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Will Mark-to-Market Finally Push Distress?

By Erika Morphy

WASHINGTON, DC-Last month, DiamondRock Hospitality acquired $69 million in debt from Wells Fargo, backed by the landmark Chicago hotel Allerton. The Maryland hotel firm bought the senior mortgage loan on the 443-room hotel after its owner, Chartres Lodging Group, was unable to repay it. DiamondRock said in a news release that it expected to own the fee title of the hotel upon completion of the foreclosure. That plan hit a bump in the road shortly afterwards, though; according to the *Wall Street Journal*, a tussle broke out between it and mezzanine lender, New York-based Petra Capital Management, with both firms vying for control.

Welcome to the new face of real estate distress: after a deep recession, with the pain particularly acute in commercial real estate, there are still few viable distressed properties or notes available for sale. In short, the deals that are being done now entail investors, such as DiamondRock, chasing after defaulted borrowers to offer capital solutions.

The pickings are so slim that many investors who had originally thought they would pursue distressed opportunities are beginning to bow out, says Gary Eisenberg, a partner with Herrick, Feinstein. "Potential bidders would underwrite conservative offers and then find themselves losing by an order of magnitude," he tells GlobeSt.com. "There is always someone willing to pay more, it seems."

There are a number of reasons behind this situation, starting with government policies put into place to combat the recession, explains Bruce Prigoff, partner with Cox Castle & Nicholson. The Troubled-Asset Relief Program, for instance, propped up the banks so they could continue to exist without mass closures. Also, the FDIC has placed great emphasis in selling assets through a structured transaction format in which the agency retains a majority of the ownership interests in the loans of failed institutions, coupled with substantial ultra-cheap FDIC guaranteed financing to the venture that acquires the loans in partnership with the FDIC.

Those two developments are unlikely to shift in the foreseeable future. However, a third factor- bank loan accounting rules-will change.

At the start of the crisis, loan accounting rules were changed to permit banks to carve off portions of loans in an A/B Note restructure so that the portion of the loan that could be supported by current cash flow and was not too far under water from a valuation standpoint could be held by the bank as a modified performing loan, Prigoff explains. "This allowed the banks to retain large portions of their portfolios that otherwise would have been classified as nonperforming," he says.

Now, the Financial Accounting Standards Board is proposing a change to the accounting standards that required banks to book loans at their current market value. The rules are not an immediate panacea-they won't go into effect until 2013 for the largest banks and 2017 for smaller institutions.

But will their eventual arrival finally lead to the traditional or typical-or, at least, market-priced-distressed deals that opportunistic investors had originally been expecting? Don't hold your breath, Prigoff advises. "The forces weighing against clearing the cloud over the real estate market through mark-to-market accounting remain very strong...regulatory pressure to move assets of the books of the banks is rumored from time to time, but is not having great effect at this time."

The concept that the overall economy is going to improve sufficiently to outrun the collapse in the real estate markets and allow the US government and banks to avoid massive losses is the real problem, he says. "Also, continuing to hold most of the real estate loans on the books of institutions with a low cost of capital is designed to minimize the losses that would be incurred if the assets were shifted to investors that have a high cost of capital and high yield expectations. In a market where new financing for real estate assets is scarce, the cost of capital rises dramatically when an asset is moved off a bank's books into the hands of a third party opportunistic investor, absent bank seller subsidized financing of the purchase. Accordingly, I do not anticipate a major change in US government policy that would bring large numbers of assets to market at this time."

Integra Realty Resources' president and COO, Jeffrey Rogers, says more patience is required on the part of distressed investors, some of which are beginning to disband funds set up for this purpose. "Memories tend to be short, but those of us who were around during the RTC days remember that the distressed assets did not begin to flow immediately. There was a process and it took years. This real estate downturn is different in many respects, but it still takes time before distressed assets are flushed through the system," he tells GlobeSt.com.

He also doesn't think a change in mark-to-market accounting regulations will have much impact. "First, the proposed rules regulate when a financial institution has to recognize a loss on a loan asset. The institution is not forced to sell the asset because it has lost value," Rogers explains. "Financial institutions could still decide to keep the loans until they increase in value. They will certainly choose this option if the borrower is covering debt service."

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