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# Introduction to REMICS

# For

# Real Estate Attorneys

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# INTRODUCTION TO REMICS FOR REAL ESTATE ATTORNEYS

## 1. General Overview of the Basics of What is a REMIC.

a. Definition. REMIC is an acronym for Real Estate Mortgage Investment Conduit. REMICs are the primary vehicle used for the securitization of residential and commercial mortgage loans. This presentation will focus on commercial mortgage loans.

b. Description. A REMIC is a structure that holds a pool of mortgage loans and issues securities backed by those loans. A REMIC may be formed as trust, a corporation, a partnership or an association, and the pool of qualified mortgage loans may consist of any number of such loans, including a single loan. The securities may be debt or equity and are typically of different classes.

c. Primary Benefits.

(i) Tax. The REMIC structure allows for the pooling of qualified mortgages and the issuance of different classes of securities backed thereby without the payment of double taxation. The interest or other income payments to the holders of the securities issued by the REMIC are fully taxable to the holders thereof as with any other security held by such holders, but the payments of interest on the mortgage loan are not taxed to the REMIC.

(ii) Non-Tax.

(A) Risk Allocation. The different classes of securities issued by a REMIC permit for a allocation of risk among the holders thereof. Investors can chose to be on the safer side of the investment by purchasing securities in one of the highest rated classes. These securities will pay an interest rate lower than what the investor could have obtained on a whole mortgage loan. Securities or interests that are in the lower or unrated tranches will be higher risk as first loss pieces and will carry an higher interest rate.

(B) Liquidity. Notwithstanding the current market dislocation, as a general rule, the REMIC securities, at least in the higher rated tranches are more liquid than whole loans.

(C) Risk Based Capital. Certain institutions, such as insurance companies, are required to maintain capital reserves against losses on assets. Generally the reserves required with respect to bonds are lower than those required for mortgage loans.

## 2. Permitted Assets.

In order to qualify as a REMIC, substantially all of the assets must be "Qualified Mortgages" and "Permitted Investments":

a. Qualified Mortgages. A qualified mortgage is any obligation secured by real property and that:

(i) is transferred to the REMIC on the start-up date for an interest in the REMIC;

(ii) is purchased by the REMIC within 3 months of the start-up date; or

(iii) represents an increase in the principal amount of an obligation under (i) or (ii) above but only if it meets certain requirements.

It also includes a qualified replacement mortgage. A qualified replacement mortgage is any mortgage that would have qualified as a qualified mortgage if it were transferred to the REMIC on the start-up date and was received in exchange for (A) an obligation within 3 months after the start-up date or (B) a defective obligation received within 2 years after the start-up date. A defective obligation is a qualified mortgage with respect to which there is a default or threatened default.

Whether an obligation is principally secured by real property is a question of the fair market value of the property as compared to the issue price of the obligation.

b. Permitted Investments. Permitted Investments include:

(i) The short term investment of payments received on qualified mortgages

(ii) Intangible Assets held for certain REMIC activities

(iii) Foreclosure property (for up to 3 years)

**3. Interests In REMICs.**

REMICs issue 2 types of interests:

a. Regular interests; and

b. Residual interests

A regular interest is any interest designated as such and (i) unconditionally entitles the holder to a specified principal amount and (ii) the interest payments are either (A) payable at a fixed rate (B) payable at a variable rate that satisfies certain requirements or (C) consists of a specified portion of the interest payment and that portion does not vary.

A residual interest is any other interest. There can only be 1 class of residual interest and all distributions with respect to the residual interest must be pro rata.

**4. Taxation.**

a. General Rule. REMICs are generally not subject to taxation; rather the interest is taxable to the interest holders.

b. Exceptions. REMICS are subject to tax in certain circumstances:

(i) Income from foreclosure property (to the extent that such income would be taxable to a REIT)

(ii) a 100% tax on contributions after start-up date

(iii) a 100% tax on prohibited transactions

**5. Defeasance.**

a. Description. Replacement of mortgaged property with government securities as collateral for the mortgage loan.

b. Purpose. Permit mortgage borrower to obtain a release of the mortgaged property without necessitating an early redemption of the bonds backed by the mortgage loan. The business purpose is to provide the mortgage borrower with the equivalent of a right to prepay without causing the lender to suffer the adverse affects of prepayment.

c. REMIC Rules. Defeasance is permitted under the REMIC rules provided that:

(i) the substitute collateral is government securities,

(ii) the mortgage documents allow the substitution,

(iii) the lien of the mortgage is released to allow the mortgagor's disposition of the encumbered real property or as part of a customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and

(iv) the release does not occur within 2 years of start-up date

d. Practice Points.

(i) Government Securities. For purposes of the REMIC rules, "government security" has the meaning provided under Section 2(a)(16) of the Investment Company Act of 1940, which provides that: "Government Security" means any security issued or guaranteed as to principal or interest by the United States, or by a person controlled by or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing. Included under this definition are: (A) U.S. Treasury notes, bills and bonds and (B) securities issued by federally chartered instrumentalities, including Fannie Mae, Freddie Mac, FHLMC, Farm Credit System, and GNMA.

When negotiating the loan documents from the borrower's side, it is important that the definition of acceptable defeasance collateral include agencies. These securities typically pay higher interest rates than treasuries and defeasing with them as opposed to with treasuries will likely significantly lower the borrower's cost of defeasance. Note that the rating agencies have additional criteria as to what constitutes acceptable defeasance collateral for purposes of maintaining the ratings on the REMIC securities and not all "government securities" qualify.

(ii) Outside Lockout Expiration Date. While REMIC rules prohibit defeasance prior to two years after the start-up day, borrower does not know if and when the start-up date will occur. Therefor it is important to negotiate a hard, outside date after which defeasance shall be permitted regardless as to whether or not the start-up date has occurred.

**6. Modifications.**

a. Issue. The modification of a mortgage, if it is a significant modification, is treated as a newly issued mortgage and may result in the mortgage not being treated as a qualified mortgage thereby imputing the REMIC's qualification as such.

b. What Constitutes a Significant Modification. Whether a modification is significant is based not on REMIC rules but are found in the general debt modification rules. Modifications that are significant include certain changes in yield, changes in timing of payments, and in the case of non-recourse debt, a "modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral..." An improvement to the property, however, is not a significant modification. The regulations provide an example whereby the owner of a shopping center builds a new improvement on vacant land subject to the mortgage. The new building is subject to the mortgage. Because the new building is an improvement and subject to the debt, it is not a material modification.

The issue is when is a change to the property an improvement and what is a substantial amount of the collateral. The common practice of what is substantial is 10% of the value of the property is changed as compared to the whole. For example, the demolition of a potion of a shopping center would not be a material modification if the value of the portion razed were less than 10% of the value of the entire center. There is a question whether the demolition of a greater-than-10% portion would be a material change if it were razed in order to do an improvement. While an improvement is within the safe harbor, conversions are not necessarily considered to be.

c. Defaults Based and Certain Other Exempted Modifications. Certain modifications are excluded from being significant include changes in the terms occasioned by a default or reasonably foreseeable default, assumption of the obligation, waiver of a due on sale or due on encumbrance clause and conversion of rate pursuant to terms of convertible mortgage

d. Releases. In general a release of a "substantial" amount of collateral for a non-recourse obligation is a significant modification. There is some authority to the effect that as long as (x) the unreleased collateral continues to fully secure the remaining debt, and (y) the loan to value ratio (and perhaps other financial covenants) are not weakened, then the released collateral will not be considered substantial. Additionally, there appears to be a practice among professionals that a release of part of a mortgage is not a modification if such release is pursuant to the loan documents. There appears to be some authority for this in the regulations 1.1001-3(c)(1)(ii).

e. Practice Points.

(i) Plan ahead. In order to take advantage of the modifications hardwired into the loan documents, the option to engage in the required conduct must be unilateral (i.e., lender cannot have the right to consent in its discretion).

(ii) REMIC Opinions. Servicer's counsel generally provides. Borrower pays, however, and good idea to minimize circumstances when lender may require.

(iii) Changes in Regulations. Changes to certain of the regulations are currently under review by the Treasury Department. The general gist of the changes is to liberalize some the restrictions under the current regulations with respect to releases, substitutions and modifications of collateral.