Going from Mark-to-Market to Mark-to-Make-Believe

BY ROBERT J. PLISKA, CRE, CPA

HAVE WE GONE FROM "MARK-TO-MARKET" to "mark-to make-believe?" Financial regulators consisting of representatives of the Federal Reserve, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and others released their guidelines, "Policy Statement on Prudent Commercial Real Estate Loan Workouts," in late October 2009. The purposes of the statement were to provide transparency and consistency to commercial real estate workout transactions and not curtail the availability of credit to sound borrowers. While the regulators' intentions are honorable, the policies may provide the opposite effect—lack of transparency and consistency and the lack of credit to sound borrowers.

In the early part of 2009, a tremendous amount of distressed commercial real estate existed. Many loans had balances that exceeded their underlying asset value. This dilemma continued throughout the year with substantial defaults and increasing amounts of distressed real estate. Later in the year, Real Capital Analytics, Inc. estimated that distressed properties exceeded $150 billion and Moody's Investors Service noted that commercial property values dropped 43 percent from their October 2007 peak and were continuing to drop. A joint study by PricewaterhouseCoopers and Urban Land Institute indicated that there was little, if any, chance of recovery for many of these properties. Further, they reported, an additional pool of distressed properties existed just in commercial mortgage-backed securities, or CMBS—$250 to $300 billion a year that matured or rolled over through 2015. This was just one of many financial sources having difficulties In the case of CMBS alone, previous underwriting would not hold water due to higher loan to values, deteriorating net operating income and rising capitalization rates. As a result, a huge amount of properties were at risk. Obtaining financing upon the expiration of their loan terms was highly questionable.

In spite of the tremendous amount of existing and future distress in commercial real estate, foreclosures and write-downs were minimal during 2009. Lenders did not want to foreclose since it would mean taking a loss on their financial statements and be a detriment to their capital ratios. Interesting terminology came into play that explained their approach: "A rolling loan gathers no loss." If lenders were forced to write down their loans, then this could cause a significant amount of additional bank failures—many more

About the Author

Robert J. Pliska, CRE, CPA, *serves as managing director for Sperry Van Ness/ Property Investment Advisors, LLC, Birmingham, Mich., specializing in the sale, financing, leasing, managing, consulting, accelerated marketing and auctioning of multifamily, retail, office, industrial, hotel and other properties. With more than 35 years of commercial real estate experience, Pliska has secured more than $1.5 billion in real estate transactions. Prior to joining Sperry Van Ness, Pliska served as president and/or officer of several commercial real estate firms. As a CPA with PricewaterhouseCoopers, he advised real estate and financial institution clients. His professional activity includes: former president and member of Detroit Area Commercial Realtors; member of the Michigan Association and recipient of the organization's* "**REALTOR**® *of the Year" award. Pliska received his master's in business administration degree from Michigan State University. He earned his bachelor's degree in accounting at the University of Detroit.*

than had already occurred. With the FDIC's insurance fund already significantly depleted and proceeding toward a deficit, the federal regulators seem to have decided to go along with the flow—try to extend the loans as long as they could. Accordingly, new descriptive terminology emerged: "extend and pretend" and "delay and pray." This "sanction" by the federal regulators of "extend and pretend" has caused great concern among many. Concerns include:

- The financial crisis and the inevitable are just being prolonged;
- An additional drag is being put on the current poor economic environment;
- New good loans may be more difficult to make due to capital being tied up in bad loans;
- Proper and consistent accounting may not be occurring, causing further differences and inconsistencies in decision making and reporting;
- Management manipulation of financial information will be easier;
- A transaction freeze will continue to take place;
- Value will be difficult to determine due to a lack of transactions;
- The period of uncertainty will just be extended.

The key point of the policy statement issued by the regulators is that loan workouts need to be designed to help ensure that a financial institution maximizes its recovery potential. Renewed or restructured loans to borrowers who have the ability to pay their debts under reasonable modified terms will **not** be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. So if the borrower and/or its guarantors can still make the payments and the financial institution would prefer to extend the loan rather than take a loss, the fact that the property is worth less is not the determining factor.

The loan can be in good standing if the borrower/guarantor can show that they can still make payments. New appraisals need not be ordered if an internal review by the institution appropriately updates the original appraisal assumptions to reflect the current market and provides an estimate of the fair value for impairment analysis. Documentation should demonstrate a full understanding of the property's current "as is" condition. However, if the institution intends to work with the borrower to get a property to "as stabilized" market value, the institution can consider the "as stabilized value" in its collateral assessment for credit risk rating. This ability to extend the loan and not report losses or reserves may be heading too far toward the "make believe" area. Just present a "good story" and the institution can buy a lot of time.

This good story accounting could provide more of a lack of transparency and consistency. Different accounting approaches may take place for similar distressed assets for different financial institutions. Two accountants and/or examiners can tell a good story much differently. It will probably make the federal regulator's job more difficult. In the 1990s, for example, banks in Japan were allowed to avoid taking losses and write-downs. The result was an entire decade of stagnation. The steps by our federal regulators could create a parallel situation. This may extend the time of lack of credit to borrowers.

In spite of the above, as of December, 2009 there seem to be some potential transactions occurring which could escalate regardless of the ability to extend these loans via the new policy statement. Some lending institutions are taking a more realistic line on distressed assets and are starting to foreclose, take deeds in lieu of foreclosure and selling their distressed assets and notes. Distressed funds that have been set up for some time awaiting the purchase of distressed assets and notes are now able to purchase them whereas they could not before—thereby getting deal flow going again and toxic assets off the lenders' financial statements.

A lack of transactions hurts everyone. The investment funds are not able to invest in the distressed properties that they have been set up for. The financial institutions are saddled with nonperforming assets that are impacting their future ability to lend. Assets continue to deteriorate and lose value due to rising vacancies, higher loan-to-value ratios and rising cap rates. Valuations are difficult to determine. Uncertainty continues.

Let's get back to reality, consistency and good reporting rather than good story, make-believe and a head-in-the-sand approach with relaxed accounting and reporting standards. Let's try to clean up our commercial real estate problems sooner versus later by taking a more realistic approach rather than have toxic loans eat at the insides of supposedly "well capitalized" institutions. Let's address our issues more timely and critically in order to get back more quickly to a better market—a market where there is more lending, less uncertainty, more transactions, better valuations, more transparency and a more vibrant economic environment. ■