Statement of
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Congressional Oversight Panel
Hearing on Commercial Real Estate's Impact on Bank Stability

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Chairman Kaufman and members of the Congressional Oversight Panel, thank you for the opportunity to discuss commercial real estate and bank stability. My testimony today will include a discussion of real estate value declines, the growth in the size of the debt market and resulting mortgage maturities, bank commercial real estate exposure and distress, and finally some aspects of our outlook for the economy, real estate and commercial real estate debt market in particular.

Commercial Real Estate Values

• One of the most important features of the current real estate cycle is the dramatic decline in property values. The most recent figures indicate that commercial property values have fallen by approximately 42% since peaking in late 2007. That is larger than the decline in the early 1990s, when commercial real estate values fell by nearly one-third, and on par with our estimates of the decline during the Depression.

Commercial Real Estate Debt Maturities

• A rising volume of maturing mortgages has put pressure on the commercial real estate debt market, and will continue to do so for several years. By Foresight Analytics' estimates, annual maturities reached $200 billion in 2006 and surpassed $300 billion in 2009.

• We further estimate that commercial real estate debt maturities will climb to approximately $350 billion per year between 2011 and 2013.

• The combination of lower property values and rising volumes of maturing mortgages has resulted in a large amount of maturing loans that are "underwater". We estimate that as much as half of the loans maturing in 2011 to 2015 are currently underwater, and that as much as $251 billion is underwater by 20% or more.

Commercial Real Estate Debt Exposure

• Many banks entered the financial crisis with substantial exposures to commercial real estate. As of the first quarter of 2007, more than 2,700 banks and thrifts (32% of the total bank count) had a commercial real estate (CRE) concentration. The greatest concentrations were among banks with $1 to $10 billion in assets and banks with $100 million to $1 billion in assets, where 56% and 43% of banks in those groups respectively had CRE concentrations.

• The number and proportion of banks with commercial real estate concentrations has fallen significantly since 2007. As of the third quarter of 2010, just under 1,300 banks and thrifts had a CRE concentration, a decline of more than 1,400 from the first quarter of 2007.

• Part of this reduction is the result of reduced amounts of debt outstanding. Approximately $300 billion of CRE loan exposure has been trimmed from banks' balance sheets over the last two years.

• Banks that received CPP funds from TARP are more likely to have commercial real estate concentrations than non-CPP recipients. We have tabulated commercial real estate concentration figures for bank and thrift subsidiaries of firms that received CPP investments — including banks that have repaid the CPP funds — with the result that as of 3Q 2010, 32% of the CPP recipients' subsidiaries had CRE concentrations, compared with 15% for non-CPP recipients' subsidiaries.

CRE Loan Performance

• Delinquency rates for construction loans and commercial mortgages have been declining, but remain high relative to pre-crisis levels. Our early estimates for 4Q 2010 indicate that construction delinquency rates stand at 18% and commercial mortgage delinquencies at 5.3%, compared with 1% delinquency rates prior to the onset of the downturn.

• Commercial real estate has accounted for an estimated $97 billion of bank charge-offs during the 2007 to 2010 period. For banks under $10 billion in assets, the proportion that commercial real estate comprises has been above average, amounting to more than 50% of all charge-offs for these banks.

Bank Distress

• We maintain a "Watch List" of banks that appear to be at elevated risk of failure. This list has proven quite accurate, capturing 96% of failed banks since the beginning of the current cycle in 2007.

• Nonperforming commercial real estate loans have been the largest problem loan type for banks on this Watch List. For more than 80% of the banks on our Watch List, nonperforming commercial real estate loans are the main problem loan type.

Market Conditions and Outlook

• Economic and real estate market conditions are improving, albeit slowly. The job market is gradually turning around. And in the commercial real estate market, occupancy rates and rents are stabilizing, but net operating income has been reduced by 15% or more from pre-recession levels.

• Liquidity has also been returning to the commercial real estate market. This has been most notable in the CMBS segment, where $11.6 billion of new issuance occurred in 2010. Our parent, Trepp, LLC expects this trend to continue, with $50 billion of issuance during 2011.

• We believe the recovery will be a prolonged one, with slow improvement in the broader economy translating into gradually increasing demand for commercial real estate.

• Delinquency rates will improve as well, as lenders continue to reduce nonperforming loan balances but this process looks likely to last several more quarters.

• We remain concerned about the volume of underwater mortgages that will mature over the next several years, and the broader issue of mortgage maturities overall.

• Continued high demand for refinancing from loans originated during the commercial real estate debt boom of the 2000s will constrain real – or inflation-adjusted – growth in the commercial mortgage market over the next decade. We believe growth in the market will more closely resemble the 1990s, when annual growth was 0.8% in real terms, rather than 2000 to 2008, when annual real growth was 9.4%.

Mr. Chairman, I thank you and the other members of the Panel. This statement constitutes my formal testimony and I look forward to any questions you might have.