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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 15, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2013-220
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2013-220, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

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 (Proposed ASU or the Proposal) from the Financial Accounting Standards Board (FASB or the Board) on Financial Instruments – Overall (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*.

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 U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of \$603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed



REIT equity market capitalization (amounting to \$544.4 billion)¹. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of \$59 billion.

NAREIT's Recommendation

NAREIT recommends that the FASB continue with its approach in the Proposal to provide companies with the ability to recognize and measure financial assets and financial liabilities based on a business model assessment. NAREIT commends the Board for working with the International Accounting Standards Board (IASB) (collectively, the Boards) in developing a mixed attribute model for the recognition and measurement of financial assets (*i.e.*, amortized cost, fair value through other comprehensive income, and fair value through net income) and financial liabilities (*i.e.*, amortized cost and fair value through net income). NAREIT has supported a mixed attribute model for financial instruments previously. For example, NAREIT recommended that the Board develop a mixed attribute model in its September 30, 2010 submission² regarding the FASB's Proposal on Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

In NAREIT's view, a mixed attribute model would be consistent with the business models of companies that own and operate real estate, as well as companies that finance transactions involving real estate. These companies typically hold or issue financial assets and financial liabilities for collection or payment of contractual cash flows for principal and interest. We believe that the amortized cost method more accurately reflects this business strategy, rather than measuring these financial instruments at fair value implying that the intention is to trade financial instruments. In addition, for companies that hold mortgage backed securities for collection or payment of contractual cash flows for principal and interest or for sale, we believe that the fair value through other comprehensive income method appropriately reflects this business strategy. For financial instruments held for trading purposes, we agree with the Board that fair value through net income is a more appropriate method.

While NAREIT supports the FASB's mixed attribute model, we recommend the following enhancements to the Proposal:

- **Synchronize embedded derivatives guidance for financial assets with financial liabilities**
- **Eliminate the assessment for cash flows based solely on principal and interest**
- **Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models in allowing for the reversal of previously recorded impairment charges**

¹ <http://returns.reit.com/reitwatch/rw1301.pdf> at page 20.

² <http://www.reit.com/~media/Files/Policy/NAREITFinancialInstrumentsLetter1810-100.ashx>



- **Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category**
- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Synchronize embedded derivatives guidance for financial assets with financial liabilities

NAREIT contends that the Proposal, as written, creates asymmetry between financial assets and financial liabilities. While financial liabilities would continue to be evaluated for bifurcation of embedded derivatives, the corresponding embedded derivative guidance for financial assets would no longer exist. As a result, the *mere existence* of an embedded derivative in a financial asset, even if of quite limited magnitude, would cause the entire financial instrument to be subject to the cash flow characteristics and business model assessment to determine its classification and measurement. In NAREIT's view, this could result in different accounting treatment for economically similar arrangements.

Common investments amongst NAREIT's membership are debt investments, which may have embedded derivatives designed to remove uncertainty about future cash flows. NAREIT believes that to the extent that an embedded derivative *exists* in debt instruments, these instruments would fail the proposed cash flow characteristics test. Consequently, these investments would be measured at fair value with changes in value recognized in net income. Thus, NAREIT believes that it is not the existence of the derivative, but the function of the derivative that should matter. An instrument with an embedded derivative that is economically similar to an instrument that qualifies for amortized cost should be accounted for at amortized cost (*i.e.*, a single instrument). If an embedded derivative is not clearly and closely related to the host contract, it should be bifurcated and accounted for separately.

NAREIT recommends that the FASB retain existing embedded derivatives guidance for financial assets, which would create symmetry with financial liabilities. NAREIT does not believe that the current embedded derivative guidance for financial assets is broken. Currently, an embedded derivative is bifurcated and accounted for separately if it is not clearly and closely related to the host contract. Preparers account for the host contract separately from the embedded derivative, which is measured at fair value with changes in value recognized in net income. In this manner, changes in fair value are isolated to the embedded derivative only, as opposed to the entire financial asset as required by the Proposal.

Eliminate the assessment for cash flows based solely on principal and interest

NAREIT believes that the criteria to classify financial instruments at amortized cost are too restrictive. For example, many financial instruments that currently are held for the collection of cash flows and are therefore measured at amortized cost would be precluded from such classification under the Proposal. Additionally, financial assets with early redemption features could fail the assessment of cash flows based solely on principal and interest when acquired at a premium or discount. Another example is an investment in subordinated tranches of a mortgage securitization. In NAREIT's view, current U.S. GAAP that requires an embedded derivatives assessment more faithfully presents the underlying economics of the transaction. Therefore,



NAREIT recommends that the FASB eliminate the assessment for cash flows based solely on principal and interest from the Proposal, and maintain existing embedded derivatives guidance for financial assets.

NAREIT also notes that the proposed cash flow test would *add* to complexity because the embedded derivative bifurcation rules would still be needed for financial liabilities. And no doubt, the proposed new test would lead to more questions and interpretation.

Converge the Proposal's impairment guidance with the FASB and IASB respective Credit Impairment models that allow for the reversal of previously recorded impairment charges

NAREIT understands that the Proposal would eliminate current impairment guidance on other-than-temporary-impairments (OTTI) for equity investments not measured at fair value through net income. The new impairment model would be based on a qualitative assessment (*i.e.*, more likely than not) as to whether the carrying amount of the investment exceeds fair value.

While we welcome the simplified approach to recording impairment charges, we are concerned that the Proposal would only allow preparers to record downward adjustments and not reverse those losses in situations where the fair value of investments subsequently increases. With the benefit of hindsight, we could observe whether market downturns are sustained. To the extent that markets stabilize, we believe that an accounting model that allows for reversals of previously recorded impairment write-downs would more accurately reflect the financial position of a company. In our view, this symmetric accounting model would provide the best information to users of financial statements.

Further, NAREIT observes that the proposed impairment model is divergent from the models proposed by the FASB and the IASB in their respective Credit Impairment models. NAREIT notes that both the FASB and IASB Credit Impairment proposals allow for the reversal of previously recorded allowance for credit losses. In our view, providing companies with the ability to reverse previously recorded impairment write-downs would serve as an opportunity for the FASB to synthesize impairment guidance within U.S. GAAP with respect to financial instruments and achieve convergence with the IASB at the same time.

Clearly articulate the threshold for sales and the consequence of selling financial assets that are classified in the amortized cost category

NAREIT understands that the Proposal would eliminate the concept of “tainting” from U.S. GAAP that occurs when a company sells financial instruments that are classified as held to maturity. Under the Proposal, the FASB indicates that such sales should be rare and infrequent. However, the Proposal does not articulate how many times such sales could occur. Nor does the Proposal indicate what the consequences are of executing sales from the amortized cost category. In order to reduce the possibility for improper sales from the amortized cost category, and work towards reducing situations whereby some companies might try to “game the system,” NAREIT recommends that the FASB clearly articulate a threshold for sales (and the consequence of selling beyond this threshold) of financial assets that are classified in the amortized cost category.



Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission³ on the FASB's *Disclosure Framework* discussion paper, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.*, 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers⁴) when compared with annual SEC financial reporting deadlines (*i.e.*, 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers⁵). According to APB 28: *Interim Financial Reporting*, each interim period is an integral part (as opposed to a discrete part) of the annual reporting period. Therefore, NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

Other Comments

NAREIT notes that in the FASB's consequential amendments document, hedge accounting for interest rate risk is not permitted for debt securities measured at amortized cost, but apparently is permitted for loans measured at amortized cost. NAREIT found this difficult to understand given that the Proposal overall treats securities and loans in the same manner. NAREIT believes hedge accounting should be permitted for both loans and securities which would be consistent with good treasury risk management practices (*e.g.*, see paragraph 825-10-55-73 in the Proposal).

NAREIT observes that the proposed held-for-sale criteria for equity method investments may be interpreted very broadly. We are concerned that this may result in certain investments being inappropriately reported at fair value through net income, which may be contrary to the Board's intention. For example, investments reported under the equity method of accounting (*e.g.*, investments in joint ventures, partnerships and limited liability companies) might be considered held-for-sale investments simply because (1) the underlying arrangements may contain explicit or implied end/termination dates or (2) management often considers a wide range of exit plans depending on future developments over a long time horizon. NAREIT does not believe this result would represent the most useful financial reporting and questions whether or not the Board intended this result.

³ <http://www.reit.com/~media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx>

⁴ <http://www.sec.gov/answers/form10q.htm>

⁵ <http://www.sec.gov/answers/form10k.htm>




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In summary, we urge the FASB and the IASB to remain committed on their convergence efforts. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

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 or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,



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