The Real Estate Roundtable

March 17, 2023

The Honorable Michael Barr
Vice Chairman of Supervision
Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Todd M. Harper
Chairman
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable Jerome Powell
Chairman
Board of Governors of the Federal
of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Michael J. Hsu
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

The Honorable Rohit Chopra
Director
Consumer Financial Protection Bureau
1700 G Street, NW
Washington, DC 20442

Gentlemen:

We are writing to encourage the financial services regulatory agencies (Agencies) to reestablish immediately a program similar to prior programs in 2009[1], 2010[2], 2020[3] and 2022[4] that encouraged financial institutions to work prudently with borrowers on commercial real estate troubled debt restructurings (TDRs). This action is needed as soon as possible, to provide time for the substantial effects of the historically rapid rise in interest rates to stabilize in markets; as well as lingering effects of the global pandemic.

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[1] Policy Statement on Prudent Commercial Real Estate Loan Workouts, FIL-61-2009, October 30, 2009, https://www.fdic.gov/news/financial-institution-letters/2009/fil09061.html

[2] Meeting the Credit Needs of Creditworthy Small Business Borrowers, FIL-5-2010, February 12, 2010, https://www.fdic.gov/news/financial-institution-letters/2010/fil10005.html

[3] Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus, March 22, 2020, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200322a1.pdf

[4] Proposed Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts, August 29, 2022 https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20220927a1.pdf

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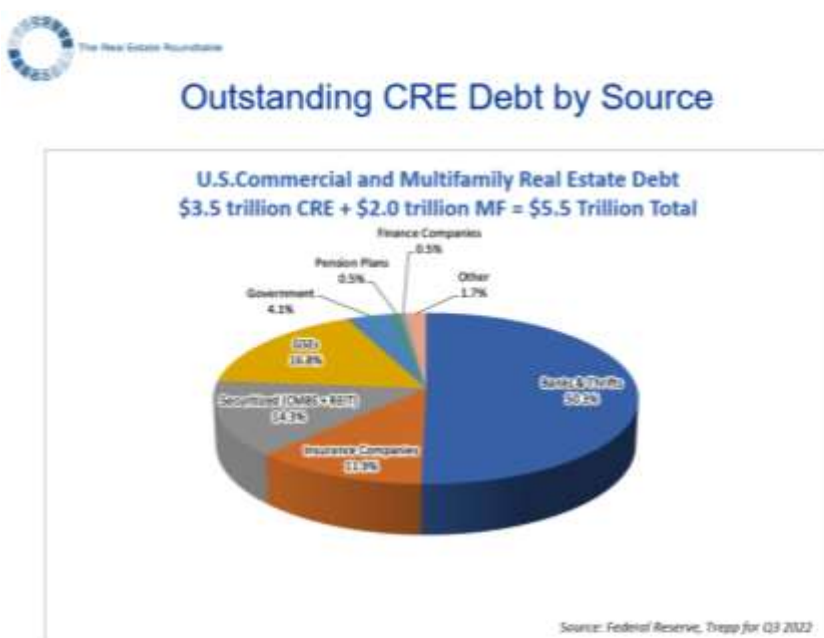
The Agencies have recently acknowledged the negative result that higher interest rates have on institutionally held government securities and have recognized that current value in the context of the higher rate environment is not constructive on such long held assets. Our request is rooted in similar realities. However, we are not asking for long term relief from value examination but instead simply the allowance of time for stability to return to real estate markets.

At this critical time, it is important that the Agencies do not engage in pro-cyclical policies such as requiring financial institutions to increase capital and liquidity levels to reflect current mark to market models. These policies would have the unintended consequence of further diminishing liquidity and creating additional downward pressure on asset values. A deflationary spiral must be avoided at all costs. As recent events are only amplifying the contraction of credit, it is important for the Agencies to take measures to maintain sufficient liquidity levels and support positive economic activity.

As recently as February, the Federal Reserve raised concerns about valuation pressures on certain asset classes: "In particular, the staff noted that measures of valuations in both residential and commercial property markets remained high, and that the potential for large declines in property prices remained greater than usual."[5]

The risk to financial institutions, including the Commercial Mortgage Backed Securities sector, and potentially to the overall financial system and the economy, posed by inflexible snapshot examinations of commercial real estate loans is quite high and, in our view very much unnecessary.

The approximately $20 trillion commercial (CRE) and multifamily (MF) commercial real estate market is financed with $5.5 trillion of debt[6], 50.3% of which is provided by commercial banks (in general, conservative leverage when originated). Of that outstanding debt, approximately $936 billion of CRE and MF debt is maturing in 2023 and 2024.



[5] Minutes of the Federal Open Market Committee, Feb. 1, 2023

[6] Federal Reserve, Trepp.

Commercial real estate debt typically has a term from three to ten years. Therefore, the bulk of outstanding debt maturing in the near term was conservatively underwritten when originated over the past ten years during this period of extraordinarily low interest rates.

Because of the very rapid rise in interest rates (a year increase in the Effective Federal Funds Rate from 0.08% to 4.58%[7]), there is growing concern about what options will be left for borrowers, or for the institutions who hold these loans, as these loans mature. Immediate value adjustments to reflect the new interest rate environment would lead to potentially significant value declines, requiring unprecedented additional equity investments or capital reserves. Such equity infusions or rising capital reserves could conservatively be expected to result in significant job losses, small business closures, greatly reduced municipal revenue, countless bankruptcies and foreclosures. There also is the potential for high negative impact to large real estate lenders and investors including universities and pension funds for teachers, unions, and others.

Moreover, it is hard to overstate the negative impact on current and future multifamily development construction loans intended to help address our country's housing shortage. These loans are typically floating rate, causing many current loan financing rates to more than double and likely halting significant amounts of future housing construction.

Similar whip saw policy changes in the 1980's (generous real estate tax benefits followed by aggressive tax penalties) resulted in immediate precipitous property declines that many commentators associate with the demise of many financial institutions and the dramatic slowing of the economy in the early 1990s. This is a bad model that we believe must be avoided today.

[7] Effective Federal Funds Rate, https://www.newyorkfed.org/markets/reference-rates/effr

Additionally, the impact of the COVID-19 shutdowns caused widespread stress in hospitality, senior housing, retail (including the enclosed shopping center market), office and other property sectors. While these markets continue to attempt to absorb and respond to the post-pandemic economy, they have not, generally speaking, fully stabilized. The health related shutdowns also obviously have raised significant and increasing questions affecting office markets nationwide. The trend is for private employers to require employees to return to the office workplace; however, many workers – particularly in the federal government – have not yet returned. This has altered the current usage and demand for office space and created very significant concerns about the future of office use, and, frankly, the future of American cities that heavily depend on property tax revenue to fund needed community services.

Early on in the pandemic, the Agencies took proactive and decisive action to allow financial institutions to deliver meaningful relief to customers by providing guidance that short-term loan modifications with terms of up to six months would not automatically result in a TDR.

Congress also took action to provide TDR relief in section 4013 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which does not limit the term of a loan modification for modifications made by December 31, 2020.

These actions proved to be particularly effective in allowing lenders to offer prudent relief to borrowers who had been acutely affected by the pandemic and whose assets are reasonably expected to return to viability over time.

The rapid interest rate increase and appraisal/valuation reductions, coupled with currently unclear future building use, is causing lenders attempting to address current refinancing requests to be stymied by uncertainty around regulatory, accounting and the risk-based capital consequences of those actions. At the same time, clearly additional equity infusions will be required to successfully refinance most maturing commercial real estate loans. These realities require time as well as a significant improvement in current market stability. Moreover, given the current turmoil reflected in recent regional banks, which is largely unrelated to commercial real estate lending practices, we anticipate that liquidity will tighten further and lending options for refinancing maturing loans will decrease.

As a result, lenders must not be forced to make immediate pro–cyclical markdowns that could reasonably be expected to result in forced asset sales leading to further deterioration of bank balance sheets. Instead, we urge that you take action immediately to provide increased latitude for financing institutions to work constructively with borrowers. Such action will avert what we believe would be an unnecessary crisis.

We appreciate the ongoing serious work of the Agencies to provide guidance to avoid unnecessary risk. However, in this case, to avoid increasing unnecessary risk, we respectfully request that the Agencies reaffirm that financial institutions have flexibility to use reasonable and prudent judgment to give borrowers and lenders more time to see properties and loans through this current evolving environment.

Thank you.

Sincerely,

Jeffrey D. DeBoer
President & Chief Executive Officer