



NCREIF

The National Council of Real Estate Investment Fiduciaries

February 15, 2008

Mr. Russell G. Golden
Director of Technical Applications and Implementation Activities,
FASB
401 Merritt 7, PO Box 5116,
Norwalk, CT 06856-5116

Reference: Proposed FSP FAS 157-c

Dear Mr. Golden,

The Real Estate Information Standards Board and Council appreciates the opportunity to provide our response on the proposed FSP FAS 157-c, *Measuring Liabilities under FASB Statement No. 157* (the “FSP”).

Responding Organization

The Real Estate Information Standards Board is the official governing body of the Real Estate Information Standards (REIS). REIS was first published in 1995 in collaboration with the National Council of Real Estate Investment Fiduciaries, the Pension Real Estate Association, and the National Association of Real Estate Investment Managers in order to provide standards for calculating, presenting and reporting investment results to the institutional real estate investment industry. The REIS Council is responsible for establishing transparency and open involvement in the REIS process and for communicating its activities to the industry. Our industry investors consist primarily of tax-exempt pension funds that own interests in the estimated \$750 billion of commercial real estate and real estate related investments held by real estate investment vehicles.

REIS represents an effort to codify a single set of desired industry practices and to improve standardization of valuation procedures, financial reporting, and reporting of investment performance return information. REIS plays an important part in the overall efficiency of the real estate investment industry as consistency, comparability and transparency are critical for institutional investors to make efficient and sound investment decisions regarding their investments, investment managers, and the asset class. REIS depends upon, and is intended to supplement and in some cases, clarify, but not replace

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other established standards from authorized bodies including, but not limited to, valuation standards established through Uniform Standards of Professional Appraisal Practice (USPAP), accounting standards established by Generally Accepted Accounting Principles (GAAP) and the performance measurement and reporting standards known as the Global Investment Performance Standards (GIPS).

Through REIS, our industry has made a firm commitment to require industry participants to elect to carry all mortgage liabilities at fair value, as provided under FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. In this regard, we have conducted extensive research and debate on the application of overall fair value principles as well as their application to liabilities (i.e., REIS Adopting Release dated June 15, 2006 at www.ncreif.org/reis). Because many of our investment vehicles trade on net asset value, consistent application of valuation principles is of paramount importance to our industry. We have two principal concerns with the FSP: 1) we believe there is inconsistency in the application of FAS 157 in the valuation of assets and liabilities; and 2) we believe clarification is required within the FSP to ensure that the valuation of a collateral dependent liability gives consideration to the valuation of the underlying asset.

We have the following specific observations on FSP 157-c:

Paragraph 2

Consistent Application of Fair Value Measurement Principles to Assets and Liabilities

The definition of the fair value of a liability used by the FSP assumes transferability which is inconsistent with our understanding of fair value principles. While we believe that the exit notion is a fundamental principle contained within all fair value measurements, the presumption that the liability to the counterparty will “continue and is not settled” does not address the transferability issue. In determining the fair value of assets in accordance with FAS 157, one would not include rights that are not physically possible, legally permissible or financially feasible to be transferred to a buyer.

For example, we believe the valuation methods, for a non-recourse, non-transferable, favorable fixed rate loan, would result in a valuation measure that would fail to recognize fundamental fair value measurement principles because it values rights (a favorable fixed rate of interest) for which the borrower possesses no right of transfer to a market participant in an exit transaction. In order to recognize an exit price, as well as to consider what is physically possible, legally permissible, and financially feasible, we believe the only execution of an exit transaction for the borrower in the circumstances is settlement of the loan for face value with the lender. We therefore do not believe that language contained in paragraphs 2 and 15B is appropriate as we believe they violate the

fundamental fair value principles and would have the effect of overstating net asset values for our industry.

Collateral Dependent Liabilities

We believe the FSP should clearly indicate that any collateral dependent liability should give careful consideration to the valuation of the underlying asset. We believe that, without clarification, this paragraph will provide an inconsistent valuation for encumbered real estate and non-recourse debt as described by the following example.

- Assume an entity owns a bowling alley valued at \$5,000,000. The property has below-market, transferable debt with the bowling alley held as collateral. The loan balance is \$3,000,000, defeasance would cost \$100,000 and the benefit of the below-market interest is \$250,000. A buyer would likely assume the liability and, accordingly, the fair value of the liability is \$2,750,000.
- Now assume that the highest and best use of the site is for a parking lot. As a parking lot, the property is worth \$10,000,000. In accordance with FAS 157, the fair value of the asset at its highest and best use would be \$10,000,000. The fair value of the liability is \$2,750,000, and the resulting net asset value of \$7,250,000.
- Assume, however, that the loan is contingent on the bowling alley and operations; therefore, a parking lot buyer would *not* be able to assume the debt. If the property were sold to a parking lot developer, the owner would pay off the loan (\$3,000,000), pay the defeasance (\$100,000) and realize \$6,900,000. In this example, net asset value is overstated not only by the incremental value of the below-market interest, but by the cost of the defeasance. In a case such as this, it would become appropriate to adjust the value of the liability by the defeasance because you must pay off the liability to realize the highest and best use value. Ultimately, liabilities must be valued giving consideration to the underlying collateral.

We strongly believe clarification needs to be added to ensure gains should not be recognized in the valuation of liabilities unless it is possible to be recognized by a reporting entity in an actual transaction. The risk exists that without some clarification, net asset value would be overstated.

Paragraph 6

The use of the term “identical” liability will be challenging for the real estate industry since it is imperative to take into account the underlying property performance risk in

valuing non-recourse debt. The search for such an example may prove to be difficult for users, and therefore we question the purpose of this term.

Paragraph 7

We believe more clarification is required in the use of the term “proceeds”. This paragraph gives the impression users should use gross proceeds net of direct transaction costs, such as transfer fees, since this would be the amount paid to transfer the liability. . In order to align with the valuation of assets we believe that unless there is a definitive decision to sell, the fair value of a liability should exclude direct transaction costs. It should be noted that direct transaction costs include only those costs, or that portion of such costs, that are unrelated to changes in effective interest rates since the date of origination of a loan. Examples of direct transaction costs include prepayment penalties and yield maintenance provisions.

We appreciate the invitation to comment on such a significant issue and if you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact me at dpoutasse@ncreif.org or (312)819-5894.

Very truly yours,

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Executive Director, NCREIF
Chair, Real Estate Information Standards Board

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