News Bulletin

May 4, 2009

TALF Update

On May 1, 2009 the Federal Reserve Board (Federal Reserve) announced updated terms and conditions for the Term Asset-Backed Securities Loan Facility, or TALF, a joint program with the U.S. Treasury Department (Treasury) to provide low-cost funding to purchasers of asset-backed securities, or ABS. The updated terms include the following:

- Commercial Mortgage-Backed Securities (CMBS) issued after January 1, 2009 will be eligible for a new series of monthly auctions beginning in late June;
- 5-year TALF loans will be available from the Federal Reserve Bank of New York (New York Fed) for CMBS and for ABS backed by student loans and loans guaranteed by the Small Business Administration — an extension of the program's currently available 3-year loans; and
- ABS backed by insurance premium finance loans will be eligible for TALF beginning in the June auction.

On March 23, 2009, Treasury announced details of the Public-Private Investment Program, or PPIP. Under PPIP, Treasury and private investors will enter into partnerships to purchase troubled mortgage-backed securities (also known as "toxic" or "legacy" securities) from financial institutions. Debt financing for PPIP purchases of troubled mortgage-backed securities will be available through an extension of TALF, called Legacy TALF. Terms of the Legacy TALF program have not been released, but the information provided for CMBS provides some information into how the New York Fed will evaluate risks associated with mortgage-backed securities.

Below, we discuss the recently announced updated terms and provide a brief description of the TALF program. For a more detailed overview of TALF, please see our Client Alert TALF: Can Wall Street Help Main Street?. Detailed program information on the TALF is regularly updated by the New York Fed on its dedicated website, available at www.newyorkfed.org/markets/talf.html. TALF is part of the Treasury's TARP and is modeled after other programs launched by the Federal Reserve to facilitate resumption of more normalized extensions of credit and economic activity. Please see our coverage of these coordinated efforts and the current financial crisis at Financial Crisis Legal Updates and News.

Background

In the third quarter of 2008, securitization funding for consumer and small business loans became unavailable. The TALF is designed to promote normalized originations of consumer and small business loans by providing low-risk funding for ABS investors, restarting the securitization markets for these products. The list of assets underlying the ABS eligible for financing with TALF loans has been expanded, including recent inclusion of mortgage servicing advances. The Federal Reserve will evaluate an asset class for addition to the program based on its potential for macroeconomic impact and the need to minimize additional risk to the government.

The New York Fed is authorized to make up to $200 billion of non-recourse loans to eligible borrowers secured by eligible ABS (subject to an increase of up to $1 trillion as described above). The ABS will be pledged as collateral for the loans and held at the New York Fed's custodian. If a borrower fails to repay its loan, the ABS will be transferred to a special purpose vehicle (SPV) to be established by the New York Fed. Treasury will purchase up to $20 billion in subordinated debt issued by the SPV; the subordinated debt will absorb the first $20 billion of losses at the SPV. The subordinated debt purchased by the Treasury would increase in proportion to the aggregate loans made by the New York Fed, up to a maximum of $100 billion. Any residual income from the SPV will be shared by the New York Fed and Treasury, after repayment of each of their loans.

Recent Announcements

Commercial Mortgage-Backed Securities

TALF loans will be made available to eligible borrowers for the purchase of CMBS through a new series of monthly auctions beginning in late June.

- CMBS terms:
  - Entitle holders to payments of principal and interest (that is, not be interest-only or principal-only)
  - Bear interest at a pass-through rate that is fixed or based on the weighted average of the underlying fixed mortgage rates
  - Must not be junior to other securities with claims on the same pool of commercial loans
- Issuer may not be an agency or instrumentality of the United States or a government sponsored enterprise
- Underlying assets must have the following characteristics:
  - Fully-funded, first-priority mortgage loans that are current in payment
  - Participation or other ownership interests will be eligible if, following a loan default, the ownership interest is senior to or *pari passu* with all other interests in the same loan in right of payment of principal and interest
  - Mortgage loans must be fixed-rate loans and no loan may provide for interest-only payments during the remaining term of the loan
  - Secured by income-generating commercial properties located in the United States
  - Originated on or after July 1, 2008
  - Underwriting must be recent and based on in-place, stabilized and recurring net operating income and current property appraisals
  - May not be CMBS, other securities, interest rate swap or cap instruments or other hedging instruments
  - Must be a pool diversified as to loan size, geography, property type, borrower sponsorship and other characteristics, unless otherwise approved by the New York Fed
  - Subject to rejection from the pool by the New York Fed prior to issuance of the CMBS
- Pooling and servicing or other agreements must include certain provisions:
  - Pro rata distributions of principal to all time tranched classes in the same distribution priority once credit support is reduced to zero as a result of both actual realized losses and appraisal reduction amounts

   - Servicing may not be held by a subordinate class once 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
   - A post-securitization appraisal will be recognized under the agreement only if requested by the servicer or the trustee
   - The mortgage loan seller must represent that improvements on the property complied with law at the time of origination
- CMBS must be rated in the highest rating category by a yet-to-be-determined number of CMBS-TALF approved rating agencies, and not be rated below the highest rating category by a CMBS-TALF rating agency

The haircut for CMBS with average lives of five years or less will be 15%. For every additional year of average life over five years, the haircut will increase by one percentage point not to exceed 10 years and a 20% haircut. Three-year loans will be available with an anticipated interest rate of 100 basis points over the three-year LIBOR swap rate and five-year loans will be available with an anticipated interest rate of 100 basis points over the five-year LIBOR swap rate.

The TALF borrower must agree not to exercise or refrain from exercising any voting, consent or waiver rights under the CMBS without the consent of the New York Fed.

While the New York Fed has posted summary eligibility information for the CMBS, additional details will be made available over the next several weeks. For example, the New York Fed has not yet identified rating agencies for the program.[1] Credit rating agencies received criticism for their role in the mortgage crisis, including allegations of issuing and maintaining ratings on mortgage-backed securities without sufficient diligence or ongoing monitoring. Ongoing reliance on rating agencies, for example, by conditioning TALF eligibility on receipt of ratings by two of the three largest credit rating agencies, has also been criticized. The New York Fed announced that it is reviewing the ratings methodology for CMBS by each rating agency interested being named as an NRSRO for the CMBS TALF program.

Insurance Premium Finance Loan ABS

The Federal Reserve expanded the types of ABS collateral eligible for a June TALF loan to include ABS backed by insurance premium finance loans. Eligibility requirements are as follows:

- If the ABS is issued by a revolving or master trust, either (1) the new ABS must be issued to refinance maturing ABS or (2) all or substantially all (95%) of the underlying loans must be issued on or after January 1, 2009;
- The average life of the ABS must be five years or less;
- The ABS issuer must acquire ownership of the entire finance loan, participation or beneficial interests are not eligible; and
- Deferred payment obligations acquired from insurance companies will not be eligible.

The haircut for premium finance loan-backed ABS will be 5% for an ABS with a weighted average life of one year or less. For each additional year of weighted average life, the haircut will increase by one percent, up to 9% for a weighted average life of five years. Interest rates on the loans will be the same as loans for consumer-backed ABS. The floating rate loan rate is 1-month LIBOR plus 100 basis points. The fixed rate loan rate is 100 basis points

[1] TALF currently requires that eligible ABS be rated in the highest ratings category by two or more major nationally recognized statistical rating organizations (each, an NRSRO), and not have a rating below the highest category by a major NRSRO. “Major” NRSROs include Standard & Poor’s, Moody’s Investors Service and Fitch Ratings.

over (1) the 1-year LIBOR swap rate for ABS with an average weighted life of less than one year, (2) the 2-year LIBOR swap rate for ABS with an average weighted life of one year to less than 2 years or (3) 3-year LIBOR swap rate for ABS with an average weighted life of two or more years.

Additional information will be made available on the New York Fed's dedicated website prior to the June auction subscription date.

5-Year Loans

Currently TALF offers 3-year loans to finance the purchase of TALF-eligible ABS. Beginning with the June auctions, 5-year loans will be made available for CMBS and ABS backed by student loans and loans guaranteed by the Small Business Administration.

Borrowers with a 5-year loan will have a cap on the excess interest they receive. Currently, interest payments received on the ABS are used to pay the interest due on the TALF loan, with any excess returned to the borrower. For a 5-year loan, any interest above the amount payable to the New York Fed as interest due on the TALF loan will be remitted to the borrower only up to the following amounts: (1) 25% per annum of the haircut amount of the loan for the first three years, (2) 10% of the haircut amount in year four and (3) 5% of the haircut amount of the loan for the final year. Interest in excess of the cap will be retained by the New York Fed and used to reduce the principal amount outstanding on the TALF loan. This interest cap will directly and indirectly reduce the risk to the New York Fed, as the outstanding TALF loan will be amortized more quickly than the underlying ABS and borrowers may have an incentive to replace TALF financing, particularly after the third year.

The Federal Reserve announced that it is currently targeting up to $100 billion for the 5-year loans. We assume that the limitation on 5-year loans reflects the Federal Reserve's desire to manage the risk associated with the longer term loans. TALF loans are non-recourse and the New York Fed's sole source of repayment is the ABS pledged to secure the TALF loan. In addition, terms for the Legacy TALF are still being developed. It is widely expected that Legacy TALF will attract more interest than the current program, as only $6.4 billion of TALF loans were extended in the March and April auctions.

Implementation Considerations

While observers and potential participants anxiously await information on Legacy TALF, ongoing amendments to the program reflect the New York Fed's keen interest in minimizing risk and developing a successful program that responds to the needs of the securitization market. For example, the TALF Frequently Asked Questions were recently updated to include a more detailed calculation for average life. We believe continued fine tuning of program terms and expansion to less mainstream asset classes demonstrates ongoing interest by the market and the New York Fed's commitment to the program's success. Detailed eligibility requirements for CMBS and the review of ratings methodologies prior to selecting credit rating agencies reflect the New York Fed's ongoing risk management efforts. These two potentially conflicting interests, expansion of the program to widest possible cross-section of the markets and minimization of risk, may be most difficult to balance in the Legacy TALF, where, to be most effective for the broader economy, the eligible collateral will be toxic.

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