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NATIONAL ASSOCIATION OF  
REAL ESTATE INVESTMENT TRUSTS®

October 25, 2013

Ms. Susan Cosper  
Technical Director  
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Financial Accounting Standards Board  
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**Delivered Electronically**

**File Reference No. 2013-290, Proposed Accounting Standards Update, *Insurance Contracts (Topic 834)***

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update, *Insurance Contracts (Topic 834)* (the Proposal) issued by the Financial Accounting Standards Board (FASB or Board).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 191 companies representing an equity market capitalization of \$676 billion<sup>1</sup> at July 31, 2013. Of these companies, 152

<sup>1</sup> <http://returns.reit.com/reitwatch/rw1308.pdf> at page 21



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were Equity REITs representing 90.9% of total U.S. listed REIT equity market capitalization (amounting to \$614.7 billion). The remainder, as of July 31, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of \$61.3 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT has actively participated in the FASB's and International Accounting Standards Board's (IASB) (collectively, Boards) efforts to develop a single set of high quality financial standards. In the time since the Board commenced its efforts to converge U.S. Generally Accepted Accounting Standards with International Financial Reporting Standards (IFRS), NAREIT has commented on the majority of projects from the Boards' joint Memorandum of Understanding.

### **NAREIT Recommendations**

NAREIT recommends that the FASB take the following actions with respect to the Proposal:

- **Cease further work on the *Insurance Contracts Proposal* at least until the IASB evaluates feedback on its respective *Insurance Proposal* and then determine whether the IASB Proposal is an improvement to existing U.S. GAAP,**
- **Clearly articulate that guarantees, representations and warranties, and indemnifications in leasing, revenue, and real estate transactions are outside the scope of the Proposal, and**
- **Synthesize the scope of the *Insurance Contracts Proposal* with current *Insurance Guidance* in U.S. GAAP.**

These recommendations and other considerations are discussed in greater detail below.

**Cease further work on the *Insurance Contracts Proposal* at least until the IASB evaluates feedback on its respective *Insurance Proposal* and then determine whether the IASB Proposal is an improvement to existing U.S. GAAP**

NAREIT understands that the FASB undertook a project on Insurance Contracts in order to develop a single converged Insurance standard with the IASB. To our knowledge, there has been no public outcry from regulators, auditors, or investors alike with respect to the manner that provisions like guarantees, representations, warranties and indemnifications are reported under current real estate and related accounting guidance. Additionally, after observing the Boards' ongoing deliberations on the Insurance project and evaluating the respective exposure drafts that have been issued by the Boards, NAREIT observes that the Boards have



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not achieved a converged Insurance standard. Given that the Boards have been unable to agree on a converged standard that would meet the overall objective of the Insurance Project, NAREIT recommends that the FASB cease its work on the Insurance Project at least until the IASB has received and evaluated feedback on its exposure draft. At that point, we believe that it would be prudent for the FASB to reconvene with the IASB in evaluating whether or not the IASB's Insurance Proposal is an improvement over existing U.S. GAAP.

**Clearly articulate that guarantees, representations and warranties, and indemnifications related to leasing, revenue, and real estate transactions are outside the scope of the Proposal**

NAREIT observes that there appear to be inconsistencies with respect to the scope and scope exceptions of the Proposal between the "Proposed Guidance" and "Basis for Conclusions." While paragraph BC58 seems to suggest that guarantees pertaining to revenue would be outside the scope of the Proposal, we noted that minimum revenue guarantees are cited as an example of insurance contracts<sup>2</sup>. We found additional inconsistencies with respect to guarantees in leasing and real estate transactions. For example, paragraph BC58 states that

The Board also decided that guarantees that are specifically addressed by other Topics, such as leasing, revenue recognition, or real estate, should not be in the scope of this proposed Update. In those cases, the Board assessed the specific economic characteristics and determined specified accounting for those guarantees. The Board decided that entities issuing those guarantees should not be required to adopt the guidance in this proposed Update because the costs may outweigh the benefits.

We attempted to reconcile this paragraph with the paragraphs on Scope and Scope Exceptions on pages 24 through 26 of the Proposal and related examples and were unable to do so in an unambiguous way.

Guarantees, representations, warranties, and indemnifications are pervasive in virtually all real estate transactions. For example, a standard real estate sale/purchase contract may contain the following representations and warranties, among others:

- That seller is the legal titleholder of the property;
- That all documents are consistent with the seller's organizational documents;

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<http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175827217882&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> at page 81.



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- That rent rolls provided to the buyer represent a true, complete and correct listing of all leases in effect as of a given date;
- That seller has not received any written notice from government authorities advising seller of any violation of any law or regulation;
- That there are no pending or threatened actions or legal proceedings;
- That there are no environmental issues with the property which is subject to the transaction;
- That the purchaser will not sell the acquired property for a specified period of time.

It is important to note that generally, these representations and warranties are limited in terms of time and dollar exposure. Many are effective for less than a year from the closing of the transaction and claims are limited by maximum amounts.

We believe that current real estate guidance in Topic 360 appropriately addresses the accounting treatment for this provision, among others. Therefore, NAREIT recommends that the Board clearly articulate that guarantees, representations and warranties, and indemnifications related to leasing, revenue, and real estate transactions are outside the scope of the Proposal. As the Basis for Conclusions is not included in the codification, NAREIT recommends that the Board ensure that these scope and scope exceptions are included in the final codified standard.

### **Synthesize the scope of the *Insurance Contracts* Proposal with current *Insurance* Guidance in U.S. GAAP**

Irrespective of whether or not the FASB follows our first recommendation above, NAREIT recommends that the Board re-evaluate the overall scope of the Proposal. NAREIT observes that developing a principles-based standard for insurance accounting has its conceptual merits. However, at the same time, NAREIT notes that there are approximately twenty pages dedicated to the scope of the Proposal. The FASB has justified extensive scope exceptions based on the fact that other U.S. GAAP provides users of financial statements with better information or due to implementation costs and market disruption exceeding any perceived benefit. In our view, a standard that is intended to be principles-based should not require this amount of interpretive guidance to establish the types of contracts that are subject to the accounting model. NAREIT recommends that the FASB develop new accounting guidance, to the extent that investors request it, for insurance transactions currently within the scope of ASC 944, *Insurance*.

Based on our evaluation of the Proposal, common transactions executed by NAREIT member companies could be subject to the Proposal. NAREIT believes that these transactions should not be included in the scope of the Proposal, as the transactions do not



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include insurance risk in the parent company consolidated financial statements and are far better addressed in a manner consistent with financial instruments accounting for credit risk or in other current U.S. GAAP for contingencies or guarantees. These transactions include:

- *Captive insurance subsidiaries;*
- *Indemnities in real estate sales agreements;*
- *Seller support of operations;*
- *Guarantees of securitized financial assets; and*
- *Representations and warranties made in whole loan sales.*

Further analysis of these transactions is included below.

#### *Captive insurance subsidiaries*

The Proposal would create dual-reporting requirements for non-insurance parent companies with captive insurance subsidiaries that have statutory reporting requirements for some NAREIT member companies. For example, a REIT may have a captive insurance subsidiary that covers losses related to "slip and fall" claims. In a typical arrangement, the captive insurance subsidiary issues an insurance contract(s) to the parent to cover any losses incurred as a result of these claims. Currently, the model to calculate the claims reserve is the same for both the captive subsidiary and the parent as both are based on accounting guidance in Accounting Standard Codification (ASC) 450, *Contingencies*, and ASC 460, *Guarantees* (e.g., actuarial model based on the sum of estimated losses on known claims and an "incurred but not reported" reserve).

The Proposal would require the captive insurance subsidiary (*i.e.*, the issuer of the contracts to its parent) to account for the insurance contract under the new model. The parent itself does not have an insurance contract with the slip and fall claimant, therefore it would continue to calculate its reserve under the old model. For external reporting purposes with the Securities and Exchange Commission at the parent level, this intercompany insurance contract would eliminate in consolidation. However, for statutory purposes, our concern is that the captive insurance subsidiary would be required to report under the Proposal. This would result in dual reporting whereby a company would be required to calculate its reserve under both models for statutory and parent-level financial reporting. The fact that the same transaction would be accounted for differently adds undue complexity and cost and lack of transparency in the financial reporting process.



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### ***Indemnities in real estate sales agreements***

NAREIT is concerned that indemnities resulting from representations and warranties within real estate sales contracts (e.g., the building is structurally sound, the title is free of liens, there are no environmental issues, etc.) could be interpreted as being included in the scope of the Proposal. The Proposal would require the seller to separate a performance obligation related to these indemnities, measure a related liability in accordance with the new model, and recognize revenue over time, based on probability weighted scenarios for loss history. In our view, the Board should clarify that the following scenarios would be outside the scope of the Proposal:

- Warranties issued by a manufacturer, dealer, or retailer of a product are excluded from the scope of the Proposal. If a company constructed the property that was sold, it might be able to argue that it is providing a warranty of its own product, and is therefore outside of the scope. What if the company develops the property, but utilizes a general contractor to build the project? What if the company leased the property for a number of years before making the decision to sell the property? In this scenario, could the company also argue that it is selling and providing a warranty of its own product? In our view, each of these examples requires further clarifying guidance to ensure consistent application of the Proposal.
- The development of probability-weighted loss scenarios for similar contracts would be difficult to implement and operationalize for the representations and warranties within real estate contracts. While the representations and warranties may be similar from contract to contract, the circumstances surrounding the particular properties sold are likely much more unique than that of a pool of largely homogenous contracts (e.g., automobile insurance). For example, two sales contracts might contain the same provisions, but one contract might relate to a property that previously had environmental issues while the other relates to a property where there are no known issues. How would the guidance apply in these scenarios? It would appear that the insurance liability would differ due to the underlying circumstances even though the contract language is identical.

### ***Seller support of operations***

Under current guidance in ASC 360-20, *Real Estate Sales*, a seller that provides a cash flow guarantee to a buyer would likely be unable to recognize the sale and any associated profit. It is unclear to us how the Proposal would interact with the proposed FASB/IASB *Revenue from Contracts with Customers* Proposal. Would a company be permitted to recognize a sale? Would a company separate performance obligations for the sales transaction from the guarantee? How would the sales price and related profit be allocated between the components? NAREIT questions whether the accounting treatment under the Proposal would provide users of financial statements with more transparent or more useful information.



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*Guarantees of securitized financial assets*

Example 4<sup>3</sup> of the Proposal indicates that guarantees on securitized assets would be treated as insurance because “financial institutions provide representations and warranties that certain assets transferred in securitization transactions conform to specified guidelines. The financial institution may be required to repurchase those assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines.”<sup>4</sup> Mortgage REITs may provide guarantees in securitization transactions. For example, a purchase and sale agreement typically contains a clause requiring the seller to repurchase the mortgage loan if it becomes 30 days delinquent during the 90 day period subsequent to sale date or if the loan required primary mortgage insurance and that insurance is denied. There is no premium paid for these representations and warranties. We are concerned that these normal representations and warranties in a sales transaction would be considered insurance under the Proposal. It is unclear why these representations and warranties should be considered insurance or why there is insurance risk in these transactions. The example notes that the triggering event is “Representation and/or warranties provided by a third party not met in a securitization;”<sup>5</sup> however, there is no representation or warranty by a third party, there is merely a representation regarding the credit quality of the loan by the seller. We believe that the risk involved with these representations and warranties is credit risk rather than insurance risk. Given that the definition of financial risk includes a change in credit rating or credit index, presumably that risk incorporates an element of credit risk. We suggest that the definition of financial risk in the Proposal be amended as follows:

Financial risk – The risk of a possible change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index or prices or risk, credit rating or credit index, or other variable<sup>6</sup>. **Financial risk includes interest rate risk, foreign exchange risk, credit risk and liquidity risk.**

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<http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175827217882&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> at page 28.



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### ***Representations and warranties made in whole loan sales***

Mortgage REITs may sell whole loans to agencies of the U.S. Government, such as Ginnie Mae, or federally chartered corporations, such as Freddie Mac or Fannie Mae. In these transactions, the seller may also have to repurchase the loan in the event that breach of any of the representation and warranties adversely affects the value of the mortgage loan. In our view, it is unclear why this type of representation and warranty would be considered an insurance contract under the Proposal, when the financial institution is merely making certain representations of the loan product it is selling to the agency. Again, there is no premium paid by Freddie Mac or Fannie Mae for these representations. It should be noted, unlike the 90 day period mentioned above for non-agency securitizations, these entities may exercise their rights under the representations and warranties any time during the life of the loan should it be found the original underwriting did not meet their standards.

NAREIT recommends that the Board specifically exclude normal representation and warranties made by the seller of loans or other financial instruments and financial guarantees from the Proposal. Alternatively, the Board could permit a policy election similar to current IASB guidance between insurance and financial instruments for financial guarantees, as many financial institutions view these instruments as having credit risk rather than insurance risk. In our view, the complexity and cost of implementing insurance accounting for these financial guarantees outweighs the perceived benefit of requiring the subsequent measurement of the financial guarantee to be “based upon the present value of the expected cash flows rather than recognizing an undiscounted best estimate liability (or updating an initial estimate) when the specified event is incurred<sup>7</sup>.”

### **Conclusion**

NAREIT supports the Board’s effort to converge U.S. GAAP with IFRS. Given that the FASB and IASB have been unable to achieve this primary objective on the Joint *Insurance* Project to date, we do not see the benefit for the FASB to go forward with developing a new insurance standard. Therefore, we recommend that the Board cease work on the Proposal at least until it can evaluate the feedback that the IASB received on its respective Proposal. At that point, the Board could make an informed decision as to whether the IASB Proposal would be an improvement over existing U.S. GAAP. Additionally, we have not heard criticism of the manner that the transactions we cited above are treated under current U.S. GAAP. In our view, the current accounting models have provided users of financial statements with sufficient information to make capital allocation decisions. We observe that the far-reaching scope of the Proposal would obfuscate financial reporting by suggesting that transactions that have financial risk would also have an element of insurance risk. NAREIT questions whether the broad scope of the Proposal was the intent of the Board.

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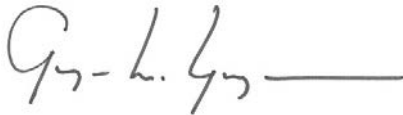
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Nevertheless, should the Board decide to move forward with a new *Insurance* standard, NAREIT respectfully requests that the Board fundamentally rethink the scope of the Proposal, and instead narrow the scope to include insurance transactions currently subject to ASC 944, *Insurance*.

\* \* \*

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at [gyungmann@nareit.com](mailto:gyungmann@nareit.com) or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at [cdrula@nareit.com](mailto:cdrula@nareit.com) or 1-202-739-9442.

Respectfully submitted,



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