



October 7, 2010

Board of Governors of the Federal Reserve System  
20th Street and Constitution Ave  
Washington, DC 20551

Dear Governors:

The Mortgage Bankers Association<sup>1</sup> (MBA) is writing to you in relation to Section 941 (i)(c)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) which requires a study (Study) of the impact of risk retention on Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* (FAS 166) and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167). MBA is the voice of the real estate finance industry, with both residential and commercial constituencies. This letter comments separately on the interaction of risk retention rules and FAS 166 and 167 as they relate to the commercial mortgage backed securities (CMBS) market and the residential mortgage backed securities market (RMBS).

### **Background**

On June 12, 2009, the Financial Accounting Standards Board (FASB) issued FAS 166 and FAS 167. FAS 166 and FAS 167 removed the concept of a qualifying special-purpose entity (QSPE) from generally accepted accounting principles (GAAP) and altered the criteria under which special purpose entities, like mortgage-backed securities (MBS) trusts, must be included in the issuer's, controlling class holder's or servicer's consolidated financial statements. FAS 166 contains rules which govern whether a

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<sup>1</sup> The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: [www.mortgagebankers.org](http://www.mortgagebankers.org).

transaction qualifies for sale treatment. FAS 167 specifies principles for the accounting for special purpose entities like securitization trusts and which party, if any, must include a securitization's assets and liabilities in its consolidated balance sheet. Specifically, FAS 167 states the party to the transaction who has both a potentially significant variable interest in the variable interest entity (VIE) and has the most power to direct those activities that have the greatest impact on the economic performance of the VIE must consolidate the VIE's assets and liabilities in its consolidated financial statements. FAS 167 does not specifically define a potentially significant variable interest. However, after the first year of experience with FAS 167, most accounting firms define that in terms of percent of default risk. Section 941 of the Dodd-Frank Act establishes a new requirement for securitizers to retain a portion of the credit risk of assets they securitize, subject to certain exceptions. The Act also requires the Board of Governors of the Federal Reserve System (Federal Reserve), in consultation with the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation and Securities and Exchange Commission to study the impact of these risk retention rules and FAS 166 and FAS 167 on asset backed securities (ABS).

MBA offers the following comments in order to assist the Federal Reserve in conducting its study. MBA's comments address the impact of credit risk retention requirements, FAS 166 and FAS 167 on the CMBS and RMBS markets.

## **CMBS Market**

### **Discussion**

MBA's primary concern is that risk retention rules may force consolidation of assets on the balance sheets of issuers, and this would greatly reduce participation in the CMBS market. Under FAS 167, an issuer which has both the right to receive significant variable benefits and the ability to direct the most significant activities of a securitization trust must consolidate. In a traditional CMBS structure, it is widely accepted that the "Special Servicer" directs the most significant activities of the CMBS Trust. However, under FAS 167, if a party has the unilateral and exclusive right to fire the Special Servicer, it will be deemed the party with the most power to direct the activities of the vehicle.

One of the underlying fundamental structural features of CMBS is to empower the holder of bonds with the first risk of loss to replace the Special Servicer on the theory that the party most likely to recognize losses from the performance of a CMBS pool will be highly motivated to ensure that the servicer does the best job possible in servicing the pool on

behalf of the bondholders. Consequently, in most CMBS transactions, the holder of the first loss bonds, sometimes called the “Controlling Class,” with consultative rights with the Special Servicer and the right to change the Special Servicer in its discretion, will be the primary beneficiary and be required to consolidate the vehicle. The theoretical underpinnings of the structure are, of course, that the Special Servicer will be highly responsive to a party who has the power to terminate its contract.

If the issuer is required to retain a significant variable interest, it would, as a matter of prudence, need the same rights as a third party first loss buyer and, consequently, would likely become the Controlling Class investor. The issuer’s retention of a first loss piece, plus its right to terminate the Special Servicer, would make it the primary beneficiary under FAS 167, and it would consequently be required to consolidate the assets and liabilities of the securitization.

This consolidation would dissuade both regulated and publicly held institutions from participating in the securitization market as securitizers because of the balance sheet and income statement distortions accompanying consolidation. If consolidation is required, assets would be significantly increased, liabilities would be significantly increased, reserves for loan losses would also be increased and, in the case of regulated institutions, capital ratios would become distorted. Distorted capital ratios might require additional capital. All of these issues would likely result in both regulated and publicly held institutions withdrawing from the market as securitizers. If regulated and publicly held institutions choose not to participate, it would leave the market to private, unregulated companies leading to significantly less liquidity and less credit available for new lending. We, therefore, urge you to draft regulations that would allow companies to avoid those consequences.

### **Conclusion**

As the Federal Reserve conducts its study of the combined impact on each individual class of asset-backed security (ABS) of risk retention requirements and their impact under FAS 166 and FAS 167, in response to the Dodd-Frank Act’s mandate, MBA submits the following with specific attention to the CMBS market:

Impacts on the market:

- If any risk retention requirements that the regulators promulgate as a result of the Dodd-Frank Act result in consolidation of assets on the balance sheets of CMBS issuers, we believe that will greatly reduce participation in the CMBS market.
- Regulated institutions, such as banks, would be required to hold additional capital should consolidation be required.
- Any requirement that issuers must retain a variable interest should be structured so that the issuers would not be obligated to consolidate the related securitization.

If that outcome is not achieved, an unintended but very real and strong disincentive will be created for regulated institutions as well as public companies to participate in the securitization market. This will starve the commercial real estate marketplace for capital, which will be a very significant drag on the overall economic recovery.

- Consolidation could lead to distortions in the balance sheet and income statements of publicly traded companies.

Recommendations:

- Regulations should be crafted in such a way to avoid consolidation on the balance sheets of CMBS issuers. The regulations should allow for a number of different forms of risk retention, provided there is an alignment of interest in assuring the performance of the loans.
- MBA would also urge you to provide flexibility in the regulations to allow for many different forms of risk retention, as allowed in Section 941 (c)(1)(E) of the Dodd-Frank Act, provided that there is an alignment of interest in assuring the performance of the loan. MBA will be providing, in a subsequent letter to the regulators, more specific recommendations for the retention of credit risk as it relates to commercial mortgages and this section of the statute.

## **RMBS Market**

### **Discussion and Recommendation**

The Dodd Frank Act requires federal banking agencies and the Securities and Exchange Commission (SEC) to issue rules to require that securitizers retain an economic interest of at least five percent of the credit risk in assets they securitize. The Dodd Frank Act also requires regulators to establish and define a specific exemption for “qualified residential mortgages” taking into consideration underwriting and product features that historical loan performance data indicates result in a lower risk of default. MBA will be issuing a letter to the banking agencies and the SEC with specific recommendations for the definition of qualified residential mortgages.

As to the interaction of FAS 166 and 167 with the proposed risk retention, MBA provides the following background information. RMBS are generally credit-enhanced in the following ways:

- A securitization could have a senior/ subordinate lien structure whereby the subordinate holder suffers first losses.
- A securitization could have over-collateralization where the amount of loans transferred exceeds the amount of beneficial interests issued with the transferor retaining the first risk of loss.
- A securitization could be credit-enhanced by a third party surety.

Typical RMBS structures have a master servicer who may perform all servicing functions themselves, or who may contract with other companies to perform certain servicing functions. The servicer(s) collects the monthly principal, interest and escrow payments (for property taxes and hazard insurance) from the mortgagors; performs collection and foreclosure services; pays tax and insurance bills; and remits principal and interest to the bondholders. When more than one servicer collects monthly principal and interest payments from mortgagors, each servicer remits to the master servicer, and the master servicer does the pool level accounting and remittance to individual bond investors. Often the master servicer is the issuer of the securities or an affiliate of the issuer.

Under FAS 167, the subordinate bond holder or the third party surety would likely be deemed to be a party with a potentially significant variable interest. In order to be required to consolidate the VIE, these parties would also need to have the power to direct the activities of an entity that most significantly impacts the entity's economic performance. Frequently, the master servicer or servicer is deemed to be the party that has this power since default risk is deemed to be the primary driver of economic performance, and the master servicer or servicer is the party that performs collection and foreclosure processes or can remove at will the Special Servicer whom they have hired to perform this function.

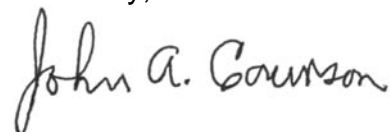
Each securitization is unique requiring the parties to study their respective retained interests and ongoing roles to determine if they have a potentially significant variable interest and the power to direct those activities that most significantly impact the entity's economic performance, including consideration of kick-out rights.

MBA's recommendation for regulations related to RMBS is similar to our recommendation for CMBS. Regulations should be crafted in such a way to avoid consolidation on the balance sheets of RMBS issuers and to provide flexibility to allow for many different forms of risk retention, as allowed in Section 941 (c)(1)(E) of the Dodd-Frank bill.

## **Conclusion**

MBA hopes the Federal Reserve finds these comments helpful. We stand ready to offer additional assistance as you undertake the various regulations and studies mandated by the Dodd-Frank Act.

Sincerely,

A handwritten signature in black ink that reads "John A. Courson". The signature is written in a cursive style with a large initial 'J' and 'C'.

John A. Courson  
President and Chief Executive Officer  
Mortgage Bankers Association