CRE Finance Council®
The Voice of Commercial Real Estate Finance

April 2, 2020

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F St., NE
Washington, DC 20549

Sagar Teotia
Chief Accountant
U.S. Securities and Exchange Commission
100 F St., NE
Washington, DC 20549

Russ Golden
Chairman
Financial Standards Accounting Board
439 Main Avenue
Norwalk, CT 06851

Dear Sirs:

In anticipation of future extensions of the COVID-19 timeline further into the year and for the reasons described below, we request that you consider taking additional steps to provide temporary relief to **all entities, including non-bank financial institutions**[1], who are required to apply the current expected credit loss (CECL) standard during this unprecedented time of market volatility. We appreciate the quick efforts to date with respect to insured depository institutions (IDIs), as outlined below, and request that these same policies, supported in Section 4014 of the CARES Act and the Interim Final Rulemaking, "Regulatory Capital Rule: Revised Transition of the Current Expected Credit Losses Methodology for Allowances"[2] of March 27, 2020, likewise apply to other entities.

1. **Section 4014 of the CARES Act:** The exemption created by Congress allows insured depository institutions (IDIs) the option to delay the use of CECL until the earlier of (i) the end of the national COVID-19 related emergency under the National Emergencies Act; or (ii) December 31, 2020.

2. **Interim Final Rulemaking**: The rule allows IDIs to keep the CECL standard largely in place but mitigates the balance sheet effects by netting go-forward losses related to credit loss reserving against regulatory capital over a five-year period (delay for two years followed by three-year phase-out).

The undersigned support these measures for **all financial institutions**, because they:

1. Establish more **consistency** in reserve reporting and disclosure across the financial services industry;

[1] Non-banks include mortgage REITs (mREITs), insurance companies, debt funds, mortgage brokers, and others.
[2] Published by the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency on March 27, 2020.

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2. Ensure **accuracy** and **reliability** in financial reporting;

3. Allow all entities to publicly report in a manner that is both transparent and avoids **unnecessary balance sheet volatility and liquidity pressures; and**

4. Alleviate pressure on non-bank lending institutions in the commercial real estate industry, which comprise 15-20% of this market's lending capacity. This time is particularly critical because lending capacity is most needed to avoid additional liquidity pressures, a trenchant downward spiral in share prices and **deepening financial instability**.

Accuracy and Reliability in Financial Reporting

There are two primary factors to consider in estimating a CECL reserve for a particular asset or asset class: (i) asset-specific credit metrics, including fair market value and operating income; and (2) macroeconomic variables, including GDP growth and employment levels.

Regarding asset-specific credit metrics, the most significant input for determining a CECL reserve for a commercial real estate related instrument is fair market value of the underlying asset. This value can be obtained from a variety of sources, most notably, an appraisal, a broker opinion of value, or a discounted cash flow model. In the current environment where markets are illiquid and not functioning normally, it is simply not possible to properly value a commercial real estate asset. Valuations rely heavily on metrics, such as net operating income, which are currently not reliable due to the government required closures of most commercial asset classes.

Regarding macroeconomic variables, CECL requires companies to incorporate macroeconomic forecasts into their loss allowance estimates for the first time, and these forecasts materially impact the CECL reserve estimates. Given the unprecedented market conditions and the significant level of uncertainty resulting from the impact of COVID-19, it is impossible to make a reliable estimate of these macroeconomic variables as they largely depend on the duration and magnitude of the economic displacement caused by COVID-19.

Most financial institutions, non-banks included, rely on economic forecasts generated by data and research firms to assist in formulating their expectations of macroeconomic conditions. **The latest updates to certain of these forecasts reflect a sharp contraction in GDP throughout 2020, as well as increasingly high unemployment rates that do not fully recover for another three years.** For non-bank institutions that carry financial instruments with shorter maturities (i.e., five years or less), these types of assumptions are significantly impactful to the CECL reserve estimates and could easily lead to inflated reserves at these institutions.

The larger non-bank institutions are currently required to implement CECL for the first time in the quarter ended March 31, 2020. They are being asked to do so in an environment where commercial real estate asset values are nearly indeterminable, and where the economy is contracting at a rapid pace with significant uncertainty as to the timing of recovery. Given these factors, the resulting CECL reserve amounts are likely to be unreliable and not indicative of the ultimate credit losses incurred by these institutions. The premise behind the CECL accounting standard was to provide investors and other constituents with more reliable information about the risk of credit losses. However, adopting CECL in the current environment is likely to produce the opposite effect.

Binding Constraints of Loss Accounting and Solutions

CECL presents covered institutions with binding balance sheet constraints that would be similar to those experienced during a crisis if incurred loss accounting were still in place, as well as certain challenges unique to the new reserve standard. Two instances of generalized pressures introduced by reserve accounting not specific to CECL are discussed below.

Capital Relief: In the broadest terms, CECL and alternative methods of loss accounting, including incurred loss accounting, require that additional reserves be reflected in the income statement and may be netted off of common equity, regulatory capital, and other types of capital. This drag against equity, balance sheets, and lending tend to increase in times of crises no matter the reserve regime in effect. As the COVID-19 timeline extends into the future, there is an increasing risk of rising reserves resulting in **reduced balance sheet capacity for lending activity**. The banking regulators have provided relief to IDIs on this front without disrupting the accounting, audit, risk man, regulatory capital, and other controls and processes already in place at institutions in compliance with CECL as of January 1, 2020. The undersigned believe that the guidance in the Interim Final Rule is a reasonable measure providing flexibility and relief that should be extended to all financial institutions.

Differentiation between Short-Term and Longer-Term Stress in Asset Classifications: One of the most important goals during this period of macroeconomic uncertainty was to allow financial institutions to **override irreversible classifications of loans** and other financial instruments in instances where there is a reasonable case to be made that the stress is limited to the events of COVID-19. As noted above, we appreciate that FASB worked with the regulatory agencies and the industry to find a solution for troubled debt restructuring classifications[3], which otherwise are irreversible.

Unique Challenge Related to Forecasting Requirement in CECL

In a crisis, especially one progressing at the current speed, forecasting is problematic. In the case of commercial real estate assets, the challenges may be more extreme than for other asset classes. Lenders, borrowers, and real estate investors are faced with fundamental asset-level questions rising from some of the relief that has been provided by Congress, the Administration, and other regulatory bodies. A partial list of those questions includes:

- How will forbearance play out for our multifamily borrowers? Where will the lines be drawn between short-term COVID-related stresses and longer-term fundamental credit problems?

- Will current shelter-in-place policies affect student housing facilities past the immediate term, with lease-up on a seasonal (university) schedule?

- To what degree will hotels and entertainment properties recover from the current shock and be stabilized by the CARES Act?

In light of the extreme volatility and uncertainty at play and the factors outlined above, which call into question the reliability, accuracy, consistency and transparency of CECL loss reserve estimates during this unprecedented time, the undersigned respectfully request that FASB grant the same deferral of the CECL standard granted to IDI banking institutions under Section 4014 of the CARES Act to other non-bank financial institutions. For these entities, financial instruments often constitute a majority of their assets.

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Extending the same relief provided to the IDIs to all financial institutions will reduce stress and confusion in the marketplace for this interim period, and is a necessary step to restarting lending and investing. The undersigned greatly appreciate your diligence around these matters. We believe they deserve immediate attention given the approach of the 1Q 2020 reporting deadline. The undersigned would be glad to serve as sources for information and as conduits to our members for discussions.

Sincerely,

Lisa A. Pendergast

Lisa Pendergast
Executive Director
Commercial Real Estate Finance Council