# The Current State of the Housing, Mortgage, and Commercial Real Estate Markets: Some Policy Proposals to Deal with the Current Crisis and Reform Proposals to the Real Estate Finance System

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*Current State of the Residential Real Estate Market*

Although there are signs of stability in new housing starts, existing home sales, and house prices, it will be a long, slow recovery of 3-4 years before we return to equilibrium conditions. The embryonic recovery in housing has been highly dependent on massive federal government intervention rather than an organic increase in buyer demand. The Federal Reserve is buying 80% of all newly created residential mortgages by purchasing FNMA and FHLMC securities. This has kept interest rates on residential mortgages in the 5% range, which has been critical to the housing market's recovery. In addition, the $8,000 first-time homebuyer tax credit has boosted demand as well as moved some home sales forward in time. According to the National Association of Realtors, first-time home buyers accounted for 47% of all home sales in 2009 – the highest percentage since at least 1981 when the data series began. The extension of the first-time homebuyer tax credit and expansion of the credit to nearly all existing home owners will further increase short-term home sales.

Government mortgage funding has also played a major role in stabilizing the housing market. A large ramp-up of the FHA mortgage insurance program provided low down payment loans to over 18% of home buyers in fiscal-year 2009, helping to make up for the lack of financing from banks and mortgage-backed securities. The share of all mortgages that were originated by the FHA, the VA, Freddie Mac or Fannie Mae hit nearly 80% in 2008, meaning that non-government entities accounted for only about 20% of all originations, compared with nearly 70% in 2005 and 2006. Thus, government support has been crucial to propping up the mortgage financing system in the absence of private funding sources. A key reason for the steep decline in private mortgage financing has been a lack of demand for mortgage-backed securities on the secondary market. The volume of prime and Alt-A mortgage-backed securities issued through the first three quarters of 2009 totaled less than $5 billion, compared with the peak of $613 billion in 2005. After peaking at $508 billion in 2005, issuance of subprime mortgage-backed securities has been virtually nonexistent since 2007.

Although the federal government's actions have had a positive impact on housing demand, the planned conclusion of several programs this year could stunt the housing market's nascent recovery. To qualify for the federal homebuyer tax credit, sales must close by June 30, 2010, which will lead to a bunching of sales in the first half of 2010 and possibly a sharp fall-off in sales in the second half of 2010. Also, the Federal Reserve plans to end its $1.25 trillion purchase program of mortgage-backed securities in the spring, which would likely push mortgage rates above 6% by year-end, deterring some potential homebuyers.

Another risk to the housing market's recovery is the foreclosure tsunami, which continues to mount with nearly 1 in 10 mortgages in the United States either in severe delinquent or foreclosure status. The mortgage foreclosure problem started as a result of poorly structured mortgages given to marginally qualified households. The Making Home Affordable mortgage modification plan was aimed at addressing the millions of subprime, Alt-A, and option ARM mortgages that were issued during the housing boom. However, the problem has now morphed to encompass millions of unemployed households unable to pay their mortgages, as well as the "underwater" mortgage issue of households walking away from loans that exceed the value of their homes. The Obama administration's plans need to be radically modified to address these massive issues if the fragile housing market recovery is to be sustainable.

*Policy Proposals to Deal with the Foreclosure Tsunami*

The following reforms must be enacted to stem the current tide of foreclosures and further stabilize the housing market:

- The "underwater" mortgage problem must be addressed through a loan modification plan that reduces the mortgage amount. A shared appreciation second mortgage that allocates part of the future appreciation of the home to the government and to the private lender involved in arranging the loan modification would reward taxpayers and private lenders with a portion of the appreciation of the value of the homes when housing markets recover, while reducing the incentive for borrowers to take unwarranted advantage of the loan modification program.
- With eight million people already losing their jobs in the "Great Recession," the government's foreclosure relief program needs to address the issue of how to deal with newly unemployed households who lack the income to qualify for a loan modification. The government should consider an "unemployment bridge loan" for up to half the mortgage payments due for a two-year period or until the person is re-employed. This bridge loan would be secured with a second mortgage against the house and could be administered through the unemployment compensation system.

In addition, the following fundamental reforms must be implemented in order to prevent another housing bubble and ensuing financial crisis from occurring in the future:

- Underwriting reforms must include full income and employment verification for all homebuyers and appraisal for all loans to ensure that borrowers are capable of repaying their mortgages.
- Mortgage instruments must be fully amortized and have payment increases restricted to income increases of borrowers. Suitability standards for mortgages should be required by looking at payment-to-income ratios.
- Loan-to-value (LTV) ratios should be altered on a countercyclical basis, with higher down payments required at the peak of the housing cycle. This would reduce the number of borrowers overextending to purchase homes at the peak of the cycle and stimulate sales activity at the trough. Throughout the cycle, a minimum down payment of 5% hard cash should be required, with no exceptions.
- Securitizations should require partial risk retention by originators and packagers to prevent a proliferation of mortgages to unqualified borrowers.
- Full recourse loans should be the standard for residential real estate so that walking away from a mortgage is a less attractive option to borrowers.
- To discourage rampant speculation, non owner-occupied loans should require a 30% hard down payment, with no exceptions.
- Federal regulation of the mortgage origination and securitization process should be much tougher in order to prevent the widespread mortgage fraud and reckless lending that occurred during the housing boom.

*Current State of the Commercial Real Estate Markets*

Like the residential market, a flood of liquidity led to a surge in investment volume in commercial real estate properties. The peak in domestic CMBS issuance of $230.2 billion in 2007 coincided with the peak in commercial property sales, which totaled $544 billion in the 12 months through October 2007, compared with less than $100 billion in properties traded four years earlier. As CMBS issuance plummeted in 2008, so did property sales. An estimated $2.2 billion in CMBS was issued in 2009, leading to $47 billion in property sales in the 12 months through November (the latest data available) – a 91% decrease from the peak sales level in 2007. The Mortgage Bankers Originations Index for commercial and multifamily loans also illustrates the dramatic

decline in mortgage loan issuance. The base index value of 100 is the average of the four quarters of 2001, prior to the start of the commercial real estate boom. After peaking at more than 350 in the second quarter of 2007, the index plunged, hitting a low of 40 in the first quarter of 2009 and increasing only slightly during the next two quarters. The index shows that originations activity has fallen not just from liquidity-fueled peak levels during the middle of the decade, but from lower levels in 2001 prior to the run-up in transaction volume and prices.

The fundamentals for nearly all commercial property types are still eroding, as vacancy rates rise and rents fall. Consequently, values have plunged between 25-50% from peak levels of 2007. As NOI declines, delinquency rates on commercial mortgages are rising substantially. Additionally, many owners that bought at the peak of the market between 2005 and 2007 are unable to refinance maturing loans on properties that are now worth substantially less than the value of the mortgage. Although the CMBS market is showing signs of life, current valuation levels on the $779 billion of mortgages that were created in the last five years will make refinancing difficult. The TALF CMBS program has had only a minimal impact on commercial real estate so far, with operations totaling just $17.4 billion in 2009. Nearly all of the loans secured through the program were for legacy CMBS. The only new issuance was $72.2 million requested in the November facility as part of Developers Diversified Realty Corporation's $400 million new issue. The TALF program is scheduled to end on March 31st for legacy CMBS and on June 30, 2010 for newly issued CMBS, and given the low volume so far, it is unlikely to have a significant impact on the CMBS market by its conclusion. We estimate that between $800 billion and $1 trillion of losses to commercial real estate equity and debt will be realized over the next few years. The annual volume of commercial mortgage maturities is expected to increase each year through 2013, meaning that losses for banks, life insurance companies, CMBS holders and other investors will continue to mount unless borrowers are able to find alternate funding sources.

Investment activity remains severely depressed because of a lack of financing options and poor market conditions. According to Real Capital Analytics, investment volume in all commercial real estate in the 12 months through November totaled just $48 billion, compared with $157 million one year earlier and a cyclical peak of $547 billion in the 12 months through October 2007. As long as capital markets, including the CMBS market, remain tight, transaction activity is unlikely to increase significantly.

Problems in commercial real estate pose a substantial risk to the broader financial system. As of the third quarter of 2009, 15.0% of real estate construction and development loans were delinquent – the highest percentage since the beginning of the data series in 1992. Rising delinquency rates on these loans threaten over 550 small and medium-sized banks, which greatly increased their lending to commercial developers in recent years as larger institutions dominated the market for home mortgages and consumer credit. The failure of these institutions would further constrain credit for individuals and small businesses, which already face few options.

*Reforms for the Commercial Real Estate Finance System*

Like the residential market, the problems in the commercial real estate sector also relate to excessive leverage and poor underwriting, and therefore our proposals to reform the commercial real estate finance system target these issues. The purpose of these reform proposals is to increase the equity cushion for real estate debt transactions and to get a better alignment of interest for the parties in the debt transaction.

- Similar to the residential mortgage market, maximum loan to values should be set countercyclically to minimize the number of borrowers becoming overextended at the market's peak. On average, loan-to-value ratios for stabilized properties should be 75% including the first mortgage and mezzanine debt. When values are at peak levels (when cap rates are less than 150 basis points above 10-year Treasuries), the maximum LTV should be reduced by 5% for each 50 basis points less than normal spreads.

- Debt coverage ratios for fixed-rate mortgages on stabilized assets should be at a minimum of 1.25 to ensure that properties are generating sufficient NOI for owners to meet debt obligations.
- Construction and development loans should be restricted to 50% of cost so that developers have a greater financial stake in their projects.
- In securitized transactions, originators and packagers of loans should be required to defer a portion of their fees until a loan seasons successfully. By sharing in the risk, these parties would have a greater incentive to underwrite and securitize high-quality loans that are likely to be repaid rather than passing on all of the risk to investors.
- The Foreign Investment in Real Property Tax Act (FIRPTA) should be substantially amended or repealed in order to attract much-needed capital to the domestic real estate markets. FIRPTA discourages foreign investment in U.S. real estate by assessing a tax on capital gains, unlike other asset classes including stocks, bonds and interest-bearing bank accounts that are not taxed by the U.S. government. The revision or elimination of the tax would provide some of the capital needed to refinance the hundreds of billions of dollars of mortgages coming due during the next few years, driving transaction activity, creating jobs and stabilizing asset values and thus, the broader financial system.