CONSIDERATIONS REGARDING THE FAIR EVALUATION OF REAL ESTATE SECURITIES BY THE BANKS

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During the current period, the financial crisis and has also landmarked the real estate transactions, their dramatic decrease diminishes more and more the value of lands and buildings.

On the local real estate market, the first signs of real estate crisis issued since the year 2008 when the value of most properties has decreased mainly due to the blocking of sources of funding. The lack of money has led both to the slowing or halting of the mortgage lending and the project financing.

Banks have become more reluctant not only with regard to granting of such loans but also regarding the portfolio of securities consistent of real estate properties (lands and buildings).

The well known London broker Tom Healy shows that "if we evaluate the properties daily especially the important ones, we would see the fall of their value every time. Until when? Who can know?" he was asking rhetorically.

Both land and buildings represent for the banks the category of real securities that can be considered to reduce the lender's exposure to the debtor at a fair value, operation required to calculate the specific provisions for credit risk and interest with influence on the financial results of the bank.

In our legislation, this way to work is stipulated in art. 10 of Regulation no. 3/19 of March 2009 concerning the classification of loans and investments as well as the establishment, adjustment and use of specific provisions for credit risk, issued by the National Bank of Romania, as: "Any real guarantee, except the general forfeit of guarantees constituted on future goods and real guarantees provided in the table from Annex 2, (n. a. from the regulation mentioned) may be taken into consideration to reduce the lender's exposure against the debtor at a value that cannot exceed its fair value."

Since the fair value is a category defined and regulated under the International Financial Reporting Standards (IFRS), and banks are required to develop methodologies for determining the fair value of the real securities received (with direct implications for the calculation of provisions, of the financial results and risks) we present some considerations related to the importance of assessing real estate securities at fair value.

The main courts of accountancy normalization (Financial Accounting Standard Board - FASB or International Accounting Standards Board - IASB), have recommended the use of practice evaluation at fair value for all balance sheet items. In 1998 IASB adopted two accounting standards, IAS 32, "Financial Instruments: Disclosure and Presentation" and IAS 39, "Financial Instruments: Recognition and Measurement" which aims to assess all financial assets and liabilities presented in the balance sheet at fair value, in order to provide comparable and relevant instruments for the users of accounting information.

For the purposes of the above, through a paragraph of IAS 39 was amended IAS 30, "information presented in the financial statements of banks and similar financial institutions, amendment that states that “a bank must show fair values of its financial assets at least for: loans and receivables created by the bank, investments held to maturity, financial assets held for trading purposes and financial assets available for sale”.

Under Regulation 3/2009 of the National Bank of Romania, in general, the fair value is defined as the value at which an asset can be traded or a debt settled voluntarily between the parties who are aware of the situation, in case of a transaction where the price is determined randomly. Theoretically, any asset is treated as a financial asset for which the fair value is given by the present value of cash flows expected to be generated by that asset and taking into account the risks related to it.

From this definition results that the fair value is given by the present value of cash flows expected to be generated by that asset and taking into account the risks related to it. It results that the fair value is a value future - oriented, because it most often corresponds to the cash flows expected to be held by the bank by using or selling an asset. In other words the fair value is the value that is assigned as the bank would liquidate at any time, entirely or partially, the balance sheet’s elements.

Just as in case of real securities, their fair value must ensure the bank’s cash flows capable to cover the volume of loan and the interest in the case the debtor does not reimburse them.

If the award of "fair value" of the item measured, i.e. its market value is not possible as there is no market price for the item which is evaluated at fair value, a substitute for the market value must be found. But between the method of determining the fair value based on market value and the method using its replacement there is a certain difference: while the market value is an objective information established by the manager and which operates independently of his judgments, the replacement of the market value is a value determined by the manager, that is, estimated on the basis of his professional judgments.

For example, for financial instruments, the fair value can take one of the following forms:

- the value of trade negotiations between two parties;
- the market price for instruments negotiated on a free market;
-the market price of an instrument that has similar financial characteristics;
- the present net value of future treasury flows updated to the market rate.

Adopting the fair value as the basis for evaluation in accountancy means the permanent correction of the costs of acquisition of assets according to their market value, that is, a permanent revaluation of the balance sheet items. The use of the evaluation at fair value involves the inclusion in the final result of the bank, the operational result obtained from actual transactions, but also some “virtual" items generated by the market development that are only potential gains or losses.

The advantages provided by accounting at fair value, primarily consist of:

- allows the financial analysts to make a fairer estimate of future treasury cash-flows;
- leads to higher quality decision and to an effective management;
- is a neutral evaluation because the price of a balance sheet element is determined on a real market in operation.

In May 2001, the European Union adopted a directive regarding the assessment at fair value of the main financial instruments, following that its provisions would be included in the right of every EU member countries. In July 2002, the Parliament and the European Commission adopted a regulation that requires listed companies, including banks to prepare the consolidated financial statements in accordance with International Financial Reporting (International Financial Reporting Standards: IFRS) starting with 2005. Also in 2003 the IASB launched the process of revising the accounting rules of IAS 32 and IAS 39 which regulate the financial instruments and the assessment at fair value (the amendment regards the option given to entities that apply IFRS to record and evaluate any new instrument introduced in the accounts at its fair value). Therefore the operation of assessing the fair value in the banking sector, particularly in the EU environment, is still a very controversial topic.

The specialists in banks in the Europe environment are some of the bitterest critics of the evaluation at fair value. They fear most of the corrections arising from reductions in value of assets in relation to market value and the effect of the operation of such losses of value that would attract an important increase in the volatility of the outcome with consequences for the markets.

The Basel Committee on banking supervision issues believes that the approach based on the fair value is appropriate in situations where it is feasible - such as the financial instruments held for trading - expressing its regarding the application of IAS 39 which requires the evaluation at fair value because the banks can change the way of managing risks.

A study of the European Central Bank (2004) on the impact of assessment at fair value in the European banking industry, shows that the new bank accountancy based on the fair value may affect the role of banks as financial intermediary and the distribution of risks between economic agents. For example, to reduce volatility in the financial statements as a result of using the fair value, the banks may engage in less risky operations (the banks may refuse to grant loans with fixed rates or providing long term loans, for fear that the risk of interest rate would have a very significant impact on the financial statements over time) and their role as financial intermediaries would change.

Thus, the financial risks normally assumed by banks, could be transferred to other operators which do not necessarily have the expertise to manage them effectively.

In conclusion, we can consider that applying the fair value assessment may have positive consequences, such as a better reflection of economic reality, due to the comparability and transparency of financial statements in the banking domain. Also the accounting harmonization and the use of certain accounting standards of quality make an important contribution to the integration and efficiency of financial markets.

At the same time, however, assessment at the fair value in the balance sheet of banks raises numerous problems regarding the estimate of value for financial instruments that are not traded on an active and liquid market such as the vast majority of bank loans.

Comparability of financial information may be affected if banks will have more options for the evaluation of assets and liabilities at fair value, such as the use of internal models based on assumptions specific to each banking entity. Regarding the real estate securities of banks as stated above, although by the Regulation of the National Bank of Romania no. 19/14.12.2006 regarding the techniques of mitigation of credit risk used by credit institutions and investment firms, minimum requirements have been established for the recognition of such securities such as their monitoring in terms of value (for real estate properties of commercial nature at least once a year and for real estate properties of housing nature, the assessment would be done at least once every three years).

We consider it to be necessary that in the current crisis conditions, the banks would provide through the internal rules a greater frequency and concrete ways of evaluating these guarantees for the mitigation of any eventual risks.

We also consider that the financial performance of borrowers, compulsory to be considered, under the Regulation of the National Bank of Romania no. 3/2009 regarding the qualitative factors (the way of management of the entity, the quality of shareholders, the nature of the guarantees received, the market conditions, etc.) would be made by banks with a greater frequency considering the turmoil of the crisis, with major implications on the banking risk.

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