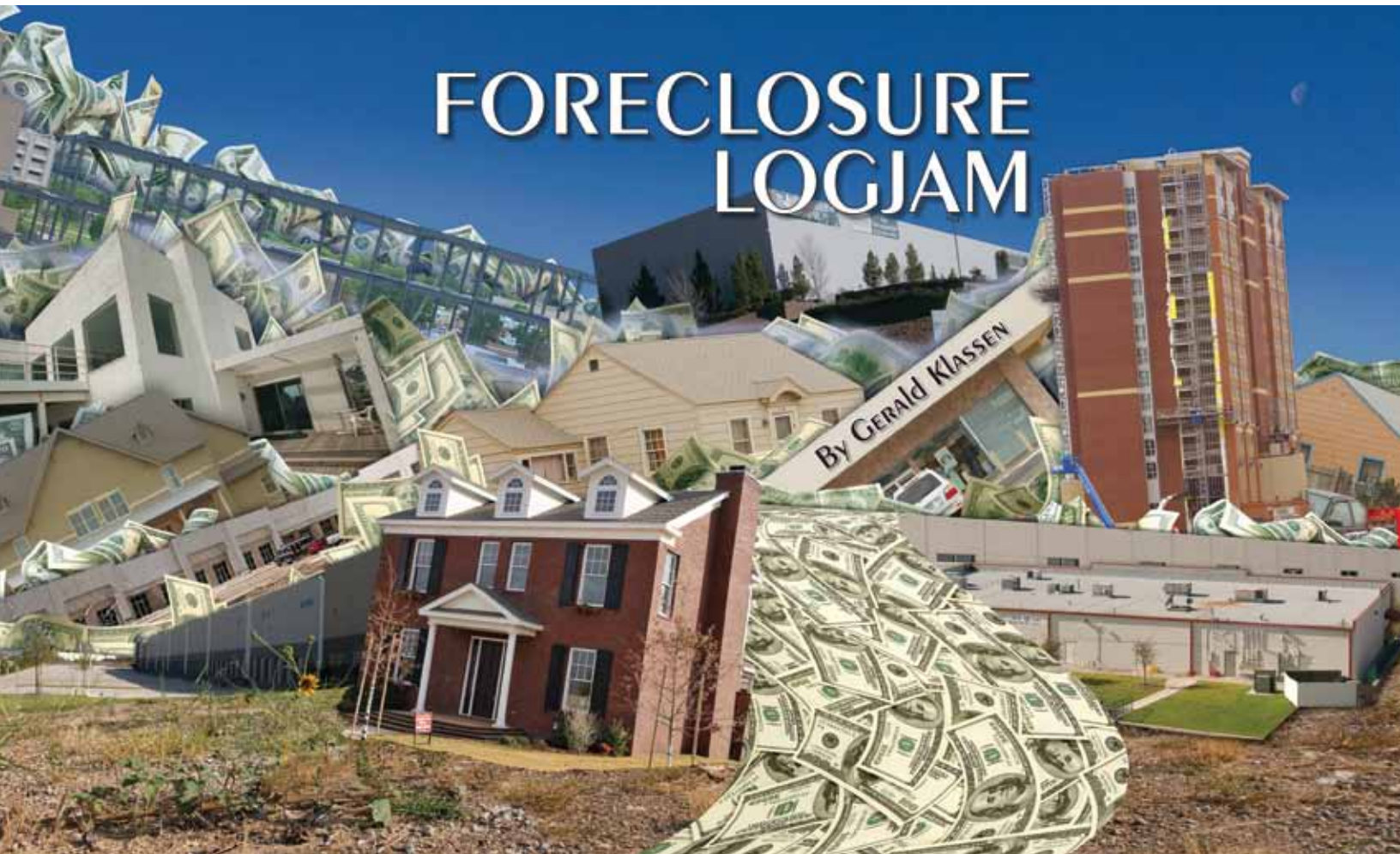


A Reprint from *Tierra Grande*

# FORECLOSURE LOGJAM

By Gerald Klassen

The battle to prevent foreclosures in both residential and commercial real estate rages on. The Federal Reserve, Federal Deposit Insurance Corporation (FDIC) and the Obama Administration are mustering all available resources to prevent foreclosures by either inflating asset values or creatively underwriting loan refinancing.

Meanwhile, the pool of private capital continues to build in anticipation of the flood of foreclosures. So what is holding things up?

## Minimizing Distressed Sales

David Wessel of the *Wall Street Journal* wrote, "Mr. Bernanke remains an academic at heart. He studied the Great Depression, concluded that letting the nation's banks collapse made a bad situation worse and vowed the Fed wouldn't make *that* mistake again."

But it is important to look at why the banks failed. The Bank Holiday of 1934 was a solvency crisis brought on largely by banks' inability to collect on mortgage payments and ultimately the losses from foreclosures. If real estate values had remained inflated, foreclosure losses would have been far smaller, and the Bank Holiday may have been avoided.

So what strategies will Bernanke pursue this time? The short answer is, any that keep a mortgage current or sustain inflated collateral values.

Four important tools have emerged to help support real estate values and prevent a flood of distressed sales.

### ***Fed and Treasury Department purchases of mortgage-backed securities (MBS)***

This tool is aimed at residential real estate and was the most-used tool in 2009. Strong bids from the Fed and U.S. Treasury produced artificially low mortgage rates that enabled many distressed homeowners to refinance their homes and attracted new homebuyers into the market.

This bold and unprecedented action kept residential real estate values from even worse declines. But this tool has run its course and has placed the Fed's balance sheet at significant risk. If mortgage rates rise as private mortgage investors re-enter the market, the Fed risks insolvency from losses on the massive MBS portfolio it owns.

### **Uncapping loss-backing of Fannie Mae and Freddie Mac**

**T**his tool is also aimed at residential real estate. In December 2009, the Obama administration removed the limit on Fannie and Freddie losses that it would be willing to fund. This unlimited backing will last through 2012. Early in 2009 the administration had said it would inject up to \$200 billion of equity into each firm to offset losses.

This Christmas Eve gift for the government-sponsored enterprises (GSEs) created an interesting opportunity to help the administration sustain artificially low mortgage rates in 2010. If the administration feels that higher mortgage rates are threatening housing, the economic recovery or the financial system, it could charge the GSEs with purchasing more MBS securities.

The GSEs could sell their agency bonds to the Federal Reserve or Treasury and use the proceeds to bid strongly for mortgages from banks. The mortgages could then be packaged into MBS and held in the GSE portfolios. Any losses during the holding period would be fully backed by the Obama administration. This backup plan could be used to support residential real estate values if the Fed does not wish to further increase its MBS portfolio.

### **Liberal guidance on commercial real estate (CRE) loan workouts**

The new guidelines for CRE loan modifications issued by bank regulators in October 2009 are a powerful tool for banks to reclassify nonperforming loans into mostly performing loans. Banks are permitted to consider the borrower's other debt obligations and cash flows when making a decision about a particular loan modification.

In addition, regulators will allow market valuation to differ from the collateral's fair value for regulatory reporting purposes. And finally, a nonperforming loan may be split into two pieces: a smaller performing loan (the "A" Note) and a second loan that is charged off (the "B" note). The big challenge for this tool will come this spring when auditors are asked to agree with the asset values assigned by management.

### **FDIC securitization**

This tool, which is a result of "outside of the box" thinking from the FDIC, also is aimed at CRE. Structured Finance News (structuredfinancenews.com) reported in October 2009 that Michael Krimminger, special advisor for policy for the office of

the chairman at the FDIC, spoke at the Information Management Network's 15<sup>th</sup> Annual ABS East conference in Miami, saying "the FDIC has acquired more than 100 failed banks, and it is likely that they may seek to do a securitization."

With Troubled Assets Relief Program (TARP) equity and an FDIC guarantee, the FDIC could tie up a lot of real estate this way and control the release of distressed properties into the market. Investors looking for distressed real estate would be left to choose between buying mortgage-backed securities from the FDIC or bidding high prices as the FDIC gradually sells assets out of the pool. The big winners in this scenario would be the property managers employed by the FDIC to work out the assets.

It is difficult to know if and how long the Fed and the bank regulators can prop up real estate values. Price declines of this magnitude have not happened since the Great Depression. Economic recovery either will occur quickly and support reflat asset values or some unexpected event will occur, causing market forces to breach the government's dam of protection around real estate values.

**I**n *The Great Depression: A Diary*, Benjamin Roth, a lawyer from Youngstown, Ohio, offered insight into the unfolding real estate crisis at that time. His observations may hint at what is ahead for modern investors.

*August 26, 1936*

*Recovery has been moving gradually forward since the bottom was reached in the summer of 1932. A spurt came in March 1935 and has continued to date. Bargains are still available in stocks although they do not compare with what could have been done in 1932. The real estate taken back by the banks during the past 5 years is still being liquidated at bargain prices but the choice now is limited. Rents are going up and it is probable that in another year the banks will have liquidated all their foreclosed real estate and then a more normal market will be established. As to the future — it is hard to say if we are heading for a boom or for a few years of normal business. The possibility of inflation makes a guess difficult.*

Foreclosure moratoriums and resistance to distressed asset sales are not unique to the current Great Recession. Roth recounts strong efforts at foreclosure moratoriums and prevention during the Great Depression:

*April 30, 1933*

*A miniature 'Shay's Rebellion' is taking place in Iowa. Enraged farmers in one place fought 50 deputy sheriffs to prevent a foreclosure sale. In another place they pulled the judge off the bench during the trial, tied a rope around his neck, abused him, threatened hanging. Finally removed his pants and left him on the highway. These places and several others are now under military control and prompt punishment will be meted out to the wrong-doers.*

## Representative FDIC Auction Results

Source	Portfolio Description	Price Paid
<i>New York Times</i> Sept 17, 2009	<ul style="list-style-type: none"> <li>• \$1.3 billion in mortgages from Franklin Bank</li> <li>• Winning bidder: Resolution Credit Solutions, 50 percent of equity in JV</li> </ul>	70 cents on the dollar
<i>CoStar/New York Times</i> Oct. 7, 2009	<ul style="list-style-type: none"> <li>• Corus Bank auction</li> <li>• \$4.5 billion of REO assets, nonperforming loans, loans in imminent risk of default and loans in foreclosure</li> <li>• Eight bidders</li> <li>• Over 100 loans backed by 8 million sf of property and 102 properties including 79 condos, 14 multifamily, 8 office, 1 land project</li> <li>• Markets: Los Angeles, Miami, Washington, D.C., New York, Chicago, Atlanta</li> <li>• High-quality assets</li> <li>• Winning bidder: Investor group led by Starwood Capital/TPG; 40 percent of equity in portfolio</li> <li>• Debt:Equity = 1:1</li> </ul>	60 cents on the dollar
Portfolio.com Nov. 16, 2009	<ul style="list-style-type: none"> <li>• Nationally, the FDIC has auctioned 3,768 commercial mortgage loans this year, face value \$1.8 billion</li> </ul>	Average price of 32 cents on the dollar
<i>Wall Street Journal</i> Dec. 23, 2009	<ul style="list-style-type: none"> <li>• The FDIC sold residential and commercial loans through eight public-private partnerships where it retained an equity interest of 50 percent to 80 percent</li> </ul>	From pennies on the dollar to more than 50 cents on the dollar
CommercialRealEstateDirect.com Jan. 8, 2010	<ul style="list-style-type: none"> <li>• \$1.02 billion of CRE loans from Franklin/IndyMac and others</li> <li>• \$455.5 million (41.5 percent) of portfolio backed by traditional commercial properties — office, industrial, retail, apartment, self-storage, hotel</li> <li>• \$310.2 million (203 loans) backed by land</li> <li>• Substantial concentration of other “oddball assets” (such as churches, car washes, funeral homes)</li> <li>• Winning bidder: Colony Capital and affiliated REIT; 40 percent equity in portfolio</li> </ul>	44 cents on the dollar

Source: Real Estate Center at Texas A&M University

## Purchasing Distressed Properties

The law firm of Dechert LLP has authored a document describing the different ways investors can purchase assets from the FDIC ([http://www.dechert.com/library/Finance\\_and\\_Real\\_Estate\\_08-09\\_24.pdf](http://www.dechert.com/library/Finance_and_Real_Estate_08-09_24.pdf)). Three different types of programs exist:

- **Direct Loan Sales Program.** Loans from failed institutions are aggregated into pools and sold through an agent to investors through a sealed bid sale or an English outcry auction at a direct sale.
- **Real Estate Sales Program.** Physical real estate from failed institutions is sold individually through auction. Information about properties for sale can be found through the FDIC website and the websites of its primary real estate advisors, CB Richard Ellis Inc. and Prescient Asset Management.
- **Structured Loan Sales Program.** This program sells loan pools through a private placement structure. Bidders compete for an equity interest in a public-private partnership and assume asset management and servicing obligations as sole membership interest holder in a newly formed limited liability company. The FDIC retains an equity interest and facilitates debt financing for the company if elected by the winning bidder.

Low prices on quality asset sales of size will not be common because of the FDIC's adoption of the Structured Loan Sales Program. This program is based on the public-private partnership funding mechanism employed by the Resolution Trust Corporation in the late days of the savings and loan crisis and is the best way for the FDIC to garner higher prices.

The FDIC's goal is to maximize return on assets, not conduct speedy liquidations. Given the FDIC's financial difficulties, they are strongly motivated to do whatever it takes to replenish the FDIC Insurance Fund by maximizing auction results.

The *Wall Street Journal* reported in December 2009 that the FDIC held \$30 billion in CRE loans available for sale in the next 12 months. The table provides a summary of auction results reported so far.

A significant test of Bernanke's ability to protect the financial system will occur in the next two years. New York-based financial analyst Keefe, Bruyette and Woods estimates that the banking sector holds approximately 80 percent of the \$500 billion in commercial debt maturing in 2010 and 2011. The controversy surrounding TARP will make it difficult for Congress to assist small and regional banks holding a large share of the maturing debt.

Keep watching. The fireworks are about to begin. 🚀

*Klassen (gklassen@tamu.edu) is a research analyst with the Real Estate Center at Texas A&M University.*

## THE TAKEAWAY

The Federal Reserve is attempting to avoid a failure of the financial system by using four important tools to support real estate values. It is difficult to know how long they can succeed or if the plan will work at all because it has never been tried before. For investors seeking to purchase distressed real estate from the FDIC, three alternative programs have been designed to facilitate the auction of assets from failed banks.



MAYS BUSINESS SCHOOL

Texas A&M University  
2115 TAMU  
College Station, TX 77843-2115

<http://recenter.tamu.edu>  
979-845-2031

**Director**, Gary W. Maler; **Chief Economist**, Dr. Mark G. Dotzour; **Senior Editor**, David S. Jones; **Managing Editor**, Nancy McQuiston; **Associate Editor**, Bryan Pope; **Assistant Editor**, Kammy Baumann; **Art Director**, Robert P. Beals II; **Graphic Designer**, JP Beato III; **Circulation Manager**, Mark Baumann; **Typography**, Real Estate Center.

#### Advisory Committee

James Michael Boyd, Houston, chairman; Barbara A. Russell, Denton, vice chairman; Mona R. Bailey, North Richland Hills; Louis A. Cortes, China Grove; Jacquelyn K. Hawkins, Austin; Joe Bob McCartt, Amarillo; D. Marc McDougal, Lubbock; Kathleen McKenzie Owen, Pipe Creek; Ronald C. Wakefield, San Antonio; and John D. Eckstrum, Conroe, ex-officio representing the Texas Real Estate Commission.

**Tierra Grande** (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, \$20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Robert Beals II, p. 1.