Statement of the

COMMERCIAL MORTGAGE SECURITIES ASSOCIATION

Before the

UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

Hearing on "Mark-to-Market Accounting: Practices and Implications"

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The Commercial Mortgage Securities Association ("CMSA") is grateful to Chairman Kanjorski, Ranking Member Garrett, and the Members of the Subcommittee for giving CMSA the opportunity to share its perspective on "mark-to-market" and the overall Fair Value Accounting ("FVA") standard. In particular, we will discuss how this standard, as currently being implemented, exacerbates the tremendous challenges facing the $3.4 trillion commercial mortgage market, and our belief that accounting policymakers can and must find workable solutions that dampen FVA's pro-cyclical effect, while also providing the transparency the FVA framework was intended to promote.

CMSA is the collective voice of the commercial real estate capital market finance industry, representing the full range of market participants including investment and commercial banks, rating agencies, accounting firms, servicers, other service providers, and investors such as insurance companies, pension funds and money managers. One of the crowning achievements of our association's efforts has been the development and implementation of a standardized CMSA Investor Reporting Package®, which has brought unparalleled transparency to our market by providing detailed bond, loan and property-level information for all commercial mortgage-backed securities (CMBS) securitizations.

The CMBS market is a responsible and key contributor to the overall economy that has provided a tremendous source of capital and liquidity to meet the needs of commercial real estate borrowers. Until recently, CMBS supported the commercial real estate market that fuels our country's economic growth, while helping provide jobs and services to local communities, as well as housing for millions of Americans in multi-family dwellings. Unfortunately, turmoil in the financial markets coupled with the overall downturn in the U.S. economy have brought the CMBS market to a standstill and created many pressing challenges. In fact, although the CMBS market provided approximately $240 billion in commercial real estate financing in 2007 (nearly 50% of all commercial lending), it provided only a small fraction (less than $13 billion) in 2008 with no new lending in more than two quarters, despite strong credit performance and enormous demand for capacity from borrowers. As such, CMSA has been actively working with financial regulators and policymakers to explore ways to get credit flowing again.

While CMBS market participants are struggling with the paralyzing effect of the credit freeze, they are simultaneously faced with the highly problematic and related effect that the FVA standard is having on their balance sheets, which must be addressed before new lending can occur. The problem is not with the FVA standard as written and intended per se – in fact, CMSA supports FVA, and we believe it works when the markets are functioning and there is not extreme volatility or disruption in those markets. However, CMSA strongly believes that the FVA standard, as currently implemented, has negative unintended consequences when the markets are illiquid and/or highly volatile. For these reasons, as explained below, CMSA urges accounting policymakers to give reporting entities specific, consistent direction on applying FVA in non-functioning markets, and also urges policymakers to address the adverse, pro-cyclical effect of current practice with respect to recognizing impairments.

Background

As the name implies, "Fair Value Accounting" (of which "mark-to-market" accounting is a subset), involves the valuation of assets or liabilities by reference to some objective, reliable measure in the market. FVA is implemented in the United States through Statement of Financial Accounting Standards ("SFAS") 157 (or "FAS 157"), promulgated by the Financial Accounting Standards Board ("FASB"), which the Securities and Exchange Commission ("SEC") has designated as the standards-setter for financial reporting. FAS 157 bases the concept of fair value on an "exit price," and provides a hierarchy of inputs used for fair value measurement based on the degree to which the inputs are observable in the market. "Level 1" in the hierarchy includes inputs that are based on quoted prices in active markets for the identical asset or liability. "Level 2" includes quoted prices of similar instruments in active markets and observable market information on valuation parameters or market-corroborated information (i.e. "observable market data"). "Level 3" corresponds to measurements that incorporate significant externally unobservable inputs that reflect the reporting entity's own assumptions and judgments regarding valuation parameters that market participants would use, such as adjustments for risk (i.e., "mark-to-model"). As a general matter, the FVA standard requires a reporting entity to use the highest level of factors for which reliable information is available.

The Problem: Market Disruptions and FVA

In theory, the availability of these three levels of input should afford a reporting entity sufficient flexibility to utilize whichever level is most appropriate for the prevailing market conditions. Thus, in the case of the present market disruptions that have led to pricing distortions, the current FVA standard should allow reporting entities to move to Level 3 for securities, which would enable them to incorporate internal management's assumptions and judgments to produce realistic valuations.

However, despite what is intended, FVA does not provide this flexibly in practice. This unfortunate result is due to a lack of clear, consistent, and specific guidance from accounting policymakers (FASB, the SEC and PCAOB) about when a market is sufficiently "non-functioning" to permit a reporting entity to rely on Level 3 data for securities. In addition, because of the FVA standard's emphasis on "observable" market data, reporting entities are encouraged to assign depressed values to securities that are the product of the current market illiquidity and a superficial valuation analysis, as well as other constraints on institutions. This application is in lieu of engaging in a more principle-based analysis of the value of their securities, which more expressly requires an assessment of the quality of data and relies on multiple inputs, thus leading to a more analytical assessment of value. Put simply, we have found that while the FVA standard works "on paper," it is not working "in practice."

The CMBS market offers a compelling example of the pricing and valuation difficulties that market participants face under the current application of FVA. Even though illiquidity (the lack of CMBS issuance or robust trading), volatility, and the overall economic downturn have combined to batter the market, CMBS loans are still performing today and our market's fundamentals remain relatively sound, which essentially means most CMBS investors are receiving principal and interest each month.

However, market illiquidity and volatility result in distorted data being used to value assets, despite the performance and cash flow that investors holding these assets are receiving. Indeed, a strict interpretation of the FVA standard's "observable market data" can result in the use of "synthetic instruments" (or "derivatives") to determine pricing. In the CMBS market, the synthetic instrument used is often the CMBX index, which – incredibly – at times has been trading at a price that suggests 99% default rates, so this clearly is not an accurate barometer of fair value given the performance of CMBS loans. In another example specific to our market, because CMBS can be relatively liquid compared to other asset types, an investor may reluctantly sell CMBS, albeit at "fire sale" prices. Although such a distressed sale is not the orderly type of transaction that forms the basis for FVA, the fact that a small number of these sales occur results in such "fire sale" prices being used as a benchmark upon which FVA determinations are made, creating an unrealistic, and self-perpetuating, downward pressure on valuations for CMBS.

This type of pricing distortion, or "under-valuation" in this case, does not provide the kind of transparency investors and the market need, and is a particular disservice to investors who intend to "buy and hold" as well as investors who do not intend to sell the CMBS assets unless the price reflects what they believe to be the fair value of those assets. Investors thus can experience severe economic stress as a result of mark-to-market losses, despite the fact that highly-rated securities themselves may be projected – even today – ultimately to experience little or no real economic loss.

These artificial devaluations are having a far-reaching ripple effect on the economy. Accounting rules are not supposed to drive business decisions, at least theoretically. Today, however, the application of FVA is impacting such decisions, as the artificial downward valuations contribute to the inability of institutions (who lack balance sheet capacity) to extend or refinance loans without a viable and stable secondary market. Yet, Treasury Secretary Geithner explicitly stated in his testimony before the House Financial Services Committee on February 10, 2009 that "[n]o [economic recovery] plan will be successful unless it restarts the securitization markets." It follows that the adverse impacts of FVA must be addressed now, because they effectively undermine all of the efforts undertaken by Congress and the Administration in recent months to address the crises in both "capital" and "liquidity," which are essential to new lending.

In our view, none of these ramifications was an outcome that was intended by the accounting policy constituencies that created the FVA framework. But, with capital and liquidity now at a premium, and as the government embarks on the numerous initiatives put in place to provide liquidity and facilitate lending, it is critical that policymakers ensure that accounting standards do not undercut these broader efforts. The application of the FVA standard in non-functioning markets needs to be addressed immediately, and should be among the highest priorities for all policymakers in order to assist in our financial recovery.

Possible Solutions

We appreciate the attention that Congress has already devoted to this issue. Although Section 132 of the Emergency Economic Stabilization Act of 2008 ("EESA") authorized the SEC to suspend SFAS 157, the SEC has not done so. The SEC did, however, conduct the study and publish the report on the effects of FVA as was directed by Section 133 of EESA. As part of this process, the SEC also held a series of public roundtable discussions on the issue, in which CMSA participated on two separate occasions.

In the SEC's FVA report, the Commission acknowledges, among other things, that there is a need for additional guidance or best practices for determining fair value in illiquid or non-functioning markets; that there should be improvements in the application and practice related to FVA especially as they relate to estimates based on "observable inputs" (i.e., Level 2 data) and "unobservable inputs" (Level 3 data); and that there should be additional guidance concerning when observable market data should be supplemented with or replaced by externally unobservable data in the form of management estimates.

CMSA along with representatives of many other industry sectors have long urged the SEC and FASB to do precisely what the SEC has suggested in its report. Preliminarily, our members believe a workable solution lies within the existing FVA framework. Thus, CMSA has asked the SEC and FASB to issue guidance on FVA clarifying that in disrupted markets such as those we now face, Level 3 data may be relied upon for securities, and we asked for clarification regarding when a market is "non-functioning." The Public Company Accounting Oversight Board, which governs the work of auditors, has likewise been requested to ensure that its standards concerning FVA are brought into line with the SEC report's conclusions and our recommendations.

It is worth noting that the Center for Audit Quality, which represents auditors, has similarly suggested that additional guidance needs to be provided about the circumstances in which it is appropriate to shift from Level 2 to Level 3 inputs when valuing an asset in a time of changing or disrupted market conditions. Likewise, our view is generally consistent with the recommendations in the recently released Financial Reform Report from the "Group of Thirty" ("G30"), the international body of public and private sector experts on economic and financial issues, of which former Federal Reserve Chairman Paul Volcker serves as Chairman of the Trustees. The G30 report recommended that "fair value accounting principles and standards should be reevaluated with a view to developing more realistic guidelines for dealing with less liquid instruments and distressed markets." Chairman Volcker testified about the G30's recommendations at a February 4, 2009 hearing before the Senate Banking Committee.

Unfortunately, however, the additional guidance that the SEC and FASB have provided to date, though well intentioned, has fallen short of our markets' needs. Essentially, reporting entities have merely been told that they have the flexibility to rely on Level 3 data for securities in non-functioning markets, but without concrete, specific guidance on when they may do so, and without information on what criteria the SEC and PCAOB would use to evaluate that decision with hindsight. In sum, the current guidance has not been sufficient to allow reporting entities to move to Level 3 with any degree of comfort, and we do not foresee markets returning to a completely normal state without some attention to pricing distortions that result from the current application of FVA. While the new short term projects announced by FASB on February 18, 2009 to provide additional guidance on fair value measurement and disclosure are welcome, this effort will not go far enough to addressing these issues.

Accounting policymakers must give reporting entities the direction they need to rely on Level 3 data, starting with a clear, specific definition of when markets are "non-functioning." Further, the description of "non-functioning" should encompass a broader range of market conditions than what is currently contemplated in FAS 157, which is essentially limited to circumstances where a market is "non-existent." This acknowledgement is necessary because a market may be so severely disrupted that there is little or no trading, but under the "non-existent" standard, one trade (which most likely would represent a distressed sale or forced transaction), would put the market back into the realm of a "functioning" one. This practice is certainly cause for concern and confusion for the CMBS market. As mentioned, the CMBS market is, at times, relatively more liquid than other types of assets an investor may own, and may be sold at "fire sale" prices as a result. A distressed sale is not the orderly kind of transaction that forms the basis for FVA, but the fact that a small number of such sales occur is interpreted to mean the market does not meet the "non-existent" characterization under FVA, so under the present implementation there would never be cause to utilize Level 3 data for CMBS valuations. Equally problematic, the "fire sale" price the distressed seller receives then becomes a benchmark upon which an FVA determination is to be made, putting added unrealistic, downward pressure on FVA valuations for CMBS. Thus, a significant decline in the number of orderly transactions, and the presence of sales primarily made by distressed sellers, are examples of circumstances that should be recognized by FAS 157 as hallmarks of a "non-functioning" market justifying a move to Level 3 data.

Additionally, CMSA believes that the problem we are now experiencing highlights the need for a more thorough examination of current "impairment" accounting models for financial instruments with a view to fully understanding their impact in non-functioning markets so that other necessary changes may be made as the markets stabilize. Specifically, accounting policymakers need to address an issue that exacerbates its pro-cyclical effect during credit and liquidity crises – the consideration of a liquidity premium "discount" along with an expected credit loss when recognizing impairment charges. Reconsideration of the models for recognizing impairments is also a recommendation made in the SEC's report on FVA. CMSA strongly agrees, and urges that this issue be addressed quickly and meaningfully because the current practice can subject investors to severe economic stress by requiring them to recognize an exaggerated level of loss despite the fact that the highly-rated securities themselves are projected to experience little or no real economic loss. Such a rubric does not provide the type of transparency needed by the market and investors who ultimately are critical to borrower access to credit. A more realistic approach is to recognize impairment only to the extent of the expected credit loss.

Further, CMSA strongly believes there is a continued role for Congress to ensure that accounting policymakers take all necessary steps toward addressing pricing and valuation issues in a meaningful manner, and assuring that the views of all constituencies are considered. We respectfully request that Congress continue to focus on the improvements that are needed in this area by mandating that the accounting policymakers (SEC, FASB and the PCAOB) take action to implement the changes they already have acknowledged are necessary by a date certain.

In conclusion, we support the FVA standard. However, while it works "on paper," action must be taken to ensure that it works as envisioned "in practice." We would urge a prompt consideration of, and response to, these issues in order to fully address and alleviate challenges facing the financial sector and overall U.S. economy.