1850-100 Comment Letter No. 81

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Ms. Leslie Seidman Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Sir David Tweedie Chairman International Accounting Standards Board 30 Cannon Street London, EC4M 6XH United Kingdom

Subject: File Reference: No. 1850-100, Exposure Draft: Leases and Exposure Draft, Leases, ED/2010/9

Dear Chairman Seidman and Chairman Tweedie:

We appreciate the opportunity to comment on the proposed Lease Accounting standards. Our organization represents the principal owners, investors and managers of the U.S. income producing commercial and multifamily real estate sector. As such, we recognize the goal of the Boards to provide greater transparency to financial reporting in domestic and international capital markets.

However, we are extremely concerned about the serious and presumably unintended economic consequences that the proposed Lease Accounting standards could have on the \$6 trillion U.S. commercial real estate market, and the resulting systemic impact it could have on commercial real estate debt and equity markets and the financial services system.

<u>Understanding the Economic Landscape</u>

We respectfully request that the Lease Accounting implementation project be delayed until an accurate economic assessment of the impact that this standard could have on the U.S. commercial real estate market, the real estate credit and capital markets, pension funds and the entire financial services sector.

- The U.S. commercial real estate sector represents approximately \$6 trillion of value supported by \$3.5 trillion in debt. Its health is vital to the economy (estimates show commercial real estate constitutes 13% of GDP by revenue) and our nation's financial system. An estimated 9 million jobs are generated or supported by real estate.
- On the equity side, real estate accounts for 46% of the \$13.6 trillion in assets held by partnerships in the U.S. It includes \$450 billion of private investments, \$160 billion from pension funds, \$170 billion from the real estate investment trust (REIT) market and \$30 billion from the life insurance companies.

- On the debt side, real estate is collateral for the nearly \$2 trillion of commercial bank debt, \$700 billion from commercial mortgage backed securities, \$300 billion life insurance companies and over \$30 billion from pension funds.
- In the retail sector alone, the leased segment includes some 2.4 billion square feet of space in, with estimated annual sales of \$4.3 trillion. Nearly 15 million people are employed in the retail sector. Current estimated market value is \$330 billion.
- For multitenant office rentals (not owner-occupied, government buildings, etc), the market is comprised of 4.4 billion square feet. Current estimated market value is approximately \$1 trillion.
- From a systemic perspective, nearly 3,000 community banks nationwide are classified as having material "commercial real estate (CRE) concentrations." According to the Congressional Oversight Panel Report, approximately \$1.4 trillion in U.S. real estate loans will come due between 2010 and 2014, with nearly half of those loans currently "underwater".

Potential Adverse Economic and Reporting Consequences of New Rules

These rules will impact the ability of commercial real estate owners to borrow and raise capital. Among the several issues that have not been fully explored and vetted are the following:

- The potential breach of loan covenants and contractual arrangements and loss of cost reimbursement for rent in contractual arrangements that are based on current US GAAP as well as overall changes to credit underwriting requirements;
- Complicated recognition and presentation requirements that mask true economic activity and do not reflect the value of a contract;
- Capitalization of estimated lease payments that artificially inflate balance sheet assets and liabilities;
- Adverse impact on the ability of businesses to borrow, the cost of leases, and capital formation;
- Adverse impact on real property valuations, with consequential impact on lenders, especially the already fragile banking sector;
- Front ended lessee cost patterns that do not reflect true economic activity, reduce earnings, reduce capital and create deferred tax assets further ballooning balance sheets;
- Differing recognition of assets and liabilities, creating mismatches that do not reflect the value of a contract for lessors;
- Rules that are not symmetrical between lessor and lessee;
- Inequitable treatment of executory costs for lessors and lessees; and
- Implementation costs.

A failure to fully understand the economic ramifications of these accounting changes or to address these issues in an attentive and deliberative manner may harm businesses that own, invest or rent commercial real estate – the industry that provides the facilities for businesses of all types to operate. In addition, the financial services sector that provides the liquidity and credit needed for these transactions to take place could also be severely impacted. This uncertainty will have short-term and long-term consequences that have the potential to undermine efforts towards economic recovery.

Specific Concerns

We appreciate what the Boards are trying to achieve, but we have grave concerns about the complexity and subjectivity of the proposed rules.

- The vast majority of real estate leases are rental contracts to obtain the use of premises where there is no option to buy. They are operating leases by their nature and thus have not been subject to financial engineering. Too much emphasis has been placed on countering potential financial engineering to make a financing look like a rental contract. The result is a set of rules rather than principles to determine lease payments to be capitalized. The unintended consequence is that payments that do not meet the proposed definition of a liability will be capitalized. The inflated capitalized amounts are then recognized in an accelerated cost pattern, further exacerbating the negative financial reporting results for lessees.
- There is a considerable amount of subjectivity and judgment that will be required by the proposed standard particularly concerning lease term and contingent rent. There is concern that the proposed rules will force tenants to disclose their renewal intentions and alter the entire landlord-tenant negotiation. Tenants could be forced to make bad business decisions to avoid the negative impacts of the proposed accounting policy. There is also concern that tenants will opt for shorter term leases, or for no renewal options, just to avoid the complexity of estimating what future options will be exercised. This could also lead to balance sheet or earnings manipulation.
- Current accounting guidance requires disclosure of future minimum rents, which is much less subjective than the calculations (lease term, contingent rentals, etc.) contained in the proposed standard. Assuming the intention of the new standard is to better enable the user of the financial statements to evaluate the company, what benefit is there to having the new accounting model over the existing disclosures?
- The future is not easy to predict, and neither tenants nor landlords have accurate crystal balls for such activity. Making assumptions about renewal and contingent rents that go beyond 12 or 24 months is nothing more than conjecture. There is simply too much risk of uncertainty regarding such estimates or judgments, and it is misleading to factor such guesswork into the net present value calculation. For retail, tenant sales are impacted by numerous knowable and many uncontrollable factors (e.g., the broader economy, competition, product positioning, consumer sentiment, etc.) Given the challenges of predicting the future and the negative economic consequences of implementing the proposal, providing the lease details in the footnotes of the financial statements would seem to provide greater clarity than trying to build a quantitative estimate of future possibilities. Regardless of the above, "likely" renewals and contingent rents do not meet the definition of a liability. The amounts capitalized will be too large. This will cause debt covenants to be broken. Lenders will either refuse to adjust the covenants as an excuse to accelerate loans, or charge fees to revise the covenants. Countless hours of staff time and legal costs will be spent renegotiating contracts.
- The concept of doing away with rent expense in favor of interest and amortization expense does not make economic sense. The reported costs would bear no relationship to the revenue/benefits generated by the leased asset. These non-cash front end costs will reduce earnings and equity, impacting the stock valuation of lessees. Lessees would be motivated to negotiate shorter, no contingent rent, lease terms. This could have profound impact on property valuations. Lessors will counter with increased contractual rents. This will also be excessively expensive for the tenants.

• One of the reasons that pension plans, insurance companies, and others invest in real estate is to try to match assets to their long term obligations. Shortening the lease terms will make it more difficult to use real estate for these long term investment obligations. Shorter lease terms will negatively impact the values of these assets for long-term investors and jeopardize this important investment class.

Impact on Economic Recovery

The proposal comes at a difficult time in the economic cycle. Fifteen million Americans are unemployed, businesses remain uncertain about investment and hiring, and one in four homes is under water. Jobs and the economy are far and away the top concerns for most Americans. The commercial real estate industry has seen values decline by as much as 30-40 percent since the peak of the market, and it continues to suffer. Imposing an accounting standard that could have a profound impact on tenant behavior will not aid the economic recovery.

Typically, a property developer tries to attract a creditworthy tenant to a project with a long-term lease in order to obtain favorable financing and valuation terms. Under the new standard, a tenant could be less inclined to sign a long-term lease. As such, the new accounting standard could drive bad business decisions regarding renewal options, lease term and other aspects of the leasing decision. In addition, the front-loading of expense could present significant challenges to tenants – particularly in this negative economic climate.

There is also broad concern that the standard will lead to declines in property values because tenants may be forced to press for shorter term leases. This could be particularly pronounced in the sale-leaseback and triple net lease market. Landlords and tenants could also be forced to reopen negotiations with their lenders regarding loan covenants and ratios. This is particularly troubling in the current tight lending environment. This standard could also have a negative impact on new development when the economic climate improves and new development again becomes feasible.

Finally, if the standard is adopted, the cost of transitioning to an entirely new accounting regime will affect staffing, systems, accounting and legal fees, and other compliance costs. Businesses just don't need that additional burden in this challenging economic period. Moreover, this measure will only add to the climate of regulatory uncertainty that is clouding the recovery.

Conclusion

We appreciate what the Boards are trying to achieve, but we have grave concerns about the impact the proposed rules will have on the commercial real estate sector and all aspects of the global economy relating to it.

Accordingly, we respectfully request that the Lease Accounting implementation project be delayed until an accurate financial and economic assessment has been made of the impact that this standard would have on the U.S. commercial real estate market, the real estate credit and capital markets, pension funds and the entire financial services sector. Rushing to complete the Lease Accounting rules by the middle of next year, the deadline for implementation that both Boards have set, will not allow for the thoughtful consideration and input needed to change financial reporting in an area that serves as keystone of the economy.

Again, we appreciate this opportunity to comment, and we look forward to working constructively with the Boards on this important matter.

Sincerely.

Jeffrey D. DeBoer

President and Chief Executive Officer