REIT Wise® 2015

March 31- April 2

NAREIT's Law, Accounting & Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Concurrent Session 1:
Financial Instruments Developments

April 1, 2014 2:45pm – 4:00pm

Presenters

Moderator:
Andrew Corsini, Partner, KPMG LLP

Panelists:
Steven Broadwater, SVP & CAO, Simon Property Group, Inc.
Daniel Gentzel, Managing Director, Chatham Financial
Serena Wolfe, Partner, EY
Stephen Yarad, CFO, MFA Financial, Inc.

FASB's Financial Instruments project

Classification and Measurement

Building a better working world

Classification and measurement

Background

- FASB issued a revised ED on classification and measurement in February 2013
  - FASB and IASB jointly deliberated selected aspects of their classification and measurement models
  - FASB's proposal and IASB's amendments to IFRS 9 would require entities to classify and measure their financial assets by applying a cash flow characteristics test and a business model test
- Redeliberations
  - FASB decided not to pursue the February 2013 proposed model and instead make only targeted amendments to existing US GAAP
- The FASB has not yet decided on an effective date
- Final standard is expected by the end of Q2 2015

Classification and measurement

Proposed changes to existing US GAAP

- Investments in equity securities (not accounted for under the equity method) would be measured at FV-NI
  - Practicability exception for investments in equity securities without readily determinable fair values
    - Measurement would be at cost less impairment, adjusted for observable price changes for an identical or similar investment of the same issuer
- Changes in instrument-specific credit risk for financial liabilities (that are measured under the fair value option) would be recognized in OCI
- Valuation allowances on deferred tax assets related to debt securities classified and measured at FV-OCI would be evaluated in combination with an entity's other deferred tax assets

Classification and measurement

Proposed changes to existing US GAAP (cont'd)

- Disclosure of the fair value of financial instruments measured at amortized cost would no longer be required for entities that are not public business entities
- Exception to measure the fair value of loans receivable for disclosure purposes on an entry price notion would be eliminated
- Transition
  - Modified-retrospective approach, with two exceptions. The FASB tentatively decided that the new disclosure requirements and the practical expedient for recognizing and measuring nonmarketable equity securities would be effective prospectively.

Classification and measurement

Existing US GAAP would be retained

- Classification and measurement models for loans and debt securities
- Accounting for equity method investments
- Guidance for bifurcating embedded derivatives from hybrid financial instruments
- Guidance for financial liabilities not measured under the FVO
- Unconditional fair value option
- Classification and measurement of lender loan commitments
- Accounting for unrealized foreign currency gains and losses on available-for-sale debt securities
- Balance sheet presentation

What does this mean for REITs?

- Proposed model is substantially consistent with current US GAAP
- REITs with large equity security holdings will experience increased income (and FFO) volatility
- REITs that have elected FVO for assets and liabilities will no longer have ‘symmetry’ in the income statement

Financial Instruments - Hedging

Topics for discussion

- Project background
- Potential changes and the impact on REITs
- Timing

Financial Instruments - Hedging

Project background

- 2008 Exposure Draft
- 2010 Proposed ASU
- IFRS 9
- Current project

Financial Instruments - Hedging

Potential changes and the impact on REITs

- FASB conducting research in certain areas
  - Risks permitted to be hedged
  - Effectiveness threshold
  - Effectiveness assessment
  - Ineffectiveness measurement
  - Presentation and disclosure
  - Hedge relationship documentation
  - Voluntary dedesignation

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Risks permitted to be hedged
  - Currently permitted risks
    - Benchmark interest rate (i.e. US Treasury, LIBOR, & Fed Funds)
    - Foreign currency
    - Credit
    - Overall changes

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Risks permitted to be hedged (continued)
  - Potential changes to permitted risks
    - Financial and non-financial component hedging
    - Changes to benchmark interest rate definition
    - Introduction of “contractually specified” concept
    - Separately identifiable & reliably measureable unlikely to be included
  - Impact
    - Expansion of risks permitted to be hedged
    - Not quite as expansive as the IASB model in IFRS 9
    - Easier to hedge SIFMA, Prime, and commodity exposures

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Effectiveness threshold
  - Current threshold – highly effective (80%-125% offset)
  - Potential changes to threshold
    - Non-financial risk – may become reasonably effective or stay at highly effective (depending on outcome of component hedging decision)
    - Financial risk – may continue to be highly effective
  - Impact
    - Minor impact on interest rate hedging
    - Commodity hedging relationships become more likely to qualify
      - Significant ineffectiveness could still exist depending on nonfinancial risk exposure permitted to be hedged

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Effectiveness assessment
  - Currently perform at inception and ongoing basis (at least quarterly)
  - Potential changes
    - Short-cut and critical terms match methods may go away
    - Quantitative assessment at inception & qualitative assessment thereafter
    - Quantitative assessment necessary if changes to critical terms of hedging relationship occur
  - Impact
    - Effectiveness assessments should become easier to administer over time, except in situations where critical terms are likely to change (e.g. forward hedging of debt issuances)
    - Ineffectiveness still needs to be measured in each hedging relationship

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Ineffectiveness measurement
  - Currently
    - Fair value hedges – all ineffectiveness recognized
    - Cash flow hedges – cumulative overhedged amount recognized
  - Potential changes
    - Fair value hedges – no changes expected
    - Cash flow hedges – over and under hedged amounts recognized
  - Impact
    - Recognize ineffectiveness on <u>over and under</u> hedged amounts

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Presentation and disclosure
  - Expanded disclosure
  - Rollforward of hedging activity
  - Impact
    - Greater transparency of where hedging related amounts are presented in financial statements

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Hedging relationship documentation
  - Considering simplified/relaxed requirements
  - Could be less punitive than current practice
  - Impact
    - Possibly more time to complete documentation
    - Goal to “get it right” rather than “receive the death penalty”

Financial Instruments - Hedging

Potential changes and the impact on REITs

- Voluntary dedesignation
  - Voluntary dedesignation is currently permitted
  - Proposal could prohibit voluntary dedesignation
  - Impact
    - Less flexibility to manage hedge portfolio

Financial Instruments - Hedging

Timing

- Next steps in the current project
  - Continue research efforts
  - Prepare and expose amendments
  - Issue ASU
  - Effective ASU

FASB's Financial Instruments project

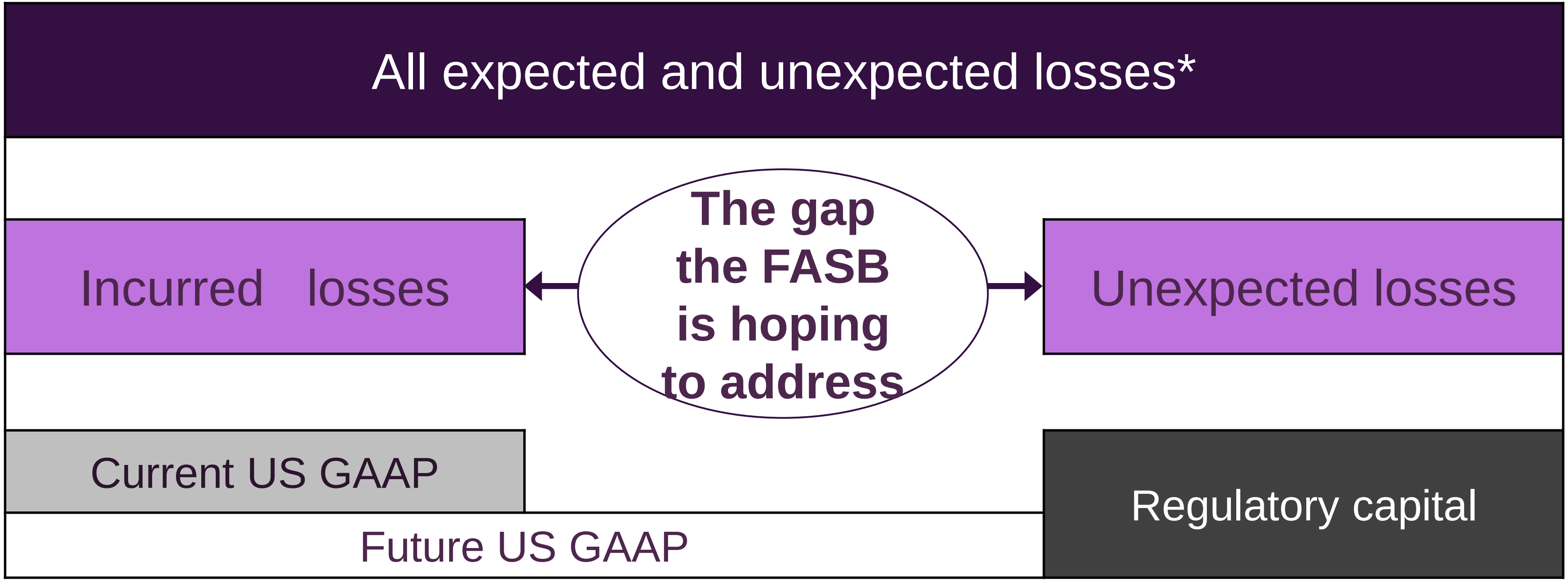
Credit loss model

FASB's Current expected credit loss model

Background

- Financial Crisis Advisory Group organized by FASB and IASB in October 2008
  - Consider how improvements in financial reporting could help enhance investors' confidence in financial markets
- Primary weaknesses identified
  - Delayed recognition of losses associated with loans and other financial instruments
  - Complexity of multiple impairment approaches
- Recommended that the Boards explore an alternative to the incurred loss model that would use forward-looking information

Expected credit losses
The concept



*This diagram is **not** drawn to scale.

The credit impairment journey

Nov 2009
ED
IASB
Lifetime losses built into effective interest rate

May 2010
ED
FASB
Lifetime expected losses on origination

Jan 2011
SD
FASB & IASB
Good book and bad book

Apr 2011
FASB & IASB
‘Three-bucket’ expected loss model

Dec 2012
ED
FASB
Current expected credit loss (CECL) model

Mar 2013
ED
IASB
Expected credit loss model

Q2 2014
IFRS 9
IASB
IFRS issues final standard

H2 2015
ASU
FASB
FASB to issue final CECL standard

Scope

- Entities would apply the proposal to financial assets including:

Debt instruments recognized at amortized cost

(Loans, held-to-maturity debt securities, trade and reinsurance receivables)

Lease receivables recognized by lessors

Loan commitments

Proposal

CECL Model

(to replace ASC 310-10, 310-30, 320-10, & 450-20)

Available-for-sale debt securities

Proposal

Retain current US GAAP

(with modifications to ASC 320-10)

Available-for-sale debt securities

- Today's other-than-temporary impairment (OTTI) model would continue to be applied to available-for-sale (AFS) debt securities with some modifications:
  - An allowance would be used to recognize the credit portion of an OTTI, so an entity would recognize reversals of those losses immediately upon improvement in credit quality
  - When assessing OTTI, an entity would no longer consider:
    - The length of time that the fair value of the AFS debt security has been less than its amortized cost basis
    - Recoveries or additional declines in the fair value of the AFS debt security after the balance sheet date

Current expected credit loss model
As proposed (December 2012 ED)

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

At least two possible outcomes, one of which reflects a credit loss

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

FASB removed the multiple outcomes approach;
a probability-weighted analysis of scenarios not required

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

For periods beyond which the entity is able to obtain reasonable and supportable forecasts, the entity would revert to its unadjusted historical credit loss experience

Current expected credit loss model
What has changed during redeliberations?

- An estimate of all **contractual cash flows** not expected to be collected would include the following elements:

The risk of loss, even if that risk is remote

Information about past events

Information about current conditions

Reasonable and supportable forecasts

Time value of money

Acceptable methods and models include: discounted cash flow, loss rate, probability of default and loss given default, provision matrices

Current expected credit loss model
Other clarifications

- Unit of measurement: measure credit losses on a collective (pool) basis when similar risk characteristics exist
  - Measure credit losses on an individual financial asset basis only when that asset does not share similar risk characteristics with other financial assets of the entity

- Collateral-based practical expedients for subsequent measurement of expected losses include:
  - For a collateral-dependent financial asset, measure CECL allowance as the difference between the collateral's fair value (adjusted for selling costs, when applicable) and the amortized cost basis of the asset
  - For a financial asset in which the borrower must continually adjust the amount of collateral securing the financial asset, limit the CECL allowance to the difference between the collateral's fair value (adjusted for selling costs) and the amortized cost basis of the asset

Current expected credit loss model
Other clarifications (continued)

- All contractual cash flows should be considered
  - The full contractual term of the financial asset, adjusted for expected prepayments
  - Expected extensions, renewals and modifications would not be considered unless the entity reasonably expects to execute a troubled debt restructuring with the borrower
- For the funded portion of loan commitments, expected credit losses should be estimated in the same manner as for other loans
  - Expected credit losses for unfunded loan commitments should reflect the full contractual period over which the entity is exposed to credit risk via a present legal obligation to extend credit, unless unconditionally cancellable by the issuer
- Areas for which FASB decided to retain current US GAAP
  - Write off when the financial asset is deemed uncollectible (also applicable to AFS debt securities)
  - Nonaccrual practices

Current expected credit loss model Practical considerations

- Lenders would need to develop estimation techniques that aim to faithfully estimate lifetime expected credit losses

- Unit of measurement
  - FASB's proposal was drafted with a pooled view, however, a bank would be permitted to measure credit losses on an individual financial asset basis only when that asset does not share similar risk characteristics with other financial assets of the entity
  - Measuring credit losses for individual loans
    - Use of fair value would not be permitted as a practical expedient
    - Requirement to use collateral when foreclosure is probable would be removed
    - Proposal would change definition of collateral-dependent
      - A financial asset for which the repayment is expected to be provided primarily or substantially through the operation (by the lender) or sale of the collateral, based on an entity's assessment as of the reporting date

Current expected credit loss model
Practical considerations (continued)

- Unit of measurement
  - Measurement of credit losses for pools of loans
    - Are companies considering the need for new or different modelling techniques or approaches to achieve the lifetime loss objective?
    - If not, what changes to current modelling techniques may be needed to capture the movement from incurred to lifetime expected losses
    - Commercial versus consumer loans
      - Different product lines for consumer loans (residential vs. credit cards)
    - Modelling assumptions
      - Policy elections
      - Estimation judgments
  - Measurement of credit losses for unfunded loan commitments
- Data needs and availability

Current expected credit loss model
Purchased credit impaired financial assets

- Current guidance for so-called purchased credit-impaired (PCI) financial assets (SOP 03-3) would be replaced with a "gross up" model
  - Recognize a CECL allowance for expected credit losses on PCI assets
  - Initial cost basis of the asset would equal the sum of (1) the purchase price and (2) the estimate of expected credit losses as of the date of acquisition
  - Subsequent accounting for PCI assets would be the same as other originated loans
- Example:

Assume Company A acquires a debt instrument with the following characteristics:

- Par amount of $100,000
- Purchase price of $80,000 (the instrument has experienced significant deterioration in credit quality since origination)
- Expected credit loss embedded in the $20,000 discount to par is determined to be $15,000

Journal entry at purchase:

Debt instrument (par amount)	100,000	
Debt instrument (noncredit discount)		5,000
Allowance for expected credit losses		15,000
Cash		80,000

- Non-credit discount of $5,000 would be accreted into interest income over the life of the instrument under ASC 310-20
- Allowance would be remeasured each reporting period

What does this mean for REITs?

- Significant impacts expected, particularly for MREITs and Equity REITs that invest in structured products
- Accounts Receivable and Lease Receivables would be in scope therefore proposed changes could be a ‘sleeper’ issue for Equity REITs
  - Change in reserves unlikely to be material but could have significant process and controls implications
- Many implementation issues remain
  - Little additional guidance provided during redeliberations
  - How to apply to high credit quality debt securities i.e. Treasuries vs. Agencies
  - Proposed accounting for purchased credit impaired financial assets could create volatility in comparison to current GAAP

Current expected credit loss model
The path forward

- Significant matters to be discussed at future meetings:
    - Transition (expect to be discussed in March 2015)
    - Effective date (to be discussed once a staff draft of the final standard has been prepared)
- We anticipate the FASB will reach final decisions in the first half of 2015 and issue a final standard in the second half of 2015