

### **State Budget Shortfalls Leave Lawmakers Scrambling For Revenue Sources**

Since the start of the recession, states have been struggling to maintain revenues and many have underperformed revenue forecasts. The most pessimistic revenue expectations have not even been met, causing massive gaps in state budgets. In order to reconcile a collective \$158 billion in revenue shortfalls prior to the beginning of the FY2010 business cycle, 48 states employed a strategy of spending cuts combined with tax and fee increases. As of October 1, 2009, all 50 states had begun their FY2010 business cycles. Despite their efforts, 35 states are facing \$32 billion in new revenue shortfalls this fiscal year.

State budget gaps are primarily due to the unusually high unemployment rate, which reached 10.2 percent nationally in October 2009. While states vary in their revenue sources to fund government operations, personal income tax and sales tax tend to be the main revenue sources for many states. When unemployment levels are high, state income tax collection levels drop. Moreover, residents reduce their spending during hard economic times, causing a reduction in sales tax collections.

In order to fund revenue shortfalls at the start of the 2010 fiscal year, many states enacted a combination of tax increases, service cuts, and layoffs. However, the \$32 billion in new shortfalls that have opened since has forced governors and state lawmakers to propose or enact yet still additional service cuts and tax increases. For example, Indiana Governor Mitch Daniels directed all state agencies to cut spending by 10 percent in addition to 5 percent cuts at the start of the current fiscal year. In Michigan, Governor Jennifer Granholm plans to cut state spending by 20 percent, on top of the 10 percent made to balance the current budget. Additionally, attempting to resolve their state deficit, Michigan Senate Democrats have proposed taxing estates worth more than \$2 million.

Funding from the economic stimulus package has provided some temporary relief for states. Otherwise, many states would have been forced to make even more drastic cuts. For the current fiscal year, states have been able to fill 30 to 40 percent of their budget deficits with money from the \$787 billion economic stimulus package. However, of the roughly \$250 billion of the stimulus package set aside for states, most will have been distributed by the end of 2010. Therefore, while the stimulus package will continue to help states fill their budget gaps in 2011, it will provide less than it did in 2010.

Conditions are expected to remain positive in only in a handful of states such as North Dakota and Iowa due to stable housing markets and high prices for agricultural commodities. However, the financial outlook remains grim for the rest of the country. In fact, the *Pew Center on the States* warned of "fiscal peril" in ten states due to rising foreclosure rates, poor financial management, and elevated unemployment rates. These states include: Illinois, Michigan, Wisconsin, California, Oregon, Nevada, Arizona, New Jersey, and Rhode Island. Furthermore, the Pew report suggests that many states will continue to see significant revenue shortfalls since "states historically have their worst years after a national recession ends, as they cope with higher Medicaid and other safety-net expenses, at the same time revenues lag because of stubborn unemployment." If state revenues continue to decline, as this study suggests, states will be forced to consider additional sources of revenue, likely in the form of new and increased taxes and fees. While potential revenue sources will vary from state to state, likely sources may include the wealthy and even real estate practitioners.

### **New Commercial Real Estate Loan Rules Aim to Help Banks Restore Lending**

On October 31, 2009, the FDIC introduced new guidelines to bank examiners that could reduce the number of bank write-offs of nonperforming commercial real estate loans. The new regulations would allow financial institutions to work with commercial real estate borrowers who continue to be creditworthy customers, despite a deterioration of their financial condition.

Under the new guidelines, banks are not necessarily required to classify certain commercial real estate loans that are technically underwater but still able to generate enough cash to pay existing debt service as delinquent mortgages. Therefore, in some circumstances, banks may preserve capital and write down fewer losses on distressed commercial real estate loans. .

Offering an example of the type of allowances created by the new guidelines, regulators suggested banks can divide troubled loans into performing and nonperforming parts. Banks can avoid taking a loss on the entire loan by only taking the loss on the nonperforming part.

Providing further illustration, the Wall Street Journal cited a hypothetical example where a developer builds a retail center, leases one site to a retailer, yet can't lease the other sites. Under the new guidelines, the bank could create a healthy loan supported by the leased space, and a nonperforming loan from the remainder of the loan. As a result, banks would be required to set aside less backup capital for the split loans than for the original loan.

The new guidelines are of particular importance to the commercial real estate community, as a study conducted by Foresight Analytics revealed that commercial real estate trouble contributed to 100 of 120 bank failures this year. Furthermore, the firm estimates that close to \$800 billion in maturing commercial real estate mortgages are underwater. The new regulations would apply to \$110-\$130 billion of these loans.

IREM will continue to support policies and principles aimed at jumpstarting commercial real estate lending and investor confidence.

### **Energy Reform Legislation Approved by Congressional Committees**

On May 21, the House Energy and Commerce Committee approved H.R. 2454, the American Clean Energy Security Act by Chairman Henry Waxman (D-CA) and Ed Markey (D-MA). The legislation includes numerous provisions relating to more stringent renewable energy and energy efficiency standards, capping carbon emissions, and increased investment in clean energy.

Of particular interest to the commercial real estate industry are the provisions in Energy Efficiency section relating to building standards. The Committee approved an amendment by Rep. Peter Welch (D-VT) which provides economic incentives for retrofitting existing buildings. The amendment, which was originally introduced as a stand-alone bill earlier this year, establishes the Retrofit for Energy and Environmental Performance (REEP) program which provides grants and loans to property owners who wish to retrofit their buildings with energy efficient improvements. IREM members lobbied in support for the Welch proposal during the Capitol Hill Visits in April.

The House bill also requires states to adopt energy efficiency building codes that meet specified federal standards. Specifically, the bill requires new buildings to be 30% more efficient in 2012 and 50% more efficient in 2016. House leadership is aiming for floor consideration of H.R. 2454 before the July 4th recess.

On June 4, the Senate Energy and Natural Resources Committee approved its own version of building energy efficiency legislation as part of a broader energy and climate bill. The bill, which is still in draft form, requires states to certify building codes that would reach a 30% energy savings. The bill would also create financial incentives and grant programs to improved energy efficiency in multi-family units, manufactured housing and commercial retrofits. At this time, it is unclear when the final bill will be considered by the full Senate.

[Click here](#) to read the IREM Statement of Policy on Energy Conservation.

### **FASB Approves Modifications to “Mark-to-Market” Accounting Rules**

On April 2, 2009, the Financial Accounting Standards Board (FASB) passed a proposal to relax current “mark-to-market” accounting rules by giving companies more leeway when valuing assets, a step that could encourage banks to trade their toxic assets more freely and thereby encourage more lending activity to stimulate the broader economy. FASB will now allow companies to use their judgment to a greater extent in determining the “fair value” of their assets. In other words, the decision will allow the assets to be valued at what they would go for in an ordinary sale, as opposed to a forced or distressed sale. The new mark-to-market rules will apply to the second quarter that began this month.

The mark-to-market rules have forced banks to take steep write-downs on some assets, especially securities tied to

high-risk mortgages. Some experts believe that mark-to-market rules were improperly forcing banks to report huge losses due to temporary conditions, which have forced banks to be hesitant to provide new loans and refinancing to businesses.

In October 2008, IREM identified the need for banks to stabilize and provide liquidity to the commercial real estate credit markets, including the commercial mortgage-backed securities market. As one of its solutions to the current credit crisis, IREM took a position to support making mark-to-market accounting rules more flexible, including the use of discounted cash flow analysis for valuing assets in illiquid markets.

### **Banking Conglomerates Permanently Barred from Real Estate Activities**

On March 12, 2009, President Barack Obama signed the \$410 billion 2009 omnibus appropriations bill. A provision of this legislation permanently prohibits banking regulators from publishing a rule defining real estate brokerage and management as financial activities and thus permissible lines of business for federally regulated banks.

For years, IREM has opposed changes or interpretations in present federal regulations which would permit any banks or bank holding companies or subsidiaries to enter the field of property management beyond properties owned by those institutions. In early 2001, the Federal Reserve Board and the U.S. Treasury Department published a proposed regulation that would let national bank holding companies and financial subsidiaries of national banks engage in real estate brokerage and management. Since that time, Congress has passed several temporary bans on banks entering the real estate brokerage and management fields. The legislation signed by Obama this week will permanently prohibit banks from engaging in real estate activities.

### **U.S. Department of Homeland Security News**

DHS announced a free online training on improvised explosive devices. This two-part Webinar, which will take place **March 18 & 25, 2009 from 1 p.m. to 2 p.m. ET**, offers essential information that will allow you to deter, prevent, detect, and respond to explosive attacks utilizing improvised explosive devices (IEDs). Part 1 focuses on how to recognize and react to IEDs, and Part 2 teaches how to plan for and respond to bomb threats and IEDs. Combined, these Webinars offer the most comprehensive review of IED protection possible. To register for the Webinar, please go to <https://connect.hsin.gov/iedregistration/>.

### **American Recovery and Reinvestment Act of 2009**

On February 17, 2009, President Obama signed into law the Economic Stimulus Package known as H.R. 1, the "American Recovery and Reinvestment Act of 2009" The bill includes \$787 billion in spending and tax cuts. Separate from the Stimulus Package, the Treasury Department recently announced a multi-pronged program intended to help lay the groundwork for restoring the flows of credit to households and businesses.

IREM and CCIM Institute legislative staff prepared a summary of the bill and Treasury plan and their impact on the commercial real estate industry. To read the summary, [click here](#).