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Clients&FriendsMemo

TALF for Legacy CMBS: New York Fed Releases Terms and Conditions and FAQs

May 20, 2009 Yesterday afternoon, the Federal Reserve Board (the "Fed") announced that, beginning in July 2009, certain high-quality commercial mortgage-backed securities issued before January 1, 2009 ("Legacy CMBS") will become eligible collateral under the Term Asset-Backed Securities Loan Facility ("TALF"). At the same time, the Federal Reserve Bank of New York (the "New York Fed") released the terms and conditions for TALF-eligible Legacy CMBS, including the criteria for Legacy CMBS and underlying assets and the loan terms and conditions for the associated TALF loans.

The expansion of eligible TALF collateral to include Legacy CMBS is intended to promote price discovery and liquidity for Legacy CMBS, with the intended consequence of further facilitating the issuance of newly issued CMBS, thereby helping borrowers finance new purchases of commercial properties or refinance existing commercial mortgages.

The initial subscription date for Legacy CMBS will be in late July 2009.[1] The subscription and settlement cycle for both newly issued CMBS and Legacy CMBS will occur in the later part of each month. The subscription and settlement cycle for ABS TALF asset classes (non-CMBS) and premium finance ABS will remain at the beginning of the month.

This memorandum summarizes the terms and conditions for TALF financing secured by Legacy CMBS. Note that the general provisions of TALF will also apply to Legacy CMBS financed under TALF. For a discussion of the general provisions of TALF, see our Clients & Friends Memo dated March 27, 2009 entitled "Update: Understanding the Term Asset-Backed Securities Loan Facility ("TALF")" and for a discussion of the terms applicable to newly issued CMBS, see our Clients & Friends Memo dated May 2, 2009 entitled "TALF for New-Issue CMBS: New York Fed Releases Terms and Conditions, FAQs and Revised TALF FAQs".

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[1] The initial subscription date for newly issued CMBS will be June 16, 2009.

Qualifying Legacy CMBS

Issue Date. Qualifying Legacy CMBS must have been issued before January 1, 2009.

Currency. Legacy CMBS must be U.S. dollar-denominated.

No Floating Rate Legacy CMBS. As with TALF eligible newly issued CMBS, Legacy CMBS must bear interest at a fixed rate or a rate based on the weighted average of the underlying fixed mortgage rates.

> *Note: Like the new-issue CMBS program, the New York Fed has excluded floating rate Legacy CMBS from being eligible TALF collateral. We understand the rationale for that exclusion to be the New York Fed's understanding that floating rate commercial mortgage loans were often used to finance "transitional" or "stabilizing" properties, and their bias against financing loans on such properties. While other new-issue program requirements (such as the requirement for underwriting based on in-place, recurring and stable cash flow) may address the exclusion of transitional properties from new-issue CMBS, the Legacy CMBS program does not contain similar restrictions (since the loans backing Legacy CMBS are not newly originated or underwritten).*

No Interest-Only or Principal-Only CMBS. Legacy CMBS must entitle holders to payments of both principal and interest.

No "Mezzanine" AAA CMBS. Upon issuance, Legacy CMBS must not have been junior to other securities with claims on the same pool of loans.

No Agency-Issued CMBS. Legacy CMBS issued by any agency or instrumentality of the United States or any government-sponsored enterprise (such as Freddie Mac and Fannie Mae) will not be considered eligible CMBS collateral for TALF.

DTC Clearance Required. Legacy CMBS must be cleared through the Depository Trust Company.

Ratings. As of the TALF loan subscription date, Legacy CMBS must have the highest long-term investment-grade ratings (i.e. "AAA") from at least two of DBRS, Inc., Fitch Ratings, Moody's Investors Service, Realpoint LLC and Standard & Poor's. The credit ratings of Legacy CMBS must satisfy the foregoing requirement without giving effect to any third-party guarantee. Further, Legacy CMBS cannot have a rating by any CMBS-eligible rating agency that is below "AAA", is currently subject to review or is currently on watch for downgrade.

> *Note: Although the program requires Legacy CMBS to be rated "AAA" by two TALF CMBS-eligible rating agencies, many Legacy CMBS were originally rated by three or more rating agencies. In such cases, all such ratings must still be in place. If any of the original rating agencies has downgraded, or placed Legacy CMBS on watch for downgrade, then such Legacy CMBS will not be eligible even if it benefits from unqualified current "AAA" ratings from two rating agencies.*

Diversified Pools. Generally, Legacy CMBS must be backed by collateral pools that are diversified in terms of loan size, geography, property type, borrower sponsorship and other typical criteria. Additionally, the New York Fed may reject a CMBS based on factors including, but not limited to: (i) the CMBS does not meet the explicit requirements stated in the terms and conditions, (ii) unacceptable performance of the mortgage loan pool (i.e., high cumulative losses, high percentage of delinquent loans, loans in special servicing or loans on servicer watch lists, or high percentage of subordinate-priority loans), or (iii) unacceptable concentrations (i.e., interests in pools that, alone or considered together with loan pools backing other TALF-financed CMBS, possess one or more concentrations (such as borrower sponsorship, property type or geographic region).

> *Note: The New York Fed has reserved the ability to exclude Legacy CMBS from the program based upon unacceptable property type concentration, geographic concentration or sponsorship concentration, not only in the subject Legacy CMBS transaction, but in the New York Fed's overall portfolio of TALF-eligible CMBS collateral. It is unclear how this element of the program will be administered, but borrowers seeking to pledge CMBS (legacy or new-issue) as collateral for TALF loans may wish to pre-clear such CMBS for TALF eligibility before acquiring it.*

Periodic Reporting. The securitization documents and underlying loan agreements with respect to Legacy CMBS must provide for sufficient reporting to enable the New York Fed to continuously monitor its position as secured lender.

> *Note: The CMBS market has been noted for its robust periodic reporting, with virtually all CMBS transactions adhering to guidelines provided by the Commercial Mortgage Securities Association ("CMSA"). Although the guidelines are not specific on this point, the requirement for reporting that is sufficient to allow the New York Fed to monitor its position as secured lender would seem to be satisfied by continued adherence to CMSA standards of reporting.*

Eligible Mortgage Loans

No Floating Rate Loans. The underlying mortgage loans backing TALF-eligible CMBS must bear interest at a fixed rate. See "No Floating Rate Legacy CMBS" above.

No Future Funding Loans. TALF eligible CMBS must not be backed by any future funding loans.

> *Note: It is not clear whether the inclusion of loans that were future funding loans at the time of securitization, but which have subsequently become fully funded will render otherwise qualifying Legacy CMBS ineligible for TALF. However, the inclusion of future funding loans in CMBS transactions that would otherwise be TALF eligible was relatively rare.*

No Re-REMICS. Underlying assets backing TALF-eligible CMBS cannot include other CMBS or other securities.

> *Note: In the RMBS market, re-REMIC techniques have been used to re-tranche existing transactions that were the subject of ratings downgrades, to re-establish "AAA" ratings for portions of such transactions. The exclusion of re-REMIC transactions from TALF eligibility would not permit re-tranching of down-graded CMBS to achieve TALF eligibility.*

No Swaps, Caps, or Other Derivatives. Underlying assets of TALF-eligible CMBS cannot include interest rate swap or cap instruments or other hedging instruments.

> *Note: It is unclear whether the inclusion of interest rate swaps in Legacy CMBS transactions to achieve a floating rate coupon for a particular class or classes would render the entire CMBS transaction ineligible for TALF. Although that result would be illogical assuming the transaction otherwise meets all TALF requirements, the program criteria literally exclude CMBS transactions that contain any derivatives contracts.*

Senior or *Pari Passu* Participations Allowed. Participations or other partial ownership interests in mortgage loans will be permitted, as long as such partial ownership interests are senior to, or pari passu with, all other interests in the same loans with respect to principal and interest payments following any loan default.

Eligible Commercial Real Estate Collateral

Collateral for Mortgage Loans. The collateral for each mortgage loan underlying TALF-eligible CMBS must be fee or leasehold interests in one or more income-generating commercial properties.

> *Note: If payments due under the mortgage loan have been defeased, the security for the loan or its predecessor must have previously included property complying with the above requirements.*

Primarily U.S. Properties. As of the TALF loan subscription date, at least 95% of the properties securing underlying mortgage loans, by related loan principal balance, must be located in the U.S. or a U.S. territory.

Terms of TALF Financing

Volume Limitation. The New York Fed is currently considering whether to limit the volume of TALF loans secured by Legacy CMBS and, if so, whether to allocate that volume via an auction or other procedure.

> *Note: The form any auction would take is unknown, however, the New York Fed utilizes a Dutch auction format in selling U.S. Treasury Bills. A Dutch auction format for TALF loans might require prospective borrowers to bid on the interest rate they are willing to pay for a particular principal amount of TALF loans, with the prospective borrowers who are willing to pay the highest margin over the corresponding LIBOR swap rate winning the auction. This format would be inconsistent, however, with the published interest rates in the release (described below).*

Terms and Interest Rate. Each CMBS TALF loan will have either a three-year maturity or five-year maturity, at the election of the borrower, and will bear interest at a fixed rate *per annum* according to the loan term:

Loan Term	Interest Rate
3 years	100 basis points over 3-year LIBOR swap rate
5 years	100 basis points over 5-year LIBOR swap rate

Haircut. The "haircut" applicable to each TALF loan will be determined based on the average life of the Legacy CMBS collateral. For Legacy CMBS with an average life of five years or less, the collateral "haircut" with respect to the corresponding TALF loan will be 15%. For Legacy CMBS with an average life in excess of five years, the collateral "haircut" will increase by 1% for each year of average life beyond five years. The average life of CMBS will be calculated as the remainder of the original weighted average life determined by the issuer of the Legacy CMBS, with certain adjustments by the New York Fed, which may include adjustments for default-related circumstances. Details of any required adjustments will be announced by the New York Fed in future publications.

TALF Loan Amount for Legacy CMBS Purchased at a Discount. For Legacy CMBS having a market value below par, the "haircut" will be applied to the market value rather than to the par value of the Legacy CMBS. The size of each TALF loan in relation to its Legacy CMBS collateral will be the dollar purchase price of the Legacy CMBS less the "base dollar haircut", or the amount of haircut that would be applicable to the Legacy CMBS assuming it was valued at par. For example, if a CMBS with a par value of $100 had a base dollar haircut of 17%, then if the dollar purchase price (i.e., market price) is 75% of par, the maximum TALF loan amount is $58 (i.e., $75 minus $17). Similarly, if the dollar purchase price (i.e., market price) is 50% of par, the maximum TALF loan amount is $33 (i.e., $50 minus $17). In the first example, the effective "haircut" (which is used to allocate principal payments, as described below), is 23% (i.e., 17 divided by 75). In the second example, the effective "haircut" is 34% (i.e., 17 divided by 50).

> *Note: As illustrated by the above example, as the dollar purchase price for a Legacy CMBS decreases, the effective haircut of the related TALF loan increases. In the release, the New York Fed indicates that the increased haircut for more discounted collateral is based on its belief that the larger the discount from par, the greater the credit concern. However, this does not take into account other factors that may affect bond pricing, such as varying interest rates payable by different Legacy CMBS, which may, independent of any credit concerns, cause a particular Legacy CMBS to trade at a greater or lesser discount.*

Allocation of CMBS Principal Amortization; Use of CMBS Cash Flow to "Turbo" TALF Principal. Any principal payments received by the TALF borrower on Legacy CMBS collateral will be allocated to reduce the principal amount of the TALF loan in proportion to the "haircut" of the TALF loan. So, if a Legacy CMBS TALF Loan has an effective haircut of 23% (as described in the example above, where the TALF Loan was in the amount of $58 on a $100 par Legacy CMBS), then 77% of any principal received on the underlying Legacy CMBS will be applied to reduce the principal balance of the TALF Loan.

Note: Although this 77% principal allocation is proportional to the effective haircut of the TALF Loan, it results in a dis-proportional allocation of principal to the repayment of the TALF Loan, since the TALF Loan balance represents only 58% of the principal balance of the underlying collateral. This principal allocation methodology will result in a "turbo-ing" or "hyper-amortization" of the TALF loan principal balance, since performing CMBS will amortize their full par value even if they are purchased at a discount.

In addition, for any Legacy CMBS TALF loan, there is an additional "turbo" or "hyper-amortization" feature. For five-year TALF loans, the TALF borrower will only be entitled to receive CMBS interest distributions in excess of the TALF loan interest payable in any TALF loan year up to an amount that equates to an implied 25% interest rate on the effective "haircut" amount. The remainder of such excess will be applied to amortize the principal balance of the TALF loan. The permitted implied 25% interest rate applies during the first three years of the term of a 5-year TALF loan, and will be reduced to 10% in year four and again to 5% in year five, which will have the effect of accelerating the "turbo" of TALF loan amortization. For any three-year TALF loan related to Legacy CMBS, the "turbo" feature requires the TALF borrower to apply any interest distributions in excess of an implied 30% interest rate to amortize the principal balance of the TALF loan.

Note: There are two differences in the manner in which these caps on current interest distributions apply to Legacy CMBS vs. new-issue CMBS. First, the Legacy CMBS program imposes a 30% cap on current interest distributions even for three-year TALF loans, whereas the new-issue program does not apply any cap for three-year loans. Second, the effective "haircut" to which the percentage caps are applied is different for Legacy CMBS having market prices below par as opposed to new-issue CMBS which may be expected to be issued at par. For Legacy CMBS, the haircut percentage of a TALF loan is likely to be less than its overcollateralization percentage (i.e., the excess of the par value of pledged Legacy CMBS over the amount of the TALF loan). In the example discussed above, the haircut on the $100 Legacy CMBS is $23, while the overcollateralization amount is $42 ($100 minus the $58 TALF Loan). The caps on current interest distributions are calculated on a notional balance equal to the applicable haircut rather than the overcollateralization percentage. Since performing CMBS pay interest on their full principal balances (rather than on their discounted purchase prices), this methodology should leave more excess interest to be applied to hyperamortize principal of the TALF Loan than would be the case with new-issue CMBS. This increased "turbo-ing" from excess interest, together with the turbo-ing achieved by the disproportional allocation of principal noted above, should provide the New York Fed with more assurance that TALF loans secured by Legacy CMBS will amortize faster (proportionally to their collateral) *than other TALF loans, increasing the borrower's "skin in the game" at the maturity of the TALF loan, and reducing the likelihood of a voluntary surrender of the collateral.*

Collateral Monitor. The New York Fed will engage a collateral monitor to evaluate Legacy CMBS that is proposed as TALF collateral. The New York Fed will have the right to reject any Legacy CMBS as TALF loan collateral based on its assessment of risk. In assessing risk, the New York Fed has indicated it will focus particular attention on any CMBS mortgage pools with large historical losses, concentrations of mortgage loans that are delinquent, in special servicing or on servicer watch lists or concentrations of subordinate priority mortgage loans, and CMBS mortgage pools that are not diversified with respect to loan size, geography, property type, borrower sponsorship and other characteristics. See "Diversified Pools" above.

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

> *Note: As with newly issued CMBS, Legacy CMBS will be AAA-rated CMBS, and as a result would not have voting control over CMBS servicing or other normal functions of transactions. The vote of AAA CMBS bondholders would generally be required only for less common actions, such as amendments to transaction documents.*

Price Validation. The New York Fed is in the process of establishing additional requirements that will be applicable to Legacy CMBS. These requirements may include the requirement that Legacy CMBS be used to fund recent secondary market transactions between unaffiliated parties that are executed on an arm's length basis. In addition, the New York Fed is considering instituting a process for price validation of such secondary market transactions.

Questions and Comments

The New York Fed has not instituted a formal process for the public to submit comments and questions with respect to this recent change to TALF. However, the New York Fed directs general questions regarding TALF to the New York Fed's Public Affairs department: 212-720-6130 or via email to TALF@ny.frb.org.

Additional Resources

CWT Financial Recovery Resource Center

Federal Reserve Press Release (Legacy CMBS), May 19, 2009

TALF (Legacy CMBS) Terms and Conditions, May 19, 2009

Frequently Asked Questions (Legacy CMBS), May 19, 2009

Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

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