

Letter of Comment No: / 6 / File Reference: EITF03-1A

October 29, 2004

Mr. Lawrence Smith
Director-Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed FASB Staff Position EITF Issue 03-1-a, Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"

Dear Mr. Smith:

The Commercial Mortgage Securities Association ("CMSA") reviews and, where appropriate, submits comments on literature that affects the accounting for commercial mortgage-backed securities ("CMBS"). This letter is intended to provide some background on CMBS, and to highlight what CMSA believes are certain anomalies or inconsistencies in the current and proposed accounting literature that addresses the accounting for CMBS, with a focus on the issues encountered by investors in non-investment grade CMBS. This letter also provides what we believe to be a potential solution to the inconsistencies highlighted.

We have read the letter that the American Securitization Forum and Bond Market Association have prepared in response to the proposed FASB Staff Position EITF 03-1-a, and concur with the recommendations made in that letter. We believe that those recommendations are more applicable to investments made in investment-grade CMBS, and therefore we are also submitting this letter for your consideration in order to highlight the unique challenges faced by investors in non-investment grade CMBS.

Background: CMBS is a unique subset of the mortgage and asset-backed securities arena as a whole. Unlike securitizations of residential mortgages, auto loans, or credit card receivables, CMBS securitizations have collateral comprised of large, non-homogeneous commercial loans. Recent trends in the industry have compressed subordination levels, such that less than 2% of the total principal securitized falls into the lowest, unrated or first-loss tranche. As a result, it is possible that an adverse event on just one or a small number of loans could cause a realized loss of principal/face amount in the unrated class/first loss piece, or even eliminate it altogether. Valuing unrated CMBS is different from valuing other asset-backed securities in that valuing CMBS is based on analyzing each asset in the collateral pool, which involves projecting future

cash flows that will be generated by each underlying asset in the securitization, which are accumulated to become the projected cash flows that will support an investor's CMBS investment.

Current and Proposed Literature: Currently, there are three accounting standards that govern the accounting for CMBS – SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, PB 6, Amortization of Discount on Certain Acquired Loans, and EITF 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets. Two additional standards have been issued that will apply to CMBS, EITF 03-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments, and SOP 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer. SOP 03-3 also amends PB 6 for CMBS acquired before its effective date, and eliminates PB 6 for securities acquired after that date.

When attempting to map out the timing and effect of the two new pronouncements on the existing accounting, it became evident to CMSA that there are many inconsistencies and "holes" in the literature, as currently drafted. The two areas that are of most concern relate to impairment and fair value.

### Impairment:

The various impairment tests that apply to CMBS investments appear to be inconsistent with one another, and apply based on different criteria that have no bearing on the nature of the CMBS investment itself. For example, the literature differentiates an unrated/first-loss piece based on whether or not it was acquired at or subsequent to origination, or retained by a transferor, even though these investments are analyzed/valued in exactly the same way by the investor. The analysis in both cases involves projecting future cash flows of the underlying collateral supporting the CMBS investment based on information available at the time the investment is made. The literature is also often unclear as to which impairment test applies in a given situation. Since these impairment tests are different and inconsistent with each other, this can lead to confusion or misapplication in practice. The following summarizes which standards will be required under different circumstances once all of the literature becomes effective, and assumes in all cases that fair value has declined below amortized cost:

CMBS Characteristic	SFAS No. 115 Test	PB 6 Test	EITF 99-20 Test	EITF 03-1 Test	SOP 03-3 Test
Retained by the entity in a securitization, purchased at origination, or purchased after origination with no decline in credit quality having occurred at the time of purchase. Cash flows are reasonably estimable, and collection is probable.	¶16 states that if the decline in fair value is other than temporary, a write-down should be taken. EITF 03-1 was intended to clarify this.	N/A	¶12(b) requires the investor to determine whether there has been an adverse change in the present value of expected cash flows since the prior quarter. If so, the decline in fair value is other than temporary, and a write down must be taken.	Footnote 2 states that the EITF 99-20 test is to be applied first, and if a write down is not taken, then ¶12 applies. This paragraph (which is supposed to apply to debt securities that can be contractually prepaid in such a way that the investor would not recover substantially all of its recorded investment, and therefore should not apply to CMBS unrated classes, since they are purchased at a discount), requires that the investor make a qualitative assessment as to whether it has the ability and intent to hold the security for a reasonable period of time until a forecasted recovery of fair value.	N/A

CMBS Characteristic	SFAS No. 115 Test	PB 6 Test	EITF 99-20 Test	EITF 03-1 Test	SOP 03-3 Test
Purchased after origination, and has experienced a decline in credit quality by the time of purchase. Cash flows are reasonably estimable and collection is probable.	¶16, states that if the decline in fair value is other than temporary, a write-down should be taken. EITF 03-1 was intended to clarify this	N/A	Not sure if EITF 99- 20 testing will apply, since the scope of SOP 03-3 specifically includes these securities, but EITF 99-20 does not exclude these securities	Not sure if EITF 03-1 testing will apply, since the scope of SOP 03-3 specifically includes these securities, but EITF 03-1 does not exclude these securities	¶7(a) states that ¶16 of SFAS No. 115 applies, but appears to contradict it by going on to state that "[f]or example, if it is probable that the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition, an other-than-temporary impairment should be considered to have occurred [emphasis added]. EITF 03-1 does not require a comparison to amounts expected at acquisition plus additional cash flows expected since acquisition, only to amounts "contractually due"

CMBS Characteristic	SFAS No. 115 Test	PB 6 Test	EITF 99-20 Test	EITF 03-1 Test	SOP 03-3 Test
Purchased at origination, or purchased after origination with no decline in credit quality having occurred at the time of purchase. Impairment has previously been taken under EITF 03-1	¶16, states that if the decline in fair value is other than temporary, a write-down should be taken. EITF 03-1 was intended to clarify this	N/A	N/A	Not sure if EITF 03-1 testing will continue to apply, since EITF 03-1 refers back to SOP 03-3 for income recognition once an impairment has been taken on a bond under the provisions of EITF 03-1, but is silent on which standard to use to test for impairment	¶7(a), as above, if the SOP 03-3 test is now to be applied (see EITF 03-1 discussion).
Retained by the entity in a securitization. Impairment has previously been taken under EITF 03-1. Cash flows are reasonably estimable and collection of cash flow estimate after previous impairment is probable.	¶16, states that if the decline in fair value is other than temporary, a write-down should be taken. EITF 03-1 was intended to clarify this	N/A	Not sure if EITF 99- 20 testing will continue to apply, since EITF 03-1 refers to SOP 03-3 once an impairment under EITF 03-1 has been taken, yet the scope of SOP 03-3 specifically excludes these securities	Not sure which EITF 03-1 impairment test to apply, Footnote 2 and ¶12, as above in addition to EITF 99-20 test or ¶16 which applies to securities that cannot be contractually prepaid	Not sure if SOP 03-3 testing will apply, since EITF 03-1 refers to SOP 03-3 once an impairment under EITF 03-1 has been taken, yet the scope of SOP 03-3 specifically excludes these securities

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Retained by the entity in a securitization, purchased at origination, or purchased after origination with no decline in credit quality having occurred at the time of purchase. Cash flows are not reasonably estimable, and/or collection is not probable.	¶16, states that if the decline in fair value is other than temporary, a write-down should be taken. EITF 03-1 was intended to clarify this.	¶17 states that no assessment is required until such time as cash flows become reasonably estimable, and collection is probable. At that time, a write down is required to the extent that gross projected cash flows do not exceed amortized cost.	Per ¶17, the cost recovery method should be used during the period when an investor places a security on non-accrual, or when the investor cannot reliably estimate cash flows. Not sure if the ¶12(b) test would apply once cash flows become more estimable and collection probable.	¶16 requires that the investor determine whether (a) it has the ability and intent to hold an investment until a forecasted recovery of fair value up to (or beyond) the cost of the investment, which in certain cases may mean until maturity, or (b) it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the debt security. Part (b) has not been defined. This test differs from the EITF 99-20 test, which requires a comparison against the cash flows projected at the last evaluation date, not the cash flows "contractually due" or expected at acquisition.	N/A

CMBS Characteristic	SFAS No. 115 Test	PB 6 Test	EITF 99-20 Test	EITF 03-1 Test	SOP 03-3 Test
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In summary, the standards are inconsistent with one another, and the application depends on a variety of factors that do not change the fact that what is being accounted for is a CMBS investment. Whether a CMBS is retained in a securitization or purchased at origination or subsequent to origination should not alter the accounting and impairment tests for the CMBS, since credit quality of the underlying assets is evaluated by the investor at time of purchase based on information available at that time, and the security is priced accordingly. The fact that an impairment has been taken under one standard should not result in applying a different standard on a go-forward basis.

#### Valuation:

Both existing and new literature is relying heavily on the fact that the FASB Board believes that an investor should be able to make a reasonable estimate of fair value in each reporting period. <sup>1</sup> Many standards, both existing and new, acknowledge that an investor might place a bond on non-accrual or cost recovery status, but no guidance exists for the subsequent recognition and measurement of that security as an AFS security in those situations in which bonds are placed on non-accrual or cost recovery because cash flows cannot be reasonably estimated, or collection is not probable.

# Proposed Accounting Methodology for Unrated and Non-Investment Grade Rated Securities:

Given the inconsistencies noted above, and also given the fact that the nature of the investment does not change regardless of when the CMBS is purchased (i.e., at or after origination) or whether an impairment has previously been recorded, we ask the Board to consider whether all or a portion of the following accounting methodology for unrated and non-investment grade rated CMBS would be more appropriate than the current regime. We do not believe that these issues exist for investment grade CMBS, since it is very unlikely that losses on the collateral loans will affect such securities. However, given the nature of unrated and non-investment grade rated CMBS, accounting literature that recognizes and allows for the difficulties encountered in accounting for these investments would be appropriate. Therefore, the discussion below refers only to unrated and non-investment grade rated CMBS and CDO bonds, which are referred to simply as CMBS for ease of reference.

#### Income Recognition:

Income recognition depends on an investor's ability to project cash flows with reasonable certainty, and to have a reasonable expectation that the projected cash flows are collectible. For CMBS that meet these criteria, the effective interest method and the methodology to reflect changes in estimates required by EITF 99-20 are appropriate.

However, situations often arise where the timing of collectibility of a particular collateral loan becomes uncertain, or where the loss severity on a loan (and therefore the expected future cash flows) becomes subject to significant uncertainty. Consider a common example where a particular borrower of a loan which collateralizes a CMBS investment is having difficulty making scheduled loan payments. Closer examination of the property collateralizing the loan highlights the fact that the property value has

<sup>&</sup>lt;sup>1</sup> See, for example, Question and Answer 69 of the FAS 140 Implementation Guidance which says: "...in a vast majority of circumstances, it should be practicable to estimate fair values."

declined since the loan was originated, perhaps due to the departure of a significant tenant. At this point, the borrower (1) may decide to simply "walk away" from the loan, allowing the special servicer to foreclose and dispose of the property at current fair market value based on in-place leases, or (2) may attempt to pay off the loan at a discount, or (3) may decide to continue paying the loan in accordance with its terms in order to maintain the borrower's reputation. Although the special servicer may be in constant contact with the borrower, the outcome will remain uncertain (and therefore the probability of any possible scenario will be virtually impossible to determine) until such time as the borrower and special servicer agree on an ultimate course of action. Projected losses on the loan at this point in time could range from zero (if the borrower decides to continue paying the loan from other sources and pay off in full at maturity) to a loss equal to the principal value on the loan minus the expected proceeds on sale of the property or the expected discounted payoff. Assume that this range is wide enough to have a significant impact on the present value of the expected future cash flows, and therefore potentially cause a write-down by the investor on its unrated CMBS investment.

In this situation, the use of the cost recovery method, where all cash payments received are applied to amortized cost and no income is recognized, is appropriate until such time as the uncertainty is resolved. It is not possible to determine the effective interest rate at which income should be recognized until such time as greater certainty exists with respect to the amount and timing of expected cash flows, since the yield is calculated based on expected future cash flows, which in this case are not possible to determine with any certainty.

## Valuation and Impairment Testing:

When the cash flows on a particular CMBS are reasonably estimable and collection is probable, a value can be derived by discounting the expected cash flows. Since a ready market does not exist for unrated CMBS, valuations must be performed by discounting expected cash flows.

However, as discussed above, situations often arise where expected cash flows cannot be determined with reasonable certainty until such time as a specific uncertainty is resolved. As discussed above, the cost recovery method is appropriate until such time as greater certainty exists with respect to the amount and timing of expected cash flows. In these situations, determining fair value with a reasonable degree of accuracy is simply not possible, since no ready market exists for unrated CMBS. Since an accurate estimate of value is simply not possible, a write-down cannot be recorded – how would the amount of the write-down be determined? Furthermore, assuming a write-down were recorded, if resolution of the uncertainty clarifies that no write down was required, the investor will have recorded an impairment charge through earnings that will be recovered through increased yield recognition in the future, which does not reflect the actual performance of the CMBS at all.

In SFAS No. 115, the FASB decided to scope out commercial real estate loans that are not securities due to the effort and cost required to make a reasonable estimate of fair value – see paragraph 45 of that Standard. When attempting to value the unrated or first-loss piece of a CMBS securitization, which is not actively traded and cannot be valued through the market, this difficulty is exponentially greater, since the value of the investment is based primarily on the underlying value of many individual commercial real

estate loans. Discounting expected cash flows will not always produce a reasonable estimate of value, particularly if expected cash flows fall into wide ranges due to short term uncertainty on the ultimate resolution of certain underlying mortgages. Although a value within the probable range of values can be selected for balance sheet purposes by discounting the probable cash flows, and then adding the present value of the high and low estimates of the uncertain cash flows to develop a range (if the security is available for sale, changes in fair value are reported in shareholders' equity as a component of accumulated other comprehensive income), subsequent changes in that value as uncertainties surrounding cash flows resolve themselves result in changes in the estimated balance sheet carrying value, not irreversible write-downs charged to earnings. During the period that uncertainties relative to cash flows exist, declines in estimated fair value below amortized cost are often temporary until such time as the uncertainty resolves itself. This logical conclusion is not, however, supported by the impairment tests required by the literature, except for PB 6.

Therefore, we would recommend that given that income recognition, valuation, and impairment testing are all dependent on having a reasonable expectation about the amount and timing of cash flows expected to be collected, consideration should be given to modifying the literature to accommodate those situations in which such an expectation does not exist, or falls into wide ranges due to short term uncertainties. We believe that, in the absence of a reliable estimate of fair value, the fair value of a security that has been placed on cost recovery for the reasons outlined above should be assumed to be equal to its amortized cost until such time as the uncertainty resolves itself. At the time that the uncertainty resolves itself, impairment testing should be carried out in accordance with EITF 99-20. In other words, if fair value has fallen below amortized cost, an assessment should be made of whether there has been an adverse change in the present value of expected cash flows since the last time that impairment testing was performed under EITF 99-20. We do not believe that it is ever appropriate to refer back to the amounts expected to be collected at the time that the security was purchased, since estimates of expected cash flows change very regularly on an unrated security due to shortfalls, appraisal reductions, actual losses on the underlying loans, prepayments, industry conditions, borrower issues, and a myriad of other variables. Rather, it is appropriate to evaluate whether an impairment has occurred in a specific period by reference to cash flows expected at the beginning of the period under evaluation. If an adverse change has occurred and as a result, fair value has dropped below amortized cost, then an impairment should be considered other than temporary.

Finally, given the fact that an adverse change in expected cash flows on almost any underlying loan can cause an adverse change to expected cash flows on an unrated CMBS investment, it follows that the unrated or first-loss CMBS behaves in a fashion more similar to a pool of loans than to a rated security. For this reason, we believe that it would make more sense to provide a loan loss valuation allowance for these securities that could be later reversed, like is presently the case for mortgage servicing rights. The investment can perform as expected for a period of time, and then an event like K-Mart's bankruptcy can cause a great deal of impairments in one quarter. The valuation allowance would allow an investor to accrue for unknown losses (similar to IBNR in insurance) in the periods they were occurring – not when the bankruptcy is declared, in this case, but during the period that events were occurring that gave rise to the bankruptcy in the same fashion as is done unsecuritized commercial mortgage loans held in portfolio.

We are attaching two flowcharts for your reference – one that outlines what we believe the current and proposed literature will require, and one that outlines this proposal.

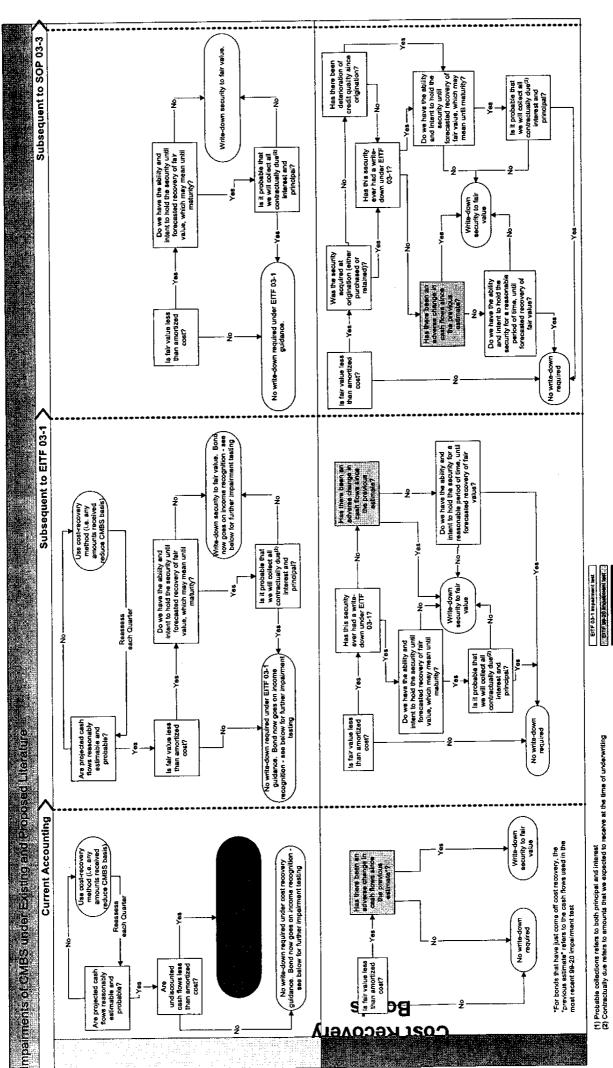
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We thank you for the opportunity to provide our comments to you, and look forward to their timely resolution. We would be pleased to discuss this letter with you or to provide you with any additional information. Please feel free to call Stacy Stathopoulos at 212-509-1950 in order to arrange a meeting at your convenience.

Very truly yours,

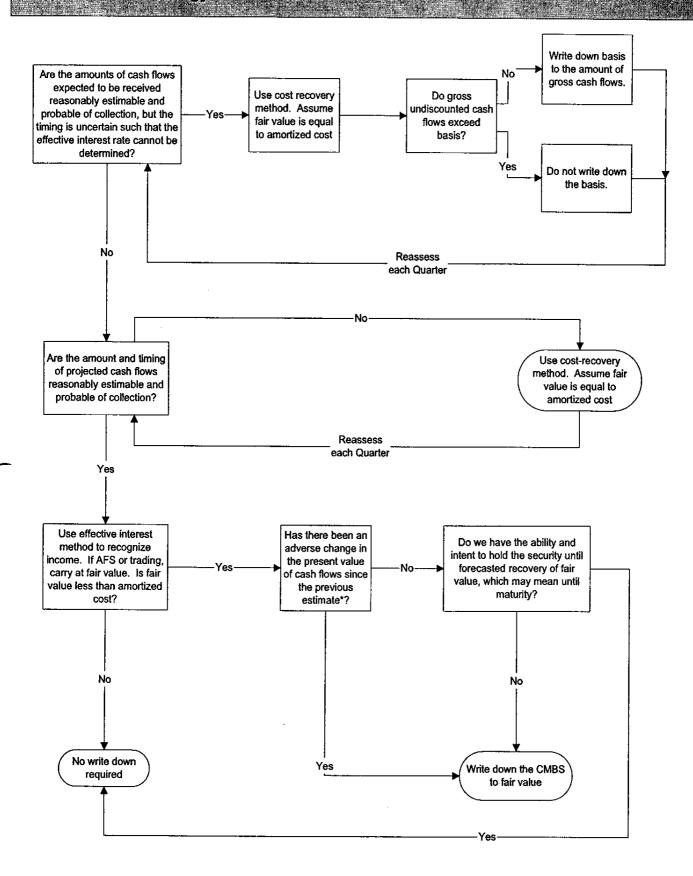
**Dottie Cunningham** 

**Chief Executive Officer** 



(1) Probable collections refers to both principal and interest (2) Contractually due refers to emounts that we expected to receive at the time of underwriting

# Proposed Methodology



<sup>\*</sup>For bonds that have just come off cost recovery, the "previous estimate" refers to the cash flows used in the most recent 99-20 impairment test