Client Advisory

Katten
Katten Muchin Rosenman LLP

TARP Task Force

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Expansion of TALF to Newly Issued CMBS Creates Opportunities for TALF Investors, Commercial Mortgage Lenders and Property Owners

On May 1, the Federal Reserve Bank of New York (FRBNY) announced that, starting in June, commercial mortgage-backed securities (CMBS) will be eligible collateral under the FRBNY's Term Asset-Backed Securities Loan Facility (TALF). Since March 17, the FRNBY, in conjunction with the U.S. Department of the Treasury (UST), has been providing non-recourse, low-interest TALF loans to eligible borrowers in order to finance purchases by those borrowers of newly issued asset-backed securities (ABS) on a highly leveraged basis. Prior to this development, those ABS only could be backed by student loans, credit card receivables, auto and equipment loans and leases, small business loans, and certain other eligible receivables. As noted by the FRBNY, the CMBS market accounted for almost half of new commercial mortgage originations before coming to a standstill last year. The inclusion of newly issued CMBS as eligible TALF collateral is intended to revive that market, and may create opportunities for many market participants:

- ***Investors.*** Investors using existing or proprietary funds or raising new capital for specific TALF investment vehicles may benefit through a greater diversity of eligible TALF collateral and through the matching of the average lives of CMBS to TALF loans with newly available five-year terms.
- ***Commercial Mortgage Lenders.*** Commercial mortgage lenders may benefit from a renewed ability to make commercial mortgage loans or refinance existing positions through securitization of TALF-eligible commercial mortgage loans.
- ***Commercial Property Owners.*** Commercial property owners and purchasers may benefit from new financing opportunities, preventing defaults on economically viable commercial properties and facilitating the sale of distressed properties, which are stated aims of the TALF program.

The following is a summary of the terms of the TALF program as it relates to CMBS, as described in documents posted on the FRBNY's website as of May 1.[1] For information regarding the TALF program with respect to non-CMBS collateral, please see Katten's general TALF client advisory.[2]

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1 For the terms and conditions specific to CMBS, see http://www.newyorkfed.org/markets/talf_cmbs_terms.html, and for frequently asked questions specific to CMBS, see http://www.newyorkfed.org/markets/talf_cmbs_faq.html. For a revised frequently asked questions document for the TALF program in general, see http://www.newyorkfed.org/markets/talf_faq.html.

2 See http://www.kattenlaw.com/federal-reserve-launches-talf-removes-executive-compensation-limits-and-revises-terms-03-06-2009/.

Summary of the TALF Program for CMBS

Under the TALF, until December 31, 2009 (or later, if the TALF program's length is extended by the FRBNY), the FRBNY in conjunction with the UST will lend up to $1 trillion[3] on a non-recourse basis to "eligible borrowers" that hold certain "eligible collateral." On a date at the end of each month to be announced by the FRBNY with respect to TALF loans for CMBS, borrowers will be able to request one or more non-recourse three-year or five-year TALF loans in a minimum principal amount of $10 million. The principal amount of each TALF loan for CMBS that has a par value greater than or equal to its market value will be equal to the lesser of the par value or market value of the CMBS pledged, in each case, minus the haircut for that class of CMBS. The principal amount of each TALF loan or CMBS pledged that has a market value above par value will be equal to the market value of the CMBS, subject to a cap of 110% of par value, minus the applicable class haircut. For loans above par value, borrowers will periodically be required to repay a portion of the loans to adjust for the expected reversion of market value to par value as the CMBS matures.

Borrowers of TALF loans secured by CMBS will be able to request fixed-rate TALF loans with either three-year or five-year terms. Interest on three-year loans will be at a fixed rate per annum equal to 100 basis points over the three-year Libor swap rate and interest on five-year loans will bear interest at a fixed rate per annum equal to 100 bps over the five-year Libor swap rate. The collateral haircut for each CMBS with an average life of five years or less will be 15%. For CMBS with average lives[4] beyond five years, collateral haircuts will increase by one percentage point for each additional year of average life beyond five years. No CMBS may have an average life beyond 10 years.

TALF loans will be prepayable by the borrower, but substitution of collateral will not be permitted. TALF loans will not be subject to mark-to-market or re-margining requirements. Interest will be payable monthly. Any remittance of principal on the CMBS must be used immediately to reduce the principal amount of the TALF loan in proportion to the TALF advance rate. For example, if the TALF advance rate was 85%, then 85% of any principal remitted on the CMBS must immediately be applied to repayment of principal on the TALF loan. In addition, 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.

At the end of the three-year or five-year term, as applicable, the borrower must repay the loan in full, arrange for the sale of the collateral, or, if the collateral value is less than the outstanding loan amount, surrender the collateral to the FRBNY.

Eligible Borrowers

TALF loans may be obtained by any U.S. company that owns eligible collateral and that has an account relationship with a primary dealer.[5] An entity is a "U.S. company" for purposes of the TALF if it is (i) a business entity or institution that is organized under the laws of the United States or a political subdivision or territory thereof (U.S.-organized) and conducts significant operations or activities in the United States (regardless of whether any such entity has a parent company that is not U.S.-organized), including any U.S.-organized subsidiary of such an entity; (ii) a U.S. branch or agency of a foreign bank (other than a foreign central bank) that maintains reserves with a Federal Reserve Bank; (iii) a U.S. insured depository institution; or (iv) an investment fund that is U.S.-organized and managed by an investment manager that has its principal place of business in the United States. Notwithstanding the foregoing, a U.S. company excludes any entity that is controlled by a foreign government or is managed by an investment manager controlled by a foreign government.

[3] The TALF program was originally planned to be up to a $200 billion aggregate commitment, but was expanded to up to a $1 trillion lending program as part of the Obama administration's overall Financial Stability Plan.

[4] The average life of a CMBS will be the remainder of the original weighted average life determined by its issuer employing industry-standard assumptions.

[5] A borrower may request loans through more than one primary dealer as long as the borrower delivers the collateral for each loan through the respective primary dealer (unless the collateral is a new issuance delivered by the underwriter/other syndicate desk).

An “investment fund” is any type of pooled investment vehicle, including a hedge fund, a private equity fund and a mutual fund, or any vehicle that primarily or exclusively invests in eligible collateral and borrows from the TALF. An eligible investment fund includes funds that only invest in TALF-eligible ABS and only borrow from the TALF, as well as funds that invest in a mix of TALF-eligible ABS and other assets. Newly formed investment funds may borrow from the TALF as long as their collateral meets the collateral eligibility requirements. To enhance certainty of TALF financing, primary dealers may submit names of prospective TALF borrowers for a pre-certification review to be conducted by the FRBNY in advance of the subscription date.

Eligible CMBS

To qualify for financing through a TALF loan, each CMBS must meet the following requirements:

- The CMBS must entitle its holders to payments of principal and interest throughout its remaining term (that is, must not be an interest-only or a principal-only security).
- The CMBS must bear interest at a fixed pass-through rate or at a rate based on the weighted average of the underlying fixed mortgage rates.
- The CMBS may not be junior to other securities with claims on the same pool of loans.
- The issuer of the CMBS must not be an agency or instrumentality of the United States or a government-sponsored enterprise.
- Each CMBS must be cleared through the Depository Trust Company.
- As of the TALF loan closing date, the CMBS must have a credit rating in the highest long-term investment-grade rating category from the required number of TALF CMBS-eligible rating agencies[6] and must not have a credit rating below the highest investment-grade rating category from any TALF CMBS-eligible rating agency. Eligible collateral will not include a CMBS that obtains such credit ratings based on the benefit of a third-party guarantee or a CMBS that a TALF CMBS-eligible rating agency has placed on review or watch for downgrade.

Assets Underlying Eligible CMBS

The assets underlying each eligible CMBS must meet the following requirements:

- The CMBS must evidence an interest in a trust fund consisting of fully-funded, first-priority mortgage loans that are current in payment at the time of the securitization, and not other CMBS, other securities or interest rate swap or cap instruments or other hedging instruments.
- The property securing each mortgage loan must include a mortgage or similar instrument on a fee or leasehold interest in one or more income-generating commercial properties located in the United States.
- A participation or other ownership interest in a loan will be considered a mortgage loan and not a CMBS or other security, 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.
- All of the underlying mortgage loans must be fixed-rate loans and must have been originated on or after July 1, 2008.
- Collateral pools are expected to be diversified with respect to loan size, geography, property type, borrower sponsorship and other characteristics. The FRBNY, however, will consider CMBS backed by nondiversified collateral on a case-by-case basis.
- None of the mortgage loans covered by the CMBS may provide for interest-only payments during any part of its remaining term (i.e., each mortgage loan must provide for amortization throughout the remaining term of the mortgage loan).
- The underlying mortgage loans must have been underwritten or re-underwritten recently prior to the issuance of the CMBS on the basis of then-current, stabilized and recurring net operating income and then-current property appraisals.
- The FRBNY will engage a collateral monitor and will reserve the right, until the issuance of the CMBS, to exclude specific loans from each pool, and the FRBNY will retain the right to reject any CMBS as TALF loan collateral based on its risk assessment.

[6] The FRBNY is in the process of deciding which rating agencies will qualify as “CMBS-eligible rating agencies.”

Pooling and Servicing Agreement Requirements

The pooling and servicing agreement and other agreements governing the issuance of the CMBS and the servicing of the assets must contain provisions to the following effects:

- If the class of the CMBS is one of two or more time-tranched classes of the same distribution priority, distribution 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."
- Control over the servicing of 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."
- 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 (i.e., a holder of a junior tranche) for the related mortgage loan or the trustee.
- The mortgage loan seller must represent that, upon the origination of each mortgage loan, the improvements at each related property were in material compliance with applicable law.
- The agreements governing the issuance of each CMBS and the servicing of its assets, and the terms and conditions of its underlying loans, are expected to permit and provide for reporting sufficient to enable the FRBNY to monitor and evaluate its position as a secured lender.
- A TALF borrower must agree not to exercise or refrain from exercising any voting, consent or waiver rights under a CMBS without the consent of the FRBNY.

Process for Applying for TALF Loans to Invest in CMBS

Eligible borrowers that are interest in applying for a TALF loan in order to purchase eligible CMBS, and that have discretionary capital available equal to the necessary haircut amount, need to establish a relationship with one of the "primary dealers" that serve as the FRBNY's trading counterparties in the execution of U.S. monetary policy. Each eligible borrower will be required to sign a "customer agreement" with such primary dealer and provide the primary dealer with all required anti-money laundering and know-your-customer information, tax documents and other due diligence information.[7] Eligible borrowers interested in participating in the TALF program should be aware that although TARP executive compensation restrictions do not apply to companies solely as a result of their participation in the TALF program, certain provisions of the Employ American Workers Act of 2009 (EAWA) may limit the ability of such borrowers to employ foreign "H1-B" employees.[8]

Katten's TARP Task Force

Katten Muchin Rosenman LLP's multidisciplinary TARP Task Force advises clients on the U.S. Treasury's Troubled Asset Relief Program created under the Emergency Economic Stabilization Act of 2008. Katten's TARP Task Force advises clients on obtaining TALF loans to purchase CMBS and ABS, and on issuing and underwriting TALF-eligible CMBS and ABS. Katten's TARP Task Force also advises clients with respect to all aspects of other TARP-related programs such as (i) the Public-Private Investment Program in which the government will finance purchases of legacy loans and securities by private sector institutions, (ii) the Capital Purchase Program, whereby the U.S. Treasury is making investments in certain publicly traded and privately held financial institutions, (iii) the new Capital Assistance Program that is providing additional capital in the form of purchase of convertible securities to financial institutions which have been subject to a stress-test, and (iv) the Making Home Affordable plan that is intended to prevent avoidable foreclosures.

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7 For more information, see the FRBNY's guide for investors located at http://www.newyorkfed.org/markets/talf_guide.html.

8 For more information regarding the application of EAWA to the TALF program, see http://www.federalreserve.gov/monetarypolicy/files/eawafaq.pdf.

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