TOO BIG TO FAIL VS. TOO SMALL TO NOTICE: ADDRESSING THE COMMERCIAL REAL ESTATE DEBT CRISIS

Tanya D. Marsh[*]

ABSTRACT

The commercial real estate industry has been devastated by the current economic crisis, losing 40% in value since the end of 2007. As a result, commercial real estate borrowers owe lenders $1 trillion more than their properties are worth. Although the federal government has been warned that the commercial real estate debt crisis may cause a double-dip recession, the government's response thus far has been to allow the market to work itself out. This Article argues that this laissez-faire response rests upon flawed assumptions about the structure of the commercial real estate industry. Compounding the problem, policymakers are incorrectly interpreting increased lending and transactions in the upper echelons of the market as a signal that their policies are working. Instead, the current approach has forced sales at distressed prices, numerous foreclosures, and, perhaps most importantly, significant small bank failures without any systemic benefits. Policymakers have seen these losses as an unfortunate but unavoidable cost of the recovery process and dismissed these small actors as not "systemically important." In fact, this Article argues that in the aggregate, small commercial real estate borrowers and small banks are vital to fueling job creation and economic recovery. By focusing primarily on the health of large financial institutions, borrowers, and properties without due consideration for the smaller players, the current policy may lengthen the economic crisis by placing further stress and uncertainty on some of the most vulnerable segments of the economy.

* Assistant Professor, Wake Forest School of Law, Winston-Salem, North Carolina. Formerly Vice President of Legal, Kite Realty Group Trust, a real estate investment trust based in Indianapolis, Indiana. Many thanks to the borrowers, lenders, attorneys, and tenants who spoke with me frankly and off the record about their own experiences in the current commercial real estate market and their thoughts regarding the issues explored in this article. Thanks also to the CoStar Group for the use of its impressive database of commercial real estate properties and transactions. Finally, thanks to the organizers and participants in the Junior Faculty Business and Financial Law Workshop at George Washington University's Center for Law, Economics, and Finance (C-LEAF).

ABSTRACT....321
INTRODUCTION....322
I. THE COMMERCIAL REAL ESTATE DEBT CRISIS AND THE CURRENT POLICY RESPONSE....326
A. *A Property-Level View of the Crisis*....328
B. *Estimating the Scope of the Commercial Real Estate Debt Crisis*....331
C. *The Current Policy Response*....334
1. *The Term Asset-Backed Securities Loan Facility*....336
2. *Regulator Guidance on Workouts*....337
II. CRITIQUING THE GOVERNMENT'S RESPONSE....340
A. *What Really Caused the Commercial Real Estate Debt Crisis*....344
B. *The Trifurcation of the Commercial Real Estate Market*....348
1. *Size of the Asset*....348
2. *Location of the Asset*....349
3. *Product Type*....349
4. *Quality of the Asset*....350
5. *Tenant Mix*....350
6. *Type of Owner*....351
7. *Type of Lender*....354
C. *The Problem with Commercial Real Estate Valuations*....357
1. *The Cost Approach*....358
2. *The Sales Comparison Approach*....359
3. *The Income Capitalization Approach*....360
III. THE INEVITABLE RESULTS OF THE GOVERNMENT'S POLICY....366
A. *Increased Consolidation at the Top of the Market*....366
1. *Real Estate Investment Trusts*....367
2. *CMBS Originations*....368
B. *Bank Failures*....371
C. *Marginalization of Limited Capital Owners and Tertiary Markets*....376
CONCLUSION....379

INTRODUCTION

The collapse of the residential real estate market in the summer of 2007 pushed the world's economy off a cliff. All Americans felt the pain. Unemployment rates rose. Residential foreclosure rates skyrocketed. Corporate investment plummeted. In the past three years, policymakers, legal academics,[1] and the press have paid significant attention to the structural causes of the residential real estate crisis and debated the government's response. The subprime aspect of the residential real estate crisis has received the most attention, and rightly so, for it reads like a traditional morality tale. Greedy investors, banks and even some borrowers profited handsomely in the short term from loans that were unlikely to be repaid. Fraud and predatory lending were rampant.[2] When the subprime machine collapsed in the summer of 2007, it dragged homeowners, investors, and large lenders down with it.[3] While residential borrowers continue to struggle to pick up the pieces, several large lenders were deemed "too big to fail," and, so the story goes, were "bailed out" by the federal government.[4] In this narrative, the greedy were punished, unless they were so central to the economic system that their failure would have caused further damage.

A few months after the collapse of the residential real estate industry, the commercial real estate industry followed, losing 40% of its value since the end of 2007.[5] Commercial real estate borrowers currently owe lenders $1 trillion more than their properties are worth.[6] As a result of the depressed valuations, borrowers and lenders have both suffered. Between January 1, 2008 and December 31, 2010, the Federal Deposit Insurance Corporation has quietly closed 322 small banks,[7] nearly all of which failed under the weight of non-performing commercial real estate loans. Countless owners of commercial real estate have lost their properties to foreclosure or been forced to sell into a distressed market.

The government has been warned repeatedly that the commercial real estate debt crisis has the potential to cause a "second wave of property-

1. *See, e.g.*, Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1 (2011); Jean Braucher, *Humpty Dumpty and the Foreclosure Crisis: Lessons from the Lackluster First Year of the Home Affordable Modification Program (HAMP)*, 52 ARIZ. L. REV. 727 (2010); Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV 1073 (2009); Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185 (2007).

2. *See generally* KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011).

3. *See generally* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010).

4. *See generally* ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES (2009).

5. CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY 2 (2010) [hereinafter COP REPORT], *available at* http://www.invotex.com/assets/cop-021110-report.pdf.

6. *See* DEUTSCHE BANK, THE FUTURE REFINANCING CRISIS IN COMMERCIAL REAL ESTATE, PART II: EXTENSIONS AND REFINEMENTS 23 (2009), *available at* http://www.appraisalinstitute.org/newsadvocacy/downloads/key_documents/FutureRefinancingCrisis_71509.pdf.

7. *Failed Bank List*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Jan. 17, 2012).

based stress"[8] to the American economy and to derail a fragile recovery;[9] however, the crisis has gone largely unexamined by policymakers, legal scholars, and the press. Instead, the government has decided to allow the market to work itself out. Although the casualties of this approach are numerous, policymakers have accepted them as regrettable but necessary, dismissing them as not "systemically important."[10] Policymakers argue that small sacrifices are necessary because commercial real estate cannot recover until it hits bottom, and that cannot happen unless borrowers and lenders are forced to accept their losses and move on.

But this Article argues that the government's *laissez-faire* response is based upon flawed assumptions about the commercial real estate industry. Most significantly, policymakers have adapted the narrative of the subprime residential real estate crisis to the commercial real estate crisis to tell another morality tale. In this telling, sophisticated commercial real estate borrowers and lenders were greedy. They profited handsomely on the run-up to the bubble and must now accept the consequences of their actions. In a slightly different version, lenders relaxed underwriting standards to maximize profits, providing loans to unworthy borrowers. When the market corrects itself, the marginal borrowers will be weeded out and the non-performing loans will be right-sized. Creditworthy borrowers and responsible lenders will survive the carnage to restart the flow of capital and all will be well.

While this narrative is compelling, reality is much more complicated. Yes, many commercial borrowers and lenders made impressive profits during the boom years. But that isn't the whole story. Those who profited most during the bubble are not necessarily the same parties that stand to lose the most today. There is strong empirical evidence that mismatched incentives and outright fraud contributed to the meltdown of the subprime residential real estate sector. There is no empirical evidence that those sins were present in commercial real estate. Compounding the problem,

8. COP REPORT, *supra* note 5, at 6; *see also* KEVIN LAMBERT, BNA: REAL ESTATE L. & INDUS. REP., CRE COMPLICATIONS INFECTING SMALL BANKS; MAY CAUSE DOUBLE DIP, SAYS HILL ROUNDTABLE 1 (2010) [hereinafter CRE COMPLICATIONS] ("[T]he losses are coming, and if the CRE credit markets are not stabilized, the losses could . . . trigger both an avalanche of bank failures and the much talked-about second dip of the recession." (quoting Rep. Walter Minnick)).

9. *See, e.g.*, Stuart Saft, *Commercial Real Estate Will Collapse*, FORBES.COM (Nov. 19, 2009, 4:00 PM), http:// www.forbes.com/ 2009/ 11/ 19/ saft -commercial -real -estate -intelligent -investing-collapse.html ("The commercial real estate market is on its last legs and unless drastic actions are taken, the effects on the broader economy will be catastrophic. The obvious problem is the excessive amount of debt placed on the properties and the amount of debt that has to be refinanced during a relatively short period of time.").

10. *Commercial Real Estate: Board of Governors of the Federal Reserve System before the Congressional Oversight Panel*, 112th Cong. 2 (2011) (statement of Patrick Parkinson, Director, Division of Banking Supervision & Regulation, Fed. Reserve), *available at* http://www.federal reserve.gov/newsevents/testimony/parkinson20110204a.htm.

policymakers have demonstrated a fundamental lack of understanding about how commercial real estate is structured, financed, and valued. They fail to accurately perceive the marketplace and therefore confuse recovery in a tiny advantaged sliver of the market with systemic recovery.

Ultimately, this Article argues that the government's *laissez-faire* approach to the commercial real estate debt crisis will lead to even more significant systemic problems. Policymakers on both sides of the aisle have repeatedly stated that small businesses are the "engine of job creation in America" and therefore integral to the economic recovery.[11] But small businesses are dependent on local and regional banks to fuel their investment and job creation efforts.[12] They are also dependent on commercial real estate owners who offer premises for rent, freeing them from investing heavily in real estate. So while the failure of each individual commercial real estate borrower or bank may be too small to notice, in the aggregate, these small institutions and entities should be considered too big, and too essential to the American economy, to be allowed to fail.

In Part I, this Article examines the commercial real estate debt crisis and the government's tepid response. Part I begins with the story of a single commercial real estate property, Whiteacre Towers, and uses that example to explain how the loss of value since 2007 has resulted in an industry-wide debt crisis. Relying on the analysis of industry economists, the Article then describes the scale and depth of the crisis and the potential impact on the broader economy. Congressional efforts to study the problem are discussed, along with the limited regulatory response.

Part II critiques the government's flawed interpretation of the crisis and presents an alternative narrative. Two key assumptions of policymakers are corrected in Part II. First, the Article demonstrates that rather than a single integrated commercial real estate market, there is a growing market segmentation exacerbated by the government's inaction. Second, the Article challenges the government's assumption that valuations of

11. Press Release, President Barack Obama, Weekly Address: Opening Doors for Small Business (Feb. 6, 2010), *available at* http://www.whitehouse.gov/the-press-office/weekly-address-president-obama-calls-new-steps-support-americas-small-businesses ("We can rebuild this economy on a new, stronger foundation that leads to more jobs and greater prosperity. I believe a key part of that foundation is America's small businesses – the places where most new jobs begin."); Ned Smith, *Small Businesses Key to America's Future, Obama Says*, BUSINESS NEWS DAILY (Feb. 23, 2011, 9:26 AM), http://www.businessnewsdaily.com/701-small-businesses-key-future-entrepreneurs-grow-economy .html ("'[W]hen our small businesses do well, then America does well.'" (quoting President Barack Obama)); Letter from Republican Leaders of United States House of Representatives to President Barack Obama (Dec. 9, 2009), *available at* http://www.speaker.gov/uploadedfiles/gop_no_cost_jobs_plan_letter.pdf ("The truth of the matter is that small business, not government, is the engine of job creation in America.").

12. *See generally* NFIB RESEARCH FOUND., FINANCING SMALL BUSINESSES: SMALL BUSINESS AND CREDIT ACCESS (2011), *available at* http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-Access-NFIB.pdf.

commercial properties are meaningful or lasting, demonstrating that valid valuations are dependent upon a functioning market, which, of course, does not presently exist.

Finally, Part III describes the inevitable effects of the commercial real estate debt crisis. Consolidation at the top of the market has already begun to take place, while in less advantaged markets, banks and borrowers are increasingly marginalized.

This Article argues that policymakers cannot meaningfully address the commercial real estate debt crisis without: (1) a clear understanding of the way that commercial real estate is structured, financed, and valued; (2) an appreciation of the true structural and economic causes of the crisis; and (3) a recognition of the impact of the failure of small borrowers and lenders on the broader economy. Although a thorough discussion of specific policy recommendations is beyond the scope of this Article, several potential responses are outlined in the Conclusion.

I. THE COMMERCIAL REAL ESTATE DEBT CRISIS AND THE CURRENT POLICY RESPONSE

In comparison to residential foreclosure statistics,[13] the commercial real estate debt problems currently appear to be mild.[14] Over 50% of outstanding commercial real estate debt is held by banks, which reported that as of September 30, 2010, only 4.41% of such mortgages were more than ninety days delinquent.[15] Approximately 20% of commercial real estate debt is held in asset-backed securities, particularly commercial mortgage backed securities (CMBS).[16] CMBS loans are also known as "securitized loans" because originating banks made commercial mortgage loans, then packaged them into a pool, sliced the interests into tranches, and sold the interests to mainly institutional investors. As of September 30, 2010, 8.58% of CMBS loans were more than thirty days late in payments or in "REO," which means that the investors had taken ownership of the

13. In the third quarter of 2010, nearly 14% of residential mortgage loans were in foreclosure or at least one payment past due. Although the overall delinquency rate is improving, the percentage of loans that are ninety days or more past due remains almost four times the average percentage over the past twenty years. Press Release, Mortgage Bankers Association, Delinquencies and Loans in Foreclosure Decrease, but Foreclosure Starts Rise in Latest MBA National Delinquency Survey (Nov. 18, 2010), *available at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/74733.htm.

14. In the third quarter of 2010, 8.58% of mortgages held in commercial mortgage backed securities, which represent 25% of outstanding commercial real estate debt, were at least one payment past due or in foreclosure. MORTGAGE BANKERS ASS'N, MORTGAGE DELINQUENCY RATES FOR MAJOR INVESTOR GROUPS Q3 2010 (2010) [hereinafter MBA REPORT], *available at* www.mortgage bankers.org/files/Research/CommercialNDR/3Q10CommercialNDR.pdf.

15. *Id*.

16. *See infra* Table 8.

secured asset through foreclosure or a deed in lieu of foreclosure.[17] While these delinquency rates are low compared to residential delinquency rates, as Table 1 demonstrates, the delinquency rates for commercial real estate mortgages have shown steady and marked increases since the beginning of 2007.[18]

Table 1: Commercial Real Estate Delinquency Rates (2000–2010)[19]

These rising delinquencies are caused by a combination of factors, including: (a) depressed real estate fundamentals like occupancy rates and rents; (b) depressed valuations; and (c) a severe and continuing lack of liquidity in commercial real estate lending. Due to these three factors, many owners of commercial real estate have found difficulty refinancing maturing debt without contributing significant additional equity or providing additional collateral. The resulting "equity gap" has been

17. MBA REPORT, *supra* note 14.

18. *Id.*

19. *Id.* Statistics on commercial real estate loan default rates rarely differentiate between technical defaults, payment defaults, and maturity defaults. This is important because it means that observers and policymakers are unable to distinguish between loans in default solely because of a drop in value and loans in default because of a more fundamental non-performance issue.

estimated to exceed $1 trillion and represents a significant source of stress on lenders and borrowers.[21]

Although the commercial real estate debt crisis is a series of systemic problems, it is also a crisis experienced by borrowers and lenders on a property-by-property, loan-by-loan basis. Therefore, the story of one typical commercial real estate asset is helpful in understanding the problems on a systemic basis.

A. A Property-Level View of the Crisis

Whiteacre Towers is a small office building in Middletown, Any State, USA. It was built in 2004 by ACME Developers, a regional real estate developer, at a cost of $9.5 million.[22] In 2005, ACME Developers obtained a typical permanent bank loan with a five-year term[23] to pay off the costs of construction. At that time, Whiteacre Towers was nearly fully leased to a variety of typical office tenants, including local law firms, accountants, and insurance agents. Like most permanent commercial real estate debt, the loan on Whiteacre Towers was partially amortizing.[24] The 2005 loan (Loan #1) was made under market conditions, including an 80% loan-to-value ratio.[25] Given the structure of the loan, ACME Developers knew that a significant balloon payment would come due upon maturity and that ACME's ability to repay would depend upon its ability to refinance. If

21. DEUTSCHE BANK, THE FUTURE REFINANCING CRISIS IN COMMERCIAL REAL ESTATE: ESTIMATES OF THE MAGNITUDE OF REFINANCING RISK, EQUITY DEFICIENCY AND LOSSES FROM MATURITY DEFAULTS (2009) [hereinafter DEUTSCHE BANK REPORT], *available at* http://fredericksburg.com/blogs/blogfiles/billf/CRE1.pdf.

22. Whiteacre Towers is a hypothetical project.

23. The term of a commercial real estate loan depends upon which category it falls into: development/construction, mini-perm, or permanent. Construction loans are the shortest-term loans, usually one to three years or until a project is complete and begins to cash flow. A mini-perm loan is designed to bridge the gap between a construction loan and a permanent loan, if a borrower needs additional time to lease up a project. Once construction is finished and a project begins to cash flow, a borrower has a strong incentive to pay off the more expensive variable-rate construction loan and acquire a permanent loan, preferably with a fixed interest rate. A mini-perm loan is a short-term loan (one to three years) that has many features of a permanent loan but is for a shorter period of time, while a project is leased up and reaches stability. Despite its name, a permanent loan is not permanent. Instead, its term is typically five to ten years. A borrower seeking to own commercial real estate in the long term will anticipate a series of permanent loans. When one matures, the borrower refinances at a then-current interest rate either with its previous lender or a new lender. The loan proceeds of the second permanent loan are used to pay off the remaining principal of the first permanent loan.

24. "Partially amortizing" means that the principal of the loan was amortized over a longer period of time than the term. For example, a loan could be amortized over 30 years and repayable in 10, leaving a large lump sum of principal due at maturity. *See, e.g.*, *In re* General Growth Properties, Inc., 409 B.R. 43, 53 (Bankr. S.D.N.Y. 2009).

25. The loan-to-value ratio is, simply, the ratio between the original principal amount of the loan and the appraised value of the property. If the property is appraised at $10 million and the loan is $8 million, then the loan-to-value ratio is 80%.

Whiteacre Towers maintained or increased its value, and if lenders were willing to loan money on similar terms as Loan #1, then ACME Developers would have no problem refinancing. The following table describes Loan #1 as well as ACME Developers' anticipated situation upon maturity.

Table 2: 2005 – Whiteacre Towers Financed with a 5-Year Loan Secured by a Mortgage (Loan #1), 30-Year Amortization, 6% Interest Rate

Appraised Value in 2005	$10,000,000
Required Loan-to-Value Ratio for Loan #1	80%
Original Principal Loan #1	$8,000,000
Required Equity for Loan #1	$1,500,000[26]

During the five-year term of Loan #1, the general state of the economy changed drastically. A few of the tenants of Whiteacre Towers failed during the early years of the recession and defaulted on their lease obligations. ACME was able to replace most of them, albeit at slightly lower rents, and the cash flow from Whiteacre Towers remained sufficient to cover the monthly mortgage payments. When Loan #1 matured in 2010, Whiteacre Towers was still performing well, and although ACME Developers wasn't making much of a profit, the property income was still covering its costs and debt service. Given the partially amortizing structure of Loan #1, ACME Developers owed a balloon payment of $7,444,320 upon maturity. Based on its expectations in 2005, it should have had no problem refinancing the balloon payment.

But in 2010, ACME Developers faced a radically different economic environment. Whiteacre Towers did not maintain or increase its value. Instead, the 2010 appraisal concluded a market value of $8,000,000, a 20% decline from 2005. Although striking, this decline represents a conservative loss. From the peak of the market, in October 2007, through December 2010, the commercial real estate price index declined by 41.9%.[27] In addition to the decrease in valuation, ACME Developers found that any lender willing to loan money secured by Whiteacre Towers required more

26. The costs of construction were $9.5 million and the loan proceeds were $8 million. Therefore, ACME Developers had to contribute $1.5 million in equity to pay off the costs of construction, which would have typically been funded with a floating-rate, short-term construction loan.

27. MOODY'S INVESTORS SERV. MOODY'S/REAL COMMERCIAL PROPERTY PRICE INDICIES, DECEMBER 2010 (2010), *available at* http://www.realindices.com/pdf/CPPI_1210.pdf. A project like Whiteacre Towers would have appreciated in value at least 10-20% between 2005 and 2007, before the market collapsed.

conservative terms than Loan #1. No lender was willing to make a loan at an 80% loan-to-value ratio. Instead, lenders generally offered loan-to-value ratios between 60 and 70%.[28]

The following table illustrates the economic reality faced by ACME Developers upon the maturity of Loan #1.

Table 3: 2010 – Loan #1 Matures

Appraised Value in 2010	$8,000,000
Payoff of Loan #1	$7,444,320
Loan-to-Value Ratio of Loan #1 at Maturity	93%
Required Loan-to-Value Ratio for Loan #2	70%
Original Principal Loan #2	$5,250,000
Required Equity for Loan #2	$2,250,000
Subtract Existing Equity	($555,680)
Equity Gap	$1,694,320

Using conservative calculations, and assuming that a lender is willing to provide Loan #2, ACME Developers will need to contribute an additional $1,694,320 of equity to refinance Whiteacre Towers. If the market value for Whiteacre Towers dropped further, or if the lender was willing to refinance only with a lower loan-to-value ratio, the "equity gap"

28. During the mid-2000s residential lending boom, loan-to-value ratios could easily exceed 100%, meaning that a residential borrower could obtain a loan with a principal amount in excess of the value of the secured real estate. This was due both to irrational exuberance and, in too many cases, outright fraud. But even in the most aggressive market, commercial loan-to-value ratios rarely exceeded 85%. (This is true with respect to first mortgage commercial real estate loans. Owners may have obtained equity investments, structured like debt, that could have reduced their own equity stake in the project to $0.) There do not appear to be any empirical studies of loan-to-value ratios employed by lenders in the 2000s, however, based on interviews with owners and lenders, loan-to-value ratios topped out at 75–85% in 2007, with rare exceptions. In 2008–2009, if an owner could obtain debt, it was only at a super-conservative loan-to-value ratio like 50–55%. Lenders willing to make commercial real estate loans have begun to relax loan-to-value ratios a bit at by the end of 2010, most ratios were reportedly in the 60-70% range. *See, e.g.*, CB RICHARD ELLIS, FINDING THE WAY BACK: ANNUAL TRENDS REPORT 2010, at 18–19 (2010) [hereinafter CBRE REPORT], *available at* http://www.cbre.com/NR/rdonlyres/53EC7E25-4B2A-4EA5-AC94-19E84AC7FB6B/821716/AnnualTrendsReport.pdf (predicting that loan-to-value ratios will "eventually increase to a 70% LTV standard" and that "CMBS loans will remain conservatively sized at 50% to 60% LTV").

between the amount needed to refinance Loan #1 and the new principal of Loan #2 would be even more dramatic.[29]

But ACME Developers, a privately held regional developer, had difficulty finding a lender on any terms. The community bank that held the 2005 mortgage was eager to remove the loan from its books and was uninterested in refinancing. National sources of debt, like commercial mortgage backed securities and life insurance companies, were unavailable to ACME Developers. This drama played out across the market. Banks essentially stopped commercial real estate lending in 2008 and 2009, and tepidly began lending again in 2010.[30] The commercial mortgage backed securities (CMBS) market, which originated $230 billion in commercial real estate loans in 2007, seemingly died overnight, originating just $27 billion between January 1, 2008 and December 31, 2010.[31] Although the CMBS market has shown some signs of rebirth,[32] a small project like Whiteacre Towers would have little chance of securing CMBS financing in any market.

The way in which the equity gap is satisfied could have significant repercussions for the American economy. The likelihood that ACME Developers will be able to raise the additional required equity and retain ownership of Whiteacre Towers largely depends on the size and status of the developer and the project. If ACME Developers fails to find the required equity, it may be forced to hand the keys back to the bank and walk away. This is a lose-lose outcome because ACME Developers forfeits the potential appreciation of an asset that it developed and built, and the bank is left holding title to an asset that it will be forced to sell into a distressed market. Foreclosure, or a deed in lieu of foreclosure, is therefore the worst option for both borrower and lender because it forces both parties to realize a loss immediately.

B. Estimating the Scope of the Commercial Real Estate Debt Crisis

The problems facing ACME Developers with respect to Whiteacre Towers are being played out throughout the $6.5 trillion commercial real estate industry. Approximately $1.4 trillion of commercial real estate debt

29. For example, if the lender for Loan #2 required a 60% Loan-to-Value Ratio, reducing the proceeds from Loan #2 to $4.8 million, the resulting equity gap would be over $2 million.

30. *See, e.g.*, CBRE REPORT, *supra* note 28.

31. CRE FIN. COUNCIL, COMPENDIUM OF STATISTICS (2011), *available at* http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Statistics/CMSA_Compendium.pdf.

32. Elaine Misonzhnik, *CMBS Lenders Are Coming Back, As Is Their Appetite for Risk*, RETAIL TRAFFIC (Jan. 12, 2011, 8:04 AM), http://retailtrafficmag.com/finance/analysis/cmbs_lenders_coming_back_appettite_risk_011111/ ("Faster than anyone thought possible—and without much in the way of government help—the CMBS market has regained its vigor.").

will mature before 2013.[33] It has been estimated that for borrowers who financed between 2005 and 2008, the peak years of the market, falling property values combined with reduced loan-to-value ratios could result in equity gaps of 30–40% on a per property basis[34] for an aggregate equity gap of $600–800 billion in the next two years alone.[35]

To calculate the aggregate equity gap accurately, the equity gap of each individual commercial real estate loan would need to be calculated based on a recent appraisal. Unfortunately, such a precise calculation is impossible because, while there is rich data available on most aspects of the commercial real estate sector, the black hole of publicly available data relates to the status of non-CMBS commercial real estate loans, which constitute 75% of the total outstanding obligations.[36] Other lenders likely have the information necessary to calculate the equity gap for each loan; however, it does not appear that regulators collect and aggregate that information.[37]

Due to the lack of actual data, attempts have been made to estimate the size of the equity gap based solely on CMBS data, which is more readily available.[38] One danger of using CMBS data to estimate the condition of bank loans is that the lenders focused on different groups of borrowers and assets. It has been observed that the CMBS originators "cherry-picked" the best real estate and most creditworthy borrowers for their products.[39] Banks made loans more broadly, particularly to smaller borrowers in connection with mainstream assets.

In May 2009, Richard Parkus, then an analyst with Deustche Bank, estimated that approximately $400 billion in CMBS loans would have an

33. DEUTSCHE BANK REPORT, *supra* note 21, at 7.

34. PRUDENTIAL REAL ESTATE INVESTORS: GLOBAL HIGH YIELD DEBT GROUP, THE INSTITUTIONAL REAL ESTATE LETTER – NORTH AMERICA 3 (2009) *available at* http://www.prei.prudential.com/media/managed/documents/pim/pru_news_release_sept_09_letter.pdf.

35. JEFFREY D. DEBOER, THE REAL ESTATE ROUNDTABLE, COMMERCIAL REAL ESTATE: DO RISING DEFAULTS POSE A SYSTEMATIC THREAT 12 (2009), *available at* http://www.rer.org/uploadedFiles/RER/Policy_Issues/Credit_Crisis/RER_WRITTEN_TESTIMONY_JEC[1].pdf (hearing before the J. Econ. Comm.); PAUL FIORILLA & JACK TAYLOR, PRUDENTIAL REAL ESTATE INVESTORS, LIFE AFTER DEBT: COMING TO GRIPS WITH THE FUNDING GAP 1 (2009) *available at* http://www2.prudential.com/o&s/prei.nsf/14e712a6b099d9d852566ef005111d0/f51abf16f8e393c78525763a00614e14$FILE/Life%20After%20Debt%20PRU.pdf.

36. *See* DEUTSCHE BANK REPORT, *supra* note 22, at 3.

37. *See infra* discussion in the Conclusion regarding the empirical work that should be done in this area.

38. *See* BEN POLEN, THE STEVEN NEWMAN REAL ESTATE INST., DISCOVERING DISTRESSED ASSETS 2 (2010), *available at* http//www.baruch.cuny.edu/realestate/pdf/Discovering-Distressed-Assets-White-Paper.pdf (lamenting the "secrecy and lack of disclosure surrounding loans held on a private balance sheet (whether owned by bank or fund)"). For example, CB Richard Ellis relied upon data from Moody's Commercial Mortgage Metrics loan analysis system. CBRE REPORT, *supra* note 28, at 19; *see also* DEUTSCHE BANK REPORT, *supra* note 22, at 4.

39. *See infra* discussion in Part II.B.

equity gap upon maturity, nearly two-thirds of the total CMBS debt.[40] Extrapolating that finding to commercial real estate debt in bank portfolios, Parkus concluded that of the $1.3 trillion of commercial real estate loans maturing between mid-2009 and mid-2014, nearly $800 billion in loans would likely experience an equity gap serious enough to likely prevent their refinancing.[41]

Prudential Real Estate Investors conducted a similar analysis with respect to the $2.8 trillion of commercial mortgages originated between 2005 and 2008. Based on assumptions of reductions in market values and higher loan-to-value ratios, Prudential concluded that the equity gap for those mortgages is between $610 billion and $825 billion.[42]

A study conducted by CB Richard Ellis in early 2010 came to a different, but still troubling, conclusion. Analyzing CMBS loans scheduled to mature between 2010 and 2019, CB Richard Ellis estimated a total equity gap of $89 billion, which represents 15.8% of the total loan balances.[43] But the study noted that not all properties were affected to the same degree. The CB Richard Ellis study found that 39% of CMBS loans had equity gaps, and that the average size of those gaps was 27.7% of the maturity loan balance.[44] It also found disparities in the year of origination. Loans made in 2007 that are scheduled to mature in 2012 and 2017 were found to have the highest percentage equity gaps.[45]

CB Richard Ellis cautioned about extrapolating the findings based on CMBS data to loans held by other lender groups.[46] It echoed the conventional wisdom that life insurance companies made more conservative loans than either CMBS originators or banks, which means that the sizes of their equity gaps are likely to be smaller.[47] Unfortunately, there is no public data regarding the performance of loans held by life insurance companies. CB Richard Ellis also cautioned that banks may face more significant equity gaps, particularly because of the volume of short-term construction and development loans in their portfolios.[48]

40. *The Impact of Economic Recovery Efforts on Corporate and Commercial Real Estate Lending: Hearing before the Cong. Oversight Panel*, 111th Cong. 34 (2009) [hereinafter Parkus Testimony] (statement of Richard Parkus, head of CMBS and ABS Synthetic Research, Deutsche Bank Securities, Inc.). Mr. Parkus has since become Executive Director of Morgan Stanley Research.

41. *Id*.

42. FIORILLA & TAYLOR, *supra* note 35, at 1.

43. CBRE REPORT, *supra* note 28, at 19–20.

44. *Id*. at 20.

45. *Id*. This conclusion makes sense since 2007 was the top of the market and loans originated in that year would have been underwritten at the height of their value.

46. *Id*. at 21.

47. *Id*.

48. *Id*.

Richard Parkus, Prudential Real Estate Investors, and CB Richard Ellis each evaluated a different pool of CMBS loans, originated and scheduled to mature at different times. Their estimates of the equity gap, therefore, vary somewhat, however, it is clear that a substantial equity gap of at least $600 billion exists in the short-term (two years) and more than $1 trillion over the long-term.[49] This equity gap must be filled, either by the borrowers in the form of additional contributed equity, or by the lenders through write-downs.

Many industry analysts and policymakers have sounded the alarm that the commercial real estate debt crisis, and the equity gap in particular, could further hamper the economic recovery.[50] Despite these warnings, as 2012 begins, the commercial real estate debt crisis remains a looming threat to the economic recovery. The equity gap is significant on a macro basis, and perhaps even more significant to the hundreds of thousands of small businesses like ACME Developers who face bankruptcy, foreclosure, or both as a result of drops in valuation. Banks, primarily local and community banks, failed on nearly a daily basis in 2010 and continue to suffer under the weight of nonperforming commercial real estate debt.

C. The Current Policy Response

Despite the dire warnings and real consequences of inaction, the federal government has taken very limited action to respond to the commercial real estate debt crisis. Several congressional committees and the Congressional Oversight Panel[51] held hearings and issued reports summarizing the testimony of witnesses representing a variety of industry participants. In each case, industry participants warned of the emerging crisis while representatives of regulatory agencies, including the Federal Deposit Insurance Corporation (FDIC), Federal Reserve, and Office of the Comptroller of the Currency, assured lawmakers that the situation was under control.

The Congressional Oversight Panel held several hearings on commercial real estate, including a field hearing in New York City on May

49. *See* Parkus Testimony, *supra* note 40, at 45; CBRE REPORT, *supra* note 28, at 20; FIORILLA & TAYLOR; *supra* note 35, at 5.

50. *See, e.g.*, COP REPORT, *supra* note 5, at 37 (the Congressional Oversight Panel issued a report in February 2010 that warned that these problems could cause a "second wave of property-based stress on the financial system"); CRE COMPLICATIONS, *supra* note 8, at 1 ("[T]he losses are coming, and if the CRE credit markets are not stabilized, the losses could . . . trigger both an avalanche of bank failures and the much talked-about second dip of the recession." (quoting Rep. Walter Minnick)) .

51. The Congressional Oversight Panel was formed by Congress on October 3, 2008 to "review the current state of financial markets and the regulatory system." COP REPORT, *supra* note 5, at 182. The COP has been quite transparent in its work. The website includes webcasts of hearings, transcripts of oral testimony, written testimony, and full text of the reports.

28, 2009, a field hearing in Atlanta on January 27, 2010, and a hearing in Washington, D.C., on February 4, 2011.[52] At each of the hearings, testimony was presented by banking regulators,[53] Wall Street analysts,[54] attorneys,[55] and trade groups representing lenders[56] and owners.[57] Based on testimony at the first two field hearings, the Panel issued a report on February 11, 2010, entitled "Commercial Real Estate Losses and the Risk to Financial Stability."[58] Although the Panel has been thorough in its research of the commercial real estate debt crisis, its work did not result in any reforms.

Several Congressional committees also held hearings,[59] although no reports were issued and no legislation was enacted.[60] The only governmental responses to the commercial real estate debt crisis came from the bank regulators: (1) the Federal Reserve extended the Term Asset-

52. *See* CONG. OVERSIGHT PANEL, MARCH OVERSIGHT REPORT: THE FINAL REPORT OF THE CONGRESSIONAL OVERSIGHT PANEL (2011), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-112shrg64832/pdf/CHRG-112shrg64832.pdf.

53. *See, e.g.*, *The Impact of Economic. Recovery Efforts on Corporate & Commercial Real Estate Lending: Hearing before Cong. Oversight Panel*, 111th Cong. (2009) [hereinafter *Impact of Economic. Recovery*] (statement of Til Scheurmann, Vice President, Fed. Reserve Bank of N.Y.); *Commercial Real Estate: Field Hearing before Cong. Oversight Panel*, 111th Cong. (2010) [hereinafter *Field Hearing*] (statement of Jon Greenlee, Associate Director, Division of Banking Supervision & Regulation, Fed. Reserve; Doreen Eberly, Acting Atlanta Regional Director, FDIC); *Commercial Real Estate's Impact on Bank Stability: Hearing before the Cong. Oversight Panel*, 112th Cong. (2011) [hereinafter *Commercial Real Estate's Impact*] (statements of Sandra Thompson, Director, Division of Supervision & Consumer Protection, FDIC; Patrick Parkinson, Director, Division of Banking Supervision & Regulation, Fed. Reserve; David Wilson, Deputy Comptroller for Credit & Market Risk, Office of the Currency).

54. Parkus Testimony, *supra* note 40; *Commercial Real Estate's Impact*, *supra* note 53 (statement of Matthew Anderson, Managing Director, Foresight Analytics).

55. *Field Hearing*, *supra* note 53 (statement of Mark Elliot, Head of the Office & Industrial Real Estate Group, Troutman Sanders).

56. *Impact of Economic. Recovery*, *supra* note 53 (statement of Kevin Pearson, Exec. Vice President, M&T Bank); *Field Hearing*, *supra* note 53 (statement of Chris Burnett, Chief Exec. Officer, Cornerstone Bank); *Commercial Real Estate's Impact*, *supra* note 53 (statement of Jamie Woodwell, Vice President of Commercial Real Estate Research, Mortgage Bankers Association).

57. *Impact of Econ. Recovery*, *supra* note 53, at 34 (statement of Jeffrey DeBoer, Chief Exec. Officer of Real Estate Roundtable); *Field Hearing*, *supra* note 53 (statement of David Stockert, Chief Exec. Officer of Post Properties).

58. COP REPORT, *supra* note 5, at 1, 5–6.

59. *See, e.g.*, *Mortg. Lending Reform: A Comprehensive Review of the Am. Mortg. Sys.: Hearing before the Subcomm. on Fin. Inst. & Consumer Credit*, 111th Cong. (2009); *The State of the Small Bus. Econ. and Identifying Policies to Promote Econ. Recovery before H. Comm. on Small Bus.*, 111th Cong. (2009); *Subcomm. on Fin. & Tax Field Hearing on Exploring Ways for Small Bus. to Access Capital: Hearing before the H. Comm. on Small Business*, 111th Cong. (2009); *Condition of Small Bus. & Commercial Real Estate Lending in Local Mkts.: Hearing Before the H. Comm. on Fin. Servs. & the H. Comm. on Small Bus.*, 111th Cong. (2010).

60. H.R. 5816, titled the "Commercial Real Estate Stabilization Act of 2010" was introduced in June 2010 and referred to the House Committee on Financial Services. It did not pass out of committee prior to the adjournment of the 111th Congress. Commercial Real Estate Stabilization Act of 2010, H.R. 5816, 111th Cong. (2010).

Backed Securities Loan Facility to commercial real estate mortgage loans; and (2) bank regulators issued guidance encouraging prudent workouts for non-performing commercial real estate loans. Each of these is analyzed in turn.

1. The Term Asset-Backed Securities Loan Facility

On November 25, 2008, the Federal Reserve Board announced the creation of the Term Asset-Backed Securities Loan Facility (TALF) of up to $200 billion to support the "issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration," but it excluded commercial real estate mortgage loans.[61] Even though the purpose of TALF was to restart stalled credit markets, few sectors of the credit markets were as frozen in the early years of the recession as commercial real estate mortgage loans.

Although left out of the original iteration of TALF, on May 1, 2009, the Federal Reserve Board announced that TALF would be expanded to include new issuance CMBS.[62] This development was greeted less than enthusiastically by the industry, which had hoped that TALF would be expanded to the so-called "legacy" CMBS, or CMBS issued prior to January 1, 2009.[63] One analyst noted that "the initial terms for TALF for new issue CMBS appear unlikely to be sufficient to bring many participants, either borrowers or investors, to the table."[64] Eighteen days later, the Federal Reserve Board expanded TALF to include legacy CMBS that met certain strict criteria.[65] The Federal Reserve noted in its May 19, 2009, press release that the expansion to legacy CMBS represented the "first addition of a legacy asset class to the list of eligible TALF collateral."[66] The Federal Reserve Board had an ambitious objective for the

61. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Nov. 25, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm.

62. Press Release, Bd. of Governors of the Fed. Reserve Sys. (May 1, 2009), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20090501a.htm.

63. DEUTSCHE BANK, TALF FOR NEW ISSUE CMBS: FED RELEASES TERMS 1 (2009).

64. *Id*.

65. Press Release, Bd. of Governors of the Fed. Reserve Sys. (May 19, 2009), *available at* http://www.federalreserve.gov/monetarypolicy/20090519b.htm ("To be eligible as collateral for TALF loans, legacy CMBS must be senior in payment priority to all other interests in the underlying pool of commercial mortgages and . . . meet certain other criteria designed to protect the Federal Reserve and the Treasury from credit risk. The FRBNY will review and reject as collateral any CMBS that does not meet the published terms or otherwise poses unacceptable risk. Eligible newly issued and legacy CMBS must have at least two triple-A ratings from DBRS, Fitch Ratings, Moody's Investors Service, Realpoint, or Standard Poor's and must not have a rating below triple-A from any of these rating agencies.").

66. *Id*.

program: "to restart the market for legacy securities and, by doing so, stimulate the extension of new credit by helping to ease balance sheet pressures on banks and other financial institutions."[67]

From July through December 2009, $2.33 billion in CMBS were issued.[68] Only $72.3 million, or approximately 3%, received support from TALF.[69] During that same time period, demand for TALF financing for legacy CMBS was much stronger—$9.22 billion was requested.[70] While a more significant figure, it still represented only about 1% of the $900 billion CMBS market.[71] The Federal Reserve closed the window on TALF support for CMBS in June 2010. Between March 2009 and June 2010, a total of $14.3 billion was invested in the program,[72] a drop in the bucket compared to the total CMBS market or the $3 trillion in outstanding commercial real estate debt.

Although the Federal Reserve stated that one purpose of TALF was to ease stress on banks by encouraging the issuance of new CMBS debt,[73] it failed to make much of a difference. David Turnbull, president of Brighton Corporation, a real estate development firm in Boise, Idaho, told the House Financial Services Committee that "[t]he TALF requirements are so complex that it is realistically available only to the very sophisticated and elite borrowers."[74]

2. Regulator Guidance on Workouts

If a loan goes into default, the lender has several options. Depending upon the process established by the loan documents and state law, the lender has the right to foreclose its mortgage in the collateral.[75] Or the lender may choose to negotiate with the borrower through a "workout" arrangement.[76] The unique circumstances of the loan and the asset dictate the workout arrangement, which generally follows one of several models.[77]

67. *Id*.

68. COP REPORT, *supra* note 5, at 124.

69. *Id*. at 125.

70. Bill McConnell, *Swan Song for TALF*, DEAL MAGAZINE (Mar. 5, 2010, 1:31 PM), http://www.thedeal.com/magazine/ID/033735/features/swan-song-for-talf.php.

71. *Id*.

72. Mark Heschmeyer, *Real Money: $5.8 Billion in TALF CMBS Loans Still Outstanding*, COSTAR GROUP (Dec. 15, 2010), http://www.costar.com/News/Article/Real-Money-$58-Billion-in-TALF-CMBS-Loans-Still-Outstanding/125065.

73. *Term Asset-Backed Securities Loan Facility: CMBS*, FED. RESERVE BANK OF N.Y., http://www.newyorkfed.org/markets/cmbs_operations.html (last visited Jan. 17, 2012).

74. McConnell, *supra* note 70.

75. GRANT S. NELSON ET AL., REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT 586–842 (Louis H. Higgins ed., 8th ed. 2009).

76. For a discussion of workout strategies, see BEN POLEN, THE STEVEN L. NEWMAN REAL ESTATE INST., DISCOVERING DISTRESSED ASSETS, WHOLE LOAN WORKOUTS AND RECAPITALIZATION

For example, the parties may agree to a discounted repayment agreement as an exit strategy. Under this strategy, the lender may agree to discount the outstanding debt as an incentive for the borrower to sell the asset and close out the loan. The parties could also agree to a short or long-term forbearance agreement to provide the borrower with time to re-tenant a property or solve another performance problem. In exchange, the borrower may agree to contribute additional equity to the project or strengthen a personal guarantee.

More radical restructurings also take place, including splitting the original note into Notes A, B, and C. Note A would be "right-sized" to permit the loan to conform to market loan-to-value ratios. Note B would be tied to cash flow formulas to allow the lender to recapture value if the operation of the property improves. Note C, if used, would be a "deferral" note which would only come due in the event of default but would be forgiven if the borrower met its obligations under Note A and perhaps Note B.

The common theme of these approaches is that workouts generally include concessions by the borrower, in the form of additional equity or strengthened guarantees, in exchange for maturity extensions, interest rate adjustments, partial forgiveness, or other concessions by the lender.[78] Workouts in lieu of foreclosure are possible only if the borrower is willing and able to make additional contributions to support the property, and the lender has faith in the borrower's continued willingness and ability to profitably manage the property. The lender's approach to a distressed asset depends in large part on the borrower.

If the lender is a bank, its approach also depends in large part upon the attitude of its supervisor and guidance from the relevant bank regulators. Particularly in the early years of the recession, banks complained that they were caught in an impossible situation—non-performing commercial real estate loans were increasing, foreclosure was a lose-lose option, but regulators were contradictory or inflexible regarding workouts.

In response to these concerns, on October 30, 2009, the Federal Deposit Insurance Corporation, along with other supervisory agencies, released a policy statement that addressed commercial real estate loan

OPPORTUNITIES (Fall 2010), *available at* http://www.baruch.cuny.edu/realestate/pdf/Discovering-Distressed-Assets-White-Paper.pdf.

77. *See generally* Richard S. Fries et al., Presentation at the International Council of Shopping Centers' U.S. Shopping Center Law Conference: Minefields, Sheer Cliffs and Rough Roads: The Landscape of Loan Workouts in 2010 (Nov. 3, 2010).

78. WILLIAM B. BRUEGGEMAN & JEFFREY D. FISHER, REAL ESTATE FINANCE AND INVESTMENTS 25–37 (John E. Biernat & Paul Ducham eds., 13th ed. 2008).

workouts.[79] The statement endorsed "prudent" workouts for certain non-performing commercial real estate loans as an alternative to foreclosure, and noted that:

> Financial institutions that implement prudent [commercial real estate] loan workout arrangements . . . will not be subject to criticism for engaging in these efforts even if the restructured loans have weaknesses that result in adverse credit classification. In addition, renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.[80]

This policy statement is an appropriate response to the commercial real estate crisis because it focuses the bank's attention on the borrower's ability to repay the loan, rather than the current market value of the property. By asserting that they will not criticize banks for "prudent" workouts, the regulatory agencies have provided the banks with much needed flexibility to avoid write-downs and write-offs on assets that may recover with the economy.[81]

However, there is no empirical research that analyzes whether this policy statement has resulted in a change in behavior on the part of banks. In order to evaluate the effectiveness of this program and craft more effective policy statements moving forward, it is important to measure whether banks have responded by engaging in increased workout activity and also to determine the nature of those workout arrangements.[82]

Many borrowers whose loans were set to mature between 2008 and 2010 were able to negotiate short-term extensions with their existing

79. FED. DEPOSIT INS. CORP., POLICY STATEMENT ON PRUDENT COMMERCIAL REAL ESTATE LOAN WORKOUTS (2009), *available at* http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf. The policy statement was co-authored by the following agencies: the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, The National Credit Union Administration, and the Federal Financial Institutions Examination Council State Liasion Committee.

80. *Id.* at 1.

81. According to the regulatory agencies, this guidance was received well by the banks and more than 97% found it helpful. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-489, BANKING REGULATION: ENHANCED GUIDANCE ON COMMERCIAL REAL ESTATE RISKS NEEDED 27, *available at* http://www.gao.gov/new.items/d11489.pdf.

82. Jason Philyaw, *Commercial Mortgage Modifications Become Huge Trend in Just Two Years*, HOUSINGWIRE (January 6, 2011, 11:15 AM), http://www.housingwire.com/2011/01/06/commercial-mortgage-modifications-become-huge-trend-in-just-two-years ("From 2000 to 2008, commercial mortgage modifications were relatively unheard of. It was a different story in 2009 and 2010. Of all loan modifications in the commercial mortgage industry over the past decade, 96% occurred in the last years, according to Standard & Poor's.").

lenders. Those extensions were admittedly not permanent solutions.[83] Instead, they recognized that neither party wins when a borrower is forced to sell into a distressed market in order to partially satisfy a maturing loan. The strategy, dubbed "extend and pretend" by critics, is not popular with those who believe that the market will correct itself.[84] For example, the *Wall Street Journal* charged that the practice may prolong the recession because "[t]he readiness to stretch out loans puts a floor under commercial real estate and keeps it from hitting bottom, which may be a precondition for a robust revival."[85]

While the expansion of TALF to CMBS loans and the guidance on workouts were both positive, neither policy has had much of an impact on the underlying problems. Policymakers have resisted any significant intervention in the commercial real estate debt crisis, essentially opting to allow the market to resolve itself.

II. CRITIQUING THE GOVERNMENT'S RESPONSE

Although it is not clear why policymakers have chosen to allow the commercial real estate market to resolve its own problems, three fundamental assumptions likely underlie this policy. First, some policymakers, even bank regulators, appear to have a limited understanding of how commercial real estate assets are valued and financed and therefore fail to understand why the market is unlikely to resolve itself without significant and widespread pain. For example, in a congressional hearing regarding the commercial real estate debt crisis, Representative Melvin Watt revealed a fundamental lack of understanding of commercial real estate loan practices while questioning a witness who had testified about the equity gap:

> [M]ost of the people I know, when they get a short-term balloon loan and they get to the end of it, they know that they have an obligation to pay that loan, not to refinance it.

83. CB RICHARD ELLIS, *supra* note 28, at 11 ("Many lenders find themselves with a large portfolio of recently-originated performing loans that are now 'underwater,' as underlying property values have sunk below outstanding loan balances. As these loans near maturity, lenders will be faced with the prospect of continually extending the loan terms, which may ultimately result in the acceptance of a loan restructuring or discounted payoff.").

84. Carrick Mollenkamp & Lingling Wei, *To Fix Sour Property Deals, Lenders 'Extend and Pretend'*, WALL ST. J., July 7, 2010, http://professional.wsj.com/article/SB100014240527487047644 04575286882690834088.html?mg=reno-wsj; CB RICHARD ELLIS, *supra* note 28, at 11 ("While the banks may be clearly motivated and justified in their actions to extend loans to continue to earn income rather than take steep losses in a liquidity-challenged capital market, such actions may be simply delaying the inevitable, especially at properties that are beginning to falter under the weight of declining net operating income.").

85. Mollenkamp & Wei, *supra* note 84.

> That is the same thing that we have criticized the speculators about. You got a lower interest rate on a 10-year loan with a balloon on it than you would have gotten on a 30-year loan had you fully amortized it.
>
> So do I understand that the real estate market is not set up anymore to amortize loans ever? Do we always contemplate that they wou'ld be refinanced at the end of some payment term? That is a troubling notion to me, because I never thought of that. . . . When we got a loan, we expected to pay it. And that is the kind of personal responsibility that we have been preaching to every borrower in this country.[86]

The witness replied that in commercial real estate, a ten-year partially amortizing loan is the longest term loan available.[87] While thirty-year, fully amortizing loans are typical in residential real estate, they are typically unavailable for income-producing commercial real estate.[88] Lenders are unwilling to commit to a commercial real estate borrower, property, or interest rate longer than ten years. What Representative Watt interpreted as speculative behavior antithetical to a message of personal responsibility is a practice consistent with the advice of bank regulators who frown on such long-term loans.

Second, as Representative Watt's question reveals, many policymakers believe that the commercial real estate debt crisis is the result of risky behavior by borrowers and lenders. Essentially, they have adopted the narrative of the subprime residential crisis[89] to the commercial real estate debt crisis, blaming poor and aggressive underwriting to non-creditworthy borrowers for the crisis. Statements by representatives of the Federal Deposit Insurance Corporation, Federal Reserve, and Office of the Comptroller of the Currency are consistent with a perspective that poor underwriting contributed to the crisis, although none of the statements specify what relaxed standards may be to blame.[90] A remark by

86. *See Alternatives for Promoting Liquidity in the Commercial Real Estate Markets, Supporting Small Business, and Increasing Job Growth: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 28 (2010) (statement of Rep. Melvin Watt, Member, H. Comm. on Fin. Servs.).

87. *Id.* at 28–29.

88. *Commercial & Residential Mortgages*, STARTUP LOANS, http://www.startuploans.org/mortgages (last visited Jan. 17, 2012); Binyamin Appelbaum, *Without Loan Giants, 30-Year Mortgage May Fade Away*, N.Y. TIMES (Mar. 3, 2011), http://www.nytimes.com/2011/03/04/business/04housing.html.

89. For a discussion of the "subprime narrative," see FATEN SABRY & CHUDOZIE OKONGWU, NERA ECON. CONSULTING, STUDY OF THE IMPACT OF SECURITIZATION ON CONSUMERS, INVESTORS, FINANCIAL INSTITUTIONS AND THE CAPITAL MARKETS, 64–76 (2009), *available at* http://www.nera.com/extImage/PUB_ASF_Report_June_2009.pdf.

90. *Id.* at 68, 72–73.

Representative Hensarling is typical of the critique: "There are many people who benefited on the upside of the run-up of the commercial real estate market. They enjoyed the upside, and now they want the taxpayer to be exposed to the downside."[91]

As Patrick Parkinson of the Federal Reserve testified to the Congressional Oversight Panel, regulators believe that some properties are in the hands of the "wrong" borrowers, and that if loans are modified or extended, the assets will continue to decline in value.[92] While some commercial properties are mismanaged, this curious statement reveals something about the regulators' perspective. It focuses more on the quality of the borrower and less on the overall declines in real estate fundamental and market values that have been well-documented during the past three years. All of the regulators emphasize that while "poor" borrowers may find it difficult to obtain loans in this environment, "creditworthy" borrowers will still be able to obtain loans. The implication is that relaxed underwriting standards allowed undeserving borrowers to obtain debt, and those borrowers will now be weeded out. Again, this is consistent with the subprime narrative, but a curious perspective in light of the underwriting of commercial real estate, which looks to the income generated by the asset itself to pay debt service and generally offers borrowers non-recourse or limited-recourse loans.[93] These statements may be a subtle signal that regulators want all new commercial real estate loans to be full-recourse, with more emphasis placed on the other assets and income streams of the borrower. If so, that change would have significant distributive repercussions for the commercial real estate market and further privilege large, well-capitalized borrowers at the expense of small borrowers. It would also ignore the historical reasons why lenders chose to employ non-recourse or limited-recourse loans in commercial real estate.[94]

Finally, in the absence of commercial real estate borrowers or lenders who are deemed "too big to fail," policymakers have dismissed many CRE

---

91. *Alternatives for Promoting Liquidity in the Commercial Real Estate Markets*, *supra* note 86, at 7 (statement of Rep. Jeb Hensarling, Member, H. Comm. on Fin. Servs.).

92. *Commercial Real Estate's Impact*, *supra* note 53, at 87 (testimony of Patrick Parkinson, Director, Division of Supervision and Consumer Protection, Board of Governors of the Fed. Reserve).

93. BRUEGGEMAN, *supra* note 78, at 447.

94. *See* GEORGE LEFCOE, REAL ESTATE TRANSACTIONS, FINANCE, AND DEVELOPMENT 205 (6th ed. 2009) (explaining that non-recourse permanent debt became routine following the real estate crisis of the early 1990s) ("Lenders noticed that non-recourse borrowers were far more willing than recourse borrowers to stand aside and allow their lenders to foreclose once convinced they had little chance of realizing any equity value. Recourse commercial borrowers, those who had guaranteed or signed mortgage-secured notes, and were no longer able to service the debt from their declining rent rolls, aggressively sought to delay foreclosure by filing lender liability lawsuits, contested bankruptcy actions or anything else they could think of to stave off the day when they would be booted out of their homes by lenders pursuing deficiency claims following foreclosure. These delays proved costly to lenders as real estate values were declining during this period.").

borrowers and lenders as too small to notice, ignoring the aggregate importance of these small institutions and entities to the broader market.[95] Two members of the Congressional Oversight Panel, A. J. Mark McWatters and Paul S. Atkins, argued that the market should resolve itself and "cull" these smaller, weaker actors, no matter how painful:

> A market economy by necessity must cull or marginalize the products and services of the weakest participants so that those who have developed innovative and competitive ideas may prosper on a level playing field. Any attempt by the Administration to prop-up the financial institutions and developers who contributed to the oversupply of CRE property is not in the best interests of the more prescient and creative market participants or the taxpayers. The opportunity for entrepreneurs to succeed or fail based upon their own acumen and judgment must survive the current recession . . . .[96]

This argument focuses on the alleged moral failings of the commercial real estate borrowers and lenders. It also assumes that someone will step in to fill the void left by the departure of the weakest participants. To the extent this statement refers to owners and borrowers, it is not clear that other more innovative actors are clamoring to acquire their real estate holdings, particularly in struggling markets. If the statement refers to the weak real estate, it will not simply go away. An older retail center may be out-positioned by a shiny new shopping center in a better location, but the weaker asset will not simply vanish. It may be redeveloped into a better use, but that kind of transformation is expensive, requires financing, and is often an illusive goal in rural areas and mature urban or suburban areas. By advocating for the weakest participants in commercial real estate to be culled or marginalized, some policymakers appear willing to sacrifice not only small businesses and small banks but also entire communities that cannot compete for tenants with higher income, more densely populated areas.

Policymakers' attempts to apply the narrative of the subprime residential real estate crisis to the commercial real estate crisis demonstrates that they do not understand (1) what actually caused the commercial real estate debt crisis, or (2) how commercial real estate is structured, financed, and valued. This Article will present an alternative narrative of the factors that led to the equity gap and the commercial real

95. NFIB RESEARCH FOUND., *supra* note 12, at 31 ("[S]mall employers own a considerable amount of commercial real estate.").

96. COP REPORT, *supra* note 5, at 159.

estate debt crisis. It will continue by refuting the flawed assumption that a single, fungible commercial real estate market exists. Finally, Part II concludes by confronting the government's assumption that current valuations are meaningful, with an explanation of the valuation methodologies utilized in commercial real estate and an analysis of the validity of such methodologies in a nonfunctioning marketplace.

A. What Really Caused the Commercial Real Estate Debt Crisis

The structural realities and economic conditions that led to the equity gap and, more broadly, the commercial real estate debt crisis are complex and intertwined. At least six separate factors can be identified as contributing to the current problems.

First, commercial real estate prices rose nearly 60% between 2004 and the market's peak in mid-2007.[97] These increased values were driven by positive economic conditions, a tightening of the relationship between supply and demand, and an influx of capital into the commercial real estate market, which drove values up. Attracted by the high fees that commercial real estate loans generate, plus the fairly low delinquency and default rates during the mid-2000s, lenders competed to make loans to qualified borrowers, putting upward pressure on loan-to-value ratios. This combination of high valuations and high loan-to-value ratios left borrowers particularly vulnerable to steep drops in valuation.

Second, the stress of the current economic crisis has caused vacancy rates to rise, asking rents to fall, and landlords to grant rent concessions to keep tenants open.[98] The drag on these fundamental metrics has reduced the net operating income of many commercial properties. Appraisers, stung by criticism that their overly optimistic evaluations of value might have played a role in the residential subprime crisis, retreated to more conservative assumptions.[99] So, in addition to experiencing actual drops in net operating income, borrowers faced appraisals that assumed further vacancy allowances and reductions in market rent going forward. This combination of factors has led to severe drops in value.

---

97. Parkus Testimony, *supra* note 40, at 34.

98. JONATHAN D. MILLER ET AL., URBAN LAND INST. & PRICEWATERHOUSECOOPERS, EMERGING TRENDS IN REAL ESTATE 51 (2011), *available at* http://www.uli.org/~/media/Documents/ResearchAndPublications/EmergingTrends/Americas/2011/ET_US2011.ashx ("Levels of concessions have been unprecedented. Malls look full, but owners forgive back rent, cap CAM [common-area maintenance] charges, or just let stores stay open without paying anything.").

99. *Full Committee Hearing on Increasing Access to Capital for Small Business: Hearing Before the H. Comm. on Small Business*, 111th Cong. 72 (2009) ("[A]ppraisers have become much more conservative in their valuations of commercial real estate . . . ." (statement of Zola Finch, Past Chair, Board of Directors, National Association of Development Companies)).

Third, the paralyzed capital markets and initial wave of foreclosures and distressed property sales distorted valuations further. In 2010, approximately 22% of all commercial real estate transactions involved distressed property.[100] Analysts predicted that distress would "continue to be a significant factor in the market well into 2011 and beyond."[101]

Fourth, the short-term nature of commercial real estate loans dictates that significant maturity rollover will take place before the capital markets have time to thaw. The years 2005–2008 saw dramatic increases in loan originations—nearly $2.8 trillion in commercial real estate loans were made during this four-year period, almost double the $1.5 trillion in loans made during the prior four years.[102] Assuming average terms between five and ten years, these loans are expected to mature between 2010 and 2018. The following table depicts estimates of the maturity dates of commercial real estate debt, categorized by type of lender.

Table 4: Commercial Mortgage Maturities by Lender Type[103]

The flood of maturities, combined with the lack of available financing, has caused values to artificially drop even further.[104] The bankruptcy

100. REAL CAPITAL ANALYTICS, U.S. CAPITAL TRENDS: THE BIG PICTURE (2011); Mark Heschmeyer, *Latest Repeat Sales Analysis Finds CRE Pricing Holding to SeeSaw Pattern*, COSTAR GROUP (Feb. 16, 2011), http://www.costar.com/News/Article/Latest-Repeat-Sales-Analysis-Finds-CRE-Pricing-Holding-to-SeeSaw-Pattern/126557?ref=100&iid=219&cid=6DB0336BB4DD8B95D26 9974470E02B45.

101. REAL CAPITAL ANALYTICS, *supra* note 100, at 3 ("A total of $300 [billion] of significant commercial property became distressed this cycle, and $190.1 [billion] of that remains unresolved. It is also important to note that while new instances of distress are slowing, the $13.8 [billion] of new distress recorded in Q4 [2010] is small only in comparison to prior quarterly inflows.").

102. FIORILLA & TAYLOR, *supra* note 35, at 1.

103. COP REPORT, *supra* note 5, at 71. Data provided by Foresight Analytics, LLC.

104. *Commercial Real Estate: Do Rising Defaults Pose a Systemic Threat?*, *supra* note 35, at 10 (testimony of Jeffrey D. DeBoer).

reorganization of General Growth Properties, the second largest public real estate investment trust (REIT), dramatically demonstrates the problem. On December 31, 2008, General Growth reported $29.6 billion in assets, primarily ownership interests in 200 shopping centers in forty-four states,[105] and $27.3 billion in debt.[106] Approximately $18.4 billion of that debt was scheduled to mature before 2012.[107] The project-level loans that constituted the vast majority of the debt were typical of the industry: three-to-seven year terms, low amortization, and balloon payments due at maturity. Like other owners of commercial real estate, General Growth's business plan was premised on its ability to refinance.[108] When the credit markets froze in mid-2008, General Growth suddenly found itself facing billions in maturing debt and an inability to refinance. In January 2009, General Growth attempted to work with the master servicers on its CMBS loans scheduled to expire through January 2010, but found that the CMBS structure did not permit such a proactive approach.[109] Without refinancing proceeds and facing a steady stream of maturities, General Growth was forced to use its operating cash to pay mounting financing obligations. On April 16, 2009, suffering from a liquidity crisis, its capital structure devastated by the inability to refinance, General Growth caused 388 of its 750 subsidiaries to file for Chapter 11 bankruptcy restructuring.[110]

Fifth, lenders, reeling from the residential real estate crisis, began paying closer attention to loan covenants, particularly loan-to-value ratios. Although these problems are particularly acute for the borrowers unable to refinance upon maturity, the equity gap represents a challenge for all commercial real estate borrowers because of the standard covenants that require maintenance of loan-to-value ratios and debt service coverage ratios.[111] Combine a partially amortizing loan with a steep drop in market value, and millions of commercial real estate loans are out of balance and therefore in technical default, even if the borrower has never missed a payment.

105. *In re* Gen. Growth Prop., Inc., 409 B.R. 43, 47–48 (Bankr. S.D.N.Y. 2009).

106. *Id*. at 48.

107. *Id*. at 55.

108. *Id*. at 53.

109. *Id*. at 54. After CMBS debt is securitized, a "master servicer" is charged with administering the loan on behalf of the investors.

110. *Id*.

111. The debt service coverage ratio represents the relationship between the monthly debt payments and the net operating income of the secured asset. There do not appear to be any empirical studies that track debt service coverage ratios over time. However, it appears that over the past decade, they have remained in the 1.25x to 1.50x range. *See* MISONZHNIK, *supra* note 32. This means that to be in compliance with a 1.25x debt service coverage ratio, the net operating income of a property must exceed 125% of the debt service payments. This required ratio is designed to ensure that a property is able to generate sufficient income to cover its expenses (taxes, maintenance, etc.) and debt service with cash to spare.

Most commercial loans are structured with covenants that specify the loan-to-value ratio and debt service coverage ratio in place during underwriting will be maintained during the life of the loan.[112] If the loan-to-value ratio falls because capitalization rates spike, even if the net income of the property remains constant, the borrower will be in default.[113] If a tenant defaults early on a lease and the debt service coverage ratio falls out of balance during re-tenanting, the borrower will be in default.[114] These kinds of defaults are often called "technical" defaults since they are not triggered by the borrower's failure to meet monthly debt service payments.[115] But the fact that defaults are "technical" does not make them less meaningful for the borrower or for the lender.[116] Covenants that require compliance with these ratios are a kind of early warning system for lenders. If the property becomes over-leveraged, or if the debt service coverage ratio is out of balance, then the lender becomes concerned that the borrower might be on the verge of payment default, or may be at risk to walk away from the property and the loan.

During the 2000s, owners worried little about technical defaults, so long as they maintained the contractual payment schedule. But during a down market, lenders need to be more aware of the fluctuating market value of the underlying collateral to allow them to take action to preserve the value of that collateral, if necessary. Although this issue is clear on a project-specific basis, there does not appear to be any empirical data that measures the number of bank loans in technical default or the average loan-to-value ratios of commercial real estate loans held by banks. If estimates of the size of the equity gap are correct, then a significant number of commercial real estate borrowers are at least in technical default. Anecdotal information from borrowers and lenders indicate that loan covenants are being used by lenders widely in order to force borrowers to invest additional equity into projects and bring loan-to-value ratios back into balance.

---

112. Joan H. Story & Jodi B. Fedor, *Lending: Mortgages and Beyond*, *in* COMMERCIAL REAL ESTATE INSTITUTE COURSE HANDBOOK (12TH ANNUAL) 413, 430–31 (2010).

113. LEFCOE, *supra* note 94, at 200.

114. *Id.* at 201.

115. *Technical Default*, INVESTOPEDIA, http://www.investopedia.com/terms/t/technical-default.asp#axzz1b3te8YAW (last visited Jan. 17, 2012).

116. For example, consider the saga of One Kendall Square, a 676,000-square-foot commercial property in Cambridge, Massachusetts. Although 90% leased and current on all debt payments, the holder of the $180 million mortgage, Anglo Irish Bank, initiated foreclosure proceedings because the property failed to meet its required loan-to-value ratio. Although the property was described as "one of the best-performing assets in the bank's U.S. portfolio," the lender was in trouble and attempted to use the technical default as leverage to force the owner to refinance and repay the loan in full prior to maturity. *Anglo Goes After Its Boston Loan Book*, IRISH EMIGRANT, http://www.irishemigrant.com/ie/go.asp?p=story&storyID=7805 (last visited Jan. 17, 2012).

A final factor contributing to the emergence of the equity gap is property taxes. Property taxes are often tied to the most recent purchase price; therefore, the rise in property values during the 2000s led to significant increases in property tax burdens.[117] Municipalities are not so quick to apply downward adjustments to property taxes when market values fall. In addition, taxing authorities are under increased stress due to the economic downturn, which discourages major adjustments to assessed valuations.

B. The Trifurcation of the Commercial Real Estate Market

At the center of the policy responses to the commercial real estate crisis is the assumption that there is a single commercial real estate market. The Federal Reserve believed that restarting the CMBS market through TALF support would begin the flow of credit and relieve pressure on banks. The regulatory agencies encourage workouts but ultimately believe that borrowers and lenders should accept losses on non-viable projects and move on. These policies assume a single, fungible market in which borrowers, buyers, sellers, lenders, and tenants move freely. It is a market in which a non-creditworthy borrower can lose a property through foreclosure and be replaced by a more creditworthy owner better able to secure a loan. It is a market in which any creditworthy borrower can avail herself of CMBS financing. It is a market that does not exist.

Instead, the income-producing commercial real estate industry is fragmented according to a number of different criteria: (1) size of the asset, (2) location of the asset, (3) product type, (4) quality of the asset, (5) tenant mix, (6) type of owner, and (7) type of lender. Once the market is broken down by these criteria, at least three different commercial real estate submarkets clearly emerge: the Investment-Grade segment, the Regional segment, and the Local segment.

1. Size of the Asset

Commercial real estate assets run the gamut from small, single tenant buildings worth less than $100,000 to super-regional shopping malls and forty-plus story office buildings worth hundreds of millions of dollars. It does not appear that any empirical studies have been done to quantify the distribution of commercial real estate assets by size. However, a quick drive around town demonstrates that in sheer numbers, the majority of

117. Christopher Hahn, *Commentary*: *Deal Creatively with Property Taxes*, LONG ISLAND BUS. NEWS, Dec. 10, 2009, http://libn.com/2009/12/10/hahn-deal-creatively-with-property-taxes/ ("[V]acancy rates are at 20-year highs and so are property taxes.").

commercial real estate assets are small, particularly in rural areas and the older parts of cities and suburbs.

2. Location of the Asset

Commercial real estate assets are classified by geographic location in a number of different ways. First is the division into primary, secondary, and tertiary markets. "Primary markets" is a very exclusive category limited to New York City (primarily Manhattan), Boston, Los Angeles, San Francisco, and Washington, D.C.[118] "Secondary markets" are large cities with strong, diversified economies like Chicago, Atlanta, Miami, Phoenix, and Charlotte.[119] "Tertiary markets" are, essentially, the rest of the country.[120]

Geographic location can also be divided by location within a population center. The "central business district," or "CBD," is basically the core of downtown where office buildings and economic activity are clustered.[121] The suburbs can be classified as "emerging" or "mature" depending on whether development activity is ongoing or the area is fully built out. Rural areas are obviously outside of cities. These classifications are important because they play a role in valuation methodologies.

3. Product Type

There are five major types of income-producing commercial real estate: (a) multi-family housing and apartments, (b) retail, (c) office, (d) industrial, and (e) hospitality (including hotels and resorts).[122] Some properties combine two or more of these uses in a single "mixed use"

118. MILLER ET AL., *supra* note 98, at 12 ("Everybody wants to be in the primary coastal cities with international airport hubs. Business and commerce concentrate there, attracting more highly educated workers to higher-paying jobs."); *id*. at 27 ("'[D]ominant institutional buyers concentrate on only eight or nine markets, ... global gateway cities for headquarters and lower-cost Sunbelt cities with international airport access for back office. . . . Accessibility and workforce are key. It's the yin and yang of links to global pathways—big airports, good labor pools, and company operations centers.'").

119. Elaine Misonzhnik, *Bush League No More*, RETAIL TRAFFIC (June 1, 2007, 12:00 PM) http://retailtrafficmag.com/mag/retail_bush_league_no ("The real estate industry is still split on what constitutes a secondary or tertiary market. REIS, Inc., for example, defines the markets based on transaction volume. The areas on the bottom of the scale fall into the secondary or tertiary category. CB Richard Ellis, on the other hand, looks at population density — a trade area with less than one million people is considered to be a secondary location, those with less than 400,000 people a tertiary one. Some companies might weigh additional considerations, including projected job growth and migration patterns.").

120. *Id*.

121. ICSC'S DICTIONARY OF SHOPPING CENTER TERMS 22 (2d ed. 2005).

122. *See* GRANT S. NELSON ET AL., REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT 1193 (8th ed. 2009).

project. For example, a multi-story building could include retail on the first floor and offices or apartments on the higher floors. Commercial real estate also includes some other highly specialized income-producing uses like medical facilities, educational facilities, sports facilities, and entertainment venues.

4. Quality of the Asset

Commercial real estate assets are classified by letter grades, generally ranging from A to C.[123] Class A assets are generally large, newer, and built of high quality materials with a high level of finish. They are located at the most convenient locations in the most desirable markets. They have ready access to parking and other customary amenities for the product type. Class B properties are generally a little older or smaller. They are in good locations, but may be out-positioned by newer, Class A properties. Class C buildings are generally older or of lesser quality construction. They are normally unrenovated and dated in finish and amenities. The quality of an asset has a direct impact on how much a landlord can charge in rent. Class A properties can obviously charge more per square foot than Class B or Class C properties.

5. Tenant Mix

All tenants may prefer Class A buildings, but not all tenants can afford to locate there. Commercial real estate owners value a predictable, secure income stream, and all owners prefer tenants with good credit and a history of profitability. The owners of Class A buildings are generally in a better position to secure the so-called "credit tenants," who are valued for their demonstrated ability to pay rent. At the other end of the spectrum are so-called "mom and pop" tenants, small businesses that either have a limited history of operations or lack of good credit standing behind the lease obligations.

It has been observed that in an environment in which vacancy rates are rising, tenants will attempt to move from Class C to Class B, and from Class B to Class A because reduced rental rates allow increases in standards at little or no cost. This phenomena results in generally lower vacancy rates for Class A buildings, compared to their lower-class competitors.

123. *See* ICSC'S DICTIONARY OF SHOPPING CENTER TERMS, *supra* note 121, at 24.

6. Type of Owner

Anyone can own commercial real estate. This Article classifies the universe of commercial real estate owners into three broad categories. "High Capital" owners are defined as large, superregional, national, and international companies and institutions with ready access to capital and sophisticated advisors. High Capital owners include public real estate investment trusts[125] (REITs), private REITs, investment managers, insurance companies, pension funds, equity funds, and national private real estate and investment companies. "Medium Capital" owners are defined as regional companies and institutions with less robust access to capital and a more limited reach. Medium Capital owners include some corporations, educational institutions, hospitals, banks, and regional private real estate and investment companies. "Limited Capital" owners are individuals. Individuals may own one commercial real estate asset for investment purposes, or they may own several, but they are not really in the business of commercial real estate.

It appears that no empirical work has been done to quantify the distribution of commercial real estate between these three classes of owners. However, Table 5, an analysis of commercial real estate transactions that occurred in 2010, provides a snapshot.

Table 5: Analysis of 2010 Commercial Real Estate Transactions by Buyer Type (U.S.)[128]

Class of Buyer	*Percentage of Total Sales Transactions in 2010*	*Percentage of Total Sales Volume in 2010*	*Average Sales Price*
High Capital	12.4%	57.6%	$8,850,351
Medium Capital	42.4%	32.3%	$1,451,431
Limited Capital	45.2%	9.4%	$396,232

125. "[A] REIT is a corporation or business trust (taxable as a corporation) formed to generate income from the leasing of real estate . . . . The REIT's principle advantage over other publicly-traded entities is that it may avoid paying federal (and in many instances state) income tax as a result of deducting dividends paid to shareholders from pre-tax income." NELSON ET AL., *supra* note 122, at 1202–03.

128. This data was derived from the CoStar Group's CoStar Property Professional database. All transactions completed between January 1, 2010, and December 31, 2010, in the United States for which a buyer type was identified were analyzed and categorized. The spreadsheets and original calculations are in the author's files.

On a rough basis, this set of data demonstrates that while High Capital buyers are involved in only 12.4% of transactions, those transactions have a high average value, which results in High Capital control of nearly 60% of total sales volume. At the other end of the spectrum, Limited Capital buyers (individuals) were responsible for purchasing nearly half of the commercial real estate assets sold in 2010, but the average transaction size was less than $400,000, which resulted in less than 10% of total sales volume.

These differences are even more significant when the second criterion, location of asset, is added to the analysis. Compare the distribution of transactions in Manhattan in 2010 versus the transactions in the 10 smallest states in the United States by population.[129]

Table 6: Analysis of 2010 Commercial Real Estate Transactions by Buyer Type (Manhattan)[130]

Class of Buyer	*Percentage of Total Sales Transactions in 2010*	*Percentage of Total Sales Volume in 2010*	*Average Sales Price*
High Capital	22.2%	52.7%	$42,061,876
Medium Capital	39.6%	39.5%	$17,673,921
Limited Capital	38.2%	7.8%	$3,617,947

It is somewhat surprising that nearly 40% of commercial real estate transactions in Manhattan involved a Limited Capital buyer, but the average size of those transactions was still small by Manhattan standards and resulted in less than 8% of total sales volume. High Capital buyers, once again, were the most dominant group, although Medium Capital buyers controlled a larger share of the total sales volume in Manhattan compared to the U.S. average. The picture in the ten smallest states is very different.

129. According to U.S. Census data, the 10 smallest states by population are: Alaska, Delaware, Hawaii, Maine, Montana, North Dakota, Rhode Island, South Dakota, Vermont, and Wyoming. U.S. CENSUS BUREAU, POPULATION DISTRIBUTION AND CHANGE: 2000 TO 2010, at 2 (2011), *available at* http://www.census.gov/prod/cen2010/briefs/c2010br-01.pdf.

130. *See supra* note 128.

Table 7: Analysis of 2010 Commercial Real Estate Transactions by Buyer Type (Ten Smallest States)[131]

Class of Buyer	*Percentage of Total Sales Transactions in 2010*	*Percentage of Total Sales Volume in 2010*	*Average Sales Price*
High Capital	4.5%	36.4%	$6,406,228
Medium Capital	43.7%	46.5%	$842,723
Limited Capital	51.8%	16.2%	$247,684

High Capital buyers are very selective in tertiary markets. They were involved in less than 5% of total transactions, but given the relatively large size of those transactions, still acquired over one-third of total sales volume. On the other hand, Limited Capital buyers were even more active in these areas than the national average and despite the even smaller average transaction size, managed to acquire 16% of total sales volume.

While there are outlier transactions in each category, this data confirms an intuitive alignment between different criteria and suggests the contours of the three separate commercial real estate markets. The commercial real estate market can be roughly broken into three segments: (1) the Investment-Grade segment, (2) the Regional segment, and (3) the Local segment.

The Investment-Grade segment is populated by High Capital owners and Class A buildings.[132] The Investment-Grade segment includes "trophy properties" and other desirable properties in primary markets.[133] As one analyst put it, "[m]any secondary cities and most tertiary markets just do not appear on investor radar screens. 'You see no demand, no capital, and no interest.'"[134]

The Regional segment is populated by High Capital and Medium Capital owners who own mainly Class A and some Class B buildings. The Regional segment includes desirable properties in secondary and tertiary markets, and some properties in primary markets.

131. *See supra* note 129.

132. MILLER ET AL., *supra* note 98, at 13 ("Premier downtown buildings remain investor mainstays in New York City, Washington, D.C., and the select few 24-hour markets situated along global pathways.").

133. Brian Louis & David M. Levitt, *U.S. Commercial Property Recovery Spares Economy Another Blow*, BLOOMBERG (Feb. 3, 2011, 11:00 PM), http://www.businessweek.com/news/2011-02-04/u-s-commercial-property-recovery-spares-economy.html.

134. MILLER ET AL., *supra* note 99, at 29.

The Local segment contains everything else. Medium Capital and Limited Capital owners own the majority of Class B and C buildings in primary, secondary, and tertiary markets. Only a few of the best properties in tertiary markets rise out of the Local segment to a higher segment of the market. The Local segment of the market represents the lion's share of commercial real estate in the United States.

This fragmentation into market segments is rough, but the significance of this alignment to the commercial real estate debt crisis becomes clear when the final criterion is added to the mix: type of lender.

7. Type of Lender

Three categories of lenders are mainly interested in commercial real estate: banks, insurance companies, and issuers of CMBS.[135] A fourth type of lender, government-sponsored entities (GSEs), represents nearly 15% of total commercial real estate debt outstanding, but that debt is limited to a single asset class—multifamily housing.[136] GSEs are not involved in lending to any other asset class.

As the following table illustrates, the majority of commercial real estate debt is held by banks.[137] As will be discussed shortly, nearly 40% of this exposure is to commercial construction loans,[138] which are significantly riskier than permanent commercial loans. Insurance companies hold approximately 10% of commercial real estate debt, and issuers of ABS or CMBS hold approximately 20%.

135. *See* Bianca A. Russo, *Commercial Mortgage Securitization*, *in* NEW DEVELOPMENTS IN SECURITIZATION 2010 COURSE HANDBOOK 1,013 (2010).

136. *See infra* Table 8 and note 140.

137. COP REPORT, *supra* note 5, at 37.

138. Parkus Testimony, *supra* note 40, at 34. The delinquency rate for construction loans as of September 30, 2010, was 19.5% compared to an average delinquency rate of 5.6% for permanent commercial loans. FORESIGHT ANALYTICS, ADVANCE 3Q 2010 DELINQUENCY RATE ESTIMATES (2010) (private research report on file with author).

Table 8: Lender Groups for Commercial Mortgage Debt[139]

(Billions of dollars; amounts outstanding as of June 30, 2010.)

Lender Group	*Commercial Mortgage Debt*[140]	*% of Total Commercial Mortgage Debt*
Banks[141]	$1,638.1	50.5%
Insurance companies[142]	$322.5	9.9%
GSEs[143]	$478.7	14.8%
ABS issuers	$651.7	20.1%
Other[144]	$152.1	4.7%
Total	$3,243.1	100%

It appears that no empirical research has been done regarding the alignment between segments of the market and types of lenders. However, anecdotal evidence suggests that strong alignment exists,[145] a conclusion that is supported by circumstantial data.

Traditionally, all commercial real estate mortgage lending was the province of local banks. A prime fictional example is the Bailey Building and Loan Association of Bedford Falls.[146] This concentration of commercial real estate debt at the local level was likely a result of the thinking that "all real estate is local" and the lack of a federal agency to

139. All data taken from FED. RESERVE, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS SECOND QUARTER 2010, at 96–97 tbls.L.218, L.219 & L.220 (2010), *available at* http://www.federalreserve.gov/releases/z1/20100917/z1.pdf.

140. Commercial mortgage debt figures were determined by combining the data from Table L.219 (multifamily residential) and Table L.220 (commercial). *Id*. at tbl.L.219 & L.220.

141. This category includes commercial banks, savings institutions, and credit unions.

142. This category includes casualty insurance companies, life insurance companies, private pension funds, and state and local government retirement funds.

143. This category includes government-sponsored enterprises, agency- and GSE-backed mortgage pools, state and local governments, and the federal government.

144. This category includes the household sector, nonfinancial corporate businesses, nonfarm corporate businesses, finance companies, and REITs.

145. *See, e.g.*, Story & Fedor, *supra* note 112.

146. IT'S A WONDERFUL LIFE (Liberty Films 1946). Note George Bailey's speech to the customers of the bank when they demanded their deposits back: "No, but you . . . you . . . you're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house . . . right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can."

create a national market for commercial real estate debt, like Fannie Mae or Freddie Mac did for residential real estate debt. The commercial real estate financing market opened up with the advent of commercial mortgage securitization in the mid-1980s, which dramatically accelerated at the end of the 1990s and beginning of the 2000s, peaking in 2007.[147] By the height of the market, CMBS loans constituted fully 25% of the dollar volume of new originations.[148]

But the strong emergence of the CMBS market did not impact all segments of the market equally. Instead, CMBS originators have a strong preference for newer, large office and retail assets[149] in primary and secondary markets with High Capital owners.[150] In the fourth quarter of 2006, the quarter with the highest origination level, the average CMBS loan was $21.1 million.[151] From the first quarter of 2004 through the fourth quarter of 2007, the average CMBS loan, averaged on a quarterly basis, ranged from $11.9 million to $52.9 million.[152] CMBS originators had strong geographical preferences, with 50% of CMBS debt on properties located in just five states: California, New York, Texas, Florida, and Illinois.[153] In contrast, the ten smallest states by population collectively represented 1.7% of total CMBS debt outstanding as of December 31, 2010.[154] This circumstantial data is consistent with the conclusion that CMBS debt is limited to the Investment-Grade segment.

Insurance companies have historically been conservative in their commercial real estate lending, preferring high quality operating properties with good credit tenants.[155] Insurance companies normally limit their lending to the Investment-Grade segment and the very best properties and borrowers in the Regional segment.[156]

Banks have provided the remainder of the commercial mortgage lending. Although banks sometimes make loans in the Investment-Grade

---

147. CRE FIN. COUNCIL, *supra* note 31, at app. A2.

148. *Id.* at exhibit 19.

149. *Id.* at exhibit 11.

150. Office and retail assets constitute nearly 60% of CMBS loans. COP REPORT, *supra* note 5, at 55 fig.23.

151. MORTG. BANKERS ASS'N, QUARTERLY SURVEY OF COMMERCIAL/MULTIFAMILY MORTGAGE BANKERS ORIGINATIONS: Q1 2009 (2009), *available at* http://www.mbaa.org/files/Research/CommercialOriginations/1Q09CMFOriginationsSurvey.pdf.

152. Misonzhnik, *supra* note 32 ("CMBS lenders have upped the average dollar amount of each individual loan that goes into the issue. . . . The reason is that with fewer smaller loans in the issue investors feel more comfortable with their ability to analyze every loan. They no longer blindly trust issuers to do the due diligence for them."); MORTG. BANKERS ASS'N, *supra* note 151.

153. CRE FIN. COUNCIL, *supra* note 31, at exhibit 10.

154. *Id*.

155. *See* Story & Fedor, *supra* note 112, at 415.

156. MILLER ET AL., *supra* note 98, at 18 (describing "loans on trophy assets in larger markets" as the "bread and butter" for life insurance company commercial real estate lending).

segment, they make nearly all of the loans in the Local segment and most of the loans in the Regional segment.[157]

C. The Problem with Commercial Real Estate Valuations

The commercial real estate industry is fairly insular and uses a specialized vocabulary.[158] Few publications aimed at a general audience explain the industry in detail, which results in a significant knowledge gap between insiders and outsiders. In particular, the art and science of real estate appraisal appears to most outsiders to be occurring in a black box. The mystery surrounding real estate appraisal is compounded by the confidentiality that surrounds the appraisals themselves. This understandably myopic view of the commercial real estate valuation process hinders policymakers from understanding the core causes of the commercial real estate debt crisis and crafting appropriate responses. This Article seeks to cure that knowledge gap with a detailed explanation of the valuation process.

The value of commercial real estate is rooted in its ability to generate income and the price that investors are willing to pay for that income. Objective attributes such as location, convenience to population centers and major thoroughfares, access to utilities, and age and quality of the improvements are important, but primarily in that they impact the rents that may be charged and the investors' perception of the risk in collecting that income stream. For example, the average asking rent for non-anchor retail space in Miami, Florida, is currently \$23.82 per square foot,[159] but only \$12.35 per square foot in Columbus, Ohio.[160] Rents in Midtown Manhattan office buildings average \$55.27 per square foot,[161] but the landlord of a Class A high-rise office building in Kansas City can only charge \$19.72 per square foot.[162] Part of these large spreads can be explained by the costs of construction. It is more expensive to build commercial real estate in some markets due to higher land prices, development controls, complicated processes for governmental approvals, and material and labor costs. Those

157. *Alternatives for Promoting Liquidity in the Commercial Real Estate Markets, Supporting Small Businesses, and Increasing Job Growth*, *supra* note 86, at 20 ("A majority of the smaller balance commercial real estate loans are on the balance sheets of our Nation's community banks." (statement of Todd Lindsey, Partner, U.S. Capital)).

158. *See* Joshua Stein & Obianuju A. Enendu, *The Language of Commercial Real Estate Finance*, PROB. & PROP., Mar.–Apr. 2009, at 59.

159. REIS, METROTREND FUTURES: RETAIL – 3RD QUARTER 2010, METRO: MIAMI (2010) (non-public research report on file with author).

160. *Id*.

161. *The Assessor: A Few Bright Spots*, WALL ST. J., Nov. 22, 2010, at A24.

162. CB RICHARD ELLIS, OFFICE OUTLOOK: KANSAS CITY 3 (2010) (non-public research report on file with author).

higher costs translate into higher rents. But retail and office tenants, for example, are also willing to pay higher average rents in Manhattan and Miami than in Kansas City and Columbus because of demographic characteristics such as higher population densities, which may translate into more significant returns for developers and owners.

In addition to these market disparities, investors generally value each $1 of rental rent in primary markets like Midtown Manhattan more highly than $1 of rental income in tertiary markets like Kansas City or Columbus for a variety of reasons.

Three appraisal methods are generally used to determine the market value of commercial real estate: (1) the cost approach, (2) the sales comparison approach, and (3) the income capitalization approach.[163] Since each of the three valuation techniques has a different perspective, they normally arrive at different estimates of market value. These three values are then reconciled for a subject property based on the appropriateness of each method for the property given market conditions and other considerations.

For example, consider the valuation of a small Midwestern retail shopping center named Blackacre Plaza.[164] The 58,029 square feet retail center was constructed by private developers in 2005 adjacent to a grocery store owned directly by its operator. Blackacre Plaza was designed to hold up to twenty-four "small shop" retail tenants in units ranging from 728 to 6,435 square feet.[165] Small shop tenants normally include local nail salons, dry cleaners, local and national restaurants, video stores, coffee shops, and beauty salons. In June 2008, Blackacre Plaza was appraised using the cost approach, sales comparison approach, and income capitalization approach.

1. The Cost Approach

The cost approach assumes that a purchaser would pay no more than the cost of producing a substitute property with the same utility.[166] This approach is useful when the improvements being appraised are relatively new, or when the property has unique or specialized improvements for

163. APPRAISAL INST., THE DICTIONARY OF REAL ESTATE APPRAISAL (5th ed. 2010); Ron C. Bingham II & D. Cooper Robertson, *Reconciling "Dirt-for-Debt" Plans with "Indubitable Equivalent" Standard*, AM. BANKR. INST. J., Oct. 2009.

164. The valuation of Blackacre Plaza is based on the non-public appraisal of a real shopping center. The name and location of the property have been changed but all other data is consistent with the actual appraisal. APPRAISAL OF [BLACKACRE PLAZA] BY [APPRAISAL COMPANY] DATED JUNE 2, 2008 [hereinafter APPRAISAL] (on file with author).

165. *Id*. at 3.

166. Bingham & Robertson, *supra* note 163.

which there is little or no sales data from comparable properties.[167] The cost approach is normally the least useful valuation method for commercial real estate.[168] In addition, while the cost approach is based on solid theory, that is, that an informed purchaser would not desire to pay more for a property than it would pay to construct a substitute property with the same utility, the cost approach is rarely considered by potential purchasers except for new construction because purchasers acquire commercial real estate not for the underlying value of the land and improvements, but for the income generated by the leases in place.

2. The Sales Comparison Approach

The sales comparison approach assumes that a purchaser would pay no more for a property than the cost of acquiring another existing property with the same utility. Data is gathered from recent sales of properties comparable to the subject property in terms of property type, size, location, age, and quality of improvements. Those comparable sales are analyzed for material differences compared with the subject and then a valuation is reached.[169]

The validity of the sales comparison approach is dependent upon an active market for the same product type in the geographic area in which the subject property is located. The sales comparison method is less reliable in

167. In the cost approach, the replacement cost of the subject improvements is estimated by applying current construction costs to the various building components. An estimate of accrued depreciation to the subject property is then made. This estimate of accrued depreciation is then deducted from the replacement cost. Finally, the market value of the underlying land is added to the depreciated cost of the improvements to arrive at a final estimate of market value. For the cost approach, the appraiser of Blackacre Plaza estimated three sums: the replacement cost of the center, the accrued depreciation, and the market value of the underlying land. After analyzing comparable sales of land in the area, the real estate under Blackacre Plaza was assigned a value of $2,160,000. APPRAISAL, *supra* note 164, at 74. The replacement cost of the buildings, that is, the amount that the appraiser estimated that it would cost to reconstruct the improvements, was estimated at $92.73 per square foot (This estimate was based on data published by Marshall Swift Valuation Service, which the appraiser described as a "nationally accepted source for construction cost data." *Id*. at 75). The estimated replacement cost of the 58,029 square foot building was therefore $5,325,953 and the estimated replacement cost of the site improvements, such as the parking lot and landscaping, was $765,000. The improvements were then depreciated in accordance with their age and economic life expectancy. Retail buildings have an expected economic life expectancy of 45 years and site improvements have an estimated economic life expectancy of 20 years. Therefore, the building improvements were depreciated by 11.67% (5.25/45) and the site improvements were depreciated by 26.25% (5.25/20). So the replacement cost, minus the appropriate depreciation, was $6,585,829. Adding in the value of the underlying land, the cost approach valued Blackacre Plaza at $8,750,000. *Id*. at 79. It is important to note that this sum does not reflect replacement cost since it includes depreciation.

168. This is particularly true if the property is older, which makes it more difficult to estimate accrued depreciation, or if there are limited land transactions in the market area of the subject property, which makes estimates of the value of the underlying land difficult to achieve.

169. Bingham & Robertson, *supra* note 163.

an inactive market or when estimating the value of properties for which no directly comparable sales data is available.

In June 2008, the appraiser of Blackacre Plaza found six comparable sales of small retail centers in the market area that took place between August 2005 and March 2008. After making adjustments for features like location, age and condition, occupancy, and land-to-building ratio, the appraiser arrived at adjusted prices per square foot ranging from $109 to $204, with a mean of $166.[170] This fairly wide range is not atypical. After a few more adjustments, the appraiser concluded a market value of $160 per square foot for Blackacre Plaza, which resulted in a value of $9,500,000 through the sales comparison approach.[171]

As this cursory summary suggests, the appraiser has a wide range of discretion in determining which sales are comparable, how to adjust the purchase prices, and how to apply that data to a valuation. Another appraiser might have reasonably used the mean price per square foot from the comparables—$166. That $6 increase would have increased the valuation of Blackacre Plaza by nearly $350,000. For larger properties, the effect of slight changes is even more significant.

3. *The Income Capitalization Approach*

The income capitalization approach assumes that a purchaser would pay no more for a property than the cost of acquiring the same income stream from an equally risky investment. This approach converts the anticipated net income from ownership of a property into a market value indication through capitalization.[172] The validity of a value estimate under the income capitalization approach is dependent upon: (a) accurate calculations or estimates of net operating income; and (b) selection of an appropriate capitalization rate.[173]

The first step in the direct capitalization approach to income capitalization is to estimate the potential income stream from the property in a single year by analyzing leases in place and comparing actual rent to market rent. This sum is referred to as the "gross income." The second step is to estimate appropriate allowances for vacancy, collection loss, and operating expenses. The net operating income (NOI) of the property for that year is calculated by deducting expenses and allowances from the

170. APPRAISAL, *supra* note 164, at 109.

171. *Id*. at 113.

172. There are two methods of income capitalization: direct capitalization and discounted cash flow analysis. Seni M. Adio, *Valuing Real Property in Tax Abatement Litigation*, PRAC. REAL EST. LAW., Mar. 2002, at 19, 21. Since they are similar, only direct capitalization is used in this example.

173. 84 C.J.S. *Taxation* § 588 (2011).

gross income. The NOI is then divided by a capitalization rate[174] to arrive at a value estimate.

The income capitalization approach is considered to be the most reliable valuation method for an operating commercial real estate asset because it reflects the valuation criteria used by most buyers—the income generating potential of the property and the anticipated rate of return.

When analyzing the value of Blackacre Plaza via the direct capitalization method, the appraiser estimated the gross income of the property based on actual leases and market rents. It then calculated, based on actual Blackacre Plaza data plus data from comparable properties in the area, a vacancy rate, collection risk, and operating expenses. Those estimated expenses were subtracted from the gross income to arrive at an estimated net operating income of $771,665 for "Year 1." The appraiser drew upon several sources of data to arrive at an appropriate capitalization rate, including an industry survey that stated the average overall capitalization rate for national strip shopping centers was 7.32%, and an industry survey that stated the average overall rate for retail neighborhood commercial centers in the local market was 8.6%. Therefore, concluded the appraiser, "an overall capitalization rate between 7.32 and 8.6 percent would be reasonable."[175] The comparable sales were again analyzed to determine the capitalization rates at which they traded. The six sales used in the sales comparison approach were found to have traded at capitalization rates ranging from 6.56% to 8.71% with an average at 7.78%. Given this data, the appraiser selected a capitalization rate of 8.5% for Blackacre Plaza, near the top of its contemplated range. Dividing the net operating income by the designated capitalization rate led to a valuation of $9,080,000.[176]

The selection of a capitalization rate is highly significant. Consider the following table, which illustrates the impact on the valuation of Blackacre Plaza through the selection of a different capitalization rate.

174. The capitalization rate is an attempt to quantify the market influences that impact cash flow, which could include macro economic factors like capital liquidity and tax policy, and local factors like the supply/demand relationship for the particular asset type. Capitalization rates are market-driven, particular to a specific geographic area and a specific type of property, and can vary widely over time. For example, in the spring of 2010, capitalization rates for office buildings located in central business districts averaged 8.0% while office buildings located in suburban areas averaged 8.8%. A small change in the capitalization rate can have a significant impact on the value of the property. That effect is amplified as the net operating income rises.

175. APPRAISAL, *supra* note 164, at 98.

176. *Id*. at 100.

Table 9: Valuation of Blackacre Plaza Through Direct Capitalization Method

Source of Information	*NOI*	*Cap Rate*	*Value*
Real Estate Research Corporation, Spring 2008 (local average for neighborhood shopping centers)	$771,665	8.6%	$8,972,849
Appraiser-selected	$771,665	8.5%	$9,080,000
Average of six comparable properties	$771,665	7.78%	$9,918,573
Korpacz, PriceWaterhouseCoopers, Second Quarter, 2008 (national average for retail centers)	$771,665	7.32%	$10,541,872

Within the range of capitalization rates deemed "reasonable" by the appraiser, the value of Blackacre Plaza by the direct capitalization method varies from $9 million to $10.5 million, a swing of over $1.5 million or 17%. As with the sales comparison method, the income capitalization approach is dependent upon recent robust market data and an appraiser's selection of "appropriate" metrics.

After analyzing the value of Blackacre Plaza through the three methods of appraisal, the results were compared and a final "market value" was determined. The June 2008 value estimates for Blackacre Plaza are as follows:

Table 10: Comparison of Values

Cost Approach	$8,750,000
Sales Comparison Approach	$9,500,000
Income Capitalization Approach	$9,080,000

After considering the various approaches, the appraiser decided that the income capitalization approach was the most reliable and concluded that the market value of Blackacre Plaza was $9,000,000.

A central assumption of policymakers is that the valuation methodologies described above reliably generate meaningful conclusions. This assumption is fundamentally flawed in a distressed commercial real estate market in which liquidity was essentially nonexistent for an extended period of time. Appraisers will caution that all three valuation methodologies are dependent upon data from a fully functioning *local* market. Blackacre Plaza is located in a Midwestern community near a large city. Although there are many comparable properties in the area, even in June 2008 there were few comparable sales, and those varied widely in valuation. The commercial real estate market, particularly in the Regional and Local segments, has not been fully functioning since the end of 2007.

The impact of a distressed market on valuation is further apparent when the June 2008 appraisal of Blackacre Plaza is compared to a second appraisal of Blackacre Plaza conducted less than twelve months later in May 2009.[177] At the time of the 2008 appraisal, Blackacre Plaza was only 55% leased with an in-place net operating income of $530,081.[178] The appraiser used the actual in-place income and assumed a market rent of $17.50 per square foot for the remaining vacant space.[179] The appraiser further assumed, based on the vacancy rates in comparable properties, that the vacancy would be leased-up over a twenty-four month period.[180] Finally, a vacancy and collection loss was estimated at 12% of the gross potential income of Blackacre Plaza.[181]

In May 2009, Blackacre Plaza was 72% leased with an in-place net operating income of $578,949.[182] However, the market rents estimated by the appraiser dropped 14% in the year, from $17.50 to $15.00.[183] This is significant because most of the tenants had standard five-year leases that were scheduled to expire in 2010 or 2011.[184] Therefore, the appraiser adjusted the in-place net operating income to take into account the likelihood that the landlord would be required to adjust rent to market rates in order to retain tenants upon lease expiration.[185] Again, the appraiser

177. APPRAISAL OF [BLACKACRE PLAZA] BY [APPRAISAL COMPANY] DATED MAY 29, 2009 [hereinafter APPRAISAL II] (on file with author).

178. APPRAISAL, *supra* note 164, at 81.

179. *Id*. at 77.

180. *Id*. at 91.

181. *Id*.

182. Appraisal II, *supra* note 177, at 86.

183. *Id*. at 102.

184. *Id*. at 84.

185. *Id*. at 99.

assumed a twenty-four month lease-up and a vacancy and collection loss of 12%.[186] So despite the significant increase in occupancy from June 2008 to May 2009, the drop in market rent led to a 28.8% decrease in the estimated net operating income for Blackacre Plaza.[187]

Table 11: Comparison of Appraisals of Blackacre Plaza

	June 2008 Appraisal	*May 2009 Appraisal*	*Difference*
Cost Approach	$8,750,000	$8,470,000	(3.2%)[188]
Sales Comparison Approach	$9,500,000	$7,300,000	(23.1%)
Estimated NOI	$771,665	$549,713	(28.8%)
Capitalization Rate	8.5%	8.75%	2.5%
Income Capitalization Approach (direct capitalization)	$9,080,000	$6,300,000	(30.62%)
Final Valuation	$9,000,000	$6,800,000	(24.44%)

The six comparable sales used by the May 2009 appraiser, which took place between January 2007 and September 2008, resulted in a range of capitalization rates between 7.56% and 9.70%, with a mean of 8.67%. This represents an 11.4% increase over the mean market capitalization rate determined by the appraiser a year earlier. The following table summarizes the comparison of capitalization rates cited by the appraiser in the two appraisals:

186. *Id*. at 98.
187. *Id*. at 99.
188. This reduction in value is primarily due to an additional year of depreciation.

Table 12: Comparison of Capitalization Rates

Source of Information	*June 2008 Cap Rates*	*May 2009 Cap Rates*	*Difference*
Real Estate Research Corporation (local average for neighborhood shopping centers)	8.6%	8.9%	3.5%
Average of six comparable properties	7.78%	8.67%	11.4%
Korpacz PricewaterhouseCoopers (national average for retail centers)	7.32%	7.63%	4.2%

Despite the improved actual performance of Blackacre Plaza during the year, the combination of the decreased estimated net operating income and the increased capitalization rate led to a 30.6% drop in the value of Blackacre Plaza via the income capitalization approach.

The lack of a functioning market also impacted the valuation of Blackacre Plaza via the sales comparison approach. The six comparable sales used by the May 2009 appraiser of Blackacre Plaza yielded purchase prices between $82 and $158 per square foot. The mean price of $124 per square foot represented a 25% decline from the six comparable sales used a year earlier. The appraiser concluded a market value of Blackacre Plaza at $130 per square foot, resulting in a loss in valuation via the sales comparison approach of 23.1% over the year.

Although it is true that capital will flow towards the highest returns relative to the perceived risks, it is also true that real estate markets are often informationally inefficient, such that the parties may not accurately perceive risk.[189] That informational inefficiency is particularly relevant in today's disrupted market. As the Blackacre Plaza example demonstrates, a

189. For example, capitalization rates are subject to market forces, one of which is liquidity. If capital is scarce, there is less demand to purchase commercial real estate assets, which raises capitalization rates (thus lowering value). If capital flows freely and interest rates are low, the environment that existed during the mid-2000s, there is increased demand for commercial real estate assets and capitalization rates decline, which in turn reduces investment return for buyers by increasing the value of commercial real estate. So the same fundamental economic effect can be observed in the residential real estate market and the commercial real estate market. But the role of capitalization rates is significant because it can create a negative feedback loop where the lack of liquidity raises capitalization rates, which makes it more difficult to owners to refinance due to the equity gap.

range of capitalization rates may be deemed reasonable at any given point in time, and two experts may widely disagree about which is appropriate for a given property. As we have seen, small changes in the selected capitalization rate can have a significant impact on valuation.

III. THE INEVITABLE RESULTS OF THE GOVERNMENT'S POLICY

Given the structure and customs of the commercial real estate industry, the government's current policy will lead to some fairly predictable results. First, debt and equity have already begun to flow into the Investment-Grade segment of the market. As a result, the High Capital buyers will increase their consolidation of the primary markets and the best properties in secondary and tertiary markets. Second, small banks with concentrations in commercial real estate lending will continue to fail under the weight of non-performing commercial real estate loans, particularly those held by Limited Capital borrowers. Third, the combination of a sluggish lending environment, depressed valuations, and the failure of their primary lenders will contribute to stress and failure among Medium and Limited Capital commercial real estate owners in secondary and tertiary markets.

A. Increased Consolidation at the Top of Market

Although all segments of the commercial real estate market initially suffered as a result of the recession and the related credit crunch, the Investment-Grade segment has begun recovering and, in some limited parts of the market, may have regained most or all of the ground lost in the past three years. Given the low interest rate environment, many investors are interested in acquiring high quality commercial real estate, particularly if it is available at a significant discount.[190] As a result, several interrelated trends have emerged. First, the public real estate investment trust is proving to be an ownership vehicle capable of thriving in this market and increasing market share.[191] Second, investors have shown increased appetite for purchasing CMBS facilities, which translates into rising originations. The renewed enthusiasm of buyers like REITs and lenders in the CMBS market

190. *See, e.g.*, MILLER ET AL., *supra* note 98, at 3 ("The smart investors who sold near market tops, avoided overleveraging, and kept powder dry are extremely well positioned to take advantage of legions of credit-starved competitors who overborrowed and overpaid. Now, the haves can attract new capital, poach tenants, and lure talent away from the have-nots. Cash-flush investors and reviving lenders should have plenty of opportunities to recapitalize debt-starved, have-not players and take preferred investment or loan-to-own positions in asset capital stacks, eventually reaping excellent risk-adjusted returns.").

191. *Id*. at 19.

are beginning to support increased deal volume and rising prices.[192] Although all of these developments are positive for the commercial real estate market, it is important to note that their impact is felt only in particular product types (notably, office) in the upper echelons of the Investment Grade segment located in primary markets.

1. Real Estate Investment Trusts

Activity in the public REIT market demonstrates investor interest in high quality commercial real estate. Currently, there are approximately 150 REITs listed on the American stock exchanges.[193] Nine REITs went public in 2010, raising approximately $2 billion.[194] As of January 10, 2011, about a dozen REIT IPOs were "on file or waiting to launch."[195] One of those, American Assets Trust, an office REIT based in San Diego, California, raised $564 million in its January 2011 IPO, exceeding expectations.[196] More REIT IPOs are expected throughout 2011 from well-known private owners like Schottenstein Realty Trust and Eola Property Trust. Schottenstein, based in Columbus, Ohio, operates 109 shopping centers totaling 11 million square feet of retail space.[197] Eola Property Trust, based in Orlando, Florida, is one of the largest privately held commercial real estate companies in the eastern United States with forty-seven office properties totaling approximately 9.9 million square feet.[198]

The private companies contemplating REIT IPOs are uniformly focused on improving their access to capital and taking advantage of acquisition opportunities caused by the equity gap. For example, Hudson Capital, LLC, a private real estate investment company based in Los Angeles, transformed into Hudson Pacific Properties, a public REIT, in a $218 million initial public offering in June 2010.[199] Hudson Pacific specializes in office buildings and sound stages in California. Its strategy is

192. *Id*. at 22–23.

193. *All About REITs*, REIT.COM, http://www.reit.com/AboutREITs/AllAboutREITs.aspx (last visited Jan. 17, 2012).

194. Elaine Misonzhnik, *Climate Improves for Potential Retail REIT IPOs*, RETAIL TRAFFIC (Jan. 19, 2011, 7:00 AM), http://retailtrafficmag.com/finance/reits/climate_improves_retail_reit_ipos/.

195. *Id*.

196. Randyl Drummer, *UPDATED: First REIT IPO of 2011 Prices This Week, While Another Fizzles*, COSTAR GROUP (Jan. 13, 2011), http://www.costar.com/News/Article/UPDATED-First-REIT-IPO-of-2011-Prices-This-Week-While-Another-Fizzles/125668.

197. Misonzhnik, *supra* note 194.

198. Eola Prop. Trust, Registration Statement for Securities to be Issued by Real Estate Companies (Form S-11, Amendment No. 2), *available at* http://yahoo.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=7646054&SessionID=g0fHHCJbf1Avpl7.

199. Kristen Scholer & Inyoung Hwang, *Hudson Pacific Raises $218 Million in IPO of Office REIT; Shares Advance*, BLOOMBERG (June 24, 2010, 4:38 PM), http://mobile.bloomberg.com/news/2010-06-24/hudson-pacific-raises-218-million-in-reit-ipo-at-bottom-of-price-range.

focused on acquiring "office properties located in submarkets with growth potential, as well as on underperforming properties that provide opportunities to implement a value-add strategy to increase occupancy rates and cash flow."[200] Hudson Pacific emphasizes that it views the current market as a "favorable acquisition environment" and that its access to capital helps position it to take advantage of emerging opportunities.[201]

2. CMBS Originations

Well-capitalized borrowers like REITs, investment managers, and pension funds are in a good position to take advantage of the distressed commercial real estate market and purchase value at discounts. Their success, however, depends in part on the availability of debt. As High Capital borrowers come back into the market, CMBS is also showing signs of rebirth. In 2007, $230 billion in CMBS debt was originated.[202] In the third and fourth quarters of 2008, the CMBS machine grounded to a complete stop.[203] There were a few issuances in late 2009 that resulted in $3 billion in 2009 originations and $12.3 billion in 2010.[204] Moody's projects that CMBS issuance will more than triple to $37 billion in 2011.[205]

Increasing the liquidity of CMBS helps shore up central business districts and larger assets. There is evidence that the higher echelons of the market are already responding well. For example, a ten story office building located at 1331 L Street NW in Washington, D.C., was purchased by the Mortgage Bankers Association in 2007 for $79 million.[206] By February 2010, the Association was underwater on its $75 million mortgage and sold the building to the CoStar Group, Inc. for $41.3 million.[207] Less than twelve months later, in January 2011, the CoStar Group sold the building to GLL Real Estate Partners, a German real estate investment fund, for $101 million.[208] These dramatic shifts in value were a

---

200. *Our Strategy*, HUDSON PAC. PROP., http://www.hudsonpacificproperties.com/about/strategy (last visited Jan. 17, 2012).

201. *Market Opportunity*, HUDSON PAC. PROP., http://www.hudsonpacificproperties.com/about/market (last visited Jan. 17, 2012).

202. CRE FIN. COUNCIL, *supra* note 31, at exhibit 4.

203. *Id*. at exhibit 2.

204. *Id*.

205. *Commercial/Multifamily Mortgage Originations Jump 36% in 2010, MBA Survey Shows*, NAT'L REAL ESTATE INVESTOR, (Feb. 9, 2011, 9:54 AM), http://nreionline.com/property/multifamily/multifamily_mortgage_originations_0209/.

206. James Hagerty, *Mortgage Bankers Association Sells Headquarters at Big Loss*, WALL ST. J., Feb. 6, 2010, http://online.wsj.com/article/SB10001424052748704829704575049111428912890.html.

207. *Id*.

208. Anton Troianovski, *CoStar Sells Washington, D.C. Building in Sign of Commercial Rebound*, WALL ST. J. DEVS. BLOG (Feb. 3, 2011), http://blogs.wsj.com/developments/2011/02/

result of two factors: (1) increased net operating income in 2011 based on a long-term lease with CoStar; and (2) falling capitalization rates in the Washington, D.C., office market. Jochen Schnier, the Chief Operating Officer of GLL, explained to the *Wall Street Journal* that in a low interest rate environment, commercial real estate is an attractive option compared to low bond yield rates. "This is a very high-profile, low-risk investment," Mr. Schnier said.[209] "The alternative investments to these investments don't really look more promising."[210] Transactions like 1331 L Street NW drove up total commercial real estate deal volume in 2010 to $126 billion, an increase of $69 billion over 2009.[211] The number of transactions involving properties valued at $100 million or greater increased from 59 in 2009 to 195 in 2010.[212] This contributed to the increase in average deal size from $11 million in 2009 to $18 million in 2010.[213]

This consolidation is not inherently problematic. High Capital owners are typically well-managed and provide lenders and tenants with stability. This increasing consolidation will pose few anti-competitive problems for two reasons. First, High Capital owners tend to focus on larger assets in primary markets, central business districts, and suburban areas with strong demographics, a profile that is inherently limited. Second, because the commercial real estate market is highly fragmented, High Capital owners control only a small percentage of assets.

The efforts of High Capital buyers generated positive news in 2010 on several fronts—increased deal flow and lending, significant capital raises by public real estate investment trusts, and indications of improving valuations. This increased transactional activity was matched by an increase in lending activity. In 2010, mortgage bankers originated $110 billion of commercial real estate loans, an increase of 36% over 2009 lending levels.[214] These statistics demonstrate positive activity in 2010 and suggest that valuations are rising and liquidity is re-entering the market. But these statistics can only be meaningful if they reflect broad economic activity, or if one presumes that there is a single commercial real estate market in which buyers, sellers, and lenders freely interact. That is

03/costar-sells-washington-building-in-sign-of-commercial-rebound/. The building was able to rebound in value so quickly in part because the CoStar Group occupies most of the space on a long-term lease.

209. *Id*.

210. *Id*.

211. REAL CAPITAL ANALYTICS, HISTORICAL STATISTICS BY YEAR (2011).

212. REAL CAPITAL ANALYTICS, *supra* note 100, at 2.

213. *Id*.

214. MORTG. BANKERS ASS'N, QUARTERLY SURVEY OF COMMERCIAL/MULTIFAMILY MORTGAGE BANKERS ASSOCIATION: Q4 2010 (2011) [hereinafter QUARTERLY SURVEY: Q4 2010], *available at* http://mbaa.org/files/Research/CommercialOriginations/4Q10CMFOriginationsSurvey.pdf.

certainly the implicit assumption being made by policymakers. It is also fundamentally flawed.

Although it is likely that policymakers viewed increased market activity in 2010 as evidence that their *laissez-faire* approach was working, a closer look at the data reveals that a recovery is underway only in the Investment Grade segment of the market, while the Regional and Local segments continue to suffer. For example, the prices of "investment-grade" commercial real estate increased by 8% in 2010, while pricing of "general grade" commercial real estate declined 8.2% in the fourth quarter of 2010.[215] The same phenomena can be seen in the positive lending statistics. Overall, commercial real estate lending increased by 36% in 2010 over 2009, but that growth was driven almost exclusively by the increase in CMBS originations, which saw a 6,110% increase from the fourth quarter of 2009 to the fourth quarter of 2010.[216] Lending by commercial banks actually declined 25% during the same time period.[217] In the fourth quarter of 2010, the average CMBS loan was $69.6 million, compared to $7.6 million for the commercial bank loans.[218] Clearly, data that attempt to describe the entire market are skewed by a small number of large transactions in the Investment-Grade segment, which masks the continuing lack of activity or value appreciation in the Regional and Local segments.[219]

While recovery in the Investment-Grade segment is good news for the economy, combined with an assumption that there is a single commercial real estate market, this increased activity can lead to the erroneous impression that stability is returning across the board. In fact, there is no indication that conditions in the Regional and Local segments of the market have substantially improved. Several respected analysts have opined that commercial real estate values have not yet hit bottom and likely will not do so until later in 2011 or 2012.[220] As one analyst bluntly put it:

215. *Id*.

216. *Id*. Life Insurance companies also increased their commercial real estate lending 170% from the fourth quarter of 2009 to the fourth quarter of 2010.

217. *Id*.

218. *Id*.

219. Commercial real estate transaction activity increased significantly in 2010, driven largely by the re-emergence of portfolio transactions and large individual deals. REAL CAPITAL ANALYTICS, *supra* note 100, at 2.

220. *Commercial Real Estate's Impact*, *supra* note 53, at 106–08 (statement of Richard Parkus, Exec. Director, Morgan Stanley Research); Mark Heschmeyer of the CoStar Group explains that "while investment-grade 'trophy' buildings are commanding higher prices, prices for the majority of 'ordinary' office property, shopping centers and warehouse buildings continue to search for a bottom." Heschmeyer, *supra* note 100.

> The capital flight to quality . . . has produced "a deep canyon" separating "trophy" and "trash" assets, "with a lot more trash." . . . Investors have . . . learned from recent cycles that prime properties hold value better in downturns and appreciate more in good times. As a result, pent-up, sidelined capital swarms apartments and office buildings in gateway cities and mostly ignores just about everything else.[221]

B. Bank Failures

One of the most significant impacts of the commercial real estate debt crisis to date has occurred very quietly. From October 1, 2000, to December 31, 2007, the FDIC closed twenty-seven American banks.[222] From January 1, 2008, to December 31, 2010, the FDIC closed 322 banks.[223] In 2010 alone, 157 banks failed, the highest annual total since 1992.[224]

Despite the attention paid to those financial institutions that are "too big to fail,"[225] the reality is that most American banks are small enough to fail without attracting much notice. There are nearly 7,000 community banks in the United States, constituting approximately 98% of all banks.[226] Ninety-one percent of all banks in the United States have assets of less than $1 billion and 36% have assets less than $100 million.[227] Community banks are a major source of credit for small businesses, including small businesses in the commercial real estate industry.[228] Community banks with assets of less than $10 billion represent 23% of the banking industry, as measured by total assets, yet they made up 56% of outstanding bank loans to small businesses. [229] Randall Compton, the CEO of Pioneer Trust Bank in Salem, Oregon, explained the role of community banks:

221. MILLER ET AL., *supra* note 98, at 6.

222. *Failed Bank List*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Jan. 17, 2012).

223. *Id*.

224. *Commercial Real Estate's Impact*, *supra* note 53, at 33 (statement of Sandra Thompson, Director, Division of Supervision & Consumer Protection, FDIC).

225. *Id*. at 90.

226. INDEP. CMTY. BANKERS OF AM., COMMUNITY BANKING FACTS (2010), http://www.icba.org/files/ICBASites/PDFs/cbfacts.pdf.

227. *Id*.

228. *Alternatives for Promoting Liquidity in the Commercial Real Estate Markets, supra* note 86, at 4 (statement of Rep. Suzanne Kosmas, Member, H. Comm. on Fin. Servs.) ("[C]ommunity banks are the lifeblood of our communities and . . . we have to ensure their continued viability.").

229. INDEP. CMTY. BANKERS OF AM., *supra* note 226.

> [W]e encourage people to deposit their funds with the community banks, because we turn around and relend it within the community. At least that's what we do, because, you know, where else are we going to go? We're not in New York. We're not in Washington. We're not in California. We're just in Salem.[230]

Commercial real estate lending played a key role in the collapse of a significant number of the 322 banks that have failed in the past thirty-six months.[231] FDIC analysis indicates that, of the 322 banks, more than 86% exceeded the commercial real estate lending concentrations guidance promulgated by bank regulators in December 2006.[232]

Representatives of the FDIC have testified that while bank failures in 2011 will remain high, 2010 represented the peak of the current cycle.[233] While that prediction may be accurate, commercial real estate debt continues to force bank closures.[234] In January 2011, eleven banks closed their doors, mostly due to non-performing commercial real estate loans.[235] The eleven failed banks reported $732 million in nonperforming loans.[236] Approximately $600 million of that pool, or 82%, were commercial

---

230. *Subcomm. on Fin. and Tax Field Hearing on Exploring Ways for Small Businesses to Access Capital: Hearing Before H. Comm. on Small Bus.*, 111th Cong. 31 (2009) (statement of Randy Compton, Chief Exec. Officer, Pioneer Trust Bank).

231. It is important to note that regulators include loans for the development of single-family subdivisions in "commercial construction loans" although that product type is not otherwise included in the definition of commercial real estate used in this article or by other data providers. *Commercial Real Estate's Impact*, *supra* note 53, at 44 (statement of Patrick Parkinson, Director, Division of Banking Supervision & Regulation, Fed. Reserve) ("Losses associated with CRE, particularly residential construction and land development lending, were the dominant reason for the high number of bank failures since the beginning of 2008, and further CRE-related bank failures are expected over the next few years."); Jon Prior, *Commercial Real Estate Problems Lead to Latest Bank Failures: Trepp*, HOUSING WIRE (Sept. 20, 2010, 10:57 AM), http://www.housingwire.com/2010/09/20/ commercial-real-estate-problems-lead-to-latest-bank-failures-trepp (In the second week of September 2010, the FDIC closed six banks. According to industry analysts, commercial real estate loans made up 82% of the $152 million in nonperforming loans held by the six banks.).

232. The Joint Guidance on CRE Lending, dated December 6, 2006, defined a commercial real estate concentration as loans which exceeded 300% of total capital. *See* FED. DEPOSIT INS. CORP., CONCENTRATIONS IN COMMERCIAL REAL ESTATE LENDING, SOUND RISK MANAGEMENT PRACTICES, at 3 (2006), *available at* http://www.fdic.gov/news/news/press/2006/pr06114a.pdf.

233. *Commercial Real Estate's Impact*, *supra* note 53, at 33 (statement of Sandra Thompson, Director, Division of Supervision & Consumer Protection, FDIC).

234. *Id.* at 52 (statement of Patrick Parkinson, Director, Division of Banking Supervision & Regulation, Fed. Reserve) ("We expect that banks will continue to incur substantial additional CRE losses over the next two years and that many banks with CRE concentrations will continue to be under stress.").

235. Jacob Gaffney, *CRE "Extend and Pretend" Reaching Breaking Point*, HOUSING WIRE (Jan. 31, 2011, 4:25 PM), www.housingwire.com/2011/01/31/cre-extend-and-pretend.

236. *Id.*

construction loans or commercial real estate mortgages.[237] Only $90 million were residential real estate loans.[238]

Many more small banks remain at risk. As of September 2010, 860 banks were designated by the FDIC as "problem institutions."[239] Many of these banks have high concentrations of construction loans and commercial real estate loans. For example, Integra Bank of Evansville, Indiana posted a loss of $35 million in the fourth quarter of 2010, due in large part to the "persistent weakness in commercial real estate markets."[240] Integra Bank stated that a "plunge" in the value of commercial real estate has resulted in capital ratios lower than levels required by the Office of the Comptroller of the Currency.[241] Community banks like Integra, with a high concentration of commercial real estate loans in tertiary markets, are in the weakest position for a short-term recovery. Without significant, widespread job growth, capitalization rates will be unlikely to fall in the markets they serve.[242] Therefore, despite the success of the "core community banking business,"[243] depressed commercial real estate values will cause the demise of many more banks like Integra.

If interest rates rise, the stress on banks will likely significantly increase.[244] More than half of bank loans are floating interest rate debt. Rising interest rates will increase the payment burdens on borrowers, sending more properties into foreclosure and increasing losses by banks.[245] One analyst described the current environment as "low-interest-rate life support" for regional and local banks:[246] "Either their balance sheets

237. *Id*.

238. *Id*.

239. *Commercial Real Estate's Impact*, *supra* note 53, at 32 (statement of Sandra Thompson, Director, Division of Supervision & Consumer Protection, FDIC).

240. *Integra Bank's Auditor Says Situation May Be Dire*, INDIANAPOLIS BUS. J., Feb. 1, 2011, http://www.ibj.com/integra-banks-auditor-says-situation-may-be-dire/PARAMS/article/24963.

241. *Id*.

242. MILLER ET AL., *supra* note 98, at 7–8 ("More than any other issue, the sputtering U.S. jobs engine compromises sustained recovery and growth in real estate markets. People need the confidence provided by a steady paycheck to resume spending in shopping centers, look for new housing, and take vacations at resorts and hotels, while more hiring would help fill empty office space.").

243. *Integra Bank's Auditor Says Situation May Be Dire*, *supra* note 240.

244. MILLER ET AL., *supra* note 98, at 9 ("Record-low interest rates ('essentially zero') have been a life-line to both real estate lenders and borrowers."); KEVIN J. THORPE, CASSIDY TURLEY, IMPLICATIONS OF RISING INTEREST RATES ON CRE RECOVERY (2010).

245. CB RICHARD ELLIS, *supra* note 29, at 16 ("The default rate for construction loans "could have been higher had it not been for the historically low LIBOR-based rates (London Interbank Offered Rate) on floating rate deals that have occurred [in 2009]. With debt service requirements lower due to low LIBOR-based rates, higher debt service reserves have effectively lengthened the term of numerous construction deals, and this effect has granted many permanent deals an enhanced ability to cover debt service. Some smaller banks, which generally have much higher-than-average exposure to commercial real estate and development deals, could face conservatorship through the FDIC, possibly resulting in a further decline in liquidity for certain commercial real estate market segments.").

246. MILLER ET AL., *supra* note 98, at 16.

improve or regulators take them over. 'It's a failed business model,' says a big banker. 'Where do they get the money?'"[247]

Regulators appear willing to allow these bank closings for at least two reasons. First, they have adopted a narrative borrowed from the subprime residential real estate crisis, that poor underwriting contributed to the crisis. Second, "[w]hile problems in the CRE market will be an ongoing concern for a number of banking organizations and a negative factor for economic growth and lending, [regulators] do not see CRE losses as a threat to systemically important financial institutions."[248]

From the regulators' perspective, bank failures are a necessary, if painful, component of the commercial real estate market hitting bottom and beginning to recover. But this view is dependent upon the assumption that there is a single commercial real estate market, and that if a bank fails, other capital sources will be available to that bank's previous customers. However, the data suggests otherwise. Overall, commercial real estate lending by banks was down 25% in the fourth quarter 2010, compared to the already depressed 2009 levels.[249] Community banks lend to borrowers in the Local segment, which is populated by older and smaller properties in tertiary markets. If Integra Bank in Evansville, Indiana, closes its doors due to its nonperforming commercial real estate loan portfolio, the FDIC will bundle the loans and sell them for 25–40 cents on the dollar to High Capital investors, who have the capital and patience to wait for the potential upside.[250] That resolution does nothing to stabilize the value of the underlying commercial real estate and does nothing for the community served by Integra Bank. If the regulators' narrative of the commercial real estate debt crisis is correct, and the banks brought this problem upon themselves by aggressive underwriting to borrowers with insufficient credit, then allowing Integra Bank to close may be a reasonable outcome

247. *Id*.

248. *Commercial Real Estate's Impact*, *supra* note 53, at 52 (statement of Patrick Parkinson, Director, Division of Banking Supervision & Regulation, Fed. Reserve).

249. QUARTERLY SURVEY: Q4 2010, *supra* note 214.

250. Mark Heschmeyer, *Real Money: Colony Capital Acquires $817 Mil in Loans from FDIC*, COSTAR GROUP, (Feb. 2, 2011), http://www.costar.com/News/Article/Real-Money-Colony-Capital-Acquires-$817-Mil-in-Loans-from-FDIC/126166 (reporting that a consortium of investors organized by Colony Capital, LLC acquired two portfolios of 1,505 loans with an aggregate balance of $817 million. The purchase price was $192.8 million, or 23.6 cents on the dollar. The FDIC retained a 50% equity interest in the portfolios.); Mark Heschmeyer, *Real Money: Starwood Pays 40 Cents on the Dollar for 137 Commercial Loans*, COSTAR GROUP, (Jan. 12, 2011), http://www.costar.com/News/Article/Real-Money-Starwood-Pays-40-Cents-on-the-Dollar-for-137-Commercial -Loans/125644 (reporting that Starwood Capital Group acquired a "non-performing commercial loan portfolio with an outstanding principal balance of $157 million from a major Midwest regional bank" for "40 cents on the dollar." This acquisition increased the holdings of the Starwood Global Opportunity Fund VIII to non-performing commercial real estate loans with an outstanding balance of $537 million, all acquired in 2010.).

for bad behavior. But there is little evidence that community banks caused the commercial real estate debt crisis. If underwriting standards were relaxed during the mid-2000s, it was because of competitive pressures due to rising valuations and investors eager to put their money in commercial real estate. There is simply no subprime aspect to commercial real estate.[251] There was no systemic fraud. There was, certainly, an ultimately irrational belief that property values would continue to increase, but that was a delusion shared by nearly every participant in the American economy. To allow community banks to fail due to circumstances that were ultimately beyond their control, particularly after stepping in to stabilize "systemically important" financial institutions like Citigroup and Bank of America, seems fundamentally unfair.[252]

But beyond fairness, there are compelling economic reasons why it is bad policy to allow community banks to fail due to the commercial real estate debt crisis. The most significant is that the key to economic recovery in secondary and tertiary markets is investment.[253] Leverage is a necessary requirement for economic investment, and small businesses, including Limited Capital owners of commercial real estate, will find it more difficult to obtain loans because of the lack of intervention by policymakers. There is a fundamental and troubling inconsistency in the message from policymakers to lenders. On the one hand, policymakers and regulators actively encourage banks to begin to lend again, particularly by extending credit to small businesses and commercial real estate borrowers.[254] On the

251. *Commercial Real Estate's Impact*, *supra* note 53, at 106 (statement of Richard Parkus, Exec. Director, Morgan Stanley Research).

252. *See, e.g.*, *Alternatives for Promoting Liquidity in the Commercial Real Estate Markets*, *supra* note 86, at 26 (statement of Rep. Spencer Bachus, Member, H. Comm. on Fin. Servs.) ("Many of our programs to date have been, I think, designed to help the larger institutions. And that is a significant failure that we have had over the past 2 or 3 years; we have neglected the smaller institutions. . . . It has also created a perception, which I think is true, in the general public that our larger institutions, both by the regulators and by the response, have been protected and insulated, when, really, a lot of the risk-taking and what happened was a direct result of some of their activities, and that our smaller banks and our businesses and commercial real estate is more of a victim of what they did. And it is really not a fair approach that has been taken.").

253. *Commercial Real Estate's Impact*, *supra* note 53, at 27 (statement of Sandra Thompson, Director, Division of Supervision & Consumer Protection, FDIC) ("Bank lending is an essential aspect of economic growth and will be vital to facilitating a recovery.").

254. Press Release, Bd. of Governors of the Fed. Reserve Sys., Interagency Statement on Meeting the Needs of Creditworthy Borrowers (Nov. 12, 2008) ("The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers."); *Commercial Real Estate's Impact*, *supra* note 53, at 36 (statement of Sandra Thompson, Director, Division of Supervision & Consumer Protection, FDIC) ("The FDIC understands that businesses rely on banks to provide credit for their operations, and that extensions of credit from banking institutions will be essential in supporting economic growth. Accordingly, we have not instructed banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or deny a refinance request solely because of weakened collateral value.") (emphasis omitted).

other hand, some in the banking community charge that field examiners are "overzealous and unduly overreaching and . . . demanding overly aggressive write-downs and reclassifications of viable commercial real estate loans and other assets."[255] Cleary, regulators and policymakers have demonstrated that they are perfectly willing to allow banks to fail because they were overexposed to commercial real estate.[256] As a result of these mixed messages, one representative of the Independent Community Bankers of America testified that:

> [Current regulatory] practices not only undermine the fundamental goal of [encouraging the extension of credit], they are costing community banks money, leading to a contraction of credit, and forcing many of them to rethink their credit policies. Under this climate, community bankers may avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital.[257]

C. Marginalization of Limited Capital Owners and Tertiary Markets

Most commercial real estate is owned by privately held Medium and Limited Capital owners. Some private borrowers are surely large and diverse enough to find the resources necessary to fill the equity gap or post

255. R. MICHAEL MENZIES, SR., INDEP. CMTY. BANKERS OF AM., EXPLORING THE BALANCE BETWEEN INCREASED CREDIT AVAILABILITY AND PRUDENT LENDING STANDARDS 154–55 (2009), *available at* http://icba.org/files/ICBASites/PDFs/test032509.pdf (hearing before the H. Comm. on Fin. Servs.) ("[Some] bankers are complaining that otherwise solid loans are being downgraded simply because they are located in a state with a high mortgage foreclosure rate. This form of stereotyping is tantamount to statewide redlining that is unjustified in today's world and could ultimately lead to capital problems at otherwise healthy banks. Other reports from community bankers cited examiners requiring write-downs or classification of performing loans due to the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have not been criticized before; and substituting their judgment for that of the appraiser.").

256. *Commercial Real Estate's Impact*, *supra* note 53, at 36 (statement of Sandra Thompson, Director, Division of Supervision & Consumer Protection, FDIC) ("[W]e expect that banks will continue to accurately recognize losses in a timely manner in accordance with accounting and financial reporting standards.").

257. MENZIES, *supra* note 255, at 155–56; *Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses: Field Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs.*, 111th Cong. 159 (2010) (statement of Greg M. Ohlendorf, President and Chief Exec. Officer, First Community Bankers of America and the Community Bankers Association of Illinois) ("While Washington policymakers exhort community banks to lend to businesses and consumers, banking regulators . . . place restrictions on banks well beyond what is required to protect bank safety and soundness. The banking agencies have moved the regulatory pendulum too far in the direction of overregulation at the expense of lending. We need to return to a more balanced approach that promotes lending and economic recovery in addition to bank safety and soundness.").

additional collateral for the loan. But many private borrowers surely cannot. Analysts have bluntly summarized the position of Limited Capital borrowers in tertiary markets: "The cash rich and well capitalized should feast off the cash poor and underleveraged. . . . Smaller players more likely get left out in the cold."[258]

If the borrower lacks the funds to fill the equity gap and finance, it could seek additional equity from a mezzanine lender or a partner willing to contribute the necessary equity in exchange for a preferred return and ownership interest in the asset.[259] During the 2000s, many small real estate developers relied upon this kind of financing to fuel their growth. But since such intermediate investors are subordinate to the first lienholder, the financing is risky and therefore expensive. Mezzanine financing could easily cost 10–15% in interest per annum. It is unlikely that a distressed asset has sufficient cash flow to support this additional expense.

Even if a lender agrees to a workout that involves partial forgiveness of debt, a small borrower may be unable to accept that arrangement given the tax consequences. As a general rule, any reduction in outstanding indebtedness due to a workout will require the borrower to recognize taxable cancellation of indebtedness income.[260] There are, however, exceptions to this general rule. Perhaps the most applicable exception is the rule that no cancellation of indebtedness income arises if the taxpayer is "insolvent" both before and after cancellation of the debt.[261] "Insolvency" is defined as the excess of liabilities immediately before the discharge over the fair market value of assets immediately before the discharge.[262]

In reaction to the dilemma facing small owners of commercial real estate who need a workout but cannot afford to pay income taxes on forgiven debt, the American Recovery and Reinvestment Act of 2009 (the "Act") included a provision that allowed certain taxpayers to defer the taxation of cancellation of indebtedness income related to certain modifications of outstanding debt in 2009 and 2010.[263] The Act added § 108(i) to the Internal Revenue Code, which set forth fairly complex rules that would permit restructuring borrowers to irrevocably elect to defer taxation over five years, for modifications occurring in 2009, or four years,

258. MILLER ET AL., *supra* note 98, at 15–16.

259. *See generally* Andrew R. Berman, *"Once a Mortgage, Always a Mortgage" – The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76 (2005).

260. Fries et al., *supra* note 77, at 30; Robert F. Reilly, *Income Tax Implications of Industrial and Commercial Property Mortgage Debt Restructuring*, AM. BANKR. INST. J., Mar. 2010, at 56.

261. I.R.C. § 108(a)(1)(B) (2006).

262. I.R.C. § 108(d)(3) (2006). A borrower could have the funds to contribute to a workout even though it is insolvent because of the widespread practice of segregating individual commercial real estate assets into "special purpose entities," usually limited liability companies or limited partnerships.

263. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1231, 123 Stat. 115, 338.

for modifications occurring in 2010.[264] The forgiven debt was still taxable as income, but borrowers were simply given more time to meet their obligations to pay. It is unclear how many taxpayers took advantage of this provision, which expired December 31, 2010.[265]

Small private borrowers face several challenges in the commercial real estate debt crisis. They have seen the market valuations of their assets fall, perhaps by as much as 40–50% since 2007. They have experienced reductions in market rent, increased tenant defaults, and slow pays. Their cash flows are suffering. If their lenders are willing to negotiate workouts, they will be required to contribute additional equity and/or provide or enhance personal guarantees. If they are lucky enough to receive partial debt forgiveness, they are required to pay taxes on the resulting cancellation of indebtedness income. For many small borrowers, alternative capital sources are unavailable due to the sizes and locations of their properties. If community banks, primary sources of support for small private borrowers, curtail commercial real estate lending, their options are severely limited.

It is not only small businesses in the commercial real estate industry that will suffer. From the perspective of tenants, the commercial real estate sector is a financing mechanism of equal importance to a line of credit.[266] Businesses that choose to lease the premises from which they operate have the flexibility to employ capital in the acquisition of equipment or payroll. If the commercial real estate sector did not exist, many other small businesses that could not afford to purchase their own buildings would also not exist. The stability of the commercial real estate sector therefore has an impact on tenants. For example, a borrower struggling to make loan payments may skimp on maintenance obligations or other functions necessary for a tenant to run her own business. Representative Shuler explained the broader implications of the commercial real estate crisis in vulnerable communities:

> This problem starts with commercial real estate but doesn't end there. . . . What starts with commercial real estate stretches from local community banks to our small businesses, decreasing the amount of job opportunities and stunting job growth. If community banks can't lend, and they can't refinance the loans on their books,

264. I.R.C. § 108(i) (Supp. IV 2010).

265. *Id.*

266. *See Commercial Real Estate's Impact*, *supra* note 53, at 38 (statement of Sandra Thompson, Director, Division of Supervision & Consumer Protection, FDIC) ("Small businesses rely heavily on commercial real estate to collateralize borrowings for working capital and other needs.").

they will be seized by the FDIC. Once that happens, small business lending and job growth are doomed.[267]

Finally, municipalities and states will suffer if borrowers and lenders are forced to trade on depressed valuations. Property tax revenues are tied to the appraised value of real estate, usually based on the most recent transaction price. As the appraised value of the tax base decreases, the revenues generated by that tax base will similarly decrease. There appears to be no empirical research measuring the impact of this phenomenon. There is anecdotal evidence, however. For example, El Paso County, Colorado, the home of Colorado Springs, suffered a nearly half-billion dollar, or 6.8%, decline in the aggregate commercial real estate valuation from 2009 to 2010.[268] It was the first decrease in the commercial real estate tax base in El Paso County since the early 1990s.[269]

CONCLUSION

In the current economic crisis, much attention has been paid to the financial institutions deemed "too big to fail." At the other end of the spectrum are the small banks that policymakers view as "not systemically important" and whose failure, therefore, is too minor to attract notice. In the aggregate, however, those small banks are incredibly important to the stability of the commercial real estate market, particularly in secondary and tertiary markets, and particularly in classes of commercial real estate leased to small businesses. As one lawmaker put it, "[f]ree markets, when allowed to function properly, aren't kind, but they are very efficient."[270] While that may be true, it is also true that allowing the free markets to solve this particular problem will inevitably result in increased stress on small businesses, small banks, and small commercial real estate owners, and that the fallout from that increased stress may hamper economic recovery efforts. Policymakers should therefore abandon their current approach of treating the failure of small banks and small commercial real estate owners as regrettable but systemically irrelevant. Instead, they should recognize that although the commercial real estate debt crisis has attracted little attention, addressing it is critical to the broader economic recovery.

---

267. *Alternatives for Promoting Liquidity in the Commercial Real Estate Markets*, *supra* note 86, at 9 (statement of Rep. Heath Shuler).

268. Rich Laden, *Commercial Real Estate Values Plunge for First Time in 20 Years, New Reappraisal Says*, GAZETTE (Colorado Springs) (Feb. 19, 2011, 2:07 PM), http://www.gazette.com/articles/first-113121-commercial-time.html.

269. *Id.*

270. *Alternatives for Promoting Liquidity in the Commercial Real Estate Markets*, *supra* note 86, at 8 (statement of Rep. Randy Neugebauer, Member, H. Comm. on Fin. Servs.).

A thorough discussion of policies that could be adopted to address the commercial real estate debt crisis will be the focus of future work. Briefly, the federal government should consider four positive interventions.

First, Congress could pass legislation to temporarily stabilize the commercial real estate market by guaranteeing or purchasing certain loans.[271] In 2010, Representative Walter Minnick of Idaho introduced such legislation in the form of the Commercial Real Estate Stabilization Act.[272] The House Committee on Financial Services held hearings to discuss the proposal, but the bill failed to make it out of committee before Congress adjourned. Representative Minnick's bill would have focused on smaller banks and permitted them to sell certain performing commercial real estate loans to larger financial institutions, which would package the loans into institutional-sized portfolios and securitize them.[273] This proposal would solve one of the fundamental disparities between lending sources for tertiary and primary markets and allow small banks to clear their books of many commercial real estate loans.[274] Although Representative Minnick's proposal was designed to sunset within three years, this kind of program would have more of an impact if it were longer-term.

Second, bank regulatory agencies need to ensure that they are conveying a clear and consistent message to banks regarding community lending. Community banks have been encouraged by regulators for years to invest in the communities they serve, particularly by making loans to small businesses and in commercial real estate. To punish them now for pursuing the goals set by regulators will discourage further lending in the future. If policymakers on both sides of the aisle believe that small businesses will provide most of the new jobs in the economic recovery, they should be focused on supporting the institutions that support small businesses, including small commercial real estate owners, particularly in tertiary markets, and small banks.

The guidance on workouts issued by the regulators in 2009 is consistent with the directive for banks to extend loans to creditworthy small

271. For example, the Small Business Administration announced a program in February 2011 to allow small businesses to refinance maturing commercial real estate loans before December 31, 2012. Congress authorized the SBA to approve up to $15 billion in loans. *See* Mark Heschmeyer, *Real Money: SBA Coming to the Rescue of Small Maturing CRE Loans*, COSTAR GROUP (Feb. 21, 2011), http://www.costar.com/News/Article/Real-Money-SBA-Coming-To-The-Rescue-of-Small-Maturing-CRE-Loans/126623.

272. *Alternatives for Promoting Liquidity in the Commercial Real Estate Markets*, *supra* note 86, at 1–2 (statement of Rep. Walter Minnick, Member, H. Comm. on Fin. Servs.).

273. *Id.*

274. One of the reasons that small loans are not packaged into CMBS is because the high transaction costs of each individual loan closing are prohibitive. It is much cheaper to create a $500 million CMBS pool from twenty-five $20 million loans than from one hundred $500,000 loans. Federal legislation could help subsidize some of the cost to encourage creation of these new securities.

businesses and commercial real estate borrowers. But empirical work should be done to evaluate the effectiveness of the guidance. In other words, do banks believe the guidance and is it making a difference for lenders and borrowers? Anecdotal evidence suggests that small banks still believe that regulators are sending mixed messages and that individual bank examiners criticize banks for lending decisions that the guidance endorses. A meaningful regulatory approach is dependant upon good information about the success or failure of current policies.

Third, several accounting rules play a role in valuation methodologies and bank regulatory issues.[275] A full discussion of the accounting rules is beyond the scope of this Article, but policymakers need to be aware of the impact of these rules and exercise discretion in adopting or extending them. The accounting rule change that has garnered the most attention is the adoption in November 2007 of "mark-to-market" accounting by the Financial Accounting Standards Board (FASB) for the first time since 1938.[276] Some economists view the application of mark-to-market accounting to commercial real estate loans to be a primary cause of the devastating losses in value suffered since late 2007. In the words of Brian Wesbury and Robert Stein:

> Simply, mark-to-market accounting needs to die. It should be stabbed in the heart with a cedar stake, shot with a silver bullet, and then buried under six feet of garlic powder. Like the evil killer in a horror flick, we need to make sure it never gets up off the floor again.[277]

Finally, accurate data is key to understanding the policy challenges posed by the commercial real estate debt crisis so that appropriate responses can be crafted. We need a far better picture of several key metrics: the equity gap of commercial real estate loans held by banks; statistics on technical and maturity defaults; and, as discussed above, data

275. *See generally* PRICEWATERHOUSECOOPERS, FAIR VALUE REPORTING FOR INVESTMENT PROPERTIES UNDER US GAAP (2010), *available at* http://www.pwc.com/us/en/asset-management/real-estate/ publications/ fair –value –reporting –for –investment –properties –us –gaap.jhtml (discussing the proposed Accounting Standards Update that would require investment property to be measured at "fair value"); FINANCIAL ACCOUNTING STANDARDS BOARD, PROPOSED ACCOUNTING STANDARDS UPDATE: LEASES (TOPIC 840) 2 (2010), *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823559205&blobheader=application%2Fpdf (proposing that landlords and tenants should apply a "right-of-use model" in accounting for all real estate leases, which essentially would require tenants to recognize the contracted rent as a liability on the balance sheet and would require landlords to recognize leases as a receivable for the right to receive future rent payments at the discounted value of the expected future rent stream).

276. Brian S. Wesbury & Robert Stein, *Bernanke Finally Fingers Mark-to-Market*, NAT'L REV. ONLINE (Mar. 8, 2010, 12:00 AM), http://www.nationalreview.com/articles/print/229276.

277. *Id.*

regarding the banks' responses to regulator guidance encouraging workout. At the Congressional Oversight Panel hearing on February 4, 2011, Patrick Parkinson of the Federal Reserve announced that his institution was working with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation to collect "loan-level" data from national and regional banks in order to better understand the credit quality and performance of those portfolios.[278] This announcement is a good step toward capturing the data that will allow regulators and scholars to assess the characteristics of commercial real estate loans held by banks to understand the importance of historic trends and craft appropriate policies going forward.

The first step to solving any problem is recognizing that the problem exists. The purpose of this Article has been to describe the commercial real estate debt crisis and the dangers posed by the government's policy of inaction. The next Article will expand upon the four proposals briefly mentioned above and provide more concrete policy recommendations to resolve the current crisis and, perhaps more importantly, prevent it from occurring again.

278. *Commercial Real Estate's Impact*, *supra* note 53, at 52 (statement of Patrick Parkinson, Director, Division of Banking Supervision & Regulation, Fed. Reserve).