Real Estate Information Standards (REIS)

June 1, 2009

Technical Director, FASB
401 Merritt 7,
PO Box 5116,
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File Reference: Proposed FSP FAS 157-f.

Dear Technical Director,

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

Responding Organization

The REIS Board is the official governing body of REIS. The REIS standards were 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 equity interests in the estimated $750 billion of commercial real estate and real estate related investments held by real estate investment vehicles of which we estimate approximately one half of such property is financed with commercial mortgage financing.

The REIS standards represent an effort to codify a single set of desired industry practices and to improve standardization of valuation procedures, fair value financial accounting and reporting, and reporting of investment performance return information. The REIS standards play 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. The REIS standards depend upon, and are intended to supplement and in some cases, clarify, but not replace other established

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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 the REIS standards, 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 (FAS 159)*. In this regard, we have conducted extensive research and debate on the application of overall fair value principles including their application to liabilities (i.e., REIS Adopting Release dated June 15, 2006). In addition, during the fall of 2008, a task force of the REIS Council conducted a survey of industry participants to assess industry sentiment surrounding the appropriateness of the REIS standard to require adoption of FAS 159. The survey results were mixed; however, the industry respondents concluded that practical and illustrative guidance should be provided to the industry with respect to how debt should be valued within the context of FAS 157. The REIS Council and Board are expected to provide additional guidance to the industry later this year (See www.ncreif.org/reis for more information.). Through these efforts we have determined that inconsistent debt valuation techniques exist.

Despite our primary goal of achieving consistent debt valuation techniques across the industry, discussion continues regarding best practices for treatment of several analytical variables. These assumptions and analytical choices include, but are not limited to the separation of mortgage notes from the real estate (aka Unit of Account) and, the treatment of non-transferable debt. The purpose of this letter is to bring to light the diverging treatments and the related ramifications of investment performance to the capital markets. We are in the real estate investment management business. Delivering clear, consistent, comparable and transparent information to our investors is of paramount importance. We suggest that the language within the FSP might be clarified to explicitly allow reasonable options – while always assuming consistent treatment and reasonable management judgment.

UNIT OF ACCOUNT

Currently there are two different reporting models that exist in the real estate investment industry for investments carried at fair value – the operating model and the non-operating model. Differences in the two models have heretofore been presentation related, and therefore reported net asset value is the same under either model. The non-operating model uses an investment company presentation where the Unit of Account is interpreted as the net equity value of the underlying real estate investments (i.e., the line item "Investments in Real Estate" on the Statement of Net Assets). In contrast, the operating reporting model uses an operating company presentation where the Statement of Net Assets show, as separate line items, the gross investment in real estate (i.e., unleveraged property) and the mortgage liability. Some in our industry have interpreted that there are two units of account within the operating model: one for the gross investment in real estate (i.e., the unleveraged property) and one for the mortgage liability.

For purposes of explanation, we refer to these different approaches to valuation as the "Net Approach" (one Unit of Account) and the "Gross Approach" (two Units of Account). Practitioners using either approach are mixed with regard to their determination of the Unit of Account, with some determining the Unit of Account based on presentation model and others disregarding presentation and determining Unit of Account based on either a purely Net Approach or a purely Gross Approach. Under the Net Approach the equity investment is valued (one Unit of Account). Under the Gross Approach, the real property and the commercial mortgage are valued separately (two Units of Account).

Differences in interpretation of Unit of Account under FAS 157 coupled with the apparent inconsistent valuation principles relating to transfer considerations for assets and liabilities (discussed below) have resulted in widespread non-comparable reporting of real estate investment performance. We think that further clarity surrounding Unit of Account considerations would help to narrow the practice for FAS 157 accounting and reporting within our industry.

We have the following specific observations on the FSP:

PARAGRAPH 11

"When estimating the fair value of a liability, an entity shall not include a separate input or adjustment to other inputs relating to the existence of a contractual restriction that prevents the transfer of the liability"

Our industry is currently examining the concept of transferability's effect on valuation techniques and has found that there is more than one approach in practice. Coupled with inconsistent interpretation of Unit of Account (described above), we think that inconsistent treatment of transferability notions among assets and liabilities as interpreted under FAS 157 also contributes to this inconsistent approach.

Consider the following two existing interpretations of the above statement in the FSP in a situation where transferability of a leveraged investment in real estate is restricted or prohibited:

<u>Interpretation 1:</u>

Under the principle described in paragraph 11, borrowers reporting loans at fair value could interpret the standard to require measurement of the liabilities as follows:

- The transfer of a liability that has a favorable interest rate that is currently non-transferable to a market participant triggers an immediate default on the non-transferable loan, resulting in the remaining principal balance becoming due and payable upon transfer. Therefore, a market participant would not receive a benefit of a favorable interest rate and the fair value of the loan would be the current remaining principal balance.

Those in our industry who support this valuation find support for their interpretation within paragraph 5 of FAS 157:

> *"Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."*

It should be noted that generally, supporters of the Net approach to valuation are likely to support this interpretation of Paragraph 11 of the proposed FSP.

Interpretation 2:

Under the principle described in paragraph 11, borrowers reporting loans at fair value could also interpret the standard to require measurement of the liabilities as follows:

- The contractual restriction on transfer cannot be considered under FAS 157 and therefore, there are interest rate value adjustments to be considered if one were to have to replace this liability under current market conditions (e.g. market rate adjustments).

Without considering the terms of the debt (i.e. rights and obligations), the level of control, structure of ownership (i.e. joint venture versus wholly-owned), and other potential variables that could affect the value of a debt instrument, the borrower would not be fully contemplating the potential for a value adjustment associated with the instrument. Given the assumptions mentioned above, the borrower could have a value adjustment related to debt with restricted transferability. Supporters of the Gross Approach for Unit of Account would be likely to support this valuation.

Because there are differing opinions currently in existence in the industry surrounding the Unit of Account and transferability issue, and both perspectives have what appear to be economically sound arguments, the industry remains conflicted in its positions on the effects of transferability on valuing liabilities. Therefore, we thought it would be important to note that the wording within paragraph 11 of the FSP does not necessarily clarify this conflict.

EXAMPLES

The following three examples serve to highlight some of the inconsistent results reported by our industry participants that are associated with varying interpretations of transferability and Unit of Account.

Example 1

One example, which has become more prevalent in our industry given the current economic environment, involves a situation where the fair value of a property asset collateralizing a loan is less than the outstanding principal balance of the loan. This could create non-transferability in substance despite the absence of a specific prohibition or restriction in the underlying agreement.

Assume the following:

- The free and clear fair value of the property asset is $10 million
- The outstanding principal balance of the non-recourse loan on the $10 million collateral is $12 million
- The fair value of the loan is $8 million

There are currently three opinions on the value of this investment currently in place in our industry:

1. Given the fair value of the property asset is below the remaining principal balance of the loan, upon transfer the loan would be in default and a market participant would assume they would be liable to the lender for the outstanding principal balance. Therefore, the value of the loan is $12 million and the value of the equity is -$2 million ($10 million - $12 million).
2. Since the fair value of the property asset is below the outstanding principal balance of the loan, a market participant would assume the asset could be used to repay the loan in default. In this case the value of the equity is $0.
3. Since the fair value of property asset is $10 million and the fair value of the loan is $8 million, the value of the equity is $2 million.

As illustrated within the three examples, different interpretations of FAS 157 and those provided within this FSP yield vastly different results where there is no difference in the economics of a transaction.

Example 2

Consider another example of valuation differences resulting from differing interpretations of Unit of Account:

Asset and liability attributes	
Asset value (Year 4)	$ 10,000,000
Loan principal	$ 4,000,000
Face loan rate	5.00%
Market loan rate	5.25%
Discount rate (with debt)	8.00%
Discount rate (free and clear)	7.50%

If the Net Approach was applied to this example and a net valuation technique (i.e., a leveraged equity analysis) was used, with the 8.00% discount rate (for a higher risk, encumbered asset) from above, the results would be as follows:

Scenario 1: Net Asset Value Approach				
	Year 1	**Year 2**	**Year 3**	**Year 4**
Asset net cash flows	750,000	750,000	750,000	750,000
Debt net cash flows	(200,000)	(200,000)	(200,000)	(200,000)
Debt principal paydown				(4,000,000)
Asset disposition				10,000,000
Net cash flows for valuation	550,000	550,000	550,000	6,550,000
Net present value	**$ 6,231,849**			

Now assume the Gross Approach is chosen then a gross valuation technique is applied to the asset independently of the debt, the 7.50% discount rate (a lower discount rate is assumed when the asset is free and clear of debt) is used, and a traditional market rate approach is used for the valuing the debt, the results would be as follows:

Scenario 2: Gross Asset and Debt Value Approach				
	Year 1	**Year 2**	**Year 3**	**Year 4**
Asset net cash flows	750,000	750,000	750,000	750,000
Asset disposition				10,000,000
Net asset cash flows for valuation	750,000	750,000	750,000	10,750,000
Net present value (asset)	10,000,000			
Debt net cash flows	(200,000)	(200,000)	(200,000)	(200,000)
Debt principal paydown				(4,000,000)
Net debt cash flows for valuation	(200,000)	(200,000)	(200,000)	(4,200,000)
Net present value (debt)	(3,964,745)			
Net combined present value	**$ 6,035,255**			

As illustrated in the examples above, all assumptions about the underlying real estate or the related liability are valid for the industry yet a difference in valuation technique, yields a difference in value of $196,594 even though the risk associated with the asset and the debt are identical.

Example 3

As illustrated in the attached Exhibit 1, fair value measurement under FAS 157 would support that only those attributes which are beneficial or detrimental to market participants are considered within the fair value measurement of an asset. Consider the illustration of the favorable real estate tax attribute of a property asset shown in Exhibit 1. The current owner who holds the asset would receive the benefit of the tax break, so that the owner's value would be $185,962 but the fair value of the asset on the fair value financial statements would not include that benefit and the fair value would be $153,793. Under one interpretation of the FSP, it does not appear that the same notions (where attributes which are beneficial (e.g. favorable financing) or detrimental to market participants) are considered within the fair value measurement of the liability. As illustrated in the example, without clarification in the FSP wording, reported results of the same transaction may be subject to substantial variation. Some industry participants think if a liability has attributes (say a favorable rate) that cannot be contractually transferred to a market participant; such attributes shall not be included as separate inputs or as adjustments to other inputs in a fair value measurement. These participants likely agree that it is appropriate assume all liabilities are transferred to market participants when measuring fair value, but think that market participant behavior would take into consideration the contractual restrictions of that transfer when measuring the liability at fair value.

CONCLUSION

Without further consideration of the effect of the Unit of Account approach concepts and the varying treatment of transferability, investment class benchmarks, performance measurement metrics and investment metrics will continue to diverge.

As mentioned above, we are working diligently to identify issues surrounding liability valuation and the impact on our industry. Within the REIS standards, we provide guidance when standards promoted by our foundational standards bodies (for accounting, US GAAP) are silent or subject to interpretation. Our desire is to achieve a reasonable level of consistency for commercial mortgage liability valuation techniques. In that way our investors receive information and measure performance which is consistent, comparable, transparent and verifiable.

We appreciate the invitation to comment on this complex matter and would like to express our gratitude to the ongoing efforts of the FASB. 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,
Douglas M. Poutasse
Executive Director, NCREIF
Chair, Real Estate Information Standards Board

EXHIBIT 1: INCONSISTENT APPLICATION OF TRANSFERABILITY CONSIDERATIONS FOR ASSETS AND LIABILITIES WITHIN FAS 157

Valuation of an asset considering restricted transferability (FAS 157)

Assumptions:

1) At 12/31/07, a commercial property is financed with non-recourse, non-transferable financing.
2) Buyers for unleveraged property require 12% returns on similar property and prevailing rates for lenders are 8% on equal credit risk.
3) City provided owner a property tax break for 15 years - $1 million per year, which is contractually not transferable.
4) The non-recourse, non-transferable financing has a face amount of $100 million, 6% fixed rate, maturing in 10 years, 30-year amortization.
5) Investment is carried on the balance sheet of a real estate investment company.

Valuation based on market participant cash flows (FAS 157):

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Rental Income	48,000	49,920	51,917	53,993	56,153	58,399	60,735	63,165	65,691	68,319
Expenses:										
Operating Expenses	30,000	30,900	31,827	32,782	33,765	34,778	35,822	36,896	38,003	39,143
Property Taxes (market taxes)	**6,000**	**6,180**	**6,365**	**6,556**	**6,753**	**6,956**	**7,164**	**7,379**	**7,601**	**7,829**
Operating Cash Flow	12,000	12,840	13,724	14,655	15,635	16,665	17,749	18,889	20,088	21,347
Sales proceeds in year 10	-	-	-	-	-	-	-	-	-	207,067
Property Net Cash Flow	**12,000**	**12,840**	**13,724**	**14,655**	**15,635**	**16,665**	**17,749**	**18,889**	**20,088**	**228,414**
Present Value at 12%	**153,793**									

Conclusion: A tradable asset considers market cash flows (excluding the tax break) when valuing the asset (i.e. unit of account) under FAS 157.

Valuation based on existing cash flows (non FAS 157):

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Rental Income	48,000	49,920	51,917	53,993	56,153	58,399	60,735	63,165	65,691	68,319
Expenses:										
Operating Expenses	30,000	30,900	31,827	32,782	33,765	34,778	35,822	36,896	38,003	39,143
Property Taxes (tax break)	**1,000**	**1,000**	**1,000**	**1,000**	**1,000**	**1,000**	**1,000**	**1,000**	**1,000**	**1,000**
Operating Cash Flow	17,000	18,020	19,090	20,212	21,388	22,621	23,914	25,269	26,688	28,176
Sales proceeds in year 10	-	-	-	-	-	-	-	-	-	207,067
Property Net Cash Flow	**17,000**	**18,020**	**19,090**	**20,212**	**21,388**	**22,621**	**23,914**	**25,269**	**26,688**	**235,243**
Present Value at 12%	**185,962**									

Conclusion: This example reflects the entity specific valuation, where the tax benefit remains within the entity.

Results: FAS 157 measurements for assets ignore the benefit of increased cash flow to the investor (tax break) by concluding that the non transferable tax break is ignored in valuing for a willing buyer and seller in the market. The resulting difference in value is $32,169.

Valuation of an liability considering restricted transferability (FSP 157-f)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Non-recourse debt service payments (6% fixed, face amount $100 million)	(7,159)	(7,159)	(7,159)	(7,159)	(7,159)	(7,159)	(7,159)	(7,159)	(7,159)	(91,882)

Present value at 8%	**(87,281)**	Value of the liability where changes in market interest rates are considered.
Remaining Loan Principal Balance	**(100,000)**	Value of the liability where changes in market interest rates are not considered.

Results: The industry is divided with respect to the appropriate valuation of the real estate investment. Some industry participants argue that the value of the investment should be $66,512 ($153,793-87,281). Others argue that the transfer would trigger an immediate default making the remaining principal balance due and payable immediately for a value of $53,793 ($153,793-100,000).