



REFA Fundamentals of Real Estate

**What's It Worth?  
FASB Fundamentals You Should Know**

July 21, 2009

**FASB Fundamentals of Real  
Estate Debt Investments**

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## Introduction

- Financial crisis or fair value accounting
- Industry views
- Political pressure
- Changes to fair value accounting pronouncements
- On the horizon

## Introduction

- Accounting for Real Estate Debt Investments
  - Loans
  - Securities
- Fair Value Measurement, FAS 157 as amended

## Real estate loans

- Accounting Treatment
  - Fair Value Option FAS 159
    - Loan adjusted to fair value through earnings
  - Loan loss reserve model
    - Impairment
      - Probable will not collect all principal and interest
      - Typically write down to fair value of collateral
    - Unallocated loss reserve
      - Probable and reasonably estimable loss
      - Models

## Real estate loan securities

- Accounting treatment
  - Fair Value Option FAS 159
    - Loan adjusted to fair value through earnings
  - Other than temporary impairment model
    - Mark asset to market with offset to equity/other comprehensive income
    - Charge earnings if decline in value deemed other than temporary

## Real estate securities, continued

- Other than temporary criteria
  - Intent to sell
  - More likely than not required to sell
  - Credit loss ( principal degradation )
- Market rate decline does not require charge to earnings

## Fair value measurement, FAS 157

- Framework
  - Determine Unit of Account
  - Determine Potential Markets Based on Highest and Best Use
    - In exchange
  - Determine Markets for Basis of Valuation
    - Principal or Most Advantageous market
    - Hypothetical Market

## Fair Value Measurement, FAS 157

- Identify and Obtain Inputs for Valuation
  - Observable vs Unobservable
- Determine valuation approach
  - Market, income, cost approaches
- Determine fair value

## Fair Value Measurement, FAS 157

- Challenges in current market environment
  - Market inactive?
  - Appropriateness of concluding transactions not orderly
  - Evaluate whether observable transactions are orderly
  - Greater judgment
  - Disclosure

# FASB 157 Loan Valuation

## From Theory to Practice



DERIVATIVE  
ADVISORS

Elaine Philbrick  
Principal

### Why do it?

- **Investor demand**
- **Balance sheet transparency**
- **Asset Liability management analytics**
  - Interest rate risk exposure
  - Credit risk assessment
  - Risk mitigation strategy
- **Competitive advantage**

## Valuation Source

- **Borrower**
  - Decide on methodology
  - Document the support for inputs, both interest rate and credit spreads
    - Credit spreads not readily available
  - Auditors and investors strongly prefer unbiased source
- **Valuation specialist**
  - Independent
  - Relationship with auditors
  - Cost
  - Transaction Capability

13

## Methodology

- **Market**
  - Secondary market prices
- **Cost**
  - Prepayment Value: FAS157 disallows
- **Income**
  - **Discounted cash flows**
    - Adjusted Discounted Cash Flow at Risk-Free Rate
    - **Discount Contract Cash Flows at Market Rate**

14

### **Valuation Inputs from Borrower**

- Outstanding Balance
- Amortization
- Contract Rate
- Rate Lock Date
- Maturity Date
- Secured/Unsecured
- Property Type
- DSC/LTV Ratios
- Guarantees
- Primary Tenant Rating
- Primary Lease Maturity
- Location

15

### **Valuation Inputs from Market**

- Market Interest Rate: Level 1
  - Treasuries, Federal Home Loan Bank rates
  - Future LIBOR cash flow curve adjusted for offer-side Swap Rate
- Market Loan Credit Spread: Level 3
- Market Financing Fees: Level 3

16

## **Practical Definition of FAS 157**

- **Borrower perspective**
- **Sell or transfer an asset**
- **Liability continues, not settled**
- **Principal or most advantageous market**
  - Affects credit spread source lender pool
- **Not distressed sale**
- **Does not include transaction costs or broker fees**
  - Specific to individual transactions disqualified
  - General market and reflected in sale price allowed

17

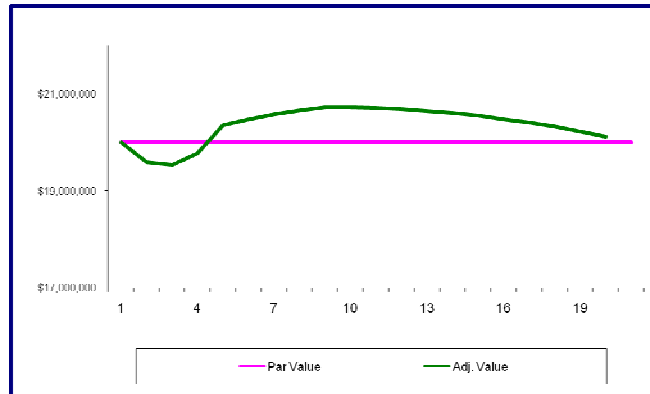
## **Credit Spreads**

- Unique and entity-specific
- Non-investment grade credit spread data not readily available
- Short cuts based on primary price drivers for cost and efficiency within an acceptable trade-off of accuracy
- Credit spreads weighted by lender type: based on market share or active market, not borrower lending pool
- Unusual loans involve some subjectivity
- Caution: adjust credit spread to relevant index!

18

## Comparison of Par and Adjusted Values: Expected Outcome

\$20 million loan at 6% fixed for 5 years



19

## Comparison of Adjusted Loan and Swap Values: Recent Experience

\$20 million loan at 1ML + 3% swapped for  
6% fixed for 5 years

CREDIT SPREADS	LOAN ADJ. VALUE	FIXED RATES	SWAP ADJ. VALUE	LOAN + SWAP
1%	(\$21,804,555)	8%	\$1,716,864	(\$20,087,691)
2%	(\$20,840,965)	7%	\$858,432	(\$19,982,533)
3%	(\$20,000,000)	6%	\$0	(\$20,000,000)
4%	(\$19,270,246)	5%	(\$858,432)	(\$20,128,678)
5%	(\$18,642,229)	4%	(\$1,716,864)	(\$20,359,093)
6%	(\$18,108,175)	3%	(\$2,575,296)	(\$20,683,471)
7%	(\$17,661,818)	2%	(\$3,433,728)	(\$21,095,545)

20

# Valuation Considerations for Real Estate Debt Securities

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## Introduction

- Structures
- Current Market
- Valuation Approach
- Valuation Consideration
- New Government Programs

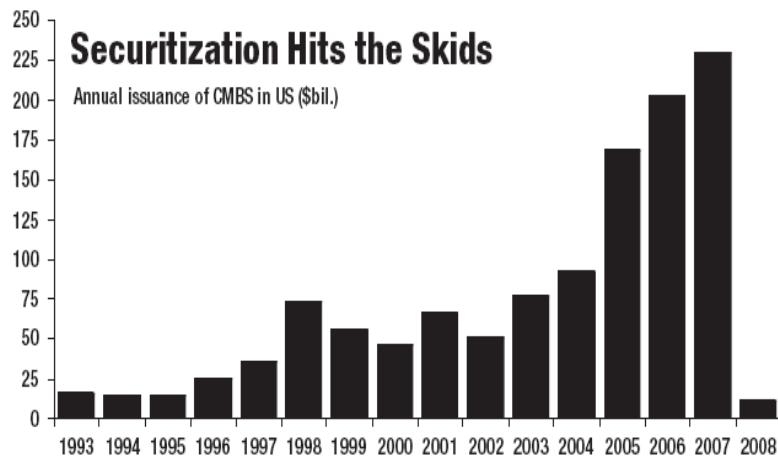
## Structures

- Bond type
- Rate Type
- Collateral Type
- Term

## Current Market

- Active (?)
- Credit Issues
- Special Servicers
- Interest Rates
- Spreads
- Rating Agencies

## Securitization Volume



Source: Commercial Mortgage Alert: January 9, 2009

## Valuation Approach

- DCF
- Comparables
- Third Party Models
- Stress Sensitivity

## Valuation Consideration

- Cash Flow
- Market Yields
- Risk Adjustments
- Extension Assumptions
- Interest Rate Curve

## New Government Programs

- TALF
  - Legacy (Issued prior to January 1, 2009)
  - New (Issued on or after January 1, 2009)
  - Eligibility
    - Credit rating in the highest long-term investment-grade rating category from two or more TALF CMBS-Eligible Rating Agencies
    - Must not have a credit rating below the highest investment-grade rating category from any TALF CMBS-Eligible Rating Agency
    - Weighted average life of no more than ten years

## New Government Programs

- PPIP
  - Legacy Loans Program
    - Residential and commercial mortgage-related whole loans
    - Located predominantly in U.S.
  - Legacy Securities Program
    - Residential or Commercial MBS issued prior to January 1, 2009
    - AAA Rating
    - Secured by predominantly U.S. assets
    - Backed by loans