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Internal Revenue Service
CC:DOM:CORP:R (REG.-100276-97; REG-122450-98)
Courier's Desk
1111 Constitution Avenue, N.W.
Washington, D.C.

Re: Proposed FASIT Regulations; Additional Comments

Ladies and Gentlemen:

In a letter dated May 19, 2000, The Bond Market Association ("Association")[1] submitted comments on the proposed FASIT regulations issued on February 4, 2000[2]. Our comments focused on aspects of the proposed regulations that were likely to affect the use of FASITs to securitize commercial mortgage loans. Since our letter was submitted, we have become aware of several additional issues that could limit the use of FASITs in that area. This letter discusses those issues. Background information regarding the Association and the commercial mortgage markets may be found in the earlier letter.

1. Changes in Circumstances

Commercial loan securitizations typically involve a trust that holds a fixed or largely fixed pool of loans and issues pass-through certificates representing interests in the trust. Securities issued by the trust are expected to be paid from the loans held by the trust. No one is standing by, ready to buy back the loans or to guarantee that they have a minimum value, before maturity. Accordingly, it is essential that the trust be able to collect payments on the loans and pass them through to trust owners over the entire life of the loans.

If a trust holding commercial mortgages were to make a FASIT election, then an early termination of the election generally would force a liquidation of the trust. Accordingly, for the FASIT vehicle to be viable, the parties must be confident that a FASIT election cannot be terminated prematurely because of factors outside of the FASIT's control.

A FASIT must meet the asset test set out in section 860L(a)(1)(D). The test requires that at all times (after an initial three month grace period) all but a de minimis amount of assets be "permitted assets" described in section 860L(c). Neither the statute nor the proposed FASIT regulations address the situation in which the status of loans held by a FASIT changes after they are acquired because of factors outside of the FASIT's control. Two examples will illustrate cases in which such a change can occur:

Example (1). A trust holding commercial mortgage loans makes a FASIT election. The trust acquires a significant loan from B, who is unrelated to the holder of the FASIT ownership interest (the "Owner"). The Owner is indirectly owned by a public company. Sometime after the acquisition, an affiliate of B makes a tender offer to buy the parent of the Owner. As a result, B becomes related to the Owner. Under section 860L(c)(2), debt of a person related to the Owner is not a permitted asset. Thus, if the status of the loan acquired from B must be retested continuously, the loan would cease to be a permitted asset because of the tender offer.

The possibility of an event such as the one described in Example (1) would make it difficult to be certain that a trust holding commercial mortgages would be able to maintain its status as a FASIT over its life, even if it does nothing but collect payments on its assets and pass them through to trust owners.

Example (2). A trust holding commercial mortgages makes a FASIT election. A significant loan that was performing when it went into the FASIT defaults because of the loss of a significant tenant. Although the trust has the right to foreclose, it believes that it will obtain a larger recovery by renegotiating the terms of the loan to stretch out payments. In exchange, the borrower agrees to pay additional interest based on revenues from the property. The change in terms could cause the loan to lose its status as a permitted asset, either on the ground that the loan no longer pays interest at a fixed or variable rate, or because the loan may no longer be debt for tax purposes.

The default in Example (2) is not caused by the trust, but rather is outside of its control. While the trust could foreclose or sell the loan, limiting it to those choices would impose a significant burden on FASIT investors compared to the position of a direct investor.

REMICs are also required to meet a continuous asset test, and thus potentially face the same concern as FASITs over the possible conversion of a qualified mortgage to a non-qualified asset due to a change in circumstances. Under the REMIC regulations, however, the definition of qualified mortgage is generally applied only when a loan is acquired by a REMIC and is not reapplied unless and until the loan is modified. A REMIC would not be forced to modify a loan except in a default setting. The REMIC regulations address that case by providing that a modification occasioned by a default or reasonably foreseeable default is disregarded in testing the continuing qualification of a mortgage.[3]

In order for a mortgage to be a FASIT permitted asset, it must meet a number of tests that do not apply to REMICs. Specifically, the mortgage must qualify as debt for tax purposes, bear certain rates of interest, not be issued by related persons, and, under the FASIT regulations, not be subject to a foreign withholding tax (if the instrument is publicly traded). We believe that the FASIT regulations should follow the approach of the REMIC regulations and apply these tests (and any others that may be relevant) only when a FASIT acquires a debt instrument.[4] A loan modification should not be considered a new acquisition requiring the status of the modified loan to be retested if the modification is occasioned by a default.

2. Definition of Variable Rate Debt Instrument

To be a permitted asset for a FASIT, a debt instrument must have interest payments meeting the requirements "applicable under clause (i) or (ii) of section 860G(a)(1)(B)(i)."[5] The cited section describes the permitted rates of interest on REMIC regular interests. Clause (i) refers to REMIC regular interests paying interest at a fixed or qualifying variable rate. Clause (ii) addresses interest consisting of a specified portion of interest payments on qualified mortgages. There are extensive regulations defining permitted variable rates for REMIC regular interests. They include rates based on a qualified floating rate, rates based on a weighted average of rates on other mortgages, combinations of fixed and floating rates, and rates calculated by adding to or subtracting from such rates a fixed amount or multiplying them by a fixed factor.[6]

The proposed FASIT regulations would allow *a variable rate debt instrument only if it is a variable rate debt instrument* (VRDI), as defined in the original issue discount regulations, that provides for interest at a qualified floating rate.[7] The most significant ways in which the FASIT regulations would cut back on the REMIC variable rate definition relate to the ability to combine different qualified floating rates and/or fixed rates over the life of a loan,[8] the treatment of caps and floors,[9] and the treatment of multiples of floating rates equal to or less than .65.[10] Thus, the FASIT regulations would not treat as a permitted asset a 10-year loan that provided for interest at a fixed rate over LIBOR, subject to a cap of 10 percent during the first 2 years and 12 percent thereafter, which is an extraordinary result. Mortgage originators have begun to originate loans that combine in a single loan agreement fixed and floating rate principal components. For example, 50 percent of the loan balance might bear interest at a floating rate and 50 percent at a fixed rate. Such a loan would not be a permitted asset under the proposed regulations if the floating rate component was 65% or less, because the rate index on the loan as a whole would be a multiple of a floating rate that is not more than .65. We recommend that the FASIT regulations follow the statute and allow a debt instrument held by a FASIT to pay interest at any variable rate that would be permitted for a REMIC regular interest.

3. Asset Guarantees

The FASIT statute has separate rules treating certain hedge and guarantee contracts as permitted assets.[11] By contrast, the REMIC sections make no mention of them. Prior to adoption of the REMIC regulations, it was universally assumed that a REMIC could hold a mortgage or pass-through certificate benefitting from a guarantee, on the ground that the guarantee was not a separate asset under general tax principles.[12] We recommend that the FASIT regulations acknowledge that a FASIT may acquire debt instruments that benefit from an asset-specific guarantee without complying with the special rules in the statute and regulations for guarantees. Any other conclusion would produce absurd results. For example, the FASIT regulations would not allow guarantee contracts that would benefit the FASIT ownership interest. To the extent a FASIT acquired a guaranteed debt instrument, the guarantee would necessarily benefit the ownership interest. It is highly unlikely that the FASIT statute was intended to be less lenient that the REMIC rules in terms of the types of credit support that are allowed. We recommend that the FASIT regulations confirm that a FASIT can always acquire a debt instrument, or pass-through certificate representing an interest in a pool of debt instruments, with a guarantee that is specific to that asset without complying with the special rules in the regulations or statute for guarantees.

* * *

As noted above, the Association is interested in facilitating the use of FASITs, particularly as workable vehicles for securitizing commercial mortgage loans. We believe that this result can best be accomplished through ongoing discussions between the drafters of the regulations and participants in these types of transactions. We would be pleased to meet or speak with you, or to provide additional information, if that would assist you in addressing the points mentioned above or in our earlier letter. If you have any questions or would like additional information, please feel free to contact the undersigned at 212.440.9403, or James M. Peaslee, Esq. of Cleary, Gottlieb, Steen & Hamilton (special outside counsel to the Association) at 212.225.2440.

Sincerely,

/S/

George P. Miller
Senior Vice President,
Deputy General Counsel

cc: Paul Saltzman, Laura González, Michael Decker - *The Bond Market Association*
James M. Peaslee, Esq - *Cleary, Gottlieb, Steen & Hamilton*

FOOTNOTES

1. The Association represents securities firms and banks that underwrite, distribute and trade debt securities, both domestically and internationally. The Association's member firms account for in excess of 95% of all primary issuance and secondary market trading activity in the U.S. debt capital markets. Among other roles, the Association's members act as issuers, underwriters and dealers in connection with mortgage-backed and asset-backed securities that are characterized, for federal income tax purposes, as REMICs and FASITs. More information about the Association and its members and activities may be obtained form the Association's website at www.bondmarkets.com.
2. A loan sponsor may be required to buy back a loan if it has breached a representation regarding the characteristics of the loan when it is transferred to the trust, but standard commercial representations would not address the FASIT qualification issues discussed in the text of this letter.
3. See Treasury regulation §§ 1.860G-2(a) (sufficiency of real property collateral tested when loan originated or acquired by REMIC), -2(b) (assumptions and modifications).

4. In our May 19 letter, we asked that a FASIT be able to treat an asset as a permitted asset until it discovers that it is not such an asset. That recommendation relates to a late discovery of a problem that existed when the asset was acquired. The recommendation in the text addresses a different point, which is a change in circumstances that occurs after an asset is acquired.
5. Section 860L(c)(1)(B).
6. See Treasury Regulation § 1.860G-1(a)(3).
7. Under a literal reading of the regulations, only a single qualified rate would be allowed over the instrument's life. See Proposed Regulation § 1.860H-2(b)(1)(ii) (requiring "a" qualified floating rate).
8. A REMIC variable rate can be a combination rate that mixes various fixed and floating rates over the life of a debt instrument. See Treasury Regulation § 1.860G-1(a)(3)(vi). The VRDI definition itself allows one fixed rate plus one or more qualified floating rates, or multiple qualified floating rates. Treasury Regulation § 1.1275-5(a)(3)(i). As already noted, the FASIT regulations, as now written, would not allow even this flexibility because they would require "a" qualified floating rate.
9. The REMIC rules allow caps and floors without restrictions. Treasury Regulation § 1.860G-1(a)(3)(iv). By contrast, a cap or floor on a debt instrument taxable as a VRDI must be either the same over the instrument's life, or not reasonably expected as of the issue date to change significantly the yield of the instrument. The FASIT regulations would also cut back on the REMIC variable rate definition by not allowing weighted average coupon rates.
10. The definition of a VRDI requires a multiplier greater than .65 but not greater than 1.35. Treasury Regulation § 1.1275-5(b)(2).
11. See section 860L(c)(1)(D).
12. For a private letter ruling reaching this result before the regulations were issued, see P.L.R. 8918045 (February 6, 1989). The TMP regulations also reach the same result, again without any guidance from the statute. See Treasury Regulation § 301.7701(i)-1(c)(4) (credit enhancement contract treated as part of asset to which it relates).