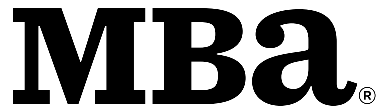

MORTGAGE BANKERS ASSOCIATION

October 24, 2019

Jay Shah
Project Manager
Financial Accounting Standards Board
401 Merritt 7
Norwalk CT 06856

Re: CECL Implementation and the Commercial Real Estate Industry

Dear Jay:

This past summer, I attended a FASB Board meeting on behalf of the Mortgage Bankers Association (MBA) at which the CECL accounting standard was on the agenda. Thank you for connecting me with Amin Mohomed and Chris Cryderman of the FASB CECL team at that meeting. During my brief conversation with Amin and Chris, they asked that I provide—as follow-up—some additional background on the application of the CECL standard to commercial real estate (CRE) loans and to the CRE finance industry. This letter provides that background information.

- First, because the CRE financing market is a $3.5 Trillion industry, the CECL treatment of CRE debt will, of course, have a substantial *cumulative* impact across many institutions including banks, life insurance companies, mortgage brokers and/or bankers, and government sponsored enterprises (GSEs).
- Second, and following up on my conversations, there are many institution-level challenges involved implementing CECL with respect to CRE loans. I describe below some of those institution-level challenges, specifically challenges regarding the use of historical data and the application of the CECL standard to certain guarantee obligations. We will continue to monitor issues that arise as implementation progresses and will share any significant developments with you. We hope that this perspective is useful to you and your team.

In addition, I saw that FASB recently released a schedule for its "CECL Implementation Workshops" that will be administered by FASB experts at various conferences and venues around the country. I would like to talk with you about the potential for MBA to host a FASB implementation workshop as part of a summit we have scheduled—to leverage the fact that we are convening a number of member firms in the CRE space you may not as easily otherwise reach (i.e., life insurance companies that do CRE lending).

Specifically, MBA's CRE team hosts annual "Financial Officers Roundtables" in Washington, DC—where financial officers at large, medium and small institutions with commercial mortgage operations gather for educational contact, networking and discussion of issues germane to the accounting aspects of CRE finance. The 2020 Roundtable will be held May 13-14. In tandem with

this event, we are also planning to organize a "CECL Summit" that will bring together institutions and industry experts in the CECL space both to educate and to encourage dialogue among those institutions who have begun implementation as well as those that have not yet begun. This event might also be a useful venue for a CECL Implementation Workshop, specifically tailored to implementation in the CRE space.

I. CHALLENGES OF USING HISTORICAL DATA FOR MODELING AND FORECASTING PURPOSES OF PROJECTING FUTURE LOSSES ON CRE LOANS

A. External historical loss data may not be a viable alternative for institutions with insufficient internal data.

A major challenge facing some institutions in the CRE industry is a lack of sufficient and relevant historical loss data for use in CECL modeling/forecasting—from either internal or external sources.

FASB established expectations for historical loss data in its CECL update, which states that that available and relevant information should be considered in assessing the collectability of cash flows, including "internal information, external information, or a combination of both relating to past events, current conditions and reasonable and supportable forecasts."[1] The most recent FASB Q&A similarly states that "An entity may have limited *internal data* for a particular portfolio to estimate the collectability of the reported amount. Therefore, the entity will need to rely on *external data* for the purposes of developing an estimate of expected credit losses."[2]

These expectations can be challenging for some in the CRE industry. Although our members collect and retain historical loss data, in some cases, the transaction volume and depth of internal performance data may be insufficient for CECL modeling purposes. For instance, many of our smaller members and life insurance companies are challenged in this regard—as they lack well-developed internal historical databases that many larger banking institutions have developed to meet sophisticated banking regulatory requirements.

Moreover, for some institutions with insufficient internal data, turning to external data may not be a viable solution. Specifically, available external CRE loan data may not be representative of the loans to which an individual institution will apply the CECL standard. For example, readily available, external data tends to be largely derived from commercial mortgage-backed securities (CMBS). The CMBS market generally finances loans with a different risk profile than other CRE financing capital sources, such as banks or life insurance companies. The differences between the character of the loans reflected in the external historical loss performance data and the loans in the institution's book of business makes it difficult for banks and life insurance companies to apply CMBS-focused historical data to accurately forecast their own portfolio's performance. We are continuing to work with our members as they develop approaches to accurately implementing CECL despite that challenge.

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[1] See Financial Accounting Standards Update No. 2016-13, Paragraph 326-20-30-7 of Topic 326 (June 2016) (hereinafter ASU 2016-13).
[2] FASB Staff Q&A, Topic 326, No. 2, Question 5 (emphasis added).

B. Internal historical data may include data that is not representative of an institution's CRE loan portfolio.

Even institutions with substantial collections of internal historical data may encounter challenges with the utility of some segments of that data for forecasting purposes. For example, some banks that participated in FDIC-assisted acquisitions of failed banks find that the historical loan performance reflected in the data from those acquired banks is so different from the bank's other CRE loans that it would not be a reasonable basis for projecting the performance of the bank's other CRE loans.

We note that FASB acknowledges that a certain amount of discretion and flexibility is allowed in the selection of information used for CECL purposes. For example, FASB states that "An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances"[3] and emphasizes that "relevant" information to the estimated collectability of the reported amount should not be ignored.[4]

Similarly, in its most recent Q&A, FASB provides for flexibility in the selection of "relevant" historical loan data (in terms of time periods). FASB advises that an institution can use historical loss information that is nonsequential, and can exercise judgement in determining which periods of historical loss information are most appropriate for estimating expected credit losses.[5] The guidance also provides that once the period is chosen, adjustments can be made to reflect differences in current asset specific risk characteristics including "underwriting standards, portfolio mix, or asset term within a pool at the reporting date."[6]

The situation we describe above appears to be analogous to the type of data issue addressed in the Q&A. We are continuing to work with our members as they develop approaches to accurately implementing CECL despite this challenge as well.

C. Historical loss data on CRE loans poses challenges in its utility for forecasting expected losses.

Even where historical data is readily available and comparable, using that data to project future losses creates challenges for the CRE finance industry. The challenges arise because, as a general matter, historical losses on CRE loans have been relatively low for an extended period of time. This creates a challenge to forecasting appropriately stressful conditions to project potential future credit losses.

In addition, the losses that have occurred historically have tended to be idiosyncratic, in that they may result from specific events or may be tied to particular geographical locations. As a result, the factors driving specific losses on CRE loans may not be broadly applicable to project future loss projections. This is another area that we are continuing to monitor as our members develop approaches to accurately implementing CECL.

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[3] ASU 2016-13, p. 2.
[4] ASU 2016-13, Paragraph BC52.
[5] FASB Staff Q&A, Topic 326, No. 2, Question 4.
[6] *Id.*

II. CECL AND THE FANNIE MAE GUARANTEE OBLIGATION WITH THE CECL RESERVE

A separate issue unique to CRE institutions participating in Fannie Mae's Delegated Underwriting and Servicing (DUS) Program with Fannie Mae arises from the application of the CECL standard to guarantee obligations under the DUS program.[7]

FASB guidance appears to contemplate that the liability assessed under Subtopic 460-10 for the guarantee obligation is a factor of the fee paid to the DUS institution by Fannie Mae as compensation for risk retention.[8] Depending on how DUS members have historically accounted for the guarantee obligation as a factor of the Fannie fee recognition, the entry of a liability for both the guarantee obligation and a CECL reserve can result in what may appear to be "double counting."

MBA's DUS member group has convened several times over the past year on this issue, and members are working with their individual accounting teams and external auditors to determine the appropriate application of CECL to their DUS-program loans. We continue to engage with our members as they address this issue.

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We appreciate FASB's commitment to provide the guidance, clarity and flexibility necessary for a broad range of industries, on an ongoing basis, as CECL implementation moves forward. We hope this background information is helpful as you do so. We will continue to keep your team updated regarding the application of CECL to CRE loans, and we look forward to continuing this dialogue as implementation progresses, and hope we can be a useful resource for you. In addition, I look forward to discussing the possibility of scheduling a CECL Implementation Workshop in connection with MBA's upcoming event in May 2020 or otherwise. Please feel free to contact me directly at khamill@mba.org or at 202-557-2746.

Sincerely,

Kelly Hamill
CREF Associate Director
Mortgage Bankers Assocation

cc: Amin Mohomed
Chris Cryderman

[7] Participating institutions in the DUS Program typically share up to one-third of the credit losses on a pro-rata basis with Fannie Mae.

[8] Paragraph BC97 of Update 2016-13 states that an entity must account for expected credit losses in addition to and separately from the fair value of the guarantee "to appropriately present expected credit losses on financial guarantees … without affecting fee recognition."