April 29, 2013

Susan M. Cosper
Technical Director
File Reference No. 2013-220
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

Dear Ms. Cosper:

The Commercial Real Estate Finance Council ("CRE Finance Council"), on behalf of its members, appreciates this opportunity to comment on the Financial Accounting Standards Board's ("FASB") revised proposal for the classification and measurement of financial instruments in FASB's Exposure Draft, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*.

The CRE Finance Council is the collective voice of the entire $3.1 trillion commercial real estate finance market. Our principal missions include setting market standards, facilitating market information, and providing education at all levels. Because our membership consists of all constituencies across the entire CRE finance markets, the CRE Finance Council has been able to develop comprehensive responses to policy questions that promote increased market efficiency and investor confidence.

For the reasons discussed below, the CRE Finance Council respectfully disagrees with several aspects of the proposal – most notably the requirement that, under the Exposure Draft, many more financial instruments would be measured at fair value through net income (profit or loss) rather than through other comprehensive income ("OCI").

Concerns With The Contractual Cash Flow Test

In its Exposure Draft, FASB proposes to measure financial instruments through either amortized cost or fair value with changes in fair value recognized through either OCI or net income. This proposal would affect, to varying degrees, all entities that hold financial assets or owe financial liabilities. As a "residual" category, the Exposure Draft would require entities to measure most financial instruments – particularly beneficial interests in securitized assets and equity investments – at fair value with changes in fair value recognized through net income rather than through OCI or amortized cost.

This shift in classification results from the contractual cash flow characteristics criterion, which indicates that unless the contractual terms of the asset give rise on specified dates to cash flows that are "solely payments of principal and interest" on the principal amount outstanding, the financial asset must be measured at fair value through net income.

Although the Exposure Draft provides that the classification and measurement of a financial asset would be determined by considering the asset's cash flow characteristics as well as the business model in which the asset is managed, the contractual cash flow characteristics criterion would effectively require most financial assets to be measured at fair value through net income. This new focus on the financial instrument's cash flow characteristics deemphasizes a reporting entity's underlying business model and strategy for the financial assets.

While the CREFC agrees that payments of principal and interest should be a factor for classification and measurement purposes, our members do not believe it should be the primary driver for classification. Instead, because an entity's business strategy and purpose for a particular investment is the primary driver for the investment, we believe this criterion should be considered in greater cases than would occur under the current proposal. Therefore, we recommend that the FASB modify the proposal's requirement to allow the business strategy to play a more predominant role. The proposal's language could be modified by changing "solely" to "primarily or substantially". CREFC is concerned that without this change most assets including commercial mortgages could not be classified to be measured at amortized cost or fair value through OCI since most assets have ancillary income of some sort. For example, commercial mortgage lenders may receive ancilliary fees for borrower assumptions, late fees and other events that can occur with commercial mortgages. Because such ancilliary fees are contingent on events that may not occur, and are designed to compensate the lender for additional costs incurred, we do not believe such fees should taint a commercial mortgage for puposes of the cash flow test and ask that FASB provide explicit guidance to that effect.

The proposal does provide some latitude with the "solely payments of principal and interest" criterion as it relates to modifications. However, we believe the scope is too narrow as it relates to only interest rate resets or leverage situations.

By effectively forcing more financial instruments to be measured at fair value through net income, the Exposure Draft would harm reporting entities and investors alike as it would increase earnings volatility. This neither promotes market efficiency nor investor confidence, nor does it provide all investors with the information they need. In fact, some investors may be deterred from investing in assets that are forced into fair value through net income as they would no longer match their liabilities or business strategy. As such, the CRE Finance Council respectfully disagrees with the proposal to require the measurement of many financial assets at fair value through net income rather than through OCI or amortized cost in accordance with an entity's underlying business model and strategy.

Lack of Convergence With IFRS

FASB also proposes to require financial liabilities that can only be settled with specific financial assets to be measured consistently with those specific assets, thereby eliminating a fair value

measurement option for accounting mismatches. This differs from IFRS 9, which contains a fair value option to measure financial assets and liabilities at fair value through net income if doing so would eliminate or significantly reduce an accounting mismatch. We respectfully recommend that the Exposure Draft should harmonize with IFRS 9 by allowing for the election of a fair value option that would eliminate an accounting mismatch.

Furthermore, the proposal would require most equity investments to be measured at fair value through net income, which would be a departure from both the International Accounting Standards Board's proposal on classification and measurement as well as current generally accepted accounting principles in the United States. Finally, financial liabilities would generally be required to be measured at amortized cost.

Time Value of Money

The proposal goes on to provide that, if there is a future modification to an instrument that could result in cash flows "more than insignificantly different" when compared to a benchmark instrument with the same credit quality and terms, the instrument's cash flows would not be deemed solely payments of principal and interest. Aside from failing to explain what constitutes a difference that is "more than insignificant," the current language would seem to require most instances of modified economic relationships (such as interest rate resets or leverage situations) to be measured at fair value through net income because the financial asset would not meet the stringent contractual cash flow characteristics criterion. Thus, because the effect of the modification on the instrument would need to be assessed at initial recognition, it would be difficult for investors to determine at inception whether cash flows would remain solely payments of principal and interest at some point in the future. Additionally, the researching and tracking of these requirements is operationally difficult and overly burdensome when the business purposes are still focused on making an investment and a return on that investment.

Prepayment Options

The Exposure Draft provides that a financial asset with a contractual provision that permits or requires the borrower to prepay a debt instrument, or permits or requires the lender to demand repayment before maturity, would result in contractual cash flows that are solely payments of principal and interest if the following two conditions are met:

> (1) The contractual provision is not contingent on future events, other than to protect the lender against the borrower's credit deterioration, a change in control of the borrower, or changes in relevant taxes or law; and
>
> (2) The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

Because borrowers often need the ability to prepay to protect themselves from uncertainty, we respectfully recommend that the proposed criterion should not be used to determine if the contractual provision meets the cash flow characteristics criterion. First, it is unclear what

constitutes "reasonable" additional compensation. Perhaps FASB could clarify by acknowledging typical prepayment penalities we see in the market today (e.g. defeasance, make whole premiums) that meet market standards can be assumed to be reasonable. More importantly, prepayment options should not necessarily impact the measurement and classification of financial assets as prepayment penalties represent a small portion of the potential cash flows from a debt instrument and it is never certain that they will be collectible.

Beneficial Interests in Securitized Financial Assets

In order for a beneficial interest in a securitized financial asset (*e.g.*, asset-backed securities and mortgage-backed securities) to give rise to contractual cash flows that are solely payments of principal and interest – and, thus, eligible for measurement at fair value through OCI or amortized cost – the credit risk exposure inherent in the tranche of beneficial interest must be equal to or lower than the credit risk exposure of the underlying pool of financial assets. As an example, FASB noted that this condition would be met if the underlying pool of assets loses 50 percent as a result of credit losses and the tranche loses 50 percent or less. As a result, the cash flow test for beneficial interests in securitization is inconsistent with the cash flow test for other instruments. Such a position causes subordinated classes, interest-only classes (and principal-only classes) to be treated as lacking contractual cash flows that are solely principal and interest on principal, thus forcing investors to report such securities at their fair value no matter what the business purpose is for the investments.

As currently drafted, the proposal would treat only the most senior tranches in a securitization as eligible for measurement at fair value through OCI or amortized cost. Indeed, credit losses are typically first absorbed by the lowest tranche, then by the next lowest tranche, and so on. As such, tranches below the most senior often bear greater credit loss exposure than the underlying pool; and, thus, all tranches but the most senior would be required to be measured at fair value through net income because the credit risk exposure of such tranches would not be equal to or lower than that of the underlying pool. Tranches exist to give investors choices based on their own needs, and multiple-risk tranches should not drive the accounting.

The proposed 50 percent threshold test for classification should not be a bright-line rule, and instead a more principles-based approach, focused on the holding entity's business purpose and strategy should be employed for securitization tranches. By effectively making only the most senior tranches eligible for OCI treatment, we believe investors would be less inclined to buy lower-rated tranches that are already priced to market, which will, in turn, frustrate the market as the structured security market relies heavily on investors in these lower-rated tranches. Accordingly, the CRE Finance Council recommends that FASB remove this credit risk assessment criterion from this proposal because, in our view, the recognition of financial assets should follow an entity's business strategy and business model, rather than require an entity to recognize the assets in a manner based primarily on cash flows. Credit risk is appropriately addressed in the proposal related to impairment.

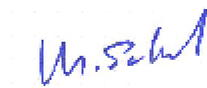
Furthermore, the requirement of cashflows that are "solely payments of principal and interest" is a concern in securitized financial assets, as there is a lack of ability to have a full view of the underlying collateral.

Conclusion

For these reasons, the CRE Finance Council, on behalf of its members, respectfully asks FASB to consider our above-stated recommendations and concerns with FASB's revised proposal regarding the classification and measurement of financial instruments.

The CRE Finance Council greatly appreciates your consideration of this comment letter. Please do not hesitate to contact us at your convenience if you have questions or if any additional information would be helpful.

Sincerely,



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