COVID-19 and the Future of Commercial Real Estate Finance

October 19, 2020
COVID-19 and the Future of Commercial Real Estate Finance

Commercial real estate (CRE) refers to a broad range of properties, including office buildings, hotels, retail storefronts, restaurants, hospitals, stadiums, schools, and apartments. The market for CRE financing is over $3 trillion. In some ways, CRE is financed similarly to a house. A borrower takes out a mortgage from a lender to purchase a property, and the property acts as security for the loan. That lender can keep the mortgage on its books or sell it to other financial firms, which may package the mortgage with other CRE mortgages into an instrument known as a commercial mortgage-backed security (CMBS). CMBS are tradable securities whose interest payments to investors flow from the mortgage payments made by CRE borrowers. CMBS comprise about $800 billion of the $3.4 trillion CRE debt market. However, the structures of CRE loans (their terms, rates, etc.) are different than residential mortgages, and these differences make the CRE market unique, varied, and complex.

Because so many different sectors of the economy participate in the CRE market, economic conditions often can have disparate effects on different subsectors. Specific government intervention in CRE historically has been limited, largely due to the generally limited federal role in CRE markets. Unlike residential mortgages that are often purchased and securitized by entities linked to the federal government, commercial mortgages are generally privately securitized. Federal financial regulators do, however, indirectly address CRE by setting the policy for bank lending to CRE markets. The regulators can incentivize or disincentivize lending to certain sectors through prudential supervision and regulation. In addition, the Federal Reserve can assuage market liquidity concerns by purchasing assets such as CMBS from investors.

The Coronavirus Disease 2019 (COVID-19) pandemic has created a unique environment for CRE. With many businesses shuttered or operating on a limited basis, CRE tenants are struggling to make their payments, either in the form of rent or mortgages. For example, restaurants and storefronts have closed down temporarily or reopened on a limited basis, placing a strain on the retail sector. With travel limited, depressed tourism has caused hotels to lose summertime revenue. Office space has been left vacant as many businesses have shifted to work-from-home models for their employees. Stadiums, arenas, and sports teams have ceased operations due to cancelled tours and seasons, or they have carried on without fans, meaning no revenue from ticket sales or concessions. Hospitals have been flooded with pandemic cases, meaning day-to-day operations have sometimes exceeded capacity, but lucrative procedures, such as elective surgeries, have been put on hold until the health care industry reaches a normal pace of work. Many school districts have closed, choosing to operate virtually in the coming semester.

While financial regulators, including the Federal Reserve, have taken measures to address various impacts of the pandemic, the 116th Congress has also considered ways to address these issues, and some of them would directly impact CRE. Many Members of Congress have called on the U.S. Treasury and the Federal Reserve to open liquidity facilities to CRE and CMBS markets. In addition, legislation, such as H.R. 7809 and S. 4670, were introduced to specifically provide relief to the CRE sector by authorizing Treasury to guarantee preferred equity investments backed by CRE mortgages or make preferred equity investments in qualifying CRE companies. Other measures, such as H.R. 6800 and H.R. 925, both of which passed the House in 2020, would provide assistance to businesses and mortgage servicers for loans in certain CRE markets.

Future economic conditions are uncertain. The impacts of the pandemic may result in a substantially changed world for CRE, as lenders structure deals and offer credit to commercial borrowers in new ways to address risks associated with changing social preferences. Further, if the economic downturn from the pandemic were to become protracted, even though failed CRE can enter private-sector bankruptcy to resolve bad debts, Congress could consider intervening and providing financial assistance as it has in other troubled sectors.
Contents

Commercial Real Estate Market Finance ................................................................. 1
  Types of CRE Loans .................................................................................................. 2
    Managing Portfolio Risk of CRE Loans ............................................................... 3
  Commercial Mortgage-Backed Securities ............................................................... 5
The Federal Role in CRE Finance ............................................................................. 5
  Federal Regulation .................................................................................................... 6
    Risk Retention Rule (Regulation RR) ..................................................................... 6
    Asset-Backed Securities Disclosure and Registration (Regulation AB) ................. 7
Policy Issues for the 116th Congress ......................................................................... 7
  Pandemic Policy Response for CRE and CMBS ....................................................... 8
    Existing Indirect Support for CRE and CMBS Finance ......................................... 9
  Legislative Proposals ............................................................................................... 11

Figures

Figure 1. Commercial Real Estate (CRE) Financing Sources .................................... 4
Figure 2. Commercial Mortgage-Backed Securities (CMBS) Delinquency Rates .......... 8

Tables

Table 1. Estimated Commercial Property Value ....................................................... 1

Appendixes

Appendix. Historical Evolution of Commercial Mortgage-Backed Securities .......... 14

Contacts

Author Information ..................................................................................................... 17
Commercial Real Estate Market Finance

Most people interact with commercial real estate (CRE) in some way on a regular basis. Whether they go to an office to work, eat out at a restaurant, shop at a mall or local business, or attend a sporting event, CRE is a part of daily life. This report examines the basic structure of how CRE is financed and explores some of the current issues that may affect the availability of finance across the CRE sector.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Value ($ trillions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multifamily Housing</td>
<td>$2.9</td>
</tr>
<tr>
<td>Office space</td>
<td>$2.5</td>
</tr>
<tr>
<td>Retail</td>
<td>$2.4</td>
</tr>
<tr>
<td>Healthcare</td>
<td>$2.3</td>
</tr>
<tr>
<td>Specialty (e.g., sports, arenas)</td>
<td>$2.2</td>
</tr>
<tr>
<td>Hospitality</td>
<td>$1.6</td>
</tr>
<tr>
<td>Industrial</td>
<td>$1.5</td>
</tr>
<tr>
<td>Other (e.g., flex, storage)</td>
<td>$0.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$16.0</strong></td>
</tr>
</tbody>
</table>


The CRE market is large and complex. Because most commercial properties are owned or leased by private companies, valuing the market is difficult, but industry analysis suggests that CRE properties are valued around $16 trillion,¹ (see Table 1 above) and outstanding CRE debt is around $3 trillion.² (See Figure 1 below.) Whereas businesses can take out commercial debt for any number of reasons, including financing acquisitions, payroll or overhead costs, or inventory, CRE financing is used to pay for the land and structure within which businesses operate. The general distinction between CRE and residential real estate is that CRE properties are used for generating income for its owner rather than used as a residence for its owner. CRE loans are used

for privately owned, government, and nonprofit projects. Common uses for CRE include office space, retail space, hotels, stadiums, schools, hospitals, and multifamily housing.

In some ways, CRE is financed like residential property; there is a lender and a borrower, and mortgages generally are secured by the property (meaning that if the borrower defaults, the lender can assume ownership of the property). However, there are key differences between commercial and residential markets. For instance, term and down payment are distinguishing factors. To purchase a home, a borrower typically takes out a 30-year mortgage. This mortgage fully amortizes, meaning that the payments are spread throughout the 30-year term. In CRE markets, borrowers take out loans for much shorter terms, typically 3-10 years, and these loans do not fully amortize. Instead, the borrower will make smaller payments until the end of the term, followed by a larger payment at the end. Another key difference is the down payment. Residential borrowers may put down anywhere from 3% to 20% of the total property value; CRE borrowers typically put down more, around 25%.

These differences reflect the cost structures and risks associated with developing and maintaining commercial property. For instance, a developer has the significant up-front cost of building a structure and will not be repaid until the property is sold or starts generating income. Lenders therefore may require shorter terms and larger down payments to account for a potential higher risk of default.

Types of CRE Loans

Four general types of CRE loans are conventional commercial mortgages, construction and land development (CLD) loans, multifamily loans, and mezzanine loans.

If a borrower wants to finance a property with a structure on it, the borrower could choose a conventional commercial mortgage. Commercial mortgages would allow the borrower to purchase some or all of an existing property; these loans usually have maturities of 10 years (but can range from 5 to 30 years) and carry loan-to-value (LTV) ratios of 65%-75%.

CLD loans finance the purchase of land, preparation of sites, and construction of buildings on those sites. Should a borrower want to build a structure, construction loans could be taken out to finance the development. These loans carry terms similar to a line of credit, where the borrower would draw down funds to build and make payments over a shorter term, often in the form of interest-only payments. CLD loans typically have maturities of three years, and they carry LTV

---


4 Multifamily housing is considered CRE because it is operated by a company or individual seeking to profit from the residents. While multifamily housing is a substantial part of CRE, this report is focused on nonresidential real estate, and discussion of multifamily housing will be limited. More on multifamily housing can be found at CRS Report R46480, *Multifamily Housing Finance and Selected Policy Issues*, by Darryl E. Getter.


ratios around 75%-85%. Once a construction loan term has expired, the borrower would replace the CLD loan with a “takeout” loan to the property, which is effectively a new loan that resembles a conventional commercial mortgage.

Loans for multifamily housing units such as apartments (referred to as multifamily loans) are similar to commercial mortgages but often have longer maturities, ranging from 10 years to 40 years. They have LTV ratios around 75%-85% and are designated specifically for apartment buildings that generate rental income.

A mezzanine loan is somewhat similar to a second mortgage. It provides additional funding on top of a first mortgage and can combine equity and debt financing. A particularly expensive project, such as a large office building or stadium, might use a mezzanine loan to effectively increase the LTV ratio. Mezzanine loans gained popularity in response to a combination of factors: stricter lending standards, enhanced regulatory capital requirements, and the influence of bond rating agencies and investors on the underwriting of the CRE loans that comprise commercial mortgage-backed securities (CMBS), discussed below. These factors created a lending environment with lower LTV ratios, limiting the amount of debt available for a CRE loan and making mezzanine financing necessary for larger projects. Mezzanine loans are typically junior to the first mortgage and can be structured as secured or unsecured debt or as equity.

### How Do CLD Loans, Mezzanine Loans, and Commercial Mortgages Interact?

In the case, for example, of a developer who wants to build a new restaurant on land that contains an old structure, the developer could go to a bank for a construction and land development (CLD) loan. A typical CLD loan might be structured as a three-year line of credit, with a balloon payment at the end of the project. The bank’s loan may provide somewhere around 80% of the financing necessary—the loan-to-value ratio for a CLD loan can vary but typically ranges from 75% to 85%. (The rest of the financing would likely come from an unsecured mezzanine loan.) The CLD loan funds would be disbursed in stages, typically aligned with predetermined phases in the project development schedule. This disbursement process would protect the bank. At the end of the construction, the developer would take out a conventional loan to pay off the CLD loan balloon payment and then begin making payments on the longer term conventional commercial mortgage.

### Managing Portfolio Risk of CRE Loans

As described above, lenders such as banks can make different kinds of CRE loans to borrowers. However, although these loans can be profitable, they can be too large or too risky to hold in the lender’s portfolio; thus financial institutions can distribute the risk of the loan to other investors in a few ways.

Two similar but distinct practices that lenders use to manage loan portfolio risk are called loan syndication and loan participation. Both practices effectively reduce the amount of exposure a lender takes on by making a loan to a borrower. For example, if a loan is too large for an

---

12 More information about loan syndications and participation loans can be found at CRS In Focus IF10736, Collateralized Loan Obligations (CLOs) and the Volcker Rule, by Darryl E. Getter.
individual lender to make, that lender can join other lenders in making a *syndicated loan*, where multiple lenders pool funds together to make one large loan to a borrower. However, if a financial institution wants to serve as the primary lender for a borrower, but the loan is too large or risky for them to make and then keep on their books, the financial institution can make the loan and sell *participations* to other lenders, giving other lenders a share of the loan, and reducing the primary lenders overall credit exposure. This way, the primary lender retains a relationship with the borrower while avoiding unwanted credit exposures.

Another practice that has grown considerably in the past few decades for CRE is for lenders to sell a loan they make into the secondary market, where it can be securitized and packaged as a CMBS. This transaction provides the lender with more cash (liquidity) to make new loans and transfers credit risk to the secondary market where investors can purchase an interest in a security that matches their risk tolerance and demand for returns.

The different sources of CRE financing are broadly illustrated in **Figure 1**. While lenders can sell loans into the secondary market at any time (meaning they can hold loans in their portfolio as long as they wish), this figure gives a reasonable snapshot of the balance of funding sources for CRE. Banks and thrifts keep about 39% of the outstanding CRE market debt in portfolio, whereas private label CMBS issuance comprises about 14% of the market.

![Figure 1. Commercial Real Estate (CRE) Financing Sources](image)

**Source:** Mortgage Bankers Association, *Role of CMBS in the Financing of Commercial and Multifamily Real Estate in America*, October 2019, p. 11.

**Notes:** CMBS = commercial mortgage-backed securities; CDO = collateralized debt obligation; ABS = asset-backed securities; GSE = government-sponsored enterprise; MBS = mortgage-backed securities.
Commercial Mortgage-Backed Securities

An asset-backed security (ABS) is a type of financial instrument that derives its value from a pool of loans, such as auto loans or mortgages. A mortgage-backed security (MBS) is a type of ABS that comprises a pool of mortgages. Similarly, a CMBS comprises commercial mortgages. Some CRE mortgages, known as CMBS loans or “conduit loans” are designed to be securitized and sold in the secondary market. CMBS loans can be attractive to borrowers because they can carry lower rates than traditional CRE mortgages and allow borrowers flexibility in transferring or prepaying their mortgages. Some financial institutions specialize in making CMBS loans to borrowers and selling them to investors. Typically, life insurance companies, pension funds, money managers, mutual funds, and commercial banks invest in CMBS products.

Figure 1 shows that private securities backed by commercial mortgages and real estate comprise around 14% of the total CRE lending market. MBS for CRE constitute over a third of the market after adding the multifamily (i.e., properties with five or more residential units) portfolios and securitized issuances from Fannie Mae and Freddie Mac (collectively referred to as the government-sponsored enterprises, or GSEs) and Ginnie Mae. CMBS markets developed substantially over the past three decades. A short history of how this market evolved is presented in the Appendix.

The Federal Role in CRE Finance

Although the federal government created an impetus for the modern CMBS market, the federal role in CRE is relatively limited, especially in nonresidential properties. That said, some federal agencies guarantee, insure, or securitize certain types of CRE loans. For example, the U.S. Small Business Administration (SBA) has programs that guarantee repayment of portions of eligible small commercial loans designed for fixed asset investments, which can include machinery or CRE. Further, federal financial system regulators have issued rules that impact CRE, and the

---


14 Fannie Mae and Freddie Mac were created by Congress to provide liquidity to residential markets. They do this by purchasing and securitizing loans. While they are private enterprises, in 2008, both institutions were brought under conservatorship by the Federal Housing Finance Agency (FHFA). More on the government-sponsored enterprises can be found at https://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Pages/About-Fannie-Mae—Freddie-Mac.aspx. Ginnie Mae is a government agency that guarantees investors the timely payment of principal and interest on mortgage-backed securities (MBS) backed by federally insured or guaranteed loans. This includes loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA). Other guarantors or issuers of loans eligible as collateral for Ginnie Mae MBS include the Department of Agriculture’s Rural Development (RD) and the Department of Housing and Urban Development’s Office of Public and Indian Housing (PIH). For more on Ginnie Mae, see https://www.ginniemae.gov/about_us/who_we_are/Pages/funding_government_lending.aspx.

15 The federal government does have a substantial presence in multifamily housing markets. For instance, the Federal Housing Administration (FHA) insures certain multifamily loans. The U.S. Department of Agriculture (USDA) guarantees (and can issue) rural multifamily loans. Ginnie Mae securitizes these FHA and USDA loans. Additionally, the GSEs have lending programs that focus on multifamily housing.

16 The U.S. Small Business Administration’s (SBA’s) 504 Loan Program makes funds available for purchasing or improving land or owner-occupied buildings. For more, see SBA, “U.S. Small Business Administration Loan Funds Available to Purchase Commercial Real Estate,” at https://www.sba.gov/offices/headquarters/oa/oa/resources/4049. For more on small business credit markets, see CRS Report R45878, Small Business Credit Markets and Selected Policy Issues, by Darryl E. Getter.
Federal Reserve has implemented asset purchase programs that include CMBS. However, these interventions are not necessarily to provide relief specifically to CRE markets, but instead to provide support to the financial system. In general, the federal government has not had a permanent presence in most traditional CRE markets.

**Federal Regulation**

Federal regulators generally have a limited and sometimes indirect role in nonresidential CRE finance. As Figure 1 suggests, banks are a significant provider of CRE finance. To the extent banks are lending to CRE borrowers, they are subject to a range of federal banking supervision and prudential regulations. Federal bank examiners also have specialized guides for how to treat CRE. Because CMBS products are securities, they are subject to regulation by Securities and Exchange Commission (SEC), as well as the banking regulators, the Department of Housing and Urban Development (HUD), and the Federal Housing Finance Agency (FHFA). The next sections of report discuss regulations adopted after the 2007-2009 financial crisis, Regulation RR and Regulation AB.

**Risk Retention Rule (Regulation RR)**

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203), which among many other things, required skin in the game for nonresidential asset-backed securities. In 2014, the banking regulators, the SEC, HUD, and FHFA adopted a rule implementing credit risk retention standards for ABS, including CMBS. The regulation is known as Regulation RR and requires issuers to retain at least 5% of any security they issue on their books. The rule contains exceptions for “qualified commercial real estate loans,” which are deemed to have well-documented and prudent terms and a creditworthy borrower.

---

17 Notably, the Federal Reserve included CMBS in its asset-backed security liquidity facilities during the aftermath of the 2007-2009 financial crisis and in the economic fallout of the Coronavirus Disease 2019 (COVID-19) pandemic.

18 For example, see OCC, Comptroller’s Handbook, “Commercial Real Estate Lending” section, 2017.

19 The laws that give the Securities and Exchange Commission (SEC) the authority over asset-backed securities (ABS) are discussed in more detail in CRS In Focus IF10032, Introduction to Financial Services: The Securities and Exchange Commission (SEC), by Gary Shorter.

20 The FDIC, the Federal Reserve, and the OCC comprise the banking regulators.


22 See DiSalvo and Johnston, Skin in the Game in the CMBS Market, 2018. Qualifying CRE loans are defined in Regulation RR as having a fixed-rate loan with a minimum maturity of 10 years and a maximum amortization of 25 years (30 for loans secured by multifamily properties). Additionally, the two years of the property’s income is documented by the lender, and the borrower’s debt service ratio must not exceed 1.25% for multifamily properties, 1.5% for leased properties, and 1.7% for all other loans. Also, the combined LTV ratio of all loans on the property cannot exceed 70%, and the LTV ratio of the first lien loan cannot exceed 65%. For more, see OCC, Federal Reserve, FDIC, Federal Housing Finance Agency, SEC, and Department of Housing and Urban Development, “Credit Risk Retention,” 79 Federal Register 77601-77766, December 24, 2014.
Legacy CMBS Versus CMBS 2.0

After the 2007-2009 financial crisis, lending and underwriting standards became more conservative in response to enhanced prudential regulation, lender concerns over creditworthiness, and investor concerns over transparency. Legacy commercial mortgage-backed securities (CMBS) is a term that refers to CMBS issued prior to 2009, and CMBS 2.0 refers to those issued after 2009. The general difference between these two types of mortgages is that Legacy CMBS have lower “subordination,” which means there would be less cushion if an investor were to take a loss. More cushion is a credit enhancement, meaning, from an investor’s perspective, the CMBS 2.0 would be safer because the issuer retains some of the risk.

Asset-Backed Securities Disclosure and Registration (Regulation AB)

On January 7, 2005, the SEC issued a final rule that clarified the requirements for registration, disclosure, and reporting for ABS, which include CMBS. With respect to CMBS, Regulation AB impacts the institutions that service CMBS transactions (referred to as servicers) and the process by which information is disclosed to investors. The Dodd-Frank Act directed the SEC to require issuers of ABS to disclose asset-level or loan-level data to enable investors to perform due diligence, among many other things. In 2014, the SEC issued a final rule to revise Regulation AB, commonly referred to as Reg AB II, to developed asset-level disclosure requirements. Further updates to Reg AB II after 2014 amended disclosure requirements and the structure of CMBS transactions.

Policy Issues for the 116th Congress

One of the most pressing issues currently facing the 116th Congress is how to address the various economic impacts of the COVID-19 pandemic. The pandemic has created a unique challenge for CRE—with many businesses shuttered or operating on a limited basis, CRE tenants, particularly retail businesses, are struggling to make their payments, either in the form of rent or mortgages. For example, restaurants and storefronts have closed down temporarily or reopened on a limited basis, placing a strain on the retail sector. With travel limited, depressed tourism caused hotels to lose summertime revenue. Office space has been left vacant, as many businesses have shifted to work-from-home models for their employees. Stadiums, arenas, and sports teams have ceased operations due to cancelled tours and seasons, or they have carried on without fans, meaning no ticket sales or concession revenue. Some hospitals were flooded with pandemic cases, meaning day-to-day operations have sometimes exceeded capacity, but lucrative procedures, such as elective surgeries, were put on hold until the health care industry reaches a normal pace of work. Many school districts have closed, choosing to operate virtually, or switched to a hybrid model of virtual and in-person classes.

---


25 Labianca et al., Role of CMBS in the Financing of Commercial and Multifamily Real Estate, 2019, p. 17.

26 For example, according to analysis from Goldman Sachs, rent collections have fallen to about 50% on average among retail locations in April and May. Conversely, industrial and office tenants have maintained a relatively high rate of rental payments. For more, see Goldman Sachs, “US Daily: Have Businesses Paid Their Rent During the Pandemic?” October 16, 2020, at https://publishing.gs.com/content/research/en/reports/2020/10/16/b070449b-25b7-46c3-8e14-8e3571932185.html.
In June 2020, CMBS delinquency rates hit almost peak levels, with 10.32% over 30 days past due. This is near the previous peak of 10.34% in 2012. As can be seen in Figure 2, the rate fell in July and August to 9.02% but remains considerably higher than pre-pandemic levels. These elevated levels are driven by delinquencies in lodging (22.96%) and retail (14.88%).

**Figure 2. Commercial Mortgage-Backed Securities (CMBS) Delinquency Rates**

<table>
<thead>
<tr>
<th>Month</th>
<th>Delinquency Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug-19</td>
<td>2.54</td>
</tr>
<tr>
<td>Sep-19</td>
<td>2.51</td>
</tr>
<tr>
<td>Oct-19</td>
<td>2.47</td>
</tr>
<tr>
<td>Nov-19</td>
<td>2.34</td>
</tr>
<tr>
<td>Dec-19</td>
<td>2.34</td>
</tr>
<tr>
<td>Jan-20</td>
<td>2.14</td>
</tr>
<tr>
<td>Feb-20</td>
<td>2.04</td>
</tr>
<tr>
<td>Mar-20</td>
<td>2.07</td>
</tr>
<tr>
<td>Apr-20</td>
<td>2.29</td>
</tr>
<tr>
<td>May-20</td>
<td>7.15</td>
</tr>
<tr>
<td>Jun-20</td>
<td>10.32</td>
</tr>
<tr>
<td>Jul-20</td>
<td>9.60</td>
</tr>
<tr>
<td>Aug-20</td>
<td>9.02</td>
</tr>
</tbody>
</table>


**Pandemic Policy Response for CRE and CMBS**

Most of the pandemic policy response regarding real estate has centered on residential real estate, resulting from the strong federal presence in the U.S. housing market. For instance, almost two-thirds of residential mortgages are backed by congressionally chartered Fannie Mae or Freddie Mac (the GSEs), and a significant portion of non-GSE mortgages are guaranteed or insured by various federal agencies. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136) tied much of the residential mortgage relief to mortgages with federal government support. The support under the CARES Act also includes some forbearance relief for multifamily mortgage borrowers with federally backed loans; however, no explicit protections are granted to nonresidential CRE borrowers.

Nonresidential CRE policy considerations differ from those pertaining to residential mortgages, where a primary policy goal is often to reduce the number of families who lose their homes. In the CRE market, the policy questions tend to focus on to what extent federal intervention may, in the hopes of avoiding potential future systemic risks, mitigate losses that would otherwise be borne by the private sector. For instance, a prolonged economic downturn may lead to businesses

---


28 Mortgage relief can be found under Title IV of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136). For more on Title IV provisions, see CRS Report R46301, *Title IV Provisions of the CARES Act (P.L. 116-136)*, coordinated by Andrew P. Scott.
such as retail stores and restaurants earning less income. To the extent these businesses are commercial mortgage borrowers, this jeopardizes their abilities to make their payments. If they are tenants, this means the borrowers are now likely to receive less income and may struggle to make mortgage payments. When the mortgage payments are not made, the loans become delinquent—at some point, the business may seek foreclosure or bankruptcy—and lenders of CRE mortgages and investors in CMBS instruments are at risk of taking losses. As long as access to bankruptcy proceedings and foreclosure is not impeded, borrowers can work out their debts with the lenders and some losses can be recouped. However, while investors in CMBS select the returns associated with their risk tolerance for taking losses, if an entire industry were to face spikes in defaults that relied heavily on CMBS financing, it could cause liquidity issues in a market that is important for providing credit to many other commercial borrowers. Further, while a default on an individual loan is not sufficient to cause broad economic impacts, if the rate of defaults increases significantly across industries, this could stress investors in CMBS and jeopardize liquidity in CRE financing markets.

### Negative Externalities, Systemic Risk, and Market Failures

Public policy intervention in the form of financial assistance is often used as a way to offset negative externalities, address systemic risk, or account for market failures.

**Negative externalities** occur when the production or consumption of a good or service causes harm to a third party. In other words, if the costs are not borne by those in the market for a good or service, then there are negative externalities. This is a type of **market failure**. For example, consider a concert venue that gathers thousands for an event during the pandemic and becomes a “super-spreader” event where the pandemic spreads to many of the attendees. In this case, the cost of managing the virus (tests, hospitalizations, quarantines, leave from work, etc.) are not solely borne by the attendees.

One question of particular importance is whether CRE poses a **systemic risk**. Systemic risk refers to the risk that some development will cause widespread financial instability. For example, the 2007-2009 financial crisis highlighted the interconnected nature of various financial institutions and the industries that depend on financing to remain liquid. **Figure 1** above shows that about 39% of CRE loans, more than $1 trillion, are held in bank portfolios. Many businesses depend on financing to remain liquid and make their bills. However, as business balance sheets deteriorate from lower economic activity, the outstanding loans may begin to enter delinquency. The extent to which this could have a systemic impact on financial institutions depends on a number of factors, including the leverage and liquidity profiles of the market. While today’s commercial mortgage markets, including commercial mortgage-backed securities, are smaller, less leveraged, and more liquid than the troubled residential mortgage markets of over a decade ago, the 2007-2009 financial crisis shows how a class of assets (e.g. residential mortgage-backed securities) can pose systemic risk.

Although systemic risk is generally associated with the financial system, if policymakers choose to intervene, they could address potential losses faced by lenders and investors, or losses by the commercial business, or some combination of the two. Some of the current policies in places are discussed below.

### Existing Indirect Support for CRE and CMBS Finance

Although there is currently no relief program dedicated to CRE, the broad policy response to COVID-19 includes some indirect support to CMBS markets. The Federal Reserve’s response to the pandemic supported CMBS markets in two ways. First, as part of its “quantitative easing,”

---

the Federal Reserve has directly purchased CMBS that comprise federally backed multifamily mortgages. Second, private CMBS are eligible for purchase through the Term Asset Backed Securities Liquidity Facility (TALF), a program to support the non-residential ABS market generally. As of September 30, 2020, TALF included 107 private CMBS loans with an outstanding value of just over $1 billion. Although these actions boost demand for CMBS, they do not directly address the losses faced by the industry and they comprise a relatively small portion of the Federal Reserve’s activities. As of September 23, 2020, agency CMBS—those multifamily housing CMBS backed by the GSEs or federal government—comprised less than 1% of the Federal Reserve’s System Open Market Account holdings. Additionally, provisions in the CARES Act provide regulatory relief to the financial system, which may enable it to meet the needs of distressed CRE borrowers. For instance, the CARES Act reduces the Community Bank Leverage Ratio for two years, making it easier for lenders to workout problematic loans.

CRE also may benefit from the Federal Reserve’s emergency programs or some of the programs established by the CARES Act, but limitations on these programs have made it difficult for some CRE businesses to participate. For example, if an eligible CRE company were to issue commercial paper or corporate bonds, it could benefit from Federal Reserve programs that purchase them. Large CRE companies are likely to be the most active issuers in securities markets. The Federal Reserve also created the Main Street Lending Program (MSLP) to offer loans with repayment deferment for smaller companies. However, CRE industry members have noted the MSLP is not well suited to their business model, due to the programs limitations. Likewise, some small CRE businesses already may have access to the SBA’s Paycheck Protection Program (PPP). The eligibility of many CRE companies depends on whether they are considered “eligible passive companies.” In addition, PPP may enhance other small businesses recipients’ abilities to make rental payments to CRE landlords.

---


31 In March 2020, the Federal Reserve authorized the Federal Reserve Bank of New York (FRBNY) to operate the TALF. To do this, FRBNY lends to an entity called a special purpose vehicle, which makes loans to U.S. companies secured by certain ABS. For more, see Federal Reserve, “Periodic Report: Update on Outstanding Lending Facilities Authorized by the Board under Section 13(3) of the Federal Reserve Act,” October 7, 2020, at https://www.federalreserve.gov/publications/files/pdcf-mmlf-cpff-smccf-talf-mlf-ppplf-msnlf-msplf-nonlf-noelf-10-8-20.pdf#page=4.


34 For more on the Community Bank Leverage Ratio, see CRS Report R45989, Community Bank Leverage Ratio (CBLR): Background and Analysis of Bank Data, by David W. Perkins.


36 The Paycheck Protection Program is explained in more detail, along with other SBA programs, in CRS Report R46284, COVID-19 Relief Assistance to Small Businesses: Issues and Policy Options, by Robert Jay Dilger, Bruce R. Lindsay, and Sean Lowry.

37 Title 13 C.F.R. §120.111.
Legislative Proposals

Recently, some Members of Congress have called for financial assistance to be more widely available to CRE and CMBS markets. For instance, Senate Committee on Banking, Housing, and Urban Affairs Chairman Mike Crapo issued a letter in July to Treasury Secretary Steven Mnuchin and Federal Reserve Board Chairman Jerome Powell encouraging them to expand the emergency lending programs associated with the pandemic by establishing a commercial real estate program.\(^{38}\) Efforts targeting CRE face a few challenges. As mentioned earlier, the pandemic has had disparate effects on various CRE subsectors. For instance, the pandemic has perhaps had a more significant impact on tourism and retail than on other subsectors. Thus, to the extent Congress is interested in providing support to these subsectors, it may consider how to craft a policy that benefits those borrowers specifically.

Potential recipients of direct financial assistance include tenants, borrowers, loan servicers, or lenders and investors, and each has important considerations:

- Financial assistance such as grants or loans directed at businesses generally could help commercial tenants meet their financial obligations, thus lowering the chances that a commercial tenant becomes insolvent. There are procedures in place to manage commercial insolvency through the bankruptcy code. This is to say that there is no general market failure simply because specific businesses becomes insolvent. In fact, a company may be able to remain a going concern by working their debts out with their lender through bankruptcy. But even if it cannot, a business closure is part of a functioning market. However, during a pandemic, where widespread business closures and limitations on operations are causing many companies to lay off employees and cut costs, Congress may seek to avoid the negative externalities of unemployment and economic decline by providing support directly to businesses.

- Alternatively, Congress may focus support on the mortgage borrowers,\(^ {39}\) through loan forbearance programs, debt relief measures, or additional loans or other financial assistance. These measures face some structural challenges. Efforts targeting borrowers face challenges with the legal contracts that private companies sign with lenders. For example, as can be the case in some industries, agreements in contracts called loan covenants are often structured to prohibit or limit a borrower’s ability to take on additional debt, as this could reduce the likelihood of a lender being repaid. This means that such borrowers would be breaking their contractual obligations if they were to accept financial assistance in the form of a loan from the Federal Reserve or another entity. Alternatively, temporary financial relief measures such as loan forbearance could help businesses remain in their leases or mortgages but would transfer some of the losses temporarily to the financial system.

- Assistance targeting mortgage services, lenders, and investors of CRE loans and CMBS may seek to keep liquidity in financing markets through the Federal Reserve, which can provide loans to financial institutions or purchase assets such as CMBS from investors. This may not directly address the cash shortfall of the

---

\(^{38}\) The letter can be found at https://www.banking.senate.gov/imo/media/doc/Chairman%20Crapo%20Letter%20to%20Treasury_Fed%207.31.20.pdf.

\(^{39}\) Not all tenants of CRE are mortgage borrowers. Many businesses pay rent or lease property from a mortgage borrower.
bodies affected by the crisis, but acts as a backstop to keep financial institutions and investors in a position to continue providing funds to the market.

Some legislation has been introduced that would directly impact CRE and CMBS markets and provide examples of the unique characteristics of the market. In May 2020, the House of Representatives passed the Heroes Act (H.R. 6800), aimed at providing another round of financial relief for people and businesses affected by the pandemic. Many of the provisions in the Heroes Act expand and amend the PPP program to make more funds available to small businesses.\(^{40}\) In addition, the Heroes Act would require the Treasury Secretary to ensure that servicers of federally backed mortgages can participate in Federal Reserve programs backed by CARES Act funds as long as Federal Reserve assistance is used for borrower assistance (e.g., loss mitigation and forbearance), among other requirements.\(^{41}\) This would apply to multifamily housing mortgages. Further, the bill would establish a forbearance program for loans to small businesses and would require the Federal Reserve to create a similar facility for creditors and debt collectors participating in the forbearance program. A second Heroes Act (H.R. 925), passed by the House in October 2020, includes, among other things, language substantially similar to the provisions from H.R. 6800 mentioned above.

Although these efforts are aimed broadly at providing relief to consumers, renters, borrowers, and servicers, other legislation would provide more specific assistance to the financing markets for CRE. For instance, in July, Representative Van Taylor introduced H.R. 7809, which would establish a sort of liquidity facility in Treasury to assist commercial mortgage borrowers. Unlike other forms of liquidity assistance offered by the Federal Reserve in the form of loans, as described above, this facility would provide funding through preferred equity purchases.

In many ways, this assistance would work similarly to a mezzanine loan, but by altering the structure slightly and issuing preferred equity, it could allow CRE and CMBS borrowers to receive assistance without breaching the loan covenants in their legally binding contracts.\(^{42}\) The preferred equity assistance would be available to borrowers who might experience a drop in revenue of at least 25% in a three-month period between March 2020 and February 2021, provided that they meet certain financial conditions. The equity instrument, which could be equal to 10% of the outstanding commercial mortgage, would operate similar to a line of credit with a one-year drawdown period and a fixed interest rate of 3%, with payments amortized over seven years. The instruments would be issued by financial institutions and guaranteed by Treasury; additionally, Treasury would provide origination fees to institutions to incentivize participation.

Preferred equity is also used in S. 4670, introduced in September by Senator Jerry Moran, which would amend the CARES Act to authorize Treasury to make preferred equity investments in CRE companies that require capital to meet their debt obligations. The bill allows Treasury to make these investments alone, or in concert with the Federal Reserve, by directly purchasing preferred equity positions in the eligible CRE companies, or by providing full or partial guarantees to financial institutions that purchase such positions.\(^{43}\) The bill would also instruct the federal

---

\(^{40}\)For more on legislative efforts to provide relief to small business, see CRS Report R46284, *COVID-19 Relief Assistance to Small Businesses: Issues and Policy Options*, by Robert Jay Dilger, Bruce R. Lindsay, and Sean Lowry.

\(^{41}\)For a closer look at the financial system provisions in the Heroes Act H.R. 6800, see CRS Report R46434, *HEROES Act, Division K—COVID-19 Housing, Economic Relief, and Oversight Act*, coordinated by Rena S. Miller.


\(^{43}\)This is similar to the guarantees proposed in H.R. 7809, although S. 4670 provides fewer details on the structure of
banking regulators to apply a risk weight of zero percent for the purposes of any risk-based capital requirements pertinent to preferred equity positions.\textsuperscript{44}

The future of many commercial real estate properties is uncertain. For instance, it remains to be seen how quickly storefronts, restaurants, hotels, stadiums, and office spaces return to full capacity, or even whether full capacity returns to pre-pandemic levels. As of now, many legislative efforts are targeting the businesses that have suffered losses due to shutdowns, social distancing, limited capacity, and remote operations, but if an economic downturn persists, stresses on the commercial sectors may begin to bleed into the financial markets, leading to liquidity shortages or potential solvency problems for lenders with significant exposure to commercial markets.

\textsuperscript{44} An overview of risk-based capital requirements can be found in CRS In Focus IF10809, Introduction to Bank Regulation: Leverage and Capital Ratio Requirements, by David W. Perkins.
Appendix. Historical Evolution of Commercial Mortgage-Backed Securities

This appendix provides some background on how commercial mortgage-backed securities (CMBS) came to exist in its current form, and it is divided into three parts. The first part discusses a range of mortgage-backed securities for illustrative purposes. The second part examines how government intervention catalyzed CMBS growth. The third part explains the two most common forms of CMBS today.

Basic MBS Structures

Bonds backing commercial mortgages date back to the 1920s, but these arrangements were simpler than today’s mortgage-backed securities (MBS) markets. A few basic kinds of MBS serve as a foundation for what is now a complex and specialized financial market for CMBS. For instance, a mortgage pass-through security (MPS) is a securitization process whereby a mortgage is sold into a trust that issues securities backed by the underlying mortgage. In this example, the mortgage payments made by the borrower would pass through the trust to the investor, effectively giving the security and the underlying mortgage the same payment schedules. The loan issuer would sell the mortgage off the books to the trust, and the investor would receive cash flows that mirror the mortgage payments. Another example is a mortgage-backed bond (MBB), which creates a fixed-term instrument with a fixed payment schedule (referred to as a “coupon payment”). The loan issuer would keep the mortgage on the books, and the investor would receive coupon payments on a fixed schedule that differ from the mortgage payments.

A collateralized mortgage obligation (CMO) is an alternative to MPS and MBB instruments. CMOs are what are referred to as “multiclass pass-through” instruments. In such an instrument, multiple mortgages are passed through to a trust, and the payments of principal and interest of all of these mortgages creates the basis for the cash flows for the investors. The trust would issue multiple classes of securities that have varying terms and levels of priorities (or seniority) over the claims to these cash flows. Tax treatment of these instruments throughout the 1980s meant that CMO issuers had to treat the instrument as debt, keeping the CMO on their balance sheets as liabilities and paying taxes on their interest incomes. (An incentive to issuing CMOs over MPSs was that the pass-through payments were collateralized by the principal and interest payments of the multiple mortgages rather than the entire single mortgage, meaning that an issuer could hold less equity in a CMO than in an MPS.)


47 The limitations of collateralized mortgage obligations (CMOs) are at least in part due to tax policy set forth by the Internal Revenue Service (IRS) in the 1980s. This is discussed in some depth in Federal Reserve Bank of San Francisco, “Mortgage Securitization & REMICs,” 1987, p. 2.
Government Intervention: Tax Law, the RTC, and Modern CMBS

Prior to the 1980s, neither MPSs, MBBs, nor CMOs allowed both the issuers to sell the mortgage(s) off their books and the investors to achieve differing cash flows from the underlying mortgage. The Tax Reform Act of 1986 (P.L. 99-514) permitted the creation of Real Estate Mortgage Investment Conduits (REMICs) in an effort to clarify how trusts that hold mortgages and issue securities would be treated under tax law. The Tax Reform Act of 1986 (P.L. 99-514) allowed REMIC issuers to avoid the income taxes of CMOs by transferring the tax liability to the holder of the securities (the investors). Under the law, REMIC issuers can treat the underlying loans as a sale of an asset, rather than a debt. This means that REMICs allowed MBSs to meet the interests of issuers who wanted to clear their balance sheets, as well as investors who wanted cash flow diversification. Today, CMOs are issued in REMIC form, and the terms are used interchangeably.

In the 1980s, lenders and investors became increasingly interested in the potential benefits of securitization. It was not until the 1990s, however, that traditional commercial mortgages began to dominate the financing options for commercial property borrowers. This was in part due to the beneficial tax treatment for REMICs set forth in the Tax Reform Act of 1986, described above. Another piece of legislation helped increase the demand for CMBS. In the late 1980s, a financial crisis resulted in the collapse of the savings and loan industry. In response to the financial turmoil, Congress passed a series of laws, including the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA; P.L. 101-73), which established the Resolution Trust Corporation (RTC) primarily to receive and resolve failed thrift institutions, among other things.

While this report generally focused on nonresidential commercial loans, multifamily loans are important to the creation of modern CMBS structures. For example, thrift institutions primarily focused on residential lending, and they originated a sizeable portfolio of commercial mortgages in the form of multifamily loans in the 1980s; so as failed thrifts entered RTC conservatorship, the RTC took over these commercial loan portfolios. It is through the models created by residential multifamily finance that CMBS took its modern form.

The RTC, a federal agency with a statutorily limited term of existence, ultimately operated from 1989 to 1995 and is credited with expanding the commercial securitization marketplace. Prior to 1990, commercial securitization took on simple forms similarly to the products mentioned in the

---


49 This tax benefit was created by allowing Real Estate Mortgage Investment Conduits (REMICs) to divide the flow of mortgage payments into varying classes of securities in a manner that exempted them from the definition of an “active manager.” More on the Tax Reform Act of 1986 (P.L. 99-514) and the tax treatment of REMICs can be found at CRS Report RS22741, Is Securitization an Obstacle to Subprime Borrower Workouts?, by Edward V. Murphy. (The report is out of print but is available to congressional clients from the author upon request.)


51 Although the financial crisis of 2007 highlighted some of the inherent risks of securitization, lenders can benefit from effectively selling a loan or multiple loans off of their balance sheets, and investors can derive new patterns of cash flows and diversification.

52 Congress authorized the Resolution Trust Corporation (RTC) to preserve affordable housing held by the receiverships and to facilitate sales to qualified parties. See Federal Deposit Insurance Corporation (FDIC), Managing the Crisis, “Executive Summary” section, p. 6, at https://www.fdic.gov/bank/historical/managing/documents/history-consolidated.pdf (hereinafter FDIC, Managing the Crisis).
section above. By 1990, the RTC had been appointed conservator for over 500 thrifts. This workload complicated one of the main challenges the RTC faced: selling assets quickly at a fair price—in 1991, FIRREA was amended to facilitate quicker sales.53

In response, the RTC created structured transaction programs and new securitization markets for less traditional assets, including commercial loans, which allowed it to dispose of large volumes of assets at more reasonable prices. For example, in 1991, to boost demand for commercial assets held by failed thrifts, such as multifamily and commercial mortgages, the RTC created a Structured Transaction Program. The program allowed the RTC to offload portfolios of 50-100 commercial loans at a time.54 In 1992, the RTC began its commercial mortgage securitization program. This program built on the simpler securitization models that were available through the 1980s and set the foundation for the modern, complex CMBS marketplace. The RTC securitization program pooled several mortgages together through a REMIC structure and facilitated the sale of CMBS securities.

Although the RTC had government support,56 enabling it to carry out these transactions, by the mid-1990s, RTC commercial mortgage securitizations were firmly a part of the financial market for commercial funding.57 In 1990, the commercial securitization was around $6 billion; by 1997, the market grew to $80 billion.58 After the RTC’s operations ended in the mid-1990s, the banks that partnered with the RTC to help bring the securities to market began issuing their own private-label CMBS; these CMBS products comprise the majority of CMBS issuance today.59 By 2007, roughly a third of outstanding commercial mortgages were financed through CMBS loans, peaking around $775 billion in CMBS outstanding.60 CMBS outstanding has fallen since its peak before the 2007 financial crisis, stabilizing around $547 billion in the first quarter of 2019.61 In 2019, annual issuance of private-label CMBS stood around $100 billion, and total private-label CMBS outstanding was around $490 billion as of March 2020.62

53 The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA; P.L. 101-73) “included language requiring the RTC to sell real estate for no less than 95 percent of its appraised (market) value. In 1991, in response to growing criticism about low sales and congressional concern with the cost of maintaining the rapidly growing inventory of properties, FIRREA was amended to reduce the minimum sales price to no less than 70 percent of appraised value.” See FDIC, Managing the Crisis, “Executive Summary” section, pp. 9-10.


55 For example, the RTC was allowed to shield investors from losses by retaining large stakes in the securities, meaning investors would face losses only if defaults exceeded the portion of the security that the RTC retained.


57 FDIC, Managing the Crisis, p. 417.


61 Private-label annual issuance data can be found at Orest Mandzy, “CMBS Issuance Hit $96.7B in 2019: Who Were
Conduit Versus Single-Asset/Single-Borrower CMBS

Today, CMBS generally come in two basic forms: conduit and single-asset/single-borrower (SASB), which together comprise about 90% of outstanding CMBS. Conduits are securitizations of a large number of CRE mortgages, with fairly standardized characteristics. For example, conduits are typically around $1 billion dollars, comprising 50-100 loans with fixed payments and maturities around 10 years. The top 10 largest loans comprise around 50% of the collateral, and the properties are typically fully leased and have stable cash flows.63

Alternatively, SASB transactions can be secured by a single asset or portfolio of assets owned by a single borrower, and these securities vary broadly. SASB transactions are smaller on average than conduits, ranging from $100 billion up to $1 billion.64 The underlying asset can have variable or fixed rates; the terms and maturities also can vary. SASB transactions potentially are riskier than conduits but provide sufficient variation to meet the different demands of different investors.

Prior to the 2007-2009 financial crisis, conduit loans comprised the overwhelming share of outstanding CMBS and CMBS issuance. The economic impact of the crisis reduced CMBS activity significantly, and in the recovery, new CMBS issuances were more evenly distributed between conduit and SASB transactions. By 2019, conduits comprised about 65% of outstanding CMBS, and 40% of CMBS issuance; SASB transactions comprised 25% of outstanding CMBS and 49% of CMBS issuance.65

Author Information

Andrew P. Scott
Analyst in Financial Economics

---

64 Rudolph, Demystifying Non-Agency Commercial Mortgage-Backed Securities, p. 2.
65 SIFMA, U.S. Non-Agency CMBS and RMBS Outstanding.
Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS’s institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.