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Via Electronic Mail and Federal Express

March 20, 2001

Mr. Timothy Lucas, Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Dear Mr. Lucas:

The Bond Market Association, the Commercial Mortgage Securities Association, the Mortgage Bankers Association of America and the Real Estate Roundtable (collectively, the "Associations") are seeking the Board's or the Staff's concurrence with our answer to the following question:

Is the disposition of a defaulted loan under the circumstances specified below, and the activity of a special servicer 1 which leads to that disposition, a permitted activity of a qualifying SPE pursuant to paragraph 35.d.(1) of FASB Statement No. 140 which addresses limitations on sales or other dispositions of assets by a qualifying SPE? 2

The Associations believe that a positive answer to this question is the appropriate response and one that is critical to the real estate industry, which heavily relies on the availability of funding of commercial mortgage loans by institutional investors through investments in commercial mortgage-backed securities ("CMBS"). The Associations estimate that there are over \$280 billion of CMBS currently outstanding, and that in excess of one-third of all commercial mortgage loans originated are securitized. Although the size of the CMBS market is vast, the number of loans which have defaulted and been liquidated is less than one percent of the loans securitized.

Certain of the Associations were among the constituents who responded to the Exposure Draft expressing the view that a servicer should be allowed to exercise what was termed at least a commercially reasonable and customary amount of discretion in deciding whether to dispose of assets in response to adverse events. Our comments at that time were much broader than what the Associations are now asking the Board and Staff to consider. We acknowledge responsibility for the unfortunate timing of this request and we wish to express our sincere regrets about the timing. Our failure to raise this matter with you earlier is due to a lack of focus on certain of the Board's statements in the basis for conclusions section of FASB 140, in particular, paragraph 190.

Nevertheless, this issue is of utmost importance to our collective membership and to the continued efficient operation of the commercial real estate debt market. As a substantive matter, we maintain that the legal documents setting forth the permitted activities of a special servicer in fact preclude discretion in the specified circumstances described in this

letter (i.e., the disposition of commercial mortgage loans which have gone into default and are serviced by a Special Servicer). The SPE does not have flexibility to operate as an ordinary business enterprise, as was suggested by paragraph 190 of FASB 140. It continues to be a passive conduit through which its beneficial interest holders own portions of its assets, as opposed to owning shares or obligations in an ordinary business enterprise. As you read this letter and consider the special circumstances we describe, we ask that you evaluate whether the SPE behaves like an ordinary business enterprise.

Background Information

CMBS transactions are almost always structured using a Real Estate Mortgage Investment Conduit (REMIC) tax election which provides further tax related restrictions against potential loan sales. Like an FASB 140 qualifying SPE, a REMIC must act as a passive conduit holding assets (qualified mortgage loans) for the benefit of its regular and residual interest holders. By statute, a REMIC is not subject to an entity level tax and is not to be included in a consolidated return. Instead, the income from the REMIC's assets is allocated among the holders of the REMIC interests.

A REMIC is most often structured as a trust which is the transferee in a transfer that meets the isolation requirements of FASB 140, paragraph 9(a). A REMIC can only dispose of mortgage assets incident to the foreclosure, default or imminent default of the mortgage, pursuant to a qualified liquidation of the REMIC, or in response to a cleanup call. 3 The transferor is only permitted to have a cleanup call or a conditional call, in the latter case conditioned on the default or imminent default of a mortgage.

CMBS transactions may involve a single transferor or they may be transactions that "commingle" mortgage assets from multiple transferors to a single SPE, as contemplated by question 60 of the FASB Special Report, Guide to Implementation of Statement 140.

Over 75% of CMBS issuance has been "conduit-originated." A conduit is a lending entity established to originate collateral expressly for securitization. Conduit loan pricing is tied to the securitization markets and conduit originators alter the composition and leverage of the loans they originate to best suit investor risk preferences.

In a typical \$1 billion commercial mortgage conduit, the collateral pools are backed by a hundred or more loans spread across multiple borrowers, multiple property types and multiple locations. Non-conduit CMBS issuance consists principally of single-borrower transactions where the underlying commercial mortgage loans are of a relatively larger size.

In a recent study of over 23,000 conduit-originated commercial mortgage loans in CMBS transactions originated from 1993 through 2000, it was determined that less than one percent of the loans were in default (i.e. 60+ days delinquent, in foreclosure, or REO).

Financial assets inherently have the risk of default. Obviously, this is an event that is out of the control of any party to the securitization transaction. When the asset that defaults is

a commercial mortgage loan whether in a conduit or non-conduit CMBS transaction, the loss severity resulting from a default could be devastating to investors in one or more CMBS classes. Where there is no immediate appraisal or liquid market for the ultimate disposal of the collateral, and the potential for a staggering loss exists, it is critical that there be a party with relevant expertise ready to address these issues and act on behalf of all beneficial interest holders in order to limit losses to all investors in the transaction. That party is the special servicer.

The special servicer is responsible for minimizing losses suffered by certificateholders on defaulted loans. Since the special servicer's capabilities and experience directly affect portfolio performance, the rating agencies rate special servicers in addition to the CMBS themselves, and the rating agency review process plays a critical role in the CMBS market. A special servicer is designated when the loans are transferred to the CMBS issuing entity even though none of the loans are non-performing at that time. In the current CMBS market, the first-loss investors generally determine who the rated special servicer will be on the transaction.

Due to the complexity of distressed real estate, for commercial properties the most effective means to resolve the servicer's responsibility to liquidate a defaulted loan on behalf of the trust may be sale of the loan itself. A special servicer is required to direct the trust to sell a defaulted loan in circumstances further described below.

The sale of defaulted loans is not intended to provide a commercial mortgage trust or any servicer or any other party acting on the trust's behalf the ability to trade in mortgage loans. In circumstances where attempts to collect principal, interest and other amounts due under a commercial mortgage loan have failed, the special servicer is, in essence, required to dispose of the mortgage loan, either in one step, (namely, through a sale of the mortgage loan) or two steps, (namely through a foreclosure of the mortgage loan followed by the sale of the mortgaged property). The method of disposition will be determined by an analysis required by the pooling and servicing agreement of which method will produce the greatest recovery on a present value basis after considering the costs of disposition and the appraised value of the property. The net proceeds from the sale of a defaulted asset are distributed to the CMBS investors in accordance with the priorities set forth in the Agreement, and are not reinvested in new assets.

The Specified Circumstances Permitting Sale of Defaulted Loans

The following is a summary of the contractual provisions governing the special servicer's duties with respect to defaulted loans in a typical CMBS transaction. These provisions, which are set forth in a pooling and servicing agreement (the "Agreement") (which is also the legal document that creates the trust (the "SPE") to which the loans are transferred and the beneficial interests (the "Certificates") in the transferred loans) have been the standard special servicing provisions, with some variation from deal to deal, since 1994 when special servicers were introduced into CMBS transactions 4:

The relationship of the servicer, special servicer to the trustee and to each other under this Agreement is intended by the parties to be that of an independent contractor and not that of a joint venturer, partner, fiduciary, manager or agent.

If a mortgage loan comes into and continues in default, the special servicer is required to service and administer such mortgage loan in accordance with the Agreement on behalf of the trustee and in the best interests of and for the benefit of the Certificate holders with a view to the maximization of the recovery on such mortgage loan to the Certificateholders (as a collective whole) on a present value basis and without regard to: (a) any relationship that the servicer or the special servicer or any affiliate thereof may have with the related mortgagor, (b) the ownership of any Certificate by the servicer or the special servicer or by any affiliate thereof, (c) the servicer's or the special servicers obligation to make principal and interest or protective advances or (d) the right of the servicer(s) to receive reimbursement of costs, or the sufficiency of any compensation payable to it.

If a mortgage loan defaults, the special servicer is obligated to obtain or perform an appraisal with respect to mortgaged property for purposes of establishing the fair market value of the mortgaged property.

If no satisfactory arrangement can be made for collection of delinquent payments, and the defaulted mortgage loan has not be released from the SPE as a result of the sale of the loan pursuant to the provisions described under item 5 below, then the special servicer is required to exercise reasonable efforts to foreclose upon the mortgaged property securing the loan.

Conditions of sale:

- a. The servicer is required to sell defaulted loan to original seller in event that default was due to breach of a representation and warranty.
- b. If the special servicer has determined that the defaulted mortgage loan will become subject to foreclosure proceedings, the special servicer is required to notify the trustee, who in turn is required to notify the representative of the most subordinate class of certificates (the "Subordinate Certificateholder Class").

The Subordinate Certificateholder Class may, at its option, purchase the defaulted loan from the trust at the "Purchase Price" (a defined term primarily equal to outstanding balance plus accrued interest) within a specified number of days.

If the Subordinate Certificateholder Class does not purchase such defaulted mortgage then the special servicer (and in some cases servicer) may have the right to purchase the defaulted mortgage loan at the Purchase Price within a specified number of days.

c. If the defaulted loan has not been purchased pursuant to items a or b above, then the special servicer is required to offer to sell such defaulted loan if the special servicer determines that such a sale would produce a greater recovery to Certificateholders on a net present value basis than would foreclosure and liquidation of the related mortgaged property. Such offering must be made in a commercially reasonable manner. The special servicer is required to accept the highest cash offer received unless no offer is received at a price that would be fair in light of the special servicer's obligation to maximize recoveries on the loan on a net present value basis.

d. In the absence of any offer determined to be fair, the special servicer is required to institute foreclosure proceeding with respect to the defaulted mortgage loan.

QSPE Analysis - Paragraph 43a

Paragraph 43.a. states that a QSPE cannot have a power to "choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure." The Associations believe that the course of action for a defaulted loan in a CMBS securitization where no arrangement can be made with the borrower to make the loan current does not afford the QSPE or its servicer with any power to choose. As further discussed below, the Associations believe that the provisions in the Agreement for these transactions set forth a course of action by which the SPE can sell noncash financial assets only in automatic response to a default on a mortgage loan in a manner fully consistent with paragraph 35.d.(1) of FASB 140. These provisions provide no right to freely sell or hold loans as a trading activity of a business enterprise.

In this letter, we have generally described the structure and rationale for CMBS transactions. These transactions are not transactions that are set up with the expectation to foreclose on the mortgage loans and profitably manage the real estate, which cannot be a QSPE per paragraph 41 of FAS 140. 5

We have also presented you with a summary of the explicit contractual provisions that govern the special servicer's duties with respect to defaulted loans. If it is determined that there can be no satisfactory arrangements to collect from the borrower, the loan will ultimately be removed from the securitization. The removal of the defaulted loan, and its conversion to cash, will happen either through the sale of the loan or by pursuing foreclosure and liquidation of the mortgaged property. It is the role of the special servicer to provide information which determines the method for disposal of the loan, and makes it an automatic event.

The special servicer's role is to determine the values of alternatives, which are the basis for dictating the course of action. First, the special servicer determines the net present value based on the proceeds it expects to receive from foreclosure and liquidation of the mortgage property. This value is the requisite minimum amount required for the sale of the loan. Under the Agreement, if a qualified buyer exists and will, in fact, buy the defaulted loan at a price that exceeds this minimum, there is an obligation to sell such

loan. Thus, the sale is "automatic" for the SPE and the special servicer. If an appropriate purchaser is not found, then the mandatory alternative is to foreclose on the loan and liquidate the mortgaged property.

The special servicer has been hired because of its expertise in dealing with problem loans of this type in order to maximize recovery and, therefore, limit the losses to investors. This necessarily involves making calculations as to the value and costs of the alternative disposition strategies and eliminates the power of a SPE to "choose". While these calculations may be more manual and require more analysis than other asset classes, that does not justify different accounting. 6

The documents for servicing must, and do, "entirely specify" the activities of special servicers, when read by those who are engaged in providing this service in accordance with the market convention and the servicing standard set forth in the Agreement. Prescribing in any more minute degree the required actions of special servicers under all circumstances would impair the effectiveness of special servicers and would lead to higher loss rates on specially serviced loans, which would benefit no one other than perhaps the defaulting borrower.

The Serious Accounting Consequences of the Trust Not Being a QSPE

If the Board or the Staff were to conclude that the SPE in the above specified circumstances is not a QSPE (which we sincerely hope would not be the case), it could lead to the inequitable (and misleading) result of requiring 100% of the transferred loans in 100% of the commercial mortgage-backed securities transactions to be maintained on the transferors' balance sheets. This potential result is due to (1) the wording of the sale criteria in paragraph 9.b, as explained below, when the transferee is not a qualifying SPE and (2) the form of substantially all REMIC transactions today (multi-class pass-through certificates) potentially being viewed as not meeting the requirements for there to be third party controlling equity of at least 3% of the asset value and be equity in legal form.

While this issue relating to the wording of the sale criteria in paragraph 9.b existed under FASB 125, the further restrictions in FASB 140 could lead to very incongruous results.

Paragraph 9.b says that the transferor has surrendered control over transferred assets if and only if each transferee (i.e. the SPE in our example) has the right to pledge or exchange the assets it received. 7 FASB 140 only allows QSPEs, and not similar SPEs, to look through to the beneficial interest holder's right to pledge or exchange their assets. According to 9.b, all other SPEs must have the ability to pledge or exchange assets, and if there is a constraint that provides more than a trivial benefit to the transferor, this will preclude sale accounting for the transferor.

As the Board is aware, the ability to sell or exchange transferred assets is restricted to some degree in most securitization transactions. For example, in securitizations of performing mortgage loans, the REMIC vehicle is the exclusive tax-free vehicle for issuing multi-class securities. Under REMIC rules, as previously mentioned above, a

REMIC does not have rights to pledge or sell its assets, except under limited circumstances. Granting the SPE the right to pledge or sell its assets without constraint would be a clear violation of the REMIC tax law and cause irreparable harm to the securitization structures which have worked so well to date.

The literal application of paragraph 9.b in these circumstances would create an ironic and unfortunate result where, on the one hand, the SPE is not quite restrictive enough to be a QPSE, but it is still a limited-purpose entity (and not an operating entity) that has documented and predetermined restrictions on the use of its assets. The result is the non-QSPE limited purpose SPE being in no-man's land, not only for purpose of consolidation but in determining whether transferors can achieve sale accounting. 8

Conclusion

The Associations believe that in the circumstances described above, the SPE's "permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents" 9 and that any dispositions of assets are done "in automatic response" to a condition "that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them." 10

What we hope we achieved in this letter is a demonstration that the sale of defaulted mortgage loans in a CMBS transaction under the circumstances described in this letter is consistent with the QSPE model and we would appreciate the Board's concurrence with this conclusion. 11

Given that there are a significant number of CMBS transactions intended to occur soon after March 31, 2001, the importance to this vital sector of the economy of favorably resolving the ambiguities described above cannot be overemphasized. In the meantime, if there are any questions, please contact any of the Association representatives identified below.

Sincerely yours,

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FOOTNOTES

The special servicer is designated at the time of transfer of the commercial mortgage loans to the SPE. If a loan becomes non-performing, the servicing of that loan is automatically transferred from the servicer to the special servicer. The special servicer has special expertise in distressed real estate assets and is obligated to oversee the resolution of non-performing mortgage loans and act as disposition manager of REO Properties.

Paragraph 35.d.(1) reads: "If it [a qualifying SPE] can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to...the...occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)." Paragraph 43.a. cites "A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default..." as an example of a power that is not a permitted activity because it is not an automatic response.

Under a safe harbor rule, a redemption of a class of regular interests with an outstanding principal balance of no more than 10% of its original principal balance is always a clean-up call.

In the early Resolution Trust Corporation (RTC) multifamily securitization transactions, the securitization documents and the pooling and servicing agreement did not provide the same detailed procedures to be performed by the Special Servicer automatically upon a default. Rather, the documentation allowed only foreclosures on defaulted loans. As a result, the loss experience to Certificateholders was much greater than would have been experienced if the Special Servicer was required to sell automatically a mortgage loan if the present value to all Certificateholders would be greater than the foreclosure and liquidation value of the Mortgaged Property. The loss experience on these early transactions has resulted in the detailed procedures that are found in the pooling and servicing agreements of today.

As expressed in paragraph 41, "an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing financial assets."

Paragraph 191 of FAS 140 acknowledges that while some financial assets need more servicing efforts than others, the amount of efforts expended in servicing an asset does not justify different accounting. Furthermore, Paragraph 39 of FASB 140 acknowledges that "decisions inherent in servicing" are consistent with passive financial assets, which a qualifying SPE is permitted to hold.

Paragraph 29 says that transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained also constrain the transferee and presumptively provide the transferor with more than trivial benefits.

Technically, under the literal wording of paragraph 9.b, this result would apply even in circumstances in which the transferor has no continuing involvement with the SPE or the assets. Surely this is not an intended result under FASB 140, given the ample discussion in FASB 140 to demonstrate that the Board did not intend to preclude sale treatment where the transferor has no continuing involvements. See, for example, paragraph 2 of FASB 140 which says that the Statement establishes standards for resolving sale vs. secured borrowing issues raised by transfers of financial assets with continuing involvement and that "Accounting for transfers in which the transferor has no continuing involvement with the transferred assets or with the transferee has not been controversial." Similarly, in paragraph 166, the Board concluded that "transferred assets from which the transferor can obtain no further benefits are no longer its assets and should be removed from its statement of financial position." We assume that there is no problem in accounting for transfers with no continuing involvement as sales.

A typical agreement provides that it may be amended only with the consent of the Holders of Certificates evidencing in the aggregate not less than a majority or a supermajority of the Certificates of each Class of Certificates affected thereby provided, however, that no such amendment shall modify the definition of "Servicing Standard" without the consent of the Holders of all Certificates then outstanding.

Since we are only talking about a loan that was performing when it was transferred to the SPE and has since gone into default, it should be self-evident that the fair value of the loan has declined below the fair value of that asset when the SPE obtained it.

The Board has in the past made accounting distinctions "in view of the long history of specialized accounting for mortgage banking activities," as you expressed in paragraph 182 of FASB 140. The most recent example is the exception in FASB 140 to the 10% minimum outside interests rule for an SPE to be demonstratively distinct afforded to guaranteed mortgage securitizations, but not other asset classes. Another example is found in EITF 89-4. The Task Force reached a consensus that an investor in the equity of a CMO entity did not have to consolidate that entity provided certain conditions were

met, but did not allow that consensus to be analogized to investments in other collateralized borrowing structures.