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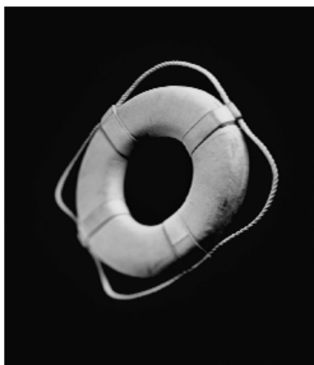

TALF Expanded to Include Legacy CMBS: The "Not-so-Troubled" Asset Relief Program?

On May 19, 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). Beginning in late July, eligible owners and purchasers of qualifying commercial mortgage-backed securities (CMBS) will be able to obtain low-cost financing for their CMBS positions.

This week's update is the latest in a series of modifications to, and expansions of, TALF since it was first announced in November 2008. There will be two programs for CMBS-backed TALF loans, the first for newly-issued CMBS, and the second for "legacy" CMBS issued prior to January 1, 2009. Details of the CMBS programs, described below, highlight the Federal Reserve's ongoing efforts to balance providing incentives to stimulate the securitization markets and minimizing its exposure to the asset-backed securities pledged as collateral for the non-recourse TALF loans.

TALF was initially created to improve lending to consumers and small businesses by providing liquidity to securities backed by consumer and small business loans. The Federal Reserve's May 19, 2009 press release highlights TALF's expanded goal of promoting "price discovery and liquidity for CMBS" which is expected to help "borrowers finance new purchases of commercial properties or refinance existing commercial mortgages on better terms."

Program details are available on a dedicated TALF website maintained by the Federal Reserve Bank of New York (New York Fed) 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.

TALF Overview

In the third quarter of 2008, securitization funding for consumer and small business loans became unavailable. TALF was initially designed to enable the resumption of normalized levels of consumer and small business loans origination by providing low-risk funding for purchasers of asset backed securities (ABS), restarting the securitization markets for these products. The Federal Reserve authorized the New York Fed to make up to $200 billion (with the potential to increase to $1 trillion) of non-recourse loans to eligible borrowers secured by eligible ABS. The ABS is pledged as collateral for the TALF loans, and held at the New York Fed's custodian. If a borrower fails to repay its loan, the ABS is transferred to a special purpose vehicle (SPV) established by the New York Fed. Treasury purchased an initial $20 billion in subordinated debt issued by the SPV; the subordinated debt will absorb any initial losses at the SPV, up to $20 billion. Treasury committed to increase the subordinated

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debt 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.

On May 1, 2009, the Federal Reserve announced the initial terms and conditions for loans collateralized by CMBS issued after January 1, 2009 and secured by mortgages originated on or after July 1, 2008. In describing this expansion beyond consumer and small business asset-backed securities, the Federal Reserve noted that the CMBS market came to a standstill in mid-2008 and that "the inclusion of CMBS as eligible collateral for TALF loans will help prevent defaults on economically viable commercial properties, increase the capacity of current holders of maturing mortgages to make additional loans, and facilitate the sale of distressed properties." In connection with the administration's financial stability plan, Treasury recently announced the creation of a public-private investment program to purchase "legacy" mortgage-backed securities and loans. The government funding for this program will come, in part, from the TALF legacy CMBS program. The legacy CMBS program will be open for eligible borrowers, whether or not they are participating in the public-private investment program.[1]

The CMBS Programs

TALF has eligibility requirements for borrowers, for the CMBS pledged as collateral for the loans and for the assets underlying the CMBS. The consumer TALF program also imposes eligibility requirements and compliance obligations on the sponsors of consumer ABS. No details have been released describing any issuer or sponsor obligations under either of the CMBS Programs.

Ratings Requirements

Both newly-issued CMBS and legacy CMBS are required to be rated in the highest ratings category by at least two of the CMBS rating agencies appointed by the New York Fed. These rating agencies are DBRS, Inc., Fitch Ratings, Moody's Investors Service, Realpoint LLC and Standard & Poor's. Rating agencies were invited to apply to the New York Fed to be named as "CMBS-eligible rating agencies." Prior to selecting rating agencies, the New York Fed reviewed the methodologies employed by each applicant for issuing and monitoring CMBS ratings. This review and approval process for rating agencies represents an enhancement of TALF for the CMBS programs.

We believe this additional diligence is a reaction to criticism that the ratings requirements in the consumer TALF programs constituted "blind" reliance on ratings as a proxy for diligence and prudent risk management. As mortgage-backed securities began experiencing unforeseen losses in 2007, credit rating agencies were blamed for contributing to the mortgage bubble by applying inadequate diligence procedures for the issuance and monitoring of credit ratings. Users of credit ratings were also criticized for placing "blind faith" in the work of third parties without conducting their own review of the methodologies and criteria used by the rating agencies, and governmental bodies were called upon to consider whether they had encouraged "undue reliance" on ratings by including ratings-related standards in regulations applicable to a broad cross-section of the financial system. As Congress, the media and the public have called for more transparency in the ratings process and more diligent protection of federal and taxpayer resources allocated to crisis related programs, it is no surprise that the New York Fed took the additional step of independently validating the utility of individual rating agencies as part of its risk management.

[1] For more information on the public-private investment program, please see our March 24, 2009 Client Alert Worth the Wait? Treasury Announces the Public-Private Investment Program.

Eligibility

Many eligibility requirements for the CMBS are the same for the newly-issued CMBS program and the legacy CMBS program. All TALF-eligible CMBS must:

- Not be subordinate to other classes of securities backed by the same pool of mortgages (although payments may be tranched with classes with pari passu security interests);
- Provide for both principal and interest payments (not be interest-only or principal-only) and must bear interest at a pass-through rate that is fixed or based on the weighted average of the underlying fixed mortgage rates;
- Be issued by an issuer other than an agency or instrumentality of the U.S. government or a government-sponsored enterprise;
- Have been rated in the highest long-term or short-term ratings category by at least two CMBS-eligible rating agencies, and not have a credit rating below that category from a CMBS-eligible rating agency;
- Be backed by a pool of fully-funded mortgage loans (and participations if, upon default, the trust has a senior interest in the loan) and not other CMBS, other securities or hedging instruments;
- Satisfy the applicable U.S. nexus requirement (legacy CMBS requires that 95% of the underlying properties, by mortgage loan principal balance, be located within the U.S. and newly-issued CMBS requires that 95% of the mortgages, by loan principal balance, have been originated by a U.S. institution or U.S. domiciled banking entity); and
- Clear through the Depository Trust Company.

Loan Terms

TALF loans backed by CMBS will be available in three-year and five-year terms. The outstanding loan amount will be based on the current market price for legacy CMBS (or purchase price for newly-issued CMBS or where an eligible borrower is funding the purchase of legacy CMBS with a TALF loan), reduced by a haircut amount. The haircut for CMBS with an average life of five years or less will be 15%, increased by one percent for each additional year of average life. Average life will be based on adjustments to the issuer's original determination of weighted average life.

For example, legacy CMBS with a remaining average life of five years and a purchase price of 75% of the par amount of the CMBS, would receive a TALF loan for 60% of par.

The interest rate charged for the TALF loan will be 100 basis points over (1) the 3-year LIBOR swap rate (for three-year loans) and (2) the 5-year LIBOR swap rate (for five-year loans).

New York Fed Risk Assessment

In addition to the above, CMBS will be evaluated for eligibility by the New York Fed on a security-by-security basis. A collateral manager and one or more agents will be retained by the New York Fed to assist in its review and management of CMBS. Legacy CMBS may be deemed ineligible based on the performance of the underlying mortgage loan pool, including the projected performance results derived from stress test scenarios performed on the pool. Additionally, the New York Fed will be managing its concentration risk on an asset-by-asset basis and TALF-wide. If CMBS independently, or considered with other TALF-financed CMBS, expose the New York Fed to concentration risk (e.g., loan size, sponsor, property type or geographic region) considered not acceptable by the New York Fed, the loan request will be denied.

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Legacy CMBS

The legacy CMBS program includes CMBS originated prior to January 1, 2009. Additional eligibility and program information will be forthcoming and will be posted on the TALF website.

Newly-issued CMBS

The newly-issued CMBS program includes CMBS originated on or after January 1, 2009 with underlying commercial mortgage loans originated no earlier than July 1, 2008.

We have more detailed information about the eligibility requirements for newly-issued CMBS, in part because newly-issued CMBS can be structured to conform to the TALF requirements. For example, the New York Fed has articulated several requirements for the pooling and servicing agreements, including:

- Requiring pro-rata distribution of principal among two or more time-tranched classes of the same distribution priority once the credit support has been reduced to zero as a result of both actual realized losses and appraisal reduction amounts;
- Prohibiting subordinate classes from having control over servicing 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;
- A post-securitization appraisal cannot be relied upon for any purpose if the appraisal had been requested by anyone other than the servicer or the trustee; and
- Each mortgage loan seller must have represented that, upon the origination of the mortgage loan, the improvements at each related property were in material compliance with applicable law.

Conclusion

With much anticipation we waited for the announcement of a specific timeframe for the first funding of legacy mortgage-related assets. Since former Treasury Secretary Paulson first suggested to Congress in September 2008 that taxpayer resources should be applied to remove the formerly-known-as “troubled” or “toxic” assets from the balance sheets of financial institutions, there has been much interest by potential sellers, buyers and market participants in seeing such a program develop. Would price discovery be possible? What would be the market implications of any prices that reflect advantageous and non-market funding rates for such purchases? Who would be eligible to sell and to buy? Would there be any bargains for purchasers with available cash and without the burdens of a clogged balance sheet?

We still don’t know the answers to these and other questions. But some of the potential benefits many sought, via identifying truly troubled assets where those with specialized servicing skills or other commercial real estate expertise might derive value, may be less likely under the current proposal. Since the beginning of 2008, there have been thousands of downgrades of CMBS. Recently, several rating agencies have undertaken comprehensive reviews of CMBS ratings and their own ratings methodologies. Eliminating the possibility of freeing financial institution balance sheets of CMBS with current ratings below the highest ratings category limits the potential of the program. Assuredly, given the Congressional, media and public scrutiny of the use of our taxpayer resources, appropriate risk management guidelines are essential. But while providing low-cost non-recourse funding for highly-rated CMBS may encourage CMBS issuance and the resurgence of a decimated market, it is unlikely to have the dramatic systemic impact on challenged financial institutions initially envisioned by our troubled asset plan sponsors.

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