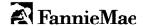
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July 31, 2003

MP&T Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: File Reference No. 1200-001

Exposure Draft on Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140

Ladies and Gentlemen:

Fannie Mae appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB's") Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets* ("ED").

Background

At Fannie Mae the securitization of mortgage loans into a mortgage-backed-security is typically initiated by a lender (transferor) who contracts with Fannie Mae corporate to transfer their loans into a stand-alone trust in return for pass-through certificates that evidence beneficial interests in the loans in the trust. Fannie Mae in its corporate capacity provides the guaranty for the timely payment of principal and interest to the certificate holders. The lender may or may not agree to retain an obligation to provide some amount of recourse to Fannie Mae corporate. The recourse agreement is between Fannie Mae and the lender—not with the trust itself. Only Fannie Mae is party to the guaranty with the trust certificate holders. A lender may retain a recourse obligation to Fannie Mae in return for a lower guaranty fee rate on the security, which reduces Fannie Mae's overall credit exposure.

Under no circumstance does either Fannie Mae in its corporate capacity or the lender retain control of the loans within the trust. Fannie Mae serves as both the guarantor and trustee for the trust. The lender may or may not provide servicing on the underlying loans. There are no reissuances of beneficial interest, and underlying loans may be replaced only if they fail to meet pre-specified underwriting criteria under normal representation and warranty provisions. These are passive structures with Fannie Mae, as trustee, holding the loans for the benefit of certificateholders and Fannie Mae in its corporate capacity, passing through the payments received from the servicer, and to the extend applicable, paying under its guaranty.

Investors in these securities hold the security on their balance sheets. Fannie Mae records on its balance sheet both a contingent and non-contingent liability (under FIN 45 and FAS 5 respectively) as a result of

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the guaranty, while the servicer records a mortgage servicing right on its balance sheet. The current accounting is consistent with both the risk and rewards and control models.

Summary

We understand the FASB's overall objectives of clarifying aspects of FAS 140 related to the permitted activities of qualifying special-purpose entities ("QSPE") in FAS 140 and providing guidance on reissuing beneficial interests. We believe the FASB's primary focus was to exclude entities that actively manage the activities within the SPE from qualifying as a QSPE. However, we believe the language in the proposal is so restrictive that any type of continuing involvement by the transferor would preclude QSPE status for plain-vanilla, passive structures used to create mortgage-backed securities guaranteed by government sponsored enterprises ("GSEs") and inappropriately result in consolidation by either the lender or GSE under FASB Interpretation No. 46, Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51 ("FIN 46"). This is the result even though neither party controls the underlying mortgages and have already accounted for their risks and rewards associated with the transaction. Our primary concerns with the ED include the following:

Inconsistent consolidation treatment: Although one of the FASB's principal tenets of high-quality financial reporting is that similar transactions should be accounted for in a similar manner, application of the ED in its current form would produce inconsistent accounting results for economically similar transactions. The ED states that if the transferor retains any direct or indirect liquidity to the SPE, the structure would not be a QSPE. However, if the transferor does not provide any direct or indirect liquidity, the structure would be a QSPE. These provisions produce counter intuitive accounting results. For example, if the lender retains a minimum level of recourse obligation such as \$1 to Fannie Mae as part of the securitization, Fannie Mae would likely be required to consolidate the SPE on its books. On the other hand, if the lender does not keep any recourse or servicing, Fannie Mae would not have to consolidate the trust because it would be a QSPE. The fact that we would have to consolidate when we have less credit risk because the lender has kept some level of recourse, yet we would not have to consolidate when we have all of the credit risk is inconsistent with the expected results. We believe consolidation should not be required because in neither case does Fannie Mae own nor have any control over the underlying loans within the mortgage-backed security.

In some instances, Fannie Mae securitizes loans that it already owns that are on our balance sheet. In cases where Fannie Mae transfers loans we own into a trust and sells the certificates to investors, we would have to consolidate the loans on our balance sheet because the trust would fail QSPE since Fannie Mae is both the transferor and guarantor. Again, the accounting results are counter intuitive to what is expected because Fannie Mae is in the same position as we would have been had the lender provided collateral without recourse (i.e. the investor owns the security and Fannie Mae has all the credit risk) when the beneficial interests are sold to investors. Although our risk position is the same at the end of the day regardless of who provides the collateral underlying the security, the ED provides inconsistent treatment for economically similar transactions.

If consolidation were required on March 31, 2003 for Fannie Mae guaranteed MBS held by other investors, Fannie Mae would have recorded an asset and liability gross up of approximately \$1.108 trillion. Our total assets would increase from \$913 billion to approximately \$2.021 trillion even though we do not own and have no control over the assets underlying the MBS. This balance sheet gross up would substantially increase Fannie Mae's minimum capital requirements.

- Departs from the underlying control model of FAS 140 and financial components approach: The principal criterion for consolidation under FAS 140 is control. FAS 140 focuses on the surrender of control for derecognition of transferred assets and exempts QSPEs from consolidation because the transferor has given up control, and the investor has control of the securities issued by the SPE. Entities should not have to consolidate just because they provide a guaranty. Providing a guaranty does not necessarily mean you have control. Our securitizations are passive and we only provide liquidity to the security when a borrower fails to pay on their loan. We already record a liability on our books associated with this risk. We believe this accounting model is the best representation of both the risk and rewards and the control of the assets.
- Conflicts with or undermines other accounting rules: The ED undermines both long-established accounting for guaranteed MBS and recently issued guidance. GSEs have traditionally used a common, passive securitization structure to facilitate the issuance of MBS. Based on statistics from the Bond Market Association, agency MBS issuances in the U.S. mortgage securitization market have increased from \$23 billion in 1980 to approximately \$1.5 trillion in 2002. Outstanding agency MBS totaled approximately \$3.2 trillion at the end of 2002. Because of the long-standing history of specialized accounting for mortgage banking activities, the Board carved out a QSPE exception for guaranteed mortgage securitizations in FAS 140 that results in the transferor recognizing the MBS retained in a securitization as securities under FAS 115. Under the FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Guarantees of Indebtedness of Others ("FIN 45") framework, we record the fair value of the guarantee obligation as a liability, which we believe more accurately reflects the distinction in risks between MBS owned by Fannie Mae and MBS guaranteed by Fannie Mae and held by other investors.
- Restrictions on servicing advances: Fannie Mae's MBS requires the servicer to advance a full month's interest to the security holder for the month in which the loan is partially or fully paid off. The servicer is not entitled to reimbursement from either the trust or Fannie Mae for this advance. The risk and cost of this requirement is factored into the overall valuation of the mortgage servicing right asset recorded on the servicer's balance sheet. Under the ED, none of our securitization trusts would qualify as a QSPE because of this requirement. Again, this would cause Fannie Mae to consolidate all MBS (because we retain the credit risk) even though the interest rate risk associated with the prepayment of the loan is already recorded on the books of the servicer.

To illustrate our concerns, we have provided the following information for the FASB's consideration in further deliberations on the ED:

- I. A comparison of accounting under current rules versus the potential accounting under the ED
- II. Specific ED provisions that would adversely affect the accounting for MBS securitizations
- III. Our recommendations on modifying the ED to ensure consistent accounting and better meet the FASB's objectives
- IV. An overview of the Fannie Mae's MBS securitization process (Appendix)

I. A Comparison of Current Accounting and Potential Accounting Under ED

The following table identifies alternative Fannie Mae securitization transactions, the current accounting for these transactions, and the potential accounting under the ED.

¹ FAS 140, paragraph 182.

| | Fannie Mae Out of Portfolio ² Securitization | Fannie Mae/ Lender Swap ³ No Recourse or Servicing | Fannie Mae/ Lender Swap ³ 1% Indircet Recourse |
|---------------------------------|---|--|---|
| SPE Used | Yes | Yes | Yes |
| Transferor | Fannie Mac | Lender | Lender |
| Fannic Mac Risks & Rewards | Full credit risk | Full credit risk | Majority of credit risk |
| Current Accounting: | | | |
| QSPE Status | Yes | Yes | Yes |
| Derecognition by Fannie Mae? | Yes | Not Applicable | Not Applicable |
| Fannie Mae Consolidate SPE? | No | No | No |
| Accounting Impact | FIN 45 guaranty liability | FIN 45 guaranty liability | FIN 45 guaranty liability |
| Potential ED Accounting: | | | |
| QSPE Status | No, Fannie Mae provides direct liquidity to SPE as transferor and guarantor | Yes | No, Lender provides indirect liquidity through recourse |
| Derecognition by Fannie Mae? | No | Not Applicable | Not Applicable |
| Fannie Mae Consolidate SPE? | Yes, based on FIN 46 because Fannie Mae has greatest risk of loss | No, QSPEs exempt from consolidation under FIN 46 | Yes, based on FIN 46 because Fannie Mae has greatest risk of loss |
| Accounting Impact | No FIN 45 guaranty liability Fannie Mae balance sheet gross up | FIN 45 guaranty liability | No FIN 45 guaranty liability Fannie Mae balance sheet gross up |

A comparison of the accounting under the ED for alternative structures exemplifies how application of the ED in its current form results in inconsistent accounting for economically similar transactions, which represents a violation of the Board's fundamental tenets of comparability and consistency outlined in FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information and discussed in

² Transfer of loans from Fannie Mae's portfolio to a stand-alone trust for securitization.

³ Transfer of loans from a lender into a stand-alone trust in exchange for MBS guaranteed by Fannie Mae.

the basis for conclusions as a desired goal in developing the FAS 140 model. The FAS 140 consolidation exemption for certain MBS securitizations would be eliminated by the proposed ED if Fannie Mae transfers loans from its portfolio to an MBS trust or a lender provided any level of recourse. Fannie Mae or the lender would be required to consolidate under the FIN 46 model even though the SPE is a passive, pass-thru arrangement, neither party has control of the SPE, and beneficial interest holders have the ability to pledge and repledge assets. A potential effect and what we believe to be unintended consequence could be the gross up of the balance sheets of both Fannie Mae and the lender. If the lender transfers loans to trust deemed nonqualifying because of the ED provisions, the transfer may not qualify for sale treatment. Thus, the lender would have to reflect the underlying loans on its balance sheet, while investors would reflect the MBS as assets. Consequently, two or more entities could report the same assets as if they both held them, a situation the FASB sought to prevent in developing the FAS 140 model.

The ED also contradicts the recently established framework of FIN 45 that results in guarantors recognizing a liability for the estimated fair value of the guaranty obligation. Because of transition provisions and grandfather clauses in the ED and FIN 45, Fannie Mae's financials would reflect a combination of three different accounting models for our guaranty obligation.

| Accounting Model | Application | Effect |
|-----------------------|--|---|
| Pre-FIN 45 Accounting | MBS held by other investors guaranteed by Fannie Mae prior to December 31, 2002 | Off-balance sheet FAS 5 liability for estimated credit losses arising from loans underlying Fannie Mae guaranteed MBS |
| 2. FIN 45 Accounting | MBS issued to other investors and guaranteed by Fannie Mae on or after January 1,2003 through effective date of proposed FAS 140 amendment | Off-balance sheet FIN 45 liability for the estimated fair value of our guaranty obligations Asset for guaranty fee receivable that equals the guaranty obligation |
| 3. ED Accounting | MBS issued and guaranteed by Fannie Mae after effective date of proposed FAS 140 amendment | |
| | a) Lender is transferor and has no recourse or servicing | QSPE status preserved FIN 45 model would continue to apply |
| | b) Fannie Mae is transferor or lender is transferor and has recourse or servicing | Would not qualify as QSPE Consolidate under FIN 46 Balance sheet gross up No FIN 45 liability |

In the proposed ED, the FASB states in paragraph A10 that it does not want the proposal to have the effect of derecognizing assets under FAS 140 and reconsolidating those assets under FIN 46 because of

⁴ FAS 140, paragraph 136, "Those accounting results would disregard one of the fundamental tenets of the Board's conceptual framework; that is, '... accountants must not disguise real differences nor create false differences.'

differences in the FAS 140 and FIN 46 models. However, the proposed amendment may have exactly that effect with MBS securitizations. We believe the proposal conflicts with the underlying concept of FAS 140 that an entity recognizes assets it controls and derecognizes assets upon surrender of control and does not strike the appropriate balance between the FASB's desired goal of integrating the concepts of control and risks and rewards. The ED undermines the financial components approach of FAS 140 by requiring consolidation if an entity provides a guaranty.

Fannie Mae noted in our August 30, 2002 comment letter on FIN 46 that we believed that it was appropriate that FIN 46 not result in lenders, servicers, guarantors, and investors in MBS having to consolidate the underlying loans because no one participant controls the activities of the SPE or holds most of the risks and rewards. The FASB specifically scoped QSPEs out of FIN 46 so that MBS trusts were exempt from consolidation. However, the ED could force Fannie Mae to consolidate guaranteed MBS held by other investors and reflect the underlying loans on our balance sheet as assets along with a corresponding liability.

II. Specific ED Provisions That Would Adversely Affect the Accounting for MBS Securitizations

Below we have cited specific paragraphs in the ED that would affect Fannie Mae and provided our suggested modification.

| Selected Citations | Potential Impact on Fannie Mae | Suggested Modification |
|--------------------------------|---|---|
| 5e. [A QSPE] may not enter | Under Fannie Mae's lender swap program, | Modify paragraph 5e |
| into an agreement | lenders as transferors may retain a certain | so that it applies only |
| with a <i>transferor</i> , its | level of recourse. The recourse agreement is | to SPEs that reissue |
| affiliates, or its agents | with Fannie Mae in its corporate capacity, | beneficial interests. |
| that commits any of | which is a beneficial interest holder (BIH) as | |
| those parties to deliver | guarantor of the trust, and not the trust. | |
| additional cash or other | Lender recourse is a commitment from the | |
| assets to the SPE or its | transferor to Fannie Mae that reduces our | |
| BIHs. That prohibition | overall credit risk, which is the source of | |
| applies to liquidity | Fannie Mae's beneficial interest. By | * " |
| commitments, financial | precluding QSPE status, either the transferor | |
| guarantees, written | or Fannie Mae would have to consolidate | |
| options, and other | depending on which party had the greatest | |
| arrangements with the | exposure to expected losses under FIN 46 | |
| SPE as well as | even though the SPE is passive, neither party | |
| commitments to | effectively controls the underlying assets, and | |
| purchase outstanding | the SPE does not reissue beneficial interests. | |
| beneficial interests | | |
| directly or indirectly | Under Fannie Mae's out of portfolio | |
| from the beneficial | transactions, Fannie Mae is the transferor and | |
| interest holders or to | a BIH as guarantor of the trust. Our guaranty | |
| otherwise settle | to the SPE would preclude QSPE status for | |
| beneficial interest with | these transactions, and we would have to | |
| their holders. | consolidate the underlying loans since we | |
| | would hold the majority of expected losses | |
| | under FIN 46. | |
| | | |
| | | <u> </u> |

| Selected Citations | Potential Impact on Fannie Mae | Suggested Modification |
|--|--|--|
| | Fannie Mae acts as an agent on behalf of the lender (transferor) in transferring loans from the lender to the SPE. It is not clear whether Fannie Mae would be considered an agent of the lender (transferor) as guarantor of the trust. If so, our guaranty to the SPE would violate QSPE status, and we would have to consolidate the underlying loans under FIN 46. | |
| 5e. 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 interest with their holders. | Fannie Mae lender contracts include indemnification provisions for breach of normal performance representations and warranties. The contract is between Fannie Mae and the lender rather than the SPE. However, Fannie Mae, as a beneficial interest holder through its guaranty, benefits from the arrangement. It is not clear from the language in paragraph 5e whether normal representations and warranties, direct or indirect, would violate QSPE status. Under Fannie Mae's lender swap program, lenders may not retain recourse but may agree to a lower guaranty fee in exchange for assuming pool insurance coverage on the underlying loans in the SPE. The lender pays insurance premiums for pool insurance and names Fannie Mae corporate as beneficiary. It is not clear whether this indirect commitment by the lender (transferor) to Fannie Mae (guarantor) would violate QSPE status. | Include an exemption for standard transferor performance representations and warranties typically contained in transfers involving guaranteed mortgage securitizations that is distinct from the performance of assets in the trust. Clarify by providing specific examples of permitted and prohibited direct and indirect arrangements. |
| 5(e)* This prohibition does not include a commitment for servicing advances if the servicer can choose not to make the advance if it believes recovery of the advance from collections of the assets of the SPE is in doubt. | Scrvicers of Fannie Mae MBS are required to pass through a full month of interest in the month a borrower prepays the loan, even though the borrower has only paid interest up to the date of the pay-off. The servicer must do this and does not have any other source of repayment for this advance. Economically they are reimbursed through the overall value of servicing. | Remove the asterisk limiting the ability to advance payments or include an exception for when a servicer advanced interest in the period of prepayment. |

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III. Recommendations on Modifying the ED

We recommend that the FASB modify the ED to ensure that QSPE status is maintained for passive securitizations that achieve legal isolation and surrender of control of assets. We believe it is essential that the FASB preserve the financial components concept underlying FAS 140 and FIN 45. Under this approach, each party records its retained interests or continuing servicing, recourse, or guaranty obligation. We believe the results of this approach better reflect the economics of the transaction and the ultimate rights and obligations. Further, it maintains consistent accounting for similar passive securitizations regardless of the securitization path.

We would like to participate in the Board's public roundtable discussion of the ED on August 28, 2003. In the interim, we would be pleased to discuss any aspect of our positions with the FASB and provide further assistance in your re-deliberations on the ED. Thank you for considering our views.

Sincerely,

Jonathan Boyles

IV. Overview of Fannie Mae MBS Securitization Process

MBS are fixed income investment instruments that represent direct ownership in a legally isolated pool of specific, conforming mortgage loans or mortgage-backed securities. Each security holder has an undivided interest in the mortgage loans in the pool and receives a pro rata share of principal and interest payments generated from cash flows of the pool. Cash flows from the pool are also passed through to the guarantor and servicer as compensation for services provided.

GSEs serve as a conduit in issuing or enabling the issuance of MBS as defined in Financial Accounting Standard No. 65, Accounting for Certain Mortgage Banking Activities ("FAS 65"). GSEs receive a guaranty fee as compensation for assuming the credit risk on loans underlying an MBS. Issuance of MBS by GSEs helps foster additional investment in mortgages by disseminating the risk associated with holding mortgage loans throughout the marketplace. MBS guaranteed by GSEs are entirely portable and transferable—the security holder may pledge, sell, or retain the security without constraint. Following is an overview of how Fannie Mae MBS are created, the rights and responsibilities of participants, and designated roles under FAS 140:

Creation of Fannie Mae MBS

- 1. Lenders originate loans with borrowers.
- 2. Lenders may either:
 - a) swap the loans in exchange for MBS guaranteed by Fannie Mae (referred to as "Lender Swap" program) or
 - b) sell the loans to Fannie Mae for cash; Fannie Mae then pools the loans from its portfolio to create MBS (referred to as an "Out-of-Portfolio" transaction)
- 3. Fannie Mae assumes credit risk on swapped loans and retains credit risk on out-of-portfolio pooled loans by guaranteeing the timely payment of principal and interest on the MBS.
- Fannie Mae uses a separate trust for each MBS pool to facilitate securitization. The pool of loans underlying the MBS is legally isolated from the transferor.
- Under the lender swap program, Fannie Mae returns the MBS to the lender and the lender may sell the MBS to investors. Under the out-of portfolio transaction, Fannie Mae sells the MBS directly to investors.

Rights and Responsibilities under Fannie Mae MBS Trusts

- 1. A borrower makes monthly P&I loan payments to the servicer.
- 2. The servicer transfers payments to the trust.
- The trust passes through a pro rata share of borrower principal and interest (P&I) payments net of guaranty and servicing fees to investors. The trust passes through the guaranty fee to Fannie Mae and the servicing fees to the servicer.
- 4. If a borrower misses a payment, the servicer will attempt to collect the delinquent payments from the borrower. Fannie Mae continues to collect its guaranty fee from the servicer while the borrower is delinquent; however, the servicer does not receive its servicing fee if the borrower misses a payment.
- Under its guaranty agreement, Fannie Mae causes the servicer to advance delinquent P&I payments to the trust on behalf of Fannie Mae to remit to MBS holders.
- 6. If a borrower does not resume payment within a specified time period, Fannie Mae is obligated to purchase the loan from the pool. Payoff of the unpaid principal balance is remitted to investors. The servicer might recover its servicing fee and guaranty fee advance from Fannie Mae upon sale

- of the collateral underlying the mortgage if there are sufficient proceeds after Fannie Mae has recovered its losses.
- If a borrower cures a default, the servicer retains the P&I payments as reimbursement of the amounts advanced. If the borrower does not cure, Fannie Mae reimburses the servicer.
- 8. As pre-specified in our guaranty agreement, Fannie Mae is required to repurchase from the trust sany loan that is delinquent for 24 months.
- 9. Servicers of Fannie Mae MBS are required to pass through a full month of interest that accrued during the month in which the borrower prepays the loan even though the borrower has only paid interest up to the date of the pay-off. The servicer must do this and does not have any other source of repayment for this advance.

Roles Under Fannie Mae MBS Trust

Transferor: Under the lender swap program, the lender is deemed the transferor because Fannie Mae does not take sufficient control of the transferred loans. Under the out-of-portfolio transaction, Fannie Mae is the transferor because it is transferring assets from its own mortgage portfolio that it controls

Guarantor: Fannie Mae is the guarantor of the beneficial interests in the trust. A fixed, monthly guaranty fee is passed through from the MBS trust to Fannie Mae based upon the pool product mix. The guarantee fee amount on an MBS pool is a function of a pre-determined monthly guaranty fee rate multiplied by the unpaid principal balance of the loans in the trust. The certificateholders are the legal beneficiaries of Fannie Mae's guarantee.

Servicer: Fannie Mae has responsibility to the trust for servicing; however, we do not directly service the mortgage loans. Fannie Mae typically subcontracts servicing to the lender originating the loans. A fixed, monthly servicing fee is passed through from the trust to the servicer. Servicing fees are based on a pre-determined rate multiplied by the unpaid principal balance of the loans in the trust.

Beneficial Interest Holders: Fannie Mae and investors are direct beneficial interest holders of Fannie Mae QSPEs. Fannie Mae is a BIH because we receive a pass through guaranty fee; investors are BIHs because they receive P&I cash flows from the underlying mortgages in the trust. We believe Fannie Mae servicers are indirect beneficial interest holders because they receives pass through servicing cash flows from the trust via servicing contracts with Fannie Mae.