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July 16, 1997

Internal Revenue Service
Couriers Desk
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
Attn: CC:DOM:CORP:R (FASIT Solicitation)

Re: Additional Comments on FASIT Regulations

Ladies and Gentlemen:

In a letter dated January 10, 1997, PSA The Bond Market Trade Association ("PSA") submitted comments [1] on issues that PSA believes should be addressed in upcoming FASIT regulations. We are writing to you now to supplement our earlier comments concerning gain recognition upon formation of a FASIT and to request a meeting between representatives of PSA and those at the IRS and Treasury responsible for developing FASIT regulations. We believe such a face-to-face meeting would be helpful to you in that we would be able to answer any questions the IRS and Treasury attorneys may have concerning our comments.

FASIT GAIN RECOGNITION RULES

Section 860I (a)[2] provides that if property is transferred to a FASIT by the holder of the ownership interest in the FASIT, the holder of the ownership interest will recognize gain, but not loss, on the property transferred. This section further provides that if property were to be transferred to the FASIT by someone other than the holder of the ownership interest, the property would be viewed as first having been transferred to the holder of the ownership interest and then transferred to the FASIT.

In the case of debt instruments that are traded on an established securities market and all assets other than debt instruments (e.g., hedging instruments), the gain recognized would equal the difference between the fair market value of the debt instrument or other asset and the adjusted basis of that debt instrument or other asset. In the case of debt instruments that are not traded on an established securities market, the gain would equal the excess of a formula amount over the debt instrument's adjusted basis. The formula amount would be the present value of all cash flows due under the debt instrument (taking into account anticipated prepayments and losses) determined by discounting those cash flows back to the date of transfer using a discount rate equal to 120% of the appropriate applicable federal rate ("AFR"). Section 860I(d)(1)(A)(ii), however, expressly grants to the IRS and Treasury regulatory authority to specify a different discount rate.

In our earlier letter, we observed that the formula valuation methodology set out in section 860(I)(d) would require a sponsor to project prepayments and defaults on debt instruments in developing a stream of reasonably expected payments. We indicated a need for guidance setting out a clear and objective methodology for projecting such payments. Further, we pointed out that verifiable market based information concerning both prepayment speeds and default rates often does not exist, and therefore, the regulations to be developed should contain certain safe harbors upon which sponsors could rely in projecting reasonably expected payments for purposes of applying the formula.

Although we continue to believe that such guidance is needed, we believe the IRS and Treasury should also consider drafting regulations that would apply the formula valuation rules to only those debt instruments for which reasonable, readily ascertainable evidence of market value does not exist. We make this recommendation for two reasons.

First, the formula valuation rules, which were apparently enacted to provide certainty concerning valuation, in fact fail to provide such certainty due to the speculative nature of projecting reasonable payments due on debt instruments. Even the adoption of regulations setting out methodologies to be employed and safe harbors for making such projections will not eliminate this uncertainty.

Second, and more importantly, the formula valuation approach is likely to distort the recognition of income attributable to debt instruments transferred to a FASIT, particularly those having relatively longer remaining terms to maturity. The formula, because it employs a discount rate of only 120% of the AFR, will likely overstate the value of the debt instruments resulting in gain recognition to a FASIT sponsor on formation of a FASIT that has nothing to do with the actual fair market value of the debt instruments. Furthermore, the gain so recognized would increase the tax basis in those debt instruments. If the sponsor retains the ownership interest in the FASIT, that basis increase would result in a stream of premium recoveries with respect to the debt instruments in future periods. In other words, the formula would produce phantom gain on formation followed by phantom deductions over the life of the securitization transaction.[3] PSA members have increasingly raised concern that the application of this formula valuation rule could render a FASIT election uneconomical to the point of being unviable as a securitization device for some asset types. We believe that this outcome would be extremely undesirable, given the FASIT statute's underlying goal of facilitating the securitization of a broad range of financial assets.

The distortion attributable to the application of the formula valuation rule would be most pronounced in a situation where a sponsor transfers loans having relatively longer maturities to a FASIT, such as commercial and residential mortgage loans. For instance, suppose that a sponsor purchased at par a self amortizing commercial mortgage loan (or a pool of such loans) for $8 million, having an anticipated term to maturity of exactly 10 years, and calling for level semiannual payments, net of servicing, of $622,492.48. Thus, the rate on the loan, reflecting semiannual compounding, would be 9.28% for an annual effective rate of 9.5% (100 basis points over the prime rate). For June, 1997, 120% of the long-term AFR, based on semiannual compounding, is 8.39%. If this rate were applied to a semiannual stream of payments in the amount of $622,492.48, it would produce a present value of $8,315,656.77. Consequently, the sponsor would have a taxable gain of $315,656.77 if the formula valuation approach applied, and this would be true even if the yield on the securities sold by the sponsor and backed by the commercial loan exceeded 8.39%. This cannot be the result envisioned by Congress.

Clearly, the purchase price paid by the sponsor in a purchase transaction from an unrelated third party contemporaneously with the formation of the FASIT is the best indicator of value. Moreover, even if the sponsor itself had originated loans over a period of time, evidence may exist in the market that would indicate the value of the loans. For instance, in the case of one-to-four family residential real estate loans, lenders will typically quote rates and discount points for loans from which one can derive a market price at which loans would be originated.

We believe the IRS and Treasury have regulatory authority to depart from this formula valuation regime where evidence exists in the market that would allow one to derive a value for a debt instrument or pool of debt instruments. First, Section 860I (d) expressly excludes from the scope of the formula valuation rules any debt instrument that is "traded on an established securities market," but it does not define that term. We suggest that the regulations interpret the term to include any debt instrument for which price quotations were readily available from any person, such as a broker, trader, or dealer. This approach would somewhat parallel that taken in Treas. Reg. § 1.1273-2(f)(5) (without including the safe harbors), and that taken in Treas. Reg. § 1.7704-1(c)(2) in defining "secondary market or substantial equivalent thereof" for purposes of determining whether a partnership is a publicly traded partnership.

Second, the Section 860I(d)(1)(A)(ii) expressly authorizes the use of a discount rate other than 120% AFR to the extent authorized by regulations. Regulations could provide that, in the case where market quotations for a class of debt instruments, such as mortgage loans, are readily available, then the appropriate discount rate to be applied would be either the quoted yield, or if prices were quoted rather than yields, the discount rate that would cause the present value of the future payments on the debt instrument(s) to equal the quoted price.

We realize that in situations where a lender originates loans, the price quoted to borrowers will reflect the costs of origination and servicing the loan. In other words, a lender could originate a $100 loan for $98 where the $2 of discount would be attributable to origination costs. The lender could subsequently sell the loan to an investor, who would not incur those costs, for $100. If concern exists that the use of origination prices, and the resulting yields they would produce would not be reflective of fair market value, the regulations could provide that the appropriate discount rate would be the yield at which comparable loans are being originated, less a specified number of basis points (e.g., 125 basis points for one-to-four family residential real estate loans). We note that the IRS has, in Rev. Proc. 91-50, 1991-2 C.B. 778, provided such a bright line rule to taxpayers in determining what constitutes normal servicing.

REQUEST FOR A MEETING

We realize that you may have concerns regarding your authority to craft regulations along the lines outlined above. We further realize that expressing a concept in abstract form is not nearly as difficult as reducing that concept to workable regulatory language. In an effort to assist you in addressing the issue set out above, as well as other issues you may have, we would be pleased to have representatives of PSA and their attorneys meet with the IRS and Treasury attorneys working on the FASIT regulation project. We believe that only in such a meeting can we have the kind of dialogue needed to crystallize the issues and develop a workable solution. After you have had an opportunity to consider our comments, please call the undersigned at (212) 440-9403, or our special outside counsel, Robert Kreitman, Esq. of Brown & Wood L.L.P. at (212) 839-8637, so that we can arrange such a meeting.

Sincerely yours,

/S/

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FOOTNOTES

1. We have attached a copy of that earlier letter for your information.

2. All section references are to the Internal Revenue Code of 1986 unless the context clearly requires a different reference.
3. We find it interesting to note that the gain created under the formula valuation rule on formation of a FASIT could be sheltered with allowable deductions and losses, while the resulting premium created in the debt instruments held by the FASIT would offset income inside the FASIT that would otherwise be passed through to the holder of the ownership interest and be subject to the special inclusionary rules of section 860J (i.e., the income could not be offset with otherwise allowable deductions or losses).