

Debt Valuation Task Force

A Survey of Plan Sponsor Perspective
and Practice.

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Debt Valuation's Recent History

Plan Sponsor have responsibility to value real estate

In 2006, the AICPA issued an audit interpretation as well as a practice aid for auditing alternative investments which describes management's responsibility as follows:

- "management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity's financial statements"
- "this responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management"

In 2007, the FASB issued SFAS 157, *Fair Value Measurements* and SFAS 159, *Fair Value Option For Financial Assets and Liabilities*, with effective dates for periods beginning after 11/15/07. Important points discussed in the documents are:

- the adequacy of fund Net Asset Value (NAV), and
- the appropriateness of the policies and procedures used by fund managers to value the underlying assets and liabilities

The current REIS Standard requires all notes payable to be carried at fair value

- Real Estate Information Standards (REIS)
 - Sponsored by NCREIF and PREA
 - REIS Board serves as governing body
 - Mission: disclose reliable, useful, comparable, transparent and meaningful information relevant to decision-making processes which can be independently verified.
 - Set of cross-disciplinary information standards for the institutional real estate industry
 - Fair value accounting
 - Valuation
 - Performance measurement and
 - Reporting standards

... yet practice is uneven

- Current REIS standard
 - Notes payable are required to be carried at fair value
 - In order to be in compliance with REIS, SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment to FASB Statement 115*, must be elected for each note payable instrument held.

- It was apparent that there was a spectrum of practices surrounding election of the Fair Value Option in the Plan Sponsor community, and therefore, uneven adherence to the REIS standard.

Broad Plan Sponsor participation in survey process

- Designed short survey of debt perspective by investment structure (open-end funds, closed-end funds, separate accounts* and direct investments)
 - Intended to be value neutral, approved with suggestions incorporated from Advisory Board
 - Interviewers at times collected narrative comments; to tabulate qualitative responses would infer a frequency or importance that may not have been intended by interviewee
- Explanatory cover letter and questions sent to NCREIF and PREA Plan Sponsor representatives
- Task force successfully interviewed 24 firms from Plan Sponsor community representing approximately \$148 billion (Net Asset Value) in U.S. Real Estate Private Equity Investments (and > \$1.8 trillion in total plan assets)
 - Participants selected by total size, investment variety, type of plan
 - Sources for identifying:
 - Pensions & Investments online directory
 - Advisory Board
 - Task Force participants
- Confidentiality and neutrality emphasized
- Experienced positive and enthusiastic participation

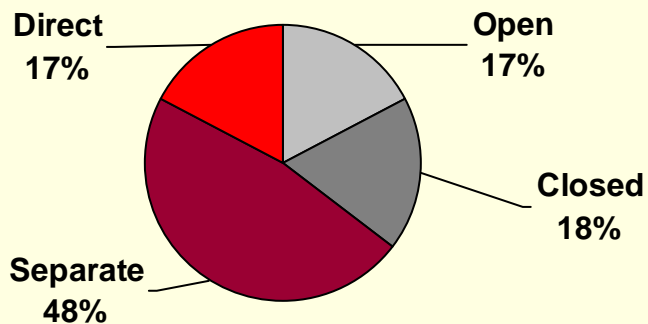
* As used herein, separate accounts refer to single investor accounts.

Plan Sponsor Summary of Results

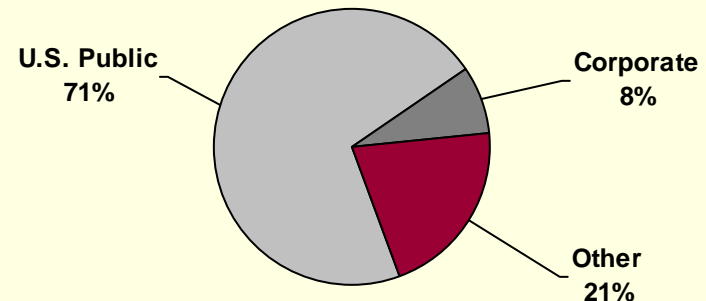
Plan Sponsor Summary Demographics

■ Number of Respondents:	24
■ Approximate NAV*	\$148 billion
■ by Fund Structure:	
■ Open-end Commingled Funds	\$26 billion
■ Closed-end Commingled Funds	\$28 billion
■ Separate Accounts	\$69 billion
■ Direct investments	\$25 billion

Representation by NAV



Representation by interviewee fund type by number of respondents



* Generally as of June 30, 2008 and represents NAV of private U.S. real estate portfolio.

Industry is divided as to whether valuation of all debt in all circumstances is appropriate

Given the recent release of FASB/AICPA standards, do you think the valuation of all debt in all circumstances is appropriate

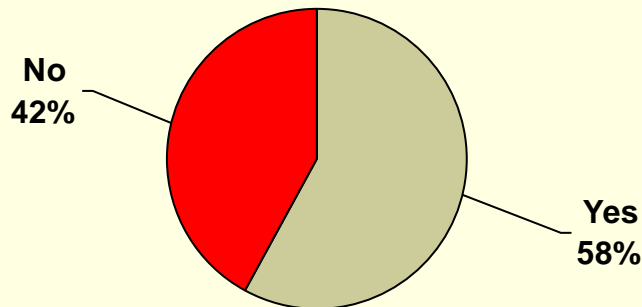
■ Based Upon Number of Respondents (24):

- Yes 58%
- No 42%

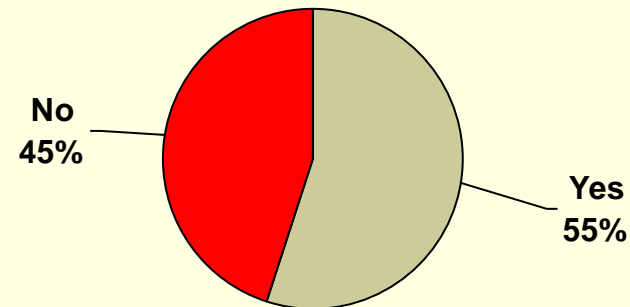
■ Based Upon Plan Total Private Real Estate Assets (\$148 billion):

- Yes 55%
- No 45%

By number of respondents



By Net Assets Value



Reasons exist on both sides; reasons to value or not sometimes contradict each other

Please explain circumstances where you think the valuation of debt is...

Appropriate

- In order to be in compliance with GAAP
- For open-end funds (traded interests)
- Whenever asset is valued
- Valuation of debt balances volatility of asset valuation
- Promotes consistency, comparability and transparency of information
- For core and stabilized properties only
- Upon sale of the asset
- When the debt valuation adjustment is material to the plan
- In order to assess exposure
- If there is a secondary market for the trading of Fund interests
- When loans are assumable
- If sale of asset is before the loan matures
- When debt terms are significantly misaligned with market
- When the Industry provides appropriate and consistently applied methodology

Not Appropriate

- When immaterial to the plan
- In closed-end funds and/or separate accounts (i.e., restricted entry/exit)
- When loans are not assumable
- Introduces volatility without enhancing understanding of property performance- could lead to focus on short-term performance rather than long-term
- When there is no economic substance to do so
- Cap rates embedded in DCF and take debt into consideration – no separate debt valuation
- When loan term is short
- When debt has floating rate
- Lack of comparability to similar alternative investments that don't value debt

Separate Accounts and Direct Investment

When a Plan Sponsor has control.

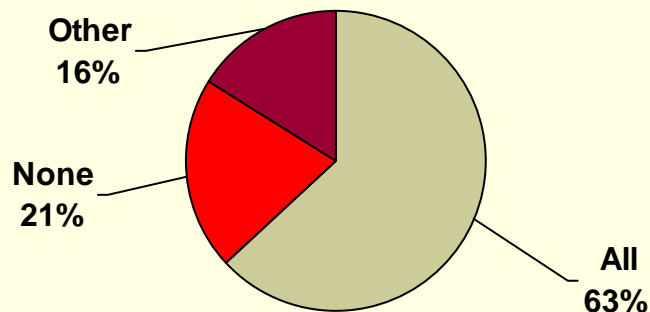
For separate accounts, majority of Plan Sponsors by number favor always valuing debt, but only half by NAV

Given the release of FASB/AICPA standards, in what circumstances will you require managers to value debt for separate accounts:

Based on Number of Respondents
With Separate Accounts (19):

- All circumstances 63%
- None 21%
- Other 16%
(e.g. contract-by-contract)

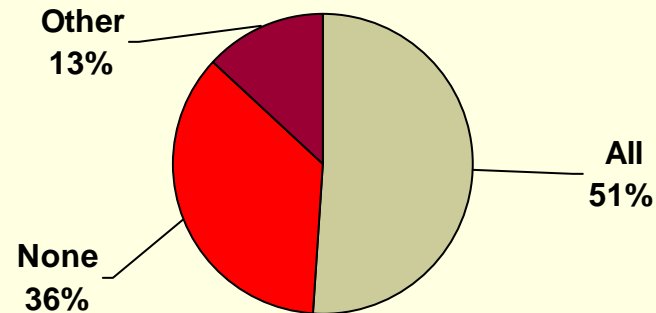
By number of respondents



Based on Net Asset Value (\$69 billion):

- All circumstances 51%
- None 36%
- Other 13%
(e.g. contract-by-contract)

By net asset value



Separate accounts - Why or why not require managers to value debt?

Value debt in all circumstances

- Consistency, comparability and transparency
- Provides additional information to make informed decisions
- Compliance with GAAP
- Compliance with REIS
- Look at what happened to failed lenders
- Internal pressure

No circumstances or other

- When leverage is immaterial to the overall plan
- Decision should be left to Investment Manager community as experts
- Decision should be loan by loan

Those with direct investments clearly support valuing debt in all circumstances

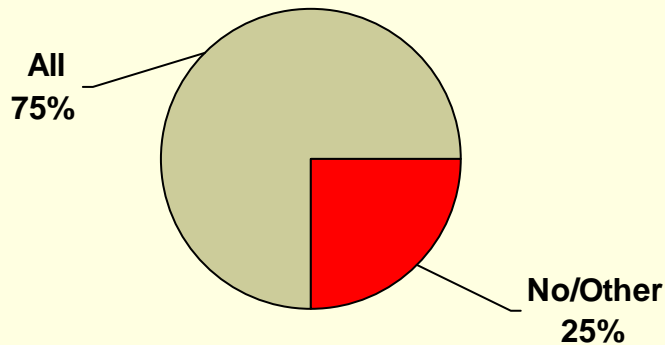
Given the release of FASB/AICPA standards, in what circumstances will value debt for direct investments:

Each Plan Sponsor who had both direct investments and separate account investments treated them consistently.

Based on Number of Respondents With Direct Investments (8):

- All circumstances 75%
- No circumstances - case by case 25%

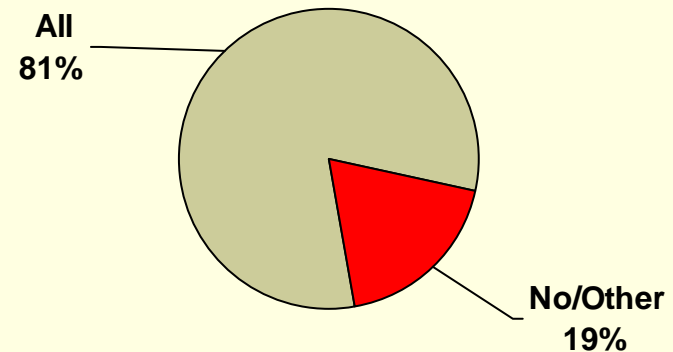
By number of respondents



Based on Net Asset Value (\$25 billion):

- All circumstances 81%
- No circumstances - case by case 19%

By net asset value



Note: Direct investment refers to Plan Sponsor investments in real estate where a manager is not used.

Commingled Funds

For commingled funds Plan Sponsors *overwhelmingly* expect to continue booking NAV as the value of their interest, no matter what debt valuation policy is selected

Given the recent release of FASB/AICPA standards, will you be reporting your share of the NAV for your commingled fund investments as the value of your interest in that fund?

- Based on number of respondents with commingled funds (20)
 - 85% - Intend to always book plan's share of NAV for commingled funds as plan's value of interest in that fund, irrespective of the fund's debt valuation policy
 - 10% - Only where all debt is valued within the commingled fund
 - 5% - Only where debt is not valued within the commingled fund

- Based on NAV (\$51 billion):
 - 90% - Intend to always book plan's share of NAV for commingled funds as plan's value of interest in that fund, irrespective of the fund's debt valuation policy
 - 9% - Only where all debt is valued within the commingled fund
 - 1% - Only where debt is not valued within the commingled fund

Why most Plan Sponsors won't deviate from recording their share of NAV

- Reliance on fund managers
- Limited staff, resources and lack of expertise
- Expense of conducting valuation
- Size of interest in commingled fund is immaterial to overall plan size
- Assumption that commingled fund is already REIS compliant
- Lack of ability to control the decision made by the investment manager
 - appropriateness of investment strategy for the plan is more important than the decision to value debt
- Plan's staff is compensated based on performance of funds: adjustments to reported results would be a conflict
- Plan relies on manager-supplied audited results regardless of debt valuation policy
- "... Serious doubts on whether marking debt adds anything more than confusion to the NAV assessment ..."

And for those who may not book NAV provided by Investment Manager...

- NAV will be examined for compliance with plan's debt valuation policy to assess overall exposure and full evaluation based on entire plan assets, not just real estate

Do you think the REIS requirements to value debt in the financial statements is appropriate? In nearly every case, a “Yes” response came with a qualifying remark.

Given that the current REIS Standard is to present all debt at fair value in a fund’s fair value financial statements: Do you think that requirement is appropriate? Please explain.

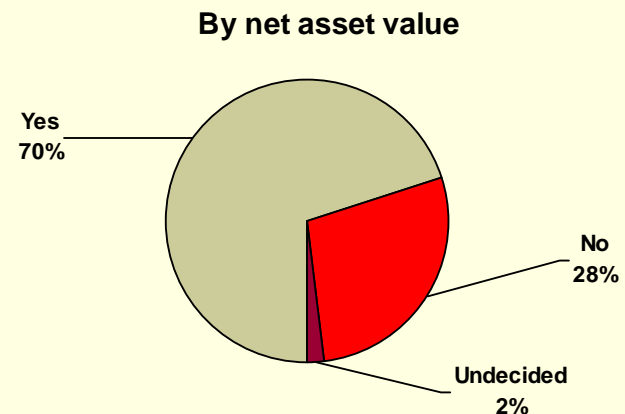
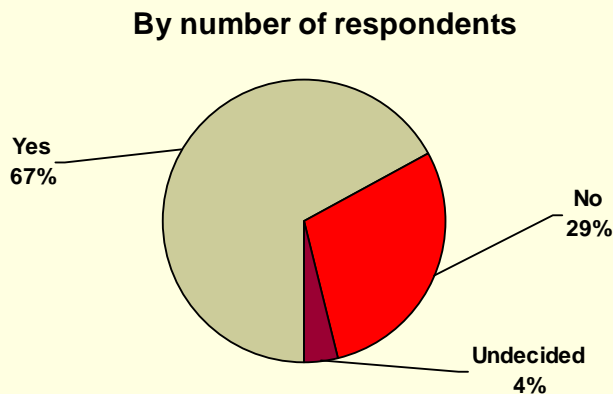
Yes responses were qualified (details in next slide)

■ Based upon Number of Respondents (24):

■ Yes	67%
■ No	29%
■ Undecided	4%

■ Based upon NAV (\$148 billion):

■ Yes	70%
■ No	28%
■ Undecided	2%



If the Standard is not appropriate....any suggestions?

Yes, but...

- All funds need to show it in the same way for comparability
- Materiality and cost to implement and maintain should be considered
- It may not be *entirely* realistic
- The rules must be applied to everyone consistently
- Quarterly is not appropriate
- Investors must be prepared to see more volatility

No, changes would be...

- Do not require valuation when debt is short term
- Specify that it applies to material changes
- Base the requirement to value debt on decision maker's intent
(e.g. holding period, assumability)
- Specify that floating-rate debt is assumed already at market
- Limit requirement to open-end funds only
- For closed-end funds, require for assumable debt only
- Change requirement to recommendation
- Make the decision to value debt the investor's decision:
- Let the manager elect per GAAP – maintain notion of election consistent with SFAS 159
- Consider annual requirement to value debt, not quarterly

REIS compliance rarely impacts manager selection for commingled funds

Commingled funds - when selecting a commingled fund for investment, do you require that it be REIS compliant?

- Based on Number of Respondents an overwhelming 90% (21) did not require REIS compliance from their managers
- One required compliance
- One was unsure
- By NAV, 83% did not require REIS compliance

While debt valuation has been discussed with investment managers it has not been a clear audit concern

- 22 of the 24 respondents utilize investment managers
 - 82% of Plan Sponsors by NAV have had discussions with investment managers
- Of the plan sponsors who had exposure to an audit (e.g., internal, external, plan level, asset level) , a discussion on the concept of debt valuation had not always occurred
 - By number of responses
 - 29% had discussed it with auditors
 - 54% had not
 - 17% were unknown
 - By NAV
 - 47% had discussed it
 - 37% had not
 - 16% unknown

Other items – alternative investments and other bases of accounting

- Generally, Plan Sponsors were unable to comment on debt valuation policy for alternative investments
 - Typically not managed by real estate division
- Other Bases of Accounting
 - 1/3 of Plan Sponsors (33% of respondents – 36% by value) have had some exposure to other bases of accounting including IFRS, Tax, and UK GAAP
 - Of those, it was unknown as to how the concept of debt valuation was treated

Industry issues to consider

- Increase REIS awareness among industry participants through publications, industry seminars and conferences and other marketing opportunities
- Provide REIS education to industry participants
 - Fund Managers, Plan Sponsors, and Independent Auditors
- Provide guidance for **how** debt should be valued, **when** it is valued
- Research notion of NAV volatility when debt is valued – fact or myth?
- Follow through with a REIS checklist

Plan Sponsor Conclusion of the Task Force for REIS Council and Board consideration:

- REIS should require the fair value of debt in either the face of the financial statements or within enhanced disclosures
 - The dollar amount of a debt valuation adjustment not reported in the Net Asset Value (NAV) within the financial statements should be required so that an investor adjustment can be made to NAV if necessary.
 - Disclosures should be subject to any necessary audits and not considered “supplemental” to the audited financial statements.
- Reasons for this conclusion:
 - Removing the “requirement” nature would lessen the importance
 - Enhanced disclosures which show the dollar impact on NAV are perceived to be a more palatable solution for Investment Managers who are not necessarily disclosing the required valuation information currently under FAS 107.
 - The answer is the important issue, not the geography

Plan Sponsor Interviewees

24 Firms - approximately \$150 billion* in U.S. Real Estate Private Equity Investments

Alaska Electrical Pension Fund
Alaska Permanent Fund
Alaska Retirement Management Board
Alcatel-Lucent Investment Management Group
APG
Brown University Investment Office
CalPERS
CalSTRS
Colorado Public Employees Retirement Account
Florida State Board of Administration
General Motors Asset Management
Iowa PERS

LACERA
MassPRIM
New York State and Local Retirement System
NYSTRS
Ohio PERS
Ohio SERS
STRS Ohio
State of Michigan Retirement System
Texas Teachers Retirement System
TIAA-CREF
University of California, Office of the Regents
Virginia Retirement System

Advisory Group Participants

Chair

Doug Poutasse, Executive Director, *NCREIF* and Chair, *REIS Board*

Jeff Kiley	Partner	<i>PricewaterhouseCoopers</i>
Tom Mulvin	Investment Officer	<i>Virginia Retirement System</i>
Joe Pagliari*	Clinical Professor of Real Estate	<i>University of Chicago Graduate School of Business</i>
Kevin Scherer	Managing Director	<i>BlackRock</i>
Lynn Thurber*	Chairman	<i>LaSalle Investment Management</i>

*REIS Board Member

Task Force Participants

Chair

Jim Strezewski, Senior Vice President, *LaSalle Investment Management*

Co-Chair

Monica Parikh, Director of Research, *Metzler, North America*

REIS Administrator

Marybeth Kronenwetter, President, *Real Estate Investment Advisors*

Lindsey Adams	Vice President, Portfolio Manager	<i>AMB Capital Partners, LLC</i>
Sara Geiger	Portfolio Manager, Real Estate	<i>Florida State Board of Administration</i>
Ken Greguski*	Director, Global Head of Performance/Client Reporting	<i>RREEF Alternative Investments</i>
Denisa Hall	Vice President	<i>Prudential Real Estate Investors</i>
Barbara McDowell*	Director, Portfolio Analytics	<i>ORG Portfolio Management</i>
Michael Morrell	Assistant Manager of Real Estate/Asset Management	<i>NYSTRS</i>
Brian Rueben	Partner	<i>Deloitte</i>
Ashley Strange	Private Markets	<i>TRS of Texas</i>
Connie Tirondola	Director, Portfolio Accounting	<i>BlackRock</i>
Candice Todd*	Executive Director	<i>Morgan Stanley Real Estate</i>
Serena Wolfe	Senior Manager	<i>Ernst & Young</i>

* REIS Council Member
11/3/08