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ON BEHALF OF
THE NATIONAL ASSOCIATION OF REALTORS®

BEFORE
U.S. JOINT ECONOMIC COMMITTEE
HEARING REGARDING
"COMMERCIAL REAL ESTATE: DO RISING DEFAULTS POSE A SYSTEMIC THREAT?"

July 9, 2009

Introduction

Chairman Maloney, Vice Chairman Schumer, Ranking Members Brady and Brownback, and Members of the Joint Economic Committee, thank you for inviting me to testify today on the crisis facing the commercial real estate markets. My name is Jim Helsel and I am a Partner with RSR Realtors, a full-service real estate company in Harrisburg, Pa. I have been involved in real estate for 34 years and currently serve as the 2009 Treasurer of the National Association of REALTORS.

I am here to testify on behalf of more than 1.1 million REALTORS who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors, and others engaged in all aspects of the real estate industry. Members belong to one or more of 1,400 local associations/boards and 54 state and territory associations of REALTORS. REALTORS thank the Joint Economic Committee for holding this very important hearing to examine the myriad of severe problems facing the commercial real estate industry.

Overall State of the Commercial Real Estate Markets

Having a sound and well functioning commercial and multifamily real estate sector is critical to our country's economic growth and development, and to millions of U.S. businesses of all sizes that provide local communities with jobs and services. It is estimated that the commercial real estate sector supports more than 9 million jobs and generates billions of dollars in federal, state and local tax revenue. Nonetheless, the overall economic downturn and crisis in the broader financial markets is directly impacting not only the fundamentals of commercial real estate finance, but also the outlook for recovery. And while the commercial and multifamily real estate markets play a vital role in the economy, these markets are now experiencing the worst liquidity challenge since the early 1990's.

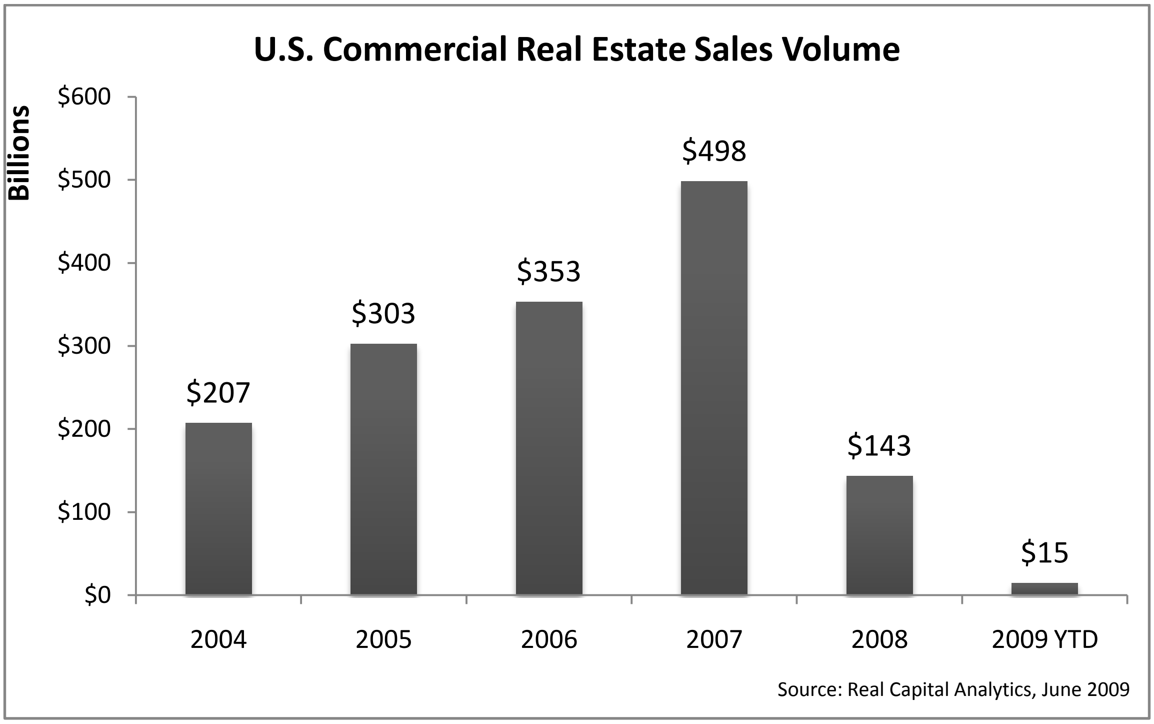
Many of us in commercial real estate have been warning for some time that the liquidity crisis facing our industry has the potential to wreak havoc on the broader economy. In fact, an apt description for the situation is that commercial real estate is the "next shoe to drop". The collapse of the nation's housing market had and continues to have a huge impact on the entire global financial system. Likewise, it is important to recognize the economic ramifications of a widespread collapse in the commercial real estate markets.

Deteriorating property fundamentals, declining property values, and a severe tightening of lending activity are all factors contributing to the current crisis. According to NAR's most recent Commercial Real Estate Outlook report, released in May of this year, "…with credit markets contracting in the wake of the financial crisis, businesses also slashed spending. The result has been a major hit for commercial real estate, translated into shrinking demand, growing space availability and a collapse in the volume of sales. As companies file for bankruptcy and as the ranks of unemployed grow, commercial space finds itself under pressure."

Nowhere is this more evident than in the retail industry. The nation's shopping center owners face a double hit – the economic recession, corresponding unemployment and reduced consumer confidence means that consumer spending is down dramatically while at the same time owners and investors face tremendous difficulties in securing financing. According to a recent International Council of Shopping Centers survey of shopping center owners — which represented a cross section of the industry that accounted for over 5,100 shopping centers and 12.6 percent of all shopping center space — 62.7 percent of respondents cited little or no confidence in refinancing company debt during 2009. In addition, 53.9 percent held that same opinion for 2010. A recent article in U.S. News & World Report entitled, "America's Most Endangered Malls" further highlighted the extent of the financial troubles facing distressed retail properties and included some startling data supporting the bleak outlook for America's retail landscape. One statement from the article bears mentioning here – "By some estimates, about 10 percent of America's malls could close within the next few years."

While demand for space is essentially in a state of full retreat, we also see that vacancy rates are climbing across all property types and transaction activity for commercial properties is in a major slowdown. To highlight this critical situation, during the first quarter of 2009, nationwide only 607 major properties exchanged hands, for a total sales volume of $9.5 billion. The figure represents a 51 percent drop in investment activity compared with the fourth quarter 2008.

The decline is evident in each sector of commercial real estate. Based on the first quarter 2009 data, office investments were down 75 percent compared to a year ago, while industrial sales volume declined 83 percent. At the same time, compared with the prior year, apartment investments dropped a significant 85 percent and retail sales contracted 72 percent.



The lack of liquidity and banks' reluctance to extend lending are also becoming apparent in the increasing level of delinquent properties. Delinquencies on commercial loans 30-plus days past due almost doubled from the first quarter of 2006 to the fourth quarter of 2008. Multi-family properties are leading the delinquency wave, with about $24.5 billion of delinquent loans.

Given that property loans are not being refinanced, there is a growing volume of distressed commercial properties. This year, the volume of distressed real estate has more than doubled. Currently, there are over 5,300 commercial properties in default, foreclosure or bankruptcy. The value of these distressed properties is in excess of $100 billion and rising. The impact is felt across all property types and across all regions of the country, weighing most heavily on the people whose livelihood depends on an economic recovery. In fact, together with retail stores and hotels, apartment buildings are taking the brunt of the refinancing crisis. Together the three sectors account for over 3,500 distressed properties, totaling more than $65 billion dollars. Geographically, New York City presents the largest problem, with Manhattan possessing almost $8 billion of distressed commercial properties. Other markets with large concentrations of distressed commercial real estate are Las Vegas, Los Angeles, Detroit, Phoenix, Chicago, Dallas and Boston.

What is alarming to us, as real estate professionals, is that banks' responses to this growing threat have been slow and inadequate. The rate at which these troubled loans are being resolved has been sluggish. Over $60 billion in assets have become distressed this year but only $4 billion worth of commercial loans have been resolved so far.

In addition, commercial banks and the commercial mortgage-backed securities (CMBS) market represent approximately 70 percent of all outstanding commercial real estate loans. However, banks have tightened their credit standards and reduced commercial real estate loan volume while the CMBS market, which has been a key source of liquidity to the commercial sector, has ceased to function. In 2007, a record high of $230 billion of CMBS was issued. In 2008, this figure dropped to $12 billion and thus far in 2009, there has not been a single CMBS issuance. Hundreds of billions of dollars of commercial real estate loans from a variety of sources are expected to mature in 2009 and over $1 trillion by 2012. Under current conditions, there is clearly insufficient credit capacity to refinance this huge wave of loan maturities. Without greater liquidity, commercial borrowers are facing a growing challenge of refinancing maturing debt and the threat of rising delinquencies and foreclosures that could cause widespread damage.

Members' Experiences

Though commercial REALTORS around the country are experiencing different types of challenges, depending to a large degree on their local markets and what type of business they focus on, I believe that most commercial practitioners, whether they are involved with retail, or office space or industrial warehouse development, will tell you that the biggest challenge in this environment is the inability to complete transactions due to a severe lack of liquidity in the markets. Underscoring this fact, a full 44 percent of our members reported financing as their most significant current challenge in a recent REALTOR® market survey.

I would like to provide you with several examples submitted to us by Commercial REALTORS from around the country: From a Memphis apartment broker and certified commercial investment specialist (CCIM), "I am now on my fifth contract for the Park Tower apartments in Memphis. It is located across from the VA Hospital in the Medical Center area of Memphis. Four out of five contracts have failed due to the lack of available financing…Lenders with and without TARP money are saying no before they review the numbers or clients. It is the worst lending market that I have seen in my 25 years in the business."

And this from a commercial REALTOR in Atlanta who specializes in industrial properties – "We recently bid on an industrial warehouse by the airport. The property was only 25 percent leased, but we were purchasing the property for $6.25 per square foot (probably 80 percent below replacement cost of the potential income stream). In the past, we would have been able to purchase that property with a loan of 75 percent and equity of 25 percent so long as the bank felt we had approached our underwriting and lease up conservatively. We underwrote the property very conservatively, and instead of 75 percent debt, we came with 75 percent equity and asked for a loan of only 25 percent. Our primary bank said no, and several small banks who would have typically strongly considered this deal said no. Over the past 10 years, we have purchased or developed close to a million square feet of industrial real estate. We have never defaulted on a loan or missed a mortgage payment. Without the ability to get a loan to leverage our potential returns, it is impossible to make real estate deals appealing enough to investors. We are basically out of business until banks start loosening their guidelines."

These are but two examples, and clearly there are thousands more around the country. Each failed transaction, foreclosure or distressed property creates further pressure and problems with widespread economic repercussions. We have lost about 6.5 million jobs over the past year and a half of economic recession. Many of these jobs have been in office, industrial, retail and multi-family sectors. A continued increase in distressed commercial properties will result in more job cuts.

Economically, commercial real estate has lagged residential real estate cycles. Even during an economic recovery, commercial real estate continues on a downward trend for a while. The residential real estate sector has been in a severe downturn for over two years. During this time, homeowners have lost over $4 trillion in wealth. Even with some positive recent signs, the residential market is still looking for a bottom. With this relationship in mind, it is obvious that for commercial real estate the worst is yet to come. The length and severity of the downturn along with the accompanying pain to business and consumers depend largely on the credit markets and the banks' willingness to step in and provide financing for properties which are well-capitalized and performing in many cases.

Policy Suggestions

To address the serious problems facing the commercial real estate finance markets, NAR believes that it is imperative that we take proactive steps now to provide liquidity and facilitate lending. We commend Congress, the financial regulators and the Administration for the development and implementation of several innovative programs and initiatives, such as the Term Asset-backed Lending Facility (TALF) and the Public Private Investment Program (PPIP). We strongly support several recent moves on the part of Treasury to strengthen the TALF program – for example, expanding TALF to include CMBS as eligible collateral, while also making the terms of TALF loans 5 years to better accommodate the longer term nature of commercial loans. Nonetheless, the TALF program is set to expire at the end of this year. NAR believes that it is absolutely essential that the TALF program be extended for another year in order to continue to provide the necessary liquidity support to keep economic recovery efforts on track.

NAR also commends the Administration for the development of its comprehensive financial regulatory reform proposal. We truly believe that it is important to have strong supervision and regulation of the nation's financial system. We stand ready to work with policymakers and the Administration in the shaping of this monumental plan but we also believe that it is essential that reform efforts do not negatively impact the efforts currently underway to revitalize and stabilize the commercial real estate markets, in particular those efforts targeted at the securitization markets.

As previously mentioned, the CMBS market has been a key player in supporting commercial real estate lending, but due to challenging capital market conditions, in the past year the CMBS market has ceased to function. The securitization markets represent an important source of liquidity and NAR believes that it is essential to protect and promote policies that support the securitized credit markets and do not impede economic recovery.

Along these lines, we believe that actions on the part of the accounting policymakers are critical as part of the overall federal government's efforts to address capital constraints, provide liquidity, and facilitate lending. NAR believes that the ability to value assets in inactive markets continues to be a serious issue and we urge policymakers to act quickly to provide meaningful and clear guidance so that market participants can effectively address application issues and ensure that "fair value" accounting standards can be achieved and applied consistently for all market conditions. Under current conditions, clear policy guidance is needed to encourage reporting entities and auditors to look to alternative and appropriate methods of asset valuation, such as the discounted cash flow model.

Finally, the intense revenue pressures created by the present economic crisis will undoubtedly drive major tax overhaul efforts. In light of this, NAR will continue to support and promote federal tax policies that strengthen and support commercial real estate. The commercial real estate market is in a state of crisis and remains vulnerable to any modifications to current tax rules that would result in reduced property values. NAR stands ready to oppose any such modifications and would urge policymakers to do the same.

Conclusion

The National Association of REALTORS applauds the bold actions that have been taken thus far to address the serious liquidity problems facing commercial real estate finance. Innovative programs and initiatives, such as the TALF and the PPIP, certainly represent part of the solution but more action is needed. NAR believes that the principles we have set forth today will help Congress and the regulators design a holistic approach that will address the liquidity crisis currently facing the commercial real estate markets.

I thank you for this opportunity to present our thoughts. As always, the National Association of REALTORS is at the call of Congress, the financial regulators, and the Administration, to help in the ongoing effort to find solutions to stabilize and ensure recovery of the commercial real estate markets. Such an effort is particularly important given that the commercial real estate sector is a key component to job creation and economic revitalization for the nation as a whole.

Again, we appreciate the Committee holding this hearing and we stand ready to assist in any way in your efforts going forward.