



ISSUE PAPER

Subject: Interpretation of FASB Statement No. 140 – Treatment of CMBS and RMBS Trusts as Qualifying Special Purpose Entities (QSPEs)

Issue: In late 2005, the Financial Accounting Standards Board (FASB) added a “Servicer Discretion Project” to its agenda to address questions about the permissible activities of a qualifying special-purpose entity (QSPE) under Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities* (FAS 140). While the project was intended originally to address questions about the permissibility of certain CMBS servicing activities, its scope has been expanded effectively to include questions about certain RMBS servicing activities. Most recently, questions have been raised about whether the planned restructurings of certain securitized residential mortgage loans that are in default or in reasonably foreseeable default are permissible activities of a QSPE.

The project concerns MBA because transfers of loans to trusts that are not QSPEs must be treated as secured borrowing arrangements, rather than as sales, for accounting purposes. If a QSPE ceases to be qualifying because it no longer meets the qualifying conditions in FAS 140, a transferor of the loans to the QSPE would be required to record a ‘repurchase’ of any remaining previously transferred loans to the QSPE and recognize any liabilities assumed.¹ The effect would be an expansion of the transferor's balance sheet to include loans to which they no longer have legal title and liabilities they are not legally obligated to pay, with negative financial statement and regulatory capital implications for the company. This would disrupt the commercial and residential real estate markets because lenders would be forced to look for alternative avenues for selling their loans, thus reducing borrowers’ access to funding through the capital markets.

Background: FAS 140 is the accounting standard for securitizations and other transfers of financial assets. The guidance in FAS 140 distinguishes transfers of financial assets that are sales from those that are secured borrowings, and stipulates that a transfer of a loan to a securitizing entity must be a QSPE in order for the transfer to be accounted for as a sale. FAS 140 contains the defining conditions for a QSPE, including a condition that the permitted activities of the QSPE must be significantly limited and entirely specified in the legal documents that established the SPE, or created the beneficial interests in the transferred assets that the SPE holds. FAS 140 went into effect for transfers of financial assets after March 31, 2001. Additional guidance on the types of activities that are permissible for QSPEs can be found also in EITF Discussion Topic D-

¹ See paragraph 55 of FAS 140.

Interpretation of FASB Statement No. 140 – Treatment of CMBS and RMBS Trusts as Qualifying Special Purpose Entities (QSPEs)

Page 2

99, *Questions and Answers Related to Servicing Activities in a Qualifying Special-Purpose Entity under FASB Statement No. 140*, which was released in July 2001, and the FASB Special Report, *A Guide to Implementation of Statement 140...*, dated 2001.

CMBS and RMBS structures have been fundamentally the same since the inception of the market in the early 1990's and early 1980's, respectively. To date, typical CMBS and RMBS trusts have been considered to meet the conditions of a QSPE as set forth in the accounting literature. In 2005, however, some auditors questioned whether the trusts used in commercial securitizations are, in fact, QSPEs based on the premise that certain types of CMBS servicing activities are not "permissible" activities of a QSPE.

To address these questions, the FASB decided on December 20, 2005 to open a special project to clarify servicer discretion in the context of a QSPE. Three specific issues were raised as examples of activities that might be contrary to the intent of FAS 140:

1. the ability to waive a due-on-sale provision (i.e. substitute borrowers);
2. the substitution by a borrower of collateral underlying a loan; and
3. the extent of permitted servicer activities in connection with the sale of real estate temporarily held by the QSPE.

The FASB formed a resource group consisting of representatives from the commercial mortgage securitization industry, the residential mortgage securitization industry, the four largest accounting firms, the banking and insurance industries, and participating observers from the Public Company Accounting Oversight Board (PCAOB), the U.S. Securities and Exchange Commission (SEC) and banking regulators. Representatives from The Capital Consortium, which is a federation of five trade associations – the Commercial Mortgage Securities Association (CMSA), Mortgage Bankers Association (MBA), the National Association of Realtors (NAR), The Real Estate Roundtable (RER) and the Securities Industry and Financial Markets Association (SIFMA) along with its affiliate the American Securitization Forum (ASF), also participate in this resource group. The purpose of the resource group was to assist the FASB staff in understanding the nature of activities exercised by servicers of different types of securitized assets.

MBA, in conjunction with the other trade associations within the Capital Consortium, provided practical information to the FASB Resource Group on how the commercial real estate industry is operating in accordance with the established accounting standards created by the FASB as they relate to servicing. MBA used these documents to educate Congressional staff of the House Financial Services Committee and Senate Banking Committee during meetings conducted during the National Policy Conference on April 26 and 27, 2006.

At a Board Meeting on July 26, 2006, FASB decided to incorporate its "Servicer Discretion Project" within its "Transfers of Financial Assets Project." During an FASB Educational Session on September 20, 2006, FASB staff introduced and received feedback from the Board on two proposed approaches for addressing questions about the permitted activities of a QSPE. One of the approaches utilizes a proposed Passive Asset/Liability (PAL) model, which would limit the activities of a qualified special-purpose entity (QSPE) to those that involve only "basic servicing." MBA participated in drafting a letter to the FASB staff from several members of the FASB Resource Group regarding

Interpretation of FASB Statement No. 140 – Treatment of CMBS and RMBS Trusts as Qualifying Special Purpose Entities (QSPEs)

Page 3

their reluctance to support the PAL model as a viable solution to the issues surrounding permitted activities of a QSPE.

MBA Position: MBA strongly believes that any decision by the FASB that would unnecessarily restrict the long-standing and beneficial activities of servicers of assets held in CMBS and RMBS trusts would have dramatic, adverse implications for all participants in those markets. Those implications would include new limitations on standard commercial loan servicing practices which would be viewed negatively by the ratings agencies.

Status: On May 30, 2007 the FASB met to discuss the initial feedback received from the FASB Resource Group on the PAL model and to discuss the Staff's research on a Linked-Presentation (LP) model as an alternative to the PAL model. The Staff explained that respondents from the FASB Resource Group generally did not support the PAL model as a workable solution to the transfers of financial assets project. The Board agreed to direct the Staff to research alternatives to the PAL model, including the LP model. The LP model removes the QSPE requirement from FAS 140 (Paragraph 9(b)) and creates criteria to determine how the assets and liabilities arising from a transfer of assets should be presented on the balance sheet. The Board directed the Staff to further research what a change in the balance sheet presentation using the LP model could mean for a company's right to pledge or exchange receivable assets. The Staff also would need to recommend the threshold for "continued involvement" and "basic servicing."

On May 24, 2007 MBA sent the FASB Chairman a position paper, FAS 140 Implications of Restructurings of Certain Securitized Residential Mortgage Loans, which sets forth the industry's positions on several questions that have been raised with respect to the reporting implications of modifications of securitized residential loans. MBA developed the position paper in response to Congressional and regulatory recommendations that lenders work constructively with residential borrowers who are financially unable to meet their mortgage payments. On June 15, 2007 House Financial Services Committee Chairman Barney Frank (D-MA) and other members of Congress sent a letter to SEC Chairman Chris Cox requesting that the SEC clarify the accounting guidance with respect to the financial reporting implications of modifications of securitized loans that are in reasonably foreseeable default.

On Friday, June 22, 2007 the Financial Accounting Standards Board (FASB) held a closed educational forum among representatives of the residential mortgage industry, including residential mortgage servicers, and attorneys, regulators and accountants, to consider issues associated with modifications of certain securitized residential mortgage loans. Two FASB members (Bob Herz and Leslie Seidman) were in attendance along with FASB staff, including Larry Smith, FASB's Director of Technical Application and Implementation Activities, and Chairman of the Emerging Issues Task Force (EITF), who will be replacing FASB member, Ed Trott, on July 1, 2007.

The FASB participants indicated that they will continue to move forward with their plans on the current FAS 140 - Transfers of Financial Assets project. However, the general consensus of FASB participants and representative from the Securities and Exchange Commission appeared to be that the servicer limited activities described in the MBA paper dated May 24, 2007 are consistent with the accounting guidance in FAS 140.

Interpretation of FASB Statement No. 140 – Treatment of CMBS and RMBS Trusts as Qualifying Special Purpose Entities (QSPEs)

Page 4

During the course of the meeting, the FASB expressed support for a principles-based approach for FAS 140 as indicated by comments made by FASB members and staff that the activities of servicers should benefit the trust as a whole rather than just the interests of specific investment classes.

The FASB web site indicates that an exposure draft of a proposed amendment of FAS 140 is scheduled to be released in the fourth quarter of 2007. MBA will continue to monitor developments by FASB on this project and work with the Capital Consortium to educate FASB on how any potential changes to the accounting treatment for securitizations may adversely impact its members.

CREF Staff Contacts: **Deborah McKinnon**
(202) 557-2746

Residential Staff Contact: **Alison Utermohlen**
(202) 557-2864

Legislative Staff Contacts: **Josh Denney**
(202) 557-2816

Date: **July 2007**