



FannieMae

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Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
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Letter of Comment No: 70
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Dear Ms. Bielstein:

Fannie Mae appreciates the opportunity to comment on the Exposure Draft entitled *Consolidation of Certain Special-Purpose Entities – an interpretation of ARB No. 51* (ED). We commend the FASB for promptly addressing questions being raised in the marketplace about the consolidation of special-purpose entities (SPEs). We believe this is a good step toward integrating the concepts of control and risks and rewards into the model for consolidation of SPEs. We generally support the ED because it appropriately applies the concepts of control and risks and rewards to participants in the securitization of mortgages. The ED sets forth a paradigm for qualifying special-purpose entities (QSPEs) that would properly not result in lenders, servicers, guarantors, and investors in the mortgage-backed securities (MBS) market having to consolidate the underlying loans. However, we recommend FASB improve the clarity of its definition of market-based fees to enhance consistent application of its QSPE paradigm. We also suggest the FASB more clearly explain the underlying principles for determining whether to consolidate SPEs. For example, the ED does not sufficiently describe how the concepts of control and risks and rewards should be aggregated when making a consolidation decision for SPEs. In addition, the principles behind the concept of variable interests and a market-based fee are inadequately described, which would make it difficult to determine which party (if any) should consolidate a SPE in a given transaction.

Application of the QSPE Paradigm to Securitization of Mortgages

Fannie Mae is deeply involved in the MBS market, and we believe the ED generally sets appropriate parameters for determining whether participants in the securitization of mortgages provide significant financial support to the QSPE that holds the mortgages and issues MBS. At June 30, 2002, we guaranteed \$945 billion in MBS. Participants in the mortgage securitization process typically include the lender that transfers loans to a QSPE, the servicer of the loans in the QSPE, the guarantor of timely payment of principal and interest to investors in MBS, and the MBS investor. None of these participants should have to consolidate the QSPE that facilitates the issuance of MBS because no one participant both controls the activities of the SPE and holds most of the risks and rewards.

The lender that transfers loans to a QSPE does not have a variable interest in a mortgage securitization because the transaction is scoped out of the ED. In a typical MBS transaction, a lender transfers loans into a Fannie Mae trust and the lender receives MBS from the trust ("swap and hold"). In some cases, a lender may provide recourse to the guarantor of the MBS to lower the guaranty fee it would pay the guarantor of the MBS. However, the lender does not have the authority to purchase and sell assets for the QSPE and cannot significantly affect the performance of the QSPE. Nor does the lender receive a fee that is not market based. Therefore, the lender that

provides recourse would not be considered a primary beneficiary of the QSPE because it lacks control over the assets in the QSPE and does not hold the most of the risks and rewards in the assets of the QSPE.

The **servicer's** obligation to service loans in a QSPE meets the definition of a variable interest; however, it would appropriately not be considered a primary beneficiary under the ED. A servicer is obligated to service the loans in the QSPE, but does not have the authority to purchase and sell assets for the SPE. A portion of the interest collected on loans in a QSPE is paid to the servicer for its efforts; however, the fee is not subordinate to other variable interest holders and the fee is market based. A servicer does not have sufficient control over the assets of the QSPE nor a sufficient level of risks and rewards through its variable interest to potentially warrant consolidation, and the ED comes to the appropriate conclusion.

The **guarantor's** obligation to ensure MBS investors receive timely payment of principal and interest on the underlying loans meets the definition of a variable interest, yet it does not provide significant enough financial support to warrant consolidation of the QSPE holding the underlying loans. Even though our guaranty of principal and interest to investors is subordinate to the interests of other parties, we receive a market-based fee. Our guaranty fee is sufficiently comparable to fees that Freddie Mac or other competing guarantors would receive for a similar arm's length transaction to overcome the presumption that it is not market based. Plus, we do not have the discretionary authority to purchase and sell assets for the QSPE and significantly affect the financial performance of the QSPE as guarantor. For these reasons, Fannie Mae's guaranty does not represent a significant enough level of control over the QSPE and risks and rewards in the QSPE to justify consolidation of the loans underlying an MBS, and the ED generally leads the guarantor to the appropriate conclusion. To improve the definition of market-based fees, we suggest the FASB generally discuss what might be sufficient evidence of comparable fees to increase consistency in application. We believe the critical issue to assessing whether there is additional control or risk and rewards in a service fee is whether the fee is negotiated in an arm's length transaction under competitive conditions.

MBS investors also hold variable interests in MBS, but they do not maintain a sufficient level of control and risks and rewards to consolidate the underlying loans. In a "swap and sell" transaction, investors give the QSPE cash to purchase the underlying loans from the lender and investors receive certificates in return. These certificates meet the definition of variable interests because investors can gain or lose from changes in the value of the underlying loans when they sell their investment based on changes in interest rates. However, investors do not have purchase or sale control over the assets of the QSPE. In addition, investors do not share in all the risks and rewards of the underlying loans as they are protected against the risk of nonpayment by the borrowers by a guaranty. The ED would produce the proper consolidation answer for MBS investors as they would not consolidate the underlying loans because they do not have the authority to purchase and sell assets for the QSPE, do not have a subordinate interest, nor do they receive a fee that is not market based.

Improving the Conceptual Framework

We believe the FASB could improve the quality of the guidance in the ED by further developing and highlighting how the concepts of control and risks and rewards should be considered in a consolidation decision. These concepts underlie the various paradigms within the ED to guide preparers to a consolidation decision, but the ED emphasizes the requirements of the paradigms much more than the concepts underlying them. For example, the ED does not provide any guidance on how entities should combine the concepts of control and risks and rewards (and the elements of investments or relationships that reflect these characteristics) to determine whether consolidation is appropriate. Such guidance would help preparers properly apply the paradigms in situations where some indicators point to consolidation while others do not. In addition, it would assist preparers with transactions

that have not been contemplated by the FASB or the marketplace. Additional conceptual guidance would increase consistency in practice and make financial information more relevant for financial statement users.

The insufficient discussion of the concepts of control and risks and rewards would make it particularly difficult to apply the definition of variable interests and identify the primary beneficiary of a SPE. The analogy between variable interests and equity interests in the basis for conclusions is not robust enough to compensate for these conceptual shortcomings. For example, which of two entities is the primary beneficiary if:

- a) one entity has more control but another has more risks and rewards, or
- b) one entity has more of the rewards and one entity has more of the risk?

Neither of these examples fit in neatly with the analogy between variable interests in a SPE and an equity investment in the basis for conclusions:

"The Board reasoned that providers of financial support to an SPE would be expected to have risks and opportunities to benefit (risks and rewards) that are of the same character as those of an equity investor. At the same time, they arrange to protect their investment through means other than ownership of voting shares. Effectively, the providers of financial support are in the same position as parents in a conventional parent-subsidiary relationship, except that the mechanism that establishes the relationship is different." (paragraph B15)

However, the equity investment analogy would not help preparers conclude whether the party holding most of the control or the party holding most of the risks and rewards would be the primary beneficiary. Furthermore, the analogy calls into question why the entity with the larger amount of expected future losses should consolidate (as proposed in paragraph 20 and footnote 3 to paragraph 9b) when another variable interest holder has a greater level of expected future gains. In the case of an equity investment, there is a chance for both increases and decreases in the market price of an equity investment depending on future events or circumstances.

The FASB should also build a conceptual framework for the application of its concept of market-based fees because there are dueling presumptions in the definition of market-based fees each with its own set of factors that overcome these presumptions. For example, as we stated earlier, there is no guidance for preparers on the level of evidence that is needed to overcome the presumption that a service is not market based. Furthermore, there is no guidance when to overcome the presumption that a fee negotiated at arm's length is not a variable interest. There is no basis for conclusions for preparers to interpret when a certain level of "investment at risk" or when a set of "certain circumstances" that would require the service provider to transfer assets or issue capital to the SPE or a party with an interest in the SPE is significant enough to overcome the notion that a service fee negotiated at arm's length is not a variable interest.

Periodic Evaluation of Consolidation

We disagree with the requirement in paragraph 14 of the ED that entities reevaluate their consolidation decision at each reporting date. We believe a reevaluation should only be necessary if there is a contractual change that causes a material change in the distribution of risks and rewards or the allocation of control. This would be comparable to evaluating whether a change in a company's ownership concentration or a change in the rights of an equity owner should necessitate a change in consolidation policy.

Our guaranty business is one of our two business segments, and it is critical to evaluating our financial performance. Even though we generally believe the ED would appropriately account for our mortgage securitization activities, we recommend that the FASB enhance its discussion of the principles underlying the

Suzanne Q. Bielstein

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determination of whether to consolidate SPEs. One avenue might be to provide indicators of when the level of risks, rewards, and control is sufficient to warrant consolidation or examples of market-based fees and sufficient discretionary authority to significantly affect the performance of an SPE. If you need any clarification about our positions or the comment letters you receive generate other issues, please contact me and we will attempt to respond promptly. Thank you for considering our views.

Sincerely,

A handwritten signature in cursive script, appearing to read "Jonathan Boyles".

Jonathan Boyles

Suzanne Q. Bielstein
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bcc: Leanne Spencer