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Accounting rules continue to have deep impact on commercial real estate

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The credit crisis has put immense pressure on the commercial real estate industry, which threatens to slow the national economic recovery. Liquidity in the commercial real estate market has been considerably hampered by one of its key lending vehicles - the nearly frozen $900 billion commercial mortgage-backed securities market, known as CMBS.

Currently, banks and the CMBS market represent most of all outstanding commercial real estate loans. In addition to banks tightening their loan volumes, the CMBS market has ceased to function with respect to new issuance until more recently. Even with the recent new issuance of CMBS by both Bank of America and Goldman Sachs over the last couple months, the CMBS market continues to be plagued by systemic dysfunction. In fact, the CMBS market provided approximately $240 billion in financing in 2007, which accounted for nearly 50% of all commercial lending. Yet in 2008, the CMBS market provided less than $13 billion in financing, despite enormous demand for capacity from borrowers. Without a functional CMBS market, many property owners across the country will face a growing challenge to refinance an estimated $1.4 trillion worth of commercial real estate loans which are set to mature over the next few years.

The liquidity crisis has been exacerbated by certain Fair Value Accounting (FVA) standards, known as Mark-to-Market. In particular, the interpretation and application of FAS 157 led banks to mark down their mortgage-backed securities as they declined in value, forcing them to report hundreds of billions of dollars in losses over the last year. However, in early April 2009, after pressure from Congress, the Financial Accounting Standards Board, known as FASB, voted to change these rules to allow assets to be valued at what they would go for in an "ordinary" sale, as opposed to a forced distressed sale - a step that would lift banks' balance sheets and thereby encourage greater lending.

While this rule change is encouraging, other FASB accounting rules such as FAS 166 and FAS 167 (formerly FAS 140 and FIN 46(R)) threaten the recovery of the securitized markets. These two new rules, effective on January 1, 2010, eliminate the Qualifying Special Purpose Entity (QSPE), which makes commercial real estate securitization possible. The QSPE enables banks and companies to treat transfers of financial assets as a sale rather than a financing for accounting purposes. This allows firms to keep these transferred assets off balance sheets. However, the new accounting rules would essentially force banks "to bring hundreds of billions of dollars in assets back onto their balance sheets, forcing them to set aside more capital." These new rules also require a company to perform a qualitative analysis when determining whether it must consolidate.

Worried that these changes could have a detrimental effect on the lending, in November 2009, Representative Scott Garrett (R-NJ) introduced an amendment to conduct a study of the impact of FAS 166 and 167 on the securitization markets during the Financial Services Committee "markup" (analysis) of the Financial Stability Improvement Act of 2009.

IREM will continue to encourage accounting policy makers to fully examine FAS 166 and 167 and consider the far-reaching implication of these changes for the securitized commercial real estate credit markets and the businesses and consumers they serve.