# Different Perspectives: Banking and the Outlook for Recovery in U.S. Real Estate Markets

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Moderator:
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**DOWNS:** IT'S A PLEASURE TO GET THE VIEWPOINTS of our three panelists: **CRE K.C. Conway**, executive managing director, Market Analytics, Colliers International Valuation and Advisory Services, and formerly an officer of the Federal Reserve banks in Atlanta and New York; **Marc Thompson** of the Bank of the West in San Ramon, Calif., also a CRE; and **Sandy Hostetter**, president of CNLBank in Orlando, Florida. Our general topic is: what important issues do you think are facing the nation's banks as we try to move ahead in this weak recovery? Go ahead and give us your thoughts to start, K.C.

**CONWAY:** Thank you Tony. Let me say first that the views I express in this discussion are my personal views and not necessarily the views of the Federal Reserve.

The three issues that I believe we have been trying to come to grips with in the bank regulatory world are: first, the size of the real estate problem; second, the concentra-

## About the Moderator

**Anthony Downs** *is a Senior Fellow at the Brookings Institution in Washington D.C. He also was a Visiting Fellow at the Public Policy Institute of California in San Francisco from July 2004 until February 2005. Downs served for 18 years as a member and then chairman of Real Estate Research Corporation, a nationwide consulting firm advising private and public decision-makers on real estate investment, housing policies, and urban affairs.*

*Downs has served as a consultant to many of the nation's largest corporations, major developers, government agencies at local, state, and national levels, and to many private foundations. President Johnson appointed him to the National Commission on Urban Problems in 1967, and HUD Secretary Jack Kemp appointed him to the Advisory Commission on Regulatory Barriers to Affordable Housing in 1989. He has been a director or trustee of General Growth Properties and the NAACP Legal and Educational Defense Fund. He also has served as a past director of the MassMutual Life Insurance Company, Bedford Property Investors, the Urban Land Institute, Essex Property Trust, the National Housing Partnership Foundation, Penton Media, and The Counselors of Real Estate.*

*Downs received a Ph.D. in economics from Stanford University. He is the author or co-author of 24 books and more than 500 articles. His books include* An Economic Theory of Democracy *(1957), translated into several foreign languages, and* Inside Bureaucracy *(1967)—both still in print. His latest books are* Real Estate and the Financial Crisis *(2009) and* The Niagara of Capital *(2007). Downs is a frequent speaker on real estate economics, housing, transportation, smart growth, urban policies, and other topics, having made more than 1,000 speeches to hundreds of organizations. He is a member of The Counselors of Real Estate, American Academy of Arts and Sciences, American Economic Association, Anglo-American Real Property Institute, National Academy of Public Administration, American Real Estate, Urban Affairs Association, and Urban Land Institute.*

tion of real estate in the banks compared to any other time in U.S. history; and third, how to refinance all the maturing commercial real estate debt when there is such a refinance gap?

Let's start with an examination of the size of the problem. According to the U.S. Federal Reserve, we have a record $3.3 trillion of outstanding commercial real estate debt in the U.S. The largest shareholder of that debt is the U.S. banks with $1.4 trillion, or 42.4 percent of the total debt.

The next largest shareholder is commercial mortgage-backed securities, or CMBS, as I'll refer to it. Outstanding CMBS commercial real estate debt is just shy of $700 billion. This amount of commercial real estate debt is unprecedented. Total outstanding commercial real estate debt was just $800 billion in 1998, or 25 percent of today's amount of $3.3 trillion. We did not quadruple the amount of commercial real estate space in the U.S. between 1998 and 2008. Thus, one can clearly see that this real estate crisis is an over-leverage event, and less an oversupply event. The U.S. Central Bank has virtually no experience with over-leverage of this magnitude. That's why policy-makers are struggling with a response. Are "extend strategies" such as the "Commercial Real Estate Loan Workout Guidance" issued in October 2009 the right policy response? Japan's experience would tell us "no."

The second major issue is the concentration of this commercial real estate debt in banks. Until this recession, U.S. banks had never exceeded a commercial real estate concentration ratio close to 50 percent of their Tier 1 capital, even during the savings and loan crisis from 1987 to 1991. Today we have institutions with ratios that reach into the 300–600 percent of Tier 1 capital range, and the average for all U.S. financial institutions exceeds 100 percent. In other words, not only do we have an unprecedented level of commercial real estate debt in the U.S. compared to any other time in our history; we also have it concentrated in our banks more than any other time in our financial system. How to unwind that concentration in commercial real estate debt when other options, CMBS for example, have yet to get back on their feet, is a huge challenge. The net effect that borrowers and developers are experiencing is a massive contraction in credit to refinance maturing real estate loans. If a solution is not developed soon, a large amount of commercial real estate debt will mature, default, and drive values down as it is foreclosed and liquidated. It's a serious problem that the regulatory community does not yet fully understand or approach with a real sense of urgency. If this commercial real estate debt is not refinanced and reconciled by 2012 to 2013, the amount of other U.S. debt (corporate, municipal, etc.) that comes due and will compete for the same capital is staggering. In excess of $10 trillion in total U.S. debt (commercial real estate, corporate, municipal, state government, etc.) comes due in the 2012 to 2015 period. The U.S. is facing a serious refinance hurdle that will likely be met with much higher interest rates.

I'll also comment by property type. Maybe some things that we're seeing are on the "good news" side: I analyzed 180 markets for the Federal Reserve Bank examiners every quarter, and there was some encouraging news. We've definitely seen correction and recovery come back in the multi-family class. We're seeing what we saw earlier in this recession two years ago; concessions come into the market which precede the rise in vacancy—we saw those rise in the 8 to 12 percent range in most markets—and vacancy rise to about 10 percent in most markets across the country, although worse than that in some markets. We've now seen national vacancy fall to about 8 percent; we're about 92 percent occupied across the board. And we've seen concessions cut in half and in many markets, even overbuilt markets where there was a lot of condo development, we've seen concessions come down to really nominal two to four percent numbers. So we're seeing real improvement in operating cash flow and occupancy, and we think part of the reason is that we didn't have the overbuilding in multi-family as we did in other classes. Overbuilding was greater in a condo or single-family housing size.

Also, the condo market is primarily concentrated in about 25 MSAs in the country, not in all 360 MSAs. What we're finding in markets like Chicago and Atlanta and others that have the bulk of the condo overbuilding is that the very expensive high-end condos are not being returned to the market for rental. If you look at, for example, the portfolio that was sold in a joint venture with the FDIC in Starwood—the good majority of that inventory has been taken off the market. They're not going to rent million-dollar rentals for $1,000 a month. So that's not going to produce a pocket of inventory or a shadow inventory that we thought was going to come to market. And so, what we're seeing now, because of the search for yield by investors, is five, and in some cases, four percent cap rates for quality apartment properties in growth-restricted markets like Austin, Texas or Baltimore. My concern is we could actually begin to see a lot of mothballed planned projects come back into the pipeline. That would restart the whole problem on multi-family, with underwriting at five percent cap rates and 95 percent occupancy.

**DOWNS:** Now let's turn to Marc Thompson.

**THOMPSON:** Hi Tony. First of all, I want the readers to know that I am speaking as a counselor of real estate professional. My views stated in this interview are not to be construed in any way as the views of Bank of the West or its senior management.

I'm Marc Thompson, a Counselor of Real Estate, and I've published four articles in *Real Estate Issues* on the risks to the economy of high aggregate commercial real estate debt growth. I work for Bank of the West in San Ramon, California, managing a senior housing lending group for its balance sheet.

One of the big observations I see in the financial markets is that the banks are being squeezed on their capital externally by the FDIC and government-sponsored entities—or GSEs, Fannie Mae, Freddie Mac, Housing and Urban Development, and internally by delinquent borrowers. What I'm finding is that all of them are managing their loss reserve capital against potential real estate losses. The FDIC, Fannie Mae, Freddie Mac, HUD, and the banks' borrowers are trying to make sure they, respectively, don't have a loss hit on capital. So banks are caught in between, trying to preserve their minimum capital requirements from claims from both sides. The FDIC, in 2009, had charged its annual fees for the following three years to shore up its FDIC loss reserve capital in preparation of future losses. GSEs are pushing back on losses on loans that were originated by the banks by having the banks buy back these faulty underwritten loans, and rightfully so in some cases. Also impacting banks' loss reserve capital are borrowers who are trying to shift as much responsibility of a loss to the bank as they can get away with. So, who's taking all the losses and who's taking all the risk of this financial crisis is the banks, and they're getting hit hard trying to meet minimum regulatory capital requirements. I just want to make sure that everyone understands that I'm seeing a continuing pattern that appears to be weakening banks' loss reserve capital levels.

My second observation is the shrinking of banks' real estate loans on their balance sheets. Banks' balance sheets are shrinking because of loan foreclosures, re-margining at loan modification, or loan payoffs due to a sale or refinance. With construction loans, I observed single-family development loans go through the foreclosure

## About the Panelists

**K.C. Conway, CRE, MAI**, *recently joined Colliers International Valuation and Advisory Services as executive managing director, Market Analytics, in Lilburn, Ga. From 2005–2010, Conway worked in the Federal Reserve System in multiple capacities, ranging from the commercial real estate subject matter expert for the Atlanta District Bank to the commercial real estate risk specialty officer designee to the New York District Bank. In these roles, he briefed Federal Reserve Board Chairman Ben Bernanke, the Board of Governors, Federal Reserve District Bank presidents, and real estate industry groups on market conditions and burgeoning issues during the 2008–2009 financial crisis. Conway has also served in various capacities for Cushman & Wakefield, the former Equitable Real Estate, Deloitte & Touche, Wells Fargo, Prudential, and SouthTrust Bank.*

*Conway is a frequent lecturer to real industry groups such as the Appraisal Institute, the American Institute of Certified Public Accountants, The Counselors of Real Estate®, CCIM Institute, and the Risk Management Association. He also teaches and lectures extensively to various state banking and finance agencies, as well as some of the nation's leading real estate centers, including the University of Colorado, DePaul University, University of Connecticut, Georgia Tech and New York University. He is a graduate of Emory University's School of Business.*

**Sandy Hostetter**, *president of CNLBank, Central Florida, Orlando, has more 29 years of experience in the financial services industry. Prior to joining CNLBank in January 2002, she spent seven years as the chief executive officer of Florida Community Partners, a not-for-profit bank lending consortium that specialized in financing for affordable housing communities. From 1982 until 1992, Hostetter was vice president of Corporate Banking for Barnett Bank of Central Florida.*

*Hostetter also has served in various capacities for The Community Playground for the City of Winter Park, Central Florida Housing and Neighborhood Development Services (HANDS), Florida Coalition for Housing, City of Orlando Mayor's Affordable AD Hoc Housing Task Force, the Association of Reinvestment Consortia for Housing, the Central Florida Not For Profit Housing Roundtable, and the Orlando Housing Authority. She holds a bachelor's degree in business administration from the University of Florida and a master's degree in business administration from the Crummer School of Business, Rollins College.*

**Marc R. Thompson, CRE, FRICS**, *has been a member of The Counselors of Real Estate®, headquartered in Chicago, for 12 years, and is a Fellow of the Institution of Chartered Surveyors, headquartered in London, since 2003. He currently serves as senior vice president of Bank of the West, San Ramon, Calif., (a BNP Paribas subsidiary), where he manages a lending operations unit that provides both construction and term financing on senior housing and care properties. Thompson is a real estate investment professional with mortgage risk assessment expertise. He has served on many industry association boards, is an active writer, and studies complexity science to enhance his understanding of complex systems, social networks and economics. He holds a master's degree in business administration, and has served as an adjunct professor of financial management studies at California State University, East Bay.*

process early in 2008 and 2009, so I don't see much single-family development portfolios in banks anymore. What I am seeing is that the income property loan portfolios are weakening in retail, office, warehouse, and industrial loans. Multi-family loans are holding up, but I did see some multi-family loan loss hits in '08 and '09 in some markets throughout the country. I am only seeing banks' real estate loan portfolios increase through distressed bank acquisitions together with loss-sharing agreements with the FDIC. So if you're seeing bank balance sheets in real estate loans increasing, it's because of bank acquisitions. It's not so much organic growth through new loan originations.

The third point I want to make is that banks are in a hyper-risk assessment period in the economic cycle after incurring two years of high regulatory scrutiny and high realized loan losses on their commercial real estate loan portfolios. There's a lot of "analysis paralysis" on every commercial real estate loan that bankers review. Commercial real estate loan originations are highly analyzed, so it takes banks twice as much effort to get a loan approved to put on its books. Frankly, I'm doing construction financing, and my group just closed one yesterday, so we are trying to do business to grow our earning loan portfolio within the bank. Commercial real estate loans have historically been the best way to get earning assets on the bank balance sheet, together with sales of bank-related products, and so that's certainly something banks want to push for, but it continues to be very, very challenging.

My fourth and last point is that organic growth is possibly a positive bank growth strategy, but is limited by the low number of good credit quality opportunities. That's really the debate—what is good enough? And that's why banks have analysis paralysis, and why it takes us so long to get credit approved; because we're still trying to figure out what is good enough internally within banks' credit administration, and externally, with FDIC and other bank regulators.

One of the things I share with K.C. is that we did have just a tremendous amount of aggregate debt growth from 2004 to 2007. I measured it via a model that I developed and published in *Real Estate Issues* last year. That illustrates about a 50 percent higher probability of loss risk than what was experienced in the savings and loan industry. If you take what we experienced in income property losses in the savings and loan industry, and take that loss rate against the outstanding at that time, then double that against aggregate debt, you get approximately a trillion in commercial real estate loan loss exposure. I observed that commercial real estate aggregate debt levels actually shrank 10 percent in the savings and loan crisis from the peak of aggregate debt in 1990, with aggregate de-leveraging ending in 1995. It decreased by 10 percent then. I calculated, based on my aggregate debt growth risk model, that commercial real estate aggregate debt levels will drop by 15 percent through 2014 and then begin to rise again over the following five to ten years. Single-family, I'm forecasting about two to three trillion dollars in losses over the next ten years, applying my aggregate debt growth model analysis. On commercial real estate loans, I'm forecasting debt losses anywhere from $600 billion to a $1 trillion. This is a forecast I've been holding since 2007, based on a previous analysis and my aggregate debt growth risk model that helps define loss risk more accurately.

**DOWNS:** Thank you very much, Marc. Sandy, do you have some thoughts?

**HOSTETTER:** Sure, I thought it might help a little bit if I give some quick background. I am the president of CNLBank, and we're on the smaller side of things compared to my co-panelists, but not all that small. When we started this downturn, our bank was about a $1.7 billion institution and the tenth largest, independent, Florida-based bank. We cover the Florida market: Orlando, Jacksonville, St. Augustine, Fort Lauderdale, Fort Meyers, Sarasota, Naples, and Coral Gables. We put a team in place that we thought could grow our bank to a five billion dollar-plus franchise, so a lot of people refer to us as a community bank, but I would say our goal is to become more of a regional player. We're in a pretty strong capital position, and the reason I'm setting it up this way is that I think both K.C. and Marc touched on some really good points here. One of the problems is that lending has just stalled. There are not a lot of deals that look that strong, number one, but number two, there is a capital crisis. As Marc said, unless your bank has the benefit of the FDIC absorbing some of the losses, or you've opened within the last two years, chances are good that you are battling a struggling portfolio. Banks cannot afford to drive lending, and by that I mean they need to protect the capital of the bank because they need to meet the more stringent capital ratios. They don't want to be growing the bank at the same time because that puts more stress on capital, and if they're working through their real estate portfolio they're probably taking some losses. Most investors are hesitant to invest in banks now unless they have already failed and are an acquisition target. Raising capital is dilutive otherwise, so I think a lot of banks are taking the position that they are going to work through their legacy real estate portfolios and not put any additional strain on capital in the meantime. And I do want to point out that we have $140 million in capital, we are in compliance with the elevated Tier 1 capital ratio of 8 percent; we're just slightly shy of the elevated Total Risk-Based Capital ratio, at 11.81 percent. So we are well-capitalized. I'm not coming to you from the position where I think we're weak.

The second issue is that most banks also have a concentration of real estate loans that they are trying to reduce to lower their risk profile. Bank examiners like to see what we refer to as the "100 to 300 buckets," whereby no more than 100 percent of your capital is invested in land and construction loans, and no more than 300 percent in all real estate lending combined, including owner-occupied loans. Those numbers just got out of control, particularly in Florida where there was a lot of speculation, and now we're trying to get back in compliance with the normal ratios. When you're looking at growing a bank with real estate loans or growing a bank with commercial loans, it is certainly faster to grow it with real estate. Real estate lending was once a substantial part of our growth. A large commercial loan is in the neighborhood of $2 million, where a large real estate loan for us could be $15 million. We aren't even replacing our runoff right now. My theory is, part of that is because the banks don't want the strain on their capital and they also don't want any more real estate exposure.

**CONWAY:** Tony, I'd like to proffer two additional observations at this point. I think the other panelists are exactly correct. What I am hearing them say is, first: bank capital is under siege on a lot of fronts. Banks have been vilified, and everyone in Washington wants a piece of their capital—whether it's in the form of holding more capital for losses, adding regulatory burden and costs in a one-size-fits-all structure that hurts community banks who were not the egregious parties, or higher taxes and fees.

Second: how can banks lend with such an unclear picture of the economy, capital and loan loss reserves? Banks are not going to lend in an uncertain climate. Incentives need to be developed to restore credit. Washington and the regulatory community need to be clear on policy and new legislation—especially Dodd-Frank. Otherwise, banks will hold onto their capital and earnings for fear they will be needed to address future losses and the cost of higher regulatory burdens. If the U.S. is not careful, it may see its banking industry move offshore. Banking in the U.S. could go the way of the auto, steel and textile industries in the 1970s and 1980s.

**DOWNS:** OK, now I'm going to take a turn. I'd like to discuss why real estate is acting like such a drag on the nation's overall economy, with an equal drag on bank prosperity. And I'm going to repeat some things that the others have said.

The first reason is one K.C. emphasized, that most banks have a very high fraction of their loans based upon real property. I used a different fraction than he did, but in the third quarter, real estate loans were 44 percent of all bank lending. By 2009, that had risen to 60.7 percent. That's more than one-third of all the assets in the banks.

The second reason, which he also mentioned, was that almost all real estate properties have fallen sharply in value, leaving many loans larger in face value than the current market values on the properties on which they are based. Today, about 25 percent of all homes with mortgages are underwater. That is, the mortgages on them are larger than the current market values of those homes. But, 31.7 percent of homes have no mortgages. Thus, considering the entire housing stock, about 17.8 percent of owner-occupied units are "underwater." From 2004 to 2006, commercial real estate loan-to-value ratios were 72 to 73 percent based on the value of the property at that time. Since then, falling prices of those values have increased the loan-to-value ratios of those loans to 94 to100 percent. That has put many of those homes underwater.

A third reason is that the prospects for rapid recovery in housing markets are very poor. Yet housing recoveries have been major positive forces in past recoveries. Existing housing sales have plunged to a record low level of about five million total sales in 2010. Banks in 2010 are down 19 percent from their peak in 2005. Homebuilding is even worse. Homebuilding starts in 2009 were 550,000 units; that is, a 71 percent drop from their peak of more than two million units in 2005. That drop from 2005 to 2009 was the biggest drop in the history of such records. Yet in 2010, new housing starts were only 529,000, actually fewer than in 2009. The number of housing foreclosure filings went from a million in 2006 to 3.9 million in 2009. There will probably be another 3.9 million again in 2010. And recently, as you know, several major banks have stopped filing foreclosures because they discovered fraudulent or inaccurate documents. So the whole foreclosure situation is a mess. Yet the already huge amount of foreclosures—72 percent of which were concentrated in just nine states—has created a large number of housing units available at relatively low prices.

That further reduces the willingness of homebuilders to start new housing.

The fourth reason is that commercial real estate, as K.C. mentioned, is about to be hit by the rolling over of huge numbers of highly leveraged loans made from 2000 to 2007, at very high property values and high loan-to-value ratios. This will create an acute shortage of borrower equity with which to pay off those loans when they roll over. In those eight years from 2000 to 2007, six times as many dollars were lent in commercial property as were lent in the preceding eight years. Most loans made in that second period of great lending were highly leveraged with cheap debt that was then available. But no such debt is now available or will be soon. If banks deleverage by reducing their huge debts, they will be unable to refinance these loans made from 2000 to 2007 without gaining more capital for reserves. In fact, the lending capacity of the entire U.S. banking system will be much smaller in the future, and is much smaller today than it was in the recent past.

The fifth reason, and one that underlies all the others, is that high rates of unemployment are likely to continue for several more years. As a result, consumers will not have the funds to return to heavy spending on goods and services, thereby stimulating small businesses. So, small businesses will have little reason to expand their resources.

The last reason I'll mention is that no sudden change in conditions is likely to radically increase the demand for workers and for new production. But such a sudden change is what World War II did to bring the Great Depression in the 1930s to a sudden end. It caused a huge influx of government spending, and the government drafted eight million people, many of whom were previously unemployed, into the armed forces. We don't have any comparable force to turn around the economy now.

**THOMPSON:** One of the things that I would like to say is that in the CMBS market, REMIC, or Real Estate Mortgage Investment Conduit laws were changed, and this is what I understand to have happened to actually provide the CMBS special servicers the ability to extend matured loans up to two years. Extensions are done so in a manner, in an "extend and pretend" kind of fashion, to provide more time for the CMBS loan to meet refinancing qualifications and not incur a tax consequence for the REMIC. So there's been some enabling of this extending of credit once those commercial loans mature in this CMBS market. Similarly, I've observed within banks this same kind of pattern of trying to provide more time for borrowers to become successful and put the loan in a position to be either refinanced or provide the property enough time to put it in a position for a sale to pay off the loan. Those things I think are definitely happening on the income property side but they're also happening to a large extent on the single-family mortgage side. What I'm observing is a stretching out of the consequence of loss, which appears to be very similar to what we saw as a pattern in Japan. Though, others are saying: "Hey, there's no way the U.S. will ever follow what Japan has gone through in the last decade." But it seems as though we're following that same pattern because the probability of real estate loss hits are too high, and that's why I threw out some numbers—to give people some perspective as to what kinds of losses will be, or potentially be, sustained by the economy. There are just so few people who can understand how big this real estate debt problem really is and why it's going take a long time and why it can't be solved quickly.

**DOWNS:** K.C., you said at one point that properties had fallen, both residential and commercial. What were your estimates of how far property values had fallen, say from their peak around 2007?

**CONWAY:** When we look at where we have come from and gone to in property values, it's easy to sum it up for both residential and commercial real estate, as follows: we have returned to 2002–2003 levels. Commercial real estate values have fallen 45 percent from their peak in 2007 to their trough in 2010. Nationwide, home prices have fallen for the first time in since 1968. They have declined more in coastal and higher priced markets like California, Florida, Washington, D.C., northern Virginia, New York, Atlanta, Chicago, Phoenix, Las Vegas, etc. We've experienced an unprecedented decline in home prices since 2007, but it is not as great as the unprecedented rise in home prices we experienced from 2000 to 2007. Double-digit annual home price appreciation and sub-6 percent cap rates were never sustainable and have simply unwound.

The real question is, where were the bank credit and risk staff and the regulators during the unprecedented rise in values in terms of intervening and challenging the sustainability of what was going on in that time period? The answer is that they were AWOL because no one wanted to be the one to stop a great party prematurely. Congress wanted higher rates of homeownership. To accomplish this, it forced the GSEs to take on a new risk profile of subprime mortgages without building up their capital base from a nominal 1 percent to, say, four to six percent, where losses have actually developed. Banks wanted more earnings, and they simply followed the herd of cattle over the cliff because "it was what everyone was doing."

The attitude that permeated the bank and regulatory environment was: "until I have losses, why should I be concerned, reserve for more losses, etc.?" It takes courage to pull away from the spiked punch bowl late in a party, but it means the difference between gain and pain. The regulatory and banking community failed. Bank regulators failed to update things like the *Interagency Appraisal and Evaluation Guidelines* to address securitization, subprime mortgage products, drive-by appraisals, etc. The last update to those guidelines was enacted in 1994 in accordance with the Financial Institutions Reform Recovery and Enforcement Act. The banks failed to adhere to a 3M approach to risk management, which means continuously measuring what is happening in markets; continuously monitoring the results; and then continuously managing the business lines in response to the risk that is building. What the banks did was essentially say: "Let's invest more in earthquake-prone areas because there has not been an earthquake in a long time, and let's just assume then that no more earthquakes will occur going forward." Until we have an earthquake, let's not plan for one.

The banking and regulatory communities alike now act very indignant and shocked that there is such destruction from an earthquake. This was not an unforeseen real estate and banking crisis. It was a failure by banks and regulators alike to manage risk. Now, Americans deal with the destruction in their wealth and the economy. We seem doomed to repeat this cycle nearly every 20 years. We deregulated the savings and loans and then changed the tax codes to drive real estate in the early 1980s, and then acted surprised at the aftermath from 1987 to 1991. Twenty years later, we essentially deregulate the mortgage industry and financially engineer residential and mortgage products to accelerate real estate without understanding their structures and risks, and once again act surprised at the financial wreckage. Directors of bank boards, regulators and legislators are all the principal tour guides down this economic path of destruction.

My concern going forward is how do we dig our way back out? The FED has spent most of its ammunition and is now engaged in supervisory policy that undermines prudent monetary policy. Printing money to capitalize on the excesses of banks devalues our currency and will lead to commodity inflation and more hardship to the American taxpayer that could rival what we experienced from 1977 to1981 when the prime interest rate rose to 21 percent. The rest of the world now holds more than half of our total debt, and I don't think those holders are going to continue to extend us credit at Triple-A borrower ratings when we don't deserve it. Really smart analysts like Meredith Whitney (Meredith Whitney Advisory Group LLC) are already out there warning about the next shoe to drop—state and municipal bond debt. We'd better learn to manage risk proactively—not reactively—if we want stable property values going forward.

**DOWNS:** Let me ask a question of Marc Thompson. You seem to imply that the number of banks may actually shrink because of the pressure on their balance sheets and the difficulties they're facing from the FDIC and other forces that are reducing their effectiveness. We have about 8,000 banks today, although we once had 14,000—not too long ago. How many more banks do you think will have to disappear before stability in their numbers is established again?

**THOMPSON:** That's a tough question to answer. The number 5,000 has been thrown around a couple of times in some discussions and what I hear in listening to other bank regulators in various states. They have their forecasts and they think that it might go down to as low as 5,000, but it's very difficult to predict what that number would be.

**DOWNS:** Let me ask Sandy a question. Your bank, you said, is very well capitalized, so you are apparently not under any pressure to disappear at this point, but are there other small banks in Florida and around you that are having trouble staying afloat?

**HOSTETTER:** Definitely. The numbers, I think, through the second week in September, showed that 127 banks had failed, and I think we're predominantly seeing that in Florida and Georgia. Banks are struggling. If you were open for business in 2004 through 2007, and had any appetite for real estate lending, you're probably dealing with the problems that those projects are experiencing.

One of the comments I was going to make is when this downturn started, I remember distinctly about a year into it thinking I'd seen this movie. I came out of Barnett Bank, and in the late '80s early '90s, Barnett Bank of Central Florida had the largest real estate portfolio in the

Barnett system. We had a floor filled with bank examiners when this downturn hit a full-blown recession. But some of the solutions that helped us get back on our feet as a nation and as a bank at that time are not available. The government gradually lowered both interest and taxes. Well, the rates can't go much lower than where they are today, and some would argue the same is true with taxes in light of our country's debt position. We've talked about the cap rates, and we've talked about the value of keeping a project going by just having more favorable interest rates, but the truth is, they can't get any better than where they are right now. I'm very concerned about raising taxes at a time when most people are struggling to get back on their feet. That could be devastating. And because we have already used one of the tools that helps us get back on track—dropping interest rates—I don't think this recovery is going to be anywhere near as swift as the one that resulted when we made those two moves back in the early '90s. And we haven't even touched on unemployment.

**DOWNS:** You think that these banks are going to go out of business? You said some of them around you are really in tough shape. Are they actually disappearing?

**HOSTETTER:** It's already happened. Several of the banks here already have been acquired. It's going to depend on how long this economy stays down. Tony, I want to be honest with you—we lucked out a little bit because we had just done a capital raise to double our footprint in Florida. Sometimes, you're lucky, and we were. We went into this with more capital than we normally have and fortunately, did not commit to the real estate investments that expanding in branches and leasing normally require. Fortunately, at the time, we realized the economy was weakening, and we were able to hold onto our capital.

**DOWNS:** Let me ask Marc a question again: you once said in a conversation with me that the FDIC was not following its own policy of assuming 80 percent of the losses of banks that closed. Where could it get the funds to follow that policy other than forcing banks to use their capital?

**THOMPSON:** As I said in my first opening point, the FDIC is managing its loss reserve capital. I've spoken to other banks that have loss-sharing agreements with the FDIC, and they're indicating to me that they're managing their loss reserve capital. In other words, if there's a loss that the bank has to get approved by the FDIC to share in, FDIC will say, on occasion, "We're not going to do that." And then the FDIC is not promoting it will not, according to these bankers that I've talked to, approve loan sales, because it doesn't want to realize those losses. It's managing the rate in which it's taking loan losses against its loss reserve capital. I believe it's as fearful of the same things that all banks are—that there are going to be further losses down the road. The FDIC has to manage its balance sheet for those losses, and so it's postponing losses on loss-sharing agreements and managing the rate—the best it can—of closing troubled banks. Everybody who's participating in the U.S. economy can't take directly or indirectly all these real estate loan losses at the same time, for fear of having nothing left to maintain minimum capital adequacy requirements or solvency on their respective balance sheets. So, what's happening out there is that even in the loss-sharing agreements, the FDIC is managing losses as anybody should be in this economy. It's managing its balance sheet to conserve loss reserve capital for future probable real estate loan losses.

**DOWNS:** To K.C.: it seems that the small banks are having difficulty raising capital, but the biggest banks have been quite successful in raising capital. We've heard a lot about banks being too big to fail, but what about small banks being too small to survive? Is that something that seems to be emerging?

**CONWAY:** It's a very legitimate concern. We recently had Meredith Whitney, who's a pretty well known bank analyst, especially on the community bank side, speak with us at the Federal Reserve, and that was a point that she did make. Her assessment was that if you're not at least a billion dollars in size, it's almost impossible for you to raise capital. And, if you're a billion in size or smaller, it's very difficult if you've got a concentration of real estate and you've got to deal with more losses. Where do you go for earnings? So, where do the earnings come from to deal with the problems of working out or extending these assets if you don't have other lending? So you're seeing a kind of feeding frenzy among the community and smaller banks who are trying to refocus into other areas such as C & R lending, or small business. But what we've heard from the small businesses is that it's not so much that credit isn't available, but that their businesses don't see the demand to go out and take the capital risk. We see, even in medium- and large-sized institutions, very low utilization of the credit by businesses. The National Federation of Independent Businesses has a real good chart and some stuff on its public Web site that shows the survey "What is the

Number One Problem of Small Businesses?" And it's not different regulation, it's not absence of credit; it's poor sales. They don't see the demand to go out and extend capital to hire employees or invest in plant equipment or additional space. And so I think what you're hearing from Sandy and the smaller banks is you're exactly right. They are at a disadvantage, and when you look at Dodd-Frank; smaller banks are going to have to comply similarly with the large banks, and that creates another kind of cost burden on them. So I think it's a legitimate concern that the smaller and community banks are raising that may have to be addressed if we want to preserve a community and smaller bank situation in this country.

**DOWNS:** Let me ask you, K.C., another question, and also Marc, maybe you could answer this, and Sandy too. What if you are looking for some way to cope with the fact that a commercial real estate loan is coming due, and the borrower does not have the equity to meet your current terms or you have lower loan-to-value ratios, lower prices and higher interest rates. Where can you go for capital and how can you respond to that situation? Are you going to lend, are you going to extend the loan forever? Are you going foreclose it and sell it quickly? What are the reactions to that situation, which is going to become much worse? Any of you can answer.

**CONWAY:** I'll start real quick, because I think the first thing the banks need to ask themselves when they're in that situation is: "what are the prospects for this loan to be taken off, be paid off and go away?" So if you look at the primary source of recent adds to the banks pre-2007, it was securitization of CMBS referral, and in 2007, CMBS was a $234 billion annual market that would basically take these assets off the banks' balance sheets and enable them to recapitalize and go back and lend and do construction and development. This year we may be lucky to see somewhere between five and ten billion in these securitizations. Every one of the new issuances that have been done since the TALF program was made available to restart securitization are essentially 60 percent or lower loan-to-value—180 to two times debt service coverage, single-borrower, not multi-borrower situations. They don't want any major leases to expire during the life of the loan. The most recent deal was a retail deal by Vornado, in which only five percent of the leases had any market rollover risk in the next ten years. That is not the profile of what's in the bank. So, if securitization is going to stay in that mode—very conservative—and they're in that mode because now the commercial borrowers and the CMBS borrowers have said: "we're going to adopt the same behavior that homeowners and mortgage folks have," which is strategic foreclosure. If the refinance gap is just too big to ever meet, we'll strategically walk away.

There was a recent *Wall Street Journal* article that interviewed Vornado Realty Trust and some others in which they openly advocated that they're incentivized to strategically default on these non-recourse CMBS deals. And that's why we're seeing this sharp rise in CMBS delinquencies that just reached 9 percent, a new record, and overall 11 percent of all CMBS entering special servicing. So the capital markets in CMBS are not crawling or walking back to life; they're barely even in existence compared to where they were. That source isn't going to be there. So if it's not there, and there aren't other sources for other sectors of real estate like multi-family, and you don't have that same equivalent for retail, or office or subdivision land, there really is no other option but an extend strategy. And I think that's why you saw the respective regulatory agencies reintroduce the "Commercial Real Estate Loan Workout Guidance" last fall, which said: "If it makes more sense, if it's prudent, to work and extend the loan rather than foreclose." In other words, if your market value is better for working it out than liquidation value and foreclosure, "by all means, do that and focus on debt service coverage rather than collateral value." So really what's being said to the banks right now is: "If you can find a way to restructure the loan into a sort of A/B note restructure and get some kind of debt service coverage of one better, we'll work with you in an extend strategy as long as you get some sort of cash flow." But that still means, in many cases, when you write and sign that loan into an A/B restructure, the charge-off of the B note is such a hit to capital that financial institutions can't even do that. The thing we're really confronted with is, as both Marc and Sandy have said, the only option in place in the banks right now is an extend strategy, because the capital markets have not opened back up to really deal with it. And if you're an under $20 million commercial real estate asset, outside of one of the top ten or 20 markets in the country, there is not refinance capital for you.

**DOWNS:** Let me ask Marc and Sandy whether you have had any of your clients decide that they didn't want to cope with their mortgage. They just walk away and hand you the keys. Has that happened to you?

**HOSTETTER:** Yes. We've have several law firms here in Central Florida advertising their services relating to strategic defaults, which is only exacerbating the problem. But I will tell you the reality is exactly what K.C. said. What we've been trying to do is to work with our borrowers to come up with a solution that works for both the borrower and the bank. We don't just let people walk away from a deal, particularly not if they have personally guaranteed our loan. And we have very, very few deals that do not carry personal guarantees, so unlike a CMBS market whereby you put it to bed in a permanent market and there's no personal liability, our loans, by and large, hold the sponsor personally liable. So I can't say we're seeing very many people go through that strategy, Tony. What we're doing instead is that we either ask for additional collateral, and if they can't right-size from a collateral standpoint, which happens in probably 20 percent of the cases, then we do our best to begin amortizing so that we can demonstrate repayment ability. Most borrowers at this point don't have a lot of liquidity left, but every deal is different. We drop the interest rate if we have to and extend for a 20- or 25-year payoff and just amortize it right on out unless they can make the debt service coverage on a more aggressive schedule.

**DOWNS:** Marc, I'm going to ask you the same question. Do you have many people walking away from their properties? Now, California is the state in which if you are in a house, I don't think they can go after you if you walk away from it.

**THOMPSON:** Yes, if your home is your primary residence, that is correct. But if you walk away and you incur a loss through a foreclosure or even a lender-approved short-sale, you have tax consequences if some of the leverage put on the house didn't increase the basis in the home; that is, paid off consumer debt with cash-out home mortgage proceeds. So there are certainly financial incentives to stay in a house to discourage strategic defaults on homes, especially if the homeowner isn't insolvent and has a net worth.

But, looking back at the savings and loan crisis, this is a perfect example of why recourse loans to the investor are very important for banks. In the savings and loans crisis, we had an "S and L" portfolio where I worked at the time consisting of recourse and non-recourse commercial real estate term debt. What I observed at the beginning of that de-leverage cycle was that a large amount of the non-recourse debt went first into strategic default. At the beginning of 1992 to 1993, we had some recourse borrowers ask for loan modifications early on, but we chose not to provide them because it was recourse debt. Frankly, we had such a high volume of distressed non-recourse commercial real estate debt for workout or foreclosure that we just didn't have any capacity to handle the recourse modification requests at the time, even though it may have been beneficial to them and the bank.

But the point is that recourse signers of the debt are responsible for that debt's full repayment. Unless the guarantor became financially exhausted, recourse commercial real estate debt has proven to be a very stable portfolio of loans. I did not see recourse debt go into foreclosure or into some kind of workout until much later in the de-leveraging cycle in 1994 and 1995. And so there is a case to have recourse debt in banks because it provides for a much more stable portfolio in difficult economic periods. When you have non-recourse debt, it's a strict economic decision to walk away or keep paying debt service out-of-pocket. "OK, I've invested my maximum equity in this commercial real estate investment. I'm not going to put in anymore equity. Here are the keys." This position was taken by many non-recourse investors during this period. I heard the same back in the S and L crisis days. Whereas if you have recourse debt, the guarantor would be served a judicial foreclosure action and go through a whole negative legal process, facing a deficiency judgment between the fair value of the property and the higher loan amount. Recourse debt discourages guarantors from going through a loan default, especially if they have a net worth to protect. So, I really believe that non-recourse debt is not to be originated for banks' balance sheets. It's just too volatile for a bank's balance sheet to manage its minimum capital requirements in challenging economic times. In a financial crisis, we're now seeing that non-recourse real estate debt creates and accelerates a systemic financial market problem in MBS portfolios—residential and commercial securitized loans—and in banks. It's too easy for an investor with a non-recourse loan to walk away from the responsibility of fully repaying it.

**DOWNS:** Let me ask this: what signs of optimism do the three of you see? Is there any way out of this? We've all been talking about how it's going to get worse or it's going to get better, only very, very slowly. Are there any optimistic signs that anyone can speak of?

**THOMPSON:** We closed a construction loan in the bank I work for with one of my group's customers yesterday. Some banks are still lending. We're doing the best we can, and it's just a harder environment to do it in. The bank I work for is well-capitalized. Bank of the West is owned by a French bank called BNP Paribas. Banks are seeing more opportunities for providing credit to credit-worthy borrowers. What I'm finding is more competition for the high-credit quality commercial real estate loan deals. I'm seeing some good competition come back to the market with three to four well-capitalized banks bidding on high-credit quality real estate projects, either on a term loan or on a construction loan opportunity. So I am seeing lending activity on commercial real estate and residential development projects in the stronger markets in California. Even with California experiencing tough economic challenges as a state, banks are making good commercial real estate loans. I would say that's a positive sign.

**DOWNS:** Sandy, do you have any optimistic thoughts?

**HOSTETTER:** Yes. We're still working through our real estate portfolio, but we are seeing some properties move. We've had a couple of large homebuilders come to us looking for large parcels of land. They're not knocking the doors down, but we feel like we're going to make a big dent in our problem assets by June of next year. And, hopefully, Tony, one of the things I would really like to communicate in this conversation, is that the banks WANT to lend. We don't make as much money not lending, nor do we have as much fun. We make a lot more money when we're out there lending, and we do want to lend. I think there are a lot of articles written that lead you to believe that the banks don't want to help people recover, and that's just not the case.

Personally, we feel like we'll be able to get back on track probably by June or July. We are currently making commercial loans. We're just trying to hold off on the real estate market to get our concentration down and work through what we have. But we're hopeful we'll be back in play by June/July of 2011.

**DOWNS:** K.C., how about you? What do you think? Anything optimistic?

**CONWAY:** There are some great finds out there. I mentioned at the beginning, multi-family is recovering, and there is some good news on the hotel side. We're seeing business travel come back, and revenue per available rooms up—RevPAR—that's the best metric to measure hotels. Essentially, of the 180 markets we're looking at, only ten of them still have RevPAR declining, so we've gone from 15 to 25 percent decline in RevPAR a year, with an overall 50 percent decline. Now we're actually seeing it grow. There are signs of progress. We're also seeing some surprise markets that were hard hit and overbuilt actually returning to positive job growth. Good examples are Charlotte, North Carolina, and Cleveland, Ohio. Those are pretty, kind of, surprise markets. Chattanooga and Knoxville, Tennessee. These are all markets that were negative in job growth for the past almost two years and are now positive.

I think the optimism is, if we can get the employment engine going again, we can fix a lot of things. That would rebuild capital, rebuild confidence, although I think we have to recognize there are still a lot of hurdles ahead of us. This isn't a quick fix this time. It's not going to be over within a year. Americans tend to like a tried-and-true convenient solution, and I think this is a recession where there is not a convenient solution. There's been a lot of damage, and the things that consumers and business and banks are doing, which are dealing with their over-leverage and trying to get their house in order, is the opposite of what's occurring in government. We can't continue the deficit structure at a national level and at municipal budget levels. Again Meredith Whitney recently released a 600-page report last week, with two years of research on how to view this problem. In the underfunding of things like pension plans by the state, we have a whole other shoe to drop out there. So I think that we need to keep trying to recognize what's good, we have to quit vilifying the banking industry. There were maybe ten, 12 institutions that were bad apples but the other 7,900-plus weren't egregious in executive compensation and doing insane things. A lot of them were doing basic blocking and tackling. We limited banks in many ways over the past decade as to what they could do to make money. A lot of things were commoditized or moved to Wall Street, such as credit cards and auto loans, and I think we need to look holistically at that and the products and lending opportunities that we can rebuild in our banking system so that we have a broad one. But the thing that concerns me the most is the deficit spending at the government level, which is going to potentially undermine what the consumer and businesses and banks are doing to get their houses in order. So, my optimism is the consumers and businesses and banks, I think, are doing the right things, but we could undermine that through our just out-of-control deficit behavior at state, local and federal levels.

**DOWNS:** Thank all three of you for taking part in this discussion. I found it very enlightening. ■