little bit more than our former panel of bank regulators who were talking about some of the steps that they've taken from a regulatory aspect to try to make it possible for banks to lend more. So I was wondering your perception, both as the banker in one case and with respect to either servicers or users in that business, how do you perceive the general attitude of banks to lend and whether that is because of, you know, perhaps over-weeding examiners who are maybe too tough, or not tough enough on the other hand, or because there are other internal aspects that are keeping lending down, or is it more of a fundamental economic question that we have right now?

So if you start Mr. Burnett, and we can go down the line.

Mr. BURNETT. It is difficult for me to speak across the board. But I know in our specific situation I have been very pleased with the relationship we have been able to maintain with our regulators through this, particularly here at the local level. They have had a good balance between the things that need to be said and the way that they say it. I will say that they are under pressure as well, obviously, to perform in their responsibilities. There are some accounting issues that must be enforced that are real Achilles to our industry right now. There are some regulations coming from Washington on liquidity that are very difficult that put banks in impossible positions of perilous liquidity.

Those are not things that are decided at the local level, but they must be enforced by the local regulatory commissioners. I don't want to take a lot of time, but I can go into a lot of different issues on accounting and the way you have to account for your loan loss reserves and interest rate caps on deposits and things like that that are all working against capital and liquidity, the two things most important to our industry right now.

Mr. ATKINS. Mr. Olasov, and then we'll just go down quickly.

Mr. OLASOV. I don't think that there is any issue that there is significantly less capital available for lending to meet prudent credit requests—certainly in commercial real estate. There's a complete drought to meet the needs of either new legitimate business properties, or, I think more acutely, in terms of refinancing this enormous wave of commercial mortgages that are coming due over the next three years. And it's easily observable. All you need to do is take a look at call reports of the banking system to take a look at a decline in loans outstanding. But I think more importantly and more perniciously, if you go to the H–8 Federal Reserve reports, you see lines of credit, either corporate lines of credit that have been cut. Again, peak to trough 1.7 trillion dollars. This is the lifeblood of businesses, who then go into the marketplace to use space to create new jobs where at the bottom you have part of the food chain of small businesses. A lot of small businesses live off credit card borrowings.

Credit cards, lines of credit available are down a trillion dollars, again peak to trough. That is absolutely observable, and very clear, and obviously it has extraordinary knock-on impacts on the economy, and specifically with respect to the ability of all the powers that be in Washington to start removing props that have been holding up the economy for the last year. That's the reason that I thought the third quarter GDP growth of three-plus percent was a very false positive, and that concerns me.

Mr. ATKINS. Mr. Stockert.

Mr. STOCKERT. Yes. I don't want to repeat everything everyone said, but it's true. I do think in fairness it's true that you can't get the loan, or is it that you can't get the loan you want to get. You certainly can't get the loan that you got before.

Mr. ATKINS. Right.

Mr. STOCKERT. And most of what we all are focused on at the moment is refinancing existing debt. Although there is not a lot of construction financing available, there is also not a lot of demand for that, because most of us, other than some in select cases where you've got builders, you just don't see the demand for it. But we live in the public market, and the public market has really been out front. In terms of price discovery, our stocks, the REIT stocks, hit their lows in March. That was a come to Jesus moment for all of us. That was price discovery on our assets. And since that time asset pricing in both the public markets and in the private markets has come back up a little bit. So back to the early comments about mark-to-market accounting. We do have to get the prices of discovery. We have to get to the right kind of reasonable price discovery, because, had we done it at all in March of 2009, we would have collapsed everybody and everything. And that would have been inappropriate to do. You know, we're getting closer today where we're finding realistic asset values in my opinion.

Mr. BARRY. Well, just quickly, one more time. I mean, on the four GSA deals, there's not financing in the marketplace. And we will get there. We are still working on them, and we will get there, but the banks are basically out of business. And it has nothing to do with balance sheet, our balance sheet.

Mr. ATKINS. Thanks. My time is up.

Chair WARREN. Thank you very much. Mr. Silvers.

Mr. SILVERS. I want to follow up on my colleague's line of questioning here. Mr. Barry and Mr. Stockert, if I understood your initial testimony, Mr. Barry, you showed us a layout of properties in downtown Atlanta. Am I right in understanding that currently you cannot proceed on that project?

Mr. BARRY. Well, the key block in the middle of it had a loan with a bank that has since been taken over by FDIC. We tried to extend the loan. We tried to do a workout, something short of continuing full payment. That didn't happen. They amortized on us. We have since agreed to come out-of-pocket and to carry it. I don't know exactly why we're doing it, because I don't think anything is going to happen in a year. We agreed to extend it for a year, to pay the interest, et cetera. And we're going to try to salvage that block because of what it means to Atlanta. What it means to Allen Plaza, and what it means to us. Do we have a tenant for it today? No. And it's the heart of what we're trying to do and what we're trying to prove in downtown Atlanta.

Mr. SILVERS. Let me just follow-up on this and I would invite any of you to respond with respect to this project or with respect to other projects, and Mr. Olasov, and Mr. Elliott, with respect to your clients' projects. It strikes me that, whether it's the GSA buildings or high-density downtown residential real estate, it's consistent with, I think, the overall direction of the economy that certainly President Obama has laid out—we want to be more energy efficient, have less traffic, and the like. With respect to the TARP, which is after all what brings us here, do you have thoughts as to what steps could be taken to make it more likely that projects that are economically beneficial are going to create jobs, steps that could be taken under the TARP to make that more likely? And, in doing so, I would hope you could respond to that question, I hope you could respond with a specific reference again to what the problems are. Mr. Barry, you said the problem is not the creditworthiness of the developer, but some other problem. There has been some talk about both the broader economy and the question of whether, say, the CMBS markets function and the like. So touch on what you see the problems are and then what the Treasury Department could do using the TARP that could be responsive, including their work in TALF or whatever comes to mind.

Mr. BARRY. Well, I'd like to take that one more time. I don't know what the answer is. What I can tell you is that we get the impression that there is blockage. That whether it is a capital problem, a liquidity problem, or a direction that the banks do not want to take—but any more real estate, regardless of what type it is, they don't want to make any deals.

Mr. SILVERS. Now, what size bank are you talking about when——

Mr. BARRY. Well——

Mr. SILVERS. When you're looking for financing, who do you start with?

Mr. BARRY. Well, the St. Louis deal was a 150 million, and most of the other FBI facilities that are under a lease to build, they are in the 55 million range. As such, we go to all the top banks in the country.

Mr. SILVERS. And they're not lending?

Mr. BARRY. They're not willing.

Mr. SILVERS. Others?

Mr. OLASOV. It's probably worthwhile to put some parameters on this. If we look at who holds commercial mortgages right now, and obviously that springs from the original source of the lending. You've got 3.4 trillion. Of that, you've got about 1.3 trillion in commercial mortgage banks. You've got another 700 billion in CMBS. You've got about a quarter of a trillion dollars in life companies and then the GSEs and pensions and others kind of play into that. So, obviously, the commercial banks have been the largest source of commercial mortgage lending over time apart from the multifamily market that Mr. Stockert was talking about before.

Now, let's take a look at where we are. Life insurance companies are actually back in the market. There's a certain kind of life company product that they might be allocating 30 billion dollars to what might be a four to five-hundred-billion-dollar ask this year. Commercial banks are shrinking their commercial real estate portfolios for lots of very obvious and justifiable reasons, including regulatory pressures, and, again, the preservation of regulatory capital.

CMBS might see ten billion dollars. It got up to 230 billion dollars in 2007. That's not going to be the source of lending. So we have to go back to commercial banks, which puts it back at the feet of TARP and COP. The way to get there, in my estimation, is to start with what motivates banks to lend or not to lend, which is the preservation of regulatory capital. And that's why the white paper that I have addresses the opportunity to allow banks to start stripping out problem loans. And in the presence of those problem loans, they are not going to continue to lend—for all the vagaries that we discussed before.

Chair WARREN. Thank you. I just want to stay on time, but I hope we can come back to this. Let me just say for those of you who may have noticed. We had originally scheduled this hearing for ten to 12:00. I think this is very valuable. If you can stay a few more minutes, what we'd like to do is finish this round of questioning and then do a lightening round, one more round of short questions. And then we want to be able to take comments from anyone in the audience who would like to come forward. We're going to have to keep them very brief, but we'd like to do that. So I hope we can get everyone out of here in maybe about 15 minutes, ten or 15 minutes. But if you can bear with us, we would be grateful for that. Mr. McWatters?

Mr. MCWATTERS. Thank you. Tell me about your access to foreign capital, through either U.S. managed hedge funds or other sources, and specifically what role FIRREA has played for an investment in the Real Properties Tax Act, and also some of the other restrictions that may be placed upon potential foreign lenders who make loans in the U.S. Any thoughts?

Mr. BARRY. The one FBI facility that we're very close to getting done is with a Swiss institution providing a letter of credit. Through investment banking, selling bonds, and using that letter of credit as collateral, we're real close.

Mr. MCWATTERS. Okay.

Mr. BARRY. And we're beginning to see some of that. We went had long, long conversations with the Japanese, similar conversations. They're not quite ready. It didn't happen, but we spent several months with them.

Mr. MCWATTERS. And there have been no discussions with sovereign wealth funds or hedge funds?

Mr. BARRY. No.

Mr. MCWATTERS. Mr. Elliott, any thoughts?

Mr. ELLIOTT. I think they are impacted with the same fundamentals that U.S. banks are, which is until there is a reasonable return or they can price themselves in a way that would be attractive for a developer to get a return, they are not going to get in the market.

But being responsive to your question of whether there are regulatory issues that they face, I haven't seen that. That's not suggesting they don't exist. I just haven't seen it.

Mr. MCWATTERS. Okay. Mr. Burnett, I assume you don't have a response, but Mr. Stockert?

Mr. STOCKERT. We really haven't encountered a lot of international capital confidence.

Mr. MCWATTERS. Well, are you involved with the REMIC rules? They have been liberalized lately, making them a little more user-friendly, but they still seem to, at least what I've heard from some people, impair the flow of capital.

Mr. OLASOV. We deal extensively with special servicers and CMBS. I'm getting ready to go out to Las Vegas to moderate a panel with them. And they consider the liberalization that came out of the IRS back in September to be a complete non-event.

Mr. MCWATTERS. Okay. That is what I've heard also. How would you suggest modifying those rules, the REMIC rules?

Mr. OLASOV. Well, it doesn't lend itself to a 30-second schedule. I'm not—honestly, I'm not sure that—that the REMIC restrictions are what ties up the special servicers. I don't think that it particularly ties their hands in seeking the highest NPV resolution.

Mr. MCWATTERS. We've heard a lot about special servicers and conflicts of interest and the like. What's your perspective on that?

Mr. OLASOV. Again, I'll try to keep this brief, but you're raising some very fraught topics. I would say that there was a bargain made really going back to the RTC days that kick started the new CMBS market. That in bulk, the alignment of interest between special servicers and B-piece investors, those bond investors holding the riskiest piece of the CMBS, was on net a good thing, not withstanding the conflicts.

In retrospect, I think a lot of people would argue that moving the discipline, of those B-piece investors out of the CMBS through CDOs, collateralized debt obligations, where they fervently took their equity off the table, should be reconsidered.

Mr. McWatters. Okay. Thank you. My time is up.

Chair Warren. Thank you. Mr. Neiman.

Mr. Neiman. Thank you. My question goes to Mr. Burnett. I am very interested and appreciate your candor with respect to the receipt of TARP capital and the experience that you had. I would like to have a clear message, though, as to some recommendations that you gave to us with respect to the use of TARP funds for community banks. I'm getting a sense that you do not feel that TARP has been sufficiently responsive to the needs of community banks. At our last hearing with Secretary Geitner, we pressed him on the details of the October program they announced, which was specifically directed to community banks and tied to specifically to small business lending. He responded that there was a reluctance from those banks to participate because of a stigma. Could you talk about the need for additional TARP funding through capital programs and how can it be changed, if you do support those, in order to make it more receptive to bankers?

Mr. Burnett. Well, I think that any time that private capital is available versus public capital, as a business person, I would choose that route to benefit the taxpayers. However, I think that at this point, public capital, at least in our sector of the industry, is simply not available from institutional levels, and there are numerous reasons for that. One of those is primarily—we've now created a system of shelf charters where a charter can be obtained and then capital can be raised from institutional investors to buy failing banks with FDIC assistance. I've had numerous institutional partners say, why would I invest in your bank, when if I hang around long enough, I may pick you up with an 80 percent agreement? So those sorts of transactions have taken public capital virtually out of the market.

That and the general concern on what the future of smaller banks is. I think Secretary Bair has said openly addressed the number of failures forthcoming. And investors don't know what to expect from Washington, in terms of closures this year or next year, so they are sitting on the sidelines.

So it is perhaps TARP that may be the only source of capital for banks in our sector. If you look at TARP across the board, I believe about eight percent of all U.S. banks receive TARP. I think there were 26 here in Georgia.

Mr. Neiman. If you would support seeing an expansion of those programs for community banks, how would you change the program in order to implement it more effectively?

Mr. Burnett. I would support seeing an expansion of the TARP program. I think, in all candor, the conditions are going to have to be changed. I know in our case a year ago, when we applied our company was in better shape than it is today, but because community banks were put at the very bottom of the stack of the applications by the time they got to any of those banks, the deteriorated banks no longer met the standards.

Mr. NEIMAN. So, recognizing the limitations on raising private capital in this market, how would you describe the reluctance of community banks to participate in TARP programs, particularly the October program announced with respect to small business lending?

Mr. BURNETT. In all candor, in my circles, I have not found banks that were reluctant to participate. What I found in Georgia is the bank's applications simply were not acted upon.

Mr. NEIMAN. I want to also ask Mr. Stockert. What is the most important message that we should leave here with respect to the impact CRE is having on affordable housing and any proposed changes that we should be recommending to Congress or the Treasury to address those concerns on the impact on affordable housing?

Mr. STOCKERT. Well, very clearly, and I said in my remarks, we feel that preserving the GSEs that are providing the good, sound, liquid financing to our industry is very important. And beyond that, we don't really deal with affordable housing per se, but I certainly can get you some more information on other suggestions we might have in that realm.

Mr. OLASOV. Excuse me, Superintendent Neiman, I feel very forcefully about this, and I just wanted to support on very strong terms what Chris was talking about. And, obviously, there are some alternatives, in terms of promoting community and regional banks and attracting new capital. We've had a number of discussions with the FDIC. I think Mr. Atkins talked before about the "F" word, forbearance. I know that's a bad term, but at the end of the day, the FDIC is chartered to find the least cost resolution. If you take a look at a 140 bank failures last year, the estimated losses against total assets was 25 percent. We've reached out with a number of institutions to find some form of matched funding where possibly open bank assistance could be provided along with investment on a subordinated basis. That's in conjunction with what one of your previous witnesses, I think Charlie Calomiris, talked to you about—the need to put public subsidies in a senior position to private capital. Not being able to do that means that you're going to restrict new private capital coming into banks, and everyone agrees that the banks need to attract new capital.

Mr. NEIMAN. And doing that through FDIC programs.

Chair WARREN. So let me just follow up in a slightly different direction on this same question. I think part of the question we are trying to ask is what works best to get new money into good projects, whether it's refinancing the existing projects or it's trying to finance new construction. And we've heard a lot about the extend and pretend softening with accounting standards and so on. We talked about loss recognition and the problems associated with loss recognition. I want to start with you partly because of your written testimony and what you've been saying here today, Mr. Olasov, but we're going to be short on time. But do you want to take one swing at how we should be thinking about that problem? How do we get the money in the banks, and then out of the banks into the projects?

Mr. OLASOV. I think that it all starts with cleaning up balance sheets. If you take a look at bank crises around the world, we've got some very good examples of what happens when there are not deliberate actions taken. Japan, obviously, is always a hot topic. And I remember meeting in mid 1990s with the Japanese DIC, where year after year we would go through this same dance with them that never led to any kind of outcome. It all had to do with papering over the problems with the Japanese banking system. My fear is that we're going to prolong the agony unnecessarily by not dealing with the removal of problem assets in a way that does not necessarily entail impairing regulatory capital.

Chair WARREN. Thank you, Mr. Olasov. Mr. Stockert.

Mr. STOCKERT. Similarly I would say make sure the rules are clear. If we all know what the rules are, we can figure it out. And then the second thing is facilitate price discovery, because that's what we're all saying. I don't think that that's fully baked in at the banks. I think that's the big bottleneck. Going back to the affordable housing question for a minute. The housing policy in this country has got to be more balanced. Multifamily apartments are affordable housing, all of them. To live across the street at Post Biltmore, you cannot buy a single family or condominium for anything like what you can rent one of our professionally run, well-appointed apartments. So balance the housing policy.

Chair WARREN. Thanks very much. I'm out of time. Mr. Atkins.

Mr. ATKINS. Well, it's too bad, I mean these are some important issues that we're talking about here, liquidity and capital issues. Ironically, of course, TARP was set up to buy troubled assets, but many of us at the time thought that was going to be impossible because of the valuation issues, regulatory ramifications, and just human nature. And so the public-private partnership is more of a battle still because of those basic issues. So how do we solve this morass, which is essentially what it comes down to, banks holding onto assets and not wanting to sell them? Mr. Olasov, or others, I was wondering if you had any quick suggestions?

Mr. OLASOV. Yeah. In fact, I was invited to talk to the OCC about CRE problems a couple of months ago. And I said, by way of establishing my bona fides, that I am an enormous proponent of fair market value accounting, but—and this is important—I think the hole that we're in is so deep right now. We can talk about numbers later on offline. I'd rather not talk about it online, to be honest with you. I think the overhang of debt in both the residential and commercial markets is so chilling that we're going to have to start looking at some kind of deferred loss accounting.

Mr. ATKINS. Those are fighting words.

Mr. OLASOV. I say that very reluctantly.

Mr. ATKINS. Anyone else?

Chair WARREN. With that breathtaking thought, maybe we should go to the next question. Is that all right?

Mr. ATKINS. I'm out of time. Yes.

Chair WARREN. Mr. Silvers.

Mr. SILVERS. Just to show you how much in sync I am with my friend Mr. Atkins, I want to put this in language that a listener might understand. Mr. Olasov, if we were to take these troubled assets off of bank books, as you're suggesting we must, and you mentioned Japan. I don't think it's possible to repeat that problem too many times. If we're going to do that, not at the prices in March 2009 but at today's prices, what would the solvency of our banking system look like?

Mr. OLASOV. I actually don't think that it would be prudent for me to answer that online, to be honest with you.

Mr. SILVERS. All right. Well, the reason why I raised it—I invite others to comment—it strikes me that when we talk about a capital problem, what each of you and what our prior panel, much to my surprise, seemed to be saying, is that we just don't have enough capital in our banking system for the assets of our banking system to be deployed properly. Now, I'm not speaking, obviously, with respect to any particular bank, but across the system that seems to be the case, and I think we've heard this over and over again. And so what I pose to you all is we need to get these assets off the books, and do so at any realistic price—and I remind you, we've got 160 billion dollars in unallocated TARP assets. This would be if we're going to do something in TARP. That's for the entire financial system. It suggests that we're just looking in the wrong place. It strongly suggests to me, at least, that you can't have this conversation without talking about restructuring the liabilities on bank balance sheets. There's no other way out. And this is actually where Japan ended. And I invite any comments before my time is up.

Chair WARREN. No, you don't. Your time ran out.

Mr. SILVERS. My time ran out.

Chair WARREN. We're going to get there and we are going to do some comments. That's why I'm trying to be disciplined about this. Mr. McWatters, before I call you for your two minutes, I'm going to say that I very much appreciate each of you coming. I appreciate this. I wish I could stay and hear the rest of the panel. Like everyone else, I am at the mercy of Delta Airlines and an obligation back in Boston that I must get back to. Since the rest of the panel will still be here, I'm going to hand the gavel over to the deputy chair. I will watch the rest of this on video. But thank you very much. I wish I could stay and talk about this. Not just for the rest of the day, but for the rest of the month. Thank you.

Mr. McWatters.

Mr. MCWATTERS. Thank you. Each of you have described problems, and that's basically what we've heard today. We wouldn't be having this meeting, if there weren't problems. If you can take two sentences, three sentences each, what's a solution? The succinct, almost sound bite type solution to the regulatory problems, accounting problems and the like, if that's possible.

Mr. BARRY. Let me just start with kind of a broad statement. Somebody mentioned a soft landing for the commercial real estate industry. We see the focus on the taxpayer, rightfully so. We see the focus on the banks, on residential moratoriums, mitigations as opposed to foreclosures. But the general feeling that the banking community gives us is that we need some love. We need banks to understand the problems that we have. We need the banks to also understand the potential of what we bring to the table. When I go back over the investment dollars that we channeled into communities, when I think of the jobs that we created in the overall economy, what we do as commercial developers is very positive. But the commercial world is in trouble and taking everybody down, and that's an awful lot of people. I must say that most of them are in the single family development side as opposed to the commercial side. But the commercial real estate world is in a world of hurt. And if there's a way that you could think about how to give some help to the commercial developers, it would be great.

That wasn't the answer you were looking for, but time has expired.

Mr. NEIMAN. I'd like to go back to our discussion particularly with the first panel regarding the CRE guidance. And I'd like to give Mr. Burnett an opportunity to respond and maybe some of the developers and others on the panel as well. How do you assess the impact and the effectiveness of that guidance, if the intent was to encourage banks to restructure CRE loans and to take write downs where required? Will it meet its objective? Is there other guidance or regulatory action that's needed?

Mr. BURNETT. I am pleased with components of the CRE guidelines. I do think that they will allow us to deal with our problems more prudently. Someone had used the term "kick the can down the road." Well, right now, if you didn't kick the can down the road and you truly wrote property values down, we don't know the depth of the capital hole. But if we believe that our markets are going to recover, and as long as those borrowers can continue servicing the debt even if it's through restructuring, then it is better to move that problem down the road as long as we have appreciating property values. And I think that's the real key determinant, do you have properties that are depressed today because of the situation we are in, but in the long term are still are viable, valuable assets.

Mr. NEIMAN. Does anyone want to comment on that?

Mr. ELLIOTT. I think it's a positive step in that it allows the property to stay in the hands of good sponsors. I think maybe you made a point earlier about one danger of not good sponsors is actually accelerated deterioration of assets, which is not a good thing. So I do think it's good keeping the property in the hands of good sponsors. It's not doing anything on prompting new loans though.

Mr. NEIMAN. Thank you.

Mr. SILVERS. Well, with that, this panel is excused. We very much appreciate your willingness to stay a little longer than we had promised. And if there are members of the audience, the Congressional Oversight Panel makes it a practice in field hearings to invite comments from the audience. Please limit your remarks and questions to one minute. There is a microphone up front. Please walk up to the microphone and introduce yourself.

Mr. MOORE. My name is Ray Moore, and——

Mr. SILVERS. Just give these folks a chance to get——

Mr. MOORE. I was hoping these gentlemen would stay and listen. I would suggest they stay and listen. My name is Ray Moore. I've been in the commercial real estate business for 35 years. And I've sat here and listened to these gentlemen cry about their particular problems. What they are doing is crying. I would suggest to Mr. Barry that when the project was going very well, Mr. Barry could have paid for that land and had equity in that land, and we wouldn't be here. I called Senator Johnny Isakson, the individual who empowered this board. He was the one that made it. He spent

21 million dollars of our taxpayer's money for you guys to come out, and I would suggest that what you all are doing is you are looking out here at the symptoms. And you are hearing all of the problems. You are out here at the symptoms. We need to go back and understand. I thought what this board was going to do—I inquired to get on this board. I was told that I did not have the national reputation to get on this board. It would have been very short because the problems we're facing today started back in 1999 with Fannie Mae and Freddie Mac by pressure from Congress and the administrations ever since to implement social programs.

Mr. SILVERS. Sir, your one minute is expired. Do you want to wind up?

Mr. MOORE. I would like to say this. This is a situation where you guys are supposed to be looking at why we got here, not looking at the symptoms out here. You are supposed to look at the reason. The reason—if you go back and see the reasons——

Mr. SILVERS. Sir, I would ask you to wind up. We mean it when we say one minute.

Mr. MOORE. If you look at the reasons why we get here, it becomes obvious to the problem. What they have done is they have overleveraged. These individuals——

Mr. SILVERS. Sir, I've asked you for a third time. Please sit down.

Mr. BOWERS. I'll try to keep my remarks to one minute. I would love to write you all a letter. I am Richard Bowers. I have a firm Richard Bowers & Company. I own downtown properties and suburban properties. I lost a property that was a commercial mortgage-backed security. I paid on time every time for ten years, couldn't get it renewed. So that's very disappointing. I really believe this economy was created in September of 2007, when virtually all liquidities stopped in the marketplace. And from that point on, from a brokerage firm and from singular developers, there was no liquidity. Demand couldn't be served. That is the sale of real estate. Values went down. In fact, it was like getting thrown off the top of your building. And employment went down because businesses couldn't get their funding or lines of credit extended. So what we've created is the greatest devaluation in personal wealth ever, the highest unemployment, which is a lot higher than ten percent. And the greatest debt per capita that we've ever had, I guess, in the world. I do believe that liquidity is the answer for the market, and there is none at least from where I sit as an entrepreneurial property owner. We go to these banks——

Mr. SILVERS. Sir, I have allowed you to go over as a speaker, but if you want to wind—if you've got a final——

Mr. BOWERS. Well, I mean, I don't believe there's liquidity in the marketplace despite what some of these people say. The regulators have been over-scrutinizing the banks in my opinion, or the banks are afraid to make loans to reputable businesses and business leaders. I also believe that a lot of this could have been much better handled than it was and still might be satisfied if liquidity could be provided. But I really do believe that either through tax benefits or government underwriting of some commercial loans, either go back 15 or 20 percent, but some of this could be avoided. Otherwise, you are just going to end up bankrupting every entrepreneurial real estate owner, in my opinion, that has a loan turnover in this country. Thank you.

Mr. SILVERS. Thank you, sir. Sir.

Mr. BOYD. My name is Bob Boyd. I'm a commercial real estate investment broker. We have a large amount of capital looking for opportunities. And we have dealt with a majority of the Atlanta banks over the last two years looking to buy toxic assets. The difficulty in making those deals happen is a function of the asked price versus the bid price. And the inability of the banks to release those assets to buyers who, in most cases, would pay all cash to buy those opportunities. As long as that continues, those opportunities don't present themselves to the marketplace. In addition, once a bank is taken over by the FDIC, that very same asset that has been part of our target in the marketplace that we understand, goes to an FDIC pool where it's completely lost in some pool purchase and as a result is sold at a much lower value than what our original offers have been. And that continues to be a problem.

Mr. SILVERS. Thank you. Is there anyone else who wishes to speak?

Mr. ATKINS. I just wanted to respond to—I would love to talk offline with the gentleman who spoke at the beginning. But just to clarify this panel here is charged with overseeing what's happening with the TARP program. There's another commission, the Financial Crisis Inquiry Commission, which is looking at the origins of what happened. I happen to agree with you that Fannie Mae and Freddie Mac actually are probably a huge problem obviously in the residential mortgage area as well as the commercial area. But you know that is not necessarily what we are dealing with here. But I don't want to open——

Mr. MOORE. I didn't realize that this was a separate group. He asked his question. I would like to respond to it. I would just say that TARP funds need to be used to create jobs. Our whole economy is kept up—it's like a balloon. Not everybody breathes confidence in it. All of our citizens breathe confidence in this big balloon. And so we need to get individual citizens breathing confidence back in this balloon and the problems are solved. Use those funds in there to get jobs to people out here. They are worried about jobs. Job creation is what this needs to be about. And the TARP funds don't need to be—these guys make mistakes. Real estate is a cyclical business. The bankers keep doing the same thing over and over. The developers keep doing the same thing over and over.

Mr. SILVERS. Everyone who spoke had a time limit. I very much agree with your comments, but everyone who spoke had a time limit. Let me just say that—I can't speak for the other panel members, we each have our own travel plans—but I'm available. I suspect maybe other panelists are available too to continue offline these conversations. We do have time rules, and it's only fair to stick to them.

On behalf of the Congressional Oversight Panel and our Chair Professor Warren, I wish to thank Georgia Tech for their hospitality and help and call this hearing adjourned.

[Whereupon, at 12.35 p.m., the hearing was adjourned.]