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Re: Effect of International Accounting Standards on Tax Treatment of Commercial Mortgage-Backed Securitisations

Dear Mr Evans,

Introduction

We are writing this letter on behalf of the members of the Commercial Mortgage Securities Association to express their concern as to the likely tax consequences of current proposals for accounting for securitisation transactions under International Accounting Standard ("IAS") 39 in the context of the general movement towards taxing companies which are within the charge to UK corporation tax on the basis of their accounting profits.

Our concerns arise in the context of special purpose vehicles used either to issue debt securities and use the proceeds to acquire loans secured on commercial property ("SPV Issuers") or to act as borrowers or property owners in connection with loans that are intended to by financed through CMBS issues ("SPV Borrowers").

We feel that if SPV Issuers or SPV Borrowers are taxed in the UK on the basis of their IAS 39 accounts, securitisation may become an uneconomic means of raising finance for real property, depriving real estate companies and the UK economy as a whole of the benefits offered by securitisation.

Since many other European jurisdictions either have tax-transparent or tax-neutral securitisation vehicle regimes, or will likely not adopt IAS for tax purposes in solo company accounts, or both, this will be a detriment to the competitiveness of the UK economy.

The CMSA

The Commercial Mortgage Securities Association (the "CMSA") is an industry group formed in 1994 and dedicated to improving the liquidity of commercial real estate debt securities through access to the capital markets. The CMSA includes as its members the wide spectrum of companies involved in the business of creating, trading, monitoring and investing in commercial mortgage-backed securities ("CMBS") including originating banks and other commercial mortgage loan originators, investing banks and other CMBS investors, mortgage servicing companies and trustees, rating agencies as well as bondholders investing in AAA-rated to non-rated CMBS classes.

Growth of the European CMBS Market

It may be helpful first of all if we outline the growth of the European CMBS Market in recent times and the benefits which we are concerned may be at risk.

The advent of CMBS in real estate finance has provided lenders with additional sources of capital to invest in real estate lending. This effectively provides commercial real estate borrowers with the ability to tap into the capital markets for their real estate debt requirements, providing them with an alternative to traditional bank lending. This gives corporates, governments and financial institutions that are real estate borrowers access to a wider range of capital sources and, therefore, more alternatives to choose from when obtaining financing secured by commercial real estate. Also, CMBS provides originating banks with an alternative to selling loans off of their balance sheets. Through a securitisation, the investor base in CMBS expands beyond the traditional whole loan investor market.

For these reasons, CMBS has grown significantly since its inception. For 2003, total new issue volume of CMBS in Europe is estimated to be $8.6 billion backed by European real estate mortgage debt and $70.3 billion backed by U.S. real estate mortgage debt. In the United States, the commercial mortgaged-back securities market is currently $550 billion, and the CMBS capital markets are now nearly on par with commercial banks to be the leading source of commercial real estate debt (approximately 15% for each sector). Set out below are tables showing the growth in European and U.S. CMBS issuance.

European CMBS Issuance Volume and Transaction, 1997 to 2003

	Issuance (US$million)	Number of Transactions
1997	8,183	13
1998	718	2
1999	4,124	7
2000	6,103	10
2001	14,494	21
2002	22,047	22
2003	8,558	12
Source: Fitch Ratings (2003 is YTD)		

US CMBS Issuance Volume and Transaction, 1990 to 2003

	Issuance (US$million)	Number of Transactions		Issuance ($billion)	Number of Transactions
1990	3,297	31	**1999**	56,803	94
1991	7,633	50	**2000**	47,218	75
1992	13,997	54	**2001**	69,341	102
1993	16,519	118	**2002**	54,278	61
1994	15,364	97	**2003**	70,354	76
1995	15,837	77			
1996	26,784	96			
1997	37,806	82			
1998	75,005	82			
Source: Fitch Ratings (2003 is projected)					

The Benefits of CMBS

Any owner of or investor in real estate in the UK and elsewhere in Europe would clearly benefit from the additional source of capital available for lending on commercial real estate. In particular, during recessive times in an economy, it is typical that there is a significant reduction in available lending sources for commercial real estate. Such lack of available capital can make it difficult for owners and investors in real estate to obtain the financing necessary to acquire or renovate their commercial real estate investments and, therefore, could have an adverse effect on the value of commercial property. CMBS provides an additional means of obtaining capital for the purpose of commercial real estate borrowing. (The growth of CMBS in the U.S. in the early 1990s has been significantly attributed to the lack of available lending sources during the recession of that period.) It is likely therefore that CMBS also performs a helpful counter-cyclical role in limiting the risk of a collapse in property prices in recessionary times.

There are multiple benefits to the investor in the CMBS transaction. The most significant benefits are: (a) the diversification of the pool of loans (if multiple loans); (b) the tranching of the CMBS securities into various rating levels (typically "AAA" to "BB"); and (c) ability to invest in commercial real estate debt in relatively low investment amounts, as compared to the principal balances of the related mortgage loans. Investors in CMBS understand that they are assuming the same risks as an investor in whole mortgage loans, such as balloon payment risks at maturity. However, these risks are considered by the investors in the pricing of their investment in the CMBS.

The inherent risks of investing in loans secured by commercial real estate are also by the rating agencies in their determination of the expected credit risk of a portfolio of mortgage loans backing a CMBS security. The rating agencies intensely review the underlying loans and properties and employ resources, both internal and external, to dissect the structure of the specific CMBS. This due diligence by the ratings agencies represents a significant departure from their review process of other asset backed securities and involves a much more thorough review of the underlying assets of such securitisations.

The rating assigned to a security conveys the rating agency's opinion of expected losses (and/or default probability) on the security. Ratings are intended to be comparable across asset types. For instance, in an expected loss framework, a CMBS security rated "BBB" has a similar loss expectation as a corporate security rated "BBB". The tables below highlight the percentage of bonds that default over twelve months for each rating category. For the purposes of this study, it is assumed that a rating of "Caa" or less to be synonymous with default. As demonstrated below, CMBS performance has exceeded the performance other sectors across virtually all rating categories. To illustrate, the first table below shows only 0.43 % of the group of CMBS rated "Ba" at any time tend to default over a period of twelve months. The comparable figure is almost five times higher for corporates (2.04 %) and much higher for ABS and CDOs (in excess of 11 %).

CMBS Bond Defaults Are Substantially More Modest Than Other Sectors

	Rating of Caa or below after 1 year					
Initial Rating	**ABS**	**CDO**	**CMBS**	**RMBS**	**Others**	**Corporates**
Aaa	0.07%	0.00%	0.00%	0.00%	0.00%	0.00%
Aa	0.22%	0.11%	0.08%	0.00%	0.00%	0.03%
A	0.09%	0.90%	0.00%	0.20%	0.25%	0.04%
Baa	0.68%	3.18%	0.20%	0.86%	2.14%	0.39%
Ba	11.10%	11.04%	0.43%	2.39%	2.38%	2.04%
B	21.71%	29.91%	2.36%	6.41%	2.33%	10.70%

Source: Moody's Investors Service

Standard & Poor's One-Year Bond Default Rates by Asset Type

Rating at Beginning of Year	**ABS**	**CDO**	**CMBS**	**RMBS**	**Corporates**
AAA	0.00%	0.00%	0.00%	0.00%	0.00%
AA	0.00%	0.00%	0.00%	0.00%	0.01%
A	0.32%	0.00%	0.00%	0.00%	0.05%
BBB	0.37%	1.80%	0.00%	0.10%	0.39%
BB	1.63%	3.40%	0.87%	1.00%	1.50%
B	10.71%	6.30%	1.52%	2.00%	6.88%

Source: Standard & Poor's Ratings

Our concerns about IAS 39

As you are aware, companies whose securities are listed on a European stock exchange will be required to prepare their consolidated accounts in accordance with IAS from 1 January 2005 and it seems likely that this requirement will effectively be extended to solo company accounts over the near future as UK GAAP is harmonised with IAS and since, in any case, there may be practical difficulties in adopting different accounting methods at solo and consolidated level. SPV Issuers frequently take the form of UK incorporated public limited companies and their securities are usually listed on the London, Dublin or Luxembourg stock exchanges. In addition, many SPV Borrowers are UK incorporated limited companies. Accordingly, many SPV Issuers and SPV Borrowers will relatively soon be required to prepare their accounts in accordance with IAS and specifically with IAS 39 which is the main standard governing the treatment of debt and derivatives.

Effect on Securitisation

IAS 39 gives rise to a number of concerns for securitisations, particularly securitisations of loans secured over real property. These concerns centre on the rules requiring most debt assets and derivatives to be marked to market, which can give rise to volatility, while liabilities (such as loan or bond finance) are typically carried at amortised cost. This differing basis of valuation of broadly matching items may result in SPV Issuers and Borrowers having accounting profits or losses in any given year even though they have made no material "economic" gain or loss. If, as seems to be current plan, these companies are to be taxed on the basis of their IAS 39 accounts, they could become liable to pay tax on their unrealised accounting profits and could become insolvent as a result.

This could become an absolute tax cost if revaluations went into reverse two or more years later beyond the one year period allowed for carryback of tax losses.

SPV Issuers and Borrowers are designed to be "tax neutral", i.e. to obtain no tax advantages for the sponsors of the transaction and to make very modest economic accounting, and taxable profit. This is because these companies contribute to the transaction only their independent legal personality and their absence of competing liabilities; although these are vital contributions to the transaction they can be obtained from the incorporation of any new vehicle company hence, quite appropriately, the returns accruing to them are very low. Third parties take the benefit of the securitisation through a variety of methods and consequently will be liable for any tax due in respect of such benefits. The Inland Revenue have, rightly if we may say so, tended to focus attention on where these benefits accrue to ensure that appropriate amounts of these benefits have been recognised in UK taxable entities and branches.

In addition, the rating agencies insist that if there is any possibility that a SPV Issuer or Borrower might have to pay any tax, (just as with any other liabilities) that the company be given adequate resources to meet the same. The only funds available to a SPV Issuer or Borrower to meet such a liability will be monies derived from the financed assets. If CMBS originators are required to set aside monies for this purpose, CMBS transactions will become a less attractive means of raising finance. CMBS is becoming an important method of financing real estate loans in Europe and, we would suggest, offers considerable benefits to participants (both borrowers and lenders) engaged in real estate finance.

We understand that extensive consultations are already underway with various representative and business bodies and welcome that fact. We have two main concerns: firstly that the volatility identified should be completely eliminated by allowing a similar tax accounting treatment (regardless of the IAS 39 treatment) for all broadly matching debt and derivatives rather than only those within a particular accounting category or those falling within restrictive IAS 39 definitions of hedging; and secondly that the solutions adopted should be clear legislative solutions and not left to practice or guidance which, however reasonably applied, is of little content in the context of securing the rating of transactions.

Conclusion

You may already be aware that various representatives of the European securitisation industry have already approached the International Accounting Standards Board with comments on IAS 39. Whilst, some of these have been addressed, it appears unlikely that others, particularly those specific to CMBS, will be taken into account.

As such, we would like to assist the Inland Revenue in its evaluation of CMBS as a source for lending capital and as an investment in order that they may properly assess the impact of the proposed accounting changes on the issuance of CMBS. As an industry, we are highly supportive of the establishment of laws and regulation that are instrumental to the issuance of commercial mortgage-backed securities. Therefore, we would like to work with the Inland Revenue in providing information that might be helpful in the establishment of a tax framework within which CMBS issuance can continue to be beneficial to the real estate industry.

We appreciate your consideration of the views of CMSA. Members of the CMSA would welcome the opportunity to meet with the Inland Revenue sometime in the coming weeks to further discuss how we might be able to assist with providing further information on CMBS. If you have any further questions or comments on this matter, please do not hesitate to contact John Cullinane at 0207 303 2803 or by email at jcullinane@deloitte.co.uk, or Conor Downey at 0207 170 8670 or by email at conor.downey@cwt-uk.com.

We are copying to your colleague Mr Richard Thomas.

Cc: Richard Thomas Esq. – Inland Revenue, Business Tax