



Statement of the

Commercial Mortgage Securities Association

Committee on Banking, Housing, and Urban Affairs of the United States Senate Subcommittee on Securities, Insurance, and Investment

“Transparency in Accounting: Proposed Changes to Accounting for Off-Balance Sheet Entities”

September 18, 2008

The Commercial Mortgage Securities Association (“CMSA”) is grateful to Chairman Reed, Ranking Member Allard, and the Members of the Subcommittee for giving CMSA the opportunity to offer its comments on proposed changes to the accounting rules for off-balance sheet entities.

Executive Summary

CMSA is the international trade organization for commercial real estate capital market finance. Unlike many trade organizations that represent a single category of competitors, CMSA’s membership consists of the leaders from each sector of the commercial mortgage-backed securities (“CMBS”) marketplace, including the largest banks and investment banks; insurance companies; investors such as money managers and specialty finance companies; servicers; other service providers to the industry; and the credit rating agencies, including DBRS, Fitch Ratings, Moody’s, Realpoint and Standard & Poor’s. Based in New York with a government relations office in Washington, D.C. and a solid presence in Canada, Europe and Japan, CMSA is the voice of the CMBS market and has a global membership of more than 400 firms and 5,000 individuals that are actively engaged in commercial real estate capital market finance activities. CMSA’s primary mission is to promote the ongoing strength, liquidity, and viability of commercial real estate capital market finance worldwide. In keeping with this mission, CMSA and its members are the leaders in setting standards and in maintaining a favorable investing environment for the more than \$900 billion in outstanding CMBS issuance in the United States. CMSA submits these comments with these dual objectives in mind.

Overall, CMSA has grave concerns that the proposed changes to the rules for securitization accounting are being pushed through so hastily that policymakers will not have sufficient time to consider other available framework options and to create the best standard in the long term. We also have serious concerns that adequate consideration will not be given to the direct and indirect consequences of any such changes. CMSA is particularly troubled that the recently proposed changes to Financial Accounting Standards Board (“FASB”) Statement 140 and Interpretation 46(R) that would eliminate the accounting significance of Qualified Special Purpose Entities (“QSPEs”) would have a tremendous impact on both capital and liquidity during an already uncertain time – effectively chilling already frozen credit markets that policymakers are working so hard to address.

Specifically, the proposal, if adopted, is certain to have a dramatic impact on the CMBS market because it would require investors who buy the first-loss piece (averaging less than 2% of the deal) and also serve as the “special servicer” to reflect on their balance sheet the remaining 98% of the transaction, despite only owning a fraction of the deal. Requiring investors to “consolidate” their balance sheets with those of the entities that issued the bonds securitizing the loans is an inaccurate reflection that will drive investors away from securitized transactions. It raises the question: what benefit to investors would there be to distort their true obligations by adding a massive obligation to their balance sheet? Consequently, such drastic changes would require substantial increases in regulatory capital requirements and create adverse liquidity implications, based solely on an inaccurate reflection. Further, this distortion of an investor’s balance sheet would likely cause them to be in violation of financial covenants (which cap their liabilities) and of their regulatory capital requirements. Such a burden will have an enormous negative impact on the U.S. capital market and securitization, which provides substantial financing options to consumers and businesses. These proposed changes could also result in a long list of other inadvertent consequences that impact our broader economy.

Make no mistake – CMSA recognizes the seriousness of the market turmoil resulting from the residential subprime mortgage crisis and related issues. CMSA also understands the desire of policymakers to take quick action to address these problems. In fact, CMSA welcomes efforts to reassess and improve disclosure and financial reporting. CMSA itself has been a leader in providing transparency to the CMBS market through the creation of its CMSA Investor Reporting Package (IRP®), which gives all market participants – including investors – in depth access to the financial underpinnings of the securitized commercial loans and their ongoing performance.

CMSA, however, strongly believes it essential that policymakers take the time necessary to produce a standard that will result in an improvement to the accounting in this area, rather than imposing changes hastily that are not beneficial in the long run. These issues require full airing and careful consideration over a reasonable period of time given their potential impact on the U.S. financial markets and overall economy. Significantly, for instance, alternative approaches to balance sheet consideration should be explored, especially ones that would enable users of financial statements to differentiate between assets that are truly controlled by the consolidated reporting entity versus ones that are not, and that appropriately recognize differences among the prevailing structures used for various asset classes. A “linked presentation” concept – which entails showing the liabilities issued in securitizations on the asset side of the balance sheet as a deduction from the amount of securitized assets within a single caption, and making parallel presentations on income and cash flow statements – is an example of an alternative approach that has been advocated by many asset-backed securities (“ABS”) market participants, including auditors. Yet, FASB has excluded linked presentation as an option purportedly because their artificial year-end deadline for finalizing rule changes does not give it adequate time to fully consider all such options.

When the supplemental disclosures that have already been recommended by various bodies in response to market disruptions are also taken into account, CMSA does not believe that a year-end deadline for final rules is a necessary response to current market conditions. A more measured and realistic, but still aggressive deadline of January 1, 2010 would permit full deliberation of policy alternatives and a public comment period commensurate with the importance of the changes under consideration, and will be better for the markets in both the short and long-term. Therefore, CMSA respectfully urges policymakers to consider a timeframe of January 10, 2010 for finalizing any rule changes.

In order to fully grasp the enormous impact of these changes, this discussion will begin with some brief background information about CMBS market with a particular focus on the role of the “B-piece” buyer in the CMBS space. CMSA’s concerns with FASB’s expedited efforts to finalize by year-end proposed changes to the securitization accounting rules are then discussed with specific focus on the potential impact on both the “B-piece” and other CMBS investors.

Discussion

The CMBS Market

The CMBS market has grown exponentially since its inception, from less than \$5 billion overall in 1990 to more than \$230 billion last year in the United States alone. Total outstanding U.S. CMBS issuance is more than \$900 billion and approaching \$1 trillion. In recent years, commercial loans securitized in CMBS represented approximately 40 percent of all commercial lending, while 80 percent of financing is believed to be securitization eligible. In short, the securitization of commercial mortgage loans plays an extremely important role in borrower access to credit and the creation of capital and liquidity in the commercial real estate market.

Commercial mortgage-backed securities (“CMBS”) are bonds that are collateralized by pools of commercial mortgage loans from which all of the principal and interest paid on those mortgages flows to investors. To create these investment vehicles, commercial mortgage loans of varying dollar amounts, property type, and location are selected and pooled by an issuer, typically an investment or commercial bank, and then transferred to a trust. The trust, known as a Qualified Special Purpose Entity (“QPSE”), is usually structured as a statutorily-created Real Estate Mortgage Investment Conduit (“REMIC”), a pass-through holding entity that typically pays no tax on the income generated by the trust assets, with taxes instead being paid by the individual investor(s) holding the beneficial ownership interest(s) in the trust. Bonds then are issued backed by the pool of assets held in the trust. Those bonds vary in yield (the amount of return on the bonds), duration (the length of time before the bond is expected to be paid off), and payment priority (the order in which investors are paid a return on their investment).

For CMBS, a key responsibility of the issuer in structuring the investment vehicle involves selecting the loans for the pool. The average CMBS pool contains approximately 200 individual commercial mortgage loans. The average CMBS deal size in 2007 was \$2.7 billion. The issuer typically strives to diversify the collateral and location to mitigate credit risk for investors. In other cases, the pool contains a more homogenous collection of loans. The purpose of such varied pools is to offer investors a variety of choices along a risk-return spectrum.

From the pooled loans in the trust, the issuer defines different classes of bonds to be secured by the pool of mortgage loans. The specifications for such classes of bonds and a detailed set of data then are submitted to one or two of the four rating agencies that are currently involved in CMBS (DBRS, Fitch Ratings, Moody’s Investors Service, and Standard & Poor’s), which in turn assign risk ratings to each class of bonds. A rating is an assessment of the likelihood that the cash flows and recoveries from the collateral will be sufficient to pay the requirement of the security. In structured finance, ratings are assigned to an individual security or tranche and not to an issuer. Generally speaking, rating levels depend on expected frequency, severity, and timing of future losses.

As policymakers consider reforms affecting the asset-backed securities market, it is important to keep in mind that there are key differences between the residential market, especially the subprime market,

and the commercial real estate market, as well as the securities that support their financing. These differences have resulted in a CMBS market that is a fundamentally sound sector of the economy while the residential market is in crisis.

First, the borrowers are different. Unlike the residential (and particularly the subprime) mortgage marketplace, commercial mortgage borrowers are highly sophisticated businesses with cash flows. And securitized commercial mortgages are “nonrecourse” meaning that ultimately, it is the mortgaged commercial property that is on the line if things go awry, not the borrower whereas in the residential space – by contrast – both the borrower and the house are at risk.

Second, in contrast to the residential mortgages included in RMBS and the personal loans and credit extensions that collateralize several other types of asset backed securities, the average size of the commercial mortgages included in the CMBS pools was approximately \$13.5 million in 2007, and the average number of commercial mortgages included in those pools was approximately 200 loans. The smaller pool size of CMBS allows for far greater scrutiny of the underlying assets, commercial borrowers, and the bonds. Indeed, this level of scrutiny creates “checks and balances” and transparency in the CMBS market that do not exist in the residential market: all CMBS stakeholders have access to loan-level databases (including the CMSA Investor Reporting Package® or “IRP®”), which gives access to the financial underpinnings of the securitized commercial loans and their ongoing performance.

Third, commercial mortgage underwriting – and the ratings based on that underwriting – is solely a function of revenue flows from the leases with third party tenants occupying the commercial properties being mortgaged, rather than on the wealth or income attributes of the property owner.

Finally, every CMBS bond structure has a non-investment grade “B-piece.” The “B-piece” refers to the lowest tranche of the CMBS classes. In a CMBS transaction, these bonds are the last to receive interest and principal cash flow and are therefore at the greatest risk in the capital structure. B-piece buyers are essential as they provide another independent fundamental analysis of the credit characteristics of the pool. Firms involved in the B-piece market typically have significant commercial real estate experience, and because B-piece buyers are at the greatest risk in the capital structure, they independently perform in-depth analysis of the real estate underlying mortgages included in a securitization as well as the terms of the mortgages, examining factors similar to those reviewed by the rating agencies. After this analysis, mortgages deemed more risky may be removed from the pool on request from the B-piece buyer. These “kick-outs” further strengthen the overall quality of the mortgage pool. Based on their projections of the timing and size of defaults and losses on the loans included in the final pools, the B-piece buyers determine the price they are willing to pay for the bonds.

Because B-piece buyers hold the first loss exposure in a CMBS transaction, they conduct comprehensive due-diligence on the loans comprising the pool and usually contract to act as the “special servicer” for the transaction in order to manage that risk. In that capacity they take over the collection of loan payments for any loans which are in default or are in imminent risk of default and work with borrowers to resolve issues surrounding such loans. As special servicers, they have a fiduciary responsibility to act in accordance with an established servicing standard which requires them to act in the best interest of all bondholders. Accordingly, ownership of the B-piece is not inconsistent with loan resolution for the benefit of all parties having an interest in the pool.

In sum, the marketplace for securitization of commercial mortgage loans has developed in a responsible manner. As a result, CMBS fundamentals are strong – far stronger than those of the residential market. For example, the delinquency rate for commercial real estate securitized loans was 0.40% in July 2008, compared to a May 2008 delinquency rate of 14.4% for securitized residential loans and 29.4% for subprime securitized residential loans. Not surprisingly, the current crisis is in the residential market, not in the commercial real estate market.

The current state of the economy has, however, created pricing pressure for the commercial real estate market. When capital is scarce, high funding costs mean that buyers have to pay a lower price for assets to make the numbers work. Healthier financial and debt markets will mean healthy prices for commercial assets, so CMSA supports policymakers' efforts to address the turmoil in the markets, including changes in disclosure and/or financial reporting by securitizers. But CMSA believes that it is not sound policy to adopt the proposed changes to FAS 140 and FIN 46(R) without due consideration of the alternatives and the long term consequences for fundamentally solid markets like that for CMBS. Such hasty decision making will ultimately prove to do more harm than good.

The Potential Adverse Consequences of the Proposed Changes to FAS 140 and FIN 46(R)

As the Subcommittee is aware, in an effort to be responsive to requests from the Securities and Exchange Commission and the President's Working Group on Financial Markets, the FASB is on an accelerated timetable to consider "short-term" fixes to securitization accounting standards, planning to finalize rule changes by the end of this year.¹ Among the proposed "short-term" fixes is the elimination of the accounting significance of QSPEs in securitization accounting standards.

The CMBS market uses QSPEs as the entities which hold the loans that serve as the security for the CMBS bonds. Other asset-backed securities (such as residential, home equity loans, student loans, auto loans and credit card receivables) also utilize QSPE accounting structures for securitization purposes. Using a QSPE has allowed issuers of CMBS bonds to receive "sales treatment," and investors who purchase QSPE bonds reflect only the bond assets they own on their balance sheet.

The most important concern with respect to the proposed changes to FAS 140 and FIN 46(R) for the CMBS market is that the proposed changes will require some first-loss piece investors to consolidate an entire pool of loans on their balance sheet, despite owning only a fraction of the bonds in the transaction. The huge impact of such a requirement on the individual investor becomes apparent given that, as discussed above, the average size of a CMBS transaction was \$2.7 billion in 2007. Under the proposed changes, the investor owning the first-loss B-piece (averaging less than 2 percent of the deal) would be required to reflect on-balance-sheet the remaining 98% percent of the nearly \$3 billion transaction that the investor *does not own*, rather than the relatively tiny fraction it does own.

This distortion of the balance sheet of affected investors likely will lead to a cascade of problematic consequences for those entities:

- regulated entities could face a substantial increase in regulatory capital requirements that may create significant liquidity implications;

¹ Although FASB intends to finalize the rule changes by year end, it has announced that it will push the effective date of the rules to January 1, 2010.

- both regulated and unregulated entities will be distracted (and capital raising efforts complicated) by explaining the dramatic changes in their financial statements to their own investors and lenders; and
- in some cases, regulated and unregulated entities will be further distracted by the need to seek waivers for financial covenant breaches triggered by accounting changes in an environment where lenders may be unreceptive to these requests.

Put simply, such an abrupt and inaccurate swelling of balance sheets can be expected to have tremendous impact on the credit markets that the policymakers are frantically attempting to address at a very challenging time.

Equally problematic, the consolidation obligation for investors may shift over time. For instance, if the lowest tranche in a bond deal is eliminated through defaults, that investor is out of the deal, which ultimately could shift the consolidation burden even to investment-grade buyers. This could further erode market liquidity or stifle its resurgence due to investment-grade buyers' reluctance and/or inability to bear this burden.

While CMSA cannot presently estimate which or how many of nearly \$1 trillion in outstanding CMBS issuance would be affected by the proposed changes, given the size of the CMBS market, it is clear that balance sheet consolidation by even a significant fraction would be a momentous change, with the potential to substantially tighten credit for consumers and businesses.

CMSA also is concerned that the proposed changes could negatively impact the international competitiveness of U.S. offerings. U.S. and international accounting policymakers have historically taken different approaches in securitization accounting. These differences have led to an international policy convergence project to resolve disparities. The proposed changes to FAS 140 and FIN 46(R) are being pushed through without allowing adequate time to consider international convergence, which may create competitive imbalances. While the changes will impact our markets in the short term, their long-term functionality must be questioned since policymakers ultimately plan to move toward international convergence in a timely manner.

CMSA cannot emphasize enough its broader-based concern that introducing any changes at this time – even if implementation of those changes is delayed or phased-in over time – will serve only to provide additional uncertainty in our real estate and other asset-backed securities markets. This seems especially imprudent at a time when market participants and policymakers are attempting to breathe life back into the markets.

CMSA certainly welcomes efforts to reassess and improve disclosure and financial reporting. Indeed, CMSA has been at the forefront in providing transparency to the CMBS market through the creation of its CMSA IRP®, which allows investors and other market participants to very closely monitor CMBS investment performance at the bond level as well as the property level. Investors also have access to many other sources of information from servicers, research firms like Trepp and Realpoint that accumulate and analyze data, and investment bank research departments, which essentially all CMBS investors utilize at some level to independently evaluate their investments and potential investments in this sector. With all the sources of transparency provided in the CMBS industry, investors can see through the bonds and mortgages to the collateral of the income producing properties and their performance, including the cash flow available to service the debt of the commercial mortgages. In keeping with our transparency standards, CMSA supports the supplemental disclosures recommended

by various bodies in response to the recent market disruptions, which many reporting entities already have begun to provide.

At the same time, CMSA strongly believes it essential that policymakers take the time necessary to produce a standard that will result in an improvement to the accounting in this area, rather than imposing changes hastily that are not beneficial in the long run. These issues deserve, indeed demand, comprehensive deliberation over a reasonable period of time given the impact on the U.S. financial markets and overall economy. All parties – including market participants and policymakers – will benefit from a deliberate process to examine and better understand all options and their consequences.

Part of this extended deliberation should include consideration of less draconian changes than the balance sheet consolidation that is currently proposed, focusing on approaches that (1) enable users of financial statements to differentiate between assets that are truly controlled by the consolidated reporting entity as opposed to those that are isolated from that entity and its creditors; and (2) appropriately recognize differences among the prevailing structures used for various asset classes. For example, “linked presentation” is one alternative worthy of thorough consideration. Under this concept, the liabilities issued in securitizations would be shown on the asset side of the balance sheet as a deduction from the amount of securitized assets, within a single caption. Parallel presentations would apply on the income and cash flow statements. FASB’s proposed rule changes, however, exclude linked presentation except as an incremental footnote disclosure, apparently largely because an artificial year-end deadline does not allow adequate time for consideration of linked presentation and other alternatives, or consideration of many ancillary, but nevertheless important, issues.

Since there have been supplemental disclosures recommended by various bodies in response to the recent market disruptions (which many reporting entities already have begun to provide), CMSA does not believe that a year-end deadline for final changes to securitization accounting rules is a necessary response to current market conditions. Instead, a more measured and realistic but still aggressive deadline of January 10, 2010 would permit the full consideration of all policy alternatives, including allowing sufficient time for Congress and other financial regulators to independently review the potential impact of the proposed accounting policy changes. The extra time will also allow for possible field testing of any proposal to ensure that policymakers and market participants can fully gauge the outcome of the proposal, and provide for a public comment period commensurate with the importance of the changes under consideration.

CMSA has formally asked the FASB to consider a timeframe of January 10, 2010 for finalizing any rule changes. CMSA accordingly urges the Subcommittee to encourage FASB to extend any artificial deadline for finalizing changes to securitization-related accounting standards and to take the time necessary to consider all options in order to create the most accurate accounting standard with the least disruption.