Letter of Comment No: 140
File Reference: 1082-200
Date Received: 11/08/02

Bob and ron:

I am concerned that there are potential unintended consequences for the ginnie mae, fannie mae and freddie mac mortgage-backed securities markets from the board's tentative decision that a holder of the majority of the variable interests (risks and rewards) must consolidate a "variable interest entity" for which there is no meaningful decision making.

Please review the following real-world (trillion dollar) examples and let me know if you think anyone would have to consolidate the "entity" under the draft interpretation as it stands now. Perhaps, i am over-reacting.

1. A mortgage banker swaps $100 million newly-originated 6.5% mortgage loans with fannie mae in exchange for $100 million fannie mae 6% guaranteed mortgage certificates. The mortgage banker retains 25 bp as a servicing fee and fannie mae takes out 25bp as a guarantee fee.

The mortgage banker is considered a transferor to a qspe (qualifies even though 100% is taken back, since it is a fas 140 guaranteed mortgage securitization) and therefore, exempt from consolidation. The mortgage banker records a servicing asset since the 25bp is considered more than "adequate compensation," even though that is the going rate.

Does fannie mae have to consolidate the qspe given its risks and rewards arising from the guarantee or does fannie mae record the guarantee at fair value pursuant to the new guarantees document or do they record guarantee fees as earned and losses pursuant to fas 5?

Assume the guarantee is without recourse back to the mortgage banker and that the expected losses are minor.

If fannie mae has to consolidate, what would they show?

$100 million of securitized mortgage loans as assets and $100 million of mbs as liabilities?

Other than the servicing of the loans, the "entity" is truly brain-dead. There is no buying, selling or substitution of loans and there is no refinancing of beneficial interests. Rather than an "entity," in substance, it is a segregated pool of assets. For tax purposes, it is a grantor trust "pass-through" entity. There are no material voting rights.

2. Same facts as in question 1, however, the mortgage banker sells the $100 million of fannie mae mbs to a wall street investment bank who in turn sells it to a commercial bank for their investment portfolio.

Does the commercial bank consolidate the qspe because it has the majority of the risks and rewards?

The credit risk is minimal since principal and interest is guaranteed by fannie mae. There is interest rate risk in that the market value will decline if interest rates rise. If they paid a premium over par, there is prepayment risk. There is potential reward in that the market value rises as rates fall. Does it matter if the bank intends to hold to maturity?

3. Instead of scenarios 1 and 2, the mortgage banker sells their loans outright to fannie mae, but retains the servicing. Fannie mae takes these loans and other 6.5% loans they purchased this month and forms fannie mae 6% mbs securities. The commercial bank puts in an order for $51 million of newly issued fannie mae 6% mbs. The $51 million that gets delivered could be 10% of a $510 million pool, it could be 51% of a $100 million pool or it could be 100% of a $51 million pool. Assume that the commercial bank gets 51% of a $100 million pool. Do they have the majority of the risks and rewards? If so, do they record $100 million of securitized mortgage loans as assets and $49 million as minority interest?

4. Instead of scenario 2, the wall street investment bank sponsors a $100 million multi-class fannie mae guaranteed remic. Fannie mae is the adminstrator of the remic but not the transferor. Fannie mae guarantees full payment of principal and interest on all classes of remic securities in exchange for a fee up-front but they are not really taking on any incremental credit risk, since they already guaranteed the original mbs. The wall street investment bank is the transferor, but does not retain any of the classes of securities. From the $100 million in fannie mae mbs, the wall st.

Investment bank slices and dices and. Creates and sells pac, tac, support, z, floater, inverse floater, io, and po classes. The commercial bank buys all of the inverse io classes and is at risk for loss of substantially all of its investment if either prepayments accelerate dramatically, or libor increases dramatically.

Does the commercial bank have the majority of the [residual] risks and rewards? If so, do they consolidate? What would they show?

$100 million securitized fannie mae mbs as assets and $100 million less the amount of their investment as liabilities?

If the answer to any of these questions is that somebody consolidates, i recommend that you refine the tentative decision.

If the answer to each of these questions is that nobody consolidates, i recommend that you explain that in the guidance in the final interpretation.

Perhaps, the guidance should be that for entities in which there is no substantive decision making, an entity would only be required to consolidate the assets and liabilities of the entity if they hold the majority of the variable interests and they could be forced to reach into their own pocket to support the assets, if they default, or to pay the other investors or to issue their own securities to third parties a la enron.

Let me know if i can be of any helpsorting any of this out!

Best regards,

Marty