Paul Hastings
StayCurrent
A CLIENT ALERT FROM PAUL HASTINGS
May 2009

Legacy CMBS TALF: Something New for Something Old

BY ERICA BERG, AZBA HABIB AND KEVIN PETRASIC

On May 19, 2009, the Board of Governors of the Federal Reserve System ("FRB") and the Federal Reserve Bank of New York ("FRBNY") announced that, starting in July, certain high quality commercial mortgage backed securities ("CMBS") issued before January 1, 2009 ("Legacy CMBS") will become eligible collateral under the Term Asset-Backed Securities Loan Facility ("TALF"). Consistent with the FRB's steady roll-out of the TALF, this represents another step in refining and expanding what is deemed TALF-eligible collateral. The significance of this expansion, however, reflects a new phase for the TALF with the addition of a legacy asset class to the list of eligible TALF collateral.[1] Arguably, it also signals a new policy direction in using the FRB's balance sheet to help clean up the so-called "toxic assets" – as discussed later in this article, it is a policy direction with which the FRB may not be particularly comfortable.[2]

With Legacy CMBS TALF, the FRB is hoping to restore a degree of liquidity to the Legacy CMBS markets. The use of the TALF program was highlighted as a key tool to resolve problems in both the Legacy CMBS and legacy residential mortgage-backed securities ("Legacy RMBS") markets in the Administration's Public-Private Investment Program in March.[3] Unlike the CMBS TALF that was announced several weeks ago,[4] Legacy CMBS TALF has the potential to provide balance sheet relief to institutions currently holding these assets. Until now, TALF has been focused exclusively on new issuances of asset-backed securities ("ABS") and CMBS. Legacy CMBS TALF reaches back to past issuances with the goal of improving the existing legacy CMBS market to encourage more activity in CMBS securitizations. As noted by the FRB, Legacy CMBS TALF should help "borrowers finance new purchases of commercial properties or refinance existing commercial mortgages on better terms."[5]

The FRB's May 19, 2009 announcement provided the following details regarding TALF-eligible Legacy CMBS, as well as certain refinements to and distinctions from previously announced TALF-eligible CMBS, along with the terms and conditions of TALF loans for which such CMBS and Legacy CMBS may be accepted as collateral:[6]

1. TALF Eligibility

- Eligible Rating Agencies. Both CMBS and Legacy CMBS must be rated at the highest long-term investment grade rating, as obtained from at least two TALF CMBS-eligible nationally recognized statistical rating organizations ("NRSROs"), and must not be rated below the highest investment grade rating by any such agency. The TALF CMBS-eligible NSRSOs recognized by the

FRB are DBRS, Fitch Ratings, Moody's, Realpoint, and Standard and Poor's.

- Original Seniority. Legacy CMBS must not be junior to other securities with claims on the same pool of loans. The FRB noted, however, that the exclusion of "junior" CMBS refers to subordination of credit support, not to a later position in the time tranche sequence.[7]

- Securitization Fund. To facilitate the inclusion of Legacy CMBS, the FRB removed the requirement imposed on TALF-eligible CMBS that it must represent an interest in a fund comprised of loans that are current in payments at the time of securitization.

- Property Types. To facilitate the inclusion of Legacy CMBS, the FRB removed the requirement imposed on TALF-eligible CMBS that mortgages underlying the security must be fixed rate loans.

- Subscription Date. The initial Legacy CMBS subscription date has not yet been announced but is anticipated to be in late July.[8]

- Origination Date. To facilitate the inclusion of Legacy CMBS, the FRB removed the requirement imposed on TALF-eligible CMBS that mortgage loans underlying the CMBS must be originated on or after July 1, 2008.

- Pooling and Servicing Agreements. For Legacy CMBS, the FRB also removed the pooling and servicing agreement requirements imposed on and governing the issuance of TALF-eligible CMBS collateral. Again, this modification was necessary to facilitate Legacy CMBS participation in the TALF.

2. TALF Loan Terms and Pricing

In addition to terms and conditions that generally govern the TALF program, the following terms that apply to TALF CMBS loans were included and/or revised to address issues with Legacy CMBS collateral:[9]

- Collateral Monitor. In monitoring Legacy CMBS TALF-eligible collateral, the FRBNY will pay particular attention to Legacy CMBS mortgage pools with (i) large historical losses, (ii) concentration of loans that are delinquent or on special servicer watch lists, (iii) concentrations of subordinate-priority mortgage loans, and (iv) CMBS mortgage pools that are not diversified with respect to loan size, geography, property type, borrower sponsorship and other characteristics. The FRBNY retains the right to reject any CMBS based on the results of its collateral monitor.[10]

- Loan Amount. The loan amount for a Legacy CMBS TALF loan is the "dollar purchase price," i.e., current fair market value ("FMV"), of the Legacy CMBS less the "base dollar haircut," which is the amount contributed by the borrower toward the purchase of the CMBS. The base dollar haircut or purchase price is a percentage of the par amount of the CMBS (i.e., the amount paid to the holder at maturity) and is calculated based on the "weighted average life" of the Legacy CMBS. If the average life of the CMBS is five years or less, the base dollar haircut is a straight 15% of par. For every year of average life above five years, the haircut increases by a percentage point.[11] Thus, Legacy CMBS with an eight year average life will have an 18% of par haircut.

  An important point to note in Legacy CMBS pricing is that although the loan amount is based on the dollar purchase price (current FMV), the borrower's price is based on a percentage of the par value. This is a feature unique to Legacy CMBS TALF and diverges significantly from the haircut based on issuance price for CMBS TALF collateral. While this pricing structure is one of the ways the FRB has designed the Legacy CMBS

program to minimize risk, it is a sharp contrast from the new issuance pricing used for the other TALF-eligible collateral categories. Using the eight year average life example from above, for a Legacy CMBS with a current FMV of $50 and a par value of $100, the borrower haircut contribution would be $18 (18% of $100) while the TALF loan amount would be $32 ($50 - $18).

Finally, another important safety mechanism the FRB included in the Legacy CMBS pricing mechanism is that Legacy CMBS will not be eligible collateral for a TALF loan if its dollar purchase price is less than its base dollar haircut. Continuing the preceding example, this would mean the current FMV of the Legacy CMBS could not be less than $18.

- Interest. As with CMBS, interest paid on Legacy CMBS TALF loans will be a fixed interest rate equal to 100 basis points over the 3-year Libor swap rate for a 3-year TALF loan, and 100 basis points over the 5-year Libor swap rate for a 5-year TALF loan.

- Remittance of Principal. As with CMBS TALF, upon receipt of any principal remittance on a Legacy CMBS TALF loan, the funds must be used to reduce the principal amount of the TALF loan in proportion to the TALF haircut.[12]

- Excess Interest Payments. Also similar to CMBS TALF, interest payments exceeding the amount required to service a Legacy CMBS TALF loan are paid to the borrower until such payments reach a certain percentage per annum of the haircut amount. After reaching the trigger amount, excess interest is applied to the TALF loan principal. For 5-year Legacy CMBS TALF loans, the excess interest trigger amount is based on the same sliding scale applicable to 5-year CMBS TALF loans (25% of the haircut in the first three years, 10% in the fourth year and 5% in the fifth year). Unlike CMBS TALF, however, 3-year Legacy CMBS TALF loans have a similar excess interest back to principal requirement that is triggered when annual interest payments exceed 30% of the haircut amount in any one year.

3. Issues Requiring Further Clarification

While the Legacy CMBS TALF announcement by the FRB and FRBNY answered many questions about how a Legacy CMBS loan program could be structured within the parameters of the TALF, it still left many issues that were highlighted in the announcement and the Legacy CMBS TALF terms and conditions unresolved.

For example, one of the issues creating the greatest uncertainty with respect to Legacy CMBS TALF is the broad discretion asserted by the FRBNY to disqualify "any CMBS as TALF loan collateral based on its risk assessment."[13] Also uncertain and equally important are the mechanics of the overall collateral monitoring process, as well as the process by which the FRBNY may reject CMBS as TALF loan collateral.

It is also unclear how the CMBS loan pool diversification requirement will affect Legacy CMBS. While new issuance CMBS may be structured and adjusted to accommodate diversification, Legacy CMBS will experience particular challenges depending on how rigidly the FRBNY applies the diversification requirement. For example, a common feature of Legacy CMBS is single sponsorship and, in many cases with Legacy CMBS, the underlying loans are geographically and otherwise similar as much by necessity as by design.

Additional uncertainty exists with the FRBNY's statement that it is in the process of establishing additional requirements that will apply to Legacy CMBS, including a requirement that TALF loans for Legacy CMBS be used to fund recent secondary market transactions between unaffiliated parties, as well as a possible requirement for a price validation process for such transactions.[14] Similarly, the FRBNY is considering requiring "default-related circumstances be considered in calculating the weighted average life of a legacy CMBS."[15]

The FRB and FRBNY have indicated that further guidance is forthcoming on these and other issues. Until that guidance is available, it is difficult to gauge the extent to which the Legacy CMBS TALF program will be effective in achieving the FRB's stated goal of restoring the CMBS markets. While it appears the FRB has had a significant and quite favorable influence on the ABS markets included in the TALF, the CMBS and RMBS markets – and particularly Legacy CMBS and Legacy RMBS – pose unique challenges from both an operational and a policy standpoint. As such, these issues may take some time to resolve.

4. Implications for Legacy RMBS TALF

It is noteworthy that when the FRB and the U.S. Treasury Department jointly announced the launch of the TALF, the agencies indicated that the TALF was "designed to catalyze the securitization markets by providing financing to investors to support their purchase of certain AAA-rated [ABS]."[16] In its announcement several days ago, the FRB indicated "the extension of eligible TALF collateral to include Legacy CMBS is intended to promote price discovery and liquidity for legacy CMBS."[17] While liquidity remains a central TALF theme, the reference to price discovery is new. In this regard, the FRB noted the underlying objective was to improve the legacy CMBS markets to facilitate the issuance of newly issued CMBS to help borrowers finance the purchase of new commercial properties or refinance existing commercial mortgages with more favorable terms.[18] Again, a similar theme, but the unmistakable message is a more pointed focus on using the FRB's liquidity tool – and its balance sheet – to accelerate recovery of the commercial real estate markets by getting at the so-called "toxic assets."

The FRB balance sheet is an issue of paramount concern both inside and outside the FRB.[19] And Legacy CMBS TALF is almost certainly the test for determining just how far the FRB will be willing to go to extend the TALF to the last major piece of the TALF puzzle – RMBS and, particularly, Legacy RMBS.

As expected, both Legacy CMBS and Legacy RMBS pose extremely difficult challenges even for an agency with the clout of the FRB's liquidity tool and balance sheet. As reported by one FRB official, "the most challenging element of the expansion to RMBS is making sure that we're doing the proper credit analysis around the risks that we might be exposing ourselves to."[20] A particular challenge with Legacy RMBS is the heterogeneous nature, i.e., lack of diversification, of the underlying mortgage loans. It appears the FRBNY proposes to address this aspect of RMBS TALF with collateral managers who will scrub the debt to determine how much capital borrowers will have to invest by way of the haircut for these loans.[21] This suggests the possibility of a program requiring substantially greater oversight and, perhaps, risk-sharing than that currently structured into the TALF.

Also as expected, the FRB is apparently considering a further extension of the TALF loan term – i.e., beyond the recently added 5-year TALF loan, which complements the original 3-year loan – in order to deal with the longer loan terms associated with many RMBS, which were, in part, the result of loan modifications.[22] While many have suggested that a 7-year TALF loan is necessary to deal with Legacy RMBS, as well as certain Legacy CMBS, this takes the FRB significantly out of its comfort zone with respect to its overall balance sheet exposure. While it is unclear, for now, how this risk and many other issues will be addressed, expect the TALF to continue to evolve and be refined by the FRB and FRBNY, with assistance and guidance from TALF participants, including the numerous issuers, sponsors and borrowers required for it to operate effectively.

✧ ✧ ✧

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

Azba A. Habib
404-815-2380
azbahabib@paulhastings.com

Washington, D.C.

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

1 Previous eligible collateral comprised of Asset Backed Securities ("ABS") and CMBS issued on or after January 1, 2009.

2 See infra, "Implications for Legacy RMBS TALF."

3 See White Paper "Public-Private Investment Program," available at http://www.treas.gov/press/releases/reports/ppip_whitepaper_032309.pdf.

4 See FRB Press Release, "Federal Reserve announces expansion of eligible collateral under Term Asset-Backed Securities Loan Facility (TALF)" (May 1, 2009), available at http://www.federalreserve.gov/newsevents/press/monetary/20090501a.htm.

5 See FRB Press Release, "Federal Reserve announces that certain high-quality commercial mortgage-backed securities will become eligible collateral under the Term Asset-Backed Securities Loan Facility (TALF)" (May 19, 2009), available at http://www.federalreserve.gov/newsevents/press/monetary/20090519b.htm.

6 See "Term Asset-Backed Securities Loan Facility (Legacy CMBS): Terms and Conditions," issued by FRBNY, (May 19, 2009) available at http://www.newyorkfed.org/markets/talf_cmbs_terms.html.

7 For example, CMBS (e.g., Class A-2) that receive principal later than the other senior CMBS classes (e.g. Class A-1) but are otherwise pari passu with such other senior CMBS, qualify for TALF financing. See "Term Asset-Backed Securities Loan Facility (Legacy CMBS): Frequently Asked Questions," issued by FRBNY, (May 19, 2009), available at http://www.newyorkfed.org/markets/talf_cmbs_faq.html.

8 The subscription and settlement cycle for both legacy and new issue CMBS will occur in the latter part of each month, whereas the cycle of non-CMBS, ABS TALF asset classes will remain in the first half of the month.

9 In addition to the above loan specifications, the FRBNY may limit the volume of TALF loans secured by Legacy CMBS, and is currently considering whether to allocate such volume via an auction or other procedure.

10 The FRBNY will utilize the services of agents in connection with reviewing CMBS and their underlying loan pools.

11 Assuming a CMBS with a par value of 100, a seven-year weighted average life, and a base dollar haircut of 17% of par: if the market price is 75% of par, the loan amount is 58 (75-17) and the collateral haircut is 23% (17/75). Under this formulation, the size of the haircut increases with the size of the price's discount from par, reflecting a recognition that large discounts from par generally indicate credit concerns.

12 For example, if the haircut was 15%, 85% of any remittance of principal on the CMBS must immediately be repaid to 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.

13 See supra, note 6.

14 Id.

15 Id.

16 See "Joint Press Release: U.S. Treasury and Federal Reserve Board Announce Launch of Term Asset-Backed Securities Loan Facility (TALF)," (March 3, 2009), available at http://www.federalreserve.gov/newsevents/press/monetary/20090303a.htm.

17 See supra, note 5.

18 Id.

19 See, e.g., "Heard on the Street: Danger of the Fed's Experimental Treatment," by Peter Eavis, The Wall St. Journal (May 22, 2009).

20 See "TALF for Home-Loan Debt Poses Hurdles," quoting Hayley Boesky, Vice President and Director of Market Analysis, FRBNY, by Jody Shenn, Bloomberg (May 22, 2009).

21 Id.

22 Id.