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Via email

Ms. Leslie Seidman, Chairman Financial Accounting Standards Board File Reference No. EITF-100E 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: File Reference No. EITF 100E, Proposed Accounting Standards Update,

Derecognition of in Substance Real Estate – a Scope Clarification

Wells Fargo & Company (Wells Fargo) is a diversified financial services company with over \$1.3 trillion in assets providing banking, insurance, investments, mortgage and consumer finance services. We appreciate the opportunity to comment on the proposed Accounting Standards Update of Topic 360, *Derecognition of in Substance Real Estate – a Scope Clarification* (the Proposed ASU). The vast majority of our commercial real estate mortgage and construction lending activities utilize special purpose entities (SPEs¹) to legally isolate the underlying real estate assets from the assets of our customers (borrowers). Our comments are made considering this perspective.

Executive Summary

We believe the loss of a controlling financial interest in a SPE should result in deconsolidation of the SPE in accordance with ASC 810². Further, we believe derecognition guidance applicable to the assets of the SPE should only apply when there has been an asset transfer. We believe these principles should apply regardless of the nature of the assets of the SPE. The Proposed ASU requires asymmetric application of the deconsolidation and derecognition guidance by the lender and borrower/ parent. We believe this asymmetry should be avoided and the Task Force should modify the proposed guidance to state that the derecognition criteria in ASC 360³ do not apply unless there is a transfer of real estate. If the Proposed ASU is not modified, we believe the Task Force should re-address the accounting by lenders to avoid potential flaws in the proposed guidance.

¹ SPEs also include variable interest entities subject to the consolidation guidance in ASC 810.

² Accounting Standards Codification Topic 810: Consolidations

³ Accounting Standards Codification Topic 360: Property, Plant and Equipment

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Specific Comments on the Proposed ASU

Our comments on the proposed guidance are as follow:

- Deferral of the debt extinguishment gain does not represent the economic substance of the transaction: The concern of the Task Force that the application of ASC 810 may result in the premature recognition of a debt extinguishment gain by the borrower/ parent is misguided. Due to the nonrecourse nature of the debt of the SPE, the maximum exposure to loss of the borrower/ parent is limited to its equity investment in the SPE. Accordingly, a transaction using a SPE creates a substantially different economic profile than a transaction where a borrower/ parent directly acquires real estate financed with recourse debt. The Proposed ASU does not capture this economic difference. Rather, it alters the accounting by artificially creating timing differences relating to the recognition of gains or losses whereby the borrower/ parent ignores the existence of the SPE, temporarily recognizes noneconomic impairment losses, then subsequently reverses this recognition as a debt extinguishment gain upon ultimate transfer of the real estate to the lender. The proposed guidance does not represent an improvement in financial reporting because it is not reflective of the underlying economics of the transactions.
- Borrowers and lenders may have different accounting models: The Proposed ASU does not address the accounting for lenders. If the proposed guidance is finalized in its current form, two potential interpretations may emerge. Either the lender would not recognize the insubstance real estate assets until the borrower/ parent has met the proposed derecognition criteria or the lender would recognize the real estate assets when it obtains a controlling financial interest in the SPE. The former interpretation would result in symmetric accounting between the borrower/ parent and the lender. The latter interpretation would not because the lender could obtain a controlling financial interest and thus consolidate the SPE prior to a transfer of the real estate. Accordingly, the borrower/ parent and lender would recognize the same real estate assets in their respective financial statements. Without specifically addressing the accounting for lenders, we believe the Proposed ASU may produce asymmetric results and will not achieve the stated objective of the Task Force as it may create diversity in practice for lenders.
- The proposed guidance may result in perpetual consolidation of real estate assets by lenders: Once the real estate assets are recognized in the financial statements of the lender, we are concerned that the lender may never be able to derecognize the real estate assets. For example, if the lender modifies the nonrecourse debt and transfers the power to make the operating decisions for the property back to the borrower/ parent, the lender should deconsolidate the SPE because the borrower/ parent has regained a controlling financial interest in the SPE. However, if the lender must evaluate derecognition of the real estate assets as a transfer of real estate, the lender may not be able to satisfy the derecognition criteria because, other than in a foreclosure scenario, the lender never obtains title to the real estate assets of the SPE. Additionally, absent a significant investment upon a restructuring by the borrower, the criteria in ASC 360 to demonstrate an adequate borrower investment

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may not be satisfied. We suggest that the Task Force include a similar example within the implementation guidance to clarify the appropriate treatment for scenarios where the lender has restructured the nonrecourse debt and transferred power back to borrower/ parent. If the Task Force proceeds with the proposed guidance, we strongly encourage the Task Force to specifically address the application by lenders to provide symmetry in accounting.

- The accounting risk of perpetual consolidation by the lender may drive business decisions:

 Carrying real estate assets, whether performing or not, on the balance sheet may have negative implications on various performance and regulatory capital metrics. In a real estate loan work out situation lenders must choose between either restructuring the existing debt or foreclosing and then disposing of the underlying real estate collateral. Because, under the Proposed ASU, a loan restructuring would result in perpetual consolidation, lenders will likely choose foreclosure and sale of the underlying real estate collateral rather than enter into a loan modification, even if the economic result might be sub-optimal, as this approach would be their only means to ensure accounting derecognition. We do not believe that it is appropriate for accounting standards to create conditions which would alter the economic decision making of the lender.
- The proposed guidance may establish a new derecognition threshold for other asset classes and will create an inconsistency among similar entities: The proposed guidance does not address other asset classes where both derecognition and consolidation guidance applies. In order to deconsolidate a SPE containing financial instruments, it is not necessary for a reporting entity to satisfy the criteria of ASC 860⁴ when it no longer has a controlling financial interest in the SPE. In this case, derecognition of the assets and liabilities of the SPE would be appropriate under ASC 810. To illustrate, assume a SPE with assets consisting of commercial real-estate loans was originally consolidated by the special servicer/residual interest holder. Upon a specified level of default of the underlying loans, the senior interest holder is able to remove the special servicer, thereby obtains a controlling interest and thus consolidates the SPE. The fact pattern in this illustration is quite similar to the scenario described in the proposed guidance, but would produce different accounting results primarily due to the form of the assets in the SPE. We fail to understand why similar transactions would be accounted for differently based on the form of the assets. We believe the derecognition guidance should be applied only in the case of a transfer, regardless of the asset class, and changing the interaction between derecognition and consolidation guidance in only one area of US GAAP creates inconsistency and is therefore inappropriate.
- The scope of the proposed guidance is not justified: The scope of the proposed guidance is limited to situations where the borrower/ parent no longer has a controlling financial interest in an in-substance real estate SPE due to a default on the nonrecourse debt. However, it is conceivable that other circumstances, for example a new equity investor that shares power with the borrower/ parent, could cause the borrower/parent to lose its controlling financial

⁴ For purposes of this comment, if the reporting entity is the initial transferor, it is assumed the initial transfer otherwise met the requirements of ASC 860-10-40-5.

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interest in the SPE. Accordingly, under such circumstances, the borrower/ parent would derecognize the assets and liabilities of the SPE pursuant to ASC 810 and the transaction would not be within the scope of ASC 360. We do not understand why the Task Force believes it is necessary to evaluate the loss of a controlling financial interest in an insubstance real estate SPE as a transfer of real estate only for the discrete set of circumstances described in the proposed guidance. While the Task Force believes the scope is justified based on the circumstances which have given rise to diversity in practice, we do not agree given the theoretical inconsistencies created by the Proposed ASU as described in our preceding paragraphs.

Conclusion

We urge the Task Force to suspend the issuance of the Proposed ASU because we do not believe that the proposed derecognition guidance should be applicable unless a transfer of real estate has occurred. While the proposed guidance may eliminate diversity in practice for the borrower/parent, it will increase diversity in practice for lenders. The only way to completely eliminate diversity in practice is to amend ASC 360 to clarify that it is only applicable when a transfer of real estate has occurred. If the Task Force decides to proceed with the proposed guidance, we recommend that the Task Force suspend the consolidation of in-substance real estate entities by lenders as long as the borrower/parent continues to recognize the real estate assets. Alternatively, although less preferential, the Task Force could explicitly exclude lenders from the derecognition requirements ASC 360 until and unless the lender obtains tile to the real estate.

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We appreciate the opportunity to comment on the issues contained in the Task Force's invitation. If you have any questions, please contact me at (415) 222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy Executive Vice President & Controller

cc: Kathy Murphy – Office of the Comptroller of the Currency Stephen Merriett – Federal Reserve Board Robert Storch – Federal Deposit Insurance Corporation Donna Fisher – American Bankers Association David Wagner – The Clearing House Association