

2011 Commercial Real Estate Liquidity Issues

While the broader economy is starting to turn around, the commercial real estate sector continues to struggle due to **reduced operating income, property values, and equity**. Additionally, commercial practitioners continue to experience difficulty in obtaining construction and land development loans, small business loans, short-term loans for capital improvements, and refinancing for mortgages.

Problems Impacting Commercial Real Estate Industry

Three main problems continue to negatively impact commercial real estate financing: bank liquidity, an equity gap, and a contraction in small business lending.

1. **Bank Liquidity**

Plummeting commercial real estate values have forced many regional and community banks – a significant source for commercial real estate lending – to take steep write-downs, resulting in bank failures and a reduction in credit.

2. **Equity Gap**

Over half of all commercial mortgages are currently “underwater” and many lenders are now demanding that borrowers come up with additional capital to cover this gap – especially problematic when a loan needs to be refinanced.

3. **Small Business Lending**

Credit to the small business community has declined, leading to a decreased workforce and business failure. This has also elevated commercial vacancies, forcing prices to fall thus placing even more pressure on community banks and reducing credit – accelerating a negative economic cycle.

NAR Solutions

Accelerated depreciation – NAR endorses legislation aimed to help incentivize equity investment in distressed CRE properties by granting investors a one-time 50% bonus depreciation. At least 80% of the investment must be used to reduce the outstanding balance of debt, with the remaining going towards capital improvements. **NAR supports the Community Recovery and Enhancement Act of 2011 (H.R. 1147), introduced by Reps. Nunes (R-CA) and Berkley (D-NV).**

Basel III – The Basel Committee on Banking Supervision announced new, higher capital standards compelling banks to boost common equity requirements to 7% by 2019 to withstand future periods of financial distress. While the goals of the new requirements are commendable, NAR supports efforts to ensure that Basel III does not reduce liquidity in commercial real estate credit markets.

Credit union lending – NAR supports raising the cap of credit union business lending from 12.25% to 25% of total assets. Similarly, NAR endorses the Obama Administration’s proposal to raise the cap to 27.5% of total assets for well-capitalized credit unions. **NAR supports the Small Business Lending Enhancement Act of 2011 (S. 509), introduced by Sen. Udall (D-CO).**

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Covered bond market – As credit markets continue to decline, the creation of a covered bond market in the U.S. will be essential to increase liquidity. Already in use in Europe and Canada, covered bonds represent a potential complementary funding source in the U.S. housing financial system as well as an alternative to securitization that could help address ongoing refinancing challenges in the commercial real estate sector.

NAR supports the United States Covered Bond Act (H.R. 940), introduced by Reps. Garrett (R-NJ) and Maloney (D-NY).

Help banks clear their balance sheets of toxic assets – NAR believes that policy makers should pursue measures to encourage more private-equity investment in small financial institutions in order to turn around and recapitalize struggling banks and bring back much needed equity into the banking system.

Lease accounting

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have proposed new accounting rules that would force many companies to capitalize commercial leases onto their balance sheets. Larger balance sheets would force lessees to shorten lease terms to minimize costs. Since lessors raise financing by using the leases and the value of the property as collateral, the amounts they can borrow in the future could be reduced if lease terms are shortened. NAR will continue to combat these proposed accounting rules.

Mortgage insurance program – NAR supports legislation to create a mortgage insurance program for commercial real estate assets to cover the equity gap (the difference between the current appraised value of a property and the debt currently servicing the property) faced by many borrowers. The program's structure would limit eligibility to properties found to be income-producing and viable in the long term. The insurance would also be for the short term and designed to cover the equity gap until the markets rebound.

Small Business Administration 504 and 7(a) loan programs – NAR supports making the Small Business Administration (SBA) loan process less arduous for potential borrowers. NAR believes an extension to the SBA's 90% guarantee as well as the elimination of loan fees will provide much-needed relief for commercial real estate practitioners as well as other small businesses. Additionally, NAR supports the inclusion of "non-owner-occupied" properties as part of the SBA's temporary 504 refinance program.

Small Business Lending Fund – Under the Small Business Jobs and Credit Act signed into law last year, the U.S. Treasury is authorized to create a \$30 billion Small Business Lending Fund (SBLF) to give troubled community banks both the capacity and incentive to increase their small business lending. Specifically, banks can voluntarily apply for funds that would be repaid over time. The U.S. Treasury will finalize rules for participation in the program. NAR encourages the U.S. Treasury to set borrowing terms that will not deter banks needing capital from participating in the program.

Term extensions – For commercial borrowers that are making their monthly payments, a simple term extension in lieu of a refinance makes perfect sense. However, lenders are currently not offering these extensions due to pressure from bank regulators. NAR will continue to push the banking agencies to provide clear and consistent guidance related to commercial real estate loan workouts.