Fair Value? The change in mark-to-market accounting rules is drawing both concern and question marks

by Bobby L. Hickman | April 23, 2009

Will the recent change in mark-to-market accounting rules really help Atlanta's troubled banks? Experts say it's too soon to know the impact – but community banker say the benefits will come more to large financial institutions than to their companies.

One school of thought believes the original Financial Accounting Standards Board (FASB) 157 rule was effective for all companies. It called for mark-to-market accounting for financial assets (such as marketable securities) in 2008 and non-financial assets in 2009. The latest change is effective for the second calendar quarter of 2009. John Fenton, assurance business line leader with accounting firm BDO Seidman LLP's Atlanta office, says for the past several years, FASB has been moving to a fair value approach for balance sheets.

FairValuePreviously historical cost "was pretty much the theory behind valuing assets: whatever you paid for the asset was what it was on your books," he says. However, the trend is now fair value approaches, which recognize that the value of an asset changes over time.

The method assumes there is an orderly market where companies can find observable information to estimate the fair value of certain investments, Fenton says. However, at the same time the rules were introduced in 2008, the financial crisis caused "situations where there was not an orderly market or recent transactions to benchmark." Banks were particularly affected as markets dried up and it became difficult to value assets.

"People were applying rules somewhat conservatively in many cases during 2008," Fenton says. "They went to the last observable price they could find," which could reflect distressed markets and forced sales. "We were finding in many cases, people were just dumping assets and getting out anyway they could," he notes.

"It's still early to tell how it's going to help," says Lee Bradley, managing director of bank development for Commerce Street Capital LLC, "We haven't gotten word yet from the regulators on how it's going to be applied."

For area banks with large real estate portfolios, Bradley says, "This can make the difference between surviving and not surviving. Those banks that are already in trouble are going to have to raise more capital to survive, regardless. But the change in mark-to-market can give them more breathing room to figure out how to be a survivor."

Bradley says for the troubled banks he's talked with in Atlanta, "The biggest thing they've been scared of is mark-to-market. If they have continued devaluation of their assets, it's a spiral over which they have no control."

Marvin Cosgray, CEO of The Buckhead Community Bank, says the new rule will not help his institution or similar ones because the rule only changed for mortgage-backed securities. "I think it will benefit larger banks in this country and Wall Street investment banks because they hold the majority of these securities. But they did not address the issue for community banks, which is mark-to-market accounting on real estate loans,"

Charles Green, president of Sunrise Bank of Atlanta, agrees, "Where new rules really impact banks is on the securities they hold as interim investments; and in housing, with Fannie Mae or Freddy Mac securities. So it's going to have a huge impact on larger institutions that hold billions of dollars of these types of securities. Even for a $500 million bank, it is a significant number because of the dramatic valuation changes. The ones that are really distressed over this are the federal home loan banks."

Joe Keating, chief investment officer for RBC Bank Chief Investment Officer, says the FASB made a "somewhat controversial decision" allowing banks to exercise more judgment in mark-to-market accounting. He says bankers and many congressional leaders maintain that "pricing assets to firesale values is sometimes flawed when markets have ceased to function," and the approach made the financial crisis worse. Opponents believe the new rules allow banks to "to hide the real value of their toxic assets and future losses," Keating notes, while adding, "The rules change by FASB seems reasonable in the current environment."

Fenton says he has heard talk that "accounting rules created or worsened the financial crisis through the deterioration of the statutory assets of banks and financial situations. Honestly, accounting rules exist to adequately report and reflect the substance and economics of a situation; they don't create the issue." However, last year Congress called on FASB and SEC to revisit the rules, Fenton says, expressing concerns "companies were applying the rules in a way not intended and making a bad situation worse." The result was the new FASB staff positions earlier this month.

Mark-to-market is also a concern for Fenton's real estate development clients. "They want to hold an asset, develop it later and realize profit down the road. With the new rules, developers have to look at whether they are able to hold that asset until they you can realize that profit – or might they get into a stressed situation and be forced to sell it? "A lot of judgment involved," he says.

"Our clients are still trying to work their way through it," Fenton says. "Financial institutions are trying to step back and evaluate in a meaningful and productive way. The jury is still out on whether this really helps."

The other side

Green says the other fallout in the banking world comes on the regulatory side. The FASB change was more about securities, he says. "The real estate issue is not an accounting rule – it's how regulatory agencies are viewing the risk associated with real estate."

Bank examiners "with much more frequency than has ever been requested want you to evaluate the value of real estate assets that may be securing your loans," Green says. "In today's marketplace – when the value of collateral is lower than it was when you made the loan – they think you should be out there renegotiating [loan terms] or taking a bigger reserve for potential loss without necessarily evaluating the performance or creditworthiness of the borrower."

The problem stems from a nearly-dead real estate market. Under a comparative methodology, Green explains, "Let's say you look within a three-mile circle at a 2,000-square-foot red brick ranch houses to see what they've sold for in the last 12 months. If there were no sales, or the only sales are foreclosures, the comparative value is extremely low." Also, the person in a home may have been there 10 years and has no plans to sell it, Green continues. "However, when that home with the lower valuation appears in your collateral, the FDIC wants you to take a bigger reserve on your loan – even though repayment ability of the borrower may not be controversial. So this is making a bad environment worse."

Cosgray says applying the modified rules to real estate rule would help community banks tremendously. "We're having to write those loans down to discounted values that we feel are theoretical losses – what I call 'voodoo accounting.' The write downs come out of the bank's profit and capital, and that hurts us."

He added mark-to-market is "a one-way street: you're required to mark the value of the asset down when it declines, but if it goes up in value later, you can't mark it up. The way the rules are written are not fair. The concept was supposed to stabilize balance sheets but the effect has been just the opposite – particularly in these unprecedented times."

Cosgray says area bankers are working with Georgia's senators in asking FASB to reconsider applying the new approach to real estate loans. Sen. Johnny Isakson is proposing to allow banks to spread the write down over five years instead of taking the entire amount immediately. "The thought is that the market would come back over that time and you won't have these theoretical losses," Cosgray adds. "We're also hoping with mortgage-backed securities they are opening the door, maybe it will be done in steps."

Bradley says he is seeing one hopeful sign. "We're seeing a lot of real estate market money coming into the market – real estate funds that want to buy bad assets from banks," Bradley says. "I've been getting lots of calls and emails from funds wanting to purchase assets from banks. That could be a sign of the bottom of the market. When the funds want to be buyers, those guys must feel like it's a bottom."