Paul Hastings
StayCurrent
A CLIENT ALERT FROM PAUL HASTINGS
May 2009

CMBS TALF: Uncertain Expectations

BY ERICA BERG AND KEVIN PETRASIC

On May 1, 2009, the Federal Reserve Board ("FRB") and Federal Reserve Bank of New York ("FRBNY") announced terms and conditions for extension of the Term Asset-Backed Securities Loan Facility ("TALF") to commercial mortgage-backed pass-through securities ("CMBS"). While inclusion of CMBS under TALF was expected following the U.S. Treasury Department's March 23, 2009 announcement of the Public-Private Investment Program ("PPIP"), how CMBS would be incorporated into TALF was uncertain. Consistent with the TALF rollout thus far, the FRB is approaching this new expansion conservatively and deliberately. As such, the willingness of the market to participate under these terms remains to be seen.

Eligible CMBS Collateral

The May 1, 2009 announcement included the following eligibility criteria (to be strictly applied) for CMBS underlying the initial CMBS TALF subscription scheduled for late June:[1]

- CMBS Issuance. The CMBS must be issued on or after January 1, 2009 and cannot be issued by an agency or instrumentality of the U.S. or any government-sponsored enterprise.[2] Each CMBS must provide for payment of principal and interest, meaning that an interest-only or principal-only payment would disqualify the CMBS from TALF participation. The CMBS must have a fixed interest rate or an interest rate based on the weighted average of the underlying mortgage loan rates.

- Ratings. The CMBS must be rated at the highest long-term investment grade rating, as obtained from at least two major nationally recognized statistical rating organizations ("NRSROs"), at the time of the closing of the TALF loan. The CMBS cannot have a rating from any NRSRO below the highest investment grade rating. The rating cannot be based on the influence of a third-party guarantee and the NRSRO cannot have placed the CMBS on a review or downgrade watch.

- Securitization Fund. The CMBS must represent an interest in a fund comprised of first-priority mortgage loans, fully funded and current in payments at the time of securitization. The underlying mortgages must be fixed-rate loans,[3] and must represent a fee or leasehold interest in an income-producing commercial property located in the U.S. or a territory of the U.S.

- Loan Origination. All loans underlying the CMBS must have been originated on July 1, 2008 or later. Each mortgage loan must have been underwritten (or re-underwritten) close to the CMBS issuance date based on then-current valuations and operating income.

- Pooling and Servicing Agreement Requirements. The agreements governing the pooling and servicing of the CMBS serving as collateral for any TALF loan (the "Agreements") must include certain provisions. If the CMBS is one of a multiple-tranched class of securities, the Agreements must specify that principal distribution must be pro rata (following the reduction of any credit enhancement to zero) to all classes based on realized losses and taking into account any reductions in appraisal. The Agreements must reflect that control over the servicing of the mortgage loans cannot be held by investors in subordinate classes of CMBS in the event the principal balance of that subordinate class is reduced by more than 75% of its original principal balance (resulting from realized losses and appraisal reductions). The mortgage loan sellers under the Agreements have to represent that any improvements on a property were in material compliance with applicable law. Finally, the Agreements must specify that no post-securitization appraisal can be recognized if obtained by anyone other than the servicer or trustee.

In addition to the above asset specifications, the FRBNY has certain expectations about, as well as discretion over, other aspects of the CMBS and the underlying mortgage loans. For example, the FRBNY expects loan pools to be diversified in terms of size, property, geography and borrower sponsorship, but it can determine on a case-by-case basis the eligibility of CMBS backed by nondiversified collateral. A novel feature of the TALF CMBS program involves the FRBNY engaging a collateral monitor with the ability to exclude specific loans from a pool up until the time of issuance of the CMBS. This new discretionary authority, signaling the tentativeness with which the FRB is approaching the CMBS market, is a sharp break from the cookie-cutter approach used in qualifying other TALF-eligible ABS collateral.

Another new feature in the TALF CMBS program is the FRBNY expectation that the terms of the agreements structuring and governing a CMBS issuance allow for reporting and auditing provisions that permit the FRBNY to monitor and review its interest as a secured lender. The FRBNY may seek to amend or disallow collateral for CMBS agreements that do not include these reporting and monitoring provisions. As a general rule, the FRBNY has the right to reject CMBS as collateral for any TALF loan.

CMBS TALF Loan Terms

In addition to the terms and conditions that generally govern the TALF program, the following specific terms apply to TALF CMBS loans:[4]

- TALF Loan Maturity. A TALF borrower using CMBS eligible collateral as security has the option to secure a three- or five-year loan maturity. A three-year loan will bear interest at 100 basis points over the three-year LIBOR swap rate; a five-year loan will bear interest at 100 basis points over the five-year LIBOR swap rate.

- Collateral Haircut. The collateral haircut for CMBS is based on the average life of a CMBS, calculated by the CMBS issuer using industry specifications and assumptions. If the average life is five years or less, the haircut will be 15%. For every year of average life above five years, the haircut will increase by a percentage point. The maximum CMBS average life is ten years.

- Remittance of Principal. Upon receipt of any principal remittance on the CMBS, the funds must be used to reduce the principal amount of the TALF loan in proportion to the TALF advance rate.[5]

- No Exercise of Rights. Without the consent of the FRBNY, a TALF borrow cannot exercise any voting, consent or waiver rights pursuant to the CMBS.

The Reserve Feature

Another unique feature of the TALF CMBS program relates to the ability of issuers to reserve TALF funding for future issuances. Again, this is recognition of the unusual characteristics of the CMBS collateral relative to other TALF-eligible collateral. Given that some CMBS deals may take months to come to the market and TALF is designed to catalyze the securitization markets, the FRBNY is considering a means for issuers to reserve TALF funding based on a future CMBS issuance. Any process is still in the early stages of consideration by the FRBNY and would likely involve a monthly reservation fee to keep the option alive. A reservation, however, cannot outlive the TALF CMBS subscription process.

Will Borrowers Participate?

While some have suggested that the TALF has not lived up to its potential in producing the kinds of numbers that government officials and the industry had hoped for, the true measure of TALF's success is perhaps more evident in the markets it has targeted. On paper, the TALF appears to have played a relatively modest role to date among the federal government's economic stimulus programs. In the markets addressed by TALF, however, the thaw has been relatively dramatic; in some cases, markets have moved overnight and substantially upon the FRB's announcement of certain collateral being included within the TALF. In addition, although past TALF subscriptions and loan issuances did not receive the participation levels originally anticipated, the most recent (May 2009 subscription) data appear more promising.

Throughout the short life of the TALF, the FRB and FRBNY have studiously examined the issues that appear to have been problematic. For example, eligible collateral classes were expanded for the second month of TALF subscriptions and, as noted above, had an immediate impact on the new asset classes. The FRB also continues to study the length of TALF loans and dates of origination to affect a more acceptable program for potential borrowers. In this regard, the TALF CMBS program will certainly undergo further scrutiny. As with previous subscriptions, the extent of interest and participation in the initial CMBS subscription in June should be valuable in understanding the appetite of borrowers for these fairly strict CMBS limitations. For now, it is difficult to see what kinds of deals are out there that will qualify for the program in the relatively short time between now and late June.

It is also evident that the details released so far on the TALF CMBS program do not appear to fulfill the promise set forth in the PPIP's goal of using TALF to encourage purchases of legacy securitization assets.[6] Despite the FRBNY's reference to the fact that "CMBS accounted for almost half of new commercial mortgage originations in 2007,"[7] it is unclear how this iteration of the TALF CMBS program will help with those legacy securities. Under the terms announced last week, the TALF CMBS program is only available for new issuances after January 1, 2009, and "all mortgage loans must have been originated on or after July 1, 2008."[8] Clearly, this does not provide relief to legacy securitization assets. Thus, it appears for now that TALF CMBS can best be characterized as a work in progress.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

Erica L. Berg
404-815-2294
ericaberg@paulhastings.com

Washington, D.C.

Kevin L. Petrasic
202-551-1896
kevinpetrasic@paulhastings.com

---

[1] *See* http://www.newyorkfed.org/markets/talf_cmbs_terms.html.

[2] Government-sponsored enterprises would include Fannie Mae, Freddie Mac or any of the Federal Home Loan Banks.

[3] None of the mortgage loans may provide for any interest-only period during the remaining outstanding term of the loan.

[4] See the general terms set forth in our prior Stay*Current*, "The TALF Catalyst?" (March 17, 2009).

[5] For purposes of clarity, FRBNY provided a sample calculation. If the advance rate was 85 percent, 85 percent of any remittance of principal on the CMBS must be repaid to the FRBNY. For a five-year TALF loan, any excess in CMBS interest distributions will be remitted to borrower of the TALF loan but only until the excess is 25% of the haircut amount; the remainder is applied to the principal of the TALF loan.

[6] See discussion of the "Expansion of TALF for Legacy Securities" in the "Public-Private Investment Program" White Paper release of the U.S. Treasury Department (March 23, 2009).

[7] FRBNY Circular No. 12091 (May 1, 2009).

[8] See "Term Asset-Backed Securities Loan Facility (CMBS): Terms and Conditions," issued by the FRBNY (May 1, 2009).