

COMMERCIAL MONTGAGE SECURITIES ASSOCIATION 30 Broad Street, 28th Floor New York, NY 10004-2304 Tel 212.509.1844 Fax 212.509.1895 www.cmbs.org

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Major Projects and Technical Activities Director Financial Accounting Standards Board 401 Merritt 7 P. O. Box 5116 Norwalk, CT 06856-5116 Letter of Comment No: | 8 File Reference: 1200-001 Date Received: 07/31/03

Re: File Reference No. 1200-001

Exposure Draft of Proposed Statement of Financial Accounting Standards Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140 (the "Proposed Statement")

Ladies and Gentlemen:

The Commercial Mortgage Securities Association ("CMSA") is pleased to provide its comments on the Proposed Statement.

CMSA is the international trade organization of the commercial real estate capital markets. CMSA's mission is to improve the liquidity of commercial real estate debt securities through capital markets access. CMSA has over 295 members, representing more than 3,000 professionals, including the largest money-center institutions, insurance companies, investment banks, money managers, loan servicers, national statistical rating agencies, and ancillary service providers. CMSA's members represent all aspects of the commercial and multifamily mortgage backed securities ("CMBS") industry, including commercial banks, investment banks, insurance companies, conduit loan originators, warehouse and portfolio lenders, CMBS purchasers, and CMBS master and special servicers.

CMBS create liquidity for long-term commercial and multifamily mortgages and real estate domestically and internationally. Morgan Stanley estimates outstanding CMBS were approximately \$411 billion at June 30, 2003, of which approximately \$360 billion were U.S. CMBS. The ability to achieve SFAS 140 sales treatment is critical to the efficient functioning of the CMBS market.

¹ Exhibit 1 summarizes relevant provisions of a typical CMBS.

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CMSA believes the form and substance of most CMBS transactions are consistent with FASB's intent when the qualifying SPE concept was created in SFAS 125 and carried forward into SFAS 140. CMSA also believes in the spirit of what FASB is trying to accomplish in the Proposed Statement. However CMSA believes the Proposed Statement places too many restrictions on qualifying SPEs, and will likely preclude virtually all securitization special purpose entities ("SPEs") from being qualifying SPEs. Exhibit 2 summarizes CMSA's specific comments on, and recommendations for improvement to, the Proposed Statement.

We hope our comments are helpful to FASB as it redeliberates the Proposed Statement. We believe CMSA's recommendations for improvement will avoid application of the Proposed Statement in a manner that produces unintended results, which would have a chilling effect on the real estate capital markets.

CMSA would be happy to discuss our comments with FASB or clarify CMSA's recommendations for improvement. Please contact Stacy Stathopoulos, CMSA's Regulatory Director, at (212) 509-1844 if CMSA can be of assistance.

Very truly yours,

Dottie Cunningham Chief Executive Officer

Typical CMBS Structure²

One or more loan sellers (each, "Loan Seller") transfers funded commercial and multifamily mortgage loans to an SPE ("First Step SPE") in a transaction that is a true sale. Concurrently, First Step SPE transfers the mortgage loans to a second SPE ("Second Step SPE"). First and Second Step SPE are both SPEs designed to make the possibility that they would enter bankruptcy or receivership remote. Second Step SPE issues several classes of its senior and subordinate CMBS to investors, which represent economic interests in Second Step SPE. Loan Seller may retain all, part, or none of the subordinate CMBS. Second Step SPE is required to use the periodic cash flows it receives from its mortgage loans to pay principal and interest on its CMBS.

Each Loan Seller obtains a true sale legal opinion with respect to its transfer of mortgage loans to First Step SPE and, where applicable, a substantive non-consolidation opinion.

In connection with the mortgage loan transfers, Loan Seller customarily makes a variety of factual representations and warranties as of the date of transfer and/or CMBS issuance relating to the characteristics, origination procedures, and servicing of their mortgage loans from the time of their origination to the time of transfer. These factual representations and warranties do not relate to the post transfer creditworthiness of the mortgage loans or mortgage loan obligors, and do not constitute recourse under regulatory accounting principles where applicable to Loan Seller.

If a representation or warranty with respect to a mortgage loan proves to have been materially incorrect on the date it was made, Loan Seller is obligated to repurchase the mortgage loan or indemnify against any resulting loss. The repurchase obligation is a customary contractual rescission right, similar to state "lemon laws" that allow buyers to return used cars if the used car seller makes misrepresentations in connection with the sale of the car. Neither the repurchase nor the indemnification obligations relate to the credit quality of the mortgage loans after the date those representations and warranties are made.

Credit support for Second Step SPE's CMBS is usually achieved through sequential allocation of mortgage loan principal and interest through the CMBS classes, beginning with the most senior CMBS class, and reverse-sequential allocation of mortgage loan losses, beginning with the most junior class. Second Step SPE is usually, although not always, designed to be a SFAS 140 qualifying SPE, and a real estate mortgage investment conduit ("REMIC")³ for tax purposes.

² Exhibit does not include all CMBS structures. CMSA would be pleased to provide additional details.

³ The REMIC rules are quite restrictive on Second Step SPE's activities.

Some of the commercial and multifamily loans included in CMBS transactions have floating interest rates. The mortgage loan originator may want to cap the related interest rate exposure, particularly when the net cash flow generated by the underlying mortgaged property cannot support an increase in interest rate beyond a certain level, and therefore may require the borrower to obtain an interest rate cap at the time of loan origination. The cap is then pledged as additional security for the mortgage loan. When Loan Seller transfers such a mortgage loan to First Step SPE, the interest rate cap, as well as the mortgage, the assignment of leases, and any other security provided by the borrower to the mortgage loan originator, is also transferred to First Step SPE and subsequently to Second Step SPE.

CMBS transactions frequently include underlying commercial mortgage loans with fixed rates, which do not match the floating rate interest payments on the CMBS (or vice-versa). Sometimes the underlying mortgage loans are payable in a different currency than the currency in which the CMBS are issued. It is customary for Second Step SPE to enter into passive, "vanilla" interest rate and/or currency swaps at the time its CMBS are issued to cover the interest rate and/or currency exposure due to this mismatch.

If an underlying mortgage loan goes into default, Second Step SPE's servicer may foreclose on the underlying mortgaged property and any other security provided for the mortgage loan. The servicer may cause a separate entity to be created to acquire the real property upon foreclosure to isolate potential environmental and other legal risks relating to ownership of such real property from the mortgage loans owned directly by Second Step SPE.

If Second Step SPE owns mezzanine commercial mortgage loans, such loans customarily include additional security in the form of a pledge of the equity securities representing ownership of the borrower to secure the related mortgage loan. If a mezzanine mortgage loan defaults, the best remedy available to the mortgage loan servicer may not be to foreclose on the second lien mortgage on the real property that secures the mortgage loan, but to foreclose on the security interest in the borrower's equity securities, thereby taking over control of the borrower, and controlling the property.

Specific Comments On The Proposed Statement

Paragraph 35(c)(1):

Proposed Text;4

A qualifying SPE may hold only ... financial assets transferred to it that are not equity instruments and that are passive in nature.

CMSA agrees that a qualifying SPE should not be allowed to hold equity securities transferred to it by a SFAS 140 transferor. CMSA believes that the definition of equity securities for this purpose should be the related definition in SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities." However, CMSA believes that it should be acceptable for a qualifying SPE to subsequently acquire equity securities upon foreclosure or other settlement after mortgage loan default.

CMSA proposes that the Proposed Text of Paragraph 35(c)(1) be changed to read "A qualifying SPE may hold only ... financial assets transferred to it that are not equity instruments at the time of their transfer to the qualifying SPE and that are passive in nature (except as permitted by paragraph 35(c)(5))" and that Paragraph 35(c)(5) be changed to read "Temporarily, nonfinancial assets and equity securities obtained in connection with the collection of financial assets that its holds."

Paragraph 35(c)(2):

Proposed Text:

A qualifying SPE may hold only ... passive derivative financial instruments entered into with counterparties other than the transferor, its affiliates, and agents that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents.

There are several aspects of CMBS transactions that could be deemed to be derivatives "entered into with counterparties who are the transferor, its affiliates and agents" which preclude qualifying SPE status under the Proposed Statement.

⁴ The text of the Proposed Statement on this Exhibit is not a verbatim quotation from the Proposed Statement.

Passive, "Vanilla" Derivatives-

Market rate, passive, "vanilla" interest rate caps required to be entered into by the borrower and pledged to the mortgage lender in connection with the origination of the related mortgage loan and market rate, passive, "vanilla" interest rate and currency hedges to protect against mismatches between the interest rate or currency of the underlying mortgage loans and the CMBS securities issued by the qualifying SPE, are frequently provided by derivative dealer affiliates of the Loan Seller (particularly when it is a commercial or investment bank). These derivatives do not function as credit enhancement for the underlying mortgage loans. They are the type of passive derivatives contemplated in Paragraphs 35(c)(2), 39, and 40 of SFAS 140.

Although it is possible for a qualifying SPE to obtain these derivatives from parties unrelated to Loan Seller, this will likely add yet another party to the related transaction and will add additional delay and expense as the third party counterparty and its counsel get up to speed on the transaction. It is not clear to CMSA why FASB is concerned that these types of derivatives (unlike total return swaps and other credit support derivatives) somehow constitute impermissible transferor credit support to the qualifying SPE.

CMSA recommends that the Proposed Statement be revised so that a qualifying SPE is only precluded from entering into derivatives such as total return swaps or other credit support derivatives with the transferor, it affiliates, or agents, by which substantially all of the risk and rewards of the qualifying SPE's assets are passed back thereto.

Beneficial Interests-

Second Step SPE may issue beneficial interests that are derivatives in their entirety (e.g., interest only securities) that are owned by Loan Seller. In addition, Loan Seller may own subordinated CMBS issued by Second Step SPE that include a derivative that may be required to be bifurcated pursuant to the related limited-scope interpretation of SFAS 140 FASB has announced it intends to issue.

If that limited scope interpretation requires (as proposed Implementation Issue D2 (which has since been withdrawn) would have) the bifurcation of derivatives out of qualifying SPE beneficial interests, it appears the Proposed Statement would preclude such interests from being held by a SFAS 140 transferor.

CMSA does not believe that beneficial interests held by Loan Seller or its affiliates or agents that are derivatives in their entirety, or derivatives bifurcated from Second Step SPE beneficial interests that are held by Loan Seller or its affiliates or agents, should preclude Second Step SPE from being a qualifying SPE, as the cash flows under such derivatives only go one way (i.e., from Second Step SPE to Loan Seller (as holder of a CMBS that is a beneficial interest)), and do not involve any Loan Seller obligation to make payments to Second Step SPE.

Paragraph 35(e):

Proposed Text:

W ...

A qualifying SPE may not enter into an agreement (other than a forward contract in a revolving period securitization) with the transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or other assets to the SPE or its beneficial interest holders.⁵

That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE as well as commitments to purchase outstanding beneficial interests directly or indirectly from the beneficial interest holders or to otherwise settle beneficial interests with their holders.

It also applies to total return swaps and any other derivative instruments that may require delivering additional financial assets.

It applies even if the commitment is contingent or conditional, whether the contract is settled net or gross, whether the settlement is current, deferred, or prepaid, and regardless of the relationship of the notional amount of the instrument, if any, with the face amount or value of the transferred assets.

CMSA believes this proposed change is too broad and restrictive. CMSA sees no reason why a qualifying SPE should not be able to require Loan Seller to repurchase a mortgage loan or indemnify against losses resulting from subsequent discovery of a breach of Loan Seller's representations and warranties made at the time of loan transfer to the qualifying SPE and/or CMBS issuance that relate to events occurring on or prior to that date. Such a prohibition would make it impossible for any securitization (including CMBS) to qualify for sales treatment using a qualified SPE, as transferor representation and warranties are required by rating agencies and investors in virtually all transactions.

Precedent for this can be found in the Federal bank regulators' risk-based capital rules, which exclude from "recourse" representations and warranties that do not provide credit enhancement with regard to future events.⁶

⁵ Obligations to make servicing advances are not subject to the requirements related to other commitments if the servicer can choose not to make the advance if it believes recovery of the advance from collections on the assets of the SPE is in doubt.

⁶ See 66 Fed. Reg. 59614, 59631 (November 29, 2001).

Furthermore, as indicated in the discussion of Paragraph 35(c)(2), CMSA sees no reason why qualifying SPEs should be precluded from receiving an assignment from a Loan Seller of the derivative instruments which are part of the security for the underlying mortgage loan, or from entering into at market, passive, "vanilla" interest rate and currency derivatives, in cases where the Loan Seller, its affiliate, or agents is the derivative counterparty, so long as the transactions are on customary market terms and conditions and are not the equivalent of total rate of return swaps or otherwise move substantial risk of loss on the underlying mortgage loans to the transferor, its affiliates, or agents.

Accordingly, CMSA requests a carve out from the proposed text of Paragraph 35(e) to permit qualifying SPEs (1) to receive the benefit of repurchase and indemnification obligations from a transferor, its affiliates, or agents relating to breaches of transferors representations and warranties relating to events occurring on or prior to the date the CMBS are issued by the qualifying SPE, and (ii) to enter into, acquire and hold at market, passive derivatives of the nature described in the immediately preceding paragraph, regardless of whether the transferor, its affiliates, or agents is the counterparty.