



September 30, 2010

VIA ELECTRONIC FILING

Robert H. Herz
Chairman
Attention: Technical Director
File Reference No. 1810-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-6116

Re: *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities, File Reference No. 1810-100*

Dear Mr. Herz:

The Commercial Real Estate (CRE) Finance Council appreciates this opportunity to provide comments on the proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities* (the “Proposal”). The CRE Finance Council is the collective voice of the entire commercial real estate (“CRE”) finance market, including investors such as insurance companies, pension funds, and money managers; portfolio and CMBS lenders, ratings agencies; accounting firms; servicers; and other service providers.

Because our membership consists of all constituencies across the entire CRE finance market, the CRE Finance Council has been able to develop comprehensive responses to policy questions to promote increased market efficiency and investor confidence. Our members provide practical advice to policymakers at all levels on measures designed to restore liquidity and facilitate lending in the commercial mortgage market and have been extremely influential in helping to develop programs such as the Term Asset-Backed Securities Loan Facility. CRE Finance Council members have also testified multiple times at Congressional hearings on the state of the CRE market, financial regulatory overhaul measures, and proposed accounting standards.

Thus, we have a distinct perspective on the tremendous challenges facing the \$3.5 trillion market for commercial real estate finance and the need to craft policy measures that support, rather than undermine, the recovery of the commercial real estate sector and that of the nation's economy as a whole.

To that end, the CRE Finance Council has played a leadership role in the development of standardized practices and in ensuring transparency for the commercial real estate finance industry, such as through our Investor Reporting Package (IRP), which we independently developed and implemented. The Securities and Exchange Commission recently acknowledged the extensive work done by CREFC on the IRP, through its proposed revisions to Regulation AB. The IRP provides a wealth of standardized information to investors and has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market. Importantly, CREFC is currently working with market participants to make even further improvements to the IRP. Furthermore, and in light of the recent economic crisis, CREFC has set up three task forces that are working to create increased transparency and disclosure, enhanced underwriting standards and industry standards for representations and warranties.

Given our unique perspective on both the challenges facing the commercial real estate market and our commitment to policy reform, our comments and observations on the FASB's Proposal will remain focused on our core competency, the commercial real estate finance market.

I. OVERVIEW

CRE Finance Council strongly believes that the FASB and IASB should work together to produce a single standard for the accounting for financial instruments that is based on the current "business model" approach. We believe that in this age of global markets and investing, a single, high-quality standard for financial instruments is critical to facilitating the cross-border movement of capital. We do not support a non-converged approach as we believe this will only create confusion in the marketplace. Further, we believe that the changes proposed by FASB do not represent an improvement in financial reporting and that the costs of implementing them significantly outweigh any perceived benefits.

We believe that the current approach, which is based on an entity's business strategy, works well and is not in need of major changes. In particular, we do not support the application of fair value to loans and other instruments that are intended to be held for realization of yield, as fair value accounting would not appropriately reflect the entity's business strategy in those instances. Further, we believe that fair value accounting actually detracts from our market participants' focus on sustainability of operating cash flows. If changes are to be made to the current approach, we believe that only modest changes to the impairment model are required, as further detailed below.

II. STATE OF THE CRE MARKETPLACE

Commercial real estate is a lagging indicator, and the market is facing an unprecedented combination of challenges as a result of the prolonged recession:

- **Severe U.S. Recession.** – With a prolonged recession (first housing-led, and then consumer driven) and unemployment at 9.6% (as of August 2010), there is no greater impact on CRE than jobs and the economy, as commercial and multifamily occupancy rates, rental income and property values have subsequently been severely impacted and perpetuate the downturn. Those impacts persist even as the recession has abated.
- **“Equity Gap.”** – The biggest challenge today is the reality that CRE assets have depreciated in value by 30% to 50% since 2007, creating an “equity gap” between the loan amount and the equity needed to re-finance a loan, which impacts even “performing” properties that continue to support the payment of monthly principal and interest on the underlying loans.
- **Significant Loan Maturities.** – Approximately \$1 trillion in CRE loans mature over the next several years, but perhaps most significantly, many of those loans will require additional “equity” to refinance given the decline in CRE asset values.
- **CMBS Restarting – Slowly.** – Even in normal economic conditions, the primary banking sector lacked the capacity to meet CRE borrower demand. That gap has been filled over the course of the last two decades by securitization (specifically, commercial mortgage-backed securities (CMBS) which utilizes sophisticated private investors – pension funds, mutual funds, and endowments, among others – who bring their own capital to the table and fuel lending. CMBS accounts, on average; for approximately 25% of all outstanding CRE debt, and as much as 50% at the peak, while readily identifiable properties funded by CMBS exist in every state. However, the volume of new CRE loan originations and thus of new CMBS has plummeted from \$240 billion in 2007 (when CMBS accounted for half of all CRE lending) to \$12 billion in 2008, \$2 billion in 2009, and \$2.4 billion through June 2010. While there is revitalized activity in the CMBS space, there is a mismatch between the types of loans that investors are willing to finance and the refinancing that existing borrowers are looking for to extend their current loans.

Clearly, in an environment where consumers, legislators and financial regulators are striving to improve the quality of loan underwriting and investor protections, the absence of certainty in our both our regulatory and accounting frameworks would create a significant obstacle to the return of a healthy real estate capital market.

Therefore, although we welcome the FASB’s efforts to create a comprehensive and simplified framework for classifying and measuring financial instruments, we are concerned that the Proposal does not achieve these objectives. We are particularly concerned that the FASB and the IASB have not been able to achieve convergence on this very important topic. In this age of global markets and investment opportunities, we believe that producing a single, high-quality standard on accounting for financial instruments is critical to facilitating the cross-border movement of capital. We believe that having both Boards produce two very different standards is counterproductive in this regard and will only create further confusion in the marketplace as issuers and investors attempt to portray and evaluate their investment opportunities. For that reason, we believe it is not in the best interest of investors and other users of financial statements for FASB to proceed with the Proposal in this form.

The following are our specific comments on the Proposal.

III. FAIR VALUE

The Proposal requires the use of fair value as the default measurement category for financial instruments, regardless of the entity's business model for managing the instrument. However, we do not believe that this would constitute an improvement in financial reporting. Rather, we believe that the current mixed-measurement model, with fair value reporting for instruments that are intended to be traded, and amortized cost reporting for instruments that a company intends to hold over the longer term (such as loans that a company intends to hold for their contractual cash flows, or an entity's own debt that it intends to settle at maturity), is superior in that it better reflects an entity's underlying business and economic reasons for holding an instrument.

While we acknowledge that fair value information provides important information regarding financial instruments, it is not necessarily the primary consideration for many participants in the commercial real estate market when evaluating commercial mortgages that often are nonrecourse to the borrower (Collateral-Dependent Financial Assets per the Proposal). Rather, investors are focused primarily on the underlying collateral property's future ability to generate positive cash flows. In making an assessment of this, investors look to information regarding underlying and contractual cash flows, which are in turn driven by:

- Terms of the note, including principal amortization;
- Credit terms of the mortgage, including reserve requirements and lock-box provisions;
- Property-specific data such as geographic location, year built, overall condition, and major features;
- Current rates and terms of leases, projections regarding renewal rates and terms, and credit quality of the tenant base;
- Market data regarding tenancy rates and the amount of net new property development;
- Macroeconomic factors such as the unemployment rate and overall health of the job market.

When additional information and data have been requested by investors, CREFC has fully supported providing such information. For example, as noted above, in response to investor demand for additional data and more standardized reporting of information related to CMBS, CREFC developed the Investor Reporting Package (IRP) in 1997. As a result, CMBS market participants now have access to a wealth of information through the IRP and "Annex A" data, which provide access to loan-, property- and bond-level information at issuance and while securities are outstanding. Such data include updated bond balances, amount of interest and principal received, bond ratings, and underlying property level financials. CREFC continues to enhance the IRP in response to the expressed needs of investors.

In contrast, we do not support the Proposal's move to fair value as the default measurement for all financial instruments, as it is our belief that there has been little support expressed by many users and preparers for this approach. In this regard, we cite a study prepared by PricewaterhouseCoopers that surveyed investors and analysts and concluded that "Fair value

information for financial instruments is considered relevant and valuable by most respondents **but is not necessarily the key consideration** in their analysis of an entity.”¹ (emphasis added). Instead, survey respondents across all geographic regions and industry sectors consistently expressed a preference for the entity’s business model (72%) to be the primary consideration when determining balance sheet classification and measurement of an instrument.

Accordingly, we do not believe that a move to fair value is warranted for instruments that management intends to hold over the long term for realization of contractual cash flows, rather than for short-term trading gains. Because our market participants are instead primarily focused on the sustainability of underlying property cash flows, we believe it is important to keep net income free from fair value movements in these instruments, as to do otherwise would overshadow important information regarding cash flows.

By the same logic, we believe that fair value *is* the appropriate measurement basis for loans held for sale. Accordingly, we would support the elimination of the current measurement basis of lower-of-cost-or-market as it would make the measurement of these loans consistent with other short-term trading instruments, and therefore result in a simplification of the current framework for accounting for financial instruments.

Conversely, we do not support a move to fair value for long-term debt, as again, we believe investors and analysts are primarily focused on an entity’s contractual cash flow obligations, in that they directly impact an entity’s ability to generate positive cash flows. In addition, we are concerned that a move to fair value would introduce a serious measurement mismatch for entities that carry a large portion of their commercial real estate assets at historical cost, such as Equity REITs. Equity REITs have both financial liabilities secured by their real estate assets and financial liabilities that they have issued in the capital markets, and while the former would appear to meet the amortized cost exception, it is less clear that the latter would. Accordingly, we believe the current approach, where entities may elect the fair value option for liabilities, is superior in that it provides for greater matching of assets and liabilities without the concomitant drawbacks of the rule-based, exception approach that is currently proposed.

Additionally, we believe that for non-trading financial liabilities that are recorded at fair value pursuant to the fair value option, the change in value attributable to the change in the entity’s own credit should be separately reported in other comprehensive income (OCI), rather than in net income. We believe that investors routinely ignore these changes in value as they are more interested in the contractual cash flows of an enterprise, and thus it would be more helpful to users if companies were to separately report this amount in OCI.

We also note that a move to fair value for commercial real estate loans and securities would introduce an additional level of subjectivity into the financial statements. Most commercial real estate financial instruments are difficult to value as there is often not a robust secondary market for these instruments, and as a result most fall in the Level Three category under Topic 820, *Fair Value Measurements and Disclosures*. Accordingly, recording these instruments at fair value would introduce more subjectivity in financial reporting and therefore less reliability without a consequent increase in benefits.

¹ PricewaterhouseCoopers, *What Investment Professionals Say About Financial Instrument Reporting*, June, 2010, p. 5.

In addition, requiring reconciliations from amortized cost to fair value on the face of the statement of financial position for financial instruments would add unnecessary complexity to balance sheet reporting and will be a major source of confusion for investors and other financial statement users. Footnote disclosure of fair value information avoids these problems and fulfills the needs of investors and other financial statement users who might want to consider this information. Thus, the footnotes continue to be the appropriate place to disclose fair value information for financial assets measured at amortized cost where the entity's business strategy is to hold them for collection of contractual cash flows.

Finally, the accounting and reporting systems for most entities involved in the commercial real estate market such as those maintained by loan servicers and other financial institutions are designed to provide information primarily regarding the repayment of interest and principal. Accordingly, a move to fair value accounting would require a tremendous and costly systems overhaul that would likely consist of a multi-year effort for many preparers. These are actual, concrete costs that must be taken into account when evaluating any proposed change to the current reporting requirements. We do not believe these costs are justified based on our comments noted above.

IV. IMPAIRMENT MODEL

As an overall matter, we believe that the FASB and IASB should work together via the Expert Advisory Panel to develop and test a single model for credit impairment. We believe it is critical that the standard-setters reach agreement on this fundamental aspect of accounting for loans and debt securities.

In developing a converged model, we believe that the FASB and IASB should adopt a single impairment model for both originated and purchased loans. In this regard we do not support the expansion of the provisions of Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3) in the Proposal. We do not understand why the model should be different for loans that were purchased versus those that were originated if the entity holds them for the same business reasons. In addition, our members have found the SOP 03-3 model to be operationally complex and not well-understood by investors and analysts. Rather than expanding this model, we believe that significant simplification could be achieved by completely eliminating a separate credit impairment model for purchased assets.

With respect to the FASB's Proposal, we support a change in the loan impairment model that would reflect an earlier recognition of impairment charges, as we believe the current approach which is based on probable incurred losses results in impairment charges being recognized too late in the cycle. In this regard, we support removing the "probable" threshold from the current framework, as we believe it is more appropriate for an entity to recognize an impairment loss as soon as its expectations change regarding the collectability of future cash flows.

However, we believe that the Proposal's approach does not go far enough in that it permits an entity to consider only information relating to past events and existing conditions, and must assume that the economic conditions existing at a point in time would remain unchanged for the

remaining life of the financial assets. That is, the Proposal would not permit an entity to consider potential future economic events beyond the reporting date.

We do not believe this approach is reflective of how entities actually perform credit evaluations in practice. Our market participants generally evaluate expected cash flows by taking into account all relevant and reliable information, which includes projections of future economic conditions. To ignore this information would result in an allowance that essentially “lags the market.” Too low as the market starts to enter a period of decline, and too high as the market starts to recover.

For example, in Case B, paragraphs IG 123-124 of the Proposal, we agree that it is appropriate to consider the impact of unemployment rates in the analysis of credit impairment, as this is an economic factor that directly impacts the performance of mortgage loans, both residential and commercial. However, we disagree with the approach whereby expectations about future economic conditions should be ignored, and as such expectations are routinely factored in to analysts’ and investors’ assessments regarding the sustainability of operating cash flows. For example, in commercial mortgages for which the maturity date is five to ten years in the future, lenders commonly look to information such as forecasts of tenant per square foot rentals and vacancy rates when determining if a loan is likely to default. Accordingly, we believe that the impairment model should be amended to allow for the consideration of conditions expected to occur over the future life of the loan.

If the impairment methodology is modified to incorporate expectations about future events, however, we do not believe that a specific charge for impairment for individual loans should be recorded at inception. For example, the typical default curve for non-amortizing commercial mortgages shows that very few losses occur in the first 18 to 24 months of the loan. Therefore, we do not believe it makes sense to “front-end” specific losses for individual loans as that is contrary to our experience.

We also object to the Proposal’s approach to recognizing and presenting interest income and credit impairment. We believe that the existing model, under which:

- interest income is based on contractual amounts due (adjusted for amortization and accretion of discounts and premiums and direct origination fees or costs);
- impairment amounts represents principal losses only; and
- the allowance is presented separately from interest income

is well understood, appropriately segregates between credit events and interest income, and produces a key metric, net interest margin that is widely used by analysts. We also note that under the current approach, proceeds on a defaulted or foreclosed loan are typically applied first to costs, then to interest owed, and then to principal, such that most losses are a loss of principal. We believe this approach makes sense as we believe it is inappropriate to continue recognizing an income benefit on a loan where loss of principal is expected. We believe the proposed approach is confusing and, while we understand that, over time, analysts may adapt to the new guidelines, it is not clear to us that the proposed approach necessarily represents an improvement in practice. Accordingly, we do not see how such a radical change in approach could be justified by the very significant costs of implementation in this area.

V. HEDGING

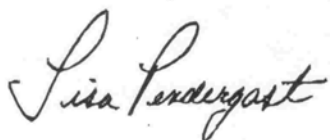
In general, we support the changes proposed to hedge accounting, as we believe that, with the elimination of shortcut accounting, many more entities will now be required to measure and assess hedge effectiveness. Therefore, modifying the effectiveness threshold from highly effective to reasonably effective, and demonstrating effectiveness via a more qualitative approach, would further the FASB's goal of simplifying this exceptionally complex standard.

However, we do not support the proposal whereby the de-designation of an effective hedge relationship would be prohibited absent 1) an expectation that the hedge is no longer expected to be reasonably effective, or 2) a concurrent sale or other termination of the hedge instrument. Many of our members dynamically hedge their portfolios of mortgage assets, and regularly de-designate derivatives as portions of the underlying portfolios are sold or otherwise settled, without necessarily terminating the derivative instrument. We do not believe that this practice has been abusive in any way, and we are concerned that this change would require an entity to incur significant costs (of terminating derivative transactions), without any justifiable benefits. Accordingly, we recommend that the FASB eliminate this change from the Proposal.

VI. CONCLUSION

The CRE Finance Council recognizes and appreciates the efforts of both FASB and IASB to converge accounting standards internationally. As the CRE market recovers from a worldwide recession, certainty in both regulatory and accounting rules will only help foster a robust recovery. We strongly encourage FASB to work with the IASB to produce a single converged standard on the accounting for financial instruments, as we believe this will facilitate greater confidence in financial reporting, and thereby promote greater stability in the marketplace. If this cannot be achieved, we urge FASB to consider the Council's recommended changes to the Proposal, and we stand ready to provide any additional assistance that may be helpful.

Sincerely,



Lisa Pendergast
Managing Director
Jeffries & Company; and
President
CRE Finance Council



Dottie Cunningham
Chief Executive Officer
CRE Finance Council