Remarks by
FDIC Chairman Sheila C. Bair
to the
Commercial Mortgage Securities Association Annual Conference
Washington, D.C.
January 20, 2010

Good afternoon. Thank you for inviting me to speak. Like all of you here today, I very much want to see the commercial real estate capital market get back on its feet. It's a vital source of financing for a key sector of the American economy.

All of us have a stake in reforms that prevent the excesses and abuses of the past, and that open the way for new lending and securitization on a much sounder footing.

Current market situation for CMBS and CRE

The financial market upheavals of the past few years – and the economic fallout that resulted – have largely revolved around U.S. real estate markets.

Residential markets fell first. After a decade-long boom that nearly tripled the average price of an American home, we saw a four-year downturn marked by historic declines in housing starts, sales, and prices.

Problems on the commercial side started later. But by some measures, they have been even more pronounced. Sales of commercial real estate (CRE) slowed dramatically in 2008 and 2009, as vacancy rates and rental rates declined significantly. And while CRE price declines began well after the fall in home values, they have actually been larger on average ... with CRE price indices down by over 40 percent from their Fall, 2007 peak.

This sharp decline in commercial real estate values is in large part because of higher required rates of return on the part of investors ... and deterioration in the availability of credit for commercial real estate financing.

As you know, issuance of commercial mortgage backed securities was virtually shut down for the last half of 2008 and much of 2009. Meanwhile, delinquency rates for properties in securitized in CMBS have increased rapidly.

Although CMBS financing grew in importance during the last economic expansion, FDIC-insured banks and thrifts still hold the largest share of commercial mortgage debt. Their dollar exposure to CRE loans stands at an historic high. As of September, CRE loans backed by income-producing properties - nonfarm, nonresidential properties or multifamily real estate - totaled $1.3 trillion, or nearly 18 percent of total loans and leases. Banks and thrifts also held almost $500 billion in construction and development loans.

The annualized net charge-off rate of 6 percent on C&D loans in the third quarter significantly exceeds the highest rate seen in the last crisis, which was about 4 percent. Credit performance has also declined for loans on income producing properties but not nearly to the same degree. Noncurrent CRE loans on income producing properties have risen by 250 percent over the past year to $44.8 billion.

Big banks vs. small banks

Despite what you may be hearing, CRE credit problems are affecting big and small banks alike. In fact, CRE noncurrent and charge-off rates are higher at banks with over one billion dollars in assets than at community banks. Industry analysts expect CMBS delinquency rates to continue climbing.

As for bank and thrift portfolios, we expect still higher noncurrent rates and charge-off rates on CRE loans backed by income producing properties in the coming quarters. Of course, the ultimate scale of losses in CRE loan portfolios depends on the pace of recovery in the U.S. economy and financial markets. On this point we remain hopeful.

Financial market spreads have normalized since the policy interventions of 2009. And economic activity continues to slowly but steadily turn around after the longest and deepest U.S. recession since the 1930s. But more needs to be done. We need to strengthen the foundations of commercial real estate financing, both by banks and in the capital markets.

Reforming securitization

That is why we are taking concrete steps to improve underwriting practices. We want to facilitate the workout of troubled real estate loans to existing borrowers. And we want to reform the securitization process to help restore credit availability.

Many of the credit losses recognized since the beginning of this crisis can be directly attributed to deficiencies in loan underwriting and administration. Prudent underwriting is a key tenet of lending. It has a dramatic influence on the performance, default characteristics, and loss severity of each loan.

Over the decades, bank regulators have insisted that lenders make sure their policies and practices ensure due diligence before a credit commitment is made. Regulators also insist on loan terms that facilitate the timely repayment of debt. As your members are now acutely aware, the past decade saw a significant departure from prudent underwriting practice and loan terms and a dramatic shift in risk-taking.

I think it's fair to say that ten years ago no one in this room would have imagined making a no-doc, teaser rate, pick-a-payment ARM to a homebuyer with a blemished credit record, and who had no verifiable income or assets. Yet lenders and investors by the droves lined up to finance such risky deals and in the process, saddled millions Americans with debt that they could not understand, or possibly repay. Conversely, there are a number of institutions around the country that did not compromise prudent lending standards, and are thus in a much stronger position to weather this downturn.

Besides residential mortgage lending, underwriting also became very relaxed in commercial lending. Intense competition among lenders led to a race-to-the-bottom in terms of risk management. Terms began to include relaxed covenants, liberal interest-only periods, gracious interest reserves, extended maturities, non-recourse terms, and very aggressive pricing. Furthermore, excessive concentrations of credit risk, especially in construction and development portfolios, are contributing to the large number of bank failures and creating significant problems at institutions across the country.

FDIC underwriting expectations

Let me set out a few fundamental expectations we have for credit underwriting, loan terms, and concentrations of credit risk. In residential lending, we expect banks to have a firm grasp on the complexity and risk in their credit portfolio. And we want them to set aside sufficient capital for unexpected losses in credit exposures that might occur.

Proper underwriting requires that a borrower's income is verified ... that credit history is reviewed, that the ability to repay is assessed and that collateral is appraised independently and not viewed as the primary source of repayment. Repayment terms should give banks a reasonable return on their loan commitment, and be economically sustainable for the borrower's income and cash flow.

In commercial lending, we expect banks to provide documented analysis of repayment capacity and collateral support, in addition to the borrower's ability to make timely payments. While we fully appreciate that commercial loan terms need to be flexible to allow for competition with other lenders ... we do not want banks to compromise pricing, covenants, or other terms to meet loan production goals.

In short, loan underwriting and administration deserve a much larger role in credit risk management going forward. Lenders need to embrace the lessons learned from this crisis. They need to establish a prudential framework for extending credit on a sounder basis.

Working out problem CRE credits.

Let me now focus on what the FDIC and other federal regulators are doing to encourage banks to continue making good loans and to work with financially distressed borrowers through loan modifications and other cooperative efforts.

At the height of the financial crisis in late 2008, the federal agencies issued a joint statement to the banking industry on meeting the needs of creditworthy borrowers. That statement reinforced our view that banks should continue to support the economy by lending prudently. The statement also pointed out that in the wake financial crisis the economy would become even more dependent on bank credit. So we noted that it would be in everyone's interest for banks to make lending a priority even while moving to strengthen their capital bases ... and to restructure problem loans.

Late last year, regulators again called attention to credit distress and credit availability with a new policy statement for handling commercial real estate loan workouts. This latest guidance encourages banks to continue making good loans to commercial real estate borrowers — many of which are small businesses — and to work with borrowers that are having difficulties because of economic conditions.

It emphasizes that restructured loans will not be subject to adverse classification by examiners solely because the value of the underlying collateral has fallen. In fact, institutions are encouraged to implement prudent, loan workouts based on an updated picture of the borrower's financial condition ... and examiners are instructed to take a balanced approach in assessing an institution's risk management practices for workouts.

The guidance gives specific examples that reflect various ways that bankers may decide to work with borrowers, including loan modifications and restructurings that can pass muster under accepted accounting principles. The FDIC is also training our examiners to make sure that they are accurately applying the guidance in the field.

We feel that this measure – which facilitates responsible workouts for existing loans – can go a long way towards addressing the economic dislocations that are hurting small business borrowers and their lenders. These are solid loan workouts that are based on the documented financial capacity of the borrower and the long-term prospects of the underlying project.

Restarting securitization & promoting good underwriting

Restoring our system of commercial real estate financing will also require fundamental reforms in the securitization process. We need reform to prevent the excesses of the past few years from recurring and to make it safe for investors to return to this market.

Securitization markets provided much of the funding for the high-risk home loans that helped precipitate the financial crisis. Development of the CDO and CDS markets enhanced growth in private-label mortgage-backed securities.

Compensation schemes at large financial institutions also fueled the growth of private securitization and related derivative instruments. Many compensation systems were not sufficiently linked to risk management, leading to badly misaligned incentives.

As deposit insurer and receiver for failed insured banks and thrifts, the FDIC has a responsibility to control the risks to the Deposit Insurance Fund. This gives us a unique opportunity to help lead the way in reforming the securitization process.

The FDIC's current rules for the treatment of securitizations under conservatorship or receivership provide important safe harbor protections for securitizations by confirming that in the event of a bank failure, the FDIC will not try to reclaim loans transferred into a securitization so long as an accounting sale had occurred.

But changes approved last year by the Financial Accounting Standards Board mean that most securitizations will no longer meet the off balance sheet standards for sale treatment. As a result, most securitizations will not meet the test in the FDIC regulation unless we amend that rule.

So in November, the FDIC Board approved a transitional safe harbor for securitizations or participations to clarify the circumstances when the FDIC, as conservator or receiver, will treat a transfer for a securitization or participation as a sale ... and, if no accounting sale is possible, when we will provide consent to investors for continued access to the financial assets that are securitized.

Under this safe harbor, all securitizations or participations in process through March 31, 2010 would be permanently grandfathered.

Last month, the FDIC Board approved a measure seeking public comment on what standards should be applied for safe harbor treatment for transactions created after March 31st. This advanced notice of proposed rulemaking opens these issues up for public comment. It requests input from the industry as to what standards we should set to help ensure that securitization will strengthen, not weaken, banks that are insured by the FDIC. The final rule will be developed based on the responses that we receive.

The proposed rule includes sample text that appropriately focuses many of the definitive requirements on residential mortgage-backed securitizations – where we have seen the most difficulties. It outlines four fundamental requirements for a well-structured securitization process in which risks can be properly evaluated and managed.

To summarize, they include:

- Simpler and more transparent structures.
- Loan level disclosures, with an adequate due diligence period and updated throughout the term of the deal.
- Compensation tied to performance.
- Origination standards and some retention of an interest in the deal by the sponsor of the securitization.

But we also recognize that there are differences between the various securitized asset classes. CMBS is different from residential MBS.

We need your input

That is why we need active involvement from your industry in spelling out the new standards that will qualify for the safe harbor under our final rule. We have all seen the role that the "originate to distribute" model of mortgage finance played in the build-up to the financial crisis.

Did securitization cause the crisis? No. There were many factors. But securitization encouraged a focus by non-banks ... and later by some insured banks and thrifts ... on deal production and fee generation at the expense of consumer protection and sound underwriting. The consequences of these combinations have been to undermine our financial and economic stability.

Our proposed conditions for a regulatory safe harbor are designed to correct the weaknesses in securitization that contributed to the crisis. We hope that these conditions would allow insured banks and thrifts to profitably securitize loans in a way that aligns incentives to support sustainable lending.

We look forward to your comments on whether they would achieve that objective. Fostering a sustainable securitization market that emphasizes transparency, loan quality, risk retention, and appropriate incentives and authorities for restructuring troubled loans will help restore investor confidence. And it will help banks diversify their funding sources while managing interest-rate risk for longer dated assets.

We will not see a return of this market without a return of investor confidence in bank originated securitizations. So I believe the views and comments of the "buy side" community will be crucial to this process.

I believe our advanced notice of proposed rulemaking is very consistent with the direction of legislation in the House and Senate to require better transparency, loan quality, risk retention, and appropriate incentives and authorities for restructuring troubled loans.

We are working with other regulators to achieve consistent regulatory reforms that will help prevent the arbitrage between different types of lenders and different types of securitizers. That said, I believe it is appropriate to set high qualitative standards for insured institutions, given their federal backing through insured deposits. And if investors respond by being more willing to invest in securities backed bank-originated loans, it is win-win for everyone.

These reforms will give investors confidence that they understand their risks and that those risks can be managed within the securitization to prevent the conflicts we've seen in the past.

Compensation reforms

Finally, we also need to reform the compensation systems that skewed economic incentives and helped fuel the rapid growth in credit markets, especially for mortgages and related derivative products. Many plans translated large short-term profits into generous payments with insufficient regard to long-term risks.

We're considering rules in a separate advanced notice of proposed rulemaking that would reallocate the burden of deposit insurance premiums toward banks that take such risks as a way to reform the economic incentives in banking. And let me emphasize that our focus is compensation structures, not levels.

Closing

As I said at the beginning of my remarks, I very much want to see the commercial real estate capital market get back on its feet. And all of us have a stake in reforms that prevent the excesses and abuses of the past.

At the same time, I do not want to inhibit innovation and progress, which are the hallmarks of America's capital markets. It's abundantly clear that we need smarter and more effective regulation. But regulators don't have all the answers.

You also have a responsibility to help us restart this market, to use your innovative talents to find solutions that turn a profit, but that prevent another financial crisis somewhere down the road. I look forward to working with all of you in achieving this common goal. Together we can make a very positive impact on economic growth, job creation, and the well-being of our nation.

Thank you very much.

Last Updated 1/20/2010