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New Accounting Proposal Could Have Devastating Impact on Commercial Real Estate Liquidity

On May 25, 2010, the Financial Accounting Standards Board (FASB), an independent body that sets US accounting standards, proposed an accounting rule change in an effort to create greater transparency in financial statements. Under this proposal, financial institutions would be required to book their loans at current market value, a method known as “fair value” or “mark-to-market” accounting. Specifically, the proposal would require banks to report the fair value and amortized cost of a loan on their balance sheets, which would force them to take huge write downs or losses, particularly during periods of economic distress.

In 2007, the FASB reinstated mark-to-market accounting for complex financial instruments such as mortgage-backed securities, which escalated the financial crisis, according to many industry analysts. However, in April 2009, FASB passed a proposal to relax these rules by giving companies more leeway when valuing assets, which helped calm financial markets. The changes came after Congress criticized FASB for the damaging effects of mark-to-market accounting, where assets valued at market prices had to be written down, even if a company intended to hold a particular asset to maturity – causing markets to freeze up and forcing more write-downs.

If implemented, the proposed mark-to-market rules would exacerbate poor economic conditions by forcing banks to take unjustified losses on assets that decline in value, reducing overall credit capacity. Moreover, the availability of credit would be greatly undermined by making it more difficult for financial institutions to make many long-term loans, the value of which, even if performing, would likely be reduced on the day the loan is made.

While this rule would pose a significant challenge for large commercial banks, smaller regional and community banks would be hit the hardest, especially ones with high commercial real estate exposure. Since commercial real estate loans are typically longer-term assets, the proposal would mandate onerous write-downs and potentially cause many smaller financial institutions to fail. As a result, credit for the commercial real estate industry as well as for other businesses and consumers would be further constrained, hindering our nation’s economic recovery. If approved, the rules would take effect for the biggest banks as early as 2013. Smaller banks, with less than $1 billion in assets would be permitted to wait until 2017.

The fair value accounting proposal comes at an inopportune time with the commercial real estate industry in the midst of a financial crisis, and nearly $1.4 trillion in loans due by 2014 and an already very limited capacity to refinance. NAR believes mark-to-market accounting rules should be more flexible and encourages the use of other valuation tools to assist with valuing assets in illiquid markets. NAR and its commercial affiliates have submitted comments to FASB, reflecting these beliefs, which were due September 30, 2010. Furthermore, NAR will continue to work with FASB and policymakers to ensure that any fair value accounting rule changes will not compromise access to credit for businesses and consumers.