

The Real Estate Roundtable

STATEMENT OF

JEFFREY D. DEBOER

ON BEHALF OF THE REAL ESTATE ROUNDTABLE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON OVERSIGHT AND ACCOUNTABILITY HEALTH CARE AND FINANCIAL SERVICES SUBCOMMITTEE

HEARING

On

HEALTH OF THE COMMERCIAL REAL ESTATE MARKETS AND REMOVING REGULATORY HURDLES TO ENSURE CONTINUED STRENGTH

RAYBURN HOUSE OFFICE BUILDING ROOM 2154 WASHINGTON, DC

TUESDAY, APRIL 30, 2024



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INTRODUCTION

Thank you, Chairwoman McClain, Ranking Member Porter and members of the Committee, for the opportunity to testify today about the post-pandemic state of commercial real estate markets and policy actions to strengthen these markets.

I am Jeffrey DeBoer, President and Chief Executive Officer of The Real Estate Roundtable.

The Real Estate Roundtable represents the leadership of the nation's leading 150 privately owned and publicly-held real estate ownership, development, lending and management firms. Collectively, Roundtable members hold portfolios containing over 12 billion square feet of developed office, retail and industrial/logistical space; over 4 million rental housing units; in excess of 5 million hotel and resort rooms; as well as properties providing health, assisted living, medical, student housing and data center support. Roundtable members and its 18 national trade association partners represent more than 3 million people working in the real estate business.

This is an important hearing as the American economy is closely linked to the commercial real estate market's strength and stability, valued at roughly \$20 trillion.

Healthy commercial real estate markets drive job growth and economic productivity. Estimates reveal that commercial real estate provides approximately \$2.3 trillion to America's GDP (13% of GDP revenue).

An estimated 15.1 million jobs are generated or supported by real estate — jobs in construction, architecture, environmental and sustainability consultation and remediation, engineering, building maintenance and security, management, leasing, brokerage, investment and mortgage lending, accounting and legal services, interior design, landscaping, and more.

Commercial real estate asset values and transaction volume provide the principal source of tax revenue for local government budgets that fund essential services including education, road construction, mass transit, law enforcement, and emergency planning. When commercial real estate values decline or markets seize up, communities suffer as their tax revenue declines, economic activity slows, small businesses and restaurants lose foot traffic, and crime frequently increases.

For millions of Americans whose pension funds invest directly or indirectly in approximately \$900 billion of commercial real estate equity, strong vibrant markets increase their retirement nest eggs.

Moreover, healthy commercial real estate markets help people reach their housing goals, achieve their business plans, and advance innovations and technologies important to us all.

In general, commercial real estate "stress" began to elevate in 2023. Uncertainties surrounding office and other spaces uses following the pandemic, combined with higher operating costs and interest rates induced by inflation, created a perfect storm of significant challenges that linger for the industry.

However, it is not accurate to paint all commercial real estate markets or asset types with a single brush, or the same condition of "health."

Office markets confront the greatest liquidity, operating cost, and demand challenges. Some individual owners and financiers are facing increasingly negative pressure, potentially leading to increases in mortgage defaults, foreclosures and large losses of equity. At the same time, many modern office buildings with strong ownership and workspace amenities are currently weathering the storm.

Other commercial real estate markets – for example housing, hospitality, industrial, assisted living, and life sciences – are not witnessing demand uncertainties, but they face varying degrees of liquidity and operating cost related stress.

Appreciating the nuances within property types, ownership structures, vintages of investments, geographic location and more are extremely important factors that policymakers should consider to strengthen the general commercial real estate markets and thereby benefit the national economy, the health of cities, job growth, housing, and retirement savings.

Moreover, from construction to leasing, planning, occupation, and investment, the world of commercial real estate is being revolutionized by the still evolving post-pandemic structural shifts in how and where we live, work, shop, and recreate.

A legacy from the pandemic concerns remote work and the chain reaction it has unleashed regarding office space needs, housing, city budgets, and urban transportation patterns. Remote work has declined from its pandemic levels but is expected to remain prevalent. At the same time, office tenants are increasingly choosing newer, more modern buildings and abandoning older buildings.

Likewise, retail shopping patterns have changed over recent years. Foot traffic in many suburban retail malls has slowed while online shopping for commodity goods has ticked up.

Even before the pandemic, the U.S. faced significant housing challenges, for all Americans but particularly for lower income residents. The pandemic magnified this challenge by disrupting building supply chains and imposing new restrictions on work practices, while at the same time boosting housing demand due to remote work.

There have been helpful policy actions including regulatory flexibility to restructure maturing existing commercial real estate loans and calls for Federal workers to return to their offices. However, additional steps are needed.

The government should continue to take appropriate steps to create incentives to restructure maturing loans and create an environment conducive for businesses and investors to invest and deploy capital. At the same time, it is important that unnecessary barriers to equity investment be lowered and that taxes on risk taking not be increased. Regulatory actions to reflect new equity, strong ownership, and the transitory nature of stabilizing commercial real estate assets is needed and would help provide the liquidity needed to reduce market stress.

Time will help reduce the current stress across commercial real estate markets. That is, time for inflation and interest rates to subside, time for future use demands to clarify further, and time for asset values to settle and transaction volume to normalize.

In addition, there are policy actions concerning Federal work place rules, the low-income housing tax credit and other housing assistance programs, debt modification rules, and investment limitations that would help convert obsolete buildings, modernize work spaces, provide housing and stabilize troubled local budgets.

We encourage Congress, the Administration, and regulators to pursue measures that could be rapidly implemented and help address this situation. We stand ready to discuss and aid in the development and implementation of policies to improve the long-term stability and growth of commercial real estate.

Commercial Real Estate's Overriding Concern: Restoring Liquidity

In all property types there is a liquidity shortage.

Commercial real estate in America is valued at approximately \$18-22 trillion. It is supported by about \$4.7 trillion of debt. Various lender types provide credit to commercial real estate markets, with banks & thrifts and government-sponsored enterprises (GSE) having the greatest share of the lending market.

Historically, most commercial real estate bank loans are 8-10 year terms, frequently interestonly, and usually originated with floating interest rates.

An environment of government-mandated artificially low interest rates began in earnest in late 2008 when the Federal Reserve slashed interest rates to zero in an unprecedented attempt to help the U.S. economy cope with the fallout from the global financial crisis.

Although interest rates increased marginally over the next decade (2010-2020), they remained historically low.

During this time period, commercial real estate markets were in relative balance (e.g. office vacancy averaging below 12%), reflecting strong demand for commercial space of all types.

Moreover, the trillions of dollars of commercial real estate loans from the era generally were characterized by conservative underwriting with loan to values of 50%-60%, and strong debt service coverage ratios of greater than 2.0x. Many commentators have noted that the CRE mortgage market overall at the time was underleveraged.

At the onset of the pandemic, in March 2020, the Fed announced two huge rate cuts at unscheduled emergency meetings, returning the federal funds target rate range of zero to 0.25%. It is easy to forget that the Fed was holding the federal funds rate at around zero as recently as the first quarter of 2022.

The Federal Reserve started hiking interest rates in the first half of 2022. In a span of roughly 18 months, it raised rates 11 times bringing, the key federal funds rate to a target range of 5.25 - 5.5% - the highest since early 2001. Not since the 1980s has the Fed hiked rates at this speed.

As concerns about a pandemic-induced recession increased, regulators for banks, insurance companies, and other commercial property lenders began calling for increased loan loss reserves on commercial real estate lending, as well as a reduction in commercial real estate portfolio concentration. In other words, liquidity began to lessen in commercial real estate markets, substantially.

In the second quarter of 2023, overall commercial debt (including lending from banks, commercial mortgage securities, and non-bank lenders) rose less than 1%. As a result, commercial property purchases fell precipitously by 53% in a year relative to Q2-2022.

A "cliff" is looming for commercial real estate. Nearly half of the \$4.7 trillion debt – that originated during a period of historically low interest rates mandated by the Fed – is scheduled the mature in 2027. However, the environment in which these loan will come to term is markedly different: base interest rates have risen nearly 500 basis points in 24 months, and lenders are encouraged to limit their exposure by reducing their commercial real estate portfolios.

The result is insufficient market liquidity to finance or refinance the purchase, sale, operation, development, and modernization of America's commercial real estate market.

Higher interest rates and diminished liquidity coupled with still evolving post-pandemic property demands has resulted in an additional problem - great uncertainty over current commercial real estate asset values.

At the beginning of 2023, commercial real estate values steadily dropped, primarily driven by cap rate expansion.¹ Overall values declined by around 20%, with office faring the worst, multifamily and retail somewhere in the middle, and industrial holding up the best. While these are averages, in some cases, we have seen values for individual assets fall by as much as 50% in the office market, and publicly traded office REITs have seen their share prices fall by over 50%. There was also diminished price discovery. By the end of 2023, commercial real estate sales were down over 70%, and lending volumes were down 46.5%. Steeply rising interest rates and pandemic-induced shifts in building use have created commercial property valuation uncertainty and dramatic reductions in transaction volume. Commercial real estate loans that were previously underwritten with conservative loan: value rations are now being reclassified by financial institutions resulting in higher institutional reserves and less capital to lend.

Uncertain Demand

The office sector is in transition and will continue to evolve. First, the government mandated shutdowns in the wake of the COVID-19 pandemic changed office usage patterns. In the post-pandemic environment, the federal government has failed to bring their workers back to the office, with only 39-49 percent of capacity being used. This trend has bled into private markets, with national vacancy rates rising to an all-time high of 19.7 percent in 2023. All of which results in reduced operating income for property owners and lower property values.

Vacancy rates in the U.S. office market have dominated headlines since 2020 and the aftermath of COVID. High vacancy rates in the U.S. office market are misunderstood—while demand has certainly diminished in the aftermath of the COVID pandemic, the growing issue is with supply. There is an excess of dated, functionally obsolete office buildings and an undersupply of offices that satisfy tenants' changing needs.²

¹ Cap rate refers to a property's asset value divided by its net operating income. It is used to measure annual operating cash flow given the price paid for a property.

² See this CRS report on federal employment in every State and every Congressional District: <u>https://crsreports.congress.gov/product/pdf/R/R47716</u>

With the implementation of flexible and work-from-home policies, many attribute the weak occupancy rates in the market to diminished tenant demand. However, another real issue faces the sector: dated, functionally obsolete office space that does not meet modern tenant preferences.

The office market has been impacted by several converging factors: the pandemic accelerated the adoption of technologies that change the way we utilize offices and their core function, tenant preferences have shifted to buildings with modern amenities and functionality, and the recent rise in interest rates has exposed older office buildings as uneconomical.

As a result, there will be a wide distribution of outcomes for owners, lenders, and local communities as a portion of the U.S. office market will need to be renovated or repurposed

Policy Recommendations

1. Bring the 2 Million Federal Employees Back to the Workplace

- During the COVID-19 public health emergency, governmental authorities ordered widespread closures of places where people gather, including office buildings. These shutdowns were appropriate at the time, and the commercial real estate industry worked diligently to create safe work environments that would accelerate the reopening of economic activity. Today, returning to in-person work is critical for the health of our cities, local economies, tax bases, and small businesses.
- Ensuring that federal employees return to the workplace is important to every State, and every Congressional District in the country not just the Greater Washington area. Hawaii has more federal civilian employees per capita (1.64%) than Virginia (1.61%). Alaska is not far behind (1.46%). On a total basis, California has more federal civilian employees (142,000) than Maryland (138,900) or Virginia (140,400). At 1.0% of employment, Oklahoma has one of the highest federal workforces in the nation.³ Research has identified a dozen cities where the reduction in local spending as a result of remote work exceeds \$2,000 annually per teleworking employee.⁴
- The White House needs to follow through on its guidance directing federal agencies to bring more of their employees back to the office. Federal employers should lead by example and return to their pre-pandemic workplace practices.
- We applaud Chairman Comer and this Committee's work in authoring the Stopping Home Office Work's Unproductive Problems (SHOW UP) Act (H.R. 139), a bill that requires each executive agency to reinstate the pre-pandemic telework policies. This bill passed the House over a year ago and should be enacted into law.

³ Congressional Research Service, *Current Federal Civilian Employment by State and Congressional District* (Sept 22, 2023)

⁴ Barrero, Jose Maria, et al, *Survey of Working Arrangements and Attitudes* (Feb 12, 2023) (available at www.wfhresearch.com)

- 2. Encourage banks and loan servicers to extend maturing loans and restructure maturing loans with new equity effectively making "cash-in refinances" converting non-performing and criticized loans to new performing loans.
 - We appreciate the policy guidance issued by financial regulators on June 30, 2023, the "Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts" calls for "financial institutions to work prudently and constructively with creditworthy borrowers during times of financial stress" and has led to an increasing amount of loan extensions. This has led to the restructuring of billions of dollars of commercial real estate loans. But much more needs to be done. We suggest policymakers focus on the following principal areas:
 - Lenders are formulaically requiring pay downs on CRE loans, even if existing equity, leasing and rental income is good. To help encourage banks with "transition assets" to constructively restructure those loans, regulators should consider issuing guidance that would reclassify a previously "criticized loan" that was successfully restructured as a new "performing loan," subject to acceptable debt service coverage, loan to value and other established parameters. The idea is to encourage restructured, solidly underwritten, newly originated commercial real estate loans.
 - Policymakers should also consider measures that would incentivize "cash-in refinances", where maturing loans are restructured with new equity and are regarded as new performing loans. It is important for lenders such as commercial banks to return to the market. Additional steps must be taken to restructure maturing loans and facilitate "new" real estate loan originations. Encourage real estate loan restructurings by modernizing the tax rules for cancellation of indebtedness income. The tax code has always encouraged the restructuring of unsustainable loans so that businesses can turn around and taxpayers can get back on their feet.⁵ Current tax rules allow an individual to defer cancellation of debt (COD) income when a loan used to acquire, construct, or improve commercial real estate is reduced or discharged by a lender.
 - Reforms to the COD rules for real estate would facilitate real estate loan restructurings in today's post-pandemic environment.⁶

3. Stimulate the production of affordable housing by lessening regulations on residential construction and creating more effective incentives.

• Increasing supply is the answer to the nation's housing problems. But the more housing is regulated, the less housing you will have. Layer upon layer of rules are piling up to restrict the production of modernized and affordable housing in the U.S.

⁵ After the financial crisis, Congress authorized businesses to defer income from discharged debts and allowed homeowners to exclude discharged mortgage debt altogether. Similar relief was extended to businesses during the pandemic.

⁶ See the bipartisan bill, Saving Our Mainstream American Locations for Leisure and Shopping Act of 2023 (H.R. 5580) introduced by Representatives Claudia Tenney and Brian Higgins.

- For example, state and local rent control and anti-eviction laws limit the income stream for existing multifamily owners to invest back into their assets. A price ceiling on rents restricts the amount of capital to pay for retrofits that bring building safety, energy efficiency, resiliency, and amenities up to modern standards that tenants expect and deserve.
- Compounding the negative effect of rent control and anti-eviction are source of income" laws. These state and local policies render the Section 8 housing voucher program *mandatory* even though Congress designed it to be *voluntary*. In "source of income" jurisdictions, multifamily owners *must* accept Section 8 vouchers from tenants that cannot pay rents otherwise priced to reflect market rates.
- This hyper-regulatory environment creates a "take it or leave it" moment for multifamily owners and developers. They will "leave it" rather than "take it" –with the consequence of hyper-regulations widening the gap between housing unit supply and demand.
- Can federal policy makers help? Yes. Absent supportive public policies, the economy will produce an insufficient supply of workforce and affordable housing because land is scarce and valuable in areas where jobs are predominantly located.
- *First and foremost*, Congress and the agencies should not make matters worse by inventing new regulations on housing development, construction, and maintenance. They should *not*, for example:
 - Create their own forms of federal rent control or eviction restrictions (such as through policies from the Federal Housing Finance Agency (FJFA), Fannie Mae and Freddie Mac) that unduly prolong occupancy terms after a tenant's lease term concludes;
 - Prevent multifamily owners from charging tenants legitimate user fees for extra services and benefits they elect beyond the payment of base rent – such as parking, EV charging, pet cleaning services, or storage of personal items in common spaces; and;
 - Limit the ability of landlords to conduct fair credit checks to assess tenants' ability to pay rent, or reasonable background checks into prior criminal histories that protect the safety of other residents.
- *Second*, Congress and the agencies should create usable incentives that both boost affordable housing access through new development and retrofits of existing buildings. For example⁷.

⁷ A broad real estate coalition has catalogued a host of pending legislation and other strategies, discussed in this section, that Congress and the agencies should enact with alacrity. The Roundtable supports their adoption and we incorporate the recommendations set forth in the <u>Real Estate Coalition Letter</u> to Congress (April 29, 2024).

- Congress should expand and strengthen tax provisions that are proven to work, such as the low-income housing tax credit (LIHTC). LIHTC is the nation's most successful tool for encouraging private investment in the production and preservation of affordable rental housing, and passage of the bipartisan Affordable Housing Credit Improvement Act (H.R. 3238) will finance the construction of nearly 2 million affordable homes over the next decade.
- Congress should also enact *The Workforce Housing Tax Credit Act* (H.R. 6686), a bipartisan measure modeled after the LIHTC that would establish a new tax credit to produce affordable rental housing for households earning 100% or less of the area median income (AMI). This bill would address the housing shortage for individuals who comprise the very fabric of strong communities nationwide, including teachers, firefighters, nurses, and police officers whose wages are not keeping pace with costs.
- A time-limited tax incentive to convert older, underutilized commercial buildings to housing would help revitalize America's cities, accelerate the economic recovery of office buildings, and create new supplies of housing in close proximity to jobs. We commend Committee Member Jimmy Gomez for his work in this area and look forward to a revised, bipartisan version of his bill with Rep. Mike Carey that incorporates many of our recommendations. Additionally, longstanding low-interest loan and guarantee programs re-authorized and boosted by the *Bipartisan Infrastructure Law* and the *Inflation Reduction Act* can be better tailored to support commercial-to-residential conversions, especially for transitoriented housing developments.⁸
- The section 8 voucher process should be streamlined. Roundtable members report they must keep apartments vacant – or float the rent for months after a tenant has moved in – before they ever receive a rental assistance check from the relevant public housing agency. Reducing friction in the complex, duplicative unit inspection process is critical to make Section 8 work better for tenants and owners alike.
- "Yes in My Backyard" ("YIMBY") strategies should be prioritized. States and localities awarded federal grants and low-interest loans should demonstrate that – as a condition to receiving U.S. subsidies – they implement zoning and land-use approvals that demonstrably increase affordable, high-density housing.
- Ramped-up energy codes and standards increasingly heighten the costs to construct and retrofit housing. However, the federal tax code's incentives for multifamily and building efficiency (Section 179D and Section 45L) are not

⁸ Through an <u>April 15 letter</u> to Jared Bernstein, Chair of the White House Council of Economic Advisers, The Roundtable recently provided a list of agency actions to minimize the financial and permitting risks inherent to conversion projects.

easily accessible to building owners and should be improved with targeted revisions. 9

4. Encourage foreign capital investment in U.S. real estate by amending or repealing the outdated Foreign Investment in Real Property Tax Act (FIRPTA).

- Foreign investors are a key source of capital for job-creating U.S. real estate projects.¹⁰ Some of the largest sources of foreign capital tend to be institutional investors from Canada, Australia, the Netherlands, Nordic countries, and other trading partners.¹¹ These investors favor U.S. real estate because of their long investing timeframes and the stability of the anticipated returns. FIRPTA imposes a discriminatory capital gains tax on passive foreign investors in U.S. real estate that does not apply to any other investable asset class. Congress should repeal the outdated FIRPTA regime altogether, which has outlived its usefulness.
- Repeal state-level restrictions on foreign investors in U.S. managed real estate funds, where non-U.S. investors have no control or access to assets in the fund. Twenty states have enacted restrictions on foreign investors in real estate and agricultural land. Eight states are considering similar measures Most of these measures are intended to protect the homeland and ensure that such investments may prevent a nefarious state actor from adversely impacting the nation's economic, military, or civil interests. Yet, the state-level restrictions have national implications and seem to disregard the Commerce Clause of the Constitution in that they interfere with the free flow of interstate and foreign commerce.
- The Roundtable supports efforts to protect the nation's economic, military, or civil security. However, we have concerns about rules that may hinder foreign investment in U.S. real estate by legitimate enterprises and capital formation by law-abiding entities.
- 5. Reject pro-cyclical measures such as the Basel III Endgame and other regulatory measures that will restrict credit and capital formation.
 - There is growing concern about the potential for a perfect storm of regulations that could stall credit markets and impair capital formation—particularly for the commercial and multifamily debt market.
 - While well-intentioned, we are concerned that the proposals—particularly the Basel III Endgame—could further increase the cost of credit, diminish lending capacity, and undermine the essential role banks play in lending and financial intermediation for real estate. These proposed regulations come at a significant economic cost without clear benefits to the resiliency of the financial system.

⁹ In this regard, The Roundtable's <u>April 15 letter</u> to the White House recommends improvements to the Section 179D tax deduction and the 45L tax credit.

¹⁰ CBRE, <u>*Global Real Estate Capital Flows*</u> (reported biannually).

¹¹ National Association of Realtors, <u>Global Commercial Real Estate International Business Trends</u> (various years).

- The largest U.S. banks' capital and liquidity levels have grown dramatically since the original Basel III standards were implemented in 2013 in response to the 2008 Global Financial Crisis. Since 2009, Tier 1 capital has increased by 56 percent and Common Equity Tier 1 capital has tripled. Today, as the Federal Reserve recently observed, the U.S. "banking system is sound and resilient, with strong capital and liquidity."
- In addition to the proposed capital increases for banks, the Securities and Exchange Commission (SEC) has a number of proposed rulemaking measures that could have a chilling effect on real estate capital markets that could further impair liquidity and be a "death by a thousand cuts" for commercial real estate capital markets. It is important for policymakers to be mindful of how all these regulations interact. Capital formation is vital when credit markets tighten to restructure maturing debt.

CONCLUSION

In summary, the rapid and steep increase in interest rates coupled with uncertain postpandemic use patterns have led to reductions in values for nearly all commercial real estate assets. This has resulted in regulator calls for higher reserves against commercial real estate loans and a general reduction in commercial real estate loan portfolios. Conditions in the nation's office market today are the most challenging, despite top tier buildings' continued high occupancy. This situation has permeated into other commercial real estate asset classes and has greatly reduced overall market liquidity and transaction volume, which in turn increases negative pressure on asset values. This self-reinforcing cycle must be broken.

It is important that government not treat all commercial real estate as monolithic. It should encourage bank lending to stable performing commercial properties with low debt service coverage in-place, continue to take appropriate steps to create incentives to restructure maturing loans and reclassify restructured loans as new preforming loans. At the same time, it is important that unnecessary barriers to equity investment be lowered; taxes on risk taking not be increased and the value of in office work be highlighted and led by Federal government workers.

Regarding housing, there are several positive steps that government should take to encourage more housing production including: stimulating the conversion of obsolete buildings into housing; increasing the low income housing volume caps; incentivizing local zoning and permitting reforms; increasing efficiency in the Section 8 housing voucher program. Rent control and eviction moratoriums are counterproductive to addressing the housing shortfall.

We stand ready to discuss and aid in the development and implementation of such measures. Thank you for the opportunity to testify today.