May 20, 2009

Federal Reserve Adds Legacy CMBS to TALF

On May 19, the Federal Reserve Bank of New York (FRBNY) announced that, starting in late July, certain AAA-rated commercial mortgage-backed securities issued before January 1, 2009 (Legacy CMBS), will be eligible collateral under the FRBNY's Term Asset-Backed Securities Loan Facility (TALF). This announcement marks the first addition of a legacy asset class to the list of eligible TALF collateral. Since March 17, the FRBNY, 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 had to be issued on or after January 1, 2009, and only could be backed by recently originated commercial mortgage loans, 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 extension of the TALF program to include Legacy CMBS is intended to promote price discovery and liquidity for existing CMBS.

The following is a summary of the terms of the TALF program as it relates to Legacy CMBS, as described in documents posted on the FRBNY's website as of May 19.[1] For information regarding the TALF program with respect to newly issued CMBS collateral and non-CMBS collateral, please see Katten's CMBS TALF client advisory[2] and Katten's general TALF client advisory.[3]

Summary of the TALF Program for Legacy 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[4] 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 Legacy 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.[5] The principal amount

[1] For the terms and conditions specific to Legacy CMBS, see http://www.newyorkfed.org/markets/talf_cmbs_terms.html, and for frequently asked questions specific to Legacy 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/expansion-of-talf-to-newly-issued-cmbs-creates-opportunities-for-talf-investors-commercial-mortgage-lenders-and-property-owners-05-04-2009/.

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

[4] 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.

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of each TALF loan for Legacy CMBS will be the current market price of the Legacy CMBS minus the base dollar haircut (the dollar amount of the haircut percentage multiplied by the par value of the Legacy CMBS) for that class of Legacy CMBS (for examples, see the "Calculating Legacy CMBS TALF Loan Sizes" section below). A Legacy CMBS will not be eligible collateral if its purchase price is less than its base dollar haircut.

Borrowers of TALF loans secured by Legacy 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 Legacy CMBS with an average life of five years or less will be 15%. For Legacy CMBS with average lives[6] beyond five years, collateral haircuts will increase by one percentage point for each additional year of average life beyond five years. No Legacy 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 Legacy 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 were 85%, then 85% of any principal remitted on the Legacy 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 Legacy CMBS interest distributions over TALF loan interest payable will be remitted to the TALF borrower only until such excess equals 25% per annum of the current haircut amount in the first three loan years, 10% in the fourth loan year and 5% in the fifth loan year, with the remainder of such excess to be applied to TALF loan principal. For a three-year TALF loan, the excess in any TALF loan year of Legacy CMBS interest distributions over TALF loan interest payable will be remitted to the TALF borrower only until such excess equals 30% per annum of the current haircut amount, with the remainder applied to TALF loan principal.

A TALF loan borrower must agree not to exercise or refrain from exercising any voting, consent or waiver rights under a Legacy CMBS without the consent of the FRBNY. 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.

Calculating Legacy CMBS TALF Loan Sizes

Certain Legacy CMBS, in contrast to newly issued classes of ABS and CMBS, are currently trading at substantial discounts from par. In recognition of the fact that large discounts from par generally indicate credit concerns, the FRBNY has devised a system of calculating loan amounts for Legacy CMBS in which the size of the effective haircut (i.e., the amount of equity contributed by a TALF borrower) increases with the size of the purchase price's discount from par. The following are two examples of how effective haircut amounts and loan sizes for Legacy CMBS TALF loans will be calculated.

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5 The FRBNY may limit the volume of TALF loans secured by Legacy CMBS and is considering whether to allocate such volume via an auction or other procedure.

6 The average life of a CMBS will be the remainder of the original weighted average life determined by its issuer employing industry-standard assumptions. In addition, the FRBNY is considering requiring that default-related circumstances be considered in calculating the weighted average life of Legacy CMBS and will announce details of any such requirement shortly.

Example 1: Assuming a Legacy CMBS with a par value of $100 and a seven-year weighted average life (and therefore a 17% haircut), with a current market price equal to 75% of par value, the maximum TALF loan size and effective haircut amounts would be calculated as follows:

Step One: The par value of the CMBS multiplied by the relevant haircut percentage equals the base dollar haircut.

Par Value		Haircut Percentage		Base Dollar Haircut
$100	x	17%	=	$17

Step Two: The market price of the CMBS minus the applicable base dollar haircut equals the maximum TALF loan size.

Market Price		Base Dollar Haircut		Maximum TALF Loan Amount
$75	-	$17	=	$58

Step Three: The base dollar haircut divided by the market price equals the effective haircut amount.

Base Dollar Haircut		Market Price		Effective Haircut Amount
$17	÷	$75	=	23%

Example 2: Assuming a Legacy CMBS with the same par value of $100 and the same seven-year weighted average life (and therefore the same 17% haircut), but with a market price equal to 50% of par value, the maximum TALF loan size and effective haircut amounts would be calculated as follows:

Step One: The par value of the CMBS multiplied by the relevant haircut percentage equals the base dollar haircut.

Par Value		Haircut Percentage		Base Dollar Haircut
$100	x	17%	=	$17

Step Two: The market price of the CMBS minus the applicable base dollar haircut equals the maximum TALF loan size.

Market Price		Base Dollar Haircut		Maximum TALF Loan Amount
$50	-	$17	=	$33

Step Three: The base dollar haircut divided by the market price equals the effective haircut amount.

Base Dollar Haircut		Market Price		Effective Haircut Amount
$17	÷	$50	=	34%

Eligible Legacy CMBS

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

- The Legacy CMBS must have been issued prior to January 1, 2009.
- The Legacy CMBS must entitle its holders to payments of principal and interest throughout its remaining term (it must not be an interest-only or a principal-only security).
- The Legacy 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 Legacy CMBS may not be junior to other securities with claims on the same pool of loans. Note that a class of Legacy CMBS that receives principal later in a waterfall than other senior CMBS classes (for example, a Class A-2 Legacy CMBS that receives principal payments after a Class A-1 Legacy CMBS) but is otherwise *pari passu* with other senior classes will qualify as eligible collateral. The exclusion of "junior" CMBS is a reference to subordination for credit support, not to a later position in a time tranche sequence.

- The issuer of the Legacy CMBS must not be an agency or instrumentality of the United States or a government-sponsored enterprise.
- Each Legacy CMBS must be cleared through the Depository Trust Company.
- As of the TALF loan closing date, the Legacy CMBS must have a credit rating in the highest long-term investment-grade rating category from at least two TALF CMBS-eligible rating agencies[7] 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 Legacy CMBS that obtains such credit ratings based on the benefit of a third-party guarantee or a Legacy CMBS that a TALF CMBS-eligible rating agency has placed on review or watch for downgrade.
- Note that the FRBNY is in the process of establishing other requirements that will apply to Legacy CMBS, including the requirement that TALF loans for Legacy CMBS be used to fund recent secondary market transactions between unaffiliated parties that are executed on an arm's length basis. The FRBNY is also considering a process for price validation of such secondary market transactions.

Assets Underlying Eligible Legacy CMBS

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

- The Legacy CMBS must evidence an interest in a trust fund consisting of fully funded mortgage loans and not other Legacy 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.[8]
- A participation or other ownership interest in a loan will be considered a mortgage loan and not a Legacy 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.
- 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.
- The FRBNY will engage a collateral monitor and will reserve the right, until the issuance of the Legacy CMBS, to exclude specific loans from each pool, and the FRBNY will retain the right to reject any Legacy CMBS as TALF loan collateral based on its risk assessment. The FRBNY will pay particular attention to the following when conducting risk assessments:

  (a) *Unacceptable performance of the mortgage loan pool*

  Legacy CMBS that represent interests in pools with high cumulative losses, a high percentage of delinquent loans, loans in special servicing or loans on servicer watch lists or a high percentage of subordinate-priority loans may be rejected. The FRBNY may consider in its decisions forecasts of pool level losses under various stress scenarios.

  (b) *Unacceptable concentrations*

  Legacy CMBS that represent interests in pools that, alone or considered together with loan pools backing other TALF-financed Legacy CMBS, possess one or more concentrations (such as borrower sponsorship, property type and geographic region) considered unacceptable to the FRBNY may be rejected.

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7 TALF CMBS-eligible rating agencies include DBRS, Inc., Fitch Ratings, Moody's Investors Service, Realpoint LLC and Standard & Poor's.

8 As of the subscription date at least 95 percent of the properties, by related loan principal balance, must be located in the United States

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.[9] 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.

An "investment fund" includes (i) any type of pooled investment vehicle that is organized as a business entity or institution, including a hedge fund, a private equity fund and a mutual fund, and (ii) any type of single-investment vehicle that is organized as a business entity or institution. 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.

Process for Applying for TALF Loans to Invest in Legacy CMBS

Eligible borrowers that are interested in applying for a TALF loan in order to purchase eligible Legacy 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.[10] 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.[11]

It also should be noted that the FRBNY has stated that it may limit the volume of TALF loans secured by Legacy CMBS, and is considering whether to allocate such volume via an auction or other procedure.

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 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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9 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).

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

11 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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