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Capital Markets

Capital Markets Client Alerts

Term Asset-Backed Securities Loan Facility (TALF) Expanded to Cover CMBS

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On Friday, May 1, 2009, the Federal Reserve Board (the "Board") announced a significant expansion of the Term Asset-Backed Securities Loan Facility ("TALF"). Starting in June 2009, newly issued commercial mortgage-backed securities ("CMBS") and securities backed by insurance premium finance loans will be "eligible collateral" authorized to be pledged to the Federal Reserve Bank of New York (the "NY Fed") to secure a TALF loan. The Board determined that the extension of "eligible collateral" to include CMBS was necessary in order to ease the current gridlock in the CMBS market which has occurred since mid-2008. The Board expects that the inclusion of CMBS as "eligible collateral" will help to prevent defaults on economically viable commercial properties, increase lending capacity for commercial mortgages and facilitate the sale of distressed properties.

In addition to expanding "eligible collateral," the Board also authorized TALF loans with maturities of five years for certain collateral (extending the previous three year maturity). Five-year maturity TALF loans will be available in June to finance purchases of newly issued CMBS, ABS backed by student loans, and ABS backed by loans guaranteed by the Small Business Administration. The Board has indicated that up to $100 billion of TALF loans could have five-year maturities, but it will continue to monitor this limit.

It is expected that the initial subscription date for TALF eligible CMBS will occur in late June 2009. The NY Fed has determined that TALF loans backed by CMBS will occur in the latter part of each month, while all other TALF loans will continue to be funded and closed at the beginning of the month. The NY Fed is continuing to develop the framework for certifications and attestations as to TALF eligibility for CMBS issuances and we will continue to provide updates on these developments.

The NY Fed is also considering permitting issuers and sponsors to reserve prospective funding amounts with the NY Fed prior to issuance of the TALF eligible CMBS. Such a process would ensure that amounts needed to fund TALF loans backed by CMBS would be available to eligible borrowers after issuers and sponsors have gone through an extended structuring and marketing period. The NY Fed expects that the issuer or sponsor who reserves funding amounts would be required to pay a monthly fee for such reservation equal to a percentage of such prospective funding amount. We will continue to monitor the NY Fed's implementation of the reservation policy.

CMBS Qualifications

In order for the securities to be eligible to be pledged to the NY Fed to secure a TALF loan, the securities must be U.S. dollar-denominated cash securities evidencing an interest in a trust fund issued on or after January 1, 2009. The underlying assets must consist of fully funded, first priority mortgage loans that are current in payment at the time of the issuance of the securities. Mortgage loans will include participation or other ownership interests if, following a default on the related mortgage loan, the ownership interest or participation is senior to or pari passu with all other interests in the same mortgage loan. The

CMBS cannot be backed by other CMBS, other securities, or interest rate swap or cap instruments or other hedging instruments. All of the mortgage loans must be fixed-rate loans which do not provide for interest-only payments during any part of its remaining term and each loan must have been originated on or after July 1, 2008. The property securing each mortgage loan must be located in the United Stated or one of its territories.

For each mortgage loan included in a TALF eligible CMBS pool, the Board will require that such mortgage loan be underwritten or re-underwritten based on, among other things, the current in-place stabilized and recurring net operating income and the then current property appraisal of the property.

The NY Fed expects the collateral pool underlying each CMBS to contain mortgage loans with diverse characteristics, but will consider non-diversified collateral on a case-by-case basis. The NY Fed will engage a collateral monitor which will have the right to exclude specific loans from each pool prior to issuance which fail to satisfy the NY Fed's risk parameters. It is unclear at this point whom the NY Fed is considering engaging as collateral monitor and how the NY Fed will determine the risk assessment of a collateral pool; however the collateral monitor would perform the same role historically performed by "B-piece" buyers and the NY Fed may tap such institutions to serve in the role of collateral monitor. The NY Fed's implementation of these policies may have a significant impact on the ability of the TALF CMBS program to achieve the goals set out by the Board.

We note that the program requires fixed rate loans which provide for amortization, and as stated below, the CMBS must have a weighted average life less than ten years. These changes are generally consistent with market expectations as to how new mortgage loans contemplated to be included in CMBS would be originated.

The requirement that mortgage loans backing TALF eligible CMBS be underwritten based on current appraisals and actual operating income may require significant capital infusions by underlying borrowers in order to refinance existing mortgage loans which had been underwritten at the peak of the commercial real estate market using pro-forma leases and lower debt service coverage ratios based on projected income. This tension may be limited however as some borrowers contemplating refinancing may have sufficient equity assuming the mortgage loan was originated prior to the peak of the commercial real estate market.

CMBS Structure

In addition to certain restrictions on qualifying assets, the Board has also placed some structural requirements on the CMBS. The issuer of TALF eligible CMBS must not be an agency or instrumentality of the United States and the pooling and servicing agreement or other governing document (the "PSA") must satisfy certain conditions. Each PSA must provide that:

- If the class of the CMBS is one of two or more time-tranched classes of the same distribution priority, distributions of principal must be made on a *pro rata* basis to all such classes once the credit support is reduced to zero as a result of both actual realized losses and "appraisal reduction amounts." In addition, the TALF eligible CMBS must not be junior to other securities issued by the same trust. This requirement would preclude financing through TALF of a subordinate "AAA" bond that provides credit support for the typical "super-senior AAA" bond. Based on market feedback, we currently expect that initial issuances of TALF eligible CMBS will have a single class of "AAA" bonds.

- Control over the servicing of the assets, whether through approval, consultation or servicer appointment rights, must not be held by investors in a subordinate class of CMBS once the principal balance of that class is reduced to less than 25% of its initial principal balance as a result of both actual realized losses and "appraisal reduction amounts." This "controlling class" with a minimum amount of investment at risk is consistent with PSAs which governed CMBS transactions issued prior to the current market disruptions.

- A post-securitization property appraisal may not be recognized for any purpose under such agreements if the appraisal was obtained at the demand or request of any person other than the servicer for the related mortgage loan or the trustee. This requirement will preclude the "B note" holder in some A/B commercial loan structures from obtaining an appraisal on the underlying property to dispute the appraisal obtained by the servicer.

- The NY Fed will require specific reporting on the underlying collateral to monitor and evaluate its position as secured lender.

Additionally, each mortgage loan seller must represent in its respective purchase agreement that, upon the origination of each mortgage loan, any improvements at each related property were in material compliance with applicable law. Historically, this representation was often qualified with respect to the knowledge of the loan seller. It is currently unclear whether the NY Fed will permit this representation by the loan seller to contain a knowledge qualifier.

The Board will also require that the CMBS have a credit rating in the highest long-term investment grade category (and not be on watch for downgrade) from a yet unknown number of eligible rating agencies. The rating must be based on the underlying assets and structure of the transaction and cannot rely on a third-party guarantee as a basis for such rating. The NY Fed is currently reviewing the rating methodologies of all rating agencies to determine which ratings agencies will be considered eligible to provide ratings on TALF eligible CMBS. Upon completion of the NY Fed's review, they are expected to release the names of the eligible ratings agencies and the number of required TALF eligible CMBS ratings agencies on the NY Fed Website (http://www.newyorkfed.org/markets/talf.html).

The Board has imposed certain other requirements on the CMBS in order to be TALF eligible. TALF eligible CMBS must pay principal and interest — interest-only or principal-only securities will not be "eligible collateral" for a TALF loan. The CMBS must bear interest at a fixed rate or must be a pass-through rate based on the weighted average rate of the underlying fixed-rate mortgage loans. Lastly, each CMBS must be cleared through the Depository Trust Company.

TALF Conditions

The terms and conditions of the TALF program will generally apply to TALF loans backed by CMBS, except as modified by the TALF CMBS terms and conditions set forth on the NY Fed website (http://www.newyorkfed.org/markets/talf_cmbs_terms.html). As stated earlier, the TALF program has been modified to include loans with five-year maturities. As such, TALF loans backed by CMBS may have a three-year or five-year maturity at the election of the borrower. The interest rate on the TALF loan will be a fixed rate per annum equal to the 3-year LIBOR swap rate or the 5-year LIBOR swap rate, plus 100 basis points, depending on the maturity of the TALF loan.

The collateral haircut for CMBS with an average life of five years or less will be 15%. For newly issued CMBS, the average life of the CMBS will be determined by the issuer using industry-standard assumptions. For each CMBS with an average life beyond five years, the collateral haircut will increase by one percentage point for each additional year of average life. CMBS must have a weighted average life less than ten years in order to be TALF eligible.

Payments of principal received on the CMBS must be proportionally used to reduce the principal balance on the TALF loan. Additionally, for a five-year TALF loan, the excess, in any TALF loan year, of CMBS interest distributions over TALF loan interest payable will be remitted to the TALF borrower only until such excess equals 25% (10% in the fourth loan year and 5% in the fifth loan year) of the haircut amount, and the remainder of such excess will be applied to TALF loan principal.

While the underlying CMBS will generally provide for certain voting or consent rights to the holders of the securities, each TALF borrower who will pledge CMBS must agree not to exercise any voting, consent or waiver rights under the CMBS governing documents without the consent of the NY Fed. The NY Fed has not released details as to whether this condition will be addressed in the Master Loan and Security Agreement or directly in the customer agreements between potential borrowers and their Primary Dealer.

It is expected that both the Board and the NY Fed will provide additional updates prior to the initial subscription date for TALF eligible CMBS. We will continue to monitor this important program to provide updates as they become available.

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